Subject: **Financial Accounting-I**	
Course Code: **BBA-104**	Author: **Dr. Chandra Shekhar**
Lesson: **1**	Vetter:

INTRODUCTION TO ACCOUNTING

STRUCTURE

1.0 OBJECTIVES

After going through this lesson, you will be able to-

- Understand the meaning and nature of accounting.
- Differentiate between various types of accounting.
- Know development of accounting principle.
- Explain the importance of accounting.

1.1 INTRODUCTION

Accounting is a system meant for measuring business activities, processing of information into reports and making the findings available to decision-makers. The documents, which communicate these findings about the performance of an organisation in monetary terms, are called financial statements.

Usually, accounting is understood as the **Language of Business**. However, a business may have a lot of aspects which may not be of financial nature. As such, a better way to understand accounting could be to call it **The Language of Financial Decisions**. The better the understanding of the language, the better is the management of financial aspects of living. Many aspects of our lives are based on accounting, personal financial planning, investments, income-tax, loans, etc. We have different roles to perform in life-the role of a student, of a family head, of a manager, of an investor, etc. The knowledge of accounting is an added advantage in performing different roles. However, we shall limit our scope of discussion to a business organisation and the various financial aspects of such an organisation.

When we focus our thoughts on a business organisation, many questions (is our business profitable, should a new product line be introduced, are the sales sufficient, etc.) strike our mind. To answer questions of such nature, we need to have information generated through the accounting process. The people who take policy decisions and frame business plans use such information.

All business organisations work in an ever-changing dynamic environment. Any new programme of the organisation or of its competitor will affect the business. Accounting serves as an effective tool for measuring the financial pulse rate of the company. It is a continuous cycle of measurement of results and reporting of results to decision-makers.

Just like arithmetic is a procedural element of mathematics, book keeping is the procedural element of accounting. Figure 1 shows how an accounting system operates in business and how the flow of information occurs.

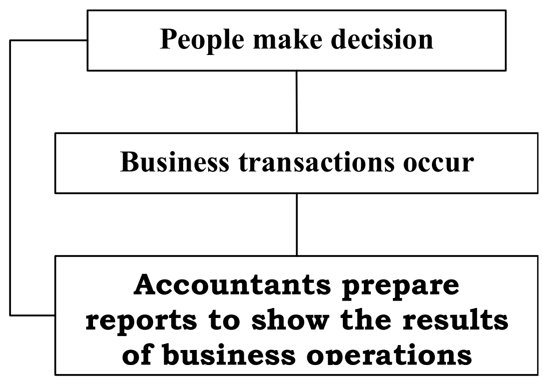

FIG 1: THE ACCOUNTING SYSTEM

Source: Liorngren, Harrison and Robinson, Financial and Management Accounting, Prentice Hall, New Jersey, 1994.

1.2 DEVELOPMENT OF ACCOUNTING DISCIPLINE

The history of accounting can be traced back to ancient times. According to some beliefs, the very art of writing originated in order to record accounting information. Though this may seem to be an exaggeration, but there is no denying the fact that accounting has a long history. Accounting records can be traced back to the ancient civilizations of China, Babylonia, Greece and Egypt. Accounting was used to keep records regarding the cost of labour and materials used in building great structures like the Pyramids.

During 1400s, accounting grew further because the needs for information of merchants in the Venis City of Italy increased. The first known description of double entry book keeping was first published in

1994 by Lucas Pacioli. He was a mathematician and a friend of Leonardo Ileda Vinci.

The onset of the industrial revolution necessitated the development of more sophisticated accounting system, rather than pricing the goods based on guesses about the costs. The increase in competition and mass production of goods led to the rise of accounting as a formal branch of study.

With the passage of time, the corporate world grew. In the nineteenth century, companies came up in many areas of infrastructure like the railways, steel, communication, etc. It led to a rapid growth in accounting. As the complexities of business grew, ownership and management of business was divorced. As such, managers had to come up with well-defined, structured systems of accounting to report the performance of the business to its owners.

Government also has had a lot to do with more accounting developments. The Income Tax brought about the concept of 'income'. Government takes a host of other decisions, relating to education, health, economic planning, for which it needs accurate and reliable information. As such, the government demands stringent accountability in the corporate sector, which forces the accounting process to be as objective and formal as possible.

1.3 AN ACCOUNTANT'S JOB PROFILE: FUNCTIONS OF ACCOUNTING

A man who is involved in the process of book keeping and accounting is called an accountant. With the coming up accounting as a specialised field of knowledge, an accountant has a special place in the structure of an organisation, because he performs certain vital functions.

The following paragraphs examine the functions of accounting and what role does an accountant play in discharging these functions.

An accountant is a person who does the basic job of maintaining accounts as he is the man who is engaged in book keeping. Since the managers would always want to know the financial performance of the business. An accountant prepares profit and loss account which reports the profits/losses of the business during the accounting period, Balance Sheet, which is a statement of assets and liabilities of the business at a point of time, is also proposed by all accountants. Since both statements are called financial statements, the person who prepares them is called a financial accountant.

Accounting information serves many purposes. A part from revealing the level of performance, it throws light on the causes of weakness and deviation from plans (in any). In this way an accountant becomes an important functionary who plays a vital role in the process of management control, which is a process of diagnosing and solving a problem. Seen from this point of view, an accountant can be referred to as a management accountant.

Tax planning is an important area as far as the fiscal management of a company is concerned. An accountant has a suggestive but very specific job to do in this regard by indicating ways to minimise the tax liability through his knowledge of concessions and incentives available under the existing taxation framework of the country.

An accountant can influence a company even by not being an employee. He can act as a man who verifies and certifies the authenticity of accounts of a company by auditing the accounts. It is a strictly professional job and is done by persons who are formally trained and qualified for the purpose. They have an educational status and a prescribed code of conduct like the Chartered Accountants in India and Certified Public Accountants in USA.

Information management is another area which keeps an accountant busy. He is the one who classifies the financial information into information for internal use (management accounting function); and information or external use (financial accounting function). Irrespective of the size and degree of automation of a business, information management is a key area and many organisations are known to have perished because they failed to recognise this as an important function of an accountant because information system is imperative for effective cost control, to forecast cash needs and to plan for future growth of the organisation.

1.4 UTILITY OF ACCOUNTING

The preceding section has just brought out the importance of information. Effective decisions require accurate, reliable and timely information. The need for quantity and quality of information varies with the importance of the decision that has to be taken on the basis of that information. The following paragraphs throw light on the various users of accounting information and what do they do with that information.

Individuals may use accounting information to manage their routine affairs like operating and managing their bank accounts, to evaluate the worthwhileness of a job in an organization, to invest money, to rent a house, etc.

Business Managers have to set goals, evaluate progress and initiate corrective action in case of unfavourable deviation from the planned course of action. Accounting information is required for many such decisions—purchasing equipment, maintenance of inventory, borrowing and lending, etc.

Investors and creditors are keen to evaluate the profitability and solvency of a company before they decide to provide money to the organisation. Therefore, they are interested to obtain financial information about the company in which they are contemplating an investment. Financial statements are the principal source of information to them which are published in annual reports of a company and various financial dailies and periodicals.

Government and Regulatory agencies are charged with the responsibility of guiding the socio-economic system of a country in such a way that it promotes common good. For example, the Securities and Exchange Board of India (SEBI) makes it mandatory for a company to disclose certain financial information to the investing public. The government's task of managing the industrial economy becomes simplify if the accounting information such as profits, costs, taxes, etc. is presented in a uniform manner without any manipulation or 'window-dressing'.

Central and State governments levy various taxes. The taxation authorities, therefore, need to know the income of a company to calculate the amount of tax that the company would have to pay. The information generated by accounting helps them in such computations and also to detect any attempts of tax evasion.

Employees and trade unions use the accounting information to settle various issues related to wages, bonus, profit sharing, etc. Consumers and general public are also interested in knowing the amount of income earned by various business houses. Accounting information helps in finding whether or not a company is over charging or exploiting the customers, whether or not companies are showing improved business performance, whether or not the country is emerging from the economic recession, etc. All such aspects draw heavily on accounting information and are closely related to our standard of living.

1.5 TYPES OF ACCOUNTING

The financial literature classifies accounting into two broad categories, viz, Financial Accounting and Management Accounting. Financial accounting is primarily concerned with the preparation of financial statements whereas management accounting covers areas such as interpretation of financial statements, cost accounting, etc. Both these types of accounting are examined in the following paragraphs.

1.5.1 Financial accounting

As mentioned earlier, financial accounting deals with the preparation of financial statements for the basic purpose of providing information to various interested groups like creditors, banks, shareholders, financial institutions, government, consumers, etc. Financial statements, i.e. the income statement and the balance sheet indicate the way in which the activities of the business have been conducted during a given period of time.

Financial accounting is charged with the primary responsibility of external reporting. The users of information generated by financial accounting, like bankers, financial institutions, regulatory authorities, government, investors, etc. want the accounting information to be consistent so as to facilitate comparison. Therefore, financial accounting is based on certain concepts and conventions which include separate business entity, going concern concept, money measurement concept, cost concept, dual aspect concept, accounting period concept, matching concept, realization concept and conventions of conservatism, disclosure, consistency, etc. All such concepts and conventions would be dealt with detail in subsequent lessons.

The significance of financial accounting lies in the fact that it aids the management in directing and controlling the activities of the firm and to frame relevant managerial policies related to areas like production, sales, financing, etc. However, it suffers from certain drawbacks which are discussed in the following paragraphs.

- The information provided by financial accounting is consolidated in nature. It does not indicate a break-up for different departments, processes, products and jobs. As such, it becomes difficult to evaluate the performance of different sub-units of the organisation.
- Financial accounting does not help in knowing the cost behaviour as it does not distinguish between fixed and variable costs.
- The information provided by financial accounting is historical in nature and as such the predictability of such information is limited.

The management of a company has to solve certain ticklish questions like expansion of business, making or buying a component, adding or deleting a product line, deciding on alternative methods of production, etc. The financial accounting information is of little help in answering these questions.

The limitations of financial accounting, however, should not lead one to believe that it is of no use. It is the basic foundation on which other branches and tools of accounting analysis are based. It is the source of information, which can be further analysed and interpreted according to the tailor-made requirements of decision-makers.

1.5.2 Management accounting

Management accounting is 'tailor-made' accounting. It facilitates the management by providing accounting information in such a way so that it is conducive for policy making and running the day-to-day operations of the business. Its basic purpose is to communicate the facts according to the specific needs of decision-makers by presenting the information in a systematic and meaningful manner. Management accounting, therefore, specifically helps in planning and control. It helps in setting standards and in case of variances between planned and actual performances, it helps in deciding the corrective action.

An important characteristic of management accounting is that it is forward looking. Its basic focus is one future activity to be performed and not what has already happened in the past.

Since management accounting caters to the specific decision needs, it does not rest upon any well-defined and set principles. The reports generated by a management accountant can be of any duration– short or long, depending on purpose. Further, the reports can be prepared for the organisation as a whole as well as its segments.

1.5.3 Cost accounting

One important variant of management accounting is the cost analysis. Cost accounting makes elaborate cost records regarding various products, operations and functions. It is the process of determining and accumulating the cost of a particular product or activity. Any product, function, job or process for which costs are determined and accumulated, are called cost centres.

The basic purpose of cost accounting is to provide a detailed break-up of cost of different departments, processes, jobs, products, sales territories, etc., so that effective cost control can be exercised.

Cost accounting also helps in making revenue decisions such as those related to pricing, product-mix, profit-volume decisions, expansion of business, replacement decisions, etc.

The objectives of cost accounting, therefore, can be summarized in the form of three important statements, viz, to determine costs, to facilitate planning and control of business activities and to supply information for short- and long-term decision. Cost accounting has certain distinct advantages over financial accounting. Some of them have been discussed succeedingly. The cost accounting system provides data about profitable and non-profitable products and activities, thus prompting corrective measures. It is easier to segregate and analyse individual cost items and to minimize losses and wastages arising from the manufacturing process. Production methods can be varied so as to minimize costs and increase profits. Cost accounting helps in making realistic pricing decisions in times of low demand, competitive conditions, technology changes, etc.

Various alternative courses of action can be properly evaluated with the help of data generated by cost accounting. It would not be an exaggeration if it is said that a cost accounting system ensures maximum utilization of physical and human resources. It checks frauds and manipulations and directs the employer and employees towards achieving the organisational goal.

1.5.4 Distinction between financial and management accounting

Financial and management accounting can be distinguished on a variety of basis like, users of information, criterion for decision making, behavioural implications, time frame, type of reports.

Table 1 presents a summary of distinctions between financial and management accounting.

TABLE 1: FINANCIAL ACCOUNTING VS MANAGEMENT ACCOUNTING

Basis of distinction		Financial accounting	Management accounting
1.	Primary user	Outside parties and manager of the business	Business managers
2.	Decision criterion	Accounts are based on generally accepted accounting principles	Comparison of costs and benefits of proposed action
3.	Behavioural implications	Concern about adequacy of disclosure. Behavioural implications are secondary behaviour	Concern about how reports will affect employee
4.	Time focus	Past orientation	Future orientation
5.	Reports	Summary reports regarding the whole entity	Detailed reports on the parts of the entity

Source: Horngren, Harrison and Robinson, Financial and Management Accounting, Prentice Hall, New Jersey, 1994.

1.6 SUMMARY

Accounting can be understood as the language of financial decisions. It is an ongoing process of performance measurement and reporting the results to decision-makers. The discipline of accounting can be traced back to very early times of human civilization. With the advancement of industry, modern day accounting has become formalized and structured. A person who maintains accounts is known as the accountant. He is engaged in multifarious activities like preparing financial statements, facilitating the control process, tax planning, auditing and information management. The information generated by accountant is used by various groups like, individuals, managers, investors, creditors, government, regulatory agencies, taxation authorities, employees, trade unions, consumers and general public. Depending upon purpose and method, accounting can be of broadly two types– financial accounting and management accounting. Financial accounting is primarily concerned with the preparation of financial statements mainly for outsiders. It is based on certain well-defined concepts and conventions and helps in framing broad financial policies. However, it suffers from certain limitations which are taken care of by the other branch of accounting, viz.; management accounting. Management accounting is meant to help in decision-making by analyzing and interpreting the information generated by financial accounting. As such, management accounting is futuristic and decision-oriented. The methods of management accounting are not very exact as they have to be varied according to the requirements of the decision. Cost accounting is an important aspect of management accounting. It emphasizes on cost determination, aiding the planning and control process and supplying information for short- and long-run decisions. The basic differences between financial and management accounting arises due to differences in users of information, differences in time frame and type of reports generated. The criterion for decision making and the behavioural implications of both types of accounting are also different.

1.7 KEYWORDS

Accrual: Recognition of revenues and costs as they are earned or incurred. It includes recognition of transaction relating to assets and liabilities as they occur irrespective of the actual receipts or payment.

Cost: The amount of expenditure incurred on or attributable to a specified article, product or activity.

Expenses: A cot relating to the operations of an accounting period.

Revenue: Total amount received from sales of goods/services.

Income: Excess of revenue over expenses.

Loss: Excess of expenses over revenue.

Capital: Generally refers to the amount invested in an enterprise by its owner.

Fund: An account usually of the nature of a reserve or provision which is represented by specifically Ear Market Assets.

Gain: A monetary benefit, profit or advantage resulting from a transaction or group of transactions.

Investment: Expenditure on assets held to earn interest, income, profit or other benefits.

Liability: The financial obligation of an enterprise other than owners' funds.

Net Profit: The excess of revenue over expenses during a particular accounting period.

1.8 SELF ASSESSMENT QUESTIONS

1. Define accounting. What purpose is served by accounting?
2. Discuss the role and activities of an accountant.
3. What are the various interested parties which use accounting information? How is such information used?
4. Explain the different types of accounting.
5. Differentiate Financial Accounting and Management Accounting in detail.

1.9 REFERENCES/SUGGESTED READINGS

1. Ashish K. Bhattacharyya (2004), "Financial Accounting for Business Managers", Prentice Hall of India Pvt. Ltd., New Delhi.

2. R.L. Gupta (2001), "Advanced Accountancy", Sultan Chand & Sons, New Delhi.

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5. S.N. Maheshwari (2004), "Management Accounting and Financial Control", Sultan Chand and Sons, New Delhi.

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Lesson: **2**	Vetter:

ACCOUNTING CONCEPTS AND CONVENTIONS

STRUCTURE

2.0 Objectives
2.1 Introduction
2.2 Meaning and Features of accounting Principles
2.3 Kinds of Accounting Principles
2.4 Accounting Concepts
2.5 Accounting Conventions
2.6 Summary
2.7 Keywords
2.8 Self assessment questions
2.9 References/suggested readings
Exhibits I to III

2.0 OBJECTIVES

After studying this lesson, you should be able to-

- Appreciate the need for a conceptual framework of accounting.
- Understand and describe the generally accepted accounting principles (GAAP).
- Know the importance and advantages of uniformity in accounting policies and practices.

2.1 INTRODUCTION

Accounting is often called the language of business because the purpose of accounting is to communicate or report the results of business operations and its various aspects to various users of accounting information. In fact, today, accounting statements or reports are needed by various groups such as shareholders, creditors, potential investors, columnist of financial newspapers, proprietors and others. In view of the utility of accounting reports to various interested parties, it becomes imperative to make this language capable of commonly understood by all. Accounting could become an intelligible and commonly understood language if it is based on generally accepted accounting principles. Hence, you must be familiar with the accounting principles behind financial statements to understand and use them properly.

2.2 MEANING AND FEATURES OF ACCOUNTING PRINCIPLES

For searching the goals of the accounting profession and for expanding knowledge in this field, a logical and useful set of principles and procedures are to be developed. We know that while driving our vehicles, follow a standard traffic rules. Without adhering traffic rules, there would be much chaos on the road. Similarly, some principles apply to accounting. Thus, the accounting profession cannot reach its goals in the absence of a set rules to guide the efforts of accountants and auditors. The rules and principles of accounting are commonly referred to as the conceptual framework of accounting.

Accounting principles have been defined by the Canadian Institute of Chartered Accountants as “The body of doctrines commonly associated with the theory and procedure of accounting serving as an explanation of current practices and as a guide for the selection of conventions or procedures where alternatives exists. Rules governing the formation of accounting axioms and the principles derived from them have arisen from common experience, historical precedent statements by individuals and professional bodies and regulations of Governmental agencies". According to Hendriksen (1997), Accounting theory may be defined as logical reasoning in the form of a set of broad principles that (i) provide a general frame of reference by which accounting practice can be evaluated, and (ii) guide the development of new practices and procedures. Theory may also be used to explain existing practices to obtain a better understanding of them. But the most important goal of accounting theory should be to provide a coherent set of logical principles that form the general frame of reference for the evaluation and development of sound accounting practices.

The American Institute of Certified Public Accountants (AICPA) has advocated the use of the word "Principle" in the sense in which it means "rule of action". It discuses the generally accepted accounting principles as follows:

Financial statements are the product of a process in which a large volume of data about aspects of the economic activities of an enterprise are accumulated, analysed and reported. This process should be carried out in conformity with generally accepted accounting principles. These principles represent the most current consensus about how accounting information should be recorded, what information should be disclosed, how it should be disclosed, and which financial statement should be prepared. Thus, generally accepted principles and standards provide a common financial language to enable informed users to read and interpret financial statements.

Generally accepted accounting principles encompass the conventions, rules and procedures necessary to define accepted accounting practice at a particular time……. generally accepted accounting principles include not only broad guidelines of general application, but also detailed practices and procedures (Source: AICPA Statement of the Accounting Principles Board No. 4, “Basic Concepts and Accounting Principles underlying Financial Statements of Business Enterprises “, October, 1970, pp 54-55)

According to ‘Dictionary of Accounting’ prepared by Prof. P.N. Abroal, “Accounting standards refer to accounting rules and procedures which are relating to measurement, valuation and disclosure prepared by such bodies as the Accounting Standards Committee (ASC) of a particular country”. Thus, we may define Accounting Principles as those rules of action or conduct which are adopted by the accountants universally while recording accounting transactions. Accounting principles are man-made. They are accepted because they are believed to be useful. The general acceptance of an accounting principle usually depends on how well it meets the following three basic norms: (a) Usefulness; (b) Objectiveness; and (c) Feasibility.

A principle is useful to the extent that it results in meaningful or relevant information to those who need to know about a certain business. In other words, an accounting rule, which does not increase the utility of the records to its readers, is not accepted as an accounting principle. A principle is objective to the extent that the information is not influenced by the personal bias or Judgement of those who furnished it. Accounting principle is said to be objective when it is solidly supported by facts. Objectivity means reliability which also means that the accuracy of the information reported can be verified. Accounting principles should be such as are practicable. A principle is feasible when it can be implemented without undue difficulty or cost. Although these three features are generally found in accounting principles, an optimum balance of three is struck in some cases for adopting a particular rule as an accounting principle. For example, the principle of making the provision for doubtful debts is found on feasibility and usefulness though it is less objective. This is because of the fact that such provisions are not supported by any outside evidence.

2.3 KINDS OF ACCOUNTING PRINCIPLES

In dealing with the framework of accounting theory, we are confronted with a serious problem arising from differences in terminology. A number of words and terms have been used by different authors to express and explain the same idea or notion. The various terms used for describing the basic ideas are: concepts, postulates, propositions, assumptions, underlying principles, fundamentals, conventions, doctrines, rules, axioms, etc. Each of these terms is capable of precise definition. But, the accounting profession has served to give them lose and overlapping meanings. One author may describe the same idea or notion as a concept and another as a convention and still another as postulate. For example, the separate business entity idea has been described by one author as a concept and by another as a convention. It is better for us not to waste our time to discuss the precise meaning of generic terms as the wide diversity in these terms can only serve to confuse the learner.

We do feel, however, that some of these terms/ideas have a better claim to be called 'concepts' while the rest should be called 'conventions'. The term 'Concept' is used to connote the accounting postulates, i.e., necessary assumptions and ideas which are fundamental to accounting practice. In other words, fundamental accounting concepts are broad general assumptions which underline the periodic financial statements of business enterprises. The reason why some of these terms should be called concepts is that they are basic assumptions and have a direct bearing on the quality of financial accounting information. The term 'convention' is used to signify customs or tradition as a guide to the preparation of accounting statements. The following are the important accounting concepts and conventions:

Accounting Concepts	**Accounting Conventions**
Separate Business Entity Concept	Convention of Materiality
Money Measurement Concept	Convention of Conservatism
Dual Aspect Concept	Convention of consistency
Accounting Period Concept	
Cost Concept	
The Matching Concept	
Accrual Concept	
Realisation Concept	

2.4 ACCOUNTING CONCEPTS

The more important accounting concepts are briefly described as follows:

1. Separate Business Entity Concept

In accounting we make a distinction between business and the owner. All the books of accounts records day to day financial transactions from the view point of the business rather than from that of the owner. The proprietor is considered as a creditor to the extent of the capital brought in business by him. For instance, when a person invests Rs. 10 lakh into a business, it will be treated that the business has borrowed that much money from the owner and it will be shown as a 'liability' in the books of accounts of business. Similarly, if the owner of a shop were to take cash from the cash box for meeting certain personal expenditure, the accounts would show that cash had been reduced even though it does not make any difference to the owner himself. Thus, in recording a transaction the important question is how does it affects the business? For example, if the owner puts cash into the business, he has a claim against the business for capital brought in.

In so-far as a limited company is concerned, this distinction can be easily maintained because a company has a legal entity like a natural person it can engage itself in economic activities of buying, selling, producing, lending, borrowing and consuming of goods and services. However, it is difficult to show this distinction in the case of sole proprietorship and partnership. Nevertheless, accounting still maintains separation of business and owner. It may be noted that it is only for accounting purpose that partnerships and sole proprietorship are treated as separate from the owner (s), though law does not make such distinction. In fact, the business entity concept is applied to make it possible for the owners to assess the performance of their business and performance of those whose manage the enterprise. The managers are responsible for the proper use of funds supplied by owners, banks and others.

2. Money Measurement Concept

In accounting, only those business transactions are recorded which can be expressed in terms of money. In other words, a fact or transaction or happening which cannot be expressed in terms of money is not recorded in the accounting books. As money is accepted not only as a medium of exchange but also as a store of value, it has a very important advantage since a number of assets and equities, which are otherwise different, can be measured and expressed in terms of a common denominator.

We must realise that this concept imposes two severe limitations. Firstly, there are several facts which though very important to the business, cannot be recorded in the books of accounts because they cannot be expressed in money terms. For example, general health condition of the Managing Director of the company, working conditions in which a worker has to work, sales policy pursued by the enterprise, quality of product introduced by the enterprise, though exert a great influence on the productivity and profitability of the enterprise, are not recorded in the books. Similarly, the fact that a strike is about to begin because employees are dissatisfied with the poor working conditions in the factory will not be recorded even though this event is of great concern to the business. You will agree that all these have a bearing on the future profitability of the company.

Secondly, use of money implies that we assume stable or constant value of rupee. Taking this assumption means that the changes in the money value in future dates are conveniently ignored. For example, a piece of land purchased in 1990 for Rs. 2 lakh and another bought for the same amount in 1998 are recorded at the same price, although the first purchased in 1990 may be worth two times higher than the value recorded in the books because of rise in land prices. In fact, most accountants know fully well that purchasing power of rupee does change but very few recognise this fact in accounting books and make allowance for changing price level.

3. Dual Aspect Concept

Financial accounting records all the transactions and events involving financial element. Each of such transactions requires two aspects to be recorded. The recognition of these two aspects of every transaction is known as a dual aspect analysis. According to this concept every business transactions has dual effect. For example, if a firm sells goods of Rs. 5,000 this transaction involves two aspects. One aspect is the delivery of goods and the other aspect is immediate receipt of cash (in the case of cash sales). In fact, the term ‘double entry’ book keeping has come into vogue and in this system the total amount debited always equals the total amount credited. It follows from 'dual aspect concept' that at any point of time owners' equity and liabilities for any accounting entity will be equal to assets owned by that entity. This idea is fundamental to accounting and could be expressed as the following equalities:

Assets = Liabilities + Owners Equity ...(1)

Owners Equity = Assets- Liabilities ...(2)

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

4. Going Concern Concept

Accounting assumes that the business entity will continue to operate for a long time in the future unless there is good evidence to the contrary. The enterprise is viewed as a going concern, that is, as continuing in operations, at least in the foreseeable future. In other words, there is neither the intention nor the necessity to liquidate the particular business venture in the predictable future. Because of this assumption, the accountant while valuing the assets does not take into account forced sale value of them. In fact, the assumption that the business is not expected to be liquidated in the foreseeable future establishes the basis for many of the valuations and allocations in accounting. For example, the accountant charges depreciation on fixed assets. It is this assumption which underlies the decision of investors to commit capital to enterprise. Only on the basis of this assumption accounting process can remain stable and achieve the objective of correctly reporting and recording on the capital invested, the efficiency of management, and the position of the enterprise as a going concern.

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

5. Accounting Period Concept

This concept requires that the life of the business should be divided into appropriate segments for studying the financial results shown by the enterprise after each segment. Although the results of operations of a specific enterprise can be known precisely only after the business has ceased to operate, its assets have been sold off and liabilities paid off, the knowledge of the results periodically is also necessary. Those who are interested in the operating results of business obviously cannot wait till the end. The requirements of these parties force the businessman 'to stop' and 'see back' how things are going on. Thus, the accountant must report for the changes in the wealth of a firm for short time periods. A year is the most common interval on account of prevailing practice, tradition and government requirements. Some firms adopt financial year of the government, some other calendar year. Although a twelve month period is adopted for external reporting, a shorter span of interval, say one month or three month is applied for internal reporting purposes.

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

6. Cost Concept

The term 'assets' denotes the resources land building, machinery etc. owned by a business. The money values that are assigned to assets are derived from the cost concept. According to this concept an asset is ordinarily entered on the accounting records at the price paid to acquire it. For example, if a business buys a plant for Rs. 5 lakh the asset would be recorded in the books at Rs. 5 lakh, even if its market value at that time happens to be Rs. 6 lakh. Thus, assets are recorded at their original purchase price and this cost is the basis for all subsequent accounting for the business. The assets shown in the financial statements do not necessarily indicate their present market values. The term 'book value' is used for amount shown in the accounting records.

The cost concept does not mean that all assets remain on the accounting records at their original cost for all times to come. The asset may systematically be reduced in its value by charging 'depreciation', which will be discussed in detail in a subsequent lesson. Depreciation has the effect of reducing profit of each period. The prime purpose of depreciation is to allocate the cost of an asset over its useful life and not to adjust its cost. However, a balance sheet based on this concept can be very misleading as it shows assets at cost even when there are wide difference between their costs and market values. Despite this limitation you will find that the cost concept meets all the three basic norms of relevance, objectivity and feasibility.

7. The Matching concept

This concept is based on the accounting period concept. In reality we match revenues and expenses during the accounting periods. Matching is the entire process of periodic earnings measurement, often described as a process of matching expenses with revenues. In other words, income made by the enterprise during a period can be measured only when the revenue earned during a period is compared with the expenditure incurred for earning that revenue. Broadly speaking revenue is the total amount realised from the sale of goods or provision of services together with earnings from interest, dividend, and other items of income. Expenses are cost incurred in connection with the earnings of revenues. Costs incurred do not become expenses until the goods or services in question are exchanged. Cost is not synonymous with expense since expense is sacrifice made, resource consumed in relation to revenues earned during an accounting period. Only costs that have expired during an accounting period are considered as expenses. For example, if a commission is paid in January, 2002, for services enjoyed in November, 2001, that commission should be taken as the cost for services rendered in November 2001. On account of this concept, adjustments are made for all prepaid expenses, outstanding expenses, accrued income, etc, while preparing periodic reports.

8. Accrual Concept

It is generally accepted in accounting that the basis of reporting income is accrual. Accrual concept makes a distinction between the receipt of cash and the right to receive it, and the payment of cash and the legal obligation to pay it. This concept provides a guideline to the accountant as to how he should treat the cash receipts and the right related thereto. Accrual principle tries to evaluate every transaction in terms of its impact on the owner's equity. The essence of the accrual concept is that net income arises from events that change the owner's equity in a specified period and that these are not necessarily the same as change in the cash position of the business. Thus it helps in proper measurement of income.

9. Realisation Concept

Realisation is technically understood as the process of converting non-cash resources and rights into money. As accounting principle, it is used to identify precisely the amount of revenue to be recognised and the amount of expense to be matched to such revenue for the purpose of income measurement. According to realisation concept revenue is recognised when sale is made. Sale is considered to be made at the point when the property in goods passes to the buyer and he becomes legally liable to pay. This implies that revenue is generally realised when goods are delivered or services are rendered. The rationale is that delivery validates a claim against the customer. However, in case of long run construction contracts revenue is often recognised on the basis of a proportionate or partial completion method. Similarly, in case of long run instalment sales contracts, revenue is regarded as realised only in proportion to the actual cash collection. In fact, both these cases are the exceptions to the notion that an exchange is needed to justify the realisation of revenue.

2.5 ACCOUNTING CONVENTIONS

1. Convention of Materiality

Materiality concept states that items of small significance need not be given strict theoretically correct treatment. In fact, there are many events in business which are insignificant in nature. The cost of recording and showing in financial statement such events may not be well justified by the utility derived from that information. For example, an ordinary calculator costing Rs. 100 may last for ten years. However, the effort involved in allocating its cost over the ten year period is not worth the benefit that can be derived from this operation. The cost incurred on calculator may be treated as the expense of the period in which it is purchased. Similarly, when a statement of outstanding debtors is prepared for sending to top management, figures may be rounded to the nearest ten or hundred.

This convention will unnecessarily overburden an accountant with more details in case he is unable to find an objective distinction between material and immaterial events. It should be noted that an item material for one party may be immaterial for another. Actually, there are no hard and fast rules to draw the line between material and immaterial events and hence, It is a matter of judgement and common sense. Despite this limitation, It is necessary to disclose all material information to make the financial statements clear and understandable. This is required as per IAS-1 and also reiterated in IAS-5. As per IAS-1, materiality should govern the selection and application of accounting policies.

2. Convention of Conservatism

This concept requires that the accountants must follow the policy of "playing safe" while recording business transactions and events. That is why, the accountant follow the rule anticipate no profit but provide for all possible losses, while recording the business events. This rule means that an accountant should record lowest possible value for assets and revenues, and the highest possible value for liabilities and expenses. According to this concept, revenues or gains should be recognised only when they are realised in the form of cash or assets (i.e. debts) the ultimate cash realisation of which can be assessed with reasonable certainty. Further, provision must be made for all known liabilities, expenses and losses, Probable losses regarding all contingencies should also be provided for. 'Valuing the stock in trade at market price or cost price which ever is less', 'making the provision for doubtful debts on debtors in anticipation of actual bad debts', 'adopting written down value method of depreciation as against straight line method', not providing for discount on creditors but providing for discount on debtors', are some of the examples of the application of the convention of conservatism.

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

3. Convention of Consistency

The convention of consistency requires that once a firm decided on certain accounting policies and methods and has used these for some time, it should continue to follow the same methods or procedures for all subsequent similar events and transactions unless it has a sound reason to do otherwise. In other worlds, accounting practices should remain unchanged from one period to another. For example, if depreciation is charged on fixed assets according to straight line method, this method should be followed year after year. Analogously, if stock is valued at 'cost or market price whichever is less', this principle should be applied in each subsequent year.

However, this principle does not forbid introduction of improved accounting techniques. If for valid reasons the company makes any departure from the method so far in use, then the effect of the change must be clearly stated in the financial statements in the year of change. The application of the principle of consistency is necessary for the purpose of comparison. One could draw valid conclusions from the comparison of data drawn from financial statements of one year with that of the other year. But the inconsistency in the application of accounting methods might significantly affect the reported data.

Accounting standards

The accounting concepts and conventions discussed in the foregoing pages are the core elements in the theory of accounting. These principles, however, permit a variety of alternative practices to co-exist. On account of this the financial results of different companies can not be compared and evaluated unless full information is available about the accounting methods which have been used. The lack of uniformity among accounting practices have made it difficult to compare the financial results of different companies. It means that there should not be too much discretion to companies and their accountants to present financial information the way they like. In other words, the information contained in financial statements should conform to carefully considered standards. Obviously, accounting standards are needed to:

a) provide a basic framework for preparing financial statements to be uniformly followed by all business enterprises,
b) make the financial statements of one firm comparable with the other firm and the financial statements of one period with the financial statements of another period of the same firm,
c) make the financial statements credible and reliable, and
d) create general sense of confidence among the outside users of financial statements.

In this context unless there are reasonably appropriate standards, neither the purpose of the individual investor nor that of the nation as a whole can be served. In order to harmonise accounting policies and to evolve standards the need in the USA was felt with the establishment of Securities and Exchange Commission (SEC) in 1933. In 1957, a research oriented organisation called Accounting Principles Boards (APB) was formed to spell out the fundamental accounting principles. After this the Financial Accounting Standards Board (FASB) was formed in 1973, in USA. At the international level, the need for standardisation was felt and therefore, an International Congress of accountants was organised in Sydney, Australia in 1972 to ensure the desired level of uniformity in accounting practices. Keeping this in view, International Accounting Standards Committee (IASC) was formed and was entrusted with the responsibility of formulating international standards.

In order to harmonise varying accounting policies and practices, the Institute of Chartered Accountants of India (ICAI) formed the Accounting Standards Board (ASB) in April, 1977. ASB includes representatives from industry and government. The main function of the ASB is to formulate accounting standards. This Board of the Institute of Chartered Accountants of India has so far formulated around 27 Accounting Standards, the list of these accounting standards is furnished. Regarding the position of Accounting standards in India, it has been stated that the standards have been developed without first establishing the essential theoretical framework. As a result, accounting standards lack direction and coherence. This type of limitation also existed in UK and USA but it was remedied long back.

Hence, there is an emergent need to make an attempt to develop a conceptual framework and also revise suitably the Indian Accounting Standards to reduce the number of alternative treatments.

2.6 SUMMARY

Accounting principles may be defined as rules of action or conduct which are adopted by the accountants universally while recording accounting transactions. Accounting principles are accepted because they are believed to be useful. The general acceptance of an accounting principle usually depends on how well it meets the three basic norms i.e., usefulness, objectiveness and feasibility. The accounting principles broadly classified into two categories namely accounting concepts and accounting conventions. The term concept is used to cannot the accounting postulates, i.e., necessary assumptions and ideas which are fundamental to accounting practice. Accounting concepts are separate business entity concepts, money measurement concept, dual aspect concept, accounting period concept, cost concept, matching concept, accrual concept, realisation concept. The term convention is used to signify customs or tradition as a guide to the preparation of accounting statement, main conventions of accounting are- (i) convention of materiality, convention of conservatism. Convention of consistency.

2.7 KEYWORDS

Creditor: Amount owned by an enterprise on account of goods purchased or services received.

Debtor: Persons from whom amounts are due for goods sold or services rendered.

Reserve: The portion of earnings of an enterprise appropriated by the management for a general or specific purpose.

Provision: Amount retained by way of providing for any known liability the amount of which cannot be determined with substantial accuracy.

Net Realisable Value: Actual selling price of an asset in the ordinary course of business less cost incurred in order to make the sale.

Inventory: Tangible property held for sale in the ordinary course of business or in the process of production for such sale.

Interim Report: The information provided with reference to a date before the close of the accounting period to owners or other interested persons concerning its operations/financial position.

Depreciation: Decrease in the value of fixed assets.

Balance Sheet: A statement of the financial position of an enterprise as at a given date.

Capital: Generally refers to the amount invested in an enterprise by its owners.

2.8 SELF ASSESSMENT QUESTIONS

1. State whether the following statements are true or false:
   a) The 'materiality concept' refers to the state of ignoring small items and values from accounts.
   b) Accounting principles are rules of action or conduct which are adopted by the accountants universally while recording accounting transactions.
   c) The 'separate entity concept' of accounting is not applicable to sole trading concerns and partnership concerns.
   d) The 'dual aspect' concept result in the accounting equation: Capital+Liabilities = Assets.
   e) The 'conservatism concept' leads to the exclusion of all unrealised profits.
   f) The balance sheet based on 'Cost concept' is of no use to a potential investor.
   g) Accounting standards are statements prescribed by government regulatory bodies.

h) Accounting statements are statements prescribed by professional accounting bodies.

i) Accounting concepts are broad assumptions.

2. Choose the correct answer from the alternations given:

(I) Accounting standards are statements prescribed by
 a) Law
 b) Bodies of shareholders
 c) Professional accounting bodies

(II) Accounting Principles are generally based on
 a) Practicability
 b) Subjectivity
 c) Convenience in recording

(III) The Policy of 'anticipate no profit and provide for all possible losses' arises due to convention of
 a) Consistency
 b) Disclosure
 c) Conservatism

(IV) Which is the accounting concept that requires the practice of crediting closing stock to the trading account
 a) Going concern
 b) Cost
 c) Matching

(V) The convention of conservatism, when applied to the balance sheet, results in
 a) understatement of assets liabilities
 b) understatement of
 c) understatement of capital.

3. Examine the role of accounting concepts in the preparation of financial statements. Do you find any of the accounting concepts conflicting with each other? Give examples.

4. Discuss briefly the basic concepts and conventions of accounting?

5. Write short notes on
   a) Going concern concept
   b) Dual aspect concept
   c) Business entity concept
   d) Convention of materiality
   e) Convention of conservatism.

6. Why accounting practices should be standardised? Explain.

7. What progress has been made in India regarding standardisation of accounting practices?

2.9 REFERENCES/SUGGESTED READINGS

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4. George Foster (2002), "Financial Statement Analysis", Pearson Education.

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EXHIBIT-I
INTERNATIONAL ACCOUNTING STANDARDS ISSUED BY ISAC

IAS-1	Disclosure of Accounting Policies.
IAS-2	Valuation and Presentation of Inventories in the context of historical cost system.
IAS-3	Consolidated financial statements.
IAS-4	Depreciation accounting
IAS-5	Information to be disclosed in financial statements
IAS-6	Accounting responses to changing prices
IAS-7	Cash flow statement
IAS-8	Unusual and prior period items and changes in accounting policies
IAS-9	Accounting for research and development activities
IAS-10	Contingencies and events occurring after balance sheet date
IAS-11	Accounting for construction contracts
IAS-12	Accounting for taxes on income
IAS-13	Presentation of current assets and current liabilities
IAS-14	Reporting financial information by segments
IAS-15	Information reflecting the effects of changing prices
IAS-16	Accounting for property, plant and equipment
IAS-17	Accounting for leases
IAS-18	Revenue recognition
IAS-19	Accounting for retirement benefits in the financial statements of employees
IAS-20	Accounting for government grants and disclosure of government assistance.
IAS-21	Accounting for effects of changes in Foreign Exchange Rates

IAS-22 Accounting for business combinations

IAS-23 Capitalisation of borrowing costs

IAS-24 Related party disclosures

IAS-25 Accounting for investments

IAS-26 Accounting and reported by retirement benefit plans

IAS-27 Consolidated financial statements and accounting for investments in subsidiaries

IAS-28 Consolidated financial statements and accounting for investments in subsidiaries

IAS-29 Financial reporting in Hyper inflationary economics

IAS-30 Disclosure in the financial statements of bank and similar financial institutions

IAS-31 Financial reporting of interests in joint ventures

IAS-32 Financial instruments: disclosure and presentation.

EXHIBIT-II
REVISED IAS ISSUED BY ISAC

IAS-2	Inventories
IAS-8	Net Profit or loss for the period, fundamental Errors changes in Accounting Policies
IAS-9	Research and Developments costs
IAS-11	Construction Contracts
IAS-16	Property, Plant and Equipment
IAS-18	Revenue
IAS-19	Retirement Benefit costs
IAS-21	The effects of changes in foreign exchanges rates
IAS-22	Business Combinations
IAS-23	Borrowing Costs

EXHIBIT-III
ACCOUNTING STANDARDS ISSUED BY ASB

AS-1	Disclosure of Accounting policies
AS-2	Valuation of Inventories
AS-3	Changes in Financial Position
AS-4	Contingencies and Events Occurring after the Balance Sheet Date
AS-5	Prior period and Extraordinary Items and changes in Accounting policies
AS-6	Depreciation Accounting
AS-7	Accounting for Construction Contracts
AS-8	Accounting for Research and Development
AS-9	Revenue Recognition
AS-10	Accounting for Fixed Assets
AS-11	Accounting for Changes in Foreign Exchange Rate
AS-12	Accounting for Government Grants
AS-13	Accounting for Investments
AS-14	Accounting for Amalgamations
AS-15	Accounting for Retirement Benefits in the Financial Statements of Employers/Employees

Subject: **Financial Accounting-I**	
Course Code: **BBA-104**	Author: **Dr. M.C. Garg**
Lesson: **3**	Vetter:

RECORDING OF TRANSACTIONS- VOUCHER SYSTEM, ACCOUNTING PROCESS, JOURNAL

STRUCTURE

3.0 OBJECTIVES

After going through this lesson, you will be able to-

- Know the meaning and steps of accounting process.
- Understand the meaning and importance of journal.
- Know the rules of journalising.

3.1 INTRODUCTION

A business enterprise generally prepares the following two basic financial statements:

Profit and Loss Account to ascertain the profit earned or loss incurred during an accounting period.

Balance Sheet to ascertain the financial position of the business as on a particular date.

Generally, a business enterprise has numerous transactions every day during an accounting period. Unless the transactions are recorded and analysed, it is not possible to determine the impact of each transaction in the above two basic statements. Traditionally, accounting is a method of collecting, recording, classifying, summarising, presenting and interpreting financial data aspect of an economic activity. The series of business transactions occurring during the accounting period and its recording is referred to an accounting process/mechanism. An accounting process is a complete sequence of accounting procedures which are repeated in the same order during each accounting period. Therefore, accounting process involves the following steps or stages:

1. Identification of transaction

In accounting, only business transactions are recorded. A transaction is an event which can be expressed in terms of money and which brings change in the financial position of a business enterprise. An event is an incident or a happening which may or may not being any change in the financial position of a business enterprise. Therefore, all transactions are events but all events are not transactions. A transaction is a complete action, to an expected or possible future action. In every transaction, there is movement of value from one source to another. For example, when goods are purchased for cash, there is a movement of goods from the seller to the buyer and a movement of cash from buyer to the seller. Transactions may be external (between a business entity and a second party, e.g., goods sold on credit to Hari or internal (do not involve second party, e.g., depreciation charged on the machinery).

Illustration: State with reasons whether the following events are transactions or not to Mr. K. Mondal, Proprietor.

(i) Mr. Mondal started business with capital (brought in cash)Rs. 40,000.
(ii) Paid salaries to staff Rs. 5,000.
(iii) Purchased machinery for Rs. 20,000 in cash.
(iv) Placed an order with Sen & Co. for goods for Rs. 5,000.
(v) Opened a Bank account by depositing Rs. 4,000.
(vi) Received pass book from bank.
(vii) Appointed Sohan as Manager on a salary of Rs. 4,000 per month.
(viii) Received interest from bank Rs. 500.
(ix) Received a price list from Lalit.

Solution: Here, each event is to be considered from the view point of Mr. Mondal's business. Those events which will change the financial position of the business of Mr. Mondal, should be regarded as transaction.

(i) It is a transaction, because it changes the financial position of Mr. Mondal's business. Cash will increase by Rs. 40,000 and Capital will increase by Rs. 40,000.
(ii) It is a transaction, because it changes the financial position of Mr. Mondal's business. Cash will decrease by Rs. 5,000 and Salaries (expenses) will increase by Rs. 5,000
(iii) It is a transaction, because it changes the financial position of Mr. Mondal's business. Machinery comes in and cash goes out.
(iv) It is not a transaction, because it does not change the financial position of the business.
(v) It is a transaction, because it changes the financial position of the business. Bank balance will increase by Rs. 4,000 and cash will decrease by Rs. 4,000.

(vi) It is also not a transaction, because it does not change the financial position of Mr. Monal.

(vii) It is also not a transaction, because it does not change the financial position of Mr. Monal.

(viii) It is a transaction, because it changes the financial position of Mr. Mondal's business. Bank interest will increase by Rs. 500 and cash will increase by the same amount.

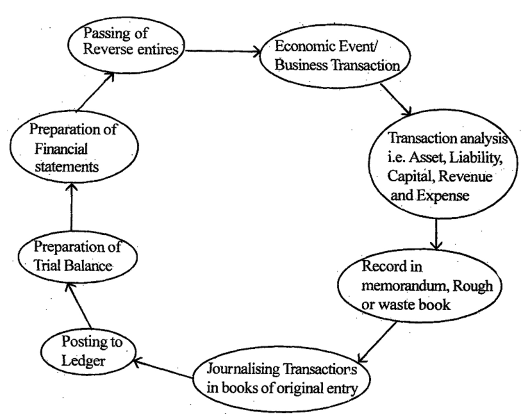
(ix) It is not a transaction, because it does not change the financial position of the business of Mr. Mondal.

2. Recording the transaction

Journal is the first book of original entry in which all transactions are recorded event wise and date-wise and presents a historical record of all monetary transactions. It may further be divided into sub-journals as well which are also known subsidiary books.

3. Classifying

Accounting is the art of classifying business transactions. Classification means statement setting out for a period where all the similar transactions relating to a person, a thing, expense, or any other subject are groped together under appropriate heads of accounts.



ACCOUNTING PROCESS

4. Summarising

Summarising is the art of making the activities of the business enterprise as classified in the ledger for the use of management or other user groups i.e. Sundry debtors, Sundry creditors etc. Summarisation helps in the preparation of Profit and Loss Account and Balance sheet for a particular fiscal year.

5. Analysis and Interpretation

The financial information or data as recorded in the books of a account must further be analysed and interpreted so to draw useful conclusions. Thus, analysis of accounting information will help the management to assess in the performance of business operation and forming future plans also.

6. Presentation or reporting of financial information

The end users of accounting statements must be benefited from analysis and interpretation of data as some of them are the 'stock holders' and other one the 'stake holders'. Comparison of past and present statement and reports, use of ratio and trend analysis are the different tools of analysis and interpretation.

From the above discussion one can conclude that accounting is a art which starts and includes steps right from recording of business transactions of monetary character to the communicating or reporting the results thereof to the various interested parties.

3.2 VOUCHER

Each transaction is recorded in books of accounts providing all the required information of the transaction. Since each transaction has an effect on the financial position of the business, there should be a documentary evidence to establish the monetary accounts at which transactions are recorded and also the transactions are properly authorised. The common documents that are generally used are as under:

(i) Payment voucher;

(ii) Receipt voucher; and

(iii) Transfer voucher.

(i) A *Payment voucher* usually on a printed standard form, is a record of payment. When payment is made for an expense, generally a bills is prepared to record full particulars of the claim by the person or organisation receiving payment. From the bill, the accounting department prepares a voucher for each payment to be made, no matter whether the amount that is paid for the goods purchased, or to pay employee's salaries, or to pay for services or to pay for any other asset acquisition.

(ii) A *Receipt voucher* is a document which is issued against cash receipts. It may also be a printed standard form. This document shows that a certain sum of money was received from a person or organisation and also, contains information of the purpose for which the money is received. It is signed by a responsible employee, authorised by the management to receive the money.

(iii) A *Transfer voucher* is used to record the residuary transactions. An internal transaction or a transaction not involving any cash payment or cash receipt, is recorded in the transfer voucher. Examples are: Goods purchased on credit; depreciation of assets, outstanding expenses, accrued income, etc.

3.3 JOURNAL

Journal is a historical record of business transaction or events. The word journal comes from the French word "Jour" meaning "day". It is a book of original or prime entry. Journal is a primary book for recording the day to day transactions in a chronological order i.e. the order in which they occur. The journal is a form of diary for business transactions. This is called the book of first entry since every transaction is recorded firstly in the journal.

Journal Entry

Journal entry means recording the business transactions in the journal. For each transaction, a separate entry is recorded. Before recording, the transaction is analysed to determine which account is to be debited and which account is to be credited.

The performa of journal is shown as follows:

JOURNAL

Date	Particulars	L.F.	Debit (Amount)	Credit (Amount)
(1)	(2)	(3)	(4)	(5)

Column 1 (Date): The date of the transaction on which it takes pale is written in this column.

Column 2 (Particulars): In this column, the name of the accounts to the debited is written first, then the names of the accounts to be credited and lastly, the narration (i.e. a brief explanation of transaction) are entered.

Column 3 (L.F.): L.F. stands for ledger folio which means page of the ledger. In this column are entered the page numbers on which the various accounts appear in the ledger.

Column 4 (Dr. Amount): In this column, the amount to be debited against the 'Dr.' Account is written along with the nature of currency.

Column 5 (Cr. Amount): In this column the amount to be credited against the 'Cr.' Account is written along with the nature of currency.

Advantages of Using Journal

Journal is used because of the following advantages:

- A journal contains a permanent record of all the business transactions.
- The journal provides a complete chronological (in order of the time of occurrence) history of all business transactions and the task of later tracing of some transactions is facilitated.
- A complete information relating to one single business transaction is available in one place with all its aspects.
- The transaction is provided with an explanation technically called a narration.
- Use of the journal reduces the possibility of an error when transactions are first recorded in this book.
- The journal establishes the quality of debits and credits for a transaction and reconciles any problems. If a business purchases a bicycle, it is necessary to decide whether the bicycle represents ordinary goods or machinery. Further any amount paid is debited to bicycle account and credited to cash account.

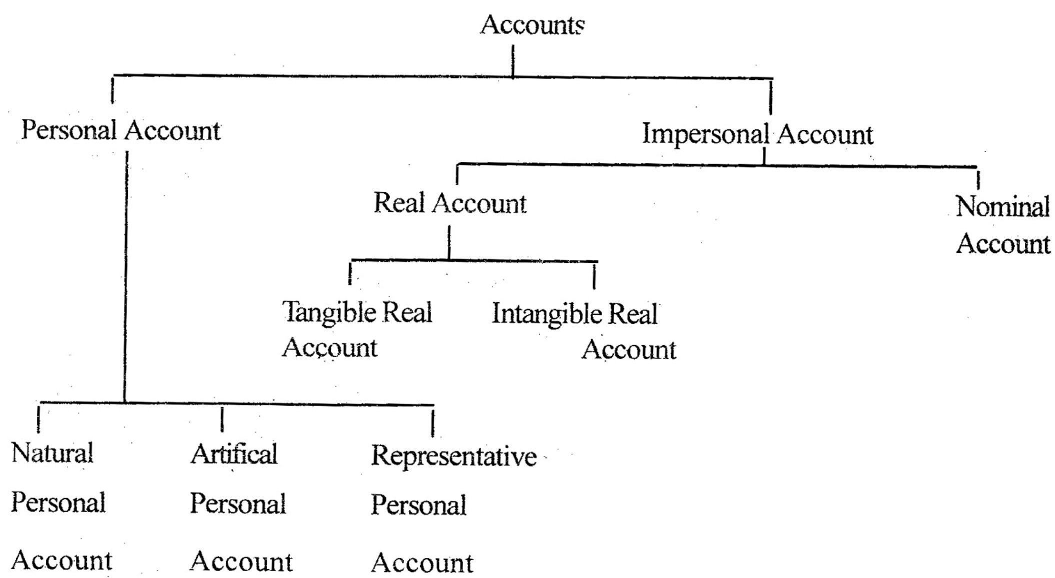
- The use of journals avoids omission or duplication of transactions or parts of transaction. Without the journal the accountant would be forced to got to the individual account to enter debits and credits. Therefore it is possible for accountant to miss part of a transaction, duplicate all or part of a transaction or incorrectly record debits and credits. Even with the Journal, it is still possible to omit transactions and make other errors. However, the Journal reduces these problems.
- Once a transaction is recorded in the journal, it is not necessary to post it immediately in the ledger accounts. In this, way, the journal allows the delayed posting.

In connection with the journal, the following points are to be remembered:

- For each transaction, the exact accounts should be debited and credited. For that, the two accounts involved must be identified to pass a proper journal entry.
- Sometimes, a journal entry may have more than one debit or more than one credit. This type of journal entry is called compound journal entry. Regardless of how many debits or credits are contained in a compound journal entry, all the debits are entered before any credits are entered. The aggregate amount of debits should be equal to the aggregate amount of credits.
- For a business, journal entries generally extend to several pages. Therefore, the total are cast at the end of each page, against the debit and credit columns, the following words and written in the particular column, which indicates, carried forward (of the amount on the next page) "Total c/f".

The debits and credits totals of the page are then written on the next page in the amount columns; and opposite to that on the left, the following words are written in the particulars column to indicate brought forward (of the amount of the previous page) "Total b/f". This process is repeated on every page and on the last page, "Grand Total" is cast.

3.3.1 Classification of Accounts



1. Personal Accounts

Accounts which are related with accounts of individuals, firms, companies are known as personal accounts. The personal accounts may further be classified into three categories:

(i) *Natural Personal Accounts*: Accounts of individuals relating to natural persons such as Akhil's A/c, Rajesh's A/c, Sohan's A/c are natural personal accounts.

(ii) *Artificial Personal Accounts*: Accounts of companies, institutions such as Reliance Industries Ltd; Lions Club, M/s Sham & Sons, National College account are artificial personal accounts. These exist only in the eyes of law.

(iii) *Representative Personal Accounts*: The accounts which represent some person such as wage outstanding account, prepaid insurance account, accrued interest account are considered as representative personal accounts.

2. Real Accounts

Real accounts are the accounts related to assets/properties. These may be classified into tangible real account and intangible real account. The accounts relating to tangible assets such as building, plant, machinery, cash, furniture etc. are classified as tangible real accounts. Intangible real accounts are the accounts related to intangible assets such as goodwill, trademarks, copyrights, franchisees, Patents etc.

3. Nominal Accounts

The accounts relating to income, expenses, losses and gains are classified as nominal accounts. For example Wages Account, Rent Account, Interest Account, Salary Account, Bad Debts Accounts.

RULES FOR DEBIT AND CREDIT

Type of Accounts		Rules for Debit	Rules for Credit
(a)	Personal Account	Debit the receiver	Credit the giver
(b)	Real Account	Debit what comes in	Credit what goes out
(c)	Nominal Account	Debit all expenses and losses	Credit all incomes and gains

Illustration: How will you classify the following into personal, real and nominal accounts?

(i) Investments

(ii) Freehold Premises

(iii) Accrued Interest

(iv) Punjab Agro Industries Corporation
(v) Janata Allied Mechanical Works
(vi) Salary Accounts
(vii) Loose Tools Accounts
(viii) Purchases Account
(ix) Indian Bank Ltd.
(x) Capital Account
(xi) Brokerage Account
(xii) Toll Tax Account
(xiii) Dividend Received Account
(xiv) Royalty Account
(xv) Sales Account

Solution

Real Account: (i), (ii), (vii), (viii), (xv).

Nominal Account: (vi), (ix), (xi), (xii), (xiii), (xiv)

Personal Account: (iii), (iv), (v), (x)

Journalizing

Journalism is the process of recording journal entries in the Journal. It is a systematic act of entering the transaction in a day book in order of their occurrence i.e., date-wise or event-wise. After analysing the business transactions, the following steps in journalising are followed:

(i) Find out what accounts are involved in business transaction.
(ii) Ascertain what is the nature of accounts involved?
(iii) Ascertain the golden rule of debit and credit is applicable for each of the accounts involved.
(iv) Find out what account is to be debited which is to be credited.
(v) Record the date of transaction in the "Date Column".

(vi) Write the name of the account to be debited very near to the left hand side in the 'Particulars Column' along with the word 'Dr' on the same line against the name of the account in the 'Particulars Column' and the amount to be debited in the 'Debit Amount column' against the name of the account.

(vii) Record the name of the account to be credited in the next line preceded by the word 'To' at a few space towards right in the 'Particulars Column' and the amount to be credited in the 'Credit Amount Column' in front of the name of the account.

(viii) Record narration (i.e. a brief explanation of the transaction) within brackets in the following line in 'Particulars Column'.

(ix) A thin line is drawn all through the particulars column to separate one Journal entry from the other and it shows that the entry of a transaction has been completed.

Illustration: Analyse the following transactions.

(a) Ramesh started his business with cash
(b) Borrowed from Nikhil
(c) Purchased furniture
(d) Purchased furniture from Mohan on credit
(e) Purchased goods for cash
(f) Purchased goods from Ram on credit
(g) Sold goods for cash
(h) Sold goods to Hari on credit
(i) Received cash from Hari
(j) Paid cash to Ram
(k) Deposited into bank
(l) Withdrew cash for personal use
(m) Withdrew from bank for office use
(n) Withdrew from bank for personal use
(o) Received cash from a customer, Shyam

(p) Paid salary by cheque

(q) Received donation in cash

(r) Paid to Ram by cheque

(s) Paid salary

(t) Paid rent by cheque

(u) Goods withdrawn for personal use

(v) Paid an advance to suppliers of goods

(w) Received an advance from customers

(x) Paid interest on loan

(y) Paid instalment of loan

(z) Interest allowed by bank.

Solution

ANALYSIS OF TRANSACTIONS

Transaction	Accounts involved	Nature of accounts	How affected	Whether to be debited or credited
(a)	Cash A/c	Real	Cash is coming in	Debit
	Capital A/c	Personal	Ramesh is the giver	Credit
(b)	Cash A/c	Real	Cash in coming in	Debit
	Loan from Nikhil A/c	Personal	Nikhil is the giver	Credit
(c)	Furniture A/c	Real	Furniture is coming in	Debit
	Cash A/c	Real	Cash is going out	Credit
(d)	Furniture A/c	Real	Furniture is coming in	Debit
	Mohan's A/c	Personal	Mohan is the giver	Credit
(e)	Purchases A/c	Real	Goods are coming in	Debit
	Cash A/c	Real	Cash is going out	Credit
(f)	Purchases A/c	Real	Goods are coming in	Debit
	Ram's A/c	Personal	Ram is the giver	Credit
(g)	Cash A/c	Real	Cash is coming in	Debit
	Sales A/c	Real	Goods are going out	Credit
(h)	Hari's A/c	Personal	Hari is the receiver	Debit
	Sales A/c	Real	Goods are going out	Credit
(i)	Cash A/c	Real	Cash is coming in	Debit
	Hari's A/c	Personal	Hari is the giver	Credit
(j)	Ram's A/c	Personal	Ram is the receiver	Debit
	Cash A/c	Real	Cash is going out	Credit
(k)	Bank A/c	Personal	Bank is the receiver	Debit
	Cash A/c	Real	Cash is going out	Credit
(l)	Drawings A/c	Personal	Ramesh is the receiver	Debit
	Cash A/c	Real	Cash is going out	Credit

Transaction	Accounts involved	Nature of accounts	How affected	Whether to be debited or credited
(m)	Cash A/c	Real	Cash is coming in	Debit
	Bank A/c	Personal	Bank is the giver	Credit
(n)	Drawings A/c	Personal	Ramesh is the receiver	Debit
	Bank A/c	Personal	Bank is the giver	Credit
(o)	Cash A/c	Real	Cash is coming in	Debit
	Shyam's A/c	Personal	Shyam is the giver	Credit
(p)	Salary A/c	Nominal	Salary is an expense	Debit
	Bank A/c	Personal	Bank is the receiver	Credit
(q)	Cash A/c	Real	Cash is coming in	Debit
	Donation A/c	Nominal	Donation is a gain	Credit
(r)	Ram's A/c	Personal	Ram is the receiver	Debit
	Bank A/c	Personal	Bank is the giver	Credit
(s)	Salary A/c	Nominal	Salary is an expense	Debit
	Cash A/c	Real	Cash is going out	Credit
(t)	Rent A/c	Nominal	Rent is an expense	Debit
	Bank A/c	Personal	Bank is the giver	Credit
(u)	Drawing's A/c	Personal	Ramesh is the receiver	Debit
	Purchases A/c	Real	Goods are going out	Credit
(v)	Advance to Suppliers A/c	Personal	Suppliers are the receivers	Debit
	Cash A/c	Real	Cash is going out	Credit
(w)	Cash A/c	Real	Cash is coming in	Debit
	Adv. from Customers A/c	Personal	Customers are the givers	Credit
(x)	Interest on Loan A/c	Nominal	Interest on loan is an expense	Debit
	Cash A/c	Real	Cash is going out	Credit
(y)	Loan A/c	Personal	Lender is the receiver	Debit
	Cash A/c	Real	Cash is going out	Credit
(z)	Bank A/c	Personal	Bank is the receiver	Debit
	Bank Interest A/c	Nominal	Bank Interest is a gain	Credit

Illustration: Prepare Journal in the books of K.K. Co. from the following transactions:

1999		Rs.	1999		Rs.
Dec. 1	Started business with a capital of	50,000	Dec. 15	Purchased goods from Ram	4,000
Dec. 6	Paid into bank	20,000	Dec. 18	Paid wages to workers	300
Dec. 8	Purchased goods for cash	4,000	Dec. 20	Recd. from Pankaj	1,000
				Allowed him discount Rs. 50	
Dec. 9	Paid to Ram	1,980	Dec. 22	Withdrawn from bank	3,000
Dec. 9	Discount allowed by him	20	Dec. 25	Paid Ram by cheque	500
Dec. 10	Cash sales	3,000	Dec. 31	Withdrawn for personal use	200
Dec. 12	Sold to Hari for cash	2,000			

Solution

IN THE BOOKS OF K.K. CO.

Journal

Date	Particulars		L.F.	Dr. Rs.	Cr. Rs.
1999					
Dec. 1.	Cash A/c	Dr.		50,000	
	To Capital A/c				50,000
	(Being business started with capital)				
6.	Bank A/c	Dr.		20,000	
	To Cash A/c				20,000
	(Being cash paid into bank)				
8.	Purchase A/c	Dr.		4,000	
	To Cash A/c				4,000
	(Being goods purchased for cash)				
9.	Ram A/c	Dr.		2,000	
	To Cash A/c				1,980
	To Discount Received A/c				20
	(Being cash paid to Ram and discount received Rs. 20)				
10.	Cash A/c	Dr.		3,000	
	To Sales A/c				3,000
	(Being goods sold for cash)				
12.	Cash A/c	Dr.		2,000	
	To Sales A/c				2,000
	(Being goods sold for cash)				
15	Purchases A/c	Dr.		4,000	
	To Ram A/c				4,000
	(Being goods purchased from Ram)				
18.	Wages A/c	Dr.		300	
	To Cash A/c				300
	(Being wages paid)				

20.	Cash A/c Dr. Discount Allowed A/c Dr. To Pankaj A/c (Being cash received from Pankaj and allowed him discount Rs. 50)		1,000 50	 1,050
22.	Cash A/c Dr. To Bank A/c (Being cash withdrawn from bank)		3,000	 3,000
25.	Ram A/c Dr. To Bank A/c (Being paid by cheque)		500	 500
31.	Drawings A/c Dr. To Cash A/c (Being withdrawn for personal use)		200	 200
	Grand Total		**90,050**	**90,050**

3.3.2 Goods Account

Generally, the term goods include every type of property such as Land, Building, Machinery, Furniture, Cloth etc. However, in accountancy its meaning is restricted to only those articles which are purchased by a businessman with an intention to sell it. For example, if a businessman purchased typewriter, it will be goods for him if he deals in typewriter but if he deals in other business say clothes then typewriter will be asset for him and clothes will be goods.

Sub-Division of Goods Accounts

The goods account is not opened in accounting books and it is to be noted goods includes purchases, sales, sales returns, purchases return of goods. However, purchase account, sales account, sales return account and purchase return account are opened in the books of account.

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

Sales Account: This account is opened for the goods sold on cash and credit.

Purchase Returns Account or Return Outward Account: This account is opened for the goods returned to suppliers.

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

Opening Entry

In case of going concern at the beginning of the new year, new books of accounts are opened and the balances relating to personal and real Accounts appearing in the books at the close of the previous year are brought forward in new books. The entry for this purpose in the books is called opening entry.

The opening entry is passed by debiting all assets and crediting all liabilities including capital. If the amount of capital is not given then this can be found out with the help of the accounting equation:

Assets = Liabilities + capital

Capital = Assets- Liabilities

Illustration: On 1st April 1998, Singh's assets and liabilities stood as follows:

Assets: Cash Rs. 6,000, Bank Rs. 17,000, Stock Rs. 3,000; Bills receivable 7,000; Debtors 3,000; Building 70,000; Investments 30,000; Furniture 4,000

Liabilities: Bills payable 5000, Creditors 9000, Ram's loan 13,000

Pass on opening Journal entry.

Date	Particulars		L.F.	Debit Amount	Credit Amount
1998					
April 1	Cash Account	Dr.		6,000	
	Bank Account	Dr.		17,000	
	Stock Account	Dr.		3,000	
	Bills receivable Account	Dr.		7,000	
	Debtors Account	Dr.		3,000	
	Building Account	Dr.		70,000	
	Investment Account	Dr.		30,000	
	Furniture	Dr.		4,000	
	To Bills payable Account				5,000
	To Creditor's Account				9,000
	To Ram's loan Account				13,000
	To Singh's capital				1,13,000
	(Being the opening balances of assets and liabilities)				
				1,40,000	1,40,000

3.4 IMPORTANT CONSIDERATIONS FOR RECORDING THE BUSINESS TRANSACTIONS

1. Trade Discount

Trade discount is usually allowed on the list price of the goods. It may be allowed by producer to wholesaler and by wholesaler to retailer for purchase of goods in large quantity. It is not recorded in the books of account and entry is made only with the net amount paid or received, for example, purchased goods of list price Rs. 8,000 at 15% trade discount from X. In this case the following entry will be passed:

		Rs.	Rs.
Purchases Account	Dr.	6,800	
To X			6,800

(Being goods purchased at 15% trade discount Less list price)

2. Amount paid or received in full settlement or cash discount

Cash discount is a concession allowed by seller to buyer to encourage him to make early cash payment. It is a Nominal Account. The person who allows discount, treat it as an expenses and debits is his books and it is called discount allowed and the person who receives discount, treat as an income and it is called discount received and credits in his books of account “Discount Received Account.” For example, X owes Rs. 6,000 to Y. He pays Rs. 5,950 in full settlement against the amount due. In the books of X the journal entry will be:

		Rs.	Rs.
Y	Dr.	6,000	
To Cash Account			5,950
To Discount Received account			50

(Being Cash paid and discount received)

In the books of Y		Rs.	Rs.
Cash Account	Dr.		5,950
Discount Allowed Account	Dr.		50
To X			6,000

(Being cash received and discount allowed)

3. Goods distributed as free samples

Some times business distributes goods as free samples for the purpose of advertisement. In this case Advertisement Account is debited and Purchases Accounts is credited. For example, goods costing Rs. 8000 were distributed as free sample. to record this transactions following entry will be passed:

		Rs.	Rs.
Advertisement Account	Dr.	8,000	
To Purchases Account			8,000

4. Interest on capital

Interest paid on capital is an expense. Therefore interest account should be debited. On the other hand the capital of the business is increases. So the capital account should be credited. The entry will be as follows:

Interest on Capital Account	Dr.
To Capital Account	

5. Interest charged on Drawings

If the interest is charged on drawings then it will be an increase in the income of business, so interest on drawings will be credited. On the other hand there will be increase in Drawings or decrease in Capital. So Drawings Account will be debited. To record this, following entry will be passed:

Drawing Account or	Dr.
Capital Account	Dr.
To Interest on Drawing Account	

6. Depreciation charged on Fixed Assets

Depreciation is the gradual, permanent decrease in the value of an assets due to wear and tear and many other causes. Depreciation is an expense so the following entry will be passed:

Depreciation Account	Dr.
To Asset Account	

7. Bad Debts

Sometimes a debtor of business fails to pay the amount due from him. Reasons may be many e.g. he may become insolvent or he may die. Such irrecoverable amount is a loss to the business. To record this following entry will be passed:

Bad Debts Account Dr.
To Debtor's Account

8. Bad Debts Recovered

When any amount becomes irrecoverable from any costumer or debtor his account is closed in the books. If in future any amount is recovered from him then his personal account will not be credited because that does not exist in the books. So the following entry is passed:

Cash Account Dr.
To Bad Debts Recovered Account

9. Purchase and Sale of investment

When business has some surplus money it may invest this amount is shares, debentures or other types of securities. When these securities are purchased, these are recorded at the purchase price paid. At the time of sale of investment the sale price of an investment is recorded in the books of accounts. The following entry is passed to record the purchase of investment:

Investment Account Dr.
To Cash Account

In case of sale of these securities the entry will be:

Cash Account Dr.
To Investment Account

10. Loss of Goods by Fire/Accident/theft

A business may suffer loss of goods on account of fire, theft or accident. It is a business loss and a nominal account. It also reduces the goods at cost price, and increases the loss/expenses of the business. The entry will be passed as:

Loss by fire/Accident/theft Account	Dr (for loss)
Insurance Company Account	Dr. (for insurance claim admitted)
To Purchases Account	

11. Income Tax Paid

Income Tax paid should be debited to Capital Account or Drawings Account and credited to cash Account in case of sole proprietorship and partnership firms. The reason behind this is that income tax is a personal expense for the sole trader and partners because it is paid on income of proprietor. The entry will be as follows:

Capital Account	Dr.
Drawing Account	Dr.
To Cash Account	

12. Bank Charges

Bank provide various services to their customers. Bank deducts some charges by debiting the account of customers. It is an expenses for the business. To record this following entry will be passed in the books of businessman/customer:

Bank Charges Account	Dr.
To Bank Account	

13. Drawings Account

It is a personal account of the proprietor. When the businessman withdraws cash or goods form the business for his personal/domestic use it is called as 'drawings'. Drawings reduce the capital as well as goods/cash balance of the business. The journal entry is:

Drawings Account Dr.
To Cash Account
To Purchases Account

14. Personal expenses of the proprietor

When the private expenses such as life insurances premium, income tax, home telephone bill, tuition fees of the son of the proprietor etc. are paid out of the cash or bank account of business it should be debited to the Drawing Account of the proprietor. The journal entry is:

Capital/Drawings Account Dr.
To Cash/Bank

15. Sale of Asset/Property

When the asset of a business is sold, there may occur a profit or loss on its sale. It should be noted carefully that sales account is never credited on the sale of asset. The journal entry is:

(i) In case there is a profit on sale of Property/Assets

Cash/Bank Account Dr.
To Asset/Property Account
To Profit on sale of Asset Account

(ii) In case of a loss on sale of asset

Cash/Bank Account Dr.
Loss on sale of Asset Account Dr.

To Asset Account

16. Amount paid or Received on behalf of customer

(i) When the business entity pays the amount on behalf of old reputed customers such as carriage in anticipation of recovering the same later on, carriage account should not be opened because carriage is not the expense of the seller. It should be debited/charged to customer's Personal account. The journal entry is:

Customer/Debtor's Account Dr.
To Cash/Bank Account

(ii) When the business entity receives the amount on behalf of customers from the third party as mutually settled between the third party and the customer, the account of the third party/person making the payment should not be opened in the books of the receiving entity. The journal entry in the books of the entity is:

Cash/Bank Account Dr.
To Customer/Debtor's Account

17. Amount paid on behalf of creditors

When the creditors/supplier instructs the business entity to make payment on their behalf, the amount so paid should be debited to creditors account and liability of the business will decrease accordingly. The journal entry is:

Suppliers/Creditors Account Dr.
To Cash/Bank Account

18. The events affecting business but they do not involve any transfer/exchange of money for the time being, they would not be recorded in the financial books. Examples of them are:

(i) On 1st January 2006 placed on order to Geeta & Sons for the supply of goods worth Rs. 1,00,000.

(ii) Babanjot, a B.Com. graduate has been appointed Sales Assistant on a salary of Rs. 5,000 p.m. on Jan., 2006.

(iii) Raman, a proprietor contracted with Bahia Builders Ltd. for the renovation of the building at an estimated cost of Rs. 5,00,000.

(iv) A shop in Adalt Bazar Patiala contracted to be taken on a rent @ Rs. 4,000 pm.

19. Paid wages/installation charges for erection of machinery

Wages and installation charges are the expenses of nominal nature. But for erection of machinery no separate account should be opened for such expenses because these expenses are of capital nature and it will be merged/debited to the cost of assets i.e. machinery. The journal entry is:

Machinery Account Dr.

To Cash/Bank Account

(Being wages/installation charges paid for the erection of machinery)

Illustration: Journalise the following transactions for the month of January 2006:

2006

Jan.1 Invested in shares of Tata Cotton Mills Ltd. and paid for the same in cash Rs. 2,000.

2 Placed on order with Mr. Shah for goods to be received a month later Rs. 1,500.

3 Invoiced goods to Mr. Love worth Rs. 1,000 and allowed a trade discount of 2 per cent.

4 Carriage Rs. 25 and freight Rs. 70 were paid by the proprietor for

the above goods but which are to be charged to Mr. Love Account.

5 Paid rent to landlord of office premises- Rs. 150, which he spent on purchase of our goods.

6 Goods valued at Rs. 700 were delivered to Ahmedabad Merchants under instructions from Mr. Gobind. They were to be charged to the latter's Account.

7 Mr. Love paid Rs. 500 due from him, and the same was spent on purchasing goods from Mr. Deepu.

8 Sold one old motor car belonging to the proprietor for Rs. 5,000 and the amount was invested in the business.

9 The proprietor paid Rs. 180 in full settlement of Mr. Manpreet for goods worth Rs. 200 purchased by him for personal use.

10 Mr. Gobind was declared insolvent and paid Rs. 450 in full settlement. The balance Rs. 250 was written off as a bad debt.

11 Mohinder our debtors, on our advice, directly paid Narinder, our creditor Rs. 2,000.

Solution

JOURNAL

Date	Particulars		L.F.	Dr. Rs.	Cr. Rs.
2006					
Jan. 1	Investment Account	Dr.		2,000	
	To Cash Account				2,000
	(Being purchase of shares of Tata Cotton Mills Ltd. paid in cash)				
2	No entry is passed as "placing of an order is not a business transaction."				
3	Mr. Love's Account	Dr.		980	
	To Sales Account				980
	(Being the entry for credit sale of goods to Mr. Love at a trade discount of 2%)				

4.	Mr. Love's Account Dr. To Cash Account (Being payment of freight and carriage on behalf of Mr. Love)		95	 95
5	Rent Account Dr. To Sales Account (Being rent paid to the landlord in the form of goods, instead of in cash)		150	 150
6	Mr. Gobind Account Dr. To Sales account (Being goods sold to Mr. Govind but delivered to A. Merchants as per instructions)		700	 700
7	Cash Account Dr. To Love's Account (Being in amount received in cash from Love)		500	 500
7	Purchases Account Dr. To Cash Account (Being entry for goods purchased from Mr. Deepu from in cash received from Love)		500	 500
8	Cash Account Dr. To Proprietor's Capital Account (Being amount invested in business out of the sale process of the owner's personal car)		5,000	 5,000
9	Proprietor's Capital Account/Drawing A/c Dr. To Cash Account (Being the amount paid to Manpreet for goods purchased for his personal use)		180	 180

10	Cash Account Dr. Bad Debts Account Dr. To Gobind's Account (Being the amount received from Gobind in full settlement of his debts)		450 250	 700
11	Narinder Dr. To Mohinder (Being cash paid by Mohinder to Narinder)		2,000	 2,000

3.5 SUMMARY

An accounting process is a complete sequence of accounting procedures which are repeated in the same order during each accounting period. Accounting process involves six steps or stages i.e. identification of transactions, recording the transaction, classifying, summarising, analysis and interpretation and reporting of financial information. In accounting, all the transactions are recorded on the basis of evidence/document which are mainly three– (i) payment voucher; (ii) receipt voucher; and (iii) transfer voucher. Recording the transaction is the first step in the process of accounting which is performed in the book called 'Journal'. Journal is a primary book for recording the day to day transactions in a chronological order, i.e., the order in which they occur. The process of recording journal entries in the journal is called journalising. For the journalising, all the accounts are classified into three categories namely personal account; real account; and nominal account.

3.6 KEYWORDS

Bad Debt: Debt owned to an enterprise which is considered to be irrecoverable.

Capital: It refers to the interest of owners in the assets of an enterprise.

Depreciation: Decrease in the value of fixed assets.

Trade Discount: Reduction on print prices of goods.

Cash Discount: A reduction granted by a supplier from the invoiced price in consideration of payment with in a stipulated period.

3.7 SELF ASSESSMENT QUESTIONS

1. "Recording of transaction is an important step in accounting process" Comment.

2. What is Journal? Distinguish between Journal and Journalising.

3. How you will classify the accounts? State the rules of journalising with respect to each class of accounts.

4. What will be the Journal entry in the following cases:
   (i) Loss of goods by theft
   (ii) Loss of cash from the cash box
   (iii) Sale and purchase of investments
   (iv) Goods taken by the proprietor for his private use.
   (v) Amount paid/received on behalf of others by the business entity
   (vi) Satinder, a marketer appointed at a salary of Rs. 3000 p.m.

5. Mr. Ravindra's position as on 1st Jan. 1999 is follows:

   Property and Assets: Buildings Rs. 15,000
   Furniture Rs. 1,500.
   Stock of Goods Rs. 20,000
   Cash at Bank Rs. 5,000

	Cash in hand Rs. 1,000, and
	Customer's Accounts Rs. 15,000.
Liabilities:	Suppliers Accounts Rs. 12,500 and
	Loan Account Rs. 30,000.

Pass necessary entries to record the above.

6. Miss Twinkle Punia started a restaurant investing Rs. 5,00,000 on Jan. 1, 2000 and further submits the details of the transactions:

2006

Jan.5: She purchased furniture for Rs. 2,75,000; Crockery Rs. 75,000 and cooking utensils Rs. 38,000

Jan. 10: She paid Rs. 1,00,000 as Salami for taking the shop on lease for ten years at Daryaganj, Delhi.

Jan. 15: She took a temporary loan of Rs. 75,000 from her brother Rupinder, a financier.

Jan. 25: She took a bank loan of Rs. 50,000 and repaid the loan taken from her brother, Rupinder partly.

Jan. 31: She appointed Lavina as a manager at a salary of Rs. 5000 p.m. and took from her a security deposit of Rs. 50,000.

Pass Journal entire in the books of Twinkle Punia.

7. Are the following entries correctly made by an Accountant Gurudev. If not give the correct entries:

			Rs.	**Rs.**
a)	Cash Account	Dr.	4,200	
	To Anil Kumar Account			4,200
	(Received cash from Ajit Kumar on behalf of his friend Ramesh Chandra)			
b)	Goods Account	Dr.	3,000	
	To Dinesh Singh Account			3,000
	(Bought goods from Dinesh Singh for cash)			

c)	Salary Account	Dr.	450	
	To Gopal Krishan Account			450
	(Paid salary to Gopal Krishan)			
d)	Landlord Account	Dr.	600	
	To Bank Account			600
	(Paid rent to Landlord by cheque)			
e)	Furniture Account	Dr.	1150	
	To Cash Account			150
	(Paid for repairs of Furniture)			

8. Journalise the following transactions:

2006			Rs.
July	2	Commenced business with Cash	25,000
	4	Purchased furniture for cash	2,000
	4	Cash purchases	14,500
	7	Bought of Somal	2,600
	7	Sold of Monica	808
	9	Rent for two years paid in advance	2,400
	9	Drawings by the proprietor for household expenses	400
	9	Goods taken out by the proprietor for domestic use	50
	9	Cash withdrawn from Bank	2,700
	10	Sold to Manohar	985
	11	Purchases made, payment through cheque	290
	14	Cash received from Popli on account	1,000
	14	Cash paid to Somal after deduction of discount Rs.130	2,470
	17	Cash received from Manohar in full settlement of his account	975
	18	Monica becomes insolvent. A dividend of Rs. 50 paise in a rupee is received.	404

18	Purchase of a scooter for cash	13,000
20	Sold goods to Amrik	864
20	Sold to Neena	378
24	Electricity bill paid	510
24	Cartage paid in cash	5
24	Repairs to scooter, payment not yet made	17
26	Payment of cash for petrol	115
26	Purchases of goods for cash	1,200
26	Purchases of office equipment for cash	1,250
27	Repairs bill paid in cash	17
28	Amrik returns goods	40
31	Depreciation of furniture	110
31	Depreciation of Scooter	220
31	Adjustment for the month's rent	180
31	Bank charges for the month	5
31	Interest on capital for the month	125
31	Salary to be credited to proprietor	200
31	Sonal agrees to take some defective goods purchased from him and immediately refunds the money.	70

9. Journalise the following transactions:

(i) Paid by cheque fire insurance premium Rs. 327

(ii) Paid by cheque proprietor's life insurance premium Rs. 210

(iii) Paid by cheque A's bill for repairs to machinery Rs. 265

(iv) Drew a cheque for pretty cash Rs. 120.

(v) Sent our acceptance at two months for Rs. 735 to M.

(vi) Bill payable due this day met at bank Rs. 330.

(vii) Received B/s acceptance for Rs. 780 from A is settlement of latter's account for Rs. 800

(viii) Discounted N's acceptance for Rs. 585 at Rs. 570
(ix) Sold goods to Murthi and he endorsed M's bill to us.
(x) Bank collected interest on our investments Rs. 95
(xi) Received dividend on shares of A & Co. Ltd. Rs. 137
(xii) Received a cheque for Rs. 93 for commission due to us.
(xiii) Invested in Government securities Rs. 5,000
(xiv) Bought shares in Best & Co. Ltd. for Rs. 3,000
(xv) Purchased Plant and Machinery for Rs. 15,500.
(xvi) Interest allowed by bank on our current account Rs. 15
(xvii) Bank charges made by bank Rs. 17
(xviii) Paid for an insertion in "The Hindu" Rs. 15
(xix) Bought goods from Seth & Co. for Rs. 750 accepted their bill for Rs. 500 Rs. 500 and gave them a cheque for Rs. 250
(xx) Sold goods to John and Co. for Rs. 650, received their acceptance for Rs. 500 and gave them a cheque for Rs. 250.
(xxi) Returned goods to A.A. Rs. 75
(xxii) B.B. returned goods to us Rs. 94
(xxiii) Bought of C & Co., goods for cash Rs. 500
(xxiv) Received dividend on shares Rs. 55.
(xxv) Bought Prize Bonds of Indian Government for Rs. 150.
(xxvi) Bought National Savings Certificates for Rs. 100
(xxvii) Paid by cheque A. Anand's bills for repairs to machinery Rs.120.
(xxviii) Received a cheque for Rs. 350 from B. Balu to be credited to M. Mani's account.
(xxvix) Received from D. Datta Rs. 970.
(xxx) Paid d. Data's cheque into the bank.
(xxxi) Bank returned D. Datta's cheque dishonoured.

(xxxii) Borrowed for the bank Rs. 5,0000.

(xxxiii) Repaid M's loan of Rs. 500 with interest Rs. 25.

3.8 REFERENCES/SUGGESTED READINGS

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Subject: **Financial Accounting-I**	
Course Code: **BBA-104**	Author: **Dr. Karam Pal Singh**
Lesson: **4**	Vetter:

LEDGER POSTING AND TRIAL BALANCE

STRUCTURE

4.0 OBJECTIVES

After going through this lesson, you should be able to-

- Know meaning and importance of ledger.
- Understand the rules regarding posting.
- Know balancing of an account.
- Know meaning and objectives of trial balance.

4.1 INTRODUCTION

It has already been discussed in earlier lesson that accounting involves recording, classifying and summarising the financial transactions. Recording is made in Journal, which has been explained in the preceding lesson. Classification of the recorded transactions is made in the ledger. This is being discussed in the present lesson.

Ledger is a book which contains various accounts. In simple words, ledger is a set of accounts. It includes all accounts of the business enterprise whether Real, Nominal or Personal. Ledger may be kept in any of the following two forms:

- Bound Ledger; and
- Loose Leaf Ledger.

It is common to keep the ledger in the form of loose-leaf cards these days instead of keeping them in bounded form. This helps in posting transactions particularly when mechanised system of accounting is used. Interestingly, nowadays, mechanised system of accounting is preferred over the manual system of accounting.

4.2 POSTING

The term 'Posting' means transferring the debit and credit items from the Journal to their respective accounts in the ledger. It is important to note that the exact names of accounts used in the Journal should be carried to the ledger. For example:

If in the Journal, Salary Account has been debited, it would not be correct to debit the Outstanding Salary Account in the Ledger. Therefore, the correct course would be to use the same account in both the Journal and Ledger.

Ledger posting may be done at any time. However, it must be completed before the annual financial statements are prepared. It is advisable to keep the more active accounts posted upto date. The examples of such accounts are the cash account, personal accounts of various parties, etc.

The Ledger posting may be made by the book-keeper from the Journal to the Ledger by any of the following methods:

- He may take a particular side first. For example, he may take the debits first and make the complete postings of all debits from Journal to the Ledger.
- He may take a particular account first and post all debits and credits relating to that account appearing on one particular page of Journal. He may then take some other account and follow the same procedure.
- He may complete posting of each journal entry before proceeding to the next entry.

It is advisable to follow the last method. Further, one should post each debit and credit item as it appears in the Journal.

The Ledger Folio (L.F.) column in the Journal is used at the time when debits and credits are posted to the Ledger. The page number of the Ledger on which the posting has been done is mentioned in the L.F. Column of the Journal. Similarly a folio column in the Ledger can also be kept where the page from which posting has been made from the Journal. Thus, these are cross references in both the Journal and the Ledger. A proper index must be maintained in the Ledger giving the names of the accounts and the page number. A specimen of Ledger is given below:

DALMIA'S A/C

Dr. Cr.

Date	Particular	J.F.	Amount (Rs.)	Date	Particular	J.F.	Amount (Rs.)

All entries relating to Dalmia's A/c shall be posted in this specimen a/c and finally the balance either debit or credit may be drawn. All rules regarding the posting must strictly be followed.

4.2.1 Rules Regarding Posting

The following rules must be observed while posting transactions in the Ledger from the Journal:

i) Separate accounts should be opened in the Ledger for posting transactions relating to different accounts recorded in the Journal. For example, separate accounts may be opened for sales, purchases, sales returns, purchases returns, salaries, rent, cash, etc.

ii) The concerned account which has been debited in the Journal should also be debited in the Ledger. However, a reference should be made of the other account which has been credited in the Journal. For example, for salaries paid, the salaries account should be debited in the Ledger, but reference should be given of the Cash Account which has been credited in the Journal.

iii) The concerned account, which has been credited in the Journal; should also be credited in the Ledger, but reference should be given of the account, which has been debited in the Journal. For example, for salaries paid, Cash Account has been credited in the Journal. It will be credited in the Ledger also, but reference will be given of the Salaries Account in the Ledger.

Thus, it may be concluded that while making posting in the Ledger, the concerned account which has been debited or credited in the Journal should also be debited or credited in the Ledger, but reference has to be given of the other account which has been credited or debited in the Journal, as the case may be. This will be clear with the following example:

Suppose salaries of Rs. 10,000 have been paid in cash, the following entry will be passed in the Journal:

Salaries Account	Dr.	10,000	
To Cash Account			10,000

In the Ledger two accounts will be opened (i) Salaries Account, and (ii) Cash Account. Since Salaries Account has been debited in the Journal, it will also be debited in the Ledger. Similarly Cash Account has been credited in the Journal and, therefore, it will also be credited in the Ledger, but reference will be given of the other account involved. Thus, the accounts will appear as follows in the Ledger:

SALARIES ACCOUNT

Dr. Cr.

Cash A/c (i)	Rs. 10,000		

CASH ACCOUNT

Dr. Cr.

		Salaries A/c (ii)	Rs. 10,000

Use of the words "To" and "By": It is customary to use words 'To' and 'By' while making posting in the Ledger. The word 'To' is used with the accounts which appear on the debit side of a Ledger Account. For example in the Salaries Account, instead of writing only "Cash" as shown above, the words "To Cash" will appear on the debit side of the account. Similarly, the word "By" is used with accounts which appear on the credit side of a Ledger Account. For example in the above case, the words "By Salaries A/c" will appear on the credit side of the Cash Account instead of only "Salaries A/c". The words 'To' and 'By' do not have any specific meanings. Modern accountants are, therefore, ignoring the use of these words.

4.2.2 Balancing of an Account

In business, there may be several transactions relating to one particular account. In Journal, these transactions appear on different pages in a chronological order while they appear in a classified form under that particular account in the Ledger. At the end of a period (say a month, a quarter or a year), the businessman will be interested in knowing the position of a particular account. This means, he should total the debits and credits of his account separately and find out the net balance. This technique of finding out the net balance of an account, after considering the totals of both debits and credits appearing in the account is known as 'Balancing the Account'. The balance is put on the side of the account which is smaller and a reference is given that it has been carried forward or carried down (c/f or c/d) to the next period. On the other hand, in the next period a reference is given that the opening balance has been brought forward or brought down (b/f or b/d) from the previous period. This will be clear with the help of the following illustration.

Illustration 1: Journalise the following transactions, post them in the Ledger and balance the accounts as on 31st March, 2006.

1. Ram started business with a capital of Rs. 10,000.
2. He purchased goods from Mohan on credit Rs. 2,000.
3. He paid cash to Mohan Rs. 1,000.
4. He sold goods to Suresh Rs. 2,000.
5. He received cash from Suresh Rs. 3,000.
6. He further purchased goods from Mohan Rs. 2,000.
7. He paid cash to Mohan Rs. 1,000.
8. He further sold goods to Suresh Rs. 2,000.
9. He received cash from Suresh Rs. 1,000

Solution

JOURNAL

Date	Particulars		L.F.	Debit Amount (Rs.)	Credit Amount (Rs.)
	Cash Account	Dr.		10,000	
	To Capital Account				10,000
	(Being commencement of business)				
	Purchase Account	Dr.		2,000	
	To Mohan				2,000
	(Being purchase of goods on credit)				
	Mohan	Dr.		1,000	
	To Cash				1,000
	(Being payment of cash to Mohan)				
	Suresh	Dr.		2,000	
	To Sales				2,000
	(Being good sold to Suresh)				
	Cash Account	Dr.		3,000	
	To Suresh				
	(Being cash received from Suresh)				3,000
	Purchases Account	Dr.		2,000	
	To Mohan				
	(Being purchase of goods from Mohan)			2,000	
	Mohan	Dr.		1,000	
	To Cash Account				
	(Being payment of cash to Mohan)				1,000
	Suresh	Dr.		2,000	
	To Sales Account				
	(Being goods sold to Suresh)				2,000
	Cash Account	Dr.		1,000	
	To Suresh				
	(Being cash received from Suresh)				1,000
				24,000	24,000

LEDGER

CASH ACCOUNT

Dr. Cr.

Date	Particular	Amount Rs.	Date	Particular	Amount Rs.
	To Capital A/c	10,000		By Mohan	1,000
	To Suresh	3,000		By Mohan	1,000
	To Suresh	1,00		By Balance c/d	12,000
		14,000	Mar. 31		14,000
April 1	To Balance b/d	12,000			

CAPITAL ACCOUNT

		Rs.			Rs.
Mar. 31	To Balance c/d	10,000		By Cash A/c	10,000
		10,000			10,000
			Apr. 1	By Balance b/d	10,000

PURCHASE ACCOUNT

		Rs.			Rs.
	To Mohan	2,000	March. 31	By Balance c/d	4,000
	To Mohan	2,000			
		4,000			4,000
April 1.	To Balance b/d	4,000			

MOHAN

		Rs.			Rs.
	To Cash	1,000		By Purchases	2,000
	To Cash	1,000		By Purchases	2,000
	To Balance c/d	2,000			
		4,000			4,000
			Apr. 1	By Balance b/d	2,000

SURESH

		Rs.			Rs.
	To Sales	2,000		By Cash A/c.	3,000
	To Sales	2,000		By Cash A/c.	1,000
		4,000			4,000

SALES ACCOUNT

		Rs.			Rs.
Mar. 31	To Balance c/d	4,000		By Suresh	2,000
				By Suresh	2,000
		4,000			4,000
			April. 1	By Balance b/d	4,000

It is to be noted that the balance of an account is always known by the side which is greater. For example, in the above illustration, the debit side of the Cash Account is greater than the credit side by Rs. 12,000. It will be therefore said that Cash Account is showing a debit balance of Rs. 12,000. Similarly, the credit side of the Capital Account is greater than debit side by Rs. 10,000. It will be, therefore, said that the Capital Account is showing a credit balance of Rs. 10,000.

4.3 TRIAL BALANCE

In case, the various debit balances and the credit balances of the different accounts are taken down in a statement, the statement so prepared is termed as a 'Trial Balance'. In other words, Trial Balance is a statement containing the various ledger balances on a particular date. For example, with the balances of the ledger accounts prepared in Illustration 1. The Trial Balance can be prepared as follows:

Thus, the two sides of the Trial Balance tally. It means the books of accounts are arithmetically accurate.

4.3.1 Objectives of Preparing a Trial Balance

(i) Checking of the arithmetical accuracy of the accounting entries

As indicated above, Trial Balance helps in knowing the arithmetical accuracy of the accounting entries. This is because according to the dual aspect concept for every debit, there must be an equivalent credit. Trial Balance represents a summary of all ledger balances and, therefore, if the two sides of the Trial Balance tally, it is an indication of this fact that the books of accounts are arithmetically accurate. Of course, there may be certain errors in the books of accounts in spite of an agreed Trial Balance. For example, if a transaction has been completely omitted, from the books of accounts, the two sides of the Trial Balance will tally, in spite of the books of accounts being wrong. This has been discussed in detail later in a separate Chapter.

(ii) Basis for financial statements

Trial Balance forms the basis for preparing financial statements such as the Income Statement and the Balance Sheet. The Trial Balance represents all transactions relating to different accounts in a summarised form for a particular period. In case, the Trial Balance is not prepared, it will be almost impossible to prepare the financial statements as stated above to know the profit or loss made by the business during a particular period or its financial position on a particular date.

(iii) Summarised ledger

It has already been stated that a Trial Balance contains the ledger balances on a particular date. Thus, the entire ledger is summarised in the form of a Trial Balance. The position of a particular account can be judged simply by looking at the Trial Balance. The Ledger may be seen only when details regarding the accounts are required.

Illustration 2: Journalise the following transactions in the books of trade. Also make their Ledger Postings and prepare a Trial Balance.

Debit Balances as on Jan. 1, 2006: Cash in hand Rs. 8,000; Cash at Bank Rs. 25,000; Stock of goods Rs. 20,000; Furniture Rs. 2,000; Building Rs. 10,000; Sundry Debtors-Vijay Rs. 2,000, Anil Rs. 1,000 and Madhu Rs. 2,000.

Credit Balances on Jan. 1, 2006: Sundry Creditors- Anand Rs. 5,000; Loan from Bablu Rs. 10,000.

The following were further transactions in the month of Jan, 2006:

Jan. 1: Purchased goods worth Rs. 5,000 for cash less 20% trade discount and 5% cash discount.

Jan. 4: Received Rs. 1,980 from Vijay and allowed him Rs. 20 as discount.

Jan. 6: Purchased goods from Bharat Rs. 5,000.

Jan. 8: Purchased plant from Mukesh for Rs. 5,000 and paid Rs. 100 as cartage for bringing the plant to the factory and another Rs. 200 as installation charges.

Jan. 12: Sold goods to Rahim on credit Rs. 600.

Jan. 15: Rahim became insolvent and could pay only 50 paise in a rupee.

Jan. 18: Sold goods to Ram for cash Rs. 1,000

Jan. 20: Paid salary to Ratan Rs. 2,000

Jan. 21: Paid Anand Rs. 4,800 in full settlement.

Jan. 26: Interest received from Madhu Rs. 200

Jan. 28: Paid to Bablu interest on Loan Rs. 500

Jan. 31: Sold goods for cash Rs. 500

Jan. 31: Withdraw goods from business for personal use Rs. 200

Solution

JOURNAL

Date	Particulars		L.F.	Debit (Rs.)	Credit (Rs.)
2006					
Jan. 1	Cash A/c	Dr.		8,000	
	Bank A/c	Dr.		25,000	
	Stock A/c	Dr.		20,000	
	Furniture A/c	Dr.		2,000	
	Building A/c	Dr.		10,000	
	Vijay	Dr.		2,000	
	Anil	Dr.		1,000	
	Madhu	Dr.		2,000	
	To Anand				5,000
	To Bablu's Loan A/c				10,000
	To Capital A/c				55,000
	(Being balances brought forward from last year)				
Jan.1	Purchase A/c	Dr.		4,000	
	To Cash A/c				3,800
	To Discount A/c				200
	(Being purchase of goods on discount)				
Jan. 4	Cash A/c	Dr.		1,980	
	Discount A/c	Dr.		20	
	To Vijay				2,000
	(Being cash received from Vijay, allowed discount Rs. 20)				
	Total carried forward (C/F)			76,000	76,000

	Total brought forward (B/F)			76,000	76,000
Jan. 6	Purchase A/c	Dr.		5,000	
	To Bharat				5,000
	(Being goods purchased)				
Jan. 8	Plant A/c	Dr.		5,300	
	To Mukesh				5,000
	To Cash A/c				300
	(Being plant purchased and payment of charges of Rs. 300)				
Jan. 12	Rahim		Dr.	600	
	To Sales A/c				600
	(Being sale of goods to Rahim)				
Jan. 15	Cash A/c	Dr.		300	
	Bad Debts A/c	Dr.		300	
	To Rahim				600
	(Being cash received from Rahim) 50 paise in a rupee				
Jan. 18	Cash A/c	Dr.		1,000	
	To Sales A/c				1,000
	(Being cash sale)				
Jan. 20	Salary A/c	Dr.		2,000	
	To Cash A/c				2,000
	(Being salary paid)				
Jan. 21	Anand	Dr.		5,000	
	To Cash A/c				4800
	To Discount A/c				200
	(Being cash paid to Anand and discount received Rs. 200)				
Jan. 26	Cash A/c	Dr.		200	
	To interest A/c				200
	(Being receipt of interest)				
	Total carried forward (C/F)			95,700	95,700

	Total brought forward (B/F)			95,700	95,700
Jan. 28	Interest on Loan	Dr.		500	
	To cash A/c				500
	(Being payment of interest on loan)				
Jan. 31	Cash A/c	Dr.		500	
	To Sales A/c				500
	(Being cash sale)				
Jan. 31	Drawings A/c	Dr.		200	
	To Purchase A/c				200
	(Being goods withdrawn for personal use)				
	Total			96,900	96,900

Ledger Posting

CASH ACCOUNT

Dr. Cr.

Date	Particulars	L.F.	Amount (Rs.)	Date	Particular	L.F.	Amount (Rs.)
2006				2006			
Jan.1	To Balance b/d		8,000	Jan.1	By Purchase A/c		3,800
Jan.4	To Vijay		1,980	Jan. 8	By Plant A/c		300
Jan.15	To Rahim		300	Jan.20	By Salary A/c		2,000
Jan.18	To Sales A/c		1,000	Jan.21	By Anand		4,800
Jan. 26	To Interest A/c		200	Jan. 28	By Interest on loan A/c		500
Jan. 31	To Sales A/c		500	Jan. 31	By Balance c/d		580
			11,980				11,980
Feb. 1	To Balance b/d		580				

INTEREST ACCOUNT

Dr. Cr.

Jan. 31	To Balance c/d	200	Jan. 26	By Cash A/c	200
		200			200
			Feb. 1	By Balance b/d	200

BANK ACCOUNT

Dr. Cr.

Jan. 1	To Balance b/d	25,000	Jan. 31	By Balance c/d	25,000
		25,000			25,000
Feb. 1.	To Balance b/d	25,000			

STOCK ACCOUNT

Dr. Cr.

Jan.1	To Balance b/d	20,000	Jan. 31	By Balance c/d	20,000
		20,000			20,000
Feb. 1	To Balance b/d	20,000			

FURNITURE ACCOUNT

Dr. Cr.

Jan. 1	To Balance b/d	2,000	Jan. 31	By Balance c/d	2,000
		2,000			2,000
Feb. 1	To Balance b/d	2,000			

BUILDING ACCOUNT

Dr. Cr.

Jan. 1	To Balance b/d	10,000	Jan. 31	By Balance c/d	10,000
		10,000			10,000
Feb. 1	To Balance b/d	10,000			

VIJAY ACCOUNT

Dr. Cr.

Jan. 1.	To Balance b/d	2,000	Jan. 4	By Cash A/c	1,980
				By Discount A/c	20
		2,000			2,000

ANIL ACCOUNT

Dr. Cr.

Jan. 1.	To Balance b/d	1,000	Jan. 31	By Balance	1,000
		1,000			1,000
Feb. 1	To Balance b/d	1,000			

MADHU ACCOUNT

Dr. Cr.

Jan. 1.	To Balance b/d	2,000	Jan. 31	By Balance c/d	2,000
		2,000			2,000
Feb. 1	To balance b/d	2,000			

ANAND ACCOUNT

Dr. Cr.

Jan. 21	To Cash A/c	4,800	Jan. 1	By Balance b/d	5,000
Jan. 21	To Discount A/c	200			
		5,000			5,000

CAPITAL ACCOUNT

Dr. Cr.

Jan. 31.	To Balance c/d	55,000	Jan. 1	By Balance b/d	55,000
		55,000			55,000
			Feb. 1	By Balance b/d	55,000

BABU'S LOAN ACCOUNT

Dr. Cr.

Jan. 31.	To Balance c/d	10,000	Jan. 1	By Balance b/d	10,000
		10,000			10,000
			Feb. 1	By Balance b/d	10,000

PURCHASE ACCOUNT

Dr. Cr.

Jan. 1.	To Cash A/c	3,800	Jan. 31	By Drawings A/c	200
Jan. 1	To Discount A/c	200	Jan. 31	By Balance c/d	8,800
Jan. 6	To Bharat	5,000			
		9,000			9,000
Feb. 1.	To Balance b/d	8,800			

DISCOUNT ACCOUNT

Dr. Cr.

Jan. 4.	To Vijay	20	Jan. 1	By Purchases A/c	200
Jan. 31	To Balance c/d	380	Jan. 21	By Anand	200
		400			400
			Feb. 1	By Balance	380

BHARAT ACCOUNT

Dr. Cr.

Jan. 31.	To Balance c/d	5,000	Jan. 6	By Purchases A/c	5,000
		5,000			5,000
			Feb. 1	By Balance b/d	5,000

PLANT ACCOUNT

Dr. Cr.

Jan. 8.	To Mukesh	5,000	Jan. 31	By Balance c/d	5,300
Jan. 8	To Cash A/c	300			
		5,300			5,300
Feb. 1	To Balance b/d	5,300			

INTEREST ON LOAN ACCOUNT

Dr. Cr.

Jan. 28.	To Cash A/c	500	Jan. 31	By Balance	500
		500			500
Feb. 1	To Balance b/d	500			

MUKESH

Dr. Cr.

Jan. 31.	To Balance c/d	5,000	Jan. 8	By Plant A/c	5,000
		5,000			5,000
			Feb. 1	By Balance b/d	5,000

SALES ACCOUNT

Dr. Cr.

Jan. 31.	To Balance c/d	2,100	Jan. 21	By Rahim	600
			Jan. 18	By Cash A/c	1,000
			Jan. 31	By Cash A/c	500
		2,100			2,100
			Feb. 1	By Balance b/d	2,100

RAHIM

Dr. Cr.

Jan. 12.	To Sales A/c	600	Jan. 15	By Cash A/c	300
			Jan. 15	By Bad Debts A/c	300
		600			600

BAD DEBTS ACCOUNT

Dr. Cr.

Jan. 15	To Rahim	300	Jan. 31	By Balance c/d	300
		300			300
Feb. 1	To Balance b/d	300			

SALARY ACCOUNT

Dr. Cr.

Jan. 20.	To Cash A/c	2,000	Jan. 31	By Balance b/d	2,000
		2,000			2,000
Feb. 1	To Balance b/d	2,000			

DRAWING ACCOUNT

Dr. Cr.

Jan. 31.	To Purchases A/c	200	Jan. 31	By Balance c/d	200
		200			200
Feb. 1	To Balance	200			

TRIAL BALANCE

(AS ON 31ST JANUARY, 2006)

Particular	Debit Amount	Credit Amount
Cash Account	580	
Interest Account		200
Bank Account	25,000	
Stock Account	20,000	
Furniture Account	2,000	
Building Account	10,000	
Anil	1,000	
Madhu	2,000	
Capital Account		55,000
Babu's Loan Account		10,000
Purchases Account	8,800	
Discount Account		380
Bharat		5,000
Plant Account	5,300	
Interest on Loan Account	500	
Mukesh		5,000
Sales Account		2,100
Bad Debts Account	300	
Salary Account	2,000	
Drawings Account	200	
	77,680	77,680

4.4 SUMMARY

Ledger is a book which contains various accounts of the business enterprise whether real, nominal or personal. The term 'posting' means transferring the debit and credit items from the journal to their respective accounts in the ledger. At the end of a period, the businessman will be interested in knowing the position of a particular account. This means, he should total the debits and credits of his account separately and final out the net balance. This technique of finding out the net balance of an account is known as balancing the account. Before preparing the final accounts, the accountant prepares a trial balance to check arithmetical errors. The trial balance is a statement containing the various ledger balances on a particular date.

4.5 KEYWORDS

Assets: Tangible objects or intangible rights owned by an enterprise and carrying probable future benefits.

Profits & Loss Account: A financial statement which represents the revenues and expenses of an enterprise and shows the excess of revenues over expenses or vice-versa.

Balance Sheet: A statement of the financial position of an enterprise as at a given date.

4.6 SELF ASSESSMENT QUESTIONS

1. Explain the rules regarding posting of transactions into the Ledger.
2. What is a Trial Balance? Explain its objectives.
3. Discuss and differentiate between Journal and Ledger.
4. Journalise the following transactions and post them into Ledger:

2006		
September	1	Started business with Rs. 50,000, out of which pad into Bank Rs. 20,000.
September	2	Bought furniture for Rs. 5,000 and machinery for Rs. 10,000.
September	3	Purchased goods for Rs. 14,000.
September	6	Sold goods for Rs. 8,000.
September	8	Purchased goods from Malhotra and Co. Rs. 11,000.
September	10	Paid telephone rent for the year by cheque Rs. 500.
September	11	Bought one typewriter for Rs. 2,100 from Universal Typewriter Co. on credit.
September	15	Sold goods to Keshav Ram for Rs. 12,000.
September	17	Sold goods to Rajesh Kumar for Rs. 2,000 for cash.
September	19	Amount withdrawn from bank for personal use Rs. 1,500.
September	21	Received cash from Keshav Ram Rs. 11,900, discount allowed Rs. 100.
September	22	Paid into bank Rs. 5,800.
September	23	Bought 50 shares in X Y and Co. Ltd at Rs. 60 per share, brokerage paid Rs. 20.
September	25	Goods worth Rs. 1,000 found defective were returned to Malhotra and Co. and the balance of the amount due to them settled by issuing a cheque in their favour.
September	28	Sold 20 shares of X Y and Co. Ltd. at Rs. 65 per share, brokerage paid Rs. 20.
September	28	Brought goods worth Rs. 2,100 from Ramesh and supplied them to Suresh at Rs. 3,000.

September	30	Suresh returned goods worth Rs. 100, which in turn were sent to Ramesh.
September	30	Issued a cheque for Rs. 1,000 in favour of the landlord for rent for September.
September	30	Paid salaries to staff Rs. 1,500 and received from travelling salesman
September	30	Rs. 2,000 for goods sold by him, after deducting the travelling expenses Rs. 100.
September	30	Paid for: Charity Rs. 101 Stationary Rs. 450 Postage Rs. 249

5. Prepare Journal, Ledger and Trial Balance from the following information. On 1st January, 1998, the following were the ledger balances of Rajan and Co.: Cash in hand Rs. 900; Cash at bank Rs. 21,000; Soni (Cr.) Rs. 3,000; Zahir (Dr.) Rs. 2,400; Stock Rs. 12,000; Prasad (Cr.) Rs. 6,000.

   Transactions during the month were:

1998		Rs.	1998		Rs.
Jan. 2	Bought goods from Prasad	2,700	Jan.22	Paid cash for stationery	50
Jan.3	Sold to Sharma	3,000	Jan.29	Paid to Prasad by cheque	2,650
Jan.5	Bought goods from Lall for cash paid by cheque	3,600			
Jan.7	Took goods for personal use	200	Jan. 30	Provide interest on capital	100
Jan.13	Received from Zahir in full Settlement	2,350	Jan. 30	Rent due to landlord	200
Jan.17	Paid to Soni in full settlement	2,920			

6. Journalise the following transactions, post them in the ledger and prepare a Trial Balance:

   January 1, 1999 *Assets*: Furniture Rs. 5,000; Machinery Rs. 10,000; Stock Rs. 4,000; Cash in hand Rs. 550; Cash at bank Rs. 7,450; Amount due from Ramesh and Co. Rs. 1,000 and amount due from Suresh Rs. 2,000.

Liabilities: Amount due to Rama Rs. 4,500; Amount due to Ranjeet Rs. 2,000; and amount due to Shyam Rs. 1,500.

1999		Rs.	1999		Rs.
Jan 1	Purchased goods from Ajay	4,500	Jan.25	Cash purchases	16,500
Jan 3	Sold goods for cash	1,500	Jan.27	Goods worth Rs. 500 were damaged in transit; a claim was made on the railway authorities for the same[2].	
Jan 5	Paid to Himanshu by cheque	5,500			
Jan 10	Deposited in bank	2,800	Jan.28	Suresh is declared insolvent and a dividend of 50 paise in the rupee is received from him in full settlement	
Jan 13	Sold goods on credit to Mukesh	1,700	Jan. 28	Bought a horse for Rs. 2,600 and a carriage for Rs. 1,200 for delivering goods to customers, paid by cheque	
Jan 15	Paid for postage	100	Jan.30	The horse bought on Jan. 29 dies, and its carcase was sold for Rs. 1,000	
Jan 16	Received cash from Rakesh	2,200	Jan.31	Allowed interest on capital @ 10% p.a. for one month	
Jan 17	Paid telephone charges	250	Jan. 31	Paid for: Salaries Rs. 150 Rent Rs.60	
Jan 18	Cash sales	1,500			
Jan 20	Purchased Govt. Securities	500			
Jan 22	Purchased goods worth trade discount and 5% cash discount from Mahesh and Co. for cash and supplied them to Ramesh and Co. at list price less 10% trade discount[1]				

(Hints :1. Sale price : Rs. 1,600 less 10% trade discount. 2. Debit Loss in Transit Account and Credit Purchases Account. On receipt of money from the Railways Debit Bank Account Credit Loss in Transit Account. Transfer any difference to P. and L. Account.).

4.7 REFERENCES/SUGGESTED READINGS

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Subject: **Financial Accounting-I**	
Course Code: **BBA-104**	Author: **Dr. Mahesh Chand Garg**
Lesson: **5**	Vetter:

SUBSIDIARY BOOKS OF ACCOUNTS

STRUCTURE

5.0 Objectives

5.1 Introduction

5.2 Cash Book

5.3 Purchase Book

5.4 Sales Book

5.5 Purchase Return Book

5.6 Sales Return Book

5.7 Bills Receivable Book

5.8 Bills Payable Book

5.9 Journal Proper

5.10 Summary

5.11 Keywords

5.12 Self assessment questions

5.13 References/suggested readings

5.0 OBJECTIVES

After going through this lesson, you should be able to-

- Know the meaning and importance of subsidiary books.
- Understand cash book.
- Familiar with other subsidiary books.

5.1 INTRODUCTION

All business transactions, at the first stage, are recorded in the book of original entry i.e. Journal and then posted into the ledger under the double entry system of book-keeping. This procedure is easy and practicable in small business houses where the number of business transactions are less and when a single person can handle the business transactions. But it is practically very difficult, rather impossible, to record all the business transactions of a day in the Journal of a large business house where the number of business transactions are varied and enormous because of the following reasons:

(a) The system of recording all transactions in a journal requires (i) writing down of the name of the account involved as many times as the transactions occur; and (ii) an individual posting of each account debited and credited and hence, involves the repetitive journalising and posting labour.

(b) Such a system does not provide the information on a prompt basis.

(c) The journal becomes bulky and voluminous.

(d) Such a system does not facilitate the installation of an internal check system since the journal can be handled by only one person.

Therefore, to overcome the shortcomings of the use of the journal as the only book of original entry, the journal is subdivided into special journals. It is divided in such a way that a separate book is used for each category of business transactions which are repetitive in nature, similar and are sufficiently large in number. Special journals refer to the journals meant for recording specific business transactions of similar nature. These special journals are also known as “Subsidiary Books” or “Day Books”. The main types of special journals are as follows:

- **(i)** **Cash Book***:* It records all those transactions which are in cash or by cheques.
- **(ii)** **Purchases Book***:* It records all transactions relating to goods purchased on credit.
- **(iii)** **Sales Book**: It records all transactions relating to goods sold on credit.
- **(iv)** **Purchases Return Book***:* It records return of goods to suppliers.
- **(v)** **Sales Return Book**: It records return of goods by the customers.
- **(vi)** **Bills Receivable Book***:* It records entries regarding bills receivables. The details of bills are given in this book.
- **(vi)** **Bills Payable Book**: All bills which are accepted and payable by a business house are recorded in this book.
- **(viii)** **Journal Proper***:* Those transactions which are not recorded in any of the above mentioned books are recorded in the Journal Proper.

Before recording transactions in these day books, it is necessary to explain the special meaning given in business to the words 'Goods', 'Purchases' and 'Sales'.

Goods: It refers to items forming part of the stock-in-trade of a business house which are purchased and are to be resold at a profit. A business house may purchase fixed assets or stationery for use in business, but they are not purchases of goods.

Purchases: It refers to the purchase of goods for resale, and not the purchase of assets or stationery. The Purchases Account, therefore, only contains purchases of goods for resale.

Sales: It refers to the sale of goods which form part of the stock-in-trade of the business.

Advantages

The advantages of using Special Journals are as under:

(a) **Facilitates division of work**: The accounting work can be divided among many persons.

(b) **Time and labour saving in journalising and posting**: For instance, when a Sales Book is kept, the name of the Sales Account will not be required to be written down in the Journal as many times as the sales transactions occur and at the same time, Sales Account will not be required to be posted again and again since, only a periodic total of Sales Book is posted to the Sales Account.

(c) **Permits the use of specialised skill**: The accounting work requiring specialised skill may be assigned to a person possessing the required skill. With the use of a specialised skill, prompt, economical and more accurate supply of accounting information may be obtained.

(d) **Permits the installation of internal check system**: The accounting work can be divided in such a manner that the work of one person is automatically checked by another person. With the use of internal check, the possibility of occurrence of error/fraud may be avoided.

5.2 CASH BOOK

A Cash Book is a special journal which is used for recording all cash receipts and cash payments. If a cash book is maintained, there is no need for preparing a cash account in the ledger. However, the other aspects of the transactions will be recorded in the ledger. Cash Book serves dual role of journal as well ledger. Cash Book is the book of original entry (Journal) since transactions are recorded for the first time from the source documents. It is a ledger in the sense that it is designed in the form of Cash Account and records cash receipts on the debit side and cash payments on the credit side.

Features

- Only cash transactions are recorded in the Cash Book.
- It performs the functions of both journal and the ledger at the same time.
- All cash receipts are recorded on the debit side and all cash payments are recorded on the credit side.
- The Cash Book, recording only cash transactions can never show a credit balance.

Kinds of Cash Book

Cash Book can be of several kinds:

(a) *Single Column Cash Book*- For recording cash transactions only.

(b) *Double (Two) Column Cash Book*- For recording cash transactions involving gain or loss on account of discount.

(c) *Triple (Three) Column Cash Book*- For recording cash and bank transactions involving gain or loss on account of discount.

(d) *Petty Cash Book*- For recording petty expenses.

Single Column Cash Book

The Single Column Cash Book has one column of amount on each side. All cash receipts are recorded on the debit (left-hand) side and all cash payments are recorded on credit (right-hand) side. In fact, it is nothing but a Cash Account. Hence, there is no need to open Cash Account in the ledger. Posting from the debit (receipt) side of the Cash Book is done to the credit side of concerned accounts and from the credit (payment) side of the Cash Book to the debit side of concerned accounts.

Balancing the Cash Book: The Cash Book is balanced in the same manner as a ledger account. To verify the accuracy of the entries made and to confirm the authenticity of cash balance, it should be balanced daily. The balance as per Cash Book must tally with the actual cash in hand. In the Cash Book, the total of amount column of the debit side always exceeds the total of credit side. As such, the Cash Book always shows a debit balance, since we cannot pay more than we have with us. At the end of the period, the balance of the Cash Book is placed on the credit side by writing "By Balance c/d" and then the totals are shown on both side in one straight line. The total of each side should be the same.

Illustration I. Enter the following transactions in the Cash Book of Mr. Nikhil.

2006		Rs.
March 1	Mr. Nikhil commenced business with Cash	6,500
March 3	Bought goods for cash	685
March 4	Paid to Mohan	95
March 6	Deposited in the bank	4,000
March 6	Purchased office furniture on cash	465
March 9	Sold goods for cash	3,000
March 12	Paid wages in cash	120
March 13	Paid for stationary	40
March 15	Sold goods for cash	2,500
March 17	Paid for miscellaneous expenses	45
March 19	Received cash from Tarlok	485
March 21	Withdrew for domestic use	250
March 22	Paid salary	400
March 25	Paid rent	90
March 28	Paid electricity bill	35
March 29	Paid for advertising	40
March 31	Paid into bank	2,500

Solution

CASH BOOK

Dr. Cr.

Date	Particulars (Receipts)	LF	Amount (Rs.)	Date	Particular (payments)	LF	Amount (Rs.)
2006				2006			
March 1	To Capital A/c		6,500	March 3	By Purchases A/c		685
March 9	To Sales A/c		3,000	March 4	By Mohan's A/c		95
March 15	To Sales A/c		2,500	March 6	By Bank A/c		4,000
March 19	To Tarlok's A/c		485	March 6	By Furniture A/c		465
				March 12	By Wages A/c		120
				March 13	By Stationery A/c		40
				March 17	By Misc. Expenses A/c		45
				March 21	By Drawings A/c		250
				March 22	By Salaries A/c		400
				March 25	By Rent A/c		90
				March 28	By Electricity A/c		35
				March 29	By Advertisement A/c		40
				March 31	By Bank A/c		2,500
				March 31	By Balance c/d		3,720
			12,485				12,485

Double Column Cash Book

This Cash Book has two amount columns one for cash and another for discount on each side. It is customary in business to allow discount when payment is received from a customer promptly and before due date. It is equally so when payment is made to a creditor before due date. All cash receipts and discount allowed are recorded on the debit side and all cash payments and discount received are recorded on the credit side of Cash Book.

The posting from the cash columns is done in the same manner as it is done in Single Column Cash Book. Entries from discount column of the debit side of the Cash Book are posted on the credit side of every individual debtor's account to whom the business has allowed the discount. The total of the debit side of the discount column is shown on the debit side of the "Discount Allowed Account" by writing "To Sundries" in the particulars column. Entries from the discount column of the credit side of the Cash Book are posted on the debit side of every individual creditor's account by whom the discount is allowed to the business. The total of the credit side of the discount column is shown on the credit side of the "Discount Received Account" by writing "By Sundries" in the particulars column.

The cash column of the Double Column Cash Book is balanced exactly in the same manner as in case of the Single Column Cash Book. But, the discount columns are not balanced but merely totalled. These totals are posted to the respective Discount Allowed Account and Discount Received Account.

Illustration 2: From the following transactions, prepare the Two Column Cash Book and also post them in the Ledger.

2006		Rs.
Aug. 1	Cash in hand	25,500
Aug. 2	Received from Rakesh and	2,900
	discount allowed to him	100
Aug. 5	Cash sales	6,000
Aug. 6	Purchased goods for cash	7,800
Aug. 8	Received from Neelam and	1,350
	allowed her discount	50
Aug. 12	Paid to Ravinder and	3,400
	received discount	200
Aug. 20	Paid rent	1,000
Aug. 25	Interest received in cash	500
Aug. 26	Paid to Kamal and	1,760
	received discount	40
Aug. 28	Machinery purchased	5,200

Aug. 30	Salaries paid	3,000

Solution

CASH BOOK

Dr. Cr.

Date	Particulars	L.F.	Discount (Rs.)	Cash (Rs.)	Date	Particulars	L.F.	Discount (Rs.)	Cash (Rs.)
2006					2006				
Aug. 1	To Bal. b/d			25,500	Aug. 6	By Purchases A/c			7,800
Aug. 2	To Rakesh's A/c		100	2,900	Aug. 12	By Ravinder's A/c		200	3,400
Aug. 5	To Sales A/c			6,000	Aug. 20	By Rent A/c			1,000
Aug. 8	To Neelam's A/c		50	1,350	Aug. 26	By Kamal's A/c		40	1,760
Aug. 25	To Interest A/c			500	Aug. 28	By Machinery A/c			5,200
					Aug. 30	By Salaries A/c			3,000
					Aug. 31	By Bal. c/d			14,090
			150	36,250				240	36,250
Sep 1	To Bal b/d			14,090					

Note: The discount columns are not balanced but these are totalled in respective column and posted in the ledger.

RAKESH'S ACCOUNT

Dr. Cr.

Date	Particulars	L.F.	Amount	Date	Particulars	L.F.	Amount
				2006			
				Aug. 2	By Cash A/c		2,900
				Aug. 2	By Discount A/c		100

SALES ACCOUNT

Dr. Cr.

Date	Particulars	L.F.	Amount	Date	Particulars	L.F.	Amount
				2006 Aug. 5	By Cash A/c		6,000

PURCHASES ACCOUNT

Dr. Cr.

Date	Particulars	L.F.	Amount	Date	Particulars	L.F.	Amount
2006 Aug.6	To Cash A/c		7,800				

NEELAM'S ACCOUNT

Dr. Cr.

Date	Particulars	L.F.	Amount	Date	Particulars	L.F.	Amount
				2006 Aug. 8	By Cash A/c		1,350

RAVINDER'S ACCOUNT

Dr. Cr.

Date	Particulars	L.F.	Amount	Date	Particulars	L.F.	Amount
2006							
Aug. 12	To Cash A/c		3,400				
Aug.12	To Discount A/c		200				

RENT ACCOUNT

Dr. Cr.

Date	Particulars	L.F.	Amount	Date	Particulars	L.F.	Amount
2006 Aug. 20	To Cash		1,000				

INTEREST ACCOUNT

Dr. Cr.

Date	Particulars	L.F.	Amount	Date	Particulars	L.F.	Amount
				2006 Aug. 25	By Cash		500

KAMAL’S ACCOUNT

Dr. Cr.

Date	Particulars	L.F.	Amount	Date	Particulars	L.F.	Amount
2006							
Aug.26	To Cash A/c		1,760				
Aug.26	To Discount A/c		40				

MACHINERY ACCOUNT

Dr. Cr.

Date	Particulars	L.F.	Amount	Date	Particulars	L.F.	Amount
2006 Aug. 28	To Cash A/c		5,200				

SALARIES ACCOUNT

Dr. Cr.

Date	Particulars	L.F.	Amount	Date	Particulars	L.F.	Amount
2006 Aug. 30	To Cash A/c		3,000				

DISCOUNT ALLOWED ACCOUNT

Dr. Cr.

Date	Particulars	L.F.	Amount	Date	Particulars	L.F.	Amount
2006 Aug.31	To Sundries A/c		150				

DISCOUNT RECEIVED ACCOUNT

Dr. Cr.

Date	Particulars	L.F.	Amount	Date	Particulars	L.F.	Amount
				2006 Aug.31	By Sundries A/c		240

Triple Column Cash Book

This type of Cash Book is an improvement over the Double Column Cash Book. In modern times, it is virtually impossible to imagine any business without having dealings with a bank. Most of the transactions relating to receipts and payments of money are made through cheques. So transactions through bank are also recorded in the cash book by adding one more column i.e. bank column on both sides of the cash book. Therefore there are three columns on both sides of the cash book i.e. cash, bank and discount columns. That is why this type of cash book is known as Triple Column Cash Book.

Receipt side (Dr side) of the Triple Column Cash Book is used to record all receipts both in cash and by cheques as also to record the discount allowed to our debtors while receiving the payment. Cash receipts are entered in the cash column whereas amounts received by cheques are entered in the bank column and discount allowed in the discount column. Posting from the debit side of the cash book is made to the credit side of each account in the ledger– in case of personal accounts credit is to be given for cash or cheques received plus discount allowed.

Payment side (Cr. side) of the Cash Book is used to record all payments both in cash and through cheques as also to record the discount received or availed by us from over creditors while making payment to them. Cash payments are recorded in the cash column, payments through cheques are entered in the bank column and discount received in the discount column. Posting from the credit side of the cash book is made on the debit side of respective accounts– in case of personal accounts debit is to be given for the total of the payments made and discount received.

After recording all the relevant transactions in the Cash Book, all the columns of the Cash Book are totalled. The difference in the cash columns is put on the credit side of Cash Book in the column by writing "By Balance c/d". The bank balance may have a debit balance or a credit balance. If the total of the debit side of the bank column is more than the total of the credit side of the bank column, it has a debit balance and if the total of the credit side is more than that of the debit side, then it has a credit balance (overdraft). However, the difference is put on the lesser side. There is no need to balance the discount columns. The discount columns of both the sides are totalled.

In the Triple Column Cash Book there will be some cross or contra entries i.e., transfer of money from cash to bank (amount deposited) and vice-versa (amount withdrawn from bank for office use). In all such cases both entries occur in the cash book and no ledger entry is required. This is indicated by a contra sign (C) in the folio column indicating thereby that the double entry aspect of this transaction is complete and it requires no posting to the ledger.

Illustration 3: Prepare a Triple Column Cash Book from the following particulars:

2006

Jan. 1. Cash in hand Rs. 50,000.
2. Paid into bank Rs. 10,000.
3. Bought goods from Hari for Rs. 200 for cash.
4. Bought goods for Rs. 2,000 paid cheque for them, discount allowed 1%
5. Sold goods to Mohan for cash Rs. 250.
6. Received a cheque from Shyam to whom goods were sold for Rs. 800. Discount allowed 12.5%
8. Purchased an old typewriter for Rs. 200. Spent Rs. 50 on its repairs.
9. Bank notified that Shyam's cheque has been returned dishonoured and debited to the account in respect of charges Rs. 10.
10. Received a money order for Rs. 25 from Hari.
11. Shyam settled his account by means of a cheque for Rs. 820, Rs. 20 being for interest charged.
12. Withdrew from bank Rs. 10,000.
18. Discounted a bill of exchange for Rs.1,000 at 1% through bank.
20. Honoured our own acceptance by cheque Rs. 5,000.
22. Withdrew for personal use Rs. 1,000.
24. Paid trade expenses Rs. 2,000.
25. Withdrew from bank for private expenses Rs. 1,500.
26. Purchased machinery from Rajiv for Rs. 5,000 and paid him by means of a bank draft purchased for Rs. 5,005.
27. Issued cheque to Ram Saran for cash purchase of furniture Rs. 1,575.
28. Received a cheque for commission Rs. 500 from R. & Co. and deposited into bank.
29. Ramesh who owned us Rs. 500 became bankrupt and paid us 50 paisa in a rupee.

30. Received payment of a loan of Rs. 5,000 and deposited Rs. 3,000 out of it into bank.
31. Paid rent to landlord 'Mohan' by a cheque of Rs. 500.
31. Interest allowed by bank Rs. 30.
31. Half-yearly bank charges Rs. 50.

Solution

TRIPLE COLUMN CASH BOOK

Dr. Cr.

Date	Particulars (Receipts)	L.F.	Discount (Rs.)	Cash (Rs.)	Bank (Rs.)	Date	Particulars (Payments)	L.F.	Discount (Rs.)	Cash (Rs.)	Bank (Rs.)
2006						2006					
Jan 1	To Balance b/d			50,000		Jan 2	By Bank A/c	C		10,000	
Jan 2	To Cash A/c	C			10,000	Jan 3	By Purchases A/c			200	
Jan 5	To Sales A/c			250		Jan 4	By Purchases A/c		20		1,980
Jan 6	To Shyam's A/c		100		700						
						Jan 8	By Typewriter A/c			200	
Jan 10	To Hari's A/c			25		Jan 8	By Typewriter A/c			50	
Jan 11	To Shyam's A/c				800	Jan 9	By Shyam's A/c		100		700
"	To Interest A/c				20	Jan 9	By Bank charges A/c				10
						Jan 12	By Cash A/c	C			10,000
Jan12	To Bank A/c	C		10,000		Jan 20	By B/P A/c				5,000
Jan 18	To B/R A/c		10		990	Jan 22	By Drawings A/c			1,000	
Jan 28	To Commission A/c				500	Jan 24	By Trade Expenses A/c			2,000	
Jan 29	To Ramesh's A/c			250		Jan 25	By Drawings A/c				1,500
Jan 30	To Loans A/c			5,000		Jan 26	By Machinery A/c				5,000
Jan 30	To Cash A/c	C			3,000	Jan 26	By Bank charges A/c				5
Jan 31	To Interest A/c				30	Jan 27	By Furniture A/c				1,575
Jan 31	To Balance c/d (Bank overdraft)				10,280	Jan 30	By Bank A/c			3,000	
						Jan 31	By Rent A/c				500
						Jan 31	By Bank charges A/c				50
						Jan 31	By Balance c/d			49,075	
			110	65,525	26,320				120	65,525	26,320

Petty Cash Book

In every business organisation, there are a number of payments which involve small amounts e.g. payments for postage, telegrams, carriage, cartage etc. If all these transactions are recorded in the Cash Book, it will increase the head cashier's work manifold and it will make the Cash Book unnecessarily bulky and uneasy. Normally, one person is handed over a small amount to meet the petty expenses of a given period (say, week, fortnight or month) and is authorised to make such payments and to record them in a separate Cash Book. Such person, amount and Cash Books are called as "Petty Cashier", 'Imprest' and 'Petty Cash Book' respectively. The Petty Cash Book may or may not be maintained on 'Imprest System'. Under both the systems (i.e. Imprest and Non-imprest), the petty cashier submits the Petty Cash Book to the Head Cashier who examines the Petty Cash Book. Under the Imprest system, the Head Cashier makes the reimbursement of the amount spent by the Petty Cashier but under Non-imprest system, the Head Cashier may handover the Cash to the Petty Cashier equal to/more than/less than the amount spent. Usually, the Petty Cash Book is maintained on the basis of imprest system.

Advantage of the Imprest System: The system of petty cash payments along with the imprest system offers the following advantages:

(1) The money in the hands of the petty cashier is limited to the imprest amount.

(2) As the periodical reimbursements are the actual expenses paid and not mere advances on account only, they are as such brought prominently to the notice of Chief Cashier.

(3) The Chief Cashier, by handing over a fixed sum, is relieved of the cumbersome work of petty disbursements.

(4) The main cash book is not unnecessarily clogged with the large number of small items. Even in the ledger, only the totals are posted.

(5) At all time, the amount of cash in hand plus expenses not reimbursed must equal the imprest amount, thus, facilitating a simple check.

(6) The maximum liability of the petty cashier can never exceed the imprest amount.

(7) The regular check of the petty cash book creates a sense of responsibility in the petty cashier.

All the heads of expenses are totalled periodically and such periodic totals are individually posted to the debit side of the concerned ledger accounts in the ledger by writing 'To Petty Cash A/c' in the particulars column. The Petty Cash Account in the ledger is credited with the total expenditure incurred during the period by writing 'By Sundries as per Petty Cash Book' in the particulars column. The ledger folio number is written under every total amount of expense to indicate that the entry has been posted in the ledger. In the folio column of the ledger account, the page number of the petty cash book is written.

Illustration 4: From the following particulars, prepare Petty Cash Book on imprest system of K.P. Singh & Co. for the month of January, 2006.

Jan. 2006		Rs.
1	Opening Balance (on imprest system)	100
2	Paid for stamps	12

3	Paid cleaner's wages	15
4	Paid for fare	16
5	Paid for office tea	15
6	Paid to proprietor for personal use	10
7	Paid for advertisement	30
8	Drew imprest from head cashier	
9	Paid for cartage	10
10	Paid for travelling expenses	25
11	Paid for telegram sent	15
12	Paid for entertainment to travelling salesmen	20
13	Advance to peon	10
14	Paid for printing bill	5
15	Paid for stationery	3
16	Drew imprest from head cashier	

PETTY CASH BOOK

Solution

Date	Particulars	Cash Book Folio.	Total Rs	Date	Particulars	Voucher No.	Postage & Telegram Rs.	Conveyance & Travelling Rs.	Staff welfare entertainment Rs.	Cartage Rs.	Printing & stationery Rs.	Misc. item Rs.	Total Rs.
2006				2006									
Jan. 1	To Balance b/d		100	Jan 2	Stamps		12						12
				Jan 3	Cleaner's Wages							15	15
				Jan 4	Fare			16					16
				Jan 5	Office Tea				15				15
				Jan 6	Proprietor							10	10
				Jan 7	Advertise-ment							30	30
				Jan 7	Balance c/d								2
			100				12	16	15	-	-	55	100
Jan. 8	To Balance b/d		2	Jan 9	Cartage					10			10
				Jan 10	Travelling			25					25
Jan. 8	To Cash from Head Cashier		98	Jan 11	Telegram		15						15
				Jan 12	Entertain-ment				20				20
				Jan 13	Advance to Peon							10	10
				Jan 14	Printing						5		5
				Jan 15	Stationery						3		3
				Jan 15	Balance c/d								12
			100				15	25	20	10	8	10	100
Jan. 16	To Balance b/d		12										
Jan. 16	To Cash from Head Cashier		88										

5.3 PURCHASE BOOK

Purchases Book (also known as Invoice Journal/Bought Journal/Purchases Journal) is used for recording only the credit purchases of goods and merchandise in which the business is dealing in, i.e. goods purchased for resale purpose for earning revenue. It records neither the cash purchases of goods nor the purchase of any asset other than the goods or merchandise.

When we purchase goods on credit we receive a statement from the supplier giving the particulars of the goods supplied by him. The statement is known as an Invoice. The invoice states the quality, price and the value of goods supplied. It also states the discount allowable (trade and cash) and the condition under which payment is expected. The entries in the purchase book are made on the basis of invoices received from the supplies with the amounts net of trade discount/quantity discount. Trade discount is a reduction granted by the supplier from the list price of goods and services on business consideration such as quantity bought, trade practices other than for prompt payment. The object of allowing trade discount is to enable the retailer to sell the goods to the customer at list price and still leaving margin for meeting business expenses and his profit. Entries in the books of both supplier as well as retailer are made on the basis of net amount i.e. invoice price less trade discount.

Posting

After recording transactions in the Purchases Book, the posting in ledger accounts will be made. The posting from the Purchases Book is made as follows:

a) Debit the Purchases Account with the periodical totals of the Purchases Book. On the debit side of the Purchases Account, write "To total as per Purchase Book" or "To Sundries" in the particulars column.

b) Personal accounts of each individual supplier is credited with the net amount of Inward Invoice recorded in Purchases Book by writing "By Purchases".

Illustration 5: Prepare the Purchases Book for the month of Feb, 2006 from the following particulars of M/s Sharma & Co. and also post them into Ledger.

2006	
Feb. 4	Purchased on credit from Rajesh Bros. & Co.
	10 Bags of Tea @ Rs. 1000 per bag
	5 Bags of Coffee @ Rs. 3000 per bag
	Trade discount @ 10%
Feb. 16	Purchased from Shiva Enterprises on credit
	20 bags of Rice @ Rs. 800 per bag
	2 bags of Wheat @ Rs. 500 per bag
	Trade discount @ 5%
Feb. 20	Purchased Furniture on Credit from Universal Furniture House for Rs. 3000
Feb 24	Bought on credit from Ashwani & Co.
	30 tin Ghee @ Rs. 400 per tin
	10 tin Oil @ Rs. 300 per tin
	Trade Discount 20%

Solution

PURCHASE BOOK OF M/S SHARMA & CO.

Date	Particulars	Invoice No.	L.F.	Details	Rs.
2006	Rajesh Bros. & Co.				
Feb. 4	10 bags of Tea @ Rs. 1,000 per bag			10,000	
	5 bags of Coffee @ Rs. 3,000 per bag			15,000	
				25,000	
	Less Trade discount @ 10%			2,500	22,500
Feb 16	Shiva Enterprises				
	20 bags of Rice @ Rs. 800 per bag			16,000	
	2 bags Wheat @ Rs. 500 per bag			1,000	
				17,000	
	Less Trade discount @ 5%			850	16,150
Feb 24	Ashwani & Co.				
	30 tin Ghee @ Rs.400 per tin			12,000	
	10 tin Oil @ Rs. 300 per tin			3,000	
				15,000	
	Less Trade discount @ 20%			3000	12,000
	Total				50,650

Note: Purchase of furniture being an asset is not to be recorded in purchase book, however, it will be recorded in Journal.

PURCHASES A/C

Dr. Cr.

Date	Particulars	L.F.	Rs.	Date	Particulars	L.F.	Rs.
2006							
Feb.28	To Sundries		50,650				

RAJESH BORS. & CO.

Dr. Cr.

Date	Particulars	L.F.	Rs.	Date	Particulars	L.F.	Rs.
				2006 Feb. 4	By Purchases		22,500

SHIVA ENTERPRISES

Dr. Cr.

Date	Particulars	L.F.	Rs.	Date	Particulars	L.F	Rs.
				2006 Feb. 16	By Purchases		16,150

ASHWANI & CO.

Dr. Cr.

Date	Particulars	L.F	Rs.	Date	Particulars	L.F.	Rs.
				1999 Feb. 24	By Purchases		12,000

5.4 SALES BOOK

Sales Book or Sales Journal is written up to record all the credit sales. Sales Book records only those goods which are sold on credit and the goods in question must be those, which the firm generally deals in. If there are cash sales they are recorded in Cash Book and sale of assets are recorded in the Journal proper.

The entries in the Sales Book are made from the copies of the invoice which have been sent to customers along with the goods. Such copies of the invoices may be termed as Outward Invoice. Each such outward invoice should be numbered consecutively and the reference be given in the Sales Book along with the entry.

The Sales book is totalled periodically. The net amount of the invoices in Sales Book is posted to the ledger as follows:

(a) Debit the personal accounts of the customers with the value of sales to them.

(b) Credit Sales Account with the periodical total.

Illustration 6: Enter the following transactions in the Sales Book and post them into the ledger:

2006	
Nov. 1	Sold to M/s Rana and Co. 1,000 metres of Terrycot B type @ Rs. 13 per metre.
	2,000 metres of cotton cloth Type A-6 @ Rs. 10 per metre. Trade discount 10%.
Nov. 16	Sold to Cloth Emporium, 1,000 pieces of Jeans @ Rs. 50 each.
	500 pieces of woollen Pullovers @ Rs. 150 each. Trade discount 10%
Nov. 25	Sold to Pandit Bros. 10 Rolls of Curtains ordinary type @ Rs. 1,500 per roll (Net).
	150 Blankets @ Rs. 80 each (Net).
	100 Blankets @ Rs. 120 each (Net).

Solution

SALES BOOK

Date	Inv. No.	Particulars	L.F.	Details	Amount
2006		M/s Rana and Co.			
		1,000 Metres of Terry cot			
		B-type			
Nov. 1		@ 13 per metre		13,000	
		2,000 Metres of cotton type			
		A-6 @ Rs. 10 per metre		20,000	
				33,000	
		Less: Trade discount 10%		3,300	29,700
		Cloth Emporium			
		1,000 Jeans Pieces @ Rs. 50		50,000	
		each			
Nov. 16		500 pieces of Wollen Pullovers			
		@ Rs. 150 each		75,000	
				1,25,000	
		Less: Trade discount 10%		12,500	1,12,500
		Pandit Brors.			
		10 Rolls of curtains ordinary			
Nov. 25		@ Rs. 1,500 each		15,000	
		150 Blankets @ Rs. 80 each		12,000	
		100 Blankets @ Rs. 120 each		12,000	39,000
					1,81,200

LEDGER

SALES ACCOUNT

Dr. Cr.

Date	Particulars	L.F.	Amount (Rs.)	Date	Particulars	L.F.	Amount (Rs.)
				2006 Nov. 30	By Total Sales as per Sales Book		1,81,200

M/S RANA & CO.

Dr. Cr.

Date	Particulars	L.F.	Amount (Rs.)	Date	Particulars	L.F.	Amount (Rs.)
2006 Nov.1	To Sales Account		29,700				

CLOTH EMPORIUM

Dr. Cr.

Date	Particulars	L.F.	Amount	Date	Particulars	L.F.	Amount
2006 Nov16	To Sales Account		Rs. 1,12,500				Rs.

PANDIT BROS.

Dr. Cr.

Date	Particulars	L.F.	Amount	Date	Particulars	L.F.	Amount
2006 Nov.25	To Sales Account		Rs. 39,000				Rs.

5.5 PURCHASE RETURN BOOK

In every business, it is not uncommon to find that the goods are returned by a business enterprise to the suppliers because of many reasons such as goods are defective, goods are not according to order. If the returns are frequent in a business, in that case a separate book may be maintained to record this type of transactions which is known as Purchases Returns Book or Returns Outward Book.

The entries in the Purchases Returns Book are usually made on the basis of debit notes issued to the suppliers. When a firm returns some goods to it suppliers, it prepares a debit note in duplicate. The original copy is sent to the supplier to whom the goods are returned. The Debit Note is so called because the supplier's account is debited with the amount of the goods returned. The standard form of a debit note is given below:

DEBIT NOTE

INDIA BOOK HOUSE
DARYA GANJ, NEW DELHI-110002

Grams: Books
No.10
Oct. 11, 1999
Your Reference: Invoice No. 119 dated Sept. 20, 1999

To
M/s National Publishing House,
Jaipur (Rajasthan)

Qty.	Particulars	Amount (Rs.)
	To Purchase Returns	
	(Account of damage-in-transit)	
5	Management Accounting by Gupta G.S. @ 20 each	100.00
10	Hindi Social Philosophy by Gopalan @ Rs. 16 each	160.00
		260.00
	Less: 20% Trade Discount	52.00
		208.00

After recording the transaction in Purchases Returns Book, posting to the ledger involves the following:

(a) The periodical total of the Purchases Return Book is posted to the credit of the Purchases Return Account in the ledger.

(b) The personal account of each individual suppliers is debited with the amount of Debit Note.

Illustration 7: From the following transactions prepare Purchases Returns Book and also post them into Ledger.

2006

Aug.1 Returned to Varinder
10 Tables @ Rs. 100 per Table

Aug. 12 Returned to Subash
5 Chairs @ 50 per Chairs

Aug. 25 Returned to Balwinder goods values Rs. 600

Solution

PURCHASE RETURN BOOK OR RETURNS OUTWARD BOOK

Date	Particulars	Debit Note No.	L.F.	Details Rs.	Rs.
2006					
Aug 1	Varinder				
	10 Tables @ Rs.100 per table			1,000	
Aug 12	Subash				
	5 Chairs @ Rs. 50 per chair			250	
Aug 25	Balwinder				600
	Total for the month				1,850

VARINDER'S ACCOUNT

Dr. Cr.

Date	Particulars	L.F.	Rs.	Date	Particulars	L.F.	Rs.
2006 Aug 1	To Purchases Return		1,000				

SUBASH'S ACCOUNT

Dr. Cr.

Date	Particulars	L.F.	Rs.	Date	Particulars	L.F.	Rs.
2006 Aug.12	To Purchases Return		250				

BALWINDER'S ACCOUNT

Dr. Cr.

Date	Particulars	L.F.	Rs.	Date	Particulars	L.F.	Rs.
1999 Aug.25	To Purchases Return		600				

PURCHASES RETURNS ACCOUNT

Dr. Cr.

Date	Particulars	L.F.	Rs.	Date	Particulars	L.F.	Rs.
				2006 Aug.31	By Total per Purchases Returns Book		1,850

5.6 SALES RETURN BOOK

Sales Return Book or Returns Inwards Book is meant for recording return of goods sold on credit. The goods which are sold for cash if returned are either exchanged for new goods or parties are paid in cash do not find a place in the Sales Return Journal. The columns used in this book are similar to Sales Book except that in place of Invoice No. the Credit Note number is recorded. Credit Note is just reverse of Debit Note and is sent by the seller to the buyer. It is an acknowledgment of the goods returned as well as information to the debtor that his account is being credited with the amount mentioned in it. Thus, the party to whom a Credit Note is sent become a creditor.

The posting from the Sales Return Book will be done periodically to the debit side of the Sales Returns Account in the ledger and the individual accounts of the customers will be credited with their respective amounts.

Illustration 8: From the following transactions, prepare the Sales Returns Book of Jindal & Co. and post them to the Ledger:

Date	Credit Note No	Particulars
5.1.06	201	Goyal & Co., Rohtak, returned to us - 2 polyster sarees @ Rs. 125 per saree
10.1.06	202	Accepted return of goods (which were sold for cash) from Garg & Co., Bhiwani, 2 Kota sarees @ Rs. 50 per saree
17.1.06	203	Mittal & Co. Hisar returned to us - 2 silk sarees @ Rs. 325 per saree.
31.1.06		Mohan returned to us one old typewriter worth Rs. 500

Solution

SALES RETURNS BOOKS

Date	Credit Note	Name of Customer	L.F.	Amount Rs.
2006				
Jan 5	201	Goyal & Co., Rohtak		250.00
Jan 17	203	Mittal & Co., Hisar		650.00
				900.00

Note: Return of Kota sarees will be recorded in the Cash Book and return of typewriter will be recorded in the Journal Proper since the Sales Returns Book records only the returns of merchandise purchased on credit.

LEDGER OF JINDAL & CO.

GOYAL & CO., ROHTAK ACCOUNT

Dr. Cr.

Date	Particulars	Folio	Amount (Rs.)	Date	Particulars	Folio	Amount (Rs.)
				2006 Jan 5	By Sales Returns A/c		250.00

MITTAL & CO., HISAR

Dr. Cr.

Date	Particulars	Folio	Amount (Rs.)	Date	Particulars	Folio	Amount (Rs.)
				2006 Jan.17	By Sales Returns A/c		650.00

SALES RETURNS ACCOUNT

Dr. Cr.

Date	Particulars	Folio	Amount (Rs.)	Date	Particulars	Folio	Amount (Rs.)
2006							
Jan 10	To Cash A/c		100.00				
31	To Sundries as per Sales Returns Book		900.00				

5.7 BILLS RECEIVABLE BOOK

Where a payment for a business transaction is not made immediately but is deferred or postponed for a few months, a bill of exchange payable some time ahead may be drawn by the creditor (seller) on his debtor (purchaser). The bill of exchange is then accepted by the debtor indicating that he would pay the amount specified therein on the expiry of the period stated on the bill. To the creditor, who draws the bill upon his customer, it is termed as Bills Receivable representing money to be received at a future date; to the debtor, the bill on acceptance becomes a Bills Payable indicating that the money has to be paid at a future date.

Transactions involving the drawing, the acceptance and negotiation of bills are recorded in Bills Receivable and Bills Payable Books respectively.

Bills Receivable Book is used to record the details of bills receivable on which the business enterprise will receive the amounts from other parties in future. The entries to be made in this book include the name of the acceptor (debtor), the terms, due date, the amount and other details.

Posting: The total of the amount column of the Bills Receivable Book is debited to the Bills Receivable Account while the amount of each bills receivable is posted to the credit of the account of the party from whom it is received.

5.8 BILLS PAYABLE BOOK

This is also a book of original entry and is used to record the particulars of all the bills payable accepted by the business enterprise for the purpose of paying at a future date amounts due by it (the business enterprise or trader) to its or his creditors. The entries to be made in this book relate to the name of the drawer, the name of the payee, the period, the due date, and other particulars. Then the acceptance is duly returned to the drawer.

Posting: The amount of each bill is posted to the debit side of the drawer's account in the ledger and the total of the amount column of the Bills Payable Book is posted to the credit of Bills Payable Account in the ledger.

The followings are the specimen of Bills Receivable and Bills Payable Books:

BILLS RECEIVABLE BOOK

S. No.	Date of receipt	From whom received	L.F.	Name of the acceptor	Where payable	Date of the bill	Period	Due date	Amount	How disposed off
1	1999 March 2	Ram Lal		Ram Lal	Punjab National Bank Chandigarh	1999 Feb. 26	3 Months	1999 May 29	1,000	Endorsed over to Shyam
2	1999 March 5	Roshan Lal		Anil	Bank of India, Hisar	March 2	3 Months	June 5	800	Realised
3	1999 April 1	Vikas Publishing Co.		Vikas	UCO Bank Kashmeri Gate, Delhi	March 20	4 Months	July 23	1,500	Discounted
									3,300	

The above form may be simplified as under:

S. No.	Date of receipt	From whom received	L.F.	Period	Due date	Amount (Rs.)
	1999				1999	
1	March 2	Ram lal		3 Months	May,19	1,000.00
2.	March 5	Roshan Lal		3 Months	June 5	800.00
3.	April 1	Vikas Publishing Co.		4 Months	July 23	1,500.00
						3,300.00

BILLS PAYABLE BOOK

S. No.	Date of receipt	From whom received	L.F.	Name of the acceptor	Where payable	Date of the bill	Period	Due date	Amount (Rs.)	How disposed off
	1999					1999		1999		
1	June, 4	Amit		Arun	Central Bank Hisar	June,2	3 Months	Sep.,5	1,200	Cash paid
	1999					1999		1999		
2	June,6	Rajat		Rajat	Bank of India Hansi	June,4	4 Months	Oct.,7	1,400	Cash paid
	1999					1999		1999		
	July, 12	Parinita		Gopal	Canara Bank Rohtak	July,6	3 Months	Oct.,9	2,000	Renewed
									4,600	

The above form may be simplified as under:

S. No.	Date of the bill	By whom drawn	L.F.	Period	Due date	Amount (Rs.)
1.	June 4	Amit		3 Months	Sept. 5	1,200
2.	June 6	Rajat		4 Months	Oct. 7	1,400
3.	July 8	Parinita		3 Months	Oct. 9	2,000
						4,600

5.9 JOURNAL PROPER

Journal Proper is a residuary book in which those transactions are recorded which cannot be recorded in any other subsidiary book such as (a) Cash Book, (b) Purchases Book, (c) Sales Book, (d) Purchases Returns Book, (e) Sales Returns Book, (f) Bills Receivable Book, and (g) Bills Payable Book. The various examples of transactions entered in a Journal Proper are given below:

(i) **Opening entry**: An Opening Entry is passed in the journal for bringing the balances of various assets, liabilities and capital appearing in the Balance Sheet of the previous accounting period, in the books of current accounting period.

(ii) **Closing entries**: Closing Entries are passed in the journal for closing the nominal accounts by transferring them to the Trading and Profit and Loss Account. These are needed at the end of the accounting year, when the final accounts are prepared.

(iii) **Transfer entries**: Transfer Entries are passed in the journal for transferring an amount from one account to another account, i.e. Transfer of Total Drawings from Drawings Account to Capital Account.

(iv) **Adjusting entries**: Adjusting Entries are passed in the journal to bring into the books of accounts certain unrecorded items like closing stock, depreciation on fixed assets, outstanding and prepaid items. These are needed at the time of preparing the final accounts.

(v) **Rectifying entries**: Rectifying Entries are passed in the journal to rectify the various errors committed while posting, totalling, balancing etc.

(vi) **Miscellaneous entries**: This include the following:

(a) Capital brought in kind. If the proprietor of the business brings in his capital contribution in kind and not in cash, such transaction can be recorded only in the Journal Proper and not in the Cash Book since this transaction does not involve any cash inflow.

(b) Purchase of Assets (other than Stock-in-trade) on credit (e.g., land, building, plant and machinery, furniture and fixture). Such transactions can neither be recorded in the Purchase Book (since no goods have been purchased) nor recorded in the Cash Book (since this transaction does not involve any cash outflow).

(c) Sales of Assets (other than Stock-in-trade) which were sold on credit. Such transaction can neither be recorded in the Sales Book (since no goods have been sold) nor can be recorded in the Cash Book (since this transaction does not involve any cash inflow).

(d) Return of Assets (other than Stock-in-trade) which were sold on credit. Such transactions cannot be recorded in the Return Inwards Book since no goods have been returned.

(e) Return of Assets (other than Stock-in-trade) which were bought on credit. Such transactions cannot be recorded in the Return Outwards book since, no goods have been returned.

(f) Endorsement of Bills Receivable to a creditor.

(g) Dishonour of Bills Receivables (not discounted with bank).

(h) Cancellation of Bills Payable.

(i) Abnormal Loss of Stock-in-trade/other assets by theft, accident, fire, etc.

(j) Writing-off Bad Debts.

5.10 SUMMARY

To overcome the shortcoming of the use of the Journal as the only book of original record, the Journal is sub-divided into special journals. Special journals refers to the journals meant for recording specific business transactions of similar nature which are known as ‘subsidiary books’ or ‘day books’. The main types of special journals are– (i) cash book; (ii) purchases book; (iii) sales book; (iv) purchase return book; (v) sales return book; (vi) bills receivable book; (vii) bills payable book; and (viii) journal propers. Cash book is a special journal which is used for recording all cash receipts and payments. Purchase book is used for recording only the credit purchases of goods and merchandise in which the business in dealing in. Sales book is used to record all the credit sales, purchase return book is used to record the goods returned by the enterprise and sales return book is used to record the goods returned by the customers. Bills receivable book and bills payable book are used to record the details of B/R and B/P respectively. Any entry which is to taking palace in the above mentioned book is being recorded in the book ‘Journal Proper’.

5.11 KEYWORDS

Bill of Exchange: An instrument is writing containing an unconditional order, signed by the maker, directing a certain person to pay a certain sum of money only to, or to the order of, a certain person or to the bearer of the instrument. For the party who will receive the money against bill is bills receivable and for counter party it is known as bills payable.

Journal: Journal is a primary book for recording the day to day transactions in a chronological order.

Goods: The items in which enterprise deals in.

Contra Entry: Entries related to cash and banks are known as contra entries.

Debit Balance: Total of debit side is greater than credit side.

5.12 SELF ASSESSMENT QUESTIONS

1. What do you mean by subsidiary books? Name the principal subsidiary books used for recording credit transactions and also give a brief account of each.

2. What is Cash Book? What are the different types of cash book? How it is balanced?

3. Write short notes on:
   (a) Petty Cash Book
   (b) Debit Note
   (c) Journal Proper
   (d) Credit Note
   (e) Contra entries

4. In which Book of Original Entry, will you record each of the following transactions?
   (i) A allowance of Rs. 50 was offered for an early payment of Cash of Rs. 1,050.
   (ii) A second hand motor car was purchased on credit from Ross for Rs. 10,000 for free delivery van.
   (iii) Goods, the payment of which is due after 2 months, were sold to M/s Bell & Co. for Rs. 1,000.
   (iv) Accounting for the partial recovery from Hari, of an amount of Rs. 2,000 earlier written-off as bad debt.
   (v) Credit purchase of stationery worth Rs. 5,000, by a stationery dealer from Mr. Dubey.

(vi) Rectifying the error of a credit Purchase of goods worth Rs. 10,000 recorded as a credit sale to Mr. Lily, discovered two months later.

(vii) A cheque of Rs. 1,000, which was received from a debtor in full settlement of a claim of Rs. 1,100, is dishonoured.

5. From the particulars given below, enter the transactions in the subsidiary books of Bishen Singh Bedi:

2006	
Jan. 1	Purchased goods from Sunil Rs. 1,500 less 10% trade discount and 5% cash discount terms.
2	Bought from Chetan goods Rs. 900 less 5% trade discount.
4	Sold to Surinder on credit goods worth Rs. 700 less 10% trade discount and 5% cash discount.
8	Sold goods to Vishwa Nath Rs. 900 after allowing 10% trade discount.
10	Booked order with Mohinder for goods Rs. 1800 less 15% trade discount.
14	Returned to Sunil goods received on Ist Instant, not being up to sample, Rs. 500 gross.
16	Sent invoice to Kapil for goods Rs. 600 on which 10% trade discount was allowed.
17	Sold to Shekhar goods Rs. 810 net
19	Kapil returned goods Rs. 300 from consignment sent on 16th instant, less 10% trade discount
21	Bought from Dilip goods Rs. 1,000 less 5% trade discount.
22	Sent credit note to Shekhar for goods returned as damaged in transit Rs. 70.

25 Received a credit note from Dilip for goods returned Rs. 300 less trade discount as per terms.

26 Chetan invoiced us goods Rs. 1,500 less 10% trade discount.

28 Received goods from Mohinder as per our order dated 10th instant.

31 Sold to Vishwanath goods Rs. 500 less 5% trade discount.

6. Record the following transactions in proper subsidiary books of Shri Mukesh:

2006

March 1 He purchased from Calico Mills 500 metres of suiting @ Rs. 60 per metre at 10% trade discount and sold to Patel at double the price than cost.

2 Patel returned 100 metres of suiting. Mukesh returned these goods to Calico Mills.

3 He purchased from Ambiaca Mills 500 saris @ Rs. 200 per sari and out of it he sold to Anand Mahila Samaj 250 saris by adding 20% on it at 10% trade discount.

4 An order for 100 Dhotis @ Rs. 19 per Dhoti is received from Anand Yuvak Mandal. He purchased from Sayaji Mills 1,000 metre shirting @ Rs. 5 per metre at 10% trade discount and 5% cash discount. Half the amount is paid.

7 He returned 100 metres shirting to Sayaji Mills and sent a debit note.

8 He purchased 60 woollen coats @ Rs. 300 per coat on cash from Anjanya Bros.

10 He purchased 500 ready-made pants @ Rs. 50 per

pant from Patwa Bros., on one month credit.

13 He purchased from Ganga Mills 50 saris @ Rs. 100 per sari and gave in "Chief Minister's Relief Fund"

7. Prepare a two column cash book from the following transactions of Sh. R.K. Gupta.

2006		Rs.
Jan 1	Cash in hand	4,000
6	Cash purchases	2,000
10	Wages paid	40
11	Cash sales	6,000
12	Cash received from Suresh	1,980
	and discount allowed	20
19	Cash paid to Munna	2,470
	and discount received	30
27	Cash paid to Radhey	400
28	Purchased goods for cash	2,070

8. Enter the following transactions in cash book with cash, discount and bank columns.

2006		Rs.
Jan 1	Cash in hand	8,000
1	Bank balance	3,000
3	Purchased goods and paid by cheque	1,000
4	Sold goods for cash	500
5	Sold good for cash	300
6	Sale proceeds of Jan. 5 deposited in bank	
9	Received from Mohan	400
	Discount allowed to him	10
12	Withdrew by cheque for private use	500

14	Withdrew cash for private use	50
15	Paid bills payable	600
17	Paid to Suresh by cheque	400
	He allowed discount	10
20	Received a cheque from Dina Nath in full settlement of his account of Rs. 525	500
21	Cheque of Dina Nath endorsed to Bhola Nath	
23	Received a cheque from Nagendra and sent it To bank.	300
	Discount allowed to him	8
25	In connection with cash sales received cash Rs. 300 and cheque for Rs. 500	
27	Received cheque from Pramod which was deposited into the bank the same day	200
28	Deposited in bank	200
29	Received cheque from Hari and immediately sent it to bank	400
	Discount allowed to him	10
30	Received cheque from Pramod	150
	Discount allowed to him	10
30	Pramod's cheque endorsed to Kailash	150
	He allowed discount	10
30	Bank notifies that Hari's cheque has been dishonoured	
30	Suresh paid directly into our Bank account	500
30	Bank notifies that Nagendra's cheque has been dishonoured.	
30	The bank has charged Rs. 50 for bank charges and allowed interest Rs. 300	

9. From the following particulars prepare the Petty Cash Book on Imprest System of Mr. A for the month of January 2006.

2006		Rs.
Jan 1	Received by Petty cashier	150
6	Paid travelling expenses	8
8	Bought postage & stamps	12
10	Purchased pens and ink	10
11	Office expenses	8
14	Purchased stationery	9
15	Tea & Coffee	6
17	Paid telephone bills	22
19	Advance paid to clerk Mr. Sham Lal	10
21	Purchased table	20
22	Paid for Limca	3
26	Paid for advertisement	18
31	Paid tips to peons	6
31	Gave marriage present to office clerk Mr. Shab	16

5.13 REFERENCES/SUGGESTED READINGS

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Subject: **Financial Accounting-I**	
Course Code: **BBA-104**	Author: **Dr. Mahesh Chand Garg**
Lesson: **6**	Vetter:

PREPARATION OF PROFIT AND LOSS ACCOUNT AND BALANCE SHEET

STRUCTURE

6.0 OBJECTIVES

After going through this chapter, you should be able-

- To know the meaning of financial statements.
- To understand the meaning and preparation of Trading Account, Manufacturing Account, Profit and Loss Account, and Balance Sheet

- To know the meaning of Adjustments and Accounting treatment of the same.

6.1 INTRODUCTION

The transactions of a business enterprise for the accounting period are first recorded in the books of original entry, then posted therefrom into the ledger and lastly tested as to their arithmetical accuracy with the help of trial balance. After the preparation of the trial balance, every businessman is interested in knowing about two more facts. They are: (i) Whether he has earned a profit or suffered a loss during the period covered by the trial balance, and (ii) Where does he stand now? In other words, what is his financial position?

For the above said purposes, the businessman prepares financial statements for his business i.e. he prepares the Trading and Profit and Loss Account and Balance Sheet at the end of the accounting period. These financial statements are popularly known as final accounts. The preparation of financial statements depends upon whether the business concern is a trading concern or manufacturing concern. If the business concern is a trading concern, it has to prepare the following accounts along with the Balance Sheet: (i) Trading Account; and (ii) Profit and Loss Account.

But, if the business concern is a manufacturing concern, it has to prepare the following accounts along with the Balance Sheet: (i) Manufacturing Account; (ii) Trading Account; and (iii) Profit and Loss Account.

Trading Account is prepared to know the Gross Profit or Gross Loss. Profit and Loss Account discloses net profit or net loss of the business. Balance sheet shows the financial position of the business on a given date. For preparing final accounts, certain accounts representing incomes or expenses are closed either by transferring to Trading Account or Profit and Loss Account. Any Account which cannot find a place in any of these two accounts goes to the Balance Sheet.

6.2 TRADING ACCOUNT

After the preparation of trial balance, the next step is to prepare Trading Account. Trading Account is one of the financial statements which shows the result of buying and selling of goods and/or services during an accounting period. The main objective of preparing the Trading Account is to ascertain gross profit or gross loss during the accounting period. Gross Profit is said to have made when the sale proceeds exceed the cost of goods sold. Conversely, when sale proceeds are less than the cost of goods sold, gross loss is incurred. For the purpose of calculating cost of goods sold, we have take into consideration opening stock, purchases, direct expenses on purchasing or manufacturing the goods and closing stock. The balance of this account i.e. gross profit or gross loss is transferred to the Profit and Loss Account. The specimen of a Trading Account is given below:

TRADING ACCOUNT

FOR THE YEAR ENDED 31ST MARCH, 2006

Particulars	Amount Rs.	Particulars	Amount Rs.
To Opening Stock		By Sales	
To Purchases		*Less* Sales Returns	
Less Purchases Returns		By Closing Stock	
To Direct Expenses:		By Gross Loss transferred to P & L A/c	
Carriage Inward			
Wages			
Fuel, Power and Lighting Expenses			
Manufacturing Expenses			
Coal, Water and Gas			
Motive Power			
Octroi			
Import Duty			
Custom Duty			
Consumable Stores			
Freight and Insurance			
Royalty on manufactured Goods			
Packing charges			

To Gross Profit transferred to P & L A/c			

Important points regarding trading account

1. Stock

The term 'stock' includes goods lying unsold on a particular date. The stock may be of two types:

(a) Opening stock

(b) Closing stock

Opening stock refers to the closing stock of unsold goods at the end of previous accounting period which has been brought forward in the current accounting period. This is shown on the debit side of the Trading Account.

Closing stock refers to the stock of unsold goods at the end of the current accounting period. Closing stock is valued either at cost price or at market price whichever is less. Such valuation of stock is based on the principle of conservatism which lays down that the expected profit should not be taken into account but all possible losses should be duly provided for.

Closing stock is an item which is not generally available in the trial balance. If it is given in Trial Balance, it is not to be shown on the credit side of Trading Account but appears only in the Balance Sheet as an asset. But if it is given outside the trial balance, it is to be shown on the credit side of the Trading Account as well as on the asset side of the Balance Sheet.

2. Purchases

Purchases refer to those goods which have been bought for resale. It includes both cash and credit purchases of goods. The following items are shown by way of deduction from the amount of purchases:

(a) Purchases Returns or Return Outwards.
(b) Goods withdrawn by proprietor for his personal use.
(c) Goods received on consignment basis or on approval basis or on hire purchase.
(d) Goods distributed by way of free samples.
(e) Goods given as charity.

3. Direct Expenses

Direct expenses are those expenses which are directly attributable to the purchase of goods or to bring the goods in saleable condition. Some examples of direct expenses are as under:

(a) Carriage Inward: Carriage paid for bringing the goods to the godown is treated as carriage inward and it is debited to Trading Account.

(b) Freight and insurance: Freight and insurance paid for acquiring goods or making them saleable is debited to Trading Account. If it is paid for the sale of goods, then it is to be charged (debited) to Profit and Loss Account.

(c) Wages: Wages incurred in a business is direct, when it is incurred on manufacturing or merchandise or on making it saleable. Other wages are indirect wages. Only direct wages are debited to the Trading Account. Other wages are debited to the Profit and Loss Account. If it is not mentioned whether wages are direct or indirect, it should be assumed as direct and should appear in the Trading Account.

(d) Fuel, Power and Lighting Expenses: Fuel and power expenses are incurred for running the machines. Being directly related to production, these are considered as direct expenses and debited to Trading Account. Lighting expenses of factory is also charged to Trading Account, but lighting expenses of administrative office or sales office are charged to Profit and Loss Account.

(e) Octroi: When goods are purchased within municipality limits, generally octroi duty has to be paid on it. It is debited to Trading Account.

(f) Packing Charges: There are certain types of goods which cannot be sold without a container or proper packing. These form a part of the finished product. One example is ink, which cannot be sold without a bottle. These type of packing charges are debited to Trading Account. But if the goods are packed for their safe despatch to customers, i.e. packing meant for transportation or fancy packing meant for advertisement will appear in the Profit and Loss Account.

(g) Manufacturing Expenses: All expenses incurred in manufacturing the goods in the factory such in factory rent, factory insurance etc. are debited to Trading Account.

(h) Royalties: These are the payments made to a patentee, author or landlord for the right to use his patent, copyright or land. If royalty is paid on the basis of production, it is debited to Trading Account and if it is paid on the basis of sales, it is debited to Profit and Loss Account.

4. Sales

Sales include both cash and credit sales of those goods which were purchased for resale purposes. Some customers might return the goods sold to them (called sales return) which are deducted from the sales in the inner column and net amount is shown in the outer column. While ascertaining the amount of sales, the following points need attention:

(a) If a fixed asset such as furniture, machinery etc. is sold, it should not be included in sales.

(b) Goods sold on consignment or on hire purchase or on sale or return basis should be recorded separately.

(c) If goods have been sold but not yet despatched, these should not be shown under sales but are to be included in closing stock.

(d) Sales of goods on behalf of others and forward sales should also be excluded from sales.

6.2.1 Closing entries for trading account

The journal entries necessary to transfer opening stock, purchases, sales and returns to the Trading Account are called closing entries, as they serve to close these accounts. These are as follows:

1. For transfer of opening stock, net purchases and direct expenses to Trading A/c.

   Trading A/c Dr.

   To Stock (Opening) A/c

   To Purchases A/c

   To Direct Expenses A/c

   (Being opening stock, purchases and direct expenses transferred to Trading Account)

2. For transfer of net sales and closing stock to Trading A/c

   Sales A/c Dr.

   Stock (Closing) A/c Dr.

   To Trading A/c

   (Being sales, closing stock transferred to Trading Account)

3. (a) For Gross Profit

Trading A/c Dr.

To Profit & Loss A/c

(Being gross profit transferred to Profit and Loss Account)

(b) For Gross Loss

Profit & Loss A/c Dr.

To Trading A/c

(Being gross loss transferred to Profit and Loss Account)

Illustration I: From the following balances extracted from the books of Mr. Bansi Lal, prepare the Trading Account for the year ending 31st March, 2006.

Purchases	42,500	Wages	5,000
Mfg. expenses	1,950	Op. Stock	10,000
Sales	67,500	Sales returns	50
Carriage inwards	100	Purchases returns	200
Freight and duty	5,000		
Stores consumed	200		
Power	300		

The value of stock unsold is Rs. 12,000.

Solution

TRADING ACCOUNT

FOR THE YEAR ENDED 31ST MARCH, 2006

To Opening stock		10,000	By Sales	67,500	
To Purchases	42,500		*Less* returns	50	67,450
Less returns	200	42,300	By Closing Stock		12,000
To Manufacturing exp.		1,950			
To Carriage inwards		100			
To Freight and duty		5,000			

To Stores consumed	200			
To Power	300			
To Wages	5,000			
To Gross Profit transferred to Profit & Loss A/c	14,600			
	79,450			79,450

6.3 MANUFACTURING ACCOUNT

The concern which are engaged in the conversion of raw materials into finished goods, are interested to knowing the cost of production of the goods produced. The cost of the goods produced cannot be obtained from the Trading Account. So, it is desirable to prepare a Manufacturing Account prior to be preparation of the Trading account with the object of ascertaining the cost of goods produced during the accounting period.

The proforma of Manufacturing Account is given as under:

MANUFACTURING ACCOUNT
FOR THE YEAR ENDING..................

Dr. Cr.

	Rs.		Rs.
To Work-in process (Opening)		By Work-in-process (Closing)	
To Raw Materials consumed:		By Sale of Scrap	
Opening Stock		By Cost of Production of finished goods during the period transferred to the Trading Account	
Add Purchases of Raw Materials			
Less Closing Stock of Raw Materials			
To Direct or Productive Wages			
To Factory Overheads:			
Power & Fuel			
Repairs of Plant			
Depreciation on Plant			

Factory Rent			

The Trading Account in case of manufacturers will appear as follows:

TRADING ACCOUNT
FOR THE YEAR ENDING.............

Dr. Cr.

	Rs.		Rs.
To Opening Stock of Finished Goods		By Sales *less* Returns	
To Cost of Production of finished goods transferred from Manufacturing Account		By Closing Stock of Finished goods	
To Purchases of Finished Goods *less* Returns		By Gross Loss transferred to Profit and Loss A/c	
To Carriage Charges on goods purchased			
To Gross Profit transferred to Profit and Loss A/c			

The gross profit or loss shown by the Trading Account will be taken to the Profit and Loss Account which will be prepared in the usual way as explained in the following pages.

Important Points Regarding Manufacturing Account

1. Raw Materials Consumed

The cost of raw materials consumed to be included in the debit side of the Manufacturing Account shall be calculated as follows:

		Rs.
Opening Stock of raw materials	....	
Add Purchases of raw materials	....	....

Less Purchase return of raw materials ....

Less Closing stock of raw materials ....

Cost of raw material consumed

2. Direct Expenses

The expenses and wages that are directly incurred in the process of manufacturing of goods are included under this head..

3. Factory Overheads

The term "overheads" includes indirect material, indirect labour and indirect expenses. Therefore, the term "factory overheads" stands for all factory indirect material, indirect labour and indirect expenses. Examples of factory overheads are: rent for the factory, depreciation of the factory machines and insurance of the factory, etc.

4. Cost of Production

Cost of production is computed by deducting from the total of the debit side of the Manufacturing Account, the total of the various items appearing on the credit side of the Manufacturing Account.

Difference between trading account and manufacturing account

	Manufacturing Account	**Trading Account**
1.	Manufacturing account is prepared to find out the cost of goods produced.	Trading Account is prepared to find out the Gross Profit/Gross Loss.
2.	The balance of the manufacturing Account is transferred to the Trading Account.	The balance of the Trading account is transferred to the Profit and Loss Account.
3.	Sale of crap is shown in the Manufacturing Account.	Sale of scrap is not shown in the Trading Account.
4.	Stocks of raw materials and work-in-	Stocks of finished goods are shown

	progress are shown in the Manufacturing Account.	in the Trading Account.
5.	Manufacturing Account is a part of the Trading account.	Trading Account is a part of the Profit and Loss Account.

6.4 PROFIT AND LOSS ACCOUNT

Trading Account results in the gross profit/loss made by a businessman on purchasing and selling of goods. It does not take into consideration the other operating expenses incurred by him during the course of running the business. Besides this, a businessman may have other sources of income. In order to ascertain the true profit or loss which the business has made during a particular period, it is necessary that all such expenses and incomes should be considered. Profit and Loss Account considers all such expenses and incomes and gives the net profit made or net loss suffered by a business during a particular period. All the indirect revenue expenses and losses are shown on the debit side of the Profit and Loss Account, where as all indirect revenue incomes are shown on the credit side of the Profit and Loss Account.

Profit and Loss Account measures net income by matching revenues and expenses according to the accounting principles. Net income is the difference between total revenues and total expenses. In this connection, we must remember that all the expenses, for the period are to be debited to this account - whether paid or not. If it is paid in advance or outstanding, proper adjustments are to be made (Discussed later). Likewise all revenues, whether received or not are to be credited. Revenue if received in advance or accrued but not received, proper adjustment is required.

A proforma of the Profit and Loss Account showing probable items therein is as follows:

PROFIT AND LOSS A/C

FOR THE YEAR ENDED ....

	Rs.		Rs.
To Gross Loss b/d		By Gross Profit b/d	
To *Selling and Distribution Expenses*:		By *Other Income*:	
Advertisement		Discount received	
Travellers' Salaries		Commission received	
Expenses & Commission		By Non-trading Interest:	
Godown Rent		Bank Interest	
Export Expenses		Rent of property let-out	
Carriage Outwards		Dividend from shares	
Bank Charges		By *Abnormal Gains*:	
Agent's Commission		Profit on sale of machinery	
Upkeep of Motor Lorries		Profit on sale of investment	
To *Management Expenses*:		By Net Loss transferred to Capital Account	
Rent, Rates and Taxes			
Heating and Lighting			
Office Salaries			
Printing & Stationary			
Postage & Telegrams			
Telephone Charges			
Legal Charges			
Audit Fees			
Insurance			
General Expenses			
To *Depreciation and Maintenance*:			
Depreciation			
Repairs & Maintenance			
To *Financial Expenses*:			
Discount Allowed			
Interest on Loans			
Discount on Bills			
To *Abnormal Losses*:			
Loss by fire (not covered by Insurance)			
Loss on Sale of Fixed Assets			

Loss on Sale of Investments To Net profit transferred to Capital A/c			

6.4.1 Important points in Profit and Loss account

1. Selling and Distribution Expenses

These expenses are incurred for promoting sales and distribution of sold goods. Example of such expenses are godown rent, carriage outwards, advertisement, cost of after sales service, selling agents commission, etc.

2. Management Expenses

These are the expenses incurred for carrying out the day-to-day administration of a business. Expenses, under this head, include office salaries, office rent and lighting, printing and stationery and telegrams, telephone charges, etc.

3. Maintenance Expenses

These expenses are incurred for maintaining the fixed assets of the administrative office in a good condition. They include repairs and renewals, etc.

4. Financial Expenses

These expenses are incurred for arranging finance necessary for running the business. These include interest on loans, discount on bills, etc.

5. Abnormal Losses

There are some abnormal losses that may occur during the accounting period. All types of abnormal losses are treated as extra ordinary expenses and debited to Profit and Loss Account. Examples are stock lost by fire and not covered by insurance, loss on sale of fixed assets, etc.

Following are the expenses not to appear in the Profit and Loss Account:

(i) Domestic and household expenses of proprietor or partners.

(ii) Drawings in the form of cash, goods by the proprietor or partners.

(iii) Personal income tax and life insurance premium paid by the firm on behalf of proprietor or partners.

6. Gross Profit

This is the balance of the Trading Account transferred to the Profit and Loss Account. If the Trading Account shows a gross loss, it will appear on the debit side.

7. Other Income

During the course of the business, other than income from the sale of goods, the business may have some other income of financial nature. The examples are discount or commission received.

8. Non-trading Income

Such incomes include interest on bank deposits, loans to employees and investment in debentures of companies. Similarly, dividend on investment in shares of companies and units of mutual funds are also known as non-trading incomes and shown in Profit and Loss Account.

9. *Abnormal Gains*

There may be capital gains arising during the course of the year, e.g., profit arising out of sale of a fixed asset. Such profit is shown as a separate income on the credit side of the Profit and Loss Account.

6.4.2 Closing entries for Profit and Loss account

(i) For transfer of various expenses to Profit & Loss A/c

Profit and Loss A/c Dr.

To Various Expenses A/c

(Being various indirect expenses transferred to Profit and Loss Account)

(ii) For transfer of various incomes and gains to Profit & Loss A/c

Various Incomes & Gains A/c Dr.

To Profit & Loss A/c

(Being various incomes & gains transferred to Profit and Loss Account)

(iii) (a) For Net Profit

Profit & Loss A/c Dr.

To Capital A/c

(Being Net Profit transferred to capital)

(b) For Net Loss

Capital A/c Dr

To Profit & Loss A/c

(Being Net Loss transferred to Capital Account)

Illustration II: From the following balances extracted at the close of year ended 31 March, 2006, prepare Profit and Loss Account as at that date:

	Rs.		Rs.
Gross Profit	51,000	Discount (Dr.)	500
Carriage Outward	2,500	Apprentice Premium (Cr.)	1,500

Salaries	5,500	Printing & Stationary	250
Rent	1,100	Rates & Taxes	350
Fire Insurance Premium	900	Travelling Expenses	200
Bad Debts	2,100	Sundry Trade Expenses	300
Commission Received	1,000	Discount allowed by Creditors	800

Solution

PROFIT & LOSS ACCOUNT OF M/S.............................

FOR THE YEAR ENDED 31ST MARCH, 2006

Dr. Cr.

Particular	Rs.	Particular	Rs.
To Carriage Outward	2,500	By Gross Profit b/d	51,000
To Salaries	5,500	By Apprentice Premium	1,500
To Rent	1,100	By Discount by Creditors	800
To Fire Insurance Premium	900	By Commission	1,000
To Bad Debts	2,100		
To Discount	500		
To Printing & Stationary	250		
To Rent & Taxes	350		
To Travelling Expenses	200		
To Sundry Trade Expenses	300		
To Net Profit transferred to Capital A/c	40,600		
	54,300		54,300

Distinction between trading account and Profit and Loss Account

	Profit and Loss Account	**Trading Account**
1.	Profit and Loss Account is	Trading Account is prepared as a

	Profit and Loss Account	**Trading Account**
	prepared as a main account.	part or section of the Profit and Loss Account.
2.	Indirect expenses are taken in Profit and Loss Account.	Direct Expenses are taken in Trading Account.
3.	Net Profit or Net Loss is ascertained from the Profit and Loss Account.	Gross Profit or Gross Loss is ascertained from Trading Account.
4.	The balance of the Profit and Loss Account i.e. Net Profit or Net Loss is transferred to proprietor's Capital Account.	The Balance of the Trading Account i.e. Gross Profit or Gross Loss is transferred to the Profit and Loss Account.
5.	Items of accounts written in the Profit and Loss Account are much more as compared to the Trading Account.	Items of account written in the Trading Account are few as compared the Profit and Loss Account.

6.5 BALANCE SHEET

A Balance Sheet is a statement of financial position of a business concern at a given date. It is called a Balance Sheet because it is a sheet of balances of those ledger accounts which have not been closed till the preparation of Trading and Profit and Loss Account. After the preparation of Trading and Profit and Loss Account the balances left in the trial balance represent either personal or real accounts. In other words, they either represent assets or liabilities existing on a particular date. Excess of assets over liabilities represent the capital and is indicative of the financial soundness of a company.

A Balance Sheet is also described as a "Statement showing the Sources and Application of Capital". It is a statement and not an account and prepared from real and personal accounts. The left hand side of the

Balance Sheet may be viewed as description of the sources from which the business has obtained the capital with which it currently operates and the right hand side as a description of the form in which that capital is invested on a specified date.

Characteristics

The characteristics of a Balance Sheet are summarised as under:

(a) A Balance Sheet is only a statement and not an account. It has no debit side or credit side. The headings of the two sides are 'Assets' and 'Liabilities'.

(b) A Balance Sheet is prepared at a particular point of time and not for a particular period. The information contained in the Balance Sheet is true only at that particular point of time at which it is prepared.

(c) A Balance Sheet is a summary of balances of those ledger accounts which have not been closed by transfer to Trading and Profit and Loss Account.

(d) A Balance Sheet shows the nature and value of assets and the nature and the amount of liabilities at a given date.

6.5.1 Classification of assets and liabilities

Assets

Assets are the properties possessed by a business and the amount due to it from others. The various types of assets are:

(a) Fixed Assets

All assets that are acquired for the purpose of using them in the conduct of business operations and not for reselling to earn profit are called fixed assets. These assets are not readily convertible into cash in the normal course of business operations. Examples are land and building, furniture, machinery, etc.

(b) Current Assets

All assets which are acquired for reselling during the course of business are to be treated as current assets. Examples are cash and bank balances, inventory, accounts receivables, etc.

(c) Tangible Assets

There are definite assets which can be seen, touched and have volume such as machinery, cash, stock, etc.

(d) Intangible Assets

Those assets which cannot be seen, touched and have no volume but have value are called intangible assets. Goodwill, patents and trade marks are examples of such assets.

(e) Fictitious Assets

Fictitious assets are not assets at all since they are not represented by any tangible possession. They appear on the asset side simply because of a debit balance in a particular account not yet written off e.g. provision for discount on creditors, discount on issue of shares etc.

(f) Wasting Assets

Such assets as mines, quarries etc. that become exhausted or reduce in value by their working are called wasting assets.

(g) Contingent Assets

Contingent assets come into existence upon the happening of a certain event or the expiry of a certain time. If that event happens, the asset becomes available otherwise not, for example, sale agreement to acquire some property, hire purchase contracts etc.

In practical no reference is made to contingent assets in the Balance Sheet. At the most, they may form part of notes to the Balance Sheet.

Liabilities

A liability is an amount which a business is legally bound to pay. It is a claim by an outsider on the assets of a business. The liabilities of a business concern may be classified as:

(a) Long Term Liabilities

The liabilities or obligations of a business which are not payable within the next accounting period but will be payable within next five to ten years are known as long term liabilities. Public deposits, debentures, bank loan are the examples of long term liabilities.

(b) Current Liabilities

All short term obligations generally due and payable within one year are current liabilities. This includes trade creditors, bills payable etc.

(c) Contingent Liabilities

A contingent liability is one which is not an actual liability. They become actual on the happenings of some event which is uncertain. In other words, they would become liabilities in the future provided the contemplated event occurs. Since such a liability is not actual liability it is not shown in the Balance Sheet. Usually it is mentioned in the form of a footnote below the Balance Sheet.

6.5.2 Marshalling of assets and liabilities

The arrangement of assets and liabilities in a particular order is called marshalling of the Balance Sheet. Assets and liabilities can be arranged in the Balance Sheet into two ways:

(a) In order of liquidity.

(b) In order of permanence.

When assets and liabilities are arranged according to their reliability and payment preferences, such an order is called liquidity order. Such arrangement is given below in Balance Sheet (a). When the order is reversed from that what is followed in liquidity, it is called order of permanence. In other words, assets and liabilities are listed in order of permanence. This order of Balance Sheet is given below in Balance Sheet (B).

BALANCE SHEET (A)

(IN ORDER OF LIQUIDITY)

Liabilities	Rs.	Assets	Rs.
Bills payable		Cash in hand	
Loans		Cash at bank	
Sundry creditors		Investments	
Outstanding expenses		Sundry debtors	
Reserves		Bills receivable	
Capital		Stock-in-trade	
Add Net Profit		Loose tools	
Add Interest		Fixtures and fittings	
Less Drawings		Plant and machinery	
		Building	
		Land	
		Goodwill	

BALANCE SHEET (B)

(IN ORDER OF PERMANENCE)

Liabilities	Rs.	Assets	Rs.
Capital		Goodwill	
Add Net Profit		Land	
Add Interest		Building	
Less Drawings		Plant and machinery	
Reserves		Fixtures and fittings	
Outstanding expenses		Loose tools	
Sundry creditors		Stock-in-trade	
Loans		Bills receivable	
Bills payable		Sundry debtors	
		Investments	
		Cash at bank	
		Cash in hand	

Illustration III: The following balances are extracted from the books of Kautilya & Co. on 31st March, 2006. You are required prepare the Trading and Profit and Loss Account and a Balance Sheet as on that date.

	Rs.		Rs.
Stock on April, 1	500	Commission (Cr.)	200
B/R	2,250	Returns Outwards	250
Purchases	19,500	Trade Expenses	100
Wages	1,400	Office Fixtures	500
Insurance	550	Cash in Hand	250
Sundry Debtors	15,000	Cash at Bank	2,375
Carriage Inwards	400	Rent & Taxes	550
Commission (Dr.)	400	Carriage Outwards	725
Interest on Capital	350	Sales	25,000
Stationary	225	Bills Payable	1,500
Returns Inwards	650	Creditors	9,825
		Capital	8,950

The closing stock was valued at Rs.12,500.

Solution

TRADING & PROFIT AND LOSS A/C OF MESSRS KAUTILYA & CO.

FOR THE YEAR ENDED 31ST MARCH, 2006

	Rs.	Rs.		Rs.	Rs.
To Opening stock		500	By Sales	25,000	
To Purchases	19,500		Less returns	650	24,350
Less returns	250	19,250	By Closing Stock		12,500
To Wages		1,400			
To Carriage Inwards		400			
To Gross Profit c/d		15,300			
		36,850			36,850
To Insurance		550	By Gross Profit b/d		15,300
To Commission		400	By Commission		200
To Interest on Capital		350			
To Stationary		225			
To Trade Expenses		100			
To Rent and Taxes		550			
To Carriage Outwards		725			
To Net Profit transferred to Capital A/c		12,600			
		15,500			15,500

BALANCE SHEET OF MESSERS KAUTILYA & CO

AS ON 31ST MARCH, 2006

Liabilities		Amount (Rs.)	Assets	Amount (Rs.)
Creditors		9,825	Cash in Hand	250
Bills Payable		1,500	Cash at Bank	2,375
Capital	8,950		Bill Receivable	2,250
Add Net Profit	12,600	21,550	Stock	12,500
			Sundry Debtors	15,000
			Office Fixtures	500
		32,875		32,875

6.6 ADJUSTMENTS

While preparing trading and Profit and Loss account one point that must be kept in mind is that expenses and incomes for the full trading period are to be taken into consideration. For example if an expense has been incurred but not paid during that period, liability for the unpaid amount should be created before the accounts can be said to show the profit or loss. All expenses and incomes should properly be adjusted through entries. These entries which are passed at the end of the accounting period are called adjusting entries. Some important adjustments which are to be made at the end of the accounting year are discussed in the following pages.

1. Closing Stock

This is the stock which remained unsold at the end of the accounting period. Unless it is considered while preparing the trading account, the gross profit shall not be correct. Adjusting entry for closing stock is as under:

Closing stock Account Dr.

To Trading account

(Being closing stock brought in to books)

Treatment in final accounts

(i) Closing stock is shown on the credit side of Trading account.

(ii) At same value it will be shown as an asset in the balance sheet.

2. Outstanding Expenses

Those expenses which have become due and have not been paid at the end of the accounting year, are called outstanding expenses. For example, the businessman has paid rent only for 4 months instead of one year. This means 8 months' rent is outstanding. In order to bring this fact into books of accounts, the following adjustment entry will be passed at the end of the year:

Rent A/c Dr.

To outstanding Rent A/c

(Being rent outstanding for 8 months)

The two fold effect of the above adjustment will be (i) the amount of outstanding rent will be added to the rent on the debit side of Profit and Loss Account, and (ii) outstanding rent will be shown on the liability side of the Balance Sheet.

3. Prepaid Expenses

There are certain expenses which have been paid in advance or paid for the future period which is not yet over or not yet expired. The benefit of such expenses is to be enjoyed during the next accounting period. Since, such expenses have already been paid, they have also recorded in the books of account of that period for which they do not relate. For example, insurance premium paid for one year Rs.3,600 on 1st July, 1996. The final accounts are prepared on 31st March, 1997. The benefit of the insurance premium for the period from 1st April to 30th June, 1997 is yet to expire. Therefore, the insurance premium paid for the period from 1st April 1997 to 30th June, 1997, i.e. for 3 months, shall be treated as "Prepaid Insurance Premium".

The adjustment entry for prepaid expenses is as under:

Prepaid Expenses Account Dr.

To Expenses Account

(Being the adjustment entry for prepaid expenses)

The amount of prepared expenses will appear as an asset in the Balance Sheet while amount of appropriate expense account will be shown in the Profit and Loss Account by way of deduction from the said expense.

4. Accrued Income

Accrued income means income which has been earned during the current accounting year and has become due but not received by the end of the current accounting period. Examples of such income are income from investments, dividend on shares etc. The adjustment entry for accrued income is as under:

Accrued Income A/c		Dr.
To Income A/c		

(Being the adjustment entry for accrued income)

Treatment in final accounts

i) The amount of accrued income is added to the relevant item of income on the credit side of the Profit and Loss Account to increase the amount of income for the current year.

ii) The amount of accrued income is a debt due from a third party to the business, so it is shown on the assets side of the Balance Sheet.

5. Income Received in Advance

Income received but not earned during the current accounting year is called as income received in advance. For example, if building has been given to a tenant on Rs.2,400 p.a. but during the year Rs.3,000 has been received, then Rs.600 will be income received in advance. In order to bring this into books of account, the following adjusting entry will be made at the end of the accounting year:

Rent A/c	Dr.	Rs.600	
To Rent Received in Advance A/c			Rs.600

The two-fold effect of this adjustment will be:

(i) It is shown on the credit side of Profit and Loss account by way of deduction from the income, and

(ii) It is shown on the liabilities side of the Balance Sheet as income received in advance.

6. Depreciation

Depreciation is the reduction in the value of fixed asset due to its use, wear and tear or obsolescence. When an asset is used for earning purposes, it is necessary that reduction due to its use, must be charged to the Profit and Loss account of that year in order to show correct profit or loss and to show the asset at its correct value in the Balance Sheet. There are various methods of charging depreciation on fixed assets. Suppose machinery for Rs.10,000 is purchased on 1.1.98, 20% p.a. is the rate of depreciation. Then Rs.2,000 will be depreciation for the year 1998 and will be brought into account by passing the following adjusting entry:

Depreciation A/c	Dr.	Rs. 2,000	
To Machinery A/c			Rs.2,000

The two-fold effect of depreciation will be:

(i) Depreciation is shown on the debit side of Profit and Loss Account, and

(ii) It is shown on the asset side of the balance sheet by way of deduction from the value of concerned asset.

7. Interest on Capital

The amount of capital invested by the trader in his business is just like a loan by the firm. Charging interest on capital is based on the argument that if the same amount of capital were invested in some securities elsewhere, the businessman would have received interest thereon. Such interest on capital is not actually paid to the businessman. Interest on capital is a gain to the businessman because it increases its capital, but it is a loss to the business concern.

Calculation of Interest on Capital

Interest is calculated on the opening balance of the capital at the given rate for the full accounting period. If some additional amount of capital has been brought in the business during the course of accounting period, interest on such additional amount of capital is calculated from the date of introduction to the end of the accounting period. The following adjustment entry is passed for allowing interest on capital:

Interest on Capital Account Dr.

To Capital Account

(Being the adjustment entry for interest on capital)

Treatment in final accounts

(i) Interest allowed on capital is an expense for the business and is debited to Profit and Loss Account, i.e. it is shown on the debit side of the Profit and Loss Account.

(ii) Such interest is not actually paid in cash to the businessman but added to his capital account. Hence, it is shown as an addition to capital on the liabilities side of the Balance Sheet.

8. Interest of Drawings

It interest on capital is allowed, it is but natural that interest on drawings should be charged from the proprietor, as drawings reduce capital. Suppose during an accounting year, drawings are Rs.10,000 and interest on drawings is Rs.500. In order to bring this into account, the following entry will be passed:

Drawings A/c Dr. Rs.500

To Interest on Drawings A/c Rs.500

The two-fold effect of interest on drawings will be:

(i) Interest on drawings will be shown on the credit side of Profit and Loss Account, and

(ii) Shown on the liabilities side of the Balance Sheet by way of addition to the drawings which are ultimately deducted from the capital.

9. Bad Debts

Debts which cannot be recovered or become irrecoverable are called bad debts. It is a loss for the business. Such a loss is recorded in the books by making following adjustment entry:

Bad Debts A/c Dr.

To Sundry Debtors A/c

(Being the adjustment entry for bad debts)

Treatment in final accounts

The profit and Loss Account is debited with the amount of bad debts and in the Balance Sheet, the Sundry Debtors balance will be reduced by the same amount in the assets side.

10. Provisions for Doubtful Debts

In addition to the actual bad debts, a business unit may find on the last day of the accounting period that certain debts are doubtful, i.e., the amount to be received from debtors may or may not be received. The amount of doubtful debts is calculated either by carefully examining the position of each debtor individually and summing up the amount of doubtful debts from various debtors or it may be computed (as is usually done) on the basis of some percentage (say 5%) of debtors at the end of the accounting period. The percentage to be adopted is usually based upon the past experience of the business. The reasons for making provision for doubtful debts are two as discussed below:

(i) Loss caused by likely bad debts must be charged to the Profit and Loss of the period for which credit sales have been made to ascertain correct profit of the period.

(ii) For showing the true position of realisable amount of debtors in the Balance Sheet, i.e., provision for doubtful debts will be deducted from the amount of debtors to be shown in the balance sheet.

For example, sundry debtors on 31.12.1998 are Rs.55,200. Further bad debts are Rs.200. Provision for doubtful debts @ 5% is to be made on debtors. In order to bring the provision for doubtful debts of Rs.2,750, i.e., 5% on Rs.55,000 (55,200-200), the following entry will be made:

Profit and Loss A/c	Dr.	Rs.2,750	
To Provision for Doubtful Debts A/c			Rs.2,750
(Being Provision for Doubtful Debts provided)			

It may be carefully noted that further bad debts (if any) will be first deducted from debtors and then a fixed percentage will be applied on the remaining debtors left after deducting further debts. It is so because percentage is for likely bad debts and not for bad debts which have been decided to be written off.

Treatment in final accounts

(i) The amount of provision for doubtful debts is a provision against a possible loss so it should be debited to Profit and Loss account.

(ii) The amount of provision for doubtful debts is deducted from sundry debtors on the assets side of the balance sheet.

11. Provision for Discount on Debtors

It is a normal practice in business to allow discount to customers for prompt payment and it constitutes a substantial sum. Some times the goods are sold on credit to customers in one accounting period whereas the payment of the same is received in the next accounting period and discount is to be allowed. It is a prudent policy to charge this expenditure (discount allowed) to the period in which sales have been made, so a provision is created in the same manner, as in case of provision for doubtful debts i.e.

Profit and loss account Dr.

To provision for discount on debtors account

(Being provision for discount on debtors provided)

Treatment in final accounts

(i) Provision for discount on debtors is a probable loss, so it should be shown on the debit side of Profit and Loss account.

(ii) Amount of provision for discount on debtors is deducted from sundry debtors on the assets side of the Balance Sheet.

Note: Such provision is made on debtors after deduction of further bad debts and provision for doubtful debts because discount is allowable to debtors who intend to make the payment.

12. Reserve for Discount on Creditors

Prompt payments to creditors enable a businessman to earn discount from them. When a businessman receives cash discount regularly, he can make a provision for such discount since he is likely to receive the discount from his creditors in the following years also. The discount received being a profit, the provision for discount on creditors amounts to an addition to the profit.

Accounting treatment of Reserve for Discount on Creditors is just reverse of that in the case of Provision for Discount on Debtors. The adjustment entries for Reserve for Discount on Creditors is as follows:

Reserve for Discount on Creditors Account Dr.

To Profit and Loss Account

(Being the adjustment entry for discount on creditors)

Treatment in final accounts

i) Reserve for discount on creditors is shown on the credit side of Profit and Loss account.

ii) In the liabilities side of the Balance Sheet, the reserve for discount on creditors is shown by way of deductions from Sundry Creditors.

13. Loss of Stock by Fire

In business, the loss of stock may occur due to fire. The position of the stock may be:

(a) all the stock is fully insured.

(b) the stock is partly insured.

(c) the stock is not insured at all.

It the stock is fully insured, the whole loss will be claimed from the insurance company. The following entry will be passed:

Insurance Co. A/c Dr.

To Trading A/c

(Being the adjustment entry for Loss of goods charged from insurance Co.)

The value of goods lost by fire shall be shown on the credit side of the trading Account and this is shown as an asset in the Balance Sheet.

If the stock is not fully insured, the loss of stock covered by insurance policy will be claimed from the insurance company and the rest of the amount will be loss for the business which is chargeable to Profit and Loss Account. In this case, the following entry will be passed:

Insurance Co. A/c Dr.

Profit and Loss A/c Dr.

To Trading A/c

(Being the adjustment entry for Loss of goods)

The amount of goods lost by fire is credited to Trading Account, the amount of claim accepted by insurance company shall be treated as an asset in the Balance Sheet, while the amount of claim not accepted is a loss so it will be debited to Profit and Loss Account.

If the stock is not insured at all, the whole of the loss will be borne by the business and the adjusting entry shall be:

Profit and Loss A/c Dr.

To Trading A/c

(Being the adjustment entry for Loss of goods)

The double effect of this entry will be (a) it is shown on the credit side of the Trading Account (b) it is shown on the debit side of the Profit and Loss Account.

14. Manager's Commission

Sometimes, in order to increase the profits of the business, manager is given some commission on profits of the business. It can be given at a certain percentage on the net profits but before charging such commission or on the net profits after charging such commission. In both the cases, the adjustment entry will be:

Profit and Loss A/c Dr.

To Commission Payable A/c

(Being the adjustment entry for manager's commission)

Treatment in final accounts

(i) The amount of managers commission being a business expenditure is shown on the debit side of the Profit and Loss account.

(ii) As the commission to manager has not been paid so far, commission payable would be shown as liability on the liability side of balance sheet.

Illustration IV: The following adjustments are to be made in the final accounts being made as on 31st March, 2006.

i) Closing Stock in hand Rs.20,000.

ii) Salaries amounting to Rs.1,000 outstanding.

iii) Depreciate Plant and Machinery @10%. The value of Plant and Machinery on 31st March, 2006 was at Rs.40,000.

iv) Prepaid insurance Rs.150.

v) Accrued income from investment Rs.1,500.

You are required to pass adjustment entries.

Solution

JOURNAL

Date	Particulars	L.F.	Dr. Rs.	Cr. Rs.
2006				
Mar 31	Closing Stock Account Dr.		20,000	
	To Trading Account		20,000	
	(Being the adjustment entry for closing stock)			
Mar 31	Salaries Account Dr.			1,000
	To Outstanding Salaries Account			1,000
	(Being the adjustment entry for outstanding Salaries)			

Mar 31	Depreciation Account Dr. To Plant and Machinery Account (Being the adjustment entry for Depreciation)		4,000	 4,000
Mar 31	Prepaid Insurance Account Dr. To Insurance Account (Being the adjustment entry for prepaid insurance)		150	 150
Mar 31	Accrued Income Account To Income on Investment Account (Being the adjustment entry for accrued income)		1,500	 1,500

Illustration V: From the following Trial Balance of Mr. Garg as on 31st March, 2006, prepare Trading Account, Profit and Loss Account and Balance Sheet.

TRIAL BALANCE

Debit Balance	Rs.	Credit Balance	Rs.
Stock on 1st April, 2005	500	Capital	2,000
Purchases	1,500	Sales	3,500
Land and Building	2,000	Sunday Creditors	750
Bills Receivable	300	Commission	50
Wages	300	Bills payable	300
Machinery	800	Loan	600
Carriage Inward	100		
Carriage Outward	100		
Power	150		
Salaries	200		
Discount Allowed	30		
Drawings	100		
Insurance Premium	20		
Cash at Bank	500		
Cash in Hand	100		
Investments	500		
	7,200		7,200

Adjustments

1. Stock as on 31st March 2006 is valued at Rs. 200.
2. Provide depreciation @ 10% on Machinery and @ 5% on Land and Building.
3. Outstanding salaries amounted to Rs.50.
4. Insurance premium is paid in advance to the extent of Rs.10.
5. Allow interest on Capital @ 6% per annum.
6. Interest on loan @ 12% per annum is due for one year.

Solution

TRADING & PROFIT AND LOSS A/C

FOR THE YEAR ENDED 31ST MARCH, 2006

Particulars		Rs.	Particulars	Rs.
To Opening stock		500	By Sales	3,500
To Purchases		1,500	By Closing Stock	200
To Wages		300		
To Carriage Inward		100		
To Power		150		
To Gross Profit c/d		1,150		
		3,700		3,700
To Salaries	200		By Gross profit b/d	1,150
Add Outstanding Salaries	50	250	By Commission	50
To Carriage Inward		100		
To Insurance Premium	20			
Less prepaid Ins.	10	10		
To Discount allowed		30		
To Depreciation on:				
Machinery	80			
Land and Building	100	180		
To Interest on Loan		72		
To Interest on Capital		120		
To Net Profit (Transferred to capital account)		435		
		1,200		1,200

BALANCE SHEET AS ON 31^{ST} MARCH 2006

Liabilities		Rs.	Assets		Rs.
Capital	2,000		Land and Building	2,000	
Add Interest on Capital	120		Less Dep.	100	1,900
Add Net profit	438		Machinery	800	
	2,558		Less Dep.	80	720
Less Drawings Loan	100	2,458	Investments		500
	600		Closing stock		200
Add Interest O/S	72	672	Bills Receivable		300
Sundry Creditors		750	Cash at Bank		500
Bills payable		300	Cash in Hand		100
Outstanding Salaries		50	Prepaid Insurance		10
		4,230			4,230

6.7 SUMMARY

Every businessman is interested in knowing about two facts i.e. whether he has earned a profit or suffered losses and what is his financial position. To fulfill above said purposes, the businessman prepares financial statements for his business i.e. trading A/c, Profit & Loss Account and Balance Sheet. Trading Account shows the result of buying and selling of goods/services during an accounting period. Profit & Loss Account considers all the indirect revenue expenses and losses and all indirect revenue incomes. If indirect revenue income exceeds indirect expenses and cases, it is called net loss. Balance sheet is a statement of financial position of a business concern at a given date. The left hand side of the balance sheet shows the liabilities and right hand the assets of the business.

6.8 KEYWORDS

Outstanding Expenses: An expense which has been incurred in an accounting period but for which no enforceable claim has became in that period.

Prepaid Expenses: Expenses which has not incurred but paid in advance.

Amortisation: The gradual and systematic writing off of an asset or an account over an appropriate period.

Assets: Tangible objects or intangible rights owned by an enterprise.

Bad-debt: Debts owed to an enterprise which are considered to be irrecoverable.

Balance Sheet: A statement of the financial position of an enterprise as at a given date.

Contingent Liability: An obligation relating to an existing condition which may arise or not.

Cost of Goods Sold: The cost of goods sold includes opening stock + net purchases + direct expenses.

Provision: An amount retained by way of providing for any known liability which cannot be determined with substantial accuracy.

Reserve: The portion of earnings appropriated by the management for a general or specific purpose.

6.9 SELF ASSESSMENT QUESTIONS

1. Distinguish between Trading Account and Profit and Loss Account. Give a specimen of Trading and Profit and Loss Account with imaginary figures.

2. What is a Balance Sheet? What do you understand by Marshalling used in the balance Sheet? Illustrate the different forms of marshalling.

3. What are closing entries? Give the closing entries which are passed at the end of the accounting period.

4. What are adjustment entries? Why are these necessary for preparing final account.

5. Prepare a Trading Account of a businessman for the year ending 31st December, 2006 from the following data:

	Rs.
Stock on 1.1.1996	2,40,000
Cash purchases for the year	2,08,000
Credit purchases for the year	4, 00,000
Cash sales for the year	3,50,000
Credit sales for the year	6,00,000
Purchases returns during the year	8,000
Sales returns during the year	10,000
Direct expenses incurred:	
Freight	10,000
Carriage	2,000
Import Duty	8,000
Clearing Charges	12,000
Cost of goods distributed as free samples during the year	5,000
Goods withdrawn by the trader for personal use	2,000
Stock damaged by fire during the year	13,000

The cost of unsold stock on 31st December, 2006 was Rs.1,20,000 but its market value was Rs.1,50,000.

6. The following Trading and Profit and Loss Account has been prepared by a junior accountant of a firm. Criticise it and redraft it correctly.

TRADING & PROFIT AND LOSS A/C

FOR THE YEAR ENDED 31ST MARCH, 2006

Particulars	Rs.	Particulars	Rs.
To Opening stock of raw material	7,352	By Closing stock of raw material	9,368
To Purchases	63,681	By Sales	1,70,852
To Sundry creditors	25,375	By Sundry debtors	40,659
To Carriage inwards	2,654	By Gross loss c/d	8,182
To Carriage outwards	394		
To Salaries	24,370		
To Wages	51,963		
To Rent, Rates & Taxes	3,981		
To Repairs to factory	35,368		
To Insurance	13,923		
	2,29,061		2,29,061

PROFIT & LOSS ACCOUNT

Particulars	Rs.	Particulars	Rs.
To Gross loss b/d	8,182	By Bank overdraft	17,681
To Interest on loans	6,180	By Interest on bank overdraft	123
To Dividend from investments	9,375	By net loss transferred to Balance Sheet	39,691
To Furniture purchases	17,681		
To Telephone charges	985		
To Electric charges	2,756		
To Depreciation- Plant & machinery	663		
To Charges general	11,673		
	57,495		57,495

7. Prepare Manufacturing, Trading and Profit & Loss Account for the year ended 31st December, 2006 and Balance Sheet as at that date of Shri S. Singh, manufacturer, from the following Trial Balance and information.

Debit Balances	Rs.		Rs.
Advertising	1,660	Salaries Office	7,380
Bad Debts	1,210	Stock 1.1.06	
Bank Charges	240	Raw Materials	10,460
Drawings	16,000	Finished Goods	14,760
Factory Power	7,228	Work in Progress	3,340
Furniture	1,800	Wages Factory	41,400
General Expenses: Factory	410	Debtors	21,120
Office	692	Cash in Hand	350
Insurance	1,804	Cash at Bank	7,852
Light and Heat	964	Credit Balances:	
Plant & Machinery (1.1.06)	30,000	Bad Debts Provision	2,000
Plant & Mach. bought on 30.6.98	4,000	Capital	70,000
Purchases	67,336	Current Account	3,246
Packing & Transport	2,170	Discount	824
Rent & Rates	2,972	Sales	1,58,348
Repairs to Plant	1,570	Creditors	12,300

Stock on 31st December, 2006 were: (a) Raw Materials Rs.7,120; Work in Progress Rs.3,480; Finished Goods Rs.19,300 and Packing Materials Rs.250. The Liabilities to be provided for: (b) Factory Power Rs.1,124 ; (c) Rent and Rates Rs.772; (d) Light and Heat Rs.320; (e) General Expenses-Factory Rs.50, Office Rs.80. Insurance Prepaid Rs.340. Provide Depreciation at 10% p.a. on plant & machinery and 5% p.a. on furniture. Increase the Bad Debts Provision by Rs.1,000. Five-Sixth of Rent and Rates, Light & Heat and Insurance are to be allotted to the Factory and one-sixth to the Office.

8. Following is the Trial Balance of Mr. Naresh for the year ended 31st March, 2006:

	Dr.	Cr.
	Rs.	Rs.
Capital	-	3,50,000
Stock on 1st April, 1996	30,000	-
Sales	-	2,00,000
Carriage	4,000	-
Freight and Customs Duty	6,000	-
Purchases	1,90,000	-
Salaries	15,000	-
Income Tax	10,000	-
Sundry Debtors and Sundry Creditors	24,000	14,000
Cash at Bank	20,200	-
Cash in Hand	5,000	-
Furniture	1,800	-
Life Insurance premium	5,000	-
Sales Tax	5,000	-
Building	1,80,000	-
Drawings	68,000	-
Office Expenses	2,000	-
Discount Received	-	2,000
	5,66,000	5,66,000

Prepare Trading and Profit and Loss Account for the period ending 31st March, 2006 and a Balance Sheet as on that date after taking following information into consideration.

1. Closing stock Rs. 80,200 (including stationery stocks Rs. 200).
2. Office expenses include stationery purchased Rs.800.
3. Sundry Debtors include Rs.3,000 receivable from Reeta and Sundry Creditors include Rs.1,000 payable to Reeta.
4. A sum of Rs.5,000 has been received from a debtor as deposit which has been credited to his account.

5. Rs.500 were written off as bad debts in previous year and this amount has been received during the current year and has been credited to Debtors Account.
6. Some employees are residing in the premises of business due to their nature of service, the rent of such portion is Rs.1,000 per month.
7. Salaries include a sum of Rs.500 which is advance salary.
8. On 1st April, 2005 books contain such furniture of Rs.600 which was sold for Rs.290 on 30th Sept., 2005 and in exchange of it a new furniture of Rs.520 was acquired, its net invoice of Rs.230 was recorded in purchase books.
9. Depreciate Buildings @ 5% p.a. and Furniture @ 10% p.a.
10. Goods worth Rs. 2,000 were in transit on the last day of the accounting year.

6.10 REFERENCES/SUGGESTED READINGS

1. Anthony N. Robert (1998), "Accounting Principles", AITBS Publishers, New Delhi.

2. Aggarwal, M.P. (1981), "Analysis of Financial Statements", Natioanl Publishing House, New Delhi.

3. S.P. Jain (2001), "Corporate Accounting", Kalayani Publishers, New Delhi.

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5. R. Narayanaswamy (2003), "Financial Accounting", Prentice Hall of India, New Delhi.

Subject: **Financial Accounting-I**	
Course Code: **BBA-104**	Author: **Dr. Mahesh Chand Garg**
Lesson: **7**	Vetter:

RECTIFICATION OF ERRORS

STRUCTURE

7.0 OBJECTIVES

After going through this lesson, you should be able:

- To know the meaning and types of errors.
- To understand the location of errors and their rectification.
- To know the meaning and use of suspense account.
- To understand the effect of errors on final account.

7.1 INTRODUCTION

Every concern is interested in ascertaining its true profit/loss and financial position at the close of the trading year. The effort of the accountant is to prepare the final accounts in such a fashion which exhibits true picture of the business. The basic information for the preparation of final accounts is supplied by the trial balance. Thus, the accuracy of the trial balance determines to a great extent the accuracy or otherwise of the information provided by final accounts. However, the trial balance is prepared to ensure the arithmetical accuracy of the records of a business and also to ensure that for every debit entry a credit of an equal amount has been recorded. Thus, a trial balance in which the total of the debits does not equal the total of credits can be taken as an evidence for the existence of some errors in the records. On the other hand, a trial balance in which the total of the debits equal the total of credits is not a conclusive proof of accuracy of the records. Certain errors may not affect the agreement of a trial balance as the erroneous entries may not violate the dual aspect concept. It means that even if the trial balance agrees, steps should be taken to ensure that the records are free from errors. It, therefore, becomes utmost important to locate such errors and rectify them so that the correct financial position of the concern may be ascertained. So whenever errors in accounting records come to notice, they should be rectified without waiting till the end of the accounting year when trial balance is to be prepared. The objectives of rectification of errors are as follows:

a) Presenting correct accounting records;
b) Ascertaining correct profit or loss for the accounting period; and
c) Exhibiting a true financial position of the concern on a particular date.

7.2 CLASSIFICATION OF ERRORS

The errors can be classified as follows:

- Clerical Errors
- Errors of Principle

7.2.1 Clerical errors

Clerical errors are those errors which are committed by the clerical staff during the course of recording the business transactions in the books of accounts. These errors are:

a) Errors of omission
b) Errors of commission
c) Compensating errors

a) Errors of Omission

When a transaction is either wholly or partially not recorded in the books of accounts, it is an error of omission. When a transaction is omitted completely, it is called "complete error of omission" and when a transaction is partly omitted, it is called a "partial error of omission". A complete error of omission does not affect the agreement of trial balance whereas partial error of omission may or may not affect the agreement of trial balance. For example, Rs. 100 paid to Ram is neither recorded in the cash book nor in the account of Ram, this error will not affect the agreement of trial balance. Only the total of the trial balance would be short by Rs. 100. But if posting is not done in one of the accounts, this will affect the agreement of trial balance.

b) Errors of Commission

Errors of commission take place when some transactions are incorrectly recorded in the books of accounts. Such errors include errors on account of wrong balancing of an account, wrong posting, wrong totalling, wrong carry forwards, etc. For example, if a sum of Rs. 255 received from Hari is credited to his account as Rs. 525, this is an error of commission. Similarly, if a sum of Rs. 500 paid to Suresh is credited to Sohan's account such an error is an error of commission. Some of the errors of commission affect the agreement of trial balance whereas others do not. Errors affecting the agreement of trial balance can be easily revealed by preparing a trial balance.

c) Compensating Errors

These errors, also called self-balancing or equalising errors, are a group of errors, the total effect of which is not reflected in the trial balance. These errors are of a neutralizing nature. One error is compensated by the other error or by errors of an opposite nature. For example, Amitabh's account is credited with Rs. 500 instead of Rs. 600; Abhijit's account credited with Rs. 160 instead of Rs. 100 and Jaya's account credited with Rs. 150 instead of Rs. 110. Here the first error of under-credit of Rs. 100 is covered by second and third errors of over-credit of Rs. 60 and Rs. 40 respectively.

7.2.2 Errors of Principle

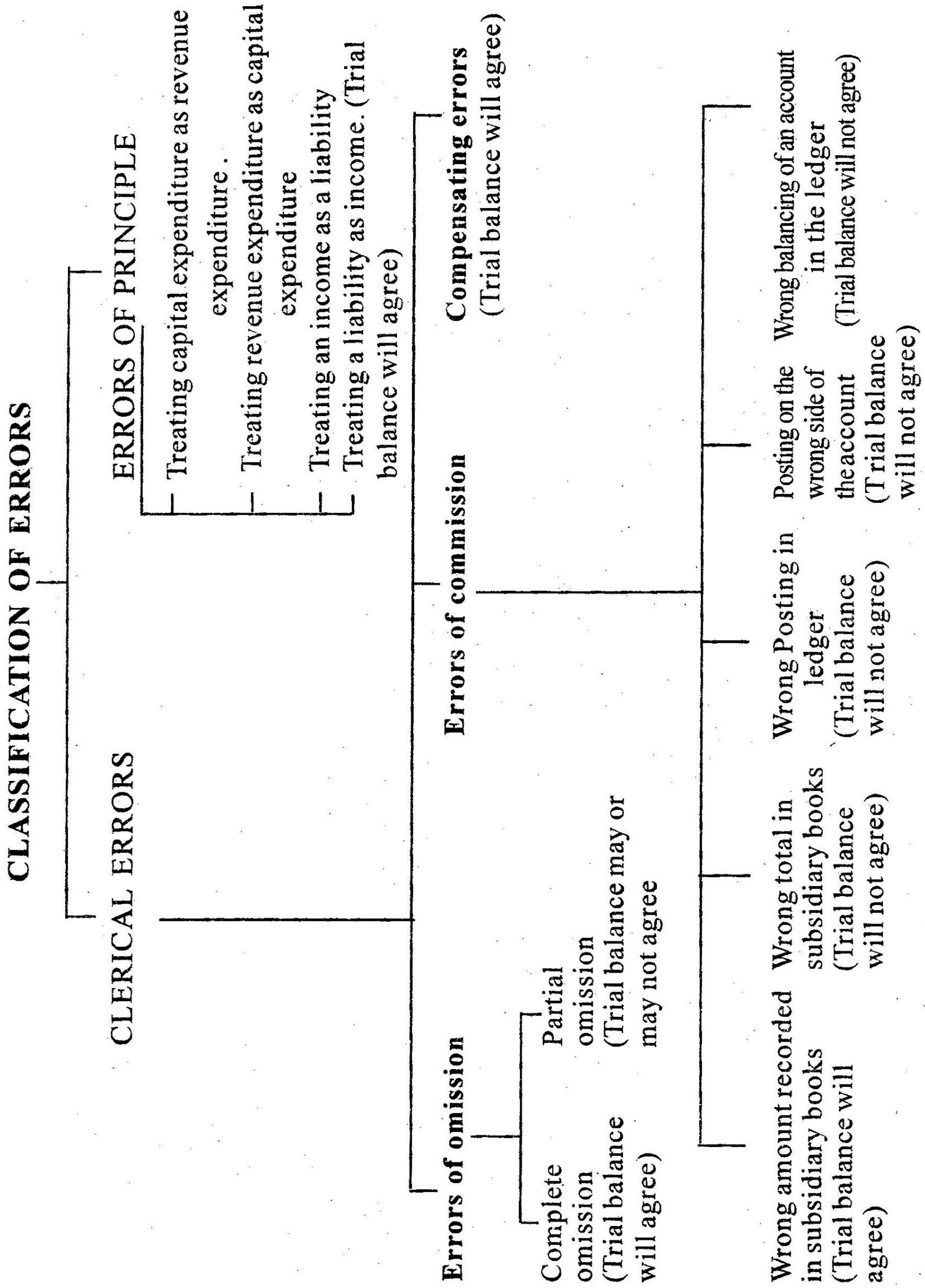
When a transaction is recorded against the fundamental principles of accounting, it is an error of principle. These errors arise because of the failure to differentiate capital and revenue items i.e. a capital expenditure is taken as a revenue expenditure or vice-versa. Similarly, a capital receipt may have been taken as a revenue receipt or vice-versa. For example, a sum of Rs. 50 paid on the repairs of furniture should be debited to repairs account, but if it is debited to the furniture account, it will be termed as an error of principle. Repair of furniture is revenue expenditure. If it is debited to furniture account, it has been taken as a capital expenditure. Such errors do not affect the agreement of the trial balance because they are correctly recorded so far as the debit or credit side of the wrong class of account is concerned. It would be appreciated that such an error arises through lack of knowledge of principles of accountancy.

7.3 LOCATION OF ERRORS

The location of errors of omissions, compensations and principles are slightly difficult because of the fact that such errors do not affect the agreement of trial balance. However, the locations of some errors of commission are comparatively easier because they affect the agreement of the trial balance. Thus, the errors can be classified into two categories from the point of view of locating them:

7.3.1 Errors which do not affect the agreement of Trial Balance

As stated, errors of omission, errors of compensating nature and errors of principle do not affect the agreement of the trial balance. Their location is, therefore, a difficult task. These are usually found out when the statements of accounts are sent to the customers or received by the business or during the course of audit and sometimes by chance. For example, if a credit sale of Rs. 2000 to Suresh has not been recorded in the books of accounts, the error will not affect the agreement of the trial balance and therefore, at the time of finalizing the accounts it may not be traced out. However, this will be found out when a statement of account is received from Suresh showing the money payable by him or when a statement of account is sent to Suresh showing the money due from him.



7.3.2 Errors which affect the agreement of Trial balance

The errors which cause a mismatch in the trial balance totals are frequently referred to as errors disclosed by a trial balance. However, the mismatch does not automatically point out the actual errors. It is only the diligence and ingenuity of the person preparing the accounts which would help in the location of errors. The procedure to be followed for location of such errors can be put as follows:

i) The totals of the trial balance itself should be thoroughly rechecked in order to find out exact or correct difference.

ii) Make sure that the balances of cash and bank are included.

iii) The difference of the two sides of the trial balance should be found and be divided by two and then find out whether a figure equal to the same (i.e. half the difference) appears in the trial balance. This procedure would enable to locate the amount placed on the wrong side.

iv) If the error remains undetected, divide the exact difference by 9. If it is divisible by 9, this will mean that there may be transposition error or slide error. A transposition error is committed when the digit of an amount is misplaced. For example, machinery account has a balance of Rs. 5689, but it has been written as Rs. 5869 in the trial balance. The resulting error is Rs. 180, which is divisible by 9. A slide error is committed when the decimal point is placed incorrectly. For example, Rs. 3670 is copied as Rs. 36.70. The resulting error is Rs. 3633.30 which is also divisible by 9.

v) See that there is no mistake in balancing of the various accounts.

vi) The schedules of debtors and creditors should be scrutinised so as to find out that all the debtors and creditors have been included in these schedules; their totals are correct.

vii) If the difference is of a substantial amount, compare the figures of trial balance of the current year with the trial balance of the preceding year and see whether there is any abnormal difference between the balances of important accounts of the two trial balances.

viii) The total of subsidiary books should be checked and it should be seen whether posting has been done from these books correctly to respective accounts in the ledger or not.

ix) It should be checked that opening balances have been correctly brought forward in the current year's books.

x) If the difference is still not traced, check thoroughly the books of original entry and their posting into the ledger and finally the balancing of various accounts.

xi) If the error still remains undetected, repeat the above steps with the help of other members of the staff, who are not involved in maintaining the books of accounts.

7.4 RECTIFICATION OF ERRORS

From the point of view of rectification of errors, these can be divided into two groups:

a) Errors affecting one account only.

b) Errors affecting two or more accounts.

7.4.1 Errors affecting One Account

The following errors affect only one account:

(a) Errors of posting

(b) Carry forward

(c) Balancing

(d) Omission from trial balance

(e) Casting

Such errors should first of all be located and rectified. These are rectified either with the help of journal entry or by giving an explanatory notes in the account concerned and not by simply crossing the wrong amount and inserting the right one.

7.4.2 Errors affecting two or more accounts

The following errors affect two or more accounts:

(a) Errors of omission

(b) Posting to wrong account

(c) Principles

As there errors affect two or more accounts, rectification of such errors is done with the help of a journal entry.

7.5 STAGES OF RECTIFICATION OF ERRORS

All types of errors can be rectified at two stages:

i) Before the Preparation of Final Accounts.

ii) After the Preparation of Final Accounts.

7.5.1 Rectification of errors before the preparation of final accounts

If the error is located before the preparation of final accounts, it is either rectified by recording or posting the necessary amount in the respective account or by recording the necessary journal entry to rectify that error. If the error is one sided, it can be rectified by recording or posting the necessary amount in that account. If it is two sided, the necessary journal entry is recorded.

a) Rectification of One sided errors

These are the errors which affect one account and will affect the agreement of trial balance. Such errors are rectified by debiting or crediting the affected account in the ledger. For example:

i) Purchase Book has been undercast by Rs. 2,000.

The error is only in purchases account. If Rs. 2000 is now posted in the debit side of purchase account as "To undercasting of Purchase Book", the error will be rectified.

ii) Amount of Rs. 1000 paid to Hari not debited to his personal account.

This error is affecting the personal account of Hari and its debit side is less by Rs. 1000 because of omission to post the amount paid. We shall now write on the debit side of Hari Account as "To Cash (omitted to be posted) Rs. 1000 to rectify this error.

iii) Goods sold to Khan wrongly debited in Sales account:

This error is affecting the sales account only as the amount which should have been posted on the credit side has been wrongly placed on the debit side of the same account. By putting double the amount of transaction on the credit side of sales account by writing "By sales to Khan wrongly debited previously", this error shall be rectified.

b) Rectification of two sided errors

As these errors affect two or more accounts, rectification of such errors can often be done with the help of a journal entry. These type of errors do not affect the agreement of trial balance. For example, if furniture purchased has been recorded through purchase book, two accounts viz. purchases account and furniture account are affected.

Thus, rectification will be made by taking these two accounts. When such errors are to be rectified, the following procedure should be followed:

1. What has been done? The journal entry which has been recorded:

Purchase Account	Dr.	Incorrect entry
To Supplier's Account		

2. What should have been done? The correct entry which was to be recorded:

Furniture Account	Dr.	Correct entry
To Supplier's Accounts		

3. What should now be done? The rectifying entry which is now to be recorded:

Furniture Account	Dr.	Journal entry relating to rectification of an error
To Purchases Account		

Illustration: An amount of Rs. 4000 paid to R. Ramesha has been credited to the account of S. Ramesha.

It is obvious that the credit, placed wrongly to the account of S.Ramesha, should be transferred to the account of R.Ramesha. The correcting entry is:

		Rs.	Rs.
S. Ramesha's Account	Dr.	4,000	
To R.Ramesha's Account			4,000

7.5.2 Rectification of errors after the preparation of final accounts

The rectification of errors after the preparation of final accounts depends upon the nature of error. If an error is a one sided error, it can be corrected by passing a rectifying entry with the help of the Suspense Account and if the error is two sided, it is rectified by passing a rectifying entry in both the affected accounts and such errors are not rectified through Suspense Account.

Suspense account

In case, the accountant is not in a position to locate the difference in the totals of the trial balance and he is in a hurry to close the books of accounts, he may transfer the difference to an account known as "Suspense Account". After transferring the difference, the trial balance is totalled and balanced. On locating the errors in the beginning or during the course of next year, suitable accounting entries are passed and the Suspense Account is closed. However, the Suspense Account should be opened only when the accountant has failed to locate the errors in spite of his best efforts. It should not be by way of a normal practice, because the very existence of the Suspense Account creates doubt about the authenticity of the books of accounts.

a) Rectification of one sided errors

It may be noted that one sided errors affect the agreement of trial balance. Hence, one sided errors are rectified through the Suspense Account. For example:

i) An item of Rs. 68 was posted as Rs. 86 in the sales account

In this case, the sales account has been credited by Rs. 86 instead of Rs. 68, so the entry with the help of Suspense Account shall be as follows:

		Rs.	Rs.
Sales A/C	Dr.	18	
To Suspense A/C			18

(Being Sales account wrongly credited with Rs. 86 instead of Rs. 68, now corrected)

ii) The total of purchase book has been taken Rs. 9 short.

In this case, the purchase book has been undercast by Rs. 9 so we should further debit the purchase account by Rs. 9.

		Rs.	Rs.
Purchases A/C	Dr.	9	
To Suspense A/C			9
(Being total of purchase book now corrected)			

iii) A sum of Rs. 102 written off as depreciation on furniture has not been posted to depreciation account.

In this case, depreciation account has not been debited, so the entry shall be:

		Rs.	Rs.
Depreciation A/C	Dr.	102	
To Suspense A/C			102
(Being depreciation on furniture not posted previously now posted)			

b) Rectification of two sided errors

As already stated, two sided errors do not affect the agreement of trial balance. These errors are rectified by means of journal entries in the affected account. Two sided errors may be located and rectified either before the preparation of final accounts or after the preparation of final accounts, the procedure is the same.

7.6 EFFECT OF ERRORS ON FINAL ACCOUNTS

It is desirable to know the effect of errors on the final accounts i.e. on the Trading and Profit and Loss Account and the Balance Sheet. Some of the errors affect the Trading and Profit and Loss Account while others affect the Balance Sheet. How these two statements will be affected depends upon the nature of the accounts in which the error lies. If the error affects the nominal account/accounts it will increase or decrease the profit because all nominal accounts are transferred to Trading and Profit and Loss Account. In this regard, the following points are to be noted:

1. Profit will increase or loss will reduce if a transaction is omitted to be posted to the debit side of a nominal account. On rectification of such a type of error, profit will decrease or loss will increase. For example salary paid to an employee is wrongly posted to his personal account and consequently salary paid is omitted to be posted to Salary Account. This error will increase the profit or reduce the loss because salary paid will not be transferred to Profit and Loss Account. At the time of the rectification of error, Salary Account will be debited and consequent thereupon, profit will decrease or loss will increase.

2. Similarly, profits will reduce or loss will increase if a nominal account is wrongly debited. With the rectification of such an error, profit will increase or loss will decrease. For example, an amount of Rs. 2000 spent on erection of machinery wrongly debited to Repairs Account instead of Machinery Account will reduce net profit by Rs. 2000 On rectification of this error, Machinery Account will be given debit and Repairs Account will be credited and consequently profit will increase or loss will decrease.

3. Profit will increase or loss will decrease if a nominal account is wrongly credited. With the rectification of this type of error, profit will decrease or loss will increase. For example, if Rs. 5000 received on account of sale of old furniture was posted to Sales Account instead of Furniture Account, the error will increase profit or decrease loss because sales will be shown at an increased amount of RS. 5000 on the credit side of the Trading and Profit and Loss Account. At the time of the

rectification of error, Sales Account will be given debit. As a result, profit will decrease or loss will increase.

4. Profit will decrease or loss will increase if an item is omitted to be posted to the credit side of a nominal account. With the rectification of the error, profit will increase or loss will decrease. For example, interest on debentures of Rs. 2,000, received is omitted to be posted to the credit side of the Interest on Debentures Account. This error will decrease profit or increase loss because interest on debentures received will not be transferred to the credit side of the Profit and Loss Account as an item of income. At the time of the rectification of the error, Interest on Debentures Account will be given a credit and, as a result, profit will increase or loss will decrease.

5. Due to increase or decrease in profit/loss by the errors in nominal accounts, the Capital Account will also, be increased or decreased. Thus, the errors in nominal accounts will also affect the Balance Sheet because the Capital Account is shown on the liability side of the Balance Sheet. So, an error in a nominal account will affect both the Profit and Loss Account and the Balance Sheet.

6. If there is an error in the personal accounts of the debtors or creditors of the business concern their respective accounts will be increased or decreased. This will have its effect on the Balance Sheet only because debtors and creditors are shown in the Balance Sheet as Assets and Liabilities respectively. Similarly, if an error is in a real account, such as Plant and Machinery Account, Cash Account, Land and Building Account, the Balance Sheet alone will be affected because assets are shown in the Balance Sheet only.

Illustration: The trial balance of a trader has agreed but the following errors are discovered after the preparation of the final accounts:

i) Rs. 500 posted to the Depreciation Account as Depreciation on Plant and Machinery was not posted to the Plant and Machinery Account.

ii) Return Outward Book is overcast by Rs. 10.

iii) Purchases Book is overcast by Rs. 4,000.

iv) An amount of Rs. 1,000 received as dividend on shares has been posted to the debit of the Interest Account.

v) Furniture was purchased from Rahim for Rs. 9,600 but the entry was passed for Rs. 6,900.

vi) Rs. 1,200 received from Anil Kapoor in settlement of account, posted to the credit of the Sales Account.

vii) Outstanding interest on loan Rs. 500 omitted to be recorded.

viii) Rs. 600 paid for the purchase of office stationery was wrongly debited to the Purchases Account.

ix) Sales of Rs. 6,000 to Mushtaq omitted to be posted to his account.

x) Rs. 200 paid for repairs were written as Rs. 20 in the Repairs Account.

xi) Discount Received, Rs. 50, omitted to be posted to the Discount Received Account.

Show the effect of these errors on the Final Accounts.

Solution

EFFECT OF ERRORS ON THE FINAL ACCOUNTS

	Trading and Profit and Loss Account		**Balance Sheet**
1.	No effect because depreciation has been posted to the Depreciation Account and hence already debited to the Profit and Loss Account.	1.	Plant and Machinery Account is overstated by Rs. 500 because depreciation has not been deducted from the Plant and Machinery Account.

	Trading and Profit and Loss Account		**Balance Sheet**
2.	Gross Profit is overcasted by Rs.10, so net Profit is also overstated by Rs.10.	2.	Capital Account is overstated by Rs.10 because of the increase in Profit.
3.	Gross Profit is understated by Rs.4,000 and net Profit has also been understated by Rs.4,000.	3.	Capital Account is understated by Rs.4,000 because of the decrease in Net Profit.
4.	Net Profit is understated by Rs.2,000 because interest Account has been debited instead of being credited .	4.	Capital Account is understated by Rs.2,000 because of the decrease in Net Profit.
5.	No effect because the error relates to a Personal and real Accounts.	5.	Creditors and Furniture have been understated by Rs.2,700.
6.	Gross Profit and Net Profit overstated by Rs.1,200 because of higher sales shown in the Trading Account.	6.	Capital Account and Sundry Debtors are overstated by Rs.1,200.
7.	Net Profit has been overstated by Rs.500.	7.	Capital Account is overstated by Rs.500 and creditors understated by Rs.500.
8.	Gross Profit understated by Rs.600. No effect on Net Profit.	8.	No effect on Balance sheet.
9.	No effect on Gross Profit and Net Profit.	9.	Sundry Debtors are understated by Rs.6,000.
10.	Net Profit has been overstated by Rs.180 because Repairs Account is posted with Rs.20 instead of Rs.200.	10.	Capital Account has been overstated by Rs.180 because of decrease in Net Profit.
11.	Net profit has been understated by Rs.50, because Discount Received Account is omitted to	11.	Capital Account has been understated by Rs.50, because of the decrease in Net Profit.

	Trading and Profit and Loss Account		**Balance Sheet**
	be posted.		

7.7 SUMMARY

Total balance in which the total of the debits equal the total of credits is not a conclusive proof of accuracy of the records. Certain errors may not affect the agreement of a trial balance as the errorneous entries may not violate the dual aspect concept. It, therefore, becomes utmost important to locate such errors and rectify them so that the true financial position of the business may be ascertained. So whenever errors in accounting records come to notice, they should be rectified. The errors can be clerical errors or errors of principle. The clerical errors are those errors which are committed by the clerical staff during the course of recording the business transactions in the books of accounts, e.g., errors of omission, errors of commission and compensating errors. Error of principle includes those transactions which are recorded against the fundamental principles of accounting. Suspense account is opened when the accountant is not in a position to locate the differences in the totals of the Trial Balance. It should not be by way of a normal practice, because the very existence of the suspense Account create doubt about the authenticity of the books of accounts.

7.8 KEYWORDS

Trial Balance: A statement which is prepared to check the arithmetical mistakes in the accounting system.

Rectifying Entry: A journal entry which is passed to remove the effect of errors.

Two-sided Errors: Errors which affects two accounts simultaneously.

One-sided Errors: Errors which affects only one account.

Suspense Account: An account created to balance the total of Trial Balance.

7.9 SELF ASSESSMENT QUESTIONS

1. What are the various kinds of errors? Which of these affect the agreement of trial balance?

2. What is suspense account? How is it prepared?

3. Is the agreement of trial balance a conclusive proof of the accuracy of the books of accounts? Discuss.

4. State which of the following errors will affect the agreement of the Trial Balance and which will not. Give rectifying journal entries wherever relevant assuming the difference in Trial Balance has been placed to Suspense Account.
   i) Purchase of a second-hand Motor Car for Rs. 15,000 has been debited to Motor Car Maintenance Account.
   ii) A sale of Rs. 5,000 to Shriram has been wrongly entered in the Sales Day Book Rs. 500.
   iii) An entry in the Purchases Returns Book of Rs. 2,000 has been omitted to be posted in the account of Shri Ramji, the supplier.
   iv) An amount of RS. 2,000 received from Shrikant has been posted to the credit of Shriman as Rs. 200.
   v) The total of the Sales Day Book for the month of July Rs. 1,50,000 has been omitted to be posted in the ledger.
5. Messers Modern Chemicals were unable to agree the Trial Balance on 30th June 2006 and have raised a Suspense Account for the difference. Later the following errors were

discovered and rectified and the Suspense Account was balanced.

a) The addition of the "Sundry Purchases" column in the Tabular Purchases Journal was short by Rs. 150 and other totals were in order.

b) A Bill of Exchange (received from Gupta) for Rs. 2,000 had been returned by the Bank as dishonoured and had been credited to the Bank and debited to Bills Receivable Account.

c) Goods of the value of Rs. 105 returned by the customer, Thomas had been posted to the debit of Thomas and also to the Sales Returns.

d) Sundry items of Furniture sold Rs. 3,000 had been entered in the Sales Day Book, the total of which had been posted to Sales Account.

e) An amount of Rs. 600 due from Vaz, a customer, had been omitted from the Schedule of Sundry Debtors.

f) Discount amounting to Rs. 30 allowed to a customer had been dully posted in his account, but not posted to Discount Account.

g) Insurance premium of Rs. 450 paid on 30th June, 2006 for the year ended 30th June 2006 had not been brought forward.

You are requested to (i) pass Journal Entries to rectify the above mistakes; (ii) draw up the Suspense Account after rectifying the above mistakes; and (iii) explain how the above errors affect the book profits for the year ended 30th June, 2006.

6. The following errors are detected in the books of Pradeep Kumar. Pass necessary journal entries for their rectification.

i) Rs. 400 paid on account of the tuition fee of the proprietor's daughter, Miss Reena, has been debited to General Expenses Account.

ii) Rs. 1,450 paid as Salary to a clerk posted as Rs. 1,250 to the Salary Account.

iii) An item of Rs. 750 for goods sold to Aruna debited to Kruna.

iv) Rs. 2,000 received in respect of bad debts but posted as Cash sales.

v) Discount Rs. 50 allowed by Rajesh omitted to be entered in the discount column of the Cash Book.

vi) Rs. 200 received as commission, debited to Commission Account.

vii) A credit purchase of Rs. 375 from Mohit and Co. has been entered in Purchases Book but the payment subsequently made to them has been debited to their personal account.

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Subject: **Financial Accounting-I**	
Course Code: **BBA-104**	Author: **Dr. Mahesh Chand Garg**
Lesson: **8**	Vetter:

ACCOUNTING OF NEGOTIABLE INSTRUMENTS

STRUCTURE

8.0 OBJECTIVES

After going through this chapter, you should be able:

- To know the meaning and advantages of bills of exchange.
- To know the various types of negotiable instruments and their characteristics.
- To understand the accounting treatment of bill of exchange.

8.1 INTRODUCTION

Business transactions are either cash transactions or credit transactions. In cash transactions, goods are sold and transferred to the purchaser by the seller for immediate cash payment. In other words, the claim of the seller of goods is settled then and there. But in case of credit transactions, the seller's claim is settled on a later date. Credit is a very powerful instrument in the development of modern structure of business. Without credit facilities, it is not possible to expand a business. Therefore, with the help of credit transactions, a trader is in a position to enter many more transactions than his actual capital. But on the other side, credit transaction bring a lot of risks to the trader. In a credit transaction, goods are sold and transferred in return of a promise to pay the price of the goods at some future date or on demand. This promise can be either be by word of mouth or in writing. It is possible that the oral promise of making the payment in future may not be fulfilled by the purchaser causing a loss to the seller of goods. Therefore, in order to avoid a such a situation, it is always better to take an undertaking in writing for the payment of the price of goods. This written undertaking may be in the form of "Bills of Exchange" or "Promissory Note" or "Cheques" or "Hundi". These are the undertakings in writing by the debtors to pay an amount of money on a definite or determinable date. These documents are known as "Negotiable Instruments."

Section 31(1) of the Negotiable Instrument Act, 1881 defines the Negotiable Instrument as "A negotiable instrument means promissory note, bill of exchange or cheque payable either on order or to bearer". The word "Negotiable" means transfer by delivery and the word "Instrument" mean a written document by which a right is created in favour of some person.

8.2 BILL OF EXCHANGE

Section 5 of the Negotiable Instrument Act, 1881 defines a Bill of Exchange as "an instrument in writing containing an unconditional order, signed by the maker, directing a certain person, to pay a certain sum of money only to or to the order of a certain person or to the bearer of the instrument". It means that if an order is made in writing by one person on another directing him to pay a certain sum of money unconditionally to a certain person or according to his instructions or to the bearer, and if that order is accepted by the person on whom the order was make, the document is a bill of exchange.

Essentials of a bill of exchange: Following are the essentials of a bill of exchange:

1. It should be in writing.

2. It should contain an order by the seller to the purchaser to make the payment in future. A mere request by the seller to the purchaser to make the payment in future does not amount to a bill of exchange.

3. The order contained in the bill should be unconditional. A bill of exchange with a conditional order cannot be made payable.

4. The maker of the bill or the seller is known as “drawer” and the bill must be signed by him, otherwise it will be invalid.

5. The purchaser upon whom the bill is drawn is known as “drawee” and he must be a certain person.

6. Amount ordered to be paid by the drawer in a bill must be certain and it should be in money alone and not in goods.

7. The person to whom payment of the bill is to be made is known as “payee” and he must be a certain person or the bearer of the bill.

SPECIMEN OF A BILL OF EXCHANGE

Stamp	266, Kamla Nagar, Hisar June 10, 2006

Rs.5000/-

Three months after date, pay to me or order the sum of rupees five thousand only for value received.

To

M/s Ganga Brothers, Sd/-

Mall Road, Rakesh

Shimla.

Classification of Bill of Exchange

Classification of the bill of exchange can be made on the following basis–

1) On the basis of place.
2) On the basis of purpose.

3) On the basis of time.

1. Classification on the basis of place

On the basis of place, bills are of two types-

a) Inland Bills

A bill is termed as Inland bill if

i) it is drawn in India on a person residing in India whether payable in or outside India or

ii) it is drawn in India on a person residing outside India but payable in India.

b) Foreign Bills

Foreign bill are those bills of exchange that are drawn outside India and made payable in India. In other words, a bill which is not an Inland Bill is a Foreign Bill.

2. Classification on the basis of purpose

On the basis of purpose of writing of the bill, the bills can again be classified as:

a) Trade Bills

Where a bill of exchange has been drawn and accepted for a genuine trade transaction, it is termed as a trade bill. For example, X has sold goods to Y for Rs.1000 on credit and X has drawn a bill on Y for the said amount, which Y accepts, then this bill is a trade bill.

b) Accommodation Bills

Where a bill of exchange is drawn and accepted for providing funds to a friend in need, it is termed as accommodation bill. In this bill, the drawer and drawee are not the creditor and the debtor respectively. These are drawn for the mutual benefit of the drawer and the acceptor and are not backed by business transactions.

3. On the basis of time

On the basis of time, a bill of exchange may be time bill or demand bill.

a) Time Bill

When payment of a bill of exchange is to be made after a particular period of time, the bill is termed as a "Time Bill". In such a case, date of maturity is always calculated by adding three days of grace. Such bills require "acceptance" of the drawee. It is generally given by writing across the face of the instrument.

b) Demand Bill

Demand bill is a bill which is payable at any time on demand. Neither the acceptance of the drawee is necessary nor any days of grace are allowed in this case.

8.3 PROMISSORY NOTE

Section 4 of the Negotiable Instrument Act, 1881 defines a Promissory Note as "as instrument in writing (not being a bank note or a currency note) containing an unconditional undertaking by the maker to pay a certain sum of money only to, or to the order of a certain person or to the bearer of the instrument." Thus, a promissory note is a written unconditional promise made by one person to another, to pay a specific sum of money either on demand or at a specified future date.

SPECIMEN OF A PROMISSORY NOTE

Rs.4000/-	440, Model Town

	Panipat
One month after date, I promise to pay Mr. Ram Kumar or order a sum of Rupees four thousand only, for the value received.	
To,	
Mr.Ram Kumar	Sd/-
1266, New Enclave,	Prakash
Jind.	

Essentials of a promissory note

The following are the essentials of a promissory note:

- It must be in writing.
- It must contain express promise to pay. Mere acknowledgment of debt is not sufficient to make a promissory note.
- The promise to pay must be unconditional. It should not depend upon contingencies which may or may not happen, because uncertainty affects the business.
- It should be signed by the maker. The person who promises to pay must sign the instrument even though it might have been written by the promissory himself.
- The maker of the promissory note must be certain. The promissory note itself must show clearly who is the person agreeing to undertake the liability to pay the amount.
- The payee must be certain. The instrument must point out with certainty the person to whom the promise has been made. The payee may be ascertained by name or by designation.
- The amount payable must be certain. There must be a certainty as to the amount promised to be paid as promissory note. In case the payment is not certain, the promissory note is not valid.

- The promise should be to pay money and money only. Money means legal tender money and not old and rare coins.
- A promissory note may be payable on demand or after a definite period of time.
- The other formalities regarding number, place, date, consideration are not essential to be incorporated in the promissory note, but it must be properly stamped according to India Stamp Act.

Difference between a bill of exchange and a promissory note

The following are the main points of differences between a bill of exchange and a promissory note:

(i) A bill of exchange is an unconditional order to pay whereas a promissory note is an unconditional promise to pay.

(ii) A bill of exchange is drawn by the creditor and he makes an order on the debtor to make the payment whereas a promissory note is written by the debtor wherein he promises to make the payment in future.

(iii) A bill of exchange has usually three parties namely, the drawer, the drawee and the payee whereas a promissory note has only two parties, i.e. the maker and the payee.

(iv) A bill of exchange is required to be accepted by the drawee (i.e., debtor) if it is to be a legal document, whereas a promissory note needs no acceptance because the debtor himself makes the promise to make the payment.

(v) Bills of exchange payable on demand do not require any stamp duty whereas promissory notes payable on demand require *advalorem* stamp duty.

(vi) The liability of the drawer of the bill of exchange is secondary because he is required to make the payment only when the drawee of the bill fails to make the payment. On the other hand, the liability of the maker of the promissory note is primary and absolute because a promissory note is written by him.

(vii) Foreign bills are usually drawn in a set of three whereas foreign promissory notes are drawn in one set only.

(viii) Foreign bills must be noted and protested on their being dishonoured but foreign promissory notes do not need any noting and protesting on their dishonour.

Advantages of bills of exchange and promissory notes

The following are the advantages of bills of exchange and promissory notes:

1. These are helpful in increasing the size of the business because they facilitate credit transactions.
2. A bill of exchange or a promissory note is a conclusive proof of the indebtedness of the purchaser of goods or services on credit.
3. A bill or a promissory note is a legal document and can be enforced in a court for its payment if its payment is refused by dishonour.
4. A bill or a promissory note fixes date of payment, so it provides a great facility to the creditor to know exactly when to expect payment and the debtor to know when to make the payment.
5. If the creditor cannot wait for the payment till the date of the maturity of the bill or the promissory note, he can get the bill discounted with he bank and get the payment before the maturity of the document.
6. Foreign trade is facilitated with the help of foreign bills of exchange.

7. A bill or a promissory note is a negotiable instrument and can be easily transferred from one person to another person in settlement of debts.

8.4 CHEQUE AND HUNDIS

Section 6 of the Negotiable Instruments Act defines a cheque as "a bill of exchange drawn on a specified banker and payable on demand."

Essentials: A cheque is similar to a bill of exchange with two additional qualifications:

1. It is always drawn on a specified banker.
2. It is always payable on demand.

Thus, all cheques are bills of exchange but all bills of exchange are not cheques.

The term "Hundis" stands for all instruments of exchange written in indigenous (vernacular) languages. These are the oldest surviving form of credit instrument in India. The meaning of hundi may be derived from the Sanskrit root "Hundi" which means to collect. It means that the hundis are used as means of collection of debts. It may be defined as "A written order, usually unconditional drawn by one person on another for payment on demand or after a specified time, of a certain sum of money, to a person named therein".

So, a hundi is almost like a bill of exchange. The only difference is that a bill of exchange is always unconditional, but a hundi is sometimes conditional, e.g., jokhami hundi. The following are three important types of hundis:

1. **Darshani Hundi:** The hundi payable at sight or demand is known as darshani hundi.

2. **Muddati Hundi:** This type of hundi is payable after the lapse of some time and not at sight or demand. These hundis serve as security for granting loans.
3. **Jokhmi Hundi:** Such type of hundi contains a conditional order, that is, payment of the hundi will be made only if the condition given in the hundi is fulfilled. Fro example, a hundi drawn against good shipped on the vessel may provide for the payment of money only when the goods arrive safely.

8.5 SOME IMPORTANT TERMS

1. **Maker or Drawer:** The person who draws or makes a Promissory Note, Cheque or Bill of Exchange is called the Maker or the Drawer.
2. **Drawee or Acceptor:** The person on whom the Bill of Exchange or Cheque is drawn and who is directed to pay is called the "Drawee". In case of a Bill of Exchange, the Drawee becomes the acceptor, when the accepts the bill.
3. **Payee:** The person named in the Bill/Promissory Note or Cheque, to whom or to whose order the money in the instrument is directed to be paid, is called the "Payee".
4. **Holder:** The person who is entitled to the possession of the Bill, Promissory Note or Cheque, in his own name and who has a right to receive or recover the amount due on the instrument, is called the 'Holder'. A person who obtains the possession of the instrument by illegal means is not a Holder. For example, a person who has stolen a cheque cannot be its holder.
5. **Holder in due course:** A Holder in due course, is a holder who obtains a negotiable instrument:
   (i) for valuable consideration
   (ii) in good faith, and

(iii) before maturity

A holder in due course will have a valid title over the instrument (i.e. he can get its payment) though the title of the transferor may be defective. For example, if A gets a cheque for Rs.10,000 signed by B, by threatening him, and later on endorses it to C, C will be a holder in due course if he accepts the cheque in good faith (i.e., without knowing that force was used by A), for consideration (i.e. by giving something in return for the cheque). In case of a bill of exchange, he must also get the instrument before the date of maturity. A cheque is payable on demand and hence the condition of maturity is not applicable.

6. **Acceptance of Bill:** The process of consenting to the order by the drawee of a Bill of Exchange, is known as acceptance of a Bill of Exchange.

7. **Endorsement:** The payee of a negotiable instrument may not himself keep the instrument with him. He may transfer the ownership of the instrument in favour of another person. Such a person can get the payment of the instrument from the drawee. The process of transferring of ownership of the instrument is termed as "endorsement" of the instrument. The person endorsing the instrument is called the 'Endorser'. The person to whom the instrument is endorsed, is called the 'Endorsee'.

8. **Drawee in case of need:** Sometimes the drawer or endorser of a bill of exchange may instruct the holder to present the bill to a second party in case the drawee or acceptor dishonours the bill. Such a second party is called "Drawee in case of need ".

9. **Maturity of Bill:** A Bill of Exchange or Promissory Note matures on the date on which it falls due. If the instrument

is payable on demand, it becomes due immediately on presentation for payment. If it is payable after the expiry of a particular period of time, the date of maturity will be calculated after adding three days of grace.

Examples:

(i) A bill dated 30th November is made payable three months after date. It falls due on 3rd March.

(ii) A bill of exchange dated 1st January is payable "one month after sight". It is presented for acceptance on 3rd January. The bill will fall due for payment on 6th February.

If an instrument is payable by instalments, it must be presented for payment on the third day after the day fixed for the payment of each instalment. Days of grace are allowed on each instalment.

10. **Dishonour:** Non-payment of the amount of a Promissory Note, Cheque or Bill of Exchange on the date of maturity is called dishonour of the instrument. In case of Bill of exchange, it will also said to be dishonoured if the drawee refuses to accept the Bill.

11. **Noting:** Noting is the authentic and official proof of presenting and dishonour of a negotiable instrument. It is a memorandum of minutes recorded by a notary public upon the dishonoured instrument or upon a paper attached thereto or partially upon the dishonoured instrument or upon a paper attached thereto or partly upon each. Its need arises in the case of the dishonour of a Bill of Exchange or a Promissory Note. However, it is not compulsory. It specifies the date of dishonour and reasons, if any, assigned for dishonour and the noting charges. It should be made within a reasonable time after dishonour.

12. **Protesting:** Protest is a formal certificate of dishonour issued by the notary public to the holder of a bill or note on his demand.
13. **Retiring of a Bill:** If all parties agree, a bill may be withdrawn before maturity either because the acceptor desires its withdrawal to avoid its dishonour or because he is desirous of paying the amount without waiting till its due date. In the former case, it is same as dishonour except noting and protesting will not be required. In the later case, usually some rebate is allowed to the acceptor for pre-payment.
14. **Renewal of Bill:** When the original Bill has been dishonoured or retired (where the drawee is not in a position to pay), and the parties agree to it, a new bill in place of the original bill may be accepted by the drawee. This is termed as Renewal of Bill. The new Bill may be for the full amount, i.e., of the old bill and noting charges, if any, plus interest.

8.6 ACCOUNTING TREATMENT

Regarding Cheques

Accounting entries regarding receipt and issue of cheques have already been explained in lesson while explaining recording of cash transactions.

Regarding Bill of Exchange, Promissory Note and Hundis

Though a bill or hundi differs from a promissory note in certain respects both are treated alike for the purpose of accounting treatment. For the purpose of accounting , bills of exchange and promissory notes need to be termed as bills receivable and bills payable when hold for money due to be received/paid at a later date. A bill of exchange is a Bill

Receivable for the drawer and a Bill Payable for the drawee. In other words, bills drawn by us and accepted by others or promissory notes given by others are our bills receivable and bills drawn by others but accepted by us or promissory notes given by us are our bills payable.

The drawer or the promisee receiving a bill receivable can treat it in any of the following four ways:

1. He can retain the bill till the date of maturity and get its payment on that date.
2. He can get the bill discounted with the bank at any time before its maturity if he is in need of money.
3. He can endorse it to a creditor.
4. He can send the bill to his Banker for its collection, the bank charges some commission for the same.

The accounting treatment of the above mentioned four cases is discussed in the following pages.

1. *When the Bill is retained by the Drawer upto the date of maturity*

Under such circumstances, the drawer himself receives the amount of the bill receivable on the due date. The following entries are passed in the books of drawer and drawee or acceptor.

Drawer's Books: The drawer records the following entire in his books:

(i) When the goods are sold on credit

Customer's Account Dr.

To Sales Account

(Being goods sold on credit)

(ii) When bill is drawn and duly accepted by the customer

Bill Receivable Account Dr.

To Customer's Account

(Being bill drawn by us and returned as duly accepted by the customer)

(iii) When the bill is presented on the due date to the drawee for payment and drawee honours the bill of making the payment

Cash Account or Bank Account Dr.

To Bills Receivable Account

(Being amount of the bill received on the due date)

It may be noted that when cash is received, it is credited to Bills Receivable Account and not to Customer's Account because cash is received against the bill receivable.

Drawee's Books: The following entries are recorded in the drawee's books:

(i) When goods are purchased on credit:

Purchases Account Dr.

To Supplier's Account

(Being purchase of goods on credit)

(ii) When a bill is accepted:

Supplier's Account Dr.

To Bills Payable Account

(Being bill accepted drawn by the supplier)

(iii) When payment of the bill is made on the due date:

Bills Payable Account Dr.

To Cash Account or Bank Account

(Being bill taken back on the due date and payment made)

Illustration: Ram sold goods to Krishan on 15th June, 2006 for Rs.1,000 and drew a bill for the amount on the same date for two months. Krishan accepted the bill and returned it to Ram. On the date of maturity of the bill, Krishan met the Bill.

Give Journal entries in the books of Ram and Krishan.

Solution

IN THE BOOKS OF RAM

JOURNAL

			Dr.	**Cr.**
Date	Particulars	L.F.	Rs.	Rs.
2006				
Jan.15	Krishan Dr.		1,000	
	To Sales Account			1,000
	(Being goods sold on credit to Krishan)			
Jan.15	Bill Receivable Account Dr.		1,000	
	To Krishan			1,000
	(Being bill duly accepted by Krishan received)			
Mar.18	Cash Account Dr.		1,000	
	To Bill Receivable Account			1,000
	(Being amount of bill received on due date)			

IN THE BOOKS OF DRAWEE OR ACCEPTOR

JOURNAL

			Dr.	Cr.
Date	Particulars	L.F.	Rs.	Rs.
2006				

Jan.15	Purchases Account Dr.		1,000	
	To Ram			1,000
	(Being credit purchases of goods from Ram)			
Jan.15	Ram Dr.		1,000	
	To Bill Payable Account			1,000
	(Being Bill drawn by Ram accepted and returned)			
Mar.18	Bill Payable Account Dr.		1,000	
	To Cash Account			1,000
	(Being payment made of bill payable on maturity)			

2) When the Bill is discounted with the bank

Drawer's Book: If the drawer does not want to keep the bill with him till the date of maturity he can get it discounted with the bank. On discounting of bill, the bill is transferred to bank and cash is received after deducting certain fees, which is called discounting charges. Following entry is recorded in the books of drawer in case of discounting of bill.

Bank Account	Dr.	(with actual amount received)
Discount Account	Dr.	(with amount of fees)
To Bills Receivable Account		(with full amount)

The drawer is not to pass any entry when the bill is met on the due date because payment of the bill is to be made to the holder of the bill i.e. the bank.

Drawee's Book: Drawee makes no entry relating to discounting of a bill because he is not affected by this transaction in any way. He will make the payment of the bill on the due date to the holder of the bill whosoever he may be. In this case, he will make the payment of the bill to the bank, because bank is the holder on the due date.

3) *Endorsement of Bill to a creditor*

The drawer or holder of the bill can endorse the bill receivable to his creditor as a consideration of the debt he owes to him. In case the drawer or holder of the bill endorses the bill in favour of a creditor and the bill is met on maturity, the following journal entries are passed in the books of the Drawer, Drawee as well as the Endorsee of the Bill of Exchange.

Drawer's Books: The entries relating to selling of goods and receiving of the Bill of Exchange will be as the same as, explained before. However, the following entry will be passed when the bill of exchange is endorsed in favour of a creditor.

Creditor's A/C Dr.
To Bill Receivable A/C
(Being bills receivable endorsed to creditor)

On the date of maturity when the bill is met, no entry is required in the books of the drawer. This is because in his books, the Bills Receivable Account has already been closed and he has no liability, if the bill is met on maturity.

Drawee's Books: Drawee does not make any entry relating to endorsement of the bill because he is not affected by this transaction. He will make the payment of the bill on the due to the holder i.e. creditor in this case.

Endorsee's Books: The following entries will be recorded in the books of the endorsee:

(i) On receipt of a bill from the endorser:
Bills Receivable Account Dr.
To Endorser's Account
(Being bill received)

(ii) When the bill is met on the due date:

Cash or Bank Account Dr.

To Bills Receivable Account

(Being amount of the bill received on the due date)

Illustration: X draws a bill on Y for three months for Rs.1,000 which Y accepts on 1st January 2006.

X endorsed it after three days to his creditor A. On due date, the bill was duly met.

Journalise the transactions in the books of X, Y and A.

Solution

X'S JOURNAL

Dr. Cr.

Date	Particulars	L.F.	Rs.	Rs.
2006				
Jan. 1	Bills Receivable Account Dr.		1,000	
	To Y			1,000
	(For acceptance received for 3 months)			
Jan. 4	A Dr.		1,000	
	To Bills Receivable Account			1,000
	(Being B/R endorsed to 'A')			

Y'S JOURNAL

Dr. Cr.

Date	Particulars	L.F.	Rs.	Rs
2006				
Jan. 1	X Dr.		1,000	
	To Bills Payable Account			1,000
	(Being acceptance given for 3 months)			
April 4	Bills Payable Account Dr.		1,000	
	To Cash Account			1,000
	(Being payment of bill made on due date)			

A'S JOURNAL

Date	Particulars	L.F.	Dr. Rs.	Cr. Rs.
2006				
Jan. 4	Bills Receivable Account Dr.		1,000	
	To X			1,000
	(For bill received duly endorsed)			
Jan. 4	Cash Account Dr.		1,000	
	To Bills Receivable Account			1,000
	(For payment of bill received on due date)			

4. *Bill sent to the Bank for Collection*

In the big business houses, bills receivables are received in a large number regularly. In such business houses it becomes difficult to present the various bills to different drawees on different due date. In such a case, the bills are sent to the banker for collection, thus entrusting the banker to do this job. An instruction is given to the banker before hand to present the respective bills to the respective drawees on due date of the respective bill and to credit the drawer's account when money is collected. Sometimes, bank makes collection charges on the collections of bills. In this connection, the following journal entries are recorded:

Drawer's Books

i) When a bill is sent to the bank for collection:

Bills sent for collection Account Dr.

To Bills Receivable Account

(Being bill receivable sent to the bank for collection)

ii) On receipt of information (advice) from the bank or the collection of the amount of the bill:

Bank Account Dr.

To Bills sent for collection Account.

(Being amount of bill collected on maturity)

If the bank has charged some amount as collection charges, then the following entry will be recorded:

Bank	Dr.	(with the amount of bill less collection charges)
Collection/Bank Charges Account	Dr.	(with the amount of collection charges)
To Bills sent for collection Account		

(Being amount of bill collected on maturity and bank charged collection charge)

Drawee's Books: No entry is passed in the drawee's books for bill receivable sent to the bank for collection because drawee is not affected by this transaction. On the due date, the drawee will make the payment of the bill to the bank because the bill is in the possession of the bank.

To pledge the bills receivables

Sometimes drawer may pledge the bill receivable as security against a loan from a third party. In such a case, the drawer will not make any entry for pledging the bill receivable because right of the payment of the bill is not exercisable by the third party who has given a loan. Right of payment of the bill will be exercised by the third party only if the repayment of the loan is not made.

Illustration: On 1st January, 2006, X sells goods to Y for Rs. 8,000 and draws four bills of exchange on him. The first for Rs.1,500 for one month, the second for Rs.1,000 for 2 months, the third for Rs.2,000 for 3 months and the fourth for Rs.3,500 for 4 months. Y accepts and returns these bills to X.

The second bill is discounted with the bank at 12% p.a. on 4th January, 2006 and on the same date the third bill is endorsed by X to his creditor Z. The fourth bill is sent to the bank for collection on 10th January, 2006.

Pass journal entries in the book of X and Y assuming that all bills are met on their due dates.

Solution

X'S JOURNAL

Date	Particulars	L.F.	Dr. Rs.	Cr. Rs.
2006				
Jan. 1	Y Dr.		8,000	
	To Sales Account			8,000
	(Being goods sold to Y on credit)			
Jan. 1	Bills Receivable Account		8,000	
	To Y			8,000
	(Being four bills for Rs.1,500, Rs.1,000, Rs. 2,000 and Rs. 3,500 accepted by Y payable 1 month, 2 months, 3 months and 4 months after date respectively).			
Jan. 4	Bank Account Dr.		980	
	Discount Account Dr.		20	
	To Bills Receivable Account			1,000
	(Being second bill discounted at bank at 12% p.a. discount charged for 2 months).			
Jan. 4	Z Dr.		2,000	
	To Bills Receivable Account			2,000
	(Being third bill endorsed over to Z)			
Jan. 10	Bills Sent for Collection Account Dr.		3,500	

	To Bills Receivable Account			3,500
	(Being fourth bill sent to the Bank for collection)			
Feb. 4	Cash Account Dr.		1,500	
	To Bills Receivable Account			1,500
	(Being payment of the first bill received on the due date)			
May 4	Bank Account Dr.		3,500	
	To Bills Sent for Collection Account			3,500
	(Being fourth bill sent to the Bank for collection collected)			

Y'S JOURNAL

Dr. Cr.

Date	Particulars	L.F.	Rs.	Rs.
2006				
Jan.1	Purchases Account Dr.		8,000	
	To X			8,000
	(Being goods purchased on credit)			
Jan.1	X Dr.		8,000	
	To Bills Payable Account			8,000
	(Being four bills for Rs.1,500, Rs.1,000, Rs. 2,000 and Rs. 3,500 accepted by Y payable 1 month, 2 months, 3 months and 4 months after date respectively).			
Feb.4	Bills Payable Account Dr.		1,500	
	To Cash Account			1,500
	(Being Payment of the first bill on the due date)			
March 4	Bills Payable Account Dr.		1,000	
	To Cash Account			1,000

	(Being payment of the second bill on the due date)			
April 4	Bills Payable Account Dr.		2,000	
	To Cash Account			2,000
	(Being third bill met on the due date)			
May 5	Bills Payable Account Dr.		3,500	
	To Cash Account			3,500
	(Being payment of the fourth bill on the due date)			

8.7 DISHONOUR OF A BILL

Dishonour of a bill means the non-acceptance of the bill or non-payment of the bill by the drawee at the time when the bill is presented for payment. So, a bill can be dishonoured in the following two ways:

1. When the bill drawn by the drawer is not accepted by the drawee.
2. When the drawee does not make the payment of the bill on the due date when it is presented for payment.

When the bill is dishonoured, it may be with any one of the following parties:

a) With the drawer, if the bill is retained by him till the maturity date.

b) With the drawer's bank, if the bill has been discounted with his banker.

c) With a creditor of the drawer, if he has endorsed to his creditor for settlement of his debt.

d) With the drawer's bank, if the bill has been sent to the bank for collection.

Accounting treatment in case of dishonour of a bill by non-acceptance

Drawer's Books

Bills Receivable Account is given debit and Drawee's Account is given credit when the bill is drawn on the drawee. When the bill is dishonoured on non-acceptances, it is obvious that reverse entry should be passed to neutralise the effect of the entry passed at the time of drawing a bill. Therefore, following journal entry is passed:

Drawee's Account Dr.
To Bills Receivable Account
(Being bill dishonoured by non-acceptance by the drawee)

Drawee's Books

The drawee has not passed any entry for the bill because he has not accepted the bill. So, no cancellation entry is required for the dishonour of a bill.

Accounting Treatment in case of a dishonour of a bill by Non-payment

Drawer's Books

i) When bill in the possession of a drawer is dishonoured
Drawee's Account Dr.
To Bills Receivable Account
(Being bill dishonoured on due date)

ii) When the bill discounted with the bank is dishonoured
Drawee's Account Dr.
To Bank Account

(Being bill discounted with the bank dishonoured)

iii) When the bill endorsed in favour of creditor in dishonoured

Drawee's Account Dr.

To creditor's Account

(Being endorsed bill dishonoured)

iv) When the bill sent to the bank for collection is dishonoured

Drawee's Account Dr.

To Bills sent for collection Account

(Being Bill Previously sent to bank for collection dishonoured)

In the above cases of dishonour of bill one thing is common that Drawee's Account has been debited to cancel the credit given to him at the time of the acceptance of the bill.

Drawee's Books

The drawee, or acceptor of the Bill, also records the entry on the dishonour of the Bill on due date. The Bill is returned to him by drawer and becomes a debtor once again to the drawer. Whether the Bill was presented by Drawer or Bank or Endorsee or by Bank (when it was sent for collection), the following journal entry is recorded on receipt of dishonoured Bill payable from Drawer:

Bill Payable Account Dr.

To Drawer

(Being Bill not met on due date)

Endorsee's Books

On dishonour of the Bill, the endorsee is entitled to receive payment from the endorser. Thus, the following journal entry is recorded:

Endorser Dr.

To Bill Receivable Account

(Being Bill dishonoured and returned to Endorser)

Bank's Books

a) When Bank purchased the bill i.e. when the bill was discounted

Drawer/Customer Account Dr.

To Bill Receivable Account

(Being Bill dishonoured and returned to customer)

b) When Bill was received by Bank for Collection

Customer's Bill for Collection Account Dr.

To Bills sent for Collection Account

(Being Bill dishonoured and returned to customer)

Noting charges

As we know when a bill is dishonoured by drawee, the drawer in order to realise his amount has to resort to legal action and for this bill is got noted from "Notary Public" which serves as a testimony to the fact of bill being dishonoured. For noting of bill, notary public charges some fees which is called noting charges. Ultimately this loss of noting charges is to be borne by the drawee. The journal entry regarding noting charges are as follows:

Drawer's Books

a) If noting charges are paid by drawer

Drawee's Account Dr.

To Cash Account

(Being noting charges on dishonoured bill paid on behalf of drawee)

b) If noting charges are paid by bank/endorsee.

Drawee's Account Dr.

To Bank/Endorsee Account

(Being noting charges paid by bank/endorsee on dishonour bill)

Drawee's Books

Noting Charges Account Dr.

To Drawer's Account

(Being noting charges on dishonoured bill paid)

Illustration: On 1st November, 1998, Ranjit accepted a bill for Rs.500 at 4 months drawn by Aloke. On 4th November, 1998 Aloke discounted the bill @ 6% p.a. with his banker. At maturity, the bill was dishonoured and the bank charged Rs.15 as noting charges. Show necessary journal entries in the books of Aloke and Ranjit recording the above transactions.

Solution

IN THE BOOKS OF ALOKE

JOURNAL

Date	Particulars	L.F.	Dr. Rs.	Cr. Rs.
1998				
Nov. 1	Bills Receivable A/c Dr.		500	
	To Ranjit A/c			500
	(Being the bill drawn on Ranjit for 4 months)			
Nov. 4	Bank A/c Dr.		490	
	Discount on Bills A/c Dr.		10	

	To Bills Receivable A/c			500
	(Being the bill discounted @ 6% p.a.)			
1999	Ranjit A/c Dr.		515	
March 4	To Bank A/c			515
	(Being the bill dishonoured and noting charges paid Rs.15)			

IN THE BOOKS OF RANJIT

JOURNAL

Dr. Cr.

Date	Particulars	L.F.	Rs.	Rs.
1998				
Nov. 1	Aloke A/c Dr.		500	
	To Bills payable A/c			500
	(Being the bill accepted for 4 months)			
1999	Bills Payable A/c Dr.		500	
March 4	Noting Charges A/c Dr.		15	
	To Aloke A/c			515
	(Being the dishonour of the bill and noting charges paid by Aloke)			

Renewal of a Bill

When the drawee of the bill, after accepting it, has some apprehension in his mind that he may not be able to honour the bill on the due date, may request the drawer of the bill to cancel the original bill and to draw a fresh bill on him for a further period of time. This is called renewal of a bill. In such a case, the drawee of a bill becomes liable to pay interest to the drawer for the extended period. The amount of the new bill include the amount of the interest less the part payment made by the drawee, if any, while requesting the drawer to renew the bill.

When a bill is renewed, the following entries are required to be passed in the books of the drawer and the drawee.

Drawer's Books

a) For the cancellation of Old bill

Drawee's Account Dr.

To Bills Receivable Account

(Being bill cancelled)

b) For Charging interest

(i) When interest is received in cash

Cash Account Dr.

To Interest Account

(Being interest received in cash)

(ii) When interest is not received in cash

Drawee's Account Dr.

To Interest Account

(Being interest due on renewed bill @...........%)

c) When the drawee wants to make a partial payment of the old bill

Cash Account Dr.

To Drawee's Account

(Being partial payment on old bill received)

d) When renewed bill is received

Bills Receivable Account Dr.

To Drawee's Account

(Being a renewed bill received for the amount due as a result of the cancellation of the old bill)

Drawee's Books

a) When the old bill is cancelled

Bills Payable Account Dr.

To Drawee's Account

(Being old bill cancelled) Dr.

b) Treatment of interest on renewed bill

(i) When interest is paid in cash

Interest Account Dr.

To Cash Account

(Being Interest paid)

(ii) When interest is not paid in cash

Interest Account Dr.

To Drawer's Account

(Being interest on renewed bill due)

c) When a partial payment of the old bill is made in cash

Drawer's Account Dr.

To Cash Account

(Being partial payment of old bill made)

d) When the new bill is accepted

Drawer's Account Dr.

To Bills Payable Account

(Being acceptance of new bill given)

Illustration: Ramesh Kumar having accepted a bill for Rs.1,000 is unable to meet the same. Before the due date, he requests Raj Kumar to receive Rs. 20 for interest and draw on him a new Bill for the amount for a further period of three months and cancel the old bill which is shortly to become due. Raj Kumar agrees to his proposal. Pass entries in the books of both the parties to the transactions.

Solution

ENTRIES IN THE BOOKS OF RAJ KUMAR

Date	Particulars		L.F.	Dr. Rs.	Cr. Rs.
	Ramesh Kumar	Dr.		1,000	
	To Bills Receivable A/c				1,000
	(For cancellation of the old Bill)				
	Cash A/c	Dr.		20	
	To Interest A/c				20
	(For Interest received)				
	Bills Receivable A/c	Dr.		1,000	
	To Ramesh Kumar				1,000
	(For the amount of new bill accepted by him)				

ENTRIES IN THE BOOKS OF RAMESH KUMAR

Bills Payable A/c	Dr.		1,000	
To Raj Kumar				1,000
(For cancellation of the old Bill)				
Interest A/c	Dr.		20	
To Cash A/c				20
(For interest paid to drawer)				
Raj Kumar	Dr.		1,000	
To Bills Payable A/c				1,000
(For a new bill accepted)				

Retiring a Bill

This is the other side of the renewal of a bill. When the drawee of a bill desires to make payment even before the due date of the bill and the drawer welcomes it, it is called retiring a bill. Simply, retiring a bill means that the drawee makes the payment before the due date. In such a case, the drawer is to allow some discount because what he was to receive after some time in the future, he receives immediately. The discount is an expense for the drawer and gain for the drawee.

The following are the accounting entries in relation to retiring a bill:

Drawer's Books

Cash Account	Dr.	(with actual amount received)
Rebate/Discount Account	Dr.	(with amount of rebate)
To Bills Receivable Account		(with full amount of the bill)

(Being bill retired under rebate)

Drawee's Books

Bill Payable Account	Dr.	(with full amount of the bill)
To Cash Account		(with actual payment)
To Rebate/Discount Account		(with rebate earned)

(Being bill retired under rebate)

Illustration: On January 1, 1997 Saju accepted a bill, drawn on him by Rinku for Rs.5,000 payable 4 months after sight, against his dues. Having surplus funds, Saju paid off the bill on 4th Feb. and was allowed a rebate of 6% p.a. Show Journal entries in the books of Saju and Rinku to record these transactions.

Solution

IN THE BOOKS OF SAJU

JOURNAL

			Dr.	Cr.
Date	Particulars	L.F.	Rs.	Rs.
1997				

Jan. 1	Rinku A/c Dr.			5,000	
	To Bills Payable A/c				5,000
	(Being the bill accepted for four months)				
Feb. 4	Bills Payable A/c Dr.			5,000	
	To Bank A/c				4,925
	To Discount Received A/c				75
	(Being the bill retired before maturity and discount received @ 6% p.a.).				

IN THE BOOKS OF RINKU

JOURNAL

Date				
1997				
Jan. 1	Bills Receivable A/c Dr.		5,000	
	To Saju A/c			5,000
	(Being the bill drawn on Saju for four months)			
Feb. 4	Bank A/c Dr.		4,925	
	Discount Allowed A/c Dr.		75	
	To Bills Receivable A/c			5,000
	(Being the bill retired and discount allowed @ 6% p.a.)			

Insolvency

Insolvency is a state of affairs when a person is unable to pay the amount due by him. If the acceptor of a bill or the maker of a promissory note becomes insolvent, the bill of exchange or the promissory note should be treated as dishonoured because he is unable to make the payment of the bill and entry relating to dishonour should be recorded.

On the adjudication of a person as insolvent, his estate vests with the official receiver who realises the bankrupt's properties and proportionally pays the creditors out of the realised sum. It is possible that a partial payment may be made by the estate of the insolvent, the balance of the amount due from the insolvent not recovered should be written off as bad debts in the drawer's books. The amount which the insolvent cannot pay to the drawer should be credited to Unpaid or Deficiency or Profit and Loss Account and Debited to Drawer's Account in the insolvent's books. The following accounting entries are recorded in the books of accounts of the drawer and the drawee.

Drawer's Books

i) Drawer's Account Dr.

To Bills Receivable/Bank/Endorsee/Bills sent for collection A/c

(Being bill dishonoured due to insolvency of drawer)

ii) Cash Account Dr (with actual amount received)

Bad Debts Account Dr. (with amount unsatisfied)

To Drawee's Account (with full amount)

(Being a final dividend received and balances written off as bad debts)

Drawee's Books

(i) Bills Payable Account Dr.

To Drawer's Account

(Being bill dishonoured due to insolvency)

(ii) Drawer's Account Dr. (with total amount due)

To Cash Account (with actual amount paid)

To Deficiency Account (with amount unsatisfied)

(Being final claim paid to creditors)

Illustration: On 1st January, 1999, Kuntal sold goods to Subhra valuing Rs.6,000. On 4th January, 1999 Kuntal received from Subhra Rs.2,000 and drew a bill receivable 3 months after date for the balance. On the same date, Kuntal endorsed the accepted bill to Aparna for full settlement of a debt of Rs.4,050. On the due date the bill was dishonoured and Subhra, having become insolvent, paid on 5th May, 1999- 60% of her acceptance. Give journal entries in the books of Kuntal and Subhra.

Solution

IN THE BOOKS OF KUNTAL

JOURNAL

Date	Particulars		L.F.	Dr. Rs.	Cr. Rs.
1999					
Jan. 1	Subhra A/c	Dr.		6,000	
	To Sales A/c				6,000
	(Being goods sold to Subhra on credit)				
Jan. 4	Cash A/c	Dr.		2,000	
	Bills Receivable A/c	Dr.		4,000	
	To Subhra A/c				6,000
	(Being the receipt of cash Rs.2,000 from Subra and a bill drawn on her for the balance for 3 months)				
April 7	Subhra A/c	Dr.		4,000	
	Discount Received A/c	Dr.		50	

	To Aparna A/c			4,050
	(Being the bill endorsed in favour of Aparna now dishonoured)			
May 5	Bank A/c Dr.		2,400	
	Bad Debt A/c Dr.		1,600	
	To Subhra A/c			4,000
	(Being the receipt of 60% of Subhra's acceptance)			

IN THE BOOKS OF SURBHA

JOURNAL

Date	Particulars	L.F.	Dr. Rs.	Cr. Rs.
1999				
Jan. 1	Purchase A/c Dr.		6,000	
	To Kuntal A/c			6,000
	(Being the purchase of goods on credit)			
Jan. 4	Kuntal A/c Dr.		6,000	
	To Cash A/c		2,000	
	To Bills Payable A/c		4,000	
	(Being the payment and acceptance of a bill for the balance for 3 months)			
April 7	Bills Payable A/c Dr.		4,000	
	To Kuntal A/c		4,000	
	(Being the bill dishonoured at maturity)			

May 5	Kuntal A/c	Dr.		4,000	
	To Bank A/c			2,400	
	To Deficiency A/c			1,600	
	(Being the payment of 60% of dues)				

8.8 SUMMARY

Negotiable Instrument Act, 1881 defines a Bill of Exchange as, "An instrument in writing containing an unconditional order, signed by the maker, directing a certain person or to the bearer of the Instrument". Bill of exchange should be in written containing an order by the seller, unconditional, signed by drawer and should be in money only. The bill of exchange may be inland bills, foreign bills, trade bills, accommodation bill, time bill and demand bill. When a bill of exchange is written in indigenous language. It is known as Hundis. The bill of exchange, hundis and promissory notes are treated alike for the purpose of accounting treatment. A bill of exchange is a bill receivable for the drawer and a bill payable by the drawee. The drawer can treat it in four ways, i.e. retaining the bill till date of maturity, get the bills discounted with the bank, endorse it to a creditor, sending the bill to his banker for its collection. Dishonour of a bill means the non-acceptance of the bill or non-payment of the bill by the drawee at the time when the bill is presented for payment.

8.9 KEYWORDS

Bill of Exchange: An instrument in writing containing an unconditional order, signed by the maker, directing a person to pay a certain sum of money only to or to the order of a certain person or to the bearer of instrument.

Hundi: Bill of exchange written in indigenous language.

Cheque: Bill of exchange drawn as a specified bank and payable on demand.

Promisory Note: Written and conditional promise made by one person to another.

Dishonour: Non-payment of the amount of a promissory note, cheque or bills of exchange on the date of maturity.

Protesting: Formal certificate of dishonour issued by notary public to the holder of bill.

8.10 SELF ASSESSMENT QUESTIONS

1. Define bill of exchange. Differentiate bill of exchange and promissory note.

2. What is meant by discounting of bill? Why is it necessary? Give accounting entries for discounting of a bill.

3. Explain the important features of bill of exchange and promissory note. What are their advantages?

4. What do you mean by renewal of a bill? Give the various journal entries which are recorded in the books of the drawer and the drawee on renewal of a bill.

5. Ajit Wadekar bought goods from Farook Engineer for Rs.2,500 on 16th February 1997. Farook Engineer, draws a bill for the amount on Ajit Wadekar on which latter gives his acceptance and returns to Engineer. The bill is for two months. On due date Wadekar honours the bill.

   Pass journal entries in the books of Ajit Wadekar and Farook Engineer.

6. A bill for Rs.500 payable three months after date is drawn by A & Co. on B & Co. and accepted by the latter. Show entries that would be passed in the journal of A & Co. in each of the following cases:

   a) If they keep the bill till maturity and then receive payment of it on due date.
   b) If they discount it at their bank for Rs.495.
   c) If they endorse it to their creditor C & Co.
   (d) If they send it to their bankers for collection.

7. Ram purchases goods worth Rs.2,000 from Shyam on 1st April, 1997. On the same day he accepted a bill drawn by Shyam for the amount, for 2 months. Shyam endorsed the bill to his creditor Radhey. On the due date the bill was dishonoured and Radhey paid Rs.20 as noting charges. Shyam paid Radhey by cheque his full amount and agreed to draw on Ram a new bill for the amount plus Rs.15 as interest. The bill was duly accepted by Ram and met on maturity. Record the transactions in the books of Ram, Shyam and Radhey.

8. Jaggi owes to Kamath Rs.2,400. The debt is discharged by Jaggi on Ist February, 1994 by accepting three bills of exchange drawn on him by Kamath- one for Rs.600 at 2 months, another for Rs.800 at 3 months and the third for Rs.1,000 at 4 months. The first bill is endorsed by Kamath in favour of Dass, his creditor. The second bill is discounted at the bank at 12% p.a. All the three bills were dishonoured. The noting charges in each case were Rs.5. On 5th June, Jaggi agreed to accept another bill for the total amount including interest at the rate 15% p.a. The bill was for 3 months. On Ist September, Jaggi became insolvent, having

his bills unpaid. On Ist October, a first and final dividend of 40 paise in rupee was received from Jaggi's estate. Give journal entries in the books of both Jaggi and Kamath.

9. Draft Journal entries necessary to record the following transactions:

   (a) Dutt's promissory note for Rs.900 endorsed in favour of Chatterjee was dishonoured. Chatterjee paid Rs.15 as noting charges. We paid Chatterjee by cheque and accepted from Dutt another bill for the amount due plus interest Rs.20.

   (b) We retired a bill for Rs.1,500 drawn by Manjeet before due date for Rs.1,490.

   (c) Krishna accepted a bill for Rs.2,000 drawn by us which Krishna discharged by paying up Rs.700 and accepting a new bill for Rs.1,320 including interest. We discounted the bill for Rs.1,290. Subsequently the bill was dishonoured.

   (d) Goswami retired his acceptance for Rs.80 by cheque Rs. 300 and a new bill for 2 months, interest at 9% p.a. being paid in cash forthwith.

   (e) Renewed our acceptance to Sampat for Rs.1,000 by cheque Rs.400 and a new bill at 3 months at 4% p.a. interest.

   (f) Our acceptance to Dharam Paul for Rs.850 was discharged by Verma Bros. Acceptance to us for a similar amount.

   (g) Our own acceptance to Sen & Co., for Rs.320 dishonoured due to omission of necessary instructions to our bank. Sen & Co., claim Rs.330 including noting charges which we settle by cheque.

(h) Patel's acceptance for Rs.2,000 which we sent to the bank for collection was returned by the bank as dishonoured. Bank paid Rs.10 as noting charges.

10. On 1st July 1994, Ramesh sold goods to Suresh priced at Rs.6,000 subject to a deduction of 16-2/3% trade discount and drew a bill on Suresh for 3 months. Suresh accepted the bill and returned it to Ramesh. Ramesh and Suresh mutually agreed that this bill should be discharged by cash payment of Rs.2,000 and a new bill on such a date as would enable the latter to earn a rebate of Rs.100 @ 10% p.a. The new bill would be accepted for 2 months at 10% p.a. interest. The new bill was met on the due date.

    Pass journal entries in the books of both the parties.

8.11 REFERENCES/SUGGESTED READINGS

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Subject: **Financial Accounting-I**	
Course Code: **BBA-104**	Author: **Dr. Mahesh Chand Garg**
Lesson: **9**	Vetter:

RECONCILIATION OF BANK ACCOUNTS

STRUCTURE

9.0 OBJECTIVES

After going through this chapter, you should be able to-

- Know the meaning and characteristics of bank reconciliation statement.
- Understand the causes of differences in the bank balance shown by cash book and pass book.
- Understand the procedure for preparation of bank reconciliation statement.

9.1 INTRODUCTION

In modern business world, the major part of the business transactions is settled by cheques. For the purpose of business transactions through cheques, every businessman maintains current accounts with banks. He keeps money in his account and deposits cheques, etc. received from customers and draws cheques in favour of his creditors for making the payments. Current account facilitates business transactions in a smoother way than cash. For instance, no substantial cash is to be kept in the business, payments of cheques are themselves records of payments made, the payee is also relieved of the risk of carrying cash.

When a businessman opens a current account in a bank, the bank issues him a cheque book and pass book. At the same time, the businessman also keeps its records relating to bank transactions either through the bank columns of the cash book or through a separate bank account in the books of accounts. When the cash is deposited or a cheque is deposited in the bank, the bank account is debited in the cash book. But when the businessman withdraws cash from the bank, the same account is credited. Similarly, when cash is deposited into bank it increases the liability of the bank and bank gives credit to the account of the client in the pass book. The bank maintains the businessman's account in its ledgers and its copy is recorded in the pass book and given to the customers.

In other words, all entries appearing in the debit side of the bank column of the cash book will be appearing in the credit side of the businessman's account in the ledger of the bank. Conversely, all entries appearing in the credit side of the bank column of the cash book will be appearing in the debit side of the businessman's account in the ledger of the bank. Sometimes it happens that balance of the bank column of the cash book does not show the same balance as that shown by the pass book. Both there balances may be correct, yet may show a difference. In order to reconcile the balance of the bank column of the cash book with that of the pass book, this statement is prepared.

The statement that is prepared for reconciling the balances of cash book and pass book is called a Bank Reconciliation Statement. Bank Reconciliation Statement is a statement which contains a complete and satisfactory explanation of the differences in the balances as per the cash book and the pass book. So, bank reconciliation is a periodical statement prepared by a trader on a particular date with the object of reconciling the two balances shown by cash book and pass book and locating the causes which are responsible for the disagreement of two balances on a particular date.

Features or characteristics of bank reconciliation statement

From the above, the following features of the statement emerge:

a) It is merely a statement not an account.
b) This is a periodical statement.
c) It is prepared on a particular day or this statement is valid for the day it is prepared.
d) The preparation of bank reconciliation statement is not a part of the double entry book-keeping.
e) The causes which are responsible for the disagreement of the two balances can easily be found out.

9.2 CAUSES/REASONS FOR DIFFERENCE IN TWO BALANCES

The relationship between the customer and the banker is that of a creditor and a debtor. So, if the bank column of the cash book shows a debit balance as on a specified date, the pass book should show an equal amount of credit balance as on that date and vice-versa. However, the balances shown by the two independent records may not agree due to the following:

- **Cheques issued but not yet presented for payment**: When a cheque is issued to a third party, it is entered in the cash book by crediting the bank account resulting in reducing the bank balance in the depositor's books. But bank debits the customer's account when the cheque is presented by that third party to the bank for payment. This means that if the cheque is not presented for payment upto the date of preparation of the bank reconciliation statement, the balance as per pass book will be higher than the balance shown by the cash book by the amount of cheque not presented for payment.
- **Cheques paid into bank but not yet collected by the bank**: Whereas a cheque is received by a businessman from a third party and he deposits it in a bank, he will debit bank account and credit the account of third party in his own books. His bank balance in cash book is therefore increased. But bank will credit that cheque not when it is deposited but only when that amount has been realised. Until the cheque has been collected, the balance appearing in the pass book would be less than the balance in the bank column of cash book.
- **Bank Charges**: The bank usually debits the account of the customer with interest on bank overdraft, collection charges, incidental charges for the various services rendered by the bank. These adjustments are shown in the pass book as and when they occur and hence the balance in the pass book decreases. Customer comes to know about it when he collects his pass book and verifies it. Until then, the bank

balance as per the pass book would be less than the bank balance as per the cash book.

- **Interest credited by bank but not entered in cash book**: Some scheduled banks give interest on current accounts to their customers if they maintain certain minimum credit balance in their current accounts. When a bank allows interest to a customer it will credit his account and his bank balance will be increased. But the customer will know about when he will receive the pass book or bank statement and then he would pass an appropriate entry in the cash book. Until then, the bank balance as per pass book would be more than the bank balance as per cash book.
- **Interest or dividend on investments etc. collected by the bank**: The businessman may entrust the task of collection of interest or dividend on investments, rent on property etc. to the banker. After the collection of this income, the bank will give credit to the account of the businessman and will increase his balance whereas there may be no entry for this income in the cash book of the businessman for want of information. The relevant entry in the cash book is made only when communicated and hence cash and pass book balances vary in the mean time.
- **Amount directly deposited into the bank by customers**: When any amount is directly deposited into the bank account of a businessman by customers then the bank gives credit to the account of that businessman immediately. This results in an increase in the bank balance by that amount. The businessman would come to know about the deposit on receiving advice from the bank or intimation from the customer. Until then the bank balance would show more balance as compared to the balance as per cash book.

- **Payments made by the bank on behalf of clients**: The businessman may give standing instructions to his bank to make the payment of insurance, rent, licence fee and other payments on his behalf when they fall due. On the instructions of the customers, the bank makes the payment on due dates and debits the client's account. But the businessman enters the same in his books only when he receives the intimation from the bank. Till it is done, the two balances show a difference.
- **Bills Collected by the bank on behalf of Customers**: The customers may authorise his banker to collect the amount against certain bills receivable from the acceptor or a drawee as and when they become due. If the acceptor of a bill receivables honours the bill on its due date, the bank will give a credit to the customer's account for the amount so collected. As a result, the bank balance will be higher by that amount than the balance as per cash book until the necessary entry in this respect is recorded in cash book.
- **Dishonour of Bills or cheques**: When the businessman sends the bills or cheques to the bank for realisation, he enters them on the debit side of his cash book and thus increases the bank balance. But the bank does not make any entry in the customer's account if these are dishonoured. This is another cause of difference between the two balances.
- **Rebate on retiring of Bills**: When the businessman makes payment of his bills payable through bank or to bank before maturity he is allowed a rebate on such payments by the bank. The bank credits the businessman's account with this rebate. Thus, there will be a difference in the balances of cash book and pass book to the extent of amount of rebate.

- **Cheques paid into bank but omitted to be entered in cash book**: Sometimes the businessman deposits a cheque into the bank but forgets to enter the same in cash book. This also causes a difference between the two balances.
- **Wrong debit or credit given by the banks**: If there is a wrong debit or credit in the books of account of the bank then it also causes a difference in the balances of books of the customer and the bank. A wrong debit or credit may be given by the bank in the following ways:
  - a) Other account holders' cheque wrongly debited or credited in the customer account by the bank.
  - b) Recording of entry on the wrong side of the pass book by the bank.

9.3 PROCEDURE FOR PREPARATION OF BANK RECONCILIATION STATEMENT

The bank reconciliation statement is prepared usually at the end of period, i.e. a month, a quarter, a half year or year as may be found convenient and necessary by the businessman taking into account the number of transactions involved. The following are the steps to be taken for preparing a bank reconciliation statement:

a) Tick off all the items in the pass book with the entries in the bank column of the cash book and make a list of the entries as are found not ticked either in the cash book or the pass book. The unticked items are responsible for the difference in the balances shown by the cash book and the pass book.

b) The balance shown by any book (i.e. cash book or pass book) should be taken as the base . This is as a matter of fact the starting point for determining the balance as shown by the other book after making suitable adjustments taking into account the causes of difference.

c) The effect of the particular cause of difference should be studied on the balance shown by the other book.

d) In case, the cause has resulted in an increase in the balance shown by the other book, the amount of such increase should be added to the balance as per the former book which has been taken as the base.

e) In case, the cause has resulted in decrease in the balance shown by the other book, the amount of such decrease should be substracted from the balance as per the former book which has been taken as the base.

f) In case, the books show an adverse balance (i.e. an overdraft) the amount of the overdraft should be put in the minus column. Bank Reconciliation Statement should then be prepared on the same pattern as if there is a favourable balance instead of their being an overdraft.

The following table will help to learn the preparation of the bank reconciliation statement-

	Dr. balance as per Cash Book or Overdraft as per Pass Book	Cr. Balance as per pass Book or Overdraft as per Cash Book
I. *Those items which affect the debit side of Cash Book:*	-	+
i) Cheques deposited but not collected by bank		
ii) Cheque though entered in Cash Book but omitted to be sent to the Bank.		
II. *Those items which affect the credit side of Cash Book:*	+	-
i) Cheques issued but not presented for payment.		
III. *Those items which affect the Credit side of pass Book:*	+	-
i) Interest/Dividend credited by bank.		
ii) Amount deposited direct by a customer into bank account.		
iii) Cheques sent to the bank but omitted to be entered into the Cash Book.		
IV. *Those items which affect the debit side of Pass Book:*	-	+
i) Bank charges charged by bank.		
ii) Interest on overdraft.		
iii) Payment made by bank on standing instructions of customer.		

The above technique will be clear with it help of the illustrations given in the following pages.

9.3.1 Where causes of differences are given

Illustration: From the following particulars prepare a Bank Reconciliation Statement as on 31st December, 2006.

i) Balance as per Cash Book Rs.5,800.

ii) Cheques issued but not presented for payment Rs. 2,000.

iii) Cheques sent for collection but not collected upto 31st December, 2005 Rs. 1,500.

iv) The Bank had wrongly debited the account of the firm by Rs. 200 which was rectified by them after 31st December.

Balance as per Pass Book is Rs. 6,100.

Solution

There is a difference of Rs.300 between the balance as shown by the Cash Book and the balance as shown by the Pass Book. A reconciliation statement can be prepared to reconcile on the following basis the balances shown by the two books.

i) The balance as shown by the Cash Book will be taken as the starting point.

ii) The cheques issued but not presented for payment have not been recorded in the Pass Book. The balance as per Pass Book has to be found out. The Bank has not yet passed the entry for the payment of these cheques since they have not been presented for payment. The balance, therefore, in the Pass Book should be more. The amount of Rs.2,000 should, therefore, be added to the balance as shown by the Cash Book.

iii) Cheques sent for collection but not yet collected must have been entered in the Cash Book, but must not have been credited by the Bank to the firm's account since they have not yet been collected. The balance in the Pass Book should, therefore, be less as compared to the Cash Book. The amount of Rs. 2,000 should, therefore, be deducted out of the balance as shown by the Cash Book.

iv) The Bank has wrongly debited the firm's account. This must have resulted in reducing balance as per the Bank Pass Book. The amount should, therefore, be deducted out of the balance shown as per the Cash Book.

The Bank Reconciliation Statement will now appear as follows:

BANK RECONCILIATION STATEMENT

	Particulars	+(Rs.)	- (Rs.)
i)	Balance as per Cash Book	5,800	
ii)	Add Cheques issued but not presented for payment	2,000	
iii)	Less Cheques sent for collection but not yet collected		1,500
iv)	Less Amount wrongly debited by the Bank.		200
		7,800	1,700
	Balance as per Bank Pass Book	6,100	

OR

Bank Reconciliation Statement can be prepared as per the balance shown by Pass Book as the starting point.

BANK RECONCILIATION STATEMENT

	Particulars	+(Rs.)	- (Rs.)
i)	Balance as per Pass Book	6,100	
ii)	Less Cheques issued but not presented for payment		2,000
iii)	Add Cheques sent for collection but not yet collected	1,500	
iv)	Add Amount wrongly debited by the Bank.	200	
		7,800	2,000
	Balance as per Bank Cash Book	5,800	

9.3.2 Where cash book balance/pass book balance has to be adjusted

Illustration II: On 31st December, 1997, the Cash Book of a firm showed a bank balance of Rs.3,000. From the following information, prepare a Bank Reconciliation Statement, showing the balance as per Pass Book.

i) Cheques have been issued for Rs.2,500 out of which cheques worth Rs.2,000 only were presented for payment.

ii) Cheques worth Rs.700 were paid on 28th December but had not been credited by the Bank. One cheque for Rs.250 was entered in the Cash Book on 30th December but was banked on 3rd January, 1998.

iii) A cheque from Mohan for Rs.200 was paid in on 26th December but was dishonoured and the advise was received on 2nd January, 1998.

iv) Pass Book showed bank charges Rs.10 debited by the bank. It also showed Rs. 400 collected by the bank as interest.

v) One of the debtors deposited a sum of Rs.250 in the account of the firm on 20th December. Intimation in this respect was received from the bank on 2nd January, 1998.

Solution

BANK RECONCILIATION STATEMENT

AS ON 31ST DECEMBER, 2006

	Particulars	+(Rs.)	- (Rs.)
i)	Dr. Balance as per Cash Book	3000	
ii)	Add Cheques issued but not yet presented for payment (Rs.2,500-Rs.2,000).		500
iii)	Add Interest collected by the bank not recorded in the Cash Book	400	
iv)	Add Amount deposited by the Customer direct into the bank not recorded in the Cash Book.	250	
v)	Less Cheques paid into bank but not yet credited by the bank		700
vi)	Less Cheque entered in the Cash Book but was omitted to be banked upto 31st December.		250
vii)	Less Cheque from Mohan paid into bank dishonoured but not yet recorded in the Cash Book.		200
viii)	Less Bank charges as per Pass Book		10
		4,150	1,160
	Cr. Balance as per Pass Book	2,990	

9.3.3 Where abstracts from the cash book and the pass book are given

Illustration III: From the following entries in the Bank column of Cash Book and the corresponding Pass Book, prepare Bank Reconciliation Statement as on 30th June, 2006.

CASH BOOK (BANK COLUMN ONLY)

Dr. Cr.

Date	Particulars	Rs.	Date	Particualrs	Rs.
2006			2006		
June 1	To Balance b/d	4,600	June 3	By Cash (Self Cheque)	800
June 4	To Maninder	3,200			
June 8	To Devinder	500	June 5	By Drawings	1,000
June 18	To Narinder	3,700	June 10	By Kailsash	2,200
June 21	To Dayal	1,400	June 15	By Shyam Lal	1,300
June 28	To Amrinder	100	June 28	By Salaries	1,800
June 30	To Kashmiri Lal	450	June 29	By Mohanto	1,900
			June 30	By Des Raj	1,700
			June 30	By Commission	20
			June 30	By Balance b/d	3,230
		13,950			13,950

BANK PASS BOOK

Date	Particulars	Dr. withdrawals	Cr. Deposits	Balance Dr./Cr.	Balance Amount
2006					
June 1	By Bal. b\d	-	-	Cr.	4,600
June 3	To Cash (Self)	800	-	Cr.	3,800
June 5	To Self (Drawings)	1,000	-	Cr.	2,800
June 6	By Maninder	-	3,200	Cr.	6,000
June 10	By Devinder	-	500	Cr.	6,500
June 14	To Kailash	2,200	-	Cr.	4,300
June 16	By Narinder	-	3,700	Cr.	8,000
June 20	To Shyam Lal	1,300	-	Cr.	6,700
June 25	By Dividend on shares	-	700	Cr.	7,400
June 28	To Salaries	1,800	-	Cr.	5,600
June 30	To Collection charges	4	-	Cr.	5,596
June 30	To Commission	20	-	Cr.	5,576
June 30	To Electricity Board	80	-	Cr.	5,496

Solution

BANK RECONCILIATION STATEMENT

AS ON 30TH JUNE, 2006

	Particulars	+(Rs.)	- (Rs.)
i)	Dr. Balance as per Cash Book	3,230	
ii)	Add Cheques issued but not yet presented(Mohanto Rs.1,900 +Des Raj Rs.1,700 +Dividend Rs.700).	4,300	
iii)	Less Cheques paid but not yet credited by Bank (Dayal Rs.1,400 + Amrinder Rs.100 + Kashmiri Lal Rs.450)		1,950
iv)	Less Collection charges charged by Bank		4
v)	Less Payment to Electricity Board		80
		7,530	2,034
	Cr. Balance as per Pass Book.	5,496	

9.3.4 When overdraft balance is given

Illustration IV: From the following particulars, prepare the Bank Reconciliation Statement:

		Rs.
(i)	Bank overdraft as per the Cash Book.	16,200
(ii)	A cheque deposited as per Bank Statement but not recorded in the Cash Book.	700
(iii)	Debit side of the Bank Column cast short.	100
(iv)	A cheque for Rs.5,000 deposited but collection as per the Bank Statement only.	4,996
(v)	A party's cheque returned dishonoured as per the Bank Statement only.	530
(vi)	Bills collected directly by the bank.	3,500
(vii)	Bank charges recorded twice in the Cash Book.	25
(viii)	A bill for Rs.8,000 discounted for Rs.7,960 returned dishonoured by the bank, noting charges being	15
(ix)	Cheques deposited but not yet collected by the bank.	2,320
(x)	Cheques issued but not yet presented for encashment.	1,250

Solution

BANK RECONCILIATION STATEMENT

	Particulars	+ Rs.	-Rs.
(i)	Bank Overdraft per the Cash Book	16,200	
(ii)	Add Cheque for Rs.5,000 deposited but collection as per Bank statement Rs.4,996.	4	
(iii)	Add Cheque returned dishonoured as per the Bank statement only.	530	
(iv)	Bill for Rs.8,000 discounted for Rs.7,960 returned dishonoured by the bank noting charges being Rs.15.	8,015	
(v)	Add Cheque deposited but not collected.	2,320	
(vi)	Less Cheque deposited but not recorded in the Cash Book.		700
(vii)	Less Debit side of the bank column cast short.		100
(viii)	Less Bills collected directly by the bank.		3,500
(ix)	Less Bank charges recorded twice in the Cash Book.		25
(x)	Less Cheques issued but not yet presented for encashment.		1,250
		27,069	5,575
	Bank overdraft as per the Pass Book (Dr.)		21,494

9.4 SUMMARY

Bank reconciliation statement is a statement which is prepared for reconciling the balances of cash book and pass book. It is a statement which contains a complete and satisfactory explanation of the differences in the balances as per the cash book and the pass-book. The balances shown by the cash book and pass book may not agree due to (i) cheques issued but not presented for payment; (ii) cheques paid into bank but not yet collected by the bank; (iii) bank charges; (iv) interest credited by bank but not entered in cash book; (v) interest or dividend on investments etc. collected by the bank; (vi) amount directly deposited into the bank by customers; (vii) payment made by the bank on behalf of client; (viii) bills collected by the bank on behalf of customers; (ix) dishonour of cheques; (x) rebate on retiring of bills; (xi) cheques paid into bank but omitted to the entered in cash book; (xii) wrong debit or credit given by the banks. Bank reconciliation statement can be prepared with the (i) debit balance of cash book; (ii) credit balance of cash book; (iii) debit balance of pass book; (iv) credit balance of pass book.

9.5 KEYWORDS

Pass Book: Copy of firm's account with bank.

Overdraft: Withdrawls in excess of bank deposits.

Favourable Balance: Debit balance of cash book.

Reconciliation: Agreement of cash bank and pass book.

9.6 SELF ASSESSMENT QUESTIONS

1. What is a Bank Reconciliation Statement? How is it prepared? Submit a proforma of a Bank Reconciliation Statement with Imaginary figures.
2. "Balance as shown by the pass book should tally with the balance as shown by the cash book of the business", Do you agree? If not, explain the reasons with suitable examples of differences betwen the two.
3. Prepare a Bank Reconciliation Statement as on 30th September, 1988 from the following extracts from the Bank pass Book and the Cash Book (Bank column only).

BANK PASS BOOK

Date	Particulars	Withdrawls Rs.	Deposits Rs.	Dr./Cr.	Balance Rs.
2006	By Balance b/d			Cr.	9,810
Sept. 1	To Mahesh Chander	740		Cr.	9,070
Sept. 3	To Balwant Garg	580		Cr.	8,490
Sept. 7	By Salaria & Co.		200	Cr.	8,690
Sept. 8	By Cash		1,000	Cr.	9,690
Sept. 12	By Santosh Arora		500	Cr.	10,190
Sept. 18	To Rameshwar Vohra	440		Cr.	9,750
Sept. 21	To Insurance Premium	400		Cr.	9,350
Sept. 26	To Bank Charges	20		Cr.	9,330
Sept. 30	To Cash	3,000		Cr.	6,330
Sept. 30	By Interest		70	Cr.	6,400
Sept. 30	By Interest on Investments		600	Cr.	7,000

CASH BOOK

(BANK COLUMN ONLY)

Date	Particulars	Amount Rs.	Date Rs.	Particulars	Amount Rs.
2006					
Sept. 1	To Balance b/d	9,810	Sept.2	By Mahesh Chander	740
Sept. 6	To S.P. Roy	300	Sept. 6	By Balwant Garg	580
Sept.10	To Salaria & Co.	200	Sept.11	By Jagan Nath	470
Sept.12	To Cash	1,000	Sept.15	By Ashok Sood	350
Sept.14	To Santosh Arora	500	Sept.18	By Rameshwar Vohra	440
Sept.19	To Baljeet Grewal	460	Sept.24	By Ashok Kumar	630
Sept.26	To Bharat Singh	780	Sept.30	By Cash	3,000
			Sept.30	By Balance c/d	6,840
		13,050			13,050
Oct. 1	To Balance b/d	6,840			

4. From the following particulars prepare a Bank Reconciliation Statement as at 31st December, 2006 of M/s. A.B. & Co. who

had cash at bank as per cash book Rs.10,500.40 and as per pass book Rs.12,350.60:

(a) The following cheques were deposited on 30th and 31st December but were not collected by 31st December, 2006.

(i) Rs.300.25 (ii) Rs. 500 (iii) Rs.200.15

(b) The following cheques were issued but not cashed by 31st December, 2006.

(i) Rs.600.25, (ii) Rs.200 (iii) Rs.489.25, (iv) Rs.50

(c) The bank collected a bill of Rs.1,500 on the 31st December, 2006 but the intimation was received by the firm on 1st January, 2007.

(d) The bank allowed interest Rs.20.30 and a commission was charged Rs.9.20 on 31st December, 2006.

5. The Cash Book of a trader showed an overdraft balance of Rs.32,750 on 31st December, 2005. On scrutiny of the Cash Book and Pass Book it was discovered that:

a) On 22nd December, sundry cheques totalling Rs.6,500 were sent to Bank for collection out of which a cheque for Rs.1,500 was wrongly recorded on the credit side of the Cash Book and cheques amounting to Rs.3,300 could not be collected by the Bank till 6th January next.

b) A cheque for Rs.4,00 was issued to a supplier on 28th December. This cheuqe was not presented to Bank till 10th January.

c) Bank had debited Rs. 2,000 towards interest on overdraft and Rs. 600 for Bank charges, but the bank advice was sent on 15th January.

d) Credit side of the bank Column of the Cash Book was undercast by Rs.100.

e) Cheques for Rs.2,000 drawn for office expenses were not encashed till 2nd January.

f) A cheque for Rs.1,000 was issued to a creditor on 27th December and was omitted to be entered in the Cash Book. It was, however, presented to Bank within 31st December.

g) Dividends amounting to Rs. 500 had been paid direct to the Bank and not entered in the Cash Book.

You are required to make necessary corrections in the Cash Book and starting with the amended balance, prepare a Bank Reconciliation Statement as at 31st December, 2006.

9.7 REFERENCES/SUGGESTED READINGS

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Subject: **Financial Accounting-I**	
Course Code: **BBA-104**	Author: **Dr. B.S. Bodla**
Lesson: **10**	Vetter:

SINGLE ENTRY SYSTEM

STRUCTURE

10.0 OBJECTIVES

After going through this lesson, you should be able to-

- Know the meaning, advantages and disadvantages of single entry system.
- Differentiate single entry system and double entry system.
- Compute profit or loss under single entry system.
- Differentiate between statement of affairs and balance sheet.

10.1 INTRODUCTION

Single Entry System is an incomplete 'double entry system'. In case of double entry system of book- keeping both the aspects of every transaction are recorded. In this system, the first entry is made to the debit of an account, and the second entry to the credit of second account. However, in case of single entry system, the business houses for their convenience and more practical approach ignore the strict rules of double entry system. The users of this system maintain only the essential records. In other words, it is a system which may not keep some books of subsidiary records and some ledger accounts which otherwise are kept in case of double entry system. In fact, single entry system may consist of double entry in respect of certain transactions such as cash paid to creditors, cash received from debtors, etc, and single entry in regard to certain events and transactions such as cash sales and purchases and expenses incurred on purchase of fixed assets. Further, the users of this system may pass no entry in respect of certain transactions, for instance, depreciation, bad debts, etc.

According to a Dictionary of Accountancy by Kohler, "A system of book-keeping in which as a rule only records of cash and of personal accounts are maintained, it is always incomplete double entry varying with the circumstances." Thus, under the so-called single entry system both the aspects of business transactions and events are not recorded and, therefore, this may be defined, "as any system which is not exactly the Double Entry System". Under the single entry system usually a cash book and personal accounts are maintained.

10.2 SALIENT FEATURES

From the foregoing discussion, the following salient features have emerged about the single entry system:

a) Under this system usually a cash book and personal accounts are maintained.

b) Usually real and nominal accounts are not kept in this system.

c) The cash book maintained, under this system usually mixes up both the personal and the business transactions.

d) In this system, it is seen quite oftenly that in order to collect the necessary information one has to depend on original vouchers. For example, the amount of credit purchases may have to be found out on the basis of original invoices received from the suppliers in case the figures are not readily available.

e) This system can be applied only in case of sole trader or partnership concerns. Limited companies, because of legal provisions, cannot keep books on single entry system.

f) It is adopted as per individual requirements and convenience by the business houses. Therefore, the system may differ from firm to firm, which brings lack of uniformity in accounting books.

10.3 DISADVANTAGES AND ADVANTAGES OF SINGLE ENTRY SYSTEM

10.3.1 Disadvantages

a) It is an incomplete system of accounting since this system does not record both the aspects of business transactions and events. Because of this limitation, one cannot prepare trial balance and, thus, the arithmetical accuracy cannot be easily checked in the absence of a trial balance. This increases the chances of misappropriations and frauds as compared to the Double Entry System of book-keeping.

b) This system lacks uniformity since the businessmen apply it as per their individual requirements and conveniences.

c) It becomes difficult to valuate assets in case a businessman wanted to sell his business.

d) In the absence of complete information for sales, purchases and other expenses, the trading and profit and loss account cannot be prepared. Hence, rate of gross profit on sales and the true profit or loss position cannot be known.

e) As there are no real accounts, the balance sheet cannot be drawn up to give a correct picture of the financial position of the business on a particular date.

f) This system hampers comparison, planning, and sound decision-making because the system does not provide accurate figures about the performance of the business and its financial position.

10.3.2 Advantages

a) This system is more economical than double entry system and hence, suitable for small business firms.

b) This system is also suitable to those firms which have more cash transaction and a large number of personal accounts.

c) This system does not require specialised knowledge of accounting since only selected books of accounts are kept under it.

10.4 CALCULATION OF PROFIT OR LOSS

In case of a business maintaining accounts according to single entry system, profit (or loss) made during the year are calculated by any of the following two methods:

i) Increase in net worth method.

ii) Conversion method.

10.4.1 Increase in NetWorth Method

Under this method, profit can be calculated by comparing the net worth in the beginning of the year and at the end of the year. Any decrease in net worth is taken as loss, but any increase in net worth is taken as profit. However, this is true only in the absence of any other information. Thus, under a pure single entry system profit cannot be calculated by preparing trading and profit and loss account. For this purpose, we need to calculate and compare capital (net worth) in the beginning and at the end of the year. For example, if net worth of the business on 1.4.1997 is Rs. 50,50,000 and it is Rs. 52,50,000 on 31st March, 1998, it can be said that the business has made profit of Rs. 2,00,000 during the period.

In order to determine the capital in the beginning of the period and at the end, we prepare 'statement of affairs'. A statement of affairs is a statement of all assets and liabilities. The excess of assets over liabilities is taken as net worth. For calculating profit by net worth method the following adjustments are required:

(i) **Adjustment for drawings:** The drawings made by proprietor from the business for his personal use are added to the capital at the end because drawings made during the year will reduce the capital at the end but not the profit for the year. In other words, accurate amount of profit (or loss) can be known only by making adjustments, in the capital at the end, for the drawings made.

(ii) **Adjustment for capital introduced:** The proprietor may introduce fresh capital in the business during the course of the financial year. This fresh capital is deducted from the capital at the end because the fresh capital will increase the capital of the proprietor at the end of the financial year, but not the profit. Thus the increase in the capital at the end due to introduction of capital during the year should not be misunderstood for increase in capital because of profits made during the year.

Steps for Preparing Statement of Affairs

The procedure for preparing the Statement of Affairs can be understood with the following steps:

a) Firstly, we are to prepare statement of affairs at the beginning for ascertaining net worth in the beginning.

b) Secondly, we shall prepare statement of affairs at the end for calculating net worth at the end.

c) Thirdly, make adjustments for drawings, and capital introduced during the year.

d) In the end, deduct net worth in the beginning from the net worth at the end. The excess of capital at the end over capital in the beginning will denote the profit.

Illustration 1: J. Sikidar keeps her books on single entry system. From the following particulars, prepare a statement showing profit or loss made by her for the year ended March 31, 2006.

	March 31, 2005 (Rs.)	March 31, 2006 (Rs.)
Debtors	16,000	19,000
Stock	12,000	15,000
Furniture	2,000	4,000
Cash in hand	1,000	1,500
Creditors	1, 200	1,800
Bank overdraft	—	2,000

During the year Sikidar introduced Rs. 10,000 as further capital in the business and withdrew Rs. 6000

Solution

Sikidar's Statement of Affairs as on 31st March, 2005

Liabilities	Rs.	Assets	Rs.
Creditors	1,200	Debtors	16,000
Capital	29,800	Stock	12,000
(Balancing Figure)		Furniture	2,000
		Cash in hand	1,000
	31,000		31,000

Sikidar's Statement of Affairs as on 31st March, 2006

Liabilities	Rs.	Assets	Rs.
Creditors	1,800	Debtors	19,000
Bank Overdraft	2,000	Stock	15,000
Capital	35,700	Furniture	4,000
(Balancing Figure)		Cash in hand	1,500
	39,500		39,500

STATEMENT OF PROFIT

FOR THE YEAR ENDING 31.3.2006

	Rs.
Capital as on 31.3.2006	35,700
Add Drawings made during the year	6,000
	41,700
Less further capital introduced	10,000
	31,700
Less capital in the beginning (31.3.2005)	29,800
Profit made during the year ending as on 31.3.2006	**1,900**

Illustration 2: M.R.P. Singh, who maintains his books by Single Entry System, has submitted returns to the Income Tax Authorities showing his income to be as follows:

	Rs.
31st Dec. 1989	3,675
,, 1990	3,700
,, 1991	3,935
,, 1992	6,875
,, 1993	6,070
,, 1994	4,630

But the Income Tax Authority is not satisfied as to the accuracy of the accounts submitted. You are asked to help in finding their accuracy. In this regard you are given with the following information:

i) Business assets and liabilities as on December 31, 1998 were: Debtors, Rs. 725; Cash at Bank, Rs. 4,735; Stock, Rs. 2,710 (at market price which is 25% above cost); Creditors, Rs. 3,660.

ii) M.R.P. Singh owed his sister, Rs. 2,000 on 31st December, 1988. On 15th March, 1991 he repaid this amount and on 1st April, 1994, he lent his sister Rs. 1,500.

iii) M.R.P. Singh owns a house which he bought in 1984 for Rs. 10,000 and a car which he bought in 1990 for Rs. 3,750. In 1993, he bought Rs. 5,000 shares in X Ltd. for Rs. 3,750.

iv) In 1994, Rs. 1,500 were stolen from his house.

v) M.R.P. Singh stated that his living expenses have been: Rs. 1,500; Rs. 2,000; Rs. 3,000; Rs. 3,500; Rs. 3,500; Rs. 3,500 during the years 1989, 1990, 1991, 1992, 1993 and 1994 respectively. These expenses are exclusive of the amount stolen.

vi) On 31st December, 1994, the business liabilities and assets were: Creditors Rs. 4,200; Debtors, Rs. 2,960; cash in hand, Rs. 9,725 and stock Rs. 3,370 (at market price which shows as gross profit of 25%).

From the information submitted, prepare a statement showing whether or not the income declared by M.R.P. Singh is accurate.

Solution

STATEMENT OF AFFAIRS

AS ON 31.12.1994

Liabilities	Rs.	Assets	Rs.	
Creditors	4,200	Cash in hand		9,725
Capital (Balancing figure)	11,013	Debtors		2,960
		Stock	3,370	
		Less Profit	842*	2,528
	15,213			15,213

*Profits involved in the Stock = $\frac{3{,}370 \times 25}{100}$ = 842.5

STATEMENT OF AFFAIRS

AS ON 31.12.1998

Liabilities	Rs.	Assets		Rs.
Creditors	3,660	Cash in hand		4,735
Capital (Balancing Figure)	3,968	Debtors		725
		Stock	2,710	
		Less Profit 20%=542**	2,168	
	7,628		7,628	

**Profits involved in the Stock = $\frac{2710 \times 25}{125}$ = 542

STATEMENT OF PROFIT FROM 1.1.1989 TO 31.12.1994

Capital as on 31.12.1994 as per Statement of Affairs	11,013	
Add Living expenses from 1.1.1989 to 31.12.1994(1,500+2,000 +3,000+3,500+3,500+3,500)	17,000	**28,013**
Less Capital as on 31.12.1988 as per Statement of Affairs	3,968	
Profits as per books during the period:	24,045	
Add Incomes not disclosed ***		
a) Repayment of Sisters loan	2,000	
b) Money lent to Sister	1,500	
c) Purchase of car	3,750	
d) Purchase of shares	3,750	
e) Amount stolen from the house	1,500	12,500
Actual Income during the period		36,545
Less Declared Income from 1989 to 1994 (3,675+3,700+3,935+6,875+6,070+4,630)		28,885
Excess of Actual Income over Declared Income		7,660

*** Purchase of property or money lent or loan repaid during 1.1.1989 and 31.12.1994 will be taken as additional income of assess, since these have not been considered so far. As the house was bought in 1984, therefore, it has been ignored.

Partnership Firms: For ascertaining the profit made by the business in case of a partnership firm, the balance in the capital accounts of all the partners will have to be considered. But, in case they (partners) have a fixed capital system, the balances in the current accounts should be considered while preparing statement of profit. Similar to the case of sole proprietorship, capital accounts of the partners should be adjusted for any amount withdrawn or fresh capital introduced by the partners before ascertaining the combined closing balance of the current accounts.

Illustration 3: Anil and Sunil are partners in a firm sharing profits and losses in the ratio of 3:2. Their capital on 1st January, 2005are in the proportion of ¾ and ¼. They do not keep their books under double entry system. Their position on 31st December, 2004 and 31st December 2005 are given as under:

	31st Dec., 2004 Rs.	31st Dec., 2005 Rs.
Machinery	1,60,000	3,00,000
Creditors	1,60,000	1,20,000
Debtors	1,40,000	1,90,000
Stock	1,20,000	1,60,000
Furniture	80,000	1,00,000
Cash at bank	40,000	50,000

You are required to ascertain the profit or loss made by the partners during the year 2005 and prepare Balance Sheet as on 31st December, 2005 after taking into consideration the following adjustments:

i) Depreciation on Machinery @ 10% and on Furniture @ 15%

ii) A provision for Bad and Doubtful Debts is to be created at 2½ % on debtors.

iii) Provide interest on capital @ 5% p.a.

Solution

STATEMENT OF AFFAIRS OF ANIL AND SUNIL

AS ON 31ST DECEMBER, 2004

Liabilities	Rs.	Assets	Rs.
Creditors	1,60,000	Cash at Bank	40,000
Combined Capital (Balancing Figure)	3,80,000	Debtors	1,40,000
		Stock	1,20,000
		Furniture	80,000
		Machinery	1,60,000
	5,40,000		5,40,000

STATEMENT OF AFFAIRS OF ANIL AND SUNIL

AS ON 31ST DECEMBER, 2005

	Rs.		Rs.
Creditors	1,20,000	Cash at bank	50,000
Combined Capital	6,80,000	Debtors	1,90,000
(Balancing Figure)		Stock	1,60,000
		Furniture	1,00,000
		Machinery	3,00,000
	8,00,000		8,00,000

STATEMENT OF PROFIT AND LOSS

FOR THE YEAR ENDED 31ST DECEMBER, 2005

	Rs.	Rs.
Capital as on 31.12.2005	6,80,000	
Less capital in the beginning	3,80,000	
Profit for the year (Before Adjustment)		3,00,000

PROFIT AND LOSS ACCOUNT OF SUNIL AND ANIL

FOR THE YEAR ENDED 31ST DECEMBER, 2005

Particulars		Rs.	Particulars	Rs.
To Interest on Capital			By Profit for the year	3,00,000
Anil	14,250			
Sunil	4,750	19,000		
To Depreciation:				
Furniture	5,000			
Machinery	30,000	35,000		
To provision for bad and Doubtful Debts	4,750			
To Net Profit transferred				
Anil	144,750			
Sunil	96,500	2,41,250		
		3,00,000		3,00,000

BALANCE SHEET OF ANIL AND SUNIL

AS ON 31ST DECEMBER, 2005

Liabilities		Rs.	Assets		Rs.
Creditors		1,20,000	Cash at bank		50,000
Capitals:			Debtors	1,90,000	
Anil*	2,85,000		Less provisions for bad and doubtful	4,750	1,85,250
Add Interest	14,250				
Add Profit	1,44,750	4,44,000	Stock		1,60,000
Sunil*	95,000		Furniture	1,00,000	
Add Interest	4,750		Less depreciation	5,000	95,000
Add Profit	96,500	1,96,250	Machinery	3,00,000	
			Less depreciation	30,000	2,70,000
		7,60,250			7,60250

Calculation of capital of partners

Combined Capital	:	3,80,000
Anil's Capital	:	3,80,000 × ¾ = Rs. 2,85,000
Sunil's Capital	:	3,80,000 × ¼ = Rs. 95,000

10.4.2 Conversion Method

We have seen under the net worth method in the preceding explanation that the method does not give details of the gross profit and net profit. Also, it does not provide a clear picture of the operational results of a business. Resultantly, it becomes just impossible to make a objective analysis of the financial statements. But the effective steps needed to strengthen the financial position of the business cannot be devised without making a meaningful analysis of financial position. Hence, it is quite essential to ascertain the missing information from the books of accounts, and other sources. The missing information can be ascertained by preparing Total Debtors Account, Receipts and Payments Account, Total Creditors Account, Memorandum Trading Account, etc. After ascertaining the required information, it will be possible to prepare a trial balance. Now, one can prepare final accounts in the usual manner since full information as under double entry system is available. Hence, under conversion method net profit is ascertained by conversion of single entry system into double entry system.

Under conversion method, firstly statement of affairs in the beginning is prepared to ascertain capital in the beginning. For preparing this statement, the students should ascertain the informations on debtors in the beginning or creditors or cash in khand or cash at bank or any other items, if these are missing. This is done by preparing a cash book, total debtors account, total creditors account, bills receivable account, bills payable account, etc. These various accounts will help in revealing a missing figure of cash, bank, credit sales, cash sales, creditors or debtors balance either in the beginning or at the end or any other information. After preparing these accounts the students should calculate total sales by adding credit sales and cash sales; total purchases by adding cash purchases and credit purchases. Information relating to nominal accounts can be ascertained from the cash book. Real accounts and amounts outstandings will be available by way of information. Now, it will be possible to prepare a trial balance. However, in practice trial balance is skipped and only such information is collected which is required for preparing the Trading and Profit and Loss Account, and Balance Sheet of the business.

In order to prepare trading and profit and loss account and balance sheet, the students needs the following information:

1. Opening stock and closing stock
2. Purchases
3. Direct expenses
4. Sales
5. Indirect expenses and other incomes
6. All assets and all liabilities
7. Capital in the beginning
8. Profit made during the year

The following illustrations would enable you to calculate the amount of the various items given above.

Opening Stock and Closing Stock: The amount of Opening and Closing Stock can be ascertained by preparing a Memorandum Trading Account.

Illustration 4: From the following particulars, find out the amount of Opening Stock:

	Rs.		
Purchases	40,000	Rate of Gross Profit on sales	20%
Sales	60,000	Closing Stock	Rs. 20,000

Solution

MEMORANDUM TRADING ACCOUNT

	Rs.		Rs.
To Opening Stock (balancing figure)	28,000	By Sales	60,000
To Purchases	40,000	By Closing stock	20,000
To Gross Profit (20% of Sales)	12,000		
	80,000		80,000

Illustration 5: From the following figures, find out the amount of Closing Stock.

	Rs.		Rs.
Opening Stock	20,000	Sales	80,000
Purchases	60,000	Rate of Gross Profit on sales	20%

Solution

MEMORANDUM TRADING ACCOUNT

	Rs.		Rs.
To Opening Stock	20,000	By Sales	80,000
To Purchases	60,000	By Closing Stock (balancing figure)	16,000
To Gross Profit (20% of Sales)	16,000		
	96,000		96,000

2. **Purchases:** Purchases are calculated by adding cash purchases and credit purchases. Cash book reveals the amount of cash purchases. The amount of credit purchases can be ascertained by preparing (i) total creditors account, and (ii) bills payable account.

Illustration 6: From the following information, ascertain the amount of Credit Purchases for the year 2005.

	Rs.		Rs.
Balance of Creditors (on 1.1.2005)	22,800	Returns Outward	7,200
		Bills accepted	13,800
Cash paid to Creditors	60,000	Creditors on 31.12.1997	28,500
Discount allowed by them	1,500	Cash Purchases	20,000

Solution

TOTAL CREDITORS ACCOUNT

	Rs.		Rs.
To Cash	60,000	By Balance b/d	22,800
To Discount	1,500	By Credit purchases (balancing figure)	88,200
To Returns Outward	7,200		
To Bill Payable a/c	13,800		
To Balance c/d	28,500		
	1,11,000		1,11,000

If we are required to find total purchases, it will be found out simply by adding cash purchases and credit purchases i.e. total purchases = 20,000 + 88,200 = 1,08,200

Bill payable account

Some times, bill payable account and total creditors account are prepared to ascertain purchases. This is required when a part of payment to creditors is made by accepting bills. This information will be depicted by bills payable account and this is taken to creditors account. The balancing figure of total creditors account is assumed as credit purchases.

Illustration 7: From the following information ascertain the amount of total purchases:

	Rs.			Rs.
Opening balance of bills payable during the year	10,000	Bill payable discharged	17,800	
Opening balance of creditors	12,000	Returns outwards		2,400
Closing balance of bills payable	14,000	Cash purchases		51,600
Closing balance of creditors			8,000	
Cash paid to creditors during the year.		60,400		

Solution

BILL PAYABLE ACCOUNT

	Rs.		Rs.
To Cash To Closing balance	17,800 14,000	By Opening Balance By Creditor being bill accepted during the year (balancing figure)	10,000 21,800
	31,800		31,800

TOTAL CREDITORS ACCOUNT

	Rs.		Rs.
To Cash	60,400	By Opening balance	12,000
To Returns outwards	2,400	By Purchases (balancing figure)	80,600
To Bills payable (taken from Bill payable a/c)	21,800		
To closing balance	8,000		
	92,600		92,600

Total Purchases = Cash Purchases + Credit Purchases

= 51,600 + 80,600

= Rs. 1,32,200

Direct Expenses: Information relating to nominal accounts can be ascertained from the cash book. These expenses may require adjustment in the light of outstanding and prepaid expenses.

Sales: Sales for the purpose of trading account are ascertained by adding cash sales and credit sales. Credit sales should be found out by preparing a Total Debtors Account while cash sales should be found out from the Cash Book.

Illustration 8: From the information given below you are required to calculate the total sales.

	Rs.
Total Debtors Account balance on 1.1.2005	39,400
Bills Receivables Account balance on 1.1.2005	12,000
Cash sales	17,000
Cash received from debtors	40,000
Bills receivable encashed during the year	25,000
Sales Returns	3,000
Bill Receivable dishonoured	2,000

Bad Debts written off	1,000
Discount Allowed	3,000
Bills Receivable balance as on 31.12.2005	18,000
Total Debtors Account balance on 31.12.2005	50,000

Solution

BILLS RECEIVABLE ACCOUNT

	Rs.		Rs.
To Balance b/d	12,000	By Cash	25,000
To Debtors (balancing figure)	33,000	By Debtors (BI/R dishonoured)	2,000
		By Balance c/d	18,000
	45,000		45,000

TOTAL DEBTORS ACCOUNT

	Rs.		Rs.
To Balance b/d	39,400	By Cash	40,000
To Bills Receivable (Dishonoured)	2,000	By Sales Returns	3,000
To Credit Sales (Balancing figure)	88,600	By Bad Debts	1,000
		By Discount Allowed	3,000
		By Bills Receivable a/c	33,000
		By Balance c/d	50,000
	1,30,000		1,30,000

Total Sales:

Cash Sales : 17,000

Credit Sales: 88,600

1,05,600

The amount of cash sales can be ascertained from the Cash Book. In case complete Cash Book has not been given, the amount of cash sales can be obtained by preparing a Receipts and Payments Accounts.

Illustration 9: From the following cash transactions find out the amount of Cash Sales:

	Rs.		Rs.
Cash Balance as on 1.1.2005	5,000	Payment made to Creditors	12,000
Bank Balance as on 1.1.2005	10,000	Cash Purchases	18,000
Cash collected from Debtors	18,000	Cash Balance as on 31.12.2005	10,000
Other Incomes	7,000	Bank Balance as on 31.12.1990	15,000

Solution

RECEIPTS AND PAYMENTS ACCOUNT

FOR THE YEAR ENDING 31ST DEC., 2005

	Rs.		Rs.
To Balance (as on 1.1.2005)		By Creditors	12,000
Cash in Hand	5,000	By Purchases	18,000
Cash at Bank	10,000	By Balance:	
To Debtors	18,000	Cash in Hand	10,000
To Other Incomes	7,000	Cash at Bank	15,000
To Cash Sales (balancing figure)	15,000		
	55,000		55,000

Indirect expenses: Indirect expenses (expenses shown in Profit and Loss a/c) can be traced to cash book. However, sometimes these expenses need adjustment in the light of outstanding and prepaid expenses.

Ascertaining Capital in the Beginning: The amount of capital in the beginning of the year can be found out by preparing the Balance Sheet of the business.

Illustration 10: From the following figures find out Ram's Capital as on 1.1.2005

	Rs.		Rs.
Cash in Hand	2,500	Plant	10,000
Cash at Bank	5,000	Building	15,000
Sundry Debtors	10,000	Sundry Creditors	7,500
Stock	5,000	Bills payable	2,500

Solutions

BALANCE SHEET

AS ON 1.1.2005

Liabilities	Amount (Rs.)	Assets	Amount (Rs.)
Bill Payable	2,500	Cash in hand	2,500
Sundry Creditors	7,500	Cash at Bank	5,000
Capital (balancing figure)	37,500	Sundry Debtors	10,000
		Stock	5,000
		Plant	10,000
		Building	15,000
	47,500		47,500

Illustration 11: Raju keeps his account on single entry system basis. From the following facts, you are requested to determine the amount of total purchases during 1997

	Rs.		Rs.
B/P 1.1.1997	10,000	Cash received from Debtors	50,000
Creditors 1.1.1997	12,000	Bill payable discharged during the year	17,800
Creditors 31.12.1997	8,000	Returns Outwards	2,400
Cash paid to the Creditors	60,400	Return Inwards	14,000
Cash purchases	51,600	Bill payable as on 31.12.1997	14,000

Solution: Calculation of Credit purchases

SUNDRY CREDITORS ACCOUNT

Particulars	Amount (Rs.)	Particulars	Amount (Rs.)
To Cash A/c	60,400	By Balance b/d	12,000
To Returns Outwards A/c	2,400	By Purchases A/c (balancing figure)	80,600
To Bills Payable A/c (i)	21,800		
To Balance c/d	8,000		
	92,600		92,600

Working Notes

1. For finding the amount of Bills Payable, there is need to prepare Bills Payable Account.

BILLS PAYABLE ACCOUNT

Particulars	Amount (Rs.)	Particulars	Amount (Rs.)
To Cash A/c	17,800	By Balance b/d	10,000
To Balance c/d	14,000	By Sundry Creditors A/c	21,800
	31,800		31,800

2. Cash received from debtors Rs. 50,000 and returns inwards (Sales Returns) Rs. 14,000 are not relevant.

3. Total Purchases = Cash Purchases +Credit Purchases
= 51,600+80,600 = 1,32,200

Illustration 12: Prepare a Trading A/c, Profit & Loss A/c for the year ended 31st December, 1988 and Balance Sheet as at that date from the following information available from the books of a Trader.

		31.12.1987	31.12.1988
		Rs.	Rs.
1.	**Liabilities & Assets:**		
	Bank Balance	20,000	9,400
	Cash in hand	3,000	2,000
	Prepaid Expenses	5,000	7,000
	Stock	70,000	60,000
	Debtors for sales	2,30,000	?
	Bill Receivable	—	?
	Furniture at written down value	70,000	82,000
	Creditors for purchases	2,20,000	2,60,000
	Outstanding Liabilities	30,000	15,000
2.	Receipts and Payments during 1988:		
	Collection from debtors (after allowing 2½ % discount)		5,85,000
	Proprietor's Drawings		50,000
	Capital introduced by proprietor		95,150
	Purchase of Furniture at the middle of the year		20,000
	4% Govt. securities purchased at 96% on 1.7.88		96,000
	Expenses		2,00,000
	Sale of Scrap		5,000
	Payment of Creditors (after receiving 2% discount)		3,92,000
	Proceeds of Bills Receivable discounted at 2%		61,2503

3. Sales are made so as to realise 33⊃∏% on sale proceeds
4. Goods worth Rs. 5,000 were taken by the proprietor.
5. During the year Bills Receivable worth Rs. 1,50,000

were drawn on Debtors. Of these, bills amounting to Rs. 30,000 were endorsed in favour of the creditors. Out of this later amount, a bill for Rs. 5,000 was dis-honoured by the debtor.

6. Sales and Purchases are made on credit.

Solution

TRADING AND PROFIT & LOSS A/C

FOR THE YEAR ENDING 31ST DECEMBER, 1988

		Rs.		Rs.
To Opening Stock		70,000	By Sales	7,05,000
To Purchases	4,65,000		By Closing Stock	60,000
Less: Drawings by Proprietor	5,000			
By Gross Profit		2,35,000		
		7,65,000		7,65,000
To Expenses		1,83,000	By Gross Profit	2,35,000
To Depreciation		8,000	By Interest on Securities	2,000
To Discount on Debtors		15,000	By Discount	8,000
To Discount on Bills Receivable		1,250	By Sale of Scrap	5,000
To Net Profit		42,750		
		2,50,000		2,50,000

BALANCE SHEET

AS ON 31ST DECEMBER, 1988

Liabilities	Rs.	Assets		Rs.
Capital		Fixed Assets		
Opening	1,48,000	Furniture	90,000	
Add: Introduced during the Year	95,150	Less: Depreciation	8,000	82,000
Profit for the year	42,750	Investments 4% Govt. Securities (Nominal Value Rs. 1,00,000)		96,000
	2,85,900			
Less Drawings	55,000	Current Assets, Loans & Advances		
	2,30,900	Advances		
Sundry Creditors	2,60,000	Stock in trade		60,000
Outstanding Expenses	15,000	Sundry Debtors		1,90,000
		Bills Receivable		57,500
		Interest Accrued		2,000
		Prepaid Expenses		7,000
		Cash in hand		2,000
		Cash at Bank		9,400
	5,05,900			5,05,900

Working Notes

(1) BALANCE SHEET

AS ON 31ST DEC., 1987

Liabilities	Rs.	Assets	Rs.
Sundry Creditors	2,20,000	Furniture	70,000
Outstanding Expenses	30,000	Stock in trade	70,000
Capital (balancing figure)	1,48,000	Sundry Debtors	2,30,000
		Prepaid Expenses	5,000
		Cash at Bank	20,000
		Cash in hand	3,000
	3,98,000		3,98,000

(2) TOTAL CREDITORS ACCOUNT

To Cash Bank	3,92,000	By Balance b/d	2,20,000
To Discount	8,000	By Sundry Debtors (bill dishonoured)	5,000
To Bill Receivable	30,000	By purchases (balancing figure)	4,65,000
To Balance c/d	2,60,000		
	6,90,000		6,90,000

(3) SALES DURING THE YEAR

	Rs.
Stock on 1st Jan. 1988	70,000
Purchases	4,65,000
	5,35,000
Less Closing stock plus goods withdrawn	65,000
Cost of Goods sold	4,70,000
Add: Profit margin: 50% on cost on 33% on selling price	2,35,000
	7,05,000

(4) TOTAL DEBTORS ACCOUNT

	Rs.		Rs.
To Balance b/d	2,30,000	By Cash/Bank	5,85,000
To Sales	7,05,000	By Discount	15,000
To Sundry Creditors (bills endorsed-dishonoured)	5,000	By Bills Receivable	1,50,000
		By Balance c/d (balancing figure)	1,90,000
	9,40,000		9,40,000

(5) BILLS RECEIVABLE ACCOUNT

To Sundry Debtors	1,50,000	By Sundry Creditors	30,000
		By Cash/Bank	61,250
		By Discount	1,250
		By Balance c/d	57,500
	1,50,000		1,50,000

(6) FURNITURE ACCOUNT

To Balance b/d	70,000	By Depreciation	
To Cash /Bank	20,000	By (balancing figure)	8,000
		By Balance c/d	82,000
	90,000		90,000

(7) CASH/BANK ACCOUNT

To Balance b/d	23,000	By Sundry Creditors	3,92,000
To Sundry Debtors	5,85,000	By Furniture	20,000
To Bills Receivable	61,250	By 4% Govt. securities	96,000
To Sale of Scrap	5,000	By Expenses	2,00,000
To Capital A/c (Capital introduced)	95,150	By Drawings	50,000
		By Balance c/d	11,400
	7,69,400		7,69,400

(8)	Expenses charged to P & L A/c Paid	2,00,000
	Add: Outstanding expenses as on 31.12.88	15,000
		2,15,000
	Less: Outstanding expenses as on 31.12.87	30,000
		1,85,000
	Add: Prepaid expenses as on 31st Dec. 87	5,000
		1,90,000
	Less: Prepaid expenses as on 31st Dec. 88	7,000
		1,83,000

Illustration 13: The books of Mr. Rohan on 1st January, 1993 disclosed the following position:

	Rs.		Rs.
Capital	8,000	Furniture	2,000
Sundry Creditors	7,500	Sundry Debtors	9,000
		Stock	4,000
		Cash at Bank	500
	15,500		15,500

During the year 1993 the books were very imperfectly kept, but an analysis of the bank transactions revealed the following:

	Rs.
Receipts from Customers	35,000
Drawings for personal expenses	6,000
Payment of Salaries	3,000
Payment to Creditors	22,000
Payment for rent	1,500
Miscellaneous	400

The schedule on 31.12.1993 of the debtors totalled Rs. 9,500 and of creditors Rs. 6,400. No inventory of the stock on 31.12.1993 was taken but it was stated that a gross profit at uniform rate of 40 per cent on turnover was made during the year. Prepare a bank account, a trading and profit and loss account for the year and a balance sheet as on 31.12.1993.

Solution

(1) Calculation of credit purchases:

TOTAL CREDITORS ACCOUNT

	Rs.		Rs.
To Cash To Balance c/d	22,000 6,400	By balance b/d By Credit Purchases (Balancing figure)	7,500 20,900
	28,400		28,400

(2) Calculation of Credit Sales:

TOTAL DEBTORS ACCOUNT

	Rs.	Rs.	
To Balance c/d To Credit Sales(Balancing figure)	9,000 35,500	By Cash By Balance c/d	35,000 9,500
	44,500		44,500

(3) Calculation of Bank Balance:

BANK ACCOUNT

	Rs.		Rs.
To Balance b/d	500	By Salaries	3,000
To Debtors	35,000	By Drawings	6,000
		By Creditors	22,000
		By Rent	1,500
		By Miscellaneous Expenses	400
		By Balance c/d	2,600
	35,500		35,500

TRADING AND PROFIT AND LOSS ACCOUNT OF ROHAN
FOR THE YEAR ENDED 31ST DECEMBER, 1993

	Rs.		Rs.
To Opening Stock	4,000	By Credit sales	35,500
To Credit purchases	20,900	By Closing Stock (Balancing figure)	3,600
To Gross Profit (40% on sales)	14,200		
	39,100		39,100
To Salaries	3,000	By Gross Profit b/d	14,200
To Rent	1,500		
To Miscellaneous expenses	400		
To Net Profit transferred to Capital	9,300		
	14,200		14,200

BALANCE SHEET OF ROHAN

AS ON 31ST DECEMBER, 1993

		Rs.		Rs.
Creditors		6,400	Cash at Bank	2,600
Capital	8,000		Stock	3,600
Add Net Profit	9,300		Sundry Debtors	9,500
	17,300		Furniture	2,000
Less Drawings	6,000	11,300		
		17,700		17,700

Illustration 14: The following is the balance sheet of the retail business of Mr. Ram as at 31st December, 1993:

	Rs.		Rs.
Mr. Ram's capital	1,25,000	Furniture and fittings	25,000
Creditors for goods	30,000	Stocks	75,000
Outstanding expenses (rent)	1,000	Sundry debtors	20,000
		Cash at bank	35,000
		Cash in hand	1,000
	1,56,000		1,56,000

You are furnished with the following information:

(1) Mr. Ram always sells his goods at a profit of 25% on sales.

(2) Goods are sold for cash and credit. Credit customers pay by cheque only.

(3) Payments for purchases are always made by cheque.

(4) It is the practice of Mr. Ram send to the bank every week-end the takings of the week after paying every week salaries of Rs. 250 to the clerk, sundry expenses of Rs. 50 and personal expenses Rs. 100.

Analysis of the bank pass book for the period ending 31st March, 1994 disclosed the following:

	Rs.
Payments to creditors	75,000
Payment of rent	4,000

Amount remitted to the bank 1,35,000 including cheques for Rs. 10,000 received from customers to whom the goods were sold on credit.

The following are the balances on 31st March, 1994:

	Rs.
Stock	32,500
Creditors for goods	32,500
Sundry debtors	30,000

On the evening of 31st March, 1974 the cashier absconded with the available cash in the cash box.

You are required to prepare a statement showing the amount of cash defalcated by the cashier and also a profit and loss account for the period ended 31st March, 1994 and a balance sheet as on that date.

Solution

RAM TRADING AND PROFIT AND LOSS ACCOUNT

FOR THE MONTH ENDING 31ST MARCH, 1994

	Rs.			Rs.
To Opening Stock	75,000	By Sales		
To Purchases	77,500	Cash	1,40,000	
To Gross profit c/d	40,000	Credit	20,000	
				1,60,000
		By Closing Stock		32,500
	1,92,500			1,92,500
To Salaries	3,250	By Gross profit b/d		40,000
To Rent	3,000			
To Sundry expenses	650			
To Net profit	33,100			
	40,000			40,000

BALANCE SHEET

AS ON 31ST MARCH, 1994

Liabilities		Rs.	Assets	Rs.
Ram's capital	1,25,000		Furniture and fittings	25,000
Add: Net profit	33,100		Stocks	32,500
	1,58,100		Sundry debtors	30,000
Less: Drawings	1,300	1,56,800	Cash at bank	91,000
Sundry Creditors		32,500	Cash defalcated-recoverable	10,800
		1,89,300		1,89,300

Working Notes

(1) TOTAL DEBTORS ACCOUNT

Dr. Dr.

	Rs.		Rs.
To Balance b/d	20,000	By Bank	10,000
To Credit sales (balancing figure)	20,000	By Balance c/d	30,000
	40,000		40,000

(2) TOTAL CREDITORS ACCOUNT

Dr. Cr.

Rs.		Rs.	
To Bank	75,000	By Balance b/d	30,000
To Balance c/d	32,500	By Credit purchases (balancing figure)	77,500
	1,07,500		1,07,500

BANK ACCOUNT

Dr Cr.

	Rs.		Rs.
To Balance b/d	35,000	By Creditors	75,000
To Debtors accounts	10,000	By Rent	4,000
To Cash remitted	1,25,000	By Balance c/d	91,000
	1,70,000		1,70,000

CASH ACCOUNT

Dr Cr.

	Rs.		Rs.
To Balance b/d	1,000	By salaries (250×13)	3,250
To Cash sales	1,40,000	By Sundry expenses (50×13)	650
		By Drawings (100×13)	1,300
		By Cash remittance	1,25,000
		By Balance-defalcated	10,800
	1,41,000		1,41,000

Cash sales	**Rs.**
Opening Stock	75,000
Add: Purchases	77,500
	1,52,500
Less: Closing Stock	32,500
Cost of sales	1,20,000
G.P. @ 33/1/3 % on cost and 25% on sales	40,000
Total Sales	1,60,000
Less: Credit Sales	20,000
Cash sales	1,40,000

Note: If it is not possible to recover the cash defalcated, the same is to be debited to profit and loss account and eliminated from the balance sheet. In the solution above it is shown as recoverable and, therefore, not debited to profit and loss account.

10.5 SUMMARY

Single entry system is a system of book-keeping in which as a rule only records of cash and of personal accounts are maintained. In this way both the aspects of business transactions and events are not recorded. The single entry system is more economical, suitable for small firms, suitable where more cash transactions and large number of personal accounts but having a lot of disadvantages in comparison to double entry system. In the single entry system, profit or loss made during the year is calculated by using two methods namely increase in networth method and conversion method. Under the increase in networth method, profit can be calculated by comparing the net worth in the beginning of the year and at the end of the year. Any decrease in net worth is taken as loss, but any increase in net worth is taken as profit. Under the conversion method, the missing information from the books of accounts and other sources are ascertained. The missing information can be ascertained by preparing total debtors account, receipts and payments account, total creditors account and memorandum trading account, then it will be possible to prepare a trial balance. Now one can prepare final accounts in the usual manner since full information as under double entry system is available. Hence, under conversion method, net profit is ascertained by conversion of single entry system into double entry system.

10.6 KEYWORDS

Balance Sheet: A statement of the financial position of an enterprise as at a given date.

Capital: The amount invested in an enterprise by its owners also called net worth.

Personal Account: Accounts which are related to any person or institution.

Double Entry System: System of accounting in which every transaction and event affects two accounts.

Statement of Affairs: A statement of the financial position of an enterprise under single entry system.

Cash Book: A subsidiary book in which only cash transactions are recorded.

10.7 SELF ASSESSMENT QUESTIONS

1. State whether the following statements are 'true' or 'false':
   (a) Trial Balance can be easily prepared when the books are kept according to Single Entry System.
   (b) Single Entry System is not suitable for a small business firm.
   (c) Limited companies are free to choose ether single entry or double entry system of accounting.
   (d) Under Single Entry System usually the personal accounts of suppliers and customers and the cash book is maintained.
   (e) According to Networth Method, the N et Profit is equal to: Capital at the end + Drawings + Fresh capital introduced – Capital in the beginning of the accounting period.
   (f) Under the Conversion Method, credit purchases and credit sales are found out by preparing the total creditors and total debtors accounts respectively.

2. Choose the most correct answer:

   (i) The capital at the end of the accounting year is ascertained by

   (a) Closing Statement of Affairs

   (b) Cash Book

   (c) Total Creditors Account

   (ii) Under Net Worth Method of Single Entry System, the basis for finding the profit is

   (a) the difference between the capital in the beginning and at the end.

   (b) the difference between the gross assets in the beginning and at the end.

   (c) the difference between the liabilities in the beginning and at the end.

   (iii) The closing balance in the Creditors Account can be ascertained from

   (a) Cash Account

   (b) Total Creditors Account

   (c) Balance Sheet at the end of the accounting period

   (iv) If the rate of gross profit is 20% on cost of goods sold and the sales are Rs. 3,00,000, the amount of gross profit will be

   (a) Rs. 60,000; (b) Rs. 75,000; (c) Rs. 50,000

   (v) Cash received from debtors needed for the construction of cash account can be had from

   (a) Total debtors account (b) Balance sheet (c) Analysis of cash book

3. Explain the single entry system of book-keeping. How does a business man ascertain the profit under such a system?

4. Define single entry system. Distinguish it from double entry system.

5. What are the steps required to convert "single entry system of book-keeping" into double entry system.

6. Bring out the defects of the single entry system of book-keeping. Also discuss the procedure of calculating profit by statement of affairs method.

7. H keeps his books by single entry system. His position on January 1, 1998 was a follows:

   Cash at Bank Rs. 5,000 Cash in hand Rs. 1,000; Stock Rs. 7,000; Sundry Debtors Rs. 8,400 ; Machinery and Plant Rs. 6,500; Bills Receivable Rs. 2,600; Creditors Rs. 2,500; Bills Payable Rs. 4,000.

   On December 31, 1998, his position was as follows:

   Cash at Bank Rs.4,300; Cash in hand Rs. 1,700; Stock Rs. 9,000; Sundry Debtors Rs. 6,000; Machinery and Plant Rs. 6,500; Bills payable Rs. 3,200; Bill Receivable Rs. 3,200; Creditors Rs. 1,600. During the year A introduced further capital of Rs. 2,000 and his drawings were Rs. 800 per month.

   Depreciate machinery and Plant by 5% and create a Reserve for Bad and Doubtful debts @ 5%

   From the above information, prepare a statement showing the profit or loss made by him for the year ended December, 31,1998.

8. X and Y started business on Ist January, 1993 with Rs. 50,000 as capital contributed equally but the profit-sharing ratio was 3:2. Their drawings were Rs. 300 and Rs. 200 per

month respectively. They had kept no accounts except the following information:-

	31.12.93	31.12.94
Machinery at cost	20,000	25,000
Stock-in-trade	30,000	30,000
Debtors	50,000	60,000
Cash	2,000	500
Creditors	30,000	20,000
Outstanding Expenses	4,000	3,000
Bank Balance (as per Pass Book)	6,000	8,000

Provision is to be made for depreciation at 10% on the cost of machinery as at the end of each year. Debtors on 31.12.93 include Rs. 5,000 for goods sent out on consignment at 25% above cost, and the goods were not sold until 1994. A cheque for Rs. 1,000 had been deposited on 31.12.93 but was credited on 2.1.1994.

A cheque for Rs. 2,000 issued on 26.12.94 was presented on 3.1.1995. A cheque for Rs. 1,000 was directly deposited by a customer on 27.12.94, and a cheque for Rs. 500 deposited in December 1994 was dishonoured. No adjustment for these was made.

Determine the profits for 1993 and 1994 and draw up a Balance Sheet as on 31st December, 1994.

9. X carries on business as retail merchant. He does not maintain regular account books. From cash sales affected by him he effects business and other payments, always retains cash of Rs. 1,000 on hand and deposits the balance in the bank account. The stock inventories for the year ended 31st December, 1997 are lost. However, he informs you that he has sold goods invariably at a price which yields him a profit

of 33/1/3 % on cost. From the following additional information supplied to you, prepare necessary final accounts for the year ended 31st December, 1997.

Assets and liabilities	1st Jan., 1997 Rs.	31st Dec., 1997 Rs.
Cash in hand	1,000	1,000
Sundry creditors	4,000	9,000
Cash at bank	N.A.	8,000
Sundry debtors	10,000	35,000
Stock of goods	28,000	N.A.

N.A.— Not Available

Analysis of the bank pass book reveals the following information:

	Rs.
Payment to creditors	70,000
Payment for business expenses	12,000
Receipts from debtors	75,000
Loan from Asit taken on 1st January, 1997 @ 10% p.a.	10,000
Cash deposited in the bank	10,000

In addition, he paid to the creditors for good Rs. 2,000 in cash and salaries Rs. 4,000 in cash. He also withdrew Rs. 8,000 cash for his personal expenses.

10. The position of Ram Lal's business as on 1st January, 1988 was as under:

Sundry creditors Rs. 17,000, Freehold Premises Rs. 50,000, Stock Rs. 25,000, Sundry Debtors Rs. 20,000, Furniture Rs.2,000.

An abstract of the Cash Book is appended below:

Receipt	Rs.	Payment	Rs.
Sundry Debtors	15,000	Over draft (1-1-1968)	10,000
Cash Sales	80,000	Expenses	50,000
		Drawings	3,000
		Sundry Creditors	20,000
		Cash in hand	2,000
		Cash at Bank	10,000
	95,000		95,000

The following additional information is available:

Closing Stock Rs. 30,000, Closing Debtors Rs. 25,000, Closing Creditors Rs. 12,000. No additions were made during the year to Premises and Furniture Account, but they are to be depreciated @ 10% and 15% respectively. A bad debt provision of 2½ % is to be raised.

Prepare a Trading and Profit and Loss Account for the year ended 31st December, 1988 and a Balance Sheet as on that date.

11. Rahul kept on proper books of account for his business. An analysis of his rough Cash Book for 1986 showed the following particulars:

Receipts	Rs.	Payments	Rs.
Received from Debtors	60,000	Overdraft on 1.1.1986	7,400
Further Capital Introduced	5,000	Paid to creditors	25,000
		Business expenses	10,000
		Wages	15,500
		Drawings	3,000
		Cash at bank	4,000
		Cash in hand	100
	65,000		65,000

The following information is also available:

	31.12.1985 Rs.	31.12.1986 Rs.
Debtors	53,000	88,000
Creditors	15,000	19,500
Stock	17,000	19,000
Machinery	20,000	20,000
Furniture	1,400	1,400

All his Sales and Purchases were on credit. Prepare Trading and Profit and Loss Account and a Balance Sheet after providing for depreciation on Machinery at 10% and on Furniture at 5% per annum.

10.8 REFERENCES/SUGGESTED READINGS

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3. S.P. Jain (2001), "Advanced Accountancy", Kalyani Publishers, New Delhi.

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Subject: **Financial Accounting-I**	
Course Code: **BBA-104**	Author: **Dr. B.S. Bodla**
Lesson: **11**	Vetter:

INVENTORY VALUATION METHODS

STRUCTURE

11.0 OBJECTIVES

After going through this lesson, you should be able:

- To know the meaning and objectives of inventory valuation.
- To understand the different methods of inventory valuation, their advantages and disadvantages.
- To know the suitability of various methods of inventory valuation.

11.1 INTRODUCTION

The literary meaning of the word inventory is stock of goods. To the finance manager, inventory connotes the value of raw materials, consumable, spares, work-in-progress, finished goods and scrap in which a company's funds have been invested. It constitutes the second largest items after fixed assets in the financial statements, particularly of manufacturing organisation. It is why that inventory valuation and inventory control have become very important functions of the accountants and finance managers. The persons interested in the accounting information assume that the financial statements contain accurate information. However, it is often observed that the financial statements don't provide actual information about some of the items, e.g. inventory and depreciation. This may be because of the variety of inventory valuation methods available with the accountant.

According to the International Accounting Standard-2 (IAS-2), 'Inventories' mean tangible property held;

(a) for sale in the ordinary course of business,

(b) in the process of production for such sale, or

(c) for consumption in the production of goods or services for sale.

Hence, the term inventory includes stock of (i) raw material and components, (ii) work-in-progress and finished goods. In case of manufacturing concern, inventory consists of raw materials, components, stores, semi-finished products and finished goods in case of a trading concern inventory primarily consists of finished goods.

11.2 OBJECTIVES OF INVENTORY VALUATION

Following are the objectives of inventory valuation:

a) Determination of Income

A major objective of inventory valuation is the proper determination of income through the process of matching appropriate cost against revenues. Gross profit is found out by deducting cost of goods sold from sales. Cost of goods sold is purchases plus opening stock minus closing stock. Hence, closing stock must be properly valued and brought into accounts. Over valuation of closing stock leads to inflation of the current year profits and deflation of the profits of succeeding years. Similarly, undervaluation leads to deflation of current years profit and inflation of the profit of the succeeding years.

b) Determination of financial position

In the balance sheet, "inventory' is a very important item. It is to be shown as current asset in the balance sheet at the end of the year. If the inventory is not properly and correctly valued, to that extent the balance sheet does not give true and fair view of the financial position of the business. Keeping in view the above objectives the auditor's duty in relation to the verification and valuation of inventories becomes more important. Therefore, while verifying he should ensure that stock taking is done by responsible a officer, stock figures match with that of stock registers, and the basis of valuation has been consistently the same from year to year. Moreover, he should carry out test checks to ensure the accuracy of valuation.

11.3 METHODS OF RECORDING INVENTORY

The records of quantity and value of inventory can be made in two ways. These as follows:

(i) Periodic Inventory System

(ii) Perpetual Inventory System

11.3.1 Periodic Inventory System

Under this system the quantity and value of inventory is ascertained by physically counting the stock at the end of the year and as on the accounting date. In case of big business houses, annual stock taking may even take a week at the end of the year in finalising the stock in hand on continuous basis. In case of this system certain items are physically counted, while others are weighed in kilos or tonnes or measured in litters. For stock taking stock sheets are used. The firms evolve such a performa of stock sheet on which all the relevant information like particulars of inventory, numbers of units, price per unit, total value, etc. can be listed and added so as to get the figure of inventory. This method offers the advantage of simplicity. Also, there is no used to maintain the various records to be maintained under perpetual inventory system. However, the limitation of this method is that discrepancies and losses in inventory will never come to light as it makes no accounting for theft, losses, shrinkage and wastage.

11.3.2 Perpetual Inventory System

This system provides as running record of inventories on hand because under this method stock registers are maintained which will give the inventory balance at any time desired. According to the Institute of Cost and Management Accountants, London, it is “a system of records maintained by the controlling department which reflects the physical movement of stocks and their current balance.” The stores ledger will give the balance of raw materials, work-in-progress and finished goods on hand. Because of this it is for the management to provide for continuous stock-taking, so that by comparing the physical balance with book balance, any discrepancies are ascertained immediately.

In this system business need not be suspended for the purpose of stock taking. The main advantage of this method is that it provides details about the quantity and value of stock of each item all times. Thus it provides a basis for control. The main drawback of this system is that it requires elaborate organisation and records and, therefore, it is more expensive.

11.4 METHODS OF VALUATION OF INVENTORIES

The basic methods of valuation of inventories are as follows:

(a) Historical cost based method

(b) Sale price based method

(c) Lower of cost or sale price

11.4.1 Methods based on Historical cost

According to AS-2 historical cost is the aggregate of costs of purchases, costs of conversion and other costs incurred in the normal course of business in bringing the inventories to their present locations and condition. Cost of purchase comprises purchase price, duties and taxes, freight inwards and other expenditure directly attributable to acquisitions. However, selling expenses such as advertisement expenses or storage cost should not be included.

The valuation of inventory at cost price will be in consonance with the realisation concept. According to this concept, revenue is not realised until the sale is complete and the inventory is converted into either cash or accounts receivable. There can thus be no recognition of revenue accretion except at the point of sale.

This is a method with very high objectivity since the inventory valuer has to base it on a transaction which is completely verifiable. The main limitation of this method is its inability to distinguish operational gains from holding gains during period of inflation. **(Note:** *Holding gain* *refers to profits which arises as a result of holding inventories during inflation)*. They may be attributed to the fact that this method matches the past inventories against revenues which have current relations. Thus, this system will result in the inclusion of "inventory profits" (i.e. holding gain) in the income statements during periods of rising prices.

Now, we shall describe the various methods for assigning historical costs to inventory and goods sold.

1. *First In First Out Method (FIFO)*

This method is based on the assumption that the materials which are purchased first are issued first. Issues of inventory are priced in order of their purchases. Inventory issues/sales are priced on the same basis until the first lot of material of goods purchased is exhausted. Thus, units issued are priced at the oldest cost price listed on the stock ledger sheets. Under this system it is not necessary that the material which were longest in stock are exhausted first. But the use of FIFO necessarily mean that the oldest costs are first used for accounting purposes. In practice, an endeavour is made by most business houses to sell of oldest merchandise or materials first. Hence when this system is followed the closing stock does not consist of most recently purchased goods.

Advantages: The following are the advantages of this method:

(i) This method is easy to operate, provided the prices of materials do not fluctuate frequently.

(ii) It gives such a value of closing stock which is vary near to current market prices since closing inventory is made of most recently purchased goods.

(iii) It is a realistic method because it takes into account the normal procedure of issuing goods/inventory, i.e. the materials are issued to production in the order of their receipts.

(iv) As it is based on historical cost, no unrealised profit enters into the financial statements for the period.

Disadvantages: This method suffers from the following limitations:

(i) Because of violent changes in prices of materials, it involves somewhat complicated calculations and, therefore, it involves somewhat complicated calculations and, therefore, increase the changes of clerical errors.

(ii) The prices of issues of materials may not reflect current market prices and, therefore, during the period of inflation, the charge to production is unreasonably low.

(iii) Comparison between different jobs executed by the firm becomes sometimes difficult. A job commenced a few minutes before another job might have consumes the supply of lower priced stock. This is particularly because of that the fact the first job might have completely exhausted the supply of materials of a particular lot.

Suitability

FIFO method is considered more suitable during the periods of falling prices. The reason is that the higher price at which the purchase of materials was made earlier stands recovered in cost. This method is suitable when the size of purchases is large but not much frequent. The moderate fluctuations in the prices of materials, and easy comparison between different jobs are also the important conditions for the use of this method.

Illustration: The following is the record of receipts of certain materials during the month of January 2006:

Jan. 2 Received 500 Units @ Rs.20 per unit

Jan. 3	Received 400 Units	@ Rs. 21 per unit
Jan. 15	Received 300 Units	@ Rs. 19 per unit
Jan. 28	Received 400 Units	@ Rs. 20 per unit

The physical inventory taken on 31st January, 2006 shows that there are 600 units in hand. Compute the inventory value on 31st January, 2006 by FIFO method.

Solution: Under FIFO method, closing inventory includes recent purchases at most recent prices. Hence, the value of the inventory on 31st January will be as follows:

January 28	Purchases	400 units	@ Rs. 20	= Rs. 8000
January 15	Purchases	200 units	@ Rs. 19	= Rs. 3800
				Rs. 11, 800

Here, the value of inventory as on 31st January 2006 has been arrived as on the presupposition that the firm uses periodic inventory system, the value of inventory would remain the same even if the perpetual inventory system is in use. To take an example, if out of 1000 units issued, 300 units were issued on January 5, while 700 units were issued on January 16, the valuation of inventory using perpetual inventory system will be done as follows:

STOCK LEDGER

Date	Receipts			Issues			Balance	
	Qty.	Rate	Amount (Rs.)	Qty.	Rate	Amount (Rs.)	Qty.	Amount (Rs.)
Jan.2	500	20	10,000	--	--	--	500	10,000
Jan.3	400	21	8.400	--	--	--	900	18,400
Jan. 5	--	--	--	300	20	6000	600	12,400
Jan.l5	300	19	5,700	--	--	--	900	18,100
Jan.16	--	--	--	200	20	4,000		
				400	21	8,400		
				100	19	1,900	200	3,800
Jan.28	400	20	8,000	--	--	--	600	11,800

From the above stock ledger it is obvious that the value of ending inventory under FIFO method is same in case of both periodic and perpetual inventory systems.

2. Last in First Out Method (LIFO)

Under this method, it is assumed that the material/goods purchased in the last are issued first for production and those received first issued/sold last. In case a new delivery is received before the first lot is fully used, price become the 'last-in' price and is used for pricing issued until either the lot is exhausted or a new delivery is received.

As stated above, materials are issued to production at cost which may be vary near to current marked price. However, inventories at the end will be valued at old prices which may be out of tune with the current maked price.

Advantages:

(i) This method takes into account the current market circumstances while valuing materials issued to various jobs or ascertaining the cost of goods sold.

(ii) No unrealised profit or loss is usually made in case this method is followed.

Disadvantages:

(i) The stock in hand is valued at a price which have become out-of-date when compared with the current inventory prices.

(ii) This method may not be acceptable for taxation purposes since the value of closing inventory may be quite different from the current market value.

(iii) Comparison among similar jobs is very difficult because they may bear different issue prices for materials consumed.

Suitability: This method is most suitable for materials which are of a bulky and non-perishable type.

Illustration: With the information given in illustration (1), compute the inventory value on 31st Jan. 1998 by LIFO method. Also prepare a store ledger account showing how the receipts and issues on 5th Jan and 700 units issued on 16th January 2006.

Solution: Under LIFO method, closing inventory includes most old purchases remaining unissued till last date. Hence, valuation of inventory under periodic inventory system would be as follows:

Hence, the value of the inventory on 31st January will be as follows:

Jan. 2	Purchases	200 units	@Rs.20	= Rs. 4,000
Jan. 28*	Purchases	400 units	@Rs.20	= Rs.8,000
				Rs. 12,000

Valuation of Inventory under perpetual inventory system

STOCK LEDGER

Date	Receipts			Issues			Balance	
	Qty	Rate	Amt. (Rs.)	Qty	Rate	Amt. (Rs.)	Qty	Amt. (Rs.)
Jan 2	500	20	10,000	-	-	-	500	10,000
Jan 3	400	21	8,400	-	-	-	900	18,400
Jan 5	-	-	-	300	21	6,300	600	12,100
Jan 15	300	19	5,700	-	-	-	900	17,800
Jan 16	-	-	-	300	19	5,700		
				100	21	2,100		
				300	19	6,000	200	4,000
Jan 28	400	20	8,000	-	-	-	600	12,000
Jan 31	-	-	-	-	-	-	600	12,000

*Closing entry of 600 units includes 200 units purchased on 2nd January but remained unissued and 400 units purchased on 28th January remaining unissued upto 31st January.

Implications of FIFO and LIFO method in case of rising and falling prices: Both these methods value the products manufactured at true costs because both are based on actual cost. But in period of rising and falling prices both have conflicting result.

In periods of rising prices the cost of production will be lower in case of FIFO method. This is simply because of the lowest material cost. Contrary to this, LIFO method will result in charging products at highest materials cost. Thus in case of rising price the application of FIFO method will result in higher profitability, and higher income tax liability, whereas the application of LIFO method result in lower profitability, which in turn will reduce income tax liability.

In periods of falling market, the cost of product will tend to be low with reference to the overall cost of inventory in case material cost is to be charged according to LIFO method. Hence, this method will be resulting in inflating of profits and increasing the tax liability. The reverse will be the case if FIFO method is followed. Production will be relatively overcharged. This will deflate the profits and reduce the income tax liability.

In periods of falling prices the ending inventory will be valued in FIFO method at a price lower than in case of LIFO method. The reverse will be the case when the prices are rising. Interestingly, on the basis of above discussion, it may be concluded that in periods of falling prices, LIFO method tends to give a more meaningful balance sheet but less realistic income statement, whereas FIFO method gives a more meaningful income statement but a less realistic balance sheet. The reverse will be the situation in periods of rising prices.

Now the question arises about the superiority of the LIFO and FIFO methods. Based on forgoing discussion about implications of these methods in case of both rising and falling markets, it may be concluded that each method has its own merits and demerits depending upon the circumstances prevailing at a particular moment of time. Thus, no generalisation can be made regarding superiority of LIFO over FIFO or vice-versa.

3. Highest-in-First-our (HIFO)

According to this method, the highest priced materials are treated as being issued first irrespective of the date of purchase. In fact, the inventory of materials or goods are kept at the lowest possible price. In periods of rising prices the closing inventory is undervalued and thus secret reserves are created. However, the highest cost of materials is recovered first. Consequently, the closing inventory amount remains at the minimum value. Hence, this method is very appropriate when the prices are frequently fluctuating. As this method involves calculation more than that of LIFO and FIFO methods, it has not been adopted widely.

4. Base stock method

The base stock method assume that each business firm whether small or large must held a minimum quantity of materials finished foods at all times in order to carry on business smoothly. These minimum quantity of inventories are valued at the cost at which the base stock was acquired. It is assumed that the base stock is created out of the lot purchased. Inventories over and above the base stock are valued according to some other appropriate method such as FIFO, LIFO, etc.

AS-2 recommends the use of this method in exception circumstances only. This is because of the fact that a large number of companies customarily maintain a minimum stock level at all times irrespective of its requirement. Actually, sometimes base stock method is used without its justification. Therefore, this method requires a clear existence of the circumstances which require that a minimum level of charging out inventory of raw material and finished goods at actual cost along with merits and demerits of the method which is used for valuation other than the base stock method.

5. Specific Identification Method

Under this method, each item of inventory is identified with its cost. The value of inventory will be constituted by the aggregate of various cost so identified. This method is very suitable for job order industries which carry out individual or goods have been purchased for a specific job or customer. In other words, this method can be applied only where materials used can be specifically and big items such as high quality furniture, paintings, metal jewellery, cars, etc.

However, this method is not appropriate in most industries because of practical problems. For instance, in case of manufacturing company having numerous items of inventory, the task of identifying the cost of every individual item of inventory becomes very cumbersome. Also, it promotes the chances of manipulating the cost of goods sold. It can be done by selecting items that have a relatively high cost or a relatively low cost, as he desires.

Example: Suppose that following information is available from records:
Opening inventory of material as on Jan. 1 , 2000 at Rs.20 = 200 units.
Purchases of materials as on Jan. 16, 2000 at Rs. 24 = 100 units.
Purchases of materials as on Jan.26, 2000 at Rs.30 = 150 units
Total units available for sale = 450 units
Units sold during January = 260 units
Inventory of materials at January end = 190 units

Now, if it assumed that the firm selected 200 items of materials that had a unit cost of Rs. 20 and 60 units of items that had a unit cost Rs. 24, the cost of goods sold for the firm would be as follow:

Cost of 200 items =	200 × 20 =	Rs. 4000
Cost of 60 items =	60 × 24 =	Rs. 1440
		Rs. 5440

Whereas, if 260 items having highest cost are selected, then the cost of goods sold would be Rs. 7100 [(150×30) + (100×24) + (10×20)].

6. Simple average Price (SAP)

This is the average of prices of different lots of purchase. Under this method no consideration is given to the quantity of purchases in various lots. For example the purchases of 500 units of materials at Rs. 10 per unit are made as on 5th January, 1995 and 800 units of materials at Rs. 14 per unit on 10th January. If at the end 200 units remains unissued/unsold, these will be valued at Rs. 12 = [(10 + 14)/2]per unit and hence, the closing inventory will be shown at Rs. 2400 (200 × 12 = 2400). In fact, this method operated on the principle that when items of materials are purchased in big lots and are put in godown, their identity is lost and, therefore, issues should be priced at the average price of the lots in godown.

7. Weighted Average Price (WAP)

Under this method, the quantity of material purchased in various lots of purchases is considered as weight while pricing the materials. Weighted average price is calculated by dividing the total cost of material in stock by the total quantity of material at the end. When this method is adopted, the question of profit or loss out of varying prices does not arise because it evens out the effect of widely fluctuating prices of different lots of purchases. This method is very popular because it reduces calculations and is based on quantity and value of material purchased.

Illustration: The following are the details of transactions regarding receipt and issue of materials:

Date	Quantity received	Rate	Quantity issued
Jan.2, 2006	100	Rs. 1.00	—
Jan.9, 2006	150	Rs. 1.20	—
Jan.14, 2006	—	—	125
Jan.17, 2006	250	Rs. 1.30	—
Jan.19, 2006	—	ð	100

You are required to prepare a stock ledger pricing the issue at (i) Simple average price and (ii) Weighted average price.

Solution:

(i) Simple Average Price Method:

STOCK LEDGER

Date	Receipts			Issues			Balance	
2006	Qty.	Rate	Amount	Qty.	Rate	Amount	Qty.	Amount
Jan.2	100	1.00	100	—	—	—	100	100
Jan.9	150	1.20	180	—	—	—	250	280
Jan.14	—	—	—	125	1.10[a]	137.50	125	143
Jan.17	250	1.30	325	--	—	—	375	518
Jan.19	—	—	—	100	1.25[b]	125.00	275	393

Working Notes

Average price on 14.1.2006 = (1.00 + 1.20)/2 = Rs. 1.10

Average price on 19.1.2006 = (1.20 + 1.30)/2 = Rs. 1.25

The price of the purchases that were made on 2nd January has been ignored while computing average price on 19.1.2006 since we have assumed that issue of 125 units on 14.1.2006 comprises all the 100 units purchased on 2.1.2006.

(i) Weighted Average Price Method

Date	Receipts			Issues			Balance	
2006	Qty.	Rate	Amt.	Qty.	Rate	Amt.	Qty.	Amt.
Jan. 2	100	1.00	100	--	--	--	100	100
Jan. 9	150	1.20	180	--	--	--	250	280
Jan.	--	--	--	125	1.12	140	125	140

14								
Jan. 17	250	1.30	325	--	--	--	375	465
Jan. 19	--	--	--	100	1.24	124	275	341

Working Notes

Weighted average price on January 14=280/250= 1.12

Weighted average price on January 19 = 465/375 = 1.24

Illustration: The Hisar Dal Mills Ltd. does not maintain a perpetual inventory of gram which it buys and issues to the mills. The physical inventory taken of 31st March, 2005 shows the following quantity of gram on hand:

10 tonnes @ 840 per tonne.

The purchases during April as follows:

5-4-1995 100 tonnes @ 850 per tonne

15-4-1995 50 tonnes @ Rs. 900 per tonne

29-4-1995 10 tonnes @ Rs. 920 per tonne

A physical inventory on 30th April, 2005 shows a stock of 15 tonnes of gram on hand. Complete inventory value on 30th April, 2005 by (i) FIFO method (ii) Weighted Average Price Method.

Solution

(i) FIFO Method: In case of FIFO method, earlier purchases are charged to earlier issues and the ending inventory includes the most recent purchases at the most recent prices. Thus, stock of 15 tonnes include 10 tonnes @ Rs. 920 per tonne purchased on 29-4-2005 and 5 tonnes @ Rs. 900 per tonne purchased on 15-4-2005. The inventory valuation will be as follows:

10 tonnes	@ Rs. 920 per tonne	Rs. 9,200
5 tonnes	@ Rs. 900 per tonne	Rs. 4,500
Inventory value on 30.4.05		**Rs. 13,700**

(ii) Weighted Average Price Method

10 tonnes	@Rs. 840	8,400
100 tonnes	@Rs. 850	85,000
50 tonnes	@Rs.900	45,000
10 tonnes	@Rs. 920	9200
170 tonnes		**1,47,600**

Average price per tonne = 1,4,600/170 = 868.24

Closing inventory (30-4-05): 15 tonnes @ Rs. 868.24=Rs. 13,023.60

11.4.2 Method Based on Sale Price

The inventories may be valued at marked or sale prices. Important among these prices are current selling prices, and net realisable value. Both of these are discussed as follows:

1. **Current Selling Prices:** The method is used in case of the product of which market as well as prices are controlled by a Government. Marketing costs being negligible are ignored under this method. This method is followed in the case of sugar industries, metal industries, etc.

2. **Net Realisable Value.** According to IAS-2, the net realisable value means, "the estimate selling price in the ordinary course of business costs of completion and less costs necessarily to be incurred in order to make the sale." Estimates of net realisable value should not be guided by temporary fluctuations in market prices. However, these should be arrived at after taking into consideration all expenses which might have to be incurred for making sales. Such cases where it is difficult to estimate the appropriate costs, say agriculture output, inventory are valued consistently at market values. This procedure of valuation is accepted because of the saleability of the output at quoted prices.

11.4.3 The Lower of Cost or Market Price (LCM Rule)

This method is based on the accounting principle of conservatism according to which profits should not be anticipated but all losses foreseen should be provided for. For instance, the ending inventory consist of items purchased at cost of Rs.210 per unit. But the market price has fallen to Rs.200 per unit at the time of valuation of inventory. Hence, the items should be valued at Rs.200 per unit. This rule violate the matching concept which requires matching of revenues with the related product costs. This method also leads to inconsistency since in one year the valuation may be based on cost while in another it may be based on market price. However, even the critics of this rule favour the application of this rule for valuing obsolete or damaged inventories.

About inventories valuation AS-2, recommends that the general rule of valuing inventories should be at lower of historical cost and net realisable value subject to certain exceptions. The historical of the inventories should normally be determined by using 'FIFO', 'LIFO' or Average 'Cost' method. Inventory of by-products cannot be separately determined. It should be valued at net realisable value.

LCM rule can be applied in anyone of the following ways:

1. **Aggregate/total inventory method**: In this method, cost price of the total inventory is ascertained and then compared with total net realisable price to arise at stock valuation.

2. **Group Method**: Under this method, groups are formed of similar or interchangeable articles of inventory. The cost and the net realisable value of each group so formed are found out. The LCM rule is applied to each group.

3. **Item-by-item-method**: According to this method, the cost and net realisable prices of each item of inventory are found out and the lower of the figures is taken into account for valuation of inventory. Both IAS-2 and AS-2 have recommended the use of "Group method" and "Item-by-Item" method for valuation of inventory. The first method namely "Aggregate or Total Inventory method" have not been recommended by both the standards. The learner's will understand the difference between all the three methods from the following illustration.

Illustration: Given the following data about inventors as at 31st December, 2005.

Category	No. of Items	Cost (Rs.)	Net Realisable Value (Rs.)
A	10	21	20
A	16	15	14
B	20	30	40
B	10	18	16

C	9	40	45
C	7	30	25
D	8	8	10
D	8	6	5

Calculate the value of inventory on the basis of lower of cost and net realisable value (1) by the aggregate method, (2) by the group and (3) by item-by-item method.

Solution

1. Aggregate Method

Quantity	Unit Price		Quantity X Price		LCM (Rs.)
	Cost (Rs.)	Net realisable Value (Rs.)	Cost (Rs.)	Net Realisable Value (Rs.)	
10	20	21	200	210	
16	15	14	240	224	
20	30	40	600	800	
10	18	16	180	160	
9	40	45	360	405	
7	30	25	210	175	
8	8	10	64	80	
8	6	5	48	40	
			1902	2094	1902

2. Group Method

Group	Qty	Unit Price		Qty X Price		Lower of cost or net Realisable value
		Cost (Rs.)	Net Realisable Value	Cost (Rs.)	Net Realisable Value	
Group A	10	20	21	200	210	
	16	15	14	240	224	
				440	434	434
Group B	20	30	40	600	800	
	10	18	16	180	160	
				780	960	780
Group C	9	40	45	360	405	
	7	30	25	210	175	

				570	580	570
Group D	8	8	10	64	80	
	8	6	5	48	40	
				112	120	112
						1896

3. Item-by-item method

Quantity	Unit Price		Quantity X Price		Lower of Cost or Net Realisable Value (Rs.)
	Cost (Rs.)	Net realisable value (Rs.)	Cost (Rs.)	Net realisable value (Rs.)	
10	20	21	200	210	200
16	15	14	240	224	224
20	30	40	600	800	600
10	18	16	180	160	160
9	40	45	360	405	360
7	30	25	210	175	175
8	8	10	64	80	64
8	6	5	48	40	40
					1823

11.5 VALUATION OF INVENTORY FOR BALANCE SHEET PURPOSE

In certain cases, it is not possible for the business to take inventory on the date of balance sheet. It might have been taken on a date earlier or later than the date of balance sheet. In such a case, when student are required to calculate the value of stock on the date of preparation of final accounts, then they should take into consideration information about additional transactions which occur during the period. For example, if value of stock on 28th March is given, then in order to find the value of stock on 31st March all purchases between these dates will be added. Likewise, if value of stock on 4th April is given and value of stock on the proceeding 31st March is required then purchases during the period will be deducted and issues/sales (at acquisition price) during this period will be added. Both of the above mentioned cases could be understood and elaborated as under:

(i) When the Position of stock is given on a date prior to the balance sheet date

In this case, the following adjustments will generally be required:

(a) Add purchases made during the period.

(b) Deduct purchases returns during the said period.

(c) Deduct inventory issued/sold between the two dates.

(d) Add sales returns between the two dates.

(ii) When the position of stock is given on a date after the balance sheet date

For example, if the balance sheet is to be prepared as on 31st March, 2005 and the stock position has been given as on 15th April, 2005 the following adjustments will be required:

(a) Less purchases made between 1st April, 2005 to 15th April, 2005.

(b) Add purchases returns between 1st April, 2005 to 15th April, 2005.

(c) Add sales (at cost price) between 1st April, 2005 to 15th April, 2005.

(d) Less sales returns between 1st April, 2005 to 15th April, 2005.

Illustration: The financial year of Sultan S. & Co. ends on 31st December 2005. Stock taking continues upto 10th January, 2006. You are required to determine, the value of costing stock (at cost) as on 31st December, 2005 from the following information:

(i) The closing stock (valued at cost) came to Rs. 50,000 on 10th January, 2006.

(ii) Purchases made in the first 10 days of January 2006 amounted to Rs. 2000.

(iii) Sales made from 1st January to 10th January in 2006 amounted to Rs. 8000. The firm makes a gross profit of 25% on sales.

Solution: Valuation of closing stock

Value of stock as on January 10, 2006	50,000
Less: Purchases after 31st December	2,000
	$\boxed{\textbf{48,000}}$
Add: Cost of goods sold during first	
10 days of January, 2006 (75% of 8000)	6,000
Value of stock as on 31st Dec. 2005	$\boxed{\textbf{54,000}}$

Illustration: The financial year of Mr. Ratan Lal & Co. ends on 30th June 2006, but the actual stock is physically only on 7th July, 2006, when it is estimated at Rs. 20,000.

Additional information:

1. Purchases between 30th June and July are Rs. 2000.
2. Purchases returns between 30th June and 7th July are Rs. 200.
3. Sales between 30th June and 7th July are Rs. 4000.
4. Sales returns between 30th June and 7th July are Rs. 100.

5. The firm makes a gross profit at 25% on cost.

Calculate the value of stock on 30th June, 2006.

Solution

MR RATAN LAL & CO.

VALUATION OF CLOSING STOCK

Stock as on July 7	Rs.
	20,000
Less: Purchases between June 30 and July 7	2,000
	18,000
Add: Purchases returns between June 30 and July 7	200
	18,200
Add: Sales (at cost price) between June 30 and July 7 [4000- one fifth of 4,000]	3,200
	21,400
Less: Sales returns (at cost price) between June 30 and July 7 [Rs.100-20]	80
Stock on June 30, 2006	21,320

Illustration: The Profit and Loss Account of Cardamom for the year ended 31st December, 2005 showed a net profit of Rs. 2,400 after taking into account the closing stock of Rs. 2,400. On a scrutiny of the books the following information could be obtained:

(1) Cardamom has taken goods valued Rs. 800 for his personal use without making entry in the books.

(2) Purchases of the year included Rs. 400 spent on acquisition of a ceiling fan for his shop.

(3) Invoices for goods amounting to Rs.2600 have been entered on 29th December, but such goods were not included in stock.

(4) Rs. 350 have been included in closing stock in respect of goods purchased and invoiced on 28th December, 2005 but included in purchases for January 2006.

(5) Sale of goods amounting to Rs. 405 sold and delivered in December, 2005 had been entered in January, 2006 sales.

You are required to ascertain the correct amount of closing stock as on 31st December, 2005 and the adjusted net profit for the year ended on that date.

Solution

Calculation of stock as on December 31, 2005:

Stock (as given already) Rs. 2400

Add Purchase not included Rs. 2600

Rs. 5000

PROFIT AND LOSS ADJUSTMENT ACCOUNT

	Rs.		Rs.
To supplier's account*	350	By Profit (given)	2,400
To Net Profit (balancing figure)	6,255	By Drawings	800
		By Fixtures and Fittings (Ceiling Fan)	400
		By Closing Stock (Goods in transit)	2,600
		By Customer's account	405
	6,605		6,605

*The treatment of these items in 2006 will have to be cancelled.

11.6 SUMMARY

The term 'inventory' includes the value of raw materials, consumable, spares, work-in-progress, finished goods and scrap in which a company's funds have been invested. As per International Accounting Standard 2 (IAS-2), "inventories' mean tangible properties held: (i) for sale in the ordinary course of business; (ii) in the process of production for such sale; (iii) for consumption in the production of goods or services for sale. There are two methods of recording inventory, i.e., Periodic Inventory System and Perpetual Inventory System. In case of Periodic Inventory System, the value and quantity of Inventory is ascertained by physically connoting the stock at the end of the year. Perpetual inventory system means running record of inventories on hand and provides the inventory balance at any time desired. Methods of inventory valuation are- (i) Historical cost based methods; (ii) sale price base methods; (iii) lower of cost or sale price. Historical cost based methods include aggregate of cost of purchases, cost of conversion and other costs incurred in the normal course of business. The different methods for assigning historical costs to inventory are- (i) first in first out method; (ii) last in first out; (iii) highest in first out; (iv) base stock method; (v) specific identification method; (vi) simple average method; (vii) weighted average price. Sale price base method includes current selling prices net realizable value.

11.7 KEYWORDS

Cost: The amount of expenditure incurred on or attributable to a specified article, product or activity.

Current Asset: Cash and other assets that are expected to be converted into cash or consumed in the production of goods or services.

First in First Out (FIFO): Computation of the cost of items sold or consumed during a period as though they were sold or consumed in order of their acquisition.

Last in, First Out (LIFO): Computation of cost of items sold or consumed during a period on the basis that the items last acquired were sold first.

Inventory: Tangible property held for sale in the ordinary course of business or in the process of production for such sale.

11.8 SELF ASSESSMENT QUESTIONS

1. State whether the following statements are 'True' or 'False':
   - (a) Periodic inventory gives a continuous balance of stock in hand.
   - (b) Inventory valuation affects only the income statement.
   - (c) A major objective of accounting for inventories is the proper determination of income.
   - (d) LIFO method is suitable for items which are of a non-perishable and bulky type.
   - (e) Inventory should be valued at the lower of historical cost and current replacement cost.
   - (f) Inventory should be valued at the lower of cost price or net realisable value.
   - (g) The system which gives continuous information regarding quantum and value of inventory is known as period inventory.

2. Indicate the correct answer:
   - (i) Inventory is valued at lower of the cost or net realisable value on account of the accounting principle of:
     - (a) Realisation

- (b) Consistency
- (c) Conservatism

(ii) Selling expenses are included in stock valuation by:

- (a) Trading concerns
- (b) Job order industries
- (c) Process industries

(iii) The system which gives continuous information regarding quantum and value of inventory is known as:

- (a) Continuous stock taking
- (b) Periodic Inventory
- (c) Perpetual Inventory

(iv) The cost formulae recommended by IAS-2 for valuation of inventories are:

- (a) FIFO or weighted average
- (b) Standard Cost
- (c) HIFO or Standard Cost

(v) The value of inventory will be the least in case of

- (a) Aggregate or total inventory method
- (b) Item-by-item method
- (c) Group or category method

3. What are the various methods of inventory valuation? Discuss the impact of each method on working results.

4. What is the principle behind valuation of inventory at cost or market price whichever is lower?

5. What are the main recommendations of AS-2 regarding valuation of inventories?

6. Differentiate the following:

   (a) LIFO and FIFO method

(b) Periodic inventory valuation and Perpetual inventory valuation

(c) Item-by-item method and Group method

7. What is the need of valuing inventory properly? Discuss. To what extent this need is fulfilled by various methods of valuing inventories.

8. Arvind Ltd. uses large quantities of a sweetening material for its products. The following figure relates to this material during the calendar year 1980:

Quarter ended (Tonnes)	Purchases	Invoice Cost per Tonne Rs.	Consumption (Tonnes)
March 31	1,000	620	600
June 30	2,100	630	1,200
September 30	700	640	1,500
December 31	1,200	670	1,350

The stock of material on December 31, 1979 was 1,000 tonnes valued for accounting purposes at cost of Rs. 600 a tonne. Delivery of goods to the factory is made on the first day of each quarter. You are required to compute the value of stock as on December 31, 2000 applying LIFO and FIFO methods.

9. Purchases of certain product during March, 1982 are set out below:

March 1	100 units	@ Rs. 10
12	100 units	@ Rs. 9.80
15	50 units	@ Rs. 9.60
20	100 units	@ Rs. 9.40

Units sold during the month were as follows:

March 10	80 units
14	100 units
30	90 units

No opening inventories

You are required to determine the cost of goods sold for March under three different valuation methods viz, FIFO, LIFO and Weighted Average Cost.

10. M/s Swadeshi Cotton Mills Ltd. take a periodic inventory of their stock of chemically at the end of each month. The physical inventory taken on 30 shows a balance of 1,000 litres of chemically in hand @ Rs. 2.28 per litre.

The following purchases were made during July:

July 1	14,000 litres	@ Rs. 2.30 per litre
July 7	10,000 litres	@ Rs. 2.32 per litre
July 1	14,000 litres	@ Rs. 2.30 per litre
July 25	5,000 litres	@ Rs. 2.35 per litre

A physical inventory on July 31 discloses that there is a stock of 10,000 litres. You are required to compute the inventory value on July 31, by each of the following methods:

(i) First in First out; (ii) Last in First out; and (iii) Average cost method.

11. Following are the details regarding inventories of a manufacturing concern as on 31st December, 1981:

Inventories categories		Cost (Rs.)	Market Prices (Rs.)
Category 1:	A	6,000	9,000
	B	10,000	9,500
Category 2:	C	15,000	17,000

D	20,000	14,000
Total	**51,000**	**49,000**

You are required to determine inventory value using "lower of cost or market value basis", according to each of the following methods:

(i) Aggregate or total inventory method; (ii) Group method; (iii) Item-by-item method.

12. The financial year of Shri X ends on 31st March, 1974, but the stock in hand was physically verified only on 7th April, 1974. You are required to determine the value of closing stock (at cost) as at 31st March, 1974 from the following information:

(i) The stock (valued at cost) as verified on 7th April, 1974 was Rs. 15,000.

(ii) Sales have been entered in the sales day book only after the despatch of goods and sales returns only on receipt of goods.

(iii) Purchases have been entered in the purchases day book on receipt of the purchases invoice irrespective of the date of the goods.

(iv) Sales as per the sales day book for the period 1st April, 1974 to 7th April, 1974 (before the actual verification) amounted to Rs. 6,000 of which goods of a sale value of Rs. 1,000 had not been delivered at the time of verification.

(v) Purchases as per the purchases day book for the period 1st April, 1974 to 7th April, 1974 (before the actual verification) amounted to Rs. 6,000 of which goods for purchase of Rs. 1,500 had not been received at the date of verification and goods for purchases of Rs. 2,000 had been received prior to 31st March, 1974.

(vi) In respect of goods costing Rs. 5,000 received prior to 31st March invoices had not been received up to the date of verification of stock.

(vii) The gross profit is 20% on sales.

11.9 REFERENCES/SUGGESTED READINGS

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Subject: **Financial Accounting-I**	
Course Code: **BBA-104**	Author: **Dr. B.S. Bodla**
Lesson: **12**	Vetter:

ACCOUNTING FOR DEPRECIATION

STRUCTURE

12.13 References/suggested readings

12.0 OBJECTIVES

After going through this lesson, you should be able to-

- Know the meaning, need and causes of depreciation.
- Know the different methods of charging depreciation.
- Understand the accounting treatment of charging depreciation.

12.1 INTRODUCTION

The term depreciation refers to the reduction in or loss of quality or value of a fixed asset through wear or tear in or tear, in use, effusion of time, obsolescence through technology and market changes or from any other cause. Depreciation take place in case of all fixed assets with certain possible exceptions e.g. land and antiques etc, although the process may be invisible or gradual. Depreciation does take place irrespective of regular repairs and proper maintenance of assets. The word 'depreciation' is closely related to the concept of business income. Unless it is charged against revenues, we cannot say that the business income has been ascertained properly. This is because of the fact that the use of long term assets tend to consume their economic value and at some point of time these assets become useless. The economic value so consumed must be recovered from the revenue of the firm to have a proper measure of its income. Hence, the reader's must understand that the process of charging depreciation is the technique used by accountants for recovering the cost of fixed assets over a period.

The following definition will make the understanding of the concept of depreciation more convenient to the learner's. According to IAS-4, "Depreciation is the allocation of the depreciable amount of an asset over its estimated useful life," According to AS-6, "depreciation is a measure of wearing out, consumption or other of value of a depreciable asset arising from use, effusion of time or obsolescence through technology and market changes. Depreciation is allocated so as to charge a fair proportion of the depreciable amount in each accounting period during the expected useful life of the assets. Depreciation includes amortisation of assets whose useful life is pre determined."

The American Institute of Certified Public Accountants (AICPA) employed the definition as given below

"Depreciation Accounting is a system of accounting which aims to distribute the cost or other basic value of tangible capital assets, less salvage value (if any) over the estimated useful life of unit (which may be a group of assets) in a systematic and retional manner. It 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."

From the above definitions it is clear that each accounting period must be charged with a fair proportion of the depreciable amount of the asset, during the expected useful life of the asset. Depreciable amount of an asset is its historical cost less the estimated residual value. Finally, it could be concluded that depreciation is a gradual reduction in the economic value of an asset from any cause.

Depreciation, Depletion and Amortisation: The terms depreciation, depletion and amortisation are used often interchangeably. However, these different terms have been developed in accounting usage for describing this process for different types of assets. These terms have been described as follows:

Depreciation: Depreciation is concerned with charging the cost of man made fixed assets to operation (and not with determination of asset value for the balance sheet). In other words, the term 'depreciation' is used when expired utility of physical asset (building, machinery, or equipment) is to be recorded.

Depletion: This term is applied to the process of removing an available but irreplaceable resource such as extracting coal from a coal miner or oil out of an oil well. Depletion differs from depreciation in that the former implies removal of a natural resource, while the latter implies a reduction in the service capacity of an asset.

Amortisation: The process of writing off intangible assets is termed as amortisation. The intangible assets like patents, copyrights, leaseholds and goodwill are recorded at cost in the books of account. Many of these assets have a limited useful life and are, therefore, written off.

Obsolescence: It refers to the decline in the useful life of an asset because of factors like (i) technological advancements, (ii) changes in the market demand of the product, (iii) legal or other restrictions, or (iv) improvement in production process.

12.2 CAUSES OF DEPRECIATION

The depreciation occurs because of the following:

1. **Constant use**: The constant use of assets results into their wear and tear, which in turn reduces their working capacity. Hence, a decrease in the value of assets may be seen due to reduced capacity. The value of assets like, machinery, furniture, etc., declines with the constant use of them.

2. **Passage of Time**: Many fixed assets lose their value with the passage of time. This holds true in case of intangible fixed assets such as patents, copy rights, lease hold properties,

etc. The term “amortisation” is generally used to indicate the reduction in the value of such assets.

3. **Depletion**: Depletion also causes decline in the value of certain assets. This is true in case of wasting assets such as mines, oil wells and forest-stands. On account of continuous extraction of minerals or oils, these assets go on declining in their value and finally they gets completely exhausted.

4. **Obsolescence**: There may not be any physical deterioration in the asset itself. Despite of this there may be reduction in the utility of an asset that results from the development of a better method, machine or process. For example, an old machine which is still in good working condition may have to be replaced by a new machine because of the later being more economical as well as efficient. In fact, new inventions, developments in production processes, changes in demand for product or services, etc. make the asset out of date.

5. **Accidents**: An asset may get reduction in its value if it meets an accident.

6. **Permanent Fall in the Market Value**: Certain assets may get permanent fall in their value and this decline in their value is treated as depreciation. For example, a permanent decline in the market value of securities and investment may be assumed as depreciation

12.3 NEED FOR PROVIDING DEPRECIATION

The need for providing depreciation arises on account of the following points:

1. **To Ascertain the Profits or Losses**: The true profits or losses could be ascertained when all costs of earning revenues have been properly charged against them. Fixed assets like building, plant and machinery, furniture, motor vehicles etc are important tool in earning business income. But the cost of the fixed asset is not charged to profit and loss of the accounting period in which the asset is purchased. Therefore, the cost of the fixed asset less its salvage value must be allocated rationally to the periods that receive benefit from the use of the asset. Thus, depreciation is an item of business expense and must be provided for a proper matching of costs with the revenue.

2. **To show the Asset as its Reasonable Value**: The assets get decrease in their value over a period of time on account of various such as passage of time, constant use, accidents, etc. Therefore, if the depreciation is not charged then the asset will appear in the balance sheet at the over stated value. This practice is unfair as the balance sheet fail to present the true financial position.

3. **Replacement of assets**: Business assets become useless at the expiry of their life and, therefore, need replacement. The cash resources of the concern are saved from being distributed by way of dividend by providing for depreciation. The resources so saved, if set aside in each year, may be adequate to replace it at the end of life of the asset.

4. **To Reduce Income Tax**: If tax is paid on the business income without providing for depreciation then it will be in excess to the actual income tax. This is a loss to the business

man. Thus, for calculating tax, depreciation should be deducted be from income similar to the other expenses.

12.4 BASIC ELEMENTS OF DEPRECIATION

In order to assess depreciation amount to be charged in respect of an asset in an accounting period the following three important factors should be considered:

1. **Cost of the asset**: The knowledge about the cost of the asset is very essential for determining the amount of depreciation to be charged to the profit and loss account. The cost of the asset includes the invoice price of the asset less any trade discount plus all costs essential to make the asset usable. Cost of transportation and transit insurance are included in acquisition cost. However, the financial charges such as interest on money borrowed for the purchase for the purchase of the asset should no be included in the cost of the asset.

2. **Estimated life of the asset**: Estimated life generally means that for how many years or hours an asset could be used in business with ordinary repairs for generating revenues. For estimating useful life of an asset one must begin with the consideration of its physical life and the modifications, if any, made, factors of obsolescence and experience with similar assets. In fact, the economic life of an asset is shorter than its physical life. The physical life is based mostly on internal policies such as intensity of use, repairs, maintenance and replacements. The economic life, on the other hand, is based mostly on external factors such as obsolescence from technological changes.

3. **Scrap Value of the Asset**: The salvage value of the asset is that value which is estimated to be realised on account of the sale of the asset at the end of its useful life. This value should be calculated after deducting the disposal costs from the sale value of the asset. If the scrap value is considered as insignificant, it is normally regarded as nil

12.5 METHODS OF RECORDING DEPRECIATION

There are two methods of recording depreciation in the books of accounts:

12.5.1 When a provision for depreciation account is maintained

The following journal entries are passed in case method is followed:

i) Depreciation account Dr.
To provision for Depreciation Account
(for providing depreciation)

ii) Profit and loss Account Dr.
To Depreciation account
(for closing depreciation account)

iii) Provision for Depreciation account Dr.
To Asset Account
(entry on sale of an asset)

iv) Any amount realised on account of sale of the asset is credited to the Asset Account. The balance, if any, in the Asset Account is transferred to the profit and loss Account.

12.5.2 When a provision for depreciation account is not maintained

The following journal entries are passed in this method:

i) Depreciation account Dr.

To Asset Account

(Entry for providing depreciation)

ii) Profit and loss Account Dr.

To Depreciation Account

(Entry for closing Depreciation Account)

iii) In case the asset is sold, the amount realised is credited to the Asset Amount. Any profit or loss on sale of the asset is transferred to the Profit and loss account.

12.6 METHODS OF CALCULATING DEPRECIATION

The following are various methods of depreciation in use:

1. Fixed instalment method or straight line method.
2. Machine hour rate method.
3. Diministing Balance method.
4. Sum of years digits method
5. Annuity method
6. Depreciation Fund Method
7. Insurance Policy Method
8. Depletion Method.

12.6.1 Straight Line Method

This is also known as fixed instalment method. Under this method the depreciation is charged on the uniform basis year after year. When the amount of depreciation charged yearly under this method is plotted on a graph paper, we shall get a straight line. Thus, the straight line method assumes that depreciations is a function, of time rather than use in the sense that each accounting period received the same benefit from using the asset as every other period. The formula for calculating depreciation charge for each accounting period is:

Amount of annual Depreciation =

$$\frac{\text{Original cost of the fixed assets} - \text{Residual value}}{\text{Estimated Life in years}}$$

For example, if an asset cost Rs. 50,000 and it will have a residual value of Rs. 2000 at the end of its useful life of 10 years, the amount of annual depreciation will be Rs. 4800 and it will be calculated as follow:

$$\text{Depreciation} = \frac{\text{Rs. } 50{,}000 - 2000}{10 \text{ Years}} = \text{Rs. } 4800$$

This method has many shortcomings. First, it does not take into consideration the reasonal fluctuations, booms and depression. The amount of depreciation is the same in that year in which the machine is used day and night to that in the another year in which it is used for some months. Second, it ignores the interest on the money spent on the acquisition of that asset. Third, the total charge for use of asset (i.e., depreciation and repairs) goes on increasing form year to year though the assets might have been use uniformly from year to year. For example, repairs cost together with depreciation charge in the beginning years is much less than what it is in the later year. Thus, each subsequent year is burdened with grater charge for the use of asset on account of increasing cost on repairs.

Illustration: H. Ltd. purchased a machinery on 1st January 1990 for Rs. 29000 and spent Rs. 2000 on its carriage and Rs. 1,000 on its erection. Machinery is estimated to have a scrap value of Rs. 5000 at the end of its useful life of 5 year. The accounts are closed every year on 31st December. Prepare the machinery account for five years charging depreciation according to straight line method.

Solution

MACHINERY ACCOUNT

Date	Particulars	Rs.	Date	Particulars	Rs.
1990	To Bank	22000	Dec. 31	By Depreciation	4000
Jan. 1	To Bank	2000	"	By Balance C/d	21000
	To Bank	1000			
		25000			25000
1991	To Balance b/d	21000	1991	By Depreciation	4000
Jan.1			Dec.31	Balance c/d	17000
		21000			21000
1992	To Balance/b/c	17000	1992	By Depreciation	4000
Jan.1			Dec. 31	By Balance c/d	13000
		17000			17000
1993	To Balance b/c	13000	1993	By Depreciation	4000
Jan.1			Dec.31	By Balance	9000
		13000			13000
1994	To Balance b/d	9000	1994	By Depreciation	4000
Jan.1			Dec.31	By Balance c/d	5000
		9000			9000

This method is very suitable particularly in case of those assets which get depreciated more on account of expire of period e.g. lease hold properties, patents, etc.

12.6.2 Machine Hour Rate Method

In case of this method, the running time of the asset is taken into account for the purpose of calculating the amount of depreciation. It is suitable for charging depreciation on plant and machinery, air-crafts, gliders, etc. The amount of depreciation is calculated as follows:

$$= \frac{\text{Acquisition cost of the assets} - \text{Scrap value}}{\text{Life of the Asset in hours}}$$

For example, if machinery has been purchased for Rs. 20000 and it will have a scrap value of Rs. 1000 at the end of its useful life of 1900 hours, the amount of depreciation per hour will be computed as follows:

$$\text{Depreciation} = \frac{\text{Acquisition cost of the assets} - \text{Scrap value}}{\text{Life of the Asset in hours}}$$

$$= \frac{\text{Rs. } 20{,}000 - 1{,}000}{1900 \text{ hours}}$$

$$= \text{Rs. } 10 \text{ per hour}$$

If in a particular year, the machine runs for 490 hours, the amount of depreciation will be Rs. 4900 (i.e., Rs. 10x490). It is obvious from this example that under machine hour rate method the amount of depreciation is closely related with the frequency of use of an asset. The simplicity in calculations and under standing is the main advantage of this methods. However, it can be used only in case of those assets whose life can be measured in terms of working time.

12.6.3 Diministing Balance Method

This is also known as Written down value method [WDV]. Under the diminishing balance method depreciation is charged at fixed rate on the reducing balance (i.e., cost less depreciation) every year. Thus, the amount of depreciation goes on decreasing every year. Under this method also the amount of depreciation is transferred to profit and loss account in each of the year and in the balance sheet the asset is shown at book value after reducing depreciation from it. For example, if an asset is purchased for Rs. 10,000 and depreciation is to be charged at 20% p.a. on reducing balance system then the depreciation for the first year will be Rs. 2000. In the second year, it will Rs. 1600 (i.e. 20% of 8000), in the third year Rs. 1280 (i.e. 20% of 6400) and so on. The rate of depreciation under this method can be computed by using the following formula:

$$\text{Depreciation rate} = -1\sqrt{\frac{\text{Net scrap value}}{\text{Acquisition cost}}}$$

For example, if the cost of an asset is 27000, scrap value Rs. 3375, economic life 3 year, the rate of depreciation would be:

$$\text{Depreciation Rate} = 1 - 3\sqrt{\frac{3375}{27000}}$$

$$= 1 - \frac{15}{30} = 50\%$$

Merits of Diministing Balance Method

(i) It is very easy to understand and calculate the amount of depreciation despite the early variation in the book value after depreciation (ii) This method put an equal burden for use of the asset on each subsequent year since the amount of depreciation goes on decreasing for each subsequent year while the charge for repairs goes on increasing for each subsequent year. (iii) This method has also been approved by the income tax act applicable in India (iv) Asset is never reduced to zero because if the rate of depreciation is (say) 20%. Then even when asset is reduced to very small value, there must remain the 80% of that small value as on written off balance.

Demerit

(i) It ignores the interest on the capital committed to purchase that asset. (ii) It does not provide adequately for replacing the asset at the end of its life. (iii) The calculation of rate of depreciation is not so simple. (iv) The formula for calculating the rate of depreciation can be applied only when there is some residual of the asset.

Suitability

This method is suitable in those cases where the receipts are expected to decline as the asset gets older and, it is believed that the allocation of depreciation of depreciation ought to be related to the pattern of assets expected receipts.

Illustration 2: A company purchases Machinery on 1st April 1990 for Rs. 20,000. Prepare the machinery account for three years charging depreciation @ 25% p.a. according to the written Down value Method.

MACHINERY ACCOUNT

Date	Particulars	Rs.	Date	Particulars	Rs.
1990 Apr. 1	To Bank	20000	1991 Mar. 31	By Depreciation By Balance C/d	5000 15000
		20000			20000
1991 Apr.1	To Balance b/d	15000	1992 Mar.31	By Depreciation By Balance c/d	3750 11250
		15000			15000
1992 Apr 1	To Balance b/d	11250	1993 Mar.31	By Depreciation By Balance c/d	2812.5 8437.5
		11250			11250

12.6.4 Sum of Years digits (SYD) Method

Under this method also the amount of depreciation goes on diministing in the future years similar to that under diministing Balance method.

For calculating the amount of depreciation to be charged to the profit and loss account this method takes into account cost, scrape value, and life of the asset. The following formula is used for determining depreciation:

$$= \frac{\text{Remaining life of the Assets at the end of the year} + 1}{\text{Sum of the digits representing the life of the asset}} \times \text{Acquisition Cost}$$

For example, an asset having an effective life of 5 years is purchased at a cost of Rs. 20,000. It is estimated that its scrap value at the end of its effective life will be Rs. 2000. The depreciation on this asset, if SYD method is followed, will be calculated as follows from one to five years:

Year		Depreciation Amount
1	=	$\frac{5}{15} \times 18000 = \text{Rs. } 6000$
2	=	$\frac{4}{15} \times 18000 = \text{Rs. } 4800$
3	=	$\frac{3}{15} \times 18000 = \text{Rs. } 3600$
4	=	$\frac{2}{15} \times 18000 = \text{Rs. } 2400$
5	=	$\frac{1}{15} \times 18000 = \text{Rs. } 1200$

12.6.5 Annuity Method

Sofar we have described such methods of charging depreciation which ignore the interest factor. Also, some times it becomes inconvenient for a company to follow any of the methods discussed earlier. Under such circumstances the company may use some special depreciation systems. Annuity method is one of these special systems of depreciation. Under this system, the depreciation is charged on the basis that besides losing the acquisition cost of the asset the business also loses interest on the amount used for purchasing the asset. Here, interest refers to that income which the business would have earned otherwise if the money used in buying the asset would have been committed in some other profitable investment. Therefore, under the annuity method the amount of total depreciation is determined by adding the cost and interest thereon at an expected rate. The annuity table is used to help in the determination of the amount of depreciation. A specimen of Annuity Table is as follows:

ANNUITY TABLE

Year	3%	4%	5%	6%
4	0.269027	0.275490	0.282012	0.288591
5	0.218335	0.224627	0.230975	0.237376
6	0.184598	0.190762	0.197012	0.203363
7.	0.160506	0.166610	0.172820	0.179135
8.	0.142456	0.148528	0.154722	0.161036
9.	0.128434	0.134493	0.140690	0.147022
10.	0.117231	0.12391	0.129505	0.135868

In case depreciation is charged according to this method, the following accounting entries are passed:

(i) Purchase of an asset
Asset Account Dr.
To Bank

(ii) For Charging interest
Asset Account Dr.
To Interest Account

(iii) For Charging depreciation:
Depreciation Account Dr.
To Asset Account

Evaluation of Annuity Method

Merits

(i) This method keep into account interest on money spent on the purchase of the asset.

(ii) The value of the asset become zero at the end of life.

Demerits

(i) This method is comparatively more difficult than the methods discussed so far.

(ii) It makes no arrangement of money to replace the old asset with the new one at the expiry of its life.

(iii) Under this method the burden on the profit and loss account is no similar in each year because the depreciation remains constant year after year but the interest goes on decreasing.

Illustration: On 1st January, 1990 a firm purchased a leasehold property for 4 year at a cost of Rs. 24000. It decides to depreciate the lease by Annuity Method by charging interest at 5% per annum. The Annuity Table shows that the annual necessary to write off Rs. 1 at 5% Rs. 0.282012. You are required to prepare the lease Hold Property Account for four years and show the net amount to be charged to the profit and loss account for these four years.

LEASE HOLD PROPERTY ACCOUNT

Date	Particulars	Rs.	Date	Particulars	Rs.
1990 Jan. 1	To Bank	24000.00	1990 Dec. 31	By Depreciation	6768.29
	To interest	1200.00	Dec.31	By balance c/d	18431.71
		25200.00			25200.00
1991 Jan.1	To balance b/d	18431.71	1991 Dec.31	By Depreciation	6768.29
Dec.31	To Interest	921.59	Dec.31	By Balance c/d	12585.01
		19353.30			19353.30
1992 Jan.1	To balance b/d	12585.01	1992 Dec.31	By Depreciation	6768.29
Dec. 31	To Interest	629.25	Dec.31	By Balance c/d	6445.97
		13214.26			13214.26
1993 Jan.1	To balance b/d	6445.97	1993 Dec.31	By Depreciation	6768.29
				By Balance c/d	9000
Dec.31	To Interest	322.30			13000
		6768.27			6768.27

NET AMOUNT CHARGEABLE TO THE PROFIT AND LOSS ACCOUNT

Year	Depreciation debited	Interest Credited	Net Charge against Profit
1990	6768.29	1200.00	5568.29
1991	6768.29	921.59	5846.70
1992	6768.29	629.25	6139.04
1993	6768.29	322.30	6445.99
Rs.	27073.16	3073.14	24000.02

12.6.6 Depreciation Fund Method

Business assets become useless at the expiry of their life and therefore, need replacement. However, all the methods of depreciation discussed above do not help in accumulating the amount which can be readily available for the replacement of the asset its useful life comes to an end Depreciation fund method takes care of such a contingency as it incorporates the benefits of depreciating the asset as well as accumulating the necessary amount for its replacement. Under this method, the amount of depreciation charged from the profit and loss account is invested in certain securities carrying a particular rate of interest. The interest received on the investment in such securities is also invested every year together with the amount of annual depreciation. In the last of the life of asset the depreciation amount is set aside interest is received as usual. But the amount is not invested because the amount is immediately needed for the purchase of new asset. Rather all the investments so far accumulated are sold away. Cash realised on the sale of investments is utilised for the purchase of new asset. The following accounting entries are generally made in order to work out this system of depreciation.

1. *At the end of the first year*

(i) for setting aside the amount of depreciation: The amount to be charge by way of depreciation is determined on the basis of sinking Fund Table given as an Appendix at the end of every book of accountancy.

Depreciation Account Dr.

To Depreciation Fund Account (or Sinking Fund A/c)

(ii) For investing the amount charged by way of depreciation:

Depreciation Fund Investment A/c Dr.

To Bank A/c

2. *In the second and subsequent years*

(i) For receiving interest. The interest on the balance of Depreciation Fund Investment outstanding in the beginning of each year will be received by the end of the year. This entry is:

Bank Account Dr.

To Depreciation Fund Account

(ii) For setting aside the amount of depreciation

Profit and Loss A/c Dr.

To Depreciation Fund A/c

(iii) For investing the amount

Depreciation Fund Investment A/c Dr.

To Bank A/c

(Annual instalment of depreciation and interest received invested)

3. *In the last year*

(i) For receiving interest:

Bank A/c Dr.

To Depreciation Fund A/c

(ii) For setting aside the amount of depreciation

Profit and loss A/c Dr.

To depreciation Fund A/c

Note: In the last year no investment will be made, because the amount is immediately required for the purchase of new asset.

(iii) For the sale of investment:

Bank A/c Dr.

To Depreciation Fund Investment A/c

(iv) For the transfer of profit or loss on sale on investments: The profit or loss on the sale of these investments is transferred to the Depreciation Fund Account.

The entry for loss:

Depreciation Fund A/c Dr.

To Depreciation Fund Investment A/c

The entry for profit

Depreciation Fund Investment A/c

To Depreciation Fund A/c

(v) For the sale of old asset:

Bank A/c Dr.

To asset A/c

(vi) The depreciation fund is transferred to asset account and any balance left in the asset account is transferred to profit and loss account. The entry is:

Depreciation Fund A/c. Dr.

To asset A/c

(vii) The balance in Asset Account represents profit or loss. Therefore it will be transferred to the profit and loss account.

(viii) The cash realised on the sale of investments and the old asset is utilised for the purchase of new asset.

Illustration: Amitabh Company Ltd. purchased 4 year lease on January , 1990 for Rs. 60,000. The company decided to charge depreciation according to depreciation fund method. It is expected that investments will earn interest @5% p.a. Sinking Fund Table shows that Rs. 0.232012 invested each year will produce Rs. 1 at the ent of 4 years at 5% p.a. At the expiry of lease , the Depreciation Fund Investments were sold for Rs. 45200. A new lease is purchased for Rs. .... on 1.1.1994. Show the journal entries and prepare the necessary accounts in the book the company.

JOURNAL

Date	Particulars		Debit	Credit
1.1.1990	Lease A/c	Dr.	60,000	
	To Bank A/c			60,000
	(Being the purchase of lease)			
31.12.90	Depreciation A/c	Dr.	13920.7	
	To Depreciation Fund A/c			13920.7
	(Being annual amount of depreciation as per sinking fund tables)			
31.12.90	Depreciation Fund Investment A/c	Dr.	13920.7	
	To Bank A/c			13920.7
	(Being purchase of the investments against the depreciation fund)			
31.12.91	Bank A/c	Dr.	696.0	
	To depreciation fund A/c			696.0
	(Being the receipt of interest on depreciation fund investment A/c transfer to depreciation fund A/c			
31.12.91	Depreciation A/c	Dr.	13920.7	
	To Depreciation Fund A/c			13920.7
	(Being annual depreciation set-aside)			
31.12.91	Depreciation Fund Investment A/c	Dr.	14616.7	
	To Bank A/c			14616.7
	(Being purchase of the investments against the depreciation fund)			
31.12.92	Bank Account	Dr.	1426.9	
	To depreciation fund A/c			1426.9
	Being receipt of interest and its transfer to depreciation fund A/c)			

31.12.92	Depreciation A/c Dr. To depreciation fund A/c (Being annual depreciation set aside)	13920.7	13920.7
31.12.92	Depreciation Fund Investment A/c Dr. To Bank A/c (Being purchase of investments)	15347.6	15347.6
31.12.93	Bank A/c Dr. To depreciation fund A/c (Being receipt of interest on depreciation fund investment)	2194.3	2194.3
31.12.93	Depreciation A/c Dr. To depreciation A/c (Being annual depreciation set aside)	13920.7	13920.7
31.12.90	Bank A/c Dr. To depreciation fund investment A/c (Being sale of Dep fund investment A/c)	45200	45200
31.12.93	Depreciation Fund Investment A/c Dr. To depreciation fund A/c (Being profit on sale investment transferred)	1315.0	1315.0
31.12.93	Depreciation fund A/c Dr. To lease A/c (Being the transfer of depreciation fund A/c to lease A/c)	61315.0	61315.0
31.12.93	Lease A/c Dr. To PCL A/c (Being Balance of lease A/c transferred to place	1315.0	1315.0
1.1.94	Lease A/c Dr. To Bank A/c	70000.0	70000.0

DEPRECIATION FUND ACCOUNT

Date	Particulars	Rs.	Date	Particulars	Rs.
31.12.90	By Balance c/d	13920.7	31.12.90	By Dep. a/c	13920.7
		13920.7			13920.7
31.12.91	To Balance c/d	28537.4	1.1.91	By Balance b/d	13920.7
			31.12.91	By Bank A/c Int.	696.0
			31.12.91	By Dec. a/c	13920.4
		28537.4			28537.4
31.12.92	By Balance c/d	43885.0	1.1.92	By Balance c/d	28537.4
			31.12.92	By Bank A/c Int.	1426.9
			31.12.92	By Dep. A/c	13920.7
		43885.0			43885.0
31.12.93	To lease A/c	61315.0	1.1.93	By Balance b/d	43885.0
			31.12.93	By Bank Interest	3194.3
			31.12.93	By Dep. a/c	61315.0
		61315.0			61315.0

LEASE ACCOUNT

Date	Particulars	Rs.	Date	Particulars	Rs.
1.1.90	To Bank A/c	60000	31.12.90	By Balance c/d	60000
		60000			60000
1.1.91	To Balance b/d	60000	31.12.91	By Balance c/d	60000
		60000			60000
1.1.92	To Balance b/d	60000	31.12.92	By Balance c/d	60000
		60000			60000
1.1.93	To Balance b/d	60000	31.12.93	By Balance c/d	60000
		60000			60000
31.12.93	To P & L A/c	1315			
	(Profit)	61315			61315

DEPRECIATION FUND INVESTMENT A/C

Date	Particulars	Rs.	Date	Particulars	Rs.
31.12.90	To Bank A/c	13920.7	31.12.90	By Balance c/d	13920.7
		13920.7			13920.7

1.1.91	To Balance b/d	13920.7	31.12.91	By Balance c/d	28537.4
31.12.92	To Bank A/c	14616.7			
		28537.4			28537.4
1.1.92	To Balance b/d	28537.4	31.12.92	By Balance c/d	43885.0
31.12.92	To Bank A/c	15347.6			
		43885.0			43885.0
1.1.93	To Balance b/d	43885.0	31.12.93	By Bank a/c	45200.0
	To Dep. Fund a/c	1315.0			
		45200.0			45200.0

12.6.7 Insurance Policy Method

Under this method, instead of investing the money in securities an insurance policy for the required amount is taken. The amount of the policy is such that it is adequate to replace the asset when it is worn out. A fixed sum equal to the amount do depreciation is paid as premium every year. Company receiving premium allows a small rate of interest on compound basis. At the maturity of the policy, the insurance company pays the agreed amount with which the new asset can be purchased. Accounting entries will be made as follows.

1. *First and every subsequent years*

(a) Depreciation Insurance policy A/c Dr.

To Bank

(Entry in the beginning of the year for payment of insurance premium)

(b) Profit and loss Account Dr.

To Depreciation fund A/c

(Entry at the end of the year for providing depreciation)

2. *Last year*

(a) Bank A/c Dr.

To Depreciation Policy A/c

(Entry for the amount of policy received)

(b) For transfer of profit on insurance policy:

Depreciation Insurance Policy A/c Dr.

To Depreciation Fund A/c

(c) For transfer of accumulated depreciation to the asset account:

Depreciation Fund A/c Dr.

To Asset A/c

(d) On purchase of new asset:

On purchase of new asset:

New Asset A/c Dr.

To Bank

Illustration: On 1.1.1993, a firm purchased a lease for four years for Rs. 50,000. It decided to provide for its replacement by means of an insurance policy for Rs. 50,000. The annual premium is Rs. 11,000. On 1.1.1997, the lease is renewed for a further period of 4 years for the same amount. Show the necessary ledger accounts.

LEASE ACCOUNT

Date	Particulars	Rs.	Date	Particulars	Rs.
1.1.93	To Bank A/c	50000	31.12.93	By Balance c/d	50000
1.1.94	To Balance b/d	50000	31.12.94	By Balance c/d	50000
1.1.95	To Bank A/c	50000	31.12.95	By Balance c/d	50000
1.1.96	To Bank A/c	50000	31.12.96	By Balance c/d	50000
				Fund a/c	

DEPRECIATION INSURANCE POLICY A/C

Date	Particulars	Rs.	Date	Particulars	Rs.
1.1.93	To Balance A/c	11000	31.12.93	By Balance c/d	11000
1.1.94	To Balance b/d	11000	31.12.94	By Balance c/d	22000

	To Bank A/c	11000			
		22000			22000
1.1.95	To Balance b/d	22000	31.12.95	By Balance c/d	33000
	To Bank A/c	11000			
		33000			33000
1.1.96	To Balance b/d	33000	31.12.96	By Bank	50000
	To Bank	11000			
Dec.31	To profit Transferred to Dep. Fund A/c	6000			
		50000			50000

DEPRECIATION FUND ACCOUNT

Date	Particulars	Rs.	Date	Particulars	Rs.
1.1.93	To Balance c/d	11000	31.12.93	By P. & L c/c	11000
1.1.94	To Balance c/d	22000	31.12.94	By Balance.b/d	11000
			Dec. 31	By P. & L a/c	11000
		22000			22000
1.1.95	To Balance c/d	33000	31.12.95	By Balance b/d	22000
				By P. & L. a/c	11000
		33000			33000
1.1.96	To Lease a/c	50000	31.12.96	By Balance b/d	33000
			Dec. 31	By P. & L. a/c	11000
			Dec. 31	By Dep. Insurance Policy a/c	6000
		50000			50000

12.6.8 Depletion Method

This is also known as productive output method. In this method it is essential to make an estimate of the units of output the asset will produce in its life time. This method is suitable in case of mines, queries, etc., where it is possible to make an estimate of the total output likely to be available. Depreciation is calculated per unit of output. Formula for calculating the depreciation rate is as under:

$$r = \frac{\text{Acquisition cost} - \text{Scrap value}}{\text{Units of output}}$$

Example: If a mine is purchased for 50,000 and it is estimated that the total quantity of mineral in the mine is 1,00,000 tonnes, the rate of depreciation would be:

$$r = \frac{50{,}000}{1{,}00{,}000} = \text{Rs. } 0.5$$

Hence, the rate of depreciation is 50 paise per tonne. In case output in a year is 20,000 tonnes, the amount of depreciation to be charged to the profit and loss account would be Rs. 10,000 (i.e., 20,000 tonnes × Rs. 0.50).

This method is useful where the output can be measured effectively, and the utility of the asset is directly related to its production use. Thus, the method provides the benefit of correlating the amount of depreciation with the productive use of asset.

12.7 SALE OF AN ASSET

An enterprise may sell an asset either because of obsolescence or inadequacy or even for other reasons. In case an asset is sold during the course of the year, the amount realised should be credited to the Asset Account. The amount of depreciation for the period of which the asset has been used should be written off in the usual manner. Any balance in the Asset Account will represent profit or loss on disposal of the asset. This balance in the Asset Account should be transferred to the profit and loss account.

Illustration: A company purchased a machinery costing Rs. 60,000 on 1.4.1990. The accounting year of the company ends on 31st December every year. The company further purchased machinery on 1st October, 1990 costing Rs. 40,000. On 1st January 1992, one-third of the machinery which was installed on 1.4.1990, became obsolete and was sold for Rs. 5000. Show how the machinery account would appear in the books of the company. The depreciation is to be charged at 10% p.a. on written down value method.

MACHINERY ACCOUNT

Date	Particulars	Rs.	Date	Particulars	Rs.
1.4.90	To Bank	60000	31.12.90	By Depreciation	45000
Oct. 1	To Bank	40000		on Rs. 60000 for 9 month	1000
				on Rs. 40000 for 3 month	
			Dec.31	By Balance c/d	94500
		100000			100000
1.191	To Balance b/d	94500	31.12.91	By Depreciation on Rs. 94500 for 1 year	9450
			Dec. 31	By Balance c/d	85050
		94500			94500
1.192	To Balance b/d	85050	31.12.91	By Bank (sale pro)	5000
			Jan. 1	By Profit Loss account loss on sale (16650-5000)	11650
			Dec. 31	By Depreciation	6840
			Dec. 31	By Balance c/d	61560
		85050			85050

*Total written down value as on Jan. 1, 1992	85050
Less written down value of 1/3 of Machinery sold (2000-(1500+1850)	16650
	68400
Depreciation at 10% on Rs. 68400	6840

12.8 DEPRECIATION ON AN ASSET PURCHASED IN THE COURSE OF A YEAR

Two alternatives are available regarding charging of depreciation on assets which have been bought during the course of an accounting year. These are as follows:

1. Depreciation may be charged only for the part of the year for which the asset could have been made available for use after purchase of it.
2. Depreciation may be charged for the full year irrespective of the date of purchase. It will be ascertained at the given rate of depreciation. The Income tax authorities also permit this.

Important Note: If there is no specific instruction in the question about depreciation, the students should give the assumption made by them in this regard. But, in case rate of depreciation has been given as a certain percentage per annum and the purchasing date has been given, it is suggested to calculate depreciation only for the part of the year for which the asset has been made available for its use.

12.9 CHANGE OF DEPRECIATION METHOD

To ensure comparability of results from year to year, it is essential that once a method of depreciation is selected by the management it should be followed consistently. However, sometimes a change in the method of depreciation may be required. The change may be required either because of statutory compulsion or required by an accounting standard or change would result in more appropriate presentational the financial statements.

The change in the method of depreciation may be desired from the current year onwards. In such a case, depreciation will be charged according to the new method from the current year.

Illustration: Om Ltd. purchased a computer for Rs. 50,000 on 1.1.1993. It has five years life and a salvage value of Rs. 5,000. Depreciation was provided on straight line basis. With effect from 1.1.1995, the company decided to change the method of depreciation to Diminishing Balance method@20% p.a. Prepare computer account from 1993 to 1996. Assume, the company prepare final accounts on 31st December every year.

COMPUTER ACCOUNT

Date	Particulars	Rs.	Date	Particulars	Rs.
1.1.93	To Cash A/c	50000	31.12.93	By Depreciation	9000
			"	By Balance c/d	41000
		50000			50000
1.1.94	To Balance b/d	41000	31.12.94	By Depreciation	9000
			"	By Balance c/d	32000
		41000			41000
1.1.95	To Balance b/d	32000	31.12.95	By Depreciation	6400
			"	By Balance c/d	25600
		32000			32000
1.1.96	To Balance b/d	25600	31.12.96	By Depreciation	5120
			"	By Balance c/d	20480
		25600			25600

Working Notes

1) Depreciation on straight line basis

$$= \text{Rs. } \frac{50{,}000 - 5{,}000}{5} = \text{Rs. } 9000$$

2) Depreciation on written down value basis during 1995

(Book value Rs. 32000)

$$= \text{Rs. } \frac{32000 \times 20}{100} = \text{Rs. } 6400$$

12.9.1 Change in the Method of Depreciation from a back date

Sometimes a change in the method of depreciation is effected retrospectively. In such a case, the following steps are required:

(i) Find out the depreciation which has already been charged according to the old method or at the old rate.

(ii) Compute the amount of depreciation that is to be charged according to the new method form the back date upto the end of the previous year.

(iii) Find the difference, if any, under (i) and (ii) mentioned above.

(iv) In the current year in addition to the depreciation for the current year charge also the difference found under step (iii).

Illustration: Taking the facts as in the illustration 7, prepare computer account for 1995 and 1996, if the firm decides on 1.1.1995 to charge depreciation according to Diministing Balance method. Assume the change in the depreciation policy is efected by the firm since the date of purchase.

Solution

COMPUTER ACCOUNT

Date	Particulars	Rs.	Date	Particulars	Rs.
1.1.95	To Balance	32000	31.12.95	By Depreciation	
				Difference for	Nil
				earlier year (1)	
				Current year (2)	6400
			Dec. 31	By Balance c/d	25600
		32000			32000
1.1.96	To Balance	25600	31.12.96	By Depreciation	5150
			“	By Balance	20480
		25600			25600

Working Notes

1) 1.1.1993 Acquisition cost of computer 50000

31.12.93	Depreciation @ 20% p.a. on 50000	10000
1.1.94	Balance	40000
31.12.94	Depreciation @ 20% on Rs. 40000	8000

Depreciation according to Diministing

Balance 18000

method for the year 1993 and 1994 (10,000+8,000)

Less Depreciation according to straight line basis 18000

(9000+9000) Nil

Difference

2)

1.195	Balance	32000
31.12.95	Depreciation @ 20% p.a. on 32000	6400
1.1.96	Balance	25600
31.12.96	Depreciation @ 20% on 25600	5120
31.12.96	Balance	20480

12.10 SUMMARY

The term depreciation refers to the reduction or loss of quality or value of a fixed asset through wear or tear, in use, effusion of time, obsolescence through technology and market changes or from any other cause. The term depreciation, depletion and amortization are used often interchangeably. However, these different terms have been developed in accounting usage for describing this process for different type of assets. The term 'depreciation' is concerned with charging the cost of man-made fixed assets, depletion applied to the process of removing an available but irreplaceable resource such as coal mines or oil well, amortisation refers to the process of writing off intangible assets. The main objectives of charging depreciation are to ascertain the true profits or losses and to show the assets at its reasonable value. The amount of depreciation to be charged depends upon cost of the asset, estimated life of the asset and scrap value of the asset. There are different methods of charging depreciation, i.e., fixed instalment method, machine hour rate method, diminishing balance method, sum of years digits method, annuity method, depreciation fund method, insurance policy method and depletion method.

12.11 KEYWORDS

Fixed Assets: Those assets which have been purchased for continuous use in the business.

Depreciation Rate: A percentage applied to the historical cost or the substituted amount of a depreciable asset.

Balance Sheet: A statement of the financial position of an enterprise as at a given time.

Depletion: A measure of exhaustation of a wasting asset represented by periodic write-off of cost.

Obsolescence: Dimunition in the value of an asset by the reason of its becoming out-of-date due to technological changes.

Provision: An amount retained by way of providing for any known liability the amount of which cannot be determined with substantial accuracy.

12.12 SELF ASSESSMENT QUESTIONS

1. Why is it necessary to calculate depreciation? Discuss various factors which are considered for calculating depreciation

2. Distinguish between the following:
   (a) Straight line method and diministing balance method.
   (b) Annuity method and depreciation Fund method.
   (c) Depreciation and depletion

3. Explain the circumstances under which different methods of depreciation can be employed.

4. Discuss the advantages and disadvantage of Insurance Policy Method and Straight Line Method.

5. What is sum of the year-digits method do depreciation? In what way does it differ from sinking fund method or depreciation?

6. A firm purchases a plant for a sum of Rs. 10,000 on 1st January 1990. Installation charges are Rs. 2,000. Plant is estimated to have a scrap value of Rs. 1,000 at the end of its useful life of five years. You are required to prepare the plant account for five years charging depreciation according to Straight Line Method

7. A plant is purchased for Rs. 20,000. It is depreciated at 5% per annum on reducing balance for five years when it becomes obsolete due to new method of production and is scrapped. The scrap produces Rs. 5,385. Show the plant account in the ledger.

8. The machinery account of a factory showed a balance of Rs. 1,90,000 on 1st January 1998. 1st accounts were made up on 31st December each year and depreciation is written off at 10% p.a. under the Diministing Balance Method.

   On 1st June 1998, New Machinery is acquired at a cost of Rs. 28,000 and installation charges incurred in erecting the machines works out to Rs. 892 on the same date. On 1st June 1998 a machine which had cost Rs. 6,000 on 1st January 1993 was sold for Rs. 750, another machine which had cost Rs. 600 on 1st January 1994, was scrapped on the same date and it realised nothing.

   Write up plant and Machinery Account for the year 1998, allowing the same rate of Depreciation as in the past calculating Depreciation to the nearest multiple of a Rupee. (Ans. Loss on Sale Rs. 2,645, Loss on scrapping Rs. 377, Closing Balance Rs. 1,94,665).

9. A company purchased a four years lease on January, 1, 1985 for Rs. 20,150. It is decided to provide for the replacement of the lease at the end of four years by setting up a Depreciation Fund. It is expected that investments will fetch interest at 4per cent. Sinking Fund tables show that to provide the requisite sum at 4percent at the end of four years, an investment of Rs. 4,745.02 is required. Investments are made to the nearest rupee.

On December 31, 1988, the investments are sold for Rs. 14,830 On 1st January, 1989, the same lease is renewed for a further period of 4 years by payment of Rs. 22,000.

Show journal entries and give the important ledger account to record the above.

10. Chillies Ltd, acquired a long-term lease of property on payment of Rs. 60,000. A leasehold Redemption Policy was taken out on which an annual premium of Rs. 1,440 was payable. The surender value of the policy on 31st March, 1997 was Rs. 12,896 to which amount the policy account stood adjusted. Next premium was paid on 20th December, 1997 and the surrender value on 31st March, 1978 was Rs. 14,444.
    (i) Show the Redemption fund account and the policy account for the year ended 31st March, 1998
    (ii) Assuming that of maturity, a sum of Rs. 60,100 was received and the balance in policy account then stood at Rs. 59,920 give the ledger accounts showing the entries necessary to close the accounts concerned. (Ans. (i) Balance at the end of 1998 Fund A/c & Policy A/c Rs. 14,444 (ii) Transfer to P & L a/c profit on maturity Rs. 100).

11. Machinery account of CSI Ltd. showed debit balance of Rs. 32,400 on 1st January, 1998. Depreciation was provided at 10% per annum. On 1st July 1998, a part of the machinery purchased for Rs. 10,000 on 1st January 1996 was sold for Rs. 7,000 and on the same date a new machinery which cost Rs. 20,000 was purchased. On 31st Dec. 1998 the company decided to change the method of depreciation from

Diministing Balance Method to Fixed Instalment Method with effect from 1st January, 1996, depreciation remaining at 10% per annum. Show Machinery account.

12.13 REFERENCES/SUGGESTED READINGS

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Subject: **Financial Accounting-I**	
Course Code: **BBA-104**	Author:
Lesson: **13**	Vetter:

ACCOUNTS FOR NON-PROFIT MAKING ORGANISATIONS

STRUCTURE

13.0 OBJECTIVES

After going through this chapter, you should be able to-

- Know the meaning and objectives of non-profit making organisations.
- Know the meaning and features of Receipts and Payments A/c, Income and Expenditure Account and Balance Sheet.

- Understand the preparation of Income and Expenditure Account and Balance Sheet.

13.1 INTRODUCTION

Non-profit making organisations, also known as non-trading institutions or organisations, include such voluntary associations of persons as are formed for the purpose of providing recreational facilities to its members or to promote art, culture, education, commerce, science, religion and other social and charitable purposes. There is no purchase or manufacture of goods for trading purposes in these non-profit making organisations. The primary object of these institutions is to render a service to their members (or society) or to satisfy members' common needs. The examples of such organisations include sport clubs, educational institutions, hospitals, libraries, temples, churches, gurudwaras, masjids. Similarly, the associations of manufacturers or traders and professionals are also non-profit making organisations and include medical councils, banker's association, teachers association, The Institute of Chartered Accountants of India, The Institute of Cost and Works Accountants of India, The Institute of Company Secretaries of India. All these entities are formed for the purpose of promotion and protection of their professional interests. The non-trading organisations too like trading organisations have to prepare the financial statements at the end of the accounting year. The non-trading institutions are different from the trading institutions in several respects. They have not to purchase and sell goods, accept or receive bills of exchange nor do they have too many credit transactions. Most of their transactions are cash transactions and, therefore, they need not maintain as many books of accounts as trading institutions have to maintain. However, they do maintain a cash book and minimum number of such other books which may be required for their purposes. For example, a Register of Members, a Minute Book are maintained in case of a club or a society, a student fee register is maintained in case of a school or a college, a summary record of outstanding fees may be kept by an Advocate or a Chartered Accountant.

At the end of the accounting period, a non-trading institution also prepares its final accounts, which include the following:

(i) Receipts and Payments Account,

(ii) Income and Expenditure Account, and

(iii) Balance Sheet.

13.2 RECEIPTS AND PAYMENTS ACCOUNT

Receipts and Payments Account is a summary of cash transactions for a given period. All the receipts, by cash or by cheque, are entered on the debit side, whereas all the payments, by cash or by cheque, are shown on the credit side. It begins with an opening balance (Cash or/and Bank) and is debited with all the items of receipts irrespective of whether they are of capital or revenue nature or whether they pertain to the accounting period or not. The payments are recorded on the credit side without making any distinction between items of capital and revenue nature and irrespective of the fact whether they belong to the accounting period or not. Moreover, this account is not used to record outstanding items of receipts and payments since these are non-cash items. At the end of the accounting period, this account is balanced to ascertain the balance of cash in hand or at the bank or the overspent amount or bank overdraft.

Features

The main features of the Receipts and Payments Account can be summarised as follows:

(a) It is a real account, i.e., it is a summarised copy of cash receipts and cash payments.

(b) It's form is similar to Cash Book (without discount and bank columns) with debit and credit sides. Receipts are recorded on the debit side while payments being entered on the credit side.

(c) It records all receipts and payments irrespective of the distinction between capital and revenue items. In other words, both capital and revenue receipts and payments are included.

(d) Only actual receipts and payments during the accounting period, whether relating to previous or current or succeeding years are recorded in it.

(e) The opening and closing balances in it mean cash in hand/bank in the beginning and at the end, respectively. The balance of Receipts and Payments Account must be debit being cash on hand and/or at bank, unless there is a bank overdraft.

Illustration: From the following particulars taken from the Cash Book of a Club, prepare a Receipts and Payments Account.

	Rs.
Opening Balance:	
Cash in hand	100
Cash at bank	500
Receipts:	
Subscriptions	3,300
Donations	260
Payments:	
Rent paid	1400
General expenses	210
Postage & stationary	70
Sundry expenses	30
Closing Cash Balance	200

Solution

RECEIPTS AND PAYMENTS ACCOUNT

FOR THE YEAR ENDED...........

Dr. Cr.

Receipts		Amount (Rs.)	Payments		Amount (Rs.)
To Balance b/d			By Rent		1400
Cash in hand	100		By Sundry Expenses		30
Cash at Bank	500	600	By General Expenses		210
			By Postage & Stationary		70
To subscriptions		3,300	By Balance c/d:		
To Donations		260	Cash in hand	200	
			Cash at Bank	2,250	2,450
			(Balancing figure)		
			4,160		4,160

13.3 INCOME AND EXPENDITURE ACCOUNT

It is a nominal account of non-trading institutions equivalent to the Profit and Loss Account of the business concerns. It shows the classified summary of incomes, expenses and losses for current accounting period along with the excess of income over expenditure (i.e. surplus) or excess of expenditure over income (i.e. deficit) which is transferred to Capital Fund in the Balance Sheet. It is generally prepared from a given Receipts and Payments Account after making necessary adjustments. An Income and Expenditure Account being itself a nominal account includes only nominal accounts or revenue items. All items of revenue nature (nominal accounts) pertaining to relevant accounting period and, which appear, on the debit side of the Receipts and Payments Account are entered on the credit side (i.e. income side) of the Income and Expenditure Account with necessary adjustments for prepaid or outstanding figures. Similarly, all the revenue items (nominal accounts) appearing on the credit side of the Receipts and Payments Account will be entered on the debit side (i.e. expenditure side) of the Income and Expenditure Account with necessary adjustments as to prepaid or outstanding items. Thus, items of capital nature, such as purchase of machinery, building, furniture, etc. shall appear in the Balance Sheet. The end balance of the Income and Expenditure Account, which may be either excess of income over expenditure or excess of expenditure over income would be added to or deducted from, as the case may be, the Capital Fund on the liabilities side of the Balance Sheet. Its essential features can be put as follows:

(a) It is debited with the expenses and losses.

(b) It is credited with the incomes.

(c) It records only those incomes, expenses and losses which are of revenue nature.

(d) It records only those incomes, expenses and losses which relates to current accounting year.

(e) It records non-cash items also (e. g. depreciation).

(f) Its balance at the end which represents either the net surplus (if credit side exceeds debit side) or net deficit (if debit side exceeds credit side) is transferred to the Capital Fund in the Balance Sheet.

Illustration: From the information given in Illustration I, prepare an Income and Expenditure Account.

Solution

INCOME AND EXPENDITURE ACCOUNT

FOR THE YEAR ENDING ON..........

Dr. Cr.

Expenditure	Amount (Rs.)	Income	Amount (Rs.)
To Rent	1400	By Subscriptions	3,300
To General Expenses	210	By Donations	260
To Postage & Stationary	70		
To Sundry Expenses	30		
To Excess of Income over Expenditure	1,850		
	3,560		3,560

13.3.1 Distinction between Receipts and Payments Account and income and expenditure account

1. Receipts and Payments Account is a summarised statement of cash receipts and cash payments during a particular period, whereas Income and Expenditure Account is the substitute of Profit and Loss Account for non-trading concerns.
2. While Receipts and Payments Account, just like cash book, commences with opening cash balance/bank balance and closes with closing cash balance/bank balance, Income and Expenditure Account has nothing to do with opening or closing cash/bank balances.
3. Receipts and Payments Account concerns itself with actual cash received or paid during the period and ignores outstanding expenses as well as income accrued whereas

Income and Expenditure Account includes all income even if not received and all expenses even if not paid.

4. Though Receipts and Payments Account includes both capital and revenue items, Income and Expenditure Account includes revenue items only.
5. While Receipts and Payments Account shows receipts on the debit side and payments on the credit side, Income and Expenditure Account shows income on the credit side and expenses on the debit side.
6. Receipts and Payments Account includes items relating to preceding as well as succeeding years. Income and Expenditure Account, on the other hand, concerns itself, only with income and expenditure of the period to which it relates.
7. In Receipts and Payments Account difference between two sides will represent closing cash/bank balance. In Income and Expenditure Account, the difference will mean either excess of income over expenditure or vice-versa.
8. Receipts and Payments Account is generally accompanied by statement of affairs, whereas Income and Expenditure Account is always accompanied by Balance Sheet.
9. Receipts and Payments Account belongs to the category of “real accounts”, but Income and Expenditure Account belongs to the family of “nominal accounts”.

13.4 BALANCE SHEET

Balance Sheet of a non-trading concern is prepared in the usual way and contains particulars of all assets on right-hand side and liabilities on left-hand side of the concern on the date on which it is prepared. The excess of total assets over total outside liabilities is known as Capital Fund. While preparing the Balance Sheet, the excess of income over expenditure is added to the opening Capital Fund and the excess of expenditure over the income is deducted from the opening Capital Fund. Sometimes, two balance sheets may have to be prepared (i) Balance Sheet in the beginning of the accounting year to ascertain the amount of Capital Fund in the beginning of the accounting year, and (ii) Balance Sheet at the end of the accounting year to show the financial position of the concern as on that date.

13.4.1 Items Peculiar to Non-profit making organisations

The technique of preparing the final accounts of a non-trading concern is similar to that of preparing final accounts of a trading concern. However, there are certain peculiar items in case of non-trading institutions. The accounting treatment of these items and their presentation in the final accounts is as follows:

1. Legacy

Legacy refers to the amount which one gets on account of a will. The amount received on account of a legacy appears on the receipts side of Receipts and Payments Account. It should not be treated as an income because it is not of recurring in nature but should be treated as capital receipt, i.e., credited to Capital Fund Account.

2. Donations

This is very common receipt for non-trading institutions. It is a sort of gift in cash or property from some person, firm or a company. It appears on the receipts side of the Receipts and Payments Account, if received in cash. Donations can be for specific purposes or for general purposes. The accounting treatment for these is as follows:

(a) Specific donation: In case a donation has been received for a specific purpose, the donation is termed as a specific donation. For example, an institution may receive donation for construction of building or for giving prizes to best artist. The amount of such donation cannot, therefore, be used for general purpose. It should be taken to the Balance Sheet on the liabilities side and be used only for the purpose which it is meant, irrespective of the amount.

(b) General donation: A donation not received for a specific purpose is termed as general donation. In case, the general donation is of a big or large amount, it can fairly taken for granted that such donation is of a non-recurring nature and, therefore, should be taken to the Balance Sheet on the liabilities side. However, if the donation is of a small amount and not meant for a specific purpose, it can be taken to credit side of the Income and Expenditure Account. Whether the donation is of big amount or small amount would depend on the facts of each case. For example, in case of an educational institution, a sum of Rs. 11,000 can be taken as a small donation, but for a cricket club, a sum of Rs. 11,000 is quite substantial and, therefore, it will be proper to take the amount of such donation received to the Balance Sheet.

Illustration: Following are the extracts from the Receipts and Payments Account of a sports club. You are required to show the different items in the Income and Expenditure Account and Balance Sheet of the club after taking into account the additional information given.

RECEIPTS AND PAYMENTS ACCOUNT

FOR THE YEAR ENDING 31ST MARCH, 1999

	Rs.		Rs.
To Donations for Pavilion	5,000		
To Subscriptions for Governor's Party	2,000		
To Donations	1,000		

Additional Information

(i) Amount spent on Pavilion Rs. 1,000.

(ii) Outstanding subscriptions for Governor's Party Rs. 500.

Solution

INCOME AND EXPENDITURE ACCOUNT

FOR THE YEAR ENDING 31^{ST} MARCH, 1999

Dr. Cr.

Expenditure	Rs.	Income	Rs.
		By Donations	1,000

BALANCE SHEET

AS ON 31^{ST} MARCH, 1999

Liabilities	Amount (Rs.)	Assets	Amount (Rs.)
Fund for Pavilion (donations received)	5,000	Outstanding Subscriptions for Governor's Party	500
Subscriptions for Governor's Party (including outstanding)	2,500	Pavilion (cost incurred)	1,000

3. Subscriptions

This is the major source of revenue income of a non-trading institution. Subscriptions are the amounts paid by the members of such entity to maintain their membership. Subscriptions may be paid periodically (usually on yearly basis) or as a lump sum for life-membership. Periodical subscriptions are treated as revenue receipts, whereas life membership subscriptions are usually treated as capital receipts and, thus, are transferred to the Capital Fund. The Receipts and

Payments Account records the amount of actual subscriptions received while the Income and Expenditure Account records only the subscriptions which relate to the accounting period, whether received or not. Adjustments may, therefore, be required to be made to find out the actual amount of income from subscription. The following illustration is being given to clarify this point:

Illustration: From the following extracts of Receipts and Payments Account and the additional information, you are required to calculate the Income from Subscriptions for the year ending 31 December, 1997 and show them in the Income and Expenditure Account, and the Balance Sheet of a Club.

RECEIPTS AND PAYMENTS ACCOUNT

FOR THE YEAR ENDING 31ST DECEMBER 1997

Dr. Cr.

Receipts		Rs.	Payments	Rs.
To Subscriptions				
1996	5,000			
1997	30,000			
1998	6,000	41,000		

Additional Information

(i) Subscription outstanding on 31.12.96 Rs. 6,000

(ii) Subscription outstanding on 31.12.97 Rs. 5,000

(iii) Subscription received in advance on 31.12.96 Rs. 6,000

Solution

INCOME AND EXPENDITURE ACCOUNT

FOR THE YEAR ENDED 31ST DEC., 1997

Dr. Cr.

Expenditure	Rs.	Income	Rs.
		By Subscription	40,000

BALANCE SHEET

AS ON 31-12-97

Liabilities	Rs.	Assets		Rs.
Subscription in advance	6,000	Subscription Outstanding		
		for 1996 (6000-5000)	1,000	
		for 1997 (5000-1000)	4,000	5,000

Working Note: Calculation of Subscription Income for 1997-

a) Subscription received during 1997 for 1997 Rs. 30,000

b) Subscription received during 1996 for 1997 Rs.6,000

c) Subscription outstanding for 1997 as on 31.12.97 Rs.4,000

$\boxed{\textbf{Rs. 40,000}}$

4. *Entrance fee or admission fee*

This is the amount of fee usually charged by a club or a society or an educational institution from the new entrants. It is usually taken as an item of income. There are arguments that since it is paid only once for all and of non-recurring nature and, therefore, should be capitalised and taken to the liabilities side of the Balance Sheet. But another argument is that though it is paid by each member only once, the club or institution receives it regularly because of frequent changes in its membership for one reason or the other. Accordingly, it should be treated as revenue income and credited to Income and Expenditure Account. In the absence of any specific instructions about entrance fee in the question, any one of the above treatment may be followed but students should append a note justifying their treatment.

5. Sale of old newspapers and periodicals

The sale proceeds of old newspapers and periodicals is of a recurring nature and should, therefore, be taken as income in the Income and Expenditure Account.

6. Sale of old fixed assets

The sale proceeds of old fixed assets are treated as capital receipts and, thus, are credited to the respective fixed assets account. However, the profit or loss on sale of fixed assets is shown in the Income and Expenditure Account.

7. Sale of sports material

Sale of sports material is a regular feature of clubs and the amount received is treated as an ordinary or revenue income. It is, therefore, shown in the credit side of the Income and Expenditure Account.

8. Endowment Fund

It is a fund arising from a bequest or gift, the income of which is devoted for a specific purpose. Thus, endowment fund is a capital receipt and is shown in the liabilities side of the Balance Sheet.

9. Payment of Honorarium

This is the payment to a person for his specific services rendered by him not as a regular employee. For example, the payment made to a Professor to deliver lecture on a topic or to a Television artist for his/her specific performance, is termed as honorarium. This is an item of expense and is shown in the debit side of the Income and Expenditure Account.

10. Special Funds

An institution may keep special funds for some special purposes. For example, a sports club may keep a special fund for meeting sports expenses or for awarding of sports prizes. In case such special funds, all incomes relating to such funds should be added to these funds in the Balance Sheet on the liabilities side. Similarly, all expenses on account of these funds should be deduced from these funds. In case of a deficit, the amount should be met out from the Income and Expenditure Account. In case of surplus, it will be better on account of convention of conservatism, to keep it in the Balance Sheet or merge it with the Capital Fund.

Illustration: Following is the information given in respect of certain items of a sports club. You are required to show them in the Income and Expenditure Account and prepare the Balance Sheet of the club.

	Rs.
Sports Fund as on 1.1.1998	10,000
Sports Fund Investments	10,000
Interest on Sports Fund Investments	1,000
Donation for Sports Fund	4,000
Sports Prizes awarded	3,000
Expenses on sports events	1,000
General Fund	30,000
General Fund Investments	30,000
Interest on General Fund Investments	4,000

Solution

INCOME AND EXPENDITURE ACCOUNT

FOR THE YEAR ENDING 31ST DECEMBER, 1998

Dr. Cr.

Expenditure	Rs.	Income	Rs.
		By interest on General Fund Investments	4,000

BALANCE SHEET

AS ON 31ST DECEMBER, 1998

Liabilities		Amount Rs.	Assets	Amount Rs.
Sports Fund	10,000		Sports Fund Investments	10,000
Add Interests on			General Fund Investments	30,000
Sports Fund Investments	1,000			
Sports Fund Donations	4,000			
	15,000			
Less Sports Prizes awarded	3,000			
	12,000			
Less Expenses on Sports events	1,000	11,000		
General Fund		30,000		

13.5 PREPARATION OF INCOME AND EXPENDITURE ACCOUNT

The practical steps involved in the preparation of an Income and Expenditure Account from the Receipts and Payments Account are as under:

Step I	Ignore opening and closing cash/bank balances appearing in the Receipts and Payments Account.
Step II	Eliminate all items of capital receipts and payments.
Step III	Ascertain the revenue income of the relevant period by excluding from the total receipts, the income received on account of previous and future years. Then add income accrued in the year but not received.
Step IV	Make adjustments as per additional information such as depreciation, bad debts, etc., if any,
Step V	Calculate the difference between the total of debit side and the total of credit side. If the total of credit side exceeds the total of debit side, show the excess of income over expenditure (surplus) on the debit side. If the total of debit side exceeds the total of credit side, the excess of expenditure over income (deficit) on the credit side of Income and Expenditure Account.

If surplus add it to the Capital Fund and if deficit deduct from Capital Fund in the Balance Sheet.

Illustration: From the following details and notes attached relating to the Haryana Tennis Club, prepare the final accounts of the year ended 31st December 1998.

On January 1998 the club's assets are:

Freehold Club house Rs. 20,000; Equipment Rs. 1,400; club subscription in arrear Rs. 160; The club owed Rs. 800 to a firm for Christmas 1997 dance catering.

SUMMARY OF RECEIPT AND PAYMENTS FOR 1998

Receipts	Rs.	Payments	Rs.
To Cash in hand	1,520	By Catering-1997 dance	800
To Subscriptions	3,280	By 1998-dances and socials	1,900
To Locker Rent	200	By Band fees-1998 dances	500
To Receipts from dances and socials	2,780	By New lawn-mover	1,060
To Sale of used match tennis balls	300	By Repairs to tennis nets	380
To Sale of old lawn-mover	160	By Match tennis balls	620
		By Match expenses	340
		By Repairs and decoration of club house	1,300
		By Balance c/d	1,340
	8,240		8,240

Notes

(i) The book value on 1 January 1998 of the old lawn mover sold during the year was Rs. 60.

(ii) The club has 40 members and the subscription is Rs.80 each per annum. The subscriptions received in 1998 included those in arrear for 1997.

(iii) On 31 December, 1998 Rs. 220 was owed to Playfair Ltd. for tennis balls supplied.

(iv) Equipment as at 31 December 1998 to be depreciated by 15% p. a.

v) Tennis balls are regarded as revenue expenditure.

Solution

INCOME AND EXPENDITURE ACCOUNT

FOR THE YEAR ENDING ON 31 DECEMBER 1998

Expenditure		Rs.	Income		Rs.
To Band fees		500	By Subscriptions	3,280	
To Repairs to tennis nets		380	Less: Outstanding(1997)	160	
To Tennis balls	620			3,120	
Add: Outstanding	220	840	Add: Outstanding (1998)	80	3,200
To Match expenses		340	By Locker rents		200
To Repairs and decorations		1,300	By Receipts from dance	2,780	
To Depreciation on Equipment			Less: Expenses	1,900	880
(15% of 2,400)		360	By Sale of used match tennis balls		300
To Excess of income over expenditure		960	By Profit on sale of lawn mover		100
		4,680			4,680

BALANCE SHEET

AS ON 1.1.1990

Owing for catering	800	Cash in hand	1,520
Capital Fund (Balancing figure)	22,280	Equipment	1,400
		Freehold club house	20,000
		Subscriptions in arrear	160
	23,080		23,080

BALANCE SHEET
AS ON 31 DECEMBER 1998

Owing for Tenis balls		220	Cash in hand		1,340
Capital Fund	22,280		Equipment	2,400	
Add: Surplus	960	23,240	Less: Depreciation	360	2,040
			Freehold club house		20,000
			Subscriptions in arrear		80
		23,460			23,460

Notes

(i) Equipment includes lawn mover.

(ii) Since there are 40 members each paying Rs. 80 as yearly subscription, the club ought to have received Rs. 3,200 as total subscriptions. Hence, Rs. 80 are outstanding for subscription.

13.6 PREPARATION OF RECEIPTS AND PAYMENTS ACCOUNT FROM INCOME AND EXPENDITURE ACCOUNT

The practical steps involved in the preparation of a Receipts and Payments Account from an Income and Expenditure Account are:

Step I Put the 'opening balances' of cash/bank as the first item on the 'Receipts side' and 'closing balances' of cash/bank as the last item on the 'Payments side' of the Receipts and Payments Account.

If one of the two balances are given, the other balance will have to be ascertained.

Step II Ascertain 'Revenue Receipts' received during the current accounting period as under and show it on the receipts side of Receipts and Payments Account:

Revenue Income (account-wise) for the current year as per Income and Expenditure Account.

Add Income received in advance at the end of current year.

Add Income outstanding in the beginning of current year.

Less Income outstanding at the end of current year.

Less Income received in advance in the beginning of the current year.

Step III Ascertain 'Revenue Payments' made during the current accounting period as under and show it on the payments side of Receipts and Payments Account:

Revenue expenses (account-wise) for the current year as per Income and Expenditure Account

Add Expenses outstanding in the beginning of current year.

Add Expenses prepaid at the end of current year.

Less Expenses outstanding at the end of current year.

Less Expenses prepaid in the beginning of current year.

Step IV Ascertain all capital receipts and capital payments from the additional information or Balance Sheets or by preparing the accounts of capital items and show the capital receipts on the 'Receipts side' and the capital payments on the 'Payments side' of the Receipts and Payments Account.

Illustration: The Income and Expenditure Account of Star Club is as follows:

INCOME AND EXPENDITURE ACCOUNT

FOR THE YEAR ENDED 31ST DECEMBER, 1997

Dr. Cr.

Expenditure	Rs.	Income	Rs.
To Salaries	1,400	By Subscriptions	1,600
To General expenses	400	By Donations	840
To Depreciation	240		
To Surplus	400		
	2,440		2,440

The Secretary of the Club informs you that the above account was prepared after making the following adjustments:

(i) Subscriptions were outstanding on 1st January 1997 (for 1996) Rs. 160 out of which Rs. 144 were received in 1997.

(ii) As on 1st January 1997 subscriptions received in advance amounted to Rs. 40, whereas on 31st December 1997 subscriptions received in advance Rs. 32. Also Rs. 56 worth subscriptions (for 1997) were outstanding as on Dec. 31, 1997.

(iii) General Expenses were outstanding on 1st January 1997 Rs. 64 and on 31st December 1997 Rs. 72. Prepaid expenses amounted to Rs. 88 in the beginning and at close Rs. 144.

(iv) Sundry assets as on 1st January 1997 Rs. 2,080 and after providing depreciation for the year 1997 the value of sundry assets was Rs. 2,160.

(v) Cash in hand on 31st December 1997 was Rs. 480.

You are required to prepare Receipts and Payments Account.

Solution

RECEIPTS AND PAYMENTS ACCOUNT

FOR THE YEAR ENDED 31ST DECEMBER, 1997

Dr. Cr.

Receipts	Rs.	Payments	Rs.
To Cash Balance b/d (1)	128	By Salaries	1,400
To Donations	840	By General expenses (2)	448
To Subscriptions (3)	1,680	By Sundry assets (4)	320
		By Cash Balance c/d	480
	2,648		2,648

Working Notes

1. Opening cash balance is the balancing figure of the Receipts and Payments Account.

2. Actual amount paid in respect of general expenses has been arrived at as follows:

		Rs.
Expenses as per Income and Expenditure Account	400	
Add outstanding in the beginning i.e. as on 1.1.1997 (paid for 1996)	64	
Add prepaid at the end i.e. as on 31.12.1997 (paid for 1998)	144	
		608
Less outstanding at the end i.e. as on 31.12.1997 (unpaid)	72	
Less prepaid in the beginning i.e. as on 1.1.1997 (paid in 1996)	88	160
General expenses-actual cash paid		448

3. Actual amount received in respect of subscriptions has been arrived at as follows:

		Rs.
Subscriptions as per Income and Expenditure Account	1,600	
Add received in advance as on 31-12-97	32	
Add Received on account of 1996 (outstanding total 160 but received only 144)	144	
		1,776
Less Outstanding at the end (i.e. not received)	56	
Less Received in 1996 for 1997 (Received in advance)	40	96
Subscriptions-actual cash received		Rs.1,680

4. Amount spent for the purchase of sundry assets has been arrived at as follows:

		Rs.
Sundry assets as on 31-12-97	2,160	
Add Depreciation charged as per Income and Expenditure Account	240	
		2,400
Less Sundry assets as on 1.1.1997		2,080
Sundry assets purchased during 1997		320

Illustration: The Income and Expenditure Account of Yogi's Club for the year 1998 is as follows:

Expenditure		Rs.	Income		Rs.
To Salaries and wages		9,500	By Subscriptions		15,000
To Misc. expenses		1,000	By Entrance fees received		500
To Audit fees		500	By Profit on annual sports meet:		
To Chief executive's honorarium		2,000	Receipts	3,000	
To printing & Stationery		900	Expenses	1,500	1,500
To Annual day celebration					
Expenses	3,000				
Less donations	2,000	1,000			
To Interest on bank loan		300			
To Depreciation on sports equipment		600			
To Excess of income over expenditure		1,200			
		17,000			17,000

Prepare (i) Receipts and Payments Account for the year 1998 and (ii) Balance Sheet as at the end of 1998 from the following information:

(i)	Subscriptions: Outstanding as on 31-12-1997	1,200
	Received in advance as on 31-12-1998	900
	Received in advances as on 31-12-1998	540
	Outstanding as on 31-12-1998	1,500
(ii)	Salaries: Outstanding as on 31-12-1997	800
	Outstanding as on 31-12-1998	900

(iii) Audit fees: The fees for 1998 were outstanding on 31-12-1998. But during 1998, audit fees for 1997 amounting to Rs. 400 were paid.

(iv) Prepaid insurance as on 31-12-1998 was Rs. 120.

(v) The club had owned grounds having a book value of Rs. 20,000. The sports equipment as on 31-12-1997 and as on 31-12-1998 after depreciation amounted to Rs. 5,200 and Rs. 5,400 respectively.

(vi) In 1997 the club had raised a bank loan of Rs. 4,000 which was outstanding throughout 1998.

(vii) On 31st December 1998 cash in hand amounted to Rs. 3,200.

Solution

YOGI'S CLUB

RECEIPTS AND PAYMENTS ACCOUNT

FOR THE YEAR ENDED 31-12-1998

	Rs.		Rs.
To Cash Balance b/d (Balancing figure) (1)	2,780	By Salaries and wages (3)	9,400
		By Misc. expenses (including insurance) (4)	1,120
To Subscriptions (2)	14,340	By Audit fees	400
To Entrance fees receipts	500	By Chief executive's remuneration	2,000
To Annual sports meet receipts	3,000	By Printing and stationery	900
To Annual day celebrations donations	2,000	By Annual day celebration expenses	3,000
		By Interest on bank loan	300
		By Annual sports meet expenses	1,300
		By Sports equipment (5)	800
		By Cash Balance c/d	3,200
	22,620		22,620

BALANCE SHEET

AS ON DECEMBER 31, 1998

		Rs.			Rs.
Salaries outstanding		900	Sports grounds		20,000
Audit fees outstanding		500	Sports equipment	5,200	
Subscription received in advance		540	*Add* Purchases	800	
Bank loan		4,000		6,000	
Capital funds as on			*Less* Depreciation	600	5,400
1-1-1998 (6)	23,080		Subscription outstanding		1,500
Add excess of income			Prepaid insurance		120
over expenditure	1,200	24,280	Cash in hand		3,200
		30,220			30,220

Working Notes

1. Cash Balance (Opening): This is the balancing figure of the Receipts and Payments Account.
2. Subscriptions received:

		Rs.
Subscriptions income as per Income and Expenditure Account		15,000
Add Subscription received in advance		540
Add Subscriptions outstanding (at the beginning)		1,200
		16,740
Less Subscriptions outstanding	1,500	
Less Subscriptions received in advance	900	2,400
		14,340

3. Salaries and wages:

As per Income and Expenditure Account	9,500
Add Outstanding (beginning) paid in 1998 for 1997	800

	10,300
Less Outstanding not paid in 1998	900
	9,400

4. Misc. expenses:

As per Income and Expenditure Account	1,000
Add Paid in 1998 for 1999	120
	1,120

5. Sports equipment:

Value of sports equipment at the end (31-12-1998)	5,400
Add Depreciation	600
	6,000
Less Value of sports equipment in the beginning	5,200
Excess representing purchase of equipment during the year	800

6. Capital Fund as on 1-1-1998

BALANCE SHEET

AS ON 1-1-1998

	Rs.		Rs.
Bank loan	4,000	Cash	2,780
Advance subscription	900	Grounds	20,000
Salaries outstanding	800	Sports equipment	5,200
Audit fee outstanding	400	Subscriptions outstanding	1,200
Capital Fund (balancing figure)	23,080		
	29,180		29,180

13.7 SUMMARY

Non-profit making organizations include such voluntary associations of persons as are formed for the purpose of providing recreational facilities to its members or to promote art, culture, education, commerce, science, religion and other social and charitable purposes. At the end of accounting period, a non-profit making organisation also prepare its final accounts, which include namely (i) Receipts and Payments Account; (ii) Income and Expenditure Account; (iii) Balance Sheet. Receipts and Payments Account is a summary of cash transactions for a given period. All the receipts are entered on the debit side and all the payments are shown on credit side. At the end of accounting period, this account is balanced to ascertain the balance of cash in hand or at the bank or the overspent amount or bank overdraft. Income and Expenditure account of non-trading institutions equivalent to the Profit & Loss Account of the business concerns. It shows the classified summary of incomes, expenses and losses for current accounting period along with the excess of income over expenditure (i.e. Surplus) or excess of expenditure over income (i.e. deficit). The surplus or deficit is being transferred to capital fund in the Balance Sheet. Balance Sheet of a non-profit making organisation is prepared in the usual way and contains all assets on right-hand side and liabilities on left-hand side.

13.8 KEYWORDS

Assets: Tangible objects or intangible rights owned by an enterprise.

Revenue Expenditure: A cost relating to the operations of an accounting period or benefits of which do not extend beyond that period.

Social Cost: The cost or loss to society resulting from the operations of an enterprise.

Social Benefit: The benefits or income of society resulting from the operations of an enterprise.

Legacy: Refers to the amount which one gets on account of a will.

Endowment Fund: The fund arising from a bequest or gift is known as endowment fund. The endowment fund is a capital receipt.

13.9 SELF ASSESSMENT QUESTIONS

1. What is Receipts and Payments Account? What are its features?

2. What is an Income and Expenditure Account? Who prepares it and why?

3. Distinguish between Receipts and Payments Account and Income and Expenditure Account. What steps are required for converting (a) Receipts and Payments Account into Income and Expenditure Account and (b) Income and Expenditure Account into Receipts and Payments Account.

4. Explain the meaning of the following terms and show how will you deal with them while preparing final accounts of a club. Support your answers with suitable examples.

   (a) Donations, (b) Entrance fee, (c) Life membership fee, (d) Receipts for a sports fund and (e) Legacy

5. The following is the Receipts and Payments Account of Hisar Football Association for the first year ending 31 December 1997:

RECEIPTS AND PAYMENTS ACCOUNT

Dr. Cr.

	Rs.		Rs.
Donation	50,000	Pavilion offices (constructed)	40,000
Reserve Fund (Life membership fees and		Expenses in connection with matches	900
entrance fees received)	4,000	Furniture	2,100
Receipts from football matches	8,000	Investment at cost	16,000
Revenue Receipts		**Revenue Payments**	
Subscriptions	5,200	Salaries	1,800
Locker Rents	50	Wages	600
Interest on Securities	240	Insurance	350
Sundries	350	Telephone	250
		Electricity	110
		Sundry expenses	210
		Balance on hand	5,520
	67,840		67,840

Additional Information

(i) Subscriptions outstanding for 1997 are Rs. 250

(ii) Salaries unpaid for 1997 are Rs. 170

(iii) Wages unpaid for 1997 are 90.

(iv) Outstanding Bill for sundry expenses are Rs. 40

(v) Donations received have to be capitalised.

Prepare from the details given above, an Income and Expenditure Account for the year ended 31.12.1997 and the Balance Sheet on the Association as on 31.12.1997

6. The following particulars relate to the Delhi Sports Club:

INCOME AND EXPENDITURE ACCOUNT

FOR THE YEAR ENDED 31ST MARCH, 1998

Expenditure	Rs.	Income	Rs.
To Salaries	15,000	By Entrance fee	1,05,000
To Printing & Stationery	22,000	By Subscriptions	1,56,000
To Advertising	16,000	By Rent	40,00
To Audit Fee	5,000		
To Fire Insurance	10,000		
To Depreciation on sports equipment	90,000		
To Excess of income over expenditure	1,43,00		
	3,01,000		3,01,000

RECEIPTS AND PAYMENTS ACCOUNT

FOR THE YEAR ENDED 31ST MARCH 1998

Receipts	Rs.	Payments	Rs.
To Balance b/f	42,000	By Salaries	10,000
To Entrance fee	1,05,000	By Printing & Stationery	26,000
To Subscriptions		By Advertising	16,000
1996-97	6,000	By Fire insurance	12,000
1997-98	1,50,000	By Investment	2,00,000
1998-99	4,000	By Balance c/f	78,000
To Rent	35,000		
	3,42,000		3,42,000

The assets on 1st April, 1997 included club grounds and pavilions Rs. 4,40,000; sports equipment Rs. 2,50,000; and furniture and fixtures Rs. 40,000. Subscriptions in arrears on that date were Rs. 8,000. Prepare the Balance Sheet as on 31st March, 1998.

7. The Income and Expenditure Account of Sunday Samsad of the year 1998 is as follows:

Expenditure	Rs.	Income	Rs.
To Salaries	9,500	By Subscription	15,000
To General Expenses	1,000	By Entrance Fee	500

To Audit Fee	500	By Contribution to Annual Dinner	2,000
To Secretaries Honorarium	1,500	By Surplus of Annual sports meet	1,000
To Printing & Stationary	900		
To Annual Dinner expenses	3,000		
To Bank charges	300		
To Depreciation	600		
To Excess of Income over Expenditure	1,200		
	18,500		18,500

This Account had been prepared after the following adjustments:

Subscription outstanding at the end of 1997	Rs. 1,200
Subscription received in advance on 31.12.97	Rs. 900
Subscription outstanding on 31.12.98	Rs. 1,500
Subscription received in advance on 31.12.98	Rs. 540

Salaries outstanding at the beginning of 1998 and at the end of 1998 were Rs. 800 and Rs. 900 respectively. General expenses include Insurance prepaid to the extent of Rs. 120. Audit fee for 1998 is as yet unpaid. During 1998 Audit fee for 1997 was paid amounting to Rs. 4,000. This was outstanding throughout 1998. On 31.12.98, Cash in hand was Rs. 3200.

Prepare the Receipts and Payments Account for the year 1998 and Balance Sheet as on 31.12.98.

13.10 REFERENCES/SUGGESTED READINGS

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