

**TEERTHANKER MAHAVEER UNIVERSITY
MORADABAD, INDIA**

**CENTRE FOR ONLINE & DISTANCE
LEARNING**



Accredited with NAAC **A** Grade

12-B Status from UGC

Programme: Master of Commerce

Course: Financial Accounting

Course Code: MCH101

Semester-I

Syllabus

OBJECTIVE AND EXPECTED OUTCOME OF THE COURSE:

To familiarize the students with the basic fundamentals of the accounting and understand the accounting mechanism necessary for the preparation of the financial statements.

UNIT I

Basics of Accounting: Accounting, Accountancy and Book-Keeping. Accounting Concepts, conventions and Principles-GAAP. Branches of accounting. Accounting equation. Accounting Cycle: Journal, Ledger and Trial Balance; Subsidiary books

UNIT II

Rectification of errors. Bank reconciliation statement. Bills of exchange. Promissory notes. Depreciation- Fixed Instalment Method and Diminishing Balance Method (Numerical); Provisions and Reserves. Final Accounts with simple adjustments (Excluding the adjustments of bad debts etc.)

UNIT IV

Average due date. Account current. Self balancing ledgers

SUGGESTED READINGS/BOOKS:

- **Financial Accounting** : Sehgal, Ashok & Deepak (Latest Edition Taxman's Allied Services)
- **Financial Accounting**: Maheshwari, S. N. (Latest Edition Vikas Publishing House)
- **Financial Accounting**: Tulsian, P. C. (Latest Edition Pearson Publications)

Table of Contents

Lesson No.	Title	Page No.
1	INTRODUCTION TO ACCOUNTING	1
2	ACCOUNTING PRINCIPLES	18
3	ACCOUNTING EQUATIONS	34
4	JOURNAL	57
5	LEDGER	83
6	SUBSIDIARY BOOKS	108
7	TRIAL BALANCE	135
8	ERRORS AND RECTIFICATION	154
9	BANK RECONCILIATION STATEMENT	172
10	CAPITAL EXPENDITURE, REVENUE EXPENDITURE AND DEFERRED REVENUE	192
11	ACCOUNTING FOR DEPRECIATION	210
12	PROVISION AND RESERVES	242
13	FINAL ACCOUNTS	263
14	FINAL ACCOUNTS WITH ADJUSTMENTS	290

LESSON 1

INTRODUCTION TO ACCOUNTING

Structure

- 1.0 Objectives
- 1.1 Introduction
- 1.2 Meaning and Definition
- 1.3 Nature of Accounting
- 1.4 Evolution of Accounting
- 1.5 Distinction between Book keeping and Accounting
- 1.6 Objectives of Accounting
- 1.7 Users of Accounting Information
- 1.8 Limitations of Accounting
- 1.9 Basic Accounting Terms
- 1.10 Let Us Sum Up
- 1.11 Key Words
- 1.12 Questions
- 1.13 References and Suggested Readings

1.0 OBJECTIVES

After studying this lesson you should be able to

- understand the meaning and nature of accounting
- trace the evolution of accounting
- highlight the importance and limitation of accounting
- identify the users of the accounting information
- understand few important accounting terms

1.1. INTRODUCTION

Let us start with the story of Mr. Naveen who runs a readymade garment shop. Mr. Naveen purchased garments worth Rs.2,00,000. He sold them for Rs. 2,50,000. He also paid shop rent Rs.10,000. He is still left with goods worth Rs.20,000. Here we can see that Mr. Naveen carried few transactions. Why? for the purpose of running his garment shop i.e. his business. After carrying on these transactions now Mr. Naveen want to know what is the outcome.

He is left with the surplus of Rs.60,000.

Goods sold for: Rs.2,50,000

Goods in hand: Rs.20,000

Total:	Rs.2,70,000
Less:	
Goods purchased for:	Rs.2,00,000
Rent of the Shop:	Rs.10,000
Total:	Rs.2,10,000
Earnings/Surplus:	Rs. 60,000

So, here earnings/surplus of Rs.60,000 is known as 'event' and whatever Mr. Naveen did to earn this money i.e. purchase, sale, shop rent are known as 'transactions'. Every business organisation record these transactions to measure their transaction so as to see what are the earnings. Accounting is a discipline which serves the purpose of measurement of transactions and helps to develop useful information for the decision makers. Accounting is a process of identifying the transactions and events, measuring the transactions and events in terms of money, recording them in a systematic manner in the books of accounts, classifying or grouping them and finally summarizing the transactions in a manner useful to the users of accounting information. Accounting is one of the key functions for almost any business; it may be handled by a bookkeeper and accountant at small firms or by sizable finance departments with dozens of employees at larger companies.

Accounting is termed as the language of the business. Language serves the purpose of communication similarly the aim of accounting is to meet the needs of the rational and sound decision-makers.

1.2 MEANING AND DEFINITION

Accounting is a discipline which records, classifies, summarises and interprets financial information about the activities of an organisation so that intelligent decisions can be made. The main purpose of accounting is to ascertain profit or loss during a specified period and to show financial condition of the business on a particular date.

In the year 1961 *The American Institute of Certified Public Accountants* defined Accounting as "the art of recording, classifying and summarising in as significant manner and in terms of money, transactions and events which in part, at least of a financial character, and interpreting the results thereof".

As per this definition accounting starts with recording of information and ends at its interpretation. But today, the dimension of accounting has broadened. The globalisation of the business, increasing interest of the society in business activities, diversification of management and ownership has increased the importance of the communication of the accounting results. This requirement of communication of the results has also become the part of accounting. This aspect of accounting is very well defined in the following definition given by the American Accounting Association in the year 1966.

The American Accounting Association defines accounting as "the process of identifying, measuring, and communicating economic information to permit informed judgements

and decisions by users of the information.” On the similar grounds Smith & Ashburne defined accounting as “the science of recording and classifying business transactions and events, primarily of a financial character and the art of making significant summaries, analysis and interpretations of these transactions and events and communicating the results to persons who must make decisions or form judgements.”

In the year 1970, the *Accounting Principles Board of the American Institute of Certified Public Accountants* (AICPA) regarded accounting as a service activity. It defined the function of accounting as “to provide quantitative information, primarily of financial nature about economic entities that is needed to be useful in making economic decisions.”

The term ‘Accountancy’ is used for the profession of accountants i.e. who do the work of accounting and are knowledgeable persons. Accounting is concerned with recording all business transactions systematically and then arranging in the form of various accounts and financial statements. And it is a distinct discipline like economics, physics, astronomy etc. The word accounting tries to explain the nature of the work of the accountants (professionals) and the word Accountancy refers to the profession these people adopt.

Thus, in simple words we can say that accounting can be defined as the process of recording, classifying, summarizing, analysing and interpreting the financial transactions and communicating the results to its users. From the above the definitions the nature of the ‘accounting, can be clearly understood:

1.4 NATURE OF ACCOUNTING

Accounting is an art: Art requires a perfect knowledge, interest and experience to do a work efficiently. Art also teaches us how to do a work in the best possible way by making the best use of the available resources. Accounting is that part of knowledge that enables us to reach our goals. It shows the way as to how these goals can be attained in the best possible way. The computation of profits or loss in a systematic manner is a clear evidence of accounting being an art. It is an art to deals with the application of various accounting rules, principles and concepts to achieve certain concrete results.

Accounting is a science: Science is a systematised body of knowledge. It establishes a relationship of cause and effect in the various related phenomenon. It is also based on some fundamental principles. Accounting is based on established laws, principles or rules. It is a science because processing of business transactions is done on the basis of certain principles, which are generally accepted and not universally applicable. Hence, accounting cannot be treated as pure science like physics, chemistry or life science, where cause and effect relationship is studies and perfect conclusions are drawn. It can be termed as social science, whose results depend upon social and economic factors and to a greater extent on human behaviour.

Accounting is a Process: Accounting has its process of recording, classifying, summarising and interpretation of the financial transactions.

(i) **Recording :** Accounting records transactions in chronological order soon after their occurrence in the proper books of accounts.

(ii) **Classifying** : It then accumulate the transactions of similar type at one place. This function is performed by maintaining the ledger in which different accounts are opened to which related transactions are posted.

(iii) **Summarising** : Accounting prepare and present the classified data in a manner useful to the internal as well as the external users. Various statements like the Income statement, the Statement of financial position, the Statement of Changes in Financial Position, the Statement of Cash Flow etc. are prepared to provide summary of the business transactions.

(iv) **Analysing**: The figures given in summarised financial statements are not going to help as such if these are not simplified. Analysis is concerned with the establishment of the relationship between the Income statement and the Statement of the financial position.

(iv) **Interpreting** : With the advent of information technology, the aforesaid three functions are performed by accounting software and now the accountant has to concentrate mainly on the interpretation aspects of accounting. The accountants should interpret the statements in a manner useful to action. The accountant should explain not only what has happened but also (a) why it happened, and (b) what is likely to happen under specified conditions.

(v) **Communicating** : The summarised, analysed and interpreted financial information is then communicated to the end users to enable them to make rational decisions. This transmission of the information is done through the preparation and distribution of the accounting reports consisting of accounting ratios, graphs, diagrams alongwith other useful information.

Accounting as a service activity: As a service activity, accounting collects and provides quantitative information, primarily financial in nature, about economic entities that is intended to be useful in making economic decisions, in making reasoned choices among alternative courses of action. Accounting in itself cannot create wealth though, if it produces information which is useful to others, it may assist in wealth creation and maintenance.

Accounting as a profession: Accounting is a career and it requires formal education for rendering any service. The candidate must pass a vigorous examination to become accounting professional. In India, the accounting education is being imparted to the examinees by national body like the Institute of Chartered Accountants of India (ICAI), New Delhi. Similarly in USA, the American Institute of Certified Public Accountants (AICPA) provide this education and certification to work as a Chartered Accountant.

Accounting as a social force: Under the changing business environment, accounting is considered responsible for protecting the interest of the society i.e. of the people who are directly or indirectly linked with its operations. The information provided by accounting is used to solve the problems of the public at large such as determination and controlling of prices. Therefore, it becomes the responsibility of the accountants to provide proper, adequate and reliable accounting information for safeguarding public interest so as the society at large is benefited.

Accounting as a language: As stated earlier, accounting is referred as the "language of business". As language helps to converse and communicate, similarly accounting communicates business events. A language and accounting have common features as regards rules and symbols. Both are based and propounded on fundamental rules and

symbols. In language these are known as grammatical rules and in accounting, these are termed as accounting rules.

Accounting as an information system: Accounting as an information system serves the needs of both profit-seeking business and non-profit organisations. It provides relevant financial information on the resources of a business so as to enable the decision makers to evaluate the financial consequences of various alternatives.

Check your Progress I

Note: Use the space given below for your answers

1) Define the term 'accounting'

2) Is accounting an art or a science?

3) Distinguish between accounting and accountancy

1.4 EVOLUTION OF ACCOUNTING

The concept of Accounting is as old as money itself. It is considered that the seeds of accounting were most likely first sown in Babylonia and Egypt around 4000 B.C. who recorded transactions of payment of wages and taxes on clay tablets. Historical evidences reveal that Egyptians used some form of accounting for their treasuries where gold and other valuables were kept. The incharge of treasuries had to send day wise reports to their superiors known as Wazirs (the prime minister) and from there month wise reports were sent to kings. Babylonia, known as the city of commerce, used accounting for business to uncover losses taken place due to frauds and lack of efficiency.

In Greece, accounting was used for apportioning the revenues received among treasuries, maintaining total receipts, total payments and balance of government financial transactions. Romans used memorandum or daybook where in receipts and payments were recorded and wherefrom they were posted to ledgers on monthly basis.

(700 B.C to 400 A.D). China used sophisticated form of government accounting as early as 2000 B.C. In India evidences of practicing Accounting can be traced from the book named "Arthashastra" written by Kautilya, King Chandragupta's minister. Other than issues relating to politics and economics, it also explains the art of proper keeping of accounts.

The modern system of accounting based on the principles of double entry system owes its origin to the Franciscan Monk Fra Luca Pacioli (1445-1515) who first published the principles of Double Entry System in 1494 at Venice in Italy. Luca Pacioli, considered as the father of modern accounting published the first text of 36 chapters on accounting '*Summa de Arithmetica, Geometria, Proportioni et Proportionalita.*' It described double-entry bookkeeping and other commerce-related concepts. Double entry bookkeeping is a system in which a debit and credit entry is entered for each transaction : "Every debit has its credit –every amount that is charged to one account must be placed to the credit of another". He used the present day popular terms of accounting Debit (Dr.) and Credit (Cr.). These were the concepts used in Italian terminology. Debit comes from the Italian *debito* which comes from the Latin *debita* and *debeo* which means owed to the proprietor. Credit comes from the Italian *credito* which comes from the Latin '*credo*' which means trust or belief. By the time Pacioli published his later work, *De Divina Proportione*, in 1509, he was so well respected that Leonardo da Vinci contributed several engravings for his text.

The Colonial expansion in the 17th century and demand for foreign goods saw the rise of 'chartered companies', the first corporations requiring permanently invested and large investment thus leading to the development of book-keeping to keep track of the assets and profits of many distinct trading ventures at different stages of completion. With the development of the corporate forms of business, especially during industrial revolution, accounting developed further.

Josiah Wedgwood, the founder of famous pottery manufacturer Wedgwood is considered by many to be a pioneer in cost accountancy. After examining business accounts, Josiah Wedgwood discovered that his head clerk had been embezzling from the company and so after hiring a new clerk he implemented weekly account reviews to keep track of his finances. These reviews allowed him to calculate detailed costs for materials and labour, leading to the discovery of overhead costs and economies of scale. The method of recording got popularity. Australia witnessed double entry book keeping for the first time when John Croaker helped to establish bookkeeping practices at the first Bank of New South Wales. In 1854, the formal accounting profession emerged in Scotland with the formation of Edinburgh Society and Glasgow Institute of Accountants. The title 'Chartered Accountant' was decided upon and adopted for members of the Society, and was soon adopted by the Glasgow Institute and the later formed Aberdeen Society. Later, in 1880, the Institute of Chartered Accountants in England and Wales was formed. In 1887 the American Association of Public Accountants was formed.

Thus, the art of accounting has been practised for centuries but it is only in the late thirties that the study of the subject 'accounting' has been taken up seriously.

1.5 DISTINCTION BETWEEN BOOK-KEEPING AND ACCOUNTING

Book-keeping is a part of accounting and is concerned with the recording of financial data relating to business operations in a significant and orderly manner. It covers

procedural aspects of accounting work and embraces record keeping function. Sometimes book-keeping and accounting are considered as synonymous but these are different from each other. Following are the differences in book keeping and accounting:

Book Keeping	Accounting
Book Keeping is a recording phase	Accounting is a summarising phase of an accounting system
Book keeping provides necessary data for accounting	Accounting starts where book keeping ends
It constitutes base for accounting	Accounting is considered as the language of the business.
Managerial decisions cannot be taken with the help of book keeping	Management takes decisions on the basis of accounting information
Book-keeping is concerned with transactions which are often routine and clerical in nature	Accounting performs other functions as well, viz., measurement and communication, besides recording
Basic knowledge of commerce is sufficient to become a book keeper	An accountant is required to have a much higher level of knowledge, conceptual understanding and analytical skill than is required of the book-keeper.
Book-keeping has no sub-field	Accounting has several sub-fields like financial accounting, management accounting, cost accounting, human resource accounting, social accounting etc.

1.6 OBJECTIVES OF ACCOUNTING

The following are the main objectives of accounting:

1. To keep systematic records: The basic objective of accounting is to keep a systematic record of financial aspect of business transactions. If the records are not kept systematically, there would have been terrific burden on human memory which in most cases would have been impossible to bear. These records are then classified and summarised in the form of financial statements.

2. To know the financial position of the business: Accounting helps the management to understand and know what the organisation own and what it owes by supplying the information like (i) Organisation's ability to meet the short term liability. (ii) The amount to be paid in long run. (iii) The amount to be received from others (iv) Fixed assets and current assets of the business etc. Information about the above matters helps the proprietor in assuring that the funds of the business are not necessarily kept idle or underutilised.

3. To ascertain the operational results: Accounting helps in ascertaining the net profit earned or loss suffered on account of carrying the business operations for a particular period of time. This is done by keeping a proper record of revenues and expense of a particular period. If the amount of revenue for the period is more than the expenditure

incurred in earning that revenue, there is said to be a profit. In case the expenditure exceeds the revenue, there is said to be a loss. Income Statement/ Profit and Loss Account will help the management, investors, creditors, etc. to understand whether the business has proved to be remunerative or not. In case it has not proved to be remunerative or profitable, the cause of such a state of affairs will be investigated and necessary remedial steps will be taken.

4. To ascertain the financial position of the business: The management is not only interested in knowing the Profit and Loss of the organisation but is also interested in knowing its financial health i.e. where he stands ?, what he owes and what he owns? This objective is served by the Balance Sheet or Statement of Financial Position. The Balance Sheet is a statement of assets and liabilities of the business on a particular date. It serves as barometer for ascertaining the financial health of the business.

5. To facilitate rational decision making: Accounting not only records the information but also analyse and interpret the same and communicate to the stakeholders to enable them to make rational decisions. The American Accounting Association has also stressed this point while defining the term accounting when it says that accounting is the process of identifying, measuring and communicating economic information to permit informed judgements and decisions by users of the information. The accounting bodies all over the world and particularly the International Accounting Standards Committee have achieved success in laying down some basic postulates on the basis of which the accounting statements have to be prepared. This has further facilitated the usefulness of the accounting information beyond the national boundaries.

Check your Progress 2

Note: Use the space given below for your answers

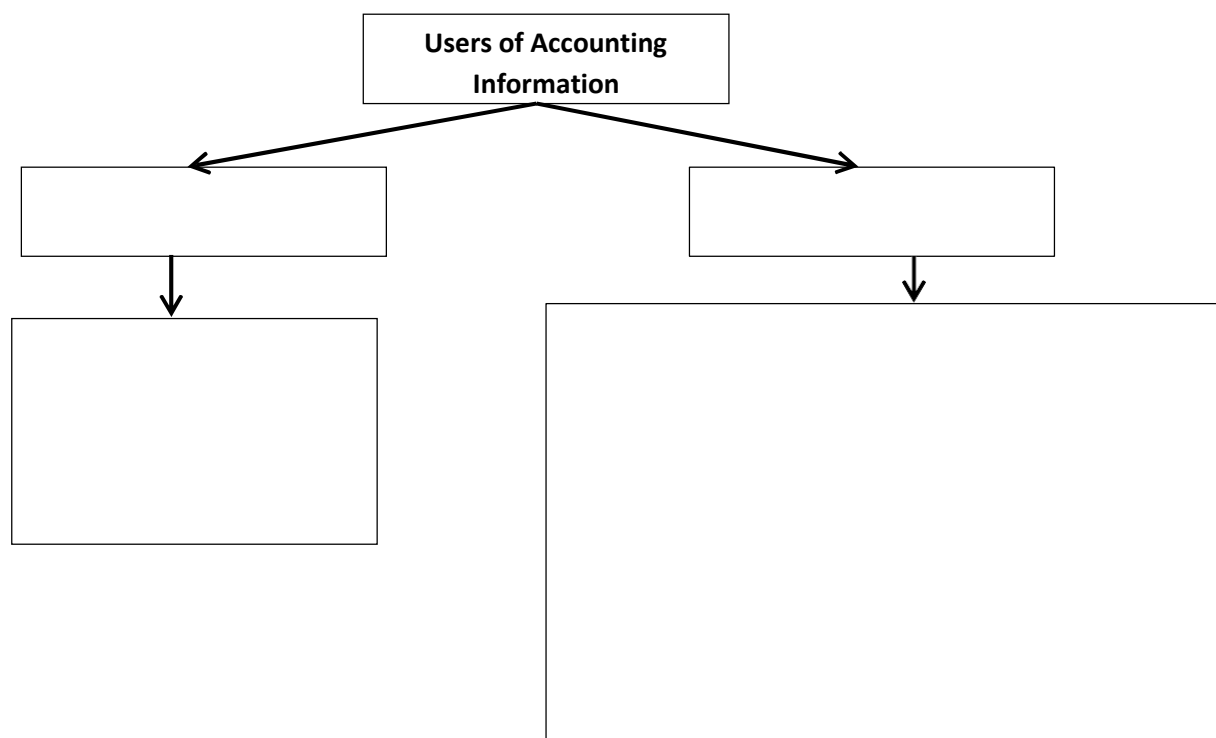
1) Trace the evolution of accounting

2) What are the objectives of accounting?

3) Distinguish between Book Keeping and Accounting

1.7 USERS OF ACCOUNTING INFORMATION

As understood from the previous section, the basic objective of accounting is to provide information which is useful for persons internal and external to the organisation. Following are the various internal and external users of the accounting information.



Internal Users of Accounting Information. Internal users of accounting information are those persons or groups which are within the organisation. Following are such internal users :

1. *Owners.* The owners provide funds to the business. They bear the risk of success or failure of the business. They are interested in knowing whether their funds are being properly used or not. They need accounting information to know the future, solvency and profitability position of the business. The financial statements prepared from time to time from accounting records depict them the profitability and the financial position.
2. *Management.* Management need the accounting information to understand the performance of the various segments and of business as a whole. Managers are responsible for the growth of the business. The increase in the value of the shareholders can be well understood from the financial statements. Accounting information also helps a manager in appraising the performance of the subordinates. Further accounting helps management in planning and controlling. On the basis of previous information management prepare various budgets. Actual performance of the management can be compared with the budgeted performance and corrective actions may be taken.
3. *Employees.* Employees are interested in the financial position of an organisation because their growth is directly related to the growth of the organisation. They too want to ensure the regular and timely payment of their salaries, growth opportunities, bonus and other employment linked benefits.

External Users of Accounting Information: External users are those groups or persons who are outside the organisation. Following can be the various external users of accounting information:

1. *Investors*: Those who are interested in investing money in an organisation seek accounting information to know the future prospects of the organisation. They want to ensure the safety of their principal amount and also want to earn adequate returns on their investments. They can know the return on investments by analysing profitability and the financial position of the organisation.

2. *Creditors*: Creditors (i.e. supplier of goods and services on credit, bankers and other lenders of money) are interested in the liquidity position of an organisation before giving loans or granting credit. They are interested in knowing whether the loan-principal and interest will be paid when due. This information helps them to frame the credit policy and to decide the rate of interest accordingly.

3. *Public and Members of Non-profit Organisations*. Public and Members of non-profit organisations such as schools, colleges, hospitals, clubs, charitable institutions etc. need accounting information to know how their contributed funds are being utilised and to ascertain if the organisation deserves continued support or support should be withdrawn keeping in view the bad performance depicted by the accounting information and diverted to another organisation. In knowing the performance of such organisations, criterion will not be the profit made but the main criterion will be the service provided to the society. The public at large is interested in the functioning of the organisation because it make a substantial contribution to the local economy in many ways including the number of people employed and their patronage to local suppliers.

4. *Government*. In order to implement the taxation policy, the Central and State Governments are interested in the accounting information. Further it also help the government in regulating the business enterprise for public food, allocate scarce resources among competing organisations, control prices, charge excise duties etc. Government also needs accounting information for compiling statistics concerning business which, in turn helps in compiling national accounts.

5. *Consumers*. Consumers need accounting information to understand the stability of the enterprise so as to ensure the supply of goods regularly.

6. *Research Scholars*. Research scholars are interested in accounting information to undertake their research studies. They collect the accounting information and analyse as per their research objectives.

1.8 LIMITATIONS OF ACCOUNTING

Accounting provides useful information to its users but we cannot say that accounting is free from limitations. Following are the limitations:

(a) Accounting permits alternative treatments : Though accounting is based on “generally accepted accounting principles”, but existence of more than one alternative for the treatment of any one item make results incomparable. For example, closing stock is may be valued using LIFO, FIFO, Weighted average method etc.

(b) Estimates may not be accurate: Accounting takes into consideration personal judgements alongwith the factual information which is often not accurate. For example estimating useful life of the machine for depreciation purpose, provision for bad and doubtful debts cannot be made with exactness. It is very difficult to expect accuracy in future estimates and objectivity suffers.

(c) Financial accounting ignores important non-monetary information: Financial accounting considers only those transactions and events which can be described in money. The transactions and events of non-monetary nature, however important, are ignored. For example, integrity of management, loyalty of employees, product quality, customer satisfaction are vital factors but do not find any place in accounting.

(d) Ignores price level changes: Accounting records all transactions at historical cost. So, changes in the value of assets are not recorded. Thus, it fails to present the current value of the business.

(e) Does not highlight efficiency or inefficiency: Accounting presents the overall picture of the organisation and does not disclose the contribution of each department in the profit and losses. It is difficult to ascertain which product is profitable and which is not. Accounting is mere presentation of the business figures which themselves are not self-explanatory. It depends upon the analysis and interpretation ability of the user who uses the information.

1.9 BASIC ACCOUNTING TERMS

Entity: Entity means a thing that has a definite individual existence. Business entity means a specifically identifiable business enterprise like Kalyan Jewellers, Reliance Industries, etc. An accounting system is always devised for a specific business entity (also called accounting entity).

Transaction: Any exchange of value for value involving money or money's worth between two or more parties is known as transaction. It can be a purchase of goods, receipt of money, payment to a creditor, incurring expenses, etc. It can be a cash transaction or a credit transaction.

Turnover: Turnover means total trading income from cash sales and credit sales.

Assets: Assets are values or financial resources owned by business. Assets are tangible objects or intangible rights owned by the organisation and carrying probable future benefits. These are economic resources of an enterprise that can be usefully expressed in monetary terms. For example, land, building, motor vehicles etc. These are shown on the asset side of the balance sheet. Assets can be broadly classified into two types: Fixed Assets and Current Assets.

Fixed Assets: Fixed assets are Asset held for the purpose of providing services and that is not held for resale in the normal course of operations of the organisation. These are held on a long-term basis, such as land, buildings, machinery, plant, furniture and fixtures. These assets are used for the normal operations of the business.

Current Assets: Current assets held on a short-term basis such as debtors (accounts receivable), bills receivable (notes receivable), stock (inventory), temporary marketable securities, cash and bank balances. These assets that are expected to be converted into cash or consumed in rendering of services in the normal course of operations of the organisation.

Account Receivable: Person from whom amounts are due for goods sold or services rendered or in respect of contractual obligations. Also termed as debtor, trade debtor, sundry debtor. The words 'Receivables' and 'Debtors' are used interchangeably.

Finished Goods : Goods held for sale in the ordinary course of business.

Investments: Assets held not for operational purposes or for rendering services, i.e., assets other than fixed assets or current assets (e.g. securities, shares, debentures, immovable properties).

Net Assets: The excess of the book value of the assets of an accounting unit over its liabilities to outsiders.

Qualifying Fixed Asset: A Qualifying Fixed Asset is an asset that necessarily takes a substantial period of time to get ready for its intended use or sale. Ordinarily a period of twelve months is considered as substantial period unless a shorter or longer period can be justified on the basis of facts and circumstances of the case. In estimating the period, the time which an asset takes, technologically and commercially, to get it ready for its intended use or sale should be considered.

Depreciable Asset: An asset which is expected to be used during more than one accounting year, has a limited useful life, and is held by the organisation or use in the 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 operations of the organisation.

Depreciation: A measure of the wearing out, consumption or other loss of value of a depreciable asset arising from use, obsolescence through technology and market changes. It is allocated so as to charge a fair proportion in each accounting period during the useful life of the asset. It includes amortisation of assets whose useful life is predetermined and depletion of wasting assets.

Liabilities: Liability is an amount owing by one person to another, payable in money, or in goods or services: the consequence of an asset or service received or a loss incurred or accrued; particularly any debt (a) due or past due (current liability), (b) due at a specified time in the future (e.g. funded debt, accrued liability), or (c) due only on failure to perform a future act (contingent liability). Liabilities are obligations or debts that an enterprise has to pay at some time in the future. They represent creditors' claims on the firm's assets. Both small and big businesses find it necessary to borrow money at one time or the other, and to purchase goods on credit. Liabilities are classified as long-term liabilities and short-term liabilities (also known as short-term liabilities).

Long-term liabilities: These are usually payable after a period of one year, for example, a term loan from a financial institution or debentures (bonds) issued by a company.

Short-term liabilities/ Current Liability: Liability including loans, deposits and bank overdrafts which fall due for payment in a relatively short period, normally not more than twelve months. These are obligations that are payable within a period of one year, for example, creditors, bills payable, bank overdraft.

Contingent Liability: An obligation relating to an existing condition or situation which may arise in future depending on the occurrence or non-occurrence of one or more uncertain future events.

Capital: Capital refers to money or money's worth invested in business. It may be brought in the form of cash or assets by the owner. It is treated as owner's equity and is a claim against assets. For the business entity capital is an obligation and a claim on the assets of business. It is, therefore, shown as capital on the liabilities side of the balance sheet.

Sales: The amount at which the goods are sold. Sales are total revenues from goods or services sold or provided to customers. Sales may be cash sales or credit sales.

Revenues: Money or money equivalent earned or accrued during an accounting period, increasing the total of previously existing net assets, and arising from provision of any type of services and rentals. These are the amounts of the business earned by selling its products or providing services to customers, called sales revenue. Other items of revenue common to many businesses are: commission, interest, dividends, royalties, rent received, etc. Revenue is also called income.

Expenses: A cost relating to the operations of an accounting period or to the revenue earned during the period or the benefits of which do not extend beyond that period. Costs incurred by a business in the process of earning revenue are known as expenses. Generally, expenses are measured by the cost of assets consumed or services used during an accounting period. The usual items of expenses are: salary, electricity, wages, discount, interest etc.

Expenditure: The amounts that were to be paid or are paid for services received or needed in the current operation of the business. Spending money or incurring a liability for some benefit, service or property received is called expenditure. For examples rent, carriage, insurance, purchase of furniture, stock, etc. If the benefit of expenditure is exhausted within a year, it is treated as an expense (also called revenue expenditure). On the other hand, the benefit of expenditure lasts for more than a year; it is treated as an asset (also called capital expenditure) such as purchase of machinery, furniture, etc.

Profit: The excess of revenues of a period over its related expenses during an accounting year profit. Profit increases the investment of the owners.

Gain: A profit that arises from events or transactions which are incidental to business such as sale of fixed assets, winning a court case, appreciation in the value of an asset.

Loss: The excess of expenses of a period over its related revenues its termed as loss. It decreases in owner's equity. It also refers to money or money's worth lost (or cost incurred) without receiving any benefit in return, e.g., cash or goods lost by theft or a fire accident, etc. It also includes loss on sale of fixed assets.

Discount: Discount is the deduction in the price of the goods sold. It is offered in two ways. Offering deduction of agreed percentage of list price at the time selling goods is one way of giving discount. Such discount is called 'trade discount'. It is generally offered by manufactures to wholesalers and by wholesalers to retailers. After selling the goods on credit basis the debtors may be given certain deduction in amount due in case if they pay the amount within the stipulated period or earlier. This deduction is given at the time of payment on the amount payable. Hence, it is called as cash discount. Cash discount acts as an incentive that encourages prompt payment by the debtors.

Voucher: The documentary evidence in support of a transaction is known as voucher. For example, if we buy goods for cash, we get cash memo, if we buy on credit, we get an invoice; when we make a payment we get a receipt and so on.

Goods: It refers to the products in which the business units are dealing, i.e. in terms of which it is buying and selling or producing and selling. The items that are purchased for use in the business are not called goods. For example, for a furniture dealer purchase of chairs and tables is termed as goods, while for other it is furniture and is treated as an asset. Similarly, for a stationery merchant, stationery is goods, whereas for others it is an item of expense (not purchases)

Drawings: Withdrawal of money and/or goods by the owner from the business for personal use is known as drawings. Drawings reduce the investment of the owners.

Purchases: Purchases are total amount of goods procured by a business on credit and on cash, for use or sale. In a trading concern, purchases are made of merchandise for resale with or without processing. In a manufacturing concern, raw materials are purchased, processed further into finished goods and then sold. Purchases may be cash purchases or credit purchases.

Stock: Stock (inventory) is a measure of something on hand-goods, spares and other items in a business. It is called *Stock in hand*. In a trading concern, the stock on hand is the amount of goods which are lying unsold as at the end of an accounting period is called *closing stock* (ending inventory). In a manufacturing company, closing stock comprises raw materials, semi-finished goods and finished goods on hand on the closing date. Similarly, *opening stock* (beginning inventory) is the amount of stock at the beginning of the accounting period.

Debtors: Debtors are persons and/or other entities who owe to an enterprise an amount for buying goods and services on credit. The total amount standing against such persons and/or entities on the closing date, is shown in the balance sheet as *sundry debtors* on the asset side.

Creditors: Creditors are persons and/or other entities that have to be paid by an enterprise an amount for providing the enterprise goods and services on credit. The total amount standing to the favour of such persons and/or entities on the closing date is shown in the Balance Sheet as *sundry creditors* on the liabilities side.

Account Payable: Amount owed by an enterprise on account of goods purchased or services received or in respect of contractual obligations. It is also termed as trade creditor or sundry creditor.

Account: A formal record of a particular type of transaction expressed in money or other unit of measurement and kept in a ledger.

Accounting Entry: A record of financial transaction in the books of account like journal, ledger, cash book, etc.

Accounting Period: The period of time for which an operating statement is customarily prepared.

Accrual Basis of Accounting: The method of accounting whereby revenues and expenses are identified with specific periods of time, such as a month or year, and are recorded as incurred, along with acquired assets, without regard to the date of receipt payment of cash; distinguished from cash basis.

Balance Sheet: A statement of the financial position of an organisation as at a given date, which exhibits its assets, liabilities, capital, reserve and other account balances at their respective book values.

Credit: Credits are value owed, given or parted with. A bookkeeping entry recording the reduction or elimination of an asset or an expense, or the creation of or addition to a liability or item of net worth or revenue; an entry on the right side of an account; the amount so recorded.

Debit: Debits are value owned or received. In a transaction the value received is recorded as debit. The goods or benefit received from a transaction; a bookkeeping

entry recording the creation of or addition to an asset or an expense, or the reduction or elimination of a liability, or item of net worth or revenue; an entry on the left side of an account; the amount so recorded.

Deferred Revenue Expenditure: Expenditure for which payment has been made or a liability incurred but which is carried forward on the presumption that it will be of benefit over a subsequent period or periods. This is also referred to as Deferred Expenditure.

Financial Statement: A balance sheet, income statement (income and expenditure), receipts & payment statement or any other supporting statement or other presentation of financial data derived from accounting records.

Check your Progress 3

Note: Use the space given below for your answers

1) Identify the internal and external users of accounting.

2) Is there any limitation to accounting? If yes, discuss

3) Explain the following:

Assets_____

Liability_____

Capital_____

Revenue_____

Expenditure_____

1.10 LET US SUM UP

Every business organisation records its transaction to measure the results of the business activity. Accounting is a discipline which records, classifies, summarises and interprets financial information about the activities of an organisation so that intelligent decisions can be made. Accounting is referred as the language of the business. Accounting plays a significant role by providing financial information to interested

parties, both internal and external, to make business decisions. Accounting starts where book keeping ends. The accounting process consists of measuring and summarizing business activities, interpreting financial information, and communicating the results to management and other decision makers. Accounting is an art as well as science. An accountant is required to have a much higher level of knowledge, conceptual understanding and analytical skill than is required of the book-keeper.

1.11 KEY WORDS

Accountancy: Accountancy is used for the profession of accountants i.e. who do the work of accounting and are knowledgeable persons.

Accounting: Accounting is the process of recording, classifying, summarizing, analysing and interpreting the financial transactions and communicating the results to its users.

Book-keeping: Book-Keeping is a part of accounting and is concerned with the recording of financial data relating to business operations in a significant and orderly manner.

Internal Users: Internal users of accounting information are those persons or groups which are within the organisation e:g Owners, Management, Employees.

External Users: External users are those groups or persons who are outside the organisation e:g Investors, Creditors, Public and Members of Non-profit Organisations, Government, Consumers, Research Scholars.

1.12 Questions

Short Answer Questions

Q:1 Define the term 'accounting'.

Q:2 Distinguish between accounting and accountancy.

Q:3 Distinguish between book-keeping and accounting.

Q:4 Is accounting an art or science? Justify your answer.

Long Answer Questions

Q:1 Discuss the nature of accounting.

Q:2 Trace the evolution of accounting.

Q:3 What are the objectives of accounting.

Q:4 How accounting help its users?

1.13 REFERENCES AND SUGGESTED READINGS

Gupta, Ambrish (2009) *Financial Accounting for Management: An Analytical Perspective*, Pearson Education India, New Delhi.

Tulsian, P.C. (2002) *Financial Accounting*, Pearson Education India, New Delhi.

Maheshwari, S.N. and Maheshwari, S.K. (2009) *Accounting for Management*, Vikas Publishing House Pvt. Ltd, Noida.

Narayanaswamy, R.N. (2011) *Financial Accounting-A Managerial Perspective*, PHI Learning Pvt. Ltd., New Delhi

Activity 1

Define accounting. What are its objectives and limitations?

Activity 2

Discuss the utility of accounting information.

LESSON 2

ACCOUNTING PRINCIPLES

Structure

- 2.0 Objectives
- 2.1 Introduction
- 2.2 Meaning and Nature
- 2.3 Basic Accounting Principles
 - 2.3.1. Accounting Concepts
 - 2.3.2. Accounting Conventions
- 2.4 Bases of Accounting
- 2.5 Nature of Accounts
- 2.6 Let Us Sum Up
- 2.7 Key Words
- 2.8 Questions
- 2.9 References and Suggested Readings

2.0 OBJECTIVES

After studying this lesson you should be able to

- grasp the basic accounting principles and observe their implications while recording transactions and events
- identify major accounting concepts and conventions
- understand the bases of accounting
- understand the nature of accounts.

2.1. INTRODUCTION

As discussed in the previous lesson, the basic objective of accounting is to provide the financial information which is useful for the stakeholders such as shareholders, creditors, potential investors, proprietors and others, in making rational decisions. This information is supplied with the help of accounting reports. It is very important that these reports should be prepared in such a manner that it is commonly understood by all. In order to maintain uniformity and consistency in preparing and maintaining books of accounts, certain rules or principles have been evolved. The basic rules are summarised as 'generally accepted accounting principles'. Accounting principles are basic norms and assumptions on which the whole accounting system has been developed and established. The accounting standards as introduced by the regulatory authority of a particular country has to be followed while preparation of the accounting reports. The present lesson will focus on 'Generally Accepted Accounting Principles'.

2.2 MEANING AND NATURE

The Canadian Institute of Chartered Accountants defines accounting principles as “The body of doctrines commonly associated with the theory and procedure of accounting serving as an explanation of current practices and as a guide for the selection of conventions or procedures where alternatives exists. Rules governing the formation of accounting axioms and the principles derived from them have arisen from common experience, historical precedent statements by individuals and professional bodies and regulations of Governmental agencies”.

Hendriksen opined that Accounting principles are logical set that form the general frame of reference for the evaluation and development of sound accounting practices.

As per *The American Institute of Certified Public Accountants (AICPA)* Principle means “rule of action”. These principles represent the most current consensus about how accounting information should be recorded, what information should be disclosed, how it should be disclosed, and which financial statement should be prepared.

The Institute of Chartered Accountants of India states that “Accounting principles are a body of doctrines commonly associated with the theory and procedures of accounting serving as an explanation of current practices and as a guide for selection of conventions or procedures where alternatives exists.” Accounting principles must satisfy the following conditions:

- (1) They should be based on real assumptions
- (2) They must be simple,, understandable and explanatory
- (3) They must be followed consistently
- (4) They should be able to reflect future predictions
- (5) They should be informational for the users.

Thus, Accounting Principles can be defined as those rules of action or conduct which are adopted by the accountants universally while recording accounting transactions. The general acceptance of an accounting principle usually depends on how well it meets three basic norms: a) Usefulness b) Objectiveness, and c) Feasibility

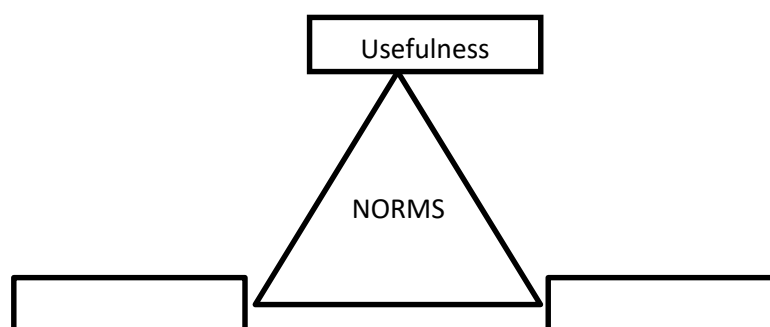


Fig:1 Norms of accounting principles

A principle is said to be useful if it increases the utility of the records to its readers. It should results in providing meaningful or relevant information to those who need it. Accounting principle is said to be objective when it is supported by facts and the information is free from personal biasness. Principle must ensure reliability which

means that the information is accurate and can be verified. The norm of feasibility states that it can be implemented without undue difficulty or cost.

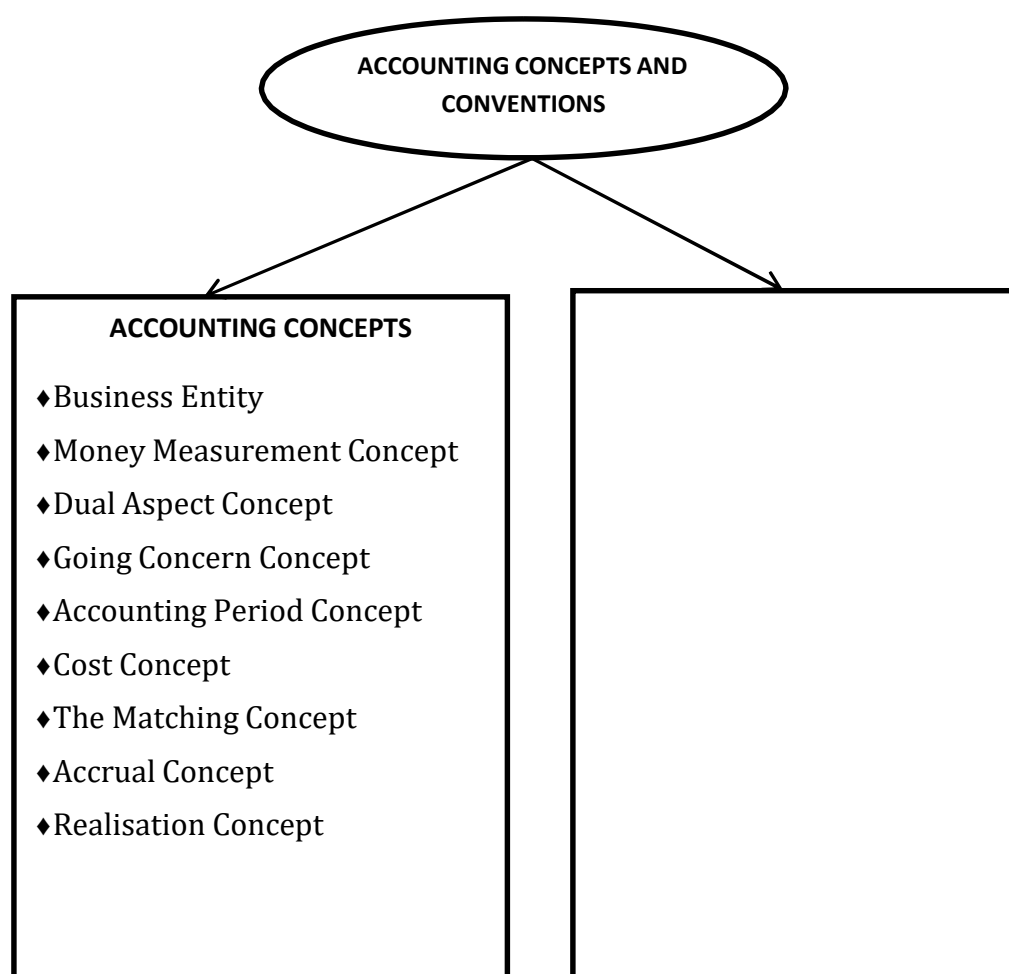
2.3 BASIC ACCOUNTING PRINCIPLES

Accounting principles are classified as concepts and conventions.

Accounting concept defines the postulates i.e. necessary assumptions on the basis of which financial statements of a business entity are prepared. The main objective is to maintain uniformity and consistency in accounting records. Concept means idea or notion which has universal application. These accounting concepts have been developed over the years of experience and thus they are universally accepted rules.

Conventions are customs or traditions. Basically, accounting conventions emerge out of accounting practices adopted by the organisations over a period of time. These conventions are derived by usage and practice. These are a guide to the preparation of accounting statement. The accountancy bodies of the world may change any of the convention to improve the quality of accounting information. Further, accounting conventions need not have universal application.

Following are the accounting concepts and conventions:



2.3.1. ACCOUNTING CONCEPTS

1. Business Entity Concept. Business entity concept states that business and owner of the business are two separate entities. All the business books of accounts records day to day financial transactions related to the business only. Transactions related to the owners are recorded in his personal books. Accountants should treat business as separate entity from its owners.

Thus, when owner contribute capital to start of the business, it is treated a liability in the books of accounts. Similarly, if the owner takes cash from the cash box for meeting certain personal expenditure, the accounts would show that cash had been reduced even though it does not make any difference to the owner himself. This withdrawal for personal use is termed as 'drawings'. Thus, in recording a transaction the important question is how does it affects the business?

Business entity concept helps in keeping business affairs free from the influence of the personal affairs of the owners. The concept is applicable to all forms of business enterprises viz. sole proprietorship, partnership, companies, etc. It may be noted that it is only for accounting purpose that partnerships and sole proprietorship are treated as separate from the owner (s), though law does not make such distinction. In fact, the business entity concept is applied to make it possible for the owners to assess the performance of their business and performance of those who manage the enterprise.

The major significance of the business entity concept is that it helps in ascertaining the profit of the business only. Further, it restraint accountants from recording of private/ personal transactions of the owners. The personal transactions are ignored.

2. Money Measurement Concept. Money measurement concept states that only those business transactions are recorded which can be expressed in terms of money. Thus, the transactions which cannot be expressed in terms of money are not recorded in the books of accounts i.e. this concept excludes those transactions or events which cannot be expressed in terms of money.

The main advantage of the money measurement concept is that money provides a common denominator by means of which heterogeneous facts about an entity can be expressed as numbers that can be added and subtracted.

The major limitation of the money measurement concept is on the scope of an accounting report. Accounting does not report the state of the CEO's health, quality of the human resources, working environment in the organisation etc. Accounting does not give the complete picture of what is happening in an organisation. Further money is expressed in terms of its value at the beginning of an event. Subsequent changes in the price level are not recorded. For example, a land purchased for Rs.10,00,000 in the year 2000 will be recorded at the same value in the year 2014 as well though the purchasing power of the rupee has been decreased over a time period. It is sometimes said that money is an unvarying yardstick of value, but this statement is inaccurate. Accountants know full well that the purchasing power of rupee changes but they do not attempt to reflect such changes in the accounts.

Business entity concept and money measurement concept are viewed as the basic concepts on which other procedural concepts hinge.

3. Dual Aspect Concept. Dual aspect concept is the core of the double entry book-keeping system. According to this concept every transactions has two aspects to be recorded. The recognition of these two aspects of every transaction is known as a dual aspect analysis. According to this concept every business transactions has dual effect. For example, it increased one asset and decreases other asset; it increases an asset and simultaneously increases liability; it decreases one asset, increases other asset; or it decreases one asset and decreases a liability also. Suppose, if a firm sells goods of Rs. 10,000 then as per dual aspect concept this transaction involves two aspects. One aspect is the delivery of goods and the other aspect is immediate receipt of cash (in the case of cash sales). Accounting systems are set up so as to record both these aspects of a transaction and that is why accounting is called a double entry system. According to this system the total amount debited always equals the total amount credited. It follows from 'dual aspect concept' that at any point in time owners' equity and liabilities for any accounting entity will be equal to assets owned by that entity. This idea is fundamental to accounting and could be expressed as the following accounting equation, which is the formal expression of the dual-aspect concept:

Assets (A) = Liabilities (L) + Owners' Equity (E) (1)

Owners' Equity (E) = Assets (A) – Liabilities (L) (2)

The above relationship is known as the 'Accounting Equation'. The term 'Owners Equity' denotes the economic resources supplied by the owners of the entity while the term 'liabilities' denotes the claim of outside parties such as creditors, debenture-holders, bank against the assets of the business. Assets are the resources owned by a business. The total of assets will be equal to total of liabilities plus owners capital because all assets of the business are claimed by either owners or outsiders.

To repeat, every transaction recorded in the accounts affects at least two items. There is no conceivable way that a transaction can result in only a single change in the accounts.

4. Going Concern Concept. Accounting assumes that the business entity will continue to operate for a long time in the future unless there is good evidence to the contrary. Financial statements are normally prepared on the assumption that an enterprise is a going concern and will continue in operations for the foreseeable future. In other words, there is neither the intention nor the necessity to liquidate the particular business venture in the predictable future. Because of this assumption, the accountant while valuing the assets does not take into account forced sale value of them.

The assumption that the business is not expected to be liquidated in the foreseeable future establishes the basis for many of the valuations and allocations in accounting. For example, the accountant charges depreciation of fixed assets values. It is this assumption which underlies the decision of investors to commit capital to enterprise. Only on the basis of this assumption can the accounting process remain stable and achieve the objective of correctly reporting and recording on the capital invested, the efficiency of management, and the position of the enterprise as a going concern.

However, if the accountant has good reasons to believe that the business, or some part of it is going to be liquidated or that it will cease to operate (say within six-month or a year), then the resources could be reported at their current values. If this concept is not followed, International Accounting Standard requires the disclosure of the fact in the financial statements together with reasons.

The major significance of the going concern concept can be indicated by contrasting it with a possible alternative, namely that the entity is about to be liquidated. Under the latter assumption, accounting would attempt to measure at all times what the entity's resources are currently worth to potential buyers. Under the going-concern concept, by contrast, there is no need to constantly measure an entity's worth to potential buyer, and it is not done. Instead, it is assumed that the resources currently available to the entity will be used in its future operations. For example, in case of manufacturing organisation, accounting recognises the value of the goods as evidenced by their selling price. The current resale values of the individual machines, supplies, and the other resources used in the manufacturing process are irrelevant because there is no intention of selling them individually.

5. Accounting Period Concept. As per going concern concept there is an indefinite life of an entity. But it is not desirable to measure its performance at the end of its life. If indefinite period is followed then nothing will accrue. There cannot be unpaid expenses and non-receipt of the revenue. So, a small but workable fraction is chosen out of infinite life cycle of the business entity for measuring performance and looking at the financial position. Accounting Period concept refers to the length of financial reporting periods. Account period is the time between two successive balance sheet dates.

Accounting period concept requires that the life of the business should be divided into appropriate segments for studying the financial results shown by the enterprise after each segment. Although the results of operations of a specific enterprise can be known precisely only after the business has ceased to operate but the knowledge of the results periodically is also necessary. Thus, the accountant must report for the changes in the wealth of a firm for short time periods for those who are interested in the operations of the business entity. Generally one year is taken up for performance measurement and appraisal of financial position.

Some accountants adopt financial year of the government, some other calendar year. In India, the financial year is followed which starts from 1st April of a year to 31st March of the immediately following year. Although a twelve month period is adopted for external users, a shorter span of interval, say one month or three month is applied for internal users of the accounting information.

The major significance of the accounting period concept is that it facilitates the comparison of the financials statements of different periods which further helps in ascertaining the performance of the entity over a time period. Secondly, it ensures uniform and consistent accounting treatment for ascertaining the profit and assets of the business. Further the matching of periodic revenues with expenses for getting correct results of the business operations gives better understanding of the operating activities of the organisation.

The accounting period concept suffers from one limitation of the allocation of long term costs. All the revenues and all the cost relating to the year in operation have to be taken into account while matching the earnings irrespective of the fact whether or not they have been received in cash or paid in cash. Despite the difficulties which stem from this concept, short term reports are of vital importance to owners, management, creditors and other interested parties. Hence, the accountants have no option but to resolve such difficulties.

6. Cost Concept. According to the cost concept an asset is ordinarily entered on the accounting records at the price paid to acquire it i.e. the historical cost or the acquisition

cost. For example, if a business buys a property for Rs. 50 lakh, it would be recorded in the books at Rs. 50 lakh, even if its market value at that time happens to be Rs. 60 lakh. Thus, assets are recorded at their original purchase price and this cost is the basis for all subsequent accounting for the business. The assets shown in the financial statements do not necessarily indicate their present market values. The term 'book value' is used for amount shown in the accounting records.

The major significance of the cost concept is that it ensures objectivity. Other measures are not so objective. For example present value base is highly subjective because to know the value of the asset one has to chase the uncertain future.

There are certain limitations also. A balance sheet based on this concept can be very misleading as it shows assets at cost even when there are wide difference between their costs and market values. Secondly, in inflationary situation then prices of all commodities go up on an average, acquisition cost loses its relevance. So, the valuation of the assets at historical cost does not reflect true position. Further, historical cost may lose comparability. Many assets do not have acquisition cost for example, human resources. The cost concept fails to recognise such asset although it is a very important asset of an organisation.

Despite of these limitations, the cost concept meets all the three basic norms of relevance, objectivity and feasibility.

7. The Matching concept. This concept is based on the accounting period concept. According to matching concept, all expenses matched with the revenues of that period should be taken into consideration i.e. when a given event affects both revenues and expenses the effect of each should be recognized in the same accounting period. For example, the sale of goods has two aspects; revenue aspect and expense aspect i.e. increase in earnings equal to the amount of revenue realized and decrease in earnings equal to the expenses. To ascertain net effect of earnings both these aspects must be recognised in the same accounting period.

Matching concept is based on accrual concept as it considers the occurrence of the expenses and incomes and do not concentrate on actual inflow or outflow of cash. It is the entire process of periodic earnings measurement, often described as a process of matching expenses with revenues. It may be noted that costs incurred do not become expenses until the goods or services in question are exchanged. Cost is not synonymous with expense. Only costs that have expired during an accounting period are considered as expenses. For example, if a commission is paid in January, 2014, for services enjoyed in November, 2013, that commission should be taken as the cost for services rendered in November 2013. This leads to adjustments for all prepaid expenses, outstanding expenses, accrued income, etc, while preparing periodic reports.

8. Accrual Concept. As per accrual concept, the effect of transactions and other events are recognised as and when they occur and are recorded in the financial statement of the periods to which they relate. Accrual means recognition of revenue and costs as they are earned or incurred and not as money is received or paid. Accrual concept makes a distinction between the receipt of cash and the right to receive it, and the payment of cash and the legal obligation to pay it. It relates to measurement of income, identifying assets and liabilities. This concept provides a guideline to the accountant as to how he should treat the cash receipts and the right related thereto.

The major significance is that accrual concept helps in proper measurement of income. Financial statements prepared on the accrual basis inform users not only of past events involving the payment and receipt of cash but also of obligations to pay cash in the future and of resources that represent cash to be received in the future. Accrual concept provides the foundation on which the structure of present day accounting has been developed.

The accrual concept, matching concept and the accounting period concepts work together for income measurement and recognition of assets and liabilities. Accounting period concept fixes up the time-frame for which the performance is to be measured and financial position is to be appraised. Accrual concept operates to measure revenues accrued and not the cash received.

9. Realisation Concept. Realisation concept is used to identify precisely the amount of revenue to be recognised and the amount of expense to be matched to such revenue for the purpose of income measurement. Realisation refers to inflows of cash or claims to cash arising from the sale of goods or services. It closely follows the cost concept. Any change in the value of asset is to be recorded only when the business realises it.

The realisation concept states that the amount recognised as revenue is the amount that is reasonably certain to be realized i.e. that customers are reasonably certain to pay. Thus, when an asset is recorded at its historical cost and appreciates due to the current value, such change is not counted unless there is certainty that such change will materialise.

Economists are highly critical about the realisation concept as they believe that this concept creates value distortion and makes accounting meaningless

Check your Progress 1

Note: Use the space given below for your answers

1) Name two concepts that are viewed as the basic concepts on which other procedural concepts hinge?

2) Which three concepts work together for income measurement and recognition of assets and liabilities? Explain.

3) Discuss the significance of business entity concept.

2.3.2. ACCOUNTING CONVENTIONS

1. Convention of Materiality: There is a doctrine called *de minimis non curat lex*, which means that the court will not consider trivial matters. Similarly the accountant does not attempt to record events so insignificant that the work of recording them is not justified by the usefulness of the results. **Materiality** captures the notion that financial reports need not include items that are so small as to be meaningless to users. Immaterial items do not appear in the financial reports. No precise quantitative materiality threshold exists, so financial statement preparers must apply judgement to decide whether a given item is immaterial.

The convention of materiality concept states that items of small significance should be ignored, if the effect is not considered material. It means that all items that have material effect on the business should be disclosed in the financial statements and items that are insignificant and not relevant to the users should not be disclosed. For example, an ordinary calculator is considered as stationery item and treated as an expense in the year of purchase though it may be used for 10 years.

Unfortunately there is no agreement as to the exact line separating material events from immaterial events, The materiality depends not only upon the amount of the item but also upon the size of the business, nature and level of information, level of the person making decision etc.

This convention suffers from a limitation of subjectivity. It depends on the discretion of the accountant that which item is material or which item is not material. An item which is material for one may be immaterial for another person. It will unnecessarily overburden an accountant with more details in case he is unable to find an objective distinction between material and immaterial events. Despite this limitation, it is necessary to disclose all material information to make the financial statements clear and understandable. This is required as per IAS-1 and also reiterated in IAS-5. As per IAS-1, materiality should govern the selection and application of accounting policies.

2. Convention of Conservatism: The convention of conservatism states that accountant should not anticipate profits but provide for all possible losses. In simple words, this concept requires that the accountants must follow the policy of "playing safe" while recording business transactions and events.

The rule of valuation of inventory at the cost or market value whichever is lower is originated from this convention. This rule means that an accountant should record lowest possible value for assets and revenues, and the highest possible value for liabilities and expenses. This is the reason why provisions are made for all known liabilities, expenses and losses, Probable losses regarding all contingencies are also be provided for, for example provision for doubtful debts on debtors in anticipation of actual bad debts', 'adopting written down value method of depreciation as against straight line method', not providing for discount on creditors but providing for discount on debtors etc.

According to the realisation concept no change should be counted unless it has materialised. The convention of conservatism takes this further by stating that it is not prudent to count unrealised gain but it is desirable to guard against all possible losses.

The convention of conservatism has been criticised by many accounting authors on the grounds that it essentially leads to understatement of income and wealth and it should not be the basis for the preparation of financial statements. The financial statements do

not present a true and fair view of state of affairs especially, when the accountant create secret reserves, by creating excess provision for bad and doubtful debts, depreciation, etc. The American Institute of Certified Public Accountant have also indicated that this concept need to be applied with much more caution and care as over conservatism may result in misrepresentation.

3. Convention of Consistency. The convention of consistency states in order to achieve comparability of the financial statements of an entity year on year, the accounting policies and methods once chosen should be followed consistently; a change in an accounting policy is made only in certain exceptional circumstances. For example, if depreciation is charged on fixed assets according to straight line method, this method should be followed year after year. Similarly, if stock is valued at 'cost or market price whichever is less', this principle should be applied in each subsequent year.

However the convention of consistency does not forbid the adoption of improved method of accounting. The accounting policy can be changed to bring the books of accounts in accordance with the issued accounting standards; in order to comply with the provision of law; or when as per changing circumstances it is felt that the new method will reflect more true and fair picture in the financial statement.

The major significance of the convention of consistency is that it facilitates the comparison of the financial statements. One could draw valid conclusions from the comparison of data drawn from financial statements of one year with that of the other year. But the inconsistency in the application of accounting methods might significantly affect the reported data.

4. Convention of Disclosure: The convention of disclosure states that all accounting statements should be honestly prepared and all facts and figures must be disclosed therein. A business should include in its financial statements anything that might affect the decisions of its shareholders to invest in the company or its lenders to provide loans. The disclosure of financial information is required for different parties who are interested in the welfare of that enterprise. For example, interested parties might want to know about the sale of a large asset for a loss that reduces the income reported for the time period, or about the special terms of a new bank loan. These details would be included as footnotes to the income statement and balance sheet. The Companies Act lays down the forms of Profit and Loss Account and Balance Sheet. Thus convention of disclosure is required to be kept as per the requirement of the Companies Act and Income Tax Act.

Check your Progress 2

Note: Use the space given below for your answers

1) The golden rule of current assets valuation- 'cost or market price whichever is lower' originated from which convention?

2) Examine the convention of conservatism.

3) What do you understand by the material information?

2.4 BASES OF ACCOUNTING

Accounting bases are the methods which have been developed by accountants to apply the fundamental concepts. These are measurement methods that are available to entities in the preparation of their financial statements. Due to the complexity of business activities and involvement of different types of transactions, there may be more than one basis which may be applied to the accounting treatment of a particular item. This means that the range of accounting bases is very wide and there is frequently more than one recognised accounting bases for dealing with a particular item. In particular, accounting bases are the methods developed for determining the (a) accounting periods in which revenues and costs should be recognised in the income statements and (b) amounts at which material items should be stated in the statement of financial position.

For example, a business enterprise is required to depreciation of its fixed assets and also to value the stock at the end of the accounting period, so that, following the accrual or matching concepts, such stock items can be set out against the sale proceeds of those items in the future accounting period and the assets can be shown at their carrying values in the statement of financial position. There are, however, a number of alternative methods of valuing stock for example LIFO or FIFO or of providing for depreciation for example straight line or written down and these are accounting bases.

Accounting policies are the specific accounting bases judged by business enterprises to be most appropriate to their circumstances and adopted by them for the purpose of preparing their financial accounts. The relationship among accounting concepts, accounting bases and accounting policies can be illustrated with the following block diagram:

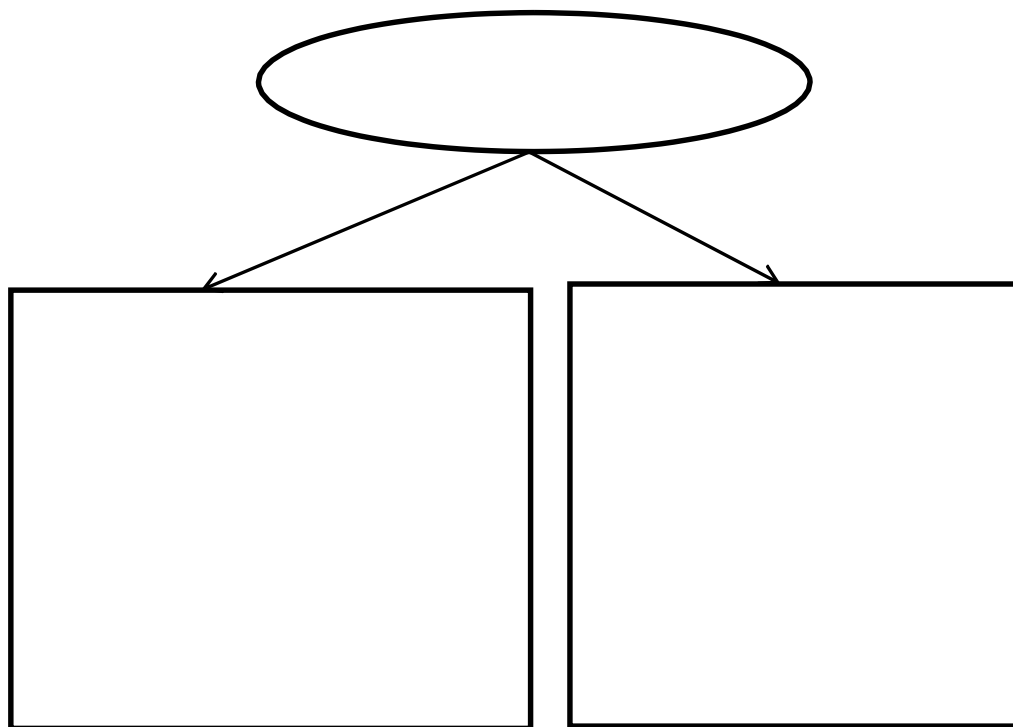


2.5 NATURE OF ACCOUNTS

According to Rorrem and Kerrigan, "An account is an comprehensive and classified record of transactions affecting one person, one kind of property or one class of gains or

losses arising out of expenses or incomes. Each account is dignified as a separate financial entity, having debtor-creditor relations with other accounts.” Basically an account is a basic information format used for recording transactions relating to revenues, expenses, asset, liability or owner’s equity. An account can be perceived of having a format similar to the capital letter ‘T’. The details are discussed in the next lessons. The nature of accounts can be well understood from its following classification:

(a) Traditional Classification and (b) Modern Classification



(A) Traditional Classification of Accounts:

As per traditional classification following is the nature of accounts:

1. Personal Accounts: Personal accounts are related to persons, that is, specific parties the business is dealing with. These accounts show the transactions with the customers, suppliers, creditors, the bank and the owner etc. For example Ram a/c, Shayam and Sons a/c, State Bank of India a/c. A business may have many credit transactions with the above persons or organizations. A separate account is to be prepared for each of them. Persons or organizations with whom the business has credit transactions are either debtors or creditors. If they have to give some money to the firm, they are called debtors. Conversely, if the firm is to pay them some money they are known as creditors. The main purpose of preparing personal accounts is to ascertain the balances due to or due from persons or organizations.

Personal accounts can be classified into following three categories:

(a) *Natural Person Personal Account:* The term ‘natural person’ means persons whoa recreation of God. For example: Prachi Account, Revti Account, Naveen Account etc.

(b) *Artificial Person Personal Account*: These are accounts of corporates, institutions etc. For example: Bank of Baroda Account, LIC Account etc.

(c) *Representative Person Personal Account*: These accounts represent a certain person or groups of persons. For example salary due to employees are termed as 'outstanding salary' account, income due not received is termed as 'accrued income' account etc.

2. Real Accounts: Real accounts are of a tangible nature, that is, the items which can be physically possessed. These accounts are accounts of assets and properties such as land, building, plant, machinery, patent, cash, investment, inventory, etc. When land is purchased for cash, the two accounts involved are land and cash - both are real accounts. But if the same land is purchased from Shyam & Co. on credit, the two accounts involved will be those of land and Shyam & Co., the former being a real account and the latter being a personal account.

3. Nominal Accounts: Nominal accounts are accounts of intangible nature, that is, accounts of items that are not visible or cannot be touched. These are the accounts of incomes, expenses, gains and losses. Examples of nominal accounts are rent paid, salary paid, discount allowed or received, etc. These accounts generally accumulate the data required for the preparation of income statement or trading and profit and loss account.

Check you progress 3

Classify the following into real, nominal, personal and valuation accounts:

1. Plant and machinery : _____
2. Purchases : _____
3. Investment: _____
4. Bank : _____
5. Tata Iron & steel Co. : _____
6. Rent : _____
7. Land and Building : _____
8. Carriage outward: _____
9. Capital : _____
10. Leasehold : _____
11. Trademark : _____
12. Return outwards : _____
13. Import duty : _____

Solution:

1. Real account 2. Real account 3. Real account 4. Personal account 5. Personal account 6. Nominal account 7. Real account 8. Nominal account 9. Personal account 10. Real account 11. Real account 12. Real account 13. Nominal account

(B) Modern Classification of Accounts:

Modern accountants classify accounts as follows:

1.Asset Account : Assets are properties or things of value, such as cash, equipment, copy rights, buildings, and land owned and controlled by an economic unit or business entity. These account are used to record all types of assets like building, machinery, computer, vehicles and others assets. Assets are balance sheet items and can be brought forward to the next period. They are tangible objects or intangible rights owned by an enterprise and carrying probable future benefits. Assets may be classified as:

Fixed Assets: These are assets acquired for relatively long period for carrying on the business of an enterprise. Examples are land, building, machinery etc.

Current Assets: These are assets acquired with the intention of converting them into cash during the normal business operation of an enterprise. Examples are cash, inventory, bills receivables etc.

Liquid Assets: These assets are also termed as ‘floating assets’ or ‘circulating assets’. Examples are all current assets excluding prepaid expenses and inventories.

Fictitious Assets: These are assets that have no real value but are shown in the books of accounts only for technical reasons. Examples are preliminary expenses.

Wasting Assets: These are assets which are exhausted with or which lose themselves in the goods they produce. For example mines, etc.

2. Liabilities Account: In this account all types of liabilities like loan given by borrowers, expense payable, good purchased on credit are recorded. Liability is also a Balance sheet item and can be brought forward to next period. These are used to denote amount which a business owes and has to return or account for. Liabilities can be divided into two categories:

Current Liabilities: The liabilities which will be due within a short time. Examples are bills payables, outstanding expenses etc. These are generally paid out of current assets.

Fixed Liabilities: Liabilities that will not due for a comparatively long time are termed as ‘fixed liabilities’. Examples are long term loans, debentures, etc.

3.Capital Account : Capital is owners’ equity in the business. It is the residual claim against the assets of the business after the total liabilities are deducted. Capital may be classified as:

Fixed Capital: This is capital invested in or represented by fixed assets.

Circulating Capital: It is capital in the form of current or floating assets.

Working Capital: It is excess of current assets over current liabilities.

4.Revenue Account : Revenue or Income accounts are used to record income earned during the year like sale of goods, interest earned on saving account, rent earned from property etc. Whenever income is earned this account is always to be credited. Revenue is the income of a recurring nature from any source.

5.Expenditure Account: Expenditure accounts are used to record all type of expense incurred during the accounting period. Expenditure may be of following types:

Capital Expenditure: Expenditure incurred for obtaining a long term advantage for the business

Revenue Expenditure: Expenditure where benefits expire within a year or which has been incurred merely to maintain the business or keep the assets in good working condition.

Deferred Expenditure: Expenditure for which payment has been made or incurred at which is carried forward on the presumption that it will be of benefit over a subsequent period (s).

2.6 LET US SUM UP

In order to maintain uniformity and consistency in preparing and maintaining books of accounts, certain rules or principles have been evolved. The basic rules are summarised as 'generally accepted accounting principles'. Accounting principles are basic norms and assumptions on which the whole accounting system has been developed and established. Accounting principles are classified as concepts and conventions. Accounting concept defines the postulates i.e. necessary assumptions on the basis of which financial statements of a business entity are prepared. Accounting conventions are customs or traditions. These are a guide to the preparation of accounting statement. The accountancy bodies of the world may change any of the convention to improve the quality of accounting information. To apply the fundamental concepts, the accountants have developed certain methods which are also known as accounting bases. There is a wide range of measurement methods that are available to entities for the preparation of their financial statements. Accounting policies are the specific accounting bases judged by business enterprises to be most appropriate to their circumstances and adopted by them for the purpose of preparing their financial accounts.

2.7 KEY WORDS

Accounting principle: Accounting principles are the assumptions and roles of accounting, the methods and procedures of accounting and the application of these rules, methods and procedures to the actual practice of accounting.

Accounting concept: It refers to assumptions and conditions on which accounting system is based.

Accounting convention: Accounting convention refers to the customs and traditions followed by accountants as guidelines while preparing accounting statements.

Accrual Basis of Accounting: In accrual basis of accounting revenues are recognized when earned and expenses are recognized when incurred, whether or not any cash is received or paid.

Cash Basis of Accounting: In cash basis of accounting revenues and expenses are recognized only when cash is received or paid, irrespective of the timing of actual sales or purchases.

2.8 QUESTIONS

Short Answer Questions

Q:1 Define accounting bases.

Q:2 What do you understand by accounting principles? Prepare a list of these principles.

Q:3 Distinguish between accounting concepts and accounting conventions.

Q:4 Define the following:

(a) Deferred expenditure (b) Liabilities account (c) Revenues (d) Assets

Long Answer Questions

Q:1 Discuss the nature of accounts.

Q:2 Critically examine the accounting concepts.

Q:3 Explain in detail accounting conventions.

Q:4 what are the qualitative characteristics of the financial statements?

2.9 REFERENCES AND SUGGESTED READINGS

Pizzey, A (2001) *Accounting and Finance: A Firm Foundation*, Cengage Learning, New Delhi.

Mukherjee, A and Hanif, M (2000) *Modern Accounting*, Vol 1, Tata Mc. Graw Hill Publishing Company Ltd., New Delhi.

Narayanaswamy, R.N. (2011) *Financial Accounting-A Managerial Perspective*, PHI Learning Pvt. Ltd., New Delhi

Maheshwari, S.N. and Maheshwari, S.K. (2012) *A Text Book of Accounting for Management*, Vikas Publishing House Pvt. Ltd., New Delhi.

LESSON 3

ACCOUNTING EQUATIONS

Structure

- 3.0 Objectives
- 3.1 Introduction
- 3.2 Origin of Transactions Source Documents
- 3.3 Vouchers
- 3.4 Accounting Equations
- 3.5 Rules of Debit and Credit
- 3.6 Let Us Sum Up
- 3.7 Key Words
- 3.8 Questions
- 3.9 References and Suggested Readings

3.0 OBJECTIVES

After studying this lesson you should be able to understand

- various source documents and vouchers
- developing and applying accounting equations to explain the effect of transactions
- recording the transactions using the rules of debit and credit

3.1 INTRODUCTION

After reading first two lessons it is clear now that accounting is a systematic method (it follows rules) of recording the economic transactions of a business so that the information can be used by both insiders (owners and managers) and outsiders (investors, suppliers and creditors) to make financial decisions. The overall accounting process comprises of identification of financial transactions, preparation of vouchers, recording entries in the books of original entry, posting to ledger, preparation of trial balance and financial statements and communication of the financial information of the organisation to the interested users.

Accountant should follow the accounting process properly to avoid any confusion or error while recording the financial transaction. This will help in the efficient functioning of financial activities of an organisation. This chapter deals with the first step of the recording aspect of the accounting process i.e. origin of transaction source, documents and vouchers. Then it covers the identification of the appropriate account

and application of the rules of debit and credit. The lesson will also deal with formation of the accounting equations.

3.2 ORIGIN OF TRANSACTION SOURCE DOCUMENTS

Accounting deals with the facts which can be verified by source documents. Source documents can be defined as an accounting terms to describe the original records that contain the details that substantiate the financial transactions that are entered into the internal accounting system of a business. In simple terms, source document is a document which becomes the basis for recording a transaction in the books of account. These documents provide the documentary evidence of a business deal or accounting event and are a critical part of an audit trail that establishes the authenticity and tracking history of an accounting system's financial records. Thus, source document acts as a written documentary evidence of the transaction that has taken place.

Source documents are real, visible, legible and meaningful records certifying the actual happening of the transactions of financial nature. In accountancy, every journal entry must be supported by source documents. So, there must be a source document for each entry to be recorded in the books of accounts. Thus, we can say that the authenticity and accuracy of the transaction can be verified with the help of source documents. These documents show the nature of the transaction and amount involved in the transaction. Even for internal events like depreciation charged, materials issued to production department for manufacturing of finished goods, the source documents are prepared. Source documents contain the following information:

- Date of transaction.
- Names and addresses of parties involved in the transaction.
- Description of the goods or services.
- Amount involved.
- Terms and conditions related to trade discounts, cash discount and other details related to delivery.
- Signature of the concerned parties.

A source document in a manual accounting system is a paper form, docket or note which records details of a transaction and provides evidence that the transaction took place. Source documents serve following **purposes**:

- They form inputs into the accounting system so that the transactions they record can be entered into the first of the accounting record i.e. journal.
- They assist internal control of the resources of the business - making sure that there is documentary evidence to support the purchase or sale of items and the receipt and payment of money (that is, it makes it more difficult for people to misappropriate or steal cash or other items).
- These source documents are also required by both company and tax auditors.
- The details from the source document are recorded in the appropriate accounting journal after the transaction has occurred. After recording, all source

documents are filed away in a document system where they can be retrieved at a later date if required.

- They are required in order to comply with the government tax law which requires that these source documents are kept for a number of years (typically from 3-7 years depending on the country). In the event of an audit, these source documents should support the data.

Following are the various types of source documents:

1. Cash Memo. Cash memo is a document that a seller passes to a buyer at the time of a specific purchase of goods or services. It indicates the amount, date and details of cash purchases and cash sales. We receive cash memo on cash purchases and issue cash memo on sales. On the basis of these cash memos, cash purchases, cash sales and cash payments are recorded in the books.

A cash memo contains the following information:

- Name and address of the supplier.
- Name and address of the purchaser.
- Serial Number of cash memo.
- Date of cash memo.
- Customer or Purchaser's Order number.
- Description of goods.
- Quantity of goods.
- Rates of Goods.
- Amount involved.
- Discount
- Sales Tax number of purchaser and supplier in case of sale of goods.
- Service tax number of the supplier in case of sale of services.
- Total amount of cash memo must be written in words and figures.
- The cash memo must be signed by the duly authorized person.
- The area of Jurisdiction must be defined in cash memo.
- Normally, E. & O. E. also printed on all cash memos. It means if there is any mistake in cash memo that is subject to correction.

The cash memo is made in duplicate but according to the requirement of business firm more than two copies also can be prepared. Following is a format of cash memo:

BUSINESS NAME BUSINESS ADDRESS LINE 1 BUSINESS ADDRESS LINE 2 BUSINESS PHONE NO., BUSINESS FAX NO. <u>CASH MEMO</u>			
S. NO. _____		DATE: _____	
QUANTITY	RATE	DESCRIPTION	TOTAL
AMOUNT IN WORDS: _____		G. TOTAL: _____	
_____		SIGN: _____	

2. Invoices and Bills. Invoice and bills are used for credit purchases and credit sales. In case of credit sale of goods invoices/bills are issued, which indicate the date, amount and details of sale. Normally, three copies of invoice are made. The first copy is given to purchaser or sent to the purchaser through post office or bank. The second copy is kept in the bundles, packets or cases of the goods and vendor retains the third copy. This third copy is used as source document for recording credit sale. In case of credit purchases of goods, the buyer receives invoice or bills and record credit purchases on its basis.

Following is a format of invoice/bill:



INVOICE

[Company Name]

[Company Slogan]

[Web Address]

Primary Business Address:

Address 2

Phone: 555-555-5555

Fax: 555-555-5555

DATE: 2010/1/1

INVOICE #: #####

Customer ID: ###

To:

Name

Title

Primary Address

Address 2

Phone: 555-555-5555

Fax: 555-555-5555

E-mail: someone@example.com

Ship To:

Name

Title

Primary Address

Address 2

Phone: 555-555-5555

Fax: 555-555-5555

E-mail: someone@example.com

Sales Rep.	P.O. Number	Ship Date	Ship Via	FOB	Terms

ITEM #	Description	QTY	Unit Price	Line Total

SubTotal:	
Taxes:	
Total:	

Make all checks payable to
[Your Company Name]

THANK YOU FOR YOUR BUSINESS

There are many similarities between cash memo and invoice/bills. The content of both cash memo and invoice are same. A cash memo is recognized as a legal document, in the same way that an invoice is. The only difference is that the cash memo is for any transaction that is paid for in cash. It is a document stating cash received for the goods sold. It is a paid bill for cash sales. An invoice can also be used in this respect, but many companies find it easier to differentiate between cash sales and credit sales. An invoice is a document showing the amount due from the buyer or the debtor it is a bill for credit sale. Further, cash memo does not create creditor debtor relationship between the seller and the buyer. Invoice creates creditor debtor relationship between the seller and the buyer. In accountancy while recording transactions cash memo is entered in the

cash book of the seller. Invoice is the basis for making entries in sales book and purchase book. In case of Cash memo, one revenue stamp is to be affixed if the cash receipt exceeds Rs.500/- (In India) but in case of an Invoice, there is no need to affix a revenue stamp.

3. Receipt. Receipt is a written acknowledgment of having received, or taken into one's possession, a specified amount of money, goods, etc. It indicates the date and amount of payment, details of the payer and the purpose of payment. The counterfeit or the carbon copy of the receipt issued is used as source document for the receipt of the amount. In the same way, when any payment is made, the issued receipt is used to record the payment in the books of accounts.

CASH RECEIPT	Date: 1/19/11		Receipt Number: 000						
	Received From: _____								
	For Payment Of: _____								
	Payment Amount: _____		\$0.00						
	<table border="1" style="width: 100%; border-collapse: collapse;"> <tr> <td style="width: 50%;">Amt Due</td> <td style="width: 50%;">\$0.00</td> </tr> <tr> <td>Amt Paid</td> <td>\$0.00</td> </tr> <tr> <td>New Bal</td> <td>\$0.00</td> </tr> </table>		Amt Due	\$0.00	Amt Paid	\$0.00	New Bal	\$0.00	Payment Method Check <input type="checkbox"/> Received By: _____ Cash <input type="checkbox"/> Memo: _____ Money Order <input type="checkbox"/> Credit Card <input type="checkbox"/>
Amt Due	\$0.00								
Amt Paid	\$0.00								
New Bal	\$0.00								

CASH RECEIPT	Date: 1/19/11		Receipt Number: 000						
	Received From: _____								
	For Payment Of: _____								
	Payment Amount: _____		\$0.00						
	<table border="1" style="width: 100%; border-collapse: collapse;"> <tr> <td style="width: 50%;">Amt Due</td> <td style="width: 50%;">\$0.00</td> </tr> <tr> <td>Amt Paid</td> <td>\$0.00</td> </tr> <tr> <td>New Bal</td> <td>\$0.00</td> </tr> </table>		Amt Due	\$0.00	Amt Paid	\$0.00	New Bal	\$0.00	Payment Method Check <input type="checkbox"/> Received By: _____ Cash <input type="checkbox"/> Memo: _____ Money Order <input type="checkbox"/> Credit Card <input type="checkbox"/>
Amt Due	\$0.00								
Amt Paid	\$0.00								
New Bal	\$0.00								

[illegible]

यूको बैंक UCO Bank		संगोल, जिला-फतेहगढ़ साहिब (पंजाब) - 140802 SANGHOL, Distt.-Fatehgarh Sahib (Pb.)- 140802 IFSC Code : UCBA0000417									
PAY				D	D	M	M	Y	Y	Y	Y
रुपये RUPEES				या धारक को OR BEARER							
अदा करें ₹											
A/c No.											
ABC/504											
PLEASE SIGN ABOVE											
#912207# 1600280261											
10											

6. Debit Note. In case the goods purchase on credit are returned, a Debit Note is issued to the seller, meaning that the Seller's Account has been debited with the amount of purchases return. This debit note is used as source document for recording purchase return. A format of Debit Note is given as under :

Name of the Firm Issuing the Note	
Address of the Firm	
Date of Issue	
No.	
DEBIT NOTE	
Against : Supplier's Name	
Goods returned as per Delivery	Amount (Rs.)
Challan No.	
(Details of goods returned)	
(Rupees Only)	
Signature of the Manager with date	

7. Credit Note. In case customer returns goods sold to him, then a Credit Note is issued to him. It means that the customer's account is credited with the amount of sales return. The Credit Note is used as source document. A format of Credit Note is given as under :

Name of the Firm Issuing the Note	
Address of the Firm	
Date of Issue	
No.	
CREDIT NOTE	
Against : Customer's Name	
Goods returned by the customer	Amount (Rs.)
Challan No.	
(Details of goods received)	
(Rupees Only)	
Signature of the Manager with date	

8. Miscellaneous. Correspondence, registration deeds, wages, salaries, water, electricity, telephone bills, tickets, conveyance bills, counterfoils and receipts, etc. are also used as source documents.

The source document may be created in either paper or electronic format. For example, automated accounting systems may generate the source document electronically or allow paper source documents to be scanned and converted into electronic images. Accounting software often provides on-screen entry forms for different types of transactions to capture the data and generate the source document. The source document is an early document in the accounting cycle. It provides the information required to analyse and classify the transaction and to create the journal entries.

3.3 VOUCHERS

A voucher is a written document to be used in support of entry made in the books of accounts. According to *J.R. Batliboi*, "A voucher may be defined as documentary evidence in support of an entry appearing in the books of accounts". According to

Ronald A. Irish, "A voucher may be a receipt, an invoice, an agreement, written requisition slip or in short any suitable written evidence, which confirms a written transaction." Following are the features of a voucher:

- (i) Vouchers are documentary evidence.
- (ii) Vouchers are written document.
- (iii) Vouchers support the entry appearing in the books of accounts.
- (iv) Vouchers present full description of the transaction.
- (v) Vouchers substantiate the accuracy of entries in the books of accounts.

FORMAT OF ACCOUNTING VOUCHERS

M/s Pratibha Furnitures 180, Nai Sarak, Delhi	
Voucher No.	Date
CREDIT	Amount (In Rs.)
.....	
..... Total	
Signature Manager	Signature Accountant

Source document, thus, can be said to initiate the accounting process. The transaction is to be recorded in the books of accounts by looking at the effect it has on accounting equation.

Check your Progress 1

Note: Use the space given below for your answers

1) What are source documents? What is the objective of source documents?

2) Is there any difference in cash memo and invoice?

3) Explain the term 'Vouchers'.

3.4 ACCOUNTING EQUATIONS

As per the dual concept 'for every debit, there is a credit'. Every transaction should have two-sided effect to the extent of same amount. This concept has resulted in accounting equation. Accounting equation states the equality of debits and credits. The left side of the equation represents Assets (Debit) and right side represents Liabilities and Owners' Equity (Credit). The relationship of assets on the left side and liabilities and owners' equity on the right side in the equation form is known as 'Accounting Equation' as given below:

$$\text{Assets (A)} = \text{Liabilities (L)} + \text{Owners' Equity (E)}$$

The above equation can be stated in any of the following forms:

$$A = L + E$$

$$\text{or } A - L = E$$

$$\text{or } A - E = L$$

$$\text{or } A - L - E = 0$$

Since the components of balance sheet are depicted in the accounting equation, it is also called as 'Balance Sheet Equation'. The owners' equity represents the amount invested by owners in the business plus retained earnings.

Assets: As discussed in the previous lesson assets are economic resources of a company. They are owned by the company and have cash value or can be converted to cash. Bank accounts, receivables (money owed to the business by customers), supplies, inventory, equipment, buildings and land are typical assets for most businesses.

Liabilities: Liabilities are the debts of the business, the money owed to various creditors, or payables. They include bank loans, mortgages, and payables to vendors

that supply goods and services to the business or to various government agencies for tax liabilities.

Equity: Equity is defined as residual ownership i.e. what's left from the assets after all creditors have been paid. In other words equity is assets minus liabilities. Equity includes capital contributed by the owners, plus any amounts of surplus income from doing business or less any losses from previous business periods. Assets are equal to the liabilities plus equity, the sources of the assets.

Let us consider the facts of the following case, step by step, to understand as to how the equation remains true even in changed circumstances.

Illustration 1

1. Started business with cash Rs. 5,00,000
2. Bought goods for cash Rs. 1,20,000 and on credit Rs. 1,30,000
3. Goods sold for cash Rs. 70,000
4. Rent paid Rs. 10,000
5. Bought computer for Rs. 25,000 on credit
6. Bought furniture for personal use Rs. 20,000
7. Sold goods to Ram for Rs.20,000
8. Salary paid Rs.20,000

Solution 1:

1. Business receives cash Rs. 5,00,000 (asset) and it owes Rs. 5,00,000 to the proprietor as his capital i.e. equity.

Assets =		Liability +		Owner's Equity	
Cash	500000		Nil	Capital	500000

- (2) Purchased goods for cash Rs. 1,20,000 and on credit Rs. 1,30,000.

Business has acquired asset namely – goods worth Rs. 2,50,000 and another asset namely, cash has decreased by Rs. 1,20,000 while liability as creditors have been created of Rs. 1,30,000.

Assets =		Liability +		Owner's Equity	
Cash	380000	Creditors	130000	Capital	500000
Goods	250000				
Total	630000		130000		500000

- (3) Sold goods for cash Rs. 70,000

This transaction has resulted in decrease of goods by Rs. 70,000 and increase in cash by Rs. 70,000

Assets		=		Liability		+		Owner's Equity	
Cash		450000		Creditors		130000		Capital	500000
Goods		180000							
Total		630000				130000			500000

(4) Rent paid Rs. 10000

This transaction has resulted in an expenditure of Rs. 10000 effecting decrease of cash and equity by Rs. 10000 each.

Assets		=		Liability		+		Owner's Equity	
Cash		440000		Creditors		130000		Capital	490000
Goods		180000							
Total		620000				130000			490000

(5) Bought computer on credit Rs. 25,000

This transaction results in acquiring an asset namely computer worth Rs. 25,000 and increasing creditors by Rs. 25,000

Assets		=		Liability		+		Owner's Equity	
Cash		440000		Creditors		155000		Capital	490000
Goods		180000							
Computer		25000							
Total		645000				155000			490000

(6) Bought furniture for personal use Rs. 20,000.

This transaction will have the effect of reducing both cash as well as capital by Rs. 20,000 each.

Assets		=		Liability		+		Owner's Equity	
Cash		420000		Creditors		155000		Capital	470000
Goods		180000							
Computer		25000							
Total		625000				155000			470000

(7). Sold goods to Ram for Rs.20,000

Selling goods on cash to Ram will reduce the goods (assets) and create the debtors (assets) by Rs.20,000 each

Assets		=		Liability		+		Owner's Equity	
---------------	--	----------	--	------------------	--	----------	--	-----------------------	--

Cash	420000	Creditors	155000	Capital	470000
Goods	160000				
Computer	25000				
Debtors	20000				
Total	625000		155000		470000

(8). Salary paid Rs.20,000

This transaction will reduce cash (assets) by Rs.20,000 and also reduce the capital by Rs.20,000 since salary is an expense.

Assets =		Liability +		Owner's Equity	
Cash	400000	Creditors	155000	Capital	450000
Goods	160000				
Computer	25000				
Debtors	20000				
Total	605000		155000		450000

Illustration 2

On 31st March 2001 Mr. Anil resigned from his employment. On that date he receives from his employer Rs. 15,000. On 1st April 2001, he started a business with Rs. 15,000. On 2nd April he opened a Bank A/c by depositing Rs. 10,000 ; on 6th April he purchased 100 units of CFL at Rs. 10,000. He paid Rs. 5,000 in cash and agreed to pay balance amount after one month. He also paid rent for the month Rs.2000.

1st April: Mr.Anil commenced business with cash Rs. 15,000.

Here the business receives cash Rs. 15000 (asset) and it owes Rs. 15000 to the proprietor as his capital i.e. equity.

Assets =		Liability +		Owner's Equity	
Cash	15000		Nil	Capital	15000

2nd April: Mr. Anil opened a bank a/c by depositing Rs.10,000

Here an account has been opened by depositing cash, this will reduce cash balance by Rs.10,000 and an asset, namely bank will be created with the same amount.

Assets =		Liability +		Owner's Equity	
Cash	5000		Nil	Capital	15000
Bank	10000				
Total	15000				15000

6th April: Mr. Anil purchased 100 units of CFL at Rs.10,000. He paid Rs.5,000 in cash and agreed to pay balance amount after one month.

Business has acquired asset namely – goods worth Rs. 10000 and another asset namely, cash has decreased by Rs. 5000 while liability as creditors have been created of Rs.5000

Assets =		Liability +		Owner's Equity	
Cash	Nil	Creditors	5000	Capital	15000
Bank	10000				
Goods	10000				
Total	20000		5000		15000

April 6: Paid rent Rs.2000

This transaction will reduce cash by Rs.2000. Rent is an expense so it will reduce owner's capital by Rs.2000.

Assets =		Liability +		Owner's Equity	
Cash	Nil	Creditors	5000	Capital	13000
Bank	8000				
Goods	10000				
Total	18000		5000		13000

Let us consider some more transactions and form an accounting equation:

Illustration 3

Transaction 1:

On 1 April Mr. Gupta starts his business by investing Rs.4,00,000 as his capital. This transaction increases cash (assets) and Gupta's capital (owners' equity) by Rs. 4,00,000.

Assets =		Liability +		Owner's Equity	
Cash	400000			Capital	400000
Total	400000				400000

Transaction 2:

On 2 April Gupta got a bank account opened by depositing Rs. 3,00,000 in it. This transaction creates an asset namely, bank and decreases cash balance by Rs. 3,00,000

Assets =		Liability +		Owner's Equity	
Cash	100000			Capital	400000

Bank	300000				
Total	400000				400000

Transaction 3:

On 5 April He purchased furniture for business for Rs. 48,000 and made payment via cheque.

This transaction creates new asset namely, furniture (assets) and decreases bank balance (assets) by Rs. 48,000.

Assets =		Liability +		Owner's Equity	
Cash	100000			Capital	400000
Bank	252000				
Furniture	48000				
Total	400000				400000

Transaction 4:

On 7 April purchased goods costing Rs. 76,000 payment made through bank.

This transaction creates another asset namely, goods (assets) and decreases cash at bank (assets) by Rs. 76,000.

Assets =		Liability +		Owner's Equity	
Cash	100000			Capital	400000
Bank	176000				
Furniture	48000				
Goods	76000				
Total	400000				400000

Transaction 5:

On 10 April purchased goods for Rs. 56,000 on credit from Honey &Co.

This transaction increases goods by Rs.56000 and creates a liability namely, creditors by Rs. 56,000.

Assets =		Liability +		Owner's Equity	
Cash	100000	Creditors	56000	Capital	400000
Bank	176000				
Furniture	48000				
Goods	132000				
Total	456000		56000		400000

Transaction 6

On 12 April he sold goods for Rs. 18,000 (costing Rs. 14,200) to Jamana Lal on credit.

This transaction created debtors (assets) by Rs. 18,000, reduces goods (assets) by Rs. 14,200 and increases profit, which will further increase owners, equity, by Rs. 3,800.

Assets =		Liability +		Owner's Equity	
Cash	100000	Creditors	56000	Capital	403800
Bank	176000				
Furniture	48000				
Goods	117800				
Debtors	18000				
Total	459800		56000		403800

Transaction 7:

On 14 April paid M/S Honey & Co. Rs. 36,000 on his account by cheque on 14 April.

This transaction decrease cash at Bank (assets) and creditor (liabilities) by Rs. 36,000.

Assets =		Liability +		Owner's Equity	
Cash	100000	Creditors	20000	Capital	403800
Bank	140000				
Furniture	48000				
Goods	117800				
Debtors	18000				
Total	423800		20000		403800

Transaction 8:

On 18 April Goods sold for Rs. 23,800 (costing Rs. 19,000) on cash.

This transaction increases cash (assets) by Rs. 23,800, decreases goods (assets) by Rs. 19,000 and increases profit (owners' equity) by Rs. 4,800.

Assets =		Liability +		Owner's Equity	
Cash	123800	Creditors	20000	Capital	408600
Bank	140000				
Furniture	48000				
Goods	98800				
Debtors	18000				
Total	428600		20000		408600

Transaction 9:

On 21 April received cheque for Rs. 18,000 from Jamana Lal

This transaction increases cash at bank (asset) by Rs. 18,000 and decreases another asset (amount due from customer, debtor) by Rs. 18,000

Assets =		Liability +		Owner's Equity	
Cash	123800	Creditors	20000	Capital	408600
Bank	158000				

Furniture	48000				
Goods	98800				
Debtors	Nil				
Total	428600		20000		408600

Transaction 10:

On 27 April paid the balance amount in cash to M/s Honey & Co.

This transaction reduces cash (assets) by Rs. 20,000 and liabilities (amount due to supplier, credit) by Rs. 20,000.

Assets =		Liability +		Owner's Equity	
Cash	103800	Creditors	Nil	Capital	408600
Bank	158000				
Furniture	48000				
Goods	98800				
Total	408600		Nil		408600

Check your Progress 2

1) Define accounting equation.

2) Develop the accounting Equation from the following transactions:

- (i) Rohan commenced business with cash 500,000
- (ii) Purchased goods for cash 300,000
- (iii) Purchased goods on credit 200,000
- (iv) Sold goods (cost Rs. 100,000) for cash 120,000
- (v) Bought refrigerator on credit 20,000
- (vi) Paid cash to a creditor 200,00
- (vii) Paid salary to employees in cash Rs.25,000
- (viii) Received rent from office building use Rs.20,000
- (ix) Purchased laptop for personal use for Rs.30,000 and office cash was used for payment of the same.
- (x) Sold goods on credit for Rs.50,000

3.5 RULES OF DEBIT AND CREDIT

As discussed in lesson 2 an account is a summary of the relevant transactions at one place relating to a particular head. It records not only the amount of transaction but also their effect and direction. These accounts are of three types:

(1) Personal Accounts

(2) Nominal Accounts

(3) Real Accounts

Depending on the type of accounts there are certain rules which help in recording the transaction in the books of accounts. These are popularly known as 'The Golden Rule of accounting'.

Before we move on to the 'Golden Rule of Accounting' let us first understand the double entry book-keeping system. The double entry book-keeping system is a systematic record keeping methods of all financial transactions of an organisation. It emphasises the fact the every transaction has two aspects i.e. every transaction affects atleast two accounts. The basic principle is every debit has a credit and every credit has a debit. As per accounting equation also the total amount debited to the records must be equal to the total amount credited.

These golden rules of accounting provide how the duality aspect of transactions is to be recorded in the books of accounts. These rules are –

Type of Account	Rule of Accounting
Personal Accounts	<i>Debit</i> the receiver and <i>Credit</i> the giver
Nominal Accounts	<i>Debit</i> all expenses and losses <i>Credit</i> all incomes and gains
Real Accounts	<i>Debit</i> what comes in <i>Credit</i> what goes out

The terms, debit and credit, in accounting indicate whether the transactions are to be recorded on the left hand side or right hand side of the account. Every transaction involves give and take aspect. The debit represents take aspect and credit the give aspect in a transaction. For example, when furniture is purchased for cash, then

furniture represents take aspect and cash represents give aspect. Thus, furniture is debited and cash is credited. Let us take following example to explain the above rules:

Illustration 4 :

During the month of April 2014, ABC Ltd. has made the following transactions –

Date	Transaction
April 1	Ram commenced business with cash Rs.50,00,000
April 2	Purchased machinery worth Rs.5,00,000 from XYZ & Co.
April 3	Purchased furniture worth Rs.50,000 from Rohit & Co.
April 4	Paid rent of the building Rs.20,000
April 5	Sold goods worth Rs.20,000
April 6	Sold goods to Hira Lal for Rs. 50,000
April 7	Paid cash to XYZ & Co. Rs. 5,00,000
April 8	Withdraw goods for personal use worth Rs.10,000

Analysis of Transactions

April 1: Commenced business with cash Rs.50,00,000.

Cash is an asset, a real account. Rule of real accounts say Debit what comes in and credit what goes out. Here cash is coming in so Cash is debited.

Cash is given by the Ram, a personal account. Rule of personal accounts say Debit the receiver and credit the giver. Here Ram is giver so Ram's capital account is credited.

Cash is given by shareholders. Cash comes in — Cash A/c is debited and shareholder

April 2 : Purchased machinery worth Rs.5,00,000 from XYZ & Co.

Machinery is a real account and it comes in. So, Machinery A/c is debited

XYZ & Co. is a personal account and they are giver. So, XYZ & Co. A/c is credited

April 3: Purchased furniture worth Rs.50,000 from Rohit & Co.

Purchasing of furniture is a real account and is coming in. So, furniture A/c is debited

Rohit & Co. is a personal account and is giver. So, Rohit & Co. A/c is credited.

April 4: Paid rent of the building Rs.20,000

Rent is an expense, a nominal account. The rule of nominal account says debit all expenses and losses and credit all incomes and gains. Here, rent is an expense therefore, it should be debited.

Cash is paid and it is a real account which goes out and it should be credited.

April 5 : Sold goods worth Rs.20,000

Sale of goods resulted in goods going out, hence, credited.

Cash is a real account and is coming in so Cash A/c should be debited.

April 6: Sold goods to Hira Lal for Rs. 50,000

Here goods are going out, hence credited.

Hira Lal has received the goods and is a personal account. So Hira Lal A/c is debited.

April 7: Paid cash to XYZ & Co. Rs. 5,00,000

Here cash is a real account and it is going out. So, Cash A/c is credited.

XYZ & Co. is receiving cash. It is a personal account thus XYZ Ltd. is debited.

April 8: Withdraw goods for personal use worth Rs.10,000

Here goods are going out. Hence, goods A/c are credited.

Goods are withdrawn for personal use. Owner, a personal account, is receiving goods.

Hence, drawings A/c is debited.

Hence, these rules of debit and credit helps in deciding about correct posting of the account at right and left side of the financial statements.

3.6 Let Us Sum Up

Accounting is a process to systematically evaluate and take events and transactions into consideration in determining the organisation's financial statements at the end of each accounting period. The first step in this process is to identify the transaction on the basis of origin source of document, such as cash memo, invoice, debit note, credit note, bill, cheque, receipt etc. The source document may be created in either paper or electronic format. For example, automated accounting systems may generate the source document electronically or allow paper source documents to be scanned and converted into electronic images. Accounting software often provides on-screen entry forms for different types of transactions to capture the data and generate the source document. The source document is an early document in the accounting cycle. It provides the information required to analyze and classify the transaction and to create the journal entries. The next step is to identify the account i.e. whether personal account, real account or nominal account. The rules of debit and credit are then applied to understand whether the account is to be posted on the right side or on the left side of the financial statements.

3.7 Key Words

Accounting Equation: The relationship of assets on the left side and liabilities and owners' equity on the right side in the equation form is known as Accounting Equation.

Source Document: A source document in a manual accounting system is a paper form, docket or note which records details of a transaction and provides evidence that the transaction took place.

Account: An account is a basic information format used for recording transactions relating to revenue, expenses, asset, liability, or owner's equity.

Transaction: Transaction in the context of accounting in any event either express or implied, that has the effect of changing the revenue, expense, asset, liability, or owners' equity of an entity.

3.8 Questions

Short Answer Questions

Q:1 What is cash memo. Draw its sample.

Q:2 If cash or cheque is to be deposited in bank, which source document is required? Draw its sample.

Q:3 Draw sample of debit note and credit note.

Q:4 Define accounting equation.

Long Answer Questions

Q:1 Discuss various source documents in details

Q:2 Anil had the following transactions:

- (i) Commenced business with cash Rs. 50,000
- (ii) Purchased goods for cash Rs. 20,000 and credit Rs. 30,000
- (iii) Sold goods for cash Rs. 40,000 costing Rs. 30,000
- (iv) Rent paid in Cash Rs. 500
- (v) Rent outstanding Rs. 100
- (vi) Bought furniture for Rs. 5,000 on credit
- (vii) Bought refrigerator for personal use for cash Rs. 5,000
- (viii) Purchased building for cash Rs. 20,000

Use the accounting equation to show the effect of the above transactions on his assets, liabilities and capital and show the final Accounting Equation.

Q:3 Apply rule of debit and credit on the following transactions:

1. Started business with cash Rs. 5,00,000

2. Bought goods for cash Rs. 1,20,000
3. Goods sold for cash Rs. 70,000
4. Rent paid Rs. 10,000
5. Bought computer for Rs. 25,000 on credit
6. Bought furniture for personal use Rs. 20,000

3.9 REFERENCES AND SUGGESTED READINGS

Gupta, Ambrish (2009) *Financial Accounting for Management: An Analytical Perspective*, Pearson Education India, New Delhi.

Tulsian, P.C. (2002) *Financial Accounting*, Pearson Education India, New Delhi.

Maheshwari, S.N. and Maheshwari, S.K. (2009) *Accounting for Management*, Vikas Publishing House Pvt. Ltd, Noida.

Narayanaswamy, R.N. (2011) *Financial Accounting-A Managerial Perspective*, PHI Learning Pvt. Ltd., New Delhi

Activity 1

Write short notes on 'Going concern concept'.

Activity 2

Explain different concept related to profit calculation.

-

LESSON-4

JOURNAL

Structure

- 4.0 Objectives
- 4.1 Introduction
- 4.2 Book of Original Entry-Journal
- 4.3 Important Considerations for Recording the Business Transactions
- 4.4 Special Purpose Journal
- 4.5 Let Us Sum Up
- 4.6 Key Words
- 4.7 Questions
- 4.8 References and Suggested Readings

4.0 OBJECTIVES

After studying this lesson you should be able to understand

- the recording aspect of accounting process
- importance of journalising and steps in journalizing
- record the transactions using the rules of debit and credit
- how to record transactions of special nature in journal
- recording in special purpose journal

4.1 INTRODUCTION

As discussed in previous lesson the source documents is the first step in recording the accounting transactions. When the source document is received the next step of recording is done. The transactions are recorded in the books of original entry i.e. journal. Since, the transactions are recorded first time, it is called book of original entry. Journal records all daily transactions of a business into the order in which they occur.

4.2 BOOKS OF ORIGINAL ENTRY-JOURNAL

After obtaining the source document, as discussed earlier, is received the transaction is recorded in the books of original entry. The book in which the transaction is recorded

for the first time is called journal or book of original entry. The word journal is derived from a French word 'jour' which means a daily, day book or log book. These transactions are recorded in chronological order i.e. in order of dates, as and when they take place. So a journal can be defined as a book containing a day-to-day record of transactions. The journal is prepared with the help of memorandum or waste book, which is a rough and temporary record of the financial transactions of the business. The literal meaning of the journal is a record of day-to-day financial transactions. The journal is an important book under the double-entry system. Journal is the first book of systematic record of the financial transactions of the business.

According to Carter "The journal as originally used, is a book of primary entry in which transactions are copied in order of dates from a memorandum or waste book. The entries as they are copied are classified into debit and credit so as to facilitate their being correctly posted afterwards in the ledger."

Maheshwari and Maheshwari defines journal as "a book containing a chronological record of transactions. A journal does not replace but precedes the ledger." Thus, journal helps in preparation of ledger.

The act of entering the transaction into journal book is called entry and registering transaction is called journalizing. It just specifies account to be debited and credited. In the following paragraphs, we will discuss the process of journalizing and posting the transactions. There are few types of transactions which occur repetitively in the business. For economic reasons, instead of recording all the transactions in journal, the similar transactions are recorded separately in subsidiary books.

Objectives of the Journal

The following are the main objectives of the journal

- * Journal is prepared to keep a systematic record of financial transactions.
- * It shows financial transactions in chronological order.
- * It presents necessary information about the financial transactions. Adequate explanation of each entry may be obtained from journal as every journal entry is supported by narration.
- * Journal is prepared to use as a legal evidence of financial transactions.
- * It facilitates the preparation of ledger book. The use of journal simplifies ledger.
- * Journal helps in solving misunderstanding and disputes in the business.

Importance & advantages of journal

- Transactions in the journal are recorded on chronological order so there's less chance to leave the transaction un-entered.
- It ensures the adoption of double entry system.

- The transactions recorded in the journals with details of the account debited and credited and the amount of each transaction.
- From journal adequate explanation of each entry may be obtained as every entry in journal is supported by the narration relating to that transaction.
- The use of journal simplifies ledger as details regarding the business transaction and are not required to be noted down in the ledger.
- From legal point of view, journal is more reliable evidence of business transactions than the ledger.

Journalizing:

The process of recording transactions in the journal is called **journalizing**. Each transaction is separately recorded after determining the particular accounts to be debited and credited.

Following are the steps followed in journalising business transactions:

Step 1 Ascertain what accounts are involved in a transaction.

Step 2 Ascertain what is the nature of the accounts involved i.e. whether it is personal account, real account or nominal account..

Step 3 Ascertain which rule of debit and credit is applicable for each of the accounts involved (see rules of debit and credit in lesson 3).

Step 4 Ascertain which account is to be debited and which is to be credited.

Step 5 Record the date of transaction in the 'Date column'. As discussed earlier the transactions are recorded in chronological order.

Step 6 Write the name of the account to be debited, very close to the left hand side i.e. the line demarcating the 'Date column' and the 'Particulars column') along with the abbreviation 'Dr.' on the same line against the name of the account in the 'Particulars column' and the amount to be debited in the 'Debit Amount column' against the name of the account.

Step 7 Write the name of the account to be credited in the next line preceded by the word 'To' at a few spaces towards right in the 'Particulars column' and the amount to be credited in the 'Credit Amount column' against the name of the account.

Step 8 Write 'Narration' (i.e. a brief description of the transaction) within brackets in the next line in the 'Particulars column'.

Step 9 Draw a line across the entire 'Particulars column' to separate one Journal entry from the other.

Format of Journal:

Following is the format of journal:

Journal
Of M/s _____
For the year _____

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

The columns of the Journal are explained below:

Date Column: The first column in a journal is date column which shows the date on which the transaction recorded against it took place.

Particulars' Column: The particulars column the account to be debited is written in the first line starting from the left hand corner of this column. In the second line the account to be credited is written leaving sufficient margin on the left side

Ledger Folio: At the time of the posting to the ledger, we need to write the Ledger Folio (in the computerized accounting the traditional ledger folio is referred to as Reference Number. Besides each account has its code number). The ledger folio (LF) column in the manual system of accounting is filled in at the time of posting of these transactions in ledger only. Thus the ledger folio shows the folio number of ledger where the transaction is posted.

Narration: After writing these two accounts, within the brackets a brief explanation of the transaction (also called narration) is given. The explanation can be in simple words and there is no need to start the narration with the word being which a practice was earlier. The journal provides date wise complete record of transactions along with the documentary evidence available to prove the occurrence of the transactions.

Debit Column: In the debit column, the amount to be debited is entered.

Credit Column: In the credit column, the amount to be credited is shown.

Some examples of journalizing the transactions are given below:

Illustration 1. Journalize the following transactions:

Transaction 1: On 1 April 2014 Mr. Raj commenced business with Rs.1,00,000.

Transaction 2: On 2 April 2014 Mr. Raj purchased goods for Rs. 35,000 for cash.

Transaction 3: On 30 April 2014 paid Rs. 2300 as rent of the office.

Transaction 4: On 3 May 2014 purchased furniture for Rs. 4,000.

Transaction 5: On 8 May 2014 sold goods for Rs.18,000 for cash.

Transaction 6: On 10 May 2014 Deposited in bank account opened in the name of business Rs.15,000.

Transaction 7: Purchased goods on 11 May 2014 from Gill & Co. on credit for Rs. 3,000.

Solution:

Transaction 1: On 1 April 2014 Mr. Raj commenced business with Rs.1,00,000.

In this transaction Mr. Raj started business with cash Rs.1,00,000. Raj is a personal account, a giver, so Raj's Capital A/c it will be credit. Cash is a real account, it is coming in, so Cash A/c will be debited.

Transaction 2: On 2 April 2014 Mr. Raj purchased goods for Rs. 35,000 for cash.

In this transaction, goods are purchased for Rs.35,000. Goods are purchased, a real account, it is coming in, so Purchase A/c will be debited. Cash is a real account, it is going out, so Cash A/c will be credited.

Transaction 3: On 30 April 2014 paid Rs. 2300 as rent of the office.

In this transaction the office rent is paid Rs.2300. Office rent is an expense, a nominal account, so Rent A/c is debited. Cash is going out, a real account, so Cash A/c will be credited.

Transaction 4: On 3 May 2014 purchased furniture for Rs. 4,000.

In this transaction furniture is purchased for Rs.4,000. Furniture is an asset, a real account, it is coming in, so Furniture A/c will be debited. Cash, a real account, is going out, so, Cash A/c will be credited.

Transaction 5: On 8 May 2014 sold goods for Rs.18,000 for cash.

In this transaction, goods are sold. Goods are going out, these are sold so Sales A/c will be credited. Cash is coming in, a real account, so Cash A/c will be debited.

Transaction 6: On 10 May 2014 Deposited in bank account opened in the name of business Rs.15,000.

In this transaction, the cash is deposited in bank. Bank is a personal account, it is a receiver, so Bank A/c will be debited. Cash is going out of a business, so Cash A/c will be credited.

Transaction 7: Purchased goods on 11 May 2014 from Gill & Co. on credit for Rs. 3,000.

In this transaction, goods are purchased on credit basis. Goods is a real account, purchased, i.e. coming in, so Purchase A/c is debited. Goods are purchased from Gill & Co., a creditor, a personal account. Gill & Co. is giver, hence Gill & Co. A/c is credited.

Journal
Of Mr. Raj
For the year 2014

Date 2014	Particulars	L/F	Debit Amount (Rs.)	Credit Amount (Rs.)
April 1	Cash A/c ----- Dr. To Raj's Capital A/c (Being business commenced)		1,00,000	1,00,000
April 2	Purchase A/c ----- Dr. To Cash A/c (Being goods purchased on cash)		35,000	35,000
April 30	Rent A/c ----- Dr. To Cash A/c (Being office rent paid)		2,300	2,300
May 3	Furniture A/c -----Dr. To Cash A/c (Being furniture purchased)		4,000	4,000
May 8	Cash A/c ----- Dr. To Sales A/c (Being goods sold on cash)		18,000	18,000
May 10	Bank A/c ----- Dr. To Cash A/c (Being bank account opened and cash deposited)		15,000	15,000
May 11	Purchase A/c -----Dr. To Gill & Co. A/c (Being goods purchased on credit from Gill & Co.)		3,000	3,000

COMPOUND ENTRY:

A compound journal entry is an accounting entry which affects more than two account heads. A simple journal entry has one debit and one credit whereas a compound journal entry includes one or more debits and/or credits than a simple journal entry. A compound journal entry may combine two or more debits and a credit, or a debit and two or more credits, or two or more of both debits and credits.

The compound/combined entries should not be interpreted to mean that more than two elements are affected in a single/simple accounting transaction. A compound/combined entry is a journal entry derived by combining two or more simple journal entries. The compound/combined entry can always be broken down into the constituent simple journal entries. Writing a compound/combined entry in place of two or more simple entries reduces the task involved in recording the transactions.

Example

The following examples illustrate the format of a compound journal entry:

Example 1: On Jan 1, 2014 Sohan Lal purchased a computer costing 50,000 from a supplier and issued a cheque of Rs.30,000. Balance amount to be paid after three months. This will be recorded as shown below:

Journal

Date	Particulars	L/F	Debit Amount (Rs.)	Credit Amount (Rs.)
	Computer A/c ----- Dr. To Bank A/c To Vendor A/c (Being computer purchased partly by paying cheque and partly on credit for 3 months)		50,000	30,000 20,000

Check your Progress 1

Note: Use the space given below for your answers. You may use extra sheets for solving questions.

1) Is compound entry a violation of dual entry concept?

2) Define Journal.

3) Frame a compound entry for following transaction:

Ram Lal paid Rs.5000 in full settlement of his account. Amount due towards him Rs.5300/-

4) Pass necessary journal entries and post them in the appropriate Ledger

Accounts of Kamal for the month of January 2006 :

1 Started business with Rs. 2,00,000 in the bank and Rs. 40,000 cash.

1 Bought shop fitting Rs. 40,000 and a van Rs. 60,000, both paid by cheque.

2 Paid rent by cheque Rs. 5,000.

3 Bought goods for resale on credit from Zakir & Co. Rs. 50,000.

5 Cash sales Rs. 5,000.

8 Paid wages of assistant in cash Rs. 1,000.

10 Paid insurance by cheque Rs. 500

12 Cash sales Rs. 8,000

15 Goods returned to Zakir & Co. Rs. 6,000.

17 Paid Zakir & Co. Rs. 30,000 by cheque.

24 Bought stationery and paid in cash Rs. 500.

25 Cash sales Rs. 15,000.

27 Paid Rao & Co. Rs. 14,000 by cheque.

31 Paid Rs. 20,000 into the bank.

4.3 IMPORTANT CONSIDERATIONS FOR RECORDING THE BUSINESS TRANSACTIONS

1.Goods Accounts: In accounting the meaning of goods is restricted to only those items which are purchased by a businessman with an intention to sell it. For example, if a businessman purchase car for office and he himself deals in stationery items then stationary items will be goods and this car is the asset of business. Goods account can be subdivided into four different parts:

Purchases Account: This is opened for goods purchased on cash and credit.

Sales Account: This account is opened for the goods sold on cash and credit. *Purchase Returns Account or Return Outward Account:* This account is opened for the goods returned to suppliers.

Sales Returns Account or Return Inward Account: This account is opened for the goods returned by customers.

Illustration: 2 Ram started business with cash Rs.5,00,000. He purchased goods worth Rs.2,00,000 from Sampat. He found that 10% of the goods were not as per order so he returned those back. He sold goods costing Rs.1,00,000 for Rs.1,35,000 to Hira Lal. Hira Lal returned 10% of the goods being not upto mark.

Transaction 1: Ram started business with cash Rs.5,00,000.

In this transaction Ram started business. Ram is a personal account, a giver, so Ram's Capital A/c will be credited. Cash, a real account, is coming in business, so Cash A/c will be debited.

Transaction 2: He purchased goods worth Rs.2,00,000 from Sampat.

In this transaction, Ram purchased goods on credit. Goods are coming in so Purchases A/c will be debited and Sampat is creditor, a personal account. He is giving the goods so Sampat A/c will be credited.

Transaction 3: He found that 10% of the goods were not as per order so he returned those back.

Here Ram returned 10% goods i.e. goods for Rs.20,000 were returned. A new account Purchases Return will be created. Goods returned means goods are going out so Purchases Returns A/c will be credited and Sampat A/c will be debited.

Transaction 4: He sold goods costing Rs.1,00,000 for Rs.1,35,000 to Hira Lal.

In this transaction Ram sold goods on credit. Goods are going out, so Sales A/c will be credited. Hira Lal is receiving the goods, since Hira Lal is a personal A/c, he is receiving goods so Hira Lal A/c will be debited.

Transaction 5: Hira Lal returned 10% of the goods being not upto mark.

Hira Lal returned 10% goods i.e. sales return for Rs. 13500. So here goods are coming back, Sales Return A/c will be debited. Hira Lal is giving the goods, a personal account, so Hira Lal A/c will be credited.

Journal
Of Mr. Raj
For the year 2014

Date	Particulars	L/F	Debit Amount Rs.	Credit Amount Rs.
------	-------------	-----	---------------------	----------------------

1	Cash A/c ----- Dr. To Ram's Capital A/c (Being business commenced)	5,00,000	5,00,000
2	Purchases A/c ----- Dr. To Sampat A/c (Being goods purchased on credit)	2,00,000	2,00,000
3	SampatA/c ----- Dr. To Purchases Return A/c (Being goods returned back)	20,000	20,000
4	Hira Lal A/c ----- Dr. To Sales A/c (Being goods sold on credit)	1,35,000	1,35,000
5	Sales ReturnA/c -----Dr. To Hira Lal A/c (Being goods not upto mark returned by Hira lal)	13,500	13,500

2. Trade Discount

A trade discount is the amount by which a manufacturer reduces the retail price of a product when it sells to a reseller. Trade discount is usually allowed on the list price of the goods. It may be allowed by producer to wholesaler and by wholesaler to retailer for purchase of goods in large quantity. It is not recorded in the books of account and entry is made only with the net amount paid or received. . If the seller were to record the retail price as well as a trade discount on an invoice to a reseller, this would create an unusually high gross sales amount in the income statement that might mislead any readers of the financial statements into thinking that the manufacturer has higher sales volume than is really the case (despite the presence of a large sales deduction for the trade discount).For example purchased goods of list price Rs. 8,000 at 10% trade discount from Vendor. In this case the following entry will be passed :

Journal

Date	Particulars	L/F	Debit Amount (Rs.)	Credit Amount (Rs.)
	Purchases A/c ----- Dr. To Vendor A/c (Being goods purchased on credit at a trade discount of 10% less list price)		7200	7200

3. Cash Discount

Cash discount is paid by seller to buyer. It is a discount that is allowed to encourage early cash payment. It is a Nominal Account. The person who allows discount, treat it as an expense and debits in his books and it is called discount allowed and the person who receives discount, treat it as an income and it is called discount received and credited in his books of account as "Discount Received Account." For example, Amit owes Rs. 7,200 to Vendor. He pays Rs. 7,000 in full settlement against the amount due. In the books of Amit, the journal entry will be :

Journal

Date	Particulars	L/F	Debit Amount (Rs.)	Credit Amount (Rs.)
	Vendor A/c -----Dr. To Cash A/c To Discount Received A/c (Being cash paid and discount received)		7,200	7,000 200

In the books of vendor the entry will be recorded as:

Journal

Date	Particulars	L/F	Debit Amount (Rs.)	Credit Amount (Rs.)
	Cash A/c----- Dr. Discount Allowed A/c -----Dr. To Amit A/c (Being cash received and discount allowed)		7,000 200	7,200

4. Goods distributed as free samples

In business activities sometimes the goods are distributed as free samples with the purpose of advertisement. The purchases account will be reduced to adjust such activities. In this case, Advertisement Account is debited and Purchases Account is credited. For example, goods costing Rs. 5000 were distributed as free sample. Following entry will be passed to record this transaction:

Journal

Date	Particulars	L/F	Debit Amount	Credit Amount
------	-------------	-----	--------------	---------------

			(Rs.)	(Rs.)
	Advertisement A/c----- Dr. To Purchases A/c (Being goods distributes as free samples)		5,000	5,000

5. Interest on capital

When owner contributes capital in business then the business also pays interest on capital as a reward to the owner for his contributions. Interest paid on capital is an expense. Therefore as per rule of the nominal account, the interest on capital account should be debited. On the other hand the capital of the business increases. So the capital account should be credited. The following entry will be passed in journal:

Journal

Date	Particulars	L/F	Debit Amount (Rs.)	Credit Amount (Rs.)
	Interest on Capital A/c ----- Dr. To Capital A/c (Being interest on capital paid)		XXXXX	XXXXX

6. Interest charged on Drawings

Like interest on capital is paid for contribution of capital similarly, interest on drawings are charged when the owner withdraw goods or cash from the business for his personal use (i.e. drawings). If the interest is charged on drawings then it will be an increase in the income of business, and as per rule of the nominal account the interest on drawings will be credited. On the other hand there will be increase in drawings or decrease in Capital. So Drawings Account will be debited. To record this, following entry will be passed :

Journal

Date	Particulars	L/F	Debit Amount (Rs.)	Credit Amount (Rs.)
	Drawings A/c-----Dr. To Interest on Drawings A/c (Being interest on drawings charged)		XXXX	XXXX

7. Depreciation charged on Fixed Assets

Depreciation is the gradual, permanent decrease in the value of an asset due to wear and tear and many other causes. Depreciation is an expense and as per rule of nominal account it will be debited and particular asset will be reduced. Suppose 10% depreciation is charged on furniture account. Furniture was worth Rs.1,00,000. So 10% depreciation will be mean Rs.10,000/-. Following entry will be passed to record this effect:

Journal

Date	Particulars	L/F	Debit Amount (Rs.)	Credit Amount (Rs.)
	Depreciation A/c ----- Dr. To Furniture A/c (Being 10% depreciation charged on furniture)		10,000	10,000

8. Bad Debts

Bad debt occurs when a debtor of business fails to pay the amount due from him. Reasons may be many e.g. he may become insolvent or he may die. Such irrecoverable amount is a loss to the business. As per rule of the nominal account the bad debts will be debited. Suppose 2% of the total debtor of Rs.50,000 becomes bad. Following entry will be passed:

Journal

Date	Particulars	L/F	Debit Amount (Rs.)	Credit Amount (Rs.)
	Bad Debts A/c ----- Dr. To Debtors A/c (Being 2% of the debtors become bad)		1,000	1,000

9. Bad Debts Recovered

When any amount becomes irrecoverable from any customer or debtor his account is closed in the books. If in future any amount is recovered from him then his personal account will not be credited because that does not exist in the books. Suppose as given in above case the bad debts were for Rs.1,000. The account was closed in books and then the payment was given by this person. Following entry is passed :

Journal

Date	Particulars	L/F	Debit Amount (Rs.)	Credit Amount (Rs.)
	Cash A/c ----- Dr. To Bad Debts Recovered A/c (Being bad debts recovered)		1,000	1,000

10. Purchase and Sale of investment

Business may invest its surplus money in shares, debentures or other type of investment alternatives. The following entry is passed to record the purchase and sale of investments:

Journal

Date	Particulars	L/F	Debit Amount (Rs.)	Credit Amount (Rs.)
	Investment A/c ----- Dr. To Cash A/c (Being investments made)		XXXX	XXXX
	Cash A/c ----- Dr. To Investment A/c (Being investments sold)		XXXX	XXXX

11. Loss of Goods by Fire/Accident/theft

Sometimes, a business may suffer loss of goods on account of fire, theft or accident. It is a business loss and a nominal account. It also reduces the goods at cost price, and increases the loss/expenses of the business. In case the goods are insured and insurance company admits claim, then the loss will be reduced accordingly. If the insurance company admits full claim then the insurance company account will be debited and the purchases account will be credited. If the insurance company admits no claim then the Loss by fire/accident account will be debited and the purchase account will be credited. If the insurance company admit claims partly then the following entry will be passed:

Journal

Date	Particulars	L/F	Debit Amount (Rs.)	Credit Amount (Rs.)
	Loss by Accident/fire/theft ----- Dr. Insurance Company A/c ----- Dr. To Purchases A/c		With unclaimed money With Claim admitted money	 With total amount

	(Being goods lost by fire and insurance company admitted partial claim)			
--	---	--	--	--

12. Income Tax Paid

Business has to pay income tax on the net income earned by it. Income tax paid is an expense and as per rule of nominal account it should be debited. In case of sole proprietor or partnership firm, income tax paid should be debited to Capital Account or Drawings Account and credited to Cash Account. In case of company income tax is debited and cash account is credited. The following entry is passed:

Journal

Date	Particulars	L/F	Debit Amount (Rs.)	Credit Amount (Rs.)
	Tax paid A/c/ capital A/c/ Drawings A/c----- Dr. To Cash A/c (Being income tax paid)			

13. Bank Charges

Banks provide various services to their customers. Bank deducts some charges by debiting the account of customers. It is an expense for the business. To record this, Bank charges account is debited and bank account is credited in the books of customer.

Journal

Date	Particulars	L/F	Debit Amount (Rs.)	Credit Amount (Rs.)
	Bank Charges A/c ----- Dr. To Bank A/c (Being bank charges deducted)			

When bank pays some interest to customer then following entry is passed:

Journal

Date	Particulars	L/F	Debit Amount (Rs.)	Credit Amount (Rs.)
	Bank A/c ----- Dr. To Interest on Bank A/c (Being interest on bank account)			

	received)			
--	-----------	--	--	--

14. Drawings Account

As stated earlier drawings is a personal account of the proprietor. When the businessman withdraws cash or goods from the business for his personal/domestic use it is called as 'drawings'. Suppose owner withdraws goods and cash for his personal use from business. Following journal entry is passed :

Journal

Date	Particulars	L/F	Debit Amount (Rs.)	Credit Amount (Rs.)
	Drawings A/c-----Dr. To Cash A/c To Purchases A/c (Being cash and goods withdrawn for personal use)			

15. Sale of Asset/Property

When the asset of a business is sold, a profit or loss on its sale may occur. Following journal entry is passed:

(a) In case of Profit

Journal

Date	Particulars	L/F	Debit Amount (Rs.)	Credit Amount (Rs.)
	Cash A/c----- Dr. To Asset A/c To Profit on Sale of Asset A/c (Being asset sold on profit)			

(b) In case of Loss

Journal

Date	Particulars	L/F	Debit Amount (Rs.)	Credit Amount (Rs.)
	Cash A/c----- Dr. Loss on Sale of asset A/c--- Dr.			

	To Asset A/c (Being asset sold at loss)			
--	--	--	--	--

16. Paid wages/installation charges for erection of machinery

Any expense which is occurred on an asset to install the same in the business should be added to that asset account as capital expense. Following journal entry is passed:

Journal

Date	Particulars	L/F	Debit Amount (Rs.)	Credit Amount (Rs.)
	Machinery A/c ----- Dr. To Cash/Bank A/c (Being wages/installation charges paid for the erection of machinery)			

17. Accrued Income

Income which has been earned but not yet received is known as accrued income. Income must be recorded in the accounting period in which it is earned. Therefore, accrued income must be recognized in the accounting period in which it arises rather than in the subsequent period in which it will be received. Let us take an example to understand the accounting entry to record accrued income:

Ram & Co. receives interest of Rs.10,000 on bank deposit for the month of March 2014 on 3rd April 2014.

Ram & Co. will recognize interest income of Rs.10,000 in the financial statements of year 2014 even though it was received in the next accounting period as it relates to the current period. Following accounting entry will be passed:

Journal

Date	Particulars	L/F	Debit Amount (Rs.)	Credit Amount (Rs.)
March31	Accrued Interest A/c ----- Dr. To Interest on Bank Deposit A/c (Being interest on bank deposit accrued but not yet received)			

On the date of receipt of the interest i.e. in the next financial year the following entry will be passed:

Journal

Date	Particulars	L/F	Debit Amount (Rs.)	Credit Amount (Rs.)
April 3	Bank A/c -----Dr. To Accrued Interest A/c (Being interest on bank deposit accrued now received)			

18. Outstanding Expenses

Outstanding expenses are those expenses which are due but not yet paid. At the time of making financial statement, we pass its adjustment journal entry.

Let us take an example:

Ram didn't pay rent due on 31 March 2014. The same was paid on 5 April 2014 i.e. in the next financial year. So while closing books for March 31, this rent due will be treated as outstanding rent. Following journal entry will be passed.

Journal

Date	Particulars	L/F	Debit Amount (Rs.)	Credit Amount (Rs.)
March 31	Rent A/c ----- Dr. To Outstanding Rent A/c (Being rent due and not paid)			

On 5 April 2014 when the rent is paid the following journal entry will be passed:

Journal

Date	Particulars	L/F	Debit Amount (Rs.)	Credit Amount (Rs.)
April 5	Outstanding Rent A/c -----Dr. To Bank A/c (Being rent outstanding now paid)			

19. Prepaid Expenses

Prepaid expense is expense paid in advance but which has not yet been incurred. Let us take an example:

Ram paid rent due for April 2014 in the month of March 2014 i.e. in the last month of closing of books. So for the accounting year 2013-14 this payment of advance rent will be treated as prepaid rent. Following journal entry will be passed.

Journal

Date	Particulars	L/F	Debit Amount (Rs.)	Credit Amount (Rs.)
March 31	Prepaid Rent A/c ----- Dr. To Cash A/c (Being rent for the month of April paid in advance)			

On 5 April 2014 when the rent becomes due the following journal entry will be passed:

Journal

Date	Particulars	L/F	Debit Amount (Rs.)	Credit Amount (Rs.)
April 5	Rent A/c ----- Dr. To Prepaid Rent A/c (Being rent paid in advance now adjusted)			

20. Income Received in Advance

Income received in advance is an income which was not due but received. Let us take an example:

Ram received rent of the building sublet Rs.10,000 due for the April 2014 in the month of March 2014 i.e. in the last month of closing of books. So for the accounting year 2013-14 this receipt of advance rent will be treated as income received in advance. Following journal entry will be passed.

Journal

Date	Particulars	L/F	Debit Amount (Rs.)	Credit Amount (Rs.)
------	-------------	-----	-----------------------	------------------------

March 31	Cash A/c ----- Dr. To Rent received in advance A/c (Being rent for the month of April received in advance)		10,000	10,000
----------	--	--	--------	--------

On 30 April 2014 when the rent becomes due the following journal entry will be passed:

Journal

Date	Particulars	L/F	Debit Amount (Rs.)	Credit Amount (Rs.)
April 30	Rent received in advance A/c---Dr. To Rent A/c (Being rent received in advance now adjusted)		10,000	10,000

Opening Entry

Opening entry is a journal entry by means of which the balances of various assets, liabilities and capital appearing in the balance sheet of previous accounting period are brought forward in the books of the current accounting period. While passing an opening entry, all assets accounts (individually) are debited and all liabilities accounts (individually) are credited and the Net worth (i.e. excess of assets over liabilities) is credited to Proprietor's Capital Account (in case of a proprietary concern) or Partners' Capital Accounts (in case of a partnership concern). If the balance of assets is more as compared to liabilities then the balancing figure is capital account. If the balance of liabilities is more than the balance of asset then the balancing figure is transferred to goodwill account.

Illustration 3 On 1st April 2014, Amit's assets and liabilities stood as follows :

Assets : Cash Rs. 10,000; Bank Rs. 25,000; Stock Rs. 30,000; Bills Receivable Rs. 5,000; Debtors Rs. 30,000; Building Rs. 7,00,000; Investments Rs. 3,00,000; Furniture Rs. 40,000
Liabilities : Bills payable Rs. 15,000, Creditors Rs. 19,000, Mrs. Amit's Loan Rs. 1,30,000.

Pass an opening Journal entry.

Solution :

Assets : Cash Rs. 10,000; Bank Rs. 25,000; Stock Rs. 30,000; Bills Receivable Rs. 5,000; Debtors Rs. 30,000; Building Rs.7,00,000; Investments Rs. 3,00,000; Furniture Rs. 40,000 Liabilities : Bills payable Rs. 15000, Creditors Rs. 19000, Mrs. Amit's Loan Rs. 1,30,000.

Journal

Date	Particulars	L/F	Debit Amount (Rs.)	Credit Amount (Rs.)
	Cash A/c----- Dr.		10000	
	Bank A/c ----- Dr.		25000	
	Stock A/c ----- Dr.		30000	
	Bill Receivable A/c ----- Dr.		5000	
	Debtors A/c----- Dr.		30000	
	Building A/c ----- Dr.		700000	
	Investment A/c ----- Dr.		300000	
	Furniture A/c -----Dr.		40000	
	To Bills Payable A/c			15000
	To Creditors A/c			19000
	To Mrs. Amit's Loan A/c			13000
	To Capital A/c (Balancing Figure)			1093000
	(Being opening entry passed)			

Check your Progress 2

Note: Use the space given below for your answers. You may use extra sheets for solving questions.

1) What is the difference between cash discount and trade discount?

2) Define opening entry. Explain with suitable example.

3) Record the following transactions in journal:

1. Sita Ram purchased machinery for Rs.40,000 and spent Rs.10,000 for its installation.
2. Bank charged Rs.100 as monthly interest.
3. Bought computer Rs. 40,000 and a computer table for Rs. 5,000, both paid by cheque.
- 4 3% of the total debtors amounting Rs.50000 became bad.
5. Bad debts recovered Rs.1000
6. Depreciate above machinery (transaction 1) @ 10%.
7. Paid wages to workers Rs. 10,000.
8. Depreciate furniture (worth Rs.10,000) @15 percent.
9. Paid personal insurance of owner by cheque Rs. 2000
10. Surplus of the firm Rs.10,000 invested in Shares
11. Withdrew goods amounting Rs.2000 and cash worth Rs.2000 for personal use.
- 12 Distributed goods as sample worth Rs.500
13. Goods lost by fire Rs.4000. Insurance company admitted full claim.
14. Goods lost by theft Rs.1000. FIR report registered.

4.4 SPECIAL PURPOSE JOURNAL

Special journals are records of original entry other than the general journal that are designed for recording specific types of transactions of similar nature. Special journals are used to make recording and posting frequently occurring transactions more efficient. These are customized to fit the needs of each business. Posting from special journals occurs differently from the General Journal. Any amounts affecting a customer or creditor are posted immediately from the special journal to the appropriate account in the Accounts Receivable or Accounts Payable subsidiary ledger.

Following are the advantages of special journals:

- (1) their use permits a division of labor
- (2) they save time in posting from the journals to the general ledgers
- (3) they reduce recording time and errors.

Most firms use at least the following special journals:

- (a) Purchases
- (b) Sales/Revenue
- (c) Cash Receipts
- (d) Cash Payments

(a) PURCHASES JOURNAL

The Purchases Journal is used to record any purchase on account. The purchase invoice or receipt is the source document for recording the purchase. When using a Purchases Journal, follow these steps:

1. Post to the creditor accounts in the subsidiary ledger from the Purchases Journal immediately. This will increase the balance in the creditor account.
2. Post any entries affecting another account immediately.
3. Total and cross-foot the journal at the end of the month.
4. Post the column totals for the Purchases Journal at the end of each month.

Each account is posted according to its column heading. The total of the Other Accounts column is not posted since these amounts have already been posted individually. Place the account numbers under each column to show the column totals have been posted.

(b) REVENUE/SALES JOURNAL

The Revenue/Sales Journal is used to record providing a service (Revenue Journal) or product (Sales Journal) on account. The sales invoice or receipt is the source document for recording these transactions. When using a Revenue/Sales Journal, follow these steps:

1. Post to the individual customer accounts in the subsidiary ledger immediately. This will increase the balance in the customer account.
2. Total and cross-foot the journal (if necessary) at the end of the month.
3. Post the column totals at the end of each month. Debit Accounts Receivable and Credit the revenue account. Place the account numbers under each column to show the column totals have been posted.

(c) CASH RECEIPTS JOURNAL

The Cash Receipts Journal is used to record any receipt of cash. When using a Cash Receipts Journal, follow these steps:

1. Post any entries affecting another account immediately to the General Ledger. Place the account number in the PR column of the Cash Receipts Journal to show that this amount has been posted.
2. Total and cross-foot the journal at the end of the month.
3. Post the column totals at the end of each month. Each account is posted according to its column heading. The total of the Other Accounts column is not posted since these amounts have already been posted individually.

Place the account numbers under each column to show the column totals have been posted. A check mark is placed under the Other Account column to show that this total has been posted as individual amounts.

(d) CASH PAYMENTS JOURNAL

The Cash Payments Journal is used to record any payment of cash. When using a Cash Payments Journal, follow these steps:

1. Post any entries affecting another account immediately to the General Ledger. Place the account number in the PR column of the Cash Receipts Journal to show that this amount has been posted.
2. Total and cross-foot the journal at the end of the month.
3. Post the column totals at the end of each month. Each account is posted according to its column heading. The total of the Other Accounts column is not posted since these amounts have already been posted individually.

Place the account numbers under each column to show the column totals have been posted. A check mark is placed under the Other Account column to show that this total has been posted as individual amounts.

4.5 LET US SUM UP

Accounting process starts with the identification of financial transactions of a business. Such financial transactions are recorded permanently in the books of accounts systematically in different specialized books. These books of accounts are called journal. Journal is prepared to keep a systematic record of financial transactions in chronological order. Adequate explanation of each entry may be obtained from journal as every journal entry is supported by narration. Journal is prepared to use as a legal evidence of financial transactions. In order to avoid tedious work of recording all entries in general journal usually firms record similar types of entries in special journals. Special journals are used to make recording and posting frequently occurring transactions more efficient. These are customized to fit the needs of each business. After transactions are recorded in journal next step is to post the entries in ledger.

4.6 KEY WORDS

Journal: A Journal is a book in which transactions are originally recorded in the chronological order, i.e. in the order in which they are occurred, according to the principles of Double Entry System. A Journal is also called a Book of Original Entry or Prime Entry.

Journalizing: The process of recording transactions in the journal is called journalizing. Each transaction is separately recorded after determining the particular accounts to be debited and credited.

Special Journal: Special journals are records of original entry other than the general journal that are designed for recording specific types of transactions of similar nature.

Bad Debts: Bad debt refers to accounts receivable/debtors (or trade accounts receivable) that will not be collected. However, bad debts can also refer to notes receivable that will not be collected.

4.7 QUESTIONS

Short Answer Questions

Q: Define Special Journal.

Q: Define Journal

Q: Write difference in trade discount and cash discount.

Q: Explain compound entry.

Q: Explain opening entry.

Long Answer Questions

Q: What is meant by Journal? Enumerate the steps in journalising.

Q: Explain the concept of Special journal. What are the different types of special journal used by organisations?

Q: Pass necessary Journal entries in the books of Hira Lal for the month of March, 2014 :

- i) Commenced business with cash Rs.50,000.
- ii) Issued a cheque for Rs. 1,000 in favour of landlord for a rent for the month of March.
- iii) Paid electricity bill of Rs. 450 by cheque.
- iv) The goods destroyed by theft Rs. 3,000.
- v) Paid wages for the installation of machinery Rs. 5,000.
- vi) Interest paid Rs. 1100.
- vii) Goods worth Rs. 4,000 given away by way of charity.
- viii) Goods taken by Proprietor worth Rs. 10,000 for personal use.

Q: From the following transactions of Mr. Satish Kumar. Write up journal entries

Jan.1 Assets-Cash in hand Rs. 2,000, Cash at bank Rs. 5,000, Stock of goods Rs. 4,000, Machinery Rs. 9000, Furniture Rs. 2,000, Sham owes Rs. 500, Ram owes Rs. 3,500. Liabilities - Loan Rs. 4,000; sum owing to Raman Rs. 3,000.

Jan.2 Sold goods to Pawan Rs. 3,000.

Jan. 5 Received Rs. 2,950 from Pawan in full settlement of his accounts.

Jan. 6 Payment made to Raman Rs. 1,975 by cheque, he allowed discount of Rs. 25.

Jan. 8 Old furniture sold for Rs. 200.

Jan. 10 Ram pays Rs. 3,400 by cheque and discount allowed to him Rs. 100, cheque deposited in bank.

Jan. 13 Paid for repairs to machinery Rs. 250

Jan. 15 Bank intimates the cheque of Ram has been returned dishonoured.

Jan. 18 Paid municipal taxes Rs. 200.

Jan. 22 Bought goods from Sita & Co. Rs. 1,000.

Jan. 25 Goods worth Rs. 600 given away as charity.

Jan. 31 Returned goods to Sita & Co. Rs. 1,000.

Jan. 31 An amount which was written off as bad debts in 1998 recovered Rs. 1,000.

4.8 REFERENCES AND SUGGESTED READINGS

1. S.N. Maheshwari, *Advanced Accountancy*, Vikas Publication House Pvt. Ltd.
2. R.L. Gupta, *Advanced Accountancy*, Sultan Chand & Sons.
- 3 M.C. Sukla and T.S. Grewal, *Advanced Accountancy*, 18th Edition, S. Chand, 2008.

Activity 1

Explain various rules for making journal entries.

Activity 2

What is the meaning of General Ledger?

Lesson 5

LEDGER

Structure

- 5.0 Objectives
- 5.1 Introduction
- 5.2 Meaning and Definition of Ledger
- 5.3 Relationship between Journal and Ledger
- 5.4 Format of a Ledger Account
- 5.5 Posting and Balancing
- 5.6 Let Us Sum Up
- 5.7 Key Words
- 5.8 Questions
- 5.9 References and Suggested Readings

5.0 OBJECTIVES

After studying this lesson you should be able to

- understand the relationship between journal and ledger
- post from journal to ledger
- understand the balancing of ledger

5.1. INTRODUCTION

In the previous lesson we have understood the first step of accounting process i.e. how to record the financial transactions in the book of original entry-Journal. We have also covered the special journals. This lesson is devoted to the next step of accounting process i.e. posting of entries from journal to ledger.

In journal, all the business transactions are recorded irrespective of the nature of transactions. Journal records all transactions but fails to give a complete picture of what actually are the transactions with a particular account. Journal does not give a complete picture of the fundamental elements of book keeping i.e. properties, liabilities, proprietorship accounts and expenses and incomes at a glance and at one place. Business transactions being recurring in nature, a number of entries are made for a particular type of transactions such as sales, purchases, receipts and payments of cash, expenses etc., throughout the accounting year. The entries are therefore scattered over in the Journal.

In fact, the whole Journal will have to be gone through to find out the combined effect of various transactions on a particular account. Though the special journal tries to solve

this concern, but if special purpose journal is a solution then it means we have to make a number of journals as per the number of accounts the business is dealing in. There are many questions like how much is to be collected to debtors, how much is to be paid to creditors, what are total salaries paid to the staff and many more. This information is not easily gathered from the journal. Thus there is a need to summarise or group the transactions recorded in the journal related to a particular account, person, or a thing or expenditure to take managerial decisions. The mechanics of collecting, assembling and summarising all transactions of similar nature at one place can better be served by a book known as 'ledger' i.e. a classified head of accounts.

5.2 MEANING AND DEFINITION OF LEDGER

Ledger is a book of accounts in which data from transactions recorded in journals are posted and thereby classified and summarized. Ledger is a principal book of accounts of the enterprise. It is rightly called as the 'King of Books'. A ledger account is an account or record used to sort and store balance sheet and income statement transactions. Examples of ledger accounts include the asset accounts such as Cash, Accounts Receivable, Inventory, Investments, Land, and Equipment. Examples of the general ledger liability accounts include debtors, creditors, expenses, investments, sales, purchase, furniture account etc.

Ledger is a set of accounts. Ledger contains the various personal, real and nominal accounts in which all business transactions of the entity are recorded. The main function of the ledger is to classify and summarise all the items appearing in Journal and other books of original entry under appropriate head/set of accounts so that at the end of the accounting period, each account contains the complete information of all transaction relating to it. Here are few definitions of ledger:

"Ledger is a book of accounts which contains in a suitably classified form, the final and permanent record of trader's transactions." (V. G. Vickery)

"A ledger is the most important book of accounts and is the destination of the entries made in the subsidiary books." (William Pickles)

"Ledger is the permanent storehouse of all the transactions." (Fieldhouse Arther)

A ledger therefore is a collection of accounts and may be defined as a summary statement of all the transactions relating to a person, asset, expense or income which have taken place during a given period of time and shows their net effect. Ledger is bound book with pages consecutively numbered. It may also be a bundle of sheets.

Features of ledger

Following are the features of ledger:

- Ledger is an account book that contains various accounts to which various business transactions of a business enterprise are posted from book of original entry i.e. journal and special purpose journal.
- It is a book of final entry because the transactions that are first entered in the journal or special purpose Books are finally posted in the ledger.
- It is also called the Principal Book of Accounts.
- In the ledger all types of accounts relating to assets, liabilities, capital, revenue and expenses are maintained.
- It is a permanent record of business transactions classified into relevant accounts.
- It is the 'reference book of accounting system and is used to classify and summarise transactions to facilitate the preparation of financial statements.

Utility of a Ledger

Ledger contains all the accounts in which all the business transactions of a business enterprise are classified. At the end of the accounting period, each account will contain the entire information of all the transactions relating to it. Following are the advantages of ledger.

- Ledger provides detailed information about revenues and expenses at one place.
- Ledger records every asset separately. Hence, one can easily get the information about the book value of any asset whenever needed.
- The information given in different ledger accounts help the management in preparing budgets and to make relevant financial decisions.
- The businessmen always want to know what he owns and what he owe to it. The ledger accounts provide this information at a glance through the account receivables and payables.
- It provides complete information about all accounts in one book.
- It facilitates the preparation of Final Accounts.

5.3 RELATIONSHIP BETWEEN JOURNAL AND LEDGER

Journal and Ledger are the most useful books kept by a business entity. The points of distinction between the two are given below :

- * Journal is the first book of recording the transactions and ledger is the final book of recording of transactions.
- * The journal is a book of original entry whereas the ledger is the main book of account.
- * Journal is a chronological record of business transactions. Transactions are recorded as and when they occur i.e. date-wise. However posting from the journal is done periodically, may be weekly, fortnightly as per the convenience of the business.
- * The journal does not disclose the complete position of an account. On the other hand, the ledger indicates the position of each account debit wise or credit wise, as the case may be.

5.4 FORMAT OF A LEDGER ACCOUNT

A ledger account can be prepared in any one of the following two forms:

Form 1

Dr.	Account						Cr.
Date	Particulars	J/F	Amount (Rs.)	Date	Particulars	J/F	Amount (Rs.)

Form 2

Dr.	Account					
Date	Particulars	J/F	Debit Amount (Rs.)	Credit Amount (Rs.)	Dr./Cr.	Balance

5.5 POSTING AND BALANCING

Posting

Basically, purpose behind preparation of the ledger is to bring all related items of this account which might have been recorded in different books of accounts on different dates at one place. The process involved in this exercise is called posting in the ledger. Thus, Posting refers to the process of transferring debit and credit amounts from the Journal or subsidiary books to the respective heads of accounts in the ledger. Journal will have at a minimum of one debit and one credit for each transaction. The ledger will have either a debit or a credit for each account used in the Journal.

Posting may be done daily, weekly fort nightly or monthly according to the convenience and requirements of the business, but care should be taken to complete it before the preparation of annual financial statements. The following rules should be followed

while posting business transactions to respective accounts in the ledger from the journal:

- i) Open separate account in the ledger for each person, asset, revenue, liability, expense, income and loss appearing in the Journal.
- ii) Enter the date of the journal entry in the Date Column of the account debited. Use the date of the journal entry, not the date on which the posting is done. Write the year and month in the left side of the date column. It is not necessary to write the year and month for other postings to the same account on the same page unless the month or year changes. The day, however is always entered.
- iii) The particulars column on the ledger contains the details of the account with which it is debited or credited.
- iv) In the ledger account Journal Folio (J/F) column, identify where the journal entry is recorded. Enter a letter for the specific journal and the journal page number.
- v) Enter the debit amount in the debit column of the ledger account, but the reference should be given of the other account which has been credited.
- vi) Similarly, the account credited in the Journal should be credited in the ledger, but the reference has to be given of the other account which has been debited in the Journal.
- vii) The debit posting should be prefixed by the word 'To' and credit posting should be prefixed by the word 'By'.
- viii) Return to the journal and, in the ledger folio (L/F) column, enter the account number of the ledger account to which debit part of the journal entry is posted. Be sure it is entered on the same line as the debit entry. This part is very important as the notation in the ledger folio indicates that the journal entry has been posted.

Let us take an example to understand the posting:

Illustration:1 On Jan 1, 2014 Sohan Lal purchased a computer costing 50,000 from a supplier and issued a cheque of Rs.50,000. On Jan 4 He purchased stock worth Rs.1,00,000 and paid by cheque. These will be recorded in the journal as shown below:

Journal

Date	Particulars	L/F	Debit Amount (Rs.)	Credit Amount (Rs.)
Jan 1	Computer A/c ----- Dr. To Bank A/c (Being computer purchased)		50,000	50,000
Jan 4	Stock A/c ----- Dr. To Bank A/c (Being computer purchased)		1,00,000	1,00,000

Now let us see how this will be posted in ledger

Dr.	Computer Account						Cr.
Date	Particulars	J/F	Amount (Rs.)	Date	Particulars	J/F	Amount (Rs.)
Jan 1	To Bank A/c		50,000				

Dr.	Bank Account						Cr.
Date	Particulars	J/F	Amount (Rs.)	Date	Particulars	J/F	Amount (Rs.)
				Jan 1	By Computer A/c		50,000
				Jan 4	By Stock A/c		1,00,000

Dr.	Stock Account						Cr.
Date	Particulars	J/F	Amount (Rs.)	Date	Particulars	J/F	Amount (Rs.)
Jan 4	To Bank A/c		1,00,000				

Check your Progress 1

Note: Use the space given below for your answers. You may use extra sheets for solving questions.

1) Define Ledger. What is the importance of writing ledger?

2) What is the relationship between journal and ledger?

3) What is posting? Write the rules of posting.

Posting of Compound Journal Entry

When a single entry is passed to record more than one transaction, it is known as a compound journal entry. However, it will be treated as several separate entries while posting. The following example will make the point clear:

Illustration 2 On Jan 1, 2014 Sohan Lal purchased a computer costing 50,000 from a supplier and issued a cheque of Rs.30,000. Balance amount to be paid after three months. This will be recorded as shown below:

Journal

Date	Particulars	L/F	Debit Amount (Rs.)	Credit Amount (Rs.)
Jan 1	Computer A/c ----- Dr. To Bank A/c To Vendor A/c (Being computer purchased partly by paying cheque and partly on credit for 3 months)		50,000	30,000 20,000

Now let us see how this will be posted in the ledger:

Dr.	Computer Account						Cr.
Date	Particulars	J/F	Amount	Date	Particulars	J/F	Amount

After transferring the entries from Journal to the ledger, the next stage is to ascertain the net effect of all the transactions posted to relevant account.

When the posting is completed, most of the accounts may have entries on both sides of the accounts i.e. debit entries and credits entries. The process of finding out the difference between the totals of the two sides of a Ledger account is known as balancing and the difference of the total debits and the total credits of accounts is known as balance.

If the total of the credit side is bigger than the total of the debit side, the difference is known as credit balance. In the reverse case, it is called debit balance.

Steps for Balancing Ledger Account

Ledger accounts may be balanced as and when it is required. Balancing is done either weekly, monthly, quarterly, biannually or annually, depending on the requirements of the business concern. The balances of various accounts are ascertained as under :

1. Total both sides of an account in a worksheet.
2. Write down the higher amount on the side obtained e.g. if the total of the debit side is higher as compared to the credit side then the amount on debit side will be written first.
3. Also write down the same total on the other side of the account i.e. the total of higher side is written against the total on the lower side also.
4. Find out the difference between the two sides of the account. In this example debit side is more than credit side; therefore, there will be a debit balance.
5. This debit balance is to be shown as "By Balance c/d" in the account on the credit side.
6. Finally, the amount of the closing balance should be brought down as the opening balance at the beginning of the next day. Remember that if the opening balance is not written on the next day, the balancing is incomplete.

Let us understand the balancing of accounts from the above illustration:

In the following computer account, the balance of debit side is Rs.50,000 and that of credit side the balance is nil. So the debit side is higher and we will write Rs.50,000 on both sides. Thereafter the balancing figure is carried down as shown below:

Dr.		Computer Account					Cr.
Date	Particulars	J/F	Amount (Rs.)	Date	Particulars	J/F	Amount (Rs.)
Jan 1	To Bank A/c		30,000	Jan31	By Balance c/d		50,000
Jan 1	To Vendor A/c		20,000		(Balancing Figure)		

			50,000			50,000
Feb 1	To Balance b/d		50,000			

Dr.	Bank Account						Cr.
Date	Particulars	J/F	Amount (Rs.)	Date	Particulars	J/F	Amount (Rs.)
Jan 31	To Balance c/d		30,000	Jan 1	By Computer A/c		30,000
			30,000				30,000
				Feb1	By Balance b/d		30,000
Dr.	Vendor Account						Cr.
Date	Particulars	J/F	Amount (Rs.)	Date	Particulars	J/F	Amount (Rs.)
Jan 31	To Balance c/d		20,000	Jan 1	By Computer A/c		20,000
			20,000				20,000
				Feb1	By Balance b/d		20,000

Illustration 3: Journalise the following transactions and also post in ledger:

March 1 Raj Kumar started business with cash Rs.4,00,000

March3 Purchased goods worth Rs.2,50,000 from Suresh

March5 Purchased furniture for Rs.30,000 from Hardik & Co.

March 8Paid Rs.29,000 to Hardik & Co. in full settlement

March10 Paid Rs.2,45,000 to Suresh in full settlement

March 12 Sold goods for cash Rs.1,50,000

March 27 Paid salary in cash Rs.10,000

March 27 Sold goods to Ramesh for Rs.2,00,000

March 28 Deposited cash in Bank Rs.2,00,000

March 29 Rent paid Rs.10,000

Journal
Of Mr. Raj Kumar
For the year 2014

Date 2014	Particulars	L/F	Debit Amount (Rs.)	Credit Amount (Rs.)
March 1	Cash A/c -----Dr. To Capital A/c (Being business commenced)		4,00,000	4,00,000
March 3	Purchase A/c----- Dr. To Suresh A/c (Being goods purchased on credit)		2,50,000	2,50,000
March 5	Furniture A/c -----Dr. To Hardik & Co. A/c (Being furniture on credit)		30,000	30,000
March 8	Hardik & Co. A/c -----Dr. To Cash A/c To Discount Received A/c (Being cash paid in full settlement and discount received)		30,000	29,000 1,000
March10	Suresh A/c----- Dr. To Cash A/c To Discount Received A/c (Being cash paid to Suresh in full settlement and discount received)		2,50,000	2,45,000 5,000
March12	Cash A/c ----- Dr. To Sales A/c (Being goods sold for cash)		1,50,000	1,50,000
March27	Salary A/c----- Dr. To Cash A/c (Being salary paid in cash)		10,000	10,000
March27	Ramesh A/c ----- Dr. To Sales A/c (Being goods sold on credit)		2,00,000	2,00,000

March 28	Bank A/c ----- Dr. To Cash A/c (Being cash deposited in bank)	2,00,000	2,00,000
March 29	Rent A/c ----- Dr. To Cash A/c (Being rent paid in cash)	10,000	10,000

Now let us prepare ledger

Dr.	Cash Account						Cr.
Date	Particulars	J/F	Amount (Rs.)	Date	Particulars	J/F	Amount (Rs.)
Mar 1	To Capital A/c		4,00,000	Mar 8	By Hardik & Co. A/c		29,000
Mar 12	To Sales A/c		1,50,000	Mar 10	By Suresh A/c		2,45,000
				Mar 27	By Salary A/c		10,000
				Mar 28	By Bank A/c		2,00,000
				Mar 29	By Rent A/c		10,000
				Mar 31	By Balance c/d (Balancing Figure)		56,000
			5,50,000				5,50,000
April 1	To Balance b/d		56,000				

Dr.	Raj Kumar's Capital Account						Cr.
Date	Particulars	J/F	Amount (Rs.)	Date	Particulars	J/F	Amount (Rs.)
Mar 31	To Balance c/d (balancing figure)		4,00,000	Mar 1	By Cash A/c		4,00,000
			4,00,000				4,00,000
				April 1	By Balance b/d		4,00,000

Dr.	Purchases Account						Cr.
Date	Particulars	J/F	Amount (Rs.)	Date	Particulars	J/F	Amount (Rs.)

Mar3	To Suresh A/c		2,50,000	Mar 31	By Balance c/d (balancing figure)		2,50,000
			2,50,000				2,50,000
April 1	To Balance b/d		2,50,000				

Dr.	Rent Account						Cr.
Date	Particulars	J/F	Amount (Rs.)	Date	Particulars	J/F	Amount (Rs.)
Mar29	To Cash A/c		10,000	Mar 31	By Balance c/d (balancing figure)		10,000
			10,000				10,000
April 1	To Balance b/d		10,000				

Dr.	Furniture Account						Cr.
Date	Particulars	J/F	Amount (Rs.)	Date	Particulars	J/F	Amount (Rs.)
Mar5	To Hardik & Co.A/c		30,000	Mar 31	By Balance c/d (balancing figure)		30,000
			30,000				30,000
April 1	To Balance b/d		30,000				

Dr.	Suresh Account						Cr.
Date	Particulars	J/F	Amount (Rs.)	Date	Particulars	J/F	Amount (Rs.)
Mar10	To Suresh A/c		2,45,000	Mar 31	By Purchases A/c		2,50,000
Mar10	To Dis. Received A/c		5,000				
			2,50,000				2,50,000

Dr.	Hardik & Co. Account						Cr.
Date	Particulars	J/F	Amount	Date	Particulars	J/F	Amount

			(Rs.)				(Rs.)
Mar8	To Cash A/c		29,000	Mar 5	By Furniture A/c		30,000
Mar8	To Dis. Received A/c		1,000				
			30,000				30,000

Dr.	Discount Received Account						Cr.
Date	Particulars	J/F	Amount (Rs.)	Date	Particulars	J/F	Amount (Rs.)
Mar31	To Balance c/d (balancing figure)		6,000	Mar 8	By Hardik & Co. A/c		1,000
				Mar10	By Suresh A/c		5,000
			6,000				6,000
				April1	By Balance b/d		6,000

Dr.	Sales Account						Cr.
Date	Particulars	J/F	Amount (Rs.)	Date	Particulars	J/F	Amount (Rs.)
Mar31	To Balance c/d (balancing figure)		3,50,000	Mar 12	By Cash A/c		1,50,000
				Mar 27	By Ramesh A/c		2,00,000
			3,50,000				3,50,000
				April1	By Balance b/d		3,50,000

Dr.	Salary Account						Cr.
Date	Particulars	J/F	Amount (Rs.)	Date	Particulars	J/F	Amount (Rs.)
Mar27	To Cash A/c		10,000	Mar 31	By Balance c/d (balancing figure)		10,000
			10,000				10,000
April 1	To Balance b/d		10,000				

Dr.	Ramesh Account						Cr.
Date	Particulars	J/F	Amount (Rs.)	Date	Particulars	J/F	Amount (Rs.)

Mar27	To Sales A/c		2,00,000	Mar 31	By Balance c/d (balancing figure)		2,00,000
			2,00,000				2,00,000
April 1	To Balance b/d		2,00,000				

Dr.	Bank Account						Cr.
Date	Particulars	J/F	Amount (Rs.)	Date	Particulars	J/F	Amount (Rs.)
Mar28	To Cash A/c		2,00,000	Mar 31	By Balance c/d (balancing figure)		2,00,000
			2,00,000				2,00,000
April 1	To Balance b/d		2,00,000				

Check your Progress 2

Note: Use the space given below for your answers. You may use extra sheets for solving questions.

1) What do understand by balancing?

2) Write various steps of balancing of ledger account. Also give suitable example.

Illustration 4

Journalise the following transactions and post the same in ledger.

Transactions in the books of M/s Mahesh Traders.	
Date	Particulars
April 1	Mahesh started his business with cash Rs 5,00,000
April 10	Mahesh opened an account in a bank with cash Rs 3,00,000

April 10	Purchased goods from Mohan Singh on credit Rs 1,40,000 and also paid carriage of Rs 2,000
April 15	Sold goods to Rajeev Rs 20,000
April 17	Due to some quality defect returned goods to Mohan Singh worth Rs 10,000
April 18	Sold goods to Sneha Rs.70,000
April 19	Purchased Furniture for cash of Rs 8,000
April 20	Paid through a cheque of Rs 5,000 for advertisement
April 21	Withdrawn Rs 6,000 from Bank for personal use
April 22	Recovered Rs 65,000 from Sneha in full settlement of her account
April 23	Interest received from Bank Rs 2,000
April 24	Rajeev has become insolvent Rs 80 paise in the rupees on a debt of Rs 20,000 was recovered as a compensation
April 30	Paid rent of Rs 10,000
April 30	Goods costing Rs 1,000 donated to NGO
April 30	Salaries paid to employees Rs 15,000

Journal
Of M/s Mahesh Traders
For the year 2014

Date 2014	Particulars	L/F	Debit Amount (Rs.)	Credit Amount (Rs.)
April 1	Cash A/c -----Dr. To Capital A/c (Being business commenced with cash)		5,00,000	5,00,000
April 10	Bank A/c ----- Dr. To Cash A/c (Being bank account opened)		3,00,000	3,00,000
April 10	Purchases A/c -----Dr. To Mohan Singh A/c (Being goods purchased on credit)		1,40,000	1,40,000
April 10	Carriage A/c-----Dr. To Cash A/c (Being carriage paid on purchase of goods)		2,000	2,000
April 15	Rajeev A/c -----Dr. To Sales A/c (Being goods sold on credit)		20,000	20,000

April 17	Mohan Singh A/c ----- Dr. To Purchases Return A/c (Being Due to some quality defect returned goods to Mohan Singh)	10,000	10,000
April 18	Sneha A/c ----- Dr. To Sales A/c (Being goods sold on credit)	70,000	70,000
April 19	Furniture A/c ----- Dr. To Cash A/c (Being furniture purchased)	8,000	8,000
April 20	Advertisement A/c -----Dr. To Bank A/c (Being cheque paid for advertisement)	5,000	5,000
April 21	Drawings A/c ----- Dr. To Bank A/c (Being money withdrawn from bank for personal use)	6,000	6,000
April 22	Cash A/c-----Dr. Discount Allowed A/c----- Dr. To Sneha A/c (Being Sneha's account settled)	65,000 5,000	70,000
April 23	Bank A/c ----- Dr. To Interest A/c (Being interest received from bank)	2,000	2,000
April 24	Cash A/c----- Dr. Bad Debts A/c-----Dr. To Rajeev A/c (Being Rajeev become insolvent Rs 80 paise in the rupees on a debt of Rs 20,000 was recovered as a compensation)	16,000 4,000	20,000
April 30	Rent A/c-----Dr. To Cash A/c (Being rent paid)	10,000	10,000

April 30	Donation A/c----- Dr. To Purchases A/c (Being goods donated to NGO)	1,000	1,000
April 30	Salaries A/c -----Dr. To Cash A/c (Being salaries paid to employees)	15,000	15,000

Now let us prepare ledger

Dr.		Cash Account					Cr.
Date	Particulars	J/F	Amount (Rs.)	Date	Particulars	J/F	Amount (Rs.)
Apr1	To Capital A/c		5,00,000	Apr 10	By Bank A/c		3,00,000
Apr 22	To Sneha A/c		65,000	Apr 10	By Carriage A/c		2,000
Apr 24	To Rajeev A/c		16,000	Apr 19	By Furniture A/c		8,000
				Apr 30	By Rent A/c		10,000
				Apr 30	By Salaries A/c		15,000
				Apr 30	By Balance c/d (Balancing Figure)		2,46,000
			5,81,000				5,81,000
May 1	To Balance b/d		2,46,000				

Dr.		Capital Account					Cr.
Date	Particulars	J/F	Amount (Rs.)	Date	Particulars	J/F	Amount (Rs.)
Apr30	To Balance c/d (balancing figure)		5,00,000	Apr 1	By Cash A/c		5,00,000
			5,00,000				5,00,000
				May1	By Balance b/d		4,00,000

Dr.		Interest Account					Cr.
Date	Particulars	J/F	Amount (Rs.)	Date	Particulars	J/F	Amount (Rs.)

Apr 30	To Balance c/d		2,000	Apr 23	By Bank A/c		2,000
			2,000				2,000
				May 1	By Balance b/d		2,000

Dr.	Bank Account						Cr.
Date	Particulars	J/F	Amount (Rs.)	Date	Particulars	J/F	Amount (Rs.)
Apr 10	To Cash A/c		3,00,000	Apr 20	By Advertisement A/c		5,000
Apr 23	To Interest A/c		2,000	Apr 21	By Drawings A/c		6,000
				Apr 30	By Balance c/d (balancing figure)		2,91,000
			3,02,000				3,02,000
May 1	To Balance b/d		3,02,000				

Dr.	Purchases Account						Cr.
Date	Particulars	J/F	Amount (Rs.)	Date	Particulars	J/F	Amount (Rs.)
Apr 10	To Mohan Singh A/c		1,40,000	Apr 30	By Donations A/c		1,000
				Apr 30	By Balance c/d (balancing figure)		1,39,000
			1,40,000				1,40,000
May 1	To Balance b/d		1,39,000				

Dr.	Mohan Singh Account						Cr.
Date	Particulars	J/F	Amount (Rs.)	Date	Particulars	J/F	Amount (Rs.)
Apr 17	To Purchases Return A/c		10,000	Apr 10	By Purchases A/c		1,40,000
Apr 30	To Balance c/d (balancing figure)		1,30,000				
			1,40,000				1,40,000
				May 1	By Balance b/d		1,30,000

Dr.		Carriage Account						Cr.
Date	Particulars	J/F	Amount (Rs.)	Date	Particulars	J/F	Amount (Rs.)	
Apr 10	To Cash A/c		2,000	Apr 30	By Balance c/d (Balancing Figure)		2,000	
			2,000				2,000	
May 1	To Balance b/d		2,000					

Dr.		Rajeev Account						Cr.
Date	Particulars	J/F	Amount (Rs.)	Date	Particulars	J/F	Amount (Rs.)	
Apr 15	To Sales A/c		20,000	Apr 24	By Cash A/c		16,000	
				Mar10	By Bad Debt A/c		4,000	
			20,000				20,000	

Dr.		Sales Account						Cr.
Date	Particulars	J/F	Amount (Rs.)	Date	Particulars	J/F	Amount (Rs.)	
Apr 30	To Balance c/d (balancing figure)		90,000	Apr 15	By Rajeev A/c		20,000	
				Apr 18	By Sneha A/c		70,000	
			90,000				90,000	
				May 1	By Balance c/d		90,000	

Dr.		Bad Debts Account						Cr.
Date	Particulars	J/F	Amount (Rs.)	Date	Particulars	J/F	Amount (Rs.)	
Apr 24	To Rajeev A/c		4,000	Apr 30	By Balance c/d (balancing figure)		4,000	
			4,000				4,000	
May 1	To Balance b/d		4,000					

Dr.		Drawings Account						Cr.
-----	--	------------------	--	--	--	--	--	-----

Date	Particulars	J/F	Amount (Rs.)	Date	Particulars	J/F	Amount (Rs.)
Apr 21	To Bank A/c		6,000	Apr 30	By Balance c/d (balancing figure)		6,000
			6,000				6,000
May 1	To Balance b/d		6,000				

Dr.		Donations Account					Cr.
Date	Particulars	J/F	Amount (Rs.)	Date	Particulars	J/F	Amount (Rs.)
Apr 30	To Purchases A/c		1,000	Apr 30	By Balance c/d (balancing figure)		1,000
			1,000				1,000
May 1	To Balance b/d		1,000				

Dr.		Purchases Return Account					Cr.
Date	Particulars	J/F	Amount (Rs.)	Date	Particulars	J/F	Amount (Rs.)
Apr 30	To Balance c/d (balancing figure)		10,000	Apr 17	By Mohan Singh A/c		10,000
			10,000				10,000
				May 1	By Balance b/d		10,000

Dr.		Rent Account					Cr.
Date	Particulars	J/F	Amount (Rs.)	Date	Particulars	J/F	Amount (Rs.)
Apr 30	To Cash A/c		10,000	Apr 30	By Balance c/d (balancing figure)		10,000
			10,000				10,000
May 1	To Balance b/d		10,000				

Dr.	Sneha Account						Cr.
Date	Particulars	J/F	Amount (Rs.)	Date	Particulars	J/F	Amount (Rs.)
Apr 18	To Sales A/c		70,000	Apr 22	By Cash A/c		65,000
				Apr 22	By Discount Allowed A/c		5,000
			70,000				70,000

Dr.	Discount Allowed Account						Cr.
Date	Particulars	J/F	Amount (Rs.)	Date	Particulars	J/F	Amount (Rs.)
Apr 22	To Sneha A/c		5,000	Apr 30	By Balance c/d (balancing figure)		5,000
			5,000				5,000
May 1	To Balance b/d		5,000				

Dr.	Furniture Account						Cr.
Date	Particulars	J/F	Amount (Rs.)	Date	Particulars	J/F	Amount (Rs.)
Apr 19	To Cash A/c		8,000	Apr 30	By Balance c/d (balancing figure)		8,000
			8,000				8,000
May 1	To Balance b/d		8,000				

Dr.	Advertisement Account						Cr.
Date	Particulars	J/F	Amount (Rs.)	Date	Particulars	J/F	Amount (Rs.)
Apr 30	To Bank A/c		5,000	Apr 30	By Balance c/d (balancing figure)		5,000

			5,000			5,000
May 1	To Balance b/d		5,000			

Dr.	Salaries Account						Cr.
Date	Particulars	J/F	Amount (Rs.)	Date	Particulars	J/F	Amount (Rs.)
Apr 30	To Cash A/c		15,000	Apr 30	By Balance c/d (balancing figure)		15,000
			15,000				15,000
May 1	To Balance b/d		15,000				

5.6 LET US SUM UP

Journal which is a first step in the accounting process, is concerned with the recording of financial transactions in an orderly manner, soon after their occurrence. The function of systematic analysis of the recorded data to accumulate the transactions of similar type at one place is performed by maintaining the ledger in which different accounts are opened to which transactions are posted. Ledger is a book of accounts in which data from transactions recorded in journals are posted and thereby classified and summarized. Ledger is a set of accounts. Ledger contains the various personal, real and nominal accounts in which all business transactions of the entity are recorded. The main function of the ledger is to classify and summarise all the items appearing in Journal and other books of original entry under appropriate head/set of accounts so that at the end of the accounting period, each account contains the complete information of all transaction relating to it.

5.7 KEYWORDS

Ledger: Ledger is a book of accounts in which data from transactions recorded in journals are posted and thereby classified and summarized.

Posting: Posting refers to the process of transferring debit and credit amounts from the Journal or subsidiary books to the respective heads of accounts in the ledger.

Balancing: The process of finding out the difference between the totals of the two sides of a Ledger account is known as balancing and the difference of the total debits and the total credits of accounts is known as balance.

5.8 QUESTIONS

Short Answer Questions

1. Define Ledger.
2. What do you understand by posting and balancing?
3. Write a ledger for following compound entry:

On March 1, 2014 Mohan Lal purchased furniture for Rs.1,50,000 from a supplier and issued a cheque of Rs.30,000. Balance amount to be paid after three months.

Long Answer Questions

1. What do you understand by ledger balancing. Explain the procedure for balancing a ledger account.
2. What is meant by posting? How is posting made from the journal in the ledger? Explain with suitable examples.
3. Explain the relationship between journal and ledger.
4. Pass necessary Journal entries in the books of Suresh Traders and journalise the same for the month of May 2014:
 - i) Started business with cash Rs.2,00,000
 - ii) Issued a cheque for Rs. 1,000 in favour of landlord for a rent for the month of May.
 - iii) Paid maintenance charges of Rs. 450 by cheque.
 - iv) The goods destroyed by fire Rs. 3,000. Insurance company admitted full claim.
 - v) Received cheque from insurance company amounting Rs.3000 against goods lost by fire.
 - v) Purchased machinery by paying cheque Rs.50,000 and paid wages for the installation of machinery Rs. 5,000.
 - vi) Accrued interest Rs. 1100.
 - vii) Goods worth Rs. 1,000 given away by way of charity and goods worth Rs.500 were distributes as free samples.
 - viii) Goods taken by Proprietor worth Rs. 10,000 for personal use.

5.9 REFERENCES AND SUGGESTED READINGS

1. S.N. Maheshwari, *Advanced Accountancy*, Vikas Publication House Pvt. Ltd.
2. R.L. Gupta, *Advanced Accountancy*, Sultan Chand & Sons.
- 3 M.C. Sukla and T.S. Grewal, *Advanced Accountancy*, 18th Edition, S. Chand, 2008.
4. Tulsian, P.C. (2002) *Financial Accounting*, Pearson Education India, New Delhi.

Activity 1

What are the utilities of ledger?

Activity 2

What are the objectives of ledger?

LESSON 6

SUBSIDIARY BOOKS

STRUCTURE

6.0 Objectives

6.1 Introduction

6.2 Meaning of Subsidiary Books

6.3 Need and advantages of Subsidiary books

6.4 Difference between Subsidiary Books and Ledger

6.5 Purchases Book

6.6 Sales Book

6.7 Purchase Return Book

6.8 Sales Return Books

6.9 Bills Receivable Book

6.10 Bills Payable Book

6.11 Journal Proper

6.12 Let Us Sum Up

6.13 Key Words

6.14 Questions

6.15 References and Suggested Readings

6.0 OBJECTIVES

After going through this lesson you will be able to

- know the meaning of subsidiary books
- Know the classification of Subsidiary Book
- Identify the difference between Subsidiary book and ledger
- Discuss Purchase Book, Purchase Return Book, Sales Book and Sales Return Book

6.1 INTRODUCTION

So far we have discussed that transactions are first recorded in journal, and then posted to ledger. In case of large organizations where there are numerous transactions, it will be difficult to record all these transactions through journal. Hence, for convenience of recording, the journal is divided into a number of special journals. These are known as subsidiary books. The number of subsidiary books maintained by a business organization depends on the size of the organization and the nature of transactions. Now, we will discuss the subsidiary books maintained by a business organization in general.

6.2 MEANING OF SUBSIDIARY BOOKS

Subsidiary books are the books of original entry that are maintained under the modern methods of book-keeping for recording the various transactions. Subsidiary books are also called primary records because the first entry of transaction is made in subsidiary books. On the basis of subsidiary books postings are made into concerned account afterwards. If the number of transaction is very large then there will be bulky journal. For quick, efficient and accurate recording of business transactions, the journal book is sub-divided. The sub-division of journal ensures that the size of journal will not be too bulky. This helps in getting useful information about liquidity position of business. These special journals are called Subsidiary Books as these facilitate the preparation of Ledger book.

Following types of books are used under subsidiary books—

1. Purchase book
2. Sales book
3. Purchase return book
4. Sales return book
5. Bills Payable book
6. Bills Receivable book
7. Journal Proper

6.3 NEED FOR MAINTAINING SUBSIDIARY BOOKS

There are following reasons for which it becomes necessary to sub-divide the journal:

1. Recording of Transactions: if the number of transactions is very large then it is not possible for a single person to record transactions in time. But if two or more persons are employed for the same purpose then it is possible only if the journals are divided.
2. Size of journal: the size of journal will become too bulky if all the transactions are recorded in one book. It will become difficult to handle this by one person.

3. More time and labour: it is a time and labour consuming process to record transactions in one journal and then post each and every individual item to the ledger.
4. Accuracy of information: if only one journal is maintained and all the transactions are recorded in this, then it may lead to certain errors and mistakes. In such a case the derived information may not be accurate and correct.
5. Classification of records: when a business records all the transactions in one book i.e. journal, then it fails to provide classified information such as monthly credit sales or purchases etc.
6. Checking and verification: it is difficult to check and verify the recorded transactions in one bulky sized journal.

ADVANTAGES OF SUBSIDIARY BOOKS

The practical system of book keeping is very useful as it has various advantages given below:

1. Division of work: this system permits the division of work among the accounting staff. There are various subsidiary books, therefore, different clerks can be entrusted with the job of writing different sub journals.
2. Time saving: due to the division of work, it is possible to perform various accounting processes simultaneously. Thus, lesser time is required to complete the accounting records.
3. Increase in efficiency: each person is required to write up only one class of transactions, therefore, he is likely to develop proficiency in his work. It increases the efficiency of work in an accurate and exact manner.
4. Minimum errors and frauds: the systematic recording of business transactions in special journals reduces the possibilities of errors and frauds. It also helps in location of errors, if any.
5. Effective internal check system: the subsidiary books lead to the division of work and each person is assigned with the specialized work so the internal check system of business becomes more effective.
6. Facility in auditing: it makes information available regarding each particular class of transactions at one place. Therefore, it facilitates the work of auditors.
7. Location of errors: different persons carry on the checking work simultaneously on different books; therefore, at the time of preparing the trial balance the errors can be located easily and quickly.
8. Easy reference: as the volume of each sub journal becomes short, therefore, it is easy to make any reference for the purpose of use.

CLASSIFICATION OF SUBSIDIARY BOOKS

Subsidiary Books	Nature of transactions recorded
-------------------------	--

Purchases Book	Credit purchase of goods
Sales Book	Credit sales of goods
Purchases Returns Book	Goods returned to supplier
Sales Returns Book	Goods returned by customers
Bill Receivable Book	Bills drawn on customers
Bills Payable Book	Bills accepted in favour of suppliers
Journal Proper	Transactions not classified above and for which there is no special journal

6.4 DIFFERENCE BETWEEN SUBSIDIARY BOOKS AND LEDGER

The differences between subsidiary books and ledger can be presented in the summarized form in the following tabular column:

Basis of Distinction	Subsidiary Books	Ledger
1. Caption of the book	These are books of Original Entry (or) Books of Prime Entry.	This is a book of Secondary Entry (or) Book of Final Entry.
2. Basis of recording	These are recorded on the basis of source documents.	These are recorded on the basis of the books of Prime Entry.
3. Order of recording	Transactions are recorded in order of their occurrence.	Transactions are recorded from subsidiary books irrespective of the date of their occurrence.

6.5 PURCHASE BOOK

In purchase book the transactions relating to credit purchase of goods are recorded. The term goods mean all the commodities and services in which the company deals in day to day activities. But cash purchases and purchase of fixed assets are not recorded in this book. This book is also known as Purchase Journal or Bought Day Book. At the end of a certain period, the total of Purchase Book is posted to the debit side of Purchase Account and the suppliers' accounts will be credited with the respective amounts in the ledger book.

Cash purchases of the goods are recorded in cash book and not in the purchase book. For recording purposes, the following points should be considered:

1. Only credit purchases of goods is to be considered.
2. Cash purchases of goods is to be recorded in cash book.
3. Purchase of goods meant for resale are to be considered.
4. If a business purchases an item not for resale in the normal course of business then it will be treated as an asset and therefore not to be recorded in the purchases book i.e. asset shall be recorded in the journal proper.

Following is the format of purchase book:

PURCHASE BOOK

Date	Particulars	Inward invoice no.	L.F.	Detail	Amount
(1)	(2)	(3)	(4)	(5)	(6)

Illustration 1

Enter the following transactions in the purchases book of M/s Grover Electronics for April, 2013:

April 5 Purchased on credit from BR. Co. Ltd.

6 TV Sets Janta Model @ Rs.2000 (Trade discount 15%)

2 Delux model@ Rs. 4500

April 7 Purchased on cash from sham Bros.

Table Lamps 2 @ Rs. 270

April 9 Purchased on credit from Modern Furnishers

Show Case 1 @ Rs, 1200

SOLUTION:

PURCHASES BOOK OF M/S GROVER ELECTRONICS

Date 2013	Invoice No	Particulars	L.F.	Details (Rs.)	Amount (Rs.)
April 5		BR. Co. Ltd.			
		6 TV Sets Janta Model @ Rs.2000		12,000	
		2 Delux model@ Rs. 4500		9,000	
				21,000	
		Less: Trade discount 15 %		3,150	17,850
April 9		Modern Furnishers			
		Show Case 1 @ Rs, 1200		1,200	1,200
		Grand Total			19,050

Illustration 2

The Rough book of M/s Chawla & Co. contains the following for the month of February 2014

Feb 1 Purchased from M/s Sharma & Co. on credit:

10 gross pencils @ Rs 8 per gross.

1 gross registers @ Rs 26 per doz.

Less trade discount @ 10%

Feb 2 Purchased for cash from subsidiary mart ;

10 gross exercise books @Rs 3 per dozen

Feb 3 Purchased typewriter for office use from M/s Office Goods Co.

on credit for Rs 800.

Feb 4 Purchased on credit from the Paper Co.

4 reams of white paper @ Rs 10 per ream,

20 reams of ruled paper @ Rs 15 per ream.

Less trade discount @ 10%

Feb 5 Purchased one dozen ink-pots @ Rs 2.50 each from M/s Singh Brothers on credit

Make out the Purchase book of M/s Chawla & Co.

Solution.

PURCHASE BOOK OF M/S CHAWLA & CO.

Date	Particulars	Invoice no.	L.F.	Details Rs.	Amount Rs.
2009					
Feb.1	M/s Sharma & Co. 10 gross pencils @ Rs. 8 per gross 1 gross registers @ Rs. 26 per doz. Less 10% trade discount			80.00 288.00 <hr/> 312.00 31.20	 280.80
Feb.4	The Paper Co. 4 reams white paper @ Rs. 10 per ream 20 reams ruled paper @ 15 per ream Less 10% trade discount			40.00 300.00 <hr/> 340.00 34.00	 306.00
Feb.5	M/s Singh Bros. 1 doz. Ink pots @ 2.50 each Total			30.00	30.00 <hr/> 586.80

6.6 SALES BOOK

This book is meant for recording credit sale of goods. Cash sale of goods and sale of articles other than goods are not recorded in this book. This book is also known as Sales Journal or Sold Day Book. When the trader sells goods on credit then he should keep record in sales book to know how much goods have been sold, when and to whom. At the end of a certain period, the total of Sales Book is posted to the credit side of Sales Account and the

customers' accounts will be debited with the respective amounts in the Ledger book. Two things are to be noted about this book:

1. Only credit sales are recorded in sales book. Cash sales of goods are recorded in the cash book.
2. The credit sale of only those goods is recorded in this book in which the firm is normally trading.

Following is the format of sales book:

SALES BOOK

Date	Particulars	outward invoice no.	L.F.	Detail	Amount
(1)	(2)	(3)	(4)	(5)	(6)

Illustration 3

Record the following transactions in the purchases book of M/S Sharma Electronics Ltd. for January, 2013:

Jan 7 Sold to M/S Bajwa Electronics

100 Philips irons @ Rs. 30 per piece

105 Philips Mixers@ Rs. 100 each

Jan 10 Sold furniture on credit to Mukat & Sons for Rs. 4,000

Jan 20 Sold to Bansal Electronics

10 washing machines @ Rs. 3,000 each

In business 10% trade discount is provided on all sales.

SOLUTION:

SALES BOOK OF M/S SHARMA ELECTRONICS LTD.

Date	Invoice No	Particulars	L.F.	Details	Amount
------	---------------	-------------	------	---------	--------

2013				(Rs.)	(Rs.)
Jan 7		M/S Bajwa Electronics			
		100 Philips irons @ Rs. 30 per piece		3,000	
				10,500	
		105 Philips Mixers@ Rs. 100 each		13,500	
				1,350	12,150
Jan 10		Less: Trade discount 10 %			
		Bansal Electronics			
		10 washing machines @ Rs. 3,000 each		30,000	
				3,000	27,000
		Less: Trade discount @ 10%			39,150
		Grand Total			

Illustration 4

From the following particulars write up the sales book of Aman, a dealer in furniture, also make the posting there from.

2014

July.4 sold on credit to Anwar.

15 tables @ Rs. 550

20 chairs @ Rs. 150

July.11 sold to Banarsi Dass & Co.

2 almirahs @ Rs. 8000

1 dinning table @ Rs. 5000

July .20 sold old typewriter at credit to Mukandi & Sons for Rs. 400

July .30 sold to Kwalitiy restaurant.

40 chairs @ Rs. 700

10 tables @ Rs. 1500

A offers trade discount at the following rates:-

Sales up to Rs. 20000 5%

Sales beyond Rs. 20000 10%

Solution:

A'S SALES BOOK

Date	Invoice no.	Particulars	L.F.	Details Rs.	Amount Rs.
2014					
June 4		Anwar 15 tables @ Rs. 550 20 chairs @ Rs. 150		8250 3000 <hr/> 11,250	
		Less Trade Discount @ 5%		562.50	10687.50
June 11		Banarsi Dass & Co. 2 Almirahs @ Rs. 8000 1 dinning table @ Rs. 5000		16000 5000 <hr/> 21,000	
		Less Trade discount @ 10%		2100	18900
June 30		Kwality Restaurant 40 chairs @ Rs. 700 10 tables @ Rs. 1500		28,000 15,000 <hr/> 43,000	
		Less Trade discount @ 10%		4,300	<u>38,700</u>
		Total			68,287.50

Check your Progress 1

Note: Use the space given below for your answers. You may use extra sheets for solving questions.

1) What are subsidiary books? What is the need of preparing these books?

2) What is the difference between ledger and subsidiary books?

5 frocks @ Rs. 10 each

Original invoice subject to 15% trade discount

Nov 15 Returned to Wings Company:

7 Pants @ Rs. 80 each

SOLUTION:

RETURNS OUTWARD BOOK

Date 2013	Invoice No	Particulars	L.F.	Details (Rs.)	Amount (Rs.)
Nov 8		Broadband Bombay			
		10 Shirts @Rs. 50 each		500	
		5 frocks @ Rs. 10 each		50	
				550	
		Less: Trade discount 15 %		82.50	467.50
April 9		Wings Company			
		7 Pants @ Rs. 80 each		560	560
		Grand Total			1027.50

Illustration 6

Record the following transactions in the returns outwards book of M/S Ahuja traders and the same into ledger:

2014

Dec .8 Returned to Broadways Bombay.

20 shirts @ rs 60 each.

6 baby frocks @ rs 10 each.

Size not according to order.

Original invoice subject to 10% trade discount.

Dec .15 Returned to Liberty Traders, Delhi.

5 bushshirts @ rs 40 each.

2 dozen socks @ rs 50 per dozen. Colour not as ordered.

Original invoice subject to 20% trade discount.

Dec .20 Returned to Fur Garment Company, Madras.

7 trousers @ rs 80 each. Poor finish.

Original invoice subject to 10% trade discount.

Dec .28 Returned to Novelty Stores, Ludhiana.

20 terelyne shirts @ rs 60 each.

2 woolen suits @ rs 100 each.

Received in excess of quantity ordered.

Original invoice subject to 30% trade discount.

SOLUTION:

RETURNS OUTWARD BOOKS

Date	Particulars	L.F.	Debit Note No	Details(Rs)	Amount(Rs)
2012 Nov. 8	Broadways, Bombay 20 shirts @rs 60 6 baby frocks @rs10 each Less 10% trade discount			1,200	1,134
				60	
				1,260	
				126	

Nov.15	Liberty Traders, Delhi 5 bushirts @rs40 2 dozen socks @rs50 per dozen			200	
				100	
				300	
	Less 20% trade discount			60	240
Nov.20	Fur Garments Co. Madras 7 trousers @rs80 each			560	
	Less 10% trade discount			56	504
Nov.28	Novelty Stores, Ludhiana 20 t-shirts @rs60 2 woolen suits @rs100			1200	
				200	
				1400	
				420	
					980
	Less 30% trade discount				2219
	Grand total				

DEBIT NOTE

It is the source of recording for Purchases Return book. A debit note is a document or statement sent by the firm to person to whom goods are returned or from whom an allowance is claimed. This statement is intimation to the supplier of goods that his account has been debited to the extent of value of goods returned or allowance claimed. It contains the description and details of goods returned, name and place of supplier to whom goods are returned and net value of goods with reason of return.

6.8 SALE RETURN BOOK

When goods sold on credit are returned by the customers, they are recorded in Sales Return Book or Returns Inward Book. At the end of a certain period, the total of this book is debited to Returns Inward Account and the customers' accounts, who have returned the goods, are credited with the respective amounts in the ledger book.

The format of the Sales Return Book is given below:

SALES RETURN BOOK

Date	Particulars	Credit Note No.	L.F.	Detail	Amount
(1)	(2)	(3)	(4)	(5)	(6)

Illustration 7

Record the following transactions in the purchases book of M/S Surindera Sports, Patiala:

2014

March 3 Bharat Sports Chandigarh

10 Cricket Bats @ Rs. 15 each

15 Foot balls @ Rs. 20 each

March 20 M/S Ray Sports Delhi

20 hockey sticks @ Rs. 40 each

Original invoice subject to a discount @ 10%

SOLUTION:

SALES RETURN BOOK

Date	Invoice No	Particulars	L.F.	Details (Rs.)	Amount (Rs.)
2014					
March 3		Bharat Sports Chandigarh			
		10 Cricket Bats @ Rs. 15 each		150	
		15 Foot balls @ Rs. 20 each		300	
				450	450
March 20		M/S Ray Sports Delhi			

		20 hockey sticks @ Rs. 40 each		800	
		Less: Trade discount @ 10%		80	720
		Grand Total			1270

Illustration 8

Record the following transactions in the sales returns book of **Surindera Sports, Patiala** and post the same into the ledger:

2013

March 3 Bharat Sports, Chandigarh returned:

10 cricket bats @ rs150 each.

15 footballs @ rs 20 each.

(original invoice subject to a discount@ 20%)

March 12 Mohan Sports, Jalandhar returned:

5 dozen reackets @ rs 120 per dozen.

(Original invoice subject to a discount @ 10%)

March 20 M/S Ray Jay Sports Delhi returned:

10 hockey sticks @ rs 40 each.

(Original invoice subject to a discount @ 10%)

March 29 Anu Sports Banur returned:

10 carrom boards @ rs 20 each.

(Original invoice subject to a discount of 15%)

SOLUTION:

IN THE BOOKS OF SURINDERA SPORTS

SALES RETURNS BOOK

DATE	CREDIT NOTE NO.	PARTICULARS	DETAILS(RS)	AMOUNT(RS)
2013 Mar.3		Bharat Sports Chandigarh 10 cricket bats @ rs 150 each 15 footballs @ rs 20 each Less 20% trade discount	1500 300 360	1440
Mar.12		Mohan Sports Jalandhar 5 dozen rackets @ rs 120 per dozen Less 110% trade discount	600 60	540
Mar.20		M/s Ray Jay Sports Delhi 10 hockey sticks @ rs 40 each Less 10% trade discount	400 80	320
Mar.29		Anu Sports Banur 10 carrom boards @rs 20 each Less 15% trade discount Grand total	200 30	170 2470

CREDIT NOTE

It is the source of recording for Sales Return book. A credit note is a document or statement sent by the firm to its customers who returned the goods or claimed allowance from the firm. This statement is an acknowledgement to the buyer who returned the goods along with a debit note. It contains the description and details of goods returned, name and place of customer returning such goods and net value of goods returned.

DISTINGUISH BETWEEN DEBIT NOTE AND CREDIT NOTE

Debit Note	Credit Note
1. A debit note is prepared and sent by customer to his supplier.	1. A credit note is prepared and sent by a supplier to his customer.

2. A debit note serves as intimation for goods returned. 3. It informs supplier that his account has been debited with the amount shown. 4. Usually, a debit note does not follow a credit note. 5. Debit notes are the basis for making entries in the purchase return book.	2. A credit note serves as an acknowledgement of goods received back. 3. It informs the customers that his account has been credited with the amount shown. 4. A credit note, generally, follows a debit note i.e. a credit note is sent on receipt of a debit note. 5. Credit notes are the basis for making entries in the sales return book.
--	--

6.9 BILLS RECEIVABLE BOOK

This book is used to record all promissory notes given and Bills of Exchange accepted by customers for the amounts due from them. A promissory note contains an unconditional promise in writing, to pay a certain sum of money only to a certain person on a specific future date.

The format of the Bill Receivable book is given as:

BILLS RECEIVABLE BOOK

Date of Receipt	From Whom received	Period of Bill	Due Date	L.F.	Amount (Rs.)	Remarks
(1)	(2)	(3)	(4)	(5)	(6)	(7)

Illustration 9

Prepare a Bill receivable book from the following:

2013

Jan 5 Received from Shashi Kant his acceptance at 3 months for Rs. 20,000

Jan 12 Acceptance received from V. Kumar for Rs. 30,000 payable after 2 months

Jan 18 Received Sunil's acceptance for Rs. 40,000 payable after 90 days.

SOLUTION:

BILLS RECEIVABLE BOOK

Date of Receipt	From Whom received	Period of Bill	Due Date	L.F.	Amount (Rs.)	Remarks
2013						
Jan 5	Shashi Kant	3 months	April 8		20,000	
Jan 12	V. Kumar	2 months	March 15		30,000	
Jan 18	Sunil	90 Days	April 28		40,000	
Jan 31	Bills receivable A/c			Dr.	1,15,000	

6.10 BILLS PAYABLE BOOK

This book is used to record all promissory notes given and Bills of Exchange accepted by the business for the amounts due to suppliers. A bill of exchange is an instrument in writing, containing an unconditional order to pay a certain sum of money only to a certain person on a specific future date.

The format of the Bill Payable book is given as:

BILLS PAYABLE BOOK

Date of acceptance	To Whom given	Period of Bill	Due Date	L.F.	Amount (Rs.)	Remarks
(1)	(2)	(3)	(4)	(5)	(6)	(7)

Illustration 10

Prepare a Bill Payable book from the following:

2013

May 1 Accepted a bill for Rs. 10,000 for 1 month drawn by M/s Lal & Sons

May 6 A bill at 60 days for Rs. 18,000 drawn by Mahabir & Co. was accepted on this day

May 22 Gave acceptance to Akash bill for Rs. 50,000 payable 90 days after date

SOLUTION:

BILLS PAYABLE BOOK

Date of acceptance	To Whom given	Period of Bill	Due Date	L.F.	Amount (Rs.)	Remarks
2013						
May 1	Lal & Sons	1 month	Marvh 4		10,000	
May 6	Mahabir & Co	50 days	April 10		18,000	
May 22	Akash	90 days	May 26		50,000	
May 31	Bills payable book			Cr.		

6.11 JOURNAL PROPER

Journal proper is book of original entry (simple journal) in which miscellaneous credit transactions which do not fit in any other books are recorded. It is also called miscellaneous journal. The form and procedure for maintaining this journal is the same that of simple journal.

The use of journal proper is confined to record the following transactions:-

1. Opening entries
2. Closing entries
3. Transfer entries
4. Adjustment entries
5. Rectification entries

6. Entries for which there is no special journal

Opening Entries:

When a businessman wants to open the book for a new year, it is necessary to journalise the various assets and liabilities before the new accounts are opened in the ledger. The journal entries so passed are called "opening entries". Suppose a businessman opens a new set of books on January 1, 2014 with cash in hand Rs.100, debtors Rs.200, stock in trade Rs.320, machinery Rs.700, furniture Rs.150, bank loan Rs.300, capital Rs.1,070 the respective opening entry in the journal will be:

Cash	100	
Sundry debtors	200	
Stock in trade	320	
Machinery	700	
Furniture & fitting	200	
To Sundry creditors		150
To Bank loan		300
To Capital		1,070
(Being the incorporation of assets and liabilities at this date)		

Journal

Date	Particulars	L/F	Debit Amount (Rs.)	Credit Amount (Rs.)
	Cash A/c----- Dr.		100	
	Sundry Debtors A/c----- Dr.		200	
	Stock A/c----- Dr.		320	
	Machinery A/c ----- Dr.		700	
	Furniture & Fittings A/c ----- Dr.		200	
	To Sundry Creditors A/c			150
	To Bank Loan A/c			300
	To Capital A/c			1070
	(Being the incorporation of assets and liabilities at this date)			

Check your Progress 2

Note: Use the space given below for your answers. You may use extra sheets for solving questions.

1) What is the difference between debit note and credit note?

2) Define Journal proper.

Closing Entries:

When the books are balanced at the close of the accounting period with a view to paper final accounts it is necessary that balance of all the income and expenses accounts must be transferred to trading and profit and loss account. The process of transferring balances to the trading and profit and loss account at the end of year is called closing the books and entries passed at that time are called closing entries. For example on 31st December, 1991 the balance in expenses accounts are: Salary Rs.500; rent Rs.200; Stationary Rs.50; legal charges Rs.100; and income accounts are: commission received Rs.50. These balance will be recorded in profit and loss account through the following closing entries:

Journal

Date	Particulars	L/F	Debit Amount (Rs.)	Credit Amount (Rs.)
	Profit and Loss A/c----- Dr. To Salary A/c To Rent A/c To Stationary A/c To Legal Charges A/c (Being Closing entry passed)		850	500 200 50 100
	Commission Received A/c---- Dr. To Profit and Loss A/c (Being closing entry passed)		50	50

Transfer Entries:

When accounts are transferred from one account to another for combination of allied items, it is necessary to pass transfer entry. For example, Drawings Rs.500 is transferred from the drawings account to the capital account to find out the net capital. The transfer entry will be passed as follows:

Journal

Date	Particulars	L/F	Debit Amount (Rs.)	Credit Amount (Rs.)
	Capital A/c ----- Dr. To Drawings A/c (Being transfer entry passed)		500	500

Adjusting Entries:

Modification of the accounts at the end of an accounting period is called adjustments. If there be any event affecting the related period of accounts but left out of the books, the same should be incorporated in the books before the preparation of the final accounts. This is done by means of adjusting entries through the journal proper. For example at the end of the year it is found that rent Rs.50 is outstanding. It is not recorded in the books. It will be taken into account by means of adjusting entry which is as follows:

Journal

Date	Particulars	L/F	Debit Amount (Rs.)	Credit Amount (Rs.)
	Rent A/c ----- Dr. To Outstanding Rent A/c (Being outstanding rent recorded)		50	50

Rectification Entries:

When an error is detected in the books, the same is rectified through an entry in the journal proper; thus is called rectification entry. For example, it was detected that an expenditure of Rs. 100 on repair to building was charged to building account. It is corrected through the following entry in the journal proper:

Journal

Date	Particulars	L/F	Debit Amount (Rs.)	Credit Amount (Rs.)
	Building Repair A/c ----- Dr. To Building A/c (Being transfer entry passed)		100	100

Entries of which there is no special journal

When a trader cannot record the entries in the above mentioned sub-journals, the same are entered in the journal proper. The common transactions which cannot be recorded in any of the book of original entry are:

- Distribution of goods as free sample.
- Distribution of goods as charity.
- Goods destroyed by fire.
- Goods stolen away by employees.
- Exchange of one asset for another asset etc.

Limitations

Following are the limitations of the subsidiary books

1. It violates the principle of double entry book keeping system because it does not record the two fold aspects of the transactions in the same book.
2. Large number of clerical staff is required to set up the system thus it is more expensive.
3. It is not suitable to small organization as it is more expensive.

6.12 LET US SUM UP

In this lesson we discussed the various subsidiary books. We have come to know that subsidiary books are the books of original entry that are maintained under the modern methods of book-keeping for recording the various transactions. There are various types of books are used under subsidiary books like Purchase book, Sales book, Purchase return book, Sales return book, Bills Payable book, Bills Receivable book, Journal Proper. These are maintained for the reasons that due to large number of transactions, it is not possible for a single person to record transactions in time. But if two or more persons are employed for the same purpose then it is possible only if the journals are divided. Writing journal in such organisations is time and labour consuming process and this is the logic behind writing subsidiary books.

6.13 KEY WORDS

Purchase book: In purchase book the transactions relating to credit purchase of goods are recorded.

Purchase return book: The book used for recording goods return to the seller is called "Purchase Return Book".

Sales book: This book is meant for recording credit sale of goods.

Sales return book: When goods sold on credit are returned by the customers, they are recorded in Sales Return Book or Returns Inward Book.

Bills Payable Book: This book is used to record all promissory notes given and Bills of Exchange accepted by customers for the amounts due from them.

Bills Receivable Book: This book is used to record all promissory notes given and Bills of Exchange accepted by the business for the amounts due to suppliers.

6.14 QUESTIONS

Short Answer Type

Q1. What do you mean by Subsidiary Books?

Q2. Explain Purchase Book and Purchase Return Book.

Q3. What do mean by Sales Book?

Q4. Write short notes on:

a) Sales Return Book

b) Bills Receivable Book

c) Bills Payable Book

Q5. Describe the advantages of subsidiary books.

Q6. Difference between debit note and credit note.

Long Answer Type

Q 1: Transactions of Beauty Ltd.

2003

June 1 Sold to P Ltd. 25 jars of cream @ Rs. 37 and 200 packets of powder @ Rs. 9.50 each less T.D. @ 10%.

- 2 Sold old books to B Ltd. on credit Rs. 750
- 4 Sold to S stores 35 packets of powder @ Rs. 9.50 for cash.
- 7 Sold to A departmental stores 310 packets of powder @ Rs. 9.50 and 40 jars of cream @ Rs. 36 each less T.D. @ 10%.

Prepare Sales day book.

Q2: Transaction of M/s Sporting Ltd.

2003

July 1 Purchased from Indian Sports Co. on credit 75 cricket bats at Rs. 100 each 90 footballs at Rs. 80 each less trade discount at 10%.

July 3 Purchased from Gripwell Co. 45 hockey sticks at Rs. 85 each for cash.

July 7 Purchased vacuum cleaner for office use from M/a Spic & Span on credit Rs. 3050

July 8 Purchased on credit from Wicket Pvt. Ltd. 40 Cricket bats at Rs. 105 each 70 footballs at Rs. 82 each less trade discount at 10%

July 9 Purchased from Green & Co. 15 Hockey sticks at Rs. 75 each on credit.

Prepare Purchase Day Book.

Q:3 Record the following transactions for the month of July,2006 in the purchases book of M/s Neha Electronics

July 5 Purchased from M/s Nelson Electronics Color T.V. @ Rs.7,000/- per pc.5 flat screen T.V@ Rs.15,000/- per pc. Trade Discount on all items @ 15%

July 20 Purchased from M/s Weston Electronics 5 Weston Stereos @ Rs.5,000 per pc. 4 Weston Color T.V. @ Rs.14,000 per pc. Trade Discount @ 20%

Prepare Purchase day book.

Q: 4 Enter the following transactions in the purchase book:-

2012

Jan .1 Purchased from M/s Suresh & Sons, Bombay:-

220 shirts @ Rs. 40 per shirt

52 Zee shirts @ Rs. 20 per shirt

Less trade discount 15%

Jan .12 Purchased from M/s Bachan & co.

8 chairs @ Rs. 85 per chair

Jan .25 Purchased from M/s Chawla Bros, Bombay

40 bush shirts @ Rs 72 per piece

Less trade discount 10%

Jan .30 Purchased from M/s Mohan & Co. for cash

35 shirts @ Rs 40 per shirt.

6.15 REFERENCES AND SUGGESTED READINGS

Bhattacharya, A. *Financial Accounting*, Prentice hall of India Pvt. Ltd, New Delhi.

Maheshwari, S.N., *Financial Accounting*, Vikash Publishing House Pvt. Ltd., New Delhi

Dam and Gautam, *Theory and Practice of Financial Accounting*, Capital Publishing Company, Guwahati.

Gupta and Radhaswamy, *Advance Accountancy*, Sultan Chand & Sons, New Delhi.

Jain and Narang, *Accounting Theory and Management Accounting*, Kalayani Publishers.

Activity 1

Difference between Subsidiary Books and Ledger.

Lesson 7

TRIAL BALANCE

Structure

- 7.0 Objectives
- 7.1 Introduction
- 7.2 Meaning and Definition of Trial Balance
- 7.3 Objectives of Preparation of Trial Balance
- 7.4 Methods of Preparation of Trial Balance
- 7.5 Limitations of Trial Balance
- 7.6 Errors
- 7.7 Let Us Sum Up
- 7.8 Key Words
- 7.9 Questions
- 7.10 References and Suggested Readings

7.0 OBJECTIVES

After studying this lesson you should be able to

- understand the various methods of preparation of a trial balance
- examine the various accounting errors that can be revealed or not revealed with the help of trial balance
- understand the steps for location of accounting errors.

7.1. INTRODUCTION

In previous lessons we have studied how the accounting transactions are recorded in the books of original entry i.e. Journal and special journal. We also studied the posting aspect of accounting cycle i.e. ledger. After we prepare journal, subsidiary books and ledger the next step is the preparation of trial balance.

Till now we have understood that the fundamental principle of double entry system of accounting is that for every debit, there must be a corresponding credit i.e. the sum total of debit amounts must equal the credit amounts of the ledger at any date. If the debit side does not match the credit side it would lead to the arithmetically inaccuracy of the books of accounts. In order to check whether the debit is equal to the credit side, the trial balance is prepared. At the end of the financial year or at any other time, the

balances of all the ledger accounts are extracted and are recorded in a statement known as Trial Balance and finally totalled up to see whether the total of debit balances is equal to the total of credit balances.

This lesson focuses on the preparation of trial balance. It also discusses the errors that are revealed and not revealed by the trial balance.

7.2 MEANING AND DEFINITION OF TRIAL BALANCE

A Trial Balance is a two-column schedule listing the titles and balances of all the accounts in the order in which they appear in the ledger. The debit balances are listed in the left-hand column and the credit balances in the right-hand column. In the case of the General Ledger, the totals of the two columns should agree.

A Trial Balance may thus be defined as a statement of debit and credit totals or balances extracted from the various accounts in the ledger books with a view to test the arithmetical accuracy of the books. The agreement of the Trial Balance reveals that both the aspects of each transaction have been recorded and that the books are arithmetically accurate. If both the sides of Trial Balance do not agree to each other, it shows that there are some errors, which must be detected and rectified if the correct final accounts are to be prepared. Thus, Trial Balance forms a connecting link between the ledger accounts and the final accounts.

7.3 OBJECTIVES OF PREPARING TRIAL BALANCE

As we have understood that the basic purpose of preparation of trial balance is to check the arithmetical accuracy of the books. The following are the main objectives of preparing the trial balance:

(i) To check the arithmetical accuracy of books of accounts: The basic principles of the double entry system of book-keeping states that every business transaction has two aspects, debit and credit. Debits must be equal to credits. It means that if debits are equal to the credits then the books of accounts are arithmetically accurate. Trial balance helps in tallying the debits and credits. However, tallying of the trial balance is not a conclusive proof of the accuracy of the accounts. It only ensures that all debits and the corresponding credits have been properly recorded in the ledger.

(ii) Helpful in preparing final accounts: Trial balance helps in the preparation of the trial balance as it records the balances of all the ledger accounts at one place. But, unless the trial balance agrees, i.e. the total of debits is equal to the total of credits, the final accounts cannot be prepared. If the trial balance does not agree, errors are located and necessary corrections are made at the earliest, so that there may not be unnecessary delay in the preparation of the final accounts.

(iii) Helps in locating errors: As discussed in above point if total of two columns of the trial balance agrees it is a proof of arithmetical accuracy in the ledger posting. However,

if the totals of the two columns do not tally it indicates that there is some mistake in the ledger accounts. This prompts the accountant to find out the errors.

(iv) Helps in Comparison: By comparing the trial balances of different years changes in figures of certain important items such as purchases, sales, debtors etc. are ascertained and their analysis is made for taking managerial decisions. So, it serves as an aid to the management.

(v) Helps in making adjustments: While making financial statements adjustments regarding closing stock, prepaid expenses, outstanding expenses etc are to be made. Trial balance helps in identifying the items requiring adjustments in preparing the financial statements.

7.4 METHODS OF PREPARATION OF TRIAL BALANCE

We must remember one thing that the Trial Balance is not an account. It is only a list or schedule of balances of ledger accounts including cash and bank balances. It is prepared on a particular date. The accounts having a debit balance are entered in the debit amount column and credit balance accounts are entered in the credit amount column. The totals of the two sides of the accounts may also be used to prepare trial balance. The sum of each column should be equal. A trial balance can be prepared by the following three methods:

1. Total method: In this method, the debit and credit totals of each account are shown in the two amount columns (one for the debit total and the other for the credit total).

Following is the format for trial balance under total method:

Trial Balance of M/s _____
as on _____

Name of the Ledger Account	L/F	Debit Total (Rs.)	Credit Total (Rs.)

2. Balance Method: In this method, the difference of each amount is extracted. If debit side of an account is bigger in amount than the credit side, the difference is put in the debit column of the Trial Balance and if the credit side is bigger, the difference is written in the credit column of the Trial Balance.

This is the most widely used method in practice. The account balances are used because the balance summarises the net effect of all transactions relating to an account and helps in preparing the financial statements. It may be noted that in trial balance, normally in place of balances in individual accounts of the debtors, a figure of sundry debtors is shown, and in place of individual accounts of creditors, a figure of sundry creditors is shown.

A specimen of the Trial Balance is given as follows:

Trial Balance of M/s _____
as on _____

Name of the Ledger Account	L/F	Debit (Rs.)	Balance	Credit (Rs.)	Balance

3. Total and Balance Method: Trial Balance is prepared by combining the first and second methods

Trial Balance of M/s _____
as on _____

Name of the Ledger Account	L/F	Debit Total (Rs.)	Credit Total (Rs.)	Debit Balance (Rs.)	Credit Balance (Rs.)

Check your Progress 1

Note: Use the space given below for your answers.

1) Define Trial Balance. What is the relevance of preparing trial balance?

2) What are the objectives of preparing trial balance?

3) State the different methods of preparing trial balance. Which one is widely used and Why?

Illustration 1: Refer to illustration 3 of lesson 5. Following are the ledgers as extracted from the illustration. Let us prepare trial balance with the methods as discussed above:

Dr.		Cash Account					Cr.
Date	Particulars	J/F	Amount (Rs.)	Date	Particulars	J/F	Amount (Rs.)
Mar 1	To Capital A/c		4,00,000	Mar 8	By Hardik & Co. A/c		29,000
Mar12	To Sales A/c		1,50,000	Mar10	By Suresh A/c		2,45,000
				Mar 27	By Salary A/c		10,000
				Mar 28	By Bank A/c		2,00,000
				Mar 29	By Rent A/c		10,000

				Mar 31	By Balance c/d (Balancing Figure)		56,000
			5,50,000				5,50,000
April 1	To Balance b/d		56,000				

Dr.	Raj Kumar's Capital Account						Cr.
Date	Particulars	J/F	Amount (Rs.)	Date	Particulars	J/F	Amount (Rs.)
Mar31	To Balance c/d (balancing figure)		4,00,000	Mar 1	By Cash A/c		4,00,000
			4,00,000				4,00,000
				April1	By Balance b/d		4,00,000

Dr.	Purchases Account						Cr.
Date	Particulars	J/F	Amount (Rs.)	Date	Particulars	J/F	Amount (Rs.)
Mar3	To Suresh A/c		2,50,000	Mar 31	By Balance c/d (balancing figure)		2,50,000
			2,50,000				2,50,000
April 1	To Balance b/d		2,50,000				

Dr.	Rent Account						Cr.
Date	Particulars	J/F	Amount (Rs.)	Date	Particulars	J/F	Amount (Rs.)
Mar29	To Cash A/c		10,000	Mar 31	By Balance c/d (balancing figure)		10,000
			10,000				10,000
April 1	To Balance b/d		10,000				

Dr.	Furniture Account						Cr.
Date	Particulars	J/F	Amount (Rs.)	Date	Particulars	J/F	Amount (Rs.)

Mar5	To Hardik & Co.A/c		30,000	Mar 31	By Balance c/d (balancing figure)		30,000
			30,000				30,000
April 1	To Balance b/d		30,000				

Dr.	Suresh Account						Cr.
Date	Particulars	J/F	Amount (Rs.)	Date	Particulars	J/F	Amount (Rs.)
Mar10	To Suresh A/c		2,45,000	Mar 31	By Purchases A/c		2,50,000
Mar10	To Dis. Received A/c		5,000				
			2,50,000				2,50,000

Dr.	Hardik & Co. Account						Cr.
Date	Particulars	J/F	Amount (Rs.)	Date	Particulars	J/F	Amount (Rs.)
Mar8	To Cash A/c		29,000	Mar 5	By Furniture A/c		30,000
Mar8	To Dis. Received A/c		1,000				
			30,000				30,000

Dr.	Discount Received Account						Cr.
Date	Particulars	J/F	Amount (Rs.)	Date	Particulars	J/F	Amount (Rs.)
Mar31	To Balance c/d (balancing figure)		6,000	Mar 8	By Hardik & Co. A/c		1,000
				Mar10	By Suresh A/c		5,000
			6,000				6,000
				April1	By Balance b/d		6,000

Dr.	Sales Account						Cr.
Date	Particulars	J/F	Amount (Rs.)	Date	Particulars	J/F	Amount (Rs.)
Mar31	To Balance c/d		3,50,000	Mar 12	By Cash A/c		1,50,000

	(balancing figure)			Mar 27	By Ramesh A/c		2,00,000
			3,50,000				3,50,000
				April 1	By Balance b/d		3,50,000

Dr.	Salary Account						Cr.
Date	Particulars	J/F	Amount (Rs.)	Date	Particulars	J/F	Amount (Rs.)
Mar 27	To Cash A/c		10,000	Mar 31	By Balance c/d (balancing figure)		10,000
			10,000				10,000
April 1	To Balance b/d		10,000				

Dr.	Ramesh Account						Cr.
Date	Particulars	J/F	Amount (Rs.)	Date	Particulars	J/F	Amount (Rs.)
Mar 27	To Sales A/c		2,00,000	Mar 31	By Balance c/d (balancing figure)		2,00,000
			2,00,000				2,00,000
April 1	To Balance b/d		2,00,000				

Dr.	Bank Account						Cr.
Date	Particulars	J/F	Amount (Rs.)	Date	Particulars	J/F	Amount (Rs.)
Mar 28	To Cash A/c		2,00,000	Mar 31	By Balance c/d (balancing figure)		2,00,000
			2,00,000				2,00,000
April 1	To Balance b/d		2,00,000				

Method 1. Total Method

**Trial Balance of M/s Raj Kumar
as on 31 March, 2014**

Name of the Ledger Account	L/F	Debit Total (Rs.)	Credit Total (Rs.)
Cash A/c		5,50,000	4,94,000
Capital A/c		-	4,00,000
Purchases A/c		2,50,000	-
Rent A/c		10,000	-
Furniture A/c		30,000	-
Suresh A/c		2,50,000	2,50,000
Hardik & Co. A/c		30,000	30,00
Discount Received A/c		-	6,000
Sales A/c		-	3,50,000
Salary A/c		10,000	-
Ramesh A/c		2,00,000	-
Bank A/c		2,00,000	-
		15,30,000	15,30,000

Method 2. Balance Method

**Trial Balance of M/s Raj Kumar
as on 31 March, 2014**

Name of the Ledger Account	L/F	Debit (Rs.)	Balance	Credit Balance (Rs.)
Cash A/c			56,000	-
Capital A/c			-	4,00,000
Purchases A/c			2,50,000	-
Rent A/c			10,000	-
Furniture A/c			30,000	-
Discount Received A/c			-	6,000
Sales A/c			-	3,50,000
Salary A/c			10,000	-

Ramesh A/c		2,00,000	-
Bank A/c		2,00,000	-
		7,56,000	7,56,000

Method 3. Total and Balance Method

Trial Balance of M/s Raj Kumar as on 31 March, 2014

Name of the Ledger Account	L/F	Debit Total (Rs.)	Credit Total (Rs.)	Debit Balance (Rs.)	Credit Balance (Rs.)
Cash A/c		5,50,000	4,94,000	56,000	-
Capital A/c		-	4,00,000	-	4,00,000
Purchases A/c		2,50,000	-	2,50,000	-
Rent A/c		10,000	-	10,000	-
Furniture A/c		30,000	-	30,000	-
Suresh A/c		2,50,000	2,50,000	-	-
Hardik & Co. A/c		30,000	30,00	-	-
Discount Received A/c		-	6,000	-	6,000
Sales A/c		-	3,50,000	-	3,50,000
Salary A/c		10,000	-	10,000	-
Ramesh A/c		2,00,000	-	2,00,000	-
Bank A/c		2,00,000	-	2,00,000	-
		15,30,000	15,30,000	7,56,000	7,56,000

Illustration 2: From the following prepare Trial Balance.

Cash in hand 14,000; Purchases returns 16,000; Salaries 16,000; Administrative expenses 24,000; Sales returns 14,000; Capital 44,000; Carriage outwards 4,000; Discount received 2400; Commission earned 1600; Land and Building 40,000; Stock 20,000; Accounts Receivables 16,000; Accounts Payables 24,000; Sales 88,000; Purchases 2,56,000; Bank overdraft 2,28,000; Manufacturing expenses 28,000; Loan 28,000; Carriage inward 2,000; Interest on investments 2,000

Solution:

Trial Balance as on 31 March, 2014

Name of the Ledger Account	L/F	Debit (Rs.)	Credit (Rs.)
----------------------------	-----	-------------	--------------

Cash in Hand A/c		14000	
Purchases Returns A/c			16000
Salaries A/c		16000	
Administrative Expense A/c		24000	
Sales Return A/c		14000	
Capital A/c			44000
Carriage Outwards A/c		4000	
Discount Received A/c			2400
Commission Earned A/c			1600
Land and Building A/c		40000	
Stock A/c		20000	
Accounts Receivables A/c		16000	
Accounts Payables A/c			24000
Sales A/c			88000
Purchases A/c		256000	
Bank Overdraft A/c			228000
Manufacturing A/c		28000	
Loan A/c			28000
Carriage Inward A/c		2000	
Interest on Investments A/c			2000
		434000	434000

7.5 LIMITATIONS OF TRIAL BALANCE

The following are the main limitations of the Trial Balance:

- (i) Trial Balance can be prepared only in those concerns where double entry system of accounting is adopted.
- (ii) Though trial balance gives arithmetic accuracy of the books of accounts but there are certain errors, which are not disclosed by the trial balance. That is why it is said that trial balance is not a conclusive proof of the accuracy of the books of accounts.
- (iii) If trial balance is not prepared correctly then the final accounts prepared will not reflect the true and fair view of the state of affairs of the business. Whatever conclusions and decisions are made by the various groups of persons will not be correct and will mislead such persons.

7.6 ERRORS

It is important for an accountant that the trial balance should tally. Normally when a trial balance tallies it means that both the debit and the credit entries have been made correctly for each transaction and it becomes a prima facie evidence of the arithmetical accuracy of the entries made in the Ledger. But even if the trial balance agrees, it does not necessarily mean that the accounting records are free from all errors, because there are certain types of errors, which are not revealed by a Trial Balance. Therefore a Trial

Balance should not be regarded as a conclusive proof of accuracy of accounts. There can be errors, which affect the equality of debits and credits, and there can be errors, which do not affect the equality of debits and credits. Some common errors are as follows:

- Error in totalling of the debit and credit sides in the trial balance.
- Error in totalling of subsidiary books.
- Error in posting of the total of subsidiary books.
- Error in account balances in wrong side or with wrong amount.
- Omission in showing an account balance in the trial balance.
- Error in the calculation of a ledger account balance.
- Error while posting a journal entry either on wrong side or with wrong amount in the ledger.
- Error in recording a transaction in subsidiary book with wrong name or wrong amount.

These errors may affect the arithmetical accuracy of the trial balance or may defeat the very purpose of accounting. There are two types of errors:

- (a) errors which are not revealed by the trial balance, and
- (b) errors which are revealed by the trial balance.

Errors may happen at any of the following stages of the accounting cycle.

A. At Recording Stage

1. Errors of principle
2. Errors of omission
3. Errors of commission

B. At Posting Stage

1. Error of omission

- i. Complete
- ii. Partial

2. Error of commission

- i. Posting to wrong account
- ii. Posting on the wrong side
- iii. Posting of wrong amount

C. At Balancing Stage

1. Wrong totaling
2. Wrong balancing

D. Preparation of Trial Balance

1. Error of Omission

2. Error of Commission

- i. Taking wrong amount
- ii. Taking wrong account
- iii. Taking to the wrong side

From the point of view of rectification, errors are classified into two categories:

- Errors which affect the trial balance; and
- Errors which do not affect the trial balance.

Errors which Affect the Agreement of Trial Balance

These errors are due to the mistake having being committed on the one side of the account. They may happen at any of the stages of the accounting process, like recording, posting, balancing, etc. such errors can be rectified by giving an explanatory note or by passing a journal entry with the help of a special account called suspense account. This is discussed in the lesson of ratification of errors. Examples of this group of errors are: errors of partial omission; error of casting (totalling); error of carrying forward; error of balancing; error of posting to the correct account but with wrong amount; error of posting to the correct account but on the wrong side; posting to the wrong side with the wrong amount and omitting to show an account in the trial balance.

Errors which do not affect the trial balance

Errors which do not affect the trial balance are committed in two or more accounts. They can be rectified by passing a journal entry giving the correct debit and credit to the concerned accounts. These correcting entries can be recorded in the journal proper. Examples of these errors are: omission to pass an entry in the books of original entry; wrong amount of transaction recorded in the journal, complete omission of the posting of accounts in the ledger.

On the basis of their nature, errors can be classified into the following categories

1. Clerical errors
2. Errors of Principle

A brief description of the above errors is given below:

(a) Clerical errors

Clerical errors are those errors, which are committed by the clerical staff during the process of recording business transactions in the books of accounts. These errors are:

1. Errors of omission
2. Errors of commission
3. Compensating errors
4. Errors of duplication

Errors of omission: When business transaction is either completely or partly omitted to be recorded in the books of prime entry it is called an 'error of omission'.

These can be of two types:

- (i) Error of complete omission
- (ii) Error of partial omission

When a transaction is completely omitted from recording in the books of original record, it is an error of complete omission. For example, purchase of office stationary not entered in books of accounts. It will not affect the trial balance.

When the recording of transaction is partly omitted from the books, it is an error of partial omission. For example purchase of office stationery recorded in the recorded in cash book but not recorded in the stationery account. It would be an error of partial omission. It will affect the agreement of trial balance.

Error of commission: These errors may be due to wrong posting of a business transaction either to a wrong account or on the wrong side of an account, or due to wrong casting (addition) i.e. over-casting or under-casting or due to wrong balancing of the accounts in the ledger.

For example: Office stationary was purchased for Rs.10,000. This transaction was correctly recorded in the cashbook. But while posting to the ledger, stationary account was debited with Rs, 1000 only. This constitutes an error of commission.

Most of the errors of commission affect in the trial balance. Such errors are generally committed by the clerical staff due to their negligence during the course of recording business transactions in the books of accounts. Though, the rules of debit and credit are followed properly yet some mistakes are committed.

Compensating errors: Compensating errors are those errors, which cancel or compensate themselves. When two or more errors are committed in such a way that the net effect of these errors on the debits and credits of accounts is nil, such errors are called compensating errors. Such errors do not affect the tallying of the trial balance.

For example, if stationary account has been overcast by Rs. 10,000 resulting in excess debit of Rs. 10,000 in purchases account and sales returns book is undercast by Rs. 10,000 resulting in short debit to sales returns account is a case of two errors compensation each other.

These errors arise when an error is either compensated or counter-balanced by another error or errors so that of the other on the debit or credit side neutralizes the adverse effect of one on credit side or debit side.

Errors of duplication: When a business transaction is recorded two times in the prime books and posted in the Ledger in the respective accounts twice, the error is known as the 'Error of Duplication'. These errors do not affect the trial balance.

(b) Errors of principle

When a business transaction is recorded in the books of original entries by violating the basic/fundamental principles of accountancy it is called an error of principle. Some examples of these errors are:

- (i) When revenue expenditure is treated as capital expenditure or vice-versa, e.g. Furniture purchased is debited to the purchase account instead of the furniture account.
- (ii) Revenue expenses debited to the personal account instead of the expenses account, e.g. salary paid to Siyaram debited to Siyaram's account rather than salary account.

These errors do not affect the Trial Balance.

The disagreement of the Trial Balance will disclose the following errors:

- (i) An item omitted to be posted from a subsidiary book into the Ledger i.e. a purchase of Rs. 12,000 from Hiralal omitted to be credited to his account. As a result of this error, the figure of sundry creditors to be shown in the Trial Balance will reduce by Rs. 12,000 and the total of the credit side of the Trial Balance will be Rs. 12,000 less as compared to the debit side of the Trial Balance.
- (ii) Posting of wrong amount to a ledger account i.e. credit sale of Rs. 20,000 to Narayan wrongly posted to his account as Rs. 2,000. The effect of this error will be that the figure of sundry debtors will reduce by Rs. 18,000 and the total of the debit side of the Trial Balance will be Rs. 18,000 less than the total of the credit side of the Trial Balance.
- (iii) Posting an amount to the wrong side of the ledger account i.e. Rs. 1,500 salary paid to the employee wrongly posted to the credit instead of the debit of the salary account. As a result of this error, the credit side of the Trial Balance will exceed by Rs. 3,000 (double the amount of the error).
- (iv) Wrong additions or balancing of ledger account, i.e. while balancing Capital Account at the end of the financial year, credit balance of Rs. 18,000 wrongly taken as Rs. 10,000. As a result of this error, the credit total of the Trial Balance will be short by Rs. 8,000.
- (v) Wrong totalling of subsidiary books, i.e. Sales Book is overcast by Rs. 10,000. As a result of this error, Credit side of the Trial Balance will be excess by Rs. 10,000 because Sales Account will appear at a higher figure on the credit side of the Trial Balance.
- (vi) An item in the subsidiary book posted twice to a ledger account, i.e. a rent paid posted twice in rent account.
- (vii) Omission of a balance of an account in the Trial Balance, i.e. cash and bank balances may have been omitted to be included in the Trial Balance.
- (viii) Balance of some account wrongly entered in the Trial Balance i.e. a balance of Rs. 479 in expense Account wrongly entered as Rs. 749 in the Trial Balance.
- (ix) Balance of some account written to the wrong side of the Trial Balance, i.e., balance of discount allowed wrongly shown to the credit side instead of the debit side of the Trial Balance.

(x) An error in the totalling of the Trial Balance will bring the disagreement of the Trial Balance.

Check your Progress 2

Note: Use the space given below for your answers. You may use extra sheets for solving questions.

1) Are there any limitations of preparation of trial balance? Discuss

2) Explain the clerical errors?

3) What errors are not revealed by the trial balance?

STEPS FOR LOCATION OF ERRORS

If the trial balance does not tally, it is a clear indication that at least one error has occurred. The error (or errors) needs to be located and corrected before preparing the financial statements. If the trial balance does not tally, the accountant should take the following steps to detect and locate the errors :

1. Recheck the total of the Trial Balance and ascertain the exact amount difference in the Trial Balance.
2. Divide the difference of the Trial Balance by two and find out if there is any balance of the same amount in the Trial Balance. It may be that such a balance might have been

recorded on the wrong side of the Trial Balance, thus causing a difference of double the amount.

3. If the mistake is not located by the above steps, the difference in the Trial Balance should be divided by 9. If the difference is evenly divisible by 9, the error may be due to transposition or transplacement of figures. A transposition occurs when 57 is written as 75, 197 as 791 and so on. A transplacement takes place when the digits of the numbers are moved to the left or right e.g. when Rs. 5,694 is written as Rs. 56.94 or s. 569.40. If there is a transposition or transplacement of figures, the search can be narrowed down to numbers where these errors might have been made.

4. See that the balances of all accounts including cash and bank balances have been included in the Trial Balance.

5. See that the opening balances have been correctly brought forward in the current year's books.

6. If the difference is of a large amount, compare the Trial Balance of the current year with that of the previous year and see that the figures under similar head of account are approximately the same as those of the previous year and whether their balances fall on the same side of the Trial Balance. If the difference between the previous year figures and the current year figures is large one, establish the causes of difference.

7. If the above listed steps fail to detect the errors, check your work as follows:

(i) Check the totals of the subsidiary books paying particular attention to carry forwards.

(ii) Check the posting made from the Journal or subsidiary books in the ledger.

(iii) Re-check the balances extracted from ledger.

(iv) Re-cast the list of balances.

If all the efforts fail to locate the errors, all the books of primary entry (subsidiary books) must be cast, and, if necessary, the postings to the ledger should be re-checked.

7.7 LET US SUM UP

After the transactions are recorded and summarised in the ledger accounts it is very important to prepare trial balance to check whether the transactions are recorded accurately. Trial Balance is indispensable to accounting. It serves as a lubricant for the smooth movement and completion of the accounting cycle. Moreover, it forms a useful connecting link between ledger accounts and final accounts. The agreement of a Trial Balance is not a conclusive proof as to the absolute accuracy of the books. It only gives an indication of the arithmetical accuracy. Even if both the sides of trial Balance agree to each other yet there may be some errors in the books of accounts. Once it is detected that the trial balance does not tally then the accountants take some steps for the identification of the errors. These errors once identified can be ratified by passing on the ratified entries.

7.8 KEYWORDS

Trial Balance: A Trial Balance is a statement of debit and credit balances extracted from all the ledgers with a view to ascertain arithmetical accuracy of posting of all transactions into the respective ledgers.

Clerical Errors: Those errors which are committed by the clerical staff during the course of recording business transactions in the books of accounts is known as clerical errors.

Compensating Errors: Compensating errors are those errors which compensate themselves.

Errors of Principle: When a transaction is recorded in the books of accounts by violating the basic principle of accounting, it is called an error of principle.

Rectification of errors : Errors affecting only one account can be rectified by giving an explanatory note or by passing a journal entry. Errors which affect two or more accounts are rectified by passing a journal entry.

Meaning and utility of suspense account : An account in which the difference in the trial balance is put till such time that errors are located and rectified. It facilitates the preparation of financial statements even when the trial balance does not tally

7.9 QUESTIONS

SHORT ANSWER QUESTIONS

1. Why the trial balance is prepared?
2. What are the main limitations of Trial Balance?
3. In case of disagreement of the Trial Balance in what order you would follow to locate the errors?

LONG ANSWER QUESTIONS

1. What do you mean by a Trial Balance? Discuss the objectives and methods of preparing a Trial Balance.
2. Is the agreement of Trial Balance a conclusive proof of the accuracy of books of accounts? If not, what are the errors, which remain undetected by the Trial Balance?
3. From the following Trial Balance prepare a Trial Balance:

Purchases 60,000; Cash account 20,000; Sales 1,00,000; Purchase returns 1,000; Sales returns 2,000; Opening stock 30,000; Closing stock 40,000; Expenses 20,000; Outstanding expenses 2,000; Bank balance 5,000; Assets 50,000; Debtors 80,000; Creditors 30,000; Capital 94,000; Suspense account 10,000

4. The following balances appear in various accounts on 31.03.2014. You are asked to prepare a Trial Balance:

Capital 20,000; Apprentice premium 300; Machinery 8,000 Insurance premium 200; Building 9,000 Interest on investment 600; Rates and taxes 500; Investments 6,000; Debtors 6,000; Bank charges 100; Stationery 900; Printing 300; Bills payable 1,950 Creditors 3,000; Loan from Raju and Co. 8,000; Office expenses 650; Opening stock 500; Wages 1,200; Bank 1,500; Sales 9,000; Cash 500; Purchases 3,500; Drawings 2,000; Furniture 2,000

7.10 REFERENCES AND SUGGESTED READINGS

T.S. Grewal, *Double Entry Book Keeping*, Sultan Chand and Sons. New Delhi.

Jain and Narang, *Financial Accounting*, Kalyani Publishers, New Delhi.

S.N. Maheshwari, *Advanced Accountancy*, Vikas Publication House Pvt. Ltd.

R.L. Gupta, *Advanced Accountancy*, Sultan Chand & Sons.

M.C. Sukla and T.S. Grewal, *Advanced Accountancy*, 18th Edition, S. Chand, 2008.

Tulsian, P.C. (2002) *Financial Accounting*, Pearson Education India, New Delhi.

Activity 1

What are the Methods of Preparation of Trial Balance.

Activity 2

What is the meaning and Definition of Trial Balance.

LESSON 8

ERRORS AND RECTIFICATION

8.0 Objectives

8.1 Introduction

8.2 Errors

8.3 Rectification of Errors which do not Affect the Trial Balance

8.4 Rectification of Errors Affecting Trial Balance

8.5 Rectification of Errors in the Next Accounting Year

8.6 Guiding Principles of Rectification of Errors

8.7 Examples

8.8 Let Us Sum Up

8.9 Key Words

8.10 Questions

8.11 References and Suggested Readings

8.0 OBJECTIVES

After studying this lesson, you should be able to understand

- meaning of the accounting errors
- the category of the errors on the basis of rectification
- rectification of the errors that do not affect trial balance
- rectification of the errors that affect the trial balance

8.1 Introduction

An accountant tries his best to follow the basic principles of accounting which states that for every debit there will be an equal credit. It implies that if the sum of all debits equals the sum of all credits, it is presumed that the posting to the ledger in terms of debit and credit amounts is accurate. But being a human accountant can also commit errors while recording business transaction in the books of accounts while posting or while balancing. In the last lesson we have seen that the trial balance is a tool for verifying the correctness of debit and credit amounts. It is an arithmetical check under the double entry system which verifies that both aspects of every transaction have been recorded accurately.

The errors committed by accountants should be located and corrected as soon as possible so that accounts give true and fair results of the operations of the business enterprise. In the previous lesson we have also understood the errors that arise in the trial balance. This lesson explains the meaning and types of errors from the rectification point of view. It also discusses how these errors can be rectified.

8.2 Errors

As stated in the previous lesson, accounting errors are the errors committed by persons responsible for recording and maintaining accounts of a business firm in the course of accounting process. These errors may be in the form of omitting the transactions to record, recording in wrong books, or wrong account or wrong totalling and so on. Accounting errors are those mistakes which occur in the book keeping or accounting, relating to a routine activity or relating to the principle of accounting. The Accounting errors happen in entering the transactions in journal or subsidiary books or at the time of posting of entries in to the ledger. The accounting errors may happen because of the omission, commission, principle or as a compensating of errors.

Few examples of accounting errors are as follows:

- Omission of recording a business transaction in the Journal or Special purpose Books
- Not posting the recorded transactions in various books of accounts to the respective accounts in ledger
- Mistakes in totalling or in carrying forward the totals to the next page
- Mistake in recording amount wrongly, writing it in a wrong account or on the wrong side of the account.

From the point of view of rectification, the errors may be classified into the following two categories:

- (a) errors which do not affect the trial balance.
- (b) errors which affect the trial balance.

The errors which do not affect the trial balance usually take place in two accounts in such a manner that it can be easily rectified through a journal entry whereas the errors which affect the trial balance usually affect one account and a journal entry is not possible for rectification unless a suspense account has been opened. Such errors are rectified by passing a nullifying entry in the respective account

Objectives behind rectification of errors

* There are some errors that affect nominal accounts which result in either increase or decrease in the business. These errors need to be rectified in order to ascertain true profits of the business.

* Certain errors affect personal accounts, real accounts and profits of the business will result in either increase or decrease in assets or liabilities of the business. Thus, there rectification is necessary.

*These errors need to be rectified well in time and with accuracy. If this is not done there are fair chances of problems and confusions in running the business.

8.3 RECTIFICATION OF ERRORS WHICH DO NOT AFFECT THE TRIAL BALANCE

These errors are committed in two or more accounts. Such errors are also known as two sided errors. They can be rectified by recording a journal entry giving the correct debit and credit to the concerned accounts.

Examples of such errors are – complete omission to record an entry in the books of original entry; wrong recording of transactions in the book of accounts; complete omission of posting to the wrong account on the correct side, and errors of principle.

The rectification process essentially involves:

- Cancelling the effect of wrong debit or credit by reversing it; and
- Restoring the effect of correct debit or credit.

For this purpose, we need to analyse the error in terms of its effect on the accounts involved which may be:

- (i) Short debit or credit in an account ; and/or
- (ii) Excess debit or credit in an account.

Therefore, rectification entry can be done by :

- (i) debiting the account with short debit or with excess credit,
- (ii) crediting the account with excess debit or with short credit.

Illustration 1: Credit sales to Raheem Rs. 50,000 were not recorded in the sales book. This is an error of complete omission. Its affect is that Raheem’s account has not been debited and Sales account has not been credited. Accordingly, recording usual entry for credit sales will rectify the error. The rectification entry will be:

Raheem A/c -----Dr	50,000
To Sales A/c	50,000

Let us take few more examples:

Illustration 2

1. Carriage paid for machinery but wrongly debited to Carriage Inward A/c

In this case the wrong entry made is:

Carriage Inward A/c ----- Dr.

To Cash/Bank A/c

The correct entry should be:

Machinery A/c ----- Dr.

To Cash/Bank A/c

Now the rectification entry needs to be passed is:

Machinery A/c ----- Dr.

To Carriage Inward A/c

(For rectification: Carriage Inward A/c wrongly debited, it is now credited. Machinery A/c should have been debited but not debited, now it is debited).

2. Rent paid to Ram Narain debited to Ram Narain A/c

In this case the wrong entry actually made is:

Ram Narain A/c----- Dr.

To Cash/Bank A/c

The correct entry should be:

Rent A/c ----- Dr.

To Cash/Bank A/c

Now the rectification entry needs to be passed is:

Rent A/c ----- Dr.

To Ram Narain A/c

(For rectification: Ram Narain A/c wrongly debited, it is now credited. Rent A/c should have been debited but not debited, now it is debited).

3. Goods withdrawn for personal use recorded as goods distributed as sample.

In this case the wrong entry made is:

Advertisement A/c----- Dr.

To Purchases A/c

The correct entry should be:

Drawings A/c----- Dr.

To Purchases A/c

Now the rectification entry needs to be passed is:

Drawings A/c-----Dr.

To Advertisement A/c

(For rectification: Advertisement A/c wrongly debited, it is now credited. Drawings A/c should have been debited but not debited, now it is debited).

4. Sold goods to Shivani Associates for Rs.500, but recorded in the books as goods purchased from Shivani Associates for Rs.500

In this case the wrong entry made is:

Purchases A/c----- Dr.

To Shivani Associates A/c

The correct entry should be:

Shivani Associates A/c ----- Dr.

To Sales A/c

Now the rectification entry needs to be passed is:

Shivani Associates A/c-----Dr. 1800

To Purchases A/c 900

To Sales Ac 900

(For rectification: Purchases A/c wrongly debited, it is now credited. Sales A/c should have been credited and now it is credited. Shivani Associates A/c was wrongly credited which was supposed to be debited, now it is debited with double amount).

8.4 RECTIFICATION OF ERRORS AFFECTING TRIAL BALANCE

The errors which affect only one account can be rectified by giving an explanatory note in the account affected or by recording a journal entry with the help of the Suspense Account. Examples of such errors are error of casting; error of carrying forward; error of balancing; error of posting to correct account but with wrong amount; error of posting to the correct account but on the wrong side; posting to the wrong side with the wrong amount; omitting to show an account in the trial balance.

An error in the books of original entry, if discovered before it is posted to the ledger, may be corrected by crossing out the wrong amount by a single line and writing the correct amount above the crossed amount and initialling it. An error in an amount posted to the correct ledger account may also be corrected in a similar way, or by making an additional posting for the difference in amount and giving an explanatory note in the particulars column. But errors should never be corrected by erasing or overwriting reduces the authenticity of accounting records and give an impression that something is being concealed.

Let us take few examples to understand the rectifications of such errors:

Illustration 3

1. Sales day book overcast for the month of March by Rs.1000

2. The purchase day book undercast for the month of March by Rs.2000
3. The sales day book on a folio was carried forward to the next page as Rs. 240 instead of Rs.420.
4. Depreciation charged to Machiney, but not posted to the Depreciation on Machinery A/c Rs.9000
5. Cash received from Mira Nair A/c Rs.5000 posted to the debit of Mira A/c
6. Interest received on the bank balance Rs.500 has been duly shown in the cash book but not posted in the Interest Received A/c.

Solution:

1. This entry will be rectified by sales A/c by writing the following line:

“To overcasting of Sales Day Book for the month of March Rs. 1000

2. Undercast of the Purchases A/c will be rectified by passing the following line:

“To Undercast of Purchases Day Book for the month of March Rs.2000.

3. Sales are shown short by Rs. 180 (420-240) and needs to be rectified. Sales A/c will be credited by writing the following line:

“By mistake in posting the wrong amount in the Sales Day Book Rs.180.”

4. Here, the amount has not been posted to the Depreciation on Machinery A/c. Hence, it needs rectification by debiting Depreciation A/c

“To omission of posting depreciation Rs.9000.”

5. Here, Mira Nair A/c is debited by Rs.5000 but it should have been credited with Rs.5000. Thus, it will be rectified by double of the amount i.e. Rs.10,000 by passing following line of rectification

“By wrong posting adjusted Rs.10,000.

6. Here, the Interest received on the bank balance has not been credited to Interest Received A/c by Rs.500. So, it will be rectified by passing the following line:

“By omission of posting Rs.500.”

Suspense Account: We all know that after the preparation of a trial balance, the final accounts are prepared. Generally, when the accountant prepares trial balance and the trial balance is not agreeing then he makes rechecking of accounts because when a trial balance disagrees, it may delay the preparation of the final accounts. In order to avoid the delays in the preparation of the final accounts, the difference in the trial balance is replaced by a new account known as suspense account.

If the credit side of the trial balance exceeds the debit side, the difference is put on the debit side of the trial balance and suspense account will show a debit balance. If the

debit side of the trial balance exceeds the credit side, the difference is put on the credit side of the trial balance and suspense account will show a credit balance. For preparing final accounts, debit balance of suspense account is written in asset side and credit balance of suspense is written in liability side of the balance sheet. Thereafter, when all the errors are rectified, the suspense account automatically closes.

Following are the reasons why suspense account will be opened:

1. A bookkeeper is unsure where to post an item and enters it to a suspense account pending instructions.
2. There is a difference in a trial balance and a suspense account is opened with the amount of the difference so that the trial balance agrees (pending the discovery and correction of the errors causing the difference). This is the only time an entry is made in the records without a corresponding entry elsewhere.

Let us consider following example to understand the usage of suspense account:

Illustration 4

Rectify the following accounting errors through Suspense Account:

1. Goods purchased from Rohit for Rs 10000 was entered in the Sales Book, however Rohit's Account was correctly credited.
2. Cash received from Rekha a debtor Rs 13200 was correctly entered in the Cash Book but was omitted to be posted to her account.
3. Sales Book was overcast by Rs 5000.
4. Cash of Rs. 5000 paid to Suresh was credited to Rakesh A/c as Rs 500.
5. The total of Purchase Returns Book of Rs3150 was carried forward as Rs1530.
6. Naresh was paid cash Rs 9500 but Sunil was debited by Rs 9000

Solution

Date	Particulars	L/F	Debit Amount (Rs.)	Credit Amount (Rs.)
	Purchase A/c ----- Dr. Sales A/c ----- Dr. To Suspense A/c (Being Purchase of good was entered in the sale book now corrected)		10000 10000	20000
	Suspense A/c ----- Dr. To Rekha A/c		13200	13200

(Being Rekha's account omitted to be credited now rectified)			
Sales A/c ----- Dr. To Suspense A/c (Being overcasting of sales Book now rectified)	5000		5000
Suresh A/c ----- Dr. Rakesh A/c----- Dr. To Suspense A/c (Being cash paid to Suresh was wrongly credited to Rakesh with wrong amount, now rectified)	5000 500		5500
Suspense A/c----- Dr. To Purchase Return A/c (Being Purchase Return Book is undercaste, now rectified)	1620		1620
Naresh A/c----- Dr. To Sunil A/c To Suspense A/c (Being Cash paid to Naresh was debited to Sunil with wrong amount, now rectified)	9500		9000 500

Check your progress 1

Use the space given below to answer your questions

1) What do you understand by rectification of errors? What are the objectives behind it?

2) Why do we open suspense account?

3) Discuss one sided errors and its rectification without using suspense account.

8.5 RECTIFICATION OF ERRORS IN THE NEXT ACCOUNTING YEAR

If some errors committed during an accounting year are not located and rectified before the finalisation of financial statements, suspense account cannot be closed and its balance will be carried forward to the next accounting period. When the errors committed in one accounting year are located and rectified in the next accounting year, profit and loss adjustment account is debited or credited in place of accounts of expenses/losses and incomes/ gains in order to avoid impact on the income statement of next accounting period.

8.6 GUIDING PRINCIPLES OF RECTIFICATION OF ERRORS

1. If error is committed in books of original entry then assume all postings are done accordingly.
2. If error is at the posting stage then assume that recording in the subsidiary books has been correctly done.
3. If error is in posting to a wrong account (without mentioning side and amount of posting) then assume that posting has been done on the right side and with the right amount.
4. If posting is done to a correct account but with wrong amount (without mentioning side of posting) then assume that posting has been done on the correct side.
5. If error is posting to a wrong account on the wrong side (without mentioning amount of posting) then assume that posting has been done with the amount as per the original recording of the transaction.
6. If error is of posting to a wrong account with wrong amount (without mentioning the side of posting) then assume that posting has been done on the right side.

7. If posting is done to a correct account on the wrong side (without mentioning amount of posting) then assume that posting has been done with correct amount as per original recording.

8. Any error in posting of individual transactions in subsidiaries books relates to individual account only, the sales account, purchase account, sales return account or purchases return account are not involved. 9. If a transaction is recorded in cash book, then the error in posting relates to the other affected account, not to cash account/bank account

10. If a transaction is recorded through journal proper, then the phrase 'transaction was not posted' indicates error in both the accounts involved, unless stated otherwise.

11. Error in casting of subsidiary books will affect only that account where total of the particular book is posted leaving the individual personal accounts unaffected.

8.7 PRACTICAL PROBLEMS

Illustration 5 Rectify the following error and find out the effect of the errors on Net Profit.

- a. Purchases of Rs.300 from Raman passed through Sales Book.
- b. Bill received from Ramu for Rs.500 passed through Bills Payable Book.
- c. An item of Rs.150 relating to Prepaid Rent was omitted to be brought forward from last year.
- d. Rs.400 paid to Mehta B, against our acceptance was debited to Mehta N.
- e. Received Rs 300 from Ajit(whose account for Rs.300 was written off earlier) and posted to the credit of Amrit
- f. Transistor sold to Karun for Rs.750 passed through Sales Book twice.

Solution:

Date	Particulars	l/f	Debit Amount Rs.	Credit Amount Rs.
a.	Purchases A/c ----- Dr Sales A/c ----- Dr To Raman A/c (Being the amount passed through sales book cancelled and debited to purchases book)		300 300	600
b.	Bills Receivable A/c ----- Dr. Bills Payable A/c ----- Dr. To Ramu's A/c		500 500	1000

Illustration 7

Ractify the following errors by making Journal Entry:

- (i) Sales for Rs.4,000 made to Mala was not entered in the Sales Book.
- (ii) Salary of Rs.10,000 paid to Accountant Sham was debited to his personal account
- (iii) Old machinery sold for Rs.5,000 was entered in the Sales Book.
- (iv) Freight paid Rs.1,000 on purchase of a Machine was debited to Freight A/c
- (v) Cash Rs.50000 paid to the creditor Nitin Modi was debited to Nitish Modi's A/c
- (vi) Amount of Rs 30,000 received from Rahul was credited to Mehul.

Solution:

Date	Particulars	Amount (Rs.)	Amount (Rs.)
(i)	Mala A/c ----- Dr. To Sales A/c (Being sales to Mala omitted to be entered in Sales Book is corrected)	4,000	4,000
(ii)	Salary A/c ----- Dr. To Sham A/c (Salary paid to Sham was debited to his personal account is now corrected)	10,000	10,000
(iii)	Sales A/c -----Dr. To Machinery A/c (Being Old machinery sold was entered in the sales Book is now corrected)	5,000	5,000
(iv)	Machine A/c ----- Dr. To Freight A/c (Being amount paid for freight on purchase of machine is debited to carriage A/c is now corrected)	1,000	1,000
(v)	Nitin Modi A/c-----Dr. To Nitish Modi A/c (Being amount paid to Nitin Modi was debited to Nitish Modi is now corrected.)	30,000	30,000
(vi)	Mehul A/c ----- Dr. To Rahul A/c	30,000	30,000

	(Being amount received from Rahul wrongly credited to Mehul's A/c is now rectified)		
--	---	--	--

8.8 LET US SUM UP

Rectification of error is very necessary after their detection. Many times errors are rectified by erasing or cutting. Errors should not be rectified in this way since it raises questions about integrity of accountant and also authenticity of the accounting books. Errors should be rectified by passing a rectification entry in the journal or ledger. Entries which are passed for rectification of errors are called rectifying errors. These errors can be classified as one-sided errors and two-sided errors.

Suspense account is an imaginary account which is opened for agreeing the trial balance. Later as and when the errors are located, these are rectified with the help of suspense account. Thus when all the errors are rectified, the suspense account will automatically stand closed. But, if the suspense account still shows a balance, it will indicate the errors that are still to be discovered. But one thing is to be kept in mind that only one sided errors are rectified with the help of suspense account.

8.9 KEY WORDS

Errors of Commission: Errors caused due to wrong recording of a transaction, wrong totalling, wrong casting, wrong balancing, etc.

Errors of Omission: Errors caused due to omission of recording a transaction entirely or partly in the books of account.

Errors of Principle: Errors arising due to wrong classification of receipts and payments between revenue and capital receipts and revenue and capital expenditure.

Compensating Errors: Two or more errors committed in such a way that they nullify the effect of each other on the debits and credits.

Rectification of errors: Errors affecting only one account can be rectified by giving an explanatory note or by passing a journal entry. Errors which affect two or more accounts are rectified by passing a journal entry.

Suspense account: An account in which the difference in the trial balance is put till such time that errors are located and rectified. It facilitates the preparation of financial statements even when the trial balance does not tally. When all the errors are located and rectified the suspense account stands disposed off.

8.10 QUESTIONS

Short Answer Questions

Q 1. What are the steps to identify the errors in the trial balance?

Q 2. What is a suspense account? Is it necessary that suspense account will balance off after rectification of the errors detected by the accountant? If not, then what happens to the balance still remaining in suspense account?

Long Answers Questions

Q 1. What are the errors of principle and what are the measures to rectify them?

Q 2. Explain the errors of commission and give two examples with measures to rectify them.

Q 3. What are the different types of errors that are usually committed in recording business transaction?

Q 4. Rectify the following errors :

- (i) Credit sales to Shekhar Rs. 6,500 were not recorded.
- (ii) Credit purchases from Sunita Rs. 8,000 were not recorded.
- (iii) Goods returned to Sohan Rs. 3,000 were not recorded.
- (iv) Goods returned from Meeta Rs. 2,000 were not recorded.

Q 5. Rectify the following errors :

- (i) Credit sales to Deepak Rs. 5,000 were recorded as Rs.6,200.
- (ii) Credit purchases from Cucu Rs. 8,000 were recorded as Rs. 8,900.
- (iii) Goods returned to Rakhi Rs. 3,000 were recorded as Rs 3,040.
- (iv) Goods returned from Aman Rs. 2,000 were recorded as Rs.1,800.

Q:6. Rectify the following errors :

- (a) Salary paid Rs. 8,000 was debited to employee's personal account.
- (b) Rent Paid Rs. 3,800 was posted to landlord's personal account.
- (c) Goods withdrawn by proprietor for personal use Rs. 2,000 were debited to sundry expenses account.
- (d) Cash received from Narayan Rs. 7,000 was posted to Narinder's account.
- (e) Cash paid to Shamu's Rs. 3,500 was posted to Ramu's account.

Q: 7 Rectify the following errors :

- (a) Credit Sales to Mala Rs. 9,000 were recorded in purchases book.
- (b) Credit Purchases from Roma Rs. 1,000 were recorded in sales book.
- (c) Goods returned to Reeta Rs. 4,900 were recorded in the sales return book.
- (d) Goods returned from Shilpa Rs. 8,000 were recorded in purchases return book.
- (e) Goods returned from Neeta Rs. 5,000 were recorded in purchases book.

- (f) Sales book overcast by Rs. 900.
- (g) Purchases book overcast by Rs. 1,500.
- (h) Sales return book overcast by Rs. 2,400.
- (i) Purchase return book overcast by Rs. 1,200.

Q:8 Rectify the following errors:

- (a) Sales book undercast by Rs.700.
- (b) Purchases book undercast by Rs.1,400.
- (c) Return Inwards book undercast by Rs.2,200.
- (d) Return outwards book undercast by Rs.1,000.

Q: 9 Rectify the following errors and ascertain the amount of difference in trial balance by preparing suspense account :

- (a) Credit sales to Gagan Rs. 8,500 were not posted.
- (b) Credit purchases from Magan Rs. 5,000 were not posted.
- (c) Goods returned to Ragan Rs. 4,500 were not posted.
- (d) Goods returned from Lagan Rs. 2,000 were not posted.
- (e) Cash paid to Shagun Rs. 8,000 was not posted.
- (f) Cash sales Rs. 2,500 were not posted.

Q:10 Rectify the following errors and ascertain the amount of difference in trial balance by preparing suspense account :

- (a) Credit sales to Geeta Rs. 8,000 were posted as Rs. 7,000.
- (b) Credit purchases from Reeta Rs. 8,000 were posted as Rs. 5,000.
- (c) Goods returned to Meeta Rs. 3,000 were posted as Rs. 8,000.
- (d) Goods returned from Neeta Rs. 2,000 were posted as Rs. 6,000.
- (e) Cash sales Rs. 3,000 were posted as Rs. 300.
- (f) Credit sales to Deepak Rs. 8,000 were posted to Deepa.
- (g) Credit purchases from Suresh Rs. 7,000 were posted to Mahesh.
- (h) Goods returned to Sarang Rs. 4,500 were posted to Narang.
- (i) Goods returned from Geeta Rs. 1,600 were posted to Meeta.
- (j) Cash sales Rs. 2,080 were posted to commission account.

Q:11 Rectify the following errors assuming that a suspense account was opened. Ascertain the difference in trial balance.

- (a) Credit sales to Sarang Rs. 8,000 were posted to the credit of his account.
- (b) Credit purchases from Martha Rs. 7,000 were posted to the debit of his account as Rs. 4,000.
- (c) Goods returned to Roshan Rs. 4,500 were posted to the credit of his account.
- (d) Goods returned from Sohan Rs. 8,000 were posted to the debit of his account as Rs. 7,000.
- (e) Cash sales Rs. 3,000 were posted to the debit of sales account as Rs. 5,000.

Q:12. Give journal entries to rectify the following errors assuming that suspense account had been opened.

- (a) Goods distributed as free sample Rs. 5,000 were not recorded in the books.
- (b) Goods withdrawn for personal use by the proprietor Rs. 2,000 were not recorded in the books.
- (c) Bill receivable received from a debtor Rs. 6,000 was not posted to his account.
- (d) Total of Returns inwards book Rs. 1,200 was posted to Returns outwards account.
- (e) Discount allowed to Reema Rs. 700 on receiving cash from her was recorded in the books as Rs. 70.

(Ans : Difference in trial balance Rs. 3,600 excess debit).

Q:13. Trial balance of Johnny did not agree. He put the difference to suspense account and discovered the following errors :

- (a) In the sales book for the month of January total of page 2 was carried forward to page 3 as Rs. 10,000 instead of Rs. 12,000 and total of page 6 was carried forward to page 7 as Rs. 56,000 instead of Rs. 50,000.
- (b) Wages paid for installation of machinery Rs. 5,000 was posted to wages account as Rs. 500.
- (c) Machinery purchased from Dharmesh for Rs. 1,00,000 on credit was entered in Purchase Book as Rs. 60,000 and posted there from to R & Co. as Rs. 10,000.
- (d) Credit sales to Rajesh Rs. 50,000 were recorded in Purchases Book.
- (e) Goods returned to Mukesh Rs. 10,000 were recorded in Sales Book.
- (f) Credit purchases from Sudesh for Rs. 60,000 were recorded in sales book. However, Sudesh was correctly credited.

(g) Credit purchases from Rudra Rs. 60,000 were recorded in Sales Book as Rs. 20,000 and posted there from to the credit of Rudra as Rs. 10,000.

(h) Credit sales to Hema Rs. 40,000 posted to the credit of Fema as Rs. 10,000.

(i) Bill receivable for Rs. 16,000 from Bikram was dishonoured and posted to debit of Allowances account.

(j) Cash paid to Sunny Rs. 50,000 against our acceptance was debited to Sonu.

(k) Old furniture sold for Rs. 30,000 was posted to Sales account as Rs. 10,000.

(l) Depreciation provided on furniture Rs. 8,000 was not posted.

(m) Material Rs. 1,00,000 and wages Rs. 30,000 were used for construction of building. No adjustment was made in the books.

Rectify the errors and prepare suspense to ascertain the difference in trial balance.

(Ans : Difference in trial balance Rs. 1,38,500 excess credit).

8.11 REFERENCES AND SUGGESTED READINGS

T.S. Grewal, *Double Entry Book Keeping*, Sultan Chand and Sons. New Delhi.

Jain and Narang, *Financial Accounting*, Kalyani Publishers, New Delhi.

S.N. Maheshwari, *Advanced Accountancy*, Vikas Publication House Pvt. Ltd.

R.L. Gupta, *Advanced Accountancy*, Sultan Chand & Sons.

M.C. Sukla and T.S. Grewal, *Advanced Accountancy*, 18th Edition, S. Chand, 2008.

Tulsian, P.C. (2002) *Financial Accounting*, Pearson Education India, New Delhi.

Activity 1

What are the errors of principle?

Activity 2

What are the guiding Principles of Rectification of Errors?

LESSON 9

BANK RECONCILIATION STATEMENT

Structure

- 9.0 Objectives
- 9.1 Introduction
- 9.2 Concept and Meaning of Bank Reconciliation Statement
- 9.3 Causes of Difference between Cash Book and Pass Book
- 9.4 Rules for preparation of Bank Reconciliation Statement
- 9.5 Need and Importance of Bank Reconciliation Statement
- 9.6 Some Illustrations
- 9.7 Let Us Sum Up
- 9.8 Key Words
- 9.9 Questions
- 9.10 References and Suggestions

9.0 OBJECTIVES

After studying this lesson you should be able to

- explain the meaning and need of Bank Reconciliation Statement
- understand the importance of reconciling cash book & pass book
- discuss the causes for difference between the balances of Pass Book and Cash Book
- prepare Bank Reconciliation Statement

9.1. INTRODUCTION

Every businessman keeps a check on the cash & bank balance available to him for meeting his expenses and liabilities and to know the receipts and payments of a particular period. He ensures that payments are of reasonable amount and expenses are not unreasonably high. Due to many causes, pass book issued by bank and cash book prepared by businessman never match with each other. To uncover any possible discrepancies, the two statements must be compared. This lesson is devoted to the preparations of these comparative statements.

9.2 CONCEPT AND MEANING OF BANK RECONCILIATION STATEMENT

On having a look to a cash book containing bank columns, it is found that bank column represent the "Bank Account" which is a personal account. The bank column of cash book is debited whenever we deposit cheques, cash, etc., into our bank account. On the other hand the bank will give a credit for the same amount in our account with them. Similarly, we credit the bank column of our cash book whenever we issue cheques,

withdraw cash, etc. from our bank, for which the bank will debit our account with them. In other words, all entries which appear on the debit side of the bank column of our cash book shall appear on the debit side of our account in the books of the bank. Therefore, in the bank column of our cash book, if the total debits (deposits) exceed total credits (withdrawals) there will be debit balance. Accordingly, as per the bank's records there will be a credit balance. In reality, our record in the bank columns in cash book and the record in our account with the bank become counterparts of each other.

A bank issues to every account-holder a copy of his account with them. This is known as the Bank Statement of Account or the Bank Pass Book. This enables the account-holder to check entries in bank column of his cash book with entries recorded in the pass book, as and when he desires to find out the exact position. The specimen ruling of a pass book is given below

Pass Book

Name.....

Account No.....

Address.....

Date	Particulars	Dr. Withdrawals	Cr. Deposits	Balance		Accountants initials
				Dr. or Cr.	Amount	

Illustration-1: - Show the following transactions to be recorded in Bank of India's pass book of Suresh.

Suresh deposited Rs. 10,000 with bank to open his current account.

Withdraw Rs. 80,00 for office use.

A cheque of Rs. 1,000 issued in favour of Shamsu and the same has been presented for payment.

A cheque of Rs. 2,000 received from Mohan was paid into the bank the same day and was duly credited by the bank.

Insurance premium of Rs 200 was paid by the bank on behalf of Suresh.

Solution:

Pass Book

Name.....Mr.Suresh

Account No.

Address....Rohan Colony, Chandigarh

Current Account with Bank of India, Chandigarh

Date	Particulars	Dr.	Cr.	Balance	Accountants
------	-------------	-----	-----	---------	-------------

						initials
				Dr. or Cr.	Amount	
	By cash		10,000	Cr.	10,000	
	To self	8,000		Cr.	2,000	
	To cheque no (Shamsu)	1,000		Cr.	1,000	
	By cheque no (Mohan)		2,000	Cr.	3,000	
	To insurance premium	200		Cr.	2,800	

In the above example when Suresh deposits cash, he becomes creditor of the bank because bank owes this amount of Suresh. But when he withdraws money, he becomes a debtor of the bank for that transaction because he is receiving the money from the bank. Also he becomes a creditor for depositing a cheque in the bank and a debtor for drawing a cheque on the bank.

Transactions given in the above example will be recorded in the Bank Column of the Triple Column Cash book (maintained by Suresh) as below:

Date	Particulars	L.F.	Cash (Rs.)	Bank (Rs.)	Discount (Rs.)	Date	Particulars	L.F.	Cash (Rs.)	Bank (Rs.)	Discount (Rs.)
	To Cash	C		10,000			By Bank	C	10,000		
	To Bank	C	8,000				By Cash	C		8,000	
	To Mohan (Cheque)			2,000			By Shamsu (Cheque)			1,000	
							By Insurance Premium			200	
							By Balance c/d			2,800	
				12,000						12,000	
	To Balance b/d			2,800							

From the Pass Book and Cash Book given above, we find the same balance, the only difference is that in Cash Book there is a debit balance whereas the same amount appears as a credit balance in the Pass Book. From the view point of the bank, Suresh is a creditor in its books because he is to receive the amount from the bank. It means that

the balance as per Pass Book. If all entries are correctly recorded in the two books, the balance should always be equal in the two books but usually it is not the case due to omission of some entries or due to incorrect recording of a few entries in any of the two books.

It is proper, therefore, for the account holder to check from time to time the entries in the Pass Book with the entries in the Bank Column of the Cash Book or the Bank Account in the ledger and point out to his bankers, the errors or omissions if any so found so that these may be rectified.

Periodically, a statement is prepared to check that there is no error in the Pass Book or Cash Book; the statement is called Bank Reconciliation Statement. It is prepared with a view to reconciling the two balances shown by Cash Book and Pass Book and locating the mistakes which have been responsible for the disagreement of the two balances on a given date. It must be kept in mind that it is statement and not an account.

However, there are some differences between the pass book and the statement of account which may be stated as under: -

Points	Pass Book	Bank Statement of Account
1. Form	It is a small bound book.	It is a loose leaf typed or handwritten statement in the form of Pass Book
2. Manner of recording	A pass book is made up to date by recording therein each transaction after its occurrence.	All transactions are recorded in the Bank Statement after a definite period.
3. Purpose	It keeps the customers informed of the position of his bank account after each transaction.	It keeps the customer informed about the position of his bank account after a period.
4. Utility	It enables the customer to resolve any discrepancy between the cash book & pass book immediately.	It enables the customer to resolve any discrepancy between the cash book & pass book only after a definite period.

9.3 CAUSES OF DIFFERENCE BETWEEN CASH BOOK AND PASS BOOK

The main reasons for difference between the balances shown by the Cash Book and the Pass Book are as given below:-

1. **Cheques issued but not yet presented for payment:** When a cheque is issued by a businessman in favour of his creditor, an entry is made on the payment side of the bank column of the Cash Book. The bank shall pass entry in its books only when it is presented to the bank for payment. If the cheque has not been presented for payment upto the date of the preparation of the Bank Reconciliation Statement, the balance as per Cash Book will be smaller than the balance shown by the pass book by the amount of that cheque.

2. **Cheques paid into bank but not yet collected or credited by the Bank:** When a businessman receives cheques from his customers, he submits them into the bank for collection and debits the bank column in his Cash Book on the same day, thus increasing his balance with the bank. But the bank will not give credit in the Pass Book on the same date when cheques are deposited into the bank by the businessman. Bank gives credit only when it receives the amount of these cheques from the banks upon which these are drawn. It takes time to collect them. Due to this time gap, there will be no entry in the Pass Book and the balance as per Cash Book will be more as compared with the Pass Book balance because it had been increased when the cheque was paid into bank.
3. **Direct payments into the Bank:** Sometimes, the debtors of the businessman directly deposit the amount due from them in his bank account. Due to this, the bank balance of the businessman shall increase by the amount of direct payments by the debtors because these payments as received by the Bank will be entered on the credit side of the account of the firm. On the other hand there will be no entry in the Cash Book up to the date of reconciliation. As a result, the Pass Book balance will be higher as compared to Cash Book Balance.
4. **Interest Credited by the bank on Current Account:** Some banks give interest on current account to their customers if they keep a certain minimum credit balance in their current account. When the interest is credited by the bank in Pass Book, the pass book balance is increased, while there will be no entry for this in the Cash Book due to lack of information. Hence, the balance as per Pass Book shall be more as compared to the balance as per Cash Book.
5. **Interest and Bank Charges by the Bank:** The banks usually debit the account of the businessman with commission, bank charges and interest on overdraft. Bank charges may be charged for the collection of outstation cheques and for the various services provided by the bank to the businessman. The balance as per Pass Book will be reduced by the amount of such transactions whereas balance as per Cash Book will not be reduced because no entry has been passed in cash Book due to lack of information.
6. **Interest or dividends on investments and rents collected by the Bank:** A businessman may authorize his bank to collect interest or dividends on investments or rents on property on his behalf. When the bank receives such amounts, bank credits the customer account with that amount, whereas, there may not be any entry in the Cash Book for such items due to lack of information. Therefore, Pass Book will show higher balance on this account.
7. **Payments made by the bank on behalf of Customers:** The businessman may give standing instructions to his banker to make payment for insurance premium, subscription to periodicals, licence fee, rent etc., on his behalf on the due dates. Whenever the bank makes such payments, the bank will debit the account of the businessman and reduce his bank balance as per pass book, whereas there will be no reduction in the balance as per cash book due to the omission of this entry in the Cash Book.

8. **Bills collected by the Bank on behalf of the customer:** Banks may be authorized to collect the amount due to certain bills of exchange from the acceptors. If the acceptor honours a bill on its due date the bank will credit the account of the trader. As a result the balance as per pass Book will be higher as compared to the Cash Book balance until the necessary entries are passed in cash book.
9. **Cheques or Bills of Exchange dishonoured:** A firm may receive a number of cheques and bills of exchange from its customers. Some of the cheques deposited by the firm into the bank for collection may be dishonoured. When a trader deposits a cheque in a bank, he debits bank column in his Cash Book, which increases his balance. But the bank gives credit only when a cheque is collected. If any cheque dishonoured, there will be no entry in Pass Book. Thus, there will arise a difference between the balances as shown by Cash Book and as shown by Pass Book.
Also a firm may receive acceptances from its Customers and may get them discounted with the bank. The firm will give debit to Bank Account for the amount of these bills less discount charged by the bank, therefore balance in Cash Book is increased. These bills may be dishonoured and its charges, if any. The firm will not record it unless it receives information for dishonour of bill up to the date of preparation of reconciliation statement. The Pass Book balance shall be less as compared to the Cash Book balance because the entry for dishonour of the bill has not yet been recorded in the Cash Book.
10. **Cheques received but omitted to be banked:** Whenever businessman receives a cheque from any customer, it might have been entered on the debit side of Cash Book but the same might not have been sent to the bank for collection up to the date of reconciliation. This omission will not increase the Pass Book balance. Thus, Cash Book will show more balance than Pass Book.
11. **Wrong debit or credit given by the Bank:** If an entry is recorded on the wrong side of the Pass Book by the bank, it shall cause a difference of twice the amount of item which is written on the wrong side of the Pass Book. For example, a sum of Rs. 4, 000 is collected by the bank as dividend on shares. Instead of crediting the account of the firm, the bank debits it by Rs. 4, 000. As a result of this Pass Book balance will be shorter by Rs. 8,000 as compared to Cash Book balance.
12. **Errors in Cash Book:** The Cash Book of a firm may have certain errors. The examples of such errors are:-
 - (a) Over casting or undercasting of debit side of bank column of Cash Book. The balance as per
Cash Book will increase in case of overcasting and decrease in case of undercasting the debit side of bank column Cash Book.
 - (b) Over casting or undercasting of credit side of bank column of Cash Book. The balance as per Cash Book will decrease in case of overcasting and increase in case of undercasting of the credit side of cash book.

- (c) There might be an entry on the wrong side or with wrong amount in the Cash Book for interest allowed or charged by the bank or dividend or interest on investments collected by the bank. Therefore the balance as shown by Cash Book and Pass Book will differ.

Until both the books are reconciled, the Cash Book and Pass Book balances rarely tally at any given date. Accordingly, a statement is drawn up to adjust the differences arising from any of these causes. Such a statement is termed as 'Bank Reconciliation Statement'.

A Bank Reconciliation Statement is therefore, a statement, prepared periodically with a view to showing the reasons for disagreement between the balances as shown by the Pass Book and Cash Book (Bank Column) or Bank Account in the ledger on a particular date. Practically when a Bank Reconciliation Statement is to be prepared we should select a date on which we wish to prepare it. We should make a comparison of bank column of Cash Book with Bank Pass Book and tick mark the common items of Cash Book and Pass Book for a given period up to the selected date and sort out the unticked items. Thereafter, by taking balance as per bank column of Cash Book or as per Bank Pass Book as the starting point, reconciliation of the two sets of record can be made.

These differences are summarised in the form of table given below:

Sr. no.	Causes	Cash Book	Pass Book
1.	Cheques issued but not yet presented for payment	Entry is made Balance = Decreased	No entry is made till the cheques are presented for payment. Balance = Same as before
2.	Cheques paid into the bank but not yet cleared.	Entry is made Balance = Increased	No entry is made till the cheques are cleared Balance = same
3.	Interest allowed by the Bank	No entry is made till the Pass Book is checked Balance = Same	Entry is made Balance = Increased
4.	Interest and Expenses Charged by the Bank	No entry is made till the Pass Book is checked Balance = Same	Entry is made Balance = Decreased
5.	Interest and dividends collected by Bank	No entry is made till the Pass Book is checked Balance = Same	Entry is made Balance = Increased

6.	Direct payments by the bank	No entry is made till the Pass Book is checked Balance = Same	Entry is made Balance = decreased
7.	Direct payments into the bank by a customer	No entry is made till the Pass Book is checked Balance = Same	Entry is made Balance = Increased
8.	Dishonor of a bill discounted with the bank	No entry is made till the pass Book is checked Balance = Same	Entry is made Balance = decreased
9.	Bills collected by the bank on behalf of the customer	No entry is made till the Pass Book is checked Balance = Same	Entry is made Balance = Increased

Check your Progress I

Note: Use the space given below for your answers

1) Explain bank reconciliation statement.

2) What is the need for preparing a bank reconciliation statement?

3) Name any three items which cause disagreement of Cash book & pass book balances.

9.4 RULES FOR PREPARATION OF BANK RECONCILIATION STATEMENT

1. If reconciliation statement is to be prepared from the Bank Balance (or Debit Balance) as per Cash Book:

- (a) Add to the Cash Book balance such items which have increased the pass book balance or have decreased Cash Book balance e.g., cheques issued but not yet presented for payment, direct payments by the debtors into the bank or dividend, interest on investments collected by the bank etc.
- (b) Deduct from the balance so selected such items which have increased the Pass Book balance or increased the Cash Book balance e.g., cheques deposited but not yet credited by the bank, payments made by bank on behalf of the firm, bank charges and commission charged by the bank etc.
- In case we start with a Bank overdraft (or Credit Balance) as per Cash Book, the above procedure should be reversed.

2. If the starting point is Bank Balance (or Credit Balance) as per Pass Book:

- (a) Add the items given in 1(b) above and
- (b) Deduct the items given in 1 (a) above.

In case of Bank overdraft (or Debit Balance) as per Pass Book the above procedure should be reversed.

Specimens of Bank Reconciliation Statements

- (a) In case the starting point is Debit Balance as per Cash Book or Cash at bank or positive balance as per Cash Book.

Bank Reconciliation Statement ofas on

	Rs.	Rs
Bank balance or Debit Balance as per Cash Book		x
Add:		
(a) Cheques drawn or issued but not yet presented for payment at the bank	X	
(b) Direct payments into the bank by the debtors of the firm	X	
(c) Dividend or interest on investments collected by the bank	X	
(d) Over casting of credit side or undercasting of debit side of the Cash Book	X	
(e) Wrong credit given by the bank	X	
(f) Interest credited by the bank but not entered in the cash book	X	
(g) Cheques sent to the bank for collection, credited by the bank, but omitted to be entered in the Cash Book	X	
		X
		X
Less:		

(a) Bank charges, commission and interest charged by the bank, but not yet entered in the Cash Book	X	
(b) Payments made by the bank on behalf of the firm not yet entered in the Cash Book	X	
(c) Wrong debit given by the bank		
(d) Cheques deposited but not yet collected and created by the bank	X	
(e) Undercasting of credit side or overcasting of debit side of the cash book	X	
(f) Cheques issued but omitted to be entered in the Cash Book	X	
(g) Dishonour of bills discounted with the bank not entered in the cash book	X	
		X
Balance as per Pass Book		X

It may be noted that if the total of items under 'less' heading exceeds the total of all add items plus the balance as per cash book, the difference will be bank overdraft as per Pass Book or debit balance as per Pass Book.

In case the reconciliation statement is started with the Bank Balance as per Pass Book (or Credit balance as per Pass Book) all the above items under *Add* heading shall be entered under *Less* and the items under *Less* will be entered under *Add* heading. It means the treatment is exactly the opposite. The difference will be Debit Bank balance as per Cash Book or Overdraft as per Cash Book depending upon the total of *Add* and *Less* items.

(b) If the starting point is Bank overdraft or credit balance as per cash book.

Bank Reconciliation Statement of.....

As on...

(a) Bank charges, commission and interest charged by the bank, but not yet entered in the Cash Book	X	
(b) Payments made by the bank on behalf of the firm not yet entered in the Cash Book	X	
(c) Wrong debit given by the bank	X	
(d) Cheques deposited but not yet collected and created by the bank	X	
(d) Undercasting of credit side or overcasting of debit side of the cash book	X	
(e) Cheques issued but omitted to be entered in the Cash Book	X	
(f) Bills discounted with the Bank, dishonoured but not yet entered in the Cash Book	X	

Less

(a) Cheques drawn or issued but not yet presented for payment at the bank	X	
(b) Direct payments into the bank by the debtors of the firm	X	
(c) Dividend or interest on investments collected by the bank	X	
(d) Over casting of credit side or undercasting of debit side of the Cash Book	X	
(e) Wrong credit given by the bank	X	
(f) Interest credited by the bank but not entered in the cash book	X	
(g) Cheques sent to the bank for collection, credited by the bank, but omitted to be entered in the Cash Book	X	

It may be noted that if the total of items under less exceeds the total of all add items plus the overdraft as per Cash Book, the resulting figure will be favourable balance as per pass book or credit balance as per Pass Book.

In case the statement is started with Bank overdraft as per Pass Book, all items under Add heading above shall be entered under less and the items under less will be entered under add heading. It means the treatment is exactly the reverse. The resulting figure shall be Bank overdraft or favourable Bank Balance as per Cash book, depending upon the total of Add and less items.

Following are the differences between bank statement and bank reconciliation statement:

Distinctions between bank statement and bank reconciliation statement

Points	Bank Statement	Bank Reconciliation Statement
1.Content	It shows the transaction of a customer with the bank for a definite period as recorded in the bank Pass Book.	It shows the causes of discrepancies between the cash book and pass book.
2.Maker	It is prepared by a bank.	It is prepared by a customer of a bank.
3.Object	Its object is to inform the customer of a bank about his transactions with the bank at the end of a period.	Its object is to reconcile the discrepancies between the cash book balance and the pass book balance on a given date.

4. Basis of preparation	It is prepared by the bank on the basis of the transactions recorded in the ledger account maintained in the name of the customer.	It is prepared on the basis of the transactions recorded in the cash book and the pass book.
5. Period	It is a statement for a period	It is a statement as on a particular date.
6. Starting Point	It starts with the bank balance of the customer as in the bank's ledger	It can be started with either the cash book balance or the pass book balance.

9.5 NEED AND IMPORTANCE OF BANK RECONCILIATION STATEMENT

The need and importance of the bank reconciliation statement may be given as follows:

1. It helps in bringing out the errors committed either in cash Book or bank statement.
2. The reconciliation statement may also show any undue delay in the clearance of cheques.
3. It helps in keeping check on the misappropriations that can be made by the cashier. Sometimes the cashier may have the tendency of cheating like he may made entries in the Cash Book only but never deposit the cash into bank. So this way bank reconciliation statement acts as a control technique too.
4. It explains the reasons for differences between the bank balance as per cash book and the bank balance as per pass book. So, it helps in making necessary adjustments or corrections at the earlier stage.

9.6 SOME ILLUSTRATIONS

Illustration-2

From the following particulars, ascertain the balance as would appear in the Pass Book of Naresh Machine Works on 31st January, 2011.

- (a) Balance as per Cash Book on 31st January, 2011 was Rs. 5,000.
- (b) Cheques issued but not cashed prior to 31st January, 2011 amounting to Rs. 1,000
- (c) Cheques paid into Bank but not collected before 31st January, 2011 amounted to Rs. 1,800.
- (d) There was a debit of Rs. 30 for bank charges in the Pass Book.

Solution:

Bank Reconciliation statement as on 31st January, 2011

	Rs	Rs
Balance as per Cash Book		5,000
Add :		
Cheques issued but not yet presented for payment	1,000	1,000
		6,000
Less:		
(a) Bank charges recorded in Pass Book but not in Cash Book	30	
(b) Cheques paid into Bank but not yet cleared and credited	1,800	
		1,830
Balance as per Pass Book		4,170

Illustration-3

On 31st December, 2012, Sonu's books showed a bank balance of Rs. 5000. On reconciling the Cash Book with the Pass Book, it was found that three cheques of Rs. 840, Rs. 960 and Rs. 720 issued on 29th December were not presented to the bank till January 4, 2013, and that two cheques of Rs. 1040 and Rs. 700 paid into the bank on the 30th December were credited by the bank on January 3, 2013. Bank had credited him with Rs. 30 as interest on 29th December and had charged Rs. 20 as commission. Prepare a Bank Reconciliation Statement as on 31st December, 2012.

Solution:

Bank Reconciliation Statement as on 31st December, 2012

	Rs.	Rs
Bank Balance as per Cash Book		5,000
Add :		
(a) Cheques issued but not yet presented for payment till 31 st December, 2012 Rs (840+960+720)	2,520	
(b) Interest credit by the Bank, but not entered in Cash Book	30	2,550
		7,550
Less:		
(a) Cheques paid into the bank but not credited up to 31 st December, 2012 Rs.(1,040+700)	1,740	
(b) Commission charged by the bank but not entered in the Cash Book	20	1,760
Balance as per Pass Book		5,790

Illustration-4

The Pass Book of Sohan showed a balance of Rs. 70,000. On 31st December, 2011, two cheques of Rs 5,750 and Rs. 6,250 were deposited into the Bank, but the bank had given credit for the same in January. Two cheques issued for payment before 31st December, 2011 amounting to Rs. 15,000 had not been cashed. There was also a debit in the pass book of Rs. 1,200 in respect of a cheque dishonoured on 31st December. Draw up Reconciliation statement as at 31st December, 2011 showing adjustments between the Pass Book and Cash Book.

Solution:

Bank Reconciliation Statement as at 31st December, 2011

Balance as per Pass book		70,000
Add:		
(a) Cheques paid into the bank but not credited up to 31 st December, 2011	12,000	
Rs.(5,750+6,250)		
(b) Cheques deposited but dishonoured, not yet entered in Cash Book	1,200	
		13,200
		83,200
Less:		
Cheques issued but not presented for payment till 31 st December, 2011	15,000	15,000
Balance per Cash Book		68,200

Illustration 5:

Prepare a Bank Reconciliation Statement as on 31st December 2012 from the following particulars:

- Bank Balance as per cash book on 31st December, 2012 was Rs. 40,000
- Cheques of Rs. 9,000 issued in December have not been presented for payment till the close of the year.
- A cheque of Rs. 3,000 was directly deposited by a customer into the Bank Account and there was no corresponding entry in the Cash Book.
- Cheques deposited into bank on 30th December 2012 have not been collected by the bank Rs. 5,000

Solution :

Bank Reconciliation Statement as on 31st December, 2012

Particulars	Rs.	Rs.
Bank balance as per Cash Book		40000
Add: Cheques issued for payment but not presented to Bank	9,000	
A cheque directly deposited into bank but not	3,000	12,000

recorded in the cash book		52,000
Less: Cheques deposited into bank but not yet collected by the bank Bank Balance as per Pass Book	5,000	5,000
		47,000

Illustration 6:

Prepare a Bank Reconciliation Statement of Ritu on 31st December from the following particulars:

- Bank balance as per Pass Book as on 31st December was Rs. 5,500.
- A cheque of Rs. 800 issued on 28th December was encashed after 31st December.
- Cheques paid into bank before 31st December and credited after 31st December were Rs. 2,700.
- A cheque of Rs. 600 deposited to and credited by the bank before 31st December was omitted to be recorded in the cash book.
- A customer directly deposited Rs. 1,500 in our bank account but the same was omitted to be recorded in the cash book.
- A bank interest of Rs. 300 credited by the bank and a bank commission of Rs. 80 debited by the bank were not recorded in the cash book.
- Bank paid our bill for Rs.1,000 but it was not recorded in the cash book.

Solution : Bank Reconciliation Statement as on 31st December

Particulars	Rs.	Rs.
Bank balance as per Pass Book (Deposit)		5,500
Add: Cheques deposited but not credited by the bank	2700	
Bank commission debited by the bank but not recorded in the cash book	80	
Direct payment of a bill by the bank not yet recorded in the cash book	1000	3780
		9280
Less: Cheques issued but not presented	800	
Cheque deposited and credited by the bank but not recorded in the cash book	600	
Direct deposit by a customer into the bank only	1500	
Bank interest credited by the bank but not recorded in the cash book	300	3200
Bank Balance as per Cash Book (Deposit)		6080

Illustration 7: -

Prepare a Bank Reconciliation Statement of Rohit on 31st December with the following particulars:

- Cash Book showed a debit balance of Rs. 9000 as on 31st December.
- Cheques amounting to Rs. 3,500 were issued to creditors but were not presented to the bank for encashment before 31st December.
- Cheques of Rs. 2,700 were deposited into bank but were not collected by the bank before 31st December.
- Interest on deposit credited by the bank but not recorded in the cash book was Rs. 150
- Bank charges debited by the bank but not recorded in the cash book before 31st

December was Rs.30

6. A customer directly deposited in our bank A/c Rs. 600 on 28th December but informed us of the matter on 2nd January next.

Solution-

Bank Reconciliation Statement as on 31st December

Particulars	Rs.	Rs.
Bank Balance as per Cash Book (Deposit)		9,000
Add: Cheques issued but not presented	3,500	
Interest on deposit credited by the bank	150	
Direct deposit by a customer	600	4,250
		13,250
Less: Cheques deposited but not credited by the bank	2,700	
Bank charges debited by the bank	30	2,730
Bank Balance as per Pass Book (Deposit)		10,520

Adjustment of cash book

In order to reconcile cash book and pass book balances at the accounting date, pass book should be called for immediately and entries for interest allowed by the bank, interest charged on overdraft, commission and bank charges, dividend and interest collected by the bank, insurance premium paid by bank etc. should be ascertained and must be recorded in the cash book (bank column only). He must also rectify the errors, if any, committed in the cash book. Otherwise, due to lack of information, posting of these items will not be made and as a result, Profit and Loss Account will not show the true profit. If cash book is already balanced, a revised or adjusted or amended cash book (bank column only) should be prepared to record the items shown in the pass book but omitted to be recorded in the cash book. After these adjustments, the reconciliation is restricted to the (i) Pass Book errors, if any, (ii) cheques issued but not yet presented, and (iii) cheques paid into the bank but not yet cleared or credited.

Illustration 8: - Keshav's cash book showed a bank overdraft of Rs. 8,000 on 31st March, 2011. On comparison of the Cash Book entries with the Pass Book, the following differences were noted down:

1. Cheques issued and entered in Cash Book for Rs. 9,000 had not yet been presented at the Bank.
 2. The Pass Book showed an item of interest on overdraft Rs. 300 not entered in the Cash Book.
 3. An out-station cheque of Rs. 5500 lodged on 29th March, 2011 did not appear in the Pass Book.
 4. There was an item of insurance premium of Rs. 500 paid by Bank on behalf of Keshav in the Pass Book.
 5. Interest on investments Rs. 1,500 collected by the bank appeared in the Pass Book.
 6. In March, Keshav discounted with the bank a bill for Rs. 6,000 and had entered this amount in his cash book but the amount credited, as in pass book, amounted to Rs. 5,850.
- (a) What would be the balance of Cash Book after making necessary additional entries?

(b) Prepare a Bank Reconciliation Statement as on 31st March, 2011.

Solution: - Adjusted **Cash Book (Bank Column)**

Date	Particulars	Amount	Date	Particulars	Amount
2011		Rs.	2011		Rs.
March 31	To Interest on Investments	1,500	March 31	By Balance b/d	8,000
March 31	To Balance c/d	7,450	March 31	By Interest on Overdraft	300
			March 31	By Insurance Premium	500
			March 31	By Discount (on Bills Receivable not previously entered in the Cash Book)	150
		8,950			8,950
			2011		
			April 1	By Balance b/d	7,450

Bank Reconciliation Statement as on 31st March, 2011

Particulars	Amount
Overdraft as per Cash Book	7,450
Add: -	
Cheques paid in but not yet cleared	5500
	12,950
Less: -	
Cheques issued but not yet presented for payment	9,000
Balance (cr.) as per Pass Book	3,950

Balance as per Pass Book is in favour the firm (Rs. 3,950) because the total of items reducing overdraft Rs. 9,000 is more than the total of items increasing overdraft Rs. 12,950

9.7 LET US SUM UP

The reconciliation process helps in identifying the discrepancies that exist between bank pass book and bank column of cash book and gives correct cash and bank position to the businessman. A businessman would never face problems like cash crisis, dishonour of cheques, misappropriation of cash, etc, if he keeps a regular check on his cash & bank balances.

9.8 KEY WORDS

Cash Book: Cash book is a subsidiary book which records the receipts and payments of cash. With the help of cash book, cash and bank balance can be checked at any point of time.

Pass Book: Pass Book is a book issued by Bank to an account holder. It is almost a copy of the account of the customer in the books of bank. The bank keeps the customer informed of the entries made in his account through Pass Book. It is the customer's duty to check the entries and immediately inform the bank of any error that he may have noticed.

Statement of Account: A statement of Account is similar to a Pass Book but it is prepared on loose sheets by the bank. It is also a copy of Customer's Account in the books of the Bank. It is periodically prepared by the bank and is sent to the customer for his examination and comparison with his own Cash Book.

9.9 QUESTIONS

SHORT ANSWER QUESTIONS

Q 1: Define bank reconciliation statement. Why it is prepared?

Q 2: Prepare bank reconciliation statement with hypothetical figures.

Q 3: Differentiate between bank statement and bank reconciliation statement.

Q 4: Identify the causes of difference between cash book and pass book.

LONG ANSWER QUESTIONS

Q 1. On 31st March 2010, the cash book of Rich showed a balance of Rs. 4,760 at bank. They had sent cheques amounting to Rs. 45,000 to the bank before 31st March, but it appears from the pass book that cheques worth only Rs. 64,000 had been credited before that date. Similarly, out of cheques for Rs. 65,000 issued during the month of March, cheques for Rs. 2,750 were presented in April, the remaining having been paid in March itself.

The Pass Book also showed the following payments:

- (a) Rs. 3,320 premium (on the joint life policy) according to standing instructions; and
- (b) Rs. 4,000 against promissory note, as per instructions.

The pass book showed that the bank had collected Rs. 6,800 as interest on Government Securities. The bank had charged interest Rs. 50 and bank charges Rs. 20. There was no entry in the cash book for the payments, receipts, interest, etc.

It was found that the total to the credit bank column in the cash book on 20th March was Rs. 110 short.

Prepare the bank reconciliation statement as on 31st March, 2010.

Q2. Prepare a bank reconciliation statement from the following particulars:-

1. Bank balance as per Pass book Rs. 60,000

2. Cheque deposited into the bank but no entry was passed in the cash book Rs. 800
3. Cheque received but not sent to bank Rs.2,500
4. Credit side of the Bank column cast short Rs. 600
5. Insurance premium paid directly by the bank understanding advice Rs. 800
6. Bank charges entered twice in twice cash book Rs. 30
7. Cheque issued but not presented to the bank for payment Rs. 1,150
8. Cheque received entered twice in the Cash Book Rs. 2,750
9. Bills discounted dishonoured not recorded in the Cash Book Rs. 4,000

Q 3 Prepare a bank reconciliation statement from the following particulars:-

1. Bank balance as per Pass book Rs. 80,000
2. Cheque deposited into the bank but no entry was passed in the cash book Rs.5,000
3. Cheque received but not sent to bank Rs.12,000
4. Credit side of the Bank column cast short Rs. 600
5. Insurance premium paid directly by the bank under standing advice Rs. 6,000
6. Bank charges entered twice in twice cash book Rs. 20
7. Cheque issued but not presented to the bank for payment Rs. 8,500
8. Cheque received entered twice in the Cash Book.Rs. 2,100
9. Bills discounted dishonored not recorded in the Cash Book Rs. 4,500

Q 4. Bank balance as per cash book of a trader as on 31st Dec. was Rs.20000. On the scrutiny of the pass book and cash book the following discrepancies were found–
 A cheque of Rs. 5000 issued on Dec 25th was not presented to bank.
 A cheque of Rs. 8000 was deposited into bank on 20th Dec and was credited in the pass book on January 2nd next.
 Bank debited Rs. 20 for bank charges and credited Rs. 500 for dividend but the same were not recorded in the cash book.
 Bank paid insurance premium Rs. 8500 and collected rent Rs. 500 but no entries were passed for them in the cash book.
 Prepare a bank reconciliation statement.

Q 5. On 31st Dec. the Pass Book shows a credit balance of Rs.7000. Before that date cheques amounting to Rs. 3000 was issued but were not presented for payment. A cheque of Rs. 9,500 paid into the bank was not credited. On 31st Dec, a cheque of Rs. 1000 which though entered in the cash book was omitted to be paid into the bank; besides there was an entry of Rs. 55 for interest.
 Prepare a bank reconciliation statement showing the adjustments.

9.10 REFERENCES AND SUGGESTED BOOKS

Gupta, Ambrish (2009) *Financial Accounting for Management: An Analytical Perspective*, Pearson Education India, New Delhi.

Tulsian, P.C. (2002) *Financial Accounting*, Pearson Education India, New Delhi.

Maheshwari, S.N. and Maheshwari, S.K. (2009) *Accounting for Management*, Vikas Publishing House Pvt. Ltd, Noida.

Narayanaswamy, R.N. (2011) *Financial Accounting-A Managerial Perspective*, PHI Learning Pvt. Ltd., New Delhi

Grewal, T. S. (1999) *Advanced Accounts*, S. Chand & Company Ltd., New Delhi.

Activity 1

What is the need and importance of Bank Reconciliation Statement?

Activity 2

What are the reasons of difference between cash book and pass book?

LESSON 10

CAPITAL EXPENDITURE, REVENUE EXPENDITURE AND DEFERRED REVENUE EXPENDITURE

STRUCTURE

1.0 Objectives

10.1 Introduction

10.2 Need to Distinguish Between Capital and Revenue

10.3 Capital Expenditure and Capital Receipts

10.4 Revenue Expenditure and Revenue Receipts

10.5 Differences between Capital Receipts and Revenue Receipts

10.6 Accounting treatment of capital and Revenue Expenditure

10.7 Difference between Capital Expenditure and Revenue Expenditure

10.8 Revenue Expenditure becoming Capital expenditure

10.9 Deferred Revenue Expenditure

10.10 Let Us Sum Up

10.11 Key Words

10.12 Questions

10.13 References and Suggested Readings

10.0 OBJECTIVES

After studying this unit you should be able to

- understanding the meaning of capital and revenue expenditure
- understanding the difference between capital and revenue expenditure
- understanding the meaning of deferred income and expenditure

10.1 INTRODUCTION

The proper distinction between capital and revenue as regard to expenditure, payments, profits, receipts and losses is one of the fundamental principles of correct accounting. It is very essential that in all cases this distinction should be rigidly observed and amounts

rightly allocated between capital and revenue. Failure or neglect to discriminate between the two will falsify the whole of the results of accounting. For example,

1. Building may be purchased and debited to purchases account;
2. Additions to be made the premises and debited to Repairs Account;
3. Some of the fixed assets may be sold and the proceeds treated as profit.

In each case both the profit and loss accounts and balance sheet would be inaccurate and misleading. These and similar mistakes are very easily made and if un-detected would soon render the accounting useless as a record of financial results. As all revenue items to balance sheet, it is necessary that proper distinction should be made between capital and revenue while preparing the final accounts of a business at the end of trading period.

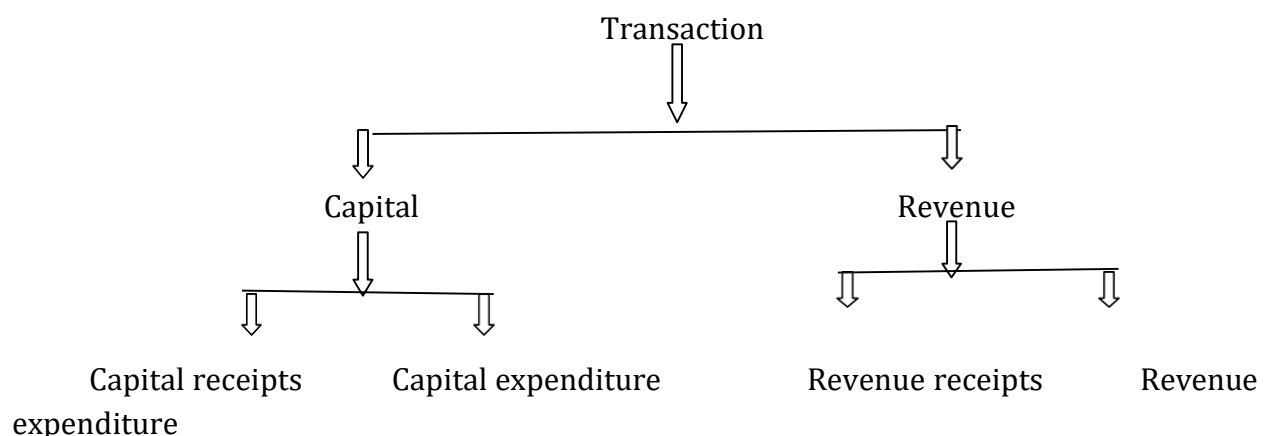
10.2 NEED TO DISTINGUISH BETWEEN CAPITAL AND REVENUE

Meaning and Features

In order to ascertain the true and fair results and financial position of a concern for a year the nature of transaction taking place during the year are to be analyzed for example:

- (a) Transactions having a long term effect are known as capital transaction
- (b) Transactions having short term effect are revenue transaction.
- (c) Transaction, the effect of which is not exhausted within the current year and which can be enjoyed in future year or years also are called capital transactions
- (d) Transaction, the effect of which is exhausted within the current year, is known as revenue transactions.

The Mechanism of capital and revenue can be studied with the help of following chart:-



The proper distinction of capital and revenue must be based upon sound accounting practices so as to get fair information about the business for a stipulated period. The following are different objects of differentiating between these items:-

1. To Ascertain true and fair Net Profit: The main motive of a business entity is to find out net profit or loss at the end of accounting period. Proper measurement of business income can be made if revenue items are included only in income statement while capital items should form part of the balance sheet figures only.

2. To Meet Requirement of income tax Provision: The distinction between Capital and revenue is important for the purpose of payments of Income Tax also. It will be difficult to calculate income liable to Tax. Only revenue receipts and not the capital receipts, that are put to tax, Similarly only revenue expenses are allowed to be deducted while finding out income whereas the amount spent On purchase/acquisition of capital assets are ignored altogether.

3. To allocate the Depreciation at the end of accounting period: Depreciation is charged against profit. As the end of year a part of fixed assets consumed during the year is debited in profit and loss accounts. Similarly some expenses such as installation charges may be debited to cost of fixed assets. Therefore a proper identification of these two items is much before final statement of a business are prepared, otherwise the statement present unfair and untrue position.

4. To Maintain Record on scientific lines: In accounting theory and practice, all capital transaction should form a part of the position statement and all revenue items be included in the income statement of every business. This is because accounting is the scientific body of knowledge and all business transactions should fall in the relevant financial statements.

10.3 CAPITAL EXPENDITURE AND CAPITAL RECEIPTS

CAPITAL EXPENDITURE

A Capital expenditure is an amount spent to acquire or improve a long-term asset such as equipment or buildings. Usually the cost is recorded in an account classified as Property, Plant and Equipment. The cost (except for the cost of land) will then be charged to depreciation expense over the useful life of the asset. Any expenditure incurred for the following purposes is **capital expenditure**:

1. For acquiring fixed assets such as land, building, plant and machinery, furniture and fitting and motor vehicles. These assets should not be acquired with a view to resell them at a profit but to retain in the business. The cost of fixed asset would include all expenditure up to the asset becomes ready for use.

2. For making improvement and extensions to the fixed asset e.g., additions to buildings.
3. For increasing the earning capacity of a business or for reducing the cost of manufacture, administration or distribution in a business e.g., expenditure incurred in removing the business to a central locality or compensation paid to retrenched employee.
4. For raising capital monies for the business such as brokerage paid for arranging loans, discount on issue of shares and debentures, underwriting commission etc.

All capital expenditures represent either an asset or liability and are shown in the balance sheet. The following is a list of the usual items of **capital expenditures**:

- Cost of goodwill.
- Cost of freehold land and building and the legal charges incurred in this connection.
- Cost of lease.
- Cost of machineries, plants, tools, fixtures, etc.
- Cost of trademarks, patents, copy rights, designs, etc.
- Cost of car, lorry etc.
- Cost of installation of lights and fans.
- Cost of any other assets acquired by way of equipment.
- Erection cost of plant and machinery.
- Cost of addition to existing assets.
- Structural improvements and alteration in the existing assets.
- Expenses for developments in case of mines and plantations.
- Expenses for administration incurred during construction and equipment of any industrial enterprise.
- Expenses incurred in experimenting which finally result in the acquisition of patent or other rights.

Definition

Kohler defined capital expenditure as “Money spent to acquire or upgrade physical assets such as buildings and machinery also called capital spending or capital expense”. Kohler talked about the amount spent on acquisition and upgradation. Carter considered the benefits derived from an asset over a period of time. According to Carter, “Capital items are those, the benefits of which is received over a number a accounting periods and revenue items are those, the full benefits of which is received in the current accounting period”.

Following are the features of capital expenditure:

1. Capital expenditure is made for acquiring fixed assets.
2. These expenditure increases the value of assets.
3. This expenditure also increases the profit earning capacity of business.
4. These expenditures are casually incurred.

As capital expenditure results in increase in the fixed asset of the entity, the accounting entry is as follows:-

Fixed assets A/c----- Dr.

To cash/payables A/c

Capital Receipts

An amount received in the form of capital from the owner and as loan from outsiders is known as capital receipts. Besides, cash received by selling shares, debentures and permanent assets is also capital receipt. Capital receipts can be defined as the proceeds from the sale of capital assets. They may be used to finance new capital expenditure or repay existing loan debt. Receipts available to finance capital expenditure in future years are normally held in the usable capital receipts reserve. It is of non-recurring type of receipt. It is treated as obligation of the business and shown on liabilities side of the balance sheet.

Items relating to capital receipts are as follows:

- * Amount received from the owner as capital.
- * Amount received through the sale of shares and debentures.
- * Amount of loan received
- * Amount received from the sale of old assets.
- * Other receipts of non-recurring nature.

10.4 REVENUE EXPENDITURE AND REVENUE RECEIPTS

REVENUE EXPENDITURE

Revenue expenditure refers to the cost that you charge to expense as soon as you incur it. William Pickles defines revenue expenditure as "Revenue expenditure refers to expenditure concerned with the costs of doing business on a day to day basis. When

companies make revenue expenditure, the expense offers immediate benefits, rather than long term ones. This is differentiated with capital expenditures, which are long term investments to help a business grow and thrive”.

In other words, it is expenditure that is concerned with the costs of doing business on a day to day basis. Certain revenue expenditures may be deductible for tax purposes. As revenue costs do not form part of the fixed asset cost, they are expensed in the income statement in the period in which they are incurred.

The accounting entry to record revenue expenditure is therefore as follows

Revenue Expenditure A/c -----Dr.

To Cash/Payable

Characteristics of Revenue Expenditure:-

Following are the essential characteristics of revenue expenditure

- (a) It is Expenditure incurred on day to day conduct of the business
- (b) Its periodicity is generally one accounting year
- (c) It is expenditure on consumable items, on goods and services for resale, either in original or improved form
- (d) It is incurred on maintaining the fixed assets in working order i.e. repairs, renewals and depreciation
- (e) It is of recurring or repetitive nature
- (f) It is incurred to maintain the earning capacity of the business
- (g) It is by nature a short period expenditure

REVENUE RECEIPTS

"Revenue receipts" refer to all money the business makes through its operations. This is a type of recurring profit that comes from repeat transactions with customers, which the business needs to survive. The business makes these repeat transactions to generate enough revenue to continue operations. Without revenue receipts, businesses fail”.

Revenue receipts are called a "collection of receipts" because each business transaction generates revenue that the business is owed, or revenue filed under accounts receivable until customers pay it. Manufacturers create revenue receipts when they sell products. Financial companies create them when they sell services. Banks earn receipts through interest when they make loans. The method of earning this revenue varies by industry.

Discounts and other special deals may lower revenue receipts from their customary amounts.

10.5 DIFFERENCES BETWEEN CAPITAL RECEIPTS AND REVENUE RECEIPTS

From the income tax point of view it is necessary to know the difference between capital and revenue receipts. Because only revenue receipts are taxed according to income tax ordinance. While capital receipts are not taxed. When it become very difficult for the assessee to differentiate the capital and revenue receipts. These are brought into the courts. However following tests may be used to distinguish between capital and revenue receipts.

- (1). Sale on Asset :** Any amount which is received by selling the fixed asset like building, land machinery etc. and kept to earn profit. It will be called the capital receipt on the other hand if floating asset like stock in trade is sold, such receipt will be called revenue receipt.

Example : Suppose a company sells the building, the amount received will be called capital receipts. If a company sells the stock in trade, the amount received will be called revenue receipts.

- (2). Substitution Source of Income:** Income received by the assessee from the employer is called revenue receipt. While the amount from the new or substituted source is called capital receipt.

Example: Mr. Alfa is manager in the factory. He receives Ten thousand Rupees as a salary. It is a revenue receipt. Mr. Alfa has been retired by the company. The company had also paid him 1 million Rupees to establish a new source. It is capital receipt.

- (3). Sale of Right:** If any person surrenders his right permanently the amount he receives will be treated as capital receipt. On the other hand if any person surrenders his right for the particular period the amount he receives will be called revenue receipt.

Example: Poet Gulzar has written the book. He surrenders his right of publishing in favor of the publisher permanently and receives 1 million Rupees. Such amount will be treated as capital receipt on the other hand if he surrenders his right only one edition and receives 1 Lakh rupees. It will be a revenue receipt.

- (4). Test Motive Behind:** The motive behind the transaction must be tested while distinguish the capital and revenue receipt. Motive will declare that amount is a capital receipt or revenue receipt.

Example: Mr. Saif purchases the shares of a company to resell at profit. The amount received by the sale is a revenue receipt. If Mr. Saif purchases the shares to earn profit but after some time he is in need of money. So he sells the shares fulfill the need the amount received by him will be treated as capital receipt.

(5). Period of Receipt: Period of receipt is not considered while distinguishing the capital and revenue receipts.

Example: Mr. Vikram sold his land on installments. The amount received monthly or annually will be also treated as capital receipt. Because he has completely surrendered his right. Mr. Shukla received 2 years advance salary in lump sum. It is revenue receipt.

(6). Receipt Judgment: While making the judgment of receipt one should know that payment is made due to the services of recipient for the employer. If so, then it should be considered as revenue receipt.

Example 1: Mr. Shan received a fee and drafted a business deal. His income will be a revenue receipt. If any person receives bonus from his employer, it is also a revenue receipt.

10.6 ACCOUNTING TREATMENT OF CAPITAL AND REVENUE EXPENDITURE:

The accounting treatment of capital and revenue expenditure is as under

(a) Revenue expenditure is treated as an expenses and therefore, charged as such against profit in the year they are incurred and recognized

(b) Capital expenditure is capitalized and therefore, added to an asset account and is shown in the balance sheet on the asset side of an enterprise

10.7 DIFFERENCE BETWEEN CAPITAL EXPENDITURE AND REVENUE EXPENDITURE

Following is the difference between capital and revenue expenditures.

Capital Expenditures		Revenue Expenditures	
1	Its effect is long term i.e., it is not exhausted within the current account year. Its benefit is enjoyed in future year or years also. In a word, its effect is reduces gradually.	1	Its effect is temporary, i.e., it is exhausted within the current accounting year.
2	An asset is acquired or the value of an asset is increased as a result of this	2	Neither an asset is acquired nor is the value of an asset increased.

	expenditure.		
3	It does not occur again and again - it is non-recurring and irregular.	3	It occurs repeatedly - It is recurring and regular.
4	Generally, it has physical existence i.e., it can be seen with eyes.	4	It has no physical existence, i.e., it cannot be seen with eyes.
5	This expenditure improves the position of the concern	5	This expenditure helps to maintain the concern
6	A portion of this expenditure is shown in the trading and profit and loss account or income and expenditure account as depreciation.	6	The whole amount of this expenditure is shown in trading and profit and loss account or income and expense account. But deferred revenue expenditures and prepaid expenses are not shown.
7	It appears in balance sheet until its benefit is fully exhausted.	7	It does not appear in balance sheet. Deferred revenue expenditure, outstanding expenditure, outstanding expenses and prepaid expenses, however, temporarily shown in the balance sheet.
8	It does not reduce the revenue of the concern. Purchase of fixed assets does not affect revenue.	8	It reduces revenue. Payment of salaries to employees decreases revenue.

Check your Progress 1

Use the space given below to answer the questions

1. Define Capital Expenditure

2. Define capital Receipts

3. What is Revenue Expenditure with examples?

4. State accounting treatment of Capital and Revenue Expenditure?

10.8 REVENUE EXPENDITURE BECOMING CAPITAL EXPENDITURE:-

The following are some of examples of revenue expenditure becoming capital expenditure.

1. Interest on capital: Such interest, if paid during the information of company is treated as capital expenditure

2. Development Expenses: Some concerns such as tea and rubber plantations, horticulture and collieries etc requires a very long period of development before they begin to earn any income .all such expenditure incurred during the period of such development is called development expenditure and is treated as a capital expenditure.

3. Repairs: These are usually a revenue charge, but the purchase of second hand plant and payments for immediate repairs necessary to make it efficient for business purpose. Such repairs are treated as capital expenditure and are added to the plant as part of its cost

4. Advertising: The cost of special advertisement campaign for the purpose of introducing a new line of good may be treated as capital expenditure, as the benefit of such advertising will be available in future year also

5. Transport expenses: They are usually a revenue charge but payments made for transporting any plant or machinery are taken as capital expenditure and added to the cost of asset.

6. Legal expenses: These expenses are revenue charge, but the legal expenses are incurred in connection with purchase of fixed assets must be treated as part of cost of capital.

7. Wages: There are revenue items, but wages paid to workman to react new machinery, the firm has bought, must be considered as an addition to the cost of machinery. Similarly wages of workmen employed in the construction of any fixed asset are capital expenditure and must be treated as part of profit

8. Carriage and Freight: Such expenses in connection with the acquisition of fixed assets are capital expenditure

9. Raw material and stores: These are normally a revenue charge but in consumed in making a fixed assets, must be treated as part of cost of assets.

Illustration 1

State the reasons whether following items of expenditure are capital and revenue:

- (1) A second hand motor car was brought for Rs.7000 and Rs 3000 were spent for repairs to put it in order.
- (2) The club building was white washed at the cost of Rs.500.
- (3) A new machinery was purchased for Rs.8000 and sum of Rs.750 was spent on its installation.
- (4) Books were purchased for Rs5000 and Rs.100 was paid for carrying the books to library.
- (5) Rs.500 was paid for legal expenses in connection with purchase of a plot of land of land.
- (6) Rs.1200 was paid for custom duty and freight on machinery imported from England.
- (7) Obtained 5 bighas of land for playground at a rent of Rs.500 per month.
- (8) Old furniture was replaced at a cost of Rs.700.
- (9) An additional classroom was constructed at a cost of Rs.3500.
- (10) A large sum of Rs.5000 was spent on advertising for the introduction of a new product.

SOLUTION:

- (1) The cost of second hand car, as well as repair expenses incurred on the same is a capital expenditure. Because a fixed asset i.e. motor car has been acquired. Thus Rs.7000 is capital expenditure Rs.3000 spent on its immediate repairs has increased its serviceability thus this amount should also be capitalized.
- (2) Rs.500 spent on white washing of building has not increased the value of building in anyway. It is maintenance expenditure. Thus it is revenue expenditure
- (3) Rs.8000 spent on purchase on new machinery is a capital expenditure as a fixed assets have increased which will result in increased earning of business Rs.750 paid for installation of the said machine is also a capital expenditure because any expenditure related to an asset until it is ready to use is a capital expenditure

(4) Rs.5000 being cost of books purchased for library is a capital expenditure as a new asset has been acquired and it will increase the utility of library. The amount of 100 paid for carriage too is a capital expenditure as any expenditure relating to any asset until it is actually put to use is capital expenditure

(5) Rs.500 paid as legal expenses on connection with purchase of land is a capital expenditure, being part of cost of land .All expenses connected with acquisition of a fixed asset are regarded as a part of purchase consideration.

(6) Custom duty and freight on machinery imported from England is a capital expenditure because machinery is fixed asset. All Expenses connected with import from England are regarded as part of purchase consideration.

(7) Rs.500 per month paid as rent for playground is a revenue expenditure. Because rent of land is a recurring expenditure-it does not increase the value of land.

(8) Rs.700 paid as a cost of repairs of old furniture is revenue expenditure as it does not increase the value of furniture

(9) Rs.3500 paid for addition to existing building is a capital expenditure because the expenditure has resulted in the increase in the value of building.

(10) Rs.5000 spent on the advertisement campaign for launching a new product is deferred revenue expenditure because its benefit is likely to be received in future period also.

Illustration 2

(2) State which of the following expenses, would be charged to capital and which to the revenue:

1. Rs.1000 were spend on machine out of which Rs.100 for repairs; Rs.200 for replacement of defective parts and Rs.700 for the improvements of the machinery. As a result of improvements the production capacity of the machine doubled.

2.A company removed their factory to more suitable premises and incurred the following expenditure : (1)cost of dismantling ,removing and re-installing plant Rs.5160;(ii)Old plant book value Rs.2250 was sold for Rs.800 and replaced by new plant cost Rs.4800.

3. Fire insurance premium was paid on 1st October for full one year Rs.600.Books are closed on 31st December every year.

4. While the construction of the factory building was in progress few cottages were built for the labor costing Rs.600 which were demolished after the completion of factory.

5. Extensive alternations were done to cinema building. Apart from alterations the entire property was in thorough repairs and the interior of the theatre including the sitting accommodation was refurnished and made more comfortable and attractive. This result in increased 'gate proceeds'

SOLUTION

1. Expenditure of Rs.100 for repairs and Rs.200 for replacement of defective parts are revenue, being necessary to keep the assets in efficient running order. This expenditure does not result in the improved of the machinery. Whereas the amount of Rs.700 spent on improvement is a capital because it increases the earning capacity of the asset.
2. (i) Cost of dismantling, removing and reinstallation of plant is revenue expenditure.
(ii) Loss of Rs.1450 (2250-800) on the sale of old plant, though arising out of fixed assets should be treated as revenue expenditure. It should be debited to profit and loss account. Cost of new plant Rs.4800 is capital expenditure because it relates to acquisition of fixed asset
3. Fire insurance premium Rs.150 representing premium for the period 1st October to 31 December is revenue expenditure and Rs.450 paid for the period from January 1 to September 30 of the next year is pre-paid to be carried forward to the next year as an asset.
4. Temporary cottages costing Rs.600 should be added to the cost of construction of the factory i.e. capital expenditure as the expenditure is connected with the fixed asset viz, factory.
5. Expenditure of Rs.8400 representing improvement and re-furnishing is capital expenditure. However, if the profits are inadequate to absorb Rs.16000 revenue expenditure, it may be spread over number of year for writing off.

Illustration 3

How would with following items as capital or revenue? Also state reasons.

- (i) A machine costing Rs.100000, depreciated to Rs.60,000 was sold for Rs.70,000.
- (ii) A plant appearing in the books at Rs.8000 and stock valued at Rs.4000 were destroyed by fire. Amount recovered from insurance company was Rs.10,000 and Rs.5000 respectively.
- (iii) Received Rs.200000 from issue of shares including s.20,000 as premium on shares.
- (iv) An old machine costing Rs.24000 (W.D.V Rs.14400) was sold for Rs.8000.
- (v) Amount realized from sale of worn out vehicles.
- (vi) Amount of rent received during the year for apart of building sublet

SOLUTION:

- (i) Profit on sale of machine Rs.(70000 -60000) should be treated as capital profit.
- (ii) Excess amount realized from insurance company over the book value of plant accounting to Rs.2000 (Rs.10000-8000) is a capital profit since the plant is an item of fixed

asset while excess amount which is realized from insurance company over the value of stock amounting to Rs, 1000(5000-4000) is a revenue profit since the stock is an current asset, which is meant for re-sale.

(iii) Rs.180000 (Rs.200000-20000) received from issue of shares will be treated as 'capital receipt' and premium of Rs.20000 should be treated as capital profit. However these should be shown in liabilities side of balance sheet.

(iv) The loss on sale of old machine amounting to Rs.6400 (14400-8000) is a revenue loss since it represent under provision of depreciation already made in earlier years and the selling price amounting to Rs.8000 is capital receipts as it shows proceeds of the sale of fixed assets.

(v) The amount realized as sale proceed of worn out vehicles is a capital receipts, being the scrap value after charging appropriate amount of depreciation.

(vi) The amount received as rent, by subletting apart of building is revenue income to be credited in profit and loss account.

10.9 DEFERRED REVENUE EXPENDITURE

Deferred Revenue

Deferred revenue is an advance payments or unearned revenue, recorded on the recipient's balance sheet as a liability, until the services have been rendered or products have been delivered. It is a liability because it refers to revenue that has not yet been earned, but represents products or services that are owed to the customer. As the product or service is delivered over time, it is recognized as revenue on the income statement. **For example**, a company that receives an advance payment of Rs. 100,000 for delivery of a product would book it as deferred revenue on its balance sheet. Once it delivers the product to the customer, the company would transfer the Rs. 100,000 from the deferred revenue account to regular revenue on its income statement.

Deferred Revenue expenditure

Deferred revenue expenditure is that expenditure for which payment has been made or a liability incurred but which is carried forward on the presumption that it will be of benefit over a subsequent period or periods. In short, it refers to that expenditure that is, for the time being, deferred from being charged against income. Such suspension of 'charging of operation may be due to the nature of expenses and the benefits expected there from. So, long as deferred revenue expenditure is not written off, this is shown on the assets side of the balance sheet under the head "Miscellaneous Expenditure."

Deferred revenue expenditure should be revenue expenditure by nature in the first instance, for example, advertisement. But its matching with revenue may be deferred considering the benefits to be accrued in future.

Difference between capital expenditure, Revenue expenditure and Deferred Revenue expenditure

Following table shows the difference between capital expenditure, revenue expenditure and deferred revenue expenditure

Capital Expenditure	Revenue Expenditure	Deferred Revenue Expenditure
Capital expenditure is the amount spent on obtaining the benefits of an asset on permanent basis	Revenue expenditure is incurred for the maintenance of the capital asset	Deferred revenue expenditure is spread over a number of years
It increases the earning capacity of the business and also reduces the operating cost	It helps to earn current revenue	It ensures the application of matching cost
Benefits are available beyond the accounting year	Benefits are consumed during the accounting year only	Benefits are available over a number of years
Shown in balance sheet	Transferred to trading and profit and loss account	Charged to profit and loss account over years
Associated with property right belonging to an entity	Not associated with any such rights	Not associated with any such right
May be treated as non-recurring expenditure	Treated as recurring expenditure	Treated as non-recurring expenditure
Represents unexpired cost	Represents expired cost	Semi-capital in nature

Check your Progress 2

Use the space given below to answer the questions.

1. How Revenue Expenditure becomes Capital Expenditure?

3. What is Deferred Revenue Expenditure?

Eastern industries shifted their factory to more suitable premises in South Delhi:-

1. A sum of Rs.9500 was spent on dismantling, removing and re-installing plant and fixtures.
2. Removal of stock from old factory to the premises cost Rs.1000.
3. Plant and machinery, which stood in books at Rs.150000 including a machine at book value of Rs.3400, this being obsolete was sold for Rs.900 and was replaced by a new machine costing Rs.4800.
4. Freight and carriage on new machinery amounted to Rs.300 and erection charges Rs.4800.
5. A sum of Rs.2200 was spent on painting the new factory.

10.10 LET US SUM UP

To sum up, one can say that the difference between capital and revenue expenditures lies between the duration of the benefit that accrues from such expenditure. The benefit of the revenue expenditure accrues in the year in which it is incurred while the capital expenditures' benefit is received over a number of years i.e. a long period of time. Hence the revenue expenditures are given treatment in the accounts of the same year in which they are incurred while in case of capital expenditures only a part of these are given treatment in a particular year and the rest is shown in the balance sheet as an asset till the full amount gets amortized over a fixed number of years.

10.11 KEY WORDS

Capital expenditure: It is the amount spent on obtaining the benefits of an asset on permanent basis.

Revenue expenditure: It is incurred for the maintenance of the capital asset.

Deferred revenue expenditure: It is spread over a number of years.

10.12 QUESTIONS

Short answer Questions.

1. Define the terms "Revenue and expenditure"
2. Difference between Capital and Revenue?
- 3 Differences between Receipt and Payment?
4. What do you mean by Deferred Revenue Expenditure?

Long answer Question.

- 1 Difference between Capital Expenditure and Revenue expenditure?
2. Give some Examples of "revenue" expenditure becoming under certain circumstances "Capital" expenditure?
3. Define Capital Receipts? Give examples

10.13 REFERENCE AND SUGGESTED READINGS

S.P. Jain, K.L. Narang, *Financial Accounting*, Published by Kalyani Publishers, Delhi.

Grewal, Shukla, S. Chand, *Financial Accounting*, Published By Sultan Chand Publications, Delhi.

Pizzey, A (2001) *Accounting and Finance: A Firm Foundation*, Cengage Learning, New Delhi.

Mukherjee, A and Hanif, M (2000) *Modern Accounting*, Vol 1, Tata Mc. Graw Hill Publishing Company Ltd., New Delhi.

Narayanaswamy, R.N. (2011) *Financial Accounting-A Managerial Perspective*, PHI Learning Pvt. Ltd., New Delhi

Maheshwari, S.N. and Maheshwari, S.K. (2012) *A Text Book of Accounting for Management*, Vikas Publishing House Pvt. Ltd., New Delhi.

Activity 1

Distinguish Between Capital Expenditure and Revenue Expenditure.

Activity 2

What is the meaning of deferred revenue expenditure?

LESSON 11

ACCOUNTING FOR DEPRECIATION

Structure

- 11.0 Objectives
- 11.1 Introduction
- 11.2 Meaning and Definition
- 11.3 Causes of Depreciation
- 11.4 Factors determining Depreciation
- 11.5 Need for providing Depreciation
- 11.6 Accounting Entries
- 11.7 Methods for providing Depreciation
- 11.8 Depreciation of various assets
- 11.9 Let Us Sum Up
- 11.10 Key Words
- 11.11 Questions
- 11.12 References and Suggested Books

11.0 OBJECTIVES

After studying this unit you should be able to

- explain the meaning of depreciation
- state the need for charging depreciation and identify its causes
- understand the different methods of depreciation and their applicability

11.1. INTRODUCTION

Fixed assets purchased and owned by every business concern such as plant, machinery, tools, buildings, leasehold, furniture etc. gradually diminish in value as they get old and become worn out by constant use in the business. Except in a few cases (e.g. land, antiques etc.) all assets depreciate. Though current assets may also lose value, the term depreciation is used only in respect of fixed assets.

According to the Matching principle, the revenue of a given period is matched against the expenses for the same period. This ensures calculation of the correct amount of profit or loss. If some cost is incurred whose benefits extend for more than one accounting period then it is not justified to charge the entire cost as expense in the year in which it is incurred. Rather such a cost must be spread over the periods in which it provides benefits. Depreciation also deals with such a situation.

Further, it may not always be possible to ascertain with certainty the amount of some particular expense. The principle of conservatism (prudence) requires that instead of ignoring such items of expenses, adequate provision must be made and charged against profits of the current period. Moreover, a part of profit may be retained in the business in the form of reserves to provide for growth, expansion or meeting certain specific needs of the business in future.

11.2 MEANING AND DEFINITION

The term depreciation has been derived from the Latin words 'de' (which denotes down) and 'pretium' (which denotes price). In common use depreciation means fall in the quality, quantity or value of an asset due to wear the tear, passage of time, obsolescence, etc. The net result of an asset's depreciation is that sooner or later the asset will become useless.

It is not easy to give a comprehensive definition to the term depreciation because under different situations it is treated differently and whatever seems to be correct in one situation may not be proper in other.

But even then some definitions are worth mentioning.

1. "Depreciation is the gradual and permanent decrease in the value of an asset from any cause".-R. N. Carter
2. "Depreciation refers to the process of estimating and recording the periodic charges to expense due to the expiration of the usefulness of a capital asset". - Malchman and Salvin
3. "Depreciation is a permanent, continuing and gradual shrinkage in the value of a fixed asset". - A. N. Aggarwal
4. "Depreciation means, "A permanent and continuing elimination in the quantity, quality or value of an asset".- William Pickles
5. "Depreciation represents loss or diminution in the value of an asset consequent upon wear and tear, obsolescence, effluxion of time, or fall in the market value". - J. R. Batliboi

From the above definitions it is clear that depreciation is the gradual, continuing and permanent fall in the quality, quantity or value of an asset.

11.3 CAUSES OF DEPRECIATION

The causes which necessitate the provision of depreciation are given below:-

- I. **Usage of asset:** The main cause of depreciation is the wear and tear of assets as they are put to use in an organisation. It results in reduction of the future earning power as well as technical capacity of the asset due to which its value gets reduced.
- II. **Losses:** Another important factor contributing to depreciation is accidents such as plant break-down, loss by fire etc.

- III. **Obsolescence:** Due to technological developments, the asset in use may become out-dated and lose a large part of its value. This fall may also be due to changes in the supply and location of material resources, etc.
- IV. **Depletion:** Where the asset is of wasting character such as mine, quarry or oil-well etc., the asset will be depleted due to the extraction of its contents.
- V. **Expiration of Certain Ledger Rights:** In case of patents, leases and licences depreciation is a time function as by the expiration of time for which the legal right to use is created lapses.
- VI. **Physical factors:** these include cases like Evaporation of liquid, loss of potency of chemicals and erosion.

11.4 FACTORS DETERMINING DEPRICIATION:

The following factors must be kept in mind while determining the amount of depreciation

- (a) The original cost of the asset, which includes the purchase price of the asset, freight, installation charges, cost of subsequent improvements in the asset etc.
- (b) The probable working life of the asset in terms of time(years or months or hours)or output (units, mileage etc.).
- (c) The estimated break-up, or residual value or scrap value i.e. what the asset will fetch when condemned or discarded.
- (d) The amount likely to be spent on repairs and renewals to keep the fixed asset in proper working condition.
- (e) The possibility of the asset becoming obsolete due to new inventions, improvements, loss of demand due to change in fashion etc.
- (f) The statutory provisions of the Indian Companies Act, and the Indian Income Tax,1961 must be kept in mind while determining the amount of annual depreciation.

1.5 REASONS FOR PROVIDING DEPRECIATION:

The need for providing depreciation arises due to the following reasons:-

1. Ascertaining true profit or loss : The true profit of an enterprise can be ascertained when all costs incurred for the purpose of earning revenues have been debited to the profit and loss account. Fall in the value of assets used in business operations is a part of the cost and should be shown in the profit and loss account of concerned accounting period. Keeping this in view, depreciation must be debited to profit & loss account, since loss in value of fixed assets is also an expense like other expenses.

2. Presentation of True and Fair value of assets : If depreciation is not provided, the value of assets shown in Balance sheet will not present the true and fair value of assets

because assets are shown at the cost price but actual value is less than cost price of the assets.

3. To ascertain the accurate cost of the production : Depreciation is an item of expense, the correct cost of production cannot be calculated unless it is also taken into consideration. Hence, depreciation must be provided to ascertain the correct cost of production.

4. Computation of correct income tax : Income tax of an enterprise is determined after charging all the costs of production. If depreciation is not charged, the profits will be higher and the income tax will also be higher. If depreciation is charged, Tax liability is reduced.

5. Provision of funds and replacement of assets : Depreciation is a non cash expense. So that amount of depreciation charged to profit and loss accounts is retained in business every year. These funds are available for replacement of the assets when its useful life is over.

6. To keep the capital intact: The downfall in the value of fixed assets due to passage of time and wear and tear must be charged to profits before they are distributed, otherwise the distributed profits may have a portion of capital in it .

11.6 ACCOUNTING ENTRIES

(A) For writing off depreciation when provision for depreciation account is not maintained:

(When asset a/c is shown at net book value)

- i. Depreciation Account..... Dr.
To Asset Account

(Being the entry for providing depreciation on asset)

- ii. Profit and Loss Account Dr.
To depreciation account

(Being the transfer of Depreciation A/c to profit and loss A/c)

As a result of depreciation, the asset appears at its reduce value in the balance sheet.

(B) In case provision for depreciation account is maintained:

(When asset a/c is shown at its original cost)

- i. Depreciation Account..... Dr.
To Asset Account

(Being the entry for providing depreciation on asset)

- ii. Profit and Loss Account Dr.
To depreciation account

(Being the transfer of Depreciation A/c to profit and loss A/c)

When an Asset is sold, the depreciation to the date of sale is transferred from provision for Depreciation Account to the Asset Account, as a result of which the fixed asset is brought down to its written down value.

The difference between the sale price and the written down value of the asset is profit or loss on sale. In case the sale price exceeds the written down value of the asset, there shall be a profit on sale.

1. Cash/Bank Account.....Dr.
 To Asset Account } sale price
2. Asset Account..... Dr.
 To profit and loss account } amount of profit

Cash/ Bank Account.....Dr sale price
 Profit and Loss Account... DrAmount of Loss
 To asset account written down value

1. Fixed Instalment Method.
2. Reducing Balance Method.
3. Annuity Method.
4. Sum of the (years) Digits Method.
5. Depreciation Fund Method.
6. Insurance Policy Method.
7. Revaluation Method.
8. Machine Hour Rate Method.
9. Mileage Method.
10. Depletion Method.

1. FIXED INSTALLMENT METHOD/ STRAIGHT LINE METHOD

This method is also known as 'Original cost method' or 'Constant Charge Method'. Under this method, depreciation is charged at fixed percentage on the original cost of the asset, throughout its estimated life. The amount of depreciation is uniform from year to year. That is why this method is also known as 'Fixed Installment Method' or 'Equal Installment method'. The annual amount of depreciation can be easily calculated by the following formula:

$$\text{Annual Depreciation} = \frac{\text{Original cost} - \text{Estimated scrap value}}{\text{Estimated life}}$$

Advantages:

1. It makes calculation of depreciation simple.
2. It can write down the asset to zero at the end of its working life.
3. It equalizes the burden of depreciation over different years.
4. The fixed assets are shown at their true worth in the Balance Sheet as the amount of depreciation is generally deducted from fixed assets.

Disadvantages:

1. It reduces the book value of an asset to zero although the asset may still be in existence.
2. It does not take into account the interest on the investment in fixed assets.
3. While the charge for depreciation remains constant year after year, the expenses on repair and renewals become larger as the assets grow old, due to which the profit and loss account, in the later years, bears more than its due share of burden.
4. The annual charge for depreciation remains the same, irrespective of the use of fixed assets.

This method, however, is suitable for depreciating assets like, short leases, patents, furniture and fixtures, plant and machinery, building etc.

ILLUSTRATION-1

From the following information you are required to calculate depreciation rate:

Cost of the Machine Rs.60,000
Erection Charges Rs.6,000
Estimated useful life 10 years
Estimated Scarp Value Rs. 6,000

Solution:

Calculation of depreciation rate for every year:

Depreciation = $\frac{\text{Original Cost of Asset} - \text{Scrap Value}}{\text{Estimated Life of an Asset}}$

$$= \frac{\text{Rs. } 66,000 - \text{Rs. } 6,000}{10}$$

$$= \frac{\text{Rs. } 60,000}{10}$$

$$= \text{Rs. } 6,000$$

Thus, the amount of depreciation would be Rs. 6,000 for every year.

ILLUSTRATION-2

A machine costing Rs. 40,000 was purchased on 1st April, 2011. Its estimated working life is four years while its scrap value is estimated at Rs. 8,000. Show Machinery account for four years.

Solution:

Machinery account

Date	Particulars	Amount	Date	Particulars	Amount
2011		Rs.	2012		Rs.
April 1	To Bank A/c	40,000	March 31	By depreciation A/c	8,000
			March 31	By balance c/d	32,000
		40,000			40,000
2012			2013		
April 1	To balance b/d	32,000	March 31	By depreciation A/c	8,000
			March 31	By balance c/d	24,000
		32,000			32,000
2013			2014		
	To balance b/d	24,000	March 31	By depreciation A/c	8,000
			March 31	By balance c/d	16,000
		24,000			24,000
2014			2015		
April 1	To balance b/d	16,000	March 31	By depreciation A/c	8,000
			March 31	By balance c/d	8,000
				(Scrap value)	16,000

The annual amount of depreciation is 8,000.

Amount of Depreciation = $\frac{\text{original cost of asset} - \text{scrap value}}{\text{estimated working life of the asset}}$

$$= \frac{40,000 - 8,000}{4} = \text{Rs. } 8,000$$

Alternatively

The amount of annual depreciation may be calculated as a fixed percentage on the original cost of the asset less scrap value. The rate of depreciation may be computed by the following formula

$$R = D/C \times 100$$

Here, R stands for percentage rate of depreciation.

D stands for annual depreciation.

And C stands for original cost of the asset.

Illustration -3

A company, whose accounting year is the calendar year purchased on 1st April, 2011 machinery costing Rs. 30,000. It purchased further machinery on 1st October, 2011 costing Rs.20, 000 and on 1st July, 2012 costing Rs. 10,000.

On 1st January, 2013 one third of the machinery installed on 1st April, 2011 became obsolete and was sold for Rs. 3,000. Show how Machinery Account would appear in the books of the company, it being given that machinery was depreciated by fixed installment method at 10% per anum. What would be the balance of machinery account on 1st January, 2014.

Solution:

Machinery Account

2011		Rs.	2011		Rs.
April 1	To Bank A/c	30,000	Dec.31	By depreciation A/c(1)	1,375
Oct. 1	To Bank A/c	20,000	Dec.31	By balance c/d	23,625
		50,000			25,000
2012			2012		
Jan 1	To balance b/d	47,250	Dec.31	By depreciation A/c(2)	5,500
July 1	To Bank A/c	10,000	Dec.31	By balance c/d	51,750
		57,250			57,250
2013			2013		
Jan.1	To balance b/d	51,750	Jan.1	To Bank A/c	3,000
			Jan 1	By profit and loss A/c(3)	5,250
			Dec 31	By depreciation A/c	5,000
				(on Rs. 50,000 for 1 year)	
			Dec 31	By balance c/d	38,500
		51,750			51,750
2014					
Jan 1	To balance b/d	38,500			

Working notes:

1. Computation of Depreciation for 2011

On Rs. 30,000 at 10% p.a. for 9 months	2,250
On Rs. 20,000 at 10% p.a. for 3months	500
	2,750

2. Calculation of Depreciation for 2012

On Rs. 50,000 (i.e.30,000+20,000)at 10%for 1 year	5,000
On 10,000at 10%for 6 months	500
	5,500

3. Computation of loss on sale

Original cost of 1/3 rd machinery on 1-4-2011	
Less	
Depreciation for 2011 for 9 months at 10 % p. a. on 10,000	750
Depreciation for 2012 @10% p.a.on Rs 10,000	1000
	1,750
	8,250
Less sale proceeds	
3,000	
Loss on sale	
5,250	

Illustration -4

On July 1, 2011, a limited company purchased second hand machinery for Rs. 20,000 and spent Rs. 4,000 on reconditioning and installing it. On January 1, 2012 the company purchased new machinery worth Rs. 15,000. On June 30, 2013, the machinery purchased on January 1, 2012 was sold for Rs. 12,000 and on July 1, 2013 fresh machinery was installed at a cost of Rs. 16,000. The company writes off 10% on the original cost. The accounts are closed on 31st March every year. Show the Machinery Accounts up to the year ending 31st March, 2014

Solution:

2011					
July 1	To Bank A/c	24,000	March 31	By depreciation a/c(1)	2,175
2012					
Jan. 1	To bank a/c	15,000	March 31	By balance c/d	36,825
		36,000			39,000
2012			2013		
Apr.1	To balance b/d	36,825	March 31	By depreciation a/c(2)	3,900
			March31	By balance c/d	32,925
		36,825			36,825
2013			2013		

Apr. 1	To balance b/d	32,925	June 30	By bank a/c	12,000
July 1	To bank a/c	16,000	June 30	By depreciation (on Rs. 30,000 for 3 months)	375
			June 30	By profit and loss a/c	750
			2014		
			March 31	By depreciation a/c	3,600
			March 31	By balance c/d	32,200
		48,925			48,925
2014					
Apr1	To balance b/d	32,200			

Working notes:

1. Calculation of depreciation for the year 2011-12

On Rs 24,000 at 10%p.a. for 9 months	1,800
On Rs.15,000at 10%p.a. for 3 months	375
	2,175

2. Calculation of depreciation for the year 2012-13

On Rs. 39,000(i.e.24,000+15,000) at 10% for one year	3,900
--	-------

3. Calculation of loss on sale

Cost of machinery on Jan. 1,2012	15,000	
Less depreciation for 3 months t 10 %p.a.		375
Written down value on 31-3-2013	13,125	
Less depreciation for 2012-13 at 10 % p.a.		375
Written down value on 30-6-2013	12,750	
Less sale proceeds	12,000	
Loss on sale	750	

Check your Progress 2

Note: Use the space given below for your answers. You may use extra sheets for solving questions.

1) Define Depreciation.

2) Discuss the advantages of providing depreciation.

3) Explain the accounting treatment of providing depreciation.

2. DIMINISHING BALANCE METHOD

This method is also known as Fixed Percentage on Declining Base Method (or) Reducing Installment Method. Under this method depreciation is charged at fixed rate on the reducing balance (i.e., Cost less depreciation) every year. Accordingly the amount of depreciation gradually reduces every year. The depreciation charge in the initial period is high depreciation charge in the initial period is high and negligible amount in the later period of the asset. The following formula used for computing depreciation rate under Written-Down Value Method.

$$R = 1 - \left(\frac{S}{C} \right)^{\frac{1}{N}}$$

Where R = Rate of Depreciation

S = Estimated Scrap Value

N = Estimated Life of the Asset

C = Original Cost of the Machine or Asset

Advantages:

- a. It is simple to understand and easy to use.
- b. It provides for constant burden on profit and loss account for depreciation and repair charges throughout the life of assets, because the high depreciation is balanced

by low repairs in the earlier years and low depreciation balances high repairs required as the asset goes older.

c. Fresh calculation are not required if any additions are made in the subsequent year.

d. It is recognized by Income Tax Authorities.

Disadvantages:

- Like the Original Cost Method, this method also ignores interest on capital invested in the asset.
- In the subsequent years, original cost of the asset is altogether lost sight of and the asset can never be reduced to zero under this method. Some balance, though insignificant, remains in the Asset Account at the end of asset life.
- It is rather difficult to identify the individual asset if there are frequent additions. This method is very useful for plant and machinery where additions and extensions take place very often. This method will not be used for those assets whose value is to be reduced to zero, i.e., patents, etc. The journal entries in this method are similar to those under the first method.

Illustration 5: A company bought Machinery for Rs. 20,000 including therein a boiler worth Rs. 2,000. The Machinery Account had been credited for depreciation on the diminishing balance method for the past four years at the rate of 10% per annum. In the beginning of the fifth year, the boiler became useless on account of damage to some of its vital parts. The damaged boiler is sold for Rs. 400 which was credited to Machinery Account. The Machinery Account is to be adjusted by taking into consideration the loss on account of the damaged boiler. Prepare the Machinery account.

Solution: -

Machinery Account

Dr.

Cr.

Date	Particulars	Amount (Rs.)	Date	Particulars	Amount (Rs.)
1st Year Beg.	To Bank A/c	20,000	1st Year End	By Depreciation A/c By Balance c/d	2,000 18,000
		20,000			20,000
2nd Year Beg.	To Balance b/d	18,000	2nd Year End	By Depreciation A/c By Balance c/d	1,800 16,200
		18,000			18,000
3rd Year Beg.	To Balance b/d	16,200	3rd Year End	By Depreciation A/c By Balance c/d	1,620 14,580

			End		
		16,200			16,200
4 th Year Beg.	To Balance b/d	14,580	4 th Year End End	By Depreciation A/c By Balance c/d	1,458 13,122
		14,580			14,580
5 th Year Beg.	To Balance b/d	13,122	5 th Year Beg. Beg. End End	By Bank A/c By Profit and Loss A/c (Loss on sale) By Depreciation A/c By Balance c/d	400 912.20 1,181 10628.80
		13,122			13,122
6 th Year Beg.	To Balance b/d	10628.80			

Working Notes: -

1. Calculation of loss on sale of boiler

	Rs.
Original cost of the boiler	2,000
Less Depreciation at 10% for 1 st year	<u>200</u>
	1,800
Less Depreciation at 10% for 2 nd year	<u>180</u>
	1,620
Less Depreciation at 10% for 3 rd year	<u>162</u>
	1,458
Less Depreciation at 10% for 4 th year	<u>145.80</u>
Written Down Value at the beginning of fifth year	1,312.20
Less: Sale Proceeds	<u>400</u>
Loss on Sale	<u>912.20</u>

2. Calculation of Depreciation for the 5th year

Balance of Machinery Rs. 13,122. Written Down Value of boiler sold is Rs. 1,312.20

Therefore, Depreciation will be calculated on Rs. 11,809.80

(i.e. 13,122-1,312.20)@ 10% = 1,181

Illustration 6: - A company purchased a second hand machine on 1st January, 2007 for Rs. 3700 and immediately spent Rs. 300 on its repairs and erection. On 1st July, 2008, it purchased another machine for Rs. 1000 and on 1st July, 2009, it sold off the first machine purchased in 2007, at Rs. 2800. On the same date, it purchased Machinery for Rs. 2500. The second machinery purchased for Rs. 1000 was also sold off on 1st July, 2010 for Rs. 200.

Depreciation was provided on Machinery at the rate of 10% on the original cost annually on 31st December. In 2008, the company changed the method of providing depreciation and adopted the written down value method, the rate of depreciation being 15%.

Give the Machinery Account for four years commencing 1st January, 2007.

Solution: -

Machinery Account

Dr.			Cr.		
Date	Particulars	Amount (Rs.)	Date	Particulars	Amount (Rs.)
2007 Jan 1	To Bank A/c (Cost)	3700	2007 Dec 31	By Depreciation (on Rs. 4000 @ 10% for one year)	400
	To Bank A/c (expense)	300		By Balance c/d	3600
		4000			4000
2008 Jan 1	To Balance B/d	3600	2008 Dec 31	By Depreciation on Rs. 3600 @ 15% for one year 540 on Rs. 1000 @ 15% for 6 months 75	615
				By Balance c/d (a) 3060 (b) 925	3,985
		4600			4600
2009 Jan 1	To Balance b/d (a)Rs. 3060 (b)Rs. <u>925</u>	3985	2009 July 1	By Bank (Sale)	2800
		2500	July 1	By Depreciation (15% on Rs. 3,060 for 6 months)	229.5
July 1	To Bank		July 1	By Profit & Loss A/c (loss on sale)	30.5
			July 1	By depreciation 15% on rs. 925 for 1 year 1,388 15% on Rs. 2500 for ½ year <u>187.5</u>	326.3
				By Balance c/d (a) Rs. 786.2 (b) Rs. <u>2312.5</u>	3098.7
		6485			6485
2010 Jan 1	To Balance b/d (a) Rs. 786.2		2010 July 1	By Bank (Sale)	200
			July 1	By Depreciation	59

	(b) Rs. <u>2312.5</u>	3098.7	July 31 Dec 31 Dec31	(15% on Rs. 786.2 for 6 months) By Profit & Loss A/c(loss on sale) By Depreciation (15% on Rs. 2312.5 for 1year) By Balance c/d	527.2 346.9 1965.6
		3098.7			3098.7
2011 Jan 1	To Balance b/d	1965.6			

Working Notes: -

1. Loss on Sale of machinery

Rs.	
W.D.V. on Jan 1 st , 2009	3060
Less: - Depreciation for 2009 (half year) at 15%	<u>229.5</u>
	2830.5
Less: - Sale proceeds	<u>2800</u>
Loss on Sale	<u>30.5</u>

2. Loss on Sale of Second machinery

Rs.	
W.D.V. on Jan 1 st , 2010	786.2
Less: - Depreciation for 2010 (half year) at 15%	<u>59</u>
	727.2
Less: - Sale proceeds	<u>200</u>
Loss on Sale	<u>527.2</u>

Comparative study of Straight Line Method and Written Down Method: -

Both Straight line and written down value methods are generally used for calculating depreciation amount. Following are the points of differences between these two methods: -

Basis of Difference	Straight Line Method	Written Down Value Method
1. Basis of charging depreciation	Depreciation is charged on Original cost.	Depreciation is charged on Book Value (i.e. original cost less depreciation charged till date).
2. Annual charge	It remains fixed (Constant) every year.	It declines year after year.

3. Total charge against profit and loss account in respect of depreciation and repairs	It is unequal year after year. It increases in later years.	It is almost equal every year.
4. Recognition by income tax law	It is not recognized.	It is recognized.
5. Suitability	It is suitable for assets in which repair charges are less, obsolescence is low, scrap value depends upon the time period involved.	It is suitable for assets, which are affected by technological changes and require more repair expenses with passage of time.

3. ANNUITY METHOD

This method is most suitable for a firm where capital is invested in the least hold properties. Under this method, while calculating the amount of depreciation, a fixed amount of depreciation is charged for every year of the estimated useful life of the asset in such a way that at a fixed rate of interest is calculated on the same amount had been invested in some other form of capital investment. In other words, depreciation is charged for every year refers to interest losing or reduction in the original cost of the fixed assets. Under the annuity method where the loss of interest is due to the investment made in the form of an asset is considered while calculating the depreciation. The amount of depreciation is calculated with the help of an Annuity Table.

Advantages

1. It is a scientific method.
2. It treats the purchase of an asset as an investment in the business itself and charges interest on the same.

Disadvantages

1. Additions to the asset are sure to throw out the calculations already made.
2. No funds are available at the end for replacement of the asset.
3. The total charge of depreciation and repairs put together does not remain fairly uniform from year to year.
4. Rate of interest is arbitrary.

Suitability

This method is mainly used in case of costly leases of long periods and other assets to which additions are not usually made and as such, in case of machinery, this method is not found suitable.

Accounting Entries: -

1. On Purchase of the asset

Asset Account Dr.

 To Bank Account

2. For Interest

 Asset Account Dr.

 To Interest Account

3. For Depreciation

 Depreciation A/c Dr.

 To Asset A/c

4. For closing Depreciation A/c

 Profit & Loss A/c Dr.

 To Depreciation A/c

5. For closing interest A/c

Interest A/c Dr.

 To Profit & Loss A/c

Points to be noted: -

1. At the end of asset's life, its balance must be zero.
2. If in a particular problem, the amount of depreciation is already given, no reference to annuity table is required.
3. Interest for the last year shall be the balancing figure.

Illustration 7: -

A firm purchases a lease for 5 years for Rs. 20,000. It decides to write off depreciation on the Annuity Method charging the rate of interest at 5% per annum. The annuity table shows that annual amount necessary to write off Re.1 for 5years at 5% is 0.230975.

Solution:

Lease Account

Dr.

Cr.

Particulars	Amount (Rs.)	Particulars	Amount (Rs.)
To Cash A/c	20,000	By Depreciation	4,619.50
To Interest A/c	1,000	By Balance c/d	16,380.5
	21,000		21,000
To Balance b/d	16,380.5	By Depreciation	4,619.50
To Interest A/c	819.025	By Balance c/d	12,580.025

	17,199.525		17,199.525
To Balance b/d	12,580.025	By Depreciation	4,619.50
To Interest A/c	629	By Balance c/d	8,589.525
	13,209.025		13,209.025
To Balance b/d	8,589.525	By Depreciation	4,619.50
To Interest A/c	429.475	By Balance c/d	4,399.5
	9019		9019
To Balance b/d	4,399.5	By Depreciation	4,619.50
To Interest A/c	220		
	4,619.5		4,619.50

4. THE SUM OF THE (YEARS) DIGITS METHOD

This method also termed as SYD Method. The Sum of years Digits Method is designed on the basis of Written-Down Value Method. Under this method the amount of depreciation to be charged to the Profit and Loss Account goes on decreasing every year throughout the life of the asset. The formula for calculating the amount of depreciation is as follows:

$$\text{Rate of Depreciation} = \frac{\text{Remaining Life of the Asset (Including current year)}}{\text{Sum of all the digits of the life of the assets in years}} \times \text{Original Cost of the Asset}$$

Illustration 8:-

A machine was purchased for a sum of Rs. 2000 having useful life of 3 years. From the above particulars, you are required to calculate depreciation under Sum of Years Digits Method.

Solution:

Calculation of Depreciation Under SYD Method :

$$\text{Rate of Depreciation} = \frac{\text{Remaining Life of the Asset (Including current year)}}{\text{Sum of all the digits of the life of the assets in years}} \times \text{Original Cost of the Asset}$$

$$\begin{aligned} \text{I Year} &= \frac{3}{1+2+3} \times \text{Rs. 2000} \\ &= \frac{3}{6} \times \text{Rs. 2000} = \text{Rs. 1000} \end{aligned}$$

$$\begin{aligned} \text{II Year} &= \frac{2}{6} \times \text{Rs. 2000} = \text{Rs. 666.7} \end{aligned}$$

$$\text{III Year} = \frac{1}{6} \text{ Rs. 2000} = \text{Rs. 333.33}$$

5. DEPRECIATION FUND METHOD

It is also called Sinking Fund Method. Like the Annuity Method, the amount of depreciation is charged with the help of Sinking Fund Table. Under this method an amount equal to the amount written off as depreciation is invested in outside securities in order to facilitate to replace the asset at the expiry useful life of the asset. In other words, the amount of depreciation charged is debited to depreciation account and an equal amount is credited to Sinking Fund Account. At the estimated expiry useful life of the asset, the amount of depreciation each year is invested in easily realizable securities which can be readily available for the replacement of the asset.

Journal Entries Under this Method: The following are the journal entries recorded under this method: -

First Year

(1) When the asset is purchased:

Asset Account Dr.

To Bank Account

(2) For Providing depreciation at the end of first year:

Depreciation Account Dr.

To Sinking Fund Account

(3) For investing the amount:

Sinking Fund Investment Account Dr.

To Bank Account

Subsequent Years

(1) For Receipt of Interest on Investment:

Bank Account Dr.

To Sinking Fund Account

(2) For Transferring Interest to Sinking Fund:

Interest on Sinking Fund Account Dr.

To Sinking Fund Account

(3) For Providing Depreciation:

Depreciation Account Dr.

To Sinking Fund Account

(4) For Investing the Amount:

Sinking Fund Investment Account Dr.

To Bank Account

Last Years

(1) For Receipt of Interest on Investment:

Bank Account Dr.

To Sinking Fund Account

(2) For Transferring Interest to Sinking Fund Account:

Interest on Sinking Fund Account Dr.

To Sinking Fund Account

(3) For Providing Depreciation:

Depreciation Account Dr.

To Sinking Fund Investment Account

(4) For Sale of Investment:

Bank Account Dr.

To Sinking Fund Investment Account

(5) For Transferring Profit and Sale of Investment:

Sinking Fund Investment Account Dr.

To Sinking Fund Account

(6) For Transferring Loss on Sale of Investment:

Sinking Fund Account Dr.

To Sinking Fund Investment Account

(7) For Closing the Asset Account by Transferring Balance of Sinking Fund Account to Asset Account:

Sinking Fund Account Dr.

To Asset Account

Illustration 9:

A company purchased a machinery on January 1 2008 for a sum of Rs. 3,00,000 for a useful life of 5 years. It is decided to provide for the replacement of machinery at the end of 5 years by setting up a depreciation fund. It is expected that the investment will fetch interest at 5%. Sinking fund table shows that Re.0.180975 if invested yearly at 5% p.a. produces Re. 1 at the end of 5th year. It is also estimated that the machinery will have a scrap value of Rs. 48,000. On 31 December 2012, the investment was sold for Rs. 195,000. On 1 January 2014, the new machinery was purchased for Rs. 3,60,000. The scrap of the old machinery realizes Rs. 51,000. Show the Journal entries and give the machinery account, depreciation fund account; depreciation fund investment account and the new machinery account.

Solution:

The amount to be charged to the profit and loss A/c has been arrived as follows:

Rs.

Original Cost of the Machinery	3,00,000
Less : Estimated Scrap Value	<u>48,000</u>
Depreciation on the plant for its whole life	<u>252,000</u>

The amount to be charged to the Profit and Loss A/c = Rs. 252,000 x 0.180975

= Rs. 45,605.70 (or)

= Rs. 45,606

Illustration 10

Mr. Sonu brought a plant on 1.1.2011 for a sum of Rs. 4,00,000 having useful life of 3 years. The estimated Scrap Value of machine is Rs. 40,000. Depreciation is calculated on the basis of Sinking Fund Method. The Sinking Fund Investments are expected to earn interest @ 5 % P.A. Sinking Fund Table shows that Re. 0.317208 if invested yearly at 5% P.A. produces Re.1 at the end of 3 years. The investments are sold at the end of 3rd year for a sum of Rs. 3,00,000. A new plant is purchased for Rs. 4,60,000 on 1.1.2014. The scrap of the old Plant sold for Rs. 30,000, you are required to prepare the necessary accounts in the books of Jacky.

Solution: -

Dr. Plant A/c			Cr.		
Date	Particulars	Amount (Rs.)	Date	Particulars	Amount (Rs.)
2011 Jan.1	To Bank A/c	4,00,000	2011 Dec. 31	By Balance c/d	4,00,000
		4,00,000			4,00,000
2012 Jan. 1	To Balance b/d	4,00,000	2012 Dec. 31	By Balance c/d	4,00,000
		4,00,000			4,00,000
2013 Jan. 1	To Balance b/d	4,00,000	2013 Dec. 31	By Depreciation Fund A/c	3,00,000
				By Bank A/c (scrap sold)	30,000
				By Profit & Loss A/c (Loss)	70,000
		4,00,000			4,00,000

Dr. New Plant A/c			Cr.		
Date	Particulars	Amount (Rs.)	Date	Particulars	Amount (Rs.)
2014 Jan.1	To Bank A/c	4,60,000			

Dr. Sinking Fund A/c			Cr.		
Date	Particulars	Amount (Rs.)	Date	Particulars	Amount (Rs.)
2011 Dec. 31	To Balance c/d	1,14,194	2011 Dec. 31	By Profit & Loss A/c	1,14,194
		1,14,194			1,14,194
2012 Jan. 1	To Balance c/d	2,34,098	2012 Jan 1 Dec. 31	By Balance c/d	1,14,194
				By Bank (Interest 5%)	5,710
				By Profit & Loss A/c	1,14,194
		2,34,098	Dec. 31		2,34,098
2013 Dec. 31	To Depreciation Fund Investment A/c (loss on sale of investment)	60,000	2013 Jan 1 Dec. 31	By Balance b/d	2,34,098
	To Plant A/c (Accumulated Depreciation)	3,00,000		By Bank (Interest 5%)	11,708
				By Profit & Loss A/c	1,14,194

		3,60,000			3,60,000
--	--	----------	--	--	----------

Dr. Sinking Fund Investment A/c			Cr.		
Date	Particulars	Amount (Rs.)	Date	Particulars	Amount (Rs.)
2011 Dec. 31	To Bank A/c	1,14,194	2011 Dec. 31	By Balance c/d	1,14,194
2012		1,14,194			1,14,194
Jan. 1 Dec. 31	To Balance b/d To Bank A/c (114194+5710)	1,14,194 1,19,904	2012 Dec. 31	By Balance c/d	2,34,098
		2,34,098			2,34,098
2013 Jan 1 Dec. 31	To Balance b/d To Bank A/c (114194+ 11708)	2,34,098 1,25,902	2013 Dec. 31 Dec. 31	By Bank A/c By Depreciation Fund A/c (Loss on sale of Investment)	3,00,000 60,000
		3,60,000			3,60,000

Working Notes

The amount charged to the Profit and Loss Account calculated is as follows:

	Rs.
Original cost of the plant	4,00,000
Less: Estimated Scrap Value	<u>40,000</u>
Depreciation on the plant for its whole life	<u>3,60,000</u>

The amount charged to the Profit and Loss Account = 3,60,000 * 0.317208
= Rs. 1,14,194.88

6. INSURANCE POLICY METHOD

Under this method an asset to be replaced by taking required amount of insurance policy from an Insurance Company. A fixed premium is paid which is equal to the amount of depreciation for every year. At the end of the agreed sum, i.e., on the maturity of the policy, the amount will be used for replacing the existing assets.

The most important feature of this method is that it endeavours the supply of required cash at the retirement of a specified asset and the asset is also insured. At maturity the insurance company pays the policy money which is normally sufficient to replace the old asset.

Advantages

1. The difficulty of purchasing investment and reinvesting the interest received is done away with, since it is a major problem with the Depreciation Fund Method.
2. There are no chances of a fall in the value of insurance policy at its maturity.

3. The asset is fully insured under this method.
4. It is simple to understand.

Disadvantages

1. There is an unbalanced burden on Profit & Loss Account of constant depreciation and increasing repairs year after year.
2. There are no chances of realizing additional amount of profit as it is in the case of Depreciation Fund Method when the investments are sold.

This method is adopted in those cases where Depreciation Fund Method can be used.

Accounting Entries

First Year and Subsequent Years

<i>(1) When Premium paid in the beginning of the year:</i>			
Depreciation Insurance Policy Account	Dr.	. * * *	
To Bank Account			* * *
<i>(2) When Depreciation provided at the end of the year:</i>			
Profit and Loss Account	Dr.	. * * *	
To Depreciation Reserve Account			* * *

In the Last Year (In addition to above two entries):

<i>(3) When Policy amount received from Insurance Company:</i>			
Bank Account	Dr.	. * * *	
To Depreciation Insurance Policy Account			* * *
<i>(4) When Profit is made on Policy:</i>			
Depreciation Insurance Policy Account	Dr.	. * * *	
To Depreciation Reserve Account			* * *
<i>(5) When Closing down of Old Asset:</i>			
Depreciation Reserve Account	Dr.	. * * *	
To Old Asset Account			* * *
<i>(6) When Purchase of New Asset:</i>			
New Asset Account	Dr.	. * * *	
To Bank Account			* * *

Illustration 11:

On 1st Jan. 2011 Portugo & Co. Purchases a lease for three years on payment of Rs. 2,00,000. And it is decided to make provision for its replacement by means of an insurance policy for Rs. 2,00,000. The annual premium is Rs. 60,000. On 1st Jan. 2014, the lease is renewed for further period of 3 years for Rs. 2,00,000. You are required to prepare the necessary ledger account.

Solution: -

Lease Account

Dr.			Cr.		
Date	Particulars	Amount (Rs.)	Date	Particulars	Amount (Rs.)
2011 Jan 1	To Bank A/c		2011 Dec	By Balance c/d	2,00,000

		2,00,000	31		
		2,00,000			2,00,000
2012			2012		
Jan 1	To Balance b/d	2,00,000	Dec 31	By Balance c/d	2,00,000
		2,00,000			2,00,000
2013			2013		
Jan 1	To Balance b/d	2,00,000	Dec 31	By Depreciation (Reserve A/c)	2,00,000
		2,00,000			2,00,000

Depreciation Reserve Account

Dr.			Cr.		
Date	Particulars	Amount (Rs.)	Date	Particulars	Amount (Rs.)
2011 Dec 31	To Balance c/d	60,000	2011 Dec 31	By Profit & Loss A/c	60,000
		60,000			60,000
2012 Dec 31	To Balance c/d	1,20,000	2012 Jan 1 Dec 31	By Balance b/d By Profit & Loss A/c	60,000 60,000
		1,20,000			1,20,000
2013 Jan 1	To Lease A/c	2,00,000	2013 Jan 1 Dec 31 Dec 31	By Balance b/d By Profit & Loss A/c By Depreciation Insurance Policy A/c	1,20,000 60,000 20,000
		2,00,000			2,00,000

Lease Account

Dr.			Cr.		
Date	Particulars	Amount (Rs.)	Date	Particulars	Amount (Rs.)
2011 Jan 1	To Bank Premium A/c	60,000	2011 Dec 31	By Balance c/d	60,000

		60,000			60,000
2012			2012		
Jan 1	To Balance b/d	60,000	Dec	By Balance c/d	1,20,000
Jan 1	To Bank Premium A/c	60,000	31		
		1,20,000			1,20,000
2013			2013		
Jan 1	To Balance b/d	1,20,000	Dec	By Bank A/c	2,00,000
Jan 1	To Bank Premium A/c	60,000	31		
Dec	To Depreciation				
31	Reserve A/c	20,000			
	(Profit Transferred)				
		2,00,000			2,00,000

Lease (New) Account

Dr.			Cr.		
Date	Particulars	Amount (Rs.)	Date	Particulars	Amount (Rs.)
2011 Jan 1	To Bank A/c	2,00,000			

Check your Progress 2

Note: Use the space given below for your answers. You may use extra sheets for solving questions.

1) Discuss the advantages and disadvantages of straight line method.

2) Examine the suitability of Annuity Method.

3) Explain the sum of the digit method.

7. REVALUATION METHOD

This method is specially designed to revalue the assets whose life span cannot be estimated correctly like in the case of livestock, loose tools, patents, bottles, corks, packages, trademarks, cutlery, crockery etc. This method is also termed as Appraisal Method. The calculation of depreciation of these assets is valued at the end of the accounting year. The difference between the value as per the last balance sheet and the present estimated value represents depreciation. In case, the present estimated value of an asset is more than the value as per the last balance sheet, the difference would be treated as appreciation. The depreciation of assets revalued will be debited to Profit & Loss A/c and credited to Asset A/c. It is very simple method.

This method provides a different amount of depreciation chargeable to Profit & Loss A/c each year and moreover, the revaluation of assets is based on market value and not on the cost price which is against the basic principles of depreciation.

Illustration 12: A firm had purchased loose tools costing Rs. 62500 on 1st April, 2011. The tools were independently valued at the end of every year and the values placed on them were as under:-

31 st December, 2011	Rs. 60000
31 st December, 2012	Rs. 50000
31 st December, 2013	Rs. 42500
31 st December, 2014	Rs. 32500

Find out the amount of depreciation for each year.

Solution: -

2011 = Rs. (62500 – 60000) = Rs. 2500
2012 = Rs. (60000 – 50000) = Rs. 10000
2013 = Rs. (50000 – 42500) = Rs. 7500
2014 = Rs. (42500 – 32500) = Rs. 10000

Illustration 13:

From the following particulars you are required to calculate depreciation of Loose Tools under Revaluation Method and Prepare a Loose Tools Account. The Loose Tool is estimated as follows :

	<u>2011</u>	<u>2012</u>	<u>2013</u>
Loose Tools 1st Jan.	25,000	6,000	12,000
Loose Tools revalued on 31 Dec.	12,500	16,000	20,000

Solution: -

Loose Tools Account

Dr.				Cr.	
Date	Particulars	Amount (Rs.)	Date	Particulars	Amount (Rs.)

2011 Jan 1	To Bank A/c	25,000	2011 Dec 31	By Depreciation (Balancing figure)	12,500
			Dec 31	By Balance c/d	12,500
		25,000			25,000
2012 Jan 1	To Balance b/d	12,500	2012 Dec 31	By Depreciation (Balancing figure)	2,500
	To Bank A/c	6,000	Dec 31	By Balance c/d	16,000
		18,500			18,500
2013 Jan 1	To Balance b/d	16,000	2013 Dec 31	By Depreciation (Balancing figure)	8,000
	To Bank A/c	12,000	Dec 31	By Balance c/d	20,000
		28,000			28,000
2014 Jan 1	To Balance b/d	20,000			

8. MACHINE HOUR RATE METHOD

This method is similar to the Depletion Method but instead of taking estimated available quantities in advance, the working life of the machine is estimated in terms of hours.

Hourly depreciation = $\frac{\text{Original cost of the machine} - \text{Scrap value}}{\text{Estimated total hours of machine life}}$

This is the charge for depreciation on that machine during the year. Special characteristic of this method is that the life of the machine is calculated in hours for which it will be used, not in years.

Illustration 14:

A machine was purchased on 1st Jan. 2011 at a cost of Rs. 3,00,000, the cost of installation being Rs. 20,000. The estimated working life of the machine was 80,000 hours. During 2011 it was worked for 10,000 hours and during 2012 for 20,000 hours. You are required to prepare Machine Account for the above said years.

Solution:

Calculation of Machine Hour Rate :

Machine Hour Rate = $\frac{\text{Cost of the Machine}}{\text{Estimated Total Hours of Life}}$

$$= \frac{\text{Rs. 3,00,000} + \text{Rs. 20,000}}{\text{Rs. 80,000}}$$

$$= \frac{\text{Rs. } 3,20,000}{\text{Rs. } 80,000}$$

= Rs. 4 Per hour.

Machinery Account

Dr.			Cr.		
Date	Particulars	Amount (Rs.)	Date	Particulars	Amount (Rs.)
2011 Jan 1	To Bank A/c (Rs. 3,00,000 + 20,000)	3,20,000	2011 Dec 31	By Depreciation (10000 hours x Rs.4)	40,000
			Dec 31	By Balance c/d	2,80,000
		3,20,000			3,20,000
2012 Jan 1	To Balance b/d	2,80,000	2012 Dec 31	By Depreciation (20,000 hrs x Rs.4)	80,000
			Dec 31	By Balance c/d	2,00,000
		2,80,000			2,80,000
2013 Jan 1	To Balance b/d	2,00,000			

9. MILEAGE METHOD

This method is used only for those assets useful life of which depends upon the fact as to how many kilometers they have covered E.g. Trucks, Buses, Motor-cars etc. The depreciation of such assets depends upon the number of kilometres covered by them during a given period.

Original Cost of the asset

Depreciation per kilometre = $\frac{\text{Original Cost of the asset}}{\text{Estimated life of the vehicle in kilometres}}$

The Depreciation for one kilometre is multiplied by the number of kilometres of one year for which the vehicle has been driven and thus depreciated for one year is computed. E.g. a truck costing rs. 60,000 was purchased and its useful life was estimated to be 2,40,000 kms.

The rate of depreciation = $\frac{\text{Rs. } 60,000}{2,40,000 \text{ kms.}} = \text{Re. } 0.25 \text{ per km.}$

And suppose during the year it operates for 50,000 kms, the amount of depreciation for the year will be 50,000* Re. 0.25 = Rs. 12,500.

10. DEPLETION METHOD

Depletion Method is mostly used for natural resources such as mines, quarries, oil and gas etc. from which certain quantity of the resources can be obtained on the basis of the

availability of minerals. The quantity of output exhaust to reaches a stage of depletion. Under this method, an estimate is made about the total quantity of the natural resources and then the depreciation is found in the following manner:

Dereciation = Original Cost * Output in tons of one year

Estimated life in terms of production units

The cost of natural resources is the price paid for its acquisition, plus price paid for development of such asset so that it is made suitable for production.

Illustration 15: Shikha bought a mine for Rs. 1,00,000. Its scrap value is Rs. 10,000 and its working life is 9 years. 1,80,000 units were expected to be produced during its working life. 10,000 units in the first, 25,000 units in the second and 50,000 units in the third year were produced. Find out the amount of depreciation for 1st year, 2nd year and 3rd year.

Solution: -

$$\begin{aligned}\text{Depreciation per unit} &= \frac{1,00,000 - 10,000}{1,80,000} \\ &= \text{Re. } 0.50\end{aligned}$$

Depreciation for different years: -

Year	Output in units	Depreciation
1 st	10,000	10,000 * Re.0.5 = Rs. 5,000
2 nd	25,000	25,000 * Re. 0.5= Rs. 12,500
3 rd	50,000	50,000 * Re. 0.5= Rs. 25,000

11.8 DEPRECIATION OF VARIOUS ASSETS

The following recommendations are made, in brief, for dealing with depreciation of various types of fixed assets: -

- Goodwill:** - Generally, no depreciation arises unless the firm's profits are decreasing. Prudent firms try to write off goodwill over a number of years. The amount written off should be shown separately in the Profit & Loss A/c.
- Freehold Land:** - In this case also no depreciation arises. Amounts written off should be shown separately.
- Freehold Buildings, Plant & Machinery, Ships etc.** Either of the straight line method and reducing installment method may be adopted as long as the asset is written off during its effective life.
- Leasehold Lands and Buildings:** - The straight line method, to write off the asset together with its cost of dilapidation (if any) within its life, is the most suitable method to follow.
In case of (c) & (d) above, the depreciation method providing funds for replacement can be profitably used.
- Loose Tools, Jigs and Patterns:** - Depreciation should be calculated by the Revaluation method.
- Patents, trade Marks, etc.:-** There is maximum legal life of such assets but the commercial life (during which such assets can be effectively exploited) may even be shorter. The asset should be depreciated by the straight line method so that it is written off within the legal or commercial life whichever is shorter.

- (g) Mines, Oil wells, Quarries, etc.: - The depreciation should be calculated by the depletion method, though traditionally no depreciation is allowed on such assets by taxation authorities.

11.9 LET US SUM UP

The method of providing depreciation on a particular asset should be consistent from year to year. If no depreciation has been charged in a particular year, the fact should be stated in the Balance sheet and the Profit & Loss A/c. If the method of charging depreciation is changed, the fact should be disclosed, together with the amount of the depreciation that should have been charged, had the old system been followed. Further, if adjustment is made for previous years also, the amount involved should be debited or credited separately in the Profit and Loss A/c, preferably in the appropriation section.

11.10 KEY WORDS

Depreciation: Depreciation is the gradual and permanent decrease in the value of an asset from any cause.

Diminishing Balance Method: Under this method depreciation is charged at fixed rate on the reducing balance (i.e., Cost less depreciation) every year. Accordingly the amount of depreciation gradually reduces every year.

11.11 QUESTIONS

Short Answer Questions

- 1) Define depreciation. State its advantages and disadvantages.
- 2) What are the various factors that effect depreciation?
- 3) Differentiate the straight line method and written down method of providing depreciation by assuming a suitable example.

Long answer questions

1. On April 01, 2010, Mission Plywood purchased a Machine for Rs. 4,80,000 and spent Rs. 20,000 on its carriage and Rs. 20,000 on its installation. It is estimated that its working life is 10 years and after 10 years its scrap value will be Rs. 10,000.
 - (a) Prepare Machine account and Depreciation account for the first four years by providing depreciation on straight line method. Accounts are closed on March 31st every year.
 - (b) Prepare Machine account, Depreciation account and Provision for depreciation account (or accumulated depreciation account) for the first four years by providing depreciation using straight line method accounts are closed on March 31 every year.
2. On July 01, 2010, Raman Purchased a Machine for Rs. 4,00,000 and spent Rs. 12,000 on its installation. At the time of purchase it was estimated that the effective commercial life of the machine will be 10 years and after 12 years its salvage value will be Rs. 12,000.

Prepare machine account and depreciation Account in the books of Raman for first three years, if depreciation is written off according to straight line method. The account are closed on December 31st, every year.

3. Shekhar Purchased a second hand machine for Rs. 60,000 on December 01, 2011 and spent Rs. 10,000 on its overhaul and installation before putting it to operation. It is expected that the machine can be sold for Rs. 8,000 at the end of its useful life of 15 years. Moreover an estimated cost of Rs. 5,000 is expected to be incurred to recover the salvage value of Rs. 6,000. Prepare machine account and Provision for depreciation account for the first three years charging depreciation by fixed installment Method. Accounts are closed on December 31, every year.

4. Neelam Purchased a second hand machine for Rs. 28,000 on July 01, 2011 and spent Rs. 10,000 on its repair and installation and Rs. 3,000 for its carriage. On September 01, 2012, it purchased another machine for Rs. 5,50,000 and spent Rs. 10,000 on its installation.

(a) Depreciation is provided on machinery @10% p.a on original cost method annually on December 31. Prepare machinery account and depreciation account from the year 2011 to 2014.

(b) Prepare machinery account and depreciation account from the year 2011 to 2014, if depreciation is provided on machinery @10% p.a. on written down value method annually on December 31.

5. Shelly purchased a machinery on January 01, 2011 for Rs. 3,50,000 and spent Rs. 20,000 on its installation. On September 01, 2011 it purchased another machine for Rs. 1,70,000. On May 01, 2002 it purchased another machine for Rs. 8,00,000 (including installation expenses).

Depreciation was provided on machinery @10% p.a. on original cost method annually on December 31. Prepare:

(a) Machinery account and depreciation account for the years 2011to 2014.

(b) If depreciation is accumulated in provision for Depreciation account then prepare machine account and provision for depreciation account for the years 2011to 2014.

6. Rekha & Sons purchased a machine for Rs. 2,00,000 on 1" Jan. 2010. The estimated useful life at 3 years with a Scrap Value Rs. 20,000. You are required to calculate depreciation charged from Profit and Loss Account by Sinking Fund Method. The Sinking Fund Table shows that 0.317208 at 5% P.A. will be in 3 years accumulate to Re.1.

[Ans : Depreciation Rs. 57097.44]

11.12 REFERENCES AND SUGGESTED BOOKS

Mukherjee, A. and Hanif, M. (2003), *Financial Accounting*, Tata Mc. Graw Hill, New Delhi.

Subhash Chandra Das (2013),*Business Accounting and Financial Management*, PHI Learning Pvt. Ltd., New Delhi.

Singhal, RK (2012), *Financial Accounting*, VK Enterprises, New Delhi.

Activity 1

What are need for providing Depreciation?

Activity 2

Explain the methods for providing Depreciation.

LESSON 12

PROVISION AND RESERVES

Structure

- 12.0 Objectives
- 12.1 Introduction
- 12.2 Provision
- 12.3 Accounting Treatment of Provision
- 12.4 Reserves
- 12.5 Secret Reserves
- 12.6 Difference between provision and Reserves
- 12.7 Let Us Sum Up
- 12.8 Key Words
- 12.9 Questions
- 12.10 References and Suggested Readings

12.0 OBJECTIVES

After studying this chapter, you will be able to: -

- Understand the terms 'Provision' and 'Reserves' and difference between them
- Discuss the different types of 'Provisions' and 'Reserves' and the accounting thereof
- Understand the importance of reserves

12.1 INTRODUCTION

In the previous lesson we had discussed about depreciation accounting and this lesson deals with another very important concept i.e. Provisions and Reserves. Normally in business firms, many expected and unexpected eventualities occur, which are supposed to be taken care of well in time in order to conduct the business operations smoothly. Here comes the role of provisions and reserves. Provisions and reserves are created at the time of the preparation of financial statements.

Basically provision in accounting refers to money written off to cover possible depreciation of assets and other liabilities. Such write-offs also cover the expected losses and contingencies of a firm. On the other hand 'reserves' refers to the amount of

money that remains after provisions and other fees have been deducted from the budget. Such money typically belongs to the business owners.

12.2 INTRODUCTION TO PROVISION

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.

It becomes important to create provision of the expenses those which are not known with certainty. Many a times it happens that in normal business working, certain expenses/losses which are related to the current accounting period but amount of which is not known with certainty because they are not yet incurred. The provision is created so that true profits can be calculated.

For example, a trader who sells on credit basis knows that some of the debtors of the current period would default and would not pay or would pay only partially. It is necessary to take into account such an expected loss while calculating true and fair profit/loss according to the principle of Prudence or Conservatism. Therefore, the trader creates a Provision for Doubtful Debts to take care of expected loss at the time of realisation from debtors. Similarly when it is known that the assets which a business firm uses will be depreciated due to wear and tear or other reasons, a provision becomes a must so as to arrive at the true value of the asset as well as to calculate true profits. In a similar way, provision for repairs and renewals may also be created to provide for expected repair and renewal of the fixed assets.

Examples of provisions are:

- Provision for depreciation;
- Provision for bad and doubtful debts;
- Provision for taxation;
- Provision for discount on debtors; and
- Provision for repairs and renewals.

Creation of provision ensures proper matching of revenue and expenses and hence the calculation of true profits. Provisions are created by debiting the profit and loss account. The amount of provision for expense and loss must be charged against the revenue of the respective current period only. In the balance sheet, the amount of provision may be shown either: (a) by way of deduction from the concerned asset on the assets side. For example, provision for doubtful debts is shown as deduction from the amount of sundry debtors and provision for depreciation as a deduction from the concerned fixed assets; or (b) On the liabilities side of the balance sheet along with current liabilities, for example provision for taxes and provision for repairs and renewals.

12.3 ACCOUNTING TREATMENT FOR PROVISION

As stated earlier the provision is to be charged in the books in the same year in which it is created. This section deals with the accounting treatment of the provisions.

The accounting treatment of all types of provisions is almost similar. Therefore, the accounting treatment is explained here taking up the case of provision for doubtful debts. As already stated that when business transaction takes place on credit basis, debtors account is created and its balance is shown on the asset-side of the balance sheet. These 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 given is a certain loss.
- Doubtful Debts are those debtors who may pay but business firm is not sure about the collection of full amount from them. As a matter of business experience, some percentage of such debtors is not likely to pay, hence treated as doubtful debts. To consider this possible loss on account of non-payment by some debtors, it is a common practice (and necessary also) to make a suitable provision for doubtful debts at the time of ascertaining true profit or loss.

The provision for doubtful debts is usually calculated as a certain percentage of the total amount due from sundry debtors after deducting/writing-off all known bad debts. Provision for doubtful debts is also called 'Provision for bad and doubtful debts'. It is created by debiting the amount of required provision to the profit and loss account and crediting it to provision for doubtful debts account.

For creating a provision for doubtful debts the following journal entry is recorded:

Profit and Loss A/c----- Dr. (with the amount of provision)
To 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 outstanding 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:

For writing off further bad debts given outside the trial balance:

Bad Debts A/c-----Dr.

To Sundry Debtors A/c

For transferring the total bad debts to the provision for Bad Debts Account:

Provision for Doubtful Debts A/c-----Dr.

To Bad Debts A/c

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.

To Provision for Doubtful Debts A/c

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.

To Profit and Loss A/c

Illustration 1

Following figures are extracted from the trial balance as on 31 December 2014:

Name of the Account	Debit Amount (Rs.)	Credit Amount (Rs.)
Sundry Debtors	1,60,000	
Bad Debts	8,000	
Provision of Bad Debts		14,000

Additional Information:

- Bad Debts proved bad but not recorded amounted to Rs. 10,000
- Provision to be maintained at 10% of Debtors.

Prepare necessary accounting entries for writing off the bad debts and creating the provision for doubtful debts account.

Solution

Journal

Date	Particulars	L.F.	Debit Amount (Rs.)	Credit Amount (Rs.)
2014				
Dec 31	Bad debts A/c----- Dr. To Sundry debtors A/c (Being bad debts written off)		10,000	10,000
Dec 31	Provision for Doubtful Debts A/c----- Dr. To Bad Debts A/c (Being bad debts transferred to provision for doubtful debts account)		18,000	18,000
Dec 31	Profit & Loss A/c ----- Dr. To Provision for doubtful debts A/c (Being short-fall charged and provision for doubtful debts)		19,000	19,000
	TOTAL		47,000	47,000

Dr. Bad Debts A/c Cr.

Date	Particulars	J.F.	Amount	Date	Particulars	J.F.	Amount
2014				2014			
Dec 31	To Balance c/d		8,000	Dec 31	By Provision for Bad & Doubtful Debts A/c		10,000
Dec 31	To Sundry Debtors A/c		10,000				
			10,000				10,000

Dr. Provision for Bad & Doubtful Debts A/c Cr.

Date	Particulars	J.F.	Amount	Date	Particulars	J.F.	Amount
2014				2014			
Dec 31	To Bad Debts A/c		18,000	Jan 1	By Balance b/d		14,000
Dec 31	To Balance c/d		15,000	Dec	By Profit and		19,000

				31	Loss A/c		
			33,000				33,000

Profit & Loss A/c
for the year ended 31st December, 2014

Dr.

Cr.

Date	Particulars	J.F.	Amount	Date	Particulars	J.F.	Amount
	To Provision for Bad & Doubtful Debts A/c		19,000				

Balance Sheet
as at 31st December, 2014

Liability	Amount (Rs.)	Amount	Amount (Rs.)
		Sundry Debtors 1,60,000	
		Less: - Bad debts <u>10,000</u>	
		1,50,000	
		Less: - Provision for	
		Bad & Doubtful Debts 15,000	1,35,000

Working Notes

Provision for Doubtful Debts required to be maintained $1,50,000 \times 10\% = 15,000$

Add: Short fall of the current provision:

Opening Balance 14,000
Less Bad Debts (18,000) 4,000
Total Provision Required = 19,000

Illustration 2

Let us take another example. Following figures are extracted from the trial balance of Shivani Associates as on March 31, 2014 is given below:

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

	Sundry Debtors		1,00,000	
--	----------------	--	----------	--

Additional Information

- Bad debts proved bad but not recorded amounted to Rs. 10,000
- Provision is to be maintained at 10% of debtors.

In order to create the provision for doubtful debts, the following journal entries will be recorded:

Journal

Date	Particulars	L.F.	Amount (Rs.)	Amount (Rs.)
			Dr.	Cr.
2014				
March 31	Bad debts A/c ----- Dr. To Sundry debtors A/c (Being bad debts written off)		10,000	10,000
March 31	Profit & Loss A/c ----- Dr. To Bad Debts A/c (Being bad debts debited to profit and loss account)		10,000	10,000
March 31	Profit & Loss A/c ----- Dr. To Provision for doubtful debts A/c (Being provision for doubtful debts created)		9,000	9,000

Working Notes

Provision for doubtful debts @10% of sundry debtors i.e.

Total Debtors = 1,00,000

Less Bad Debts= 10,000

Balance= 90,000

Provision @10% = 90,000 X 10% = 9,000

PROVISION FOR DISCOUNT ON DEBTORS

Generally when the money is collected from the debtors they are for discount. A business firm usually allows this cash discount to their customers. Once it is known out of experience that an X amount of discount is usually allowed, then in order to calculate the true profits it is advisable to create a provision for discount on debtors with that X amount. The tenure of the cash discount period may spilt-over into the following accounting year for the sales made during the current year. The accounting treatment is given here as under;

Accounting Treatment

Discount is allowed to debtor:

Discount Allowed A/c ----- Dr.

To Debtors A/c

Discount allowed transferred to P&L A/c

Profit and Loss A/c----- Dr.

To Provision for Discount on Debtors A/c

Total bad debts transferred to provision for doubtful debts.

Provision for Discount on Debtors A/c ----- Dr.

To Discount Allowed A/c

Let us take the following illustrations to understand this:

Illustration 3

Following figures are extracted from the Trial Balance as at March 31, 2014

Name of Account	Debit Amount (Rs.)	Credit Amount(Rs.)
Sundry Debtors	5,00,000	
Discount Allowed	5,000	
Provision for Discount Allowed		1,000

Additional information

- Provision for Discount Allowed is to be maintained at 2%.

Solution: -

Journal

Date	Particulars	L.F.	Amount (Rs.) Dr.	Amount (Rs.) Cr.
2014				
March 31	Provision for Discount on Debtor A/c -----Dr. To Discount Allowed A/c (Being discount allowed written off)		5,000	5,000
March 31	Profit & Loss A/c -----Dr. To Provision for Discount on Debtor A/c (Being Provision created for Discount on Debtor)		14,000	14,000
	TOTAL		19,000	19,000

Dr. Discount Allowed A/c Cr.

Date	Particulars	J.F.	Amount	Date	Particulars	J.F.	Amount
2014				2014			
Mar 31	To Balance b/d		5,000	Mar 31	By Provision for Discount on Debtors A/c		5,000
			5,000				5,000

Dr. Provision for Discount on Debtors A/c Cr.

Date	Particulars	J.F.	Amount	Date	Particulars	J.F.	Amount
Mar 31	To Discount Allowed A/c		5,000	Apr 1, 2013	By Balance b/d		1,000
	To Balance c/d			Mar 31, 2014	By P & L A/c		

Mar 31			10,000				14,000
			15,000				15,000

Profit and Loss Account
for the year ended March 31, 2014

Date	Particulars	J.F.	Amount	Date	Particulars	J.F.	Amount
	To Provision for Discount on Debtors A/c		14,000				

Balance Sheet
as at 31st December, 2014

Liability	Amount (Rs.)	Asset	Amount (Rs.)
		Debtors 5,00,000	
		Less: Provision for discount on Debtors <u>10,000</u>	4,90,000

Working Notes

Provision for discount on debtors:

Rs.

Provision required for discount allowed on debtors 10,000

Discount Allowed 5,000

Less

Opening Balance of Provision for discount allowed 1,000

Provision to be charged to Profit and Loss Account 14,000

Alternative Calculation

Rs.

Provision required for discount on debtors as on March 31, 2014 10,000

Add Discount Allowed during the year as per Trial Balance 5,000

Total amount received 15,000

Less Provision for discount of debtors. as per Trial Balance	1,000
Provision to be charged to Profit & Loss account for the Year ended Mar 31, 2014	<u>14,000</u>

Check your Progress I

Note: Use the space given below for your answers

1) Explain the term 'Provision'. Why do we create provision?

2) Pass the necessary journal entry for the treatment of provision for bad debts.

3) Pass the necessary journal entry for the treatment of provision for discount on debtors.

12.4 RESERVES

A part of the profit may be set aside and retained in the business to provide for certain future needs like growth and expansion or to meet future contingencies such as workmen compensation. Unlike provisions, reserves are the appropriations of profit to strengthen the financial position of the business. Reserve is not a charge against profit as it is not meant to cover any known liability or expected loss in future. However, retention of profits in the form of reserves reduces the amount of profits available for distribution among the owners of the business. It is shown under the head Reserves and Surpluses on the liabilities side of the balance sheet after capital. Examples of reserves are:

- General reserve;
- Workmen compensation fund;
- Investment fluctuation fund;
- Capital reserve;

- Dividend equalisation reserve;
- Reserve for redemption of debenture.

Types of Reserves

A reserve is created by retention of profit of the business can be for either a general or a specific purpose.

1. General reserve: When the purpose for which reserve is created is not specified, it is called General Reserve. It is also termed as free reserve because the management can freely utilise it for any purpose. General reserve strengthens the financial position of the business. The creation and maintenance of general reserve helps in realizing certain well recognized purposes especially from the view point 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. 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.

2. Specific reserve: Specific reserve is the reserve, which is created for some specific purpose and can be utilised only for that purpose. 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 are some 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 business-like 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.

Examples of specific reserves are given below :

(i) Dividend equalisation reserve: This reserve is created to stabilise or maintain dividend rate. In the year of high profit, amount is transferred to Dividend Equalisation reserve. In the year of low profit, this reserve amount is used to maintain the rate of dividend.

(ii) Workmen compensation fund: It is created to provide for claims of the workers due to accident, etc.

(iii) Investment fluctuation fund: It is created to make for decline in the value of investment due to market fluctuations.

(iv) Debenture redemption reserve: It is created to provide funds for redemption of debentures.

Reserves are also classified as revenue and capital reserves according to the nature of the profit out of which they are created.

3. Revenue reserves : Revenue reserves are created from revenue profits which arise out of the normal operating activities of the business and are otherwise freely available for distribution as dividend. 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;
- Workmen compensation fund;
- Investment fluctuation fund;
- Dividend equalisation reserve;
- Debenture redemption reserve;

4. Capital reserves: Capital reserves are created out of capital profits which do not arise from the normal operating activities. Such reserves are not available for distribution as dividend. These reserves can be used for writing off capital losses or issue of bonus shares in case of a company.

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 are 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 foot-note 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.

Difference between Revenue and Capital Reserve

Revenue reserves and capital reserves are differentiated on the following grounds:

BASIS OF DIFFERENCE	REVENUE RESERVE	CAPITAL RESERVE
1. Source of creation	Revenue reserve is created out of revenue profits which arise out of normal operating activities of the business and are otherwise available for dividend distribution.	Capital reserve is created primarily out of capital profit, which does not arise out of the normal operating activities of the business and not available for dividend distribution. But revenue profits may also be used for this purpose.
2. Purpose	The basic purpose is to strengthen the financial position so as to meet unforeseen contingencies or for some specific purposes.	Capital reserves are created in order to fulfil the legal compliance or accounting practices.
3. Usage	These reserves if specific in nature, can be utilised only for the purpose for which it is created. If the reserve is created for the general purpose	It can be utilised for specific purposes as provided in the law in force e.g. to write off capital losses or issue of bonus shares.

	than it can be utilised for any purpose including distribution of dividend.	
4. Distribution of Dividend	It can be used for distribution of dividends.	It can not be used for cash dividend distribution.

Check your Progress 4

Note: Use the space given below for your answers

1) Explain the term 'Reserves'. Why do we create reserves?

2) What are the different types of reserves?

3) Distinguish between revenue reserve and capital reserve.

Importance of Reserves

Creation of reserve is important in the sense that a business firm consider it proper to set up some mechanism to protect itself from the consequences of unknown expenses 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 resource to meet certain significant demands 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 reserves in business activities and in accounting. The amount so set aside may be meant for the purpose of :

- Meeting a future contingency
- Strengthening the general financial position of the business;
- Redeeming a long-term liability like debentures, etc.

12.5 SECRET RESERVE

Secret reserve is a reserve which does not appear in the balance sheet. It may also help to reduce the disclosed profits and also the tax liability. The secret reserve can be merged with the profits during the lean periods to show improved profits. Management may resort to creation of secret reserve by charging higher depreciation than required. It is termed as 'Secret Reserve', as it is not known to outside stakeholders. Secret reserve can also be created by way of:

- Undervaluation of inventories/stock
- Charging capital expenditure to profit and loss account
- Making excessive provision for doubtful debts
- Showing contingent liabilities as actual liabilities

Creation of secret reserves within reasonable limits is justifiable on grounds of expediency, prudence and preventing competition from other firms. The biggest advantage is that business concern is enable to absorb any unexpected losses without the information to public. Further it helps the firm in maintaining the rate of dividend during adverse trading conditions without disclosing this matter to the public. The entry of the competing business firms may be avoided by using secret reserve.

There are certain drawbacks as well. Management may utilize this reserve to cover their mistakes or misdeeds. Presence of secret reserve makes the financial statements not to disclose a true and fair view of the financial position of the enterprise. Creation of secret reserve is not a healthy practice as it leads to violation of accounting assumption.

RESERVE FUND

A reserve fund is usually created either to replace a fixed asset at the end of its useful life or to repay a liability in the future, e.g. redemption of debentures etc.

Funds are cash or cash equivalents. In accounting, the term 'fund' means money invested in assets which can produce income, e.g. securities. It should have a ready market and can easily be converted into cash. Funds also refer to assets for specific purposes, which are not generally available for normal business activities, a fund sets aside cash or other assets to achieve specific objectives. Reserves are not usually represented by earmarking assets, if they are, they are expressed as 'reserve fund'. A reserve represented by an earmarked asset is usually cash or marketable securities. For example, if an organization set aside profits for building construction, the reserve so

created is known as 'building funds'. When an amount equal to the reserve created is invested outside the business in securities, the reserve so created is known as 'building fund'.

12.6 DIFFERENCE BETWEEN RESERVE AND PROVISION

According to Subhash Chandra Das, provision means providing an amount for unknown liability which cannot be determined with accuracy. Provisions are charged to profit and loss account, As per Indian Companies Act, the provision shall mean any amount written-off or retained by providing for depreciation, renewals or diminution in value of assets, or retained by providing or known liability which cannot be determined with substantial accuracy. The provisions are created to take care of decrease in asset or increase in liability. Whereas 'reserve' refers to undistributed profit used for meeting some liability. It is created out of profit by appropriating profit for redemption of liability. For example, preference shares, debentures, or for replacing assets. Reserve is the amount which is in excess of provision.

However, following table explains the points of difference between reserve and provision:

BASIS OF DIFFERENCE	PROVISION	RESERVE
Meaning	A provision is created for some specific object.	A reserve is meant for meeting an unanticipated situation.
Basic nature	Charge against profit. It is created even though there are no profits.	Appropriation of profit. If there is no sufficient profit, a reserve cannot be created.
Purpose	It is created to provide funds for a known liability or expense pertaining to current accounting period, the amount of which is not certain.	It is created to strengthen the financial position of the business. Some reserves are also mandatory under law.
Utilization	It can be utilised only for the purpose for which it is created.	Reserves can be used in the payment of any liability or loss.
Effect on taxable profits	It reduces taxable profits.	It has no effect on taxable profit.
Presentations in balance sheet	It is shown either (i) by way of deduction from its related item or (ii) In the	It is shown on the liabilities side after capital amount.

	liabilities side along with current liabilities.	
Place in accounting	A provision is not shown as excess of asset over liabilities but it is helpful for determining the real valuation of assets.	Reserves show the excess of assets over liabilities
Element of compulsion	Creation of provision is necessary to ascertain true and fair profit or loss in compliance 'Prudence' or 'Conservatism' concept. It must be made even if there are no profits.	Generally, creation of a Reserve is at the discretion of the management. Reserve cannot be created unless there are profits. However, in certain cases law has stipulated for the creation of specific reserves such as 'Debenture' 'Redemption' reserve.
Use for the payment of dividend	It cannot be used for dividend distribution.	It can be used for dividend distribution.

12.7 LET US SUM UP

The assumption of going concern states that the business is to continue for the long period. This it becomes important to consider current as well as future contingencies into account while ascertaining the profit for the year. Provisions and reserves are related to future needs of the business firm for which part of current earning must be set aside while preparing final accounts. Provision refers to the amount retained by way of providing for a definitely existing liability whose amount can not be determined accurately. It is created in order to provide funds for the known liability in future, to calculate the correct net profits, to find out the true financial position, and for equitable distribution of expenses. Reserve is the amount set aside of the profits with a view to strengthen the financial position of the business entity. The reserve can be general reserve, specific reserve contingency reserve, reserve for expansion, investment fluctuation reserve, workmen compensation reserve, etc. Besides strengthening the financial position of the business reserve is helpful in meeting future unanticipated loss, equalizing dividends, fulfilling specific purpose like debenture redemption etc.

12.8 KEY WORDS

Provision: Provision is any amount written-off or retained by providing for depreciation, renewals or diminution in value of assets, or retained by providing or known liability which cannot be determined with substantial accuracy. The provisions are created to take care of decrease in asset or increase in liability.

Reserve: Reserve refers to undistributed profit used for meeting some liability. It is created out of profit by appropriating profit for redemption of liability. For example, preference shares, debentures, or for replacing assets. Reserve is the amount which is in excess of provision.

Secret Reserve: The reserve which cannot be disclosed in the balance sheet is known as secret reserve. This reserve may be created by (a) charging excess depreciation, (b) showing contingent liability as real liability and (c) excess provision for bad and doubtful debts etc.

General Reserve: This reserve is created to meet any future contingency to provide additional working capital.

Specific Reserve: This reserve is created for specific purpose, for example, capital redemption reserve and so on.

Reserve Fund: A reserve fund is usually created either to replace a fixed asset at the end of its useful life or to repay a liability in the future, e.g. redemption of debentures etc.

12.9 QUESTIONS

Short Answer Questions

1. What are 'provisions'. How are they created? Give accounting treatment in case of provision for doubtful Debts.
2. Give four examples each of 'revenue reserve' and 'capital reserves'.
3. Distinguish between 'general reserve' and 'specific reserve'.
4. Explain the concept of 'secret reserve'.
5. Name and explain different types of reserves in details.
6. Distinguish between 'provision' and 'reserve'.

Long Answer Questions

1. Give four examples each of 'provision' and 'reserves'.
2. Pass the necessary Journal entries and clearly show the working notes separately.

	Debit Amount (Rs.)	Credit Amount (Rs.)

Debtors	50,000	
Bad debts	1,000	
Discount Allowed	1,000	
Provision for Doubtful Debts		2000
Provision for discount on Debtors		1000

Additional information

It is desired to create a provision for Bad and Doubtful debts @ 3% on Debtors and Provision for discount on debtors @ 2%.

12.10 REFERENCES AND SUGGESTED READINGS

Mukherjee, A. and Hanif, M. (2003), *Financial Accounting*, Tata Mc. Graw Hill, New Delhi.

Subhash Chandra Das (2013), *Business Accounting and Financial Management*, PHI Learning Pvt. Ltd., New Delhi.

Singhal, RK (2012), *Financial Accounting*, VK Enterprises, New Delhi.

Nirmal Gupta (2007), *Corporate Accounting: Theory & Practice*, Ane Books Pvt. Ltd.

Activity 1

What is the difference between provision and Reserves.

Activity 2

What are the accounting treatment of provision?

LESSON-13

FINAL ACCOUNTS

Structure

- 13.0 Objectives
- 13.1 Introduction
- 13.2 Definition of financial statement
- 13.3 Manufacturing Account
- 13.4 Trading Account
- 13.5 Profit and Loss Account
- 13.6 Balance sheet
- 13.7 Let Us Sum Up
- 13.8 Key Words
- 13.9 Questions
- 13.10 References and Suggested Books

13.0 OBJECTIVES

After studying this lesson you should be able to understand

- Basics of Final Accounts
- Preparation of Manufacturing account
- Ascertainment of gross profit through preparation of Trading account
- Ascertainment of Profit and Loss through preparation of profit and loss account
- Preparation of the Balance Sheet

13.1 INTRODUCTION

The basic objective of preparing financial records is to see whether the business is in profit or loss. For this the entire accounting cycle is followed. As discussed in previous lesson that the transactions of a business enterprise are first recorded in the journal, then posted there from into the ledger and lastly a trial balance is prepared to test their arithmetical accuracy. From the trial balance final accounts are prepared. Preparation of final account is the last stage of the accounting cycle. It helps businessman to ascertain the financial position of his business firm as a whole during the particular period. Final accounts include Manufacturing and Trading, Profit and Loss Account and Balance Sheet. The determination of profit or loss is done by preparing a Trading, Profit and Loss Account. The purpose of preparing the Balance Sheet is to know the financial

soundness of a concern as a whole during the particular period. In this lesson we will learn how the statements of the financial position are prepared after preparing manufacturing account, trading account and profit and loss account.

13.2 DEFINITIONS OF FINANCIAL STATEMENT

According to **John N.Myer** “The financial statements provide a summary of the accounts of a business enterprise, the Balance sheet reflecting the assets and liabilities and the Income statement showing the results of operations during a certain period.”

These final accounts consist of financial statements that are discussed as follows:

1. Trading Account, Profit and loss account, and
2. Balance Sheet.

13.3 MANUFACTURING ACCOUNT

Manufacturing account is prepared by the business enterprises that are engaged in manufacturing activities. In order to ascertain the cost of goods manufactured, the manufacturing account is prepared. In this account, both direct and indirect expenses relating to the process of manufacturing are recorded (i.e., debited to this account).The manufacturing account is closed by transferring its balance (cost of goods produced) to the trading account.

Pro-forma of a Manufacturing account

Dr.		Cr.	
Particulars	Rs	Particulars	Rs
To Materials:		By Sale of Scrap	
Opening stock...		By Closing Stock	
Raw Material...		Raw material...	
Work-in-progress...		Work-in-progress...	
To Purchases:		By Cost of the Goods	
Raw Materials...		(transferred to trading	
Work-in-progress...		account)	
To Carriage Inwards			
To Factory Wages			
To Factory Rent			
To Fuel, Power, Gas			
To Factory Insurance			

To Depreciation			
To Overheads(manufacturing)			
To Repairs			
To Taxes			
To Royalty on Production			
To General Expenses			
To Misc. Expenses (manufacturing)			

Illustration: 1 From the following information, calculate cost of goods sold :

Particulars	Rs.
Stock of materials on 1.1.2013	35,000
Stock of materials on 31.12.2013	5,000
Purchases of materials	62,000
Purchase Returns	2,000
Wages	10,000
Factory expenses	3,500
Freight and Carriage	4,000
Other direct expenses	2,500

Solution:

Manufacturing Account

Dr.

Cr.

Particulars	Rs	Particulars	Rs
To Opening stock	35,000	By Closing Stock	5,000
To Purchases of material-62000		By Cost of the Goods	1,10,000
Less Purchases return- (2000)	60,000	(transferred to trading A/c)	
To Wages	10,000		
To Factory Expenses	3,500		
To Freight and Carriage	4,000		
To Other direct expenses	2,500		

13.4 TRADING ACCOUNT

Trading account is a constituent of financial statements. In practice, it is treated along with Trading and Profit and Loss Account, as one account and one unit. Trading account is prepared to know whether a business enterprise has earned profit or suffered loss. Gross profit or gross loss is the difference between cost of goods and sales. Therefore, for preparing a trading account, we need to know:

- (1) Net sales revenue = Cash sales + Credit sales – Sales return
- (2) Cost of Goods Sold = Opening stock + Net Purchases – Closing stock + Direct expenses
- (3) Net purchases = Cash purchases + Credit purchases – Purchases return
- (4) Gross profit = Net Sales Revenues – Cost of Goods sold

Items appearing on the debit side of the Trading Account:

- 1. Opening Stock: Stock in hand on the commencement of the year or period is termed as opening stock.
- 2. Purchases: It indicates total purchases both cash and credit purchases.
- 3. Purchases Returns or Returns Outwards: Purchases return are the goods sent back to the person from whom we have purchased the goods because of the defect in the goods or goods are not as per the order made. These are subtracted from the purchases to get the Net purchases.
- 4. Direct Expenses on Purchases: Some of the direct expenses are:
 - (a) Wages: It is also known as productive wages or manufacturing wages.
 - (b) Carriage or Carriage inwards
 - (c) Octroi duty: Duty paid to bring goods within municipal limits.
 - (d) Customs duty, dock dues, clearing charges, import duty etc.
 - (e) Fuel, power, lighting charges related to production
 - (f) Oil, Grease, waste

Items appearing on the credit side of the Trading Account:

- (a) Sales: It indicates total sales both cash and credit sales.
- (b) Sales Return or return: These are subtracted from the sales to get the Net sales.
- (c) Closing stock: The stock left at the end of the year.
- (d) Carriage outwards:

Pro-forma of a Trading account

Trading Account of.....
for the year ended on.....

Dr.

Cr.

Particulars	Rs	Particulars	Rs
To Opening Stock	-----	By Sales	-----
To Purchase (less return)	-----	By Closing Stock	-----
To Direct Expenses	-----	By Gross Loss (balancing figure)	-----
To Gross Profit (balancing figure)	-----		
Total	-----	Total	-----

Balancing of Trading Account

The difference between two sides of Trading Account indicates either Gross profit or Gross Loss. If the total on the credit side is more, difference represents Gross Profit. On the other hand, if the total side of debit side is high, the difference represents Gross loss. The Gross profit or Gross loss is transferred to Profit and Loss Account.

Closing Entries of Trading Account:

Trading Account is a ledger account. Hence, no direct entries should be made in the trading account. Several Items such as Purchases, Sales are first recorded in the journal and then posted to ledger account. The same accounts are closed by transferring them to the trading account. Hence it is called closing entries. These are as follows:

1. For transfer of opening stock, net purchases and direct expenses to Trading account:

Trading A/c	Dr.
To Opening Stock A/c	
To Purchases (Net) A/c	
To Direct Expenses A/c	

2. For transfer of net sales and closing stock to Trading Account:

Sales (Net) A/c	Dr.
(Closing) Stock A/c	Dr.
To Trading A/c	

3. For Gross Profit

Trading A/c Dr.
To Profit and Loss A/c

4. For Gross Loss

Profit and Loss A/c Dr.
To Trading A/c

Advantages of Trading Account: Following are the advantages of preparation of trading account:

1. The result of Purchases and sales can be clearly ascertained.
2. Gross profit ratio to sales can also be ascertained. It helps to determine price.
3. Gross profit ratio to direct expenses can also be ascertained. And so that unnecessary expenses can be eliminated.
4. Comparison of trading account details with previous year details help us to draw better administrative policies.

Differences between Trading Account and Manufacturing Account

A Trading Account differs from Manufacturing Account on the following aspects:

<i>Basis of Distinction</i>	<i>Trading Account</i>	<i>Manufacturing Account</i>
1. Main objective of preparation	This is prepared to ascertain the gross profit or gross loss	The main object is to ascertain the cost of goods manufactured
2. Transfer of A/c	This is transferred to the Profit and Loss Account	This is transferred to Trading Account
3. Stock of finished goods	This account shows the stock of finished goods (opening and closing)	This account does not show the stock of Finished Goods (both opening and closing)
4. Raw Materials and work-in-progress	Trading Account does not deal with raw materials and work-in-progress. This deals with only finished goods	Manufacturing account deal with raw material and work-in-progress.

Illustration: From the following information prepare Trading Account for the year ending on March 31, 2014:

Opening Stock-Rs 30,000; Cash Purchases-Rs 70,000; Carriage Inwards-Rs 5,000; Freight Inwards-Rs 2,500; Wages-Rs 7,500; Credit Purchases-Rs 50,000; Cash Sales-Rs 60,000; Credit Sales-Rs 1,50,000; Purchases return-Rs 10,000; Sales Return-Rs 15,000; Stock at the End-Rs 40,000.

Solution:

Trading Account for the year ended on March 31, 2014

Dr.		Cr.	
Particulars	Rs	Particulars	Rs
To Opening Stock	30,000	By Net Sales:	
To Net Purchase:		Cash Sales	60,000
Cash Purchase 70,000		Add: Credit Sales	<u>1,50,000</u>
Add: Purchases Return			2,10,000
<u>50,000</u>		Less: Sales Return	<u>15,000</u>
12,000			1,95,000
Less: Purchases Return		By Closing Stock	40,000
<u>10,000</u>	1,10,000		
To Wages	7,500		
To Carriage Inwards	5,000		
To Freight Inwards	2,500		
To Gross Profit transferred to Profit and Loss Account	80,000		
Total	2,35,000	Total	2,35,000

Check your Progress 1

Note: Use the space given below for your answers. You may use extra sheets for solving questions.

1) How is the cost of goods calculated?

2) Define Trading account.

3) Prepare a Trading account for the following trial balance:

Trial Balance of M/s Trinity Foods" as on 31 March, 2014

Particulars	L/F	Debit Amount (in Rs)	Credit Amount (in Rs)
Cash A/c	—	10,000	
Capital A/c	—		
Bank A/c	—	77,000	1,00,000
Furniture A/c	—	25,000	
Purchases A/c	—	65,000	
Ram A/c	—		
Sales A/c	—		15,000
Rahim A/c	—	50,000	1,25,000
Salaries and Wages A/c	—	5,000	
Rent Paid A/c	—	8,000	
Total		2,40,000	2,40,000

4) Prepare a Trading Account of Rajesh Kumar for the year ending 31st march 2014 from the following particulars

Particulars	Amount	Particulars	Amount
Stock of goods 1-4-2013	2,50,000	Sales: Cash	5,00,000
		Credit	11,70,000
Carriage inwards	10,000	Return by Customers	20,000
Purchases: Cash	3,50,000	Stock of goods 31-3-2014	4,70,000
Credit	8,00,000		
Return to Supplier	25,000		

13.5 PROFIT AND LOSS ACCOUNT

The purpose of profit and loss account is prepared to ascertain the net profit or net loss suffered by a business enterprise during an accounting period. This account starts with gross profit on the credit side which is brought forward from the trading account. It is followed only by the items of revenue incomes and revenue losses. But profit or loss brought on sale of capital items is recorded here. After recording all items, both sides of the Profit and Loss account are totalled. If credit side total exceeds debit side, the difference is Net Profit. On the other hand, if debit side exceeds the credit side such difference is termed as Net Loss.

Some the terms that are frequently appearing in the preparation of Profit and Loss Account have to be understood in the proper context. They are as follows:

(1) Outstanding Income: The amount which is due and not yet received. A person is entitled to receive the “outstanding income” once it becomes due legally.

(2) Accrued Income: The amount which is earned but not yet due and receivable.

Items appearing on the debit side of Profit and Loss Account:

Followings are the items which are included in the debit side of profit and loss account.

1. Gross Loss: Gross loss is the debit balance of trading account which transferred to the profit and loss account.
2. Selling and distribution expenses: Expenses incurred for the promotion of sales and distribution of sold goods are selling and distribution expenses. Packing charge, carriage , freight outward, sales tax, forwarding charge , export duty , travelling expenses etc are the examples of selling and distribution expenses.
3. Administrative Expenses: Administrative expenses are those expenses which are incurred for day to day running of office management.
4. Financial Expenses: Financial Expenses are incurred for arranging fund to run the business. Cash discount allowed, interest on capital, interest on loan discount on bill etc. are the examples of financial expenses.
5. Maintenance Expenses: Expenses incurred for maintaining the fixed assets are called fixed expenses. Repair and renewable depreciation of assets are some examples of maintenance expenses.
6. Abnormal Losses: Abnormal losses are those losses which are incurred due to the carelessness of the management. Loss on sale of asset , stock lost by fire etc are the examples of abnormal losses.

Items appearing on the credit side of Profit and Loss Account:

Following items are included in the credit side of profit and loss account

1. **Gross Profit:** Gross profit is transferred from trading account and it is the beginning item of profit and loss account.
2. **Non-trading Income:** Interest received from bank, incomes received from outside investments like share and debenture are known as non-trading incomes.
3. **Other incomes:** Those incomes other than income from sale of goods are called other income. Discounts or commission received are the examples of other income.

Advantages of Profit And Loss Account

The main advantages of profit and loss account are as follows:

1. Profit and loss account gives the actual information about net profit or net loss of the business for an accounting period.
2. Profit and loss account gives the actual information about indirect expenses.
3. Profit and loss account serves to determine the ratio between net profit to sales.
4. Profit and loss account helps in determining the ratio between net profit to operating expenses.
5. Profit and loss account helps in controlling indirect expenses.

Closing Entries Relating to Profit and Loss Account

The preparation of Profit and Loss Account requires the transfer of all items (nominal accounts relating to Profit and Loss Account) in the Trial Balance to the Profit and Loss Account with the help of the following closing entries:

- A. For Debit: (items of revenue expenses and losses) (or for items other than those record in debit side of Trading Account)

Profit and Loss A/c	Dr.
To Respective items A/c (individually)	

- B. For Credit: (items of revenue income and gains) (or for items other than those recorded in credit side of Trading Account)

Respective items A/c(individually)	Dr.
To Profit and Loss Account	

- C. For Net Profit:

Profit and Loss Account	Dr.
To Capital account	

Pro-forma of a Profit and Loss account

Profit and Loss Account
of.....
for the year ended on.....

Dr.

Cr.

Particulars	Rs	Particulars	Rs
To Salaries	-----	By Gross Profit B/d	-----
To Rent and Rates	-----	By Interest received	-----
To Repairs	-----	By Discount received	-----
To Bank Charges	-----	By Commission received	-----
To Audit Fees	-----	By Net Loss (Balancing Figure)	-----
To Carriage Outwards	-----		
To Lighting	-----		
To Stationary	-----		
To Insurance	-----		
To Postage	-----		
To Discount Allowed	-----		
To Provision for Bad Debts	-----		
To Depreciation	-----		
To Advertising	-----		
To Net Profit (Balancing Figure)	-----		
Total	-----	Total	-----

Illustration: From the following Trail balance, prepare a Trading Account and Profit and Loss Account for M/s JK Associates:

Trial Balance
of M/s JK Associates
as on 31st March 2014

Dr

Cr.

Particulars	Rs	Particulars	Rs
Purchases	16,000	Sales	30,000
Wages	6,500	Capital	10,655

Discount	1,300	Mortgage and Interest on date	3,050
Salaries	2,000	Sundry Creditors	2,100
Travelling Expenses	500		
Carriage Inward	275		
Insurance	150		
Commission	325		
Rent and Rates	500		
Cash in hand	25		
Cash at Bank	2,725		
Repairs	300		
Sundry expenses	55		
Mortgage interest	150		
Building	4,000		
Machinery	1,500		
Horses and Carts	500		
Opening Stock	5,750		
Sundry debtors	3,250		
Total	45,805	Total	45,805

Closing Stock was Rs. 6,075.

Solution:

**Trading and Profit and Loss Account
of M/s JK Associates
as on 31st March, 2014**

Dr.

Cr.

Particulars	Rs	Particulars	Rs
-------------	----	-------------	----

To Opening Stock	5,750	By Sales	30,000
To Purchases	16,000	By Closing Stock	6,075
To Wages	6,500		
To Carriage Inward	275		
To Gross Profit c/d	7,550		
	36,075		36,075
To Salaries	6,500	By Gross Profit c/d	7,550
To Rent and Rates	500		
To Travelling expenses	500		
To Sundry Expenses	55		
To Repairs	300		
To Insurance	150		
To Commission	325		
To Mortgage interest	150		
To Discount	1,300		
To Net Profit	2,270		
Total	7,550	Total	7,550

Check your Progress 2

1) Profit and Loss account of business helps in calculating

2) Prepare Trading and profit & loss account for the following trail balance of Raj and Sons. for the year ended Mar 31, 2014

Particulars	Rs
Capital	75,000
Stock	3,000

Sales	90,000
Purchases	25,000
Sales Return	1,000
Purchases Return	1,500
Cash in hand	2,500
Discount(Cr.)	160
Salaries	1,500
Creditors	15,000
Bills Payable	12,000
Commission(Cr.)	300
Discount(Dr.)	100
Insurance	120
Carriage	400
Carriage on Sales	350
Wages	2,000
Depreciation	100
General Expenses	600
Advertisement Expenses	250
Travelling Expenses	300
Building on lease	70,000
Stock at the end (March 31,2014)	5,000
Bad Debts	120

13.6 BALANCE SHEET

A Balance Sheet is the statement prepared to show the financial position of business. It is prepared only after the Trading and Profit and Loss account have been prepared. After Trading and Profit and Loss Account have been prepared, balances remaining in the trail balance represent either assets or liabilities existing on the date of financial close. It summarises on the one side-the right hand side-the assets of the business enterprise and on the left hand side-liabilities of the business enterprise. Hence, a balance sheet may be called as a statement of Assets and Liabilities of a business entity at a particular date.

Objectives of preparing Balance Sheet

The main objectives of preparing a Balance Sheet is to ascertain the financial position of the business on a particular date. While ascertaining the financial position, we also obtain the following additional information:

- 1. Nature and Value of the assets:** A balance sheet contains various assets in classified, from with their respective values and as such it gives a clear picture about the nature and the value of different assets Comprising fixed assets, current assets etc.
- 2. Nature and extent of liabilities and actual capital:** Like assets, a balance sheet also contains different liabilities in a classified form and shows the amount of liabilities the business owes to different types of creditors. It also shows the actual capital of the business at the end of trading period, representing the excess of assets over liabilities.
- 3. Solvency of the business:** If the assets exceed the liabilities the business is considered as solvent. Greater is the difference, stronger is the financial position. On the other hand, if liabilities exceed the assets, the business is considered as insolvent.
- 4. Over-trading and under-trading:** If the total creditors exceed assets - Cash, Bank, Investments, Debtors etc., the position of the business is financially unsound, indicating over-trading. For sound financial position, a business must have sufficient working capital. On the other hand, under-trading indicates excess liquid assets over current liabilities, showing idleness of the funds.

Characteristics of Balance sheet

1. It is prepared on particular date and not for particular period.
2. It is prepared after preparation of Trading and profit and loss account
3. As assets must be equal to total liabilities, the two sides of the balance must have the same total
4. It shows the financial position of a business as a going concern.
5. It is a statement of assets (debit balances) and liability (credit balances) and not an account.

Contents of Balance Sheet

The right-hand side of a balance sheet is called the “Assets” side and the left-hand side is called the “Liabilities” side.

Items shown on the Assets side of a Balance Sheet: The debit balances of ledger accounts were not transferred to the Trading and Profit and Loss Account are to be shown on the Assets side of the balance sheet. Assets are generally classified as Current Assets, Investments and Fixed Assets. Further, fixed assets are classified into two categories-Tangible assets and Intangible assets.

Current assets: Current assets are those assets which are held for a short period and can be easily be converted into cash.

Example: Cash in hand, Cash at bank, Raw material, Stock of goods, Bills receivable, Debtors, Prepaid expenses and so on.

Investments: Acquisition of assets which in turn earn interest, dividend, rent or any other incomes are referred to as investments.

Example: Shares, Debentures, Bonds and Fixed Deposits. These are usually held in business for a long period, generally more than a year.

Fixed Assets: The term fixed assets refer to those assets for use in business activities rather than for resale in the course of the business. They are usually held in the business activities rather than for resale in the course of the business. They are usually held in the business for a relatively longer period. Fixed assets are classified into Tangible fixed assets and Intangible fixed assets.

Tangible Fixed Assets: Assets can be seen and they possess physical existence. For example- Land, Building, Plant, Machinery, Furniture and Fixtures and Vehicles etc.

Intangible Fixed Assets: Assets cannot be seen and they do not possess any physical existence. For example- Goodwill, Patents, Copyrights and Trademarks etc.

Fictitious Assets: These are the assets which do not have any tangible existence or realizable value but represents actual cash expenditure. These are not shown in the balance sheet. For example- Share issue expenses by a corporate, preliminary expenses and issue of debentures etc.

Items shown on the Liabilities side of a Balance Sheet:

Fixed Liabilities: Those liabilities which are payable to the owners only on the liquidation of the company after making the payment of other outside liabilities are called fixed liabilities.

Current Liabilities: Current liabilities are those type of liabilities which are payable out of current assets within the next accounting period. Bills payable, short term bank overdraft are the examples of current liabilities.

Long term Liabilities: Long term liabilities are those liabilities which are not payable within the next accounting period but will be payable within next few years. Debentures are the example of long term liabilities.

Advantages of preparing Balance Sheet:

The preparation of Balance sheet gives following advantages:

- It is helpful in ascertaining the financial position of the business by showing assets and liabilities of the concern on a specific date.
- It discloses the solvency of business by showing how much assets are available for payment of liabilities.
- It also disclose the proprietary interest of owner.
- It helps in calculation of various ratios which help in better management of business.
- It helps in comparison of assets and liabilities of business on two dates to ascertain the progress being made by business.
- It helps to ascertain the amount of capital employed in business.

Pro Forma of Balance sheet

The **vertical format** of financial statements as per SCHEDULE VI (REVISED) and the major structural changes in the classification and disclosure of information in the financial statements are discussed below in detail.

XYZ Company Balance Sheet as on 31 March, 2014

(Rs.)

Liabilities & Stockholders' Equity	
Current Liabilities	
Accounts payable	15,000
Salaries Payable	9,000
Total Current Liabilities	24,000
Non Current Liabilities	
Long Term Bonds payable	20,000
Mortgages	35,000
Total Non Current Liabilities	55,000
Total Liabilities	79,000
Stockholders' equity	

Common stock	50,000
Retained earnings	1,000
Total Liabilities and Stockholders' equity	130,000
Assets	
Current Assets	
Cash	10,000
Accounts Receivable	20,000
Inventories	30,000
Deposits, prepayments	5,000
Other Assets	65,000
Total Assets	130,000

The **horizontal form of balance sheet** represents: right-hand side represents Assets side and left hand side depicts the Liabilities side.

Balance Sheet of M/s Free Flow Fluids as on 31 March 2014

Liabilities	Amount	Assets	Amount
Eq. Share Capital	35,00,000	Goodwill	8,00,000
Pr. Share Capital	12,00,000	Land	35,00,000
...	...	Buildings	27,00,000
...
...
...	...	Sundry Debtors	26,00,000
Sundry Creditors	13,00,000	Bills Receivable	15,00,000
Bills Payable	12,00,000	Bank Balance	...
Bank Overdraft	5,00,000	Cash	1,16,000
	2,54,20,000		2,54,20,000

Sequence of items in the Balance Sheet (Marshalling of Assets and Liabilities):

Assets and Liabilities shown in the balance sheet may be put down in two ways:

1. In order of permanence or
2. In order of Liquidity

1. In order of permanence: Under this method, the assets are arranged in the decreasing order of permanence. Permanence means affinity of an asset to stay with the organisation or the longevity of the life of an asset with the organisation. The longer an asset stays with an organisation, the more permanence it has.

Balance Sheet of M/s Free Flow Fluids as on 31 March, 2014

Liabilities	Amount	Assets	Amount
Eq. Share Capital	35,00,000	Goodwill	8,00,000
Pr. Share Capital	12,00,000	Land	35,00,000
...	...	Buildings	27,00,000
...
...
...	...	Sundry Debtors	26,00,000
Sundry Creditors	13,00,000	Bills Receivable	15,00,000
Bills Payable	12,00,000	Bank Balance	...
Bank Overdraft	5,00,000	Cash	1,16,000
	2,54,20,000		2,54,20,000

2. In order of Liquidity: Under this method, the assets are arranged in the decreasing order of their liquidity. Liquidity is the characteristic of an asset to get converted to cash, the faster an asset can be converted into cash the more liquid it is.

Balance Sheet of M/s Free Flow Fluids as on 31 March 2014

Liabilities	Amount	Assets	Amount
Bank Overdraft	5,00,000	Cash	11,60,000
Bills Payable	12,00,000	Bank Balance	...
Sundry Creditors	13,00,000	Bills Receivable	15,00,000
...	...	Sundry Debtors	26,00,000
...
...
...	...	Buildings	27,00,000
Pr. Share Capital	12,00,000	Land	35,00,000
Eq. Share Capital	35,00,000	Goodwill	8,00,000
	2,54,20,000		2,54,20,000

Difference between Trial Balance and Balance Sheet

The difference between Trial Balance and Balance Sheet are:

- Trial Balance is the 'means' of a accounting process of which Balance sheet is the 'end' because a balance sheet is always prepared from the figures taken out of trial balance.
- The purpose of preparing a trial balance is to check the arithmetical accuracy of account books; but balance sheet is drafted to reveal the financial position of the business.
- The two sides of balance sheet are called 'liabilities' and 'assets' sides respectively but in case of trial balance the columns are 'debit' and 'credit' columns.
- For completing the accounting cycle, the preparation of balance sheet is necessary; but the preparation of trial balance is not always necessary.
- Trial balance contains in it all the three types of account viz. personal, real and nominal, but balance sheet contains only personal and real accounts.
- Generally, trial balance does not contain closing stock but balance sheet does.

Difference between Profit and Loss Account and Balance Sheet

Profit and Loss Account	Balance Sheet
(1) It is prepared with the debit or credit balance of Nominal Account.	(1) It shows the assets and liabilities on a particular date.
(2) Profit and Loss Account reveals the Net Profit or Net Loss of a concern during the particular period.	(2) It is a statement of financial position on a particular date.
(3) The difference between the two sides of Trading Account will be gross profit and loss account will be Net Profit or Net Loss	(3) The difference between the two sides of profit transferred to Profit and Loss Account. transferred to liability side of Balance Sheet.
(4) The debit or credit balances of nominal accounts are closed by transferring Profit and Loss Account.	(4) It is the statement of static in nature thus, accounts do not require to close them.

Illustration: From the following informations of Jansons Ltd. on 31st March, 2003 you are required to prepare the Trading, Profit and Loss A/c and Balance Sheet:

Particulars	Rs.(Dr.)	Particulars	Rs.(Cr.)
Opening Stock	5,000	Capital	89,500

Bills Receivable	22,500	Commission (Cr.)	2,000
Purchases	1,95,000	Return Outward	2,500
Wages	14,000	Sales	2,50,000
Trade Expenses	1,000	Bills Payable	15,000
Insurance	5,500	Creditors	98,250
Office Fixtures	5,000	Closing Stock	12,500
Sundry Debtors	1,50,000		
Cash in Hand	2,500		
Carriage Inward	4,000		
Cash at Bank	23,750		
Commission (Dr.)	4,000		
Rent & Rates	5,500		
Interest on Capital	3,500		
Carriage Outward	7,250		
Stationery	2,250		
Return Inward	6,500		

5) Name any three current assets and four fixed assets.

13.7 LET US SUM UP

Final accounts are prepared to ascertain the net profit or loss for a period and the financial position of the business entities on a particular date. Trading account is treated along with profit and loss account as one. Next stage after preparation of trail balance is the preparation of trading account to ascertain gross profit or loss for the period. After the preparation of trading account profit and loss account is prepared to ascertain the net profit which is to be transferred to capital account in balance sheet. Balance sheet is the statement comprising the summary of financial position of enterprise on a particular date and it is prepared after making the necessary amendments.

13.8 KEY WORDS

Balance sheet: a statement of the assets, liabilities, and capital of a business or other organization at a particular point in time, detailing the balance of income and expenditure over the preceding period.

Gross profit: A company's revenue minus its cost of goods sold. Gross profit is a company's residual profit after selling a product or service and deducting the cost associated with its production and sale.

Profit and loss account: an account in the books of an organization to which incomes and gains are credited and expenses and losses debited, so as to show the net profit or loss over a given period.

Trading account: The part of an income statement that shows how the gross profit was generated through trading activities.

13.9 QUESTIONS

Short Answer Questions

1. What do you understand by Manufacturing Account?
2. What is the Significance of Preparing Manufacturing Account?
3. Briefly explain the components of Manufacturing Account.
4. What do you understand by Trading Account?
5. Briefly explain the Profit and Loss Account.
6. What do you understand by Balance Sheet?

Long Answer Questions

1. What are the main features of final accounts?
2. What is the difference between
 - (a) Profit and Loss Account and balance sheet and
 - (b) Trial balance and balance sheet
3. Draw a specimen ruling of Manufacturing, Trading and Profit and Loss Account and Balance Sheet.
4. From the following information, you are required to prepare Trading, Profit and Loss Account and Balance Sheet :

Particulars	Rs.(Dr.)	Particulars	Rs.(Cr.)
Salaries	5,500	Creditors	9,500
Rent	1,300	Sales	32,000
Cash in hand	1,000	Capital	30,000
Debtors	40,000	Loans	10,000

Trade Expenses	600		
Purchases	25,000		
Advances	2,500		
Bank Balance	5,600		
Total	81,500	Total	81,500

Additional Information

(I) The Closing Stock amounted to Rs. 9000

Q .From the following Trial Balance of M & S Co., you are required to Prepare Trading, Profit and Loss Account and Balance Sheet for tile year ended 31" Dec. 2014:

Particulars	Rs.(Dr.)	Particulars	Rs.(Cr.)
Opening Stock	20,000	Sales	1,09,000
Purchases	25,500	Purchase Returns	1,325
Factory Wages	13,000	Bills Payable	10,000
Carriage Inwards	500	Short-Term Loan	7,500
Salaries	17,500	Bank Overdraft	1,500
Carriage Outwards	250	Capital	80,000
General Expenses	225	General Reserve	13,500
Rent	1,750	Creditors	2,000
Sales Returns	1,000		
Interest	1,500		
Commission	550		
Maintenance	1,150		
Bad Debts	600		
Drawings	22,500		
Good will	20,000		
Loose Tools	5,000		
Copy Rights	20,000		
Land & Buildings	30,000		
Machinery	20,000		
Bills Receivable	3,000		
Furniture	3,000		

Debtors	22,500		
Cash at Bank	13,300		
Total	2,42,825	Total	2,42,825

Additional Information

(1) Stock at the end Rs. 17,500.

Q. From the following particulars of MIs Ramesh & Co as on 31st March 2014, you are required to prepare Trading, Profit and Loss Account and Balance Sheet as on that date :

Particulars	Rs.(Dr.)	Particulars	Rs.(Cr.)
Sundry Debtors	30,600	Sundry Creditors	10,000
Bills Receivable	5,000	Capital Account	70,000
Plant and Machinery	75,000	Bad Debts Provision	350
Purchases	1,90,000	Bills Payable	7,000
Freehold Premises	50,000	Reserve	20,000
Salaries	21,000	Closing Stock	30,000
Wages	24,400	Sales	3,31,700
Postage and Stationery	1,750		
Carriage Inward	1,750		
Carriage Outward	1,000		
Bad Debts	950		
Office General Charges	1,500		
Cash at Bank	5,300		
Cash in hand	800		
Total	4,39,050	Total	4,39,050

13.10 REFERENCES AND SUGGESTED BOOKS

1. S.N. Maheshwari, *Advanced Accountancy*, Vikas Publication House Pvt. Ltd.
2. R.L. Gupta and V.K. Gupta, *Principals and practice of Accountancy*, Sultan Chand & Sons.
- 3 M.C. Sukla and T.S. Grewal, *Advanced Accountancy*, 18th Edition, S. Chand, 2008.
4. P.C Tulsian, *Financial Accounting*, Pearson Education, New Delhi

Activity 1

What is the difference between profit and loss account and balance sheet?

Activity 2

What adjustments are required to close the books of accounts?

LESSON-14

FINAL ACCOUNTS WITH ADJUSTMENTS

Structure

- 14.0 Objectives
- 14.1 Introduction
- 14.2 Adjustment Entries
- 14.3 Few Illustrations
- 14.4 Let Us Sum Up
- 14.5 Key Words
- 14.6 Questions
- 14.7 References and Suggested Books

14.0 OBJECTIVES

After studying this lesson you should be able to understand

- Treatment of special adjustments while finalisation of the final accounts
- Effect of the adjustments on the final accounts

14.1 INTRODUCTION

In the previous lesson we got to understand how the last step of accounting cycle i.e. preparation of final accounts is done. But even after preparation of final accounts we find that there are certain transactions which do not result in any inflow or outflow of cash into the business but are necessary to give effect for ascertaining the correct amount of profits. Such transactions are related to depreciation on fixed assets, Provision for doubtful debts, interest on capital and drawings etc.

Matching concept of accounting lays down that all expenses of current year which have been paid or not must be debited to the profit and loss account of current year. It means that all such expenses which have become due but not yet paid or those expenses which have been paid but were not yet due must be adjusted, otherwise, the profits disclosed by Profit and loss account will not be true profits. Matching concept of accounting also applies to incomes which lays down that income of current year must be credited in profit or loss account of current year irrespective of the fact whether they have been received or not.

So this lesson is specifically devoted to understanding of the effect of these adjustments and also how these adjustments would be treated in the final accounts.

14.2 ADJUSTMENT ENTRIES

A fundamental principle in the preparation of the Trading and Profit and Loss Account is that expenses and incomes for the full accounting period are taken into account in the calculation of gross/ net profit or loss. The income statement must contain any revenue or expenses relating to preceding or succeeding period. This means adjustments have to be made for outstanding expenses, advance payments, accrued incomes, incomes received in advance, provision for bad debts etc. Adjustment entries are passed to give effect to these adjustments. There are many adjustments because earlier we have not passed any journal entry, so at the time of making final account we have to adjust them.

Following are the adjustment entries are explained in detail:

14.2.1. Closing Stock

Closing stock is the amount of inventory that a business still has on hand at the end of a reporting period. It includes raw materials, work-in-progress and finished goods. The amount of closing stock can be ascertained with a physical count of the inventory. It can also be determined by using a perpetual inventory system and cycle counting to continually adjust inventory records to arrive at ending balances.

(a) When closing stock is not given within the trial balance but is given as a information for adjustment, then adjustment entry will be as follows:

Closing Account ----- Dr.
To Trading Account

First it will be shown at trading account credit side and then at assets side of balance sheet as current asset.

(b) When closing stock is shown inside the trial balance then it has to be shown only on the assets side of balance sheet as current asset.

Effects on Final Accounts

1. Closing stock will be shown at trading account credit side.
2. Closing stock will be shown on assets side of balance sheet as current asset.

Treatment shown in Trading and Profit and loss account:

Dr.

Cr.

Particulars	Amount (Rs.)	Particulars	Amount (Rs.)
		By closing stock	

Treatment shown in Balance Sheet:

Liabilities	Amount (Rs.)	Assets	Amount (Rs.)
		Closing stock	

14.2.2. Interest on Capital

The proprietor may wish to ascertain his profit after considering the interest which he losses by investing his money in the firm. Interest to be charged is an expense for the business on one hand and income to the proprietor on the other hand. Interest on capital being an expense is debited to profit and loss account and same amount of interest on capital is added to capital on the Liabilities side.

Following adjusting entry is recorded at the end of accounting period:

Interest on Capital A/c ----- Dr.
To Capital A/c

Effects on Final Accounts

1. Interest on capital being an expense is debited to profit and loss account.
2. The amount of interest on capital is added to capital on the Liabilities Side.

Treatment shown in Trading and Profit and loss account:

Dr.

Cr.

Particulars	Amount (Rs.)	Particulars	Amount (Rs.)
To Interest on capital			

Treatment shown in Balance Sheet:

Liabilities	Amount (Rs.)	Assets	Amount (Rs.)
Capital			
(+) Interest on Capital			

14.2.3. Interest on Drawings

As business allows interest on capital it also charges interest on drawings made by the proprietor. Interest so charged is an income for the business on one hand and expense for the proprietor on the other hand. The interest on drawings being an income is credited to profit and loss account and is shown as a deduction from the capital at the Liabilities side of Balance sheet.

Following adjusting entry is passed at the end. of accounting period:

Capital A/c ----- Dr.

To Interest on Drawings A/c

Effects on Final Accounts

1. Interest on drawings being an income is credited to profit and loss account
2. Interest on drawings is shown as deduction from the capital at the Liabilities side of Balance sheet.

Treatment shown in Trading and Profit and loss account:

Dr.

Cr.

Particulars	Amount (Rs.)	Particulars	Amount (Rs.)
		By Interest on Drawings	

Treatment shown in Balance Sheet:

Liabilities	Amount (Rs.)	Assets	Amount (Rs.)
Capital			
(-) Interest on Drawings			

14.2.4. Provision for Discount on Debtor

It is normal practice in trade to allow discount to customers for prompt payment and it constitutes a substantial sum. Sometimes the goods are sold on credit to customers in one accounting period where as the payment of the same is made by them in the next accounting period and so discount is to be allowed. It is a prudent policy to charge this expenditure to the period in which sales have been made, so a provision is created in the same manner, as in case of provision for doubtful debts

NOTE: An important point to note is that no discount will be allowed on debts that become bad. Therefore, the provision required for discount will be in respect of the other debts only. So the amount of provision for discount be calculated after deducting the provision for bad debts from sundry debtors.

Following adjusting entry is passed at the end of accounting period:

Discount Allowed A/c ----- Dr.

To Debtor's Personal A/c

Effects on Final Accounts

1. The provision for discount is charged to debit side of profit and loss account.
2. It is deducted from the debtor's account shown on the assets side of balance sheet.

Treatment shown in Trading and Profit and loss account:

Dr.

Cr.

Particulars	Amount (Rs.)	Particulars	Amount (Rs.)
To Provision for discount on debtors			

Treatment shown in Balance Sheet:

Liabilities	Amount (Rs.)	Assets	Amount (Rs.)
		Sundry Debtors	
		(-) Provision for discount on debtors	

14.2.5. Provision for Discount on Creditors

Prompt payment, if made, enables a businessman to receive discount. The question arises whether this discount should be treated as income of the period in which purchases were made or of the period when the payment is made, if both events are in different accounting years, it has been well decided by accountants that it should be treated as income of the period in which purchases are made. So on last date of accounting period if some amount is still payable to creditors, a provision should be created for such probable income and amount should be credited to the profit and loss account of that year in which purchases are made and subtracted from creditors on the liabilities side of Balance sheet.

Following adjusting entry is passed for it :

Provision for Discount on Creditors A/c ----- Dr.

To Profit and loss A/c

Effects on Final Accounts

1. The provision for discount is the amount that should be credited to the profit and loss account.
2. It is deducted from creditors on the liabilities side of Balance sheet.

Treatment shown in Trading and Profit and loss account:

Dr.

Cr.

Particulars	Amount (Rs.)	Particulars	Amount (Rs.)
		By Provision for discount on creditors	

Treatment shown in Balance Sheet:

Liabilities	Amount (Rs.)	Assets	Amount (Rs.)
Sundry Creditors (-) Provision for discount on creditors			

14.2.6. Outstanding expenses or expenses payable or expenses due but not paid

Certain expenses relating to a particular period may not have been paid in that accounting period. All such expenses which are due for payment in one accounting year but actually paid in future accounting years or payment of which is postponed are all outstanding or unpaid expenses. All such expenses must be accounted for in that accounting year in which they are incurred, irrespective of the fact whether they are paid or not. In other words, all paid and also unpaid expenses must be recorded in an accounting year if they relate to that accounting year only with a view to ascertain true trading results e.g. if salaries for the last month are not paid, no entry will appear in books of accounts unless these are paid. So profit and loss account in respect of salaries will thus be under charged than the actual expenditure, therefore the profit will be more.

Following adjusting entry is passed for it :

Expenses A/c ----- Dr.

To Outstanding Expenses A/c

Effects on Final Accounts

1. Outstanding expenses will add in expenses. If it is direct it will go to trading account's debit side, if it is indirect nature then it will go to the debit side of profit and loss account

2. It will be the current liability so it will go to the liability side of balance sheet

Treatment shown in Trading and Profit and loss account:

Dr.

Cr.

Particulars	Amount (Rs.)	Particulars	Amount (Rs.)
To Outstanding Expenses			

Treatment shown in Balance Sheet:

Liabilities	Amount (Rs.)	Assets	Amount (Rs.)
Outstanding Expenses			

14.2.7. Advance expenses

The benefit of some of the expenses already spent will be available in the next accounting year also, Such a portion of the expense is called pre-paid expense; since such expenses are already paid, they are also recorded in the books of accounts of that period to which they do not relate. The result shown by the final accounts of a particular period will not be correct because such expenses relate to future periods. Therefore, such prepaid expenses must be adjusted in the books of accounts to arrive at true profit. Generally insurance, taxes, telephone subscriptions, rent etc. are paid in advance, thus requiring adjustment e.g. Rent paid by x for one year on 1.7.14 when his accounting year is calendar year; thus rent for 6 months will remain unexhausted and will be carried forward to the next year.

Following adjusting entry is passed for it :

Advance Expenses A/c----- Dr.

To Expenses A/c

Effects on Final Accounts

1. It will deduct from respective expenses paid.

2. It will be the current asset so it will go to assets side of balance sheet

Treatment shown in Trading and Profit and loss account:

Dr.

Cr.

Particulars	Amount (Rs.)	Particulars	Amount (Rs.)
To Advance Expenses			

Treatment shown in Balance Sheet:

Liabilities	Amount (Rs.)	Assets	Amount (Rs.)
		Advance Expenses	

14.2.9. Income received in advance

Sometimes, traders receive certain amounts during a particular trading period which are to be earned by them in future periods. Such incomes though actually received and therefore, recorded i.e. not yet earned. Such incomes should be credited to the profit and loss account of the year in which these are earned. Therefore, such income though received is not the income but a liability of that period.

Following adjusting entry is passed for it :

Income A/c----- Dr.
 To Advance Income A/c

Effects on Final Accounts

1. It will be deduct from the income received on the credit side of profit and loss account.
2. It will shown as liability in the liabilities side of balance sheet

Treatment shown in Trading and Profit and loss account:

Dr.

Cr.

Particulars	Amount (Rs.)	Particulars	Amount (Rs.)
		By Income received in advance	

Treatment shown in Balance Sheet:

Liabilities	Amount (Rs.)	Assets	Amount (Rs.)
Income received in advance			

14.2.10. Goods use for personal use or Drawings

Drawings are goods or cash taken from business by the Owner for this personal use. Drawings of goods will be deducted from the amount of purchases in Trading account and also from the Owner's equity in Balance sheet. Drawing of cash will be just deducted from Owner's equity in balance sheet.

Following adjusting entry is passed for it :

Trading A/c ----- Dr.
To Drawings A/c

Effects on Final Accounts

1. Drawing of goods will be deducted from the amount of purchases in Trading account
2. Drawing of goods will be deducted from the amount the Owner's equity in Balance sheet

Treatment shown in Trading and Profit and loss account:

Dr.

Cr.

Particulars	Amount (Rs.)	Particulars	Amount (Rs.)
To Purchases			
(-) Drawings			

Treatment shown in Balance Sheet:

Liabilities	Amount (Rs.)	Assets	Amount (Rs.)
Owners capital			
(-) Drawings			

14.2.11. Goods destroyed by fire

If Goods in case gets destroyed by fire then it will be shown in credit side of trading account and also in profit and loss account's debit side. And it will not go to balance sheet.

Following adjusting entry is passed for it :

Loss by Fire or Accident A/c ----- Dr.
To Trading A/c

If there is no insurance, it will also go to profit and loss account

Profit and loss A/c ----- Dr.

To Loss by Fire/Accident

Effects on Final Accounts

1. It will shown in credit side of trading account and also in profit and loss account's debit side.
2. It will not go to balance sheet.

Treatment shown in Trading and Profit and loss account:

Dr.

Cr.

Particulars	Amount (Rs.)	Particulars	Amount (Rs.)
To Gross Profit c/d		By Loss by Fire (in case of Insurance)	
	XXXXXX		XXXXXX
To Loss by Fire/Accident		By Gross Profit b/d	

Treatment shown in Balance Sheet:

Liabilities	Amount (Rs.)	Assets	Amount (Rs.)
NO EFFECT		NO EFFECT	

14.2.12. Depreciation

The value of fixed assets diminishes gradually with their use for business purposes. Although this decrease in the value happens every day but its accounting is done only at the end of accounting period.

Following adjusting entry is passed for it :

Depreciation A/c----- Dr.

To Particulars Asset A/c

Effects on Final Accounts

1. It will go to the debit side of profit and loss account
2. It will deduct from fixed asset. Because it decrease the value of asset =fixed asset - depreciation

Treatment shown in Trading and Profit and loss account:**Dr.****Cr.**

Particulars	Amount (Rs.)	Particulars	Amount (Rs.)
To Depreciation on particular asset			

Treatment shown in Balance Sheet:

Liabilities	Amount (Rs.)	Assets	Amount (Rs.)
		Particular Asset	
		(-) Depreciation on particular asset	

14.2.13. Provisional for doubtful debts

At the end of the year, after writing off the bad debts about whom we were sure of becoming irrecoverable, there may still be some customer balances from whom it is doubtful to collect the entire amount. However, it can't be written off as bad because non-recovery of such amount is not certain. But at the same time the balance in sundry debtors account should be brought down to its net realizable figure so that balance sheet may not exhibit the debtors at more than their actual realizable value. Therefore, to show the approximately correct value of the sundry debtors in the balance sheet a provision or reserve is created for possible bad debts. Such an adjustment entry is recorded at the end of accounting year.

Provision for bad debts is an attempt to anticipate possible losses due to bad debts and to keep aside an amount out of profit to meet the loss estimated in the following years.

Following adjusting entry is passed for it :

Profit and Loss A/c -----Dr.

To Provision for bad debts A/c

Effects on Final Accounts

1. Net value of provision for doubtful debt account transfer to profit and loss account's debit side = total bad debt + closing balance or provision of doubtful debt or this year provision - opening balance of provision for doubtful debts
2. Deduct from debtor = debtor – new bad debts – this year provision or closing balance of provision for bad debts

Treatment shown in Trading and Profit and loss account:**Dr.****Cr.**

Particulars	Amount (Rs.)	Particulars	Amount (Rs.)
To Provision for doubtful debts			

Treatment shown in Balance Sheet:

Liabilities	Amount (Rs.)	Assets	Amount (Rs.)
		Sundry Debtors	
		(-) Provision for doubtful debts	

Some important considerations while creating provision for bad debts

(i) Sundry debtors account should not be credited with the amount of provision for doubtful debts because the loss has not actually been incurred.

(ii) Treatment of bad debts or provision for bad debts appearing inside the trial balance. If some balance (credit) is already appearing in provision for doubtful debts account inside the trial balance, it is the previous years unutilized balance of this account. If some bad debts are also appearing on the debit side of the trial balance, these should be transferred to provision for bad debts account, with the help of following entry:

Provision for bad debts A/c ----- Dr.

To Bad debts A/c

It is important to note that, as these items appear inside the trial balance, so these are to appear only in profit and loss account as debtors have already been reduced during the year.

(iii) When bad debts and provision for bad debts appear in trial balance, new provision is to be created and further bad debts are to be written off. If already bad debts and provision for bad debts are appearing in trial balance, these should be adjusted and only difference should be taken to profit and loss account.

If bad debts written off plus bad debts to be written off plus new provision for bad debts is more than the credit balance of old provision appearing in the trial balance, the difference should be debited to profit and loss account.

14.2.14. Commission to manager on profits

Sometimes the manager is entitled to a commission on profits.. Such commission may be :

(a) Fixed percentage on net profits before charging such commission.

(b) Fixed percentage on net profits- after charging such commission.

Such commission being an expense is debited to commission account. However, as it has not yet been paid, so commission payable account is given the credit and finally it is shown in the balance sheet as a liability. Calculation of Commission First of all trading account should be prepared in usual manner and after transferring the gross profit or loss all expenses and incomes should be debited or credited except the commission which is still to be calculated.

Following adjusting entry is passed for it :

Commission A/c----- Dr.

To Outstanding Commission A/c

Effects on Final Accounts

1. It will be shown in the debit side of profit and loss account as o/s commission to manager

If it charge on the amount after charging such commission then we will calculate =profit before commission X Rate/ 100+rate

2. It will be shown as liability

Treatment shown in Trading and Profit and loss account:

Dr.

Cr.

Particulars	Amount (Rs.)	Particulars	Amount (Rs.)
To Commission to Manager			

Treatment shown in Balance Sheet:

Liabilities	Amount (Rs.)	Assets	Amount (Rs.)
Commission to Manager			

Check your Progress 1

1) Mention the effect of net profit and net loss on the capital of the business.

2) Stock is available both inside and outside of the trial balance. What is the difference between the treatment of the two.

3) What adjusting entry will be passed for the prepaid rent ?

4) What journal entry will you pass for the recovery of bad debts previously written off?

14.3 FEW ILLUSTRATIONS

Illustration: The following is the trail balance of Shri Ram at 31st March, 2014 and it is desired to prepare final accounts showing the results of the transactions of the year:

Particulars	Debit(Rs.)	Credit (Rs.)
Capital account		41,000
Plant and Machinery	51,000	
Furniture	2,600	
Stock, April 1,2013	48,000	
Motor Van	12,000	
Sundry debtors	45,000	
Cash in hand	400	

Balance at Bank	6,500	
Wages-Factory	1,50,000	
Wages-office	14,000	
Purchases	2,13,500	
Sales		4,80,000
Bills Receivable	7,200	
Bills Payable		5,600
Sundry creditors		52,000
Returns Inwards	9,300	
Provision for bad debts		2,500
Drawings	6,000	
Return Outwards		5,500
Return	6,000	
Lighting	800	
Telephone	1,350	
Insurance	300	
Advertisement	6,350	
General Expenses	1,000	
Bad debts	2,500	
Discount allowed	6,500	
Discount received		3,700
Total	5,90,300	5,90,300

The following adjustments are to be made:

- (a) Stock on March 31, 2014 was Rs 52,000
- (b) Rent due but not paid, March 31, 2014 was Rs 2,000
- (c) Lighting due but not paid, March 31, 2014 was Rs 300
- (d) Insurance paid in advance was Rs 100
- (e) Depreciation to be written off:
 - Plant and machinery @ 33.33%
 - Office Machinery @ 10%

Motor Furniture @ 33.33%

(f) The provision for bad and doubtful debts has to be increased to Rs 2,000

(g) Discounts at 2.5% on debtors and creditors are to be provided

Solution: **Trading and Profit and Loss Account of M/s Shri Ram**
as on 31 March, 2014

Dr.		Cr.	
Particulars	Rs	Particulars	Rs
To Opening Stock	48,000	By Sales	4,80,000
To Purchases	2,13,500	Less: Returns	<u>9,300</u>
Less: Returns	<u>5,500</u>	By Closing Stock	52,000
To Wages(factory)	1,50,000		
To Gross Profit c/d	1,16,700		
	5,22,700		5,22,700
To Salaries and wages	14,000	By Gross Profit b/d	1,16,700
To Rent	6,000	By Discount Received	3,700
Add: Outstanding	<u>2,000</u>	By provision for discount from	1,300
To Lighting	800	creditors	
Add: Outstanding	<u>300</u>		
To Telephone	1,350		
To Insurance	300		
Less: Prepaid	<u>100</u>		
To General Expense	1,000		
To Depreciation:			
Plant & Machinery	17,000		
Office Furniture	260		
Motor Van	<u>4,000</u>		
To Advertisement	6,350		
To Provision for Bad Debts:			

New provision	3,000			
Add: Bad debts	<u>2,500</u>	3,000		
Less: Opening provision	<u>2,500</u>	6,500		
To Discount allowed				
To Provision for discount to debtors		1,050		
To Net Profit c/d		57,890		
Total		1,21,700	Total	1,21,700

Balance Sheet
of M/s Free Flow Fluids
as on March 31, 2014

Liabilities		Amount	Assets		Amount
Capital	41,000	92,890	Plant & Machinery	51,000	34,000
Add: Profit	57,890		Less: Depreciation	17,000	
	<u>98,890</u>		Office Furniture	2,600	
Less:Drawings	<u>6,000</u>		Less: Depreciation	260	8,000
Sundry Creditors	52,000		Motor van	<u>12,000</u>	
			Less: Depreciation	4,000	
Less:Provision for discount	1,300		Stock in trade		40,950
Bills payable	<u> </u>		Sundry Debtors	45,000	
			Less: Provision for	3,000	
Outstanding Expenses			Bad debts	<u> </u>	
			42,000	40,950	
			Less: Prov. for discount	<u>1,050</u>	
			Bills receivable		7,200
			Cash in hand		400
			Cash at bank		6,500
			Prepaid Expenses		100
		1,51,490			1,51,490

Illustration Given is the Trial Balance of Ms. Malini as on 31.3.2014. You are required to prepare final accounts:

<u>Trial Balance</u>		
<u>Particulars</u>	<u>Debit</u>	<u>Credit</u>
15 % Loan		2,000.00
Annual Insurance (taken on 1st July)	1,800.00	
Bills Receivable	1,200.00	
Capital		1,40,000.00
Carriage Inward	8,700.00	
Carriage Outward	2,300.00	
Cash at Bank	10,100.00	
Cash - In - Hand	100.00	
Commission		1,800.00
Creditors & Debtors	20,200.00	12,000.00
Discount	1,200.00	
Int. on Loan	200.00	
6 % Investment (on 1st May, 2013)	3,600.00	
Motor Cycle	34,600.00	
Op. Stock	15,500.00	
Plant & Machinery	80,700.00	
Power & Fuel	1,500.00	
Prov. For Bad Debts		200.00
Purchase Return		700.00
Purchases	36,000.00	
Rent		12,000.00
Rent & Taxes	1,200.00	
Return inward	300.00	
Salary	5,000.00	
Sales		58,000.00
Wages	2,500.00	
	2,26,700.00	2,26,700.00

Some Important Points:

- a) Stock on 31st March, 2014 valued at ₹ 20,000.00.

- b) Commission Outstanding worth ₹ 200.00
- c) Plant and Machinery includes ₹ 5,700 worth of old machinery and remaining new machinery was purchased on 1st Oct, 2013. Depreciate it by 10 % on WDV basis.
- d) Loan was taken on 1st April, 2013.
- e) Write off ₹ 400 as bad debts. Maintain 5 % prov. For doubtful debts and 2 % as Prov. for Discount.
- f) Depreciate Motor Cycle by 5 %.
- g) Bill Receivable include ₹ 200 of bill dishonored.

Solution:

Trading and Profit and Loss A/c			
Particulars	Amount	Particulars	Amount
To Opening stock	15500	By Sales 58000	
To Purchase 36000		Less Sales Return <u>300</u>	57700
Less Purch. Ret. <u>700</u>	35300	By Closing Stock	20000
To Wages	2500		
To Carriage Inward	8700		
To Power & Fuel	1500		
To Gross Profit c/d	14200		
	77700		77700
To Insurance 1800		By Gross Profit b/d	14200
Less prepaid		By Comm. 1800	
for 3 months <u>450</u>	1350	Add O/s <u>200</u>	2000
To Carriage outward	2300	By Int. On Investments	198
To Discount	1200	(6% for 11 months o/s)	
To Interest on loan 200		By Rent	12000
Add o/s interest <u>100</u>	300		
To Rent & Taxes	1200		
To Salary	5000		
To Depreciation			
Motor Cycle 1730			
Plant & Mach old 570			
Plant & Mach new <u>3750</u>	6050		
To Bad Debts	400		

To Prov. For B. D.			
new at 5% 1000			
Less old as in TB <u>200</u>	800		
To Prov. For Dis. on Debtors	380		
To Net Profit	9418		
	28398		28398

Balance Sheet

Liabilities	₹	Assets	₹
Capital 140000		Plant & Mach.New	
Add Profit <u>9418</u>	149418	(80700-5700) 75000	
15% Loan	2000	Less Dep.	
Outstanding Interest on Loan	100	for 6 months <u>3750</u>	71250
Creditors	12000	Plant & Mach.Old 5700	
		Less Dep. <u>570</u>	5130
		Motor Cycle 34600	
		Less Dep. <u>1730</u>	32870
		6% Investments	3600
		Debtors 20200	
		Add B/R Dishonor <u>200</u>	
		20400	
		Less Bad debts <u>400</u>	
		20000	
		Less Prov. For BD <u>1000</u>	
		19000	
		Less Prov. for Dis. <u>380</u>	18620
		Bills Receivable 1200	
		Less B/R Dishonor <u>200</u>	1000
		Cash at Bank	10100
		Cash in hand	100
		Stock	20000
		Prepaid Insurance	450
		Commission O/s	200

	Interest on Investments (6% for 11 months o/s)	198
163518		163518

Illustration From the following trial balance of Mr. Lakhani as on 31.3.2014, you are requested to prepare final accounts.

Trial Balance

<u>Particulars</u>	<u>Debit (₹)</u>	<u>Credit (₹)</u>
Bad Debts	5,000.00	
Bills Payables		40,000.00
Bills Receivable	20,000.00	
Capital		2, 50,000.00
Cash At Bank	40,000.00	
Cash In Hand	16,000.00	
Drawings	20,000.00	
Electricity Exps.	9,000.00	
Furniture And Fixtures	15,000.00	
Interest		2,000.00
Land And Building	1, 00,000.00	
Office Expenses	25,000.00	
Plant And Machinery	57,000.00	
Purchases	1, 00,000.00	
Rates And Taxes	8,000.00	
Rent		16,000.00
Repairs	3,000.00	
Salaries (For 10 Months)	20,000.00	
Sales		1, 70,000.00
Stock	50,000.00	
Sundry Creditors		70,000.00
Sundry Debtors	15,000.00	

Telephone Exps.	6,000.00	
Trading Expenses	5,000.00	
Wages	30,000.00	
	5, 46,000.00	5, 46,000.00

Additional Information:

1. Closing Stock was valued at ₹ 1, 00,000.00.
2. Write off ₹ 1,000 as bad debts. And make 3 % discount on Debtors. Further make 10% as provision for doubtful debts.
3. Manager A is entitled for 5% commission on profit before commission while manager B is entitled for 10% commission on profit after commission.
4. Purchases include a purchase of Computer ₹ 12,000 on 1st October, 2013.
5. Sales include ₹10,000 of goods sent on Approval Basis.
6. Depreciate Furniture by 10%, Computer by 15% and reduce Plant and Machinery to ₹ 50000

Solution:

Trading and Profit and Loss A/c			
Particulars	Amount	Particulars	Amount
To Opening stock	50000	By Sales 170000	
To Purchase 100000		Less on approval <u>10000</u>	160000
Less Purchase of Comp <u>12000</u>	88000	By Closing Stock 100000	
To Wages	30000	Add Sales on approval	
To Gross Profit c/d	102000	<u>10000</u>	110000
	270000		270000
To Office Expenses	25000	By Gross Profit b/d	102000
To Telephone Expenses	6000	By Rent	16000
To Trading Expenses	5000		
To Electricity Expenses	9000		
To Interest	2000		
To Repairs	3000		
To Rates & Taxes	8000		
To Salary 20000			
Add O/s Salary <u>4000</u>	24000		
To Depreciation			
Furniture 1500			

Plant & Mach 7000			
Computer <u>900</u>	9400		
To Bad Debts 5000			
Add additional bad debts <u>1000</u>	6000		
To Provision for Bad debts	400		
To Prov. For Discount on debtors	108		
To Net Profit c/d	20092		
	118000		118000
To Manager A's Commission (20092 X .05)	1005	By Net Profit b/d	20092
To Manager B's Commission (20092-1005) X 10/110	1735		
To Net Profit	17352		
	20092		20092

Balance Sheet

Liabilities	₹	Assets	₹
Capital 250000		Furniture, Fixtures 15000	
less Drawings <u>20000</u>		Less 10% Depreciation <u>1500</u>	13500
230000		Land & Building	100000
Add Profit <u>17352</u>	247352	Plant & Machinery 57000	
Outstanding Salary	4000	Less Depreciation <u>7000</u>	50000
Creditors	70000	Computer 12000	
Bills Payable	40000	Less Depreciation <u>900</u>	11100
Managers Commission			
A 1005		Debtors 15000	
B <u>1735</u>	2740	Less Additional bad debts <u>1000</u>	
		Less on approval <u>10000</u>	
		Less Provision for bad debts <u>400</u>	
		Less Prov for Dis. <u>108</u>	3492
		Bills Receivable	20000
		Cash at Bank	40000
		Cash in hand	16000
		Stock	110000
	364092		364092

Check your Progress 2

1) Mention items to be added to and deducted from capital at the liabilities side.

2) Explain the treatment of accidental loss of goods in the final accounts, if

(a) Goods are not insured.

(b) Goods are insured and full claim is admitted by the Insurance Company.

3) From the following Trial balance extracted from the books of J. N.S., prepare a Trading account, profit loss account for the year ended 31st March, 2014 and a balance sheet as on that date.

Capital.....	20000
Drawings.....	1,700
Plant and Machinery	12,000
Horses and Carts.....	2,600
Debtors... ..	3,600
Creditors.....	2,600
Purchases and Sales	2000
Wages.....	800
Cash at Bank.....	2600
Salaries... ..	800
Repairs.....	190
Stock.....	1,600
Rent	450

Manufacturing Expenses.....	150
Bills Payable	2350
Bad debts... ..	500
Carriage.....	<u>160</u>

The following adjustments are made:

1. Closing Stock Rs 1,600.
2. Depreciate Plant & Machinery 10%, Horses & Cans 15%.
3. Allow interest on capital at 5% P.A.
4. Rs 150 is due for wages
5. Paid rent Rs 50 in advance.

14.4 LET US SUM UP:

Let us summarise the adjustments discussed in this lesson

1. Following adjustment entries are passed in final accounts:

Name of items	Adjustment entry	Effect on trading and profit and loss account	Effect on balance sheet
Closing stock	Closing stock a/c dr. To trading a/c	Closing stock will write in the credit side of trading account	It will show as asset in the final account
Interest on Capital	Interest on Capital Account dr. To Capital Account	Interest on Capital is an expenditure charged to debit side of profit and loss account.	It is added to capital shown on the liability side of the balance sheet.
Interest on Drawings	Capital Account dr. To Interest on Drawings Account	Interest on drawings is charged on the credit side of the profit and loss account.	It is deducted from the capital account shown on the liability side of the Balance Sheet.
Provision for Discount on Debtor	Discount Allowed Account dr. To Debtor's Personal Account	The provision for discount is charged to debit side of profit and loss account.	It is deducted from the debtor's account shown on the assets side of balance sheet.
Provision for Discount on Creditors	Provision for Discount on Creditor's a/c dr. To Profit and Loss Account	The provision for discount on creditors treated as an anticipated profit charged to the credit side of profit and loss account.	And it is deducted from sundry creditors shown on the liability side of the balance sheet.

Outstanding expenses or expenses payable or expenses due but not paid	Expenses a/c dr. To outstanding exp.	Outstanding expenses will add in expenses. If it is direct it will go to trading account's debit side , if it is indirect nature then it will go to the debit side of profit and loss account	It will be the current liability so it will go to the liability side of balance sheet.
Advance expenses	Advance expenses a/c dr. To expenses account	It will deduct from respective expenses paid.	It will be the current asset so it will go to assets side of balance sheet
Income receivable	Outstanding income a/c dr. To income account a/c	It will add in the income and go to credit side of profit and loss account	It will show as asset in the assets side of balance sheet
Income received in advance	Income account dr. To advance income a/c	It will deduct from the income received	It will be shown as liability in the liabilities side of balance sheet
Goods use for personal use	Drawings a/c dr. To purchase a/c	It will deduct from purchase in the debit side of trading account = purchase –drawing in goods	It will deduct from capital in the liabilities side of balance sheet =capital- drawing in goods
Goods destroyed by fire	Loss by fire or accident account dr. To trading a/c <i>If there is no insurance, it will also go to profit and loss account</i> Profit and loss account dr. To loss by fire/accident	It will shown in credit side of trading account And also in profit and loss account's debit side	It will not go to balance sheet
Depreciation	Depreciation a/c dr. To respective asset a/c	It will go to the debit side of profit and loss account	It will deduct from fixed asset . Because it decrease the value of asset =fixed asset - depreciation
Provisional for doubtful debts	If you have make any provision for doubtful debts the its journal entry will passed Provision for doubtful debt a/c dr. To Bad debts a/c (New bad debts which is not shown in trial balance will transfer to provision for doubtful	Net value of provision for doubtful debt account transfer to profit and loss account's debit side =total bad debt + closing balance or provision of doubtful debt or this year provision - opening balance of provision for doubtful debts	Deduct from debtor = debtor – new bad debts – this year provision or closing balance of provision for bad debts

	debt account)		
Commission to manager on profits	Commission a/c dr. To outstanding commission a/c	It will shown in the debit side of profit and loss account as o/s commission to manager If it charge on the amount after charging such commission then we will calculate =profit before commission X Rate/ 100+rate	It will shown as liability

4.5 KEY WORDS

Interest on Drawings : Interest on drawings is charged on the drawings made. The interest so charged is an income for the business on one hand and expense for the proprietor on the other hand. The interest on drawings being an income is credited to profit and loss account and is shown as a deduction from the capital at the Liabilities side of Balance sheet.

Advance expenses: The benefit of some of the expenses already spent will be available in the next accounting year also, Such a portion of the expense is called pre-paid expense; since such expenses are already paid, they are also recorded in the books of accounts of that period to which they do not relate. The result shown by the final accounts of a particular period will not be correct because such expenses relate to future periods. Therefore, such prepaid expenses must be adjusted in the books of accounts to arrive at true profit.

Income received in advance: Sometimes, traders receive certain amounts during a particular trading period which are to be earned by them in future periods. Such incomes though actually received and therefore, recorded i.e. not yet earned. Such incomes should be credited to the profit and loss account of the year in which these are earned. Therefore, such income though received is not the income but a liability of that period.

Goods use for personal use or Drawings: Drawings are goods or cash taken from business by the Owner for this personal use. Drawings of goods will be deducted from the amount of purchases in Trading account and also from the Owner's equity in Balance sheet. Drawing of cash will be just deducted from Owner's equity in balance sheet.

Goods destroyed by fire: If Goods in case gets destroyed by fire then it will be shown in credit side of trading account and also in profit and loss account's debit side. And it will not go to balance sheet.

Depreciation: The value of fixed assets diminishes gradually with their use for business purposes. Although this decrease in the value happens every day but its accounting is done only at the end of accounting period.

4.6 QUESTIONS

Short Answer Questions

- 1) Distinguish between outstanding income and accrued income.
- 2) What do you understand by Provision for Bad and Doubtful Debts?
- 3) Write Short notes on :
 - (a) Closing Stock
 - (b) Outstanding Expenses
 - (c) Prepaid Expenses
 - (d) Accrued Income
 - (e) Provision for Discount on Creditors.
- Q4) What are adjusting entries? Why are these necessary for preparing final accounts?

Long Answer Questions

- 1) What is Trading account? Draw a pro forma of a trading account. Pass necessary Closing entries relating to trading account with the help of a practical example.
- 2) On 31st December, 2014 the following Trial Balance was extracted from the books of Mr. Himmat Singh.

Particulars	Rs. P.	Particulars	Rs. P.
Dr. Balances:		Rates Taxes and Insurance	2,891
Drawings	3,000	Advertising	3,264
Sundry Debtors	20,100	General Expenses	3,489
Interest on Loan	300	Bills Receivable	6,882
Cash in Hand	2,050	Cr. Balances:	
Stock on 1 st Jan, 2014	6,839	Capital	28,000
Motor Vehicles	10,000	Sundry Creditors	10,401
Cash at Bank	3,555	Loan on Mortgage	9,500
Land & Buildings	12,000	Bad Debts Reserve	710
Bad Debts	525	Sales	1,10,243
Purchases	66,458	Purchases Returns	1,346
Sales Returns	7,821	Discounts	540
Carriage Outward	2,404	Bills Payable	2,614

Carriage Inward	2,929	Rent Received	250
Salaries	9,097		

Prepare Trading and Profit and Loss Account for the year ended 31st December, 2014 and Balance Sheet as on that date, after making adjustments for the following matters:

1. Depreciate Land and Building at 2-1/2 % and Motor Vehicles at 20%.
2. Interest on Loan at 6% p.a. is unpaid for six months.
3. Goods costing Rs. 500 were sent to a customer on sale or return for Rs. 600 on 30th December, 2014 and had been recorded in the books as actual sales.
4. Salaries amounting to Rs. 750 and rates amounting to Rs. 350 are outstanding.
5. Prepaid Insurance amounted to Rs. 150.
6. The provision for Bad Debts is to be maintained at 5% on Sundry Debtors.
7. Provide for manager's Commission at 10% on net profits after charging such commission.
8. Stock in hand on 31st December, 2014 was valued at Rs. 6,250.

3) Mrs. Gurdeep Singh , shopkeeper had prepared the following trial balance from his ledger as on 31st March, 2014 :

Particulars	Dr. (Rs.)	Cr. (Rs.)
Purchases and Sales	6,20,000	8,30,000
Cash in hand	4,200	
Cash at Bank	24,000	
Stock of goods on 01-04-2006	1,00,000	
Capital A/c		5,77,200
Drawings	8,000	
Salaries	64,000	
Postage and telephones	23,000	
Salesmens's commission	70,000	
Insurance	18,000	
Advertising	34,000	
Furniture	44,000	
Printing and Stationery	6,000	

Motor Car	96,000	
Bad debts	4,000	
Cash discount	8,000	
General expenses	60,000	
Carriage inwards	20,000	
Carriage outwards	40,000	
Wages	40,000	
Debtors and creditors	2,00,000	80,000
	<u>14,87,200</u>	<u>14,87,200</u>

You are required to prepare Trading and Profit & Loss Account for the year ended 31st March, 2014 and Balance Sheet on that date. You are also given the following information:

1. Stock on 31-3-2014 was Rs. 1,45,000.
2. Mr. Gurdeep Singh had withdrawn goods worth Rs. 5,000 during the year.
3. Purchases include purchase of furniture worth Rs. 10,000.
4. Debtors are bad to the extent of Rs. 5,000.
5. Creditors include a balance of Rs. 4,000 to the credit of Mr. Mandeep in respect of which it has been decided and settled with the party to pay only Rs. 1,000.
6. Sales include goods worth Rs. 15,000 sent to Gyan & Co. on approval and remaining unsold as on 31-3-2014. The cost of the goods was Rs. 10,000.
7. Provision for Bad Debts is to be created at 5% on Sundry Debtors.
8. Depreciate Furniture by 15% and Motor Car by 20%.
9. The salesmen are entitled to a commission of 10% on total sales.

14.7 REFERENCES AND SUGGESTED BOOKS

1. S.N. Maheshwari, *Advanced Accountancy*, Vikas Publication House Pvt. Ltd.
2. R.L. Gupta and V.K. Gupta, *Principals and practice of Accountancy*, Sultan Chand & Sons.
3. M.C. Sukla and T.S. Grewal, *Advanced Accountancy*, 18th Edition, S. Chand, 2008.
4. P.C Tulsian, *Financial Accounting*, Pearson Education, New Delhi

Activity 1

What is the accounting treatment of Provision for Bad and Doubtful Debts?

Activity 2

What do you understand by outstanding income and accrued income?
