



BCM(N)-201

FINANCIAL ACCOUNTING



Department of Commerce
School of Management Studies and Commerce

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FINANCIAL ACCOUNTING



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FINANCIAL ACCOUNTING

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UNIT-1

Meaning, Objects, Scope and Functions of Accounting

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Learning Objectives

After going through this Unit, you will be able to clearly understand the following:

- Concept and meaning of Accountancy, Book - keeping and Accounting.
- Accounting Process.
- Features of Accounting.
- Scope of Accounting.
- Objectives of Accounting.
- Functions of Accounting.

1.1 Introduction

Accounting is not new for any individual. In our daily life, we are using the accounting without even knowing it. For example, if you are purchasing different items, it would be difficult to remember the details of all transactions because of limitation of mind. Therefore, it is necessary for you to write all these transactions in a piece of paper. This recording of transaction is an important function of accounting. At the same time, you would like to know the balance of money in your pocket is correct or not. Accounting is a language of business. The basic function of any language is to serve as a means of communication. Accounting also serves this function. It records business transactions taking place during the accounting period. In other words, where ever money is involved, accounting is required to account for it. 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 and to have control over the firm's property.

1.2 Definition

The accounting has been defined by number of authors and accounting bodies from time to time. Many definitions of the term are available.

According to A.W. Johnson, the renowned scholar in accountancy, as he said in his Elementary “Accounting may be defined as the collection, compilation and systematic recording of business transactions in terms of money, the preparation of financial reports, the analysis and interpretation of these reports and the use of these reports for the information and guidance of management.”

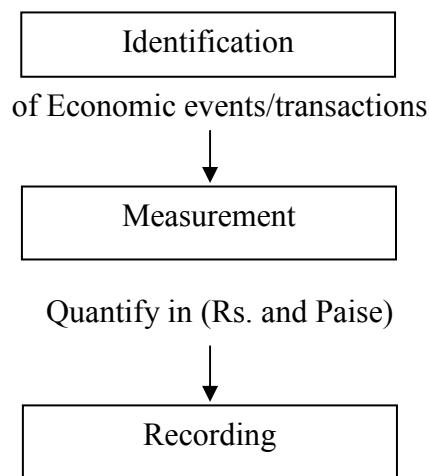
According to American Institute of Certified Public Accounts Committee on Terminology, “Accounting is the art of recording, classifying and summarizing in a significant manner and in terms of money transactions and events which are, in part at least, of a financial character and interpreting the results thereof.”

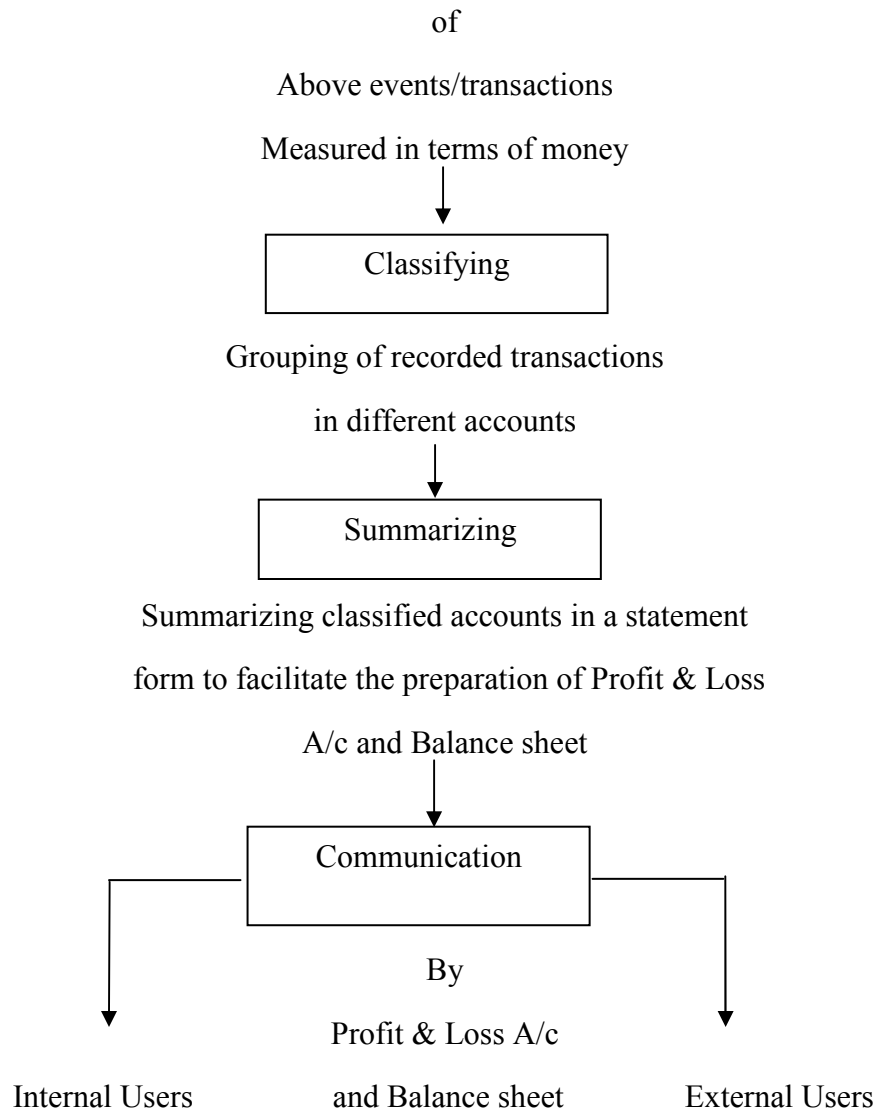
The definition given by American Accounting Association emphasized the broader perspective of accounting. It reads thus, “Accounting refers to the process of identifying, measuring and communicating economic information to permit informed judgment and decisions by users of the information.”

1.3 Accounting Process

To boil down the above definitions, the whole accounting process may be depicted with the help of the following flow chart:

FLOW CHART OF ACCOUNTING PROCESS





On the basis of the above flow chart of accounting process, a comprehensive definition of accounting may be given as follows:

“ Accounting is an art of recording, classifying and summarizing of business transactions and events which can be expressed in terms of money with a view to communicate the results of the accounting period to the users i. e. external and internal with the help of accounting reports i. e., Profit and Loss Account and Balance Sheet”

1.4 Features of Accounting

- It is an art.
- It records transactions / events which can be measured in terms of money only.
- It classifies business transactions in terms of different accounts.
- It summarizes and prepares final accounts i. e. Profit and Loss Account and Balance Sheet
- It communicates results to the users for taking intelligent decisions.

1.5 Scope of Accountancy

The scope of accountancy covers all the accounting activities write from the identification of various transactions till the communication of results. Therefore, scope of accountancy can be studied under two headings:

1.5.1 Book- Keeping

It is the presentation of routine records of all monetary transactions taking place in an accounting period. Book-Keeping involves:

- (i) Identifying the transactions related to accounting period and business.
- (ii) Measuring the transactions in terms of money.
- (iii) Recording the measured transactions in a book known as Journal.
- (iv) Classifying the recorded transactions in a book known as Ledger.

1.5.2 Accounting

Accounting starts where Book-keeping ends. The accounting covers all the accounting activities write from preparation of financial statements and their reporting to users. Thus, Accounting involves:

- (i) Summarizing the classified transactions in a statement known as Trial Balance.
- (ii) Rectification of errors.

- (iii) Preparation of Profit and Loss Account and Balance Sheet with the help of Trial Balance.
- (iv) Communicating the interpreted information to the users.

Main difference between book keeping and accounting are as follows:

Points of Distinction	Book-keeping	Accounting
1. Object	The object of book-keeping is to prepare original books of accounts, trial balance and final accounts and to maintain systematic records of financial results.	The object of accounting is to record, classify , summarize , analyze and interpret the business transactions and to ascertain operating results & financial
2. Scope	It has limited scope and is concerned with recording, classifying and summarizing of business transactions.	It has wider scope and covers book-keeping plus analysis and interpretation.
3. Level of work	It is restricted to clerical work and is done by lower level of management.	It is concerned with all levels of management . lower level clerks prepare the accounts, medium level report it and top level interpret it.
4. Mutual dependence	It has to depend on accounting for making the accounting record more useful.	It has to depend on book-keeping for getting the required information from accounting records and for making them useful for planning , control and decision making.

5. Results of the business	It shows the net result and financial position of the business as the scope extends to the preparation of the final accounts.	It analyses the operating results and financial position of the business.
6. Stages	Bookkeeping is a primary stage.	Accounting is the secondary stage. It begins where book-keeping ends.

1.6 Objects of Accounting

The object of accounting can be, broadly, said as to find out the financial position, amount of profit or loss, amount of assets and liabilities etc. and communicating information to users. The main objects of accounting are narrated below:

1.6.1 Maintain Accounting Record

The maintenance of the accounting records in a systematic manner is the primary objective of the accounting because the volume of transactions is so large. The records will relate to incomes, expenses, assets, liabilities etc.

1.6.2 Ascertains Profit or Loss

In order to know the operational performance of an enterprise, the amount of profit or loss at the end of the accounting period is ascertained by preparing Profit and Loss Account based on the facts and figures obtained from the various books of accounts prepared for the purpose. Similarly, in case of non-profit organizations, the excess or deficit of income and expenditure can be ascertained also by preparing the Income and Expenditure Account.

1.6.3 Ascertain Financial Health

The primary objective of the accounting is also to know the financial soundness of an enterprise. This can be ascertained by preparing the Balance Sheet at the end of the accounting period on a certain date. This can be prepared with the help of systematic records of assets and liabilities maintained by an enterprise. The owner of the organization wants to know how much business owns and how much business owes to others.

1.6.4 Communicate Information to Users

The ultimate aim of preparing the books of accounts and financial statements is to generate information needed by the internal as well as external users for the purpose of taking the intelligent decisions. The information is communicated with the help of financial statements i.e., Profit and Loss Account and Balance Sheet.

1.6.5 Prevent Defalcation of Funds

It is essential to maintain regular and systematic books of accounts. This act of accounting will help in preventing defalcation of cash, goods and property.

1.6.6 Satisfy Government Authorities

If the books of accounts are maintained properly, this will ensure the correctness of the accounting information. This act of accounting will prove the genuineness and correctness of the accounts before the Income Tax and Sales Tax authorities and also before various government departments.

1.7 Functions of Accounting

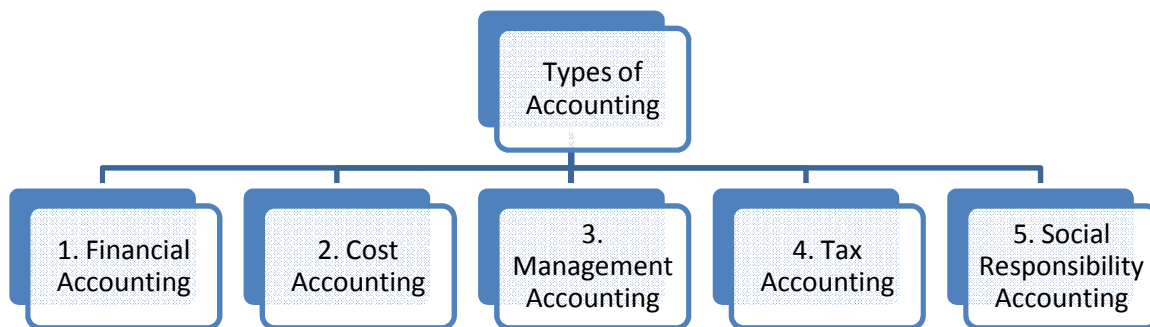
The main function of accounting is to identify the transactions in monetary terms that will be recorded in books of accounts and present the results in the form of operational performance and financial position of the business. In other words, the whole process of accounting can be taken as functions of accounting. The accounting broadly covers the following four functions:

1. Identification of business transactions which can be measured in terms of money. These transactions must be related to the business and accounting period.

2. Recording and analyzing the identified transactions in the books of accounts i.e. Journal and Ledger.
3. Preparation of summary statements i. e. Trial Balance and accounting reports in the form of Profit and Loss Account and Balance Sheet.
4. Supply the necessary information about the operational performance and financial soundness to the users for decision making.

1.8 Types of Accounting

Accounting can be classified into the following categories:



1.8.1 Financial Accounting

The main purpose of this type of accounting is to record business transactions in the books of accounts in such a way that operating results for a particular period and financial condition on a particular date can be known for the information of the various groups of the persons.

1.8.2 Cost Accounting

Cost accounting deals with the cost of production and its various constituents. It is concerned with the classification, allocation, recording, summarizing and reporting current and prospective costs. Cost accounting like financial accounting serves the needs of proprietors, managers and interested outsiders. Cost accounting is the systematic process of determining unit cost at different levels of production.

1.8.3 Management accounting

Management in the business is concerned with decision making for the efficient working of the enterprises, so management accounting is a system to assemble and furnish the useful material and summarized accounting information to the management. Management accounting as such is the effective blending of financial and cost accounting together with financial management. The ultimate end of management is to maximize profit at the minimum cost and sacrifice. The management accounting serves as an effective tool for determining right line of action in future.

1.8.4 Tax Accounting

The branch of accounting which is used for tax purposes is called Tax Accounting. On the basis of this accounting sales tax and income are computed.

1.8.5 Social responsibility accounting

It is the branch of accounting which involves accounting for social costs incurred by the enterprises and social benefits created by it.

1.9 Summary

- (i) Accounting is a language of business.
- (ii) Accountancy covers book-keeping and accounting.
- (iii) Book-Keeping is the preparation of routine records. In other words, writing of transactions in different books of accounts

- (iv) The scope of accountancy covers all accounting activities or the whole accounting process.
- (v) The objectives of accounting is to find out the profit or loss and financial position of the business and communicating information to users for taking decisions.
- (vi) The functions of accounting cover the analysis of transactions/events, recording of these transactions and preparing accounting reports.

1.10 Glossary

Accounting: it is an art of recording, classifying, summarizing, interpreting and communicating the results to the final stakeholders.

Financial Year: A financial year is a period of 12 months for which a business or government prepares its accounts and calculates profit, loss, and tax.

Financial Accounting: Financial Accounting is the branch of accounting that deals with recording, classifying, summarizing and presenting financial transactions of a business in a systematic manner, to find out profit and loss and financial position of the business.

1.11 Check your Progress

1. What is the primary purpose of accounting?
 - a. To conduct independent examinations of financial statements
 - b. To systematically record, summarize, and analyze financial transactions
 - c. To provide legal advice to businesses
 - d. To market and promote financial products

2. Financial accounting mainly deals with:
 - a) Decision making
 - b) Recording business transactions

- c) Cost control
- d) Budget preparation

3. Financial accounting records only:

- a) Personal transactions
- b) Non-monetary transactions
- c) Monetary transactions
- d) Estimated transactions

4. Which statement shows the financial position of a business?

- a) Trading Account
- b) Profit and Loss Account
- c) Balance Sheet
- d) Cash Book

1.12 Answers to check your progress

1. b, 2.b, 3.c , 4.c

1.13 Terminal Questions

- 1. Define accounting. Explain its scope.
- 2. Explain the objectives of accounting.
- 3. Define accounting and explain its features.
- 4. Write a note on accounting process.
- 5. What is accounting? Explain its functions.

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UNIT-2

Accounting Concepts, Conventions and Standards

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 - 2.2.2 Going Concern Concept
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- 2.8 Answers to check your progress
- 2.9 Terminal Questions
- 2.10 Reference Books

Learning Objective

After going through this chapter you would understand:

- Concept of Accounting
- Conventions of Accounting

- Meaning of Accounting Standard
- Need of Accounting Standards
- Accounting Standards issued

2.1 Introduction

In modern age, Accountancy is a language of business through which the accountants express their ideas and thoughts. Accountants follow principles, rules, concepts and conventions to communicate the same meaning of the language. Therefore, for maintaining accounts systematically and properly, accountants must have the full knowledge of their rules, principles, concepts and conventions. The Institute of Chartered Accountants of India has developed Accounting Standards from time to time to ensure credibility and reliability of the financial statement i.e. Profit and Loss Account and Balance Sheet. Accounting needs a set of rules, concepts and conventions that are called Accounting Principles. Accounting has been developed on the basis of these principles. The adoption of these principles by the Accountant in preparation of their accounts ensures the credibility and reliability of financial statement i.e. Profit and Loss Account and Balance Sheet. Accounting Principles are not static. It calls for change from time to time to meet the requirements of changing needs of the business.

2.2 Accounting Concepts

The accounting concepts refer to necessary assumptions or conditions upon which accounting is based. These are conceived for accounting in a systematic manner. There are several concepts which have been developed on the basis of the relation of income and expenditure of the business. Though, many accounting concepts are developed and used but there is general agreement on the following concepts:

2.2.1 Business Entity Concept

This concept is very old. In accounting business is treated as a separate entity from its owner who is supplier of capital. Business and owner are two separate persons. Accounts

are prepared to give information about the business and not of the owner. In other words, accountant is recording only those transactions which are related to the business. The transactions of the owner are not recorded in the books of accounts because we want to communicate operational results i.e. profit or loss and financial position of the business only. This concept is applicable in all types of organizations i.e. sole proprietorship, partnership, company etc.

Features

- (i) Business and owner are two separate persons.
- (ii) The transactions related to business only are recorded in the books of accounts.
- (iii) Business has got a separate legal existence e.g. company form of organization.
- (iv) Accounts only show the operational results and financial position of the business and not of the owner of the business.

Example

- (i) Proprietor is treated as creditor to the extent of capital invested in the business. Therefore, capital is shown on the liability side of the Balance Sheet.
- (ii) If the household expenses of the proprietor are paid out of business cash. This transaction will be treated as personal transaction of the owner.

2.2.2 Going Concern Concept

Under this concept, it is taken that the life of the business is for indefinite period. It has no relation with the life of the owner. In other words, the business entity has a continuity of life. This concept is very important in relation to the preparation of financial statements. The fixed assets are valued on the basis of the going concern concept. This concept also implies that existing liabilities will be paid at maturity. An out side person would like to invest money in the business when he knows that the business will continue in near future. Exception to this concept is that in certain cases the life of the business may be a fixed period e.g. Construction Contracts, Joint Ventures.

Features

- (i) The business will continue to exist in near future.
- (ii) The duration of the business does not depend upon the life of the proprietor's.
- (iii) The business continues in its own momentum.
- (iv) The future of the entity cannot be predicted.
- (v) There may be a possibility of end of its life due to insolvency, dissolution, liquidation, amalgamation, absorption etc.

Example

- (i) Assets are depreciated on the basis of expected life.
- (ii) The financial statements are part of a continuous inter-related series of statements.

2.2.3 Money Measurement Concept

It is the basic feature of the accounting that the business will record only those transactions which can be measured in terms of money. This concept fulfills this basic requirement of the accounting. This concept adds to usefulness to financial data. This facilitates comparison of two heterogeneous facts as they can be made homogenous by expressing them in terms of money. This concept makes the accounting statements comparable by measuring all items of their statements in terms of money.

Features

- (i) The transactions which can be measured in terms of money are only recorded in the books of accounts.
- (ii) Non-monetary transactions are ignored. For example, the efficiency of the worker may affect the cost of the production.
- (iii) Money is accepted as medium of exchange for goods and services.
- (iv) Concept adds usefulness to financial data,
- (v) This makes the financial statement comparable.

This concept has two limitations. The first limitation is that it does not take into account changes in the purchasing power of money. Another limitation is that non-monetary transactions are not recorded in the books of accounts though these transactions have significant affect on the performance of the business. For example health of the owner, bad relations between purchase manager and production manager.

Example

(i) A business owns one building, one machine etc. cannot be recorded in the business until unless the value of these assets expressed in terms of money i.e. Building Rs. 500000, Machine Rs. 200000.

(ii) A business has got an order due to reputation of the owner. This will not be recorded.

2.3.4 Dual Aspect Concept

This concept lies at the heart of the whole accounting system. The traditional and modern accounting systems are based on this concept. It is based on the Double Entry System. According to this concept, every transaction has two aspects i.e. one is receiving aspect and the other is giving aspect. Of the two aspects one aspect will be debit and other aspect will be credit. The debits will be equal to credits. In Unit-3, this concept has been discussed in detail.

2.2.5 Accounting Period Concept

The accounting period concept has come into use with a view to ascertaining profit or loss, financial position etc. of an organization during a particular period when the life of the organization is taken as indefinite and continuing. Under this concept, the accounts are prepared for a specific period i.e. for one year. The financial position and profitability of the concern is ascertained at regular intervals i.e. three months or six months or a year. The Profit and Loss Account is prepared for a specific period and the Balance Sheet is prepared on a specific date. Thus, accounting at the end of every 12 months has become the practice, because in such accounting the impact of all seasons of the year can be found. This period of 12 months is known as accounting period. The accounting year may

be financial year or calendar year. This concept is very important from the point of view of measurement of income, expenses, assets, liabilities, ascertaining profit or loss and financial health and the segregation of capital expenditure and revenue expenditure etc.

2.2.6 The Cost Concept

This is very important concept from the point of view of valuation of asset. The accounting records are based on cost. The basic function of business is the exchange of goods and services through the medium of money. The money paid for exchange becomes the cost of goods and services. The assets and liabilities are shown at cost. This keeps the accounts away from the personal bias of accountants. This cost price becomes the basis for all subsequent accounting. It is helpful in making true and fair and comparable accounting records. The cost concept under the inflationary conditions becomes unrealistic.

2.2.7 Realization Concept

This concept is related to the realization of revenue. The revenue is realized either by sale of goods or by the rendering of services. As a general principle, revenue is considered to be realized when sale is made and goods are delivered and the customer becomes legally liable to pay. In case of hire purchase sales, the down payment and installment payments received or due from time to time shall be treated as realized.

2.2.8 Matching Concept

The aim of every business is to earn profit. The profit is insured by the process of matching expenditure against income. The difference between the cost and revenue will be profit or loss. This is done on the basis of accounting period concept. For the purpose of periodic matching of expenses and revenues, expenses must be specifically incurred for earning the said revenues and must pertain to the same interval of time. This concept has a number of limitations. There may be certain expenses which may neither be directly related to the cost of product nor to particular period e.g. preliminary expenses, discount on issue of shares, heavy advertisement expenses etc. Similarly, the distinction between personal and business expenses will also be another problem in matching.

2.2.9 Objective Evidence Concept

According to this concept, the accounting entries made in the books must be supported by some objective evidences. This is needed to ascertain the correctness of the entries made in the books. This concept helps to minimize the possibility of errors and frauds. Without strictly adherence to this concept, the confidence of users of accounting information cannot be maintained.

Example

The examples of objective evidences are vouchers, invoices, bills, cash memo, bank statements, physical verification of stocks etc.

2.3 Accounting Conventions

The accounting conventions mean the custom or traditions which are used as a guide to the preparation of accounting statements. The following are important conventions:

2.3.1 Convention of Disclosure

The convention of disclosure implies that all the books of accounts must be true and fair and all information must be disclosed therein. This convention requires the disclosure of such information which, if not disclosed, might adversely affect the decisions. The disclosure can be made by way of foot notes, within the body of the financial statements, in chairman's speech, minutes of the meeting etc. This convention also applies to events occurring after the date of Balance Sheet.

Example

The examples of disclosure of material facts are contingent liability, market value of investment, changes in the methods of valuation of stock and depreciation etc.

2.3.2 Convention of Materiality

The concept expresses that all material information related to the financial statements must be disclosed. The information is material if its non-disclosure influences the decisions of users of financial statements. The term materiality is a subjective term. It is a matter of judgment and it is left to the accountant for taking a decision whether particular

information is material or immaterial. This materiality differs from individual to individual, business to business and period to period. Indian Accounting Standard-5 states that all material information should be disclosed that is necessary to make financial statements clear and understandable.

2.3.3 Convention of Consistency

It is said that the procedure and system of accounting should remain unchanged. In other words, the same accounting principles and procedure should be used for preparing books of accounts and final accounts for different periods. The convention of consistency makes the financial statements comparable and users can take proper decisions by using these financial statements and vice-versa. But this convention does not mean that no change should be made in accounting procedures. If changes are made the impact of change should be clearly stated in the financial statements.

Example

The system of charging depreciation on assets should be kept consistent. The method of valuation of closing stock should be same year after year.

2.3.4 Convention of Conservatism

This convention is the convention of work cautiously or play safe. This convention ensures that risk and uncertainties inherent in the business transactions should be given a due consideration. It takes into consideration a possibility of loss but ignores a prospect of profit or gain till realized. Adoption of this convention makes the financial base of the business strong. An excessive and unnecessary application of this convention will lead to create secret reserve, which directly contradicts the convention of full disclosure.

Example

- (i) Making provisions for doubtful debts.
- (ii) Valuation of closing stock at cost price or market price whichever is less.
- (iii) Creating provision against the fluctuation in the price of investments.
- (iv) Amortization of intangible assets like goodwill.
- (v) No provisions for discount on creditors.

2.4 Accounting Standards

The objective of accounting is to provide true and fair information to the users of financial statements. This is possible only when the financial statements are prepared on the basis of common policies and standards. Thus, financial accounting process should be well regulated. For the purpose, accounting standards have been framed by national and international accounting bodies with a view to improve the quality of the financial statements.

2.4.1 Meaning of Accounting Standard

An accounting standard is a broad guideline regarding the principles and methods. In other words, accounting standard is a written document issued from time to time by the accounting profession institutions. Such accounting institutions and bodies are Financial Accounting Standard Board (US), Accounting Standards Committee (UK), Accounting Standards Committee (Canada), Accounting Standards Board (India) etc.

2.4.2 Objective of Accounting Standards

The objective of accounting standard is to standardize the diverse accounting policies and practices at present in use in India to ensure comparability and reliability to the financial statements.

2.4.3 Significance of Accounting Standards

The accounting standard ensures uniformity, comparability and qualitative improvement in the preparation and presentation of financial statements. The application of these standards ensures credibility and reliability of financial statements. It helps to the auditors in performing their duty and discharging their attest function.

2.4.4 Procedure for Issuing Accounting Standards

Accounting standards in India are issued by the Institute of Chartered Accountants of India (ICAI). For the purpose, the Institute constituted an Accounting Standard Board (ASB) on 21st April, 1977. ASB will issue guidance notes on the accounting standards and give clarification on issues arising there from. ASB will also review the accounting

standards at periodical intervals. Generally, the following procedure is adopted for formulating the accounting standards:

Step-1 ASB shall determine the broad areas in which accounting standards need to be formulated and the priority in regard to the selection thereof.

Step-2 ASB will be assisted by study groups constituted to consider specific subjects.

Step-3 ASB will hold a dialogue with the representative of the Government, Public Sector Undertakings, Industry and other organizations for ascertaining their views.

Step-4 On the basis of the work of the study groups and the dialogue with organizations, an exposure draft of the proposed standard shall be prepared and issued for comments by the members of the Institute and the public at large.

Step-5 The draft of the proposed standard shall be finalized after taking into consideration the comments received and shall be submitted to the Council of the Institute.

Step-6 The final draft of the proposed standard may be modified by the Council of the Institute with the consultation of ASB, if found necessary.

Step-7 The accounting standard on the relevant subject will then be issued under the authority of the Council.

2.4.5 Accounting Standards Issued by ICAI

The following Accounting Standards have been issued by the Institute of Chartered Accounts of India:

List of Accounting Standards

S. No.	Accounting Standard No. (AS) No.	Title of Accounting Standard
1.	AS-1	Disclosure of Accounting Policies
2.	AS-2 (Revised)	Valuation of Inventories
3.	AS-3 (Revised)	Cash Flow Statements

4.	AS-4 (Revised)	Contingencies and Events Occurring after the Balance Sheet Date
5.	AS-5 (Revised)	Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies
6.	AS-6 (Revised)	Depreciation Accounting
7.	AS-7	Accounting for Construction Contracts
8.	AS-8	Accounting for Research and Development
9.	AS-9	Revenue Recognition
10.	AS-10	Accounting for Fixed Assets
11.	AS-11	Accounting for the Effects of Changes in Foreign Exchange Rates
12.	AS-12	Accounting for Government Grants
13.	AS-13	Accounting for Investment
14.	AS-14	Accounting for Amalgamations
15.	AS-15 (Revised)	Accounting for Employee Benefits
16.	AS-16	Borrowing Costs
17.	AS-17	Segment Reporting
18.	AS-18	Related Party Disclosures
19.	AS-19	Leases
20.	AS-20	Earnings Per Share
21.	AS-21	Consolidated Financial Statements
22.	AS-22	Accounting for Taxes on Income
23.	AS-23	Accounting for Investments in Associates in Consolidated Financial Statements
24.	AS-24	Discontinuing Operators
25.	AS-25	Interim Financial Reporting
26.	AS-26	Intangible Assets
27.	AS-27	Financial Reporting of Interest in Joint Ventures
28.	AS-28	Impairment of Assets
29.	AS-29	Provisions, Contingent Liabilities and Contingent Assets

2.5 Summary

The accounting concepts refer to necessary assumptions or conditions upon which accounting is based.

The Business Entity Concept states that the business is treated as a separate entity from its owner who is supplier of capital. This concept is applicable in all types of organizations.

According to Going Concern Concept, an entity is a going concern, and it will continue to operate for long period in future.

The Money Measurement Concept states that the business will record only those transactions which can be expressed in terms of money. Non-monetary transactions will not be recorded.

The Dual Aspect Concept means every transaction has two aspects i.e. one is receiving aspect and the other is giving aspect. Both the aspects are recorded in the books of accounts.

According to the Accounting Period Concept, accounts are prepared for a specific period i.e. for one year.

The Cost Concept states that the accounting records are based on cost. The assets and liabilities are shown at cost.

Under Realization Concept, revenue is realized when goods are transferred to the customer either for cash or on credit.

Matching Concept explains that the profit is measured by the process of matching expenditure against income.

According to Objective Evidence Concept, accounting entries made in the books of accounts must be supported by some objective evidence.

The accounting convention means the custom or traditions which are used as a guide to the preparation of accounting statements.

The Convention of Disclosure implies that all information must be disclosed related to the financial statements by way of foot notes, within the body of the financial statements etc.

Materiality Convention holds that all material information should be disclosed that is necessary to make financial statements clear and understandable.

The Consistency Convention requires that a business has to treat all similar events in the same manner unless it has a sound reason to change the method of treatment.

Conservatism Convention states that the accountants should make provisions for all possible losses but should not take into consideration all prospective profits.

Accounting standard is a broad guideline regarding the principles and methods.

The objective of accounting standard is to harmonize the diverse accounting policies and practices.

The accounting standards ensure uniformity, comparability, credibility and reliability of the financial statements.

2.6 Glossary

Accounting Period: The period for which the books of accounts are usually maintained i.e. a period of 12 months.

Cost: The price at which an asset is acquired.

ASB: Accounting Standard Board.

ICAI: The Institute of Chartered Accountants of India.

2.7 Check your Progress

Fill in the blanks

1. holds that all material information should be disclosed that is necessary to make financial statements clear and understandable.
2. The objective of is to harmonize the diverse accounting policies and practices.
3. The means the custom or traditions which are used as a guide to the preparation of accounting statements.
4. The refer to necessary assumptions or conditions upon which accounting is based.

2.8 Answers to check your progress

1. Materiality Convention
2. Accounting Standard
3. accounting convention
4. accounting concepts

2.9 Terminal Questions

1. What do you understand by Business Entity Concept Explain?
2. Define convention: What are different conventions?
3. Define Concept and explain two concepts in detail.
4. Write notes on:
 - (i) Money Measurement Concept
 - (ii) Going Concern Concept
 - (iii) Matching Concept
5. Write notes on:
 - (i) Convention of Disclosure
 - (ii) Convention of Consistency
6. Define Accounting Standard and state the advantages of setting accounting standards.
7. List the names of accounting standards issued by the Institute of Chartered Accountants of India.

2.10 References

1. Financial Accounting Principles and Practice- Prof. Jawahar Lal and Dr. Seema Srivastava
2. Financial Accounting - Sri P.C. Tulsian
3. Advanced Accountancy - Sri R. L. Gupta and Sri M. Radhaswamy

4. Advanced Accountancy - Sri S. P. Jain and Sri K.L. Narang.

UNIT-3

Double Entry System and Accounting Equation

- 3.1 Introduction
- 3.2 Meaning of Double Entry System
- 3.3 Merits of Double Entry System
- 3.4 Demerits of Double Entry System
- 3.5 Account
- 3.6 Classification of Accounts
- 3.7 Rules of determining debit and credit
- 3.8 Accounting Equation
- 3.9 Rules of debit and credit as per accounting equation
- 3.10 Summary
- 3.11 Glossary
- 3.12 Check your progress
- 3.13 Answers to check your progress
- 3.14 Essay Type questions
- 3.15 References

Learning Objectives

After study this chapter you should be able to:

- Understand the concept of double entry system of book-keeping.
- Understand the merits and demerits of double entry system.
- Explain the meaning of account and its classification.
- Know the rules of debit and credit in respect of each account.
- Understand the Accounting Equation.

- Know the rules of debit and credit under Accounting Equation

3.1. Introduction

Every individual of the society is maintaining accounts in his / her own way. His / her objective is to know the arithmetical accuracy of the transactions which he /she done in a day and what is the remaining balance of cash in hand at the end of the day. For this purpose, he/ she write all the transactions, as per his / her convenience, in a piece of paper and total it and find out the balance of cash in hand. But on any day if he / she wants to know that how much expenditure has been done on a particular item (account) then it will be very difficult until unless all the paper slips are maintained chronologically. But this system of writing transactions will not be feasible if the numbers of transactions are large and are of different nature. This requires a proper system of recording, analyzing and summarizing of transactions. This system is known as Double Entry System. Running a business involves a large number of transactions of different nature relating to various items of purchase and sale of merchandise, assets and properties. Similarly, payments are made and received regularly. An owner of the business cannot remember the exact details of each and every transaction taking place during a period. This necessitates the recording of transactions in a systematic and analytical manner so as to ascertain correctly the profit earned or loss incurred during the particular period. Thus, there is a need of scientific system of accounting. The only system of account keeping which is recognized as scientific is the “Double Entry System.”

3.2 Meaning of Double Entry System

The whole accounting system is based on double entry system. In 1494 Luca Pacioli, an Italian Mathematician introduced the Double Entry System of Account-keeping. The double entry system means every transaction has double effect i.e. When we receive something then we give something else in return. For example, in case of purchase of goods in cash we received goods and pay cash. These two aspects are called accounts. Of the two accounts one account is debited while the other account is credited with an equal

amount. Thus, on a particular date the total of all debits must be equal to total of all credits because every debit has corresponding credit.

3.3 Merits of Double Entry System

- (i) The complete record of all transactions can be kept.
- (ii) The system provides complete information of all recorded transactions in the books.
- (iii) The arithmetical accuracy of the recorded transactions under this system can be ascertained.
- (iv) The operational results i.e. Profit / Loss of any period can be ascertained by the preparation of Profit and Loss Account.
- (v) The financial position on a particular date can be ascertained by the preparation of Balance Sheet.
- (vi) The mistakes and/ or frauds can be easily detected, rectified and prevented.
- (vii) The past or made information can be obtained any time from the accounts for the purpose of taking various decisions from time to time.
- (viii) All types of organizations can keep accounts under this system.
- (ix) Cash Balance available in the business can be ascertained any time.
- (x) As this system is universally accepted, accounts maintained under this system become easily acceptable to all parties i.e. Income Tax, Trade Tax, financial institutions etc.
- (xi) The results of one period can be compared with another period because of the scientific system of maintaining accounts.

3.4 Demerits of Double Entry System

- (i) Under this system accounts book become voluminous because of elaborated record of transactions hence, involve more labour and paper work.
- (ii) It is expensive to keep detailed accounts.
- (iii) It is difficult for persons to keep accounts under this system, unless they have requisite knowledge of the system.
- (iv) Under this system, accounts are maintained by many persons, so secrecy of accounts cannot be maintained .

3.5 Account

The statement which is prepared in a condensed form by recording together all the transactions of a similar type regarding any particular person, asset, liability, income or expenditure is called an Account.

3.6 Classification of Accounts

In order to record each and every transaction of a business properly, all transactions have been grouped in three types of accounts:

1. Personal Accounts
2. Real Accounts
3. Nominal Accounts

1. Personal Accounts

These accounts record business dealings with natural person, artificial person and representative persons. For example, Accounts of Meera, Radha & co. etc.

2. Real Accounts

The accounts relating to all tangible and intangible real assets are called Real Accounts. For example, Goods, Cash, Land, Goodwill etc.

3. Nominal Accounts

The accounts related to expenses, losses, incomes, and gains are called Nominal Accounts. For example, Wages, Salaries, Dividend received, Commission earned etc.

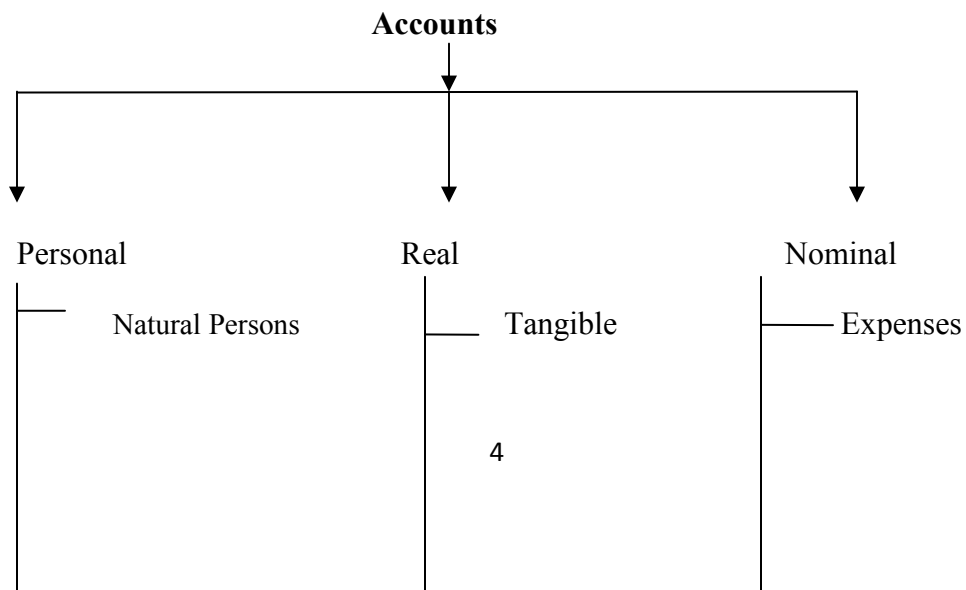




Illustration 1

State under what heading would you classify each of the following accounts as per classification of accounts:

- (i) Cash account
- (ii) Rent Paid Account
- (iii) Bank Account
- (iv) Rent received Account
- (v) Land Account
- (vi) Goodwill Account
- (vii) Subhash account
- (viii) A & Co. Account
- (ix) Capital Account
- (x) Bills Receivable Account

Solution

Table Showing Type of Account

Account	Type of account
(i) Cash Account	Real
(ii) Rent Paid Account	Nominal
(iii) Bank Account	Real
(iv) Rent Received Account	Nominal
(v) Land Account	Real (Tangible)
(vi) Goodwill Account	Real (Intangible)
(v) Subhash Account	Personal (Natural)
(vii) A & Co. Account	Personal (Artificial)
(viii) Capital Account	Personal (Representative)
(ix) Bills Receivable Account	Real

3.7 Rules for Determining Debit and Credit

In earlier discussions, it has already been explained that for keeping accounts according to Double Entry System, two accounts concerned with each transaction are to be decided and one of these accounts is to be debited and the other is to be credited. For this purpose, all the transactions are grouped under three types of accounts. When to debit and when to credit depends upon the type of accounts involved. The Double Entry System has given ruling for this. The following table shows the rules of debit and credit for each account:

Rules of Debit and Credit

Type of Account	Debit	Credit
Personal Account	Receiver	Giver
Real Account	What comes in	What goes out
Nominal Account	Expenses and Losses	Incomes and gains

The above rules of debit and credit are golden rules of Debit and Credit.

Illustration 2

From the following transactions mention:

- (a) Nature of account
- (b) The Debit and Credit of the accounts
 - (i) Purchase of Land in Cash
 - (ii) Sale of Furniture to Shivam on Credit
 - (iii) Interest Received
 - (iv) Salary paid by cheque
 - (v) Received cash from Ramesh
 - (vi) Cash sales of goods
 - (vii) Cash purchases of goods

Solution**Table Showing Nature of Account and Debit and Credit**

S. No.	Accounts	Nature of Account	Debit or Credit	Reasons.
(i)	Land	Real	Debit	(Comes in)
	Cash	Real	Credit	(Goes out)
(ii)	Shivam	Personal	Debit	(Receiver)
	furniture	Real	Credit	(Goes out)
(iii)	Cash	Real	Debit	(Comes in)
	Interest	Nominal	Credit	(Income)
(iv)	Salary	Nominal	Debit	(Expenses)
	Bank	Real	Credit	(Goes out)
(v)	Cash	Real	Debit	(comes in)
	Ramesh	Personal	Credit	(Giver)
(vi)	Cash	Real	Debit	(Comes in)
	Goods	Real	Credit	(Goes out)
(vii)	Goods	Real	Debit	(Comes in)
	Cash	Real	Credit	(Goes out)

3.8 Accounting Equation

The Debit and Credit can also be ascertained without the application of the Golden rules of Debit and Credit. This rule has been expressed with the help of Accounting Equation. Accounting Equation is a statement of equality between the debit and credit. It signifies that the assets of a business are always equal to the total liabilities of business and Owner's equity (capital). This relationship if represented in equation form is known as Accounting Equation.

$$\text{Assets} = \text{Liabilities} + \text{Owner's Equity (Capital)}$$

Or $A = L + C$

Or Resources = Outsiders' claim + owners claim

The above equation can also be expressed as;

$$C = A - L$$

Or $L = A - C$

This is also called Balance Sheet Equation because it represents the relationship between Balance Sheet items. Thus, this equation should always be in balance because the total of left hand side of the Balance Sheet must be equal to the right hand side of the Balance Sheet.

3.9 Rules of Debit and Credit as per Accounting Equation

For deciding debit and credit, the Accounting Equation can also be shown as follows;

$$A + E = L + C + R$$

Where A = Asset, E = Expense, L = Liability, C = Capital, R = Revenue (Income)

On the basis of above equation, the rules of debit and credit will be as follows:

- (1) When the items on the left hand side of the equation (A and E) increase in value debit them and credit them when they decrease in value.
- (2) When the items of the right hand side of the equation (L + C + R) increase in value credit them and debit them when they decrease value.

These rules are also represented with the help of the following account chart:

Asset		Liabilities	
Dr		Cr	
Increase		Decrease	Increase
(+)		(-)	(+)
Expenses		Income	
Dr		Cr	
Increase		Decrease	Increase
(+)		(-)	(+)

Capital or owner's Equity

Dr	|	Cr
Decrease		Increase
(-)		(+)

Now let us decide debit and credit as per Accounting Equation.

Illustration 3

Find out the Debit and Credit in the following transactions using Accounting Equation.

1. Purchased goods for cash.
2. Purchased goods on credit from Rahim
3. Sold goods for cash.
4. Sold goods on credit to Raja.
5. Received dividend in cash.
6. Wages paid in cash.
7. Purchase of furniture for cash.

Solution

Table Showing Effect of Transaction and Debit and Credit

S. No.	Accounts	Effect of Transactions	Debit or Credit
1.	Goods	Increases asset	Debit
	Cash	Decreases asset	Credit
2.	Goods	Increases asset	Debit
	Rahim	Increases Liabilities to Rahim	Credit
3.	Cash	Increases asset	Debit
	Goods	Decreases asset	Credit

4.	Raja	Increases asset of receivables	Debit
	Goods	Decreases asset	Credit
5.	Cash	Increases asset	Debit
	Dividend	Increases income	Credit
6.	Wages	Increases Expenses	Debit
	Cash	Decreases asset	Credit
7	Furniture	Increases asset	Debit
	Cash	Decreases asset	Credit

3.10 Summary

The whole accounting system is based on Double Entry System. This system introduced by Lucas Pacioli in 1494. Double Entry System means every transaction has dual aspects. One aspect will be debit and other aspect will be credit. Double Entry System is recognized as scientific system. All types of organizations keep accounts under this system. The arithmetical accuracy of the recorded transactions can be ascertained. Requisite Knowledge of the system is required. The aspects of the transactions related to person, asset, liability, income or expenditure is called an Account. The accounts related to natural, artificial or representative persons are called Personal Account. The accounts related to expenses or losses and incomes and gains are called Nominal Account. Accounting equation is statement of equality between Debit and Credit.

3.11 Glossary

Debit: The left hand side of an account is called Debit.

Credit: The right hand side of an account is called Credit.

Account: An account is a statement which shows all the transactions relating to a particular item during a period of time.

Accounting Equation: $\text{Assets} = \text{Capital} + \text{Liability}$

3.12 Check your progress

Fill in the blanks

1. means every transaction has dual aspects.
2. Double Entry System was introduced by..... in 1494.
3.is statement of equality between Debit and Credit.
4. The accounts related to expenses or losses and incomes and gains are called

3.13 Answers to check your progress

1. Double Entry System
2. Lucas Pacioli
3. Accounting equation
4. Nominal Account.

3.14 Essay Type Questions

1. What do you mean by Double Entry System of Book-keeping? What are its advantages?
2. Define Double Entry System and describe its merits and demerits.
3. Define Account. How are accounts classified?
4. State the different classes of accounts and explain the rules of debiting and crediting for each class of accounts.
5. Explain the following with example?
 - (i) Personal Account
 - (ii) Real Account
 - (iii) Nominal Account
6. What is an Accounting Equation? What are its elements? Explain.
7. Define Accounting Equation. Explain rules of debiting and crediting under the Accounting Equation.

3.15 References

1. Financial Accounting Principles and Practice- Prof. Jawahar Lal and Dr. Seema Srivastava
2. Financial Accounting - Sri P.C. Tulsian
3. Advanced Accountancy - Sri R. L. Gupta and Sri M. Radhaswamy
4. Advanced Accountancy - Sri S. P. Jain and Sri K.L. Narang.

3.16 Practical Problems

1. State under what heading would you classify each of the following accounts as per classification of accounts:

- (i) Furniture
- (ii) Dividend Received
- (iii) Ram Account
- (iv) Bills Payable Account
- (v) Salary Paid Account
- (vi) Machinery Account
- (vii) Bad Debt Account
- (viii) Carriage Account
- (ix) Cash Account
- (x) Bank Loan Account

[Ans. : (i) Real (ii) Nominal (iii) Personal (iv) Personal (v) Nominal (vi) Real (vii) Nominal (viii) Nominal (ix) Real (x) Personal]

2. State under what heading would you classify each of the following accounts as per Accounting Equation;

- (i) Capital
- (ii) Land
- (iii) Rent Received
- (iv) Wages Paid

- (v) Cash
- (vi) Bills Receivable
- (vii) Interest Received
- (viii) Stationery
- (ix) Building
- (x) Bank Loan

[Ans.: (i) Capital (ii) Asset (iii) Income (iv) Expense (v) Asset (vi) Asset (vii) Income (viii) Expense (ix) Asset (x) Liability]

3. From the following transactions of Mr. Sunil find out the accounts to be debited and credited:

- (i) Sunil started business with cash
- (ii) Deposited cash into Bank
- (iii) Furniture Purchased on credit from R & Co.
- (iv) Goods Purchased on cash
- (v) Goods sold on Cash
- (vi) Salary Paid
- (vii) Paid cash to R & Co.
- (viii) Interest received
- (ix) Sold old furniture for cash
- (x) Received cash from Mr. Suresh

[Ans. : (i) Cash Dr. Capital Cr. (ii) Bank Dr. Cash Cr. (iii) Furniture Dr. R & Co. Cr. (iv) Goods Dr. Cash Cr. (v) Cash Dr. Goods Cr. (vi) Salary Dr. Cash Cr. (vii) R & Co. Dr. Cash Cr.(viii) Cash Dr. Interest Cr. (ix) Cash Dr. Furniture Cr. (x) Cash Dr. Suresh Cr.]

UNIT-4

Journal

- 4.1 Introduction
- 4.2 Journal
- 4.3 Features
- 4.4 Format of Journal
- 4.5 Process of Journalizing
- 4.6 Advantages of Journal
- 4.7 Limitations
- 4.8 Cash Book: Introduction
- 4.9 Features
- 4.10 Objectives
- 4.11 Advantages
- 4.12 Types of Cash Book
 - 4.12.1 Single column cash book
 - 4.12.2 Double column cash book
 - 4.12.3 Triple column cash book
 - 4.12.4 Imprest cash book
- 4.13 Summary
- 4.14 Glossary
- 4.15 Check your progress
- 4.16 Answers to check your progress
- 4.17 Terminal Questions
- 4.18 Reference Books
- 4.19 Practical Problems

Learning Objectives

After study this chapter you should be able to:

- Meaning and Features of Journal
- Format of Journal
- Steps in Journalizing
- Advantages and Limitations of Journal
- Understand the meaning of the Cash Book
- Know the features of the Cash Book
- Understand the purpose of maintaining the Cash Book.
- Understand the advantages of maintaining the Cash Book.
- Understand the different types of Cash Book.

4.1 Introduction

In this modern age quite a large number of transactions occur daily in the business. Because of the limited learning power, as soon as transaction occurs, it should be recorded in a book with full detail. The first step of book-keeping is the recording of transaction in Journal which is also called book of Original Entry.

4.2 Journal

The word journal has been derived from the French word “Jour” which means day. Hence, the Journal means the book in which daily transactions are primarily recorded. Journal is a book of original entry. In this book, transactions are recorded in a chronological order as and when they take place. The recording of the transaction in journal is technically known as journalizing. Journal is also called the book of Prime Entry

4.3 Features

Features of Journal are given below

- (1) Journal is a book of prime entry.
- (2) Transactions are recorded in chronological order.
- (3) Gives full details of the transaction in the form of narration
- (4) Journal is an assistant to the ledger.
- (5) The nature of account is clearly mentioned in the Journal.

4.4 Format of Journal

The format of Journal is as follows:

Date	Particulars	Ledger Folio	Amount Debit (Dr.) Rs.	Amount Credit (Cr) Rs.

4.5 Steps in Journalizing

Steps of journalizing are given below

1. Identification of transaction to be recorded.
2. Identification of accounts involved.
3. Application of the rules of debit and credit related to the accounts.
4. Write the transaction in particular column of the journal.
5. Write narration.

Illustration 1

The following transactions are related for the month of April, 2012. You are required to make journal entry in the Journal.

2012

April 2 Received from Mr. Ram Rs. 5000 on account.

April 7 Paid wages Rs.1000.

April 10 Received Rs.2500 for interest.

April 18 Paid rent and taxes Rs. 800.

April 19 Purchased goods for cash Rs. 1500.

April 23 Sold goods for cash Rs. 2000.

April 24 Purchased goods from Mr. Bhim on credit Rs 3000.

April 26 Sold goods to Mr. Ram Rs. 1250 on credit.

April 29 Received from the owner as capital Rs. 5000.

Solution

Date	Particulars	LF	Amount Dr Rs.	Amount Cr Rs.
2012 April 2	Cash A/c Dr To Ram A/c (Being cash Received on account)		5000	5000
April 7	Wages A/c Dr To Cash A/c (Being wages Paid in cash)		1000	1000
April 10	Cash A/c Dr To Interest A/c (Being interest received)		2500	2500
April 18	Rent and Taxes A/c Dr To Cash A/c (Being Rent and Taxes Paid)		800	800
April 19	Purchase A/c Dr To Cash A/c (Being goods purchased in cash)		1500	1500
April 23	Cash A/c Dr To Sales A/c (Being cash sales)		2000	2000
April 24	Purchase A/c Dr To Bhim A/c (Being credit purchase from Bhim)		3000	3000
April 26	Ram A/c Dr To sales A/c (Being credit sales to Ram)		1250	1250
April 29	Cash A/c Dr To capital A/c (Being capital brought in cash)		5000	5000
	Total		22050	22050

4.6 Advantages of Journal

1. All the transactions of the business are daily recorded in this book. Therefore, there is less chance of left out of any transaction.
2. Detailed information are available of the transaction from merely seeing the entry because of narration is given for each entry.
3. The chances of mistakes in writing an entry are minimized to a considerable extent because before writing an entry proper classification of account is done and the rule of debit and credit is followed.
4. Since the transactions are recorded in chronological order, therefore, any transaction can be easily find out.
5. Journal helps in locating errors in Ledger because folio of ledger is mentioned in Journal and vice – versa.
6. The Journal is a basic evidence of transaction because each and every transaction recorded in journal is supported by documentary evidences.

4.7 Limitations

- If all the transactions whether cash or credits are recorded in journal, it will become very bulky book. Therefore, handling of journal will be a difficult task.
- Daily cash balance cannot be ascertained.
- Location of any transaction will be very difficult if the exact date of transaction is not known.

4.8 Cash Book :Introduction

Cash is the resource used by the businessman in running his business. Proper management of cash is essential. It is objective of every owner of the business to know the cash balance as and when need arise. Therefore, there is a need that a separate book should be maintained by the enterprise for recording the cash and bank transactions. Such book is called Cash Book.

Cash Book is a book of original entry. This book is used to record all transactions relating to Cash/Bank receipts and Cash/Bank payments. This is the main book and maintained by all types of business organization irrespective of the size i.e. small, medium or big. The cash transactions are first recorded in this book and then posted in Ledger. This is divided into two parts. The left hand side is used to record cash receipts while right hand side is used for recording cash

payments. The difference of the two sides represents credit or debit balance of cash. The Cash Book is considered an account in the Ledger.

4.9 Features

Cash book has the following features

- The Cash Book is a book of original Entry.
- The Cash Book records only cash transactions in chronological order.
- The Cash Book has two sides—Debit side and Credit side.
- The cash receipts are recorded on debit side.
- The cash payments are recorded on credit side.
- The difference between the debit side and credit side represents the positive or negative balance.
- Generally, negative balance of cash does not appear in the Cash Book while in case of bank balance, it may be possible.
- The Cash Book acts as an account of the Ledger.

4.10 Objective

- To record properly cash and bank transactions in chronological order.
- To know the cash in hand and cash at bank at any point of time.
- To ensure effective management of cash and bank transactions.

4.11 Advantages

The organization can have the following advantages by maintaining the Cash Book proper:

- One of the important objectives of the business is to have effective control over inflow and out flow of cash. This is possible only when the cash transactions are properly recorded. The Cash Book is fulfilling the objective.
- The internal check on the cash can be effectively exercised with the help of Cash Book. The cash balance shown by the Cash Book can be physically verified by

checking cash in hand in cash box. Any difference of these two shows that either any transaction is not recorded/wrongly recorded or temporary embezzlement of cash by the cashier.

- Cash Balance and Bank Balance can be ascertained any time through Cash Book for taking the future decisions regarding cash transactions.
- Errors can be detected easily and responsibility can be fixed.
- There is no need of maintaining Cash Account and Bank Account in the Ledger. Thus, this will result into saving in time, reduction in posting errors and size of the Ledger.

4.12 Types of Cash Book

Cash Book can be classified under following types:

- 4.12.1 Single Column Cash Book
- 4.12.2 Double Column Cash Book
- 4.12.3 Triple Column Cash Book
- 4.12.4 Petty Cash Book

4.12.1 Single Column Cash Book

This is a simple Cash Book which contains only one column of amount i.e. Cash. This is generally prepared by small businessmen having more cash transactions and less bank transactions.

Illustration 1

Following transactions relate to the Current Book Agency, 2012. Prepare a Cash Book and balance it:

2012	
January 1. Cash in hand	Rs. 5400
January 2. Furniture Purchased for cash	Rs. 900
January 5 Books Purchased for cash	Rs 2800
January 7. Cash sales	Rs. 2000

January 8. Paid wages	Rs. 200
January 10. Paid cash to Loyal Publisher	Rs. 1000
January 12. Books Purchased for cash	Rs. 2000
January 14. Books sold for cash	Rs. 1000
January 15. Paid Salary	Rs. 500
January 21. Purchased stationery	Rs. 200
January 25. Postage	Rs. 100
January 28. Books sold	Rs. 1000
January 30. Rent Paid	Rs. 500

Solution**Current Book Agency****Cash Book**

Date	Particulars	LF	Amount Rs.	Date	Particulars	LF	Amount Rs.
2012				2012	By Furniture Purchased		900
Jan. 1	To Balance b/d		5400	Jan. 2	By Books Purchased		2800
Jan. 7	To Sales		2000	Jan. 5	By Wages		200
Jan. 14	To Sales		1000	Jan. 8	By Loyal Publisher		1000
Jan. 28	To Sales		1000	Jan. 10	By Book Purchased		2000
				Jan. 12	By Salary		500
				Jan. 15	By Stationary		200
				Jan. 21	By Postage		100
				Jan. 25	By Rent		500
				Jan. 30	By Balance c/d		1200
			9400				9400
Feb. 1	To Balance b/d		1200				

4.12.2 Double Column Cash Book

There are two columns of amount on each side of Cash Book i.e. one column for cash transactions and other column for bank transaction. When the number of bank transactions

is large, it is convenient to have separate amount column for bank transactions. This helps in having the up-dated information about the position of the bank account from time to time.

Illustration 2

Record the following transactions in a Double Column Cash Book with the Cash and Bank Columns and balance the book on 31st March, 2012:

2012

March 1 Opening Balance:

Cash	Rs. 13500
Bank	Rs. 40000
March 2 Paid to Ramesh in cash	Rs 5000
March 3 Sold for cash	Rs 12000
March 5 Paid to Sundaram by cheque	Rs 15000
March 6 Received cheque from Shyam	Rs 15000
March 8 Received cheque from Vinod	Rs 40000
March 10 Goods purchased for cash	Rs 8000
March 12 Withdrew from Bank	Rs 10000
March 14 Sold goods for cash	Rs 8000
March 15 Purchased stationery for cash	Rs 2000
March 17 Deposited Cash in Bank	Rs 7000
March 20 Withdrew from Bank for personal use	Rs 5000
March 26 Paid to Siddharth by cheque	Rs 4000
March 28 Rent paid by cheque	Rs 5200
March 31 Paid Salaries in cash	Rs 12000

Solution**Cash Book**

Date	Particulars	LF	Cash Rs.	Bank Rs.	Date	Particulars	LF	Cash Rs.	Bank Rs.
2012					2012				
March 1	To Balance b/d		13500	40000	March 2	By Ramesh		5000	
March 3	To Sales		12000		March 5	By Sundaram			15000
March 6	To Shyam			15000	March 10	By Goods purchased		8000	
March 8	To Vinod			40000	March 12	By Cash	C		10000
March 12	To Bank	C	10000		March 15	By Stationery		2000	
March 14	To sales		8000		March 17	By Bank	C	7000	
March 17	To cash	C		7000	March 20	By Drawings			5000
April 1	To Balance b/d		43500	102000	March 26	By Siddharth			4000
			9500	62800	March 28	By Rent			5200
					March 31	By salaries		12000	
					March 31	By Balance c/d		9500	62800
								43500	102000

C = Control Entry

4.12.3 Triple Column Cash Book

It is a Cash Book with three columns on each side for recording cash, Bank and Discount. Offering and accepting cash discount is closely related to receipt and payment of cash. So discount allowed and discount received should be simultaneously recorded along with cash in order to get full knowledge.

Illustration 3

Record the following transactions in the Triple Column Cash Book and balance it:

2012

April 1 Opening Balance:

Cash in hand Rs. 4000

Cash at Bank Rs. 16500

April 3 Received from Suresh Rs. 1800

Allowed him discount	Rs. 50
April 5 Paid for stationery in cash	Rs. 350
April 9 Paid to Ram by cheque and was allowed discount	Rs. 3150
April 18 Paid miscellaneous expenses in cash	Rs. 80
April 20 Rajaneesh settled his account for Rs 4000 Less discount @5% by cheque	Rs. 170
April 24 Withdrew from Bank for office use	Rs. 500
April 25 Purchased Goods by cheque	Rs. 2500
April 27 Sold goods for cash	Rs. 1500
April 28 Cash deposited in Bank	Rs. 3500
April 30 Paid salaries in cash	Rs. 2000

Solution**Cash Book**

Date	Particulars	LF	Discount Rs.	Cash Rs.	Bank Rs.	Date	Particulars	LF	Discount Rs.	Cash Rs.	Bank Rs.
2012 April 1	To Balance b/d			4000	16500	2012 April 5	By stationery			350	
April 3	To Suresh		50			April 9	By Ram		80		3150
April 20	To Rajaneesh		200	1800		April 18	By Miscellaneous Exp.			170	
April 24	To Bank	C			3800	April 24	By Cash				500
April 27	To sales	C		500		April 25	By Bank				2500
April 28	To Cash			1500	3500	April 28	By Salaries			3500	
						April 30	By Balance			2000	
						April 30	c/d			1780	
						April 30					17650
			250	7800	23800				80	7800	23800
May 1	To Balance b/d			1780	17650						

4.12.4 Petty Cash Book

In every organization, a large number of petty payments which are of recurring nature such as postage, conveyance, stationary, cartage, traveling, and entertainment etc. are made every day. If all these payments are managed by main cashier and are recorded in the main Cash Book then the cashier may be overburdened and the size of the Cash Book may become very bulky and it may also lead to errors and mistakes. In order to avoid this and keep the main cashier busy with many important works, large organizations, normally, appoint another cashier to record all transactions of petty payments in the Cash Book which is called petty Cash Book and the cashier is called Petty Cashier. A fixed amount is given by main cashier to Petty cashier and after spending money, petty cashier submits his accounts and take the money equivalent to amount already spend from the main cashier. The fixed amount given by the main cashier to petty cashier is known as imprest money.

Illustration 4

Enter the following transactions in the Petty Cash Book of Sugandham under imprest system for the month of February, 2012:

2012	
February 1 Opening Balance	Rs 2.70
February 1 Cash received from Head Cashier	Rs 48.00
February 2 Purchased stamps	Rs 3.70
February 3 Carriage on goods	Rs 3.30
February 4 Purchase of stationery	Rs 4.00
February 5 Conveyance	Rs 1.00
February 6 Repairs	Rs 5.50
February 7 Telegrams	Rs 3.00
February 8 Conveyance	Rs 10.00
February 9 Entertainment	Rs 5.40
February 10 Wages	Rs 2.50
February 11 Carriage	Rs 2.00
February 12 Tea	Rs 5.00

4.13 Summary

- Cash Book is a book of original entry. It records transactions related to Cash /Bank receipts and payments in chronological order.
- The primary object of a Cash Book is to know the Cash and Bank balances at any time.
- The advantage of maintaining Cash Book is to have effective control over inflow and out flow of cash.
- The internal check on the cash can be effectively exercised with the help of Cash Book.
- The errors and frauds can be easily detected.
- The organizations depending upon the requirement are using different types of Cash Book. These are Single Column Cash Book, Double Column Cash Book and Triple Column Cash Book.
- A Single Column Cash Book has only one column for amount i.e. for Cash whereas Double Column Cash Book has two columns for amount i.e. one of Cash and other for Bank, Bank and Discount. It records all these three aspects of the transaction.
- When there is large number of petty cash payments of recurring nature such as postage, conveyance, entertainment, cartage etc. Organizations generally maintain a separate Cash Book for recording petty cash payments. Such separate cash book is known as Petty Cash book. The person who maintains this cash book is called Petty Cashier.
- The Petty Cash Book is maintained under imprest system generally.
- The maintenance of the Petty Cash Book reduces the main cashier work load, size of the main cash book, errors and mistakes.

4.14 Key Words

- Cash Book: It is the original book which records all Cash and Bank transactions.
- Contra Entry: A contra entry is that entry of which debit and credit aspects are simultaneously recorded in Cash Book.

- Imprest: A fixed sum of money given to and maintained by the Petty Cashier.
- Single Column Cash Book: It is a book having single column for amount on each side which records all receipts and payment of cash.
- Double Column Cash Book: It is a book having two columns for amount on each side i.e. one for Cash and other for Bank. It records Cash and Bank transactions both simultaneously
- Triple Column Cash Book: It is a complete Cash Book having three columns on each side for Discount, Cash and Bank.
- Petty Cash Book: It is a book which records small payments of recurring nature.

4.15 Check your progress

1. MCQ Questions

1) **When a firm maintains a cash book, it need not maintain:**

- a. Journal Proper
- b. Purchase (journal) book
- c. Sales (journal) book
- d. Bank and Cash account in the ledger

2) **Double column cash book records:**

- a. All transactions
- b. Cash and bank transactions
- c. Only cash transactions
- d. Only credit transactions

3) **Cash book does not record transaction of:**

- a. Cash nature

- b. Credit nature
- c. Cash and credit nature
- d. None of these

2. State whether the following statements are true or false

1. Cash book records all cash receipts.
2. The debit side of cash book is always greater.
3. Bank columns are not balanced in cash book.
4. All receipts are entered in the credit side of cash book.
5. Only cash receipts and cash payments are recorded in the cash book.
6. Payments are recorded at the credit side of cash book
7. Credit transactions are not recorded in the cash book.
8. The petty cashier generally works on imprest system.
9. Discount account should be balance in the cash book.
10. When we buy furniture in cash, we debit cash account.

4.16 Answers to Check your progress

1.

1) d, 2) c, 3 (b

2. True/ False

1(t), 2.(t),3(f),4(f),5(t),6(t),7(t),8(t),9(f), 10(f)

4.17 Essay Type Questions

1. Define journal. Explain its features.
2. What are advantages and limitations of preparing journal? Explain.
3. What do you mean by Journal? Describe the steps of journalizing.
4. Give the format of journal with example.
5. Define Cash Book. Explain its features and objectives of Cash Book.
6. What do you mean by Cash Book? What are its advantages? Explain.
7. State the features and objectives of cash book.
8. What are different types of Cash Book.? Explain briefly.
9. What is Double Column Cash Book? Give its specimen with example.
10. Give the rulings of the Triple Column Cash Book with example.
11. Why Petty Cash Book is maintained by an organization? Give its specimen.

4.18 References

1. Financial Accounting Principles and Practice- Prof. Jawahar Lal and Dr. Seema Srivastava
2. Financial Accounting - Sri P.C. Tulsian
3. Advanced Accountancy - Sri R. L. Gupta and Sri M. Radhaswamy
4. Advanced Accountancy - Sri S. P. Jain and Sri K.L. Narang.

4.19 Practical Problems

1. Journalise the following transactions in the book of Mr. Sugandham:

2012

January 2 Started business with capital Rs. 40000

January 3 Purchased furniture Rs. 16000

January 4 Bought goods	Rs. 6000
January 5 Sold goods to Radheyshyam in cash	Rs. 5000
January 7 Purchased goods	Rs. 4000
January 9 Paid shop rent.	Rs. 2000
January 10 Cash received from Ram	Rs. 5000
January 12 Cash sales	Rs. 2000
January 14 Paid electric bill	Rs. 500
January 15 Wages paid	Rs. 400

2. Enter the following transactions in the Journal of Shreyas:

2012

February 1 Started business with cash Rs. 5000	Rs.15000
Machinery Rs. 10000	
February 2 Bought from Sadhana Enterprise goods on credit	Rs. 3000
February 3 Cash sales	Rs. 2000
February 4 Purchased goods for cash.	Rs.10000
February 6 Sold goods to Ramesh on credit	Rs. 3000
February 8 Cash paid to Sadhana Enterprise	Rs. 3000
February 9 Purchased Furniture	Rs. 1000
February 13 Cash received from Ramesh	Rs. 3000
February 15 Paid wages	Rs. 1000
February 17 Stationary purchased	Rs. 300
February 18 Interest received	Rs. 500
February 22 Paid salary	Rs. 2000
February 23 Paid electric bill	Rs. 400
February 25 Drew cash for personal use	Rs. 2000
February 28 Deposited cash into Bank	Rs. 5000

3. Write the following transactions in the Single Column Cash Book of Madan Lal:

2012	
March 1 Opening Balance	Rs. 5000
March 2 Received cash from Anand	Rs. 20000
March 3 Goods purchased	Rs. 15000
March 5 Goods sold	Rs. 5000
March 7 Paid rent	Rs. 500
March 8 Paid salary	Rs. 2000
March 10 Paid cash to Maninder	Rs. 2500
March 16 Received cash from Mahesh	Rs. 3000
March 19 Goods sold	Rs. 500
March 23 Goods Purchased	Rs. 6000
March 28 Goods sold	Rs. 10000
March 30 Purchased stationery	Rs. 500
March 31 Purchased furniture	Rs. 2000

(Ans. Cash in hand Rs. 15000)

4. Record the following transactions in a Double Column Cash Book and find out the Cash and Bank Balances:

2012	
April 2 Opening Balance:	
Cash	Rs. 10000
Bank	Rs. 35000
April 4 Cash received from sale of shares	Rs. 1,10,000
April 6 Deposited in Bank	Rs. 1,00,000
April 9 Paid to Mr. Ram by cheque	Rs. 25000
April 11 Wages paid in cash	Rs. 6000

April 16 Received from Mr. Sudhanshu a cheque and sent to Bank	Rs. 12,000
April 18 Withdrawn from Bank	Rs. 10,000
April 21 Salary paid in Cash	Rs. 8,000
April 23 Sold goods for cash and banked the same	Rs. 16,000
April 25 Paid rent by cheque	Rs. 2,000
April 28 Goods purchased by cheque	Rs. 20,000
April 30 Deposited in Bank	Rs. 15,000

(Ans. Cash Balance Rs. 1,000, Bank Balance Rs.1,21,000)

5. From the following transactions of Mr. Tulsi, prepare a Triple Column Cash Book for the month of April 2012:

2012

April 2 Opening Balance :

Cash in Hand	Rs. 3680
Bank Balance	Rs. 15000
April 3 Cheque issued to Mr. Pramod to settle the account of Rs.2900	Rs. 2860
April 5 Furniture purchased from Kohli Furniture by cheque	Rs. 1000
April 7 Received from Naresh (in full settlement of Rs. 1400)	Rs. 1360
April 11 Paid to Suresh	Rs. 250
April 14 Received cheque from Rajendra	Rs. 1300
April 16 Given a Loan to Ashok by cheque	Rs. 500
April 19 Withdrew from Bank	Rs. 1500
April 21 Paid rent by cheque	Rs. 1000
April 23 Paid telephone charges by cheque	Rs. 200
April 26 Received interest on investment	Rs. 350
April 28 Rajendra, cheque returned dishonoured	Rs. 1300
April 30 Collection charges as per Pass Book	Rs. 60

(Ans. Cash Balance Rs. 6640, Bank Balance Rs 7880)

6. From the following transactions prepare Petty Cash Book under impress System:

2012

May 1 Received cheque from the Head Cashier for starting balance and cashing the same	Rs. 500
May 1 Postage expenses	Rs. 22
May 2 Paid for cartage	Rs. 10
May 3 Cleaning charges	Rs. 13
May 4 Conveyance charges	Rs. 12
May 5 Purchased stationery	Rs. 20
May 7 Postage expenses	Rs. 25
May 8 Bus fare	Rs. 20
May 9 Entertainment expenses	Rs. 10
May 12 Travelling expenses	Rs. 15
May 15 Postage expenses	Rs. 25
May 18 Conveyance expenses	Rs. 20
May 19 Entertainment expenses	Rs. 15
May 21 Cartage	Rs. 14
May 23 Telegram charges	Rs. 10
May 25 Wages	Rs. 15
May 29 Purchased stationery	Rs. 20
May 30 Puja donation	Rs. 21
May 31 Office cleaning	Rs. 15

(Ans.: Cash in hand Rs. 198)

UNIT-5

Other Subsidiary Books

- 5.1 Introduction
- 5.2 Sub-Division of Journal
- 5.3 Day Book
 - 5.3.1 Purchase book
 - 5.3.2 Format of purchase book
 - 5.3.3 Process of recording
 - 5.3.4 Purchase return book
 - 5.3.5 Format of Purchase return book
 - 5.3.6 Sales book
 - 5.3.7 Format of sales book
 - 5.3.8 Process of recording
 - 5.3.9 Sales return book
 - 5.3.10 Format of sales return book
- 5.4 Journal Proper
 - 5.4.1 Contents of journal proper
- 5.5 Summary
- 5.6 Glossary
- 5.7 check your progress
- 5.8 Answers to check your progress
- 5.9 Terminal questions
- 5.10 References
- 5.11 Practical Problems

Learning Objectives

After study this chapter you should be able to:

- Explain the meaning of day books
- Explain the format of different day books

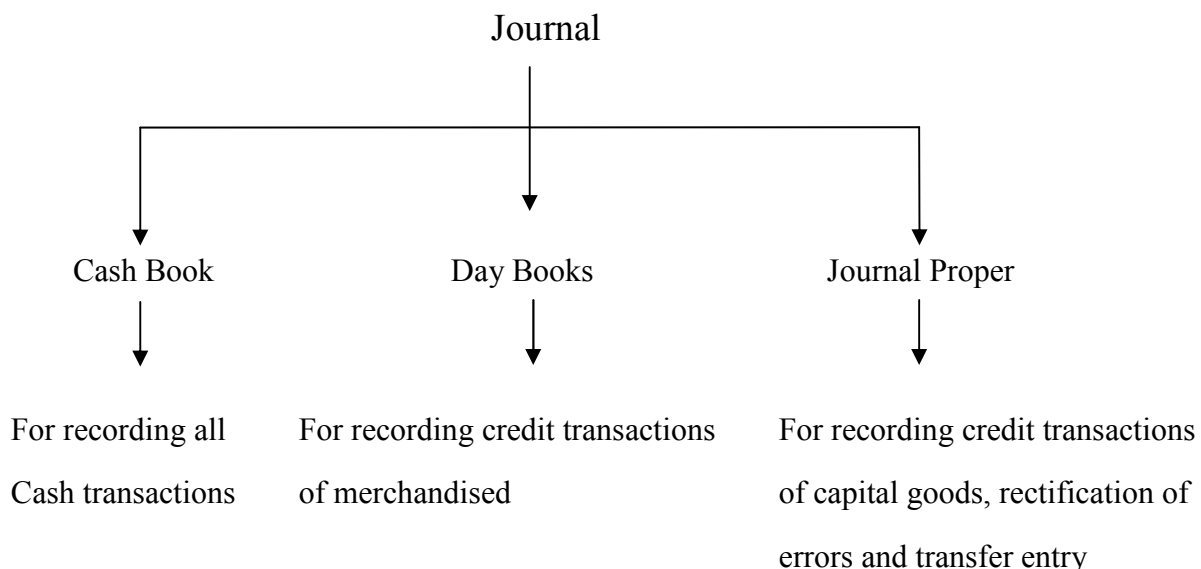
- Explain the content of journal proper

5.1 Introduction

We know that a business cannot be run successfully only on the basis of cash transactions for the long time. In order to ensure the growth and prosperity, the growth in sales is required. This objective can be achieved only by running the business on cash and credit both. We have need to purchase goods on credit. Similarly, we have to sell goods on credit for increasing the sales and creating competitive image in the market. We have already discussed earlier that all the cash transactions are recorded in Cash Book. For recording the credit transactions of purchase and sale of merchandised, different Day Books are used. These Day Books are discussed in this unit. In a business enterprise, originally all transactions are used to be recorded in a single book known as Journal. But with the increase in the size of the business and the volume of transactions significantly both cash and credit, it becomes difficult to record all the transactions in one book i.e. Journal. This may also lead to errors and mistakes. Therefore, for saving of time, labour and maintaining error free accounts more than one book of original entry should be maintained. Thus, sub-division of Journal is essential.

5.2 Sub-Division of Journal

The Journal may be divided on the basis of type of transactions as follows:



We have already discussed the Cash Book in detail in Unit- 4. Therefore, only Day Books and Journal Proper will be discussed in detail in this unit.

5.3 Day–Books

If non-cash transactions are numerous, it becomes essential to record different types of non-cash transactions i.e. credit purchase, credit sales, credit purchase return and credit sales return in different Day–Books. These are named as Purchase Book, Purchase Return Book, Sales Book and Sales Return Book.

5.3.1 Purchase Book

All credit purchases of merchandised are recorded in Purchase Book chronologically. Cash purchases are recorded in Cash Book. Purchases of any property or assets such as furniture, machinery, office equipments etc. on credit are not recorded in this book. These are recorded in Journal Proper. The property or assets purchased on cash are recorded in Cash Book. The entries are made in Purchase Book with the help of Invoices/Bills with the net amount. If any trade discount allowed by the seller, the net price will be shown in the amount column. Cash discount shall not be written in this Book. At the end of the fixed period i.e. a month, the figures in the amount column shall be totaled and posted in the Ledger in Purchase Account on Debit side. This book is also known as Purchase Day Book or Purchase Journal or Bought Day Book.

5.3.2 Proforma of Purchase Book

There are several columns in this book which are Date, Particulars, Invoice/ Bill Number, Ledger Folio, Detail Amount and Remark. These columns are shown as under:

Purchase Book

Date	Name of Supplier	Invoice/Bill No.	LF	Details Rs.	Amount Rs.	Remarks

5.3.3 Process of Recording

The following three steps are undertaken for recording transactions:

- (i) An entry is made in Purchase Book with the help of invoice/Bill.
- (ii) A simultaneous entry is made on the credit side of the relevant supplier's account in the Ledger.
- (iii) At periodical intervals, generally, at the end of the month, the total of the Purchase Book is posted on the debit side of the Purchase Account in the Ledger.

Illustration-1

Enter the following transactions of M/s Sheetal Traders into Purchase Book for the month of March, 2012.

2012

March 3 Bought 12 Plastic Tubes @ Rs.7 per tube from Shyam Lal, Freight and packing charges Rs. 1 per tube.

March 6 Purchased 20 electrical irons from Shanti Traders@Rs.300 per electric iron less discount of 5% and cash discount of 5%.

March 12 Purchased 50 Bulbs @Rs 10 each from Surya Bulb.

March 16 Purchased 20 Tube Lights @ Rs. 40 each from Philips.

March 24 Purchased 10 Table Lamps@ Rs.50 from G. K. Electricals less 10% discount.

March 28 Purchased 10 Table Fans@ Rs. 500 from General Electricals

Solution:

Sheetal Traders

Purchase Book

Date	Name of Supplier	Invoice No.	LF	Details Rs.	Amount Rs.
2012 March 3	Shyam Lal 12 Plastic Tube@ Rs.7 per tube Add Freight & Packing			84.00 12.00	

March 6	Shanti Traders 20 Electric Irons@ Rs. 300 per Electric Iron. Less 5% Trade Discount			6000.00 300.00	96.00 5700.00
March 12	Surya Bulb 50 Bulbs@ Rs. 10 each			500.00	500.00
March 16	Philips 20 Tube Lights@ Rs. 40 each			800.00	800.00
March 24	G.K. Electricals 10 Table Lamps @ Rs. 50 Less 10 % Discount			500.00 50.00	450.00
March 28	General Electricals 10 Table Fans@ Rs. 500			5000.00	5000.00
Total					12546.00

5.3. 4 Purchase Return Book

There is a custom of returning goods purchased on credit on account of any defect in the goods or goods are not in accordance of the purchased order or for any other reasons. Such purchase returns of merchandised on credit are recorded in a book which is called Purchased Return Book or Return Outward Book. For every return, a Debit Note in duplicate is prepared and the original one is sent to the supplier for making necessary entries in his book together with reasons for return.

5.3.5 Performa of Purchase Return Book

The columns of this book are as under:

Purchase Return Book

Date	Name of Supplier	Debit Note No.	LF	Details Rs.	Amount Rs.	Remarks

Illustration-2

From the following particulars prepare Purchase Return Book of Sheetal Traders:

2012

March 12 Returned 3 Table Fans priced at Rs500 each to Shyam Traders due to some technical defect, Debit Note No. 201

March 25 Returned to Philips 5 Tube Lights priced at Rs. 40 each due to breakage, Debit Note No. 210

March 28 Returned 2 Electric Irons to General Electric priced at Rs. 100 each due to technical defect. Debit Note No. 215

Solution:**Sheetal Trader****Purchase Return Book**

Date	Name of Supplier	Debit Note No.	LF	Details Rs.	Amount Rs.	Remarks

2012	Shyam Traders	201				Technical
March 12	3 Table Fans@ Rs.500 each			1500	1500	Defect
March 25	Philips	210				Breakage
	5 Tube Lights@ Rs. 40 each			200	200	
March 28	General Electrical	215				Technical
	2 Electric Irons@ Rs 100			200	200	Defect
	Total				1900	

5.3.6 Sales Book

All credit sales of merchandised are recorded chronologically in a book which is called Sales Book or Sales Journal or Sales Day Book. Cash sales are recorded in Cash Book. Credit sales of any asset or property will not be recorded in this book. This will be recorded in Journal Proper. Periodically, at the close of each month, the amount column is totaled and posted in the Ledger in the credit of Sales Account.

5.3.7 Proforma of Sales Book

There are several columns in this book which are Date, Name of Customer, Invoice No. etc. These columns are shown as under:

Sales Book

Date	Name of Customer	Invoice/Bill No.	LF	Details Rs.	Amount Rs.	Remarks

5.3.8 Process of Recording-

The following three steps are undertaken;

- (i) An entry is made in the Sales Book with the help of carbon copy of the invoice prepared by the firm.
- (ii) A simultaneous entry is made on the debit side of the respective customer's account in the Customer Ledger.
- (iii) At periodical intervals, generally, at the end of the month, the total of Sales Book is posted on the credit side of the Sales Account in the Ledger.

Illustration-3

From the following transactions of Shiva Tea Centre, write up Sales Book for April 2012:

2012

April 2 Sold to Madhusudan 15 Kg. of Darjeeling Tea@Rs.300 per kg. Invoice No.130, Freight Rs. 50, Trade Discount 5%.

April 7 Sold to Surya Hotel 10 kg. Assam Tea@Rs 350 per kg., Invoice No.133 Freight Rs. 40.

April 16 Sold to Chaman 2kg. Leaf Tea@ Rs. 500 per kg. Invoice No.140 Trade Discount 10 %.

April 25 Sold to Kerala Café Hotel Dust Tea 20kg. @Rs. 200 per kg. Invoice No. 145 Add Sale tax 3 %

April 28 Sold to Suman Stores 8 kg. of Green Label Tea @ Rs. 400 per kg. Invoice No. 150.

Solution:

Shiva Tea Centre

Sales Book

Date	Name of Customer	Invoice No.	LF	Details Rs.	Amount Rs.
2012 April 2	Madhusudan 15 kg. Darjeeling tea @ 300 per kg.	130		4500	
	Less Trade Discount 5%			225	
April 7	Add Fright.	133		4275 50	4375
April 16	Surya Hotel 10 kg. Assam Tea @ Rs. 350 per kg.	140		3500	3540
April 25	Add Freight			40	
April 28	Chaman 2Kg. Leaf Tea @ Rs.500 per kg.	145		1000	900
	Less Trade Discount 10%	150		100	
	Kerala Café 20kg. Hotel Dust Tea@ Rs.200 per kg.			4000	4120
	Add Sales Tax 3%			120	
	Suman Stores 8 kg Green Label Tea @ Rs. 400 per kg.			3200	3200
	Total				16035

5.3.9 Sales Return Book

There is also a custom of returning goods sold on credit on account of any defect or goods are not dispatched according to purchase order or for any other reasons. Such sales return of merchandised on credit are recorded in a book which is called Sales Return Book or Sales Inward Book. On receipt of the goods, seller prepares a Credit Note in Duplicate. The original copy is sent to the customer and the duplicate copy is kept as a basis for recording in Sales Return Book.

5.3.10 Proforma of Sales Return Book

The columns of Sales Return Book are as under:

Sales Return Book

Date	Name of the customer	Credit Note No.	LF	Details Rs.	Amount Rs.	Remarks

Illustration-4

From the following transactions of Shiva Tea Centre, write up Sales Return Book for May, 2012:
2012

May 5 Received from Madhusudan 2 kg. Darjeeling Tea @ Rs. 300 per kg. Trade Discount 5 % due to poor packing.

May 8 Returned by Kerala Café Dust Tea 5 kg. @Rs 200 per kg. for being inferior quality.

May 26 Returned by Suman 2 kg. of Green Label Tea @ Rs. 400 per kg. due to expiry.

Solution:**Shiva Tea Centre****Sales Return Book**

Date	Name of the Customer	Credit Note No.	LF	Details Rs.	Amount Rs.	Remarks
2012 May 5	Madhusudan 2 kg. of Darjeeling Tea@ Rs. 300 per kg. Trade Discount			600 30	570	Poor packing

May 8	Kerala café 5kg. Dust Tea @ Rs.200 per kg.			1000	1000	Inferior Quality
May 26	Suman 2 kg. of Green Label Tea @ Rs 400.			800	800	Expiry
Total					2370	

5.4 Journal Proper

We have already studied that all cash transactions related to merchandised, assets and property and persons are recorded in Cash Book. Similarly, we have also studied that all credit transactions related to purchase and sale of merchandised are recorded in Purchase Book and Sales Book respectively. Their returns are recorded in Purchase Return Book and Sales Return Book. Apart from these transactions, there are certain other transactions which have been not recorded in any of the above books. Such transactions are purchase and sale of assets and property on credit, rectification of errors, non-cash transactions etc. These transactions are recorded in a separate book which is called Journal Proper. Therefore, this book is also called residuary book. In other words, any transaction which could not be recorded in any book will be recorded in Journal Proper. The format of Journal Proper is same as of Journal.

5.4.1 Contents of Journal Proper

The Journal Proper contains the following types of entries:

- (i) Opening Entries
- (ii) Closing Entries
- (iii) Transfer Entries
- (iv) Rectification Entries
- (v) Adjustment Entries
- (vi) Purchase or sale of assets and property on credit
- (vii) Miscellaneous Entries

Illustration-5

From the following transactions prepare the Journal Proper:

2012

Jan. 2 Purchased Machinery on credit from Agrawal Trader for Rs. 1,00,000

Feb. 3 Sold two old typewriters to Shyam @Rs. 200

March 10 Goods worth Rs. 500 taken by the proprietor is transferred from the Purchase Account to Drawings Account.

March 15 Hariom started business with stock Rs. 5000, Furniture costing Rs. 10,000 and Delivery Van valued at Rs 50,000.

Solution:**Journal Proper**

Date	Particulars	LF	Amount Dr Rs.	Amount Cr Rs.
2012 Jan 2	Machinery A/c Dr To Agrawal Traders A/c Being Machinery Purchased on credit		1,00,000	1,00,000
Feb 3	Shyam A/c Dr To Typewriters A/c Being two typewriters sold on credit		400	400
March 10	Drawings A/c Dr To Purchase A/c Being the transfer entry		500	500
March 15	Stock A/c Dr Furniture A/c Dr Delivery Van A/c Dr To Capital A/c Being the opening entry		5,000 10,000 50,000	65,000
	Total		1,65,900	1,65,900

5.5 Summary

- Credit transactions are also essential in addition to the cash transactions for running a business successfully and competitively. Therefore, for convenience, the Journal is divided into three parts i.e. Cash Book, Day Books and Journal Proper.
- All credit purchases of merchandised only are recorded in Purchase Book chronologically. Similarly, any return of these goods to the supplier on account of any defect in the goods or goods are not in accordance with the purchase orders etc. is recorded in Purchase Return Book.
- All credit sales of merchandised only are recorded in a book known as Sales Book. Similarly, any return of goods by the customer on account of any defect in goods or goods are not in accordance with the purchase order etc. is recorded in Sales Return Book.
- The transactions, which could not be recorded in any books of account, will be recorded in Journal Proper. Therefore, this book is called residual book. The Journal Proper contains the entries related to opening and closing, transfer and rectification, purchase or sale of assets and property on credit and Adjustment and Miscellaneous.

5.6 Glossary

Invoice: It is sent by, a seller to the purchaser along with goods sold. It provides necessary details of goods, quantity, rate, value, total amount payable etc.

Trade Discount: It is a discount allowed for bulk purchases. Trade discount is, generally, restricted to businessmen only.

Cash Discount: Cash discount is allowed to debtors as per terms and conditions for encouraging the payment on or before the due date.

Credit Note: Credit note is prepared and sent by the supplier when goods are returned to the supplier.

Debit Note: Debit note is prepared and sent by the purchaser when goods are returned to the supplier.

5.7 Check your Progress

Fill in the Blanks

1. Transactions which are not recorded in other books are recorded in
2. Credit purchases of goods are recorded in
3. Credit note is prepared insituation.
4. Debit note is prepared insituation.

5.8 Answers to check your progress

1. Journal Proper
2. Purchase book
3. sales return
4. purchase return

5.9 Terminal Questions

1. What do you mean by Day Book? What are its different types? Explain.
2. What is Purchase Book? Give a proforma of it with imaginary figures.
3. What is Sales Book? Give a proforma of it with imaginary figures.
4. What is Journal Proper? Discuss the different types of entries made in this book.
5. Write a note on the following:
 - (i) Purchase Return Book.
 - (ii) Sales Return Book.
6. Give a specimen of Purchase Return Book and explain its contents
7. Give a specimen of Sales Return Book and explain its contents.

5.10 References

1. Financial Accounting Principles and Practice- Prof. Jawahar Lal and Dr.Seema Srivastava
2. Financial Accounting- Sri P. C. Tulsian

3. Advanced Accountancy - Sri R. L. Gupta and Sri M. Radhaswamy
4. Advanced Accountancy-Sri S. P. Jain and Sri K. L. Narang.

5.11 Practical Problem

1. From the following particulars write up the Purchase Book of Mr. Sugandham for January, 2012;

2012

Jan. 2 Purchased from Govind Electronics 100 Radio Sets @ Rs. 240 each, Trade Discount 10%, Invoice No. 201

Jan. 5 Purchased from Madhur Electronics 20 C D Player @ Rs.2000 each, Packing charges Rs. 200, Invoice No. 205.

Jan. 10 Purchased from Arya Electronics 500 CDs @ Rs. 10 each, Trade Discount 2%, Invoice No. 210.

Jan. 22 Purchased from Misra Brothers 20 CD stands @ Rs 50 each, Invoice No. 214.

Jan. 27 Purchased from Sudershan 5 TV sets @ Rs 3000 each, Trade Discount 5%, cash Discount 5%, Invoice No.220.

(Ans. Total of Purchase Book Rs 42510)

2. Khaneja Watch has the following credit sales during the month of February, 2012. Write the transactions in Sales Book:

2012

Feb. 2 Sold to Noroton Watch Co. 10 Wrist Watches @ Rs. 250 each,

Feb. 4 Sold to Zenith Watch 12 Table Clocks @ Rs. 100 each, Trade Discount 5 %,

Feb. 6 Sold to Ghadiwala 10 Wall Clocks @ Rs 200 each, Trade Discount 10 % Cash Discount 5 %,

Feb. 17 Sold to Kohinoor Stores 10 Calculators @ Rs. 100 each,

Feb. 22 Sold to Imperial & co. 20 Wrist Watches @ Rs 500 each Trade Discount 10%,

Feb. 25 Sold to Kashi Stores 10 Wall Clocks with alarm @ Rs. 300 each.

(Ans. Total of Sales Book Rs. 18440)

3. Record the following transactions in the Purchase Return Book of Sugandham for the month of January, 2012.

2012

Jan. 6 Govind Electronics returned 2 Radio @ 240 each, Trade Discount 10% due to Breakage,

Jan. 8 Madhur Electronics returned 1 CD player @ Rs. 2000 due to technical defect,

Jan. 13 Arya Electronics returned 5 CDs @ Rs.10 each, on account of breakage, Trade Discount 2%,

Jan. 25 Mishra Brothers returned 1 CD stand @ Rs. 50 on account of defective,

Jan. 29 Sudershan returned 1 TV set @Rs3000 due to defective, Trade Discount 5%.

(Ans. Total of Purchase Return Book Rs. 5822)

4. Enter the following transactions which took place in the month of February, 2012 in Sales Return Book:

2012

Feb. 5 Norton Watch Co .returned 2 Wrist Watches @ Rs 250 each,

Feb. 8 Zenith Watch returned 2 Table Clocks @ Rs. 100 each, Trade Discount 5%,

Feb. 10 Ghadiwala returned 3 Wall Clocks @ Rs. 200 each,

Feb. 20 Kohinoor Stores returned 1 Calculator @ Rs 100.

(Ans. Total of Sales Return Book Rs. 1330)

Unit -6

Ledger

- 6.1 Introduction
- 6.2 Definition of ledger
- 6.3 Format of ledger
- 6.4 Posting
- 6.5 Practical problems and solutions
- 6.6 Classification of ledger accounts
- 6.7 Summary
- 6.8 Glossary
- 6.9 Check your progress
- 6.10 Answers to check your progress
- 6.11 Self examination questions
- 6.12 Reference Books
- 6.13 Practical Problems

Objectives

After study this chapter you should be able to:

- Explain the meaning of ledger and its objectives.
- Explain the format of ledger.
- Explain the process of posting of transactions in ledger.
- Explain the process of balancing of ledger accounts.

6.1 Introduction

After making Journal entries, the next step is to classify the transactions. In order to classify the transactions the respective accounts are opened in the ledger which is popularly known as Ledger Posting. Ledger is a book which contains various accounts. In other words ledger is a set of accounts. It contains all accounts of the business enterprise whether Real, Nominal or Personal.

From the Journal debit and credit items are posted to their respective accounts in ledger. Posting means transferring of the debit and credit items in to ledger. Ledger is also known as book of second entry. As the first entry is done in the journal and then the entries are posted in the ledger. It should be noted that the exact names of account used in the journal should be carried to ledger. Also posting may be done at any time. However it should be completed before the financial statements are prepared.

6.2 Ledger Defined

Ledger is a principal book which includes all the accounts Personal, Real and Nominal (for example, Assets Accounts, Liabilities Accounts, Income Accounts, Expenses Accounts) to which the transactions recorded in the books of Journal entry are transferred. Since the ledger is the destination of all transactions and provides summary of different types of transactions, it becomes an essential part of accounting.

Ledger is known as a permanent record and is more frequently referred as a formal record of all transactions relating to a change in a particular head or item.

6.3 Format of a Ledger Account

A Ledger account has two sides; viz Debit and Credit. Each of the side has four columns, Date, Particulars, Journal folio and Amounts. Usually, Ledger Accounts are prepared in the following format :

Name of the Account:				Ledger Folio No.....			
Dr.							Cr.
Date	Particulars	J.F.	Amounts	Date	Particulars	J.F.	Amounts

Note: Journal Folio is the number of page in the Journal Book from where the entries are taken

for posting.

6.4 Ledger Posting

After knowing the format of Ledger accounts, it is important to know the process of transferring the items from Journal to ledger accounts. This process of transferring the items (Debit and Credit) from Journal to ledger is known as posting.

Process of Posting in Ledger Account: for Posting the items in Ledger account, you should follow the following process:

- You should open a separate ledger account for each entry on the basis of entries given in the journal. For example, in the first entry of Business commencement, i.e.

Journal Entry				
Date	Particulars	L.F.	Amounts	Amounts
Jan-1	Cash A/c Dr. To Capital A/c. (Being business started.)		10,00,000	10,00,000

In this situation two accounts Cash and Capital should be opened in the Ledger book.

- In Ledger Account on the debit side in the column of Particulars the word '**To**' and on the credit side in the column of particulars the word '**By**' is used to indicate Debit and Credit respectively.
- Suppose, you opened Cash Account in Ledger. In this case, since cash a/c is debited in journal, so it will be debited in ledger as well. But remember, while posting in ledger a/c of cash, the reference of respective credit a/c will be given. Ledger posting can be understood by the following format :

Name of the Account: Cash Account							L. Folio No..
Dr.						Cr.	
Date	Particulars	J.F.	Amounts	Date	Particulars	J.F.	Amounts
1-Jan	To Capital A/c		10,00,000				

Name of the Account: Capital Account							L. Folio No..
Dr.							Cr.
Date	Particulars	J.F.	Amounts	Date	Particulars	J.F.	Amounts
				1-Jan	By Cash A/c		10,00,000

In this way separate ledger account is prepared for each debit and credit items recorded in the journal and are posted in the aforementioned manner.

- After posting in the respective ledger accounts, the next step is balancing of ledger accounts. At the end of a given period, may be at the end of the year or the month, it may be necessary to know the balance of each account. It is very easy to balance an account. For balancing an account, we make total of both the sides, if it equals then there is no balance in that particular a/c. But if the difference comes, then this difference is known as balance.
- In case, the debit side of ledger a/c is greater than the credit side, account is called to have debit balance otherwise credit balance.
- When an account is having credit balance, it is written on the debit side as 'To Balance C/d' with the amount of difference. By doing so, both the sides would be equal and the totals of both the sides are written opposite to each other. And after this, the credit balance is written on the credit side of the account as 'By Balance b/d' or b/f (b/d stands for brought down and b/f stands for brought forward.)

Important Point: *Students, you should always remember that Nominal accounts are never balanced because their balance is transferred to Profit & Loss Account. Balancing is done for only two type of accounts; i.e. Personal and Real Accounts and their balance goes to Balance Sheet.*

Balancing of ledger account can be understood by the following format:

Name of the Account: Cash Account							L. Folio No..
Dr.							Cr.
Date	Particulars	J.F.	Amounts	Date	Particulars	J.F.	Amounts

1-Jan	To Capital A/c	<u>10,00,000</u>	Jan-31	By Balance C/d	<u>10,00,000</u>
		<u>10,00,000</u>			<u>10,00,000</u>
Feb-1	To Balance b/d	10,00,000			

Name of the Account: Capital Account				L. Folio No..			
Dr.				Cr.			
Date	Particulars	J.F.	Amounts	Date	Particulars	J.F.	Amounts
Jan-31	To Balance C/d		<u>10,00,000</u>	Jan-1	By Cash A/c		<u>10,00,000</u>
			<u>10,00,000</u>				<u>10,00,000</u>
				Feb-1	By Balance b/d		10,00,000

Note: Some accountants adjust the capital account with the net Profit or Loss of the Business and do not balance it till finalization of accounts. Here, we have assumed that the balance of Profit & Loss Account and Capital A/c are shown separately in the balance sheet.

6.5 Practical Problems and Solutions

Q.1 Journalize the following transactions, post the entries in ledger of Y.T. Limited for the year 2012 :

January-1	Y.T. started his business with Rs. 2, 00,000
January-20	Goods purchased Rs.10,000
January-25	Goods purchased from Dhiraj Rs. 18,000
January-31	Purchased Fixed Assets for Rs.5,000
Feb- 7	Goods sold to Mr. Kishan Rs. 5,000
Feb-11	Sold goods for cash Rs. 4,000.
Feb-21	Purchased goods from Chitra Rs.50,000
March-31	Salary Paid Rs. 15,000
April-1	Paid Rs 17,900 to Dhiraj after receiving Cash Discount Rs. 100.
April-5	Y.T.withdrew Rs.5,000 for his personal use.
April-30	Paid for Printing & Stationery Rs. 2500
May-10	Postage expenses incurred Rs.50

Solution :

Journal Entries in the books of Y.T. Limited					
Date	Particulars		L.F.	Amounts	Amounts
1-Jan	Cash	A/c	Dr	2,00,000	
		To Capital	A/c		2,00,000
	(Being Business Started.)				
20-Jan	Purchases	A/c	Dr	10,000	
		To Cash	A/c		10,000
	(Being goods purchased)				

25-Jan	Purchases	A/c	Dr	18,000	
		To Dhiraj's	A/c		18,000
	<u>Being goods purchased from Dhiraj)</u>				
31-Jan	Fixed Assets	A/c	Dr	5,000	
		To Cash	A/c		5,000
	<u>(Being fixed assets purchased.)</u>				
7-Feb	Kishan's	A/c	Dr	5,000	
		To Sales	A/c		5,000
	<u>(Being goods sold to kishan)</u>				
11-Feb	Cash	A/c	Dr	4,000	
		To Sales	A/c		4,000
	<u>(Being goods sold)</u>				
21-Feb	Purchases	A/c	Dr	50,000	
		To Chitra's	A/c		50,000
	<u>(Being goods purchased from Chitra)</u>				
31-Mar	Salary	A/c	Dr	15,000	
		To Cash	A/c		15,000
	<u>(Being Salary Paid)</u>				
1-Apr	Dhiraj's	A/c	Dr	18,000	
		To Cash	A/c		17,900
		To Discount	A/c		100
	<u>(Being final payment made and discount received.)</u>				
5-Apr	Drawings	A/c	Dr	5000	
		To Cash	A/c		5000
	<u>(Being drawings made)</u>				
30-Apr	Printing & Stationery	A/c	Dr	2,500	
		To Cash	A/c		2,500
	<u>(Being expenses incurred)</u>				
10-May	Postage Expenses	A/c	Dr	50	
		To Cash	A/c		50
	<u>(Being expenses incurred)</u>				
Grand Total				132,550	132,550

Ledger Accounts :

Cash Account							
Dr.				Cr.			
Date	Particulars	J.F.	Amounts	Date	Particulars	J.F.	Amounts

1-Jan	To Capital A/c	2,00,000	1-Jan	By Purchases A/c	10,000
11-Feb	To Sales A/c	4,000	31-Jan	By Fixed Assets A/c	5,000
			31-Mar	By Salary A/c	15,000
			1-Apr	By Dhiraj's A/c	17,900
			30-Apr	By Printing & Stat. A/c	2,500
			10-May	By Postage Exp.A/c	50

Dr. Capital Account								Cr.
Date	Particulars	J.F.	Amounts	Date	Particulars	J.F.	Amounts	
				1-Jan	By Cash A/c		2,00,000	

Dr. Purchases Account								Cr.
Date	Particulars	J.F.	Amounts	Date	Particulars	J.F.	Amounts	
20-Jan	To Cash A/c		10,000					
25-Jan	To Dhiraj's A/c		18,000				-	
21-Feb	To Chitra's A/c		50,000					

Dr. Dhiraj's Account								Cr.
Date	Particulars	J.F.	Amounts	Date	Particulars	J.F.	Amounts	
1-Apr	To Cash A/c		17,900	25-Jan	By Purchases A/c		18,000	
	To Discount A/c		100				-	

Dr. Discount Account								Cr.
Date	Particulars	J.F.	Amounts	Date	Particulars	J.F.	Amounts	
				1-Apr	By Dhiraj's A/c		100	

Dr. Fixed Assets Account								Cr.
Date	Particulars	J.F.	Amounts	Date	Particulars	J.F.	Amounts	
31-Jan	To Cash A/c		5,000					

Dr. Kishan's Account								Cr.
Date	Particulars	J.F.	Amounts	Date	Particulars	J.F.	Amounts	
7-Feb	To Sales A/c		5000				-	

-							
Sales Account							
Dr.							Cr.
Date	Particulars	J.F.	Amounts	Date	Particulars	J.F.	Amounts
				7-Feb	By Kishan's A/c		5,000
				11-Feb	By Cash A/c		4,000
-							
Chitra's Account							
Dr.							Cr.
Date	Particulars	J.F.	Amounts	Date	Particulars	J.F.	Amounts
				21-Feb	By Purchases A/c		50,000
-							
Salary Account							
Dr.							Cr.
Date	Particulars	J.F.	Amounts	Date	Particulars	J.F.	Amounts
31- Mar	To Cash A/c		15,000				
-							
Printing & Stationery Account							
Dr.							Cr.
Date	Particulars	J.F.	Amounts	Date	Particulars	J.F.	Amounts
30- Apr	To Cash A/c		2,500				
-							
Postage Expenses Account							
Dr.							Cr.
Date	Particulars	J.F.	Amounts	Date	Particulars	J.F.	Amounts
10- May	To Cash A/c		50				

Q.2 With the help of following information provided by Sapna Limited, open necessary ledger accounts:

Opening Balance (As on Jan-1, 2012) :

Cash in hand Rs. 10,000

Cash at bank Rs.27,000

Stock in trade Rs. 22,000

Land & Building Rs. 12,000

Sundry Debtors Rs. 6,000

Sundry Creditors Rs. 7,000

Jan-1 Goods purchased worth RS. 7000, trade discount @10% on Price

Jan-10 Received RS. 5800 from debtors and discount allowed RS. 200

Jan-21 Goods sold to Bittu Ji Rs.10000

Jan-31 Goods sold to Vaishnavi Enterprises in cash RS.10,000

Solution :

Cash Account							
Dr.				Cr.			
Date	Particulars	J.F.	Amounts	Date	Particulars	J.F.	Amounts
1-Jan	To Balance b/d		10,000	1-Jan	By Purchases A/c		6300
10-Jan	To Debtors A/c		5800	31-Jan	By Balance c/d		19500
31-Jan	To Sales A/c		10,000				
			<u>25,800</u>				<u>25,800</u>
1-Feb	To Balance b/d		19,500				

Bank Account							
Dr.				Cr.			
Date	Particulars	J.F.	Amounts	Date	Particulars	J.F.	Amounts
1-Jan	To Balance b/d		<u>27,000</u>	31-Jan	By Balance c/d		<u>27,000</u>
			<u>27,000</u>				<u>27,000</u>
1-Feb	To Balance b/d		27,000				

Stock-in-trade Account							
Dr.				Cr.			
Date	Particulars	J.F.	Amounts	Date	Particulars	J.F.	Amounts
1-Jan	To Balance b/d		22,000	31-Jan	By Balance c/d		22,000
			<u>22,000</u>				<u>22,000</u>
1-Feb	To Balance b/d		22,000				

Land & Building Account							
Dr.				Cr.			
Date	Particulars	J.F.	Amounts	Date	Particulars	J.F.	Amounts
1-Jan	To Balance b/d		12,000	31-Jan	By Balance c/d		12,000
			<u>12,000</u>				<u>12,000</u>
1-Feb	To Balance b/d		12,000				

Sundry Debtors Account							
Dr.				Cr.			
Date	Particulars	J.F.	Amounts	Date	Particulars	J.F.	Amounts
1-Jan	To Balance b/d		6,000	10-Jan	By Cash A/c		5800
					By Discount A/c		200
			<u>6000</u>				<u>6000</u>

Sundry Creditors Account							
Dr.				Cr.			
Date	Particulars	J.F.	Amounts	Date	Particulars	J.F.	Amounts
31-Jan	To Balance C/d		<u>7000</u>	1-Jan	By Balance b/d		<u>7,000</u>
			<u>7000</u>				<u>7,000</u>
				1-Feb	By Balance b/d		7,000

Purchases Account							
Dr.				Cr.			
Date	Particulars	J.F.	Amounts	Date	Particulars	J.F.	Amounts
1-Jan	To Cash A/c		6300	31-Jan	By Balance c/d		6300
			<u>6300</u>				<u>6300</u>
1-Feb	To Balance b/d		6300				

Sales Account							
Dr.				Cr.			
Date	Particulars	J.F.	Amounts	Date	Particulars	J.F.	Amounts
31-Jan	To Balance c/d		20,000	21-Jan	By Bittuji		10,000
				31-Jan	By Cash A/c		<u>10,000</u>
			<u>20,000</u>				<u>20,000</u>
							20,000
				1-Feb	By Balance b/d		

Bittuji's Account							
Dr.				Cr.			
Date	Particulars	J.F.	Amounts	Date	Particulars	J.F.	Amounts
21-Jan	To Sales A/c		10,000	31-Jan	By Balance C/d		10,000
			<u>10,000</u>				<u>10,000</u>
1-Feb	To Balance b/d		10,000				

Q.3 Journalise the following transactions and Prepare necessary ledger accounts in the books of L.K.Enterprises:

- Business Started with Capital of Rs. 1,00,000
- Goods worth Rs.700 given as charity.
- Received Rs. 975 from Gopalji in final settlement of his account for Rs. 1,000

- d. Paid Rs.480 to Vishu in full settlement of his account for Rs. 500
- e. Paid Rs. 380 to Swati on her account for Rs. 400
- f. Rent paid to landlord Rs. 1000
- g. Salary paid Rs. 5,000
- h. Depreciation on office furniture Rs. 1000

Solution :

Journal Entries in the books of L.K.Enterprises					
Date	Particulars	L.F.	Amounts	Amounts	
a.	Cash A/c	Dr	1,00,000		
	To Capital A/c			1,00,000	
	(Being Business Started.)				
b.	Charity A/c	Dr	700		
	To Purchases A/c			700	
	(Being Charity made)				
c.	Cash A/c	Dr	975		
	Discount A/c	Dr	25		
	To Gopalji's A/c			1000	
	(Being Payment received and discount allowed)				
d.	Vishu A/c	Dr	500		
	To Cash A/c			480	
	To Discount A/c			20	
	(Being final payment made and discount received.)				
e.	Swati's A/c	Dr.	400		
	To Cash A/c			380	
	To Discount A/c			20	
	(Being final payment made and discount received.)				
F	Rent A/c	Dr	1000		
	To Cash A/c			1000	
	(Being Rent Paid)				
g.	Salary A/c	Dr	5000		
	To Cash A/c			5000	
	(Being Salary Paid)				
h.	Depreciation A/c	Dr	1000		
	To Office Furniture A/c			1000	
	(Being Furniture Depreciated.)				
	Grand Total		1,09,600	1,09,600	

Classification of Ledger Accounts:

Dr. Cash Account								Cr.	
Date	Particulars	J.F.	Amounts	Date	Particulars	J.F.	Amounts		
	To Capital A/c		1,00,000		By Vishu's A/c		480		
	To Gopalji's A/c		975		By Swati's A/c		380		
			-		By Rent A/c		1,000		
					By Salary A/c		5,000		
Dr. Capital Account								Cr.	
Date	Particulars	J.F.	Amounts	Date	Particulars	J.F.	Amounts		
					By Cash A/c		1,00,000		
Dr. Charity Account								Cr.	
Date	Particulars	J.F.	Amounts	Date	Particulars	J.F.	Amounts		
	To Purchases A/c		700						
Dr. Purchases Account								Cr.	
Date	Particulars	J.F.	Amounts	Date	Particulars	J.F.	Amounts		
					By Charity A/c		700		
Dr. Gopalji's Account								Cr.	
Date	Particulars	J.F.	Amounts	Date	Particulars	J.F.	Amounts		
					By Cash A/c		975		
					By Discount A/c		25		

Vishu's Account							
Dr.							Cr.
Date	Particulars	J.F.	Amounts	Date	Particulars	J.F.	Amounts
	To Cash A/c		480				
	To Discount A/c		20				
Swati's Account							
Dr.							Cr.
Date	Particulars	J.F.	Amounts	Date	Particulars	J.F.	Amounts
	To Cash A/c		380				
	To Discount A/c		20				
Rent Account							
Dr.							Cr.
Date	Particulars	J.F.	Amounts	Date	Particulars	J.F.	Amounts
	To Cash A/c		1000				
Depreciation Account							
Dr.							Cr.
Date	Particulars	J.F.	Amounts	Date	Particulars	J.F.	Amounts
	To Office Furniture A/c		1,000				
Salary Account							
Dr.							Cr.
Date	Particulars	J.F.	Amounts	Date	Particulars	J.F.	Amounts
	To Cash A/c		5,000				

Q.4 With the help of following information provided by Lakshmi Limited open necessary ledger accounts for the month of March -2012.

- a. Purchased Goods from Goldi Ltd. Rs. 60,000
- b. Goods sold to Sandhya ji Rs. 80,000
- c. Paid income-tax Rs. 5000
- d. Charge depreciation on Machine @ 10% p.a. (Cost of Machine Rs. 1,00,000).

- e. Received commission Rs. 700.
- f. Stationery purchased Rs. 800
- g. Salary Paid to office employees Rs. 4000

Solution :

Cash Account							
Dr.							
Date	Particulars	J.F.	Amounts	Date	Particulars	J.F.	Amounts
	To Commission A/c		700		By Income Tax A/c		5,000
					By Stationery A/c		800
					By Salary A/c		4,000
			-				
Purchases Account							
Dr.							
Date	Particulars	J.F.	Amounts	Date	Particulars	J.F.	Amounts
	To Goldi's A/c		60,000				-
Goldi's Account							
Dr.							
Date	Particulars	J.F.	Amounts	Date	Particulars	J.F.	Amounts
					By Purchases A/c		60,000
							-
Sandhyaji's Account							
Dr.							
Date	Particulars	J.F.	Amounts	Date	Particulars	J.F.	Amounts
	To Sales A/c		80,000				
Sales Account							
Dr.							
Date	Particulars	J.F.	Amounts	Date	Particulars	J.F.	Amounts
					By Sandhyaji's A/c		80,000
Income Tax Account							
Dr.							
Date	Particulars	J.F.	Amounts	Date	Particulars	J.F.	Amounts
	To Cash A/c		5000				-
							-

Depreciation Account							
Dr.					Cr.		
Date	Particulars	J.F.	Amounts	Date	Particulars	J.F.	Amounts
	To Machinery A/c		10,000				

Commission Account							
Dr.					Cr.		
Date	Particulars	J.F.	Amounts	Date	Particulars	J.F.	Amounts
					By Cash A/c		700

Salary Account							
Dr.					Cr.		
Date	Particulars	J.F.	Amounts	Date	Particulars	J.F.	Amounts
	To Cash A/c		4,000				

Stationery Account							
Dr.					Cr.		
Date	Particulars	J.F.	Amounts	Date	Particulars	J.F.	Amounts
	To Cash A/c		800				

6.7 Summary

After journalizing the transactions, the next step is to classify the transactions. In order to classify the transactions the respective accounts for each item of transactions are opened in the ledger which is popularly known as Ledger Posting.

Ledger is a principal book which includes all the accounts, Personal, Real and nominal to which the transactions recorded in the books of Journal entry are transferred. Since the ledger is the destination of all transactions and provides summary of different types of transactions, it becomes an essential part of accounting.

Ledger is known as a permanent record and is more frequently referred as a formal record of all transactions relating to a change in a particular head or item.

Balancing is done for only two type of accounts; i.e. Personal and Real Accounts and their balance goes to Balance Sheet. Nominal accounts are never balanced because their balance is transferred to Profit & Loss Account.

6.8 Glossary

Ledger: Ledger is a book of secondary entry. Transactions are posted from journal to ledger in account wise.

Creditors Account: It is liability ledger that records the money business or individual owes to suppliers, vendors or lenders for goods and services or loans provided on credit.

6.9 Check your progress

Fill in the Blanks

1.is the page number in the journal from which the transactions are posted.
2. Transfer of transactions from journal to ledger is termed as.....
3. After the posting of transactions in ledger , the next step is tothe accounts.

6.10 Answers to check your progress

1. Journal folio, 2. Posting, 3. Balance

6.11 Terminal Questions

- Q.1 What is Ledger? How is it prepared?
- Q.2 Enumerate any five utilities of a ledger.
- Q.3 Explain the procedure of ledger posting.
- Q.4 Explain the procedure for balancing a ledger account.

6.12 Reference Books

1. Financial Accounting Principles and Practice- Prof. Jawahar Lal and Dr. Seema Srivastava
2. Financial Accounting - Sri P.C. Tulsian
3. Advanced Accountancy - Sri R. L. Gupta and Sri M. Radhaswamy

4. Advanced Accountancy - Sri S. P. Jain and Sri K.L. Narang.

6.13 Numerical Questions for Practice:

Q.1 Journalize the following transactions and Prepare necessary ledger accounts in the books of L.K.Enterprises:

- i. Business Started with Capital of Rs. 1,00,000
- j. Goods worth Rs.700 given as charity.
- k. Received Rs. 975 from Gopalji in final settlement of his account for Rs. 1,000
- l. Paid Rs. 480 to vishu in full settlement of his account for Rs.500
- m. Paid Rs. 380 to Swati on her account for ₹ 400
- n. Rent paid to landlord Rs. 1000
- o. Salary paid Rs. 5,000
- p. Depreciation on office furniture Rs. 1000

Answer: Total of Journal – Rs. 1,09,600

Q.2 Journalise the following transactions and prepare ledger accounts in the books of Radha Limited.

- h. Purchased Goods from Goldi Ltd. Rs. 40,000
- i. Goods sold to Sri Pappuji Rs. 30,000
- j. Paid income-tax Rs.5000
- k. Charge depreciation on Machine @ 10% p.a. (Cost of Machine Rs. 70,000).
- l. Provide interest on loan from Bittuji (Rs. 60,000) @10% p.a.
- m. Received commission Rs. 500.
- n. Stationery purchased Rs. 500
- o. Salary Paid to office employees Rs. 1000
- p. Rent received Rs.2000

Answer: Total of Journal – Rs 92,000

Q.3 With the help of following information provided by Radhika Limited, Journalize the following transactions and open necessary ledger accounts:

Opening Balance (As on April-1, 2012) :

Cash in hand Rs. 40,000

Cash at bank Rs. 17,000

Stock in trade Rs.37,000

Plant & Machinery Rs. 1, 20,000

Sundry Debtors Rs. 60,000

Sundry CreditorsRs 70,000

April-10 Goods purchased worth Rs. 27000, trade discount @15% on Price

April-20 Received Rs.5800 from debtors and discount allowed Rs. 200
 April-21 Salary Paid Rs.5750
 April-24 Commission received Rs 660
 April-24 Interest Paid Rs. 470
 April-25 Rent Paid Rs.4000
 April-25 Goods sold to BittuJi Rs.1,00,000
 April-26 Commission paid Rs.450
 April-28 Postage Paid Rs. 550
 April-30 Goods sold to Ambuj Enterprises in cash Rs. 20,000

Q.4 Journalize the following transactions, post the entries in ledger of Bittu Limited for the year 2012:

January-1, Bittu started his business with Rs. 5, 00,000
 January-20 Goods purchased from Rama Limited Rs.40,000
 January-25, Goods purchased from Virendra Limited Rs. 28,000
 January-31 Goods sold to Gopal Limited for Rs. 15,000
 Feb- 7 Goods sold to Mr.Shashwat Rs. 25,000
 Feb-11 Sold goods for cash Rs.24,000.
 Feb-21 Purchased goods from Swati limited Rs. 50,000
 March-31 Salary Paid Rs.5,000
 April-1 Paid Rs 27,900 to Virendra limited after receiving Cash Discount Rs. 100.
 April-5 Bittu withdrew Rs.5,000 for his personal use.
 April-30 Paid for Printing & Stationery Rs.500

Q.5 Journalize the following transactions and Prepare necessary ledger accounts in the books of Gopeshwer Enterprises:

- a. Business Started with Capital of Rs. 5,00,000
- b. Purchased goods from pappu limited Rs 40,000
- c. Goods purchased in cash Rs.30,000
- d. Goods sold to palan limited Rs. 20000
- e. Received Rs. 19,950 from palan limited in final settlement of his account for Rs.20,000
- f. Income tax paid Rs.10,000
- g. Salary paid Rs.25,000
- h. Depreciation on plant & machinery Rs.1000

Unit -7

Bank Reconciliation Statement

7.1 Introduction

7.2 Meaning and Definition of Bank Reconciliation Statement

7.2.1 Use of Bank Reconciliation Statement

7.3 Possible Reasons for difference

7.4 How to prepare bank reconciliation statement

7.5 Practical problems and solutions

7.6 Summary

7.7 Glossary

7.8 Check your progress

7.9 Answers to check your progress

7.10 Terminal questions

7.11 Reference

7.12 Numerical Questions for practice

Learning Objectives

After study this chapter you should be able to:

- Understand banking transactions and explain the meaning of bank reconciliation statement.
- Know the importance of bank reconciliation statement.
- Understand the reasons of difference of cash book and pass book.
- Prepare bank reconciliation statement with the corrected bank balance method
- Prepare bank reconciliation statement with the extracts of cash book and pass book

7.1 Introduction

We usually operate a bank account in which we deposit and withdraw money from time to time according to our need. In due course, we maintain a record with ourself of these deposits and withdrawals. Sometimes when we get our pass-book updated and feel surprised to find that the balance shown by the pass book is different from what it should have been as per our records. This difference, sometimes, is obvious due to certain reasons. But what is more important, that, we must know the reasons behind the differences.

The same situation may be faced by business organizations as well. These business organizations normally maintain record of all of their banking transactions in their bank column of the cash book. Ideally, on a particular date, the bank balance shown by the bank column of cash book and that shown by the pass book should be the same. But if there is difference between the two, the accountants need to find out the reasons in order to reconcile the balance.

In order to reconcile the difference between the bank balance shown by the Pass book and that of Bank column of cash book, a statement is prepared by the accountants, which reconciles the balances. This statement is called as Bank Reconciliation Statement.

Bank Reconciliation Statement is prepared to reconcile the difference between the balance of pass book and that of Cash book.

7.2 Meaning and Definition of Bank Reconciliation Statement

Business organization maintains the cash book for recording cash and bank transactions. The Cash book serves the purpose of both the cash account and the bank account. It shows the balance of both at the end of a particular period. Bank also maintains an account for each customer in its book. All deposits by the customer are recorded on the credit side of his account and all withdrawals are recorded on the debit side of his account. A copy of this account is

regularly sent to the customer by the bank either in the form of 'Pass Book' updation or Bank statement.

It is usual to tally the firm's bank transactions as recorded by the bank with the cash book. But sometimes the bank balances as shown by the cash book and that shown by the pass book/bank statement do not match. If the balance shown by the pass book is different from the balance shown by bank column of cash book, the business firm will identify the causes for such difference. It becomes necessary to reconcile them. To reconcile the balances of Cash Book and Pass Book a statement is prepared. This **statement is called as 'Bank Reconciliation Statement.**

Finally, we can define Bank Reconciliation Statement to as , "a statement prepared to reconcile the difference between the balances as per the bank column of the cash book and pass book on any given date."

7.2.1 Use of Bank Reconciliation Statement :

Preparing Bank Reconciliation Statement is not a compulsory task of an accountant. It can be prepared by accountants any time as there is no specific date for preparing it. Main objective of preparing Bank Reconciliation Statement is to check, that all transactions relating to bank are properly recorded by the business as well as the bank.

So, it is prepared to reconcile the bank balances shown by the cash book and by the bank statement. It is very helpful in detecting, if there is any error in recording the transactions and ascertaining the correct bank balance on a particular date.

7.3 Possible Reasons for difference:

Normally, it is said that since the time period of posting the transactions in the bank column of cash book and time period of posting in the bank pass book of the firm are often different, hence the difference arises. The possible reasons for difference in balance of cash book and pass book may be described as follows:

1. **Cheques issued but not yet presented for payment:** This is one of the obvious reason for difference in balance as per cash book and pass book. Since cheques are valid for a

period of three months, hence, businessmen usually deposit it after few days of the receipt. And, in case accountant receives bank statement during these days, the difference in the balances of cash book and pass book comes into light.

2. **Cheques deposited into bank but not yet collected:** Although, due to use of technology and CBS –Core banking Solutions, time taken by banks in clearing cheques has drastically been shortened. Now, it takes a maximum of 2-3 working days to get our cheques cleared. If bank statement is issued within these days, it is obvious that balance shown by pass book and that of cash book would differ.
3. **Amount directly deposited in the bank account:** In modern day business, in order to cut down the time for collection of cash, businessmen give their account number to the clients and instruct them to deposit the amount in their account directly and save time which used to be lost in transit of posting of cheques and depositing them in bank and again in clearing. This direct deposit by customers, sometimes, is not reported to the businessman and balance of cash book and pass book differs.
4. **Interest and dividend received by the bank:** Sometimes we authorize our banker to receive certain payment on our behalf and in such cases we come to know about certain receipts, only then, when we receive our bank statement. Such receipts are also one of the reasons for difference in cash book and pass book balances.
5. **Bank Charges deducted from account:** There are certain annual charges, which bankers charge from their clients for service. Such charges come to our notice, when we receive the bank statement. Since they are not recorded in cash book, hence the balance of cash book and pass book differs.
6. **Dishonour of Cheques/Bill discounted:** In business, we normally discount the bills after paying certain amount of discounting charges. In case any bill is dishonoured, the amount of bill is automatically debited from the account of the customer by the banker. This debit from bank account may also be a reason for difference between the balance shown by cash book and that of pass book.
7. **Direct Payments made by the bank on behalf of the customers:** Sometimes we give standing instructions to our banker for making certain payment in order to ensure timely payments and avoid penalties. This is done mainly in case of taxes etc. These payments become one of the reasons for difference in the balances of cash book and pass book.

8. **Wrong Debit/Credit entry by the bank:** Wrong debit or credit by the banker is also one of the reasons for the differences in cash book and pass book balances.
9. **Wrong Debit/Credit entry by the business in cash book:** Like bank, sometimes there is a wrong debit or credit entry by the accountant of business in cash book also occurs which leads to the differences in cash book and Pass book balances.

These are the most important and frequent reasons for differences in cash book and pass book balances but this list can not be said to be exhaustive. Wherever, there is difference of timing and amount between banker and accountant of the business, the balances shown by both the parties would differ.

7.4 How to Prepare Bank Reconciliation Statement:

Preparing reconciliation statement is like convincing a friend of you, who is not happy due to some reasons. If you satisfy your friend by **eliminating the reasons of difference, he will be happy and problem will be resolved. Similarly, bank reconciliation statement acts as a problem solver between the two balances –Cash Book and Pass Book.**

The first step in preparing Bank Reconciliation Statement is to identify the possible reasons for difference in the balances shown by cash book and that of a pass book. Bank Reconciliation statement is prepared to reconcile both the balances without making change in the cash book balance.

There can be two situations while preparing Bank reconciliation Statement which are as follows:

1) Favorable balances: Favorable balance means the positive balance of cash book or pass book. It can be reconciled in following manner:

(a) Balance (Debit) as per **cash book** is given and the balance as per **pass book** is to be ascertained.

(b) Balance (Credit) as per **pass book** is given and the balance as per **cash book** is to be ascertained.

Broadly speaking we can say that when we start with balance as per cash book, we have to find out the balance as per pass book and vice-versa.

2. Unfavourable balance/overdraft balance: Unfavourable balance indicates about the negative balance of cash book or passbook. It can be reconciled in following manner:

(a) Balance (Credit) as per cash book (i.e. overdraft) is given and the balance as per pass book is to be ascertained.

(b) Balance (Debit) as per pass book (i.e. overdraft) is given and the balance as per cash book is to be ascertained.

The following steps are taken to prepare the bank reconciliation statement:

Favourable balances: When debit balance as per cash book or credit balance as per pass book is given:

Bank Reconciliation Statement

As on.....

Particulars	Amounts	Amounts
Balance as per Cash book		XXX
Add : All transactions due to which the balance of pass book has increased	XXX	XXX
		XXX
Less: All transactions due to which the balance of pass book has decreased.	XXX	XXX
Balance as per Pass book		XXX

Note : In case, the balance as per pass book is taken as starting point all transactions that have resulted in increasing the balance of the Cash book will be added and all transactions that have resulted in decreasing the balance of Cash book will be deducted.

Bank Reconciliation Statement

As on.....

Particulars	Amounts	Amounts
-------------	---------	---------

Balance as per Pass book		XXX
Add : All transactions due to which the balance of cash book has increased	XXX	XXX
		XXX
Less: All transactions due to which the balance of cash book has decreased.	XXX	XXX
Balance as per Cash book		XXX

Unfavorable Balance/Overdraft Balance: Sometimes a businessman withdraws excess amount from the bank account which results into the debit (-) closing balance. This balance is called 'overdraft balance' as per Pass Book. In Cash book this overdraft is shown as credit balance.

Credit balance as per cash book/Debit balance as per Pass Book :

Overdraft balance is to be shown in the minus column of statement as the starting point. The other steps remain the same.

7.5 Practical Problems and Solutions:

Q.1 With help of following information provided by Sri L.K. Limited, prepare a bank reconciliation statement as on December 31, 2012 .

Bank balance as per cash book Rs.1,00,000.

Cheques issued but not presented for payment Rs. 12,000.

The bank had directly collected dividend of Rs. 16,000 and credited to bank account but was not entered in the cash book.

Bank charges of Rs. 800 were not entered in the cash book.

A cheque for Rs. 12,000 was deposited but not collected by the bank.

Solution : 1

Bank Reconciliation Statement of Sri L.K. Limited

As on 31st December,2012

Particulars	Amounts	Amounts
Balance as per Cash book		1,00,000
Add : 1. Cheques issued but not presented for payment	12,000	
2. Dividend directly collected by bank but not entered in the cash book	16,000	
		28,000
		1,28,000

Less: 1. Bank Charges not entered in the cash book	800	
2. Cheque deposited but not yet collected by the bank	12,000	12,800
Balance as per Pass book		1,15,200

Q.2 you are provided with the following information relating to bank account of M/s Rita Limited.

Balance as per pass book Rs.45,000 on June 30th, 2012.

Cheques issued before 30th June 2012, amounting to Rs. 30,000 had not been presented for payment.

Two cheques of Rs.5,000 and Rs. 6,500 were deposited into the bank on June 10th, 2012 but the bank gave credit for the same in August, 2012.

There was also a debit in the passbook of Rs. 2,500 in respect of a cheque dishonored on 31st March 2012.

Prepare a bank reconciliation statement as on June 30th, 2012.

Solution :2

Bank Reconciliation Statement of M/s Rita Limited

As on 30th June,2012

Particulars	Amounts	Amounts
Balance as per Pass book		45,000
Add : 1. Cheques deposited in the bank but not collected	11,500	
2. Cheque dishonored but not entered in cash book	2,500	14,000
		59,000
Less: 1 Cheques issued but not presented for payment	30,000	30,000
Balance as per Cash book		29,000

Q.3 With the help of following information of Sri Virendra Limited, you are required to prepare a Bank Reconciliation Statement as on 30th July, 2012.

Overdraft as per cash book Rs. 25,000

Cheques deposited in the bank but not collected Rs.10,000

Cheques issued but not presented for payment Rs.4,000

Bank debited Rs. 500 on account of bank charges.

Solution :3**Bank Reconciliation Statement of Sri Virendra Limited****As on 30th July, 2012**

Particulars	Amounts	Amounts
Overdraft as per Cash book		25,000
Add : 1. Cheques deposited in the bank but not collected	10,000	
2. Bank Charges debited by bank	500	10,500
		35,500
Less: 1 Cheques issued but not presented for payment	4,000	4000
Overdraft as per Pass book		31,500

Q.4 You are provided with the following information of Ambuj Limited as on 21st February, 2012 .

Overdraft as per passbook Rs.60,000

Insurance Premium paid by the bank on behalf of customer Rs.800

Interest on overdraft charged by bank Rs. 500

Cheque issued but not presented for payment Rs.4000

Cheque deposited but not yet collected Rs.8000

Prepare Bank Reconciliation Statement.

Solution : 4**Bank Reconciliation Statement of Sri Ambuj Limited****As on February, 21st, 2012**

Particulars	Amounts	Amounts
Overdraft as per Pass book		60,000
Add : 1. Cheques issued but not presented for payment	4,000	
		4,000
		64,000
Less: 1 Insurance Premium Paid by bank on behalf of customer	800	
	500	
2 Interest on Overdraft charged by bank	8,000	9,300
3 Cheques Deposited but not yet collected		
Overdraft as per Cash book		54,700

Q.5 With the help of following details prepare a bank reconciliation statement:

Balance as per Cash book Rs. 15,600. Comparison of records indicated following points for differences:

Cheques deposited in bank but not credited Rs. 6,000

Cheques issued but not presented for payment 3,000

Insurance Premium paid by the bank 4,000 but not entered in cash book.

Bank interest credited by the bank 800

Bank charges debited by the bank 200

Amount directly deposited by a customer in the bank account 8,000

Ans: Balance as per passbook 17,200)

Solution : 5

Bank Reconciliation Statement of XXX

As on

Particulars	Amounts	Amounts
Balance as per Cash book		15,600
Add : 1. Cheques issued but not presented for payment	3,000	
2. Bank interest credited by the bank	800	
3. Amount directly deposited by a customer in the bank account	8,000	
		11,800
		27,400
Less: 1. Cheques deposited in the bank but not credited	6,000	
2. Insurance Premium paid by the bank but not entered in the Cash book	4,000	
3. Bank Charges debited by the bank	200	
		10,200
Balance as per Pass book		17,200

7.6 Summary

Business organizations normally maintain record of all of their banking transactions in their bank column of the cash book. Ideally, on a particular date, the bank balance shown by the bank column of cash book and that shown by the pass book should be the same. But if there is difference between the two, the accountants need to find out the reasons in order to reconcile the balance.

In order to reconcile the difference between the bank balance shown by the Pass book and that of Bank column of cash book, a statement is prepared by the accountants, which reconciles the balances. This statement is called as **Bank Reconciliation Statement**.

7.7 Glossary

Bank Reconciliation Statement: A statement that reconcile the difference between the bank balance shown by the Pass book and that of Bank column of cash book

Favorable Balance: When debit balance as per cash book or credit balance as per pass book is given:

7.8 Check your Progress

Fill in the Blanks

1. Business organization prepare.....to record cash and bank transactions.
2. Bank reconciliation statement is prepared by.....
3. Main objective of preparing Bank Reconciliation Statement is to check, that all transactions are properly recorded in cash book and

7.9 Answers to check your progress

1. cash book, 2. bank, 3. Pass book

7.10 Terminal Questions

- Q.1 what is Bank Reconciliation statement? Why and how is it prepared?
- Q.2 what is the utility of Bank Reconciliation statement?
- Q.3 Enumerate the causes of difference in the balance of cash book and pass book.

Q.4 State 5 the reasons where the balance shown by the bank passbook does not match with the balance as shown by the bank column of the cash book.

7.11 Reference Books

1. Financial Accounting Principles and Practice- Prof. Jawahar Lal and Dr. Seema Srivastava
2. Financial Accounting - Sri P.C. Tulsian
3. Advanced Accountancy - Sri R. L. Gupta and Sri M. Radhaswamy
4. Advanced Accountancy - Sri S. P. Jain and Sri K.L. Narang.

7.12 Numerical Questions for Practice

Q.1 With the help of following information of Chitra Limited, prepare a, bank reconciliation statement as on 31st March, 2012.

Balance as per cash book Rs. 6,400

Cheque issued but not presented for payment Rs.3,600

Cheque deposited but not collected upto March 31, 2005 Rs. 4,000

Bank charges debited by bank Rs.300

Ans : Balance as per passbook Rs. 5700)

Q.2 Following informations are available to you for preparing a bank reconciliation statement of Sundu Limited as on 31st December,2012.

Balance as per cash book Rs.15,600

After comparing the cash book with passbook following points are reported:

Cheques issued but not presented for payment Rs. 3,000

Insurance premium paid by the bank but not recorded in cash book Rs.4000

Cheque deposited in bank but not collected Rs.6,000

Bank interest credited by the bank Rs. 800

Bank charges debited by the bank Rs.200

Amount directly deposited by a customer in the bank account Rs. 8,000

Ans : (Balance as per passbook □17,200)

Q.3 Credit Balance as per passbook of Vishu Babu is reported to be Rs.1500. Following other information is given as follows:

Cheques deposited in bank account but not yet collected Rs. 750

Bank Charges debited by bank from his account Rs.150

Cheques issued but not yet presented for payment Rs. 1,250

Bank credited an interest amounting to Rs. 50 in his account on 31st March 2012.

Prepare a bank reconciliation statement as on 31st March,2012.

Ans: (Balance as per cash book Rs. 1,100)

Q.4 From the following particulars of Sapna Limited you are required to prepare a bank reconciliation statement as on December 31, 2012.

Balance as per Passbook was Rs.1,00,000

Two cheques amounting Rs.4,000 and Rs.10,000 were deposited in the month of September 2012, but were not credited by the bank till December,31st,2012.

A cheque of Rs. 1600 which was received from a client was entered in cash book but was not deposited in bank.

Cheques for Rs.20,000 were deposited in bank not yet collected.

Interest on investment Rs. 2,000 collected by bank but not entered in the cash book.

Ans: Balance as per cash book Rs.1,33,600

Overdraft :

Q.5 Mr. Huntu requests you to prepare a bank reconciliation Statement for him on 30th September,2012with the help of following information :

Overdraft as per Cash Book of Rs. 16,000

Cheques deposited in the bank but not yet collected Rs.4,000

Cheques issued but not presented for payment Rs.1,600

Bank charged Rs. 120 on account of interest and Rs. 200 in the name of bank charges.

Ans : Overdraft as per passbook Rs.18,720.

Q.6 You are provided with the following information relating to Sapna Enterprises.

Credit balance in the bank column of cash book 1,20,000 (Overdraft).

After examining the cash book and bank statement following points came into the light:

Cheques received and recorded in the cash book but not sent to the bank for collection Rs. 20,000.

Payment received from a customer directly in the bank account Rs. 28,000 which was not entered in the cash book.

Cheques issued for Rs.2,50,000 not presented for payment till date.

Interest of ₹ 12,000 charged by the bank was not entered in the cash book

Prepare a bank reconciliation statement as on 31st December,2012.

Ans : Balance as per Pass Book Rs. 1,26,000 (Favorable)

Q.7 Following information are related to Rita Limited. You are required to prepare a Bank Reconciliation Statement as on 30th July,2012.

Overdraft as per passbook Rs.200,000

Interest on overdraft charged by bank Rs. 20,000

Insurance Premium paid by the bank on behalf of customer Rs.12,000

Cheque issued but not presented for payment Rs.15,000

Cheque deposited but not yet collected Rs.16,000

The bank account of the firm was wrongly debited by the bank in the month of June with an amount of Rs.700

Ans : Overdraft as per cash Book Rs. 1,66,300

Q.8 With the help of following particulars, prepare a bank reconciliation statement of M/s Gangesh Enterprises as on 31st December, 2012

Balance as per passbook is Rs. 20,000.

Bank recorded a cash book deposit of Rs.21, 000 as Rs. 2,100.

Cheques issued but not presented for payment Rs. 10,000

Bank charges debited by the bank Rs.100

Cheques sent to the bank for collection but not yet collected Rs.6, 500

Ans. Balance as per cash book Rs.35, 500

Unit-8

Bills of Exchange

- 8.1 Introduction**
- 8.2 Meaning of Bills of Exchange**
- 8.3 Features of Bills of Exchange**
- 8.4 Advantages of Bills of Exchange**
- 8.5 Discounting of Bill**
- 8.6 Maturity of Bill or due date of bill**
- 8.7 Endorsement of Bill**
- 8.8 Accounting Treatment**
 - 8.8.1 on maturity**
- 8.9 Dishonor of Bill**
 - 8.9.1 Renewal of Bill**
 - 8.9.2 Retiring a Bill /Payment of Bill before the due date:**
 - 8.9.3 Accommodation Bill**
- 8.10 Practical Problems and Solutions**
- 8.11 Summary**
- 8.12 Glossary**
- 8.13 Check your progress**
- 8.14 Answers to check your progress**
- 8.15 Terminal Questions**
- 8.16 Reference Books**
- 8.17 Practical questions for Practice**

Objectives

After study this chapter you should be able to:

- Explain the meaning of bills of exchange and its parties
- Explain the accounting treatment of bills of exchange
- Explain the renewal of bills
- Explain the accounting treatment and process of accommodation bill

8.1 Introduction

When goods are sold or bought for cash, payment is received immediately. On the other hand, when goods are sold on credit the payment is deferred to a future date. In such a situation, normally the firm relies on the credentials of party to make payment on the due date. But in some cases, to avoid any possibility of delay or default, an instrument of credit is used through which the buyer assures the seller that the payment shall be made according to the agreed terms and conditions. In India, Bills of Exchange, Promissory note; instruments of credit have been in use since time immemorial and are popularly known as *Hundies*.

8.2 Meaning of Bill of Exchange

According to the Negotiable Instruments Act 1881, a bill of exchange is defined as an instrument in writing containing an unconditional order, signed by the maker, directing a certain person to pay a certain sum of money only to, or to the order of a certain person or to the bearer of the instrument.

8.3 Features of Bills of Exchange

The following features of a bill of exchange emerge out of this definition:

- ❖ A bill of exchange must be in black and white; i.e. in writing.
- ❖ It is an order for a person to make payment.
- ❖ The order to make payment is unconditional.
- ❖ The bill of exchange must be signed by the maker of the bill.
- ❖ The payment to be made must be certain.
- ❖ The date on which payment is made should also be certain.
- ❖ The bill of exchange must be payable to a certain person.
- ❖ The amount mentioned in the bill of exchange is payable either on demand or on the expiry of a fixed period of time.
- ❖ It must be stamped as per the requirement of law.

The person who writes the bill is known as '**Drawer**'. The debtor who accepts the bill is known as '**Drawee**' and the party that receives payment is known as '**Payee**'.

A bill of exchange is generally drawn by the creditor upon his debtor. It has to be accepted by the drawee (debtor) or someone on his behalf. It is just a *draft* till its acceptance is made.

8.3.1 Parties to a Bill of Exchange: Normally, there are three parties to a bill of exchange:

a) Drawer: Drawer is the maker of the bill of exchange. A seller/creditor who is entitled to receive money from the debtor can draw a bill of exchange upon the buyer/debtor. The drawer after writing the bill of exchange has to sign it as maker of the bill of exchange.

b) Drawee: Drawee is the person upon whom the bill of exchange is drawn. Drawee is the purchaser or debtor of the goods upon whom the bill of exchange is drawn. He is the one who gives his acceptance on the bill.

c) Payee: Payee is the person to whom the payment is to be made. The drawer of the bill himself will be the payee if he keeps the bill with him till the date of its payment.

The payee may change in the following situations:

- (1) In case, the drawer has got the bill discounted, normally the banker, who has discounted the bill will become the payee;
- (2) In case, the bill is endorsed in favour of a creditor of the drawer, the creditor will become the payee.

8.4 Advantages of Bill of Exchange

The bills of exchange as instruments of credit are used frequently in business because of the following advantages:

- **Acts as a framework for relationships:** A bill of exchange represents a device, which provides a framework for enabling the credit transaction between the seller/creditor and buyer/debtor on an agreed basis.
- **Certain terms and conditions:** The creditor knows the time when he would receive the money so also debtor is fully aware of the date by which he has to pay the money. This is due to the fact that terms and conditions of the relationships between debtor and creditor such as amount

required to be paid; date of payment; interest to be paid, if any, place of payment are clearly mentioned in the bill of exchange.

- **Convenient means of credit:** A bill of exchange enables the buyer to buy the goods on credit and pay after the period of credit. However, the seller of goods even after extension of credit can get payment immediately either by discounting the bill with the bank or by endorsing it in favour of a third person or party.
- **Conclusive proof:** The bill of exchange is a legal evidence of a credit transaction implying thereby that during the course of trade buyer has obtained credit from the seller of the goods, therefore, he is liable to pay to the seller. In the event of refusal of making the payment, the law requires the creditor to obtain a certificate from the Notary Public Officer to make it a conclusive evidence of the happening.
- **Easy transferability:** A debt can be settled by transferring a bill of exchange through endorsement and delivery.

8.5 Discounting of Bill

If the holder of the bill needs funds, he can approach the bank for encashment of the bill before the due date. The bank shall make the payment of the bill after deducting some interest (called discount in this case). This process of encashing the bill with the bank is called discounting the bill. The bank gets the amount from the drawee on the due date.

8.6 Maturity of Bill or Due Date of the Bill

The term maturity refers to the date on which a bill of exchange or a promissory note becomes due for payment. In arriving at the maturity date three days, known as *days of grace*, must be added to the date on which the period of credit expires. Thus, if a bill dated **March 1** is payable one month after date, the due date would be **April 4**, i.e. one month and 3 days after March 01.

However, where the date of maturity is a public holiday, the instrument will become due on the **preceding** business day. In this case, if April 04, falls on a public holiday then the April 03 will be the maturity date. But when an emergent holiday is declared under the Negotiable Instruments Act 1881, by the Government of India which may happen to be the date of maturity of a bill of exchange, then the date of maturity will be the next working day immediately after the holiday. For example, the Government declared a holiday on April 04 which happened to be the day on which a bill of exchange drawn by Tripathi upon Agrawal for ₹ 10,000 became due for

payment, Since April 04, has been declared a holiday under the Negotiable Instruments Act, therefore, April 05, will be the date of maturity for this bill.

8.7 Endorsement of Bill

Any holder may transfer a bill unless its transfer is restricted, i.e. the bill has been negotiated containing words prohibiting its transfer. The bill can be initially endorsed by the drawer by putting his signatures at the back of the bill along with the name of the party to whom it is being transferred. The act of signing and transferring the bill is called endorsement.

8.8 Accounting Treatment

For the person who draws the bill of exchange and gets it back after its due acceptance, it is a bill receivable; B/R. For the person who accepts the bill, same, it is a bills payable; B/P. In case of a promissory note for the maker it is a bills payable and for the person in whose favour the promissory note is drawn it is a bills receivable. Bills Receivables are current assets and Bills payable are current liabilities. Bills of Exchange and Promissory Notes are used interchangeably.

In the Books of Drawer:

As far as accounting treatment for the bill of exchange in the books of drawer is concerned, there can be following four possible situations:

1. He can retain it till the date of maturity, and
 - (a) Receive the payment on date of maturity directly from the debtor, or
 - (b) Get it collected through the banker.
2. He can get the bill discounted from the bank.
3. He can endorse the bill in favour of his Creditor.

The accounting treatment in the books of receiver under all the four situations is explained as follows :

Note: It is assumed that the bill is duly honored on maturity by the party which has given the acceptance.

Situation 1 : When the bill is retained by the receiver with him till date of its maturity :

Journal Entries in the books of Receiver				
Date	Particulars	L.F.	Amounts	Amounts

1 on Receiving the bill :		
Bills Receivable A/c Dr.	XXX	
To Debtors A/c		XXX
(Being acceptance received.)		
<hr/>		
2 On maturity of the bill		
Bank A/c Dr.	XXX	
To Bills Receivable A/c		XXX
(Being Payment received.)		

Note: However, when the bill of exchange is retained by the receiver with him and sent to bank for collection a few days before maturity, the following two entries are recorded:

On sending the bill for collection		
Bills Sent for Collection A/c Dr.	XXX	
To Bills Receivable A/c		XXX
(Being B/R sent to the bank for collection.)		
<hr/>		
on receiving the advice from bank for payment		
Bank A/c	Dr.	XXX
To Bills Sent for Collection A/c		XXX
(Being payment collected.)		

Situation: 2 when the drawer gets his B/R discounted from the bank:

On receiving the bill :		
Bills Receivable A/c Dr.	XXX	
To Debtors A/c		XXX
(Being acceptance received.)		
<hr/>		
On Discounting the bill		
Bank A/c	Dr.	XXX
Discount A/c Dr.	XXX	
To Bills Receivable A/c		XXX
(Being bill discounted.)		

On Maturity of bill : At maturity of bill, No entry is recorded in the books of drawer because the bill becomes the asset of the bank, therefore, the bank collects the amount of the bill from the acceptor hence, no journal entry is recorded.

Situation: 3 When the bill is endorsed by the Drawer to his creditor :

On receiving the bill :		
Bills Receivable A/c Dr.	XXX	
To Debtors A/c		XXX
<u>(Being B/R Accepted.)</u>		
On endorsing the bill		
Creditor's A/c Dr.	XXX	
To Bills Receivable A/c		XXX
<u>(Being B/R endorsed)</u>		

8.8.1 On Maturity:

No entry is recorded in the books of drawer at the time of maturity because the bill has been transferred in favour of the creditor; therefore the creditor becomes its owner and will receive the payment on maturity. Hence, no entry is recorded in the books of drawer or endorser.

In the Books of Drawee:

Following journal entries are recorded in the books of Drawee under all the four Situations. There is no difference for the drawee, either the bill is retained, discounted or endorsed. Drawee is expected to accept the bill and make the payment at the time of maturity.

On accepting the bill :		
Creditor's A/c Dr.	XXX	
To Bills Payable A/c		XXX
<u>(Being acceptance made.)</u>		
On maturity of the bill :		
Bills Payable A/c Dr.	XXX	
To Bank A/c		XXX
<u>(Being Bill Paid off.)</u>		

8.9 Dishonour of a Bill :

When the drawee fails to make the payment on the due date, it is said that he has not honoured the bill and bill is called to be dishonoured. In such situation, liability of the person who gave his acceptance is restored. Hence, the entries made on the receipt of the bill should be reversed.

Journal Entries in case bill is Dishonoured						
Situation	In the books of Drawer			In the books of Drawee		
1. When the bill is retained by the drawer till the due date	Drawee's	A/c	Dr	B/P	A/c	Dr
	To	B/R	A/c	Noting Charges	A/c	Dr

	(Being bill dishonoured)	To Drawer's Personal A/c
2. When the bill has been endorsed to someone by drawer	Drawee's A/c Dr To Endorsee's A/c	(Being bill dishonoured)
	(Being bill dishonoured)	Do
3. When drawer gets the bill discounted by his banker	Drawee's A/c Dr To Bank A/c	Do
	(Being bill dishonoured)	
4. When the bill was sent by drawer for collection	Drawee's A/c Dr To Bills sent for collection A/c	Do
	(Being bill dishonoured)	

Note: In case of dishonor of a bill, in all the situations the same entry is made in the books of Drawee.

Noting Charges: As per practice a bill should duly be presented on due date. Drawee is not held responsible, in case the bill is not presented for payment on due date. Proper presentation of the bill means that it should be presented on the date of maturity to the Drawee during business working hours.

In order to establish the fact that the bill was dishonored, despite its due presentation, it may preferably to be *got noted* by Notary Public Officer. Noting authenticates the fact of dishonor. For providing this service, a fees is charged by the Notary Public Officer (N.P.O.) which is known as *Noting Charges*.

The following facts are usually noted by the N.P.O.:

- Date, fact and reasons of dishonor;
- If the bill is not expressly dishonored, the reasons N.P.O. assumes it as dishonoured and;
- The amount of noting charges.

Journal Entries for the Noting Charges :

Journal Entries for the amount of Noting Charges				
Situation	In the books of Drawer		In the books of Drawee	
1. When It is paid by Drawer himself.	Drawee's A/c Dr		Noting Charges A/c Dr	
	To Cash A/c		To Drawer's A/c	
	(Being Noting Charges Paid.)		(Being noting charges reim-	

					bursed to Drawer.)
2. When N/C is paid by the Endorsee	Drawee's	A/c	Dr		
	To Endorsee's	A/c			
	(Being Noting Charges paid by Endorsee.)				
3. When it is Paid by the Bank for the discounted bill	Drawee's	A/c	Dr		
	To Bank	A/c			
	(Being Noting Charges Paid by the banker.)				
4. When it is paid by the bank in case the bill is sent for collection	Drawee's	A/c	Dr		
	To Bank	A/c			
	(Being Noting Charges Paid by the banker.)				

Important Point : Here ,it is to be noted that Noting Charges are to be borne by the Drawee in any case. This is why; in every case drawer debits the drawee for the amount of noting charges. It is said that, since this charge has been paid by drawer/endorsee/bank, only because of the default of drawee, hence it is to be borne by the drawee only.

Example: 3 On February 14, 2012 Sapna sold goods to Bittu for Rs. 6,000 and drew upon him a bill of exchange for 2 months. Bittu accepted the bill and returned it to Sapna. On the date of maturity the bill was dishonoured by Bittu. Record the necessary journal entries in all the situations given as under in the books of Sapna and Bittu :

- When the bill kept by Sapna till its due date ;
- When the bill is discounted by Sapna for Rs. 100;
- When the bill is endorsed to Gopal by Sapna.

Solution:3

Journal Entries in the Books of Sapna						
Situation : a) When the bill kept by Sapna till its due date :						
Date	Particulars			L.F.	Amounts	Amounts
14-Feb	Bittu's	A/c	Dr		6,000	
	To Sales	A/c				6,000
	(Being goods sold to bittu)					
14-Feb	B/R/	A/c	Dr		6,000	
	To Bittu's	A/c				6,000
	(Being acceptance received.)					

17-Apr	Bittu's A/c	Dr	6,000	
	To B/R A/c			6,000
	(Being bill dishonoured.)			

Journal Entries in the Books of Sapna				
Situation : b) When the bill is discounted by Sapna				
Date	Particulars	L.F.	Amounts	Amounts
14-Feb	Bittu's A/c	Dr	6,000	
	To Sales A/c			6,000
	<u>(Being goods sold to bittu)</u>			
14-Feb	B/R/ A/c	Dr	6,000	
	To Bittu's A/c			6,000
	<u>(Being acceptance received.)</u>			
15-Feb	Bank A/c	Dr	5,900	
	Discount A/c	Dr	100	
	To B/R A/c			6,000
	<u>(Being bill discounted.)</u>			
17-Apr	Bittu's A/c	Dr	6,000	
	To Bank A/c			6,000
	<u>(Being bill dishonoured.)</u>			

Journal Entries in the Books of Sapna				
Situation : c) When the bill is discounted by Sapna				
Date	Particulars	L.F.	Amounts	Amounts
14-Feb	Bittu's A/c	Dr	6,000	
	To Sales A/c			6,000
	<u>(Being goods sold to bittu)</u>			
14-Feb	B/R/ A/c	Dr	6,000	
	To Bittu's A/c			6,000
	<u>(Being acceptance received.)</u>			
15-Feb	Gopal's A/c	Dr	6,000	
	To B/R A/c			6,000
	<u>(Being bill endorsed Gopal.)</u>			
17-Apr	Bittu's A/c	Dr	6,000	
	To Gopal's A/c			6,000
	<u>(Being bill dishonoured.)</u>			

Journal Entries in the Books of Bittu

Journal Entries in the Books of Sapna						
In All Situations :						
14-Feb	Purchases	A/c	Dr	6,000		
		To Sapna's A/c			6,000	
	(Being goods purchased.)					
14-Feb	Sapna's	A/c	Dr	6,000		
		To B/P A/c			6,000	
	(Being acceptance made.)					
17-Apr	B/P	A/c	Dr	6,000		
		To Sapna's A/c			6,000	
	(Being bill dishonoured.)					

8.9.1 Renewal of the Bill

Sometimes, drawee feels that it may be difficult for him to meet the obligation of the bill on due date and may, therefore, approach the drawer with a request for extension of time for payment. If drawer agrees on it, the old bill is cancelled and a new bill with new terms of payment is drawn and duly accepted and delivered. This is called renewal of the bill.

Since the cancellation of bill is mutually agreed upon between both the parties, so, noting of the bill is not required. The drawee may have to pay interest to the drawer for the extended period of credit or any other condition to which they agree. The interest is paid in cash or may be included in the amount of the new bill. Sometimes, a part of the amount due may be paid and the new bill may be drawn only for the balance amount.

The journal entries in the books of the drawer and the drawee will be the same as it is made in case of dishonor of bill. As far as the amount of interest is concerned, normally it is paid by the drawee to drawer in cash. If it is not paid in cash, the drawer debits the drawee's account and credits the interest account, and the drawee debits the interest a/c and credits the drawer's account in his books.

Journal Entries in case of Renewal of the Bill: Following Journal Entries are made in the books of Drawer and Drawee:

Situation	In the books of Drawer			In the books of Drawee		
	1. For Cancellation of Bill	Drawee's	A/c	Dr	Bills Payble	A/c	Dr

	To Bills Receivable A/c (Being old bill cancelled.)		To Drawer's A/c (Being old bill got cancelled.)
2. For Interest	Drawee's A/c Dr To Interest A/c (Being Interest Charged.)		Interest A/c Dr To Drawer's A/c (Being Interest due.)
3. For New Bill	Bills Receivable A/c Dr. To Drawee's A/c (Being acceptance received.)		Drawer's A/c Dr To Bills Payble A/c (Being acceptance made.)

8.9.2 Retiring a Bill /Payment of Bill before the due date:

Sometimes a bill of exchange is arranged to be paid off before the due date by mutual understanding of both the parties which is known as retiring the bill. This happens when the drawee of the bill has funds at his disposal and he makes a request to the drawer to accept the payment of the bill before its due date. If the holder of the bill agrees to do so, the bill is said to have been *retired*.

In order to encourage the practice of retirement of the bill, the holder allows some discount called *Rebate on bills* for the period between date of retirement and maturity. The rebate is normally calculated at a certain rate of interest.

The accounting treatment on the retirement of a bill is similar to the accounting treatment when a bill is honored by the acceptor on the due date in the normal course. The only difference between the two is that in case of retiring a bill, some rebate is allowed to the debtor for prepayment.

The following journal entries are recorded in this case :

Situation	In the books of Drawer	In the books of Drawee
1. Retiring a Bill	Cash A/c Dr	Bills Payble A/c Dr
	Rebate on bill A/c Dr	To Cash A/c
	To Bills Receivable A/c	To Rebate on bills A/c
	(Being payment of bill received before due date and rebate allowed @.....)	(Being payment made and rebate received @....)

8.9.3 Accommodation Bill :

Normally, bills of exchange or promissory notes are drawn to finance the actual transactions in goods, i.e., an acceptance is made to settle a trade debt owing to the drawer by the drawee in case

of a bill of exchange and the bill is called a *trade bill*. As it originates from genuine trade transaction (purchase and Sale) it is for value received and is enforceable.

Apart from financing transaction in goods, bills of exchange promissory notes can also be used for raising funds temporarily by the businessmen. Such a bill is called an '*accommodation bill*' as it is accepted by the drawee to accommodate the drawer. Hence, the drawee is called the '*accommodating party*' and the drawer is called the '*accommodation party*'.

Sometimes, the accommodation parties agree to raise the funds through an accommodation bill for mutual benefits. It can be done in any of the following two manners:

- (1) The drawer and the drawee share the proceeds of the bill in an agreed ratio.
- (2) Each draws a bill on the other and the other accepts the bill.

In the first situation the discounting charges are shared by drawer and drawee in the ratio in which they share the fund raised through the bill. But in the second case the discount is not shared because each party retains the entire proceeds of the bill drawn and discounted by him.

On due date, each party meets their acceptance out of its own resources, if each of them draws and accepts bills of the same denomination and tenure. But where they share the proceeds of the same bill, the drawer should remit, just before maturity, the balance due to the drawee, to ensure that the latter could duly meet his acceptance.

In nut shell we can say that an accommodation bill helps both the parties to the instrument to temporarily raise the necessary funds from discounting institutions like banks and help each other.

Example: 4 Lalan draws upon Palan a bill for ₹ 20,000 on April 01, 2012 for three months and the latter accepts the same to accommodate Lalan. Lalan discounts it with his bank at 6 % per annum on the same date. Lalan remitted the amount one day before the maturity of the bill to Palan. Palan met the bill on the date of its maturity.

Solution: 4

Journal Entries in the Books of Lalan				
1-Apr	B/R	A/c	Dr	20,000

		To Palan's A/c		20,000
		(Being acceptance received.)		
April-1	Bank A/c	Dr	19,700	
	Discount A/c	Dr	300	
		To B/R A/c		20,000
		(Being bill discounted.)		
3-Jul	Palan's A/c	Dr	20,000	
		To Bank A/c		20,000
		(Being Payment made.)		

Journal Entries in the Books of Palan				
1-Apr	Lalan's A/c	Dr	20,000	
		To B/P A/c		20,000
		(Being acceptance made.)		
3-Jul	Bank A/c	Dr	20,000	
		To Lalan's A/c		20,000
		(Being Payment received from Lalan a day before maturity.)		
4-Jul	B/P A/c	Dr	20,000	
		To Bank A/c		20,000
		(Being Payment made.)		

Example: 5 Ashutosh and Shashwat were in need of funds. On October 01, 2012 Ashutosh drew upon a bill of Rs. 9,000 for 2 months. Prashant accepted the bill and returned to Ashutosh. Ashutosh got it discounted at 5% from Bank immediately. Half of the amount was remitted to Prashant. On the due date Ashutosh sent the required amount to Prashant, who met the bill.

Record these transactions in the books of Ashutosh and Prashant.

Solution :5

Journal Entries in the Books of Ashutosh						
Date	Particulars			L.F.	Amounts	Amounts
1-Oct	B/R A/c	Dr			9,000	
		To Prashant's A/c				9,000
		(Being acceptance received.)				
1-Oct	Bank A/c	Dr			8,925	
	Discount A/c	Dr			75	
		To B/R A/c				9,000
		(Being bill discounted.)				
1-Oct	Prashant's A/c	Dr			4,500	

	To Cash A/c		4,462.5	
	To Discount A/c		37.5	
	(Being half amount sent to Prashant.)			
3-Dec	Prashant's A/c	Dr	4500	
	To Bank A/c			4500
	(Being Payment Made.)			

Journal Entries in the Books of Prashant					
Date	Particulars		L.F.	Amounts	Amounts
1-Oct	Ashutosh's A/c	Dr		9,000	
	To B/P A/c				9,000
	(Being acceptance made.)				
1-Oct	Cash A/c	Dr		4462.5	
	Discount A/c	Dr		37.5	
	To Ashutosh's A/c				4500
	(Being half amount received.)				
3-Dec	Cash A/c	Dr		4500	
	To Ashutosh's A/c				4500
	(Being share of Ashutosh received.)				
4-Dec	B/P A/c	Dr		9000	
	To Cash A/c				9000
	(Being payment made.)				

8.10 Practical Problems and Solutions

Example :1

Gopal sold goods for RS. 10, 000 to Ramesh on credit on Jan 01, 2012. Gopal drew a bill of exchange upon Ramesh for the same amount for three months. Ramesh accepted the bill and returned it to him. Ramesh met his acceptance on maturity. Record these transactions in the journal of Gopal under the following circumstances:

- (i) Gopal retained the bill till the date of its maturity and received the payment directly.
- (ii) Gopal got his bill discounted @ 16% p.a from his bank
- (iii) Gopal endorsed the bill to his creditor Sonu.
- (iv) Gopal retained the bill and on March, 31 2012 sent the bill for collection to his bank. On April 05, 2012 bank advice was received.

Solution : 1

Journal Entries in the Books of Gopal

In Situation 1) When Gopal retained the bill till the date of its maturity and received the payment directly.

Date	Particulars	L.F.	Amounts	Amounts
1-Jan	Ramesh's A/c Dr To Sales A/c (Being Goods sold)		10,000	10,000
1-Jan	Bills Receivable A/c Dr. To Ramesh's A/c (Being acceptance received.)		10,000	10,000
5-Apr	Bank A/c Dr. To Bills Receivable A/c (Being Payment received.)		10,000	10,000

In Situation-2) When Gopal got his bill discounted @ 16% p.a from his bank

Date	Particulars	L.F.	Amounts	Amounts
1-Jan	Ramesh's A/c Dr To Sales A/c (Being Goods sold)		10,000	10,000
1-Jan	Bills Receivable A/c Dr. To Ramesh's A/c (Being acceptance received.)		10,000	10,000
1-Jan	Bank A/c Dr. Discount A/c Dr. To Bills Receivable A/c (Being bill discounted @ 16% p.a.)		9,600 400	10,000

In Situation-3) When Gopal endorsed the bill to his creditor Sonu.

Date	Particulars	L.F.	Amounts	Amounts
1-Jan	Ramesh's A/c Dr To Sales A/c (Being Goods sold)		10,000	10,000
1-Jan	Bills Receivable A/c Dr. To Ramesh's A/c (Being acceptance		10,000	10,000

	received.)			
1-Jan	Sonu's A/c	Dr	10,000	
	To Bills Receivable A/c			10,000
	(Being Bill endorsed to Sonu.)			

In Situation-4) When Gopal retained the bill and on March, 31 2012 sent the bill for collection to his bank and bank advice was received.

Date	Particulars	L.F.	Amounts	Amounts
1-Jan	Ramesh's A/c Dr		10,000	
	To Sales A/c			10,000
	(Being Goods sold)			
1-Jan	Bills Receivable A/c Dr.		10,000	
	To Ramesh's A/c			10,000
	(Being acceptance received.)			
Mar-31	Bills Sent for Collection A/c Dr.		10,000	
	To Bills Receivable A/c			10,000
	(Being bill sent to the bank for collection.)			
5-Apr	Bank A/c Dr.		10,000	
	To Bills sent for Collection A/c			10,000
	(Being amount collected by the bank.)			

Journal Entries in the books of Ramesh

1-Jan	Purchases A/c	Dr.	10,000	
	To Gopal's A/c			10,000
	(Being Goods purchased from Gopal on credit.)			
1-Jan	Gopal's A/c	Dr	10,000	
	To Bills Payble A/c			10,000
	(Being acceptance made.)			
4-Apr	Bills Payable A/c	Dr.	10,000	
	To Bank A/c			10,000
	(Being Bill Paid off.)			

Example :2

On March 15, 2012 Shashwat sold goods for Rs. 4,000 to Kishan on credit. Kishan accepted a bill of exchange drawn upon him by Shashwat payable after three months. On April, 10 Shashwat endorsed the bill in favour of his creditor Vishu in full settlement of his debt of Rs. 4,100. On May 15, Vishu discounted the bill with his bank @ 12% p.a. On the due date Kishan met the bill. Record the necessary journal entries in the books of Shashwat, Kishan and Vishu.

Solution-2**Journal Entries in the books of Shashwat**

Date	Particulars	L.F.	Amounts	Amounts
15-Mar	Kishan's A/c Dr To Sales A/c (Being Goods sold)		4,000	4,000
15-Mar	Bills Receivable A/c Dr. To Kishan's A/c (Being acceptance received.)		4,000	4,000
10-April	Vishu's A/c Dr To Bills Receivable A/c To Discount A/c (Being Bill endorsed to Vishu in the full settlement of the debt of ₹100.)		4,100	4,000 100

Journal Entries in the books of Kishan

15-Mar	Purchases A/c Dr. To Shashwat's A/c (Being Goods purchased from Shashwat on credit.)		4,000	4,000
15-Mar	Shahswat's A/c Dr To Bills Payble A/c (Being acceptance made.)		4,000	4,000
18-June	Bills Payable A/c Dr. To Bank A/c (Being Bill Paid off.)		4,000	4,000

Journal Entries in the books of Vishu

Date	Particulars	L.F.	Amounts	Amounts
------	-------------	------	---------	---------

10-Apr	Bills Receivable	A/c	Dr	4,000	
	Discount	A/c	Dr	100	
		To Shashwat's	A/c		4,100
	(Being B/R received in final payment from shashwat.)				
15-May	Bank	A/c	Dr.	3,880	
	Discount	A/c	Dr.	120	
		To Bills Receivable	A/c		4,000
	(Being bill discounted @ 12% p.a.)				

8.11 Summary

Goods are usually sold on credit to the customers. In such cases, in order to avoid any possibility of delay or default, an instrument of credit is used through which the buyer assures the seller that the payment shall be made according to the agreed conditions. In India, Bills of Exchange, *promissory note*; instruments of credit have been in use since time immemorial and are popularly known as Bills of exchange.

Sometimes, bills are also used for raising funds temporarily by the businessmen. Such a bill is called an 'accommodation bill' as it is accepted by the drawee to accommodate the drawer. Hence, the drawee is called the 'accommodating party' and the drawer is called the 'accommodation party'.

8.12 Glossary

Bills of Exchange : A bill of exchange is a written, legally binding order used in trade that directs one party to pay a fixed sum of money to another party on demand or at a predetermined future date.

Bills Discounting: Bill discounting is a short-term financing method where a business sells its unpaid, credit-based sales invoices (bills of exchange) to a bank or financial institution at a small discount.

Hundi : Bills of exchange , written in the Indian language is known as Hundi.

Promissory Note : the promise to make payment of certain specified amount to the creditor on demand or after expiry of certain period is known as Promissory Note.

8.13 Check your progress

Fill in the Blanks

1. in some cases, to avoid any possibility of delay or default,is used through which the buyer assures the seller that the payment shall be made according to the agreed terms and conditions.
2. Person who draws the bill is called.....
3. is the person to whom the payment is to be made.

8.14 Answers to check your progress

1. an instrument of credit
2. Drawer,
3. Payee

8.15 Terminal Questions

- Q.1 Name any two types of commonly used negotiable instruments.
- Q.2 Write two points of distinction between bills of exchange and promissory note.
- Q.3 State any four essential features of bill of exchange.
- Q.4 State the three parties involved in a bill of exchange.
- Q.5 What is meant by maturity of a bill of exchange?
- Q.6 What is meant by dishonor of a bill of exchange?
- Q.7 Name the parties to a promissory note
- Q.8 What is meant by acceptance of a bill of exchange?
- Q.9 What is Noting of a bill of exchange.
- Q.10 What is meant by renewal of a bill of exchange?

8.16 Reference Books

1. Financial Accounting Principles and Practice- Prof. Jawahar Lal and Dr.Seema Srivastava
2. Financial Accounting- Sri P. C. Tulsian
3. Advanced Accountancy - Sri R. L. Gupta and Sri M. Radhaswamy

4. Advanced Accountancy-Sri S. P. Jain and Sri K. L. Narang.

8.17 Practical Questions for Practice:

Q.1 On Jan 01,2012, Goldi purchased goods from Gopal for ₹ 5,000.Gopal drew a bill for the due amount on Goldi payable after 3 months. On the date of maturity of the bill the Government of India declared emergent holiday under the Negotiable Instrument Act 1881. The bill was duly presented and the payment was received. Record the necessary Journal entries in the books of Goldi and Gopal.

Hint: Due Date for maturity April-5(Next working day after the date of maturity.)

Q.2 Radha Ji sold goods worth ₹10,000 to M/S Lakshmi on Jan 07, 2012 and drew upon him a bill of exchange payable after 2 months. M/S Lakshmi accepted Radha's draft and handed over the same to him after acceptance. Radha Ji immediately discounted the bill with his bank@12% p.a. On the due date M/S Lakshmi met his acceptance.

Journalise the above transactions in the books of Radha Ji and M/S Lakshmi .

Q.3 On Feb 14, 2012, Bittu purchased goods for ₹16,000 from Shashwat. He immediately made a payment of ₹6,000 by cheque and for the balance accepted a bill of exchange drawn upon him by Shashwat. The bill of exchange was payable after 40 days. Five days before the maturity of the bill, Shashwat sent the same to his bank for collection. The bank duly presented the bill to Bittu on the due date who met the bill. The bank informed the same to Shashwat.

Prepare Shashwat's account in the books of Bittu and Bittu's account in the books of Shashwat.

Q.4 On April 01, 2012 Y.T. sold goods worth ₹ 20,000 to Rita. 50% of the payment was made immediately by Rita on which Y.T. allowed a cash discount of 2%. For the balance Y.T. drew a bill on Rita Payble after 5 months. Since, the date of maturity of bill was a public holiday; Y.T. presented the bill on a day, as per the provisions of Negotiable Instrument Act which was met by Rita. State the date on which the bill was presented by Y.T. for payment and Journalise the above transactions in the books of Y.T. and Rita.

Q.5 D.K. Bose sold goods worth ₹ 20,000 to B.K. on 8.2.2012 and drew upon him a bill of exchange payable after two months. B.K. accepted the bill and returned the same to D.K. On the due date the bill was met by the drawee.

Record the necessary Journal entries in the books of D.K. Bose and B.K. in the following circumstances.

- ❖ When the bill was retained by D.K. Bose till the date of its maturity.
- ❖ When D.K.Bose immediately discounted the bill @ 10% p.a. with his bank.
- ❖ When the bill was endorsed immediately by D.K. Bose in favour of his creditor Ram.
- ❖ When three days before its maturity, the bill was sent by D.K.Bose to his bank for collection.

Q.6 On Jan 01, 2012 Gangesh sold goods for ₹ 20,000 to Babli and drew upon her a bill of exchange payable after two months. One month before the maturity of the bill Babli approached Gangesh to accept the payment against the bill at a rebate @ 12% p.a. Gangesh agreed to the request of Babli and Babli retired the bill under the agreed rate of rebate.

Journalise the above transaction in the books of Gangesh and Babli and also open necessary accounts.

Q.7 Ambuj sold goods to Sapna on Jan 07, 2012 for ₹ 8,000. He drew a bill of exchange for the same amount on Sapna for 5 months. On the same date Sapna accepted the bill and returned it to Ambuj. On the due date Ambuj presented the bill to Sapna which was dishonoured. Ambuj paid ₹ 20 as noting charges. Five days after the dishonour of his acceptance Sapna settled her debt by making a payment of ₹ 8,120 including interest and noting charges.

Record the necessary journal entries in the books of Ambuj and Sapna.

Q.8 Gopal sold goods worth ₹ 7,000 to Sandhya on March 12, 2012. ₹ 3,500 were paid by Sandhya immediately and for the balance she accepted a bill of exchange drawn upon her by Gopal payable after four months. Gopal discounted the bill immediately with her bank. On the due date Sandhya dishonoured the bill and the bank paid Rs.30 as noting charges.

Record the necessary journal entries in the books of Gopal and Sandhya.

Q.9 Vishu purchased goods worth ₹ 12,000 from Swati on 2.1.2012 and accepted a bill of exchange drawn by Swati for the same amount. The bill was payable after two months. On 12.2.2012 Swati sent the bill to her bank for collection. The bill was duly presented by the bank. Vishu dishonoured the bill and the bank paid ₹ 40 as noting charges.

Record the necessary journal entries for the above transactions in the books of Swati and Vishu.

Q.10 On February 21, 2012 Y.T. accepted a months bill for ₹ 30,000 drawn on him by Rita for latter's benefit. Rita discounted the bill on same day @ 7 % p.a. On the due date Rita sent a cheque to Y.T. for honouring the bill. Y.T. duly honoured his acceptance.

Record the journal entries in the Books of Rita and Y.T.

Q.11 On April 01, 2012, Kanha and Vishu drew on each other a bill for ₹ 10,000 payable 3 months after the due date for their Mutual benefit. On April 2, they discounted with their bank each other's bill at 10 % p.a. On the due date each met their own acceptance. Give journal entry in the books of Kanha and Vishu.

Q.12 On October 01, 2012 Palanji drew a bill on Vishu for ₹ 20,000 for 3 months for mutual accommodation. Vishu accepted the bill and returned it to Palanji. Palanji discounted the same with his bankers @ 10% p.a. The proceeds were shared between Palanji and Vishu in proportion of 2:1. On the due date, vishu remits his proportion to Palanji who fails to meet the bill and as a result Vishu has to meet it. Palanji gave a fresh acceptance for the amount due to Vishu plus interest of ₹ 200 and met his second acceptance on due date. Record the necessary journal entries in the books of Palanji and Vishu.

Unit-9

Depreciation

- 9.1 Introduction**
- 9.2 Depreciation Accounting: Definition**
- 9.3 Reasons of Depreciation**
- 9.4 Why we charge depreciation?**
- 9.5 Factors affecting the amount of depreciation**
- 9.6 Ways for charging depreciation**
- 9.7 Methods of allocating depreciation**
- 9.8 Summary**
- 9.9 Glossary**
- 9.10 Check your progress**
- 9.11 Answers to check your progress**
- 9.12 Terminal Questions**
- 9.12 References**
- 9.13 Practical Problems**

Objectives

After study this chapter you should be able to:

- Define the meaning of depreciation
- Understand the reasons and why depreciation charged
- Know the various methods of calculating depreciation

9.1 Introduction

On the basis of Fundamental Accounting Concept of Going Concern, assets are classified as Fixed Assets and Current Assets. Fixed assets are used in the business to derive benefits for more than one accounting period. Periodic profit is measured by charging cost against periodic revenue as per matching concept. Since fixed assets are used to generate periodic revenue, an appropriate proportion of the cost of fixed assets, which is believed to be used or expired for generation of periodic revenue, needs to be charged as cost. Such an appropriate proportion of the cost of fixed assets is termed as *Depreciation*.

Generally, the term ‘depreciation’ is used to denote decrease in value but in accounting, this term is used to denote decrease in the book value of a fixed asset. Depreciation is the permanent and continuous decrease in the book value of a fixed asset due to use, passage of time, obsolescence, expiration of legal rights or any other cause. According to the Institute of Chartered Accountants in England and Wales, ‘Depreciation represents that part of the cost of a fixed asset to its owner which is not recoverable when the asset is finally out of use by him. Provision against this loss of capital is an integral cost of conducting the business during the effective commercial life of the asset and is not dependent on the amount of profit earned’.

Depreciation is not the result of fluctuations in the value of fixed assets since, the fluctuation is concerned with the market price of the fixed asset whereas the depreciation is concerned with the historical cost.

9.2 Defining Depreciation accounting:

According to the American Institute of Certified Public Accountants (AICPA), 'Depreciation Accounting is a system of accounting which aims to distribute cost or the basic value of tangible capital assets less salvage (if any), over the estimated useful life of the unit (which may be group of assets) in a systematic and rational manner. It is a process of allocation and not of valuation'.

An analysis of the definition given above highlights the characteristics of depreciation as follows:

- (a) It is related to *Depreciable fixed assets* only.
- (b) It is a fall in the *book value* of depreciable fixed asset.
- (c) The fall in the book value of an asset is *due to* the use of the asset in business operations, effluxion of time, obsolescence, and expiration of legal rights or any other cause.
- (d) It is a *permanent decrease* in the book value of an asset.
- (e) It is a *continuous decrease* in the book value of an asset.

Comprehensively, the term 'Depreciation' covers Depletion, Amortization and Obsolescence.

The term 'Depletion' refers to the physical deterioration by the exhaustion of natural resources (ore-deposits in mines, oil wells, quarries, timber stands etc.).

The term 'Amortisation' refers to the economic deterioration by the expiration of intangible assets (patents, copyrights, goodwill etc.)

The term 'Obsolescence' refers to the economic deterioration by

- (a) invention of improved technique or equipment
- (b) market decline due to change in taste and fashion etc.
- (c) inadequacy of existing plant to meet the increased business.

9.3 Reasons of Depreciation: Depreciation may occur due to following reasons:

(a) Wear and Tear: When the fixed assets are put to use, the value of such assets may decrease due to usage. Such decrease in the value of assets is said to be due to physical wear and tear.

(b) Time: When the assets are exposed to the forces of nature like weather, winds, rains, etc. the value of such assets may decrease even if they are not put to any use.

(c) Changes in economic environment: The value of an asset may decrease due to decrease in the demand of the asset. The demand of the asset may get down due to technological changes, changes in the habits of consumers etc.

(d) Expiration of legal rights: When the use of an asset (e.g., patents, leases) is governed by the time bound arrangement, the value of such assets may decrease with the passage of time.

9.4 Why we charge depreciation?

Practically, following reasons are given for charging depreciation:

- ❖ **To ascertain true results of operations:** For proper matching of costs with revenues, it is necessary to charge the depreciation (cost) against income (revenue) in each accounting period. Unless the depreciation is charged against income, the result of operations would stand overstated. Result by, the Income Statement would fail to present a true and fair picture of the profits and losses of an accounting entity.
- ❖ **To provide true and fair picture of the financial position of business:** For presenting a true and fair picture of the financial position, it is necessary to charge the depreciation. If the depreciation is not charged, the unexpired cost of the asset concerned would be overstated. Result by, the Balance Sheet would not present a true and fair picture of the financial position of an accounting entity.
- ❖ **To ascertain the true cost of production:** For ascertaining the cost of production, it is necessary to charge depreciation as a component of cost of production. If the depreciation on fixed assets is not charged, the cost records, would not present a true and fair view of the cost of production.
- ❖ **To comply with legal requirements:** In India, in case of companies, it is compulsory to charge depreciation on fixed assets before it declares dividend as per the provisions of Sec. 205(1) of The Companies Act, 1956.

- ❖ **To use it as a source of fund** : A portion of profits is kept aside in the form of depreciation and accumulated each year to provide a definite amount at a certain future date for the specific purpose of replacement of the asset at the end of its useful life.

9.5 Factors affecting the amount of depreciation

- Historical cost of a depreciable asset implies the cost incurred on its acquisition, installation, commissioning and for additions to or improvements thereof which are of capital nature.
- Expected useful life of a depreciable asset implies either the period over which a depreciable asset is expected to be used by the enterprise or the number of production or similar units expected to be obtained from the use of the asset by the enterprise.
- Estimated residual value of a depreciable asset implies the value expected to be realized on its sale or exchange on the expiry of its useful life.

9.6 Ways for charging depreciation

Depreciation may be charged in following two ways:

- By charging it to Asset Account.
- By Creating Provision for Depreciation/Accumulated Depreciation Account.

A. Charging it to Asset account: Under this method of recording depreciation, depreciation is directly credited to the 'Respective Asset Account' and as a result, the Respective Asset Account appears at its book value (i.e. Original Cost *less* depreciation till date). In this case, following journal entries are recorded in the books of the firm:

Journal Entries in the Books of LK Limited						
Date	Particulars			L.F.	Amounts	Amounts
For the Purchase of Assets	Assets	A/c	Dr		XXX	
		To Cash	A/c			XXX
	(Being Assets purchased.)					
For Providing Depreciation	Depreciation	A/c	Dr		XXX	
		To Assets	A/c			XXX
	(Being Assets depreciated.)					
For transferring	P/L	A/c	Dr		XXX	

Dep- reciation to P/L A/c	To Depreciation A/c				XXX
	(Being Dep. trd. To P/L A/c.)				
in case asset is sold	Bank	A/c	Dr	XXX	
	P/L	A/c	Dr	(Loss)	XXX
		To Assets	A/c		XXX
		To P/L A/c (Profit)			XXX
		(Being assets sold)			

Note: In case of loss on sale of assets, Profit & loss Account is debited and in case of Profit on sale of assets, Profit & Loss A/c is credited.

B. By Creating Provision for Depreciation/Accumulated Depreciation Account :

In this way Provision for Depreciation A/c is created from P/L Account for which following journal entries are recorded :

Date	Particulars	L.F.	Amounts	Amounts
For Providing Depreciation	Depreciation A/c Dr		XXX	
	To Provision for Depreciation A/c			XXX
	(Being Depreciation Charged.)			
For Closure of Depreciation A/c	Profit & Loss A/c Dr		XXX	
	To Depreciation A/c			XXX
	(Being Depreciation trd.to P/L A/c.)			

9.7 Methods of Allocating Depreciation

There are several methods of allocating depreciation like Straight Line Method, Diminishing Balance Method, Sum of the Years Digit Method, Annuity method etc. The most commonly used methods in industrial and commercial enterprises are the Straight Line Method (SLM) and the Written Down Value Method (WDV) or Diminishing Balance Method.

1. Straight Line Method' of Depreciation (SLM) : Under the straight line method, a fixed and equal amount in the form of depreciation, according to a fixed percentage on the original cost, is written off during each accounting period over the expected useful life of the asset.

Ways to Calculate the Rate of Depreciation under SLM:

The amount and rate of depreciation is calculated as under:

$$\text{Amount of Depreciation} = \frac{\text{Cost of the Machine} - \text{Salvage Value}}{\text{Life of the Plant}}$$

$$\text{Rate of Depreciation} = \frac{\text{Amount of Depreciation}}{\text{Cost of Assets}} \times 100$$

Suitability of Straight Line Method: This method is suitable for those assets in relation to which:

- (a) Repair expenses are less, and
- (b) The possibility of obsolescence is less.

It is suitable for furniture, patent, copyright, trademark, lease etc.

Advantages of S.L.M.: The main merits of Straight Line Method are as follows:

- ❖ It is easy to understand.
- ❖ It is easy to calculate the amount and rate of depreciation.
- ❖ Under this method, the book value of the asset becomes zero or equal to its scrap value at the expiry of its useful life.

Demerits of S.L.M. : The main demerits of Straight Line Method are as follows:

- ❖ The total charges (i.e. depreciation plus repairs and renewals) in later years are more as compared to that in earlier years since; the amount of repairs and renewals goes on increasing as the asset grows older whereas the amount of depreciation remains constant year after year.
- ❖ It does not take into consideration the interest on the capital invested in the asset.
- ❖ It does not provide for the replacement of the asset on the expiry of its useful life.

Example: 1 L.K. Enterprises purchased machinery for ₹ 40,000. Expenses incurred on its installation ₹ 10,000. The scrap value at the end of its expected useful life of 4 years is estimated at ₹ 10,000. Calculate the amount of depreciation for the first year ending on 31st March, 2012 if this machine is purchased on:

- (a) 1st April, 2011.

(b) 1st July, 2011.

(c) 1st January,2012.

Solution: 1

Calculation of the Total Cost of the Plant:

Cost of the Machinery + Expenses incurred on installation

Cost of the Plant =	Rs. 40,000
Installation Cost =	Rs. 10,000
Total Cost =	Rs. 50,000

$$\text{Amount of Depreciation} = \frac{\text{Cost of the Machine} - \text{Salvage Value}}{\text{Life of the Plant}}$$

$$\frac{50,000 - 10,000}{4}$$

10,000 per annum

1) Amount of Depreciation, in case the machine is purchased on 1st April,2011 :

In this case, since the machine is purchased on 1.4.2011 ,hence the depreciation would be calculated for 12 months. So, the amount of depreciation would be 10,000.

2) When the Machine is purchased on 1st July 2011 :

In this case the depreciation would be calculated for 9 months, hence the amount would be $10,000 \times 9/12 = \text{Rs. } 7,500$.

3) When the machine is purchased on 1st January,2012 :

In this case depreciation would be calculated for 3 months. In this case, the amount of depreciation would be $10,000 \times 3/12 = \text{Rs. } 2,500$.

Example:2

On 1st January 2012, Radha Ltd. purchased a machinery for Rs. 1,00,000. There will be no salvage value of the plant.The expected useful life of the plant is 10 years. Depreciation is to be provided according to Straight Line Method. You are *required to* prepare machinery Account for the first three years assuming that the accounts are closed on 31st December every year.

Solution: 2

Machinery Account							
Date	Particulars	J.F	Amounts	Date	Particulars	J.F.	Amounts
1.1.2012	To Cash A/c		1,00,000	31.12.2012	By Depreciation A/c		10,000
				31.12.2012	By Balance C/d		90,000
			1,00,000				1,00,000
1.1.2013	To Balance B/d		90,000	31.12.2013	By Depreciation A/c		10,000
				31.12.2013	By Balance C/d		80,000
			90,000				90,000
1.1.2014	To Balance b/d		80,000	31.12.2014	By Depreciation A/c		10,000
				31.12.2014	By Balance C/d		70,000
			80,000				80,000

2. Diminishing Balance Method/ Written Down Value Method (WDV Method) :

Written Down Value Method' of Depreciation (WDV): Under this method, depreciation is calculated at a fixed percentage upon the original cost (in the first year) and written down value, (in subsequent years) of an asset. Asset is written off during each accounting period over the expected useful life of the asset. Under this method, the rate of depreciation remains constant year after year whereas the amount of depreciation goes on decreasing.

Method for Calculation of Rate of Depreciation under WDV Method:

The rate of depreciation is calculated by the following formulae:

$$\text{Rate of Depreciation: } R = \left[1 - \sqrt[n]{\frac{S}{C}} \right] \times 100$$

Where R = Rate of Depreciation (in %),

n = Useful life of the asset (in years)

S = Scrap value at the end of useful life of the asset

C = Cost of the asset

Suitability of Written Down Value Method: This method is suitable for those assets in relation to which

- (1) The amount of repairs and renewals increases with the asset growing older.
- (2) The possibilities of obsolescence are more.

W.D.V. is suitable for plant and machinery ,building etc.

Advantages of W.D.V.Method : followings are the main advantages of diminishing balance method of depreciation :

1. The total charges (i.e., depreciation plus repairs renewals) remains almost uniform year after year, since in earlier years the amount of depreciation is more and the amount of repairs and renewals is less, whereas in later years the amount of depreciation is less and the amount of repairs & renewals is more. In this way, the impact of amount of depreciation on profit and loss A/c is balanced which is not possible under straight line method because amount of depreciation is the same throughout the life of the assets.
2. This method is logical in the sense that as the asset grows older, the amount of depreciation also goes on decreasing.

Demerits of Written Down Value Method:

- It is difficult to calculate the rate of depreciation.
- It does not take into consideration the interest on capital invested in the asset.
- It does not provide for the replacement of the asset on the expiry of its useful life.
- It takes a very long time to write an asset down to its break-up value, unless a very high rate is used.

Example :3

On 1st January, 2012, Gopal Ji Ltd. purchased a machine for RS. 2,00,000 including an installation cost of Rs. 20,000. On 1st July 2013 this machine is sold for Rs. 60,000. Depreciation is to be provided @ 10% p.a. according to Written Down Value Method. You are required to prepare machinery Account and depreciation account. Assume that accounts are closed on 31st December every year.

Solution: 3

Machinery Account

Date	Particulars	J.F.	Amounts	Date	Particulars	J.F.	Amounts
1.1.2012	To Cash A/c		2,00,000	31.12.2012	By Depreciation A/c		20,000
				31.12.2012	By Balance C/d		1,80,000
			2,00,000				2,00,000
1.1.2013	To Balance B/d		1,80,000	1.7.2013	By Cash A/c		160,000
				1.7.2013	By P/L A/c		11,000
				1.7.2013	By Depreciation A/c		9,000
			180,000				1,80,000

Change in the Method of Depreciation:

As per the revised Accounting Standard- 6 issued by ICAI, the depreciation method selected should be applied consistently, to provide comparability of the results of the operations of the enterprise from period to period. A change from one method of providing depreciation to another would be made only if, the adoption of the new method is required by statute or for compliance with an Accounting Standard or, if it is considered that the change would result in a more appropriate preparation or presentation of the financial statements of the enterprise.

When such a change at the method of depreciation is made, depreciation should be recalculated in accordance with the new method from the date of the asset coming into use. The deficiency or surplus arising from retrospective re-computation of depreciation in accordance with the new method should be adjusted in the accounts in the year in which the method of depreciation is changed. In case the change in the method results in deficiency in depreciation in respect of past year the deficiency should be charged in the statement of profit and loss.

In case, the change in the method results in surplus, the surplus should be credited to the statement of profit and loss. Such a change should be treated as a change in the accounting policy and its effect should be quantified and properly disclosed.

Steps involved in applying the change in the method of depreciation from retrospective date:

First Step: Calculate the total depreciation already provided on assets existing as at the end of previous accounting year (i.e., assets other than sold/discarded/destroyed/exchanged up to the end of previous accounting year) under the existing method.

Second Step: Calculate the total depreciation on assets existing as at the end of previous accounting year retrospectively from the date of the asset coming into use by adopting the new method up to the end of previous accounting year.

Third Step: Calculate the difference between the total depreciation under existing method and that under new method. **(Amount under Step 1 – Amount under Step 2.)**

Fourth Step : Adjust the short depreciation (excess of Step 2 over Step 1) by debiting Profit and Loss Account and crediting the Asset Account/Provision for Depreciation Account.

OR Adjust the excess depreciation (excess of Step 1 over Step 2) by debiting Assets/Account/Provision for Depreciation Account and crediting Profit and Loss Account.

Final Step: Charge depreciation from the current accounting year and onwards by adopting new method.

Example: 4 On 1st January 2010 Gopeshwer Ltd. purchased a Machine costing Rs. 1,00,000 and provided depreciation @ 10% p.a. on Straight Line Method basis. At the end of the year 2013, the company decided to change the method of depreciation from Straight Line Method to Written Down Value Method retrospectively, the rate of depreciation remaining the same. Prepare the Machinery Account up to the year 2013.

Solution: 4

Working Note:

1) Calculation of Depreciation under existing method ; i.e. Straight Line Method :

Depreciation = 1,00,000 X 10% = 10,000.

Depreciation for three year = 10,000 X 3 =30,000.

2) Depreciation under New method ;i.e. Written Down Value method :

Depreciation for three years :

First Year - 100,000 X10% = 10,000

Second Year – 90,000 X 10% = 9,000

Third Year - 81,000 X 10% = 8,100

Total Depreciation = 27,100

3) Difference between old method and new method = 30,000 – 27,100 = 2,900

Note : In this case, an excess amount of Rs. 2,900 has already been provided, which is to be adjusted from Profit & Loss Account. Profit & Loss A/c would be credited with the excess amount of depreciation.

Machinery Account							
Date	Particulars	J.F	Amounts	Date	Particulars	J.F.	Amounts
1.1.2010	To Cash A/c		1,00,000	31.12.2010	By Depreciation A/c		10,000
				31.12.2010	By Balance C/d		90,000
			1,00,000				1,00,000
1.1. 2011	To Balance B/d		90,000	31.12.2011	By Depreciation A/c		10,000
				31.12.2011	By Balance C/d		80,000
			90,000				90,000
1.1.2012	To Balance b/d		80,000	31.12.2012	By Depreciation A/c		10,000
				31.12.2012	By Balance C/d		70,000
			80,000				80,000
1.1.2013	To Balance b/d		70,000	31.12.2013	By Depreciation A/c		7,290
30.12.2013	To P/L A/c (Excess Depreciation)		2,900	31.12.2013	By Balance C/d		65,610
			72,900				72,900

9.8 Summary of the Chapter:

The term ‘depreciation’ is used to denote decrease in value but in accounting, this term is used to denote decrease in the book value of a fixed asset. Depreciation is the permanent and continuous decrease in the book value of a fixed asset due to continuous use, obsolescence, expiration of legal rights or any other cause. There are many methods for charging depreciation like Straight Line Method (S.L.M.) , Written Down Value Method (W.D.V. Method), Sum of the Years Digit Method, Annuity Method etc but out of all these methods W.D.V. and S.L.M. are the most popular methods of depreciation.

For depreciation, Accounting Standard - 6 (AS-6) issued by The Institute of Chartered Accountants of India is applicable.

9.9 Glossary

Depreciation: Depreciation is an accounting method used to spread the cost of a tangible asset over its useful life. It reflects how items like machinery, vehicles, or buildings lose value over time due to wear and tear, or obsolescence.

Amortization: In accounting, amortization is a method of obtaining the expenses incurred by an intangible asset arising from a decline in value as a result of use or the passage of time.

9.10 Check your knowledge

Fill in the Blanks

1. Depreciation is related to the decrease in the value of assets .
2. refers to the economic deterioration by the expiration of intangible assets.
3. Under..... method the rate of depreciation remains constant year after year whereas the amount of depreciation goes on decreasing.
4. For depreciation, Accounting Standard (AS) is issued by The Institute of Chartered Accountants of India is applicable.

9.11 Answers to check your knowledge

1. fixed , 2. Amortisation , 3. Diminishing balance , 4. AS-6

9.12 Terminal Questions

Q.1 What is the need for providing depreciation?

Q.2 What are the causes of depreciation?

Q.3 What are the factors which determine the amount of depreciation?

Q.4 State the type of assets for which Straight Line method and Diminishing balance methods of depreciation are suitable .

Q.5 Distinguish between Straight Line Method and Written Down Value Method of depreciation.

9.13 Reference Books

1. Financial Accounting Principles and Practice- Prof. Jawahar Lal and Dr.Seema Srivastava

2. Financial Accounting- Sri P. C. Tulsian
3. Advanced Accountancy - Sri R. L. Gupta and Sri M. Radhaswamy
4. Advanced Accountancy-Sri S. P. Jain and Sri K. L. Narang.

9.14 Practical Problems for Practice:

Q.1 Shashwat Ltd. purchased a second hand plant on April 1, 2010 for ₹ 1,20,000 and immediately spent ₹ 80,000 for bringing the same in working condition. On July 1, 2010 additional machinery costing ₹ 80,000 was purchased. The firm provided depreciation on straight line method at 20% per annum on the original cost of the asset. You are required to show Machinery Account for the calendar years 2010 to 2013.

Q.2 Radha Limited purchased a machinery on January,1,2011 for ₹ 90,000 and paid ₹ 10,000 on its installation. On 1.7.2011 another machinery of ₹ 50,000 was purchased. Depreciation is to be provided annually on every 31st December at 10% p.a. on written down value. On 1.1.2013, however, the firm decided to change the method of providing depreciation and adopted the method of providing depreciation @ 10% p.a. on the original cost, with retrospective effect.

Q.3 On 1st April 2010 Ambuj Ltd. purchased a Machine costing ₹ 2,00,000 and provided depreciation @ 20% p.a. on Straight Line Method basis. At the end of the year 2012, the company decided to change the method of depreciation from Straight Line Method to Written Down Value Method retrospectively, the rate of depreciation remaining the same. Prepare the Machinery Account up to the year 2012.

Q.4 On 1st January, 2011, Bittu Ltd. purchased a machine for ₹ 1,00,000 including an installation cost of ₹ 10,000. On 1st July 2014 this machine is sold for ₹ 60,000. Depreciation is to be provided @ 5% p.a. according to Written Down Value Method. You are required to prepare machinery Account and depreciation account. Assume that accounts are closed on 31st December every year.

Q.5 On 1st April 2012, Sapana Ltd. purchased machinery for ₹ 50,000. There will be no salvage value of the plant. The expected useful life of the plant is 5 years. Depreciation is to be provided according to Straight Line Method. You are *required to* prepare machinery Account for the first four years assuming that the accounts are closed on 31st March every year.

Q.6 On 1st January, 2008, a firm purchased a machinery for ₹ 1,00,000. On 1st October, 2008 additional machinery costing ₹ 50,000 was purchased. On 1st October, 2009 the machinery

purchased on 1st January, 2008 was sold for ₹ 60,000. The firm provides depreciation on its machinery @ 10% per annum on original cost.

The firm closes its books of accounts on 31st December every year. You are required to show the machinery account for three accounting years ending 31st December 2011.

Unit-10

TRIAL BALANCE

- 10.1** Introduction
- 10.2** Trial Balance
- 10.3** Features of Trial Balance
- 10.4** Objectives of Trial Balance
- 10.5** Trial Balance and Errors
- 10.6** Similarity of Trial Balance and Balance Sheet
- 10.7** Trial balance limitations
- 10.8** Format of Trial Balance
- 10.9** Methods of Preparation of Trial Balance
 - 10.9.1** Total Method
 - 10.9.2** Balance Method
- 10.10** Advantages of Trial Balance
- 10.11** Summary
- 10.12** Glossary
- 10.13** Check your Progress
- 10.14** Answers to check your progress
- 10.15** Terminal Questions
- 10.16** References

Learning Objectives

After going through this Unit, you will be able to :

- Understand the meaning of Trial Balance
- Explain the objectives of trial balance.
- Draw the format of trial balance with its complete columns.
- Prepare trial balance method according to total and balance method.

10.1 Introduction

All the transactions of financial nature are recorded in the books of accounts. Journal Proper and subsidiary books record all business transactions originally. With the help of journal and subsidiary books, we prepare ledger accounts. After balancing the ledger accounts, we would like to check the arithmetical accuracy of our accounts and for this purpose trial balance is prepared. The preparation of trial balance is the third step of recording business transactions in the books of accounts. The first step is to record the

business transactions in the subsidiary books and journal proper. The second step is to prepare ledger accounts on the basis of subsidiary books and journal. And then trial balance is prepared.

10.2 Trial Balance

A trial balance is a list of all the General ledger accounts (both revenue and capital) contained in the ledger of a business. This list will contain the name of the nominal ledger account and the value of that nominal ledger account. The value of the nominal ledger will hold either a debit balance value or a credit balance value. The debit balance values will be listed in the debit column of the trial balance and the credit value balance will be listed in the credit column. The profit and loss statement and balance sheet and other financial reports can then be produced using the ledger accounts listed on the trial balance.

The name comes from the purpose of a trial balance which is to prove that the value of all the debit value balances equal the total of all the credit value balances. Trialing, by listing every nominal ledger balance, ensures accurate reporting of the nominal ledgers for use in financial reporting of a business's performance. If the total of the debit column does not equal to the total value of the credit column then this would show that there is an error in the nominal ledger accounts. This error must be found before a profit and loss statement and balance sheet can be produced.

The trial balance is usually prepared by a bookkeeper or accountant who has used daybooks to record financial transactions and then post them to the nominal ledgers and personal ledger accounts. The trial balance is based on the double-entry system and uses the classic 'T' account format for presenting values.

Definitions:

- A trial balance is a list of all the nominal ledger (general ledger) accounts contained in the ledger of a business. This list will contain the name of the nominal ledger account and the value of that nominal ledger account.

- A Trial balance is a statement consists of direct & indirect expenses, Incomes and Liabilities and Assets which is the source for preparation of the Balance Sheet.
- A trial balance is a list of Debit and Credit or a list of Debit & Credit Balance of all the ledger accounts prepared on any particular date.
- Trial balance is a statement which is prepared to check the arithmetical accuracy of the accounts.
- It will be prepared with the help of balances of different accounts in ledger or it can be prepared based on following principle.

Debit: All expenses, losses and assets

- Cash/bank
- Drawings
- Purchases
- Furniture, Building etc.
- Opening stock/Closing stock
- Rent, printing & stationary, salaries etc.
- Loans given
- Preliminary expenses
- Sales returns
- Profit & Loss a/c (loss)

Credit: All Incomes, gains and liabilities

- Capital
- Creditors, Bank overdraft, Bills payable etc.
- Sales
- Purchase Returns
- Discount received, interest received etc.
- Provision for bad & doubtful debts

- Outstanding expenses
- Profit & Loss a/c (profit)
- Reserve fund

10.3 Features of Trial Balance:

- Trial balance can be prepared anytime during the accounting period.
- It is prepared to check the arithmetical accuracy of posting of entries from journal to ledger, in other words it is an instrument for carrying out the job of checking and testing.
- It is based on the double entry system of book keeping for checking the accuracy of posting. However it does not reveal all errors.

10.4 Objectives of Preparing a Trial Balance

Following are the objectives of preparing Trial Balance

(i) To check arithmetical accuracy

Arithmetical accuracy in ledger posting means writing correct amount, in the correct account and on its correct side while posting transactions from various original books of accounts, such as Cash Book, Purchases Book, Sales Book, etc. It also means not only the correct balance of ledger account but also the totals of the special purpose Books.

(ii) To help in preparing Financial Statements

The ultimate objective of the accounting is to prepare financial statements i.e. Trading and Profit and Loss Account, and Balance sheet of a business enterprise at the end of an accounting year. These statements contain balances of various ledger accounts. As Trial Balance contains balances of all ledger accounts, in financial statements the balances of ledger accounts are carried from the Trial balance for proper analysis.

(iii) Helps in locating errors

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

Comparison of ledger account balances of one year with the corresponding balances with the previous year helps the management taking some important decisions. This is possible by using the Trial Balances of the two years.

(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. Trial Balance is generally prepared at the end of the year. However it can be prepared at any time during the accounting year to check the accuracy of the posting.

10.5 Trial Balance and Errors

You have learnt that if the sum of the two columns of Trial Balance is equal i.e. the Trial Balance is in agreement, it means that the accounting entries have been arithmetically correct and correctly posted in the ledger. If the totals do not tally it means there are some errors in recording and/or in posting in the ledger of the business.

The reasons due to which the totals of the two columns of Trial balance may not agree and can be listed as follows:

(i) The totals of the Special Purpose Books like Sales Book, Purchases Book, etc are not totaled correctly or there is some mistake in the posting of these totals in their respective accounts in the ledger.

(ii) The items from different Special Purpose Books and Journal may be posted to the wrong side of the account or a wrong amount is posted to the wrong account.

(iii) The balancing of an account is not done correctly.

(iv) There may be mistake in carrying balance from the ledger account to the Trial Balance.

You may conclude that if the trial balance is in agreement, the business transactions have been correctly recorded or posted into ledger. However, the agreement of Trial Balance is not a conclusive proof of the correctness of recording and posting of business transactions. There can be errors and the sum of each column of the Trial Balance may still be equal. You have learnt that business transactions are so recorded that all debits have the credits with the same amount and vice-a-versa. So the Trial Balance must necessarily agree. Even if the debits are matched with credits though there can be mistakes in recording and posting.

For example, if goods have been purchased from Surender, and if not entered in the Purchases Book, this error will not affect the agreement of the Trial Balance.

Errors affecting trial balance

- Incorrect additions
- Incorrect recordings
- Incorrect debit and credit
- Incorrect ledger balance
- Incorrect debit and credit in ledger
- Incorrect posting
- Incorrect missing of transaction

Errors not affecting trial balance

- Transaction is not journalized
- A correct journal entry is not posted
- A journal entry is posted twice
- Incorrect accounts are used in journalizing posting
- Offsetting errors are made in recording the amount of a transaction

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; 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 analyze 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.

10.6 Similarity of a Trial Balance and Balance sheet

1. Both show the financial position as of a particular date.
2. Both show the balances of Ledger accounts and not the transactions.
3. Both can be used to do comparative analysis.
4. 'To' and 'By' words are not used in both.
5. Both are statements, not accounts.
6. Both are prepared on a specific date.
7. Balance of cash book is written in both.

Difference between Trial Balance and Balance Sheet

The following are the points of difference between trial balance and balance sheet

TrialBalance	Balance Sheet
<ol style="list-style-type: none"> 1. It is a list of balance extracted from the ledger accounts. 2. It contains the balance of all 	<ol style="list-style-type: none"> 1. It is a statement of assets and liabilities. 2. It contains the balance of only

<p>accounts - real, nominal and personal.</p> <p>3. It is prepared before the preparation of trading and profit and loss account.</p> <p>4. It does not contain the value of the closing stock of goods.</p> <p>5. Expenses due but not paid and incomes due but not received do not appear in the trial balance</p>	<p>those accounts which represents assets and liabilities.</p> <p>3. It is prepared after the preparation of trading and profit and loss account.</p> <p>4. It contains the value of closing stock, which appears on the assets side.</p> <p>5. Expenses due but not paid appear on the liability side and income due but not received appear on the asset side of the balance sheet</p>
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10.7 Trial Balance limitations

Trial balance is taken as test of arithmetical accuracy. If both the debit and credit column of trial balance are equal to each other, we assume that there is no mistake in the posting of journal and subsidiary books to ledger accounts, in carrying forward balances of ledger accounts to trial balance and even in the balancing of the ledger accounts. This assumption is correct but should never be taken as conclusive proof of accuracy. It means that there are certain errors which remain undetected by trial balance. Both the debit and credit columns of trial balance may be equal inspite of certain mistakes of omission and principles. These errors may be mentioned as under

- i. An **error of original entry** is when both sides of a transaction include the wrong amount. For example, if a purchase invoice for £21 is entered as £12, this will result in an incorrect debit entry (to purchases), and an incorrect credit entry (to the relevant creditor account), both for £9 less, so the total of both columns will be £9 less, and will thus balance.
- ii. An **error of omission** is when a transaction is completely omitted from the accounting records. As the debits and credits for the transaction would balance, omitting it would still leave the totals balanced. A variation of this error is omitting one of the ledger account totals from the trial balance.

- iii. An **error of reversal** is when entries are made to the correct amount, but with debits instead of credits, and vice versa. For example, if a cash sale for £100 is debited to the Sales account, and credited to the Cash account. Such an error will not affect the totals.
- iv. An **error of commission** is when the entries are made at the correct amount, and the appropriate side (debit or credit), but one or more entries are made to the wrong account of the correct type. For example, if fuel costs are incorrectly debited to the postage account (both expense accounts). This will not affect the totals.
- v. An **error of principle** is when the entries are made to the correct amount, and the appropriate side (debit or credit), as with an error of commission, but the wrong type of account is used. For example, if fuel costs (an expense account), are debited to stock (an asset account). This will not affect the totals.
- vi. **Compensating errors** are multiple unrelated errors that would individually lead to an imbalance, but together cancel each other out.
- vii. A **Transposition Error** is an error caused by switching the position of two adjacent digits. Since the resulting error is always divisible by 9, accountants use this fact to locate the mesenteries number. For example, a total is off by 72, dividing it by 9 gives 8 which indicates that one of the switched digit is either more, or less, by 8 than the other digit. Hence the error was caused by switching the digits 8 and 0 or 1 and 9. This will also not affect the totals.

10.8 Format of Trial Balance

Your Business Name

**Trial Balance
June 31, 20XX**

Items	Debit (Rs.)	Credit (Rs.)
Cash	800.00	
Accounts Receivable	400.00	
Supplies	600.00	
Prepaid Rent	1,200.00	
Equipment	10,000.00	

	Accounts Payable		3,000.00
	Owner, Capital		9,000.00
	Owner, Drawing	1,000.00	
	Sales		3,000.00
	Salary Expense	700.00	
The	Misc. Expense	300.00	
	Total	15,000.00	15,000.00

Trial Balance, which can be taken at any point in time, lists all ledger accounts and their balances and is used to prove the equality of debits and credits. Assets are listed first followed by liabilities and then owner's equity. Debit balances are listed in the left column and credit balances in the right column. The trial balance shows the accounts balance, it ensure that all transactions were entered or entered into the proper accounts. Below is an example of a Trial Balance.

A trial balance is an internal document used only by company employees; it is not meant to be available to persons outside the company.

Example

Following is an example of what a simple Trial Balance looks like:

ABC LTD
Trial Balance as at 31 December 2011

Items	Debit	Credit
	Rs.	Rs.
Share Capital		15,000
Furniture & Fixture	5,000	
Building	10,000	
Creditor		5,000
Debtors	3,000	
Cash	2,000	
Sales		10,000

Cost of sales	8,000	
General and Administration Expense	2,000	
Total	30,000	30,000

1. Title provided at the top shows the name of the entity and accounting period for which the trial balance has been prepared.
2. Account Title shows the name of the accounting ledgers from which the balances have been extracted.
3. Balances relating to assets and expenses are presented in the left column (debit side) whereas those relating to liabilities, income and equity are shown on the right column (credit side).
4. The sums of all debit and credit balances are shown at the bottom of their respective columns.

Problem 1

Journalize the following transactions, post them to ledger and balance the accounts. Also prepare a trial balance as on 31st April 1993.

1993

- April 1 Ravi started business with Rs. 15,000 of which Rs. 4,000 were borrowed at 15% p.m. from Shri Shashi
- April 2 Purchased goods worth Rs. 4,000 from Anant at 2% trade discount
- April 3 Cash sales to Madan Rs. 1,200
- April 6 Credit sales to Salvi Rs. 2,000 less trade discount 2%
- April 9 Paid cash Rs. 1,950 to Anant and received discount of Rs. 10
- April 12 Received Rs. 1,950 from Salvi in full settlement of his dues
- April 14 Returned goods of the price of Rs. 100 to Anant
- April 16 Paid into bank Rs. 5,000
- April 18 Issued a cheque of Rs. 1,000 to Anant on account
- April 19 Purchased goods worth Rs. 2,000 from Anant
- April 22 Sold goods costing Rs. 1,000 at 25% profit to Ratan
- April 22 Received commission of Rs. 800 from S & Co.
- April 24 Received a cheque of Rs.395 from Ratan and he was allowed discount of Rs. 5
- April 25 Ratan returned goods worth Rs. 50
- April 30 Paid interest on loan of Rs. 50 to Shashi
- April 30 Paid salaries of Rs. 2,000 out of which Rs. 1,200 was paid by cheque
- April 30 Paid into bank Rs. 500
- April 30 Paid office rent by cheque Rs. 300

Solution

Date	Particulars	L.F.	Dr.(Rs.)	Cr. (Rs).
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1993 Apr.1	Cash A/c Dr. To Capital A/c To Shashi's Loan A/c (Being cash brought into business and loan taken from Shashi @ 15% to start the business)		15,000	11,000 4,000
Apr.2	Purchase A/c Dr. To Anant's A/c (Being credit purchase from Anant)		3,920	3,920
Apr.3	Cash A/c Dr. To Sales A/c (Being cash sales)		1,200	1,200
Apr.6	Salvi A/c Dr. To Sales A/c (Being credit sales to Salvi)		1,960	1,960
Apr.9	Anant's A/c Dr. To Cash A/c To Discount A/c (Being cash paid to and received discount from Anant)		1,960	1,950 10
Apr.12	Cash A/c Dr. Discount A/c Dr. To Salvi's A/c (Being cash received from and allowed discount to Salvi)		1,950 10	1,960
Apr.14	Anant's A/c Dr. To Returns Outwards A/c (Being returned goods to Anant)		98	98
Apr.16	Bank A/c Dr. To Cash A/c (Being cash paid into bank)		5,000	5,000
Apr.18	Anant's A/c Dr. To Bank A/c (Being cheque issued to Anant)		1,000	1,000
Apr.19	Purchase A/c Dr. To Anant's A/c (Being credit purchases from Anant)		2,000	2,000
Apr.22	Ratan's A/c Dr. To Sales A/c (Being credit sales to return)		1,250	1,250
Apr.22	Cash A/c Dr. To Commission A/c (Being commission received)		800	800
Apr.24	Cash A/c Dr. Discount A/c Dr. To Ratan's A/c (Being received a cheque from and allowed discount to Ratan)		395 5	400
Apr.25	Ratan's A/c To Returns Inwards A/c Dr. (Being received goods returned by Ratan)		50	50

Apr.30	Interest A/c Dr. To Cash A/c (Being paid interest for April'93 to Shashi on loan taken from him)		50	50
Apr.30	Salaries A/c Dr. To Cash A/c To Bank A/c (Being paid salaries Rs. 800 in cash and Rs. 1,200 by cheque)		2,000	800 1,200
Apr.30	Bank A/c Dr. To Cash A/c (Being cash deposited in bank)		500	500
Apr.30	Rent A/c Dr. To Bank A/c (Being issued cheque for office rent for April'93)		300	300

Trial Balance as on 30th April 1993

Particular	Dr. (Rupees)	Cr. (Rupees).
Cash A/c	11,045	--
Bank A/c	3,000	--
Salaries A/c	2,000	--
Rent A/c	300	--
Commission A/c	--	800
Interest A/c	50	--
Discount A/c	5	--
Capital A/c	--	11,000
Shashi's Loan A/c	--	40,00
Creditors (Anant) A/c	--	2,862
Debtor (Ratan)	800	--
Purchases A/c	5,920	--
Sales A/c	--	4,410
Returns Outwards A/c	--	98
Returns Inwards A/c	50	--
Total	23,170	23,170

Problem 2

Enter the following transactions in the subsidiary books, post them to ledger and prepare a trial balance.

1998	Mr. X started a business	1,00,000
1 Dec.	Purchased furniture from Vikram Furniture for	20,000
5 Dec.	Purchased goods for cash	15,000
7 Dec.	Purchased goods from AB & Co. for (trade discount	30,000
10 Dec.	20%)	25,000
12 Dec.	Opened a bank account by depositing	15,000
14 Dec.	Sold goods for cash	1,000

15 Dec.	Purchased stationery from Sayyed Stationery Mart	5,000
18 Dec.	for	400
20 Dec.	Sold goods to Yusuf	5,000
21 Dec.	Goods returned by Yusuf	20,000
22 Dec.	Payment to AB & Co. by cheque	2,000
23 Dec.	Purchased goods on credit from Ramesh & Co. for	400
23 Dec.	Returned goods to Ramesh & Co. worth	5,000
29 Dec.	Paid electricity bill for	2,000
30 Dec.	Cash sale for	
	Withdrew for private use from bank.	

Solution

Dr.					Cr.				
Cash Book (with Bank Column)									
Date	Particulars	LF	Cash	Bank	Date	Particulars	LF	Cash	Bank
1998					1998				
1Dec	To Capital		1,00,000		1Dec	By Purchase		15,000	
12	To Cash (Opening A/c)			25,000	12	By Bank (Opening A/c)		25,000	
14	To Sales		15,000		21	By AB & Co.		5,000	
29	To Sales		5,000		23	By Electricity Drawing		400	
1999	To Bal.		1,20,000	25,000	30	By A/c A/c		2,000	18,000
1Jan	B/d		79,600	18,000	31	By Bal. C/d		79,600	
								1,20,000	18,000

Purchase Day Book

Date	Particulars	L.F.	Rs.
1998			
10 Dec.	AB & Co. 30,000		
	Less: Trade discount <u>6,000</u>		24,000
22 Dec.	Ramesh & Co.		20,000
	Purchase Account Dr.		44,000

Sales Day Book

Date	Particulars	L.F.	Rs.
1998			
18 Dec.	Yusuf		5,000
	Sales Account Cr.		5,000

Purchase Return Book

Date	Particulars	L.F.	Rs.
1998 23 Dec.	Ramesh & Co. Purchases Return A/c		2,000
	Cr.		2,000

Sales Return Book

Date	Particulars	L.F.	Rs.
1998 20 Dec.	Yusuf Sales Returns A/c Dr.		400
			400

Journal Proper

Date	Particulars	L.F.	Rs.	Rs.
1998 5 Dec.	Furniture A/c Dr. To Vikram Furniture A/c (Being furniture purchased on credit)		20,000	20,000
15 Dec.	Stationery A/c To Sayyed Stationery Mart A/c (Being purchase of stationery)		1,000	1,000

Ledger of X
Capital Account

Date	Particular	Rs.	Date	Particular	Rs.
1998 31 Dec	To Balance c/d	1,00,000	1998 1 Dec	By Cash A/c	1,00,000
		1,00,000			1,00,000
			1999 1 Jan	By Balance b/d	1,00,000

Furniture Account

Date	Particular	Rs.	Date	Particular	Rs.
1998 5 Dec	To Vikram Furniture A/c	20,000	1998 31 Dec	By Balance c/d	20,000
		20,000			20,000
1999 1 Jan	To Balance b/d	20,000			

Vikram Furniture Account

Date	Particular	Rs.	Date	Particular	Rs.
1998			1998	By Furniture A/c	

31 Dec	To Balance c/d	20,000	5 Dec		20,000
		20,000			20,000
			1999		
			1 Jan	By Balance b/d	20,000

Purchases Account

Date	Particular	Rs.	Date	Particular	Rs.
9 Dec	To Cash A/c	15,000			
31 Dec	To Purchase day book	44,000	31 Dec	By Balance c/d	59,000
		59,000			59,000
1999					
1 Jan	To Balance b/d	59,000			

Sales Account

Date	Particular	Rs.	Date	Particular	Rs.
1998			1998		
			14 Dec	By Cash A/c	15,000
			29 Dec	By Cash A/c	5,000
31 Dec	To Balance c/d	25,000	31 Dec	By Sales Day Book	5,000
		25,000			25,000
			1999		
			1 Jan	By Balance b/d	25,000

Stationery Account

Date	Particular	Rs.	Date	Particular	Rs.
1998			1998		
15 Dec	To Sayyed Stationery Mart A/c	1,000	31 Dec	By Balance c/d	1,000
		1,000			1,000
1999					
1 Jan	To Balance b/d	1,000			

Sayyed Stationery Account

Date	Particular	Rs.	Date	Particular	Rs.
1998			1998		
31 Dec	To Balance c/d	1,000	15 Dec	By Stationery A/c	1,000
		1,000			1,000
			1999		
			1 Jan	By Balance b/d	1,000

Electricity Account

Date	Particular	Rs.	Date	Particular	Rs.
1998			1998		
23 Dec	To Cash	400	31 Dec	By Balance c/d	400
1999		400			400

1 Jan	To Balance b/d	400			
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Drawing Account

Date	Particular	Rs.	Date	Particular	Rs.
1998			1998		
30 Dec	To Bank	2,000	31 Dec	By Balance c/d	2,000
		2,000			2,000
1999					
1 Jan	To Balance b/d	2,000			

Purchase Return Account

Date	Particular	Rs.	Date	Particular	Rs.
1998			1998		
31 Dec	To Balance c/d	2,000	31 Dec	By Purchase Return Books	2,000
		2,000			2,000
			1999		
			1 Jan	To Balance b/d	2,000

Sales Return Account

Date	Particular	Rs.	Date	Particular	Rs.
1998			1998		
31 Dec	To Sales Return Book	400	31 Dec	By Balance c/d	400
		400			400
1999					
1 Jan	To Balance b/d	400			

AB & Co. Account

Date	Particular	Rs.	Date	Particular	Rs.
1998			1998		
21 Dec	To Bank A/c	5,000	10 Dec	By Purchases A/c	24,000
31 Dec	To Balance c/d	19,000			24,000
		24,000			
			1999		
			1 Jan	By Balance b/d	19,000

Ramesh & Co. Account

Date	Particular	Rs.	Date	Particular	Rs.
1998			1998		
23 Dec	To Purchase Return	2,000	2 Dec	By Purchase A/c	20,000
31 Dec	To Balance c/d	18,000			

		20,000			20,000
			1999		
			1 Jan	By Balance b/d	18,000

Yusuf Account

Date	Particular	Rs.	Date	Particular	Rs.
1998			1998		
18 Dec	To Sales A/c	5,000	20 Dec	By Sales Returns	400
			31 Dec	By Balance c/d	4,600
		5,000			5,000
1999					
1 Jan	To Balance b/d	4,600			

Trial Balance as on 31-12-1998

Sr. No.	Particular	L.F.	Dr. Rs.	Cr. Rs.
	Capital Account			1,00,000
	Furniture Account		20,000	
	Vikram Furniture Account			20,000
	Purchase Account		59,000	
	Sales Account			25,000
	Stationery Account		1,000	
	Sayyed Stationery Mart			1,000
	Electricity Account		400	
	Drawings Account		2,000	
	Purchases Returns A/c			2,000
	Sales Returns A/c		400	
	AB & Co. Account			19,000
	Ramesh & Co. Account			18,000
	Yusuf Account		4,600	
	Cash Account		79,600	
	Bank Account		18,000	
	Total		1,85,000	1,85,000

10.9 Methods of Preparation of Trial Balance

The trial balance is usually prepared on a loose sheet of paper. The ruling of trial balance is similar to that of a journal. We may prepare a trial balance in one of the following forms:

1. Total Trial Balance Method
2. Balance Trial Balance Method

10.9.1 Total Trial Balance Method:

According to total trial balance method two sides of each ledger account i.e., debit and credit side are added up and debit and credit totals so obtained are placed in the debit and credit columns of the trial balance respectively. Thus we may draw the following trial balance by taking out the debit side total and credit side total of each account in the ledger.

Trial Balance

Ledger Account	J.F	Total Debits	Total Credits
		Rs.	Rs.
Cash Account		12,453	8,436
Sundry Debtors Account		43,675	34,453
Sundry Creditors Account		23,654	31,298
Discount Account		430	550
Purchases Account		26,670	--
Sales Account		--	32,145
Machinery Account		10,000	--
Building Account		20,000	--
Capital Account		--	35,000
Rent Account		3,400	--
Wages Account		600	--
Salaries Account		1,000	--
		1,141,882	1,141,882

One clear defect of this method is that mistakes may be committed more often while preparing the trial balance, because large number of figures would be required to be enlisted. Thus, the process becomes unwieldy and cumbersome.

10.9.2 Balance Trial Balance Method:

The task of preparing a trial balance under balance - trial balance method is much simplified. There is well known axiom that if equals are subtracted from equals the remainders are equal. On this assumption, in place of writing against each account the debit as well as the credit total the balance alone is written. The difference between the

two sides of an account is called the balance. If the debit side of an account is greater than the credit side, the balance falls on the debit side and is known as "debit balance." If the credit side of an account is greater than the debit, the the balance is on the credit side and is called "credit balance."

Rules of Balancing Accounts: Rules of balancing each account is as follows:

1. Add up both sides of the account
2. Find out the difference in a separate slip.
3. Put the difference on the lighter side.
4. Add up both sides again.
5. Rule off.

Trial Balance

Ledger Account	J.F	Debit	Credit
Cash Account		4,017	--
Sundry Debtors Account		9,222	--
Sundry Creditors Account		--	7,644
Discount Account		--	120
Purchases Account		26,670	--
Sales Account		--	32,145
Machinery Account		10,000	--
Building Account		20,000	--
Capital Account		--	35,000
Rent Account		3,400	--
Wages Account		600	--
Salaries Account		1,000	--
		74,909	74,909

The second method has the added advantages and is the one that is generally used. There are comparatively less chances of committing errors. As the magnitude of figures is smaller the process is not cumbersome. It does not appear to be unwieldy. Moreover, in

a trial balance, the exact position of any account on the date of trial balance can be determined at a glance.

10.10 Advantages of Trial Balance

The advantages of trial balance are:

- It ensures that the transactions recorded in the books of accounts have identical debit and credit amount.
- Balance of each ledger account has been computed correctly.
- Balance of each and every ledger account has been transferred accurately and on the correct side of the sheet on which trial balance has been prepared.
- The debit and the credit columns of trial balance have been added up correctly.

10.11 Summary

- The accuracy of the accounts must be checked before financial reports are prepared.
- The procedure for checking the equality of the debits and credits in the accounts is called taking a trial balance.
- The first step in taking a trial balance is to find the balances of the accounts. The next step is to list the accounts and their balances. Then the debts and credits are totaled. The total of the debits should be equal to the total of the credits.
- The accounts are listed on the trial balance form in the order they appear in the ledger.
- If the trial balance is in balance, it is probable that the accounts in the ledger are correct.
- If the total debits and the total credits are not equal, the trial balance and the accounts must be checked to find and then correct the error.

10.12 Glossary

Trial Balance: A statement that lists the closing balances of all general ledger accounts—assets, liabilities, equity, revenue, and expenses—at a specific point in time

Financial Statements: Formal, structured records summarizing a business's financial activities, performance, and position over a specific period

10.13 Check Your Progress

1. Goods of the value Rs. 1,500 taken by the proprietor for his personal use should be debited to :

- i. Drawings Account
- ii. Sales Account
- iii. Purchases Account

2. Therecord daily transactions of a business in the order in which they occur.

- i. Journal
- ii. Ledger
- iii. Account
- iv. Trial Balance

3. The various debit and credit balances of the different accounts are taken down in a statement which is known as.....

- i. Journal
- ii. Final Account
- iii. Trial Balance
- iv. Ledger

4. As a rule, closing balance in any account ends with suffix..... And the opening balance with suffix.....

- i. c/d , a/c
- ii. c/d , b/d
- iii. b/d , c/d

- iv. b/d , a/c
5. Which of the following accounts will invariably have a debit balance?
- Bank Account
 - Accounts Receivable Account
 - Accounts Payable Account
 - Loan Account
6. Which of the following accounts will invariably have a credit balance ?
- Discount Account
 - Accounts Payable Account
 - Cash Account
7. The balance ofaccount will be shown at the debit column of the trial balance.
- Cash
 - Creditors account
 - Bank overdraft account
 - Capital account
8. Trial Balance is
- a statement
 - an account
 - a summary
 - an information

10.14 Answers to Check Your Progress

- i
- i
- iii
- ii
- ii
- ii

7. i

8. i

10.15 Terminal Questions

1. Define trial balance. Why is it prepared? Is the trial balance a conclusive proof of arithmetical accuracy in the books of accounts?
2. Why do you regard Trial Balance as a test of the arithmetical accuracy of the books of account? List the errors that will be disclosed by the Trial Balance.
3. If the Trial Balance does not tally, it means there are some errors in the books of account. How are the errors located? Describe the procedure fully.
4. Is the Trial Balance a conclusive proof of the accuracy of the books of account? Discuss the errors not disclosed by the Trial Balance.
5. What are the different types of the errors that are usually committed in recording transactions? Explain with example.
6. State the advantage of preparing a Trial Balance. Also give its limitations, if any

Exercise-1

Trial balance of Khatau did not agree. He put the difference to suspense account and discovered the following errors:

- (a) Credit sales to Manas Rs. 16,000 were recorded in the purchases book as Rs. 10,000 and posted to the debit of Manas as Rs. 1,000.
- (b) Furniture purchased from Noor Rs. 6,000 was recorded through purchases book as Rs. 5,000 and posted to the debit of Noor Rs. 2,000.
- (c) Goods returned to Rai Rs. 3,000 recorded through the Sales book as Rs. 1,000.
- (d) Old machinery sold for Rs. 2,000 to Maneesh recorded through sales book as Rs. 1,800 and posted to the credit of Manish as Rs. 1,200.
- (e) Total of Returns inwards book Rs. 2,800 posted to Purchase account.

Rectify the above errors and prepare suspense account to ascertain the difference in trial balance.

(Ans: Difference in trial balance Rs. 15,000 excess debit).

Exercise-2

Trial balance of John 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. 1,000 instead of Rs. 1,200 and total of page 6 was carried forward to page 7 as Rs. 5,600 instead of Rs. 5,000.

- (b) Wages paid for installation of machinery Rs. 500 was posted to wages account as Rs. 50.
- (c) Machinery purchased from R & Co. for Rs. 10,000 on credit was entered in Purchase Book as Rs. 6,000 and posted there from to R & Co. as Rs. 1,000.
- (d) Credit sales to Mohan Rs. 5,000 were recorded in Purchases Book.
- (e) Goods returned to Ram Rs. 1,000 were recorded in Sales Book.
- (f) Credit purchases from S & Co. for Rs. 6,000 were recorded in sales book. However, S & Co. was correctly credited.
- (g) Credit purchases from M & Co. Rs. 6,000 were recorded in Sales Book as Rs. 2,000 and posted there from to the credit of M & Co. as Rs. 1,000.
- (h) Credit sales to Raman Rs. 4,000 posted to the credit of Raghvan as Rs. 1,000.
- (i) Bill receivable for Rs. 1,600 from Noor was dishonored and posted to debit of Allowances account.
- (j) Cash paid to Mani Rs. 5,000 against our acceptance was debited to Manu.
- (k) Old furniture sold for Rs. 3,000 was posted to Sales account as Rs. 1,000.
- (l) Depreciation provided on furniture Rs. 800 was not posted.
- (m) Material Rs. 10,000 and wages Rs. 3,000 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. 13,850 excess credit).

Exercise-3

From the following transactions pass journal entries and show ledger accounts in the Books of S. Banerjee and prepare a Trial Balance.

- a) Started business with cash Rs. 1,50,000, Goods worth Rs. 80,000, Office Equipment Rs.70,000 and his private car worth Rs. 1,20,000 which will henceforth be used solely for business purpose.
- b) Bought furniture worth Rs. 40,000 of which those worth Rs. 10,000 are for office use and the balance for stock. Purchased 3 motor cars worth Rs. 1,50,000 each from Ganguly & Co. for stock.
- c) Purchased 2 motor cars worth Rs. 80,000 each from Ganguly & Co. for business use.
- d) Purchased for cash 1 motor car worth Rs. 70,000 for private use.
- e) Returned motor cars worth Rs. 1,50,000 from stock and that worth Rs. 80,000 for business use to Ganguly & Co.
- f) Sold office equipment for Rs. 40,000
- g) Sold one of the motor cars for stock for Rs. 2,00,000/- ; paid landlord Rs. 12,000 for rent.
- h) One-third of the premises are occupied by the proprietor for his own residence.
- i) Sold the third car for Rs. 3, 50,000/-

(Ans. Trial Balance Rs. 15,00,000/-)

10.16 References:

- http://en.wikipedia.org/wiki/Trial_balance
- <http://www.nos.org/srsec320newE/320EL10.pdf>

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- www.allinterview.com › *Categories* › *Business Management*
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UNIT- 11

RECTIFICATION OF ERROR

- 11.1 Introduction
 - 11.1.1 Definition
- 11.2 Errors
 - 11.2.1 errors of commission
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- 11.3 Rectification of errors
 - 11.3.1 Rectification of one-sided errors
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- 11.4 Effect of rectifying entries on Profits
- 11.5 Rectification of accounting errors
- 11.6 Rectification of errors through suspense Account
- 11.7 Methods of rectification of accounting errors
- 11.8 Examples
- 11.9 Summary
- 11.10 Glossary
- 11.11 Check your Progress Questions
- 11.12 Answers to check your Progress Questions
- 11.13 Terminal Questions
- 11.14 Reference Books

Learning Objectives

After going through this Unit, you will be able to :

- rectify errors before preparing the final accounts
- explain the use of suspense account

- prepare the suspense account
- rectify errors located during subsequent accounting years
- compute the effect of rectifying errors on profits
- Classify the error on the basis of nature i.e. error of omission, error of commission etc.
- Classify the error on the basis of impact on ledger i.e. one sided error and two sided error.
- Explain the various method of rectifying of the error.

11.1 Introduction

Rectification of errors may be defined as correction of errors which had been done in the books of accounts of company/firm due to ignorance or not knowing the principles of accounting. Sometime, errors may be due to cheating by accountant or other employees. In that case rectification of errors is so difficult because cheaters try their best to hide the error. At that time, investigation should be done by independent auditor. In this lesson you will learn about locating, classifying and analyzing accounting errors and their rectification. You know that Trial Balance is prepared to verify the arithmetical accuracy of accounting records. When the Trial Balance does not tally it means there are errors in the books of account. In this you learnt about the errors that affect the Trial Balance and also studied the procedure for locating such errors. In the process of rechecking, a number of errors are detected. These errors must be rectified before preparing the final accounts. In this unit you will learn about the method of rectifying various errors and study the effect of the rectification on the profit of the business. You are advised to go through lesson once again and note the errors that are usually committed in the process of recording various transactions in subsidiary books and their postings.

11.1.1 Definition

- Rectification of errors may be defined as correction of errors which had been done in the books of accounts of company due to ignorance or not knowing the principles of accounting. Sometime, errors may be due to cheating by accountant or other employees. In that case rectification of errors is so difficult because cheaters try their

best to hide the error. At that time, investigation should be done by independent auditor.

- Requirements for the accounting for and reporting of a change in accounting principle, change in accounting estimate, change in reporting entity or the correction of a transaction. Accounting Changes and Error Correction is a pronouncement made by the Financial Accounting Standards Board (FASB) and is a Statement of Financial Accounting Standards (SFAS). It outlines the rules for correcting and applying changes to financial statements. This pronouncement, Number 154, replaced FASB Statement No. 3 and the Accounting Principle Board (APB) Opinion No. 20. It was issued in May 2005.

11.2 Errors

The trial balance is prepared to check the arithmetical accuracy of accounts. If the trial balance does not tally, it implies that there are arithmetical errors in the accounts which require location, detection and rectification thereof. Even if the trial balances tallies, there may still some errors.

There are two types of errors:

- (a) Errors which are not revealed by the trial balance,
 - (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. 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

Errors can be classified into the following four categories on the basis of the nature of errors and explained here under.

- i. Errors of commission
- ii. Errors of omission
- iii. Errors of principle
- iv. Compensating (offsetting) errors.

11.2.1 Errors of Commission

These errors by definition are of clerical nature. These errors may be committed at the time of recording and/or posting. At the time of recording, the wrong amount may be recorded in journal which will be carried throughout. Such errors will not affect the agreement of the trial balance. These errors may also be committed at the time of posting, by way of posting wrong amount, to the wrong side of an account or in the wrong account. The errors resulting in posting to wrong account will not affect agreement of trial balance, whereas, other errors of posting will resulting disagreement of trial balance.

For example, an amount of Rs.10,000 received from customer (Debtor) is correctly recorded on the debit side of the cash book but while posting, the customer's account is credited with Rs.1,000. This is an error, which is committed at the time of posting, by posting wrong amount to the account. This will result in disagreement of trial balance, since, the credit total of the trail balance will be short by Rs. 9,000.

11.2.2 Errors of Omission

The errors of omission may be committed at the time of recording the transaction in the books of original entry or while posting to the ledger. An omission may be complete or partial. Such errors are known as errors of omission. For example, Machinery purchased for Rs. 50,000 by issuing a cheque is recorded first in the credit side of cash book, in the bank column. Suppose it is not posted to the debit of machinery account, it is an error of partial omission. The trial balance will not tally. Suppose the transaction is not entered in the cash book and hence ignored completely, this is a case of complete omission. It means as if the

transaction has not taken place at all. It will not affect the trial balance and hence the trial balance will tally. This is true only in case of complete omission.

11.2.3 Errors of Principle

Accounting entries are recorded as per the generally accepted accounting principles. If any of these principles are violated or ignored, errors resulting from such violations are known as errors of principle. As an illustration, Periodicity principle requires maintaining proper distinction between capital and revenue items. An error of principle may occur due to incorrect classification of expenditure or receipts between capital and revenue. This is very important because it will have an impact on financial statements. It may lead to under/over stating of income or assets or liabilities, etc. For example, amount spent on additions to the buildings should be treated as capital expenditure and must be debited to the asset account. Instead, if this amount is debited to maintenance and repairs account, it is treated as a revenue expense. This is an error of principle. Since instead of asset account, i.e. buildings, the maintenance and repairs account (expense) is debited, the trial balance will still tally but would not be correct as per generally accepted accounting principles. Such errors are not disclosed by the trial balance. This will result in understating of income due to extra charge under maintenance and repairs account and understating the value of buildings in the balance sheet.

11.2.4 Compensating Errors

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. They do not affect the tallying of the trial balance. For example: In a credit sale transaction, the sales account is credited in excess by say, Rs.5,000 and similarly the suppliers account in case of a credit purchase is understated by Rs.5,000, this is a case of two errors compensating for each other's effect. It is to be noted that extra credit to the sales account is offset by lower credit to the creditor's account, both being credit balance. Since, one plus is set off by the other minus, the net effect of these two errors being of compensating nature and do not affect the agreement of trial balance.

Classification of Errors – for the Purpose of Rectification

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.

11.3 Rectification of errors

Any error when located must be rectified. However, the rectification should not be made by overwriting or by striking off the wrong entry. This would destroy the authenticity of the books of account. Hence, the errors should always be corrected by making suitable entries called rectifying entries. For purposes of rectification the errors are divided into two categories:

- (i) One-sided errors,
- (ii) Two-sided errors.

One-sided Errors: Certain errors affect only one side of an account, either the debit side or the credit side. Such errors are called 'one-sided errors'. Examples of one-sided errors are:

- i) Rs. 100 received from Deshmukh was posted to his account as Rs. 10. It means Deshmukh's Account has been credited with Rs. 10 instead of Rs. 100 and there is no mistake in the Cash Book. Thus, this error has affected only one side of an account.
- ii) The Purchases Book is overcast by Rs. 1,000. This will affect the debit side of Purchases Account where the total of the Purchases Book is posted, and no other account is affected.

Two-sided Errors: Certain errors may affect two or more accounts. Such errors are called 'two-sided errors'. Examples of two-sided errors are:

- (i) A credit sale of Rs. 1,080 to Anand was wrongly recorded in the Sales Book for Rs. 1,800. This error will affect two accounts via. Anand's Account and Sales Account. Anand's Account has been debited by Rs. 1,800 instead of Rs. 1,080. The Sales Account has also been credited by an additional amount of Rs. 720 (Rs. 1,800-Rs. 1,080), the Sales Book will show a higher total.
- (ii) A sale of Rs. 500 made to Kamal has been posted on the debit side of Kishore's Account. This error will affect two accounts viz., Kamal's Account and Kishore's Account. An entry of Rs. 500 does not appear on the debit side of Kamal's Account whereas Kishore's Account has been wrongly debited with that amount.

11.3.1 Rectification of One-sided Errors

Generally errors are corrected by passing suitable journal entries. You know passing a journal entry means debiting one account and crediting another. But in the case of one-sided error only one account is involved. So it cannot be corrected by passing journal entry. It is rectified by noting the correction on the appropriate side. Take the first example of one-sided error. Deshmukh's Account was credited short by Rs. 90. This will be corrected by an additional entry for Rs. 90 on the credit side of his account as follows:

Deshmukh's Account

Dr.

Cr.

	By Difference in amount received from him posted on	Rs. 90
--	--	------------------

In the second example of one-sided error, the Purchases Account is debited in excess by Rs. 1,000. This will be corrected by crediting the Purchases Account with Rs. 1,000 as follows:

Purchase amount

Dr.

Cr.

	By Over casting of Purchases Book for the month of . . .	Rs. 1000
--	---	--------------------

The wrong total in the Purchases Book will be circled with red ink and the correct total entered above or below the circle. The person doing the rectification will also put his initials.

Let us take a few more examples of one-sided errors and study how they will be rectified.

- 1. The Sales Returns Book for the month of June was under cast by Rs. 10:** You know the periodical total of the Sales Returns Book is posted to the debit side of Sales Returns Account. So, a mistake in totaling the Sales Returns Book will affect only the Sales Returns Account. It has been debited short by Rs. 10. So, this error can be corrected by an additional entry for Rs. 10 on the debit side of Sales Returns Account as shown below:

Sales return amount

Dr.

Cr.

To Under casting of Sales Returns Book for the month of June	Rs.10 ..
---	-----------------

2. A payment of Rs. 1,000 towards interest was posted twice to Interest Account:

You know when interest is paid it is recorded on the credit side of the Cash Book and posted on the debit side of Interest Account. The error lies in repeating the posting to interest -Account. Thus, it has affected only the Interest Account which now shows an excess debit of Rs. 1,000. This will be corrected by crediting the Interest Account with Rs. 1,000 as follows:

Interest amount

Dr.		Cr.
	By Double posting from Cash Book on . now, rectified.	Rs. 1000

3. A receipt of Rs. 300 towards commission was omitted to be posted: You know receipt of commission is recorded on the debit side of cash book and posted on the credit side of the commission account. The error lies in omitting to post. Hence it has not been credited by Rs. 300. This error can be corrected by making the posted as below.

Commission amount

Dr.		Cr.
	By Omission of posting from Cash Book	Rs. 300

4. A credit sale for Rs. 1,000 to Tiwari was posted to the credit side of his account:

You know a credit sale is entered in the Sales Book and posted on the debit side of the customer's account from the Sales Book. This error relates to posting on wrong side of

Tiwari's Account. His account should have been debited and not credited. To correct this error, we have not only to remove the wrong credit of Rs. 1,000 from his account but also give a debit of Rs. 1,000 to his account. Hence, the error can be rectified by debiting Tiwari's Account with double the amount i.e. Rs. 2,000 as shown below:

Tiwari's amount	
Dr.	Cr.
To Posting of sales made to him on credit side on ... now rectified	Rs.2000. .

11.3.2 Rectification of Two-sided Errors

You have learnt that one-sided errors are corrected by noting the correction on the appropriate side of the account affected by the error. They cannot be rectified by suitable journal entries because only one account was involved. Two-sided errors are mostly rectified by journal entries. It is because such errors affect two or more accounts and in most cases the debit and credit are equally affected. Take the case of first example of two-sided errors given earlier. A credit sale of Rs. 1,080 to Anand was wrongly recorded in the Sales Book as Rs. 1,800. The two accounts affected are:

- (i) Anand's Account which shows an excess debit of Rs. 720, and
- (ii) Sales Account which stands credited in excess by Rs. 720. To rectify this error we must credit Anand's Account with RS. 720 and debit the Sales Account with Rs. 720. So, a journal entry can be passed as follows:

	Rs.	Rs.
Sales Account	Dr. 720	
To Anand		720
(Being sales of Rs. 1,080 to Anand wrongly recorded in the Sales Book as Rs. 1,800 now rectified)		

Take the second example of two-sided errors given earlier. A sale of Rs. 500 made to Kamal was posted to the debit side of Kishore's Account. The two accounts affected are:

- (i) Kamal's Account which has not been debited by Rs. 500, and
- (ii) Kishore's Account which has been wrongly debited with Rs. 500.

To rectify this error we have to debit Kamal's Account with Rs. 500 and credit Kishore's Account with Rs. 500. So, journal entry for the rectification of this error will be as follows

		Rs .
Rs.		
Kamal	Dr.	500
To Kishore		500
(Being rectification of wrong debit to Kishore for sale made to kamal)		

11.4 Effect of rectifying entries on Profits

You have seen that the creation of Suspense Account helps in tallying the Trial Balance and avoiding delay in the preparation of final accounts. The errors still remain to be detected and rectified. So, the Profit and Loss Account prepared from such Trial Balance is subject to the undetected errors. The profit thus arrived at may be less or more than the actual profits. Similarly, when the errors are detected and rectified during the next year, the rectifying entries will have their effect on the profit of the next year. The profit is affected only if the errors involve accounts which usually appear in the Trading and Profit and Loss Account (nominal accounts) and not those which appear in the Balance Sheet (real and personal accounts).

Let us understand it with the help of an example. Suppose Rs. 24,000 paid for salaries during 1986 was posted to the Salaries Account as Rs. 20,400. This error has resulted in short debit of Rs. 3,600 to Salaries Account and so the salaries charged to Profit and Loss Account are short by Rs. 3,600. This would overstate the profits of 1986. When this error will be detected in 1987 and the rectifying entry passed, Rs. 3,600 will be added to salaries of 1987 and so the profit of 1987 will be decreased by Rs. 3,600.

Thus, both the errors and the rectifying entries affect the profit. The effect of rectifying entries will be the reverse of the effect of errors.

Table 11.1
Effect of Errors and Rectifying Entries on Profits

Nature of error in nominal account	Effect of error on profit	Effect of Rectifying Entry on Profit
Excess debit	Reduces	increases
Excess credit	Increases	reduces
Short debit	Increases	reduces
Short credit	Reduces	increases
Omission of debit	Increases	reduces
Omission of credit	Reduces	increases

11.5 Rectification of accounting errors

By now you must have understood well that every business enterprise prepares its financial statements to provide information of profit earned or loss incurred by it during an accounting period and its financial position on the relevant date. This information will be most useful only if the information is accurate. How can the business concern achieve this objective if there are number of errors in the accounting? Your immediate response will be that errors in accounts should be detected at the earliest and be corrected before preparing the financial statements.

It should be clear in your mind that the errors should never be rectified by erasing or overwriting because it will encourage manipulations and frauds in accounts. In accounting practice there are some definite methods to rectify the accounting errors. These are based on accounting practices and procedures. Rectification of errors using these methods is called rectification of accounting errors. So it is a process of rectification. It is generally done by passing an entry to nullify the effect of error.

11.6 Methods of rectification of accounting errors

Before preparing Trial Balance

- (i) Instant correction
- (ii) Correction in the affected account

After preparing Trial Balance

Before preparing Trial Balance

(i) Instant correction

If the error is detected immediately after making an accounting entry, it may be corrected by neatly crossing out the wrong entry and making the correct entry and the accountant should put his initials. For example, an amount of Rs. 3500 is written as Rs. 5300. This can be corrected as 3500.

(iii) Correction in the affected accounts

In case error is detected on a date later than the date on which the transaction was recorded but before the Trial Balance, the rectification will be made by making a correction in the affected account.

11.7 Rectification of errors through suspense Account

You have learnt that the Trial Balance prepared at the end of a period by the business concern must agree. It means the sum of its debit column and sum of credit column should agree. But if the totals do not agree the difference amount is written in a new account. This account is called Suspense Account. If the total of the debit side of the Trial Balance is more than the total of its credit side, the difference amount will be written in Suspense A/c on its credit side i.e. Suspense A/c is credited and vice-versa. You have also learnt that the two sides of the Trial Balance do not agree because there is some error or errors in the accounts, which is reflected in the Suspense Account. Thus, Suspense A/c is a summarized account of errors. Opening of a Suspense Account is a temporary arrangement. As soon as the error that has led to Suspense Account is rectified, this account will disappear. One point needs to be noted that Suspense A/c is the result of one sided errors. So one sided errors are corrected through Suspense A/c. completing the double entry when an error is corrected by placing the correct amount on the debit of the proper account, the credit is placed in Suspense Account or vice-a-versa.

For example, Gopal's Account was debited short by Rs.100. The error will be rectified through Suspense A/c by debiting Gopal A/c and crediting Suspense A/c by Rs.100.

Journal entry for the same is as follows :

Gopal	Dr.	100	
	To Suspense A/c		100

(Gopal's A/c debited short
is now corrected)

Similarly, while correcting as one sided error the proper account is credited with the correct amount, the debit is placed in the Suspense A/c. For example, Sales Book for December, 2006 is undercast by Rs. 500. The error will be rectified by debiting Suspense A/c and crediting Sales A/c

Journal Entry for the same will be as follows :

Suspense A/c	Dr	500	
	To Sales A/c		500

(Sales Book under cast is rectified)

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 assumes 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.

11.8 Solved Examples

Example: 1

Rectify the following errors :

Cash sales Rs. 16,000

- (i) were not posted to sales account.
- (ii) were posted as Rs. 6,000 in sales account.
- (iii) were posted to commission account.

Solution

(i)

Suspense A/c	Dr.		16,000
To Sales A/c			16,000

(Cash sales not posted to sales account now rectified)

(ii)

Suspense A/c	Dr.	10,000	
	To Sales A/c		10,000

(Cash sales Rs. 16,000 were posted to sales account as Rs. 6,000, now rectified)

(iii)

Commission A/c	Dr.	16,000	
	To Sales A/c		16,000

(Cash sales posted to commission account instead of sales account, now corrected)

Example 2.

Depreciation written-off as the machinery Rs. 2,000

- (i) was not posted
- (ii) was not posted to machinery account
- (iii) was not posted to depreciation account

Solution

- (i) It was recorded through journal proper. From journal proper posting to all the accounts are made individually. Hence, no posting was made to depreciation account and machinery account. Therefore, rectification entry will be :

Depreciation A/c	Dr.	2,000	
	To Machinery A/c		2,000

(Depreciation on machinery not posted, now corrected)

In this case posting was not made to machinery account. It is to be assumed that depreciation account should have been correctly debited. Therefore, rectification entry shall be :

Suspense A/c	Dr.	2,000	
	To Machinery A/c		2,000

(Depreciation on machinery not posted to Machinery account, now corrected).

-
- (ii) In this case depreciation account was not been debited. However, machinery account must have been correctly credited. Therefore, rectification entry shall be :

Depreciation A/c	Dr.	2,000
To Suspense A/c		2,000

(Depreciation on machinery not posted to Depreciation account, now corrected).

11.9 Summary

Mistakes committed in the accounting treatment knowingly or unknowingly are known as Errors. These errors may be regarding omission, commission, principle and compensating. Maintenance and auditing of accounts is a continuous process. If errors are detected before ledger accounts are closed, rectification of errors is made in the concerned account by debiting or crediting as per requirement. Errors detected after preparation of final accounts are rectified in such a way , that profit or loss of the current year is not affected. In order to achieve this objective profit and loss adjustment is debited or credited as the case may be.

11.10 Key words

One-sided error : An error which affects the debit or credit side of one account only.

Profit and Loss Adjustment Account: An account opened for avoiding the effect of rectifying entries in respect of previous year's errors on the profit or loss of the current year.

Suspense Account: An account opened to make the Trial Balance tally temporarily. It represents the net effect of undetected one-sided errors.

Two-sided errors: An error which involves two or more accounts and both the debit and credit aspects.

11.11 Check your progress questions

True and Flase

1. It is incorrect to debit repairs account for the amount spent on the repairs of car purchased second hand.
2. Purchases account will be credited for goods taken by the proprietor for personal use.

3. Errors of principles can be detected by trial balance.
4. Undercasting purchase book is error of omission.
5. Errors of complete omission are detected by trial balance.
6. Errors of principle do not affect the trial balance.
7. In case of compensating error one error neutralizes the effect of other error.
8. The equality of debit and credit of trial balance does not mean that the individual accounts are also accurate.

11.12 Answers to check your progress questions

1. F, 2. T, 3.F, 4. T, 5.F,6.T, 7.T, 8.T

11.13 Terminal Questions

1. What are one-sided errors? Give five examples. Explain the method of rectifying one-sided errors?
2. What are two-sided errors? Give five examples and show how two-sided errors are corrected?
3. Explain the rectification of errors through suspense account?
4. What are accounting errors? Give example and method of rectifying of accounting errors?

11.14 References

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11.15 Numerical Questions

1. Rectify the following errors:

- (i) Credit sales to Mohan Rs. 7,000 were not recorded.
- (ii) Credit purchases from Rohan Rs. 9,000 were not recorded.
- (iii) Goods returned to Rakesh Rs. 4,000 were not recorded.
- (iv) Goods returned from Mahesh Rs. 1,000 were not recorded.

2. Rectify the following errors :

- (i) Credit sales to Mohan Rs. 7,000 were recorded as Rs.700.
- (ii) Credit purchases from Rohan Rs. 9,000 were recorded. as Rs.900.
- (iii)Goods returned to Rakesh Rs. 4,000 were recorded as Rs 400.
- (iv)Goods returned from Mahesh Rs. 1,000 were recorded as Rs.100.

3. Rectify the following errors:

- (i) Credit Sales to Mohan Rs. 7,000 were recorded in purchases book.
- (ii) Credit Purchases from Rohan Rs. 9,00 were recorded in sales book.
- (iii) Goods returned to Rakesh Rs. 4,000 were recorded in the sales return book.
- (iv) Goods returned from Mahesh Rs. 1,000 were recorded in purchases return book.
- (v) Goods returned from Nahesh Rs. 2,000 were recorded in purchases book.

4. Rectify the following errors and ascertain the amount of difference in trial balance by preparing suspense account:

- (a) Credit sales to Mohan Rs. 7,000 were not posted.
- (b) Credit purchases from Rohan Rs. 9,000 were not posted.
- (c) Goods returned to Rakesh Rs. 4,000 were not posted.
- (d) Goods returned from Mahesh Rs. 1,000 were not posted.
- (e) Cash paid to Ganesh Rs. 3,000 was not posted.

(f) Cash sales Rs. 2,000 were not posted.

(Ans : Difference in trial balance Rs. 2,000 excess credit).

5. Rectify the following errors assuming that a suspense account was opened. Ascertain the difference in trial balance.

- (i) Credit sales to Mohan Rs. 7,000 were posted to Karan as Rs. 5,000.
- (ii) Credit purchases from Rohan Rs. 9,000 were posted to the debit of Gobind as Rs 10,000.
- (iii) Goods returned to Rakesh Rs. 4,000 were posted to the credit of Naresh as Rs 3,000.
- (iv) Goods returned from Mahesh Rs. 1,000 were posted to the debit of Manish as Rs. 2,000.
- (v) Cash sales Rs. 2,000 were posted to commission account as Rs. 200.

(Ans : Difference in trial balance Rs. 14, 800 excess debit).

6. Rectify the following errors assuming that suspense account was opened. Ascertain the difference in trial balance.

- (i) Credit sales to Mohan Rs. 7,000 were recorded in Purchase Book. However, Mohan's account was correctly debited.
- (ii) Credit purchases from Rohan Rs. 9,000 were recorded in sales book. However, Rohan's account was correctly credited.
- (iii) Goods returned to Rakesh Rs. 4,000 were recorded in sales return book. However, Rakesh's account was correctly debited.
- (iv) Goods returned from Mahesh Rs. 1,000 were recorded through purchases return book. However, Mahesh's account was correctly credited.
- (v) Goods returned to Naresh Rs. 2,000 were recorded through purchases book. However, Naresh's account was correctly debited.

(Ans : Difference in trial balance Rs. 6,000 excess debit).

Unit-12

ADJUSTMENT ENTRIES

- 12.1 Introduction
- 12.2 Adjusting Process
- 12.3 Adjusting Entries
 - 12.3.1 Accruals
 - 12.3.2 Deferrals
- 12.4 Summary
- 12.5 Glossary
- 12.6 Check your progress
- 12.7 Answers to check your progress
- 12.8 Terminal Questions
- 12.9 Reference

Objectives

After studying this unit you should be able to:

- explain why adjustment entries are necessary at the time of preparing the final accounts
- list the items in respect of which adjustments are usually made
- pass adjustment entries

12.1 Introduction

Adjustment entries are accounting journal entries that convert a company's accounting records to the accrual basis of accounting. An adjusting journal entry is typically made just prior to issuing a company's financial statements.

The accrual method of accounting says that we should try to match revenues and expenses at the time we record revenues. It also says that we should try to match revenues and expenses (and hence income) to an accounting period. An accounting period is the period of time over which income is calculated. National Construction has an accounting period of one year. This means that we should make adjustments to the financial statements at the end of the year to try and make the income figure as realistic and accurate as possible for that one year. For instance, Brown knows that he owes some interest on his loans, but this has not been recorded yet because he hasn't received a statement from the bank. This interest expense should be recorded at the end of his current year, or the income calculated for the year will be larger than it should be, and smaller the next year when the interest expense is finally taken into account.

Every adjusting entry has an associated journal entry that involves the recordation of cash. The cash is recorded either before or after the adjusting journal entry. *Recorded* and *unrecorded* refer to the timing of the cash payment or cash receipt which is recorded in the journal. Recorded adjusting journal entries come after the recording of the cash payment or cash receipt. Unrecorded adjusting journal entries come before the recording of the cash payment or cash receipt. The cash payment or cash receipt can be recorded in two ways: before or after the adjusting entry is recorded.

The cash payment or cash receipt can be made before the recorded adjusting journal entry into either a permanent (real or balance sheet) account (i.e., asset or liability account) or a temporary (nominal or income statement) account (i.e., expense or revenue account). Recorded adjusting entries are alternately referred to as deferred. Deferred is defined as the aligning (matching) of recorded costs and revenues with appropriate periods, where cash has previously been received or disbursed, but revenue has not been earned nor has expense been incurred.

The preferred recordation of the disbursement of an advance payment for products to be used or services to be performed or delivered in the future is into an asset account. This asset account could be called prepaid expense or deferred expense, but is most often more specific as to the type of expense, such as Unexpired Insurance. These accounts appear in the asset account section of the balance sheet and do not affect or appear in the income statement until the product is used or service is performed.

The preferred method of recording the cash is into a permanent account, so that the expense can be apportioned or deferred into the correct period, where the revenue is earned or the expense is used in the production of revenue. The alternate method, where the cash is recorded into an expense or revenue account at the time the cash is received or disbursed, will require a “correcting” adjusting entry to apportion the expense or revenue and to establish the corresponding asset or liability account to be apportioned in future periods. If Brown had wanted accurate monthly income figures, he would have had to choose an accounting period of one month and would have had to adjust the financial statements at the end of every month. Most companies actually do choose an accounting period of one month. The adjusting entries are recorded in the journal in the same way as any other journal entry and the same rules apply. With a manual accounting system, adjusting entries are usually done after the trial balance is prepared and proven to be correct. After the adjusting entries are posted to the ledger accounts, an adjusted trial balance is prepared to ensure that no posting or adding mistakes have been made. The financial statements are then prepared.

12.2 Adjusting Process

During an accounting period, a business keeps a record of all its transactions. At the end of this period, it totals these transactions to produce an income statement and then calculate the changes to the assets and liabilities listed on its balance sheet. However, the business may have acquired assets or liabilities that are either not reflected in the records of transactions or are not accurately reflected. The business makes a series of accounting entries to put this right. For Examples, A prominent example of adjusting entries is that made to the accounts receivable and accounts payable. This means the money the company is owed by customers and owes to suppliers. The adjusting entries process here involves looking through records to find any purchases or supplies that have taken place, but where the invoice for payments has not yet been received or issued. Another example is with prepayment, such as for insurance or rent. If the company has paid a flat amount to cover a period of time but this extends into the next accounting period, adjusting entries are needed. This involves working out what proportion of the payment covered the current period; the rest of the payment can't be classed as an expense yet, meaning total expenses

on the income statement must be reduced appropriately. A less-obvious example comes where a customer has paid in advance for a service or product the business has not yet provided. An adjusting entry is needed to reflect the fact that the company owes goods or services to the value of the payment, and thus the amount must be listed as a liability on the balance sheet.

You have learnt about the preparation of final accounts (Trading and Profit and Loss Account and the Balance Sheet) without any adjustments. Before preparing the final accounts, it is necessary to find out whether the books of account contain a complete record of all transactions relating to the year for which they are being prepared. In practice, generally, the accounts do not contain all items of expenses and incomes which relate to the current year. They may, on the other hand, contain certain items which relate to the next year. Therefore, while preparing the final accounts it becomes necessary to make certain adjustments in respect of some items of expense and incomes. In this unit you will learn

- (i) which are the items that need adjustment,
- (ii) how such adjustments are made in the books of account, and
- (iii) how final accounts are prepared with various adjustments.

12.3 Adjusting Entries

Adjusting entries are journal entries made at the end of the accounting period to allocate revenue and expenses to the period in which they actually are applicable. Adjusting entries are required because normal journal entries are based on actual transactions, and the date on which these transactions occur may not be the date required to fulfill the matching principle of accrual accounting. The two major types of adjusting entries are:

- **Accruals:** for revenues and expenses that are matched to dates before the transaction has been recorded. On the other hand, accrued items are those for which the firm has been realizing revenue or expense without yet observing an actual transaction that would result in a journal entry. For example, consider the case of salaried employees who are paid on the first of the month for the salary they earned over the previous month. Each day of the month, the firm accrues an additional liability in the form of salaries to be paid on the first day of the next month,

but the transaction does not actually occur until the pay checks are issued on the first of the month. In order to report the expense in the period in which it was incurred, an adjusting entry is made at the end of the month. For example, in the case of a small company accruing Rs.80,000 in monthly salaries, the journal entry might look like the following:

Date	Account Titles & Explanation	Debit	Credit
9/30	Salary expense	80,000	
	To Salaries payable		80,000
	(Salaries accrued in September, to be paid on Oct 1.)		

In theory, the accrued salary could be recorded each day, but daily updates of such accruals on a large scale would be costly and would serve little purpose - the adjustment only is needed at the end of the period for which the financial statements are being prepared. Some accrued items for which adjusting entries may be made include:

- Salaries
- Past-due expenses
- Income tax expense
- Interest income
- Unbilled revenue

- **Deferrals:** for revenues and expenses that are matched to dates after the transaction has been recorded. Deferred items are those for which the firm has recorded the transaction as a journal entry, but has not yet realized the revenue or expense associated with that journal entry. In other words, the recognition of deferred items is postponed until a later accounting period. An example of a deferred item would be prepaid insurance. Suppose the firm prepays a 12-month insurance policy on Sep 1. Because the insurance is a prepaid expense, the journal entry on Sep 1 would look like the following:

Date	Account Titles & Explanation	Debit	Credit
9/1	Prepaid Expenses	12,000	
	To Cash		12,000

(12-month prepaid insurance policy)

The result of this entry is that the insurance policy becomes an asset in the Prepaid Expenses account. At the end of September, this asset will be adjusted to reflect the amount "consumed" during the month. The adjusting entry would be:

Date	Account Titles & Explanation	Debit	Credit
9/30	Insurance Expense	1,000	
	To Prepaid Expenses		1,000
	(Insurance expense for September)		

This adjusting entry transfers Rs.1000 from the Prepaid Expenses asset account to the Insurance Expense account to properly record the insurance expense for the month of September. In this example, a similar adjusting entry would be made for each subsequent month until the insurance policy expires 11 months later. Some deferred items for which adjusting entries would be made include:

- Prepaid insurance
- Prepaid rent
- Office supplies
- Depreciation
- Unearned revenue

▪ **Categories of Adjusting Entries**

The two basic categories of adjusting entries are prepaid and *accruals*. In a prepaid adjustment, the cash payment occurs before an expense is recorded or the cash receipt occurs before the revenue is earned. Prepaid are also called deferrals because the recognition of revenue or expense is deferred to a date after the cash is received or paid. Accrual adjustments are the opposite. An accrual records an expense before the cash payment or it records the revenue before the cash is received. Adjusting entries fall into five types:

	Prepayments (Deferral - cash paid or	Accrual - cash paid or
--	--------------------------------------	------------------------

	received before consumption	received after consumption
Expenses	Prepaid expenses: for expenses paid in cash and recorded as assets before they are used	Accrued expenses: for expenses incurred but not yet paid in cash or recorded
Revenues	Unearned revenue: for revenues received in cash and recorded as liabilities before they are earned	Accrued revenues: for revenues earned but not yet recorded or received in cash

- **Prepaid Expenses**

Prepaid expenses are assets that have been paid for but which will become expenses over time. Insurance is a good example. An insurance policy is an asset. It is paid for in advance, will last for a period of time, and expires on a fixed date. You buy insurance to cover you for the whole year, so you should allocate its cost evenly over the year.

When National Construction bought one year of truck insurance on August 1, 1995 Brown made this journal entry to record it:

Aug 1, 95	Prepaid Insurance	1450	2,000	
	Cash in Bank	1020		2,000
	(Truck Insurance expiring 31 July 96)			

At his year end he must make an adjusting entry to expense the amount of insurance used up between Aug. 1, 1995 and Jan. 31, 1996. Six months of insurance has been used, so the expense is $6/12 \times \text{Rs.}2,000 = \text{Rs.}1,000$. The adjusting entry to record this requires an Insurance Expense account and reduces the balance of the Prepaid Insurance account:

Jan 31, 96	Insurance Expense	5240	1,000	
	Prepaid Insurance	1450		1,000
	(Adjustment for prepaid insurance)			

- **Use of Supplies**

Maintenance supplies are used up throughout the year. It is therefore necessary to record their use as an expense. The way to determine the amount of the expense is to physically take an inventory of what is left at the end of the accounting period.

Since the balance of the Maintenance Supplies account tells us how much should be there, we can subtract the ending inventory and determine how much was used. Brown takes an inventory of National's maintenance supplies on January 31, 1996 and finds that what is left is worth Rs.300. He then knows that he used up Rs.700 worth of supplies because the account balance told him that there should have been Rs.1,000 worth of supplies there. This is because he had debited the account for Rs.1,000 when he purchased the supplies.

His journal entry to expense the supplies and reduce the Maintenance Supplies account balance to what is really left is:

Jan 31, 96	Truck Maintenance Expense	5080	700	
	Maintenance Supplies	1400		700
	(Adjustment for supplies used)			

- **Depreciation**

Equipment deteriorates during use and therefore loses value each year. Part of the cost of the equipment should be allocated as an expense to each year's operation benefiting from its use. This allocation of the cost of a piece of equipment over its useful life is called depreciation.

Brown determines a fair allocation of the cost of his equipment over its useful life and determines these depreciation figures for the year ended January 31, 1996: Trucks – Rs.8,000; Construction Equipment – Rs.5,000; and Buildings – Rs.4,000. Rather than simply reduce the balance of the Trucks, Construction Equipment and Buildings accounts on the balance sheet, more information is provided if we create accounts called Accumulated Depreciation for each, which have credit balances for the same reasons as the Allowance for Doubtful Accounts account.

On the balance sheet the Trucks account would look like this:

Fixed Assets		
Trucks	32,000	
Less: Accumulated Depreciation	8,000	
Trucks: net		24,000

Here the "net" means net of depreciation.

The journal entries to adjust the statements for the depreciation expense are:

Jan 31, 96	Depreciation Expense	5100	8,000	
	Accumulated Depreciation – Trucks	1610		8,000
	(To record '95's depreciation)			
Jan 31, 96	Depreciation Expense	5100	5,000	
	Accumulated Depreciation – Eqpt.	1610		5,000
	(To record '95's depreciation)			
Jan 31, 96	Depreciation Expense	5100	4000	
	Accumulated Depreciation – Bldgs.	1610		4,000

- **Accrued Expenses**

Some expenses have accrued (been incurred even though National hasn't yet received a bill or invoice from the supplier of the goods or services) by year end. National owes its employees wages of Rs.1,000 because it is one week before payday, and Brown's banker tells him that by January 31, 1996 National's loans had accumulated unpaid interest as follows:

Mortgage – Rs.600; Bank Loan – Rs.300 and Operating Loan – Rs.100. The adjusting entries to record these unpaid, but accrued, expenses are:

Jan 31, 96	Wage Expense	5020	1,000	
	Wages Payable	2060		1,000
	(Adjusting entry for accrued wages)			

Jan 31, 96	Interest Expense – Mortgage	5140	600	
	Interest Expense – Bank Loan	5160	300	
	Interest Expense – Operating Loan	5180	100	
	Interest Payable.	2020		1,000
	(Adjusting entry for accrued interest)			

When these accrued expenses are actually paid (for instance, National pays its Rs.2,000 payroll on February 7) Brown must consider the amount that he has already expensed in an adjusting entry (Rs.1,000 wage expense on January 31) to be sure that he doesn't count it twice.

In this case the journal entry to record the actual payment of wages would be:

Feb 7, 96	Wage Expense	5020	1,000	
	Wages Payable	2060	1,000	
	Cash in Bank	1020		2,000
	(Wage expense and payment after Jan. 31.)			

Another option is to reverse the adjusting entry and then enter the wage transaction as if the adjusting entry had never been made. Such an entry (like the first one below) is called a reversing entry.

Feb 7, 96	Wages Payable	2060	1,000	
	Wage Expense	5020		1,000
	(To reverse adjusting entry of Jan 31.)			
Feb 7, 96	Wage Expense	5020	2,000	
	Cash in Bank	1020		2,000
	(Wages to Feb. 7, 1996.)			

- **Accrued Revenues**

Some revenues have been earned by year end even though National hasn't invoiced a customer or received payment. A good example is interest accrued on the company's cash in the bank. Brown's banker tells him that National's bank deposits have earned interest of Rs.600 by January 31, 1996, but that the bank won't pay the interest until the middle of the next month.

The adjusting entry to record this earned, but unpaid, interest is:

Jan 31, 96	Interest Receivable	1100	600	
	Interest Earned on Deposits	4300		600
	(Adjusting entry on accrued interest earned)			

When, on February 15, National is paid interest of Rs.700, including the Rs.600 that has already been recorded as Interest Earned and Interest Receivable, the journal entry is:

Feb 15, 96	Cash in Bank	1020	700	
	Interest Receivable	1100		600
	Interest Earned on Deposits	4030		100
	(Interest earned, receivable and paid.)			

- **Unearned Revenues**

Some businesses collect cash from customers in advance of performing work. Receiving cash before earning it creates a liability to perform work in the future called **unearned revenue**. The company owes a product or a service to the customer, or it owes the customer his or her money back. Only after completing the job will the business *earn* the revenue. Because of this delay, unearned revenue is also called **deferred revenue**. Unearned revenue occurs when the company is paid cash before it does all the work to earn it.

- **Bad debts**

You know when goods are sold on credit, the personal account of the buyer is debited and so he becomes a debtor to the business. Later, when he pays the amount due from him, his personal account is credited. His account thus stands closed. Sometimes, a debtor fails to pay his debt either partially or completely. The amount of debt which cannot be recovered from the debtor is

called 'Bad Debt'. It is a loss to the business and so must be charged to Profit and Loss Account. The following journal entry is passed when a debt becomes bad.

Bad Debts Account	Dr.
To Concerned Debtor's Account	
(Being bad debts)	

The effect of this entry will be: (i) debtor's personal account stands closed, and (ii) a new account called Bad Debts Account is opened in the books.

The total amount of bad debts incurred during the year appears as a separate item in the Trial Balance and the Sundry Debtors appear at reduced amount. The Bad Debts Account, like any other account of expenses on losses, is transferred to the Profit and Loss Account by means of the following closing entry.

Profit and Loss Account	Dr.
To Bad Debts Account	
(Being bad debts transferred to Profit and Loss Account)	

- **Bad Debts given Outside the Trial Balance:** Sometimes, the bad debts to be written off may be stated outside the Trial Balance as an adjustment item. It means that such bad debts have not been written off. For convenience, we may call them 'further bad debts'. It is necessary to record such bad debts at the time of preparing the Final Accounts. This is done by passing the following adjustment entry.

Bad Debts Account	Dr.
To Sundry Debtors	
(Being bad debts written off)	

Such additional bad debts are treated in the final accounts as follows:

- i) **On the debit side of Profit and Loss Account** as addition to Bad Debts already written off.
- ii) **On the assets side of the Balance Sheet** as deduction from Sundry Debtors

It is important to understand the difference between the treatment of bad debts given inside the Trial Balance and the bad debts given outside the Trial Balance. You know that the bad debts given in Trial Balance are those bad debts which have been written off during the accounting year. It means that the accounts of the concerned debtors have already been closed. Hence, such bad debts are not to be deducted from Sundry Debtors in the Balance Sheet. They will be shown only in the Profit and Loss Account the bad debts given outside the Trial Balance (further bad debts) are still to be written off. The entry for writing off such bad debts is to be recorded at the time of preparing final accounts and both the debit and the credit affects will appear in the final accounts as explained earlier. Thus, the bad debts given in the Trial Balance and also those given outside the Trial Balance will be shown in the Profit and Loss Account. But only those bad debts will be deducted from Sundry Debtors in the Balance Sheet which are given outside the Trial Balance.

- **Provision for bad debts**

In any business where goods are sold on credit, bad debts usually occur. When it is certain that a debt will not be recovered, the amount is written off as bad debt. But, it is also likely that some of the remaining debts may not be recovered in full. From experience we know that certain percentage of amounts due from debtors may not be recovered. This will be a loss to the business. You have learnt that according to Conservatism Concept all possible losses must be provided for. Hence it is a common practice to make a suitable provision for doubtful debts at the time of preparing the final accounts. Otherwise, the Profit and Loss Account will not reveal the correct amount of profit or loss and the Balance Sheet will not show the true position of Sundry Debtors. The provision for doubtful debts is usually calculated as a certain percentage of the total amount due from Sundry Debtors after writing off all known bad debts.

Provision for doubtful debts is also called 'Provision for Bad Debts' or 'Provision for Bad and Doubtful Debts'. Such provision is made by debiting the amount of doubtful debts to the Profit and Loss Account thus, the journal entry for creating such provision will be as follows.

- Additional bad debts are irrecoverable debts in addition to what has been shown in the Trial Balance as bad debts
- Provision for bad and doubtful debts is created for future payments due from debtors but seems to be irrecoverable. It is created on the basis of past experiences.

12.5 Glossary

- **Adjustment Entry:** Journal entry passed to make an adjustment in the relevant accounts.
- **Adjustment Item:** An item given outside the Trial Balance which requires adjustment at the time of preparing final accounts.
- **Adjusted Purchases:** Amount of purchases after adjusting both the opening and closing stocks.
- **Bad Debts:** Debts which cannot be recovered.
- **Depreciation:** A permanent decrease in the value of a fixed asset caused by wear and tear or the passage of time.
- **Doubtful Debts:** Debts of doubtful recovery.
- **Outstanding Expenses:** Expenses incurred during the accounting year but not yet paid.
- **Outstanding Incomes:** Incomes earned during the accounting year but not yet received.
- **Prepaid Expenses:** Expenses paid but the benefit of which is yet to be received.
- **Provision for Bad Debts:** A provision made for loss expected to arise from doubtful debts.
- **Provision for Discount on creditors:** A provision made for the anticipated gains on account of discounts receivable from creditors.
- **Provision for Discount on Debtors:** A provision made for discounts likely to be allowed to debtors.
- **Unearned Incomes:** Income in respect of which the services are yet to be rendered.

12.6 Check your progress

True and False

1. Prepaid expenses are assets of the business.
2. Unearned income is the liability of the business.
3. Accrued income or income due but not received are two different things.
4. Unearned income means income received in advance.

12.7 Answers to check your progress

1. T, 2. T, 3. F, 4. T

12.8 Terminal Questions

- What is meant types by Adjustment Entries and explain of adjusting entries?
- Elaborate the different categories for adjusting entries?
- Differentiate between the accruals and deferrals entries?
- Define bad debts. Also explain the provision of bad debts?
- Differentiate between accrued revenues and unearned revenues?

Exercise

On 1st April, 2006 reserve for Bad Debts shows a balance of Rs. 3200 Bad debts during the year as per ledger were Rs.2100. Debtors amounted to Rs 7000. After closing of the ledger, it was found that there were bad debts of Rs. 800. It was decided to create a reserve for doubtful debts on creditors @6%.

Make necessary journal entries and show the items in Profit & loss account and Balance Sheet.

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Unit-13

Capital and Revenue Transactions, Reserves and Provisions

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- 13.14 References

Learning Objectives

After going through this Unit, you will be able to :

- Learn the criteria for identifying Revenue expenditure and distinguish it from capital expenditure.
- Learn the difference between Revenue Expenditure and Deferred Revenue Expenditure.
- Learn the distinction between capital and revenue receipts.

13.1 Introduction

In accounting capital and revenue items are different. All the revenue items are recorded in trading and profit & loss account and capital items are recorded in balance sheet. If these are not recorded properly then neither trading and profit & loss account would depict true profit nor would loss nor balance sheet depict true financial position. Hence for the knowledge of true financial result of business it is necessary to differentiate between two.

For a company, this is the total amount of money received by the company for goods sold or services provided during a certain time period. It also includes all net sales, exchange of assets; interest and any other increase in owner's equity and is calculated before any expenses are subtracted. Net income can be calculated by subtracting expenses from revenue. In terms of reporting revenue in a company's financial statements, different companies consider revenue to be received, or "recognized", different ways. For example, revenue could be recognized when a deal is signed, when the money is received, when the services are provided, or at other times. There are rules specifying when revenue should be recognized in different situations for companies using different accounting methods, such as cash basis and accrual basis accounting.

For the government, the increase in assets of governmental funds that do not increase liability or recovery of expenditure. This revenue is obtained from taxes, licenses and fees.

13.1.1 Definition

- Revenue expense is costs in day to day running of the business for example servicing a machine, spare parts etc. Revenue expenditure is normally charged against profit in the Income statement in the year it is expensed.
- Capital expenditure is on an item that will help generate profits over the longer term (12 months or more) so a purchase of a machine or van etc. The item is depreciated

over the items useful life and each depreciate able amount is charged to the Income statement in the year the item has help generate profit.

- Capital transactions are those that involve fixed assets ... for example the purchase of a machine. This would not appear in the profit and loss account, but would be reflected in the balance sheet.
- Revenue transactions are those that are involved with the profit making activity - the goods sold or materials purchased and the incidental costs that are incurred making the profit. These expenses will appear in the profit and loss account.
- A transaction affecting non-current items such as fixed assets, long-term debt, or share capital, rather than revenue transactions.
- Revenue is spending on day-to-day items to run services, such as staffing, supplies and purchase of services from a variety of external providers.

13.2 Expenditure Items

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

Expenditure on:

1. Purchase of goods
2. Wages
3. Purchase of raw material
4. Import duty
5. Coal , gas, water, oil, heating and lighting
6. Salaries
7. Rent, rates , taxes
8. Stationary and printing
9. Repairs and renewals
10. Depreciation on fixed assets
11. Office expense
12. Research and development

13.3 Types of expenditure

- 1. Capital Expenditure**
- 2. Revenue Expenditure**
- 3. Deferred Revenue Expenditure**

13.3.3 Capital Expenditure

Funds used by a company to acquire or upgrade physical assets such as property, industrial buildings or equipment. This type of outlay is made by companies to maintain or increase the scope of their operations. These expenditures can include everything from repairing a roof to building a brand new factory. The amount of capital expenditures a company is likely to have depends on the industry it occupies. Some of the most capital intensive industries include oil, telecom and utilities.

In terms of accounting, an expense is considered to be a capital expenditure when the asset is a newly purchased capital asset or an investment that improves the useful life of an existing capital asset. If an expense is a capital expenditure, it needs to be capitalized; this requires the company to spread the cost of the expenditure over the useful life of the asset. If, however, the expense is one that maintains the asset at its current condition, the cost is deducted fully in the year of the expense. The various types of capital expenditure are explained as under:

- **Expenditure which results in the acquisition of a permanent asset:**

All assets mean anything which can be converted into cash later. All money spent for acquiring an asset is capital expenditure.

- **Expenditure in connection with the purchase, receipt or erection of a fixed asset:**

All expenses, in addition to the purchase price, incurred for making the asset ready for use are added to the cost of the asset and thus this expenditure are called capital expenditure. Expenditure of this type are wages paid to workers for erecting machines, the cost of the platform on which the machine will be fixed, overhaul of second-hand machines purchased, interest on the loan raised to purchase a fixed asset, etc.

- **Expenditure for the extension of or improvement in fixed assets:**

If because of any expenditure the profit earning capacity is increased, through lowering cost or increasing output the expenditure will be capital expenditure.

- **Expenditure incurred to acquire the right to carry on business:**

The expenses necessary for either establishing the business, like preliminary expenses for floating a company, or obtaining license will be capital expenditure. Similarly the cost of a patent that is the right to produce certain goods in a certain manner will be capital expenditure.

Expenditure incurred to acquire a tangible asset:

Even if the asset does not prove to be profitable, the expenditure incurred on it is treated as capital expenditure.

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.

13.3.4 Revenue Expenditure:

All the expenditures which are incurred in the day to day conduct and administration of a business and the effect-of which is completely exhausted within the current accounting year are known as "**revenue expenditures**". These expenditures are recurring by nature i.e. which are incurred for meeting day today requirements of a business and the effect of these expenditures is always short-lived i.e. the benefit thereof is enjoyed by the business within the current accounting year. These expenditures are also known as "expenses or expired costs." e.g. Purchase of goods, salaries paid, postages, rent, traveling expenses, stationery purchased, wages paid on goods purchased etc.

This expenditure is incurred on items or services which are useful to the business but are used up in less than one year and, therefore, only temporarily increase the profit-making capacity of the business.

Revenue expenditure also includes the expenditure incurred for the purchase of raw material and stores required for manufacturing saleable goods and the expenditure incurred to

maintain the- fixed assets in proper working conditions i.e. repair of machinery, building, furniture etc.

Increase in the assets of an organization or the decrease in liabilities during an accounting period, primarily from the organization's operating activities. This may include sales of products (sales), rendering of services (revenues), and earnings from interest, dividends, lease income, and royalties. In Government Accounting, the gross receipts and receivables from taxes, customs, etc., without consideration of appropriations and allotments and the examples of revenue expenditure given below

1. Wages paid to factory workers.
2. Oil to lubricate machines.
3. Power required to running machine or motor.
4. Expenditure incurred in the ordinary conduct and administration of business, i.e. rent, carriage on saleable goods, salaries, wages manufacturing expenses, commission, legal expenses, insurance, advertisement, free samples, postage, printing charges etc.
5. Repair and maintenance expenses incurred on fixed assets.
6. Cost of saleable goods.
7. Depreciation of fixed assets used in the business.
8. Interest on borrowed money.
9. Freight, cartage, octroi duty, transportation, insurance paid on saleable goods.
10. Petrol consumed in motor vehicles.
11. Service charges to motor vehicles.
12. Bad debts.

13.3.5 Deferred Revenue Expenditure

Sometimes, some expenditure is of revenue nature but its benefit likely to be derived over a number of years. Such expenditure is called deferred revenue expenditure. The two examples of deferred revenue expenditure and their treatment in final accounts: When a new firm enters in to market, it undertakes special advertising campaign on which it spends heavy amount. The benefit of this expenditure will certainly come in some future years. Hence it

will not be justified to charge this expenditure only in the profit and loss account of the year in which it incurred. This expenditure must be spread over the period over which the benefit is likely to last. Suppose this expenditure will cover 3 years. Hence 1/3 of the expenditure must be charged to each year Profit and Loss Account.

13.3.6 Revenue V/s. Deferred Revenue

Revenue expenditure is that which is incurred in anticipation of generating future income for not more than one yr for example- exp incurred in sales promotion and advertisement of an enterprise. Whereas deferred revenue exp. are those for which payment has been made or a liability has been incurred on the presumption that it will be of benefit over a subsequent period or periods.

13.4 Difference between Capital Expenditure and Revenue Expenditures

S. No	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.	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 expenditure.	Neither an asset is acquired nor is the value of an asset increased.
3	It does not occur again and again - it is non-recurring and irregular.	It occurs repeatedly - It is recurring and regular.
4	Generally, it has physical existence i.e., it can be seen with eyes.	It has no physical existence, i.e., it cannot be seen with eyes.
5	This expenditure improves the position of the concern.	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.	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.	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	It reduces revenue. Payment of salaries to employees decreases revenue.

	not affect revenue.	
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13.4.1 Capitalized Receipts and Revenue Receipts:

Receipts refer to the actual amounts of cash received. They can be either of capital nature or revenue nature.

Capital receipts include the following:

1. Capital brought in by the proprietor at the commencement and any additions made subsequently.
2. Money borrowed from partners, bankers, private individuals etc.
3. Money received by the sale of fixed assets.
4. Money received on account of capital profit.

Revenue receipts include the following:

1. Money received by the sale of floating assets - by sale of goods.
2. Money received on account of some revenue profit.

Distinction between Capital Receipt and Revenue Receipt:

Revenue Receipt	Capital Receipt
<ol style="list-style-type: none"> 1. It has short-term effect. The benefit is enjoyed within one accounting period. 2. It occurs repeatedly. It is recurring and regular. 3. It is shown in profit and loss account on the credit side. 4. It does not produce capital receipt. 5. This does not increase or decrease the value of asset or liability. 6. Sometimes, expenses of capital nature are to be incurred for revenue receipt, e.g. purchase of shares of a company is capital expenditure but dividend received on shares is a revenue receipt. 	<ol style="list-style-type: none"> 1. It has long-term effect. The benefit is enjoyed for many years in future. 2. It does not occur again and again. It is nonrecurring and irregular. 3. It is shown in the Balance Sheet on the liability side. 4. Capital receipt, when invested, produces revenue receipt e.g. when capital is invested by the owner, business gets revenue receipt (i.e. sale proceeds of goods etc.). 5. The capital receipt decreases the value of asset or increases the value of liability e.g. sale of a fixed asset, loan from bank etc. 6. Sometimes expenses of revenue nature are to be incurred for such receipt e.g. on obtaining loan (a capital receipt) interest is paid until its repayment.

13.4.2 Capital Payment and Revenue Payments:

Capital payment is an amount paid on account of some capital expenditure and a **revenue payment** is an amount actually paid on account of some revenue expenditure. Expenditure is

the full amount incurred whether paid or not, whilst payments refer to the amount actually paid and for example, if a building is purchased for Rs.20,000 from X and Rs.10,000 is paid in cash and the remaining sum to be paid after six months; Rs.20,000 is capital expenditure, but Rs.10,000 is only capital payment. Similarly if goods are purchased from X for 30,000 and Rs.15,000 is paid in cash; Rs.30,000 is revenue expenditure but only Rs.15,000 is revenue payment.

13.4.3 Capital Profit and Revenue Profits:

Capital profit means a profit made on the sale of a fixed asset or profit earned on raising monies for the business. For example a building purchased for Rs.20,000 is sold for Rs.25,000 the profit Rs.5,000 thus made is a capital profit and Revenue profit on the other hand is a profit made by the business e.g., profit on the sale of goods, income from investments, commission earned etc.

Whenever, capital profit is made it should either be transferred to the capital account of the proprietor or credited to capital reserve account which would appear as a liability on the balance sheet. But capital profits should in no case be transferred to profit and loss account because it is non-trading profit. Revenue profits on the other hand should be transferred to profit and loss account because they arise out of regular trading operation.

13.4.4 Capital Losses and Revenue Losses:

Capital loss means a loss made on the sale of a fixed asset or a loss incurred in connection with the raising of money for business. Capital loss may be shown as an asset in the balance sheet. But as this asset is a fictitious nature, it would advisable to write off it. Revenue loss, on the other hand, is the loss incurred in trading operations such as loss on the sale of goods. Revenue losses are charged to profit and loss account of the year in which they occur.

13.4.5 Capitalized or Deferred Revenue Expenditures:

Where a certain revenue expenditure incurred is of such a nature that its benefit is likely to be spread over a certain number of years, or where it is of non-recurring and special nature and large in amount, in such circumstances, instead of debiting the entire amount to the profit and loss account of the year in which it has been incurred, it may be spread over a number of years, a proportionate amount being charged to each year's profit and loss account. The remaining portion of the expenditure is carried forward and is known as capital expenditure or deferred revenue expenditure and is shown as an asset in the balance sheet. Item such as

preliminary expenses, costs of issue of debentures are examples that may be classified under this head.

13.5 Exceptions to General rules

There are certain expenses which are usually of revenue in nature but under certain circumstances they become capital expenditures. The following are the examples of expenses which are usually revenue but under certain circumstances become capital.

13.5.1 Legal Charges

These are, as a rule, revenue charges, but legal charges incurred in connection with the purchase of a fixed asset are capital expenditures as they form an additional cost of the asset acquired.

13.5.2 Wages

Wages are ordinary a revenue expenditure. But in a manufacturing business where the firm's own men are employed in making of fixed asset, the wages paid for such purpose would be capitalized. For example if the firm's own men are employed in making extension to the factory building or in erection of plant or manufacturing tools for own requirements. the wages and salaries paid to the persons are not revenue but capital expenditures.

13.5.3 Brokerage and Stamp Duty:

Normally these are revenue expenditures, but brokerage paid on acquisition of a property and stamp duty involved thereon can be capitalized.

13.5.4 Freight and Carriage:

This is revenue charge, but freight and carriage paid on newly acquired plant or fixed assets are capital expenditures.

13.5.5 Advertising

Ordinarily amount expended on advertising is revenue charge but the cost of special advertising undertaken for the purpose of introducing a new line of goods may be capitalized.

13.5.6 Development Expense:

In concern like collieries, mines, tea, rubber etc., all expenses incurred during the period of development are treated as capital.

13.5.7 Preliminary Expenses:

These are the expenses incurred in connection with the formation of a public company. These expenses although are revenue in nature but are allowed to be capitalized and can be shown as an asset in the balance sheet.

Illustration:

Do you consider the following to be capital or revenue items? Give reasons.

1. Amount contributed by the proprietor as his capital.
2. Amount realized from sale of old furniture.
3. Money borrowed from a bank to acquire fixed assets.
4. Amount received from a debtor whose account was previously written off as bad.
5. Rs.20,000 received from sale of old machinery which had cost Rs.12,000.
6. A motor car, whose book value is Rs.8,000 was sold for Rs.60,000.
7. Received Rs.2,00,000 from the sale of shares of a company.
8. Expenses on issue of shares amounted to Rs.2,500.
9. Plant and Machinery which stood in books at Rs.7,50,000, included a machine at book value of Rs.1,50,000. This being obsolete was sold off for Rs.50,000 and was replaced by a new machine which costs Rs.2,40,000.
10. The fixtures and fittings appeared in the books at Rs.75,000. Of these some portion of the book value of Rs.15,000 was discarded and sold off for Rs.16,000 and new i furniture was acquired for Rs.12,000.

Solution:

No.	Nature of Items	Reasons
1.	Capital Receipt.	Amount contributed by the proprietor in his business is a capital receipt because the benefit of this receipt will be enjoyed for a long-period of time by the business
2.	Capital Receipt.	When furniture was purchased it was a capital expenditure. Therefore, the sale of furniture will be a capital receipt now.
3.	Capital Receipt.	Money is borrowed to acquire fixed assets that will benefit the business for many years, so it is a capital receipt.
4.	Revenue Receipt.	When debtor's account was previously written off, it was treated as a revenue loss (expenditure), now, amount received from him will be treated as a revenue receipt.
5.	(a) Rs.20,000, Capital Receipt (b) Rs.8000, Capital Profit.	Furniture of Rs.12,000 was sold for Rs.20,000 and there was a profit of Rs.8,000. Therefore, Rs.20,000 is a Capital Receipt and the profit of Rs.8,000 is regarded as Capital Profit.

6.	(a) Capital Receipt Rs.60,000 (b) Capital loss Rs.20,000	A motor car of the book value of Rs.80,000 is sold for Rs.60,000 and so there is a loss of Rs.20,000. The full amount received Rs.60,000 is a capital receipt and loss of Rs.20,000 is a capital loss, because this is not a loss which occurred in the ordinary course of the business.
7.	Capital Receipt	Amount received from sale of share is a capital receipt because it will benefit for a long-period of time.
8.	Capital Expenditure.	Amount spent on issue of shares is a capital expenditure because it is incurred to raise the capital of the business.
9.	(a) Capital Receipt Rs.50,000 (b)Capital Expenditure Rs. 2,40,000.	Amount received on sale of a portion of plant and machinery is treated as capital receipt (Rs.50,000) and Rs.1,00,000, the difference between the book value of the machine sold and the amount realized on sale will have to be charged off to revenue as depreciation. Rs.2,40,000, the cost of new machinery is treated as a capital expenditure.
10.	(a) Capital Receipt Rs.16000 (b) Capital Profit Rs.1,000 (c) Capital Expenditure Rs. 12,000	Rs.1,000, the difference between the book value of fixture and fitting discarded and the amount received on sale of them will be treated as capital profit and Rs.12,000, the cost of new fixture etc. is a capital expenditure. The total value realized Rs.16,000 from sale is treated as a capital receipt.

13.5.8 Revenue Expenditures are not treated as Revenue Expenditures:

There are some items of expenditure which are revenue by nature, yet they are not regarded as revenue expenditure. Such expenditures may be divided into two groups:

1. Deferred revenue expenditure
2. Capitalized revenue expenditure

13.5.9 Deferred Revenue Expenditure

This is a revenue expenditure, the benefit of which is not confined to one accounting year - it extends to future accounting year or years also. However, this expenditure does not result in the acquisition of any fixed asset. For example, heavy advertisement expenditure is incurred on introduction of a new product in the market. This is revenue expenditure in nature and the benefit is enjoyed by the business over a number of years, but no asset of permanent nature is acquired. A portion of this expenditure is treated as revenue expenditure chargeable in the current accounting year and the remaining portion is temporarily treated as capital expenditure and shown on the Asset side of the Balance Sheet. Below are a few examples of such expenditure:

- (a) Expenditure incurred to the formation of a joint stock company i.e. Preliminary Expenses.
- (b) Expenditure on research and experiment connected with the introduction of a new product.
- (c) Heavy expenditure on advertisement for marketing a new product.
- (d) Heavy expenditure on repairs to property.
- (e) Expenditure on removal of business from one place to another place.

13.6 Capitalized Expenditure

Some expenditure although of revenue natures basically, are directly connected with fixed assets and spent directly on the acquisition of fixed assets. Such expenditures are added to the cost of assets and are called "Capitalized Expenditures". For example, we buy a second-hand plant for Rs.50,000. This is undoubtedly a capital expenditure. A further sum of Rs.5,000 is spent on its repair and overhauling in order to bring the plant into proper working order. Expenditure on account of repair and overhauling, although revenue by nature, will be treated as Capital Expenditure in this case and will be debited to plant account not to Repairs A/c. Thus, a revenue expenditure which increases the utility or productive capacity of an asset is treated as capitalized expenditure. Below are a few examples of such expenditure:

- (a) Expenditure on installing an asset. i.e. installation charges.
- (b) Expenditure on repair to property, if the production capacity or utility of the property is increased. It may, however, be noted that sometimes a new asset may require some repair after its purchase but before it is installed and put into operation. Cost of such repair, although it may not increase the production capacity of the asset, will be treated as a capitalized expenditure.
- (c) Expenditure incidental to purchase of fixed assets, e.g. freight, clearing charges, customs duty, carriage, octroi duty and import duty on assets purchased.
- (d) Expenditure on removal of old property.
- (e) Cost of repair to second-hand assets: Repair is revenue expenditure. But the cost of repair after buying a second-hand asset to bring them into proper working condition is treated as Capitalized Expenditure.

- (f) Wages: It is revenue expenditure but if paid for installation of a machine or plant, then it is treated as a capitalized expenditure.
- (g) Legal Charges: Legal charges i.e. lawyer's fee, court fee in connection with the purchase of asset of permanent nature are regarded as capital expenditure.
- (h) Interest: Interest paid is generally revenue expenditure. But in some industries like iron & steel, cement industry etc., a concern has to wait for a long period before it starts operation. Interest for such period on capital and loan is treated as capital expenditure.

Illustration:

State with reasons whether the following should be considered as deferred revenue expenditure or capitalized expenditure.

1. Preliminary expenses paid in the formation of a company.
2. Heavy advertisement expenses paid to introduce a new product in the market.
3. Wages paid for the installation of machinery.
4. Carriage paid on the purchase of machinery.
5. Cost of overhauling and painting a second-hand truck newly-purchased.
6. Research and experimental expenses to introduce a new product.

Solution:

No.	Nature of Expenditure	Reason
1.	Deferred revenue expenditure.	At the time of formation of a company certain expenses are incurred which are revenue by nature e.g. cost of preparing documents, registration fee, cost of stamp etc. Such expenditures are large in amount and it will be logical to spread such expenditures over a number of years.
2.	Deferred revenue expenditure.	It is ordinarily revenue expenditure. But if heavy advertisement expenses are paid to introduce a new product, then, the benefit will be received for a number of years, so it is treated as deferred revenue expenditure.
3.	Capitalized expenditure or capital expenditure.	This expenditure is regarded as a part of the cost of machinery, so it is regarded as a capitalized expenditure.
4.	Capitalized expenditure.	Carriage paid on machinery is also regarded as an additional cost of the machinery, therefore, treated as a expenditure.
5.	Capitalized expenditure.	Cost of overhauling and painting is incurred to bring the second-band truck into proper working

		order, so it is regarded as capitalized expenditure.
6.	Deferred revenue expenditure.	The benefit of this expenditure will be enjoyed for many years, so it is regarded as a deferred revenue expenditure.

Note: Both deferred revenue expenditure and capitalized expenditure are shown on the asset side of the Balance Sheet.

Illustration

State with reasons whether the following items of expenditure are capital or revenue.

(i) Wages paid on the purchase of goods.	(ii) Carriage paid on goods purchased.
(iii) Transportation paid on machinery purchased.	(iv) Octroi duty paid on machinery.
(v) Octroi duty paid on goods.	(vi) A second-hand car was purchased for Rs.7,000 and Rs.5,000 were spent for its repairs and overhauling.
(vii) Office building was whitewashed at a cost of Rs.3,000.	(viii) A new machinery was purchased for Rs.80,000 and a sum of Rs.1,000 was spent on its installation and erection.
(ix) Books were purchased for Rs.50,000 and Rs.1,000 were paid for carrying books to the library.	(x) Land was purchased for Rs.1,00,000 and Rs.5,000 were paid for legal expenses.
(xi) Rs.50,000 were paid for customs duty and freight on machinery purchased from Japan.	(xii) Old furniture was repaired at a cost of Rs.500.
(xiii) An additional room was constructed at a cost of Rs.15,000.	(xiv) Damages paid on account of the breach of contract to supply certain goods.
(xv) Cost of replacement of an old and worn out part of machinery.	(xvi) Repairs to a motor car met with an accident.
(xvii) Rs.10,000 paid for improving a machinery.	(xviii) Cost of removing plant and machinery to a new site.
(xix) Cost of acquiring the goodwill of an old firm.	(xx) Cost of redecorating a cinema hall.
(xxi) Cost of putting up a gallery in a cinema hall.	(xxii) Compensation paid to a director for loss of his office.
(xxiii) Premium paid on the redemption of debentures.	(xxiv) Costs of attending a mortgage.
(xxv) Commission paid on issue of debentures.	(xxvi) Cost of air-conditioning the office of the director of a company.
(xxvii) Repairs and renewal of machinery.	(xxviii) Cost of acquiring patent rights and trademarks.
(xxix) Compensation paid to workers for termination of their services.	(xxx) Compensation paid to a person injured by company's car.
(xxxi) Expenditures incurred on alteration in windows ordered by municipal authorities.	(xxxii) Painting expenditures of a newly-constructed factory.
(xxxiii) Expenditures incurred on renewal of patent.	(xxxiv) Expenditures on replacement of a slate roof by a glass roof.
(xxxv) Rs.10,000 spent on dismantling,	(xxxvi) Legal expenses incurred in an income

removing and reinstalling machinery and fixtures.	tax appeal.
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Solution:

Sr. No.	Nature of Expenditure	Reasons
(i)	Revenue expenditure	Wages paid on goods purchased and revenue expenditure because goods purchased are meant for resale. It is recurring by nature as goods are purchased repeatedly in a business.
(ii)	Revenue expenditure.	The carriage paid on purchases is revenue expenditure because goods purchased are meant for resale and whenever goods are purchased carriage is paid to bring the goods to the warehouse of the business.
(iii)	Capital expenditure.	Machinery purchased is useless until it is brought to the business. As machinery is a fixed asset and transportation paid is an additional cost to the machinery, so it is a capital expenditure.
(iv)	Capital expenditure.	Octroi duty paid on machinery is also an additional cost to the machinery, If it is not paid, the machinery cannot be taken to the business, so it is a capital expenditure.
(v)	Revenue expenditure.	Octroi duty paid on goods is revenue expenditure because goods mean saleable goods. It is recurring and is paid repeatedly whenever goods are purchased.
(vi)	Capital expenditure.	A second-hand car is a fixed asset as it "can be used for many years and its utility does not diminish in one year, so it is a capital expenditure. But it is useless if it is not made good to work, so the amount spent on its repair and overhauling is also a capital expenditure.
(vii)	Revenue expenditure.	Whitewashing of a building is necessary for its maintenance and because of this expenditure the profit earning capacity of the business has not increased, so it is a revenue expenditure.
(viii)	Capital expenditure.	Machinery is a permanent asset of the business and can be used for many years but it will benefit to the business until it is installed and erected at a proper place. So amount spent on purchase of machinery, on its installation and erection is capital expenditure.
(ix)	Capital expenditure.	Fixed asset "Books" has been acquired and can be used for many years. Cost of carrying books is regarded as a part of purchase price of the books, so it is a capital expenditure.
(x)	Capital expenditure.	Land purchased is a fixed asset. All expenses' connected with its acquisition are regarded as a part of its purchase price.
(xi)	Capital expenditure.	Machinery is a fixed asset. All expenses connected with its import from Japan are regarded as a part of its purchase price, So it is capital expenditure.
(xii)	Revenue expenditure.	Value of furniture does not increase as a result of its repair -- it is simply kept in a proper working condition.
(xiii)	Capital expenditure	This is an addition to a fixed asset and as a result of this expenditure the value of the building has increased, so it is a

		capital expenditure.
(xiv)	Revenue expenditure.	In this case the goods have not been supplied by the business to the customer according to the contract between them. The customer claimed damages which the business paid. It is a usual thing that happens in ordinary course of trading, so it is a revenue expenditure.
(xv)	Revenue Expenditure.	A worn out part of the machinery is simply the cost of repair and maintenance of fixed asset. The value and profit earning capacity of the machinery has not increased in any way, so it is revenue expenditure.
(xvi)	Revenue Expenditure	Cost of repair to a motor car does not increase the value of the car; it is simply incurred to put back the car into working condition, so it is Revenue expenditure.
(xvii)	Capital expenditure.	Cost has been incurred to 'improve (h machinery. It increases the value and profit earning capacity of the machinery, so it is capital expenditure.
(xviii)	Capital expenditure.	Plant and machinery have been removed to a new site in order to increase their profit-earning capacity, so cost of removal is a capital expenditure.
(xix)	Capital expenditure.	Goodwill is an intangible asset and it will benefit to the business for many years. So cost of acquiring goodwill (using the name of an old firm) is always a capital expenditure.
(xx)	Revenue expenditure.	Generally a cinema hall is decorated regular and re-decorating cost is a recurring expenditure Moreover, it will not add to the capacity of the hall, so it is revenue expenditure.
(xxi)	Capital expenditure.	As a gallery has been put up in the cinema hall, it increases the capacity of the hall, which in turns enhances the profit-earning capacity of the business; therefore, the cost is treated as a capital expenditure.
(xxii)	Revenue expenditure.	Compensation paid to the director of a company, for the loss of his office is revenue expenditure because the company will get the benefit of this expenditure only for one year.
(xxiii)	Capital expenditure.	By issuing debentures, money is borrowed from the public for a long period of time and is used in the purchase of fixed assets or on the expansion of the business; therefore, premium paid is a capital expenditure.
(xxiv)	Capital expenditure.	Mortgage means a deed showing that the money has been borrowed (loan raised) by mortgaging assets as collateral security. The assets will remain mortgaged with the lender until the loan has been repaid. So the assets have been utilized for raising loan and the cost attending the mortgage is, therefore, a capital expenditure.
(xxv)	Capital expenditure.	Debentures are considered as borrowed capital and are used for the acquisition of fixed assets such as machinery etc., therefore, commission paid on issue of debentures is a capital expenditure.
(xxvi)	Capital expenditure.	By making the office of the director, air-conditioned, the efficiency of the director will increase and it will last for many years, so cost of air-conditioning is a capital expenditure.

(xxvii)	Revenue expenditure.	Annual repair and renewal of machinery is necessary to keep it in a proper working condition, therefore, this expenditure is considered as revenue expenditure.
(xxviii)	Capital expenditure.	Patents and trademarks are intangible assets, the benefit of, which is received for many years, so cost of acquiring these assets is a capital expenditure.
(xxix)	Capital expenditure.	By terminating inefficient workers, the business will run more economically and profit-earning capacity of the business will increase, so compensation paid to them is a capital expenditure.
(xxx)	Revenue expenditure.	It happened in the ordinary course of business, so, compensation paid to the injured person is revenue expenditure.
(xxxi)	Revenue expenditure.	This expenditure will add nothing to the value of the building and will have no effect on the profit-earning capacity of the business, so it is revenue expenditure.
(xxxii)	Capital expenditure.	Amount spent on painting a new factory is regarded as a part of the cost of factory building; therefore, it is a capital expenditure.
(xxxiii)	Revenue Expenditure.	If patent is renewed annually, then it is revenue expenditure as it has been incurred in the ordinary course of business.
(xxxiv)	Capital expenditure.	As a slate roof is replaced by a glass roof, it will increase the efficiency of the building and therefore, it is a capital expenditure.
(xxxv)	Revenue Expenditure	Amount of Rs.10,000 spent on dismantling removing and re-installing machinery and fixtures will be treated as revenue expenditure. May be treated as deferred revenue expenditure item and spread over a number of years.
(xxxvi)	Revenue Expenditure	This expenditure has been incurred in the ordinary course of the business being expense o carrying on the business, therefore, it is a revenue expenditure.

13.7 Reserves and Provisions

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 the capital. Examples of reserves are:

- General Reserve
- Workmen Compensation fund

- Investment fluctuation fund
- Capital reserve
- Dividend equalization reserve
- Reserve for redemption of debenture

Provisions: There are 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. It is necessary to make provisions of such items for ascertaining true net profits. 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 principal of Prudence or Conservatism. Therefore, the trader creates a provision for doubtful debts to take care of expected loss at the time of realization from debtors. In a similar way, provisions 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
- Provisions for repairs and renewals.

It must be noted that the amount of provision for expenses and loss is charge against the revenue of the current period. 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. In the balance sheet , the amount of provision may be shown either:

- 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 sundrt debts and provision for depreciation as a deduction from the concerned fixed assets.
- On the liabilities side of the balance sheet along with current liabilities , for example provision for taxes and provision for repairs and renewals.

13.8 Difference between Reserves and Provisions

Basis of Difference	Provision	Reserves
1. Basic nature	Charge against profit.	Appropriation of profit.
2. Purpose	It is created for a known liability or expense pertaining to current accounting period, the amount of which is not certain.	It is made for strengthening the financial position of the business. Some reserves are also mandatory under law.
3 Effect on taxable profits	It reduces taxable profits	It has no effect on taxable profits.
4 Presentations in Balance Sheet	It is shown either i) by way of deduction from the item on the asset side for which it is created, or ii) in the liabilities side along with current liabilities	It is shown on the liabilities side after capital amount.
5 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 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.
6 Use for the payment of dividend	It cannot be used for dividend distribution.	It can be used for dividend distribution.

13.9 Summery

It is important to distinguish between revenue expenditure and a capital expenditure and between a revenue receipt and a capital receipt because only revenue items appear in the final

accounts. **Revenue expenditure:** (1) Revenue Expenditure are considered as an expense and must be debited to the final account, whereas revenue receipts are revenue of the business and must be credited; whereas revenue receipts are revenue of the business and must be credited to the final account. (2) Revenue expenditure is cost incurred for the day-to-day running expenses of the business. They include the purchase of stock for resale, purchase of services such as employee's wages, electricity, water, and cost of carriage of goods, stationery, and depreciation on fixed assets. **Capital Expenditure:** Capital Expenditure is payments for the purchase of assets that can be used over and over again in the business. Normally, such assets can last for more than one accounting period. **Revenue Receipts:** Revenue receipts refer to receipts from the normal activities of the business. For example, revenue receipts of a trading organization are receipts from sale of goods, discounts received, commission received and interest on bank deposits. **Capital receipts:** Capital receipts refer to receipts that are derived from sources other than the normal trading activities of the business. It may comprise capital paid by partners, or in the case of a limited company, sums received from its shareholders or debenture holders, loans and proceeds from the sale of its assets.

13.10 Glossary

Capital Expenditure : When benefit of expenditure extends more than one accounting period, it is termed as capital expenditure.

Revenue Expenditure: it is treated as an expense for the current year.

13.11 Check your Knowledge

Fill in the Blanks

1. Amount spent on creation of machinery is.....expenditure.
2. Revenue expenditure appears in
3. Capital expenditure increase the.....capacity of business.
4. Depreciation of fixed assets isexpenditure.
5. Proper distinction should be made between capital and revenue while preparingof a business at the end of the trading period.

6.expenditure is expenditure the benefit of which would normally be treated as revenue expenditure but it is not written off in one period of accounting as its benefit is not completely exhausted in the year in which it is incurred.

13.12 Answers to check your knowledge

1. capital , 2. Trading and Profit & Loss account, 3. Earning, 4. Revenue 5. Final accounts, 6. Deferred revenue
-

13.13 Terminal Questions

1. What is revenue expenditure? Explain with example.
2. What is capital expenditure? Explain with example.
3. What are capital and revenue receipts? give example
4. Distinguished between capital, revenue and deferred revenue expenditure.
5. Explain the differences between capital and revenue receipts.

13.14 References

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UNIT 14

FINAL ACCOUNTS-INCOME STATEMENT

- 14.1 Introduction
- 14.2 Income Statement
 - 14.2.1 Trading Account
 - 14.2.2 Profit and Loss Account
 - 14.2.3 Explanation of Relevant Items which normally appear in Trading and Profit and Loss Account
 - 14.2.4 Items on the credit side
- 14.3 Process of preparing trading and profit and loss account
 - 14.3.1 Process of Preparation of Trading and Profit and Loss Account (without adjustment)
 - 14.3.2 Preparation of Trading and Profit and Loss Account (With adjustments)
- 14.4 Summary
- 14.5 Glossary
- 14.6 Check your knowledge
- 14.7 Answers to check your knowledge
- 14.8 Self Assessment
- 14.9 Reference

OBJECTIVES

After studying this unit, student will be able to explain:

1. Meaning of Income Statement
2. Need and Role of Income Statement
3. Format of Trading and Profit and Loss Account
4. Difference between Gross Profit and Net Profit
5. Process of preparation(both with adjustments and without adjustment) of Income Statement

14.1 INTRODUCTION

Financial statements viz. Trading and Profit and loss account and Balance Sheet, prepared at the end of accounting year, serve the informational needs of a wide group of shareholders. They are

not just the systematic record of financial transactions of a business maintained to comply with the legal requirements only, financial statements also serves as a tool for evaluating the performance of management, help the prospective investors in assessing the financial performance and financial position of a business, is a source of information for the management which helps it in taking appropriate decisions in time, helps the government in assessing tax liability of the business etc.

The basic objectives of preparing financial statements are:

- (a) Trading and Profit and Loss account is prepared to present a true and fair view of the financial performance of the business;
- (b) Balance Sheet helps to present a true and fair view of the financial position of the business;

For a manufacturer, the financial statements consist of:

- Manufacturing account,
- Trading account
- Profit and loss account
- Profit and loss appropriation account and
- Balance Sheet

This section of the reading material is devoted to basics of Income statement. After studying this section, student will be able to explain the meaning of Income statement, need and role of income statement and process of preparing the income statement.

14.2 INCOME STATEMENT

Meaning : Income statement is composed of two parts i.e. trading account and second Profit and Loss account. It is also known as Trading and Profit and Loss account and is prepared to reveal the status of financial performance of a business in terms of profit earned or loss sustained by it over an accounting period, normally one year. It is prepared on the basis of information contained in the Trial Balance and additional information, if any. To calculate the net figure termed as profit or loss all the incomes and expenses of revenue nature are transferred from the trial balance to

Trading and Profit and Loss account. Profit is revenue less expenses. If expenses are more than revenues, the figure is termed as loss.

14.2.1 Trading Account

The trading account ascertains the result from basic operational activities of the business i.e. manufacturing, purchasing and selling of goods. It is prepared to ascertain whether direct trading business has been profitable or not. The net result of the trading account is either gross profit or Gross loss. Gross profit or loss is calculated after deducting cost of goods sold from net sales. Where cost of goods sold include cost of purchases and other direct expenses.

Direct expenses means all those expenses which are directly connected with the manufacture, purchase of goods and bringing them to the point of sale like carriage inwards, wages, factory lighting, coal, water and royalty on production, etc.

In simple words, Gross profit is the excess of sales over purchases and direct expenses. If the amount of purchases including direct expenses is more than the sales revenue, the end result is gross loss. Gross profit/loss can be calculated through an equation also:

$$\text{Gross Profit} = \text{Sales} - \text{Purchases} + \text{Direct Expenses}$$

14.2.2 Profit and Loss Account

Profit and Loss account is the second part of income statement. It is prepared to find out the net result i.e. Net profit or loss earned from the business. The process of writing of profit and loss account starts with the transfer of Gross Profit or Gross loss to this account from trading account. Thereafter indirect expenses are transferred from the trial balance to the debit side of the profit and loss account and incomes of revenue nature other than sales are transferred to the credit side of the profit and loss account. If the total of the credit side of the profit and loss account is more than the total of the debit side, the difference is the net profit. On the other hand, if the total of the debit

side is more than the total of the credit side, the difference is the net loss incurred by the business firm. Net profit/loss in the form of an equation is shown as follows:

$$\text{Net Profit} = \text{Gross Profit} + \text{Other Incomes} - \text{Indirect Expenses}$$

Net profit or net loss so computed is transferred to the capital account in the balance sheet.

Format of the Trading and Profit and Loss account is as given below:

**Trading and Profit and Loss Account of ABC
for the year ended March 31, 2012**

Dr.	Amount		Cr.
Expenses/Losses	Rs.	Revenues/Gains	Amount
			Rs.
To Opening stock	xxxx	By Sales less return	xxxx
To Purchases less return	xxxx		
To Wages	xxxx		
To Carriage inwards	xxxx		
To Gross profit c/d (Balancing Fig.)	xxxx	By Gross loss b/d(Bal. fig)	xxxx
Total	xxx	Total	xxx
To Gross loss b/d	xxx		
		By Gross profit b/d	xxx
To Rent/rates and taxes	xxx	By Interest received	xxx
To Salaries	xxx		
To Repairs and renewals	xxx	By Net loss	xxx
To Bad debts	xxx		
To Net profit ² (transferred to .. capital account)	xxx		
Total	xxx	Total	xxx

14.2.3 Explanation of Relevant Items which normally appear in Trading and Profit and Loss Account

Trading and profit and loss account is prepared at the end of the accounting period. Only incomes and expenses of revenue nature are considered while preparing this account. Different items appearing in the trading and profit and loss account are explained hereunder:

Items on the debit side

- (i) Opening stock: The first item which appears on the debit side of the trading account is opening stock. It is the stock of goods in hand at the beginning of the accounting year. This is the closing stock of goods of the previous year which has been carried forward and appears in the trial balance.
- (ii) Purchases less Returns: Goods, which have been bought for sale are booked in the purchases account and appear on the debit side of the trading account. Purchases less return means net purchase after deducting from total purchases (cash as well as credit purchases) goods returned back to supplier are recorded. Goods which are returned to suppliers are termed as purchases return.
- (iii) Wages: Remuneration paid to workers who are directly engaged in factory for loading, unloading and production of goods is an expenditure of revenue nature and therefore it is debited to trading account.
- (iv) Carriage Inwards: Carriage Inward refers to expenses incurred on transporting goods from the suppliers place to the place of business. Expenses incurred during the year for brining goods inward to the place of business are debited to the trading account.
- (v) Packaging charges: Cost of packaging material used in the product form part of goods sold and therefore debited to Trading account.
- (vi) Salaries: Salaries paid to the administrative and other supporting staff for the services rendered by them is debited to the profit and loss account. This includes salary paid in kind i.e. in the form of certain facilities such as free meals, rent free accommodation, free uniform, medical and conveyance facility.
- (vii) Rent paid: Amount of rent paid by the business on account of use of premises of someone else is shown on the debit side of the profit and loss account.
- (viii) Interest paid: Interest paid on account of loan taken from Banks or other FIs is an indirect expense and is debited to profit and loss account.

Besides the above stated expenses, expenses on account of repair of machinery etc, commission paid to business agents, depreciation and loss on account of bad debts may also be found on the debit side of the Trading and Profit and Loss of organizations.

14.2.4 Items on the credit side

- (i) Sales less returns: Net sales i.e. total sales made in a year minus sales returned are shown on the credit side of the trading account. Total sales include both cash and credit sales.
- (ii) Other incomes: Besides income on account of sales, other incomes such as interest received, discount received, commission received etc. are also recorded in the profit and loss account.

The above list of incomes and expenses is not exhaustive. In reality, there can be many more other items of incomes and expenses seen in the Trading and Profit and Loss account.

14.3 Process of Preparing Trading and Profit and Loss Account

As discussed earlier, trading and profit and loss account is prepared on the basis of trial balance and additional information, if any. The process of writing the Trading and Profit and loss account is discussed under two different situations i.e.

1. Without Adjustments
2. With Adjustments

The preparation of trading and profit and loss account requires that the balances of all the revenue incomes and expenses are transferred to it from the trial balance. Following closing entries are passed for transferring the revenue receipts and payments to the trial balance.

For transferring and closing the Opening stock account, Purchases account, Wages account, Carriage inwards account and direct expenses account, following entry is passed:

Trading A/c	Dr.
To Opening stock A/c	
To Purchases A/c	
To Wages A/c	
To Carriage inwards A/c	
To All other direct expenses A/c	

Purchase return account is closed by transferring its balance to the purchases account.

Bank	3,000	
Sales		1,45,000
Wages	7,000	
Creditors		20,000
Salaries	25,000	
10% Long term loan		10,000
Furniture	14,000	
Commission received		5,000
Rent of building	23,000	
Debtors	45,000	
Bad debts	5,000	
Purchases	<u>75,000</u>	
Total	<u>2,02,000</u>	<u>2,02,000</u>

Solution

**Trading and Profit and Loss Account of ABC
for the year ended March 31, 2012**

Dr.			Cr.
Expenses/Losses	Amount	Revenues/Gains	Amount
	Rs.		Rs.
To Purchases	75,000	By Sales	1,45,000
To Wages	7,000		
To Gross profit(bf) c/d	63,000		
Total	<u>1,45,000</u>		<u>1,45,000</u>
To Salaries	25,000	By Gross profit b/d	63,000
To Rent of building	23,000	By Commission received	5,000
To Bad debts	5,000		
To Net Profit (transferred to capital account)	15,000		
Total	<u>68,000</u>		<u>68,000</u>

Gross profit, which represents the basic operational activity of the business, is computed as Rs. 63,000. The gross profit is transferred from trading account to profit and loss account. Besides gross profit, business has earned an income of Rs. 5,000 as commission received and has spent Rs. 53,000 (Rs. 25,000 + Rs.23,000 + Rs.5000) on expenses/losses including salaries, rent and bad debts. Therefore, the net profit is calculated as Rs. 15,000.

Closing of the accounts of revenue expenses:

i)	Trading A/c	Dr.	82,000	
		To Purchases A/c		75,000
		To Wages A/c		7,000

ii)	Profit and Loss A/c	Dr.	53,000	
	To Salaries A/c			25,000
	To Rent of building A/c			23,000
	To Bad debts			5,000

Closing of the accounts of revenue incomes:

iii)	Sales A/c	Dr.	1,45,000	
	To Trading A/c			1,45,000
iv)	Commission received A/c	Dr.	5,000	
	To Profit and Loss A/c			5,000

Closing and Opening Stock Adjustments

In illustration no 14.1: It is presumed that there is no opening stock and further all the stock which was purchased during the year has been sold and therefore there is no closing stock. In the absence of opening and closing stock, the total of purchases and direct expenses is taken as Cost of goods sold.

In the example, notice that purchases amount to Rs. 75,000 and wages amount to Rs. 7,000. Hence, the cost of goods sold using the following formula came out to be:

$$\text{Cost of Goods Sold} = \text{Purchases} + \text{Direct Expenses} = \text{Rs. } 75,000 + \text{Rs. } 7,000 = \text{Rs. } 82,000$$

Let us change the above example, assume that out of the goods of Rs. 75,000 purchased in the current year, ABC could sell goods costing Rs. 50,000 only. This means there will be unsold stock of goods costing (closing stock) Rs. 25,000 in hand. The cost of goods sold in this case will be:
 $= \text{Purchases} + \text{Direct Expenses} - \text{Closing Stock} = \text{Rs. } 75,000 + \text{Rs. } 7,000 - \text{Rs. } 25,000 = 57,000$

Gross Profit = Sales – Cost of Goods Sold = 145000 – 57,000 = 88,000. Gross Profit increased from Rs. 63,000 to Rs. 88,000

Trading Account of ABC for the year ended March 31, 2012			
Expenses/Losses	Amount Rs.	Revenues/Gains	Amount Rs.
To Purchases	75,000	By Sales	1,45,000
To Wages	7,000	By Closing stock	25,000
To Gross profit c/d	88,000		
Total	1,70,000	Total	1,70,000

Expenses/Losses	Amount Rs.	Revenues/Gains	Amount Rs.
To Opening stock	1,00,000	By Sales	10,00,000
To Purchases	5,00,000	By Closing stock	3,00,000
To Freight inwards	30,000		
To Wages	10,000		
To Gross profit	6,60,000		
Total	13,00,000	Total	13,00,000

Illustration 14.3

From the below given information, prepare a trading account of M/s. XYZ for the year ended March 31, 2011:

	Rs.
Opening stock	27,000
Purchases	1,25,000
Sales	2,70,000
Wages	30,000
Closing stock	85,000

Solution

**Trading Account of M/s. XYZ
for the year ended March 31, 2011**

Dr.			Cr.
Expenses/Losses	Amount Rs.	Revenues/Gains	Amount Rs.
To Opening stock	27,000	By Sales	2,70,000
To Purchases	1,25,000	By Closing Stock	85,000
To Wages	30,000		
To Gross profit	1,73,000		
Total	3,55,000	Total	3,55,000

Illustration 14.4

From the below given information of M/s Rose Products of the year 2010-11, prepare the trading account.

	Rs.
Opening stock	1,50,000
Purchases	10,000
Return inwards	10,000
Sales	4,00,000
Return outwards	7,000
Factory rent	20,000
Wages	40,000

Solution

**Trading Account of M/s Rose Products
for the year ended March 31, 2011**

Dr.			Cr.
Expenses/Losses	Amount	Revenues/Gains	Amount

	Rs.		Rs.
To Opening stock	1,50,000	By Sales	3,00,000
To Purchases	10,000	Less : Return	<u>10,000</u>
Less:Return Outwards	<u>7,000</u>	inwards	2,90,000
To Factory rent	20,000		
To Wages	40,000		
To Gross profit	77,000		
Total	<u>2,90,000</u>	Total	<u>2,90,000</u>

Illustration 14.5

From the following information, prepare a profit and loss account for the year ending March 31, 2011.

	Rs.
Gross profit	80,000
Rent	15,000
Salary	20,000
Commission paid	5,000
Interest paid on loan	5,000
Advertising	8,000
Discount received	7,000
Printing and stationery	4,000
Legal charges	5,000
Bad debts	3,000
Depreciation	2,000
Interest received	9,000
Loss by fire	2,000

Solution

**Profit and Loss Account
for the year ended March 31, 2011**

Dr.			Cr.
Expenses/Losses	Amount	Revenues/Gains	Amount
	Rs.		Rs.
To Rent	15,000	By Gross profit	80,000
To Salary	20,000	By Discount received	7,000
To Commission	5,000	By Interest received	9,000
To Interest paid on loan	5,000		
To Advertising	8,000		
To Printing and Stationery	4,000		
To Legal charges	5,000		
To Bad debts	3,000		
To Depreciation	2,000		
To Loss by fire	2,000		

To Net profit (transferred to the capital account)	27,000	
	96,000	96,000

Illustration 14.6

From the following balances obtained from the few accounts of M/s. Tikuram. Prepare the Trading and Profit and Loss Account.

	Rs.		Rs.
Stock on Apr. 01, 2010	18,000	Bad debts	200
Purchases for the year	25,000	Rent	600
Sales for the year	47,000	Discount allowed	600
Purchase expenses	2,000	Commission paid	1100
Salaries and wages	500	Sales expenses	600
Advertisement	100	Repairs	600

Closing stock on March 31, 2011 is Rs. 5,500

**Trading and Profit and Loss Account of M/s. Tikuram
for the year ended March 31, 2011**

Dr. Expenses/Losses	Amount Rs.	Revenues/Gains	Cr. Amount Rs.
To Opening stock	18,000	By Sales	47,000
To Purchases	25,000	By Closing stock	5,500
To Purchase expenses	2,000		
To Gross profit c/d	7,500		
Total	52,500	Total	52,500
To Salaries and Wages	500	By Gross profit b/d	7,500
To Rent	600		
To Advertisement	100		
To Commission	1100		
To Discount allowed	600		
To Bad debts	200		
To Sales expenses	600		
To Repairs	600		
To Net profit (Transferred to capital account)	3200		
Total	7500	Total	7500

14.3.2 Preparation of Trading and Profit and Loss Account (With adjustments)

In the previous section on preparation of trial balance without adjustments, you learnt about the preparation of simple final accounts in the format of trading and profit and loss account. The preparation of simple final accounts ignored the accounting complexities which arise because of the requirement of compliance with accrual basis of accounting approach while preparing Income Statement. Accrual basis of accounting requires that while preparing the Income statement revenues be considered on earned basis and not on receipt basis, and the expenses be considered on incurred basis and not on paid basis i.e. only that amount of income and expenses is recorded in the Income statement of a particular year which belongs to that year. e.g. an amount of Rs. 1,000 paid on July 01, 2010 towards insurance premium. We know that general insurance premium paid usually covers a period of 12 months. Suppose the accounting year ends on March 31, 2011, it means that 25% of the insurance premium paid on July 01, 2010 relates to the next accounting year 2011-12. Therefore expense of Rs.750 on account of payment of Insurance Premium will be booked in the trading and profit and loss account of 2010-11 and balance Rs. 250 will be booked in 2011-12

A large number of items are required to be adjusted while preparing the financial statements e.g. salary of March 2011 paid in April 2011 will have to be shown as expense in the Profit and Loss account of 2010-11, similarly electricity bill of Feb-March 2011 paid in April 2011 will have to be booked as expense of Profit and Loss account of 2010-11 etc. Similarly, adjustments will also be required in respect of certain incomes received in advance or those which have accrued but are still to be received. In this section of the unit, we shall discuss the procedure to be followed while preparing Trading and Profit and Loss account when adjustments are required to be made.

The main objective of making various adjustments is to ensure that the final accounts reveal the true profit or loss and the financial position of the business. The items which usually need adjustments include:

1. Closing stock
2. Outstanding/expenses and Prepaid/Unexpired expenses
4. Accrued income and Income received in advance
6. Depreciation

7. Bad debts and Provision for doubtful debts

9. Provision for discount on debts etc.

The information about transactions which need adjustment is given in the form of additional information along with Trial Balance. It is to be noted that since books of accounts are maintained as per double entry system, all adjustments are booked in the final accounts at two places.

In order to make the accounting treatment for adjustments simple for understanding, we have taken the same trial balance of ABC as was taken for Illustration no. 14.1 in this unit. Accounting treatment of all above stated items which need adjustment will be explained through the same trial balance, which is reproduced below:

Trial Balance of ABC as on March 31, 2012				
Account Title	L.F.	Debit Amount Rs.	Credit Amount Rs.	
Cash		5,000		
Capital			22,000	
Bank		3,000		
Sales			1,45,000	
Wages		7,000		
Creditors			20,000	
Salaries		25,000		
10% Long term loan			10,000	
Furniture		14,000		
Commission received			5,000	
Rent of building		23,000		
Debtors		45,000		
Bad debts		5,000		
Purchases		75,000		
	Total	<u>2,02,000</u>		<u>2,02,000</u>

1. Closing Stock

As discussed earlier. Accounting treatment of transactions which need adjustment is reflected at two places. Therefore, the adjustment with regard to the closing stock is done by:

- (i) by crediting it to the trading and profit and loss account,
- (ii) by showing it on the asset side of the balance sheet.

The adjustment entry to be recorded in this regard is:

2. Outstanding Expenses

Outstanding Expenses refers to those expenses of the business enterprise which have become due for payment but has not be discharged yet. Normally almost all businesses have some expenses which, at the end of accounting year, are due for payment but has yet to be paid. As the expense belongs to the current accounting year, it is logical that it should be duly charged against revenue of the current year for computation of the true amount of profit or loss.

Following adjustment entry is passed to record these expenses :

Concerned expense (State the specific name of expenditure viz. salary, electricity etc.) A/c Dr.

To Outstanding expense A/c

The amount of outstanding expenses is added to the total of expenses under a particular head in the trading and profit and loss account.

We will continue with previous example of ABC and use its Trial Balance for explaining the process of adjustment of outstanding expenses.

Illustration 14.8

Assume that ABC owes Rs.1000 as wages relating to the year 2011-12 to one of his employees. It means total expense on account of wages of ABC has been Rs. 8000(7000+1000). The total amount to be booked in this case in trading account is Rs. 8000. For the adjustment of outstanding wages following journal entry will be passed:

Wages A/c Dr. 1000

To Wages outstanding A/c 1000

The amount of outstanding wages will be added to wages account for the preparation of the trading and profit and loss account as shown below:

Trading and Profit and Loss Account of ABC for the year ended March 31, 2012

Dr. Expenses/Losses	Amount Rs.	Revenues/Gains	Cr. Amount Rs.
To Purchases	75,000	By Sales	1,45,000
To Wages		By Closing Stock	20,000
Paid	7000		
Add Wages outstanding 1000	8,000		

To Gross profit (bf) c/d	82,000		
Total	1,65,000		1,65,000
To Salaries	25,000	By Gross profit b/d	82,000
To Rent of building	23,000	By Commission received	5,000
To Bad debts	5000		
To Net Profit (transferred to capital account)	34,000		
Total	87,000		87,000

Note : Second Effect “Outstanding wages will be shown in the Balance Sheet as current liability”.

3. Prepaid Expenses

Prepaid expenses refer to the payments made in advance for the services yet to be availed. In the normal course of business operations, advance payments are made to a large number of parties. In case at the end of accounting year it is found that some payments have been made and the benefit of the recipient of that payment will be realized in the coming time then this payment will be treated as prepaid expense and following adjustment entry is made in respect of prepaid expenses:

Prepaid expense A/c Dr.

To concerned expense A/c

The above entry will have the effect of reducing the particular expense in the trading and profit and loss account.

Illustration 14.9

Let us assume that ABC has paid an amount of Rs 2000 on account of advance salary to one of its new employee who has joined the firm on 31st March. Therefore, the expense on account of salary of ABC for the year 2011-12 is Rs. 23,000 (Rs. 25000 – Rs. 2000). Following journal entry will be passed for the adjustment:

Prepaid salary A/c	Dr.	2,000	
	To salary A/c		2,000

In order to book the correct expenditure on account of salary in the profit and loss account, advance payment will be deducted from salary head in the profit and loss account as shown below:

**Trading and Profit and Loss Account of ABC
for the year ended March 31, 2012**

Dr.		Amount	Revenues/Gains	Cr.
Expenses/Losses		Rs.		Amount
				Rs.
To Purchases		75,000	By Sales	1,45,000
To Wages			By Closing Stock	20,000
Paid	7000			
Add Wages outstanding	<u>1000</u>	8,000		
To Gross profit (bf) c/d		82,000		
Total		1,65,000		1,65,000
To Salaries			By Gross profit b/d	82,000
Paid	25,000			
Less Prepaid	<u>2,000</u>	23,000		
To Rent of building		23,000	By Commission received	5,000
To Bad debts		5,000		
To Net Profit (transferred to capital account)		36,000		
Total		87,000		87,000

Note: Second Effect "Prepaid salary will be shown in the Balance Sheet as current asset".

4. Accrued Income

It refers to those incomes, which have legally become due to the business but has not been received by the end of accounting period. A large variety of accrued incomes are found normally in every kind of business at the end of accounting year. Since the income has become legally due it belongs to the current year only and must be recorded as income in the trading and profit and loss account of the current year. The adjusting entry for recording the accrued income in the current year is :

Accrued income A/c	Dr.
To Concerned income A/c	

This entry will have the effect of increasing the balance in the concerned income account.

In the trading and profit and loss account, to incorporate the adjustment, the amount of accrued income will be added to the related income in the profit and loss account.

Illustration 14.10

Continuing with the example of ABC, Let us, for example, assume that ABC has given some help to a fellow businessman M/s Raj Sons by arranging new business during the year 2011-12 orders on commission. Commission of Rs 3000 due from M/s. Raj Sons is pending on 31-03-2012. This implies that income from commission earned during 2011-12 is Rs. 8,000 (Rs.5,000 + Rs. 3,000).

Following adjustment entry will be passed to give effect to the accrued commission as follows:

Accrued Commission A/c	Dr.	3,000
To Commission A/c		3,000

Effect of accrued commission in trading and profit and loss account will be recorded as follows:

Trading and Profit and Loss Account of ABC for the year ended March 31, 2012

Dr. Expenses/Losses	Amount Rs.	Revenues/Gains	Cr. Amount Rs.
To Purchases	75,000	By Sales	1,45,000
To Wages Paid 7000	8,000	By Closing Stock	20,000
Add Wages outstanding <u>1000</u>	8,000		
To Gross profit (bf) c/d	82,000		
Total	<u>1,65,000</u>		<u>1,65,000</u>
To Salaries Paid 25,000	23,000	By Gross profit b/d	82,000
Less Prepaid <u>2,000</u>	23,000		
To Rent of building	23,000	By Commission Received	5,000
To Bad debts	5,000	Add Accrued	<u>3,000</u>
To Net Profit (transferred to capital account)	39,000		8,000
Total	<u>90,000</u>		<u>90,000</u>

Observe that the accrued income has resulted in an increase in the net profit by Rs. 3000.

Note : Second effect, Accrued Commission will be shown in the balance sheet as current asset.

Paid	25,000		
Less Prepaid	<u>2,000</u>	23,000	
To Rent of building		23,000	By Commission
To Bad debts		5,000	Received
To Net Profit (transferred to capital account)		37,000	5,000
			Add Accrued
			3,000
			Less commission
			Received in advance 2,000
Total		<u>88,000</u>	<u>6,000</u>
			<u>88,000</u>

Net profit reduced by Rs. 2000.

Note: Second effect “Commission received in advance will be shown as current liability in the Balance Sheet”.

Depreciation

Depreciation is the decrease in the value of assets on account of wear and tear and passage of time. It is treated as a business expense and is debited to profit and loss account. This, in effect, amounts to writing-off a portion of the cost of an asset which has been used in the business for the purpose of earning profits. The entry for providing depreciation is:

Depreciation A/c	Dr.
To asset* A/c	

*Specific asset account is to be credited

Illustration 14.12

Trial Balance of ABC shows that the firm owns furniture worth Rs. 14,000. Let us assume that the rate of depreciation on furniture is 10% per annum. Accounting entry required to be passed to give effect to depreciation on furniture as follows:

Depreciation A/c	Dr. 1,400
To Furniture A/c	1,400

Depreciation will be recorded in the profit and loss account as follows:

Trading and Profit and Loss Account of ABC for the year ended March 31, 2012

Dr.		Revenues/Gains	Cr.
Expenses/Losses	Amount Rs.		Amount Rs.
To Purchases	75,000	By Sales	1,45,000
To Wages		By Closing Stock	20,000
Paid	7000		

Add Wages outstanding	<u>1000</u>	8,000		
To Gross profit (bf) c/d		82,000		
Total		<u>1,65,000</u>		<u>1,65,000</u>
To Salaries			By Gross profit b/d	82,000
Paid	25,000			
Less Prepaid	<u>2,000</u>	23,000		
To Rent of building		23,000	By Commission	
To Bad debts		5,000	Received	5,000
To Depreciation		1,400	Add commission Accrued	3,000
To Net Profit (transferred to capital account)		35,600		
			Less commission	
			Received in advance	2,000
Total		<u>88,000</u>		<u>6,000</u>
				<u>88,000</u>

Depreciation is debited to Profit and Loss account and it has reduced the net profit of the enterprise by Rs 1400.

Note : Second effect “Depreciation will be deducted from the value of furniture in the Balance Sheet”.

Bad Debts

Bad debts refer to the amount loss suffered by the firm because of default made by the debtors of the firm in making the payment of money due from them to the firm. The entry passed to book the loss on account of bad debts is:

Bad-debts A/c	Dr.
To Debtors A/c	

The amount of Rs. 5000 shown against the bad debts account in the trial balance is the one which is already recorded in the books of accounts and which has already been deducted while calculating the balance in the debtors account. Amount of Bad-debts already accounted for is shown just in the profit and loss account on debit side as you can see in the trading and profit and loss account drawn earlier.

In case information about the bad-debts is given in the additional information and not as a part of trial balance. Then amount of bad debts is shown in the profit and loss account on the debit side and is also shown as deduction form debtors in the balance sheet.

Illustration 14.13

Let us assume that Mr. Z a debtor of ABC who owed ABC an amount of Rs. 3,000 had become insolvent, and nothing is receivable from him. But the amount of bad debts related to him is still to be account for. This fact appears as additional information and is termed as further bad debts.

The adjustment entry to be recorded for the amount will be as follows:

Bad debts A/c	Dr. 3,000
To Debtors A/c	3,000

This entry will reduce the value of debtors to Rs. 37,000 (Rs. 45,000 –Rs. 5000 – Rs. 3000) and increases the amount of bad debts to Rs. 8,000 (Rs.5000 +Rs. 3000).

The treatment of additional bad debts in profit and loss account is shown below:

**Trading and Profit and Loss Account of ABC
for the year ended March 31, 2012**

Dr.		Amount	Revenues/Gains	Cr.
Expenses/Losses		Rs.		Amount
				Rs.
To Purchases		75,000	By Sales	1,45,000
To Wages			By Closing Stock	20,000
Paid	7000			
Add Wages outstanding	<u>1000</u>	8,000		
To Gross profit (bf) c/d		82,000		
Total		<u>1,65,000</u>		<u>1,65,000</u>
To Salaries			By Gross profit b/d	82,000
Paid	25,000			
Less Prepaid	<u>2,000</u>	23,000		
To Rent of building		23,000	By Commission	
To Bad debts	5,000		Received	5,000
Add Additional Bad debts	<u>3,000</u>	8,000	Add commission Accrued	3,000
To Depreciation		1,400	Less commission	
			Received in advance	2,000
To Net Profit (transferred to capital account)		32,600		
Total		<u>88,000</u>		<u>6,000</u>
				<u>88,000</u>

Provision for Bad and Doubtful Debts

Many a times it is not possible to assess the amount of bad debts accurately. In such cases, instead of booking bad debts straight way firms create provisions of bad debts. In other words, provision for bad debts is simply an estimation of the amount of loss a firm expects to incur on account of

bad debts. Provision for bad debts is created by debiting profit and loss account. Following journal entry is recorded to create provision for bad debts:

Profit and Loss A/c Dr.
 To Provision for doubtful debts A/c

Provision for doubtful debts is deducted from the debtors in the balance sheet.

Illustration 14.14

Let us assume, debtors worth Rs. 1000 more are likely to default on their payments next year. The adjustment entry to record this additional estimated loss on account of bad debts will be:

Profit and loss A/c Dr. 1000
 To Provision for doubtful debts A/c 1000

The adjustment in the trading and profit and loss account will be as follows:

Trading and Profit and Loss Account of ABC for the year ended March 31, 2012

Dr.			Cr.
Expenses/Losses	Amount	Revenues/Gains	Amount
	Rs.		Rs.
To Purchases	75,000	By Sales	1,45,000
To Wages		By Closing Stock	20,000
Paid	7000		
Add Wages outstanding	<u>1000</u>		
To Gross profit (bf) c/d	82,000		
Total	<u>1,65,000</u>		<u>1,65,000</u>
To Salaries		By Gross profit b/d	82,000
Paid	25,000		
Less Prepaid	<u>2,000</u>		
To Provision for bad debts	1,000		
To Rent of building	23,000	By Commission	
To Bad debts	5,000	Received	5,000

Add Additional Bad debts	<u>3,000</u>	8,000	Add commission Accrued	3,000
To Depreciation		1,400	Less commission	
			Received in advance	2,000
To Net Profit (transferred to capital account)		31,600		
Total		88,000		6,000
				88,000

It may be noted that the provision created for doubtful debts at the end of a particular year becomes the opening balance of the next year and is used for meeting the loss due to bad debts incurred during the next year. The balance left in the provision for bad debts account after adjusting the bad debts of the current year is also taken into account while making provision for doubtful debts required at the end of the current year. The opening balance of provision for bad debts is also called old provision and provision created at the end of accounting year is called new provision.

Let us try to understand the process of recording the bad debts and provision for doubtful debts with the help of an example.

Illustration 14.15

An extract from a trial balance on March 31, 2012 is given below:

	Rs.
Sundry debtors	50,000
Bad debts	4,000
Provision for doubtful debts	5,000

Additional Information:

Write-off further bad debts Rs. 500 and create a provision for doubtful debts @ 5% on debtors.

Pass the journal entries to record the above. Also record it in the profit and loss account.

In this case, the following journal entries will be recorded:

(a) Bad debts A/c	Dr.	500
To Sundry debtors		500

(Entry for additional bad debts)

(b) Provision for doubtful debts A/c	Dr.	4,500
To Bad debts A/c		4,500

(Bad debts adjusted against the provision)

(c) Profit and Loss A/c	Dr.	1,975
To Provision for doubtful debts A/c		1,975

(Amount charges from profit and loss account)

Profit and Loss Account
for the year ended March 31, 2012

Debit Side of Profit and Loss Account

Provision for doubtful debts:

Bad debts	4,000
Further bad debts	500
New provision	<u>2,475</u>
	6,975
Less Old provision	<u>5,000</u>
Additional Provision Required	1,975

Illustration 14.16

From the following balances, prepare the trading and profit and loss account for the year ending March 31, 2012.

Debit Balances	Amount	Credit Balances	Amount
	Rs.		Rs.
Drawings	6,300	Capital	1,55,000
Cash at bank	14,000	Discount received	3,150
Bills receivable	1,900	Loans	10,000
Land and Building	42,600	Purchases return	2500
Furniture	5,140	Sales	2,90,000

Discount allowed	4,000	Reserve for bad debts	5,650
Bank charges	200	Creditors	18,670
Salaries	6,520		
Purchases	2,05,000		
Stock (opening)	60,000		
Sales return	1,910		
Carriage	5,190		
Rent and Taxes	7,750		
General expenses	3,610		
Plant and Machinery	31,700		
Book debts	82,840		
Bad debts	1,460		
Insurance	4,850		
	4,84,970		4,84,970

Adjustments

1. Closing stock Rs. 60,000
2. Create a reserve for bad and doubtful debts @ 10% on book debts
3. Insurance prepaid Rs. 500
4. Rent outstanding Rs. 1500
5. Interest on loan is due @ 6% p.a.

Solution

**Trading and Profit and Loss Account
for the year ended March 31, 2012**

Dr.			Cr.
Expenses/Losses	Amount	Revenues/Gains	Amount
	Rs.		Rs.
To Opening stock	60,000	By Sales	2,90,000
To Purchase	2,05,000	Less : Sales return (1,910)	2,88,090
Less Purchases return	<u>2,500</u>	By Closing stock	60,000
To Carriage	5,190		

To Gross profit c/d		80400		
		3,48,090		3,48,090
To Discount allowed		4,000	By Gross profit b/d	80,400
To Bank charges		200	By Discount received	3,150
To Salaries		6,520		
To Rent and Taxes	7,750			
Add Rent outstanding	1,500	9,250		
To General expenses		3,610		
To Insurance	4,850			
Less Insurance prepaid	500	4,350		
To Bad debts	1,460			
Add New provision	<u>8,284</u>			
for bad debts	9,744			
Less Old provision	<u>5,650</u>			
for bad debts		4,094		
To Interest on loan outstanding		600		
To Net profit (transferred to capital account)		50,926		
		83,550		83,550

Illustration 14.17

The following were the balances extracted from the books of M/s Y as on March 31, 2011:

Debit Balances	Amount	Credit Balances	Amount
	Rs.		Rs
Cash in hand	840	Sales	99,000
Cash at bank	630	Return outwards	1000
Purchases	40,000	Capital	62,000
Return inwards	700	Sundry creditors	6,300

Wages	8,400	Rent	9,000
Fuel and Power	4,750		
Carriage on sales	3500		
Carriage on purchases	2140		
Opening stock	5,700		
Building	32,000		
Freehold land	10,000		
Machinery	20,000		
Salaries	15,600		
Patents	7,800		
General expenses	3,200		
Insurance	630		
Drawings	5,240		
Sundry debtors	14,500		

Taking into account the following adjustments prepare trading and profit and loss account and balance sheet as on March 31, 2011 :

- Stock in hand on March 31, 2011, was Rs. 7,000.
- Machinery is to be depreciated at the rate of 10% and patents @ 20%.
- Salaries for the month of March, 2011 amounting to Rs. 1,500 were outstanding.
- Insurance includes a premium of Rs. 170 on a policy expiring on September 30, 2012.
- Further bad debts are Rs. 725. Create a provision @ 5% on debtors.
- Rent receivable Rs. 1,000.

Solution

Books of M/s Y

Trading and Profit and Loss Account for the year ended March 31, 2011

Dr.			Cr.
Expenses/Losses	Amount	Revenues/Gains	Amount
	Rs.		Rs.
To Opening stock	5,700		
To Purchases	40,000	By Sales	99,000

Less Return outwards	1000	39,000	Less Return inwards	700	98,300
To Wages		8,400	By Closing stock		7,000
To Fuel and Power		4,750			
To Carriage on purchases		2,140			
To Gross profit c/d		45,310			
		1,05,300			1,05,300
To Salaries	15,600		By Gross profit b/d		45,310
Add Outstanding salaries	1,500	17,100	By Rent	9,000	
To Carriage		3,500	Add Accrued rent	1,000	10,000
To General expenses		3,200			
To Insurance	630				
Less Prepaid insurance	85	545			
To Further bad debts	725				
Add Provision for bad debts	689	1,414			
To Depreciation : Machinery	2,000				
Patent	1,560	3,560			
To Net profit		25,991			
(transferred to capital account)					
		55,310			55,310

Illustration 14.18

The following balances were extracted from the books of Shri. R Sons on March 31, 2011

Account Title	Amount	Account Title	Amount
	Rs.		Rs.
Capital	5,00,000	Rent (Cr.)	3,100
Drawings	2,17,600	Railway freight on sales	16,040
Purchases	90,000	Carriage inwards	2,380
Sales	1,50,370	Office expenses	1,350
Purchases return	2,850		
Stock on April 01, 2010	21,460	Postage and Telegram	1,820

Bad debts	1600	Sundry debtors	62,070
Bad debts reserve	3,140	Sundry creditors	10,920
April 01, 2010			
Cash in bank	15,400		
Rates and Insurance	1,600	Cash in hand	5,210
Discount (Cr.)	210	Office furniture	4,500
Bills receivable	1,280	Salaries and Commission	9,560
Sales returns	4,200	Addition to buildings	9,000
Wages	6,200		
Buildings	28,000		

Prepare the trading and profit and loss account as on March 31, 2011 after keeping in view the following adjustments :

- (i) Depreciate old building by Rs. 625 and addition to building at 2% and office furniture at 5%.
- (ii) Write-off further bad debts Rs. 570.
- (iii) Increase the bad debts reserve to 6% of debtors.
- (iv) On March 31, 2005 Rs. 570 are outstanding for salary.
- (v) Rent receivable Rs. 200 on March 31, 2011.
- (vi) Interest on capital at 5% to be charged.
- (vii) Unexpired insurance Rs. 240.
- (viii) Stock was valued at Rs. 14,290 on March 31, 2011.

**Trading and Profit and Loss Account
for the year ended March 31, 2011**

Dr.		Cr.	
Expenses/Losses	Amount	Revenues/Gains	Amount
	Rs.		Rs.
To Opening stock	21,460	By Sales	1,50,370
To Purchases	90,000	Less Sales Return	<u>4,200</u>
Less Purchase return	<u>2,850</u>		1,46,170
To Carriage inwards	2,380		

To Wages	6,200	By Closing stock	
14,290			
To Gross profit c/d	43,270		
	1,60,460		1,60,460
To Railway freight on sales	16,040	By Gross profit c/d	43,270
		By Rent	3,100
To Office expenses	1,350	Add Accrued rent	<u>200</u> 3,300
To Postage and Telegram	1,820	By Discount	210
To Printing and Stationery	660	By Net Loss	13,980
To Salary and Commission	9,560		
Add Outstanding salary	<u>570</u> 10,130		
To Rates and Insurance	1,600		
Less unexpired insurance	<u>240</u> 1,360		
To Bad debts	1,600		
Add Further bad debts	570		
Add New bad debts	<u>3,690</u>		
provision	5860		
Less Old provision	<u>3,140</u> 2,720		
for bad debts			
To Interest on capital	25,000		
To Depreciation on building	625		
To Depreciation on addition	180		
to building			
To Depreciation on furniture	175		
	60,060		60,060

14.4 Summary

Income statement is prepared at the end of accounting year. It a summary statement of revenue incomes earned and an expense incurred by the organization during the concerned accounting year and is composed of two parts i.e. trading account and Profit and loss account. The basic purpose of preparing the Income statement is to find out the true picture of the financial performance of the organization. Preparation of trading and profit and loss account is easier when there are no adjustments as compared to the situation when adjustments are required to be incorporated.

14.5 Glossary

Gross Profit : is the profit a company earns from its core business activity, before deducting operating expenses, interest and taxes.

Net Profit: is the final profit after deducting all expenses from total revenue.

14.6 Check your knowledge

TRUE/FALSE

1. Wages account is closed by transferring its balance to Profit and Loss account
2. Purchase Return account is closed by transferring its balance to Profit and Loss account.
3. Adjustment entries are passed for the transactions which are not yet recorded in the accounts
4. Provision for Bad debts is created by debiting it to Bad debt account
5. Additional Information given about Salary outstanding is adjusted by stating it as liability in the balance sheet and adding it to salary paid in the profit and loss account.
6. Additional Information given about accrued interest income in case of trading organization is adjusted by showing it as an asset in the balance sheet and as income on the credit side in the trading account
7. Additional Information given about Bad debts is adjusted by debiting it to Profit and Loss account.

8. Depreciation given in the trial balance is adjusted by deducting it from the concerned asset in the balance sheet.
9. Closing stock appears in the Trial Balance normally
10. Information about transactions given in the form of additional information may have single or dual effect depending upon the information given.

FILL IN THE BLANKS

1. _____ account enables the trader to find out Gross Profit or Loss
2. _____ account enables the trader to find out the Net Profit or Loss.
3. Direct Expenses appears on _____ side of _____ account.
4. Indirect Expenses appears on _____ side of _____ account.
5. Trading account of ABC31st March, 2012
6. Wages and Salary appear on _____ account.
7. is the first item on the debit side in trading account
8. _____ shows the Financial Position of a Trader.
9. Assets – Liabilities = _____
10. Assets – Capital = _____

14.7 Answers to check your knowledge

TRUE/FALSE

1. False
2. False
3. True
4. False
5. True
6. False
7. False
8. False
9. False
10. False

Fill in the blanks

1. Trading account
2. Profit and Loss account
3. Debit Side, Trading account
4. Debit Side, Profit and Loss account
5. For the year ending
6. Trading Account

7. Opening Stock
8. Balance Sheet
9. Capital
10. Liabilities

14.8 Self-Assessment Questions

1. Explain the need of Trading and Profit and Loss account.
2. “Trading account is a statement of direct expenses and incomes and profit and loss account deals with indirect incomes and expenses”, explain the statement.
3. How do you calculate the provision to be made for the current year for bad debts when information about bad debts, further bad debts, old provision and new provision is given?
4. “Adjustment entries has dual effect”, explain the statement with the help of few examples.
5. What is accrual basis of accounting?

14.9 References

1. Financial Accounting Principles and Practice- Prof. Jawahar Lal and Dr.Seema Srivastava
2. Financial Accounting- Sri P. C. Tulsian
3. Advanced Accountancy - Sri R. L. Gupta and Sri M. Radhaswamy
4. Advanced Accountancy-Sri S. P. Jain and Sri K. L. Narang.

Unit 15

Final Accounts-Balance Sheet

- 15.1 Introduction
- 15.2 Format of Balance Sheet
- 15.3 Preparation of Balance Sheet
- 15.4 Comprehensive Illustration
- 15.5 Summary
- 15.6 Glossary
- 15.7 Check your Progress
- 16.8 Answers to check your progress
- 16.9 Self Assessment
- 16.10 Reference

Objectives

After going through this unit, students would be able to:

- Understand the meaning of Balance Sheet
- Understand the need of Balance Sheet
- Understand the format of Balance Sheet
- Explain the terms associated with balance sheet;
- Understand the process of writing of Balance sheet with and without adjustment entries;

15.1 Introduction

The primary objective of preparing the financial statements is to calculate the profit and loss made by the business firm during the year and also to understand the financial position of the business on a given date. Preparation of final accounts from a trial balance includes the preparation of Trading and Profit and Loss Account and the Balance Sheet. Balance Sheet is not

an account rather it is a statement of assets owned and liabilities owed by a business enterprise on a particular date. It can be prepared in a vertical or horizontal format. Balance sheet helps in understanding the financial position of a business enterprise. In this section, we will discuss the need of preparing the Balance Sheet, format of Balance Sheet and the process of writing the Balance Sheet. However, this study material aims to achieve the following specific objectives:

Meaning

Balance sheet can be described as “a Statement which sets out the Assets and Liabilities of a business firm and which serves to ascertain the financial position of the business on that particular day.” Financial position means the ability of the organization to meet its liabilities in time.

Financial position can also be described as the position of the value of assets owned as compared to the value of liabilities owed. This statement is prepared at the end of the accounting period after the preparation of the trading and profit and loss account is complete. Almost every transaction affects the financial position of the business but because it is not feasible to draw up a balance sheet after every transaction, therefore it is prepared at the end of a specified period, usually, a year.

This period of one year is referred to as **accounting period** or **fiscal year** or **financial year**. It is called balance sheet because it is a statement of balances of ledger accounts that have not been closed by transferring them to trading and profit and loss account and are required to be carried forward to the next year. Balance sheet represents the financial position of a business enterprise on a particular date and is valid only until another transaction is carried out by the entity.

15.2 Format of Balance Sheet

Having examined the meaning of the balance sheet, we will now try to discuss the format of balance sheet. There is no prescribed format of balance sheet for the sole proprietorship firms and for the partnership firms. However, Schedule VI Part I of the Companies Act 1956 prescribes the format and the order in which the assets and liabilities of a company should be shown.

Balance sheet preparation is the systematic arrangement of the assets and liabilities of a firm. On the basis of structure there are two styles (i.e. The American style and the English style) followed for the preparation of Balance Sheet. As per American style, assets are shown on the left hand side and liabilities and capital on the right hand side. The **English style** is just opposite to the American style. i.e., assets are shown on the right hand side of the Balance Sheet and liabilities and the capital on the left hand side. In India, we generally follow the English style.

Besides the structure of the balance sheet, format of the balance sheet can further be classified into two categories on the basis of order of recording of assets in it i.e.

1. Permanency order
2. Liquidity order

In case of permanency order, assets are arranged in the balance sheet in the order of the degree of liquidity enjoyed by each one of them starting with that asset which is the least liquid asset and then other assets are arranged in the order of decreasing degree of permanency. Below given is format of balance sheet where permanency order has been followed for the arrangement of assets.

Balance Sheet as on _____

Liabilities	Rs.	Assets	Rs.
Capital		Goodwill	
Mortgage		Patents and Trade Marks	
Bank Overdraft		Furniture and Fittings	
Outstanding Expenses		Plant and Machinery	
Income Received in Advance		Unexpired Expenses	
Creditors		Stock-in-Trade	
Bills Payable		Sundry Debtors	
Loan		Investments	
		Bills Receivable	
		Cash in Bank	
		Cash in Hand	
Total	xxx	Total	xxx

In the above format designed according to permanency order, the first asset written is Goodwill, which is the most illiquid asset. Its highly difficult to sell goodwill. Thereafter other assets have been arranged according to increasing degree of liquidity attached with each one of

them. Cash in hand which is the most liquid asset is written at the last. Permanence order is followed in case of those businesses wherein liquidity is not much important e.g. jewelry business.

Liquidity order is just opposite to permanency order. In case of liquidity order, assets are arranged in the balance sheet in such a manner that those assets which are highly liquid are stated first as compared to those assets which are comparatively less liquid. i.e. Cash in Hand will be written first as compared to Cash at Bank as Cash in hand enjoys better degree of liquidity as compared to cash at bank. Below given is the format of balance sheet prepared according to liquidity order:

Balance Sheet as on _____

Liabilities	Rs.	Assets	Rs.
Current Liabilities		Current Assets	
Creditors		Cash in Hand	
Bills Payable		Cash at Bank	
Bank Overdraft		Stock-in-Trade	
Outstanding Expenses		Debtors	
Income Received in Advance		Bills Receivable	
		Prepaid Expenses	
Fixed Liabilities		Fixed Assets	
Loan		Furniture and Fixtures	
Mortgage		Plant Machinery	
Capital		Land	
		Goodwill	
Total	xxx	Total	xxx

In the above format, assets have been arranged in the order of decreasing degree of liquidity. Cash in Hand which is most liquid is written first, followed by Cash at bank which is less liquid as compared to cash in hand and more liquid as compared to stock-in-trade. Liquidity order for arrangement of assets in the balance sheet is followed in case of those business enterprises in which liquidity is highly important and keeps on fluctuating widely.

On more way for classification of the format of balance sheet is T account form and Report Form. In case of T account form assets are listed on one side and liabilities and owners' equity on the other. The above stated formats of Balance Sheet are T-account forms. In case of Report form format liabilities and capital are listed above the assets. Below given is an example of

Report form format of balance sheet. It is also known as vertical form of balance sheet as liabilities and assets are arranged in the vertical form. First of all liabilities of owners and outsiders are stated. Thereafter assets of the business are written.

Balance Sheet as on.....

Particulars	Sch. No.	Figures as at the end of the current financial year (Rupees)	Figures as at the end of the previous financial year (Rupees)
1	2	3	4
I. Sources of funds (a) Shareholders' Funds: (i) Capital (ii) Reserves and surplus (b) Loan funds (i) Secured loans (ii) Unsecured loan TOTAL II. Application of funds (a) Fixed assets: (i) Gross block (ii) Less: Depreciation (iii) Net block (iv) Capital work-in-progress (b) Investments: (c) Current assets, loans and advances (i) Inventories (ii) Sundry debtors (iii) Cash and bank balances (iv) Other current assets (v) Loans and advances Less: Current liabilities and provisions (i) Liabilities (ii) Provisions Net current assets (d) (i) Miscellaneous expenditure to the extent not written off or adjusted (ii) Profit and loss account TOTAL			

Explanation of the Terms used in Balance Sheet

Following is the explanation of the terms which are normally used in the balance sheet:

Current Assets

Current assets, also known as liquid assets, are those assets, which are either in the form of cash or will normally be converted into cash within one year. Current assets include such assets as Cash in Hand, Cash at Bank, Inventory, Debtors, Bills Receivable, Prepaid expenses and short term investments etc.

Current Liabilities

Current liabilities also known as short term liabilities, are those liabilities which are due for payment within a period of one year. These liabilities are usually paid out of current assets. Current liabilities include liabilities such as bank overdraft, bills payable, sundry creditors, short-term loans, outstanding expenses, etc.

Fixed Assets

Fixed assets are the long term assets of the firm. Sometimes these assets are also referred to as 'Fixed Block' or 'Block Capital'. Such assets are not acquired for the purpose of resale. The benefits of these assets are available not only in the accounting period in which the cost is incurred but over several accounting periods. They are acquired with the intention of making use of them for the business for a period of more than one year. The example of fixed assets includes land, building, plant and machinery, furniture and fixtures, etc.

Valuation of the fixed assets in the balance sheet is made on the basis of original cost minus depreciation. Depreciation is the decrease in the value of the asset due to regular use and passage of time. All fixed assets, with the exception of land, are depreciated. Land is not subject to depreciation and hence shown separately from other fixed assets.

Long-term Liabilities

Long-term liabilities include those liabilities which will become due for payment after one year. In other words we can say all liabilities other than the current liabilities are known as long-term liabilities. Such liabilities are usually payable after one year of the date of the balance sheet. The examples of long-term liabilities include loans from bank, other FIs, Public Deposits etc.

Capital

Capital refers to the amount of money contributed by the owners of the Business. It also includes that part of business profits which is retained by the business with itself in the form of retained earnings. It can also be described as the excess of assets over outsiders' liabilities.

Drawings

Drawings refer to the amount withdrawn by the proprietor from the business for his personal use. Drawings reduce the capital of the proprietor in the business. Therefore, the drawings account is closed by deducting it from proprietor's capital account.

Intangible Assets

Intangible assets are those assets which have value but cannot be seen and touched. They are incorporeal, representing intrinsic value without being material. One of the most commonly referred examples of intangible assets is **goodwill**. Goodwill reflects the ability of a firm to earn profits in excess of normal return. Goodwill can be recorded as an asset only when it is purchased. Intangible assets may also lose value with the passage of time like fixed assets. The value of intangible assets should also be expired over a period of their useful life. Such an expiration cost is called amortization, which is similar to depreciation.

Investment

Investments represent the funds invested in other organizations in the form shares, debentures or government securities etc. They are shown at a cost price. Investments may be short term or long-term. Depending upon the time period for which money is invested; investments may be classified as long term or short term investments.

Provisions or Estimated Liabilities

Provision or estimated liabilities refer to those liabilities of the business which are legally due for payment but the amount of liability cannot be precisely determined, e.g. suppose the bill of electricity comes after every two months and the bill for the months of March and April will come on April end. While preparing the profit and loss account on 31st March, in order to ensure compliance with matching principle, we will have to estimate the liability on account of electricity bill for the month of march and create a provision for the same as the electricity for this month is already consumed and liability is due, but exact amount of liability is not known.

Contingent Liabilities

Contingent liabilities are different from estimated liabilities. Contingent liabilities are those liabilities which have not become due for payment yet. These liabilities may or may not arise depending upon the happening or non- happening of some future event. Most commonly referred example of contingent liabilities include case regarding compensation claimed by an employee of the company pending in the court of law. If the court verdict goes against the firm, liability will arise otherwise there will be no liability.

15.3 Preparation of Balance Sheet

Balance sheet as discussed earlier is a statement of assets, liabilities and owner's capital. This statement is prepared on the basis of information given in trial balance. As you might have seen earlier, that the trial balance has two sides i.e. debit side and credit side. On each of the two sides, there are two categories of accounts i.e. on the debit side you have account heads of expenses/losses and assets and on the credit side of trial balance you have again two varieties of account heads i.e. Income/gain and Liability. One category of account head from each side i.e. account head related to expense/loss from debit side and income/gains from credit side have already been dealt with and closed by transferring it to trading and profit and loss account. The other category of account heads i.e. Asset heads from debit side and liability heads from credit side of the trial balance are used for the preparation of trial balance.

The process of writing the balance sheet will be explained under the following two situations:

1. When there is no adjustment i.e. only trial balance is given
2. When there are adjustments i.e. some additional information is given along with the trial balance

Preparation of Balance Sheet (When there is no adjustment)

The process of writing the balance sheet in the absence of adjustments is very simple. It is prepared on the basis of the information contained in the Trial Balance and the net result of the income statement. All the accounts of assets, liabilities and capital from the trial balance are shown in the balance sheet. Accounts of capital and liabilities are shown on the left hand side, known as Liabilities. Assets and other debit balances are shown on the right hand side, known as Assets. The process is explained with the help of following illustration.

Illustration 15.1**Trial Balance of ABC as on March 31, 2012**

Account Title	L.F.	Debit Amount Rs.	Credit Amount Rs.
Cash		5,000	
Capital			22,000
Bank		3,000	
Sales			1,45,000
Wages		7,000	
Creditors			20,000
Salaries		25,000	
10% Long term loan			10,000
Furniture		14,000	
Commission received			5,000
Rent of building		23,000	
Debtors		45,000	
Bad debts		5,000	
Purchases		<u>75,000</u>	
	Total	<u>2,02,000</u>	<u>2,02,000</u>

Balance Sheet of ABC as at March 31, 2012

Liabilities	Amount Rs.	Assets	Amount Rs.
Capital	22,000	Furniture	14,000
Add Profit	15,000	Cash	5,000
10 % Long-term loan	10,000	Bank	3,000
Creditors	20,000	Debtors	45,000
	<u>67,000</u>		<u>67,000</u>

There are a total of 14 account heads in the trial balance, seven account heads dealing with incomes and expenses were taken to trading and profit and loss account from the trial balance and the net of those seven account heads i.e. a profit of Rs. 15,000 and the remaining seven account heads are considered for preparing the balance sheet. Since we follow double entry system of book keeping, total of both the assets and liabilities side of the balance sheet must be equal.

Preparation of Balance Sheet (With Adjustments)

Final accounts are prepared on accrual basis(as already discussed in Unit 14), i.e. only those incomes and expenses are recorded in trading and profit and loss account which actually belong

to that period for which the trading and profit and loss account is being prepared. Compliance of accrual basis requires that those expenses which belong to other years (i.e. years other than the year for which trading and profit and loss account is being prepared) should be ignored while preparing the profit and loss account even if they are paid during the current accounting year. Similarly all incomes which belong to other accounting years should be ignored even if they are received during the current accounting year. Further, all those expenses are required to be added, which benefit the current accounting period whether the payment has been made or not. In case of earnings, add all those revenue items which have been earned currently but not yet been received. The above stated corrections in the final account are called Adjustments, which are made with the help of adjusting entries. Adjustments ensure a proper matching of costs and revenue for obtaining correct profit or loss for the given accounting period. The items which usually need adjustments include:

1. Closing stock
2. Outstanding/expenses and Prepaid/Unexpired expenses
4. Accrued income and Income received in advance
6. Depreciation
7. Bad debts and Provision for doubtful debts
9. Provision for discount on debts etc.

To make the process of understanding the accounting treatment of above stated adjustments in the Balance Sheet, we will make use of the trial balance of ABC given in Illustration no. 15.1 above.

1. Closing Stock

As discussed earlier, accounting treatment of transactions which need adjustment is reflected at two places. Therefore, the adjustment with regard to the closing stock is done by:

- (i) crediting it to the trading and profit and loss account,
- (ii) showing it on the asset side of the balance sheet.

The adjustment entry to be recorded in this regard is:

Closing stock A/c	Dr.
-------------------	-----

To Trading A/c

Illustration 15.2

Let us assume that the firm ABC has closing stock worth Rs. 20000 on 31st March, 2012.

Solution:

Accounting Treatment

Following Journal Entry will be passed

Closing Stock A/c	Dr.	20,000
To Trading A/c		20,000

1. It will be shown in the trading account on the credit side, gross profit and in turn net profit will go up by Rs. 20,000. Net profit will rise to Rs.35,000 (Refer to illustration 14.7 of unit no 14)
2. Closing Stock of Rs. 20,000 will appear in the Balance Sheet as a current asset. The Balance Sheet after incorporation of information about closing stock will be as given below:

Balance Sheet of ABC as at March 31, 2012

Liabilities	Amount Rs.	Assets	Amount Rs.
Capital	22,000	Furniture	14,000
Add Profit	35,000	Cash	5,000
10 % Long-term loan	10,000	Bank	3,000
Creditors	20,000	Debtors	45,000
		Stock	20,000
	87,000		87,000

2. Outstanding Expenses

Outstanding Expenses refer to those expenses of the business enterprise which have become due for payment but have not been discharged yet. Normally almost all businesses have some expenses which, at the end of accounting year, are due for payment but have yet to be paid. As the expense belongs to the current accounting year, it is logical that it should be duly charged against revenue of the current year. Following adjustment entry is passed to record these expenses:

Prepaid expenses refer to the payments made in advance for the services which have not yet been availed. In the normal course of business operations, advance payments are made to a large number of parties. In case at the end of accounting year it is found that some payments have been made and the benefit from the recipient of that payment has not been realized yet and will be realized in the coming time, then this payment will be treated as prepaid expense. Following adjustment entry is made in respect of prepaid expenses:

Prepaid expense A/c Dr.
 To concerned expense A/c

The above entry will have the effect of reducing the amount of particular expense in the trading and profit and loss account. Further, prepaid expense is a firm's claim against the outsider and therefore, **will be shown as current asset in the balance sheet.**

Illustration 15.4

Let us assume that ABC has paid an amount of Rs 2000 on account of advance salary to one of its new employee who has joined the firm on 31st March. Therefore, the expense on account of salary of ABC for the year 2011-12 is Rs. 23,000 (Rs. 25000 – Rs. 2000) instead of Rs. 25,000.

Accounting Treatment

Following journal entry will be passed for the adjustment:

Prepaid salary A/c Dr. 2,000
 To salary A/c 2,000

1. In order to book the correct expenditure on account of salary in the profit and loss account, advance payment will be deducted from salary head in the profit and loss account. It will increase net profit by Rs.2000.
2. In the balance sheet, **prepaid salary will be shown as a current asset** as you can see below

Balance Sheet of ABC as at March 31, 2012

Liabilities		Amount	Assets	Amount
		Rs.		Rs.
Capital	22,000		Furniture	14,000

Add Profit	36,000	58,000	Cash	5,000
10% Long-term loan	10,000		Bank	3,000
Creditors	20,000		Debtors	45,000
Wages Outstanding	1,000		Stock	20,000
			Prepaid Salary	2,000
		89,000		89,000

4. Accrued Income

It refers to those incomes, which have legally become due to the business but has not been received by the end of accounting period. A large variety of accrued incomes are found normally in every kind of business at the end of accounting year. Since the income has become legally due it belongs to the current year only and must be recorded as income in the trading and profit and loss account of the current year. The adjusting entry for recording the accrued income in the current year is:

Accrued income A/c	Dr.
To Concerned income A/c	

This entry will have the effect of increasing the balance in the concerned income account. To incorporate the adjustment, the amount of accrued income will be added to the related income head in the profit and loss account. **In the balance sheet accrued income will be shown as current asset.**

Illustration 15.5

Continuing with the example of ABC, Let us, for example, assume that ABC has given some help to a fellow businessman M/s Raj Sons by arranging new business for them during the year 2011-12. Commission of Rs 3000 due from M/s. Raj Sons is pending on 31-03-2012. This implies that income from commission earned during 2011-12 is Rs. 8,000 (i.e. Rs.5,000 + Rs. 3,000).

Accounting Treatment

Following adjustment entry will be passed to give effect to the accrued commission:

Accrued Commission A/c	Dr.	3,000
To Commission A/c		3,000

1. This will increase income from commission by Rs. 3,000 and hence net profit will go up by Rs. 3,000.
2. In the Balance Sheet, **accrued commission will be shown as current asset** as given below:

Balance Sheet of ABC as at March 31, 2012

Liabilities		Amount	Assets		Amount
		Rs.			Rs.
Capital	22,000		Furniture		14,000
Add Profit	39,000	61,000	Cash		5,000
10% Long-term loan		10,000	Bank		3,000
Creditors		20,000	Debtors		45,000
Wages Outstanding		1,000	Stock		20,000
			Prepaid Salary		2,000
			Commission Accrued		3,000
		92,000			92,000

5. Income Received in Advance

It refers to that amount of the income which though has been received in the current accounting period but actually will become due in the next accounting period legally. It is also known as Unearned Income. Following adjustment entry is passed for recording the Income received in advance:

Add Profit	37,000	59,000	Cash	5,000
10% Long-term loan		10,000	Bank	3,000
Creditors		20,000	Debtors	45,000
Wages Outstanding		1,000	Stock	20,000
Commission received				
In advance		2,000	Prepaid Salary	2,000
			Commission Accrued	3,000
		92,000		92,000

6. Depreciation

Depreciation is the decrease in the value of asset on account of wear and tear and passage of time. It is treated as a business expense and is debited to profit and loss account. This, in effect, amounts to writing-off a portion of the cost of an asset which has been used in the business for the purpose of earning profits. The entry for providing depreciation is:

Depreciation A/c	Dr.
To asset* A/c	

*Specific asset account is to be credited

Illustration 15.7

Trial Balance of ABC shows that the firm owns furniture worth Rs. 14,000. Let us assume that the rate of depreciation on furniture is 10% per annum.

Accounting Treatment

Accounting entry required to be passed to give effect to depreciation on furniture as follows:

Depreciation A/c	Dr. 1,400
To Furniture A/c	1,400

1. Depreciation will be recorded in the profit and loss account as an expense and it will reduce the net profit by Rs. 1,400.

2. In the balance sheet **Depreciation of Rs.1,400 will be shown as deduction from furniture account** as shown below:

Balance Sheet of ABC as at March 31, 2012

Liabilities	Amount	Assets	Amount
	Rs.		Rs.
Capital	22,000	Furniture	14,000
Add Profit	35,600	Less Depreciation	<u>1400</u>
			12,600
10% Long-term loan	10,000	Cash	5,000
Creditors	20,000	Bank	3,000
Wages Outstanding	1,000	Debtors	45,000
Commission received		Stock	20,000
In advance	2,000	Prepaid Salary	2,000
		Commission Accrued	3,000
	<u>90,600</u>		<u>90,600</u>

7. Bad Debts

Bad debts refer to the amount loss suffered by the firm because of default made by the debtors of the firm in making the payment of money due from them to the firm. The entry passed to book the loss on account of bad debts is:

Bad-debts A/c	Dr.
To Debtors A/c	

The amount of Rs. 5000 shown against the bad debts account in the trial balance is the one which is already recorded in the books of accounts and which has already been deducted while calculating the balance in the debtors account.

Amount of Bad-debts already accounted for is shown just in the profit and loss account on debit side and **not deducted from debtors in the balance sheet as it already stands deducted.**

In case information about the bad-debts is given in the additional information section and not as a part of trial balance, then amount of bad debts is shown in the profit and loss account on the debit side as expense and is also **shown as deduction form debtors in the balance sheet.**

Illustration 15.8

Let us assume that Mr. Z a debtor of ABC who owed ABC an amount of Rs. 3,000 had become insolvent, and nothing is receivable from him. But the amount of bad debts related to him is still to be account for. This fact appears as additional information and is termed as further bad debts.

Accounting Treatment

The adjustment entry to be recorded for the amount will be as follows:

Bad debts A/c	Dr. 3,000
To Debtors A/c	3,000

1. In the trading account additional bad debts will be shown on debit side as addition to bad debts already shown in trial balance, it will reduce the amount of net profit by Rs. 3,000.
2. In the balance sheet, **Rs 3,000 on account of additional bad debts will be shown as deduction from debtors**, as given below:

Balance Sheet of ABC as at March 31, 2012

Liabilities		Amount	Assets	Amount
		Rs.		Rs.
Capital	22,000		Furniture	14,000
Add Profit	34,000	56,000	Cash	5,000

10% Long-term loan	10,000	Bank	3,000
Creditors	20,000	Debtors	45,000
Wages Outstanding	1,000	Less Bad debts	<u>3,000</u>
			42,000
Commission received		Stock	20,000
In advance	2,000	Prepaid Salary	2,000
		Commission Accrued	3,000
	<u>89,000</u>		<u>89,000</u>

8. Provision for Bad and Doubtful Debts

Many a times it is not possible to assess the amount of bad debts accurately. In such cases, instead of booking bad debts straight way, firms create provisions for bad debts. In other words, provision for bad debts is simply an estimation of the amount of loss a firm expects to incur on account of bad debts. Provision for bad debts is created by debiting it to profit and loss account. Following journal entry is recorded to create provision for bad debts:

Profit and Loss A/c	Dr.
To Provision for doubtful debts A/c	

Provision for doubtful debts is recorded on the debit side of profit and loss account and is deducted from the debtors in the balance sheet.

Illustration 15.9

Let us assume, debtors worth Rs. 1000 more are likely to default on their payments next year.

Accounting Treatment

The adjustment entry to record this additional estimated loss on account of bad debts will be:

Profit and loss A/c	Dr.	1000
To Provision for doubtful debts A/c		1000

1. In the profit and loss account, provision for bad debts of Rs. 1000 will be recorded on the debit side. It will reduce the net profits by Rs. 1000.
2. In the Balance sheet, **provision for bad debts will be shown as deduction from debtors** as given below:

Balance Sheet of ABC as at March 31, 2012

Liabilities		Amount	Assets		Amount
		Rs.			Rs.
Capital	22,000		Furniture		14,000
Add Profit	33,000	55,000	Cash		5,000
10% Long-term loan		10,000	Bank		3,000
Creditors		20,000	Debtors	45,000	
Wages Outstanding		1,000	Less Bad debts	3,000	
			Less Provision	<u>1,000</u>	41,000
			Stock		20,000
Commission received					
In advance		2,000	Prepaid Salary		2,000
			Commission Accrued		3,000
		<u>88,000</u>			<u>88,000</u>

15.4 Comprehensive Illustrations

Illustration 15.10

From the following balances, prepare the Balance Sheet of IS Traders as on March 31, 2012.

Debit Balances	Amount	Credit Balances	Amount
-----------------------	---------------	------------------------	---------------

	Rs.		Rs.
Drawings	6,300	Capital	1,55,000
Cash at bank	14,000	Discount received	3,150
Bills receivable	1,900	Loans	10,000
Land and Building	42,600	Purchases return	2500
Furniture	5,140	Sales	2,90,000
Discount allowed	4,000	Reserve for bad debts	5,650
Bank charges	200	Creditors	18,670
Salaries	6,520		
Purchases	2,05,000		
Stock (opening)	60,000		
Sales return	1,910		
Carriage	5,190		
Rent and Taxes	7,750		
General expenses	3,610		
Plant and Machinery	31,700		
Book debts	82,840		
Bad debts	1,460		
Insurance	4,850		
	4,84,970		4,84,970

Adjustments

1. Closing stock Rs. 60,000
2. Create a reserve for bad and doubtful debts @ 10% on book debts
3. Insurance prepaid Rs. 500
4. Rent outstanding Rs. 1500
5. Interest on loan is due @ 6% p.a.

Solution

Net profit of IS Traders is Rs. 50,926. Refer Illustration No. 14.16 of Unit 14

**Balance Sheet of IS Traders
as on March 31, 2012**

Liabilities	Amount Rs.	Assets	Amount Rs.
Creditors	18,670	Cash at bank	14,000
Loan	10,000		
Add Interest on loan outstanding	<u>600</u>	Book debts	82,840
Rent outstanding	1,500	Less Reserve for bad debts	<u>8,284</u>
Capital	1,55,000	Bills receivable	1,900
Add Net profit	50,926	Land and Building	42,600
	2,05,926	Furniture	5,140
Less Drawings	<u>6,300</u>	Plant and Machinery	31,700
	1,99,626		

Insurance (prepaid)	500
Closing stock	60,000
	2,30,396

Illustration 15.11

The following were the balances extracted from the books of M/s Y as on March 31, 2011:

Debit Balances	Amount Rs.	Credit Balances	Amount Rs
Cash in hand	840	Sales	99,000
Cash at bank	2,300	Return outwards	1,000
Purchases	40,000	Capital	62,000
Return inwards	700	Sundry creditors	6,300
Wages	8,400	Rent	9,000
Fuel and Power	4,750		
Carriage on sales	3,500		
Carriage on purchases	2,140		
Opening stock	5,700		
Building	32,000		
Freehold land	10,000		
Machinery	20,000		
Salaries	15,600		
Patents	7,800		
General expenses	3,200		
Insurance	630		
Drawings	5,240		
Sundry debtors	14,500		

Taking into account the following adjustments prepare trading and profit and loss account and balance sheet as on March 31, 2011 :

- Stock in hand on March 31, 2011, was Rs. 7,000.
- Machinery is to be depreciated at the rate of 10% and patents @ 20%.
- Salaries for the month of March, 2011 amounting to Rs. 1,500 were outstanding.
- Insurance includes a premium of Rs. 170 on a policy expiring on September 30, 2012.
- Further bad debts are Rs. 725. Create a provision @ 5% on debtors.
- Rent receivable Rs. 1,000.

Solution

Net Profit of M/s Y is Rs. 25,991. Refer Illustration 14.17 of unit 14.

Balance Sheet of M/s Y as at March 31, 2011			
Liabilities	Amount	Assets	Amount

	Rs.		Rs.
Sundry creditors	6,300	Cash in hand	840
Salaries outstanding	1,500	Cash in bank	2300
Capital 62,000		Sundry debtors	14,500
Add Net profit 25,991		Less Further	725
Less Drawings 5,240	82,751	bad debts	13,775
		Less Provision	689
		for bad debts	
		Insurance prepaid	85
		Stock	7,000
		Rent accrued	1,000
		Freehold land	10,000
		Building	32,000
		Machinery	20,000
		Less Depreciation	2,000
		Patents	7,800
		Less Depreciation	1,560
	90,551		90551

15.5 Summary

A Balance Sheet is statement of what a company owns and what it owes at a particular point of time. It does not give a clear statement of the profit made during the year. Therefore, to assess profitability during any year we need, detail about the profits made during the year. Most companies provide information about the profit they have made during the year in a document attached to the balance sheet, called the profit and loss account.

15.6 Glossary

Trading Account: The statement prepared to ascertain the gross profit/ loss of the business enterprises is known as Trading Account.

Balance Sheet : Statement prepared to ascertain the status of assets and liabilities of the business enterprise on a particular date is called balance sheet.

Gross Profit: The excess of revenue generated over cost of manufacture or purchase of a product is known as gross profit.

15.7 Check your Knowledge

Fill In the Banks

1. On the basis of structure, the two styles of writing balance sheet are.....and
2. On the basis of degree of liquidity attached with the assets, assets can be arranged in the balance sheet on.....basis and.....basis
3. Balance Sheet helps in assessing theof the firm.
4. Schedule.....of the companies act describes the format of balance sheet for the companies.
5. Balance Sheet of M/s Z31st March, 2012.
6. refer to liabilities which are legally due but exact amount of payment is not yet known.
7.refer to liabilities which may or may not arise.
8.refer to liabilities which are due for payment within a year.
9.refer to assets which don't have any physical existence
10.are the assets which have useful life of more than one year.

TRUE/FALSE

1. Total of asset side of the balance sheet is always equal to the total of liability side.
2. Depreciation given in the trial balance is shown in the balance sheet as deduction from the concerned asset.
3. Wages outstanding given in additional information is not shown in the balance sheet
4. Provision is created for liabilities which have not become due yet but amount is known with certainty
5. Commission received in advance is shown as asset in the Balance Sheet.
6. Prepaid Salary is shown as asset in the balance sheet.
7. Accrued Income is shown in the balance sheet as current asset.
8. Closing stock normally appears in the Trial Balance.
9. Net effect of profit and loss account is recorded in the balance sheet
10. Financial Position shown in the balance sheet relates to one full accounting year

15.8 Answers to check your knowledge questions

Fill in the Blanks

1. American Style, English Style
2. Permanency Order and Liquidity Order
3. Financial Position
4. VI
5. as on
6. Provision
7. Contingent Liabilities
8. Current Liabilities

9. Intangible Assets
10. Fixed Assets

True and False

11. True
12. False.
13. False
14. False
15. False
16. True
17. True
18. False
19. True
20. False
24. Net Profit = Rs. 170400; Balance Sheet Total = Rs. 3,32,200

15.9 SELF-ASSESSMENT QUESTIONS

1. Discuss the various categories of format used for preparation of Balance Sheet.
2. What is permanency order followed for the preparation of balance sheet. In what type of organizations permanency order is suitable?
3. Explain the process of preparation of balance under circumstances when some additional information about the adjustments is given. You may make use of an hypothetical example.
4. From the following trial balance extracted from the books of Rana X-Rays as on 31.03.12. Prepare trading and Profit & Loss A/c and Balance Sheet

Trial Balance as on 31.03.12

Particulars	Dr. Balances Rs.	Particulars	Cr. Balances Rs.
Cash in hand	2,000	Capital	1,00,000
Machinery	40,000	Sales	2,34,400
Stock	40,000	Sundry Creditors	39,000
Bills receivable	1,600	Bank overdraft	21,000
Sundry debtors	50,000	Return outwards	2,000
Wages	65,000	Discount received	1,200
Land	35,000	Bills payable	1,800
Carriage inwards	2,400		
Purchases	96,000		
Salaries	25,000		
Rent	3,000		
Postage	2,000		

Return inwards	3,200		
Drawings	10,000		
Furniture	17,000		
Interest	600		
Cash at bank	6,600		
Total	3,99,400	Total	3,99,400

Stock as on 31.03.12 is Rs. 1, 30,000

UNIT 16

SINGLE ENTRY SYSTEM

- 16.1 Introduction
- 16.2 Meaning of Single Entry System
- 16.3 Characteristics of Single Entry System
- 16.4 Ascertainment of Profit and Loss account
- 16.5 Statement of Affairs or Net worth Method
- 16.6 Summary
- 16.7 Glossary
- 16.8 Check your progress
- 16.9 Answers to check your progress
- 16.10 Terminal Questions
- 16.11 Reference

Learning Objectives

After reading this unit, students will be able to understand:

1. The concept of single entry system
2. Difference between single entry system and double entry system
3. Process of ascertainment of profit or loss from the records maintained as per single entry system
4. Process of ascertainment of financial position of the business from the records maintained as per single entry system

16.1 Introduction

In fact there does not exist any system of accounting which is based on single entry. The system which is known as single entry system is in fact, broadly speaking, is a distorted version of double entry system of accounting. Single entry system does not fully take into account the dual aspect of a transaction while recording it in the books of account. Sometimes it records both the aspects of transactions, sometimes only one aspect is recorded and in some cases no aspect of transaction is recorded in the books. As per normal practice, under the single entry system normally the personal aspects of the transactions are recorded and the nominal and real aspects are omitted altogether.

Therefore, any system that falls short of complete double entry method is called single entry system. The ledger contains only the personal accounts of debtors and creditors, all impersonal accounts such as purchases, sales, wages, carriage, rent etc., are not recorded. Thus the system does not consider the two fold aspect of every transaction. In simple words, single entry system can be described as system of accounting wherein complete process, rules etc. as required under double entry system for maintenance of books of accounts is not followed.

Single Entry System may be defined as a system which does not strictly conform to the double entry system of bookkeeping, maintains personal accounts of debtors, creditors and record of cash transactions mainly, but does not maintain impersonal accounts like purchases, sales, furniture and salaries account etc.

But every business may be operating on a small scale, medium scale or large scale, irrespective of the system of accounting it is following, has to ascertain the profit or loss for the year and the financial position as at the end of the year. This unit deals with the basics of single entry system and process of ascertainment of profit or loss and financial position of the firms that maintain incomplete records or maintain records as per single entry system.

16.2 Meaning of Single Entry System

In fact, as discussed earlier, there is no such system of accounting which is based on single entry concept. Single entry system is a misnomer as it is incomplete form of double entry system of book keeping. It is a system of maintaining records whereby accountant record the dual aspects of some transactions with proper debits and credits, records only one aspect of certain other category of transactions and totally skip recording of certain other categories of financial transactions. Therefore, this system of maintaining books of accounts is also known as incomplete records. It can be described as that system of accounting wherein entrepreneur maintains the record of business transactions as per his convenience and don't keep himself bound by the procedures and principles of double entry system of book keeping.

16.3 Characteristics of Single Entry System

As discussed earlier, the incomplete system of maintaining record of financial transactions of a business is referred to as Single Entry System of accounting. Small shopkeepers such as grocers and vendors may choose to follow single entry system voluntarily. The features of incomplete records are as under:

- **Record of only Personal accounts and Cash Transactions**

As such there is no rule regarding categories of accounts to be opened or type of record to be maintained in case of single entry system. However, it is found that firms' following single entry system normally maintains record of personal accounts i.e. record of Debtors, creditors and of the information related to cash transactions. No record is maintained for transactions related to real or nominal accounts.

- **Unsystematic**

There is no systematic method of recording the financial transactions in single entry system. Even the personal transactions of owners may also be recorded in the cash book. There is no prescribed set of books as it is there in case of double entry system. Different organizations maintain records according to their own convenience and needs.

- **Profit or Loss ascertained from original vouchers**

In case of requirement of information about profit or loss, original vouchers such as sales invoice or purchase invoice, etc are referred. Thus, dependence on original vouchers is inevitable. The profit or loss for the year cannot be ascertained with high degree of accuracy, we can make an estimate only.

- **Statement of Affairs**

Statement of affairs prepared, as a substitute of balance sheet, under single entry system does not reflect the true financial position of the firm.

Reasons for Maintaining Record as per Single Entry System

- **No Need to Hire Professionals**

The maintenance of accounting record as per single entry system is very easy. Even those people who are not trained in writing of books of accounts and don't have proper knowledge of accounting principles, can maintain record of financial transactions of the business. There is no need to hire professional accountants.

- **Inexpensive**

As only selective transactions are recorded, volume of record maintained as per single entry system is very less as compared to the quantum of record required to be maintained under double entry system and further firm is not required to hire professional accountants for writing the books of accounts. Therefore, Single entry system of accounting is an inexpensive mode of writing the books of accounts.

- **Less Time consuming**

As few transactions are recorded, single entry system of book keeping is less time consuming.

- **Convenient Mode of Maintaining Records**

As the record is kept by the firm according to its requirement and as there are no set formats, procedures etc. followed for maintenance of records as per single entry system is convenient.

Limitations of Single Entry System

Single entry system suffers from a number of below mentioned limitations:

- **Accuracy of Records cannot be ensured**

In single entry system, only one aspect of the transaction is recorded. Further, there is no provision of preparing the trial balance to check arithmetical accuracy of the books of accounts. Because of the above two reasons, arithmetical accuracy of the books of accounts maintained as per single entry system cannot be ensured.

- **Correct Assessment of Financial Position and Financial performance not possible**

Because of complete omission of some financial transactions and partial omission of some other transactions, correct assessment of financial position and financial performance of business is not possible.

- **Legal Compliance difficult**

Books of accounts are looked into by a wide variety of authorities to check compliance of various business laws e.g. Income tax authorities examine the books of accounts to check the accuracy of the books of accounts for assessment of tax liability. Single entry system, since, is an incomplete system does not serve the purpose of these authorities. Similarly in case of loss due to mishap, justification of claims filed for insurance with the insurance companies will be difficult.

16.4 Ascertainment of Profit and Loss

All types of business organizations, irrespective of their size and line of business, are always keen in assessing the results of business operations and the financial position. The result of business operations and financial position can be known by preparing the profit and loss account and balance sheet.

In case of single entry system, preparation of financial statements is bit difficult as compared to preparation of financial statements under double entry system. In case of single entry system, the problem faced is how to use the information, available in the incomplete records, to ascertain the profit or loss for the particular accounting year and also to determine the financial position of an entity as at the end of the year. There are two ways which can be used to find out the profit earned or loss incurred and to find out the financial position of the business. The two methods are as follows:

1. Statement of Affairs or Net worth Method.
2. Conversion method

16.5 Statement of Affairs or Net worth Method

There are two steps involved in this method, at first step we prepare statement of affairs to find out the capital of the firm. At second step a statement is prepared to find out the amount of profit earned or loss incurred by the business.

Step: 1

At first step two statements of affairs are prepared. Statement of affairs shows assets on one side and the liabilities on the other like a balance sheet. The difference between the totals of the two sides i.e. balancing figure is the capital. One statement of affairs is prepared for the beginning of accounting period and the second statement of affairs is prepared for the end of accounting period. The objective of preparing the statement of affairs is to find out the capital at the beginning and at the end of accounting period. The difference between the opening capital and closing capital helps us in ascertaining the profit earned or loss incurred during the year. Though statement of affairs is a statement of assets and liabilities like balance sheet, but it is not called a balance sheet because the data is not fully based on ledger balances. The amounts of items like fixed assets, outstanding expenses, bank balances, etc. are ascertained from the original vouchers. Specimen of the statement of affairs is given below:

Statement of Affairs as at —			
Liabilities	Amount	Assets	Amount
	Rs.		Rs.
Creditors	....	Furniture	....
Bills payable	....	Machinery	....
Outstanding expenses	....	Land and Building	....
Capital (balancing figure)*	....	Debtors	....
		Stock	....
		Cash and Bank	....
		Capital (balancing figure)*	....
	XXXX		XXXX

* Capital is the balancing figure. Depending on total of liability and assets side, it can come on either of two sides i.e. where the total of liabilities side is more than total of assets side, capital would be shown in assets side and it represents debit balance of capital. If total of assets side is more than liability side, capital would be shown on liability side and it represents credit balance of capital.

Step 2

Once the statements of affairs, both for the beginning and the end of the accounting period are prepared and amount of capital for both the periods is ascertained, the next step is to prepare the statement of profit and loss. Statement of Profit and Loss is prepared to ascertain the exact amount of profit or loss made during the year. The excess or shortage of closing capital over opening capital after adjustments for the fresh capital introduced and the amount of capital withdrawn is the exact amount of profit earned or loss incurred by the firm. The format of statement of Profit and Loss account is as given below:

Statement of Profit or Loss for the year ended

Particulars	Amount
	Rs.
Capital as at the end of the year (Computed from statement of affairs prepared for the end of year)	XXXX
<i>Less</i> Additional capital introduced during the year	XXXX
<i>Add</i> Drawings (capital withdrawn during the year)	XXXX
Adjusted capital at the end of year	XXXX
<i>Less</i> Capital as at the beginning of year	<u>XXXX</u>

(Computed from statement of affairs prepared for the beginning of year)

Profit or Loss made during the year

XXXX

Positive net result of above computation represents the profit earned during the year. In case the net result of the above computation is a negative amount, it would represent the loss sustained during the year.

Illustration 16.1

Mr. Rajinder started his stationery business on April 1, 2011 with a capital of Rs. 2,50,000. He did not maintain his accounts as required under double entry system. During September, 2011 he introduced fresh capital of Rs. 50,000. He withdrew Rs. 20,000 for personal use during December, 2011.

On March 31, 2012, assets and liabilities of Mr. Rajinder were as follows:

Total creditors Rs. 85,000; Total debtors Rs. 3,45,800; Stock Rs. 45,750 ; Cash at bank Rs. 45,680.

Calculate profit or loss made by Mr. Rajinder during the first year of his business using the statement of affairs method.

Solution:

Step 1

In this example, only one statement of affairs will be prepared at the end of the accounting period as capital at the beginning of accounting period is already given.

**Books of Mr. Rajinder
Statement of Affairs as on March 31, 2012**

Liabilities	Amount Rs.	Assets	Amount Rs.
Creditors	85,000	Cash at bank	45,680
Capital	3,52,230	Debtors	3,45,800
(balancing figure)		Stock	45,750
	4,37,230		4,37,230

Statement of Profit or Loss for the year ended March 31, 2012

Particulars	Amount Rs.
Capital on March 31, 2012	352,230
Add Drawings during the year	<u>20,000</u>
	372,230
Less Additional capital introduced during the year	<u>50,000</u>
Adjusted capital at end of the year, i.e. March 31, 2012	3,22,230
Less Capital at the beginning of year, i.e. April 01, 2011	<u>2,50,000</u>
Profit made during the year	72,330

Illustration 16.2

Mrs. Tejinder runs a small electronics product shop. She is not maintaining detailed accounting records as required under double entry system. On April 01, 2011, available information from her records indicated that she had the following assets and liabilities:

Land Rs. 4,00,000, Buildings Rs. 1,00,000, Stock Rs.1,50,000, Cash at bank Rs. 75,700, Cash in hand Rs. 8,150, Debtors Rs. 20,750, Creditors Rs. 65,300 and Outstanding wages Rs. 25,000. She withdrew Rs. 2,000 every month for meeting her personal expenses. She had also introduced Rs. 5,000 during the year as additional capital. On March 31, 2012 her position was as follows:

Land Rs. 4,00,000, Buildings Rs. 1,00,000, Stock Rs.85,000, Cash at bank Rs. 1,20,400, Cash in hand Rs. 35,840, Debtors Rs. 47,050, Creditors Rs. 25,600.

Calculate the profit made by Mrs. Tejinder during the year using statement of affairs method.

Solution:

**Books of Mrs. Tejinder
Statement of Affairs as on April 1, 2011
and March 31, 2012**

Liabilities	Apr. 11 Rs.	March, 12 Rs.	Assets	Apr. 11 Rs.	March, 12 Rs.
Creditors	65,300	25,600	Land	4,00,000	4,00,000
Wages outstanding	25,000	–	Buildings	1,00,000	1,00,000
Capital	6,64,300	7,62,690	Debtors	20,750	47,050
(Balancing figure)			Stock	1,50,000	85,000
			Cash at bank	75,700	1,20,400
			Cash in hand	8,150	35,840
	7,54,600	7,88,290		7,54,600	7,88,290

Statement of Profit or Loss for the year ended on March 31, 2012

Particulars	Amount Rs.
Capital as on March 31, 2012	7,62,690
Add Drawings during the year	<u>24,000</u>

	7,86,690
Less Additional capital introduced during the year	<u>5,000</u>
Adjusted capital at the end of the year (31.3.2012)	7,81,690
Less Capital as on April 01, 2004	<u>6,64,300</u>
Profit made during the year	1,17,390

Difference between Statement of Affairs and Balance Sheet

Both statement of affairs and balance sheet are the statements of financial position and show the assets and liabilities of a business entity on a particular date. However, there are some basic differences between the two. These differences are explained below:

Sr. No.	Statement of Affairs	Balance Sheet
1	A statement of affairs is prepared from incomplete records	Balance sheet is prepared from records maintained on the basis of double entry book-keeping
2	Value of Assets cannot be verified as they are recorded on the basis of estimates	Value of assets and liabilities can be verified from the ledger accounts
3	Objective of preparing a statement of affairs is to ascertain the amount of capital on a particular date	Balance sheet is prepared to know the financial position of the business at a particular date
4	While recording assets and liabilities, some assets or liabilities may get omitted and this omission may remain unknown because the effect of this omission gets adjusted in the capital account balance and the total of both sides of statement match	Omission of any asset or liability not possible as two sides of balance sheet will not agree and the accountant will trace the missing item from accounting records.
5	Omissions of assets or liabilities cannot be discovered easily	Omission of assets or liabilities can be discovered easily
6	Statement of affairs is less reliable	Balance Sheet is more reliable

16.6 Conversion Method

Conversion method is yet another method which takes information from the accounting record maintained as per single entry system, and converts it into double entry system to ascertain profit earned or loss incurred by the firm and also assess the financial position of the business enterprise by preparing the profit and loss account and balance sheet. The process followed under this method for the preparation of Trading and profit and loss account and Balance Sheet is explained below:

Preparing Trading and Profit and Loss Account and the Balance Sheet

Complete information regarding expenses, incomes, assets and liabilities is a prerequisite for the preparation of trading and profit and loss account and the balance sheet. In case of records maintained as per single entry system detailed information about all the items is not available e.g. details of some items like cash purchases, cash sales, debtors, creditors and other cash payments and receipts are easily available, while there are a number of items the details of which will have to be ascertained in an indirect manner by using the logic of double entry. The most common items the information of which is normally missing in the records maintained as per single entry system are:

- Opening capital
- Credit sales
- Credit Purchase
- Payments to debtors
- Payments to creditors
- Bills payable accepted
- Bills receivable received

The above list is not exhaustive, there may a wide variety of other information which is not available from the records maintained as per single entry system but is required for the purpose of preparation of Trading and profit and loss account and Balance Sheet. The information about the above stated items has to be ascertained using the logic of double entry system. As already discussed, opening capital can be worked out by preparing the statement of affairs at the beginning of the year. For other items, like cash purchases, cash sales etc., process to be followed for ascertainment of information has been explained with the help of examples below:

Ascertainment of Information about Credit Sales

The information about the amount of credit sales made in a year is usually not available from records maintained as per single entry system. Some other information related to debtors may also be missing. In order to find out the information about credit sales or to find out any other missing information about the debtors, one has to prepare total debtors account. The process of calculating information about credit sales or any other debtors' related information is explained below with the help of an example:

Format of Total Debtors Account

Dr.					Cr.		
Date	Particulars	J.F.	Amount Rs.	Date	Particulars	J.F.	Amount Rs.
	To Balance b/d		xxxx		By Cash (Cash received)		xxxx
					By Bank (cheque received)		xxxx
	To Bills receivable (bills dishonoured)		xxxx		By Discount allowed		xxxx
	To Bank (cheque dishonoured)		xxxx		By Bad debts		xxxx
	To Credit sales (balancing figure)		xxxx		By Bills receivable (bills received)		xxxx
					By Sales return		xxxx
					By Balance c/d		xxxx
			xxxx				xxxx

Illustration No. 16.3

Following information is obtained from the books of M/s KD and Sons:

	Rs.
Debtors on April 01, 2011	25,000
Debtors on March 31, 2012	60,000
Cash received from debtors	70,000
Discount allowed	3,000
Bills receivable	20,000
Bad debts	1,000
Find out the credit sales made by M/s KD and sons during the year.	

Solution

M/s KD and Sons

Total Debtors Account							
Dr.							Cr.
Date	Particulars	J.F.	Amount	Date	Particulars	J.F.	Amount
			Rs.				Rs.
2011							
Apr.01	To Balance b/d		25,000		By Cash		70,000
	To Credit sales		1,29,000		By Discount		3,000
	(balancing figure)				By Bills receivable		20,000
					By Bad debts		1,000
					By Balance c/d		60,000
			1,54,000				1,54,000

Ascertainment of Information about Credit Purchases

The information about the amount of credit purchases made in a year is usually not available from the records maintained as per single entry system. Some other information related to creditors may also be missing. In order to find out the information about credit purchase or to find out any other missing information about the creditors, one has to prepare total creditors account. The process of calculating information about credit purchases or any other creditors' related information is explained below with the help of an example:

Format of Total Creditors Account							
Dr.							Cr.
Date	Particulars	J.F.	Amount	Date	Particulars	J.F.	Amount
			Rs.				Rs.
	To Cash paid		xxxx		By Balance b/d		xxxx
	To Bank		xxxx		By Bank (cheques		xxxx
	(cheques issued)				dishonoured)		
	To Bills payable		xxxx		By Bills payable		xxxx
	(bills accepted)				(bills dishonoured)		
	To Discount received		xxxx		By Credit purchases		xxxx
	To Purchases return		xxxx				
	To Balance c/d		xxxx				
			xxxx				xxxx

Illustration 16.4

Following information is extracted from the books of M/s Brakbon:

	Rs.
Opening balance of creditors	35,000
Closing balance of creditors	70,000
Payment made in cash	80,000
Discount received	5,000

Find out the value of credit purchases made during the year.

Solution:

Books of Brakbon							
Total Creditors Account							
Dr.							Cr.
Date	Particulars	J.F.	Amount	Date	Particulars	J.F.	Amount
			Rs.				Rs.
	To Cash		80,000		By Balance b/d		35,000
	To Discount		5,000		By Credit purchases		1,20,000
					(balancing figure)		
	To Balance c/d		70,000				
			1,55,000				1,55,000

Ascertainment of Information about Bills Receivable and Bills payable

Generally in case of maintenance of books of accounts as per single entry system, information about the figures of the bills received and bills accepted during the year are not given. To find out the information about bills received, one can prepare total bills receivable account and to find out the information about bills accepted one can prepare total bills payable account. The process of finding out the information about bills receivable and bills payable can be explained with the help of examples given below.

Format of Total Bills Receivable Account

Dr.							Cr.
Date	Particulars	J.F.	Amount	Date	Particulars	J.F.	Amount
			Rs.				Rs.
	To Balance b/d		xxxx		By Bank		xxxx
					By Sundry debtors (bills dishonoured)		
	To Sundry debtors (bills received)		xxxx		By Bills honoured		xxxx
					By Balance c/d		xxxx
			xxxx				xxxx

Format of Total Bills Payable Account

Dr.							Cr.
Date	Particulars	J.F.	Amount	Date	Particulars	J.F.	Amount
			Rs.				Rs.
	To Bank (bills matured)		xxxx		By Balance b/d		xxxx

To Sundry creditors (bills dishonoured)	xxxx	By Sundry creditors (bills accepted)	xxxx
To Balance c/d	xxxx		
	xxxx		xxxx

Illustration 16.5

From the following data available from the records of M/s Jogindra Furnishings, find out the value of bills received and bills accepted during the year:

	Rs.
Opening bills receivable	15,000
Opening bills payable	39,000
Bills receivable dishonoured	3,000
Bills payable dishonoured	63,000
Closing bills payable	58,000
Bills collected during the year	15,000
Closing bills receivable	14,000

Solution**Total Bills Receivable Account**

Dr.				Cr.			
Date	Particulars	J.F.	Amount Rs.	Date	Particulars	J.F.	Amount Rs.
	To Balance b/d		15,000		By Sundry debtors (bills dishonoured)		3,000
	To Sundry debtors (bills received-balancing figure)		17,000		By Bank (bills collected)		15,000
					By Balance c/d		14,000
			32,000				32,000

Total Bills Payable Account

Dr.				Cr.			
Date	Particulars	J.F.	Amount Rs.	Date	Particulars	J.F.	Amount Rs.
	To Bill dishonoured		63,000		By Balance b/d		39,000
	To Balance c/d		58,000		By Sundry Creditors (Bills accepted - balancing figure)		82,000
			1,21,000				1,21,000

Ascertainment of Missing Information through Summary of Cash

To ascertain information about any missing item of receipt or payment, cash book summary showing all receipts and payments made during the year is prepared and the balancing figure is taken as the amount of missing item.

Sometimes, information pertaining to two or more transactions may be seen missing simultaneously e.g. if both amount paid to creditors and that received from debtors are missing along with the information pertaining to any one cash receipts or payment, then any one of these may be obtained first through the total creditors or total debtors account, as the case may be, and then the other missing information may be ascertained from the cash book summary.

After tracing the missing figures, the final accounts may be prepared straight away or one may first examine the accuracy of information by preparing trial balance and thereafter prepare final statements.

The components of the trial balance and their sources of information are summarized below:

Sr. No.	Component	Source of Information
1	Bills receivable received	Total bills receivable account
2	Bills payable accepted	Total bills payable account
3	Cash/Bank balance	Summary of cash
4	Credit purchases	Total creditors account
5	Cash purchases	Summary of cash
6	Credit sales	Total debtors account
7	Cash Sales	Summary of cash
8	Expenses and Revenues	Cash Summary and Additional Information
9	Closing assets (except stock) and liabilities	Closing List
10	Opening Assets (Including opening stock) and Liabilities	Opening List
11	Opening Capital	Opening Statement of Affairs
12	Other losses and Gains	All the accounts and additional Information

Illustration 16.6

From the following information for the year ended March 31, 2012, you are required to find out the amount of total purchases and total sales of M/s Labhu Ram:

	Amount
	Rs.
Total Creditors as on April 01, 2011	70,000

Total Debtors as on April 01, 2011	55,000
Bills receivable as on April 01, 2011	46,000
Bills payable as on April 01, 2011	35,000
Bad debts	5,000
Discount received	2,000
Return inwards	6,000
Discount allowed	5,000
Cash sales	59,000
Cash purchases	15,000
Total debtors as on March 31, 2012	78,000
Cash paid to creditors	96,000
Cash received from debtors	83,000
Cash received against bills receivable	22,000
Payment made against bills payable	35,000
Total creditors as on March 31, 2012	43,000
Bills payable as on March 31, 2012	57,000
Bills receivable as on March 31, 2012	41,000

Solution**Total Bills Receivable Account**

Dr.						Cr.	
Date	Particulars	J.F.	Amount	Date	Particulars	J.F.	Amount
			Rs.				Rs.
	To Balance b/d		46,000		By Cash		22,000
	To Total debtors		17,000		By Balance c/d		41,000
	(balancing figure)						
			63,000				63,000

Total Bills Payable Account

Dr.						Cr.	
Date	Particulars	J.F.	Amount	Date	Particulars	J.F.	Amount
			Rs.				Rs.
	To Cash		35,000		By Balance b/d		35,000
	To Balance c/d		57,000		By Total creditors		57,000
					(balancing figure)		
			92,000				92,000

Total Debtors Account

Dr.						Cr.	
Date	Particulars	J.F.	Amount	Date	Particulars	J.F.	Amount
			Rs.				Rs.
	To Balance b/d		55,000		By Bad debts		5,000
	To Sales				By Return inwards*		6,000

(balancing figure)	1,39,000	By Discount allowed	5,000
		By Cash	83,000
		By Bills receivable (Transfer from bills receivable account)	17,000
		By Balance c/d	78,000
	1,94,000		1,94,000

*Assumed that return inward is the returns made by the debtors.

Total Creditors Account							
Dr.							Cr.
Date	Particulars	J.F.	Amount	Date	Particulars	J.F.	Amount
			Rs.				Rs.
	To Discount received		2,000		By Balance b/d		70,000
	To Cash		96,000		By Purchases (credit)		1,42,000
					(balancing figure)		
	To Bills payable (transfer from bills payable account)		57,000				
	To Balance c/d		57,000				
			2,12,000				2,12,000

Working Notes

- (i) Total Purchases = Credit purchases + Cash Purchases = Rs. 1,42,000 + Rs. 15,000 = Rs. 1,57,000.
(ii) Total Sales = Credit Sales + Cash Sales = Rs. 1,39,000 + 59,000 = 1,98,000

Illustration 16.7

Calculate the value of net sales from the below given information:

	Rs.
Debtors on April 01, 2011	70,000
Debtors on March 31, 2012	60,000
Opening balance of bills receivable as on April 01, 2011	27,000
Closing balance of bills receivable as on March 31, 2012	34,000
Cash received from debtors	3,15,000
Cash received against bills receivable	32,000
Bill receivables (dishonored)	9,000
Cash sales	2,40,000
Sales return out of cash sales	17,000

Solution

Net Sales = Credit Sales + Cash Sales – Sales Return

Cash Sales and Sales Return are given, Credit sales will be ascertained from total debtors account.

Net Sales = 3,44,000+ 2,40,000-17,000 = Rs. 5,67,000

Working Notes

Calculation of Credit Sales

Total Bills Receivable Account							
Dr.				Cr.			
Date	Particulars	J.F.	Amount	Date	Particulars	J.F.	Amount
			Rs				Rs.
	To Opening balance		27,000		By Cash		32,000
	To Debtors (Bills receivable)		48,000		By Bills receivable		9,000
	(balancing figure)		75,000		(dishonoured)		34,000
					By Closing balance		75,000

Total Debtors Account							
Dr.				Cr.			
Date	Particulars	J.F.	Amount	Date	Particulars	J.F.	Amount
			Rs.				Rs.
	To Opening balance		70,000		By Cash received		3,15,000
	To Bills receivable		9,000		By Bills receivable		48,000
	(dishonoured)				(transferred from		
	To Sales (balancing figure)		3,44,000		bills receivable		
					account)		
			4,23,000		By Closing balance		60,000
							4,23,000

Illustration 16.8

M/s. ABC and Sons follows single entry system for maintaining record of financial transactions. From the following information available from his records, prepare profit and loss account for the year ending on March 31, 2012 and a balance sheet as at that date. The rate of depreciation on furniture is 10%.

Summary of Cash

Dr.		Cr.	
Receipts	Amount	Payments	Amount
	Rs.		Rs.
To Balance b/d	10,000	By Cash purchases	17,000
To Cash sales	45,000	By Paid to creditors	18,000
To Received from debtors	33,000	By Sundry expenses	10,000
		By Cartage	6,000
		By Drawings	9,000
		By Balance c/d	28,000

88,000**88,000****Other information****March 31, 2012**

	March 31, 2011	March 31, 2012
	Rs.	Rs.
Debtors	8,000	11,000
Creditors	15,400	7,000
Stock of materials	11,000	15,500
Washing equipment	30,000	30,000
Furniture	5,000	5,000
Discount allowed during the year		1,700
Discount received during the year		1,800

Solution

Books of M/s ABC and Sons
Trading and Profit and Loss Account
for the year ended on March 31, 2012

Expenses/losses	Amount	Revenues/gains	Amount
	Rs.		Rs.
To Opening stock	11,000	By Sales	82,700
To Purchases	28,400	By Closing stock	15,500
To Cartage	6,000		
To Gross profit c/d	52,800		
	98,200		98,200
To Sundry expenses	10,000	By Gross profit b/d	52,800
To Discount allowed	1,700	By Discount received	1,800
To Depreciation	500		
To Net profit (transferred to capital account)	42,400		
	54,600		54,600

Balance Sheet as at March 31, 2012

Liabilities	Amount	Assets	Amount
	Rs.		Rs.
Capital	48,600	Washing equipment	30,000
Add Profit	<u>42,400</u>		
	91,000		
Less Drawings	<u>9,000</u>	Furniture	5,000
Creditors	7,000	Less Depreciation	<u>500</u>
		Stock of materials	15,500
		Debtors	11,000
		Cash	28,000
	89,000		89,000

Working Notes**Total Debtors Account**

Dr.				Cr.			
Date	Particulars	J.F.	Amount Rs.	Date	Particulars	J.F.	Amount Rs.
	To Balance b/d		8,000		By Cash		33,000
	To Sales (credit) (balancing figure)		37,700		By Discount allowed		1,700
			45,700		By Balance c/d		11,000
							45,700

Total Creditors Account

Dr.				Cr.			
Date	Particulars	J.F.	Amount Rs.	Date	Particulars	J.F.	Amount Rs.
	To Cash		18,000		By Balance b/d		15,400
	To Discount received		1,800		By Purchases (credit) (balancing figure)		11,400
	To Balance c/d		7,000				
			26,800				26,800

Statement of Affairs as at March 31, 2011

Liabilities	Amount Rs.	Assets	Amount Rs.
Creditors	15,400	Washing equipment	30,000
Capital	48,600	Furniture	5,000
(balancing figure)		Stock of material	11,000
		Debtors	8,000
		Cash	10,000
	64,000		64,000

Illustration 16.9

Mr. Ramanuj started business on April 01, 2011 with cash of Rs. 65,000, Machinery worth 30,000, Furniture of Rs. 12,000 and Stock of 5,000. During the year he further introduced Rs. 30,000 in his business. From the following information extracted from his books, you are required to prepare final accounts for the ended March, 2012:

	Rs.
Receipt from debtors	57,000
Cash sales	55,000
Cash purchases	35,000
Wages paid	3,000
Salaries to staff	15,000
Trade expanses	6,000
Electricity bill of factory	8,500

Drawings of Ramanuj	2,000
Cash paid to creditors	41,000
Discount allowed	700
Discount received	2,200
Bad debts written-off	1,200
Cash balance at end of year	18,000

Mr. Ramanuj used goods worth 2,500 for domestic purposes, which is not recorded in the books. Charge depreciation on furniture 20% and machinery 10% p.a. On March 31, 2012 his debtors were worth 65,000 and creditors Rs. 30,000, stock in trade was valued on that date at Rs. 28,000.

Solution:

Books of Mr. Ramanuj
Trading and Profit and Loss Account
for the year ended March 31, 2012

Expenses/Losses	Amount Rs.	Revenues/Gains	Amount Rs.
To Opening stock	5,000	By Sales	Cash 55,000
To Purchases :			Credit <u>1,23,900</u>
Cash : 35,000			1,78,900
Credit : <u>73,200</u>		By Closing stock	28,000
1,08,200			
<i>Less</i> Goods used for private use	2,500		
	1,05,700		
To Wages	3,000		
To Electricity bill of factory	8,500		
To Gross profit c/d	84,700		
	<u>2,06,900</u>		<u>2,06,900</u>
To Salaries	15,000	By Gross profit b/d	84,700
To Trade expenses	6,000	By Discount received	2,200
To Discount allowed	700		
To Bad debts	1,200		
To Depreciation			
Furniture 2,400			
Machinery 3,000	5,400		
To Net profit (transferred to capital account)	58,600		
	<u>86,900</u>		<u>86,900</u>

Balance Sheet of Mr. Ramanuj as at March 31, 2012

Liabilities	Amount Rs.	Assets	Amount Rs.
Creditors	30,000	Cash	96,500
Capital	1,12,000	Stock	28,000
<i>Add</i> Net profit	58,600	Debtors	65,000

	1,70,600				Furniture	12,000	
Add Additional capital	30,000				Less Depreciation	2,400	9,600
	2,00,600				Machinery	30,000	
Less Drawings					Less Depreciation	3,000	27,000
Cash	2,000						
Goods	<u>2,500</u>	4,500	196,100				
			<u>2,26,100</u>				<u>2,26,100</u>

Working Notes**(i) Total Debtors Account**

Dr.				Cr.			
Date	Particulars	J.F.	Amount Rs.	Date	Particulars	J.F.	Amount Rs.
	To Balance b/d		NIL		By Cash		57,000
	To Sales (credit) (balancing figure)		1,23,900		By Discount allowed		700
					By Bad debts		1,200
					By Balance c/d		65,000
			<u>1,23,900</u>				<u>1,23,900</u>

(ii) Total Creditors Account

Dr.				Cr.			
Date	Particulars	J.F.	Amount Rs.	Date	Particulars	J.F.	Amount Rs.
	To Cash		41,000		By Balance b/d		NIL
	To Discount received		2,200		By Purchase credit (balancing figure)		73,200
	To Balance c/d		30,000				
			<u>73,200</u>				<u>73,200</u>

(iii) Statement of Affair as on March 31, 2011

Liabilities	Amount Rs.	Assets	Amounts Rs.
Capital (balancing figure)	1,12,000	Cash	65,000
		Stock	5,000
		Furniture	12,000
		Machinery	30,000
	<u>1,12,000</u>		<u>1,12,000</u>

(iv) Summary of Cash

Dr. Receipts	Amount Rs.	Payments	Cr. Amount Rs.
-----------------	---------------	----------	----------------------

To Balance b/d	65,000	By Purchases	35,000
To Capital	30,000	By Wages	3,000
To Debtors	57,000	By Salaries	15,000
To Sales	55,000	By Trade expenses	6,000
		By Electric bill	8,500
		By Drawings	2,000
		By Creditors	41,000
		By Balance c/d	96,500
	2,07,000		2,07,000

Illustration 16.10

Mr. Balwinder maintains books as per single entry system. From the following particulars prepare the final Accounts, after providing for doubtful debts @10 per cent of debtors outstanding.

(i) Balance Sheet as on April 1, 2011

Liabilities	Amount Rs.	Assets	Amount Rs.
Capital	110,000	Motor Car	60,000
Bills payable	40,000	Stock	50,000
Creditors	40,000	Debtors	45,000
		Bills receivable	25,000
		Cash in hand	10,000
	1,90,000		1,90,000

(ii) Cash Transactions during the year

Particular	Amount Rs.	Particular	Amount Rs.
To Balance b/d	10,000	By Furniture	25,000
To Receipt from debtors	1,35,000	By Wages	7,500
To Bills receivable	14,000	By Purchases	42,000
To Sales	1,15,000	By Drawings	12,000
		By Bills payable	31,000
		By General expenses	20,400
		By Payment to creditors	69,300
		By Balance c/d	66,800
	2,74,000		2,74,000

(iii) Other Information

Particulars	Amount Rs.
Bills receivable drawn (received)	6,700
Discount to customers	2,000

Discount from suppliers	600
Credit purchases	35,200
Closing stock	41,000
Closing balance of debtor	57,400
Closing balance of bills payable	12,100

Solution:

**Books of Mr. Balwinder
Trading and Profit and Loss Account
for the year ended March 31, 2012**

Expenses/Losses	Amount Rs.	Revenues/Gains	Amount Rs.
To Opening stock	50,000	By Sales	
To Purchases			
Cash	42,000	Cash	1,15,000
Credit	35,200	Credit	1,56,100
To Wages	7,500	By Closing stock	41,000
To Gross profit c/d	1,77,400		
	<u>312,100</u>		<u>3,12,100</u>
To General expenses	20,400	By Gross profit b/d	1,77,400
To Discount allowed	2,000	By Discount received	600
To Reserve for bad debts	5,740		
To Net profit	1,49,860		
	<u>1,82,000</u>		<u>1,82,000</u>

Balance Sheet as March 31, 2012

Liabilities	Amount Rs.	Assets	Amount Rs.
Capital	1,10,000	Motor car	60,000
Add Net profit	<u>1,49,860</u>	Furniture	25,000
Less Drawings	<u>12,000</u>	Stock	41,000
	2,47,860		
Creditors	2,200	Debtors	57,400
Bills payable	12,100	Less Provision	<u>5,740</u>
		Bills receivable	17,700
		Cash	66,800
	<u>2,62,160</u>		<u>2,62,160</u>

Working Notes**(i) Total Bills Receivable Account**

Dr.

Cr.

Date	Particulars	J.F.	Amount	Date	Particulars	J.F.	Amount
			Rs.				Rs.
	To Balance b/d		25,000		By Cash (receipt)		14,000
	To Debtors		6,700		By Balance c/d		17,700
	(bills drawn) (balancing figure)						
			31,700				31,700

(ii) Total Debtors Account

Dr.	Date	Particulars	J.F.	Amount	Date	Particulars	J.F.	Cr.	Amount
				Rs.					Rs.
		To Balance b/d		45,000		By Cash (receipt)		1,35,000	
		To Credit sales		1,56,100		By Bills (drawn)		6,700	
		(balancing figure)				By Discount allowed		2,000	
						By Balance c/d		57,400	
				2,01,100				2,01,100	

(iii) Total Bills payable Account

Dr.	Date	Particulars	J.F.	Amount	Date	Particulars	J.F.	Cr.	Amount
				Rs.					Rs.
		To Cash (paid)		31,000		By Balance b/d		40,000	
		To Balance c/d		12,100		By Creditors (bills accepted)		3,100	
						(balancing figure)			
				43,100				43,100	

Total Creditors Account

Dr.	Date	Particulars	J.F.	Amount	Date	Particulars	J.F.	Cr.	Amount
				Rs.					Rs.
		To Cash		69,300		By Balance b/d		40,000	
		To Bills payable		3,100		By Credit purchases		35,200	
		To Discount received		600					
		To Balance c/d		2,200					
		(balancing figure)							
				75,200				75,200	

16.7 Summary

Single entry system of book keeping is the distorted version of double entry system. Business organizations operating on small scale who cannot afford the cost of maintaining detailed accounting

records maintain their accounts as per single entry basis. In case of single entry system, firms normally maintain accounts of debtors, creditors, other personal accounts and record of cash transactions only. There are two methods i.e. Net worth method and second Conversion method which are helpful in assessing the profit or loss and financial position of the business enterprises from records maintained as per single entry system.

16.8 Glossary

Accounting: the technique of preparing financial statements from book keeping records.

Asset: Something owned by the business which has a measurable cost –fixed assets, current assets and other assets.

Current Assets: assets which are normally realized in cash or used up in operations during one accounting period is normally one year.

Current liability: a liability due for payment within one operating period, normally one year. This does not include long term- term liabilities or shareholder's fund.

16.9 Check your Knowledge

True and False

1. In single entry system normally record of transactions related to real account heads is maintained.
2. It is not possible to correctly estimate the financial position of the business from the records maintained as per single entry system.
3. Missing information about credit sales can be found from Total Debtors account
4. Missing information about opening capital can be found from opening statement of affairs
5. Statement of Affairs can also be written as Balance Sheet.

Fill in the Blanks

6. To find out profit or loss, drawings made by the proprietor are added to thecapital.
7. Statement of affairs method used to ascertain the financial position of the business under single entry system is also known as.....
8.method is used to convert the information of single entry system for preparing trading and profit and loss account and balance sheet.
9. There aresteps involved in the statement of affairs method.

10. Information about closing assets can be found fromlist.

16.10 ANSWERS TO SELF ASSESSMENT QUESTIONS

True and False

1. False
2. True
3. True
4. True
5. False

Fill in the Blanks

6. Closing
7. Net worth Method
8. Conversion
9. Two
10. Closing

16.11 Self Assessment

1. Explain the meaning and need of single entry system of accounting.
2. Write a note on advantages of single entry system
3. Write a note on limitations of single entry system
4. Explain the net worth method used to find profit or loss under single entry system
5. Write a note on conversion method
6. Explain the process of preparation of profit and loss account and balance sheet from the records maintained under single entry system. You make take hypothetical example for this.

16.12 References

1. Financial Accounting Principles and Practice- Prof. Jawahar Lal and Dr.Seema Srivastava
2. Financial Accounting- Sri P. C. Tulsian
3. Advanced Accountancy - Sri R. L. Gupta and Sri M. Radhaswamy
4. Advanced Accountancy-Sri S. P. Jain and Sri K. L. Narang.

Unit 17

Accounts of Non-Trading Institutions

- 17.1 Introduction
- 17.2 Non-Trading Organizations
- 17.3 Accounting Records of Non-trading Organizations
- 17.4 Financial Statements of Non-trading Organizations
- 17.5 Income and Expenditure Account
- 17.6 Balance Sheet
- 17.7 Accounting Treatment of Special Items Related to Non-trading Organizations
- 17.8 Summary
- 17.9 Glossary
- 17.10 Check your progress
- 17.11 Answers to check your progress
- 17.12 Terminal Questions
- 17.13 References

OBJECTIVES

After studying this unit, students will be able to;

- Explain the meaning and characteristics of non-trading organizations;
- Explain the meaning of different kinds of terms related to non-trading organisation
- List out the main financial statements prepared by non-trading organizations;
- Explain the procedure of preparing Receipt and Payment Account from a given date;
- Explain the procedure of preparing the Income and Expenditure Account;
- Prepare Income and Expenditure Account and Balance Sheet;
- List out the difference between the Receipt and Payment Account and the Income and Expenditure Account;

17.1 Introduction

There are certain organizations which are set up for providing services to its members and to the society at large. Such organizations may or may not earn profits as their main objective is to render service. Organizations like clubs, charitable institutions, schools, religious organizations, trade unions, welfare societies and societies established for the promotion of art and culture fall in the category of non-trading organizations. They are managed by trustees. These organizations normally do not undertake any business activity. However, these organizations are accountable to their members and the society for the management of funds and they, therefore, have to maintain proper books of accounts. As a part of their financial statements, non-trading organizations prepare Receipt and Payment Account; Income and Expenditure Account; and Balance Sheet at the end of every accounting period (normally a financial year). In this unit of the study material, we have explained the meaning of non-trading organizations and have also explained the process of writing up of financial statements of these organizations.

17.2 Non-Trading Organizations

Non-trading organizations refer to the organisations that work for the welfare of the social groups or the society at large, earning of profits is not their main motive. Non-trading organisations unlike trading organisations normally, they do not manufacture, purchase or sell goods and may not have credit transactions. The major sources of their income mainly include subscriptions from their members, membership fees, grants-in-aid, donations and income from investments, etc. Since the non-trading organisations are formed for social welfare and earning of profits is not their main objective, these organizations do not prepare Profit and loss account. However, since these organisations make use of societal funds collected in the form of grant in aids, therefore they do maintain financial records to meet statutory requirements and to exercise control over utilization of their funds. Non-trading organisations do prepare Receipt and Payment account, Income and Expenditure Account and Balance Sheet at the end of the accounting year and submit these to the Registrar of Societies.

Characteristics

Provide Service to Society

The main aim of non-trading organisations is to provide service to a specific group or public at large such as health care, education, sports, and recreation etc. The service may be provided either free of cost or at nominal cost. Profit earning is not their main objective. The performance of these organisations is dependent on the basis of their contributions to the welfare of the society rather than on the owners' satisfaction.

Charitable Trusts/Societies

Non-trading organisations are formed mainly as charitable trusts/societies.

Source of Income

The main sources of income of such organisations include subscriptions from members, donations, legacies, grant-in-aid, income from investments, etc. The funds collected by these organisations from different sources are added to Capital or General Fund.

Non Distribution of Surplus

Surplus generated in the form of excess of income over expenditure is not distributed amongst the members. It is simply added in the capital fund and becomes a part of capital of the organisation.

Management

Management of the non-trading organizations is in the hands of the managing committee. Managing committee is elected by the members of the organization from amongst themselves.

Accounting Records

These organizations use same accrual basis of accounting as used by other business units. The monetary transactions are recorded through vouchers as per double entry system. But unlike trading organisations, non-trading organisations don't prepare profit and loss account; the main financial statements prepared by these organisations include Receipt and Payment account, Income and Expenditure account and Balance Sheet.

17.3 Accounting Records of Non-trading Organisations

Non-trading organizations are required to maintain proper accounting records and also maintain effective control over utilization of funds as per statutory requirements. Because these organizations don't do any business, their main sources of income are subscriptions from members, donations, financial assistance from government and income from investments. As most of the transactions conducted by these organisations are in cash or through the bank, therefore, they usually keep a cash book in which all receipts and payments are duly recorded. A ledger containing the accounts of all incomes, expenses, assets and liabilities is also maintained. Further, a stock register is maintained to keep complete record of all fixed assets and other inventory. Capital fund also called general fund is maintained to which all the collections from life membership fee, donation, legacies, and surplus generated etc. received from year to year is added. Non-trading organisations don't have any capital account.

Financial statements are prepared at the end of the accounting year on the basis of information contained in the cash book and ledger.

17.4 Financial Statements of Non-trading Organisations

Although non-trading organizations are non-profit making entities and don't indulge in any trading or business activities but they are required to prepare financial statements at the end of the each accounting period. As per legal requirements they are required to provide the necessary financial information to the members, donors, contributors and also to the Registrar of Societies. The final accounts of a 'non-trading organization' include:

1. Receipt and Payment Account
2. Income and Expenditure Account, and
3. Balance Sheet.

These organizations don't prepare 'Trading and Profit and Loss account'.

1. Receipt and Payment Account

Receipt and Payment account is like a consolidated cash book made on annual basis. All the cash receipts and cash payments made in a year are recorded in receipt and payment account on consolidated basis e.g. subscriptions received from the members on different dates, shall be shown on the receipts side of the Receipt and Payment Account as one item with its total amount. In simple words it can be described as the summary of cash and bank transactions.

There is legal obligation on non-trading concerns to prepare Receipt and Payment account as it is required to be submitted to the Registrar of Societies along with the Income and Expenditure Account, and the Balance Sheet. Below given is the format of Receipt and Payments account:

Receipt and Payment Account for the year ending _____			
Dr.			Cr.
Receipts	Amount	Payments	Amount
	(Rs.)		(Rs.)
Balance b/d		Balance b/d (Bank overdraft)	xxx
Cash in Hand	xxx	Wages and Salaries	xxx
Cash at Bank	xxx	Rent	xxx
Subscriptions	xxx	Rates and Taxes	xxx
General Donations	xxx	Insurance	xxx
Sale of newspaper	xxx	Printing and Stationery	xxx
periodicals/waste paper		Postage and courier	xxx
Sale of old sports materials	xxx	Advertisement	xxx
Interest on fixed deposits		Sundry expenses	xxx
Interest/Dividend on general	xxx	Telephone charges	xxx
investments		Entertainment expenses	xxx
Locker Rent	xxx	Audit fees	xxx
Sale of scraps	xxx	Honorarium	xxx
Proceeds from charity show	xxx	Repair and Renewals	xxx
Miscellaneous receipts	xxx	Upkeep of ground	xxx
Grant-in-aid**	xxx	Conveyance	xxx
Legacies	xxx	Newspapers and Periodicals	xxx
Specific Donations	xxx	Purchases of Assets	xxx
Sale of Investments	xxx	Purchase of Investments	xxx
Sale of Fixed Assets	xxx	Balance c/d	xxx
Life membership fees	xxx	Cash in hand	xxx
Entrance fees	xxx	Cash at Bank ¹	xxx
Receipts on account of	xxx		
specific purpose funds			
Interest on specific funds'	xxx		
investments			
Balance b/d (Bank Overdraft) ¹	xxx		
	xxxx		xxxx

1. Either of these two items will appear in the Receipt and Payments account depending upon the bank balance of the organization. In case of bank overdraft, balance will come of receipt side. In case receipts are more than payments then balance will appear on payment side.
2. The above data can also be shown in the form of the respective accounts in the ledger. A detailed illustrative list of items of receipts and payments is given as follows:

Receipts

1. Donations
 - (a) General
 - (b) Specific purpose
2. Entrance Fees
3. Legacies
4. Sale of Investments
5. Sale of Fixed Assets
6. Subscriptions from Members
7. Life Membership Fees
8. Sale of old Newspapers
9. Sale of Old Sports Material
10. Interest on Fixed Deposits
11. Interest/ Dividend on Investments
12. Proceed from Charity Shows
13. Sale of Scrap
14. Grant-in-aid
15. Interest/Dividend on Specific Fund Investments
16. Miscellaneous Receipts.

Payments

1. Purchase of Fixed Assets
2. Purchase of Sports Material
3. Investment in Securities
4. Printing and Stationery
5. Postage and Courier Charges
6. Advertisements
7. Wages and Salary
8. Honorarium
9. Telephone Charges
10. Electricity and Water Charges
11. Repairs and Renewals
12. Upkeep of Play Ground
13. Conveyance Charges
14. Subscription for Periodicals
15. Audit Fees
16. Entertainment Expenses
17. Municipal Taxes
18. Charity
19. Insurance

Preparation of Receipt and Payment Account

1. All Receipts and Payments made in a year are to be recorded on consolidated basis irrespective of whether they pertain to the current period, previous period or succeeding period.
2. While recording receipts or payments no distinction is made between receipts and payments of capital and revenue nature. All receipts and payments are to be recorded.
3. Non cash transactions/items like depreciation are not to be recorded.
4. None of the receivable income and payable expense is to be entered in this account as they do not involve inflow or outflow of cash.
5. The opening balance in Receipt and Payment Account represents cash in hand/ cash at bank which is shown on its receipts side. No distinction is made in receipts/payments made in cash or through bank. With the exception of the opening and closing balances, the total amount of each receipt and payment is shown in this account.
6. The closing balance of this account represents cash in hand and bank balance as at the end of the year, which appear on the credit side of the Receipt and Payment Account. However, if it is bank overdraft at the end it shall be shown on its debit side as the last item.

The process of preparation of Receipts and Payment Account is explained with the help of Illustration no. 17.1 given below:

Illustration 17.1**Cash Book (Columnar)**

Dr.				Cr.			
Date	Details	L.F.	Bank Amount (Rs.)	Office Date	Details	L.F.	Bank Office Amount (Rs.)
20011				2011			
April 1	Balance b/d		30,000	April 7	Insurance premium		13,000
April 12	Subscriptions		1,00,000	May 18	Printing and stationery		11,000
April 13	Entrance fees		23,000	May 26	Postage		510
May 2	Life membership Fees		11,000		courier fees		
June 1	Locker rent			June 19	Telephone expenses		850
July 3	Life membership fees		5,000	July 21	Wages and salaries		17,000
Aug. 4	Donation for building		55,000	July 7	Rates and Taxes		21,000
Sept. 3	Subscriptions (2010-2011)		33,000	July 29	Govt. securities		90,000
Sept. 10	Subscription		41,000	Aug. 23	Printing and stationery		12,000
Sept. 19	Entrance fees		14,000	Aug. 25	Postage and courier service		400
Nov. 12	Subscription		31,000	Sept. 13	Lighting		11,500
Nov. 15	Subscription (2012-13)		15,000	Sept 15	Telephone expenses		160
2012				Oct. 10	Wages and salaries		13,000
Feb. 14	Subscription		23,000	Oct. 12	Printing and stationery		16,000
Mar. 26	Interest on government securities		19,000	Oct. 30	Govt. securities		1,50,000
				Dec. 19	Wages and Salaries		24,000
				2012			
				Jan. 10	Courier charges		750
				Feb. 18	Telephone expenses		890
				Mar. 16	Postage and Courier fees		930
				Mar. 19	Lighting		13,600
				Mar. 24	Wages and Salaries		24,000
				Mar. 31	Balance c/d		900
			4,00,000				30,510
							70,000

Step 1

Part A - Item wise consolidation of Receipts**Subscription**

A. Subscription (2011-12)	Rs.
April 12 Subscriptions	1,00,000
Sept. 10 Subscription	41,000
Nov. 12 Subscription	31,000
Feb. 14 Subscription	23,000
Total	1,95,000
B. Subscription (2010-11)	
Sept. 3 Subscriptions	33,000
Total	33,000
C. Subscription (2012-13)	
Nov. 15 Subscription	15,000
Total	15,000

Total Subscription Received (A+B+C) Rs. 2,43,000

Entrance Fees

Date	Rs.
April 13 Entrance fees	23,000
Sept. 19 Entrance fees	14,000
Total	37,000

Locker Rent

Date	Rs.
June 1	46,000

Life Membership fees

Date	Rs.
May 2	11,000
July 3	5,000
Total	16,000

Donation for Building

Date	(Rs)
Aug. 4	55,000
Total	55,000

Interest on Government Securities

Date	Rs.
Mar. 26	19,000
Total	19,000

Part B -Item wise consolidation of Payments

Insurance Premium

Date	Rs.
April 7	13,000
Total	13,000

Printing and Stationery

Date	Rs.
May 18	11,000
Aug. 23	12,000
Oct. 12	16,000
Total	39,000

Postage and Courier Services fees

Date	Rs
May 26	510
Aug. 25	400
Mar. 16	930
2012 Jan. 10	750
Total	2,590

Telephone Expenses

Date	Rs.
June 19	850
Sept 15	160
Feb. 18	890
Total	1,900

Wages and Salaries

Date	Rs.
July 21	17,000
Oct. 10	31,000
Dec. 19	24,000
Mar. 24	24,000
Total	96,000

Rates and Taxes

Date	Rs
July 7	21,000
Total	<u>21,000</u>

Govt. Securities

Date	Rs
July 29	90,000
Oct. 30	1,50,000
Total	<u>2,40,000</u>

Lighting

Date	Rs.
Sept, 13	11,500
Mar. 19 , 2012	13,600
Total	<u>25,100</u>

Receipt and Payment Account for the year ending March 31, 2012

Dr.		Cr.
Receipts	Amount (Rs.)	Payments Amount (Rs.)
Cash in hand as on April 1, 2011	30,000	Printing and Stationery Lighting
Cash at bank as on April 1, 2011	24,000	Rates and Taxes
Subscription:		Telephone charges
2010–11	33,000	Postage and Courier
2011–12	1,95,000	Wages and Salaries
2012–13	15,000	Insurance Premium
Donation for building	55,000	Purchase of govt. securities
Entrance fees	37,000	Cash in hand as on March 31, 2012
Life membership fee	16,000	Cash at bank as on March 31, 2012
Interest on investment in Government securities	19,000	
Locker rent	46,000	
	<u>4,70,000</u>	
		<u>4,70,000</u>

Illustration 17.2

From the following particulars relating to Poor Peoples' Dreams, prepare a Receipt and Payment account for the year ending March 31, 2012.

Receipts	Amount (Rs.)	Payments	Amount (Rs.)
Opening cash balance	5,000	Furniture purchased	1,200
Opening bank balance	9,400	Office expenses	800

Subscriptions collected for:		Rent paid	2,400
2009 Rs. 1,500		Sports materials purchases	4,100
2010 Rs. 6,500		Refreshments	700
2011 Rs. 1,100	9,100	Expenses for maintenance	2,300
Sale of refreshments	1,200	of tennis court	
Entrance fees received	1,700	Salary	2,000
		Tournament expenses	2,700
		Closing cash in hand	9,00

Solution

Books of Poor Peoples' Dreams
Receipt and Payment Account
for the year ending March 31, 2012

Dr.		Payments	Cr.
Receipts	Amount		Amount
	(Rs.)		(Rs.)
Balance b/d		Rent	2,400
Cash	5,000	Sports materials purchased	4,100
Bank	9,400	Refreshments	700
Subscriptions		Maintenance expenses for	2,300
2009 1,500		tennis court	
2010 6,500		Salary	2,000
2011 1,100	9,100	Tournament expenses	2,700
Sale of refreshments	1,200	Furniture purchased	1,200
Entrance fees	1,700	Office expenses	800
		Balance c/d	
		Cash	900
		Bank (balancing figure)	9,300
	26,400		26,400

17.5 Income and Expenditure Account

It is akin to trading and profit and loss account of trading organizations and can be described as a summary of income earned and expenditure incurred during the accounting year. Accrual basis of accounting is followed to prepare this account. Like trading and profit and loss account only revenue income and expenses are considered for preparing Income and Expenditure account. Excess of income over expenditure represents surplus and excess of expenditure over income represents deficit. Net operating result i.e. surplus (i.e. excess of income over expenditure) or deficit (i.e. excess of expenditure over income), is added or deducted respectively to the capital fund shown in the balance sheet.

The Income and Expenditure Account is prepared with the help of Receipts and payments Account and additional information relating to outstanding expenses/incomes, prepaid expenses, and non cash items like depreciation, etc. Format of Income and Expenditure is given below:

Income and Expenditure Account for the year ending on			
Expenditure	Amount (Rs.)	Income	Amount (Rs.)
Printing and Stationery	xxxx	Subscriptions	xxxx
Lighting	xxxx	Entrance fees	xxxx
Rates and Taxes	xxxx	Interest on investment in government securities	xxxx
Telephone charges	xxxx	Locker rent	xxxx
Postage and courier charges	xxxx	Deficit*(Excess of expenditure over income)	
Wages and Salaries	xxxx	(Balancing figure)	
Insurance Premium	xxxx		
Surplus* (Excess of income over expenditure)(Balancing Fig.)	xxxx		
	XXXX		XXXX

*Only one of these two items will appear in the income and expenditure account.

Note: The actual items in the Income and Expenditure may vary from organization to organization.

Preparation of Income and Expenditure Account

1. Income and Expenditure statement is prepared on the basis of Receipt and Payment Account and additional information, if any.
2. Follow accrual basis of accounting for preparing Income and Expenditure account.
3. Only revenue income and expenditure is to be considered while preparing Income and Expenditure account. Exclude the capital receipts and capital payments as these are to be shown in the Balance Sheet. Exclude the donations received for specific purpose.
4. Only that portion of receipts and payments is to be recorded in Income and Expenditure which belongs to current accounting year. Make adjustments by excluding the amounts relating to the preceding and the succeeding periods and including the amounts relating to the current year not yet received.
5. Opening and closing balances of cash and bank will not appear in the Income and Expenditure account.
6. Even non-cash items of income and expenditure e.g. depreciation on fixed assets, provision for doubtful debts etc. are also to be considered while preparing income and expenditure account

Process of preparation of Income and Expenditure account is explained below with the help of an example.

Illustration 17.3

Following Income and Expenditure account is prepared with the help of data given in Illustration no. 17.1.

Income and Expenditure Account for the year ending on March 31, 2012

Dr.		Income	Cr.
Expenditure	Amount		Amount
	(Rs.)		(Rs.)
Printing and Stationery	39,000	Subscriptions	1,95,000
Lighting	25,100	Entrance fees	37,000
Rates and Taxes	21,000	Interest on investment	19,000
Telephone charges	1,900	in government securities	
Postage and courier charges	2,590	Locker rent	46,000
Wages and Salaries	96,000		
Insurance Premium	13,000		
Surplus (Excess of income over expenditure)	98,410		
	2,97,000		2,97,000

In preparing the above Income and Expenditure, following items have been ignored:

1. Opening and closing cash/bank balances.
2. Payment for purchase of Government securities being capital expenditure.
3. Amount of subscriptions received for the year 2010-11 and 2012-13.
4. Life membership fee as it is of capital nature.
5. Donation for building as it is for a specific purpose.

Illustration 17.4

From the Receipt and Payment Account given below, prepare the Income and Expenditure Account of Senior Citizens' Healthcare organisation for the year ended March 31, 2012.

Receipt and Payment Account for the year ending March 31, 2012

Dr.		Payments	Cr.
Receipts	Amount		Amount
	(Rs.)		(Rs.)
Balance b/d (Cash in hand)	4,500	Salary	1,100
Subscriptions	28,400	Rent	720
Entrance Fees	1,480	Lighting Charges	2,200
Donations	2,160	Taxes	3,100
Rent of hall	1,260	Printing and Stationery	450
Sale of investments	2,800	Sundry expenses	610
		Books purchased	7,000
		Fixed deposit with bank	15,000
		Balance c/d	
		Cash in hand	6,400
		Cash at bank	4,020
	40,600		40,600

Solution

Books of Senior Citizens' Healthcare Organisation Income and Expenditure Account for the year ending March 31, 2012

Dr.		Income	Cr.
Expenditure	Amount (Rs.)		Amount (Rs.)
Salary	1,100	Subscriptions	28,400
Rent	720	Entrance fees	1,480
Lighting Charges	2,200	Donation	2,160
Taxes	3,100	Rent of hall	1,260
Printing & Stationery	450		
Sundry Expenses	610		
Surplus (excess of income over expenditure)	25,120		
	33,300		33,300

Distinction between Income and Expenditure Account and Receipt and Payment Account

Basis of distinction	Income and Expenditure Account	Receipt and Payment Account
Nature	It is a summary of incomes and expenses like trading and profit and loss account	It is the summary of cash receipts and payments like cash account
Nature of Items	Only Revenue incomes and revenue expenses are recorded.	All types of Receipts and payments are recorded whether of revenue nature or of capital nature.
Period	Only those Incomes and expenses are recorded which relate only to the current period	All Receipts and payments are recorded including those belonging to preceding and succeeding periods
Recording of Non-cash Items	Non cash items like depreciation, provisions etc. are considered.	Non-cash items are not considered while preparing this account.
Opening Balance	There is no opening balance	Opening Balance of cash and bank recorded in the beginning
Closing Balance	Balance at the end represents excess of income over expenditure or vice-versa	Balance at the end represents cash in hand and at bank at the end

17.6 Balance Sheet

Non-trading organizations, like trading organizations, also prepare their balance sheet. Balance sheet of non-trading organizations is almost similar to the balance sheet of trading organizations with only one difference i.e. non-trading organizations have capital fund or general fund in their balance sheet in place of capital. The basic objective of preparing the balance sheet is to ascertain the financial position of the organization.

Preparation of Balance Sheet

1. Take the Capital/General Fund as per the opening balance sheet and add surplus or deduct deficit, as the case may be, to this as determined from the Income and Expenditure Account. Further, add entrance fees, legacies, life membership fees, etc. received during the year.
2. Record all the fixed assets on the asset side of the balance sheet. These assets are to be recorded after adjustments for the additions/sale made in the year and also after recording the effect of depreciation charged during the year.
3. Compare items on the receipt side of the Receipts and Payments Account with income side of the Income and Expenditure Account and items on the payments side of the Receipt and Payment Account with expenditure side of the Income and Expenditure Account. The comparison is made to ascertain the assets like subscriptions due but not yet received, incomes received in advance, sale of fixed assets made during the year, items to be capitalized (i.e. taken directly to the Balance Sheet) e.g. legacies, interest on specific fund investment and liabilities like outstanding expenses, prepaid expenses, etc. This comparison will also help in identifying amount of fixed assets purchased during the year.

Illustration 17.5

From the following Receipt and Payment Account and additional information relating to Sutlej Club, prepare Income and Expenditure Account for the year ended March 31, 2012 and balance sheet as on that date.

Receipts	Amount (Rs.)	Payments	Amount (Rs.)
Balance b/d (Cash in Hand)	31,000	Balance b/d (bank overdraft)	21,000
Member's subscriptions	3,77,000	Upkeep of field and pavilion	1,65,000
Member's admission fee	24,000	Tournament expenses	40,000
Sale of old sports materials	3,100	Rates and Insurance	18,000
Hire of ground	31,000	Telephone	4,200
Subscription for tournament	41,000	Postage and Courier charges	3,700
Life membership fee	63,000	Printing and Stationery	22,900
Donations	7,30,000	Secretary's honorarium	37,000
		Investments	4,50,000
		Purchase of sports materials	82,000

Balance c/d 4,56,300

13,00,100

13,00,100

Assets at the beginning of the year were:

	<i>Rs.</i>
Play ground	6,30,000
Cash in hand	31,000
Stock of sports materials	1,06,000
Printing and Stationery	14,500
Subscriptions receivable	32,000

Donations and Surplus on account of tournament are to be kept in Reserve for a permanent pavilion. Subscriptions due on March 31, 2012 were Rs. 49,000. Write-off sixty per cent of sports materials and twenty percent on printing and stationary.

Solution

**Books of Sutlej Club
Income and Expenditure Account for the year
ending March 31, 2012**

Dr.		Income		Cr.
Expenditure	Amount (Rs.)			Amount (Rs.)
Upkeep of field and pavilion	1,65,000	Subscriptions	3,77,000	
Rates and Insurance	18,000	Add: Outstanding		
Telephone	4,200	(closing)	49,000	
Postage and Courier charges	3,700		4,26,000	
Printing & Stationery	22,900	Less: Outstanding		
Add: Opening stock	14,500	(opening)	32,000	3,94,000
Available for use	37,400	Admission fees		24,000
Less: Closing stock	29,920	Sale of old sports material		3,100
Stationery		Hire of Ground		31,000
Secretary's honorarium	37,000			
Sports materials consumed:				
Opening stock	1,06,000			
Add: Purchases	82,000			
	1,88,000			
Less: Closing stock	75,200			
	1,12,800			
Surplus				
(Excess of income over expenditure)	1,03,920			
	4,52,100			4,52,100

Note: Since the opening balance is not given, the same has been ascertained by preparing opening balance sheet as follows.

Balance Sheet of Excellent Cricket Club as on March 31, 2012

Liabilities	Amount (Rs.)	Assets	Amount (Rs.)
Capital Fund	7,92,500	Cash in hand	4,56,300
Add: Surplus	1,03,920	Outstanding subscriptions	49,000
	8,96,420	Stock of sports materials	75,200
Add: Life membership fee	63,000	Stock of printing and stationery	29,920
Surplus from Tournament (Rs.41000-40,000)	1,000	Pavilion Fund: Investments	4,50,000
Donation	7,30,000	Play ground	6,30,000
	16,90,420		16,90,420

Balance Sheet of Excellent Cricket Club as on March 31, 2011

Liabilities	Amount (Rs.)	Assets	Amount (Rs.)
Bank overdraft	21,000	Cash in hand	31,000
Capital/General fund (balancing figure)	7,92,500	Outstanding subscription	32,000
		Stock of sports materials	1,06,000
		Printing and Stationery	14,500
		Play ground	6,30,000
	8,13,500		8,13,500

17.7 Accounting Treatment of Special Items Related to Non-trading Organizations

1. Subscriptions

Subscription is the main source of income of non-trading organizations. It is collected from the members on annual basis.

Accounting Treatment of Subscription

Receipt and Payment Account: Total Subscription received in a year, irrespective of the year to which it belongs, is shown as receipt in the Receipt and Payment Account.

Income and Expenditure Account: In Income and Expenditure Account only that amount of subscription is shown which is related to the current period only irrespective of the fact whether it has been received or not.

Balance Sheet: Subscription received in advance for the next year will be shown as liability and subscription outstanding at the end of the year will be shown as an asset.

Illustration 17.6

A club received Rs. 50,000 as subscriptions during the year 2011-12. Rs 5000 in the total subscription received belong to the year 2010-11 and Rs.10, 000 to 2012-13. One of the members has not yet paid the subscription of Rs. 1500 for the year 2011-12.

Receipt and Payment account

Total subscription received in 2011-12 i.e. Rs. 50,000 will be shown on the receipt side in Receipt and Payment account.

Income and Expenditure account

		Rs.
Subscriptions received in	2011-12	50,000
Less: Subscriptions for the year	2010-11	<u>5,000</u>
		45,000
Less: Subscription for the year	2012-12	<u>10,000</u>
		35,000
Add: Subscriptions outstanding for the year	2011-12	<u>1,500</u>
Income from subscriptions for the year	2011-12	36,500

Illustration 17.7

From the piece of information taken from Receipt and Payment Account and the additional information, show as how they would appear in the Income and Expenditure Account for the year ending March 31, 2012 and the Balance Sheet:

Receipt and Payment Account for the year ending March 31, 2012

Dr.			Cr.
Receipts	Amount	Payments	Amount
	(Rs.)		(Rs.)
Subscriptions:			
2010-11	4,000		
2011-12	23,000		
2012-13	3,000		
		30,000	

Additional Information: Rs.

1. Subscriptions outstanding March 31, 2011 is Rs. 4,500
2. Total Subscriptions outstanding March 31, 2012 is Rs 6,500
3. Subscriptions received in advance Rs 1,500 as on March 31, 2011

Solution

Income and Expenditure Account for the year ending on March 31, 2012

Expenditure			Amount
	Amount	Income	Amount
	(Rs.)		(Rs.)

Subscriptions	23,000
Received for 2011-12	
Add: Outstanding for 2006-07	6,000
Add: Received in advance for 2011-12	1,500
	30,500

Note: Total amount of subscriptions outstanding as on 31-3-12 are Rs. 6,500. This includes Rs. 500 (Rs. 4,500 – Rs. 4,000) for subscriptions still outstanding for 2010–11. Hence, the subscriptions outstanding for 2006–07 are Rs. 6000 (Rs. 6,500 – Rs. 500).

Balance Sheet (Relevant Data) as on March 31, 2012				
Liabilities	Amount (Rs.)	Assets		Amount (Rs.)
Subscription Received in Advance for 2012-13		Subscription Outstanding:		
		2010-11	500	
	3,000	2011-12	6,000	6,500

*Relevant data only

2. Donations

Donations is a kind of gift received from an individual or an organization. It can be in the form of cash or kind. Donations can be categorized into two kinds i.e. Donation for specific purpose and General Donations. Accounting treatment of specific and general donations is given below:

I. Specific Donations

If the donor has specified the purpose for which the donation is to be used then such donation is called Specific Donation. Specific donation is capitalized and shown on the liabilities side of the Balance Sheet. Specific donation is not recorded as income in the income and expenditure account.

II. General Donations

It is a gift received from the donor without any conditions from the donor regarding the purpose for which it is allowed to be used. These are treated as revenue receipts and are recorded as income in the Income and Expenditure Account of the current year.

3. Admission Fees

It is onetime payment given by the members at the time of becoming member of the organization. Depending upon whether the receipt of income is a regular feature or not, we may treat this income as revenue income or capital receipt. In case of organizations like clubs and some charitable institutions, receipt of admission fee is irregular and the amount of fees is quite high. Therefore, it is treated as non-recurring item and credited directly to capital/general fund.

In case of educational institutions, the entrance fees are a regular income and the amount involved may also be small. In their case, as per practice admission fee is treated as a revenue receipt. However, if

there is specific instruction, it is advisable to treat the entire amount as capital receipt and the relevant amount should be directly added to capital/general fund.

4. Life Membership Fees

Life membership fee received in lump sum is treated as capital receipt and is credited directly to the capital/general fund.

5. Legacies

It is the transfer of property by the deceased under will. Legacy is not a regular receipt and therefore it is recorded in the Receipt and Payment Account and is added to capital fund/general fund in the balance sheet. However, in case amount received under a legacy is small, then it may be treated as revenue income and recorded as income in the Income and Expenditure Account.

6. Receipt from Sale of an old asset

Total Receipts from the sale of an old asset will be shown in the Receipt and payment account. Profit or Loss on sale will be recorded in the Income and Expenditure account. Value of asset sold will be reduced in the balance sheet by an amount equal to book value of the asset.

7. Receipt from Sale of Periodicals

Receipts from sale of periodicals is of recurring nature and therefore is treated as revenue receipt and shown as the income in the Income and Expenditure Account.

8. Receipt from Sale of Sports Materials

Sale of used sports materials is the regular feature with any Sports Club. Therefore, it is usually shown as income in the Income and Expenditure Account.

9. Payment of Honorarium

Honorarium is the remuneration paid to a specially trained person who has rendered his special services to the organization on some special occasion like payment made to an artist for giving performance at the club is an example of honorarium. Payment of honorarium is of revenue nature and is shown in the Income and Expenditure Account.

10. Endowment Fund

Endowment fund is the donation received for some specific purpose. It is a receipt of capital nature and therefore is shown on the Liabilities side of the Balance Sheet as an item of a specific purpose fund.

11. Government Grant

Since the main aim of non-trading organizations is the social welfare, therefore government in order to help these organizations keep on extending grant to them. These grants may be received regularly or they may be received once in a while. The recurring grants like 95% grant in aid received regularly in colleges, is treated as revenue receipt (i.e. income of the current year) and credited to Income and Expenditure account. However, grants like building grant which are received almost once in life time are treated as capital receipt and a capital fund is created in the balance sheet in their name. Cash subsidy received is treated as revenue receipt.

12. Special Funds

Non-trading organizations some time creates special funds for meeting the expenses of some special occasions or for the achievement of some specific objective like 'Prevention of female feticide fund' 'prize funds', 'match fund' and 'sports fund', etc. Income earned on the investments made from these funds is treated as capital receipt and is added to the respective fund in the balance sheet. Similarly, the expenses incurred on such specific purposes are also deducted from the special fund. The accounting treatment of special purpose funds is explained below with the help of an example.

Illustration 17.8

Show how you would deal with the following items in the final account of a Club:

Details	Debit Amount (Rs.)	Credit Amount (Rs.)
Sports Fund		70,000
Sports Fund Investments	70,000	
Income from sports Fund Investments		10,000
Expense incurred in organizing sports event	4,000	

Solution

Balance Sheet as on.....			
Liabilities	Amount	Assets	Amount
	(Rs.)		(Rs.)
Sports fund	70,000	Sports Fund Investments	70,000
Add: Income from Investments	10,000 80,000		
Less: Expenses on Sports events	6,000 74, 000		

13. Stationery

Stationery is a consumable item and normally expenses incurred on stationary are charged to Income and Expenditure Account. But in case opening and/or closing stock of stationery is given, work out the cost of stationery consumed and show that amount in Income and Expenditure Account. Show the closing stock in the balance sheet. Accounting treatment of stationery is explained below with the help of illustration no. 17.9.

Illustration 17.9

Extract of a Receipt and Payment Account for the year ended on March 31, 2012:

Payments:

Stationery Rs. 50,000

Additional Information:

Details	April 1, 2011	March 31, 2012
Stock of stationery	7,000	4,000
Creditors for stationery	20,000	4,000

Calculate the amount of stationery consumed during the year 2011-12 for booking in income and expenditure account.

Solution

Details	Amount (Rs.)
Payment made for the purchase of stationery as per Receipts and Payments A/c	50,000
Less: Payment for 2010-11 (i.e. creditors in the beginning)	20,000
Payment made for the year 2011-12	30,000
Add: Creditors at the end (i.e. Payment not yet made.)	4,000
Stationery Purchased for the year 2011-12	34,000
Add: Stock in the beginning	7,000
Stationery Available for consumption during 2011-12	41,000
Less: Stock at the end	4,000
Stationery Consumed during 2011-12 to be taken to the Expenditure side of the Income and Expenditure account	37,000

The amount of expense on stationery will be worked out as follows:

Stationery Purchases	34,000
Add: Opening stock	7,000
	41,000
Less: Closing stock	4,000 (will be recorded in balance sheet)
	37,000 (will be shown as expense in income & expenditure a/c)

Illustration 17.10

Prepare Income and Expenditure Account and Balance Sheet for the year ended March 31, 2012 from the following information.

Receipt and Payment Account for the year ending March 31, 2012			
Receipts	Amount (Rs.)	Payments	Amount (Rs.)
Balance b/d	67,000	Salaries and Wages:	
Subscriptions:		2010-11	6,300

2010-11	8,700		2011-12	103,100	1,09,400
2011-12	3,51,300		Sundry expenses		42,300
2012-13	17,200	3,77,200	Freehold land		52,400
Entrance fees		19,500	Stationery		26,100
Locker rent		44,300	Rates		29,000
Revenue from refreshment		52,200	Refreshment expenses		46,400
Income from investments		54,400	Telephone charges		1,000
			Investments		1,85,000
			Audit fee		2,000
			Balance c/d		1,21,000
					<u>6,14,600</u>
		<u>6,14,600</u>			<u>6,14,600</u>

The following additional information is provided to you:

1. There are 2000 members each paying an annual subscription of Rs. 200, Rs. 8,700 were in arrears for 2010-11 as on April 1, 2011.
2. There was an outstanding telephone bill for Rs. 1,000 on March 31, 2012.
3. Outstanding sundry expenses as on March 31, 2011 totaled Rs. 2,300.
4. Stock of stationery as on March 31, 2011 was Rs. 2400; on March 31, 2012, it was Rs. 3,100.
5. On March 31, 2011 Building stood at Rs. 4,00,000 and it was subject to depreciation @ 5% p. a.
6. Investment on March 31, 2011 stood at Rs. 8, 00,000.
7. On March 31, 2012, income accrued on investments purchased during the year amounted to Rs. 1,800.

Solution

Income and Expenditure Account for the year ended on March 31, 2012

Dr.		Amount	Income	Amount	Cr.
Expenditure		(Rs.)		(Rs.)	
Salaries and Wages		1,03,100	Subscriptions	4,00,000	
Sundry Expenses	42,300		Entrance fees	19,500	
Less: Outstanding on			Locker rent	44,300	
31.3.2011	2,300	40,000	Income from refreshment:		
Stationery : (consumed)			Revenue from	52,200	
Opening stock	2,400		refreshment		
Add: Purchases	26,100		Less: Refreshment	46,400	5,800
Less: Closing stock	3,100	25,400	expenses		
Rates		29,000	Income from	54,400	
			investments		
Telephone charges	1,000		Add: Accrued income	1,800	56,200
Add: Outstanding	1,000	2,000	on current year		
audit fee		2,000	investment		
Depreciation on building		20,000			
Surplus (excess of Income over					

expenditure)	3,04,300	
	5,25,800	5,25,800

Balance Sheet as on March 31, 2012

Liabilities	Amount (Rs.)	Assets	Amount (Rs.)
Outstanding Telephone Expenses	1,000	Cash and Bank Balance	1,21,000
Subscription received in Advance	17,200	Subscription in Arrears	48,700
General Fund	12,69,500	Stock of Stationery	3,100
Add: Surplus	3,04,300	Accrued Interest on investment:	1,800
	15,73,800	Investments	8,00,000
		Additions	1,85,000
		Building	4,00,000
		Less: Depreciation	20,000
		Land	52,400
	15,92,000		15,92,000

Balance Sheet as on March 31, 2011

Liabilities	Amount (Rs.)	Assets	Amount (Rs.)
Outstanding Sundry Expenses	2,300	Cash and Bank balance	67,000
Outstanding Salary and Wages	6,300	Subscription in arrears	8,700
General Fund		Stock of stationery	2,400
(Balancing figure)	12,69,500	Investments	8,00,000
		Building	4,00,000
	13,56,400		13,56,400

Income and Expenditure Account based on Trial Balance

Normally in case of non-trading organizations, Income and Expenditure account and Balance Sheet is prepared on the basis of information given in Receipts and Payments Account and the additional information given. However, Income and Expenditure Account and Balance Sheet may also be prepared by drawing information from Trial Balance and additional information, if any. The process of preparation of Income and Expenditure account and Balance sheet through the use of trial balance and additional information is explained below with the help of Illustration no. 17.11.

Illustration 17.11

From the trial balance and other information given below for a school, prepare Income and expenditure Account for the year ended on 31.3.2012 and a Balance Sheet as on that date:

Debit Balance	Amount (Rs.)	Credit Balance	Amount (Rs.)
Building	6,00,000	Admission fees	15,400

Furniture	1,10,000	Tuition fees received	5,25,000
Library books	1,55,000	Creditors for supplies	16,400
Investment @10%	5,00,000	Rent for the school hall	8,600
Salaries	4,80,000	Miscellaneous receipts	32,600
Stationery	30,000	Government grant	2,95,000
General expenses	12,000	General fund	9,85,000
Sports expenses	11,000	Donation for library books	73,000
Cash at bank	53,000	Sale of old furniture	21,000
Cash in hand	21,000		
	19,72,000		19,72,000

Additional Information:

- (i) Fees yet to be received for the year are Rs. 23,000.
(ii) Salaries yet to be paid amount to Rs. 26,000.
(iii) Furniture costing Rs. 24000 was purchased on October 1, 2011.
(iv) The book value of the furniture sold was Rs. 40,000 on April 1, 2011

Solution

Income and Expenditure Account for the year ending on March 31, 2012			
Expenditure	Amount (Rs.)	Income	Amount (Rs.)
Loss on sale of old furniture (40,000 –21,000)	19,000	Admission fees	15,400
Salaries	4,80,000	Tuition fees	5,25,000
Add: outstanding	<u>26,000</u>	Add: Outstanding	23,000
Stationery	30,000	Rent for the school hall	8,600
General expenses	12,000	Miscellaneous receipts	32,600
		Government grant	2,95,000
		Interest accrued on investments	50,000
Sports expenses	11,000		
Surplus (excess of income over expenditure)	3,71,600		
	9,49,600		9,49,600

Working Notes:

1. As admission fee is a regular income of a school, so it has been taken as a revenue income of the school.

Balance Sheet as on March 31, 2012

Liabilities	Amount (Rs.)	Assets	Amount (Rs.)
Creditors for Supplies	16,400	Buildings	6,00,000
Outstanding Salaries	26,000	Furniture	1,10,000
Donation for Library Books	73,000	Less: Sold	40,000

General fund	9,85,000			70,000	
Add: Surplus	3,71,600	13,56,600	Add Purchased	24,000	
					94,000
			Accrued Tuition fees		23,000
			Library books		1,55,000
			Investments @ 10%		5,00,000
			Interest accrued		50,000
			Cash at Bank		
				53,000	
			Less furniture purchased	<u>24,000</u>	29,000
			Cash in Hand		21,000
		14,72,000			14,72,000

17.8 Summary

Non-trading organisations are the organisations which are promoted mainly for social welfare. Earning of profits is not the primary objective of these organizations. Like trading organisations, it is compulsory for these organisations to prepare their financial accounts and submit annual financial statements with the registrar of societies. Non-trading organisations don't prepare trading and profit and loss account, however they prepare Receipt and Payments account, Income and Expenditure account and Balance Sheet. Receipt and Payments account is a summary of cash receipts and cash payments, Income and Expenditure account is like profit and loss account. While writing Income and Expenditure account accrual basis of accounting is followed.

17.9 Glossary

Non-trading institutions: is an organizations that does not exist to buy and sell goods for profit. Its main purpose is to provide services to members, public or for social cause.

Receipts and payment account : it is a summary of all cash and bank transactions of a non-trading institutions during a financial year.

Income Expenditure account : is a profit & loss account of a non-trading institutions.

17.10 Check your progress

True/False

1. Non trading organisations are promoted with profit motive.

2. Income and Expenditure account is maintained on cash basis.
3. Donations received for specific purpose should be capitalized.
4. Admission fees received in case of schools should be booked in profit and loss account.
5. Non trading organisations maintain General Fund in place of capital fund of trading organisations.

Fill in the Blanks

6.is a donation received for some specific purpose.
7. Expenses incurred for specific purposes for which some special fund is maintained should be deducted from.....
8. Non-trading organisations submit their financial statements to.....
9. Along with Income and Expenditure account and Balance Sheet non-trading organisations also submit.....
10. Legacies is the gift received under

17.11 Answers to Check your progress

True/False

1. False
2. False
3. True
4. True
5. True

Fill in the Blanks

6. Endowment Fund
7. Special fund maintained for that purpose
8. Registrar of Societies
9. Receipt and payment account
10. Will

17.12 Terminal Questions

1. State the meaning of 'Non-trading Organisations'.
2. Write a note on Receipt and Payment Account.
3. State the meaning of Income and Expenditure Account.
4. What are the feature of Receipt and Payment Account?
5. What steps are taken to prepare Income and Expenditure Account from a Receipt and Payment Account?
6. Explain the statement: "Receipt and Payment Account is a summarized version of Cash Book".
7. "Income and Expenditure Account of a Not-for-Profit Organisation is akin to Profit and Loss Account of a business concern". Explain the statement.

17.13 References

1. Financial Accounting Principles and Practice- Prof. Jawahar Lal and Dr. Seema Srivastava
2. Financial Accounting - Sri P.C. Tulsian
3. Advanced Accountancy - Sri R. L. Gupta and Sri M. Radhaswamy
4. Advanced Accountancy - Sri S. P. Jain and Sri K.L. Narang

UNIT 18

USES OF COMPUTER IN ACCOUNTING

- 18.1 Introduction**
- 18.2 Role of computer in accounting**
- 18.3 component of computerized system of accounting**
- 18.4 Transaction processing system in computerized accounting**
- 18.5 Need for computerized accounting**
- 18.6 Limitation of computerized system of accounting**
- 18.7 Summary**
- 18.8 Glossary**
- 18.9 Check your progress**
- 18.10 Answers to check your progress**
- 18.11 Terminal questions**
- 18.12 References**

Learning Objectives

After reading this unit, students will be able to explain:

1. Explain the role of computer in accounting;
2. Differentiate between manual accounting system and computerized accounting system;
3. State the need for computerized accounting;
4. Describe the basic requirements of computerized accounting.

18.1 Introduction

The use of computers, due to increase in scale of business, in accounting has become inevitable. In the initial years of the emergence of the concept of business on this planet, you might have studied while studying the need of maintaining accounts, that because of limited scale of operations entrepreneurs used to memorize the business transactions and were not maintaining detailed written records. With the passage of time, scale of operations of businesses increased and it became impossible for them to memorize business transactions and then they started maintaining accounts of business transactions in written form. Till last few years accounts of business organizations were maintained in manual way. All the books required to be maintained as per double entry system were written manually by the accountants.

Over the last few years, because of liberalization, privatization and globalization of the economies, scale of business organizations have increased tremendously from village level to state, country and international levels. Further, vast degree of diversification in the line of businesses has been witnessed by the present generation. The substantial increase in the scale of business, great amount of diversification and further huge escalation in the labour cost has necessitated for the business organizations to shift from manual system of accounting to computerized system of accounting.

The basic objective of this unit is to familiarize the students with computerized system of accounting, role of computers in accounting and need of use of computers in accounting.

18.2 Role of Computer in Accounting

Till recently manual system of maintaining books of accounts such as Journal, Cash Book, Special purpose books, ledger and also writing of annual financial statements was satisfactory and complete method. Under manual system, as you might know, accountants were required to prepare books of accounts, summary of transactions and financial statements manually. However, with the advancement in technology, system of maintain accounting records has changed from manual to computerized.

Computerised system of accounting makes use of various machines, like counting machines, bar code readers, which are capable of performing different accounting functions. All these machines are connected with each other through a computer which further helps in operating these machines and leads to writing of financial records in a systematic manner and helps in the maintenance of accounting data on a real-time basis.

The implementation of the system of computerized accounting is done through accounting software. Accounting software can be designed by the companies customized according to their requirements or firms may use standardized accounting software like Tally. A wide variety of standardized accounting softwares are available in the market having different features and cost. Firm should be careful in choosing the accounting softwares as it is a costly affair and if a wrong software is selected it may result not only in loss of the money spent on its purchase but system of writing financial records will also get adversely affected.

18.3 Components of Computerized accounting system

A computerized accounting system is an information system that records the financial transactions of a business enterprise as per accounting concepts and conventions and helps in generating a wide variety of required reports. Accounting system, be it manual or computerized, is made up of two aspects; Firstly, it works as per accounting principles and second, there is a user-defined framework for maintenance of records and generation of reports.

Computerized accounting system works on the basis of hardware as well as software. Further the selection of hardware and software is interdependent. The type of software determines the structure of the hardware. The selection of both software and hardware is dependent upon a number of factors such as the scale of operations, availability of budget, number of users, level of secrecy, the degree of threat of hacking, degree of risk of attack from various kinds of viruses and the nature of various activities of functional departments in an organization.

In the case of a restaurant, quantum of business transactions is relatively small, a Personal Computer with local made software may be sufficient. But in case of large business organizations having a number of geographically scattered factories and offices, more advanced

computer systems supported by sophisticated networks will be required to handle the voluminous data and the complex reporting requirements. Like in the case of banks having thousands of branches and wherein lacs of transactions are required to be booked, use of highly advanced and efficient softwares like 'Iflex' etc. are used.

Computerized accounting system is a database-oriented application. The transaction data is stored in scientifically-designed database. Data entry operator operates on the database through the required interface and has the facility of taking a large variety of reports by transforming the data stored in the database

.Therefore, the fundamentals of computerized accounting include all the basic requirements of any database-oriented application in computers

Every computerized accounting system has following basic requirements;

1. *Accounting Framework*: Accounting framework is composed of a set of principles, coding and grouping structure of accounting.
2. *Operating Procedure*: It is a well-defined operating procedure blended suitably with the operating environment of the organization.
3. *Front-end Interface*: This software helps the user to interact with the back-end database and to enter the transactions into the software. For example, a transaction relating to sale of goods may be dealt with the accounting system through a sales voucher, which appears on the monitor of user and when entered into the system is stored in the database.
4. *Back-end Database*: This is used for storage of data and is hidden from the user. User can extract information from this data base to the extent he is authorized to access it.
5. *Data Processing*: Data processing is done to organize the raw data into information which can be useful for decision making purposes. A large number of actions in a systematic way are taken to transform the data into decision useful information.

6. *Reporting System*: This system helps the user in generating a report from the database as per his requirement. Modern accounting softwares are highly advanced and make it possible for the user to generate hundreds and thousands of different kinds of reports in different formats for use in decision making.

Functions of Computerized Accounting System

Preparation of accounting documents;

Computerized accounting makes use of the data base oriented applications. Books of accounts like journals, ledgers, etc., which are an essential part of manual accounting are not required to be maintained as per computerized accounting system. Data stored in database is the maintain data treasure tapped to generate required information, reports and documents like Cash Memo, Bills and invoices, stock statements, sales reports etc., and for preparing accounting vouchers. Some of the accounting softwares which are widely used in industry include Tally, Cash Manager, Best Books, Sage, Wings 2000 and Ace Pays, etc. Following is the sequence and processes through which data passes in computerized accounting system:

1. **Source Documents**: The first step is to capture accounting data from transaction/s and use that to prepare a document, called voucher. Voucher is a document which expresses and documents an accounting transaction. The relevant accounting data is set out in the voucher. Voucher has a specific number, date, account head debited/credited, narration and signatures of authorities approving the voucher. These documents are so designed as to permit the recording of accounting data in a systematic manner.
2. **Recording of Data**: The accounting data contained in vouchers is recorded in a computer's storage device through a pre-designed Data Entry Form. The data entry form is designed in a format similar to physical voucher document. The data entry form designed using software appears on computer monitor. Through data entry form data is entered into the computer.

3. **Data Storage:** A suitable data storage structure is created for the storage of data. All the account heads are classified into various categories and code number is assigned to each account head. e.g. look at the following hypothetical example:

<i>Code</i>	<i>Name</i>	<i>Type</i>
1200	Creditors Account	2
1901	Salary Account	3

The category type 2 above refers to *Liabilities* and the category type 3 indicates *Expenses*. The data storage structures are created as a part of structuring database for accounting.

4. Preparation of Trial Balance and Financial Statements

Data stored in the database is transferred into Ledger account automatically by the computer. Through the data, any sort of reports can be generated including Trial Balance, Trading, Profit and Loss account and Balance Sheet.

18.4 Transaction Processing System in Computerized Accounting

The first stage in computerized accounting is Transaction processing system (TPS). The main functions of transaction processing system include recording of data, processing of data, checking validate of data and store transactions that occur in the business and its subsequent retrieval and usage. Various steps involved in transaction processing system include Data Entry, Data Validation, Processing and Revalidation, Storage, Information and Reporting.

These steps can be explained with an example making use of Automatic Teller Machine (ATM) facility by a Bank-Customer.

1. Data Entry

A bank customer operates an ATM facility to make a withdrawal and to perform number of other banking transactions. He feeds data into computer through the help of ATM card. This card contains, in the magnetic strip portion, information about the name of the customer, account number etc. Inserting of card and Personal Identification number (PIN) enables the customer to have access to his account. The insertion of card, PIN number and other required information by the customer constitutes data entry which is processed after validation by the computerized personal banking system.

2. Data Validation

Once data entry is complete, computer in order to ensure the accuracy and reliability of input conducts data validation process by comparing the data input with some predefined standards or known data. 'Error Detection' and 'Error Correction' procedures are followed to conduct data validation. Error detection aims at detecting errors while error correction procedures advices to the user for entering correct data input.

3. Processing and Revalidation

Processing and Revalidation process is done on both the input data and output of the system. Input validation process ensures that in case of Online Transaction Processing (OLTP) the processing of data occurs almost instantaneously provided the data that has been fed to the system is valid. On the other hand, check output validity (revalidation) occurs to ensure that the transaction in terms of delivery of money by ATM has been duly completed.

4. Storage and Reporting

Processing and Revalidation ensures that only valid transactions are stored in the database. This stored data can be processed, as and when required, making use of the Query facility to produce desired information. Desired reports thereafter can be prepared on the basis of the required information content according to the decision usefulness of the report.

18.5 Need for Computerized Accounting

In the present day world, use of computers in maintaining the accounting records has become inevitable. Following factors have necessitated the use of computers:

1. Numerous Transactions

In the present day world, because of the substantial increase in the quantum of business transactions, it has become almost impossible to maintain the financial accounts manually. The computerized accounting system is capable of handling large number of transactions with speed and accuracy and has therefore necessitated the use of computers for maintenance of accounting records.

2. Instant Reporting

The economic and business environment these days is highly volatile and also there is a very stiff competition in the market, because of all these reasons, management is always required to take quick decisions. For taking right decisions, management keeps on asking for various kinds of reports from the accounts department. Computerized accounting system is capable of offering quick and quality reporting and therefore helps in meeting the majority of informational needs of the management.

3. Reduction in paper work

Traditional system of maintaining financial records manually involved use of huge quantum of paperwork and also requires large physical storage space to keep accounting books and documents. Larger the number of transactions larger is the requirement of paper. Introduction of computerized accounting system has substantially reduced the use of paper work and also the requirement of space for their safe storage.

4. Flexible and Up-to-date reporting

Computerized accounting system is capable of generating reports of any balance as when required and for any duration which is within the accounting period and in wide variety of desired formats. It facilitates the real time production of management information reports, accounting records are updated automatically as and when accounting data is entered and stored. Latest database reports help management to monitor and control the business effectively. A report on Debtors' status would indicate the possibilities of bad debts and enable the management in taking corrective measures in time. For example, if the company

has a policy of restricting the credit sales to a fixed amount to a given party, the updated information is available on the computer system immediately when a voucher is entered through the data entry form. However, it takes time when it comes to a manual accounting system. Besides, the results may not be accurate.

5. Accounting Queries

Attending to accounting queries, which is a costly and quite difficult affair under manual accounting, can easily be attended under computerized accounting system. For example, a query to identify quantity of inventory which is two months old can be easily answered by using the structured query language (SQL) support of database technology in the computerized accounting system.

6. On-line facility

Computerized accounting system offers online facility to store and process transaction data. Information can be retrieved to generate and view financial reports. The on-line transaction facility has changed the whole system of doing businesses all over the world. Internet marketing, e-commerce and internet banking has become possible. A large number of banking transactions are, these days, done by the customers through internet only leading to saving in cost and precious time.

7. Saves in Operational Cost

Computerized accounting system is cost effective so far as operational cost of record keeping and maintenance is concerned. It helps in savings in cost involved in use of papers, manpower required for recording and taking care of accounting documents. In case of computerized accounting the requirement of additional manpower in accounts department is restricted to only the data operators for storing additional vouchers. There is absolutely no additional cost of processing additional transaction data.

8. Accuracy

Manual system of writing of accounts moves through number of stages and each stage is managed by different group of people. Involvement of large number of people in recording and processing of information as required under manual system is likely to distort the information and lead to inaccurate reports. On the other hand, the information content of reports generated by the computerized accounting system is accurate and therefore quite

reliable for decision making. In computerized accounting system the possibility of error is eliminated because the primary accounting data is entered once for all the subsequent usage and processes in preparing the accounting reports.

9. Security

Under manual accounting system it is very difficult to ensure the safety of accounting information and in protecting its leakage to competitors and other rivals because it is open to inspection by any eyes dealing with the books of accounts. Computerized accounting system is better as compared to manual system from the point of view of security of information also; as under computerized accounting system only the authorized users are permitted to have access to accounting data. Security provided by the computerized accounting system is far superior compared to any security offered by the manual accounting system.

10. Access to Information to multiple users on Real Time Basis

Computerized accounting systems which are inter-linked through a network of computers facilitate the availability of information to multiple users at the same time. Various users are not required to wait, till the time records are being used by other users as is the case with manual accounting system, to retrieve the information they need.

11. Legibility

In manual accounting system, record is handwritten. Sometimes because of poor handwriting of the accountant it becomes difficult to read the entries. This type of problem is not faced in computerized accounting because the characters (alphabets, numerals, etc.) are type written using standard fonts. This helps in avoiding errors caused by untidy written figures in a manual accounting system.

12. Efficiency

The computer based accounting systems ensure better use of resources and time. This brings about efficiency in generating decisions, useful information and reports. For example, helps in performing complex calculations, thus saving time to do all calculations manually, Client data can be stored in database bringing it up fast and efficiently. Similarly, automated form filling can be accomplished through computing which can be a time consuming process when done by hand.

13. Customer Relationship Management

Computerized accounting system helps in management of data which can be very handy for the organizations in better customer relationship management.

In the present extremely complex society, introduction of computers has emerged as blessings. They can be used to process information, to generate reports and perform mathematical calculations etc. in a quick and accurate manner. It will not be wrong to say that, without the power of computer systems, today's modern business world could not function. One particular organizational function they facilitate is marketing. Such things as invoices, stock checks, purchase orders, prepare payroll, purchase progress reports and other standardized document forms can be exchanged directionally between computer systems instantaneously for automatic processing. This system saves money and strengthens relationships between customers and suppliers by providing a good means for useful and vital communication. This can provide management and suppliers with access to relevant and up-to-date information.

Comparison between Manual and Computerised Accounting

Accounting can be defined as the process of identifying, recording, classifying, and summarizing financial transactions to produce the financial reports for their ultimate analysis. Let us understand these activities in the context of manual and computerised accounting system:

1. **Identification of Account Head:** The first step before recording the financial transactions into books of accounts is to identify the account heads which has got affected because of the transaction under consideration so that the concerned account heads can be debited or credited, as the case may be. This step of accounting i.e. identification of transactions, based on application of accounting principles, is same in both manual and computerized accounting system.
2. **Recording:** The data content of business transactions in case of computerized accounting is stored in a systematically structured accounting database. On the other hand, the recording of financial transactions, in manual accounting system is through books of original entries i.e. Journal.

3. **Classification:** Classification means grouping of information related to same accounting head at one place. In a manual accounting system, classification of business transactions is done by posting the entries into ledger accounts. This results in transaction data duplication. In computerized accounting, no such data duplication is made. In order to produce ledger accounts the data content already stored in accounting database is processed to appear in the form of a desired report. Different forms of reports are generated from the same transaction data.
4. **Summarization:** In manual accounting system summarization of transactions is done to produce trial balance. As a result, preparation of ledger accounts becomes a prerequisite for preparing the trial balance. The preparation of ledger accounts is not a prerequisite for generating trial balance in a computerized accounting system. In computerized accounting, the originally stored transactions data are processed to generate the trial balance.
5. **Adjusting Entries:** In a manual accounting system, to ensure compliance with the matching principle, adjusting entries are made. These entries are recorded to match the expenses of the accounting period with the revenues generated by these expenses. Adjusting entries may also be made to rectify the errors. On the other hand, in computerized accounting, Journal vouchers are prepared and stored to ensure compliance with matching principle. In computerized accounting there is nothing like passing adjusting entries for errors and rectification.
6. **Financial Statements:** In a manual system of accounting, the preparation of financial statements is dependent on the availability of trial balance. However, in computerized accounting, there is no such requirement. Financial statements can be prepared by direct processing of originally stored transaction data.
7. **Closing the Books:** At the end of the accounting period, to close the books of accounts closing entries are made. After the preparation of financial reports, the accountants prepares for the next accounting period and pass closing and reversing journal entries. In

computerized accounting, there is year-end processing to create and store opening balances of accounts in database.

8. **Reports:** In manual accounting system the main reports produced are only financial statements. In case of computerized accounting a wide variety of reports can be generated
 - a. from the database stored.

9. **Linking with other networks:** Computerized accounting enables the user to link his database with other networks. This is useful for preparing the consolidated accounts of holding and subsidiary companies. Whereas the same is not that easy in case of manual accounting.

Selection of Accounting Software

Accounting software in computerized accounting system is like a foundation of the house. Efficiency of the whole accounting system is dependent upon the software selected for this. Many organizations have wasted a lot of money in the past because of wrong selection of computerized accounting software. Need to buy accounting software may arise at the time of introduction of computerized accounting system in the organization for the first time or it may arise later on also at the time of replacement of existing system. A number of factors have to be considered before acquiring accounting software like the scale of business transactions, variety of business transaction, safety of data, requirement of putting data online, accounting expertise of people responsible in organization for accounting work etc.

Classification of Accounting Packages

The basic objective of any Computerized Accounting System is to permit recording of data, storing of data, processing of data and generate reports as per the requirements of the user. Depending upon the suitability of the software to the organization, one may select any one of the following three types of accounting softwares:

- ❖ **Ready to use**
- ❖ **Customized**
- ❖ **Tailored**

1. Ready-to-Use

Ready to use accounting softwares are standardized softwares which can be purchased from the market and straight way put to use. They are like readymade shirts. Ready to use accounting softwares are less costly, easy to learn and use softwares. These accounting softwares are suitable to business organizations operating on a very small scale where the quantum of accounting transactions is very low, number of users is less and there is no need of linking the system with other networks. These softwares are not good in ensuring the safety of the data as the security aspect is little low and the software is prone to data frauds. Most of the vendors selling Ready-to-use accounting softwares provide free of cost training to the accountants of buyer organizations. One of the most widely used Ready-to-use accounting software is Tally.

2. Customized

Customized softwares are those softwares which are designed according to the requirement of specific customer. The aim of customized accounting software is to meet the special requirement of the user. The best example of customized software is the software used in Indian railways. Many banking sector organizations have also got designed accounting softwares according to their requirements. Organization normally goes in for customized accounting softwares when standardized accounting softwares available in the market do not suit or fulfill its requirements.

As the customized accounting softwares are designed on order according to the requirements of specific users, the installation and maintenance cost of these softwares is relatively high. Vendor charges extra cost for customization. Customized accounting softwares may allow the facility of large number of users, linking with other networks, higher level of safety etc. Customized accounting softwares are bit difficult to operate and accountants need to go

under specialized training to operate these softwares. Because of high installation and operational cost, only large and medium scale organizations go in for customized accounting softwares.

3. Tailored

Large business organization having multiple users and branches scattered over large geographical area like banks prefer to go in for tailored accounting softwares. These softwares are organization specific, designed to meet the needs of a particular organization. These softwares offer very high degree of data and transaction security. Cost of installation and maintenance is very high. Training cost is also very high as these softwares are difficult to learn and operate.

Factors Affecting Selection of Accounting Software

Following factors should be taken into consideration at the time of selecting accounting software:

1. Scale of Organization

- a. Scale of operations, variety, and volume of business transactions and the size of organisation are amongst the most important factors which do affect the selection of the accounting software. In case of small organizations, where the number and variety of accounting transactions is less, one may opt for a simple, single user operated, Ready-to-use software. On the other hand, in case of large organisation, one may require sophisticated 'Tailored' software to meet the multi-user requirements, geographically scattered and connected through complex networks.

2. Reports Generating Facility and Other Functions

- a. The functions which an organisation wants to perform through accounting software and the requirement of various kinds of reports used in the organization also affect the acquisition of accounting software. In case of organization which requires simply the financial statements or cash flow/ratio analysis, they may use

ready-to-use software. However, in case of organizations which need various kinds of reports like cost sheets, inventory statement, sales reports of various products or regions, they may need customized accounting software to meet their specific requirements. Besides the facility of generating various kinds of reports, availability of functions like allowing mathematical calculations, generating graphs etc. may also affect the choice of accounting software.

3. Ability of Employees and Requirement of Training

- a. Ability of the employees to understand and implement the accounting softwares also effects the selection of accounting software. In case of organizations, wherein literacy level amongst the employees is low, simple Ready-to use softwares are preferred over complex Tailor made softwares. Whereas organisations having skilled and literate manpower can go for complex ‘Tailor made Software’. Further requirement of the level of training required to understand and implement accounting software also affects the choice of accounting software. Simple accounting softwares which are easy to learn through simple training are capable of attracting more users.

4. Flexibility

- a. Ability of the software to run on various kinds of softwares like windows, linux, unix etc. also effect the choice of the accounting software. Accounting softwares which can be easily switched from one operating system to another are preferred over those softwares which run on one operating software only. Further the ability of the softwares to make available various report in variety of designs also affect the flexibility of the accounting software. Further in case of some more flexible software, there is a provision to increase or decrease the number of users as per requirement.

5. Cost of Installation and Maintenance

- a. This is again one of the major factors affecting the choice of accounting software. The ability of the organization in meeting the cost of installation and maintenance of hardware and software greatly affects the choice of accounting software. Ready-to-use softwares, as discussed earlier, are less costly as compared to 'Tailored' softwares. Cost benefit analysis must be conducted by the organisations before selecting the accounting software as certain software which appears cheap to buy, involve heavy maintenance and alteration costs, e.g. cost of addition of modules, training of staff, updating of versions, data failure/restoring costs. Whereas, the accounting software which appears expensive to buyers initially, sometimes requires least maintenance and free upgrading and negligible alteration costs.

6. Reputation of Software Developer

- a. A large numbers of vendors of accounting softwares are tapping the market, some of them are laymen. One should be very careful in selecting the vendor of accounting softwares. Preferably accounting softwares of reputed vendors who have a good track record in providing the after sales services should be selected.

7. Secrecy

- a. Another area of concern at the time of selecting accounting software is the security of data. Those accounting softwares which prevent unauthorized persons from accessing data are more secure. As the cost of installation and maintenance of accounting softwares is directly related to the degree of secrecy of data offered by the software, organization should do cost benefit analysis.

8. Linking with Other Networks

- a. Facility of linking with other networks or systems for the transfer of database is an important factor particularly for organisations which are spread over wide geographical area or are divided into number of divisions. The accounting

software which allow data transfer and linking with other networks without compromising the safety of data are preferred.

18.6 Limitations of Computerized System of Accounting

1. Fraud Prone

History is witness to this fact that computerized accounting has led to increase in the rate of frauds and embezzlements. Every now and then we see news in the papers regarding some computer technology related fraud. Frauds are normally committed by alteration of data, programs, hacking of passwords etc. Further, computer related crimes are difficult to detect, whereas in a manual accounting system detection is possible on first sight. In case of manual accounting system it is easy to find out the persons responsible for frauds whereas identification of embezzler is difficult in case of computerized systems.

2. System Failure

Technology whereas on the one hand has helped us in improving the level of efficiency, on the other hand high rate of system failures has proved a curse. System failure due to hardware crashing and the subsequent stoppage of work is common problem of computerized accounting system. Software failure occurs mainly because of improper handling, attack by viruses, hacking etc. No full proof solutions are available as of now to tackle the menace of attacks on software by viruses.

3. Training

Comprehensive training to staff is a prerequisite for effective implementation of computerized accounting system. The Tailored softwares which are bit difficult to operate generally require specialized staff personnel. Huge amount is spent by the organization to provide training to staff, so that the use is able to handle the hardware and software an efficient and effective way.

4. Adverse Effect on Employment Generation

Computerized accounting has greatly affected the employment generation potential of business organizations. The work in case it is to be done manually if requires 10 employees, in case of computerized accounting system is done by one man only. For over populated countries, introduction of computerized accounting may not be desirable. Initially, there has been a

significant degree of resistance from the existing accounting staff, partly because of the fear that they shall be made redundant and largely because of the perception that they shall be less important to the organization.

5. Inability to Check Unanticipated Errors

Computers lack and the ability to judge, in case human beings commit error while entering data computers fail to detect that. Besides above limitations computerized accounting requires regular maintenance and lack the ability to take decisions.

18.8 Glossary

Computerized accounting system: is an accounting system where accounting data is processed using computers and accounting software instead of manual books.

Customized Software : is software that is built or modified specifically for one organization's needs, instead of using ready-made software.

18.9 Check your progress questions

Fill in the Blanks

1. Computerized system of accounting helps in maintaining record of financial transactions ontime basis.
2. The first stage in computerized accounting system is
3.is a standardized accounting software.
4.procedures are followed to conduct data validation
5. Accounting softwareis widely used in banks for maintenance of records.

TRUE/FALSE

1. Ready to use, and Customized are the examples of accounting softwares.
2. Ledger accounts are also maintained in computerized accounting system

3. A query to identify quantity of inventory which is two months old can be easily answered by using the structured query language (SQL) support of database technology in the computerized accounting system.
4. Customized accounting software are bit difficult to operate and accountants need to go under specialized training to operate these software.
5. Tailored software offer very high degree of data and transaction security

18.10 Answers to check your progress questions

1. Real Time
2. Transaction processing system
3. Tally
4. Error Detection and Error Prevention
5. Iflex
6. True
7. False
8. True
9. True
10. True

18.11.1 Terminal Questions

1. Write a note on the role of computers in accounting.
2. What are the components of computerized system of accounting
3. Explain the difference between computerized system of accounting and manual system of accounting.
4. “Computerized system of accounting is superior to manual system of accounting”, Give your comments.

18.12 Reference

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