



Fundamentals of Financial Accounting

CERTIFICATE IN ACCOUNTING TECHNICIANS

Paper-I

STUDY NOTES



Directorate of CAT

The Institute of Cost Accountants of India

(Statutory body under an Act of Parliament)

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CAT SYLLABUS 2021

Summary of the Course:

CAT Course Part-I (160 Hrs)

Paper I	:	Fundamentals of Financial Accounting
Paper II	:	Applied Business and Industrial Laws
Paper III	:	Financial Accounting - 2
Paper IV	:	Statutory Compliance

Delivery Strategy

Class Room oral coaching

Learning Strategy

Class Room Learning

On-line/off-line self paced studies through Online self assessment/study module.

ASSESSMENT STRATEGY

On line/off line periodical self-assessment

Course end examination- Multiple Choice Questions

To be answered on-line

Competency Level -Part-II (140 Hrs)

- Computer Fundamentals by Microsoft and Computerized Accounting- Tally ERP 9.0 – 35 hours
- SAP End User Program of 25 hours
- Cambridge - Generic Skills for Employability – 20 hours
- eFiling by experts from Industry – 20 hours
- Introduction to Costing Principles & Preparation of Cost Statements- 40 hours
- 5-days Orientation Programme



PAPER I: FUNDAMENTALS OF FINANCIAL ACCOUNTING

OBJECTIVES

To provide an insight into the fundamentals of financial accounting and its principles.

Learning Aims

The Syllabus aims to test the student's ability to:

- Understand and explain the conceptual framework of Accounting
- Prepare Accounts for various entities under different situations

Skill set required

Level A: Requiring the skill levels of knowledge and comprehension

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Fundamentals of Financial Accounting-(Accounting Paper I)

1. Process of Accounting
2. Reconciliation Statement
3. Accounting for Depreciation
4. Preparation of Final Accounts
5. Cash and Fund Flow Statements
6. Ratio Analysis

Section A: Fundamentals of Financial Accounting

1. Process of Accounting

- Basic Accounting Formulas and Accounting Terminologies
- Capital and Revenue transactions- capital and revenue expenditures, capital and revenue receipts
- Measurement, Valuation and Accounting estimates
- Double entry system, Books of prime entry, Subsidiary Books
- Recording of Cash and Bank transactions
- Voucher preparations
- Preparation of Ledger Accounts



- Preparation of Trial Balance- interpretation and usefulness
- Rectification of Errors

2. Reconciliation Statements

- Bank Reconciliation Statement
- Receivables / Payables Reconciliation Statement

3. Accounting for Depreciation

- Methods, computation and Accounting treatment

4. Preparation of Final Accounts

of a Profit-making concern (for sole proprietorship concern and partnership firm only)

- Preparation of Trading Account, Profit & Loss Account and Balance Sheet
- Accounting treatment of bad debts, reserve for bad and doubtful debts, provision for discount on debtors and provision for discount on creditors of a Non – Profit making concern.
- Preparation of Receipts and Payments Accounts
- Preparation of Income and Expenditure Accounts
- Preparation of Balance Sheet

5. Cash and Fund Flow Statements

6. Ratio Analysis



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STUDY NOTE – 1

PROCESS OF ACCOUNTING

This Study Note includes:

- Introduction
- Definitions
- Accounting Cycle
- Objectives of Accounting
- Basic Accounting Terms
- Generally Accepted Accounting Principles
- Accounting Concepts and Conventions
- Events and Transactions
- Voucher
- The Concepts of "Account", "Debit" and "Credit"
- Types of Accounts
- The Accounting Process
- Accounting Equation
- Accrual Basis & Cash Basis of Accounting
- Capital & Revenue Transactions
- Accounting Standards
- Double Entry System, Books of Prime Entry, Subsidiary Books
- Trial Balance
- Measurement, Valuation & Accounting Estimates
- Opening entries, Closing entries, Transfer entries and Rectification entries

1.1 INTRODUCTION

Business is an economic activity undertaken with the motive of earning profits and to maximize the wealth for the owners. Business cannot run in isolation. Largely, the business activity is carried out by people coming together with a purpose to serve a common cause. This team is often referred to as an organization, which could be in different forms such as sole proprietorship, partnership, body corporate etc. The rules of business are based on general principles of trade, social values, and statutory framework encompassing national or international boundaries. While these variables could be different for different businesses, different countries etc., the basic purpose is to add value to a product or service to satisfy customer demand.



Paper I: Fundamentals of Financial Accounting

The business activities require resources (which are limited & have multiple uses) primarily in terms of material, labour, machineries, factories and other services. The success of business depends on how efficiently and effectively these resources are managed. Therefore, there is a need to ensure the businessman tracks the use of these resources. The resources are not free and thus one must be careful to keep an eye on cost of acquiring them as well.

As the basic purpose of business is to make profit, one must keep an ongoing track of the activities undertaken in course of business. Two basic questions would have to be answered:

- (a) What is the result of business operations? This will be answered by finding out whether it has made profit or loss.
- (b) What is the position of the resources acquired and used for business purpose? How are these resources financed? Where the funds come from?

The answers to these questions are to be found continuously and the best way to find them is to record all the business activities. Recording of business activities has to be done in a scientific manner so that they reveal correct outcome. The science of book-keeping and accounting provides an effective solution. It is a branch of social science. This study material aims at giving a platform to the students to understand basic principles and concepts, which can be applied to accurately measure performance of business. After studying the various chapters included herein, the student should be able to apply the principles, rules, conventions and practices to different business situations like trading, manufacturing or service.

Over years, the art and science of accounting has evolved together with progress of trade and commerce at national and global levels. Professional accounting bodies have been doing intensive research to come up with accounting rules that will be applicable. Modern business is certainly more complex and continuous updating of these rules is required. Every stakeholder of the business is interested in a particular facet of information about the business. The art and science of accounting helps to put together these requirements of information as per universally accepted principles and also to interpret the results. It is interesting to note that each one of us has an accountant hidden in us. We do see our parents keep track of monthly expenses. We make a distinction between payment done for monthly grocery and that for buying a house or a car. We understand that while grocery is a monthly expense and buying a house is like creating a resource that has indefinite future use. The most common accounting record that each one of us knows is our bank passbook or a bank statement, which the bank maintains for us. It tracks each rupee that we deposit or withdraw from our account. When we go to supermarket to buy something, the cashier at the counter will record things we buy and give us a 'bill' or 'cash memo'. These are source documents prepared for the transaction between the supermarket and us. While these are simple examples, there could be more complex business activities. A good working knowledge of keeping records is therefore necessary. Professional accounting bodies all over the world have been functioning with the objective of providing this body of



Study Note-1 : Process of Accounting

knowledge. These institutions are engaged in imparting training in the field of accounting. Let us start with some basic definitions, concepts, conventions and practices used in development of this art as well as science.

1.2 DEFINITIONS

In order to understand the subject matter with clarity, let us study some of the definitions which depict the scope, content and purpose of Accounting. The field of accounting is generally sub-divided into:

- (a) Book-keeping
- (b) Financial Accounting
- (c) Cost Accounting and
- (d) Management Accounting

Let us understand each of these concepts.

(a) Book-keeping

The most common definition of book-keeping as given by J. R. Batliboi is "Book-keeping is an art of recording business transactions in a set of books."

As can be seen, it is basically a record keeping function. One must understand that not all dealings are, however, recorded. Only transactions expressed in terms of money will find place in books of accounts. These are the transactions which will ultimately result in transfer of economic value from one person to the other. Book-keeping is a continuous activity, the records being maintained as transactions are entered into. This being a routine and repetitive work, in today's world, it is taken over by the computer systems. Many accounting packages are available to suit different business organizations.

It is also referred to as a set of primary records. These records form the basis for accounting. It is an art because, the record is to be kept in such a manner that it will facilitate further processing and reporting of financial information which will be useful to all stakeholders of the business.

(b) Financial Accounting

It is commonly termed as Accounting. The American Institute of Certified Public Accountants defines Accounting as "an art of recoding, 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 first step in the cycle of accounting is to identify transactions that will find place in books of accounts. Transactions having financial impact only are to be recorded. E.g. if a businessman negotiates with the customer regarding supply of products, this will not be recorded. The negotiation is a deal which will potentially create a transaction and will have exchange of



money or money's worth. But unless this transaction is finally entered into, it will not be recorded in the books of accounts.

Secondly, the recording of the business transactions is done based on the Golden Rules of accounting (which are explained later) in a systematic manner. Transaction of similar nature are grouped together and recorded accordingly. e.g. Sales Transactions, Purchase Transactions, Cash Transactions etc. One has to interpret the transaction and then apply the relevant Golden Rule to make a correct entry thereof.

Thirdly, as the transactions increase in number, it will be difficult to understand the combined effect of the same by referring to individual records. Hence, the art of accounting also involves the step of summarizing them. With the aid of computers, this task is simplified in today's accounting though. The summarization will help users of the business information to understand and interpret business results.

Lastly, the accounting process provides the users with statements which will describe what has happened to the business. Remember the two basic questions we talked about, one to know whether business has made profit or loss and the other to know the position of resources that are used by the business.

It can be noted that although accounting is often referred to as an art, it is a science also. This is because it is based on universally applicable set of rules. However, it is not a pure science as there is a possibility of different interpretation.

(c) Cost Accounting

According to the Chartered Institute of Management Accountants (CIMA), Cost Accountancy is defined as "application of costing and cost accounting principles, methods and techniques to the science, art and practice of cost control and the ascertainment of profitability as well as the presentation of information for the purpose of managerial decision-making."

It is a branch of accounting dealing with the classification, recording, allocation, summarization and reporting of current and prospective costs and analyzing their behaviours. Cost Accounting is frequently used to facilitate internal decision making and provides tools with which management can appraise performance and control costs of doing business. It primarily involves relating the costs to the different products produced and sold or services rendered by the business. While Financial Accounting deals with business transactions at a broader level, Cost Accounting aims at further breaking it up to the last possible level to identify costs with products and services. It uses the same Financial Accounting documents and records. Modern computerized accounting packages like ERP systems provide for processing Financial as well as Cost Accounting records simultaneously.



Study Note-1 : Process of Accounting

This branch of accounting deals with the process of ascertainment of costs. The concept of cost is always applied with reference to a context. Knowledge of cost concepts and their application provide a very sound platform for decision making. Cost Accounting aims at equipping management with information that can be used for control on business activities.

(d) Management Accounting

Management Accounting is concerned with the use of Financial and Cost Accounting information to managers within organizations, to provide them with the basis in making informed business decisions that would allow them to be better equipped in their management and control functions. Unlike Financial Accounting information (which, for public companies, is public information), Management Accounting information is used within an organization (typically for decision-making) and is usually confidential and its access available only to a selected few.

According to the Chartered Institute of Management Accountants (CIMA), Management Accounting is "the process of identification, measurement, accumulation, analysis, preparation, interpretation and communication of information used by management to plan, evaluate and control within an entity and to assure appropriate use of and accountability for its resources. Management Accounting also comprises the preparation of financial reports for non management groups such as shareholders, creditors, regulatory authorities and tax authorities"

Basically, Management Accounting aims to facilitate management in formulating strategies, planning and constructing business activities, making decisions, optimal use of resources, and safeguarding assets of business.

These branches of accounting have evolved over years of research and are basically synchronized with the requirements of business organizations and all entities associated with them. We will now see what are they and how accounting satisfies various needs of different stakeholders.

1.2.1 Difference between Book-keeping and Accountancy

The Significant difference between Book-keeping and Accountancy are:-

Sl No.	Points of Difference	Book Keeping	Accountancy
1.	Meaning	Book-keeping is considered as ends.	Accountancy is considered as beginning.
2.	Functions	The primary stage of accounting function is called Book-keeping.	The overall accounting functions are guided by accountancy.
3.	Depends	Accountancy can complete its functions with the help of Book-keeping.	Accountancy depends on Book-keeping for its complete functions.



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4.	Data	The necessary data about financial performances and financial positions are taken from Book-keeping.	Accountancy can take its decisions, prepare reports and statements from the data taken from Book-keeping.
5.	Recording of Transactions	Financial transactions are recorded on the basis of accounting principles, concepts and conventions.	Accountancy does not take any principles, concepts and conventions from Book-keeping.

1.2.2 Difference between Management Accounting and Financial Accounting

The significant difference between Management Accounting and Financial Accounting are:

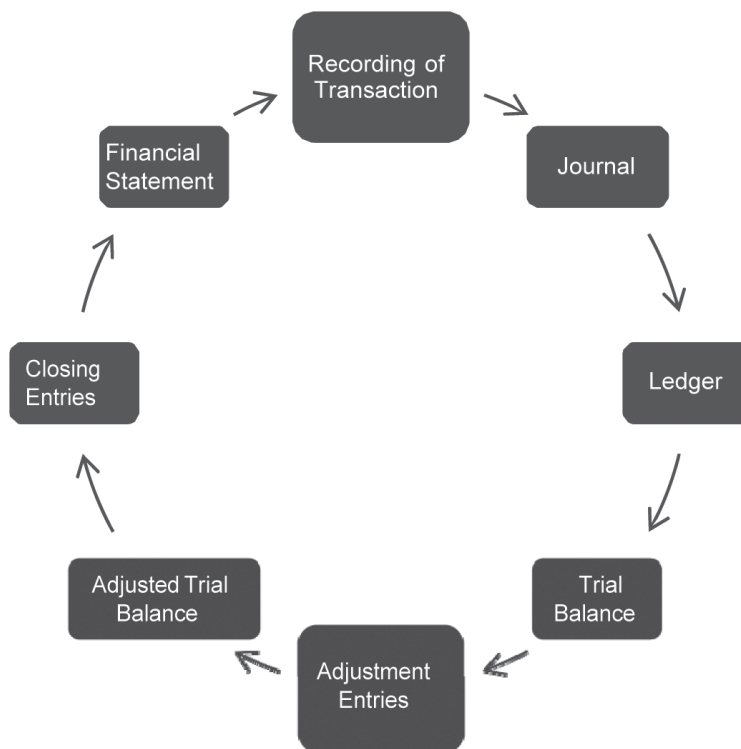
Management Accounting		
1.	Management Accounting is primarily based on the data available from Financial Accounting.	Financial Accounting is based on the monetary transactions of the enterprise.
2.	It provides necessary information to the management to assist them in the process of planning, controlling, performance evaluation and decision making.	Its main focus is on recording and classifying monetary transactions in the books of accounts and preparation of financial statements at the end of every accounting period.
3.	Reports prepared in Management Accounting are meant for management and as per management requirement.	Reports as per Financial Accounting are meant for the management as well as for shareholders and creditors of the concern.
4.	Reports may contain both subjective and Objective figures.	Reports should always be supported by relevant figures and it emphasizes on the objectivity of data.
5.	Reports are not subject to statutory audit.	Reports are always subject to statutory audit.
6.	It evaluates the sectional as well as the entire performance of the business.	It ascertains , evaluates and exhibits the financial strength of the whole business.

When complete sequence of accounting procedure is done which happens frequently and repeated in same directions during an accounting period, the same is called an accounting cycle.

Study Note-1 : Process of Accounting

Steps/Phases of Accounting Cycle

The steps or phases of accounting cycle can be developed as under:



1.3 ACCOUNTING CYCLE

- Recording of Transaction:-** As soon as a transaction happens it is at first recorded in subsidiary book.
- Journal:-** The transactions are recorded in Journal chronologically.
- Ledger:-** All journals are posted into ledger chronologically and in a classified manner.
- Trial Balance:-** After taking all the ledger account closing balances, a Trial Balance is prepared at the end of the period for the preparations of financial statements.
- Adjustment Entries:-** All the adjustments entries are to be recorded properly and adjusted accordingly before preparing financial statements.
- Adjusted Trial Balance:-** An adjusted Trail Balance may also be prepared.
- Closing Entries:-** All the nominal accounts are to be closed by the transferring to Trading Account and Profit and Loss Account.
- Financial Statements:-** Financial statement can now be easily prepared which will exhibit the true financial position and operating results.



1.4 OBJECTIVES OF ACCOUNTING

The main objective of Accounting is to provide financial information to stakeholders. This financial information is normally given via financial statements, which are prepared on the basis of Generally Accepted Accounting Principles (GAAP). There are various accounting standards developed by professional accounting bodies all over the world. In India, these are governed by The Institute of Chartered Accountants of India, (ICAI). In the US, the American Institute of Certified Public Accountants

(AICPA) is responsible to lay down the standards. The Financial Accounting Standards Board (FASB) is the body that sets up the International Accounting Standards. These standards basically deal with accounting treatment of business transactions and disclosing the same in financial statements.

The following objectives of accounting will explain the width of the application of this knowledge stream:

- (a) To ascertain the amount of profit or loss made by the business i.e. to compare the income earned versus the expenses incurred and the net result thereof.
- (b) To know the financial position of the business i.e. to assess what the business owns and what it owes.
- (c) To provide a record for compliance with statutes and laws applicable.
- (d) To enable the readers to assess progress made by the business over a period of time.
- (e) To disclose information needed by different stakeholders

Let us now see which are different stakeholders of the business and what do they seek from the accounting information. This is shown in the following table.

Stakeholder	Interest in business	Accounting Information
Owners/Investors/ existing and potential	Profits or losses	Financial statements, Cost Accounting records, Management Accounting reports
Lenders	Assessment of capability of the business to pay interest and principal of money lent. Basically, they monitor the solvency of business.	Financial statement and analysis thereof, reports forming part of accounts, valuation of assets given as security.
Customers and suppliers	Stability and growth of the business	Financial and Cash flow statements to assess ability of the business to offer better business terms and ability to supply the products and services.

Study Note-1 : Process of Accounting

Government	Whether the business is complying with various legal requirements	Accounting documents such as vouchers, extracts of books, information of purchase, sales, employee obligations etc. and financial statements
Employees and trade unions	Growth and profitability	Financial statements for negotiating pay packages
Competitors	Performance and possible tie-ups in the era of mergers and acquisitions	Accounting information to find out possible synergies

1.4.1 Users of Accounting Information

Accounting provides information both to internal users and the external users. The internal users are all the organizational participants at all levels of management (i.e. top, middle and lower). Generally top level management requires information for planning, middle level management which requires information for controlling the operations. For internal use, the information is usually provided in the form of reports, for instance Cash Budget Reports, Production Reports, Idle Time Reports, Feedback Reports, whether to retain or replace an equipment decision reports, project appraisal report, and the like.

There are also the external users (e.g. Banks, Creditors). They do not have direct access to all the records of an enterprise, they have to rely on financial statements as the source of information. External users are basically, interested in the solvency and profitability of an enterprise.

1.4.2 Types of Accounting Information

Accounting information may be categorized in number of ways on the basis of purpose of accounting information, on the basis of measurement criteria and so on. The various types of accounting information are given below:

I. Accounting Information relating to financial transactions and events.

- (a) **Financial Position-** Information about financial position is primarily provided in a balance sheet. The financial position of an enterprise is affected by different factors, like -
 - (i) Information about the economic resources controlled by the enterprise and its capacity in the past to alter these resources is useful in predicting the ability of the enterprise to generate cash and cash equivalents in the future.
 - (ii) Information about financial structure is useful in predicting future borrowing needs and how future profits and cash flows will be distributed among those with an interest in the enterprise; it is also useful in predicting how successful the enterprise is likely to be in raising further finance.



- (iii) Information about liquidity and solvency is useful in predicting the ability of the enterprise to meet its financial commitments as they fall due. Liquidity refers to the availability of cash in the near future to meet financial commitments over this period. Solvency refers to the availability of cash over the longer term to meet financial commitments as they fall due.

- (b) **Financial Performance-** Information about financial performance is primarily provided in a Statement of Profit and Loss which is also known as Income Statement.

Information about the performance of an enterprise and its profitability, is required in order to assess potential changes taking place in the economic resources that it is likely to control in the future. Information about variability of performance is also important in this regard. Information about performance is necessary in predicting the capacity to generate cash flows from its available resource. It is an important input in forming judgments about the effectiveness of an enterprise to utilize resources

- (c) **Cash Flows-** Information about cash flows is provided in the financial statements by means of a cash flow statement.

Information concerning cash flows is useful in providing the users with a basis to assess the ability of the enterprise to generate cash and cash equivalents and the needs of the enterprise to utilise those cash and cash equivalent.

These information may be classified as follows:

- (i) on the basis of Historical Cost
- (ii) on the basis of Current Cost
- (iii) on the basis of Realizable Value
- (iv) on the basis of Present Value

II. Accounting information relating to cost of a product, operation or function.

III. Accounting information relating to planning and controlling the activities of an enterprise for internal reporting.

This information may further be classified as follows:

- (i) Information relating to Finance Area,
- (ii) Information relating to Production Area
- (iii) Information relating to Marketing Area
- (iv) Information relating to Personnel Area
- (v) Information relating to Other Areas (such as Research & Development)



Study Note-1 : Process of Accounting

- vi. Accounting information relating to Social Effects of business decisions.
- vii. Accounting information relating to Environment and Ecology.
- Viii. Accounting information relating to Human Resources.

1.4.3 Qualitative Characteristics of Accounting Information

Qualitative characteristics are the attributes that make the information provided in financial statements useful to its users.

Qualitative Characteristics of Accounting Information can be segregated in the following categories

- (i) Reliability
- (ii) Relevance
- (iii) Materiality
- (iv) Understandability
- (v) Comparability

(i) Reliability: To be useful, information must also be reliable. Information has the quality of reliability when it is free from material error and bias and can be depended upon by users to represent faithfully that which it either portrays to represent or could reasonably be expected to represent. Information may be relevant but so unreliable in nature or representation that its recognition may be potentially misleading and so it becomes useless. Reliability of the financial statements is dependent on the following:

- (a) **Faithful Representation-** To be reliable, information must represent faithfully the transactions and other events which either portrays to represent or could reasonably be expected to represent. Most financial information is subject to some risks of being less than faithful representation of that which it purports to portray. This is not due to bias, but rather to enhance difficulties either in identifying the transactions or other events to be measured in devising or applying measurements and presentation techniques that can convey messages that correspond with those transactions and events.
- (b) **Substance Over Form-** If information is to represent faithfully the transactions and other events that it portrays to represent, it is necessary that they are accounted for and presented in accordance with their substance and economic reality and not merely by their legal forms. The substance of transactions or other events is not always consistent with that which is apart from their legal or contrived form.
- (c) **Neutrality-** To be reliable the information contained in financial statements must be neutral.



Financial statements are not neutral if by selective presentation of information, they influence the making of a decision or judgment in order to achieve a predetermined result or outcome.

- (d) **Prudence-** The preparers of financial statements have to contend with uncertainties that inevitably surround many events and circumstances. Such uncertainties are recognized by the disclosure of their nature and extent and by exercise of prudence in the financial statements. Prudence is the inclusion of a degree of caution. In the exercise of judgement needed in making the estimate required under conditions of uncertainties so that assets or income are not overstated and liabilities or expenses are not understated. However, the exercise of prudence does not allow the creation of hidden reserves or excessive provisions, i.e. the deliberate understatement of assets or income or deliberate over statement of liabilities or expenses.
- (e) **Completeness-** To be reliable the information in the financial statements must be complete within the bounds of materiality and cost. An omission can cause information to be false or misleading and thus, unreliable and deficient in terms of its relevance.

- (ii) **Relevance:** To be useful, information must be relevant to the decision-making needs of users.

Information has the quality of relevance when it influences the economic decisions of the users by helping them to evaluate past, present or future events or confirming or correcting their past evaluation. The productive and confirmatory roles of information are interrelated. For example, information about the current level and structure of asset-holding has value to users when they endeavour to predict the ability of the enterprise to take advantage of opportunities and its ability to react to adverse situations. The same information plays a confirmatory role in respect of past prediction about, for example, the way in which the enterprise would be structured or the outcome of planned operations.

- (iii) **Materiality:** The relevance of information is affected by its nature and materiality. Information is material if its omission or mis-statement could influence the economic decisions of users made on the basis of financial statements. Materiality depends on the size of the item or error judged in the particular circumstance of its omission or mis-statement. Thus, materiality provides a threshold or a cut-off point rather than being a primary qualitative characteristic which information must have if it is to be useful.
- (iv) **Understandability:** The information provided in financial statements must be easily understandable by users. For this purpose, users are assumed to have a reasonable knowledge of business and economic activities, accounting and a willingness to study the information with reasonable diligence. However, information about complex matters



Study Note-1 : Process of Accounting

that should be included in the financial statements because of its relevance to the decision making needs of users and should not be excluded merely on the grounds that it may be too difficult for certain users to understand.

- (v) **Comparability:** The financial statements of an enterprise should be comparable. For this purpose users should be informed of the accounting policies, any changes in those policies and the effects of such changes. This qualitative characteristic requires pursuance of consistency in choosing accounting policies. Lack of consistency may disturb the comparability quality of the financial statement information. Accordingly, accounting standard on disclosure of accounting policies consider consistency as a fundamental accounting assumption along with accrual and going concern.

1.5 BASIC ACCOUNTING TERMS

In order to understand the subject matter clearly, one must grasp the following common expressions always used in business accounting. The aim here is to enable the student to understand with these often used concepts before we embark on accounting procedures and rules. You may note that these terms can be applied to any business activity with the same connotation.

- (i) **Transaction:** It means an event or a business activity which involves exchange of money or money's worth between parties. The event can be measured in terms of money and changes the financial position of a person e.g. purchase of goods would involve receiving material and making payment or creating an obligation to pay to the supplier at a future date. Transaction could be a cash transaction or credit transaction. When the parties settle the transaction immediately by making payment in cash or by cheque, it is called a cash transaction. In credit transaction, the payment is settled at a future date as per agreement between the parties.
- (ii) **Goods/Services:** These are tangible article or commodity in which a business deals. These articles or commodities are either bought and sold or produced and sold. At times, what may be classified as 'goods' to one business firm may not be 'goods' to the other firm. e.g. for a machine manufacturing company, the machines are 'goods' as they are frequently made and sold. But for the buying firm, it is not 'goods' as the intention is to use it as a long term resource and not sell it. Services are intangible in nature which are rendered with or without the object of earning profits.
- (iii) **Profit:** The excess of Revenue Income over expense is called profit. It could be calculated for each transaction or for business as a whole.
- (iv) **Loss:** The excess of expense over income is called loss. It could be calculated for each transaction or for business as a whole.
- (v) **Asset:** Asset is a resource owned by the business with the purpose of using it for generating future profits. Assets can be Tangible and Intangible. Tangible Assets are the Capital assets



which have some physical existence. They can, therefore, be seen, touched and felt, e.g. Plant and Machinery, Furniture and Fittings, Land and Buildings, Books, Computers, Vehicles, etc. The capital assets which have no physical existence and whose value is limited by the rights and anticipated benefits that possession confers upon the owner are known as Intangible Assets. They cannot be seen or felt although they help to generate revenue in future, e.g. Goodwill, Patents, Trade-marks, Copyrights, Brand Equity, Designs, Intellectual Property, etc.

Assets can also be classified into Current Assets and Non-Current Assets.

Current Assets – An asset shall be classified as Current when it satisfies any of the following:

- (a) It is expected to be realised in, or is intended for sale or consumption in the Company's normal Operating Cycle,
- (b) It is held primarily for the purpose of being traded ,
- (c) It is due to be realised within 12 months after the Reporting Date, or
- (d) It is Cash or Cash Equivalent unless it is restricted from being exchanged or used to settle a Liability for at least 12 months after the Reporting Date.

Non-Current Assets – All other Assets shall be classified as Non-Current Assets. e.g. Machinery held for long term etc.

- (vi) Liability:** It is an obligation of financial nature to be settled at a future date. It represents amount of money that the business owes to the other parties. E.g. when goods are bought on credit, the firm will create an obligation to pay to the supplier the price of goods on an agreed future date or when a loan is taken from bank, an obligation to pay interest and principal amount is created. Depending upon the period of holding, these obligations could be further classified into Long Term or non-current liabilities and Short Term or current liabilities.

Current Liabilities – A liability shall be classified as Current when it satisfies any of the following:

- (a) It is expected to be settled in the Company's normal Operating Cycle,
- (b) It is held primarily for the purpose of being traded,
- (c) It is due to be settled within 12 months after the Reporting Date, or
- (d) The Company does not have an unconditional right to defer settlement of the liability for at least 12 months after the reporting date (Terms of a Liability that could, at the option of the counterparty, result in its settlement by the issue of Equity Instruments do not affect its classification)

Non-Current Liabilities – All other Liabilities shall be classified as Non-Current Liabilities. E.g. Loan taken for 5 years, Debentures issued etc.



Study Note-1 : Process of Accounting

- (vii) **Internal Liability:** These represent proprietor's equity, i.e. all those amount which are entitled to the proprietor, e.g., Capital, Reserves, Undistributed Profits, etc.
- (viii) **Working Capital:** In order to maintain flows of revenue from operation, every firm needs certain amount of current assets. For example, cash is required either to pay for expenses or to meet obligation for service received or goods purchased, etc. by a firm. On identical reason, inventories are required to provide the link between production and sale. Similarly, Accounts Receivable generate when goods are sold on credit. Cash, Bank, Debtors, Bills Receivable, Closing Stock, Prepayments etc. represent current assets of firm. The whole of these current assets form the working capital of a firm which is termed as Gross Working Capital.

$$\begin{aligned}\text{Gross Working capital} &= \text{Total Current Assets} \\ &= \text{Long term internal liabilities plus long term debts plus the} \\ &\quad \text{current liabilities minus the amount blocked in the fixed} \\ &\quad \text{assets.}\end{aligned}$$

There is another concept of working capital. Working capital is the excess of current assets over current liabilities. That is the amount of current assets that remain in a firm if all its current liabilities are paid. This concept of working capital is known as Net Working Capital which is a more realistic concept.

$$\text{Working Capital (Net)} = \text{Current Assets} - \text{Currents Liabilities.}$$

- (ix) **Contingent Liability:** It represents a potential obligation that could be created depending on the outcome of an event. E.g. if supplier of the business files a legal suit, it will not be treated as a liability because no obligation is created immediately. If the verdict of the case is given in favour of the supplier then only the obligation is created. Till that it is treated as a contingent liability. Please note that contingent liability is not recorded in books of account, but disclosed by way of a note to the financial statements.
- (x) **Capital:** It is amount invested in the business by its owners. It may be in the form of cash, goods, or any other asset which the proprietor or partners of business invest in the business activity. From business point of view, capital of owners is a liability which is to be settled only in the event of closure or transfer of the business. Hence, it is not classified as a normal liability. For corporate bodies, capital is normally represented as share capital.
- (xi) **Drawings:** It represents an amount of cash, goods or any other assets which the owner withdraws from business for his or her personal use. e.g. if the life insurance premium of proprietor or a partner of business is paid from the business cash, it is called drawings. Drawings will result in reduction in the owners' capital. The concept of drawing is not applicable to the corporate bodies like limited companies.



- (xii) **Net worth:** It represents excess of total assets over total liabilities of the business. Technically, this amount is available to be distributed to owners in the event of closure of the business after payment of all liabilities. That is why it is also termed as Owner's equity. A profit making business will result in increase in the owner's equity whereas losses will reduce it.
- (xiii) **Non-current Investments:** Non-current Investments are investments which are held beyond the current period as to sale or disposal. e. g. Fixed Deposit for 5 years.
- (xiv) **Current Investments:** Current investments are investments that are by their nature readily realizable and are intended to be held for not more than one year from the date on which such investment is made. e. g. 11 months Commercial Paper.
- (xv) **Debtor:** The sum total or aggregate of the amounts which the customer owe to the business for purchasing goods on credit or services rendered or in respect of other contractual obligations, is known as Sundry Debtors or Trade Debtors, or Trade Payable, or Book-Debts or Debtors. In other words, Debtors are those persons from whom a business has to recover money on account of goods sold or service rendered on credit. These debtors may again be classified as under:

(i)	Good debts	The debts which are sure to be realized are called good debts.
(ii)	Doubtful Debts	The debts which may or may not be realized are called doubtful debts.
(iii)	Bad debts	The debts which cannot be realized at all are called bad debts.

It must be remembered that while ascertaining the debtors balance at the end of the period certain adjustments may have to be made e.g. Bad Debts, Discount Allowed, Returns Inwards, etc.

- (xvi) **Creditor:** A creditor is a person to whom the business owes money or money's worth. e.g. money payable to supplier of goods or provider of service. Creditors are generally classified as Current Liabilities.
- (xvii) **Capital Expenditure:** This represents expenditure incurred for the purpose of acquiring a fixed asset which is intended to be used over long term for earning profits there from. e. g. amount paid to buy a computer for office use is a capital expenditure. At times expenditure may be incurred for enhancing the production capacity of the machine. This also will be a capital expenditure. Capital expenditure forms part of the Balance Sheet.



Study Note-1 : Process of Accounting

(xviii) Revenue expenditure: This represents expenditure incurred to earn revenue of the current period.

The benefits of revenue expenses get exhausted in the year of the incurrence. e.g. repairs, insurance, salary & wages to employees, travel etc. The revenue expenditure results in reduction in profit or surplus. It forms part of the Income statement.

(xix) Balance Sheet: It is the statement of financial position of the business entity on a particular date.

It lists all assets, liabilities and capital. It is important to note that this statement exhibits the state of affairs of the business as on a particular date only. It describes what the business owns and what the business owes to outsiders (this denotes liabilities) and to the owners (this denotes capital). It is prepared after incorporating the resulting profit/losses of Income statement.

(xx) Profit and Loss Account or Income Statement: This account shows the revenue earned by the business and the expenses incurred by the business to earn that revenue. This is prepared usually for a particular accounting period, which could be a month, quarter, a half year or a year. The net result of the Profit and Loss Account will show profit earned or loss suffered by the business entity.

(xxi) Trade Discount: It is the discount usually allowed by the wholesaler to the retailer computed on the list price or invoice price. e.g. the list price of a TV set could be Rs. 15000. The wholesaler may allow 20% discount thereof to the retailer. This means the retailer will get it for Rs. 12000 and is expected to sale it to final customer at the list price. Thus the trade discount enables the retailer to make profit by selling at the list price. Trade discount is not recorded in the books of accounts. The transactions are recorded at net values only. In above example, the transaction will be recorded at Rs. 12000 only.

(xxii) Cash Discount: This is allowed to encourage prompt payment by the debtor. This has to be recorded in the books of accounts. This is calculated after deducting the trade discount. e.g. if list price is Rs. 15000 on which a trade discount of 20% and cash discount of 2% apply, then first trade discount of Rs. 3000 (20% of Rs. 15000) will be deducted and the cash discount of 2% will be calculated on Rs. 12000 (Rs.15000 – Rs. 3000). Hence the cash discount will be Rs. 240/- (2% of Rs. 12000) and net payment will be Rs. 11,760 (Rs.12,000 - Rs. 240)

Let us see if we can apply these in the following examples.



ILLUSTRATION 1

Fill in the blanks:

- (a) The cash discount is allowed by _____ to the _____.
- (b) Profit means excess of _____ over _____.
- (c) Debtor is a person who _____ to others.
- (d) In a credit transaction, the buyer is given a _____ facility.
- (e) The fixed asset is generally held for _____.
- (f) The current liabilities are obligations to be settled in _____ period.
- (g) The withdrawal of money by the owner of business is called _____.
- (h) The amount invested by owners into business is called _____.
- (i) Transaction means exchange of money or money's worth for _____.
- (j) The net result of an income statement is _____ or _____.
- (k) The _____ shows financial position of the business as on a particular date.
- (l) The _____ discount is never entered in the books of accounts.
- (m) Vehicles represent _____ expenditure while repairs to vehicle would mean _____ expenditure.
- (n) Net worth is excess of _____ over _____.

Answers:

(a) creditor, debtor	(h) Capital
(b) income, expenditure	(i) Value
(c) Owes	(j) Profit, loss
(d) Credit	(k) Balance sheet
(e) Longer period	(l) Trade
(f) Short	(m) Capital, revenue
(g) Drawings	(n) Total assets, total liabilities

ILLUSTRATION 2.

Give one word or a term used to describe the following:-

- (a) An exchange of benefit for value
- (b) A transaction without immediate cash settlement.
- (c) Commodities in which a business deals.
- (d) Excess of expenditure over income.
- (e) Things of value owned by business to earn future profits.

Study Note-1 : Process of Accounting

- (f) Amount owed by business to others.
- (g) An obligation which may or may not materialise.
- (h) An allowance by a creditor to debtor for prompt payment.
- (i) Assets like brand value, copy rights, goodwill

Answers:

(a) Transaction	(f) Liability
(b) credit transaction	(g) Contingent liability
(c) goods	(h) Cash discount
(d) Loss	(i) Intangible assets
(e) Assets	

1.6. GENERALLY ACCEPTED ACCOUNTING PRINCIPLES

A widely accepted set of rules, conventions, standards, and procedures for reporting financial information, as established by the Financial Accounting Standards Board are called Generally Accepted Accounting Principles (GAAP). These are the common set of accounting principles, standards and procedures that companies use to compile their financial statements. GAAP are a combination of standards (set by policy boards) and simply the commonly accepted ways of recording and reporting accounting information.

GAAP is to be followed by companies so that investors have a optimum level of consistency in the financial statements they use when analyzing companies for investment purposes. GAAP cover such aspects like revenue recognition, balance sheet item classification and outstanding share measurements.

1.7. ACCOUNTING CONCEPTS AND CONVENTIONS

As seen earlier, the accounting information is published in the form of financial statements. The three basic financial statements are

- (i) The Profit & Loss Account that shows net business result i.e. profit or loss for a certain periods
- (ii) The Balance Sheet that exhibits the financial strength of the business as on a particular dates
- (iii) The Cash Flow Statement that describes the movement of cash from one date to the other.

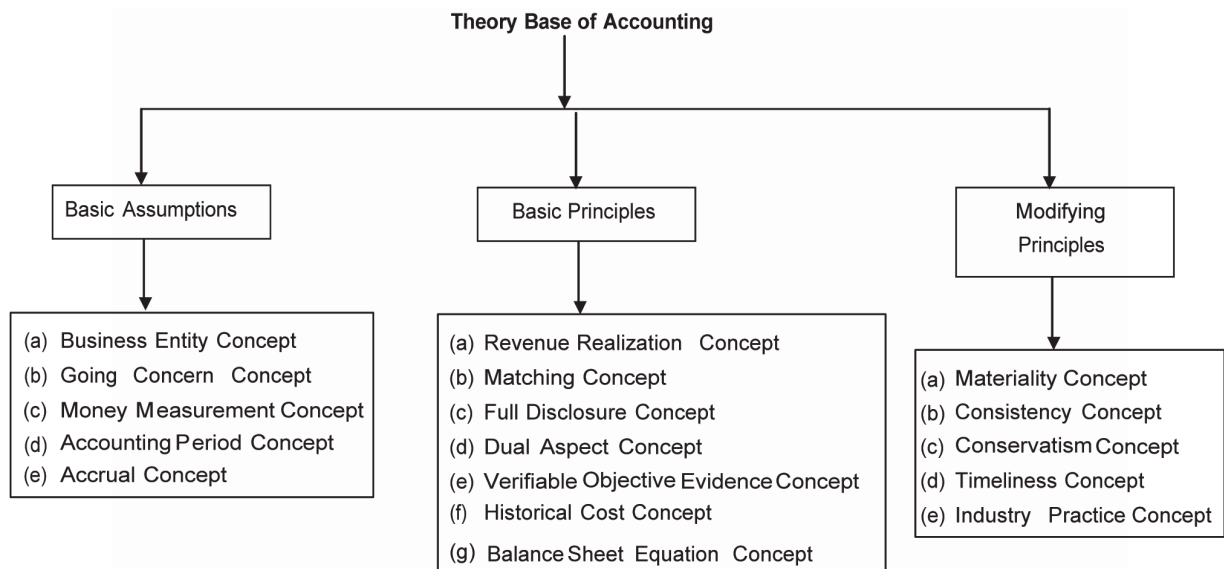
As these statements are meant to be used by different stakeholders, it is necessary that the information contained therein is based on definite principles, concrete concepts and well accepted convention.

Accounting principles are basic guidelines that provide standards for scientific accounting practices and procedures. They guide as to how the transactions are to be recorded and



reported. They assure uniformity and understandability. Accounting concepts lay down the foundation for accounting principles. They are ideas essentially at mental level and are self-evident. These concepts ensure recording of financial facts on sound bases and logical considerations. Accounting conventions are methods or procedures that are widely accepted. When transactions are recorded or interpreted, they follow the conventions. Many times, however, the terms-principles, concepts and conventions are used interchangeably.

Professional Accounting Bodies have published statements of these concepts. Over years, many of these concepts are being challenged as outlived. Yet, no major deviations have been made as yet. Path breaking ideas have emerged and the accounting standards of modern days do require companies to record and report transactions which may not be necessarily based on concepts that are in vogue for long. It is essential to study accounting from the basic levels and understand these concepts in entirety.



A. BASIC ASSUMPTIONS

(a) Business entity concept

As per this concept, the business is treated as distinct and separate from the individuals who own or manage it. When recording business transactions, the important question is how will it affect the business entity? How they affect the persons who own it or run it or otherwise associated with it is irrelevant. Application of this concept enables recording of transactions of the business entity with its owners or managers or other stakeholders. For example, if the owner pays his personal expenses from business cash, this transaction can be recorded in the books of business entity. This transaction will take the cash out of business and also reduce the obligation of the business towards the owner.



Study Note-1 : Process of Accounting

At times it is difficult to separate owners from the business. Consider an individual, who runs a small retail outlet. In the eyes of law, there is no distinction made between financial affairs of the outlet with that of the individual. The creditors of the retail outlet can sue the individual and collect his claim from personal resources of the individual. However, in accounting, the records are kept as distinct for the retail outlet and the individual respectively. For certain forms of business entities, such as limited companies this distinction is easier. The limited companies are separate legal persons in the eyes of law as well.

The entity concept requires that all the transactions are to be viewed, interpreted and recorded from 'business entity' point of view. An accountant steps into the shoes of the business entity and decides to account for the transactions. The owner's capital is the obligation of business and it has to be paid back to the owner in the event of business closure. Also, the profit earned by the business will belong to the owner and hence is treated as owner's equity.

(b) Going Concern Concept

The basic principles of this concept is that business is assumed to exist for an indefinite period and is not established with the objective of closing it down. So unless there is good evidence to the contrary, the accountant assumes that a business entity is a 'going concern' - that it will continue to operate as usual for a longer period of time. It will keep getting money from its customers, pay its creditors, buy and sell goods, use assets to earn profits in future. If this assumption is not considered, one will have to constantly value the worth of the assets and resource. This is not practicable. This concept enables the accountant to carry forward the values of assets and liabilities from one accounting period to the other without asking the question about usefulness and worth of the assets and recoverability of the receivables.

The going concern concept forms a sound basis for preparation of a balance sheet.

(c) Money Measurement Concept

A business transaction will always be recorded if it can be expressed in terms of money. The advantage of this concept is that different types of transactions could be recorded as homogenous entries with money as common denominator. A business may own Rs. 3 Lacs cash, 1500 kg of raw material, 10 vehicles, 3 computers etc. Unless each of these is expressed in terms of money, we cannot find out the assets owned by the business. When expressed in the common measure of money, transactions could be added or subtracted to find out the combined effect. In the above example, we could add values of different assets to find the total assets owned.

The application of this concept has a limitation. When transactions are recorded in terms of money, we only consider the absolute value of the money. The real value of the money may fluctuate from time to time due to inflation, exchange rate changes, etc. This fact is not considered when recording the transaction.



(d) The Accounting Period Concept

We have seen that as per the going-concern concept the business entity is assumed to have an indefinite life. Now if we were to assess whether the business has made profit or loss, should we wait until this indefinite period is over? Would it mean that we will not be able to assess the business performance on an ongoing basis? Does it deprive all stakeholders the right to the accounting information? Would it mean that the business will not pay income tax as no income will be computed?

To circumvent this problem, the business entity is supposed to be paused after a certain time interval. This time interval is called an accounting period. This period is usually one year, which could be a calendar year i.e. 1st January to 31st December or it could be a fiscal year in India as 1st April to 31st March. The business organizations have the freedom to choose their own accounting year. For certain organizations, reporting of financial information in public domain are compulsory. In India, listed companies must report their quarterly unaudited financial results and yearly audited financial statements. For internal control purpose, many organizations prepare monthly financial statements. The modern computerized accounting systems enable the companies to prepare real-time online financials at the click of button.

Businesses are living, continuous organisms. The splitting of the continuous stream of business events into time periods is thus somewhat arbitrary. There is no significant change just because one accounting period ends and a new one begins. This results into the most difficult problem of accounting of how to measure the net income for an accounting period. One has to be careful in recognizing revenue and expenses for a particular accounting period. Subsequent section on accounting procedures will explain how one goes about it in practice.

(e) The Accrual Concept

The accrual concept is based on recognition of both cash and credit transactions. In case of a cash transaction, owner's equity is instantly affected as cash either is received or paid. In a credit transaction, however, a mere obligation towards or by the business is created. When credit transactions exist (which is generally the case), revenues are not the same as cash receipts and expenses are not same as cash paid during the period.

When goods are sold on credit as per normally accepted trade practices, the business gets the legal right to claim the money from the customer. Acquiring such right to claim the consideration for sale of goods or services is called accrual of revenue. The actual collection of money from customer could be at a later date.

Similarly, when the business procures goods or services with the agreement that the payment will be made at a future date, it does not mean that the expense effect should



Study Note-1 : Process of Accounting

not be recognized. Because an obligation to pay for goods or services is created upon the procurement thereof, the expense effect also must be recognized.

Today's accounting systems based on accrual concept are called as Accrual system or mercantile system of accounting.

B. BASIC PRINCIPLES

(a) The Revenue Realisation Concept

While the conservatism concept states whether or not revenue should be recognized, the concept of realisation talks about what revenue should be recognized. It says amount should be recognized only to the tune of which it is certainly realizable. Thus, mere getting an order from the customer won't make it eligible to recognize as revenue. The reasonable certainty of realizing the money will come only when the goods ordered are actually supplied to the customer and he is billed. This concept ensures that income unearned or unrealized will not be considered as revenue and the firms will not inflate profits.

Consider that a store, sales goods for Rs. 25 lacs during a month on credit. The experience and past data shows that generally 2% of the amount is not realized. The revenue to be recognized will be Rs. 24.50 lacs. Although conceptually the revenue to be recognized at this value, in practice the doubtful amount of Rs. 50 thousand (2% of Rs. 25 lacs) is often considered as expense.

(b) The Matching Concept

As we have seen the sale of goods has two effects: (i) a revenue effect, which results in increase in owner's equity by the sales value of the transaction and (ii) an expense effect, which reduces owner's equity by the cost of goods sold, as the goods go out of the business. The net effect of these two effects will reflect either profit or loss. In order to correctly arrive at the net result, both these aspects must be recognized during the same accounting period. One cannot recognize only the revenue effect thereby inflating the profit or only the expense effect which will deflate the profit. Both the effects must be recognized in the same accounting period. This is the principle of matching concept.

To generalize, when a given event has two effects – one on revenue and the other on expense, both must be recognized in the same accounting period.

(c) Full Disclosure Concept

As per this concept, all significant information must be disclosed. Accounting data should properly be clarified, summarized, aggregated and explained for the purpose of presenting the financial statements which are useful for the users of accounting information. Practically, this principle emphasizes on the materiality, objectivity and consistency of accounting data which should disclose the true and fair view of the state of affairs of a firm. This principle is



going to be popular day by day as per Companies Act, 1956 major provisions for disclosure of essential information about accounting data and as such, concealment of material information, at present, is not very easy. Thus, full disclosure must be made for such material information which are useful to the users of accounting information.

(d) Dual Aspect Concept

The assets represent economic resources of the business, whereas the claims of various parties on business are called obligations. The obligations could be towards owners (called as owner's equity) and towards parties other than the owners (called as liabilities).

When a business transaction happens, it will involve use of one or the other resource of the business to create or settle one or more obligations. e.g. consider Mr. Suresh starts a business with the investment of Rs. 25 lacs. Here, the business has got a resource of cash worth Rs. 25 lacs (which is its asset), but at the same time it has created an obligation of business towards Mr. Suresh that in the event of business closure, the money will be paid back to him. This could be shown as:

$$\text{Assets} = \text{Liabilities} + \text{Capital}$$

In other words,

Cash brought in by Mr. Suresh (Rs. 25 lacs) = Liability of business towards Mr. Suresh (Rs. 25 lacs)

We know that liability of the business could be towards owners and parties other than owners, this equation could be re-written as:

$$\begin{aligned} \text{Assets} &= \text{Liabilities} + \text{Owner's equity} \\ \text{Cash Rs. 2500000} &= \text{Liabilities Rs. nil} + \text{Mr. Suresh's equity Rs. 25,00,000} \end{aligned}$$

This is the fundamental accounting equation shown as formal expression of the dual aspect concept. This powerful concept recognizes that every business transaction has dual impact on the financial position. Accounting systems are set up to simultaneously record both these aspects of every transaction; that is why it is called as Double-entry system of accounting. In its present form the double entry system of accounting owes its existence to an Italian expert Mr. Luca Pacioli in the year 1495.

Continuing with our example of Mr. Suresh, now let us consider he borrows Rs. 15 lacs from bank. The dual aspect of this transaction-on one hand the business cash will increase by Rs. 15 lacs and a liability towards the bank will be created for Rs. 15 lacs.

$$\begin{aligned} \text{Assets} &= \text{Liabilities} + \text{Owner's equity} \\ \text{Cash Rs. 40,00,000} &= \text{Liabilities Rs. 15,00,000} + \text{Mr. Suresh's equity Rs. 25,00,000} \end{aligned}$$



Study Note-1 : Process of Accounting

The student must note that the dual aspect concept entails recognition of the two effects of each transaction. These effects are of equal amount and reverse in nature. How to decide these two aspects? The golden rules of accounting are used to arrive at this decision. After recording both aspects of the transaction, the basic accounting equation will always balance or be equal.

The above concepts find the application in preparation of the balance sheet which is the statement of assets and liabilities as on a particular date. We will now see some more concepts that are important for preparation of Profit and Loss Account or Income Statement.

(e) Verifiable Objective Evidence Concept

Under this principle, accounting data must be verified. In other words, documentary evidence of transactions must be made which are capable of verification by an independent respect. In the absence of such verification, the data which will be available will neither be reliable nor be dependable, i.e., these should be biased data. Verifiability and objectivity express dependability, reliability and trustworthiness that are very useful for the purpose of displaying the accounting data and information to the users.

(f) Historical Cost Concept

Business transactions are always recorded at the actual cost at which they are actually undertaken. The basic advantage is that it avoids an arbitrary value being attached to the transactions. Whenever an asset is bought, it is recorded at its actual cost and the same is used as the basis for all subsequent accounting purposes such as charging depreciation on the use of asset, e.g. if a production equipment is bought for Rs. 1.50 crores, the asset will be shown at the same value in all future periods when disclosing the original cost. It will obviously be reduced by the amount of depreciation, which will be calculated with reference to the actual cost. The actual value of the equipment may rise or fall subsequent to the purchase, but that is considered irrelevant for accounting purpose as per the historical cost concept.

The limitation of this concept is that the balance sheet does not show the market value of the assets owned by the business and accordingly the owner's equity will not reflect the real value. However, on an ongoing basis, the assets are shown at their historical costs as reduced by depreciation.

(g) Balance Sheet Equation Concept

Under this principle, all which has been received by us must be equal to that has been given by us and needless to say that receipts are clarified as debits and giving is clarified as credits. The basic equation, appears as :-



Debit = Credit

Naturally every debit must have a corresponding credit and vice-e-versa. So, we can write the above in the following form –

Expenses + Losses + Assets = Revenues + Gains + Liabilities

And if expenses and losses, and incomes and gains are set off, the equation takes the following form –

Asset = Liabilities

or, Asset = Equity + External Liabilities

i.e., the Accounting Equation.

C. MODIFYING PRINCIPLES

(a) The Concept of Materiality

This is more of a convention than a concept. It proposes that while accounting for various transactions, only those which may have material effect on profitability or financial status of the business should have special consideration for reporting. This does not mean that the accountant should exclude some transactions from recording. e.g. even Rs. 20 worth conveyance paid must be recorded as expense. What this convention claims is to attach importance to material details and insignificant details should be ignored while deciding certain accounting treatment. The concept of materiality is subjective and an accountant will have to decide on merit of each case. Generally, the effect is said to be material, if the knowledge of an event would influence the decision of an informed stakeholder.

The materiality could be related to information, amount, procedure and nature. Error in description of an asset or wrong classification between capital and revenue would lead to materiality of information. Say, If postal stamps of Rs. 500 remain unused at the end of accounting period, the same may not be considered for recognizing as inventory on account of materiality of amount. Certain accounting treatments depend upon procedures laid down by accounting standards. Some transactions are by nature material irrespective of the amount involved. e.g. audit fees, loan to directors.

(b) The Concept of Consistency

This concept advocates that once an organization decides to adopt a particular method of revenue or expense recognition in line with the other concepts, the same should be consistently applied year after year, unless there is a valid reason for change in the method. Lack of consistency would result in the financial information becoming non-comparable between the different accounting periods. The insistence of this concept would result in avoidance of window dressing the results by choosing the accounting method by convenience and thereby either inflating or understating net income.



Study Note-1 : Process of Accounting

Consider an example. An asset of Rs. 10 lacs is purchased by a business. It is estimated to have useful life of 5 years. It will follow that the asset will be depreciated over a period of 5 years at the rate of Rs. 2 lacs every year. The estimate of useful life and the rate of depreciation cannot be changed from one period to the other without a valid reason. Suppose the firm applies the same depreciation rate for the first three years and due to change in technology the asset becomes obsolete, the whole of the remaining amount could be expensed out in the fourth year.

However, it may be difficult to be consistent if the business entities have two factories in different countries which have different statutory requirement for accounting treatment.

(c) The Conservatism Concept

Accountants who prepare financial statements of the business, like other human being, would like to give a favourable report on how well the business has performed during an accounting period. However, prudent reporting based on skepticism builds confidence in the results and in the long run best serves all the divergent interests of users of financial statements. This philosophy of prudence leads to the conservatism concept.

The concept underlines the prudence of under-stating than over-stating the net income of an entity for a period and the net assets as on a particular date. This is because business is done in situations of uncertainty. For years, this concept was meant to “anticipate no profits but recognize all losses”. This can be stated as

- (i) Delay in recognizing income unless one is reasonably sure
- (ii) Immediately recognize expenses when reasonably sure

This, of course, does not mean to overdo and create window dressing in reporting. e.g. if the business has sold Rs. 20 Lacs worth goods on the last day of accounting period and also received a cheque for the same, one cannot argue that the revenue should not be recognized as it is not certain whether the cheque will be cleared by the bank. One cannot stretch the conservatism concept too much. But at the same time, if the business has to receive Rs. 5 lacs from a customer to whom goods were sold quite some time ago and no payments are forthcoming, then while determining the net income for the period, the accountant must judge the likelihood of the recoverability of this money and the prudence will prevail to make a provision for this amount as doubtful debtors.

Let us take another example. A business had purchased goods for Rs. 10 lacs before the end of an accounting period. If sold at the usual selling price, the goods would fetch the price of Rs. 12.50 lacs. Due to innovative product introduced by the competition, the goods are likely to be sold for Rs. 9 lacs only. At what value should the goods be shown in the balance sheet? Would it be at Rs. 10 lacs being the actual cost of buying? Or would it



be at Rs. 9 lacs? Here, the conservatism principle will come in play. The stock of goods will be valued at Rs. 9 lacs, being the lower of cost or net realisable value, as per AS-2.

(d) Timeliness Concept

Under this principle, every transaction must be recorded in proper time. Normally, when the transaction is made, the same must be recorded in the proper books of accounts. In short, transaction should be recorded date-wise in the books. Delay in recording such transaction may lead to manipulation, misplacement of vouchers, misappropriation etc. of cash and goods. This principle is followed particularly while verifying day to day cash balance. Principle of timeliness is also followed by banks, i.e. every bank verifies the cash balance with their cash book and within the day, the same must be completed.

(e) Industry Practice

As that are different types of industries, each industry has its own characteristics and features. There may be seasonal industries also. Every industry follows the principles and assumption of accounting to perform their own activities. Some of them follow the principles, concepts and conventions in a modified way. The accounting practice which has always prevailed in the industry is followed by it. e.g Electric supply companies, Insurance companies maintain their accounts in a specific manner. Insurance companies prepare Revenue Account just to ascertain the profit/loss of the company and not Profit and Loss Account. Similarly, non-trading organizations prepare Income and Expenditure Account to find out Surplus or Deficit.

CONCLUSION

The above paragraphs bring out essentially broad concepts and conventions that lay down principles to be followed for accounting of business transaction. While going through the different topics, students are advised to keep track of concepts applicable for various accounting treatment. One would have by now understood the importance of these concepts in preparation of basic financial statements. More clarity will emerge as one explores the ocean of different business transactions arising out of complex business situations. The legal and professional requirements also have their say in deciding the accounting treatment. Let us see if you can apply these concepts in the following illustrations.

Illustration 3.

Recognise the accounting concept in the following:

- (1) The business will run for an indefinite period.
- (2) The business is distinct and separate from its owners.
- (3) The transactions are recorded at their original cost.



Study Note-1 : Process of Accounting

- (4) The transactions recorded are those that can be expressed in money terms.
- (5) Revenues will be recognized only if there is reasonable certainty that it will be paid for.
- (6) Accounting treatment once decided should be followed period after period.
- (7) Every transaction has two effects to be recorded in books of accounts.
- (8) Transactions are recorded even if an obligation is created and actual cash is not involved.
- (9) Stock of goods is valued at lower of its cost and realizable value.
- (10) Effects of an event must be recognized in the same accounting period.

1.8 EVENTS AND TRANSACTIONS

Event is a transaction or change recognized on the financial statements of an accounting entity. Accounting events can be either external or internal. An external event would occur with an outside party, such as the purchase or sales of a good. An internal event would involve changes in the accounting entity's records, such as adjusting an account on the financial statements.

An accounting event is any financial event that would impact the account balances of a company's financial statements. Every time the company uses or receives cash, or adjusts an entry in its accounting records, an accounting event has occurred.

1.8.1 Transaction vs. Events

Transactions is exchange of an asset with consideration of money value while events is any thing in general purpose which occur at specific time and particular place. All transactions are events but all events are not transactions. This is because in order events to be called transaction an event must involve exchange of values.

1.9 VOUCHER

It is a written instrument that serves to confirm or witness (vouch) for some fact such as a transaction. Commonly, a voucher is a document that shows goods have bought or services have been rendered, authorizes payment, and indicates the ledger account(s) in which these transactions have to be recorded.

1.9.1 Types of Voucher - Normally the following types of vouchers are used. i.e.:

- (i) Receipt Voucher
- (ii) Payment Voucher
- (iii) Non-Cash or Transfer Voucher
- (iv) Supporting Voucher



(i) Receipt Voucher

Receipt voucher is used to record cash or bank receipt. Receipt vouchers are of two types. i.e.

- (a) Cash receipt voucher – it denotes receipt of cash
- (b) Bank receipt voucher – it indicates receipt of cheque or demand draft

(ii) Payment Voucher

Payment voucher is used to record a payment of cash or cheque. Payment vouchers are of two types. i.e.

- (a) Cash Payment voucher – it denotes payment of cash
- (b) Bank Payment voucher – it indicates payment by cheque or demand draft.

(iii) Non Cash Or Transfer Voucher

These vouchers are used for non-cash transactions as documentary evidence. e.g., Goods sent on credit.

(iv) Supporting Vouchers

These vouchers are the documentary evidence of transactions that have happened.

1.9.2 Source Documents

Vouchers are the documentary evidence of the transactions so happened. Source documents are the basis on which transactions are recorded in subsidiary books i.e. source documents are the evidence and proof of transactions.

Name of the Book		Source document
(a)	Cash Book	Cash Memos, Cash Receipts and issue vouchers
(b)	Purchase Books	Inward invoice received from the creditors of goods
(c)	Sales Book	Outward Invoice issued to Debtors
(d)	Return Inward Book	Credit Note issued to Debtors and Debit Notes received from Debtors
(e)	Returns Outward Book	Debit Note issued to creditors and Credit Note received from creditors.

1.10 THE CONCEPTS OF 'ACCOUNT', 'DEBIT' AND 'CREDIT'

One must get conversant with these terms before embarking to learn actual record-keeping based on the rules.

An 'Account' is defined as a summarised record of transactions related to a person or a thing. e.g. when the business deals with customers and suppliers, each of the customers and supplier will

Study Note-1 : Process of Accounting

be a separate account. We must know that each one of us is identified as a separate account by the bank when we open an account with them. The account is also related to things – both tangible and intangible.

e.g. land, building, equipment, brand value, trademarks etc. are some of the things. When a business transaction happens, one has to identify the 'account' that will be affected by it and then apply the rules to decide the accounting treatment.

Typically, an account is expressed as a statement in form of English letter 'T'. It has two sides. The left hand side is called as "Debit" side and the right hand side is called as "Credit" side. The debit is connoted as 'Dr' and the credit by 'Cr'. The convention is to write the Dr and Cr labels on both sides as shown below. Please see the following example:

Dr.	Cash Account	Cr.
Debit Side		Credit Side

Each side of the account will show effects, so that one can easily take totals of both sides and find out the difference between the two. Such difference in the two sides of an account is called 'balance'. If the total of debit side is more than the credit side, the balance is called as 'debit balance' and if the total of credit side is more than the debit side, the balance is called as 'credit balance'. If the debit and credit side are equal, the account will show 'nil balance'.

The balances are to be computed at the end of an accounting period. These balances are then considered for preparation of income statement and balance sheet. Let us see the example.

Dr.	Cash Account		Cr.
Particulars	Amount (Rs.)	Particulars	Amount (Rs.)
Cash brought into business	1,00,000	Paid for goods purchased	50,000
Received for goods sold	25,000	Paid for rent	15,000
		Balance at the end	60,000
	1,25,000		1,25,000

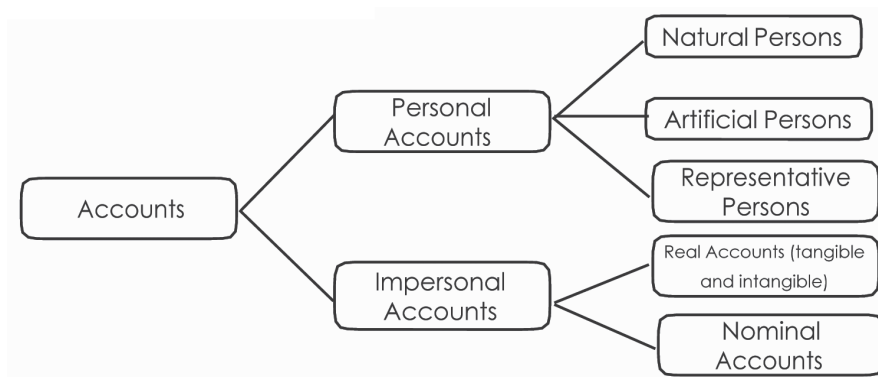
It can be seen from the above example that the debit side of cash account shows the receipt of cash into the business and the credit side reflects the cash that has gone out of the business. What is the meaning of the balance at the end? Well, it shows that cash balance available in the business.

1.11 TYPES OF ACCOUNTS

We have seen that an account may be related to a person or a thing – tangible or intangible. While doing business transactions (that may be large in number and complex in nature), one may come across numerous accounts that are affected. How does one decide about accounting treatment for each of them? If common rules are to be applied to similar type of accounts, there must be a way to classify the account on the basis of their common characteristics.



Please take look at the following chart.



Let us see what each type of account means.

(1) Personal Account: As the name suggests these are accounts related to persons.

- (a) These persons could be natural persons like Suresh's A/c, Anil's a/c, Rani's A/c etc.
- (b) The persons could also be artificial persons like companies, bodies corporate or association of persons or partnerships etc. Accordingly, we could have Videocon Industries A/c, Infosys Technologies A/c, Charitable Trust A/c, Ali and Sons trading A/c, ABC Bank A/c, etc.
- (c) There could be representative personal accounts as well. Although the individual identity of persons related to these is known, the convention is to reflect them as collective accounts. e.g. when salary is payable to employees, we know how much is payable to each of them, but collectively the account is called as 'Salary Payable A/c'. Similar examples are rent payable, Insurance prepaid, commission pre-received etc. The students should be careful to have clarity on this type and the chances of error are more here.

(2) Real Accounts: These are accounts related to assets or properties or possessions. Depending on their physical existence or otherwise, they are further classified as follows:-

- (a) **Tangible Real Account** – Assets that have physical existence and can be seen, and touched. e.g. Machinery A/c, Stock A/c, Cash A/c, Vehicle A/c, and the like.
- (b) **Intangible Real Account** – These represent possession of properties that have no physical existence but can be measured in terms of money and have value attached to them. e.g. Goodwill A/c, Trade mark A/c, Patents & Copy Rights A/c, Intellectual Property Rights A/c and the like.

(3) Nominal Account: These accounts are related to expenses or losses and incomes or gains e.g. Salary and Wages A/c, Rent of Rates A/c, Travelling Expenses A/c, Commission received A/c, Loss by fire A/c etc.



Study Note-1 : Process of Accounting

1.12 THE ACCOUNTING PROCESS

There are two approaches for deciding when to write on the debit side of an account and when to write on the credit side of an account:

- A. American Approach/ Modern Approach
 - B. British Approach/ Traditional Approach/Double Entry System
- A. American approach:** In order to understand the rules of debit and credit according to this approach transactions are divided into the following five categories:
- (i) Transactions relating to owner, e.g., Capital – These are personal accounts
 - (ii) Transactions relating to other liabilities, e.g., suppliers of goods – These are mostly personal accounts
 - (iii) Transactions relating to assets, e.g., land, building, cash, bank, stock-in-trade, bills receivable – These are basically all real accounts
 - (iv) Transactions relating to expenses, e.g., rent, salary, commission, wages, cartage – These are nominal accounts
 - (v) Transactions relating to revenues, e.g., interest received, dividend received, sale of goods – These are nominal accounts

The rules of debit and credit in relation to these accounts are stated as under:

(i)	For Capital Account	Debit means decrease Credit means increase
(ii)	For any Liability Account	Debit means decrease Credit means increase
(iii)	For any Asset Account	Debit means increase Credit means decrease
(iv)	For any Expense Account	Debit means increase Credit means decrease
(v)	For any Revenue Account	Debit means decrease Credit means increase

A careful perusal of the above rules will reveal that meaning of debit is the same for the first three types of accounts on the one side and last two types of accounts on the other. It also reveals that in the first three cases 'debit' stands for decrease, and for increase in the last two cases. Similarly, 'credit' stands for increase in the first three cases and for decrease in the last two cases. The meaning of debit and credit has been diagrammatically illustrated as under:

ANY ASSET ACCOUNT

DEBIT		CREDIT	
Record increase on this side	↑	Record decrease on this side	↓

ANY CAPITAL ACCOUNT

DEBIT		CREDIT	
Record decrease on this side	↓	Record increase on this side	↑



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ANY LIABILITY ACCOUNT

DEBIT		CREDIT	
Record decrease on this side	↓	Record increase on this side	↑

ANY REVENUE ACCOUNT

DEBIT		CREDIT	
Record decrease on this side	↓	Record increase on this side	↑

ANY EXPENSE ACCOUNT

DEBIT		CREDIT	
Record increase on this side	↑	Record decrease on this side	↓

The rules can be further compressed in the following way:

ANY CAPITAL, LIABILITY OR REVENUE ACCOUNT

DEBIT		CREDIT	
Record decrease on this side	↓	Record increase on this side	↑

ANY ASSET OR EXPENSE ACCOUNT

DEBIT		CREDIT	
Record increase on this side	↑	Record decrease on this side	↓

TO SUM UP

For Assets	Increase in Assets	Dr.
	Decrease in Assets	Cr.
For Liabilities	Decrease in Liabilities	Dr.
	Increase in Liabilities	Cr.
For Capital	Decrease in Capital	Dr.
	Increase in Capital	Cr.
For Incomes	Decrease in Income	Dr.
	Increase in Income	Cr.
For Expense	Increase in Expense	Dr.
	Decrease in Expense	Cr.
For Stock	Increase in Stock	Dr.
	Decrease in Stock	Cr.

Study Note-1 : Process of Accounting

Illustration 4

Ascertain the debit and credit from the following particulars under Modern Approach.

- Started business with capital.
- Bought goods for cash.
- Sold goods for cash.
- Paid salary.
- Received Interest on Investment.
- Bought goods on credit from Mr. Y
- Paid Rent out of Personal cash.

Solution

Effect of Transaction		Account	To be Debited/ Credited
(a)	Increase in Cash	Cash A/c	Debit
	Increase in Capital	Capital A/c	Credit
(b)	Increase in Stock	Purchase	Debit
	Decrease in Cash	A/c Cash A/c	Credit
(c)	Increase in Cash	Cash A/c	Debit
	Decrease in Stock	Sale A/c	Credit
(d)	Increase in Expense	Salary A/c	Debit
	Decrease in Cash	Cash A/c	Credit
(e)	Increase in Cash	Cash A/c	Debit
	Increase in Income	Interest A/c	Credit
(f)	Increase in Stock	Purchase A/c	Debit
	Increase in Liability	Y A/c	Credit
(g)	Increase in Expense	Rent A/c	Debit
	Increase in Liability	Capital A/c	Credit

B. British Approach or Double Entry System :

When one identifies the account that is getting affected by a transaction and type of that account, the next step is to apply the rules to decide whether the accounting treatment is to debit or credit that account. The Golden Rules will guide us whether the account is to be debited or credited.

There is one rule for each basic type of account i.e. personal, real and nominal. These rules are shown in the following chart.



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Personal Account	→	Debit the receiver or who owes to business Credit the giver or to whom business owes
Real Account	→	Debit what comes into business Credit what goes out of business
Nominal Account	→	Debit all expenses or losses Credit all income or gains

We will see the following example to understand application of these rules. Consider the following transactions:

- (i) Mr. Vikas and Mrs. Vaibhavi who are husband and wife started offering consultancy services, by investing cash of Rs. 5,00,000 and Rs. 2,50,000 respectively.

From business point of view the two effects of this transaction are: first, the cash of Rs. 7,50,000 has come into business and second, there is an obligation of the business towards Mr. Vikas and Mrs. Vaibhavi.

Now, we know that Cash is real account, so rule for real account will apply. Cash has come into the business thereby increasing the asset. Hence, Cash Account should be debited.

We also know that Vikas's A/c and Vaibhavi's A/c are personal accounts, so rule for personal account will apply. (As both Vikas and Vaibhavi are givers of cash, their respective accounts will be credited.)

The answer will be	Debit Cash	Rs. 7,50,000
	Credit Vikas's Capital	Rs. 5,00,000
	Credit Vaibhavi's capital	Rs. 2,50,000

Please note that the total debits and total credit match. It is the reflection of the dual aspect concept

- (ii) They buy office furniture of Rs. 25,000 for cash.

Here, the two effects are: First, Furniture (which is an asset) has come into the business and second cash (which is also an asset) that has gone out of business.

Since, both the accounts viz. Furniture and Cash are real accounts, rule for real account will apply. Furniture has come in (asset increase), it will be debited and cash has gone out (asset decrease), it will be credited.

The answer will be:-	Debit Furniture	Rs. 25,000
	Credit Cash	Rs. 25,000

- (iii) They open a current account with Citi Bank by depositing Rs. 1,00,000

Here, the two effects are: First, cash in hand has gone out (asset decrease) and second, the business cash at bank has increased (asset increase). Cash is a real account and Bank is a personal account.



Study Note-1 : Process of Accounting

The answer will be	Debit Citi Bank	Rs. 1,00,000
	Credit Cash	Rs. 1,00,000

- (iv) They pay office rent of Rs. 15,000 for the month by cheque drawn on their Citi Bank to M/s Realtors Properties.

Here, the two effects are: First, since the payment is made by cheque, bank balance will reduce (asset decrease), and second, rent being an item of expense rent expense will increase.

Citi Bank A/c being a personal A/c, rule for personal account will apply. Citi bank A/c will be credited.

Rent A/c being a nominal account, rule for nominal account will apply. Since, rent is paid, it is an expense. Hence, Rent A/c will be debited.

The answer will be	Debit Rent	Rs. 15,000
	Credit Citi Bank	Rs. 15,000

In case of a cash transaction, the party with whom the transaction is made, is not recorded, but the cash or bank account is recorded.

- (v) They buy a motor car worth Rs. 4,50,000 from Millennium Motors by making a down payment of Rs. 50,000 by cheque drawn on Citi Bank and the balance by taking a loan from HDFC Bank.

Here the effects will be: First, Motor Car (which is an asset) has come into the business (increase in asset). Second, Bank balance (which is an asset) has reduced (decrease in asset). Thirdly, there is an obligation created towards HDFC Bank from whom loan of Rs. 400000 is taken (increase in liability).

Citi Bank is a personal account, so rule for personal account will apply. Citi Bank will be credited. Motor Car is a real account is so rule for real account will apply. Motor Car has come in, so Motor Car A/c will be debited.

HDFC Bank is provider of loan to whom money is payable by the business in future. HDFC Bank account being a personal account, rule for personal account will apply. HDFC Bank being the giver, it will be credited. (Note: In different opinions, we can consider Citi Bank A/c as Real Account. The reason behind that is the balance at Citi Bank A/c belongs to the business, so it is an asset. However, in any circumstances HDFC Bank, who has paid Millennium Motors on behalf of the business, cannot be considered as Real Account. It is a Personal Account as it does not hold any business cash)

The answer will be	Debit Motor Car	Rs. 4,50,000
	Credit Citi Bank	Rs. 50,000
	Credit Loan from HDFC Bank	Rs. 4,00,000



Will you now answer as to why no accounting treatment is considered for Millennium Motors?

- (vi) Vikas and Vaibhavi carried out a consulting assignment for Avon Pharmaceuticals and raise a bill for Rs. 1000000 as consultancy fees. Avon Pharmaceuticals have immediately settled Rs. 250000 by way of cheque and the balance will be paid after 30 days. The cheque received is deposited into Citi Bank.

Here the effects will be: First, the work done by Vikas and Vaibhavi has resulted in the revenue for the business. What should be the amount of revenue considered? Is it Rs. 10 lac for which work is done or only Rs. 2.50 lacs which is received? The revenue of entire Rs. 10 lac will be considered as by doing the work the business has acquired legal claim against Avon Pharmaceutical. Second effect will be cash that is received by way of cheque (asset increase). The third effect will be the amount of Rs. 7.50 lacs, which Avon Pharmaceuticals owes to the business.

Consultancy fees received (revenue earned) being income, rule for nominal account will apply and this account will be credited. Cheque received and deposited into Citi bank will increase the balance at the bank. Citi Bank being a personal account will be debited. The amount receivable from Avon is an asset, but it's due from Avon at a future date. To be able to recover it from them, their personal account will have to be created in books of accounts. Avon Pharmaceuticals is a personal account and they are receiver of consultancy, it will be debited.

The answer will be	Debit Citi Bank	Rs. 2,50,000
	Debit Avon Pharmaceuticals	Rs. 7,50,000
	Credit Consultancy Fees	Rs. 10,00,000

- vii) They have employed a receptionist on a salary of Rs. 5,000 per month and one officer at a salary Rs. 10,000 per month. The salary for the current month is payable to them.

Is this a transaction to be recorded in the books? Remember accrual concept? Accordingly the expense of salary for the current month must be recognized as the expense for the current month even if it's not paid for. In fact, the business owes the salary to its employees and this obligation (which is a liability) must be shown in the books.

The effects will be: First, salary being an item of expense, is a nominal account and rule for nominal account will be applied. So, Salary A/c will be debited. Secondly, the obligation to pay salary is towards both employees, the convention is not to create separate employee accounts, but to use a representative personal account named as Salary Payable account. Since, this is personal account, rule of personal account will apply. Employees being givers of service, it will be credited.

Study Note-1 : Process of Accounting

The answer will be:	Debit Salary	Rs. 15,000
	Credit Salary payable	Rs. 15,000

Please look at the way we have approached each transaction and decided about accounting treatment. If you follow these logical steps, you will certainly be able to grasp the basics thoroughly. Under double entry system, the accounting of a business transaction involves the following steps:

- Consider whether an event qualifies to be entered in books of accounts in money terms
- If the answer to the above is 'yes', then assess the two aspects of the transaction
- Determine what type of 'account' is affected by each of the aspects
- Apply the Golden Rule of 'Debit' and 'Credit'
- Prepare the basic document such as invoice, voucher, debit note or credit note
- Record the transaction in the primary books or subsidiary books
- Carry out the posting into the ledger
- Prepare the list of all ledger balances and ensure it tallies
- Rectify the errors, if any
- Pass adjustment entries
- Prepare adjusted Trial Balance
- Prepare the financial statements – the Income Statement and Balance Sheet

Although it looks to be a lengthy process on paper, in practice it does not take time. In a computerised accounting environment in fact one has to prepare basic documents and enter them into accounting program. The computer program automatically carries out the rest of the processes to give us real time online financial statements. To get a hang of this, students are advised to lay their hands on simple computerized accounting packages to gain real time exposure.

Illustration 5.

Ascertain the Debit Credit under British Approach or Double Entry System. Take previous illustration.

Solution.

Step-I	Step-II	Step-III	Step-IV
(a) Cash A/c	Real	Comes in	Debit
Capital A/c	Personal	Giver	Credit
(b) Purchase A/c	Nominal	Expenses	Debit
Cash A/c	Real	Goes out	Credit



(c)	Cash A/c	Real	Comes in	Debit
	Sales A/c	Nominal	Incomes	Credit
(d)	Salary A/c	Nominal	Expenses	Debit
	Cash A/c	Real	Goes out	Credit
(e)	Cash A/c	Real	Comes in	Debit
	Interest A/c	Nominal	Incomes	Credit
(f)	Purchase A/c	Nominal	Expenses	Debit
	Y' A/c	Personal	Giver	Credit
(g)	Rent A/c	Nominal	Expenses	Debit
	Capital A/c	Personal	Giver	Credit

1.13 ACCOUNTING EQUATION

The whole Financial Accounting depends on Accounting Equation which is also known as Balance Sheet Equation. The basic Accounting Equation is:

$$\text{Assets} = \text{Liabilities} + \text{Owner's equity}$$

$$\left. \begin{array}{l} \text{or } A = L + P \\ \text{or } P = A - L \\ \text{or } L = A - P \end{array} \right\} \text{Where } A = \text{Assets, } L = \text{Liabilities, } P = \text{Capital}$$

While trying to do this correlation, please note that incomes or gains will increase owner's equity and expenses or losses will reduce it.

Students are advised to go through the following illustration to understand this equation properly.

Illustration 6.

Prepare an Accounting Equation from the following transactions in the books of Mr. X for January, 2020 :-

- 1 Invested Capital in the firm Rs. 20,000
- 2 Purchased goods on credit from Das & Co. for Rs. 2,000
- 4 Bought plant for cash Rs. 8,000
- 8 Purchased goods for cash Rs. 4,000
- 12 Sold goods for cash (cost Rs. 4,000 + Profit Rs. 2,000) Rs. 6,000.
- 18 Paid to Das & Co. in cash Rs. 1,000
- 22 Received from B. Banerjee Rs. 300
- 25 Paid salary Rs. 6,000
- 30 Received interest Rs. 5,000
- 31 Paid wages Rs. 3,000

Study Note-1 : Process of Accounting

Solution

Effect of transaction on Assets, Liabilities and Capital

Date	Transaction	Assets =	Liabilities +	Capital
Jan., 2020				
1	Invested Capital in the firm, Rs. 20,000	20,000	–	20,000
2	Purchased goods on credit from Das & Co. Rs. 2,000	+ 2,000	+ 2,000	–
	Revised Equation	22,000=	2,000 +	20,000
4	Bought Plant for cash Rs. 8,000	+ 8,000 – 8,000	– –	– –
	Revised Equation	22,000 =	2,000 +	20,000
8	Purchased goods for cash Rs. 4,000	+ 4,000 – 4,000	– –	– –
	Revised Equation	22,000=	2,000 +	20,000
12	Sold Goods for cash (Cost Rs. 4,000 + Profit Rs. 2,000)	+ 6,000 – 4,000	– –	– +2,000
	Revised Equation	24,000	2,000 +	22,000
18	Paid to Das & Co. for Rs. 1,000	– 1,000	– 1,000	–
	Revised Equation	23,000 =	1,000 +	22,000
22	Received from B.Banerjee for Rs. 300	+ 300 – 300		
	Revised Equation	23,000 =	1,000 +	22,000
25	Paid salary for Rs. 6,000	– 6,000		– 6,000
	Revised Equation	17,000 =	1,000 +	16,000
30	Received Interest for Rs. 5,000	+ 5,000		+5,000
	Revised Equation	22,000 =	1,000 +	21,000
31	Paid Wages for Rs.3,000	– 3,000		-3,000
	Revised Equation	19,000 =	1,000 +	18,000

1.14 ACCRUAL BASIS AND CASH BASIS OF ACCOUNTING

(i) Accrual Basis of Accounting

Accrual Basis of Accounting is a method of recording transactions by which revenue, costs, assets and liabilities are reflected in the accounts for the period in which they accrue. This basis includes consideration relating to deferrals, allocations, depreciation and amortization. This basis is also referred to as mercantile basis of accounting. Under the Companies Act 1956, all companies are required to maintain the books of accounts according to accrual basis of accounting



(ii) Cash Basis of Accounting

Cash Basis of Accounting is a method of recording transactions by which revenues, costs, assets and liabilities are reflected in the accounts for the period in which actual receipts or actual payments are made.

1.14.1 Distinction between Accrual Basis of Accounting and Cash Basis of Accounting

Accrual basis of accounting differs from Cash basis of accounting in the following respects:

	Basis of Distinction	Accrual Basis of Accounting	Cash Basis of Accounting
1.	Prepaid/ Outstanding Expenses/ accrued/ unaccrued Income in Balance Sheet.	Under this, there may be prepaid/ outstanding expenses and accrued/ unaccrued incomes in the Balance Sheet.	Under this, there is no prepaid/ outstanding expenses or accrued/ unaccrued incomes.
2.	Higher/lower Income in case of prepaid expenses and accrued income	Income Statement will show a relatively higher income	Income Statement will show lower income.
3.	Higher/lower income incase of outstanding expenses and unaccrued income	Income Statement will show a relatively lower income. This basis is recognized under the	Income Statement will show higher income.
4.	Recognition under the Companies Act. 1956.	Companies Act, 1956.	This basis is not recognized under the Companies Act, 1956.
5.	Availability of options to an accountant to manipulate the accounts by way of choosing the most suitable method out of several alternative methods of accounting e.g. FIFO/LIFO/SLM/ WDV	Under this, an accountant has options.	Under this an accountant has no option to make a choice as such.

1.14.2 Hybrid or Mixed Basis

Is the combination of both the basis i.e. Cash as well as Accrual basis. Incomes are recorded on Cash basis but expenses are recorded on Accrual basis.

This is not a system of accounting on its own. It is a combination of the Cash Basis Accounting and Accrual Basis Accounting. This system is based on the concept of conservatism.

Under the hybrid system of accounting, incomes are recognised as in Cash Basis Accounting i.e. when they are received in cash and expenses are recognised on accrual basis i.e. during the accounting period in which they arise irrespective of when they are paid.

Study Note-1 : Process of Accounting

Illustration 7.

Mr. Anil Roy, a junior lawyer, provides the following particulars for the year ended 31st December, 2020:

Fees received in cash in 2020	60,000
Salary paid to Staff in 2020	8,000
Rent of office in 2020	14,000
Magazine and Journal for 2020	1,000
Travelling and Conveyance paid in 2020	3,000
Membership Fees paid in 2020	1,600
Office Expenses paid in 2020	10,000

Additional Information:-

Fees include Rs. 3,000 in respect of 2019 and fees not yet received is Rs. 7,000. Office rent includes Rs. 4,000 for previous year and rent of Rs. 2,000 not yet paid. Membership fees is paid for 2 years.

Compute his net income for the year 2020, under – (a) Cash Basis, (b) Accrual Basis and (c) Mixed or Hybrid Basis.

Solution (i)

Mr. Anil Roy
Statement of Income (Cash Basis)
For the year ended 31st December, 2020

Particulars	Amount (Rs.)	Amount (Rs.)
Fees received		60,000
Less :		
Salary	8,000	
Office Rent	14,000	
Magazine & Journal	1,000	
Travelling & Conveyance	3,000	
Membership Fees	1,600	
Office Expenses	10,000	37,600
Net Income		22,400



Solution (ii)

Mr. Anil Roy

**Statement of Income (Accrual Basis)
For the year ended 31st December, 2020**

Particulars	Amount (Rs.)	Amount (Rs.)	Amount (Rs.)
Fees received		60,000	
Add: Accrued fees for 2020		7,000	
		67,000	
Less: Fees for 2019 received in 2020		3,000	64,000
Less :			
Salary		8,000	
Office Rent	14,000		
Add: Outstanding rent	2,000		
	16,000		
Less: Rent for 2019 paid in 2020	4,000	12,000	
Magazine & Journal		1,000	
Travelling & Conveyance		3,000	
Membership Fees	1,600		
Less: Advance fee paid for 2021 ($\frac{1}{2} \times 1600$)	800	800	
Office Expenses		10,000	34,800
Net Income			29,200

Solution (iii)

Mr. Anil Roy

**Statement of Income (Mixed or Hybrid Basis)
For the year ended 31st December, 2020**

Particulars	Amount (Rs.)	Amount (Rs.)	Amount (Rs.)
Fees received			60,000
Less :			
Salary		8,000	
Office Rent	14,000		
Add: Outstanding rent	2,000		
		16,000	
Less: Fees for 2019	4,000	12,000	

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Magazine & Journal		1,000	
Travelling & Conveyance		3,000	
Membership Fees	1,600		
Less: Advance	800	800	
Office Expenses		10,000	34,800
Net Income			25,200

1.14.3 Conversion of Cash Basis of Accounting into Accrual Basis of Accounting:

When accounting is done under Cash Basis and the final accounts are prepared, the same can be converted into Accrual Basis from the beginning of the next financial period. The following procedure should be followed for the purpose.

At first it is necessary to ascertain the amount of outstanding and prepaid expenses and at the same time, accrued incomes and income received in advance.

Thereafter following journal entries should be made:

				Dr.	Cr.
S No.	Particulars		L.F.	Amount (Rs.)	Amount (Rs.)
(a)	Accrued Income A/c	Dr.			
	Prepaid Expenses A/c	Dr.			
	To, Profit and Loss Adjustment A/c (Bringing into account the accrued income, prepaid expenses for converting the cash basis of accounting into accrual basis)				
(b)	Profit and Loss Adjustment A/c	Dr.			
	To, Income Received in Advance A/c				
	To, Outstanding Expenses A/c (Bringing into account the income received in advance and outstanding expenses for converting the cash basis of accounting into accrual basis)				
(c)	If there is a profit as a result of above adjustment-				
	Profit and Loss Adjustment A/c	Dr.			
	To, Capital A/c (Profit transferred to capital account as a result of conversion from cash basis to accrual basis.)				



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	If there is a loss as a result of above adjustment-				
	Capital A/c To, Profit and Loss Adjustment A/c (Loss transferred to capital account as a result of conversion from cash basis to accrual basis.)	Dr.			

Illustration 8.

X and Y formed partnership sharing profits as 2 : 1. The term was to distribute mercantile profit. But cash profit has been calculated all through. Now it is desired to convert cash accounts into mercantile accounts. The details are :

	Cash Profit (Rs.)	Closing Outstanding Income (Rs.)	Closing Outstanding Expenses (Rs.)
1st Year	10,000	1,000	500
2nd Year	12,000	3,000	1,000
3rd Year	18,000	2,000	800

Pass conversion entry.

Solution

Cash Profit for three years (Rs.10,000 + Rs.12,000 + Rs.18,000)	40,000	
Add : Closing outstanding incomes	2,000	
		42,000
Less : Closing outstanding expenses		800
Mercantile Profit		41,200
Less : Cash profit which are already distributed		40,000
Profit to be distributed between X and Y in 2 : 1.		1,200

Journal

Thus, the entry being :

				Dr.	Cr.
S No.	Particulars		L.F.	Amount (Rs.)	Amount (Rs.)
(a)	Outstanding Income A/c	Dr.		2,000	
	To Outstanding Expenses A/c				800
	“ X's Capital A/c				800
	“ Y's Capital A/c				400
	(Cash basis of accounting converted into mercantile basis of accounting).				

1.15 CAPITAL AND REVENUE TRANSACTIONS

The concepts of capital and revenue are of fundamental importance to the correct determination of accounting profit for a period and recognition of business assets at the end of that period. The distinction affects the measurement of profit in a number of accounting periods.

Capital has been defined by economists as those assets which are used in the production of goods and rendering of services for further production of assets. In accounting, on the other hand, the capital of a business is increased by that portion of the periodic income which has not been consumed by the owner.

The relationship between capital and revenue is that of between a tree and its fruits. It is the tree which produces the fruits, and it is the fruit that can be consumed. If the tree is tendered with care, it will produce more fruits, conversely, if the tree is destroyed, there will be no more fruits. Likewise, revenue comes out of capital and capital is the source of revenue. Capital is invested by a person in the business so that it may produce revenue. Moreover, as a fruit may give birth to another new tree, different revenues may also produce further new capital.

Capital can be brought in by a person into the business in different forms-cash or kind. When capital is brought in the form of cash, it is spent away on various items of assets that make the business a running concern. Capital of the firm is thus, represented by its inventory of assets.

Capital of a business can be increased in a two fold way:

1. When the owner brings in more capital to the business; and/or
2. When the owner does not consume the entire periodic income.

When the owner brings in further capital to his business, the amount is credited to the Capital Account. Likewise, the net income for a period is credited to the Capital Account, and if his drawings are less than that income, the capital is increased by the difference. Example, Capital Rs. 500, Profit Rs. 300, drawings

Rs. 350. So the revised capital will be Rs. 450 (Rs. 500 + Rs. 300 - Rs. 350)

The difference between the two terms 'revenue' and 'receipt' should be carefully distinguished. A receipt is the inflow of money into business, whereas revenue is the aggregate exchange value received for goods and services provided to the customers.

1.15.1 Capital and Revenue Expenditures

Capital expenditure is the outflow of funds to acquire an asset that will benefit the business for more than one accounting period. A capital expenditure takes place when an asset or service is acquired or improvement of a fixed asset is effected. These assets are expected to provide benefits to the business in more than one accounting period and are not intended for resale in the ordinary course of business. In short, it is an expenditure on assets which is not written off completely against income in the accounting period in which it is acquired.



Revenue expenditure is the outflow of funds to meet the running expenses of a business and it will be of benefit for the current period only. A revenue expenditure is incurred to carry on the normal course of business or maintain the capital assets in a good condition.

It may be pointed out here that an expenditure need not necessarily be a payment made to somebody in cash - it may be made by the exchange of another asset, or by assuming a liability. Expenditure incurrence and expenditure recognition are distinct phenomena. Expenditure incurrence refers to the receipt of goods and services, whereas expenditure recognition is a matter to be decided whether the expenditure is of capital or revenue nature. For example, the buying of an asset is a capital expenditure but charging depreciation against profit is a revenue expenditure, over the entire life of that asset. Most of the capital expenditures made by a business become revenue expenditures. On the application of periodicity, accrual and matching concepts, accountants identify all revenue expenditures for a given period for ascertaining profit. An expenditure which cannot be identified to a particular accounting period is considered of capital nature.

1.15.2 The accounting treatments of capital and revenue expenditure are as under:

Revenue expenditures are charged as an expense against profit in the year they are incurred or recognised. Capital expenditures are capitalised-added to an asset account.

The following are the points of distinction between capital expenditure and revenue expenditure:

S. No.	Capital Expenditure	S. No.	Revenue Expenditure
1.	The economic benefits of Capital expenditures are enjoyed for more than one accounting period.	1.	The economic benefits of Revenue expenditures are enjoyed within a particular accounting period.
2.	Capital expenditures are of non-recurring in nature.	2.	Revenue expenditures are of recurring in nature.
3.	All capital expenditures eventually become revenue expenditures like depreciation	3.	Revenue expenditures are not generally capital expenditures.
4.	Capital expenditures are not matched with capital receipts.	4.	All revenue expenditures are matched with revenue receipts.

1.15.3 Rules for Determining Capital Expenditure

An expenditure can be recognised as capital if it is incurred for the following purposes :

An expenditure incurred for the purpose of acquiring long term assets (useful life is at least more than one accounting period) for use in business to earn profits and not meant for resale, will be treated as a capital expenditure. For example, if a second hand motor car dealer buys a piece of furniture with a view to use it in business; it will be a capital expenditure. But if he buys second



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hand motor cars, for re-sale, then it will be a revenue expenditure because he deals in second hand motor cars.

When an expenditure is incurred to improve the present condition of a machine or putting an old asset into working condition, it is recognised as a capital expenditure. The expenditure is capitalised and added to the cost of the asset. Likewise, any expenditure incurred to put an asset into working condition is also a capital expenditure.

For example, if one buys a machine for Rs. 5,00,000 and pays Rs. 20,000 as transportation charges and

Rs. 40,000 as installation charges, the total cost of the machine comes upto Rs. 5,60,000. Similarly, if a building is purchased for Rs. 1,00,000 and Rs. 5,000 is spent on registration and stamp duty, the capital expenditure on the building stands at Rs. 1,05,000.

If an expenditure is incurred, to increase earning capacity of a business will be considered as of capital nature. For example, expenditure incurred for shifting 'the 'factory for easy supply of raw materials. Here, the cost of such shifting will be a capital expenditure.

Preliminary expenses incurred before the commencement of business is considered capital expenditure. For example, legal charges paid for drafting the memorandum and articles of association of a company or brokerage paid to brokers, or commission paid to underwriters for raising capital.

Thus, one useful way of recognising an expenditure as capital is to see that the business will own something which qualifies as an asset at the end of the accounting period.

Some examples of capital expenditure:

- (i) Purchase of land, building, machinery or furniture;
- (ii) Cost of leasehold land and building;
- (iii) Cost of purchased goodwill;
- (iv) Preliminary expenditures;
- (v) Cost of additions or extensions to existing assets;
- (vi) Cost of overhauling second-hand machines;
- (vii) Expenditure on putting an asset into working condition; and
- (viii) Cost incurred for increasing the earning capacity of a business.

1.15.4 Rules for Determining Revenue Expenditure

Any expenditure which cannot be recognised as capital expenditure can be termed as revenue expenditure. A revenue expenditure temporarily influences only the profit earning capacity of the business. An expenditure is recognised as revenue when it is incurred for the following purposes :



Expenditure for day-to-day conduct of the business, the benefits of which last less than one year. Examples are wages of workmen, interest on borrowed capital, rent, selling expenses, and so on.

Expenditure on consumable items, on goods and services for resale either in their original or improved form. Examples are purchases of raw materials, office stationery, and the like. At the end of the year, there may be some revenue items (stock, stationery, etc.) still in hand. These are generally passed over to the next year though they were acquired in the previous year.

Expenditures incurred for maintaining fixed assets in working order. For example, repairs, renewals and depreciation.

Some examples of revenue expenditure

- (i) Salaries and wages paid to the employees;
- (ii) Rent and rates for the factory or office premises;
- (iii) Depreciation on plant and machinery;
- (iv) Consumable stores;
- (v) Inventory of raw materials, work-in-progress and finished goods;
- (vi) Insurance premium;
- (vii) Taxes and legal expenses; and
- (viii) Miscellaneous expenses.

1.15.5 Replacement of Fixed Assets

The above rules of capital and revenue expenditure do not hold good when an existing asset is replaced for another. If an asset is replaced with a similar kind of asset, the expenditure incurred is treated as Revenue Expenditure. For example, if a set of weighing machines in a shop becomes defective and is replaced with a similar set, the cost of replacement should be treated as revenue expenditure and it should be charged to the Profit and Loss Account. However, if an asset is replaced with an asset which is superior than the previous one, the expense is partly capital and partly revenue. For example, if a manual typewriter costing Rs. 5,000 is replaced with an electronic typewriter costing Rs. 15,000, then Rs. 5,000 will be revenue expenditure and the excess value of the new typewriter over the old one, Rs. 10,000 will be capital expenditure.

1.15.6 Deferred Revenue Expenditures

Deferred revenue expenditures represent certain types of assets whose usefulness does not expire in the year of their occurrence but generally expires in the near future. These type of expenditures are carried forward and are written off in future accounting periods. Sometimes, we make some revenue expenditure but it eventually becomes a capital asset (generally of an intangible nature). If one undertake substantial repairs to the existing building, the deterioration of the premises may be avoided. We may engage our own employees to do that work and pay



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them at prevailing wage-rate, which is of a revenue nature. If this expenditure is treated as a revenue expenditure and the current year's-profit is charged with these expenses, we are making the current year to absorb the entire expenses, though the benefit of which will be enjoyed for a number of accounting years. To overcome this difficulty, the entire expenditure is capitalised and is added to the asset account. Another example is an insurance policy. A business can pay insurance premium in advance, say, for a 3 year period. The right does not expire in the accounting period in which it is paid but will expire within a fairly short period of time (3 years). Only a portion of the total premium paid should be treated as a revenue expenditure (portion pertaining to the current period) and the balance should be carried forward as an asset to be written off in subsequent years.

AS 26 - Intangible Asset does not accept this view. Para 56 states, "Expenditure incurred to provide future economic benefit to an enterprise that can be recognized as an expense when it is incurred.

e.g. expenditure incurred on Scientific Research is recognized as an expense when it is incurred". In short, the whole amount of expenditure is treated as expense for the current year only and will not proportionately be transferred as deferred charge.

1.15.7 Capital and Revenue Receipts

A receipt of money may be of a capital or revenue nature. A clear distinction, therefore, should be made between capital receipts and revenue receipts.

A receipt of money is considered as capital receipt when a contribution is made by the proprietor towards the capital of the business or a contribution of capital to the business by someone outside the business. Capital receipts do not have any effect on the profits earned or losses incurred during the course of a year.

Additional capital introduced by the proprietor; by partners, in case of partnership firm, by issuing fresh shares, in case of a company; and, by selling assets, previously not intended for resale.

A receipt of money is considered as revenue receipt when it is received from customers for goods supplied or fees received for services rendered in the ordinary course of business, which is a result of the firm's activity in the current period. Receipts of money in the revenue nature increase the profits or decrease the losses of a business and must be set against the revenue expenses in order to ascertain the profit for the period.

The following are the points of difference between capital receipts and revenue receipts:

S. No.	Revenue Receipt	S. No.	Capital Receipt
1.	It has short-term effect. The benefit is enjoyed within one accounting period.	1.	It has long-term effect. The benefit is enjoyed for many years in future.



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2.	It occurs repeatedly. It is recurring and regular.	2.	It does not occur again and again. It is nonrecurring and irregular.
3.	It is shown in profit and loss account on the credit side, as an income for the year	3.	It is shown in the Balance Sheet on the liability side.
4.	It does not produce capital receipt.	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.	This does not increase or decrease the value of asset or liability.	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 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.	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.

1.15.8 Capital and Revenue Profits

While ascertaining the trading profit of a business for a particular period, a proper distinction is to be made between capital and revenue profits. If profit arises out of an ordinary nature, being the outcome of the ordinary function and object of the business, it is termed as 'revenue profit'. But, when a profit arises out of a casual and non-recurring transaction, it is termed as capital profit. Revenue profit arises out of the sale of the merchandise that the business deals in.

Capital Profit arises from :-

- (a) Profit prior to incorporation;
- (b) Premium received on issue of shares;
- (c) Profit made on re-issue of forfeited shares;
- (d) Redemption of Debenture at a discount;
- (e) Profit made on sale or revaluation of a Fixed Asset.

Generally, capital profits arise out of the sale of assets other than inventory at a price more than its book value or in connection with the raising of capital or at the time of purchasing an existing business. For example, if an asset, whose book value is ₹ 5,000 on the date of sale, is sold for ₹ 6,000 then ₹ 1,000 will be considered as capital profit. Likewise, issue of shares at a premium is also a capital profit. Revenue profits are distributed to the owners of the business or transferred



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to General Reserve Account, being shown in the balance sheet as a retained earning. Capital profits are generally capitalised-transferred to a capital reserve account which can only be utilised for setting off capital losses in future. Capital profits of a small amount (arising out of selling of one asset) is taken to the Profit and Loss Account and added with the revenue profit-applying the concept of materiality.

1.15.9 Capital and Revenue Losses

While ascertaining losses, revenue losses are differentiated from capital losses, just as revenue profits are distinguished from capital profits. Revenue losses arise from the normal course of business by selling the merchantable at a price less than its purchase price or cost of goods sold or where there is a declining in the current value of inventories. Capital losses may result from the sale of assets, other than inventory for less than written down value or the diminution or elimination of assets other than as the result of use or sale (flood, fire, etc.) or in connection with raising capital of the business (issue of shares at a discount) or on the settlement of liabilities for a consideration more than its book value (debenture issued at par but redeemed at a premium). Treatment of capital losses are same as that of capital profits. Capital losses arising out of sale of fixed assets generally appear in the Profit and Loss Account (being deducted from the net profit). But other capital losses are adjusted against the capital profits. Where the capital losses are substantial, the treatment is different. These losses are generally shown on the balance sheet as fictitious assets and the common practice is to spread that over a number of accounting years as a charge against revenue profits till the amount is fully exhausted.

Illustration 9.

State whether the following are capital, revenue or deferred revenue expenditure.

- (i) Carriage of ₹ 7,500 spent on machinery purchased and installed.
- (ii) Heavy advertising costs of Rs. 20,000 spent on the launching of a company's new product.
- (iii) Rs. 200 paid for servicing the company vehicle, including Rs. 50 paid for changing the oil.
- (iv) Construction of basement costing Rs. 1,95,000 at the factory premises.

Solution :

- (i) Carriage of Rs. 7,500 paid for machinery purchased and installed should be treated as a Capital Expenditure.
- (ii) Advertising expenses for launching a new product of the company should be treated as a Revenue Expenditure. (As per AS-26)
- (iii) Rs. 200 paid for servicing and oil change should be treated as a Revenue Expenditure.
- (iv) Construction cost of basement should be treated as a Capital Expenditure.



Illustration 10.

State whether the following are capital or revenue expenditure.

- (i) Paid a bill of Rs. 10,000 of Mr. Kumar, who was engaged as the erection engineer to set up a new automatic machine costing Rs. 20,000 at the new factory site.
- (ii) Incurred Rs. 26,000 expenditure on varied advertisement campaigns under taken yearly, on a regular basis, during the peak festival season.
- (iii) In accordance with the long-term plan of providing a well- equipped Labour Welfare Centre, spent Rs. 90,000 being the budgeted allocation for the year.

Solution :

- (i) Expenses incurred for erecting a new machine should be treated as a Capital Expenditure.
- (ii) Advertisement expenses during peak festival season should be treated as a Revenue Expenditure.
- (iii) Expenses incurred for Labour Welfare Centre should be treated as a Capital Expenditure.

Illustration 11.

Classify the following items as capital or revenue expenditure :

- (i) An extension of railway tracks in the factory area;
- (ii) Wages paid to machine operators;
- (iii) Installation costs of new production machine;
- (iv) Materials for extension to foremen's offices in the factory;
- (v) Rent paid for the factory;
- (vi) Payment for computer time to operate a new stores control system,
- (vii) Wages paid to own employees for building the foremen's offices.

Give reasons for your classification.

Solution :

- (i) Expenses incurred for extension of railway tracks in the factory area should be treated as a Capital Expenditure because it will yield benefit for more than one accounting period.
- (ii) Wages paid to machine operators should be treated as a Revenue Expenditure as it will yield benefit for the current period only.
- (iii) Installation costs of new production machine should be treated as a Capital Expenditure because it will benefit the business for more than one accounting period.



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- (iv) Materials for extension to foremen's offices in the factory should be treated as a Capital Expenditure because it will benefit the business for more than one accounting period.
- (v) Rent paid for the factory should be treated as a Revenue Expenditure because it will benefit only the current period.
- (vi) Payment for computer time to operate a new stores control system should be treated as Revenue Expenditure because it has been incurred to carry on the normal business.
- (vii) Wages paid for building foremen's offices should be treated as a Capital Expenditure because it will benefit the business for more than one accounting period.

Illustration 12.

For each of the cases numbered below, indicate whether the income/expenditure is capital or revenue.

- (i) Payment of wages to one's own employees for building a new office extension.
- (ii) Regular hiring of computer time for the preparation of the firm's accounts.
- (iii) The purchase of a new computer for use in the business.
- (iv) The use of motor vehicle, hired for five 'years, but paid at every six months.

Solution :

- (i) Payment of wages for building a new office extension should be treated as a Capital Expenditure.
- (ii) Computer hire charges should be treated as a Revenue Expenditure.
- (iii) Purchase of computer for use in the business should be treated as a Capital Expenditure.
- (iv) Hire charges of motor vehicle should be treated as a Revenue Expenditure.

Illustration 13.

State with reasons whether the following are capital or revenue expenditure :

- (i) Freight and cartage on the new machine Rs. 150, and erection charges Rs. 500.
- (ii) Fixtures of the book value of Rs. 2,500 sold off at Rs. 1,600 and new fixtures of the value of Rs. 4,000 were acquired. Cartage on purchase Rs. 100.
- (iii) A sum of Rs. 400 was spent on painting the factory.
- (iv) Rs. 8,200 spent on repairs before using a second hand car purchased recently, to put it in usable condition.



Solution :

- (i) Freight and cartage totaling Rs. 650 should be treated as a Capital Expenditure because it will benefit the business for more than one accounting year.
- (ii) Loss on sale of fixtures Rs. $(2,500 - 1,600) = \text{Rs. } 900$ should be treated as a Capital Loss. The cost of new fixtures and carriage thereon should be treated as a Capital Expenditure because the fixture will be used for a long period. So Rs. $(4,000 + 1,000)$ the cost of new fixture will be Rs. 4,100.
- (iii) Painting of the factory should be treated as a Revenue Expenditure because it has been incurred to maintain the factory building.
- (iv) Repairing cost of second hand car should be treated as a Capital Expenditure because it will benefit the business for more than one accounting year.

Illustration 14.

State the nature (capital or revenue) of the following expenditure which were incurred by Vedanta & Co. during the year ended 30th June, 2020 :

- (i) Rs. 350 was spent on repairing a second hand machine which was purchased on 8th May, 2020 and Rs. 200 was paid on carriage and freight in connection with its acquisition.
- (ii) A sum of Rs. 30,000 was paid as compensation to two employees who were retrenched.
- (iii) Rs. 150 was paid in connection with carriage on goods purchased.
- (iv) Rs. 20,000 customs duty is paid on import of a machinery for modernisation of the factory production during the current year and Rs. 6,000 is paid on import duty for purchase of raw materials.
- (v) Rs. 18,000 interest had accrued during the year on term loan obtained and utilised for the construction of factory building and purchase of machineries; however, the production has not commenced till the last date of the accounting year.

Solution :

- (i) Repairing and carriage totaling Rs. 550 for second hand machine should be treated as a Capital Expenditure.
- (ii) Compensation paid to employees shall be treated as a Revenue Expenditure.
- (iii) Carriage paid for goods purchased should be treated as a Revenue Expenditure.
- (iv) Customs duty paid on import of machinery to be treated as a Capital Expenditure. However, import duty paid for raw materials should be treated as a Revenue Expenditure.
- (v) Interest paid during pre-construction period to be treated as a Capital Expenditure.



Study Note-1 : Process of Accounting

Illustration 15.

State with reasons whether the following items relating to Parvati Sugar Mill Ltd. are capital or revenue :

- (i) Rs. 50,000 received from issue of shares including Rs. 10,000 by way of premium.
- (ii) Purchased agricultural land for the mill for Rs. 60,000 and Rs. 500 was paid for land revenue.
- (iii) Rs. 5,000 paid as contribution to PWD for improving roads of sugar producing area.
- (iv) Rs. 40,000 paid for excise duty on sugar manufactured.
- (v) Rs. 70,000 spent for constructing railway siding.

Solution :

- (i) Rs. 40,000 (50,000 – Rs. 10,000) received from issue of shares will be treated as a Capital Receipt. The premium of Rs. 10,000 should be treated as a Capital Profit.
- (ii) Cost of land Rs. 60,000 to be treated as Capital Expenditure and land revenue of Rs. 500 to be treated as Revenue Expenditure.
- (iii) Contribution paid to PWD should be treated as a Revenue Expenditure.
- (iv) Excise duty of Rs. 40,000 should be treated as a Revenue Expenditure.
- (v) Rs. 70,000 spent for constructing railway siding to be treated as a Capital Expenditure.

Illustration 16.

State with reasons whether the following are Capital Expenditure or Revenue Expenditure:

- (i) Expenses incurred in connection with obtaining a licence for starting the factory were Rs. 10,000.
- (ii) Rs. 1,000 paid for removal of stock to a new site.
- (iii) Rings and Pistons of an engine were changed at a cost of Rs. 5,000 to get full efficiency.
- (iv) Rs. 2,000 spent as lawyer's fee to defend a suit claiming that the firm's factory site belonged to the Plaintiff. The suit was not successful.
- (v) Rs. 10,000 were spent on advertising the introduction of a new product in the market, the benefit of which will be effective during four years.
- (vi) A factory shed was constructed at a cost of Rs. 1,00,000. A sum of Rs. 5,000 had been incurred for the construction of the temporary huts for storing building materials.

Solution :

- (i) Rs. 10,000 incurred in connection with obtaining a license for starting the factory is a Capital Expenditure. It is incurred for acquiring a right to carry on business for a long period.



- (ii) Rs. 1,000 incurred for removal of stock to a new site is treated as a Revenue Expenditure because it is not enhancing the value of the asset and it is also required for starting the business on the new site.
- (iii) Rs. 5,000 incurred for changing Rings and Pistons of an engine is a Revenue Expenditure because, the change of rings and piston will restore the efficiency of the engine only and it will not add anything to the capacity of the engine.
- (iv) Rs. 2,000 incurred for defending the title to the firm's assets is a Revenue Expenditure.
- (v) Rs. 10,000 incurred on advertising is to be treated as a Deferred Revenue Expenditure because the benefit of advertisement is available for 4 years, Rs. 2,500 is to be written off every year.
- (vi) Cost of construction of Factory shed of Rs. 1,00,000 is a Capital Expenditure, similarly cost of construction of small huts for storing building materials is also a Capital Expenditure.

Illustration 17.

State clearly how you would deal with the following in the books of a Company :

- (i) The redecoration expenses Rs. 6,000.
- (ii) The installation of a new Coffee-making Machine for Rs. 10,000.
- (iii) The building of an extension of the club dressing room for Rs. 15,000.
- (iv) The purchase of Snacks & food stuff Rs. 2,000.
- (v) The purchase of V.C.R. and T.V. for the use in the club lounge for Rs. 15,000.

Solution :

- (i) The redecoration expenses of Rs. 6,000 shall be treated as a Deferred Revenue Expenditure.
- (ii) The installation of a new Coffee - Making Machine is a Capital Expenditure because it is the acquisition of an asset.
- (iii) Rs. 15,000 spent for the extension of club dressing room is a Capital Expenditure because it creates an asset of a permanent nature.
- (iv) The purchase of snacks & food stuff of Rs. 2,000 is a Revenue Expenditure.
- (v) The purchase of V.C.R. and T.V. for Rs. 15,000 is a Capital Expenditure, because it is the acquisition of assets.



Study Note-1 : Process of Accounting

1.16 Accounting standards

SL. No.	Accounting Standards (AS)	IND AS No.	Name of IND AS
			I. Standards on Presentation
1	AS 1	Ind AS 1	Presentation of Financial Statements
2	AS 3	Ind AS 7	Statement of Cash Flows
3	AS 5	Ind AS 8	Accounting Policies, Changes in Accounting Estimates and Errors
4	AS 4	Ind AS 10	Events after the Reporting Period
5	AS 25	Ind AS 34	Interim Financial Reporting
6	No Corresponding Standard	Ind AS 29	Financial Reporting in Hyperinflationary Economies
			II. Standards on Consolidation
7	AS 21	Ind AS 27	Consolidated and Separate Financial Statements
8	AS 23	Ind AS 28	Investments in Associates
9	AS 27	Ind AS 31	Interests in Joint Ventures
10	AS 14	Ind AS 103	Business Combinations
			III. Standards on Revenue
11	AS 2	Ind AS 2	Inventories
12	AS 7	Ind AS 11	Construction Contracts
13	AS 9	Ind AS 18	Revenue
14	AS 12	Ind AS 20	Accounting for Government Grants and Disclosure of Government Assistance
15	AS 11	Ind AS 21	The Effects of Changes in Foreign Exchange Rates
			IV. Standards on Liabilities and Provisions
16	AS 15	Ind AS 19	Employee Benefits
17	AS 29	Ind AS 37	Provisions, Contingent Liabilities and Contingent Assets
18	Guidance Note	Ind AS 102	Share-based Payment
19	No Corresponding Standard	Ind AS 104	Insurance Contracts
			V. Standards on Disclosures
20	AS 18	Ind AS 24	Related Party Disclosures
21	AS 20	Ind AS 33	Earnings Per Shares
22	AS 17	Ind AS 108	Operating Segments
			VI. Standards on Assets



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23	AS 16	Ind AS 23	Borrowing Costs
24	AS 28	Ind AS 36	Impairments of Assets
25	AS 26	Ind AS 38	Intangible Assets
26	No Corresponding Standard	Ind AS 40	Investment Property
27	AS 10 & AS 6	Ind AS 16	Property, Plant and Equipment
28	AS 19	Ind AS 17	Leases
29	AS 24	Ind AS 105	Non-Current Assets Held for Sale and Discontinued Operations
30	Guidance Note	Ind AS 106	Exploration for and Evaluation of mineral Resources
			VII. Standards on Taxes
31	AS 22	Ind AS 12	Income Taxes
			VIII. Standards on Financial Instruments
32	AS 31	Ind AS 32	Financial Instruments: Presentation
33	AS 30	Ind AS 39	Financial Instruments: Recognition and Measurement
34	AS 32	Ind AS 107	Financial Instruments: Disclosures
			IX. Standards on First Time Adoption
35	No Corresponding Standard	Ind AS 101	First Time Adoption of Ind AS

Comparative Statement of AS & IND AS (Ind As – wise)

SL. No.	Accounting Standards (AS)	IND AS No.	Name of IND AS
1	AS 1	Ind AS 1	Presentation of Financial Statements
2	AS 2	Ind AS 2	Inventories
3	AS 3	Ind AS 7	Statement of Cash Flows
4	AS 5	Ind AS 8	Accounting Policies, Changes in Accounting Estimates and Errors
5	AS 4	Ind AS 10	Events after the Reporting Period
6	AS 7	Ind AS 11	Construction Contracts
7	AS 22	Ind AS 12	Income Taxes
8	AS 10 & AS 6	Ind AS 16	Property, Plant and Equipment



Study Note-1 : Process of Accounting

9	AS 19	Ind AS 17	Leases
10	AS 9	Ind AS 18	Revenue
11	AS 15	Ind AS 19	Employee Benefits
12	AS 12	Ind AS 20	Accounting for Government Grants and Disclosure of Government Assistance
13	AS 11	Ind AS 21	The Effects of Changes in Foreign Exchange Rates
14	AS 16	Ind AS 23	Borrowing Costs
15	AS 18	Ind AS 24	Related Party Disclosures
16	AS 21	Ind AS 27	Consolidated and Separate Financial Statements
17	AS 23	Ind AS 28	Investments in Associates
18	No Corresponding Standard	Ind AS 29	Financial Reporting in Hyperinflationary Economies
19	AS 27	Ind AS 31	Interests in Joint Ventures
20	AS 31	Ind AS 32	Financial Instruments: Presentation
21	AS 20	Ind AS 33	Earnings Per Shares
22	AS 25	Ind AS 34	Interim Financial Reporting
23	AS 28	Ind AS 36	Impairments of Assets
24	AS 29	Ind AS 37	Provisions, Contingent Liabilities and Contingent Assets
25	AS 26	Ind AS 38	Intangible Assets
26	AS 30	Ind AS 39	Financial Instruments: Recognition and Measurement
27	No Corresponding Standard	Ind AS 40	Investment Property
28	No Corresponding Standard	Ind AS 101	First Time Adoption of Ind AS
29	Guidance Note	Ind AS 102	Share-based Payment
30	AS 14	Ind AS 103	Business Combinations
31	No Corresponding Standard	Ind AS 104	Insurance Contracts
32	AS 24	Ind AS 105	Non-Current Assets Held for Sale and Discontinued Operations
33	Guidance Note	Ind AS 106	Exploration for and Evaluation of mineral Resources
34	AS 32	Ind AS 107	Financial Instruments: Disclosures
35	AS 17	Ind AS 108	Operating Segments



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Comparative Statement of AS & IND AS (AS- Wise)

SL. No.	Accounting Standards (AS)	IND AS No.	Name of IND AS
1	AS 1	Ind AS 1	Presentation of Financial Statements
2	AS 2	Ind AS 2	Inventories
3	AS 3	Ind AS 7	Statement of Cash Flows
4	AS 4	Ind AS 10	Events after the Reporting Period
5	AS 5	Ind AS 8	Accounting Policies, Changes in Accounting Estimates and Errors
6	AS 7	Ind AS 11	Construction Contracts
7	AS 9	Ind AS 18	Revenue
8	AS 10 & AS 6	Ind AS 16	Property, Plant and Equipment
9	AS 11	Ind AS 21	The Effects of Changes in Foreign Exchange Rates
10	AS 12	Ind AS 20	Accounting for Government Grants and Disclosure of Government Assistance
11	AS 14	Ind AS 103	Business Combinations
12	AS 15	Ind AS 19	Employee Benefits
13	AS 16	Ind AS 23	Borrowing Costs
14	AS 17	Ind AS 108	Operating Segments
15	AS 18	Ind AS 24	Related Party Disclosures
16	AS 19	Ind AS 17	Leases
17	AS 20	Ind AS 33	Earnings Per Shares
18	AS 21	Ind AS 27	Consolidated and Separate Financial Statements
19	AS 22	Ind AS 12	Income Taxes
20	AS 23	Ind AS 28	Investments in Associates
21	AS 24	Ind AS 105	Non-Current Assets Held for Sale and Discontinued Operations
22	AS 25	Ind AS 34	Interim Financial Reporting
23	AS 26	Ind AS 38	Intangible Assets
24	AS 27	Ind AS 31	Interests in Joint Ventures
25	AS 28	Ind AS 36	Impairments of Assets
26	AS 29	Ind AS 37	Provisions, Contingent Liabilities and Contingent Assets

Study Note-1 : Process of Accounting

27	AS 30	Ind AS 39	Financial Instruments: Recognition and Measurement
28	AS 31	Ind AS 32	Financial Instruments: Presentation
29	AS 32	Ind AS 107	Financial Instruments: Disclosures
30	Guidance Note	Ind AS 102	Share-based Payment
31	Guidance Note	Ind AS 106	Exploration for and Evaluation of mineral Resources
32	No Corresponding Standard	Ind AS 29	Financial Reporting in Hyperinflationary Economies
33	No Corresponding Standard	Ind AS 40	Investment Property
34	No Corresponding Standard	Ind AS 101	First Time Adoption of Ind AS
35	No Corresponding Standard	Ind AS 104	Insurance Contracts

Need for Accounting Standards

1. It helps in dissemination of timely and useful financial information to all Stakeholders and users.
2. It helps to provide a set of standard accounting policies, valuation norms and disclosure requirement.
3. It ensures disclosures of accounting principles and treatments, where important information is not otherwise statutorily required to be disclosed.
4. It helps to reduce or totally eliminate, accounting alternatives, thereby it leads to better inter-firm and intra-firm comparison of Financial Statements.
5. It reduces scope of creative accounting, i.e. twisting of accounting policies to produce Financial Statement favourable to a particular interest group.

1.17 DOUBLE ENTRY SYSTEM, BOOKS OF PRIME ENTRY, SUBSIDIARY BOOKS

1.17.1 Double Entry System - This part we have already explained in 1.12 B

1.17.2 Books of Prime Entry

A journal is often referred to as Book of Prime Entry or the book of original entry. In this book transactions are recorded in their chronological order. The process of recording transaction in a journal is called as 'Journalisation'. The entry made in this book is called a 'journal entry'.



1.17.2.1 Functions of Journal

- (i) *Analytical Function*: Each transaction is analysed into the debit aspect and the credit aspect. This helps to find out how each transaction will financially affect the business.
- (ii) *Recording Function*: Accountancy is a business language which helps to record the transactions based on the principles. Each such recording entry is supported by a narration, which explain, the transaction in simple language. Narration means to narrate – i.e. to explain. It starts with the word – Being ...
- (iii) *Historical Function*: It contains a chronological record of the transactions for future references.

1.17.2.2 Advantages of Journal

The following are the advantages of a journal:

- (i) *Chronological Record*: It records transactions as and when it happens. So it is possible to get a detailed day-to-day information.
- (ii) *Minimising the possibility of errors*: The nature of transaction and its effect on the financial position of the business is determined by recording and analyzing into debit and credit aspect.
- (iii) *Narration*: It means explanation of the recorded transactions.
- (iv) *Helps to finalise the accounts*: Journal is the basis of ledger posting and the ultimate Trial Balance.

The Trial balance helps to prepare the final accounts.

The specimen of a journal book is shown below.

Date	Particulars	Voucher number	Ledger folio	Debit Amount (Rs.)	Credit Amount (Rs.)
dd-mm-yy	Name of A/c to be debited Name of A/c to be credited (narration describing the transaction)	–	Reference of page number of the A/c in ledger	–	–

Explanation of Journal

- (i) *Date Column*: This column contains the date of the transaction.
- (ii) *Particulars*: This column contains which account is to be debited and which account is to be credited. It is also supported by an explanation called narration.



Study Note-1 : Process of Accounting

- (iii) *Voucher Number*: This Column contains the number written on the voucher of the respective transaction.
- (iv) *Ledger Folio (L.F.)*: This column contains the folio (i.e. page no.) of the ledger, where the transaction is posted.
- (v) *Dr. Amount and Cr. Amount*: This column shows the financial value of each transaction. The amount is recorded in both the columns, since for every debit there is a corresponding and equal credit.

All the columns are filled in at the time of entering the transaction except for the column of ledger folio. This is filled at the time of posting of the transaction to 'ledger'. This process is explained later in this chapter.

Example:

As per voucher no. 31 of Roy Brothers, on 10.05.2020 goods of ' 50000 were purchased. Cash was paid immediately. Ledger Folios of the Purchase A/c and Cash A/c are 5 and 17 respectively. Journal entry of the above transaction is given below:

In the books of Roy Brothers Journal Entries

Date	Particulars	Voucher number	Ledger folio	Debit Amount (Rs.)	Credit Amount (Rs.)
10.05.2020	Purchase A/c Dr.	31	5	50,000	—
	To, Cash A/c (Being goods purchased for Cash)		17		50,000

Illustration 18.

Let us illustrate the journal entries for the following transactions:

2020 April

- 1 Mr. Vikas and Mrs. Vaibhavi who are husband and wife start consulting business by bringing in their personal cash of Rs. 5,00,000 and Rs. 2,50,000 respectively.
- 10 Bought office furniture of Rs. 25,000 for cash. Bill No. - 2020/F/3
- 11 Opened a current account with Punjab National Bank by depositing Rs. 1,00,000
- 15 Paid office rent of Rs. 15,000 for the month by cheque to M/s Realtors Properties. Voucher No. 3
- 20 Bought a motor car worth Rs. 4,50,000 from Millennium Motors by making a down payment of Rs. 50,000 by cheque and the balance by taking a loan from HDFC Bank. Voucher No. M/12/7



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- 25 Vikas and Vaibhavi carried out a consulting assignment for Avon Pharmaceuticals and raise a bill for Rs. 10,00,000 as consultancy fees. Bill No. B12/4/1 raised. Avon Pharmaceuticals have immediately settled Rs. 2,50,000 by way of cheque and the balance will be paid after 30 days. The cheque received is deposited into Bank.
- 30 Salary of one receptionist @ Rs. 5,000 per month and one officer @ Rs. 10,000 per month. The salary for the current month is payable to them.

Solution:

The entries for these transactions in a journal will look like:

In the Books of Vikash & Vaibhavi Journal Entries Journal Folio-1

Date	Particulars	Voucher number	L.F.	Debit Amount (Rs.)	Credit Amount (Rs.)
01-04-2020	Cash A/c Dr.		1	7,50,000	
	To Vikas's Capital A/c		2		5,00,000
	To Vaibhavi's capital A/c (Being capital brought in by the partners)		3		2,50,000
10-04-2020	Furniture A/c Dr.	2020/F/3	4	25,000	
	To Cash A/c (Being furniture purchased in cash)		1		25,000
11-04-2020	Punjab National Bank A/c Dr.		5	1,00,000	
	To Cash A/c (Being current account opened with Punjab National Bank by depositing cash)		1		1,00,000
15-04-2020	Rent A/c Dr.	3	6	15,000	
	To Punjab National Bank A/c (being rent paid to Realtors Properties for the month)		5		15,000
20-04-2020	Motor Car A/c Dr.	M/12/7	7	4,50,000	
	To Punjab National Bank A/c		5		50,000
	To Loan from HDFC Bank A/c (Being car purchased from Millennium Motors by paying down payment and loan arrangement)		8		4,00,000



Study Note-1 : Process of Accounting

25-04-2020	Punjab National Bank A/c	Dr.	B12/4/1	5	2,50,000	
	Avon Pharma A/c	Dr.		9	7,50,000	
	To Consultancy Fees A/c (Being amount received and revenue recognized for fees charged)			10		10,00,000
30-04-2020	Salary A/c	Dr.		11	15,000	
	To Salary payable A/c (Being the entry to record salary obligation for the month)			12		15,000

Illustration 19.

Journalise the following transactions in the books of Mr. Roy

2020 April

- 1 He started business with a capital of - Plant Rs. 10,000, Bank Rs. 8,000, Stock Rs. 12,000
- 2 Bought furniture for resale Rs. 5,000 Bought furniture for Office decoration Rs. 3,000
- 3 Paid rent out of personal cash for Rs. 2,000
- 8 Sold furniture out of those for resale Rs. 6,000
- 12 Paid Salary to Mr. X for Rs. 1,200
- 15 Purchased goods from Mr. Mukherjee for cash Rs. 3,000
- 18 Sold goods to Mr. Sen on credit for Rs. 8,000
- 20 Mr. Sen returned goods valued Rs. 1,000
- 22 Received cash from Mr. Sen of Rs. 6,500 in full settlement
- 28 Bought goods from Mr. Bose on credit for Rs. 5,000
- 30 Returned goods to Mr. Bose of Rs. 500 and paid to Mr. Bose Rs. 4,000 in full settlement.

In the Books of Mr. Roy

Journal Entries

Date	Particulars	L.F.	Debit Amount (Rs.)	Credit Amount (Rs.)
01-04-2020				
1	Plant A/c	Dr.	10,000	5,00,000
	Bank A/c	Dr.	8,000	
	Stock A/c	Dr.	12,000	15,000
	To, Capital A/c [Being Plant, Bank, Stock introduced to the business]			30,000



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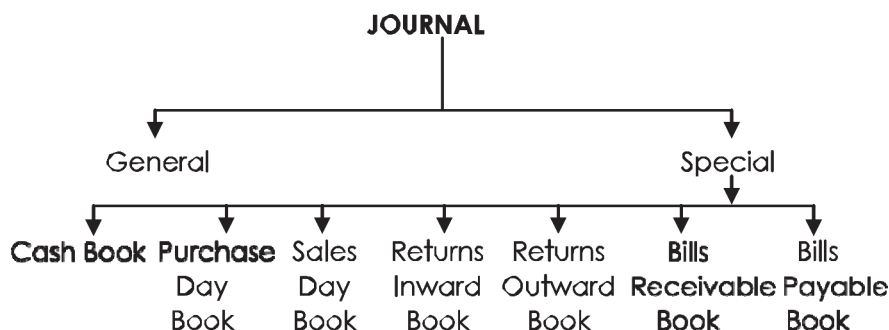
2	Purchase A/c	Dr.		5,000	
	To, Bank A/c [Being furniture purchased for resale]				5,000
	Furniture A/c	Dr.		3,000	
	To, Bank A/c [Being furniture purchased for office decoration]				3,000
3	Rent A/c	Dr.		2,000	
	To, Capital A/c [Being rent paid out of personal cash]				2,000
8	Cash A/c	Dr.		6,000	
	To, Sales A/c [Being furniture out of those meant for resale are sold]				6,000
12	Salary A/c	Dr.		1,200	
	To, Bank A/c [Being salary paid to Mr. X]				1,200
15	Purchase A/c	Dr.		3,000	
	To, Cash A/c [Being goods purchased]				3,000
18	Mr. Sen A/c	Dr.		8,000	
	To, Sales A/c [Being goods sold on credit to Mr. Sen]				8,000
20	Returns Inward A/c	Dr.		1,000	
	To, Mr. Sen A/c [Being goods returned from Mr. Sen]				1,000
22	Cash A/c	Dr.		6,500	
	Discount Allowed A/c	Dr.		500	
	To, Mr. Sen A/c [Being cash received from Mr. Sen in full settlement]				7,000
28	Purchase A/c	Dr.		5,000	
	To, Mr. Bose A/c [Being goods purchased from Mr. Bose on credit]				5,000
30	Mr. Bose A/c	Dr.		5,000	
	To, Cash A/c				4,000
	To, Returns Outward A/c				500
	To, Discount Received A/c [Being goods returned to Mr. Bose and paid cash in full settlement]				500

Study Note-1 : Process of Accounting

Please observe the convention of entry. Accounts to be debited are written first with 'Dr' as a suffix, and accounts to be credited are written subsequently with a prefix 'To'.

1.17.2.3 Sub-division of Journals

Journal is divided into two types -(i) General Journal and (ii) Special Journal.



(i) General Journal

- This is a book of chronological record of transactions.
- This book records those transactions which occur so infrequently that they do not warrant the setting up of special journals.

Examples of such entries:

- opening entries
- closing entries
- rectification of errors.

The form of this general journal, is as under:

JOURNAL

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

L.F. : Ledger Folio

Dr : Debit

Cr : Credit

Recording of transactions in this book is called journalising and the record of transactions is known as journal entry.



(ii) Special Journal

It is subdivided into Cash Book, Purchase Day Book, Sales Day Book, Returns Inward Book, Returns Outward Book, Bills Receivable Book and Bills Payable Book. These books are called subsidiary books.

Importance of Sub-division of journals

When the number of transactions is large, it is practically not possible to record all the transactions through one journal because of the following limitations of Journal:

- (i) The system of recording all transactions in a journal requires (a) writing down the name of the account involved as many times as the transaction occurs; and (b) an individual posting of each account debited and credited and hence, involves the repetitive journalizing and posting labour.
- (ii) Such a system can not provide the information on a prompt basis.
- (iii) Such a system does not facilitate the installation of an internal check system because the journal can be handled by only one person.
- (iv) The journal becomes huge and voluminous.
- (v) To overcome the shortcomings of the use of the journal only as a book of original entry, the journal is sub-divided into special journal.

The journal is sub-divided in such a way that a separate book is used for each category of transactions which are repetitive in nature and are sufficiently large in number.

1.17.2.4 Compound Journal

If for a single transaction, only one account is debited and one account is credited, it is known as simple journal.

If the transaction requires more than one account which is to be debited or more than one account is to be credited, it is known as Compound Journal.

The following illustration will make it clear :

Illustration 20.

- (i) Started business with Cash ₹50,000; Plant ₹24,000; Stock ₹4,000
- (ii) Sold Goods for Cash ₹8,000 and to Ms. Agarwal for ₹10,000
- (iii) Ms. Agarwal settled her account less discount Rs. 600



Study Note-1 : Process of Accounting

Solution:

**In the Books of
Journal**

Date	Particulars	L.F.	Debit Amount (Rs.)	Credit Amount (Rs.)
(i)	Cash A/c	Dr.	50,000	
	Plant A/c	Dr.	24,000	
	Stock A/c	Dr.	4,000	
	To Capital A/c (Being business started with cash, plant and stock as capital)			78,000
(ii)	Cash A/c	Dr.	8,000	
	Ms. Agarwal's A/c	Dr.	10,000	
	To Sales A/c (Being goods sold for cash Rs. 8,000 and on credit Rs. 10,000)			18,000
(iii)	Cash A/c	Dr.	9,400	
	Discount Allowed A/c	Dr.	600	
	To Ms. Agarwal's A/c (Being cash received as final settlement and discount allowed)			10,000

1.17.3 Subsidiary Books

Although once understood, the entries are easy to be written, but if transactions are too many, it may become difficult to manage them and retrieve. Imagine there are 25 purchase transactions in a day. Because the journal will record all transaction chronologically, it may be possible that the purchase transactions could be scattered i.e. they may not all come together one after the other. Now, at the end of the day if the owner wants to know the total purchases made during the day, the accountant will spend time first to retrieve all purchase transactions from journal and then take total. This involve time.

This being the greatest limitation of journal, it is generally sub-divided into more than one journal. On what logic is such a sub-division made? It is done on the basis of similar transactions which are clubbed in a single book e.g. purchase transactions, sales transaction etc. The sub-division of journal is done as follows:



Transaction	Subsidiary Book
All cash and bank transactions	Cash Book - has columns for cash, bank and cash discount
All credit purchase of goods - only those Goods that are purchased for resale are covered here.	Purchase Day Book or Purchase register
All credit sale of goods	Sales Day Book or sales register
All purchase returns - i.e. return of goods back to suppliers due to defects	Purchase Return Book or Return Outward Book
All sales returns - i.e. return of goods back from customers	Sales Return Book or Return Inward Book
All bill receivables - these are bills accepted by customers to be honoured at an agreed date. This is dealt with in depth later in the study note	Bills Receivable Book
All bills payable - these are bills accepted by the business to be honoured by paying to suppliers at an agreed date.	Bills Payable Book
For all other transactions not covered in any of the above categories - i.e. purchase or sale of assets, expense accruals, rectification entries, adjusting entries, opening entries and closing entries.	Journal Proper

Let us see the formats for each of these and examples as illustration.

1.17.3.1 Recording of cash and Bank Transactions

1.17.3.1.1 Cash Book

A Cash Book is a special journal which is used for recording all cash receipts and all cash payments. Cash Book is a book of original entry since transactions are recorded for the first time from the source documents. The Cash Book is larger in the sense that it is designed in the form of a Cash Account and records cash receipts on the debit side and cash payments on the credit side. Thus, the Cash Book is both a journal and a ledger.

1.17.3.1.2 Cash Book as the only Book of Original Entry

This cash Book records all types of transactions even if there are some credit transactions i.e. all transactions are recorded and not like the ordinary Cash Book where only cash transactions are recorded. For non cash transactions, that will be two entries in the cash Book, ultimately that will be no effect in cash Balance. For example, if goods are sold to Mr. X on credit for Rs. 5,000, the entries will be

Study Note-1 : Process of Accounting

Date	Particulars	L.F.	Debit Amount (Rs.)	Credit Amount (Rs.)
(1)	Cash A/c	Dr	5,000	
	To Sales A/c			5,000
(2)	X A/c	Dr	5,000	
	To Cash A/c			5,000

1.17.3.1.3 Types of Cash Book

There are different types of Cash Book as follows:

- (i) **Single Column Cash Book:** Single Column Cash book has one amount column on each side. All cash receipts are recorded on the debit side and all cash payments on the payment side, this book is nothing but a Cash Account and there is no need to open separate cash account in the ledger.
- (ii) **Double Column Cash Book:** Cash book with Discount Column has two amount columns, one for cash and other for Discount on each side. All cash receipts and cash discount allowed are recorded on the debit side and all cash payments and discount received are recorded on the credit side.
- (iii) **Triple Column Cash Book:** Triple Column Cash Book has three amount columns, one for cash, one for Bank and one for discount, on each side. All cash receipts, deposits into bank and discount allowed are recorded on debit side and all cash payments, withdrawals from bank and discount received are recorded on the credit side. In fact, a triple-column cash book serves the purpose of Cash Account and Bank Account both. Thus, there is no need to create these two accounts in the ledger.

Dr.	Specimen of Single Column Cash Book							Cr.
Receipts				Payments				
Date	Particulars	L.F.	Cash	Date	Particulars	L.F.	Cash	



Dr.	Specimen of Double Column Cash Book									Cr.
Receipts					Payments					
Date	Particulars	L.F.	Cash	Disc. Allowed	Date	Particulars	L.F.	Cash	Disc. Received	

Dr.	Specimen of Triple Column Cash Book										Cr.
Receipts						Payments					
Date	Particulars	L.F.	Cash	Bank	Disc. Allowed	Date	Particulars	L.F.	Cash	Bank	Disc. Received

Double Column Cash Book containing contra transaction and cheque transaction

The double column Cash book has columns on both the sides of the Cash book. This cash book can have two columns on both the sides as under :

- (a) Cash and Discount Columns,
- (b) Cash and Bank columns,
- (c) Bank and Discount columns.

(I) Contra Transactions

Transactions which relates to allowing discount or receiving discount in cash after the settlement of the dues are known as Contra Transactions.

Example:

- Received Rs. 500 as discount from Mr. Ghosh whose account was previously settle in full.

Date	Cash A/c	Dr.	500	
	To Discount Received A/c (Being cash received as discount from Mr. Ghosh whose account was previous settled in full)			500

- Paid ' 400 as discount to Mr. Ghosh Dastidar who settled his account in full previously.

Date	Discount Allowed A/c	Dr.	400	
	Cash A/c (Being discount allowed in cash to Mr. Ghosh Dastidar who settled his account in full)			400

(II) Cheque Transactions

When a cheque is received and no any other information at a later date about the same is given, it will be assumed that the said cheque has already been deposited into bank on the same day when it was received. Then the entry should be as under:

Bank A/c Dr.
To Debtors/Party A/c

But if it is found that the said cheque has been deposited into the bank at a later date, then the entry will be:

- (i) When the cheque is received Cash A/c Dr.
To Debtors/Party A/c
- (ii) When the same was deposited into bank at a later date

Bank A/c	Dr.
To Cash A/c	

- (iii) When the said cheque is dishonoured by the bank
- | | |
|-------------------|-----|
| Debtors/Party A/c | Dr. |
| To Bank A/c | |

Let us see an illustration for the following cash and bank transactions in the books of Mr. Abhishek

January 1	Opening cash balance was Rs. 3,800 and bank balance was Rs. 27,500
January 4	Wages paid in cash Rs. 1,500
January 5	received cheque of Rs. 19,800 from KBK enterprises after allowing discount of Rs. 200
January 7	Paid to consultancy charges by cheque for Rs. 7,500
January 10	Cash of Rs. 2,500 withdrawn from bank
January 12	Received a cheque for Rs. 4,500 in full settlement of the account of Mr. X at a discount of 10% and deposited the same into the Bank.
January 15	X's cheque returned dishonoured by the Bank



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Dr.	In the Books of Mr. Abhishek Cash Book										Cr.
Receipts						Payments					
Date	Particulars	L.F.	Cash (Rs.)	Bank (Rs.)	Disc. Allowed (Rs.)	Date	Particulars	L.F.	Cash (Rs.)	Bank (Rs.)	Disc. Received (Rs.)
1 Jan	Opening Balance		3,800	27,500		4 Jan	Wages paid		1,500		
5 Jan	Recd from KBK			19,800	200	7 Jan	Consultancy fees			7,500	
10 Jan	Cash withdrawn		2,500			10 Jan	Cash withdrawn			2,500	
12 Jan	Mr. X			4,500	500	15 Jan	Mr. X			4,500	500
							Closing balance		4,800	37,300	
			6,300	51,800	700				6,300	51,800	500

Please note that the balance of discount columns is not taken and these are posted directly to the respective ledger account separately. The balance of cash and bank columns are posted into cash and bank accounts periodically. The posting into ledger is explained later in this chapter.

1.17.3.2 Purchase Day Book

The purchase day book records the transactions related to credit purchase of goods only. It follows that any cash purchase or purchase of things other than goods is not recorded in the purchase day book. Periodically, the totals of Purchase day book are posted to Purchase account in the ledger. The specimen Purchase day book is given below:

In the Books of Purchase Day Book

Date	Name of the Suppliers and details of Goods purchased	Invoice reference	L. F.	Amount (Rs.)	Remarks

The format for Purchase Return is exactly the same; hence separate illustration is not given.

Let us see an illustration for following transactions for a furniture shop:

1. Bought 20 tables @ Rs. 500 per table from Majestic Appliances on credit @ 12% trade discount as per invoice number 22334 on 2nd March.



Study Note-1 : Process of Accounting

- Purchased three dozen chairs @ Rs. 250 each from Metro chairs as per invoice number 1112 on 4th March.
- Second hand furniture bought from Modern Furnitures on credit as per invoice number 375 for Rs. 1200 on 7th March.
- Purchased seven book racks from Mayur Furnitures for Rs. 4900 paid for in cash on 6th March.
- Purchased Machinery for Rs. 30000 from Kirloskar Ltd on 9th March as per invoice number 37.

In the Books of Furniture Shop Purchase Day Book

Date	Name of the Suppliers and details of Goods purchased	Invoice reference	L. F.	Amount (Rs.)
2nd March	Majestic Appliances			8,800
	20 tables@ 500 and 12% trade discount (20 * 500) = 10000 less 12% discount	22334		
4th March	Metro Chairs			9,000
	3 dozen chairs @ 250 per chair	1112		
7th March	Modern Furnitures	375		1,200
	Total			19,000

Please note that the transaction for purchase of book rack will not be entered in the purchase book as it is not purchased on credit. (Where will it go then? it will go to the cash book!). Similarly purchase of machinery will not form part of purchase book. It will be entered in Journal Proper.

1.17.3.3 Sales Day Book

The sales day book records transaction of credit sale of goods to customers. Sale of other things, even on credit, will not be entered in the sales day book but will be entered in Journal Proper. If goods are sold for cash, it will be entered in cash book. Total of sales day book is periodically posted to sales account in the ledger. The specimen of a sales day book is given below.

In the books of Sales Day Book

Date	Particulars	Invoice reference	L. F.	Amount	Remarks

The format of sales return book is exactly the same; hence a separate illustration is not given.



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Let us see how will be the following transaction recorded in the books of a Cloth Merchant.

1st July	Sold Tip Top clothing 50 suits of Rs. 2,200 each on two months credit on invoice number -2
11th July	Sold to New India Woolen 100 sweaters @ Rs. 250 each on invoice number 55
13th July	Received an order from Modern clothing for 100 trousers @ Rs. 500 at trade discount of 10%
17th July	Sold 50 sarees to Lunkad brothers @ Rs. 750 each
25th July	Sold T-shirts at exhibition hall for cash for Rs. 7,500

In the books of Cloth Merchant Sales Day Book

Date	Name of the Suppliers and details of Goods purchased	Invoice reference	L. F.	Amount (Rs.)
1st July	Tip Top Clothing 50 suits @ Rs. 2,200	2		1,10,000
11th July	New India Woolen 100 sweaters @ Rs. 250	55		25,000
17th July	Lunkad brother 50 sarees @ Rs. 750			37,500
	Total			1,72,500

Here again, cash sales at exhibition hall are not recorded. Also, merely getting an order for goods is not a transaction to be entered in sales book.

1.17.3.4 Other Subsidiary Books - Returns Inward, Return Outward, Bills Receivable, Bills Payable.

(i) Return Inward Book- The transactions relating to goods which are returned by the customers for various reasons, such as not according to sample, or not up to the mark etc contain in this book. It is also known as Sales Return Book.

Generally when a customer returns good to suppliers he issues a Debit Note for the value of the goods returned by him. Similarly the supplier who receives those goods issues a Credit Note.

Returns Inward Day Book

Date	Particulars	Outward Invoice	L.F.	Details	Totals	Remarks

(ii) Return Outward Book- This book contains the transactions relating to goods that are returned by us to our creditors e.g. goods broken in transit, not according to the sample etc. It's also known as Purchase Return Book.



Study Note-1 : Process of Accounting

Return Outward Day Book

Date	Particulars	Debit Note	L.F.	Details	Totals	Remarks

(iii) Bills Receivable Book- It is such a book where all bills received are recorded and therefrom posted directly to the credit of the respective customer's account. The total amounts of the bills so received during the period (either at the end of the week or month) is to be posted in one sum to the debit of Bills Receivable A/c.

Bills Receivable Day Book

No. of Bills	Date of Receipt	From whom	Name of the Receiver	Name of Drawer	Name of Acceptor	Date Bill	Due Date	L.F.	Amount of Bill	How Disposed of

(iv) Bills Payable Book- Here all the particulars relating to bills accepted are recorded and therefrom posted directly to the debit of the respective creditor's account. The total amounts of the bills so accepted during the period (either at the end of the week or month) is to be posted in one sum to the credit of Bills Payable A/c.

Bills Payable Day Book

No. of Bills	Date of Acceptance	To whom given	Name of the Drawer	Name of Payee	Where Payable	Date of Bill	Due Date	L.F.	Amount of Bill	How Disposed of

1.17.3.5 Journal Proper

Credit transactions that cannot be entered in any other subsidiary book are entered in journal proper. It will cover purchase or sale of assets, expense accruals, rectification entries, adjusting entries, opening entries and closing entries. The format of journal proper is exactly the same as given in the section 1.17.2.2 The entries here recorded in the same way as shown in that illustration.

1.17.3.6 Ledger Accounts

Ledger is the main book or principal book of account. The entries into ledger accounts travel through the route of journal and subsidiary books. The ledger book contain all accounts viz.



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assets, liabilities, incomes or gains, expenses or losses, owner's capital and owner's equity. The ledger is the book of final entry and hence is a permanent record. There is a systematic way in which transactions are posted into a ledger account. Once the transactions are posted for an accounting period, the ledger accounts are balanced (i.e. the difference between debit side and credit side is calculated). These balances are used to ultimately prepare the financial statement like Profit and Loss A/c and Balance sheet. The ledger may also be divided as General ledger and Sub-ledgers. While the General Ledger will have all ledger accounts, the sub-ledgers will have individual accounts of customers and suppliers. If there are 10 customers, the general ledger will not have 10 individual accounts for each customer. Instead, these 10 customer account will exist in what is called as 'Receivables or Debtors Ledger' and the general ledger will have only one account that represents the customers. This is named as Debtors Control Account. Similar is the case of supplier accounts. Such sub-ledgers are necessary for better control over individual accounts. Also, this will avoid the general ledger from becoming too big, especially when number of customers and suppliers is large.

The specimen of a typical ledger account is given below.

Dr.	Ledger-Account						Cr.
Receipts				Payments			
Date	Particulars	J.F.	Cash	Date	Particulars	J.F.	Cash

1.17.3.6.1 Ledger Posting

As and when the transaction takes place, it is recorded in the journal in the form of journal entry. This entry is posted again in the respective ledger accounts under double entry principle from the journal. This is called ledger posting.

The rules for writing up accounts of various types are as follows :

Assets	Increases on the left hand side or the debit side and decreases on the credit side or the right hand side.
Liabilities	Increases on the credit side and decreases on the debit side.
Capitals	The same as liabilities.
Expenses	Increases on the debit side and decreases on the credit side. Incomes or gain: Increases on the credit side and decrease on the debit side. To summarise



Study Note-1 : Process of Accounting

Dr.	Assets	Cr.	Dr.	Liabilities & Capital	Cr.
Increase		Decrease	Decrease		Increase
Dr.	Expenses or Loses	Cr.	Dr.	Income or Gains	Cr.
Increase		Decrease	Decrease		Increase

The student should clearly understand the nature of debit and credit.

A debit denotes:

- (a) In the case of a person that he has received some benefit against which he has already rendered some service or will render service in future. When a person becomes liable to do something in favour of the firm, the fact is recorded by debiting that person's account : (relating to Personal Account)
- (b) In case of goods or properties, that the value and the stock of such goods or properties has increased, (relating to Real Accounts)
- (c) In case of other accounts like losses or expenses, that the firm has incurred certain expenses or has lost money. (relating to Nominal Account)

A credit denotes:

- (a) In case of a person, that some benefit has been received from him, entitling him to claim from the firm a return benefit in the form of cash or goods or service. When a person becomes entitled to money or money's worth for any reason. The fact is recorded by crediting him (relating to Personal Account)
- (b) In the case of goods or properties, that the stock and value of such goods or properties has decreased. (relating to Real Accounts)
- (c) In case of other accounts like interest or dividend or commission received, or discount received, that the firm has made a gain (relating to Nominal Account)

At a glance:

Dr. (Debit side)	Cr. (Credit side)
DESTINATION Where the economic benefit reaches / is received.	SOURCE of each economic benefits
Receiver	Given
What comes in	What goes out
All expense and losses	All income and gains



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Let us now understand the mechanism of posting transaction into the ledger account. Consider the transaction: Rent paid in cash for Rs.10000. The journal entry for this transaction would be:

Jan 15	Rent A/c	Dr	10,000	
	To Cash A/c			10,000

We will open two ledger accounts namely Rent A/c and Cash A/c. Let us see how the posting is made

Dr.	Rent Account						Cr.
Date	Particulars	J.F.	Amount (Rs.)	Date	Particulars	J.F.	Amount (Rs.)
Jan15	To Cash A/c		10,000				

Dr.	Cash Account						Cr.
Date	Particulars	J.F.	Amount (Rs.)	Date	Particulars	J.F.	Amount (Rs.)
				Jan 15	By Rent A/c		10,000

Please observe the following conventions while posting a transaction into ledger accounts. Note that both the effects of an entry must be recorded in the ledger accounts simultaneously.

- 1) The posting in the account which is debited, is done on the debit side by writing the name of the account or accounts that are credited with the prefix 'To'.
- 2) The posting in the account which is credited, is done on the credit side by writing the name of the account or accounts that are debited with the prefix "By".

Let us now see how we can create ledger account for the seven journal entries that we passed for Illustration 18.

Folio No. 1

Dr.	Cash Account						Cr.
Date	Particulars	J.F.	Amount (Rs.)	Date	Particulars	J.F.	Amount (Rs.)
1.4.2020	To Vikas's capital	1	500,000	10.4.2020	By Furniture	1	25,000
1.4.2020	To Vaibhavi's capital	1	250,000	11.4.2020	By Punjab National Bank	1	1,00,000
				30.4.2020	By Balance c/d		6,25,000
	Total		750,000		Total		7,50,000
1.5.2020	To Balance b/d		625,000				



Study Note-1 : Process of Accounting

Folio No. 2

Dr.	Mr. Vikas's Capital Account						Cr.
Date	Particulars	J.F.	Amount (Rs.)	Date	Particulars	J.F.	Amount (Rs.)
30.4.2020	To Balance c/d		5,00,000	1.4.2020	By Cash	1	5,00,000
			5,00,000				5,00,000
				1.5.2020	By Balance b/d		5,00,000

Folio No. 3

Dr.	Mrs. Vaibhavi's Capital Account						Cr.
Date	Particulars	J.F.	Amount (Rs.)	Date	Particulars	J.F.	Amount (Rs.)
				1.4.2020	By Cash	1	2,50,000

Folio No. 4

Dr.	Furniture Account						Cr.
Date	Particulars	J.F.	Amount (Rs.)	Date	Particulars	J.F.	Amount (Rs.)
10.4.2020	To Cash		25,000				

Folio No. 5

Dr.	Punjab National Bank Account						Cr.
Date	Particulars	J.F.	Amount (Rs.)	Date	Particulars	J.F.	Amount (Rs.)
11.4.2020	To Cash	1	1,00,000	15.4.2020	By Rent	1	15,000
25.4.2020	To Consultancy Fees	1	2,50,000	20.4.2020	By Motor Car	1	50,000

Folio No. 6

Dr.	Rent Account						Cr.
Date	Particulars	J.F.	Amount (Rs.)	Date	Particulars	J.F.	Amount (Rs.)
15.4.2020	To Punjab National Bank	1	15,000				



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Folio No. 7

Dr.		Motor Car Account						Cr.
Date	Particulars	J.F.	Amount (Rs.)	Date	Particulars	J.F.	Amount (Rs.)	
20.4.2020	To Punjab National Bank	1	50,000					
"	To Loan from HDFC Bank	1	4,00,000					

Folio No. 8

Dr.		Loan from HDFC Bank Account						Cr.
Date	Particulars	J.F.	Amount (Rs.)	Date	Particulars	J.F.	Amount (Rs.)	
				20.4.2020	By Motor Car	1	4,00,000	

Folio No. 9

Dr.		Avon Pharmaceuticals Account						Cr.
Date	Particulars	J.F.	Amount (Rs.)	Date	Particulars	J.F.	Amount (Rs.)	
25.4.2020	To Consultancy Fees	1	7,50,000					

Folio No. 10

Dr.		Consultancy Fees Account						Cr.
Date	Particulars	J.F.	Amount (Rs.)	Date	Particulars	J.F.	Amount (Rs.)	
				25.4.2020	By Punjab National Bank	1	2,50,000	
				25.4.2020	By Avon Pharma	1	7,50,000	

Folio No. 11

Dr.		Salary Account						Cr.
Date	Particulars	J.F.	Amount (Rs.)	Date	Particulars	J.F.	Amount (Rs.)	
30.4.2020	To Salary payable	1	15,000					



Study Note-1 : Process of Accounting

Folio No. 12

Dr.	Salary Payable Account						Cr.
Date	Particulars	J.F.	Amount (Rs.)	Date	Particulars	J.F.	Amount (Rs.)
				30.4.2020	By Salary	1	15,000

Please carefully observe the posting of journal entries into various ledger accounts. Do you see some further calculation in the cash A/c and Mr. Vikas's Capital A/c? What is done is that after posting all

transactions to these accounts, the difference between the debit and credit sides is calculated. This difference is put on the side with smaller amount in order to tally grand totals of both sides. The convention is to write "To Balance c/d" or "By balance c /d" as the case may be. This procedure is normally done at the end of an accounting period. This process is called as "balancing of ledger accounts".

Once the ledgers are balanced for one accounting period, the balance needs to be carried forward to the next accounting period as a running balance. This is done by writing "To Balance b/d" or "By balance b/d" as the case may be after the grand totals. This is also shown in the Cash A/c and Mr. Vikas's Capital Account.

Could you now attempt to balance the other ledger accounts and carry the balances to the next accounting period?

Important Note:

Please remember the balances of personal and real accounts only are carried down to the next accounting period as they represent resources and obligations of the business which will continue to be used and settled respectively in future. Balances of nominal accounts (which represent incomes or gains and expenses or losses) are not carried down to the next period. These balances are taken to the Profit and Loss account (or Income statement) prepared for the period. The net result of the P&L Account will show either net income or net loss which will increase or decrease the owner's equity.

In the above example, please note that the balances of Rent A/c, Consultancy Fees Account and Salary Account will not be carried down to the next period, but to the P&L Account of that period. As illustration, we have shown it for Rent A/c.

1.17.3.6.2 Posting to Ledger Accounts from Subsidiary books

In the above section, we explained posting to ledger accounts directly on the basis of journal entries. In practice, however, we know that use of subsidiary books is in vogue. Let us see how the posting to ledger accounts is done based on these records.



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For each of the subsidiary books, there is a ledger account e.g. for purchase book, there is Purchase Account, for sales book there's Sales A/c, for cash book there will be Cash A/c as well as Bank A/c and so on.

Let us continue with illustration seen in the section 1.17.3.1.3 above and post the totals into respective ledger accounts.

Dr.	Cash Account						Cr.
Date	Particulars	J.F.	Amount (Rs.)	Date	Particulars	J.F.	Amount (Rs.)
1st Jan	To Balance b/d		3,800		By sundries as per cash book		1,500
	To Miscellaneous Receipts		2,500		By Balance c/d		4,800
			6,300				6,300

Dr.	Purchases Account						Cr.
Date	Particulars	J.F.	Amount (Rs.)	Date	Particulars	J.F.	Amount (Rs.)
	To sundries as per purchase book		19,000		By transfer to P&L A/c		19,000

Dr.	Sales Account						Cr.
Date	Particulars	J.F.	Amount (Rs.)	Date	Particulars	J.F.	Amount (Rs.)
	To transfer to P&L A/c		1,72,500		By sundries as per sales book		1,72,500

1.17.3.6.3 Typical Ledger Account Balances

We have seen how to balance various ledger accounts. It can be seen that while some accounts will show debit balance, while the other will show credit balance. Is there any relationship between the type of account (whether it is the account of asset, liability, capital, owner's equity, incomes or gain, expenses or losses) and the kind of balance (debit or credit) it should show?

The answer is generally 'Yes'. You may test to find the following are typical relationships.

Type of Account	Type of balance
All asset accounts	Debit balance
All liability accounts	Credit balance
Capital & Owner's equity account	Credit balance
Expenses or loss accounts	Debit balance
Incomes or gain accounts	Credit balance

Study Note-1 : Process of Accounting

Let us test these possibilities for confirmation. How does one go about testing this? Consider 'Cash A/c'. Whenever business receives cash we debit it, and whenever it is paid we credit it. Is it possible to see a situation that credits to cash are more than debits? In other words could we have negative cash in hand? No. Cash account will therefore always show a debit balance. So is true for all real asset accounts. After solving problems, if the contrary is observed, there is every chance that an error has been made while passing the accounting entries.

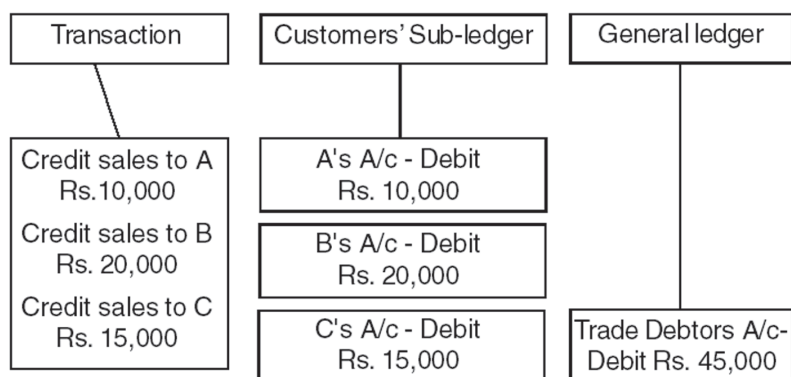
1.17.3.6.4 The Structure of Ledger

In practice, for the sake of convenience and ease of operations, the ledger is subdivided as follows:

- General Ledger:** This contains all main ledger accounts excepting individual accounts of customers, vendors and employees. For these categories there will be only one representative account in the general ledger e.g. for customers - Trade Debtors A/c (or Trade Receivables Control A/c), for suppliers - Trade Creditors A/c (or Trade Payables A/c) etc.
- Sub-Ledgers:** These are primarily, Customers' Ledger, Suppliers Ledger, Employees ledger etc. The customer ledger will have all individual accounts of all customers. Suppliers' ledger will have all individual accounts of all suppliers. Employee ledger will have individual accounts of all employees.

The balances of all individual accounts must tally with the balance reflected in the representative A/c in the general ledger. For this a periodical reconciliation is a must.

For example, if business has 3 customers A, B, and C; then an A/c for each of them is opened in the sub-ledger called Customers ledger and General Ledger will have only one A/c by the name of Trade Debtors A/c. All transactions with each of them will be recorded in the individual accounts as well as the control ledger. See the following:



Such separation is made for better control. A person in charge of customer accounting is given responsibility of all individual customer accounting in the Customers sub-ledger, whereas another



person be given responsibility for Suppliers' sub-ledger. In bigger organizations this division of labour is an absolute necessity. The person looking after General ledger is different.

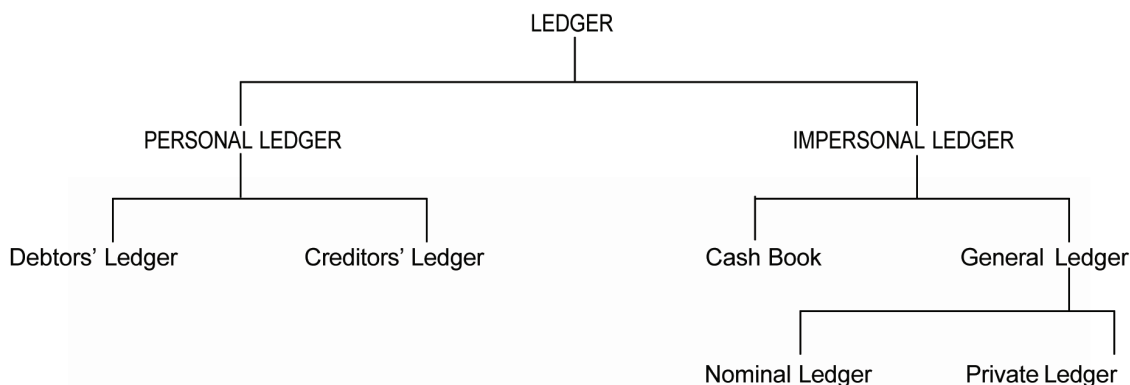
Simultaneous posting of transactions into sub-ledgers A/cs and representative A/cs in general ledger may be quite tedious in manual accounting. But computerised accounting automates this process as well.

1.17.3.6.5 Subdivisions of Ledger

Practically, the Ledger may be divided into two groups -

(a) Personal Ledger & (b) Impersonal Ledger.

They are again sub-divided as :



Personal Ledger: The ledger where the details of all transactions about the persons who are related to the accounting unit, are recorded, is called the Personal Ledger.

Impersonal Ledger: The Ledger where details of all transactions about assets, incomes & expenses etc. are recorded, is called Impersonal Ledger.

Again, Personal Ledger may be divided into two groups:

Viz. (a) Debtors' Ledger, & (b) Creditors' Ledger.

(a) Debtors' Ledger: The ledger where the details of transactions about the persons to whom goods are sold, cash is received, etc. are recorded, is called Debtors' Ledger.

(b) Creditors' Ledger: The ledger where the details of transactions about the persons from whom are purchase goods on credit, pay to them etc. are recorded, is called Creditors' Ledger.

Impersonal Ledger may, again be divided into two group, viz, (a) Cash Book; and (b) General Ledger.

(a) Cash Book: The Book where all cash & bank transactions are recorded, is called Cash Book.



Study Note-1 : Process of Accounting

- (b) General Ledger: The ledger where all transactions relating to real accounts, nominal accounts, details of Debtors' Ledger and Creditors' Ledger are recorded, is called General Ledger.

General Ledger may, again, be divided into two groups. Viz, Nominal Ledger; & Private Ledger.

- (a) Nominal Ledger: The ledger where all transactions relating to incomes and expenses are recorded, is called Nominal Ledger.
- (b) Private Ledger: The Ledger where all transactions relating to assets and liabilities are recorded, is called Private Ledger.

1.17.3.6.6 Advantages of sub-division of Ledger.

The advantages of sub-division of ledger are:

- (a) Easy to Divide work : As a result of sub-division, the division of work is possible and records can be maintained efficiently by the concerned employee.
- (b) Easy to handle : As a result of sub-division, the size and volume of ledger is reduced.
- (c) Easy to collect information: From the different classes of Ledger a particular type of transactions can easily be found out.
- (d) Minimizations of mistakes : As a result of sub-division chances of mistakes are minimized.
- (e) Easy to compute : As a result of sub-division, the accounting work may be computed quickly which is very helpful to the management.
- (f) Fixation of responsibility: Due to sub-division, allotment of different types of work to different employees is done for which concerned employee will be responsible.

1.18 TRIAL BALANCE

After the transactions are posted to various ledger accounts (either from journal or from subsidiary books) and they are balanced, the next stage is to draw up the list of all balances. We know that some ledger accounts will show 'debit balance' (debit side greater than the credit side), while the other will reflect a 'credit balance' (credit side being higher than debit side). All account balances are listed to ensure that the total of all debit balances equals the total of all credit balances. Why does this happen? Remember the dual aspect concept studied earlier in this study note?. According to this concept, every debit has equal corresponding credit. This list of balances is called Trial Balance.

According to the Dictionary for Accountants by Eric. L. Kohler, Trial Balance is defined as "a list or abstract of the balances or of total debits and total credits of the accounts in a ledger, the purpose being to determine the equality of posted debits and credits and to establish a basic



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summary for financial statements". According to Rolland, Trial Balance is defined as "The final list of balances, totaled and combined, is called Trial Balance".

As this is merely a listing of balances, this will always be as on a particular date. Further it must be understood that Trial Balance does not form part of books of account, but it is a report prepared by extracting balances of accounts maintained in the books of accounts.

When this list with tallied debit and credit balances is drawn up, the arithmetical accuracy of basic entries, ledger posting and balancing is ensured. However, it does not guarantee that the entries are correct in all respect. This will be explained later in this chapter.

Although it is supposed to be prepared at the end of accounting period, computerized accounting packages are capable of providing instant Trial Balance reports even on daily basis, as the transactions are recorded almost on line.

Let us prepare the trial balance for the ledger accounts from the illustration 18.

Trial Balance as on...

Account name	Debit (Rs.)	Credit (Rs.)
Cash A/c	6,25,000	
Vikas's capital A/c		5,00,000
Vaibhavi's capital A/c		2,50,000
Furniture A/c	25,000	
Punjab National Bank A/c	2,85,000	
Rent A/c	15,000	
Motor Car	4,50,000	
Loan from HDFC A/c		4,00,000
Avon Pharmaceuticals	7,50,000	
Consultancy fees A/c		10,00,000
Salary A/c	15,000	
Salary payable A/c		15,000
Total	21,65,000	21,65,000

It can be seen that the totals of debit and credit balances is exactly matching. This is the result of double entry book-keeping wherein every debit has equal corresponding credit. Here you can check for yourself, the relationship between type of account and type of balance explained in section 1.17.3.6.3 above.



Study Note-1 : Process of Accounting

1.18.1 Feature's of a Trial Balance

1. It is a list of debit and credit balances which are extracted from various ledger accounts.
2. It is a statement of debit and credit balances.
3. The purpose is to establish arithmetical accuracy of the transactions recorded in the Books of Accounts.
4. It does not prove arithmetical accuracy which can be determined by audit.
5. It is not an account. It is only a statement of account.
6. It is not a part of the final statements.
7. It is usually prepared at the end of the accounting year but it can also be prepared anytime as and when required like weekly, monthly, quarterly or half-yearly.
8. It is a link between books of accounts and the Profit and Loss Account and Balance sheet.

1.18.2 Preparation of Trial Balance:

1. It may be prepared on a loose sheet of paper.
2. The ledger accounts are balanced at first. They will have either "debit-balance" or "credit balance" or "nil-balance".
3. The accounts having debit-balance is written on the debit column and those having credit-balance are written on the credit column.

The sum total of both the balances must be equal, for "Every debit has its corresponding and equal credit".

1.18.3 Purpose of a Trial Balance

It serves the following purposes :

1. To check the arithmetical accuracy of the recorded transactions.
2. To ascertain the balance of any ledger Account.
3. To serve as an evidence of fact that the double entry has been completed in respect of every transaction.
4. To facilitate the preparation of final accounts promptly.

1.18.4 Is Trial Balance indispensable?

It is a mere statement prepared by the accountants for his own convenience and if it agrees, it is assumed that at least arithmetical accuracy has been done although there may be a lot of errors.

Trial Balance is not a process of accounts, but its preparation helps us to finalise the accounts. Since it is prepared on a particular date, as at / as on is stated.



1.18.5 Forms of a Trial Balance

A trial balance may be prepared in two forms, they are -

1. Journal Form
2. Ledger Form

The trial balance must tally irrespective of the form of a trial balance.

1. **Journal Form:** This form of a Trial balance will have a format of Journal Folio. It will have a column for serial number, name of the account, ledger folio, debit amount and credit amount columns in this journal form.

The ledger folio will show the page number on which such account appears in the ledger.

Specimen of Journal Form of Trial Balance:

Trial Balance as on

Sl. No.	Name of the Account	L.F.	Debit Balance (Rs.)	Credit Balance (Rs.)

2. **Ledger Form :** This form of a trial balance have two sides i.e. debit side and credit side. In fact, the ledger form of a trial balance is prepared in the form of an account. Each side of the trial balance will have particulars (name of the account) column, folio column and the amount column.

Specimen of ledger form of Trial Balance

Dr.	Trial Balance as on						Cr.
Date	Name of the Account	L.F.	Amount (Rs.)	Date	Name of the Account	L.F.	Amount (Rs.)

1.18.6 Method of Preparation

1. Total Method or Gross Trial Balance.
2. Balance Method or Net Trial Balance.
3. Compound Method.

These are explained as under :-

1. **Total Method or Gross Trial Balance :** Under this method, two sides of the accounts are totaled.



Study Note-1 : Process of Accounting

The total of the debit side is called the “debit total” and the total of the credit side is called the “credit total”. Debit totals are entered on the debit side of the Trial Balance while the credit total is entered on the credit side of the Trial Balance.

If a particular account has total in one side, it will be entered either in the debit column or the credit column as the case may be.

- Advantages :**
- (a) It facilitates arithmetical accuracy of the accounts.
 - (b) Extraction of ledger balances is not required at the time of preparation of Trial Balance.

Disadvantages : Preparation of final accounts is not possible.

2. **Balance Method or Net Trial Balance :** Under this method, all the ledger accounts are balanced.

The balances may be either “debit-balance” or “credit balance”.

- Advantages :**
- (a) It helps in the easy preparation of final accounts.
 - (b) It saves time and labour in constructing a Trial Balance.

Disadvantages : Errors may remain undisclosed irrespective of the agreement of Trial Balance.

3. **Compound Method :** Under this method, totals of both the sides of the accounts are written in the separate columns. Along with this, the balances are also written in the separate columns. Debit balances are written in the debit column and credit balances are written in the credit column of the Trial Balance.

Advantages : It offers the advantage of both the methods.

Disadvantages : Lengthy process and more time consumed in the preparation of a Trial Balance.

Summary of Rules

Debit Balance	–	All Assets, Drawings, Debtors, Expenses and losses.
Credit Balance	–	All liabilities, Capital, Creditors, Gains and Incomes.

1.18.7 Trial Balance - Utility and Interpretation

The utility of Trial balance could be found in the following:

- (1) It forms the basis for preparation of Financial statements i.e. Profit and Loss Account and Balance sheet.
- (2) A tallied trial balance ensures the arithmetical accuracy of the entries made. If the trial balance does not tally, the errors can be found out, rectified and then financial statements can be prepared.



- (3) It acts as a quick reference. One can easily find out the balance in any ledger account without actually referring to the ledger.
- (4) If the listing of ledger accounts is systematically done in the trial balance, one can do quick time analysis. Hence, listing is usually done in the sequence of Asset accounts, Liability accounts, Capital accounts, Owner's equity accounts, Income or gain accounts and Expenses or losses accounts in that order.

One can draw some quick inferences from trial balance by interpreting the same. If one plots monthly trial balances side by side, one can analyse the movement of balances in various accounts e.g. one can see how expenses are increasing or decreasing or showing a trend of movements. By comparing the owner's equity balances as on two dates, one can interpret the business result e.g. if the equity has gone up, one can interpret that business has earned net profit and vice versa.

1.18.8 Trial Balance and Errors

We have seen that a tallied Trial Balance (T. B.) ensures arithmetical accuracy. What does it mean? It means entries have been passed as per double entry, that every debit has equal corresponding credit. If the T.B. does not tally, there could be errors in transaction entry. Such errors are called 'Errors affecting trial balance'. These can be:

- (a) Only one effect of a transaction is posted to ledger e.g. for rent paid in cash, if entry is posted to cash but not to rent account, then obviously the T.B. will not match.
- (b) Posting of wrong amount in one of the ledger accounts e.g. rent of Rs. 1,000 is paid in cash. The posting to Rent A/c is done for Rs. 1,000, Cash A/c is recorded at Rs. 10,000. The T.B. will not tally.
- (c) If one of the posting is entered twice, T.B. will not match.
- (d) If the balance in a ledger is not correctly taken to the T.B. e.g. the Rent A/c has a balance of Rs.1,000, but while taking it to the T.B. it is taken as Rs. 100, the T.B. will through up difference.
- (e) Taking balance to the wrong side in the T.B. e.g. a debit balance of Rs. 5,00,000 in Debtors A/c is taken as credit balance in the TB, then there will be a mismatch.
- (f) Wrong carry forwards also will result in the T.B. mismatch.

No financial statements can be prepared if the T.B. does not tally. Hence, the errors will have to be rectified before proceeding further. The accountants therefore endeavour to minimize errors by being more careful and by doing periodical scrutiny of the entries.

There are certain type of errors that will not affect tallying of the T.B. i.e. it will tally but still there will be errors. These are as follows:

- (a) **Error of omission:** if any entry is totally missed, the T.B. will tally but will be incorrect and incomplete.



Study Note-1 : Process of Accounting

- (b) **Compensating error:** if there are two errors that are compensating each other, still the T.B. will tally but not accurate.
- (c) **Wrong a/c head:** if entry for insurance paid is wrongly debited to Commission A/c, tallying of T.B. will not be affected.
- (d) **Error of duplication:** if a transaction is recorded twice, again the T.B. will match.
- (e) **Error of principle:** if interest received is wrongly entered as debit to interest and credit to cash, there won't be any mismatch in the T.B.

For the above type of errors, the identification process is very time consuming. Only strict vigil and ongoing audit of entries could minimize such errors. Of course, the computerised accounting packages do provide built mechanisms to avoid occurrence of these mistakes.

After preparation of TB, if the difference not major, it is temporarily transferred to "Suspense A/c" until the errors are located and corrected.

1.18.8.1 Errors which are not disclosed by a Trial Balance

The following errors cannot be detected by a Trial Balance :

- (a) **Errors of Omission:** When the transaction is not at all recorded in the books of accounts, i.e. neither in the debit side nor in the credit side of the account - trial balance will agree.
- (b) **Errors of Commission:** Where there is any variation in figure/amount, e.g. instead of Rs. 800 either Rs. 80 or Rs.8,000 is recorded, in both sides of ledger accounts - trial balance will agree.
- (c) **Errors of Principal:** When accounts are prepared not according to double entry principle e.g. Purchase of a Plant wrongly debited to Purchase Account - Trial balance will agree.
- (d) **Errors of Misposting:** When wrong posting is made to a wrong account instead of a correct one although amount is correctly recorded, e.g., sold goods to B but wrongly debited to D's Account- trial balance will agree.
- (e) **Compensating Errors :** When one error is compensated by another error e.g. Discount Allowed Rs.100 not debited to Discount Allowed Account, whereas interest received Rs.100, but not credit to Interest Account - trial balance will agree.

1.18.8.2 Procedure to locate Errors:

If the Trial Balance does not agree, the following procedure should carefully be followed:

- (i) At first, check all ledger account balance one by one.
- (ii) Addition of both the columns (Debit and Credit) should be checked.
- (iii) If any difference comes divide the same by 2 and see whether the said figure appear on the correct side or not.



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- (iv) Additions of the subsidiary books, and ledger accounts to be checked up.
- (vi) Posting from subsidiary books to the ledger to be checked up.
- (vii) Opening balance of all account whether brought forward correctly or not to be checked up.
- (viii) Even if the trial balance does not agree upto this level checking should be started again from the journal and book of original entry using tick mark (<).

AT A GLANCE

Trial Balance as at / as on

Heads of Accounts	Side of Trial Balance	Reasons
Cash in hand	Debit	Assets
Cash at Bank	Debit	Assets
Cash at Bank (overdrawn)	Credit	Liability
Bank Overdraft	Credit	Liability
Capital	Credit	Liability
Opening stock	Debit	Assets
Wages	Debit	Expenses
Purchase	Debit	Expense/Increase in stock
Carriage Inwards	Debit	Expenses
Freight	Debit	Expenses
Royalty on production	Debit	Expenses
Gas, Water, Fuel	Debit	Expenses
Motive Power	Debit	Expenses
Import Duty	Debit	Expenses
Sales	Credit	Income/Decrease in stock
Discount Allowed	Debit	Losses
Discount Received	Credit	Gains
Bad Debts	Debit	Losses
Reserve /Provision for Bad & Doubtful Debt (Opening)	Credit	Gains
Commission Received	Credit	Incomes
Salaries	Debit	Expenses
Commission paid	Debit	Expenses
Rent, rates, and taxes	Debit	Expenses
Repairs and maintenance	Debit	Expenses
Insurance	Debit	Expenses
Carriage outward	Debit	Expenses

Study Note-1 : Process of Accounting

Trade charges	Debit	Expenses
Royalty on sales	Debit	Expenses
Interest paid	Debit	Expenses
Interest received	Credit	Income
Advertisement	Debit	Expenses
Sundry expenses	Debit	Expenses
Miscellaneous expenses	Debit	Expenses
Miscellaneous receipts	Credit	Incomes
Income tax	Debit	Drawings/Assets
L.I.C. Premium	Debit	Drawings/Assets
Office expenses	Debit	Expenses
Export duty	Debit	Expenses
Allowances	Debit	Losses
Rebates	Debit	Losses
Sales tax	Debit	Expenses
Horses and Carts	Debit	Assets
Watch Dog Squad	Debit	Assets
Loan Secured	Credit	Liability
Loans Advanced	Debit	Assets
Reserve Funds	Credit	Liability
Sinking Fund	Credit	Liability
Sinking Fund Investments	Debit	Assets
Ecology Fund	Credit	Liability
Ecology Fund Investments	Debit	Assets
Building Fund	Credit	Liability
Building	Debit	Assets
Land	Debit	Assets
Plant	Debit	Assets
Machinery	Debit	Assets
Furniture & fittings	Debit	Assets
Motor vehicles	Debit	Assets
Computer	Debit	Assets
Office equipments	Debit	Assets
Goodwill	Debit	Assets
Patent rights	Debit	Assets
Copyrights	Debit	Assets



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Trade marks	Debit	Assets
Investments	Debit	Assets
Shares & Securities	Debit	Assets
G. P. Notes	Debit	Assets
Sundry debtors	Debit	Assets
Sundry creditors	Credit	Liability
General Reserve	Credit	Liability
Bill Receivable	Debit	Assets
Bills Payable	Credit	Liability
Provision for Discount on Debtors	Credit	Liability
Provision for Discount on Creditors	Debit	Assets
Lighting and Heating	Debit	Expense
Drawings	Debit	Assets
Contribution to Provident Fund	Debit	Assets
Prize Fund	Credit	Liability
Depreciation	Debit	Losses
Provision for Depreciation	Credit	Liability
Returns Inwards	Debit	Losses
Returns Outwards	Credit	Gains
Freehold Property	Debit	Assets
Premises	Debit	Assets
Leasehold Property	Debit	Assets
Loose Tools	Debit	Assets
Petty Cash	Debit	Assets
Provident Fund	Credit	Liability
Debentures Purchased	Debit	Assets
Debentures (from Public)	Credit	Liability
Loan on Mortgage	Credit	Liability
Prepaid Expenses	Debit	Assets
Outstanding Expenses	Credit	Liability
Bad Debts Recovered	Credit	Gains
Accrued Incomes	Debit	Assets
Apprenticeship Premium received	Credit	Income
Books	Debit	Assets
Newspaper and Magazine	Debit	Expenses
Profit and Loss A/c (Dr.)	Debit	Losses



Study Note-1 : Process of Accounting

Profit and Loss A/c (Cr.)	Credit	Gains
Accumulated Depreciation	Credit	Liability
Postage and Telegram	Debit	Expense
Travelling & Conveyance	Debit	Expenses

Illustration 21.

From the following ledger account balances, prepare a Trial Balance of Mr. Sen for the year ended 31st March, 2019.

Capital Rs. 80,000 ; Sales Rs.10,00,000; Adjusted Purchase Rs. 8,00,000; Current A/c(cr) Rs. 10,000; Petty Cash

Rs. 10,000; Sales Ledger Balance Rs. 1,20,000; Purchase Ledger Balance Rs. 60,000; Salaries Rs.24,000; Carriage Inwards Rs. 4,000; Carriage Outward Rs. 6,000; Discount Allowed Rs. 10,000; Building Rs. 80,000; Outstanding Expenses Rs. 10,000; Prepaid Insurance Rs. 2,000; Depreciation Rs. 4,000; Cash at Bank Rs. 80,000; Loan A/c (cr) Rs. 66,000; Profit & Loss A/c(cr) Rs. 20,000; Bad Debts Recovered Rs. 2,000; Stock at 31.03.2019

Rs. 1,20,000; Interest Received Rs. 10,000; Accrued Interest Rs. 4,000; Investment Rs. 20,000; Provision for Bad Debts (01.04.2018) Rs. 6,000; General Reserve Rs. 20,000.

Solution:

Trial Balance of Mr. Sen as on 31st March, 2019

Dr.

Cr.

Heads of Accounts	Amount (Rs.)	Heads of Accounts	Amount (Rs.)
Adjusted Purchase	8,00,000	Capital	80,000
Petty Cash	10,000	Sales	10,00,000
Sales Ledger Balance	1,20,000	Current A/c	10,000
Salaries	24,000	Purchase Ledger Balance	60,000
Carriage Inward	4,000	Outstanding Expenses	10,000
Discount Allowed	10,000	Loan A/c	66,000
Building	80,000	Profit & Loss A/c(cr)	20,000
Prepaid Insurance	2,000	Bad Debts Recovered	2,000
Depreciation	4,000	Interest Received	10,000
Cash at Bank	80,000	Provision for Bad debts	6,000
Stock (31.03.2013)	1,20,000	General Reserve	20,000
Accrued Interest	4,000		
Investment	20,000		
Carriage outward	12,84,000		12,84,000

Note: Closing Stock will appear in Trial Balance since there is adjusted purchase.



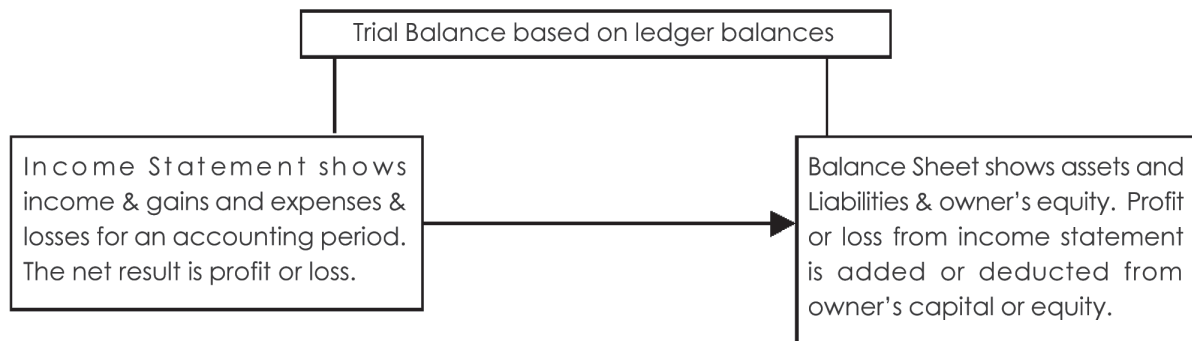
Adjusted purchase = Opening Stock + Purchase - Closing Stock.

It may be noted that if only adjusted purchase is considered then the matching concept is affected. Hence, to satisfy the matching concept, closing stock is also considered in Trial Balance.

1.19 MEASUREMENT, VALUATION AND ACCOUNTING ESTIMATES

At the end of the last section, it was stated that Trial Balance forms the basis for preparing financial statements. However, there are certain other tasks that have to be completed before these final accounts are prepared. You know that accounting entries are made on the basis of actual transactions carried out during an accounting period. These are all included in the trial balance. However, there could be certain other business realities which are to be recognized as either asset, liability, income, gain, expense, loss or a combination thereof. As we know the matching concept necessitates the consideration of all aspects which may affect the financial result of the business. Technically these are called as adjustments for which entries need to be passed, without which the financial statements will not give a true and fair view of business activity. We discuss some of these entries and adjustments in the following sections.

Before discussing these, let us understand the meaning of Income Statement and Balance Sheet.



Depending on the nature of business, the income statement is prepared in different forms like:

- a) In case of manufacturing concern, a manufacturing, trading and P&L A/c is prepared
- b) In case of a trading or service organization, a trading and P&L A/c is prepared

The manufacturing or trading accounts show Gross margins (or gross losses) and the P&L A/c shows Net Profit or net loss.

The Balance Sheet exhibits the list of assets (which indicate resources owned) and the liabilities & owners' capital and equity (which shows how the resources are funded).

For company type of organizations, standard formats for P&L and Balance Sheet are given in the Companies Act that is to be adhered to. The accounting should be as per the prescribed Accounting Standards.

Study Note-1 : Process of Accounting

1.19.1 Closing Stock

We know when goods are purchased for resale we include them in Purchases A/c, while goods sold are shown in Sales A/c. At the end of accounting period, some of these goods may remain unsold. If we show the entire cost of purchases in income statement, it will not be as per the matching concept. We should only show the cost of those goods that are sold during the period. The balance cost should be carried forward to the next accounting period through the balance sheet. How should the closing stock be valued? According to the conservative principle, the stock is valued at lower of cost or market price. If cost of stock is Rs. 125000 and its realizable market price is only Rs. 115000, then the value considered is Rs. 115000 only. What it means is the difference of Rs. 10000 is charged off to the current periods profits.

Students are advised to refer to Accounting Standard 2 - 'Valuation of Inventories' to get thorough knowledge.

Please remember the closing stock figure does not appear in the trial balance, but is valued and directly taken to the P&L A/c. The entry passed for this is:

Closing Stock A/c	Dr
To Trading and P&L A/c	

In solving the examination problem, this entry is not actually passed, but the effect of its outcome is given. Here, one effect is "show closing stock as asset in balance sheet" and second effect is "show it on the credit side of trading a/c".

Note : But, if the closing stock appears in the debit side of Trial Balance, it means it has already been adjusted against purchases. In that case, the closing stock will appear only in the asset side of the Balance Sheet.

1.19.2 Depreciation

When the business uses its assets to earn income, there is wear and tear of the asset life. Assets will have limited life and as we go on using it, the value diminishes. Again the question to be asked is - at what value should the asset be shown in the balance sheet? Consider a machine was bought on 1st April 2019 for Rs. 200000. It's used for production activity throughout the year. When the final accounts are being prepared, at what value should it be shown in balance sheet as on 31st March 2020?

Well, according to cost principle initial entry for purchase of machine is shown at cost paid for it e.g. Rs.200000 in this case. But the fact that the machine is used must be recognized in financials. Hence the value in the balance sheet must be brought down to the extent of its use. This is called as Depreciation. How is it calculated? While there are different methods of calculating depreciation (explained in subsequently), the simple idea is to spread it over the useful life of the asset, so that at the end of its life the value is zero. In our example, if useful life of the machine is



taken as 10 years, the depreciation will be simply Rs. 200000 ÷ 10 i.e. Rs. 20000 every year. So a depreciation of Rs. 20000 will be charged to the profit of every year and value of asset will be brought down by the same value.

Students are advised to refer to Accounting Standard 6 issued by ICAI to get thorough knowledge on Depreciation accounting.

The entry passed for this is:

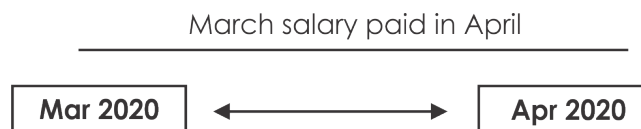
Depreciation A/c Dr
 To Fixed Asset A/c

The effect given is one - include in the P&L A/c as expense for the period and two - reduce from asset value in the balance sheet.

Please refer study Note 3 for further explanation.

1.19.3 Accrued Expenses or Outstanding Expenses

There may be expenses incurred for the current accounting period, but not actually paid for. The matching concept, however, necessitates that this expense must be recognized as expense for the current year and should not be deferred till its actual payment. Typically, we know salary for the month is normally paid in the 1st week of the next month. Imagine the accounting period close on 31st March. The salary for the month of March is not paid till 31st March. But as it is related to this month, it must be booked as expense for the current month and also as a liability payable in the next month (which is in next accounting period). This can be shown as follows:



The entry for this is:

Expense A/c Dr
 To Outstanding Expense A/c or Expense payable A/c

The two effects when preparing the final accounts are:

One - add in respective expense in P&L A/c and two - show as a liability in the balance sheet.

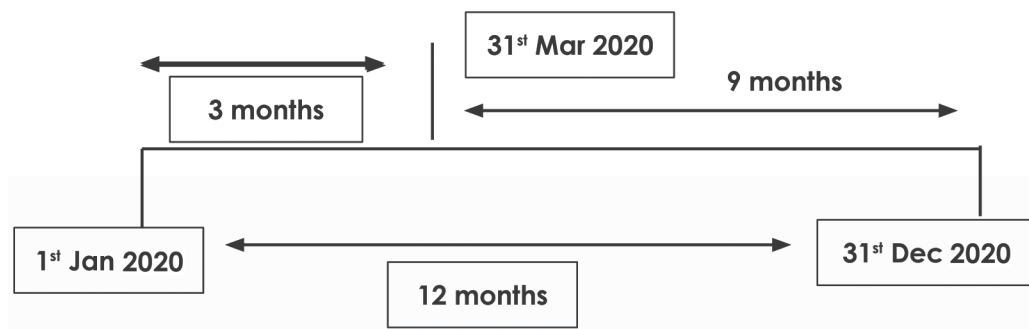
1.19.4 Prepaid Expenses

At times we may pay for certain expenses which are period related. For example, the business has taken an insurance policy against fire on which the annual premium payable is Rs. 75000. The policy is taken on 1st January 2020 valid till 31st December 2020. But the company's accounting period ends on 31st March 2020. When considering the insurance expense for the accounting year, what amount should be considered? See the following.

Study Note-1 : Process of Accounting

As can be seen, out of the total premium period of 12 months, only 3 months are related to the current accounting period and the remaining 9 months' premium is related to the next accounting period. Hence only 3 months' premium is to be considered as expense for the current year i.e. Rs.18750 ($75000 \div 4$).

The entry for this is:



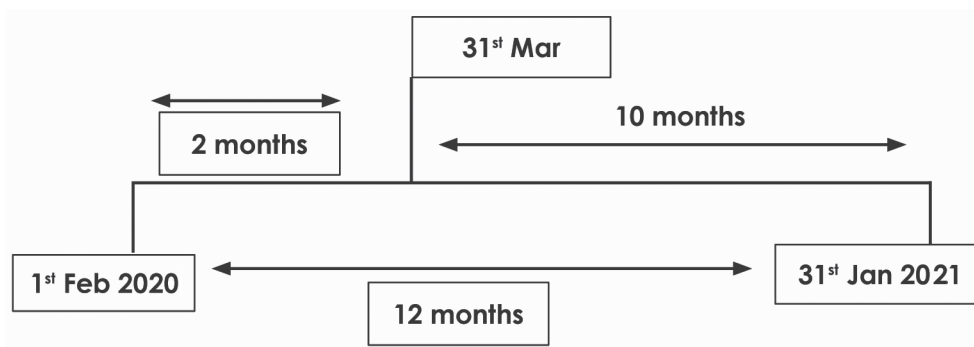
Prepaid Insurance A/c Dr
To Insurance A/c

The two effects while preparing final accounts are:

One - Reduce from respective expense in P&L A/c and two - show as an asset in the balance sheet

1.19.5 Accrued Incomes

Just as expenses accrue, there are instances of income getting accrued at the end of accounting period. The extent to which it accrues, it must be booked as income for the current accounting period. Consider, the business has put a One year fixed deposit of Rs. 100000 with Citi Bank at a fixed interest of 9% p.a. on 1st February 2020 and the interest is credited by the bank on a semi-annual basis. Also, consider that the accounting period ends on 31st March 2020. The Citi bank will credit the 1st semi-annual interest on 31st July 2020 and the next on 31st January 2021. Now, consider the following :





It can be noticed that interest for the 2 months will be considered as accrued as on 31st of March 2020 and must be taken as income for the current accounting year.

The entry for this is:

Accrued Interest A/c	Dr
To Interest A/c	

The two effects while preparing final accounts are:

One - Show as income in the P&L A/c and two - show as an asset in the balance sheet

1.19.6 Income Received in Advance

If an income is received which is not related to the current accounting period, it cannot be included in the current year's P&L A/c. So, if it's already included as income it must be reduced.

The entry for this is:

Respective Income A/c	Dr
To Income received in advance A/c	

The effects while preparing final account are:

One - Reduce from respective income and two - show it as liability in balance sheet

1.19.7 Accounting In Practice

These are days of computerised accounting. Even smaller firms like sole proprietors use accounting packages like Tally 9.0 which are very strong. At this stage it is necessary to understand the practical aspects of how accounting is actually done by these packages. Based on years of experience, they come with a standard chart of account. The chart of account is nothing but master ledger accounts and they are numerically coded for quick and easy identification and reporting. There are customized screens made to enter different transactions. Hence, the user can not by mistake put a purchase transaction into sales book. The customers and vendors are also alpha-numerically coded for ease of identification. Once the basic documents are entered, the job of posting, balancing and trial balance is all automated. So actually, most of the potential errors can be avoided.

There is an increased feeling among students that when there are automated systems available, why should one go through the study of manual processes. This is absolutely essential for grasping basic concepts. Once, you thoroughly understand them, it will be easy to operate any computerised accounting package in practice.

Comprehensive Illustrations

To enable the students to get complete grasp of this process, comprehensive examples are given below.

Study Note-1 : Process of Accounting

Illustration 22.

Journalize the following transactions in the books of Gaurav, post them into ledger and prepare trial balance for June 2020 :

June 1	Gaurav started business with Rs. 10,00,000 of which 25% amount was borrowed from wife.
June 4	Purchased goods from Aniket worth Rs. 40,000 at 20% TD and 1/5th amount paid in cash.
June 7	Cash purchases Rs. 25,000.
June 10	Sold goods to Vishakha Rs. 30,000 at 30% TD and received 30% amount in cash.
June 12	Deposited cash into bank Rs. 20,000.
June 15	Uninsured goods destroyed by fire Rs. 5,500.
June 19	Received commission Rs. 3,500.
June 22	Paid to Aniket Rs. 25,500 in full settlement of A/c.
June 25	Cash stolen from cash box Rs. 1,000.
June 27	Received from Vishakha Rs. 14,500 and discount allowed Rs. 200.
June 30	Interest received Rs. 2,400 directly added in our bank account.

Solution

In the books of Gaurav Journal

				Dr.	Cr.
Date 2020	Particulars		L.F.	Amount (Rs.)	Amount (Rs.)
1-Jun	Cash A/c	Dr		1,000,000	
	To Capital A/c				750,000
	To Loan from Wife A/c (Being capital brought into business)				250,000
4-Jun	Purchases A/c	Dr		32,000	
	To Cash A/c				6,400
	To Aniket's A/c (Being goods purchased at 20% TD & 1/5th amount paid in cash)				25,600
7-Jun	Purchases A/c	Dr		25,000	
	To Cash A/c (Being cash purchases)				25,000



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10-Jun	Cash A/c	Dr		6,300	
	To Sales A/c	Dr		14,700	
	Vishakha's A/c (Being goods sold at 30% TD & 30% amount received in cash)				21,000
12-Jun	Bank A/c	Dr		20,000	
	To Cash A/c (Being cash deposited in bank)				20,000
15-Jun	Loss by Fire A/c	Dr		5,500	
	To Purchases A/c (Being uninsured goods lost by fire)				5,500
19-Jun	Cash A/c	Dr		3,500	
	To Commission A/c (Being commission received)				3,500
22-Jun	Aniket's A/c	Dr		25,600	
	To Cash A/c				25,500
	To Discount A/c (Being paid to Aniket in full settlement & dis- count received)				100
25-Jun	Loss by Theft A/c	Dr		1,000	
	To Cash A/c (Being cash stolen)				1,000
27-Jun	Cash A/c	Dr		14,500	
	Discount A/c			200	
	To Vishakha's A/c (Being amount received from Vishakha & discount allowed)				14,700
30-Jun	Bank A/c			2,400	
	To Interest A/c (Being interest received directly added into bank account)				2,400
				1,150,700	1,150,700



Study Note-1 : Process of Accounting

Cash Account							
Dr.							Cr.
Date	Particulars	J.F.	Amount (Rs.)	Date	Particulars	J.F.	Amount (Rs.)
1/6/20	To Capital A/c		7,50,000	4/6/20	By PurchasesA/c		6,400
1/6/20	To Loan from Wife A/c		2,50,000	7/6/20	By Purchases A/c		25,000
10/6/20	To Sales A/c		6,300	12/6/20	By Bank A/c		20,000
19/6/20	To Commission A/c		3,500	22/6/20	By Aniket's A/c		25,500
27/6/20	To Vishakha's A/c		14,500	25/6/20	By Loss by Theft A/c		1,000
				30/6/20	By Balance c/d		9,46,400
			10,24,300				10,24,300

Capital Account							
Dr.							Cr.
Date	Particulars	J.F.	Amount (Rs.)	Date	Particulars	J.F.	Amount (Rs.)
30/6/20	To Balance c/d		7,50,000	1/6/20	By Cash A/c		7,50,000
			7,50,000				7,50,000
				1/7/20	By Balance b/d		7,50,000

Loan from Wife Account							
Dr.							Cr.
Date	Particulars	J.F.	Amount (Rs.)	Date	Particulars	J.F.	Amount (Rs.)
30/6/20	To Balance c/d		2,50,000	1/6/20	By Cash A/c		2,50,000
			2,50,000				2,50,000
				1/7/20	By Balance b/d		2,50,000

Purchases Account							
Dr.							Cr.
Date	Particulars	J.F.	Amount (Rs.)	Date	Particulars	J.F.	Amount (Rs.)
4/6/20	To Cash A/c		6,400	15/6/20	By loss by fire		5,500
4/6/20	To Aniket's A/c		25,600	30/6/20	By Bal c/d		51,500
7/6/20	To Cash A/c		25,000				
			57,000				57,000
1/7/20	To Balance b/d		51,500				



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Aniket's Account							
Dr.							Cr.
Date	Particulars	J.F.	Amount (Rs.)	Date	Particulars	J.F.	Amount (Rs.)
22/6/20	To Cash A/c		25,600	4/6/20	By Purchases A/c		25,500
22/6/20	To Discount A/c		100				2,50,000
			25,600				25,600

Vishakha's Account							
Dr.							Cr.
Date	Particulars	J.F.	Amount (Rs.)	Date	Particulars	J.F.	Amount (Rs.)
10/6/20	To Sales A/c		14,700	27/6/20	By Cash A/c		14,500
				27/6/20	By Discount A/c		200
			14,700				14,700

Sales Account							
Dr.							Cr.
Date	Particulars	J.F.	Amount (Rs.)	Date	Particulars	J.F.	Amount (Rs.)
30/6/20	To Balance c/d		21,000	10/6/20	By Cash A/c		6,300
				10/6/20	By Vishakha's A/c		14,700
			21,000				21,000
				1/7/20	By Balance b/d		21,000

Bank Account							
Dr.							Cr.
Date	Particulars	J.F.	Amount (Rs.)	Date	Particulars	J.F.	Amount (Rs.)
12/6/20	To Cash A/c		20,000	30/6/20	By Balance c/d		22,400
30/6/20	To Interest A/c		2,400				
			22,400				22,400
1/7/20	To Balance b/d		22,400				

Loss by Fire Account							
Dr.							Cr.
Date	Particulars	J.F.	Amount (Rs.)	Date	Particulars	J.F.	Amount (Rs.)
5/6/20	To Purchases A/c		5,500	30/6/20	By Balance c/d		5,500
			5,500				5,500
1/7/20	To Balance b/d		5,500				



Study Note-1 : Process of Accounting

Dr. Commission Account				Cr.			
Date	Particulars	J.F.	Amount (Rs.)	Date	Particulars	J.F.	Amount (Rs.)
30/6/20	To Balance c/d		3,500	19/6/20	By Cash A/c		3,500
			3,500				3,500
			3,500	1/7/20	By Balance b/d		3,500

Dr. Discount Account				Cr.			
Date	Particulars	J.F.	Amount (Rs.)	Date	Particulars	J.F.	Amount (Rs.)
27/6/20	To Vishakha's A/c		200	22/6/20	By Aniket's A/c		100
				30/6/20	By Balance c/d		100
			200				200
1/7/20	To Balance b/d		100				

Dr. Loss by Theft Account				Cr.			
Date	Particulars	J.F.	Amount (Rs.)	Date	Particulars	J.F.	Amount (Rs.)
25/6/20	To Cash A/c		1,000	30/6/20	By Balance c/d		1,000
			1,000				1,000
1/7/20	To Balance b/d		1,000				

Dr. Interest Account				Cr.			
Date	Particulars	J.F.	Amount (Rs.)	Date	Particulars	J.F.	Amount (Rs.)
30/6/20	To Balance c/d		2,400	30/6/20	By Bank A/c		2,400
			2,400				2,400
				1/7/20	By Balance b/d		2,400

Trial Balance as on 30.6.20

	Dr.	Cr.
Name of Account	(Rs.)	(Rs.)
Cash A/c	9,46,400	----
Capital A/c	----	7,50,000
Loan from Wife A/c	----	2,50,000



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Purchases A/c	51,500	----
Aniket's A/c	----	----
Vishakha's A/c	----	----
Sales A/c	----	21000
Bank A/c	22,400	----
Loss by Fire A/c	5,500	----
Commission A/c	----	3500
Discount A/c	100	----
Loss by Theft A/c	1,000	----
Interest A/c	----	2,400
Total	10,26,900	10,26,900

Illustration 23.

Journalize the following transactions in the books of M/s Kothari & Sons, post them into ledger and prepare trial balance for April 2020:

Apr. 1	Commenced business with Rs. 40,000. Apr. 4: Bought goods for cash Rs. 4,000
Apr. 7	Sold goods Rs. 700
Apr. 10	Bought goods from M/s Bhandari Bros. Rs. 3,000 at 10% trade discount.
Apr. 14	Purchased machinery of Rs. 5,000 from M/s Kirloskar Bros.
Apr. 16	Paid for transportation of machinery Rs. 500 & installation charges Rs. 300 on it. Apr. 20: Paid quarterly interest on borrowed amount of Rs. 5,000 at 12% p.a.
Apr. 24	Supplied goods to M/s Kunal & Sons Rs. 3,500.
Apr. 27	Paid to M/s Bhandari Bros. Rs. 2600 in full settlement of account.
Apr. 28	M/s Kunal & Sons returned goods worth Rs. 300 & paid for Rs. 1,200 on account. Apr. 29: Received commission Rs. 250.
Apr. 30	Paid conveyance to manager Rs. 450.

Solution

In the books of M/s Kothari and Sons Journal

			Dr.	Cr.
Date 2020	Particulars	L.F.	Amount (Rs.)	Amount (Rs.)
1-Apr	Cash A/c	Dr	40,000	
	To Capital A/c (Being cash introduced as capital)			40,000



Study Note-1 : Process of Accounting

4-Apr	Purchases A/c	Dr		4,000	
	To Cash A/c (Being bought goods for cash)				4,000
7-Apr	Cash A/c	Dr		700	
	To Sales A/c (Being sold goods for cash)				700
10-Apr	Purchases A/c	Dr		2,700	
	To M/s Bhandari Bros. A/c (Being purchased goods at 10% TD)				2,700
14-Apr	Machinery A/c	Dr		5,000	
	To M/s Kirloskar Bros. A/c (Being purchased machinery on credit)				5,000
16-Apr	Machinery A/c	Dr		800	
	To Cash A/c (Being transportation & installation charges on machinery paid)				800
20-Apr	Interest A/c	Dr		150	
	To Cash A/c (Being paid quarterly interest on borrowed amt. of Rs. 5000 at 12% p.a.)				150
24-Apr	M/s Kunal & Sons A/c	Dr		3,500	
	To Sales A/c (Being goods sold on credit)				3,500
27-Apr	M/s Bhandari Bros. A/c	Dr		2,700	
	To Cash A/c				2,600
	To Discount A/c (Being paid in full settlement & discount received)				100
28-Apr	Return Inwards A/c	Dr		300	
	Cash A/c			1,200	
	To M/s Kunal & Sons A/c (Being goods returned & received on account)				1,500
29-Apr	Cash A/c	Dr		250	
	To Commission A/c (Being commission received)				250
30-Apr	Conveyance A/c	Dr		450	
	To Cash A/c (Being conveyance paid to manager)				450
	Total			61,750	61,750



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Ledger

Dr.	Cash Account						Cr.
Date	Particulars	J.F.	Amount (Rs.)	Date	Particulars	J.F.	Amount (Rs.)
11/4/20	To Capital A/c		40,000	4/4/20	By Purchases A/c		4,000
7/4/20	To Sales A/c		700	16/4/20	By Machinery A/c		800
28/4/20	To M/s Kunal & Sons A/c		1200	20/4/20	By Interest A/c		150
29/4/20	To Commission A/c		250	27/4/20	By M/s Bhandari Bros. A/c		2,600
				30/4/20	By Conveyance A/c		450
				30/4/20	By Balance c/d		34,150
			42,150				42,150
1/5/20	To Balance b/d		34,150				

Dr.	Capital Account						Cr.
Date	Particulars	J.F.	Amount (Rs.)	Date	Particulars	J.F.	Amount (Rs.)
30/4/20	To Balance c/d		40,000	1/4/20	By Cash A/c		40,000
			40,000				40,000
				1/5/20	By Balance b/d		40,000

Dr.	Purchase Account						Cr.
Date	Particulars	J.F.	Amount (Rs.)	Date	Particulars	J.F.	Amount (Rs.)
4/4/20	To Cash A/c		4,000	30/4/20	By Balance c/d		6700
10/4/20	To M/s Bhandari Bros. A/c		2,700				
			6,700				6,700
1/5/20	To Balance b/d		6,700				



Study Note-1 : Process of Accounting

Dr.				Sales Account				Cr.
Date	Particulars	J.F.	Amount (Rs.)	Date	Particulars	J.F.	Amount (Rs.)	
30/4/20	To Balance c/d		4,200	7/4/20	By Cash A/c		700	
				24/4/20	By M/s Kunal & Sons A/c		3,500	
			4,200				4,200	
				1/5/20	By Balance b/d		4,200	

Dr.				M/s. Bhandari Bros. Account				Cr.
Date	Particulars	J.F.	Amount (Rs.)	Date	Particulars	J.F.	Amount (Rs.)	
27/4/20	To Cash A/c		2,600	10/4/20	By Purchases A/c		2,700	
27/4/20	To Discount A/c		100					
			2,700				2,700	

Dr.				Machinery Account				Cr.
Date	Particulars	J.F.	Amount (Rs.)	Date	Particulars	J.F.	Amount (Rs.)	
14/4/20	To M/s Kirloskar Bros. A/c		5,000	30/4/20	By Balance c/d		5,800	
16/4/20	To Cash A/c		800					
			5,800				5,800	
1/5/20	To Balance b/d		5,800					

Dr.				M/s Kirloskar Bros. Account				Cr.
Date	Particulars	J.F.	Amount (Rs.)	Date	Particulars	J.F.	Amount (Rs.)	
30/4/20	To Balance c/d		5,000	14/4/20	By Machinery A/C		5,000	
			5,000				5,000	
				1/5/20	By Balance b/d		5,000	

Dr.				Interest Account				Cr.
Date	Particulars	J.F.	Amount (Rs.)	Date	Particulars	J.F.	Amount (Rs.)	
20/4/20	To Cash A/c		150	30/4/20	By Balance c/d		150	
			150				150	
1/5/20	To Balance b/d		150					



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M/s Kunal & Sons Account							
Dr.							Cr.
Date	Particulars	J.F.	Amount (Rs.)	Date	Particulars	J.F.	Amount (Rs.)
24/4/20	To Sales A/c		3,500	28/4/20	By Return Inwards A/c		300
				28/4/20	By Cash A/c		1,200
				30/4/20	By Balance c/d		2,000
			3,500				3,500
1/5/20	To Balance b/d		2,000				

Discount Account							
Dr.							Cr.
Date	Particulars	J.F.	Amount (Rs.)	Date	Particulars	J.F.	Amount (Rs.)
0/4/20	To Balance c/d		100	27/4/20	By M/s Bhandari Bros. A/c		100
			100				100
				1/5/20	By Balance b/d		100

Return Account							
Dr.							Cr.
Date	Particulars	J.F.	Amount (Rs.)	Date	Particulars	J.F.	Amount (Rs.)
28/4/20	To M/s Kunal & Sons A/c		300	30/4/20	By Balance c/d		300
			300				300
1/5/20	To Balance b/d		300				

Commission Account							
Dr.							Cr.
Date	Particulars	J.F.	Amount (Rs.)	Date	Particulars	J.F.	Amount (Rs.)
0/4/20	To Balance c/d		250	29/4/20	By Cash A/c		250
			250				250
				1/5/20	By Balance b/d		250



Study Note-1 : Process of Accounting

Dr.		Conveyance Account					Cr.
Date	Particulars	J.F.	Amount (Rs.)	Date	Particulars	J.F.	Amount (Rs.)
30/4/20	To Cash A/c		450	30/4/20	By Balance c/d		450
			450				450
1/5/20	To Balance b/d		450	1/5/20	By Balance b/d		250

Trial Balance as on 30.4.20

	Dr.	Cr.
Name of Account	(Rs.)	(Rs.)
Cash A/c	34,150	----
Capital A/c	----	40,000
Purchases A/c	6700	----
Sales A/c	----	4,200
M/s Bhandari Bros. A/c	----	----
Machinery A/c	5,800	----
M/s Kirloskar Bros. A/c	----	5,000
Interest A/c	150	----
M/s Kunal & Sons A/c	2,000	----
Discount A/c	----	100
Return Inwards A/c	300	----
Commission A/c	----	250
Conveyance A/c	450	----
Total	49,550	49,550

Illustration 25.

Enter the following transactions in the proper subsidiary books and post them to ledger accounts. Also prepare Trial Balance:

2020

Jan. 1	Purchased goods worth Rs. 6,000 from M/s Akshaykumar & Sons.
Jan. 5	Sold goods to M/s Vinaykumar Rs. 2,000.
Jan. 7	Purchased goods from M/s Vinod Bros. Rs. 4,000 at 5% TD.
Jan. 9	Sold goods to Pravinkumar on cash Rs. 500.



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Jan. 12	Bought goods from Jayant Kumar Rs. 3,500 at 10% TD. Jan. 17: Supplied goods to M/s Rajnikant Rs. 2,500 at 5% TD. Jan. 20: Sold furniture to M/s Narendrakumar worth Rs. 1,200. Jan. 22: Returned goods to M/s Vinod Bros. Rs. 500 gross.
Jan. 25	M/s Vinaykumar returned goods worth Rs. 500.
Jan. 27	Sent debit note to M/s Akshaykumar for Rs. 200.
Jan. 30	Sold goods to Narendrakumar worth Rs. 9,000 and received half amount on the spot.
Apr. 30	Paid conveyance to manager Rs. 450.

Purchases Book

Date	Particulars	Inward Invoice No.	L.F.	Amount (Rs.)
1/1/20	M/s Akshaykumar			6,000
7/1/20	M/s Vinod Bros. (4000 - 5% TD)			3,800
12/1/20	Jayant Kumar (3500 - 10% TD)			3,150
				12,950

Sales Book

Date	Particulars	Outward Invoice No.	L.F.	Amount (Rs.)
5/1/20	M/s Vinaykumar			2,000
17/1/20	M/s Rajnikant (2500 - 5% TD)			2,375
30/1/20	M/s Narendrakumar			4,500
				8,875

Return Inwards Book

Date	Particulars	Credit Note No.	L.F.	Amount (Rs.)
5/1/20	M/s Vinaykumar			500
				500

Return Outwards Book

Date	Particulars	Debit Note No.	L.F.	Amount (Rs.)
22/1/20	M/s Vinod Bros. (500 - 5% TD)			475
27/1/20	M/s Akshaykumar			200
				675



Study Note-1 : Process of Accounting

Dr.		Cash Book					Cr.
Date	Particulars	J.F.	Amount (Rs.)	Date	Particulars	J.F.	Amount (Rs.)
9/1/20	To Sales A/c (Being cash sales)		500	31/1/20	By Balance c/d		5,000
30/1/20	To Sales A/c (Being cash sales)		4,500				
			5,000				5,000
1/2/20	To Balance b/d		5,000				

Dr.		Purchases Account					Cr.
Date	Particulars	J.F.	Amount (Rs.)	Date	Particulars	J.F.	Amount (Rs.)
31/1/20	To Sundries as per purchases book			31/1/20	By Balance c/d		12,950
			12,950				12,950
1/2/20	To Balance b/d		12,950				

Dr.		Sales Account					Cr.
Date	Particulars	J.F.	Amount (Rs.)	Date	Particulars	J.F.	Amount (Rs.)
31/1/20	To Balance c/d		13,875	9/1/20	By Cash A/c		500
				30/1/20	By Cash A/c		4,500
				31/1/20	By Sundries as per Sales Book		8,875
			13,875				13,875
				1/2/20	By Balance b/d		13,875

Dr.		Return Inwards Account					Cr.
Date	Particulars	J.F.	Amount (Rs.)	Date	Particulars	J.F.	Amount (Rs.)
31/1/20	To Sundries as per return inwards book		500	31/1/20	By Balance c/d		500
1/2/20	To Balance b/d						
			500				500



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Dr.				Return Outwards Account				Cr.
Date	Particulars	J.F.	Amount (Rs.)	Date	Particulars	J.F.	Amount (Rs.)	
31/1/20	To Balance c/d		675	31/1/20	By Sundries as per return outwards book		675	
			675	1/2/20	By Balance b/d		675	

Dr.				M/s Akshaykumar Account				Cr.
Date	Particulars	J.F.	Amount (Rs.)	Date	Particulars	J.F.	Amount (Rs.)	
27/1/20	To Return Outwards A/c		200	1/1/20	By Purchases A/c		6000	
31/1/20	To Balance c/d		5,800					
			6,000				6,000	
				1/2/20	By Balance b/d		5,800	

Dr.				M/s Vinod Bros Account				Cr.
Date	Particulars	J.F.	Amount (Rs.)	Date	Particulars	J.F.	Amount (Rs.)	
22/1/20	To Return Outwards A/c		475	7/1/20	By Purchases A/c		3800	
31/1/20	To Balance c/d		3,325					
			3,800				3800	
				1/2/20	By Balance b/d		3325	

Dr.				Jayant Kumar Account				Cr.
Date	Particulars	J.F.	Amount (Rs.)	Date	Particulars	J.F.	Amount (Rs.)	
31/1/20	To Balance c/d		3,150	12/1/20	By Purchases A/c		3,150	
				1/2/20	By Balance b/d		3,150	

Dr.				M/s Vinay Kumar Account				Cr.
Date	Particulars	J.F.	Amount (Rs.)	Date	Particulars	J.F.	Amount (Rs.)	
5/1/20	To Sales A/c		2,000	25/1/20	By Return Inwards A/c		500	
				31/1/20	By Balance c/d		1,500	
			2,000				2,000	
1/2/20	To Balance b/d		1,500					



Study Note-1 : Process of Accounting

Dr.	M/s Rajnikant Account						Cr.
Date	Particulars	J.F.	Amount (Rs.)	Date	Particulars	J.F.	Amount (Rs.)
17/1/20	To Sales A/c		2,375	31/1/20	By Balance c/d		2,375
1/2/20	To Balance b/d		2,375				

Dr.	M/s Narendra Kumar Account						Cr.
Date	Particulars	J.F.	Amount (Rs.)	Date	Particulars	J.F.	Amount (Rs.)
20/1/20	To Furniture A/c		1,200	31/1/20	By Balance c/d		5,700
30/1/20	To Sales A/c		4,500				
			5,700				5,700
1/2/20	To Balance b/d		5,700				

Dr.	Furniture Account						Cr.
Date	Particulars	J.F.	Amount (Rs.)	Date	Particulars	J.F.	Amount (Rs.)
31/1/20	To Balance c/d		1,200	20/1/20	By M/s Narendra Kumar A/c		1,200
				1/2/20	By Balance b/d		1,200

Trial Balance as on 31.1.20

	Dr.	Cr.
Name of Account	(Rs.)	(Rs.)
Cash A/c	5,000	-----
Purchases A/c	12,950	-----
Sales A/c	-----	13,875
Return Inwards A/c	500	-----
Return Outwards A/c	-----	675
M/s Akshaykumar A/c	-----	5,800
M/s Vinod Bros. A/c	-----	3,325
Jayant Kumar A/c	-----	3,150
M/s Vinaykumar A/c	1,500	-----
M/s Rajnikant A/c	2,375	-----
M/s Narendrakumar A/c	5,700	-----
Furniture A/c	-----	1,200
Total	28,025	28,025



Illustration 26.

The total of debit side of Trial Balance of a larger boot and shoe repairing firm as on 31.12.2020 is Rs. 1,66,590 and that of the credit side is Rs. 42,470. After several checking and re-checking the mistakes are discovered :

Items of Account	Correct Figure (as it would be)	Figures as it appear in the Trial Balance
Opening Stock	Rs. 14,900	Rs. 14,800
Repairs	Rs. 61,780	Rs. 61,780 (appear in the Debit side)
Rent & Taxes	Rs. 2,160	Rs. 2,400
Sundry Creditors	Rs. 6,070	Rs. 5,900
Sundry Debtors	Rs. 8,060	Rs. 8,310

Ascertain the correct total of the Trial Balance.

Solution:

Particulars	Debit (Rs.)	Credit (Rs.)
Total as per Trail Balance	1,66,590	42,470
Opening Stock understated (14,900-14,800)	+100	-
Repairs being credit balance, but shown as debit balance	-61,780	+61,780
Rent & Taxes overstated (2,400-2,160)	-240	-
Sundry Creditors understated (6,070-5,900)	-	+170
Sundry Debtors overstated (8,310-8,060)	-250	-
Total	1,04,420	1,04,420

1.20 OPENING ENTRIES, CLOSING ENTRIES, TRANSFER ENTRIES AND RECTIFICATION ENTRIES

(i) Opening Entries:

The opening entry is an item which is passed in the Journal proper or General Ledger. The purpose of passing this entry is to record the opening balances of the accounts transferred from the previous year to the new year. The accounts which are appearing on the assets side of balance sheet are debited in the opening entry while which accounts are appearing in the liabilities side are credited.

Study Note-1 : Process of Accounting

At the end of each accounting period, the books of accounts need to be closed for preparation of final accounts. Also, in the beginning of the new accounting period, new books of accounts are to be opened. For this purpose, opening and closing entries need to be passed. These entries are passed in journal proper.

The opening entries are passed only for those ledger A/c balances which are carried forward from earlier period to the current accounting period. In other words, the balances of assets, liabilities and owners' capital and equity accounts are only considered for such opening entries. The opening entry is passed with the closing balances of assets and liabilities & capital accounts in the last year's balance sheet.

The entry can be given as:

All Asset A/cs Dr

To All Liabilities A/c

To Owners' Capital A/cs

Illustration 26.

Consider the following balances in the Balance Sheet as on 31st March 2020. Pass the opening entry on 1st April 2020.

Subodh's Capital A/c	2,75,000
Loan from HDFC bank	4,25,000
Plant and machinery	3,30,000
Cash in hand	20,000
Balance at Citi bank	1,75,000
Trade Debtors	3,55,000
Closing stock	1,35,000
Trade Payables	2,95,000
Outstanding Expenses	40,000
Prepaid Insurance	20,000

Solution:

The opening entry will be as follows:

Plant and machinery A/c	Dr	3,30,000	
Cash in hand A/c	Dr	20,000	
Balance at Citi bank A/c	Dr	1,75,000	
Trade Debtors A/c	Dr	3,55,000	
Closing stock A/c	Dr	1,35,000	
Prepaid Insurance	Dr	20,000	



To Subodh's Capital A/c			2,75,000
To Loan from HDFC bank A/c			4,25,000
To Trade Payables A/c			2,95,000
To Outstanding Expenses A/c			40,000

(ii) Closing Entries:

All the expenses and gains or income related nominal accounts must be closed at the end of the year. In order to close them, they are transferred to either Trading A/c or Profit and Loss A/c. Journal entries required for transferring them to such account is called a 'closing entry'.

The Closing Entries are passed on the basis of trial balance for transferring the balances to Trading and profit and loss A/c. These entries are mainly for:

- a) For transferring purchases and direct expenses (goods related) to Trading A/c

Trading A/c	Dr
To Opening stock A/c	
To Purchases A/c	
To Factory expenses A/c	
To Freight & carriage inward A/c	

- b) For transferring sales and closing stocks Sales A/c

Closing Stock A/c	Dr
To Trading A/c	Dr

- c) For transferring gross profit or gross loss to P&L A/c

For Gross Profit	Dr
Trading A/c	
To P&L A/c	
For Gross Loss	
P&L A/c	Dr
To Trading A/c	

- d) For transferring expenses

P&L A/c	Dr
To Respective expense A/c	

- e) For transferring Incomes

Respective income A/cs	Dr
To P&L A/c	



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f) For transferring Net profit or Net loss

For Net Profit

P&L A/c

Dr

To Capital A/c

For Net Loss

Capital A/c

Dr

To P&L A/c

Illustration 27.

Pass closing entries for the following particulars as on 31st March 2019 presented by X Ltd.

Particulars	Amount (Rs.)
Opening stock	10,000
Purchases	50,000
Wages	5,000
Returns outward	5,000
Sales	1,00,000
Returns inward	10,000
Salaries	8,000
Insurance	1,000
Bad debts	3,000
Interest received	3,000
Discount allowed	4,000
Discount received	3,000
Closing stock	15,000

Solution

In the Books of X Ltd.

Journal

Date	Particulars			Dr.	Cr.
2019			L.F.	Amount (Rs.)	Amount (Rs.)
March 31st	Trading A/c	Dr.		75,000	
	To, Opening Stock A/c				10,000
	To, Purchases A/c				50,000
	To, Wages A/c				5,000
	To, Returns inward A/c (Transfer to balances for closing the latter accounts)				10,000



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	Sales A/c	Dr.		1,00,000	
	Returns outward A/c	Dr.		5,000	
	Closing Stock A/c	Dr.		15,000	
	To, Trading A/c (Transfer of balances for closing the former accounts)				1,20,000
	Trading A/c	Dr.		45,000	
	To, Profit and Loss A/c (Gross profit transferred)				45,000
	Profit and Loss A/c	Dr.		16,000	
	To, Salaries A/c				8,000
	To, Insurance A/c				1,000
	To, Bad Debts A/c				3,000
	To, Discount allowed A/c (Transfer of balances for closing the latter accounts)				4,000
	Interest received A/c	Dr.		3,000	
	Discount received A/c	Dr.		3,000	
	To, Profit and Loss A/c (Transfer of balances for closing the former accounts)				6,000
	Profit and Loss A/c	Dr.		35,000	
	To, Capital A/c (Net profit transferred to Capital A/c)				35,000

(iii) Transfer Entries:

When it is necessary for an amount or balance of one account to be transferred to some other account, it is done by means of a transfer journal entry in the Journal Proper.

i.e. Transfer of Total Drawings A/c. to Capital A/c

Capital A/c	Dr.
To, Drawings A/c	

(iv) Rectification Entries (Rectification of errors):

These entries are passed when errors or mistakes are discovered in accounting records. These entries are also known as Correction Entries. These entries are also passed in Journal Proper.

In this study note, you were introduced to the reasons why errors could occur and to the fact that while some errors affect trial balance and some errors do not affect it. In this section, we will see

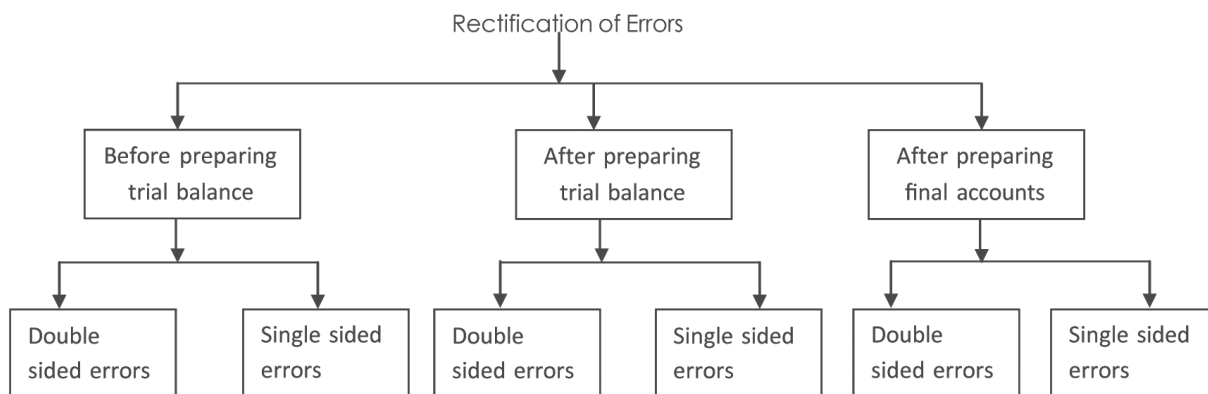
Study Note-1 : Process of Accounting

in depth how the corrections are made to the wrong entries.

When the errors affecting the T.B. are made, the normal practice is to put the difference to an A/c called as 'Suspense A/c' till the time errors are located. On identification of errors, the one effect goes to the correct A/c and the other effect to the Suspense A/c. This is done for one sided errors e.g. if sales book total is wrongly taken, but individual customers are correctly debited. Such error will cause difference in trial balance as only Sales A/c is wrongly credited. In such cases the rectification entry will be passed through Suspense A/c. In all other cases the rectification is done by debiting or crediting the correct A/c head and by crediting or debiting the wrong A/c head.

Let us recapitulate the types of errors and the ways to rectify them in the following table.

Type of error		Rectification
a)	Error of principle - entering revenue expense as capital expense or vice versa or entering revenue receipt as capital receipt or vice versa.	A journal entry is passed to give correct effect.
b)	Error of Omission - transaction forgotten to be entered in books of accounts.	Simply, the correct entry is passed.
c)	Errors of commission - entering to wrong head of account.	Debit or credit wrong A/c head and post it to correct head.
d)	Compensating errors - more than one error that could compensate effect of each other.	Pass correcting entry
e)	Wrong totaling of subsidiary books	As it affects T.B., pass through Suspense A/c
f)	Posting on wrong side of an A/c	Pass an entry with double effect - one to cancel wrong side and other to give effect on correct side
g)	Posting of wrong amount	Pass entry with differential amount





A. Before Preparation of Trail Balance

If errors are detected before the preparation of Trail Balance, the effect of each error should be known.

The errors are of two types: viz

- (a) Double Sided Error;
- (b) Single Sided Error

(a) Double Sided Error:

The following principles should be followed for the purpose.

- (i) What was the correct entry?
- (ii) What entry had been done?
- (iii) Rectifying entry.

Example: Purchased a Building for (Rs.) 3,00,000 wrongly passed through purchase account.

Solutions:

(i)	Building A/c	Dr. 3,00,000	
	To Cash A/c		3,00,000
(ii)	Purchase A/c	Dr. 3,00,000	
	To Cash A/c		3,00,000
(iii)	Building A/c	Dr. 3,00,000	
	To Purchase A/c		3,00,000

(b) Single Sided Error

Under the circumstances, no separate entry is required but the affected account should be rectified by appropriate posting.

Example: Purchase account was overcast by (Rs.) 10,000.

Solution:

The correction to be made in Purchase Account in the following manner.

Dr.	Purchase Account		Cr.
	Amount (Rs.)		Amount (Rs.)
To		By Error - Wrong posting	10,000

So, purchase account should be credited by (Rs.) 10,000.

Study Note-1 : Process of Accounting

B. After Preparation of Trial Balance

If the errors are detected after the preparations of trial balance, the following procedure should be followed:

(a) Double Sided Errors; and (b) Single Sided Errors.

(a) Double Sided Errors:

Same as method (a) above i.e., before preparation of Trial Balance.

(b) Single Sided Errors:

In case of Single side errors, relevant account to be rectified by applying Suspense Account.

Suspense Account

If the Trial Balance does not agree we cannot prepare final accounts. In order to prepare final account, the difference so appeared in trial balance is to be passed through Suspense Account. When the errors will be located and rectified suspense account will automatically be Nil or closed. The suspense account will appear in the Balance Sheet. When it appears in the debit side of trial balance, the same will appear in the assets side of the Balance Sheet and vice-versa.

Example: Sales Day Book was overcast by (Rs.) 1,000.

		(Rs.)	(Rs.)
Sales A/c	Dr.	1,000	
To Suspense A/c			1,000

C. After Preparation of Final Accounts

If the errors are detected after the preparation of final accounts the following steps should carefully be followed.

(a) For Double Sided Errors

- Same as (A) before preparation of Trial Balance or (B) after preparation of Trial Balance. But all the nominal accounts are to be replaced by Profit and Loss Adjustment Account. And the rest one will be same as (A) or (B) stated earlier.
- Suspense Account will be carried forward to the next year; and
- Real and Personal Accounts are to be carried forward to the next year. Example: Purchase a Plant wrongly debited to Purchase Account for (Rs.) 10,000.

Solution:

(i) If after Trial Balance

Plant A/c	Dr.
To Purchase A/c	



(ii) If after Final Account

Plant A/c Dr.
To Profit and Loss Adjustment A/c

(b) for Single Sided Errors:

Same principle is to be followed like (B) after preparation of Trial Balance and all the nominal account are to be preplaced by Profit and Loss Adjustment Account.

Example - Discount allowed was not posted to discount Account for (Rs.) 500.

Solution:

(i) If after Trial Balance

Discount Allowed A/c Dr.
To Suspense A/c

(ii) If after Final Account

Profit and Loss Adjustment A/c Dr.
To Suspense A/c

Illustration 28.

Rectify the following errors assuming that the errors were detected (a) Before the Preparation of Trial Balance; (b) After the preparation of Trial Balance and (c) After the preparation of Final Accounts.

- (i) Purchase Plant for (Rs.) 10,000 wrongly passed through Purchase Account.
- (ii) Sales Day Book was cast short by (Rs.) 1,000.
- (iii) Cash paid to Mr. X for (Rs.) 1,000 was posted to his account as (Rs.) 100.
- (iv) Purchase goods from Mr. T for (Rs.) 3,500 was entered in the Purchase Day Book as (Rs.) 500.
- (v) Paid salary for (Rs.) 3,000 wrongly passed through wages account.

Solution:

**In the Books of
Journal (without narration)**

Before preparation of Trial Balance				After preparation of Trial Balance			After preparation of Final Accounts		
		Dr.	Cr.		Dr.	Cr.		Dr.	Cr.
i)	Plant A/c	10,000		Plant A/c	10,000		Plant A/c	10,000	
	To Purchase A/c		10,000	To Purchase A/c		10,000	To P&L Adjustment A/c	10,000	

Study Note-1 : Process of Accounting

(ii)	Sales account will be credited with (Rs.)	1,000		Suspense A/c	1,000		Suspense A/c	1,000	
				To Sales A/c.		1,000	To P&L Adjustment A/c	1,000	
(iii)	X Account will be debited when (Rs.)	900		X A/c	900		X A/c	900	
				To Suspense A/c		900	To Suspense A/c		900
(iv)	Purchase A/c	3,000		Purchase A/c	3,000		P&L Adjustment A/c	3,000	
	To T A/c		3,000	To T A/c		3,000	To T's A/c.		3,000
(v)	Salary A/c	3,000		Salary A/c	3,000		P&L Adjustment A/c.	3,000	
	To Wages A/c		3,000	To wages A/c.		3,000	To P&L Adjustment A/c		3,000

Illustration 29.

A merchant, while balancing his books of accounts notices that the T.B. did not tally. It showed excess credit of (Rs.) 1,700. He placed the difference to Suspense A/c. Subsequently he noticed the following errors:

- Goods brought from Narayan for (Rs.) 5,000 were posted to the credit of Narayan's A/c as (Rs.) 5,500
- An item of (Rs.) 750 entered in Purchase returns book was posted to the credit of Pandey to whom the goods had been returned.
- Sundry items of furniture sold for (Rs.) 26,000 were entered in the sales book.
- Discount of (Rs.) 300 from creditors had been duly entered in creditor's A/c but was not posted to discount A/c.

Pass necessary journal entries to rectify these errors. Also show the Suspense A/c.

Solution:

- Goods bought from Narayan are posted to credit of his A/c as (Rs.) 5,500 instead of (Rs.) 5,000. Here, it is correct to credit Narayan's A/c. But the mistake is extra credit of (Rs.) 500. This is one sided error, as posting to purchases A/c is correctly made. So the rectification entry will affect the suspense A/c. This needs to be reversed by the rectification entry:

Narayan's A/c	Dr.	500	
To Suspense A/c			500



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- (b) Goods bought from Pandey were returned back to him. It should have appeared on the debit side of his A/c. For rectifying we will need to debit his A/c with double the amount i.e. (Rs.) 1500 ((Rs.) 750 to cancel the wrong credit and another (Rs.) 750 to give effect for correct debit) and the effect will go to Suspense A/c. The correction entry is:

Pandey A/c	Dr.	1,500	
To Suspense A/c			1,500

- (c) Sale of furniture was recorded in sales book. What's wrong here? Remember that sales book records sale of goods only and nothing else. Sale of furniture will appear in either cash book (if sold for cash) or journal proper (if sold on credit). Hence, wrong credit to Sales A/c must be removed and credit should be given to Furniture A/c. It's important to note that this rectification entry will not affect the Suspense A/c. The correction entry is:

Sales A/c	Dr	26,000	
To Furniture A/c			26,000

- (d) The discount received from creditor is not entered in discount A/c but was correctly recorded in creditors' A/c. This is one sided error and will therefore be routed through suspense for correction. A discount is received; it must be credited being an income.

Suspense A/c	Dr	300	
To Discount received A/c			300

Let us now see how suspense A/c will look like. Excess credit of (Rs.) 1,700 in Trial Balance will be shown on the debit side of suspense A/c. This will bring in total debit equal to total credit.

Dr.		Suspense Account					Cr.
Date	Particulars	J.F.	Amount (Rs.)	Date	Particulars	J.F.	Amount (Rs.)
	To Balance b/d		1,700		By Narayan		500
	To Discount received		300		By Pandey		1,500
			2,000				2,000

Please observe that after correcting passing all rectification entries, the Suspense A/c tallies automatically.

Illustration 30.

Pass necessary journal entries to rectify the following errors:

- (a) An amount of (Rs.) 200 withdrawn by owner for personal use was debited to trade expenses.
(b) Purchase of goods of (Rs.) 300 from Nathan was wrongly entered in sales book.
(c) A credit sale of (Rs.) 100 to Santhanam was wrongly passed through purchase book.

Study Note-1 : Process of Accounting

- (d) (Rs.) 150 received from Malhotra was credited to Mehrotra.
- (e) (Rs.) 375 paid as salary to cashier Dhawan was debited to his personal A/c.
- (f) A bill of (Rs.) 2,750 for extension of building was debited to building repairs A/c
- (g) Goods of (Rs.) 500 returned by Akashdeep were taken into stock, but returns were not posted.
- (h) Old furniture sold for (Rs.) 200 to Sethi was recorded in sales book.
- (i) The period end total of sales book was under cast by (Rs.) 100
- (j) Amount of (Rs.) 80 received as interest was credited to commission.

Solution:

Date	Particulars			Amount (Rs.)	Amount (Rs.)
(a)	Wrong Entry	Trade Expenses	Dr	200	
		To Cash			200
	Correct entry	Drawings	Dr	200	200
		To cash			200
	Rectification entry	Drawings	Dr	200	
		To Trade Expenses			200
(b)	Wrong Entry	Nathan	Dr	300	
		To Sales			300
	Correct entry	Purchases	Dr	300	
		To Nathan			300
	Rectification entry	Purchases	Dr	300	
		Sales	Dr	300	
		To Nathan			600
(c)	Wrong Entry	Purchases	Dr	100	
		To Santhanam			100
	Correct entry	Santhanam	Dr	100	
		To Sales			100
	Rectification entry	Santhanam	Dr	200	
		To Sales			100
		To Purchases			100



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(d)	Wrong Entry	Cash	Dr	150	
		To Mehrotra			150
	Correct entry	Cash	Dr	150	
		To Malhotra			150
	Rectification entry	Mehrotra	Dr	150	
		To Cash			150
(e)	Wrong Entry	Dhawan	Dr	375	
		To Cash			375
	Correct entry	Salary	Dr	375	
		To Cash			375
	Rectification entry	Salary	Dr	375	
		To Dhawan			375
(f)	Wrong Entry	Building Repairs	Dr	2,750	
		To Cash			2,750
	Correct entry	Buildings	Dr	2,750	
		To Cash			2,750
	Rectification entry	Buildings	Dr	2,750	
		To Building Repairs			2,750
(g)	Wrong Entry	No Entry Passed			
	Correct entry	Sales Returns	Dr	500	
		To Akashdeep			500
	Rectification entry	Sales Returns	Dr.	500	
		To Akashdeep			500
(h)	Wrong Entry	Sethi	Dr	200	
		To Sales			200
	Correct entry	Sethi	Dr	200	
		To Furniture			200
	Rectification entry	Sales	Dr	200	
		To Furniture			200
(i)	Wrong Entry	No Entry Passed			
	Correct entry	Suspense	Dr	100	
		To Sales			100
	Rectification entry	Suspense	Dr	100	
		To Sales			100



Study Note-1 : Process of Accounting

(j)	Wrong Entry	Cash	Dr	80	
		To Commission			80
	Correct entry	Cash	Dr	80	
		To Interest			80
	Rectification entry	Commission	Dr.	80	
		To Interest			80

EFFECT OF ERRORS ON PROFIT OR LOSS

Some errors may affect the profit or loss for the period while other won't. How to find it out? Remember, the P & L A/c reflects items of incomes, gains, expenses and losses. All these accounts are nominal accounts. When an error occurs which affects a nominal account, it will affect profit or loss otherwise not. So, errors that affect real and personal accounts will not affect profit or loss.

Illustration 31.

Rectifying the following errors by way of journal entries and work out their effect on profit or loss of the concern:

- Return inward book was cast short by Rs. 500.
- Rs. 300 received from Ram has been debited to Mr. Shyam.
- Wages paid for the installation of a machine debited to wages account for Rs. 1,000.
- A purchase made for Rs. 1,000 was posted to purchase account as Rs. 100.
- Purchase of furniture amounting to Rs. 3,000 debited to purchase account.
- Goods purchased for proprietor's use for Rs. 1,000 debited to purchase account.

Solution

In the Books of X Ltd.

Journal

Date	Particulars		L.F.	Dr. Amount (Rs.)	Cr. Amount (Rs.)
(a)	Return Inward A/c	Dr.		500	
	To, Suspense A/c				500
	(Return Inward Book was cast short, now rectified.)	Dr.		15,000	
(b)	Suspense A/c	Dr.		600	
	To, Ram A/c				300
	To Shyam A/c (Received from Mr. Ram has been debited to Mr. Shyam A/c, now rectified.)				300



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(c)	Machinery A/c	Dr.		1,000	
	To, Wages A/c (Wages paid for maintenance of machinery debited to Wages A/c, now rectified.)				1,000
(d)	Purchase A/c	Dr.		900	
	To, Suspense A/c (Purchase account was short by Rs. 900, now rectified.)				900
(e)	Furniture A/c	Dr.		3,000	
	To, Purchase A/c (Furniture purchased wrongly debited to purchase account, now rectified)				3,000
(f)	Drawings A/c	Dr.		1,000	
	To, Purchase A/c (Goods purchased for proprietor's use, debited to purchase account, now rectified.)				1,000

Effect on Profit

Date	Particulars	Increase (Rs.)	Decrease (Rs.)
(a)	Decrease in Profit		500
(b)	No Effect in Profit	-	-
(c)	Increase in Profit	1,000	-
(d)	Decrease in Profit		900
(e)	Increase in Profit	3,000	-
(f)	Increase in Profit	1,000	-
	Total	5,000	1,400
	Increase in Profit	-	3,600
		5,000	5,000

Illustration 32.

The books of M/s Shakti trading for the year ended 31st march 2020 were closed with a difference that was posted to Suspense A/c. The following errors were found subsequently:

- Goods of Rs. 12,500 returned to Thick & Fast Corporation were recorded in Return Inward book as Rs. 21,500 and from there it was posted to the debit of Thick & Fast Corporation.
- A credit sale of Rs. 7,600 was wrongly posted as Rs. 6,700 to customer's A/c in sales ledger.



Study Note-1 : Process of Accounting

- c) Closing stock was overstated by Rs. 5,000 being totaling error in the schedule of inventory.
- d) Rs. 8900 paid to Bala was posted to the debit of Sethu as Rs. 9,800
- e) Goods purchased from Evan Traders for Rs. 3,250 was entered in sales book as Rs. 3,520
- f) Rs. 1,500, being the total of discount column on the payment side of the cash book was not posted.

Rectify the errors and pass necessary entries giving effects to Suspense A/c and P & L Adjustment A/c.

Solution

- a) There are 2 errors: one - return outward is wrongly recorded as return inward and two - amount is also recorded wrongly. First, we need to remove extra debit to Thick & Fast corporation i.e. Rs. 9,000 (21,500-12,500) by crediting it. Also we need to remove wrong credit of Rs. 21500 in sales return by debiting it and credit Rs. 12,500 to Purchase returns A/c.

The rectification entry will be:

Suspense A/c	Dr	21,500
To Thick & Fast Corp		9,000
To P & L Adjustment A/c		12,500

- b) In this case, error has occurred only in customer's A/c. hence, profit or loss won't be affected and the P & L Adjustment A/c will not be in picture. As customer's A/c is debited for Rs. 6,700 instead of

Rs. 7,600, it needs to be corrected.

The rectification entry will be:

Sundry Debtors A/c	Dr	900
To Suspense A/c		900

- c) Over casting of closing stock had affected profit which must be reduced through P & L Adjustment A/c.

The rectification entry is:

P & L Adjustment A/c	Dr	5,000
To Suspense A/c		5,000

- d) As only personal accounts are affected, there won't be an effect on Profits. So rectification will be done through Suspense A/c only. The rectification entry is:

Bala A/c	Dr	8,900
Suspense A/c	Dr	900
To Sethu A/c		9,800



- e) This transaction involves correction of purchase as well as sales, and hence will affect profit. As the purchases were booked as sales, we will need to cancel sales by debiting and freshly debit purchase. So overall effect on profit will be $3,250 + 3,520$ i.e. 6,770. The rectification entry will be:

P & L Adjustment A/c	Dr	6,770
To Evan Traders		6,770

- f) If discount is appearing on payment side of cash book, it indicates discount received while making payment and is an item of income. Hence, it will affect profit. The accounting entry will be:

Suspense A/c	Dr	1,500
To P & L Adjustment A/c		1,500

Illustration 33.

You are presented with a trial balance of S Ltd as on 30.06.2020 showing the credit is in excess by Rs. 415 which was been carried to Suspense Account. On a close scrutiny of the books, the following errors were revealed:

- A cheque of Rs. 3,456 received from Sankar after allowing him a discount of Rs. 46 was endorsed to Sharma in full settlement for Rs. 3,500. The cheque was finally dishonored but no entries are passed in the books.
- Goods of the value of Rs. 230 returned by Sen were entered in the Purchase Day Book and posted therefrom to Das as Rs. 320.
- Bad debts aggregating Rs. 505 written off during the year in the Sales Ledger but were not recorded in the general ledger.
- Bill for Rs. 750 received from Mukherjee for repairs to Machinery was entered in the Inward Invoice Book as Rs. 650.
- Goods worth Rs. 1,234 Purchased from Mr. Y on 28.6.2020 had been entered in Day Book and credited to him but was not delivered till 5 th June 2020. Stock being taken by the purchase on 30.06.2020. The title of the goods was, however, passed on 28.06.2020.
- Rs. 79 paid for freight on Machinery was debited to freight account as Rs. 97. You are required to pass the necessary journal entries for correcting the books.

Study Note-1 : Process of Accounting

Solution

In the books of S Ltd.

Journal

				Dr.	Cr.
Date	Particulars		L.F.	Amount (Rs.)	Amount (Rs.)
(a)	Sankar A/c	Dr.		3,502	
	Discount Received A/c	Dr.		44	
	To, Sharma A/c				3500
	To Discount Allowed A/c (Cheque received from Sankar was endorsed to Sharma after allowing discount Rs.46 , it was dishonored, now rectified)				46
(b)	Return Inward A/c	Dr.		230	
	Das A/c	Dr.		320	
	To, Purchase A/c				230
	To, Sen A/c				230
	To Suspense A/c (Goods returned by sen for Rs. 230 wrongly recorded in Purchase Day Book as an credit to Das as Rs. 320, now rectified.)				90
(c)	Bad debts A/c	Dr.		505	
	To Suspense A/c (Bad debts written off but not recorded, now rectified)				505
(d)	Repairs A/c	Dr.		750	
	To, Purchase A/c				650
	To, Mukherjee A/c (Repairs of machinery for Rs. 750 wrongly recorded as Rs. 650 on Purchase A/c, now rectified.)				100
(e)	Goods- in- Transit A/c	Dr.		1,234	
	To Trading A/c (Goods were in Transit which were not considered, now rectified)				1,234
(f)	Machinery A/c	Dr.		79	
	Suspense A/c			18	
	To Freight A/c (Amount paid for freight on machinery was wrongly debited to freight account, now rectified)				97



Illustration 34.

The books of accounts of A Co. Ltd. for the year ending 31.3.2019 were closed with a difference in books carried forward. The following errors were detected subsequently:

- Return outward book was under cast by Rs. 100.
- Rs. 1,500 being the total of discount column on the credit side of the cash book was not posted.
- Rs. 6,000 being the cost of purchase of office furniture was debited to Purchase A/c.
- A credit sale of Rs. 760 was wrongly posted as Rs. 670 to the customers A/c. in the sales ledger.
- The Sales A/c. was under casted by Rs. 10,000 being the carry over mistakes in the sales day book.
- Closing stock was over casted by Rs. 10,000 being casting error in the schedule or inventory.

Pass rectification entries in the next year.

Prepare suspense account and state effect of the errors in determination of net profit of last year.

Solution

**In the Books of A Co. Ltd.
Journal**

				Dr.	Cr.
Date 2019	Particulars		L.F.	Amount (Rs.)	Amount (Rs.)
(a) April 1	Suspense A/c	Dr.		100	
	To Profit & Loss Adjustment A/c (Returns outward book was under cast now rectified).				100
(b)	Suspense A/c	Dr.		1,500	
	To Profit & Loss Adjustment A/c (Discount received was not recorded, now rectified).				1,500
(c)	Office Furniture A/c	Dr.		6,000	
	To Profit & Loss Adjustment A/c (Office furniture purchased wrongly debited to Purchase A/c. not rectified.)				6,000
(d)	Debtors' A/c	Dr.		90	
	To Suspense A/c. (Debtors account was posted Rs. 670 in place of Rs. 760, now rectified)				90

Study Note-1 : Process of Accounting

(e)	Suspense A/c.	Dr.		10,000	
	To Profit & Loss Adjustment A/c. (Sales account was under casted, now rectified)				10,000
(f)	Profit & Loss Adjustment A/c.	Dr.		10,000	
	To Opening Stock A/c. Closing Stock was overcasted, now rectified.)				10,000

Dr.	Suspense Account				Cr.
Date	Particulars	Amount (Rs.)	Date	Particulars	Amount (Rs.)
2019 April	To Profit & Loss Adjustment A/c	100	2019	By Difference in Trial	21,510
1	``		April 1	Balance	
	``	1,500		`` Debtors A/c.	90
	``	10,000			
		10,000			
		21,600			21,600

Effect on Profit

			Increase (+) (Rs.)	Decrease (-) (Rs.)
Item	(a)		-	100
	(b)		-	1,500
	(c)		-	6,000
	(d)	No effect	-	-
	(e)		-	10,000
	(f)		10,000	-
			10,000	17,600
Profit will be decreased by			7,600	-
			17,600	17,600

Illustration 35.

The Trial Balance of a concern has agreed but the following mistakes were discovered after the preparation of final Accounts.



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- (a) No adjustment entry was passed for an amount of Rs. 2,000 relating to outstanding rent.
- (b) Purchase book was overcast by Rs. 1,000.
- (c) Rs. 4,000 depreciation of Machinery has been omitted to be recorded in the book.
- (d) Rs. 600 paid for purchase of stationary has been debited to Purchase A/c.
- (e) Sales books was overcast by Rs. 1,000.
- (f) Rs. 5,000 received in respect of in respect of Book Debt had been credited to Sales A/c.

Show the effect of the above errors in Profit and Loss Account & Balance Sheet.

Solution:

Effects of the errors in profit and loss A/c. and Balance Sheet

Profit & Loss A/c.		Balance Sheet	
(a)	Profit was overcasted by Rs. 2,000	(a)	Capital was also overstates by Rs. 2,000 & outstanding Liability was understated by 2,000.
(b)	Gross profit was under casted by Rs. 1,000 & also the Net Profit.	(b)	Capital was understates by Rs. 1,000.
(c)	Net Profit was overstated by Rs. 4,000.	(c)	Machinery was overstates by Rs. 4,000 & so the Capital A/c. was also overstated by Rs. 4,000.
(d)	No effect on Net Profit.	(d)	No effect in Balance Sheet.
(e)	Gross Profit and Net Profit were overstates by Rs. 1,000.	(e)	Capital was overstates by Rs. 1,000.
(f)	Gross Profit & Net Profit were overstated by Rs. 5,000.	(f)	Capital & Sundry Debtors were overstates by Rs. 5,000.

Thus.

Effect in Profit			Effect in Balance Sheet			
Item	Increase (+) (Rs.)	Decrease (-) (Rs.)			Assets	Liabilities
(a)	2,000	-	(a)	-	-	(+) 2,000
(b)	-	1,000			(-) 2,000	
(c)	4,000	-	(b)	-	(-) 1,000	
(d) No effect	-	-	(c)	(+) 4,000	(+) 4,000	
(e)	1,000	-	(d) No effect	-	-	



Adjusting Entry

E.g. Depreciation A/c Dr.
To, Fixed Assets A/c

STUDY NOTE – 2

RECONCILIATION STATEMENTS

This Study Note includes:

- Bank Reconciliation
- Receivable Reconciliation
- Payable Reconciliation

2.1 BANK RECONCILIATION

We have studied the Cash Book which has two columns viz. Cash and Bank. The majority of transactions get settled through cash or Bank. For cash received or paid, the effect in the cash box is instant. The transactions settled through the medium of Bank (i.e. by way of cheque, pay order, draft etc) take a little longer time. If customer pays by cheque, it is deposited in the Bank who will sent it for clearance and then only it will be credited by the Bank into the A/c of business entity. This may take about a week. Similarly, when a cheque is issued to supplier, he will deposit in his Bank which in turn will clear it. Because of such time lag, there would be difference in the records.

The records here would mean Cash Book (in books of business entity) and Pass Book (maintained by the Bank). The contents of Bank Pass Book (or Bank statement) are exactly the same as that of Cash Book with a mirror image effect. When cheques is received the entry in books of accounts of business is

Bank A/c	Dr
To customer A/c	

For the Bank, this amount is collected through the clearing system and payable to the Business Entity's A/c. The entry in their books will be

Clearing A/c	Dr
To Business Entity's A/c	

Hence they will show it as payable i.e. as a credit. Thus all debits in the Bank column of the Cash Book will correspond to the credit entries in the Bank Passbook and all credits in the Bank column of the Cash Book will correspond to the debit entries in the Bank Passbook. Due to the time differences, these entries may not exactly match at a given point of time. This necessitates that these two statements are reconciled regularly:



- 1) To identify differences
- 2) To know reasons for differences
- 3) To ensure the required entries are made in the books of accounts
- 4) To ensure that entries are made by the Bank in time.

A statement which is prepared to reconcile the causes of difference between Bank Balance as per Cash Book and Bank Balance as per Pass Book/ Bank Statement is known as a Bank Reconciliation statement.

It may be noted that before the final accounts are prepared, Bank Reconciliation is a must. It is a very important preparatory step. If an entity has A/c with more than one Bank, all such A/cs must be reconciled regularly i.e. weekly or monthly. In these days of internet Banking where the Bank statements are available online, the reconciliation also can be an online activity. In fact, modern accounting packages are equipped with automatic reconciliations. A Bank statement is entered in the computer system (or a soft copy is uploaded) and then a programme is run which will throw up the transactions leading to the differences.

Features of a Bank Reconciliation statement

1. It is a statement.
2. It is not a part of the process of Accounts.
3. It is prepared to reconcile the causes of difference between the Bank balance as per Cash Book and the Bank balance as per Pass Book.
4. It can be prepared at any time during the financial year, as and when it is required.
5. Since it is prepared on a particular date, it is written as Bank Reconciliation statement as at/ as on

It is necessary for a beginner to understand the mechanism of how to prepare the Bank Reconciliation statement. The first milestone on this journey is to understand the various reasons for differences between the two records.

2.1.1 Reasons for Differences between Cash Book and Pass Book

The differences are basically of two types:

- (A) Items appear in Cash Book but not appearing in Pass Book and
- (B) Items appear in Pass Book but not appearing in the Cash Book

Let us understand these reasons:

(A) Items not appearing in Bank Pass Book

- (1) Cheques issued by business entity not debited by the Bank - This may be because they might not have been Banked by the payee or it may still be under clearance. The entry



Study Note - 2 : Reconciliation Statements

in Cash Book will be made immediately when the cheque is issued thereby reducing the Bank balance in the books of entity's books of A/cs. Here, Bank balance as per Cash Book will be less, but as per Bank Pass Book it will be more. This is also termed as unpresented cheques.

- (2) **Cheques deposited but not credited by the Bank** - The business entity may receive cheques or draft which is deposited into the Bank for collecting the payment. Again entry in Cash Book will be instant thereby increasing the balance. Here, Bank balance as per Cash Book will be more than the balance as per Bank passbook. This is also called as outstanding cheques.
- (3) **Errors** - The Bank may by mistake miss out entering the debit or credit which results in the difference.
- (4) **Standing Instructions** - The entity may give standing instruction to the Bank for certain regular payments like loan repayment installment, transfer of funds etc. This may get entered in the Cash Book immediately, but Pass Book entry may be delayed.

(B) Items not appearing in the Cash Book

- (1) **Bank interest, Bank charges etc.** - The Bank will charge interest on overdraft or also charges for services, issue of demand draft, pay orders etc. Here, being the source of transaction, the Bank will record in the Pass Book immediately and send the debit advice slips to the business entity. The entry in the Cash Book may be delayed. Similarly the Bank could credit interest on fixed deposits, which may get entered in business books at a later date.
- (2) **Direct deposits in Bank account** - Sometimes customers or others may directly deposit an amount in the Bank for goods or services rendered. The Bank will enter it immediately, but entry in Cash Book will appear later.
- (3) **Bills for collection** - The Business Entity may send bills of exchange for collection. The Bank will collect the payment and credit the same in the passbook. The entry in Cash Book will be made only after receipt of information from the Bank.
- (4) **Errors** - The records may be missed out by the book-keeper of the Business Entity.

Need of Bank Reconciliation Statement

- 1. It helps to understand the actual Bank balance.
- 2. It helps to identify the mistakes in the Cash Book and the Pass Book.
- 3. It helps to detect and prevent frauds and errors in recording the Banking transactions.
- 4. It helps to incorporate certain expenditures/income debited/credited by Bank in the books of accounts.



Methods of preparation of Bank Reconciliation Statement

1. Rules of Addition and Subtraction.
2. Debit and Credit Method.

2.1.2 Steps in Preparing Bank Reconciliation Statement

One has to have a systematic approach towards preparation of the reconciliation. To avoid a lengthy reconciliation, one must ensure that the entries in the Cash Book are absolutely online. One also must obtain the Bank statements at regular intervals. Once this checking is done, Bank reconciliation could be done by following these steps:

- (a) Identify the balances and the character thereof. Remember, a debit balance in Cash Book means asset where as a credit balance means a Bank overdraft. In Bank passbook, it's reverse. A debit balance in Pass Book means overdraft and a credit balance is a favourable balance. This must be carefully understood.
- (b) Based on the above, start with the balance (or overdraft) as per one book and arrive at the balance (or overdraft) as per the other book. The items of differences will be added to or deducted from the balance (or overdraft) with which the reconciliation is started.
- (c) The end result should be the balance (or overdraft) as per the other book e. g. if you start with balance as per Cash Book, then after adding or deducting items of differences, you should arrive at the balance (or overdraft) as per the Pass Book.
- (d) One has to make sure that all the items of differences from Cash Book as well as Bank book are taken into account in the reconciliation statement.
- (e) Whether the items of differences should be added or deducted will depend on the sequence you follow. This is shown in following table:

When reconciliation is started with →	Bal. as per CB	OD as per CB	Bal as per PB	OD as per PB
Cheques deposited in Bank, but not cleared	Less	Add	Add	Less
Cheques issued, but not presented in Bank	Add	Less	Less	Add
Bank charges debited in PB only	Less	Add	Add	Less
Interest debited in PB only	Less	Add	Add	Less
Payments by Bank debited in PB only	Less	Add	Add	Less
Direct payment by customer in PB only	Add	Less	Less	Add
Bills discounted & dishonoured in PB only	Less	Add	Add	Less
Cheques deposited, dishonoured in PB only	Less	Add	Add	Less



Study Note - 2 : Reconciliation Statements

Interest, Dividend, Commission collected by Bank not recorded in the Cash Book	Add	Less	Less	Add
Overcasting of payment side of Cash Book or Undercasting of Receipt side of Cash Book	Add	Less	Less	Add
Undercasting of Payment side of Cash Book or overcasting of Receipts side of Cash Book	Less	Add	Add	Less
Deposits recorded twice in the Cash Book or excess amount recorded in the Cash Book	Less	Add	Add	Less
Undercasting of credit side of the Pass Book or overcasting of the debit side of the Pass Book	Less	Add	Add	Less
Cheques deposited into Bank and credited without recording in the Cash Book	Add	Less	Less	Add
Wrong debit in the Pass Book for issue of cheque, Bank charges, etc.	Less	Add	Add	Less
Wrong credit in the Pass Book for deposit of cheque, interest, etc.	Add	Less	Less	Add
Cheques drawn but not actually issued to the suppliers/ creditors	Add	Less	Less	Add
Bank charges recorded twice in the Cash Book	Add	Less	Less	Add
Amount withdrawn from Bank not recorded in the Cash Book	Less	Add	Add	Less

Please note the abbreviations CB - Cash Book, PB - Pass Book, OD - Overdraft

Illustration 1.

On 31.12.20, P. Roy's Bank Balance as shown by the Cash Book was Rs. 75,000. On receipt of Bank Statement it was found that :-

- (i) Three cheques of Rs.3,000, Rs. 4,000 and Rs.1,500 drawn in favour of suppliers respectively on 28th, 29th and 30th December, 2020 had been debited in the Bank Statement on 2nd January 2021.
- (ii) The Bank had credited Rs.8,000 on 30th December, 2020, in respect of collection made by Bank directly from a customer, the intimation not having yet been received.
- (iii) Two cheques of Rs.5,000 and Rs.6,000 were deposited into Bank on 30th December, 2020 had been credited in the Bank statement on 4th January, 2021.
- (iv) The Bank had debited Rs.30 as incidental charges on 30th December, 2020 but not entered in the Cash Book.



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Show the reconciliation of the Bank Balance as per Cash Book with the Bank Balance as per Bank Statement as on 31st December, 2020.

Solutions:

Bank Reconciliation Statement of Mr. P. Roy as on 31st December, 2020

Particulars			Amount (Rs.)	Amount (Rs.)
Bank Balance as per Cash Book (Dr.)				75,000
Add:	(i)	Cheques issued but not presented for payment Rs.3,000, Rs.4,000 & Rs.1500 respectively.	8,500	
	(ii)	Collection by Bank from a Customer not recorded in the Cash Book	8,000	16,500
Less:	(i)	Cheques deposited but not credited in the Pass Book on 31.12.12		91,500
		Rs.5,000 + Rs.6,000 respectively.	11,000	
	(ii)	Bank charges not recorded in the C.B. Balance as per Pass Book (Cr.)	30	11,030
				80,470

The Bank statement of Mr. J. White dated 31.12.2020 showed a balance with his Bank of Rs. 924, when checked with his Cash Book the following were noted :

- During December, the Bank had paid Rs.200 for a yearly contribution of Mr. White, made to a local charity, as per his standing order. This amount appeared in the Bank statement but not in the Cash Book.
- The Bank had credited his account with Rs.28 interest and had collected on his behalf Rs. 230 as dividends. No corresponding entries were made in the Cash Book.
- A cheque of Rs. 65 deposited into the Bank on 28.12.2020 was not cleared by the Bank till after 31.12.2020.
- A cheque of Rs.150 deposited into and cleared by the Bank before 31.12.2020 was not entered in the Cash Book, through an oversight.
- Cheques drawn by and posted to parties by Mr. White on 31.12.2020 for Rs.73, Rs.119 and Rs. 46 were presented for payment to the Bank only on 3.1.2021.



Study Note - 2 : Reconciliation Statements

Solutions:

Bank Reconciliation Statement as on 31st December, 2020

Particulars			Amount (Rs.)	Amount (Rs.)
Bank balance as per Pass Book (Cr.)				924
Add:	(i)	Payment of contribution by the Bank not entered in the Cash Book	200	
	(ii)	Cheque deposited but not cleared	65	265
Less:	(i)	Interest and dividend collected by the Bank not entered in the Cash Book - Interest	28	
		- Dividend	230	
	(ii)	Cheque deposited and cleared but not entered in the Cash Book	150	
	(iii)	Cheques issued but not presented Rs. (73+119+46)	238	646
Bank balance as per Cash Book (Dr.)				543

Illustration 3.

Mr. Suresh request you to ascertain the Bank balance as per the Pass Book for January 2019, as his cash clerk reported a figure of Rs.11,515 (credit) as on 31.1.2019. Scrutiny revealed the following discrepancies :

- (i) Cheques issued and deposited by the cash clerk in January 2013, were Rs. 15,000 and Rs. 7,000 respectively. However, against the above, the Bank had paid out and debited cheques worth Rs.9,000 only and cleared and credited cheques worth Rs. 4,000 only, by 31.1.2019.
- (ii) A customer had paid in Rs. 6,400 directly into Suresh's Bank account, the effect of which was missing in the Cash Book.
- (iii) Bank commission of Rs. 45 charged and interest earned Rs. 1,400 on investments of Mr. Suresh, where only recorded in the Pass Book.
- (iv) Total cash withdrawals of Rs. 3,000 by self and bearer cheques for office use, were recorded erroneously as Rs. 5,000 in the Cash Book.



Solutions:

Mr. Suresh

Bank Reconciliation Statement as on 31st January, 2013

Particulars			Amount (Rs.)	Amount (Rs.)
Overdraft as per Cash Book			11,515	
Add:	(i)	Cheques deposited but not cleared (7,000 - 4,000)	3,000	
	(ii)	Bank commission charged by the Bank	45	3,045
				14,560
Less:	(i)	Cheques issued but not presented for payment	6,000	
		(15,000 - 9,000)		
	(ii)	Direct deposit by a customer	6,400	
	(iii)	Interest on investment credited in the Pass Book only	1,400	
	(iv)	Withdrawals of Rs. 3,000 recorded in the Cash Book as Rs. 5,000	2,000	15,800
Bank balance as per Pass Book (Cr.)				1,240

Illustration 4.

The Bank Pass Book of Mr. Anil showed an overdraft of Rs. 6,000 on 31.12.2020. Prepare the Bank Reconciliation Statement based on the following details:

- Cheques issued but not presented upto 31.12.2020, Rs. 5,500
- Cheques deposited but not credited upto 31.12.2020, Rs. 9,000
- Bank commission Rs. 30/- was entered only in the Pass Book.
- A cheque for Rs. 6,500/- issued in settlement of a debt was encashed on 28.12.2020 but entered in the Cash Book as Rs. 8,500/-

Solutions:

Mr. Anil

Bank Reconciliation Statement as on 31st December, 2020

Particulars			Amount (Rs.)	Amount (Rs.)
Overdraft as per Pass Book			6,000	
Add:	(i)	Cheques issued but not presented for payment	5,500	
	(ii)	Cheque for Rs. 6,500 issued and encashed but entered in the Cash Book at Rs.8,500 (8,500-6,500)	2,000	7,500
				13,500
Less:	(i)	Cheques deposited but not credited	9,000	
	(ii)	Bank commission entered in the Pass Book only	30	9,030
Overdraft as per Cash Book				4,470



Study Note - 2 : Reconciliation Statements

Illustration 5.

From the following particulars of M/s Suresh enterprises, prepare a Bank reconciliation statement:

- 1) Bank overdraft as per Pass Book as on 31st March 2020 was Rs. 8,800
- 2) Cheques deposited in Bank for Rs. 5,800 but only Rs. 2,000 were cleared till 31st March
- 3) Cheques issued were Rs. 2,500, Rs. 3,800 and Rs. 2,000 during the month. The cheque of Rs. 5,800 is still with supplier.
- 4) Dividend collected by Bank Rs. 1,250 was wrongly entered as Rs. 1,520 in Cash Book.
- 5) Amount transferred from fixed deposit A/c into the current A/c Rs. 2,000 appeared only in Pass Book
- 6) Interest on overdraft Rs. 930 was debited by Bank in Pass Book and the information was received only on 3rd April 2020.
- 7) Direct deposit by M/s Rajesh Traders Rs. 400 not entered in Cash Book.
- 8) Corporation tax Rs. 1,200 paid by Bank as per standing instruction appears in PB only.

Solutions:

Bank Reconciliation Statement as on 31st March, 2020

Particulars			Amount (Rs.)	Amount (Rs.)
Overdraft as per Pass Book			8,800	
Add:	(i)	Cheques issued but not presented till 31st March	5,800	
	(ii)	Transfer from fixed deposit	2,000	
	(iii)	Direct deposit by M/s Rajesh Traders	400	8,200
				17,000
Less:	(i)	Cheques deposited but not cleared (5,800 - 2,000)	3,800	
	(ii)	Dividend collected excess recorded in CB (1,520 - 1,250)	270	
	(iii)	Interest on overdraft debited in PB only	930	
	(iv)	Corporation tax paid appeared in PB only	1,200	6,200
Overdraft as per Cash Book				10,800



Illustration 6.

Mr. Narayan has given extract of his HDFC Bank statement for the month of December 2020 as follows:

Details	Withdrawal	Deposit (Rs.)	Balance (Rs.)	
Balance as on 1-12-2020			12,500	Cr
Deposits realized:				
Cash		60,000	72,500	Cr.
Customers' cheques :				
– Deposited in Nov 20		5,000	77,500	Cr
– Deposited in Dec 20		1,70,000	2,47,500	Cr
Bank charges	400		2,47,100	
Cash paid	10,000		2,37,100	
Cheques honoured :				
– Issued before Dec 20	68,100		1,69,000	Cr
– Issued in Dec 20	1,56,000		13,000	Cr

His Cash Book showed cash balance of Rs. 3,000 and Bank OD of Rs. 53,450 as on 1st December 2020. His transactions during December 2020 were as follows:

- Cash collected on sales Rs. 60,000 which was Banked on a daily basis. Credit sales were Rs.1,90,000
- Cheques received from customers for Rs. 1,50,000 in full settlement of the invoices of Rs.1,53,000
- Credit purchases were Rs. 1,55,000
- Cheques of Rs. 1,32,000 were issued against the November purchases of Rs. 1,34,000
- Advances received from customers Rs. 30,000 & advances paid to suppliers Rs. 25,000
- Amount withdrawn from Bank Rs. 10,000 of which Rs. 4,000 was for personal use of Mr. Narayan and balance was for business expenses.
- Expenses Rs. 9,000 of which Rs. 5,000 was by cheque and the rest by cash
- Cash paid on behalf of customer Rs. 4,500
- Bank charges Rs. 150 debited by Bank in November were recorded in Cash Book in December on receipt of Bank statement.



Study Note - 2 : Reconciliation Statements

It was noticed that cheques Rs. 2,500 deposited and cheques Rs. 5,500 issued before 1st December were not cleared by 31st December. Prepare Cash Book for December 2020 with discount, cash and Bank columns. Also prepare Bank reconciliation statement as on 30th November and as of 31st December 2020.

Solution

Dr. **Cash Book of Mr. Narayan for the month of December 2020** Cr.

Particulars	Disc (Rs.)	HDFC (Rs.)	Cash (Rs.)	Particulars	Disc (Rs.)	HDFC (Rs.)	Cash (Rs.)
Balance b/d			3,000	Balance b/d (OD)		53,450	
Cash sales			60,000	Cash deposited in Bank (contra)			60,000
Cash deposited in Bank (contra)		60,000		Cheques issued to suppliers	2,000	1,32,000	
Customers cheques deposited	3,000	1,50,000		Advances to suppliers by cheque		25,000	
Advance cheques from Customers		30,000		Cash withdrawn (contra)		6,000	
Cash withdrawn (contra)			6,000	Drawings		4,000	
				Expenses paid		5,000	4,000
				Cash paid on behalf of Customer	4,500		
				Bank charges		150	
				Balance c/d		14,400	500
	3,000	2,40,000	69,000		2,000	2,40,000	69,000

Please note here, the reconciliation statements are asked for 2 different dates. We must find out items of differences between Cash Book and Bank statement as on both dates and then should prepare the reconciliation statements. Transactions of credit sales and credit purchases for the month will have no relevance of posting in Cash Book.

HDFC Bank reconciliation as on 30th November 2020

Particulars	Amount (Rs.)	Amount (Rs.)
Balance as per Bank statement (credit)		12,500
Add: (i) cheques deposited but not cleared (5,000+ 2,500)	7,500	
(ii) Bank charges not recorded in CB	150	7,650
		20,150
Less: (i) Cheques issued not presented (68,100 + 5,500)		23,600
Balance as per Cash Book (Overdraft)		(53,450)



HDFC Bank reconciliation as on 30th November 2020

Particulars			Amount (Rs.)	Amount (Rs.)
Balance as per Cash Book				14,400
Add:	(i)	Cheques issued but not presented		
	(ii)	Issued in November	5,500	
	(iii)	Issued in December (162000 - 156000)	6,000	11,500
				25,900
Less:	(i)	Cheques deposited but not cleared Deposited in November	2,500	
		Deposited in December (1,80,000 - 1,70,000)	10,000	
	(ii)	Bank charges for December not entered in CB	400	
				12,900
Balance as per Pass Book				13,000

2.1.3 Amendment in Cash Book

Sometimes, in order to find out the correct balance at Bank or cash to amend the Cash Book before the preparation of Bank Reconciliation statement. In short, Bank Reconciliation Statement should be prepared by taking the balance shown by the amended Cash Book. The students should remember that usually two types of transactions are recorded in amended Cash Book i.e., (i) Items which were not at all recorded in Cash Book. (ii) Any error made by Cash Book. The transactions which are already recorded in Cash Book i.e., the rest of the transactions will go Bank reconciliation statement.

But it must be remembered that preparation of amended Cash Book is possible only when the balance as per Cash Book is given.

Step to be followed for preparation:

- Open the cash with the Balance as per Cash Book, whether favourable or unfavourable,
- Against the items (i.e., which are not recorded in Cash Book as any other error made by Cash Book.)
- Close the Cash Book and find out the balance,
- Prepare Bank Reconciliation Statement by taking the Cash Book balance and rest of the transaction which are not adjusted against amended Cash Book.

Illustration 7.

The Bank column of the Cash Book showed an overdraft of Rs. 5,000 on 31-03-2020, whereas as per Bank statement the overdraft is Rs. 4,200. The following differences were noticed between the two records:



Study Note - 2 : Reconciliation Statements

- (a) Cheques of Rs. 2,400 issued but not encashed by customers
- (b) Cheques deposited but not cleared Rs. 1,200
- (c) Collection charges debited by Bank not recorded in CB Rs. 100
- (d) Bank interest charged by the Bank not recorded in CB Rs. 300
- (e) Cheques dishonoured debited by Bank not in CB Rs. 400
- (f) Interest directly received by Bank not entered in CB Rs. 400 Prepare Bank reconciliation statement after amending the CB.

Solution :

Here, please note that amended CB is asked. What it actually means is to record all revenue (expense or income) items of differences and those items that are recorded in PB only must first be recorded in the CB and then the reconciliation statement should be prepared by taking the revised balance as per CB. Here is the amended CB.

Dr.		Cash Book (Bank column only)		Cr.	
Particulars	Amount (Rs.)	Particulars	Amount (Rs.)		
To Interest received	400	By Balance b/d (OD)	5,000		
		By collection charges	100		
		By Bank interest	300		
To Balance c/d (OD)	5,400	By customer (chq dishonoured)	400		
	5,800		5,800		

Bank reconciliation statement as on 31-03-2020

	Rs.
Bank OD as per CB	5,400
Add: Cheques deposited, but not cleared	1,200
Less: cheques issued but not encashed	(2,400)
Bank OD as per PB	4,200

Illustration 8.

The following is a summary from Cash Book of M/s Adarsh Trading for the month of Sept 2020

	(Rs.)		(Rs.)
Balance b/d	1,407	Payments	15,520
Receipts	15,073	Balance c/d	960
	16,480		16,480



On investigation it was found that

- (a) Bank charges of Rs. 35 were not entered in the Cash Book
- (b) A cheque of Rs. 47 issued to supplier was entered by mistake as a receipt in the Cash Book.
- (c) A cheque of Rs. 18 was returned by the Bank marked as 'refer to drawer' but it's not entered in Cash Book
- (d) The balance brought forward in Sept 2020 should have been Rs. 1,470
- (e) Cheques paid to suppliers Rs. 214, Rs. 370 and Rs. 30 have not been presented for payment.
- (f) Deposits of Rs. 1542 on 30th Sept were cleared by the Bank on 2nd October.
- (g) The Bank charged a cheque wrongly to Adarsh trading Rs. 72
- (h) Bank statement shows overdraft of Rs. 124 as on 30th Sept 2020.

Show what adjustments will you make in the Cash Book and prepare a Bank reconciliation statement as on 30-09-2020.

Solution

As we know, the errors in the Cash Book must first be corrected and entries that have been missed out in the CB should be recorded.

Dr.		Cash Book for Sept 2020		Cr.	
Particulars	Amount (Rs.)	Particulars	Amount (Rs.)		
To Original balance b/d	960	By Bank charges not recorded earlier	35		
To Error in balance carried (1,470 - 1,407)	63	By Cheques issued recorded as receipt	94		
		By Now corrected (2*47)			
		By Cheque returned	18		
		By Revised balance c/d	876		
	1,023		1,023		

Bank Reconciliation from member as on 30.9.2020

Particulars			Amount (Rs.)	Amount (Rs.)
Balance as per Cash Book				876
Add:	Cheques issued but not presented (214 + 370 + 30)		614	614
				1,490
Less:	(i)	Deposits not cleared	1542	
	(ii)	Cheques charged by mistake	72	
Overdraft as per Pass Book				1,614
				(124)



Study Note - 2 : Reconciliation Statements

Illustration 9.

D's Cash Book shows an overdrawn position of Rs. 3,630 on 31.3.2019, though the Bank Statement shows only Rs. 3,378 overdrawn. Detailed examination of two records revealed the following:

- A cheque for Rs. 1,560 in favour of Rath Associates has been omitted by the Bank from its statement, thus, cheque having been debited to another customer's account.
- The debit side of owned book has been under caste by Rs. 300.
- A cheque for Rs. 182 drawn in payment of electricity amount had been entered in the Cash Book on Rs. 128 & was shown correctly in the Bank statement.
- A cheque for Rs. 210 from S. Gupta having been paid into Bank, was dishonoured & shown as such on Bank statement, although no entry relating to dishonoured had been made in Cash Book.
- The Bank had debited a cheque for Rs. 126 to D's A/c. in error. It should have been debited to Sukhal's A/c.
- A dividend of Rs. 90 on D's holding of equity shares has been duly shown by Bank, no entry has been made in Cash Book.
- A lodgement of Rs. 1,080 on 31.3.2019 had not been credited by Bank.
- Interest on Rs. 228 had been directly debited by Bank not recorded in Cash Book.
- You are required to prepare a Bank Reconciliation Statement after necessary amendment in Cash Book as on 31.3.2019.

In the Books of Mr. D

Dr.

Cash Book (Bank Column only)

Cr.

Date	Particulars	Amount (Rs.)	Date	Particulars	Amount (Rs.)
2019	To Dividend A/c.	90	2019	By Balance b/d.	3,630
March 31	" Error (under casting in debited side)	300	March 31	" Electric Charges A/c. Cheque drawn for [Rs. 182 wrongly recorded as Rs.128 (Rs.182 - Rs.128)]	54
	" Balance c/d.	3,732		" S. Gupta's A/c.	
				- Cheque dishonoured	210
				Rs. Bank Interest	228
		4,122			4,122
				By Balance b/d.	3,732



Bank Reconciliation Statement as at 31st March 2019

Particulars			Amount (Rs.)	Amount (Rs.)
Overdraft as per Cash Book				3,732
Add:	(i)	A cheque for Rs. 126 wrongly debited by Bank.	126	
	(ii)	A lodgement not credited by Bank	1,080	
				1,206
Less:	(i)	A cheque was issued in favour of Rath Associates not debited by Bank		4,938
				1,560
Overdraft as per Pass Book.				3,378

Illustration 10.

Perfect Pvt. Ltd. has two accounts with Ever Bank Ltd. The accounts were known as 'Account-I' and Account-II'. As at Dec. 31, 2019, the balance as per A/c books reflected the following:

Account-I Rs. 1,25,000 Regular balance.

Account-II Rs. 1,11,250 Overdraft balance.

The accountant failed to tally the balance with the Pass Book and the following information was available :

- (a) The Bank has charged Interest on Account-II Rs. 11,375 and credited Interest on Account-I Rs. 1,250.

These were not recorded by the accountant.

- (b) Rs. 12,500 drawn on Dec.10, 2019, from Account-I was recorded in the books of Account-II.
- (c) Bank charges of Rs. 150 and Rs. 1,125 for Account-I and Account-II were not recorded in the books.
- (d) A deposit of Rs. 17,500 in Account-I was wrongly entered in Account-II in the books.
- (e) Two cheques of Rs. 12,500 and Rs. 13,750 deposited in Account-I, but entered in Account-II in the books, were dishonoured. The entries for dishonoured cheques were entered in Account-II.
- (f) Cheques issued for Rs. 1,50,000 and Rs. 15,000. from Account-I and Account-II, respectively, were not presented until Jan. 5, 2020
- (g) Cheques deposited Rs. 1,25,000 and Rs. 1,17,500 in Account-I and II, respectively, were credited by Bank on Feb. 2, 2020.



Study Note - 2 : Reconciliation Statements

You are required to prepare the Bank Reconciliation Statement for Account-I and II.

Solution.

In the books of Perfect Pvt. Ltd.,

Bank Reconciliation Statement, Account-I as at 31st December 2019

Particulars			Amount (Rs.)	Amount (Rs.)
Bank Balance as per account book				1,25,000
Add :	(i)	Interest earned but not recorded in Cash Book	1,250	
	(ii)	Deposits not entered in Cash Book	17,500	
	(iii)	Cheques deposited but not entered (Rs. 12,500 + Rs.13,750)	26,250	
	(iv)	Cheques issued but not presented for payment	1,50,000	1,95,000
				3,20,000
Less :	(i)	Withdrawals not entered in Cash Book	12,500	
	(ii)	Bank charges debited in Pass Book but not entered in Cash Book	150	
	(iii)	Cheques dishonoured but not recorded in Cash Book (Rs.12,500 + Rs. 13,750)	26,250	
	(iv)	Cheques deposited but not credited by the Bank	1,25,000	
				1,63,900
Bank Balance as per Pass Book				1,56,100.

Bank Reconciliation Statement, Account-II as at 31st December 2019

Particulars			Amount (Rs.)	Amount (Rs.)
Overdraft Balance as per Account Book				1,11,250
Add :	(i)	Interest charges on overdraft but not entered in Cash Book	11,375	
	(ii)	Bank charges debited by Bank but not entered in Cash Book	1,125	
	(iii)	Deposits wrongly entered	17,500	
	(iv)	Cheques deposited but not credited by the Bank	1,17,500	1,47,500
				2,58,750
Less :	(i)	Withdrawals wrongly recorded	12,500	
	(ii)	Cheques issued but not presented	15,000	
				27,500
Overdraft balance as per Pass Book				2,31,250



2.1.4 Preparation of Bank Reconciliation Statement are given. Where both Cash Book and Pass Book are given

(a) The book relates to the same period

When Cash Book and Pass Book of the identical period are given the following steps are needed.

1st step- Deposits sides of the Pass Book (Debit Side) and Cash Book (Credit side) should be checked thoroughly and put an asterisk mark on all the matching items. All the items without any signs in the Cash Book is an indication that it is required to be entered by the Bank. Separate the items under the heading "Cash / Cheques deposited but yet to be credited by the Bank" and in the same way , items without any sign in the Pass Book is indicating that deposits are yet to be entered in the Cash Book. Separate the items under the heading "Cheques/ Cash credited by the Bank are needed to be included in the Cash Book."

2nd Step- All the matching withdrawals on the Pass Book (Debit side) with the payments of the Cash Book (Credit side) should be marked with an asterisk one by one. All the items without any signs in the Cash Book indicate payments are needed to be included by the Bank. Separate the items under the heading "Cheques issued/ drawn and required to be presented in the Bank for payment" and in the same way, Items without any sign in the Pass Book is an indication that withdrawals yet to be entered in the Cash Book. Separate the items under the heading "Cheques/ Cash debited by the Bank yet to be entered in the Cash Book".

3rd Step- Separate list should be maintained for any other item under appropriate heading , e.g, errors in Cash Book, or, Pass Book, etc, which may cause any difference.

4th Step - after considering the separate listed items and closing balances of Pass Book and Cash Book Bank Reconciliation Statement should be prepared.

Procedure for Preparation of Bank Reconciliation Statement

1. Selection of a date : The last date of the month or accounting period is selected to reconcile the balances of Cash Book and Pass Book.
2. Comparison of entries : The transactions recorded in the Pass Book and Cash Book (Bank column) are compared. In most cases, the pay-in-slips (i.e. for deposits) and the counterpart of cheques are considered to find out the causes of discrepancies.
3. Selection of base : To select the starting point. To decide what balance to start with, Cash Book balance or Pass Book balance.



Study Note - 2 : Reconciliation Statements

Illustration 11.

The following are the Cash Book and Bank Pass Book of Sri N for the month of April, 2020.

Dr. Cash Book (Bank Column only) Cr.

Date	Particulars	Amount (Rs.)	Date	Particulars	Amount (Rs.)
2020 April 1	To Balance b/d	12,500	2020 April 1	By Salaries A/c (Cheque No. 183)	4,000
4	" Sales A/c	8,000	6	" Purchase A/c (Cheque No. 184)	3,200
8	" P A/c	1,500	11	Machinery A/c (Cheque No. 185)	6,000
13	" M A/c	3,400	15	" Omprakash A/c (Cheque No. 186)	1,000
18	" Kamal A/c	4,600	19	" Drawings A/c (Cheque No. 187)	800
21	" Furniture A/c	1,200	23	" K A/c (Cheque No. 188)	2,000
25	" Sales A/c	3,800		" S A/c (Cheque No. 189)	1,000
30	" F A/c	3,000	27	" Printing A/c (Cheque No. 190)	500
			30	" Balance c/d	19,500
		38,000			38,000

Pass Book

Date 2020 April	Particulars	Cheque No.	Debit (Withdrawals) (Rs.)	Credit (Deposits) (Rs.)	Dr. or Cr.	Balance
1	By Balance b/d				Cr.	12,500
2	To Cheque	183	4,000		Dr.	8,500
6	By Cheque			8,000	Cr.	16,500
6	To Cheque	184	3,200		Dr.	13,300
10	By Cheque			1,500	Cr.	14,800
16	" Cheque			3,400	Cr.	18,200
17	To Cheque	187	800		Dr.	17,400



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20	By Cheque			4,600	Cr.	22,000
24	" Cheque			3,800	Cr.	25,800
28	To Cheque	185	6,000		Dr.	19 800
28	" Cheque	189	1,000		Dr.	18,800
30	By Interest			100	Cr.	18,900
30	" Deposit			3,000	Cr.	21,900
	(K.Sen)					
30	" Charges		10		Dr.	21,890

Yes are required to prepare a Bank Reconciliation Statement as at 30th April 2020.

Solution

**In the books of Perfect Pvt. Ltd.,
Bank Reconciliation Statement, Account-I as at 31st December 2019**

Particulars	Amount (Rs.)	Amount (Rs.)
Bank Balance as per Cash Book		1,11,250
Add : Cheques issued but not presented (Rs.1,000 + Rs.2,000 + Rs. 500)	3,500	
Direct deposit made by the customer, Sri K. Sen	3,000	
Interest credited by Bank, but not entered in Cash Book	100	
		6,600
		26,100
Less : Cheques deposited but not credited (Rs.1,200 + Rs. 3,000)	4,200	
Bank charges debited by Bank but not entered in Cash Book	10	
		4,210
Bank Balance as per Pass Book		21,890



Study Note - 2 : Reconciliation Statements

Illustration 12.

Following are the extracts of Cash Book and Pass Book of Mr. Sunil. Prepare a Bank reconciliation statement.

Dr. **Cash Book (Bank column only)** **Cr.**

Date	Particulars	Amount (Rs.)	Date	Particulars	Amount (Rs.)
1-Jan. 20	To Balance b/d	1,080	2-Jan. 20	By Wages A/c	850
2-Jan. 20	To Interest A/c	52	6-Jan. 20	By Investments A/c	1,000
5-Jan. 20	To Kamdar A/c	900	8-Jan. 20	By Purchases A/c	306
8-Jan. 20	To Sales A/c	609	9-Jan. 20	By Self A/c	160
10-Jan. 20	To Rent A/c	56	10-Jan. 20	By Bapat A/c	210
12-Jan. 20	To Ganpat A/c	1,252	10-Jan. 20	By Drawings A/c	80
13-Jan. 20	To Ram A/c	888	14-Jan. 20	By Fakir A/c	1,822
			15-Jan. 20	By Mustafa A/c	810
15-Jan-12	To Balance c/d (OD)	401			
		5,238			5,238

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

Date	Particulars	Amount (Rs.)	Date	Particulars	Amount (Rs.)
2-Jan. 20	To Wages A/c	850	1-Jan. 20	By Balance b/d	1,132
6-Jan. 20	To Investments A/c	1,000	6-Jan. 20	By Kamdar A/c	900
7-Jan. 20	To Purchases A/c	306	8-Jan. 20	By Sales A/c	609
9-Jan. 20	To Self A/c	160	10-Jan. 20	By Rent A/c	56
10-Jan. 20	To Self A/c	80	10-Jan. 20	By Jamdar A/c	200
13-Jan. 20	To Bills Payable A/c	100			
15-Jan. 20	To Balance c/d	401			
		2,897			2,897



Solution

The reconciliation period is 1st Jan to 15th Jan 2020. From comparison of both the extracts it can be found that:

- (a) Cheques issued to Bapat, Fakir and Mustafa are not encashed till 15th Jan 2020 and will appear in reconciliation.
- (b) Direct deposit by Jamdar is not appearing in Cash Book is also a reconciliation item
- (c) Interest received of Rs. 52 is appearing in Cash Book only. This has to be dealt with carefully. Interest is normally credited by Bank first and then on the basis of credit advice an entry is made in Cash Book. Hence, it's probable that the interest must have been credited by Bank before 1st Jan and it would have appeared in the reconciliation statement of December. This item is thus not considered.
- (d) Cheques received from Ganpat and Ram not cleared till 15th Jan and hence will appear in the reconciliation statement.
- (e) Bills payable cleared by Bank not recorded in Cash Book will appear as item of reconciliation.

Bank Reconciliation Statement as on 15-1-20

Particulars	Amount (Rs.)	Amount (Rs.)
Overdraft as per Cash Book		401
Less: Cheques issued not presented till 15th Jan (210+1822+810)	2,842	
Less: Direct deposit by Jamdar	200	3,042
		2,641
Add: Cheques deposited but not cleared (1252+888)	2,140	
Add: Bills payable not recorded in CB	100	2,240
Balance as per Pass Book		401

Under this method, we are to see that the transactions which appear in both the Cash Book and the Bank Statement but not in the same month. Thus, put a tick mark (✓) on the transactions which appeared on the debit side of Cash Book and debit side of the Pass Book or Bank Statement and vice- versa which need reconciliation.

Study Note - 2 : Reconciliation Statements

Illustration 13.

In the books of Mr. P. Mukherjee

Dr.

Cash Book (Bank Column only)

Cr.

Date	Particulars	Amount (Rs.)	Date	Particulars	Amount (Rs.)
2019 March 1	To Balance b/d.	5,000	2019 March 2	By Salaries A/c	3,000
3	`` A. Bose A/c	500	4	`` Drawings A/c	3,000
5	`` B. Banerjee A/c	1,000	8	`` P. Sen A/c	1,000
7	`` C. Sur A/c	4,000	12	`` S. Kumar A/c	2,000
9	`` D. Sen A/c	2,000	15	`` D. Saha A/c	1,000
20	`` P. Pal A/c	3,000	18	`` Wages A/c	3,000
			24	`` Rent A/c	500
			30	`` T. Koley A/c	1,500
			31	`` Balance c/d.	500
		15,500			15,500

Bank Pass Book

Dr.

Mr. P Mukherjee in ----- with Bank

Cr.

Date	Particulars	Amount (Rs.)	Date	Particulars	Amount (Rs.)
2019 April	To Balance b/d.	1,500	2019 April	By A. Bose A/c	
3	`` P. Sen A/c	1,000	1	`` C. Sur A/c	500
5	`` S. Kumar A/c	2,000	3	`` D. Sen A/c	4,000
	`` T. Koley A/c	1,500	5	`` P. Paul A/c	2,000
6	`` D. Saha A/c	1,000	8		3,000
	`` B. Saha A/c	3,000			

Prepare a Bank Reconciliation Statement as on 31st March, 2019.



Solution:

Bank Reconciliation Statement as at 31st March, 2019

Particulars	Amount (Rs.)	Amount (Rs.)
Balance as per Cash Book		500
Add: Cheque issued but not passed:		
P. Sen	1,000	
S. Kumar	2,000	
D. Saha	3,000	
T. Koley	1,500	7,500
		8,000
Less: Chequed deposited but not credited:		
A. Bose	500	
C. Sur	4,000	
D. Sen	2,000	
P. Paul	3,000	9,500
Overdraft as per Pass Book		1,500

2.2 RECEIVABLE RECONCILIATION

A business enterprise apart from cash sales, also provides/offers credit to its customers. During the number of transactions taking place on a daily basis, there is a need to reconcile the balance receivable from the customers/debtors. The process of reconciliation may be detailed as under:

- Step 1: Ascertain total credit sales to customer
- Step 2: Ascertain total collections - in cash, cheque or any other mode received
- Step 3: Identify whether there is any Bills Receivable (B/R) accepted by the customer
- Step 4: Identify any cheque return/ goods returned/ bills dishonoured during the accounting period
- Step 5: Check whether any credit note is raised against the customer for short-supply of goods or for excess payment or allowing special discount

Illustration 14.

Mr. B sold goods on credit to various customers. Details related to one of the customer, Mr.Z, is as under:

- (i) Goods sold on credit Rs.5,00,000
- (ii) Goods returned by the customer Rs.30,000 due to defective quality, credit note raised but not recorded.



Study Note - 2 : Reconciliation Statements

- (iii) Payment received from customer in cash Rs.1,00,000 and by cheques Rs. 2,30,000. Out of cheques received, a cheque of Rs. 38,000 was dishonoured by bank.
- (iv) Customer accepted two Bills of Rs.19,000 and Rs. 56,000 for 2 months and 3 months respectively.
- (v) Credit note raised against the customer Rs. 3,400 for excess payment charged against one of the consignment.

Mr. Z, the customer is in need to ascertain the actual balance due to Mr. B. Prepare a Reconciliation Statement.

Solution:

Receivable from Mr. Z - Reconciliation Statement

Particulars	Amount (Rs.)
Credit Sales during the period	5,00,000
Less: Goods returned by the Customer, adjustment of credit note	30,000
Less: Payment received in cash	1,00,000
Less: Payment received by cheque less dishonored cheque (2,30,000 -38,000)	1,92,000
Less: Bills Receivable accepted by Customer, yet to be matured (19,000 +53,000)	72,000
Less : Adjustment of Credit Note raised	3,400
Net Receivable from Customer	1,02,600

Note: This reconciliation statement can be made against gross block of customers/debtors. However, it is advisable to ascertain individual reconciliation statements.

2.3 PAYABLE RECONCILIATION

A business enterprise apart from cash purchases also makes credit purchases from its vendors/suppliers. During the number of transactions taking place on a daily basis, there is a need to reconcile the balance payable to the vendors/suppliers. The process of reconciliation may be detailed as under:

- Step 1: Ascertain total credit purchases made from different vendors/suppliers
- Step 2: Ascertain total payments - in cash, cheque or any other mode remitted
- Step 3: Identify whether there is any Bills Payable (B/P) accepted
- Step 4: Identify any cheque return/ goods returned/ bills payable accepted but dishonoured during the accounting period
- Step 5: Check whether any debit note is raised against the vendor/supplier for short-supply of goods or for excess payment or claiming special discount



Illustration 15:

Amaranth purchases goods on credit from various suppliers. However, there is a difference of opinion which has arisen with one of its suppliers. While the Supplier claims that the amount receivable from Amarnath is Rs. 2,53,000, on the other hand, Amarnath claims that the amount payable is Rs. 2,35,000. On evaluation of records the following were identified:

- (i) A purchase of Rs. 71,000 was recorded by the supplier as Rs. 78,000.
- (ii) Goods returned by Amarnath amounting to Rs. 5,000, but the stock is in transit and has not reached the supplier/vendor.
- (iii) Cheques issued to vendor for Rs. 28,000, in transit.
- (iv) Bills raised for goods purchased from the supplier, amounting Rs. 22,000, but goods are yet to reach the warehouse/godown of Amarnath.

Prepare a suitable Reconciliation statement.

Solution:

Amount due to Supplier - Payable Reconciliation Statement

Particulars	Amount (Rs.)
Amount due to supplier (as per books of the Supplier)	2,53,000
Less: Overstatement of sales figure in the books of supplier	7,000
(i.e. goods sold by supplier to Amarnath for Rs. 71,000 but recorded as Rs. 78,000)	1,92,000
Less: Goods returned to supplier, now in transit	5,000
Less: Cheques issued to vendor, now in transit	28,000
Add: Bills raised against goods purchased, not stock-in-transit, i.e. not yet reached the warehouse of the supplier	22,000
Amount due to supplier (as per books of Amarnath)	2,35,000

Note: This reconciliation statement can be made against gross block of vendors/suppliers. However, it is advisable to ascertain individual reconciliation statements.



STUDY NOTE – 3

ACCOUNTING FOR DEPRECIATION

This Study Note includes:

- Introduction
- Certain Useful Terms
- Nature of Depreciation
- Causes of Depreciation
- Characteristics of Depreciation
- Objective of and Necessity for providing Depreciation
- Measurement of Depreciation
- Methods of Charging Depreciation
- Provision for Depreciation Account
- Disposal of an asset
- Profit or Loss on sale of assets - Method of Depreciation Calculation
- Change of Method - Prospective and Retrospective
- Application of AS 6 - Depreciation Accounting
- Application of AS 10 - Accounting for Fixed Asset

3.1 INTRODUCTION

A business or concern holds fixed assets for regular use and not for resale. The capability of a fixed asset to render service cannot be unlimited. Except land, all other fixed assets have a limited useful life. The benefit of a fixed asset is received throughout its useful life. So its cost is the price paid for the 'Series of Services' to be received or enjoyed from it over a number of years and it should be spread over such years.

Depreciation means gradual decrease in the value of an asset due to normal wear and tear, obsolescence etc. In short, depreciation means the gradual diminution, loss or shrinkage in the utility value of an asset due to wear and tear in use, effluxion of time or introduction of technology in the market. A certain percentage of total cost of fixed assets which has expired and as such turned into expense during the process of its use in a particular accounting period.

Indian Accounting Standard (AS 6) states that "Depreciation is allocated so as to charge a fair proportion of the depreciable amount in each accounting period during the expected useful life of the asset."



"Depreciation accounting is a system of accounting which aims to distribute the cost or other basic value of tangible capital assets, less salvage (if any), over the estimated useful life of the unit (which may be a group of assets) in a systematic and rational manner. It is a process of allocation, not of valuation. Depreciation for the year is the portion of the total charge under such a system that is allocated to the year. Although the allocation may properly take into account occurrences during the year, it is not intended to be the measurement of the effect of all such occurrences."

The above definition may be criticized as under:

- i. It does not classify properly what is meant by systematic and rational manner. The word 'rational' may mean that it should reasonably be related to the expected benefits in any case.
- ii. Historical cost and any other kind of cost should be allocated or not to be does not defined by this definition.
- iii. Some Accountants are in a belief that depreciation is nothing but an arbitrary allocation of cost.

According to them, all the conventional methods say allocation of historical cost over a number of years arbitrarily.

3.2 CERTAIN USEFUL TERMS:

Amortization - Intangible assets such as goodwill, trademarks and patents are written off over a number of accounting periods covering their estimated useful lives. This periodic write off is known as Amortization and that is quite similar to depreciation of tangible assets. The term amortization is also used for writing off leasehold premises. Amortization is normally recorded as a credit to the asset account directly or to a distinct provision for depreciation account; Though the write off of intangibles that have no limited life is not approved by some Accountants, some concerns do amortize such assets on the ground of conservatism.

Depletion - This method is specially suited to mines, oil wells, quarries, sandpits and similar assets of a wasting character. In this method, the cost of the asset is divided by the total workable deposits of the mine etc. And by following the above manner rate of depreciation can be ascertained. Depletion can be distinguishable from depreciation in physical shrinkage or lessening of an estimated available quantity and the latter implying a reduction in the service capacity of an asset.

Obsolescence - The term 'Obsolescence' refers to loss of usefulness arising from such factors as technological changes, improvement in production methods, change in market demand for the product output of the asset or service or legal or medical or other restrictions. It is different from depreciation or exhaustion, wear and tear and deterioration in that these terms refer to functional loss arising out of a change in physical condition.



Study Note - 3 : Accounting For Depreciation

Dilapidation - In one sentence Dilapidation means a state of deterioration due to old age or long use. This term refers to damage done to a building or other property during tenancy.

3.3 NATURE OF DEPRECIATION:

Depreciation is a term applicable in case of plant, building, equipment, machinery, furniture, fixtures, vehicles, tools. These long-term or fixed assets have a limited useful life, i.e. they will provide service to the entity (in the form of helping in the generation of revenue) over a limited number of future accounting periods. Depreciation implies gradual decrease in the value of an asset due to normal wear and tear, obsolescence etc. In short, depreciation means the gradual diminution, loss or shrinkage in the utility value of an asset due to wear and tear in use, effluxion of time or introduction of technology in the market. It makes a part of the cost of assets chargeable as an expense in profit and loss account of the accounting periods in which the assets helped in earning revenue.

Thus, International Accounting Standard (IAS)-4 provides that "Depreciation is the allocation of the depreciable amount of an asset over its estimated useful life."

In Accounting Research Bulletin No. 22, AICPA observed that "Depreciation for the year is the portion of the total charge under such a system that is allocated to the year. Although the allocation may properly take into account occurrences during the year, it is not intended to be the measurement of the effect of all such occurrences."

3.4 CAUSES OF DEPRECIATION

A. Internal Causes

- (i) **Wear and tear** : Plant & machinery, furniture, motor vehicles etc. suffer from loss of utility due to vibration, chemical reaction, negligent handling, rusting etc.
- (ii) **Depletion (or exhaustion)** : The utility or resources of wasting assets (like mines etc.) decreases with regular extractions.

B. External or Economic Causes

- (i) **Obsolescence** : Innovation of better substitutes, change in market demand, imposition of legal restrictions may result into discarding an asset.
- (ii) **Inadequacy** : Changes in the scale of production or volume of activities may lead to discarding an asset.

C. Time element : With the passage of time some intangible fixed assets like lease, patents, copyrights etc., lose their value or effectiveness, whether used or not. The word "amortization" is a better term to speak for the gradual fall in their values.

D. Abnormal occurrences : An accident, fire or natural calamity can damage the service potential of an asset partly or fully. As a result the effectiveness of the asset is affected and reduced.



3.5 CHARACTERISTICS OF DEPRECIATION

The Characteristics of Depreciation are :

- i. It is a charge against profit.
- ii. It indicates diminution in service potential.
- iii. It is an estimated loss of the value of an asset. It is not an actual loss.
- iv. It depends upon different assumptions, like effective life and residual value of an asset.
- v. It is a process of allocation and not of valuation.
- vi. It arises mainly from an internal cause like wear and tear or depletion of an asset. But it is treated as any expense charged against profit like rent, salary, etc., which arise due to an external transaction.
- vii. Depreciation on any particular asset is restricted to the working life of the asset.
- viii. It is charged on tangible fixed assets. It is not charged on any current asset. For allocating the costs of intangible fixed assets like goodwill, etc, a certain amount of their total costs may be charged against periodic revenues. This is known as amortization.

3.6 OBJECTIVE OF AND NECESSITY FOR PROVIDING DEPRECIATION

Eric Kohler defined depreciation as "the lost usefulness, expired utility, the diminution in service yield." Its measurement and charging are necessary for cost recovery. It is treated as a part of the expired cost for an asset. For determination of revenue, that part or cost should be matched against revenue. The objects or necessities of charging depreciation are :

- (i) **Correct calculation of cost of production:** Depreciation is an allocated cost of a fixed asset. It is to be calculated and charged correctly against the revenue of an accounting period. It must be correctly included within the cost of production.
- (ii) **Correct calculation of profits:** Costs incurred for earning revenues must be charged properly for correct calculation of profits. The consumed cost of assets (depreciation) has to be provided for correct matching of revenues with expenses.
- (iii) **Correct disclosure of fixed assets at reasonable value:** Unless depreciation is charged, the depreciable asset cannot be correctly valued and presented in the Balance Sheet. Depreciation is charged so that the Balance Sheet exhibits a true and fair view of the affairs of the business.
- (iv) **Provision of replacement cost:** Depreciation is a non-cash expense. But net profit is calculated after charging it. Through annual depreciation cash resources are saved and accumulated to provide replacement cost at the end of the useful life of an asset.



Study Note - 3 : Accounting For Depreciation

- (v) **Maintenance of capital:** A significant portion of capital has to be invested for purchasing fixed assets. The values of such assets are gradually reduced due to their regular use and passage of time. Depreciation on the assets is treated as an expired cost and it is matched against revenue. It is charged against profits. If it is not charged the profits will remain inflated. This will cause capital erosion.
- (vi) **Compliance with technical and legal requirements:** Depreciation has to be charged to comply with the relevant provisions of the Companies Act and Income Tax Act.

Note: As per Companies Act 1956, a company have to provide for depreciation on fixed assets before declaration of dividends.

3.7 MEASUREMENT OF DEPRECIATION

Measurement of depreciation is quite difficult to calculate the exact amount of depreciation since they depend on a number of factors. Some of the factors are;

- i. The actual cost of asset.
- ii. The additions, if any, made to the assets during the year taking into consideration the date of purchase.
- iii. The expected amount of interest of opportunity loss.
- iv. The estimated life of the asset.
- v. The scrap, break-up or the residual value of asset.
- vi. Obsolescence, i.e. the chance of the asset going out of fashion.
- vii. The renewals and repairment of the asset.
- viii. The legal provisions relating to the depreciation. (Provision of Companies Act , Income Tax Act and others)

All the above said factors should be taken into consideration at the time of determining the amount of depreciation in such a way that a proper and reasonable estimate can be provided against the amount of depreciation.

3.8 METHODS OF CHARGING DEPRECIATION

There are different concepts about the nature of depreciation. Moreover, the nature of all fixed assets cannot be the same. As a result, different methods are found to exist for charging depreciation. A broad classification of the methods may be summarized as follows :

Capital/Source of Fund

- (i) Sinking Fund Method
- (ii) Annuity Method
- (iii) Insurance Policy Method



Time Base

- (i) Fixed Installment Method
- (ii) Reducing Balance Method
- (iii) Sum of Years' Digit Method
- (iv) Double Declining Method

Use Base

- (i) Working Hours Method
- (ii) Mileage Method
- (iii) Depletion Service Hours Method Unit method

Price Base

- (i) Revaluation Method
- (ii) Repairs Provision Method

Some important Methods of Charging Depreciation are discussed as below :

I. Fixed/Equal Installment OR Straight Line Method

Features :

- (i) A fixed portion of the cost of a fixed asset is allocated and charged as periodic depreciation.
- (ii) Such depreciation becomes an equal amount in each period.
- (iii) The formula for calculation of depreciation is :

$$\text{Depreciation} = (V-S)/n$$

Where,

V= Cost of the Asset

S= Residual value or the expected scrap value

n= estimated life of the asset

Illustration 1.

Calculate the Rate of Depreciation under Straight Line Method (SLM) in each of the following:-

Machine No.	Cost of Machine	Expenses incurred at the time of purchase to be capitalized	Estimated Residual Value	Expected Useful Life in years
1	90,000	10,000	20,000	8
2	24,000	7,000	1,000	6
3	95,000	15,000	20,000	3
4	2,20,000	80,000	50,000	5

Study Note - 3 : Accounting For Depreciation

Solution

Machine No.	Cost of Machine (Rs.)	Expenses incurred at the time of purchase to be capitalized (Rs.)	Total Cost of Asset = (b+c) (Rs.)	Estimated Residual Value (Rs.)	Expected useful Life in years	Depreciation = (d-e)/f (Rs.)	Rate of Depreciation under SLM = (g/d) × 100
a	b	c	d	e	f	g	h
1	90,000	10,000	1,00,000	20,000	8	10,000	10%
2	24,000	7,000	31,000	3,100	6	4,650	15%
3	1,05,000	20,000	1,25,000	12,500	5	22,500	18%
4	2,50,000	30,000	2,80,000	56,000	10	22,400	8%

Illustration 2

A machine is purchased for Rs. 7,00,000. Expenses incurred on its cartage and installation Rs. 3,00,000. Calculate the amount of depreciation @ 20% p.a. according to Straight Line Method for the first year ending on 31st March, 2020 if this machine is purchased on:

- (a) 1st April, 2020
- (b) 1st July, 2020
- (c) 1st October, 2020
- (d) 1st January, 2021

Solution:

Here, Total Cost of Asset = Purchased Price + Cost of Cartage and Installation
= Rs. 7,00,000 + Rs. 3,00,000 = Rs. 10,00,000

Amount of Depreciation :

= Total Cost of Asset × Rate of Depreciation ×

Period from the date of purchase to
date of closing accounts

12

- (a) The machine was purchased on 1st April, 2020: $12/12 = 2,00,000$
Amount of Depreciation = Rs. 10,00,000 × 20% × $9/12 = 1,50,000$
- (b) 1st July, 2020
Amount of Depreciation = Rs. 10,00,000 × 20% × $6/12 = 1,00,000$
- (c) 1st October, 2020
Amount of Depreciation = Rs. 10,00,000 × 20% × $6/12 = 1,00,000$
- (d) 1st January, 2021
Amount of Depreciation = Rs. 10,00,000 × 20% × $3/12 = 50,000$



II. Reducing / Diminishing Balance Method OR Written Down Value Method

Features :

- Depreciation is calculated at a fixed percentage on the original cost in the first year. But in subsequent years it is calculated at the same percentage on the written down values gradually reducing during the expected working life of the asset.
- The rate of allocation is constant (usually a fixed percentage) but the amount allocated for every year gradually decreases.

Illustration 3.

On 1.1.2018 a machine was purchased for Rs. 1,00,000 and Rs. 50,000 was paid for installation. Assuming that the rate of depreciation was 10% on Reducing Balance Method, calculate amount of depreciation upto 31.12.2020.

Solution

Year	Opening Book Value (Rs.)	Rate	Depreciation (Rs.)	Closing Book Value (Rs.)
2018	1,50,000	10%	15,000	1,35,000
2019	1,35,000	10%	13,500	1,21,500
2020	1,21,500	10%	12,150	1,09,350

Note: Cost of the machine (i.e. Opening Book Value for the year 2018)

$$= \text{Cost of Purchase} + \text{Cost of Installation}$$

$$= \text{Rs. } 1,00,000 + \text{Rs. } 50,000 = \text{Rs. } 1,50,000$$

Illustration 4.

On 1.1.18 machinery was purchased for Rs. 80,000. On 1.7.19 additions were made to the amount of Rs. 40,000. On 31.3.2020, machinery purchased on 1.7.2019, costing Rs. 12,000 was sold for Rs. 11,000 and on 30.06.2020 machinery purchased on 1.1.2018 costing Rs. 32,000 was sold for Rs. 26,700. On 1.10.2020, additions were made to the amount of Rs. 20,000. Depreciation was provided at 10% p.a. on the Diminishing Balance Method.

Show the Machinery Accounts for three years from 2018-2020. (year ended 31st December)

Solution

Statement of Depreciation

Particulars	Machines-I Cost = Rs. 80,000		Machines-II Cost = Rs. 40,000		Machines-III Cost = Rs. 20,000	Total Depreciation
1.1.2018 Book Value	48,000	32,000				
31.12.2018 Depreciation	4,800	3,200				8,000
01.01.2019 W.D.V.	43,200	28,800				



Study Note - 3 : Accounting For Depreciation

01.07.2019			28,000	12,000		
31.12.2019 Depreciation	4,320	2,880	1,400	600		9,200
01.01.2020 W.D.V.	38,880	25,920	26,600	11,400		
31.03.2020 Depreciation				285		
W.D.V.				11,115		
Sold For				11,000		
Loss on sale				115		
30.06.2020 Depreciation		1,296				
W.D.V.		24,624				
Sold for		26,700				
Profit on Sale		2,076				
01.10.2020 Purchase					20,000	
31.12.2020 Depreciation	3,888		2,660		500	8,629
01.01.2021 WDV	34,992		23,940		19,500	

Dr.

Machinery Account

Cr.

Date	Particulars	Amount (Rs.)	Date	Particulars	Amount (Rs.)
01.01.18	To, Bank A/c	80,000	31.12.18	By, Depreciation A/c	8,000
				" Balance c/d	72,000
		80,000			80,000
01.01.19	To, Balance b/d	72,000	31.12.19	By, Depreciation A/c	9,200
01.07.19	" Bank A/c	40,000		" Balance c/d	1,02,800
		1,12,000			1,12,000
01.01.20	To, Balance b/d	1,02,800	31.3.20	By, Bank (Sale) A/c	11,000
30.06.20	" P & L A/c (Profit on Sale)	2,076		" Depreciation A/c	285
	" Bank A/c	20,000	30.6.20	" P & L A/c (Loss on Sale)	115
				" Bank A/c (Sale)	26,700
			31.12.12	" Depreciation A/c	1,296
				" Depreciation A/c	7,048
				" Balance c/d	78,432
		1,24,876			1,24,876



III. Sinking Fund Method

A sinking fund is a fund created with a specific purpose which may be :

- (i) To redeem or repay a long term liability, e.g., debenture, long-term loans, etc. or
- (ii) To replace a wasting asset, e.g., a mine; or
- (iii) To replace an asset of depreciable nature; or
- (iv) To renew a lease.

When a sinking fund is created to provide for replacement of wasting assets, it is in effect depreciation; the installments are charged against profits.

Under this method, the asset is kept in the books at its original cost. Every year during the estimated life of the asset, an equal amount of depreciation is charged to profit and loss account and credited to a Depreciation Fund or Sinking Fund Account. At the same time a provision for replacement of the asset

is made by investing an amount equal to the depreciation charged, in securities outside the business by debiting Depreciation Fund Investment or Sinking Fund Investment Account and crediting Bank. Interest received on the investment is credited to the Depreciation Fund Account and is also reinvested likewise. The amount that is annually provided as depreciation is such that this, with compound interest will be sufficient to provide a sum equal to the cost of asset, less residual value (if any), by the time the asset is expected to become useless.

At the end of the working life of the asset, the investment are sold away and the money realised therefrom is utilized for purchasing a new asset. Profit or Loss on such sale, if any, is transferred to the Depreciation Fund Account. The old asset account, standing in the books at original cost, is closed by setting it off against the Depreciation Fund Account.

The formula for calculation of the depreciation amount is as follows :

$$D = \frac{C}{(1+i)^n - 1}$$

Where,

D = Depreciation

C = Cost of the asset

i = Rate of Depreciation n = Life of the asset

Journal Entries under the Sinking Fund method :



Study Note - 3 : Accounting For Depreciation

At the end of first year

- (i) For annual depreciation

Profit & Loss A/c Dr.
 To Depreciation Fund A/c (annual contribution)
or To Sinking Fund A/c

- (ii) For investment of annual depreciation

Sinking Fund Investment A/c Dr.
 To Bank A/c (invested amount)

At the end of second/subsequent years

- (i) Profit & Loss A/c ... Dr.
 To Sinking Fund A/c (annual contribution)

- (ii) Bank A/c Dr.
 To Interest on Investment A/c (annual interest)

- (iii) Interest on Investment A/c Dr.
 To Sinking Fund A/c (interest transferred)

- (iv) Sinking Fund Investment A/c Dr.
 To Bank A/c

[amount invested usually = annual contribution + annual interest]

When the working life of the asset ends (i), (ii) & (iii) same as above; (iv) not made in the last year

- (v) Bank A/c Dr.
 To Sinking Fund Investment A/c

- (vi) Sinking Fund Investment A/c Dr.
 To Sinking Fund A/c (Profit on Sale) (Investments sold out) OR

- (vii) Sinking Fund A/c..... Dr.
 To Asset A/c [Asset A/c closed]

- (viii) Sinking Fund A/c Dr.
 To Sinking Fund Investment A/c (Loss on Sale)

Notes:

- (i) No investment is made in the last year as the investments are to be sold out.
(ii) Sinking Fund Account may be called Depreciation Fund Account also. It is to be shown on the liability side of Balance Sheet.



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- (iii) Sinking Fund Investments Account may be called Depreciation Fund Investments Account also. It is to be shown on the Asset side of the Balance Sheet.
- (iv) Annual Contribution (charged in lieu of annual depreciation) = Original Cost x Present Value of Rs. 1 at given interest rate.

Illustration 5.

On 1.7.2016 W Ltd. purchased a machinery for Rs. 1,10,000 and spent Rs. 6,000 on its installation. The expected life of the machine is 4 years, at the end of which the estimated scrap value will be Rs. 16,000. Desiring to replace the machine on the expiry of its life, the company establishes a Sinking Fund. Investments are expected to realize 5% interest.

On 30.06.2020, the machine was sold off as scrap for Rs. 18,000 and the investments were retained at 5% less than the book value. On 1.7.2020, a new machine is installed at a cost of Rs. 1,25,000.

Sinking Fund table shows that Rs. 0.2320 invested each year will produce Rs. 1 at the end of 4 years at 5%. Show the necessary ledger accounts in the books of W Ltd.

Solution

Sum required	Annual contribution
1	0.2320
(Rs. 1,10,000 + Rs. 6,000 - Rs. 16,000) = Rs. 1,00,000	= 0.2320 x 1,00,000
	= Rs. 23,200

In the Books of W Ltd.

Dr.

Sinking Fund Account

Cr.

Date	Particulars	Amount (Rs.)	Date	Particulars	Amount (Rs.)
30.6.17	To Balance b/d.	23,200	30.6.17	By Profit and Loss A/c	23,200
		23,200			23,200
30.6.17	To Balance c/d	47,560	30.6.18	By, Balance b/d	23,200
			30.6.17	By, Bank (interest @ 5%)	1,160
				A/c By, Profit and Loss A/c	23,200
		47,560			47,560
30.6.19	To Balance c/d	73,138	01.7.18	By, Balance b/d	47,560
			30.6.19	By, Bank (interest @ 5%) A/c	2,378
				By, Profit and Loss A/c	23,200
		73,138			73,138



Study Note - 3 : Accounting For Depreciation

30.6.19	To, Sinking Fund Investment A/c		01.7.19	By, Balance b/d	73,138
	- Loss on sale	3,657	30.6.20	By, Bank interest @ 5%	3,657
	To, Machinery A/c. - Transfer	96,338		By, Profit and Loss A/c	23,200
		99,995			99,995

Dr.

Sinking Fund Investment Account

Cr.

Date	Particulars	Amount (Rs.)	Date	Particulars	Amount (Rs.)
30.6.17	To, Bank A/c.	23,200	30.6.17	By, Balance c/d	23,200
		23,200			23,200
01.07.17	To, Balance b/d	23,200	30.6.18	By, Balance c/d	47,560
30.6.18	To, Bank A/c. (Rs.1,160 + Rs. 23,200)	24,360			
01.7.18	To, Balance b/d	47,560	30.6.19	By, Balance c/d	73,138
30.6.19	To, Bank A/c. (Rs.2,378 + Rs. 23,200)	25,578			
		73,138			73,138
01.7.20	To, Balance b/d	73,138	30.6.20	By, Bank A/c - Sales	69,481
				By, Sinking Fund A/c -Loss on sale (balancing figure)	3,657
		73,138			73,138

IV. Annuity Method

The annuity method considers that the business, besides losing the original cost of the asset also loses interest, on the amount used for buying the asset, which he would have earned in case the same amount would have been invested in some other form of investment. Thus, the asset account is debited with interest, which is ultimately credited with amount of depreciation which remains fixed year after year. The annual amount of depreciation is determined with the help of annuity table. The amount of depreciation is determined by adding the cost of the asset (i.e., purchase price) and interest thereon at an expected rate.

The Journal entries are as follows :

- (i) Depreciation A/c Dr.
 To Asset A/c
 (for depreciation as calculated from annuity table)



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Study Note - 3 : Accounting For Depreciation

Year- IV			Year-IV		
Opening	To, Balance b/d	4,295	Closing	By , Depreciation A/c	2,310
Closing	" Interest A/c	215		" Balance c/d	2,200
		4,510			4,510
Year- V			Year-V		
Opening	To, Balance b/d	2,200	Closing	By, Depreciation A/c	2,310
Closing	" Interest A/c	110			
		2,310			2,310

V. Revaluation Method

This method should be adopted only where the asset is represented by a large number of small and diverse items of small unit cost, e.g., hand tools, live-stock, sacks etc. in such cases it is not possible to attempt to depreciate each individual item. In this method the following steps to be taken :

1st, at the end of financial year, all items, which are in good condition and can serve well, are valued at cost.

2nd, the cost, as calculated above, is compared with the opening balance and the difference is charged as depreciation.

3rd, purchases of asset are debited to asset account in a normal manner.

It is very important to note that under this method the total amount to be written off as depreciation is directly credited to asset account (not an accumulated depreciation account)

Illustration 7.

On 1.1.2020, A Ltd. has a stock of bottles valued at Rs. 8,000. On 1.7.20, they purchased additional bottles which amounted to Rs. 5,000. On Dec. 31, 2020, the entire stock of bottles was revalued at Rs. 10,500. Show the Bottle Account for the year 2020.

In the book of A. Ltd.

Dr.			Bottle Account			Cr.		
Date	Particulars	Amount (Rs.)	Date	Particulars	Amount (Rs.)			
2020			2020					
Jan. 1	To, Balance b/d	8,000	Dec. 31	By Depreciation A/c (bal. fig.)	2,500			
July 1	“ Bank A/c	5,000						
				“Balance C/d	10,500			
		13,000			13,000			



VI. Depletion Unit Method

This method is specially suited to mines, oil wells, quarries, sandpits and similar assets of a wasting character. The cost of the natural resources is the price paid for its acquisition plus price paid for the development of such asset in order to bring it to a state suitable for production.

The periodic depletion is better not calculated in terms of year. Rather it is better to calculate the cost per unit and then multiply the cost of units produced in that particular year. Depletion for each unit extracted is determined as follows :

$$\text{Depletion per unit (U)} = \frac{\text{Acquisition cost (C) - Residual value (S)}}{\text{Estimated life in terms of production units (n)}}$$

Illustration 8.

In 2018, a company acquired a mine at a cost of Rs. 5,00,000. The estimated reserve of minerals is 50,00,000 tonnes, of which 80% is expected to be realised. The first three years raisings are 1,50,000; 2,00,000 and 2,50,000 tonnes, respectively. Show the Mines Account, charging depreciation under Depletion Method.

Solution :

Total quantity expected to be realized --- 80% of 50,00,000, i.e. 40,00,000 tonnes.

Cost of the mine Rs. 5,00,000

$$\text{Hence, Charge per tonne} = \frac{\text{Rs. 5,00,000}}{40,00,000} = \text{Rs. 0.125 or } 1/8.$$

Therefore, Depreciation for 2018 = 1,50,000 × 1/8 = Rs. 18,750
 for 2019 = 2,00,000 × 1/8 = Rs. 25,000
 for 2020 = 2,50,000 × 1/8 = Rs. 31,250



Study Note - 3 : Accounting For Depreciation

Dr.			Mines Account			Cr.		
Date	Particulars	Amount (Rs.)	Date	Particulars	Amount (Rs.)			
2018	To Bank A/c	5,00,000	2018 Dec. 31	By, Depreciation A/c	18,750			
				" Balance c/d	4,81,250			
		5,00,000			5,00,000			
2019 Jan.1	To Balance b/d	4,81,250	2019 Dec.31	By, Depreciation A/c	25,000			
				" Balance c/d	4,56,250			
		4,81,250			4,81,250			
2020 Jan. 1	To Balance b/d	4,56,250	2020 Dec. 31	By, Depreciation A/c	31,250			
				"Balance c/d	4,25,000			
		4,56,250			4,56,250			
2021 Jan.1	To Balance b/d	4,25,000						

3.9 PROVISION FOR DEPRECIATION ACCOUNT

Provision of depreciation is the collected value of all depreciation. Provision of depreciation account is the account of provision of depreciation. With making of this account we are not credited depreciation in asset account. But transfer every year depreciation to provision of depreciation account. Every year we adopt this procedure and when assets are sold we will transfer sold asset 'total depreciation' to credit side of asset account, for calculating correct profit or loss on fixed asset. This provision uses with any method of calculating depreciation.

There are following features of provision for depreciation account :

- Fixed asset is made on its original cost and every year depreciation is not transfer to fixed asset account.
- Provision of depreciation account is Conglomerated value of all old depreciation.
- This system can be used both in straight line and diminishing method of providing depreciation. The journal entries will be :

(i) For purchase of asset

Asset's A/c	Dr.
To Cash/Bank A/c	

(ii) For providing depreciation at end of year

Depreciation A/c	Dr.
To Provision for depreciation A/c	



- (iii) For sale of assets
Cash/Bank A/c Dr.
To Asset Sales A/c
- (iv) Cost of assets sold transferred from Assets Account to Sale of Assets Account.
Assets Sales A/c Dr.
To Asset's A/c.
- (v) Total depreciation on asset sold transferred from provision for depreciation account.
Provision for depreciation A/c Dr.
To Asset Sales A/c
- (vi) Profit or loss on sale of assets will be transferred from asset sale account to Profit or Loss Account.

3.10 DISPOSAL OF AN ASSET

When an asset is sold because of obsolescence or inadequacy or any other reason, the cost of the asset is transferred to a separate account called "Asset Disposal Account". The following entries are to be made:

- (i) When the cost of the asset is transferred:
Asset Disposal A/c Dr.
To, Asset A/c (original cost)
- (ii) When depreciation provided on the asset is transferred:
Provision for Depreciation A/c Dr.
To, Asset Disposal A/c
- (iii) For charging depreciation for the year of sale:
Depreciation A/c Dr.
To, Asset Disposal A/c
- (iv) When cash received on sale of asset:
Bank/Cash A/c Dr.
To, Asset Disposal A/c
- (v) When loss on disposal is transferred to Profit & Loss A/c:
Profit & Loss A/c Dr.
To, Asset Disposal A/c
- (vi) When profit on disposal is transferred to Profit & Loss A/c:
Asset Disposal A/c Dr.
To, Profit & Loss A/c



Study Note - 3 : Accounting For Depreciation

Illustration 9.

S & Co. purchased a machine for Rs. 1,00,000 on 1.1.2018. Another machine costing Rs. 1,50,000 was purchased on 1.7.2019. On 31.12.2020, the machine purchased on 1.1.2018 was sold for Rs. 50,000. The company provides depreciation at 15% on Straight Line Method. The company closes its accounts on 31st December every year. Prepare - (i) Machinery A/c,

(ii) Machinery Disposal A/c and (iii) Provision for Depreciation A/c.

Solutions:

S & Co.

Dr. **Machinery Account** Cr.

Date	Particulars	Amount (Rs.)	Date	Particulars	Amount (Rs.)
1.1.2018	To, Bank A/c	1,00,000	31.12.2018	By, Balance c/d	1,00,000
		1,00,000			1,00,000
1.1.2019	To, Balance b/d	1,00,000			
1.7.2019	To Bank A/c	1,50,000	21.12.2019	By, Balance b/d	2,50,00
		2,50,000			2,50,000
1.1.2020	To Balance b/d	2,50,00	21.12.2020	By, Machinery	1,00,000
				Disposal A/c	
			31.12.2020	By, Balance c/d	1,50,000
		2,50,000			2,50,000
1.1.2021	To, Balance b/d	1,50,000			

Dr. **Provision for Depreciation Account** Cr.

Date	Particulars	Amount (Rs.)	Date	Particulars	Amount (Rs.)
31.12.2018	To, Balance c/d	15,000	31.12.2018	By, Depreciation A/c	15,000
		15,000			15,000
31.12.2019	To, Balance c/d	41,250	1.1.2019	By, Balance b/d	15,000
			31.12.2019	By, Depreciation A/c (Rs. 15,000 + Rs. 11,250)	26,250
		41,250			41,250
31.12.2020	To, Machinery Disposal A/c	30,000	1.1.2020	By, Balance b/d	
31.12.2020	To, Balance c/d	33,750	31.12.2020	By, Depreciation A/c	22,750
		63,750			63,750
			1.1.2021	By, Balance b/d	33,750



Cr.

Date	Particulars	Amount (Rs.)	Date	Particulars	Amount (Rs.)
1.12.2020	To, Machinery A/c	1,00,000	31.12.2020	By, Provision for Depreciation A/c	30,000
			31.12.2020	By, Depreciation A/c	15,000
			31.12.2020	By, Bank A/c	50,000
			31.12.2020	By, Profit & Loss A/c (Loss on Sale)	5,000
		1,00,000			1,00,000

Working Notes

- Depreciation for the machine purchased on 1.7.2019
For the year 2019 (used for 6 months) = Rs. 1,50,000 $\times$ 15% $\times$ $\frac{6}{12}$ = Rs. 11,250
For the year 2020 (used for full year) = Rs. 1,50,000 $\times$ 15% = Rs. 22,500
- Depreciation for the machine purchased on 1.1.2018
Depreciation = Rs. 1,00,000 $\times$ 15% = Rs. 15,000
So, Depreciation for 2 years = Rs. 15,000 $\times$ 2 = Rs. 30,000

3.11. PROFIT OR LOSS ON SALE OF ASSETS - METHOD OF DEPRECIATION CALCULATION

Sometimes an asset is sold before the completion of its useful life for some unavoidable circumstances (due to obsolescence etc.) including a part of the asset which is no longer required in future. If the sale price is less than the WDV, there will be loss, and vice versa. The profit & loss on sale of asset is adjusted in the year of Sale in Profit & Loss Account.

Accounting Treatment

a. Where no provision for depreciation account is maintained:

WDV of the amount sold will be transferred to 'Assets Disposal Account'. The entries will be as follows:

- (i) WDV of asset has been transferred to Asset Disposal A/c--

Asset Disposal A/c Dr.
To Asset A/c

- (ii) In case of Sale of an Asset---

Cash/Bank A/c Dr.
To Asset Disposal A/c

Study Note - 3 : Accounting For Depreciation

- (iii) For depreciation (if any)---
- | | |
|--------------------------|-----|
| Depreciation (P & L A/c) | Dr. |
| To Asset Disposal A/c | |
- (iv) In case of Profit on Sale of Asset
- | | |
|----------------------|-----|
| Asset Disposal A/c | Dr. |
| To Profit & Loss A/c | |
- (v) In case of Loss on Sale of Asset
- | | |
|-----------------------|-----|
| Profit & Loss A/c | Dr. |
| To Asset Disposal A/c | |

b. Alternative Approach

In this situations, all adjustments are to be prepared through the assets account. The entries are as follows:

- (i) In case of Assets sold
- | | |
|---------------|-----|
| Cash/Bank A/c | Dr. |
| To Assets A/c | |
- (ii) In case of Depreciation
- | | |
|-----------------------------------|-----|
| Depreciation (Profit & Loss) A/c | Dr. |
| To Assets A/c | |
- (iii) In case of Profit on Sale
- | | |
|------------------|-----|
| Assets A/c | Dr. |
| To Profit & Loss | |
- (iv) In case of Loss on Sale
- | | |
|-------------------|-----|
| Profit & Loss A/c | Dr. |
| To Assets A/c | |

Illustration 10.

On 1st April, 2018, Som Ltd. purchased a machine for Rs.66,000 and spent Rs.5,000 on shipping and forwarding charges, Rs.7,000 as import duty, Rs.1,000 for carriage and installation, Rs.500 as brokerage and Rs.500 for an iron pad. It was estimated that the machine will have a scrap value of Rs. 5,000 at the end of its useful life which is 15 years. On 1st January, 2019 repairs and renewals of Rs. 3,000 were carried out. On 1st October, 2020 this machine was sold for Rs. 50,000. Prepare Machinery Account for the 3 years.



Solutions:

In the books of Som Ltd.

Dr.			Machinery Account			Cr.		
Date	Particulars	Amount (Rs.)	Date	Particulars	Amount (Rs.)			
1.04.2018	To, Bank A/c	66,000	31.03.2019	By, Depreciation A/c	5,000			
01.04.2018	To, Bank A/c	14,000	31.03.2019	By, Balance c/d	75,000			
		80,000			80,000			
01.04.2019	To, Balance b/d	75,000	31.03.2020	By, Depreciation A/c	5,000			
			31.03.2020	By, Balance c/d	70,000			
		75,000			75,000			
01.04.2020	To, Balance b/d	70,000	01.10.2020	By, Depreciation A/c	2,500			
			01.10.2020	By, Bank A/c (Sale)	50,000			
			01.10.2020	By, Profit & Loss A/c (Loss)	17,500			
		70,000			70,000			

Working Note :

1. Total Cost = Rs.66,000 + Rs.5,000 + Rs.7,000 + Rs.1,000 + Rs.500 + Rs.500 = Rs.80,000

$$\text{Depreciation} = \frac{\text{Total Cost} - \text{Scrap Value}}{\text{Expected life}} = \frac{80,000 - 5,000}{15} = 5,000$$

The amount spent on repairs and renewals on 1st January, 2019 is of revenue nature and hence, does not form part of the cost of asset.

3.12. CHANGE OF METHOD - PROSPECTIVE AND RETROSPECTIVE

As per AS-6, the depreciation method selected should be applied consistently from period to period. Change in depreciation method should be made only in the following situations :

- For compliance of statute.
- For compliance of accounting standards.
- For more appropriate presentation of the financial statement.

The change in method may be made possible in two ways :

- With prospective effect, and
- With retrospective effect



Study Note - 3 : Accounting For Depreciation

- (i) **With prospective effect** - Under this method, the change in method is to be taken into consideration for the rest of the useful life of the asset commencing from the year in which such change is effected and not from the beginning of the year.

Illustration 11.

Rise Ltd. purchased a machinery for Rs. 1,00,000 on 1.1.2017. The machine was depreciated at 10% p.a. under the Straight Line Method. On 1.1.2020, the company decided to change the method of depreciation from Straight Line Method to Diminishing Balance Method without retrospective effect. Prepare Machine A/c from 2017 to 2020.

Solutions:

In the books of Rise Ltd.

Dr.			Machinery Account			Cr.		
Date	Particulars	Amount (Rs.)	Date	Particulars	Amount (Rs.)			
01.01.17	To, Bank A/c	1,00,000	31.12.17	By, Depreciation A/c	10,000			
				By, Balance c/d	90,000			
		1,00,000			1,00,000			
01.01.18	To, Balance b/d	90,000	31.12.18	By, Depreciation A/c	10,000			
				By, Balance c/d	80,000			
		90,000			90,000			
01.01.19	To, Balance b/d	80,000		By, Depreciation A/c	10,000			
				By, Balance c/d	70,000			
		80,000			80,000			
			31.12.20	By, Depreciation A/c – 10% on Rs. 70,000	7,000			
01.01.20	To, Balance b/d	70,000		By, Balance c/d	63,000			
		70,000			70,000			

Illustration 12.

A second hand machine was purchased on 1.1.2015 for Rs. 4,00,000 overhauling and installation expenses for the same machine amounted to Rs. 1,00,000. Another machine was purchased for Rs. 2,00,000 on 1.7.2015.

On 1.7.2017, the machine installed on 1.1.2015 was sold for Rs. 2,50,000. Dismantling charges for the machine sold on 1.7.2017 was Rs.10,000. On the same date, another machine was purchased for Rs. 8,00,000 and was commissioned on 30.9.2017. The company had adopted calendar year as its financial year. Under the existing practice, the company provides depreciation @10% p.a. on



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original cost. In 2018, it has been decided that depreciation will be charged on the overhauling balance @ 15% p.a.. The change is not to be made with retrospective effect.

Show Plant Account for 2015-2019.

Solutions:

Statement of Depreciation

Particulars	Machine-I (Rs.)	Machine-II (Rs.)	Machine-III (Rs.)	Total Depreciation (Rs.)
1.1.2015 Bank (including expenses)	5,00,000			
1.7.2018 Bank		2,00,000		
31.12.2016 Depreciation @ 10%	50,000	10,000		60,000
1.1.2016 WDV	4,50,000	1,90,000		
31.12.2016 Dep. @ 10%	50,000	20,000		70,000
1.1.2015 W.D.V.	4,00,000	1,70,000	8,00,000	
1.7.2015 Dep.@10%	25,000			
	3,75,000			
Add : Dismantling Charges	10,000			
	3,85,000			
Sold for	2,50,000			
Loss on sale	1,35,000			
31.12.2017 Dep. @ 10%		20,000	40,000	85,000
1.1.2018 WDV		1,50,000	7,60,000	(20,000+40,000+25,000)
31.12.2018 Dep. @ 15%		22,500	1,14,000	1,36,500
1.1.2019 WDV		1,27,500	6,46,000	
31.12.2019 Dep. @ 15%		19,125	96,900	1,16,025
1.1.2020 WDV		1,08,375	5,49,100	

Dr.

Machinery Account

Cr.

Date	Particulars	Amount (Rs.)	Date	Particulars	Amount (Rs.)
01.01.15	To Bank A/c	4,00,000	31.12.15	By Depreciation A/c	60,000
01.01.15	To Bank A/c (Expenses)	1,00,000	31.12.15	By Balance c/d	6,40,000
01.01.15	To Bank A/c	2,00,000			
		7,00,000			7,00,000

Study Note - 3 : Accounting For Depreciation

01.01.16	To Balance b/d	6,40,000	31.12.16	By Depreciation A/c	70,000
			31.12.16	By Balance c/d	5,70,000
		6,40,000			6,40,000
01.01.17	To Balance b/d	5,70,000	01.07.17	By Bank A/c (Sale)	2,50,000
01.07.17	To Bank A/c	8,00,000		By Depreciation A/c	25,000
01.07.17	To Bank A/c (Expenses)	10,000		By P&L A/c	1,35,000
			31.12.17	By Depreciation A/c	60,000
				By Balance c/d	9,10,000
		13,80,000			13,80,000
01.01.18	To Balance b/d	9,10,000	31.12.19	Depreciation A/c	1,36,500
				By Balance c/d	7,73,500
		9,10,000			9,10,000
1.01.19	To Balance b/d	7,73,500	31.12.19	By Depreciation A/c	1,16,025
				By Balance c/d	6,57,475
		7,73,500			7,73,500
01.02.20	To Balance b/d	6,57,475			

(ii) With retrospective effect

Procedure to be followed in this case :

- (i) Depreciation should be recalculated applying the new method from the date of its acquisition/ installation till the date of change of method.
- (ii) Difference between the total depreciation under the new method and the accumulated depreciation under previous method till the date of change may be surplus/ deficiency.
- (iii) The said surplus is credited to Profit & Loss account under the head "depreciation written Back".
- (iv) Deficiency is charged to profit & Loss account.
- (v) The journal entries will be :
 - (a) If old value is less

Profit and Loss A/c.	Dr.
To, Assets A/c.	
 - (b) If old value is more

Asset A/c.	Dr.
To, Profit and Loss A/c.	
- (vi) The above change of depreciation method should be treated as change in accounting policy and its post effect should be disclosed and quantified.



Illustration 13.

Ram Ltd. which depreciates its machinery at 10% p.a. on Diminishing Balance Method, had on 1st January, 2020 Rs. 9,72,000 on the debit side of Machinery Account.

During the year 2020 machinery purchased on 1st January, 2018 for Rs. 80,000 was sold for Rs. 45,000 on 1st July, 2020 and a new machinery at a cost of Rs. 1,50,000 was purchased and installed on the same date, installation charges being Rs. 8,000.

The company wanted to change the method of depreciation from Diminishing Balance Method to Straight Line Method with effect from 1st January, 2017. Difference of depreciation up to 31st December, 2020 to be adjusted. The rate of depreciation remains the same as before. Show Machinery Account.

Solution

In the books of Ram Ltd.

Dr.

Machinery Account

Cr.

Date	Particulars		Amount (Rs.)	Date	Particulars	Amount (Rs.)
01.01.20	To, Balance b/d			01.07.20	By, Depreciation A/c	3,240
					[W.N.3]	
		9,07,200			By, Bank A/c-Sale	45,000
		64,800	9,72,000		By, Loss on sale of	
			1,58,000		Machine A/c (W.N.4)	16,560
01.07.20	To, Bank A/c (1,50,000 + 8,000)					
				31.12.20	By, Depreciation A/c:	
					- For the year 2020	1,12,000
				31.12.20	- For ½ year	7,900
					By, Profit & Loss A/c :	
					Adjustment	11,200
					By, Balance c/d :	
					- M (9,07,200 - 1,12,000	7,84,000
					- 11,200)	
					- M	Nil
					- M (1,58,000 - 7,900)	1,50,100
			11,30,000			11,30,000



Study Note - 3 : Accounting For Depreciation

Working Notes :

- (1) At 10% depreciation on Diminishing Balance Method :
- | | |
|---|-----------|
| If balance of machinery in the beginning of the year is | Rs.
10 |
| Depreciation for the year is | 1 |
| Balance of Machinery at the end of the year | 9 |
- By using the formula, balance of asset on 1st January 2017 will be calculated as follows :
- | | |
|--|-----------|
| Balance as on 1st January, 2020 | 9,72,000 |
| Balance as on 1st January, 2019 is $9,72,000 \times \frac{10}{9} =$ | 10,80,000 |
| Balance as on 1st January, 2018 is $10,80,000 \times \frac{10}{9} =$ | 12,00,000 |
- This balance, Rs. 12,00,000 is composed of 2 machines, one of Rs. 11,20,000 and another of Rs. 80,000.
- | | |
|--|----------|
| Depreciation at 10% p.a. on Straight Line Method on Rs. 11,20,000 | 1,12,000 |
| Total Depreciation for 2018 and 2019 (Rs. 1,12,000 x 2) | 2,24,000 |
| Total Depreciation charged for 2018 and 2019 on Diminishing Balance Method (1,12,000 + 1,00,800) | 2,12,800 |
| Balance to be charged in 2020 to change from Diminishing Balance Method to Straight Line Method | 11,200 |
- (2) Machine purchased on 1st January, 2018 for Rs. 80,000 shows the balance of Rs. 64,800 on 1st January 2020 as follows :
- | | |
|------------------------------|--------|
| Purchase price | 80,000 |
| Less : Depreciation for 2018 | 8,000 |
| | 72,000 |
| Less : Depreciation for 2019 | 7,200 |
| Balance as on Jan. 1, 2020 | 64,800 |
- (3) On second machine (original purchase price Rs. 80,000), depreciation at 10% p.a. on Rs. 64,800 for 6 months, viz., Rs. 3,240 has been charged to the machine on July 1 2020 i.e., on date of sale.
- (4) Loss on sale of (ii) machine has been computed as under :
- | | |
|---|--------|
| Balance of the machine as on 1.1.2020 | 64,800 |
| Less : Depreciation for 6 months up to date of sale | 3,240 |
| Balance on date of sale | 61,560 |
| Less : Sale proceeds | 45,000 |
| Loss on sale | 16,560 |



Illustration 14

M/s. Hot and Cold commenced business on 01.07.2015. When they purchased a new machinery at a cost of Rs. 8,00,000. On 01.01.2017 they purchased another machinery for Rs. 6,00,000 and again on 01.10.2019 machinery costing Rs. 15,00,000 was purchased. They adopted a providing of charging @ 20% p.a. on diminishing balance basis.

On 01.07.2019, they changed the method of providing depreciation and adopted the method of writing off the Machinery Account at 15% p.a. under straight line method with retrospective effect from 01.07.2015, the adjustment being made in the accounts for the year ended 30.06.2020.

The depreciation has been charged on time basis. You are required to calculate the difference in depreciation to be adjusted in the Machinery on 01.07.2019, and show the Machinery Account for the year ended 30.06.2020.

Solution

In the books of M/s Hot and Cold

Dr.			Machinery Account			Cr.		
Date	Particulars	Amount (Rs.)	Date	Particulars	Amount (Rs.)			
01.07.19	To, Balance b/d	6,73,280	30.6.20	By Depreciation A/c	3,78,750			
	To, Profit and Loss A/c (Depreciation Overcharged)	21,720		By Balance c/d	18,16,250			
01.10.19	To, Bank A/c (Purchase)	15,00,000						
		21,95,000			21,95,000			

Workings :

1. Statement of Depreciation:

Date	Particulars	Machine - I	Machine - II	Total Depreciation
01.07.2015	Book Value	8,00,000		
30.06.2016	Depreciation @ 20%	1,60,000		1,60,000
01.07.2016	W.D.V.	6,40,000		
01.01.2017	Bank (Purchase)		6,00,000	
30.06.2017	Depreciation @ 20%	1,28,000	60,000	1,88,000
01.07.2017	W.D.V.	5,12,000	5,40,000	
30.06.2018	Depreciation @ 20%	1,02,400	1,08,000	2,10,400
01.07.2018	W.D.V.	4,09,600	4,32,000	
30.06.2019	Depreciation @ 20%	81,920	86,400	1,68,320
		3,27,680	3,45,600	
		6,73,280		7,26,720



Study Note - 3 : Accounting For Depreciation

2. Depreciation Overcharged:

Now depreciation under Straight Line Method

On Rs. 8,00,000 @ 15% = Rs. 1,20,000 x 4 years = Rs. 4,80,000
(from 01.07.2015 to 30.06.2019)

? On Rs. 6,00,000 @ 15% = Rs. 90,000 x 2 years = Rs. 2,25,000
(from 01.01.2017 to 30.06.2019)

Rs. 7,05,000

Depreciation overcharged = Reducing Balance Basis - Straight Line Basis
= Rs. (7,26,720 - 7,05,000)
= Rs. 21,720

3. Depreciation for the year:

On Rs. 14,00,000 @ 15% for the year = Rs. 2,10,000

On Rs. 15,00,000 @ 15% for the 9 months = Rs. 1,68,750

Rs. 3,78,750

3.13. APPLICATION OF AS 6- DEPRECIATION ACCOUNTING

“Depreciation Accounting” (AS 6) (Revised)

The Accounting Standard regarding depreciation was issued at first in 1982. But it was revised in 1994. The revised standard (AS 6) is now mandatorily applicable to all concerns in India for accounting periods commencing on or after 1.4.1995. The important matters to be noted from (AS 6) are :

What is Depreciation as per AS-6?

Depreciation is a measure of wearing out, consumption or other loss of value of a depreciable asset arising from use and passage of time. Depreciation is nothing but distribution of total cost of assets over its useful life.

“Depreciable Assets” are the assets which : -

- (a) are expected to be used for more than one accounting period;
- (b) have limited useful life;
- (c) are held by an enterprise for use in production or supply of goods and services, for rental to others or for administrative purposes but not for sale in the ordinary course of business.

AS-6 is not applicable to the following assets:

- Forests, Plantations
- Wasting Assets, Minerals and Natural Gas



- Expenditure on research and development
- Goodwill
- Live stock - Cattle, Animal Husbandry.

How to calculate Depreciation?

Following are required to ascertain the depreciation of a Depreciable Asset

- Historical cost or other amount in place of historical cost like revalued amount
- Estimated useful life of depreciable assets
- Estimated residual or scrap value of depreciable assets

Computation of Depreciation:

$$\frac{\text{Cost (Residual Value of the end of useful life)}}{\text{Estimated useful in No. of years}}$$

How to ascertain the cost of depreciable assets?

Cost of depreciable assets is the total cost spent in connection with the acquisition; installation and commissioning of the assets as well as for add item or improvement of the depreciable assets.

“**Useful Life**” of a depreciable asset is the period over which the assets are expected to be used by the enterprise, which is generally shorter than the physical life.

Useful Life of a Depreciable asset depends on the following factors -

- Predetermined by legal contractual limits
- Depends upon the number of shifts for which the asset is to be used
- Repair and Maintenance policy of enterprise
- The theological obsolescence
- Innovation/improvement in the production method
- Change in demand of output
- Legal or other restrictions.

Estimated residual or scrap value:

This is the estimated value of a depreciable asset at the end of its useful life.

Change in Method of Depreciation:

The method selected for charging depreciation should be consistently followed. However, if situations demand (like change of statute, compliance with Accounting Standard, etc.) a



Study Note - 3 : Accounting For Depreciation

change of method may be made, that would result in change in accounting policy (which may be required by statute or for compliance with an Accounting Standards or for more appropriate presentation of financial statement), In that case -

- (i) if the change affects the state of affairs of Balance Sheet and Profit and Loss account of the current period or the Financial Statements of later period, then such change must be disclosed in financial statement. The amount, by which the financial statement is affected, should be disclosed to the extent it is ascertainable.
- (ii) the depreciation should be recalculated under the new method with effect from the date of the asset coming into use till the date of change of method, that is, with retrospective effect. Difference between the total depreciation under new method and the accumulated depreciation under the old method till the date of change of method should be computed first. Then the resultant surplus or deficiency is to be charged to credit and debit side of the Profit and Loss A/c respectively.

Change in Useful Life:

If there is a change in useful life of an asset, outstanding depreciable amount on the date of change in estimated useful life of asset is required to be allocated over the revised remaining useful life.

Any addition or extension essential for an existing asset, should be depreciated over the remaining life of the asset.

If the historical cost of an asset changes due to exchange fluctuations, price adjustments, etc. the depreciation on the revised unamortized depreciable amount should be provided prospectively for the rest of the life of the asset.

For any asset revalued, the provision for depreciation should be made on the revalued amount for the remaining useful life of the asset.

In the financial statements, the matters to be disclosed are-

- (i) The historical cost or any amount substituting it;
- (ii) Total depreciation for the period for each
- (iii) The related accumulated depreciation.

The method of charging depreciation should also be disclosed.

3.14. APPLICATION OF AS 10- ACCOUNTING FOR FIXED ASSET

Accounting Standard for Fixed Assets (AS 10)

Accounting Standard 10 is related with accounting of Fixed Assets. The important matters to be noted from (AS 10) are :



Fixed asset is an asset

- which is held with an intention of being used for the purpose of producing and providing goods and services
- which is not held for sale in the normal course of business
- which is expected to be used for more than one accounting period

Examples of Fixed Assets are-

- Land
- Building- Freehold/Leasehold
- Plant and Machinery
- Furniture & Fitting etc.

This accounting standard is applicable to all assets except the following:

- Forest, plantations and similar regenerative natural resource.
- Wasting assets like minerals, oil and natural gas
- Expenditure on real estate development
- Live stock

Fixed assets shall be shown in financial statement either at historical cost or revalued price.

- (a) The gross book value of a fixed asset should be either historical cost or a revaluation computed in accordance with the Accounting Standard. [Set out in paragraphs 20 to 26 and 27 to 32 of the Standards]

Historical cost of a Fixed Asset: It consist of the following:

- Purchase price
- Import duties and other taxes which is non-refundable in nature
- Any cost which is directly attributable to bring the asset to the working condition for its intended use.

In case of any self-constructed assets costs attributable to its construction and allocable to it, should be included in its value.

Items fixed assets retired from active use and held for disposal should be shown separately in the financial statements and stated at net book value or realizable value, whichever is lower.

If any subsequent expenditure causes an addition to the already expected future benefits of an asset, such expenditure should be added with the value of the asset.

Study Note - 3 : Accounting For Depreciation

Cost of assets acquired in exchange of existing assets:

- Fixed assets exchanged not similar

In case a new asset is acquired in part exchange of an old asset the exchange price should be recorded at fair market value of the asset acquired or at fair market value of the asset given up, if it is more clearly evident.

- Fixed assets exchanged are similar

In case a new asset is acquired in part exchange of an old asset the exchange price should be recorded at fair market value of the asset acquired or at fair market value of the asset given up, if it is more clearly evident or net book value of the old asset.

- Fixed asset acquired in exchange of shares, etc. should be recorded at its fair market value or the fair market value of the shares, etc. whichever is more clearly available.

Any loss or gain on the retirement or disposal of any fixed asset carried at cost should be recognized in the profit and loss account if the value of any asset increases on revaluation, its accumulated depreciation should not be debited to Profit & Loss Account. The depreciation on such revalued amount should be adjusted against Revaluation Reserves.

Disclosure requirement as per Accounting Standard 10:

- Gross and the net book values of fixed assets at the beginning and at the end of the accounting period showing there in any additions, disposal, acquisition and other movement.
- Expenditure incurred on account of fixed assets in the course of construction or acquisition.
- Revalued amount which is substituted for historical cost of the fixed asset, method adopted to compute the revalued amount, and whether an external valuer has valued the fixed assets, in case where fixed assets are stated at revalued amount.



STUDY NOTE – 4

PREPARATION of FINAL ACCOUNTS

This Study Note includes:

- Introduction
- Preparation of Financial Statements
- Bad Debts
- Preparation of Financial Statement of Non-Trading Concern

4.1 INTRODUCTION

Preparation of final accounts is the final destination of the accounting process. As discussed earlier these final accounts include two statements – Income statement which reflects the outcome of business activities during an accounting period (i.e. profit or loss) and the balance sheet which show the position of the business at the end of the accounting period (i.e. resources owned as assets and sources of funds as liabilities plus capital). The objective of financial statements is to provide information about the financial strength, performance and changes in financial position of an enterprise that is useful to a wide range of users in making economic decisions. Financial statements should be understandable, relevant, reliable and comparable. Reported assets, liabilities and equity are directly related to an organization's financial position. Reported income and expenses are directly related to an organization's financial performance.

Financial statements are intended to be understandable by readers who have “a reasonable knowledge of business and economic activities and accounting and who are willing to study the information diligently”.

In this chapter, we will see how conceptually these statements are prepared and what each of them contains.

4.2 PREPARATION OF FINANCIAL STATEMENTS

4.2.1 Profitability Statement – This statement is related to a complete accounting period. It shows the outcome of business activities during that period in a summarized form. The activities of any business will include purchase, manufacture, and sell.

4.2.2 Balance Sheet – Business needs some resources which have longer life (say more than a year). Such resources are, therefore, not related to any particular accounting period, but are to be used over the useful life thereof. The resources do not come free. One requires finance to acquire them. This funding is provided by owners through their investment, bank & other through



loans, suppliers by way of credit terms. The Balance Sheet shows the list of resources and the funding of the resources i.e. assets and liabilities (towards owners and outsiders). It is also referred as sources of funds (i.e. liabilities & capital) and application of funds (i.e. assets). Let us discuss these statements in depth.

4.2.2.1 Trading Account: It is an account which is prepared by a merchandising concern which purchases goods and sells the same during a particular period. The purpose of it to find out the gross profit or gross loss which is an important indicator of business efficiency.

The following items will appear in the debit side of the Trading Account:

- (i) **Opening Stock:** In case of trading concern, the opening stock means the finished goods only. The amount of opening stock should be taken from Trial Balance.
- (ii) **Purchases:** The amount of purchases made during the year. Purchases include cash as well as credit purchase. The deductions can be made from purchases, such as, purchase return, goods withdrawn by the proprietor, goods distributed as free sample etc.
- (iii) **Direct expenses:** it means all those expenses which are incurred from the time of purchases to making the goods in suitable condition. This expenses includes freight inward, octroi, wages etc.
- (iv) **Gross profit:** If the credit side of trading A/c is greater than debit side of trading A/c gross profit will arise. The following items will appear in the credit side of Trading Account:

- (i) **Sales Revenue:** The sales revenue denotes income earned from the main business activity or activities. The income is earned when goods or services are sold to customers. If there is any return, it should be deducted from the sales value. As per the accrual concept, income should be recognized as soon as it is accrued and not necessarily only when the cash is paid for. The Accounting standard 7 (in case of contracting business) and Accounting standard 9 (in other cases) define the guidelines for revenue recognition. The essence of the provisions of both standards is that revenue should be recognized only when significant risks and rewards (vaguely referred to as ownership in goods) are transferred to the customer. For example, if an invoice is made for sale of goods and the term of sale is door delivery; then sale can be recognized only on getting the proof of delivery of goods at the door of customer. If such proof is pending at the end of accounting period, then this transaction cannot be taken as sales, but will be treated as unearned income.
- (ii) **Closing Stocks :** In case of trading business, there will be closing stocks of finished goods only. According to convention of conservatism, stock is valued at cost or net realizable value whichever is lower.
- (iii) **Gross Loss:** When debit side of trading account is greater than credit side of trading account, gross loss will appear.



Study Note - 4 : Preparation Of Final Accounts

Preparation of Trading Account

Illustration 1.

Preparation of Trading Account Following are the ledger balances presented by M/s. P. Sen as on 31st March 2020.

Particulars	Amount (Rs.)	Particulars	Amount (Rs.)
Stock (1.4.2019)	10,000	Sales	3,00,000
Purchase	1,60,000	Return Inward	16,000
Carriage Inwards	10,000	Return Outward	10,000
Wages	30,000	Royalty on Production	6,000
Freight	8,000	Gas and Fuel	2,000

Additional Information :

- (1) Stock on 31.3.2020: (i) Market Price Rs. 24,000; (ii) Cost Price Rs. 20,000;
- (2) Stock valued Rs. 10,000 were destroyed by fire and insurance company admitted the claim to the extent of Rs. 6,000.
- (3) Goods purchased for Rs. 6,000 on 29th March, 2020, but still lying in-transit, not at all recorded in the books.
- (4) Goods taken for the proprietor for his own use for Rs. 3,000.
- (5) Outstanding wages amounted to Rs. 4,000.
- (6) Freight was paid in advance for Rs. 1,000.

Solution

In the books of M/s. P. Sen
Trading Account
For the year ended 31st March, 2020

Particulars	Amount (Rs.)	Amount (Rs.)	Particulars	Amount (Rs.)	Amount (Rs.)
To Opening Stock		10,000	By, Sales	3,00,000	
To Purchase	1,60,000		Less : Return Inward	16,000	2,84,000
Less : Return Outward	10,000				
	1,50,000		By, Closing Stock	20,000	
Less : Goods taken by					
Proprietor	3,000		Add : Stock Destroyed	10,000	
		1,47,000			30,000
Add : Goods in transit	6,000	1,53,000	Add : Goods in-Transit	6,000	36,000
To Wages	30,000				
Add : Outstanding	4,000	34,000			



To Carriage Inward					
To Freight	8,000				
Less : Prepaid	1,000	7,000			
To Royalty on production	6,000	6,000			
To Gas & fuel	2,000	2,000			
Profit & Loss A/c	98,000	98,000			
Gross Profit transferred	3,20,000	3,20,000			3,20,000

Note:

- (a) Stock should be valued as per cost price or market price whichever is lower.
- (b) The claim which was admitted by insurance company and the loss of stock, will not appear in Trading Account.

4.2.2.2 Profit and Loss Account:

The following items will appear in the debit side of the Profit & Loss A/c:

- (i) Cost of Sales: This term refers to the cost of goods sold. The goods could be manufactured and sold or can be directly identified with goods.
- (ii) Other Expenses : All expenses which are not directly related to main business activity will be reflected in the P & L component. These are mainly the Administrative, Selling and distribution expenses. Examples are salary to office staff, salesmen commission, insurance, legal charges, audit fees, advertising, free samples, bad debts etc. It will also include items like loss on sale of fixed assets, interest and provisions. Students should be careful to include accrued expenses as well.
- (iii) Abnormal Losses: All abnormal losses are charged against Profit & Loss Account. It includes stock destroyed by fire, goods lost in transit etc.

The following items will appear in the credit side of Profit & Loss A/c:

- (i) Revenue Incomes : These incomes arise in the ordinary course of business, which includes commission received, discount received etc.
- (ii) Other Incomes : The business will generate incomes other than from its main activity. These are purely incidental. It will include items like interest received, dividend received, etc .The end result of one component of the P & L A/c is transferred over to the next component and the net result will be transferred to the balance sheet as addition in owners' equity. The profits actually belong to owners of business. In case of company organizations, where ownership is widely distributed, the profit figure is separately shown in balance sheet.



Study Note - 4 : Preparation Of Final Accounts

Dr. **Trading Account for the year ended** Cr.

Particulars	Amount (Rs.)	Particulars	Amount (Rs.)
Opening Stock		Sales	
Finished goods		less sales returns	
Purchases		Closing stock	
Less : purchase returns		Finished goods	
Gross Profit (transferred to P & L A/c)		Gross Loss (transferred to P & L A/c)	
Total		Total	

Dr. **Profit and Loss Account for the year ended** Cr.

Particulars	Amount (Rs.)	Particulars	Amount (Rs.)
Gross Loss (transferred from Trading A/c)		Gross Profit (transferred from Trading A/c)	
Administrative expenses		Other Income	
Office salaries		interest received	
Communication		Commission received	
Travel & Conveyance		Profit on sale of assets	
Office rent		Rent received	
Depreciation of office assets		Net loss	
Audit fees		Total	
Insurance			
Repairs & maintenance			
Selling & Distribution expenses			
Advertising			
Salesmen commission			

Preparations of Profit & Loss Account

Illustration 2.

From the following particulars presented by Sri Tirlhankar for the year ended 31st March, 2021, Prepare Profit and Loss Account.

Gross Profit Rs.1,00,000, Rent Rs.22,000; Salaries Rs.10,000; Commission (Cr.)Rs.12,000; Insurance Rs.8,000; Interest (Cr.) 6,000; Bad Debts Rs.2,000; Provision for Bad Debts (1.4.2020) 4,000 Sundry Debtors 40,000; Discount Received Rs.2,000; Plant & Machinery 80,000.



Adjustments:

- (a) Outstanding salaries amounted to Rs. 4,000;
- (b) Rent paid for 11 months;
- (c) Interest due but not received amounted to Rs. 2,000
- (d) Prepaid Insurance amounted to Rs. 2,000;
- (e) Depreciate Plant and Machinery by 10% p.a.
- (f) Further Bad Debts amounted to Rs. 2,000 and make a provision for Bad @5% on Sundry Debtors.
- (g) Commissions received in advance amounted to Rs. 2,000.

Solution

**In the Books of Sri Tirlhankar
Profit and Loss Account
For the year ended 31st March 2021**

Dr.

Cr.

Particulars	Amount (Rs.)	Amount (Rs.)	Particulars	Amount (Rs.)	Amount (Rs.)
To Rent	22,000		By Trading A/c		1,00,000
Add Outstanding	2,000	24,000	Gross Point		
To Salaries	10,000		" Commission	12,000	
Add : Outstanding	4,000	14,000	Less : Received in advance	2,000	10,000
"Insurance	8,000		" Interest	6,000	
Less : Prepaid	2,000	6,000	Add : Accrued interest	2,000	8,000
"Bad Debts	2,000				
Add : further Bad Debts	2,000	4,000	"Discount received		2,000
"Depreciation on Plant & Machinery @10% on	80,000	8,000	"Provision for Bad Debts	4,000	
"Capital A/c (Net Profit Transferred)		66,100	Less : New Provision @5% on 40,000-2,000)	1,900	2,100
		1,22,100			1,22,100

4.2.2.3 Profit and Loss Appropriation Account

We know that the net profit or loss is added to or deducted from owner's equity. The net profit may be used by the business to distribute dividends, to create reserves etc. In order to show these adjustments, a P & I Appropriation A/c is maintained. Distribution of profits is only appropriation and does not mean a P & L Appropriation A/c is maintained. Distribution of profits is only appropriation is added in owner's equity.

Study Note - 4 : Preparation Of Final Accounts

The format of P & L Appropriation A/c is given below :

Solution

Dr. **Profit and Loss Appropriation Account for the year ended** Cr.

Particulars	Amount (Rs.)	Particulars	Amount (Rs.)
To Proposed dividend		By Net Profit transferred from P & L A/c	
To Transfer to General Reserve			
To Surplus carried to Capital A/c			
Total		Total	

Illustration 3

X, Y and Z are three Partners sharing profit and Losses equally. Their capital as on 01.04.2020 were 80,000; Y Rs.60,000 and Z Rs.50,000.

They mutually agreed on the following points (as per partnership deed)

- (a) Interest on capital to be allowed @5% p.a. (b) X to be received a salary @Rs.500 P.M. (c) Y to be received a commission @4% on net profit after charging such commission.
- (d) After charging all other items 10% of the net profit to be transferred General Reserve.

Profit from Profit and Loss Account amounted to Rs.66,720. Prepare a Profit and Loss Appropriation Account for the year ended 31st March, 2021.

Solution

In the books of X, Y and Z
Profit and Loss Appropriation Account
For the year ended 31st March, 2021

Dr. Cr.

Particulars	Amount (Rs.)	Amount (Rs.)	Particulars	Amount (Rs.)	Amount (Rs.)
To Interest on Capital :			By Profit and Loss A/c	66,720	
X	4,000				
Y	3,000				
Z	2,500	9,500			
“ Salaries					
X (500x12)		6,000			
“ Commission					
Y		19,701			



" General Reserve		4,9252			
" Net Divisible Profit					
X	14,775				
Y	14,775				
Z	14,775	44,325			
		66,720			66,720

Working:

- Net Profit before charging Y's Commission = (66,710-15,500)** = Rs.51,220
Less : Y's commission @4% i.e. - (4/104 x Rs.51,220) = Rs. 1,970
= Rs.49,250

- Transfer to General Reserve = Rs.49,250 x 10% = Rs.4,925**

4.2.2.4 Balance Sheet : Horizontal format of Balance Sheet is also used by the business other than company

A. Liabilities

4.2.2.4 Balance Sheet : Horizontal format of Balance Sheet is also used by the business other than company

A. Liabilities

- Capital :** This indicates the initial amount the owner or owners of the business contributed. This contribution could be at the time of starting business or even at a later stage to satisfy requirements of funds for expansion, diversification etc. As per business entity concept, owners and business are distinct entities, and thus, any contribution by owners by way of capital is liability.
- Reserves and Surplus :** The business is a going concern and will keep making profit or loss year by year. The accumulation of these profit or loss figures (called as surpluses) will keep on increasing or decreasing owners' equity. In case of non-corporate forms of business, the profits or losses are added to the capital A/c and not shown separately in the balance sheet of the business.
- Long Term or Non-Current Liabilities :** These are obligations which are to be settled over a longer period of time say 5-10 years. These funds are raised by way of loans from banks and financial institutions. Such borrowed funds are to be repaid in installments during the tenure of the loan as agreed. Such funds are usually raised to meet financial requirements to procure fixed assets. These funds should not be generally used for day-to-day business activities. Such loan are normally given on the basis of some security from the business e.g. against a charge on the fixed assets. So, long term loan are called as "Secured Loan" also.



Study Note - 4 : Preparation Of Final Accounts

- (d) **Short Term or Current Liabilities :** A liability shall be classified as Current when it satisfies any of the following :
- It is expected to be settled in the organisation's normal Operating Cycle,
 - It is held primarily for the purpose of being traded,
 - It is due to be settled within 12 months after the Reporting Date, or
 - The organization does not have an unconditional right to defer settlement of the liability for at least 12 months after the reporting date (Terms of a Liability that could, at the option of the counterparty, result in its settlement by the issue of Equity Instruments do not affect its classification)

Current liabilities comprise of :

- (i) **Sundry Creditors:** Amounts payable to suppliers against purchase of goods. This is usually settled within 30-180 days.
- (ii) **Advances from customers:** At times customer may pay advance i.e. before they get delivery of goods. Till the business supplies goods to them, it has an obligation to pay back the advance in case of failure to supply. Hence, such advances are treated as liability till the time they get converted to sales.
- (iii) **Outstanding Expenses:** These represent services procured but not paid for. These are usually settled within 30–60 days e.g. phone bill of Sept is normally paid in Oct.
- (iv) **Bills Payable:** There are times when suppliers do not give clean credit. They supply goods against a promissory note to be signed as a promise to pay after or on a particular date. These are called as bills payable or notes payable.
- (v) **Bank Overdrafts:** Banks may give fund facilities like overdraft whereby, business is permitted to issue cheques up to a certain limit. The bank will honour these cheques and will recover this money from business. This is a short term obligation.

B. Assets

In accounting language, all debit balances in personal and real accounts are called as assets. Assets are broadly classified into fixed assets and current assets.

- (a) **Fixed Assets:** These represent the facilities or resources owned by the business for a longer period of time. The basic purpose of these resources is not to buy and sell them, but to use for future earnings. The benefit from use of these assets is spread over a very long period. The fixed assets could be in tangible form such as buildings, machinery, vehicles, computers etc, whereas some could be in intangible form viz. patents, trademarks, goodwill etc. The fixed assets are subject to wear and tear which is called as depreciation. In the balance sheet, fixed assets are always shown as "original cost less depreciation".



- (b) **Investments:** These are funds invested outside the business on a temporary basis. At times, when the business has surplus funds, and they are not immediately required for business purpose, it is prudent to invest it outside business e.g. in mutual funds or fixed deposit. The purpose is to earn a reasonable return on this money instead of keeping them idle. These are assets shown separately in balance sheet.

Investments can be classified into Current Investments and Non-current Investments.

Non-current Investments are investments which are restricted beyond the current period as to sale or disposal.

Whereas, current investments are investments that are by their nature readily realizable and is intended to be held for not more than one year from the date on which such investment is made.

- (c) **Current Assets:** An asset shall be classified as Current when it satisfies any of the following :
- It is expected to be realised in, or is intended for sale or consumption in the organisation's normal Operating Cycle,
 - It is held primarily for the purpose of being traded,
 - It is due to be realised within 12 months after the Reporting Date, or
 - It is Cash or Cash Equivalent unless it is restricted from being exchanged or used to settle a Liability for at least 12 months after the Reporting Date.

Current assets comprise of:

- (i) **Stocks:** This includes stock of raw material, semi-finished goods or WIP, and finished goods. Stocks are shown at lesser of the cost or market price. Provision for obsolescence, if any, is also reduced. Generally, stocks are physically counted and compared with book stocks to ensure that there are no discrepancies. In case of discrepancies, the same are adjusted to P & L A/c and stock figures are shown as net of this adjustment.
- (ii) **Debtors:** They represent customer balances which are not paid. The bad debts or a provision for bad debt is reduced from debtors and net figure is shown in balance sheet.
- (iii) **Bills receivables:** Credit to customers may be given based on a bill to be signed by them payable to the business at an agreed date in future. At the end of accounting period, the bills accepted but not yet paid are shown as bills receivables.
- (iv) **Cash in Hand:** This represents cash actually held by the business on the balance sheet date. This cash may be held at various offices, locations or sites from where the business activity is carried out. Cash at all locations is physically counted and verified with the book balance. Discrepancies if any are adjusted.
- (v) **Cash at Bank:** Dealing through banks is quite common. Funds held as balances with bank are also treated as current asset, as it is to be applied for paying to suppliers. The balance



Study Note - 4 : Preparation Of Final Accounts

at bank as per books of accounts is always reconciled with the balance as per bank statement, the reasons for differences are identified and required entries are passed.

- (vi) Prepaid Expenses: They represent payments made against which services are expected to be received in a very short period.
- (vii) Advances to suppliers: When amounts are paid to suppliers in advance and goods or services are not received till the balance sheet date, they are to be shown as current assets. This is because advances paid are like right to claim the business gets.

Please note that both current assets and current liabilities are used in day-to-day business activities. The current assets minus current liabilities are called as working capital or net current assets. The following report is usual horizontal form of balance sheet. Please note that the assets are normally shown in descending order of their liquidity. Also, capital, long term liabilities and short term liabilities are shown in that order.

In case other than Company :

Capital & Liabilities	Amount	Assets	Amount
Capital (separate figures are shown for each owner)		Fixed Assets :	
		Land less depreciation	
		Building less depreciation	
Long term Liabilities :		Plant and Machinery	
Loans from banks or financial		less depreciation	
institutions		Vehicles less depreciation	
Current Liabilities		Computer systems less depreciation	
Sundry creditors		Office equipments less depreciation	
Bill payable		Current Assets :	
Advance from customers		Stocks	
Outstanding expenses		Sundry debtors less provisions	
Total		Bill receivables	
		Cash in hand	
		Cash at bank	
		Prepaid expenses	
		Advance to suppliers	
		Total	

Illustration 4.

From the following particulars prepare a Balance Sheet of Mr. X, for the year ended 31st March, 2021. Capital : Rs. 2,00,000; Drawings : Rs. 40,000 ; Cash In Hand : Rs. 20,000 ; Loan from Bank : Rs. 40,000; Sundry Creditors: Rs. 40,000; Bills Payable: Rs. 20,000; Bank Overdraft : Rs. 20,000; Goodwill: Rs. 60,000; Sundry Debtors : Rs. 80,000; Land and Building: Rs. 50,000; Plant and Machinery: Rs. 80,000; Investment: Rs. 20,000; Bills Receivable: Rs. 10,000.



Paper I: Fundamentals of Financial Accounting

The following adjustments are made at the time of preparing final accounts:

- I. Outstanding Liabilities for : Salaries Rs. 10,000; wages Rs. 20,000; Interest on Bank Overdraft Rs. 3,000; and Interest on Bank Loan Rs. 6,000.
- II. Provide Interest on Capital @ 10% p.a.
- III. Depreciation on Plant and Machinery by 10% p.a.
- IV. Bad Debts amounted to Rs. 10,000 and make a provision for Bad Debts @ 10% on Sundry Debtors.
- V. Closing stock amounted to Rs. 1,20,000.

Net profit for the year amounted to Rs. 96,000 after considering all the above adjustments.

Solution

In the books of Mr. X

Balance Sheet as at 31.03.2021

Dr.

Cr.

Particulars	Amount (Rs.)	Amount (Rs.)	Particulars	Amount (Rs.)	Amount (Rs.)
Capital	2,00,000		Goodwill		60,000
Add : Interest on Capital @10%	20,000		Land and Building		50,000
Add : Net Profit	96,000		Plant and Machinery	80,000	
		3,16,000	Less : Depreciation@10%	8,000	72,000
Less : Drawings	40,000	2,76,000	Investment		20,000
			Closing Stock		1,20,000
Bank Overdraft	20,000				
Add : Out, Interest	3,000	23,000	Sundry Debtors	80,000	
Bank Loan	60,000		Less : Bad Debts	10,000	
Add : Out Interest	6,000	66,000		70,000	
			Less : Prov. for Bad debts @10%	7,000	63,000
			Bill Receivable		10,000
Sundry Creditors		40,000	Cash at Bank		40,000
Bill Payable		20,000	Cash in Hand		20,000
Outstanding Liabilities :					
Salaries	10,000				
Wages	20,000	30,000			
		4,55,000			4,55,000



Study Note - 4 : Preparation Of Final Accounts

Example

Indicate where the following items will be shown in various components of P & L A/c :

(1) Wages	(2) Salaries of office staff
(3) Depreciation on office car	(4) Noon sign advertisement
(5) Power & fuel	(6) Repairs of Machinery
(7) Maintenance of office building	(8) Purchase returns or return outwards
(9) Closing stock of WIP	(10) Opening stock of finished goods
(11) Interest received	(12) Commission paid
(13) Telephone	(14) Travel & conveyance
(15) Insurance	(16) Audit fees
(17) Carriage inward	(18) Freight outward
(19) Bad debts	(20) Provision for outstanding rent
(21) Return inwards or sale returns	(22) Discount earned
(23) Depreciation on delivery van	(24) Printing and Stationery
(25) Sales	

Solution :

Item	Treatment	Where
Wages	Trading A/c	Dr
Salaries to office staff	P & L A/c	Dr
Depreciation on office car	P & L A/c	Dr
Power & fuel	Trading A/c	Dr
Repairs to machinery	Trading A/c	Dr
Maintenance of office building	P & L A/c	Dr
Purchase returns or return outwards	Trading A/c	Dr less from purchases
Closing stock of WIP	Trading A/c	Cr
Opening stock of finished goods	Trading A/c	Dr
Interest received	P & L A/c	Cr
Commission paid	P & L A/c	Dr
Telephone	P & L A/c	Dr
Travel & conveyance	P & L A/c	Dr
Insurance	P & L A/c	Dr
Audit fees	P & L A/c	Dr
Carriage inward	Trading A/c	Dr
Freight outward	P & L A/c	Dr



Paper I: Fundamentals of Financial Accounting

Bad debts	P & L A/c	Dr
Provision for outstanding rent	P & L A/c	Dr
Return inwards or sales returns	Trading A/c	Cr less from sales
Discount earned	P & L A/c	Cr
Depreciation on delivery van	P & L A/c	Dr
Printing and stationery	P & L A/c	Dr
Sales	Trading A/c	Cr

Illustration 5.

Indicate where the following items will be shown in the balance sheet.

- (1) Credit balance in the bank column of the cash book
- (2) Debit balance to the account of A who is a customer
- (3) Credit balance in A/c of B who is supplier
- (4) Debit balance in A/c of C who is a supplier
- (5) Credit balance in A/c of D who is a customer
- (6) Outstanding rent
- (7) Insurance paid for the next year
- (8) Loan from HDFC bank for 7 years
- (9) Interest due on loan
- (10) Provision for doubtful debtors
- (11) Net Profit for the year
- (12) Machinery
- (13) Accumulated depreciation on vehicle
- (14) Cash at Bangalore office
- (15) Balance with Citi Bank

Answer:

- (1) Credit balance in the bank column of cash book indicates a liability towards bank. This is actually a bank overdraft. Hence, it should be shown as Current Liability.
- (2) Debit balance in A's A/c means amount due from him as a customer. To be shown as Sundry Debtors.



Study Note - 4 : Preparation Of Final Accounts

- (3) Credit balance in supplier's A/c is a liability, hence will be shown under Current Liabilities.
- (4) Debit balance in supplier's A/c reflects an advance given to supplier, hence will be shown under Current Asset.
- (5) Credit balance in customer's A/c means advance from customer, hence will be shown as Current Liability.
- (6) Outstanding rent will be shown under Current Liability.
- (7) Insurance paid for next year is 'prepaid' for current year, hence will be taken as Current Asset
- (8) Loan from HDFC is for 7 years which is a long term loan, hence will be shown as Long Term Liability.
- (9) Interest due on loan is Current Liability.
- (10) Provision for doubtful debts will be reduced from the sundry debtor's amount under Current Assets as it denotes chances of not receiving the money from customers.
- (11) Net Profit for the year will be added to the Capital or to Reserves and Surplus in Balance Sheet.
- (12) Machinery is a Fixed Asset.
- (13) Accumulated depreciation on vehicle is reduction in its value, so will be shown as deduction from vehicle under Fixed Assets.
- (14) Cash at Bangalore office is a Current Asset.
- (15) Balance with Citi Bank is Current Asset.

Illustration 6.

Mahindra Traders operates in an industry that has a high rate of bad debts. On 31st March 2020, the Accounts Receivables showed a balance of Rs. 7,50,000 before any year end adjustment and the balance in the Reserve of doubtful debts was Rs. 37,500. The year end balance in the Reserve for Doubtful Debts A/c will be based on the following ageing schedule.

Days outstanding	Amount (Rs.)	Probability of collection
Less than 16	4,50,000	0.99
16-30	1,50,000	0.94
31-45	75,000	0.80
46-60	45,000	0.65
61-75	15,000	0.50
Over 75	15,000	0.00



Paper I: Fundamentals of Financial Accounting

Find out the appropriate balance in the Reserve for Doubtful Debts Account as on 31st March, 2020. Show how Debtors balance be shown in the Balance Sheet. Calculate the effect of year end adjustment on Account of Reserve for Doubtful Debts.

Solution :

We need to work out the provision for doubtful debts based on the collection probability given e.g. in the first ageing band, the probability to collection is given as 0.99 which means 1% of the outstanding amount in this band is unlikely to be collected, so a provision of 1% will be needed. The total provision required based on the ageing is shown in the following table.

Days outstanding	Amount (Rs.)	Probability of collection	Provision required	Provision Amt (Rs.)
Less than 16	4,50,000	0.99	1%	4,500
16-30	1,50,000	0.94	6%	9,000
31-45	75,000	0.80	20%	15,000
46-60	45,000	0.65	35%	15,750
61-75	15,000	0.50	50%	7,500
Over 75	15,000	0.00	100%	15,000
Total	7,50,000			66,750

It will be seen that the existing provision in the books stands at Rs.37,500, as against the required provision of Rs.66,750. This means additional provision of Rs.29,250 will be required to be made as year end adjustment for the year ended 31-03-2020. The answer will be :

(a) Appropriate balance in Reserve for Doubtful Debts A/c as on 31-03-2020 is Rs.66,750.

(b) Debtors amount will be shown in the Balance Sheet as under :

Outstanding debtors	7,50,000
Less : Reserve for doubtful debts	37,500
Additional provision required	29,250
	66,750

(c) The effect of this additional provision of Rs.29,250 will reduce the profit for the year by the same amount

Illustration 7

A property dealer owned many properties which if had acquired by taking bank loans. There were separate loan agreements for different properties. In some cases, interest was paid in advance and in other cases it was payable in arrears. These properties were let out to different tenants on various agreements. Some agreements provided for rentals in advance while the other provided for rent payable in arrears. The dealer has given the following balances :



Study Note - 4 : Preparation Of Final Accounts

	31.03.2019	31.03.2020
Interest payable	12,000	14,500
Interest prepaid	8,000	6,400
Rentals due from tenants	15,000	19,000
Rentals received in advance	3,000	2,500

During the year 2019-20 the amount of interest payable transferred to P & L A/c was Rs.56,000 and cash collected from tenants for rentals was Rs.1,16,000.

You are required to prepare Interest Payable A/c and Rental Income A/c for the year ended 2019-20.

Solution :

Please note although 4 different figures are given, we are asked to prepare only two accounts. This means the opening as well as closing balance will have to be written in these 2 accounts only. thus, we should find out what these 4 figures represent. This is shown in following table:

	31.03.2019 Opening	31.03.2020 Closing
Interest payable	Liability	Liability
Interest prepaid	Asset	Asset
Rentals due from tenants	Asset	Asset
Rentals received in advance	Liability	Liability

Please be careful to notice how the opening and closing balances are shown. Now, students should be able to interpret the balancing figures in these accounts.

Dr.	Interest payable Account						Cr.
Date	Particulars	J.F.	Amount (Rs.)	Date	Particulars	J.F.	Amount (Rs.)
	To Balance b/d (prepaid)		8,000		By Balance b/d (due)		12,000
	To, Cash paid (balancing figure)		51,900		By P & L A/c		56,000
	To Balance c/d (due)		14,500		By, Balance c/d (prepaid)		6,400
			74,400				74,400
	To, Balance b/d (prepaid)		6,400		By, Balance b/d (due)		14,500



Paper I: Fundamentals of Financial Accounting

Dr.		Rentals Income Account					Cr.
Date	Particulars	J.F.	Amount (Rs.)	Date	Particulars	J.F.	Amount (Rs.)
	To Balance b/d (receivable)		15,000		By Balance b/d (advance)		3,000
	To P&L A/c (balancing figure)		1,20,500		By Cash received		1,16,000
	To Balance c/d (advance)		2,500		By, Balance c/d (receivable)		19,000
			1,38,000				1,38,000
	To, Balance b/d (prepaid)		19,000		By, Balance b/d (due)		2500

The balancing figure in Interest Payable A/c will reflect interest actually paid during the year, whereas the balancing figure in Rentals Income is the income taken to P & L A/c for the year.

Illustration 8

Following is the Trail Balance of M/s Brijesh and Sons. Prepare final accounts for the year ended on 31st March, 2020

Particulars	Debit (Rs.)	Credit (Rs.)
Stock as on 01-04-2019	2,00,000	
Purchases and Sales	22,00,000	35,00,000
Bills receivables	50,000	
Returns	100,000	50,000
Carriage Inwards	50,000	
Debtors and Creditors	200,000	4,00,000
Carriage Outwards	40,000	
Discount	5,000	5,000
Salaries and Wages	2,20,000	
Insurance	60,000	
Rent		60,000
Wages and salaries	80,000	
Bad debts	10,000	
Furniture		4,00,000



Study Note - 4 : Preparation Of Final Accounts

Brijesh's capital		5,00,000
Brijesh's drawing	70,000	
Loose tools	1,00,000	
Printing & stationery	30,000	
Advertising	50,000	
Cash in hand	45,000	
Cash at bank	2,00,000	
Petty Cash	5,000	
Machinery	3,00,000	
Commission	10,000	30,000
Total	44,85,000	44,85,000

Adjustments :

- Stock on 31st March was valued at Cost price Rs.4,20,000 and market price Rs.400,000
- Depreciate furniture @10% p.a. and machinery @20% p.a. on reducing balance method.
- Rent of Rs.5,000 was paid in advance (iv) Salaries & wages due but not paid Rs.30,000.
- Make a provision for doubtful debts @5% on debtors.
- Commission receivable - Rs.5,000.

Solution

Dr. **Trading Account for the year ended 31st March, 2020** Cr.

Particulars	Amount (Rs.)	Amount (Rs.)	Particulars	Amount (Rs.)	Amount (Rs.)
Opening stock			Sales	3,500,000	
Finished goods		2,00,000	Less Sales Returns	100,000	3,400,000
Purchases	22,00,000				
Less : Purchases returns	50,000	21,50,000	Closing Stock		
Carriage inwards		50,000	Finished goods		4,00,000
Wages & salaries		80,000			
Gross Profit c/d		13,20,000			
		38,00,000			38,00,000



Paper I: Fundamentals of Financial Accounting

Dr. Profit & Loss Account for the Year Ended 31st March, 2020 Cr.

Particulars	Amount (Rs.)	Amount (Rs.)	Particulars	Amount (Rs.)	Amount (Rs.)
Administrative expenses			Gross Profit b/d		13,20,000
Salaries & wages	2,20,000		Discount received		5,000
Add: Not paid	30,000	2,50,000	Commission received	30,000	
Depreciation on furniture		40,000	Add : receivable	5,000	35,000
Depreciation of Machinery		60,000			
Insurance		60,000			
Rent		60,000			
Less: Paid in advance	5,000	55,000			
Printing & Stationery		30,000			
Selling & Distribution					
expenses:					
Advertising		50,000			
Carriage Outwards		40,000			
Discounts		5,000			
Bad debts		10,000			
Commission		10,000			
Provision for doubtful debts		10,000			
Net profit		740,000			
		13,60,000	Total		13,60,000

Dr. Profit & Loss Account for the Year Ended 31st March, 2020 Cr.

Capital & Liabilities	Amount (Rs.)	Amount (Rs.)	Assets	Amount (Rs.)	Amount (Rs.)
Brijesh's Capital	5,00,000		Fixed Assets: Furniture	400,000	
Less : Drawings	70,000		Less: Depreciation	40,000	3,60,000
Add : Net Profit for the year					
Long term Liabilities:-	7,40,000	11,70,000	Machinery	300,000	
			Less: Depreciation	60,000	2,40,000
			Loose tools		1,00,000



Study Note - 4 : Preparation Of Final Accounts

Current Liabilities: Sundry creditors		4,00,000	Current Assets : Stocks		4,00,000
Outstanding salaries & wages		30,000	Sundry debtors	200,000	
			Less: Provision for doubtful debts	10,000	1,90,000
			Bills receivables		50,000
			Cash in hand		45,000
			Cash at bank		2,00,000
			Petty cash		5,000
			Prepaid Rent		5,000
			Commission receivable		5,000
		16,00,000			16,00,000

Notes :

- (1) Closing stock is valued at market price here as it is less than cost price (conservatism concept)
- (2) Returns in debit column mean sales return, while that in credit column means purchase returns
- (3) Discounts in debit column mean allowed (expense) and that in credit means received (income)
- (4) Commission in debit column mean allowed (expense) and that in credit means received (income)
- (5) There are two peculiar items given in the IB. One is Salaries & Wages and the other is Wages and salaries. The interpretation is -where first reference is made to wages, it's assumed to be directly for goods and taken to Trading A/c. If the first reference is to salaries, it's assumed to be related to office and taken to P & L.

Illustration 9

Mr. Arvind Kumar had a small business enterprise. He has given the trial balance as at 31st March, 2020

Particulars	Debit (Rs.)	Credit (Rs.)
Mr. Arvinkumar's Capital		1,00,000
Machinery	36,000	
Depreciation on machinery	4,000	
Repairs to machinery	5,200	
Wages	54,000	



Paper I: Fundamentals of Financial Accounting

Salaries	21,000	
Income tax of Mr. Arvindkumar	1,000	
Cash in hand	4,000	
Land & Building	1,49,000	
Depreciation on building	5,000	
Purchases	2,50,000	
Purchase returns		3,000
Sales		4,98,000
Citi Bank		7,600
Accrued Income	3,000	
Salaries outstanding		4,000
Bills receivables	30,000	
Provision for doubtful debts		10,000
Bills payable		16,000
Bad debts	2,000	
Discount on purchases		7,080
Debtors	70,000	
Creditors		62,520
Opening stock	74,000	
Total	7,08,200	7,08,200

Additional information:

- (1) Stock as on 31st March 2020 was valued at Rs. 60,000
- (2) Write off further Rs. 6,000 as bad debt and maintain a provision of 5% on doubtful debt.
- (3) Goods costing Rs. 10,000 were sent on approval basis to a customer for Rs. 12,000 on 30th March, 2020. This was recorded as actual sales.
- (4) Rs. 2,400 paid as rent for office was debited to Landlord's A/c and was included in debtors.
- (5) General Manager is to be given commission at 10% of net profits after charging his commission.
- (6) Works manager is to be given a commission at 12% of net profit before charging General Manager's commission and his own.



Study Note - 4 : Preparation Of Final Accounts

You are required to prepare final accounts in the books of Mr. Arvind Kumar.

Solution

In the books of Mr. Arvind Kumar

Dr. **Trading Account for the year ended 31st March, 2020** Cr.

Particulars	Amount (Rs.)	Amount (Rs.)	Particulars	Amount (Rs.)	Amount (Rs.)
Opening Stock			Sales	498,000	
Finished goods		74,000	Less : Sent an approval	(12,000)	4,86,000
Purchases	2,50,000				
Less : Purchase returns	(3,000)	2,47,000	Closing Stock : Finished goods	60,000	
Wages		54,000	Add sent on approval	10,000	70,000
Gross Profit c/d		181,000			
		5,56,000			5,56,000

Dr. **Profit and Loss Account for the year ended 31st March, 2020** Cr.

Particulars	Amount (Rs.)	Amount (Rs.)	Particulars	Amount (Rs.)	Amount (Rs.)
Administrative expenses			Gross Profit b/d		1,81,000
Salaries		21,000	Discount received		7,080
Repairs to machinery		5,200			
Depreciation of Machinery		4,000			
Depreciation of Building		5,000			
Rent		2,400			
Selling & Distribution expenses :					
Bad debts	2,000				
Additional bad debts :	6,000				
Provision for doubtful debts	2,480				
Less : Provision opening	(10,000)	480			
Commission to works manager		18,000			
Commission to General Manager		12,000			
Net Profit		1,20,000			
		1,88,080			1,88,080



Paper I: Fundamentals of Financial Accounting

Dr.

Balance Sheet as on 31st March, 2020

Cr.

Particulars	Amount (Rs.)	Amount (Rs.)	Particulars	Amount (Rs.)	Amount (Rs.)
Arvind kumar's Capital	1,00,000		Fixed Assets:		
Less: drawings (income tax)	(1,000)		Land & building		1,49,000
Add: Net Profit for the year	1,20,000	2,19,000	Machinery		36,000
Long term Liabilities:			Current Assets:		
Current Liabilities:			Stocks	60,000	
Sundry creditors		62,520	Add: Sent on approval	10,000	70,000
Outstanding salaries		4,000	Sundry debtors	70,000	
			Sundry debtors		
			Less: Goods on approval	(12,000)	
Citi Bank Overdraft		7,600	Less : Bad debts	(6,000)	
			Less : Related to landlord	(2,400)	
Bill payable		16,000			
Commission payable		30,000	Less : Provision for doubtful debts	(2,480)	47,120
			Bills receivable		30,000
			Cash in hand		4,000
			Accrued Income		3,000
		3,39,120			3,39,120

Notes :

- (1) The closing entries are passed for the items : depreciation, accrued income, outstanding salary, Hence, they are directly taken to the respective places in Balance Sheet and P & L A/c.
- (2) Income tax paid for Mr. Arvind Kumar will be treated as drawings.
- (3) Commission payable to works manager & general manager is computed as below :

Profit before charging any commission	150,000
Commission to works manager @ 12% on 150,000	18,000
Profit after works manager's commission	132,000
Commission to General Manager	12,000



Study Note - 4 : Preparation Of Final Accounts

Illustration 10

Jamnadas provides you with the following T. B. as on 31st March, 2020

Particulars	Debit (Rs.)	Credit (Rs.)
Stock as on 1st April 11	35,000	
Depreciation	5,000	
Accumulated depreciation		40,000
Fixed Asset	50,000	
Loss on sale of fixed asset	8,000	
Investments	1,25,000	
Profit on sale of investments		80,000
Sales at 20% gross margin		800,000
Purchases	7,50,000	
Customers' accounts	1,00,000	20,000
Creditors' accounts	5000	60,000
Expenses	42,000	
Discount	18,000	12,000
Commission	50,000	80,000
Amounts due to principals		8,000
Amounts due from dealers	75,000	
Deposits with Principals	1,00,000	
Deposits from dealers		1,50,000
Cash	7,000	
Income on investments		5,000
Interest on deposit with Principals	12,000	
Interest on deposits from dealers	18,000	
Prepaid/outstanding expenses		
As on 31st March, 2019	7,000	13,000
As on 31st March, 2020	9,000	6,000
Fixed deposits with bank	2,00,000	
Interest on fixed deposits with bank	20,000	
Drawings/Capital	60,000	3,00,000
Banks		58,000
Total	16,64,000	16,64,000



Paper I: Fundamentals of Financial Accounting

The cost of fixed assets sold is Rs.30,000 accumulated depreciation being Rs.9,000

Prepare the financial statements. Also separately show Accumulated depreciation A/c, & Expenses A/c.

Solution :

Dr. Accumulated Depreciation Account Cr.

Date	Particulars	Amount (Rs.)	Date	Particulars	Amount (Rs.)
31.03.2020	To, Asset (Sold)	9,000	01.04.2019	By Balance b/d (Bal. Fig)	44,000
			31.03.2020	By P & L (depreciation)	5,000
31.03.2020	To, Balance c/d	40,000			
		49,000			49,000
				By balance b/d	40,000

Dr. Expenses Account Cr.

Date	Particulars	Amount (Rs.)	Date	Particulars	Amount (Rs.)
01.04.2019	To Balance (prepaid)	7,000	01.04.2019	By, Balance b/d (due)	13,000
31.04.2020	To, Cash paid (Bal. figure)	45,000	31.03.2020	By, P&L A/c (42,000-13,000+7,000)	36,000
1.04.2020	To, Balance b/d (due)	6,000	31.03.2020	By Balance c/d (pre paid)	9,000
		58,000			58,000
	To Balance b/d (pre paid)	9,000		By, Balance b/d (due)	6,000

Dr. Trading Account for the year ended 31st March 2020 Cr.

Particulars	Amount (Rs.)	Particulars	Amount (Rs.)
Opening Stock		Sales	8,00,000
Finished goods	35,000		
Purchases	7,50,000		
		Closing stock : Finished goods	1,45,000
Gross Profit c/d	1,60,000		
	9,45,000		9,45,000



Study Note - 4 : Preparation Of Final Accounts

Dr. **Profit and Loss Account for the year ended 31st March, 2020** Cr.

Particulars	Amount (Rs.)	Particulars	Amount (Rs.)
Administrative Expenses	-	Gross Profit b/d	1,60,000
Expenses	36,000	Profit on sale of investment	80,000
Depreciation	5,000	Discount received	12,000
Loss on sale of fixed assets	8,000	Commission received	80,000
Discount allowed	18,000	Income from investments	5,000
Commission given	50,000	Interest deposits with principals	12,000
Interest on deposits to dealers	18,000	Interest bank deposits	20,000
Net profit	234,000		
Total	3,69,000	Total	3,69,000

Sales	8,00,000	(this is op stock 35,000+purchases 750,000) (785,000-640,000)
Gross margin on sales @20%	1,60,000	
Cost of goods sold	6,40,000	
Goods available for sale	7,85,000	
Hence, closing stock should be	1,45,000	

Dr. **Balance Sheet as on 31st March, 2020** Cr.

Capital & Liabilities	Amount (Rs.)	Amount (Rs.)	Assets	Amount (Rs.)	Amount (Rs.)
Jamnadas's Capital	3,00,000		Fixed Assets :	80,000	
Less : Drawings	(60,000)		Less : Acc. Dep for sold	(30,000)	
Add : Net Profit for the year	2,34,000	4,74,000	Balance of assets	50,000	
			Depreciation opening	44,000	
Long term Liabilities			Less : Acc Dep for sold	(9,000)	
Current Liabilities :			Add for the year	5,000	
Sundry creditors		60,000	Net Acc. Dep	40,000	
Advance from Customers		20,000	Net fixed Asset		10,000
Dues to Principal		8,000			
Bank overdraft		58,000	Investments		1,25,000



Paper I: Fundamentals of Financial Accounting

Outstanding expenses		6,000	Current Assets :		1,45,000
			Stocks		
Deposits from dealers		1,50,000	Sundry debtors		1,00,000
			Deposits with Principals		1,00,000
			Cash in hand		7,000
			Fixed deposit with Bank		2,00,000
			Dues from dealers		75,000
			Advance to suppliers		5,000
			Prepaid expenses		9,000
		776,000			776,000

Please carefully interpret the balances given, Customer balances are in debit as well as credit column, While debit indicates Debtor and credit means advances received from customers. Same logic will apply to suppliers, commission, discounts. Computation of closing stock was very important in this case.

Illustration 11 :

Abhay runs a small shop and deals various goods. He has not been able to tally his trial balance and has closed it by taking the difference to Suspense A/c. It is given below :

Particulars (as on 31st March, 2020)	Debit (Rs.)	Credit (Rs.)
Abhay's capital		1,50,000
Drawings	75,000	
Fixed assets	1,35,000	
Opening stock	36,500	
Purchase & returns	6,75,000	13,500
Sales & returns	34,000	8,50,000
Due from customer & to creditors	95,000	3,25,000
Expenses	45,750	
Cash		3,000
Bank deposits & interest earned	55,000	5,750
Suspense A/c		4,000
Advertising		2,00,000
Total	13,51,250	13,51,250



Study Note - 4 : Preparation Of Final Accounts

Mr. Abhay has requested you to help him in tallying his trial balance and also prepare his final accounts, On investigation of his books you get the following information :

- (i) Closing Stock on 31st March, 2020 was Rs.45,000 at cost and could sell over this value.
- (ii) Depreciation of Rs.13,500 needs to be provided for the year.
- (iii) A withdrawal slip indicated a cash withdrawal of Rs.15,000 which was charged as drawing. However, it was noticed that Rs.11,000 was used for business purpose only and was entered as expenses in cash book.
- (iv) Goods worth Rs.19,000 were purchased on 24th March, 2020 and sold on 29th March, 2020 for Rs.23,750 Sales were recorded correctly, but purchase invoice was missed out.
- (v) Purchase returns of Rs.1,500 were routed through sales return. Party's A/c was correctly posted.
- (vi) Expenses include Rs.3,750 related to the period after 31st March, 2020.
- (vii) Purchase book was over-cast by Rs.1,000. Posting to suppliers A/c is correct.

Solution :

Rectification of errors :

- (a) Cash withdrawn was recorded as

Cash A/c	Dr	15,000
To Bank		15,000

But it was charged to drawing and Rs.11,000 was recorded as expenses as well i.e.

Drawings A/c	Dr	15,000
Expenses A/c	Dr	11,000
To Cash		26,000

This resulted in negative cash of Rs.11,000. The rectification entry to be passed is

Cash A/c	Dr	11,000
To Drawings		11,000

- (b) Omitted transaction to be recorded

Purchase A/c	Dr	19,000
To Suppliers A/c		19,000

- (c) Incorrect recording of purchase returns corrected by

Suspense A/c	Dr	3,000
To Purchase return A/c		1,500
To sales return A/c		1,500



Paper I: Fundamentals of Financial Accounting

- (d) Incorrect expenses rectified by
- | | | |
|----------------------|----|-------|
| Prepaid expenses A/c | Dr | 3,750 |
| To Expenses A/c | | 3,750 |
- (e) Over-casting of purchase book rectified by
- | | | |
|--------------|----|-------|
| Suspense A/c | Dr | 1,000 |
| To Purchases | | 1,000 |

Based on these rectification we can now proceed to complete the final accounts.

Dr. Cr. **Trading Account for the year ended 31st March, 2020**

Particulars	Amount (Rs.)	Amount (Rs.)	Particulars	Amount (Rs.)	Amount (Rs.)
To Opening Stock	-	36,500	By Sales	8,50,000	
To Purchases	6,75,000		Less : Returns	(34,000)	
Less : Returns	(13,500)		Add : Rectification	1,500	8,17,500
Less : Additional returns	(1,500)		By : Closing Stock	-	
Add : Purchase missed out	19,000		Finished goods		45,000
Less : Over-casting rectified	(1,000)	6,78,000			
To Gross Profit c/d		1,48,000			
		8,62,500			8,62,500

Dr. Cr. **Profit and Loss Account for the year ended 31st March, 2020**

Particulars	Amount (Rs.)	Amount (Rs.)	Particulars	Amount (Rs.)	Amount (Rs.)
To Expenses	45,750		By Gross Profit b/d		1,48,000
Less : Prepaid	3,750	42,000			
			By Interest on Bank deposits		5,750
To, Depreciation		13,500			
To, Advertising		2,00,000	By, Net Loss		1,01,750
		2,55,500			2,55,500



Study Note - 4 : Preparation Of Final Accounts

Dr. **Balance Sheet as on 31st March, 2020** Cr.

Liabilities	Amount (Rs.)	Amount (Rs.)	Assets	Amount (Rs.)	Amount (Rs.)
Abhay's Capital	1,50,000		Fixed Assets		
Add : Wrong charge to drawing	11,000		Gross Block	1,35,000	
		1,61,000	Less : Depreciation	13,500	1,21,500
Less : Drawings	75,000	86,000			
Current Liabilities			Current Assets :		
Sundry Creditors	3,25,000		Stocks		45,000
Sundry Debtors	1,70,500		Sundry Debtors		95,000
Stationery and Printing	1,200				
Cash at Bank	65,000				
Interest on Loan	8,000				
Interest Due but not paid on loan					1,500
Loan Account					90,000
				12,31,920	12,31,920

Additional Information

- (i) Salaries include Rs.10,000 towards renovation of Proprietor's residence
- (ii) Closing Stock amounted to Rs.75,000

Mr. Oswal, however, request you to prepare a Trading and Profit and Loss Account for the year ended 1st March, 2021 and a Balance Sheet as on that date following cash basis of accounting

Solution:

In the books of Mr. Oswal Trading and Profit and Loss Account for the year ended 31st March, 2021

Dr. **Profit and Loss Account for the year ended 31st March, 2020** Cr.

Particulars	Amount (Rs.)	Amount (Rs.)	Particulars	Amount (Rs.)	Amount (Rs.)
To Opening Stock		50,000	By Sales		6,50,000
"Purchases		4,20,000	" Closing Stock		75,000
"Profit & Loss A/c Gross Profit transferred		2,55,000			
		7,25,000			7,25,000



Paper I: Fundamentals of Financial Accounting

To Salaries	40,000		By Trading A/c		
Less : Outstanding	6,000		Gross Profit Transferred		2,55,000
Salaries	34,000		"Dividend from Investment	8,000	
Add : Advance Salary	2,500		Less : Accrued	1,500	6,500
		36,500			
Less : Renovation (Drawings)	10,000	26,500			
"Insurance	1,200				
Add : Prepaid	370	1,570			
"Rent		10,000			
Add : Advance Rent	2,000	12,000			
"Electricity Charges	2,650				
Less : Outstanding	450	2,200			
"Miscellaneous Expenses		14,000			
"Stationery & Printing		1,200			
"Interest on Loan	8,000				
Less : Outstanding	1,500	6,500			
"Telephone Charges		6,000			
"Depreciation :					
Plant & Machinery	37,500				
Furniture & Fixtures	8,000	45,500			
"Capital Account					
Net Profit transferred		1,46,030			
		2,61,500			2,61,500

Dr.

Balance Sheet as at 31st March, 2021

Cr.

Liabilities	Amount (Rs.)	Amount (Rs.)	Assets	Amount (Rs.)	Amount (Rs.)
Capital Account	2,11,970		Plant and Machinery (at cost less depreciation)		2,12,500
Add : Net Profit during the year	1,46,030		Furniture & Fixtures		72,000
	3,58,000		Investment Stock in		80,000



Study Note - 4 : Preparation Of Final Accounts

Less : Drawings (24,000-10,000)	34,000	3,24,000	Trade		75,000
			Debtors		1,70,500
Loan Account		90,000	Cash in hand		3,000
Sundry Creditors		2,64,000	Cash at Bank		65,000
		6,78,000			6,78,000

Illustration 13 :

The following Trial Balance has been prepared from the books of Mr. Saxena as on 31st March, 2021 after making necessary adjustments for depreciation on Fixed Assets, outstanding and accrued items and difference under Suspense Account.

Trial Balance

Particulars	Dr (Rs.)	Particulars	Cr (Rs.)
Machineries	1,70,000	Sundry Creditors	82,000
Furniture	49,500	Capital Account	2,45,750
Sundry Debtors	38,000	Outstanding Expenses	
Drawings	28,000	Salaries	1,500
Travelling Expenses	6,500	Printing	600
Insurance	1,500	Audit Fees	1,000
Audit Fees	1,000	Bank Interest	1,200
Salaries	49,000	Discounts	1,800
Rent	5,000	Sales (Less Return)	6,80,000
Cash in hand	7,800		
Cash at Bank	18,500		
Stock - in-trade (01-04-2020)	80,000		
Prepaid Insurance	250		
Miscellaneous Expenses	21,200		
Discounts	1,200		
Printing & Stationery	1,500		
Purchase (Less Returns)	4,60,000		
Depreciation :			
Machineries	30,000		
Furniture	5,500		
Superise Account	39,400		
	10,13,850		10,13,850



Paper I: Fundamentals of Financial Accounting

On the subsequent scrutiny following mistakes were noticed :

- (i) A new machinery was purchase for Rs.50,000 but the amount was wrongly posted to Furniture Account as Rs.5,000.
- (ii) Cash received from Debtors Rs.5,600 was omitted to be posted in the ledger.
- (iii) Goods withdrawn by the proprietor for personal use but no entry was passed Rs.5,000
- (iv) Sales included Rs.30,000 as goods sold cash on behalf of Mr. Thakurlal who allowed 15% commission on such sales for which effect is to be given.

You are further told that :

- (a) Closing stock on physical verification amounted to Rs.47,500.
- (b) Depreciation on Machineries and Furniture has been provided @15% and 10% respectively, on reducing balancing system.

Full year's depreciation is provided on addition.

You are requested to prepare a Trading and Profit and Loss Account for the year ended 31st March, 2021 and a Balance Sheet as on that date so as to represnt a True and Correct picture.

Solution

In the books of Mr. Sexena

Dr. Trading and Profit and Loss Account Cr.

Particulars	Amount (Rs.)	Amount (Rs.)	Particulars	Amount (Rs.)	Amount (Rs.)
To Opening Stock		80,000	By Sales (Rs.6,80,000-Rs.30,000)		6,50,000
" Purchases	4,60,000		" Closing Stock		47,500
Less : Drawings	5,000	4,55,000			
"Profit & Loss A/c					
Gross Profit transferred		1,62,500			
		6,97,500			6,97,500
To, Salaries :		49,000	By, Trading A/c (Gross Profit)		1,62,500
"Rent		5,000	"Bank Interest		1,200
"Insurance		1,500	" Selling Commission		
"Audit Fees		1,000	(15% on Rs.30,000)		4,500
"Printing & Stationery		1,500	" Discount Received		1,800



Study Note - 4 : Preparation Of Final Accounts

" Miscellaneous Expenses		21,200			
"Discount Allowed		1,200			
"Travelling Expenses		6,500			
"Depreciation					
Machinery	37,500				
Furniture	5,000	42,500			
"Capital Account					
Net Profit transferred		40,600			
		1,70,000			1,70,000

Dr. Balance Sheet as at 31st March, 2021 Cr.

Particulars	Amount (Rs.)	Amount (Rs.)	Particulars	Amount (Rs.)	Amount (Rs.)
Capital Account	2,45,750		Machinery	2,50,000	
Add : Net Profit	40,600		Less : Depreciation	37,500	2,12,500
	2,86,350				
Less : Drawings (28,000-5,000)	33,000	2,53,350	Furniture	50,000	
			Less : Depreciation	5,000	45,000
Sundry Creditors		82,000	Stock		47,500
Outstanding Liabilities			Debtors (38,000-5,600)		32,400
Salaries	1,500		Cash		7,800
Audit Fees	1,000		Bank		18,500
Printing	600	3,100	Prepaid Insurance		250
Thakurlal's A/c (30,000-4,500)		25,500			
		3,63,950			3,63,950

Notes :

Rs.

1. Machinery as per Trial Balance	1,70,000
Add : Depreciation	30,000
	2,00,000
Additions	50,000
	2,50,000



Paper I: Fundamentals of Financial Accounting

2.	Furniture	49,500
	Add : Depreciation	5,500
		55,000
	Less : Wrong Debit	5,000
3.	Suspense A/c. is eliminated by item	50000
	(i) 45,000 (50,000-5,000) and item	
	(ii) by 5,600 (debited), respectively	

Illustration 14.

The following Trail Balance has been extracted from the books of Mr. Agarwal as on 31.03.2020

Trial Balance as on 31.03.2020

Particulars		Dr (Rs.)	Particulars	Cr (Rs.)
Purchase		6,80,000	Sales	8,38,200
Sundry Debtors		96,000	Capital Account	1,97,000
Drawings		36,000	Sundry Creditors	1,14,000
Bad Debts		2,000	Outstanding Salary	2,500
Furniture & Fixtures		8,100	Sale of Old Papers	1,500
Office Equipments		54,000	Bank Overdraft (UBI)	60,000
Salaries		24,000		
Advanced Salary		1,500		
Carriage Inward		6,500		
Miscellaneous Expenses		12,000		
Travelling Expenses		6,500		
Stationery & Printing		1,500		
Rent		18,000		
Electricity & Telephone		6,800		
Cash in Hand		5,900		
Cash at Bank (SBI)		53,000		
Stock (01.04.2019)		50,000		
Repairs		7,500		
Motor Car		56,000		
Depreciation :				
Furniture	9,000			
Office Equipment	6,000	15,000		
		12,13,200		12,13,200



Study Note - 4 : Preparation Of Final Accounts

Additional Information

- (i) Sales includes Rs.60,000 towards goods for cash on account of a joint venture with Mr. Reddy who incurred Rs.800 as forwarding expenses. The Joint Venture earned a profit of Rs.15,000 to which Mr. Reddy is entitled to 60%.
- (ii) To motor car account represents an old motor car which was replaced on 01.04.2019 by a new motor car costing Rs.1,20,000 with an additional cash payment of Rs.40,000 laying debited to Purchase Account
- (iii) UBI has allowed an overdraft limit against hypothecation of stocks keeping a margin of 20%. The present balance is the maximum as permitted by the Bank.
- (iv) Sundry Debtors include Rs.4,000 as due from Mr. Trivedi and Sundry Creditors include Rs.7,000 as payable to him.
- (v) On 31.03.2020 outstanding rent amounted to Rs.6,000 and you are informed that 50% of the total rent is attributable towards Agarwal's resident.
- (vi) Depreciation to be provided on motor car @20% (excluding sold item).

Mr. Agarwal request you to prepare a Trading and Profit & Loss Account for the year ended 31.03.2020 and a Balance Sheet as on that date.

Solution

In the books of Mr. Agarwal Trading and Profit and Loss Account

Dr.			For the year ended 31st March, 2020			Cr.		
Particulars		Amount (Rs.)	Amount (Rs.)	Particulars		Amount (Rs.)	Amount (Rs.)	
To, Opening Stock			50,000	By, Sales		8,38,200		
"Purchases		6,80,000		Less : Sale account of		60,000	7,78,200	
Less : Motor Car		40,000	6,40,000	Joint Venture				
"Carriage Inward			6,500					
"Profit & Loss A/c			1,56,700					
Gross Profit transferred								
			8,53,200				8,53,200	
To, Salaries			24,000	By, Trading A/c Gross Profit transferred			1,56,700	
" Travelling Expenses			6,500	"Sale of old papers			1,500	
" Printing & Stationery			1,500	"Profit on Joint Venture (40% of Rs.15,000)			6,000	



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"Electricity & Telephone		6,800	"Profit on replacement of Motor Car [(1,20,000- (56,000+40,000))]		24,000
" Rent	18,000				
Add : Outstanding	6,000				
	24,000				
Less : Drawings	12,000	12,000			
"Bad Debts		2,000			
"Miscellaneous Expenses		12,000			
"Repairs		7,500			
"Depreciation on :					
Furniture	9,000				
Office Equipment	6,000				
Motor Car	24,000	39,000			
"Capital Account					
Net Profit transferred		76,900			
		1,88,200			1,88,200

Solution:

Dr.

Balance Sheet as at 31st March, 2021

Cr.

Particulars	Amount (Rs.)	Amount (Rs.)	Particulars	Amount (Rs.)	Amount (Rs.)
Capital Account	1,97,000		Furniture & Fixtures	90,000	
Add : Net Profit	76,900		Less : Depreciation	9,000	
	2,73,900				81,000
Less : Drawings			Office Equipment	60,000	
(36,000+12,000)	48,000				
		2,25,900	Less : Depreciation	6,000	
Bank Overdraft		60,000			54,000
Creditors	1,14,000		Motor Car	56,000	
Less : Due to Trivedi	4,000		Additions	1,20,000	
		1,10,000		1,76,000	
			Less : Sold	56,000	
				1,20,000	
			Less : Depreciation	24,000	



Study Note - 4 : Preparation Of Final Accounts

Amount payable to		54,000			96,000
Reddy (60,000-6,000)					
Outstanding Liabilities			Stock		75,000
Salaries	2,500		Debtors	96,000	
Rent	6,000		Less : Due from Trivedi	4,000	
		8,500			92,000
			Cash		9,500
			Bank		53,000
			Prepaid Salary		1,500
		4,58,400			4,58,400

Working

- Depreciation on Motor Car
on new motor car i.e., @20% on Rs.1,20,000 = Rs.24,000
- Profit on Replacement of Motor Car

Cost of new Motor Car		1,20,000
Less : Exchange Value	56,000	
Cash Payment	40,000	96,000
Profit on replacement		24,000
- Closing Stock
 Maximum allowable limit of overdraft subject to a margin of 20% stock.
 Overdraft which is given Rs.60,000 that is equal to 80%
 So value of closing stock = Rs.60,000 x 100/80 = Rs.75,000

FINAL ACCOUNTS OF PARTNERSHIP FIRM

Illustration 15 :

From the following particulars prepare a Final Accounts of M/s. X & Y for the year ended 31st March, 2021

Particulars	Amount (Rs.)	Particulars	Amount (Rs.)
Sales	8,20,000	Land	11,000
Opening Stock	3,00,000	Purchase	3,80,000
Loan (Dr.)	20,000	Interest (Cr.)	1,000
Wages	60,000	Salaries	40,000
Carriage Inwards	4,000	Carriage Outwards	2,000
Returns inward	4,000	Returns Outwards	3,000



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Furniture	10,000	Trade change	8,000
Drawings		Capital	
- X	12,000	- X	24,000
- Y	10,000	- Y	16,000
Cash	3,000		

Additional Information

- (i) Closing Stock amounted to Rs.1,20,000;
- (ii) Provide Interest on drawings (on an average 6 months) and interest on capital @6% and 4% respectively.
- (iii) Y is to get a salary of Rs.400 p.m
- (iv) X is to get a commissions @ 2% on gross sales
- (v) 50% of the profit is to be transferred to Reserve Fund.
- (vi) Depreciations on furniture @10% p.a.

The partners share profit and loss equally.

Solution:

In the books of M/s. X & Y Trading and Profit and Loss Account

Dr.

Cr.

Particulars	Amount (Rs.)	Amount (Rs.)	Particulars	Amount (Rs.)	Amount (Rs.)
To, Opening Stock		3,00,000	By, Sales	8,20,000	
"Purchases	3,80,000		Less : Return Inwards	4,000	8,16,000
Less : Returns Outwards	3,000	3,77,000	"Closing Stock		1,20,000
"Wages		60,000			
Carrige inward		4,000			
" Profit & Loss A/c					
"Gross Profit transferred		1,95,000			
		9,36,000			9,36,000
To, Salries		40,000	By, Trading A/c		
"Carriage Outward		2,000	Gross Profit		1,95,000
"Trade Charge		8,000	"Interest		1,000
"Depreciation on :					
To, Furniture		1,000			
To P&L Appropriation A/c					
Net Profit transferred		1,45,000			
		1,96,000			1,96,000



Study Note - 4 : Preparation Of Final Accounts

Profit and Loss Appropriation Account

For the year ended 30th September 2021

Dr.

Cr.

Particulars	Amount (Rs.)	Amount (Rs.)	Particulars	Amount (Rs.)	Amount (Rs.)
To, Interest on Capital			By Profit and Loss A/c		1,45,000
X :	960		Net Profit		
Y :	640	1,600	By Intest on Drawings		
			X :	360	
To, Salary			Y :	300	660
Y :		4,800			
To, Commission - X		16,400			
"Reserve Fund (50%)		61,430			
"Net Divisble Profit					
X :	30,715				
Y :	30,715				
		61,430			
		1,45,660			1,45,660

Dr.

Capital Account

Cr.

Particulars	X (Rs.)	Y (Rs.)	Particulars	X (Rs.)	Y (Rs.)
To, Drawings	12,000	10,000	By, Balance b/d	24,000	16,000
" Interest on Drawings	360	300	" Interest on Capital	960	640
" Balance c/d	59,715	41,855	" Salary	-	4,800
			" Commission	16,400	-
			" Share of Profit	30,715	30,715
	72,075	52,155		72,075	52,155

Dr.

Capital Account

Cr.

Liabilities	Amount (Rs.)	Amount	Assets	Amount (Rs.)	Amount (Rs.)
Capital :			Land		11,000
X		59,715	Furniture	10,000	
Y		41,855	Less : Depreciation	1,000	9,000
Reserve Fund		61,430			
			Loan		20,000
			Closing Stock		1,20,000
			Cash		3,000
		1,63,000			1,63,000



Illustration 16.

A and B are partners sharing profits in preportion to their Capitals. At the close of their financial year on 30th September, 2020. The following balances stood to the credit of the partnes :

Capital Account	A	20,000
	B	5,000
Current Accounts	A	1,060
	B	2,800

The Partnership deed provided :-

- (a) B shall be credited with a partnership salary of Rs.1,000/- per annum for running business :
- (b) B shall be entitled to a commission of 10% of the Divisible Profit before charging such commission.
- (c) Interest at 5% per annum to be allowed on Capital and Current Account.
- (d) The partners drawings were :

Rs.	
A	10,000
B	3,000

The Interest to be charged on such drawings were :

A	330
B	80

In addition to the entries necessary to record the above particulars the following balances were extracted from the books of the firm as on 30th September, 2021 :

Particulars	Amount (Rs.)
Freehold Premises	15,000
Sundry Creditors	24,150
Advertising	4,339
Office Salaries	2,189
Sundry Debtors	16,020
Office Expenses	622
Insurance	364
Delivery Expenses	2,203
Stock	21,069
Provision for Doubtful Debts - as on 30-09-2020	600
Trading Account Credit Balance	34,628
Machinery and Plant - balance at the begining	13,280

Study Note - 4 : Preparation Of Final Accounts

Machinery - additions	1,560
Motor Vans	900
Factory Expenses paid in advance	70
Cash at bank	2,841
Cash in hand	31
Mortgage on freehold premises at 6% per annum	10,000
Office Furniture	300
Mortgage interest	450
Patents	4,000

You are required to prepare a Profit & Loss Account for the year ended 30th September, 2021 and the Balance Sheet as on that date.

Given below are the additional information towards the preparation of the required Final Accounts

- (i) Depreciation to be provided as follows :

Plant, old balance	10% per annum
Plant - additions (for full year)	25% per annum
Office Furniture	10% per annum
Patents	10% per annum
- (ii) Motor Vans are to be taken at Rs.800 for the purpose of Final Accounts.
- (iii) The Provision for Bad Debts is to be made up to 5% on Sundry Debtors.
- (iv) Interest on the mortgage has been paid up to 30th June, 2021
- (v) The following amounts are to be carried forward to next year.
Insurance Rs.62. Advertising Rs.878
- (vi) Office Salaries Rs.69 were owing at the end of the year.

Solution

In the books of A & B

Profit and Loss Account

Dr.			For the year ended 30th September, 2021			Cr.			
Particulars		Amount (Rs.)		Amount		Particulars		Amount (Rs.)	
To Office Salaries		2,189				By, Gross Profit (Trading A/c Credit Balance)		34,628	
Add : Outstanding		69		2,258					



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" Office Expenses		622			
"Insurance	364				
Less : Prepaid	62	302			
" Delivery Expenses		2,203			
"Advertising	4,339				
Less : Carried forward	878	3,641			
"Provision for Bad Debts					
(5% of Rs.16,020)	801				
Less : Old Reserve	600	201			
" Mortgage Interest	450				
Add : Outstanding					
(@6% on Rs.10,000 for 3 months)	150	600			
"Depreciation on :					
Plant & Machinery	1,718				
Office Furniture (10% on Rs.300)	30				
Patents (10% on Rs.4,000)	400				
Motor Vans (Rs.900-800)	100	2,248			
"Profit and Loss					
Appropriation Account					
Gross Net Profit transferred		22,733			
		34,628			34,628

Profit and Loss Appropriation Account

Dr.

For the year ended 30th September, 2021

Cr.

Particulars	Amount (Rs.)	Amount	Particulars	Amount (Rs.)	Amount (Rs.)
To Office Salaries	2,189		By, Gross Profit (Trading A/c Credit Balance)		34,628
To Salary		1,000	By, Profit and Loss A/c		22,733
" Interest on Capital			Gross Net Profit transferred Interest on Drawing :		
A ;	1,000		A : Rs. 330		
B :	250	1,250	B : Rs. 80		410



Study Note - 4 : Preparation Of Final Accounts

To Interest on Current A/c (C)					
A :	53				
B :	140	193			
To Commission - B		2,070			
" Divisible Profit					
A :	14,904				
B :	3,726	18,630			
		23,143			23,143

Balance Sheet

Dr.

As at 30th September, 2021

Cr.

Particulars	Amount (Rs.)	Amount	Particulars	Amount (Rs.)	Amount (Rs.)
Capital Account			Fixed Assets :		
A :		20,000	Freehold Premises		15,000
B :		5,000	Patents	4,000	
		25,000	Less : Depreciation	400	3,600
Current Accounts					
A :		1,060			
Add : Interest on Capital	1,000		Plant and Machinery	13,280	
Interest on Current A/c	53		Addition during the year	1,560	
Profit		14,904			14,840
	17,017		Less : Depreciation	1,718	13,122
Less : Drawings	10,000				
	7,017		Motor Vans	900	
Less : Interest on Drawings	330	6,687	Less : Depreciation	100	800
B :	2,800		Office Furniture	300	
Add : Interest on Capital	250		Less : Depreciation	30	270
Interest on Current A/c	140				
Salary	1,000		Current Assets :		
Commission	2,070		Stock		21,069
Profit	3,726		Sundry Debtors	16,020	
	9,986		Less : Provision for Bad Debts	801	15,219



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Less : Drawings	3,000				
	6,986		Prepaid Factory Expenses		70
Less : Interest on Drawings	80	6,906	Prepaid Insurance		62
Mortgage on Freehold Premises	10,000		Advertising Suspenses		878
Add : Interest Accrued	150	10,150	Cash in hand		31
Sundry Creditors		24,150	Cash at Bank		2,841
Salaries Accrued		69			
		72,962			72,962

Workings

(1) Depreciation on Plant and Machinery

Old balance :	10% on Rs.13,280	= Rs.1,328
Additions :	25% on Rs.1,560	= Rs.390
		= Rs.1,718

(2) Interest on Capital :

A :	5% on Rs.20,000	= Rs.1,000
B :	5% on Rs.5,000	= Rs.250
		= Rs.1,250

(3) Interest on Current Account

A :	5% on Rs.1060	= Rs.53
B :	5% on Rs.2,800	= Rs.140
		= Rs.193

(4) B's Commission

Divisible Profit before charging commission
 Rs. (23,733+410)-Rs. (1,000+1,250+193)
 = 23,143- Rs.2,443 = Rs.20,700
 Commission = 10% of Rs.20,700 = Rs.2,070

(5) Apportionment of divisible Profit :

Capital Ration A : B = Rs.20,000 : Rs.5,000 = 4:1
 A's share of profit = Rs.18,630 x 4/5 = Rs.14,904
 B's share of profit = Rs.18,630 x 1/5 = Rs.3,726



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Solution :

In the Books of P Journal

Date	Particulars	L.F.	Debit	Credit
01.04.2020	Z A/c	Dr.	4,000	
	To Sales A/c (Being goods sold on credit to Z)			4,000
15.04.2020	Cash A/c	Dr.	3,000	
	To Z A/c (Being cash realized from Z)			3,000
08.08.2020	Bad Debts A/c	Dr.	1,000	
	To Z A/c (Being the capital expenditure transferred to the Capital Fund)			1,000

Dr. Z Account Cr.

Date	Particulars	Amount (Rs.)	Date	Particulars	Amount (Rs.)
Apr, 1	To Sales A/c	4,000	Apr 15	By Cash A/c	3,000
			Aug 8	" Bad Debt A/c	1,000
		4,000			4,000

Dr. Sales Account Cr.

Date	Particulars	Amount (Rs.)	Date	Particulars	Amount (Rs.)
Mar, 31	To, Balance c/d	4,000	Apr 1	By Z A/c	4,000
		4,000			4,000
		4,000			4,000

Dr. Bad Debts Account Cr.

Date	Particulars	Amount (Rs.)	Date	Particulars	Amount (Rs.)
Aug 8	To, Z A/c	1,000	Mar 31	By Profit and Loss A/c	1,000
		1,000			1,000

Profit and Loss Account (Extract)

Dr. For the year ended 31st Cr.

Particulars	Amount (Rs.)	Particulars	Amount (Rs.)
To Bad Debts A/c.	1,000		

Study Note - 4 : Preparation Of Final Accounts

Balance Sheet (Extract)

Dr.

As at 31st March, 2021

Cr.

Liabilities	Amount (Rs.)	Amount (Rs.)	Assets	Amount (Rs.)	Amount (Rs.)
			Debtors		
			Less : Bad debts	1,000	Nil
				1,000	

- (ii) **Doubtful Debts** : The debts which will be receivable or not cannot be ascertainable at the date of preparing the final accounts (i.e. the debts which are doubtful to realise) is known as doubtful debts. Practically it cannot be treated as a loss on that particular date, as such, it cannot be written off. But, it should be charged against Profit and Loss Account on the basis of past experience of the firm.
- (iii) **Good Debts** : The debts which are not bad i.e. there is neither any possibility of bad debts nor any doubts about its realization, is called goods debts. As such, no provision is necessary for it.

4.3.2 Provisions for Bad (and Doubtful) Debts

It has already been stated above that for any unknown/known part of doubtful debts provision must be made against Profit and Loss Account on the basis of past experience. This is known as Provision for Bad Debts; Reserve for Bad Debts or Provision for Bad and Doubtful Debts. It must be noted that Provision should be calculated on the basis of certain percentage on total doubtful debts (after adjusting bad debts, if any). It is nothing but a loss of the current year which actually written off in the next year. This is done on the reason that the amount of loss is impossible to ascertain until it is proved bad. That is why, it is charged against " Profit and Loss Account in the form of Provision.

There are two methods to record the transaction relating to Bad Debts and Provision for Bad Debts.

Accounting Steps :

First Method

The 1st Year

- (a) **For Bad Debts**
 Bad Debts A/c Dr.
 To Sundry Debtors A/c
- (b) **For managing provision for Bad Debts**
 Profit and Loss A/c Dr.
 To Provision for Bad Debts A/c
- (c) **For Transferring Bad Debts**
 Profit and Loss A/c Dr.



To Bad Debts A/c

The Second/subsequent year

(a) (i) **For Bad Debts**

Bad Debts A/c Dr.

To Sundry Debtors A/c

(ii) **Profit and Loss A/c**

Dr.

To Bad Debts A/c

(b) **For provision of Bad Debts**

(i) If closing provision is more than the opening provision

Profit and Loss A/c Dr.

To Provision for Bad debts A/c

(ii) If Closing Balance is less than opening provision

Provision for Bad Debts A/c Dr.

To Profit and Loss A/c

Second Method

The 1st Year

(a) (i) **For Bad Debts**

Bad Debts A/c Dr.

To Sundry Debtors A/c

(ii) Profit and Loss A/c

Dr.

To Bad Debts A/c

(b) **For provision for Bad Debts**

Profit and Loss A/c Dr.

To Provision for Bad Debts A/c

The Second/subsequent year

(a) (i) **For Bad Debts**

Bad Debts A/c Dr.

To Sundry Debtors A/c

(ii) Profit and Loss A/c

Dr.

To Bad Debts A/c

(b) **For provision for Bad Debts**

(i) If new provision is more than the old provision

Profit and Loss A/c Dr.

To Provision for Bad debts A/c



Study Note - 4 : Preparation Of Final Accounts

- (ii) If new provision is less than old provision
 Provision for Bad Debts A/c Dr.
 To Profit and Loss A/c

Illustration 18.

Prepare Bad Debts Accounts, Provision for Bad Debts Accounts under each of the above methods from the following information:-

01.01.2019	Provision for Bad Debts	5,000
31.12.2019	Bad Debts written off	3,000
	Sundry Debtors	1,25,000
31.12.2020	Bad Debts written off	2,500
	Sundry Debtors	1,00,000

Provision for Doubtful debts to be provided for @5% for 2019 and 2.5% for 2020. Show also the Profit and Loss Account and Balance Sheet.

Solution :

First Method

In the Books of

Dr.			Cr.		
Bad Debts Account					
Date	Particulars	Amount (Rs.)	Date	Particulars	Amount (Rs.)
2019 Dec, 31	To, Sundry Debtors	3,000	2019 Dec 31	By, Profit and Loss A/c	3,000
	A/c				
		3,000			3,000
2020 Dec, 31	To, Sundry Debtors	2,500	2020 Dec, 31	By, Profit and Loss A/c	2,500
	A/c				
		2,500			2,500

Dr.			Cr.		
Provision for Bad Debts Account					
Date	Particulars	Amount (Rs.)	Date	Particulars	Amount (Rs.)
2019 Dec 31	To Balance c/d	6,250	2019 Jan 1	By, Balance b/d	5,000
	(5% on Rs.1,25,000)			" Profit and Loss A/c (Bal Trf)	1,250
		6,250	Dec 31		6,250
2020	To, Profit and Loss A/c	3,750	2020 Jan,1	By, Balance b/d	6,250
	" Balance c/d	2,500			
	(2.5% on 1,00,000)				
		6,250			6,250



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Profit and Loss Account (Extract)

Dr. Cr.
For the year ended 31st Dec, 2019

Particulars	Amount (Rs.)	Amount (Rs.)	Particulars	Amount (Rs.)
To Bad Debts A/c		3,000		
“Provision for Bad Debts	6,250			
Less : Existing Provision	5,000	1,250		

Profit and Loss Account (Extract)

Dr. Cr.
For the year ended 31st Dec, 2020

Particulars	Amount (Rs.)	Particulars	Amount (Rs.)	Amount (Rs.)
To Bad Debts A/c	2,500	By Provision for Bad Debts	6,250	
		Less : Existing Provision	3,500	3,750

Balance Sheet (Extract)

Dr. Cr.
As at 31st December, 2019

Particulars	Amount (Rs.)	Particulars	Amount (Rs.)	Amount (Rs.)
		Debtors		
		Less : Bad debts	1,25,000	1,18,750
			6,250	

Balance Sheet (Extract)

Dr. Cr.
As at 31st December, 2020

Particulars	Amount (Rs.)	Particulars	Amount (Rs.)	Amount (Rs.)
		Debtors	1,00,000	97,500
		Less : Bad debts	2,500	1,18,750

Second Method

Dr. Cr.
Bad Debts Account

Date	Particulars	Amount (Rs.)	Date	Particulars	Amount (Rs.)
2019 Dec, 31	To, Sundry Debtors A/c	3,000	2019 Dec 31	By, Provision for Bad Bad Debts A/c- Transfer	3,000
		3,000			3,000
2020 Dec, 31	To, Sundry Debtors A/c	2,500	2020 Dec, 31	By, Profit and Loss A/c	2,500
		2,500			2,500



Study Note - 4 : Preparation Of Final Accounts

Dr. **Provision for Bad Debts Account** Cr.

Date	Particulars	Amount (Rs.)	Date	Particulars	Amount (Rs.)
2019 Dec 31	To, Bad Debts A/c	3,000	2019 Jan 1	By, Balance b/d	5,000
	"Balance c/d (5% on Rs.1,25,000)	6,250			
			2019	" Profit and Loss A/c (Bal fig)	4,250
		9,250			9,250
2020 Dec,31	To, Bad debts A/c	2,500	2020 Jan, 1	By, Balance b/d	6,250
	"Profit and Loss A/c	1,250			
	"Balance c/d (2.5% on 1,00,000)	2,500			
		6,250			6,250

Profit and Loss Account (Extract)

Dr. **For the year ended 31st Dec, 2019** Cr.

Particulars	Amount (Rs.)	Amount (Rs.)	Particulars	Amount (Rs.)
To Provision for Bad Debts	6,250			
Add : Provision Required	3,000			
	9,250			
Less : Existing Provision	3,000			
		6,250		

Profit and Loss Account (Extract)

Dr. **For the year ended 31st Dec, 2020** Cr.

Particulars	Amount (Rs.)	Amount (Rs.)	Particulars	Amount (Rs.)	Amount (Rs.)
To Bad Debts A/c		2,500	By, Provision for Bad Debts	6,250	
			Less : Provision required	2,500	3,750

The Balance Sheet under this method will be similar to the First Method stated above.

Illustration 19

On 01.01.2020 the balance of Provision for Doubtful Debts was Rs.5,000. The Bad Debts during the year were Rs.900. The sundry Debtors as on 31.12.2020 stood at Rs.40,400 out of these debtors of Rs.400 are bad and cannot be realized. The Provision for Doubtful Debts is to be raised to 5% On Sundry Debtors. Show the necessary ledger accounts and the balance sheet.



Study Note - 4 : Preparation Of Final Accounts

Balance Sheet (Extract)

Dr.

As at 31st Dec, 2020

Cr.

Particulars	Amount (Rs.)	Particulars	Amount (Rs.)	Amount (Rs.)
		Debtors	40,400	
		Less : Bad debts	400	
			40,000	
		Less : Provision for Bad debts	2,000	
				38,000

Illustration 20.

It was decided to make a specific provisions in the accounts for the year ended 31.03.2020 from the following doubtful debts after examining the sales ledger of the firm :

A : Rs.1,900; B Rs.300; C 2,680 and D 1,380

It was decided to make also a general provision of 5% on the other debtors who were on 31st March, 2019 amounted to Rs.2,16,000.

No other transaction relating to the debtors were made but successors of A and D sent final dividend of Rs.600 and Rs.840 respectively and C paid his debt in full.

On 31.03.2020, it was decided to maintain the provision against B's debt and make further provision for the following debts considered doubtful :

E Rs.1,300; F Rs.680 and G Rs.1020

The other debtors amounted to Rs.2,60,000 and it was required to make the general provision for doubtful debts equal to 5% of these debts. Show Bad Debts Account and Provision for Bad Debts Account.

Solution :

In the Books of

Dr.

Sundry Debtors Account

Cr.

Date	Particulars	Amount (Rs.)	Date	Particulars	Amount (Rs.)
2020	To, Sundry Debtors A/c	1,840	2020	By Provision for Bad debts A/c	1,840
		1,840			1,840



Paper I: Fundamentals of Financial Accounting

Dr. Provision for Bad Debts Account Cr.

Date	Particulars	Amount (Rs.)	Date	Particulars	Amount (Rs.)
2020 Dec 31	To, Bad Debts A/c	1,840	2019 April, 1	By Balance b/d	17,060
			2020	Profit and Loss A/c (further provision required)	1,080
2020 Dec, 31	To, Balance c/d	16,300			
		18,140			18,140

Working

1. Bad Debts

A : (1,900-600)	1,300
D : (1,380-840)	540
	1,840

2. Opening Balance of provision for Bad debts

A	1,900
B	300
C	2,680
D	1,380
General provision (5% of Rs.2,16,000)	10,800
	17,060

3. Closing Balance of provision for Bad debts

B :	300
E :	1,300
F :	680
G :	1,020
General Provision (5% of Rs.2,60,000)	13,000
	16,300

4.3.3. Provision for Discount On Debtors :

We know that Cash discount is allowed by the suppliers to customer for prompt settlement of cash. Naturally a provision is created for this purpose. Thus, the provision which is created

Study Note - 4 : Preparation Of Final Accounts

on Sundry Debtors for allowing discount or receipt of Cash in that accounting period is called Provision for Discount on Debtors. It is needless to say that if the customer pays their debts before the due dates, they may claim discount and that is why discount is allowed to debtors for prompt settlement is an usual way, where goods are sold on credit, debtors accounts are debited but the amount may not be realized in this same accounting periods. Naturally, a possible aims to allow discount whether cash is received. The Same will happen in the next accounting period, Due to this reason a provision for discount on debtors is made on the basis of past experience at an estimate rate on Sunday Debtors. Care should be taken while calculating discount. Discount should be calculated at a specified rate on of debtors (i.e. after discounting bad debts and provision for bad debts)

Accounting Steps

For the First year

- (a) (i) For discount Allowed
- | | |
|------------------------|-----|
| Discount allowed A/c | Dr. |
| To, Sundry Debtors A/c | |
- (ii) When discount Allowed is transferred
- | | |
|-----------------------|-----|
| Discount allowed A/c | Dr. |
| To Sundry Debtors A/c | |
- (b) For provision for discount on debtors-
- | | |
|---------------------------------------|--|
| Profit & Loss A/c | |
| To, Provision for Disc on Debtors A/c | |

For the Second/Subsequent year

- (a) (i) For discount Allowed
- | | |
|------------------------|-----|
| Discount allowed A/c | Dr. |
| To, Sundry Debtors A/c | |
- (ii) For provision for discount on debtors -
- | | |
|--|-----|
| Profit and Loss A/c | Dr. |
| To, Provision for Discount on Debtor A/c | |
- (ii) If new provision is less than old one
- | | |
|--------------------------------------|-----|
| Provision for Discount on Debtor A/c | Dr. |
| To, Profit and Loss A/c | |

Illustration 21.

On 01.04.2020, M/s Singh Bros. had a provision for bad debts of Rs.6,500 against their book debts. During 2020-13, Rs.4,200 proved irrecoverable and it was desired to maintain the provision



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for bad debts @4% on debtors which stood at Rs.1,95,000 before writing off Bad Debts. They also decided to maintain a provision for discount on debtors @2% show Provision for Bad Debt Account and Provision for Discount on Debtors Account as would appear in the books of the firm in 2020-13

Solution :

Dr. In the books of Provision for Bad Debt Account Cr.

Date	Particulars	Amount (Rs.)	Date	Particulars	Amount (Rs.)
2020-21	To Bad Debts A/c	4,200	2020	By, Balance b/d	6,500
Mar, 31	" Balance c/d (4% on Rs.1,95,000- Rs.4,200 or Rs.1,90,800)	7,632	Apr, 1	"Profit & Loss A/c - further provision required	5,332
		11,832			11,832

Dr. Provision for Discount on Debtors Account Cr.

Date	Particulars	Amount (Rs.)	Date	Particulars	Amount (Rs.)
2021 Mar, 31	To, Balance c/d (2% on Rs.1,95,000 - Rs.4,200-Rs.7,632)	3,663	2020 Apr. 1	By Balance b/d "Profit & Loss A/c - further provision required	3,663
		3,663			3,663

Illustration 22.

A company maintain its reserve for bad debts @5% and a reserve for discount on debtors @2%.

You are given the following details :

	2019 (Rs.)	2020 (Rs.)
Bad debts	800	1,500
Discount allowed	1,200	500

Sundry debtors (before providing all bad debts and discounts) amounted to Rs.60,000 on 31.12.2019 and Rs.42,000 on 31.12.2020.

On 1.1.2019, Reserve for bad debts and Reserve of discount on debtors had balance of Rs.4,550 and Rs.800 respectively.

Show Reserve for Bad Debts and Reserve for Discount on Debtors Account.



Study Note - 4 : Preparation Of Final Accounts

Solution:

In the books of
Dr. Reserve for Bad Debts Account Cr.

Date	Particulars	Amount (Rs.)	Date	Particulars	Amount (Rs.)
2019 Dec, 31	To Bad Debts A/c	800	2020 Apr, 1	By, Balance b/d	4,550
	To Profit and Loss A/c (provision found excess)	850			
	To, Balance c/d (5% on Rs. 58,000)	2,900			
		4,550			4,550
2020 Dec, 31	To, Bad Debts A/c	1,500	2020 Dec,31	By, Balance b/d	2,900
	To Balance c/d (5% on Rs.40,000)	2,000		By, Profit & Loss A/c for the provision required	600
		3,500			3,500

Dr. Reserve for Discount on Debtors A/c Cr.

Date	Particulars	Amount (Rs.)	Date	Particulars	Amount (Rs.)
2019 Dec, 31	To Discount Allowed A/c	1,200	2020 Apr, 1	By, Balance b/d	500
	To Balance c/d (2% on Rs.58,000- Rs.2,900)	1,102		" Profit & Loss A/c - further provision required	1,502
		2,302			2,302
2020 Dec, 31	To, Discount Allowed A/c	500		By, Balance b/d	1,102
	To Balance c/d (2% on Rs.40,000 -Rs.2,000)	760		" Profit & Loss A/c - further provision required	158
		1,260			1,260

4.3.4 Provision for Discount on Creditors

We also know that cash discount is received by the customer which is allowed by the creditors for prompt settlement of debts. So, a provision should be created for the purpose. Thus, the



provision which is created on sundry Creditors for securing discount for payment of cash in the next accounting period is called Provision for Discount on Creditors. When goods are purchased on credit creditors accounts are debited and discount received account is credited. But the amount may not be paid in full in the same accounting period. Thus, a question arises to receive discount when cash is paid. The same will happen in the next accounting period. As much, a provision is to be made for discount on creditors on the basis of past experience at an estimated rate on sundry creditors.

Accounting Steps

In the First year

- (a) (i) **For discount Received**
Sundry Creditors A/c Dr.
To Discount Received A/c
- (ii) **When transferred**
Discount Received A/c Dr.
To Profit & Loss A/c
- (b) **When Provision is made for Discount**
Provision for Discount on Creditors A/c. Dr.
To Profit and Loss A/c

In the second/subsequent years

- (a) **For Discount Received**
- (i) Sundry Creditors A/c Dr.
To Discount Received A/c
- (ii) Discount for Transfer
Discount Received A/c Dr.
To Provision for discount on Creditors A/c

Next Provision is estimated

- (i) **If new provision is more than old provision**
Provision for Discount on Creditors A/c Dr.
To Profit and Loss A/c.
- (ii) **If new provision is less than old one**
Profit and Loss A/c Dr.
To Provision for Discount on Creditors A/c



Study Note - 4 : Preparation Of Final Accounts

Illustration 23

Prepare necessary ledger accounts from the following :

Provision for Discount on Creditors as on 01.01.2019	Rs.	4,000
Discount Received during the year 2019	Rs.	2000
Sundry Creditors as on 31.12.2019	Rs.	1,20,000
Discount Received during 2020	Rs.	500
Sundry Creditors as on 31.12.2020	Rs.	40,000

Provision to be made for discount on creditors @5%

Show also the profit and Loss Account and Balance Sheet.

Solution :

Dr. **In the books of Discount Received Account** **Cr.**

Date	Particulars	Amount (Rs.)	Date	Particulars	Amount (Rs.)
2019 Dec, 31	To, Provision for discount on creditors A/c Transfer	2,000	2019 Dec, 31	By, Sundry Creditors A/c	2,000
		2,000			2,000
2020 Dec, 31	To Provision for discount on creditors A/c	500	2020 Dec, 31	By, Sundry Creditors A/c	500
		500			500

Dr. **Provision for Discount on Creditors Account** **Cr.**

Date	Particulars	Amount (Rs.)	Date	Particulars	Amount (Rs.)
2019 Dec, 31	To Balance b/d	4,000	2019 Dec, 31	By Discount Received A/c	2,000
	"Profit & Loss A/c				
	Further provision required	4,000		" Balance c/d (5% on 1,20,000)	6,000
		8,000			8,000
2020 Dec, 31	To Balance b/d	6,000	2020 Dec, 31	By Discount Received A/c	500
				" Profit & Loss A/c	
				" Provision formed in excess	3,500
				" Balance c/d	2,000
				" Balance c/d (5% on - Rs.40,000)	
		6,000			6,000



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Dr. For the year ended 31st Dec, 2020 Cr.

Date	Particulars	Amount (Rs.)	Amount (Rs.)
	By, Provision for Discount on Creditors :		
	Provision required	6,000	
	Add : Discount Received	2,000	
		8,000	
	Less : Existing Provision	4,000	4,000

Profit & Loss Account (Extract)

Dr. For the year ended 31st December, 2019 Cr.

Particulars	Amount (Rs.)	Amount (Rs.)	Particulars	Amount (Rs.)
To, Provision for Discount on creditors A/c	6,000		By Discount Received A/c	500
Existing Provision	2,000			
Less : Provision required		4,000		

Balance Sheet (Extract)

Dr. As at 31.12.2019 Cr.

Liabilities	Amount (Rs.)	Amount (Rs.)	Particulars	Amount (Rs.)
Sundry Creditors	1,20,000			
Less : Provision for Discount on Creditors	6,000	1,14,000		

Balance Sheet (Extract)

Dr. As at 31.12.2020 Cr.

Liabilities	Amount (Rs.)	Amount (Rs.)	Particulars	Amount (Rs.)
Sundry Creditors	40,000			
Less : Provision for Discount on Creditors	2,000			
		38,000		

4.3.5 Recovery for Bad Debts

We know that bad debt is a loss and as much, transferred to current year's Profit and Loss Account. Now, if the amount of bad debt is received in any succeeding year the same will be credited to Profit and Loss of that year as an income that is recovery of bad debt is as income i.e., clear profit

Study Note - 4 : Preparation Of Final Accounts

Accounting Steps

(a) **When bad debts are recovered**

Cash/Bank A/c Dr.
 To Bad Debts Recovery A/c

(b) **When the same is transferred**

Bad Debts Recovery A/c Dr.
 To Profit & Loss A/c

Illustration 24

On 31.12.2019, Sundry Debtors and Provision for Bad Debts are Rs.50,000 and Rs.5,000 respectively. During the year 2020, Rs.3,000 are bad and written off on 30.09.2020, an amount of Rs.400 was received on account of a debt which was written off as bad last year on 31.12.2020, the debtors left was verified and it was found that sundry debtors stood in the books were Rs.40,000 out of which a customer Mr. X who owed Rs.800 was to be written off as bad.

Prepare Bad Debt A/c. Provision for bad A/c assuming that some percentage should be maintained for provision for bad debt as it was on 31.12.2019.

Show also how the illustration appears in Profit and Loss A/c, and Balance Sheet.

Solution :

Dr.			Bad Debts Account			Cr.		
Date	Particulars	Amount (Rs.)	Date	Particulars	Amount (Rs.)			
2020 Sept.30	To Sundry Debtors A/c	3,000	2020 Dec. 31	By, Provision for Bad Debt A/c	3,800			
Dec. 31	To, X A/c	800						
		3,800			3,800			

Dr.			Provision for Bad Debts Account			Cr.		
Date	Particulars	Amount (Rs.)	Date	Particulars	Amount (Rs.)			
2020 Dec.31	To, Bad Debt A/c	3,800	2021 Dec, 31	By, Balance b/d	5,000			
	“ Balance c/d (10% on - Rs.39,200, Rs.40,000-Rs.800)	3,920		“ Profit & Loss A/c - for the provision required	2,720			
		7,720			7,720			



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Profit & Loss Account (Extract)

Dr.

For the year ended 31.12.2020

Cr.

Particulars	Amount (Rs.)	Amount (Rs.)	Particulars	Amount (Rs.)
To, Provision for Bad Debts :	3,920		By, Bad Debts	400
Prov. Required			Recovery	
Add : Bad Debts	3,400			
Less : Existing Provision	7,320			
	5,000	2,300		

Balance Sheet (Extract)

Dr.

As at 31.12.2020

Cr.

	Assets	Amount (Rs.)	Amount (Rs.)
	Sundry Debtors	40,000	
	Less : Bad Debts	800	
		39,200	
	Less : Provision for Bad Debts	3,920	35,280

Illustration 25

A & Company limited maintains provision for bad debts at 5% & provision for discount at 2.5%. the company also maintains a reserve for discount on creditors at 2%.

From the following particulars write up bad debt account, provision for bad debt account, Provision for discount on debtors account. And provision for discount on creditors account.

Balance on 01.01.2019

Provision for bad debts Rs.10,000

Provision for Discount on Debtors Rs.5,000

Provision for Discount on Creditors Rs.4,000

Total Debtors as on 31.12.2019 were Rs.2,40,000 after writing of bad debts Rs.6,000 & allowing discount Rs.2,000

On 31.12.2020 total debtors were Rs.2,00,000 after writing bad debt Rs.1,000 in allowing discount Rs.500. Total creditors as on 31.12.2019 & 31.12.2020 were Rs.1,00,000 & 1,50,000 respectively.

Discount received during each of the year amounted to Rs.500 & 3,000 respectively



Study Note - 4 : Preparation Of Final Accounts

Solution :

In the books of A & Co. Ltd.

Dr. Bad Debts Account Cr.

Date	Particulars	Amount (Rs.)	Date	Particulars	Amount (Rs.)
2019 Dec, 31	To, Sundry Debtors A/c	6,000	2019 Dec, 31	By Provision for Bad Debts A/c - Transfer	6,000
		6,000			6,000
2020 Dec, 31	To, Sundry Debtors A/c	1,000	2020	By Provision for Bad Debts A/c	1,000
		1,000			1,000

Dr. Provision for Bad Debts Account Cr.

Date	Particulars	Amount (Rs.)	Date	Particulars	Amount (Rs.)
2019 Dec.31	To, Bad Debts A/c	6,000	2019 Jan, 1	By, Balance b/d	10,000
	" Balance c/d (5% on Rs.2,40,000)	12,000		" Profit & Loss A/c	8,000
		18,000			18,000
2020 Dec. 31	To, Bad Debts A/c	1,000	2019 Jan, 1	By, Balance b/d	12,000
	" Profit & Loss A/c - Provision formed in excess(balancing figure)	1,000			
	" Balance c/d (5% on Rs.2,00,000)	10,000			
		12,000			12,000

Dr. Provision for Discount on Debtors Account Cr.

Date	Particulars	Amount (Rs.)	Date	Particulars	Amount (Rs.)
2019 Dec. 31	To, Discount allowed A/c	2,000	2019 Jan.1	By, Balance b/d	5,000
	" Balance c/d (2.5% on Rs.2,40,000-12,000)	5,700		" Profit & Loss A/c Further provision required	2,700
		7,700			7,700



2020 Dec, 31	To, Discount allowed A/c	500	2020 Jan, 1	By, Balance b/d	5,700
	" Profit & Loss A/c - Provision formed in excess (balancing figure)	450			
	" Balance c/d (2.5% on Rs.2,00,000- Rs.10,000)	4,750			
		5,700			5,700

4.4 PREPARATION OF FINANCIAL STATEMENTS OF A NON-TRADING CONCERN

Until now, we have seen accounting treatment for business transaction of business entities whose main objective is to earn profit. There are certain organisations that are not established for making profit but to provide some service. These services are generally given to members who make subscriptions to avail them. These are also called as non-trading entities. The examples of such organisations are:

- Gymkhana / sports clubs
- Educational institutions
- Public hospitals
- Libraries
- Cultural clubs like Rotary or Lions club
- Religious institutions
- Charitable trusts

These organisations get their funds in the form of contributions by way of entrance fees, life membership fees, annual subscriptions, donations, grants, legacies etc. The accounting of such organisations is based on similar principles followed by the other organisations. Given the nature of these institutions, there are certain items of revenue and expenses that need special understanding so that accounting treatment could be correctly decided.

4.4.1 Special Items

There are certain items of revenue and expenses that are unique for the non-trading entities. They could be listed as:

Revenue items	Expenditure items
Donations	Upkeep of grounds
Entrance fees	Tournament expenses
Subscriptions	Prize
Grants received	Events



Study Note - 4 : Preparation Of Final Accounts

Let us see what accounting treatment should be given to some of the special items:

- (a) Entrance Fees – These are received at the time of admission of a new member and thus are one- time fees. They are non-recurring in nature. It could be either capitalized as they are non-recurring or taken as revenue as per the rules of the institution. There's a view that addition of member is an ongoing activity and thus every year the institute will get entrance fees. So it may be taken as a normal revenue receipt.
- (b) Donations – They could be used for meeting capital or revenue expenses. If donations are received for a special purpose, the amount is credited to a fund from which the amounts are disbursed. The fund may be invested in specified securities. Income from such investments is credited to the fund A/c only. Small donation amounts which are not earmarked for any specific purpose may be treated as revenue receipts.
- (c) Legacy – Many times trusts are formed in the memory of certain persons by their will. In such case after the demise of the person, the funds pass on to the institution. Such legacies are of course one-time and therefore should be taken to the capital fund.
- (d) Endowments – Sometimes, donations are also in the form of endowments to be used as per instructions of the donor. These are to be treated as capital receipts.
- (e) Life membership fees – These could be taken as capital receipts and every year a charge is debited based on some logic. In other words, when received, it could be treated as deferred receipt in the balance sheet and every year a specific amount is credited to I & E A/c.
- (f) Subscriptions – These are annual receipts and therefore taken as revenue receipts. These must be recognised as revenue on the accrual concept.

4.4.2 Financial Statements

These non-profit organisations prepare

4.4.2.1 Receipt and Payment Account – This is similar to cash book. Entries are made on cash basis and items pertaining to previous year or current year or subsequent years are also recorded. Receipts are shown on debit side and payments are shown on credit side. Capital as well as revenue items are entered in the R & P A/c. This account is real account in nature. No provisions are recorded in this account. The account has an opening and a closing balance which is reflected as an asset in the balance sheet.

Features of receipts and payment account

1. It is an Account which contains all Cash and Bank transactions made by a nonprofit organization during a particular financial period.
2. It starts with the opening balances of Cash and Bank. All Cash Receipts both capital & revenue during the period are debited to it.



3. All Cash Payments both capital & revenue during the period are credited to this Account. It ends with the closing Cash and Bank Balances.
4. While recording the Cash and Bank transactions all entries are made on Cash Basis.
5. It is a summary of Cash Book.
6. It follows Real Account.

4.4.2.2 Income and Expenditure account – This is similar to the Profit and loss A/c and is prepared exactly based on same principles. As the name suggests only revenue items are recorded herein. Incomes are recorded on the credit side while the expenses on the debit side. Both incomes and expenses must be taken on the basis of accrual concept. This account should reflect only items that are pertaining to current period. Previous and subsequent year items are to be excluded. This account shows either a surplus or deficit. Excess of income over expenditure is called surplus and excess of expenditure over income is called as deficit.

Features of income and expenditure Account

1. It follows Nominal Account.
2. All expenses of revenue nature for the particular period are debited to this Account on accrual basis.
3. Similarly all revenue incomes related to the particular period are credited to this account on accrual basis.
4. All Capital incomes and Expenditures are excluded.
5. Only current year's incomes and expenses are recorded. Amounts related to other periods are deducted. Amounts outstanding for the current year are added.
6. Profit on Sale of Asset is credited. Loss on Sale of Asset is debited. Annual Depreciation on Assets is also debited.
7. If income is more than expenditure, it is called a Surplus, and is added with Capital or General Fund etc. in the Balance Sheet.
8. If expenditure is more than income, it is a deficit, and is deducted from Capital or General Fund etc. in the Balance Sheet.

4.4.2.3 Balance Sheet – It is prepared as on the last day of the accounting period. It also has assets and liabilities and prepared based on accounting equation. But, there's no capital account. Instead there is a capital fund. The surplus or deficit from Income & Expenditure A/c is adjusted against this capital fund at the end of the year.



Study Note - 4 : Preparation Of Final Accounts

4.4.2.4 Receipt and Payment Account

Receipts	Amount (Rs.)	Payments	Amount (Rs.)
Starts with opening balance		All payments-Capital or revenue	
All receipts - capital or revenue		May be related to any period previous	
May be related to any period previous,		current or subsequent	
Current or subsequent		End with closing balance	

4.4.2.5 Income and Expenditure Account

Expenses	Amount (Rs.)	Income	Amount (Rs.)
Only revenue expenses		Only revenue receipts	
Only related to current period.		Only related to current period	
Shows either surplus		Or shows deficit	

4.4.2.6 Difference between Receipts and Payments Accounts and Income and Expenditure Account

Receipts & Payments Account	Income & Expenditure Account
It is a summarised Cash Book	It closely resembles the Profit & Loss Account of a Trading concern.
Receipts are debited and Payments are credited.	Incomes are credited and Expenditures are debited.
Transactions are recorded on Cash basis.	Transactions are recorded on Accrual Basis
Amounts related to previous period or future period may remain included. Outstanding amount for current year is excluded.	Transactions are recorded on accrual basis. All amounts not related to the current period are excluded.
It records both Capital and Revenue transactions.	Outstanding amounts of current period are added.
It serves the purpose of a Real Account.	It records Revenue transactions only.
It starts with opening Cash and Bank	It serves the purpose of a Nominal Account.
Balances and ends with closing Cash and Bank Balances.	It does not record such balances, rather its final balance shows a surplus or a deficit for the period.



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It does not record notional loss or noncash expenses like bad debts, depreciations etc.	It considers all such expenses for matching against revenues
Its closing balance is carried forward to the same account of the next accounting Period.	Its closing balance is transferred to Capital Fund or General Fund or Accumulated Fund in the same period's Balance Sheet.
It helps to prepare an Income & Expenditure A/c.	It helps to prepare a Balance Sheet.

4.4.2.7 Difference between Profit and Loss Account and Income and Expenditure Account

Profit and Loss Account	Income & Expenditure Account
It is prepared by business undertaking	It is prepared by non-trading organizations.
The credit balance of Profit and Loss A/c is known as "net profit" and added to opening capital.	Credit balance of Income and Expenditure A/c is known as excess of income over expenditure or surplus and added to opening capital fund.
The debit balance of this Profit and Loss A/c is known as "net loss" and deducted from opening capital	Debit balance of this Income and Expenditure A/c is known as "excess of expenditure over income" or deficit and deducted from opening capital fund.
To, check correctness of accounts trial balance is prepared before preparing this account	To check correctness of accounts, receipts and payments account is prepared before preparing this account.

4.4.2.8 Fund Asset Accounting and its peculiarities:

Following are the concepts of some funds which are generally maintained by organizations:

- (i) **Capital Fund** : It is also called "General Fund" or "Accumulated Fund." It is actually the Capital of a non-profit concern. It may be found out as the excess of assets over liabilities. Usually "Surplus" or "Deficit" during a period is added with or deducted from it. A portion of Capitalised incomes like donations may be added with it.
- (ii) **Special Fund**: It may be created out of special donation or subscription or out of a portion of the "Surplus". For example a club may have a "Building Fund". It may be used for meeting some specific expenses or for acquiring an asset. If any income is derived out of investments made against this fund or if any profit or loss occurs due to sale of such investments, such income or profit or loss is transferred to this fund.

Other Treatments

- (a) **If the Special Fund is used to meet an expense**

Special Fund A/c

Dr.

To Bank A/c (amt. of expense)



Study Note - 4 : Preparation Of Final Accounts

The balance of the Fund is shown as a liability.

If the balance is transferred to Capital Fund, the entry will be—

Special Fund A/c	Dr.
To Capital Fund A/c (Balance of Special Fund)	

(b) **If the Special Fund is used to purchase an asset**

Asset A/c	Dr.
To Bank A/c (Cost of the asset)	
Special Fund A/c	Dr.
To Capital Fund A/c (Special Fund closed)	

(iii) **Donations**

- (a) Donation received for a particular purpose should be credited to Special Fund. For example, Donation received for Building should be credited to Building Fund A/c.
- (b) For other donations received the by-laws or rules of the concern should be followed.
- (c) If there is no such rule, donations received of non-recurring nature should be credited to Capital Fund. Recurring donations received should be credited to Income & Expenditure Account.
- (d) Donation paid by the concern should be debited to Income & Expenditure Account.

(iv) **Legacy received** : It is to be directly added with Capital Fund after deduction of tax, (if any). It is a kind of donation received according to the will made by a deceased person.

(v) **Entrance Fees or Admission Fees**

- (a) The rules or by-laws of the concern should be followed.
- (b) If there is no such rule, Admission or Entrance Fees paid once by members for acquiring membership should be added with Capital Fund.
- (c) If such fees are of small amounts covering the expenses of admission only, the fees may be credited to Income & Expenditure Account.

(vi) **Subscriptions**

- (a) Annual subscriptions are credited to Income & Expenditure Account on accrual basis.
- (b) Life membership subscription is usually credited to a separate account shown as a liability.

Annual Subscription apportioned out of that is credited to Income & Expenditure Account and deducted from the liability. Thus the balance is carried forward till the contribution by a member is



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fully exhausted. If any member dies before hand, the balance of his life Membership contribution is transferred to Capital Fund or General Fund.

Illustration 26

Ujjwal Vavishwa Club was holding a building valuing Rs. 10 lakhs as on 31.03.2019. Building Fund stands Rs. 8 lakhs and Cash at Bank is Rs. 15 lakhs as on 01.04.2019. During the year 2019-20 donation received for the building fund is Rs. 20 lakhs. Give the journal entries and the effect in the Balance Sheet as on 31.03.2020

- If i) It purchases building of Rs. 15 lakhs during 2019-20
 ii) It purchases building of Rs. 30 lakhs during 2019-20

Solution :

Journal Entries

(Rs. in Lakhs)

Date	Particulars	L. F.	Debit	Credit
31.03.2020	Bank A/c	Dr.	20	
	To, Donation for Building Fund A/c (Donation received for Building Fund)			20
	Building A/c	Dr.	15	
	To, Bank A/c (Building purchased utilizing the Building Fund)			15
	Building Fund A/c	Dr.	15	
	To, Capital Fund A/c (Being the capital expenditure transferred to the Capital Fund)			15

Balance Sheet as on 31.03.2020

Liabilities	Amount (Rs.)	Amount (Rs.)	Assets	Amount (Rs.)	Amount (Rs.)
Capital Fund			Building	10.00	
Add : Building	15.00		Add : Purchase of building	15.00	25.00
Fund (Amount Transferred)	8.00		Bank	15.00	
Building Fund	20.00		Add : Donation Received	20.00	
Add : Donation	28.00			35.00	
Less : Amount transferred to Capital Fund	15.00		Less : Purchase of Building	15.00	
		13.00			20.00

Study Note - 4 : Preparation Of Final Accounts

Journal Entries

(Rs. in Lakhs)

Date	Particulars	L. F.	Debit	Credit
31.03.2020	Bank A/c	Dr.	20	
	To, Donation for Building Fund A/c (Donation received for Building Fund)			20
	Building A/c	Dr.	30	
	To, Bank A/c (Building purchased utilizing the Building Fund)			30
	Building Fund A/c	Dr.	28	
	To, Capital Fund A/c (Being the capital expenditure transferred to the Capital Fund)			28

Balance Sheet as on 31.03.2020

Liabilities	Amount (Rs.)	Amount (Rs.)	Assets	Amount (Rs.)	Amount (Rs.)
Capital Fund			Building	10.00	
Add : Building	28.00		Add : Purchase of building	30.00	40.00
Fund (Amount Transferred)	8.00		Bank	15.00	
Building Fund	20.00		Add : Donation Received	20.00	
Add : Donation	28.00			35.00	
Less : Amount transferred to Capital Fund	28.00		Less : Purchase of Building	30.00	5.00
		NIL			

Illustration 27

On 31st December 2019, a club had subscription in arrears of Rs.16,000 and in advance Rs.4,000. During the year ended 31-12-2020, the club received subscription of Rs.2,08,000 of which Rs.10,400 was related to 2021. On 31st December 2020, there were 4 members who had not paid subscription for 2020 @ Rs.1,600 per person. Write up subscription A/c for the year 2020.

Solution

A single subscription account should be prepared to reflect both advance and arrears figures. The balancing figure will reflect the subscription amount that will be recognised as Income and transferred to I & E A/c as shown below:



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Dr. Subscription Account Cr.

Particulars	Amount (Rs.)	Particulars	Amount (Rs.)
To, Balance c/d (arrears)	16,000	By, Balance c/d (advance)	4,000
To T & E A/c (income for 2020)	1,92,000	By, R & P A/c (received)	2,08,000
To, Balance c/d (advance)	10,400	By, Balance c/d (arrears)	6,400
	2,18,400		2,18,400

Illustration 28

The sports club of Orissa had received in 2019-2020 Rs. 2,000 towards subscription. Subscription for 2018-19 unpaid on 1.4.2019 were Rs. 200.

Subscriptions paid in advance on 31.3.2019 were Rs. 50 and the same on 31.3.2020 was Rs. 40. Subscriptions for 2019-2020 unpaid on 31.3.2020 were Rs. 90.

Show how the subscriptions item will appear in the Income and Expenditure Account.

Solution

Particulars	Amount	(Rs.)
Subscriptions received during the year 2019-2020	2,000	
Add : Subscription outstanding on 31.3.2020	90	
	2,090	
Less : Subscription outstanding on 1.4.2019	200	
	1,890	
Add : Subscription paid in advance on 31.3.2019	50	
	1,940	
Less : Subscription received in advance on 31.3.2020	40	
Subscription Income for 2019-2020	1,900	

Illustration 29:

The amount of Subscription appears in the Income and Expenditure Account of South Indian Club is Rs.3000

Adjustments were made in respect of the following

Subscription for 2019 unpaid at 1st Jan. 2020, Rs.400; Rs.200 of which was received in 2020

Subscription paid in advance at 01.01.2020 Rs.100.

Subscription paid in advance at 31.12.2020 Rs.80.

Subscription for 2020 unpaid at 31.12.2020 Rs.140.

Prepare Subscription Account



Study Note - 4 : Preparation Of Final Accounts

Solution :

Dr.		Subscription Account		Cr.	
Particulars	Amount (Rs.)	Particulars	Amount (Rs.)		
To, Balance b/d	400	By, Balance b/d	100		
To, Income & Expenditure A/c	3,000	By, Balance (unpaid for 2019) (Rs.400-Rs.200) c/d	200		
To, Balance (paid in advance to 2020)	80	By, Cash Received (bal fig)	3,040		
		By, Balance (b/d 2020) c/d	140		
	3,480		3,480		
To, Balance b/d :		By Balance b/d (2020)	80		
For 2019	200				
For 2020	140				

Illustration 30

From the following information, prepare the Subscription Account for the year ending on March, 31, 2020

- Subscription in arrears on 31.03.2019 Rs. 1,500
- Subscription received in advance on 31.03.2019 Rs. 1,000
- Amount of Subscription received during 2019-20 Rs. 40,000, which includes Rs. 1,000 for the year 2018-19, Rs. 1,500 for the year 2020-13.
- Subscription outstanding Rs. 1,000.

Solution :

Dr.		Subscription Account		Cr.	
Particulars	Amount (Rs.)	Particulars	Amount (Rs.)		
To, Balance b/d	1500	By, Balance b/d	1,000		
To, Income & Expenditure A/c	39,500	By, Bank A/c	40,000		
		By Balnce c/d			
		For 2018-19	500		
To Balance c/d		For 2019-20	1,000		
For 2020-13	1,500				
	42,500		42,500		

Illustration 31

The accumulated balance of Life Membership fees at the beginning of the year 2020 was Rs.6,40,000. This represents the balance of life membership fees paid by 20 members since the



club started about 6 years ago. In the current year, 10 new life memberships were received totaling Rs. 4,00,000.

It's the policy of the club to spread these fees over 20 years to income. The amount payable per person is always Rs.40,000.

What is the amount to be recognised as income for the current year and what amount will be deferred through the balance sheet?

Solution:

Income to be recognised for new members

Life membership fees per person	Rs.40,000
Income to be spread over	20 years
Income to be recognised each year	Rs.2,000
Members added during the year	10
Income to be recognised (10*2000)	Rs.20,000
Amount to be carried forward	Rs.3,80,000
Income to be recognised for old members	
No. of members	20
Income to be recognised each year	Rs.2,000
Income to be recognised (20*2000)	Rs.40,000
Total income to be recognised (20,000+40,000)	Rs.60,000

Amount to be shown in the balance sheet

Accumulated Balance	Rs.6,40,000
Add: New fees received	Rs.4,00,000
Less: Recognised as income	(Rs.60,000)
Balance to be carried forward	Rs.9,80,000

4.4.2.9 Restaurant Trading and Bar Trading

Some clubs have Restaurant and Bar facilities for members and outsiders. Under the circumstances, Restaurant Trading or Bar Trading Account is opened to ascertain the Restaurant or Bar profit, it is just like Trading Account which is opened in case of a trading concern. The Restaurant or Bar profit so ascertained from Restaurant Trading or Bar Trading is transferred to the Income and Expenditure Account as we generally transfer the Gross Profit from Trading Account to Profit and Loss Account in case of Trading concern. Hence, the method of preparing a Restaurant or Bar Trading Account is just like the method of preparing a Trading Account.



Study Note - 4 : Preparation Of Final Accounts

Illustration 32

The following summary of the Cash Book has been prepared by the treasurer of a club:

Receipts	Amount (Rs.)	Payment	Amount (Rs.)
To Balance b/d	4,740	By wages-outdoor staff	13,380
" Subscriptions	29,720	" Restaurant Purchase	50,400
" Entrance Fees	3,200	" Rent-18 Months' to July 30, 2020	7,500
" Restaurant Receipts	56,800	" Rates	2,700
" Games & Competition Receipts	13,640	" Secretary's Salary	3,120
" Due to Secretary for Petty Expenses	80	" Lighting	7,200
		" Competition Prizes	4,000
		" Printing & Postage etc.	6,000
		" Placed in Fixed Deposit	8,000
		" Balance c/d	5,880
	1,08,180		1,08,180

On April 1, 2019 the club's assets were:- Furniture Rs. 48,000, Restaurant stock Rs. 2,600; Stock of prizes Rs. 800; Rs. 5,200 was owing for supplies to the restaurant.

On March, 31, 2020, the Restaurant stocks were Rs. 3,000 and prizes in hand were Rs. 500, while the club owed Rs. 5,600 for restaurant supplies.

It was also found that subscriptions unpaid at March 31, 2020, amounted to Rs. 1,000 and that the figure of Rs. 29,720 shown in the Cash Book included Rs. 700 in respect of previous year and Rs. 400 paid in advance for the following year.

Prepare an account showing the Profit or Loss made on the Restaurant and a General Income and Expenditure Account for the year ended 31.3.2020, together with a Balance Sheet as at that date, after writing 10% off the Furniture.

Solution :

Restaurant Trading Account

Dr.

For the year ended 31st March, 2020

Cr.

Liabilities	Amount (Rs.)	Amount (Rs.)	Assets	Amount (Rs.)	Amount (Rs.)
To Opening Stock A/c		2,600	By Restaurant Receipts A/c		56,800
" Purchases A/c	50,400		" Closing Stock A/c		3,000



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" Add : Outstanding for 31.03.2020	5,600				
	56,000				
" Less Outstanding for 01.04.2019	5,200				
		50,800			
" Income & Expenditure A/c (G. P. transferred)		6,400			
		59,800			59,800

Dr.

Balance Sheet As at 1st April , 2019

Cr.

Liabilities	Amount (Rs.)	Assets	Amount (Rs.)
Accumulated Fund : (bal. fig.)	50,390	Furniture and Equipment	48,000
Owing for supplies to Restaurant	5,200	Restaurant Stock	2,600
Outstanding Rent (Jan. to March, 2019)	1,250	Stock of Prize	800
		Outstanding Subscriptions	700
		Cash and Bank	4,740
	56,840		56,840

Income and Expenditure Account

Dr.

For the year ended 31st March, 2020

Cr.

Liabilities	Amount (Rs.)	Amount (Rs.)	Assets	Amount (Rs.)	Amount (Rs.)
To Wages A/c		13,380	By Subscription :	29,720	
			Subscription already received		
" Rent A/c	7,500		Less : Outstanding for		
				1,4,11	700
" Less : Outstanding on 01.04.2019	1,250			29,020	
	6,25	0	Add : Outstanding for 2020	1,000	
" Less : Prepaid for 3 months (7,500 x 3/18)	1,250	5,000		30,020	

Study Note - 4 : Preparation Of Final Accounts

" Rates A/c		2,700	Less : Received in advance	400	29,620
" Secretary's Salary A/c		3,120	" Games Competition Receipts		13,640
" Lighting, Cleaning, Services		7,200	" Restaurant Trading - Gross Profit		6,400
" Competition Prize A/c	4,000				
" Add : Opening Stock	800				
	4,800				
" Less : Closing Stock	500	4,300			
" Printing, Postage and Sundries		6,000			
" Dep. on Furniture and Equipment @10%		4,800			
" Surplus - Excess of income over expenditure					
		49,660			49,660

Dr.

Balance Sheet As at 31st March, 2020

Cr.

Liabilities	Amount (Rs.)	Amount (Rs.)	Assets	Amount (Rs.)	Amount (Rs.)
Accumulated Fund :			Furniture and Equipment	48,000	
Balance on 01.04.2019	50,390		Less : Depreciation	4,800	43,200
Add : Surplus	3,160	53,550	Restaurant Stock		3,000
Entrance fees		3,200	Stock of Prize		500
Subscription received in advance		400	Outstanding Subscriptions		1,000
Owing for supplies to Restaurant		5,600	Prepaid Rent		1,250
Outstanding Petty Expenses		80	Fixed Deposit with Bank		8,000
			Cash and Bank		5,880
		62,830			62,830

Illustration 33

'Citizen Club' was registered in a city and the accountant prepared the following Receipts and Payments Account for the year ended Dec. 31, 2020 and showed a deficit of Rs. 14,520 :



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		(Rs.)	(Rs.)
Receipts :	Subscriptions	62,130	
	Fare Receipts	7,200	
	Variety Show Receipts (net)	12,810	
	Interest	690	
	Bar Collection	22,350	
	Cash spent more	1,000	1,06,180
Payments :	Premium	30,000	
	Honorarium to Secretary	12,000	
	Rent	2,400	
	Rates and Taxes	3,780	
	Printing and Stationery	1,410	
	Sundry Expenses	5,350	
	Wages	2,520	
	Fair Expenses	7,170	
	Bar Purchase- Payment	17,310	
	Repairs	960	

	(Rs.)	(Rs.)
New Car (less proceeds of old car Rs.9,000)	37,800	
		1,20,700
Deficit The additional information should be obtained		14,520

	1.1.2020 (Rs.)	31.12.2020 (Rs.)
Cash in hand	450	-
Bank balance as per Pass Book	24,690	10,440
Cheques issued not presented for Sundry Expenses	270	90
Subscription due	3,600	2,940
Premises at Cost	87,000	1,17,000
Accumulated dep. on Premises	56,400	-
Car at Cost	36,570	46,800
Accumulated dep. on Car	30,870	-
Bar Stock	2,130	2,610
Creditors for Bar Purchases	1,770	1,290



Study Note - 4 : Preparation Of Final Accounts

Cash overspent represents honorarium to secretary not withdrawn due to cash deficit. His annual honorarium is Rs.12,000. Depreciation on premises and car is to be provided at 5% and 20% on written-down value.

You are required to prepare the correct Receipts and Payments Account, Income and Expenditure Account and Balance Sheet as at Dec. 31,2020

Solution :

In the Books of Citizen Club

Dr. Receipts and Payments Accounts for the year ended 31st December, 2020 Cr.

Receipts	Amount (Rs.)	Payment	Amount (Rs.)
To Balance b/d	450	By, Premises A/c	30,000
" Bank (24,690-270)	24,420	" Honorarium to Secretary A/c	11,000
" Subscription	62,130	" Rent A/c	2,400
" Fair Receipts	7,200	" Rates & Taxes	3,780
" Variety Show Receipts	12,810	" Printing and Stationery A/c	1,410
" Interest	690	" Sundry Expenses A/c	5,350
" Bar Receipts	22,350	" Wages A/c	2,520
		" Fair Expenses A/c	7,170
		" Bar Purchases A/c	17,310
		" Repairs A/c	960
		" New Car A/c	37,800
		" Bank Balance (10,440-90)	10,350
	1,30,050		1,30,050

Solution :

Income and Expenditure Accounts

Dr. For the year ended 31st December, 2020 Cr.

Expenditure	Amount (Rs.)	Amount (Rs.)	Income	Amount (Rs.)	Amount (Rs.)
To Honorarium to Secretary	11,000		By, Subscriptions	62,130	
Add : Outstanding	1,000	12,000	Add : Outstanding for 2020	2,940	
" Rent		2,400		65,070	
" Rates and Taxes		3,780	Less : Outstanding for 2019	3,600	61,470
" Printing and Stationery		1,410	" Fair receipts		7,200



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" Sundry Expenses		5,350	" Variety show receipts		12,810
" Wages		2,520	" Interest		690
" Fair Expenses		7,170	" Bar receipts		22,350
" Bar Purchases : Bar Stock (1.1.20)	2,130		" Profit on sale of old car [(Rs.9,000- (36,750- 30,870))]		3,300
Add : Purchases (Cash)	17,310				
	19,440				
Less : Creditors (1.1.20)	1,770				
	17,670				
Add : Creditors (31.12.20)	1,290				
	18,960				
Less : Stock (31.12.20)	2,610	16,350			
" Repairs		960			
" Depreciation on :					
Premises @5% on 60,600		3,030			
Car @20% on 46,800		9,360			
"Surplus - Excess of Income		43,490			
over Expenditure					
		1,07,820			1,07,820

Dr.

Balance Sheet As at 31st December, 2020

Cr.

Liabilities	Amount (Rs.)	Amount (Rs.)	Assets	Amount (Rs.)	Amount (Rs.)
Capital Fund as on 01.01.2020	65,130		Premises at Cost	1,17,000	
Add : Surplus	43,490	1,08,620	Less : Depreciation	59,430	57,570
Creditors (for bar purchase)		1,290	Car at Cost	46,800	
Secretary's honorarium			Less : Depreciation	9,360	37,440
		1,000	Bar Stock		2,610
			Outstanding Subscription		2,940
			Cash at Bank		10,350
		1,10,910			1,10,910

Study Note - 4 : Preparation Of Final Accounts

Dr. **Balance Sheet As at 1st January, 2020** Cr.

Liabilities	Amount (Rs.)	Amount (Rs.)	Assets	Amount (Rs.)	Amount (Rs.)
Capital Fund (bal. in figure)		65,130	Premises at Cost	87,000	
Creditors (for bar purchase)		1,770	Less : Depreciation	56,400	30,600
			Car at Cost	36,570	
			Less : Depreciation	30,870	5,700
			Bar Stock		2,130
			Outstanding Subscription		3,600
			Cash at bank		24,420
			Cash in Hand		450
		66,900			66,900

Illustration 34

Prepare Income & Expenditure A/c for the year ended 31-12-2020 and the balance sheet as on 31-12-2020 in the books of an Education society.

Particulars	Debit (Rs.)	Credit (Rs.)
Library Books	2,30,000	
Books added during the year	52,200	
Furniture	1,59,500	
Addition to furniture	35,500	
Building	37,89,000	
Investment	21,25,000	
Creditors		1,77,900
Debtors	59,700	
Investment reserve fund		1,85,000
Entrance fees		2,02,600
Examination fees		32,500
Certificate fees		7,800
Subscriptions received		2,75,800
Hire charges		95,500
Interest		85,000
Other receipts		4,400



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Salary	1,55,900	
Printing & Stationery	8,500	
Postage & Telephone	2,500	
Insurance	10,400	
Examination expenses	24,000	
Periodicals	15,600	
Prizes fund		2,15,000
Prizes Investments	2,10,400	
Prizes investment income		10,200
Prizes given	9,500	
Prizes bank balance	2,450	
Donation (capital)		1,99,000
General expenses	5,250	
Capital Fund		54,71,720
Bank Balance	65,500	
Cash in hand	1,520	
Total	69,62,420	69,62,420

Additional Information :

Subscription receivable Rs.22,500 subscription received for 2021 Rs.7,850 interest accrued on investments Rs.6,250 salary outstanding for 2020 Rs.12,500. Prepaid insurance Rs.4,500

Depreciate books @15% building @1% and furniture @10%

Dr. Income & Expenditure Account for the year ended 31.12.2020 Cr.

Liabilities	Amount (Rs.)	Amount (Rs.)	Assets	Amount (Rs.)	Amount (Rs.)
To Salary	1,55,900		By Examination Fees		32,500
Add : Outstanding	12,500	1,68,400	By Certificate fees		7,800
To Printing & Stationery		8,500	By Subscriptions	2,75,800	
To Postage & Telephone		2,500	Add : Receivable	22,500	
To Insurance	10,400		Less : Pre-received	(7,850)	2,90,450
Less : Prepaid	(4,500)	5,900	By Hire charges		95,500
To Examination Expenses		24,000	By Interest		85,000
To Periodicals		15,600	By Other Receipts		4,400
To General Expenses		5,250	By Accrued interest		6,250
To Depreciation on Books		38,415			



Study Note - 4 : Preparation Of Final Accounts

To Depreciation on Building		37,890			
To Depreciation on Furniture		17,725			
To Surplus		1,97,720			
		5,21,990			5,21,990

Dr.

Balance Sheet as on 31-12-2020

Cr.

Liabilities	Amount (Rs.)	Amount (Rs.)	Assets	Amount (Rs.)	Amount (Rs.)
			Building	37,89,000	
			Less : Depreciation @1%	(37,890)	37,51,110
Capital Fund	54,71,720		Library Books	2,30,000	
Add : Entrance Fees	2,02,600		Add : Purchased in 2020	52,000	
Add : Donations	1,99,000		Less : depreciation @15%	(38,415)	2,43,785
Add : Surplus	1,97,720	60,71,040	Furniture & Fixture	1,59,500	
			Add : Purchased in 2020	35,500	
			Less : Depreciation @10%	(17,725)	1,77,275
Investment Reserve Fund		1,85,000			
Prize Fund	2,15,000		Investment		21,25,000
Add : Fund Income	10,200		Prize Investments		2,10,400
Less : Fund Expenses	(9,500)	2,15,700	Debtors		59,700
Creditors		1,77,900	Prize Bank Balance		2,450
Subscription received in advance		7,850	Bank Balance		65,500
Salary Outstanding		12,500	Cash in hand		1,520
			Subscription receivable		22,500
			Interest Accrued		6,250
			Prepaid Insurance		4,500
		66,69,990			66,69,990

Illustration 35

The following information was obtained from the books of Young Bengal Club as on 31-03-2020 at the end of first year of the club. Prepare the receipt & Payment A/c, Income & Expenditure A/c and Balance sheet of the club

- (1) Donations received for building & books - Rs. 2,00,000



	Rev. Income (Rs.)	Actual Receipts (Rs.)
Entrance fees	17,000	17,000
Subscription	20,000	19,000
Locker rent	600	600
Sundry Income	1,600	1,060
Refreshment account	Nil	16,000

	Rev. Expenditure (Rs.)	Actual Receipts (Rs.)
Land (Cost Rs.10,000)	Nil	10,000
Furniture (Cost Rs.146,000)	Nil	130,000
Salaries	5,000	4,800
Maintenance of play ground	2,000	1,000
Rent	8,000	8,000
Refreshment account	Nil	8,000

Receipts	Amount (Rs.)	Payment	Amount (Rs.)
To Donations	2,00,000	By Library books	25,000
To Entrance Fees	17,000	By Land	10,000
To Subscription	19,000	By Furniture	1,30,000
To Locker Rent	600	By Salaries	4,800
To Sundry income	1,060	By Maintenance	1,000
To Refreshment A/c	16,000	By Rent	8,000
		By Refreshment A/c	8,000
To Balance c/d (Overdraft)	1,08,140	By 9% Govt. Bonds	1,60,000
		By Term deposits	15,000
	3,61,800		3,61,800



Study Note - 4 : Preparation Of Final Accounts

Dr. **Income & Expenditure Account for the year ended 31-12-2020** Cr.

Receipts	Amount (Rs.)	Payment	Amount (Rs.)
To Salary	5,000	By Entrance fees	17,000
To Maintenance of ground	2,000	By Subscriptions	20,000
To Rent	8,000	By Locker rent	600
To Depreciation on furniture	14,600	By Sundry Income	1600
To Depreciation on books	2,500		
To Surplus	7,100		
	39,200		39,200

Dr. **Balance Sheet as on 31-12-2020** Cr.

Liabilities		Amount (Rs.)	Assets	Amount (Rs.)
Payable for furniture		16,000	Land	10,000
Salary payable		200	Library Books (25000-2500)	22,500
Maintenance payable		1,000	Furniture (146000-14600)	1,31,400
Refreshment account	16,000		9% Govt. Bonds Term	1,60,000
Less : Spent	(8,000)	8,000	Deposit Subscription	15,000
Bank Overdraft		1,08,140	Receivable Sundry	1,000
Donations		2,00,000	Income accrued	540
Capital Fund		7,100		
		3,40,440		3,40,440

Illustration 36

Surya Trust runs a charitable hospital and a dispensary. The following balances were extracted from their books

Particulars	(Rs.)	Debit (Rs.)	Credit (Rs.)
Capital Fund			18,00,000
Donation received			12,00,000
Fees received from Patients			600,000
Recovery from amenities - rent etc.			5,50,000
Recovery for food supplies			2,80,000
Surgical equipments		9,10,000	
Building, theaters etc.		6,40,000	
Consumption of			



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Medicines	2,40,000		
Foodstuff	1,80,000		
Chemicals	60,000	4,80,000	
Closing Stock of			
Medicines	40,000		
Foodstuff	8,000		
Chemicals	2,000	50,000	
Sale of medicines from dispensary			6,20,000
Opening Stock of medicines (dispensary)	1,10,000		
Purchase of medicines (dispensary)		6,00,000	
Salaries			
Administrative Staff	60,000		
Doctors, nurses etc.	3,00,000		
Assistant in dispensary	30,000	3,90,000	
Electricity and power charges			
Hospital		2,10,000	
Dispensary	4,000	2,14,000	
Furniture fitting and equipments		1,60,000	
Ambulance		60,000	
Postage & Telephone (net of recover)		52,000	
Medical Journals		42,000	
Ambulance maintenance (net of recovery)			1,600
Consumption of linen, bedsheets etc.		1,80,000	
3-year 11% Fixed deposit (kept on 01-04-2019)	10,00,000		
Cash in hand	12,100		
Cash at bank	70,500		
Debtors (dispensary)	1,21,000		
Creditors (dispensary)		82,000	
Remuneration to trustees, trust expenses	42,000		
Total		51,33,600	51,33,600

Additional information

- Dispensary supplies medicines to hospital on requisition and delivery notes; for which no adjustment has been made in books. Cost of such supplies was Rs.1,20,000.
- Stock of medicines as close at dispensary was Rs.80,000.
- Donations were received towards corpus of the trust.
- Stock of medicines on 31st March 2020 included Rs.8,000 of medicines belonging to patients that have not been considered while calculating the consumption.



Study Note - 4 : Preparation Of Final Accounts

- (v) One of the well-wisher donated surgical equipments the market value of which was Rs.80,000 as on 31-3-2020.
- (vi) The hospital is to receive a grant of 25% of the amount spent on poor people. Such expenditure in the year was Rs.1,00,000.
- (vii) Out of fees recovered from patients, 10% is given to specialists.
- (viii) Depreciation on Surgical equipment is 20%, buildings 5%, Furniture 10% and Ambulance 30%. Prepare Income & Expenditure accounts for dispensary, trust and hospital separately for the year ended 31-3-2020 and the balance sheet as on 31-03-2020.

Dr. **Income & Expenditure Account for the year ended 31-03-2020 Trust** Cr.

Receipts	Amount (Rs.)	Payment	Amount (Rs.)
To Deficit in hospital	2,67,400	By Profit from dispensary	76,000
To Postage, telephone etc.	52,000	By Interest due on F. D.	1,10,000
To Trustee remuneration etc.	42,000	By Net deficit for the year	175,400
	3,61,400		3,61,400

Dr. **Income & Expenditure Account for the year ended 31-03-2020 - Dispensary** Cr.

Expenditure	Amount (Rs.)	Income	Amount (Rs.)
To Opening Stock	1,10,000	By Sales	6,20,000
To Purchases	600,000	By Issues to hospital	1,20,000
To Gross profit c/d	1,10,000	By Closing Stock	80,000
	8,20,000		8,20,000
To Salaries	30,000	By Gross Profit b/d	1,10,000
To Electricity charges	4,000		
To Trust A/c (surplus transferred)	76,000		
	1,10,000		1,10,000

Dr. **Income & Expenditure Account for the year ended 31-03-2020 Hospital** Cr.

Expenditure	Amount (Rs.)	Income	Amount (Rs.)
To Opening Stock		By Sales	6,20,000
To Consumption:		By Fees from patients	6,00,000
Medicines	3,68,000	By Room rents etc	5,50,000
Food stuff	1,80,000	By Food recoveries	2,80,000
Chemicals	60,000	By Ambulance receipts	1,600



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To Salaries		By Grants	25,000
Doctors		3,00,000	
Administrative staff	60,000		
To Due to specialists	60,000		
(10 % on 6 lacs)			
To Electricity & Power	2,10,000		
To Medical journals	42,000		
To Linens, bed sheets	1,80,000		
To Depreciation on:			
Surgical equipment @ 20% on 9.90	1,98,000		
Building @ 5%	32,000		
Furniture @10%	16,000		
Ambulance @ 30%	18,000	By Trust A/c (deficit transferred)	2,67,400
	17,24,000		17,24,000

Dr.

Balance Sheet as on 31-03-2020

Cr.

Liabilities	Amount (Rs.)	Amount (Rs.)	Assets	Amount (Rs.)	Amount (Rs.)
Capital Fund			Cash in hand		12,100
Opening Balance	18,00,000		Cash at Bank		70,500
Add : Donations	12,00,000		Fixed Deposit		10,00,000
Add : Value of gift	80,000		Interest accrued on F.D.		1,10,000
Less : Deficit	(1,75,400)	29,04,600	Debtors		1,21,000
			Grant due		25,000
Creditors :			Stocks :		
			Dispensary		
			80,000+hospital		
			32,000+8,000+2,000		
For machines		82,000	32,000+8,000+2,000		1,22,000
Due to specialists		60,000	198,000)		7,92,000
			Building (640,000-32,000)		6,08,000
			Furniture		1,44,000
			(160,000-16,000)		
			Ambulance		42,000
			(60,000-18,000)		
		30,46,600			30,46,600



Following is the receipt and payment A/c of a club for the year ended 31-03-2020

Dr.		Receipt and Payments for the year ended 31-03-2020		Cr.	
Receipts		Amount (Rs.)	Payment	Amount (Rs.)	
Opening balance			Administrative expenses	1,25,000	
Cash		3,000	Programme expenses	2,75,000	
Bank		7,000	F. D. with bank	1,25,000	
Membership fees received : up to 31-03-2019		14,000	Investment in bonds	3,00,000	
For 2019-20		1,50,000	Fixed assets purchased	80,000	
For 2020-21		16,000			
Advertisements		5,00,000			
F. D. with bank		75,000			
Interest on savings A/c		700			
Interest on F. D.		22,000	Closing balance :		
			Cash	2,700	
			Bank	5,000	
Investment matured (Cost 80,000 & interest 8,000)		1,00,000			
		9,12,700		9,12,700	

The club informs you that :

- (a) Membership fee for 2019-20 due is Rs.25,000; it includes Rs.1,000 from a member who has not yet paid for 2018-19 as well. A provision needs to be done on this.
- (b) Income receivable on 31-03-2020 on ICICI bond is Rs.30,000 and on Govt. Securities is Rs.24,000
- (c) Prepaid expenses on 31-03-2006 amounts to Rs.7,000
- (d) Outstanding expenses as on 31-03-2020 Rs.8,000
- (e) Depreciation to be provided is Rs.12,500
- (f) Programme is an annual feature



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The balance sheet as on 31-03-2019 is also provided as below :

Dr.	Balance Sheet as on 31-03-2021		Cr.
Receipts	Amount (Rs.)	Payment	Amount (Rs.)
Trust fund	5,00,000	Cash	3,000
Accumulated in advance	1,05,000	Bank Savings A/c	7,000
Subscriptions in advance	10,000	Fixed Deposit	2,00,000
Outstanding Expenses	10,000	Govt. Securities	3,00,000
		Fixed Assets	95,000
		Subscription receivable	15,000
		Prepaid expenses	5,000
	6,25,000		6,25,000

Prepare Income and expenditure a/c and the closing balance sheet for the year 2019-20

Solution

Dr.	Subscription Account		Cr.
Particulars	Amount (Rs.)	Particulars	Amount (Rs.)
To, Opening receivable	15,000	By, Opening advance received	10,000
To, I & E A/c	1,85,000	By, Received during year	1,80,000
(balancing figure)		By, Closing receivable :	
To, Closing advance received	16,000	for 2018-19	1,000
		for 2019-20	25,000
	2,16,000		2,16,000

Dr.	Expenses A/c		Cr.
Particulars	Amount (Rs.)	Particulars	Amount (Rs.)
To, Opening prepaid	5,000	By, Opening outstanding	10,000
To, Bank	1,25,000	By, I & E A/c (balancing figure)	1,21,000
To Closing outstanding	8,000	By, Closing prepaid	7,000
	1,38,000		1,38,000



Study Note - 4 : Preparation Of Final Accounts

Provision for doubtful subscriptions

For 2018-19	1,000
For 2019-20	1,000
	2,000

Dr. Income & Expenditure Account for the year ended 31-03-2020

Cr.

Particulars	Amount (Rs.)	Particulars	Amount (Rs.)
To, Administrative expenses	1,21,000	By, Subscriptions	1,85,000
To, Depreciation on assets	12,500	By, Interest income	84,700
To, Provision on subscriptions	2,000	By, Surplus from programme	2,50,000
		By, Profit on sale of investment	12,000
To Surplus	3,96,200		
	5,31,700		5,31,700

Dr. Balance Sheet as on 31-03-2020

Cr.

Particulars	Amount (Rs.)	Particulars	Amount (Rs.)
Trust Fud	5,00,000	Cash	2,700
Accumulated surplus	1,05,000	Bank saving A/c	5,000
Surplus for 2019-20	3,96,200	Fixed deposit	2,50,000
Outstanding expenses	8,000	Govt. Securities	2,20,000
Subscription in advance	16,000	ICICI bonds	3,00,000
		Interest receivable on :	
		Govt. securities	24,000
		Bonds	30,000
		ICICI Bond Receivable	24,000
		Prepaid Expenses	7,000
		Fixed assets (1,75,000-12,500)	1,62,500
	1,025,200		10,25,200
Profit on disposal of Investment			
Amount received	1,00,000		
Less : interest	8,000		
Net received	92,000		
Cost of disposed investment	80,000		
Profit on disposal	12,000		



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Illustration 38

The Ranchi cricket club has given below its Receipts and Payments A/c for the year ended 31st December, 2020.

Date	Receipts	Amount	Date	Payments	Amount
1st Jan	Balance b/d - cash	56,000	1st Jan to	Groundman's wages	3,00,000
	Balance b/d- bank	35,000	31st Dec	Ground rent	1,50,000
	Balance b/d- F.D.	75,000	2020	Repairs to pavilion	12,000
1st Jan	Subscriptions	4,15,000		Cricket equipment	40,000
to 31st	Bar takings	4,25,000		8% Govt. securities	1,00,000
Dec	Surplus on tournaments	38,800		Bar purchases	3,05,000
2020	Bank interest	3,500		Sundry expenses	7,800
	Donations	25,000		Insurance	3,500
			31st Dec	Balance c/d-Cash	42,000
				Balance c/d- Bank	13,000
				Balance c/d- F. D.	1,00,000
		10,73,300			10,73,300

Additional information:

- Pavilion was the only asset having a book value of Rs.450,000 (cost 750,000 less depreciation 300,000). Depreciation for the year amounted to Rs.25,000.
- Expenditure on cricket equipment is to be written off in the year in which incurred.
- Other assets and liabilities were as follows:

31st December

	2019 (Rs.)	2020 (Rs.)
Bar stocks	15,000	25,000
Creditors for Bar purchases	46,000	67,000
Creditors for sundry expenses	900	1200
Insurance in advance	750	600
Rent owing	35,000	40,000

The club does not wish to take any credit for subscriptions. In December 2020, the club decided to set up a special fund of Rs.100,000 as endowment for the best player award. This was invested in 8% Govt. securities as shown above.

Prepare (a) Statement showing Capital fund as on 31-12-2019, (b) Income and expenditure A/c for the year ended 31-12-2020 and (c) the balance sheet as on that date



Study Note - 4 : Preparation Of Final Accounts

Solution

Capital fund as on 31-12-2019

Bar Stock	15,000
Insurance prepaid	750
Pavilion	450,000
Cash in hand	56,000
Cash at Bank	35,000
Cash in F D	75000
Less : Creditors & accrued exp.	(81,900)
Capital Fund	5,49,850

Dr.

Income & Expenditure Account

Cr.

Expenditure	Amount (Rs.)	Income	Amount (Rs.)
To, Ground man's wages	3,00,000	By, Subscriptions	4,15,000
To, Rent	1,55,000	By, Surplus on tournaments	38,800
To, Repairs to pavilion	12,000	By, Bank Interest	3,500
To Cricket equipment	40,000	By, Donations	25,000
To, Sundry expenses	8,100	By, Profit on Bar takings	1,09,000
To, Insurance	3,650		
To, Depreciation on pavilion	25,000		
To, Surplus	47,550		
	5,91,300		5,91,300

Dr.

Balance Sheet as on 31-12-2020

Cr.

Liabilities	Amount (Rs.)	Assets	Amount (Rs.)
Creditors for bar Purchases	67,000	Cash	42,000
Creditors for expenses	1,200	Bank	13,000
Outstanding rent	40,000	Fixed deposit	1,00,000
Capital Fund (549,850+47,550)	5,97,400	Bar stocks	25,000
		Prepaid Insurance	600
		8% Govt. Securities	1,00,000
		Pavilion (450,000-25,000)	4,25,000
	7,05,600		7,05,600



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Notes :

(a) The rent, sundry expenses and insurance are to be arrived at as follows

Item	Paid	Last Year/ Next Year	Current Year	Working	Recognized
Rent	1,50,000	35,000	40,000	$1,50,000 - 35,000 + 40,000$	1,55,000
Sundry Expenses	7,800	900	1,200	$7,800 - 900 + 1,200$	8,100
Insurance	3,500	600	750	$3,500 - 600 + 750$	3,650

(b) The profit on Bar takings is calculated as follows :

Opening bar stocks	15,000
Add : Purchases $(3,05,000 - 4,60,00 + 67,000)$	3,26,000
Less : Closing bar stocks	25,000
Consumption	3,16,000
Bar takings	4,25,000
Surplus on Bar takings	1,09,000

(c) The figure of surplus in the I & E A/c is the balance figure

Illustration 39

Prepare the Balance Sheet of Ocean Blue club based on following information

Furniture (before depreciation)	8,000	Outstanding consultancy	1,000
Depreciation on furniture	800	Allowances outstanding	800
Building fund	30,000	Capital Grants	10,000
Income from building fund	2,000	Entrance fees (50% be funded)	4,000
Fixed deposits	20,000	Legacies received(funded)	8,000
Opening General fund	10,000	Prize fund	10,000
Excess of income over expenditure	20,000	Income of prize fund	1,000
Opening balance of capital fund	60,000	Expenses of prize fund	800
Cost of swimming pool	40,000	Investment of prize fund	10,000
Equipments	20,000	Balance in current A/c	10,000
Investment of general fund	36,000	Cash in hand	800
Subscription outstanding	10,000		



Study Note - 4 : Preparation Of Final Accounts

Solution

Dr.

Balance Sheet as on 31-03-2020

Cr.

Liabilities	Amount (Rs.)	Amount (Rs.)	Assets	Amount (Rs.)	Amount (Rs.)
Capital Fund			Fixed Assets :		
Op balance	60,000		Swimming Pool		40,000
Add : Capital grants	10,000		Equipments		20,000
Add : Legacies	8,000		Furniture	8,000	
Add : Entrance fees (50%)	2,000	80,000	Less : Depreciation	800	7,200
General Fund			Investment		
Op balance	10,000		General fund	36,000	
Surplus	20,000	30,000	Prize fund	10,000	46,000
Building Fund			Receivables		
Op balance	30,000		Subscription		10,000
Add : Income	2,000	32,000			
Prize Fund			Cash & Bank		
Op balance	10,000		Cash in hand	800	
Add : Income	1,000		Current A/c	10,000	
Less : Expenses	800	10,200	Fixed deposit	20,000	30,800
Allowances					
Outstanding		800			
Consultancy					
Outstanding		1,000			
		1,54,000			1,54,000

4.4.2.10 Preparation of opening and closing Balance Sheet from a given Receipt and Payment account and Income and Expenditure account

A. In order to prepare opening Balance Sheet, the following steps are to be taken, one after another:

- Take all the opening assets and liabilities which are given under the Income and Expenditure Account and the Receipts and Payments Account as adjustments, one by one, i.e., assets on the assets side of the opening Balance Sheet and liabilities on the liabilities side of the opening Balance Sheet.
- Opening balance of the Cash and Bank Account are to be taken from the Receipts



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and Payments Account which are represented by "To, Balance b/d".

- (iii) Now, the difference between the assets side of the Balance Sheet and Liabilities side is the opening capital or "Capital Fund."

B. In order to prepare the closing Balance Sheet, the following steps are to be followed:

- Take all the opening fixed assets (if not sold/discarded/lost, etc), with additions, if any (which is to be taken from the Receipts and Payments Accounts) after charging depreciation, if any, in the assets side of the balance Sheet.
- Take the closing liabilities including the capital Fund (which we will get from the opening Balance Sheet) and other funds such as Donation, Entrance Fees etc., including all the other current Liabilities and Outstanding Expenses.
- Now compare each and every individual item of Income and Expenditure Account with the items shown by the Receipts and Payments Account for the same. For example, if Salary Account is shown by the Income and Expenditure Account as Rs. 1,500, and if the same account is shown by the Receipts and Payment Account, as, Rs. 1,125, it means Rs. 375 remains outstanding which must be shown in the liabilities side of the closing Balance Sheet. Income and Expenditure Account takes only the revenue item for the current year.

Consider the following

Dr. **Income and Expenditure Account for the year ended 31st December, 2020** Cr.

Expenditure	Amount (Rs.)	Income	Amount (Rs.)
To, Salary A/c	1,500		

Dr. **Receipts and Payments Account for the year ended 31st December, 2020** Cr.

Receipts	Amount (Rs.)	Payment	Amount (Rs.)
		By, Salary A/c	1,125

Dr. **Balance Sheet (Closing) as at 31st December, 2020** Cr.

Liabilities	Amount (Rs.)	Assets	Amount (Rs.)
Outstanding Salary	375		

Again, if Receipts and Payments Account shows that the salary paid is Rs. 1,800, it reveals that Rs. 300 has been paid in advance which will be shown in the assets side of the closing balance Sheet under the head 'Prepaid Salary'. In the opposite case, i.e., in case of an income, it will be reversed. For example, if Interest Account is shown by the Income and Expenditure Account as



Study Note - 4 : Preparation Of Final Accounts

Rs. 1,500, and, if the same account is shown by the Receipts and Payments Account only Rs. 300 is accrued which is shown in the assets side of the closing Balance Sheet.

Then consider the following:

Dr. Income and Expenditure Account for the year ended 31st December, 2020 Cr.

Expenditure	Amount (Rs.)	Income	Amount (Rs.)
		By, Interest A/c	1,800

Dr. Receipts and Payments Account for the year ended 31st December, 2020 Cr.

Receipts	Amount (Rs.)	Payment	Amount (Rs.)
To, Interest A/c	1,200		

Dr. Balance Sheet (Closing) as at 31st December, 2020 Cr.

Liabilities	Amount (Rs.)	Assets	Amount (Rs.)
		Accrued Interest	300

Again, if Receipts and Payments Account shows that the Interest Received amounts to Rs. 2,250, it reveals that Rs. 750 (i.e., Rs. 2,250 - Rs. 1,500) has been received as advance interest – which must be shown in the liability side of the closing Balance Sheet.

There are certain items which are also to be adjusted, e.g., Depreciation of assets, etc.

Illustration 40

The following particulars related to Fast Sports Club :

Dr. Income and Expenditure Account for the year ended 31st December, 2020 Cr.

Expenditure	Amount (Rs.)	Income	Amount (Rs.)
To Salaries	6,000	By Admission Fees	15,000
" Printing & Stationery	2,500	" Subscriptions	25,000
" Advertising	1,000	" Rent Receipts	4,800
" Insurance Charges	900		
" Electricity	500		
" Dep. on sports Equipments	12,000		
" Surplus	21,900		
	44,800		44,800



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Dr. Receipts and Payments Account For the year ended 31st December, 2020 Cr.

Receipts	Amount (Rs.)	Amount (Rs.)	Assets	Amount (Rs.)	Amount (Rs.)
To Balance b/d		5,000	By, Salary (including Adv.)		7,500
“ Admission Fees-			“ Printing & Stationery		2,500
2019	2,500		“ Advertising		1,000
2020	13,500	16,000	“ Insurance		
“ Subscription			(party for next year)		1,200
2019	1,000		“ Electricity		500
2020	23,000		“ Fixed Assets Purchased		20,000
2021	2,000	26,000	“ Balance c/d		17,900
“ Rent		3,600			
		50,600			50,600

On 01.01.2020 the Club had the following assets :

Land and Building Rs.60,000; Sports Equipment Rs.30,000; Furniture Rs.4,500. Prepare opening and closing Balance Sheet.

Solution :

Fast Sports Club

Dr. Balance Sheet as at 31st December, 2019 Cr.

Liabilities	Amount (Rs.)	Assets	Amount (Rs.)	Amount (Rs.)
Capital Fund	1,06,600	Land and Building		60,000
		Sports Equipment		30,000
		Furniture		4,500
		Rent Receivable		3,600
		Adm. Fee Receivable		2,500
		Outstanding Subs.		1,000
		Cash and Bank		5,000
	1,06,600			1,06,600



Study Note - 4 : Preparation Of Final Accounts

Dr. **Balance Sheet as at 31st December, 2020** Cr.

Liabilities	Amount (Rs.)	Amount (Rs.)	Assets	Amount (Rs.)	Amount (Rs.)
Capital Fund	1,06,600		Land and Building		60,000
Add : Surplus	21,900	1,28,500	Sports Equipment	30,000	
Subscription Received in Advance		2,000	Less : Depreciation	12,000	18,000
			Furniture		4,500
			Fixed Assets (other)		20,000
			Prepaid Insurance		300
			Prepaid Salary		1,500
			Rent Receivable		4,800
			Outstanding Subs.		2,000
			Outstanding Adm. Fee		1,500
			Cash and Bank		17,900
		1,30,500			1,30,500

Illustration 41

The following are the items of Receipts and Payments of the Bengal Club as summarized from the books of account maintained by the Secretary :

Dr. **Balance Sheet as at 31st December, 2020** Cr.

Receipts		Amount (Rs.)	Assets	Amount (Rs.)	Amount (Rs.)
Opening Balnce 1.1.2020		4,200	Manager's Salary		1,000
Entrance Fees	2019	1,000	Printing and Stationery		2,600
Do	2020	10,000	Advertising		1,800
Subscriptions	2019	600	Fire Insurance		1,200
Do	2020	15000	Investment Purchased		20,000
Interest Received on Investment		3,000	Closing Balance 31.12.2020		7,600
Subscriptions	2021	400			
		34,200			34,200



Paper I: Fundamentals of Financial Accounting

It was ascertained from enquiry that the following represented a fair picture of the income and Expenditure of the Club for the year 2020 for audit purpose :

Expenditure		Amount (Rs.)	Income	Amount (Rs.)	Amount (Rs.)
Manager's Salary		1,500	Entrance Fees		10,500
Printing & Stationery	2,000		Subscription		15,600
Add : Accrued	400	2,400	Interest on Investments		4,000
Advertising (accrued Nil)		1,600			
Audit Fees		500			
Fire Insurance		1,000			
Depreciation		4,940			
Excess of Income over Expenditure		18,160			
		30,100			30,100

You are required to prepare the Balance Sheet of the Club as on 31.12.2019 and 31.12.2020, it being given that the values of the Fixed Assets as on 31.12.2019 were: Building Rs. 44,000, Cricket Equipment Rs. 25,000 and Furniture Rs. 4,000. The rates of depreciation are Building 5%, Cricket Equipments 10%, Furniture 6%.

You are entitled to make assumptions as may be justified.

Solution

In the books of Bengal Club

Dr.

Balance Sheet as at 31st December, 2019

Cr.

Liabilities	Amount (Rs.)	Assets	Amount (Rs.)
Outstanding Liabilities		Building	44,000
Advertisement (1,800-1,600)	200	Furniture	4,000
Printing and Stationery (2,600-2,000)	600	Cricket Equipment	25,000
Capital Fund	78,000	Entrance Fees in arrear	1,000
(Balancing figure)		Subscription in arrear	600
		Cash	4,200
	78,800		78,800



Study Note - 4 : Preparation Of Final Accounts

Dr.

Balance Sheet as at 31st December, 2020

Cr.

Expenditure	Amount (Rs.)	Amount (Rs.)	Income	Amount (Rs.)	Amount (Rs.)
Capital Fund :			Building	44,000	
Balance on 1.1.2020	78,000		Less : Depreciation 5%	2,200	41,800
Add : Excess of Income					
over Expenditure	18,160	96,160	Furniture	4,000	
Subscription Received in Advance		400	Less : Depreciation 6%	240	3,760
Outstanding Liabilities Printing and Stationery		400	Cricket Equipment	25,000	
Manger's Salary (1,500-1,000)		500	Less : Depreciation 10%	2,500	22,500
			Investments		20,000
Audit Fees		500	Subscriptions in arrear (15,600-15,000) Entrance Fees in arrear (10,500-10,000)		600
			Accrued Interest on Investments (4,000-3,000) Prepaid Insurance (1,200-1,000)		1,000
			Cash		7,600
		97,960			97,960

Note: Advertisement expenses and Printing and Stationery which were paid in excess over Income and Expenditure A/c are assumed to be outstanding for the previous year.

4.4.2.11 Preparation of Receipts and Payments Account from a given Income and Expenditure Account and a Balance Sheet

Receipts and Payments Account is a summary of Cash Book. If both Income and Expenditure Account and the Opening Balance Sheet are given, we are to consider each and individual items, one by one. Consider the following example:



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Illustration 42

Dr. Balance Sheet (Extract) as at 31st December, 2020 Cr.

Liabilities	Amount (Rs.)	Assets	Amount (Rs.)
Outstanding Salary	700	Prepaid Insurance	500
		Outstanding Subscription	2,000

Dr. Income and Expenditure Account for the year ended 31st December, 2020 Cr.

Expenses	Amount (Rs.)	Income	Amount (Rs.)
Salary	6,000	Subscription	12,000
Insurance	3,000		

Adjustments :

- (i) Salary outstanding for the year 2020 amounted to Rs.1000
- (ii) Insurance Prepaid amounted to Rs.800
- (ii) Subscription outstanding for the year 2020 amounted to Rs.3,000

Solution

(i)	Particulars	Amount (Rs.)
	Amount paid on account of salary in Receipts and Payments Account	6,000
	Less : Outstanding for 2020	1,000
		5,000
	Add : Outstanding for 2019	700
		5,700

(ii)	Particulars	Amount (Rs.)
	Amount paid on account of salary in Receipts and Payments Account	3,000
	Less : Outstanding for 2021	800
		3,800
	Less : Prepaid Insurance for 2020 paid in 2019	500
		3,300

(i)	Particulars	Amount (Rs.)
	Amount received on account of salary in Receipts and Payments Account	12,000
	Less : Outstanding for 2020	3,000
		9,000
	Less : Prepaid Insurance for 2020 paid in 2019	2,000
		11,000

STUDY NOTE – 5

CASH & FUND FLOW STATEMENTS

This Study Note includes:

- Understanding income and cash
- Meaning of Cash Flow, & Definitions
- Cash Flow Vs. Income
- Cash & Non-Cash Transactions
- Depreciation & the Tax Shield
- Direct Method
- Indirect Method
- Funds Flow Definition
- Difference between Funds Flow & Cash Flow
- Funds Flow Statement Cases Study
- Advantages & Disadvantages
- Summary

5.1 UNDERSTANDING INCOME AND CASH!

The understanding of the concept of income and cash, will be the basis for learning above cash flow statements. The following example will enhance your understanding of this concept.

Rahul asked his father, Mr. Mehra “Dad, you say your income is Rs.60,000/ p.m.. Why do you give Mummy only Rs. 25,000/ for household expenses ? What do you do with the rest of the cash?” Rahul's query was genuine. After all, if income is not cash available to do as one feels fit, and then what is?

Mr. Mehra was very happy that Rahul was thinking about serious issues & decided this was a good time to explain to him, the difference between income & cash.

Mr. Mehra's monthly budget	Rs.	Rs.
Salary Income		60, 000
(Less) Taxes & Other Deductions	15, 000	
Provident Fund	10, 000	
Equated Monthly Installment (EMI)		
(On Car Loan including Principal & Interest)	4, 000	
LIC & Health Insurance	4, 000	
Total	33, 000	



Rahul understood now “Thank you for telling me; I understand that income & cash flow are totally different”

5.2 MEANING OF CASH FLOW, & DEFINITIONS

The Final Accounts of a Company include

P & L A/c, Balance Sheet & Statement of Cash Flows

There are three components of a Cash Flow Statement,

- a) Cash Flow from Operating Activities
- b) Cash Flow from Investing Activities
- c) Cash Flow from Financing Activities

The net result is the change in cash flow during the period. This period could be a month, half year, year, etc. but must be clearly mentioned in the heading.

Cash comprises cash on hand and demand deposits with banks. Demand Deposit means a deposit (of any type) with the bank, which must be repaid to the depositor when demanded

Cash equivalents are short term, highly liquid investments that are readily convertible into known amounts of cash and which are subject to an insignificant risk of changes in value. In other words, this implies three things:

- a) The investment is highly liquid
- b) Its cash value is known with near certainty
- c) It is extremely short term (hence, subject to insignificant risk)

Cash flows are inflows and outflows of cash and cash equivalents. If inflows are greater, there is a net cash inflow; if outflows are greater, there is a net cash outflow.

A transfer between one kind of cash, say bank FD & another kind of cash, say current A/c in the bank or another cash equivalent, will be ignored.

Operating activities are the principal revenue-producing activities of the enterprise and other activities that are not investing or financing activities. Cash Flow from Operations is the most important constituent of the Cash Flow Statement.

If a firm generates positive flow from operations, it is a healthy sign. It means that the main business of the firm is sustainable.

Cash flows from operating activities include cash:

- i) Received from sales (of goods & services)
- ii) Received from royalties, commissions, fees etc.
- iii) Paid for purchases of goods & services (including expenses)

Study Note - 5 : Cash & Fund Flow Statements

- iv) Paid for salaries & wages to employees
- v) Paid on behalf of employees
- vi) Received from or Paid for Income Taxes...excluding those relating specifically to financing & investing activities
- vii) Received from or Paid for options & contracts held for dealing or trading
- viii) Received from or Paid for sale & purchase of securities

Investing activities are the acquisition and disposal of long-term assets and other investments not included in cash equivalents.

Long-term assets include land, buildings, plant & machinery

Cash flows from investing activities include cash:

- i) Paid to purchase fixed assets (tangible & intangible)
- ii) Received from disposal of fixed assets
- iii) Paid for shares, warrants & debt of another entity
- iv) Received from disposal of shares, warrants & debt of another entity
- v) Paid as loans & advance to a third party
- vi) Received as repayment of loans & advances made to third parties
- vii) Paid for & Received from other investments (which do not relate to operations or financing)

Financing activities are activities that result in changes in the size and composition of the owners' capital (including preference share capital in the case of a company) and borrowings of the enterprise

Companies borrow money or raise fresh capital by issuing equity &/or preference shares. These are financing activities.

There are two types of capital, Own Capital & Loan Capital

Own capital includes Equity Shares, Preference Shares & Retained Earnings

Loan Capital comprises all borrowings

Any transaction which affects the above is a Cash Flow from Financing Activities... e.g.

- i) Cash received by issuing shares (equity, equity related or preference)
- ii) Cash received from issue of debentures, loans, bonds & all short-term as well as long-term borrowing
- iii) Cash used to repay borrowed amounts
- iv) Cash used to redeem preference shares



Some Special Items

Interest & Dividends:

- a) In case of a financial enterprise, cash flows arising from interest paid & interest & dividend received is a cash flow from operating activities. This is logical, as the business of the financial enterprise is borrowing money, lending it &/or investing it. That is the core operation of the organization

Dividend paid will be classified as cash flow from financing activities.

- b) In all other cases, cash flows from interest & dividend paid should be classified as cash flows from financing activities: cash flow from interest & dividends received is cash flow from investing activities.

Taxes on Income:

If it is practicable to identify tax paid as tax on net operating income, tax on net investing income & tax on net financing income, the taxes should be segregated accordingly. Usually however, it is not feasible to clearly indicate the distinction. Therefore, taxes on income are invariably grouped under Cash Flow from Operating Activities.

Do remember, capital gains on sale of property is clearly identifiable. In this case, tax paid on the capital gains will be treated as Cash Flow from Investing Activities. The same logic is extended to all other transactions

Extraordinary Items:

These include windfall gains, winning a lottery, settlement of insurance claims, law suits (in favour or against). These items must be grouped under the Cash Flow heading as is relevant, Operating, Investing or Financing. The disclosure should be made separately, that these are extraordinary items, of a non-recurring nature.

Investment & Divestment in Subsidiaries, Associates & Joint Ventures

Should be shown as Cash Flow from Investing Activities. Specific mention should be made of the nature of transaction & it should be limited to transactions to & from the company & its associate entities

Please refer Annexure 6.1 for an actual cash flow statement of Reliance Industries Ltd for the year 2019-20

Case Study 1

- 1 Mr. X starts a company with Rs.100,000/ (own capital)
- 2 He also borrows Rs. 30,000/ from the bank
- 3 Equipment purchased for Rs.50,000/ in cash
- 4 Sales Rs.120,000/. The customer pays Rs. 80,000/ in cash & promises to pay the balance after two months

Study Note - 5 : Cash & Fund Flow Statements

5 Expenses for wages, interest, routine maintenance is Rs.90,000/

6 The company pays a dividend of Rs. 10,000/

5.3 CASH FLOW VS. INCOME

Before we proceed, it is important to understand fully, the distinction between cash flow & income.

If one borrows money, it will generate a cash inflow, but it is not income

If one sells goods on credit, it will may lead to a profit but it has not delivered a cash flow (until the debtor pays his dues)

In the case study above, the borrowing from the bank of Rs. 30,000/ is a cash flow, but not an income. Similarly, the credit portion of sales will generate profit, but no cash inflows yet

Back to our Case Study 1. Remember the basic accounting rule

Assets = Liabilities + Owners' Equity (Capital)

1 Mr. X starts a company with Rs. 100,000/ (own capital)

Assets	Liabilities + Owner's Equity
Cash	Contributed Capital
+1,00,000	+1,00,000

Journal Entry

Cash A/c	Dr	100,000/-	
	To Capital A/c		100,000/-

2 He also borrows Rs.30,000/- from the bank

Assets	Liabilities + Owner's Equity
Cash	Bank Loan
+30,000	+30,000

Journal Entry

Cash A/c	Dr	30,000/-	
	To Capital A/c		30,000/-

3 Equipment purchased for Rs.50,000/ in cash

Assets	Liabilities + Owner's Equity
- Cash	Equipment
-50,000	-50,000

Journal Entry

Cash A/c	Dr	50,000/-	
	To Capital A/c		50,000/-



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- 4 Sales Rs.120,000/- The customer pays Rs.80,000/- in cash & promises to pay the balance after two months

Assets	Liabilities + Owner's Equity
Cash	Contributed Capital
+80,000	+1,20,000

Journal Entry

Cash A/c	Dr	80,000/	
A/cs Receivable	Dr.	40,000/	
	To Sales		120,000/

- 5 Expenses for wages, interest routine maintenance in Rs.90,000/-

Assets	Liabilities + Owner's Equity
– Cash	– Retained Earning
– 90,000	– 90,000

Journal Entry

Expenses	Dr	90,000/-	
	To Cash A/c		90,000/-

- 6 The company pays a dividend of Rs.10,000/-

Assets	Liabilities + Owner's Equity
– Cash	– Retained Earning
– 10,000	– 10,000

Journal Entry

Dividends Paid	Dr	10,000/-	
	To Cash A/c		10,000/-

All the above transactions can be summed up as follows, as per the accounting equation
 Cash+A/cs Receivable+ Equipment = Loans +Contr. Capital +Retained Earnings

1)	+100,000		=		+100,000
2)	+30,000		=	+30,000	
3)	- 50,000	+50,000	=		
4)	+80,000	+40,000	=		+120,000
5)	-90,000		=		-90,000
6)	-10,000		=		-10,000
	+60,000	+40,000	+50,000	=	+30,000 +100,000 +20,000



Study Note - 5 : Cash & Fund Flow Statements

Balance Sheet as on 31st March 2020

Liabilities	Rs.	Assets	Rs.
Bank Loan	30,000	Cash	60,000
Capital	100,000	Receivables	40,000
Retained Earnings	20,000	Equipment	50,000
Total	150,000	Total	150,000

Income Statement for the year ended 31st March 2020

	Rs.
Revenues	120,000
Less: Expenses	90,000
Net Profit	30,000
Less: Dividends Paid	10,000
Retained Earnings	20,000 (which is shown in the Balance Sheet)

Statement of Cash Flows for the year ended 31/3/20

Operating activities:			
Cash from Sales	(4)	80,000	
Payments for expenses	(5)	(90,000)	
Net cash from operating activities – A			(10,000)
Investing activities:			
Purchase of equipment	(3)	(50,000)	
Net cash from investing activities – B			(50,000)
Financing activities:			
Borrowings		(2)	30,000
Owner contributions	(1)	100,000	
Payment of dividends	(6)	(10,000)	
Net cash from financing activities – C			120,000
Increase in cash balance – A+B+C			60,000
Add: Cash balance at the beginning of the year			0
Cash balance at the end of the year			60,000

You will notice that while Net Profit is 30,000/, Cash balances have increased by 60,000/ (Retained earnings is 20,000/ after payment of 10,000/ dividend)



5.4 CASH & NON- CASH TRANSACTIONS

Non-cash Transactions:

Transactions which do not involve cash are non-cash & hence not reported in the cash flow statement. Nevertheless, separate disclosure must be made of significant investing & financing transactions e.g.

- i) Acquisition of another company funded by issue of shares
- ii) Purchase of fixed assets on credit
- iii) Conversion of debentures into equity

5.5 DEPRECIATION & THE TAX SHIELD

Depreciation is a non-cash expense. However, it provides a tax shield.

What is a Tax Shield ?

Profit before Tax (PBT) = Revenues – Depreciation – Expenses

Cash Flow = Total Cash In – Total Cash Out

Profit after Tax (PAT) = PBT – Tax

Consider a case of equipment purchased for Rs.100,000/ with a life of 10 years & depreciation charged on Straight Line Basis viz. $100000/10 = 10,000$ p.a.

Income Tax Rate is 30%

Profit Before Depreciation & Before Tax is	Rs.25,000/
Tax @ 30% will be	Rs.7,500/ (without depreciation)
Profit before Tax (but after Depreciation)	Rs. 15,000/ (25,000-10,000 Dep.)
Tax @ 30% will be	Rs. 4,500/ (with depreciation)

The firm has saved Rs. 3,000/ income tax by providing depreciation

Hence, the Tax Shield due to Depreciation is Rs. 3,000/ (7,500-4,500)

It is apparent that depreciation is a non-cash expense, but it is a pre-tax item of expense. Hence, it provides a tax shield which would vary with both, the quantum of depreciation & the rate of income tax

In the above example, if the tax rate was 40% the tax shield would have become 4,000/ (10000×0.4)

5.6 DIRECT METHOD

Under Direct method, cash receipt from operating revenues and cash payments for operating expenses are arranged and presented in the cashflow statement. The difference between cash receipts and cash payments is the net cashflow from operating activities. It is in effect a cash

Study Note - 5 : Cash & Fund Flow Statements

basis Profit and Loss account. In this case, each cash transaction is analyzed separately and the total cash receipts and payments for the period is determined. The summarized data for revenue and expenses can be obtained from the financial statements and additional information. We may convert accrual basis of revenue and expenses to equivalent cash receipts and payments. Make sure that a uniform procedure is adopted for converting accrual base items to cash base items. Under direct method, items like depreciation, amortization of intangible assets, preliminary expenses, debenture discount, etc. are ignored from cashflow statement since the direct method include only cash transactions and noncash items are omitted. Likewise, no adjustment made for loss or gain on the sale of fixed assets and investments.

Cashflow Statement (Direct Method)		Rs.
Cashflows from Operating Activities		xxx
Cash receipts from customers		(xxx)
Cash paid to suppliers and employees		xxx
Cash Generated from Operations		(xxx)
Income-tax paid		xxx
Cashflow before extraordinary items		xxx
Proceeds from earthquake settlement etc.		(xxx)
Net cashflow from operating activities	(a)	
Cashflows from Investing Activities		(xxx)
Purchase of fixed assets		xxx
Proceeds from sale of equipment		xxx
Interest received		xxx
Dividend received	(b)	(xxx)
Net cashflow from investing activities		
Cashflows from Financing Activities		xxx
Proceeds from issuance of share capital		xxx
Proceeds from long-term borrowings		(xxx)
Repayments of long-term borrowings		(xxx)
Interest paid		(xxx)
Dividend paid		xxx
Net cashflow from financing activities	(c)	xxx
Net Increase (Decrease) in cash and cash equivalents during the period	(a+b+c)	
Cash and cash equivalents at beginning of period		xxx
Cash and cash equivalents at end of period.		xxx



5.7 INDIRECT METHOD

In this method the net profit (loss) is used as the base and convert it to net cash provided or used in operating activities. The indirect method adjusts net profit for items that affected net profit but did not affect cash. Noncash and non-operating charges in the profit and loss account are added back to the net profit while noncash and non-operating credits are deducted to calculate operating profile before working capital changes. It is a partial conversation of accrual basis profile to cash basis profit. Necessary adjustments are made for increase or decrease in current assets and current liabilities to obtain net cash from operating activities.

Cashflow Statement (Indirect Method)		(Rs.)
Cashflow from Operating activities		
Net profit before tax and extraordinary items	xxx	
Adjustment for:		
- Deprecation		xxx
- Foreign exchange		xxx
- Investment		xxx
- Gain or loss on sale of fixed assets		(xxx)
- Interest/dividend		xxx
Operating Profit Before Working Capital Changes	xxx	
Adjustment for:		
- Trade and other receivables		(xxx)
- Inventories		xxx
- Trade payables		xxx
Cash Generated from Operations		(xxx)
- Interest paid		(xxx)
- Direct taxes		xxx
Cash before Extraordinary Items		xxx
Deferred revenue		xxx
Net cashflow from operating activities	(a)	xxx
Cashflow from Investing activities		
Purchase of fixed assets		(xxx)
Sale of fixed assets		xxx
Sale of investments		xxx
Purchase of investments		(xxx)
Interest received		xxx

Study Note - 5 : Cash & Fund Flow Statements

Dividend received		xxx
Loans to subsidiaries		xxx
Net cashflow from investing activities	(b)	xxx
Cashflow from Financing activities		
Proceeds from issue of share capital		xxx
Proceeds from long term borrowings		xxx
Repayment to finance/lease liabilities		(xxx)
Dividend paid		(xxx)
Net cashflow from financing activities	(c)	xxx
Net increase (decrease) in cash and cash equivalents during the period	(a+b+c)	xxx
Cash and cash equivalents at the beginning of the year		xxx
Cash and cash equivalents at the end of the year		xxx

5.8 FUNDS FLOW DEFINITION

“Fund” means net working capital...viz. current assets-current liabilities. Funds Flow Statement shows all sources & uses of Funds in the relevant period. The net result of this statement is that it shows net increase or net decrease in the working capital employed. Another name for Funds Flow Statement is “Statement of Sources & Applications of Funds”

Funds Flow Statement measures the

Changes in Working Capital i.e. Changes in Current Assets &/ Or Changes in Current Liabilities.

While it is easy to understand cash flows as seen in Case Study 1, where we clearly marked all transactions which involved either a cash inflow or outflow, funds flow may take some more thought....

Please consider the following...

Is there a Change in Funds Flow in these transactions ? (answer Y/N, with reasons)

- 1 Purchased Furniture for Cash
- 2 Purchased Furniture on Credit
- 3 Purchased Machinery by issue of Shares
- 4 Bad Debts written off
- 5 Purchased short-term investments for Cash

1 Purchased Furniture for Cash

Yes, Cash changes (current asset, hence working capital changes)



2 Purchased Furniture on Credit

Yes, creditors change (current liabilities, hence working capital changes)

3 Purchased Machinery by issue of Shares

No, fixed assets & capital change (neither of which affects working capital)

4 Bad Debts written off

Yes, debtors change (current assets, hence working capital changes)

5 Purchased short-term investments for Cash

No, both changes are in current assets, equal amounts, opposite signs, hence net figure of current assets remains the same, thus working capital is unaffected

Sources of Funds are

i) Funds from Trading Operations

Start with the Net Profit (after depreciation & income tax but before appropriations)

ADD

Depreciation

Goodwill, Preliminary expenses, Cost of Issue of Debentures, written off during the year

Loss on sale of Fixed Assets

Loss on sale of Investments

SUBTRACT

Profit on sale of Fixed Assets

Profit on sale of Investments

Profit on Revaluation of Fixed Assets

Non-operating incomes

ii) Funds from Issue of Shares

Shares issued for cash or any other current asset will alter working capital & will be considered a source of funds. Proceeds from shares issued in consideration of fixed assets is not a source of funds. However, such a transaction should be disclosed in order to give a true & fair picture of the transactions

The actual amount received will be treated as a source of funds for the period under consideration.

Issue of Debentures & raising long-term loans from Financial Institutions (FIs) Please apply the same principles as in ii) above

Sale Proceeds of Long-term investments & fixed assets



Study Note - 5 : Cash & Fund Flow Statements

The actual proceeds should be shown as a source of funds if the sale increases a current asset. However, if the sale is an exchange of two long-term investments or fixed assets, the amount will not figure in sources of funds. A separate disclosure is required to explain the transaction.

Please remember to remove the element of profit/loss from the P&L A/c in this calculation, since entire amount is included in sale proceeds

Non-operating Incomes are also a source of funds

Applications of Funds are

1. Purchase of Fixed Assets
2. If the amount is paid for in cash, by other current asset or by reduction in a current liability
3. Purchase of Long-term investments
4. Redemption of Preference Shares & Debentures

Do note, if preference shares or debentures are redeemed by issue of fresh equity, preference shares or debentures, then it is not an application of funds. As always, in such a case, a clear disclosure is mandatory

5. Repayment of Long-term loans
6. Payment of Dividend
7. Payment of Income Tax

If Income tax is treated as a current liability, payment of Income Tax will not be shown as an application of funds. However, if Income Tax is treated as an appropriation (below the line), the Provision for Income Tax will be added to Funds from Trading Operations & the actual Tax paid will be shown as an application of funds.

5.9 DIFFERENCE BETWEEN FUNDS FLOW & CASH FLOW

FUND FLOW	CASH FLOW
*It is based on accrual accounting system.	All transactions effecting the cash and cash equivalent are considered.
*Changes in Working Capital	Changes in Cash & Cash equivalent
*No opening & closing balances	Contains both, opening & closing cash
*Records sources & applications of funds	Records inflows & outflows of cash
*Net result is increase or decrease in Working Capital	Net result is increase/ decrease in cash
*Is accompanied by Statement showing	No such statement needed



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*Changes in Working Capital	
* It shows the funds generated and applied as regards long-term assets long-term liabilities and capital.	In shows the cashflow flow operating financing and investment activities.

5.10 FUNDS FLOW STATEMENT CASE STUDY

Balance Sheet of Aam Company as on 31/03/2020

As at 31/03/2019	Liabilities	As at 31/03/2020	As at 31/03/2019	Assets	As at 31/03/2020
300,000	Share Capital	450,000	200,000	Machinery	221,000
30,000	Securities Premium	50,000	272,000	Stock	350,000
100,000	General Reserve	130,000	80,000	Debtors	79,000
50,000	P & L	30,000	20,000	Cash	115,000
107,000	Creditors	110,000	105,000	Bank	147,000
60,000	Provisions for Tax	97,000			
30,000	Proposed Dividend	45,000			
677,000		912,000	677,000		912,000

Depreciation on machinery is @15% p.a. A machine with a book value of 40,000/- was sold for 55,000/- on 01/04/2019 & a new machine was purchased for 100,000/-

On 1/4/2019, fresh equity was issued at a premium

We shall prepare Statement of changes in working capital

Funds Flow Statement

Working Notes

P&L A/c

Particulars	Amount	Particulars	Amount
To Gen. Reserve	30000	By Bal. b/f	221,000
To Prop. Dividend	45000	By Net Profit	350,000
To Bal. c/f	30000	(bal. fig)	350,000
Total	105000	Total	115,000



Study Note - 5 : Cash & Fund Flow Statements

Machinery A/c

Particulars	Amount	Particulars	Amount
To Bal. b/f	200000	By Bank (sale value)	55000
To P & L A/c (Profit on Sale)	15000	By Dep. 15% on 260000	39,000
To Bank (purchased)	100000	By Bal. c/f	221000
Total	315000	Total	315000

3 Funds from Operations

Net Profit for the year	55,000
Less: Profit on sale of machine	(15,000)
Operating Profit	40,000
Add: Depreciation on machinery	39,000
Funds from Operating activities	79,000
Equity issued during the year	150,000 (450,000-300,000)
Premium	20,000 (50,000-30,000)
Total funds on issue of fresh equity	170,000

Now we can prepare the required statements

Statement of Changes in Working Capital

Particulars	On 31/3/11	On 31/3/12	Increase	Decrease
			in Working Capital	
Current Assets				
Stock	272,000	350,000	78,000	1,000
Debtors	80,000	79,000		
Cash	20,000	115,000	95,000	
Bank	105,000	147,000	42,000	
(A)	477,000	691,000	215,000	1,000
Current Liabilities :				
Creditors	107,000	110,000		3,000
Provision for Tax	60,000	97,000		37,000
(B)	167,000	207,000	0	40,000
Working Capital (A-B)	310,000	484,000		
Change in Working Capital (A+B)			215,000	41,000



Net increase in Working Capital is 174,000 . This figure remains the same whether we start from WC on 31/3/20 & deduct WC on 31/3/19, or consider total increase in working capital & deduct total decrease in working capital

*** Important Note**

When Net Current Assets increase, Working Capital will increase because

$$WC = CA - CL.$$

When Net Current Assets decrease, WC will decrease

When Net Current Liabilities increase, WC will decrease

When Net Current Liabilities decrease, WC will increase

Remember these equations & you will never go wrong !

Sources	Amount	Applications	Amount
Funds From Operations	79,000	Purchase of Machinery	100,000
Issue of Equity at a premium	170,000	Payment of Dividend (for previous year)	30,000
Sale of Machinery	55,000	Net Increase in WC	174,000
Total	304,000	Total	304,000

Please note, the net increase in Working Capital in this statement is exactly the same as calculated separately in the Statement of changes in working capital

5.11 ADVANTAGES & DISADVANTAGES

Advantages of Cash Flow Statement

1. It provides an insight into actual performance of the company. A company may have huge profit, but if most of its sales is on credit, the cash flow statement will reflect it
2. Operating Cash Flow will show whether the core operations of the organization are cash accretive or depleting.
3. If the Financing Cash Flow shows huge borrowings & therefore the overall cash position is fine, this statement will raise red flags for the management to take corrective action
4. Using historical data & estimates, cash budgets can be prepared. This helps the organization to decide on timing of loans, investments & issue of securities
5. Together with P&L & BS, cash flow statements ensure that all stakeholders can independently evaluate the performance of the company
6. Changes in depreciation & other window dressing can be spotted using a cash flow statement



Study Note - 5 : Cash & Fund Flow Statements

Disadvantages of Cash Flow Statement

1. It ignores non cash transactions, which may be significant
2. It does not take into consideration the fundamental accounting concept of accrual

5.12 SUMMARY

Cash Flow & Fund Flow Statements are important tools for management control. Cash Flow statement is mandatory & together with P&L & BS, is a part of final accounts of companies. There are two methods of calculating Cash Flow From Operations viz. Direct & Indirect. The end results are the same. Cash flow statement measures changes in cash & cash equivalents over the period under consideration. Funds flow statement measures changes in working capital. Working Capital is Current Assets - Current Liabilities. Funds flow statement shows the sources & uses of funds.



STUDY NOTE – 6

RATIO ANALYSIS

This Study Note includes:

- Ratio Analysis

6.1 RATIO ANALYSIS

Ratio analysis is the process of determining and interpreting numerical relationships based on financial statements. A ratio is a statistical yard stick that provides a measure of the relationship between variables or figures. This relationship can be expressed as percent (cost of goods sold as a percent of sales) or as a quotient (current assets as a certain number of times the current liabilities).

As ratios are simple to calculate and easy to understand there is a tendency to employ them profusely. While such statistical calculations stimulate thinking and develop understanding there is a danger of accumulation of a mass of data that obscures rather than clarifies relationships. The financial analyst has to steer a careful course. His experience and objectives of analysis help him in determining which of the ratios are more meaningful in a given situation.

The Parties Interested: The persons interested in the analysis of financial statements can be grouped under three heads:

(i) Owners or investors; (ii) Creditors; and (iii) Financial executives. Although all these three groups are interested in the financial conditions and operating results of an enterprise the primary information that each seeks to obtain from these statements is to serve. Investors desire a primary basis for estimating earning capacity. Creditors (trade and financial) are concerned primarily with liquidity and ability to pay interest and redeem loan within a specific period. Management is interested in evolving analytical tools that will measure costs, efficiency, liquidity and profitability with a view to making intelligent decisions.

Significance

- (i) Commercial bankers and trade creditors and the institutional lenders are mostly concerned with the ability of a borrowing enterprise to meet its financial obligations timely. As a result they are most interested in ratios like the current ratio, acid test ratio, turnover of receivables, inventory turnover, coverage of interest by level of earnings, etc.
- (ii) Long-term creditors would be interested in the working capital position of the borrower as an indication of ability to pay interest and principle in case earnings decline. So, they are



interested in the ratios of total debt to equity, net worth to total assets, long-term debt to equity, long term debt to net working capital, fixed assets to networth, fixed assets to long term debt, fixed debt to capitalization etc. The number of times fixed charges are covered by earnings before interest and taxes will be of particular interest for such long-term creditors.

- (iii) Investors in shares are primarily interested in per share ratio like earnings per share, book value per share, market price per share, dividends per share, etc. They would also be interested in knowing the capitalization rate ($E/P \text{ Ratio} = \text{Earnings per share} / \text{Price per share}$ ratio) which is the reciprocal of $P/E \text{ Ratio}$ ($\text{Price} / \text{Earnings ratio}$) and also the dividend yield, i.e.; $D/P \text{ Ratio}$.

Advantages of Ratio Analysis

Ratio Analysis is (useful) relevant in assessing the performance of a firm in respect of the following purposes:

- (i) **To measure the liquidity position:** The purpose of ratio analysis to measure the liquidity position of a firm. Whether the firm is able to meet its current obligations when they become due or not? A firm can be said to be liquid, if it has sufficient liquid funds to pay the interest charges on short-term debt within a year. The liquidity ratio are useful in credit analysis by banks and other financial institutions.
- (ii) **To know the solvency position:** Ratio analysis is helpful for assessing the long-term financial liability of the firm. The long term solvency is measured through the leverage, and profitability ratios. These ratios reveal the strengths and weaknesses of a firm in respect of the solvency position. The leverage ratios indicates the proportion of various sources of finance in the firms capital structure, particularly the ratio of debt and equity share capital.
- (iii) **Operating efficiency or turnover of the firm:** The ratios are helpful in measuring the operating efficiency or the turnover of the firm. These ratios indicate the efficiency in utilizing the assets of the firm such as fixed assets turnover ratio, total resources turnover ratio etc.
- (iv) **To assess the profitability position of the firm:** The ratios are useful to assess and measure the profitability of the firm in respect of sales and the investments. These ratios are concerned about the over -all profitability of the firm.
- (v) **Inter-firm and intra - firm comparison:** Ratios are not only reflects the financial position of a firm, but also serves as a tool for remedial actions. This is made possible only due to inter-firm comparison. This would demonstrate the relative position of the firm vis-d-vis its competitors. If there is any variance in the ratios either with the industry average or with, those of competitors, the firm has to identify the reasons and would take remedial measures.



Study Note - 6 : Ratio Analysis

- (vi) **Trend Analysis:** The trend analysis of ratios indicates whether the financial position of a firm is improving or deteriorating over the years. The significance of a trend analysis of ratio lies in the fact that the analysis can know the direction of movement whether the movement is favourable or unfavourable.

Thus, ratio analysis is considered better than a mere comparison of figures in carrying out an overall appraisal of a company's business.

Standards for Comparison

For making a proper use of ratios, it is essential to have fixed standards for comparison. A ratio by itself has very little meaning unless it is compared to some appropriate standard. Selection of proper standards of comparison is most important element in ratio analysis. The four most common standards used in ratio analysis in Financial Management are: absolute, historical, horizontal and budgeted.

Absolute: Absolute standards are those which become generally recognized as being desirable regardless of the type of company, the time, stage of business cycle and the objectives of the analyst.

Historical: Historical (also known as internal) standards involves comparing a company's own past performance as a standard for the present or future. But this standard may not provide a sound basis for judgment as the historical figure may not have represented an acceptable standard. It is also called as intra firm comparison.

Horizontal: In case of horizontal (external) standards, one company is compared with another or with the average of other companies of the same nature. It is also called as inter-firm comparison.

Budgeted: The budgeted standard is arrived at after preparing the budget for a period. Ratio developed from actual performance are compared to the planned ratios in the budget in order to examine the degree of accomplishment of the anticipated targets of the firm.

Limitations of Ratio Analysis

- (i) It is always a challenging job to find an adequate standard. The conclusions drawn from the ratios can be no better than the standards against which they are compared.
- (ii) It is difficult to evaluate the differences in the factors that affect the company's performance in a particular year as compared with that of another year and that of another company. The task becomes more difficult when comparison is made of one company with another when they are of substantially different size, age and diversified products.
- (iii) While making comparisons of ratios, due allowance should be made for changes in price level. A change in price level can seriously affect the validity of comparisons of ratios computed for different time periods and particularly in case of ratios whose numerator and denominator are expressed in different units of currency.



- (iv) Comparisons are also become difficult due to differences in definition. The terms like gross profit, operating profit, net profit etc. have not got precise definitions and there is considerable diversity in practice as to how they should be measured.
- (v) A Balance Sheet may fail to reflect the average or typical situation, as it is prepared as of one moment of time. It ignores short-term fluctuations in assets and equities that may occur within the period covered by the two Balance Sheet dates.
- (vi) Various differences are found among the accounting methods used by different companies which variously affect the comparability of financial statements. Methods of recording and valuing assets, write-offs, costs, expenses etc differ from company to company.
- (vii) As ratios are simple to calculate and easy to understand, there is a tendency to over-employ them. While such statistical approach stimulates thinking, it is also likely to lead to the accumulation of a mass of data; if due care is not taken, that might obscure rather than clarify relationships.

Sources of Financial Data for Analysis

The sources of information for financial statement analysis are:

- (a) Annual Reports
- (b) Interim financial statements
- (c) Notes to Accounts
- (d) Statement of cash flows
- (e) Business periodicals
- (f) Credit and investment advisory services

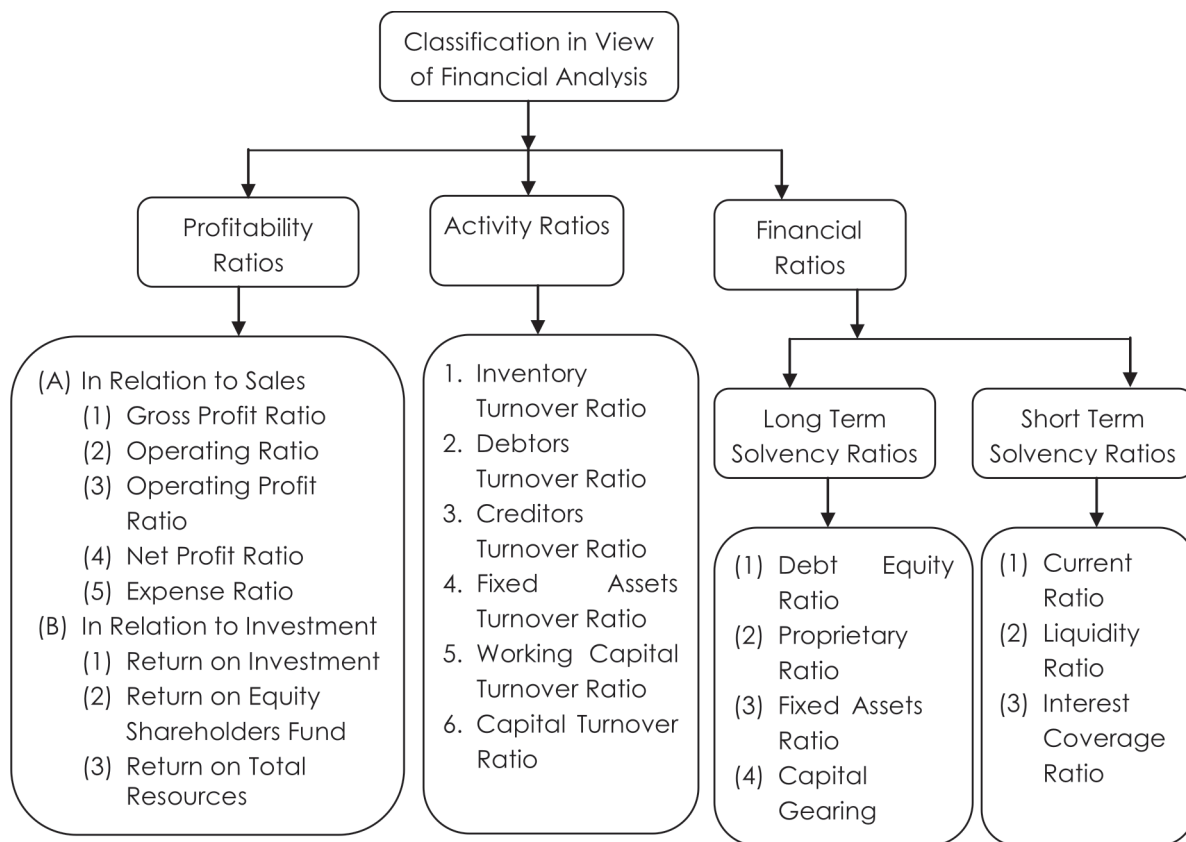
Window Dressing

The term window dressing means manipulation of accounts in a way so as to conceal vital facts and present the financial statements in a way to show a better position than what it actually is. On account of such a situation, presence of a particular ratio may not be a definite indicator of good or bad management. For example, a high stock turnover ratio is generally considered to be an indication of operational efficiency of the business. But this might have been achieved by unwarranted price reductions or failure to maintain proper stock of goods.

Similarly, the current ratio may be improved just before the Balance Sheet date by postponing replenishment of inventory. For example, if a company has got current assets of ₹ 4,000 and current liabilities of ₹ 2,000 the current ratio is 2, which is quite satisfactory. In case the company purchases goods of ₹ 2,000 on credit, the current assets would go up to ₹ 6,000 and current liabilities to ₹ 4,000. Thus reducing the current ratio to 1.5. The company may, therefore. Postpone the purchases for the early next year so that its current ratio continues to remain at 2 on the

Study Note - 6 : Ratio Analysis

Balance Sheet date. Similarly, in order to improve the current ratio, the company may pay off certain pressing current liabilities before the Balance Sheet date. For example, if in the above case the company pays current liabilities of ₹1,000, the current liabilities would stand reduced to ₹1,000, current assets would stand reduced to ₹3,000 but the current ratio would go up to 3.



PROFITABILITY RATIOS

These ratios give an indication of the efficiency with which the operations of business are carried on. The following are the important profitability ratios:

(i) Overall Profitability Ratio

This is also called as Return on Investment (ROI) or Return on Capital Employed (ROCE) ratio. It indicates the percentage of return on the total capital employed in the business. It is calculated as follows:

$$\text{ROI} = \text{Operating Profit} / \text{Capital Employed}$$

The term 'Operating Profit' means "profit before interest and tax while the term 'capital employed' refer to the sum-total of long-term funds employed in the business.



Significance: ROI measures the profit which a firm earns by investing a unit of capital. It is desirable to ascertain this periodically. The profit being the net result of all operations, ROI, expresses all efficiencies or inefficiencies of a business collectively. Thus, it is a dependable measure for judging the overall efficiency or inefficiency of the business.

(ii) Price Earning Ratio (P/E Ratio)

This ratio indicates the number of times the earning per share is covered by its market price. It is calculated as follows:

$$\text{P/E Ratio} = \frac{\text{Market Price Per Equity Share}}{\text{Earning Per Share}}$$

For example, if the market price of an equity share is ₹ 20 and earnings per share is ₹ 5, the price earnings ratio will be 4 (i.e., $20 \div 5$). This means for every one rupee of earning people are prepared to pay ₹ 4. In other words, the rate of return expected by the investors is 25%

Significance: P/E Ratio helps the investors in deciding whether to buy or not to buy the shares of a company at a particular price. For Instance, in the example given, if the EPS falls to ₹ 3, the market price of the share should be ₹ 12 (i.e. 3×4). In case the market price of the share is ₹ 15, it will not be advisable to purchase the company's shares at that price.

(iii) Gross Prom Ratio (GPR)

This ratio expresses the relationship between Gross Profit and Net Sales. It can be computed as follows:

$$\text{GPR} = \frac{\text{Gross Profit}}{\text{Net Sales (i.e.. Sales less returns)}} \times 100$$

Significance: The ratio indicates the overall limit within which a business must manage its operating expenses. It also helps in ascertaining whether the average percentage of mark-up on the goods is maintained.

(iv) Net Profit Ratio (NPR)

The ratio indicates net margin earned on a sale of ₹ 100. It is calculated as follows:

$$\text{NPR} = \frac{\text{Net Profit}}{\text{Net Sales}} \times 100$$

Significance: The ratio helps in determining the efficiency with which the affairs of a business are being managed. Constant increase in the above ratio year after year is a definite indication of improving conditions of the business.

Study Note - 6 : Ratio Analysis

(v) Operating Ratio

This ratio is a complementary of net profit ratio. In case the net profit ratio is 20%, the operating ratio will be 80%. It is calculated as follows:

$$\text{Operating Ratio} = \frac{\text{Operating Cost}}{\text{Net Sales}} \times 100$$

Operating cost includes cost of direct materials, direct labour, direct expenses and all overheads. Financial charges such as interest, provision for taxation, etc. are not to be included in operating cost.

Significance: The ratio is the test of the operational efficiency with which the business has carried on. The operating ratio should be low enough to leave a portion of sales for giving a fair return to the investor.

(vi) Fixed Charges Cover Ratio (FCCR)

The ratio indicates the number of times the fixed financial charges are covered by income before interest and tax. This ratio is calculated as follows:

$$\text{FCCR} = \frac{\text{Income before Interest and Tax}}{\text{Interest}}$$

Significance: The ratio is significant from the lender's point of view. It indicates whether the business would earn sufficient profits to pay periodically the interest charges. Higher the ratio, better it is.

(vii) Pay-out Ratio

The ratio indicates what proportion of earning per share has been used for paying dividend. It can be calculated as follows:

$$\text{Pay-Out Ratio} = \frac{\text{Dividend per equity share}}{\text{Earning per equity share}}$$

Significance: The ratio is an indicator of the amount of earnings that have ploughed back in the business. The lower the pay-out ratio, the higher will be the amount of earnings ploughed back in the business. A lower pay-out ratio means a stronger financial position of the company.

(viii) Dividend Yield Ratio (DYR)

The ratio is calculated by comparing the rate of dividend per share with its market value. It is calculated as follows:

$$\text{DYR} = \frac{\text{Dividend Per Share}}{\text{Market Price Per Share}} \times 100$$



Significance: The ratio helps an intending investor in knowing the effective return he is going to get on his investment. For example, if the market price of a share is ₹ 25, paid-up value is ₹ 10 and dividend rate is 20%. The dividend yield ratio is 8% (i.e. $10 \times 2/25$). The intending investor can now decide whether it will be advisable for him to go for purchasing the shares of the company or not at the price prevailing in the market.

(ix) Return on Shareholders funds or Return on Net Worth

This ratio expresses the net profit in terms of the equity shareholders funds. This ratio calculated as follows:

$$\text{Net Worth} = \frac{\text{Net Profit after Interest \& Tax}}{\text{Net Worth}} \times 100 \quad [\text{Net Worth} = \text{Equity Capital} + \text{Reserves \& Surplus}]$$

Significance: This ratio is an important yardstick of performance for equity shareholders since it indicates the return on the funds employed by them.

ACTIVITY RATIOS

These ratios indicate the efficiency with which capital employed is rotated in the business. The various turnover ratios are as follows:

(i) Over-all Turnover Ratio

The ratio indicates the number of times the capital employed has been rotated in the process of doing a business. The ratio is computed as follows:

$$\text{Overall Turnover Ratio} = \frac{\text{Net Sales}}{\text{Capital Employed}}$$

Significance: The overall profitability of a business depends on two factors, viz., (a) the profit margin, and (b) turnover. The profit margin is disclosed by the net profit ratio while the turnover is indicated by the overall turnover ratio. A business with a lower profit margin can achieve a higher ROI if its turnover is high. This is the reason for wholesalers earning a larger return on their investment even when they have a lower profit margin. A business should not, therefore, increase its profit margin to an extent that it results in reduced turn-over resulting in reduction of overall profit.

(ii) Fixed Assets Turnover Ratio

The ratio indicates the extent to which the investment in fixed assets has contributed towards sales. The ratio can be calculated as follows:

$$\text{Fixed Assets Turnover Ratio} = \frac{\text{Net Sales}}{\text{Net Fixed Assets}}$$



Study Note - 6 : Ratio Analysis

Significance: The comparison of fixed assets turnover ratio over a period of time indicates whether the investment in fixed assets has been judicious or not. Of course, investment in fixed assets does not push up sales immediately but the trend of increasing sales should be visible. If such trend is not visible or increase in sales has not been achieved after the expiry of a reasonable time it can be very well said that increased investments in fixed assets has not been judicious.

(iii) Debtors' Turnover Ratio

The ratio indicates the speed with which money is collected from the debtor. It is computed as follows:

$$\text{Debtors Turnover Ratio} = \frac{\text{Credit Sales}}{\text{Average Accounts Receivable}}$$

The term average account receivable includes trade debtors and bills receivable. Average accounts receivable are computed by taking the average receivables in the beginning and at the end of the accounting year. The higher the ratio, better it is.

Debtors turnover ratio is used for computing the debt collection period. The formula for its computation is as follows:

$$\text{Debt Collection Period} = \frac{\text{Months or days in a year}}{\text{Debtors turnover ratio}} \times \frac{\text{Average Debtors}}{\text{Credit Sales}} \times 365$$

For example, if the credit sales are ₹ 80,000, average accounts receivable ₹ 20,000, the debtors' turnover ratio and debt collection period will be computed as follows:

$$\text{Debtors Turnover Ratio} = \frac{80,000}{20,000} = 4$$

$$\text{Debt Collection Period} = \frac{12 \text{ months}}{4} = 3 \text{ months}$$

This means on an average three months credit is allowed to the debtor. An increase in the credit period would result in unnecessary blockage of funds and with increased possibility of losing money due to debts becoming bad.

Significance: Debtors Turnover Ratio or Debt Collection Period Ratio measures the quality of debtors since it indicates the speed with which money is collected from the debtor. A shorter collection period implies prompt payment by debtors. A longer collection period implies too liberal and inefficient credit collection performance. The credit policy should neither be too liberal nor too restrictive. The former will result in more blockage of funds and bad debts while the latter will cause lower sales which will reduce profits.



(iv) Creditors Turnover Ratio

This is similar to Debtors Turnover Ratio. It indicates the speed with which payments for credit purchases are made to creditor it can be computed as follows:

$$\text{Creditors Turnover Period} = \frac{\text{Credit Purchases}}{\text{Average Accounts Payable}}$$

The term 'accounts payable' include trade creditors and bills payable.

From the creditors turnover, ratio, creditors payment period can be computed as follows:

$$\text{Credit Period Enjoyed} = \frac{\text{Months or days in a year}}{\text{Creditors Turnover}}$$

For example, if the credit purchases during a year are ₹1,00,000, Average accounts payable ₹25,000, the Creditors Turnover Ratio will be '4' (i.e., 1,00,000 / 25,000) while the creditors payment period would be 3 months (i.e., 12 months/4).

Significance: The creditors turnover ratio and the creditors payment period indicate about the promptness or otherwise in making payment for credit purchases. A higher creditors turnover ratio or a lower creditors payment period signifies that the creditors are being paid promptly thus enhancing the credit-worthiness of the company. However, a very favourable ratio to this effect also shows that the business is not taking full advantage of credit facilities which can be allowed by the creditors.

(v) Stock Turnover Ratio

The ratio indicates whether the investment in inventory is efficiently used and whether it is within proper limits. It is calculated as follows:

$$\text{Stock Turnover Ratio} = \frac{\text{Cost of Goods Sold during the year}}{\text{Average Inventory}}$$

Average inventory is calculated by taking the average of inventory at the beginning and at the end of the accounting year.

Significance: The ratio signifies the liquidity of inventory. A high inventory turnover ratio indicates brisk sales and vice-versa. The ratio is therefore a measure to discover possible trouble in the form of overstocking or over-valuation of inventory.

FINANCIAL RATIOS

They are also termed as 'Solvency Ratios'. These ratios indicate about the financial position of the company. A company is considered to be financially sound if it is in a position to carry on its business smoothly and meet all its obligations both short-term and long-term without strain. The Financial or Solvency Ratios can therefore be classified into following categories:



Study Note - 6 : Ratio Analysis

- (i) Long-term Solvency Ratios, which include fixed assets ratio, debt equity ratio and proprietary ratio;
- (ii) Short-term Solvency Ratios, which include current ratio, liquidity ratio, super-quick ratio and defensive interval ratio & debt service coverage ratio.

Each of these ratios are now being discussed in detail in the following pages: Long-term Solvency Ratios (i) Fixed Assets Ratio:

The ratio indicates the extent to which fixed assets have been acquired by use of long-term funds. The ratio is expressed as follows:

$$\text{Fixed Assets Ratio} = \frac{\text{Net Fixed Assets}}{\text{Long-term Funds}}$$

The term 'Net Fixed Assets' means original cost of fixed assets less depreciation to date. The ratio should not be more than '1'. The ideal ratio is 0.67.

Significance: It is sound principle that fixed assets should be financed out of long-term funds. As a matter of fact a part of working capital termed as core-working capital, should also be financed by long-term funds. The ratio is therefore an indication of the fact whether the company has followed sound financial policy or not. In case the ratio is more than '1', it shows that a part of working capital has also been used to acquire fixed assets, which may prove quite troublesome for the company.

(ii) Debt-Equity Ratio

The ratio is determined to ascertain the proportion between the 'outsiders' 'funds and shareholders funds' in the capital structure of an enterprise. The term outsiders', funds is generally used to represent total long-term debt. The ratio can be computed as follows:

$$\text{Debit - Equity Ratio} = \frac{\text{Total Long-term Debt}}{\text{Shareholders Funds}}$$

The ratio may also be calculated for ascertaining proportion of long-term debt in the total long-term funds. In such a case the ratio will be computed as follows:

$$= \frac{\text{Total Long-term Debt}}{\text{Total Long - term Funds}}$$

The ratio is considered to be ideal if the shareholders' funds are equal to total long-term debt. However, these days the ratio is also acceptable if the total long-term debt does not exceed twice of shareholders' funds.



Significance: The ratio is an indication of the soundness of the long-term financial policies pursued by the business enterprise. The excessive dependence on outsiders' funds may cause insolvency of the business. The ratio provides the margin of safety to the creditors. It tells the owners the extent to which they can gain by maintaining control with a limited investment.

(iii) Proprietary Ratio

It is a variant of Debt-Equity Ratio. It establishes relationship between the proprietors' or shareholders' funds and the total tangible assets. It may be expressed as follows:

$$\text{Proprietary Ratio} = \frac{\text{Shareholder's Funds}}{\text{Total Tangible Assets}}$$

Significance: The ratio focuses attention on the general financial strength of the business enterprise. The ratio is of particular importance to the creditors who can find out the proportion of shareholders funds in the total assets employed in the business. A high proprietary ratio will indicate a relatively little danger to the creditors or vice-versa in the event of forced reorganization or winding up of the company.

Short-term Solvency Ratios

(i) Current Ratio

The ratio is an indicator of the firm's commitment to meet its short-term liabilities. It is expressed as follows:

$$\text{Current Ratio} = \frac{\text{Current Assets}}{\text{Current Liabilities}}$$

An ideal current ratio is '2'. However, a ratio of 1.5 is also acceptable if the firm has adequate arrangements with its bankers to meet its short-term requirements of funds.

Significance: The ratio is an index of the concern's financial stability, since, it shows the extent to which the current assets exceed its current liabilities. A higher current ratio would indicate inadequate employment of funds, while a poor current ratio is a danger signal to the management.

(ii) Liquidity Ratio / Quick Ratio / Acid Test Ratio

The ratio is also termed as Acid Test Ratio or Quick Ratio. The ratio is ascertained by comparing the liquid assets i.e., current assets (excluding stock and prepaid expenses) to current liabilities. The ratio may be expressed as follows:

$$\text{Liquidity Ratio} = \frac{\text{Liquid Assets}}{\text{Current Liabilities}}$$

Liquid Assets = Current Assets - Inventory - Prepaid Expenses



Study Note - 6 : Ratio Analysis

Some accountants prefer the term liquid liabilities for current liabilities. The term 'liquid liabilities' means liabilities payable within a short period. Bank overdraft and cash credit facilities (if they become permanent modes of financing) are excluded from current liabilities for this purpose. The ratio may be expressed as follows:

$$\text{Liquidity Ratio} = \frac{\text{Liquid Assets}}{\text{Liquid Liabilities}}$$

Liquid Liability = Current Liability - Bank Overdraft - Cash Credit

The ideal ratio is '1'.

Significance: The ratio is an indicator of short-term solvency of the company. A comparison of the current ratio to quick ratio should also indicate the inventory hold-ups. For instance, if two units have the same current ratio but different liquidity ratios, it indicates over-stocking by the concern having low liquidity ratio as compared to the firm which has a higher liquidity ratio.

(iii) Super-quick Ratio

It is a slight variation of quick ratio. It is calculated by comparing the super quick assets with the current liabilities (or liquid liabilities) of a firm. The ratio may be expressed as follows:

$$\text{Super-quick Ratio} = \frac{\text{Super Quick Assets}}{\text{Current Liabilities}}$$

The term 'Super-Quick Assets' means current assets excluding stock, prepaid expenses and debtors. Thus, super-quick assets comprise mainly cash, bank balance and marketable securities.

Significance: This ratio is the most rigorous test of a firm's liquidity position. In case the ratio is 1, it means the firm can meet its current liabilities any time.

The ratio is a conservation test and not widely used in practice.

(iv) Defensive-Interval Ratio (DIR)

This ratio denotes the liquidity of a firm in relation to its ability to meet projected daily expenditure from operations. It can be expressed as follows:

$$\text{Defensive Interval Ratio} = \frac{\text{Liquid Assets (quick assets)}}{\text{Daily Cash requirements (Projected)}}$$

Daily cash requirements (projected) = Projected cash operating expenditure/Number of days in a year.

Significance: The DIR is thought by many people to be a better liquidity measure than the quick and current ratios. Because these ratios compare assets to liabilities rather than comparing assets to expenses, the DIR and current/quick ratios would give quite different results if the company has a lot of expenses, but no debt.



(v) Debt Service Coverage Ratio (DSCR)

This ratio indicates whether the business is earning sufficient profits to pay not only the interest charged, but also whether due of the principal amount. The ratio is calculated as follows:

$$\text{Debt Service Coverage Ratio} = \frac{\text{Profit after Taxes} + \text{Depreciation} + \text{Interest on Loan}}{\text{Interest on Loan} + \text{Loan repayment in a year}}$$

Significance: The ratio is the key indicator to the lender to assess the extent of ability of the borrower to service the loan in regard to timely payment of interest and repayment of loan instalment. A ratio of 2 is considered satisfactory by the financial institutions the greater debt service coverage ratio indicates the better debt servicing capacity of the organization.

RATIOS IN DIFFERENT INDUSTRIES

(1) Ratios used in hotel industry:

The variety of ratios used by hotel industry which are:

- 1) Room Occupancy Ratio
- 2) Bed Occupancy Ratio
- 3) Double Occupancy Ratio
- 4) Seat Occupancy Ratios etc.

(2) Ratios used in transport industry:

The following important ratios are used in transport industry:

- 1) Passenger Kilometers
- 2) Seat occupancy Ratios
- 3) Operating cost per kilometer

(3) Bank Industry:

The following important ratios are used in Bank Industry:

- 1) Operating expenses ratios for various periods
- 2) Loans to deposits ratios
- 3) Operating income ratios for various periods

(4) Telecom Industry:

The following important ratios are used in telecom Industry.

- 1) Average duration of the outgoing call
- 2) Number of outgoing calls per connection
- 3) Revenue per customer



Study Note - 6 : Ratio Analysis

Illustration 1

Following is the Profit and Loss Account and Balance Sheet of PKJ Ltd. Redraft them for the purpose of analysis and calculate the following ratios:

- 1) Gross Profit Ratio
- 2) Overall Profitability Ratio
- 3) Current Ratio
- 4) Debt-Equity Ratio
- 5) Stock-Turnover Ratio
- 6) Finished goods Turnover Ratio
- 7) Liquidity ratio

Dr.		Profit and Loss A/c		Cr.	
Particulars	Amount (Rs.)	Particulars	Amount (Rs.)		
Opening stock of finished goods	1 ,00,000	Sales	10,00,000		
Opening stock of raw material	50,000	Closing stock of raw material	1 ,50,000		
Purchase of raw material	3,00,000	Closing stock of finished goods	1 ,00,000		
Direct wages	2,00,000	Profit on sale of shares	50,000		
Manufacturing Exp	1 ,00,000				
Administration Exp	50,000				
Selling & distribution Exp	50,000				
Loss on sale of Plant	55,000				
Interest on debentures	10,000				
Net Profit	3,85,000				
	13,00,000				13,00,000

Balance Sheet

Liabilities	Amount (Rs.)	Assets	Amount (Rs.)
Equity share capital	1 ,00,000	Fixed assets	2,50,000
Preference share capital	1 ,00,000	Stock of raw material	1 ,50,000
Reserves	1 ,00,000	Stock of finished goods	1 ,00,000



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Debentures	2,00,000	Bank balance	50,000
Sundry Creditors	1,00,000	Debtors	1,00,000
Bills Payable	50,000		
	6,50,000		6,50,000

Solution:

PKJ Ltd. Income Statement

(Rs.)

Sales		1,00,000
(-) Cost of goods sold:		
Raw material consumed (50,000 + 3,00,000 - 1,50,000)	2,00,000	
Wages	2,00,000	
Manufacturing expenses	1,00,000	
Cost of production	5,00,000	
(+) Opening stock of finished goods	1,00,000	
(-) Closing stock of finished goods	(1,00,000)	(5,00,000)
Gross profit		5,00,000
(-) Operating expenses:		
Administrative expenses	50,000	
Selling and distribution	50,000	(1,00,000)
Operating profit		4,00,000
(+) Non operating income (Profit on Sale of Shares)		50,000
(-) Loss on sale of plant		(55,000)
EBIT		3,95,000
(-) Interest		(10,000)
EBT / Net Profit		3,85,000

Position Statement

(Rs.)

Bank	50,000
Debtors	1,00,000
Liquid Assets	1,50,000
(+) Stock (R.M.+F.G.)	2,50,000

Study Note - 6 : Ratio Analysis

Current Assets	4,00,000
(-) Current liabilities (S.C.B.P.)	(1,50,000)
Working capital	2,50,000
(+) Fixed assets	2,50,000
Capital employed in business	5,00,000
(-) External liabilities	(2,00,000)
Shareholders funds	3,00,000
(-) Preference share capital	(1,00,000)
Equity share capital	2,00,000

Represented by

Equity share capital	1,00,000
(+) Reserves	1,00,000
	2,00,000

$$(1) \text{ Gross Profit Ratio} = \frac{\text{Gross Profit}}{\text{Sales}} \times 100 = \frac{5,00,000}{10,00,000} \times 100 = 50\%$$

$$(2) \text{ Overall Profitability Ratio} = \frac{\text{Operating Profit}}{\text{Capital Employed}} \times 100 = \frac{4,00,000}{5,00,000} \times 100 = 80\%$$

$$(3) \text{ Current Ratio} = \frac{4,00,000}{1,50,000} = 2.67 \text{ times}$$

$$(4) \text{ Debt equity Ratio} = \frac{\text{Long term debt}}{\text{Long term fund}} \times 100 = \frac{2,00,000}{5,00,000} = 4$$

$$(5) \text{ Stock Turnover Ratio} = \frac{\text{Raw Material Consumed}}{\text{Average Stock of raw material}} = \frac{2,00,000}{1,00,000} = 2$$

$$[\text{Average stock of Raw Material} = \frac{50,000 + 1,50,000}{2} = 1,00,000]$$

$$(6) \text{ Finished Goods Turnover Ratio} = \frac{\text{COGS}}{\text{Average Stock of finished goods}} = \frac{5,00,000}{1,00,000} = 5$$

$$[\text{Average stock of Finished Goods} = \frac{1,00,000 + 1,00,000}{2} = 1,00,000]$$



$$(7) \text{ Liquidity Ratio} = \frac{\text{Liquid Assets}}{\text{Liquid Liabilities}} = \frac{1,50,000}{1,50,000} = 1$$

$$\begin{aligned} \text{Liquid Assets} &= \text{Current Assets} - \text{Inventories} - \text{Prepaid Expenses} \\ &= 4,00,000 - 1,50,000 - 1,00,000 \end{aligned}$$

$$\begin{aligned} \text{Liquid Liability} &= \text{Current Liability} - \text{Bank Overdraft} - \text{Cash Credit} \\ &= 1,50,000 - 0 \\ &= ₹ 1,50,000 \end{aligned}$$

Illustration 2

A company has a profit margin of 20% and asset turnover of 3 times. What is the company's return on investment? How will this return on investment vary if?

- (i) Profit margin is increased by 5%?
- (ii) Asset turnover is decreased to 2 times?
- (iii) Profit margin is decreased by 5% and asset turnover is increase to 4 times?

Solution:

Net profit ratio	= 20% (given)
Assets turnover ratio	= 3 times (given)
Return on Investment (ROI)	= Net Profit ratio x Assets turnover ratio
	= 20% x 3 times = 60%

(i) If net profit ratio is increased by 5%:

Then Revised Net Profit Ratio = 20 + 5 = 25%

Asset Turnover Ratio (as before) = 3 times

∴ ROI = 25 % x 3 times = 75%

(ii) If assets turnover ratio is decreased to 2 times:

NP Ratio (as before) = 20%

Revised Asset Turnover Ratio = 2 times

∴ ROI = 20% x 2 times = 40%

(iii) If net profit ratio falls by 5% and assets turnover ratio raises to 4 times:

Then Revised NP Ratio = 20 - 5 = 15%

Revised Asset Turnover Ratio = 4 times

∴ ROI = 15%x4 = 60%

Study Note - 6 : Ratio Analysis

Illustration 3

The following is the Balance Sheet of M/S Yamuna Enterprise for the year ended 31-12-2015:

Balance Sheet as on 31st December, 2015

Liabilities	Amount (Rs.)	Assets	Amount (Rs.)
Equity share capital	1,00,000	Cash in hand	2,000
12% Preference share capital	1,00,000	Cash in bank	10,000
16% Debentures	40,000	Bills Receivable	30,000
18% Public debts	20,000	Investment	20,000
Bank overdraft	40,000	Debtors	70,000
Creditors	60,000	Stock	40,000
Outstanding Creditors	7,000	Furniture	30,000
Proposed dividends	10,000	Machinery	1,00,000
Reserves	1,50,000	Land & Building	2,20,000
Provision for taxation	20,000	Goodwill	35,000
Profit & Loss Account	20,000	Preliminary expenses	10,000
	5,67,000		5,67,000

During the year provision for taxation was ₹ 20,000. Dividend was proposed at ₹ 10,000. Profit carried forward from the last year was ₹ 15,000. You are required to calculate:

- Short term solvency ratios, and
- Long term solvency ratios.

Solution:

Short term solvency ratios:

$$\text{Current Ratio} = \frac{\text{Current Assets}}{\text{Current Liabilities}} = \frac{1,52,000}{1,37,000} = 1.109 \text{ times}$$

$$\text{Current Assets} = 2,000 + 10,000 + 30,000 + 70,000 + 40,000 = 1,52,000$$

$$\text{Current Liabilities} = 40,000 + 60,000 + 7,000 + 10,000 + 20,000 = 1,37,000$$

The ideal ratio is 2 but in the instant case it is only 1.109. hence, it is not satisfactory.

$$\text{Liquid Ratio} = \frac{\text{Liquid Assets}}{\text{Liquid Liabilities}} = \frac{1,12,000}{97,000} = 1.155 \text{ times}$$

$$\text{Liquid Assets} = \text{Current Assets} - \text{Inventory}$$

$$= 1,52,000 - 40,000$$

$$= 1,12,000 \text{ Liquid Liability} = \text{Current Liability} - \text{Bank Overdraft} - \text{Cash Credit}$$

$$= 1,37,000 - 40,000$$

$$= 97,000.$$



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This indicates that the company's EBIT covers 4.5 times of its interest expenses, which is quite satisfactory.

Calculation of EBIT

	(Rs.)
Profit retained	5,000
(+) Proposed dividend	10,000
PAT	15,000
(+) Tax	20,000
PBT	35,000
(+) Interest [6400 + 3600]	10,000
EBIT	45,000

Interest = 16% of 40,000 + 18% of 20,000 = 6400 + 3600 = 10,000

Long term solvency ratios:

$$\text{Debt Equity Ratio} = \frac{\text{Long Term Debt}}{\text{Long Term Fund}} = \frac{60,000}{3,85,000} = 0.156 \text{ times}$$

Tools for Financial Analysis and Planning

Long term debt

	(Rs.)
Debentures	40,000
Public debt	20,000
	60,000

Long term fund

	(Rs.)
Equity Share Capital	1,00,000
Preference Share Capital	1,00,000
Debentures	40,000
Public Debts	20,000
Reserves	1,50,000
Profit and Loss Account	20,000
	4,30,000
Less: Goodwill	35,000
Preliminary Expenses	10,000
	3,85,000

Study Note - 6 : Ratio Analysis

Share holder funds

	(Rs.)
Equity capital	1,00,000
Preference capital	1,00,000
Reserves	1,50,000
P&L A/c	20,000
(-) Good will	35,000
(-) Preliminary exp	10,000
	3,25,000

Long term debt/ share holders funds = $60,000 / 3,25,000 = 0.18$ times Both are quite satisfactory. It seems the company has adopted a conservative policy for raising finance. Under such policy the equity share holders may not avail the benefit of trading on equity.

→ Fixed Assets Ratio = Fixed Assets / Long Term Funds = $3,50,000 / 3,85,000 = 0.91$ times

The ratio is satisfactory.

→ Proprietary Ratio Share holder Funds / Total Tangible Assets
= $[3,25,000 / (5,67,000 - 4,50,00)] = 0.6226$ times

Ratio is ideal. And long term position is quite satisfactory, it is advised to improve short term solvency.

Illustration 4

Following is the Balance Sheet of Sun Ltd., as on December 31, 2015.

Liabilities	Amount (Rs.)	Assets	Amount (Rs.)
Equity Share Capital	20,000	Goodwill	12,000
Capital Reserves	4,000	Fixed Assets	28,000
8% Loan on mortgage	16,000	Stocks	6,000
Trade creditors	8,000	Debtors	6,000
Bank over draft	2,000	Investments	2,000
Taxation:		Cash in hand	6,000
Current	2,000		
Future	2,000		
Profit & Loss A/c:			
PAT for the year			
Less: Transfer to: 1 2,000			
Reserves 4,000			
Dividend 2,000	6,000		
	60,000		60,000



Sales amounted to ₹1,20,000. Calculate ratio for (a) testing liquidity, and (b) testing solvency.

Solution:

Ratios for testing liquidity

1. Current Ratio = Current Assets/ Current Liabilities = 20,000/12,000 = 1.67 times
2. Liquidity Ratio = Liquid Assets/ Current Liabilities = 14,000/12,000 = 1.17 times

The liquid position of the company is satisfactory. Both the current ratio and liquidity ratio are satisfactory. Ratios for testing solvency

1. Debt- equity Ratio = Share holders Funds/ Total Long Term Funds = 18,000/36,000 = 0.5 times
2. Fixed Assets Ratio = Net profit before interest and tax/ Interest = 14,000/1,280 = 10.94 times

All solvency ratios are very much favorable to the company judged from the above, the company has satisfactory position both from liquidity and solvency viewpoints.

Working notes:

1. Current Assets

	(Rs.)
Stock	6,000
Debtors	6,000
Investments*	2,000
Cash in hand	6,000
	20,000

*presumed to be short- term.

2. Current Liabilities

	(Rs.)
Trade creditors	8,000
Bank overdraft	2,000
Taxation*	2,000
	12,000
	20,000

*excluding future taxation presumed to be payable after a year.

3. Liquid Assets

	(Rs.)
Current Assets	20,000
Less: Stock	6,000
	14,000

Study Note - 6 : Ratio Analysis

4. Liquid Liability

	(Rs.)
Current Liability	12,000
Less: Bank Overdraft	2,000
	10,000

5. Share holders' Funds

	(Rs.)	(Rs.)
Equity share capital	20000	
Capital reserves	4000	
P & L accounts balance	6000	30000
Less: Goodwill		12000
		18000

6. Long Terms Funds

	(Rs.)
Share holders' funds	18,000
Mortgage loan	16,000
Future taxation	2,000
	36,000

7. Interest Calculation:

$$8\% \text{ of } 16,000 = 1,280$$

Illustration 5

With the help of the following information complete the Balance Sheet of PKJ Ltd.

	(Rs.)
Equity share capital	1,00,000
The relevant ratios of the company are as follows:	
Current debt to total debt	40
Total debt to owner's equity	60
Fixed assets to owner's equity	60
Total assets turnover	2 Times
Inventory turnover	8 Times



Solution:

**In the Books of PKJ Ltd.
Balance Sheet**

Liabilities	Amount (Rs.)	Assets	Amount (Rs.)
Owners equity	1,00,000	Fixed Assets	60,000
Current debt	24,000	Cash	60,000
Long term debt	36,000	Inventory	40,000
	1,60,000		1,60,000

Working Notes:

- Fixed assets = $0.60 \times \text{Owners equity} = 0.60 \times ₹ 1,00,000 = ₹ 60,000$.
- Total debt = $0.60 \times \text{Owners equity} = 0.60 \times ₹ 1,00,000 = ₹ 60,000$.
- Total assets consisting of fixed assets and current assets must be equal to ₹ 1,60,000 (Assets = Liabilities + Owners equity). Since fixed assets are ₹ 60,000 hence, current assets should be ₹ 1,00,000.
- Total equity = Total debt + Owners equity = ₹ 60,000 + ₹ 1,00,000 = ₹ 1,60,000.
- Total assets turnover = 2 Times; Inventory turnover = 8 Times. Therefore, Inventory/Total assets = $2/8 = 1/4$; Total assets = ₹ 1,60,000. Therefore, Inventory = $1,60,000 / 4 = 40,000$.
- Cash = ₹ 1,00,000 - ₹ 40,000 = ₹ 60,000.

Illustration 6

Using the following data, prepare the Balance Sheet:

	(Rs.)
Gross profits	54,000
Shareholders Funds	6,00,000
Gross Profit Margin	20%
Credit Sales to Total Sales	80%
Total Assets turnover	0.3 times
Inventory turnover	4 times
Average collection period (a 360 days year)	20 days
Current ratio	1.8
Long-term Debt to Equity	40%

Study Note - 6 : Ratio Analysis

Solution:

Balance Sheet

Liabilities	Amount (Rs.)	Assets	Amount (Rs.)
Creditors (bal. Fig.)	60,000	Cash	42,000
Long Term Debts	2,40,000	Debtors	12,000
Share Holders Fund	6,00,000	Inventory	54,000
		Fixed Assets (bal. fig).	7,92,000
	9,00,000		9,00,000

Working Notes:

- Gross Profit:
 GP Margin = 20%
 GP = ₹ 54,000
 Sales = $54,000 / 20\% = ₹ 2,70,000$
- Credit Sales:
 Credit Sales = 80% of Total Sales
 $= 2,70,000 \times 80\% = ₹ 2,16,000$
- Total Assets:
 Total Assets Turnover = Sales / Total Assets = 0.3 Times
 Total Assets = $2,70,000 / 0.3 = ₹ 9,00,000$
- Inventory Turnover:
 Inventory Turnover = Cost of Goods Sold / Inventory $\times 100$
 $= 2,70,000 - 54,000 / \text{Inventory}$
 Inventory = $2,16,000 / 4 = ₹ 54,000$
- Debtors:
 Debtors = Credit Sales $\times 20 / 360 \text{ days} = ₹ 12,000$
- Creditors:
 Total Assets = 9,00,000
 Total of Balance Sheet = 9,00,000
 Now, Long Term Debt = Long Term Debt / Equity = 40%
 Long Term Debt = 40% of equity
 $= 6,00,000 \times 40\% = ₹ 2,40,000$



Now Balancing figure of Liability side is creditors

$$= 9,00,000 - 6,00,000 \text{ (Equity)} - 2,40,000 \text{ (Long Term Debt)}$$

$$= ₹ 60,000$$

$$\text{Creditors} = ₹ 60,000$$

7. Current Ratio – Cash:

$$\text{Current ratio} = \text{Current Assets} / \text{Current Liabilities}$$

$$1.8 = \text{Debtors} + \text{Inventory} + \text{Cash} / \text{Creditors}$$

$$1.8 = 12,000 + 54,000 + \text{Cash} / 60,000$$

$$1,08,000 = 66,000 + \text{Cash}$$

$$\text{Cash} = ₹ 42,000$$

8. Fixed Assets:

Balancing figure on Assets Side is Fixed Assets.

9. Sales

$$\text{COGS} = \text{Sales} - \text{G.P.}$$

$$\text{COGS} = ₹ 2,70,000 - 54,000 = ₹ 2,16,000$$

Illustration 7

PKJ Limited has the following Balance Sheets as on March 31, 2016 and March 31, 2015:

Balance Sheet

(₹ in Lakhs)

Particulars	March 31, 2015	March 31, 2016
Source of Funds		
Shareholders Funds	2,377	1,472
Loan Funds	3,570	3,083
	5,947	4,555
Application of Funds		
Fixed Assets	3,466	2,900
Cash and bank	489	470
Debtors	1,495	1,168
Stock	2,867	2,407
Other Current Assets	1,567	1,404
Less: Current Liabilities	(3,937)	(3,794)

Study Note - 6 : Ratio Analysis

	5,947	4,555
Sales	22,165	13,882
Less: Cost of Goods sold	20,860	12,544
Gross Profit	1,305	1,338
Less: Selling, General and Administrative expenses	1,135	752
Earning before Interest and Tax (EBIT)	170	586
Less: Interest Expenses	113	105
Profits before Tax	57	481
Less: Tax	23	192
Profits after Tax (PAT)	34	289

Required:

- Calculate for the year 2015-16:
 - Inventory Turnover Ratio
 - Financial Leverage
 - Return on Investment (ROI)
 - Return on Equity (ROE)
 - Average Collection period.
- Give a brief comment on the Financial Position of PKJ Limited.

Solution:

1. Ratios for the year 2015-16

- (a) Inventory Turnover Ratio

$$= \text{Cost of goods sold} / \text{Average Inventory}$$

$$= 20,860 / (2,867 + 2,407) / 2$$

$$= 20,860 / 2,637 = 7.910$$

- (b) Financial Leverage

	2015-2016	2014-2015
= EBIT / EBT	= 170 / 57	= 586 / 481
	= 2.98	= 1.22



(c) Return on Investment

ROI = NOPAT / Sales x Sales / Average Capital employed

$$= \frac{57 \times (1 - 0.4)}{\times 22,165} \times \frac{22,165}{(5,947 + 4,555) / 2}$$

$$= \frac{57 \times (0.6)}{22,165} \times \frac{22,165}{5,251}$$

$$= 34.2 / 5,251$$

$$= 0.65\%$$

(d) Return on Equity

ROE = PAT / Average share holders fund

$$= 34 / [(2,377 + 1,472)] / 2)$$

$$= 34 / 1,924.5$$

$$= 1.77\%$$

(e) Average Collection Period

Average Collection Period = Average Debtors / Average Sales per day

$$= [(1,495 + 1,168) / 2] / [22,165 / 365 \text{ days}]$$

$$= 1,331.5 / 60.73 = 22 \text{ days.}$$

Financial position of PKJ Limited

A careful analysis of above Balance Sheet shows that current ratio of company is 1.5 which is less than the standard (i.e. 2) and short-term solvency ratio is therefore not satisfactory. At the same time lot of capital is blocked in inventory as compared to previous year. This affects liquidity of the firm.

As regards utilization of Debt Capital, the percentage of debts to total assets is not high, but as compared to equity, debt content is more in capital structure. Company is said to be levered with higher proportion of debt in its capital structure. This situation involves considerable risk to shareholders in capital structuring, the company should ensure that cost of debt remains lower than return on investment.

Study Note - 6 : Ratio Analysis

Illustration 8

The following figures and ratios are related to a company:

(a) Sales for the year (all credit)	₹ 30,00,000
(b) Gross Profit ratio	25 per cent
(c) Fixed assets turnover (basis on cost of goods sold)	1.5
(d) Stock turnover (basis on cost of goods sold)	6
(e) Liquid ratio 1:1	
(f) Current ratio	1.5:1
(g) Debtors collection period	2 months
(h) Reserve and surplus to share capital	0.6:1
(i) Capital gearing ratio	0.5
(j) Fixed assets to net worth	1.20:1

You are required to prepare Balance Sheet of the company on the basis of above details.

Solution:

Preparation of Balance Sheet of a Company

Working Notes:

- Cost of Goods Sold = Sales – Gross Profit (=25% of Sales)
= ₹ 30,00,000 – ₹ 7,50,000
= ₹ 22,50,000
- Closing Stock = Cost of Goods sold/Stock Turnover
= ₹ 22,50,000 / 6
= ₹ 3,75,000
- Fixed Assets = Cost of Goods Sold / Fixed Assets Turnover
= ₹ 22,50,000 / 1.5
= ₹ 15,00,000
- Current Assets:
Current Ratio Stock = 1.5 and Liquid Ratio = 1
= 1.5 – 1 = 0.5
Current Assets = Amount of Stock x 1.5 / 0.5
= ₹ 3,75,000 x 1.5/0.5 = ₹ 11,25,000
- Liquid Assets (Debtors and Cash) = Current Assets – Stock
= ₹ 11,25,000 – ₹ 3,75,000
= ₹ 7,50,000



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6. Debtors

$$= \text{Sales} \times \text{Debtors Collection Period} / 12$$

$$= ₹ 30,00,000 \times 2 / 12$$

$$= ₹ 5,00,000$$
7. Cash

$$= \text{Liquid Assets} - \text{Debtors}$$

$$= ₹ 7,50,000 - ₹ 5,00,000$$

$$= ₹ 2,50,000$$
8. Net worth

$$= \text{Fixed Assets} / 1.2$$

$$= ₹ 15,00,000 / 1.2$$

$$= ₹ 12,50,000$$
9. Reserves and Surplus
 Reserves and Share Capital
$$= 0.6 + 1 = 1.6$$

 Reserves and Surplus
$$= ₹ 12,50,000 \times 0.6 / 1.6$$

$$= ₹ 4,68,750$$
10. Share capital

$$= \text{Net worth} - \text{Reserves and Surplus}$$

$$= ₹ 12,50,000 - ₹ 4,68,750$$

$$= ₹ 7,81,250$$
11. Current Liabilities

$$= \text{Current Assets} / \text{Current Ratio}$$

$$= ₹ 11,25,000 / 1.5$$

$$= ₹ 7,50,000$$
12. Long-Term Debts
 Capital Gearing Ratio
$$= \text{Long-term Debts} / \text{Equity shareholder's Fund Long - Term Debts}$$

$$= ₹ 12,50,000 \times 0.5$$

$$= ₹ 6,25,000$$

Balance Sheet of a Company

Liabilities	Amount (Rs.)	Assets	Amount (Rs.)
Equity Share Capital	7,81,250	Fixed Assets	15,00,000
Reserves and Surplus	4,68,750	Current Assets	
Long-term Debts	6,25,000	Stock	3,75,000
Current Liabilities	7,50,000	Debtors	5,00,000
		Cash	2,50,000
	26,25,000		26,25,000

Study Note - 6 : Ratio Analysis

Illustration 9

PKJ Limited has made plans for the next year 2015-16. It is estimated that the company will employ total assets of ` 25,00,000; 30% of assets being financed by debt at an interest cost of 9% p.a. The direct costs for the year are estimated at ` 15,00,000 and all other operating expenses are estimated at ` 2,40,000.

The sales revenue are estimated at ` 22,50,000. Tax rate is assumed to be 40%.

Required to calculate:

- (a) Net profit margin
- (b) Return on Assets
- (c) Asset turnover
- (d) Return on equity

Solution:

The net profit is computed as follows:

Particulars	(Rs.)
Sales Revenue	22,50,000
Less: Direct Costs	15,00,000
Gross Profits	7,50,000
Less: Operating Expense	2,40,000
EBIT	5,10,000
Less: Interest (9% x 7,50,000)	67,500
EBT	4,42,500
Less: Taxes (@ 40%)	1,77,000
PAT	2,65,500

- (a) Net Profit Margin

$$\begin{aligned} \text{Net Profit Margin} &= \text{EBIT} (1-t) / \text{Sales} \times 100 \\ &= 5,10,000 \times (1 - 0.4) / 22,50,000 = 13.6\% \end{aligned}$$

- (b) Return on Assets (ROA)

$$\begin{aligned} \text{ROA} &= \text{EBIT} (1-t) / \text{Total Assets} \\ &= 5,10,000 (1 - 0.4) / 25,00,000 \\ &= 3,06,000 / 25,00,000 = 0.1224 = 12.24\% \end{aligned}$$



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(c) Asset Turnover

Asset Turnover

= Sales / Assets

= 22,50,000 / 25,00,000 = 0.9

(d) Return on Equity (ROE)

ROE

= PAT / Equity

= 2,65,500 / 17,50,000 = 15.17%

Illustration 10

With the help of the following ratios regarding Indu Films draw the Balance Sheet of the company for the year 2015:

Current Ratio	2.5
Liquidity ratio	1.5
Net working capital	₹ 3,00,000
Stock turnover ratio (cost of sales /closing stock)	6 times
Gross profit ratio	20%
Fixed Assets turnover ratio (on cost of sales)	2 times
Debt collection period	2 months
Fixed Assets to share holders net worth	0.80
Reserve and surplus to capital	0.5

Solution:

Balance Sheet of Indu Films for the year 2015

Liabilities	Amount (Rs.)	Assets	Amount (Rs.)
Share capital	5,00,000	Fixed assets	6,00,000
Reserve and surplus	2,50,000	Stock	2,00,000
Long-term borrowings (Bal. Fig.)	1,50,000	Debtors	2,50,000
Current liabilities	2,00,000	Bank	50,000
	11,00,000		11,00,000

Study Note - 6 : Ratio Analysis

Working notes:

If Current Liabilities	1
Current Assets	2.5
It means difference on Working Capital	1.5
Working Capital is 1.5	₹ 3,00,000
Therefore, Current Assets	₹ 5,00,000
Current Liabilities	₹ 2,00,000
As Liquidity Ratio	1.5
And Current Liabilities	₹ 2,00,000
(Bank and Debtors) $(2,00,000 \times 1.5)$	₹ 3,00,000
Stock $(5,00,000 - 3,00,000)$ i.e., Current Assets- Liquid Assets	₹ 2,00,000
Cost of sales (as stock turnover ratio is 6)	₹ 12,00,000
Sales (as G.P. ratio is 20%, $1,200,000 + 20/80 \times 1,200,000$)	₹ 15,00,000
Fixed Assets are ₹ 1,200,000/2, since Debtors collection	
Fixed Assets Turnover Ratio is 2 times	₹ 6,00,000
Debtors are ₹ 1,500,000/6 since debtors collection period is 2 months	₹ 2,50,000
Shareholders' net worth $600,000 \times 1/0.80$	₹ 7,50,000
Out of shareholders' net worth Reserves and Surplus $(7,50,000 \times 0.5/1.5)$	₹ 2,50,000
Therefore, Share capital	₹ 5,00,000



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Notes



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