# Financial Accounting

## DMGT104

LOVELY PROFESSIONAL UNIVERSITY

# FINANCIAL ACCOUNTING

Produced & Printed by
**EXCEL BOOKS PRIVATE LIMITED**
A-45, Naraina, Phase-I,
New Delhi-110028
for
Lovely Professional University
Phagwara

# SYLLABUS

## Financial Accounting

***Objectives:*** To develop conceptual knowledge about the preparation and use of financial statements.

| S. No. | Description |
|---|---|
| 1. | ***Introduction to Accounting:*** Book-Keeping & its importance, Accounting- Meaning, Importance, Difference between Book Keeping and Accounting, Accrual Basis and Cash basis of Accounting. |
| 2. | ***Generally Accepted Accounting Principles:*** Accounting Concepts and Conventions, Accounting terminology. |
| 3. | Accounting Standards and Accounting Policies, Accounting Standard-1. Accounting Equation, Accounting Cycle. |
| 4. | Preparation of Journal, Ledger and Balancing. |
| 5. | ***Subsidiary Books:*** Cash Book and other subsidiary books. Trial Balance: Different types of errors disclosed and not disclosed by Trial Balance. |
| 6. | ***Financial Statements:*** Capital & Revenue Expenditure and Receipts, Accounting Standard-9, Profit & Loss Account (with adjustments) & Balance Sheet. |
| 7. | Depreciation, Provisions and Reserves, Accounting Standard-6. |
| 8. | Bank Reconciliation Statement. |
| 9. | ***Corporate Financial Statements:*** Nature, types, uses and limitations. |
| 10. | Role of Computers in Accounting including introduction to Tally. |

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# Unit 1: Introduction to Accounting

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## Objectives

After studying this unit, you will be able to:

- Understand needs and objectives of accounting
- Know branches of accounting
- Know users and difference between book-keeping and accounting
- Describe meaning, importance and rules of double entry system

## Introduction

Accounting is a business language which elucidates the various kinds of transactions during the given period of time.

Accounting is broadly classified into three different functions *viz.*

- Recording
- Classifying and
- Summarizing

American Institute of Certified Public Accountants Association defines the term accounting as follows "Accounting is the process of recording, classifying, summarizing in a significant manner of transactions which are in financial character and finally results are interpreted."

The main object of a business house is to earn profit. Accounting is the medium of recording the business activities and it considered as a language of business. To find out the results of a business, the information relating to the cost of the products and revenues from the products is collected. Then the costs and revenues are compared to find out the profit or loss of the business. If volume of sales of the products is high and the number of transaction of the business is very high, it is impossible to keep all these transactions in the mind of a business man. Thus a need of recording of all these business transactions rose. The recording of business transactions or activities is done through a process of accounting. There is an old quotation of a well known author of accounting Prof. R.R. Gupta, First write or record before one deliver the goods or renders the services and if there is any disagreement in future, use the writing or record as an evidence to resolve the misunderstanding or rectifying the errors.

Today the business activities are recorded not only to find out the profit or loss of the business, but are also to judge the financial position of the business. Accounts of the business are prepared from the point of view of owner and also serve the purpose of outsiders. Creditors and investors want to know how safe their investment is—Labours in conducting the negotiations for wages and government to determine the economic policies etc. Thus accounts of a business are the evidence on the basis of which the financial decisions are taken.

*Caution* Accounting is not an equivalent function to book keeping. Accounting is broader in scope than the book keeping; the earlier cannot be equated to the latter.

## 1.1 Meaning and Definition of Accounting

Accounting is treated as the language of business. It records all the transactions which can be measured in money and have occurred in a particular period. Accounts of a business provide useful information to its users.

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There are many definitions of accounting. Some of the most important definitions are given below:

1. As per Robert N. Anthony – "Accounting system is a means of collecting, summarizing, analyzing and reporting, in monetary terms, information about the business".
2. The American Accounting Association (AAA) has defined accounting as, "the process of identifying, measuring and communicating economic information to permit informal judgments and decisions by users of information".
3. The Committee on Terminology of American Institute of Certified Public Accountants gave a generally accepted definition of accounting – "Accounting is the art of recording, classifying and summarizing in a significant manner and in terms of money transactions and events which are, in part at least, of a financial character, and interpreting the results thereof."

On the basis of above definitions we conclude that accounting is a science as well as an art of recording of activities of the business which can be measured in money and analyzing and interpreting them.

## 1.1.1 Characteristics of Accounting

On the basis of above definitions, the characteristics of accounting may be drawn as follows:

1. ***Accounting is the art of recording of financial transactions of the business:*** All those transactions of business which are financial in nature are recorded in accounting and those which are not of financial nature are not recorded in accounting. As the honesty of the workers cannot be measured in money, it cannot be recorded into accounting.
2. ***Classifying and summarising of recorded data is done in accounting:*** In accounting the financial transactions are recorded in the journal. With the help of journal, the recorded data are classified into ledger under appropriate heads. Then with the help of ledger the trial balance and financial statements are prepared.
3. ***Data are recorded in terms of money:*** In accounting, the financial data are recorded in a definite term i.e. money. No other unit is accepted to record the business transaction. If there is sale of 100 articles at the rate of ₹ 50 per article, only the monetary value of these articles i.e. ₹ 5,000 (100 x ₹ 50) is recorded.
4. ***Accounting is a science also:*** On account of recording of business transactions in a systematic manner, it is also called a science. First the business transactions are recorded in the primary books i.e. journal, for classification the ledger is prepared. With the help of ledger the trail balance, profit and loss account and balance sheet is prepared. Profit and loss account is prepared after a period to find the result of the business and balance sheet to know the financial position of the business.
5. ***Analysing and interpretation of the results is done in accounting:*** It not only record classifies and summaries the business data but also analyse and interprets the results for the future decisions. On the basis of data forecasting regarding profit, sales, etc., may be done.

## 1.1.2 Objectives of Accounting

The main purpose of book-keeping and accounting is to furnish the necessary financial data to the persons interested in the business. These persons can be the internal users of the business and external users of the business. Among the internal users all the managers at lower, middle and top level are included. While among the external users, investors, creditors, government and

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public are included. The financial statements are supplied to the external users for the necessary information. In brief, following are the objectives of accounting:

1. ***To maintain the systematic records of the business:*** The primary objective of the accounting is to maintain the records of all transactions of the business. As the memory of human being is very limited and short, it would be very difficult to remember all the transactions especially if there is a huge amount of transaction. So it is very necessary to record all business transactions properly to determine the amount of profit or loss and the financial position of the business on a particular date.
2. ***To ascertain the profit or loss of the business:*** The main objective of the business is to earn a profit. Exact profit can be ascertained with the help of financial accounting which helps to determine the net profit or loss of the business over a period. For the determination of the amount of profit or loss, a trading and profit and loss account is prepared at the end of a period. If there is excess of revenue for a period over the expenses incurred to earn that revenue, it is said to be a profit. And if there is excess of expenses over the revenue, it is said to be a loss. In the case of profit the management can take the decisions relating to selling price and output etc. In the case of loss, the causes of such a loss are investigated and remedial action is taken by the management.
3. ***To present the financial position of the business:*** The objective of the accounting is not only recording of the financial transactions of the business and determination of profit or loss but also to present the financial position of the business. To present the financial position, financial accounting helps in the preparation of balance sheet. Balance sheet is the statement of assets and liabilities of the business. It also gives the information about the borrowed capital as well as owned capital along with different assets such as fixed assets, current assets and miscellaneous. Balance sheet is the reflector of the financial position of a business (solvency and insolvency).
4. ***To provide the financial information to the various users:*** One more objective of the accounting is to provide the required financial information to the different users - internal as well as external users. Internal users of the financial statements are owners, shareholders, management and external users of the financial statements are debenture holders, creditors, investors, employees, government, etc.
5. ***For Decision Making:*** These days accounting has taken upon itself the task of collection, analysis and reporting of information at the required points of time to the required levels of authority in order to facilitate rational decision-making.

### 1.1.3 Need of Financial Accounting

A well known author of Accounting, [Prof. R.R. Gupta, Principal, Poddar College, Nawalgarh (Rajasthan)] wrote in …..”First write/record before one delivers goods or renders the services and if there is any disagreement in future, use the writing or record as an evidence to resolve the misunderstanding or rectifying the error.”

Recording of business transactions is necessary from owners’ point of view and other interested party as well. The persons included in the second category are the suppliers of the materials, products and services to the business, the government and the society at large. The creditors (suppliers who are willing to take their payment later) are interested to know whether the business will be able to pay them later (solvency of the business) whereas the government wants to know whether the business has paid whatever was due to them in terms of taxes, fees, etc.

*Did u know?* **What are the purposes of preparing financial statements?**

1. Accounting provides necessary information for decisions to be taken initially and it facilitates the enterprise to pave way for the implementation of actions.

2. It exhibits the financial track path and the position of the organization.
3. Being business in the dynamic environment, it is required to face the ever changing environment. In order to meet the needs of the ever changing environment, the policies are to be formulated for the smooth conduct of the business.
4. It equips the management to discharge the obligations at every moment.
5. Obligations to customers, investors, employees, to renovate/restructure and so on.

## 1.1.4 Scope of Accounting

The Scope of accounting is divided into following two parts:

1. Branches of Accounting
2. Accounting as a science or an art

### Branches of Accounting

The main objectives of accounting are to record the business transactions and to provide the necessary information to the internal and external users of the financial statements. In order to achieve the above objectives, the accounting is classified into followings branches:

1. ***Financial Accounting:*** It is the original form of accounting. It refers to the recording of daily business financial transaction. Recording of the transaction is done in such a way that the profit of the business may be ascertained after a definite period and the picture of the financial position of the business may be presented.
2. ***Cost Accounting:*** As the name indicates, this accounting is related with the ascertainment of cost of the product in a period. Under this system, record of raw materials used in production, wages and labour paid and other expenses incurred on production are kept to control the costs.
3. ***Management Accounting:*** The accounting which provides the necessary information to the management is called management accounting. Under this, the analysis and interpretation of the accounts, prepared by financial accounting, are done in a manner so that the managers may forecast, plan for future and frame the policy.
4. ***Tax Accounting:*** Under tax accounting, the accountants prepare the accounts as per the provisions of taxation. The accounts prepared as per taxation provisions may differ from the accounts prepared as per financial accounting.
5. ***Inflation Accounting:*** The financial statements are prepared on the basis of historical cost which do not present the true picture of the financial position and correct profit or loss of the business due to inflation. Thus the fresh financial statements are prepared keeping in mind the price level changes under inflation accounting.
6. ***Human Resource Accounting:*** Human Resource Accounting means the accounting for human being as now in an organization human being is treated as an asset like other physical assets. It is recorded in the books like other assets. HRA deals with the measurement of costs on recruiting, selecting, hiring, training, placing and development of the employees in one side and on the other side it deals with the present economic value of the employees. For the determination of the value of human being different methods are used under HRA.
7. ***Responsibility Accounting:*** Responsibility accounting is a special technique of management under which accountability is established according to the responsibility delegated to the

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various levels of management. Management information and reporting system is instituted to give adequate feedback in terms of the delegated responsibility. Under this system, units of an organization, under a specified authority in a person, are developed as responsibility center and evaluated individually for their performance.

**Accounting as Science or an Art**

Accounting is both the science and art. Study of science is based on some principles and it is systemized. It is a science because the business transactions are recorded on the basis of some principles and journal of transaction, ledger posting, trial balance and preparation of final statements are done in a sequence. Art is the creation of practical applications and rules for the completion of any work. On the basis of it, accounting is an art as we do not only study principles of accounting but also we learn to apply these principles in practice to record the business transaction. Thus accounting is both science and art.

### 1.1.5 Users of Accounting Information

There are two types of persons interested in financial statements: (1) Internal users, and (2) External users.

1. ***Internal Users:*** These are: (a) Shareholders, (b) Management, and (c) Trade unions employees, etc.
   (a) *Shareholders* are interested to know the welfare of the business. They can know the operational results through such financial statements and the financial position of the business.
   (b) *Management* is interested to take important decisions relating to fixing up the selling prices and making future policies.
   (c) *Trade unions and employees* are interested to know the operational results because their bonus etc. is dependent on the profit earned by the business. Financial statements also help in their negotiations for wages/salaries.
2. ***External Users:*** The following are most important external users of financial statements:
   (a) *Investors:* They are interested to know the earning capacity of business which can be known through financial statements. They can also know the financial soundness of the business through financial statements.
   (b) *Creditors, Lenders of Money etc.:* The creditors and lenders of money etc. can also know the financial soundness through financial statement. They have to see two things (i) Regularity of income and (ii) solvency of the business so that their investment is risk free.
   (c) *Government:* Government is interested to formulate laws to regulate business activities and also law relating to taxation etc. Financial statements help while computing National Income statistics etc.
   (d) *Taxation authorities:* Financial statements provide information relating to operational results as well as financial position of the business. Tax authorities decide the amount of tax as per financial statement. It is very useful to other taxation authorities such as sales tax etc.
   (e) *Stock Exchanges* are meant for dealing in share/securities. Purchase and sale of such shares and securities are possible through stock exchanges which provide financial information about each company which is listed with them.

(f) *Consumer:* Consumer is interested in information on the continued existence of the business and thus probability of the continued supply of the products, parts and after sale services. They ensure continuous existence of a business, especially in case of durable products which require after sales service and spare parts.

## 1.1.6 Importance and Advantages of Accounting

Appropriate and adequate accounting system plays a vital role for the successful operation of the business. It also helps in the determination of cost of production, controlling internal as well as external activities of the business, forecasting of profit, cost and sales, etc. Accounting is also useful in locating the errors, distribution of dividend and bonus to shareholders. Thus, accounting is being used as a means to achieve the objective of the business. The other advantages of the accounting are as follows:

1. ***Replacement of human memory:*** As the human's memory is limited and short, it is difficult to remember all the transactions of the business. Therefore, all the financial transactions of the business are recorded in the books. By this way the businessmen cannot only see the records at the required time but can also remember them for a long time. Thus, recording of the transactions is the replacement of human's memory.
2. ***Helpful in the determination of financial results and presentation of financial position:*** Accounting is very useful in the determination of the profit and loss of a business and showing the financial position of the business.
3. ***Helpful in assessing the tax liability:*** Generally, a businessman has to pay corporate tax, VAT and excise duty, etc. Therefore, it is necessary that proper accounts should be maintained to compute the tax liability of the business.
4. ***Helpful in the case of insolvency:*** Sometimes the businessman becomes the insolvent. If he has properly maintained the accounts, he will not face the problems in explaining few things in the court.
5. ***Helpful in the valuation of business:*** If the business is shut down and sold, accounting helps the businessman to determine the value of business. It would be possible only in that case when the accounts of the business are properly maintained.
6. ***Helpful in the valuation of goodwill and shares:*** If accounts of the business are properly maintained, it would be quite convenient to determine the value of goodwill. Goodwill is very important for the determination of the value of shares of the company.
7. ***Accounting makes comparative statement possible:*** Proper and adequate accounting helps in comparing the income, expenditure, purchase, sale of the current year with that of the previous years. And then future plans, policies and forecasting may be possible.
8. ***Raising of funds become easy:*** It helps in raising funds from investors or financial institutions by promising investors a fixed claim (interest payments) on the cash flows generated by the assets, with a limited or no role in the day-to-day running of the business.

## 1.1.7 Limitation of Accounting

In spite of being so many uses and advantages of accounting, it has a number of limitations which are as follows:

1. ***Recording of monetary items only:*** In accounting only those transactions, which have the monetary value, are recorded. And those transactions which do not have the financial value whether those are important in business, are not recorded in the accounting. For example, efficiency of the management, honesty of the workers, etc.

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2. ***Effect of inflation:*** In accounting the transactions are recorded at the historical cost. Accordingly the assets of the business are shown at cost in the balance sheet. Thus the balance sheet prepared on the basis of historical cost ignores the price-level changes (inflation). In this way the balance sheet of the business does not present the true and fair picture of the business.
3. ***Conflict between accounting principles:*** In accounting, one accounting principle conflicts another. For instance, inventory should be valued on the basis of 'least of the cost and market price' as per the principle of the conservatism. If in the first year, inventory is valued on the basis of cost (being lower than market price) and in the second year at the market price (being lower than cost), this principle conflicts the accounting principle of the consistency.
4. ***Financial statements are affected by personal judgment of the accountants:*** Personal decisions of the accountants regarding the adoption of accounting policies, affects the results of the financial statements. As a result the financial statements lose their objectivity.
5. ***Financial statements do not reflect the right picture of the business:*** Sometimes the profit and loss account of the business does not show the accurate profit/loss and the balance sheet does not show the true picture of the business because the assets shown in the balance sheet are shown at the realizable (resalable) value which is wrong. Some worthless figures are also shown in the balance sheet as preliminary expenses, discount on issue of shares/debentures, etc.

### Self Assessment

Fill in the blanks:

1. ...................... is the process of recording, classifying, summarizing in a significant manner of transactions which are in financial character and finally results are interpreted.
2. The users of accounting are ...................... and external.
3. Accounting records all the transactions which can be expressed either in .......................
4. The creditors are interested to know the ................... of the business.
5. The primary objective of the accounting is to maintain the records of all ...................... of the business.

## 1.2 Process of Accounting

Accounting is described as origin for the creation of information and the continuous utility of information. Now the question is how is this information created? For this, there is a step by step process, as shown in Figure 1.1.

After the creation of information, the developed information should be appropriately recorded.

Are there any scales/guides available for the recording of information? If yes, what are they?

They are as follows:

1. ***What to record:*** Financial Transaction is only to be recorded
2. ***When to record:*** Time relevance of the transaction at the moment of recording
3. ***How to record:*** Methodology of recording—It contains two different systems of accounting *viz.* cash system and accrual system.

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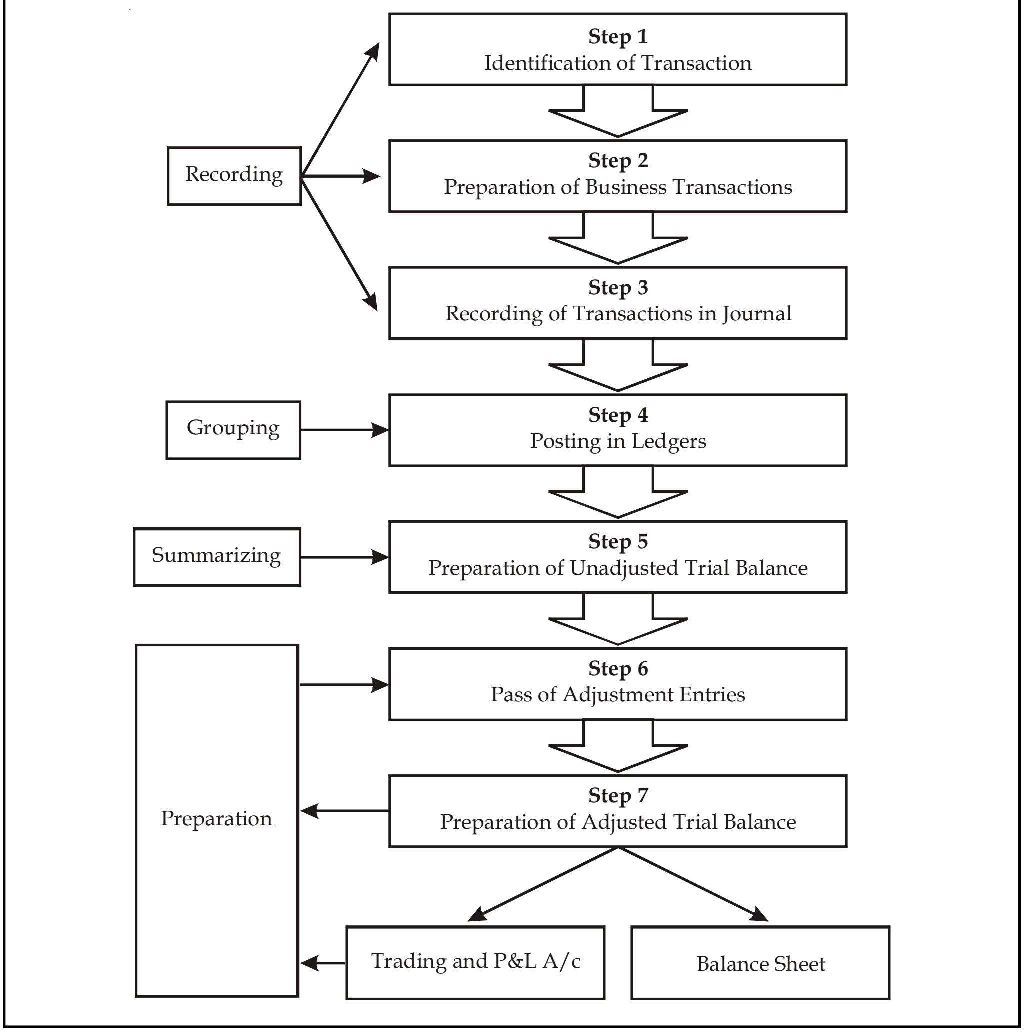
Figure 1.1: Process of Accounting




### 1.2.1 Cash System

The revenues are recognized only at the moment of realization but the expenses are recognized at the moment of payment. For example, sale of goods will be considered under this method that only at the moment of receipt of cash out of sale of goods. The charges which were paid only will be taken into consideration but the outstanding, not yet paid will not be considered.

*Example:* Rent paid only will be considered but not the outstanding of rent charges.

### 1.2.2 Accrual System

The revenues are recognized only at the time of occurrence and expenses are recognized only at the moment of incurring. Whether the cash is received or not out of the sales, that will be registered/counted as total value of the sales.

The next most important step is to record the transactions. For recording, the value of the transaction is inevitable, to record values; the classification of values must be essentially done.

**Notes**

### 1.2.3 Values

There are four different values in the business practices that should be followed or recorded in the system of accounting:

1. ***Original Value:*** It is the value of the asset only at the moment of purchase or acquisition.
2. ***Book Value:*** It is the value of the asset maintained in the books of the account. The book value of the asset could be computed as follows:

   Book Value = Gross (Original) value of the asset – Accumulated depreciation
3. ***Realizable Value:*** Value at which the assets are realized.
4. ***Present Value:*** Market value of the asset.

*Did u know?* **What are the purposes of preparing financial statements?**

1. Accounting provides necessary information for decisions to be taken initially and it facilitates the enterprise to pave way for the implementation of actions.
2. It exhibits the financial track path and the position of the organization.
3. Being business in the dynamic environment, it is required to face the ever changing environment. In order to meet the needs of the ever changing environment, the policies are to be formulated for the smooth conduct of the business.
4. It equips the management to discharge the obligations at every moment.
5. Obligations to customers, investors, employees, to renovate/restructure and so on.

### Self Assessment

Fill in the blanks:

6. The …………………… are recognized only at the moment of realization but the …………………… are recognized at the moment of payment.
7. For ……………………, the value of the transaction is inevitable, to record values; the classification of values must be essentially done.
8. …………………… the value of the asset only at the moment of purchase or acquisition.

## 1.3 Book-keeping

Book-keeping includes recording of journal, posting in ledgers and balancing of accounts. All the records before the preparation of trail balance are the whole subject matter of book-keeping. Thus, book-keeping many is defined as the science and art of recording transactions in money or money's worth so accurately and systematically, in a certain set of books, regularly that the true state of businessman's affairs can be correctly ascertained. Here it is important to note that only those transactions related to business are recorded which can be expressed in terms of money.

### 1.3.1 Definition

"Book-keeping is the art of recording business transactions in a systematic manner".

**— A.H. Rosenkamph.**

"Book-keeping is the science and art of correctly recording in books of account all those business transactions that result in the transfer of money or money's worth".

**—R.N. Carter**

"Book-keeping is the recording of financial transactions in a methodological manner so that, information of any point may be quickly obtained".

**—D.J. Favell**

## 1.3.2 Importance of Book-keeping

1. Book-keeping provides a permanent record of each transaction. It provides combined effect of all transaction on financial position.
2. Soundness of a firm can be accessed from the records of assets and abilities on a particular date.
3. Entries related to incomes and expenditures of a concern facilitate to know the profit and loss for a given period.
4. It enables to prepare a list of customers and suppliers to ascertain the amount to be received or paid.
5. It is a method gives opportunities to review the business policies in the light of the past records.
6. Amendment of business laws, provision of licenses, assessment of taxes etc., are based on records.

## 1.3.3 Difference between Book-keeping and Accounting

The following table explains the key differences between book-keeping and accounting:

**Table 1.1: Difference between Book-keeping and Accounting**

| Basic of difference | Book-keeping | Accounting |
|---|---|---|
| Transactions | Recording of transactions in books of original entry. | To examine these recorded transactions in order to find out their accuracy. |
| Posting | To make posting in ledger | To examine this posting in order to ascertain its accuracy. |
| Total and Balance | To make total of the amount in journal and accounts of ledger. To ascertain balance in all the accounts. | To prepare trail balance with the help of balances of ledger accounts. |
| Income Statement and Balance Sheet | Preparation of trading, Profit & loss account and balance sheet is not book-keeping | Preparation of trading, profits and loss account and balance sheet is included in it. |
| Rectification of errors | These are not included in book-keeping | These are included in accounting. |
| Special skill and knowledge | It does not require any special skill and knowledge as in advanced countries this work is done by machines. | It requires special skill and knowledge. |
| Liability | A book-keeper is not liable for accountancy work | An accountant is liable for the work of book-keeper. |

Notes

## Self Assessment

Fill in the blanks:

9. …………………… includes recording of journal, posting in ledgers and balancing of accounts.
10. Book-keeping provides a permanent record of each …………………… .

## 1.4 Methods of Accounting

Business transactions are recorded in two different ways.

### 1.4.1 Single Entry

It is incomplete system of recording business transactions. The business organization maintains only cash book and personal accounts of debtors and creditors. So the complete recording of transactions cannot be made and trail balance cannot be prepared.

### 1.4.2 Double Entry

It this system every business transaction is having a twofold effect of benefits giving and benefit receiving aspects. The recording is made on the basis of both these aspects. Double Entry is an accounting system that records the effects of transactions and other events in at least two accounts with equal debits and credits.

The modern system of book keeping is based on the double entry system. Therefore, we are discussing this system only. The father of this system is the Lucas Pacioli. He gave the details of this system in his book "*De Compute Set Scripturise*" in Italy in 1494 A.D. As per this system every transaction of the business has double aspects/double effect. Therefore, every transaction must be recorded at two places or accounts. If in a transaction someone is a giver, some other will be a receiver.

*Did u know?* This system of accounting is also called Mercantile System or Western System of Accounting.

This system is so organized, accurate, complete and scientific that it is now adopted universally. In the words of Keller, M.J. Keller in – *Intermediate Accountancy*, "The most common system of accounting data for an enterprise is the double entry system. As the name implies, the entry made for each transaction is composed of two parts, a 'debit' and a 'credit'.

#### Importance of Double Entry System

As we know that double entry system of accounting is a systematic and scientific system of accounting, so it offers a number of advantages. The following are the most important advantages of the system:

1. ***Complete record of transactions:*** Under this system, recording of all transactions is done whether related to personal or impersonal accounts.
2. ***Ascertainment of profit or loss:*** Under this system of accounting complete profit and loss account can be prepared by which profit or loss of a particular period can be ascertained.
3. ***Mathematical check on accuracy:*** Every debit has a credit, so it is an accurate system as far as mathematical accuracy is concerned which may be proved by preparing trial balance.

4. ***Check for fraud:*** Scope of fraud is limited as it minimizes the chances of fraud because of scientific system.

5. ***Ascertainment and knowledge of financial position of the business:*** Under this system, it is possible to know the financial position of the business at any time. For this purpose Balance Sheet can be prepared any time.

6. ***Possibility of full control over business:*** Under this system full information is available which enables the management to exercise full control over the business.

7. ***Easy accessibility of information:*** Under this system all information is easily available and accessible which is very helpful and useful for the management.

8. ***Possibility of comparative study:*** Under this system, it is possible to prepare comparative statement and also compare the previous year's results with the current year's result and take corrective steps as and when necessary to improve the operational results.

9. ***Reliable information:*** Under this system information received is reliable.

### Steps involved in Double Entry System

1. ***Preparation of Journal:*** Journal is called the book of original entry. It records the effect of all transactions for the first time. Here the job of recording takes place.

2. ***Preparation of Ledger:*** Ledger is the collection of all accounts used by a business. Here the grouping of accounts is performed. Journal is posted to ledger.

3. ***Trial Balance preparation summarizing:*** It is a summary of ledge balances prepared in the form of a list.

4. ***Preparation of Final Account:*** At the end of the accounting period to know the achievements of the organization and its financial state of affairs, the final accounts are prepared.

### Rules of Double Entry System

As per the principles of the double entry system, each transaction of the business is recorded at two places. In other words, two entries are made for every financial transaction of the business. If someone is giving something in the business, it has two sides – one is giver and other is receiver. The system of double entry can be understood easily by an equation which is called accounting. Following are some transactions of the business to explain it.

***For example***

1. Mr. Kamlesh started business with cash of ₹ 2,00,000.

   In this transaction, one side cash is coming into business and in the other side capital is being brought by Mr. Kamlesh. Thus:

   Capital = Assets (Cash)

   ₹ 2,00,000 = ₹ 2,00,000

2. In the next transaction, if a plant of ₹ 50,000 is purchased in cash, this transaction will also leave two sides. In one side cash is going and in other side plant is coming. In this situation, the accounting equation will be as follows:

   Capital = Plant + Cash (Assets)

   ₹ 2,00,000 = ₹ 50,000 + (₹ 2,00,000 – 50,000)

**Notes**

3. If a loan of ₹ 1,50,000 are taken from the SBI, it will also affect the accounting equation by two sides. On one side, cash will increase and on the other side, liabilities of the business will increase. This may be depicted as follows:

   Capital + Liability (Loan) = Plant + Cash

   ₹ 2,00,000 + 1,50,000 = ₹ 50,000 + (1,50,000 + 1,50,000)

   ₹ 3,50,000 = ₹ 3,50,000

4. If some goods of ₹ 20,000 are purchased on credit, it will also affect the accounting equation in two ways. On one side it increases the goods and on the other side it increases the liability (creditors). Now the changed form of the above accounting equation will be as follows:

   Capital + Loan + Creditors = Plant + Cash + Goods

   ₹ 2,00,000 + 1,50,000 + 20,000 = ₹ 50,000 + 3,00,000 + 20,000

   ₹ 3,70,000 = ₹ 3,70,000

   Capital + Liabilities = Assets

*Notes* By observing the effect of above transactions on the accounting equation, we note that total of assets always remain equal to the total of capital and liabilities. Thus, the principle of double entry system may be summarized as for every debit side there is an equivalent credit side and *vice versa*.

*Task* What will be the impact of following transactions on balance sheet?

1. R started business with cash of ₹ 500000
2. Machinery purchased for ₹ 100,000.
3. Payment made to creditors of ₹ 20000
4. Goods sold for ₹ 15000

*Caselet*

## ICAI told to Hasten Process for Double-entry Accounting System

"There is a need to set up a separate committee for converting the single entry accounting system to double entry. The process is rather slow. It should be hastened," Mr K. Rahman Khan, Honorary Deputy Chairman, Rajya Sabha, and member of the Institute of Chartered Accountants of India (ICAI), said.

While stating that the accounting system has already been converted to double entry in local bodies, Mr Khan added that the institute should play a vital role in monitoring governmental expenditure.

"A chartered accountant's responsibility should not be limited to his clients alone. He owes it to the society. The institute and the custodian of government expenditure – Comptroller

*Contd...*

Notes

and Auditor General of India have already resolved to effect the conversion. Various governments across the globe now follow the double entry accounting system. We need to switch to double entry quickly," he added.

He clarified his statement by stating: "I am not saying that the Government accounts are not perfect. We need to ensure better transparency. The double entry accounting system would help measure cost escalation, go into the details of total public expenditure and so on."

The Vice-President of ICAI, Mr G. Ramasamy, said that the Governmental outgo towards the Mahatma Gandhi National Rural Employment Guarantee Act Scheme totalled over ₹ 42,000 crore and there were over 6 lakh panchayats in the country preparing their expenditure statement. "The institute is supporting the panchayats prepare the statement," he said.

On implementation of International Financial Reporting Standards (IFRS), he said by July 31, all approvals would be in place. The institute has started programmes to enlighten professionals and jumpstart the process in India, launched certification course on IFRS. "In the first phase, we have started with Nifty companies with a turnover of over ₹ 1,000 crore."

The institute, he said has inked MoUs with its various international counterparts to augment bilateral relationships. "We recently interacted with professional bodies in West Asia, discussed the need for improving networking ties between members and professionals of the two countries. We are looking to enter into mutual recognition agreements with the professional bodies in Canada, Singapore and New Zealand among others," he said.

***Source:*** http://www.thehindubusinessline.in/2010/07/05/stories/2010070551931300.htm

### Self Assessment

Fill in the blanks:

11. …………………… is incomplete system of recording business transactions.
12. …………………… system of accounting is a systematic and scientific system of accounting, so it offers a number of advantages.

## 1.5 Types of Accounts

The object of bookkeeping is to keep a complete record of all the transactions that place in the business. To achieve this object, business transactions have been classified into three categories:

1. Transactions relating to persons.
2. Transactions relating to properties and assets
3. Transactions relating to incomes and expenses.

The accounts falling under the first heading are known as 'personal Accounts'.

The accounts falling under the second heading are known as 'Real Accounts', the accounts falling under the third heading are called 'Nominal Accounts'. The accounts can also be classified as personal and impersonal.

### 1.5.1 Personal Accounts

Accounts recording transactions with a person or group of persons are known as personal accounts. These accounts are necessary, in particular, to record credit transactions.

Notes

Personal accounts are of the following types:

1. ***Natural persons:*** An account recording transactions with an individual human being is termed as a natural persons' personal account. For example, Kamal's account, Mala's account, Sharma's accounts. Both males and females are included in it
2. ***Artificial or legal persons:*** An account recording financial transactions with an artificial person created by law or otherwise is termed as an artificial person, personal account. For example, Firms' accounts, limited companies' accounts, educational institutions' accounts, Co-operative society account.
3. ***Groups/Representative personal Accounts:*** An account indirectly representing a person or persons is known as representative personal account. When accounts are of a similar nature and their number is large, it is better tot group them under one head and open a representative personal account. For example, prepaid insurance, outstanding salaries, rent, wages, etc.

When a person starts a business, he is known as proprietor. This proprietor is represented by capital account for that entire he invests in business and by drawings accounts for all that which he withdraws from business. So, capital accounts and drawings account are also personal accounts.

The rule for personal accounts is:

Debit the receiver

Credit the giver

### 1.5.2 Real Accounts

Accounts relating to properties or assets are known as 'Real Accounts', A separate account is maintained for each asset e.g., Cash Machinery, Building, etc.,

Real accounts can be further classified into tangible and intangible.

1. ***Tangible Real Accounts:*** These accounts represent assets and properties which can be seen, touched, felt, measured, purchased and sold. For example, Machinery account Cash account, Furniture account, stock account, etc.
2. ***Intangible Real Accounts:*** These accounts represent assets and properties which cannot be seen, touched or felt but they can be measured in terms of money. For example, Goodwill accounts, patents account, Trademarks account, Copyrights account, etc.

   The rule for Real accounts is:

   Debit what comes in

   Credit what goes out

### 1.5.3 Nominal Accounts

Accounts relating to income, revenue, gain expenses and losses are termed as nominal accounts. These accounts are also known as fictitious accounts as they do not represent any tangible asset. A separate account is maintained for each head or expense or loss and gain or income. Wages account, Rent account Commission account, Interest received account are some examples of nominal account.

The rule for Nominal accounts is:

Debit all expenses and losses

Credit all incomes and gains

## Self Assessment



Fill in the blanks:

13. Accounts recording transactions with a person or group of persons are known as …………………… .
14. An account recording transactions with an individual human being is termed as a …………………… .
15. Accounts relating to properties or assets are known as …………………… .
16. Accounts relating to income, revenue, gain expenses and losses are termed as …………………… .

## 1.6 Accounting Terminology

### Account

An account is a record used to properly classify the activity recorded in the General Ledger.

### Accounting

Accounting is recording and reporting of financial transactions, including the origination of the transaction, its recognition, processing, and summarization in the financial statements.

### Accrual Basis

Accrual basis is a method of accounting that recognizes revenue when earned, rather than when collected and expenses when incurred rather than when paid. The college uses the accrual basis for its accounting.

### Asset

An asset is anything of use to future operations of business and belonging of an enterprise. An asset is what the college owns. For example- land, property, buildings, equipment, cash in bank accounts, other investments and accounts receivable.

### Credit

A credit is an entry on the right side of a double-entry accounting system that represents the reduction of an asset or expense or the addition to a liability or revenue.

### Debit

A debit is an entry on the left side of a double-entry accounting system that represents the addition of an asset or expense or the reduction to a liability or revenue.

### Double-Entry Accounting

Double-entry accounting is a method of recording financial transactions in which each transaction is entered in two or more accounts and involves two-way, self-balancing posting. Total debits must equal total credits. The college uses this method of accounting.

Notes

### Expense/Costs

It is the expenditure incurred by enterprise to earn revenue. An expense is funds paid by the college. For example-paychecks to employees, reimbursements to employees, payments to vendors for goods or services.

***Equity:*** It refers to total claims against enterprise. It is further dividers into Owner's Claim (Capital) and Outside's Claim (Liability).

### GAAP

GAAP stands for Generally Accepted Accounting Principles which are conventions, rules, and procedures necessary to define accepted accounting practice at a particular time. The highest levels of such principles are set by FASB.

### FASB

FASB stands for Financial Accounting Standards Board which is an independent, private, nongovernmental authority for the establishment of accounting principles in the United States.

### General Ledger

The general ledger is the collection of all asset, liability, fund balance (net assets), revenue and expense accounts.

### Journal Entry

A journal entry is a group of debit and credit transactions that are posted to the general ledger. All journal entries must net to zero so debits must equal credits.

### Liability

A liability is what the college owes. For example-loans, taxes, payables, long term debt from a bond issue, funds held by the college for a third party such as a student group.

### Subsidiary Ledger

A subsidiary ledger is a group of accounts containing the detail of debit and credit entries. For example detail information contained in Accounts Payable.

### Revenue

Revenue is funds collected by the college; it can also be called income. It is monetary value of products/services sold to customers during the period. For example-tuition, fees, rentals, income from investment.

### Cash Book

Cash book was used to record all cash and bank related transactions. Some records only the cash related transactions while other use the cash book for both type of transactions. A cash book which is used to record both cash and bank transactions is referred to as Two-column Cash Book. Some accountants use cash book as Cash Book cum Journal. One column of the cash book on both the pages is used for cash transactions and other column for recording all other entries including bank transactions.

### Journal

The journal is used for recording all transactions which cannot be recorded in the Cash Book. Sometimes it is supported by some subsidiary books e.g. Purchase Book, Sales Register, etc.

### General Ledger

The General Ledger contains all the accounts of an enterprise. Since the final information pertaining to the financial position of a business emerges only from accounts and, therefore, the Ledger is also called the Principal Book.

### Trial Balance

In accounts every amount that is placed on the debit side of an account must have a corresponding entry on the credit side of some other account. This is the technical aspect of the principle of double entry system. This being the case, it is but natural that the total of all debit balances should agree with the total of all credit balances. In fact, all businesses periodically tabulate the debit and credit balances separately in a statement to see whether the total of debit balances agrees with the total of credit balances or not. Such a statement is known as Trial Balance. The accountant heaves a sigh of relief when the Trial Balance drawn by him tallies because it is a good proof that the ledger has been correctly written up. However, it is not a conclusive proof of accuracy.

### Profit and Loss Account

This is prepared to see the loss incurred or profit earned by an enterprise within specific period. This is usually made on a yearly basis.

### Balance Sheet

The Balance Sheet is a statement summarizing the financial position of a business on a given date. It summaries on the right hand side the assets of the business and on the left hand side the liabilities of the business including what the business owes to the proprietor viz., the capital invested by him. The total of all the assets must be equal to the total of all the liabilities.

So an accountant has to write the cash book and journal first, and then post all those entries written in cash book and journal to general ledger. Then he prepares the Trial Balance – the most difficult job. After this he prepares the Profit & Loss Account and Balance Sheet. He also has to reconcile the banks, prepares other report like sale register, inventory position, list of debtors and creditors, purchase and sales returns etc. Doing all this work manually not only requires lot of patience but it is a time consuming and very much laborious job.

## Self Assessment

17. The …………………… is used for recording all transactions which cannot be recorded in the Cash Book.
18. The …………………… contains all the accounts of an enterprise.
19. …………………… was used to record all cash and bank related transactions.

## 1.7 Accounting Cycle

Accounting Cycle starts from recording individual transactions in the books of accounting and ends at the preparation of financial statements and closing process. The financial accounting cycle is the process of recording business transactions and processing accounting data to generate

Notes

useful financial information i.e. financial statements including income statement, balance sheet, cash flow statement and statement of shareholders equity. The time period principle requires that a business should prepare its financial statements after a specified period of time, say a year, a quarter or on a monthly basis. This is achieved by following the accounting cycle during each period.

**Figure 1.2: Accounting Cycle**


### 1.7.1 Distinction between Book-keeping and Accounting

Book-keeping and accounting can be distinguished as follows:

**Table 1.2: Distinction between Book-keeping and Accounting**

| Basis of Difference | Book-Keeping Accounting | Accounting |
|---|---|---|
| 1. Objective | 1. The objective of book- keeping is to record the transactions of economic nature. | 1. Whereas the objective of accounting is not only the recording of transactions but also analyzing and interpreting the data. |
| 2. Nature (Art or science) | 2. It is an art. | 2. It is a science. |
| 3. Scope | 3. The scope of book-keeping is very limited. | 3. The scope of accounting is very wide. |
| 4. Functions | 4. Most of the functions of book-keeping are now-a-days performed by machines. | 4. Functions of accounting involves expert human beings in the art of analysis and interpretation. |
| 5. Accounting Process | 5. Book-keeping is just one part of accounting process. | 5. Accounting involves the entire process of accounting that is why it is said that accounting begins where book-keeping ends. |
| 6. Rules to be followed | 6. Rules of accounting are followed for recording. | 6. Along with rules, assumptions and conventions are also there to follow. |

*Contd...*

Notes

| | | |
|---|---|---|
| 7. Net Results Profit or loss | 7. Net results of the business cannot be known from book-keeping. | 7. Whereas accounting is used to find out net results of the business. |
| 8. Time | 8. Transactions are immediately recorded. | 8. Transactions are generally recorded after a gap of time or at the end of a financial year. |

## 1.8 Summary

- Accounting is the medium of recording the business activities and considered as a language of business.
- Accounting is the art of recording, classifying and summarizing in a significant manner and in terms of money transactions and events which are, in part at least, of a financial character, and interpreting the results thereof.
- Identification of financial transactions, recording, classifying them into different groups, summarizing them into trial balance and preparation of financial statements and analyzing and interpreting them, are included in the accounting process.
- Financial accounting, cost accounting, management accounting, responsibility accounting, tax accounting, inflation accounting, etc., are the branches of accounting. Accounting is an art as well as a science.
- Accounting is done for the following objective:
  - ❖ For maintaining the systematic records
  - ❖ For ascertaining the profit/loss of the business
  - ❖ To present the financial position
  - ❖ To provide the financial information
- Accounting plays an important role in the determination of profit, financial position, tax liability, valuation of goodwill and shares and comparative study.

## 1.9 Keywords

***Accounting Conventions:*** Customs and traditions which guide the accountants to record the financial transactions.

***Accounting Process:*** It includes the recording of financial transactions, ledger posting, preparation of financial statements and analyzing and interpretation of them.

***Cost Accounting:*** Accounting relating to the ascertainment of cost of the product.

***Management Accounting:*** Presenting of accounting information in such a way as to assist the management in taking the important decisions and making the policies.

## 1.10 Review Questions

1. Accounting is the process of recording, classifying and summarizing of accounting transactions. Explain.
2. What are the key internal and external users of accounting information?
3. State the key branches of accounting.
4. Is there any difference between book-keeping and accounting?

**Notes**

5. Illustrate the key points which make double entry accounting system more significant than the other traditional accounting systems.
6. As per the double entry system of accounting what will be the impact of following transactions on balance sheet:
   (i) Mr. Rakesh started business with cash of ₹1,00,000
   (ii) Gods sold on credit for ₹10000
   (iii) Furniture purchased for ₹5000
7. Explain the meaning and importance of double entry system of accounting.
8. What is meaning of Debit and Credit?
9. Explain the different methods of accounting.
10. Explain the various types of accounts.

### Answers: Self Assessment

| | | | |
|---|---|---|---|
| 1. | Accounting | 2. | Internal |
| 3. | Money or money's worth | 4. | Solvency |
| 5. | Transactions | 6. | Revenues, Expenses |
| 7. | Recording | 8. | Original Value |
| 9. | Book-keeping | 10. | Transaction |
| 11. | Single Entry | 12. | Double entry |
| 13. | Personal accounts | 14. | Natural persons' personal account |
| 15. | Real Accounts | 16. | Nominal accounts |
| 17. | Journal | 18. | General Ledger |
| 19. | Cash book | | |

## 1.11 Further Readings

*Books*

Dr. S.N. Maheshwari, Sharad, K. Maheshwari, *Financial Accounting*, Vikas Publishing Co. Pvt. Ltd., New Delhi.

Grewal, T.B, Double Entry Book-keeping.

Jain and Narang, Advanced Accountancy.

R.L. Gupta, M. Radhaswami, *Advanced Accountancy*, Sultan Chand, New Delhi.

T.S. Grewal, M.C. Shukla, *Advanced Accounts*, S. Chand, New Delhi.

*Online links*

www.futureaccountant.com

http://www.globusz.com/

# Unit 2: Principles of Accounting

Notes

**CONTENTS**



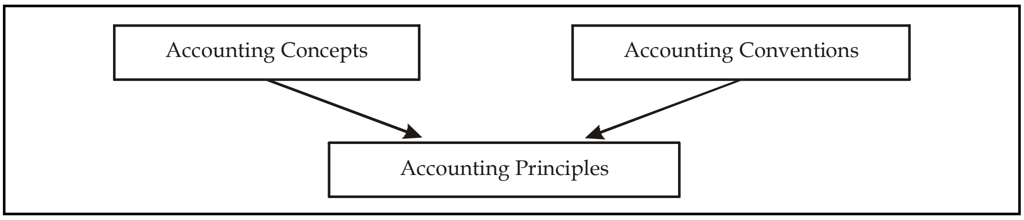
## Objectives

After studying this unit, you will be able to:

- Generally accepted accounting principles
- Accounting concepts and conventions
- Capital and revenue items
- Accounting equation and accounting cycle

## Introduction

The transactions of the business enterprise are recorded in the business language, which routed through accounting. The entire accounting system is governed by the practice of accountancy. The accountancy is being practiced through the universal principles which are wholly led by the concepts and conventions.



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## 2.1 Generally Accepted Accounting Principles

Accounting principles are those rules of actions on the basis of which the transactions of the business are recorded, classified and summarized. If the financial statements are not prepared on the basis of these principles, there will be low acceptability and difficulty to understand them, and the comparison will be impossible and unreliable. Therefore, the accountants recommend that there should be common concepts and conventions of accounting so that the above difficulties and problems may not occur. These common concepts and conventions of accounting have become the basic accounting concepts and conventions as these are commonly accepted by the body of the professional accountants all over the world to prepare the financial statements, Therefore, they are termed as Generally Accepted Accounting Principles (GAAP).

*Caution* There are various bodies, national and international, who from time to time frame guidelines, define terms, formulate principles and standards to be used in the field of Accounting and finance, The industry, firms, business groups have to follow these, both as legal provisions and as convenience.

*Caselet*

### Enron & Accounting Issues: Yawning GAAP

The Enron Corp imbroglio holds many lessons for Indian accounting professionals most of whom are working in a country which fancies itself as a software sweatshop and, therefore, have to deal frequently with tricky revenue recognition issues.

In fact, revenue recognition is so tricky that the Financial Accounting Standards Board (FASB), which sets the global benchmark for private sector accounting, has tagged it "the largest single category of fraudulent financial reporting and financial statement restatements".

But what do revenue recognition issues have to do with Enron? The answer is... just about everything.

Consider these facts: Between 1996 and 2000, the energy trading outfit reported an increase in its sales from $13.3 billion to $100.8 billion. In one single accounting year, 1999-2000, it doubled its reported sales. And said that it was set to double its sales again the following year.

How was Enron able to claim this phenomenal increase in sales revenue? Very simple—it exploited a loophole in accounting rules that allowed it to book revenue from energy-derivative contracts at their gross—as against net value.

The basic incongruity of this practice becomes apparent if you examine the way a Wall Street firm—which is also in trading, although not energy trading—books its revenue. Let's say Wall Street Company X handles, on behalf of a client, the sale of 10,000 shares worth $500,000 of Company Y. It would record as revenue its commission on the sale or the spread between the bid price and the ask price—a few hundred dollars. But Enron (or any other energy trader in the US, for that matter) handling an energy trade would book the full $500,000.

According to Enron's 2000 annual report, it was in the business of building "wholesale businesses through the creation of networks involving selective asset ownership,

*Contd...*

Notes

contractual access to third-party assets and market-making activities". It seems to have used the term "wholesale businesses" to mean trading, plain and simple. From which it made more than 90 per cent of its revenue....

To make matters worse, Enron bought and sold the same goods over and over again. And all this trading—a good amount of which was being carried on with purportedly independent partnerships which do not look very independent on examination—was being booked as revenue at full value.

It got away with this fancy bookkeeping because the FASB just could not make up its mind about how energy contracts should be accounted for and, at some point or the other, decided that each company had a "free option" to do what it wanted.

However, looking on the positive side of things, all this number-pumping without any basis in good accounting ensured that the Enron bankruptcy, in the words of the US Treasury Secretary, Mr Paul O'Neill, had no "spill-over effect."

The downside, of course was that it did not do anything for its profits because of the steady erosion in its trading margins (caused, ironically enough, by the entry of many players into a market created by Enron) from 5.3 per cent in 1998 to less than 1.7 per cent in the third quarter of the current year.

In retrospect, it would seem that the company made frantic attempts to keep up its profits in spite of diminishing margins through various methods, including the setting up of several off-the-balance sheet entities represented as independent of Enron to which it sold assets or portfolios of assets.

It created so-called special purpose entities (SPEs) like the Chewco and JEDI partnerships to get assets like power plants off its books. Enron was able to do this because, under standard accounting, a company is allowed to spin off its assets—and related debts—to an SPE if an outside investor has put up capital worth at least three per cent of the SPE's total value.

These methods also stretched across the lumping of assets into its trading business and the booking as operating revenues the proceeds of the sale of fixed assets.

Gaps, it would seem, abound in GAAP....

***Source:*** http://www.thehindubusinessline.in/2002/01/20/stories/2002012001470100.htm

## Self Assessment

Fill in the blanks:

1. Accounting records all the transactions which can be expressed either in ........................
2. Every financial transaction of the business has ........................ and recorded at two places.

## 2.2 Classification of Accounting Principles

Accounting principles are broadly classified into three categories, these are:

- Basic Assumptions
- Basic Principles (Concepts)
- Modifying Principles (Conventions)

Notes

The classification of accounting principles is shown in the following figure:

**Figure 2.1: Classification of Accounting Principles**

Accounting Principles

- Basic Accounting Assumptions
  - (i) Separate Business Entity
  - (ii) Going Concern
  - (iii) Money Measurement Concept
  - (iv) Accounting Period
- Basic Principles (Concept)
  - (i) Revenue Reorganization Principles
  - (ii) Cost Principle
  - (iii) Dual Aspect Principle
  - (iv) Full Disclosure Principle
  - (v) Matching of Cost and Revenue Principle
  - (vi) Objectivity Principle
- Modifying Principles (Conventions)
  - (i) Conservatism
  - (ii) Consistency
  - (iii) Timeliness
  - (iv) Materiality
  - (v) Cost-Benefit Principle
  - (vi) Industry Practices

### 2.2.1 Basic Accounting Assumptions

The owner and business are treated as two distinct entities and we record those view point of business.

1. ***Separate Business Entity:*** As per this assumption, business is considered a separate entity from its owner(s). This assumption helps in keeping the business transactions strictly free from the effect of personal affairs of the owner. For instance, when a person start the business with cash of ₹2,00,000 then this amount increases the balance of cash from the point of business and on the other hand the owner is treated as a liability and this is shown in the liability side of the balance sheet as owner's capital. For this transaction this journal entry is passed:

   | | | | |
   |---|---|---|---|
   | Cash A/c | | Dr. | 2,00,000 |
   | | To Owner's Capital A/c | | 2,00,000 |

   This concept is becoming more popular because in one sense capital itself may be regarded as a liability—the amount due from the business to the owner. This concept is applicable to the all forms of business organizations whether it is a limited company, partnership firm or a sole trader.

2. ***Going Concern Concept:*** As per International Accounting Standards, it is a fundamental accounting assumption underlying the preparation of financial statements. Under this assumption, "the enterprise is normally viewed as a going concern, that is, as continuing in operation for the foreseeable future. Under this all assets are shown at cost price and not at market price and depreciation is provided on cost price in order to calculate true profit. It is assumed that the enterprise has neither the intention nor the necessity of liquidation or of curtailing materially the sale of its operations". Under this assumption the assets of the business are valued by the accountants on the basis of going concern concept, historical cost and expected life of the assets.

3. ***Money Measurement Concept:*** Money is medium to value quantities. As per this assumption, only those transactions of the business are recorded in the accounting which can be measured

in money. Those transactions/activities of the business which cannot be measured in money are not recorded in accounting.

4. ***Accounting Period Assumption:*** As per the going concern concept, the income of the business can be measured at the time of the liquidation of the business or at the time when business is sold. But practically it is very difficult to wait such a long period that is also not definite. Therefore, it is agreed among the accountants that the economic life of the business is divided into different segment for the purpose of preparing of the financial statements and the determination of profits. Generally this segment of time is one year either calendar year or a financial year. Sometime it may be less than twelve months i.e., quarterly, half yearly, etc. Reports made for less than twelve months are called interim reports and are less reliable than annual reports. At the end of each segment (period) profit and loss account and balance sheet are prepared.

## 2.2.2 Basic Accounting Principles (Concepts)

These basic accounting principles are commonly accepted/agreed principles by the accountants to record the business financial transactions. These are as follows:

### Money Measurement Concept

This is the concept tunes the system of accounting as fruitful in recording the transactions and events of the enterprise only in terms of money. The money is used as well as expressed as a denominator of the business events and transactions. The transactions which are not in the expression of monetary terms cannot be registered in the book of accounts as transactions.

*Example:*

1. 5 machines, 1 ton of raw material, 6 forklift trucks, 10 Lorries and so on. The early mentioned items are not expressed in terms of money instead they are illustrated only in numbers. The worth of the items is getting differed from one to the other. To record the above enlisted items in the book of accounts, all the assets should be converted into money.
2. 5 lathe machines worth ₹1,00,000; 1 ton of raw materials worth amounted ₹15,00,000 and so on.

*Caution*

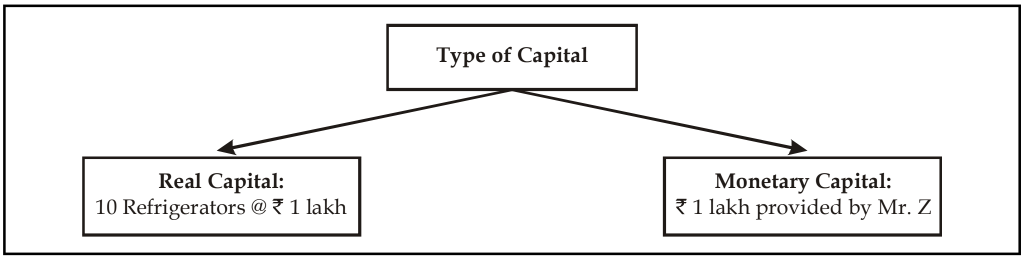
- The transactions which are not in financial in character cannot be entered in the book of accounts.
- Recording of transactions are only in terms of money in the process of accounting

### Business Entity Concept

This concept treats the owner as totally a different entity from the business. To put in to nutshell "Owner is different and Business is different". The capital which is brought inside the firm by the owner, at the commencement of the firm is known as capital. The amount of the capital, which was initially invested, should be returned to the owner considered as due to the owner; who was nothing but the contributory of the capital.

Notes

*Example:* Mr. Z has brought a capital of ₹1 lakh for the commencement of retailing business of refrigerators. The brought capital of ₹1 lakh is utilized for the purchase of refrigerators from the Godrej Ltd. He finally bought 10 different sized refrigerators. Out of 10 refrigerators, one was taken away by himself as the owner.




### In the Angle of the Firm

The amount of the capital ₹1 lakh has to be returned to the owner Mr. Z, which considered being as due. Among the 10 newly bought refrigerators for trading, one was taken away by the owner for his personal usage. The one refrigerator drawn by the owner for his personal usage led the firm to sell only 9 refrigerators. It means that ₹90,000 out of ₹1 Lakh is the volume of real capital and the ₹10,000 worth of the refrigerator considered to be as drawings; which illustrates the capital owed by the firm is only ₹90,000 not ₹1 lakh.

### In the Angle of the Owner

The refrigerator drawn worth of ₹10,000 nothing but ₹10,000 worth of real capital of the firm was taken for personal use as drawings reduced the total volume of the capital of the firm from ₹1 lakh to ₹90,000, which expected the firm to return the capital due amounted ₹90,000.

*Notes* Owner and business organizations are two separate entities.

### Going Concern Concept

The concept deals with the quality of long lasting status of the business enterprise irrespective of the owners' status, whether he is alive or not. This concept is known as concept of long term assets.

The fixed assets are bought in the intention to earn profits during the season of the business. The assets which are idle during the slack season of the business retained for future usage, in spite of that those assets are frequently sold out by the firm immediately after the utility leads to mean that those assets are not fixed assets but tradable assets. The fixed assets are retained by the firm even after the usage is only due to the principle of long lastingness of the business enterprise.

If the business disposes the assets immediately after the current usage by not considering the future utility of the assets in the firm which will not distinguish in between the long-term assets and short-term assets known as tradable in categories.

### Revenue Recognition Principle

It is also called revenue realization principle which means profit should be considered only when realised. As per this principle the revenue is recorded in accounting when the sales have taken place. If there is expectation that will be a particular transaction there in future, that is not recorded in accounting. Revenue/sales is considered to be made when title of ownership of goods passes from the seller to buyer and the buyer become legally liable to pay.

However, this principle has some exemptions which are as follows:

1. In the case of sales made on the basis of hire purchase system where ownership is not transferred at the time of sales while it is transferred at time of final payment. Herewith, sales are presumed to the extent of installment received.
2. In the case of contract accounts, if the contract is for long period revenue cannot be realized until the contract is not completed. Here, only a part of total revenue is treated as realized.

### Cost Principle

This principle is closely related to the going concern concept. As per this principle every transaction of the business should be recorded at its historical cost and not at its market price. At the time of recording of the transactions, their market price is not considered. Sometimes its market price may be less than or more than its actual cost but its actual cost is recorded in accounts because of cost principle. Under this principle the historical cost of a transaction becomes the base cost for the subsequent years. On the basis of this cost, the depreciation is charged on the assets and the balance is shown in the balance sheet. All the fixed assets and current assets are recorded at historical cost. Thus, we observe that the balance sheet prepared on the basis of historical cost does not give us actual results for those applicable of fixed assets and current assets. Due to the changing in the price level changes, the financial statements become irrelevant for the users. This led to the inflation accounting to came into existence.

### Dual Aspect Principle

This is the basic principle of accounting. As per this principle every financial transaction of the business has dual effect and recorded at two places. Therefore, it is called double entry system. On the basis of this principle it is said that every debit must have an equivalent credit and every credit must have an equivalent debit because every transaction of the business has two aspects. For instance, if Mr. Aditya Raj started a business for cash ₹2,00,000 there will be two aspects of this transaction. In one aspect cash is coming into business while in the other aspect the business has to pay this amount to Mr. Aditya Raj. Because Mr. Aditya Raj has given the amount to the business. For this transaction the following journal entry will be passed:

Cash A/c Dr.

To Mr. Aditya Raj

Or

To Capital A/c

This transaction can be expressed in the following equation:

Capital = Assets (Cash)

₹2,00,000 = ₹2,00,000

Here cash (assets) is the resource of the business and capital is the claim of the proprietor as business has to return this amount to the proprietor.

If the business purchases furniture of ₹20,000 on credit, the above equation will change as follows:

Capital + Creditors = Cash + Furniture

₹2,00,000 + 20,000 = ₹2,00,000 + ₹20,000

Capital + Liabilities = Assets

Notes

Thus, we find that in the above equations the total of assets is always equal to the liabilities. Technically we can say that for every debit there is an equivalent credit. This relationship of assets and liabilities is also called accounting equation.

### Full Disclosure Principle

As per this principal, the financial statements should disclose true and fair view so that these may provide accurate and sufficient information to the users of financial statements. Disclosure principle means to give all the information relating to the economic activities of the business to the owner, creditors and investors. Nowadays this principle is getting more importance as big business houses are being run in the form of limited companies. As per Companies Act 1956, the profit and loss account and the balance sheet of the company must show true and fair view of the company. Therefore, companies are giving the foot notes regarding some items as investments, contingent liabilities, etc., along with the balance sheet.

### Matching of Cost and Revenue Principle

As per the going concern concept, the accurate profit/loss of the business can be determined at the time of liquidation of the business or sale of the business. But it will generate a lot of problems. Therefore, the economic life of the business is divided into different segments in order to determine the profit/loss of the business. Generally a segment of the economic life of the business becomes of a year. To compute the operational profits/loss of the business in a year, it is necessary to find the expenses and revenues relating to the period. Then all the revenues of that period are matched with all the expenses/costs incurred to earn that revenue. This matching is called the principle of matching of cost and revenue. The results of this match becomes as follows:

$$\text{Profit} = \text{Revenue} - \text{Expenses}$$

Herewith the matching means an appropriate association between the revenues of a period and expenses/costs of that period. In other words the incomes/loss of the business can be determined if the revenues (incomes) of a period are compared (matched) with the expenditure of that period. For the recognition of the revenues/expenses the accurate system of accounting is adopted. Therefore, a proper adjustment is also made in the accounts for the outstanding expenses, prepaid expenses, accrued incomes and unaccrued incomes. At the time of reorganization of the revenue/ expenses, the following points are kept in mind:

1. The expenses which are being spent to earn revenue must be of the same period for which profit is being computed.
2. Revenues/expenses of a period must be computed on the basis of accrual accounting system.
3. If some revenues are received in advance, they must be treated as the income of that period in which goods are supplied/services are rendered.

### Objectivity Principle

It is also known as objective evidence concept. As per this principle the transactions which are recorded in accounting must be on the objective and factual basis. There should be a voucher or documentary evidence behind each entry in the accounting. The entry must be free from personal bias and based on the rational approach. If the entries are made without evidence, it will lose the confidence of the several users of the financial statements about their reliability. For the auditing of the financial statements, there is also a need of objective evidence.

### 2.2.3 The Modifying Accounting Principles (Conventions)

Basic accounting assumptions and principles provide us the various rules to prepare the financial statements. If these financial statements are relevant and reliable, they will give much useful information to the various users of the financial statements. In order to prepare the true and fair financial statements, there is a need to modify the accounting assumptions and principles. These modified accounting principles are as follows:

1. ***Conservation (Prudence):*** As per the law of conservatism, at the time of preparing the financial statements, all the possible losses must be kept in mind and all anticipated profits/gains should be left out. In other words the accounts must follow the policy of playing safe. Likewise stock-in-trade is valued at 'market price or cost whichever is least', provision for bad and doubtful debt, provision for depreciation on fixed assets, etc., are maintained. This principle is being criticized nowadays on the ground that it goes against the principle of disclosure. The accountants create a secrete reserve through the provision of bad and doubtful debts, depreciation and the valuation of stock. The financial statements loose their true and fair view. Profit and loss account depicts the lower income and the balance sheet understates the assets and the liabilities of the business.

   Today the law of conservatism has been replaced by prudence. It means that conservatism is adopted only in the inevitable uncertainties and doubts. The accountants should also give the reasons for adopting a particular accounting techniques, method and policies without undue conservatism.

2. ***Consistency:*** In order to enable the management to do the comparison of the results of the several years of the business, whatever accounting policy is adopted in a year, must be adopted in the coming years. There should be uniformity in accounting process, rules & methods. As a result biasness of accountant is removed.

   According to Kohlar there are three forms of consistency:

   (a) Vertical Consistency is used in the different financial statements of the business on the same date. For instance, depreciation on fixed assets is used in the income statement and the balance sheet on the same date.

   (b) Horizontal Consistency enables the comparison of the profit or performance of a business in a year with the performance of another year for example the depreciation methods.

   (c) Third Dimensional Consistency refers to the same principles or practices of accounting adopted by the different firms in an industry.

3. ***Timeliness:*** Accounting information given in the financial statements must be reliable and relevant. In order to be relevant, this information must be supplied in time. If late and obsolete information is provided, it will hamper the management and the users of the financial statements to take appropriate, timely and rational decision.

4. ***Materiality:*** Herewith, the materiality means that only that information should be disclosed and attached with financial statements which influence the decisions of shareholders, investors and creditors, etc. and the other insignificant details must be ignored. Moreover, an item of information may be material for one purpose while that may be immaterial for other. This is a subjective matter. For example, the cost of the component may be very much significant for small businessman while it may be insignificant for a large businessman. In one more example, the Companies Act permits to ignore the paise at the time of preparation of financial statements while for the income tax purpose the income is rounded off to the nearest ten.

Notes

5. ***Cost-Benefit Principle:*** As per this principle the cost of using an accounting principle should not exceed its benefits. It does not mean that to curtail the costs, no information or a little information should be given to the users of the financial statements.

6. ***Industry Practice:*** Different accounting principle/practice is adopted in the different industries. At the time of preparing the financial reports and presenting the accounting information the prevailing accounting practices in a particular industry should be kept in mind. For example, disclosing of investments and stock at the cost or market price whichever is lower. Thus we see that the prevailing accounting practices in an industry play an important role in adopting the accounting practices.

*Caselet*

## Rule versus Principle

Students of accounting would be well aware of the long discussed differences between rule-based accounting and principle-based accounting. Both have their protagonists. While the US GAAP is rule-based, the International Accounting Standards (IAS), both as IAS and IFRS, are principle-based.

The debate on which is better will be put to rest when the US GAAP converges with IFRS eventually and becomes principle-based. Being principle-based means that broad principles are laid out by the standard-fixing body and the interpretation is left to the users of these standards.

The problem (and also the benefit) with principle-based accounting is that most of the times, in a situation which requires a finding, one would have to exercise a great deal of judgment based on substance as opposed to a readymade solution being available for a particular issue prescribed in the rule-based accounting.

While the US accounting is considered to be rule-based, one can find echoes of principle-based accounting also in it. In the widely publicised 1969 case of Continental Vending where the auditors were questioned for lack of professional standards, the court gave a direction to the jury to look at the facts and the substance of the case rather than rules of accountancy and mere adherence to GAAP.

The court held that in the audit report the statement “fairly presented … in accordance with generally accepted accounting principles” is two statements rather than one, i.e., “fairly presented” is principle-based and the other “in accordance with generally accepted accounting principles” is rule-based.

**Problems for Auditors**

The preparation of financial statements in accordance with the GAAP in a rule-based environment, however, presents problems to the auditors. If an auditor were to confront the management over a certain treatment of a transaction, the management is likely to ask the auditor “show me where it says I can’t do that”.

In other words, in a rule-based environment, the onus is on the auditor to demonstrate clearly that the particular treatment is not permitted and hence closes the avenues for the auditor to develop further arguments that would be available in a principle-based accounting environment (Principles-based Accounting, by Ronald M. Mano, Matthew Mouritsen and Ryan Pace, published in the CPA Journal, February 2006).

Since accounting standards followed in India have their origin in the IAS, the Indian accounting standards are principle-based. However, there are exceptions to the rule. One

*Contd...*

prime example is the Income Recognition and Asset Classification (IRAC) norms prescribed by the Reserve Bank of India for provisioning for non-performing assets applicable to banks.

Thus, if any asset is non-performing, based on certain prescribed criteria, a provision is created for the potential loan loss irrespective of the security available with the bank.

**Subjectivity Issue**

Principle-based accounting has its own issues too. Ian Wright, Director of Corporate Reporting at the Financial Reporting Council of UK, writing in accountancy magazine (October 2008), talks about the subjectivity that is present in the IFRS.

The IFRS is full of words and phrases that are open to interpretation. The accompanying table has a selection of the probabilities in IFRS literature that a user is expected to interpret in the context of understanding what an accounting standard requires.

Ian Wright also identifies other issues that are potentially problematic.

The IFRS literature contains an increasing range of technical terms which don't translate well into languages other than English. Also, the standards were written in different eras and sometimes by individual national standard-setters due to which the usage of the English language differs resulting in them being structured in disparate ways.

One can therefore see the potential hazards in interpreting a principle-based accounting standard that contains highly subjective phraseology.

In this context, one can expect problems of interpretation in India also. For instance, the word "shall" (a key word in accounting standards) is used in a manner that is completely different from its usage in countries where English is the mother tongue. Any user of IFRS would therefore need to be alive to these issues when interpreting IFRS.

***Hint:*** The preparation of financial statements in accordance with the GAAP in a rule-based environment.

***Source:*** www.thehindubusinessline.com

## Self Assessment

Fill in the blanks:

3. …………………… enables the comparison of the profit or performance of a business in a year with the performance of another year.
4. The revenues are recognized only at the moment of …………………….
5. Book Value = Gross (Original) value of the asset …………………….
6. The …………………… are the persons who owe to an enterprise an amount for receiving goods or services on credit.
7. …………………… is a liability which arises only on the happening of an uncertain event.
8. …………………… = total assets – total liabilities

## 2.3 Capital and Revenue Items

A businessman is interested to know the net result of his business operations after a certain period. But neither the trial balance nor the books of accounts reveal the net results of the business. For this, the financial statements are prepared. But before you learn how to prepare these statements, it is all the more necessary to know about the nature of expenditure and receipts i.e. capital and revenue. This will help in recording correctly the items in these statements.

Notes

### 2.3.1 Capital and Revenue Expenditures

In business, there are thousands of items of expenditure. The following are some of these expenditures which are generally incurred in all types of business:

1. Purchase of goods
2. Purchase of fixed assets such as Building, Furniture, Machine, etc.
3. 'Carriage inwards'
4. Octroi
5. Purchase of Raw Material
6. Import duty
7. Coal, gas, water, oil, grease, fuel, heating and lighting
8. Wages paid to workers for installation of machinery
9. Salaries
10. Rent, rates and taxes
11. Stationery and printing
12. Postage and Telegrams
13. Entertainment
14. Repairs and renewals
15. Depreciation on fixed assets
16. Office expenses
17. Bank charges
18. General expenses
19. Travelling expenses
20. Overhauling of second hand machinery purchased
21. Major repairs affected for reconditioning a machinery/the old assets
22. Increasing the seating capacity of a cinema hall
23. Constructing an additional room
24. Carriage for bringing a fixed asset to place of business
25. Shifting business to convenient premises
26. Advertisement on introducing a new product in market
27. Replacement of hand driven machine by automatic machine
28. Research and development

On the basis of items of expenditure, the expenditure can be classified into three categories:

1. Capital Expenditure,
2. Revenue Expenditure, and
3. Deferred Revenue Expenditure.

Notes

## Capital Expenditure

The expenditure incurred for acquiring a fixed asset or which results in increasing the earning capacity of the business is known as Capital Expenditure.

The benefits of capital expenditures are generally availed in several accounting years. Following are some of the examples of Capital Expenditure.

1. Expenditure incurred for the acquisition of a fixed asset

   *Example:* Building, furniture, machinery, etc.

2. Expenditure incurred for the inward carriage or erection of a fixed asset

   *Example:*

   (a) Carriage paid in connection with the purchase of fixed asset;

   (b) Wages paid to laborers' in connection with the installation of machinery.

   These expenses form part of the cost of the fixed asset.

3. Expenditure incurred for extension or improvement of an existing fixed asset

   *Example:* Money spent in connection with increasing the seating capacity of a cinema hall or constructing an additional room.

4. Expenditure incurred for the major repairs of an old asset

   *Example:* Repairs for reconditioning machinery.

5. Expenditure incurred for the replacement of an old asset with a new asset.

   *Example:* Replacing a hand-driven machine by automatic machine.

## Revenue Expenditure

An expenditure incurred in the course of regular business a transaction of a concern is availed during the same accounting year is known as Revenue Expenditure. Following are some of the examples, of Revenue Expenditure.

1. Expenditure incurred on the purchase of raw materials.

2. Expenditure incurred in the day-do-day running of business.

   *Example:* Wages, salaries, rent, rates and taxes, office expenses, interest, discount, etc.

3. Expenditure incurred for the upkeep of an asset

   *Example:* Repairs, maintenance charges, etc.

4. Expenditure incurred for the purchase of goods meant for sale.

   *Example:* Purchases, carriage inwards, import duty, octroi, etc.

5. Depreciation of fixed assets.

Notes

The above examples are not exhaustive and are not universally accepted. Whether expenditure is capital expenditure or revenue expenditure depends upon its purpose and nature of the business.

*Example:*

1. Amount spent on the purchase of furniture is a capital expenditure but it is revenue expenditure for a business dealing in furniture.
2. Amount spent on Plant and Machinery is a capital expenditure but it is revenue expenditure for a business dealing in engineering goods.
3. Amount spent on wages or carriage are revenue expenditure, but when wages are paid for the installation of a new machinery or carriage paid to bring the machine to the place of business, they are capital expenditure as they increase the value of fixed asset i.e. machinery here.

### Deferred Revenue Expenditure

There are certain revenue expenditures that are incurred during one accounting year but are applicable wholly or in part in future periods such as heavy expenditure on advertisement for introducing a new product in the market or for exploring new markets for the product. These expenditures appear to be revenue expenditure. But it is not so because the benefit from this is likely to the enjoyed over a number of years. Such expenditure whose benefit is enjoyed not in one year but over a number of years is known as deferred revenue expenditure. It is a fictitious asset. At though it appears in balance sheet on asset side, it is really not an asset to business.

*Example:*

1. Heavy initial expenditure incurred on Advertisement for introducing a product in the market.
2. Expenditure incurred in shifting business to more convenient premises.
3. Expenditure incurred on research and development

*Task*

Choose the right kind of expenditure by putting a Tick Mark in correct column:

| **Expenditure** | **Capital** | **Revenue** | **Deferred Revenue** |
|---|---|---|---|
| 1. Salaries | | | |
| 2. Legal Charges | | | |
| 3. Wages for installing a machinery | | | |
| 4. Depreciation | | | |
| 5. Repairs of furniture purchased second hand | | | |
| 6. Advertisement for introducing a new product | | | |
| 7. Carriage paid on goods purchased | | | |
| 8. Research & Development expenditure | | | |
| 9. Expenditure on dismantling and reinstallation of Plant | | | |
| 10. Office expenses | | | |
| 11. Expenditure on the construction of an additional room | | | |
| 12. Maintenance charges of building | | | |

Notes

Following are the main points of difference between capital and revenue expenditures.

**Table 2.1: Distinction between Capital and Revenue Expenditure**

| Basis of Difference | Capital Expenditure | Revenue Expenditure |
|---|---|---|
| Purpose | It is incurred for the purchase of fixed assets. | It is incurred for the maintenance of fixed assets. |
| Earning capacity | It increases the earning capacity of the business. | It does not increase the earning capacity of the business. |
| Periodicity of benefit | Its benefits are spread over a number of years. | Its benefit is only for one accounting year. |
| Placement in financial statements | It is an item of Balance Sheet and is shown as an asset. | It is an item of Trading and Profit and Loss Account and is shown on the debit side of either of the two. |
| Occurrence | It is non-recurring expenditure in nature. | It is usually a recurring expenditure. |

## 2.3.2 Capital and Revenue Receipts

Just as expenditures are classified into Capital or Revenue Expenditure, in the same way receipts are classified into:

1. Capital Receipts, and
2. Revenue Receipts.

1. ***Capital Receipts:*** The receipts which do not arise out of normal course of business are known as Capital Receipts. These do not effect profit/loss of business. They either increase liability or reduces the asset.

*Example:*

1. Receipts from sale of fixed assets.
2. Additional capital introduced by the Proprietor.
3. Loans raised.

2. ***Revenue Receipts:*** The receipts which arise out of normal course of a business are known as Revenue Receipts. These are shown on credit side of P/L account.

*Example:*

1. Income from sale of goods.
2. Rent received form letting out the business property.
3. Dividend received from shares.
4. Interest received from investment.

Notes

## Self Assessment

Fill in the blanks:

9. The expenditure incurred for acquiring a fixed asset or which results in increasing the earning capacity of the business is known as …………………….
10. An expenditure incurred in the course of regular business a transaction of a concern is availed during the same accounting year is known as …………………….
11. The receipts which do not arise out of normal course of business are known as …………………….
12. The receipts which arise out of normal course of a business are known as ……..………….

## 2.4 Summary

- Accounting is the process of recording, classifying, summarizing in a significant manner of transactions which are in financial character and finally results are interpreted.
- The revenues are recognized only at the moment of realization but the expenses are recognized at the moment of payment.
- The charges which were paid only are taken into consideration but the outstanding, not yet paid is not considered.
- The revenues are recognized only at the time of occurrence and expenses are recognized only at the moment of incurring.
- The financial statements are found to be more useful to many people immediately after presentation only in order to study the financial status of the enterprise in the angle of their own objectives.
- The entire accounting system is governed by the practice of accountancy.
- The accountancy is being practiced through the universal principles which are wholly led by the concepts and conventions.
- Money measurement concept tunes the system of accounting as fruitful in recording the transactions and events of the enterprise only in terms of money.
- Business entity concept treats the owner as totally a different entity from the business.
- Going concern concept deals with the quality of long lasting status of the business enterprise irrespective of the owners' status, whether he is alive or not.
- Matching concept only makes the entire accounting system as meaningful to determine the volume of earnings or losses of the firm at every level of transaction.
- Duality or Double entry accounting concept is the only concept which portrays the two sides of a single transaction.

## 2.5 Keywords

***Accrual System:*** The revenues are recognized only at the time of occurrence and expenses are recognized only at the moment of incurring.

***Assets:*** The economic resources of an entity. They include such items as cash, accounts receivable (amounts owed to a firm by its customers), inventories, land, buildings, equipment, and even intangible assets like patents and other legal rights and claims. Assets are presumed to entail probable future economic benefits to the owner.

***Book Value:*** It is the value of the asset maintained in the books of the account. The book value of the asset could be computed as follows:

Book Value = Gross (Original) value of the asset – Accumulated depreciation

***Liabilities:*** Amounts owed to others relating to loans, extensions of credit, and other obligations arising in the course of business.

## 2.6 Review Questions

1. Accounting is the process of recording, classifying and summarizing of accounting transactions. Explain.
2. The entire accounting system is governed by the practice of accountancy. What are the key principles used in accounting?
3. What are the key assumptions of going concern concept?
4. Every debit transaction is appropriately equated with the transaction of credit. Define.
5. Classify the various kinds of values in accounting process.
6. Distinguish between material and immaterial transactions of business.
7. Singania Chartered Accountants Firm established in the year 1956, having very good number of corporate clients. It continuously maintains the quality in audit administration with the clients since its early inception. The firm is eagerly looking for promising students who are having greater aspirations to become auditors. The firm is having an objective to recruit freshers to conduct preliminary auditing process with their corporate clients.

   For which the firm would like to select the right person who is having conceptual knowledge as well as application on the subjects. It has given the following Balance sheet to the participants to study the conceptual applications. The participants are required to enlist the various concepts and conventions of accounting.

   (a) List out the various accounting concepts dealt in the above balance sheet.

   (b) Explain the treatment of accounting concepts.
8. Why does the accounting equation remain in balance?
9. Liability is defined as currently existing obligations which a business enterprise requires to meet sometime in future. Explain.
10. What are the key accounting conventions?

## Answers: Self Assessment

| | | | |
|---|---|---|---|
| 1. | Money or money's worth | 2. | Dual effect |
| 3. | Horizontal Consistency | 4. | Realization |
| 5. | Accumulated depreciation | 6. | Debtors |
| 7. | Contingent liability | 8. | Capital |
| 9. | Capital Expenditure | 10. | Revenue Expenditure |
| 11. | Capital Receipts | 12. | Revenue Receipts |

Notes

## 2.7 Further Readings

*Books*

Khan and Jain, “Management Accounting”.

M.P. Pandikumar, “Accounting & Finance for Managers”, Excel Books, New Delhi.

R.L. Gupta and Radhaswamy, “Advanced Accountancy”.

S.N. Maheswari, “Management Accounting”.

V.K. Goyal, “Financial Accounting”, Excel Books, New Delhi.

*Online link*

www.futureaccountant.com

# Unit 3: Accounting Standards

**CONTENTS**



## Objectives

After studying this unit, you will be able to:

- Define the meaning and need of accounting standards
- Describe the Accounting policies
- Know the Accounting standards-1

## Introduction

For the interest of customers, investors, owners, it is necessary that financial statement of a company should be transparent, properly disclosed, consistent and reliable. For this purpose accounting standards are framed by ICAI in India.

## 3.1 Accounting Standards

There are many users of financial statements as investors, creditors, government, consumers, owners, etc. They take many economic decisions on the basis of financial statements. If the financial statements are not properly regulated, there is possibility that the financial statements may mislead and provide the distorted picture of the business in the place of true and fair picture of the business. Proper regulation of the process of accounting it is essential so that these statements should be transparent, properly disclosed, consistent and reliable. Adequate disclosure in the accounts is also required. For this purpose, accounting standards are prepared at the national and international level. Actually the generally accepted accounting principles are codified by the accounting standards. Accounting standards prepares the norms and guidelines to prepare the financial statements and annual reports. At the international level the International Accounting Standard Committee (IASC) has issued the International Standards. In this committee, there are leading professional bodies of UK, USA, Australia, France and Canada. India is also a member of this committee. India has also prepared its own accounting standards, which are prepared by the Institute of Chartered Accountant of India (ICAI).

Notes

### 3.1.1 Meaning of Accounting Standards

It is a set of Certain generally accepted rules, principles, concepts and conventions issued by the Institute of chartered Accountants of India in consultation with other International Accounting bodies. The purpose of making uniform rules and principles is to make the preparation and presentation of financial statement easy, relevant, reliable, understandable and finally comparable. In other words, Accounting standards are the basis of accounting policies and practices to facilitate the recording of transactions and events in such a way which can change them into financial statements, to be used by the persons interested in getting the correct and reliable information with a view to take future decisions.

The basic objective of Accounting Standards is to remove variations in the treatment of several accounting aspects and to bring about standardization in presentation. They intent to harmonize the diverse accounting policies followed in the preparation and presentation of financial statements by different reporting enterprises so as to facilitate intra-firm and inter-firm comparison.

### 3.1.2 Need and Formulation of Accounting Standards

The adoption and appreciation of accounting standards ensures uniformity, comparability and qualitative improvement in preparation and presentation of financial statements. So, that they may give true and fair picture. What is the need of adoption of accounting standards in the accounting process? How do the accounting standards help in improving the quality of the financial Statement? The answer of these questions may be explained by an example, suppose a company adopts LIFO method for the valuation of its closing stock and another company adopts FIFO method for the valuation of its closing stock, valuation of the closing stock of both the companies will differ. As a result the profit or loss of both companies will also differ. In order to avoid such situation, AS-2 is made.

Take another example of depreciation, if a company adopts diminishing balancing method for the depreciation and another company adopts the fixed installment method for depreciation, the amount of depreciation of both the companies will differ. As a result profit/loss will also differ and the comparison of these companies will not be possible. For the purpose AS-6 is prepared by ICAI in India. Similarly, AS-1 gives guidelines for the disclosure of accounting policies, so that the users of financial statements may perceive the reported profits in its correct perspective.

*Did u know?* In India, the Accounting Standards are formulated by the Accounting Standard Board (ASB).

ASB determines the broad area requiring for formulation of AS. At the time of preparation of Accounting Standards, ASB gets help from different groups for this purpose a study group is made. In this group the members of ICAI participates. Then a wide discussion is held. In this discussion, the representatives of Government, Public Sector Units, and other organizations participate. After the discussion an Exposure Draft (ED) for AS is proposed and issued by ICAI. Then it is dispatched to different outside bodies as ICWAI, ICSI, CBDT, SCOPE, etc. This ED comprises the following points:

1. A Statement of concepts and fundamental accounting principles relating to the standard.
2. Definitions of the terms used in the standard.
3. The manner in which the accounting principles have been applied for the formulation of the standard.
4. The presentation and disclosure requirements in complying with the standard.

**Notes**

5. Class of enterprises to which the standard will apply.
6. Date from which the standard will be effective.

After the publication of ED, the comments and views are collected from the different corners. Then ASB finalizes the proposed standard and submit it to the council of the Institute of chartered accountant of India for the approval. The council considers the ED and, if found necessary, modifies with the consolation of the Accounting Standard Board. Then final shape of the standard is issued under the authority of the council. In the beginning, this is recommendatory and after some period it becomes mandatory. The board has issued the following standards for adoption worldwide. A number of provisional standards relating to other aspects of accounting are an anvil.

### 3.1.3 Nature

The Institute of chartered Accountants of India had set up Accounting Standards Board on 22nd April, 1977 to formulate accounting standards on a number of accounting issues, taking into account the accounting standards developed by the International Accounting Standard Committee, prevailing laws in India, business customs usages and conventions etc. The Accounting Standards made were not mandatory in the beginning but after the amendment in the Sec 211(3C) of Companies Act, 1956 Accounting Standards out of 28 have been made mandatory. The Auditor is required to give in his report to the shareholders that accounts are prepared (drawn) in accordance with the provisions relating to Accounting Standards in India.

The Purpose of this exercise is to make the financial statements more reliable, comparable, consistent and transparent. These standards are made taking into account the laws of the country, business custom, environments etc. If there is a change in any law of the country or change in business custom or environment, the accounting standards are also changed/altered. This flexibility of Accounting Standards is a special feature which makes them more popular and friendly with the users.

If any enterprise wants to change/modify any business custom/practice the same must be properly disclosed along with its effects. For example—change of depreciation method, must be disclosed along with its effect on profit or loss.

The Institute of Chartered Accountants of India has issued the following accounting standards:

AS 1. Disclosure of Accounting policies.

AS 2. Valuation of Inventories.

AS 3. Cash Flow Statement.

AS 4. Contingencies and Events occurring after the Balance Sheet Date.

AS 5. Net Profit or loss for the period, prior items and changes in accounting policies.

AS 6. Depreciation Accounting.

AS 7. Accounting for Construction Contracts.

AS 8. Accounting for research and development.

AS 9. Revenue Recognition.

AS 10. Accounting for fixed Assets.

AS 11. Accounting for the effects of changes in foreign Exchange rates.

AS 12. Accounting for Government grants.

AS 13. Accounting for Investments.

AS 14. Accounting for Amalgamations.

AS 15. Accounting for Retirement benefits in the financial statements of employers.

AS 16. Borrowing Costs.

AS 17. Segment Reporting.

AS 18. Related Party Disclosures.

AS 19. Leases.

AS 20. Earnings Per share.

AS 21. Consolidated financial statements.

AS 22. Accounting for Taxes on Income.

AS 23. Accounting for Investments in Associates in Consolidated Financial Statements.

AS 24. Discontinuing operations.

AS 25. Interim Financial Reporting.

AS 26. Intangible Assets.

AS 27. Financial Reporting of Interests in Joint Ventures.

AS 28. Impairment of Assets.

AS 29. Contingent Liabilities and Contingent Assets.

AS 30. Financial Instruments: Recognition and Measurement

AS 31. Financial Instruments: Presentation

AS 32. Financial Instruments: Disclosures and limited revision to AS-19

According to Government of India, there are 31 accounting standards. But 32 are also included in 31st accounting standard (Financial Instrument: Presentation). So we can say that there are 32 accounting standards.

*Notes* AS-3, AS-6 and AS-24 are desirable but the rest are mandatory.

## Self Assessment

Fill in the blanks:

1. The basic objective of …………………… is to remove variations in the treatment of several accounting aspects and to bring about standardization in presentation.
2. The …………………… are codified by the accounting standards.

## 3.2 Accounting Standards in India

### Statements of Accounting Standards (AS 1) Disclosure of Accounting Policies

The following is the text of the Accounting Standard (AS) 1 issued by the Accounting Standards Board, the Institute of Chartered Accountants of India on 'Disclosure of Accounting Policies'. The Standard deals with the disclosure of significant accounting policies followed in preparing and presenting financial statements.

In the initial years, this accounting standard will be recommendatory in character. During this period, this standard is recommended for use by companies listed on a recognised stock exchange and other large commercial, industrial and business enterprises in the public and private sectors.

## Introduction

1. This statement deals with the disclosure of significant accounting policies followed in preparing and presenting financial statements.
2. The view presented in the financial statements of an enterprise of its state of affairs and of the profit or loss can be significantly affected by the accounting policies followed in the preparation and presentation of the financial statements. The accounting policies followed vary from enterprise to enterprise. Disclosure of significant accounting policies followed is necessary if the view presented is to be properly appreciated.
3. The disclosure of some of the accounting policies followed in the preparation and presentation of the financial statements is required by law in some cases.
4. The Institute of Chartered Accountants of India has, in Statements issued by it, recommended the disclosure of certain accounting policies, e.g., translation policies in respect of foreign currency items.
5. In recent years, a few enterprises in India have adopted the practice of including in their annual reports to shareholders a separate statement of accounting policies followed in preparing and presenting the financial statements.
6. In general, however, accounting policies are not at present regularly and fully disclosed in all financial statements. Many enterprises include in the Notes on the Accounts, descriptions of some of the significant accounting policies. But the nature and degree of disclosure vary considerably between the corporate and the non-corporate sectors and between units in the same sector.
7. Even among the few enterprises that presently include in their annual reports a separate statement of accounting policies, considerable variation exists. The statement of accounting policies forms part of accounts in some cases while in others it is given as supplementary information.
8. The purpose of this Statement is to promote better understanding of financial statements by establishing through an accounting standard the disclosure of significant accounting policies and the manner in which accounting policies are disclosed in the financial statements. Such disclosure would also facilitate a more meaningful comparison between financial statements of different enterprises.

## Explanation

### *Fundamental Accounting Assumptions*

9. Certain fundamental accounting assumptions underlie the preparation and presentation of financial statements. They are usually not specifically stated because their acceptance and use are assumed. Disclosure is necessary if they are not followed.
10. The following have been generally accepted as fundamental accounting assumptions:
    (a) *Going Concern:* The enterprise is normally viewed as a going concern, that is, as continuing in operation for the foreseeable future. It is assumed that the enterprise has neither the intention nor the necessity of liquidation or of curtailing materially the scale of the operations.

Notes

(b) *Consistency:* It is assumed that accounting policies are consistent from one period to another.

(c) *Accrual:* Revenues and costs are accrued, that is, recognised as they are earned or incurred (and not as money is received or paid) and recorded in the financial statements of the periods to which they relate. (The considerations affecting the process of matching costs with revenues under the accrual assumption are not dealt with in this Statement.)

*Task* Find out the legal status of accounting standards in India.

**Nature of Accounting Policies**

11. The accounting policies refer to the specific accounting principles and the methods of applying those principles adopted by the enterprise in the preparation and presentation of financial statements.

12. There is no single list of accounting policies which are applicable to all circumstances. The differing circumstances in which enterprises operate in a situation of diverse and complex economic activity make alternative accounting principles and methods of applying those principles acceptable. The choice of the appropriate accounting principles and the methods of applying those principles in the specific circumstances of each enterprise calls for considerable judgment by the management of the enterprise.

13. The various statements of the Institute of Chartered Accountants of India combined with the efforts of government and other regulatory agencies and progressive managements have reduced in recent years the number of acceptable alternatives particularly in the case of corporate enterprises. While continuing efforts in this regard in future are likely to reduce the number still further, the availability of alternative accounting principles and methods of applying those principles is not likely to be eliminated altogether in view of the differing circumstances faced by the enterprises.

**Areas in which Differing Accounting Policies are Encountered**

14. The following are examples of the areas in which different accounting policies may be adopted by different enterprises.

    (a) Methods of depreciation, depletion and amortisation

    (b) Treatment of expenditure during construction

    (c) Conversion or translation of foreign currency items

    (d) Valuation of inventories

    (e) Treatment of goodwill

    (f) Valuation of investments

    (g) Treatment of retirement benefits

    (h) Recognition of profit on long-term contracts

    (i) Valuation of fixed assets

    (j) Treatment of contingent liabilities

15. The above list of examples is not intended to be exhaustive.

**Considerations in the Selection of Accounting Policies**

16. The primary consideration in the selection of accounting policies by an enterprise is that the financial statements prepared and presented on the basis of such accounting policies should represent a true and fair view of the state of affairs of the enterprise as at the balance sheet date and the profit or loss for the period ended on that date.

17. For this purpose, the major considerations governing the selection and application of accounting policies are:

    (a) *Prudence:* In view of the uncertainty attached to future events, profits are not anticipated but recognised only when realised though not necessarily in cash. Provision is made for all known liabilities and losses even though the amount cannot be determined with certainty and represents only a best estimate in the light of available information.

    (b) *Substance over Form:* The accounting treatment and presentation in financial statements of transactions and events should be governed by their substance and not merely by the legal form.

    (c) *Materiality:* Financial statements should disclose all "material" items, i.e. items the knowledge of which might influence the decisions of the user of the financial statements.

## Disclosure of Accounting Policies

18. To ensure proper understanding of financial statements, it is necessary that all significant accounting policies adopted in the preparation and presentation of financial statements should be disclosed.

19. Such disclosure should form part of the financial statements.

20. It would be helpful to the reader of financial statements if they are all disclosed as such in one place instead of being scattered over several statements, schedules and notes.

21. Examples of matters in respect of which disclosure of accounting policies adopted will be required are contained in paragraph 14. This list of examples is not, however, intended to be exhaustive.

22. Any change in an accounting policy which has a material effect should be disclosed. The amount by which any item in the financial statements is affected by such change should also be disclosed to the extent ascertainable. Where such amount is not ascertainable, wholly or in part, the fact should be indicated. If a change is made in the accounting policies which has no material effect on the financial statements for the current period but which is reasonably expected to have a material effect in later periods, the fact of such change should be appropriately disclosed in the period in which the change is adopted.

23. Disclosure of accounting policies or of changes therein cannot remedy a wrong or inappropriate treatment of the item in the accounts.

## Accounting Standard

(The Accounting Standard comprises paragraphs 24-27 of this Statement. The Standard should be read in the context of paragraphs 1-23 of this Statement and of the 'Preface to the Statements of Accounting Standards.)

24. All significant accounting policies adopted in the preparation and presentation of financial statements should be disclosed.

Notes

25. The disclosure of the significant accounting policies as such should form part of the financial statements and the significant accounting policies should normally be disclosed in one place.
26. Any change in the accounting policies which has a material effect in the current period or which is reasonably expected to have a material effect in later periods should be disclosed. In the case of a change in accounting policies which has a material effect in the current period, the amount by which any item in the financial statements is affected by such change should also be disclosed to the extent ascertainable. Where such amount is not ascertainable, wholly or in part, the fact should be indicated.
27. If the fundamental accounting assumptions, viz. Going Concern, Consistency and Accrual are followed in financial statements, specific disclosure is not required. If a fundamental accounting assumption is not followed, the fact should be disclosed.

### Self Assessment

Fill in the blanks:

3. Statements of Accounting Standards (AS 1) Disclosure of Accounting Policies deals with the disclosure of significant accounting policies followed in preparing and presenting ……………………….
4. …………………… is made for all known liabilities and losses even though the amount cannot be determined with certainty and represents only a best estimate in the light of available information.

## 3.3 Summary

- Accounting Standards is a set of certain generally accepted rules, principles, concepts and conventions issued by the Institute of chartered Accountants of India in consultation with other International Accounting bodies.
- The basic objective of Accounting Standards is to remove variations in the treatment of several accounting aspects and to bring about standardization in presentation.
- The accounting policies refer to the specific accounting principles and the methods of applying those principles adopted by the enterprise in the preparation and presentation of financial statements.

## 3.4 Keywords

***Accounting Policies:*** The accounting policies refer to the specific accounting principles and the methods of applying those principles adopted by the enterprise in the preparation and presentation of financial statements.

***Accounting Standards:*** It is a set of certain generally accepted rules, principles, concepts and conventions issued by the Institute of chartered Accountants of India in consultation with other International Accounting bodies.

***Going Concern:*** The enterprise is normally viewed as a going concern, that is, as continuing in operation for the foreseeable future.

***Materiality:*** Financial statements should disclose all "material" items, i.e. items the knowledge of which might influence the decisions of the user of the financial statements.

## 3.5 Review Questions

1. What do you understand by accounting standards? Explain and also what is the legal status of Accounting Standards in India.
2. How many Accounting Standards are given by the Institute of Chartered Accountants of India? And how many of them are made mandatory. Explain.

### Answers: Self Assessment

1. Accounting Standards
2. Generally Accepted Accounting Principles
3. Financial Statements
4. Provision

## 3.6 Further Readings

*Books*

Khan and Jain, "Management Accounting".

M.P. Pandikumar, "Accounting & Finance for Managers", Excel Books, New Delhi.

R.L. Gupta and Radhaswamy, "Advanced Accountancy".

S.N. Maheswari, "Management Accounting".

V.K. Goyal, "Financial Accounting", Excel Books, New Delhi.

*Online link*

www.futureaccountant.com

Notes

# Unit 4: Accounting Equation and Accounting Cycle

CONTENTS



## Objectives

After studying this unit, you will be able to:

- Explain the concept of accounting equation
- Describe accounting cycle

## Introduction

As discussed earlier accounting is the art of recording, classifying and summarizing the business transactions of the financial nature. Under the recording process of accounting journal and subsidiary books are maintained, under classification of transactions the ledger is maintained while in the summarizing process trial balance and final accounts (P&L A/c and Balance Sheet) are prepared.

## 4.1 Accounting Equation

The basic accounting equation is the foundation for the double-entry bookkeeping system. It shows how assets were financed: either by borrowing money from someone (liability) or by paying your own money (shareholders' equity).

Assets = Liabilities + Capital (Shareholders or Owners equity)

The accounting equation is also the basis for the most basic of accounting reports, the aptly named Balance Sheet. A balance sheet reports what a business owns (assets), what it owes (liabilities) and what remains for the owners (equity) as of a certain date. This equation should remain in balance at all times because of double-entry accounting or bookkeeping. This can be further understood by the following illustrations.

An owner's investment into the company will increase the company's assets and will also increase owner's equity. When the company borrows money from its bank, the company's assets increase and the company's liabilities increase. When the company repays the loan, the company's assets decrease and the company's liabilities decrease. If the company pays cash for a new delivery van, one asset (cash) will decrease and another asset (vehicles) will increase. If a company provides a service to a client and immediately receives cash, the company's assets increase and the company's owner's equity will increase because it has earned revenue. If the company provides a service and allows the client to pay in 30 days, the company has increased its assets (Accounts Receivable) and has also increased its owner's equity because it has earned service revenue. If the company runs a radio advertisement and agrees to pay later, the company will incur an expense that will reduce owner's equity and has increased its liabilities.

*Example:* If a business has ₹1,000 of assets at a particular time those assets must be matched by the total of the claims of creditors and owners. Here is one example of an infinite number of acceptable balance sheets:

**Fazal-ur-Rehman and Sons.**
**Balance Sheet**

| | (₹) |
|---|---|
| Assets | 1000 |
| Liabilities | 500 |
| Equity | 500 |
| **Total Liabilities and Equity** | **1000** |

### Equity as Residual Claims

Equity is simply the difference between assets and liabilities. The owner has positive equity only to the extent that assets exceed liabilities.

*Example:* If a business has ₹1,000 of assets and ₹600 of liabilities the ₹600 of liabilities are, in effect, a claim on the assets. Equity is the difference between the assets and liabilities, or ₹400.

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

Equity is simply the difference between assets and liabilities. The owner has positive equity only to the extent that assets exceed liabilities.

*Example:* If a business has ₹1,000 of assets and ₹500 of liabilities the ₹500 of liabilities are, in effect, a claim on the assets. Equity is the difference between the assets and liabilities, or ₹500.

If a business ceases operations remaining assets first go to outside creditors. The claims of owners can be realized only after outside creditors' claims are satisfied. So equity represents the owners' residual claim on business assets.

*Notes* **Rules for Accounting Equation**

Following rules help in making the accounting equation:

(i) ***Assets:*** If there is increase in assets, this increase is debited in assets account. If there is decrease in assets, this decrease credited in assets account.

(ii) ***Liabilities:*** When liabilities are increase, outsider's equities are credited and when liabilities are decreased, outsider's equities are debited.

(iii) ***Capital:*** When capital is increased, it is credited and when capital is withdrawn, it is debited.

(iv) ***Expenses:*** Owner's equity is decreased by the amount of revenue expenses.

(v) ***Income or profits:*** Owner's equity is increased by the amount of revenue income.

Notes

### 4.1.1 Effect of Transactions on the Accounting Equation

You have learnt that assets, liabilities and capital are the three basic elements of every business transaction, and their relationship is expressed in the form of accounting equation which always remains equal. At any point of time, there can be a change in the individual asset, liability or capital, but the two side of the accounting equation always remain equal. Let us verify this fact by taking up some transactions and see how these transactions affect the accounting equation:

*Example:*

1. Mr. Kamlesh started business with cash of ₹2,00,000.

   In this transaction, one side cash is coming into business and in the other side capital is being brought by Mr. Kamlesh. Thus:

   Capital = Assets (Cash)

   ₹2,00,000 = ₹2,00,000

2. In the next transaction, if a plant of ₹50,000 is purchased in cash, this transaction will also leave two sides. In one side cash is going and in other side plant is coming. In this situation, the accounting equation will be as follows:

   Capital = Plant + Cash (Assets)

   ₹2,00,000 = ₹50,000 + ₹ (2,00,000 – 50,000)

3. If a loan of ₹1,50,000 is taken from the SBI, it will also affect the accounting equation by two sides. On one side, cash will increase and on the other side, liabilities of the business will increase. This may be depicted as follows:

   Capital + Liability (Loan) = Plant + Cash

   ₹2,00,000 + 1,50,000 = ₹50,000 + (1,50,000 + 1,50,000)

   ₹3,50,000 = ₹3,50,000

4. If some goods of ₹20,000 are purchased on credit, it will also affect the accounting equation in two ways. On one side it increases the goods and on the other side it increases the liability (creditors). Now the changed form of the above accounting equation will be as follows:

   Capital + Liabilities = Assets

   Capital + Loan + Creditors = Plant + Cash + Goods

   ₹2,00,000 + 1,50,000 + 20,000 = ₹50,000 + 3,00,000 + 20,000

   ₹3,70,000 = ₹3,70,000

***Illustration 1:*** Consider X Ltd. having the following position of assets and liabilities as on 31st March, 2011:

| **Assets** | **(₹ in lakhs)** |
|---|---|
| Land & Building | 120 |
| Plant & Machinery | 235 |
| Furniture & Fittings | 35 |
| Inventory | 90 |
| Debtors | 40 |
| Cash & Bank Balance | 25 |
| | **545** |

| **Liabilities** | |
|---|---|
| Equity | 345 |
| Long-term loan | 140 |
| Short-term loan | 25 |
| Creditors | 35 |
| | **545** |

The following are some of the transactions entered into by X Ltd. during 2010-2011.

(a) Purchased a piece of land for ₹ 5 lakhs in cash.

(b) Collected ₹ 35 lakhs from debtors outstanding as on 31st March, 2011.

(c) Repaid an instalment of long-term loan ₹ 15 lakhs.

(d) Paid ₹ 20 lakhs to creditors

Show the effect of the above transactions upon the accounting equation.

***Solution:*** The accounting equation (A = L + C) as on 31st March, 2011 stands as below:

A = L + C

or ₹ 545 lakhs = ₹ 200 lakhs + ₹ 345 lakhs.

The above equation is affected by every transaction entered into during 2010-2011. We shall show the effect of each transaction separately.

(a) Purchased a piece of land for Rs. 5 lakhs in cash:

*Original position:*

A(₹ 545 lakhs) = L(₹ 200 lakhs) + C(₹ 345 lakhs)

*Revised position:*

A[₹ 545 lakhs + ₹ 5 lakhs (land) – ₹ 5 lakhs (cash)] = L(₹ 200 lakhs) + C (₹ 345 lakhs)

or A(₹ 545 lakhs) = L(₹ 200 Lakhs) + C(₹ 345 lakhs)

(b) Collected ₹ 35 lakhs from debtors outstanding as on 31st March, 1997:

A[₹ 545 lakhs + ₹ 35 lakhs (cash) – ₹ 35 lakhs (debtors)] = L(₹ 200 lakhs) + C(₹ 345 lakhs)

or A(₹ 545 lakhs) = L(₹ 200 lakhs) + C(₹ 345 lakhs)

(c) Repaid an instalment of long-term loan ₹ 15 lakhs:

A[₹ 545 lakhs – ₹ 15 lakhs (cash)] = L[₹ 200 lakhs – ₹ 15 lakhs (long-term loan)] + C (₹ 345 lakhs)

or A(₹ 530 lakhs) = L(₹ 185 lakhs) + C(₹ 345 lakhs)

(d) Paid ₹ 20 lakhs to creditors:

A[₹ 530 lakhs – ₹ 20 lakhs (cash)] = L(₹ 185 lakhs – ₹ 20 lakhs (creditors)] + C(₹ 345 lakhs)

or A(₹ 510 lakhs) = L(₹ 165 lakhs) + C(₹ 345 lakhs)

Notes

*Illustration 2:* ABC Ltd. is a company incorporated to carry on the business of selling soft drinks. ABC Ltd.'s transactions for the month of January were as follows:

Jan. 1 Issued equity shares of ₹ 20,00,000 (cash received in full).

Jan. 5 Purchased land for ₹ 5,75,000.

Jan. 8 Purchased a building for ₹ 4,40,000, paying ₹ 1,40,000 in cash and the balance payable in three monthly installments.

Jan. 15 Purchased machinery worth ₹ 2,20,000.

Jan. 20 Purchased syrup (raw material) for making soft drinks worth ₹ 5,75,000, paying ₹ 1,75,000 in cash and accepting a bill drawn by the supplier for the balance.

Jan. 25 Purchased further machinery worth ₹ 50,000.

Jan. 31 Sold cold drinks worth ₹ 50,000 (consuming ₹ 30,000 of syrup).

Show the effects of the above transactions upon the accounting equation.

***Solution:***

*(Figures are in ₹)*

| | Assets | | | | | Liabilities | | + Capital |
|---|---|---|---|---|---|---|---|---|
| | Cash | Inventory | Land | Building | Machinery | Creditors | Bills Payable | |
| Jan. 1 | (+)20,00,000 | | | | | = | | + 20,00,000 |
| Jan. 5 | (–)5,75,000 | | +5,75,000 | | | | | |
| Balance | 14,25,000 | | 5,75,000 | | | | | |
| Jan. 8 | (–) 1,40,000 | | | + 4,40,000 | | = +3,00,000 | | |
| Balance | 12,85,000 | | 5,75,000 | 4,40,000 | | = 3,00,000 | | 20,000,00 |
| Jan. 15 | (–) 2,20,000 | | | | +2,20,000 | = | | |
| Balance | 10,65,000 | | 5,75,000 | 4,40,000 | 2,20,000 | = 3,00,000 | | 20,00,000 |
| Jan. 20 | (–)1,75,000 | +5,75,000 | | | | | + 4,00,000 | |
| Balance | 8,90,000 | 5,75,000 | 5,75,000 | 4,40,000 | 2,20,000 | = 3,00,000 | 4,00,000 | 20,00,000 |
| Jan. 25 | (–) 50,000 | | | | +50,000 | | | |
| Balance | 8,40,000 | 5,75,000 | 5,75,000 | 4,40,000 | 2,70,000 | = 3,00,000 | 4,00,000 | 20,00,000 |
| Jan. 31 | + 50,000 | (–) 30,000 | | | | | | + 20,000 (50,000–30,000) |
| Balance | 8,90,000 | 5,45,000 | 5,75,000 | 4,40,000 | 2,70,000 | =3,00,000 | 4,00,000 | 20,20,000 |

## Self Assessment

Fill in the blanks:

1. The basic accounting equation is the foundation for the …………………… system.
2. A …………………… reports what a business owns (assets), what it owes (liabilities) and what remains for the owners (equity) as of a certain date.
3. An owner's investment into the company will increase the company's assets and will also increase …………………….
4. Accounting Equation serves as a basis for preparing …………………….
5. Liabilities = …………………… – Capital

Notes

## 4.2 Accounting Cycle

Accounting is described as origin for the creation of information and the continuous utility of information. Now the question is how is this information created? For this, there is a step by step process, as shown below accounting cycle. It is a complete sequence beginning with recording of transaction and ends with preparation of final accounts. The major steps involved in the accounting cycle are:

1. ***Analyse Transactions:*** The first step of a accounting cycle is to know what type of transaction we are dealing with; we also need to verify that the information is correct and that transactions have taken place only with proper authorization. Most accounting transactions originate with what are called source documents, which are the invoices, orders, time cards, checks, and other "paperwork" (or now, commonly digital files) which provide the first indication that a transaction has taken place (or will be taking place in the future.)

2. ***Preparing Journals:*** The journal is the "book of original entry," the place where the transactions first become part of the official financial records of the organization. We make journal entries which specify the accounts which are affected by a transaction, and the amount of money involved.

3. ***Post to Ledger A/c:*** The ledger is the entire group of accounts maintained by an organization. Posting refers to the transfer of the journal entries to the ledger. In a manual system, posting was a separate process. In computerized systems, posting is typically accomplished contemporaneously with recording the transaction in the journal.

4. ***Preparation of Trial Balance:*** A trial balance is nothing more than a summation of the account balances to be sure that the books do, in fact, balance.

5. ***Post Closing Entries:*** Closing entries are the entries that we make to close the temporary accounts (the expense and revenue accounts). In manual systems, each closing entry had to be made individually. In computerized systems, a single command closes the books.

6. ***Preparation of Financial Statement:*** Last step includes the preparation of Trading and Profit & Loss A/c and opening and closing balance sheet.

*Notes* ***Classifying:*** It is one of the most important processes of the accounting. Under this, grouping of transactions is carried out on the basis of certain segments or divisions. It can be described as a method of rational segregation of the transactions. The segregation is generally done into two categories, *viz.*

1. Cash transactions and
2. Non-cash transactions.

The preparation of the ledger A/cs and Subsidiary books are prepared on the basis of rational segregation of accounting transactions. For example, the preparation of cash book is involved in the unification of cash transactions.

***Summarizing:*** The ledger books are appropriately balanced and listed one after another.

The list of the name of the various ledger book A/c and their accounting balances is known as Trial Balance. The trial balance is summary of all unadjusted name of the accounts and their balances.

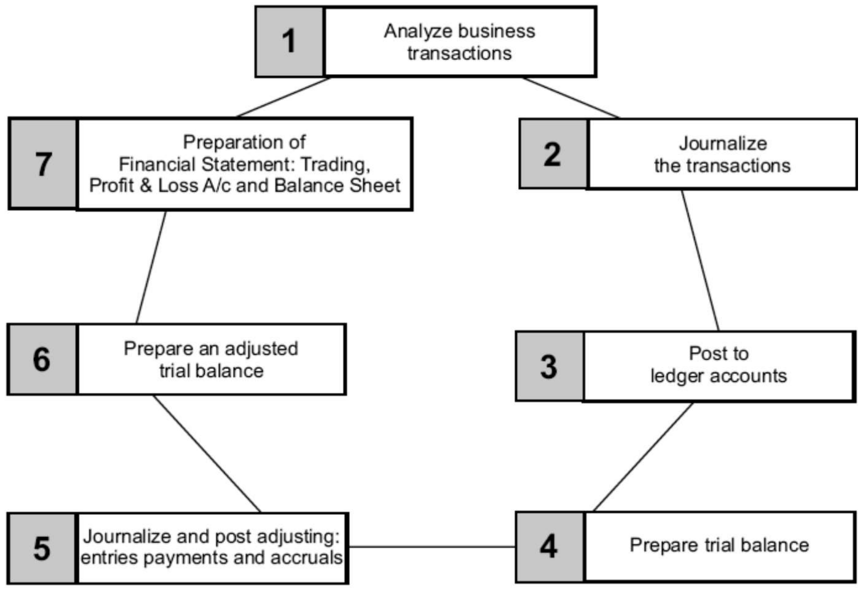
*Contd...*

Notes

> ***Preparation:*** After preparing, the summary of various unadjusted A/c are required to adjust to the tune of adjustment entries which were not taken into consideration at the time of preparing the trial balance. Immediately after the incorporation of adjustments, the final statement is readily available for interpretations.

The following figure explains the key steps of accounting cycle:

**Figure 4.1: Steps of Accounting Cycle**




### 4.2.1 Account

An account is a statement in which the date wise details regarding the business transactions as persons, companies, representatives, assets, liabilities, income and expenditures and profit & loss are given.

#### Kinds of Accounts

For the purpose of ruling of debit and credit, under double entry system the accounts are classified on the basis of two approaches. These are:

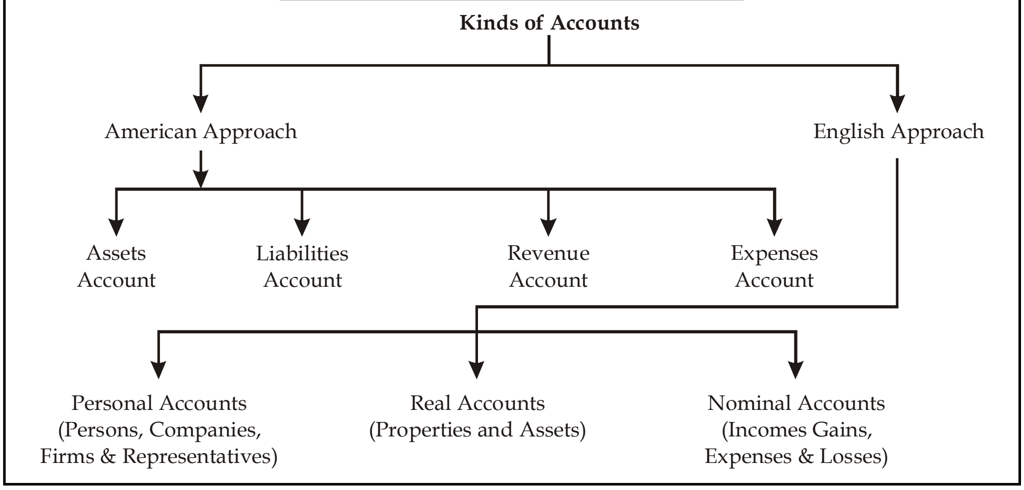
1. American Approach
2. English Approach

1. ***American Approach:*** As per this approach the accounts relating to financial transactions are classified as follows:
   (a) *Assets Accounts:* Under this heading those transactions are kept which are relating to the business assets as plant, machinery, land, building, etc.
   (b) *Liabilities Account:* Under this heading those accounts are kept which are relating to the credit purchases and outstanding expenses, loans, capital, etc.
   (c) *Capital Account:* Capital account is an account stating the amount of fund and assets invested by the owner's in the business.

(d) *Revenue Accounts:* Revenue accounts include the transactions relating to income, commission, interest, dividend, sales, etc.

(e) *Expenses Accounts:* These include those accounts which are relating to the expenses of business as repairs, rent, maintenance, insurance and lighting, etc.

**Figure 4.2: Classification of Accounts**




2. ***English Approach:*** Under this approach accounts are classified into following three categories:

(a) *Personal Account:* Here those accounts are included which are relating to persons, firms, companies, representatives and organizations as Shiam Lal & Company's Account, etc.

(b) *Real Account:* Accounts which are relating to the assets and properties of the business are counted under this heading. Assets can be real or intangible. Real assets are as land & buildings, plant & machinery, cash and stock, etc. While intangible assets may be as goodwill, patents and trademarks, etc.

(c) *Nominal Account:* Accounts which are relating to the revenues, incomes, expenses and losses of the business are called nominal accounts. For example, rent, commission, interest, dividend, etc.

## Self Assessment

Fill in the blanks:

6. …………………… is described as origin for the creation of information and the continuous utility of information.

7. Under …………………… heading those transactions are kept which are relating to the business assets as plant, machinery, land, building, etc.

## 4.3 Summary

- The recording of business transactions in the books of account is based on a fundamental equation called Accounting Equation.
- This equation expresses the equality of assets on the one side and other side equity.
- Expenses and Revenue also affect the accounting equation. Their effect is always on the capital account.

Notes

- The accounting equation is also the basis for the most basic of accounting reports, the aptly named Balance Sheet.
- A balance sheet reports what a business owns (assets), what it owes (liabilities) and what remains for the owners (equity) as of a certain date.
- Accounting is described as origin for the creation of information and the continuous utility of information.

## 4.4 Keywords

***Accounting Equation:*** The recording of business transactions in the books of account is based on a fundamental equation called Accounting Equation.

***Asset:*** Any physical thing or right owned that has money value is an asset.

***Liability:*** It means the amount which the firm owes to outsiders that is, accepting the proprietors.

***Stock:*** The goods purchased are for selling, if the goods are not sold out fully, a part of the total goods purchased is kept with the trader unlit it is sold out, it is said to be a stock.

## 4.5 Review Questions

1. "Accounting equation remains intact under all circumstances" Justify the statement with the help of example.
2. "Accounting is described as origin for the creation of information and the continuous utility of information." Discuss.
3. Why accounting equation does remains in balance?
4. "Accounting is the process of recording, classifying and summarizing of accounting transactions." Discuss.
5. Prepare accounting equation from the following Transactions:

| | |
|---|---|
| Hemant started business with cash | ₹ 3,00,000 |
| Purchased goods for cash | ₹ 80,000 |
| Sold goods [costing ₹ 30,000] for cash | ₹ 45,000 |
| Purchased goods from Monika | ₹ 70,000 |
| Salary paid | ₹ 7,000 |
| Commission received | ₹ 5,000 |
| Paid Cash to Monika in full settlement | ₹ 69,000 |
| Goods sold to Rahul {Costing ₹ 20,000} for cash | ₹ 25,000 |

6. Prepare accounting equation on the basis of the following:

   (i) Anup started business with cash ₹ 250,000

   (ii) Purchased goods for cash ₹ 35000

   (iii) Purchased office furniture for cash ₹ 12000

   (iv) Paid rent ₹ 7000

   (v) Sold goods (costing ₹ 30000) for ₹ 50000 for cash

**Notes**

7. Show the accounting equation on the basis of the following transactions
   - (i) Manu started business

     Cash ₹ 600000

     Goods ₹ 100000
   - (ii) Purchased office machine for cash ₹ 90000
   - (iii) Sold goods (costing ₹ 60000) for credit to Asha
   - (iv) Purchased building for cash ₹ 130000
   - (v) Cash received from Ashu ₹ 80000
   - (vi) Purchased goods on credit to M/s Ashok Trader for cash ₹ 70000
   - (vii) Salaries paid ₹ 6000
   - (viii) Insurance prepaid ₹ 10000
   - (ix) Cash paid to M/s Ashok traders in full settlement ₹ 68000

### Answers: Self Assessment

| | | | |
|---|---|---|---|
| 1. | double-entry bookkeeping | 2. | Balance sheet |
| 3. | Owner's equity | 4. | Balance Sheet |
| 5. | Assets | 6. | Accounting |
| 7. | Assets Accounts | | |

## 4.6 Further Readings

*Books*

Khan and Jain, "Management Accounting".

M.P. Pandikumar, "Accounting & Finance for Managers", Excel Books, New Delhi.

R.L. Gupta and Radhaswamy, "Advanced Accountancy".

S.N. Maheswari, "Management Accounting".

V.K. Goyal, "Financial Accounting", Excel Books, New Delhi.

*Online link*

www.futureaccountant.com

Notes

# Unit 5: Preparation of Journal, Ledger and Balancing

CONTENTS



## Objectives

After studying this unit, you will be able to:

- Prepare journal
- Construct journal entries between the accounts of two different categories
- Illustrate opening and compound journal entries
- Prepare ledger
- Make ledger posting
- Illustrate the balancing of accounts

## Introduction

Journal is a book of accounts in which all day to day business transactions are recorded in a chronological order i.e. in the order of their occurrence. Transactions when recorded in a Journal are known as entries. It is the book in which transactions are recorded for the first time. Journal is also known as 'Book of Original Record' or 'Book of Primary Entry'.

The accounting process does not stop here. The transactions are recorded in number of books in chronological order. Such recording of business transactions serves little purpose of accounting. Items of same title in different books of accounts need to be brought at one place under one head called an account. There are numerous account titles of items/persons or accounts. All the accounts, if brought in one account book, will be more informative and useful. The account book so maintained is called Ledger.

Notes

## 5.1 Books of Original Record

The accounting process includes the identification of financial transactions, recording of them and summarizing. Thus, after identifying the financial nature items the first step of accounting process is the recording the transactions. The books in which these transactions are recorded first time are called the books of original entries or records. These books of original records are divided into following three:

### Memorandum Book

It is also called the waste book. When a transaction takes place in the business it is first roughly written in the memorandum book chronologically for the memory only. Then after some time, these transactions are recorded in the journal and subsidiary book. After recording these transactions, this book is destroyed. Therefore, it is called waste book.

### Journal

'Journal' word is derived from French word '*Jour*' which means a day book. Journal is a primary book of original entries for accounting data. In the Journal the business transactions are recorded chronologically that is called Journalising. Thus the accounting data are recorded first time in this book. In the words of Carter, "A Journal, as originally used, is a book of primary entry in which transactions are copied in the order of date from a memorandum or waste book. The entries are then copied and classified into debts and credits, so far to facilitate their being correctly posted afterwards in the ledger". The proforma of a Journal is given here under:

**Pro forma of a Journal**

| Date | Particulars | L.F. | Amount Dr. (₹) | Amount Cr. (₹) |
|---|---|---|---|---|
| | | | | |

As per the above pro forma of Journal the first column is kept for date means date of transaction is recorded, second wide column for particulars of business transactions in which the related accounts are showed along with their narrations. Third column is for ledger folio number where the journal entry is posted in ledger. The fourth and fifth columns are kept for debit amount and credit amount.

*Did u know?* **What is meant by the journal entry?**

It is an entry systematically recorded to the tune of golden rules of accounting in the journal book is known as journal entries.

Notes

### 5.1.1 Rules of Debiting and Crediting in Journal

In the Journal the business transactions of the financial nature are recorded on the basis of debit and credit. The accounts are debited and credited on the basis of following rules. These rules are based on the english classification of accounts.

1. ***Personal Account:*** If in a transaction, a person receives something in cash or goods, it is debited and if that person gives, that is credited. Debit account is denoted by 'Dr.' while credit account is denoted by 'Cr.' In brief, the rule of personal account is

   Receiver is debited (Dr.)
   Giver is credited (Cr.)

2. ***Real Account:*** If in a transaction, the assets are coming into business, they are debited and if those are going outside from business, they are credited. Thus these rules are as below:

   'What comes in' is debited
   'What goes out' is credited

3. ***Nominal Account:*** The rules of debiting and crediting of nominal account are – the expenses and losses of the business are debited and the gains and profit of the business are credited. In brief the rules are:

   Expenses and Losses are debited
   Incomes and Gains are credited

At the time of Journalising of the transactions, when an account is debited it is denoted by 'Dr.' and crediting of an account by 'To'. When a transaction is recorded first of all its two aspects (accounts) are identified, those may of the same group (same type of account) or different groups (different types of accounts). Then the rules of debiting and crediting are applied. On the completion of a page of the Journal it is totaled and the balance is carried forward to the next page.

***Illustration 1:*** Journalise the following transactions in the books of Mr. Ram Krishna:

| **2007** | | **(₹)** |
|---|---|---|
| July 1 | Mr. Ram Krishna Started business with cash | 2,00,000 |
| July 4 | Goods purchased in cash | 20,000 |
| July 5 | He deposited in Bank | 40,000 |
| July 7 | Goods sold | 15,000 |
| July 10 | Goods purchased from Mr. Kamlesh on credit | 25,000 |
| July 11 | Furniture purchased | 18,000 |
| July 12 | Wages paid | 4,000 |
| July 20 | Interest received | 500 |
| July 25 | Cash paid to Mr. Kamlesh | 25,000 |
| July 30 | Additional capital brought by Mr. Ram Krishna | 50,000 |

*Solution:*

**Notes**

**Journal of Mr. Ram Krishna**

| Date | Particulars | | L.F. | Amount Dr. (₹) | Amount Cr. (₹) |
|---|---|---|---|---|---|
| 2007 | | | | | |
| July 1 | Cash Account | Dr. | | 2,00,000 | |
| | To Capital Account | | | | 2,00,000 |
| | (Being start of business by Mr. Ram Krishna) | | | | |
| July 4 | Purchase Account | Dr. | | 20,000 | |
| | To Cash Account | | | | 20,000 |
| | (Being purchase of goods in cash) | | | | |
| July 5 | Bank Account | Dr. | | 40,000 | |
| | To Cash Account | | | | 40,000 |
| | (Being deposit of cash into Bank) | | | | |
| July 7 | Cash Account | Dr. | | 15,000 | |
| | To Sales Account | | | | 15,000 |
| | (Being sale of goods in cash) | | | | |
| July 10 | Purchase Account | Dr. | | 25,000 | |
| | To Mr. Kamlesh | | | | 25,000 |
| | (Being purchase on credit from Mr. Kamlesh) | | | | |
| July 11 | Furniture Account | Dr. | | 18,000 | |
| | To Cash Account | | | | 18,000 |
| | (Being purchase of furniture) | | | | |
| July 12 | Wage Account | Dr. | | 8,000 | |
| | To Cash Account | | | | 8,000 |
| | (Being payment of wages in cash) | | | | |
| July 20 | Cash Account | Dr. | | 500 | |
| | To Interest Account | | | | 500 |
| | (Being receipt of interest) | | | | |
| July 25 | Mr. Kamlesh | Dr. | | 25,000 | |
| | To Cash Account | | | | 25,000 |
| | (Being payment of credit purchases) | | | | |
| July 30 | Cash Account | Dr. | | 50,000 | |
| | To Capital Account | | | | 50,000 |
| | (Being introduction of additional capital in business) | | | | |
| | Total | | | 3,97,500 | 3,97,500 |

*Notes* For the purpose of Journalising of the transactions, the goods are classified into purchases, sales, purchase returns and sales returns.

Notes

When some amount is brought into to start the business it is called Capital. Therefore, such an amount is transferred to Capital Account.

### 5.1.2 Compound Journal Entry

When two or more transactions take place in the business relating to a same account on the same date, in the place of passing many entries for the same account a single journal entry is pass which is called a compound journal entry. Compound entry can be of following three types:

(a) Single debit account and more than one credit account

(b) Single credit account and more than one debit accounts

(c) More than one debit account and more than one credit account

For example, if a debtor is allowed cash discount and he makes the payment. Then the accounts involved are three, i.e., (1) Cash A/c (2) Discount A/c and (3) The Debtors A/c

The following compound entry is to be passed:

**Dr.** **Cr.**

| Date | Particulars | L.F. | (₹) | (₹) |
|---|---|---|---|---|
| | Cash A/c Dr.<br>Discount A/c Dr.<br>To Debtors A/c<br>(Debtor paid & was allowed discount.) | | | |

***Illustration 2:*** Journalise the following transactions with narration:

**2006**

Aug 1 Commenced business with cash ₹ 40,000 and Goods ₹ 20,000,

Aug 3 Purchased goods 'From 'X' and Co. for ₹ 10,000 Paid Cash ₹ 5,000,

Aug 5 Goods returned to 'X' Co. ₹ 200,

Aug 10 Sold goods to 'Y' & Co. ₹ 30,000 and cash received from him ₹ 20,000,

Aug 15 'Y' & Co. returned goods ₹ 500,

***Solution:***

**Journal Entries**

| Date | Particulars | L.F. | Amount Dr. (₹) | Amount Cr. (₹) |
|---|---|---|---|---|
| 2006 | | | | |
| Aug 1 | Cash A/c Dr.<br>Goods A/c<br>Dr.<br>To Capital A/c<br>(business commenced with cash and goods) | | 40,000<br>20,000 | <br><br>60,000 |
| Aug 3 | Purchases A/c Dr.<br>To X & Co.<br>(Goods purchased from x) | | 10,000 | <br>10,000 |

*Contd...*

Notes

| | | | | |
|---|---|---|---|---|
| Aug 3 | X & Co. Dr.<br>To cash A/c<br>Paid cash<br>(If combined entry is passed) | | 5,000 | <br>5,000 |
| Aug 3 | Purchases A/c Dr.<br>To cash A/c<br>To X & Co.<br>(Goods purchased from X and paid cash) | | 10,000 | <br>5,000<br>5,000 |
| Aug 5 | X & Co. Dr.<br>To Purchases Returns A/c<br>(Goods returned to X) | | 200 | <br>200 |
| Aug 10 | Cash A/c Dr.<br>Y& Co. Dr.<br>To sales A/c<br>(Goods sold to Y and cash received from him) | | 20,000<br>10,000 | <br><br>30,000 |
| | If separate entries are made then | | | |
| Aug 10 | Y& Co. Dr.<br>To Sales A/c<br>(Goods sold to Y) | | 30,000 | <br>30,000 |
| Aug 10 | Cash A/c Dr.<br>To Y & co.<br>(Cash received from him) | | 20,000 | <br>20,000 |
| Aug 15 | Sales Return A/c Dr.<br>To Y & Co.<br>(Goods returned by Y & Co.) | | 500 | <br>500 |

### 5.1.3 Opening Journal Entry

The closing balances of accounts of one year are transferred to the next year. In the next year these balances become the opening balances. After recording the opening balances, the transactions of the year are recorded. To record the opening balances a Journal entry is passed which is called opening entry. Suppose in a business there are closing balances of cash of ₹10,000, plant ₹90,000 and capital of ₹1,00,000, and then opening Journal entry will be as follows:

| | | | |
|---|---|---|---|
| Assets Account | Dr. | 90,000 | |
| Cash Account | Dr. | 10,000 | |
| To Capital Account | | | 1,00,000 |

*Illustration 3:* Pass the necessary opening entry on 1st January, 2006 in the books of Gopinath.

| | |
|---|---|
| Cash in hand | 3,000 |
| Cash at Bank | 16,000 |
| Stock in trade | 30,000 |
| Furniture & Fittings | 5,000 |
| Sundry Debtors | 21,000 |
| Sundry Creditors | 18,000 |
| Loan from Ganesh & Co. | 9,000 |

Notes

*Solution:*

**Opening Journal Entries**

| Date | Particulars | | L.F. | Dr. (₹) | Cr. (₹) |
|---|---|---|---|---|---|
| 1.1.2006 | Cash in hand A/c | Dr. | | 3,000 | |
| | Cash at Bank A/c | Dr. | | 16,000 | |
| | Stock in trade A/c | Dr. | | 30,000 | |
| | Furniture's Fittings A/c | Dr. | | 5,000 | |
| | Sundry debtors A/c | Dr. | | 21,000 | |
| | To Sundry creditors A/c | | | | 18,000 |
| | To Ganesh & Co. A/c | | | | 9000 |
| | To Capital A/c | | | | 48,000 |
| | (Opening entry in respect of assets and liabilities. Difference between Assets and liabilities is equal to capital) | | | | |

## Subsidiary Books of Original Records

If all the transactions of the business are recorded in Journal it will be too bulky to manage. Therefore, nowadays original records are maintained in the subsidiary books. These subsidiary books are also called sub-division of Journal. They are classified as follows:

### *Cash Book or Journal*

When it is the part of ledger it is called cash account. In the cash book all the cash transactions are directly recorded. As per Carter, "Cash book is a book of original entry, the object of which is to record all receipts and payments of money". In the cash book all the cash receipts are recorded in the left hand sides and all the cash payments are recorded in the right hand side. And the difference of these two sides is called the closing balance of cash. Generally, four types of cash book are prepared. These are:

1. Simple Cash Book or One Column Cash Book
2. Cash and Discount Cash Book or Double Column Cash Book
3. Cash, Bank and Discount Cash Book or Three Column Cash Book
4. Petty Cash Book

The pro forma of the simple cash book is given below:

**Pro Forma of a Simple Cash Book**

| Date | Particulars | L.F. | Amount (₹) | Date | Particulars | L.F. | Amount (₹) |
|---|---|---|---|---|---|---|---|
| | | | | | | | |

## Special Journal

Notes

This journal is the part of general journal. Under this division of Journal, the following Journals or books are included:

1. ***Purchase Book*** is also known as Bought Book or Purchase-Day Book. All the credit purchase of goods is recorded in this book. In this book the data wise transactions of purchase are recorded. This book has six columns. In the first column the date of transaction is recorded, in second column invoice number is mentioned, in third column details of the transactions are kept, in the fourth column ledger folio number is given, and the last two columns are left for amount in the transaction. The proforma of the purchase day book is given below:

**Proforma of Purchase Book**

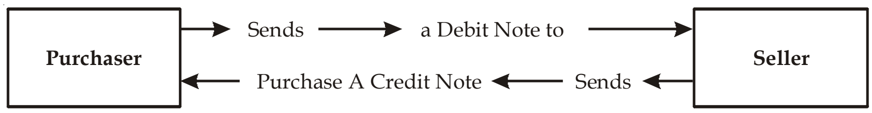
| Date | Invoice No. | Particulars | L.F. | Details (₹) | Amount (₹) |
|---|---|---|---|---|---|
| | | | | | |

2. ***Sales Book*** is known by the different names as Sales-Day-Book, or Sales Journal. In this book all the credit sales of goods are recorded. At the time of sale of goods an invoice is prepared. On the basis of this invoice, all the credit sales are recorded in this book. The sale of others except goods is recorded in the Journal Proper. Its columns are similar to that of the Purchase book. It is given below:

**Proforma of Sales Book**

| Date | Invoice No. | Particulars | L.F. | Details (₹) | Amount (₹) |
|---|---|---|---|---|---|
| | | | | | |

3. ***Purchase Return Book*** is also called Purchase Return Journal or Return Outward Book. In this book those goods are entered which are returned to the suppliers. If the goods were purchased in cash and returned, then such goods are not entered in this book. Entry for such goods is done in these books which were purchased on credit. When the goods are returned to the supplier, along with the goods a note is also sent to the supplier which carries all the details of the goods returned, such a note is called Debit note. It is prepared in duplicate copy. One copy is sent to the supplier and one copy is kept safe for future reference. This note in the hands of seller is called credit note. In other words purchaser will dispatch a debit note to the seller and seller will send a credit note to purchaser.



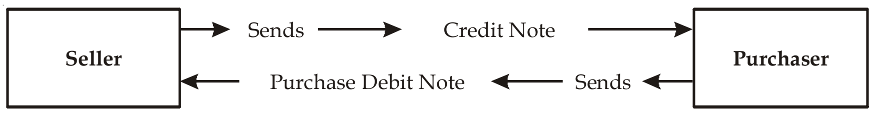

**Proforma of Purchase Return Book**

| Date | Debit Note No. | Particulars | L.F. | Details (₹) | Amount (₹) |
|---|---|---|---|---|---|
| | | | | | |

Notes

4. ***Sales Return Book*** is known as Sales Return Journal or Return Inwards Book. In the case of goods sold on credit some goods are being returned by the customers, such goods are recorded in this book. Here same columns are maintained as in the Purchase Return Book except Debit Note No. In the place of debit note no., credit note no. is given in this book.

   When some goods are returned by the customer, a note is provided to them which is called credit note. Credit note means that his account has been credited with the amount of goods return. This credit note works as a debit note for the party receiving back the goods. The customers debits the account of that party from whom it has been received. Thus




**Proforma of Sales Return Book**

| Date | Credit Note No. | Particulars | L.F. | Details (₹) | Amount (₹) |
|---|---|---|---|---|---|
| | | | | | |

5. ***Bills Receivable Book*** is also called the Bills Receivable Journal. When a company receives various bills from its debtors, details of all these bills are datewise recorded in the Bills Receivable Book. The proforma of this book is given below:

**Proforma of Bills Receivable Book**

| S.No. | Date | From whom received | Date of Bill | Period | Due Date | L.F. | Amount (₹) |
|---|---|---|---|---|---|---|---|
| | | | | | | | |

6. ***Bills Payable Book*** is also known as Bills Payable Journal. When the various bills are accepted for its various creditors, details of such bills are recorded in this book in chronological order. The proforma of this book is given below:

**Proforma of Bills Payable Book**

| S.No. | Date | From whom given | Date of Bill | Period | Due Date | L.F. | Amount (₹) |
|---|---|---|---|---|---|---|---|
| | | | | | | | |

## Journal Proper

According to the rules of accounting, all the business transactions are recorded into Journal first, and then they are posted in Ledger. If all the credit and cash transactions are recorded into Journal, there will be a large number of transactions and it will become too bulky. Therefore,

Notes

Journal is sub-divided into cash and credit transactions. Cash transactions are directly recorded into cash book and credit sales and credit purchase are directly recorded in the sales and purchase books and the remaining transactions are recorded into Journal Proper. These transactions may be relating to:

1. Opening Entry
2. Closing Entry
3. Transferring
4. Rectification, and
5. Adjustment

### Other Subsidiary Books

As per the nature of the business, the entrepreneurs may maintain some other books also. These may be:

1. Consignment Outwards Book
2. Sale and Return Book
3. Cash Collection Book
4. Cash Sales Book.

*Notes* Journalising can be generally categorized into following various categories:

1. Taking place within the same natured accounts
2. Taking part in between accounts of two different in categories.

***Illustration 4:*** Record the following transactions into various Subsidiary Books and Journal Proper of Mr. Shiv Kumar:

2008

| | |
|---|---|
| January 1 | Cash in hand ₹ 31,400, Cash at Bank ₹ 50,800 and Capital Account ₹ 82,200. |
| January 2 | Bought goods for cash ₹ 8,200. |
| January 5 | Purchased goods from Lalit Mohan & Co. for ₹ 11,600 less 10% trade discount. |
| January 7 | Sold goods to Shobhit & Co. for ₹ 17,800 less 20% trade discount. |
| January 9 | Withdrew ₹ 1,000 from bank for private use. |
| January 12 | Sold goods to Karim for ₹ 12,800. |
| January 15 | ₹ 10,000 paid to Lalit Mohan in full settlement of their claim. |
| January 18 | Goods worth ₹ 800 returned by Karim. |
| January 20 | Received ₹ 8,000 from Karim. |
| January 21 | Purchased goods from Krishna & Co. for ₹ 17,400. |
| January 23 | ₹ 12,000 paid to Krishna & Co. by cheque, discount allowed ₹ 600. |
| January 24 | Purchased furniture for ₹ 1,600 from Sardar Furniture House on credit. |

Notes

January 26 Paid into bank ₹ 4,400.

January 28 Karim declared insolvent, a first and final dividend of 50 paise in a rupee is received from him.

January 29 Goods worth ₹ 1,200 returned to Krishna & Co.

January 31 Interest on capital provided ₹ 822.

January 31 Goods worth ₹ 800 taken by Mr. Shiv Kumar for his personal use.

January 31 Paid salaries to staff ₹ 3,600.

January 31 Paid into bank ₹ 40,000.

January 31 Bought 200 shares in Dehradun Chemicals Ltd. at ₹ 11, per share Brokerage paid ₹ 50.

January 31 Received ₹ 11,800 from Shobhit & Co. discount allowed ₹ 200.

***Solution:***

**Journal Proper**

| Date | Particulars | | L.F. | Amount Dr. (₹) | Amount Cr. (₹) |
|---|---|---|---|---|---|
| 2008 | | | | | |
| January 01 | Cash Account | Dr. | | 31,400 | |
| | Bank Account | Dr. | | 50,800 | |
| | To Capital Account | | | | 82,200 |
| | (Entry made for opening balances) | | | | |
| January 24 | Furniture Account | Dr. | | 1,600 | |
| | To Sardar Furniture House | | | | 1,600 |
| | (Being purchase of furniture on credit from Sardar Furniture House) | | | | |
| January 28 | Bad Debts Account | Dr. | | 2,000 | |
| | To Karim | | | | 2,000 |
| | (On the insolvency of Karim 50 paise in a rupee received and balance treated as bad debts) | | | | |
| January 31 | Interest on Capital Account | Dr. | | 822 | |
| | To Capital Account | | | | 822 |
| | (Interest on capital charged) | | | | |
| January 31 | Drawing Account | Dr. | | 800 | |
| | To purchase Account | | | | 800 |
| | (Proprietor took goods for personal use) | | | | |
| January 31 | Capital Account | Dr. | | 1,800 | |
| | To Drawing Account | | | | 1,800 |
| | (Balance of drawing account transferred to Capital account) | | | | |
| | Total | | | 89,222 | 89,222 |

Notes

**Sales Book**

| Date | Particulars | L.F. | Details (₹) | Amount (₹) |
|---|---|---|---|---|
| 2008 | | | | |
| Jan. 7 | Shobhit & Co.: Sale of goods | | 17,800 | |
| | (–) 20% discount | | 3,560 | 14,240 |
| Jan. 12 | Karim: Sale of goods | | | 12,800 |
| Jan. 31 | Total: Sale – Credit balance | | | 27,040 |

**Purchase Book**

| Date | Particulars | L.F. | Details (₹) | Amount (₹) |
|---|---|---|---|---|
| 2008 | | | | |
| Jan. 5 | Lalit Mohan & Co.: Goods purchased | | 11,600 | |
| | (–) 10% Discount | | 1,160 | 10,440 |
| Jan. 21 | Krishna & Co. | | | 17,400 |
| Jan. 31 | Total: Purchases debited | | | 27,840 |

**Sales Return Book**

| Date | Particulars | L.F. | Details (₹) | Amount (₹) |
|---|---|---|---|---|
| 2008 | | | | |
| Jan. 18 | Karim: Sales return | | 800 | |
| Jan. 31 | Sales Return debited | | | 800 |

**Purchase Return Book**

| Date | Particulars | L.F. | Details (₹) | Amount (₹) |
|---|---|---|---|---|
| 2008 | | | | |
| Jan. 29 | Krishna & Co.: Returns | | 1,200 | |
| Jan. 31 | Purchase Returns Credited | | | 1,200 |

*Caution* The points to be observed at the moment of journalising:

1. The nature of the accounts to be identified
2. The accounts to be correlated to the golden rules
3. The entry to be passed through proper debiting and crediting of the accounts respectively.

Notes

| Date | Particulars | L.F. | Discount (₹) | Cash (₹) | Bank (₹) | Date | Particulars | L.F. | Discount (₹) | Cash (₹) | Bank (₹) |
|---|---|---|---|---|---|---|---|---|---|---|---|
| 2008 | | | | | | 2008 | | | | | |
| Jan 1 | To balance | | - | 31,400 | 50,800 | Jan 2 | By Purchases A/c | | - | 8,200 | - |
| | b/d | | | | | Jan 9 | By Drawings A/c | | - | - | 1,000 |
| Jan 20 | To Karim | | - | 8,000 | - | Jan 15 | By Lalit Mohan | | 440 | 10,000 | - |
| Jan 26 | To cash A/c | c | - | - | 4,400 | Jan 23 | By Krishna & Co. | | 600 | - | 12,000 |
| Jan 28 | To Karim | | - | 2,000 | - | Jan 26 | By Bank A/c | c | - | 4,400 | |
| Jan 31 | To sales A/c | | - | 43,600 | - | Jan 31 | By Advertisement A/c | | - | - | 1,000 |
| Jan 31 | To cash | c | - | - | 40,000 | Jan 31 | By Salaries A/c | | - | 3,600 | - |
| Jan 31 | To Shobhit & Co. | | 200 | 11,800 | - | Jan 31 | By Bank A/c | | - | 40,000 | - |
| | | | | | | Jan 31 | By Investment A/c | c | - | 2,250 | - |
| | | | | | | Jan 31 | By Balance C/d | | - | 28,350 | 81,200 |
| | | | 200 | 96,800 | 95,200 | | | | 1,040 | 96,800 | 95,200 |
| Feb 1 | To balance b/d | | | 28,350 | 81,200 | | | | | | |

*Task* Identify nature of the transactions:

Ramchander has purchased goods on credit from M/s Royals Aventis for ₹ 15,000. The portions of the goods were found to be damaged which worth of ₹ 5,000. Ramchander immediately returned the damaged goods to Royals.

1. Identify the various types of accounts involved in the above illustrated transactions.
2. Pass the journal entries with regards to the nature of accounts involved.

## Self Assessment

Fill in the blanks:

1. Journalising is the process of entering transactions in …………………….
2. Another name for Journal is …………………….
3. Transactions, when recorded in Journal, are known as …………………….
4. The explanation of a Journal entry is known as …………………….
5. In a Journal entry preposition …………………… is used before the name of the account to be credited.
6. Journal is a …………………… of original entries for accounting data.
7. The journal is known as the …………………….
8. The process of transferring the entries from Journal to Ledger accounts is called …………………….

## 5.2 Ledger

Journal of a business is very useful but it does not reply the different queries as how much amount is due from debtors, how much is to be paid to creditors and what is the balance of a particular account etc. For the reply of all these queries the ledger is prepared from the Journal entries. Ledger is the set of accounts in which all types of account (personal, real or nominal) are kept. There can be two forms of ledger:

(a) Bound Ledger

(b) Loose Leaf Ledger

A ledger in traditional way, is normally kept in the form of bound note books. In bigger business enterprises, it is not easy to maintain a large and variety of transaction in a single book. To overcome this difficulty, loose leaf shuts takes the place of bound books.

Under loose leaf ledger, appropriate sheets are introduced. Additional pages may be added to any extent, completed account may be removed to reduced volume, any account may be rearranged so as to suit the needs of the enterprises. This mode of maintaining ledger in the form of loose sheets is called loose leaf ledger.

### Posting

The process of transferring the entries from Journal to Ledger accounts is called posting. In other words account wise selection of debit or credit items and recording them into the relevant side of the relevant account is called posting. The process of posting is done after a period as week,

Notes

fortnight or a month. For example, if rent as an expense is shown in the debit in Journal, this will be posted in the debit side of the Rent (Expenses) A/c in the Journal. The proforma of a Ledger account is given below:

**Proforma of an Account**
**Name of Account………**

| Date | Particulars | L.F. | Amount (Dr.) (₹) | Date | Particulars | L.F. | Amount (Cr.) (₹) |
|---|---|---|---|---|---|---|---|
| | | | | | | | |

In the above proforma of an account, there are two sides of an account. Left hand side is debit side and right hand side is credit side. In both the sides, the first column is for date and second column for details, third column for the Journal folio number and in the last column the amount of the transaction is recorded.

### Rules of Posting in Ledger Account

At the time of posting of transactions from Journal to ledger the following points/rules should be kept in mind:

1. In the debit side of a ledger account, the word 'To' is used while in the credit side word 'By' is used.
2. All those accounts are opened in the Ledger which are given in the Journal.
3. All the debit items of an account given in Journal are posted in the debit side of the respective account. And all the credit items of an account given in Journal are posted in the credit side of the respective account in ledger.
4. The name of the account, in which posting is being made, is not written. But the posting is done by the name of other account given in the opposite side of that entry in the Journal.
5. At the time of posting if the page is full and account is not complete, its total is carried to the next page and then remaining posting is done.

## 5.3 Balancing

There can be several transactions relating to a particular account in the different places in the Journal. Such transactions are collected and recorded in the concerned account. At the end of the accounting period, the businessman becomes interested to know the position of these accounts. The position of an account is determined by calculating the net balance of the account for which debit and credit sides of the account are totalled separately. If total of debit side is greater than the total of credit side, difference is written in the credit side of the account and that is carried to next year. And if the total of credit side is greater than the total of debit side, difference is written in debit side and carried to next year. Thus totals of both the sides become equal and account is closed.

*Did u know?* **How are the account transactions classified?**

The accounts are classified through the preparation of ledger.

## Balancing of Different types of Accounts

Notes

***Assets:*** All asset accounts are balanced. These accounts always have a debit balance.

***Liabilities:*** All Liability accounts are balanced. All these accounts have a credit balance.

***Capital:*** This account is always balanced and usually has a credit balance.

***Expense and Revenues:*** These Accounts are not balanced but are simply totaled up. The debit total of Expense/Loss will show the expense/Loss. In the same manner, credit total of Revenue/

Income will show increase in income. At the time of preparing the Trial Balance, the totals of these are taken to the Trial Balance.

*Example:* Record the following transactions in the Journal and post them into Ledger of Mr. Aditya Raj:

| **2008** | | **(₹)** |
|---|---|---|
| March 1 | Purchase of Goods from Ramautar | 3,20,000 |
| March 10 | Paid Rent for the month | 2,000 |
| March 11 | Purchase of Plant | 1,00,000 |
| March 12 | Paid Salaries | 12,000 |
| March 15 | Paid Ramautar | 1,00,000 |
| March 20 | Sold Goods to Shyam | 20,000 |
| March 25 | Received from Shyam | 30,000 |
| March 31 | Reserved Cash from Cash Sales | 2,50,000 |
| March 31 | Wages Paid | 5,000 |

***Solution:***

**Journal of Mr. Aditya Raj**

| Date | Particulars | | L.F. | Amount (Dr.) (₹) | Amount (Cr.) (₹) |
|---|---|---|---|---|---|
| 2008 | | | | | |
| March 1 | Purchase Account | Dr. | | 3,20,000 | |
| | To Ramautar | | | | 3,20,000 |
| | (Being purchase of goods on credit) | | | | |
| March 10 | Rent Account | Dr. | | 2,000 | |
| | To Cash Account | | | | 2,000 |
| | (Being payment of rent) | | | | |
| March 11 | Plant Account | Dr. | | 1,00,000 | |
| | To Cash Account | | | | 1,00,000 |
| | (Being purchase of plant) | | | | |
| March 12 | Salaries Account | Dr. | | 12,000 | |
| | To Cash Account | | | | 12,000 |
| | (Being payment of salaries) | | | | |

*Contd...*

Notes

| | | | | | |
|---|---|---|---|---|---|
| March 15 | Ramautar | Dr. | | 1,00,000 | |
| | To Cash Account | | | | 1,00,000 |
| | (Being payment to Ramautar) | | | | |
| March 20 | Shyam | Dr. | | 20,000 | |
| | To Sales Account | | | | 20,000 |
| | (Being goods sold on credit) | | | | |
| March 25 | Cash Account | Dr. | | 30,000 | |
| | To Shyam | | | | 30,000 |
| | (Being receipts of cash) | | | | |
| March 31 | Cash Account | Dr. | | 2,50,000 | |
| | To Sales Account | | | | 2,50,000 |
| | (Being goods sold in cash) | | | | |
| March 31 | Wages Account | Dr. | | 5,000 | |
| | To Cash Account | | | | 5,000 |
| | (Being payment of wages) | | | | |
| | Total | | | 8,39,000 | 8,39,000 |

**Ledger**
**Cash Account**

| Date | Particulars | L.F. | Debit (₹) | Date | Particulars | L.F. | Credit (₹) |
|---|---|---|---|---|---|---|---|
| 2008 | | | | 2008 | | | |
| March 25 | To Shyam | | 30,000 | March 10 | By Rent A/c | | 2,000 |
| March 31 | To Sales A/c | | 2,50,000 | March 11 | By Plant A/c | | 1,00,000 |
| | | | | March 12 | By Salaries A/c | | 12,000 |
| | | | | March 15 | By Ramautar | | 1,00,000 |
| | | | | March 31 | By Wages | | 5,000 |
| | | | | March 31 | By Balance c/d | | 61,000 |
| | | | 2,80,000 | | | | 2,80,000 |
| 2008 April 1 | To Balance b/d | | 61,000 | | | | |

**Purchase Account**

| | | | | | | | |
|---|---|---|---|---|---|---|---|
| 2008 | | | (₹) | 2008 | | | (₹) |
| March 1 | To Ramautar | | 3,20,000 | March 31 | By Balance c/d | | 3,20,000 |
| | | | 3,20,000 | | | | 3,20,000 |
| 2008 April 1 | To Balance b/d | | 3,20,000 | | | | |

**Ramautar's Account**

| | | | | | | | |
|---|---|---|---|---|---|---|---|
| 2008 | | | (₹) | 2008 | | | (₹) |
| March 15 | To Cash A/c | | 1,00,000 | March 1 | By Purchase A/c | | 3,20,000 |
| March 31 | To Balance c/d | | 2,20,000 | | | | |
| | | | 3,20,000 | | | | 3,20,000 |
| | | | | April 1 | To Balance b/d | | 2,20,000 |

Notes

**Rent Account**

| | | | | | | | |
|---|---|---|---|---|---|---|---|
| 2008 | | | (₹) | 2008 | | | (₹) |
| March 10 | To Cash A/c | | 2,000 | March 31 | By Balance c/d | | 2,000 |
| | | | 2,000 | | | | 2,000 |
| 2008<br>April 1 | To Balance b/d | | 2,000 | | | | |

**Plant Account**

| | | | | | | | |
|---|---|---|---|---|---|---|---|
| 2008 | | | (₹) | 2008 | | | (₹) |
| March 11 | To Cash A/c | | 1,00,000 | March 31 | By Balance c/d | | 1,00,000 |
| | | | 1,00,000 | | | | 1,00,000 |
| 2008<br>April 1 | To Balance b/d | | 1,00,000 | | | | |

**Salaries Account**

| | | | | | | | |
|---|---|---|---|---|---|---|---|
| 2008 | | | (₹) | 2008 | | | (₹) |
| March 12 | To Cash A/c | | 12,000 | March 31 | By Balance c/d | | 12,000 |
| | | | 12,000 | | | | 12,000 |
| 2008<br>April 1 | To Balance b/d | | 12,000 | | | | |

**Shyam's Account**

| | | | | | | | |
|---|---|---|---|---|---|---|---|
| 2008 | | | (₹) | 2008 | | | (₹) |
| March 20 | To Sales A/c | | 20,000 | March 31 | By Balance c/d | | 30,000 |
| March 31 | To Balance b/d | | 10,000 | | | | |
| | | | 30,000 | | | | 30,000 |
| | | | | April 1 | To Balance b/d | | 10,000 |

**Sales Account**

| | | | | | | | |
|---|---|---|---|---|---|---|---|
| 2008 | | | (₹) | 2008 | | | (₹) |
| March 1 | To Balance b/d | | 2,70,000 | March 20 | By Shyam | | 20,000 |
| | | | | March 31 | By Cash A/c | | 2,50,000 |
| | | | 2,70,000 | | | | 2,70,000 |
| | | | | April 1 | To Balance b/d | | 2,70,000 |

**Wages Account**

| | | | | | | | |
|---|---|---|---|---|---|---|---|
| 2008 | | | (₹) | 2008 | | | (₹) |
| March 31 | To Cash A/c | | 5,000 | March 31 | To Balance c/d | | 5,000 |
| | | | 5,000 | | | | 5,000 |
| 2008<br>April 1 | To Balance b/d | | 5,000 | | | | |

Notes

Journalise the following transactions and post them in the ledger 2011.

| | | |
|---|---|---|
| January 1: | Commenced business with cash | 50000 |
| January 3: | Paid into bank | 25000 |
| January 5: | Purchased furniture for cash | 5000 |
| January 8: | Purchased goods and paid by cheque | 15000 |
| January 8: | Paid for carriage | 500 |
| January 14: | Purchased Goods from K. Murthy | 35000 |
| January 18: | Cash Sales | 32000 |
| January 20: | Sold Goods to Ashok on credit | 28000 |
| January 25: | Paid cash to K. Murthy in full settlement | 34200 |
| January 28: | Cash received from Ashok | 20000 |
| January 31: | Paid Rent for the month | 2000 |
| January 31: | Withdrew from bank for private use | 2500 |

***Solution:***

**Journal**

| Date | Particulars | L.F. | Amount (Dr.) (₹) | Amount (Cr.) (₹) |
|---|---|---|---|---|
| 2007 | | | | |
| Jan. 1 | Cash A/c Dr. | | 50,000 | |
| | To Capital A/c | | | 50,000 |
| | (Commenced business with cash) | | | |
| Jan. 3 | Bank A/c Dr. | | 25,000 | |
| | To Cash A/c | | | 25,000 |
| | (Cash paid in the Bank) | | | |
| Jan. 5 | Furniture A/c Dr. | | 5,000 | |
| | To Cash A/c | | | 5,000 |
| | (Purchased furniture for cash) | | | |
| Jan. 8 | Purchase A/c Dr. | | 15,000 | |
| | To Bank A/c | | | 15,000 |
| | (Purchased goods and paid by cheque) | | | |
| Jan. 8 | Carriage A/c Dr. | | 500 | |
| | To Cash A/c | | | 500 |
| | (Cash paid for carriage charges) | | | |
| Jan. 14 | Purchase A/c Dr. | | 35,000 | |
| | To K. Murthy | | | 35,000 |
| | (Goods purchased on credit) | | | |
| Jan. 18 | Cash A/c Dr. | | 32,000 | |
| | To Sales A/c | | | 32,000 |
| | (Goods sold for cash) | | | |

*Contd...*

Notes

| | | | | | |
|---|---|---|---|---|---|
| Jan. 20 | Ashok | Dr. | | 28,000 | |
| | To Sales A/c | | | | 28,000 |
| | (Goods sold to Ashok credit) | | | | |
| Jan. 25 | K Murthy | Dr. | | 35,000 | |
| | To Cash A/c | | | | 34,200 |
| | To Discount A/c | | | | 800 |
| | (Cash paid to K. Murthy a discount allowed by them) | | | | |
| Jan. 28 | Cash A/c | Dr. | | 20,000 | |
| | To Ashok | | | | 20,000 |
| | (Cash received from Ashok on Account) | | | | |
| Jan. 31 | Rent A/c | Dr. | | 2,000 | |
| | To Cash A/c | | | | 2,000 |
| | (Cash paid for rent) | | | | |
| Jan. 31 | Drawings A/c | Dr. | | 2,500 | |
| | To Bank A/c | | | | 2,500 |
| | (Cash withdrawn from bank for domestic use) | | | | |

**Ledger**
**Cash A/c**

**Dr.** **Cr.**

| Date | Particulars | J.F. | Amount (₹) | Date | Particulars | J.F. | Amount (₹) |
|---|---|---|---|---|---|---|---|
| 2006 | | | | 2006 | | | |
| Jan. 1 | Capital A/c | | 50,000 | Jan. 3 | Bank A/c | | 25,000 |
| Jan. 18 | Sales A/c | | 32,000 | Jan. 5 | Furniture | | 5,000 |
| Jan. 28 | Ashok | | 20,000 | Jan. 8 | Carriage | | 500 |
| | | | | Jan. 25 | K. Murthi | | 34,200 |
| | | | | Jan. 31 | Rent A/c | | 2,000 |
| | | | | Jan. 31 | Balance c/d | | 35,300 |
| | | | 1,02,000 | | | | 1,02,000 |
| Feb. 1 | Balance b/d | | 35,300 | | | | |

**Capital A/c**

| | | | | | | | |
|---|---|---|---|---|---|---|---|
| 2006 | | | (₹) | 2006 | | | (₹) |
| Jan. 31 | Balance c/d | | 50,000 | Jan. 1 | Cash A/c | | 50,000 |
| | | | | Feb. 1 | Balance b/d | | 50,000 |

**Bank A/c**

| | | | | | | | |
|---|---|---|---|---|---|---|---|
| 2006 | | | (₹) | 2006 | | | (₹) |
| Jan. 2 | Cash A/c | | 25,000 | Jan. 8 | Purchases A/c | | 15,000 |
| | | | | Jan. 31 | Drawings A/c | | 2,500 |
| | | | | Jan. 31 | Balance c/d | | 7,500 |
| | | | 25,000 | | | | 25,000 |
| Feb. 1 | Balance b/d | | 7,500 | | | | |

Notes

**Furniture A/c**

Dr. Cr.

| Date | Particulars | J.F. | Amount (₹) | Date | Particulars | J.F. | Amount (₹) |
|---|---|---|---|---|---|---|---|
| 2006 | | | | 2006 | | | |
| Jan. 1 | Cash A/c | | 5,000 | Jan. 31 | Balance c/d | | 5,000 |
| Feb. 1 | Balance b/d | | 5,000 | | | | |

**Purchase A/c**

Dr. Cr.

| Date | Particulars | J.F. | Amount (₹) | Date | Particulars | J.F. | Amount (₹) |
|---|---|---|---|---|---|---|---|
| 2006 | | | | | | | |
| Jan. 8 | Bank | | 15,000 | | Trading A/c | | 50,000 |
| Jan. 14 | K. Murthy | | 35,000 | | | | |
| | | | 50,000 | | | | 50,000 |

**Carriage A/c**

Dr. Cr.

| Date | Particulars | J.F. | Amount (₹) | Date | Particulars | J.F. | Amount (₹) |
|---|---|---|---|---|---|---|---|
| 2006 | | | | | | | |
| Jan. 8 | Cash | | 500 | | Trading A/c | | 500 |
| | | | 500 | | | | 500 |

**K. Murthy A/c**

Dr. Cr.

| Date | Particulars | J.F. | Amount (₹) | Date | Particulars | J.F. | Amount (₹) |
|---|---|---|---|---|---|---|---|
| 2006 | | | | 2006 | | | |
| Jan. 25 | Cash | | 34,200 | Jan. 14 | Purchases | | 35,000 |
| Jan. 25 | Discount | | 800 | | | | |
| | | | 35,000 | | | | 35,000 |

**Sales A/c**

Dr. Cr.

| Date | Particulars | J.F. | Amount (₹) | Date | Particulars | J.F. | Amount (₹) |
|---|---|---|---|---|---|---|---|
| 2006 | | | | 2006 | | | |
| Jan. 1 | Trading A/c | | 60,000 | Jan. 18 | Cash | | 32,000 |
| | | | | Jan. 20 | Ashok | | 28,000 |
| | | | 60,000 | | | | 60,000 |

Notes

**Ashok A/c**

**Dr.** **Cr.**

| Date | Particulars | J.F. | Amount (₹) | Date | Particulars | J.F. | Amount (₹) |
|---|---|---|---|---|---|---|---|
| 2006 | | | | 2006 | | | |
| Jan. 20 | Sales A/c | | 28,000 | Jan. 28 | Cash | | 20,000 |
| | | | | Jan. 31 | Balance c/d | | 8,000 |
| | | | 28,000 | | | | 28,000 |
| Feb. 1 | Balance b/d | | 8,000 | | | | |

**Rent A/c**

**Dr.** **Cr.**

| Date | Particulars | J.F. | Amount (₹) | Date | Particulars | J.F. | Amount (₹) |
|---|---|---|---|---|---|---|---|
| 2006 | | | | 2006 | | | |
| | Cash A/c | | 2,000 | | Profit & Loss A/c | | 2,000 |
| | | | 2,000 | | | | 2,000 |

**Drawing A/c**

**Dr.** **Cr.**

| Date | Particulars | J.F. | Amount (₹) | Date | Particulars | J.F. | Amount (₹) |
|---|---|---|---|---|---|---|---|
| 2006 | | | | 2006 | | | |
| Jan. 10 | Bank | | 2,500 | Jan. 31 | Balance c/d | | 2,500 |
| | | | 2,500 | | | | 2,500 |
| Feb. 1 | Balance b/d | | 2,500 | | | | |

*Task* Following are the transactions of Dhani Ram and Sons for the month of July 2006. Make journal entries, post them into ledger and balance the account.

| | | |
|---|---|---|
| 2006 | | (₹) |
| July 1 | Commenced business with cash | 60,000 |
| July 2 | Paid into bank | 40,000 |
| July 5 | Purchased furniture for cash | 5000 |
| July 7 | Purchased Goods and paid for them by cheque | 20000 |
| July 10 | Sold Goods to Lata Gupta for cash | 12000 |
| July 12 | Sold Goods to Mahavir on credit | 24000 |
| July 18 | Purchased Goods from Harish | 30000 |
| July 19 | Withdrew cash for domestic use | 2500 |
| July 20 | Received a cheque from Mahavir on account | 18900 |
| | Allowed him discount | 100 |

*Contd...*

Notes

| | | |
|---|---|---|
| July 27 | Paid to Harish cash on account | 16800 |
| | Discount allowed by him | 200 |
| July 31 | Paid salary by cheque | 1800 |
| | Paid cash for telephone bill | 600 |

### Self Assessment

Fill in the blanks:

9. Ledger contains various...................... in it.
10. The process of transfer of entries from Journal and special purpose books to ledger is called......................
11. Ledger is also called......................
12. Ledger is a...................... book of accounting system.
13. Classification of transactions is being done only on the basis of preparing the......................

## 5.4 Summary

- Journal is the first book of the original entries in which all the business transactions of the financial nature are recorded, then posted to ledger accounts.
- Accounts are of three types – Personal, Real and Nominal Account.
- Rules of Debiting and Crediting in Journal –

  Personal A/c – Receiver – Debit and Giver-Credit

  Real A/c – What comes in – Debit, What goes out – Credit

  Nominal Account – Expenses and Losses are Debited and Income and Gains are credited
- Subsidiary Books of Original Entries are classified into – Cash Book, Special Journal, Journal Proper and Others.
- Posting is the process of selecting of transactions from Journal on the basis of accounts and writing them into ledger accounts.
- To test the arithmetical accuracy of the ledger accounts, the Trial Balance is prepared. Trial Balance is the list of accounts taken from ledger.
- An expenditure done to get the advantages in the business for a long period is called capital expenditure and if it is done for a short period and during the normal course of business, it is called Revenue expenditure.
- Ledger is nothing but preliminary book of accounting transactions at which, each account is separately maintained through the allotment of various pages for exclusive recording.
- Posting is the process of selecting of transactions from Journal on the basis of accounts and writing them into ledger accounts.

## 5.5 Keywords

**Notes**

***Credit:*** Giver in Personal Account, Going assets in Real Accounts and Incomes in Nominal Accounts.

***Debit:*** Receiver in Personal Account, Coming Assets in Real Account and Expenses in Nominal Accounts.

***Double Entry System:*** Accounting which is based on the two aspects of the transactions.

***Journal:*** The primary book in which the transactions are recorded first time.

***Ledger:*** It is the classification of accounts in which various accounts are maintained.

***Nominal A/c.:*** Accounts of incomes, expenses and gains or losses.

***Personal A/c.:*** Accounts which are related to person, firms, companies and representatives.

***Process of Accounting:*** It includes the recording of transactions into Journal, classifying into Ledger and summarizing into Trial Balance and Final Accounts.

***Real A/c:*** All the assets accounts are included into it.

## 5.6 Review Questions

1. What do you mean by Posting? Give the rules of posting.
2. What are the key steps in balancing a ledger A/c?
3. State the relation between journalizing and ledger posting with suitable examples.
4. Why is ledger known as the primary book or the principal-book of accounts? Can profit of the business and its financial position be known without maintaining ledger?
5. What is the rule for posting the debit account from the journal into the ledger account?
6. Why is ledger prepared?
7. Enumerate the various types of ledgers which may be maintained by a business.
8. Mr. Kamal Nath was doing a business as a cloth merchant. On 1st July, 2007 his assets were: Furniture and Office Equipment = ₹12,500, Stock ₹1,25,000 Cash in Hand ₹3,000, Bank Balance ₹42,500, Amounts due from Brijesh ₹6,000, Amount due from Girijesh ₹7,500. On the date he owed ₹10,000 to Manish and ₹7,250 to Naresh. His transactions during the month were as follows. You have to Journalise these transactions and from that information prepare his Ledger.

| **2008** | | **(₹)** |
|---|---|---|
| July 2 | Sold cloth on credit to Xavier | 2,500 |
| July 3 | Purchased cloth from Yogesh | 10,000 |
| July 4 | Paid Rent by cheque | 4,000 |
| July 5 | Purchase of cloth by cheque | 10,000 |
| July 7 | Cash sales | 2,250 |
| July 8 | Received cheque from Brijesh | 5,900 |
| | Allowed him discount | 100 |

Notes

| | | |
|---|---|---|
| July 9 | Paid for stationery | 250 |
| July 10 | Drawn cash for private use | 1,250 |
| July 11 | Purchased cloth on credit from Manish | 12,500 |
| July 12 | Sent cheque to Manish (in full settlement for July 1 transactions) | 9,750 |
| July 13 | Sold cloth on credit to Girijesh | 9,000 |
| July 14 | Paid telephone charges | 400 |
| July 15 | Cash Sales | 1,500 |
| July 18 | Paid for Advertisement | 1,750 |
| July 19 | Cash Purchases | 3,000 |
| July 30 | Paid Salaries for July | 4,000 |

9. Prepare the account of X & Co. from the following:

| **2006** | | **(₹)** |
|---|---|---|
| Feb 1 | Balance due from X & Co. | 1,000 |
| Feb 3 | Cash sales to X & Co. | 700 |
| Feb 4 | Bought furniture from X & Co. | 250 |
| Feb 6 | Murthy returned goods to us | 200 |
| Feb 9 | X & Co. Purchased goods from us | 1,200 |
| Feb 10 | Return of goods from X & Co. | 150 |
| Feb 20 | X & Co. settled his account by cheque and received discount | 20 |

10. Journalize the following transactions in the Books of Ranga Rao with Narration.

| **2006** | | **(₹)** |
|---|---|---|
| June 1 | Ram commenced business with cash | 10,000 |
| June 2 | Paid to Bank | 8,000 |
| June 3 | Bought goods for cash | 500 |
| June 4 | Bought Furniture for office | 400 |
| June 10 | Withdrew from Bank cash for office | 1,000 |
| June 13 | Goods sold to Shyam | 600 |
| June 15 | Bought goods of Krishan | 410 |
| June 18 | Trade Expenses paid | 100 |
| June 19 | Received cash from Shyam | 590 |
| | Allowed him discount | 10 |
| June 25 | Wages paid | 50 |
| June 28 | Krishan paid off in full settlement of his account | 400 |
| June 30 | Rent paid | 100 |
| June 30 | Interest on capital | 500 |

11. The following were the transactions of Delite Furniture, Delhi during July 2006

| **2006** | | **(₹)** |
|---|---|---|
| July 1 | Started business with | |
| | Cash | 3,500 |
| | Bank | 9,200 |
| July 3 | Bought furniture from M/s New Light | 2,000 |
| July 5 | Bought furniture for the office | 1,000 |
| July 6 | Sold furniture to Roop | 2,000 |
| July 8 | Bought furniture | 1,800 |
| July 10 | Returned furniture to M/s New Light | 50 |
| July 12 | Roop returned furniture | 200 |
| July 14 | Paid taxi fare | 10 |
| July 15 | Sold furniture to Sanjay for ₹ 500 | |
| | Less trade discount @ 10% | |
| July 17 | Received Commission | 15 |
| July 18 | Paid to New light by cheque | 1,000 |
| July 19 | Paid to Bank | 200 |
| July 22 | Received a cheque for ₹ 500 from Roop and deposited the same in Bank. | 500 |
| July 23 | Paid Rent to Naresh | |
| July 24 | Roop's cheque dishonoured. | 150 |
| July 25 | Furniture taken for personal use | 400 |
| July 26 | Received interest | 10 |
| July 27 | Received dividend | 25 |
| July 29 | Postage stamp paid | 5 |
| July 30 | Paid house rent by cheque | 100 |
| July 31 | Withdrawn from bank for office use | 2,000 |
| July 31 | Salary paid | 300 |
| July 31 | Taxes paid | 250 |

You are required to journalize the above transactions in the books of M/s Delite Furniture and post them in their respective ledger accounts.

12. Classify the following accounts as per modern classification of accounts:

(a) Cash brought in as capital

(b) Machinery purchased

(c) Goods sold for cash

(d) Goods purchased for cash

(e) Goods sold for credit

(f) Goods purchased on credit

(g) Rent Paid

Notes

(h) Dividend Received

(i) Discount allowed

(j) Discount received

(k) Plant purchased

(l) Furniture sold.

(m) Withdrew for personal use

(n) Cash received from debtors

(o) Electricity Paid

(p) Wages Paid

(q) Royalty Received

(r) Bad debts written off

(s) Bank overdraft

(t) Purchases returns /returns inward

(u) Sales returns/returns out ward.

(v) Purchases during the period

(w) Sales during the period.

13. Journalise/explain the rule of debit and credit in the following cases, indicating clearly the nature of the accounts.

| | | |
|---|---|---|
| July 1 | Goods purchased from Rao for | ₹ 20,000 |
| July 5 | Goods sold for cash | ₹ 4,000 |
| July 7 | Paid to Rao | ₹ 10,000 |
| July 10 | Goods purchased for cash | ₹ 3,000 |
| July 17 | Paid salaries | ₹ 5,000 |
| July 24 | Goods sold to Reddy | ₹ 12,000 |
| July 31 | Rent paid | ₹ 2,000 |
| July 31 | Interest received | ₹ 1,000 |

14. M/s Harisaran & Sons, Delhi took on 1.1.2006 a fire insurance policy for ₹ 1,00,000. Paying ₹ 2,000 as premium during the year. On 1.7.06 Goods were destroyed by fire for ₹ 1,50,000. The Insurance company agreed to pay ₹ 85,000 on 1.8.06. Journalise the above in the books of M/s Harisaran & Sons.

15. How do we balance the following types of accounts?

(a) Assets

(b) Expense

(c) Capital

(d) Revenue

Notes

## Answers: Self Assessment

1. The journal
2. Original book of entries/Primary Book of entries
3. Entries
4. Narration
5. 'To'
6. Primary book
7. Book of original entry
8. Posting
9. Accounts
10. Posting
11. Principal Book of Account
12. Reference book
13. Ledger accounts

## 5.7 Further Readings

*Books*

Khan and Jain, "Management Accounting".

M.P. Pandikumar, "Accounting & Finance for Managers", Excel Books, New Delhi.

R.L. Gupta and Radhaswamy, "Advanced Accountancy".

S.N. Maheswari, "Management Accounting".

V.K. Goyal, "Financial Accounting", Excel Books, New Delhi.

*Online links*

http://www.globusz.com/

www.futureaccountant.com

Notes

# Unit 6: Subsidiary Books

CONTENTS



## Objectives

After studying this unit, you will be able to:

- Prepare Subsidiary books
- Initiate Purchase and purchase return book
- Construct Sales and sales return book

## Introduction

Before we list various books into which the journal is sub-divided, let us understand the basis for its subdivision. You may adopt any basis. But, the principle generally followed is that transactions of the same nature are to be recorded at one place. For example, the cash receipts and cash payments may be grouped into one category and recorded in a separate book. Similarly, all credit purchases of goods may be grouped into one category, all credit sales of goods into another category and recorded in separate books.

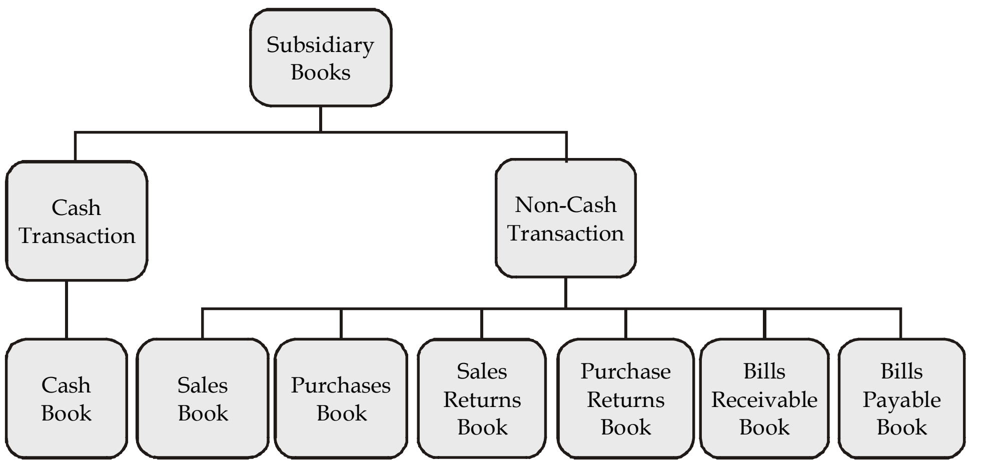
## 6.1 Meaning of Subsidiary Books

In the past, traders use to keep record of the transaction in the journal. But it was later found not convenient. If all the transaction is recorded in the journal then the journal book becomes more thick and difficult to handle it. In big business houses, it becomes impossible to carry on the work of recording business transaction. Therefore now a days large scale business firms like to keep record of transaction in subsidiary books instead of journal. Subsidiary books are the book of original entry and it is also called primary records because the first entry of transaction is made in subsidiary books. Subsidiary Books refers to books meant for specific transactions of similar nature. Subsidiary Books are also known as Special journals or day books. To overcome shortcoming of the use of the journal only as a book of original entry, the journal is subdivided into specific journals or subsidiary books. In practice, the journal is sub-divided in such a way that a separate book is used for each category of transactions which are repetitive in nature and are sufficiently large in number. In any large business the following subsidiary books are generally used.

1. ***Cash Book:*** It is used for recording all receipts and payments of cash, including cash purchases and cash sales of goods.
2. ***Purchases Book:*** It is used for recording credit purchases of goods only.
3. ***Purchases Returns Book:*** It is used for recording goods returned to suppliers.
4. ***Sales Journal:*** It is used for recording credit sales of goods only.
5. ***Sales Returns Book:*** It is used for recording goods returned by the customers.
6. ***Bills Receivable Book:*** It is used for recording bills of exchange and promissory notes received from the debtors.
7. ***Bills Payable Book:*** It is used for recording bills of exchange and promissory notes accepted by the business in favor of creditors.
8. ***Journal Proper:*** This book is used for recording all such transactions which are not covered by any of the above mentioned special journals, for example, credit purchases of fixed assets, opening entry, rectification entries, etc.

It must, however, be noted that there is no rigidity as to the number of special journals. Depending on the necessity, the number of journals may be increased or decreased.

**Figure 6.1**



Notes

*Did u know?* **What is meant by the Non-cash transaction?**

A non-cash transaction is a transaction in terms of credit and conditions of the enterprise.

The non-cash transactions shall include the following transactions of the enterprise, which do not involve any cash; they are as follows:

1. Credit sales Book
2. Credit purchases Book
3. Credit Sales Return Book
4. Credit Purchases Return Book
5. Bills Payable Book – Outcome of Credit transaction, and
6. Bill Receivable Book – Outcome of Credit transaction

### 6.1.1 Advantages of Subsidiary Books

The following are the advantages of having a number of subsidiary books:

1. ***Classification of transactions becomes automatic:*** As there is a separate book for each type of transactions, the transactions of same nature are automatically brought at one place.
2. ***Reference becomes easy:*** If any reference is required, it can be traced easily by referring to the appropriate subsidiary book. You do not have to go through all the transactions recorded in the journal.
3. ***Facilitates division of work:*** The division of journal into various subsidiary books facilitates division of work among many persons. This, in turn, facilitates prompt recording of transactions and saves a lot of time.
4. ***More particulars:*** More details about the transactions can be given-in subsidiary books than would be possible in one book.
5. ***Responsibility can be fixed:*** The work of maintaining a particular book can be entrusted to a particular person. He will be responsible for keeping it up-to-date and in order.
6. ***Facilitates checking:*** When the Trial Balance does not agree, the location of errors will be relatively easy.

## 6.2 Cash Book

Having outlined various subsidiary books, we shall now discuss the most important subsidiary book called 'Cash Book'. Cash book is the book of accounts where most of the transactions are generally related with the receipts and payment of cash. It may be either purchase of goods for cash or sale of goods for cash or it may be either payment of expenses or receipts of income. In any business there would be numerous cash transactions which involve either receipts or payments of cash. Cash sales, receipt of cash from debtors, cash purchases, and payments to creditors, payment of various expenses such as salaries, wages, rent, taxes, etc., are some examples of transactions involving cash. AU these are recorded in cash book, receipts on one side and payments on the other.

Every business unit, small or big, maintains a cash book. It enables the businessman to know and verify the amount of cash in hand from time to time. As a matter of fact, cash book plays a

**Notes**

dual role. It is a book of prime entry and also serves the purpose of a Cash Account. It is designed in the form of a ledger account and records cash receipts on the debit side and payments on credit side. It is also balanced in the same way. Hence, when cash book is maintained, there is no need to have a Cash Account in the ledger.

### Kinds of Cash Book

There are different types of cash books maintained by the business. They are:

1. Simple or Single Column Cash Book
2. Two or Double Column Cash Book
3. Three or Triple Column Cash Book
4. Petty Cash Book

We shall now consider them one by one and learn how they are prepared and posted into ledger.

## 6.2.1 Single Column Cash Book

Look at the pro forma of a Single Column Cash Book shown below. Doesn't it look like a ledger account? Yes, it does. In fact a Single Column Cash Book is nothing but a Cash Account. It is used for recording all cash receipts and cash payments and serves the purpose of Cash Account as well. It is called Single Column Cash Book just because it has only one amount column on each side.

**Dr.** **Cr.**

| Date | Particulars (Receipts) | L.F. | Amount (₹) | Date | Particulars (Payments) | L.F. | Amount (₹) |
|---|---|---|---|---|---|---|---|
| | | | | | | | |

*Notes*

1. c/d stands for Carried Down whereas b/d stands for Brought Down.
2. One thing which is very important to remember while recording a transaction in the Cash Book is that no distinction is adopted about capital or revenue nature of transactions i.e., all the transactions are recorded in the Cash Book.

### Recording in Single Column Cash Book

You know that Cash Account is a real account. According to rules, Cash Account is to be debited when cash is received and credited when cash is paid. Hence, the debit side of the cash book is used for recording all cash receipts and the credit side for all cash payments. Let us now discuss how entries are made in this book.

As explained above, whenever cash is received, it is to be recorded on the debit side. The date on which it is received is recorded in the date column. The name of the account from which it is received is mentioned in the particulars column. In the L.F. (Ledger Folio) column the page number of the account in the ledger, where the posting is made, is to be recorded at the time of

Notes

posting. The amount column is meant for recording the amount received. Similarly, whenever cash is paid, it is recorded on the credit side. Here, in particulars column we write the name of the party to whom payment is made, and complete the other columns in the same manner as on the debit side.

### Posting the Single Column Cash Book

As said earlier, Cash Book also serves the purpose of a Cash Account, so there is no need to open a Cash Account in the ledger. When a cash transaction is recorded in the cash book, posting of the cash aspect of the transaction in Cash Account stands fully covered. What remains to be posted is the other aspect of the transaction. The posting of this aspect will complete the double entry. The rules of posting therefore are:

1. For all transactions entered on the debit side of the cash book, credit the concerned Subsidiary Books: C accounts in the ledger individually by writing 'By Cash Account';
2. For all transactions entered on the credit side, debit the concerned accounts in the ledger individually by writing To Cash Account'.

Thus, the posting into the ledger accounts is completed.

*Notes* The transactions entered on the debit side of the cash book are to be posted on the credit side of the accounts in the ledger and vice versa.

### Balancing of Single Column Cash Book

You have already learnt how to balance a ledger account. The cash book is balanced just like any other ledger account. The cash book will always show a debit balance. This is because the cash payments can never exceed the amount of cash available. For example, if you have ₹ 10 in your pocket, can you pay ₹ 15? You cannot. So the total of the debit side in the cash book will always be more than the total of the credit side his difference indicates the cash in hand. It shall be entered on the credit side by writing 'By Balance c/d' in particulars column and showing the amount in the amount column. Now total the amount columns and you will find that the two sides are equal.

After closing the cash book, the balance is shown on the debit side by writing 'To Balance b/d'. It becomes the opening balance of cash for the next period. Note that the cash book shall generally show a debit balance and occasionally a nil balance. Look at example it shows the recording, posting and balancing of a Single Column Cash Book.

*Example:* Prepare a cash book from the following:

| **2010** | | **(₹)** |
|---|---|---|
| June 1 | Cash in hand | 7,850 |
| June 2 | Cash Purchases | 2300 |
| June 3 | Cash Sales | 6,250 |
| June 4 | Wages paid in cash | 25 |
| June 6 | Cash paid to Ram | 1,220 |

*Contd...*

Notes

| | | |
|---|---|---|
| June 7 | Cash Received from Mohan | 2260 |
| June 8 | Paid to a creditor in full Settlement of his account Amounting to ₹ 4500 | 4,410 |
| June 9 | Paid cartage | 15 |
| June 10 | Issued a cheque to a creditor | 11,500 |
| June 11 | Goods purchased from Arun on credit | 2,750 |
| June 14 | Cash Sales | 2,670 |
| June 15 | Goods sold to Amit on credit | 6,500 |
| June 17 | Cash Sales of ₹ 7500 of which ₹ 5700 were deposited in bank | |
| June 18 | Received a cheque from Amit and deposited in a bank | 2,500 |
| June 24 | Rent paid | 500 |
| June 29 | Electricity paid | 1,210 |
| June 30 | Cash purchases | 2,450 |

***Solution:***

**Cash Book**

**Dr.** **Cr.**

| Date | Particulars | L.F. | (₹) | Date | Particulars | L.F. | (₹) |
|---|---|---|---|---|---|---|---|
| 2010 | | | | 2010 | | | |
| June 1 | To Balance b/d | | 7,850 | June 2 | By Purchases a/c | | 2,300 |
| June 3 | To Sales a/c | | 6,250 | June 4 | By Wages a/c | | 25 |
| June 7 | To Mohan's a/c | | 2,260 | June 6 | By Ram's a/c | | 1,220 |
| June 14 | To Sales a/c | | 2,670 | June 8 | By Creditor's a/c | | 4,410 |
| June 17 | To Sales a/c | | 7,500 | June 9 | By Cartage | | 15 |
| June 18 | To Amit a/c | | 2,500 | June 17 | By Bank a/c | | 5,700 |
| | | | | June 18 | By Bank a/c | | 2,500 |
| | | | | June 24 | By Rent a/c | | 500 |
| | | | | June 29 | By Electricity a/c | | 1,210 |
| | | | | June 30 | By Purchases a/c | | 2,450 |
| | | | | June 30 | By Balance c/d | | 8,700 |
| | | | 29,030 | | | | 29,030 |
| July 1 | To Balance b/d | | 8,700 | | | | |

*Notes*

1. Cheque issued on June 10 to a creditor is not recorded in the Cash Book.
2. Goods purchased from Arun on June 11 is also not recorded as per rule no credit transaction is recorded.
3. Similarly goods sold to Amit on credit is also not recorded.
4. Cheque received from a debtor is recorded treating it as cash received as it is banked immediately.

Notes

### 6.2.2 Two Column Cash Book

When cash is received from a debtor, some discount may be allowed to him. Similarly, when payment is made to a creditor, some discount may be allowed by him. This is termed as Cash Discount and it has to be recorded in the books of account. While making compound journal entries for such transactions, you learnt that cash and discount go together. You know that receipts from debtors and payments to creditors are to be recorded in the cash book. Now the question arises as to how to record the cash discount. One method is to record the discount aspect separately in the journal. But this would be cumbersome, and the possibility of failing to record can also happen. Hence accountants have developed a practice of recording the discount aspect in tile cash book itself. For this, an extra amount column is added on both sides of the cash book. Look at the proforma shown below. The discount given to debtors is recorded on the debit side and the discount received from creditors is recorded on the credit side. Thus, now there are two amount columns on both sides of the cash book, one for discount and the other for cash. It is called 'Two Column Cash Book'.

*Notes* **Discount is of two types:**

1. ***Trade Discount:*** It is given for increasing the volume of sales and it is adjusted in the invoice, hence no entry is passed in the books of the business, as it is always deducted from the catalogue price. It is usually allowed by a whole seller to a retailer.

   ***For example,*** if the printed price of a book is ₹ 200 and 10% is offered as a trade discount, then it is ₹ 20/- and the net price would be ₹ 180/- i.e., (₹ 200 – ₹ 20) accordingly entries are to be made by the seller as well as the buyer for ₹ 180 in their books.

2. ***Cash Discount:*** It is given for prompt payment, hence, it is recorded in the Cash Book. When discount is given for prompt payment, it is a loss, hence, it is to be shown on the debit side of the Cash Book whereas discount received is to expedite payment to the outsiders, hence, it is shown on the credit side of the Cash Book.

No balance of discount columns is taken; simply the total of both the sides is given.

The following is the form of Double Columns Cash Book.

**Dr.** **Cr.**

| Date | Particulars (Receipts) | L.F. | Discount (₹) | Cash (₹) | Date | Particulars (Payment) | L.F. | Discount (₹) | Cash (₹) |
|---|---|---|---|---|---|---|---|---|---|
| | | | | | | | | | |

#### Recording in Two Column Cash Book

Recording of cash transactions in a Two Column Cash Book is similar to Single Column Cash Book. As for cash discount, it is entered on the debit side if allowed to the debtor and on the credit side if received from the creditor.

For example, Roop owes ₹ 1000 to M/s Goyal Traders of Muzaffar Nagar. The firm offers a discount of 1% if payment is made within one month. Roop makes the payment within stipulated time. So he is offered ₹ 10 as discount and he makes the payment of ₹ 990 to the firm. The following entry is required to be passed in the Journal if no Cash Book is used in the books of M/s Goyal Traders.

**Dr.** **Cr.**

| Date | Particulars | | L.F. | (₹) | (₹) |
|---|---|---|---|---|---|
| | Cash A/c | Dr. | | 990 | |
| | Discount A/c | Dr. | | 10 | |
| | To Roop | | | | 1000 |
| | (Cash received and discount allowed.) | | | | |

If Cash Book is used, then both the accounts namely cash and discount are to be recorded on the debit side of the Cash Book. Similarly, if discount is received for making prompt payment then such items are to be recorded on the credit side of the Cash Book, i.e., amount received or paid in the Amount/Cash column and discount allowed/received in the discount column.

## Posting the Two Column Cash Book

The entries in the cash columns of Two Column Cash Book are posted to the ledger accounts in the same way as we did in the case of single column cash book. The entries in the discount columns are also to be posted to the respective personal accounts. The entries in discount allowed column will be posted to the credit side of the respective personal accounts by writing 'By Discount Allowed A/c'. Similarly, the entries in the discount received column will be posted to the debit side of the respective personal accounts by writing 'To Discount Received A/c'.

*Example:* Cash received from Devi Traders ₹ 490 and discount allowed ₹ 10: This transaction will be entered in particulars column on the debit side of the cash book by writing 'To Devi Traders A/c'. An amount of ₹ 10 will be shown in discount allowed column and ₹ 490 in cash column. Its posting into Devi Traders' Account in the ledger will be made as follows:

**Devi Traders Account**

**Dr.** **Cr**

| | | | | | (₹) |
|---|---|---|---|---|---|
| | | | | By Cash A/c | 490 |
| | | | | By Discount Allowed A/c | 10 |

As for the transactions relating to cash, the double entry is complete as soon as postings have been made to the respective personal accounts. But it is not so for the discount aspect. The cash book does not serve the purpose of discount account. We have to open 'Discount Allowed Account' and 'Discount Received Account' in the ledger. The total of discount allowed columns on the debit side of the cash book is posted to the debit side of the 'Discount Allowed Account' in the ledger by writing 'To Sundries'. Similarly, the total of discount received column on the credit side of the cash book is posted to the credit side of the 'Discount Received Account' in the ledger by writing 'By Sundries'. This will complete the double entry in respect of discount allowed and discount received.

*Notes* The postings in the two discount accounts are made only for the totals and not for the individual transactions. Thus we save time and labour.

Notes

## Balancing the two Column Cash Book

In case of Two Column Cash Book, only the cash columns are balanced. Procedure is similar to Single Column Cash Book. The discount columns are not balanced, they are simply totalled. This is because the two discount columns relate to two separate accounts-the Discount Allowed Account and the Discount Received Account.

*Example:* From the following transactions write up a two column cash book and post into ledger:

**1991**

Jan. 1 Cash in hand ₹ 2,000

Jan. 7 Received from Riaz & Co. ₹ 200; discount allowed ₹ 10

Jan. 12 Cash sales ₹ 1,000

Jan. 15 Paid Zahoor Sons ₹ 500; discount received ₹ 15

Jan. 20 Purchased goods for cash ₹ 300

Jan. 25 Received from Salman ₹ 500; discount allowed ₹ 15

Jan. 27 Paid Hussain & Sons ₹ 300

Jan. 28 Bought furniture for cash ₹ 100

Jan. 31 Paid rent ₹ 100

***Solution:***

**Cash Book**

**Dr.** **Cr.**

| Date | Particulars | V.N. | L.F. | Discount | Cash | Date | Particulars | V.N. | L.F. | Discount | Cash |
|---|---|---|---|---|---|---|---|---|---|---|---|
| 1991 | | | | | | 1991 | | | | | |
| Jan.1 | To Balance b/d | | | 10 | 2,000 | Jan.5 | By Zahoor & Sons | | | 15 | 500 |
| Jan.7 | To Riaz & Co. | | | 15 | 200 | Jan.20 | By purchase A/c | | | | 300 |
| Jan.12 | To Sales A/c | | | | 1,000 | Jan.27 | By Hussan & Sons | | | | 300 |
| Jan.25 | To Salman | | | | 500 | Jan.28 | By Furniture A/c | | | | 100 |
| | | | | | | Jan.31 | By Rent A/c | | | | 100 |
| | | | | | | | By Balance c/d | | | | 2,400 |
| | | | | 25 | 3,700 | | | | | 15 | 3,700 |
| 1991 | | | | | | | | | | | |
| Feb.1 | To Balance b/d | | | | 2,400 | | | | | | |

**Riaz & Co.**

| | | | | | |
|---|---|---|---|---|---|
| | | | 1991 | | (₹) |
| | | | Jan. 7 | By Cash | 200 |
| | | | | By Discount | 10 |

**Sales Account**

| | | | | | |
|---|---|---|---|---|---|
| | | | 1991 | | (₹) |
| | | | Jan. 12 | By Cash | 1,000 |

Notes

**Salman Account**

| | | | | | |
|---|---|---|---|---|---|
| | | | 1991<br>Jan. 25 | By Cash<br>By Discount | (₹)<br>500<br>15 |

**Babar Account**

| | | | | | |
|---|---|---|---|---|---|
| 1991<br>Jan. 18 | To Cash | (₹)<br>1,000 | | | |

**Zahoor Account**

| | | | | | |
|---|---|---|---|---|---|
| 1991<br>Jan. 15 | To Cash<br>By Discount | (₹)<br>500<br>15 | | | |

**Purchases Account**

| | | | | | |
|---|---|---|---|---|---|
| 1991<br>Jan. 20 | To Cash | (₹)<br>300 | | | |

**Hussain & Sons**

| | | | | | |
|---|---|---|---|---|---|
| 1991<br>Jan. 27 | To Cash | (₹)<br>300 | | | |

**Furniture Account**

| | | | | | |
|---|---|---|---|---|---|
| 1991<br>Jan. 28 | To Cash | (₹)<br>100 | | | |

**Rent Account**

| | | | | | |
|---|---|---|---|---|---|
| 1991<br>Jan. 31 | To Cash | (₹)<br>100 | | | |

**Discount Account**

| | | | | | |
|---|---|---|---|---|---|
| 1991<br>Jan. 31 | To Sundries as per<br>Cash book | (₹)<br><br>25 | 1991<br>Jan. 31 | By Sundries as per<br>Cash book | (₹)<br><br>15 |

### 6.2.3 Three or Triple Column Cash Book

This type of Cash Book is used by the big business organisations because (i) there is large number of transactions and (ii) receipts and payments are through cheques. Under these Cash Book three columns meant for (A) Discount, (B) Cash, and (C) Bank, are shown on both the sides of the Cash Book. Other columns remain as usual. This Cash Book contains three columns; hence it is termed as Three Column Cash Book.

In the debit side of Triple Column Cash Book, cash receipt, cheque receipts and cash discount columns respectively. Similarly in the credit side of Triple Column Cash Book payment of cash, payment by cheque and cash discount received are recorded in Cash, Bank and Discount columns respectively. The transactions which affect cash and bank account at a time are called contra

Notes

entries and are recorded in both sides of Triple Column Cash Book. The balance of cash column is the closing cash in hand; the balance of bank column is the cash at bank or bank overdraft. The discount column is not balanced but only totaled.

Following is the form of Three Columns Cash Book:

**Three Columns Cash Book**

**Dr.** **Cr.**

| Date | Particulars | L.F. | Discount (₹) | Cash (₹) | Bank (₹) | Date | Particulars | L.F. | Discount (₹) | Cash (₹) | Bank (₹) |
|---|---|---|---|---|---|---|---|---|---|---|---|
| | | | | | | | | | | | |

Important points to be noted while recording the transactions:

- When opening cash and bank balances are given, record on the debit side of cash and bank columns
- When opening bank balance is given as overdraft, it should be recorded on the credit side in the bank column
- When cash is received, it should be recorded on the debit side cash column, in the same way cash payments made by the firm shown in the cash column on credit side.
- When cash or Cheque is received from debtors through cash sales or any other sources, it is recorded in the cash column on debit side, if the Cheque is deposited into bank on the same day or assumed to be deposited on the same day, it is recorded in the bank column on the debit side.
- If any payment is made or debt is cleared in the form of Cheques, it is recorded in the bank column on the credit side.
- If the firm allows discount, it is recorded in the discount column on the debit side.
- If the discount is received, it is recorded on the discount column on the credit side.
- If the Cheques sent to bank for collection are dishonored, these should be recorded in the bank column on the credit side. Similarly, if we receive any information that the Cheques issued by us are dishonored, it should be promptly noted in the bank column on the debit side.
- If cash is withdrawn from the bank for the business use, it should be recorded in the cash column on debit side and bank column on the credit side.
- If we deposit cash into bank it should be recorded in the bank column on debit side and credit side in the cash column. This type of transaction is called as contra entry. Where both the sides are affected. To indicate that is a contra entry, the alphabet 'C' is mentioned in the Ledger folio column on the both sides.

Contra entries will appear in the following occasions:

- When an account is opened with a bank
- The firm's cash is deposited in the bank
- The cash is withdrawn from bank for office use
- The Cheques received from debtors, are deposited in the bank.

Moreover, if the company has opened two bank accounts i.e., one bank account in State bank of Patiala and another bank account in Panjab National Bank then withdrawal from one bank and deposit the same to another bank will also be shown through contra entry.

Notes

*Solution:*

**Cash Book**

| Date | Particulars | V. No. | L.F. | Cash | Bank | | Discount | | Date | Particulars | V. No. | L.F. | Cash | Bank | | Discount | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| **2011 April** | | | | **(₹)** | **HDFC (₹)** | **PNB (₹)** | **HDFC (₹)** | **PNB (₹)** | **2011 April** | | | | **(₹)** | **HDFC (₹)** | **PNB (₹)** | **HDFC (₹)** | **PNB (₹)** |
| 1 | To Opening Balance | | | 15,200 | 25,750 | 20,000 | | | 4 | By Cash A/c | | (c) | | | 10,000 | | |
| 3 | To Mars Ltd. A/c | | | | 22,850 | | 150 | | 10 | By Salaries A/c | | | 20,500 | | | | |
| 4 | To Bank A/c | | (c) | 10,000 | | | | | 12 | By Neptune Ltd. A/c | | | | | 46,500 | | 500 |
| 20 | To Pluto Ltd. A/c | | | 15,500 | | | | | 15 | By Mars Ltd. A/c | | | | 22,850 | | | |
| 25 | To M/s Ghaziabad Mkt. A/c | | | | | 16,700 | | 300 | 30 | By Bank A/c | | (c) | 5000 | | | | |
| 30 | To Cash A/c | | (c) | | 5,000 | | | | | | | | | | | | |
| 30 | To Balance A/c | | | | | 19,800 | | | 30 | By Closing Balance | | | 15,200 | 30,750 | | | |
| | | | | **40,700** | **53,600** | **56,500** | **150** | | | | | | **40,700** | **53,600** | **56,500** | | **500** |

Notes

*Example:* Given below are the cash and bank transactions of Zupiter Ltd. for the month of April 2011:

**2011**

April 1 Opening balance-cash ₹ 15,200; HDFC bank ₹ 25,750, PNB bank ₹ 20,000.

April 3 Received a cheque of HDFC from Mars Ltd., a customer, of ₹ 22,850 in full settlement of their dues of ₹ 23,000.

April 4 Withdrew cash from PNB bank ₹ 10,000.

April 10 Paid salaries by cash ₹ 20,500.

April 12 Issued cheque of PNB to Neptune Ltd., a supplier, of ₹ 46,500 in full settlement of his claim of ₹ 47,000.

April 15 Cheque of HDFC received from Mars Ltd., dishonoured by bank.

April 20 Cash received from Pluto Ltd. ₹ 15,500.

April 25 Collected a cheque of PNB from M/s Ghaziabad Mkt. ₹ 16,700 in settlement of their dues of ₹ 17,000.

April 30 Deposited ₹ 5,000 to HDFC bank.

Prepare a triple column cash book.

(***Note:*** See solution of the above example on the previous page)

*Example:* From the following particulars, write up the Cash Book of M/s K.K. of Chennai with Cash and Bank columns and bring down the final balance.

| 2009 | | (₹) |
|---|---|---|
| Oct. 1 | Cash in hand | 100 |
| Oct. 1 | Cash at bank | 3,500 |
| Oct. 5 | Paid salary by cheque | 250 |
| Oct. 7 | Paid to K.K. & Co. by cheque | 260 |
| Oct. 9 | Received a cheque from B & Co. | 2,500 |
| Oct. 12 | Bought goods for cash paid by cheque | 750 |
| Oct. 15 | Received cash from M/s S. Chand | 1,500 |
| Oct. 17 | Deposited cash into bank | 1,450 |
| Oct. 18 | Sundry creditors were paid by cheque | 1,250 |
| Oct. 19 | Received from debtors by cheque which could not be sent to bank | 1,780 |
| Oct. 20 | B & Co. cheque dishonoured | 2,500 |
| Oct. 22 | B & Co. paid cash | 2,500 |
| Oct. 24 | R & Co. issued a cheque for ₹ 470 in full satisfaction of his account for | 500 |
| Oct. 27 | Shyam Lal was paid ₹ 395 in full settlement of his A/c amounting to | 400 |
| Oct. 31 | Deposited into the Bank | 2,200 |

***Solution:***

**Three Columns Cash Book**

**Dr.** **Cr.**

| Date | Particulars | L.F. | Discount (₹) | Cash (₹) | Bank (₹) | Date | Particulars | L.F. | Discount (₹) | Cash (₹) | Bank (₹) |
|---|---|---|---|---|---|---|---|---|---|---|---|
| 2009 | | | | | | 2009 | | | | | |
| Oct. 1 | To Balance b/d | | | 100 | 3,500 | Oct. 5 | By Salaries A/c | | | – | 250 |
| Oct. 9 | To B & Co. | | | – | 2,500 | Oct. 7 | By K & Co. | | | – | 260 |
| Oct. 15 | To S. Chand | | | 1,500 | – | Oct. 12 | By Purchase A/c | | | – | 750 |
| Oct. 17 | To Cash A/c | (C) | | – | 1450 | Oct. 17 | By Bank A/c | (C) | | 1450 | – |
| Oct. 19 | To Debitors | | | 1,780 | – | Oct. 18 | By S. Creditors | | | – | 1250 |
| | A/c | | | 2,500 | – | Oct. 20 | By B & Co | | | – | 2,500 |
| Oct. 22 | To B & Co. | | 30 | | 470 | Oct. 27 | By Shyam Lal | | 5 | 395 | |
| Oct. 24 | To R & Co. | (C) | | | 2,200 | Oct. 31 | By Bank A/c | (C) | | 2,200 | |
| Oct. 31 | To Cash A/c | | | | | | By Balance c/d | | | 4,885 | 5,110 |
| | | | 30 | 5,880 | 10,120 | | | | 5 | 5,880 | 10,120 |

## 6.2.4 Petty Cash Book

The Petty Cash Book records all the transactions which are very small in terms of money. In such situation, a fixed amount of cash in the beginning of the month is given to a person who is known as petty cashier. After a fixed period say a week or month, he is again reimbursed or paid back the amount whatever he has spent at the end of week or period. Such a system is known as imprest system.

Thus, this type of system (the Imprest System) is very useful. It contains one column to record the receipt of cash to be taken from the head cashier and other column to record payments of various counts. All such payments are to be totalled to know the total amount spent, so that necessary accounts be debited. The following is the proforma of Petty Cash Book:

**Analytical Petty Cash Book**

| Receipts (₹) | Date | Particulars | Voucher No. | Total Amount (₹) | Printing & Stationery | Cartage | Postage | Remarks |
|---|---|---|---|---|---|---|---|---|
| | | | | | | | | |

*Example:* Enter the following transactions in Analytical Petty Cash Book.

| 2009 | | (₹) |
|---|---|---|
| Jan. 1 | Received cheque from head cashier | 100.00 |
| Jan. 2 | Paid for postage and telegram | 15.00 |
| Jan. 3 | Stationery purchased | 5.00 |
| Jan. 14 | Paid for cartage | 8.00 |
| Jan. 18 | Paid for travelling | 7.00 |
| Jan. 27 | Tea for guests | 6.00 |
| Jan. 29 | Office cleaning charges | 12.00 |
| Jan. 30 | Paid for carriage | 4.00 |
| Jan. 31 | Telegram charges | 8.00 |

Notes

*Solution:*

**Analytical Petty Cash Book**

(₹)

| Receipts | Date | Particulars | Voucher No. | Total Amount | Postage telegram | Stationary | Cartage Travelling | Tea & office expenses | Remarks |
|---|---|---|---|---|---|---|---|---|---|
| | **2009** | | | | | | | | |
| 100.00 | Jan. 1 | To cash a/c | | – | | | | | |
| | Jan. 2 | By Postage & telegram | | 15.00 | 15.00 | – | – | – | |
| | Jan. 3 | By Stationery | | 5.00 | – | 5.00 | – | – | |
| | Jan. 14 | By Cartage | | 8.00 | – | – | 8.00 | – | |
| | Jan. 18 | By Travelling | | 7.00 | – | – | 7.00 | 6.00 | |
| | Jan. 27 | By Tea for guest | | 6.00 | – | – | – | 12.00 | |
| | Jan. 29 | By office cleaning charges | | 12.00 | – | – | – | – | |
| | Jan. 30 | By Carriage | | 4.00 | | – | – | – | |
| | Jan. 31 | By Telegram | | 8.00 | 8.00 | – | 4.00 | | |
| | | By Balance c/d | | 35.00 | 23.00 | 5.00 | 19.00 | 18.00 | |
| | | Total | | 100.00 | | | | | |
| 35.00 | Feb. 1 | To Balance b/d | | | | | | | |
| 65.00 | | To Cash | | | | | | | |

## Self Assessment

Fill in the blanks:

1. Only................................ are recorded in the cash book.
2. Cash payments are recorded on the............................. of the cash book.
3. According to the rules of accounting, all the business transactions are firstly recorded in journal and then posted in........................................
4. The................................. is an incentive given or received for prompt payment.
5. The.......................... records all the transactions which are very small in terms of money.
6. An................................... is given to the buyer when sales are made on credit
7. Purchase return book is also known as..................................

## 6.3 Other Subsidiary Books

Following are other subsidiary books:

### 6.3.1 Purchases Day Book

All credit purchases are recorded in this book which are either used for resale or raw materials used for production. The purchases which are made for cash are not at all recorded in this book. Similarly, the assets which are bought for running the business are also not recorded such as machinery, furniture, etc. All these assets and cash purchases are separately recorded in the journal Cash Book.

Following is the form of Purchases Day Book:

**Purchases Day Book**

| Date | Particulars | Invoice No. | L.F. | Details (₹) | Amount (₹) |
|---|---|---|---|---|---|
| I | II | III | IV | V | VI |

(a) Column is meant for date.

(b) Column is meant for writing details regarding name of supplier, name of articles purchased and number i.e., quantities.

(c) Invoice No.: An Invoice is given to the seller when purchases are made on credit

(d) Ledger Folio

(e) Amount of the purchase

Thus, all the credit purchases are totalled which give us the amount of total credit purchases made during the period.

*Example:* Following information is obtained from the books of Mr. Joseph.

| **2011** | | **(₹)** |
|---|---|---|
| July 1 | Purchased goods from Robert on credit | 4000 |
| July 2 | Purchased office furniture from Delite Furniture on credit | 5000 |
| July 3 | Purchased on credit goods from Robinson | 3000 |
| July 4 | Purchased stationery on credit from Bittoo | 500 |
| July 5 | Purchased goods for cash | 7,500 |

You are required to make out a purchases day book of Mr. Joseph.

***Solution:***

| Date | Particulars | Invoice No .1 | L.F. | Amount (₹) |
|---|---|---|---|---|
| 2011 | | | | |
| July 1 | Robert | | | 4000 |
| July 3 | Robinson | | | 3000 |
| | Total | | | 7000 |

*Notes*

1. Furniture purchased or stationery purchased is not at all recorded as they were bought for running and maintaining the business. Hence to be recorded in the journal of the business.

2. Similarly goods purchased for cash are also not recorded in this book. It would be recorded either in the main journal or in the Cash Book.

Thus, It is clear from the above Purchases Day Book that the total credit purchases made during the period are ₹ 7,000 and total amount of creditors to be shown and posted and credited in their

Notes

accounts is also ₹ 7,000. Thus, the total amount of debit (purchases) equals the total amount of credit (creditors) satisfying the very principle of double entry system of book-keeping (accounting).

*Task* Enter the following transactions in the Purchases Book and post the same in the relevant ledger accounts.

| | | |
|---|---|---|
| 2001 | | (₹) |
| Aug. 1 | Bought goods from S | 1,500 |
| Aug. 4 | Bought goods from N | 1,000 |
| Aug. 8 | Bought goods from A | 500 |

### 6.3.2 Sales Day Book

The goods which are sold on credit are recorded in this book but if sales are made for cash or assets are sold either for cash or on credit, they are not at all recorded in this book, but are recorded either in the cash book or in the journal. The form of this book is similar to that of purchases book. Following is the form of Sales Day Book.

| Date | Particulars | Invoice No. | L.F. | Details (₹) | Amount (₹) |
|---|---|---|---|---|---|
| I | II | III | IV | V | VI |
| | Details of goods-sold-trade discount if any total | | | | |

Thus, all the credit sales are totalled which give us the amount of total credit sales made during the period.

***Invoice:*** An Invoice is given to the buyer when sales are made on credit.

*Example:* Following are the transactions of a publishing house, Delhi. Enter the following in the sales book.

**2011**

July 1 Sold to Manoj Book Depot, Delhi on credit.
10 copies of introduction to Accounting Part I for XII Class @ ₹ 55 each.
5 copies of Mathematics Part II for XII Class @ ₹ 90 each.
Trade Discount allowed 20%.

July 10 Sold to M/s Agarwal Book Depot, Meerut on credit.
10 copies of Introduction to Accounting Part I for XII Class @ ₹ 55 each.
5 copies of physics for XII class @ ₹ 120 each.
Trade discount 10%.

July 15 Sold to M/s Gupta & Sons 1 typewriter for ₹ 500

July 18 Sold to M/s Kishan Lal & Co. for cash.
5 copies of Physics for XII Class @ ₹ 120 each.
Trade Discount 20%.

July 25 Sold to M/s Mittal Bros. Kanpur on credit
5 copies of Chemistry for XII Class @ ₹ 100 each.
5 copies Mathematics for XII Class @ ₹ 90 each.
Trade discount 15%

*Solution:*

**Notes**

**Sales Day Book**

| Date | Particulars | L.F. | Voucher No. | Details ₹ — P. | Amount ₹ — P. |
|---|---|---|---|---|---|
| 2011 | | | | | |
| July 1 | M/s Manoj Book Depot, Delhi | | | | |
| | 10 copies Introduction to | | | | |
| | Accounting Part I | | | | |
| | For XII Class | | | | |
| | @ ₹ 55/-each | | | 550 — 00 | |
| | 5 Copies Mathematics Part II | | | | |
| | for XII Class | | | | |
| | @ ₹ 90/-each | | | 450 — 00 | |
| | | | | 1000 — 00 | |
| | Trade discount @ 20% | | | 200 — 00 | 800 – 00 |
| July 10 | M/s Agarwal Book Depot, Meerut. | | | | |
| | 10 copies Introduction to Accounting | | | | |
| | Part I for XII Class | | | | |
| | @ ₹ 55/-each | | | 550 — 00 | |
| | 5 Copies Physics for XII Class | | | 600 — 00 | |
| | @ ₹ 120/-each | | | 1150 — 00 | |
| | Trade discount @ 10% | | | 115 — 00 | 1035 — 00 |
| | M/s Mittal Bros, Kanpur | | | | |
| | 5 copies of Chemistry for XII Class | | | 500 — 00 | |
| | @ ₹ 100/- each | | | 450 — 00 | |
| July 25 | 5 copies Mathematics for XII Class | | | 950 — 00 | |
| | @ ₹ 90/-each | | | 142 — 00 | |
| | Trade discount @ 15% | | | | 807 — 50 |
| | Total | | | | 2642 – 50 |

*Notes:* 1. Sale of typewriter is not entered in this day book because it is an asset.

2. Similarly Cash Sales to M/s Kishan Lal & Co. is also not recorded because of cash sale.

## 6.3.3 Purchase Returns Book

This book is also known as Returns Outward Book. This book records all the returns to the suppliers which are made during the period. The return is of goods or raw materials purchased from the Suppliers and Return is on account of difference in quantity or quality. This book is used when the returns are in sufficient number. If returns are not much, then it may be recorded in the Journal. The form of Purchase Returns Book is similar to that of Purchase Day Book.

**Form of Purchase Returns Book**

| Date | Particulars | L.F. | Debit Note No. | Details (₹) | Amount (₹) |
|---|---|---|---|---|---|
| I | II | III | IV | V | VI |
| | | | | | |

Notes

*Caution* *Debit Note:* Whenever goods are returned to the supplier, a letter which is known as the debit note is also sent along with returned goods. The purpose of this note is to inform the supplier about this deduction or debit given to his account. This note contains the following particulars such as:

(a) Name and address of the supplier

(b) Description of the goods returned

(c) Rate and total value

(d) Invoice No., along with date

(e) Signature

*Example:* Enter the following transactions in proper Subsidiary Books.

| 2011 | | (₹) |
|---|---|---|
| Jan. 1 | Purchased goods from Ramu | 5.000 |
| Jan. 2 | Bought goods from Hari | 6,500 |
| Jan. 8 | Goods returned to Hari | 50 |
| Jan. 10 | Bought goods from Gopal | 15,000 |
| Jan. 14 | Krishna sent goods. | 20,000 |
| Jan. 20 | Returned goods to Gopal | 150 |
| Jan. 22 | Returned goods to Ramu | 80 |
| Jan. 25 | Goods purchased on credit from X & Co. 8,000 | |

***Solution:***

**Purchases Day Book**

| Date | Particulars | L.F. | Invoice No. | Amount (₹) |
|---|---|---|---|---|
| **2011** | | | | |
| Jan.1 | Ramu | | | 5.000 |
| Jan.2 | Hari | | | 6500 |
| Jan.10 | Gopal | | | 15000 |
| Jan. 14 | Krishna | | | 20,000 |
| Jan.25 | X & Co. | | | 8000 |
| | Total | | | 54,500 |

**Purchases Returns Book**

| Date | Particulars | L.F. | Debit note No. | Amount (₹) |
|---|---|---|---|---|
| **2011** | | | | |
| Jan.8 | Hari | | | 50 |
| Jan.20 | Gopal | | | 150 |
| Jan.22 | Ramu | | | 80 |
| | Total | | | 280 |

### 6.3.4 Sales Returns Book

This is also known as Returns Inward Book. This book records all the transactions related to the return of goods by the customers. As and when goods are returned by the customers, a credit note is issued and the entry is made in this book. This book again contains the same columns which a Purchases Returns Book contains. There is only one difference i.e. in place of Debit Note No. the column is used to note the Credit Note No. The form of sales Returns Book is as follows:

**Sales Returns Book**

| Date | Particular | Credit Note No. | L.F. | Details (₹) | Amount (₹) |
|---|---|---|---|---|---|
| I | II | III | IV | V | VI |
| | | | | | |

*Caution* *Credit Note:* As and when goods are returned by the customers, a credit note is being sent to him. Credit note means that his account has been credited with the amount of goods return.

*Example:* Enter the following transactions in the Sales Returns Book

**2011**

July 01 Ramesh returned goods ₹ 6500

July 10 Allowance claimed by Murthy ₹ 9,500 accepted

July 15 Suresh returned us goods worth ₹ 2000

July 20 Received a Debit note from Narayan for ₹ 600

July 25 Received goods returned by Chandra ₹ 500

July 30 Allowance granted to Mohan for breakage ₹ 500

July 30 Received goods returned by Arvind and paid ₹ 1,600 in full settlement.

***Solution:***

**Sales Returns Book**

| Date | Particulars | Credit Note No. | Ledger Folio | Amount (₹) |
|---|---|---|---|---|
| 2011 | | | | |
| Jul 1 | Ramesh | | | 6,500 |
| Jul 10 | Murthy | | | 9,500 |
| Jul 15 | Suresh | | | 2,000 |
| Jul 25 | Chandra | | | 500 |
| Jul 30 | Mohan | | | 500 |
| | | | Total | 19,000 |

***Notes:***
1. Transaction of July 20, receiving a debit note is not a transaction. Sales Returns book is written on the basis of Credit note.
2. Transaction of July 30, it is a cash transaction. It is not to be entered in sales returns book.

Notes

**Ledger**

**Ramesh A/c**

Dr. Cr.

| Date | Particulars | JF | Amount (₹) | Date | Particulars | JF | Amount (₹) |
|---|---|---|---|---|---|---|---|
| | | | | 2011 | | | |
| | | | | Jul 1 | By Sales Returns A/c | | 6,500 |

**Murthy A/c**

Dr. Cr.

| Date | Particulars | JF | Amount (₹) | Date | Particulars | JF | Amount (₹) |
|---|---|---|---|---|---|---|---|
| | | | | 2011 | | | |
| | | | | Jul 10 | By Sales Returns A/c | | 9,500 |

**Suresh A/c**

Dr. Cr.

| Date | Particulars | JF | Amount (₹) | Date | Particulars | JF | Amount (₹) |
|---|---|---|---|---|---|---|---|
| | | | | 2011 | | | |
| | | | | Jul 15 | By Sales Returns A/c | | 2,000 |

**Chandra A/c**

Dr. Cr.

| Date | Particulars | JF | Amount (₹) | Date | Particulars | JF | Amount (₹) |
|---|---|---|---|---|---|---|---|
| | | | | 2011 | | | |
| | | | | Jul 25 | By Sales Returns A/c | | 500 |

**Chandra A/c**

Dr. Cr.

| Date | Particulars | JF | Amount (₹) | Date | Particulars | JF | Amount (₹) |
|---|---|---|---|---|---|---|---|
| | | | | 2011 | | | |
| | | | | Jul 30 | By Sales Returns A/c | | 500 |

**Sales Returns A/c**

Dr. Cr.

| Date | Particulars | JF | Amount (₹) | Date | Particulars | JF | Amount (₹) |
|---|---|---|---|---|---|---|---|
| 2011 | | | | | | | |
| Jul 31 | To Sundries as per Sales Returns book | | 19,000 | | | | |

## 6.3.5 Bills Receivable Book

A bill of exchange accepted by a customer is called bills receivable. When bills are received from debtors and number of such bills received is larger (big) then such bills are recorded in a separate book, known as bills Receivable Book. All such bills are totalled for a particular period and are posted in the accounts of the debtors from whom such bills are received. Following is the form of Bills Receivable Book.

Notes

**Bills Receivable Book**

| Date of Receipt | Date of Receipt | From Whom Received | Drawer | Acceptor | Endorser (s) | Date of Bill | Tenor or Terms of Bill | Due date | Where payable | L.F. | Cash Discount allowed | Amount of bill (₹) | Remarks |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | | | | | | | | | | | | | |

*Example:* From the following transactions of a trader prepare the bills receivable book and post it into ledger:

**2011**

January 5 Drew a bill on Amit & Co. at 2 m/d for ₹ 700.

January 10 Acceptance received from Rohit at 3 m/d for ₹ 1,000.

January 20 Pankaj gives his acceptance at 3 m/d for ₹ 800.

January 30 Bill at 2 m/d for ₹ 100 is drawn on Gaurav.

***Solution:***

**Bills Receivable Book**

| Date | Particulars | Term | Due Date | L.F. | Amount (₹) |
|---|---|---|---|---|---|
| **2011** | | | | | |
| Jan. 5 | Amit & Co. | 2 m/d | March 8 | | 700 |
| Jan. 10 | Rohit | 3 m/d | April 13 | | 1,000 |
| Jan. 20 | Pankaj | 3 m/d | April 21 | | 800 |
| Jan. 30 | Gaurav | 2m/d | March 3 | | 100 |
| | | | | | 2,600 |

**Bills Receivable Account**

| | | | | | |
|---|---|---|---|---|---|
| **2011** | | **(₹)** | | | |
| Jan. 30 | By Sundries as per B/R Book | 2,600 | | | |

**Amit & Co.**

| | | | | | |
|---|---|---|---|---|---|
| | | | **2011** | | **(₹)** |
| | | | Jan. 5 | By Bill receivable | 700 |

**Rohit Traders**

| | | | | | |
|---|---|---|---|---|---|
| | | | **2011** | | **(₹)** |
| | | | Jan. 10 | By Bill receivable | 1,000 |

**Pankaj**

| | | | | | |
|---|---|---|---|---|---|
| | | | **2011** | | **(₹)** |
| | | | Jan. 30 | By Bill receivable | 800 |

Notes

**Gaurav**

| | | | | | |
|---|---|---|---|---|---|
| | | | **2011** | | **(₹)** |
| | | | Jan. 30 | By Bill receivable | 100 |

### 6.3.6 Bills Payable Book

Where either purchases are made for credit or loans are taken, then Bills are issued which are termed as Bills Payable. The book in which these bills are recorded is termed as Bills Payable Book. All such Bills are totalled after a lapse of a certain period and are posted in the accounts of the creditors to whom such bills are issued. Following is the form of Bills Payable Book:

**Bills Payable Book**

| Date | To Whom Payable | Term | Drawer | Acceptor | Endorser (s) | Due Date | Where payable | L.F. | Amount (₹) | Remarks |
|---|---|---|---|---|---|---|---|---|---|---|
| | | | | | | | | | | |

*Example:* From the following transactions of a trader prepare the bills payable book and post it into ledger:

**2011**

January 5 Accepted a bill at 3 m/d for ₹ 200 drawn by Rohen & Co.

January 20 gave acceptance at 2 m/d for ₹ 500 to Dhruv.

January 30 Acceptance at 1 m/d for ₹ 500 given to Feroz & Co.

***Solution:***

**Bills Payable Book**

| Date | Particulars | Term | Due Date | L.F. | Amount (₹) |
|---|---|---|---|---|---|
| **2011** | | | | | |
| Jan. 5 | Rohen & Co. | 3 m/d | April 8 | | 200 |
| Jan. 20 | Dhruv | 2 m/d | March 23 | | 500 |
| Jan. 30 | Feroz & Co. | 1 m/d | March 30 | | 500 |
| | | | | | 1,200 |

**Bills Payable Account**

| | | | | | |
|---|---|---|---|---|---|
| | | | **2011** | | **(₹)** |
| | | | Jan. 31 | By Sundries as per B/p Book | 1,200 |

**Rohen & Co.**

| | | | | | |
|---|---|---|---|---|---|
| **2011** | | **(₹)** | | | |
| Jan. 5 | By Bill Payable | 200 | | | |

**Dhruv**

| | | | | | |
|---|---|---|---|---|---|
| **2011** | | **(₹)** | | | |
| Jan. 20 | By Bill Payable | 500 | | | |

**Feroz & Co.**

Notes

| 2011 | | (₹) | | | |
|---|---|---|---|---|---|
| Jan. 31 | By Bill Payable | 500 | | | |

*Task* Prepare a Cash Book with Bank column only:

| 2009 | | (₹) |
|---|---|---|
| July 1 | Balance at bank | 10,000 |
| July 4 | Received a cheque from Pankaj | 5,000 |
| July 7 | Issued a cheque to Rakesh | 6,000 |
| July 10 | Received dividend by bank draft | 2,000 |
| July 15 | Mukesh was paid by issuing a cheque | 1,500 |
| July 20 | Deposited into bank | 7,000 |
| July 24 | Interest collected by bank | 200 |
| July 28 | Dividend collected by bank | 500 |
| July 31 | Bank charges debited | 800 |

***Hint:*** Total of Cash Book ₹ 24,700, Closing Balance ₹ 16,400.

## Self Assessment

Multiple Choice Questions:

8. Cash book is to record the:
   (a) Cash receipts
   (b) Cash Payments
   (c) Both (a) & (b)
   (d) Cash receipts, payment, Bank Receipts, payments, Discount received and paid
9. Sales book is to record the:
   (a) The entire sales volume
   (b) The cash sales only
   (c) The credit sales only
   (d) The credit sales with the discounts
10. When equity (net assets) is subtracted from total assets the amount remaining is known as which of the following?
   (a) Total revenue
   (b) Total liabilities
   (c) Total expenses
   (d) Net income or net loss
   (e) All of the above

Notes

## 6.4 Summary

- The regular/frequent occurrence of transactions are recorded only in the separate books which are known as subsidiary book of accounts or subsidiary journals, instead of being recorded in the regular journal.
- Subsidiary books are classified on the basis of transactions viz Cash transactions and Noncash-transactions.
- The purchases book is known in other words as purchase journal. It is a book meant for credit purchases only for resale.
- Purchase return book is a book of goods returned to the supplier which are out of credit purchases.
- Sales book is a book maintained by the enterprise only during the moment of selling the goods on credit. It is known in other words as a sales journal.
- Sales return is a book that registers the goods sold on credit and received from the buyers.

## 6.5 Keywords

***Bill of Exchange:*** A bill of exchange is an unconditional order signed by the maker which directs the recipient to pay a fixed sum of money to a third party at a future date.

***Journal:*** The primary book in which the transactions are recorded first time.

***Ledger:*** It is the classification of accounts in which various accounts are maintained.

***Non-cash Transactions:*** A Non-cash transaction is a transaction in terms of credit and conditions of the enterprise.

***Purchase Book:*** It is known in other words as purchase journal. It is a book meant for credit purchases only for resale.

***Sales Book:*** It is a book maintained by the enterprise only during the moment of selling the goods on credit. It is known in other words as a sales journal.

***Sales Return Book:*** Sales return is a book that registers the goods sold on credit and received from the buyers.

***Subsidiary Book:*** It is a book maintained for routine transactions of the enterprise.

***Trial Balance:*** Trial balance is a list in which all the balances of the accounts of Ledger are showed to test the arithmetical accuracy of the posting in ledger.

## 6.6 Review Questions

1. Illustrate the preparation of records for non cash transactions with suitable examples.
2. Explain the nature of petty cash book.
3. What is the difference between a petty cash book and a simple cash book?

4. Compose three columns Cash Book from the following transactions:

| 2006 | | (₹) |
|---|---|---|
| Jan. 1 | Cash in hand | 567 |
| Jan. 1 | Cash at bank | 12,675 |
| Jan. 2 | Received from Ashish and | 7,900 |
| | allowed him a discount | 100 |
| Jan. 4 | Deposited into the bank | 5,000 |
| Jan. 6 | Furniture purchased for cash | 2,500 |
| Jan. 7 | Paid to Vikas by cheque | 7,800 |
| | and received discount | 200 |
| Jan. 14 | Received from Manish by cheque and Deposited into bank | 5,000 |
| Jan.16 | Cash Sales | 8,000 |
| Jan. 20 | Deposited into bank | 6,000 |
| Jan. 25 | Purchased a Machine and paid by a cheque | 12,000 |
| Jan. 26 | Paid by cheque to Kishore | 1,370 |
| | and received discount | 30 |
| Jan. 27 | Withdrew from bank for office use | 2,500 |
| Jan. 28 | Purchased goods for cash | 5,000 |
| Jan. 29 | Paid wages by cheque | 4,500 |
| Jan. 31 | Paid Rent | 500 |

5. What are the different types of trade bills books?
6. Write a short note on the following:
   (a) Debit Note
   (b) Credit Note
7. Make the proforma of purchase return book and sales return book and explain it.
8. Explain the significance of preparing subsidiary books of accounts.

## Answers: Self Assessment

| | | | |
|---|---|---|---|
| 1. | cash transactions | 2. | credit side |
| 3. | ledger | 4. | discount |
| 5. | petty cash book | 6. | Invoice |
| 7. | Returns Outward Book | 8. | (d) |
| 9. | (c) | 10. | (b) |

Notes

## 6.7 Further Readings

*Books*

Khan and Jain, “Management Accounting”.

M.P. Pandikumar, “Accounting & Finance for Managers”, Excel Books, New Delhi.

R.L. Gupta and Radhaswamy, “Advanced Accountancy”.

S.N. Maheswari, “Management Accounting”.

V.K. Goyal, “Financial Accounting”, Excel Books, New Delhi.

*Online links*

http://www.globusz.com/

www.scribd.com

www.futureaccountant.com

# Unit 7: Trial Balance

Notes

CONTENTS



## Objectives

After studying this unit, you will be able to:

- Understand the preparation of trial balance
- Identify the types of errors
- Distinguish the errors which are revealed and not revealed by the trial balance

## Introduction

Every transaction which takes place in the business is recorded either in the journal or in the subsidiary books. It is posted in the concerned accounts. After posting is over, final accounts are prepared in order to know the operational results of the business during a particular or fixed period and also to depict financial position of the business on a particular date. Final accounts can be prepared only if information relating to balances of all accounts is available. This function of supplying necessary and accurate balances is performed by Trial Balance so it is very much necessary to know the meaning of Trial Balance.

## 7.1 Meaning of Trial Balance

Trial balance is a list in which all the balances of the accounts of Ledger are showed to test the arithmetical accuracy of the posting in ledger. It is prepared after the end of a particular period – year, half year or quarter. Trial balance prepares a base for the preparation of final accounts. After the completion of trial balance, the financial accounts - P&L Account and Balance Sheet are prepared to disclose the overall results of the business after a period. The proforma of a trial balance is given hereunder:

**Proforma of Trial Balance**

| S. No. | Particulars | Amount Dr. (₹) | Amount Cr. (₹) |
|---|---|---|---|
| | | | |

Notes

Generally three columns are made in the trial balance. The first wide column is kept for the particulars of accounts and the two columns for debit amount and credit amount are made.

### 7.1.1 Objects and Functions of Trial Balance

The main objectives of preparing a trial balance are to check the arithmetical accuracy of all transactions. In every trial balance, the total of debit balances must agree with the total of credit balances. It is a proof of arithmetical accuracy of postings but it is not a conclusive evidence of correctness of the books of accounts. The other objects and functions of a trial balance are as under:

1. It serves as a summary of all accounts.
2. It helps in locating errors if any.
3. It acts as a base for the preparation of final accounts.

## 7.2 Methods of Preparation of Trial Balance

A trial balance is prepared by the following three methods:

1. Balance Method
2. Total Method
3. Balance and Total Method or Combined Method

Among the above methods the balance method is the most popular and statutory method to prepare the Trial Balance. Under this method the balance of all the accounts are recorded. If an account shows a debit balance in the ledger, this balance is recorded in the debit side of the trial balance and if it has a credit balance, in the credit side of it is written. If any account has no balance means its total of debit side is equal to the total of credit side, it is not recorded in the Trial Balance. After recording the balances of all accounts of the Ledger, the amounts of both the sides are totalled to check the arithmetical accuracy of the ledger. If the total of debit side agrees with the total of credit side, it proves that books are at least arithmetically correct. However, the trial balance is not the sole proof of accuracy of the books of Ledger. There may be errors which are discussed later in this unit.

Total Method instead of taking balance of each account, the total of both the sides of each account is taken. Combined method is both the above explained method i.e., balance as well as total method are used. This method is not in use because of wastage of time and labour.

***Illustration 1:*** Prepare ledger accounts and also a trial balance from the following transactions:

| **2011** | | **(₹)** |
|---|---|---|
| July 1 | Ram commenced business with cash | 10,000 |
| July 3 | Paid to bank | 8,000 |
| July 3 | Bought goods for cash | 500 |
| July 5 | Bought office furniture | 400 |
| July 10 | Drew from bank for office | 1,000 |
| July 13 | Goods sold to Shyam | 600 |
| July 15 | Bought goods from Krishan | 410 |

Notes

| | | |
|---|---|---|
| July 18 | Trade expenses paid | 100 |
| July 19 | Received cash from Shyam | 590 |
| | allowed him discount | 10 |
| July 25 | Wages paid | 50 |
| July 29 | Krishan paid off in full settlement of his account | 400 |
| July 31 | Rent paid | 100 |
| July 31 | Interest due on Capital | 500 |

***Solution:***

**Capital A/c**

**Dr.** **Cr.**

| Date | Particulars | J.F. | Amount (₹) | Date | Particulars | J.F. | Amount (₹) |
|---|---|---|---|---|---|---|---|
| 2011 | | | | 2011 | | | |
| July 31 | To Balance c/d | | 10,500 | July 1 | By Cash | | 10,000 |
| | | | | July 31 | By Int. on capital | | 500 |
| | | | 10,500 | | | | 10,500 |
| | | | | Aug 1 | By Balance b/d | | 10,500 |

**Cash A/c**

**Dr.** **Cr.**

| Date | Particulars | J.F. | Amount (₹) | Date | Particulars | J.F. | Amount (₹) |
|---|---|---|---|---|---|---|---|
| 2011 | | | | 2011 | | | |
| July 1 | To Capital A/c | | 10,000 | July 3 | By Bank A/c | | 8,000 |
| July 10 | To Bank A/c | | 1,000 | July 3 | By Purchases A/c | | 500 |
| July 19 | To Shyam | | 590 | July 5 | By Office furniture A/c | | 400 |
| | | | | July 18 | By Trade Exp. A/c | | 100 |
| | | | | July 25 | By Wages A/c | | 50 |
| | | | | July 29 | By Krishan | | 400 |
| | | | | July 31 | By Rent A/c | | 100 |
| | | | | July 31 | Balance c/d | | 2040 |
| | | | 11,590 | | | | 11,590 |
| Aug. 1 | To Balance b/d | | 2,040 | | | | |

**Bank A/c**

**Dr.** **Cr.**

| Date | Particulars | L.F. | Amount (₹) | Date | Particulars | L.F. | Amount (₹) |
|---|---|---|---|---|---|---|---|
| 2011 | | | | 2011 | | | |
| July 3 | To Cash A/c | | 8,000 | July 10 | By Cash A/c | | 1,000 |
| | | | | July 31 | Balance c/d | | 7,000 |
| | | | 8,000 | | | | 8,000 |
| Aug. 1 | To Balance b/d | | 7,000 | | | | |

Notes

**Purchases A/c**

Dr. Cr.

| Date | Particulars | J.F. | Amount (₹) | Date | Particulars | J.F. | Amount (₹) |
|---|---|---|---|---|---|---|---|
| 2011 | | | | 2011 | | | |
| July 3 | To Cash A/c | | 500 | July 31 | By Balance c/d | | 910 |
| July 15 | To Krishan | | 410 | | | | |
| | | | 910 | | | | 910 |
| Aug. 1 | To Balance b/d | | 910 | | | | |

**Sales A/c**

Dr. Cr.

| Date | Particulars | J.F. | Amount (₹) | Date | Particulars | J.F. | Amount (₹) |
|---|---|---|---|---|---|---|---|
| 2011 | | | | 2011 | | | |
| July 31 | To Balance c/d | | 600 | July 13 | By Shyam | | 600 |
| | | | | Aug. 1 | By Balance b/d | | 600 |

**Office Furniture A/c**

Dr. Cr.

| Date | Particulars | J.F. | Amount (₹) | Date | Particulars | J.F. | Amount (₹) |
|---|---|---|---|---|---|---|---|
| 2011 | | | | 2011 | | | |
| July 3 | To Cash A/c | | 400 | July 31 | By Balance c/d | | 400 |
| Aug. 1 | To Balance b/d | | 400 | | | | |

**Shyam A/c**

Dr. Cr.

| Date | Particulars | J.F. | Amount (₹) | Date | Particulars | J.F. | Amount (₹) |
|---|---|---|---|---|---|---|---|
| 2011 | | | | 2011 | By Cash A/c | | 590 |
| July 13 | To Sales A/c | | 600 | July 19 | By Discount A/c | | 10 |
| | | | 600 | | | | 600 |

**Krishan A/c**

Dr. Cr.

| Date | Particulars | J.F. | Amount (₹) | Date | Particulars | J.F. | Amount (₹) |
|---|---|---|---|---|---|---|---|
| 2011 | | | | 2011 | | | |
| July 29 | To Cash A/c | | 400 | July 15 | By Purchases A/c | | 410 |
| July 29 | Discount A/c | | 10 | | | | |
| | | | 410 | | | | 410 |

Notes

**Trade Expenses A/c**

Dr. Cr.

| Date | Particulars | J.F. | Amount (₹) | Date | Particulars | J.F. | Amount (₹) |
|---|---|---|---|---|---|---|---|
| 2011 | | | | 2011 | | | |
| July 18 | To Cash A/c | | 100 | July 31 | By Balance c/d | | 100 |
| Aug. 1 | To Balance b/d | | 100 | | | | |

**Wages A/c**

Dr. Cr.

| Date | Particulars | J.F. | Amount (₹) | Date | Particulars | J.F. | Amount (₹) |
|---|---|---|---|---|---|---|---|
| 2011 | | | | 2011 | | | |
| July 25 | To Cash A/c | | 50 | July 31 | By Balance c/d | | 50 |
| Aug. 1 | To Balance b/d | | 50 | | | | |

**Rent A/c**

Dr. Cr.

| Date | Particulars | J.F. | Amount (₹) | Date | Particulars | J.F. | Amount (₹) |
|---|---|---|---|---|---|---|---|
| 2011 | | | | 2011 | | | |
| July 31 | To Cash A/c | | 100 | July 31 | By Balance c/d | | 100 |
| Aug. 1 | To Balance b/d | | 100 | | | | |

**Interest on Capital A/c**

Dr. Cr.

| Date | Particulars | J.F. | Amount (₹) | Date | Particulars | J.F. | Amount (₹) |
|---|---|---|---|---|---|---|---|
| 2011 | | | | 2011 | | | |
| July 31 | To Capital A/c | | 500 | July 31 | By Balance c/d | | 500 |
| Aug. 1 | To Balance b/d | | 500 | | | | |

**Discount A/c**

Dr. Cr.

| Date | Particulars | J.F. | Amount (₹) | Date | Particulars | J.F. | Amount (₹) |
|---|---|---|---|---|---|---|---|
| 2011 | | | | 2011 | | | |
| July 19 | To Shyam | | 10 | July 29 | By Krishan | | 10 |
| | To Balance c/d | | 10 | July 31 | By Balance c/d | | 10 |
| | | | 20 | | | | 20 |
| Aug. 1 | To Balance b/d | | 10 | Aug. 1 | By Balance b/d | | 10 |

*Notes:* No balance is ascertained practically but the total of both the sides of discount A/c is brought down in the trial balance.

Notes

**Trial Balance**
**(As on July, 31, 2011)**

| S. No. | Particulars | Amount (Dr.) (₹) | Amount (Cr.) (₹) |
|---|---|---|---|
| | Capital A/c | ---- | 10,500 |
| | Cash A/c | 2,040 | --- |
| | Bank A/c | 7,000 | --- |
| | Purchases A/c | 910 | --- |
| | Sales A/c | ---- | 600 |
| | Office Furniture A/c | 400 | ---- |
| | Trade Expenses A/c | 100 | ---- |
| | Wages A/c | 50 | ---- |
| | Rent A/c | 100 | ---- |
| | Interest on Capital A/c | 500 | ---- |
| | Discount A/c | 10 | 10 |
| | Total | 11,110 | 11,110 |

***Illustration 2:*** From the following ledger accounts of Kalkaji Ltd. prepare Trial Balance for year 2010-2011 by (i) total method (ii) combined method (both balance method and total method):

**Cash A/c**

**Dr.** **Cr.**

| Date | Particulars | J.F. | Amount (₹) | Date | Particulars | J.F. | Amount (₹) |
|---|---|---|---|---|---|---|---|
| 2011 | | | | 2011 | | | |
| Jan. 1 | Capital A/c | | 50,000 | Jan. 2 | Bank A/c | | 40,000 |
| Jan. 28 | Ranjeet | | 9,900 | Jan. 12 | Freight A/c | | 200 |
| | | | | Jan. 31 | Salary A/c | | 3,000 |
| | | | | Jan. 31 | Rent A/c | | 2,400 |
| | | | **59,900** | | | | **45,600** |

**Bank A/c**

**Dr.** **Cr.**

| Date | Particulars | J.F. | Amount (₹) | Date | Particulars | J.F. | Amount (₹) |
|---|---|---|---|---|---|---|---|
| 2011 | | | | 2011 | | | |
| Jan. 2 | Cash A/c | | 40,000 | Jan. 8 | Furniture A/c | | 12,000 |
| Jan. 14 | Sales A/c | | 16,000 | Jan. 10 | Purchases A/c | | 20,000 |
| | | | | Jan. 20 | Vikas | | 12,000 |
| | | | | Jan. 31 | Drawings | | 4,000 |
| | | | **56,000** | | | | **48,000** |

**Furniture A/c**

**Dr.** **Cr.**

| Date | Particulars | J.F. | Amount (₹) | Date | Particulars | J.F. | Amount (₹) |
|---|---|---|---|---|---|---|---|
| 2011 | | | | | | | |
| Jan. 8 | Bank A/c | | 12,000 | | | | |
| | | | **12,000** | | | | |

Notes

**Capital A/c**

**Dr.** **Cr.**

| Date | Particulars | J.F. | Amount (₹) | Date | Particulars | J.F. | Amount (₹) |
|---|---|---|---|---|---|---|---|
| | | | | 2011 | | | |
| | | | | Jan. 1 | Cash A/c | | 50,000 |
| | | | | | | | **50,000** |

**Purchases A/c**

**Dr.** **Cr.**

| Date | Particulars | J.F. | Amount (₹) | Date | Particulars | J.F. | Amount (₹) |
|---|---|---|---|---|---|---|---|
| 2011 | | | | | | | |
| Jan. 10 | Bank A/c | | 20,000 | | | | |
| Jan. 12 | Vikas | | 15,000 | | | | |
| | | | **35,000** | | | | |

**Sales A/c**

**Dr.** **Cr.**

| Date | Particulars | J.F. | Amount (₹) | Date | Particulars | J.F. | Amount (₹) |
|---|---|---|---|---|---|---|---|
| | | | | 2011 | | | |
| | | | | Jan. 14 | Bank A/c | | 16,000 |
| | | | | Jan. 20 | Ranjeet | | 14,000 |
| | | | | | | | **30,000** |

**Vikas A/c**

**Dr.** **Cr.**

| Date | Particulars | J.F. | Amount (₹) | Date | Particulars | J.F. | Amount (₹) |
|---|---|---|---|---|---|---|---|
| 2011 | | | | 2011 | | | |
| Jan. 20 | Bank A/c | | 12,000 | Jan. 12 | Purchases A/c | | 15,000 |
| | | | **12,000** | | | | **15,000** |

**Ranjeet A/c**

**Dr.** **Cr.**

| Date | Particulars | J.F. | Amount (₹) | Date | Particulars | J.F. | Amount (₹) |
|---|---|---|---|---|---|---|---|
| 2011 | | | | 2011 | | | |
| Jan. 20 | Sales A/c | | 14,000 | Jan. 25 | Cash A/c | | 9,900 |
| | | | | Jan. 28 | Discount A/c | | 100 |
| | | | **14,000** | | | | **10,000** |

**Freight A/c**

**Dr.** **Cr.**

| Date | Particulars | J.F. | Amount (₹) | Date | Particulars | J.F. | Amount (₹) |
|---|---|---|---|---|---|---|---|
| 2011 | | | | | | | |
| Jan. 12 | Cash A/c | | 200 | | | | |
| | | | **200** | | | | |

Notes

**Salary A/c**

| Dr. | | | | | | | Cr. |
|---|---|---|---|---|---|---|---|
| **Date** | **Particulars** | **J.F.** | **Amount (₹)** | **Date** | **Particulars** | **J.F.** | **Amount (₹)** |
| 2011<br>Jan. 31 | Cash A/c | | 3,000 | | | | |
| | | | **3,000** | | | | |

**Rent A/c**

| Dr. | | | | | | | Cr. |
|---|---|---|---|---|---|---|---|
| **Date** | **Particulars** | **J.F.** | **Amount (₹)** | **Date** | **Particulars** | **J.F.** | **Amount (₹)** |
| 2011<br>Jan. 31 | Cash A/c | | 2,400 | | | | |
| | | | **2,400** | | | | |

**Drawings A/c**

| Dr. | | | | | | | Cr. |
|---|---|---|---|---|---|---|---|
| **Date** | **Particulars** | **J.F.** | **Amount (₹)** | **Date** | **Particulars** | **J.F.** | **Amount (₹)** |
| 2011<br>Jan. 31 | Bank A/c | | 4,000 | | | | |
| | | | **4,000** | | | | |

**Discount A/c**

| Dr. | | | | | | | Cr. |
|---|---|---|---|---|---|---|---|
| **Date** | **Particulars** | **J.F.** | **Amount (₹)** | **Date** | **Particulars** | **J.F.** | **Amount (₹)** |
| 2011<br>Jan. 28 | Ranjeet | | 100 | | | | |
| | | | **100** | | | | |

***Solution:***

(i) Total Method

**Trial Balance of Kalkaji Ltd. as on 31st January, 2011**

| Name of the Ledger Account | Balance (Dr.) (₹) | Balance (Cr.) (₹) |
|---|---|---|
| Cash | 59,900 | 45,600 |
| Bank | 56,000 | 48,000 |
| Furniture | 12,000 | – |
| Capital | – | 50,000 |
| Purchases | 35,000 | – |
| Sales | | 30,000 |
| Vikas | 12,000 | 15,000 |
| Ranjeet | 14,000 | 10,000 |

*Contd...*

Notes

| | | |
|---|---|---|
| Freight | 200 | – |
| Salary | 3,000 | |
| Rent | 2,400 | |
| Drawings | 4,000 | |
| Discount | 100 | |
| | **1,98,600** | **1,98,600** |

(ii) Combined Method (both balance method and total method)

**Trial Balance of Kalkaji Ltd. as on 31st January, 2011**

**Dr.** **Cr.**

| Name of the Ledger Account | Total Amounts (₹) | (₹) | Balance Amounts (₹) | (₹) |
|---|---|---|---|---|
| Cash | 59,900 | 45,600 | 14,300 | – |
| Bank | 56,000 | 48,000 | 8,000 | – |
| Furniture | 12,000 | – | 12,000 | – |
| Capital | – | 50,000 | – | 50,000 |
| Purchases | 35,000 | – | 35,000 | – |
| Sales | | 30,000 | – | 30,000 |
| Vikas | 12,000 | 15,000 | – | 3,000 |
| Ranjeet | 14,000 | 10,000 | 4,000 | – |
| Freight | 200 | – | 200 | – |
| Salary | 3,000 | – | 3,000 | – |
| Rent | 2,400 | – | 2,400 | – |
| Drawings | 4,000 | – | 4,000 | – |
| Discount | 100 | – | 100 | – |
| | **1,98,600** | **1,98,600** | **83,000** | **83,000** |

## Preparation of Trial Balance with the Help of Balances

In the examination problems the Ledger accounts are not given but a list of balances of accounts is given. With the help of these balances the students are asked to prepare the Trial Balance. Students should kept in mind the following rules to prepare a Trial Balance:

1. The balances of all the assets accounts and drawing accounts are recorded in the debit side of the Trial Balance.
2. The balances of all the liabilities and capital accounts are recorded in the credit side of the Trial Balance.
3. The balances of all expenses and losses of the business are showed in the debit side of the Trial Balance.
4. The balances of all incomes and gains are disclosed in the credit side of the Trial Balance.
5. The balances of sales and sale returns are disclosed in the credit side and debit side of Trial Balance respectively.
6. The balances of purchases and purchase returns are disclosed in the debit side and credit side of the Trial Balance respectively.

Notes

*Illustration 3:* Mr. Akshey Kumar furnishes the following balances as on 31st March, 2008. You have to prepare a Trial Balance with the following information:

| Particulars | (₹) | Particulars | (₹) |
|---|---|---|---|
| Interest on Capital | 24,000 | Salaries | 1,28,000 |
| Creditors | 6,00,000 | Capital | 8,00,000 |
| Discount Received | 23,000 | Drawings | 2,46,000 |
| Loan | 1,74,000 | Machinery | 3,00,000 |
| Purchase Returns | 40,000 | Bills Payable | 20,000 |
| Sales Return | 6,000 | Furniture | 6,00,000 |
| Advertisement | 1,63,000 | Debtors | 5,00,000 |
| Commission Received | 20,000 | Bank Loan | 2,00,000 |
| Rent | 10,000 | Patents | 60,000 |
| Purchases | 19,00,000 | | |
| Sales | 32,60,000 | | |
| Opening Stock | 12,00,000 | | |

*Solution:*

**Trial Balance**
**(as on 31st March, 2008)**

| Particulars | Amount (Dr.) (₹) | Amount (Cr.) (₹) |
|---|---|---|
| Interest on Capital | 24,000 | – |
| Creditors | – | 6,00,000 |
| Discount Received | – | 23,000 |
| Loan | – | 1,74,000 |
| Purchase Returns | – | 40,000 |
| Sale Returns | 6,000 | – |
| Advertisement | 1,63,000 | – |
| Commission Received | – | 20,000 |
| Rent | 10,000 | – |
| Purchases | 19,00,000 | – |
| Sales | – | 32,60,000 |
| Opening Stock | 12,00,000 | – |
| Salaries | 1,28,000 | – |
| Capital | – | 8,00,000 |
| Drawings | 2,46,000 | – |
| Machinery | 3,00,000 | – |
| Bills Payable | – | 20,000 |
| Furniture | 6,00,000 | – |
| Debtors | 5,00,000 | – |
| Bank Loan | – | 2 00 000 |
| Patents | 60,000 | – |
| **Total** | **51,37,000** | **51,37,000** |

From the above trial balances it is clear that the total of debit side will agree with the total of credit side if Ledger accounts are arithmetically correct. If these totals do not tally with each other, there will be some error in the ledger accounts.

*Task* From the following transactions, pass journal entries, prepare ledger accounts and also prepare Trial Balance under:

| | | (₹) |
|---|---|---|
| 1. | Anil started business with | 8,000 |
| 2. | Purchased furniture | 1,000 |
| 3. | Purchased goods | 6,000 |
| 4. | Sold goods | 7,000 |
| 5. | Purchased from Raja | 4,000 |
| 6. | Sold to Somu | 5,000 |
| 7. | Paid to Raja | 2,500 |
| 8. | Received from Somu | 3,000 |
| 9. | Paid rent | 200 |
| 10. | Received commission | 100 |

## Self Assessment

Fill in the blanks:

1. …………………… is a statement which shows balances of all accounts on a particular date.
2. The balances of all the liabilities and capital accounts are recorded in the …………………… of the Trial Balance.
3. The balances of all incomes and gains are disclosed in the …………… of the Trial Balance.
4. ………………… is found when one account is debited or credited in the place of another account.
5. …………………… occur when any business transaction is completely or partially omitted from the recording in the books of original records.
6. …………………… occur when there is wrong classification between the capital and revenue nature incomes or expenditures.
7. Suspense A/c is shown in the …………………….
8. The balances of all the assets accounts and drawing accounts are recorded in the …………………… of the Trial Balance.
9. The balances of all incomes and gains are disclosed in the ……………… of the Trial Balance.

Notes

## 7.3 Types of Errors

There are two types of errors:

### Errors which cannot be located by Trial Balance

The following errors cannot be detected by the trial balance means in spite of agreeing the totals of debit side and credit side, these errors occur in the accounts.

1. ***Error of Omission:*** These errors occur when any business transaction is completely omitted from the recording in the books of original records.

*Example:* As goods, sold of ₹ 10,000 to Mr. Ram, is entered nowhere in the original books then its effect will also not come on the ledger and trial balance. Thus such type of errors cannot be located by trial balance.

2. ***Error of Commission:*** Such types of errors are found when one account is debited or credited in the place of another account.

*Example:* As cash received from Shyam ₹ 1,000 has been credited in the name of Ram. Such type of errors do not affect the agreement of the totals of the debit and credit side of the trial balance but they affect the result of the business.

3. ***Error of Principle:*** These errors occur when there is wrong classification between the capital and revenue nature incomes or expenditures.

*Example:* As the purchases of furniture of ₹ 20,000 are entered in the book of purchases while it should be in furniture account. Such errors cannot be located by trial balance.

4. ***Compensating Error:*** When two errors of the same account occur and the effect of one error is compensated by the effect of other error it is called compensating error.

*Example:* If purchase of ₹ 10,000 from Ajay is credited only by ₹ 1,000 while the purchases from Vijay for ₹ 1,000 is credited by ₹ 10,000. Thus, such type of errors do not affect on the agreement of the Trial Balance.

### Errors which can be located by Trial Balance

The error which affects the agreement of the totals of the Trial balance can be located easily. These errors may be relating to:

(i) Totals of the subsidiary books or ledger accounts.

(ii) Balancing of an account of the ledger.

(iii) Wrong posting of any amount in any account.

(iv) Posting of any account may be in the wrong side of the account.

(v) Balance of any account may be omitted in writing in the Trial Balance.

(vi) Wrong total of the Trial Balance.

(vii) Partially omitted means omission may be the part of the transaction. If it is a part of the transaction then it would affect trial balance and can be located by trial balance.

Thus we see that errors are of two types:

1. ***Error of Principle***
2. ***Clerical errors which are of the following types:***
   (i) Error of Omission.
   (ii) Error of Commission.
   (iii) Compensatory errors.

***Steps to point out errors:*** If the trial balance does not agree, the following steps can be taken in order to point out the errors. These are based on hit and trial method.

1. To see whether the total of both the columns agree or does not agree. In order to see it, it must be again totalled.
2. It is also necessary to see whether the balances of all the accounts including cash and bank have been properly recorded or not.
3. Difference of both the sides must be checked carefully and if possible see whether any such item is there which is exactly of the same amount being omitted/left out. If it is not then have half of the difference and again compare it with the amount of any item of the same amount which is being left out or wrongly put.
4. Subsidiary books must also be checked again, so that if any error has taken place could be rectified.
5. Still, if there is any error, thorough and complete checking of all ledger accounts is required.

***Rectification of Errors:*** Errors are/can be rectified if the correcting entries are passed in the books of account. For this, care and alertness is exercised to see whether error is in both the accounts or is in one account only. If the error affects both the accounts, then a fresh entry is to be passed and if it affects only one account, the rectification is done by recording in one account only.

1. ***Rectification of Errors when error affects only one account:*** If it is so, no journal entry is required to pass; it is corrected by debiting or crediting the concerned account. For example, Sales book was overcasted by ₹ 250 [As the sales book was overcasted by ₹ 250], hence sale account is to be debited by ₹ 250 in order to rectify the error. This error affects only one account. Similarly, if the Purchases Day Book is undercasted by ₹ 100 then the error also affects only one account and this can be corrected by debiting purchases account by ₹ 100. Likewise paid ₹ 20 as repairs were recorded ₹ 25 in Repairs account again the error is in one account i.e., repair account. It may be corrected by crediting repair A/c by ₹ 5 i.e. the difference (₹ 25 - ₹ 20).
2. ***Rectification of Errors when it affects both the accounts:*** If it is so, it is rectified by passing a journal entry. For example, received ₹ 150 from Shri Bhagwan were credited to sales account. This error affects both the accounts i.e., (i) Shri Bhagwan A/c and (ii) Sales A/c.

Journal entry for correction would be:

**Dr.** **Cr.**

| S. No. | Particulars | L.F. | (₹) | (₹) |
|---|---|---|---|---|
| 1. | Sales A/c Dr. | | 150 | |
| | To Shri Bhagwan A/c | | | 150 |
| | (Error in Sales a/c and Shri Bhagwan A/c rectified) | | | |

Similarly, if Building is purchased for ₹ 2 lacs is recorded in the Purchases Book, again the error affects both the accounts i.e. (1) Building A/c (2) Purchases A/c.

Notes

Though the error is of principle, in the above case Purchases A/c is unnecessarily debited and Building A/c is wrongly left out. In order to rectify the error the following entry (correcting the error) is to be passed:

**Journal Entry for Correction (Rectification)**

**Dr.** **Cr.**

| S. No. | Particulars | L.F. | (₹) | (₹) |
|---|---|---|---|---|
| 1. | Building A/c Dr. | | 2,00,000 | |
| | To Purchases A/c | | | 2,00,000 |
| | (Error in Building A/c and Purchases A/c rectified) | | | |

**Journal Entry already passed which was a wrong entry**

**Dr.** **Cr.**

| S. No. | Particulars | L.F. | (₹) | (₹) |
|---|---|---|---|---|
| 1. | Purchases A/c Dr. | | 2,00,000 | |
| | To Cash/Creditor A/c | | | 2,00,000 |
| | (Building Purchased) | | | |

**Correct entry required to pass**

**Dr.** **Cr.**

| S. No. | Particulars | L.F. | (₹) | (₹) |
|---|---|---|---|---|
| 1. | Building A/c Dr. | | 2,00,000 | |
| | To Cash/Creditor A/c | | | 2,00,000 |
| | (Buildings Purchased) | | | |

Thus, we see that if the error affects both the accounts, then it can be rectified by passing a journal entry as explained above.

*Did u know?* **What is suspense account?**

Sometimes, it is not possible to point out errors easily, and then the difference is put to an account, known as suspense account. Suspense A/c is shown in the trial balance. As and when Errors are located, the same is debited or credited for rectifying the error and the other account which is credited or debited is the suspense account. Thus, the suspense account is automatically closed.

***Illustration 4:*** Rectify the following Errors:

(a) A sale of goods to Raja Ram for ₹ 2500 was passed through the Purchases book.

(b) Salary ₹ 800 paid to Hari Babu was wrongly debited to his personal account.

(c) Furniture purchased on credit from Mohan Singh for ₹ 1000 was entered in the Purchases book.

(d) ₹ 5000 spent on the extension of building was debited to the buildings repairs account.

(e) Goods returned by Mani Ram ₹ 1200 were entered in Returns outward book.

*Solution:*

Notes

**Journal Entries to rectify the errors**

Dr. Cr.

| S. No. | Particulars | L.F. | Amount (₹) | Amount (₹) |
|---|---|---|---|---|
| (a) | Raja Ram Dr. | | 5,000 | |
| | To Purchases A/c | | | 2500 |
| | To Sales A/c | | | 2500 |
| | (A sale of goods to Raja Ram through the Purchases book is rectified.) | | | |
| (b) | Salary A/c Dr. | | 800 | |
| | To Hari Babu | | | 800 |
| | (Salary wrongly debited in his personal A/c is rectified.) | | | |
| (c) | Furniture A/c Dr. | | 1,000 | |
| | To Purchases A/c | | | 1000 |
| | (Furniture purchased was wrongly entered in the Purchases book is rectified.) | | | |
| (d) | Buildings A/c Dr. | | 5,000 | |
| | To Buildings Repairs A/c | | | 5000 |
| | (Sent on extension of building was wrongly debited to Building repairs A/c is rectified.) | | | |
| (e) | Returns Inward A/c (Sales Returns) Dr. | | 1,200 | |
| | Returns Outward A/c (Purchases Returns A/c) Dr. | | 1,200 | |
| | To Mani Ram | | | 2400 |
| | (Goods returned by Mani Ram were entered in returns outward book.) | | | |

***Illustration 5:*** Rectify the following errors:

(a) Sales book was overcasted by ₹ 200.

(b) ₹ 100 received as rent from the tenant was debited to rent account.

(c) Received ₹ 500 from Sudan Mittal was credited to Sales book.

(d) Paid ₹ 200 as salary, but were debited ₹ 20 in Salary account.

(e) Paid ₹ 20 as repairs were recorded ₹ 25 in Repairs account.

*Solution:*

(a) As the sales book was overcast by ₹ 200, so sales A/c is to be debited by ₹ 200 in order to rectify the error, this error affects only one account.

Dr. Cr.

| S. No. | Particulars | L.F. | Amount (₹) | Amount (₹) |
|---|---|---|---|---|
| (b) | Suspense A/c Dr. | | 200 | |
| | To Rent A/c | | | 200 |
| | (Rent A/c was wrongly debited, hence rectified by₹ 200.) | | | |

*Contd...*

Notes

| | | | | |
|---|---|---|---|---|
| (c) | Sales A/c Dr. | | 500 | |
| | To Sudan Mittal | | | 500 |
| | (Sales A/c was wrongly credited in place of Sudan Mittal, rectified.) | | | |
| (d) | Salary A/c Dr. | | 180 | |
| | To Suspense A/c | | | 180 |
| | (Salary A/c was debited less by ₹ 180, hence rectified.) | | | |
| (e) | Suspense A/c Dr. | | 05 | |
| | To Repairs A/c | | | 05 |
| | (Excess in repairs A/c credited to rectify the error.) | | | |

***Illustration 6:*** Rectify the following errors:

(i) ₹ 700 paid for the purchase of new office furniture charged to office expenses A/c.

(ii) Goods worth ₹ 174 were sold to Roop but latter A/c was actually credited by ₹ 147.

(iii) Sales Day book was undercasted by ₹ 200.

(iv) The total of the discount column on the debit side of the Cash book was short by ₹ 30.

(v) An amount of ₹ 1000 withdrawn by the proprietor for his personal use was debited to Trade expenses A/c.

(vi) ₹ 200 was received on account of rent but was credited to dividend A/c.

(vii) Goods sold to Mr. Rakesh for ₹ 705 but entry was made for ₹ 570.

(viii) An amount of ₹ 325 owing by Mukesh was omitted from the list of Sundry debtors.

***Solution:***

**Journal Entries to rectify the errors**

**Dr.** **Cr.**

| S. No. | Particulars | L.F. | Amount (₹) | Amount (₹) |
|---|---|---|---|---|
| (i) | Office Furniture A/c Dr. | | 700 | |
| | To Office expenses A/c | | | 700 |
| | (Error in office expenses A/c rectified.) | | | |
| (ii) | Roop Dr. | | 321 | |
| | To Suspense A/c | | | 321 |
| | (Error in Roop A/c rectified.) | | | |
| (iii) | Suspense A/c Dr. | | 200 | |
| | To Sales A/c | | | 200 |
| | (Error in sales A/c rectified.) | | | |
| (iv) | Discount A/c Dr. | | 30 | |
| | To Suspense A/c | | | 30 |
| | (Discount columns on debit side short by ₹ 30 corrected.) | | | |
| (v) | Proprietor Drawings A/c Dr. | | 1000 | |
| | To Trade expenses A/c | | | 1000 |
| | (Error in trade expenses A/c rectified.) | | | |

*Contd...*

| | | | | | |
|---|---|---|---|---|---|
| (vi) | Dividend A/c Dr. | | 200 | |
| | To Rent A/c | | | 200 |
| | (Error in dividend A/c rectified.) | | | |
| (vii) | Rakesh Dr. | | 135 | |
| | To Sales A/c | | | 135 |
| | (Error in Rakesh and Sales A/c rectified [₹ 705 – 570].) | | | |
| (viii) | Mukesh (Sundry Debtors) Dr. | | 325 | |
| | To Suspense A/c | | | 325 |
| | (Error in Mukesh A/c rectified.) | | | |

*Illustration 7:* Rectify the following errors:

(i) A sale of furniture of ₹ 700 had been credited to Sales A/c.

(ii) ₹ 1000 paid as rent to landlord was debited to Landlord account.

(iii) Materials from store ₹ 1000 and wages ₹ 400 had been used in making tools and equipments for use in our factory, but no adjustments were made in the books.

(iv) Purchase book was undercasted by ₹ 100.

(v) A sale of ₹ 500 to Gupta & Co. was credited to their account.

***Solution:***

**Journal Entries to rectify the errors**

**Dr.** **Cr.**

| S. No. | Particulars | L.F. | Amount (₹) | Amount (₹) |
|---|---|---|---|---|
| (i) | Sales A/c Dr. | | 700 | |
| | To Furniture A/c | | | 700 |
| | (Sale of furniture wrongly credited to sales A/c hence rectified.) | | | |
| (ii) | Rent A/c Dr. | | 1000 | |
| | To Landlord | | | 1000 |
| | (Landlord A/c was wrongly debited hence rectified.) | | | |
| (iii) | Tools and Equipments A/c Dr. | | 1,400 | |
| | To Materials A/c | | | 1000 |
| | To Wages A/c | | | 400 |
| | (Adjustment made for materials & wages used for making tools etc.) | | | |
| (iv) | Purchases A/c Dr. | | 100 | |
| | To Suspense A/c | | | 100 |
| | (Purchase book was under cast, hence rectified.) | | | |
| (v) | Gupta & Co. A/c Dr. | | 1000 | |
| | To Suspense A/c | | | 1000 |
| | (A sale which was wrongly credited in his A/c, is rectified.) | | | |

*Illustration 8:* Pass journal entries to rectify the following errors:

(i) A cheque of ₹ 700 received for damages had been deposited in the proprietor's private bank account.

(ii) An item of purchase for ₹ 151 was entered in the purchase book as ₹ 15 and posted to the supplier account as ₹ 51.

(iii) The sale book was undercasted by ₹ 100.

Notes

(iv) An amount of ₹ 2,000 received from Ram has been wrongly posted to the credit of Ravi as ₹ 200.

(v) Discount column of the receipt side of the cash book was wrongly added as ₹ 40 instead of ₹ 140.

***Solution:***

**Journal Entries to rectify the errors**

**Dr.** **Cr.**

| S. No. | Particulars | L.F. | Amount (₹) | Amount (₹) |
|---|---|---|---|---|
| (i) | Proprietor's A/c Dr. | | 700 | |
| | To Sundry Income A/c | | | 700 |
| | (Proprietor's A/c was wrongly credited hence rectified.) | | | |
| (ii) | Purchases A/c Dr. | | 136 | |
| | To Supplier's A/c | | | 100 |
| | To Suspense A/c | | | 36 |
| | (Purchases A/c & Supplier's A/c were wrongly debited & credited hence rectified.) | | | |
| (iii) | Suspense A/c Dr. | | 100 | |
| | To Sales A/c | | | 100 |
| | (Sales A/c was under cast hence credited by ₹ 100.) | | | |
| (iv) | Ravi Dr. | | 200 | |
| | Suspense A/c Dr. | | 1,800 | |
| | To Ram | | | 2000 |
| | (Ravi's A/c wrongly credited in place of Ram, hence rectified.) | | | |
| (v) | Suspense A/c Dr. | | 100 | |
| | To Discount A/c | | | 100 |
| | (Discount column on the receipt side of the cash book wrongly totalled, hence rectified.) | | | |

***Illustration 9:*** The following errors were detected in the accounts of M/s Rajesh & Sons for the year ended on 30th June, 2006.

(i) A bill for ₹ 2000 for the erection of a small cycle shed was debited to repairs A/c.

(ii) A cheque for ₹ 200 received from Ram & Co. was dishonoured and debited to discount account.

(iii) A sum of ₹ 500 drawn by the proprietor for his personal expenses was debited to travelling expenses account.

(iv) Goods to the value of ₹ 100 returned by Ram were put into stock but no entry was made in the books.

(v) A cheque of ₹ 100 received from Kartar Chand was credited to the account of Tota Ram and debited to cash instead of the bank account.

(vi) Wages paid to the firm's own workman for certain additions to the new machinery amounted to ₹ 500 were posted to wages account.

Give journal entries to correct these errors.

Notes

*Solution:*

**Journal Entries to rectify the errors**

**Dr.** **Cr.**

| S. No. | Particulars | L.F. | Amount (₹) | Amount (₹) |
|---|---|---|---|---|
| (i) | Buildings A/c Dr.<br>To Repairs A/c<br>(Repairs A/c was wrongly debited in place of buildings A/c, hence rectified.) | | 2000 | <br>2000 |
| (ii) | Ram & Co. Dr.<br>To Discount A/c<br>(Rectification of error in discount A/c in place of Ram & co.) | | 200 | <br>200 |
| (iii) | Proprietor's Drawings A/c Dr.<br>To Travelling Expenses A/c<br>(Error in travelling expenses A/c rectified.) | | 500 | <br>500 |
| (iv) | Sales returns A/c Dr.<br>To Ram<br>(Goods returned by Ram were not entered, hence rectified.) | | 100 | <br>100 |
| (v) | I. Tota Ram Dr.<br>To Kartar Chand<br>(Error in Tota Ram A/c rectified.) | | 100 | <br>100 |
| | II. Bank A/c Dr.<br>To Cash A/c<br>(Error in Cash A/c rectified.) | | 100 | <br>100 |
| (vi) | Machinery A/c Dr.<br>To Wages A/c<br>(Error in wages A/c rectified.) | | 500 | <br>500 |

***Effects of errors on the profits and losses (profit and loss A/c and Balance Sheet) (Final Accounts):*** If the error/errors are there or committed, the effect of such errors would be either decrease or increase in the Gross Profit/Net Profit. The Profit/Loss depicted by profit and loss account would not be correct, so it is necessary to rectify the errors and arrive at the correct amount of profit/loss of the period. Similarly, financial position as given by the Balance Sheet would also not be correct if some errors are there/committed. Again, it is also must to rectify the errors at the earliest, so that Balance Sheet can depict a true and fair view of the business. The following illustrations would clarify the above points.

***Illustration 10:*** On 31st Dec, 2006 the Trial balance of Sunil & Co., balanced after inserting a suspense account in the nominal ledger. In the course of audit, the following facts were discovered:

(a) ₹ 120 received from A had been posted to B's account in the sales ledger.

(b) ₹ 50 paid for postage stamps had been entered correctly in the cash book, but not posted.

(c) In casting the Sales Day Book ₹ 878 were carried forward as ₹ 787.

Notes

(d) An Invoice of ₹ 960 in respect of Motor Car debited to Motor Car A/c included the cost of licence ₹ 60.

(e) ₹ 540 credited to Partners' current Account for interest on capital had been debited to Bank Interest account.

(f) Discount received from Mittal & Co. ₹ 200 had not been posted to Discount A/c. Pass entries necessary to correct the errors and prepare the suspense account. Also find out what effect these errors would have on the profit for the year ending 31st Dec, 2006.

***Solution:***

**Journal Entries to rectify the errors**

**Dr.** **Cr.**

| S. No. | Particulars | | L.F. | Amount (₹) | Amount (₹) |
|---|---|---|---|---|---|
| (a) | B | Dr. | | 120 | |
| | To A | | | | 120 |
| | (Error in B's A/c Corrected.) | | | | |
| (b) | Postage A/c | Dr. | | 50 | |
| | To Suspense A/c | | | | 50 |
| | (Postage A/c Omission corrected.) | | | | |
| (c) | Suspense A/c | Dr. | | 91 | |
| | To Sales A/c | | | | 91 |
| | Sales Day Book balance | | | | |
| | Wrongly carried forward | | | | |
| | (Hence corrected 878 – 787) | | | | |
| (d) | Motor Licence A/c | Dr. | | 60 | |
| | To Motor Car A/c | | | | 60 |
| | (Error in Motor Car A/c corrected.) | | | | |
| (e) | Suspense A/c | Dr. | | 1080 | |
| | To Partner's Current A/c | | | | 540 |
| | To Bank Interest A/c | | | | 540 |
| | (Error in Bank Interest A/c corrected and partners' A/c credited.) | | | | |
| (f) | Suspense A/c | Dr. | | 200 | |
| | To Discount A/c | | | | 200 |
| | (Omission in Discount A/c corrected.) | | | | |

**Suspense A/c**

**Dr.** **Cr.**

| S. No. | Particulars | J.F. | Amount (₹) | S. No. | Particulars | J.F. | Amount (₹) |
|---|---|---|---|---|---|---|---|
| (c) | To Sales A/c | | 91 | (b) | By Postage A/c | | 50 |
| (e) | To Partners' current A/c | | 540 | | By Balance | | 1321 |
| (f) | To Bank Int. A/c | | 540 | | | | |
| | To Discount A/c | | 200 | | | | |
| | | | 1371 | | | | 1371 |

Effects on the profit for the year 2006:

(a) No effect.

(b) Net profit is higher by ₹ 50.

(c) Gross profit and Net profit is reduced by ₹ 91.

(d) Net profit is higher by ₹ 60.

(e) Net Profit is reduced by ₹ 540.

(f) Net profit is lower by ₹ 200.

The total effect of all errors on profit is ₹ 721 i.e. profit is lower to the extent of ₹ 721 and if corrected, Net profit increase by ₹ 721.

***Illustration 11:*** Consider the following trial balance :

**Trial Balance**
**(As on 31 March 2011)**

| S. No. | Particulars | LF | Amount (Dr.) (₹) | Amount (Cr.) (₹) |
|---|---|---|---|---|
| 1. | Capital Account | | | 5,00,000 |
| 2. | Sales Account | | | 25,50,000 |
| 3. | Purchases Account | | 18,75,000 | |
| 4. | Salaries Account | | 5,20,000 | |
| 5. | Rent, rates & taxes | | 1,67,500 | |
| 6. | Interest income | | | 1,25,000 |
| 7. | Interest expenses | | 1,76,000 | |
| 8. | Bank Loan | | | 20,00,000 |
| 9. | Returns inward | | 32,000 | |
| 10. | Returns outward | | | 25,000 |
| 11. | Carriage inward | | 87,500 | |
| 12. | Carriage outward | | 55,000 | |
| 13. | Income tax paid | | 50,000 | |
| 14. | Property, plant and equipment | | 18,00,000 | |
| 15. | Debtors | | 3,55,000 | |
| 16. | Creditors | | | 1,75,000 |
| 17. | Cash and Bank balances | | 1,76,000 | |
| 18. | Suspense Account | | 81,000 | |
| | | | **53,75,000** | **53,75,000** |

The accountant could not tally the trial balance, and put the difference in suspense account.

***Other Information:*** While inspecting the books of accounts, the accountant found the following errors:

(a) Rent for the month of October 2010 of ₹ 10,000 was wrongly debited to salaries account.

(b) Carriage outward of ₹ 7,500 was debited to carriage inward account.

(c) Cash sales of ₹ 45,000 was debited in purchases account.

(d) Cash paid to creditors ₹ 22,500 was debited to creditors account as ₹ 25,200.

(e) Interest paid ₹ 5,350 was debited in interest income account

(f) Return inward of ₹ 25,350 was credited in return inward account.

(g) Cash paid to creditors ₹ 61,500 was credited in creditors account.

Redraft the trial balance after rectifying the above errors.

Notes

***Solution:*** The accountant could not tally the trial balance. The total of 'credit side' was more than that of 'debit side' by ₹ 81,000. The accountant perhaps had to close the trial balance and present it before his boss. He put the entire difference of ₹ 81,000 in suspense account and made the trial balance tally. He, however, did not stop worrying about the difference of ₹ 81,000 in the trial balance. That is how he detected the errors as mentioned above. Since the trial balance has already been prepared, the accountant needs to pass complete journal entries to rectify the errors.

**Journal Entries**

| S. No. | Particulars | | L.F. | Amount (Dr.) (₹) | Amount (Cr.) (₹) |
|---|---|---|---|---|---|
| (a) | Rent A/c | Dr. | | 10,000 | |
| | To Salaries A/c | | | | 10,000 |
| | (Rent paid for the month of October, 2003 wrongly debited to salaries account, now rectified) | | | | |
| (b) | Carriage Outward A/c | Dr. | | 7,500 | |
| | To Carriage Inward A/c | | | | 7,500 |
| | (Carriage outward charges wrongly debited to carriage inward account, now rectified) | | | | |
| (c) | Suspense A/c | Dr. | | 90,000 | |
| | To Purchases A/c | | | | 45,000 |
| | To Sales A/c | | | | 45,000 |
| | (Cash sales erroneously debited in purchases account, now corrected) | | | | |
| (d) | Suspense A/c [25,200-22,500] | Dr. | | 2,700 | |
| | To Creditors A/c | | | | 2,700 |
| | (Rectification of excess debit in creditors account) | | | | |
| (e) | Interest expense A/c | Dr. | | 5,350 | |
| | To Interest Income A/c | | | | 5,350 |
| | (Rectification of wrong entry in interest income account) | | | | |
| (f) | Return Inward A/c | Dr. | | 50,700 | |
| | To Suspense A/c | | | | 50,700 |
| | (Return inward of ₹ 25,350 wrongly credited in that account, now rectified) | | | | |
| (g) | Creditors A/c | Dr. | | 1,23,000 | |
| | To Suspense A/c | | | | 1,23,000 |
| | (Rectification of a wrong credit in creditors account) | | | | |

Let us now re-open the affected ledger accounts, and make the postings of rectification entries. We shall not unnecessarily open other accounts.

**Rent, Rates & Taxes Account**

Dr. Cr.

| Date | Particulars | J.F | Amount (₹) | Date | Particulars | J.F. | Amount (₹) |
|---|---|---|---|---|---|---|---|
| 2011 | | | | 2011 | | | |
| 31 March | To Balance b/d | | 1,67,500 | 31 March | By Balance c/d | | 1,77,500 |
| 31 March | To Salaries A/c | | 10,000 | | | | |
| | | | 1,77,500 | | | | 1,77,500 |

Notes

**Salaries Account**

**Dr.** **Cr.**

| Date | Particulars | J.F. | Amount (₹) | Date | Particulars | J.F. | Amount (₹) |
|---|---|---|---|---|---|---|---|
| 2011 | | | | 2011 | | | |
| 31 March | To Balance b/d | | 5,20,000 | 31 March | By Rent A/c | | 10,000 |
| | | | | 31 March | By Balance c/d | | 5,10, 000 |
| | | | 5,20,000 | | | | 5,20,000 |

**Carriage Outward Account**

**Dr.** **Cr.**

| Date | Particulars | J.F. | Amount (₹) | Date | Particulars | J.F. | Amount (₹) |
|---|---|---|---|---|---|---|---|
| 2011 | | | | 2011 | | | |
| 31 March | To Balance b/d | | 55,000 | 31 March | By Balance c/d | | 62,500 |
| 31 March | To Carriage inward A/c | | 7,500 | | | | |
| | | | 62,500 | | | | 62,500 |

**Carriage Inward Account**

**Dr.** **Cr.**

| Date | Particulars | J.F. | Amount (₹) | Date | Particulars | J.F. | Amount (₹) |
|---|---|---|---|---|---|---|---|
| 2011 | | | | 2011 | | | |
| 31 March | To Balance b/d | | 87,500 | 31 March | By Carriage outward A/c | | 7,500 |
| | | | | 31 March | By Balance c/d | | 80,000 |
| | | | 87,500 | | | | 87,500 |

**Purchases Account**

**Dr.** **Cr.**

| Date | Particulars | J.F. | Amount (₹) | Date | Particulars | J.F. | Amount (₹) |
|---|---|---|---|---|---|---|---|
| 2011 | | | | 2011 | | | |
| 31 March | To Balance b/d | | 18,75,000 | 31 March | By Suspense A/c | | 45,000 |
| | | | | 31 March | By Balance c/d | | 18,30,000 |
| | | | 18,75,000 | | | | 18,75,000 |

**Sales Account**

**Dr.** **Cr.**

| Date | Particulars | J.F. | Amount (₹) | Date | Particulars | J.F. | Amount (₹) |
|---|---|---|---|---|---|---|---|
| 2011 | | | | 2011 | | | |
| 31 March | To Balance c/d | | 25,95,000 | 31 March | By Balance b/d | | 25,50,000 |
| | | | | 31 March | By Suspense A/c | | 45,000 |
| | | | 25,95,000 | | | | 25,95,000 |

Notes

**Creditors Account**

Dr. Cr.

| Date | Particulars | J.F. | Amount (₹) | Date | Particulars | J.F. | Amount (₹) |
|---|---|---|---|---|---|---|---|
| 2011 | | | | 2011 | | | |
| 31 March | To Suspense A/c | | 1,23,000 | 31 March | By Balance b/d | | 1,75,000 |
| 31 March | To Balance c/d | | 54,700 | 31 March | By Suspense A/c | | 2,700 |
| | | | 1,77,700 | | | | 1,77,700 |

**Interest Expense Account**

Dr. Cr.

| Date | Particulars | J.F. | Amount (₹) | Date | Particulars | J.F. | Amount (₹) |
|---|---|---|---|---|---|---|---|
| 2011 | | | | 2011 | | | |
| 31 March | To Balance b/d | | 1,76,000 | 31 March | By Balance c/d | | 1,81,350 |
| 31 March | To Interest income A/c | | 5,350 | | | | |
| | | | 1,81,350 | | | | 1,81,350 |

**Interest Income Account**

Dr. Cr.

| Date | Particulars | J.F. | Amount (₹) | Date | Particulars | J.F. | Amount (₹) |
|---|---|---|---|---|---|---|---|
| 2011 | | | | 2011 | | | |
| 31 March | To Balance c/d | | 1,30,350 | 31 March | By Balance b/d | | 1,25,000 |
| | | | | 31 March | By Interest Expense A/c | | 5,350 |
| | | | 1,30,350 | | | | 1,30,350 |

**Return Inward Account**

Dr. Cr.

| Date | Particulars | J.F. | Amount (₹) | Date | Particulars | J.F. | Amount (₹) |
|---|---|---|---|---|---|---|---|
| 2011 | | | | 2011 | | | |
| 31 March | To Balance b/d | | 32,000 | 31 March | By Balance c/d | | 82,700 |
| 31 March | To Suspense A/c | | 50,700 | | | | |
| | | | 82,700 | | | | 82,700 |

**Suspense Account**

Dr. Cr.

| Date | Particulars | J.F. | Amount (₹) | Date | Particulars | J.F. | Amount (₹) |
|---|---|---|---|---|---|---|---|
| 2011 | | | | 2011 | | | |
| 31 March | To Balance b/d | | 81,000 | 31 March | By Return Inward A/c | | 50,700 |
| 31 March | To Purchase A/c | | 45,000 | 31 March | By Creditors A/c | | 1,23,000 |
| 31 March | To Sales A/c | | 45,000 | | | | |
| 31 March | To Creditors A/c | | 2,700 | | | | |
| | | | 1,73,700 | | | | 1,73,700 |

Notes

We redraft the trial balance as below with rectified balances. The ledger accounts, which have undergone rectification, are marked (*)

**Trial balance (Revised)**
**(As on 31 March 2011)**

| S. No. | Particular | Amount (Dr.) (₹) | Amount (Cr.) (₹) |
|---|---|---|---|
| 1. | Capital Account | | 5,00,000 |
| 2. | Sales Account* | | 25,95, 000 |
| 3. | Purchases Account* | 18,30,000 | |
| 4. | Salaries Account* | 5,10,000 | |
| 5. | Rent, rates & taxes Account* | 1,77,500 | |
| 6. | Interest income Account* | | 1,30,350 |
| 7. | Interest expenses Account* | 1,81,350 | |
| 8. | Bank Loan Account | | 20,00,000 |
| 9. | Returns Inward Account* | 82,700 | |
| 10. | Returns Outward Account | | 25,000 |
| 11. | Carriage Inward Account* | 80,000 | |
| 12. | Carriage Outward Account* | 62,500 | |
| 13. | Income tax paid Account | 50,000 | |
| 14. | Property, plant and equipment | 18,00,000 | |
| 15. | Debtors Account | 3,55,000 | |
| 16. | Creditors Account* | | 54,700 |
| 17. | Cash and Bank balances | 1,76,000 | |
| | | 53,05,050 | 53,05,050 |

The suspense account no longer figures in the Trial Balance. It implies that all the errors affecting the agreement of trial balance have been identified and rectified.

## Self Assessment

Multiple Choice Questions:

10. Purchases Day Book under cast by ₹ 200.
    (a) Error of Principle
    (b) Compensating Error
    (c) Error of Omission
    (d) Error of Commission.
11. Amount spent on the repair of a plant is wrongly debited to repairs A/c:
    (a) Error of Omission
    (b) Error of Commission
    (c) Error of Principle
    (d) Compensating Error.
12. Mr. Ram's account is debited in place of Shyam's A/c for ₹ 500.
    (a) Error of Omission
    (b) Error of Principle

Notes

(c) Error of Commission

(d) Compensating Error.

13. Sales day book overcast by ₹ 150.

(a) Error of Omission

(b) Error of Commission

(c) Compensation Error

(d) Error of principle.

14. Purchase of Furniture is debited to Purchases A/c.

(a) Error of Omission

(b) Error of Principle

(c) Error of Commission

(d) None of the above.

15. Bad debts recovered from a debtor are credited to his account.

(a) Error of Omission

(b) Error of Commission

(c) Error of Principle

(d) Compensating Error.

## 7.4 Summary


- Trial Balance is a list of accounting balances and their names; of the enterprise during the specified period which includes debit and credit balances of the various balanced ledger accounts out of the journal entries.
- Purposes of preparing the Trial Balance are to prepare a statement of disclosure of final accounting balances of various ledger accounts on a particular date.
- There can be certain errors in recording the accounting transactions in primary and secondary books of accounts.
- The following errors cannot be detected by the trial balance means in spite of agreeing the totals of debit side and credit side
  - ❖ Error of omission
  - ❖ Error of commission
  - ❖ Error of principle
  - ❖ Compensating error
- The errors which can be located in the trial balance are wrong total, balancing error, positioning error etc.
- Sometimes, it is not possible to point out errors easily, then the difference is put to an account, known as suspense account.

Notes

## 7.5 Keywords

***Bill of Exchange:*** A bill of exchange is an unconditional order signed by the maker which directs the recipient to pay a fixed sum of money to a third party at a future date.

***Suspense Account:*** Sometimes, it is not possible to point out errors easily, and then the difference is put to an account, known as suspense account.

***Trial Balance:*** It is the list of accounts taken from the ledger.

## 7.6 Review Questions

1. What is a Trial Balance? Name the errors that are disclosed by Trial Balance.
2. What is Trial Balance? Is it true to say that results are accurate if Trial Balance tallies?
3. What do you mean by a Trial Balance? Discuss its main objects and show how it is prepared.
4. Give two examples each of the one sided and doubles sided errors. How are they corrected?
5. Explain the errors (i) which are revealed by the Trial Balance and (ii) the errors which are not revealed by the trial balance.
6. Is the agreement of a Trial Balance a conclusive proof of accuracy of ledger accounts? If not, what are the errors which remain undetected by the Trial balance?
7. Discuss the errors which do not affect the agreement of a trial balance.
8. Distinguish between:
   (a) Balance Sheet and a Trial Balance
   (b) Errors of commission and errors of omission.
9. Write short-notes on the following:
   (a) Error of Principle
   (b) Compensatory errors
   (c) Factors affecting disagreement of Trial Balance.
10. The following balances are extracted from the books of Mr. Rakesh as on 31.12.2005

**Prepare a trial balance**

| | (₹) | | (₹) |
|---|---|---|---|
| Capital | 15,000 | Purchases | 7 ,200 |
| Land & Building | 15,600 | Provision for bad debts | 370 |
| Bank overdraft | 2,500 | Sales | 17,000 |
| Cash in hand | 680 | Wages | 1250 |
| Stock in Trade as on 1.1.04 | 6,000 | Salaries | 700 |
| Advertisement | 210 | Insurance | 40 |
| Rent & Taxes | 160 | Discount allowed | 300 |
| Interest & Discount received | 300 | Repairs to building | 210 |
| Debtors | 6420 | Creditors | 4,100 |
| | | General Expenses | 500 |

11. Give the journal entries necessary to rectify the following errors:
   (a) A payment of ₹ 250 for purchase of a Typewriter for office use has been debited to Purchases A/c.

Notes

(b) A credit sale of ₹ 127 to Mr. Chandra has been posted to the debit of Mr. Kuchhal's account from the Sales Day book.

(c) A payment of ₹ 96 for white washing the office has been charged to Buildings accounts.

12. Rectify the following Errors:

    (a) Sales to Vinod ₹ 143 posted to his account as ₹ 134.

    (b) Sales to Vinod ₹ 143 debited to his account as ₹ 134.

    (c) Sales to Vinod ₹ 143 credited to his account as ₹ 134.

13. Rectify the following Errors:

    (a) Wages paid for the construction of office debited to wages account ₹ 1,500.

    (b) Cartage paid for the newly purchased furniture ₹ 10 posted to cartage account.

    (c) Furniture purchased on credit from Ram for ₹ 300 posted as ₹ 30.

    (d) Sales to X ₹ 400 posted to Y's account.

    (e) Wages paid ₹ 2,550 were recorded in the cash book as ₹ 2,505.

    (f) Purchases from Y ₹ 1,002 were omitted from the books.

14. There was difference in the trial balance of Sri Arihant which was put to a newly opened suspense account. Subsequently the following mistakes were discovered. Pass journal entries to rectify them and ascertain the difference in the trial balance.

    (a) Materials Costing ₹ 1700 in the erection of the machinery and the wages for it amounting to ₹ 1,400 were included in the purchases account and the wage account respectively.

    (b) Goods sold under credit terms ₹ 16,900 to music were recorded properly in the sales book but were debited to his account as ₹ 19600 and carriage outward and freight paid ₹ 700 chargeable from him were posted to sales expenses account.

    (c) Sales return by Yogeshwar ₹ 2300 were correctly recorded in the sales return book from where they were debited to Yogeshwar's account by ₹ 32.

    (d) Old furniture originally purchased for ₹ 1800 written down to ₹ 1100 was sold for ₹ 1700 and was credited to furniture account.

    (e) Machinery purchased on credit ₹ 17000 was recorded in purchases book and transport charges for the machine ₹ 1200 were debited to trade expenses account.

## Answers: Self Assessment

| | | | |
|---|---|---|---|
| 1. | Trial Balance | 2. | Credit side |
| 3. | Credit side | 4. | Error of commission |
| 5. | Error of omission | 6. | Error of principle |
| 7. | Trial balance | 8. | Debit side |
| 9. | Credit side | 10. | (d) |
| 11. | (c) | 12. | (d) |
| 13. | (b) | 14. | (b) |
| 15. | (b) | | |

## 7.7 Further Readings

*Books*

Khan and Jain, “Management Accounting”.

M.P. Pandikumar, “Accounting & Finance for Managers”, Excel Books, New Delhi.

R.L. Gupta and Radhaswamy, “Advanced Accountancy”.

S.N. Maheswari, “Management Accounting”.

V.K. Goyal, “Financial Accounting”, Excel Books, New Delhi.

*Online link*

www.futureaccountant.com

Notes

# Unit 8: Financial Statements

CONTENTS



## Objectives

After studying this unit, you will be able to:

- Understand meaning of financial statements
- Prepare trading and profit & loss A/c
- Prepare balance sheet
- Construct adjustments entries
- Prepare final accounts with adjustments

## Introduction

In the present unit, you will study about the final accounts with adjustments. After studying this unit, you will be able to understand the trading and profit & loss account, balance sheet and key adjustments related to them. Every organisation prepares its final accounts after a particular period to know its financial results and financial position. Final accounts mean profit & loss account and the balance sheet. Profit & loss account also contains one more account, known as trading account, and if the business is manufacturing any item or article, then Manufacturing account is also there. All these accounts are prepared only after preparing trial balance.

Notes

## 8.1 Meaning of Financial Statements

Financial statements mean (i) Balance sheet, (ii) profit & loss account, and (iii) several other schedules. Nowadays one more statement is also prepared that is funds flow statement or cash flow statement.

Whatever business activities are done, it is essential to know its operational results i.e. whether business is running at profit or loss, for this purpose balances of all ledger accounts are taken and a statement of balances is prepared which is known as trial balance. Final accounts are prepared from such balances. Therefore, it is necessary to know the meaning and object of final accounts.

Final accounts mean profit & loss account and the balance sheet. Profit & loss account also contains one more account, known as Trading account, and if the business is manufacturing any item or article, then Manufacturing account is also there. All these accounts are prepared only after preparing trial balance.

## 8.2 Objectives of Preparing Final Accounts

There are two objectives of preparing Final accounts- (1) know the operational results i.e. profit or loss during a particular period through the profit & loss account which is also known as income statement, and (2) ascertain the financial position of the business on a particular date through the balance sheet, also known as position statement.

**Persons Interested in Financial Statements**

*Did u know?* There are two types of persons interested in financial statements—1. Internal users and 2. External users.

1. ***Internal Users:*** These are (a) Shareholders, (b) Management, and (c) Trade unions employees.

    (a) Shareholders are very much interested in the financial statements. They are very much interested in the welfare of the business. They can know the operational results through such financial statements and the financial position of the business along with the earning capacity of the business.

    (b) Management is interested to take important decisions relating to fixing up the selling prices and making future policies.

    (c) Trade unions and employees are interested to know the operational results because their bonus etc. is dependent on the profit earned by the business. Financial Statements also help in their negotiations for wages/salaries.

2. ***External Users:*** There are number of persons interested in financial statements. They are termed as external users. The following are most important external users of financial statements.

    (a) *Investors:* They are interested to know the earning capacity of business which can be known through financial statements. They can also know the financial soundness of the business through financial statements.

    (b) *Creditors, Lenders of Money etc.:* The creditors and lenders of money etc. can also know the financial soundness through financial statement. They have to see two things (i) Regularity of income and (ii) solvency of the business so that their investment is risk free.

Notes

(c) *Government:* Government is interested to formulate laws to regulate business activities and also law relating to taxation etc. Financial statements help while computing National Income statistics etc.

(d) *Taxation authorities:* Financial Statements provide information relating to operational results as well as financial position of the business. Tax authorities decide the amount of tax as per financial statement. It is very useful to other taxation authorities such as sales tax etc.

(e) Stock Exchange is meant for dealing in share/securities. Purchase and sale of such shares and securities are possible through stock exchanges which provide financial information about each company which is listed with them.

Thus, we see that financial statements are very helpful and useful.

### Self Assessment

Fill in the blanks:

1. …………………… mean profit & loss account and the balance sheet.
2. There are two types of persons interested in financial statements: (a) …………………… users and (b) …………………… users.

## 8.3 Capital and Revenue Expenditure and Receipt

As per matching concept of accounting the revenues of a period are matched with the expenses incurred in this period to generate this revenue in order to determine the amount of profit or loss of the business. To calculate the accurate amount of profit or loss it is must that there should be a recognition of the revenues and expenditures. If there is wrong recognition of expenses or revenues, results of the business will also be wrong. Thus the distinction between the capital and revenue items is very important. In spite of being a difficult job of distinction of capital and revenue items, some rules are framed for the recognition of these items.

### 8.3.1 Classification of Expenditures

Expenditures of a business are classified into following three:

1. ***Capital Expenditure:*** If expenditure is incurred in the business to get its benefit for a long period, such expenditure is called capital expenditure. Capital expenditure may be done to acquire the new assets (tangible or intangible), to enhance the earning capacity of the business, for some addition and improvement of the existing properties or assets, for the development of the business or for the replacement of an existing assets.

   Some examples of capital expenditure are given below:

   (i) Expenditure to acquire a fixed asset as purchase of plant and machinery, land and buildings and furniture, etc.

   (ii) Expenditure for the addition and improvement of the assets as construction of a room in the building.

   (iii) Expenditure for the erection or setting up of a new plant.

   (iv) Expenditure to acquire the right to run the business as copyright, patents, licence etc.

Notes

2 ***Revenue Expenditure:*** When expenditure is done for a short period (less than one year) and for the regular operation of business, it is termed as revenue expenditure. Their benefits are taken by the business in the current period only. For example:

(a) Expenses incurred during the normal course of business – as salaries of the staff, fuel and electricity used for the running of machinery and cost of sales.

(b) Expenses for the maintenance of the assets – repairs of machinery.

(c) Wear and tear and obsolescence of the assets and decrease in the value of assets.

3 ***Deferred Revenue Expenditure:*** When revenue expenditure is done for the benefit of two or three years, it is termed as deferred revenue expenditure. For example, cost of heavy campaign of advertisement, preliminary expenses, etc. The benefit of such type of expenditure is enjoyed by the company for a number of years. Therefore, the entire amount of such expenditure is not transferred to the profit & loss account of a year. The entire amount of such expenditure is divided by a period of time (no. of years in which the benefit of such expenditure will be enjoyed). The dividend received in written off by transferring into profit & loss account and the unwritten off portion of the expenditure is shown in the balance sheet as a fictitious asset.

### 8.3.2 Classification of Receipts

As distinction is made between the capital expenditure and revenue expenditure, similarly to calculate the accurate profits or loss of the business distinction between the capital receipt and revenue receipts is done. Therefore, these words should be clearly understood.

1. ***Capital Receipts:*** Capital receipts include the sale of fixed assets, long-term investments, issue of share capital, debentures and loan raised. Capital receipts are different from the capital profits or loss. The entire amount from the sale of assets is called capital receipts and the difference of sale proceeds and cost of assets is capital profit or loss.

2. ***Revenue Receipts:*** Receipts which are obtained during the normal course of business are called revenue receipts. In other words the receipts which are not capital receipts are revenue receipts as sale of goods. Revenue receipts are different from revenue profits or loss. For example, goods worth ₹ 5,000 are sold at ₹ 6,000. Here, the entire sale of ₹ 6,000 will be revenue receipts and the revenue profit will be ₹ 1,000 only.

**Distinction between Capital Expenditure and Revenue Expenditure**

| Basis of differences | Revenue Expenditure | Capital Expenditure |
|---|---|---|
| 1. Purpose | It is incurred to do the business and is shown on debit side of P&L A/c. | It is spent to acquire the permanent Assets. It forms a part of Balance Sheet |
| 2. Period of benefits | It is for a shorter period i.e. Less than a year. | It is for a longer period i.e., more than one year. |
| 3. Charges | It is shown either in Trading A/c or Profit & Loss A/c | It is shown only in the Balance sheet. |
| 4. Increase in earning capacity. | It does not increase the earning capacity of the business but helps in maintaining the present profit earning capacity. | It definitely adds (increases) the earning capacity of the business. |
| 5. Nature (recurring) | Its recurring | It is non-recurring |
| 6. Transfer | It is non transferable | It is transferable |
| 7. Representation | It is an expired cost | If represents unexpired costs. |

Notes

*Example:* State whether the following expenditure is of capital or revenue nature:

1. ₹ 2,000 spent on repairing of a second hand plant.
2. ₹ 15,000 spent on air conditioner in an office.
3. ₹ 10,000 spent on advertizing in connection with the introduction of a new product.
4. ₹ 100 paid for carriage of goods purchased.
5. Salary of ₹ 5,000 paid to an employee of the business.
6. A sum of ₹ 5,000 was paid as compensation to an employee who was retrenched.
7. Purchase of raw materials for ₹ 25,000.

***Solution:***

| Amount Spent | Nature of Expenditure |
|---|---|
| 1. Spent on repairing of a second hand plant. | 1. It is of capital nature because it makes the plant in working condition, hence it is a capital expenditure. |
| 2. Spent on air conditioner in an office. | 2. It is of capital nature because an asset of permanent nature is purchased, hence it is a capital expenditure. |
| 3. Spent on advertizing in connection with the introduction of a new product. | 3. It is of capital nature because benefits of it will be available for number of years, hence, it is capital expenditure. |
| 4. Paid for carriage of goods purchased. | 4. It is of revenue nature because goods purchased are for resale hence it is a revenue expenditure. |
| 5. Salary paid to an employee. | 5. It is of revenue nature as it is necessary to run the business. |
| 6. Paid compensation to an employee. | 6. It is of revenue nature as it is necessary for the business. |
| 7. Purchases of raw Materials. | 7. It is of revenue nature as it is necessary to run the business. |

*Example:* Classify the following expenditure into capital and Revenue expenditure:

(i) Expenditure towards additions to machinery, in order to double the production: ₹ 4000.

(ii) Expenditure necessitated by the negligence of the employees incurred for repairs to Machinery: ₹ 2400.

(iii) Expenditure of ₹ 1600 towards replacement of worn out parts of machinery.

(iv) Expenditure incurred on painting the factory premises: ₹ 1,000.

***Solution:***

(i) Capital Expenditure as it increases the value of Machinery.

(ii) It is revenue expenditure as the nature of expenditure is revenue type.

(iii) It is revenue expenditure as the nature of expenditure is revenue because of replacement of a worn out parts of Machinery.

(iv) It is also revenue expenditure as the expenses are incurred every year for the painting of the factory premises to make the premises neat, clean and healthy.

*Example:* State in each of the following cases whether the expenditure is a capital Expenditure or revenue expenditure or deferred revenue expenditure:

(i) Legal expenses incurred to defend a suit for breach of a contract to supply goods.

(ii) Custom duty paid on Imported Machinery.

(iii) Heavy expenditure incurred on advertising a new product.

(iv) Amount spent to overhaul a motor truck purchased second hand.

(v) Wages paid to workers for converting raw materials into finished products.

(vi) Wages paid to workers for setting up new machinery.

(vii) Office rent paid in advance for three years.

(viii) Expenditure on development of a product.

***Solution:***

(i) It is revenue expenditure because it is incurred in the normal course of business.

(ii) It is a capital expenditure because it adds to the cost of imported machinery.

(iii) Deferred revenue expenditure because the benefit of this expenditure will be available for number of years. The proportionate amount will be written off every year.

(iv) It is a capital expenditure because the expenditure incurred will improve the present condition of the motor truck.

(v) It is revenue expenditure as it has been incurred in the normal course of the business.

(vi) It is a capital expenditure because this is incurred to put an asset into working condition and such expenditure is capitalized also.

(vii) It is deferred revenue expenditure because the right does not expire in the accounting period in which it is paid; only a proportionate part of rent paid is to be treated as revenue expenditure and balance should be carried forward as an asset to be written off in subsequent years.

(viii) It is revenue expenditure as it is incurred in the normal course of business.

### Self Assessment

Fill in the blanks:

3. If expenditure is incurred in the business to get its benefit for a long period, such expenditure is called …………………….

4. When expenditure is done for a short period (less than one year) and for the regular operation of business, it is termed as …………………….

## 8.4 Statement of Accounting Standard (AS-9) Revenue Recognition

The following is the text of the Accounting Standard (AS) 9 issued by the Institute of Chartered Accountants of India on 'Revenue Recognition'.

In the initial years, this accounting standard will be recommendatory in character. During this period, this standard is recommended for use by companies listed on a recognised stock exchange and other large commercial, industrial and business enterprises in the public and private sectors.

Notes

## Introduction

1. This Statement deals with the bases for recognition of revenue in the statement of profit & loss of an enterprise. The Statement is concerned with the recognition of revenue arising in the course of the ordinary activities of the enterprise from
   (i) The sale of goods,
   (ii) The rendering of services, and
   (iii) The use by others of enterprise resources yielding interest, royalties and dividends.
2. This Statement does not deal with the following aspects of revenue recognition to which special considerations apply:
   (i) Revenue arising from construction contracts;
   (ii) Revenue arising from hire-purchase, lease agreements;
   (iii) Revenue arising from government grants and other similar subsidies;
   (iv) Revenue of insurance companies arising from insurance contracts.
3. Examples of items not included within the definition of "revenue" for the purpose of this statement are:
   (i) Realised gains resulting from the disposal of, and unrealised gains resulting from the holding of, non-current assets e.g. appreciation in the value of fixed assets;
   (ii) Unrealised holding gains resulting from the change in value of current assets, and the natural increases in herds and agricultural and forest products;
   (iii) Realised or unrealised gains resulting from changes in foreign exchange rates and adjustments arising on the translation of foreign currency financial statements;
   (iv) Realised gains resulting from the discharge of an obligation at less than its carrying amount;
   (v) Unrealised gains resulting from the restatement of the carrying amount of an obligation.

## Definitions

4. The following terms are used in this Statement with the meanings specified:
   4.1 Revenue is the gross inflow of cash, receivables or other considerations arising in the course of the ordinary activities of an enterprise from the sale of goods, from the rendering of services, and from the use by others of enterprise resources yielding interest, royalties and dividends. Revenue is measured by the charges made to customers or clients for goods supplied and services rendered to them and by the charges and rewards arising from the use of resources by them. In an agency relationship, the revenue is the amount of commission and not the gross inflow of cash, receivables or other consideration.
   4.2 Completed service contract method is a method of accounting which recognises revenue in the statement of profit & loss only when the rendering of services under a contract is completed or substantially completed.
   4.3 Proportionate completion method is a method of accounting which recognises revenue in the statement of profit & loss proportionately with the degree of completion of services under a contract.

## Explanation

Notes

5. Revenue recognition is mainly concerned with the timing of recognition of revenue in the statement of profit & loss of an enterprise. The amount of revenue arising on a transaction is usually determined by agreement between the parties involved in the transaction. When uncertainties exist regarding the determination of the amount, or its associated costs, these uncertainties may influence the timing of revenue recognition.

6. ***Sale of Goods***

6.1 A key criterion for determining when to recognise revenue from a transaction involving the sale of goods is that the seller has transferred the property in the goods to the buyer for a consideration. The transfer of property in goods, in most cases, results in or coincides with the transfer of significant risks and rewards of ownership to the buyer. However, there may be situations where transfer of property in goods does not coincide with the transfer of significant risks and rewards of ownership. Revenue in such situations is recognised at the time of transfer of significant risks and rewards of ownership to the buyer. Such cases may arise where delivery has been delayed through the fault of either the buyer or the seller and the goods are at the risk of the party at fault as regards any loss which might not have occurred but for such fault. Further, sometimes the parties may agree that the risk will pass at a time different from the time when ownership passes.

6.2 At certain stages in specific industries, such as when agricultural crops have been harvested or mineral ores have been extracted, performance may be substantially complete prior to the execution of the transaction generating revenue. In such cases when sale is assured under a forward contract or a government guarantee or where market exists and there is a negligible risk of failure to sell, the goods involved are often valued at net realisable value. Such amounts, while not revenue as defined in this Statement, are sometimes recognised in the statement of profit & loss and appropriately described.

7. ***Rendering of Services***

7.1 Revenue from service transactions is usually recognised as the service is performed, either by the proportionate completion method or by the completed service contract method.

(i) *Proportionate completion method:* Performance consists of the execution of more than one act. Revenue is recognised proportionately by reference to the performance of each act. The revenue recognised under this method would be determined on the basis of contract value, associated costs, number of acts or other suitable basis. For practical purposes, when services are provided by an indeterminate number of acts over a specific period of time, revenue is recognised on a straight line basis over the specific period unless there is evidence that some other method better represents the pattern of performance.

(ii) *Completed service contract method:* Performance consists of the execution of a single act. Alternatively, services are performed in more than a single act, and the services yet to be performed are so significant in relation to the transaction taken as a whole that performance cannot be deemed to have been completed until the execution of those acts. The completed service contract method is relevant to these patterns of performance and accordingly revenue is recognised when the sole or final act takes place and the service becomes chargeable.

Notes

8. The Use by Others of Enterprise Resources Yielding Interest, Royalties and Dividends

8.1 The use by others of such enterprise resources gives rise to:

(i) interest-charges for the use of cash resources or amounts due to the enterprise;

(ii) royalties-charges for the use of such assets as know-how, patents, trademarks and copyrights;

(iii) dividends-rewards from the holding of investments in shares.

8.2 Interest accrues, in most circumstances, on the time basis determined by the amount outstanding and the rate applicable. Usually, discount or premium on debt securities held is treated as though it were accruing over the period to maturity.

8.3 Royalties accrue in accordance with the terms of the relevant agreement and are usually recognised on that basis unless, having regard to the substance of the transactions, it is more appropriate to recognise revenue on some other systematic and rational basis.

8.4 Dividends from investments in shares are not recognised in the statement of profit & loss until a right to receive payment is established.

8.5 When interest, royalties and dividends from foreign countries require exchange permission and uncertainty in remittance is anticipated, revenue recognition may need to be postponed.

9. Effect of Uncertainties on Revenue Recognition

9.1 Recognition of revenue requires that revenue is measurable and that at the time of sale or the rendering of the service it would not be unreasonable to expect ultimate collection.

9.2 Where the ability to assess the ultimate collection with reasonable certainty is lacking at the time of raising any claim, e.g., for escalation of price, export incentives, interest etc., and revenue recognition is postponed to the extent of uncertainty involved. In such cases, it may be appropriate to recognise revenue only when it is reasonably certain that the ultimate collection will be made. Where there is no uncertainty as to ultimate collection, revenue is recognised at the time of sale or rendering of service even though payments are made by installments.

9.3 When the uncertainty relating to collectability arises subsequent to the time of sale or the rendering of the service, it is more appropriate to make a separate provision to reflect the uncertainty rather than to adjust the amount of revenue originally recorded.

9.4 An essential criterion for the recognition of revenue is that the consideration receivable for the sale of goods, the rendering of services or from the use by others of enterprise resources is reasonably determinable. When such consideration is not determinable within reasonable limits, the recognition of revenue is postponed.

9.5 When recognition of revenue is postponed due to the effect of uncertainties, it is considered as revenue of the period in which it is properly recognised.

(Accounting Standard comprises paragraphs 10-14 of this Statement. The Standard should be read in the context of paragraphs 1-9 of this Statement and of the 'Preface to the Statements of Accounting Standards'.)

10. Revenue from sales or service transactions should be recognised when the requirements as to performance set out in paragraphs 11 and 12 are satisfied, provided that at the time of

performance it is not unreasonable to expect ultimate collection. If at the time of rising of any claim it is unreasonable to expect ultimate collection, revenue recognition should be postponed.

11. In a transaction involving the sale of goods, performance should be regarded as being achieved when the following conditions have been fulfilled:

    (i) the seller of goods has transferred to the buyer the property in the goods for a price or all significant risks and rewards of ownership have been transferred to the buyer and the seller retains no effective control of the goods transferred to a degree usually associated with ownership; and

    (ii) no significant uncertainty exists regarding the amount of the consideration that will be derived from the sale of the goods.

12. In a transaction involving the rendering of services, performance should be measured either under the completed service contract method or under the proportionate completion method, whichever relates the revenue to the work accomplished. Such performance should be regarded as being achieved when no significant uncertainty exists regarding the amount of the consideration that will be derived from rendering the service.

13. Revenue arising from the use by others of enterprise resources yielding interest, royalties and dividends should only be recognised when no significant uncertainty as to measurability or collectability exists. These revenues are recognised on the following bases:

    (i) *Interest:* On a time proportion basis taking into account the amount outstanding and the rate applicable.

    (ii) *Royalties:* On an accrual basis in accordance with the terms of the relevant agreement.

    (iii) *Dividends from investments in shares:* When the owner's right to receive payment is established.

### Disclosure

14. In addition to the disclosures required by Accounting Standard 1 on 'Disclosure of Accounting Policies' (AS 1), an enterprise should also disclose the circumstances in which revenue recognition has been postponed pending the resolution of significant uncertainties.

## Appendix

This appendix is illustrative only and does not form part of the accounting standard set forth in this Statement. The purpose of the appendix is to illustrate the application of the Standard to a number of commercial situations in an endeavour to assist in clarifying application of the Standard.

**Sale of Goods**

1. ***Delivery is delayed at buyer's request and buyer takes title and accepts billing:*** Revenue should be recognised notwithstanding that physical delivery has not been completed so long as there is every expectation that delivery will be made. However, the item must be on hand, identified and ready for delivery to the buyer at the time the sale is recognised rather than there being simply an intention to acquire or manufacture the goods in time for delivery.

*Contd...*

Notes

2. ***Delivered subject to conditions***

   (a) ***Installation and inspection i.e. goods are sold subject to installation, inspection etc.:*** Revenue should normally not be recognised until the customer accepts delivery and installation and inspection are complete. In some cases, however, the installation process may be so simple in nature that it may be appropriate to recognise the sale notwithstanding that installation is not yet completed (e.g. installation of a factory-tested television receiver normally only requires unpacking and connecting of power and antennae).

   (b) ***On approval:*** Revenue should not be recognised until the goods have been formally accepted by the buyer or the buyer has done an act adopting the transaction or the time period for rejection has elapsed or where no time has been fixed, a reasonable time has elapsed.

   (c) ***Guaranteed sales i.e. delivery is made giving the buyer an unlimited right of return:*** Recognition of revenue in such circumstances will depend on the substance of the agreement. In the case of retail sales, offering a guarantee of "money back if not completely satisfied", it may be appropriate to recognise the sale but to make a suitable provision for returns based on previous experience. In other cases, the substance of the agreement may amount to a sale on consignment, in which case it should be treated as indicated below.

   (d) ***Consignment sales i.e. a delivery is made whereby the recipient undertakes to sell the goods on behalf of the consignor:*** Revenue should not be recognised until the goods are sold to a third party.

   (e) ***Cash on delivery sales:*** Revenue should not be recognised until cash is received by the seller or his agent.

3. ***Sales where the purchaser makes a series of instalment payments to the seller, and the seller delivers the goods only when the final payment is received:*** Revenue from such sales should not be recognised until goods are delivered. However, when experience indicates that most such sales have been consummated, revenue may be recognised when a significant deposit is received.

4. Special order and shipments i.e. where payment (or partial payment) is received for goods not presently held in stock e.g. the stock is still to be manufactured or is to be delivered directly to the customer from a third party.

   Revenue from such sales should not be recognised until goods are manufactured, identified and ready for delivery to the buyer by the third party.

5. Sale/repurchase agreements i.e. where seller concurrently agrees to repurchase the same goods at a later date.

   For such transactions, that are in substance a financing agreement, the resulting cash inflow is not revenue as defined and should not be recognised as revenue.

6. Sales to intermediate parties i.e. where goods are sold to distributors, dealers or others for resale.

   Revenue from such sales can generally be recognised if significant risks of ownership have passed; however in some situations the buyer may, in substance, be an agent and in such cases the sale should be treated as a consignment sale.

7. ***Subscriptions for publications:*** Revenue received or billed should be deferred and recognised either on a straight line basis over time or, where the items delivered vary

*Contd...*

Notes

in value from period to period, revenue should be based on the sales value of the item delivered in relation to the total sales value of all items covered by the subscription.

8. ***Instalment sales:*** When the consideration is receivable in installments, revenue attributable to the sales price exclusive of interest should be recognised at the date of sale. The interest element should be recognised as revenue, proportionately to the unpaid balance due to the seller.

9. ***Trade discounts and volume rebates:*** Trade discounts and volume rebates received are not encompassed within the definition of revenue, since they represent a reduction of cost. Trade discounts and volume rebates given should be deducted in determining revenue.

**Rendering of Services**

1. ***Installation Fees:*** In cases where installation fees are other than incidental to the sale of a product, they should be recognised as revenue only when the equipment is installed and accepted by the customer.

2. ***Advertising and insurance agency commissions:*** Revenue should be recognised when the service is completed. For advertising agencies, media commissions will normally be recognised when the related advertisement or commercial appears before the public and the necessary intimation is received by the agency, as opposed to production commission, which will be recognised when the project is completed. Insurance agency commissions should be recognised on the effective commencement or renewal dates of the related policies.

3. ***Financial service commissions:*** A financial service may be rendered as a single act or may be provided over a period of time. Similarly, charges for such services may be made as a single amount or in stages over the period of the service or the life of the transaction to which it relates. Such charges may be settled in full when made or added to a loan or other account and settled in stages. The recognition of such revenue should, therefore, have regard to:

   (a) Whether the service has been provided "once and for all" or is on a "continuing" basis;

   (b) The incidence of the costs relating to the service;

   (c) When the payment for the service will be received. In general, commissions charged for arranging or granting loan or other facilities should be recognised when a binding obligation has been entered into commitment, facility or loan management fees which relate to continuing obligations or services should normally be recognised over the life of the loan or facility having regard to the amount of the obligation outstanding, the nature of the services provided and the timing of the costs relating thereto.

4. ***Admission fees:*** Revenue from artistic performances, banquets and other special events should be recognised when the event takes place. When a subscription to a number of events is sold, the fee should be allocated to each event on a systematic and rational basis.

5. ***Tuition fees:*** Revenue should be recognised over the period of instruction.

6. ***Entrance and membership fees:*** Revenue recognition from these sources will depend on the nature of the services being provided. Entrance fee received is generally

*Contd...*

Notes

> capitalised. If the membership fee permits only membership and all other services or products are paid for separately, or if there is a separate annual subscription, the fee should be recognised when received. If the membership fee entitles the member to services or publications to be provided during the year, it should be recognised on a systematic and rational basis having regard to the timing and nature of all services provided.

### Self Assessment

Fill in the blanks:

5. …………………… from service transactions is usually recognised as the service is performed, either by the proportionate completion method or by the completed service contract method.
6. Revenue is the …………………… receivables or other considerations.

## 8.5 Final Accounts with Adjustments

Final accounts are prepared from the various balances depicted by the Trial Balance. Some balance of the Trial Balance accounts are used to prepare the Trading Account and some for the preparation of the Profit & Loss Account and the remaining balances are transferred to the Balance Sheet. Thus all the balances of accounts of the Trial Balance are used in the final accounts. Therefore the preparation of final accounts is the final stage of accounting.

### 8.5.1 Trading and Profit & Loss Account

In the Trading and Profit & Loss Account all those accounts are disclosed which affect the profit or loss of the business. In other words all the nominal accounts of the Trial Balance are used to prepare the Trading and Profit & Loss Account. In the left hand side, all the expenses incurred during a period and in the right hand side all the incomes earned during a period are disclosed. This account contains two parts:

- Trading Account
- Profit & Loss Account

### 8.5.2 Trading Account

Trading account is the comparison of sales and purchase. This account is prepared to determine the amount of gross profit or gross loss on sales. Trading account is prepared to know the trading result. Trading result indicates gross profit or loss of the trading period. Gross profit or loss is the difference between selling price and purchase price of the goods sold. If selling price of the goods sold is more than the purchase price, the difference is known as gross profit. On the contrary, when the situation is reverse, the difference is termed as gross loss. Here, purchase price includes the cost of shipment and other direct expenses incurred until the goods reach the point of sale and to make the goods ready for sale, if any. The proforma of Trading Account is given.

Notes

**Proforma of Trading Account**
**In the Books of …………….**

**Trading Account**
**(for the year ending …………….)**

| Particulars | Amount (Dr.) (₹) | Particulars | Amount (Cr.) (₹) |
|---|---|---|---|
| To Opening Stock | ------- | By Sales ---------- | |
| To Purchases --------- | | Less: Returns ---------- | ------- |
| Less: Returns --------- | ------- | By Closing stock | ------- |
| To Wages & Salaries | ------ | By Gross Loss (if any) | |
| To Carriage Inwards | ------- | Transferred to P/L A/c | ------- |
| To Cartage | ------ | | |
| To Frieght | ------- | | |
| To Light Power & Heating in factory | ------ | | |
| To Factory Insurance | ------- | | |
| To Works Manager's Salary | ------ | | |
| To Foreman's Salary | ------- | | |
| To Factory Rent & Taxes | ------ | | |
| To Motive Power | ------- | | |
| To Factory Repairs | ------ | | |
| To Factory Expenses | ------- | | |
| To Octroi duty | ------ | | |
| To Custom Duty | ------- | | |
| To Manufacturing Exps. | ------ | | |
| To Consumable Stores | ------- | | |
| To Gross Profit Transferred to P/L A/c | ------- | | |
| | ------ | | ------- |

*Notes*

- There is no particular proforma of the Trading Account. The above proforma given is traditional one. That is not as per law. Here the students are advised to follow this proforma.
- If the total of credit side is more than the total of debit side, difference is called gross profit or vice versa gross loss.

***Gross Profit:*** After showing all the items of debit side and credit side, each side is totalled. If the total of credit side is higher than the total of debit side, the difference is termed as Gross Profit. In case of reverse situation i.e. debit side is higher than the credit side, it is a Gross Loss. Though the gross profit or gross loss is not a real profit or real loss that is why it is taken to Profit & Loss account from where Net Profit or Net Loss is calculated.

Notes

Following are the main points of difference between gross profit and net profit.

Table 8.1

| Gross Profit | Net Profit |
|---|---|
| It is the excess of net sales over cost of purchase or manufacture (all expense relating to purchase or manufacture of goods) of goods. | It is the excess of gross profit over all indirect expenses. |
| It is not true profit of the business. | It is true profit of the business. |
| It shows credit balance of the trading account | It shows credit balance of the profit and loss account. |
| The progress of the business can be judged by the comparison of gross profit with net sales | The profitability of the business can be measured by the comparison of net profit with net sales. |

## Detailed Study of Different Items Appearing in Trading Account

1. ***Opening Stock:*** Whenever Trading account is prepared, stock of the last year is shown as opening stock of the current year, which is passed through an opening entry and appears in the trial balance. It is generally shown as a first time in the Trading account but if the business is a new one, just started, then there would not be any opening stock. In case of a trading concern finished goods is the only item which is available for sale whereas in case of a manufacturing concern, opening stock is of: (a) Raw Materials, (b) Finished Goods, and (c) Semi-finished Goods.

   Following entries are passed in books of the business:

**For Adjustment of Opening Stock**

| S. No. | Particulars | L.F. | Amount (Dr.) (₹) | Amount (Cr.) (₹) |
|---|---|---|---|---|
| 1. | Purchases A/c<br>To opening stock A/c<br>(Adjustment for opening stock) | | | |

**For Adjustment of Closing Stock**

| S. No. | Particulars | L.F. | Amount (Dr.) (₹) | Amount (Cr.) (₹) |
|---|---|---|---|---|
| 2. | Closing stock A/c Dr.<br>To purchases A/c<br>(Adjustment for closing stock) | | | |

*Note* Thus, there will be no opening stock in the trial balance because of the above adjustment for opening stock and amount of adjusted purchases is to be shown on the debit side of trading account and amount of closing stock on the assets side of the Balance sheet.

2. ***Purchases are shown in the trial balance:*** It is the sum of cash purchases + credit purchases. The balance of Purchases A/c is always debit balance and if there is any return to be shown by purchases returns (returns - outwards) A/c, which is having a credit balance, must be deducted from the total purchases in order to arrive at the correct figure of Net Purchases.

**Notes**

Thus in Trading account purchases returns are shown by way of deduction from the purchases as follows:

| | (₹) |
|---|---|
| Total purchases as per trial Balance | 1,00,000 |
| –Total Returns | –3,000 |
| | 97,000 |

Sometimes it happens that the goods are received but invoice is not received that is why it is not entered in the purchases A/c. In such a case, a closing entry at the end of the year must be passed which is as follows:

| | | | | |
|---|---|---|---|---|
| | Purchases A/c Dr.<br>To Supplier A/c<br>(Goods received entered) | | | |

If any purchase is made by the proprietor for his /her personal use, then it must also be deducted from total purchases. Sometimes if the delivery of goods is to take place in future under a contract of Business, such goods must not be included in the total purchases.

3. ***Direct Expenses:*** The expenses, which are incurred on acquiring goods for resale purposes are termed as direct expenses which are shown on the debit side of the Trading account. Such expenses, might have been paid or outstanding or paid in advance, the net amount is shown in the trading account. Such expenses are:

   (a) *Carriage Inwards:* The expenses which are incurred for bringing goods in the business for resale purposes are called carriage inwards. Such items of expenses are shown on the debit side of the Trading account. If carriage is paid for bringing any asset in the business such as Plant/Machinery is not shown in the Trading account, but is added in the cost of the asset.

   (b) *Wages on Purchases:* If any wage is paid for making or manufacturing as article or on goods meant for resale is a direct expenses and is shown on the debit side of the trading account whereas if wages are paid for bringing any asset such as plant etc. is not a direct expense and is added in the cost of the plant. Similarly, if wages are paid after the goods are sold, it is unproductive wages, hence to be shown in the profit & loss A/c.

   (c) *Freight on Purchases:* When freight is paid or is payable on the goods purchased for resale, it is a direct expense and is shown to the debit side of the Trading A/c but if any freight is paid on the purchase of an asset, then it is added in the cost of the asset.

   (d) *Other direct Expenses:* Such as:

      (i) Fuel, lighting, power: Generally goods are manufactured with the help of coal, or power/electricity and lighting for the factory. Such expenses are also direct expenses, and are shown on the debit side of the Trading account.

      (ii) Octroi duty, custom etc.: Whenever goods are purchased from outside, municipality (Municipal Corporation) charges some tax, known as octroi which is direct expenses to be debited in the Trading account. Similarly, when Goods are purchased from abroad or foreign countries. Import duty is to be paid which is also a direct expense and to be shown in Trading account but if the asset such as plant/machinery is purchased and import duty is paid then it is added in the cost of plant/machinery.

(iii) Packing expenses which are incurred for packing the goods for resale, are direct expenses and to be shown in Trading account, but if packing is done for sending goods to the customer's address, such expenses are realized from the customers, hence are not direct expenses.

4. ***Sales:*** Total amount of sales, cash sales and credit sales, is shown on the credit side of the trading account and if there is any sales-return (return inwards) is to be deducted from such sales.

*Notes*

1. If some assets is sold then it is not a revenue receipt but it is a capital receipt to be shown by way of deduction from total assets.
2. Sometimes sales had taken place, but goods are not delivered, then such goods should not be included in the closing stock but be kept separately.
3. Similarly goods are sent on consignment or sale or return basis or hire purchase basis, cannot be included in the sales because the buyer is free to return.

5. ***Closing Stock:*** The second item of the credit side of trading account is the closing stock. The goods which could not be sold during a fixed period, are termed as closing stock. This item is not shown in the trial balance because its valuation is done at the end after closing of all the accounts. That is why it is shown as a footnote beneath the trial balance, but when purchases are adjusted with opening and closing stock, then the balance of closing account is debit, hence it is shown as an asset in the Balance Sheet. Valuation of closing stock poses a number of problems such as cost price or market price, but as per convention stock is always valued at cost or market price whichever is less. This rule is based on the principle of probable losses which are taken into account, but not the probable gains. It is also necessary to be careful while valuing closing stock correctly. Otherwise gross profit, thus ascertained, would not be correct one, if it is not followed strictly then the Gross profit would be incorrect and misleading. Journal entries to be passed for closing stock & opening stock.

| S. No. | Particulars | L.F. | Amount (Dr.) (₹) | Amount (Cr.) (₹) |
|---|---|---|---|---|
| (i) | Closing stock A/c Dr.<br>To trading A/c<br>(Closing stock shown on the credit side of Trading A/c) | | | |
| (ii) | if closing stock A/c Dr.<br>To purchases A/c<br>(If closing stock is transferred to purchases A/c, then it cannot be shown in the trading A/c, but to be shown in the Balance Sheet only.) | | | |
| (iii) | Trading A/c Dr.<br>To opening stock<br>(Opening stock transferred) | | | |

***Illustration 1:*** From the following information, prepare the trading account for the year ended 31st March 2011.

| | | |
|---|---|---|
| Stock on 1st April 2005 (Opening stock) | | ₹ 4,000 |
| Purchases | | |
| (i) | Cash purchases | 20,000 |
| (ii) | Credit purchases | 50,000 |
| Sales | | |
| (i) | Cash sales | 20,000 |
| (ii) | Credit sales | 60,000 |
| Stock on 31st March 2011 (Closing Stock) | | ₹ 6,000 |

***Solution:***

**Dr. Trading Account for the year ended 31st March 2006 Cr.**

| | (₹) | | (₹) |
|---|---|---|---|
| To Opening stock | 4,000 | By Credit sales 20,000 | |
| To Credit purchases 20,000 | | By Cash sales 60,000 | |
| To Cash purchases 50,000 | | By Total sales | 80,000 |
| To Total purchases | 70,000 | By Closing stock | 6,000 |
| To Gross profit c/d | 12,000 | | |
| | 86,000 | | 86,000 |

***Illustration 2:*** Prepare trading account of M/s Sundar and sons as on 31st March 2011

| | | (₹) |
|---|---|---|
| Opening stock on 1st April 2004 | | 50,000 |
| Purchases | | |
| (i) | Cash | 1,20,000 |
| (ii) | Credit | 1,00,000 |
| Sales | | |
| (i) | Cash | 40,000 |
| (ii) | Credit | 1,00,000 |
| Purchase Returns | | 20,000 |
| Carriage Inwards | | 10,000 |
| Marine insurance on purchase | | 6,000 |
| Other direct expenses | | 4,000 |
| Sales Returns | | 30,000 |
| Stock as on 31st March 2011 | | 10,000 |

In this problem, return outwards and inwards are given in addition to cash and credit purchases and sales of a firm to find out the net purchases and the net sales of the firm.

Net Sales = Cash Sales + Credit Sales – Sales Returns

Net Purchases = Cash Purchases + Credit Purchases – Purchase Returns

Notes

***Solution:***

**Trading account for the year ended 31st March 2011**

**Dr** **Cr**

| | | (₹) | | | (₹) |
|---|---|---|---|---|---|
| To Opening Stock | | 50,000 | By Cash Sales | 40,000 | |
| To Cash Purchase | 1,20,000 | | *Add:* Credit Sales | 1,00,000 | |
| *Add:* Credit Purchase | 1,00,000 | | By Total Sales | 1,40,000 | |
| To Total Purchase | 2,20,000 | | *Less:* Sales Return | 30,000 | |
| *Less:* Purchase Return | 20,000 | | By Net Sales | | 1,10,000 |
| To Net Purchase | | 2,00,000 | By Closing Stock | | 10,000 |
| To Carriage Inwards | | 10,000 | By Gross Loss c/d | | 1,50,000 |
| To Marine Insurance | | 6,000 | | | |
| To Other Direct Expenses | | 4,000 | | | |
| | | 2,70,000 | | | 2,70,000 |
| To Gross Loss B/d | 1,50,000 | 1,50,000 | | | |

Gross Loss is due to an excess of the debit side total over the credit side total.

***Illustration 3:*** From the following information, calculate the stock at the end:

| | (₹) |
|---|---|
| Opening stock | 62,000 |
| Purchases | 4, 20,000 |
| Sales | 6,00,000 |

Rate of Gross Profit on Cost = $33\frac{1}{3}$

***Solution:***

Gross profit on cost = $33\frac{1}{3}$

Hence Gross profit on Sales = $\frac{33\frac{1}{3}}{133\frac{1}{3}} = \frac{1}{4}$ or 25%

**Trading Account**
**(for the year ended………)**

| Particulars | (₹) | Particulars | (₹) |
|---|---|---|---|
| To opening stock | 62,000 | By sales (given) | 6,00,000 |
| To purchases | 4,20,000 | By closing stock | |
| To gross profit | | (Balancing figure) | 32,000 |
| On cost $33\frac{1}{3}$% or 25% on sales which is ₹ 6,00,000 | 1,50,000 | | |
| | 6,32,000 | | 6,32,000 |

Thus, we can say that the value of stock at the end was ₹ 32,000.

Notes

Task Calculate the Gross Profit from the following:

| | (₹) |
|---|---|
| Opening stock | 11,500 |
| Purchases | 1,05,000 |
| Wages | 3,500 |
| Sales | 1,40,000 |

***Hint:*** ₹ 20,000

### 8.5.3 Profit & Loss Account

Profit & Loss Account is the second part of Trading and Profit & Loss Account. Trading Account depicts the gross profit which is the difference of sales and cost of sale. Thus the gross profit cannot treated as net profit while the businessman wants to know how much net profit he has earned from the operating activities during a period. For this purpose Profit & Loss Account is prepared keeping in mind all the operating and non-operating incomes and losses of the business. In the debit (left hand side) side all the expenses and losses are disclosed and in the credit side (right hand side) all the incomes are disclosed. The excess of credit side over debit side is called net profit while the excess of debit side over credit side shows net loss. Net profit increases the net worth of the business, therefore, it is added to the capital of owner. Net loss decreases the net worth of business so it is subtracted from capital. The proforma of Profit & Loss Account is given below:

**Proforma of Profit & Loss Account**

| Particulars | (₹) | Particulars | (₹) |
|---|---|---|---|
| To Gross Loss (if any) transferred | | By Gross Profit (transferred | |
| from Trading Account | ---- | from Trading Account) | ---- |
| To Staff Salries | ---- | By Discount Received | ---- |
| To Office Rent | ---- | By Commission Received | ---- |
| To Rates & Taxes | ---- | By Dividend | ---- |
| To Office Lighting and Heating | ---- | By Interest Received | ---- |
| To Printing & Stationary | ---- | By Rent from Tenant | ---- |
| To Bank Charges | ---- | By Interest from Bank | ---- |
| To Insurance | ---- | By Interest on Drawings | ---- |
| To Telephone Charges | ---- | By Profit on Sale of | |
| To Legal Expenses | ---- | Investment | ---- |
| To Repairs | ---- | By Provision for Discount on | |
| To Postage & Stamps | ---- | Creditors | ---- |
| To Trade Expenses | ---- | By Bad Debts recovered | ---- |
| To Establishment Exps. | ---- | By Profit on Sale of Assets | ---- |
| To Audit Fees | ---- | By Other Incomes | ---- |
| To Charity & Donations | ---- | By Net Loss (if any) | |
| To Management Exps. | ---- | transferred to Capital A/c | ---- |

*Contd...*

Notes

| | | | |
|---|---|---|---|
| To Depreciation on | | | |
| Land & Buildings | ---- | | |
| Plant and Machinery | ---- | | |
| Furnitures | ---- | | |
| To Stable Expenses | ---- | | |
| To Directors Fee | ---- | | |
| To Bank Charges | ---- | | |
| To Interest on Loan | ---- | | |
| To Interest on Capital | ---- | | |
| To Discount on B/R | ---- | | |
| To Sales Tax | ---- | | |
| To Advertisement | ---- | | |
| To Bad Debts | ---- | | |
| To Agents' Commission | ---- | | |
| To Travelling Expenses | ---- | | |
| To Free Samples distributed | ---- | | |
| To Warehouse Expenses | ---- | | |
| To Packing Expenses | ---- | | |
| To Brokerage | ---- | | |
| To Distribution Expenses | ---- | | |
| To Delivery Van Expenses | ---- | | |
| To Provision for Bad and Doubtful | ---- | | |
| Debts | ---- | | |
| To Entertainment Expenses | | | |
| To Carriage Cutward | ---- | | |
| To Loss on Sale of Assets | ---- | | |
| To Licence Fees | ---- | | |
| To Repairs of Assets & Motor Car | ---- | | |
| To Loss by Fire | ---- | | |
| To Conveynance Expenses | ---- | | |
| To Net Profit (Transferred to | ---- | | |
| Capital A/c.) | ---- | | |
| | ---- | | |
| | ----- | | ----- |

## Operating Profit and Net Profit

Operating profit is the excess of profit over operating expenses. Operating expenses include office and administrative, selling and distributive expenses, cash discount allowed, interest on short term loans etc. Therefore operating profit = Net sales – operating expenses, whereas operating expenses = cost of Goods sold + administrative and office expenses + Selling and distributive expenses or

Operating Profit = Net Profit + Non-operating expenses – non-operating income.

Net Profit means the excess of revenue over expenses and losses (whether operating or non-operating). In other words, net profit is calculated by deducting operating expenses from operating profit as well as non operating profit.

Non operating expenses are such expenses which are incidental or indirect to the main operations of the business. Such expenses are interest on loan, charities and donations, loss on sale of fixed assets, loss due to theft, pilferage or loss by fire.

Non-operating income is receipt of interest, rent, dividend, profit on sale of fixed assets etc. Such incomes are always added in order to compute net profit.

***Illustration 4:*** Compute operating profit and net profit from the following information:

| Particulars | (₹) | Particulars | (₹) |
|---|---|---|---|
| Gross profit | 2,50,000 | Donation | 4,250 |
| Salaries | 77,000 | Rent received | 2,300 |
| Advertizing | 4,000 | General Expenses | 550 |
| Rent and taxes | 26,500 | Interest on investment | 4,300 |
| Insurance charges | 3,720 | | |
| Audit fee | 2,700 | | |
| Carriage outward | 1,210 | | |
| Loss on sale of plant | 3,100 | | |
| Printing and stationery | 1,100 | | |
| Interest on loans | 15,000 | | |
| Loss by theft | 12,500 | | |
| Profit on sale of Machinery | 41,000 | | |

***Solution:***

**Statement showing operating profit & Net profit**

| Particulars | | (₹) | (₹) |
|---|---|---|---|
| **Gross Profit** | | | 2,50,000 |
| **Less** | | | |
| Office and administrative expenses | | | |
| Salaries | 77,000 | | |
| Rent and taxes | 26,500 | | |
| Insurance charges | 3,720 | | |
| Audit fee | 2,700 | | |
| Printing and stationery | 1,100 | | |
| General expenses | 550 | 1,11,570 | |
| **Less** | | | |
| Selling and distributive expenses | 1,210 | | |
| Carriage outwards | 4,000 | 5,210 | -1,16,780 |
| Advertising | | | 1,33,220 |
| **Operating profit** | | | |
| **Add-** | | | |
| Non operating Income- | | | |
| Interest on investments | 4,300 | | |
| Rent received | 2,300 | | |
| Profit on sale of Machinery | 41,000 | 47,600 | +47,600 |
| **Less** | | | 1,80,820 |

*Contd...*

Notes

| | | | |
|---|---|---|---|
| Non operating expense- | | | |
| Interest on loans | 15,000 | | |
| Loss on sale of plant | 3,100 | | |
| Donations | 4,250 | | |
| Loss by theft | 12,500 | 34,850 | – 34,850 |
| Net profit | | | 1,45,970 |

In case of Net loss reverse entry is to be passed i.e.

| | | | | |
|---|---|---|---|---|
| | Capital A/c (Net loss) Dr. | | | |
| | To profit & loss A/c<br>Net loss transferred | | | |

***Illustration 5:*** Following is the trial balance of R. Prasad on 30th June 2010

| Particulars | Dr. (₹) | Cr. (₹) |
|---|---|---|
| Capital | - | 15,000 |
| Purchases | 20,000 | - |
| Sales | - | 30,000 |
| Wages | 1,200 | - |
| Furniture | 800 | - |
| Salaries | 900 | - |
| Traveling Expenses | 700 | - |
| Commission | 300 | - |
| Cash in hand | 1,000 | - |
| Cash at Bank | 3,400 | - |
| Buildings | 16,000 | - |
| Debtors & Creditors | 4,500 | 4,000 |
| Bills Payable & Bills Receivable | 600 | 800 |
| Telephone | 100 | |
| Returns | 500 | 200 |
| | 50,000 | 50,000 |

On 30th June 2010 stock was valued at ₹ 7,500. Prepare Trading and Profit & Loss account for the year ended on 30th June 2010

***Solution:***

**Trading and Profit & Loss account of Mr. R. Prasad**
**(for the year ended on 30th June 2010)**

| Particulars | | (₹) | Particulars | | (₹) |
|---|---|---|---|---|---|
| To Purchases | 20,000 | | By sales | 30,000 | |
| -Returns | 200 | 19,800 | -Returns | 500 | 29,500 |
| To Wages | | 1,200 | By Closing stock | | 7,500 |
| To Gross Profit c/d | | 16,000 | | | |
| | | 37,000 | | | 37,000 |
| To Salaries | | 900 | By Gross profit b/d | | 16,000 |
| To Travelling Expenses | | 700 | | | |

*Contd...*

Notes

| | | | |
|---|---|---|---|
| To Commission | 300 | | |
| To Telephone | 100 | | |
| To Net Profit | 14,000 | | |
| | 16,000 | | 16,000 |

***Cost of Raw Material consumed:*** If there is opening stock of raw materials in the business and purchases are made of raw materials during the year and some stock is left at the end, then the cost of raw materials consumed is to be calculated as follows:

| | (₹) |
|---|---|
| Opening stock of Raw Materials | - |
| + Purchases made | - |
| – Returns during the period | - |
| – Closing stock of Raw Materials | - |
| Cost of raw-materials consumed | |

*Task* Calculate the cost of materials consumed from the following:

| Opening Stock | (₹) |
|---|---|
| Raw materials | 4,500 |
| Work in Progress | 12,000 |
| Finished Goods | 14,800 |
| Sales | 50,000 |
| Purchases during the year | 24,500 |
| Carriage inwards | 500 |
| Closing stock—raw materials | 1,500 |
| Work in Progress | 4,800 |
| Finished Goods | 2,700 |

***Hint:*** ₹ 28000

### 8.5.4 Manufacturing Account

If in the business some goods are being manufactured along with the trading activities, a manufacturing account is also prepared. In the case of trading activities (selling and purchasing of goods) only, the Trading and Profit & Loss Account is prepared to compute the net profit which is discussed in the preceding pages. In case there is a manufacturing unit in the business with the trading, such a businessman's income statement will include:

(i) Manufacturing Account

(ii) Trading Account

(iii) Profit & Loss Account

Manufacturing Account is prepared to know the results of manufacturing unit i.e. cost of production.

**Notes**

It includes:

[Debit side]

1. Carriage inwards paid on the purchase of raw materials is to be shown on the debit side of Manufacturing account.

2. Manufacturing wages and other direct expenses - are also shown on the debit side of manufacturing account.

   Prime Cost = Cost of Direct Manufacturing + Wages + Direct expenses.

3. ***Factory Expenses:*** All expenses of the factory such as wages, power and fuel, rent and rates, factory lighting, depreciation on machinery, salaries of manager and factory workers, repairs etc. is debited to this account.

4. ***Work in Progress:*** Whenever manufacturing is done, it always happens that some of the articles are not OK for sale, hence these are termed as Work in Progress. If such stock is there at the beginning, then it is added with the factory cost whereas if such stock is there at the end it is deducted from factory cost. Work in progress is also termed as semi-finished goods.

   [Credit side]

   (i) Closing stock of Raw Materials if not shown along with cost of raw materials consumed.

   (ii) Closing stock of work in progress/Semi-finished goods. Difference of credit and debit side of the manufacturing account is transferred to trading account.

   (iii) Sale of scarp, if any.

This account is prepared before the trading account. The balance of this account is transferred to Trading Account. The proforma of Manufacturing Account is given hereunder:

**Pro forma of Manufacturing Account**
**Manufacturing Account**
**(for the year ending ………)**

| Particulars | | (₹) | Particulars | | (₹) |
|---|---|---|---|---|---|
| To Opening Stock | | | By Closing Stock | | |
| Raw Materials | -------- | | Raw Materials | ------ | |
| Work-in-progress | -------- | ---- | Work-in-progress | ------ | ---- |
| To Purchase of materials | ----- | | By Sale of Scrape | | ---- |
| Less returns | ----- | ---- | By Cost of Production (Transferred to Trading A/c) | | ---- |
| To Manufacturing Wages | | ---- | | | |
| To Carriage Inwards | | ---- | | | |
| To Factory Expenses | | ---- | | | |
| To Stores Consumed | | ---- | | | |
| To Factory Rent | | ---- | | | |
| To Electricity | | ---- | | | |
| To Depreciation on Plant | | ---- | | | |
| To Repairs of Plant | | ---- | | | |
| To Works Manager's Salary | | ---- | | | |
| To Coal and Fuel | | ---- | | | |
| To Other Factory exps. | | ---- | | | |
| | | ---- | | | ---- |

Notes

*Illustration 6:* **Manufacturing, Trading and Profit & Loss A/c**

From the following particulars of Mr. Amit Agrawal, prepare a Manufacturing Account, Trading and Profit & Loss Account for the year ended 31st March, 2010.

| | (₹) |
|---|---|
| Purchase of Raw Material | 39,58,500 |
| Return Inwards | 21,000 |
| Stock on 31st March, 2008: | |
| Raw Materials | 3,63,000 |
| Work-in-Progress | 3,00,000 |
| Finished Goods | 4,11,000 |
| Productive Wages | 6,00,000 |
| Factory Expenses | 5,52,000 |
| General Office Expenses | 90,000 |
| Salaries | 1,80,000 |
| Distribution Expenses | 30,000 |
| Selling Expenses | 2,10,000 |
| Purchase Expenses | 1,80,000 |
| Export Duty | 90,000 |
| Import Duty | 60,000 |
| Interest on Bank Loan | 1,80,000 |
| Stock on 1st April, 2007: | |
| Raw Material | 1,20,000 |
| Work-in-Progress | 90,000 |
| Finished Goods | 1,23,000 |
| Sales | 58,50,000 |
| Return Outwards | 25,500 |
| Carriage Inwards | 31,500 |
| Discount allowed | 3,000 |
| Sale of Scrap | 6,000 |
| Depreciation on Plant | 1,50,000 |
| Depreciation on Furniture | 12,000 |

***Solution:***

**Manufacturing Account**
**(for the year ending 31st March, 2010)**

| Particulars | (₹) | Particulars | (₹) |
|---|---|---|---|
| To Opening Stock | | | |
| Materials | 1,20,000 | By Sale of Scrap | 6,000 |
| Work-in-Progress | 90,000 | By Closing Stock: | |
| To Purchase less Returns | | Materials | 3,63,000 |
| (39,58,500 - 25,500) | 39,33,000 | Work-in-Progress | 3,00,000 |

*Contd...*

Notes

| | | | |
|---|---|---|---|
| To Productive Wages | 6,00,000 | By Cost of Production | |
| To Factory Exps. | 5,52,000 | (Transferred to Trading A/c) | 50,76,000 |
| To Purchase Exps. | 1,80,000 | | |
| To Import Duty | 60,000 | | |
| To Carriage Inwards | 30,000 | | |
| To Depreciation on Plant | 1,50,000 | | |
| To Repairs to Machines | 30,000 | | |
| | 57,45,000 | | 57,45,000 |

**Trading and Profit & Loss Account**
**(for the year ending 31st March, 2010)**

| Particulars | Amount (₹) | Particulars | Amount (₹) |
|---|---|---|---|
| To Opening Stock of Finished Goods | 1,23,000 | By Sales less Returns (58,50,000 – 21,000) | 58,29,000 |
| To Cost of Production | | By Closing Stock | 4,11,000 |
| (Transfer from Manufacturing A/c) | 50,76,000 | | |
| To Gross Profit c/d | 10,41,000 | | |
| | 62,40,000 | | 62,40,000 |
| To General Office Exps. | 90,000 | By Gross Profit b/d | 10,41,000 |
| To Salaries | 1,80,000 | | |
| To Depreciation on Furniture | 12,000 | | |
| To Discount Allowed | 9,000 | | |
| To Carriage Outwards | 25,500 | | |
| To Interest on Bank Loan | 1,80,000 | | |
| To Export Duty | 90,000 | | |
| To Selling Expenses | 2,10,000 | | |
| To Distribution Expenses | 30,000 | | |
| To Net Profit (Transferred to Capital A/c) | 2,14,500 | | |
| | 10,41,000 | | 10,41,000 |

## Self Assessment

Fill in the blanks:

7. In the ...................... all those accounts are disclosed which affect the profit or loss of the business.
8. ...................... is the comparison of sales and purchase.
9. ...................... is prepared to know the results of manufacturing unit i.e. cost of production.

## 8.6 Balance Sheet

After the determination of the net profit of the business through the Trading and Profit & Loss Account, the businessman wants to know the financial position of the business. For this purpose he prepares a statement which is called the Balance Sheet. The Balance Sheet depicts the financial position of the business on a fixed date. Balance Sheet is prepared with those balances of Trial Balance which are left out (personal and real accounts) after taking out the nominal accounts' balances to prepare the Trading and Profit & Loss Account. A Balance Sheet has two sides – assets side and liabilities side. The assets and liabilities are shown in a particular order.

Asset = Liabilities + Capital

## Definition of Balance Sheet

1. "The Balance Sheet is a statement at a given date showing on one side the traders' property and possessions and on the other hand his liabilities".

   ***—Palmer***

2. "Balance Sheet is a screen picture of the financial position of a business at a certain moment."

   ***—R. Stead***

3. "Balance Sheet is a list of balances in the assets and liability accounts. This list depicts the position of assets and liabilities of a specific business at a specific point of time".

   ***—American Institute of Certified Public Accountants***

## Presentation of a Balance Sheet

As the Trading and Profit & Loss account can be presented in two forms namely (1) Horizontal/ Traditional form and (2) Vertical form (New, Recent development, Latest), similar is the case of Balance Sheet, this can be presented either (1) Horizontal form or (2) vertical or single column form. As we know, Balance sheet is prepared with a view to depict, the financial position of a business concern that too on a particular date, it is better if it portrays the full and complete information about financial soundness of the business. Under (1) Horizontal form, the Balance Sheet depicts the assets on the right hand side of the Balance sheet, whereas the assets are properly classified and shown such as (a) Fixed Assets (b) Investments (c) Current assets (d) Miscellaneous assets and the liabilities are shown on the left hand side of the Balance Sheet whereas liabilities are shown separately such as (i) Owned funds (ii) Borrowed funds i.e. funds borrowed from outsider that too long-term or short-term.

The Balance sheet is a document or a statement which tells how the funds are collected i.e. (1) Management of raising Funds and (2) How these are utilized i.e. Management of working capital and fixed assets. So it is necessary that the following information is supplied by the balance sheet.

(i) All the fixed assets must be shown as cost i.e. original costs and if depreciation is provided, it must be shown by way of deduction, if there is a change in the method of showing assets, it must be stated clearly.

(ii) As far as closing stock is concerned, it must be valued at cost or market value whichever is less.

(iii) Valuation of Investments–Cost as well as market value be given separately.

(iv) Book debts must be shown on book value and if any provision is made, this fact must be clearly stated. If there are some doubtful debts which are not provided, should be given separately.

Notes

### *Balance sheet is presented in a Horizontal form*

**Balance Sheet of Mr. Faquir Chand**
**(as on 31st March, 2011)**

| Liabilities | | (₹) | Assets | (₹) |
|---|---|---|---|---|
| Capital | 24,000 | | Machinery at Cost | 12,400 |
| +Net Profit | 67,900 | | Less depreciation | |
| - Drawings | 91,900 | | Furniture & Fixture | 6,500 |
| | 4,000 | | At cost less depreciation | |
| | | 87,900 | Closing Stock | 52,000 |
| Bank overdraft | | 5,000 | Sundry Debtors | 63,000 |
| Bills Payable | | 7,000 | Bills Receivable | 5,000 |
| Sundry Creditors | | 40,000 | Cash in hand | 1,000 |
| | | 1,39,900 | | 1,39,900 |

### *Vertical Presentation of Balance Sheet*

Balance sheet may also be presented vertically or in a single column form. In this case fixed assets are to be taken first + Amount of working capital i.e. Current Assets – Current liabilities, to be contributed by the owner in the form of capital + net profit or- Net Loss.

If the above Balance sheet of Mr. Faquir Chand is presented in a single column (vertical form) it would be like this:

**Balance Sheet on Mr. Faquir Chand**
**(as on March 31st 2011)**

| Particulars | (₹) | (₹) |
|---|---|---|
| Fixed Assets | | |
| Machinery | 12,400 | |
| Furniture & Fixture | 6,500 | |
| +Working Capital i.e. | | 18,900 |
| Current Assets | | |
| Cash in hand | 1,000 | |
| Bills Receivables | 5,000 | |
| Sundry debtors | 63,000 | |
| Closing Stock | 52,000 | |
| Current Assets | 1,21,000 | |
| (–) Current liabilities | | |
| Bank overdraft | 5,000 | |
| Bills Payable | 7,000 | |
| Sundry Creditors | 40,000 | |
| | 52,000 | |
| Working Capital | | 69,000 |
| Net Assets | | 87,900 |
| Capital Contributed by the owner | 24,000 | |
| + Net Profit | 67,900 | |
| Total Capital | 91,900 | |
| – Drawings | 4,000 | |
| Net Liabilities | | 87,900 |

**Notes**

***Illustration 7:*** From the following Trial balance of Mr. Gopal for the year ending 31.3.2011, prepare Trading and Profit & Loss account and Balance Sheet as on 31.3.2011.

| Particulars | Dr. (₹) | Cr. (₹) |
|---|---|---|
| Opening stock | 25,000 | - |
| Capital | | 2,25,000 |
| Debtors and creditors | 30,000 | 17,500 |
| Purchases and sales | 2,00,000 | 3,50,000 |
| Returns | 7,500 | 5,000 |
| Carriage | 4,000 | - |
| Wages | 12,500 | - |
| Commission | | 6,500 |
| Machinery | 40,000 | - |
| Furniture | 10,000 | - |
| Bad debts | 4,000 | - |
| Provision for doubtful debts | | 5,000 |
| B/R and B/P | 15,000 | 3,500 |
| Land and Buildings | 2,00,000 | - |
| Taxes and Insurance | 8,500 | - |
| Discount allowed | 6,000 | - |
| Bank | 25,000 | - |
| Drawings | 25,000 | - |
| | 6,12,500 | 6,12,500 |

Value of closing stock is ₹ 20,000

***Solution:***

**Trading and Profit & Loss Account of Mr. Gopal**
**For the year ending on 31.3.2011**

| Particulars | | (₹) | Particulars | | (₹) |
|---|---|---|---|---|---|
| To opening stock | | 25,000 | By sales | ₹ 3,50,000 | |
| To purchases | ₹ 2,00,000 | | By Returns | 7,500 | 3,42,500 |
| To Returns | 5,000 | 1,95,000 | By Closing stock | | 20,000 |
| To carriage | | 4,000 | | | |
| To wages | | 12,500 | | | |
| To Gross Profit c/d | | 1,26,000 | | | |
| | | 3,62,500 | | | 3,62,500 |
| To taxes and Insurance | | 8,500 | By Gross Profit b/d | | 1,26,000 |
| To Discount allowed | | 6,000 | By commission | | 6,500 |
| To Net profit | | 1,19,000 | By provision for | D/D 5000 | |
| | | | - Bad debts during the year | 4000 | 1000 |
| | | 1,33,500 | | | 1,33,500 |

Notes

**Balance sheet of Mr. Gopal as on 31.3.2011**

| Liabilities | | (₹) | Assets | (₹) |
|---|---|---|---|---|
| | (₹) | | Machinery | 40,000 |
| Capital | 2,25,000 | | Furniture | 10,000 |
| + Net profi | 1,19,000 | | Land and Buildings | 2,00,000 |
| | 3,44,000 | | Debtors (30,000) | 30,000 |
| – Drawings | –25,000 | | B/R | 15,000 |
| – Creditors | | 3,19,000 | Stock | 20,000 |
| B/P | | 17,500 | Bank | 25,000 |
| | | 3,500 | | |
| | | 3,40,000 | | 3,40,000 |

## Marshalling of Assets and Liabilities

Order of presenting the assets and liabilities in the Balance Sheet is called marshalling of assets and liabilities. A Balance Sheet may be prepared by marshalling the assets and liabilities in the following orders:

1. ***Balance Sheet prepared in Liquidity Order:*** Here liquidity means conversion of assets into cash. When a Balance Sheet is prepared on the basis of liquidity order, more easily convertible assets into cash are shown first and those assets which cannot be easily converted into cash are shown later and so on. In the case of liabilities, first those liabilities are shown which are payable earlier and then those liabilities are shown which are payable later. The proforma of such a Balance Sheet is given.

**Proforma of Balance Sheet in Order of Liquidity**
**(as on ………………….)**

| Liabilities | | Amount (₹) | Assets | Amount (₹) |
|---|---|---|---|---|
| **Current Liabilities** | | | **Current Assets** | |
| Sundry Creditors | | ------ | Cash in Hand | ------ |
| Bank Overdraft | | ------ | Cash at Bank | ------ |
| Short-term Loan | | ----- | Short-term Investment | ------ |
| Outstanding Expenses | | ----- | Prepaid Expenses | ------ |
| Unaccrued Income | | ----- | Bills Receivable | ------ |
| Bills Payable | | ----- | Accrued Incomes | ------ |
| **Long-term Liabilities** | | | Debtors | ------ |
| Capital | ------- | | Closing Stock | ------ |
| + Net Profit | ------- | | **Fixed Assets** | |
| | ------- | | Land & Building | ----- |
| - Drawings | ------- | ----- | Plant & Machinery | ----- |
| Long-term Loans | | ----- | Furniture | ----- |
| Contingent Liabilities | | | Investments (Long-term) | ----- |
| | ------- | | Goodwill | ------ |
| | ------- | | Patents & Trademarks | ------ |
| | | | Livestock | ------ |
| | | ------- | | ------- |

2. ***Balance Sheet prepared in Permanency Order:*** Balance Sheet prepared under this order is the reverse of the Balance Sheet prepared in liquidity order. In this case first those assets are shown which are more permanent means fixed assets and then less permanent assets (Current Assets) are shown. Similarly, first long-term liabilities (more permanent) are shown then less permanent (short-term on current) liabilities are shown. The proforma of such type of Balance Sheet is given below:

**Proforma of Balance Sheet in Permanency Order**
**(as on …………….)**

| Liabilities | | Amount (₹) | Assets | Amount (₹) |
|---|---|---|---|---|
| **Long-term Liabilities** | | | **Fixed Assets** | |
| Capital | ------ | | Land & Building | ----- |
| + Net Profit | ------ | | Plant & Machinery | ----- |
| | ------ | | Furniture | ----- |
| - Drawings | ------ | ------ | Long-term Investment | ----- |
| Long-term Loans | | ------ | Goodwill | ----- |
| **Current Liabilities** | | | Patents & Trademarks | ----- |
| Sundry Creditors | | ------ | Livestock etc. | ----- |
| Bank Overdraft | | ------ | **Current Assets** | |
| Bill Payable | | ------ | Cash in Hand | ----- |
| Short-term Loan | | ------ | Cash in Bank | ----- |
| Outstanding Expenses | | ------ | Short-term Investments | ----- |
| Unaccrued Incomes | | ------ | Bill Receivable | ----- |
| | | | Prepaid Expenses | ----- |
| | | | Accrued Incomes | ----- |
| | | | Debtors | ----- |
| | | | Closing Stock | ----- |
| | | ------ | | ------ |

*Illustration 8:* **Manufacturing, Trading and Profit & Loss Account and Balance Sheet**

From the following Trial Balance of Mr. Aditya, prepare a Trading Manufacturing and Profit & Loss Account and Balance Sheet as on 31st December, 2007.

**Trial Balance**
**(as on 31st December, 2007)**

| Particulars | Amount (₹) | Amount (₹) |
|---|---|---|
| Stock on 1.1.2007: | | |
| Raw Materials: | 8,000 | --- |
| Work-in-Progress | 20,000 | --- |
| Finished Goods | 40,000 | --- |
| Manufacturing Wages | 40,000 | --- |
| Purchases of Raw Materials | 1,20,000 | --- |
| Factory Rent | 20,000 | --- |
| Carriage of Raw Materials | 12,000 | --- |

*Contd...*

Notes

| | | |
|---|---|---|
| Salary of the Works Manager | 8,000 | --- |
| Office Rent | 8,000 | --- |
| Printing and Stationary | 4,000 | --- |
| Bad Debts | 4,000 | --- |
| Sales | --- | 2,40,000 |
| Land and Buildings | 1,20,000 | --- |
| Plant and Machinery | 80,000 | --- |
| Depreciation on Plant | 8,000 | --- |
| Sundry Debtors | 20,000 | --- |
| Sundry Creditors | --- | 1,20,000 |
| Cash in Hand | 20,000 | --- |
| Capital | --- | 1,72,000 |
| | 5,32,000 | 5,32,000 |

Closing stock on 31st December, 2007 were as follows:

| | (₹) |
|---|---|
| Raw Materials | 20,000 |
| Work-in-Progress | 16,000 |
| Finished Goods | 40,000 |

***Solution:***

**In the Books of Mr. Aditya**
**Manufacturing Account**
**(for the year ended 31st December, 2007)**

| Particulars | | (₹) | Particulars | | (₹) |
|---|---|---|---|---|---|
| To Opening Stock: | | | By Closing Stock: | | |
| To Raw Materials | 8,000 | | By Raw Material | 20,000 | |
| To Work-in-Progress | 20,000 | 28,000 | By Work-in-Progress | 16,000 | 36,000 |
| To Purchase of Materials | | 1,20,000 | By Cost of Production | | |
| To Carriage on Raw Materials | | 12,000 | (Transfer to Trading A/c) | | 2,00,000 |
| To Depreication on Plant | | 8,000 | | | |
| To Manufacturing Wages | | 40,000 | | | |
| To Factory Rent | | 20,000 | | | |
| To Salary of Works Manager | | 8,000 | | | |
| | | 2,36,000 | | | 2,36,000 |

**Trading and Profit & Loss Account**
**(for the year ending 31st December, 2007)**

| Particulars | Amount (₹) | | Amount (₹) |
|---|---|---|---|
| To Opening Stock: | | By Sales | |
| Finished Goods | | By Closing Stock | 2,40,000 |
| To Cost of Production | 40,000 | Finished Goods | |
| (Transfer from Manufacturing A/c) | 2,00,000 | | 40,000 |

*Contd...*

Notes

| | | | |
|---|---|---|---|
| To Gross Profit (carried to P. & L. A/c) | 40,000 | | |
| | 2,80,000 | By Gross Profit (brought from Trading A/c) | 2,80,000 |
| To Office Rent | 8,000 | | 40,000 |
| To Printing & Stationary | 4,000 | | |
| To Bad Debts | 4,000 | | |
| To Net Profit (carried to Capital A/c) | 24,000 | | |
| | 40,000 | | 40,000 |

**Balance Sheet**
**(as on 31st December, 2007)**

| Liabilities | | Amount (₹) | Assets | Amount (₹) |
|---|---|---|---|---|
| Capital | 1,72,000 | | Land and Buildings | 1,20,000 |
| + Net Profit | 24,000 | 1,96,000 | Plant and Machinery | 80,000 |
| Sundry Creditors | | 1,20,000 | Sundry Debtors | 20,000 |
| | | | Stock on 31st Dec., 2007: | |
| | | | Raw Materials | 20,000 |
| | | | Work-in-Progress | 16,000 |
| | | | Finished Goods | 40,000 |
| | | | Cash in Hand | 20,000 |
| | | 3,16,000 | | 3,16,000 |

## Adjustment Entries

Final accounts are prepared from the balances of Trial Balance. The final account will show the true and proper picture of the business only when all the transactions of the business are properly recorded. Therefore, before the preparation of final accounts the accountant must see that all the transactions of the current year have been recorded properly in the books or not. If the accountant find that some transactions are not incorporated in the books or wrongly incorporated in books or partially incorporated in books, to complete the records and rectifying the errors done, some adjustments are done. These adjustments entries are made in accounts through passing the adjustment entries.

Usually adjustment entries are made in the books before preparing the final accounts for the following items:

1. ***For Outstanding Expenses of the business***

   Outstanding expenses are the expenses incurred during a particular trading period, but not yet paid by the closing date of that period. For example, unpaid salaries, unpaid rent, unpaid wages, etc.

   Relating Expenses Account Dr.

   To Outstanding Expenses Account

   The outstanding expenses at the time of preparation of final account are shown in the liability side and on the other hand it is added in the relating expenses in the Debit side of Profit & Loss Account.

Notes

***Illustration 9:*** On 1st Jan 2011, Mr. Ram took a loan from Bank of Rajasthan Ltd. of ₹ 10,000 @ 18% per annum. Interest is payable half yearly and accounts of Ram are closed on 31st March every year.

Pass Necessary journal entries to give its effect and prepare relevant ledger accounts and show the item in the Balance sheet as on 31.03.2011.

***Solution:***

**In the books of Ram**
**Journal Entry**

| Date | Particulars | L.F. | Dr. (₹) | Cr. (₹) |
|---|---|---|---|---|
| 31.3.11 | Interest A/c Dr.<br>To outstanding interest A/c<br>(Interest for 3 months due but not paid) | | 450 | 450 |

***Ledger Accounts:***

**(1) Interest A/c**

Dr. Cr.

| Date | Particulars | J.F. | (₹) | Date | Particulars | J.F. | (₹) |
|---|---|---|---|---|---|---|---|
| 31.3.11 | To Interest Outstanding A/c | | 450 | 31.3.06 | By P & L A/c | | 450 |

**(2) Interest outstanding A/c**

Dr. Cr.

| Date | Particulars | J.F. | (₹) | Date | Particulars | J.F. | (₹) |
|---|---|---|---|---|---|---|---|
| 31.3.11 | To Balance A/c | | 450 | 30.1.06 | By Interest A/c | | 450 |

**Balance sheet As on 31.3.11**

| Liabilities | (₹) | Assets | (₹) |
|---|---|---|---|
| Interest outstanding A/c | 450 | | |

2. ***For Prepaid Expenses of the Business***

   Prepaid expenses are the expenses relating to the next trading period but paid during the current period. In short, prepaid expenses are the expenses paid in advance. Insurance premium, rent etc., are the examples of prepaid expenses.

   Prepaid Expenses Account Dr.

   To Relating Expenses Account

   The prepaid expenses are disclosed in the assets side of the Balance Sheet and subtracted from the relating expenses in the debit side of Profit & Loss Account.

***Illustration 10:*** Mr. Ashish took a fire Insurance Policy on 1st Oct., 10 for ₹ 50,000 Insurance Premium paid ₹ 5,000. Accounts are closed on 31st March, 11 Pass necessary journal entries to give its effect and prepare relevant ledger A/c and show the item in the Balance Sheet as on 31st March, 2011.

*Solution:*

Notes

**Journal Entries**

| Date | Particulars | L.F. | Dr. (₹) | Cr. (₹) |
|---|---|---|---|---|
| 1.10.10 | Insurance Premium A/c Dr.<br>To cash A/c<br>(Insurance Premium paid) | | 5,000 | 5,000 |
| 31.3.11 | Prepaid Insurance Premium A/c Dr.<br>To Insurance Premium A/c<br>(Advance payment of Premium for six months) | | 2,500 | 2,500 |

**Ledger Accounts**
**Insurance Premium A/c**
**(for the year ending 31st March 2011)**

Dr. Cr

| Date | Particulars | L.F | (₹) | Date | Particulars | L.F | (₹) |
|---|---|---|---|---|---|---|---|
| 1.10.10 | To cash A/c | | 5,000 | 31,3,11 | By prepaid Insurance A/c<br>By P & L A/c | | 2,500<br>2,500 |
| | | | 5,000 | | | | 5,000 |

**(2) Prepaid Insurance A/c**

Dr. Cr

| Date | Particulars | L.F | (₹) | Date | Particulars | L.F. | (₹) |
|---|---|---|---|---|---|---|---|
| 31.3.11 | To Insurance Premium A/c | | 2,500 | 31.3.11 | By Balance c/d | | 2,500 |

**Balance Sheet**
**(as on 31.3.11)**

| Liabilities | (₹) | Assets | (₹) |
|---|---|---|---|
| | | Prepaid Insurance A/c | 2,500 |

3. *For Accrued Incomes of the Business*

   Accrued incomes are revenues that have been earned but cash has not yet been received and no transaction has been recorded. Incomes which are due/earned but not received, are not recorded in the books of accounts unless such incomes are received, but if this practice continues, then it is not good because the results shown by the trading and Profit & loss A/c would not be correct such Incomes may be rent, interest, commission etc.

   Accrued Income Account Dr.

   To Relating Income Account

   The accrued incomes are disclosed in the assets side of the Balance Sheet and added in income in the credit side of the Profit & Loss Account.

***Illustration 11:*** Mr. Das has let out premises on rent on 01.07.10 @ ₹ 2,000 per month but rent is receivable at the end of one year whereas accounts are closed on 31st March 06. Pass necessary journal entries to give its effect and prepare ledger accounts and show how the item would appear in the Balance Sheet as on 31.03.11.

Notes

*Solution:*

Rent for 9 months @ ₹ 2,000/- p.m.

Total Rent = 2,000 × 9 = 18,000

Journal Entry at the end of accounting year

| Date | Particulars | L.F. | (₹) | (₹) |
|---|---|---|---|---|
| 31.3.2011 | Earned Rent A/c Dr.<br>To Rent A/c<br>(Rent accrued for 9 Months) | | 18,000 | <br>18,000 |

In the above case Earned Rent is a personal account and Rent (Income) is a nominal A/c.

**Rent A/c**

**Dr.** **Cr.**

| Date | Particulars | J.F. | (₹) | Date | Particulars | J.F. | (₹) |
|---|---|---|---|---|---|---|---|
| 31.3.11 | To P & L A/c | | 18,000 | 31.3.11 | By Earned Rent A/c | | 18,000 |

**Earned Rent A/c**

**Dr.** **Cr.**

| Date | Particulars | J.F. | (₹) | Date | Particulars | J.F. | (₹) |
|---|---|---|---|---|---|---|---|
| 31.3.11 | To Rent A/c | | 18,000 | 31.3.11 | By Balance c/d | | 18,000 |

**Balance Sheet (as on 31.3.11)**

| Liabilities | (₹) | Assets | (₹) |
|---|---|---|---|
| | | Accrued Interest | 18,000 |

4. *For Unaccrued Incomes of the Business*

Sometimes the Business receives some incomes though not yet due. This is as per terms of the contract. Such Incomes are rent received in advance or interest Received in advance etc. For example business premises are let out by the owner to a tenant on the condition that rent for the year is to be paid in advance though it is not due if accounts are prepared during the period of receipt of rent then adjusting entry is also to be passed so that we may get accurate results.

Relating Income Account Dr.

To Unaccrued Income Account

Unaccrued incomes are disclosed in the liability side of the Balance Sheet and subtracted from the relating incomes in the credit side of the Trading and Profit & Loss Account.

*Illustration 12:* M/s ABC takes deposits on the basis of Hundies, on which interest is generally paid in advance, which are matured on the expiry of stipulated periods. Mr. Pankaj has given ₹ 20,000 to the firm for deposit against Hundi for a period of 1 year rate of interest is 15%- Date of issue 01.09.10. Accounts are closed on 31st March, 2011 by Mr. Pankaj pass the necessary journal entries to give its effects and prepare ledger accounts and show its effects how this would appear in the Balance Sheet of Mr. Pankaj as on 31st March, 2011.

**Notes**

***Solution:***

In the books of Pankaj

Interest Received 20,000 × 15/100 = ₹ 3,000 for a year
Interest Actually due for 7 months =
7/12 × 3000 = ₹ 1,750
Received in advance 5/12 × 3,000 = ₹ 1,250

**Journal Entries**

**Dr.** **Cr.**

| Date | Particulars | L.F. | (₹) | (₹) |
|---|---|---|---|---|
| 1.9.10 | ABC (Hundies A/c) Dr.<br>To Cash A/c<br>(Hundies purchased) | | 20,000 | 20,000 |
| 1.9.10 | Cash A/c Dr.<br>To Interest A/c<br>(Interest received for one year) | | 3,000 | 3,000 |
| 31.3.11 | Interest A/c Dr.<br>To unaccrued/unearned Interest A/c<br>(Interest unearned for 5 months ) | | 1,250 | 1,250 |

**Ledger Accounts**
**(I) Interest A/c**

**Dr.** **Cr.**

| Date | Particulars | J.F. | (₹) | Date | Particulars | J.F. | (₹) |
|---|---|---|---|---|---|---|---|
| 31.3.11 | To Interest Accrued A/c | | 1250 | 1.9.10 | By cash A/c | | 3,000 |
| 31.3.11 | To P & L A/c | | 1,750 | | | | |
| | | | 3,000 | | | | 3,000 |

**(II) Interest Unaccrued A/c**

**Dr.** **Cr.**

| Date | Particulars | L.F. | (₹) | Date | Particulars | L.F. | (₹) |
|---|---|---|---|---|---|---|---|
| 31.3.11 | To Balance A/c | | 1250 | 31.3.11 | By Interest A/c | | 1,250 |

Thus, we see that Interest A/c is transferred to Profit & Loss A/c as it is a nominal A/c whereas interest unaccrued A/c is a personal A/c, is to be shown on the liabilities side of the Balance Sheet.

**Balance Sheet of Mr. Pankaj**
**As on 31.3.2011**

| Liabilities | (₹) | Assets | (₹) |
|---|---|---|---|
| Interest unaccrued A/c | 1,250 | | |

5. ***For the Depreciation on Assets***

Depreciation refers to reduction in the value of fixed asset due to wear and tear, passage of time, obsolescence, etc. Depreciation is generally charged as a percentage on the book value of the asset for which the asset is used.

Depreciation Account Dr.

To Relating Assets Account

Depreciation is subtracted from the relating assets in the assets side of the Balance Sheet and disclosed in the debit side of Trading and Profit & Loss Account.

Notes

6. ***Interest on Capital and Drawings:***

(i) *For Interest on Capital*

Interest on capital refers to the amount of interest allowed on the capital invested by the proprietor in the business.

Interest on Capital Account Dr.

To Capital Account

Interest on Capital is added to the capital of owner in the liabilities side of the Balance Sheet and disclosed in the debit side of the Trading and Profit & Loss Account.

(ii) *For Interest on Drawings*

Interest on drawings refers to the interest charged on the amount withdrawn by the proprietor from his business for personal use.

Drawings Account Dr.

To Interest on Drawings Account

Interest on Drawings is subtracted from the amount of capital along with the drawings and also shown in the credit side of income in Profit & Loss Account.

***Illustration 13:*** Given below is the Trial Balance of a trader as on 31st March 2011.

| Particulars | (₹) | (₹) |
|---|---|---|
| Cash in hand | 5,000 | |
| Land & Building | 80,000 | |
| Plant & Machinery | 50,000 | |
| Debtors and Creditors | 25,000 | 40,000 |
| Stock on 1.4.2009 | 10,000 | |
| 15% Investments on 1.4.2009 | 20,000 | |
| Purchases and sales | 95,000 | 1,90,000 |
| Bank Overdraft | | 20,000 |
| Wages | 28,000 | |
| Salaries | 16,000 | |
| Rent, Rates and Taxes | 15,000 | |
| Bad Debts | 6,000 | |
| Drawings | 5,000 | |
| Bills Receivable and Bills Payable | 15,000 | 21,000 |
| Carriage Inwards | 6,000 | |
| Custom Duty on Purchases | 16,000 | |
| Life Insurance Premium | 4,000 | |
| Advertisement | 30,000 | |
| Provision for Doubtful Debts | | 2,000 |
| Interest on Investments | | 2,000 |
| Trade Expenses | 11,000 | |
| Furniture | 20,000 | |
| Sales Tax | | 25,000 |
| Capital | | 1,57,000 |
| | 4,57,000 | 4,57,000 |

*Additional Information:*

Notes

1. Stock on 31st March 2011 was valued at ₹ 40,000.
2. Included in debtors are ₹ 8,000 due from Ram and included in creditors are ₹ 6,000 due to Ram.
3. Bills Receivable include a bill of ₹ 5,000 received from Varun, which has been dishonoured.
4. Sales include ₹ 5,000 for the goods sold on approval basis. Goods are sold at a profit of 25% on cost.
5. Wages include ₹ 5,000 spent on the erection of machinery.
6. Advertisement include ₹ 20,000 spent at the time of launching a new product. It is the policy of the business to write off such expenses in 5 years.
7. Create a provision for doubtful debts at 5% on debtors.
8. Prepaid taxes amounted to ₹ 2,000.
9. Depreciate machinery by 10%

Prepare Trading and Profit & Loss Account for the year ended 31st March 2011 and a Balance Sheet as on that date.

***Solution:*** Trading and Profit & Loss Account of Mr. Alok for the year ended on 31.3.2011.

**Balance Sheet of Mr. Alok**
**as on 31.3.2011**

| Particulars | | (₹) | Particulars | | (₹) |
|---|---|---|---|---|---|
| To Stock | | 10,000 | By Sales | 1,90,000 | |
| To Purchases | | 95,000 | – Sale on approval | 5,000 | 1,85,000 |
| To Carriage | | 6,000 | By Closing Stock | 40,000 | |
| To Custom Duty | | 16,000 | +Sale on approval | 4,000 | 44,000 |
| To Wages | 28,000 | | (5000-1000) | | |
| – Erection of Machine | 5,000 | 23,000 | | | |
| To Gross Profit c/d | | 79,000 | | | |
| | | 2,29,000 | | | 2,29,000 |
| To Salaries | | 16,000 | By Gross Profit b/d | | 79,000 |
| To Rent, Rates & Taxes | 15,000 | | By Int on Investments | 2,000 | |
| – Prepaid | 2,000 | 13,000 | + Accrued Interest | 1,000 | 3000 |
| To Bad debts | 6,000 | | | | |
| + New Prov | 950 | | | | |
| | 6,950 | | | | |
| – Old | 2,000 | 4,950 | | | |
| To Trade Expenses | | 11,000 | | | |
| To Advertisement | 30,000 | | | | |
| – Deferred | 16,000 | 14,000 | | | |
| To Depreciation on Machinery | | 5,500 | | | |
| To Net Profit | | 17,550 | | | |
| | | 82,000 | | | 82,000 |

Notes

**Balance Sheet of Mr. Alok**
**as on 31.3.2011**

| Liabilities | | (₹) | Assets | | (₹) |
|---|---|---|---|---|---|
| Capital | 1,57,000 | 10,000 | Cash in hand | | 5,000 |
| + Net Profit | +17,550 | | Land & Building | | 80,000 |
| | 1,74,550 | | Accrued Taxes | | 2,000 |
| – Drawings (5000+4000) | –9,000 | 1,65,550 | Furniture | | 20,000 |
| Bank Overdraft | | 20,000 | Plant & Machinery | 50,000 | |
| Bills Payable | | 21,000 | + Erection | +5,000 | |
| Creditors | 40,000 | | | 55,000 | |
| – Common | 6,000 | 34,000 | – Depreciation | –5,500 | 49,500 |
| Sales Tax payable | | 25,000 | Investments | 20,000 | |
| | | | + Accrued Int | 1,000 | 21,000 |
| | | | Debtors | 25,000 | |
| | | | – Common | 6,000 | |
| | | | | 19,000 | |
| | | | + Varun | 5,000 | |
| | | | | 24,000 | |
| | | | – Approval | 5,000 | |
| | | | Poor | 19,000 | |
| | | | | 950 | 18,050 |
| | | | Bills receivable | | 10,000 |
| | | | Stock | | 44,000 |
| | | | Deferred Advertisement | | 16,000 |
| | | 2,65,550 | | | 2,65,550 |

7. ***Closing Stock:*** The stock of goods remaining unsold at the end of the trading period is called closing stock.

   *Adjusting Entry*

   Closing Stock Account Dr.

   To Trading Account

   *Accounting Treatment*

   (i) To be entered on the credit side of the trading account.

   (ii) To be entered on the asset side of the balance sheet.

8. ***Interest on Loan and Investments:***

   If the business has taken a loan and interest is paid, then interest being a loss, is immediately charged/debited to Profit & Loss A/c, but if interest is accrued but not paid because of the terms of contract of business, then it must be provided for in books of account, otherwise operational results would not be accurate but incomplete and defective.

   (i) *For Interest on Loan Payable*

   Profit & Loss Account Dr.

   To Interest on Loan Account

   Interest on Loan payable is added to the amount of Loan in the liability side of the Balance Sheet and also shown in the debit side of Profit & Loss Account.

(ii) *For Interest on Investment Receivable*

Interest on Investment Account Dr.

To Profit & Loss Account

Interest on Investment Receivable is added to investment in the assets side of the Balance Sheet and also shown in the credit side of income in Profit & Loss account.

9. ***For Bad Debts:*** Bad debts refer to the amount due from debtors which are irrecoverable. In short, bad debt is a debt which is written off as bad.

Bad Debts Accounts Dr.

To Sundry Debtors Account

Bad Debts are deducted from the sundry debtors in the assets side of the Balance Sheet and shown in the debit side of Profit & Loss Account.

10. ***For Provision for Bad and Doubtful Debts:*** A doubtful debt is an amount due from debtors, the recovery of which is doubtful. The provision or reserve made out of the current year's profits for meeting the losses arising out of doubtful debts is known as provision for doubtful debts. As we know that there are two types of transactions: (1) For cash, and (2) For credit. In the modern era of science and technology business is not possible without credit and if it is so then there is always a possibility that out of total sums, some of these may not recover because of non-payment by the customer and if it happens, which is quite common in almost every business, only difference is of the degree, so it is very much necessary to provide for bad debts and this has become a part of policy decisions. The debts which are bad, immediately entry is passed in the books of the business, but the debts which are not yet declared as bad (irrecoverable) but the possibility is there that some of them may be declared as bad, that is why it is necessary to provide for and this is done by passing an adjustment entry.

(i) *When the provision is created:*

Profit & Loss Account Dr.

To Provision for Bad and Doubtful Debts Account

Such a provision is subtracted from the debtors in the assets side of Balance Sheet and also shown in the debt side of Profit & Loss Account.

(ii) *When Bad Debts are written off against the Provision for Bad and Doubtful Debts:*

Provision for Bad and Doubtful Debts Account Dr.

To Bad Debts Account

(iii) *When excess amount of the provision is transferred:*

Provision for Bad and Doubtful Debts Account Dr.

To Profit & Loss Account

The debts which are declared bad, immediately an entry for such loss is passed which is as follows:

| S. No. | Particulars | L.F. | Dr. (₹) | Cr. (₹) |
|---|---|---|---|---|
| | Bad debts A/c Dr.<br>(profit and loss A/c)<br>To sundry Debtors A/c<br>(debtors to the extent declared as bad) | | | |

Notes

The effect of the above Journal entry is that the balance of sundry debtors account is reduced to the extent of bad debts and bad debts being a loss are transferred to profit & loss account of the relevant year.

Recovery of Bad debts written off-Sometimes the debts which are written off as bad, are recovered fully or a part of it, is recovered, then it is profit which is directly transferred to profit & loss account and not in the debtors personal account. The entry in such case would be:

| S. No. | Particulars | L.F. | Dr. (₹) | Cr. (₹) |
|---|---|---|---|---|
| | Cash A/c Dr.<br>To Bad debts Recovered A/c<br>(Profit & Loss A/c)<br>Bad debts recovered | | | |

***In case of doubtful debts:*** On the basis of past experience, if any, a provision is created from Profit & loss account and is credited to provision for bad and doubtful debts account. The Journal entry would be:

| S. No. | Particulars | L.F. | Dr. (₹) | Cr. (₹) |
|---|---|---|---|---|
| | Profit and Loss A/c Dr.<br>To provision for Bad and doubtful debts A/c<br>Provision made | | | |

The effect of the above journal entry would be reduction of year's profit and creation of provision to be shown on the liabilities side of the Balance sheet. But the practice is that the provision for bad and doubtful debt is deducted from total debtors on the assets side in the year of creation, but next year when actual bad debts take place, such amount is debited not from the profit & loss account, but from the provisions for Bad and doubtful debts account and the balance, if any in this account, is deducted from the total debtors account.

***Illustration 14:*** Mr. Ram Lal closes his books on 31st Dec., 2011 on that date debtors were ₹ 50,000. On the basis of past year experience, this has been a practice to provide for bad and doubtful debts @ 10%.

You are required to journalize the above and prepare the ledger accounts and also show it in the Balance sheet as on 31st Dec 2011

***Solution:***

**Journal Entry**

| S. No. | Particulars | L.F. | (₹) | (₹) |
|---|---|---|---|---|
| 31.12.11 | Profit and loss A/c Dr. | | 5,000 | |
| | To provision for Bad & Doubtful debts A/c | | | 5,000 |
| | Provision for Bad & doubtful debts created @ 10% on ₹ 50,000 | | | |

**Ledger Accounts**
**Provision for Bad and doubtful debts A/c**

| Date | Particulars | L.F. | (₹) | Date | Particulars | L.F. | (₹) |
|---|---|---|---|---|---|---|---|
| 31.12.11 | To Balance c/d | | 5,000 | 31.12.05 | By P & L A/c | | 5,000 |

Notes

**Balance Sheet**
**As on 31.12.11**

| Liabilities | (₹) | Assets | | (₹) |
|---|---|---|---|---|
| | | Sundry Debtors | 50,000 | |
| | | -provision for | | |
| | | Bad & doubtful debts | 5,000 | 45,000 |

11. ***For Discount Provision on Debtors***

The provision or reserve made for meeting the loss arising on account of the discount that will have to be allowed to the debtors who pay their dues promptly is known as provision for discount on debtors.

(i) *When the provision for discount on debtors is created:*

Profit & Loss Account Dr.

To Provision for Discount on Debtors Account

Provision for discount on Debtors is subtracted from Sundry Debtors in the assets side of Balance Sheet and shown in the debit side of Profit & Loss Account.

(ii) *When the amount of discount is written off against the Provision for Discount Account:*

Provision for Discount on Debtors Account Dr.

To Discount on Debtors Account

(iii) *When excess amount of provision is transferred:*

Provision for Discount on Debtors Account Dr.

To Profit & Loss Account

***Illustration 15:*** The following figures appear in the books of Shri Hanuman Prasad.

| | | (₹) |
|---|---|---|
| Jan 1 | Provision for bad and doubtful debts | 2,400 |
| Jan 1 | Provision for discount on debtors | 1,120 |
| Dec 31 | Bad debts written off | 940 |
| Dec 31 | Discount allowed during the year | 1,860 |
| Dec 31 | Bad debts recovered | 50 |
| Dec 31 | Debtors | 20,120 |
| | Write off further ₹ 480 (definitely bad) | |

Create a provision for discount on debtors @ 2% and also for bad and doubtful debts @ 4% you are required to journalize the above and Prepare Provision for bad and doubtful debts A/c and provision for discount on debtors A/c and bad debts A/c & discount A/c.

***Solution:***

**Journal Entries**

| Date | Particulars | L.F. | (₹) | (₹) |
|---|---|---|---|---|
| Dec 31 | Provision for Bad & doubtful debts Dr. | | 940.00 | |
| | To Bad debts A/c | | | 940.00 |
| | (Bad debts transferred.) | | | |

*Contd...*

Notes

| | | | | | |
|---|---|---|---|---|---|
| Dec 31 | Provision for discount on debtors A/c Dr.<br>To Discount allowed A/c<br>(Discount allowed transferred.) | | | 1,860.00 | 1,860.00 |
| Dec 31 | Bad debts Recovered A/c Dr.<br>To Profit & Loss A/c<br>(Gain transferred.) | | | 50.00 | 50.00 |
| Dec 31 | Provision for Bad & doubtful debts A/c Dr.<br>To Profit & loss A/c<br>(Excess transferred.) | | | 194.40 | 194.40 |
| Dec 31 | Profit and loss A/c Dr.<br>To Provision on discount on debtors A/c<br>(Discount on debtors transferred.) | | | 377.00 | 377.00 |

*Ledger Accounts*

**(i) Provision for Bad and doubtful debts A/c**

| Date | Particulars | (₹) | Date | Particulars | (₹) |
|---|---|---|---|---|---|
| Dec. 31 | To Bad debts A/c | 1,420 | Jan. 1 | By Balance b/d | 2,400.00 |
| Dec 31 | To P & L A/c<br>(Bal. Figure) | 194.40 | | | |
| Dec. 31 | To Balance c/d | 785.60 | | | |
| | | 2,400.00 | | | 2,400.00 |

**(ii) Bad debts A/c**

| Date | Particulars | (₹) | Date | Particulars | (₹) |
|---|---|---|---|---|---|
| Dec 31 | To S. debtors A/c | 940 | Dec 31 | By Provision for Bad & Doubtful debts A/c | 1,420 |
| Dec 31 | To debtors A/c | 480 | | | |
| | | 1,420 | | | 1,420 |

**(iii) Provision for Discount on Debtors A/c**

| Date | Particulars | (₹) | Date | Particulars | (₹) |
|---|---|---|---|---|---|
| Dec 31 | To Discount on Debtors | 1,860 | Jan 1 | By Balance b/d | 1,120 |
| Dec 31 | To Balance c/d | 377 | Dec. 31 | By Profit & Loss A/c | 1,117 |
| | | 2,237 | | | 2,237 |

**(iv) Discount on Debtors A/c**

| Date | Particulars | (₹) | Date | Particulars | (₹) |
|---|---|---|---|---|---|
| Dec 31 | To S. Debtors | 1,860 | Dec 31 | By Provision for Discount on Debtors A/c | 1,860 |

**(v) S. Debtors A/c**

| Date | Particulars | (₹) | Date | Particulars | (₹) |
|---|---|---|---|---|---|
| Dec 31 | To Balance b/d | 20,120 | Dec. 31 | By Bad debts | 480 |
| | | | | By Balance c/d | 19,640 |
| | | 20,120 | | | 20,120 |

Notes

*Note* Bad debts recovered are directly transferred to Profit & Loss A/c.

12. ***For Discount Provision on Creditors***

The provision or reserve for discount on creditors is created for expected discount from the creditors who are paid dues promptly.

(i) *When provision for discount on creditors is created:*

Provision for Discount on Creditors Account Dr.

To Profit & Loss Account

Provision for discount on creditors is deducted from Creditors in the liability side of Balance Sheet and shown in the Credit side of Profit & Loss Account.

(ii) *When discount on creditors is written off against the provision:*

Discount on Creditors Account Dr.

To Provision for Discount on Creditors Account

***Illustration 16:*** A trader maintains a provision for discount on creditors A/c. The following balances have been extracted from his books.

| | Date<br>31.12.10<br>(₹) | Date<br>31.12.11<br>(₹) |
|---|---|---|
| Discount Received | 300 | 50 |
| Sundry creditors | 15,000 | 10,000 |
| Provision for Discount on Creditors (opening) | 400 | To be credited @ 2% for 05 & 06 |

You are required to prepare Provision for Discount on creditor's A/c as well as discount received A/c.

***Solution:***

**Discount Received A/c**

| Date | Particulars | (₹) | Date | Particulars | (₹) |
|---|---|---|---|---|---|
| 31.12.10 | Prov. For discount on creditors A/c | 300 | 31.12.10 | By S. creditors | 300 |
| 31.12.10 | Prov. For discount on creditors A/c | 50 | 31.12.11 | By S. creditors | 50 |

**Provision for Discount on Creditors A/c**

| Date | Particulars | (₹) | Date | Particulars | (₹) |
|---|---|---|---|---|---|
| 31.12.10<br>31.12.10 | To Balance b/d<br>To P & L A/c<br>(Balancing figure) | 400<br>200 | 31.12.10<br>31.12.10 | By Discount Recd.<br>By Balance c/d<br>2% on 15,000 | 300<br>300 |
| | | 600 | | | 600 |
| 1.1.11 | To Balance b/d | 300 | 31.12.11 | By Discount Recd.<br>By P&L A/c<br>By Balance c/d<br>2% on 10,000 | 50<br>50<br>200 |
| | | 300 | | | 300 |

Notes

13. ***Creation of Reserve:*** The term reserve is most commonly used to describe any part of shareholders' equity, except for basic share capital.

    Equity reserves are created from several possible sources:

    (a) Reserves created from shareholders' contributions, the most common examples of which are:

    - Legal reserve fund: It is required in many legislations and it must be paid as a percentage of share capital
    - Share premium: amount paid by shareholders for shares in excess of their nominal value

    (b) Reserves created from profit, especially retained earnings, i.e. accumulated accounting profits. However, profits may be distributed also to other types of reserves, for example:

    - Legal reserve fund from profit: many legislations require creation of the fund as a percentage of profits
    - Remuneration reserve: will be used later to pay bonuses to employees or management.
    - Translation reserve: arises during consolidation of entities with different reporting currencies

    Reserve is the profit achieved by a company where a certain amount of it is put back into the business which can help the business in their rainy days.

14. ***Sales Tax:*** Sales tax is the tax paid by a business concern to the government on the sales made by it. In can be deducted from sales. Alternatively, it can be treated as selling expense and can be entered on the debit side of the profit & loss account.

15. ***Income tax and life insurance premium:*** These are personal expenses of the proprietor and should be treated as drawings. Since these are drawings they should be deducted from capital on the liabilities side of the balance sheet.

***Illustration 17:*** From the following trial balance of Mr. Nagaraj prepare the final accounts.

**Trial balance as on March 31, 2011**

| Ledger Accounts | Debit (₹) | Credit (₹) |
|---|---|---|
| Land and Buildings | 50,000 | |
| Purchases | 1,10,000 | |
| Stock | 40,000 | |
| Returns | 1,500 | 2,500 |
| Wages | 10,000 | |
| Salaries | 9,000 | |
| Office expenses | 2,400 | |
| Carriage inwards | 1,200 | |
| Carriage outwards | 2,000 | |
| Discounts | 750 | 1,200 |
| Bad debts | 1,200 | |
| Sales | 2,05,000 | |
| Capital account | 1,30,000 | |
| Insurance | 1,500 | |

*Contd...*

Notes

| | | |
|---|---|---|
| Commission | 1,500 | |
| Plant and Machinery | 50,000 | |
| Furniture and Fixtures | 10,000 | |
| Bills Receivable | 20,000 | |
| Sundry debtors and creditors | 40,000 | 25,000 |
| Cash in hand | 1,500 | |
| Cash at bank | 4,500 | |
| Office equipment | 12,000 | |
| Bills payable | 2,350 | |
| **Total** | **3,67,550** | **3,67,550** |

***Adjustments:***

(a) Closing stock amounted to ₹ 60,000.

(b) Outstanding liabilities: Wages ₹ 2,000, Rent ₹ 3,000.

(c) Depreciate land and buildings at 5%, plant and machinery, office equipment and furniture and fixtures at 10%.

(d) Insurance premium prepaid to the extent of ₹ 200.

***Solution:***

**In the books of Mr. Nagaraj**
**Trading A/c for the year ending March 31, 2011**

**Dr.** **Cr.**

| | | (₹) | | | (₹) |
|---|---|---|---|---|---|
| To Opening stock | | 40,000 | By Sales | 2,05,000 | |
| To Purchases | 1,10,000 | | Less: Returns | 1,500 | 2,03,500 |
| Less: Returns | 2,500 | 1,07,500 | By Closing Stock | | 60,000 |
| To Wages | 10,000 | | | | |
| Add: Outstanding | 2,000 | 12,000 | | | |
| To Carriage inwards | | 1,200 | | | |
| To Profit and Loss A/c | | 1,02,800 | | | |
| (Gross profit transferred to profit and loss A/c) | | | | | |
| | | **2,63,500** | | | **2,63,500** |

**Profit & Loss A/c for the year ending March 31, 2007**

**Dr.** **Cr.**

| | | (₹) | | (₹) |
|---|---|---|---|---|
| To Salaries | | 9,000 | By Trading A/c (gross profit | 1,02,800 |
| To Office expenses | | 2,400 | transferred from trading A/c) | |
| To Carriage outwards | | 2,000 | By Discount | 1,200 |
| To Discount | | 750 | By Commission | 1,500 |
| To Bad debts | | 1,200 | | |
| To Insurance | 1500 | | | |
| Less: Prepaid | 200 | 1,300 | | |

*Contd...*

Notes

| | | | | |
|---|---|---|---|---|
| To Outstanding rent | | 3,000 | | |
| To Depreciation: | | | | |
| Land and Buildings | 2,500 | | | |
| Plant and Machinery | 5,000 | | | |
| Furniture & Fixture | 1,000 | | | |
| Office equipment | 1,200 | 9,700 | | |
| To Capital A/c | | 76,150 | | |
| (Net Profit transferred) | | | | |
| | | **1,05,500** | | **1,05,500** |

**Balance Sheet as on March 31, 2007**

| Liabilities | | (₹) | Assets | | (₹) |
|---|---|---|---|---|---|
| Capital | | | Fixed Assets | | |
| Opening balance | 1,30,000 | | Land & Buildings | 50,000 | |
| *Add:* Net profit | 76,150 | 2,06,150 | *Less:* Depreciation @ 5% | 2,500 | 47,500 |
| | | | Plant and Machinery | 50,000 | |
| | | | *Less:* Depreciation @ 10% | 5,000 | 45,000 |
| | | | Furniture & Fixtures | 10,000 | |
| Long Term Liabilities | | | *Less:* Depreciation @ 5% | 1,000 | 9,000 |
| | | | Office equipments | 12,000 | |
| | | | *Less:* Depreciation @ 10% | 1,200 | 10,800 |
| Current Liabilities | | | Investments | | |
| Creditors | | 25,000 | | | |
| Bills payable | | 2,350 | Current Assets | | |
| Outstanding Wages | | 2,000 | Bills Receivable | | 20,000 |
| Outstanding Rent | | 3,000 | Debtors | | 40,000 |
| | | | Cash in hand | | 1,500 |
| | | | Cash at bank | | 4,500 |
| | | | Closing Stock | | 60,000 |
| | | | Prepaid Insurance | | 200 |
| | | 2, 38,500 | | | 2,38, 500 |

*Illustration 18:* **Final Accounts with Adjustment**

Prepare final accounts from the following balances of Mr. Ankit as on 31st December, 2007.

**Extracts of Balances**
**as on 31st December, 2007**

| Debit Balances | (₹) | Credit Balances | (₹) |
|---|---|---|---|
| Drawings | 45,000 | Capital Account | 6,09,000 |
| Goodwill | 90,000 | Bills Payable | 41,400 |
| Land and Building | 1,80,000 | Sundry Creditors | 91,500 |
| Plant and Machinery | 1,20,000 | Purchase Returns | 7,950 |
| Loose tools | 9,000 | Sales | 3,45,000 |
| Bills Receivable | 6,000 | | |

*Contd...*

Notes

| | | | |
|---|---|---|---|
| Stock 1.1.2007 | 1,20,000 | | |
| Purchase | 1,53,000 | | |
| Wages | 60,000 | | |
| Carriage Inwards | 3,600 | | |
| Carriage Outwards | 4,500 | | |
| Coal and Gas | 16,800 | | |
| Salaries | 12,000 | | |
| Rent, Rates and Taxes | 8,400 | | |
| Discount allowed | 4,500 | | |
| Cash at Bank | 75,000 | | |
| Cash in Hand | 4,200 | | |
| Sundry Debtors | 1,35,000 | | |
| Repairs | 5,400 | | |
| Printing and Stationery | 1,500 | | |
| Bad Debts | 3,600 | | |
| Advertisments | 10,500 | | |
| Sales Returns | 6,000 | | |
| Furniture and Fittings | 3,600 | | |
| General Expenses | 15,750 | | |

*Adjustments*

(a) Closing stock on 31st December, 2007 was ₹ 1,80,000.

(b) Depreciate Plant and Machinery at 5%, Loose Tools at 15% and Furniture and Fittings at 5%.

(c) Provide 2½% for Discount on Sundry Debtors and Creditors and 5% for Bad and Doubtful Debts.

(d) Outstanding Wages ₹ 4,500 and Rent and Taxes ₹ 2,550.

*Solution:*

**In the Book of Mr. Ankit**
**Trading and Profit & Loss Account**
**(for the year ending on 31st December, 2007)**

| Particulars | | Amount (₹) | Particulars | Amount (₹) |
|---|---|---|---|---|
| To Opening Stock | | 1,20,000 | | |
| To Purchases Less Returns | | | By Sales Less Returns | 3,39,000 |
| (₹ 1,53,000 – 7,950) | | 1,45,050 | (₹ 3,45,000 – 6,000) | 1,80,000 |
| Wages | 60,000 | | By Closing Stock | |
| + O/s Wages | 4,500 | 64,500 | | |
| To Carriage Inwards | | 3,600 | | |
| To Coal and Gas | | 16,800 | | |
| To Gross Profit C/d | | 1,69,050 | | |
| | | 5,19,000 | | 5,19,000 |
| To Carriage Outwards | | 4,500 | By Gross Profit b/d | 1,69,050 |

*Contd...*

Notes

| | | | | |
|---|---|---|---|---|
| To Salaries | | 12,000 | By Reserve for Discount on Creditors @ $2^1/_2$% | 2,250 |
| To Rent, Rates & Taxes | 8,400 | | | |
| + Outstanding | 2,550 | 10,950 | | |
| To Discount Allowed | | 4,500 | | |
| To Repairs | | 5,400 | | |
| To Printing & Stationary | | 1,500 | | |
| To Bad Debts | 3,600 | | | |
| + New Provision (D/D) | 6,750 | | | |
| | 10,350 | | | |
| + Provision for Discount | 3,206 | 13,556 | | |
| To Advertisement | | 10,500 | | |
| To General Expenses | | 15,750 | | |
| To Depreciation on: | | | | |
| Plant & Machinery | 6,000 | | | |
| Loose tools | 1,350 | | | |
| Furniture & Fittings | 180 | 7,530 | | |
| To Net Profit | | | | |
| (transferred to Capital A/c) | | 85,114 | | |
| | | 1,71,300 | | 1,71,300 |

**Balance Sheet**
**(as on 31st December, 2007)**

| Liabilities | | Amount (₹) | Assets | | Amount (₹) |
|---|---|---|---|---|---|
| Capital | 6,09,000 | | Goodwill | | 90,000 |
| Add: Net Profit | 85,114 | | Land & Buildings | | 1,80,000 |
| | 6,94,114 | | Plant & Machinery | 1,20,000 | |
| Less: Drawings | 45,000 | 6,49,114 | Less: Depreciation | 6,000 | 1,14,000 |
| Bills Payable | | 41,400 | Furniture & Fittings | 3,600 | |
| Creditors | 90,000 | | Less: Depreciation | 180 | 3,420 |
| Less: Provision for | | | Loose Tools | 9,000 | |
| Discount | 2,250 | 87,750 | Less: Depreciation | 1,350 | 7,650 |
| Outstanding Wages | | 4,500 | Sundry Debtors | 1,35,000 | |
| Outstanding Rent | | 2,550 | Less: Prov. for D/D | 6,750 | |
| | | | | 1,28,250 | |
| | | | Less: Prov. for | | |
| | | | Discount | 3,206 | 1,25,044 |
| | | | Bills Receivable | | 6,000 |
| | | | Closing Stock | | 1,80,000 |
| | | | Cash in Hand | | 4,200 |
| | | | Cash at Bank | | 75,000 |
| | | 7,85,314 | | | 7,85,314 |

## Self Assessment

Notes

Fill in the blanks:

10. The …………………… will show the true and proper picture of the business only when all the transactions of the business are properly recorded.
11. …………………… prepared under this order is the reverse of the Balance Sheet prepared in liquidity order.
12. Order of presenting the assets and liabilities in the Balance Sheet is called …………………… of assets and liabilities.

## 8.7 Summary

- Final accounts include the Trading and Profit & Loss Account and Balance Sheet.
- Trading and Profit & Loss Account is prepared to calculate the net profit earned by business during a period.
- Balance Sheet of a business is prepared to disclose the financial picture of the business.
- The Trading Account shows the gross profit which is the difference of sales and cost of sales.
- Profit & Loss Account shows the net profit which is computed by matching the total revenues and expenses of the business.
- Balance Sheet is a statement which has two sides – Liability side and Assets side.
- Before preparing the final accounts of the business some adjustments are also done (if required).

## 8.8 Keywords

***Financial Statements:*** These include the Trading and Profit & Loss Account, and Balance Sheet of the business.

***Gross Loss:*** It is the excess of cost of sales over sales.

***Gross Profit:*** It is calculated by comparing the sales and cost of sales. It is the excess of sales over cost of sales.

***Net Loss:*** Excess of expenditures over revenues is called net loss.

***Net Profit:*** It is the excess of revenues over expenses. It is depicted by P& L A/c.

***Trial Balance:*** It is the list of accounts taken from the ledger.

## 8.9 Review Questions

1. What do you mean by errors? Which type of errors can not be detected by Trial Balance? Explain.
2. What do you mean by Trading Account? Give the proforma of Trading Account and explain why it is prepared.
3. What is the importance of Balance Sheet? Give a form of Balance Sheet in Liquidity order with imaginary examples.
4. What do you mean by adjustment? Explain the different adjustment entries.

Notes

5. From the following balances draw up a Trading and Profit & Loss Account and Balance Sheet:

| | (₹) |
|---|---|
| Amit Joseph's Capital | 30,000 |
| Bank Overdraft | 7,500 |
| Machinery | 20,100 |
| Cash in hand | 1,500 |
| Fixture & Fitting | 8,250 |
| Opening stock | 67,500 |
| Bills Payable | 10,500 |
| Creditors | 60,000 |
| Debtors | 94,500 |
| Bill receivable | 7,500 |
| Purchases | 75,000 |
| Sales | 1,93,500 |
| Returns from customers | 1,500 |
| Returns to Creditors | 1,650 |
| Salaries | 13,500 |
| Manufacturing Wages | 6,000 |
| Commission | 8,250 |
| Trade Expenses | 2,250 |
| Discount (Cr.) | 6,000 |
| Rent | 3,300 |

The Closing Stock amounted to ₹ 78,000.

6. The following balances are extracted on 31st March, 2008 from the book of Mr. Rajesh Pratap.

| | (₹) | | (₹) |
|---|---|---|---|
| Capital | 4,90,000 | Loan | 1,57,600 |
| Drawing | 40,000 | Sales | 13,07,200 |
| General Expenses | 50,000 | Purchases | 9,40,000 |
| Buildings | 2,20,000 | Motor Car | 40,000 |
| Machinery | 1,86,800 | Prov. for Bad Debts | 18,000 |
| Opening Stock | 3,24,000 | Commission (Cr.) | 26,400 |
| Coal and Power | 44,800 | Car Expenses | 36,000 |
| Taxes and Insurance | 26,300 | Bills Payable | 77,000 |
| Wages | 1,44,000 | Cash in Hand | 1,600 |
| Debtors | 1,25,600 | Bank Overdraft | 66,000 |
| Creditors | 50,000 | Donation | 2,100 |
| Discount (Dr.) | 11,000 | | |

**Notes**

Prepare the Final Accounts for the year ending 31st March, 2008, after taking into accounts the following adjustments:

(a) Write off ₹ 3,200 for bad debts and make provision for Bad debts @5% on debtors.

(b) Depreciate Machinery by 10% and Motor Car by 12%.

(c) Interest ₹ 15,000 is outstanding of Loan.

(d) It was decided to transfer ₹ 5,000 every year to charity fund.

(e) 1/3 of car expenses and depreciation amount is to be transferred to owner's account.

(f) Stock valued on 31st March, 2008 was ₹ 4,70,000.

### Answers: Self Assessment

1. Final accounts
2. Internal, External
3. Capital expenditure
4. Revenue expenditure
5. Revenue
6. Gross inflow of cash
7. Trading and Profit & Loss Account
8. Trading account
9. Manufacturing Account
10. Final account
11. Balance Sheet
12. Marshalling

## 8.10 Further Readings

*Books*

Khan and Jain, "Management Accounting".

M.P. Pandikumar, "Accounting & Finance for Managers", Excel Books, New Delhi.

R.L. Gupta and Radhaswamy, "Advanced Accountancy".

S.N. Maheswari, "Management Accounting".

V.K. Goyal, "Financial Accounting", Excel Books, New Delhi.

*Online links*

www.futureaccountant.com

http://www.globusz.com/

Notes

# Unit 9: Analysis and Interpretation of Financial Statements

CONTENTS



## Objectives

After studying this unit, you will be able to:

- Understand the meaning of Analysis and Interpretation of Financial Statements
- Describe the procedure for Analysis and Interpretation of Financial Statements
- Have types of Analysis of Financial Statements
- Know the techniques of Analysis and Interpretation

## Introduction

We know that the financial statements include – Trading and Profit & Loss Account, Profit & Loss Appropriation Account and the Balance Sheet. These statements give only the information to the management regarding the financial conditions, and profits which help the management to control the business. Therefore, for the better understanding of the financial statements, the self-appraisal of the business and for the better judgement of outsiders regarding the performance of the company, the analysis of the financial statements is done.

## 9.1 Meaning of Analysis of Financial Statements

Analysis of financial statement is the process of critically examining of the data of the financial accounts. The main function of this analysis is to find the strengths and weakness of the business by using different tools. Financial analysis severs the interests of the shareholders, debentures, long-term and short-term investors, bankers, creditors, politicians, journalists, legislators, economists and researchers by classifying, rearranging and regrouping the financial statements. Thus it helps the interested parties to reach on significant conclusion.

In the words of John M. Myer - "Financial statement analysis is largely a study of relationship among the various financial factors in a business as disclosed by a single set of statements and a study of the trends of these factors as shown in a series of statements".

Thus, the financial statement analysis refers to the classification, diagnosis and comparison of the data of financial statements so that the profitability, financial position managerial efficiency and weakness of the business may be disclosed.

### 9.1.1 Meaning of Financial Statement Interpretation

Interpretation is relating to the drawing of conclusion, inference and criticism of the analysed financial data to judge the profitability & financial soundness of firm. Interpretation comes next to the analysis of financial statements. Interpretation of financial statement is not possible without analysis of financial data.

In the words of Spiecer and Peglar, "Interpretation of accounts may be defined as the art and science of translating the figures, in such a way, as to reveal the financial strength and weakness of the business and the causes which have contributed therein".

## 9.2 Analysis and Interpretation of Financial Statements

Analysis and interpretation of financial statements are two different terms but are closely associated because without interpretation analysis is useless and without analysis interpretation is impossible. Analysis not only classifies the financial data into simple form but also helps in creating a relationship of one accounting figure with another so that the meaningful conclusion of the financial data may be drawn by the interpreter. For this purpose the interpreter must be well experienced and quite intelligent to read and understand the analysed data.

As per Kennedy and McMullar, "The analysis and interpretation of financial statements are an attempt to determine the significance and meaning of financial statements data so that a forecast may be made of the prospects for future earnings, ability to pay interest and debt maturities (both current and long-term) and probability of a sound dividend policy".

### 9.2.1 Procedure for Analysis and Interpretation

Generally the following procedure is adopted for the analysis and interpretation of financial statements:

1. Before the analysis, the objective and extent of analysis and interpretation should be determined. Extent of analysis is based on the objectives of analysis.
2. All the required financial data should be collected and studied from financial statements. If required, the financial statements should be rearranged or reorganized to find the same nature items.
3. To reduce the complexity of the financial statements, the figures of the financial statements should be approximated to the thousand or hundred.
4. To create a relationship among the income statement and financial position statement, different analysis techniques as ratio analysis, trend and common size should be used.
5. If there are given some additional information relating to interpretation except financial statement those must also be collected.
6. If it is required for the comparison, the financial data should be rearranged in the tables in a logical way.

Notes

7. To interpret the financial data and to draw a conclusion, the proper tool (technique) as average comparative statement should be used.
8. The analysed trend of the data should be interpreted keeping in mind the economic fact of the business.
9. The interpreted data and conclusion drawn should be presented to the management in a brief and clear report.

### Self Assessment

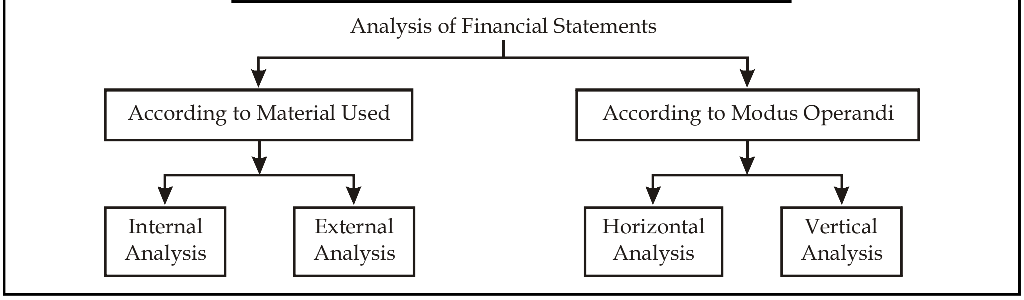
Fill in the blanks

1. …………………… is relating to the drawing of conclusion, inference and criticism of the analysed financial data.
2. To reduce the complexity of the financial statements, the figures of the financial statements should be approximated to the …………………….

## 9.3 Types of Financial Statement Analysis

There are different parties who have their interest in the financial statements. Their purposes of analysis of the financial statements are also different. On the basis of their usage and purposes the financial analysis is classified as below:

**Figure 9.1: Classification of Financial Analysis**




### According to Material Used

On the basis of materials used by the analyst, the analysis is classified into following two:

1. ***Internal Analysis:*** Internal analysis of financial statements is done by such person who can access the books of accounts and other related information of the business. Generally, such persons are the employees, management executives, sometimes government, regulatory bodies, or court. Generally internal analysis of financial statement is done for the purpose of management.
2. ***External Analysis:*** External analysis of financial statement is done by such parties who cannot approach the books of accounts as investors, creditors and general public. This analysis is based on the published financial statements. They cannot access to the enterprise for data.

### According to Modus Operandi

On the basis of this, the financial analysis is classified into following two:

1. ***Horizontal Analysis:*** It is also known as dynamic analysis or trend analysis. When the financial data of a company for several years are analysed and compared, such type of

analysis is called horizontal analysis. For this type of analysis the data of the different years are kept in the different columns horizontally. The percentage increases of one year's figures are taken as base year's figures. The base year may be the beginning year, preceding year or different year (chain base). Thus horizontal analysis may be done for periodical long-term, trend analysis and comparative study.

2. ***Vertical Analysis:*** It is also known as structural analysis or static analysis. Under this type of analysis a single set of financial statement prepared on a particular date is analysed. In this analysis only the quantitative relationship is created or one item of the financial statement is compared with other items of that statement as percentage of assets to total assets and percentage of profit to sales, etc. The example of this analysis is the common size statement and financial ratio.

In the modern financial analysis both the above analysis are like backbone.

## 9.4 Techniques of Analysis and Interpretation

To simplify the financial statements for the purpose of analysis and interpretation the following techniques/tools are used:

### Comparative Financial Statement Analysis

These statements are very important for the analysis and interpretation. Inter-firm financial statements can be prepared for the comparison of the results and financial position of two firms. Similarly, the inter-period financial statements can be prepared. Inter-period comparison is done very easily by inter-period financial statements. For the preparation of inter-period comparison the accounting data of the different periods are shown in the different columns along with the absolute and relative changes. Relative changes are calculated in the percentage based on the previous year. Among the comparative financial statements the following statements are included:

1. ***Comparative Balance Sheet:*** As per Prof. Fulke, "Comparative Balance Sheet is the study of the trend of the same business enterprise on the different dates". In the comparative balance sheet the changes in the amount of various items of the balance sheets of the same business as liabilities, assets and owner's equity in the two periods are presented in such a way so that the users of the financial statements may observe the changes easily. In the single balance sheet only the closing balances of different accounts are shown while in the comparative balance sheet the closing balances of the different items are showed along with their absolute changes and relative changes. Comparative balance sheet is very useful to study the trends in the changes of items. The comparative balance sheet is more concerned with the changes in assets, liabilities and owner's equity and their trends while in the single balance sheet is concerned with the book values of the items and the financial position of the business. However, the comparative balance sheet does not show the relationship of one item with the other items.

   To prepare the comparative balance sheet, the four columns are drawn. In the first two columns of amount the absolute data of the two balance sheets are showed and in the third column increase or decrease in the assets and liabilities as well as owner's equity are showed and in the fourth and last column the percentage of increase or decrease is showed. After preparing the comparative balance sheet the analyst gives his interpretation regarding the financial position (short-term and long-term) and profitability of the business. Comparative balance sheet may be understood easily in the following illustration.

Notes

*Illustration 1:* The Balance Sheets of Kavita Ltd. for the year ending 31st Dec. 2006 and 2007 are as follows:

| Liabilities | 31st Dec. 2006 (₹) | 31st Dec. 2007 (₹) | Assets | 31st Dec. 2006 (₹) | 31st Dec. 2007 (₹) |
|---|---|---|---|---|---|
| Equity Share Capital | 8,000 | 10,000 | Land & Building | 4,000 | 6,000 |
| Capital Reserve | 300 | 1,800 | Plant & Machinery | 2,000 | 3,000 |
| 10% Debentures | 1,200 | 1,600 | Investment | 1,200 | 1,600 |
| Creditors | 500 | 600 | Debtors | 800 | 1,000 |
| | | | Stock | 1,600 | 1,800 |
| | | | Cash | 400 | 600 |
| Total | 10,000 | 14,000 | Total | 10,000 | 14,000 |

Draw a comparative Balance Sheet showing increase and decrease both in absolute figures and in percentage and then interpret the changes.

***Solution:***

**Comparative Balance Sheet of Kavita Ltd.**

| | 31st Dec. 2006 (₹ (000)) | 31st Dec. 2007 (₹ (000)) | Increase or Decrease (₹ (000)) | Increase or Decrease in % |
|---|---|---|---|---|
| **Assets: Fixed Assets:** Land and Building | 4,000 | 6,000 | +2,000 | $\frac{2000}{4000} \times 100 = 50$ |
| Plant & Machinery | 2,000 | 3,000 | +1,000 | $\frac{1000}{2000} \times 100 = 50$ |
| Total Fixed Assets | 6,000 | 9,000 | 3,000 | $\frac{3000}{6000} \times 100 = 50$ |
| **Investment** | 1,200 | 1,600 | 400 | $\frac{200}{600} \times 100 = 33.33$ |
| **Current Assets :** | | | | |
| Debtors | 800 | 1,000 | 200 | $\frac{200}{800} \times 100 = 25$ |
| Stock | 1,600 | 1,800 | 200 | $\frac{200}{1600} \times 100 = 12.5$ |
| Cash | 400 | 600 | 200 | $\frac{200}{400} \times 100 = 50$ |
| Total of Current Assets | 2,800 | 3,400 | 600 | $\left(\frac{200}{2800} \times 100\right) = 21.43$ |
| **Total Assets** | 10,000 | 14,000 | 4,000 | $\frac{4000}{10000} \times 100 = 40$ |
| **Liabilities** Equity Share Capital | 8,000 | 10,000 | 2,000 | $\frac{2000}{8000} \times 100 = 25$ |
| Reserve and Surplus | 300 | 1,800 | 1,500 | $\frac{1500}{300} \times 100 = 500$ |
| 10% Debentures (Secured Loan) | 1,200 | 1,600 | 400 | $\frac{400}{1200} \times 100 = 33.33$ |

*Contd...*

Notes

| | | | | |
|---|---|---|---|---|
| **Total of Fixed Liabilities** | 9,500 | 13,400 | 3,900 | $\left(\frac{3900}{9500} \times 100\right) = 41.05$ |
| Creditors | 500 | 600 | 100 | $\frac{100}{500} \times 100 = 20$ |
| **Total Liabilities** | 10,000 | 14,000 | 4,000 | $\frac{4000}{10000} \times 100 = 40$ |

**Interpretation**

- During the current year the company has increased its fixed assets by 50% by issuing shares and debenture i.e. 58.33%.
- There is an increase of 33.33% in investment, 21.43% in current assets, and 20% in current liabilities and 500% in reserve and surplus.
- The financial position of the company is well.

2. ***Comparative Profit & Loss Account or Comparative Income Statement:*** The profit & loss account gives the summary of the results of the business activities, but it does not convey the changes in the earning of the business. The comparative income statement serves this purpose. It shows the operating results for a number of accounting periods along with he absolute and relative changes.

   To prepare the comparative income statement, the same columns are drawn as in the case of comparative balance sheet. First two columns are kept for the original figures and next two for the changes and percentage changes.

3. ***Comparative Statement of Cost of Production:*** Comparative statement of cost of production is prepared to analyse and interpret the cost and its components. It is the part of comparative income statement. This statement is prepared to show the absolute change in the different elements of cost and the relationship of the different elements of cost with total cost of production. On the basis of this statement, the cost of production is controlled.

   The first two columns of this statement are kept for the actual figures of cost of two periods and the next two columns shows the percentage of each element of cost with total cost of production. Last two columns show the increase and decrease with their percentages. This is explained in the following examples:

***Illustration 2:*** Following is the statement of cost of goods manufactured by Raj Co. Ltd. present the data in suitable form for analysis:

| | **2007 (₹)** | **2006 (₹)** |
|---|---|---|
| Raw materials: | | |
| Opening Stock | 46,000.00 | 42,000.00 |
| Purchases | 4,74,000.00 | 4,30,000.00 |
| | 5,20,000.00 | 4,72,000.00 |
| Less: Closing Stock | 52,000.00 | 46,000.00 |
| Add: Material Consumed | 4,68,000.00 | 4,26,000.00 |
| Direct Labour | 6,32,000.00 | 5,06,000.00 |
| Manufacturing Expenses | 2,84,000.00 | 2,42,000.00 |
| | 13,84,000.00 | 11,74,000.00 |

*Contd...*

Notes

| | | |
|---|---|---|
| Valuation of Goods in Process of Stock: | | |
| Opening of year | 28,000.00 | 26,000.00 |
| Closing of year | 32,000.00 | 28,000.00 |
| Increase | 4,000.00 | 2,000.00 |
| Cost of Goods Manufactured | 13,80,000.00 | 11,72,000.00 |

***Solution:***

**Raj Company Limited**
**Comparative Statement of Cost of Goods Manufactured**

| Particulars | Amount | | % of cost of Goods Manf. | | Increase (+) Decrease (-) | |
|---|---|---|---|---|---|---|
| | 2007 ₹ in 000 | 2006 ₹ in 000 | 2007 | 2006 | Absolute ₹ in 000 | Relative in % |
| Raw Materials Used | 468 | 426 | 33.91 | 36.35 | +42 | +9.86 |
| Direct Labour | 632 | 506 | 45.80 | 43.17 | +126 | +24.90 |
| Manufacturing Expenses | 284 | 242 | 20.58 | 20.65 | +42 | +17.36 |
| Total | 1,384 | 1,174 | 100.29 | 100.17 | +210 | +17.89 |
| Less Increase in Work-in-Progress | 4 | 2 | 0.29 | 0.17 | +2 | |
| Cost of Goods Manufactured | 1,380 | 1,172 | 100.00 | 100.00 | +208 | +17.75 |

*Task* Calculate the cost of materials consumed from the following:

| | (₹) |
|---|---|
| Opening stock | 11,500 |
| Purchases | 1,05,000 |
| Wages | 3,500 |
| Sales | 1,40,000 |

***Hint:*** ₹ 20,000

4. ***Comparative Statement of Working Capital:*** When two periods' statement of working capital are compared, comparative statement of working capital is prepared. This statement depicts the absolute changes in the each element of working capital and the changes in total working capital also. The example of the comparative statement of working capital is given below:

***Illustration 3:*** From the following balance sheets, prepare a schedule of changes in working capital.

Notes

| Particulars | 31st March | |
|---|---|---|
| | 2006 (₹) | 2007 (₹) |
| **Assets** | | |
| Cash in Hand | 10,000 | 14,000 |
| Cash at Bank | 14,000 | 18,000 |
| Book Debts | 24,000 | 22,000 |
| Inventory | 8,000 | 6,000 |
| Bills Receivable | 4,000 | 3,000 |
| Prepaid Expenses | 400 | 600 |
| Short-term Investment | 10,000 | 16,000 |
| Accrued Interest | 2,000 | 1,200 |
| Building | 40,000 | 44,000 |
| Plant and Machinery | 18,000 | 12,000 |
| | 1,30,400 | 1,36,800 |
| **Liabilities** | | |
| Accounts Payable | 16,000 | 12,000 |
| Notes Payable | 6,000 | 4,000 |
| Bank Overdraft | 8,000 | 6,000 |
| Outstanding Expenses | 600 | 400 |
| Provision for Bad Debts | 1,000 | 1,400 |
| Share Capital | 40,000 | 40,000 |
| Debentures | 40,000 | 60,000 |
| Mortgage Loan | 18,800 | 13,000 |
| | 1,30,400 | 1,36,800 |

*Solution:*

**Schedule Of Changes In Working Capital**

| Particulars | 31st March 2006 (₹) | 31st March 2007 (₹) | Charges in Working Capital | |
|---|---|---|---|---|
| | | | Increase (Debit) (₹) | Decrease (Credit) (₹) |
| **Current Assets** | | | | |
| Cash in Hand | 10,000 | 14,000 | 4,000 | - |
| Book Debts | 24,000 | 22,000 | - | 2,000 |
| Cash at Bank | 14,000 | 18,000 | 4,000 | - |
| Inventory | 8,000 | 6,000 | - | 2,000 |
| B/R | 4,000 | 3,000 | - | 1,000 |
| Prepaid Expenses | 400 | 600 | 200 | - |
| Short-term Investments | 10,000 | 16,000 | 6,000 | - |
| Accured Interest | 2,000 | 1,200 | - | 800 |
| **Total Current Assets** | 72,400 | 80,800 | | |

*Contd...*

Notes

| | | | | |
|---|---|---|---|---|
| **Current Liabilities** | | | | |
| Account Payable | 16,000 | 12,000 | 4,000 | - |
| Notes Payable | 6,000 | 4,000 | 2,000 | - |
| Bank Overdraft | 8,000 | 6,000 | 2,000 | - |
| Outstanding Expenses | 600 | 400 | 200 | - |
| Provision for Bed Debts | 1,000 | 1,400 | - | 400 |
| **Total of Current Liabilities** | 31,600 | 23,800 | | |
| Working Capital | | | | |
| (Current Assets – Current Liabilities) | 40,800 | 57,000 | - | 16,200 |
| Net Increase in Working Capital | 16,200 | - | - | - |
| | 57,000 | 57,000 | 22,400 | 22,400 |

## Common Size Statements Analysis

The comparative financial statements are only concerned with the changes but they do not show the relationship of the different items of balance sheet with total assets or total liabilities. In the common size statements the relation of individual items of the balance sheet to the total assets is shown in the form of percentage. In the case of common size balance sheet, in assets side the total of assets is treated as a common base. On the basis of it the percentage of other assets are calculated. The total of all percentage of individual assets becomes hundred which represent the total of assets. In the liability side of the balance sheet the total of liabilities is taken a common base (100). Then the percentages for other liabilities are computed on the basis of this common base. The total of all percentages of individual liabilities becomes 100. In the case of common size profit & loss account total sales are assumed to be equal to 100, then percentages of all other items of P&L A/c are calculated on the common base of sales. This type of analysis is called vertical analysis.

*Notes* The common size statements are two: (a) common size balance sheet, and (b) common size profit & loss account.

The illustrations of these two statements are given below:

***Illustration 4:*** The accompanying balance sheet and profit & loss account relate to Rajeev Ltd., convert them into common-size statements.

**Balance Sheet as at 31st March, 2008**

*(₹ in lakh)*

| | Previous Year 2007 | Current Year 2008 |
|---|---|---|
| **Liabilities:** | | |
| Equity Share Capital (of ₹ 10 each) | 480 | 480 |
| General Reserves | 192 | 364 |
| Long-term Loans | 364 | 339 |
| Creditors | 134 | 104 |
| Outstanding Expenses | 12 | - |
| Other Current Liabilities | 18 | 13 |
| | 1,200 | 1,300 |

*Contd...*

Notes

| | | |
|---|---|---|
| **Assets:** | | |
| Plant | 804 | 780 |
| Cash | 108 | 156 |
| Debtors | 120 | 130 |
| Inventories | 168 | 234 |
| | 1,200 | 1,300 |

**Income Statement**
**for the year ended March 31, 2008**

*(₹ in lakh)*

| | Previous Year 2007 | Current Year 2008 |
|---|---|---|
| Gross Sales | 740 | 960 |
| Less: Returns | 40 | 60 |
| Net Sales | 700 | 900 |
| Less: Cost of Goods Sold | 380 | 430 |
| Gross Profit | 320 | 470 |
| Less: Selling General and Administrative Cost | 100 | 144 |
| Operating Profit | 220 | 326 |
| Less : Interest Expenses | 40 | 34 |
| Earning Before Taxes | 180 | 292 |
| Less : Taxes | 63 | 103 |
| Earning After Taxes | 117 | 189 |

***Solution:***

**Income Statement (Common Size)**
**(For the year ended March 31, 2008)**

*(Percentage)*

| Particulars | Previous Year 2007 | Current Year 2008 |
|---|---|---|
| Net Sale | 100.0 | 100.0 |
| Cost of Goods Sold | 54.3 | 47.8 |
| Gross Profit | 45.7 | 52.2 |
| Selling, General and Administrative Expenses | 14.3 | 16.0 |
| Operating Profit | 31.4 | 36.2 |
| Interest | 5.7 | 3.8 |
| Earning Before Taxes | 25.7 | 32.4 |
| Taxes | 9.0 | 11.4 |
| Earning After Taxes (EAT) | 16.7 | 21.0 |

**Balance Sheet (Common size as at March 31, 2008)**

*(Percentage)*

| Particulars | Previous year | Current year |
|---|---|---|
| Owner's Equity | | |
| Equity Share Capital | 40.0 | 36.9 |
| General Reserves | 16.0 | 28.0 |
| | 56.0 | 64.9 |

*Contd...*

Notes

| | | |
|---|---|---|
| **Long-term Borrowings:** | | |
| Loan | 30.3 | 26.1 |
| Current Liabilities: Creditors | 11.2 | 8.0 |
| Outstanding Expenses | 1.0 | - |
| Other Liabilities | 1.5 | 1.0 |
| | 13.7 | 9.0 |
| **Total Liabilities** | 100.0 | 100.0 |
| **Fixed Assets:** | | |
| Plant Assets Net of Accumulated Depreciation | 67.0 | 60.0 |
| **Current Assets:** | | |
| Cash | 9.0 | 12.0 |
| Debtors | 10.0 | 10.0 |
| Inventories | 14.0 | 18.0 |
| | 33.0 | 40.0 |
| **Total Assets** | 100.0 | 100.0 |

*Task* Calculate the cost of materials consumed from the following:

| | |
|---|---|
| Opening Stock | (₹) |
| Raw materials | 4,500 |
| Work in Progress | 12,000 |
| Finished Goods | 14,800 |
| Sales | 50,000 |
| Purchases during the year | 24,500 |
| Carriage inwards | 500 |
| Closing stock—raw materials | 1,500 |
| Work in Progress | 4,800 |
| Finished Goods | 2,700 |

***Hint:*** ₹ 28000

## Trend Analysis

Trend analysis is an important technique for the analysis and interpretation of financial statements. Generally, the trend means tendency. To know the tendency of the data of the financial statement, the data of four to five years are required. Data may be taken from the balance sheet and profit & loss account. It depends on the objective of analysis. To compute the tendency one year's figures are taken as base year. On the basis of this base year the other year's relative figures are computed. On the basis of these relative figures the tendency of a particular item is determined. The trend analysis of the business activities and financial position may be done in the following ways:

- Trend Percentage/Ratio
- Graphic or Diagrammatic Presentation

1. ***Trend Percentage/Ratio:*** To calculate the trend percentage the following procedure is adopted:

   (i) First of all the original figures of the financial statement are set in a statement.

   (ii) One year's figures (the earliest year) are assumed as base year's figure i.e. 100.

   (iii) In order to compute the trend percentage the each and every item of the other years are divided by the corresponding item of the base year and multiplied by 100.

***Illustration 5:*** From the following items of the asset side of the balance sheet of Alka Ltd. for the period 31.3.2004 to 31.3.2007, calculate trend percentage taking 2004 as the base year:

| | ₹ in '000' | | | |
|---|---|---|---|---|
| | **2004 (₹)** | **2005 (₹)** | **2006 (₹)** | **2007 (₹)** |
| Cash | 80 | 120 | 160 | 140 |
| Debtors | 40 | 80 | 60 | 30 |
| Stock | 100 | 150 | 120 | 140 |
| Other Current Assets | 40 | 20 | 50 | 60 |
| Land and Building | 800 | 1,000 | 1,200 | 1,200 |
| Furniture | 160 | 200 | 120 | 200 |
| Plant | 200 | 250 | 260 | 300 |
| Total Assets | 1,420 | 1,820 | 1,970 | 2,070 |

***Solution:***

**Comparative Balance Sheet**
**From 31st March 2004 to 31st March 2007**
**(Showing Trend Percentage)**

*(₹ in '000')*

| **Assets** | **31st March** | | | | **Trend Percentage Base 2004 $\left(\frac{\text{Current}}{\text{Base}} \times 100\right)$** | | | |
|---|---|---|---|---|---|---|---|---|
| | **2004** | **2005** | **2006** | **2007** | **2004** | **2005** | **2006** | **2007** |
| **Current Assets:** | | | | | | | | |
| Cash | 80 | 120 | 160 | 140 | 100 | 150 | 200 | 175 |
| Debtors | 40 | 80 | 60 | 30 | 100 | 200 | 150 | 75 |
| Stock | 100 | 150 | 120 | 140 | 100 | 150 | 120 | 140 |
| Other Current Assets | 40 | 20 | 50 | 60 | 100 | 50 | 125 | 150 |
| ***Total Current Assets*** | 260 | 370 | 390 | 370 | 100 | 142 | 150 | 142 |
| **Fixed Assets:** | | | | | | | | |
| Land and Building | 800 | 1,000 | 1,200 | 1,200 | 100 | 125 | 150 | 150 |
| Furniture | 160 | 200 | 120 | 200 | 100 | 125 | 75 | 125 |
| Plant | 200 | 250 | 260 | 300 | 100 | 125 | 130 | 150 |
| ***Total Fixed Assets*** | 1,160 | 1,450 | 1,500 | 1,700 | 100 | 125 | 136 | 146 |
| **Total** | 1,420 | 1,820 | 1,970 | 2,070 | 100 | 128 | 138 | 145 |

2. ***Graphic or Diagrammatic Presentation:*** The trend percentage/ratio discussed in the previous method may be represented by graphs and diagrams. Two or three variables can be represented on graphs very easily. If different variables of the financial statements are represented by graphs and diagrams, that quickly draws the human attraction. Nowadays there is a trend to show the important variable on the graphs. These diagrams are also

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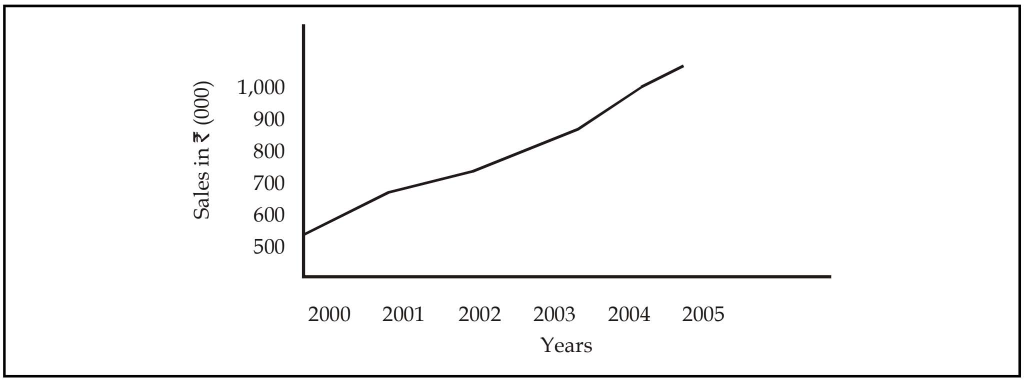
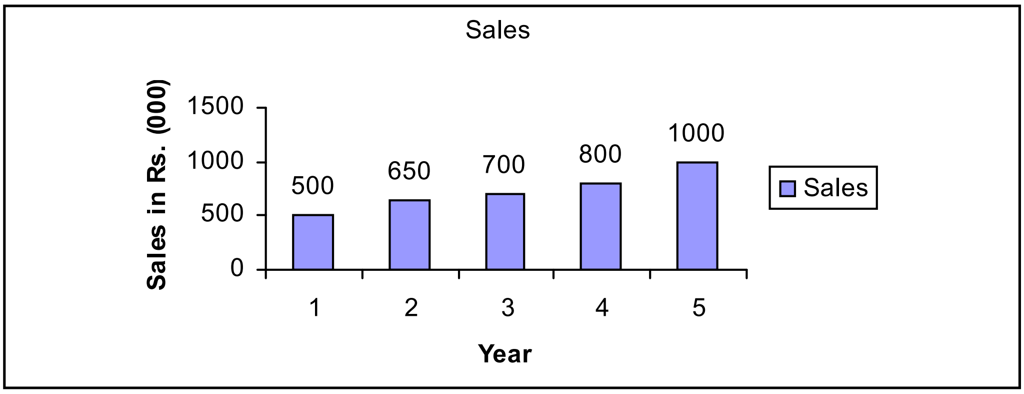
being published with the financial statements. For example, the sale of XY Co. Ltd for the last five years is as follows:

| Years | 2000 | 2001 | 2002 | 2003 | 2004 |
|---|---|---|---|---|---|
| Sales (000) ₹ | 500 | 650 | 700 | 800 | 1,000 |

These figures may be represented graphically as follows:




The sale of the company is represented on the diagram as follows:




### Fund Flow Analysis

Fund flow analysis has become very popular technique to analyze the financial statements. Fund flow statement does not reveal the financial position of the business like the financial statement but it reveals the changes in the working capital in two periods. Working capital is the life blood of the business. This statement also gives the information regarding the sources and application of fund (working capital). Sources of fund are profit from operation, issue of capital loans, sale of fixed assets, etc., while the application of fund are the purchase of fixed assets, redemption of capital, payment of dividend purchase of investment, etc.

### Cash Flow Analysis

Cash flow analysis is also similar to fund flow analysis. Now it is being prepared by the companies along with the balance sheet and profit & loss account. It is prepared as per Accounting Standard-3 of the Institute of Chartered Accountant of India. The fund flow statement reveals the changes in the fund/working capital while the cash flow statement reveals the changes in the cash during two periods. It also gives the information regarding the sources of cash and uses of cash during a period.

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**Ratio Analysis**

This technique is based on the ratios. The ratios are the relationship among the different accounting figures. Ratio analysis helps the management and different users of financial statements in determining the profitability of business and the financial position of the business. Profitability, solvency, liquidity and efficiency of the business can be easily determined by this analysis.

**Break-even Analysis**

This is an important technique of the management to take some decision. Under this analysis the costs of production are divided into fixed and variable cost. From sales the fixed cost is subtracted to find the contribution. On the basis of contribution, the break-even point (BEP) is determined. It is that point of sales or production at which the company gains no profit, and suffers no loss. Several managerial decisions as make or buy, shut down point, price determination, etc. are taken with the help of break-even analysis.

## Self Assessment

Fill in the blanks:

3. The …………………… are the relationship among the different accounting figures.
4. Cash flow analysis is also similar to …………………….
5. …………………… does not reveal the financial position of the business like the financial statement but it reveals the changes in the working capital in two periods.

## 9.5 Summary

- Analysis of financial statements is the process of critically examining the data of financial accounts. The main work of this process is to find the strengths and weakness of the business.
- Interpretation is relating to the drawing of conclusion, inference and criticism of the analysed financial data.
- Analysis and interpretation of the financial statements are closely associated. Without interpretation the analysis is useless and without analysis, interpretation is impossible.
- Analysis of financial statements is of two types—analysis according to materials used and analysis according to modus operandi.
- Analysis according to materials used is of two types i.e. internal analysis and external analysis.
- Similarly, the analysis according to modus operandi is also divided into two - horizontal analysis and vertical analysis.
- For the interpretation and analysis of the financial statement the following techniques are used:
  - Comparative Financial Statement Analysis
  - Common Size Statement Analysis
  - Trend Analysis
  - Fund Flow Analysis

Notes

- Cash Flow Analysis
- Ratio Analysis
- Break-Even Analysis

## 9.6 Keywords

***Analysis of Financial Statement:*** Classifying, rearranging and regrouping of financial statements to find the weakness and strength of the business is analysis of financial statements.

***Financial Statements:*** Profit & Loss Account, Profit & Loss Appropriation Account and Balance Sheet are included in the term financial statements.

***Fund:*** Fund means the working capital.

***Ratio:*** It is the relationship of two or more financial items.

## 9.7 Review Questions

1. What do you mean by financial analysis? Explain its procedure.
2. Distinguish clearly between the internal and external financial analysis.
3. Differentiate between horizontal and vertical analysis and explain which one is better.
4. What do you understand by the analysis and interpretation of financial statements? Explain in brief its various techniques.

### Answers: Self Assessment

1. Interpretation
2. Thousand or hundred
3. Ratios
4. Fund flow analysis
5. Fund flow statement

## 9.8 Further Readings

*Books*

Khan and Jain, "Management Accounting".

M.P. Pandikumar, "Accounting & Finance for Managers", Excel Books, New Delhi.

R.L. Gupta and Radhaswamy, "Advanced Accountancy".

S.N. Maheswari, "Management Accounting".

V.K. Goyal, "Financial Accounting", Excel Books, New Delhi.

*Online link*

www.futureaccountant.com

# Unit 10: Accounting and Depreciation for Fixed Assets

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Notes

## Objectives

After studying this unit, you will be able to:

- Understand the meaning and definition of fixed assets
- Define the method of accounting of historical cost
- Have the valuation of fixed assets
- Describe method of accounting for revalued assets
- Evaluate tangible fixed assets in special cases
- Describe fixed assets of special type (intangible assets) and disclosure of fixed assets
- Define the meaning, definition and significance of depreciation on fixed assets
- Know the methods of depreciation on fixed assets
- Differentiate 'Provision' and 'Reserves'
- Discuss the different type of 'Provisions' and 'Reserves' and the accounting thereof.

## Introduction

Fixed assets comprise a significant portion of the total assets of the business. Therefore, their presentation in the financial statements is important. The fixed assets also play an important role in the determination of profit and depicting the financial position of the business.

*Did u know?* **Why is it being considered as a cumbersome task in matching?**

The benefits/revenues of the fixed assets are expected to accrue for many numbers of years but not within a year. The initial investment on the assets at the time of purchase should be matched against the revenue pattern of the same year after year in order to find out the profitability of the long term investment.

## 10.1 Meaning and Definition of Fixed Assets

In many enterprises the fixed assets are grouped into various categories such as land, buildings, plant and machinery, vehicles, furniture and fittings, goodwill, patents, trademarks and designs.

*Did u know?* **What are the items which are not covered under fixed assets?**

Under the fixed assets the following items are not considered on which special considerations apply:

1. Forests, plantations and similar regenerative natural resources,
2. Wasting assets including mineral rights, expenditure on the exploration for and extraction of minerals, oil, natural gas and similar non-generative resources,
3. Expenditure on real estate development, and
4. Livestock.

As per Accounting Standard - 10 (AS - 10) "Fixed asset is an asset held with the intention of being used for the purpose of producing or providing goods or services and is not held for sale in the

Notes

normal course of business". Thus fixed assets are those assets which are acquired and retained in the business for long period for the purpose of carrying on the business. These are not for resale. As per AS-10, land, building, plant, machinery, vehicle which are not for resale and kept in the business for the production of goods and services, comprise fixed assets.

### 10.1.1 Method of Accounting Historical Cost of Tangible Assets

1. The cost of fixed assets comprises of its purchase price including import duties and non-refundable taxes and any directly attributable cost of bringing the assets to its working condition for its intended use. The direct attributable costs are:

   (a) Site preparation,

   (b) Initial delivery and handling cost,

   (c) Installation cost, such as special foundation for plant, and

   (d) Professional fees as the fees of architects and engineers.

   The financing cost relating to deferred credits or to borrowed funds attributable to the construction or acquisition of fixed assets.

2. Administration and other general overhead expenses are usually excluded from the cost of fixed assets because they do not relate to a specific fixed cost.

   The expenditure incurred on start-up and commissioning of the project, including the expenditure incurred on test runs and experimental production, is usually capitalized as an indirect element of the construction cost.

3. If the interval between the date of project is ready to commence commercial production and the date at which commercial production actually begins is prolonged, all expenses incurred during this period are charged to the P&L A/c. However, the expenditure incurred during this period is also sometimes treated as deferred revenue expenditure.

4. To calculate the gross book value of the self-constructed fixed assets, all those costs that relate directly to specific assets and those that are attributable to the construction activity in general can be allotted to the specific assets, are considered.

5. When a fixed asset is acquired in exchange for another asset, its cost is usually determined by reference to the fair market value of the consideration given. It may be appropriate to consider the fair market value of the asset acquired if this is more clearly evident. An alternative accounting treatment that is sometimes used for an exchange of assets, particularly when the assets exchanged are similar, is to record the asset acquired at the net book value of the asset given up in each case and adjustment is made for any balancing receipt or payment of cash or other consideration.

6. Subsequent expenditure relating to fixed asset for the improvement should be added to the gross book value. Only that expenditure which increases the future benefits from the existing asset beyond its previously assessed standard performance is included in the gross book value.

7. The cost of an addition to an existing asset which is of a capital nature and which becomes an integral part of the existing asset is usually added to its gross book value.

8. An item of fixed asset is eliminated from the financial statements, on disposal.

9. Items of fixed assets that have been retired from active use and are held for disposal are stated at less than their net book value and net realizable value and are shown separately in the financial statements.

Notes

10. In historical cost financial statements, gains or losses arising on disposal are generally recognized in the profit and loss statement.
11. On disposal of a previously revalued item of fixed asset, the difference between net disposal proceeds and the net book value is normally charged or credited to the profit and loss statement except that, to the extent such a loss is related to an increase which was previously recorded as a credit to revaluation reserve and which has not been subsequently reversed or utilized, it is charged directly to the account. The amount standing in revaluation reserve following the retirement or disposal of an asset which relates to that asset may be transferred to general reserve.

*Notes* **Reasons for Depreciation**

1. ***Wear and Tear of the Asset:*** The long term assets are becoming less efficient and poor quality in operations due to the continuous usage of the asset.
2. ***Exhaustion:*** Nothing will be left due to the continuous extraction of resources. The resources in the oil wells, mine fields will be completely exhausted due to incessant extraction. This has to be replaced by a new method of exploration. Investment in new exploration methods requires depreciation as a charge against the revenues of the wells/fields.

   For example, Oil & Natural Gas Corporation Ltd. (ONGC) indulges in the process of new oil exploration projects through research projects. The new projects should then be identified and invested by huge initial investment outlay through the current revenues out of the existing projects on account of replacement due to depletion of resources.
3. ***To face technological obsolescence:*** To replace the old machinery with new machinery, before the expiry of the economic life period of the asset in order to maintain the efficiency and economy of the asset. The typewriter was replaced by the electronic typewriter during the yester periods of office automation. To replace the old typewriter which is neither efficient nor economical, it should be replaced by the new electronic typewriter through the depreciation charge on the old one.
4. ***Accident:*** The value of the asset mainly depends upon the efficiency and economy; which gets affected due to accident.

### 10.1.2 Basis for the Valuation of Fixed Assets

As per AS-10, there are two bases to compute the gross book value of fixed assets. These are – historical cost and revaluation. Gross book value of a fixed asset is its historical cost or the other amount substituted for historical cost in the books of account of financial statements. When this amount is shown as net of accumulated depreciation, it is termed as net book value.

***Illustration 1:*** Aditya Co. Ltd. acquired machinery from Hindustan Machine Tools Ltd. on 30.9.2007 at a quoted price of ₹ 400 lakhs on which a cash discount of 5% was offered on immediate payment. Value Added Tax (VAT) on the quoted price is 8%. The company incurred the following addition expenses:

| | (₹) |
|---|---|
| Transit insurance | 4,00,000 |
| Transportation charges | 10,00,000 |

Notes

| | |
|---|---|
| Foundation charges | 3,00,000 |
| Installation charges | 5,00,000 |

The company borrowed a sum of ₹ 360 lakh from HDFC Bank at 16% interest per annum. The machinery was ready for use on 31st March, 2008. Ascertain the cost of machinery.

***Solution:***

**Calculation of Cost of Acquisition of Machinery**

*(₹ in Laks)*

| | | |
|---|---|---|
| Quoted Price of Machinery | 400 | |
| Less: 5% Cash Discount of quoted price | 20 | |
| Price after discount | 380 | |
| Add: VAT @8% on quoted price | 32 | 412 |
| Add: Transit insurance | 4 | |
| Transportation charges | 10 | |
| Foundation charges | 3 | |
| Installation charges | 5 | 22 |
| Interest on loan | | |
| @ 16% on ₹ 360 for 6 months (from 1.10.07 to 31.3.2008) | | 28.8 |
| Cost of Acquisition of Machinery | | 462.8 |

*Task* Mr. Ramesh purchased a second hand machine for ₹ 24,000 on 1st April, 2006. He spend ₹ 10,000 on its overhaul and installation. Depreciation is written off 10% p.a. on the original cost. On 30th June, 2008 machine was found to be unsuitable and sold for ₹ 19,000. Prepare the machine account from 2006 to 2008 assuming that accounts are closed on 31st December, every year.

## 10.1.3 Method of Accounting Revalued Tangible Assets

Accounting for the revaluation of fixed assets is very commonly accepted and preferred. In this valuation fixed assets is done by a competent valuer. For the adoption of this method the following guiding principles should be kept in minds which are given in AS-10:

1. When a fixed asset is revalued in financial statements, an entire class of assets should be revalued, or the selection of assets for revaluation should be made on a systematic basis.

2. The revaluation in financial statements of a class of assets should not result in the net book value of that class being greater than the recoverable amount of assets of that class.

3. When a fixed asset is revalued upwards, any accumulated depreciation existing at the date of the revaluation should not be credited to the profit and loss statement.

4. An increase in net book value arising on revaluation of fixed assets should be credited directly to owners' interests under the head of revaluation reserve, except that, to the extent that such increase is related to and not greater than a decrease arising on revaluation previously recorded as a charge to the profit and loss statement, it may be credited to the

Notes

profit and loss statement. A decrease in net book value arising on revaluation of fixed asset should be charged directly to the profit and loss statement except that to the extent that such a decrease is related to an increase which was previously recorded as a credit to revaluation reserve and which has not been subsequently reversed or utilized, it may be charged directly to that account.

5. On disposal of a previously revalued item of fixed asset, the difference between net disposal proceeds and the net book value should be charged or credited to the profit and loss statement except that to the extent that such a loss is related to an increase which was previously recorded as a credit to revaluation reserve and which has not been subsequently reversed or utilized, it may be charged directly to that account.

***Illustration 2:*** Amar Club purchased a plant on 1st January, 2003, for₹ 150 lakhs. The machine was depreciated on straight line basis for the year 2003, 2004, 2005 and 2006, using a depreciation rate of 10% p.a. On 1st January, 2007 the machine was revalued at₹ 135 lakhs and the same was adopted. What will be the carrying cost of plant as on 31.12.2008. There will be no change in the economic life of the plant.

***Solution:***

**Calculation of Carrying Cost of Plant**

*(₹ in lakhs)*

| | |
|---|---|
| Purchase of Plant on 1st Jan. 2003 | 150 |
| *Less:* Depreciation @10% p.a. for 4 years $\frac{150 \times 10 \times 4}{100}$ | 60 |
| Balance on 1st January, 2007 | 90 |
| Add: Credit given due to revaluation (135-90) | 45 |
| Revaluation of plant | 135 |
| *Less:* Depreciation for 2007 | |
| (as the remaining life of the plant is only 6 years therefore, 1/6 of the revalued plant will be 1/6 of 135) | 22.5 |
| Balance on 1st Jan., 2008 | 112.5 |
| *Less:* Depreciation for 2008 | 22.5 |
| Balance of plant on 31st Dec. 2008 | 90.00 |

### 10.1.4 Valuation of Fixed Tangible Assets in Special Cases

In such cases the principles given in the AS-10 are adopted for the valuation of fixed assets. These are given below:

1. In the case of fixed assets acquired on hire purchase terms, although legal ownership does not vest in the enterprise, such assets are recorded at their cash value, which if not readily available, is calculated by assuming an appropriate rate of interest. They are shown in the balance sheet with an appropriate narration to indicate that the enterprise does not have full ownership thereof.

2. When an enterprise owns fixed assets jointly with others (otherwise a partner in a firm), the extent of its share in such assets, and the proportion in the original cost, accumulated depreciation and written down value are stated in the balance sheet. Alternately, the pro-rata cost of such jointly owned assets is grouped together with similar fully-owned assets. Details of such jointly owned assets are indicated separately in the fixed assets register.

3. Where several assets are purchased for a consolidated price, the consideration is apportioned to the various assets on a fair basis as determined by competent valuers.

### 10.1.5 Valuation of Intangible Assets

The following guiding principles of AS-10 are kept in mind for the valuation of fixed assets of special type (intangible assets):

**Goodwill**

1. Goodwill, in general, is recorded in the books only when some consideration in money or money's worth has been paid for it. Whenever a business is acquired for a price (payable either in cash or in shares or otherwise) which is in excess of the value of the net assets of the business taken over, the excess is termed as 'goodwill'. It arises from business connections, trade name or reputation of an enterprise or from other intangible benefits enjoyed by an enterprise.
2. As a matter of financial prudence, goodwill is written off over a period. However, many enterprises do not write off goodwill and retain it as an asset.

**Patent**

3. Patents are normally acquired in two ways:
   (i) By purchase, in which case patents are valued at the purchase cost including incidental expenses, stamp duty, etc. and
   (ii) By development within the enterprise, in which case identifiable costs incurred in developing the patents are capitalized. Patents are normally written off over their legal term of validity or over their working life, whichever is shorter.

**Know-how**

4. Know-how, in general, is recorded in the books only when some consideration in money or money's worth has been paid for it. Know-how is generally of two types:
   (i) Relating to manufacturing processes; and
   (ii) Relating to plans, designs and drawings of buildings or plant or machinery
5. Know-how related to plans, designs and drawings of buildings or plant and machinery is capitalized under the relevant asset heads. In such cases depreciation is calculated on the total cost of those assets, including the cost of the know-how capitalized. Know-how related to manufacturing processes is usually expensed in the year in which it is incurred.
6. Where the amount paid for know-how is a composite sum in respect of both the types mentioned in above (5) such consideration is apportioned amongst them on a reasonable basis.
7. Where the consideration for the supply of know-how is a series of recurring annual payments as royalties, technical assistance fees, contribution to research, etc., such payments are charged to the profit and loss statement each year.

### 10.1.6 Disclosure regarding Fixed Assets

The following information should be disclosed in the financial statements:

1. Gross and net book values of fixed assets at the beginning and end of an accounting period showing additions, disposals, acquisitions and other movements;
2. Expenditure incurred on account of fixed assets in the course of construction or acquisition; and

Notes

3. Revalued amounts substituted for historical costs of fixed assets, the method adopted to compute the revalued amounts, the nature of indices used, the year of any appraisal made, and whether an external valuer was involved, in case where fixed assets are stated at revalued amounts.

## 10.2 Meaning and Definition of Depreciation on Fixed Assets

Depreciation means the fall or decrease in the value of assets. Depreciation is a permanent fall in the value of depreciable assets on using in the operation of business. In the depreciable assets land, forest, goodwill, livestock, R&D are not included. Depreciation is not visible like other expenses of the business which are clear and considered at the time of calculation of profit/loss of the business. But it is not so in the case of depreciation on assets. Its amount is also not fixed. It is based on past experience. Some businessmen do not provide depreciation on assets and do not deduct from the gross profit to calculate the net profit.

One thing we have to keep in our mind that depreciation is calculated on the fixed assets. And it is charged against the profit to ascertain the net profit. Of course the current assets may lose their values. Loss on account of valuation of current assets is calculated on the basis of cost or market price whichever is less. Valuation of current asset is done for the purpose of balance sheet only.

Generally there is depreciation in all fixed assets due to some reasons. There are a few cases in which the values of the assets appreciate as land, antiques and old paintings, etc. As per Accounting Standard-6 the depreciable assets are those which:

1. Are expected to be used during more than one accounting period, and
2. Have a limited useful life, and
3. Are held by an enterprise for use in the production or supply of goods and services, for rental to others, or for administrative purposes and not for the purpose of sale in the ordinary course of business.

### 10.2.1 Definitions

In the AS-6 the depreciation is defined as, "Depreciation is a measure of wearing out, consumption or other loss of value of a depreciable asset, arising from use, affluxion of time or obsolescence through technology and market changes. Depreciation is allocated so as to change a fair proportion of the depreciable amount in each accounting period during the expected useful life of the asset. Depreciation includes amortisation of assets whose useful life is predetermined."

As per *International Accounting Standards Committees*, "Depreciation is the allocation of the depreciable amount of an asset over its estimated useful life. Depreciation for the accounting period is charged to income either directly or indirectly".

According to *J.H. Burton*, "Depreciation is the shrinkage in the value of an asset at a given date as compared with its value at a previous date".

From the above definition it is clear that depreciation is gradual fall in the value of the assets due to some reasons.

### 10.2.2 Significance of Depreciation

Depreciation is provided in the books from the following point of view:

1. ***To present the assets at its true value in balance sheet:*** Depreciation is computed on the fixed assets. It is shown against the fixed assets in the balance sheet. By doing so the

balance sheet depicts the true and fair view of the financial position of the business. If we do not make a provision for depreciation for fixed assets it would be incorrect and the balance sheet would not show the true value of assets.

2. ***To ascertain the correct profits or losses:*** The true profit can be ascertained only after deducting the all costs from the revenue of a period. As the assets are used in the business to earn revenues. The value of assets falls due to such use in the business. Therefore, such a fall in the value should be treated as a cost and should be charged against the profit. Payment for the purchase of assets should be treated a prepaid expenses and it should be spreaded over a period of time in order to ascertain the true profit.

3. ***To create a fund for the replacement of assets:*** If the depreciation on fixed assets is provided and charged against the profit every year, there will be reduction in the profit by the amount of depreciation. If the amount is transferred into a fund account, on the expiry of the life of the machine, there will be creation of depreciation fund to replace the fixed assets.

Thus we see that depreciation plays an important role in the determination of the true amount of profit, presentation of true and fair financial view of the business and the replacement of assets on the expiry of the life of the assets.

## 10.2.3 Methods of Recording of Depreciation

There are two methods to record the depreciation on fixed assets in the books of owner:

1. ***When provision for depreciation account is maintained:*** Under this method, the amount of depreciation each year is transferred to the provision for depreciation account and the assets are shown in the books at their original cost. And when assets are sold on the expiry of its useful life, sales proceeds of the assets and the amount of provision for depreciation is transferred to the assets account. Profit or loss arises from the sale of the assets is carried to profit and loss account. Under this method the following journal entries are passed in the books of owner:

   (i) When depreciation is charged on Assets:

   Depreciation Account Dr.

   To Provision for Depreciation Account

   (ii) When depreciation is transferred to P&L Account:

   P&L Account Dr.

   To Depreciation Account

   (iii) When assets are sold on the expiry of useful life of the Assets:

   Provision for Depreciation Account Dr.

   To Assets Account

   (iv) If there is any profit on the sale of Assets:

   Assets account Dr.

   To P&L Account

   (v) If there is any loss on the sale of Assets:

   P&L Account Dr.

   To Assets Account

Notes

2. ***When Provision for Depreciation Account is not Maintained:*** In this case the depreciation on the assets is not transferred to the provision for depreciation account, but that is transferred to assets account and the assets are shown at the written down value (cost of assets minus depreciation) in the balance sheet. Depreciation is treated as an expense and is transferred to the profit & loss account. Under this method the following journal entries are passed in the books of owner:

   (i) When depreciation is charged on Assets:

   Depreciation Account Dr.

   To Assets Account

   (ii) When depreciation is transferred to the P&L Account:

   P&L Account Dr.

   To Depreciation Account

   (iii) If the assets are sold at profit on the expiry of the useful life of Assets:

   Cash Account Dr.

   To Assets Account

   To P&L Account

   (iv) In the case of loss the following entry is passed:

   Cash Account Dr.

   P&L Account Dr.

   To Assets Account

### Self Assessment

Fill in the blanks:

1. Depreciation accounting is mainly based on the …………………….
2. Depreciation is the permanent decrease in the value of the …………………….
3. Depreciation is calculated on the basis of …………………….
4. …………………… can be created for replacement of fixed assets.
5. Amount of depreciation if charged on the basis of …………………… remains constant for every year.
6. The original value of the asset is the …………………… of the asset.
7. Reserve is created to strengthen the …………………… of the business.
8. The profits can be distributed without providing for depreciation with the prior permission of the …………………….

## 10.3 Methods for Providing Depreciation

There are various methods of allocating depreciation over the useful life of the assets. The method of providing the depreciation is selected on the basis of various factors as types of assets, nature of business, circumstances prevailing in business, etc.

These methods are given below:

1. Straight Line Method
2. Diminishing Balance Method or Written Down Value Method
3. Annuity Method
4. Depreciation Fund Method
5. Insurance Policy Method
6. Revaluation Method
7. Depletion Method
8. Machine Hour Rate Method

## 10.3.1 Straight Line Method

This method is also known as fixed installment method. In this method, depreciation is ascertained on the original cost by a fixed percentage keeping in mind the scrap value of the assets. Under this method the amount of depreciation remains uniform/fixed and the value of the asset becomes zero at the end of its life. It may also be calculated by the following formula:

$$\text{Depreciation} = \frac{\text{Original Cost – Scrape Value}}{\text{life of Assets in Year}}$$

### Merits

Following are the merits of this method:

1. This method is very simple and easy to use.
2. The value of the asset becomes zero at the end of the life of the assets as total value is divided by the life of the assets.
3. This method is suitable to such type of assets which take physical deterioration as buildings, leasehold properties, etc.

### Demerits

In spite of being so many merits mentioned above, this method has following demerits:

1. The amount of depreciation does not change while the amount of repairs and renewal increases with the passage of time.
2. Under this method the amount of depreciation is not invested outside the firm. Therefore, there is a loss of interest.
3. If any other asset is purchased during the year, depreciation is calculated separately.
4. This method is not recognized in income tax rules.

***Illustration 3:* Fixed Installment Method**

Mr. Ramesh purchased a second hand machine for ₹ 24,000 on 1st April, 2006. He spends ₹ 10,000 on its overhaul and installation. Depreciation is written off 10% p.a. on the original cost. On 30th June, 2008 machine was found to be unsuitable and sold for ₹ 19,000. Prepare the machine account from 2006 to 2008 assuming that accounts are closed on 31st December, every year.

Notes

*Solution:*

**In the books of Mr. Ramesh**
**Machine Account**

| Date | Particulars | (₹) | Date | Particulars | (₹) |
|---|---|---|---|---|---|
| 2006 | | | 2006 | | |
| April 1 | To Cash A/c (24,000 + 10,000) | 34,000 | Dec. 31 | By Depreciation (for 9 months) | 2,550 |
| | | | Dec. 31 | By Balance c/d | 31,450 |
| | | 34,000 | | | 34,000 |
| 2007 | | | 2007 | | |
| Jan. 1 | To Balance b/d | 31,450 | Dec. 31 | By Depreciation A/c (for 12 months) | 3,400 |
| | | | Dec. 31 | By Balance c/d | 28,050 |
| | | 31,450 | | | 31,450 |
| 2008 | | | 2008 | | |
| Jan. 1 | To Balance b/d | 28,050 | June 30 | By Depreciation A/c (6 months) | 1,700 |
| | | | | By Cash A/c (Sale) | 19,000 |
| | | | | By P&L A/c (Loss) | 7,350 |
| | | 28,050 | | | 28,050 |

*Working Note:*

1. Cost of Machine = 24,000 + 10,000 = ₹ 34,000

2. Depreciation for 2006 = $\frac{34{,}000 \times 10}{100} \times \frac{9}{12} = 2{,}550$

3. Depreciation for 2007 = $\frac{34{,}000 \times 10}{100} = 3{,}400$

4. Depreciation for 2008 (for 6 months) = $\frac{34{,}000 \times 10}{100} \times \frac{6}{12} = ₹\,1{,}700$

***Illustration 4:*** On 1st April, 2004, Abhimanyu & Co. purchased a furniture of ₹ 90,000. The estimated effective life of the furniture is 4 years with scarp value of ₹ 10,000. Calculate depreciation on fixed line method and show furniture account of 4 years assuming that company maintains provision for depreciation account.

*Solution:*

## Calculation of Depreciation

$$\text{Depreciation} = \frac{\text{Original Cost} - \text{Scrap Value}}{\text{Economic Life}} = \frac{90{,}000 - 10{,}000}{4} = 20{,}000$$

**Furniture Account**

| Date | Particulars | (₹) | Date | Particulars | (₹) |
|---|---|---|---|---|---|
| 2004 | | | 2005 | | |
| April 1 | To Bank A/c | 90,000 | March 31 | By Balance c/d | 90,000 |
| | | 90,000 | | | 90,000 |
| 2005 | | | 2006 | | |
| April 1 | To Balance b/d | 90,000 | March 31 | By Balance c/d | 90,000 |
| | | 90,000 | | | 90,000 |

*Contd...*

Notes

| | | | | | |
|---|---|---|---|---|---|
| 2006 | | | 2007 | | |
| April 1 | To Balance b/d | 90,000 | March 31 | By Balance b/d | 90,000 |
| | | 90,000 | | | 90,000 |
| 2007 | | | 2008 | | |
| April 1 | To Balance b/d | 90,000 | March 31 | By Provision for Depreciation A/c | 80,000 |
| | | | | By Balance c/d | 10,000 |
| | | 90,000 | | | 90,000 |

**Provision for Depreciation Account**

| Date | Particulars | (₹) | Date | Particulars | (₹) |
|---|---|---|---|---|---|
| 2005 | | | 2005 | | |
| March 31 | To Balance c/d | 20,000 | March 31 | By Depreciation A/c | 20,000 |
| 2006 | | | 2005 | | |
| March 31 | To Balance c/d | 40,000 | April 1 | By Balance b/d | 20,000 |
| | | | 2006 | | |
| | | | March 31 | By Depreciation A/c | 20,000 |
| | | 40,000 | | | 40,000 |
| 2007 | | | 2006 | | |
| March 31 | To Balance c/d | 60,000 | April 1 | By Balance b/d | 40,000 |
| | | | 2007 | | |
| | | | March 31 | By Depreciation A/c | 20,000 |
| | | 60,000 | | | 60,000 |
| 2008 | | | 2007 | | |
| March 31 | To Furniture A/c | 80,000 | April 1 | By Balance b/d | 60,000 |
| | | | 2008 | | |
| | | | March 31 | By Depreciation A/c | 20,000 |
| | | 80,000 | | | 80,000 |

## 10.3.2 Diminishing Balance Method

This method is also known as written-down-value method. In this method depreciation is calculated on diminishing value but rate of depreciation remains constant. The amount of depreciation on assets decreases every year but the value of the asset do not becomes zero. Rate of depreciation can be determined with the help of cost of assets, scrap value and useful life of the assets. The formula to compute the rate of depreciation is given below:

$$\text{Rate} = \left(1 - \sqrt[n]{\frac{S}{C}} \times 100\right)$$

Where, N for number of years of useful life of the asset.

S for scrap value

C for cost of asset

R for rate of depreciation

Notes

**Distinction between Fixed Instalment Method and Diminishing Value Method of Depreciation Fixed Assets**

| Basis of Difference | Fixed/Straight Line Method | Diminishing Value Method |
|---|---|---|
| 1. Basis of charge and amount of depreciation. | Depreciation is calculated on the basis of original cost of asset *i.e.* Cost scrap value if any No. of useful life of assets (in years). The amount of depreciation remains constant (fixed) every year. | Depreciation is a certain percentage of value of assets. The amount of depreciation decreases every year. |
| 2. Value of assets | Value of asset becomes zero at the end of its life. | Value of asset can never be zero even thought the asset becomes obsolete/useless. |
| 3. Burden of depreciation. | The burden of depreciation remains uniform as the amount of depreciation remains constant every year. | The burden of depreciation is heavier in the beginning but becomes lighter in the subsequent years. |
| 4. Suitable system. | This method is suitable to such assets where the cost of assets, scrap value if any and life of asset are easily known and the burden of repairs in not much or remains constant. | The method is suitable to such assets where a the cost, scrap value of asset and life of asset cannot he ascertained easily and the burden of repairs also increases. |
| 5. Income Tax point of view. | This system is not recognized under income tax rules. | This method is considered suitable under income tax rules. |
| 6. Effect on profit and loss a/c | In the begining, the amounts of depreciation repairs charges are lesser but increases in subsequent years. Though the amount of depreciation remains constant but the amount of repairs increases because of higher maintendence changes | The amount of depreciation of repairs charges total change on P&L A/c remains constant though the amount of depreciation decreases but repairs changes increase and over all burden on P&L remains constant. |

*Illustration 5:* **Sale of Assets and Written Down Value Method**

Lakshmi Narain Company Ltd., whose accounting year is the calendar year purchased machineries on 1st April, 2006 costing ₹ 45,000.

It further purchased a machine costing ₹ 30,000 on 1st October, 2006 and another machine costing ₹ 15,000 on 1st July, 2007.

On 1st January, 2008 of the machineries which were purchased on 1st April, 2006 one machine costing ₹ 15,000 became obsolete and was sold for ₹ 4,500.

Prepare the machinery account for all the three years in the books of the company after charging the depreciation at 10% per annum on written down value method.

***Solution:***

**In the Books of Lakshmi Narain Co. Ltd.**
**Machinery Account**

| Date | Particulars | (₹) | Date | Particulars | (₹) |
|---|---|---|---|---|---|
| 2006 | | | 2006 | | |
| April 1 | To Cash A/c | 45,000 | Dec. 31 | By Depreciation A/c | 4,125 |
| Oct. 1 | To Cash A/c | 30,000 | Dec. 31 | By Balance c/d | 70,875 |
| | | 75,000 | | | 75,000 |

*Contd...*

Notes

| | | | | | |
|---|---|---|---|---|---|
| 2007 | | | 2007 | | |
| Jan. 1 | To Balance b/d | 70,875 | Dec. 31 | By Depreciation A/c | 7,837.50 |
| July 1 | To Cash A/c | 15,000 | Dec. 31 | By Balance c/d | 77,737.50 |
| | | 85,875 | | | 85,875 |
| 2008 | | | 2008 | | |
| Jan. 1 | To Balance b/d | 77,737.50 | Jan. 1 | By Bank (Sale of 1/3 machine) | 4,500 |
| | | | | By P&L A/c. (Loss on sale) | 7,987.50 |
| | | | | By Depreciation A/c | 6,555 |
| | | | | By Balance c/d | 58,995 |
| | | 77,737.50 | | | 77,737.50 |

*Working Note:*

1. Depreciation on Machine I acquired on April 1, 2006 = $\frac{45{,}000 \times 10}{100} \times \frac{9}{12} = 3{,}375$

   Depreciation on Machine II acquired on October 1, 2006 = $\frac{30{,}000 \times 10}{100} \times \frac{3}{12} = 750$

   Total Depreciation for 2006 = 3,375 + 750 = 4,125

2. Depreciation on Machine I = $\frac{(45{,}000 - 3{,}375) \times 10}{100} = 4{,}162.50$

   Depreciation on Machine II = $\frac{(45{,}000 - 750) \times 10}{100} = 2{,}925$

   Depreciation on Machine III = $\frac{15{,}000 \times 10}{100} \times \frac{6}{12} = 750$

   Total Depreciation = 4,162.50 + 2,925 + 750 = 7,837.50

3. W.D.V. of one whole machine on 1st January 2008 (45,000 – 3,375 – 4,162.50)

   = 37,462.50

   W.D.V. of 1/3 of machine I = $\frac{37{,}462.50}{3} = 12{,}487.50$

   Sale of machine = 4,500

   Loss on sale = 12,487.50 – 4,500 = 7,987.50

4. Depreciation for 2008

   Depreciation on 2/3 of Machine I = $\frac{(37{,}462.50 - 12{,}487.50) \times 10}{100} = 2{,}497.50$

   Depreciation on IInd Machinery = $\frac{(30{,}000 - 750 - 2{,}925) \times 10}{100} = 2{,}632.50$

   Depreciation on IIIrd Machinery = $\frac{(15{,}000 - 750) \times 10}{100} = 1{,}425$

   Total Depreciation = 2,497.50 + 2,632.50 + 1,425 = 6,555

## *Change in the Method of Depreciation*

As per the consistency convention of accounting, if once a method of depreciation has been adopted by the management, it should be used consistently. However, due to some statutory

Notes

compulsion, requirement of the Accounting Standard, etc. the management can change the method of providing the depreciation on assets from diminishing balance method to fixed installment method or vice versa. When the management decides to change the method of depreciation, there can be the following two methods of such a change:

1. The method of charging the depreciation can be changed from the current year onwards. It is called a prospective change. In such a situation new method of charging the depreciation is applied from the current year over the remaining economic life of the assets.
2. When the method of charging the depreciation is changed from the back date or retrospective year, it poses some problem. In such situation, first of all the depreciation is computed on the assets by the new method from the back date. Similarly depreciation on the assets is find by the old method (which is already shown in the books). Then the amount of these two depreciation are compared. If the amount of depreciation calculated by new method exceeds, excess of the amount is credited to the assets account in the current year and also shown in the debit side of P&L A/c. If the amount of depreciation calculated by new method is less than the amount of depreciation calculated by old method, this shortage is debited to the assets account in the current year and also in the credit side of the P&L A/c.

### 10.3.3 Annuity Method

Under this method depreciation on assets is calculated keeping into account the cost of assets along with interest thereon. The annuity method is a compounded interest method whereby the depreciation is calculated based on the assumption that depreciation plus the normal cost of capital to finance the assets are constant over the life of the assets. Interest along with cost of assets is taken into account under this method while calculating the amount of depreciation. Amount of interest is debited to assets account every year and then amount of depreciation is credited to assets account. Calculation of interest is based on the opening balance of the asset. So it (interest) decreases every year but the amount of depreciation remains constant which is taken from the annuity tables for depreciation. This amount of depreciation is that much by which the value of asset becomes zero.

In other words, if a firm purchases a plant of ₹ 50,000 and it only provides depreciation of ₹ 10,000 every year, after five years it will collect fund of ₹ 50,000 to replace the new plant. In this case one point is ignored that interest means if this firm invested this amount of ₹ 50,000 in some other form of securities in the place of buying assets, it would get return some interest along with the principal amount of ₹ 50,000. In this method the amount of depreciation is determined by adding the depreciation and interest thereon. The amount of depreciation is computed with the help of annuity table. Under this method the following journal entries are passed for depreciation and interest thereon.

1. When depreciation is charged on Assets

   Depreciation Account Dr.

   To Assets Account

2. When interest on cost of assets is calculated and showed

   Assets Account Dr.

   In Assets Account

3. When interest is transferred to P&L A/c

   Interest Account Dr.

   To P&L Account

**Notes**

*Illustration 6:* **Annuity Method**

A Plastic Manufacturing Firm takes a lease costing ₹ 4,00,000 for 4 years. It decides to write off this lease by annuity method. You are given from the annuity table that in order to write off the lease on Annuity Method at 5 per cent interest per annum, the amount to be written off annually as depreciation amounts to ₹ 1,12,804.

Show lease account for all the four years.

***Solution:***

**Lease Account**

| Date | Particulars | (₹) | Date | Particulars | (₹) |
|---|---|---|---|---|---|
| 1st year | To Bank A/c | 4,00,000 | 1st year | To Depreciation A/c | 1,12,804 |
| | To Interest A/c | 20,000 | | To Balance c/d | 3,07,196 |
| | | 4,20,000 | | | 4,20,000 |
| 2nd year | To Balance b/d | 3,07,196 | 2nd year | By Depreciation A/c | 1,12,804 |
| | To Interest A/c | 15,360 | | By Balance c/d | 2,09,752 |
| | | 3,22,556 | | | 3,22,556 |
| 3rd year | To Balance b/d | 2,09,752 | 3rd year | By Depreciation A/c | 1,12,804 |
| | To Interest A/c | 10,488 | | By Balance c/d | 1,07,436 |
| | | 2,20,240 | | | 2,20,240 |
| 4th year | To Balance b/d | 1,07,436 | 4th year | By Depreciation A/c | 1,12,804 |
| | To Interest A/c | 5,368 | | | |
| | | 1,12,804 | | | 1,12,804 |

## 10.3.4 Depreciation Fund Method or Sinking Fund Method

This method is designed in such a way so that the accumulated amount may be readily available to replace the assets on the expiry of the useful life of the assets. Under this method a sinking fund is created with the amount of depreciation on assets. An equivalent amount of the depreciation is invested in some government or marketable securities each year and the amount of interest on these securities is also reinvested in same securities. On the expiry of the economic life of the assets, these securities are sold in the market and from the amount realized, the old assets are replaced. If there is any profit or loss from the sale of these securities, that is transferred to the profit and loss account. To adopt this method the following journal entries are passed:

1. At the end of first year, when depreciation (which is calculated with the help of sinking fund table) is charged and transferred to sinking fund or depreciation fund account -

    Depreciation Account Dr.

    To Sinking Fund Account

2. When depreciation account is transferred to P&L Account

    P&L Account Dr.

    To Depreciation Account

    Alternatively in the place of above two entries, the following one entry may be passed

    P&L Account Dr.

    To Sinking Fund Account

Notes

3. When at the end of 1st year, an equivalent amount to the depreciation is invested in some securities

   Sinking Fund Investment Account Dr.

   To Cash/Bank Account

4. At the end of second year when interest on the first year's sinking fund investment is received

   Bank Account Dr.

   To Sinking Fund Account

5. When depreciation on assets is charged

   P&L Account Dr.

   To Sinking Fund Account

6. When annual installment of depreciation along with the interest received on previous year's investment is invested in some securities

   Sinking Fund Investment Account Dr.

   To Bank Account

   (For the subsequent years the same pattern is adopted.)

7. On the expiry of the economic life of the assets, if S.F. investments are sold at profit

   Bank Account Dr.

   To Sinking Fund Investment Account

   To Sinking Fund Account (profit on sale)

   If there is loss on sale of investment:

   Bank Account Dr.

   Sinking Fund Account Dr.

   To Sinking Fund Investment A/c

8. When old assets are sold

   Bank Account Dr.

   To Assets Account

9. When the balance of sinking fund account is transferred to assets account

   Sinking Fund Account Dr.

   To Assets Account

10. The balance of assets account (if any) transferred to P& L account

   P&L Account (loss) Dr

   To Assets Account

   Or

   Assets Account Dr

   To P&L Account (Profit)

Notes

*Illustration 7:* **Depreciation Fund Method**

On 1st January, 2003 a machinery was purchased for ₹ 1,00,000 by XYZ Co. Ltd, It is to be replaced after four years. It is expected that investment will yield a net interest of 4% p.a. A depreciation fund is established to collect the necessary amount.

On 31st December, 2006 the company had a balance of ₹ 45,500. The Depreciation Fund Investments realised ₹ 73,500. The new machinery cost ₹ 1,07,500.

Pass the Journal entries and make the necessary accounts in the books of XYZ Co. Ltd.

***Solution:***

**In the Books of XYZ Co. Ltd.,**
**Journal Entries**

| Date | Particulars | L.F. | Amount (Dr.) (₹) | Amount (Cr.) (₹) |
|---|---|---|---|---|
| 2003<br>Jan. 1 | Machinery Account Dr.<br>To Cash Account<br>(Being purchase of machinery) | | 1,00,000 | 1,00,000 |
| Dec. 31 | Depreciation Account Dr.<br>To Depreciation Fund Account<br>(Being provision made for annual depreciation) | | 23,549 | 23,549 |
| Dec. 31 | Depreciation Fund Investment A/c Dr.<br>To Cash Account<br>(Being investment of annual depreciation) | | 23,549 | 23,549 |
| 2004<br>Dec. 31 | Cash Account Dr.<br>To Depreciation Fund Account<br>(Being receipt of interest on last year's investments) | | 942 | 942 |
| Dec. 31 | Depreciation Account Dr.<br>To Depreciation Fund Account<br>(Being provision made for annual depreciation) | | 23,549 | 23,549 |
| Dec. 31 | Depreciation Fund Investment A/c Dr.<br>To Cash Account<br>(Being investment of annual depreciation and interest on last year's investment) | | 24,491 | 24,491 |
| 2005<br>Dec. 31 | Cash Account Dr.<br>To Depreciation Fund Account<br>(Being receipts of interest on the last year's investments of ₹ 48,040). | | 1,922 | 1,922 |
| Dec. 31 | Depreciation Account Dr.<br>To Depreciation Fund Account<br>(Being provision made for annual depreciation) | | 23,549 | 23,549 |
| Dec. 31 | Depreciation Fund Investment A/c Dr.<br>To Cash Account<br>(Being investment of annual depreciation and the interest) | | 25,471 | 25,471 |

*Contd...*

Notes

| | | | | |
|---|---|---|---|---|
| 2006 | | | | |
| Dec. 31 | Cash Account Dr. | | 2,940 | |
| | To Depreciation Fund Account | | | 2,940 |
| | (Being receipts of interest on the previous year's investments) | | | |
| Dec. 31 | Depreciation Account Dr. | | 23,549 | |
| | To Depreciation Fund Account | | | 23,549 |
| | (Being provision made for annual depreciation) | | | |
| 2006 | | | | |
| Dec. 31 | Cash Account Dr. | | 73,500 | |
| | Depreciation Fund Account Dr. | | 11 | |
| | To Depreciation Fund Investment A/c. | | | 73,511 |
| | (Being sale of D.F. Investment and loss thereon transferred to D.F. Account) | | | |
| Dec. 31 | Depreciation Fund Account Dr. | | 1,00,000 | |
| | To Machinery Account | | | 1,00,000 |
| | (Being the transfer of machinery to depreciation fund account) | | | |
| Dec. 31 | Machinery Account Dr. | | 1,07,500 | |
| | To Cash Account | | | 1,07,500 |
| | (Being purchase of new machinery) | | | |

**Ledger of XYZ Co. Ltd**
**Machinery Account**

| Date | Particulars | L.F. | (₹) | Date | Particulars | L.F. | (₹) |
|---|---|---|---|---|---|---|---|
| 2003 | | | | 2003 | | | |
| Jan. 1 | To Cash Account | | 1,00,000 | Dec. 31 | By Balance c/d | | 1,00,000 |
| | | | 1,00,000 | | | | 1,00,000 |
| 2004 | | | | 2004 | | | |
| Jan. 1 | To Balance b/d | | 1,00,000 | Dec. 31 | By Balance c/d | | 1,00,000 |
| | | | 1,00,000 | | | | 1,00,000 |
| 2005 | | | | 2005 | | | |
| Jan. 1 | To Balance b/d | | 1,00,000 | Dec. 31 | By Balance c/d | | 1,00,000 |
| | | | 1,00,000 | | | | 1,00,000 |
| 2006 | | | | 2006 | | | |
| Jan. 1 | To Balance b/d | | 1,00,000 | Dec. 31 | By Depreciation Fund A/c | | 1,00,000 |
| | | | 1,00,000 | | | | 1,00,000 |

**Depreciation Fund Account**

| Date | Particulars | L.F. | (₹) | Date | Particulars | L.F. | (₹) |
|---|---|---|---|---|---|---|---|
| 2003 | | | | | | | |
| Dec. 31 | To Balance c/d | | 23,549 | | By Depreciation A/c | | 23,549 |
| | | | 23,549 | | | | 23,549 |

*Contd...*

Notes

| | | | | | | | |
|---|---|---|---|---|---|---|---|
| 2004 | | | | | | | |
| Dec. 31 | To Balance c/d | | 48,040 | | By Balance b/d | | 23,549 |
| | | | | | By Cash A/c (Interest) | | 942 |
| | | | | | By Depreciation A/c | | 23,549 |
| | | | 48,040 | | | | 48,040 |
| 2005 | | | | | | | |
| Dec. 31 | To Balance c/d | | 73,511 | | By Balance b/d | | 48,040 |
| | | | | | By Cash (Interest) | | 1,922 |
| | | | | | By Depreciation A/c | | 23,549 |
| | | | 73,511 | | | | 73,511 |
| 2006 | | | | | | | |
| Dec. 31 | To D.F. Investment A/c. | | 11 | | By Balance b/d | | 73,511 |
| Dec. 31 | To Machinery A/c | | 1,00,000 | | By Cash (Interest) | | 2,940 |
| | | | | | By Depreciation A/c | | 23,549 |
| | | | | | By P&L A/c | | 11 |
| | | | 1,00,011 | | | | 1,00,011 |

**Depreciation Fund Investment Account**

| Date | Particulars | L.F. | (₹) | Date | Particulars | L.F. | (₹) |
|---|---|---|---|---|---|---|---|
| 2003 | | | | 2003 | | | |
| Dec. 31 | To Cash Account | | 23,549 | Dec. 31 | By Balance b/d | | 23,549 |
| | | | 23,549 | | | | 23,549 |
| 2004 | | | | 2004 | | | |
| Jan. 1 | To Balance b/d | | 23,549 | Dec. 31 | By Balance c/d | | 48,040 |
| Dec. 31 | To Cash Account | | 24,491 | | | | |
| | | | 48,040 | | | | 48,040 |
| 2005 | | | | 2005 | | | |
| Jan. 1 | To Balance b/d | | 48,040 | Dec. 31 | By Balance c/d | | 73,511 |
| Dec. 31 | To Cash Account | | 25,471 | | | | |
| | | | 73,511 | | | | 73,511 |
| 2006 | | | 73,511 | 2006 | | | |
| Jan. 1 | To Balance b/d | | | Dec. 31 | By Cash A/c | | 73,500 |
| | | | | Dec. 31 | By Depreciation Fund A/c | | 11 |
| | | | 73,511 | | | | 73,511 |

**Depreciation Account**

| Date | Particulars | L.F. | (₹) | Date | Particulars | L.F. | (₹) |
|---|---|---|---|---|---|---|---|
| 2003 | | | | 2003 | | | |
| Dec. 31 | To Depreciation Fund A/c | | 23,549 | Dec. 31 | By P&L A/c | | 23,549 |
| 2004 | | | | 2004 | | | |
| Dec. 31 | To Depreciation Fund A/c | | 23,549 | Dec. 31 | By P&L A/c | | 23,549 |
| 2005 | | | | 2005 | | | |
| Dec. 31 | To Depreciation Fund A/c | | 23,549 | Dec. 31 | By P&L A/c | | 23,549 |
| 2006 | | | | 2006 | | | |
| Dec. 31 | To Depreciation Fund A/c | | 23,549 | Dec. 31 | By P&L A/c | | 23,549 |

Notes

*Working Note*

As per Sinking Fund Table there should be annual investment of ₹ 0.23549 to get ₹ 1 at the end of 4 years @4% p.a.

Thus the amount investment should be = ₹ 0.23549 × 1,00,000 = ₹ 23,549.

### 10.3.5 Insurance Policy Method

The method is similar to the sinking fund method. Under this method to replace the assets, an insurance policy is taken by the firm. Amount of premium is paid by the annual amount of depreciation while under the sinking fund method, some securities were bought by the firm. The amount of premium with interest accumulates with the insurance company. On the expiry of the useful life of the assets, the insurance policy matures. On maturity the amount is made available by the insurance company which is used for the purchase of new assets. Thus this method provides more safety and liquidity to the funds. Under this method the following journal entries are passed.

1. When depreciation is charged:

   P&L Account Dr.

   To Depreciation Fund Account

2. When amount of premium is paid

   Depreciation Fund Policy Account Dr.

   To Bank Account

3. When amount of policy is received from insurance company on maturity

   Bank Account Dr.

   To Depreciation Fund Policy Account

4. There may be profit or loss on the policy that is transferred to the depreciation fund account. Then following entry is passed for profit

   For Profit:

   Depreciation Fund Policy Account Dr.

   To Depreciation Fund Account

   For Loss:

   Depreciation Fund Account Dr.

   To Depreciation Fund Policy Account

5. When new assets are acquired:

   Assets Account Dr.

   To Bank Account

*Illustration 8:* **Insurance Policy Method**

ABC Company Ltd. took a lease which is to be replaced after 3 years for ₹ 4,00,000 on 1st April, 2005 and decided to provide for its replacement by means of an insurance policy for ₹ 4,00,000. The annual premium is ₹ 1,19,333.33. On 1st April, 2008 the lease is renewed for ₹ 4,80,000.

Show necessary accounts in the books of the company.

*Solution:*

Notes

**Lease Account**

| Date | Particulars | (₹) | Date | Particulars | (₹) |
|---|---|---|---|---|---|
| 2005 | | | 2005 | | |
| April 1 | To Bank A/c | 4,00,000 | March 31 | By Balance c/d | 4,00,000 |
| 2006 | | | 2006 | | |
| April 1 | To Balance b/d | 4,00,000 | March 31 | By Balance c/d | 4,00,000 |
| 2007 | | | 2007 | | |
| April 1 | To Balance b/d | 4,00,000 | March 31 | By Depreciation Fund A/c | 4,00,000 |

**Depreciation Fund Account**

| Date | Particulars | (₹) | Date | Particulars | (₹) |
|---|---|---|---|---|---|
| 2006 | | | 2006 | | |
| March 31 | To Balance c/d | 1,19,333 | March 31 | By Profit & Loss A/c | 1,19,333 |
| 2007 | | | 2007 | | |
| March 31 | To Balance c/d | 2,38,666 | April 1 | By Balance b/d | 1,19,333 |
| | | | 2007 | | |
| | | | March 31 | By Profit & Loss A/c | 1,19,333 |
| | | 2,38,666 | | | 2,38,666 |
| 2008 | | | 2006 | | |
| March 31 | To Lease A/c | 4,00,000 | April 1 | By Balance b/d | 2,38,666 |
| | | | March 31 | By Profit & Loss A/c | 1,19,333 |
| | | | | By Depreciation Fund Insurance Policy | 42,001 |
| | | 4,00,000 | | | 4,00,000 |

**Depreciation Fund Insurance Policy Account**

| Date | Particulars | (₹) | Date | Particulars | (₹) |
|---|---|---|---|---|---|
| 2006 | | | 2006 | | |
| March 31 | To Bank (Premium on Policy) | 1,19,333 | March 31 | By Balance c/d | 1,19,333 |
| 2006 | | | 2007 | | 2,38,666 |
| April 1 | To Balance b/d | 1,19,333 | March 31 | By Balance c/d | |
| 2007 | | | | | |
| March 31 | To Bank A/c | 1,19,333 | | | |
| | | 2,38,666 | | | 2,38,666 |
| 2007 | | | 2008 | | 4,00,000 |
| April 1 | To Balance c/d | 2,38,666 | March 31 | By Bank A/c | |
| 2008 | | | | | |
| March 31 | To Bank A/c | 1,19,333 | | | |
| March 31 | To Depreciation Fund A/c. | 10,501 | | | |
| | | 4,00,000 | | | 4,00,000 |

Notes

### 10.3.6 Revaluation or Appraisal Method

As its name is indicating, depreciation is calculated on the basis of revaluation of assets. After some time or interval of a year, the assets are revalued by experts. The difference of the valuation of the two periods is called depreciation or appreciation of that period. Generally, this method is used in the case of livestock, copyrights and patents.

### 10.3.7 Depletion Method

It is also known as production method. This method is useful for natural assets as coal mines, oil wells, etc. These are taken for excavation for a definite period on the contact basis. In this case the depreciation is computed on the basis of production. First the total production of the contract period is estimated, then total depreciable cost is divided by the total production and multiplied by annual output to determine the annual amount of depreciation. In the form of formula:

$$\text{Annual Depreciation} = \frac{\text{Annual Output}}{\text{Total Estimated Output}}$$

### 10.3.8 Machine Hour Rate Method

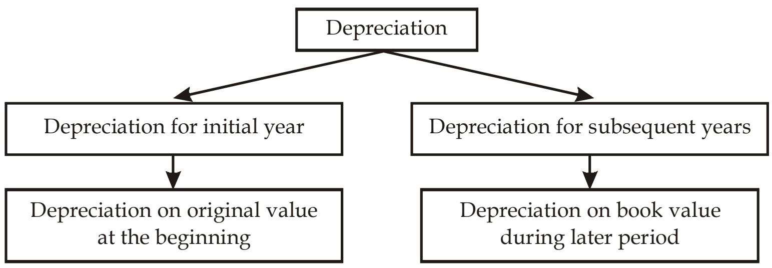
When depreciation is calculated on the basis of working hours of the machine or plant, this method is used. The original cost of plant or machinery is divided by the total number of working hours of the machine or plant to find the machine hour rate. To compute the depreciation of a year the machine hour rate is multiplied by the total working hours of the machine/plant in a year. This procedure may be explain in the following formula -

$$\text{Machine Hour Rate} = \frac{\text{Original Cost of Machine}}{\text{Total Working Hours of the Machine During its Life}}$$

$$\text{Annual Depreciation} = \text{Machine Hour Rate} \times \text{Working Hours in a Year}$$

*Notes* Straight line method vs. Written down value method

Under this method of charging depreciation, unlike the straight line method, the percentage is usually given for calculation. While calculating this method, the depreciation is calculated on two different values.



Notes

*Case Study*

## Tata Steel Ltd.

Tata Steel Ltd. wants to establish its EOU in the state of Orissa through exploration of iron ore. It identified that the state of Orissa is one of the ideal states having greater potential of iron ore than any other state in India. The firm has reached lease contract with the Government of Orissa for the amount of ₹ 200 Cr towards the extraction of 40,00,000 tonnes iron ore from the field for 10 years. The firm would like to establish a processing plant which amounts to ₹ 50 Cr to produce the quality carbon steel for the foreign industrial buyers. The life period of the machine is denominated in terms of 2,50,000 working hours. The firm is required to extract the iron ore.

| Year | 1 | 2 | 3 | 4 | 5 | 6 | 7 | 8 | 9 | 10 |
|---|---|---|---|---|---|---|---|---|---|---|
| Expected Extraction Per Year in Lakh | 8 | 7 | 6 | 5 | 4 | 3 | 3 | 2 | 1 | 1 |
| Hrs. Working | 1,00,000 | 75,000 | 25,000 | 12,500 | 6,250 | 6,250 | 6,250 | 6,250 | 6,250 | 6,250 |

To meet out the cost of escalation, the firm should invest the amount of depreciation in the interest bearing securities. The rate of interest is 8%.

**Questions**

1. To go for further replacement after 10 years, how much should the firm charge depreciation in the case of iron ore field ? Which method should be applied? Reason out the suitability of the method opted.
2. To replace the machinery recently bought after 10 years how much should be charged as depreciation in accordance with the working hours given? Which method is considered to be most suitable to replace? Why?
3. To replace the both investments viz on the iron ore field and processing unit, how much the firm should invest during the 10 years time span?

## Self Assessment

State true or false:

9. Amount of depreciation, if charged on the basis of written down value method, increases every year.
10. Depreciation is charged to find out the correct P&L accounting balance.
11. The depreciation charge is a mean to recover the cost of operations of the enterprise.
12. Under written down value method depreciation is charged on the original value of the asset.
13. The following formula to highlights the application of Diminishing Balance method in charging depreciation is = (S/C)1/n – 1.
14. Profit or loss arises from the sale of the assets is carried to profit and loss appropriation account.
15. When provision for depreciation account is maintained the assets are shown in the books at their original cost.

Notes

## 10.4 Provision and Reserves

Every business enterprise, irrespective of its form of organization, likes to conduct its operations in a prudent manner so as to be able to meet all eventualities—both expected and unexpected. This is done, among other things, by making provisions, and creating reserves, at the time of the preparation of financial statements.

### 10.4.1 Meaning of Provisions

The term 'provision' means an amount, which is: written off, or retained, by way of providing for depreciation, renewals, diminution in the value of assets; or retained by way of providing for any unknown future liability of which the amount cannot be determined with reasonable accuracy.

Obviously, where the amount of a liability is known, or can be ascertained, a definite liability should be created, e.g., liability for outstanding interest. Examples of provisions are provision for doubtful debts, provision for depreciation, provision for repairs, provision for discount on debtors, provision for taxation, and provision for legal damages likely to arise from a pending suit.

Provision is a charge against the profit of the year and hence, it is debited to profit and loss account before calculating the net profit for the year, and is shown in the balance sheet after the certain liabilities on the liability side. It is to be noted that provision has to be made irrespective of the fact whether a firm make a profit or not, otherwise it leads to breach of prudential business behaviour.

### 10.4.2 Meaning of Reserves

Reserve means amount set aside out of profits (as calculated by the profit and loss account) or other surpluses which are not meant to cover any liability, contingency, commitment or legal requirement. Thus, reserve covers the case of amount which is neither a liability nor a provision. It is allocation of the profit and not a charge against the current revenues.

It, in fact, belongs to the proprietors over and above the capital contributed by them. In case amount equal to a reserve is invested in outside securities, it is called 'Reserve Fund' but the absence of this conditions entitles it to be called simply 'reserve'.

When it is called fund and meant for a given purpose, it is called "Specific Reserve", otherwise "General Reserve". Examples of reserves are Capital Reserve, General Reserve, Contingency Reserve, Dividend Equalization Reserve, Debenture Redemption Fund, etc.

### 10.4.3 Importance of Provisions and Reserves

A business firm in general, and a corporate enterprise in particular may consider it proper to set up some mechanism to protect itself from the consequences of known liabilities and losses it may be required to bear in future. It may also regard it as more appropriate in certain cases to reduce the amount that can be drawn by the proprietors as profit in order to conserve business resources to meet certain significant demands for them in future. An example of such a demand is the much - needed expansion in the scale of business operations. This is presented as the justification for the role of provisions and reserves in business activities and in accounting.

The amount so set aside may be meant for the purpose of:

- Fulfilling some specific requirements like repairs and renewals of an asset;
- Meeting a future liability or loss;
- Strengthening the general financial position of undertaking;
- Redeeming a long-term liability like debentures.

Notes

### 10.4.4 Distinction

The identification and understanding of the precise scope of 'provisions' and 'reserves ' require explanation of differences between them for clarification of their respective roles in business and in accounting.

- ***Purpose:*** A provision is created for some specific liability in view but reserve is meant to meet the future legal obligations or investment requirements of business for development.
- ***Mode of Creation:*** A provision is a charge against profit and loss account of the year and has to be created even when profits are not expected. A reserve is an appropriation of profits and can be made out of either profit earned during a year or from already existing surplus, e.g. contingency reserve.
- ***Presentation in Balance Sheet:*** A provision is generally presented as a deduction from the item for which it has been created on the asset side of the balance sheet or as a liability after current liabilities as part of external equities. Reserve is listed as distinct item on the liabilities side of them balance sheet.
- ***Utilization:*** Very rigid restrictions are enforced in practice on the use of provisions in business operations to make them adhere to the purpose for which they have been meant. Contrary to this, the balance of general reserve, or any account of such a nature, is always available for any bonafide requirements of business. However, reserves created under specific legal obligations such as "Capital Redemption Reserve or Debenture Redemption Reserve" is to be used within the framework of the law only.
- ***Identification with Operations:*** A provision is made for meeting a particular liability or likely loss on a specific item. Therefore, they cannot be distanced from business operations and their investment outside the business is just not possible. Reserves, being of a general nature, can be invested outside the business to avoid the possibility of their non-availability in the event of need as well as to earn some additional income with their help. However, outside investment of reserves by business is not mandatory in all situations.

### 10.4.5 Types of Provisions

The number of provisions maintained by a business undertaking depends upon its requirements, which are governed by the volume, range and nature of its operations. Generally, a business firm creates and maintains provisions for taxations, repairs and renewals, depreciation, discount on debtors, bad and doubtful debts. But provision for doubtful debts and provision for discount on debtors has been discussed at appropriate stages.

*Notes* **Provision for Doubtful Debts**

When business transaction takes place on credit basis, debtors may be of three types:

- Good Debtors are those from where collection of debt is certain.
- Bad Debts are those debtors from where collection of money is not possible and the amount of credit is a loss.
- Doubtful Debts are those who may pay but firm is not sure about cent per cent collection from them. In fact, as a matter of business experience, some percentage of such debtors is not likely to pay, hence treated as doubtful debts.

Notes

When it is certain that a debt will not be recovered, the amount is written off as bad debts. But it is also likely that some of the remaining debts may not be recovered in full. This will be a loss to the business. Hence, it is a common practice to make a suitable provision for doubtful debts at the time of ascertaining the profit or loss. The balance sheet will not show the true position of sundry debtors. The provision for doubtful debts is usually calculated as a certain percentage of the total amount due from sundry debtors after writing off all known bad debts. Provision for doubtful debts is also called 'Provision for Bad Debts', or 'Provision for Bad and Doubtful debts'.

Such a provision is made by debiting the amount of doubtful debts to the profit and loss account and crediting the account of provision for doubtful debts. Thus, the journal entry for creating such a provision is as follows:

Profit and Loss A/c Dr.

Provision for Doubtful Debts A/c

The bad debts arising during the year are first written off from the 'provision for doubtful debts' account. In doing so, the opening balance standing to the credit of the provision for doubtful debts account may not be sufficient to meet the current amount of bad debts as also the requirements of future doubtful debts. This deficit is to be provided for at the end of the year by a charge to the profit and loss account. In case, the annual amount provided for is to be adjusted for any unused surplus representing credit balance. The following are the journal entries required when the provision for bad debts exists in the books:

1. For writing off further bad debts given outside the trial balance:

   Bad Debts A/c Dr.

   Sundry Debtors A/c

2. For transferring the total bad debts to the provision for Bad Debts Account:

   Provision for Doubtful Debts A/c Dr.

   Bad Debts A/c

3. For debiting the Profit and Loss Account with the amount of new provision plus the excess of bad debts over the old provision:

   Profit and Loss A/c Dr.

   Provision for Doubtful Debts A/c

4. For crediting the Profit and Loss Account with excess of the old provision over the total bad debts plus new provision, if any:

   Provision for Doubtful Debts A/c Dr.

   Profit and Loss A/c

### 10.4.6 Types of Reserves

Reserves are broadly of two types—*Capital Reserve* and *Revenue Reserve*

- ***Capital Reserve:*** 'Capital Reserve' is an accounting mechanism for conserving profits. The amount so set apart as 'Capital Reserve' imparts an element of stability to the overall finances of a business enterprise. Capital reserve arises either as a gain on sale of long-term assets or an settlement of liabilities. Again of capital nature may also arise due to the basic transaction of being of capital nature. For example, sale of equity shares at a premium. Further, allocation of revenue reserve may be made to capital reserve due to legal obligations. Capital reserve does not include any free balance that might be used for the distribution of profits. It is this crucial factor alone which tends to provide the much-needed financial stability to an corporate undertaking.

Capital reserve comes into existence from out of the capital profits arising from:

- Profits emerging from the revaluation of fixed assets after observing all restrictions;
- Profits accruing on the sale of fixed assets;
- Profits from the re-issue of share once forfeited by a company's
- Issue of shares at premium
- Profits arising at the time of amalgamation and absorption of companies
- Profit prior to incorporation of a company;
- Creation of capital Redemption Reserve upon the redemption preference shares. Capital reserves always have credit balance which is shown on the liabilities side of the balance sheet.

Whenever this reserve is utilized, capital reserve account is debited. It is also required that the manner of the utilization of capital reserve during an accounting period must be clearly stated in the balance sheet either in its body itself or by way of a footnote to the financial statements. This is due to the reason that there are rigid restrictions, both laid down by law and enforced by accounting standards, on the use of capital reserve.

- ***Revenue Reserves:*** Revenue reserves are created out of revenue profit which is usually distributable profits. All distributable profits are not always available for paying dividend since a certain amount may be required to be kept aside either by law (minimum) or as a managerial decision (higher amount) for business needs. It is only after this that profit will be available for distribution by way of dividend.

  Examples of revenue reserves are:

  - General Reserve
  - Dividend Equalisation Reserve
  - Debenture Redemption Reserve (only after complete redemption of those debenture under whose trust deed this reserve were created).

- ***General Reserve:*** A general reserve is retention of a portion of revenue profits for the improvement of the overall financial status of an enterprise and to improve its health in general.

  An important point about general reserve is that it is a salient feature of corporate finance. The creation and maintenance of general reserve helps in realizing certain well recognized purposes especially from the viewpoint of financial management.

  - Improvement of the general financial position of the business by conserving resources, which would have otherwise been frittered away at the expense of prudent management.
  - Arrangement for meeting unforeseen and abnormal losses irrespective of their nature.
  - Providing avenues for the further expansion of business operations. General reserve is created by debiting the profit and loss appropriation account and crediting general reserve account. The latter account is placed on the liabilities side of the balance sheet. When the balance on this account is used for any purpose, general reserve account is debited.

Notes

Any such use of general reserve has to be stated in some way in the balance sheet. A number of provisions have been included in the companies Act for the regulation, creation and utilization of general reserve. This underlines the importance attached to it in the functioning of corporate enterprises. A word of caution about the commonly perceived role of general reserve is necessary. General reserve is widely regarded as a means of strengthening the overall financial position of the business entity. However, this depends upon the proper valuation of the assets and liabilities of the business. In case assets and liabilities are properly valued, the balance on general reserve is indicative of the financial health of an enterprise but it is not so in the absence of this vital condition.

- ***Specific Reserves:*** A business undertaking in contemporary times is involved in a range of business activities in pursuance of its goal of creating value of the organization. Some of the of contingency situations can be looked after and financially managed by the creation of provisions for known or expected contingencies. Management may as well like to provide a second line of deface against some of these contingencies as a measure of abundant caution. A specific reserve is created for a given purpose. It cannot be used for any other purpose except for which they are created. There can possibly be any number of reserves in business, every one of them characterized by some peculiar feature dictated by the specific purpose which they are meant to serve. However, there is an undercurrent of common characteristics shared by them.

    - They are sharply focused from the viewpoint of their use because they are built up for some specific purpose or the other.
    - A businesslike approach to the management of these reserves may require that their balances be invested outside the business.
    - All specific reserves are presented on the liabilities side of the balance sheet, as they are credit balances.

    When any specific reserve is utilized, the amount drawn upon is debited to the account of the reserve concerned. The reserves are credited at the time of the preparation of financial statements by allocations decided to be made to them by management and the corresponding credit is given to profit and loss appropriation account.

### Self Assessment

State true and false:

16. Depreciation cannot be provided increase of loss, in a financial year.
17. Under written down value method, depreciation is charged on the original cost of the asset.
18. Provision is the charges against profits for all apprehended losses.
19. Capital reserves are freely distributed as profits.
20. All reserves appear on the liability side of the balance sheet.

## 10.5 Statements of Accounting Standards (AS 6) Revised – Depreciation Accounting

The following is the text of the revised Accounting Standard (AS) 6, 'Depreciation Accounting', issued by the Council of the Institute of Chartered Accountants of India.

**Notes**

## Introduction

1. This Statement deals with depreciation accounting and applies to all depreciable assets, except the following items to which special considerations apply:

   (i) Forests, plantations and similar regenerative natural resources;

   (ii) Wasting assets including expenditure on the exploration for and extraction of minerals, oils, natural gas and similar non-regenerative resources;

   (iii) Expenditure on research and development;

   (iv) Goodwill;

   (v) Live stock.

   This statement also does not apply to land unless it has a limited useful life for the enterprise.

2. Different accounting policies for depreciation are adopted by different enterprises. Disclosure of accounting policies for depreciation followed by an enterprise is necessary to appreciate the view presented in the financial statements of the enterprise.

## Definitions

3. The following terms are used in this statement with the meanings specified:

   3.1 *Depreciation* is a measure of the wearing out, consumption or other loss of value of a depreciable asset arising from use, affluxion of time or obsolescence through technology and market changes. Depreciation is allocated so as to charge a fair proportion of the depreciable amount in each accounting period during the expected useful life of the asset. Depreciation includes amortisation of assets whose useful life is predetermined.

   3.2 *Depreciable assets* are assets which

   (i) Are expected to be used during more than one accounting period; and

   (ii) Have a limited useful life; and

   (iii) Are held by an enterprise for use in the production or supply of goods and services, for rental to others, or for administrative purposes and not for the purpose of sale in the ordinary course of business.

   3.3 *Useful life* is either (i) the period over which a depreciable asset is expected to be used by the enterprise; or (ii) the number of production or similar units expected to be obtained from the use of the asset by the enterprise.

   3.4 *Depreciable amount* of a depreciable asset is its historical cost, or other amount substituted for historical cost in the financial statements, less the estimated residual value.

## Explanation

4. Depreciation has a significant effect in determining and presenting the financial position and results of operations of an enterprise. Depreciation is charged in each accounting period by reference to the extent of the depreciable amount, irrespective of an increase in the market value of the assets.

Notes

5. Assessment of depreciation and the amount to be charged in respect thereof in an accounting period are usually based on the following three factors:
   (i) Historical cost or other amount substituted for the historical cost of the depreciable asset when the asset has been revalued;
   (ii) Expected useful life of the depreciable asset; and
   (iii) Estimated residual value of the depreciable asset.
6. Historical cost of a depreciable asset represents its money outlay or its equivalent in connection with its acquisition, installation and commissioning as well as for additions to or improvement thereof. The historical cost of a depreciable asset may undergo subsequent changes arising as a result of increase or decrease in long-term liability on account of exchange fluctuations, price adjustments, changes in duties or similar factors.
7. The useful life of a depreciable asset is shorter than its physical life and is:
   (i) Predetermined by legal or contractual limits, such as the expiry dates of related leases;
   (ii) Directly governed by extraction or consumption;
   (iii) Dependent on the extent of use and physical deterioration on account of wear and tear which again depends on operational factors, such as, the number of shifts for which the asset is to be used, repair and maintenance policy of the enterprise etc.; and
   (iv) Reduced by obsolescence arising from such factors as:
      (a) Technological changes;
      (b) Improvement in production methods;
      (c) Change in market demand for the product or service output of the asset; or
      (d) Legal or other restrictions.
8. Determination of the useful life of a depreciable asset is a matter of estimation and is normally based on various factors including experience with similar types of assets. Such estimation is more difficult for an asset using new technology or used in the production of a new product or in the provision of a new service but is nevertheless required on some reasonable basis.
9. Any addition or extension to an existing asset which is of a capital nature and which becomes an integral part of the existing asset is depreciated over the remaining useful life of that asset. As a practical measure, however, depreciation is sometimes provided on such addition or extension at the rate which is applied to an existing asset. Any addition or extension which retains a separate identity and is capable of being used after the existing asset is disposed of, is depreciated independently on the basis of an estimate of its own useful life.
10. Determination of residual value of an asset is normally a difficult matter. If such value is considered as insignificant, it is normally regarded as nil. On the contrary, if the residual value is likely to be significant, it is estimated at the time of acquisition/installation, or at the time of subsequent revaluation of the asset. One of the bases for determining the residual value would be the realisable value of similar assets which have reached the end of their useful lives and have operated under conditions similar to those in which the asset will be used.

11. The quantum of depreciation to be provided in an accounting period involves the exercise of judgement by management in the light of technical, commercial, accounting and legal requirements and accordingly may need periodical review. If it is considered that the original estimate of useful life of an asset requires any revision, the unamortised depreciable amount of the asset is charged to revenue over the revised remaining useful life.

12. There are several methods of allocating depreciation over the useful life of the assets. Those most commonly employed in industrial and commercial enterprises are the straight-line method and the reducing balance method. The management of a business selects the most appropriate method(s) based on various important factors e.g., (i) type of asset, (ii) the nature of the use of such asset, and (iii) circumstances prevailing in the business. A combination of more than one method is sometimes used. In respect of depreciable assets which do not have material value, depreciation is often allocated fully in the accounting period in which they are acquired.

13. The statute governing an enterprise may provide the basis for computation of the depreciation. For example, the Companies Act, 1956 lays down the rates of depreciation in respect of various assets. Where the management's estimate of the useful life of an asset of the enterprise is shorter than that envisaged under the provisions of the relevant statute, the depreciation provision is appropriately computed by applying a higher rate. If the management's estimate of the useful life of the asset is longer than that envisaged under the statute, depreciation rate lower than that envisaged by the statute can be applied only in accordance with requirements of the statute.

14. Where depreciable assets are disposed of, discarded, demolished or destroyed, the net surplus or deficiency, if material, is disclosed separately.

15. The method of depreciation is applied consistently to provide comparability of the results of the operations of the enterprise from period to period. A change from one method of providing depreciation to another is made only if the adoption of the new method is required by statute or for compliance with an accounting standard or if it is considered that the change would result in a more appropriate preparation or presentation of the financial statements of the enterprise. When such a change in the method of depreciation is made, depreciation is recalculated in accordance with the new method from the date of the asset coming into use. The deficiency or surplus arising from retrospective recomputation of depreciation in accordance with the new method is adjusted in the accounts in the year in which the method of depreciation is changed. In case the change in the method results in deficiency in depreciation in respect of past years, the deficiency is charged in the statement of profit and loss. In case the change in the method results in surplus, the surplus is credited to the statement of profit and loss. Such a change is treated as a change in accounting policy and its effect is quantified and disclosed.

16. Where the historical cost of an asset has undergone a change due to circumstances specified in para 6 above, the depreciation on the revised unamortised depreciable amount is provided prospectively over the residual useful life of the asset.

## Disclosure

17. The depreciation methods used, the total depreciation for the period for each class of assets, the gross amount of each class of depreciable assets and the related accumulated depreciation are disclosed in the financial statements along with the disclosure of other accounting policies. The depreciation rates or the useful lives of the assets are disclosed only if they are different from the principal rates specified in the statute governing the enterprise.

Notes

18. In case the depreciable assets are revalued, the provision for depreciation is based on the revalued amount on the estimate of the remaining useful life of such assets. In case the revaluation has a material effect on the amount of depreciation, the same is disclosed separately in the year in which revaluation is carried out.

19. A change in the method of depreciation is treated as a change in an accounting policy and is disclosed accordingly.

**(The Accounting Standard comprises paragraphs 20-29 of this Statement. The Standard should be read in the context of paragraphs 1-19 of this Statement and of the 'Preface to the Statements of Accounting Standards'.)**

20. The depreciable amount of a depreciable asset should be allocated on a systematic basis to each accounting period during the useful life of the asset.

21. The depreciation method selected should be applied consistently from period to period. A change from one method of providing depreciation to another should be made only if the adoption of the new method is required by statute or for compliance with an accounting standard or if it is considered that the change would result in a more appropriate preparation or presentation of the financial statements of the enterprise. When such a change in the method of depreciation is made, depreciation should be recalculated in accordance with the new method from the date of the asset coming into use. The deficiency or surplus arising from retrospective recomputation of depreciation in accordance with the new method should be adjusted in the accounts in the year in which the method of depreciation is changed. In case the change in the method results in deficiency in depreciation in respect of past years, the deficiency should be charged in the statement of profit and loss. In case the change in the method results in surplus, the surplus should be credited to the statement of profit and loss. Such a change should be treated as a change in accounting policy and its effect should be quantified and disclosed.

22. The useful life of a depreciable asset should be estimated after considering the following factors:

    (i) Expected physical wear and tear;

    (ii) Obsolescence;

    (iii) Legal or other limits on the use of the asset.

23. The useful lives of major depreciable assets or classes of depreciable assets may be reviewed periodically. Where there is a revision of the estimated useful life of an asset, the unamortised depreciable amount should be charged over the revised remaining useful life.

24. Any addition or extension which becomes an integral part of the existing asset should be depreciated over the remaining useful life of that asset. The depreciation on such addition or extension may also be provided at the rate applied to the existing asset. Where an addition or extension retains a separate identity and is capable of being used after the existing asset is disposed of, depreciation should be provided independently on the basis of an estimate of its own useful life.

25. Where the historical cost of a depreciable asset has undergone a change due to increase or decrease in long term liability on account of exchange fluctuations, price adjustments, changes in duties or similar factors, the depreciation on the revised unamortised depreciable amount should be provided prospectively over the residual useful life of the asset.

26. Where the depreciable assets are revalued, the provision for depreciation should be based on the revalued amount and on the estimate of the remaining useful lives of such assets. In case the revaluation has a material effect on the amount of depreciation, the same should be disclosed separately in the year in which revaluation is carried out.
27. If any depreciable asset is disposed of, discarded, demolished or destroyed, the net surplus or deficiency, if material, should be disclosed separately.
28. The following information should be disclosed in the financial statements:
    (i) The historical cost or other amount substituted for historical cost of each class of depreciable assets;
    (ii) Total depreciation for the period for each class of assets; and
    (iii) The related accumulated depreciation.
29. The following information should also be disclosed in the financial statements along with the disclosure of other accounting policies:
    (i) Depreciation methods used; and
    (ii) Depreciation rates or the useful lives of the assets, if they are different from the principal rates specified in the statute governing the enterprise

## Self Assessment

Fill in the blanks:

21. A change in the …………………… of depreciation is treated as a change in an accounting policy and is disclosed accordingly.
22. …………………… has a significant effect in determining and presenting the financial position and results of operations of an enterprise.

## 10.6 Summary

- Fixed assets are those assets which are held with the intention of being used for the purpose of producing goods or providing services and are not held for the sale in the normal course of business.
- There are two basis for the valuation of fixed tangible assets – (a) historical cost (b) revaluation.
- The cost of fixed cost comprises of its purchase price and direct costs and import duties and directly attributable costs.
- At the time of revaluation of assets, the entire class of assets is revalued. The basis of revaluation should be disclosed.
- When the assets are purchased on the basis of Hire Purchase System, such assets are shown in the balance sheet at their cash value.
- There is special treatment of intangible assets as goodwill, patents, know-how, etc.
- Depreciation is the decrease in the value of assets at the given date due to wear and tear, obsolescence, efflux of time, accident and exhaustion.

Notes

- Cost of assets, residual value of assets, and useful life of assets are the important factors of depreciation.
- There are several methods for providing depreciation on fixed assets. The method of the depreciation is selected on the basis of various factors as – types of assets, nature of business and circumstances prevailing in the business etc.
- Depreciation is a permanent and gradual diminution in the value of an asset caused by usage and effluxion of time.
- The accounting treatment is designed to record all transactions of purchase and sale of an asset and charging of depreciation with the objective of reducing the value of an asset to zero or its residual value as the case may be.
- ***Types of Reserves***
    - *Capital reserve:* It is a mode for retaining profits in business, which are not available for distribution as dividends. It is always a credit balance.
    - *General reserve:* It means retention of a portion of profit, not for any particular purpose, but for the improvement of overall financial position of an enterprise.
- ***Types of Provisions***
    - *Provision for doubtful debts:* This provision is made on certain percentage of total debtors appearing in the trial balance. It is meant for the recovery of doubtful overdue account.
    - *Provision for discount on debtors:* This provision is also made on debtors and is treated as a loss for the current year.

## 10.7 Keywords

***Amortization:*** The process of writing off the intangible assets.

***Cost of Assets:*** It includes the cost of acquisition, installation, commissioning etc.

***Depreciable Assets:*** Assets which are used in business for more than one accounting year, have a limited useful life, and used in the business for production and not for the purpose of sale.

***Depreciation:*** A permanent fall in the value of assets due to its use in business, efflux of time, obsolescence and market changes.

***Fixed Assets:*** Those assets which are held in the business with an intention of being used in producing goods or providing services and not held for sale during the normal course of business, are called fixed assets.

***Reserve:*** It is allocation of profit. It is an amount set aside out of profits and is meant to strengthen, the general financial position of a business enterprise.

***Residual Value:*** It is that value which will be fetched from the sale of the assets on the expiry of the useful life of the assets.

***Useful Life of Assets:*** The estimated period for which the assets will be used in the business efficiently.

## 10.8 Review Questions

1. Explain the different components of cost of fixed assets.
2. Give the method of accounting at historical cost of tangible assets.

3. When the goodwill of the business is shown in the books? Should it be retained in the business? Explain.
4. What are the bases for the valuation of tangible fixed assets? Explain.
5. Explain the principles of valuation of intangible assets.
6. What information are disclosed in the financial statements regarding the valuation of fixed assets? Explain.
7. Explain the significance of depreciation? What factors should be kept in mind for determining the amount of depreciation?
8. What are the different methods of providing depreciation? Explain any three of them.
9. Differentiate between 'Fixed Installment Method' and 'Written Down Value Method'.
10. Define depreciation as per Accounting Standard VI? Explain the need and significance of providing depreciation.
11. Define depreciation.
12. What are the factors effecting depreciation?
13. State the meaning of reserves. Explain the different types of reserves.
14. Distinguish between:
    (i) Provision and Reserve
    (ii) Capital Reserve and Revenue Reserve
15. On 1st April 2005, Arjun Co. Ltd. purchased a plant costing ₹ 4,50,000 and spent ₹ 30,000 on its erection. The estimated effective life of the plant is 4 years with scrape value of ₹ 80,000. Calculate depreciation on the straight line method and show plant account of 4 years if:
    (i) Provision for depreciation is not maintained.
    (ii) Provision for depreciation is maintained.
16. On 1st January 2004, Arora & Company purchased second hand machinery for ₹ 1,85,000 and spent ₹ 10,000 on repair and ₹ 5,000 on installation. On 1st July, 2005 the company purchased second hand machinery for ₹ 50,000. On 1st July 2006 the machinery purchased on 1st January 2004, was sold for ₹ 1,40,000 and on the same date a fresh machine is purchased for ₹ 1,25,000. On 1st July, 2007 the machinery purchased for ₹ 50,000 on 1st July 2005 was sold for ₹ 10,000.
17. In 2004, depreciation was charged @10% on original cost, however, in 2005 the company decided to write-off depreciation @15% on written-down value method. Show the machinery account for 4 years.
18. Mr. Akshey took a lease for 5 years for ₹ 30,000. He decided to write off lease by annuity method presuming the rate of interest at 5% p.a. the annuity table shows that annual amount necessary to write off ₹ 1 in five years at 5% p.a. is ₹ 0.230975. Prepare the lease account for 5 years.
19. On 1st January, 2005, Mr. Aditya Raj purchased a three years lease of premises for ₹ 1,50,000 and it is decided to make provision for replacement of the losses by means of a depreciation fund. The expected rate of interest on investment is 5% p.a. The sinking fund table shows that ₹ 0.317208 at 5% p.a. will in 3 years accumulate ₹ 1. Show the journal entries and necessary accounts.

Notes

## Answers: Self Assessment

1. Concept of income
2. Fixed assets
3. Cost price
4. Depreciation funds
5. Straight line method
6. Purchase value
7. Financial position
8. Central Government
9. False
10. True
11. True
12. False
13. False
14. False
15. True
16. False
17. False
18. True
19. False
20. True
21. Method
22. Depreciation

## 10.9 Further Readings

*Books*

Dr. S.N. Maheshwari, Sharad, K. Maheshwari, *Financial Accounting*, Vikas Publishing Co. Pvt. Ltd., New Delhi.

Grewal, T.B, *Double Entry Book Keeping*.

Jain & Narang, Advanced Accountancy.

R.L. Gupta, M. Radhaswami, *Advanced Accountancy*, Sultan Chand, New Delhi.

T.S. Grewal, M.C. Shukla, *Advanced Accounts*, S. Chand, New Delhi.

*Online links*

www.futureaccountant.com

http://www.globusz.com/

# Unit 11: Bank Reconciliation Statement

Notes

CONTENTS



## Objectives

After studying this unit, you will be able to:

- Describe the purpose of bank reconciliation statement
- Identify the causes of difference in cash book and pass book
- Realise rectification of errors

## Introduction

Business organisations record all the cash and bank transactions in cash book of the company. The Bank also maintains an account for each customer in its book. A copy of this account is regularly sent to the customer by the bank which is called 'Pass Book' or 'Bank statement'. It is usually to tally the firm's bank transactions as recorded by the bank with the cash book but sometimes the bank balances as shown by the cash book and that shown by the bank statement do not match. If the balance shown by the pass book is different from the balance shown by bank column of cash book, the business firm will identify the causes for such difference. It becomes necessary to reconcile them. To reconcile the balances of Cash Book and Pass Book a statement is prepared. This statement is called the 'Bank Reconciliation Statement'.

## 11.1 Purpose of Bank Reconciliation Statement

The reconciliation statement is the most common tool used by organizations for reconciling the balance as per books of company with the bank statement and is made at the end of every month. The main objective of reconciliation is to ascertain if the discrepancy is due to error rather than timing.

It is prepared from time to time to check that all transactions relating to the bank are properly recorded by the businessman in the bank column of the cash book and by the bank in its ledger account. Thus, it is prepared to reconcile the bank balances shown by the cash book and by the bank statement. It helps in detecting, if there is any error in recording the transactions and ascertaining the correct bank balance on a particular date.

The need and importance of the bank reconciliation statement may be given as follows:

1. The reconciliation process helps in bringing out the errors committed either in Cash Book or Pass Book.

**Notes**

2. Bank reconciliation statement may also show any undue delay in the clearance of cheques.
3. Sometimes the cashier may have the tendency of cheating, like he makes entries in the Cash Book, but does not deposit the cash into bank. These types of frauds by the entrepreneur's staff or bank staff may be detected only through bank reconciliation statement. So this way bank reconciliation statement acts as a control technique too.

*Caution* Bank Reconciliation Statement is a statement prepared to reconcile the difference between the balances as per the bank column of the cash book and pass book on any given date.

### Self Assessment

Fill in the blanks:

1. The main objective of reconciliation is to ascertain if the discrepancy is due to error rather than …………………….
2. Direct payments made by banks will …………………… the balances in the pass book.
3. The bank reconciliation statement is prepared without making change in the …………………… balance.
4. While reconciling the pass book through the check book the interest allowed by banks will be …………………….
5. While reconciling the check book through pass book the interest and expenses will be …………………… from the balance as per pass book.

## 11.2 Causes of Difference

A transaction relating to bank has to be recorded in both the books i.e. Cash Book and Pass Book but sometimes it happens that a bank transaction is recorded only in one book and not recorded simultaneously in other book this causes difference in the two balances. The causes for difference may be illustrated in detail as follows:

1. ***Cheques issued by the firm but not yet presented for payment:*** When cheques are issued by the firm, these are immediately entered on the credit side of the bank column of the cash book. Sometimes, the receiving person may present these cheques to the bank for payment on some later date. The bank will debit the firm's account when these cheques are presented for payment. There is a time period between the issue of cheque and being presented in the bank for payment. This may cause difference to the balance of cash book and pass book.
2. ***Cheques deposited into bank but not yet collected:*** When cheques are deposited into bank, the firm immediately enters it on the debit side of the bank column of cash book. It increases the bank balance as per the cash book. But, the bank credits the firm's account after these cheques are actually realised. A few days are taken in clearing of local cheques and in case of outstation cheques few more days are taken. This may cause the difference between cash book and pass book balance.
3. ***Amount directly deposited in the bank account:*** Sometimes, the debtors or the customers deposit the money directly into firm's bank account, but the firm gets the information only when it receives the bank statement. In this case, the bank credits the firm's account with the amount received but the same amount is not recorded in the cash book. As a result the balance in the cash book will be less than the balance shown in the Pass Book.

4. ***Bank charges:*** The bank charge in the form of fees or commission is charged from time to time for various services provided from the customers' account without the intimation to the firm. The firm records these charges after receiving the bank intimation or statement.

*Example:* Interest on overdraft balance, credit cards' fees, outstation cheques, collection charges, etc.

As a result, the balance of the cash book will be more than the balance of the pass book.

5. ***Direct receipts by the bank:*** Sometimes, the interest on debentures or dividends on shares held by the account holder is directly deposited by the company through Electronic Clearing System (ECS). But the firm does not get the information till it receives the bank statement. As a consequence, the firm enters it in its cash book on a date later than the date it is recorded by the bank. As a result, the balance as per cash book and pass book will differ.

6. ***Direct payments made by the bank:*** Sometimes, bank makes certain payments on behalf of the customer as per standing instructions. Telephone bills, rent, insurance premium, taxes, etc., are some of the expenses. These expenses are directly paid by the bank and debited to the firm's account immediately after their payment but the firm will record the same on receiving information from the bank in the form of Pass Book or bank statement. As a result, the balance of the pass book is less than that of the balance shown in the bank column of the cash book.

7. ***Dishonour of cheques/bill discounted:*** If a cheque deposited by the firm or bill receivable discounted with the bank is dishonoured, the same is debited to firm's account by the bank. But the firm records the same when it receives the information from the bank. As a result, the balance as per cash book and that of pass book will differ.

8. ***Errors committed in recording transactions by the firm:*** There may be certain errors from the firm's side, e.g., omission or wrong recording of transactions relating to cheques deposited, cheques issued and wrong balancing etc. In this case, there would be a difference between the balances as per Cash Book and as per Pass Book.

9. ***Errors committed in recording transactions by the Bank:*** Sometimes, bank may also commit errors, e.g., omission or wrong recording of transactions relating to cheques deposited etc. As a result, the balance of the bank pass book and cash book will not agree.

*Notes*

- The Bank Reconciliation Statement is prepared as on a particular date to reconcile the balances as per the cash book and as per the bank statement by identifying the causes of the difference and showing their impact.
- The Bank Reconciliation Statement is not a part of books of accounts.
- Causes of difference in the balances as per the cash book and the bank statement can be many, like cheques issued but not presented for payment, cheques deposited but not yet credited, etc.

***Illustration 1:*** Both the balances as per the cash book and the bank statement are positive.

XYZ Ltd. maintains a current account with the State Bank of India. As on 31st March, 2004, the bank column of its cash book showed a debit balance of ₹ 1,54,300. However, the bank statement showed a different balance as on that date.

Notes

The following are the reasons for such a difference:

| | | (₹) |
|---|---|---|
| (i) | Cheques deposited but not yet credited by the bank | 75,450 |
| (ii) | Cheques issued but not yet presented | 80,760 |
| (iii) | Bank charges not yet recorded in the cash book | 1,135 |
| (iv) | Cheques received by the bank directly | 1,35,200 |
| (v) | Insurance premium paid by the bank as per standing instructions not yet intimated | 15,400 |

Find out the balance as per the bank statement.

**Bank Reconciliation Statement**
**as on 31st March, 2004**

| Particulars | Amount (₹) | Amount (₹) |
|---|---|---|
| Bank balance as per the cash book | | 1,54,300 |
| *Add:* | | |
| Cheques issued but not yet presented | 80,760 | |
| Cheques received by the bank directly not recorded in the cash book | 1,35,200 | |
| | | 2,15,960 |
| | | 3,70,260 |
| *Deduct.* | | |
| Cheques deposited but not yet credited | 75,450 | |
| Bank charges not yet recorded in the cash book | 1,135 | |
| Insurance premium paid by the bank directly as per standing instructions | 15,400 | |
| | | 91,985 |
| Balance as per the pass book | | 278,275 |

***Illustration 2:*** Both the balances as per the cash book and the bank statement are negative.

Ashok Ltd.'s cash book showed a bank overdraft of ₹ 76,240 as on 30th June, 2004. The bank statement as on that date also showed an overdraft but the figure is different. The following are the causes:

| | | (₹) |
|---|---|---|
| (i) | Cheques deposited but not yet collected | 1,02,500 |
| (ii) | Cheques issued but not yet presented for payment | 76,200 |
| (iii) | A cheque of ₹ 10,500 deposited on 25th May 2004 was dishonoured on 29th June 2004 but not intimated by bank till 30th June, 2004 | |
| (iv) | Bank charges not recorded in the cash book | 2,760 |
| (v) | Interest on overdraft not intimated | 1,250 |

**Bank Reconciliation Statement**
**as on 30th June, 2004**

| Particulars | Amount (₹) | Amount (₹) |
|---|---|---|
| Bank overdraft as per the cash book | | 76,240 |
| *Add:* | | |
| Cheques deposited but not yet collected by the bank | 1,02,500 | |
| Cheque dishonoured by the bank not yet recorded | 10,500 | |
| Bank charges not yet recorded | 2,760 | |
| Interest on overdraft not yet intimated | 1,250 | |
| | | 1,17,010 |
| | | 1,93,250 |
| *Deduct:* | | |
| Cheques issued but not yet presented for payment | | 76,200 |
| Overdraft as per the bank statement | | 1,17,050 |

***Illustration 3:*** The cash book showing a favourable balance and the bank statement showing an overdraft.

The bank statement of Karan & Co. showed an overdraft of ₹ 56,740 as on 30th September, 2004. The cash book, however, showed a positive balance of ₹ 45,520 as on the same date. The accountant of Karan & Co. found that the difference in the balance was due to the following:

| | | (₹) |
|---|---|---|
| (i) | Cheques issued to supplier not yet presented | 1,54,320 |
| (ii) | Cheques deposited in the bank not yet credited by the latter | 2,06,200 |
| (iii) | A cheque received by the bank from a customer has been wrongly credited by the bank in Andersen & Co. account | 64,720 |
| (iv) | Dividend received by the bank not yet intimated | 15,740 |
| (v) | Bank charges not yet recorded in the cash book | 1,400 |

**Bank Reconciliation Statement**
**as on 30th September, 2004**

| **Particulars** | **Amount (₹)** | **Amount (₹)** |
|---|---|---|
| Overdraft as per the bank statement | | 56,740 |
| *Add:* | | |
| Cheques issued to supplier not yet presented | 1,54,320 | |
| Dividend received by the bank not yet intimated | 15,740 | |
| | | 1,70,060 |
| | | 2,26,800 |
| *Deduct:* | | |
| Cheques deposited not yet credited by the bank | 2,06,200 | |

*Contd...*

Notes

| | | |
|---|---|---|
| Cheque received from a customer wrongly credited by the bank in Andersen & Co. A/c | 64,720 | |
| Bank charges not yet recorded | 1,400 | |
| | | 2,72,320 |
| Bank balance (debit) as per the cash book | | 45,520 |

You may notice here that the nature of the balance is reversed (overdraft to favourable) because the deductions are more than the additions or, to put it simply, the balance is reversed if you get a negative figure.

***Illustration 4:*** From the following particulars, prepare Bank Reconciliation statement of Rajesh as on 31st December 2006.

(a) Balances as per cash book on 31st December 2006 ₹ 4,250.

(b) Cheques for ₹ 3,100 were issued during the month of December, but only cheques for ₹ 1,400 were presented for payment during December.

(c) Cheque and cash amounting to ₹ 5,900 were deposited in the bank during the month of December but credit was given only for ₹ 3,450.

(d) The bank paid during December 2006 a sum of ₹ 495 as life insurance premium.

(e) The bank credited ₹ 100 as interest and debited ₹ 45 as bank charges, for which there were no corresponding entries in the cash book.

***Solution:***

**Bank Reconciliation Statement of Rajesh as on December 31, 2006.**

| | | ₹ | ₹ |
|---|---|---|---|
| | **Bank balance as per Cash Book** | | **4250** |
| *Add:* | Cheque issued but not yet presented for payment | 1700 | |
| | Interest credited only in the pass book | 100 | 1800 |
| | | | 6050 |
| *Less:* | Cheque deposited but not yet credited by the book | 2450 | |
| | Life insurance premium debited only in the pass book | 495 | |
| | Bank charges debited only in the pass book | | 45 |
| | | | 2990 |
| | **Bank balance as per Pass Book** | | **3060** |

***Illustration 5:*** From the following transactions prepare Bank Reconciliation Statement as on March 31, 2007 of a firm.

(a) Bank balance as per pass book ₹ 9,800.

(b) A cheque of ₹ 5,000 deposited into bank on March 26, 2007, was credited in the first week of April.

(c) Cheque issued to a creditor ₹ 7,000 on March 28, 2007 was presented to the bank on April 8, 2007.

(d) A cheque of ₹ 2,000 deposited into the bank was found dishonoured but the entry of dishonour is pending in the cash back.

(e) A cheque of ₹ 3,000 issued to Mr. Alex was dishonored due to the difference in the amount mentioned in words, but the entry of dishonour is not yet done in the cash book.

(f) A cheque of ₹ 4,000 was deposited in the bank and found credited before March 31, 2007 but omitted to record in the cash book.

(g) A cheque of ₹ 5,000 received from customer and debited to the bank column of the cash book, but not sent to the bank.

(h) A wrong debit of ₹ 500 was found in the bank column of the cash book

(i) A wrong debit of ₹ 2,000 was found in the pass book.

(j) Bank charges ₹ 100 found debited in the pass book.

(k) A draft of ₹ 5,000 has been sent to the Supplier of Machine and credited to cash book (bank column) but an additional debit of ₹ 50 was made in the bank for charges.

(l) Bills payable ₹ 10,000 was paid by the bank at a discount of 2%, but the full credit was given to the bank account in the cash book.

(m) Direct payments made by customers into the bank amounted to ₹ 8,000, but intimation was given to the business in the first week of April.

***Solution:***

**Bank Reconciliation Statement as on March 31, 2007.**

| | | ₹ | ₹ |
|---|---|---|---|
| | **Bank balance as per Pass Book** | | **9,800** |
| *Add:* | Cheque deposited but not yet credited by the bank | 5,000 | |
| | Cheque deposited dishonoured debited in the pass book but not entered in the cash book | 2,000 | |
| | Cheque received but not sent to bank | 5,000 | |
| | Wrong debit in the cash book | 500 | |
| | Wrong debit in the pass book | 2,000 | |
| | Bank charges debited only in the pass book | 100 | |
| | Discount charges are entered only in the pass book | 200 | 14,800 |
| *Less:* | Cheque issued but not presented for payment | 7,000 | |
| | Cheque issued dishonoured entered in the pass book but not entered in the cash book | 3,000 | |
| | Cheque deposited and entered in the pass book but not entered in the cash book | 4,000 | |
| | Bank charges debited only in the pass book | 50 | |
| | Direct payments entered in the pass book but not entered in the cash book | 8,000 | (22,050) |
| | **Bank balance as per Cash Book** | | **2,550** |

**Notes:**

| **Pass book credit balance is given and cash book balance is to be found** | **Pass Book Cr. ₹ (1)** | **Cash Book Dr. ₹ (2)** | **Adjustment to be made. (2–1)** |
|---|---|---|---|
| Let us assume initially bank balance was same in cash book and pass book | 20,000 | 20,000 | |
| Effect of each reason on these balances | | | |
| (b) | 20,000 | 25,000 | Add ₹ 5,000 |
| (c) | 20,000 | 13,000 | Deduct ₹ 7,000 |
| (d) | 20,000 | 22,000 | Add ₹ 2,000 |
| (e) | 20,000 | 17,000 | Deduct ₹ 3,000 |

Notes

*Example:* Rectification of the Cash Book.

As we have already mentioned that the difference in the bank balances may be due to some errors or omissions committed by you. So, you have to make necessary amendments in the cash book first and then prepare a bank reconciliation statement.

Verma Ltd. showed a bank balance of ₹ 1,24,250 as on 31st March, 2004. The bank statement, however, showed a different figure. The following items were detected:

| | | (₹) |
|---|---|---|
| (i) | Cheques deposited but not yet credited by the bank | 1,74,020 |
| (ii) | Cheques issued but not yet presented for payment | 1,06,240 |
| (iii) | The balance in the bank column of the cash book on page 23 has been carried forward as ₹ 45,720 instead of ₹ 45,270. | |
| (iv) | Bank charges not yet recorded | 1,045 |
| (v) | A cheque received from a customer has been wrongly shown in the cash column of the cash book instead of the bank column | 26,740 |

**Cash Book (Bank Column Only)**

**Dr.** **Cr.**

| Date | Particulars | V No | JF | Amount (₹) | Date | Particulars | V No | JF | Amount (₹) |
|---|---|---|---|---|---|---|---|---|---|
| 2004 | | | | | 2004 | | | | |
| 31st March | To Balance b/d | | | 1,24,250 | 31st March | By Carry forward error | | | 450 |
| | To cash a/c | | | 26,740 | | By Bank Charges | | | 1,045 |
| | (Cheque received wrongly shown in cash column) | | | | | By Balance c/d | | | 1,49,495 |
| | | | | 1,50,990 | | | | | 1,50,990 |

**Bank Reconciliation Statement**
**As on 31st March, 2004**

| Particulars | Amount (₹) | Amount (₹) |
|---|---|---|
| Bank balance (amended) as per cash book | | 1,49,495 |
| *Add:* | | |
| Cheques issued but not yet presented for payment | | 1,06,240 |
| | | 2,55,735 |
| *Less:* | | |
| Cheques deposited but not yet credited by the bank | | 1,74,020 |
| Balance as per the bank statement | | 81,715 |

*Task* On December 31, 2006, the cash book of the M/s Mona Plastics shows the credit balance ₹ 6,500. Cheques amounting to ₹ 3,500 deposited into bank but were not collected by the bank. Firm issued cheques of ₹ 1,000 which were not presented for payment. There was a debit in the pass book of ₹ 200 for interest and ₹ 400 for bank charges. Prepare Bank Reconciliation Statement.

*Caselet*

## Probe Blames Lack of Internal Controls

An independent legal counsel appointed by IT major Wipro has found that lack of internal controls led to the embezzlement committed by one of the former junior employees between November 2006 and December 2009.

The legal counsel submitted the probe report last week to the audit committee set up to investigate the fraud early.

Based on the findings of the legal counsel, Wipro said that if corrections were to be carried out to the annual financial results of the company in view of the "misstatements identified during the probe together with other "uncorrected audit adjustments'', profit-after-tax for 2009-10 would have been higher by 2.1 per cent (approximately ₹ 92 crore). Wipro's Chief Financial Officer, Mr Suresh C. Senapaty, told Business Line that the external legal counsel was appointed on the advice of the SEC. "He formally submitted the report this month and measures have already been taken to tighten the system," he said. Stating that it has been able to recover most of the embezzled amounts, Wipro, which is listed on the New York Stock Exchange, in its latest disclosure to the US Securities and Exchange Commission, said its audit panel has concluded that mistakes were committed in certain accounting entries and that they were also not supported by any documents. "We and our independent registered public accounting firm also identified the lack of internal controls that gave rise to the embezzlement and financial statement misstatements as material weaknesses in internal control over financial reporting," Wipro said in its disclosure to SEC. The material weaknesses related to sharing of online banking access passwords and Wipro's internal accounting system passwords by certain employees within the finance and accounting departments including those responsible for external financial reporting.

There was lack of effective controls over recording of journal entries, including inadequate documentation which resulted in ineffective controls over bank reconciliation statements, exchange rate fluctuation accounts and outstanding liabilities accounts and also there was lack of timely and adequate reconciliation and review of period and end reinstatement of foreign currency inter-company and unit balances, including recording of appropriate adjustments. Also, segregation of duties with respect to recording and initiating banking payments was found insufficient.

***Source:*** http://www.thehindubusinessline.in/2010/11/17/stories/2010111753810100.htm

Notes

## Self Assessment

Fill in the blanks:

6. Overdraft means ……………………… balance.
7. The balance of cash book is ……………………… in case of overdraft.
8. Bank charges will ……………………… in case of overdraft as per Cash Book.
9. Cheques issued but not encashed will ……………………… in case of the overdraft as per Pass Book.
10. Interest allowed by bank …………………… in case of the favourable balance of cash book.

## 11.3 Summary

- The bank reconciliation statement is prepared as on a particular date to reconcile the differences between the check books and pass book by identifying the causes of difference and showing their impact.
- There are a lot of reasons due to which the balances of a cash book and pass book do not match, and then the bank reconciliation statement is prepared to reconcile both the balances.
- The bank reconciliation statement facilitates checking of errors and frauds in the books of accounts.

## 11.4 Keywords

***Bank Overdraft:*** If the bank statement shows a debit balance at a particular point of time, it is known as overdraft. It implies that the account is overdrawn, i.e., withdrawals are more than deposits.

***Bank Statement:*** It gives the details of transactions between the bank and the customer. Every bank provides bank statements to each customer either weekly or monthly.

***Pay-in-Slips:*** Documents supporting cheques deposited into the bank.

## 11.5 Review Questions

1. What is a Bank Reconciliation statement?
2. Why is a bank reconciliation statement prepared?
3. What are the causes of differences between the bank balance shown by cash book and the balance shown by bank statement?

Notes

4. The following cash book (bank column) and bank statement of M/s XYZ are available for the month of April 2004:

**Cash Book (Bank Column) Only**

**Dr.** **Cr.**

| Date | Particulars | Amount (₹) | Date | Particulars | Amount (₹) |
|---|---|---|---|---|---|
| 2004 | | | 2004 | | |
| April | | | April | | |
| 1 | To Balance b/d | 27,340 | 3 | By Salary | 57,975 |
| | | | | (Chq. No. 14625) | |
| 5 | To Debtors: | | 4 | By Creditors: | |
| | Cheques 475923 | 37,230 | | Cheques 14626 | 36,940 |
| | | 576264 | | | 45,200 |
| | | 14632 | | | 47,950 |
| | | 71924 | | | 15,425 |
| | | 14633 | | | 68,960 |
| | | 82569 | | | 25,626 |
| | | | 7 | By Insurance Premium | |
| 6 | To Bills Receivable | 17,250 | | Chq. No. 14627 | 13,740 |
| 7 | To Interest | | 8 | By Creditors: | |
| | (Chq. No. 565260) | 4,640 | 8 | Chq. No. 1462 | 37,940 |
| 10 | To Cash | 25,640 | | Chq. No. 14629 | 61,255 |
| 12 | To Dividend | 18,240 | | Chq. No. 14630 | 42,960 |
| | (Chq. No. 266640) | 14631 | | | 55,200 |
| 15 | To Debtors: | | | | |
| | Chq. No. 55655 | 79,240 | | | |
| | Chq. No. 66926 | 54,500 | 13 | By Cash | 15,640 |
| | Chq. No. 36246 | 30,000 | 15 | By Loan | |
| | Chq. No. 37923 | 25,650 | | (Chq. No. 14634) | 30,000 |
| | | | | (Instalment) | |
| 18 | To Dividend | 12,655 | 20 | By Creditors: | |
| | (Chq. No. 264923) | | | Chq. No. 14635 | 25,300 |
| | | | | Chq. No. 14636 | 17,920 |
| | | | | Chq. No. 14637 | 50,000 |
| 25 | To Debtors: | | | | |
| | Chq. No. 74243 | 86,240 | | | |
| | Chq. No. 92765 | 33,943 | | | |
| | Chq. No. 77237 | 57,940 | 30 | by Balance | 34,979 |
| | | 5,96,759 | | | 5,96,759 |

Notes

**Super Bank Ltd.**
**Bank Statement of M/s XYZ**
**for the month of April 2004**

| Date | Details | Dr. (₹) | Cr. (₹) | Balance (₹) |
|---|---|---|---|---|
| April 2004 | | | | |
| 1 | Balance | | | 75,760 |
| 3 | To Chq. No. 14625 | 57,975 | | |
| 6 | By Bills discounted | | 17,250 | 35,035 |
| 8 | By Chq. No.475923 | | 37,230 | 72,265 |
| 9 | To Chq. No. 14626 | 36,940 | | 35,325 |
| 10 | By Chq. No. 565260 | | 4,640 | 39,965 |
| ″ | ″ Cash | | 25,640 | 65,605 |
| 13 | To Cash | 15,640 | | 49,965 |
| 15 | ″ Chq. No. 14632 | 47,950 | | 2,015 |
| ″ | By Chq. No.576264 | | 45,100 | 47,115 |
| ″ | ″ Chq. No. 71924 | | 15,325 | 62,440 |
| 16 | To Chq. No.14633 | 68,960 | | (6,520) |
| 17 | By Chq. No. 266640 | | 18,200 | 11,680 |
| 18 | To Chq. No. 14634 | 30,000 | | (18,320) |
| 20 | By Chq. No.55655 | | 79,240 | 60,920 |
| ″ | ″ Chq. No. 66926 | | 54,250 | 1,15,170 |
| 22 | To Chq. No. 14628 | 37,940 | | 77,230 |
| ″ | ″ Chq. No. 14629 | 61,255 | | 15,975 |
| 23 | By Chq. No. 264923 | | 12,640 | 28,615 |
| 28 | ″ Chq. No. 36246 | | 29,640 | 58,255 |
| ″ | ″ Chq. No. 74243 | | 86,240 | 1,44,495 |
| ″ | To Chq. No. 14575 | 48,420 | | 96,075 |
| 29 | To Chq. No. 14630 | 42,960 | | 53,115 |
| 30 | Balance | | | 53,115 |

A cheque (No. 14575) issued to supplier on 28th March 2004 has been debited in the bank statement on 28th April 2004.

Read the above details carefully and prepare a bank reconciliation statement as on 30th April 2004.

5. Akash Ltd.'s books showed a bank balance of ₹ 1,54,360. The bank statement showed a different figure. The following differences were detected:

| | | (₹) |
|---|---|---|
| (i) | Cheques deposited but not yet credited by bank | 1,56,340 |
| (ii) | Cheques issued but not yet presented for payment | 1,76,260 |
| (iii) | Cheques received by the bank directly | 1,46,200 |

Notes

| | | |
|---|---|---|
| (iv) | A cheque for ₹ 76,500 deposited in the bank was dishonoured but not yet recorded in cash book | |
| (v) | Bank charges not yet recorded | 1,760 |
| (vi) | A cheque deposited in bank has been wrongly credited by the latter in Neptune's account | 46,740 |
| (vii) | Dividend received by the bank not intimated | 20,200 |

Prepare a bank reconciliation statement after making necessary amendments in the cash book.

## Answers: Self Assessment

1. Timing
2. Decrease
3. Cash book
4. Added
5. Deducted
6. Unfavourable
7. Credit
8. Increase
9. Decrease
10. Adds

## 11.6 Further Readings

*Books*

Khan and Jain, "Management Accounting".

M.P. Pandikumar, "Accounting & Finance for Managers", Excel Books, New Delhi.

R.L. Gupta and Radhaswamy, "Advanced Accountancy".

S.N. Maheswari, "Management Accounting".

V.K. Goyal, "Financial Accounting", Excel Books, New Delhi.

*Online links*

www.cbdd.edu

www.futureaccountant.com

www.textbooksonline.tn.nic.in

Notes

# Unit 12: Corporate Financial Statements

**CONTENTS**



## Objectives

After studying this unit, you will be able to:

- Understand the nature of corporate financial statements
- Have types of corporate financial statements
- Use of corporate financial statements
- Describe the limitation of corporate financial statements

## Introduction

Corporate entities registered in India are primarily guided by the provisions of the Companies Act, 1956. Every company is required to keep proper books of accounts showing all money received and spent and the details thereof; sale and purchase of goods; income earned and expenses accrued and assets and liabilities. As per the provisions of the Companies Act, 1956 proper books of accounts shall not be deemed to be kept if such books are insufficient to give a true and fair view of the state of affairs of a company.

*Did u know?* **What is proper books of account?**

Two essential conditions are to be satisfied for a set of books of accounts to be called proper books of account:

(a) Double entry accounting is followed while recording transactions.

(b) The books of accounts are maintained on accrual basis.

Section 209 of the Companies Act, 1956 states that proper books of accounts shall be maintained at the company's registered office unless the Board of Directors decides to keep them at another place in India. A company gets its funds partly from its owners and partly from lenders. Owners' contribution is called equity share capital. In fact, there are traditionally two types of shares recognised in the Companies Act—Equity Share and Preference Share. Of late, a new class of share is allowed to be issued—Non-voting Share. Preference shareholders enjoy privilege or preference over equity shareholders on two counts:

(i) in respect of dividend (distribution of profits) and

(ii) in respect of repayment of principal in case of liquidation of a company.

Thus, equity shareholders are real risk takers and hence they are the true owners of a company.

The external borrowings by the company may be in the form debentures, term loans from financial institutions or commercial banks, public deposits, etc. The external borrowings have a definite cost in the sense that they are to be serviced at a fixed rate of interest periodically. Even preference shareholders are paid a predetermined rate of dividend. But since equity shareholders have a 'residual' interest in profits, they are not paid a fixed rate of dividend. Dividend on equity shares is a function of profit.

Companies earn profits as they carry on business. No company expects a loss to be incurred—loss is only an accident or an unwelcome feature. The entire profits are not distributed as dividend—a part of the profit is kept as 'reserves' to meet any future contingencies or to plough back in the business. A company also creates provision to meet any specific future happening. The only difference between a reserve and a provision is that reserve is created for some unforeseen event whereas provision is created for a known liability of which the amount cannot be determined with substantial accuracy.

The funds thus generated from internal and external sources are applied to acquire fixed assets and also to acquire current assets, like inventories.

It can be mentioned here that companies registered in India will have to follow Indian GAAP (Generally Accepted Accounting Principles) while preparing and presenting their financial statements. Indian GAAP generally comprise of three regulatory frameworks: (a) the Companies Act, 1956; (b) the Accounting Standards of ICAI; and (c) the SEBI disclosure norms. The third framework (c) is applicable only in case of listed companies. Consider the following paragraph which clearly articulates the basis of preparation of financial statements:

"…… The financial statements are prepared in accordance with Indian Generally Accepted Accounting Principles ("GAAP") under the historical cost convention on the accruals basis. GAAP comprises mandatory accounting standards issued by the Institute of Chartered Accountants of India ("ICAI"), the provisions of the Companies Act, I956, and guidelines issued by the Securities and Exchange Board of India……..

The preparation of the financial statements in conformity with GAAP requires management … to make estimates and assumptions that affect the reported balances of assets and liabilities and disclosures relating to contingent assets and liabilities as at the date of the financial statements and reported amounts of income and expenses during the period……. Actual results could differ from those estimates." (Source: Annual Report, Infosys Technologies Ltd.)

The above statement highlights another feature of financial statements. The preparers of financial statements are required to make estimates and apply judgments while reporting the financial elements. The readers of financial statements are, therefore, forewarned that actual results could vary from the estimates.

The resultant impact of the performance of a company is measured periodically through the preparation of financial statements. Thus, financial statements are external reports. At the end of every accounting period, each company comes out with a printed annual report which is a public document. The annual report comprises of normally the following:

(a) Chairman's statement.

(b) Report from board of directors

(c) Financial statistics.

(d) Financial statements.

(e) Auditors' report.

(f) Major accounting policies.

(g) Consolidated financial statements (if applicable).

## 12.1 Nature of Corporate Financial Statements

The corporate financial statements are the financial reports or formal record of the financial and business activities of a firm. The corporate financial statements actually give a summary of the financial condition and profitability of the firm in both long- and short-term. The corporate financial statements are generally complex in nature as they contain analysis and discussion on the management decisions and financial statement notes. The financial statement notes define each and every item in the balance sheet besides describing cash flow statement and income statement in details.

*Caution* In India, every company has to present its financial statements in the form and contents as prescribed under Section 211 of the Companies Act, 1956.

### 12.1.1 Objective of Corporate Financial Statements

The prime objective of **corporate financial statements** is to give information on the performance, financial strength and financial position changes of a company. This financial statement is valuable for the users while they go for economic decisions. The major criterion of a financial statement is that it should be relevant, comparable, understandable and reliable. The financial position of a company refers to the reported equity, assets and liabilities while the financial performance of a company refers to the reported income and expenditures of the company. The corporate financial statements are understood by those people who have significant knowledge of economics and business activities.

## 12.2 Types of Corporate Financial Statements

The four basic types of corporate financial statements are:

- Income statement
- Balance sheet
- Statement of cash flows
- Statement of retained earnings

### 12.2.1 Income Statement

The income statements are also called as the profit loss statements. This statement gives information on the result of various operations of the company over a term period. An income statement is a type of summary flow report that lists and categorizes the various revenues and expenses that result from operations during a given period - a year, a quarter or a month. The difference between revenues and expenses represents a company's net income or net loss. The amounts shown in the income statement are the amounts recorded for the given period – a year, a quarter or a month. The next period's income statement will start over with all amounts reset to zero.

While the balance sheet shows accumulated balances since inception, the income statement only shows the amounts earned or expensed during the period in question. Some of the key indicators reported on the income statement include:

- Revenues are simply the annual incoming revenue flow, usually broken into different categories (reflecting the different lines of the company's business).
- Operating expenses include the expenses directly associated with the firm's day-to-day operations, including wages and salaries, benefits, supplies, parts, raw materials, rents and leases, etc. This is sometimes called the company's "cost of sales."
- Operating profit equals revenues minus direct operating expenses, before deducting certain overhead costs (such as interest expenses, R&D costs, restructuring charges, etc.) which are associated with the firm's overall existence (rather than with its specific day-to-day operations). A strong operating profit is a sign of the inherent underlying profitability of the company's real business activity.
- Other deductions are then subtracted from the company's operating profit, to generate an estimate of its final bottom-line profitability. Two of the most important of these are interest costs and depreciation. Interest costs are the actual cash payments made to banks and other lenders (including bondholders) from whom the company has borrowed money to finance its various activities. Depreciation, on the other hand, is an imaginary charge that reflects the gradual wearing out of the actual machinery, equipment, buildings, and other real assets which the firm uses in its business. The company doesn't actually have to "pay" anyone for this wear-and-tear, but it does have to recognise in its income statement the inevitable decline in the value of these assets.
- Special one-time charges are also sometimes deducted at this stage of the income statement, including one-time payouts for severance costs and other expenses associated with layoffs or downsizing, or one-time "write-offs" of capital value by companies who are experiencing chronic losses. In some cases, a researcher will want to analyse a company's profits before these special one-time charges, in cases where you want to demonstrate the continuing viability of a company's core business (a picture which can be clouded by one-time charges).
- Net income before tax equals the overall final profit of the company after all these various charges are considered.
- Net income is the company's final profit, after deducting a charge for income tax. If the company has generated a before-tax loss, sometimes the income tax charge is positive, since the company can set these losses against other profits (historical or anticipated) to reduce its tax payments; this is called a "tax recovery." Some income statements will provide additional details on how this net income is distributed between different categories of the company's owners. For example, many companies have "preferred shareholders," who may receive a special dividend out of the company's profits, before any remaining profits are ascribed to the company's other or "common" shareholders. But if it is the profitability of the company that you are interested in, not the well-being of a particular group of shareholders, then you will want to analyse the company's net income before any distributions to preferred shareholders.

Notes

*Example:* The following example shows some of the common elements of the Income Statement.

**Sample Company Income Statement**
**January 1, 2009 to December 31, 2009**

| Particulars | Amount | Amount |
|---|---|---|
| **Income** | | |
| Gross Sales | 346,400 | |
| Less returns and allowances | 1,000 | |
| Net Sales | | 345,400 |
| Cost of Goods | | |
| Merchandise Inventory, January 1 | 160,000 | |
| Purchases | 90,000 | |
| Freight Charges | 2,000 | |
| Total Merchandise Handled | 252,000 | |
| Less Inventory, December 31 | 100,000 | |
| Cost of Goods Sold | | 152,000 |
| Gross Profit | | 193,400 |
| Interest Income | | 500 |
| **Total Income** | | **193,900** |
| **Expenses** | | |
| Salaries | 68,250 | |
| Utilities | 5,800 | |
| Rent | 23,000 | |
| Office Supplies | 2,250 | |
| Insurance | 3,900 | |
| Advertising | 8,650 | |
| Telephone | 2,700 | |
| Travel and Entertainment | 2,550 | |
| Dues & Subscriptions | 1,100 | |
| Interest Paid | 2,140 | |
| Repairs & Maintenance | 1,250 | |
| Taxes & Licenses | 11,700 | |
| **Total Expenses** | | **133,290** |
| **Net Income** | | **₹ 60,110** |

## 12.2.2 Balance Sheet

The balance sheet is based on the equation: assets = liabilities + owners' equity. The balance sheet is also known as the statement of financial condition or position. It gives information on the net equity, assets and liabilities of a company at a given point of time. It indicates everything the company owns (assets), everything the company owes to creditors (liabilities) and the value of the ownership stake in the company (shareholders' equity, or capital). The balance sheet date

Notes

is the ending date of the period or year, and is a continuation of the amounts recorded since the inception of the company or organization. The balance sheet is a "snapshot" of the financial position of the company at the balance sheet date and shows the accumulated balance of the accounts. Assets and liabilities are separated between *current* and *long-term*, where current items are those items, which will be realized or paid, within one year of the balance sheet date. Typical current assets are cash, prepaid expenses, accounts receivable and inventory. The major categories reported on the balance sheet include:

- Assets are divided into various categories: current assets (including cash or other highly liquid financial assets, accounts receivable, and the value of inventories), and fixed assets or investments. The fixed assets item includes the "book" value of the company's accumulated purchases of property and equipment: that is, what the company paid for those assets, less their estimated depreciation over the years they have been used. This book value may differ from the actual usefulness or resale value of those assets.
- Liabilities are also divided into current and long-run. Current liabilities include accounts payable, and the value of debt and interest on debt that is due within the next year. Another major liability is the company's long-term debt (that which comes due later than one year from the present).
- Shareholder's equity is a special kind of liability. The shareholders' equity, in essence, is what the company "owes" to its own shareholders. It is equal to the value of the company's assets, minus what the company owes to people or businesses other than its own shareholders.

Another term for this value is the "net worth" of the company. A company's shareholders' equity should (by definition) equal the value of any initial equity funds advanced by the shareholders (through public offerings of new stock or other financing methods), plus the cumulative value of the company's retained earnings (that is, that portion of the company's past profits which were not paid back to shareholders in the form of dividends). Because equity is treated as a liability, the company's total assets and total liabilities (including shareholders' equity) are always equal. If a company's accumulated liabilities (excluding shareholders' equity) are greater than its total assets, then shareholders' equity is negative. Usually, a company will only have negative shareholders' equity if it has experienced a string of losses, which have more than wiped out the value of the equity which shareholders put into the company (through their initial investments in the company) and any accumulated profits which the company earned in earlier, happier times. A company with negative equity is usually (but not always) facing a serious risk of bankruptcy.

*Example:* **Sample Balance Sheet**

**Sample Balance Sheet**
**for the Month Ended __________**

| Asset | (₹) | Liabilities | (₹) |
|---|---|---|---|
| Cash | 15,300 | Accounts Payable | – |
| Accounts Receivable | 1,000 | Equity | 600 |
| Supplies | 500 | Sample Business Plan, Capital | 51,200 |
| Land | 10,000 | Other | – |
| Building | 25,000 | Total Liabilities | – |
| Total Assets | 51,800 | Owner's Equity | 51,800 |

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### 12.2.3 Statement of Cash Flow

The statement of cash flow gives information on the cash flow activities of a company. This statement specially covers the fields of investment, operation and financing activities of the company. The statement of cash flow shows all sources and uses of a company's cash during the accounting period. Sources of cash listed on the statement include revenues, long-term financing, sales of noncurrent assets, and an increase in any current liability account or a decrease in any current asset account. Uses of cash include operating losses, debt repayment, equipment purchases and increases in current asset accounts.

The main items covered in the cash flow statement include:

- **Cash generated from operating** details the actual cash surplus raised by a company's day-today business. This is sometimes referred to, for short, as a company's "cash flow." It will equal the company's net after tax profit (from the income statement), adjusted for any noncash revenues or expenses which were included on the income statement. For example, depreciation (which is an imaginary charge deducted from revenue in the income statement) is added back in, on this statement, as are deferred taxes, one-time non-cash charges and provisions, and other non-cash charges. The bottom line of this section tells you how much actual money was generated by a company's business in the previous period.
- **Cash provided by financing activities** reports on any net cash that was raised by the company from financial markets – such as new loans from banks or bondholders, or new equity funds raised from the stock market (through new issues of the company's shares), less the costs associated with raising those funds. Companies usually raise new funds to pay for new investments (such as expansion in operations, or new equipment or facilities). One item which appears in this section with a negative sign is the regular dividend payout to a company's existing shareholders. Since dividends are considered to be a continuing "cost" of previous efforts to raise money from shareholders, they are deducted here from the sum of the company's other financing activities.
- **Cash used in investing activities** describes how the company spent some of its cash on new investments – such as investments in new equipment or buildings, acquisition of other companies, and other investments.

The first two segments of the cash flow statement are usually positive (since they usually, but not always, indicate how the company "raised" money). The third segment is usually negative (since it usually, but not always, indicates that the company "spent" money on incremental investments). The overall balance of the three sections of the cash flow statement therefore shows whether the net effect of these three components was positive or negative. If the net balance is positive, then the company finished the period with more cash (or highly liquid cash alternatives) in the bank than it started with. Its cash balance (which was reported as one type of asset on the balance sheet) grew. If the cash flow balance was negative, this means that the company's cash balance shrank during the period.

The bottom of the cash flow statement will usually summarise how much cash the company started the period with, the net change in cash, and then the closing cash balance.

Researchers and analysts are often interested in the cash flow situation of companies which are in financial distress. Even healthy companies, of course, may experience a negative change in cash during the year – if, for example, they are expanding rapidly and therefore spending more on new investments than they actually raise from their internal cash flow and from new financing.

But in the long-run, of course, a company cannot keep spending more money than it takes in. For companies in trouble, analysts want to keep an eye on the current amount of cash in the bank (to be sure the company has enough funds on hand to cover its bills). In fact, if the company's auditors think that cash-on-hand may not be sufficient to pay the bills (including anticipated operating losses) in the next few months, they will issue what is called a "going concern" warning that is attached to the audited financial statement. They are warning investors, in other words, that the company's cash stockpile may not be enough the pay the company's bills, which usually forces the company to seek bankruptcy protection (hence eliminating its status as a "going concern").

*Example:* **Sample Cash Flow Statement**

**Sample Business Plan**
**Sample Cash Flow Statement**
**Statement for the Month Ended_________.**

| | | |
|---|---|---|
| Cash Flow from Operating Activities | | |
| Net Income | | 1,800 |
| Non-cash Expenses and Revenues | | |
| Include income | | |
| Increase in Accounts Receivable | 1,000 | |
| Increase in Supplies | 500 | |
| Increase in Accounts Payable | 600 | (900) |
| Net Cash Flow from Operating Activities | | 900 |
| Cash Flows from Investing Activities | | |
| Purchase of land | (10,000) | |
| Purchase of Building | (25,000) | |
| Net Cash Flow used by Investing Activities | | |
| Cash Flow Financing Activities | | |
| Invested | 50,000 | |
| Withdrawals | (600) | |
| Net Cash Flow provided by Financing Activities | | 49,400 |
| Net Increase (Decrease) in Cash | | 15,000 |

## 12.2.4 Statement of Retained Earnings

The statement of retained earnings describes the changes that occur in the retained earnings of a company. The statement of retained earnings shows the amount of accumulated earnings that have been retained within the company since its inception. At the end of each fiscal year-end, the amount of net income or loss is added to the opening amount of retained earnings to arrive at the closing retained earnings. Retained earnings can be decreased by such items as dividends paid to shareholders.

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*Example:* Written below is a sample of a retained earnings statement.

**Quartz Corporation**
**Statements of Retained Earnings**
**For the year ending December 31, 2009**

| | |
|---|---|
| Retained earning - January 1, 2009 | $400,000 |
| *Add:* Net income | 115,000 |
| | $515,000 |
| *Less:* Dividends | 35,000 |
| Retained earnings - December 31, 2009 | $480,000 |

## Self Assessment

Fill in the blanks:

1. Income statement is also called profit and loss statement (P&L) and …………………….
2. The purpose of the …………………… is to show managers and investors whether the company made or lost money during the period being reported.
3. A retained earnings statement explains the …………………… in a company's retained earnings over the reporting period.
4. The …………………… provides an insight into the financial status of a company at a particular time.
5. The cash flow may be from many activities of a firm involving particularly its operations, …………………… and finance.

## 12.3 Uses of Corporate Financial Statements

The uses of financial statements vary from entity to entity. For different people, they have different uses. Though no complete list can be provided for their uses, presented under is a brief list of benefits they give to their users.

1. ***For equity investors and lenders:*** The existing equity investors and lenders to a company need to monitor their investments and to evaluate the performance of management. For this purpose, they have no aid else than the financial statements of a firm.

   The prospective equity investors and lenders use financial statements to decide whether or not to invest in an organisation.
2. ***For finance specialists:*** Investment analysts, money managers, and stockbrokers, use financial statements to make buy/sell/hold recommendations to their clients.
3. ***For credit rating agencies:*** Rating Agencies such as Moody's and Standard & Poor's assign credit ratings on the basis of the financial statements of a company.
4. ***For customers and suppliers:*** Major customers of and suppliers to an organization evaluate the financial strength and staying power of the company as a dependable resource for their business. For this purpose, the best possible aids are those of the financial statements of the organization.
5. ***For Labor unions:*** Labor unions use financial statements of a company to gauge how much of a pay increase a company is able to afford in upcoming labor negotiations.

6. ***For the Board of directors:*** Board of directors of an organization uses its financial statements to review the performance of management in general and company in particular.

7. ***For Managers:*** Managers, too, are interested in measuring the operating performance in terms of profitability and return on invested capital. If they are not owners, managers must still satisfy the owners' expectations in this regard. As managers, they are interested in measures of operating efficiency, asset turnover, and liquidity or solvency. These will help them manage day-to-day activities and evaluate potential credit customers and key suppliers.

8. ***For Competitors:*** Existing Competitors of an organization use its financial statements to benchmark their own financial results.

   Potential competitors of an organization use its financial statements to assess how profitable it may be to enter the industry.

9. ***For Government agencies:*** The financial statements of a company are very useful for the government agencies responsible for taxing, regulating, or investigating the company.

10. ***For associated personnel:*** The financial statements of a company are also useful for politicians, lobbyists, issue groups, consumer advocates, environmentalists, think tanks, foundations, media reporters, and others who are supporting or opposing any particular public issue the company's actions affect.

11. ***For partners:*** The financial statements of a company are used by actual or potential joint venture partners, franchisors or franchisees, and other business interests who need to know about the company and its financial situation.

### Self Assessment

State true or false:

6. The prospective equity investors and lenders use financial statements to decide whether or not to invest in an organisation.

7. Existing Customers of an organization use its financial statements to benchmark their own financial results.

8. Board of directors of an organization uses its financial statements to review the performance of management in general and company in particular.

## 12.4 Limitation of Corporate Financial Statements

Some of the limitations of the financial statements are as follows:

1. As the historical costs and money measurement concepts govern the preparation of the balance sheet and income statements, hence these financial statements are essentially statements reflecting historical facts. It ignore inflationary trend and does not reflect the true current worth of the enterprise,

2. Certain important qualitative elements are omitted from the financial statements because they are incapable of being measured in monetary terms like the quality and reputation of the management team, employee and other,

3. There are items in the assets side of the balance sheet which has no real value and are merely deferred charges to future incomes like preliminary/pre-incorporation expenses and other,

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4. There are still the following issues or challenges in preparing the financial statements which may amount to overstatement of the accounting profit of an entity:
   (a) When to and how much to recognize revenue in the Income statement.
   (b) The constant challenge of when to expense or to capitalize the expenses. It is important to determine definitely what is revenue expenditure and capital expenditure otherwise the accounting profit will be overstated or understated:

       *Example:* Capitalization of borrowing costs, etc.
   (c) Method of depreciations and the rates to depreciate into the income statement are selected by management to suit their business needs. Are the rates intentionally been made lower or the depreciation rates are higher to accelerate the depreciation of the fixed assets,
   (d) Adequacy of provisions and method of providing for doubtful debts. Are the trade debtors recoverable and to what extent the accounting method for provision for doubtful debts shows the realistic picture.
   (e) Basis of valuation of assets – when can costs change to reflect current values? Using replacement or current costs?
   (f) Consolidation challenges – what to eliminates to reflects the overall group performance. Some items might be omitted to show a higher accounting profits.

### Self Assessment

Fill in the blanks:

9. Financial statements ignore ...................... trend and does not reflect the true current worth of the enterprise.
10. There are items in the assets side of the balance sheet which has no real value and are merely deferred charges to future incomes like ...................... expenses and other.

## 12.5 Summary

- The corporate financial statements actually give a summary of the financial condition and profitability of the firm in both long and short term.
- The prime objective of corporate financial statements is to give information on the performance, financial strength and financial position changes of a company.
- The four basic types of corporate financial statements are:
  - Income statement
  - Balance sheet
  - Statement of cash flows
  - Statement of retained earnings
- The uses of financial statements vary from entity to entity. For different people, they have different uses.
- As the historical costs and money measurement concepts govern the preparation of the balance sheet and income statements, hence these financial statements are essentially statements reflecting historical facts.

Notes

## 12.6 Keywords

***Balance Sheet:*** The balance sheet is based on the equation: assets = liabilities + owners' equity.

***Corporate Financial Statements:*** The corporate financial statements are the financial reports or formal record of the financial and business activities of a firm.

***Income Statement:*** The income statements are also called as the profit loss statements.

***Statement of Cash Flow:*** The statement of cash flow gives information on the cash flow activities of a company.

***Statement of Retained Earnings:*** The statement of retained earnings describes the changes that occur in the retained earnings of a company.

## 12.7 Review Questions

1. What is the Nature of Corporate Financial Statements?
2. Write down the Objective of Corporate Financial Statements.
3. Briefly explain the four basic types of corporate financial statements.
4. What are the Uses of Corporate Financial Statements?
5. Explain the Limitation of Corporate Financial Statements.

### Answers: Self Assessment

| | | | |
|---|---|---|---|
| 1. | Statement of Operations | 2. | income statement |
| 3. | changes | 4. | balance sheet |
| 5. | investment | 6. | True |
| 7. | False | 8. | True |
| 9. | inflationary | 10. | preliminary/pre-incorporation |

## 12.8 Further Readings

*Books*

Khan and Jain, "Management Accounting".

M.P. Pandikumar, "Accounting & Finance for Managers", Excel Books, New Delhi.

R.L. Gupta and Radhaswamy, "Advanced Accountancy".

S.N. Maheswari, "Management Accounting".

V.K. Goyal, "Financial Accounting", Excel Books, New Delhi.

*Online links*

http://www.globusz.com/

www.scribd.com

www.futureaccountant.com

Notes

# Unit 13: Computerised Accounting

CONTENTS



## Objectives

After studying this unit, you will be able to:

- Explain the role of computer in accounting;
- Differentiate between manual accounting and computerised accounting;
- State the need for computerised accounting
- Describe the basic requirements of computerised accounting.

## Introduction

With the expansion of business the number of transactions increased. The manual method of keeping and maintaining records was found to be unmanageable. With the introduction of computers in business, the manual method of accounting is being gradually replaced. And finally, the database technology has revolutionized the accounts department of the business organizations.

Keeping accurate accounting records is a vital part of managing an organisation. Apart from helping to keep it afloat financially and legally, it is also a requirement of funding bodies. Smaller groups can usually manage with simple bookkeeping procedures but bigger groups juggling with larger sums of money and more complex financial transactions may find their workload eased by using a computerised accounting system. The good news is that there are easy to use and reasonably priced computerised accounting packages on the market that are either aimed at, or can be adapted to, voluntary sector organizations.

## 13.1 Role of Computers in Accounting

The most popular system of recording of accounting transactions is manual which requires maintaining books of accounts such as Journal, Cash Book, Special purpose books and ledger

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and so on. The accountant is required to prepare summary of transactions and financial statements manually. The advanced technology involves various machines capable of performing different accounting functions, for example, a billing machine. This machine is capable of computing discount, adding net total and posting the requisite data to the relevant accounts.

With substantial increase in the number of transactions, a machine was developed which could store and process accounting data in no time. Such advancement leads to number of growing successful organisations. A newer version of machine is evolved with increased speed, storage, and processing capacity. A computer to which they were connected operated these machines.

As a result, the maintenance of accounting data on a real-time basis became almost essential. Now maintaining accounting records become more convenient with the computerised accounting.

The computerised accounting uses the concept of databases. For this purpose an accounting software is used to implement a computerised accounting system. It does away the necessity to create and maintain journals, ledgers, etc., which are essential part of manual accounting. Some of the commonly used accounting software's are Tally, Cash Manager, Best Books, etc.

Accounting software is used to implement a computerised accounting. The computerised accounting is based on the concept of database. It is basic software which allows access to the data contained in the data base. It is a system to manage collection of data insuring at the same time that it remains reliable and confidential.

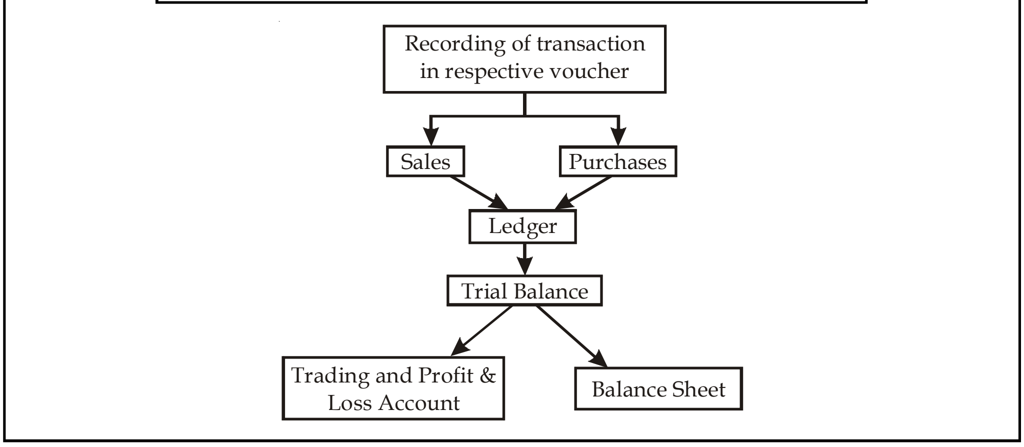
Following are the components of computerised accounting software:

1. ***Preparation of accounting documents:*** Computer helps in preparing accounting documents like Cash Memo, Bills and invoices, etc., and preparing accounting vouchers.

2. ***Recording of transactions:*** Every day business transactions are recorded with the help of computer software. Logical scheme is implied for codification of account and transaction. Every account and transaction is assigned a unique code. The grouping of accounts is done from the first stage. This process simplifies the work of recording the transactions.

3. ***Preparation of Trial Balance and Financial Statements:*** After recording of transaction, the data is transferred into Ledger account automatically by the computer. Trial Balance is prepared by the computer to check accuracy of the records. With the help of trial balance the computer can be programmed to prepare Trading, Profit & Loss account and Balance Sheet. These components can be shown as:

**Figure 13.1: Components of Computerised Accounting Software**



Notes

## Self Assessment

Fill in the blanks:

1. The most popular system of recording of accounting transactions is …………………… which requires maintaining books of accounts such as Journal, Cash Book, etc.
2. …………………… is prepared by the computer to check accuracy of the records.

## 13.2 Computerised Accounting

A computerised accounting system is an accounting information system that processes the financial transactions and events as per Generally Accepted Accounting Principles (GAAP) to produce reports as per user requirements. Every accounting system, manual or computerised, has two aspects. First, it has to work under a set of well-defined concepts called *accounting principles*. Another, that there is a user-defined framework for maintenance of records and generation of reports.

In a computerised accounting system, the framework of storage and processing of data is called *operating environment* that consists of hardware as well as software in which the accounting system, works. The type of the accounting system used determines the operating environment. Both hardware and software are interdependent. The type of software determines the structure of the hardware. Further, the selection of hardware is dependent upon various factors such as the number of users, level of secrecy and the nature of various activities of functional departments in an organisation.

Transaction processing system (TPS) is the first stage of computerised accounting system. The purpose of any TPS is to record, process, validate and store transactions that occur in various functional areas of a business for subsequent retrieval and usage. TPS involves following steps in processing a transaction: Data Entry, Data Validation, Processing and Revalidation, Storage, Information and Reporting.

It is one of the transaction processing systems which is concerned with financial transactions only. When a system contains only human resources it is called manual system; when it uses only computer resources, it is called computerised system and when it uses both human and computer resources, it is called computer-based system.

These steps can be explained with an example making use of Automatic Teller Machine (ATM) facility by a Bank-Customer.

1. ***Data Entry:*** Processing presumes data entry. A bank customer operates an ATM facility to make a withdrawal. The actions taken by the customer constitute data which is processed after validation by the computerised personal banking system.
2. ***Data Validation:*** It ensures the accuracy and reliability of input data by comparing the same with some predefined standards or known data.

   This validation is made by the 'Error Detection' and 'Error Correction' procedures. The control mechanism, wherein actual input data is compared with predetermined norm is meant to detect errors while error correction procedures make suggestions for entering correct data input.

   The Personal Identification Number (PIN) of the customer is validated with the known data. If it is incorrect, a suggestion is made to indicate the PIN is invalid. Once the PIN is validated, the amount of withdrawal being made is also checked to ensure that it does not exceed a prespecified limit of withdrawal.

**Notes**

3. ***Processing and Revalidation:*** The processing of data occurs almost instantaneously in case of Online Transaction Processing (OLTP) provided a valid data has been fed to the system. This is called check input validity. Revalidation occurs to ensure that the transaction in terms of delivery of money by ATM has been duly completed. This is called check output validity.

4. ***Storage:*** Processed actions, as described above, result into financial transaction data i.e. withdrawal of money by a particular customer, are stored in transaction database of computerised personal banking system. This makes it absolutely clear that only valid transactions are stored in the database.

5. ***Information:*** The stored data is processed making use of the Query facility to produce desired information.

6. ***Reporting:*** Reports can be prepared on the basis of the required information content according to the decision usefulness of the report.

Take the case of a club, for example, where the number of transactions and their variety is relatively small, a Personal Computer with standardized software may be sufficient. However, for a large business organisation with a number of geographically scattered factories and offices, more powerful computer systems supported by sophisticated networks are required to handle the voluminous data and the complex reporting requirements. In order to handle such requirements, multi-user operating systems such as UNIX, Linux, etc., are used.

Modern computerised accounting systems are based on the concept of *database*. A database is implemented using a database management system, which is define by a set of computer programmes (or software) that manage and organize data effectively and provide access to the stored data by the application programmes. The accounting database is well-organized with active interface that uses accounting application programs and reporting system.

Every computerised accounting system has two basic requirements:

- ***Accounting Framework:*** It consists a set of principles, coding and grouping structure of accounting.

- ***Operating Procedure:*** It is a well-defined operating procedure blended suitably with the operating environment of the organisation.

The use of computers in any database oriented application has four basic requirements as mentioned below;

- ***Front-end Interface:*** It is an interactive link or a dialog between the user and database-oriented software through which the user communicates to the back-end database. For example, a transaction relating to purchase of goods may be dealt with the accounting system through a purchase voucher, which appears on the computer's monitor of data entry operator and when entered into the system is stored in the database. The same data may be queried through reporting system say purchase analysis software programme.

- ***Back-end Database:*** It is the data storage system that is hidden from the user and responds to the requirement of the user to the extent the user is authorised to access.

- ***Data Processing:*** It is a sequence of actions that are taken to transform the data into decision useful information.

- ***Reporting System:*** It is an integrated set of objects that constitute the report.

The computerised accounting is also one of the database-oriented applications wherein the transaction data is stored in well-organized database.

Notes

The user operates on such database using the required and desired interface and also takes the desired reports by suitable transformations of stored data into information. Therefore, the fundamentals of computerised accounting embrace all the basic requirements of any database-oriented application in computers. Accordingly, the computerised accounting system has the above four additional requirements.

### 13.2.1 Need and Requirements of Computerised Accounting System

The need for computerised accounting arises from advantages of speed, accuracy and lower cost of handling the business transactions.

- ***Numerous Transactions:*** The computerised accounting system is capable of handling large number of transactions with speed and accuracy.
- ***Instant Reporting:*** The computerised accounting system is capable of offering quick and quality reporting because of its speed and accuracy.
- ***Reduction in paper work:*** A manual accounting system requires large physical storage space to keep accounting records/books and vouchers/documents. The requirement of stationery and books of accounts along with vouchers and documents is directly dependent on the volume of transactions beyond a certain point. There is a dire need to reduce the paper work and dispense with large volumes of books of accounts. This can be achieved by introducing computerised accounting system.
- ***Flexible reporting:*** The reporting is flexible in computerised accounting system as compared to manual accounting system. The reports of a manual accounting system reveal balances of accounts on periodic basis while computerised accounting system is capable of generating reports of any balance as when required and for any duration which is within the accounting period.
- ***Accounting Queries:*** There are accounting queries which are based on some external parameters. For example, a query to identify customers who have not made the payments within the permissible credit period can be easily answered by using the structured query language (SQL) support of database technology in the computerised accounting system. But such an exercise in a manual accounting system is quite difficult and expensive in terms of manpower used. It will still be worse in case the credit period is changed.
- ***On-line facility:*** Computerised accounting system offers online facility to store and process transaction data so as to retrieve information to generate and view financial reports.
- ***Scalability:*** Computerised accounting system is fully equipped with handling the growing transactions of a fast growing business enterprise. The requirement of additional manpower in Accounts department is restricted to only the data operators for storing additional vouchers. There is absolutely no additional cost of processing additional transaction data.
- ***Accuracy:*** The information content of reports generated by the computerised accounting system is accurate and therefore quite reliable for decision-making.

  In a manual accounting system the reports and information are likely to be distorted, inaccurate and therefore cannot be relied upon.

  It is so because it is being processed by many people, especially when the number of transactions to be processed to produce such information and report is quite large.
- ***Security:*** Under manual accounting system it is very difficult to secure such information because it is open to inspection by any eyes dealing with the books of accounts. However, in computerised accounting system only the authorized users are permitted to have access

to accounting data. Security provided by the computerised accounting system is far superior compared to any security offered by the manual accounting system.

Notes

### 13.2.2 Basic Requirements of the Computerised Accounting System

The basic requirements of any computerised accounting system are the followings:

- *Accounting framework:* It is the application environment of the computerised accounting system.

  A healthy accounting framework in terms of accounting principles, coding and grouping structure is a precondition for any computerised accounting system.

- *Operating procedure:* A well-conceived and designed operating procedure blended with suitable operating environment of the enterprise is necessary to work with the computerised accounting system.

The computerised accounting is one of the database-oriented applications wherein the transaction data is stored in well-organized database. The user operates on such database using the required interface and also takes the required reports by suitable transformations of stored data into information.

Therefore, the fundamentals of computerised accounting include all the basic requirements of any database-oriented application in computers.

On the basis of the discussions, these are the following differences between manual accounting and computerised accounting

**Table 13.1: Difference between Manual Accounting and Computerised Accounting**

| Point of Difference | Manual Accounting | Computerised Accounting |
|---|---|---|
| 1. Recording | Recording of financial transactions is through books of original entry. | Data content of these transactions is stored in well designed data bases. |
| 2. Classification | Transactions recorded in the books of original entry are further classified by posting them into ledger accounts. This results in transaction data duplicity. | No such data duplications is made. In order to produce ledger accounts the stored transaction data is processed to appear as classified so that same is presented in the form of report. |
| 3. Summarising | Transactions are summarized to produce trial balance by ascertaining the balances of various accounts. | The generation of ledger accounts is not necessary condition for trial balance. |
| 4. Adjusting entries | Adjusting entries are made to adhere to the principle of matching. | There is nothing like making adjusting entries for errors and rectifications. |
| 5. Financial statements | The preparation of financial statements assumes the availability of trial balance. | The preparation of financial statements is independent of producing the trial balance. |

## Self Assessment

Fill in the blanks:

3. A computerised accounting system is an accounting information system that processes the financial transactions and events as per …………………… to produce reports as per user requirements.

4. …………………… is the first stage of computerised accounting system.

Notes

## 13.3 Salient Features of Computerised Accounting

Following are the silent features of computerised accounting:

- ***Fast, Powerful, Simple and Integrated:*** Computerised accounting is designed to automate and integrate all the business operations, such as sales, finance, purchase, inventory and manufacturing. With Computerised accounting, accurate, up-to-date business information is literally at the fingertips. The Computerised accounting combine with enhanced MIS, Multi-lingual and Data organization capabilities to help the company simplify all the business processes easily and cost-effectively.
- ***Complete Visibility:*** Computerised accountings giving the company sufficient time to plan, increase the customer base, and enhance customer satisfaction. With Computerised accounting the company will have greater visibility into the day-to-day business operations and access to vital information.
- ***Enhanced User Experience:*** Computerised accounting allows the company to enter data in a variety of ways which makes work a pleasure. Adapting to the specific business needs is possible.
- ***Accuracy, Speed:*** Computerised accounting has User-definable templates which provides fast, accurate data entry of the transactions; thereafter all documents and reports can be generated automatically, at the press of a button.
- ***Scalability:*** Computerised accounting adapts to the current and future needs of the business, irrespective of its size or style.
- ***Power:*** Computerised accounting has the ability to handle huge volumes of transactions without compromising on speed or efficiency.
- ***For Improved Business Performance:*** Computerised accounting is a highly integrated application that transforms the business processes with its performance enhancing features which encompass accounting, inventory, reporting and statutory processes. This helps the company access information faster, and takes quicker decisions. Computerised accounting also guarantees real-time optimization of operations and enhanced communication.
- ***Quick Decision Making:*** Generates real-time, comprehensive MIS reports and ensures access to complete and critical information, instantly.
- ***Complete Reliability:*** Computerised accounting makes sure that the critical financial information is accurate, controlled and safe from data corruption.

### Self Assessment

Fill in the blanks:

5. …………………… allows the company to enter data in a variety of ways which makes work a pleasure.
6. Computerised accounting makes sure that the critical …………………… is accurate, controlled and safe from data corruption.

## 13.4 Sourcing of Accounting Software

Accounting software is an integral part of the computerised accounting system. An important factor to be considered before acquiring accounting software is the accounting expertise of people responsible in organisation for accounting work. People, not computers, are responsible for accounting.

> *Notes* The need for accounting software arises in two situations: (a) when the computerised accounting system is implemented to replace the manual system or (b) when the current computerised system needs to be replaced with a new one in view of changing needs.

### Accounting Packages

Every Computerised Accounting System is implemented to perform the accounting activity (recording and storing of accounting data) and generate reports as per the requirements of the user. From this perspective, the accounting packages are classified into the following categories:

(a) Ready to use

(b) Customised

(c) Tailored

Each of these categories offers distinctive features. However, the choice of the accounting software would depend upon the suitability to the organisation especially in terms of accounting needs.

#### *Ready-to-Use*

Ready-to-Use accounting software is suited to organisations running small/conventional business where the frequency or volume of accounting transactions is very low. This is because the cost of installation is generally low and number of users is limited. Ready-to-use software is relatively easier to learn and people (accountant) adaptability is very high. This also implies that level of secrecy is relatively low and the software is prone to data frauds.

The training needs are simple and sometimes the vendor (supplier of software) offers the training on the software free. However, this software offers little scope of linking to other information systems.

#### *Customised*

Accounting software may be customised to meet the special requirement of the user. Standardised accounting software available in the market may not suit or fulfil the user requirements. For example, standardised accounting software may contain the sales voucher and inventory status as separate options. However, when the user requires that inventory status to be updated immediately upon entry of sales voucher and report be printed, the software needs to be customised.

Customised software is suited for large and medium businesses and can be linked to the other information systems. The cost of installation and maintenance is relatively high because the high cost is to be paid to the vendor for customisation. The customisation includes modification and addition to the software contents, provision for the specified number of users and their authentication, etc. Secrecy of data and software can be better maintained in customised software. Since the need to train the software users is important, the training costs are therefore high.

#### *Tailored*

The accounting software is generally tailored in large business organisations with multi users and geographically scattered locations. This software requires specialised training to the users. The tailored software is designed to meet the specific requirements of the users and form an

Notes

important part of the organizational MIS. The secrecy and authenticity checks are robust in such softwares and they offer high flexibility in terms of number of users. To summarise, the following table represents the comparison between the various categories of accounting software:

| Basis | Ready to use | Customised | Tailored |
|---|---|---|---|
| Nature of business | Small, conventional business | Large, medium business | Large, typical business |
| Cost of installation and maintenance | Low | Relatively high | High |
| Expected Level of secrecy (Software and Data) | Low | Relatively high | Relatively high |
| Number of users and their interface | Limited | As per specifications | Unlimited |
| Linkage to other information system | Restricted | Yes | Yes |
| Adaptability | High | Relatively high | Specific |
| Training requirements | Low | Medium | High |

### Self Assessment

Fill in the blanks:

7. …………………… is an integral part of the computerised accounting system.
8. ………………… accounting software is suited to organisations running small/ conventional business where the frequency or volume of accounting transactions is very low.

*Task* Enumerate the basic requirements of any computerised accounting system.

## 13.5 Summary

- The most popular system of recording of accounting transactions is manual which requires maintaining books of accounts such as Journal, Cash Book, Special purpose books, and ledger and so on.
- A computerised accounting system is an accounting information system that processes the financial transactions and events as per Generally Accepted Accounting Principles (GAAP) to produce reports as per user requirements.
- Accounting software is an integral part of the computerised accounting system. An important factor to be considered before acquiring accounting software is the accounting expertise of people responsible in organisation for accounting work. People, not computers, are responsible for accounting.

## 13.6 Keywords

***Accounting Software:*** It is an integral part of the computerised accounting system.

***Computerised accounting system:*** A computerised accounting system is an accounting information system that processes the financial transactions and events as per Generally Accepted Accounting Principles (GAAP) to produce reports as per user requirements.

***Manual Accounting:*** It is recording of financial transaction through books of original entry.

**Notes**

***Transaction processing system (TPS):*** Transaction processing system (TPS) is the first stage of computerised accounting system. The purpose of any TPS is to record, process, validate and store transactions that occur in various functional areas of a business for subsequent retrieval and usage.

## 13.7 Review Questions

1. Explain the role of Computers in Accounting.
2. Differentiate between Manual accounting and Computerised accounting system.
3. List the various advantages of computerised accounting systems.
4. Give two examples each of the organisations where 'ready-to-use', 'customized', and 'tailored' accounting packages respectively suitable to perform the accounting activity.
5. Distinguish between 'ready-to-use' and 'tailored' accounting software.
6. Define a computerised accounting system. Distinguish between a manual and computerised accounting system.
7. Discuss the advantages of computerised accounting system over the manual accounting system.
8. Describe the various types of accounting software along with their advantages and limitations.
9. 'Accounting software is an integral part of the computerised accounting system'. Explain.
10. 'Computerised Accounting Systems are best form of accounting system'. Do you agree? Comment.

### Answers: Self Assessment

| | | | |
|---|---|---|---|
| 1. | Manual | 2. | Trial Balance |
| 3. | Generally Accepted Accounting Principles (GAAP) | 4. | Transaction processing system (TPS) |
| 5. | Computerised accounting | 6. | Financial Information |
| 7. | Accounting software | 8. | Ready-to-Use |

## 13.8 Further Readings

*Books*

Khan and Jain, "Management Accounting".

"Learning in Tally" Ramesh Bangia (PBP)

M.P. Pandikumar, "Accounting & Finance for Managers", Excel Books, New Delhi.

R.L. Gupta and Radhaswamy, "Advanced Accountancy".

S.N. Maheswari, "Management Accounting".

Tally Solutions aims to double revenues in 2011-12. "The Economic Times" (The Times of India). 10 April 2011.

V. K. Goyal, "Financial Accounting", Excel Books, New Delhi.

*Online link*

www.futureaccountant.com

Notes

# Unit 14: Introduction to Tally

CONTENTS



## Objectives

After studying this unit, you will be able to:

- Understand About Tally
- Explain VAT Features in Tally ERP 9
- Discuss Starting the Tally
- Discuss Balance Sheet

## Introduction

Tally is versatile and massive software package. It is used by various types of trade and industry. Tally Software business was set up in 1986 by late S.S. Goenka, who was the founder of the company Peutronics Private Limited., Bangalore. He mentors his son Bharat Goenkar in creating software that would handle the financial accounts for his business. Bharat Goenkar spends a lot of months to develop path breaking technology. Tally is user friendly software used to solve all the complicated accounting structure.

Tally offers extremely high reliability data. Tally uses a flexi-field, flexi-length, self indexed weighted file structure for an extremely compact and fast database. Tally is robust and will not be affected even if there is a power failure or if the machine is shut down while the system is still functioning and hence there will be no data loss. Tally uses signaling quality data integrity

**Notes**

checks at regular levels to ensure complete reliability of data. Tally maintains all Books of accounts starting from records of vouchers, ledgers etc. Tally handles different types of vouchers like Payment, receipt, adjustment entries like Journals, Debit notes, Credit notes, Sales, Purchases, Receipt notes, Delivery notes etc. Tally follows the double entry system of accounting and hence will eliminate any possible errors.

## 14.1 About Tally

Tally is complete Accounting system. It handles different types of vouchers, for example, Payments, Receipts, Journals, Debit Notes, Sales, Purchase, Delivery note and etc. Accounts Receivables is the amount to be received from Sundry Debtors and Accounts Payable is the amount payable to Sundry Creditors. Tally provides complete bill wise information of amounts receivable as well as payable either Party wise or Group wise. Activate 'Bill Wise' details by pressing F11 (Features). Now Create a Party (Ledger A/c) under the group 'Sundry Debtors' as well as one under group 'Sundry Creditors', and also activate 'Maintain balances bill by bill' for all the Parties while you are in Ledger creation mode.

Tally allows the user to define account heads as per his requirements. Tally offers 28 predefined widely used Groups. Of these 28 predefined groups 15 groups are Primary groups and the remaining 13 are sub groups. Among the 15 predefined groups 9 Groups are Balance Sheet items and the remaining 6 groups are Profit & Loss items. The user is allowed to alter the arrangement of any of these 28 Groups. Further the user is allowed to create any number of Groups as per his/ her requirements, which can either be a Primary or a Sub-Group. Tally also allows the user to have a multiple tree like structure groupings. This flexibility and ease of configuration allows Tally to be used across industries and geography.

Tally allows users to Drill Down from any report to lower levels of reports till the voucher. For example, user can view a Balance sheet and then select the required group in the Balance Sheet and drill down till the vouchers. Any changes then made in the voucher (i.e. if allowed by current security levels), is reflected real time at all levels.

Tally allows users to select any report for a particular date or for any range of dates. Once you have selected a Report, press F2 (F2 in case of Day Book) and specify the date range (From and To). You can also do simultaneous comparison side by side for any two selected periods including across financial years. All reports from Tally are generated based on the transaction date rather than the date of actual entry and hence Tally ensures that information is always represented accurately. This unique approach to bank reconciliation allows review of past date status for auditing purpose.

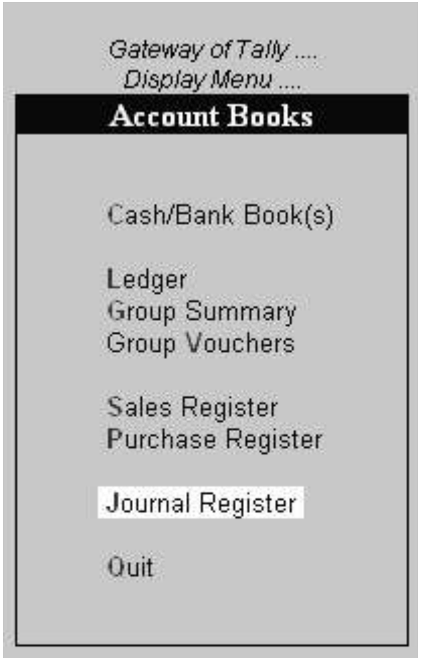
Tally provides columnar reports in Sales register, Purchase Register and Journal registers as well as Ledgers and Cash/Bank Books.

### 14.1.1 Gateway to Tally Menu

*Notes* If we select Display > Accounts Books the menu shows the full patch picture.

The menu displays primary choices. Menu options are dependent on activation of options. In some cases, you may find some options appearing as grayed indicating that option is not active. The menu is a drill-down, on selecting an option, if a sub-menu exists for the selected option, it would be displayed. If next level sub-menu exists, it would appear below it – showing the entire path at top of the menu. By selecting Quit – last option in each menu (by pressing Esc key in keyboard) you can return to the upper level menu.

Notes




You can select a menu in either of the following mode:

- Press the highlighted character. Example, to select create Company, Press **C** (the highlighted character). This is the easy way of selection.
- Move highlight bar on the option with up/Down arrow key in keyboard and press

  **Enter**
- Double click the option (Click twice, fast in left button in mouse)

Tally provides predefined vouchers and also allows defining different types of vouchers as per trade nature. The integrated system ensures real-time linking of accounts and inventory, resulting in accurate tracking of information. Blazing speed ensures quick data entry and retrieval of information. A Tally user can maintain 'Outstanding Reports' along with Age Wise analysis. Credit Limits can be given 'amount wise' as well as 'period wise'. Once Credit limits are set for a Party, then the user cannot bill the particular Party beyond the specified limit. Only the authorized user can alter the Credit Limits. This helps to monitor as well as control any potential slow collection and warns about the potential bad debts.

*Did u know?* Using the function key F11 and configuration key F12 we set these type of limitation for accounting and inventory transaction.

## 14.2 VAT Features in Tally ERP 9

The salient features provided for VAT in Tally.ERP 9 are as follows:

- Quick, easy to setup and use.
- Predefined VAT/Tax Classifications for Purchase and Sale of goods

**Notes**

- Facility to create separate VAT ledgers with VAT/Tax Classifications for input as well as output VAT
- Facility to generate and print VAT & NHIL invoice and Return
- Complete tracking of each transaction till generation of returns
- Better VAT-returns management
- Facility to generate VAT Computation report with details pertaining to
  - The value of transactions recorded using the classifications available for VAT
  - VAT Payable or refundable
- Provision to generate - **VAT Classification Vouchers** report for each of the VAT/Tax classifications
- Facility to drill-down the various VAT classifications from VAT Computation report till the last level of voucher entry
- Greater tax compliance

## Self Assessment

Fill in the blanks:

1. …………………… uses a flexi-field, flexi-length, self indexed weighted file structure for an extremely compact and fast database.
2. Tally provides predefined …………………… and also allows defining different types of vouchers as per trade nature.

## 14.3 Starting the Tally

### Create A Company

The first step to start tally is to Create a company. To create a company uses the command:

Gateway of Tally > Company Info. > Create

- Take the cursor to Create Company.
- Enter.
- Your Screen will change and show the basic data required for the creation of the Company.
- Give the name of the company and press enter.
- Give the Mailing name and address. This is optional and can be omitted by leaving it blank.
- Give the Income Tax Number. This is optional and can be left blank.
- Give the sale tax number if you so desire.
- Currency symbol may be given in terms of local currency. For India it will be in rupee terms

Notes

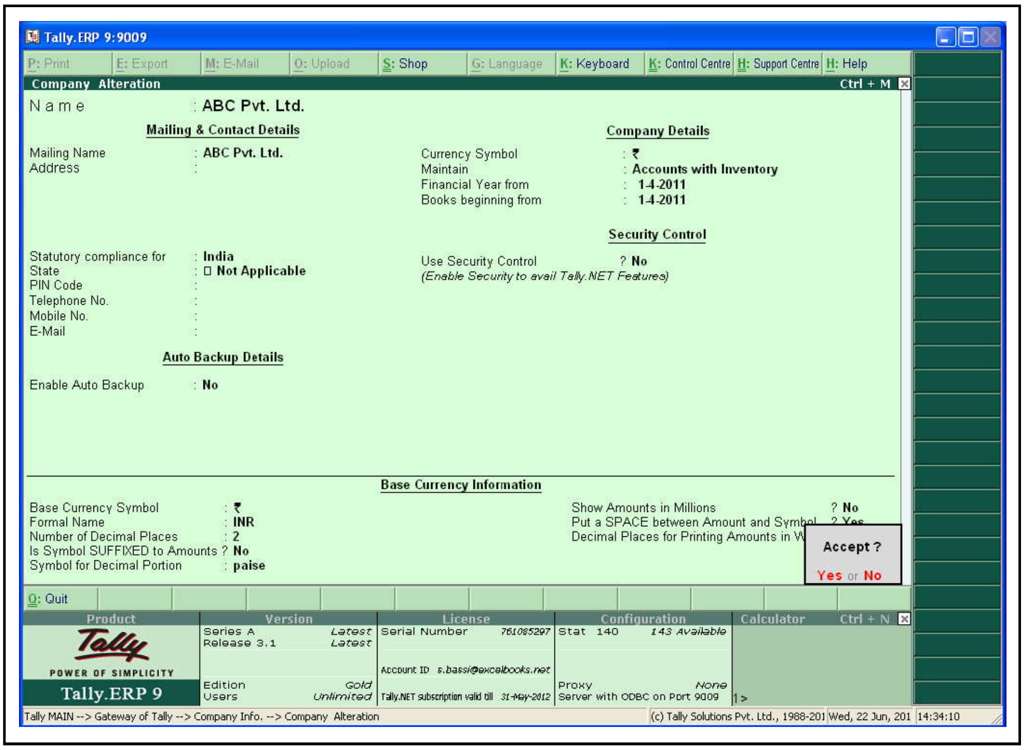
- As we come to next option i.e. Maintain, the Tally will ask the following information:
    - *Maintain Accounts Only:* Choose this option if you want to maintain only Account Books without any inventory transaction (Suitable for Professionals and service Industry People).
    - *Maintain Accounts with Inventory:* This option permits you to keep Accounts as well as inventory information.
    - *Maintain Inventory only:* If you do not want to keep any other financial data except the inventory, choose this option.

> *Notes* If you want to change your option relating to maintenance of accounts with inventory, you can always change at a later stage. Once process of Company creation is completed, you will find a button [F11] – Company Features – on the bottom right hand corner of your screen. Companies Features are modifiable settings pertaining to the current company you are working with. One of the settings is a question pertaining to maintenance of accounts with inventory. One can select this option depending upon the needs of financial data and reports.

- ***Financial Year:*** Give here the financial year of the Company. Tally considers 12 months from the date you give here as the Financial year. The books are closed exactly 12 months after this date.
- ***Books beginning From:*** Though normally the books are maintained from the beginning of the financial year, but Tally give you the facility of starting your books at a date other than the beginning of the financial year but close the books according to the financial year selected by you. For example, your company is established on 30th June 1999. The financial year stated is from 1.4.1999 to 31.3.2000. The books will begin on 30th June 99 and close on 31st March 2000. It ensures smooth transition to the next year.
- ***Security Control:*** For secrecy of your data, Tally provides a password based access control to different parts of the system based on the authority lists created by the administrator.

  Give the name of the administrator (presumably yourself) and your password. Repeat password by way of verification. The password is not displayed to protect it.
- ***Tally Audit:*** This feature allows the auditor or the administrator to track the changes in the accounting information. If you wish to use this facility select YES.
- ***Base Currency Information:*** Tally has the facility of working in different currencies. You can select the currency of your choice according to your need. Please also mention the number of decimal places for the base currency (usually it is Two).

Notes




## Select A Company

After the process of Company creation is completed, the company gets loaded automatically for the first time. But you have more than one companies, you have to Select the company in which you want to work. This is simple. Just take the cursor to the option – SELECT A COMPANY. This will show you the list of company in your Tally. Select any of these and start working.

## Alter A Company

You can modify, at any time, any information given whilst creating the company. At the gateway of Tally [ALT] +F3 -> Alter. The menu below gives options relating to company information. This includes Alter.

## Shut A Company

Shut a company means to unload it without deleting it. Simply select it again to load and work on it again. Double click the button **[ALT][ F1]: Shut Cmp** or press [ ALT ]+ F1 and select the company you want to shut.

## Security Control and Password

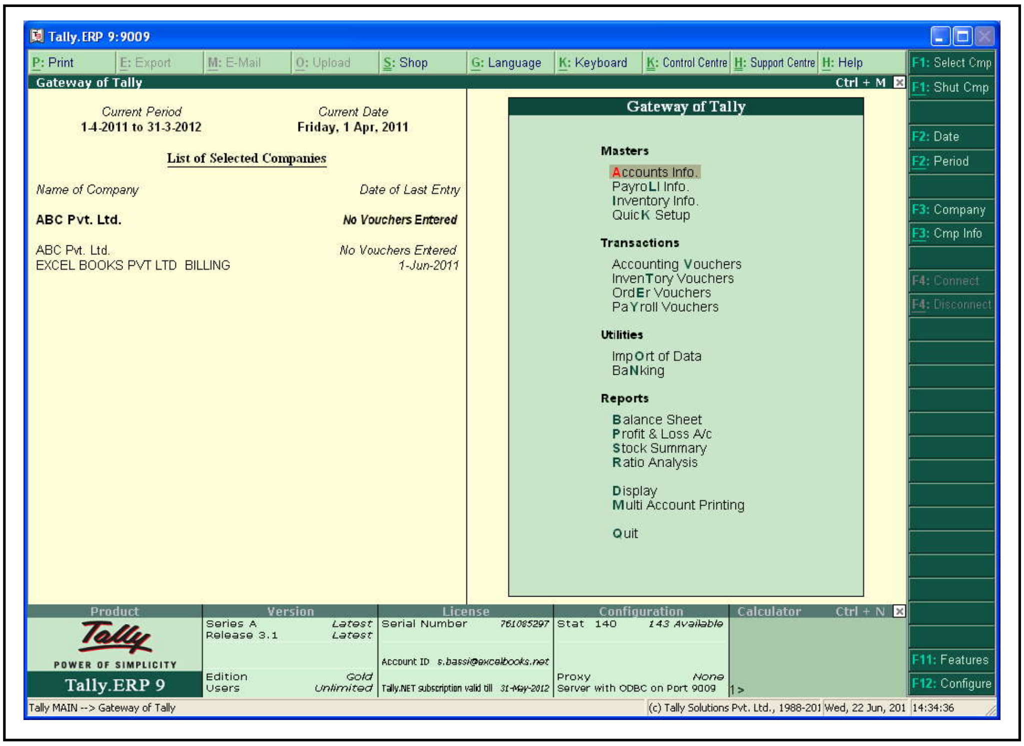
Tally allows you to set up authority levels and users who are placed at these levels. The authority levels decide the rights of the users.

**Notes**

*Notes* Tally has two security types already set up. One is Owner and other is Data Entry. Owner has full access and rights to all parts of Tally but Data Entry has restricted rights.

To reach to the security level first creates company and then use the following command:

Gateway of Tally > [ALT] + F3 > Security Control




## Maintain Ledger A/C

Tally maintains details of all ledgers that are defined by the user. You can define your chart of accounts that is maintain groups, ledger etc. Ledger reports can be used for scrutiny of accounts. Most accounting systems across the globe follow the concept of separate Personal and Nominal accounts. Tally follows the concept of single ledger systems, which includes both Personal and Nominal accounts.

After the creation of necessary masters, you should proceed with the ledger creation. Ledger account heads are the actual account heads to which we identify the transactions, that is passing of all vouchers using ledger. Hence, a thorough understanding of account classification is important for working with ledgers. Tally creates the following two ledgers on its own and the other ledgers should be created by you. (i) Cash under Cash-in-hand group, (ii) Profit & Loss.

Account under Primary Ledger. When you create a new company where Books beginning from and Financial Year From date are the same, you should create all the ledgers appearing in the Balance Sheet as at the previous date with opening balance. Also create ledgers appearing in Profit & Loss Account but with zero (0) opening balances unless Books Beginning From date is different than Financial Year Form.

## Creation of Ledger

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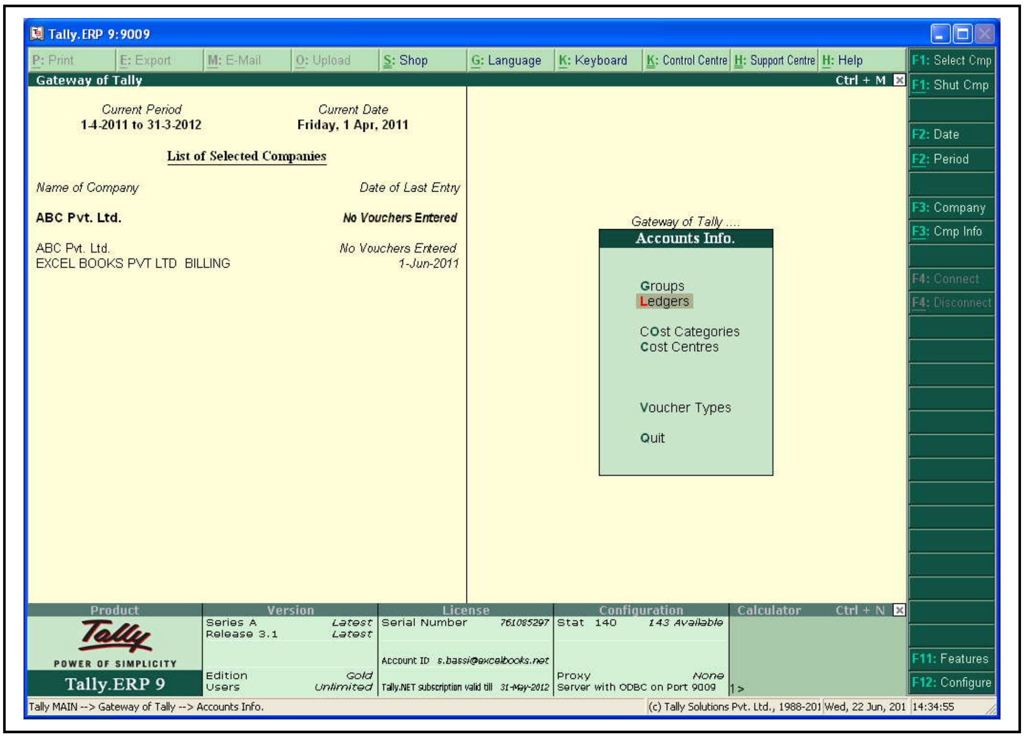
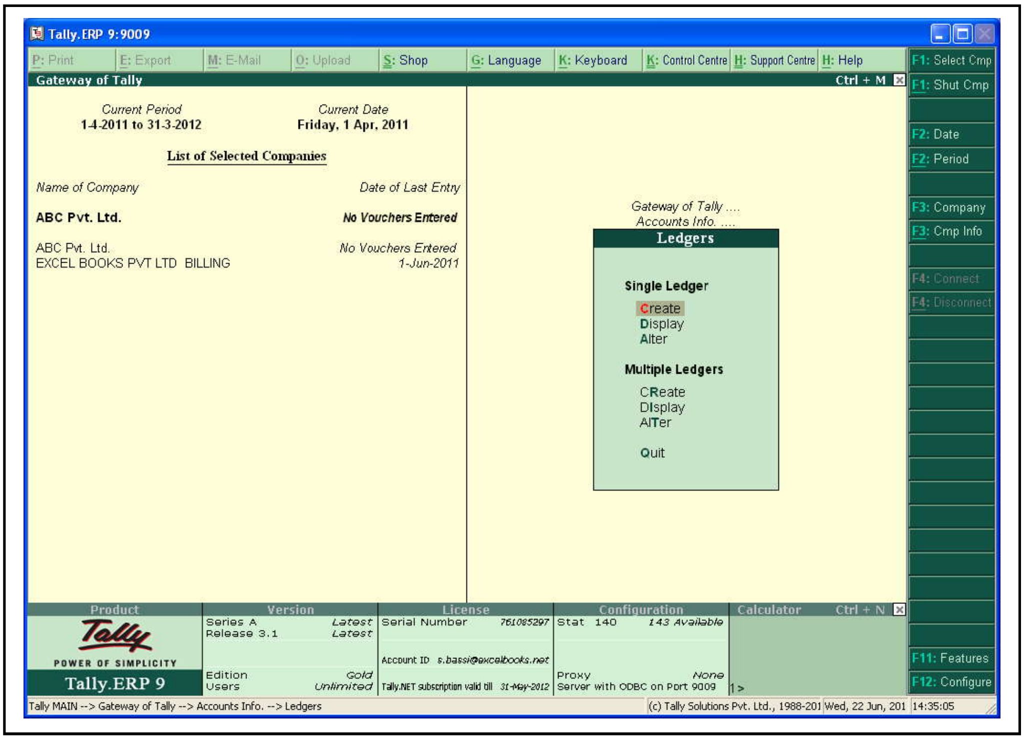
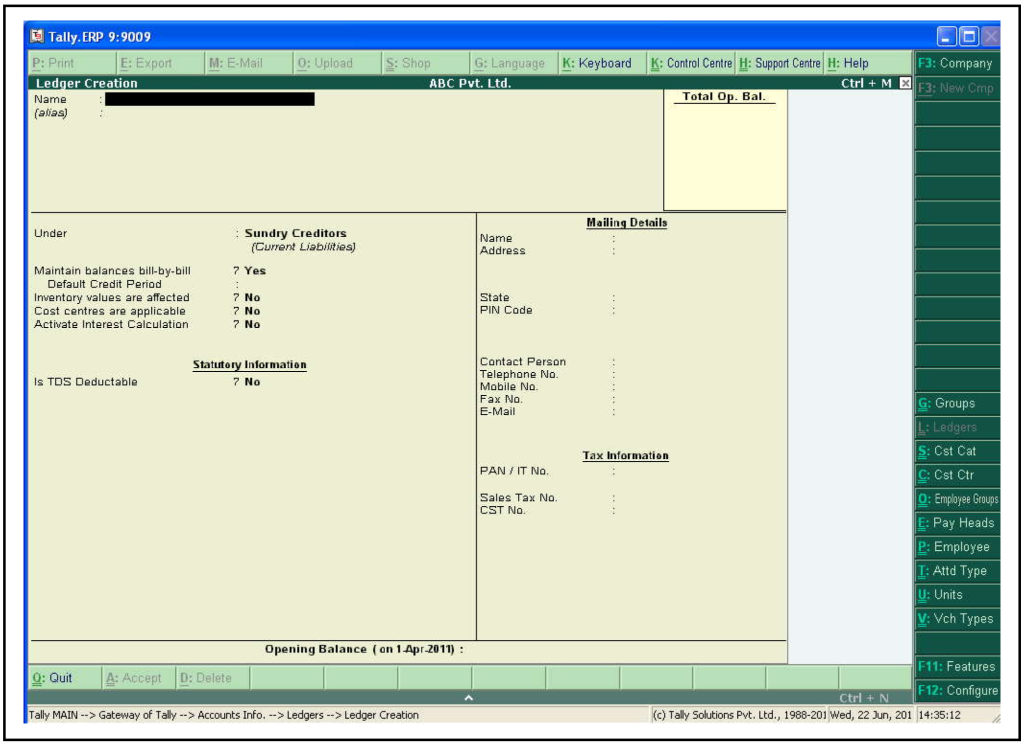
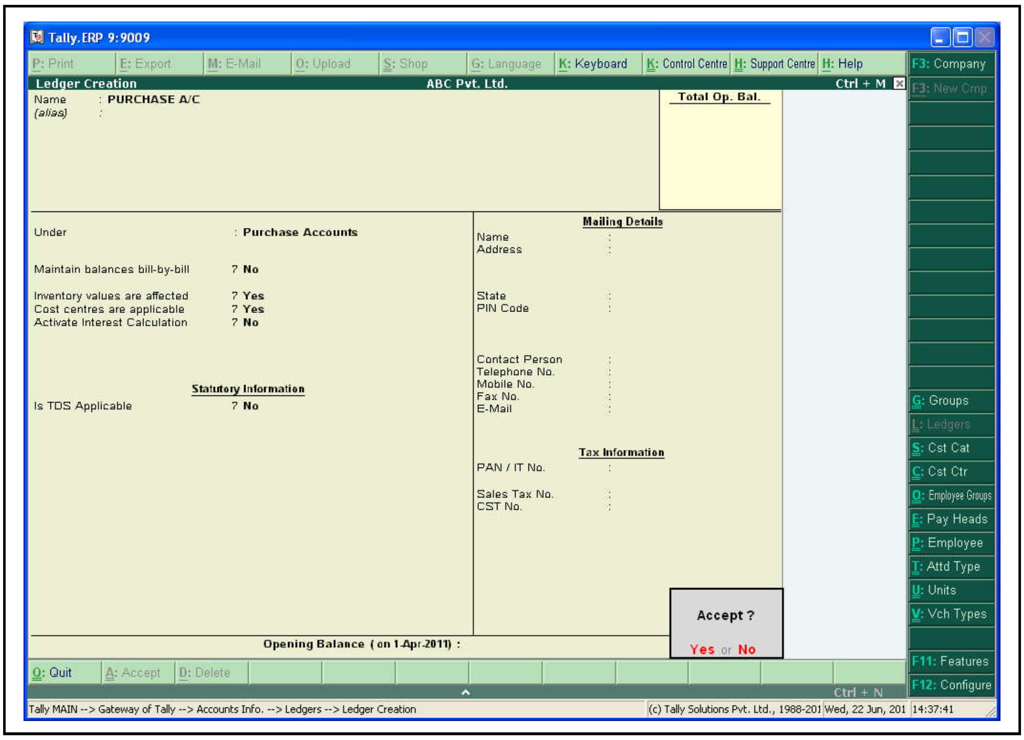
Gate way of Tally <Account info <Ledger <Create <Press F12.



**Notes**

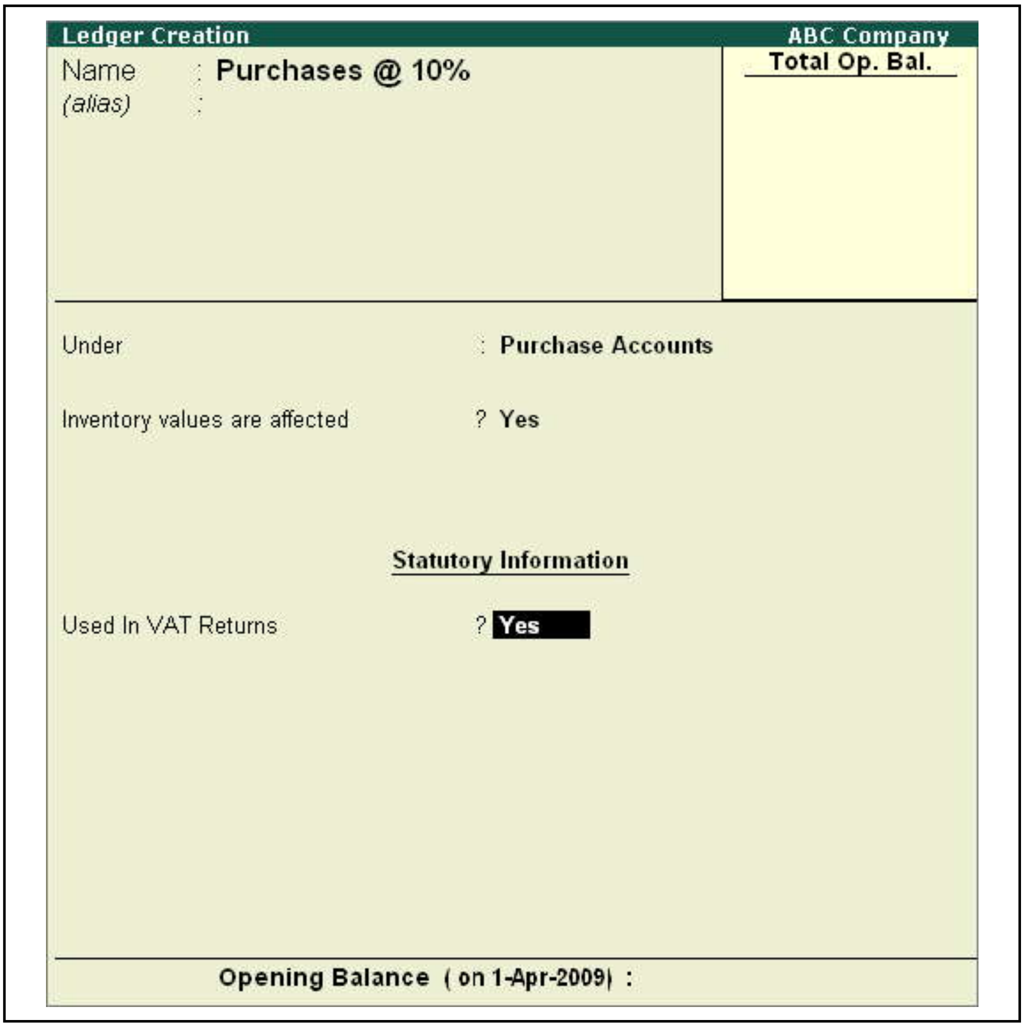



To Create Account Ledgers Individually select Create form *single Ledger* under Accounts Info Ledgers Create and also press F11 to configure Maintain Bill wise details to Yes and for Non-trading Accounts also to set Yes.

Notes

The result will be as follows:




1. ***Name:*** Here, enter the name of the ledger. Tally will not accept same names. We also create the alias name for the ledger, to conveniently retrieve later.

2. ***Under:*** Under this option, you should select the group from the list of groups that will be displayed along with the ledger creation screen.

3. ***Inventory values are affected:*** This option should be given 'Yes' for those ledgers which will affect the inventory position of the company. For example, Purchase, Purchase Returns, Sales, Sales Returns, etc.

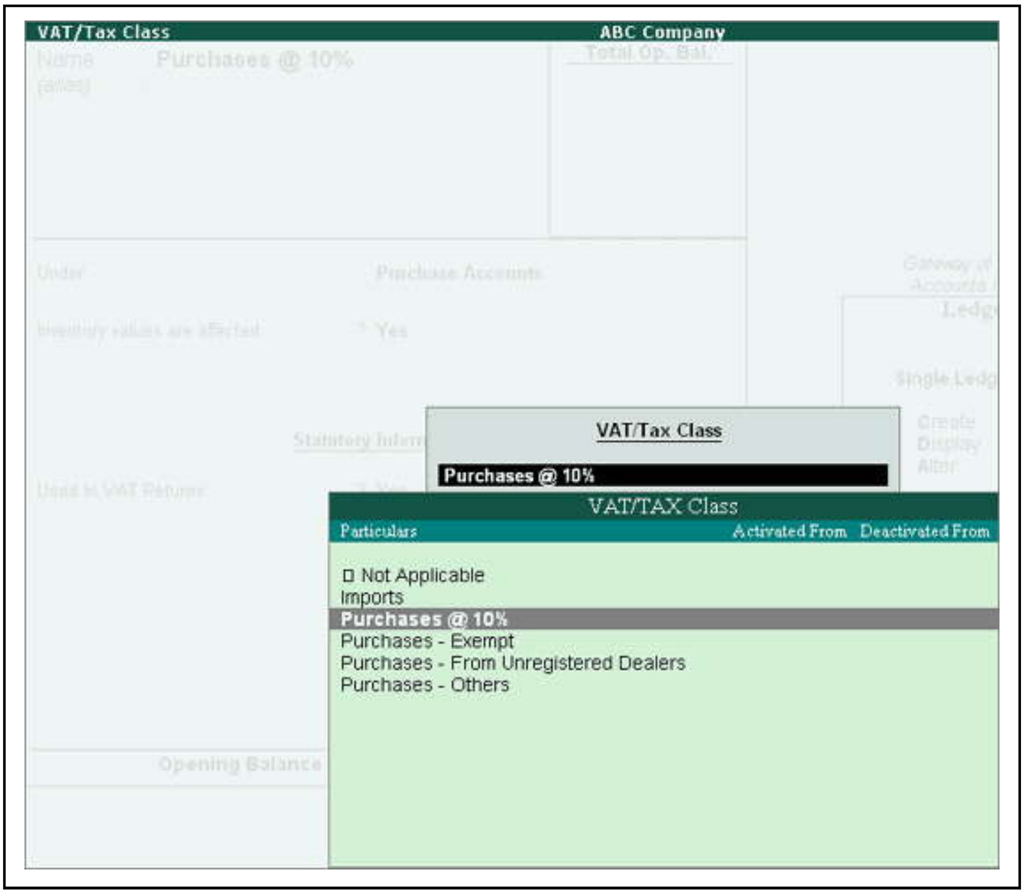
4. ***Maintain balances Bill-by-Bill:*** To get this option give 'Yes' to Maintain Bill-wise details in Company Features-F11. This option is useful only for Sundry Debtors and Creditors. It can also be used where some tracking is needed like Project-wise Expenses or income, installments due, installment-wise outstanding details. Enter due date of the bill or credit days under the option default credit period.

Notes

5. ***Opening Balance:*** Enter the opening balance of the respective your bank account as on the date of Books beginning from option in Company Creation Screen.

6. ***Mailing and Related Details:*** Tally by default carries the ledger name here. You can also enter any other mailing name as you wish. This name is printed in all external documents i.e. other than internal reports, books of accounts, etc. The Address Details, Income Tax Number, Sales Tax Number, the person to whom you should contact should be given in the respective menus. This option is available only for parties' accounts (Capital, Sundry Debtors and Creditors). Further, you can also give the Telephone number, Details regarding Fax and the E- mail address. We can also add Notes for ledger account. This option is available for all ledgers. This is useful to add remarks or notes about the ledger like the credit worthiness of the party. In this context we create in the single ledger option to bring up the Single Ledger screen. We setup "Conveyance" ledger under the "Indirect Expenses" group.

7. ***Set used in VAT Returns to Yes:*** Select the required **VAT/Tax Class**, for example, Purchases @ 10%




- Press **Enter** to return to the purchase ledger creation screen
- Accept the Purchase Ledger Creation screen.
- It is recommended that separate Purchase Ledgers be created for each of the purchase related VAT/Tax classifications.

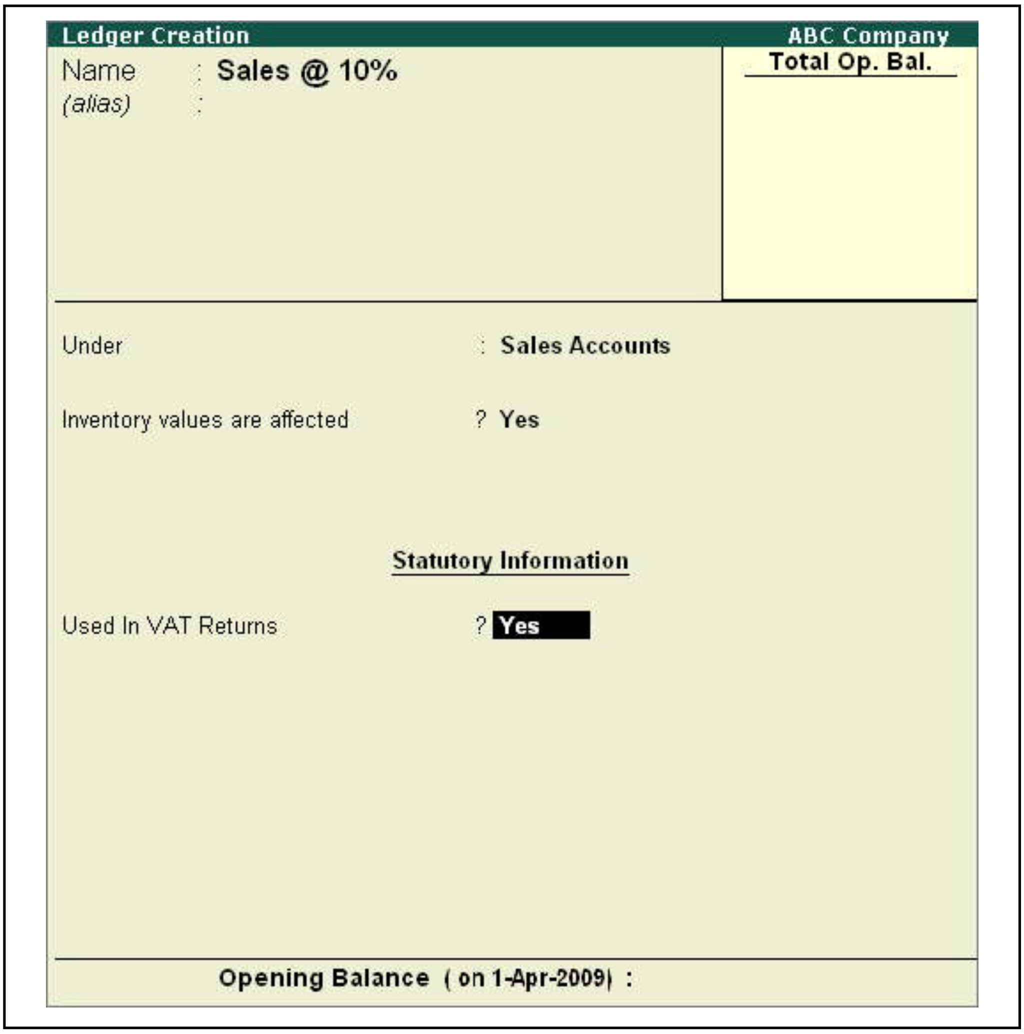
## Creating a Sales Ledger

**Notes**

To create a **Sales** ledger

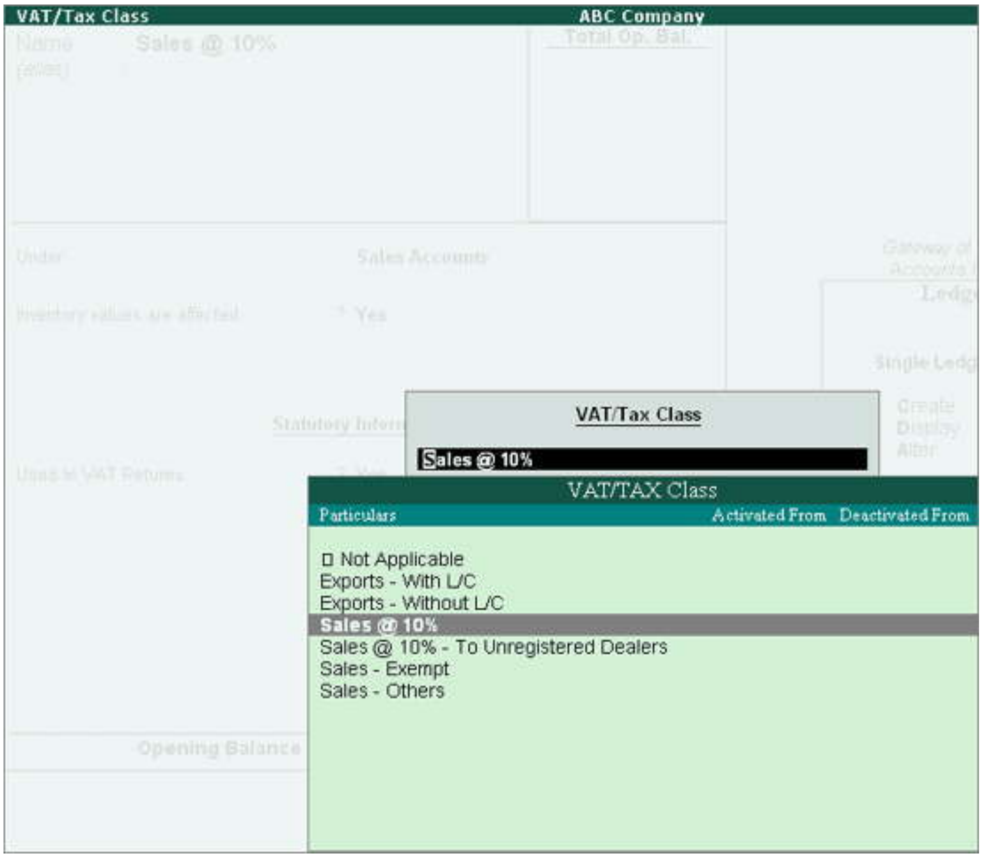
Go to **Gateway of Tally > Accounts Info > Ledger > Create**

1. Enter the **Name** of the sales ledger
2. In the **Under** field, select the **Sales Accounts** from the **List of Groups**
3. Set **Inventory values are affected** to **Yes**




4. Set used in VAT Returns to Yes
5. Select the required **VAT/Tax Class**, for example, Sales @ 10%

Notes




6. Accept the sales ledger creation screen.

It is recommended that separate Sales Ledgers be created for each of the sales related VAT/Tax classifications.

*Task* Create sales return ledger.

### 14.3.1 Creating VAT Ledger

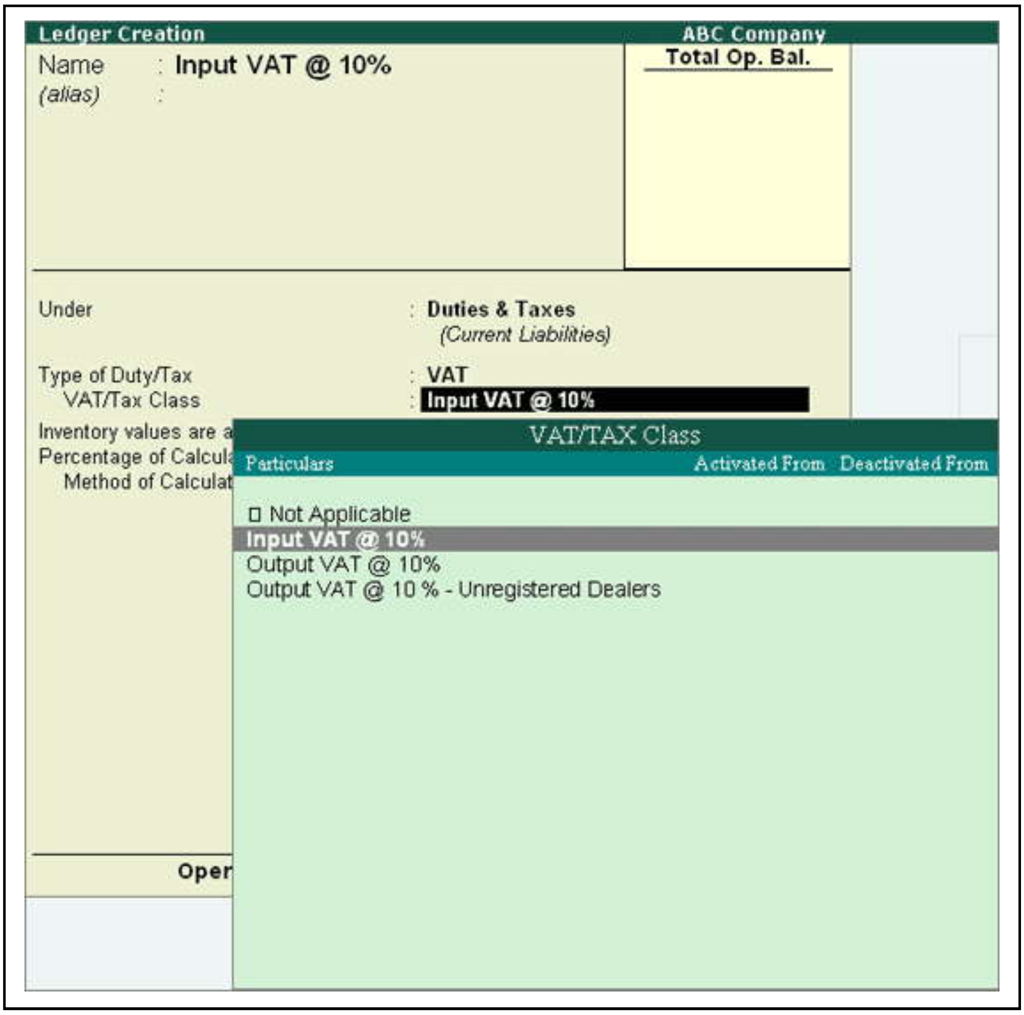
#### Creating an Input VAT Ledger

To create an input VAT ledger,

Go to Gateway of Tally > Accounts Info. > Ledgers > Create

- Enter the Name of the VAT Ledger as Input VAT @ 10%
- In the Under field, select Duties & Taxes from List of Groups
- Select the Type of Duty/Tax as VAT
- In the VAT/TAX Class field, select Input VAT @ 10%

Notes




- By default Inventory Values are affected is set to No
- Set Percentage of Calculation will be set to 10% as per the VAT/Tax Class selected
- The Method of Calculation will be automatically set to On VAT Rate
- Enter the opening balance, if any
- Accept the Input VAT ledger.

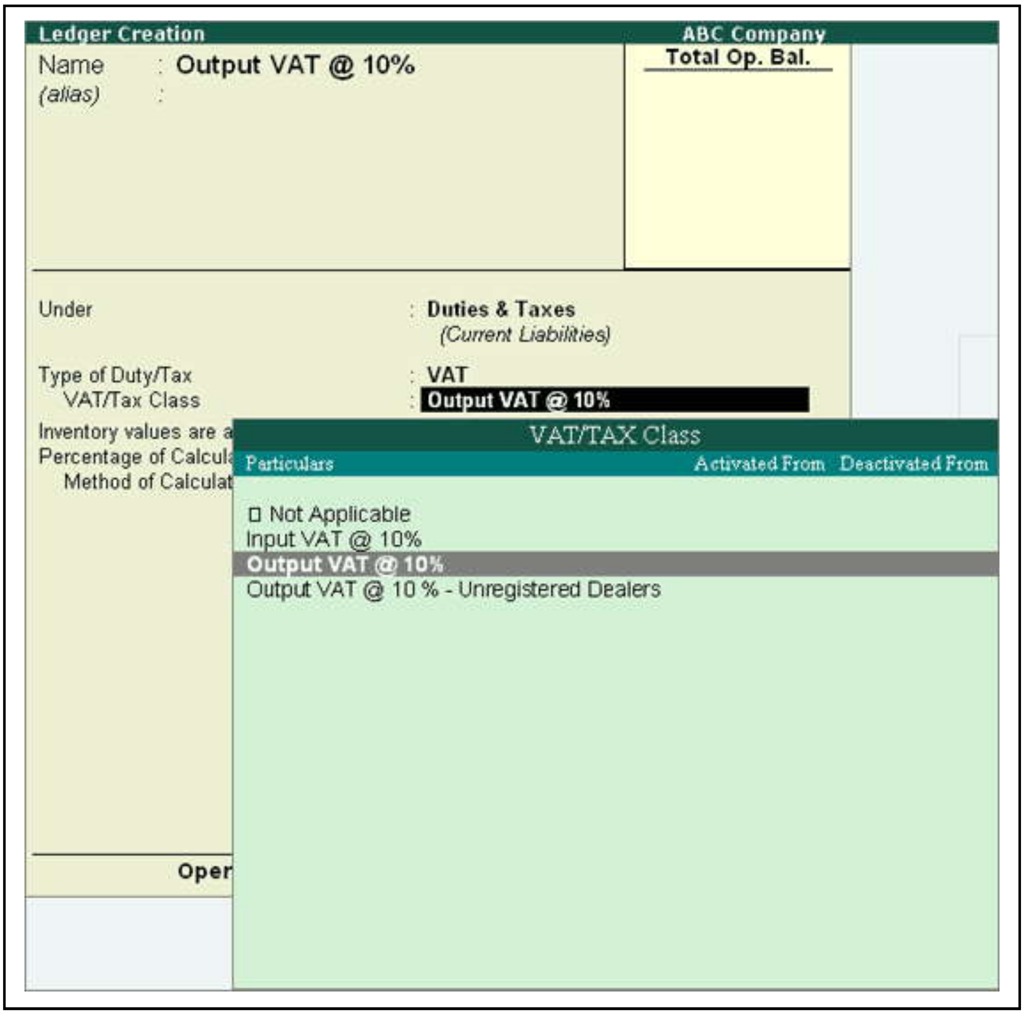
### Creating an Output VAT Ledger

To create an output VAT ledger,

Go to Gateway of Tally > Accounts Info. > Ledgers > Create

- Enter the Name of the VAT Ledger as Output VAT @ 10%
- In the Under field, select Duties & Taxes from List of Groups
- Select the Type of Duty/Tax as VAT
- In the VAT/TAX Class field, select Output VAT @ 10%

Notes




- By default Inventory Values are affected is set to No
- Set Percentage of Calculation will be set to 10% as per the VAT/Tax Class selected
- The Method of Calculation will be automatically set to On VAT Rate
- Enter the opening balance, if any
- Accept the Output VAT ledger.

### 14.3.2 Creating a Party Ledger

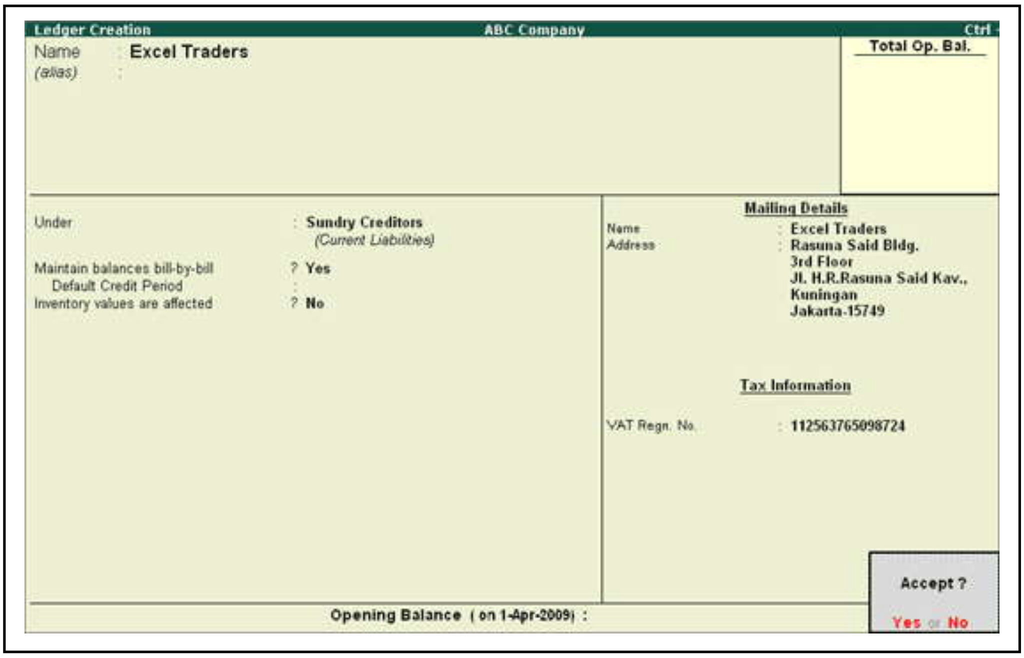
To create a ledger for the **Supplier**,

Go to Gateway of Tally > Accounts Info > Ledgers > Create

- Enter the name of the ledger in the **Name** field
- In the **Under** field, select **Sundry Creditors** from **List of Groups**
- Set **Maintain Balances Bill by Bill** to **Yes/No**

**Notes**

- By default **Inventory Values are affected** is set to **No**
- Enter the **Mailing Details**
- Enter the **15 digit VAT Regn. No.**
- Press **Y** or **Enter** to accept and save.




## Self Assessment

Fill in the blanks:

3. The first step to start tally is to ...................... a company.
4. After the process of ...................... is completed, the company gets loaded automatically for the first time.

## 14.4 Reports and Day Book

Books of account record the transaction details as entered. Although items are posted too many different ledgers, Tally brings all the transactions of a particular category together into a book of account for viewing and printing. The Gateway of Tally menu provides access to all the financial reports listed in the Display Menu.

### 14.4.1 Profit & Loss Account

The Profit & Loss Account shows the operational results over a given period. It lists out the Incomes and Expenditures based on the Primary Groups of Tally and the Profit & Loss Account in Tally is updated instantly with every transaction voucher that is entered and saved. The profit & loss account in Tally.ERP 9 displays the information based on the default primary groups. It is updated instantly with every transaction/voucher that is entered and saved. No special processing is required to produce a profit & loss account in Tally.ERP 9.

**Notes**

To view the Profit & Loss Account

Go to Gateway of Tally > Profit & Loss Account

The Profit & Loss Account is displayed according to the configuration set up for it in F12: Configure. The Profit & Loss Account is displayed as shown:

Profit & Loss A/c — ABC Company — Ctrl + M

| Particulars | ABC Company 1-Apr-2006 to 15-Jun-2006 | Particulars | ABC Company 1-Apr-2006 to 15-Jun-2006 |
|---|---|---|---|
| Opening Stock | 22,500.00 | Sales Accounts | 11,49,250.00 |
| Purchase Accounts | 1,88,03,680.00 | Direct Incomes | 1,00,10,000.00 |
| Direct Expenses | 15,000.00 | Closing Stock | 1,16,69,750.00 |
| *Gross Profit c/o* | *39,87,820.00* | | |
| | 2,28,29,000.00 | | 2,28,29,000.00 |
| *Nett Profit* | *1,77,42,820.00* | *Gross Profit b/f* | *39,87,820.00* |
| | | Indirect Expenses | 1,37,55,000.00 |
| Total | 1,77,42,820.00 | Total | 1,77,42,820.00 |

The **Profit & Loss** account is generated and updated immediately from the date of opening of books till the date of last entry.

Press **F2: Period** to change the period as required.

### Horizontal Form of Profit & Loss Account

The Profit & Loss A/c, by default is in horizontal form. However, you may configure the same to view in Vertical form by pressing it in **F12: Configure**. You can view additional information or toggle to another report using the options available in the Button Bar.

*Did u know?* Some of the Button Bar options are:

- Select **F1: Detailed/Condensed** to display more information or condense.
- Change the date of the Profit & Loss Account using **F2: Period**.
- Add new columns too
  - Display the Profit & Loss Account for a different period to compare with the current one
  - Display the Profit & Loss Account in a different currency
  - Display a column with Budget figures and analyse variances
  - See the effect of different Stock Valuations on the Profit/Loss account.
  - Select and compare Profit & Loss of different companies.

Notes

### 14.4.2 Trial Balance

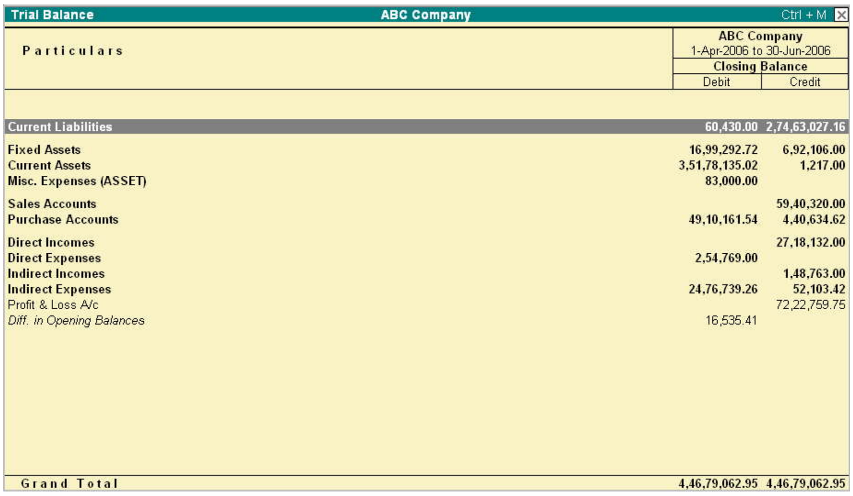
Trial Balance is a report of all account balances for the company sorted by groups, i.e., it is displayed in a grouped form, comprising main groups and their closing balances. You can see that the debit and credit balances match.

In Tally, the matching of the Trial Balance is a foregone conclusion since all voucher entries are in Debit-Credit format and must balance at the entry point.

To view the Trial Balance

Go to ***Gateway of Tally > Display>Trial Balance***

*Notes* As per accounting principles, the Trial Balance does not list Closing Stock.

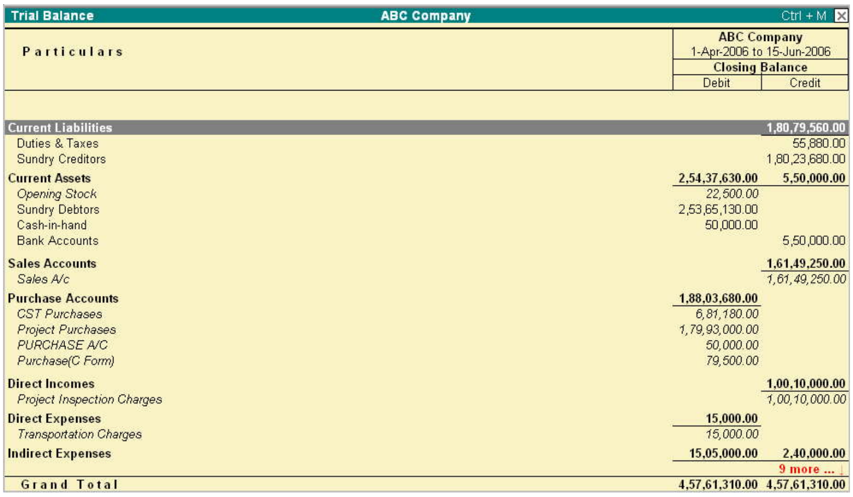


Trial Balance — ABC Company — Ctrl + M

| Particulars | ABC Company 1-Apr-2006 to 30-Jun-2006 Closing Balance Debit | Credit |
|---|---|---|
| **Current Liabilities** | 60,430.00 | 2,74,63,027.16 |
| **Fixed Assets** | 16,99,292.72 | 6,92,106.00 |
| **Current Assets** | 3,51,78,135.02 | 1,217.00 |
| **Misc. Expenses (ASSET)** | 83,000.00 | |
| **Sales Accounts** | | 59,40,320.00 |
| **Purchase Accounts** | 49,10,161.54 | 4,40,634.62 |
| **Direct Incomes** | | 27,18,132.00 |
| **Direct Expenses** | 2,54,769.00 | |
| **Indirect Incomes** | | 1,48,763.00 |
| **Indirect Expenses** | 24,76,739.26 | 52,103.42 |
| Profit & Loss A/c | | 72,22,759.75 |
| *Diff. in Opening Balances* | 16,535.41 | |
| **Grand Total** | 4,46,79,062.95 | 4,46,79,062.95 |

- Select **F1**: **Detailed** to break down the grouped information or simply drill down a Group for further detail.

  The screen appears as shown



Trial Balance — ABC Company — Ctrl + M

| Particulars | ABC Company 1-Apr-2006 to 15-Jun-2006 Closing Balance Debit | Credit |
|---|---|---|
| **Current Liabilities** | | 1,80,79,560.00 |
| Duties & Taxes | | 55,880.00 |
| Sundry Creditors | | 1,80,23,680.00 |
| **Current Assets** | 2,54,37,630.00 | 5,50,000.00 |
| *Opening Stock* | 22,500.00 | |
| Sundry Debtors | 2,53,65,130.00 | |
| Cash-in-hand | 50,000.00 | |
| Bank Accounts | | 5,50,000.00 |
| **Sales Accounts** | | 1,61,49,250.00 |
| *Sales A/c* | | 1,61,49,250.00 |
| **Purchase Accounts** | 1,88,03,680.00 | |
| *CST Purchases* | 6,81,180.00 | |
| *Project Purchases* | 1,79,93,000.00 | |
| *PURCHASE A/C* | 50,000.00 | |
| *Purchase(C Form)* | 79,500.00 | |
| **Direct Incomes** | | 1,00,10,000.00 |
| *Project Inspection Charges* | | 1,00,10,000.00 |
| **Direct Expenses** | 15,000.00 | |
| *Transportation Charges* | 15,000.00 | |
| **Indirect Expenses** | 15,05,000.00 | 2,40,000.00 |
| | | 9 more ... |
| **Grand Total** | 4,57,61,310.00 | 4,57,61,310.00 |

Notes

- Select **F5: Led-wise** to list all ledgers and their closing balances.

  The screen appears as shown

**Trial Balance** — **ABC Company** — Ctrl + M

| Particulars | ABC Company 1-Apr-2006 to 15-Jun-2006 Closing Balance | |
|---|---|---|
| | Debit | Credit |
| Opening Stock | 22,500.00 | |
| Cash | 50,000.00 | |
| CP Limited | | 50,000.00 |
| CST | | 55,880.00 |
| CST Purchases | 6,81,180.00 | |
| Customer | 2,15,130.00 | |
| General Maintenance | 75,000.00 | |
| HDFC Bank Ltd | | 5,00,000.00 |
| Labour Charges Paid | 70,000.00 | |
| Printing & Stationary | 4,55,000.00 | |
| Profit & Loss Account | | 500.00 |
| Project Customer - B'Lore | 2,51,50,000.00 | |
| Project Inspection Charges | | 1,00,10,000.00 |
| Project Purchases | 1,79,93,000.00 | |
| Project Sales | 5,00,000.00 | |
| PURCHASE A/C | 50,000.00 | |
| Purchase(C Form) | 79,500.00 | |
| Sales A/c | | 1,61,49,250.00 |
| Staff Welfare | 75,000.00 | |
| Supplier | | 80,680.00 |
| Supplier A | | 1,79,43,000.00 |
| | | 4 more ... |
| **Grand Total** | **4,57,61,310.00** | **4,57,61,310.00** |

- Select **New Column** to bring up the closing balances for another date.

  The screen appears as shown

**Trial Balance** — **ABC Company** — Ctrl + M

| Particulars | ABC Company 1-Apr-2006 to 15-Jun-2006 Closing Balance | | *ABC Company 1-Apr-2006 to 1-May-2006* Closing Balance | |
|---|---|---|---|---|
| | Debit | Credit | Debit | Credit |
| **Current Liabilities** | | 1,80,79,560.00 | | *1,80,43,000.00* |
| **Current Assets** | 2,54,37,630.00 | 5,50,000.00 | *1,53,82,500.00* | *50,000.00* |
| **Sales Accounts** | | 1,61,49,250.00 | | *1,60,00,000.00* |
| **Purchase Accounts** | 1,88,03,680.00 | | *1,87,73,000.00* | |
| **Direct Incomes** | | 1,00,10,000.00 | | *10,000.00* |
| **Direct Expenses** | 15,000.00 | | *15,000.00* | |
| **Indirect Expenses** | 15,05,000.00 | 2,40,000.00 | *6,65,000.00* | |
| Profit & Loss Account | | 500.00 | | 500.00 |
| *Diff. in Opening Balances* | | 7,32,000.00 | | 7,32,000.00 |
| **Grand Total** | 4,57,61,310.00 | 4,57,61,310.00 | *3,48,35,500.00* | *3,48,35,500.00* |

### 14.4.3 Journals, Day Books and Registers

Journal, Sales Register, Purchase Register, Debit Note Register, Credit Note Register, Payment Register, Receipts Register, etc., are the different kinds of Registers.

To view the Day Book

Go to ***Gateway of Tally > Display>Daybook***

Notes

The Day Book lists all transactions made over a particular day and by default displays the last voucher entry date of a regular voucher. It could also be set up to list all the transactions made over a period.

Press **F2: Period** on the button bar or press the keys **Alt+F2**.

All the transactions include all financial vouchers, reversing and memorandum journals as well as inventory vouchers.

Consider an example:

### Day Book for Current Date

Day Book — ABC Company — Ctrl + M

Day Book — For 1-Apr-2006

| Date | Particulars | Vch Type | Vch No. | Debit Amount<br>Inwards Qty | Credit Amount<br>Outwards Qty |
|---|---|---|---|---|---|
| 1-4-2006 | Customer | Sales | 14 | 1,515.00 | |
| 1-4-2006 | Supplier | Sales | 15 | 520.00 | |
| 1-4-2006 | Customer | Sales | 16 | 500.00 | |
| 1-4-2006 | Customer | Sales | 17 | 500.00 | |
| 1-4-2006 | Customer | Sales | 18 | 4,800.00 | |
| 1-4-2006 | Bank Account | Sales | 19 | | |
| 1-4-2006 | VAT Payable | Payment | 1 | 275.36 | |
| 1-4-2006 | Total Tax Payable | Journal | 1 | 420.00 | |
| 1-4-2006 | Output VAT 1% | Journal | 2 | 100.00 | |
| 1-4-2006 | Direct Expenses | Journal | 3 | 5,050.00 | |
| 1-4-2006 | Input Credit on Capital Goods | Journal | 4 | 555.56 | |
| 1-4-2006 | Tax Recoverable | Journal | 5 | 57,500.00 | |
| 1-4-2006 | Supplier | Credit Note | 1 | | 550.00 |
| 1-4-2006 | Customer | Credit Note | 2 | | 1,560.00 |
| 1-4-2006 | Supplier | Debit Note | 1 | 520.00 | |
| 1-4-2006 | Supplier | Debit Note | 2 | 520.00 | |
| 1-4-2006 | Supplier | Purchase | 1 | | 5,00,000.00 |
| 1-4-2006 | Supplier | Purchase | 2 | | 15,600.00 |
| 1-4-2006 | Supplier | Purchase | 3 | | 10,400.00 |
| 1-4-2006 | Supplier | Purchase | 4 | | 4,992.00 |
| 1-4-2006 | Supplier | Purchase | 5 | | 5,000.00 |
| 1-4-2006 | Supplier | Purchase | 6 | | 10,100.00 |
| 1-4-2006 | Supplier | Purchase | 7 | | 10,100.00 |
| 1-4-2006 | Supplier | Purchase | 8 | | 5,00,000.00 |
| 1-4-2006 | Supplier | Purchase | 9 | | 4,867.20 |

### Day Book for a Period

Day Book — ABC Company — Ctrl + M

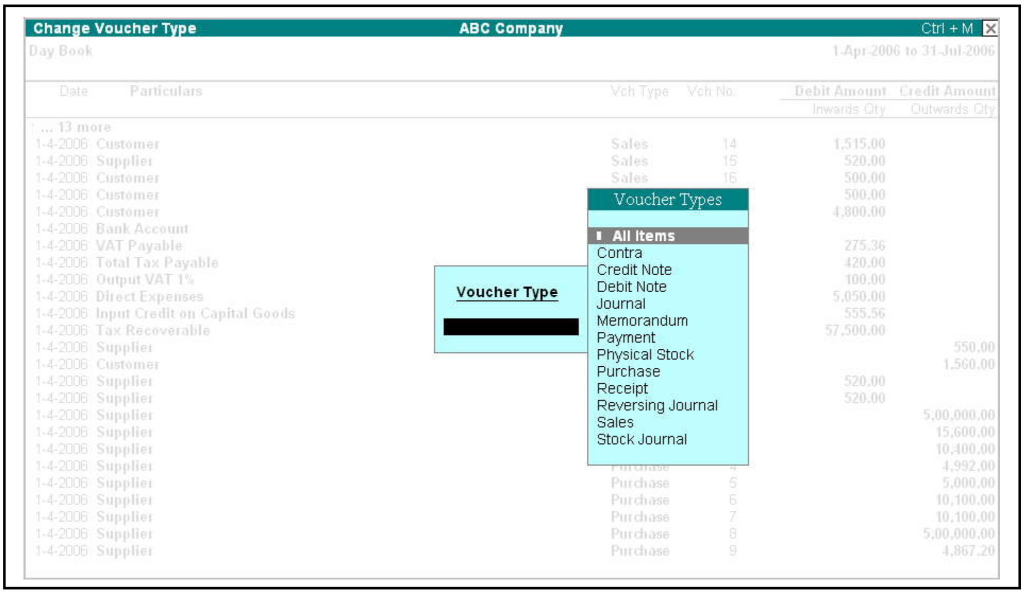
Day Book — 1-Apr-2006 to 31-Jul-2006

| Date | Particulars | Vch Type | Vch No. | Debit Amount<br>Inwards Qty | Credit Amount<br>Outwards Qty |
|---|---|---|---|---|---|
| 1-4-2006 | Customer | Sales | 14 | 1,515.00 | |
| 1-4-2006 | Supplier | Sales | 15 | 520.00 | |
| 1-4-2006 | Customer | Sales | 16 | 500.00 | |
| 1-4-2006 | Customer | Sales | 17 | 500.00 | |
| 1-4-2006 | Customer | Sales | 18 | 4,800.00 | |
| 1-4-2006 | Bank Account | Sales | 19 | | |
| 1-4-2006 | VAT Payable | Payment | 1 | 275.36 | |
| 1-4-2006 | Total Tax Payable | Journal | 1 | 420.00 | |
| 1-4-2006 | Output VAT 1% | Journal | 2 | 100.00 | |
| 1-4-2006 | Direct Expenses | Journal | 3 | 5,050.00 | |
| 1-4-2006 | Input Credit on Capital Goods | Journal | 4 | 555.56 | |
| 1-4-2006 | Tax Recoverable | Journal | 5 | 57,500.00 | |
| 1-4-2006 | Supplier | Credit Note | 1 | | 550.00 |
| 1-4-2006 | Customer | Credit Note | 2 | | 1,560.00 |
| 1-4-2006 | Supplier | Debit Note | 1 | 520.00 | |
| 1-4-2006 | Supplier | Debit Note | 2 | 520.00 | |
| 1-4-2006 | Supplier | Purchase | 1 | | 5,00,000.00 |
| 1-4-2006 | Supplier | Purchase | 2 | | 15,600.00 |
| 1-4-2006 | Supplier | Purchase | 3 | | 10,400.00 |
| 1-4-2006 | Supplier | Purchase | 4 | | 4,992.00 |
| 1-4-2006 | Supplier | Purchase | 5 | | 5,000.00 |
| 1-4-2006 | Supplier | Purchase | 6 | | 10,100.00 |
| 1-4-2006 | Supplier | Purchase | 7 | | 10,100.00 |
| 1-4-2006 | Supplier | Purchase | 8 | | 5,00,000.00 |
| 1-4-2006 | Supplier | Purchase | 9 | | 4,867.20 |

**Notes**

You can also filter the list so as to display the transactions of a particular voucher type using **F4: Chg Vch** button from the button bar.

The screen appears as shown:




There are three ways to view various types of registers:

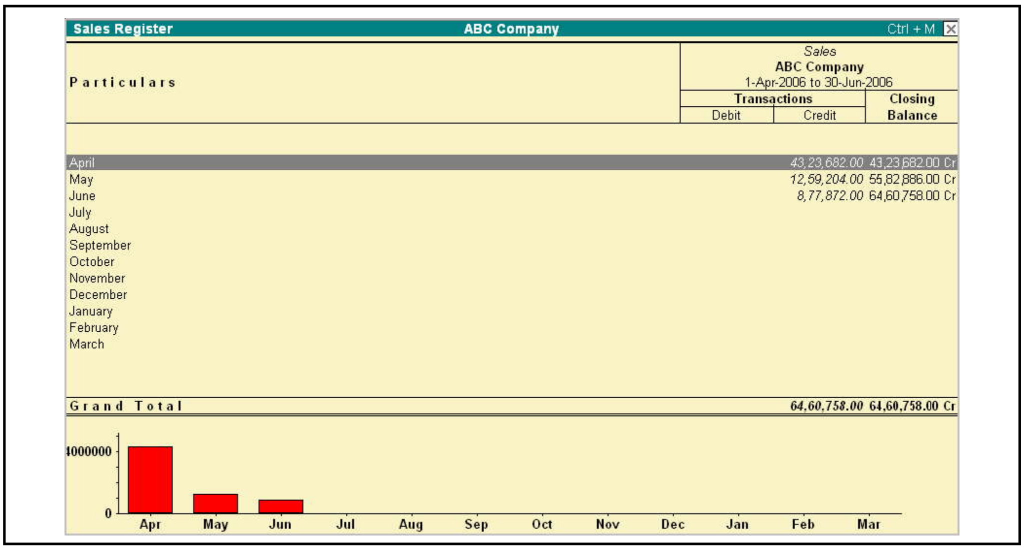
1. From the Display menu
2. By changing the type of voucher from within a register
3. From the Statistics page

Consider the **Sales Register** which includes most of the options.

Sales Register (Sales Day Book)

Go to ***Gateway of Tally > Display >Account books > Sales Register***

The following screen displays.



By default, all registers display Monthly Summary with transactions and closing balances. For Balance Sheet Accounts, opening balance is displayed at the top of the screen.

Select a month and press **Enter** to see the Sales Voucher Register.

A list of all sales vouchers pertaining to the month you selected displays. You can use the options in the button bar to change the display according to your preferences. You can change the period of the report as well as the depth of information.

Use **F12: Configure** to see the report with some or all of the following information, namely Narrations, Bill-wise details, Cost Centre details and Inventory details.

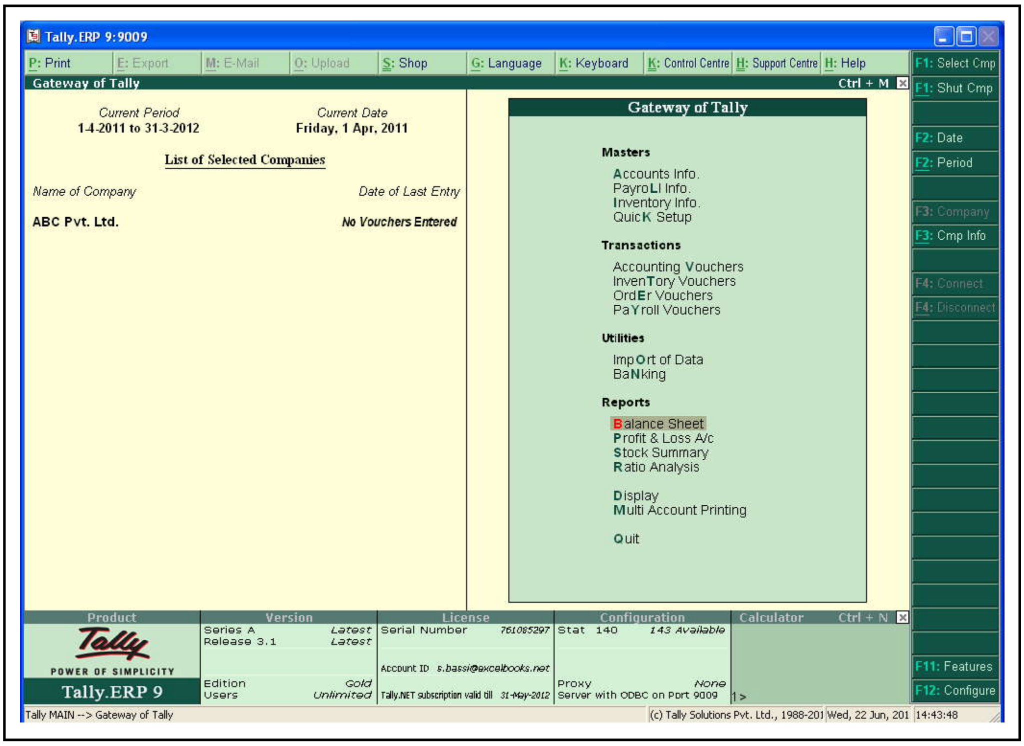
Click on **F1: Detailed** to view the reports in detailed format.

## 14.5 Balance Sheet

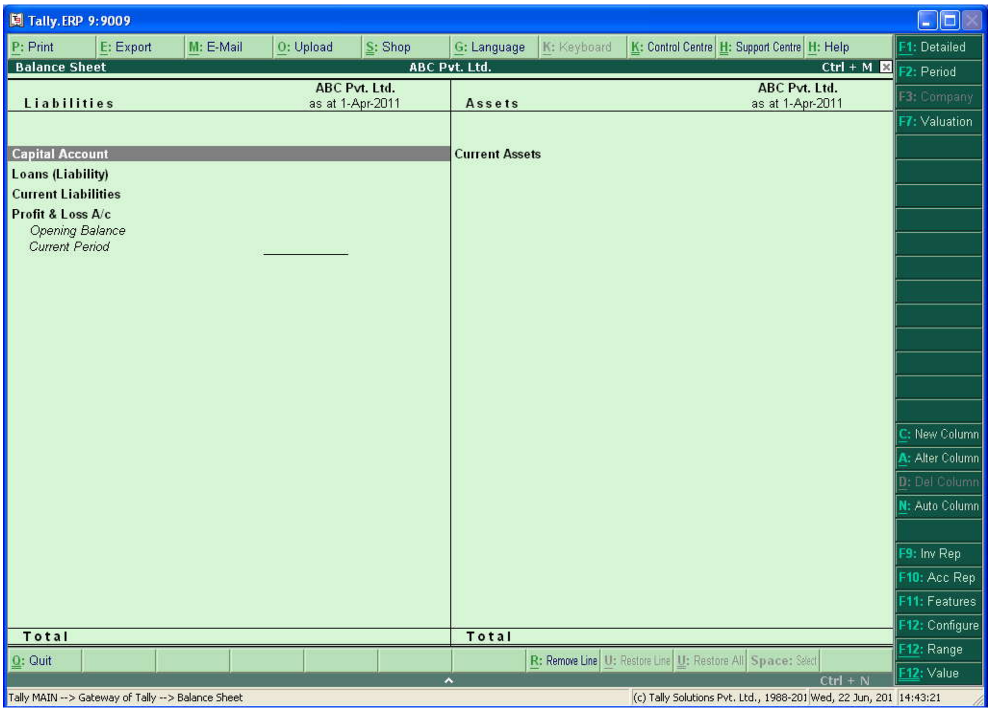
To create a balance sheet use:

**Gateway of Tally > Balance Sheet > Enter**

Balance Sheet generates a report giving the details of Assets and Liabilities in vertical/horizontal form. To view Balance Sheet use the above command and your screen will show the Balance Sheet in the desired format. The right hand side of your screen will show the keys to be used to change the reporting format e.g.



**Notes**




*Notes*

F1 : To see the detailed Balance Sheet i.e. it will show the breakup of the grouped figures.

F2 : To change the date.

F10 : To see the various Accounting reports e.g. Cash Flow, Funds Flow, Profit & Loss A/c, Trial Balance, etc. As you press the button F10, a pop-up screen will display the Accounting reports you can see. Just select from it to see the desired report.

F11 : Features

F12 : Configure. If the Balance Sheet shown is in horizontal form and you want to see it in vertical form, select F12. A pop up screen will appear and give you the options you can select to alter the display screen.

Alt F12 : Range

Ctrl F12 : Value

### Self Assessment

Notes

5. …………………… generates a report giving the details of Assets and Liabilities in vertical/ horizontal form.
6. To view Balance Sheet use the …………………… command and your screen will show the Balance Sheet in the desired format.

## 14.6 Summary

- Tally is complete Accounting system. It handles different types of vouchers, for example, Payments, Receipts, Journals, Debit Notes, Sales, Purchase, Delivery note, etc.
- Tally allows the user to define account heads as per his requirements. Tally offers 28 predefined widely used Groups.
- Tally allows users to select any report for a particular date or for any range of dates. Once you have selected a Report, press F2 (F2 in case of Day Book) and specify the date range (From and to).
- To create a company uses the command: Gateway of Tally > Company Info. > Create
- To create a **Sales** ledger: Go to **Gateway of Tally > Accounts Info > Ledger > Create**
- To create an input VAT ledger: Go to Gateway of Tally > Accounts Info. > Ledgers > Create
- To create a ledger for the **Supplier**: Go to Gateway of Tally > Accounts Info > Ledgers > Create
- **To create a balance sheet use:** Gateway of Tally > Balance Sheet > Enter

## 14.7 Keywords

***Balance Sheet:*** Balance Sheet generates a report giving the details of Assets and Liabilities in vertical/horizontal form.

***Shut A Company:*** Shut a company means to unload it without deleting it. Simply select it again to load and work on it again.

***Tally:*** Tally is versatile and massive software package. It is used by various types of trade and industry.

***VAT:*** It is multi point sales tax with get off for tax paid on purchase.

## 14.8 Review Questions

1. "Tally 9 is also concurrently multilingual communication". Comment.
2. Briefly explain the meaning of tally? Write down the salient feature of VAT in Tally ERP 9.
3. Briefly discuss the Starting the Tally.
4. What is Balance Sheet? Write down the Gateway of Tally.

### Answers: Self Assessment

1. Tally
2. Vouchers
3. Create
4. Company creation
5. Balance Sheet
6. Gateway of Tally > Balance Sheet > Enter

**Notes**

## 14.9 Further Readings

*Books*

Khan and Jain, "Management Accounting".

"Learning in Tally" Ramesh Bangia (PBP)

M.P. Pandikumar, "Accounting & Finance for Managers", Excel Books, New Delhi.

R.L. Gupta and Radhaswamy, "Advanced Accountancy".

S.N. Maheswari, "Management Accounting".

Tally Solutions aims to double revenues in 2011-12. "The Economic Times" (The Times of India). 10 April 2011.

V.K. Goyal, "Financial Accounting", Excel Books, New Delhi.

*Online link*

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