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JAMMU

SELF LEARNING MATERIAL
PGDBM - IST SEMESTER

PAPER : III **UNIT : I - V**

SUBJECT : FINANCIAL ACCOUNTING

Course Co-ordinator
Rohini Gupta Suri
(94191-86716)

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FINANCIAL ACCOUNTING

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Course Title : Financial Accounting **Total Marks : 100**

Paper : III **Internal Assessment : 20**

Duration of Examination : 3 hrs. **Semester Examination : 80**

Objectives : The course has been outlined with a purpose to enable students to understand accounting concepts, tools and techniques for taking managerial decisions.

UNIT–I

Introduction, Meaning of Accountancy, Difference between Book-Keeping and Accounting, Accounting Process, Objectives for accounting, Limitations of Accounting, Basic terminologies in accounting.

Accounting Concepts, conventions and Principles : Double Entry Accounting Introduction, Meaning of double entry accounting, Classification of accounts in relation to Rules of debit and credit : Accounting equation.

UNIT–II

Journal and its characteristics, analysing business transactions and passing entries in a journal. Posting entries into Ledger and significance of Ledger balances. Difference between Journal and Ledger : Preparation of Trail Balance.

UNIT–III

Working Capital Management : Nature of working capital : Need for working capital : Factors affecting Working Capital Requirement : Estimation of working capital requirement : Financing working capital requirement.

UNIT–IV

Classification of Receipts and Expenditure into capital and revenue : Contents of Trading and Profit and Loss account. Closing entries of trading account. Preparation of profit and loss account.

UNIT–V

Classification and arrangements of assets and liabilities in balance sheet - grouping and marshalling : Distinction between trail balance and balance sheet. Preparation of balance sheet with elementary level adjustments and raationale behind adjustments.

Note for Paper Setter :

The question paper shall contain two questions from each Unit (Total 10 Questions) and the candidates shall be required to answer one question from each unit (total number of questions to be attempted shall be five. i.e. there shall be internal choice within each unit)

SUGGESTED READINGS

1. C.M. Juneja, J.S. Arora, R.C. Chawla. Elements of Book-Keeping. Kalyani Publishers : Eighteenth edition (2013)
2. Grewal, T.S. Introduction to Accounting S. Chand & Company, New Delhi.
3. Narayanaswaamy. R. Financial Accounting - A Managerial Prespective, Prentice Hall of India. New Delhi.
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5. Maheswari & Maheswari, Accounting for Managers, Vikas Publishing, New Delhi.
6. Anthony, Robert N. et. al. Accounting : Text and cases, Tata McGraw Hill, New Delhi.
7. Bhattacharya, Ashish K. Financial Accounting for Business Managers, Prentice Hall of India.
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OBJECTIVES

After going through this lesson, you will be able to understand:

- the concept of accounting, book keeping & accountancy along with branches of accounting.
- the accounting information, users & qualitative characteristics of accounting information & the systems of accounting.
- various accounting terms which are commonly used in accounts.
- meaning, nature & necessity of accounting principles
- fundaments accounting assumptions or concepts & principles
- meaning of an account, classification & balancing an account
- meaning of debit and credit, rules & significance of debit & credit balance in accounts.
- meaning of accounting equation.
- effect of transactions on an accounting equation.

STRUCTURE

1.1 Meaning and Characteristics of Accounting

1.2 Accounting Process

1.3 Branches of Accounting

1.4 Book Keeping, Accounting and Accountancy

1.5 Objectives, Functions, Advantages & Limitations of Accounting.

1.6 Accounting Information, its Users & Qualitative Characteristics

1.7 Systems of Accounting

1.1 MEANING AND CHARACTERISTICS OF ACCOUNTING

Accounting is primarily concerned with recording of financial transactions, summarising them and communicating financial information to the users. The users of financial information are proprietors, creditors, debtors, investors, government agencies, employees, etc. Since accounting is a medium of communication, it is called the language of business.

"Accounting is the art of recording, classifying and summarising in a significant manner and in terms of money, transactions and events which are, in part at least, of a financial character, and interpreting the results thereof."

-American Institute of Certified Public Accountants

"Accounting is the science of recording and classifying business transactions and events, primarily of a financial character, and the art of making significant summaries, analysis and interpretations of those transactions and events and communicating the results to persons who must make decisions or form judgment."

-Smith and Ashburne

"Accounting is the process of identifying, measuring and communicating

economic information to permit informed judgments and decisions by users of the information."

-American Accounting Association

In simple words, accounting is the process of collecting, recording, summarising and communicating financial information to the users for decision-making.

ATTRIBUTES (CHARACTERISTICS) OF ACCOUNTING

The definitions of accounting bring to light the following attributes of accounting:

1. Identification of Financial Transactions and Events: Accounting records only those transactions and events which are of financial nature as they bring change in the resources of a firm. The process involves identifying transactions that are of financial nature. For example, purchase of raw material or sale of finished goods by a firm. These transactions are identified with the help of bills and receipts as evidence of the transactions.

2. *Measuring the Identified Transactions:* Accounting measures the transactions and events in terms of a common measurement unit, i.e., the currency of the country. In other words, financial transactions and events are measured in terms of money. For example, purchase of goods, say 10 tonnes of steel for Rs. 2,50,000 and 1,000 bags of cement for Rs. 2,75,000 is measured in terms of money, i.e., Rs. 5,25,000.

3. Recording: Accounting is an art of recording business transactions in the books of accounts. Recording is the process of recording business transactions of financial character in the book of original entry, i.e., Journal. This book is further sub-divided into subsidiary books such as Cash Journal or Cash Book (for recording cash transactions), Purchases Journal or Purchases Book (for recording credit purchases of goods), Sales Book (for recording credit sales), etc.

4. Classifying: Accounting is an art of classifying business transactions. Classification is the process of collecting similar transactions at one place by opening accounts in the Ledger Book. The transactions recorded in the 'Journal' or the subsidiary books are classified or posted to the main book of account known as Ledger. This book contains individual account heads under which all financial transactions of a similar nature are collected. For example, in Rahul's account in the Ledger, all business transactions connected with Rahul are posted so that what is ultimately due to Rahul or due from Rahul can be ascertained.

5. Summarising: Accounting is an art of summarising financial transactions. This involves presenting the classified data in a manner which is understandable and useful to internal as well as external users of accounting statements. This process leads to the preparation of the following statements:

(i) Trial Balance, (ii) Trading and Profit and Loss Account or Statement of Profit and Loss (in case of companies), and (iii) Balance Sheet.

Trading Account, Profit and Loss Account or Statement of Profit and Loss (in case of companies) and Balance Sheet are collectively known as **Final Accounts** or **Financial Statements.**

6. Analysis and Interpretation: Financial data is analysed and interpreted so that the users of financial data can make a meaningful judgment of the financial performance (profit) and financial position of the business. Analysis helps in planning for the future in a better way.

7. Communicating: Finally, accounting function involves communicating the financial data, i.e., financial statements to its users. The accounting information must be provided in time and presented to the users so that decisions are taken at the appropriate time.

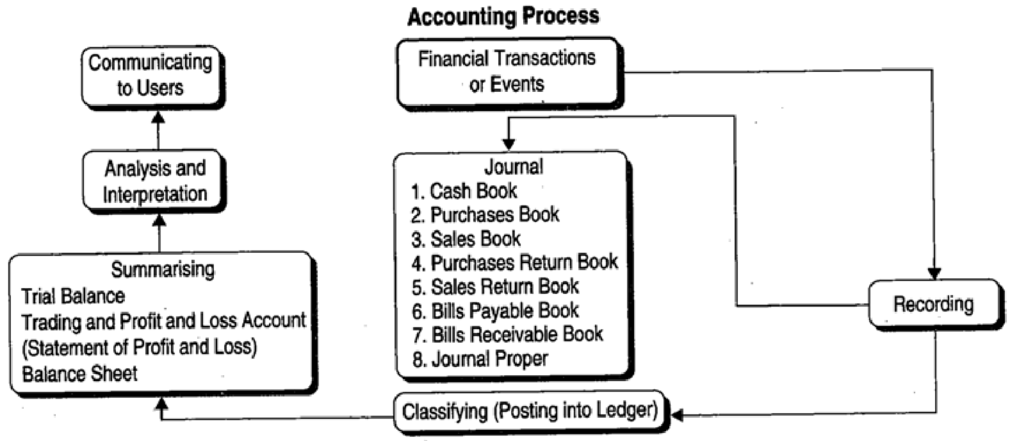
IS ACCOUNTING A SCIENCE OR AN ART?

Accounting is an Art as well as a Science. Art is the technique which helps us to achieve our desired objectives. Accounting is an art of recording, classifying and summarising financial transactions. It helps us in knowing the profitability and financial position of the business.

Any organised knowledge based on certain basic principles is a 'science'. Accounting is also a science as it is an organised knowledge based on, certain basic principles.

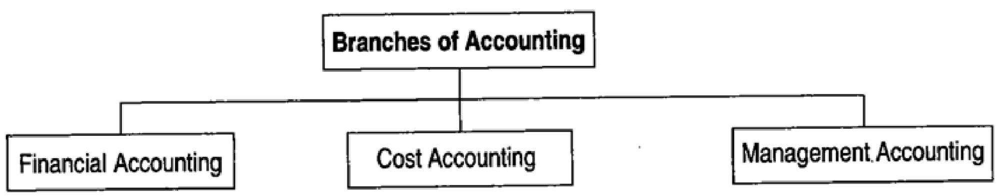
1.2 ACCOUNTING PROCESS

Based on the attributes of accounting, the steps of accounting process are as follows: (i) Financial Transactions, (ii) Recording, (iii) Classifying, (iv) Summarising, (v) Analysing and Interpreting and (vi) Communicating. The accounting process may be explained with the help of a diagram:



1.3 BRANCHES OF ACCOUNTING

The changing business scenario through centuries has given rise to specialised branches of accounting which could cater to the changing requirements. These branches are:



Financial Accounting

Financial Accounting is that branch of accounting which records financial transactions and events, summarises and interprets them and communicates the results to the users. It ascertains profit earned or loss incurred during an accounting period (usually a year) and the financial position on the date when the accounting period ends. The end-product of Financial Accounting is the Profit and Loss Account for the period ended (which shows the profit earned or loss incurred) and the Balance Sheet as on the last day of the accounting period (which shows the financial position). In short, Financial Accounting is mainly confined to the preparation of financial statements, i.e., the Profit and Loss Account and the Balance Sheet, for the users of accounting information.

Cost Accounting

The limitation of Financial Accounting in respect of information relating to the cost of products or services led to the development of a specialised branch, i.e., Cost Accounting. It ascertains the cost of products manufactured or services rendered and helps the management in decision-making (say price fixation) and exercising controls.

Management Accounting

Management Accounting is the most recently developed branch of accounting. It is concerned with generating accounting information relating to funds, costs, profits, etc., as it enables the management in decision-making. We may say that Management Accounting addresses the needs of a single user group, i.e., the management.

1.4 BOOK KEEPING, ACCOUNTING AND ACCOUNTANCY

The terms 'Book Keeping' and 'Accounting' are often considered as same. But it is not so. The two terms are distinct from each other. Accounting is a wider concept and includes Book Keeping.

Meaning of Book Keeping

Book Keeping is a part of accounting being a process of recording of financial transactions and events in the books of accounts. Thus, Book Keeping involves:

1. Identifying financial transactions and events,
2. Measuring them in terms of money,
3. Recording the identified financial transactions and events in the books of accounts, and
4. Classifying recorded transactions and events, i.e., posting them into Ledger accounts.

Definitions of Book Keeping

"Book Keeping is an art of recording in the books of accounts the monetary aspect of commercial and financial transactions."

-Northcott

"Book Keeping is an art of recording business dealings in a set of books."

-J.R. Batliboi

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

-R.N. Carter

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

-A.N. Rosen Kampff

Accounting

Accounting is an art of recording, classifying and summarising the financial data and interpreting the results thereof. Accounting is a wider concept than Book Keeping. It starts where Book Keeping ends. In other words, Book Keeping is a part of accounting.

DIFFERENCE BETWEEN BOOK KEEPING AND ACCOUNTING

Basis	Book Keeping	Accounting
1. Scope	Book keeping is concerned with identifying financial transactions, measuring them in money terms, recording them in the books of accounts and classifying them.	Accounting is concerned with summarising the recorded transactions, interpreting them and communicating the results.
2. Stage	It is a primary stage. It is the basis for accounting.	It is a secondary stage. It begins where book keeping ends.
3. Objective	The objective of book keeping is to maintain systematic records of financial transactions.	The objective of accounting is to ascertain net results of operations and financial position and to communicate information to the interested parties.
4. Nature of job	This job is routine in nature.	This job is analytical and dynamic in nature.
5. Performance	Junior staff performs this function.	Senior staff performs this function.
6. Special skills	Book keeping is mechanical in nature and, thus, does not require special skills.	Accounting requires special skills and ability to analyse and interpret.

Accountancy

Accountancy is a systematic knowledge of accounting. It explains how to deal with various aspects of accounting. It educates us how to maintain the books of accounts and how to summarise the accounting information and communicate it to the users. In the words of Kohler, accountancy refers to the entire body of the theory and practice of accounting.

Accounting and Accountancy

Accountancy is an area of knowledge whereas accounting is the action or process used in this area. Accounting depends on the rules and principles framed by accountancy but accountancy does not depend on accounting. Thus, it may be said that accountancy is knowledge of accounting and accounting is the application of accountancy.

1.5 OBJECTIVES, FUNCTIONS, ADVANTAGES & LIMITATIONS OF ACCOUNTING

OBJECTIVES OF ACCOUNTING

The objectives of accounting are:

1. Record of Financial Transactions and Events: The objective of accounting is to record financial transactions and events of the organisation in the books of accounts by following the principles of accounting in a systematic manner.

2. Determine Profit or Loss: Another objective of accounting is to determine the financial performance, i.e., profit earned or loss incurred, for the accounting period. Income Statement or Trading and Profit and Loss Account or Statement of Profit and Loss (by companies) prepared at the end of the accounting year shows the profit earned or loss incurred during the accounting year.

3. Determine Financial Position: Another objective of accounting is to determine financial position. It is known from the Balance Sheet. Financial position of the business is as relevant for the users of financial statements as is the Income Statement.

4. Assisting the Management: Another objective of accounting is to assist the management by providing financial information to it. The management often requires financial information for decision-making, exercising control, budgeting and forecasting.

5. Communicating Accounting Information to Users: Another objective of accounting is to provide accounting information to users who analyse them as per their individual requirements.

6. Protecting Business Assets: Another objective of accounting is to have records of assets owned by the business. Accounting maintains record of assets owned by the business which enables the management to protect them and exercise control.

FUNCTIONS OF ACCOUNTING

The functions of accounting are:

1. Maintaining Systematic Accounting Records: The primary function of accounting is to maintain systematic accounting records of financial transactions and events. It means that the accounting records should be maintained following the accounting principles and concepts. In other words, the function of Book Keeping is the primary function of accounting. It is so because reliable financial statements can be drawn if Book Keeping is proper. The process of Book Keeping involves recording financial transactions and events in the books of accounts and classifying the recorded transactions. The transactions having been classified, Trial Balance can be drawn to prepare financial statements, i.e., Income Statement and Position Statement.

2. Preparation of Financial Statements: Financial statements means final accounts prepared at the end of the accounting period. It includes Income Statement (Profit and Loss Account or Statement of Profit and Loss, in the case of companies) and Position Statement (Balance Sheet). It is an important function of accounting because the financial statements show the financial performance, i.e., profit earned or loss incurred during the accounting year and the financial position, i.e., Balance Sheet as at the end of the accounting year. Both the statements are important for all the users because users make decisions on the basis of these statements.

3. Meeting Legal Requirements: Accounting records are accepted as evidence by the court of law if they are maintained systematically following the accounting principles and concepts. Besides, the law such as the Companies Act, Income Tax Act, VAT Act, etc., require submissions of returns in the form and period as is prescribed in the law. The returns can be prepared if the accounting records are maintained systematically and timely. Besides, the returns so submitted may have to be proved correct before the authorities. A systematic accounting record maintained following the accounting principles and concepts is accepted by the authorities to be correct. Thus, it is a function of accounting to meet the legal requirements.

4. Communicating the Financial Data: It is yet another function of accounting to communicate the financial data to the users, which may be internal users or external users, such as management, banks, employees, government authorities, etc.

5. ***Assistance to Management:*** Management often requires information beyond the information conveyed by the financial data. Accounting records should be maintained in such a manner that the information sought by the management is available, which in turn helps in decision-making. For example, financial statements do not show since when the amount is due from debtors. It is the function of accounting to make such information available to the management. Similarly, accounting record should be maintained in such a manner that the assets owned are known. It will assist the management in protecting the assets and also exercising control.

ADVANTAGES OF ACCOUNTING

1. ***Financial Information about Business:*** Financial performance during the accounting period, i.e., profit or loss and also the financial position at the end of the accounting period is known through accounting.

2. ***Assistance to Management:*** The management makes business plans, takes decisions and exercises control over the affairs on the basis of accounting information.

3. ***Replaces Memory:*** A systematic and timely recording of transactions obviates the necessity to remember transactions. The accounting record provides the necessary information.

4. ***Facilitates Comparative Study:*** A systematic record enables a businessman to compare one year's results with those of other years and locate significant factors leading to change, if any.

5. ***Facilitates Settlement of Tax Liabilities:*** A systematic accounting record immensely helps in settlement of income tax, sales tax, VAT and excise duty liabilities, since it is a good evidence of the correctness of transactions.

6. ***Facilitates Loans:*** Loan is granted by the banks and financial institutions on the basis of growth potential which is supported by the performance. Accounting makes available the information with respect to performance.

7. ***Evidence in Court:*** Systematic record of transactions is often accepted by the Courts as good evidence.

8. ***Facilitates Sale of Business:*** If someone desires to sell his business, the accounts maintained by him will enable the ascertainment of the proper purchase price.

9. Helps in Decision-making: Accounting helps in taking a large number of decisions like the amount to be withdrawn by proprietor, the price at which goods should be sold, etc.

LIMITATIONS OF ACCOUNTING

1. Accounting is not Fully Exact: Although most of the transactions are recorded on the basis of evidence such as sale or purchase or receipt of cash, yet some estimates are also made for ascertaining profit or loss. Examples of this are providing depreciation on the basis of estimated useful life of an asset, possible bad debts, the probable market price of the stock of goods, etc.

2. Accounting does not Indicate the Realisable Value: The Balance Sheet does not show the amount of cash which the firm may realise by the sale of all the assets. This is because many assets are not meant to be sold; they are meant for use and are shown at cost less depreciation that may have been written off.

3. Accounting Ignores the Qualitative Elements: Since accounting is confined to monetary matters only, qualitative elements like quality of staff, industrial relations and public relations are ignored.

4. Accounting Ignores the Effect of Price Level Changes: Accounting statements are prepared at historical cost. Money, as a measurement unit, changes in value. It does not remain stable. Unless price level changes are considered while preparing financial statements, accounting information will not show true financial results.

5. Accounting may Lead to Window Dressing: The term window dressing means manipulation of accounts so as to conceal vital facts and present the financial statements in such a way as to show better position than what it actually is. In this situation, income statement (i.e., Profit and Loss Account) fails to provide a true and fair view of the result of operations and the Balance Sheet fails to provide a true and fair view of the financial position of the enterprise.

1.6 ACCOUNTING INFORMATION, ITS USERS & QUALITATIVE CHARACTERISTICS

"Accounting is a service activity. Its function is to provide qualitative information, primarily financial in nature, about economic entities that is intended to be useful in making economic decisions."

-Accounting Principles Board

As an information system, accounting collects financial data, records it in the books of accounts, classifies and summarises it to produce financial information that is communicated to its users. Accounting begins with the identification of transactions of financial nature and ends with the preparation of financial statements (i.e., Income Statement and Balance Sheet). Each step in the process of accounting generates information. Generation of information is not an end in itself, it is a way to facilitate the communication of information to users of accounting information.

Types of Accounting Information

Accounting information refers to the financial statements generated through the process of Book Keeping, use of which helps the users to arrive at decisions. The financial statements so generated are the Income Statement, i.e., Profit and Loss Account and the Position Statement, i.e., Balance Sheet. The information made available by these statements can be categorised into the following:

1. Information Relating to Profit or Surplus;
2. Information Relating to Financial Position; and
3. Information about Cash Flow.

Let us now discuss these in detail.

1. Information Relating to Profit or Surplus: The Income Statement makes available the accounting information about the profit earned or loss incurred as a result of business operations or otherwise during an accounting period.

A firm prepares Trading Account, a part of the Profit and Loss Account, which provides information about Gross Profit or Gross Loss and Profit and Loss Account provides information about the Net Profit or Net Loss.

A company prepares Statement of Profit and Loss in the form prescribed in Schedule VI of the Companies Act, 1956.

A Not-For-Profit Organisation prepares Income and Expenditure Account instead of Profit and Loss Account because it carries on welfare or charitable activities and not business. The excess of income over expenditure is termed as 'Surplus' while excess of expenditure over income is termed as 'Deficit'.

2. Information Relating to Financial Position: The Position Statement, i.e., the Balance Sheet makes available the information about the financial position of the entity. The Position Statement provides information about the assets owned by the entity, amounts receivable and the cash and bank balance held by it. These are represented in the liabilities by the amounts owed by the entity towards loans, creditors and amounts payable. The difference between the two is represented by capital, i.e., amount due to owners. In the case of Not-For-Profit Organisation, difference between assets and liabilities is termed as 'General Fund'.

3. Information about Cash Flow: Cash Flow Statement is a statement that shows flow, both inflow and outflow of cash during a specific period. It is of immense use as many decisions such as payment of liabilities, payment of dividend and expansion of business, etc., are based on availability of cash.

USERS OF ACCOUNTING INFORMATION

Users of Accounting Information may be categorised into Internal Users and External Users.

Internal Users

(i) Owners: Owners contribute capital in the business and thus are exposed to maximum risk. Naturally, they are interested in knowing the profit earned or loss suffered by the business besides the safety of their capital. The financial statements give the information about profit or loss and financial position of the business.

(ii) Management: The management makes extensive use of accounting information to arrive at informed decisions such as determination of selling price, cost controls and reduction, investment into new projects, etc.

(iii) Employees and Workers: Employees and workers are entitled to bonus at the year-end, which is linked to the profit earned by an enterprise. Therefore, the employees and workers are interested in financial statements. Besides, the financial statements also reflect whether the enterprise has deposited its dues into the provident fund and employees state insurance, etc., or not.

External Users

(i) Banks and Financial Institutions: Banks and financial institutions are an essential part of any business as they provide loans to businesses. Naturally, they watch the performance of the business to know whether it is making progress as projected to ensure the safety and recovery of the loan advanced. They assess it by analysing the accounting information.

(ii) **Investors and Potential Investors:** Investment involves risk and also the investors do not have direct control over the business affairs. Therefore, they rely on the accounting information available to them and seek answers to questions such as-what is the earning capacity of the enterprise and how safe is their investment?

(iii) **Creditors:** Creditors are those parties who supply goods or services on credit. It is a common business practice that a large number of suppliers remain invested in credit sales. Before granting credit, creditors satisfy themselves about the credit-worthiness of the business. The financial statements help them immensely in making such an assessment.

(iv) **Government and its Authorities:** The government makes use of financial statements to compile national income accounts and other information. The information available to it enables it to take policy decisions. Government levies varied taxes such as excise duty, VAT, service tax and income tax. These government authorities assess correct tax dues after an analysis of the financial statements.

(v) **Researchers:** Researchers use accounting information in their research work.

(vi) **Consumers:** Consumers require accounting information for establishing good accounting control so that cost of production may be reduced with the resultant reduction in the prices of products they buy. Sometimes, prices of some products are fixed by the government, so it needs accounting information to fix fair prices so that consumers and producers are not exploited.

(vii) **Public:** They want to see the business running since it makes substantial contribution to the economy in many ways, e.g., employment of people, patronage to suppliers, etc. Thus, financial accounting provides useful financial information to various user groups for decision-making.

QUALITATIVE CHARACTERISTICS OF ACCOUNTING INFORMATION

Qualitative characteristics are attributes that make the accounting information useful to users. The qualitative characterstics are:

1. **Reliability:** Accounting information must be reliable. Reliability of information means it is verifiable, free from material error and bias.

2. **Relevance:** Accounting information must be relevant to the user. Information is relevant if it meets the needs of the users in decision-making.

3. **Understandability:** Understandability means that the information provided through the financial statements must be presented in a manner that the users are able to understand it.

4. **Comparability:** Comparability means that the users should be able to compare the accounting information of an enterprise of the period either with that of other periods, known as intra-firm comparison or with the accounting information of other enterprises, known as inter-firm comparison.

1.7 SYSTEMS OF ACCOUNTING

The systems of recording transactions in the books of accounts are two namely:

1. Double Entry System and 2. Single Entry System.

1. Double Entry System

Double Entry System of accounting is a system of accounting under which both, debit and credit, aspects of accounting are recorded. A transaction has two aspects-Debit and Credit and at the time of recording a transaction, it is recorded once on the debit side and again on the credit side, For example, at the time of cash purchases, goods are received and in return cash is paid. In the transaction, two aspects are involved, i.e., receiving goods and paying cash and under the Double Entry System, both these aspects are recorded. One part, i.e., the receipt of goods, is debited and the second part, i.e., payment of cash, is credited. In other words, if only two accounts are affected (as in the purchase of building for cash), one account, Building, is debited and the other account, Cash, is credited for the same amount. If more than two accounts are affected by a transaction, the sum of the debit entries must be equal to the sum of the credit entries. Thus, on any day, total amount debited is equal to the total amount credited.

Thus, we can define Double Entry System as: "The system which recognises and records both aspects of a transaction. The Double Entry System has proved to be a scientific and complete system of accounting."

Features of the Double Entry System

1. It maintains a complete record of each transaction.

2. It recognises two-fold aspect of every transaction, viz., the aspect of receiving (value in) and the aspect of giving (value out).

3. In this system, one aspect is debited and the other aspect is credited following the rules of debit and credit.

4. Since one aspect of a transaction is debited and the other is credited, the total of all debits is always equal to total of all credits. It helps in establishing arithmetical accuracy by preparing the Trial Balance.

Stages of Double Entry System

A complete system of double entry book keeping has following three stages:

1. Recording the transactions in the Journal.

2. Classifying transactions in the Journal by posting them to the appropriate ledger accounts and then preparing the Trial Balance.

3. Closing the books and preparing the final accounts.

All these stages shall be discussed one by one in succeeding chapters.

Advantages of the Double Entry System

The advantages of Double Entry System are:

(i) Scientific System: Double Entry System is a scientific system of recording business transactions as compared to other systems of Book Keeping. It helps attain the objectives of accounting.

(ii) Complete Record of Transactions: Under the system, both sides of a transaction are recorded. It is a complete record as it results in showing correct income or loss, assets and liabilities.

(iii) A Check on the Accuracy of Accounts: By the use of this system, accuracy of the accounting work can be established through the Trial Balance.

(iv) Determining Profit or Loss: Profit earned or loss incurred during a period can be determined by preparing Profit and Loss Account.

(v) Knowledge of Financial Position: Financial position of the firm or the institution can be ascertained at the end of each period by preparing the Balance Sheet.

(vi) Full Details for Purposes of Control: The system permits accounts to be maintained in as much detail as necessary and, therefore, provides significant information for purposes of control, etc.

(vii) Comparative Study is Possible: Results of one year may be compared with those of previous years and reasons for the change may be ascertained.

(viii) Helps Management in Decision-making: Management may be able to obtain good information for its work, especially in making decisions.

(ix) Frauds and Misappropriation: Frauds and misappropriation are minimized since complete information about all assets and liabilities is available.

It is because of these advantages that the Double Entry System has been used extensively in all countries.

2. Single Entry System

Single entry system of recording transactions in the books of accounts may be defined as an incomplete Double Entry System. In this system, all transactions are not recorded on double entry basis. As regards some transactions, both aspects of the transactions are recorded, as regards others, either one aspects is recorded or not recorded at all. Instead of maintaining all the accounts, only Personal Accounts and Cash Book are maintained under this system. The accounts maintained under this system are incomplete and unsystematic and, therefore, not reliable. The Single Entry System is also known as Accounts from Incomplete Records.

Since all transactions are not recorded under double entry principle, it is not possible to prepare a Trial Balance. As a result, the Profit and Loss Account and the Balance Sheet cannot be prepared.

1.8 ACCOUNTING TERMS

In business, various accounting terms are used. It is necessary to understand these terms as they are part of the standard accounting terminology.

1. BUSINESS TRANSACTION:

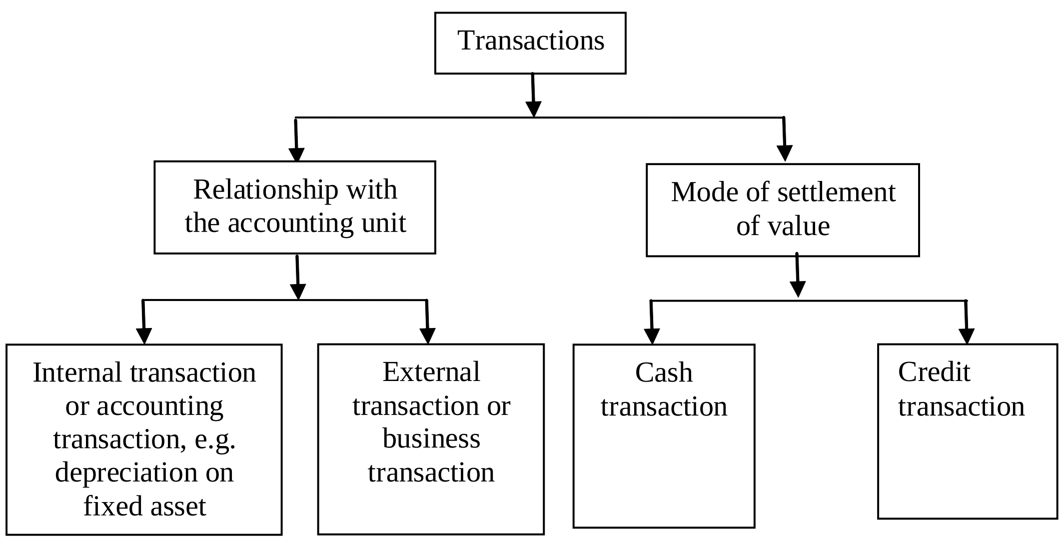
The term 'Business Transaction' means a financial transaction or event entered into by two parties and is recorded in the books of accounts. It is a financial event expressed in terms of money which brings a change in the financial position of an enterprise. It is an agreement between two parties involving the transfer or exchange of goods or services.

Examples of business transactions are sales of goods, purchases of goods, receipt from debtors, payment to creditors, purchase or sale of fixed assets, payment of interest, dividend, etc.

Characteristics of a Business Transaction

1. It is concerned with money or money's worth of goods or services.
2. It arises out of the transfer or exchange of goods or services.
3. It brings about a change in the financial position (i.e., in Assets and Liabilities).
4. It has an effect on the accounting equation.
5. It has dual aspect or two sides-'receiving' (Debit) and 'giving' (Credit)

A transaction may be a cash transaction or a credit transaction. When the amount is transacted immediately on entering into a transaction it is a cash transaction and when it is promised to pay later, it is a credit transaction. Transactions may be external (between a business entity and a second party, for example, goods sold on credit to Z) or internal (does not involve second party, e.g., depreciation charged on machinery).



2. ACCOUNT:

Account is a summarised record of transactions relating to a particular head at one place. It records not only the amount of transactions but also their effect and direction. For example, purchases of goods, whether cash or credit, are shown in 'Purchases Account'.

3. CAPITAL:

Capital is the amount invested by the proprietor or partner in the business. It may be in the form of money or assets having a monetary value. It is a liability of the business towards the proprietor or partner which increases with further investments made in the business and the amount of profit earned. On the other hand, it decreases when it is withdrawn (drawings) or loss is incurred by the business. In the case of companies, capital is contributed by many and they are known as **shareholders.** It is considered as a liability because under "Business Entity Concept", business is a separate and distinct entity from its owners. Transactions are recorded in the books of accounts from the point of view of business. Capital is also known as **Owner's Equity or Net Worth**. It is always equal to assets less liabilities. It can be expressed as:

Capital = Assets - Liabilities

4. DRAWINGS:

It is the amount withdrawn or goods taken by the proprietor or partner for personal use. Goods so taken by the proprietor or partner are valued at purchase cost. Drawings reduces the investment (or capital) of the owners. Drawings by the proprietor or partner is debited to Drawings Account. At the time of preparing Balance sheet it is deducted from the capital of the proprietor or partner, as the case is.

5. LIABILITIES:

Liabilities mean amount owed (payable) by the business. Liability towards the owners of the business is termed as internal liability. On the other hand, liability towards the outsiders, i.e., other than the owners (proprietor) is termed as external liability.

External liability arises because of credit transactions or loans taken. Examples of external liability are creditors, bank overdraft, long-term borrowings, and other liabilities. Liability can be further classified into: (i) Non-current Liability: Non-current Liability is that liability which is payable after a period of more than a year from the end of the accounting period. Examples of Non-current Liability are long-term loans, debentures, etc. (ii) Current Liability: Current Liability is that liability which is payable within 12 months from the end of the accounting period. Examples of Current Liability are creditors, bills payable, short-term loans, etc.

6. ASSETS:

Assets are the properties (tangible assets and intangible assets) owned by a business. They are the economic resources of the business. In other words, anything which will enable the firm to get cash or an economic benefit in the future, is an asset. Examples of assets are land, building, machinery, furniture, stock, debtors, cash and bank balances, trademark, rights, goodwill, etc.

"Assets are future economic benefits, the rights, which are owned or controlled by an organisation or individual." **-Finney and Miller**

"Assets are property or legal right owned by an individual or a company to which money value can be attached." **-R. Brockington**

"Assets are valuable resources owned by a business which are acquired at a measurable money cost." **-Prof. R.N. Anthony**

What emerges from the above definitions is that an asset should have the following characteristics:

1. It should be owned (i.e., property) by the business.
2. It may be in tangible (physical) form or intangible form.
3. It should have some value attached to it.
4. It should be capable of being measured in money terms.

Assets can be classified into (i) Non-current Assets, (ii) Current Assets, and (iii) Fictitious Assets:

(i) Non-current Assets: Non-current Assets are those assets which are held by a business not with the purpose to resell but are held either as investment or to facilitate business operations. In other words, those assets are held by the business from a long-term point of view. Examples of non-current assets are Fixed assets, Non-current Investments, Long-term Loans and Advances and other Non-current Assets.

Fixed Assets: Fixed assets are those non-current assets of an enterprise which are held not to resell but with the purpose to increase its earning capacity. Fixed assets are further classified into:

(a) Tangible Assets: Tangible Assets are those assets which have physical existence, i.e., they can be seen and touched. Examples of tangible assets are land, building, machinery, computer, furniture, goods, etc.

(b) Intangible Assets: Intangible Assets are those assets which do not have physical existence, i.e., they cannot be seen and touched. Examples of intangible assets are patents, goodwill, trademark, Computer Software, etc.

(ii) Current Assets: Current Assets are those assets which are held by the business with the purpose of converting them into cash within a short period, i.e., one year. For example, goods are purchased with a purpose to resell and earn profit, debtors exist to convert them into cash, i.e., receive the amount from them, bills receivable exist again for receiving cash against it, etc. Prepaid expenses are also classified as Current Assets although they cannot be converted into cash. They are so classified because a part of the benefit from such expenses is available in the next accounting year.

(iii) Fictitious Assets: Fictitious Assets are those assets which are neither tangible assets nor intangible assets. They are losses not written off in the year in which they are incurred but in more than one accounting period. In the case of firms, an example of fictitious asset is Deferred Revenue Expenditure. Discount or Loss on Issue of Debentures is an example of fictitious asset in the case of companies.

Classification of Assets in the case of companies as per Schedule III of the Companies Act, 2013

Assets like liabilities are classified by Schedule III of the Companies Act 2013 into (i) Current Assets, and (ii) Non-current Assets. They are defined as follows:

(i) Current Assets: **An asset is a current asset if it satisfies any one of the following criteria's:**

(a) it is expected to be realised in or is intended for sale or consumption in the company's normal operating cycle; or

(b) it is held primarily for the purpose of being traded ***or*** **,**

(c) it is expected to be realised within 12 months from the reporting date or

(d) it is cash and cash equivalent unless it is restricted from being exchanged or used to settle a liability for at least 12 months after the reporting date

(ii) Non-current Assets: **Non-current Assets are those assets which are not current assets.**

Operating Cycle **means the time between the acquisition of an asset for processing and its conversion into cash and cash equivalents. If the operating cycle cannot be identified, it is taken to be a period of 12 months.**

7. RECEIPTS:

Receipt is the amount received or receivable for selling assets, goods or services.

Receipts are further categorised into revenue receipts and capital receipts.

Revenue Receipts: It is the amount received or receivable in the normal course of business say against sale of goods or rendering of services. Examples of revenue receipts are: amount received or receivable against sale of goods or rendering of services, interest on fixed deposits or investments, etc.

Capital Receipts: It is the amount received or receivable against transactions which are not revenue in nature. For example, amount received or receivable for sale of machinery, building, furniture, investment, loan, etc.

8. EXPENDITURE AND EXPENSE:

EXPENDITURE: It is the amount spent or liability incurred for acquiring assets, goods or services. Expenditure may be categorised into:

(i) Capital Expenditure: It is an expenditure incurred to acquire assets or improving the existing assets which will increase the earning capacity of the business, i.e., will give benefit of enduring nature to the business. It may be incurred to acquire tangible asset or intangible asset. Examples of capital expenditure are purchase of machinery to manufacture goods, purchase of furniture or computers to carry on business. Capital Expenditure is shown on the assets side of the Balance Sheet.

(ii) Revenue Expenditure: Revenue Expenditure is the expenditure incurred, the benefit of which is consumed or exhausted within the accounting period. It has direct relationship with revenue or with the accounting period, e.g., cost of goods sold, salaries, rent, electricity expenses, etc. Revenue Expenditure is shown on the debit side of the Trading Account or Profit and Loss Account, in the case of firms and in the Expenses part of the Statement of Profit and Loss, in the case of companies.

(iii) Deferred Revenue Expenditure: Deferred Revenue Expenditure is a revenue expenditure in nature but is written off (charged) in more than one accounting period. For example, large advertising expenditure that will give benefit for more than one accounting period is a Deferred Revenue Expenditure

Revenue: **Revenue means the amount which, as a result of operations, *i.e.,* sale of goods or services, is added to the capital. Revenue is gross inflow of cash, receivables or other consideration arising in the course of ordinary activities of the enterprise from the sale of goods, from-rendering of services and from the use by others of enterprise resources yielding interest, dividends, etc. Examples of revenue are receipts from sale of goods, rent, commission, etc.**

Revenue differs from income. Sale of goods and services is revenue and cost of sale of goods and services is an expense. The difference between revenue and expense is income.

Income = Revenue - Expense.

EXPENSE: It is the cost incurred for generating revenue. According to **R.N. Anthony,** *"Expense is a monetary measure of inputs or resources consumed."* It is a value which has expired during the accounting period. It may be

(i) cash payment such as salaries, wages, rent, etc.

(ii) writing off a part of fixed assets (i.e., depreciation).

(iii) an amount written off out of a current asset (say bad debts).

(iv) decline in the value of assets (say investments).

(v) cost of goods sold.

An expense is charged (debited) to Trading Account or Profit and Loss Account.

Prepaid Expense: It is an expense that has been paid in advance and the benefit of which will be available in the following year or years. For example, insurance premium of Rs. 10,000 has been paid for one year beginning 1st October, 2014. The financial year ends on 31st March, 2015. It means premium for six months, i.e., 1st April, 2014 to 30th September, 2015 amounting to Rs. 5,000 is paid in advance. Thus, the amount of premium paid in advance (Rs. 5,000) is Prepaid Expense. It will be accounted as an expense in the financial year ending 31st March, 2015.

Outstanding Expense: It is an expense that has been incurred but has not been paid. For example, an audit has been conducted by a chartered accountants firm against which audit fee of Rs. 20,000 is to be paid. It means a liability of Rs. 20,000 has been incurred, which is yet to be paid. It is termed as Outstanding Expense. It is debited to the Profit and Loss Account and also shown under the head Current Liabilities in the Balance Sheet.

9. INCOME, PROFIT, GAIN, LOSSES AND COST:

Income: It is the profit earned during a period. In other words, the difference between revenue and expense is termed as Income. It is a broader term than the term 'profit' and includes profit from activities other than its Operating Activities. For example, goods costing Rs. 15,000 are sold for Rs. 21,000, the cost of goods sold, i.e., Rs. 15,000 is expense, the sale of goods, i.e., Rs. 21,000 is revenue and the difference, i.e., Rs. 6,000 is income. Income is also known as profit. It can, therefore, be expressed as:

Income = Revenue - Expense

Profit: It means income earned by the business from its Operating Activities, i.e., the activities carried put by the enterprise to earn profit. Profit is further divided into gross profit and net profit.

Gross Profit: Gross Profit is the difference between revenue from sales and/or services rendered over its direct cost.

Net Profit: Net Profit is the profit earned after allowing for all expenses. In case expenses are more than the revenue, it is Net Loss.

Gain: Gain is a profit of irregular or non-recurrent nature. It is a profit that arises from transactions which are the Operating Activities of the business but are incidental to it such as gain on sale of fixed asset or investments.

Loss: Loss is excess of expenses of a period over its revenues. It decreases the owner's equity. It is a broad term and includes loss incurred in its operating (business) activities, money or money's worth lost against which the firm receives no benefit, e.g., cash or goods lost in theft and loss arising from events of non-recurring nature, e.g., loss on sale of fixed assets.

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

10. PURCHASES, PURCHASES RETURN, SALES AND SALES RETURN

Purchases: The term 'Purchases' is used for purchases of goods for resale or for producing the finished products which are also to be sold. The term 'purchases' includes both cash and credit purchases of goods. Goods purchased for cash are termed as Cash Purchases and goods purchased on credit are termed as Credit Purchases.

Purchases Return: Goods purchased may be returned to the seller for any reason, say, they are defective. Goods so returned are known as Purchases Return or Returns Outward.

Sales: The term 'Sales' is associated with or used for sale of goods that are dealt with by the firm. The term 'Sales' includes both cash and credit sales. When goods are sold for cash, they are termed as Cash Sales and when sold on credit, they are termed as Credit Sales.

Sales Return: Goods sold when returned by the purchaser are termed as Sales Return or Returns Inward.

11. GOODS AND STOCK/INVENTORY

Goods: Goods are the physical items of trade. It is a term that applies to all the items making up the sales or purchases of a business. They are thus Stock-in-Trade of an enterprise, which are purchased or manufactured with a purpose of selling. For an enterprise dealing in home appliances such as T.V., fridge, A.C., etc., are goods. Similarly, for a stationer, stationery is goods.

Stock/Inventory: Stock (Inventory) is a tangible asset held by an enterprise for the purpose of sale in the ordinary course of business or for the purpose of using it in the production of goods meant for sale. Stock (Inventory) may be:

(i) Opening Stock (Inventory) or (ii) Closing Stock (Inventory).

(i) Opening Stock (Inventory) is the stock-in-hand in the beginning of the accounting year. In other words, it is stock-in-hand at the end of the previous accounting year.

(ii) Closing Stock (Inventory) is the stock-in-hand at the end of the current accounting period.

Stock or Inventory may be of the following kinds:

(i) Stock or Inventory of Goods: Stock, Goods or Inventory in the case of a trading concern comprises stock (Inventory) of goods remaining unsold. In the case of manufacturing concern, it comprises processed goods manufactured for the purpose of sale. It is valued at cost or net realisable value, whichever is lower,

(ii) Stock or Inventory of Raw Material: It comprises the stock of raw material used for manufacturing of goods lying unused. For example, stock of cloth to be used for stitching shirts. It is valued at cost or net realisable value, whichever is lower.

(iii) ***Work-in-Progress:*** It is a stock that is in the process of being finished, i.e., they are partly finished goods. It is valued at an aggregate of cost of raw material used, cost of labour, other production cost, i.e., power, fuel, etc.

Stock or Inventory is classified in the Balance Sheet as a Current Asset. It is valued on the basis of "cost or net realisable value (market price) whichever is lower" principle.

12. TRADE RECEIVABLES AND TRADE PAYABLE

Trade Receivables: It is the amount receivable for sale of goods or services rendered in the ordinary course of business. Trade Receivables is a sum total of debtors and bills receivable.

Debtor: Debtor is a person who owes amount to the enterprise against credit sales of goods or services in its ordinary course of business. For example, when goods are sold to a person on credit that person is called a Debtor because he owes the amount to the enterprise. The amount due is known as debt.

Bills Receivable: Bill Receivable means a Bill of Exchange accepted by a debtor, the amount of which will be received on the specified date. It is included in Trade Receivables because Bill Receivable replaces a debtor.

Trade Receivable as defined in Schedule III of the Companies Act, 2013

Trade Receivable is the amount receivable against goods sold and services rendered in the normal course of business.

Trade Payables: It is the amount payable for purchase of goods or services taken in the ordinary course of business. Trade Payables is the sum total of creditors and bills payable.

Creditor: Creditor is a person to whom an enterprise owes amount against credit purchases of goods or services taken. For example, Mohan is a creditor of a firm when goods are purchased from him on credit.

Bills Payable: Bill Payable means a Bill of Exchange accepted, the amount of which will be payable on the specified date. It is included in Trade Payables because Bill

Payable replaces a creditor.

> **Trade Payable as defined in Schedule III of the Companies Act, 2013**
>
> **Trade Payable is the amount payable against goods purchased and services taken in the normal course of business.**

13. VOUCHER AND DISCOUNT

Voucher: Voucher is an evidence of a business transaction. Examples of voucher are Cash Memo, Invoice or Bill, Receipt, Debit/Credit Notes, etc.

Discount: When customers are allowed rebate in the prices of goods by the business or from the amount paid by customers it is known as a Discount.

Trade Discount: Trade Discount is the rebate allowed by the seller on the basis of sales, either quantity or value. Sales are recorded at net value, i.e., Sales - Trade Discount. Similarly, purchases are recorded by the purchaser at net value, i.e., Purchases - Trade Discount.

Cash Discount: Cash Discount is the rebate allowed for timely payment of due amount. It is an expense for the party allowing the discount and income for the party receiving cash discount. It is recorded in the books of accounts of both the parties.

14. BOOKS OF ACCOUNT, ENTRY, DEBIT AND CREDIT

Books of Account: Books of Account are those books in which transactions are recorded, and include Cash Book, Bank Book, Journal Proper and Ledger.

Entry: A transaction and event when recorded in the books of account is known as an Entry.

Debit: An account has two parts, i.e., debit and credit. The left side is the debit side while the right side is the credit side. If an account is to be debited, then the entry is posted to the debit side of the account. In such an event, it is said that the account is debited. It has been derived from an Italian word 'Debito'.

Credit: Credit is the right side of an account. If an account is to be credited, then the entry is posted to the credit side of the account. In such an event, it is said that the account is credited. It has been derived from an Italian word 'Credito'.

15. DEPRECIATION, COST OF GOODS SOLD AND BAD DEBTS

Depreciation: Depreciation is a fall in the value of an asset because of usage or with afflux of time or obsolescence or accident. It is an allocation of cost of fixed asset in each accounting year during its expected useful life.

Cost of Goods Sold: Cost of Goods Sold is the direct cost attributable to the production of goods sold or services rendered.

Bad Debts: Bad Debt is the amount owed to the business that is written off because it has become irrecoverable. It is a loss for the business and is, thus, debited to Profit and Loss account.

16. INSOLVENT AND SOLVENT

Insolvent: Insolvent is a person or enterprise which is not in a position to pay its debts.

Solvent: Solvent is a person or enterprise which is in a position to pay its debts.

17. BOOK VALUE AND BALANCE SHEET

Book Value: This is the amount at which an item appears in the books of accounts or financial statements.

Balance Sheet: It is a statement of the financial position of an individual or enterprise at a given date, which exhibits its assets, liabilities, capital, reserves and other account balances at their respective book values.

18. PROPRIETOR AND ENTITY

Proprietor: The person who makes the investment and bears all the risks associated with the business is called proprietor.

Entity: An Entity means an economic unit which performs economic activities (e.g., Reliance Industries, Bajaj Auto, Maruti, TISCO). A business entity means an enterprise established in accordance with law to engage in business activities. These include proprietorship firms, partnership firms, corporations, companies, etc. An accounting system is always devised for a specific business entity (also called Accounting Entity).

1.9 CONCEPT OF ACCOUNTING PRINCIPLES

Accounting is commonly described as a language of business. As rules of grammar exist for language, similarly accounting principles exist for accounting.

Accounting principles, concepts and conventions commonly known as Generally Accepted Accounting Principles or GAAPs are the basic rules that define the parameters and constraints within which accounting operates. These principles are the theory base of accounting, on the basis of which financial statements are prepared. In other words, they are the guidelines for preparing the financial statements. The Institute of Chartered Accountants of India (ICAI) has issued Accounting Standards to standardise the accounting practices adopted to prepare financial statements. The Companies Act, 1956 has made them mandatory for the management and also for the auditors.

MEANING AND NATURE OF ACCOUNTING PRINCIPLES

"Principles of Accounting are the general law or rule adopted or proposed as a guide to action, a settled ground or basis of conduct or practice."

-The American Institute of Certified Public Accountants

Accounting Principles are the rules of action or conduct adopted by accountants universally while recording accounting transactions. They are the norms or rules which are followed in giving accounting treatment to various items of assets, liabilities, expenses, incomes, etc. For example, Inventory (stock) should be valued at lower of its cost or net realisable value. Fixed assets should be depreciated over their useful life. Accounting Principles are the basic or fundamental propositions generally accepted by accountants as a set of Accounting Principles based on which transactions are recorded and Financial Statements are prepared. These principles are classified into two categories i.e. Accounting Concepts & Accounting Conventions.

1. Accounting Concepts: Accounting Concepts are the basic assumptions or fundamental propositions within which accounting operates. They are generally accepted accounting rules based on which transactions are recorded and financial statements are prepared. It is important to follow the accounting concepts because it enables the users of financial statements to understand them better and in the same manner.

2. Accounting Conventions: Accounting Conventions are the outcome of accounting practices or principles being followed by the enterprises over a period of time. Conventions may undergo a change with time to bring about improvement in the quality of accounting information.

FEATURES OF ACCOUNTING PRINCIPLES

1. Accounting Principles are Man-Made: Accounting Principles are man-made and, therefore, they do not stand the scrutiny like the principles of natural science. They are the best possible suggestions based on practical experiences. They are recommended for use by all enterprises to ensure uniformity and understandability

2. Accounting Principles are Flexible: Accounting Principles are not rigid but flexible. Whenever a situation arises that requires solution; accountants arrive at a reasoned and reasonable decision which gradually becomes the accepted Accounting Principle. It must be borne in mind that Accounting Principles are not permanent and change with time.

3. Accounting Principles are Generally Accepted: Accounting Principles are the bases and guidelines for accounting and are generally accepted. The general acceptance of an Accounting Principle usually depends on how it meets three criteria: relevance, objectivity and feasibility.

(i) Relevance: Accounting Principles are relevant if they result in information that is useful to the users of accounting information.

(ii) Objective: Accounting Principles are objective if they are not influenced by the personal bias of the persons preparing the accounting information.

(iii) Feasible: Accounting Principles are feasible if they can be applied without undue complexity and cost.

NECESSITY OF ACCOUNTING PRINCIPLES

Accounting information is better understood if it is prepared following the set of Accounting Principles uniformly. It means the same Accounting Principles are followed by all entities in preparing their final accounts. Accounting information is meaningful and useful for users of accounting information if the accounting records and financial statements are prepared following generally accepted accounting information in standard forms which are understood.

1.10 FUNDAMENTAL ACCOUNTING ASSUMPTIONS OR CONCEPTS

Fundamental Accounting Assumptions or Concepts are the assumptions which are presumed to have been followed in preparing the annual accounts. The entities which do not follow any of the fundamental accounting assumptions are required to disclose which of these assumptions have not been followed and the reasons for not following them. The Fundamental Accounting Assumptions are:

1. Going Concern Assumption;
2. Consistency Assumption; and
3. Accrual Assumption.

Let us discuss them in detail:

1. Going Concern Assumption: According to this assumption, it is assumed that business shall continue for a foreseeable period and there is no intention to close the business or scale down its operations significantly. This implies that it will not be dissolved in the immediate future unless there is a clear evidence of closure. It is because of this concept that a distinction is made between a capital expenditure, i.e., expenditure that will give benefit for a long period and revenue expenditure, i.e., one whose benefit will be consumed or exhausted within the accounting period. On the basis of this concept, fixed assets are recorded at their original cost and depreciated in a systematic manner without reference to their market value. For example, a machine purchased is expected to last 10 years. The cost of the machinery is spread on a suitable basis over the next 10 years for ascertaining the profit or loss for each year. The total cost of the machine is not treated as an expense in the year of purchase itself.

2. Consistency Assumption: According to the Consistency Assumption, accounting practices once selected and adopted, should be applied consistently year after year. The concept helps in better understanding of accounting information and makes it comparable (a qualitative characteristic of accounting information) with that of previous years. Consistency eliminates personal bias and helps in achieving results that are comparable. The concept is particularly important when alternative accounting practices are equally acceptable. For example, two methods of charging depreciation, Written Down Value Method and Straight Line Method, are equally acceptable. Under the assumption, method once chosen and applied should be applied consistently year after year. But, it does not mean that practice once adopted cannot be changed. The accounting practice may be changed if the law or Accounting Standard requires it or the change will result in more meaningful presentation. If an enterprise desires to adopt an alternative practice, it must disclose the change and its impact on the profit or loss.

3. ***Accrual Assumption:*** According to the Accrual Assumption, a transaction is recorded in the books of accounts at the time when it is entered into and not when the settlement takes place. Thus, revenue is recognised when it is realised, i.e., when sale is complete or services are rendered; it is immaterial whether cash is received or not. Similarly, expenses are recognised as expenses in the accounting period in which the revenue related to it is recognised, whether paid in cash or not.

The concept is particularly important because it recognises the assets, liabilities, incomes and expenses as and when transactions relating to it are entered into. Under this concept, profit is regarded as earned at the time the goods or services are sold to a customer, i.e., the legal title is passed to the customer, who, in turn, has an obligation to pay for them. Similarly, expense is regarded as incurred when the goods or services are purchased and an obligation to pay for them is assumed.

Let us take examples to understand the Accrual Concept.

M/s. RSM & Co. purchases computers on 1st January, 2013 amounting to Rs. 5,00,000 to be paid on 15th April, 2013. Since the asset has been acquired by the enterprise and has in the process incurred a liability to the extent of that amount on 1st January, 2013, it must record the transaction in its books of accounts on 1st January, 2013. The transaction on recording shall reflect that the enterprise owns assets (computers) worth Rs. 5,00,000 and also owes an equal amount of money to the supplier.

Similarly, if M/s. RSM & Co. makes a sale of goods to M/s. VS & Co. on 27th February, 2013 for Rs. 15,000 on credit of two months, the sale must be recorded on 27th February, 2013 although the amount will be received on 27th April, 2013. The transaction is recorded because the revenue has been earned, although the amount has not been received. M/s. VS & Co. should also record the purchase in its books of accounts on 27th February, 2013 because goods have been purchased although the amount has not been paid

1.11. ACCOUNTING PRINCIPLES

1. ***Accounting Entity or Business Entity Principle:*** According to the Business Entity principle, business is considered to be separate and distinct from its owners. Business transactions, therefore, are recorded in the books of accounts from the business point of view and not from that of the owners. Owners being regarded as separate and distinct from business they are considered creditors of the business to the extent of their capital. Their account with the business is credited with the capital introduced and profit earned during the year, etc., and debited by the drawings made. For example, when the proprietor introduces capital, Cash Account or Bank Account is debited and Capital Account is credited. Amount in the credit of the capital is a liability of the enterprise towards the proprietor. This principle applies to every form of enterprise including proprietorship firms.

A Balance Sheet of a proprietary firm (imaginary amounts) will appear as follows:

BALANCE SHEET
as at…..

Liabilities	Rs.	Assets	Rs.
Capital account		**Fixed assets**	
Opening Balance	2,50,000	Machinery	2,00,000
Add: introduction during the year	1,00,000	Vehicles	75,000
Profit for the year	1,50,000	**Current assets**	
	5,00,000	Cash in hand	25,000
Less: Drawing	1,26,000	Balance with bank	74,000
	3,74,000		3,74,000

The Accounting Entity principle is a useful principle as from it, responsibility accounting has developed. It has made possible ascertaining the results of each department or division of the enterprise.

2. ***Money Measurement Principle:*** According to the Money Measurement Principle, transactions and events that can be measured in money terms are recorded in the books of accounts of the enterprise. In other words, money is the common denominator in recording and reporting all transactions. Consider that an enterprise has Rs. 10,000 cash, 6 tonnes of raw material, 6 trucks and 10,000 sq. yards land. These assets cannot be added and shown in the Financial Statements unless their monetary value is ascertained. However, the principle suffers from two major limitations:

(a) Transactions and events that cannot be measured in money terms are not recorded in the books of accounts, howsoever important they may be to the enterprise. For example, human resources with the enterprise are important to the enterprise but are not reflected in the financial statements because they cannot be measured and expressed in money terms.

(b) The value of money is considered to have static value as the transactions are recorded at the value on the transaction date.

3. ***Accounting Period Principle:*** According to the Accounting Period Principle, the life of an enterprise is broken into smaller periods so that its performance is measured at regular intervals. The accounts of an enterprise are maintained following Going Concern Concept, meaning the enterprise shall continue its activities for a foreseeable future. One may argue that the financial statements of the enterprise should be prepared at the end of its life. It is possible to do so, but a number of users of Financial Statements and many of them, especially the management and bankers, require the information from the accounts at regular intervals so that decisions can be taken at the appropriate time. Management requires information at regular intervals to assess the performance, funds requirement (short-term as well as long-term), banks require accounting information periodically because they have invested money and have to ensure its safety and returns. Similarly, the Government has to assess the tax dues from the enterprise.

In view of the above, the life of the enterprise is broken into smaller periods (usually one year) which are termed as the 'Accounting Period'.

An accounting period is the interval of time at the end of which Income Statement (Profit and Loss Account or Statement of Profit and Loss, in the case of companies) and Balance Sheet are prepared to know the results and resources of the business.

4. **Full Disclosure Principle:** According to the Principle of Full Disclosure, "*there should be complete and understandable reporting on the financial statements of all significant information relating to the economic affairs of the entity*." Apart from legal requirements, good accounting practice requires all material and significant information to be disclosed. Whether information should be disclosed or not always depends on the materiality of the information. The Companies Act, 1956 provides for disclosures (termed as legally required disclosures) yet there may be many material information which if disclosed will make the financial statements more meaningful. Disclosure of material information will result in better understanding. For example, the reasons for low turnover should be disclosed.

5. ***Materiality Principle:*** The Materiality Principle refers to the relative importance of an item or an event. According to the American Accounting Association, "*an item should be regarded as material if there is a reason to believe that knowledge of it would influence the decision of an informed investor*." Thus, whether an item is material or not will depend on its nature and/or amount. It, thus, means that it is a matter of exercising judgment to decide which item is material and which is not. And only those items should be disclosed that have significant effect or are relevant to the user. An item may be material for one enterprise but may not be material for another. For example, amount spent on repairs of building, say Rs. 2,50,000 is material for an enterprise having a turnover of say Rs. 1,50,000 but it is not material for an enterprise having a turnover of say Rs. 15,00,00,000. On the other hand, closure of a production plant, even temporarily, say because of an environmental problem is material.

6. Prudence or Conservatism Principle: The Prudence Principle is many a time described using the phrase "*Do not anticipate a profit, but provide for all possible losses*." In other words, it takes into consideration all prospective losses but not the prospective profits. The application of this concept ensures that the financial statements present a realistic picture of the state of affairs of the enterprise and do not paint a better picture than what it actually is. For example, closing stock is valued at lower of cost or net realisable value or making the provision for doubtful debts and discount on debtors in anticipation of actual bad debts and discount. Conservatism does not record anticipated revenues but provides all anticipated expenses and losses, thus, it may overstate liabilities. It has a drawback as it may be used to create secret reserve (e.g., by creating excess provision for doubtful debts, depreciation, etc.), and thus financial statements may not depict a true and fair view of state of affairs of the business. The Concept of Conservatism needs to be applied with more caution and care so that the results reported are not distorted.

7. Cost Concept or Historical Cost Principle: According to the Cost Concept, an asset is recorded in the books of accounts at the price paid to acquire it and the cost is the basis for all subsequent accounting of the asset. Asset is recorded at cost at the time of its purchase but is systematically reduced in value by charging depreciation. The market value of an asset may change with the passage of time but for accounting purposes it continues to be shown in the books of accounts at its book value (i.e., cost at which it was purchased minus depreciation provided up-to-date). For example, an asset is purchased for Rs. 5,00,000 and if at the time of preparing the final accounts, even if its market value is say, Rs. 4,00,000 or Rs. 7,00,000, yet the asset shall be recorded at its purchase price of Rs. 5,00,000.

Cost concept brings objectivity in the preparation and presentation of financial statements. They are not influenced by the personal bias or judgments.

8. Matching Concept or Matching Principle: This concept is based on the accounting period concept. An important objective of business is to determine profit periodically. It is necessary to match 'revenues' of the period with the 'expenses' of that period to determine correct profit (or loss) for the accounting period. Profit earned by the business during a period can be correctly measured only when the revenue earned during the period is matched with the expenditure incurred to earn that revenue. It is not relevant when the payment was made or received. Therefore, as per this concept, adjustments are made for all outstanding expenses, prepaid expenses, accrued income, unearned income, etc.

In brief, according to this concept, the expenses for an accounting period are matched against related revenues, rather than cash received and cash paid. This concept should be followed while preparing financial statements to have a true and fair view of the profitability and financial position of a business firm.

9. Dual Aspect or Duality Principle: According to the Dual Aspect Concept, every transaction entered into by an enterprise has two aspects, a debit and a credit of equal amount. Simply stated, for every debit there is a credit of equal amount in one or more accounts. It is also true vice versa. For example, Rahul starts a business with a capital of Rs. 1,00,000. There are two aspects to the transaction. On one hand, the business has an asset of Rs. 1,00,000 (cash) while on the other hand, it has a liability towards Rahul of Rs. 1,00,000 (capital of Rahul). Thus, we can say

Capital (Equities) = Cash (Asset)

Rs. 1,00,000 = Rs. 1,00,000

Suppose further, the enterprise borrows amount from a bank; its assets will increase but this will mean that out of the total assets, amount equal to borrowing is payable to the outsiders. Thus, we can say

Owner's equity or capital + Claims of outsiders = Assets

Or

Assets = Owner's equity + Claims of outsiders

This fundamental equation will always remain good. In other words, accounting equation demonstrates the fact that for every debit there is an equivalent credit. As a matter of fact the entire system of Double Entry Book Keeping is based on this concept.

10. Revenue Recognition Concept: According to the Revenue Recognition Concept, revenue is considered to have been realised when a transaction has been entered into and the obligation to receive the amount has been established. It is to be noted that recognising revenue and receipt of an amount are two separate aspects. Let us take an example to understand it. An enterprise sells goods in February 2013 and receives the amount in April 2013. Revenue of this sales should be recognised in February 2013, i.e., when the goods are sold. It is so because the legal obligation has been established (upon sales) in February 2013. Let us take another example. Suppose, an enterprise has received an advance in February 2013 for the sales to be made in May 2013, revenue shall be recognised in May 2013, upon sales having been made because the legal obligation to receive the amount has been established in May 2013.

11. Verifiable Objective Concept: The Verifiable Objective Concept holds that accounting should be free from personal bias. Measurements that are based on verifiable evidences are regarded as objectives. It means all accounting transactions should be evidenced and supported by business documents. These supporting documents are cash memo, invoices, sales bills, etc., and they provide the basis for accounting and audit.

1.12 ACCOUNT, CLASSIFICATION & BALANCING AN ACCOUNT

Transactions are recorded in the books of accounts on the basis of evidences, i.e., source documents, such as invoices for purchases, invoices for sales, debit and credit notes, etc. Rules of debit and credit are applied to each transaction and recorded in the books of original entry, i.e., Journal and Special Purpose Books in a chronological order. The transactions recorded in the books of accounts are transferred (posted) to the specific account maintained in the Ledger. At this stage, it is appropriate to define and understand the term 'account'.

ACCOUNT

Account is a summarised record of transactions at one place relating to a particular head. It records not only the amount of transactions but also their effect and direction.

An account is divided into two parts, i.e., debit and credit. It is usually in a T form and the commonly used layout of an account is as follows:

Dr.			NAME OF THE ACCOUNT, e.g., WAGES ACCOUNT				Cr.
Date	**Particulars**	**J.F.**	**Amount**	**Date**	**Particulars**	**J.F.**	**Amount**
Date of the transaction	**Name of the other account**	**Page or Reference Number of the Subsidiary Book, where the entry was first recorded, *e.g.*, Cash Book**	**Amount of the transaction**	**Date of the transaction**	**Name of the other account**	**Page or Reference Number of the Subsidiary**	**Amount of the transaction**

Note the following points about the layout of account:

- Name of the account is written at the top.
- Account is divided into two identical halves, separated by a thick vertical line.
- Left hand side is called the debit side ('debit' is abbreviated as 'Dr.').
- Right hand side is called the credit side ('credit' is abbreviated as 'Cr.').
- Date of the transaction is entered in the column for 'Date'.
- In the 'Particulars' column, the name of the other account involved in the transaction is entered.
- The 'folio' or Journal Folio (J.F.) column is used as a referencing system where the original entry was recorded in the Journal Book.
- In the last column, the amount transacted is written.

It is illustrated below by taking imaginary amounts:

CASH ACCOUNT

Date	Increase	J.F.	Rs.	Date	Decrease	J.F.	Rs.
2014				2014			
April 1	Opening balance		10,000	April 2	Payments for purchases		5,600
April 3	Cash sales of goods		5,000	April 4	Payments to creditors		2,000
April 10	Receipts from debtors		7,000	April 7	Wages and salaries		1,600
April 14	Receipts from commission		2,000	April 28	Rent		1,000
April 21	Sale of fixed assets		3,000	April 29	Postage		200
April 27	Commission		500	April 29	Cartage		100
							10,500
					Closing balance		17,000
			27,500				27,500

What has been done is place the increases in cash on the left hand side (i.e., receipts side or Debit side) and the decreases on the right hand side (i.e., payments side or Credit side). The closing balance is ascertained by deducting the total of payments, Rs. 10,500 from the total of the left hand side, Rs. 27,500.

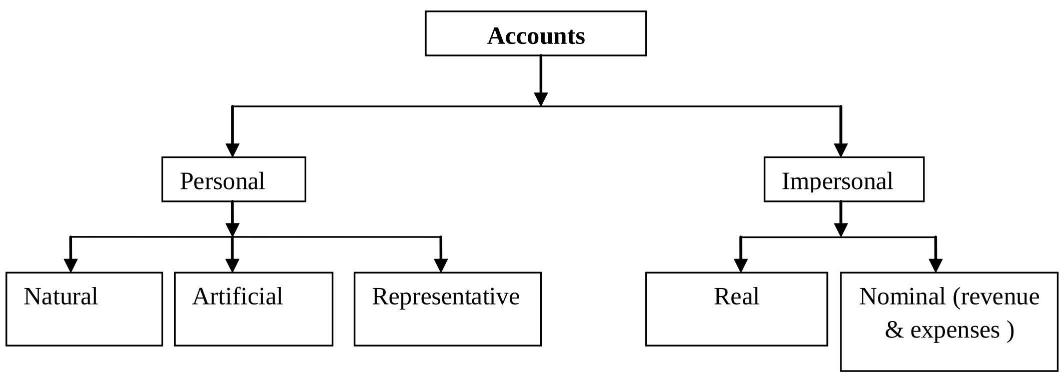
CLASSIFICATION OF ACCOUNTS

Accounts can be classified in two ways:

1. Traditional Classification 2. Modern Classification

1. Traditional Classification of Accounts

This is an old system of classifying accounts. Under this system, accounts are classified into two groups as shown below:



1. Personal Accounts: Accounts which relate to persons, i.e., individuals, firms, companies, debtors or creditors, etc., are Personal Accounts. Examples of Personal Accounts are the account of Ram & Co., a credit customer, or the account of Jhaveri & Co., a supplier of goods. A Capital Account is the account of the proprietor and, therefore, is also personal but adjustments on account of profits and losses are made in it. Similarly, a Drawings Account is also a Personal Account. The main purpose of preparing a Personal Account is to ascertain the balance due to or due from persons or organisations.

Personal account can be classified into three categories:

i. *Natural personal account:* The term natural personal means persons who are creation of god. Therefore, these will includes account in individual name. for eg. Ram's account, Asha's account etc.

ii. *Artificial personal account:* These account includes accounts of a corporate bodies, or institutions which are recognized as persons in business dealing. For eg. The account of the limited company, the account of club etc.

iii. *Representative personal account:* These are accounts which represent a certain person or a group of person's. For eg. if rent is due to the landlord, an outstanding rent account will be opened in the books. The outstanding rent account represents the amount of rent payable to the landlord.

Rule of debit and credit : debit the receiver, credit the giver.

2. Impersonal Accounts: Accounts which are not personal such as machinery account, cash account, etc. are termed as impersonal accounts. These can be further sub-divided into two accounts:

i. Real account: Real accounts are the account which relate to the tangible or intangible assets of the firm (excluding debtors). Example of tangible assets are land, buildings, investment, plants, machinery etc. Examples of intangibles assets are goodwill, patents, trademark, etc.

Rule of debit and credit : debit what comes in, credit what goes out.

ii. Nominal (revenue & expense) account: Account which are related to expenses, losses, gain, revenue, etc. are termed as nominal account. These are salary account, purchase account, interest paid account, sale account, and commission received account. The net result of all the nominal accounts is profit or loss which is transferred to the capital account.

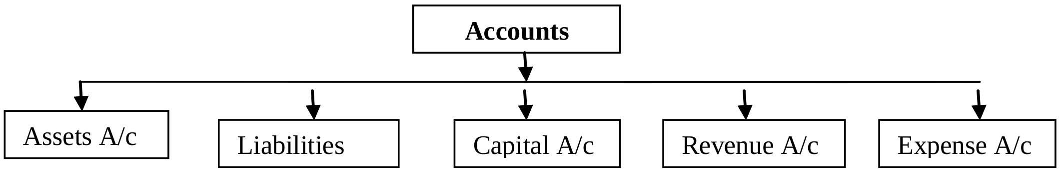
Rule of debit and credit: debit all expenses & losses, credit all income & gains.

Rules of Debit and Credit (Traditional) At a Glance

Types of accounts	***Account to be debited***	***Account to be credited***
Personal a/c	Receiver	Giver
Real a/c	What comes in	What goes out
Nominal a/c	Expense & loss	Income & gain

2. Modern Classification of Account

The accounts are classified according to what is called modern classification of accounts.



1. **Assets Accounts:** These accounts are accounts of assets and properties such as land and building, plant and machinery, furniture, patents, inventory etc.

2. **Liabilities Accounts:** These accounts are that of lenders, creditors for goods, outstanding for expenses, etc.

3. **Capital Account:** They refers to the account of the proprietor/partner who invested in the business e.g. capital account of owner, capital account of partner, drawing account, current account of partner.

4. **Revenue Account:** These are account of income and gains e.g. are sale, discount received, interest received, bad debts etc.

5. **Expense Account:** These are accounts which show the amount spent or even lost in carrying on business operations, eg. are purchases, wages paid, depreciation etc.

Rules for Debit & Credit

Types of Account	***Accounts to be debited***	***Accounts to be credited***
1. Assets a/c	Increase	Decrease
2. Liabilities a/c	Decrease	Increase
3. Capital a/c	Decrease	Increase
4. Revenue a/c	Decrease	Increase
5. Expense a/c	Increase	Decrease

BALANCING AN ACCOUNT

At an end of the period (say a day, month, or a year), it may be necessary to know the balance in an account. A balance of an account is the difference between the total of its debit and credit sides. If the total of debit side is more than the total of credit side, the account is said to have a debit balance. It has a credit balance when total of credit side is more than the total of the debit side.

The process of balancing is as follows:

1. Total the two sides (i.e., debit & credit) of the account.

2. Calculate the difference in total of the two sides.

3. The difference is the balance.

4. Entre the difference in the side with shorter total. Now the total of the two sides will match.

If credit side is shorter, then the amount is entered into credit side by writing "by balance c/d" in the particulars column. It is carried forward by writing in the debit side "to balance b/d", it begin a debit balance.

If debit side is shorter, then the amount is entered on the debit side by writing "to balance c/d" in the particular's column. It is carried forward by writing on the credit side "by balance b/d", it begin a credit balance.

The account shows that the firm has a liability towards Ranjan for Rs. 8,500.

It is to be noted that revenue and expense accounts are not balance, they are totaled and transferred to the profit and loss account. Balances is assessed, liabilities and capital accounts are transferred to the balance sheet.

Balancing of accounts is also discussed in the chapter of ledger.

1.13 MEANING OF DEBIT & CREDIT, RULES & ITS SIGNIFICANCE

MEANING OF DEBIT AND CREDIT

Debit and Credit are two opposite terms. In simple words, debit refers to the left side of an account and credit refers to the right side of an account. In the abbreviated form Dr. stands for debit and Cr. stands for credit. An item recorded on the debit side of an account is said to be debited to the account. A debit entry signifies that value has flowed to the named account, e.g., payment to a creditor signifies that payment has been made for the goods purchased from him. Thus, his account is debited.

An item recorded on the credit side of an account is said to be credited to the account. A credit entry signifies that value has flown from the source indicated by the name of the account, e.g., receipt of cash from a debtor signifies that debtor has made payment for the goods purchased by him. Thus, his account is credited. Debit and credit are simply additions to or subtractions from an account.

RULES OF DEBIT AND CREDIT

Under Double Entry System of accounting each transaction has two aspects. One aspect is debit aspect, i.e., receiving or incoming aspect. Another aspect is credit aspect, i.e., giving or outgoing aspect. Debit and credit aspects of a transaction form the basis of Double Entry System.

Debit and credit are simply additions to or subtractions from an account. We have discussed in chapter on Accounting Equation that by deducting the total of liabilities from the total of assets, the capital can be ascertained, as follows:

Assets = Liabilities + Capital

Or

Assets - Liabilities = Capital

We had also discussed that if there is any change on one side of the equation, there will be a change of similar amount on the other side of the equation or among the items comprised in the same side of the equation. This is due to the dual aspect effect of the transactions. It will become clear from the following illustration:

Transactions	Total Assets =	= Liabilities	+ Owners Capital
	Rs.	Rs.	Rs.
(1) Started business with cash Rs. 10,000	+10,000		+10,000
(2) Borrowed Rs. 5,000	+ 5,000	+ 5,000	
(3) Withdrew cash from business Rs. 2,000	-2,000		-2,000
(4) Loan repaid to the extent of 71,000	-1,000	-1,000	
Balance	**12,000**	**4,000**	**8,000**

The above method is suitable only if the number of transactions are few. But if the transactions are voluminous, a different procedure of putting increases and decreases in different columns is useful and this also yields significant information. The transactions given above are shown below according to this method:

	Total Assets	=	Liabilities		+	Owner's Capital
	Increase Rs.	Decrease Rs.	Increase Rs.	Decrease Rs.	Increase Rs.	Decrease Rs.
1	10,000					10,000
2	5,000			5,000		
3		2,000			2,000	
4		1,000	1,000			
Total	15,000	3,000	1,000	5,000	2,000	10,000
Balance	12000	=		4,000 +		8,000

In accounting, the tradition followed is as follows:

1. Increases in assets are recorded on the debit side, i.e., left hand side and decreases on the credit side, i.e., right hand side.

2. In the case of liabilities and capital, increases are recorded on the credit side, i.e., right hand side and decreases on the debit side, i.e., left hand side.

From the above examples, the following rules can be derived:

(i) When there is an increase in the amount of an asset, its account is debited; the account is credited if there is a reduction in the amount of the asset: Let us take an example to understand this. Suppose, furniture of Rs. 800 is purchased, Furniture Account will be debited by Rs. 800 since the asset has increased by the amount. Later, if furniture of Rs. 300 is sold, the reduction will be recorded by crediting Furniture Account by Rs. 300.

(ii) When there is an increase in the amount of liability, the account is credited; the account is debited if there is a reduction in the amount of liability: Suppose, a firm borrows Rs. 5,000 from Mohan. Mohan's Account will be credited since Rs. 5,000 is now owed to him. If later the loan is repaid, Mohan's Account will be debited since the liability does not exist, i.e., paid

(iii) When there is an increase in the proprietor's capital, the account is credited; the account is debited if the amount is withdrawn by the proprietor: Suppose, the proprietor introduces additional capital, the Capital Account is credited. If the owner withdraws capital, Capital Account is debited.

(iv) Profit leads to an increase and loss to a reduction in the capital: According to the rule mentioned in (iii) above, profits, i.e., revenue may be directly credited to the Capital Account and expenses and losses may be similarly debited.

However, it is more useful to record all incomes, gains, expenses and losses separately. By doing so, very useful information becomes available regarding the factors which have contributed to the year's profit or loss. Later, net result of incomes, gains, expenses and losses is ascertained and adjusted in the Capital Account.

Since incomes and gains increase capital, the rule is to credit all gains and incomes and since expenses and losses decrease capital, the rule is to debit all expenses and losses in the concerned accounts. Of course, if there is a reduction in any income or gain, the concerned account is debited; similarly for any reduction in an expense or loss, the concerned account is credited.

The rules given above can be summarised as follows:

(i) Increases in assets are debits; decreases are credits.

(ii) Increases in liabilities are credits; decreases are debits.

(iii) Increases in owner's capital are credits; decreases are debits.

(iv) Increases in expenses are debits, decreases are credits

(v) Increases in revenues or incomes are credits; decreases are debits.

It should be noted that an increase in assets is favourable to the firm but an increase in expenses is not, even though in both the cases, the fact remains that the increase is recorded on the debit side. Similarly, increase in liabilities is not favourable but an increase in revenue is favourable. Nonetheless, both are recorded on the credit side. Thus, the terms 'debit' and 'credit' should not be taken to mean respectively favourable and unfavourable-they merely describe the two sides of an account. In other words, *both debit and credit may represent either increase or decrease depending upon the nature of an account. The rules of debit and credit depend on the nature of account.*

Another way to understand the rules of debit and credit is as follows:

Rules of Debit and Credit

Assets = Liabilities + Capital + Profits – Losses

(1) Assets

Debit	Credit
Increase (+)	Decrease (-)

(2) Liabilities

Debit	Credit
Decrease (-)	Increase (+)

(3) Capital

Debit	Credit
Decrease (-)	Increase (+)

(4) Expense (Loss)

Debit	Credit
Increase (+)	Decrease (-)

(5) Revenue

Debit	Credit
Decrease (-)	Increase (+)

Study the following illustrations and observe how increase and decrease in various accounts are debited and credited.

Illustration 1: On which side an increase in the following accounts will be recorded? Also, mention the nature of the account.

(i) Machinery a/c (ii) Creditor's a/c (iii) Mohan (proprietor)

(iv) Sales a/c (v) Carriage outwards a/c (iv) Cash a/c

(vii) Debtor's a/c (viii) Rent a/c (ix) Interest payable a/c

(x) Bills payable

Solution

(i) Debit-Asset (ii) Credit-Liability (iii) Credit-Capital

(iv) Credit-Revenue (v) Debit-Expense (vi) Debit-Asset

(vii) Debit-Asset (viii) Debit - Expense (ix) Credit - Liability

(x) Credit-Liability

SIGNIFICANCE OF DEBIT AND CREDIT BALANCE IN ACCOUNTS

Some accounts show debit balances and some credit balances. These balances are as follows

1. Credit balance in the capital account means amount due to the owner of the business. In other words, the amount invested in the business by the owner.

2. Credit balance in bank account, suppliers accounts etc. means amount payable by the business i.e. liability of the business.

3. Debit balance in cash account, bank account, debtor's account means cash in hand, cash at bank and amount receivables against sale respectively.

4. Credit balance in discount received account, interest received account etc. means income earned by the business.

5. Debit balance in discount allowed account, salary, rent, interest paid account, etc. means expenses.

So, we can briefly say that:

a. debit balance is either an asset (cash, bank, etc.) or an expense (salary, rent, etc.) and

b. credit balance shows income earned or liability or the amount invested by the proprietor.

1.14 MEANING OF AN ACCOUNTING EQUATION

An Accounting Equation is a mathematical expression which shows that the assets and liabilities of a firm are equal. An Accounting Equation is based on the dual aspect concept of accounting meaning, every transaction has two aspects-debit and credit. It holds that for every debit there is a credit of equal amount and vice versa. It means, total claims (those of outsiders and of the proprietors) will always equal the total assets of the firm. The claims, also known as equities, are of two types:

1. Owner's equity or capital and
2. Liabilities or amounts due to outsiders (i.e., Outsiders' Equity).

We can express it as follows:

Assets = Equities (Total Claims) Or Assets = Liabilities + Capital

Or

Liabilities = Assets - Capital Or Capital = Assets - Liabilities

The above relationship is known as the **Accounting Equation** or the **Balance Sheet Equation.**

An Accounting Equation always holds true with every change that occurs due to a transaction entered into. It is because of the reason that it is based on the dual aspect concept of accounting.

A transaction may affect either both sides of the equation by the same amount or one side of the equation only, by both increasing or decreasing it by equal amounts. Transactions from the Accounting Equation viewpoint, can be divided into two, i.e.,

1. Transactions Affecting Two Items and
2. Transactions Affecting More Than Two Items.

Let us discuss them in detail.

1. Transactions Affecting Two Items: As the title suggests, these are those transactions that affect two items of the accounting equation or Balance Sheet. Transactions affecting opposite sides are:

(i) Increase in Asset, Increase in Liability: Transaction such as credit purchases increase asset (stock) and also increase liability (creditor). Similarly, loans from bank increases asset (cash) and also increase liability (loan).

(ii) Decrease in Liability, Decrease in Asset: Transaction of payment to a creditor decreases liability (creditor) and also reduces asset (cash or bank).

(iii) Increase in Asset, Increase in Owner's Equity: Introduction of capital by the proprietor increases asset (cash or bank) and also liability (capital).

(iv) Decrease in Owner's Capital, Decrease in Asset: Drawings by the proprietor decrease liability (capital) and also asset (cash or bank).

Transactions affecting same side but in opposite direction are:

(i) Increase in Asset, Decrease in Another Asset: Transactions such as cash purchases or receipt from debtors increase one asset (goods and cash or bank, respectively) and decrease another asset (cash or bank and debtors).

(ii) Decrease in Liability, Increase in Another Liability: Settlement of creditor by issue of Bill of Exchange decreases a liability (creditor) and increases another liability (Bill of Exchange).

2. Transactions Affecting More Than Two Items: Some transactions affect more than two items of the accounting equation or a Balance Sheet. For example, when a sale is made in cash for Rs. 30,000, it is made at cost (Rs. 25,000) plus profit (Rs. 5,000). Cost of goods (Rs. 25,000) reduces asset (stock of goods); cash increases by Rs. 30,000 and the owner's capital increases by the profit (Rs. 5,000). It should be noted that profit increases the owner's capital and loss decreases it.

1.15 EFFECT OF TRANSACTIONS ON ACCOUNTING EQUATION

The procedure to workout an Accounting Equation is:

1. Analyse the transaction in terms of such variables as assets, liabilities, capital, revenues and expenses.

2. Decide the effect of the transactions in terms of increase or decrease on variables mentioned in 1.

3. Record the effect on the relevant side of the equation.

Let us take a few transactions to understand the accounting equation.

Suppose, Rakesh starts business and the following successive transactions are entered into:

(1) He commences his business with Rs. 20,000 as Capital.

Effect: It means that the firm has assets totaling Rs. 20,000 in the form of cash and claims against the firm are also Rs. 20,000 in the form of capital. The equation, stands as follows:

	Assets	**=**	**Liabilities +**		**Capital**
	Cash				
Capital introduced	20,000	=	0	+	20,000

(2) Purchases furniture for Rs. 500 in cash.

Effect: It means cash in hand is reduced by Rs. 500 but a new asset (furniture) of the same amount has been purchased. Thus, total of assets remains unchanged. The equation will now appear as follows:

	Assets				**Liabilities**	**+**	**Capital**
	Cash	+	Furniture	=			Rakesh's
Old balance	20,000	+	0	=	0	+	20,000
New transaction	-500	+	500	=	0	+	0
New balance	19,500	+	500	=	0	+	20,000

It may be noted that the total assets remain equal to liabilities plus capital.

(3) Purchases goods for Rs. 1,000 in cash.

Effect: It means cash in hand is reduced by Rs. 1,000 and another asset, i.e., stock has come into existence but the total of assets remains unchanged. The equation now will be as follows:

	Assets							**Liabilities +**		**Capital**
	Cash	+	Furniture	+	Stock	=				Rakesh's
Old balance	19,500	+	500	+	0	=		0	+	20,000
New transaction	-1,000	+	0	+	1,000	=		0	+	0
New balance	18,500	+	500	+	1,000	=		0	+	20,000

(4) Purchase goods for Rs. 2,000 on credit.

Effect: It means the stock has increased by Rs. 2,000 making the total assets Rs. 22,000. A liability of Rs. 2,000 to the supplier of the goods (creditors) has arisen. The equation now will be as follows:

	Assets						**Liabilities +**		**Capital**
	Cash	+	Furniture	+	Stock	=	Creditor's		Rakesh's
Old balance	18,500	+	500	+	1,000	=	0	+	20,000
New transaction	0	+	0	+	2,000	=	2,000	+	0
New balance	18,500	+	500	+	3,000	=	0	+	20,000

(5) Sold goods costing Rs. 2,500 on credit for Rs. 4,000.

Effect: It means a debtor has come into existence to the extent of Rs. 4,000. The stock will be reduced only by Rs. 2,500, being the cost of goods sold. The net increase in assets Rs. 1,500 i.e. Rs. 4,000 - Rs. 2,500 (Profit) will be added to the capital. The position now will be shown as:

	Assets								=	**Liabilities +**		**Capital**
	Cash	+	Furniture	+	Stock	+	Debtors		=	Creditor's		Rakesh's
Old balance	18,500	+	500	+	3,000	+	0		=	2,000	+	20,000
New transaction	0	+	0	-	2,000	+	4,000		=	0	+	1,500
New balance	18,500	+	500	+	3,000	+	4,000		=	2,000	+	21,500

(6) Paid Rs. 1,000 for rent and Rs. 5,000 for salaries.

Effect: It means cash in hand has reduced by Rs. 6,000; it is an expense and no asset comes into existence. Hence, capital will be reduced by this amount as shown below:

	Assets							=	**Liabilities +**		**Capital**
	Cash	+	Furniture +		Stock	+	Debtors =		Creditor's		Rakesh's
Old balance	18,500	+	500	+	500	+	4,000	=	2,000	+	21,500
New transaction	-6,000	+	0	-	0	+	0	=	0	+	6,000
New balance	12,500	+	500	+	500	+	4,000	=	2,000	+	15,500

(7) Rakesh withdraws Rs. 2,000 for personal use.

Effect: Cash in hand is reduced by Rs. 2,000 and capital will also reduced by the same amount. The new accounting equation will be as follows:

	Assets							=	**Liabilities +**		**Capital**
	Cash	+	Furniture +		Stock	+	Debtors =		Creditor's		Rakesh's
Old balance	12,500	+	500	+	500	+	4,000	=	2,000	+	15,500
New transaction	-2,000	+	0	-	0	+	0	=	0	+	2,000
New balance	10,500	+	500	+	500	+	4,000	=	2,000	+	13,500

It will be observed from above that the total of assets will always be equal to the total of liabilities and the capital. The last equation stated above can also be presented in the form of a statement i.e. balance sheet. It is given below:

BALANCE SHEET OF RAKESH as at……

Liabilities		Rs.	Assets	Rs.
Creditors		2,000	Cash	10,500
Capital	15,500		Stock	500
Less: Drawing	(2000)	13,500	Debtors	4,000
			Furniture	5,000
		15,500		15,500

The balance sheet shows the sources from where fund have been obtained. The left hand side does that in the above case Rs.2,000 have been obtained from the outsider and Rs. 13,500 have been contributed by the proprietor. The other side known as assets side shows how the funds stand invested.

A conclusion apparent from the transactions given above is that every transaction has a two-sided effect. In other words, the dual aspect concept will always hold good. A reduction or increase in an asset will have a corresponding effect on liabilities or capital. This is because of the rule that every receiver is a giver and every giver is a receiver.

1.16 RULES FOR ACCOUNTING EQUATIONS

1. When capital is increased, it is credited (+) and when a part of the capital is withdrawn, i.e., drawing are made, it is debited (-).

Interest on capital is an expense for the business, and thus, profit is reduced by the amount and since interest on capital is an income for proprietor, it is added to capital.

Interest on drawing is a profit for the business therefore, added to profit and thus, capital. Since it is a loss/expense for the owner, it is deducted from capital.

Assets and liabilities will not be affected by interest on capital and interest on drawing.

2. Revenue: Owners, equity (capital) is increased by the amount of revenue.

3. Expenses: Owners equity (capital) is decreased by the amount of expenses.

Income= Revenue - Expenses

Income is the profit earned during an accounting period. Profit increased the owner's equity (capital) and loss decreases the owner equity (capital).

4. Outsiders equity: When liabilities are increased, outsiders equity are credited (+) and when liabilities are decreased, outsider liabilities are debited (-).

5. Assets: If there is an increase in assets, the increase is debited (+) in the asset account. If there is decrease in assets, the decrease is credited (-) in the asset account.

6. It is possible that when one asset increased, the other asset decreased eg. Purchase of furniture for cash. Thus, furniture increase and cash decrease.

7. It is possible that one assets decreases, the assets increases, eg., sale of furniture for cash. Thus, cash increases and furniture decreases.

8. It is possible that one liability increases, the other liability decreases, eg., on dishonor of bills payable, the bills payable account is debited and the creditors account is credited. Thus, creditor increase and the amount of bill payable decrease.

9. It is possible that one liability decreases and the other liability increases eg., creditor were made payment by accepting bill payable. Thus, creditors decreases and bill payable increases.

10. It is possible that when an asset increases, liability also increases, eg., furniture is purchased on credit. Thus, furniture increased and the amount of creditors also increases.

11. It is possible that when an asset decreases, liability also decreases, eg., cash paid to creditor. Thus, cash decreases and the amount of creditors also decreases.

12. Effect of out siding expenses (eg., out siding salary); increases in liability and decrease in capital.

13. Accrued income: Increase in assets and increase in capital.

14. Income received in advance: Increase in assets (as cash) and increase in liabilities.

15. An increase in an asset, without a corresponding increase in liability or a corresponding decrease in another asset, means an increase in capital. Conversely, an increase in liability without a corresponding increase in asset.

Illustration 2 : Prepare the accounting equation on the basis of the following:

1. Sachin started business and introduced capital Rs. 1,00,000 in cash.

2. Purchase goods in cash Rs. 50,000

3. Purchase from M/s Samrat furnitures Rs. 20,000

4. Sold goods costing Rs. 25,000 for Rs. 35,000

5. Paid M/s Samrat furniture in cash

Solution

S.No.	Transaction	Asset	=	Liabilities	+	Capital
1	Sachin started business with cash	1,00,000	=	0	+	1,00,000
2	Purchased goods in cash	+50,000				
		-50,000				
	New equation	1,00,000	=	0	+	100,000
3	Purchased goods from M/s Samrat furnitures	+20,000	=	20,000	+	0
	New equation	1,20,000	=	20,000	+	100,000
4	Sold goods costing Rs. 25,000 for Rs. 35,000 (note)	-25,000				
		+35,000	=	0	+	10,000
	New equation	1,30,000	=	20,000	+	1,10,000
5	Paid M/s Samrat furniture in cash	-20,000	=	-20,000	+	0
	New equation	1,10,000	=	0	+	1,10,000

Note: Sale of goods has resulted in a profit of Rs. 10,000. It has been added to capital because net profit at the year end is transferred to capital amount.

Illustration 3 : Prepare the accounting equation on the basis of following:

1. Started business with cash Rs. 70,000.

2. Credit purchases of goods Rs. 18,000.

3. Payment made to creditor in full settlement Rs. 17,500.

4. Purchase of machinery for cash Rs. 20,000.

Solution

S.No.	Transaction	Asset					=	Liabilities	+	Capital
		Cash Rs.	+	Stock Rs.	+	Machinery Rs.	=	Creditors Rs.	+	Capital Rs.
1.	Started business with cash Rs. 70,000	70,000	+	0	+	0	=	0	+	70,000
2.	Credit purchases of goods Rs. 18,000.	0	+	18,000	+	0	=	18,000	+	0
	New equation	70,000	+	18,000	+	0	=	18,000	+	70,000
3.	Payment made to creditor in full settlement Rs. 17,500.	-17,500	+	0	+	0	=	-18,000	+	500
	New equation	52,500	+	18,000	+	0	=	0	+	70,500
4.	Purchase of machinery for cash Rs. 20,000.	-20,000	+	0	+	20,000	=	0	+	0
	New equation	32,5000	+	18,000	+	20,000	=	0	+	70,500

Illustration 4 : Mr. Rakesh started business as on 1st April 2011 with a capital of Rs. 1,50,000. During the year, the following transactions took place.

		Rs.
1.	Furniture purchased for cash	20,000
2.	Purchased goods from Mahesh on credit	25,000
3.	Sold goods (costing Rs. 10,000) on Mohan for Cash	14,000
4.	Additional capital introduced	20,000
5.	Commission received in advance	2,000

6. Paid to creditor (Mahesh) Rs. 22,500 in full settlement.

7. Sold goods (costing Rs. 15,000) for Rs. 18,000 out of which Rs. 5,000 received in cash.

8. Depreciation on furniture provided @ 10%

Solution

No.	Transaction	Asset				= Liabilities		+ Capital
		Cash + Rs.	Furniture + Rs.	Stock + Rs.	Debtors Rs.	= Creditors + Rs.	Commn. Recd. in Advance + Rs.	Capital Rs.
1.	Commenced business with cash	1,50,000 +	0 +	0 +	0 =	0 +	0 +	1,50,000
	Furniture purchased for cash	-20,000 +	20,000 +	0 +	0 =	0 +	0 +	0
2.	**New Equation**	1,30,000 +	20,000 +	0 +	0 =	0 +	0 +	1,50,000
	Purchased goods from Mahesh	0 +	0 +	25,000 +	0 =	25,000 +	0 +	0
3.	**New Equation**	1,30,000 +	20,000 +	25,000 +	0 =	25,000 +	0 +	1,50,000
	Cash Sales (Profit Rs. 14,000 - Rs. 10,000)	14,000 +	0 -	10,000 +	0 =	25,000 +	0 +	4,000
4.	**New Equation**	1,44,000 +	20,000 +	15,000 +	0 =	25,000 +	0 +	1,54,000
	Additional capital introduced	20,000 +	0 +	0 +	0 =	25,000 +	0 +	20,000
5.	**New Equation**	1,64,000 +	20,000 +	15,000 +	0 =	25,000 +	0 +	1,74,000
	Commission received in advance	2,000 +	0 +	0 +	0 =	0 +	2,000 +	20,000
6.	**New Equation**	1,66,000 +	20,000 +	15,000 +	0 =	25,000 +	2,000 +	1,74,000
	Paid to creditor Mahesh Rs. 22,500 in full settlement	-22,500 +	0 +	0 +	0 =	-25,000 +	0 +	2,500
7.	**New Equation**	1,43,500 +	20,000 +	15,000 +	0 =	0 +	2,000 +	1,76,500
	Sold goods (costing Rs. 15,000) for Rs. 18,000 out of which Rs. 5000 received in cash	5,000 +	0 -	15,000 +	13,000 =	0 +	0 +	3,000
8.	**New Equation**	1,48,500 +	20,000 +	0 +	13,000 =	0 +	2,000 +	1,79,500
	Depreciation on furniture @ 10% on Rs. 20,000	0 -	2,000 +	0 +	0 =	0 +	0 -	2,000
	New Equation	1,48,500 +	18,000 +	0 +	13,000 =	0 +	2,000 +	1,77,500

1.17 SUMMARY

Accounting is an art of recording, classifying and summarizing in terms of money transactions and events of a financial nature and interpreting the results thereof. Process of accounting is the sequence of accounting procedure for recording, classifying and summarising transactions. Maintaining systematic records of transactions, ascertain profit & loss, ascertaining financial position, assisting in management, communicating accounting information to users, protecting business assets and facilitation in decision making are the objectives of accounting. Accounting information is the information of financial nature relating to entities. It is useful in taking decisions. Accounting information is provided to the users through financial statements. Advantages of accounting are financial information ,assistance to management, replacement of memory, comparative study, settlement of tax liability, facilitates loan, evidence in court, sale of business, assistance in the event of insolvency and helpful in partnership account. Limitations of accounting are not fully exact, does not indicate realisable value, ignores qualitative elements, ignore the effect of price level changes and lead to window dressing. Single entry system and double entry system are the two systems of accounting. In business, various accounting terms are used. accounting terms which are covered under this chapter are business transactions, account, capital, drawing, liabilities, assets, receipts, expenditure, expenses, income, profit, gain, loss, purchases, sales, goods, stock, trade payable, trade receivable, cost, voucher, book of account, entry, debit, credit, proprietor, depreciation, cost of goods sold, bad debts, insolvent, solvent, book value, balance sheet and entity. Accounting principles are the norms or rules which are to be followed in treating various items of assets, liabilities, expenses, incomes, etc. Generally accepted accounting principles (GAAP) refers to the rules or guidelines adopted for recording and reporting business transactions, in order to bring uniformity and consistency in the preparation and presentation of financial statements. An account is a summarised record of relevant transactions at one place relating to a particular head. It records not only the amount of transactions but also their effect and direction. Debit and credit are simply additions to or subtraction from an account. In accounting, debit refers to the left hand side of any account and credit refers to the right hand side. Both debit and credit may represent either increase or decrease depending upon the nature of an account. Accounts are classified as asset account, liabilities account, capital account, revenue account and expenses account. The rule of debit and credit depends on the nature of an account. Assets, expenses and losses accounts normally have debit balance; whereas liability, income and capital accounts normally have credit balance. Accounting equation is the basis for double entry system of book keeping. Total assets of the business firm are provided by the creditors/lenders and the owners. Therefore, at any point of time, the total assets of a business are equal to its total liabilities.

1.18 SELF ASSESSMENT QUESTIONS

1. Who are the users of accounting information?
2. Explain historical recognition concept.
3. What is the rule of expenses account?
4. Goods costing Rs. 10,000 have been sold for cash at 25% profit. How will you show the transaction in the accounting equations.

1.17 IN-TEXT ACTIVITY

1. What is the accounting process?

----

2. Distinguish between revenue receipts and capital receipts.

----

3. What is accounting entity or business entity principle.

----

4. If the capital is Rs. 2,00,000; creditors Rs. 50,000; revenue during the year Rs. 5,00,000 and expenses during the year Rs. 4,00,000. Calculate total assets.

1.19 FURTHER READING

1. Double Entry Book Keeping (Financial Accounting): T.S.Grewal
2. Financial Accounting for Business : A. K. Bhattacharya
3. Elements of Book Keeping : C.M.Juneja J.S.Arora & R.C.Chawla

OBJECTIVES

After going through this lesson, you will be able to understand:

- meaning of journal & journalising, compound journal entry, opening journal entry, advantages of a journal and sub-division of journal
- meaning & utility of a ledger, posting of entries into ledger accounts, balancing of accounts and distinction between journal & ledger
- meaning &features of trial balance, functions/objectives of preparing trial balance and limitations of a trial balance

STRUCTURE

INTRODUCTION

2.1 Journal

2.2 Characteristics or Features of a Journal

2.3 Advantages of a Journal

2.4 Steps in Journalising

2.5 Totalling and Carry Forward

2.5.1 Recording in Journal

2.5.2 Simple and Compound Journal Entries

2.5.3 Entries of Some Specific Transactions

2.5.4 Opening Entry

2.6 Ledger

2.6.1 Posting the Entries

2.6.2 Mechanics of Posting

INTRODUCTION

Business transactions are recorded in the books of accounts which are customarily divided into two classes (1) Journal and (2) Ledger. Journal is a book in which transactions are recorded in the order in which they occur, i.e., in chronological order. Journal is called the Book of Original Entry since all transactions are initially recorded in it.

2.1 JOURNAL

Meaning of a Journal: *A Journal is the primary book of accounts in which transactions are first recorded in a chronological order, i.e., as they are entered into*. Transactions are recorded in the Journal book from the accounting voucher that is prepared on the basis of source documents, i.e., cash memo, invoices, purchase bills, etc.

Definitions

"The basic book of accounting is called Journal. Precisely it is the book of prime entry which means-Day Book. Trader records his total daily transactions in it. The process of recording the transactions into Journal is called Journalising."

-Rowland

"A Journal is a book, employed to classify or sort out transactions in a form convenient for their subsequent entry in the Ledger." **-Cropper**

"A Journal is a chronological record of financial transactions of a business." **-M.J. Keeler**

Journal makes it possible to review the effect of a transaction on the business. It shows for each transaction the transaction date, name of accounts that are to be debited or credited, Ledger page number (Ledger folio) of the accounts, the amount of debit and credit.

All business transactions can be recorded in a simple Journal. Alternatively, an enterprise may use separate Journals to record particular type of transactions, e.g., credit purchases may be recorded in Purchases Journal; credit sales may be recorded in Sales Journal, purchases return may be recorded in Purchases Return Journal, and so on. These Journals are called **Special Journals**.

Terms or Expressions Associated with Journal

(i) Book of Original Entry: Journal is called a Book of Original Entry (also called Book of Prime Entry) because a transaction is first recorded or written in this book and thereafter transferred, i.e., posted into the Ledger Account.

(ii) Journal Entry: An entry recorded in the Journal is called a Journal Entry.

(iii) Journalising: The process of recording a transaction in a Journal is known as Journalising.

(iv) Posting: The transfer of Journal entry to a Ledger Account is called Posting.

2.2 CHARACTERISTICS OR FEATURES OF A JOURNAL

1. Day-to-day transactions are recorded in a Journal in chronological order.

2. It is a book of original entry in which transactions are written before they are posted in the Ledger.

3. It records both the debit and credit aspects of a transaction by using the Double Entry System of Book Keeping.

4. A Journal is a record which shows complete details of a transaction in one entry. Journalising means recording a transaction in the Journal and the form in which it is recorded is known as a Journal Entry.

2.3 ADVANTAGES OF A JOURNAL

Advantages of a Journal are:

1. Journal Reduces the Possibility of Error: The possibility of errors is reduced as the amounts to be debited and credited are written side by side and the two can be compared to see that they are equal. If the accounts are written up directly, it is possible that a wrong amount may be written or the amount written on the debit side may be more or less than on the credit side.

2. Journal Provides an Explanation of the Transaction: Along with the entry in the Journal, a complete explanation (narration) is written so that it is possible to understand the entry properly later.

3. Journal Provides a Chronological Record of All Transactions: Transactions are entered in the Journal in a chronological order, hence, the order in which they occur enters the record permanently.

FORMAT OF A JOURNAL

The format of a Journal is as follows:

JOURNAL

Date (1)	Particular (2)	L.F. (3)	Dr. Amount Rs. (4)	Cr. Amount Rs. (5)

L.F. stands for Ledger Folio

1. Date: In this column, the transaction date is written.

2. Particulars: In this column, two aspects of transactions are recorded, i.e., the name of the two accounts affected by the transaction. The name of the account to be debited is followed by the word 'Dr.' written close to the Right-hand margin line, while the name of the account to be credited preceded by the word 'To' is written in the next line, a little to the right. Narration, i.e., a brief description of the transaction is also written.

3. Ledger Folio: In this column, the number of the Ledger page is written to which the amount is posted in the Ledger.

4. Debit Amount: In this column, the amount debited is written.

5. ***Credit Amount:*** In this column, the amount credited is written.

Note: All the columns, except the Ledger Folio column, are completed at the time of Journalising. The Ledger Folio column is filled in at the time of posting.

2.4 STEPS IN JOURNALISING

Steps involved in Journalising are:

Step 1: Ascertain the accounts that are affected by a transaction.

Step 2: Ascertain the nature of the accounts affected.

Step 3: Ascertain the account to be debited and credited by applying the rules of debit and credit.

Let us, at this point, recapitulate the rules of debit and credit. Rules of Debit and Credit

Types of Account	*Debit*	*Credit*
1. Assets Account	Increase ↑	Decrease ↓
2. Liabilities Account	Decrease ↓	Increase ↑
3. Capital Account	Decrease ↓	Increase ↑
4. Revenue Account	Decrease ↓	Increase ↑
5. Expense Account	Increase ↑	Decrease ↓

Step 4: Ascertain the amount by which the accounts are to be debited and credited.

Step 5: Write the date and month of the transaction in the 'Date' column and the year at the top.

Step 6: Write in the 'Particulars' column name of the account to be debited. Along with the name of the account, abbreviation 'Dr.' is written in the same line against the name of the account. Write the amount to be debited in the 'Debit Amount' column.

Step 7: Write in the 'Particulars' column name of the account to be credited. Name of the account to be credited is written in the next line preceded by the word 'To'. The word 'To' is written towards the right after leaving a few spaces. Write the amount to be credited in the 'Credit Amount' column.

Step 8: Write brief description of the transaction starting from the next line in the 'Particulars' column. This brief description of the transaction is called narration.

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

Journal columns will become clear from an imaginary entry given below:

Date	Particular	L.F.	Dr. Amount Rs.	Cr. Amount Rs.
2014 May 5	Cash A/c Dr. To Mohan (Being the cash received from Mohan in payment of the amount due from him)	53* 37*	2,500	 2,500

*53 is the folio page in the Ledger which is Cash Account where the posting off 2,500 will be found; 37 is the folio page in the Ledger which is Mohan's Account where the posting of 2,500 will be found.

2.5 TOTALLING AND CARRY FORWARD

Usually, the number of transactions in a business are voluminous and require a number of pages of a Journal. Amounts of the debit and credit columns on each page are totalled and carried forward to the next page. In the Particulars column, against the total, the words 'Total c/f' (carried forward) are written. It indicates that the total has been carried forward to the next page. In the next page, in the Particulars column, against the amount brought forward, the words 'Total b/f' (brought forward) are written. It indicates that the total has been brought forward from the previous page. Further, transactions are recorded and amounts in the two columns are totalled again. This process is followed till recording of the last transaction. Each page of the Journal is totalled to ensure correctness in recording the amounts. Remember, under the dual aspect concept, every debit has a corresponding credit of equal amount. It means amounts debited in a transaction should be equal to the amounts credited. Thus, totals of debit column and credit column should match.

Important Considerations

1. If a transaction relates to sales or purchases of goods and the name of the seller or purchaser is given and it is not stated as a cash transaction, it is considered to be a credit transaction. For example, 'Goods sold to Mohan' means that it is a credit transaction.

Accordingly, Mohan's Account will be debited and the Sales Account credited.

2. If a transaction relates to sales or purchases and the name of seller or purchaser is given along with cash, it is taken as cash transaction. For example, 'Goods sold to Mohan for cash', it is sales of goods in cash. Accordingly, Cash Account will be debited and Sales Account credited.

3. If a transaction relates to sales or purchases and the name of the seller or purchaser is not given, it is considered as a cash transaction. For example, goods sold for Rs. 10,000.

4. In Expenses Accounts, even if the name of the party receiving or making payment is given, it is still treated as a cash transaction. Personal Account will not be opened. For example, if a salary of Rs. 5,000 is paid to Ranjan, the transaction will not be recorded in the account of Ranjan, instead Salary Account and Cash Account will be affected.

5. Introduction of funds in the business by the proprietor known as capital is credited to his Capital Account whereas withdrawal of cash or goods for personal use is debited to Drawings Account.

2.5.1 RECORDING IN JOURNAL

Transactions are recorded in the Journal on the basis of source documents following the rules of debit and credit. Let us take some examples to understand how a transaction is recorded in a Journal.

Example 1. Shri Dutta started business and introduced capital of Rs. 1,00,000. The transaction is recorded by passing the following Journal entry:

Date	Particulars	LF.	Dr. (Rs.)	Cr. (Rs.)
	Bank/Cash A/c ...Dr. To Capital A/c (Being the amount invested in business)		1,00,000	1,00,000

Reason for Debit and Credit:

(i) Bank/Cash Account is debited because it is received by the firm. It being an Asset Account, the rule 'Increase in assets is debited and decrease credited' is applied.

(ii) Dutta's Capital Account is credited because capital is increasing. It being a Capital Account, the rule 'Increase in capital is credited and decrease debited is applied.

Example 2. Purchased furniture from Raj Furniture for Rs. 10,000, paid in cash. The transaction is recorded by passing the following Journal entry:

Date	Particulars		L.F.	Dr.(Rs.)	Cr. (Rs.)
	Furniture A/c To Cash A/c (Being the furniture purchased against cash)	...Dr.		10,000	10,00

Reason for Debit and Credit:

(i) Furniture Account is debited because the firm has purchased furniture, i.e., has received it. It being an Asset Account, the rule 'Increase in assets is debited and decrease credited' is applied.

(ii) Cash Account is credited because the firm has paid cash for purchase of furniture. It being an Asset Account, the rule 'Increase in assets is debited and decrease credited' is applied.

Example 3. Paid rent Rs. 3,000 in cash. The transaction is recorded by passing the following Journal entry:

Date	Particulars		LF.	Dr. (Rs.)	Cr.(Rs.)
	Rent A/c To Cash A/c (Being the rent paid in cash)	...Dr.		3,000	' 3,000

Reason for Debit and Credit:

(i) Rent Account is debited because it is an expense. It being an Expense Account, the rule 'Increase in expenses is debited and decrease credited' is applied.

(ii) Cash Account is credited because the firm has paid cash towards the expenses. It being an Asset Account, the rule 'Increase in assets is debited and decrease credited' is applied.

Example 4. Purchased goods for Rs. 50,000 for cash. The transaction is recorded by passing the following Journal entry:

Date	Particulars		LF.	Dr.(Rs.)	Cr.(Rs.)
	Purchases A/c To Cash A/c (Being the goods purchased for cash)	...Dr.		50,000	 50,000

Reason for Debit and Credit:

(i) Purchases Account is debited because the firm has purchased goods for the purpose of sale. It being an Expense Account, the rule 'Increase in expenses is debited and decrease credited' is applied.

(ii) Cash Account is credited because the firm has paid cash for purchases of goods. It being an Asset Account, the rule 'Increase in assets is debited and decrease credited' is applied.

Example 5. Interest received Rs. 1,000 in cash. The journal entry is passed is:

Date	Particulars		LF.	Dr.(Rs.)	Cr.(Rs.)
	Cash A/c	...Dr.		1,000	
	To Interest received A/c				1,000
	(Being the interest received)				

Reason for Debit and Credit:

(i) Cash Account is debited because the firm has received cash. It being an Asset Account, the rule 'Increase in assets is debited and decrease credited' is applied.

(ii) Interest Received Account is credited because the firm has received an income. It being a Revenue Account, the rule 'Increase in revenue is credited and decrease debited' is applied.

Example 6. Paid a creditor Rs. 5,000. The Journal entry passed is:

Date	Particulars		LF.	Dr.(Rs.)	Cr.(Rs.)
	Creditors A/c	...Dr.		5,000	
	To Cash A/c				5,000
	(Being the amount paid to a creditors)				

Reason for Debit and Credit:

(i) Creditor's Account is debited because the firm has paid the liability towards a creditor. It being a Liability Account, the rule 'Increase in liability is credited and decrease debited' is applied.

(ii) Cash Account is credited because the firm has paid cash to a creditor. It being an Asset Account, the rule 'Increase in assets is debited and decrease credited' is applied.

A transaction entered into by the business can be recorded by applying the rules of debit and credit to each aspect of it. Let us take an illustration for better understanding.

Illustration 1. You are required to give (a) Journal Entries, (b) Nature of Account (Whether Asset, Liability, Capital, Expense, or Revenue), (c) Nature of change, and (d) Appropriate rule for recording the change for the following transactions:

1. Nitin invested Rs. 5,00,000 cash in the business.
2. Purchased building for Rs 2,50,000 in cash.

3. Purchased merchandise (goods) on account for Rs 50,000.

4. Sold merchandise for cash Rs 75,000.

5. Nitin withdrew cash Rs 12,500 for personal use.

6. Paid Rent Rs 2,000; Salary Rs 4,000.

7. Cash sales Rs 10,000.

8. Cash deposited in bank Rs 20,000.

Solution:

Date	Particulars	L. F.	Dr. Rs	Cr. Rs	Nature of Account	Nature of Change	Appropriate Rule
1.	Cash A/c ...Dr. To Capital A/c (Being the amount invested in business)		5,00,000	 5,00,000	Asset Capital	Increase Increase	Increase in asset is debited Increase in capital is credited
2.	Building A/c ...Dr. To Cash A/c (Being the building purchased for cash)		2,50,000	 2,50,000	Asset Asset	Increase Decrease	Increase in asset is debited Decrease in asset is credited
3.	Purchases A/c ...Dr. To Supplier (Party) (Being the goods bought on credit)		50,000	 50,000	Expenses Liability	Increase Increase	Increase in expense is debited Increase in liability is credited
4.	Cash A/c ...Dr. To Sales A/c (Being the cash sales)		75,000	 75,000	Asset Revenue	Increase Increase	Increase in asset is debited Increase in revenue is credited
5.	Drawings A/c ...Dr. To Cash A/c (Being the cash withdrawn from business)		12,500	 12,500	Capital Asset	Decrease Decrease	Decrease in capital is debited Decrease in asset is credited
6.	Rent A/c ...Dr. Salary A/c ...Dr. To Cash A/c (Being the expenses paid for the month)		2,000 4,000	 6,000	Expenses Expenses Asset	Increase Increase Decrease	Increase in expenses is debited Increase in expenses is debited Decrease in asset is credited
7.	Cash A/c ...Dr. To Sales A/c (Being the cash sales)		10,000	 10,000	Asset Revenue	Increase Increase	Increase in asset is debited. Increase in revenue is credited
8.	Bank A/c ...Dr. To Cash A/c -. (Being the cash deposited into bank)		20,000	 20,000	Asset Asset	Increase Increase	Increase in asset is debited; Decrease in asset is credited

Illustration 2. Transactions of Ramesh for April are given below. Journalise them.

2015	Rs.	
April 1	Ramesh started business with cash	1,00,000

April 2	Paid into bank	70,000
April 3	Bought goods for cash	5,000
April 4	Drew cash from bank for office	1,000
April 13	Sold goods to Krishna	1,500
April 20	Bought goods from Shyam	2,250
April 24	Received from Krishna	1,500
April 28	Paid cash to Shyam	2,150
April 30	Cash sales for the month	8,000
April 30	Paid salary to Ram	3,000

Solution:

Date	**Particulars**	**L.F.**	**Dr. (Rs.)**	**Cr. (Rs.)**
2015 April 1	Cash A/c …..Dr. To Capital A/c (Being the amount invested by Ramesh in the business as capital)		1,00,000	1,00,000
April 2	Bank A/c …..Dr. To Cash A/c (Being the amount paid into the bank)		70,000	70,000
April 3	Purchases A/c …..Dr. To Cash A/c (Being the goods purchased for cash)		5,000	5,000
April 4	Cash A/c …..Dr. To Bank A/c (Being the cash withdrawn from the bank)		1,000	1,000
April 13	Krishna A/c …..Dr. To Sales A/c (Being the goods sold to Krishna on credit)		1,500	1,500
April 20	Purchases A/c …..Dr. To Shyam (Being the goods bought from Shyam on credit)		2,250	2,250
April 24	Cash A/c …..Dr. To Krishna (Being the cash received from Krishna)		1,500	1,500
April 28	Shyam …..Dr. To Cash A/c (Being the amount paid to Shyam)		2,150	2,150
April 30	Cash A/c …..Dr. To Sales A/c (Being the goods sold for cash)		8,000	8,000
April 30	Salaries A/c …..Dr. To Cash A/c (Being the amount paid for salary)		3,000	3,000
	Total		1,94,400	1,94,400

Illustration 3. Journalise the following transactions:

2015	Rs.	
Jan. 1	Started business with cash	50,000
Jan. 3	Paid into bank	40,000
Jan. 5	Sold goods to Mohan	22,000
Jan. 9	Goods returned by Mohan	2,000
Jan. 11	Goods purchased from Shyam	31,500
Jan. 15	Goods returned to Shyam	1,500
Jan. 18	Bought furniture for office use by cheque	9,000
Jan. 22	Purchased goods for cash	1,000
Jan. 22	Paid cartage	50
Jan. 30	Paid interest on loan	500

Date	Particulars		LF.	Dr.(Rs.)	Cr.(Rs.)
2015 Jan. 1	Cash A/c	...Dr.		50,000	
	To Capital A/c				50,000
	(Being the business started with cash)				
Jan. 3	Bank A/c	...Dr.		40,000	
	To Cash A/c				40,000
	(Being the amount deposited into the Bank)				
Jan. 5	Mohan	...Dr.		22,000	
	To Sales A/c				22,000
	(Being the goods sold to Mohan)				
Jan. 9	Sales Return A/c	...Dr.		2,000	
	To Mohan				2,000
	(Being to goods returned by Mohan)				
Jan. 11	Purchases A/c	...Dr.		31,500	
	To Shyam				31,500
	(Being the goods purchased from Shyam)				
Jan. 15	Shyam	...Dr.		1,500	
	To Purchases Return A/c				1,500
	(Being the goods returned to Shyam)				
Jan. 18	Furniture A/c	...Dr.		9,000	
	To Bank A/c				9,000
	(Being the furniture bought and paid by cheque)				
Jan. 22	Purchases A/c	...Dr.		1,000	
	To Cash A/c				1,000
	(Being the goods purchased against cash)				
Jan. 22	Cartage A/c	...Dr.		50	
	To Cash A/c				50
	(Being the cartage paid)				
Jan. 30	Interest on Loan A/c,	...Dr.		500	
	To Cash A/c				500
	(Being the payment of interest on loan)				
	Total			1,57,550	1,57,558

2.5.2 SIMPLE AND COMPOUND JOURNAL ENTRIES

Entries in a Journal are of two types:

1. Simple Journal Entry and 2. Compound Journal Entry.

1. **Simple Journal Entry:** Simple Journal Entry is an entry in which only two accounts are affected, i.e., one account is debited and another is credited with an equal amount. The entries in Illustrations 2 arid 3 above are examples of Simple Journal Entry.

2. **Compound Journal Entry:** Compound Journal Entry is an entry in which two or more accounts are debited and one or more accounts are credited or vice versa. For example, a debt of Rs. 5,000 due from Satish (Debtor) has been discharged by receipt of Rs. 4,850 cash, Rs. 150 allowed as discount. The transaction affects three accounts as follows:

Cash A/C	Asset a/c:	Cash a/c (RS.4,850) to be debited because cash, *i.e.*, an asse has increased.
Discount allowed a/c	Expense a/c :	Discount allowed a/c (RS. 150) to be debited because it is a expense or loss for business.
Satish (debtor)	Asset a/c:	Satish (debtor) (RS. 5,000) to be credited because it is an asset.

The entry for the transaction is a Compound Entry as follows:

		Rs.	Rs.
Cash A/c	...Dr.	4,850	
Discount Allowed A/c	...Dr.	150	
To Satish			5,000

(Being the amount received from Satish and allowed him discount)

Let us take another example of a Compound Entry. Salary of Rs. 5,000 and trade expenses of Rs.3,000 are payable for the year ended 31st March, 2015. These expenses can be recorded in the books of accounts with the following compound Journal entry:

		Rs.	Rs.
Salary A/c	...Dr.	5,000	
Trade expenses A/c	...Dr.		3,000
To Expenses payable			8,000

(Being the salary and trade expenses payable provided)

Illustration 4 (Compound Journal Entries). Record the following transactions in a Journal:

2015		Rs.
Jan 1	Paid to Mohan in full settlement of his account of Rs. 10,000	9,500
Jan 5	Received from Ram Rs. 12,000 in cash and allowed him discount	100
Jan 7	Paid salaries	5,000
Jan 7	Paid rent	3,000
Jan7	Paid wages	1,000
Jan 10	Purchased goods of Rs. 20,000 out of which goods of Rs. 12,000 were on credit from Shayam Lal	

Solution: In the Books of

Journal

S.No.	Particulars	L.F.	Dr. Rs.	Cr. Rs.
1	Mohan ... Dr. To Cash A/c To Discount Received A/c (Being the payment to Mohan in full settlement of his account)		10,000	 9,500 500
2	Cash A/c ... Dr. Discount Allowed A/c ... Dr. To Ram (Being the receipt of money from Ram and allowed him discount)		12,000 100	 12,100
3	Salaries A/c ... Dr. Rent A/c ... Dr. Wages A/c ... Dr. To Cash A/c (Being the payment of salaries, rent and wages)		5,000 3,000 1,000	 9,000
4	Purchases A/c ... Dr. To Cash A/c To Shyam Lal (Being goods purchased for cash Rs. 8,000 and on credit from Shyam Lai for Rs. 12,000).		20,000	 8,000 12,000

2.5.3 Entries of Some Specific Transactions

1. ***Bad Debts:*** In a business, if an amount is not realised or is partially realised, the amount not realised is a loss and is termed as Bad Debt. The following Journal entries are passed in such a case:

(i) *When the amount is not recovered:*

Bad Debts A/c ...Dr. [With the amount not received]

To Debtor's Personal A/c

(Being the amount not recoverable written off as bad debt)

(ii) *When a part of debt is not recovered:* If a debtor becomes bankrupt and is unable to pay his debt in full, the unrealised amount is a loss to the business, i.e., a bad debt. The Journal entry passed is:

Cash or Bank A/c ...Dr. [With the amount received]

Bad Debts A/c ...Dr. [With the amount not recovered]

To Debtor's Personal A/c [Total amount of debtor]

(Being the amount received and balance written off as bad debt, not recoverable)

2. ***Bad Debts Recovered:*** Sometimes a debtor whose account had been earlier written off as a Bad Debt pays some amount. The amount so received is a gain to the business because the amount was earlier written off as a loss, i.e., bad debt. The entry of bad debts recovered is:

Cash or Bank A/c ...Dr.

To Bad Debts Recovered A/c

(Being the amount earlier written off as bad debt, now recovered)

Amount earlier written off as Bad Debt and recovered (in part or full) is credited to Bac Debts Recovered

Illustration 5 (Insolvency and Bad Debts). Journalise the following transactions:

(i) Sohan is declared insolvent. Received from his Official Receiver a dividend of 60 paise in the rupee on a debt of Rs. 1,000.

(ii) Mohan who owed Rs. 2,000 has become insolvent. He pays 50 paise in a rupee in full and final settlement.

(iii) Received cash for a bad debt written off last year Rs. 700.

Solution: In the Books of Journal ...

S.No.	Particulars	L.F.	Dr. Rs.	Cr. Rs.
1	Cash A/c ...Dr. Bad Debts A/c ...Dr. To Sohan (Being the cash dividend of 60 paise in the rupee out of his debt of Rs. 1,000 received from Sohan on his insolvency)	.	600 400	 1,000
2	Cash A/c ...Dr. Bad Debts A/c . ..Dr. To Mohan (Being 50 paise in rupee received from Mohan out of a debt of Rs. 2,000 in full and final settlement)		1,000 1,000	 2,000
3	Cash A/c ...Dr. To Bad Debts Recovered A/c* (Being the cash received on account of recovery of a bad debt which was previously written off)		700	 700

*Recovery of bad debt written off last year is a gain, therefore, it is credited to the Bad Debts Recovered Account.

3. ***Cash Withdrawn for Personal Use:*** Cash withdrawn for personal use is termed as 'Drawing'. The entry passed is:

Drawings A/c ...Dr.

To Cash A/c

(Being the cash withdrawn for personal use)

4. ***Banking Transactions:*** Businesses have a Bank Account through which most of the payments are received and paid. Payment by cheque, cheque received, withdrawal of cash from bank, deposit into bank, bank charges charged by bank and interest charged on overdraft by bank, etc., are examples of banking transactions. If the books of accounts show a debit balance in the Bank Account, it means that such amount is lying deposited in the bank. And if the books of accounts show a credit balance in the Bank Account, it means that such amount is overdrawn and is payable to the bank. At the time of recording banking transactions, following important considerations should be kept in mind:

1. Bank Account is an asset account and rule of debit and credit for an asset account, i.e., 'Increase is debited and decrease is credited' will apply. When amount is deposited in a bank, Bank Account is debited and when amount is withdrawn Bank Account is credited.

For example, cash deposit into bank increases the bank balance. Thus, Bank Account is debited. Cash withdrawal from the bank reduces the bank balance. Thus, the bank is credited.

2. If a cheque is received and is not deposited in the bank on the same day, it is debited to Cheques-in-Hand Account. When the cheque is deposited, Bank Account is debited and Cheques-in-Hand Account credited. If the cheque is deposited on the day it is received, Bank Account is debited instead of Cheques-in-Hand Account.

Let us take the Journal entries relating to banking transactions:

S.No.	Transaction	Entry	Nature of Account	Rule of Dr. & Cr.
1.	Cash deposited for opening an account	Bank A/c ...Dr. To Cash A/c	Asset Inc. Asset Dec.	Dr the Inc. in asset Cr. the Dec. in asset
2.	Cash withdrawn	Cash A/c ...Dr. To Bank A/c	Asset Inc. Asset Dec.	Dr. the Inc. in asset Cr. the Dec. in asset
3.	Cash withdrawn for personal use	Drawings A/c ...Dr. To Bank A/c	Capital Dec. Asset Dec.	Dr. the Dec. in capital Cr. the Dec. in asset
4.	Payment by cheque to a creditor (say Rakesh)	Rakesh ...Dr. To Bank A/c	Liability Dec. Asset Dec.	Dr. the Dec. in liability Cr. the Dec. in asset
5.	Payment by draft to a creditor (say Vikas)	Vikas ...Dr. Bank Charges A/c ...Dr. To Bank A/c	Liability Dec. Expenses Inc. Asset Dec.	Dr. the Dec. in liability Dr. the Inc. in expense Cr. the Dec. in asset
6.	Payment of expenses	Expenses A/c ...Dr. To Bank A/c	Expenses Inc. Asset Dec.	Dr. the Inc. in expense Cr. the Dec. in asset
7.	Charges paid to or charged by Bank	Bank Charges A/c ...Dr. To Bank A/c	Expenses Inc. Asset Dec.	Dr. the Inc. in expenses Cr. the Dec. in asset
8.	Cheque or draft received from a debtor (say Rahul) and deposited into bank the same day	Bank A/c / ...Dr. To Rahul	Asset Inc. Asset Dec.	Dr. the Inc. in asset Cr. the Dec. in asset
9.	Cheque received from a debtor (say Ankur) and not deposited into bank the same day	Cheques-in-Hand A/c* .Dr. To Ankur	Asset Inc. Asset Dec.	Dr. the Inc. in asset Cr. the Dec. in asset ,
10.	Above cheque/draft deposited into the bank	Bank A/c ...Dr. To Cheques-in-Hand A/c*	Asset Inc. Asset Dec.	Dr. the Inc. in asset Cr. the Dec. in asset
11-	Deposited cheque dishonoured (say of Ankur). .	Ankur ...Dr. To Bank A/c	Asset Inc. Asset Dec.	Dr. the Inc. in asset Cr. the Dec. in asset
.12.	Interest charged by the bank	Interest A/c ...Dr. To Bank A/c	Expenses Inc. Asset Dec.	Dr. the Inc. in expense Cr. the Dec. in asset
13.	Interest allowed by the bank	Bank A/c ...Dr. To Interest Received A/c	Asset Inc. Revenue Inc.	Dr, the Inc. in asset Cr. the Inc. in revenue
14.	Bank makes payment on firm's behalf (say insurance premium)	Insurance Premium A/c ..Dr. To Bank A/c	Expenses Inc. Asset Dec.	Dr. the Inc. in expense Cr. the Dec. in asset
15.	Collection by bank on our behalf (say dividend)	Bank A/c ...Dr. To Dividend A/c	Asset Inc. Revenue Inc.	Dr. the Inc. in asset Cr. the Inc. in revenue.
16.	Repayment of bank loan in cash	Bank Loan A/c ...Dr. To Cash A/c	Liability Dec. Asset Dec.	Dr. the Dec. in liability Cr. the Dec. in asset
17.	Repayment of bank loan by issue of cheque	Bank Loan A/c ...Dr. To Bank A/c	Liability Dec. Asset Dec.	Dr. the Dec. in liability Cr. the Dec . in asset
18.	Transfer of funds from one bank to another (say from SBI to PNB)	Bahk (PNB) A/c ...Dr. To Bank (SBI) A/c	Asset Inc. Asset Dec.	Dr. the Inc. in asset Cr. the Dec. in asset

* Cheques-in-Hand Account is debited because the cheque received has not been deposited into bank on the same day. On deposit of cheque into bank, this account is credited.

Illustration 6 (Banking transaction). Journalise the following transactions.

2015		Rs.
Jan. 1	Paid into bank for opening a current account	20,000
Jan. 2	Withdrawn cash for private expenses	1,000
Jan. 3	Withdrawn from bank	3,000
Jan. 4	Withdrawn from bank for private use	2,000
Jan. 5	Placed in fixed deposit account at bank by transfer from current account	5,000
Jan. 10	Goods purchased and amount paid by cheque	2,500

Solution: Journal

Date	Particulars	L.F.	Dr. (Rs.)	Cr. (Rs.)
2015 Jan. 1	Bank A/c ...Dr. To Cash A/c (Being the cash deposited into the bank)		20,000	20,000
Jan. 2	Drawings A/c ...Dr. To Cash A/c (Being the cash withdrawn for personal use)		1,000	1,000
Jan. 3	Cash A/c ...Dr. To Bank A/c (Being the cash withdrawn for office use)		3,000	3,000
Jan. 4	Drawings A/c ...Dr. To Bank A/c (Being the cash withdrawn from bank for personal use)		2,000	2,000
Jan. 5	Fixed Deposit A/c ...Dr. To Bank A/c (Being the transfer from Current Account to Fixed Deposit Account)		5,000	5,000
Jan. 10	Purchases A/c. ...Dr. To Bank A/c (Being the goods purchased and payment made through cheque)		2,500	2,500

5. Discount: A reduction in amount, either to encourage more purchase or prompt payment is called a Discount. A discount may be classified into:

(i) Trade Discount and (ii) Cash Discount.

(i) Trade Discount: Trade Discount is allowed when the goods are-sold to the purchaser for resale to the ultimate consumer or when the goods are purchased in large quantity. Trade Discount is allowed as a deduction from the sale value and the sale is recorded in the books of accounts at net amount, i.e., sale value less trade discount. The purchaser records it in the Purchases Book at the net purchase value.

(ii) Cash Discount: Cash Discount is an allowance or deduction allowed when amount is received promptly or before its due date. It is usually allowed as a percent (say 2%) of the amount received.

Cash Discount, received or allowed, is recorded separately in the books. Obviously, Cash Discount is allowed when payment is received and Cash Discount is received when a payment is made. Cash discount allowed is debited to **Discount Allowed Account** and cash discount received is credited to the **Discount Received Account**.

If both Trade Discount and Cash Discount are allowed, Trade Discount is allowed first and thereafter, Cash Discount is allowed. In other words, Cash Discount is calculated on the net amount.

Illustration 7. Pass the Journal entries for the following transactions:

(i) Purchased goods from Sanjiv of Rs. 40,000 at terms 10% Trade Discount and 5% Cash Discount. Paid amount at the time of purchase itself.

(ii) Purchased goods from Vijay of Rs. 40,000 on 10% Trade Discount and 5% Cash Discount. Half of the amount was paid at the time of purchase.

(iii) Sold goods to Anil for Rs. 20,000, allowed him 10% Trade Discount and 10% Cash Discount. Received half of the amount by cash and balance half by cheque within specified time.

(iv) Sold goods to Ajay for Rs. 50,000 allowing 5% Cash Discount and 10% Trade Discount. Half of the amount was received by cheque within specified time.

Solution: JOURNAL

Date	Particulars	L.F.	Dr. (Rs.)	Cr. (Rs.)
1.	Purchases A/c ………Dr.		36,000	
	To Cash A/c			34,200
	To Discount Received A/c			1,800
	(Being the goods purchased from Sanjiv @ 10% Trade Discount and 5% Cash Discount)			
2.	Purchases A/c …………..Dr.		36,000	
	To Vijay			18,000
	To Cash A/c			17,100
	To Discount Received A/c			900
	(Being the goods purchased from Vijay @ 10% Trade Discount and 5% Cash Discount. Half of the amount paid)			
3.	Cash A/c ……Dr.		8,100	
	Bank A/c …...Dr.		8,100	
	Discount Allowed A/c ……Dr.		1,800	
	To Sales A/c			18,000
	(Being the goods sold to Anil at 10% Trade Discount and 10% Cash Discount on Cash basis)			
4.	Cash A/c …….Dr.		22,500	
	Bank A/c …….Dr.		21,375	
	Discount Allowed A/c ……Dr.		1,125	
	To Sales A/c			45,000
	(Being the goods sold to Anil at 10% Trade Discount and 10% Cash Discount on Cash basis)			

Working Notes:

Calculation of Trade Discount and Cash Discount		Rs.
(i)	Invoice Price of Goods	40,000
	Less: Trade Discount @ 10%	4,000
		36,000
	Less: Cash Discount @ 5%	1,800
	Amount Paid	34,200
(ii)	Invoice Price of Goods	40,000
	Less: Trade Discount @ 10%	4,000
	Net Value of Goods	36,000
	A. Cash Transaction (Rs.36,000 x1/2)	18,000
	B. Credit Transaction (Rs.36,000 x 1/2)	18,000
	Cash Transaction	18,000
	Less: Cash Discount 5%	900
		17,000
(iii)	Gross Value of Sales	20,000
	Less: Trade Discount @ 10%	2,000
		18,000
	Less: Cash Discount @ 10%	1,800
	Amount Paid	16,200
	(Cash) 8,100 (i.e.,1/2 of Rs. 16,200) (Cheque) 8,100 (1/2)	
(iv)	Gross Value of Sales	50,000
	Less: Trade Discount @ 10%	5,000
	Net Value of Sales	45,000
A.	Cash Transaction (Rs. 45,000 x 1/2)	22,500
	Less: Cash Discount 5%	1,125
		21,375
B.	Credit Transaction	
	1/2 of Rs. 45,000	22,500

Illustration 8 *(Payments on Account and Payments in Full Settlement)*. Journalise the following transactions in the books of K.G. Gupta:

(i) Received Rs.9,750 from Hari Ram in full settlement of his account for Rs.10,000.

(ii) Received Rs. 9,750 from Shyam on his account for Rs.10,000.

(iii) Received first and final dividend of 60 paise in the rupee from the Official Receiver of Mr. Ashok who owed Rs. 10,000.

(iv) Paid Rs. 4,800 to Sohan in full settlement of his account for Rs. 5,000.

(v) Paid Rs. 4,800 to Mohan on his account against Rs. 5,000 due.

Solution Journal

	Particulars	L.F.	Dr. (Rs.)	Cr. (Rs.)
1.	Cash A/c ...Dr. Discount Allowed A/c ...Dr. To Hari Ram (Being the cash received from Hari Ram after allowing him discount of Rs. 250)		9,750 250	 10,000
2.	Cash A/c ...Dr. To Shyam (Being the cash received from Shyam on account)		9,750	 9,750
3.	Cash A/c ...Dr. Bad Debts A/c ...Dr. To Ashok (Being the 60 paise in the rupee received from Ashok)		6,000 4,000	 10,000
4.	Sohan ....Dr. To Cash A/c To Discount Received A/c (Being the cash paid to Sohan after receiving discount of 200)		5,000	 4,800 200
5.	Mohan ...Dr. To Cash A/c (Being the cash paid to Mohan on account)		4,800	 4,800

DISTINCTION BETWEEN TRADE DISCOUNT AND CASH DISCOUNT

Basis	*Trade Discount*	Cash *Discount*
Nature	It is allowed on purchases made in large quantity.	It is allowed on payment being made promptly on or before an agreed date.
Recording	It is hot recorded separately in the books of accounts .	Cash Discount is recorded separately in the books of accounts.
Deduction from Invoice	It is deducted from the invoice.	It is not deducted from the invoice.
Nature of Transaction	It is allowed on' both credit and cash transactions.	It is allowed only on payment.
Consideration	The consideration for allowance, is purchases.	The "consideration for allowance is payment.
Relation	It is related to sales and purchases of goods.	It is related to payment.

6. Goods Taken for Personal Use: Goods taken for personal use is also a drawing. The entry passed is:

Drawings A/c ...Dr.
  To Purchases A/c
(Being the goods taken for personal use)

Note: Cost of goods withdrawn is debited to Drawings Account and credited to Purchases Account. It is not considered as a sale but a decrease in purchases as no profit is earned on such goods.

7. Goods Given as Charity: Goods given as charity is not sale of goods since it is not for a consideration. The amount of purchases is reduced with the cost of goods given as charity. The entry passed is:

Charity A/c ...Dr.
  To Purchases A/c
(Being the goods given as charity, hence credited to Purchases Account)

Illustration 9. Record the following transactions in a Journal:

(i) Withdrawn goods for personal use (Cost Rs. 500, Sales Price Rs. 700).

(ii) Goods costing Rs. 500 given as charity.

(iii) Received Rs. 975 from Hari in full settlement of his account for Rs. 1,000.

(iv) Paid Rs. 1,400 to Guri in cash in full settlement of his account for Rs. 1,500.

(v) A cheque for Rs. 5,000 received from Rajiv deposited into bank was returned dishonoured.

Solution **JOURNAL**

Date	Particulars	L.F.	Dr. (Rs.)	Cr. (Rs.)
1	Drawings A/c …..Dr.		500	
	To Purchases A/c			500
	(Being the goods withdrawn for personal use)			
2	Charity A/c …..Dr		500	
	To Purchases A/c			500
	(Being the goods given as charity)			
3	Cash A/c …..Dr		975	
	Discount Allowed A/c …..Dr		25	
	To Hari			1,000
	(Being the amount received from Hari and allowed him discount)			
4	Guri . …..Dr		1,500	
	To Cash A/c			1,400
	To Discount Received A/c			100
	(Being the amount paid in full settlement)			
5	Rajiv …..Dr		5,000	
	To BankA/c			5,000
	(Being the cheque deposited into bank returned dishonoured)			

8. ***Distribution of Goods as Free Samples:*** Goods may be distributed as free samples to increase sales. It is in the nature of advertisement expense. Hence, it is debited to the Advertisement Account or Samples Account and deducted from purchases:

Advertisement A/c or Samples A/c ...Dr.

To Purchases A/c

(Being the goods distributed as free samples)

9. ***Loss by Theft or Fire:*** In both the cases, it is loss to business. The entry passed is:

Loss by Theft or Fire A/c ...Dr.

To Purchases A/c

(Being the loss of goods by theft or fire)

Note: Loss by Theft or Fire Account is debited because the loss is an expense account and the Purchases Account is credited because the purchases decrease. The loss will be treated in accounts as follows:

(i) *When goods (stock) are fully insured, loss is to be borne by the Insurance Company.* The entry passed is:

Insurance Co. or Insurance Claim A/c ...Dr.

To Loss by Theft or Fire A/c

(Being the loss of goods recoverable from the insurance company)

Insurance claim is an asset and will be shown as an asset in the Balance Sheet till the amount is received.

(ii) When the goods are partly insured:

Insurance Co. A/c	...Dr.	[Claim admitted]
Profit and Loss A/c	...Dr.	[Loss - claim not admitted]
To Loss by Theft or Fire A/c		[Total loss]

(Being the insurance claim partially admitted. Balance amount transferred to Profit and Loss A/c)

(iii) *When claim is received from the Insurance Company:*

Bank A/c ...Dr.

To Insurance Co.

(Being the insurance claim received)

(iv) *When the stock is not insured, loss is borne by the firm. At the end of the year, balance in loss by Theft or Fire Account is transferred to Profit and Loss Account:*

Profit and Loss A/c ...Dr.

To Loss by Theft or Fire A/c

(Being the loss transferred to Profit and Loss Account)

10. Goods used to make an Asset: When goods are used to make/construct an asset, value of the asset increases. Therefore, Asset Account is debited. The entry is:

Asset A/c ...Dr.

To Purchases A/c

(Being the goods used for making an asset)

Illustration 10. Journalise the following in the books of a timber merchant:

(i) Goods costing Rs. 500 were used by the proprietor for domestic purposes.

(ii) Rs. 200 due from Hari are bad debts.

(iii) Goods costing Rs. 3,000 were destroyed by fire. They were not insured.

(iv) Goods damaged by fire Rs. 1,000 and Insurance Co. accepted claim of Rs. 800.

(v) Goods costing Rs. 500 given as charity (Sales Price Rs. 600).

(vi) Paid landlord Rs. 1,500 for rent. One third of the premises is occupied by the proprietor for his own residence.

(vii) Sold household furniture for Rs. 5,000 in cash and paid the money into business.

(viii) Wood used for making office furniture Rs.2,000.

Solution JOURNAL

Date	Particulars	L.F.	Dr. (Rs.)	Cr. (Rs.)
1	Drawings A/c ….Dr. To Purchases A/c (Being the goods used for domestic purpose)		500	500
2	Bad Debts A/c ..Dr. To Hari (Being the bad debts written off)		200	200
3	Loss by Fire A/c ..Dr. To Purchases A/c (Being the goods destroyed by fire, they being not insured, it was a loss)		3,000	3,000
4	Loss by Fire A/c ..Dr. To Purchases A/c (Being the goods destroyed by fire, claim was lodged, they being insured)		1,000	1,000
5	Insurance Co. ..Dr. To Loss by Fire A/c (Being the insurance claim lodged with the Insurance Co.)		1,000	1,000
6	BankA/c ..Dr. Profit and Loss A/c ..Dr. To Insurance Co. (Being the insurance claim of ? 1,000 accepted by the Insurance Co. at? 800)		800 200	1,000
7	Charity A/c .Dr. To Purchases A/c (Being the goods costing ? 500 given as charity)		500	500
8	Rent A/c (2/3rd oft 1,500) ...Dr. Drawings A/c ...Dr. To Cash A/c (Being the.rent paid to landlord, 1/3rd of rent debited to Drawings Account, as 1/3rd of the premises is occupied by the proprietor for personal residence)		1,000 500	1,500
9	Cash A/c .Dr. To Capital A/c (Being the sale of household furniture and the proceeds brought into the business)		5,000	5,000
10	Furniture A/c ..Dr. To Purchases A/c (Being the wood used in making office furniture)		2,000	2,000

11. Purchase and Sale of Fixed Assets: Fixed assets include land, building, plant, machinery, furniture and fixtures, motor car, etc., when fixed asset is purchased, the asset account (individually) is debited. It is not debited to Purchases Account as fixed asset is not for the purpose of sales. Similarly, when fixed asset is sold, it is credited to Asset Account and not to Sales Account. Accounting entries are as follows:

(i) On Cash Purchase of Asset: Asset A/c ...Dr. To Cash or Bank A/c (Being the asset purchased against payment)	***(i) On Cash Sale of Asset:*** Cash or Bank A/c ….Dr. To Asset A/c (Being the asset sold against payment)
(iii) On Credit Purchase of Asset: Asset A/c. Dr. To Supplier's A/c (Being the asset purchased on credit)	***(ii) On Credit Sale of Asset-*** *Purchaser's* A/c …. Dr. To Asset A/c (Being the asset sold on credit)

12. Expenditure on the Installation of Machinery and on the Construction of Building: Machinery and Building are the assets of a business. Any expenditure incurred on carriage and installation of machinery, e.g., freight, wages paid for the installation, etc., is 'capital expenditure' and therefore, is debited to the Machinery Account. In other words, all expenses incurred on the purchase of an asset increase the cost of the asset and is debited to the particular Asset Account and not to Expense Account. For example, expenditure incurred for the construction of building such as purchase of construction materials and payment of wages are also capital expenditure and debited to the Building Account.

Illustration 11. Journalise the following transactions in the books of Gopal, a trader:

2015		**Rs.**
May 1	Purchased building and issued cheque	15,00,000
May 10	Purchased machinery from Remson on credit	2,00,000
May 15	Bought furniture from Hind Traders for cash	10,000
May 20	Bought a motor van and issued cheque	5,00,000
May 21	Paid for installation of machinery	2,500
May 25	Bricks, cement, etc., for Rs. 1,50,000 and timber for Rs. 2,00,000 purchased and used for the construction of building. Payment was made by cheque	

Solution Journal

Date	Particulars	L.F.	Dr. (Rs.)	Cr. (Rs.)
2015 May 1	Building A/c .... Dr. To Bank A/c (Being the building purchased and cheque issued)		15,00,000	15,00,000
May 10	Machinery A/c .... Dr. To Remson (Being the machinery purchased on credit from Remson)		2,00,000	2,00,000
May 15	Furniture A/c .... Dr. To Cash A/c (Being the furniture purchased on cash)		10,000	10,000
May 20	Motor Van A/c .... Dr. To Bank A/c (Being the motor van purchased and issued cheque)		5,00,000	5,00,000
May 21	Machinery A/c .... Dr. To Cash A/c (Being Rs. 2,500 paid for installation of machinery)		2,500	2,500
May 25	Building A/c .... Dr. To BankA/c (Being the bricks, cement, etc., for Rs. 1,50,000 and timber for Rs. 2,00,000 purchased and used for. the construction of building)		3,50,000	3,50,000

13. Central Sales Tax (CST): It is charged by the seller on inter-state sale, i.e., sale made outside the state. For example, sale made by a dealer (seller) in Rajasthan to a dealer (purchaser) in Delhi, it is a case of inter-state sale.

CST Collected on Sales: Sales Tax collected on sales is a liability as it is collected on behalf of the Government. It must be deposited in the Government Account by the due date. The entries passed are:

(i) Cash or Debtors'A/c ...Dr.

To Sales A/c

To Central Sales Tax A/c

(Being the sales made and Central Sales Tax collected)

(ii) At the time of depositing Sales Tax in the Government Account, the entry passed is:

Central Sales Tax A/c ...Dr.

To Cash or Bank A/c

(Being the Central Sales Tax collected and deposited in Government Account)

CST paid on Purchases: CST paid on purchases is a cost, it being not recoverable. Therefore, it is debited to Purchases Account.

14. ***Value Added Tax (VAT):*** VAT is the tax levied on sale made within the state. VAT paid on purchases is adjustable against VAT collected on sale. Thus, VAT paid is an asset while VAT collected is a liability of the business. VAT paid is adjusted against VAT collected. If the balance in VAT Collected Account is more than the balance in VAT Paid Account, the difference is deposited in the Government Account. In case the balance in VAT Paid Account is more than the balance in VAT Collected Account, it is carried forward to the next year as recoverable.

(i) *When VAT is paid at the time of purchases:*

Purchases A/c …..Dr.
VAT Paid A/c …..Dr.
To Cash or Bank or Creditor's A/c
(Being the purchases made and VAT paid recorded)

(ii) When VAT is collected at the time of sales:

Cash or Bank or Debtor's A/c ..…Dr.
To Sales A/c
To VAT Collected A/c
(Being the sales made and VAT collected recorded as liability)

(iiii) When VAT is paid to the Government:

(a) VAT Collected A/c
To VAT Paid A/c
(Being the balance in VAT Paid A/c transferred to VAT Collected A/c)

(b) VAT Collected A/c
To Cash or Bank A/c
(Being the balance in VAT Collected A/c after transfer of balance in VAT Paid A/c deposited)

15. ***Sundry Expenses:*** Often petty expenses are incurred in a business such as on refreshment, postage, conveyance, etc. Such expenses are normally debited in one account, i.e., Sundry Expenses Account. The Journal entry passed is:

Sundry Expenses A/c ...Dr.
To Cash A/c
(Being the miscellaneous expenses incurred)

Important Note

Adjustment Entries (16 to 21). These entries are passed at the end of the year to make necessary adjustments in accounts so that the final accounts show true and fair result of the business.

16. Closing Stock or Inventory: Closing Stock or Inventory is the goods unsold at the end of the year. It is not given in Trial Balance but is given as an additional information. In order to calculate the correct gross profit or gross loss, it should be brought into the books. Adjustment entry for Closing Stock is as follows:

Closing Stock A/c ...Dr.
    To Trading A/c
(Being the Closing Stock recorded)

Remember: *Closing Stock is to be valued at cost or net realisable value* **(i.e., market price) whichever is lower.**

17. Outstanding Expenses: Outstanding expenses are the expenses that relate to the current accounting year but have not been paid till the year end. They are accounted in the books of accounts as expense and also payable.

Example: Wages for the year ended 31st March, 2015 are Rs. 60,000. Out of this, Rs. 5,000 for the month of March, 2015 have been paid in April, 2015. Since, Rs. 5,000 as on 31st March, 2015 is yet to be paid it should be recorded in the books by passing the following Journal entry:

Wages A/c	...Dr. 5,000	
To Outstanding Wages A/c		5,000
(Being the outstanding wages accounted)		

18. Prepaid Expenses: Payment of expenses like Insurance, Rent of Shop, etc., are paid in advance, benefit of which may expire in the next accounting year. Such expenses are termed as prepaid expenses. Example: On 1st July, 2014, Rs. 1,200 were paid as insurance premium for the shop for the whole year. Final accounts have to be prepared on 31st March, 2015. It mean advance payment has been made for the period 1st April, 2015 to 30th June, 2015. Since, payment relating to the period 1st April, 2015 to 30th June, 2015 relates to the next year, it should be recorded in the books for the year ended 31st March, 2015 a prepaid expenses. Journal entry passed is:

Prepaid Insurance Premium A/c ...Dr. 300

To Insurance Premium A/c 300

(Being the amount transferred to Prepaid Insurance Premium A/c for the period 1st April, 2015 to 30th June, 2015)

Note: Prepaid Insurance Premium A/c is an asset.

19. Depreciation: Due to efflux of time or obsolescence or use of fixed assets, value of these assets decreases every year. This fall in value is called Depreciation. It is an expense, hence, a loss. The Journal entry passed is:

Depreciation A/c ...Dr.

To Asset A/c

(Being the depreciation on asset provided)

20. Accrued Income or Income Accrued but not Due: The income which is earned but not received is called accrued income. For example, interest on investment has become due but not received. For accrued income, following adjustment entry is passed:

Accrued Income A/c ...Dr.

To Income A/c

(Being the income earned but not yet received)

Accrued Income is an asset for the firm. Any increase in asset is always debited.

21. Income Received in Advance or Unearned Income: Income received but not earned during the accounting period is called income received in advance. For example, if Building has been given to a tenant on rent for Rs. 2,40,000 p.a. but during the year Rs. 3,00,000 has been received, then Rs. 60,000 will be the income (rent) received in advance. The Journal entry passed is:

Rent A/c ...Dr. 60,000

To Rent Received in Advance A/c 60,000

(Being the rent received in advance)

Unearned Income is a liability for the firm. Any increase in liability is always credited.

22. Interest on Capital: Interest may be allowed on proprietor's capital. It is an expense for the firm. If interest is allowed on capital, the entry passed is:

Interest on Capital A/c ...Dr.

To Capital A/c

(Being the interest on capital allowed @... %)

23. ***Interest on Drawing:*** Drawing means withdrawal of cash or goods for personal use by the proprietor. If interest is charged on drawing, it is an income. The entry passed is:

Drawing A/c …..Dr.

To Interest on Drawing A/c

(Being the interest on drawing charged @.....%)

Illustration 11. Pass the Journal entries for the following adjustments as on 31st March, 2015:

(i) Stock at the end of the year Rs. 20,000.

(ii) Salaries due to Administrative Staff Rs. 7,500.

(iii) Out of the rent paid this year, Rs. 2,000 relates to the next year.

(iv) Provide 10% depreciation on furniture costing Rs.5,000.

(v) Provide 10% interest on capital amounted to Rs. 1,00,000.

(vi) Charge interest on drawings Rs. 1,000.

(vii) Paid Rs. 200 for refreshment for a customer.

(viii) Rent due to landlord Rs. 500.

(ix) Interest due but not received Rs. 5,000.

Solution: Journal

Date	Particulars	L.F.	Dr. (Rs.)	Cr. (Rs.)
1	Closing Stock A/c ....Dr.		20,000	
	To Trading A/c			20,000
	(Being the closing stock brought into account)			
2	Salaries A/c ....Dr.		7,500	
	To Outstanding Salaries A/c			7,500
	(Being the salaries due to Administrative Staff)			
3	Prepaid Rent A/c ....Dr.		2,000	
	To Rent A/c			2,000
	(Being the rent paid in advance)			
4	Depreciation A/c ....Dr.		500	
	To Furniture A/c			500
	(Being the depreciation provided on furniture)			
5	Interest on Capital A/c ....Dr.		10,000	
	To Capital A/c			10,000
	(Being the interest provided on capital)			
6	Drawings A/c ....Dr.		1,000	
	To Interest on Drawings A/c			1,000
	(Being the interest charged on drawings)			
7	Sundry Expenses A/c ....Dr.		200	
	To Cash A/c			200
	(Being the amount incurred on refreshment for a customer)			
8	Rent A/c ....Dr.		500	
	To Outstanding Rent A/c			500
	(Being the outstanding rent during the year)			
9	Accrued Interest A/c ....Dr.		5,000	
	To Interest A/c			5,000
	(Being the interest due but not received)			

Illustration : 12 (Comprehensive). Journalise the following transactions :

(i) Mr. Peter started business with cash Rs. 40,000, cheque for Rs. 60,000 and a building valued at Rs. 5,00,000.

(ii) Purchased goods amounting to Rs. 2,00,000 out of which goods of Rs. 1,80,000 were purchased on credit from D. Lal.

(iii) Sold goods on credit to Ramesh Rs. 1,60,000.

(iv) Received cheque for Rs. 1,56,000 from Ramesh in full settlement of his account.

(v) Paid Rs. 1,78,000 to D. Lal in full settlement of Rs. 1,80,000 due to hom by cheque.

(vi) An old machine with the book value of Rs. 80,000 is exchanged for a new machine of Rs. 2,40,000. The old machine is valued at Rs. 50,000 for exchange purposes by Machine Tools Ltd.

(vii) Purchased a machinery from Pele & Sons of Rs. 50,000 on credit.

(viii) Depreciation of Rs. 5,000 was provided on the machinery at the end of the year.

(ix) Paid income tax Rs. 5,000.

(x) A cheque from a customer amounted to Rs. 5,000 deposited in the bank was returned dishonoured.

Solution :

In the Books of Mr. Peter

JOURNAL

Date	Particulars	L.F.	Dr. (Rs.)	Cr. (Rs.)
(i)	Cash A/c ....Dr. Bank A/c* ....Dr. Building A/c ....Dr. To Capital A/c (Being the business started with cash Rs. 40,000 cheque Rs. 60,000 and building of Rs. 5,00,000)		40,000 60,000 5,00,000	 6,00,000
(ii)	Purchase A/c ....Dr. To Cash A/c To D.Lal (Being the goods purchased cash Rs. 20,000 and on credit from Dr. Lal for Rs. 1,80,000)		2,00,000	 20,000 1,80,000
(iii)	Ramesh ....Dr. To Sales A/c (Being the goods sold to Ramesh on credit for Rs. 1,60,000)		1,60,000	 1,60,000
(iv)	Bank A/c* ....Dr. Discount Allowed A/c ....Dr. To Ramesh (Being the cheque received from Ramesh and allowed him discount of Rs. 4,000)		1,56,000 4,000	 1,60,000
(v)	D.Lal ....Dr. To Bank A/c To Discount Received A/c (Being the cheque issued to D.Lal in full settlement of his duties Rs. 1,80,000)		1,80,000	 1,78,000 2,000
(vi)	(New) Machine A/c ....Dr. Profit and Loss A/c (Rs. 80,000 - Rs. 50,000) ....Dr. To (Old) Machine A/c** To Machine Tools Ltd. (Being the exchange of old machine worth Rs. 80,000 valued at Rs. 50,000 for a new machine of Rs. 2,40,000)		2,40,000 30,000	 80,000 1,90,000
(vii)	Machinery A/c ....Dr. To Pele & Sons (Being the purchase of machinery on credit from Pele & Sons)		50,000	 50,000
(Viii)	Depriciation A/c ....Dr. To Machinery A/c (Being the purchase of machinery for the year)		5,000	 5,000
(ix)	Drawings A/c ....Dr. To Cash A/c (Being the purchase of machinery for the year)		5,000	 5,000
(x)	Customer ....Dr. To Bank A/c (Being the cheque deposited into bank dishonoured)		5,000	 5,000

* It is assumed the cheque was deposited into bank on the same day.

** The old machine should be credited with the book value and not the exchange value in order to cancel the Old Machine Account.

2.5.4 Opening Entry

Books of accounts are closed at the end of each year and a new set of books in the beginning of the new year is started. First entry in the Journal is to record the closing balances of the previous year as they become the opening balances of the new year. The entry passed to record closing balances of the previous year is called the **Opening Entry.** The Balance Sheet prepared at the end of the year reflects the closing balances of each asset and liability and is the basis for the opening entry. While passing an Opening Entry, all Assets Accounts are debited and Liabilities Accounts are credited.

The following example will make it more clear:

BALANCE SHEET
as at 31st March, 2015

Liabilities	Rs.	Assets	Rs.
Mahendra & Sons	5,600	Cash in Hand	430
Capital	20,000	Cash at Bank	2,675
		Sundry Debtors	7,495
		Closing Stock	9,000
		Machinery and Equipment	6,000
	25,600		25,600

Now, based on the above Balance Sheet, the Opening Entry will be:

Particulars	L.F.	Dr. (Rs.)	Cr. (Rs.)
Cash A/c ….Dr.		430	
Bank A/c ….Dr.		2,675	
Sundry Debtors A/c ….Dr.		7,495	
Stock A/c …Dr.		9,000	
Machinery and Equipment A/c ….Dr.		6,000	
To Mahendra & Sons			5,600
To Capital A/c			20,000
(Being the balance brought forward)			

Illustration 13. Journalise the following transactions in the books of Gaurav, a trader.

Balance as on 1st April, 2015

Debit Balances : Cash in Hand – Rs. 18,000; Cash at Bank - Rs. 25,600; Stock of Goods - Rs. 50,000; Furniture - Rs 10,000; and Building - Rs. 4,51,400.

Debtors : Vijay- Rs. 2,700; Anil - Rs. 1,500; Ashwani - Rs. 2,000; Anupam - Rs. 1,800; and Madhu - Rs. 5,000.

Credit Balances : Creditors : Anand - Rs. 5,400; Arya - & Co. - Rs. 77,000; Balwant Rai - 52,000; and Mrs. Anita's Loan - Rs. 1,00,000.

2015

April 1 Purchased goods worth Rs. 50,000 less 20% trade discount and 5% cash discount.

April 3 Rs. 2,646 received from Vijay and allowed him discount Rs. 54.

April 5 Bought 100 shares in Bharat Ltd. @ Rs. 15 per share, brokerage paid Rs. 30.

April 8 Goods worth Rs. 500 were damaged in transit, a claim was made on the railway authorities for the same.

April 10 Cash Rs. 5,292 paid to Anand and discount allowed by him Rs. 108.

April 13 Received cash from the railway in full settlement of claim for damaged in transit.

April 15 Anupam is declared insolvent and dividend of 50 paise in the rupee is received from him in full settlement.

April 18 Sold 40 shares in Bharat Ltd. @ Rs. 18 per share, brokerage paid Rs. 15.

April 20 Bought a horse for Rs. 20,000 and a carriage for Rs. 1,000 for delivering goods to customers.

April 22 Paid for : Charity	Rs. 502
Postage	Rs. 200
Stationery	Rs. 199

April 30 One month's interest on Mrs. Anita's Loan @ 12% p.a. became due but could not be paid.

April 30 The horse bought on April 20 died, its carcasss was sold for Rs. 5,000.

April 30 Received from travelling salesman Rs. 30,00 for goods sold by him after deducting his travelling expenses Rs. 150.

April 30 Paid for : Salaries	Rs. 3,500
Rent	Rs. 1,500

April 30 Sold goods worth Rs. 12,000 less 10% trade discount.

Date	Particulars		L.F.	Dr. (Rs.)	Cr. (Rs.)
2015 April 1	Cash A/c	....Dr.		18,000	
	Bank A/c	....Dr.		25,600	
	Stock A/c	....Dr.		50,000	
	Furniture A/c	....Dr.		10,000	
	Building A/c	....Dr.		4,51,400	
	Vijay	....Dr.		2,700	
	Anil	....Dr.		1,500	
	Ashwani	....Dr.		2,000	
	Anupam	....Dr.		1,800	
	Madhu	....Dr.		5,000	
	To Anand				5,400
	To Arya & Co.				77,000
	To Balwant Co.				52,000
	To Mrs. Anita's Loan				1,00,000
	To Capital A/c (Balancing Figure)				3,33,600
	(Being the balance brought in from last year)				
April 1	Purchased A/c	....Dr.		40,000	
	To Cash A/c				38,000
	To Discount Received A/c				2,000
	(Being the goods worth Rs. 50,000 bought for cash less 20% trade discount and 5% cash discount. Trade discount is not shown in the books but cash discount is shown in the books)				
April 3	Cash A/c	....Dr.		2,646	
	Discount Allowed A/c	....Dr.		54	
	To Vijay				2,700
	(Being the cash received from Vijay and allowed him discount)				
April 5	Investment in Shares A/c	....Dr.		1,530	
	To Cash A/c				1,530
	(Being the purchase of 100 shares from Vijay and allowed him discount)				
April 8	Investment in Shares A/c	....Dr.		500	
	To Purchase A/c				500
	(Being the claim sent to railway for goods damaged in transit)				
April 10	Anand	....Dr.		5,400	
	To Cash A/c				5,292
	To Discount Received A/c				108
	(Being the cash received in full settlement of claim for damages from railway)				
April 13	Cash A/c	....Dr.		500	
	To Railway Claim A/c				500
	(Being the cash received in full settlement of claim for damaged from railway)				
April 15	Cash A/c	....Dr.		900	
	Bad Debts A/c	....Dr.		900	
	To Anupam				1,800
	(Being the hall dues received from Anupam and balance written off as bad debts)				

Date	Particulars		L.F.	Dr. (Rs.)	Cr. (Rs.)
April 18	Cash A/c To investments in Shares A/c (Being 40 shares in Bharat Ltd. sold @ Rs. 18 per share less brokerage Rs. 15)	....Dr. .		705	705
April 20	Livestock A/c Carriage A/c To Cash A/c (Being the horse and carriage brought for delivering goods to customers)	....Dr. ....Dr.		20,000 1,000	21,000
April 22	Charity A/c Postage A/c Stationery A/c To Cash A/c (Being the cash paid for charity, postage and stationery)	....Dr. ....Dr. ....Dr.		501 200 199	900
April 30	Interest A/c To Mrs. Anita's Loan A/c (Being the interest payable on Mrs. Anita's Loan Rs. 1,00,000 @ 12% p.a. For one month)	....Dr.		1,000	1,000
April 30	Cash A/c Profit and Loss A/c To Livestock A/c (Being the horse carcass and for cash balance of cost of horse written off as loss)	....Dr. ....Dr.		5,000 15,000	20,000
April 30	Cash A/c Travelling Expenses A/c To Sales A/c (Being Rs. 3,000 cash received for sales from travelling salesman after deducting his travelling expenses Rs. 150)	....Dr. ....Dr.		3,000 150	3,150
April 30	Salaries A/c Rent A/c To Cash A/c (Being the payment of salaries and rent)	....Dr.		3,500 1,500	5,000
April 15	Cash A/c To Sales A/c (Being the sales of goods worth Rs. 12,000 less 10% trade discount)	....Dr. ....Dr.		10,800	10,800

2.6 LEDGER

Meaning of a Ledger: Earlier, we discussed the term Account. In an account, transactions of one nature are posted or summarised. All the accounts put together becomes a 'Ledger'. A Ledger may be defined as a "*book or register which contains, in a summarised and classified form, a permanent record of all transactions.*" It is the most important book of accounts, since the Trial Balance is drawn from it and from the Trial Balance, Financial Statements are prepared. Hence, the Ledger is called the **Principal**

Book.

Features of a Ledger

(i) The Ledger is a master record of all the accounts of a business firm.

(ii) It is prepared from Journal.

(iii) Ledger Accounts show the current balance in all accounts.

(iv) Trial Balance and Final Accounts are prepared from Ledger Accounts.

(v) Ledger Accounts summarise the effect of transactions upon assets, liabilities, capital, incomes and expenditures.

Utility of a Ledger: Ledger is the Principal Book of accounts which contains information regarding business transactions in the form of an account. Information about any account, cannot be extracted from the Journal, as it is a chronological record of business transactions. It can be extracted from a ledger account because all transactions relating to that account are written in that particular account. Generally, information required in business from time to time is:

- How much amount is due from a particular customer?
- How much amount is owed to a particular supplier?
- How much is the amount of purchase and sales during a given period?
- How much amount has been incurred on a particular head of expenditure?
- How much amount has been earned under a particular head of income?

Ledger, being the classified record of transactions can provide answer to the above, questions.

Liability Account in a Ledger shows the amount that the firm owes to creditors and others and Asset Accounts show the amount receivable from debtors or values of assets and stock. Revenue Accounts show the sources of income and Expenses Account shows the amount of expenses incurred under various heads.

Ledger is the basis of preparing the Trial Balance which helps in ascertaining the arithmetical accuracy of the accounts. Trial Balance is the basis for preparing the Final Accounts. Thus, without Ledger, it is difficult to prepare Profit and Loss Account and Balance Sheet.

Format of a Ledger: The format of ledger account is as follows:

Dr. **NAME OF THE ACCOUNT, e,g,, Wages a/c** **Cr.**

Date	Particulars	Folio (J.F.)	Amount (Rs.)	Date	Particulars	Folio (J.F.)	Amount (Rs.)
Date of the transaction	Name of the other account	Page or Reference Number of Subsidiary Book, where the entry was first ' recorded, *e.g.*, Cash Book	Amount of the transaction	Date of the transaction	Name of the other account	Page or Reference Number of Subsidiary Book, where the entry. was first recorded, e.g., Cash Book	Amount of the transaction

2.6.1 Posting the Entries

The process of transferring the transactions written in the Journal to the Ledger Account is called ***Posting****. In other words, the process of transferring entries from the Journal to the Ledger Accounts is termed as posting. Posting is necessary as it summarises all transactions relating to that account at one place.*

2.6.2 Mechanics of Posting

Following procedure is followed for posting the debit and credit aspects of the transaction recorded in a Journal:

1. Posting of an Account debited in a Journal entry: The steps to be followed are:

First. Identify the account to be debited in the Ledger.

Second. Enter the date of the transaction in the 'Date' column on the debit side of the account.

Third. Write the name of the account which has been credited in the respective entry in the 'Particulars' column on the debit side of the account as 'To' (name of account credited).

Fourth. Record the page number of the Journal where the entry exists in the 'Journal Folio (J.F.)' column.

Fifth. Enter the relevant amount in the 'Amount' column on the debit side.

2. *Posting of an Account credited in a Journal entry:* The steps to be followed are:

First. Identify the account to be credited in the Ledger.

Second. Enter the date of the transaction in the 'Date' column on the credit side.

Third. Write the name of the account which has been debited in the respective entry in the 'Particulars' column on the credit side of the account as 'By' (name of account debited).

Fourth. Record the page number of the Journal where the entry exists in the Journal Folio (J.F.) column.

Fifth. Enter the relevant amount in the 'Amount' column on the credit side.

For example, furniture of Rs. 1,200 is purchased from Modern Furnishers on March 6.

The Journal entry is:

		Rs.	Rs.
Furniture A/c	...Dr.	1,200	
To Modern Furnishers			1,200
(Being the furniture purchased on credit from Modern Furnishers)			

The process of posting will be in the Furniture Account in the 'Particulars' column we shall write 'To Modern Furnishers'. In the account of Modern Furnishers will be written as 'By Furniture Account'. The two accounts will, thus, appear as under:

Dr. FURNITURE ACCOUNT Cr.

Date	Particulars	J.F.	Rs.	Date	Particulars	J.F.	Rs.
March,6	To Modern Furnishers	57*	1,200				

Dr. MORDERN FURNITURE *Cr.*

Date	Particulars	J.F.	Rs.	Date	Particulars	J.F.	Rs.
				March, 6	By Furniture A/c	57*	1,200

*Journal Folio is imaginary.

The process of posting is also illustrated in the following chart:

JOURNAL

Date	Particular	L.F.	Dr. (Rs.)	Cr. (Rs.)
2015 May 5	Cash A/c ….Dr. To Sales A/c (Being the sales of goods for cash vide Cash Memo No….).		600	600
May 8	Mohan …..Dr. To Cash A/c To Discount Received A/c (Being the cash paid to and discount allowed by Mohan)		425	410 15
May 10	Purchases A/c ……Dr. To Dutt (Being the goods purchased from Dutt on credit		800	800

Ledger

Dr. CASH ACCOUNT Cr.

Date	Particulars	J.F.	Rs.	Date	Particulars	J.F.	Rs.
2015 May 5	To Sales A/c		600	2015 May 8	By Mohan		410

Dr. SALES ACCOUNT Cr.

Date	Particulars	J.F.	Rs.	Date	Particulars	J.F.	Rs.
				2015 May 5	By Cash A/c		600

Dr. SALES ACCOUNT Cr.

Date	Particulars	J.F.	Rs.	Date	Particulars	J.F.	Rs.
				2015 May 5	By Cash A/c		600

Dr. DISCOUNT RECEIVED ACCOUNT Cr.

Date	Particulars	J.F.	Rs.	Date	Particulars	J.F.	Rs.
				2015 May 8	By Mohan		15

Dr. MOHAN Cr.

Date	Particulars	J.F.	Rs.	Date	Particulars	J.F.	Rs.
2015 May 8	To Cash A/c To Discount Received A/c		410 15				

Dr. DUTT Cr.

Date	Particulars	J.F.	Rs.	Date	Particulars	J.F.	Rs.
				2015 May 10	By Purchases A/c		800

2.6.3 Posting of Opening Entry

As discussed earlier, all assets will show a debit balance. Such accounts will be opened and the relevant amount will be written on the debit side as 'To Balance brought down (b/d)'. On the contrary, the accounts of liabilities show credit balance. An account for each liability will be opened and the relevant amount will be written on the credit side as 'By Balance brought down (b/d)'.

Illustration 15. Pass the Opening Entry on 1st April, 2015 on the basis of the following information taken from the books of Mr. Ashok. Also, post the opening entry:

	Rs.
Cash in Hand	20,000
Sundry Debtors	60,000
Stock of Goods	40,000
Plant	50,000
Land and Building	1,00,000
Sundry Creditors	1,00,000

Solution JOURNAL

Date	Particular	L.F.	Dr. (Rs.)	Cr. (Rs.)
2015 April 1	Cash A/c ....Dr.		20,000	
	Sundry Debtors A/c .....Dr.		60,000	
	Stock A/c ......Dr.		40,000	
	Plant A/c ......Dr.		50,000	
	Land and Building A/c ..... Dr.		1,00,000	
	To Sundry Creditors' A/c			1,00,000
	To Capital A/c (Note)			1,70,000

Note: The excess of assets over liabilities is the proprietor's capital and is credited to his Capital account.

Ledger of Mr. Ashok

Dr. CAPITAL ACCOUNT Cr.

Date	Particulars	J.F.	Rs.	Date	Particulars	J.F.	Rs.
2015 April 1	To Balance B/d		20,000				

Dr. SUNDRY DEBTORS ACCOUNT Cr.

Date	Particulars	J.F.	Rs.	Date	Particulars	J.F.	Rs.
2015 April 1	To Balance B/d		60,000				

Dr. STOCK ACCOUNT Cr.

Date	Particulars	J.F.	Rs.	Date	Particulars	J.F.	Rs.
2015 April 1	To Balance B/d		40,000				

Dr. PLANT ACCOUNT Cr.

Date	Particulars	J.F.	Rs.	Date	Particulars	J.F.	Rs.
2015 April 1	To Balance B/d		50,000				

Dr. LAND & BUILDING ACCOUNT Cr.

Date	Particulars	J.F.	Rs.	Date	Particulars	J.F.	Rs.
2015 April 1	To Balance B/d		1,00,000				

Dr. SUNDRY CREDITORS ACCOUNT Cr.

Date	Particulars	J.F.	Rs.	Date	Particulars	J.F.	Rs.
				2015 April 1	To Balance B/d		60,000

Dr. CAPITAL ACCOUNT Cr.

Date	Particulars	J.F.	Rs.	Date	Particulars	J.F.	Rs.
				2015 April 1	To Balance B/d		1,70,000

Use of the words 'To' and 'By': It is customary to use the word 'To' with accounts which appear on the debit side of a Ledger Account. Similarly, the word 'By' is used with accounts which appear on the credit side of a Ledger Account. The words 'To' and 'By' do not have any specific meaning. Modern accountants, therefore, ignore the use of these words.

2.6.4 BALANCING OF ACCOUNTS

Balance of an account is the difference between the total of debit and credit sides of an account. After posting the transactions, accounts are balanced every year or after a certain period to ascertain the net effect of entries in the accounts. The difference in total of the two sides is written on the side whose total is short. For example, if the total of credit side is Rs. 50,000 and that of debit side is Rs. 40,000, the difference, i.e. Rs. 10,000 is written as Balance c/d on the debit side. It means the account has a credit balance of Rs. 10,000. On the other hand, if total of debit side is Rs. 75,000 and that of credit side is Rs. 55,000, the difference, i.e., Rs. 20,000 is written as Balance c/d on the credit side. It means, the account has a debit balance of Rs. 20,000. Debit balance is then written on the debit side as 'To balance brought down' or 'To Balance b/d', which is the opening balance for the new period. Credit balance is then written on the credit side as 'By Balance brought down', or 'By Balance b/d'. This is the opening balance for the new period. The total of the debit and credit sides of some accounts may be equal those accounts will not show any balance. The concept of balancing is illustrated in the following diagram:

Total the Two Sides of Ledger Account

Find the Difference

If the Debit Side Total is more than the Credit Side Total write the Difference on the Credit Side as ‘By Balance c/d’

If the Credit Side Total is more than the Debit side Total write the Difference on the Debit side as ‘To Balance c/d’

Make the total of the Debit Side equal to the Total of the Credit

Draw a Double Line after the Totals

Bring forward the Balance on the Next Date

If Debit Balance, write on the Debit Side as ‘To Balance b/d’

If Credit Balance write on the Credit Side as ‘By Balance b/d’

A perusal of cash account below reveals that the total of receipts (Debit) side is Rs.1,10,500 and that of payments (Credit) side is Rs.80,150. Thus, the account has a debit balance of 30,350, which is Cash-in-Hand.

Types of Accounts that are Balanced: Normally, Assets, Liabilities and Capital Accounts are balanced. Revenue and Expenses Accounts are not balanced. These accounts are closed by transferring to Trading or Profit and Loss Account at the end of the accounting year.

The Ledger Accounts based on Journal entries in Illustration 2 will be opened as follows:

LEDGER

Dr. CASH ACCOUNT **Cr.**

Date	**Particulars**	**J.F.**	**Rs.**	**Date**	**Particulars**	**J.F.**	**Rs.**
2015				2015			
April 1	To Capital A/c		1,00,000	April 2	By Bank A/c		70,000
April 4	To Bank A/c		1,000	April 3	By Purchases A/c		5,000
April 24	To Krishna		1,500	April 28	By Shyam		2,150
April 30	To Sales A/c		8,000	April 30	By Salaries A/c		3,000
				April 30	By Balance *c/d*		30,350
			1,10,500				1,10,500
	To Balance *b/d*		30,350				

Dr. CAPITAL ACCOUNT **Cr.**

Date	**Particulars**	**J.F.**	**Rs.**	**Date**	**Particulars**	**J.F.**	**Rs.**
2015				2015			
April 30	To Balance c/d		1,00,000	April 1	By cash a/c		1,00,000
				May 1	By balance b/d		1,00,000

Dr. BANK ACCOUNT **Cr.**

Date	**Particulars**	**J.F.**	**Rs.**	**Date**	**Particulars**	**J.F.**	**Rs.**
2015				2015			
April 2	To Cash a/c		70,000	April 4	By Cash a/c		1,000
				April 30	Balance c/d		69,000
			70,000				70,000
May 1	By balance b/d		69,000				

Dr. PURCHASE ACCOUNT* **Cr.**

Date	**Particulars**	**J.F.**	**Rs.**	**Date**	**Particulars**	**J.F.**	**Rs.**
2015							
April 3	To Cash a/c		5,000				
April 20	To Shyam		2,250				

Dr. SALES ACCOUNT* **Cr.**

Date	**Particulars**	**J.F.**	**Rs.**	**Date**	**Particulars**	**J.F.**	**Rs.**
				2015			
				April 13	By Krishna		1,500
				April 30	By Cash a/c		8,000

Dr. KRISHNA **Cr.**

Date	**Particulars**	**J.F.**	**Rs.**	**Date**	**Particulars**	**J.F.**	**Rs.**
2015				2015			
April 13	To Sales a/c		1,500	April 24	By cash a/c		1,500
			1,500				1,500

Dr. SHYAM **Cr.**

Date	**Particulars**	**J.F.**	**Rs.**	**Date**	**Particulars**	**J.F.**	**Rs.**
2015				2015			
April 28	To Cash a/c		2.150	April 20	By Purchases a/c		2,250
April 30	To Balance c/d		100				
			2,250				2,250
				May 1	By Balance b/d		100

Dr. SALARIES ACCOUNT*** **Cr.**

Date	**Particulars**	**J.F.**	**Rs.**	**Date**	**Particulars**	**J.F.**	**Rs.**
2015							
April 30	To Cash a/c		3,000				

Note: At the end of an accounting period, accounts marked(*) are closed by transfer to the Trading Account' and accounts marked(**) are closed by transfer to the 'Profit and Loss Account'. In other words, balance of accounts related to Goods Account, (e.g., Purchases Account, Sales Account, Purchases Return Account and Sales Return Account) and Direct Expenses Accounts are transferred to the Trading Account and accounts being indirect expenses or incomes are transferred to the Profit and Loss Account. Such accounts are balanced only for Trial Balance purpose. Account balances in the nature of assets and liabilities appear in the Balance Sheet which are not closed but carried forward to the next accounting period.

Illustration 14 : Journalise the following transctions, post them in Ledger accounts and balance them :

		Rs.
2015		
April 1	Kamal started business with cash.......	1,00,000
April 2	Bought goods for cash.......	30,500
April 3	Opened Bank Account with cash.......	50,000
April 4	Sold goods for cash.......	40,000
April 7	Bought goods from Surya on credit.......	30,000
April 10	Sold goods to Rakesh on credit.......	25,000
April 15	Purchsed Plant and Machinery and payment is made by cheque.......	16,600
April 19	Paid to Surya in cash.......	10,000
April 21	Received loan from Anil and deposited the same into bank	8,000
April 23	Goods returned to Surya.......	1,000
April 26	Withdraw from back for personal use.......	5,000
April 27	Paid to Surya by Cheque.......	8,000
April 29	Received cash from Rakesh.......	10,000
April 30	Purchased stationery by cash.......	200
April 30	Paid wages and salaries.......	10,000

Solution :

In the Books of Kamal
JOURNAL

Date	Particulars	L.F.	Dr. (Rs.)	Cr. (Rs.)
2015 April 1	Cash A/c ....Dr. To Capital A/c (Being the business started with capital of Rs. 1,00,000 brought in cash)		1,00,000	1,00,000
April 2	Purchases A/c ....Dr. To Cash A/c (Being the goods purchased for cash)		30,500	30,500
April 3	Bank A/c ....Dr. To Cash A/c (Being the Bank Account opened for depositing cash into bank)		50,000	50,5000
April 4	Cash A/c ....Dr. To Sales A/c (Being the Bank Account opened by depositing cash into bank)		40,000	40,000
April 7	Purchase A/c ....Dr. To Surya (Being the goods purchased on credit from Surya		30,000	30,000

April 10	Rakesh To Sales A/c (Being the goods sold to Rakesh on credit)	....Dr.		25,000	25,000
April 15	Plant and Machinery A/c To Ban A/c (Being the plant and machinery purchased by cheque)	....Dr.		16,600	16,600
April 19	Surya To Cash A/c	....Dr.		10,000	
	(Being the amount paid to Surya in Cash)				10,000
April 21	Bank A/c To Anil's Loan A/c	....Dr.		8,000	
	(Being the loan from Anil received and deposited into bank)				8,000
April 23	Surya To Returns Outward A/c (Being the goods returned to Surya)	....Dr.		1,000	1,000
April 26	Drawings A/c To Bank A/c	....Dr.		5,000	
	(Being the amount withdrawn from bank for personal use)				5,000
April 27	Surya To Bank A/c	....Dr.		8,000	
	(Being the amount paid to Surya by cheque)				8,000
April 29	Cash A/c To Rakesh	....Dr.		10,000	
	(Being the cash received from Rakesh)				10,000
April 30	Stationery A/c To Cash A/c	....Dr.		200	
	(Being the stationery purchased to cash)				10,200
April 30	Wages and Salaries A/c To Cash A/c	....Dr.		10,000	
	(Being the wages and salaries paid in cash)				10,000

Ledger

Dr. **CASH ACCOUNT** **Cr.**

Date	Particulars	J.F.	Rs.	Date	Particulars	J.F.	Rs.
2015				2015			
April 1	To Capital a/c		1,00,000	April 2	By Purchases A/c		30,500
April 4	To Sales A/c		40,000	April 3	By Bank A/c		50,000
April 29	To Rakesh		10,000	April 19	By Surya		10,000
				April 30	By Stationery A/c		200
				April 19	By Wages and Salaries A/c		10,000
				April 19	By Balance c/d		49,300
			1,50,000				1,50,000
May 1	To balance b/d		49,300				

CAPITAL ACCOUNT

Dr. Cr.

Date	Particulars	J.F.	Rs.	Date	Particulars	J.F.	Rs.
2015				2015			
April 30	To balance c/d		1,00,000	April 1	By Cash A/c		1,00,000
			1,00,000				1,00,000
				May 1	To balance b/d		1,00,000

PURCHASES ACCOUNT*

Dr. Cr.

Date	Particulars	J.F.	Rs.	Date	Particulars	J.F.	Rs.
2015				2015			
April 2	To Cash A/c		30,500	April 30	By balance c/d		60,500
April 7	To Surya		30,000				
			60,500				60,500
May 1	To balance b/d		60,500				

BANK ACCOUNT

Dr. Cr.

Date	Particulars	J.F.	Rs.	Date	Particulars	J.F.	Rs.
2015				2015			
April 3	To Cash A/c		50,000	April 15	By Plant and Machinery A/c		16,600
April 21	To Anil's Loan A/c		8,000	April 30	By Drawings a/c		5,000
				April 30	By Surya		8,000
				April 30	By Balance c/d		28,400
			58,000				58,000
May 1	To balance b/d		28,400				

SALES ACCOUNT*

Dr. Cr.

Date	Particulars	J.F.	Rs.	Date	Particulars	J.F.	Rs.
2015				2015			
April 30	To Balance c/d		65,000	April 4	By Cash A/c		40,000
				April 30	By Rakesh		25,000
			65,000				65,000
				May 1	To balance b/d		65,000

SURYA

Dr. Cr.

Date	Particulars	J.F.	Rs.	Date	Particulars	J.F.	Rs.
2015				2015			
April 19	To Cash A/c		10,000	April 7	By Purchase A/c		30,000
April 23	To Returns Outward A/c		1,000				
April 27	To Bank A/c		8,000				
April 30	To Balance c/d		11,000				
			30,000				30,000
				May 1	To balance b/d		11,000

RAKESH

Dr. | Cr.

Date	Particulars	J.F.	Rs.	Date	Particulars	J.F.	Rs.
2015				2015			
April 10	To Sales A/c		25,000	April 29	By Cash A/c		10,000
				April 30	By Balance c/d		15,000
			25,000				25,000
May 1	To Balance b/d		15,000				

PLANT AND MACHINERY ACCOUNT

Dr. | Cr.

Date	Particulars	J.F.	Rs.	Date	Particulars	J.F.	Rs.
2015				2015			
April 15	To Bank A/c		16,600	April 30	By Balance c/d		16,600
			16,600				16,600
May 1	To Balance b/d		16,600				

ANIL'S LOAN ACCOUNT

Dr. | Cr.

Date	Particulars	J.F.	Rs.	Date	Particulars	J.F.	Rs.
2015				2015			
April 30	To Balance c/d		8,000	April 21	By Bank A/c		8,000
			8,000				8,000
				April 1	By Balance b/d		8,000

RETURNS OUTWARD ACCOUNT*

Dr. | Cr.

Date	Particulars	J.F.	Rs.	Date	Particulars	J.F.	Rs.
2015				2015			
April 30	To Balance c/d		1,000	April 23	By Surya		1,000
			1,000				1,000
				April 1	By Balance b/d		1,000

DRAWINGS ACCOUNT

Dr. | Cr.

Date	Particulars	J.F.	Rs.	Date	Particulars	J.F.	Rs.
2015				2015			
April 26	To Bank A/c		5,000	April 30	By Balance c/d		5,000
			5,000				5,000
May 1	To Balance b/d		5,000				

STATIONERY ACCOUNT*

Dr. | Cr.

Date	Particulars	J.F.	Rs.	Date	Particulars	J.F.	Rs.
2015				2015			
April 30	To Cash A/c		200	April 30	By Balance c/d		200
			200				200
May 1	To Balance b/d		200				

WAGES & SALARIES ACCOUNT*

Dr. **Cr.**

Date	Particulars	J.F.	Rs.	Date	Particulars	J.F.	Rs.
2015				2015			
April 30	To Cash A/c		10,000	April 30	By Balance c/d		10,000
			10,000				10,000
May 1	To Balance b/d		10,000				

** Expenses and Revenues Accounts (Purchases Account, Sales Account, Returns Outward Account, Stationery Account, Wages and Salaries Account) are not balanced but are closed at the end of the year by transferring to Trading Account or Profit and Loss Account. They have been balancecd only for the purpose of showing them in the Trial Balance.*

2.6.5 Distinction between Journal and Ledger

Pointof Distinction	Journal	Ledger
1. Nature of Book	It is a book of primary entry.	It is a book of final entry.
1. Basis for Preparation	Primary documents (such as vouchers, receipts, etc.) are the basis for recording transactions in the Journal.	Journal is the basis for recording transactions in the Ledger.
2. Stage of Recording	Recording in the Journal is the first stage.	Recording in the Ledger is the second stage.
3. Object	It is prepared to record all transactions in chronological order.	It is prepared to see the net effect of various transactions affecting a particular account;
4. Format	Journal has five columns: 1. Date, 2. Particulars, 3. Ledger Folio, 4. Debit Amount, 5. Credit Amount.	Ledger has four identical columns on debit and credit side: 1. Date, 2. Particulars, 3. Journal Folio, 4. Amount.
5. Balancing	Journal is not balanced.	All Ledger accounts (except Nominal Accounts) are balanced in the Ledger.
6. Process	The process of recording in Journal is called Journalising.	The process of recording in the Ledger is called Posting.
7. Basisof Preparation m Filial Accounts	Journal directly does not serve as basis for the preparation of final accounts.	Ledger serves as the basis for the preparation of final accounts.

2.7 TRIAL BALANCE

After posting the transactions in the accounts and balancing them, a statement is prepared to show separately the debit and credit balances. Such a statement is known as Trial Balance. The total of the debit side of Trial Balance must be equal to that of its credit side. This is based on the principle that in double entry system, for every debit there is a corresponding credit of equal amount. The agreement of Trial Balance shows arithmetical accuracy of the accounting process. If the two sides do not agree, there is definitely some error or errors. *It must be remembered that equalising the two sides of a Trial Balance is not the sole and conclusive proof of the correctness of accounting work.*

2.7.1 Meaning of Trial Balance

"A Trial Balance is a statement, prepared with the debit and credit balances of the Ledger Accounts to test the arithmetical accuracy of the books." **-J.R. Batliboi.**

"A Trial Balance is the list of debit and credit balances, taken out from the Ledger, It also includes the balances of cash and bank taken from the Cash Book."

-Carter.

A Trial Balance is prepared after having posted the Journal entries into the Ledger and balancing the accounts. The balance of an account is the difference between the total of the debit entries and the total of the credit entries in an account. If the total of debit entries is greater, it is called a **Debit Balance.** Likewise, if the total of credit entries is greater, it is called a **Credit Balance.** All Ledger Accounts showing debit balances are posted in one column and those showing credit balances are posted in the other. We have already discussed that under the Double Entry System, for every debit there is an equal and corresponding credit. Therefore, the total of debit balances in different accounts in the Ledger must be equal to the total of credit balances in different accounts, i.e., the total of the two columns should agree. If they agree, it means that both the aspects of each transaction have been recorded in the correct side of the Ledger.

2.7.2 Characteristics or Features of a Trial Balance

1. It is a list of balances of Ledger Accounts and Cash Book.

2. It is not a part of the Double Entry System of Book Keeping. It is a result of Double Entry System of Book Keeping. It is only a working paper.

3. It can be prepared on any date.

4. It verifies the arithmetical accuracy of posting of entries from the Journal to the Ledger.

5. It is not a conclusive proof of the accuracy of the books of accounts since some errors are not disclosed by the Trial Balance, for example, error of principle.

2.7.3 Objectives or Functions of a Trial Balance

(i) To Ascertain the Arithmetical Accuracy of Ledger Accounts: The Trial Balance enables one to establish whether posting and other accounting processes have been carried out without committing arithmetical errors.

(ii) To Help Prepare the Final Accounts: Financial Statements are prepared from, the Trial Balance. Preparation of Financial Statements, therefore, is the second objective of preparing a Trial Balance.

(iii) Summary of Each Account: The Trial Balance offers a summary of the Ledger. The Ledger may have to be referred to only when more detail is required in respect of an account.

(iv) To Help in Locating Errors: The Trial Balance helps in locating errors in Book Keeping work. It should, however, be borne in mind that it does not disclose all the errors in Book Keeping but only the arithmetical inaccuracies.

2.7.4 Preparing a Trial Balance

A Trial Balance is prepared by placing the debit or credit balances separately in the two columns. Debit balances are placed in the 'Debit Column' and credit balances in the 'Credit Column'.

Format of a Trial Balance is as follows:

TRIAL BALANCE
as on

Heads of Account	LF.	Dr. (Rs.)	Cr. (Rs.)

While preparing a Trial Balance, the following points should be borne in mind:

(i) It is prepared on a particular date which should be written on the top.

(ii) In the first column, the name of the account is written.

(iii) In the second column, Ledger Folio, i.e., the page number of the Ledger where the balance appears is written.

(iv) In the third column, the debit balance, if any, is written.

(v) In the fourth column, the credit balance is written.

(vi) The two columns are totalled at the end.

Consider the following Ledger account:

Dr. RAMESH Cr.

Date	Particulars	JF	Rs.	Date	Particulars	J.F.	Rs.
2013				2013			
April 1	To Balance *b/d*		20,000	April 5	By Bank A/c		19.800
April 6	To Sales A/c		18 500	April 5	By Discount A/c		200
April 27	To Sales A/c		11,300	April 11	By Sales Return A/c		2,500
				April 30	By Balance *c/d*		27,300
			49,800				**49,800**
May 1	To Balance c/d		27.300				

In the Trial Balance, the account will appear as follows:

Heads of Account	LF.	Dr. (Rs.)	Cr. (Rs.)
Ramesh		27,300	

Hints for Preparing a Trial Balance

1. A Trial Balance is prepared with the help of Ledger and Cash Book.

2. While preparing a Trial Balance all Accounts i.e., Assets, Liabilities, Capital, Expenses and Revenue Accounts are considered. These Ledger Accounts except cash and bank balances are taken from the ledger.

3. In addition to these, the cash balance and bank accounts are also taken from the Cash Book.

4. If an account does not have a balance, it is ignored.

5. The Ledger Accounts showing debit balances are shown in the debit column of a Trial Balance and the Ledger Accounts showing credit balances are shown in the credit

column of a Trial Balance.

6. Purchases Account always has a debit balance which is shown in the debit column of a Trial Balance.

7. Sales Account always has a credit balance which is shown in the credit column of a Trial Balance.

8. Returns Inward Account or Sales Return Account always has a debit balance and hence is shown in the debit column of a Trial Balance.

9. Returns Outward Account or Purchases Return Account always has a credit balance and hence is shown in the credit column of a Trial Balance.

10. Opening Stock Account has a debit balance which is shown in the debit column a Trial Balance.

11. Generally, closing stock does not appear in the Trial Balance. It is usually give as an additional information or adjustment outside the Trial Balance. It represents the balance of goods unsold out of opening stock and purchases. To incorporate the closing stock in the books, Closing Stock Account is debited and the Trading Account is credited by the amount of unsold stock at the end. Closing stock appears as an asset on the assets side of the Balance Sheet.

If the closing stock appears in the Trial Balance, it means that it has already been adjusted through purchases by debiting the closing stock and crediting the Purchase Account. In this case, closing stock will not be shown on the credit side of the Trading Account but will be shown as an asset on the assets side of the Balance Sheet.

12. Accounts of assets such as Plant and Machinery, Furniture and Fixtures, Land Building, Motor Car, Bills Receivable, Goodwill, Trade Marks, Patents an Copy Right, Cash in Hand, etc., have a debit balance and are shown in the debit column of a Trial Balance.

13. Bank balance may be debit or credit. If bank balance is debit, it is shown in the debit column of a trial balance. If it is credit, it is shown in the credit column of a trial balance.

14. Accounts of incomes and gains have credit balances and are shown in the credit column of a Trial Balance.

15. Accounts of expenses and losses have debit balances and are shown in the debit column of a Trial Balance.

Debit Balances: Assets, drawings, debtors, expenses and losses.
Credit Balances: Liabilities, capital, creditors, incomes and gains.

Illustration 15. From the following transactions, pass the necessary Journal entries i the books of Mohan & Co., post them into their Ledger and prepare the Trial Balance.

Date	Particulars	Rs.
2012		
Jan. 1	Mohan started business with cash	80,000
Feb. 5	Purchased goods	25,000
Feb. 20	Sold goods	30,000
May 10	Purchased goods from, Sohan	18,000
May 25	Sold goods to Ramesh	20,000
June 15	Cash given to Sohan	18,000
June 28	Cash received from Ramesh	20,000
Aug. 2	Purchased goods for cash from Sohan	19,000
August 29	Withdrew for personal use	1,500
Oct. 10	Purchased goods from Dinesh	17,000
Nov. 20	Cash paid to Dinesh	16,800
	Discount allowed by him	200
Dec. 31	Paid salaries	2,000

Solution: JOURNAL

Date	Particulars	L.F.	Dr. (Rs.)	Cr. (Rs.)
2012				
Jan. 1	Cash A/c ...Dr. To Capital A/c (Being the cash brought in for capital)		80,000	80,000
Feb. 5	Purchases A/c ..Dr. To Cash A/c (Being the goods purchased for cash)		25,000	25,000
Feb. 20	Cash A/c ...Dr. To Sales A/c (Being the sales of goods for cash)		30,000	30,000
May 10	Purchases A/c ...Dr To Sohan (Being the purchases of goods from Sohan)		18,000	18,000
May 25	Ramesh ...Dr To Sales A/c (Being the sales of goods to Ramesh)		20,000	20,000
June 15	Sohan ...Dr. To Cash A/c (Being the cash paid to Sohan)		18,000	18,000
June 28	Cash A/c ….Dr. To Ramesh (Being the cash received from Ramesh)		20,000	20,000
Aug. 2	Purchases A/c* ...Dr. To Cash A/c (Being the purchases of goods for cash)		19,000	19,000
August 29	Drawings A/c ...Dr. To Cash A/c (Being the cash withdrawn for pers onal use)		1,500	1,500
Oct. 10	Purchases A/c ...Dr. To Dinesh (Being the goods purchased from Dinesh)		17,000	17,000
Nov. 20	Dinesh ...Dr. To Cash A/c To Discount Received A/c (Being the cash paid to the extent of 716,800 to Dinesh and he allowed discount of 7,200)		17,000	16,800 200
Dec. 31	Salaries A/c ...Dr. To Cash A/c (Being the salaries paid)		2,000	2,000
	Total		2,67,500	2,67,500

* As it is a cash transaction, hence name of Sohan has not been recorded.

Dr. CASH ACCOUNT Cr.

Date	Particulars	L.F.	Rs.	Date	Particulars	L.F.	Rs.
2012				2012			
Jan. 1	To Capital a/c		80,000	Feb. 5	By Purchase a/c		25,000
Feb. 20	To Sales a/c		30,000	June 15	By Sohan		18,000
June 28	To Ramesh		20,000	Aug. 2	By Purchase a/c		19,000
				Aug. 29	By Drawing a/c		1,500
				Nov. 20	By Dinesh		16,800
				Dec. 31	By Salaries a/c		2,000
				Dec. 31	By Balance c/d		47,700
			1,30,000				**1,30,000**
2013 Jan. 1	To balance b/d		47,700				

Dr. CAPITAL ACCOUNT Cr.

Date	Particulars	J.F.	Rs.	Date	Particulars	J.F.	Rs.
2012 Dec. 31	To Balance c/d		80,000	2012 Jan. 1	By Cash A/c		80,000
				2013 Jan. 1	By Balance b/d		80,000

Dr. PURCHASES ACCOUNT Cr.

Date	Particulars	J.F.	Rs.	Date	Particulars	J.F.	Rs.
2012							
Feb. 5	To Cash A/c		25,000				
May 10	To Sohan		18,000				
Aug. 2	To Cash A/c		19,000				
Oct. 10	To Dinesh		17,000				
			79,000				

Dr. SALES ACCOUNT Cr.

Date	Particulars	J.F.	Rs.	Date	Particulars	J.F.	Rs.
				2012			
				Feb. 20	By Cash A/c		30,000
				May 25	By Ramesh		20,000
							50,000

Dr. SOHAN Cr.

Date	Particulars	J.F.	Rs.	Date	Particulars	J.F.	Rs.
2012 June 15	To Cash a/c		18,000	2012 May 10	By Purchases a/c		18,000

Dr. RAMESH Cr.

Date	Particulars	J.F.	Rs.	Date	Particulars	J.F.	Rs.
2012 May 25	To Sales a/c		20,000	2012 June 28	By Cash a/c		20,000

Dr. DRAWING ACCOUNT Cr.

Date	Particulars	J.F.	Rs.	Date	Particulars	J.F.	Rs.
2012 Aug. 29	To Cash a/c		1,500	2012 Dec. 31	By Balance c/d		1,500
2013 Jan. 1	To balance b/d		1,500				

Dr. DINESH Cr.

Date	Particulars	J.F.	Rs.	Date	Particulars	J.F.	Rs.
2012 Nov. 20 Nov. 20	To Cash a/c To Discount received a/c		16,800 200	2012 Oct. 10	By Purchases a/c		17,000
			17,000				17,000

Dr. DISCOUNT RECEIVED ACCOUNT Cr.

Date	Particulars	J.F.	Rs.	Date	Particulars	J.F.	Rs.
				2012 Nov.20	By Dinesh		200

Dr. SALARIES ACCOUNT Cr.

Date	Particulars	J.F.	Rs.	Date	Particulars	J.F.	Rs.
2012 Dec. 31	To Cash a/c		2,000				

TRIAL BALANCE
as on 31st December, 2012

Heads of Accounts	L.F.	Debit Balance	Credit Balance
Capital a/c		....	80,000
Cash a/c		47,700	.....
Purchases a/c		79,000	.....
Sales a/c		.....	50,000
Drawing a/c		1,500	....
Discount received a/c		....	200
Salaries a/c		2,000	.....
Total		1,30,200	1,30,200

Notes:

1. At the end of the year, balance of Purchases Account will be transferred to the debit of Trading Account and balance of Sales Account will be transferred to the credit of Trading Account.

2. Balance of Salary Account will be transferred to the debit of Profit and Loss Account and balance of Discount Received Account will be transferred to the credit of Profit and Loss Account.

Expenses and Revenue Accounts are not balanced but are closed at the end of the accounting period by sterling their balances to Trading and Profit and Loss Account

Illustration 16 : Enter the following transactions in the subsidiary books, post them into the Ledger and prepare a Trial Balance :

2012		Rs.
Nov. 1	Sudhir commenced business with cash	1,00,000
Nov. 4	Bought furniture from Raj Furniture House	5,000
Nov. 5	Purchased goods for cash	10,000
Nov. 8	Purchased goods from Marathi & Co. For Rs. 15,000 Trade Discount 10%	
Nov. 9	Opened a Bank Account by depositing	15,000
Nov. 10	Sold goods for cash	20,000
Nov. 10	Purchased stationery from R.K. Mart	500
Nov. 11	Sold goods to Zakir Khan	13,000
Nov. 14	Goods returned by Zakir Khan	3,000
Nov. 15	Payment to Marathi & Co. by Cheque	5,000
Nov. 20	Goods purchased on credit from Khosla & Co.	10,000
Nov. 25	Goods returned to Kholsa & Co.	2,000
Nov. 28	Paid electricity bill	200
Nov. 29	Cash Sales	10,000
Nov. 30	Withdraw Rs. 2,000 for private use from the bank	

Solution :

CASH BOOK (DOUBLE COLUMN)

Dr. Cr.

Date	Particulars	L.F.	Cash Rs.	Bank Rs.	Date	Particulars	L.F.	Cash Rs.	Bank Rs.
2012					2012				
Nov. 1	To Capital A/c		1,00,000		Nov. 5	By Purchases A/c		10,000	
Nov. 9	To Cash A/c	(C)		15,000	Nov. 9	By Bank A/c	(C)	15,000	
Nov. 10	To Sales A/c		20,000		Nov. 15	By Marathi & Co.			5,000
Nov. 29	To Sales A/c		10,000		Nov. 28	By Electricity Charges A/c		200	
					Nov. 30	By Drawings A/c			2,000
					Nov. 30	By Balance c/d		1,04,800	8,000
			1,30,000	15,000				1,30,000	15,000
Dec. 1	To Balance b/d		1,04,800	8,000					

PURCHASE BOOK

Date	Particulars	L.F.	Details (Rs.)	Amount Rs.
2012				
Nov. 8	Marathi & Co.		15,500	13,500
	Less : Trade Discount		1,500	
Nov. 20	Khosla & Co.			10,000
Nov. 30	**Purchases A/c ....Dr.**			23,500

SALES BOOK

Date	Particulars	L.F.	Details (Rs.)	Amount Rs.
2012				
Nov. 11	Zakir Khan			13,000
Nov. 30	**Sales A/c ....Cr.**			13,000

PURCHASES RETURN BOOK

Date	Particulars	L.F.	Details (Rs.)	Amount Rs.
2012 Nov. 25	Khosla & Co.			2,000
Nov. 30	**Purchases Return A/c ....Cr.**			2,000

SALES RETURN BOOK

Date	Particulars	L.F.	Details (Rs.)	Amount Rs.
2012 Nov. 14	Zakir Khan			3,000
Nov. 30	**Sales Return A/c ....Dr.**			3,000

JOURNAL PROPER

Date	Particulars	L.F.	Details (Rs.)	Amount Rs.
2012 Nov. 4	Furniture A/c ....Dr. To Raj Furniture House (Being the furniture purchased on cr+edit)		5,000	5,000
Nov. 10	Stationery A/c ....Dr. To R.K. Mart (Being the stationery purchased on credit)		500	500
Nov. 30	Total		5,500	5,500

Dr. CAPITAL ACCOUNT Cr.

Date	Particulars	J.F.	Rs.	Date	Particulars	J.F.	Rs.
2012 Nov. 30	To Balance c/d		1,00,000	2012 Nov. 1	By Cash A/c		1,00,000
				Dec. 1	By Balance b/d		1,00,000

Dr. FURNITURE ACCOUNT Cr.

Date	Particulars	J.F.	Rs.	Date	Particulars	J.F.	Rs.
2012 Nov. 4	To Raj Furniture House		5,000	2012 Nov. 30	By Balance c/d		5,000
Dec. 1	To Balance b/d		5,000				

Dr. RAJ FURNITURE ACCOUNT Cr.

Date	Particulars	J.F.	Rs.	Date	Particulars	J.F.	Rs.
2012 Nov. 30	To Balance c/d		5,000	2012 Nov. 4	By Furniture A/c		5,000
				Dec. 1	By Balance b/d		5,000

Dr. PURCHASES ACCOUNT Cr.

Date	Particulars	J.F.	Rs.	Date	Particulars	J.F.	Rs.
2012 Nov. 5	To Cash A/c		10,000	2012 Nov. 30	By Balance c/d		33,500
	To Sundries A/c (Purchases Book)		23,500				
			33,500				
Dec. 1	To Balance c/d		33,500				

Dr. SALES ACCOUNT Cr.

Date	Particulars	J.F.	Rs.	Date	Particulars	J.F.	Rs.
2012 Nov. 30	To Balance c/d		43,000	2012 Nov. 10	By Cash A/c		20,000
				Nov. 29	By Cash A/c		10,000
				Nov. 30	By Sundries A/c (Sales Book)		13,000
			43,000				43,000
				Dec. 1	By Balance c/d		43,000

Dr. STATIONERY ACCOUNT Cr.

Date	Particulars	J.F.	Rs.	Date	Particulars	J.F.	Rs.
2012 Nov. 10	To R.K. Mart		500	2012 Nov. 30	By balance c/d		500
Dec. 1	To Balance c/d		500				

Dr. R.K. MART Cr.

Date	Particulars	J.F.	Rs.	Date	Particulars	J.F.	Rs.
2012 Nov. 30	To Balance c/d		500	2012 Nov. 1	By Stationery A/c		500
				Dec. 1	By Balance b/d		500

Dr. ELECTRICITY CHARGES ACCOUNT Cr.

Date	Particulars	J.F.	Rs.	Date	Particulars	J.F.	Rs.
2012 Nov. 28	To Cash A/c		200	2012 Nov. 30	By Balance c/d		200
Dec. 1	To Balance b/d		200				

Dr. DRAWINGS ACCOUNT Cr.

Date	Particulars	J.F.	Rs.	Date	Particulars	J.F.	Rs.
2012 Nov. 30	To Balance A/c		2,000	2012 Nov. 30	By Balance b/d		2,000
				Dec. 1			2,000

Dr. PURCHASES RETURN ACCOUNT Cr.

Date	Particulars	J.F.	Rs.	Date	Particulars	J.F.	Rs.
2012 Nov. 30	To Balance c/d		2,000	2012 Nov. 30	By Sundries A/c (Purchases Return Book)		2,000
				Dec. 1	By Balance b/d		2,000

Dr. SALES RETURN ACCOUNT Cr.

Date	Particulars	J.F.	Rs.	Date	Particulars	J.F.	Rs.
2012				2012			
Nov. 30	To Sundries A/c (Sales Return Book)		3,000	Nov. 30	By balance c/d		3,000
Dec. 1	To Balance c/d		3,000	Dec. 1			

Dr. MARATHI & CO. Cr.

Date	Particulars	J.F.	Rs.	Date	Particulars	J.F.	Rs.
2012			5,000	2012			13,500
Nov. 30	To Sundries A/c (Sales Return Book)		8,500	Nov. 30	By Purchases A/c		
			13,500				13,500
Dec. 1	To Balance c/d			Dec. 1	By balance c/d		8,500

Dr. KHOSLA & CO. Cr.

Date	Particulars	J.F.	Rs.	Date	Particulars	J.F.	Rs.
2012				2012	By Purchases A/c		10,000
Nov. 25	To Purchases Return A/c		2,000	Nov. 30			
Nov. 30	To Balance c/d		8,000				
			10,000				10,000
				Dec. 1	By Balance b/d		8,000

Dr. ZAKIR KHAN Cr.

Date	Particulars	J.F.	Rs.	Date	Particulars	J.F.	Rs.
2012				2012			
Nov. 11	To Sales A/c		13,000	Nov. 14	By Sales Return A/c		3,000
				Nov. 30	By Blance c/d		10,000
			13,000				13,000
Dec. 1	To Balance c/d		10,000	Dec. 1			

TRIAL BALANCE
as on 30th November, 2012

Head of Accounts	L.F.	Debit Balance Rs.	Credit Balance Rs.
Cash A/c		1,04,800	.....
Bank A/c		8,000	.....
Capital A/c		.....	1,00,000
Furniture A/c		5,000	....
Raj Furniture House		....	5,000
Purchases A/c		33,500	....
Sales A/c		...	43,000
Stationery A/c		500	...
R.K. Mart		...	500
Electricity Charges A/c		200	....
Drawings A/c		2,000	....
Purchases Return A/c		...	2,000
Sales Return A/c		3,000	...
Marathi & Co.		...	8,500
Khosla & Co.		...	8,000
Zakir Khan		10,000	......
Total		1,67,000	1,67,000

2.7.5 LIMITATIONS OF A TRIAL BALANCE

Trial balance is not a conclusive proof of accuracy. There are many errors which may remain undetected even if the trial balance agrees. These are :

i. Error of complete omissions: An error of omission is an error when a transaction is completely or partially omitted from being recorded in the books of accounts.

ii. Errors of principles: When a transaction is recorded in contravention of accounting principle, it is known as an Error of Principle. Such an error does not affect the trial balance as amounts are placed on the correct side but in a wrong account.

iii. Compensating errors: These are those errors whose effect of which is nullified by another error of equal amount.

iv. Incorrect amount entered in journal.

v. Posting to the wrong account and

vi. An entry posted twice in the ledger.

2.8 SUMMARY

Journal is the primary book of accounts in which transactions are first recorded in a chronological order. Journal entry may be simple journal entry or compound journal entry. In case of existing business, assets and liabilities appearing in the previous year's balance sheet will have to be brought forward to the current year. This is done by means of a journal entry termed as 'opening entry'. Ledger is a principal book in which all the accounts are put together. Being the principal book of accounts, a ledger contains all the information regarding various accounts. It helps in preparing the final accounts. Posting to the ledger is the process of transferring information contained in the journal to the ledger. Trial balance is a statement in which the debit and credit balances of all accounts are written with a view to ascertain the arithmetic accuracy of the books of accounts.

2.9 SELF ASSESSMENT QUESTIONS

1. An account is not opened in the name of the proprietor in the books of a firm. Give reason.

2. Debts written off as bad, if recovered subsequently, should be credited to the Debtors account. Is it correct? Give reasons.

3. What is the difference between trade discount and cash discount.

4. Enter the following transactions in the subsidiary books, post thei into the Ledger and prepare a Trial Balance:

Date	Particulars	Rs.
Nov. 1	Sudhir commenced business with cash	1,00,000
Nov. 4	Bought furniture from Raj Furniture House	5,000
Nov. 5	Purchased goods for cash	10,000
Nov. 8	Purchased goods from,Marathi & Co. for Rs. 15,000. Trade Discount 10%	
Nov. 9	Opened a Bank Account by depositing	15,000
Nov. 10	Sold goods for cash	20,000
Nov.10	Purchased stationery from R.K. Mart	500
Nov.11	Sold goods to Zakir Khan	13,000
Nov.14	Goods returned by Zakir Khan	3,000
Nov.15	Payment to Marathi & Co. by cheque	5,000
Nov.20	Goods purchased on credit from Khosla & Co.	10,000
Nov.25	Goods returned to Khosla & Co.	2,000
Nov. 28	Paid electricity bill	200
Nov. 29	Cash sales	10,000
Nov. 30	Withdrew Rs. 2,000 for private use from the bank	

2.10 IN-TEXT QUESTIONS

1. What are the steps in journalising.

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2. What is the difference between journal and ledger.

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3. Why trial balance is prepared.

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4. What are the limitations of trial balance.

2.11 FURTHER READING

1. Double Entry Book Keeping (Financial Accounting): T.S.Grewal
2. Financial Accounting for Business : A. K. Bhattacharya
3. Elements of Book Keeping : C.M.Juneja J.S.Arora & R.C.Chawla

OBJECTIVES

After going through this lesson, you will be able to understand:

- the meaning, concept and kinds of working capital.
- Importance of working capital.
- Factors determining the working capital requirements
- Forecast/Estimate of working capital requirements
- Financing of working capital.

STRUCTURE

3.1 Meaning and Concept of Working Capital

3.2 Classification or Kinds of Working Capital

3.3 Importance or Advantages of Adequate Working Capital

3.4 Excess or Inadequate Working Capital

3.5 The Need or Objects of Working Capital

3.6 Factors Determining the Working Capital Requirements

3.7 Forecast/ Estimate of Working Capital Requirements

3.8 Financing Working Capital Requirement

3.9 Summary

3.10 Self Assessment Questions

3.11 In-Text Activity

3.12 Further Reading

3.1 MEANING AND CONCEPT OF WORKING CAPITAL

Capital required for a business can be classified under two main categories viz.,

(i) Fixed Capital, and (ii) Working Capital.

Every business needs funds for two purposes-for its establishment and to carry out its day-to-day operations. Long-term funds are required to create production facilities through purchase of fixed assets such as plant and machinery, land, building, furniture, etc. Investments in these assets represent that part of firm's capital which is blocked on a permanent or fixed basis and is called fixed capital. Funds are also needed for short-term purposes for the purchase of raw materials, payment of wages and other day-to-day expenses, etc. These funds are known as working capital. In simple words, working capital refers to that part of the firm's capital which is required for financing short term or current assets such as cash, marketable securities, debtors and inventories. Funds, thus, invested in current assets keep revolving fast and are being constantly converted into cash and this cash flows out again in exchange for other current assets. Hence, it is also known as revolving or circulating capital or short-term capital.

In the words of Shubin, "Working capital is the amount of funds necessary to cover the cost of operating the enterprise."

According to Genestenberg, "Circulating capital means current assets of a company that are changed in the ordinary course of business from one form to another, as for example, from cash to inventories, inventories to receivables, receivables into cash."

CONCEPTS OF WORKING CAPITAL

There are two concepts of working capital :

(A) Balance Sheet Concept.

(B) Operating Cycle or Circular Flow Concept

(A) Balance Sheet Concept

There are two interpretations of working capital under the balance sheet concept:

(i) Gross Working Capital

(ii) Net Working Capital.

In the broad sense, the term working capital refers to the gross working capital and represents the amount of funds invested in current assets. **Thus, the gross working capital is the capital invested in total current assets of the enterprise.** Current assets are those assets which in the ordinary course of business can be converted into cash within a short period of normally one accounting year. Examples of current assets are :

CONSTITUENTS OF CURRENT ASSETS	
1.	Cash in hand and bank balances.
2.	Bills Receivables.
3.	Sundry Debtors (less provision for bad debts).
4.	Short-term loans and advances
5.	Inventories of stock, as: *(a)* Raw materials, *(b)* Work-in-process *(c)* Stores and spares, *(d)* Finished g6ods. .
6.	Temporary Investments of surplus funds.
7.	Prepaid Expenses.
8.	Accrued Incomes.

In a narrow sense, the term working capital refers to. the net working capital. Net working capital is the excess of current assets over current liabilities, or say :

Net Working Capital = Current Assets-Current liabilities.

Net working capital may be positive or negative. When the current assets exceed the current liabilities, the working capital is positive and the negative working capital results when the current liabilities are more than the current assets. Current liabilities are those liabilities which are intended to be paid in the ordinary course of business within a short period of normally one accounting year out of the current assets or the income of the business. Examples of current liabilities are:

CONSTITUENTS OF CURRENT LIABILITIES	
1.	Bills payable.
2.	Sundry creditors or accounts payable.
3.	Accrued or outstanding expenses.
4.	Short-term loans, advances and deposits.
5.	Dividends payable.
6.	Bank overdraft.
7.	Provision for taxation, if it does not amount to appropriation of profits.

The gross working capital concept is financial or going concern concept whereas net working capital is an accounting concept of working capital. These two concepts of working capital are not exclusive, rather both have their own merits. -

The gross concept is sometimes preferred to the net concept of working capital for the following reasons :

1. It enables the enterprise to provide correct amount of working capital at the right time.
2. Every management is more interested in the total current assets with which it has to operate than the sources from where it is made available.
3. The gross concept takes into consideration the fact that every increase in the funds of the enterprise would increase its working capital.
4. The gross concept of working capital is more useful in determining the rate of return on investments in working capital.

The net working capital concept, however, is also important for the following reasons:

1. It is a qualitative concept which indicates the firm's ability to meet its operating expenses and short-term liabilities.

2. It indicates the margin of protection available to the short-term creditors, i.e., the excess of current assets over current liabilities?

3. It is an indicator of the financial soundness of an enterprise.

4. It suggests the need for financing a part of the working capital requirements out of permanent sources of funds.

To conclude, it may be said that, both, gross and net, concepts of working capital are important aspects of the working capital management. The net concept of working capital may be suitable only for proprietary form of organisations such as sole-trader or partnership firms. But the gross concept is very suitable to the company form of organisation where there is a divorce between ownership, management and control.

However, it may be made clear that ***as per the general practice, net working capital is referred to simply as working capital.*** In the words of Hoagland, "Working capital is descriptive of that capital which is not fixed. But the more common use of the working capital is to consider it as the difference between the book value of the current assets and current liabilities."

The following example explains both the concepts of working capital:

Balance Sheet of Pearl India Ltd.
as on 31.3.2008

Liabilities	*Rs.*	*Assets*	*Rs.*
Equity Shares	2,00,000	Goodwill	20,000
,8% Debentures	1,00,000	Land and Buildings	1,50.000
Reseevc & Surplus	50,000	Plant and Machinery	1,00,000
Sundry Creditors	1,50,000	Inventories:	
•Bills Payable	30,000	Finished Goods	60;000
Outstanding Expenses	20,000	Work-in-process	40,000
Bank Overdraft	50,000	Prepaid Expenses	20.000
Provision for Taxation	20,000	Marketable Securities	60,000
Proposed Dividend	30,000	Sundry Debtors	90,000
		Bills Receivables	20,000
		Cash & Bank Balance	90,000
	6,50,000		6,50,000

(i) Gross Working Capital = Total of Current Assets

= 60,000+40,000+20,000+60,000+90,000+20,000+90,000=Rs. 3,80,000

(ii) Net Working Capital = Current Assets- Current Liabilities

Total of Current Assets=Rs. 3,80,000

Total of Current Liabilities =1,50,000 + 30,000 + 20,000 + 50,000 + 20,000 + 30,000 = Rs. 3,00,000

W.C. (Net) = Rs. 3,80,000-3,00,000 = Rs. 80,000

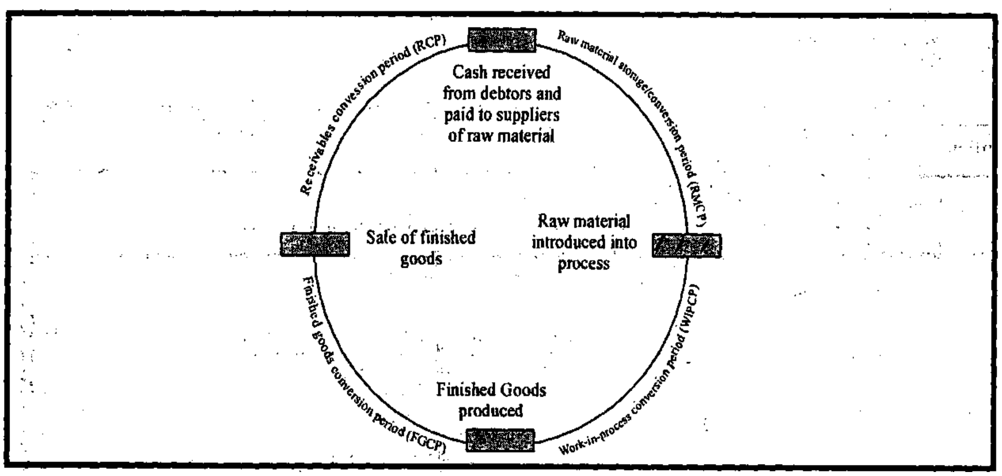
Positive or Negative Working Capital

The net working capital of a firm may be positive or negative. When the total current assets exceed the current liabilities, the working capital is positive and the negative working capital results when the current liabilities are more than the current assets. The position of negative working capital does not allow a firm to utilise efficiently the fixed assets due to non-availability of liquid funds and it adversely affects its profitability or the rate of return.

In fact, no firm can continue business for a long-term with a negative working capital. The business of the firm may have to be closed due to technical insolvency.

(B) Operating Cycle or Circular Flow Concept

As discussed earlier, working capital refers to that part of firm's capital which is required for financing short-term or current assets such as cash, marketable securities, debtors and inventories. Funds, thus, invested in current assets keep revolving fast and are being constantly converted into cash and this cash flows out again in exchange for other current assets. Hence, it is also known as revolving or circulating capital. The circular flow concept of working capital is based upon this operating or working capital cycle of a firm. The cycle starts with the purchase of raw material and other resources and ends with the realisation of cash from the sale of finished goods. It involves purchase of raw material and stores, its conversion into stock of finished goods through work-in-progress, with progressive increment of labour and service costs, conversion of finished stock into sales, debtors and receivables and ultimately realisation of cash and this cycle continues again from cash to purchase of raw material and so on. The speed/time duration required to complete one cycle determines the requirements of working capital-longer the period of cycle, larger is the requirement of working capital.



The gross operating cycle of a firm is equal to the length of the inventories and receivables conversion periods. Thus,

$$\boxed{\text{Gross Operating Cycle} = \text{RMCP} + \text{WIPCP} + \text{FGCP} + \text{RCP}}$$

Where, RMCP = Raw Material Conversion Perio

WIPCP = Work-in-Process Conversion Period

FGCP = Finished Goods Conversion Period

RCP = Receivables Conversion Period

However, a firm may acquire some resources on credit and thus defer payments for certain period. In that case, net operating cycle period can be calculated as below :

$$\boxed{\text{Net Operating Cycle Period} = \text{Gross Operating Cycle Period} - \text{Payable Deferral period}}$$

Further, following formula can be used to determine the conversion periods.

1. Raw Material Conversion Period = Average Stock of Raw Material/ Raw Material Consumption Per Day
2. Work-in-Process Conversion Period= Average Stock of Work-in-Progress/Total Cost of Production Per Day
3. Finished Goods Conversion Period= Average Stock of Finished Goods/ Total Cost of Goods Sold Per Day
4. Receivables Conversion Period= Average Accounts Receivables/ Net Credit Sales Per Day
5. Payables Deferral Period= Average Payables/Net Credit Purchase Per Day

The following illustration explains the determination of operating cycle.

Illustration 1. From the following information extracted from the books of a manufacturing concern, compute the operating cycle in days :

Period covered	365 days
Average period of credit allowed by suppliers	16 days
	(Rs. '000)
Average total of debtors outstanding	480
Raw material consumption	4,400
Total production cost	10,000
Total cost of goods sold for the year	10,500
Sales for the year	16,000
Value of average stock maintained :	
Raw materials	320
Work-in-progress	350
Finished goods	260

Solution: Computation of Operating Cycle

(a) Length of Raw Material Inventory Period = Average Stock of Raw Material/ Raw Material Consumption Per Day

= 320/4400*365= 27 days

(b) Length of Work-in-Progress Conversion Period = Average Stock of Work-in-Progress/Total Cost of Production Per Day

= 350/10,000*365= 13 days

(c) Length of Finished Stock Period = Average Stock of Finished Goods/ Total Cost of Goods Sold Per Day

=260/10,500*365=9 days

(d) Period of Credit Allowed to Debtors = Average Total Debtors Outstanding/Sales Per Day

=480/16000*365= 11 days

(e) Gross Total Period of Operating Cycle (a+b+c+d)	60 days
Less: Average period of credit allowed by supplier	16 days
Net total period of operating cycle	44 days

3.2 CLASSIFICATION OR KINDS OF WORKING CAPITAL

Working capital may be classified in two ways :

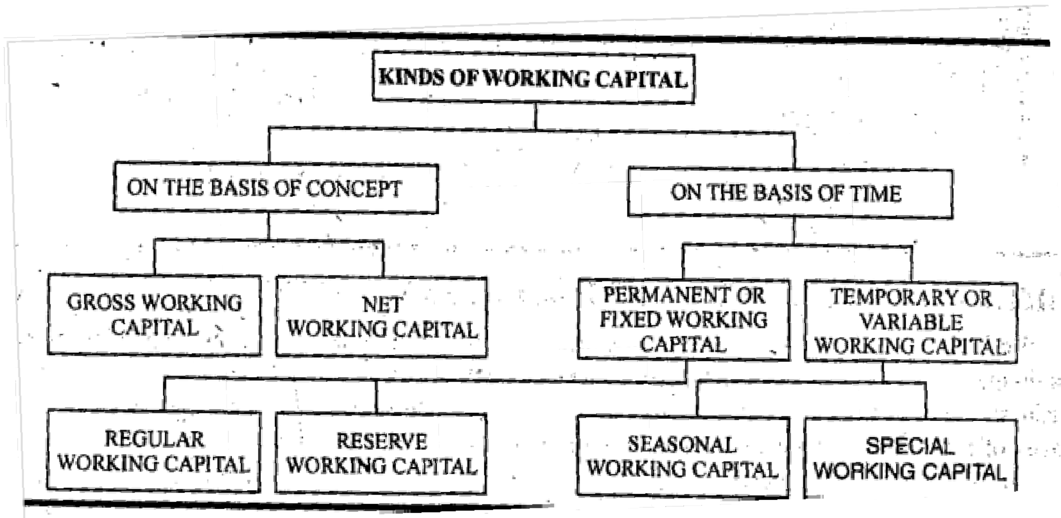
(a) On the basis of concept

(b) On the basis of time.

On the basis of concept, working capital is classified as gross working capital and net working capital as discussed earlier. This classification is important from the point of view of the financial manager.

On the basis of time, working capital may be classified as :

1. Permanent or fixed working capital
2. Temporary or variable working capital



1. **Permanent or Fixed Working Capital.** Permanent or fixed working capital is the minimum amount which is required to ensure effective utilisation of fixed facilities and for maintaining the circulation of current assets. There is always a minimum level of current assets which is continuously required by the enterprise to carry out its normal business operations. For example, every firm has to maintain a minimum level of raw materials, work-in-process, finished goods and cash balance. This minimum level of current assets is called permanent or fixed working capital as this part of capital is permanently blocked in current assets. As the business grows, the requirements of permanent working capital also increase due to the increase in current assets. The permanent working capital can further be classified as regular working capital and reserve working capital required, to ensure circulation of current assets from cash to inventories, from inventories to receivables and from receivables to cash and so on. Reserve working capital is the excess amount over the requirement for regular working capital which may be provided for contingencies that may arise at unstated periods such Is strikes, rise in prices, depression, etc.

2. **Temporary or Variable Working Capital.** Temporary or variable working capital is the amount of working capital which is required to meet the seasonal demands and some special exigencies. Variable working capital can be further classified as seasonal working capital and special working capital. Most of the enterprises have to provide additional working capital to meet the seasonal and special needs. The capital required to meet the seasonal needs of the enterprise is called seasonal working capital. Special working capital is that part of working capital which is

required to meet special exigencies such, as launching of expensive marketing campaigns for conducting research, etc.

Temporary working capital differs from permanent working capital in the sense that it is required for short periods and cannot be permanently employed gainfully in the business. Figures given below Illustrate; the difference between permanent and temporary working capital.

In Fig. 1, permanent working capital is stable or fixed over time while the temporary or variable working capital fluctuates. In Fig. 2, permanent working capital is also increasing with the passage of time due to expansion of business but even then it does not fluctuate as variable working capital which sometimes increases and sometimes decreases.

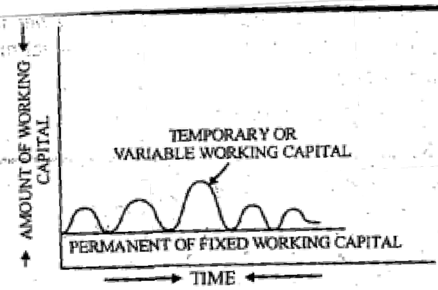


Fig. 1

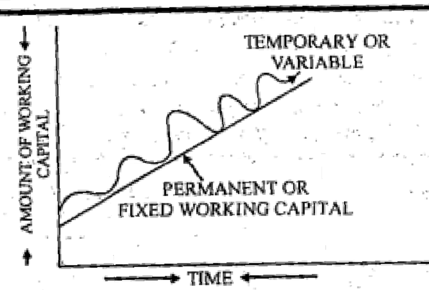


Fig. 2

3.3 IMPORTANCE OR ADVANTAGES OF ADEQUATE WORKING CAPITAL

Working capital is the life blood and nerve centre of a business. Just as circulation of blood is essential in the human body for maintaining life, working capital is very essential to maintain the smooth running of a business. No business can run successfully without an adequate amount of working capital. The main advantages of maintaining adequate amount of working capital are as follows :

1. **Solvency of the business.** Adequate working capital helps in maintaining solvency of the business by providing uninterrupted flow of production.

2. **Goodwill.** Sufficient working capital enables a business concern to make prompt payments and hence helps in creating and maintaining goodwill.

3. **Easy loans.** A concern having adequate working capital, high solvency and good credit standing can arrange loans from banks and others on easy and favourable terms.

4. **Cash discounts.** Adequate working capital also enables a concern to avail cash discounts on the purchases and hence it reduces costs.

5. **Regular supply of raw materials.** Sufficient working capital ensures regular supply of raw materials and continuous production.

6. **Regular payment of salaries, wages and other day-to-day commitments.** A company which has ample working capital can make regular payment of salaries, wages and other day-to-day commitments which raises the morale of its employees, increases their efficiency, reduces wastages and costs and enhances production and profits.

7. **Exploitation of favourable market conditions.** Only concerns with adequate working capital can exploit favourable market conditions such as purchasing its requirements in bulk when the prices are lower and by holding its inventories for higher prices.

8. **Ability to face crisis.** Adequate working capital enables a concern to face business crisis in emergencies such as depression because during such periods, generally, there is much pressure on working capital.

9. **Quick and regular return on investments.** Every Investor wants a quick and regular return on his investments. Sufficiency of working capital enables a concern to pay quick and regular dividends to its investors as there may not be much pressure to plough back profits. This gains the confidence of its investors and creates a favourable market to raise additional funds in the future.

10. **High morale.** Adequacy of working capital creates an environment of security, confidence, high morale and creates overall efficiency in a business.

3.4 EXCESS OR INADEQUATE WORKING CAPITAL

Every business concern should have adequate working capital to run its business operations. It should have neither redundant or excess working capital nor inadequate or shortage of working capital. Both excess as well as short working capital positions are bad for any business. However, out of the two, it is the inadequacy of working capital which is more dangerous from the point of view of the firm.

Disadvantages of Redundant or Excessive Working Capital

1. Excessive Working Capital means idle funds which earn no profits for the business and hence the business cannot earn a proper rate of return on its investments.
2. When there is a redundant working capital, it may lead to unnecessary purchasing and accumulation of inventories causing more chances of theft, waste and, losses.
3. Excessive working capital implies excessive debtors and defective credit policy which may cause higher incidence of bad debts.
4. It may result into overall inefficiency in the organisation.
5. When there is excessive working capital, relations with banks and other financial institutions may not be maintained.
6. Due to low rate of return on investments, the value of shares may also fall.
7. The redundant working capital gives rise to speculative transactions.

Disadvantages or Dangers of Inadequate Working Capital

1. A concern which has inadequate working capital cannot pay its short-term liabilities in time. Thus, it will lose its reputation and shall not be able to get good credit facilities.
2. It cannot buy its requirements in bulk and cannot avail of discounts, etc.
3. It becomes difficult for the firm to exploit favourable market conditions and undertake profitable projects due to lack of working capital.
4. The firm cannot pay day-to-day expenses of its operations and it creates inefficiencies, increases costs and reduces the profits of the business.
5. It becomes impossible to utilise efficiently the fixed assets due to non-availability of liquid funds.
6. The rate of return on investments also falls with the shortage of working capital.

3.5 THE NEED OR OBJECTS OF WORKING CAPITAL

The need for working capital cannot be over emphasised. Every business needs some amount of working capital. The need for working capital arises due to the time gap between production and realisation of cash from sales. There is an operating cycle involved in the sales and realisation of cash. There are time gaps in purchase of raw materials and production; production and sales; and sales and realisation of cash. Thus, working capital is needed for the following purposes:

1. For the purchase of raw material, components and spares.
2. To pay wages and salaries.
3. To incur day-to-day expenses and overhead costs such as fuel, power and office expenses, etc.
4. To meet the selling costs as packing, advertising, etc.
5. To maintain the inventories of raw material, work-in-progress, stores and spares and finished.

For studying the need of the working capital in a business, one has to study the business under varying circumstances such as a new concern, as a growing concern and as one which has attained maturity. A new concern requires a lot of liquid funds to meet initial expenses like promotion, formation, etc. These expenses are called preliminary expenses and are capitalized. The amount needed as working capital in a new concern depends primarily upon its size and the ambitions of its promoters. Greater the size of business unit, generally, larger will be the requirements of working capital. The amount of working capital needed goes on increasing with the growth and expansion of business till it attains maturity. At maturity the amount of working capital needed is called normal working capital. There are many other factors which influence the need of working capital in a business and these are discussed in the next pages.

3.6 FACTORS DETERMINING THE WORKING CAPITAL REQUIREMENTS

The working capital requirements of a concern depend upon a large number of factors such as nature and size of business, the character of their operations, the length of production cycles, the rate of stock turnover and the state of economic situation. It is not possible to rank them because all such factors are of different importance and the influence of individual factors changes for a firm over time. However, the following are important factors generally influencing the working capital requirements.

1. **Nature or Character of Business.** The working capital requirements of a firm basically depend upon the nature of its business. Public utility undertakings like Electricity, Water Supply and Railways need very limited working capital because they offer cash sales only and supply services, not products, and as such no funds are tied up in inventories and receivables. On the other hand trading and financial firms require less investment in fixed assets but have to invest large amounts in current assets like inventories, receivables and cash; as such they need large amount of working capital. The manufacturing undertakings also require sizable working capital alongwith fixed investments. Generally speaking it may be said that public utility undertakings require small amount of working capital, trading and financial firms require relatively very large amount, whereas manufacturing undertakings require sizable working capital between these two extremes.

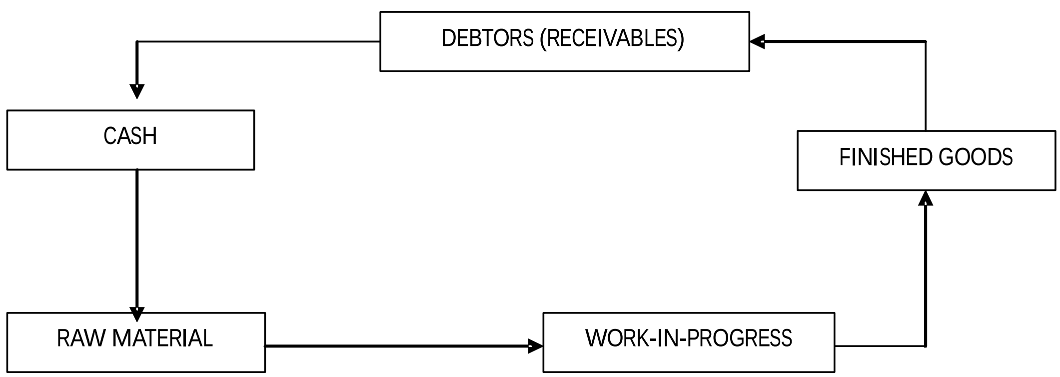
2. **Size of Business/Scale of Operations.** The working capital requirements of a concern are directly influenced by the size of its business which may be measured in terms of scale of operations. Greater the size of a business unit, generally larger will be the requirements of working capital. However, in some cases even a smaller concern may need more working capital due to high overhead charges, inefficient use of available resources and other economic disadvantages of small size.

3. **Production Policy.** In certain industries the demand is subject to wide fluctuations due to seasonal variations. The requirements of working capital, in such cases, depend upon the production policy. The production could be kept either steady by accumulating inventories during slack periods with a view to meet high demand during the peak season or the production could be curtailed during the slack season and increased during the peak season. If the policy is to keep production steady by accumulating inventories it will require higher working capital.

4. **Manufacturing Process/Length of Production Cycle.** In manufacturing business, the requirements of working capital increase in direct proportion to length of manufacturing process. Longer the process period of manufacture, larger is the amount of working capital required. The longer the manufacturing time, the raw materials and other supplies have to be carried for a longer period in the process with progressive increment of labour and service costs before the finished product is finally obtained. Therefore, if there are alternative processes of production, the process with the shortest production period should be chosen.

5. **Seasonal Variations.** In certain industries raw material is not available throughout the year. They have to buy raw materials in bulk during the season to ensure an uninterrupted flow and process them during the entire year. A huge amount is, thus, blocked in the form of material inventories during such season, which gives rise to more working capital requirements. Generally, during the busy season, a firm requires larger working capital than in the slack season.

6. **Working Capital Cycle**, In a manufacturing concern, the working capital cycle starts with the purchase of raw material and ends with the realisation of cash from the sale of finished products. This cycle involves purchase of raw materials and stores, its conversion into stocks of finished goods through work-in-progress with progressive increment of labour and service costs, conversion of finished stock into sales, debtors and receivables and ultimately realisation of cash and this cycle continues again from cash to purchase -of raw material and so on.



WORKING CAPITAL CYCLE OF A MANUFACTURING CONCERN

The speed with which the working capital completes one cycle determines the requirements of working capital-longer the period of the cycle larger is the requirement of working capital.

7. **Rate of Stock Turnover.** There is a high degree of inverse co-relationship between the quantum of working capital and the velocity or speed with which the sales are effected. A firm having a high rate of stock turnover will need lower amount of working capital as compared to a firm having a low rate of turnover. For example, in case of precious stone dealers, the turnover is very slow. They have to maintain a large variety of stocks and the movement of stocks is very slow. Thus, the working capital requirements of such a dealer shall be higher than that of a provision store.

8. Credit Policy. The credit policy of a concern in its dealings with debtors and creditors influence considerably the requirements of working capital. A concern that purchases its requirements on credit and sells its products/services on cash requires lesser amount of working capital. On the other hand a concern buying its requirements for cash and allowing credit to its customers, shall need larger amount of working capital as very huge amount of funds are bound to be tied up in debtors or bills receivables.

9. Business Cycles. Business cycle refers to alternate expansion and contraction in general business activity. In a period of boom i.e., when the business is prosperous, there is a need for larger amount of working capital due to increase in sales, rise in prices, optimistic expansion of business, etc. On the contrary in the times of depression i.e., when there is a down swing of the cycle, the business contracts, sales decline, difficulties are faced in collections from debtors and firms may have a large amount of working capital lying idle.

10. Rate of Growth of Business. The working capital requirements of a concern increase with the growth and expansion of its business activities. Although, it is difficult to determine the relationship between the growth in the volume of business and the growth in the working capital of a business, yet it may be concluded that for normal rate of expansion in the volume of business, we may have retained profits to provide for more working capital but in fast growing concerns, we shall require larger amount of working capital.

11. Earning Capacity and Dividend Policy. Some firms have more earning capacity than others due to quality of their products, monopoly conditions, etc. Such firms with high earning capacity may generate cash profits from operations and contribute to their working capital. The dividend policy of a concern also influences the requirements of its working capital. A firm that maintains a steady high rate of cash dividend irrespective of its generation of profits needs more working capital than the firm that retains larger part of its profits and does not pay so high rate of cash dividend.

12. Price Level Changes. Changes in the price level also affect the working capital requirements. Generally, the rising prices will require the firm to maintain larger amount of working capital as more funds will be required to maintain the same current assets. The effect of rising prices may be different for different firms. Some firms may be affected much while some others may not be affected at all by the rise in prices.

13. **Other Factors.** Certain other factors such as operating efficiency, management ability, irregularities of supply, import policy, asset structure, importance of labour, banking facilities, etc., also influence the requirements of working capital.

3.7 FORECAST/ ESTIMATE OF WORKING CAPITAL REQUIREMENTS

"Working capital is the life-blood and controlling nerve centre of a business." No business can be successfully run without an adequate amount of working capital. To avoid the shortage of working capital at once, an estimate of working capital requirements should be made in advance so that arrangements can be made to procure adequate working capital.

Methods of Estimating Working Capital Requirements

The following methods are usually followed in forecasting working capital requirements of a firm :

1. Percentage of Sales Method
2. Regression Analysis Method (Average Relationship between Sales and Working Capital)
3. Cash Forecasting Method
4. Operating Cycle Method
5. Projected Balance Sheet Method

1. Percentage of Sales Method

This method of estimating working capital requirements is based on the assumption that the level of working capital for any firm is directly related to its sales value. If past experience indicates a stable relationship between the amount of sales and working capital, then this basis may be used to determine the requirements of working capital for future period. Thus, if sales for the year 2007 amounted to Rs 30,00,000 and working capital required was Rs. 6,00,000; the requirement of working capital for the year 2008 on an estimated sales of Rs. 40,00,000 shall be Rs. 8,00,000; i.e. 20% of Rs. 40,00,000. The individual items of current assets and current liabilities can also be estimated on the basis of the past experience as a percentage of sales. This method is simple to understand and easy to operate but it cannot be applied in all cases because the direct relationship between sales and working capital may not be established.

Illustration 2. The following information has been provided by a company for the year ended 30.6.2008:

Liabilities	*Rs.*	*Assets*	*Rs.*
Equity share capital	2,00,000	Fixed assets less depreciation	3,00,000
8% Debentures	1,00,000	Inventories	1,00,000
Reserves and surplus	50,000	Sundry debtors	70,000
Long term loans	50,000	Cash and bank	10,000
Sundry creditors	80,000		
	4,80,000		4,80,000

Sales for the year ended 30.6.2008 amounted to Rs. 10,00,000 and it is estimated that the same will amount to Rs. 12,00,000 for the year 2008-09.

You are required to estimate the working capital requirements for the year 2008-09 assuming a linear relationship between sales and working capital.

Solution:

Estimation of Working Capital Requirements

	Actual 2007-2008 (Rs.)	*Percentage to Sales 2007-08 (Rs.)*	*Estimate 2008-09 (Rs.)*
Sales	10,00,000	100	12,00,000
Current Assets :			
Inventories	1,00,000	10	1,20,000
Sundry debtors	70,000	7	84,000
Cash and bank	10,000		12,000
Total Current Asset (CA)	**1,80,000**	**18**	**2,16,000**
Current Liabilities :			
Sundry creditors	80,000	8	96,000
Total Current Liabilities (CL)	80,000	8	96,000
Working Capital (CA - CL)	1,00,000	10	1,20,000

Illustration 3. The following are the extracts from the balance sheet of a company as on 30.6.2008. Compute the additional working capital required by the company for the year ending 30.6.2009.

		(Rs.)
Fixed Assets :		
Land and buildings	12,50,000	
Plant and machinery	7,50,000	
		20,00,000
Current Assets :		
Stock	20,00,000	
Debtors	7,50,000	
Cash and bank	5,00,000	
Less : Current Liabilities :	32.50.000	
Creditors	8,50,000	
Taxation	2,00,000	
Bank overdraft	3,50,000	
Bills payable	4,00,000	
	18,00,000	
Working Capital		14,50,000
		34,50,000

Additional information:

(i) It is estimated that sales will increase by 25% next year.

(ii) Maximum amount of overdraft that can be availed will be only Rs. 4,00,000.

(iii) There will be no increase in the liability for tax due to increase in sales.

(iv) Period of credit allowed to customers and stock turnover will remain unchanged

(v) Period of credit allowed by creditors and that for bills payable will remain the same.

(vi) There will be no increase in the amount of cash and bank balance.

Solution:

Computation of Additional Working Capital Requirements			
	Actual 2007-2008 (Rs.)	***Estimated Increase (Rs.)***	***Estimate 2008-09 (Rs.)***
Current Assets :			
Stock	20,00.000	5,00,000	25,00,000
Debtors	7,50,000	1,87,500	9,37,500
Cash and bank	5,00,000	—	5,00,000
Total Current Assets (CA)	32,50,000	6,87,500	39,37,500
Current Liabilities :			
Creditors	8,50,000	2,12,500	10,62,500
Taxation	2,00,000	—	2,00,000
Bank overdraft	3,50,000	50,000	4,00,000
Bills payable	4,00,000	1,00,000	5,00,000
Total Current Liabilities (CL)	18,00,000	3,62,500	21,62,500
Working Capital (CA - CL)	14,50,000	3,25,000	17,75,000
Additional Working Capital Required = Rs. 3,25,500			

2. Regression Analysis Method (Average Relationship between Sales and Working Capital)

This method of forecasting working capital requirements is based upon the statistical technique of estimating or predicting the unknown value of a dependent variable from the known value of an independent variable. It is the measure of the average relationship between two or more variables, i.e.; sales and working capital, in terms of the original units of the data.

The relationships between sales and working capital is represented by the equation :

$$\mathbf{y = a + bx}$$

Where, y = Working capital (dependent variable)

a = Intercept of the least square

b = Slope of the regression line

x = Sales (independent variable)

For determining the values 'a' and 'b' two normal equations are used which can be solved simultaneously :

$$\Sigma y = na + b\Sigma x$$

$$\Sigma xy = a\Sigma x + b\Sigma x^2$$

Illustration 4. The sales and working capital figures of Suvidha Ltd. for a period of 5 years are given as follows :

You are required to forecast the working capital requirements of the company for the year 2008-09 taking the estimated sales of Rs. 200 lakhs.

Solution:

Year	*Sales (Rs. lakhs)*	*Working Capital (Rs. lakhs)*
2003-04	60	12
2004-05	80	15
2005-06	120	20
2006-07	130	21
2007-08	160	23

The relationship between sales and working capital can be represented by:

y = **a** + bx

Year	*Sales (x)*	*Working Capital (y)*	*xy*	*X^2*
2003-04	60	12	720	3,600
2004-05	80	15	1,200	6,400
2005-06	120	20	2,400	14,400
2006-07	130	21	2,730	16,900
2007-08	160	23	3,680	25,600
n = 5	$\Sigma x = 550$	$\Sigma y = 91$	$\Sigma xy = 10,730$	$\Sigma x^2 = 66,900$

$\Sigma y = na + b\ \Sigma x$

$\Sigma xy = a\ \Sigma x + b\ \Sigma x^2$

Putting the valus in the above equations :

$91 = 5a + 550\ b$ ……………………………………(i)

$10,730 = 550\ a + 66,900\ b$…………………………(ii)

Multiplying equation (i) with 110, we get:

$10,010 = 550\ a + 60,500\ b$ …………………………(iii)

Subtracting equation (iii) equation (i)

$720= 0+ 6400\ b$

$b=0.1125$

Putting the value of b in equation (i)

$91=5a+550*0.1125$

$91=5a+61.875$

$5a=29.125$

$a=5.825$

Now, putting the values of a and b in the equation $y = a + bx$:

$y = a + bx$ (Where y and x are estimated working capital and estimated sales respectively)

$y = 5.825 + 0.1125 * 200$

$y = 27.825$

Thus, when estimated sales for 2008-09 are Rs. 200 lakhs, the amount of estimated working capital shall be Rs. 27.825 lakhs.

3. Cash Forecasting Method

This method of estimating working capital requirements involves forecasting of cash receipts and disbursements during a future period of time. Cash forecast will include all possible sources from which cash will be received and the channels in which payments are to be made so that a consolidated cash position is determined. This method is similar to the preparation of a cash budget. The excess of receipts over payments represents surplus of cash and the excess of payments over receipts causes deficit of cash or the amount of working capital required. The following illustration explains the cash forecasting method of estimating working capital requirements.

Illustration 5. Texas Manufacturing Company Ltd. is to start production on 1st January, 2009. The prime cost of a unit is expected to be Rs. 40 out of which Rs. 16 is for materials and Rs. 24 for labour. In addition, variable expenses per unit are expected to be Rs. 8 and fixed expenses per month Rs. 30,000. Payment for materials is to be made in the month following the purchases. One-third of sales will be for cash and the rest on credit for settlement in the following month. Expenses are payable in the month in which they are incurred. The selling price is fixed atRs. 80 per unit. The number of units manufactured and sold are expected to be as under:

Jan.	900
Feb	1,200

March 1,800

April 2,100

May 2,100

June 2,400

Solution:

Statement Showing Requirement of Working Capital

	Jan. Rs.	Feb Rs.	March Rs.	April Rs.	May Rs.	June Rs.
Payment:						
Materials	—	14,400	19,200	28,800	33,600	33,600
Wages	21,600	28,800	43,200	50,400	50,400	57,600
Fixed Expenses	30,000	30,000	30,000	30,000	30,000	30,000
Variable Expenses	7,200	9,600	14,400	16,800	16,800	19,200
	58,800	**82,800**	**1,06,800**	**1,26,000**	**1,30,800**	**1,40,400**
Receipts:						
Cash sales	24,000	32,000	48,000	56,000	56,000	64,000.
Debtors	-	48,000	64,000	96,000	1,12,000	1,12,000
	24,000	**80,000**	**1,12,000**	**1,52,000**	**1,68,000**	**1,76,000**
Working Capital Required (Payments- Receipts)	34,800	2,800	-	-	-	-
Surplus	-	-	5,200	26,000	37,200	35,600
Cumulative Requirements of Working Capital:	34,800	37,600	32,400	6,400	-	-
Surplus Working Capital	-	-	-		30,800	66.400

Working Notes :

(i) As payment for material is made in the month following the purchase, there is no payment for material in January. In February, material payment is calculated as 900 x 16= Rs. 14,400 and in the same manner for other months.

(ii) Cash sales are calculated as :

For January 900*8*1/3 = Rs. 24,000 and in the same manner for other months.

(iii) Receipts from debtors are calculated as :

For Jan.-Nil because cash from debtors is collected in the month following the sales.

For Feb.- 900*80*2/3 = Rs. 48,000

For March-1200 *80*2/3= Rs. 64,000 , and so on.

4. Operating Cycle Method

This method of estimating working capital requirements is based upon the operating cycle concept of working capital. We have discussed earlier, in this chapter, the concept and determination of duration of operating cycle. The cycle starts with the purchase of raw material and other resources and ends with, the realisation of cash from the sale of finished goods. It involves purchase of raw materials and stores, its conversion into stock of finished goods through work-in-process with progressive increment of labour and service costs, conversion of finished stock into sales, debtors and receivables, realisation of cash and this cycle continues again from cash to purchase of raw material, and so on. The speed/ time duration required to complete one cycle determines the requirement of working capital - longer the period of cycle, larger is the requirement of working capital and vice-versa. The requirements of working capital be estimated as follows :

Working Capital Required= Cost of goods sold* Operating cycle (days)/ 365 or 360 days + desired cash balance

Illustration 6. Details of X Ltd. for the year 2007-08, are given as under :

Cost of goods sold	Rs. 48,00,000
Operating cycle	60 days
Minimum desired level of cash balance	Rs. 75,000

You are required to calculate the expected working capital requirement by assuming 360 days in a year.

Solution:

Expected Working Capital Required= Cost of goods sold* Operating cycle (days)/ 365 or 360 days + desired cash balance

=48,00,000*60/360 + 75,000

=Rs. 8,75,000

For proper computation of working capital under this method, a detailed analysis is made for each individual component of working capital. **The value of each individual item of**

current assets and current liabilities is determined on the basis of estimated sales or budgeted production or activity level as follows :

(a) Stock of Raw Material. The amount of working capital funds to be invested in holding stock of raw material can be estimated on the basis of budgeted units of production, estimated cost of raw material per unit and the average duration for which the raw material is held in stock by using the following formula :

$$\frac{\text{Budgeted annual units of prodn. x Est. cost of raw material per unit x Avg. raw material holding period in days/months/weeks}}{\text{No. of days/months/weeks in a year}}$$

(Note. 360 days in a year may be assumed in place of 365 to simplify calculations in some cases)

(b) **Stock of Work-in-Process.** In manufacturing/processing industries the production is carried on continuous basis. At the end of the period, some work remains incomplete even though all or some expenses have been incurred, this work is known as work-in-progress or partly completed or semi-finished goods. The work-in-process consists of direct material, direct labour and production overheads locked up in these semifinished goods.

The value of work-in-process depends upon the stage of completion of the production process as regards materials, labour and production overheads, only those costs should be considered which have already been incurred as the rest of the costs shall be incurred later for conversion of work-in-process into finished goods. However, if information about the degree/stage of completion is not available, it may be assumed that 100% of material cost has been incurred on units of work-in-process, but only 50% of labour and overhead costs may be assumed to be incurred. This assumption is based upon the notion that full raw material is fed into the process in the beginning (even though there are uncompleted products) and labour and overhead cost accrue evenly during the period of production process.

The amount of funds estimated to be invested in work-in-process may be computed as:

$$\frac{\text{Budgeted annual units of production x Estimated WIP cost per unit x Average WIP holding period in days/months/weeks}}{\text{No. of days/months/weeks in a year}}$$

Note. (i) 360 days a year may be assumed to simplify calculations.

(ii) In the absence of information about stage of completion of WIP with regard to material labour and overheads, 100% of material cost, and 50% of labour and production overheads cost may be assumed as the estimated cost of work-in-process.

(iii) In case cash cost approach is followed for estimation of working capital, then depreciation should be excluded from production overheads while calculating cost of work-in-process. However, under the total approach, depreciation is also included.

(c) Stock of Finished Goods. The amount of funds to be invested in holding stock of finished goods can be estimated on the basis of annual budgeted units of production, estimated cost of production per unit and the average holding period of finished goods stock by using the following formula :

$$\frac{\text{Budgeted annual units of production x Estimated cost of production per unit x Average holding period of finished goods in days/months/weeks}}{\text{No. of days/months/weeks in a year}}$$

Note. (i) Cost of production consist of 100% of material, labour and production overheads costs.

(ii) Under the total cost approach, depreciation is included in the cost of goods produced. However, depreciation is to be excluded under the cash cost approach.

(d) Investment in Debtors/Receivables. When the sales are made by a firm on cash basis, the amount is realised immediately and no funds are blocked for after sale period. However, in case of credit sales, there is a time lag between sales and realisation of cash. Thus, funds are to be invested in receivables, i.e. debtors and bills receivables. However, actual amount of funds locked up in receivables is only to the extent of cost of sales and not the actual sales which include profit. It would, therefore, be more appropriate to ascertain the amount of funds to be invested in debtors/receivables at cost of sales and not the selling price. But in case, **total approach** is followed for estimation of working capital then receivables may be computed on the basis of **selling price**.

$$\frac{\text{Budgeted units of credit sales * Cost of sales per unit *Average collection period of receivables in days/months/weeks}}{\text{No. of days/months/weeks in a year}}$$

Note: (i) Cost of sales = Cost of goods produced/sold + Office and administrative overheads + Selling and distribution overheads

(ii) Selling price per unit should be considered in place of cost of sales per unit in case total approach es to be followed for estimation of working capital. Under the **total approach**, all costs including depreciation and profit margin are included.

(e) Cash and Bank Balance. Cash is one of the current assets of a business. It is needed at all times to keep the business going. A business firm has to always keep sufficient cash to meet its obligations. Thus, a minimum desired cash and bank balance to be maintained by a firm should be considered as an important component of current assets while estimating the working capital requirements.

(f) Prepaid Expenses. Some of the expenses like wages, manufacturing overheads, office and administrative expenses and selling and distribution expenses etc. may have to be paid in advance. Such prepayment of expenses should also be estimated while computing working capital requirements of a firm.

(g) Trade Creditors. The term trade creditors refers to the creditors for purchase of raw material, consumables, stores etc. The suppliers of goods, generally, extend some period of credit in the normal course of business. The trade credit arrangement of a firm with its suppliers is an important source of short-term finance. It reduces the amount of net working capital required by a firm. The amount of funds to be provided by creditors can been estimated as follows :

$$\frac{\text{Budgeting annual units of production x Estimated raw material cost per unit x Average payment period of creditors in days/months/weeks}}{\text{No. of days/months/weeks in a year}}$$

(h) Creditors for Wages and Other Expenses. Wages and salaries are usually paid on monthly, fortnightly or weekly basis for the services already rendered by employees. The longer the payment-period, the greater is the amount of current liability towards employees or the funds provided by them. In the same manner, other expenses may also have to be paid after the lag of a certain period. The amount of such accrued or outstanding expenses reduces the level of net working capital requirements of a firm. The creditors for wages and other overheads may be computed as follows :

$$\frac{\text{Budgeted annual production in units x Estimated labour/overheads cost per unit x Average time lag in payment of wages/overheads in days/months/weeks}}{\text{No. of days/months/weeks in a year}}$$

Note. (i) The creditors for wages and each of the overheads may be calculated separately.

(ii) In case of selling overheads, budgeted annual sales in units should be considered in place of budgeted production units.

(i) Advanced Received. Sometimes a payment may be received in advance alongwith purchase order, such advances reduce the amount of net working capital required by a firm.

3.8 FINANCING WORKING CAPITAL REQUIREMENT

The working capital requirement of a concern can be classified as:

(a) Permanent or fixed working capital requirements.

(b) Temporary or variable working capital requirements.

In an concern, a part of the working capital investment are as permanent investments in fixed assets.

This is so because there is always a minimum level of current assets which are continuously required by the enterprise to carry out its day-to-day business operations and this minimum cannot be expected to reduce at any time. This minimum level of current assets gives rise to permanent or fixed working capital as this part of Working capital is permanently blocked in current assets.

Similarly, some amount of working capital may be required to meet the seasonal demands and some special exigencies such as rise in prices, strikes, etc. this proportion of working capital gives rise to temporary or Variable working capital which cannot be permanently employed gainfully in business.

The fixed proportion of working capital should be generally financed from the fixed capital sources while the temporary or variable working capital requirements of a concern may be met from the short term sources of capital.

The various sources for the financing of working capital are as follows :

SOURCES OF WORKING CAPITAL	
Permanent or fixed source	**Temporary or variable**
Shares	Commercial Banks
Debentures	Indigenous Bankers
Public deposits	Trade Creditors
Ploughing back of profits	Instalment Credit
Loans from Financial Institutions.	Advance
	Accounts Receivable-Credit/Factoring
	Accrued Expenses
	Commercial Paper

FINANCING OF PERMANENT/FIXED OR LONG-TERM WORKING CAPITAL

Permanent working capital should be financed in such a manner that the enterprise may have its uninterrupted use for a sufficiently long period. There are five important sources of permanent or long-term working capital.

1. Shares. Issue of shares is the most important source for raising the permanent or long-term capital. A company can issue various types of shares as equity shares, preference shares and deferred shares. According to the Companies Act, 1956, however, a public company cannot issue deferred shares. Preference shares carry preferential rights in respect of dividend at a fixed rate and in regard to the repayment of capital at the time of winding up the company. Equity shares do not have any fixed commitment charge and the dividend on these shares is to be paid subject to the availability of sufficient profits. As far as possible, a company should raise the maximum amount of permanent capital by the issue of shares.

2. **Debentures**. A debenture is an instrument issued by the company acknowledging its debt to its holder. It is also an important method of raising long-term or permanent working capital. The debenture-holders are the creditors of the company. A fixed rate of interest is paid on debentures. The interest on debentures is a charge against profit and loss account. The debentures are generally given floating charge on the assets of the company. When the debentures are secured they are paid on priority to other creditors. The debentures may be of various kinds such as simple, naked or unsecured debentures, secured or mortgaged debentures, redeemable debentures, irredeemable debentures, convertible debentures and non-convertible debentures. The debentures as a source of finance have a number of advantages both to the investors and the company. Since interest on debentures have to be paid on certain predetermined intervals at a fixed rate and also debentures get priority on repayment at the time of liquidation, they are very well suited to cautious, investors. The firm issuing debentures also enjoys a number of benefits such as trading on equity, retention of control, tax benefits, etc.

3. **Public Deposits.** Public deposits are the fixed deposits accepted by a business enterprise directly from the public. This source of raising short term and medium-term finance was very popular in the absence of banking facilities. In the past, generally, public deposits were accepted by textile industries in Ahmedabad and Bombay for periods of 6 months to 1 year. But now-a-days even long-term deposits for 5 to 7 years are accepted by the business houses. Public deposits as a source of finance have a large number of advantages such as very simple and convenient source of finance, taxation benefits, trading on equity, no need of securities and an inexpensive source of finance. But it is not free from certain dangers such as, it is uncertain, unreliable, unsound and inelastic source of finance. The Reserve Bank of India has also laid down certain limits on public deposits. Non-banking concerns cannot borrow by way of public deposits more than 25% of its paid-up capital and free reserves.

4. **Ploughing Back of Profits.** Ploughing back of profits means the reinvestments by concern of its surplus earnings in its business. It is an internal source of finance and is not suitable for an established firm for its expansion, modernisation and replacement etc. This method of finance has a number of advantages as it is the cheapest rather cost-free

source of finance; there is no need to keep securities; there is no dilution of control; it ensures stable dividend policy and gains confidence of the public. But excessive resort to ploughing back of profits may lead to monopolies, misuse of funds, over capitalisation and speculation, etc.

5. Loans from Financial Institutions. Financial institutions such as Commercial Banks, Life Insurance Corporation, Industrial Finance Corporation of India, State Financial Corporations, State Industrial Development Corporations, Industrial Development Bank of India, etc. also provide short-term, medium-term and long-term loans. This source of finance is more suitable to meet the medium-term demands of working capital. Interest is charged on such loans at a fixed rate and the amount of the loan is to be repaid by way of installments in a number of years

FINANCING OF TEMPORARY, VARIABLE OR SHORT-TERM WORKING CAPITAL

1. Indigenous Bankers: Private money-lenders and other country bankers used to be the only source of finance prior to the establishment of commercial banks. They used to charge very high rates of interest and exploited the customers to the largest extent possible. Now-a-days with the development of commercial banks they have lost their monopoly. But even today some business houses have to depend upon indigenous bankers for obtaining loans to meet their working capital requirements.

2. Trade Credit: Trade credit refers to the credit extended by the suppliers of goods in the normal course of business. As present day commerce is built upon credit, the trade credit arrangement of a firm with its suppliers is an important source of short-term finance. The credit-worthiness of a firm and the confidence of its suppliers are the main basis of securing trade credit. It is mostly granted on an open account basis whereby supplier sends goods to the buyer for the payment to be received in future as per terms of the sales invoice. It may also take the form of bills payable whereby the buyer signs a bill of exchange payable on a specified future date.

When a firm delays the payment beyond the due date as per the terms of sales invoice, it is called **stretching accounts payable.** A firm may generate additional short-term finances by stretching accounts payable, but it may have to pay penal interest charges as well as to forgo cash discount. If a firm delays the payment frequently, it adversely affects the credit worthiness of the firm and it may not be allowed such credit facilities in future.

The main advantages of trade credit as a source of short-term finance include :

i. It is an easy and convenient method of finance.

ii. It is flexible as the credit increases with the growth of the firm.

iii. It is informal and spontaneous source of finance.

However, the biggest disadvantage of this method of finance is charging of higher prices by the suppliers and loss of cash discount.

3. Installment Credit. This is another method by which the assets are purchased and the possession of goods is taken immediately but the payment is made in installments over a pre-determined period of time. Generally, interest is charged on the unpaid price or it may be adjusted in the price. But, in any case, it provides funds-for sometime and is used as a source of short-term working capital by many business houses which have difficult fund position.

4. Advances. Some business houses get advances from their customers and agents against orders and this source is a short-term source of finance for them. It is a cheap source of finance and in order to minimise their investment in working capital, some firms having long production cycle, specially the firms manufacturing industrial products prefer to take advances from their customers.

5. Factoring or Accounts Receivable Credit. Another method of raising short-term finance is through accounts receivable credit offered by commercial banks and factors. A commercial bank may provide finance by discounting the bills or invoices of its customers. Thus, a firm gets immediate payment for sales made on credit. A factor is a financial institution which offers services relating to management and financing of debts arising out of credit sales. Factoring is becoming popular all over the world on account of various services offered by the institutions engaged in it. Factors render services varying from bill discounting facilities offered by commercial banks to a total take over of administration of credit sales including maintenance of sales ledger, collection of accounts receivables, credit control and protection from bad debts, provision of finance and rendering of advisory services to their clients. Factoring may be on a recourse basis, where the risk of bad debts is borne by the client, or on a non-recourse basis, where the risk of credit is borne by the factor.

At present, factoring in India is rendered by only a few financial institutions on a recourse basis. However, the Report of the Working Group on Money Market (Vaghul Committee) constituted by the Reserve Bank of India has recommended that banks should be encouraged to set up factoring divisions to provide speedy finance to the corporate entities.

Inspite of many services offered by factoring, it suffers from certain limitations. The most critical fall outs of factoring include; (i) the high cost of factoring as compared to other sources of short-term finance, (ii) the perception of financial weakness about the firm availing factoring services, and (iii) adverse impact of tough stance taken by factor, against a defaulting buyer, upon the borrower resulting into reduced future sales.

6. Accrued Expenses. Accrued expenses are the expenses which have been incurred but not yet due and hence not yet paid also. These simply represent a liability that a firm has to pay for the services already received by it. The most important items of accruals are wages and salaries, interest, and taxes. Wages and salaries are usually paid on monthly, fortnightly or weekly basis for the services already rendered by employees. The longer the payment-period, the greater is the amount of liability towards employees or the funds provided by them. In the same manner, accrued interest and taxes also constitute a short-term source of finance. Taxes are paid after collection and in the intervening period serve as a good source of finance. Even income-tax is paid periodically much after the profits have been earned. Like taxes, interest is also paid periodically while the funds are used continuously by a firm. Thus, all accrued expenses can be used as a source of finance.

The amount of accruals varies with the change in the level of activity of a firm. When the activity level expands, accruals also increase and hence they provide a spontaneous source of finance. Further, as no interest is payable on accrued expenses, they represent a free source of financing. However, it must be noted that it may not be desirable or even possible to postpone these expenses for a long period. The payment period of wages and salaries is determined by provisions of law and practice in industry. Similarly, the payment dates of taxes are governed by law and delays may attract penalties. Thus, we may conclude that frequency and magnitude of accruals is beyond the control of managements. Even then, they serve as a spontaneous, interest free, limited source of short-term financing.

7. Deferred Incomes. Deferred incomes are incomes received in advance before supplying goods or services. They represent funds received by a firm for which it has to supply goods or services in future. These funds increase the liquidity of a firm and constitute an important source of short-term finance. However, firms having great demand for its products and services, and those having good reputation in the market can demand deferred incomes.

8. Commercial Paper. Commercial paper represents unsecured promissory notes issued by firms to raise short-term funds. It is an important money market instrument in advanced countries like U.S.A. In India, the Reserve Bank of India introduced commercial paper in the Indian money market on the recommendations of the Working Group on Money Market (Vaghul Committee). But only large companies enjoying high credit rating and sound financial health can issue commercial paper to raise short-term funds. The Reserve Bank of India has laid down a number of conditions to determine eligibility of a company for the issue of commercial paper. Only a company which is listed on the stock exchange has a net worth of at least Rs. 10 crores and a maximum permissible bank finance of Rs. 25 crores can issue commercial paper not exceeding 30 per cent of its working capital limit.

The maturity period of commercial paper, in India, mostly ranges from 91 to 180 days. It is sold at a discount from its face value and redeemed at face value on its maturity. Hence, the cost of raising funds, through this source, is a function of the amount of discount and the period of maturity and no interest rate is provided by the Reserve Bank of India for this purpose. Commercial paper is usually bought by investors including banks, insurance companies, unit trusts and firms to invest surplus funds for a short-period. A credit rating agency, called CRISIL, has been set up in India by ICICI and UTI to rate commercial papers.

Commercial paper is a cheaper source of raising short-term finance as compared to the bank credit and proves to be effective even during period of tight bank credit. However, it can be used as a source of finance only by large companies enjoying high credit rating and sound financial health. Another disadvantage of commercial paper is that it cannot be redeemed before the maturity date even if the issuing firm has surplus funds to pay back.

9. Working Capital Finance By Commercial Banks. Commercial banks are the most important source of short-term capital. The major portion of working capital loans are provided by commercial banks. They provide a wide variety of loans tailored to meet the specific requirements of a concern.

The different forms in which the banks normally provide loans and advances are as follows:

(a) Loans

(b) Cash Credits

(c) Overdrafts

(d) Purchasing and Discounting of bills.

(a) Loans. When a bank makes an advance in lump-sum against some security it is called a loan. In case of a loan, a specified amount is sanctioned by the bank to the customer. The entire loan amount is paid to the borrower either in cash or by credit to his account. The borrower is required to pay interest on the entire amount of the loan from the date of the sanction. A loan may be repayable in lump sum or installments. Interest on loans is calculated at quarterly rests and where repayments are stipulated in installments, the interest is calculated at quarterly rests on the reduced balances. Commercial banks generally provide short-term loans up to one year for meeting working capital requirements. But now-a-days term loans exceeding one year are also provided by banks. The term loans may be either medium-term or long-term loans.

(b) Cash Credits. A cash credit is an arrangement by which a bank allows his customer to borrow money upto a certain limit against some tangible securities or guarantees. The customer can withdraw from his cash credit limit according to his needs and he can also deposit any surplus amount with him. The interest in case of cash credit is charged on the daily balance and not on the entire amount of the account. For these reasons, it is the most favourite mode of borrowing by industrial and commercial concerns. The Reserve Bank of India issued a directive to all scheduled commercial banks on 28th March 1970, prescribing a commitment charge which banks should levy on the unutilised portion of the credit limits.

(c) Overdrafts. Overdraft means an agreement with a bank by which a current account-holder is allowed to withdraw more than the balance to his credit upto a certain limit. There are no restrictions for operation of overdraft limits. The interest is charged on daily overdrawn balances. The main difference between cash credit and overdraft is that overdraft is allowed for a short period and is a temporary accommodation whereas the cash credit is allowed for a longer period. Overdraft accounts can either be clean overdrafts, partly secured or fully secured.

(d) Purchasing and Discounting of Bills. Purchasing and discounting of bills is the most important form in which a bank lends without any collateral security. Present day commerce is built upon credit. The seller draws a bill of exchange on the buyer of goods on credit. Such a bill may be either a clean bill or a documentary bill which is accompanied by documents of title to goods such as a railway receipt. The bank purchases the bills payable on demand and credits the customer's account with the amount of bill less discount. At the maturity of the bills, bank presents the bill to its acceptor for payment. In case the bill discounted is dishonoured by non-payment, the bank recovers the full amount of the bill from the customer along with expenses in that connection.

In addition to the above mentioned forms of direct finance, commercial banks help their customers in obtaining credit from their suppliers through the letter of credit arrangement.

Letter of Credit

A letter of credit popularly known as L/c is an undertaking by a bank to honour the obligations of its customer upto a specified amount, should the customer fail to do so. It helps its customers to obtain credit from suppliers because it ensures that there is no risk of non-payment. L/c is simply a guarantee by the bank to the suppliers that their bills upto a specified amount would be honoured. In case the customer fails to pay the amount, on the due date, to its suppliers, the bank assumes the liability of its customer for the purchases made under the letter of credit arrangement.

A letter of credit may be of many types, such as :

(i) Clean Letter of Credit. It is a guarantee for the acceptance and payment of bills without any conditions.

(ii) Documentary Letter of Credit. It requires that the exporter's bill of exchange be accompanied by certain documents evidencing title to the goods.

(iii) Revocable Letter of Credit. It is one which can be withdrawn by the issuing bank without the prior consent of the exporter.

(iv) Irrevocable Letter of Credit. It cannot be withdrawn without the consent of the beneficiary.

(v) ***Revolving Letter of Credit.*** In such type of letter of credit the amount of credit it automatically.

3.9 SUMMARY

Working capital concept are important aspects of the management. Working capital is descriptive of that capital which is not fixed. It is an indicator of the financial soundness of an enterprise. Working capital is that part of the firm's capital which is required for financing short term or current assets. Its requirements of a concern depend upon large number of factors. It is basically depend upon nature of its business.

3.10 SELF ASSESSMENT QUESTIONS

1. What do you mean by working capital? Also discuss its types.
2. How working capital is different from capital?
3. What is letter of credit?
4. Write a brief note on commercial papers a source of working capital.

3.11 IN-TEXT ACTIVITY

1. Discuss the disadvantages of excess and inadequate working capital.

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2. What factors do you consider in estimating the working capital needs of a concern?

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3. What are the permanent sources of working capital?

4. What are the temporary sources of working capital ?

3 .12 FURTHER READING

1. Management Accounting : Shashi K. Gupta & R.K.Gupta
2. Financial Management : M.Y.Khan & P.K.Jain
3. Financial Management : I.M.Pandey
4. Financiaal Accounting for Business Decision : Ashish K. Bhattacharya

OBJECTIVES

After going through this lesson, you will be able to understand:

- the meaning, importance and objectives of financial statements.
- users of financial statements.
- capital expenditure and revenue expenditure.
- capital receipts and revenue receipts.
- preparation of trading account and profit & loss account

STRUCTURE

4.1 Meaning and Importance/Objectives of Financial Statements

4.2 Users of Financial Statements

4.3 Classification of Capital and Revenue Items

4.4 Preparation of Final Accounts

 4.4.1 Preparation of Trading Account

 4.4.2 Preparation of Profit & Loss Account

4.5 Summary

4.6 Self Assessment Questions

4.7 In-Text Activity

4.8 Further Reading

4.1 MEANING AND IMPORTANCE/OBJECTIVES OF FINANCIAL STATEMENTS

Financial Statements are the statements prepared at the end of the accounting period to how financial performance during the accounting period and financial position of the business as on date. A complete set of Financial Statements includes (i) Balance Sheet, (ii) Profit and Loss Account and (iii) schedules and notes forming part of Balance Sheet and Profit and Loss Account. They are also known as final accounts. Financial Statements are the end-product of the accounting function, drawn from the Trial Balance. They are prepared to know:

(i) the profit earned or loss incurred from the business operations during an accounting period. It is known from the Profit and Loss Account. Few enterprises also prepare Trading Account in addition to the Profit and Loss Account, and

(ii) the financial position, by preparing the Balance Sheet.

OBJECTIVES AND IMPORTANCE

The objectives and importance of the Financial Statements are:

(a) Profit and Loss Account

(i) Determine Gross Profit or Gross Loss: Trading Account, which is a part of Profit and Loss Account, is prepared to know gross profit earned or gross loss incurred by the business during the accounting period. It shows whether sales generate adequate profit to meet other operating expenses and expansion plans.

(ii) Determine Net Profit or Net Loss: Profit and Loss Account shows net profit earned or net loss incurred by the business during the accounting period.

(iii) Comparison with the Previous Year's Profit: Profit determined by the Trading Account and Profit and Loss Account for the accounting period can be compared with that of the previous year's profit. It helps in determining whether the business is progressing as per plans or not.

(iv) Details of Indirect Expenses: Indirect expenses are shown in the Profit and Loss Account. These expenses may be compared over the period and suitable steps may be taken for exercising control on them.

(v) Maintaining Reserves: To meet future uncertainties and to strengthen financial position of the firm, reserves are set aside out of profits. The amount set aside as reserves depends upon net profit earned.

(vi) Calculation of Ratios: For financial analysis, several ratios are calculated with the help of information/data available in the Profit and Loss Account. For example, Net Profit Ratio, Operating Ratio, Return on Capital Employed, etc.

(b) Balance Sheet

(i) Ascertaining Financial Position: Balance Sheet is a part of Financial Statements that shows the financial position of the business on a particular date under various heads. If assets are more than outside liabilities, the business is considered to be in sound financial position.

(ii) Comparison with Previous Year: The amounts under various heads of Balance Sheet can be compared with that of previous year to assess the change in financial position.

(iii) Analysis of Individual Items: An analysis of individual items of Balance Sheet can be carried out to ascertain whether long-term funds (long-term loans, capital, etc.) have been invested in long-term assets, whether the current assets are realised as stipulated, whether the business has sufficient working capital, whether appropriate credit period is enjoyed, etc.

(iv) Calculating Ratios: Balance Sheet enables calculation of financial position ratios such as Debt-Equity ratio (to determine whether debts are sufficiently covered); current ratio (to determine working capital adequacy), etc. Ratio analysis helps analysing over or under investment in fixed assets, working capital, etc., and in the process helps in taking appropriate decisions.

4.2 USERS OF FINANCIAL STATEMENTS

The information in the Financial Statements is of interest to a number of internal and external parties. They include:

Internal Users

(i) Owners: Owners contribute capital in the business and thus bear maximum risk. They are interested to know the profit earned or loss incurred by the business, besides safety of their capital. The Financial Statements give this information about the business.

(ii) Management: Management makes extensive use of accounting information to arrive at informed decisions such as determination of selling price, cost controls and reduction, investment into new projects, etc.

(iii) Employees and Workers: Employees and workers are entitled to bonus at the year end, which is linked to the profit earned by an enterprise. Therefore, the employees and workers are interested in Financial Statements. Besides, financial statements also show whether the enterprise has deposited its dues into the Provident Fund and Employees State Insurance, etc., or not.

External Users

(i) Banks and Financial Institutions: Banks and financial institutions provide loans to the businesses. They watch performance of the business to know whether it is progressing as projected to ensure safety and recovery of the loan advanced. They assess it by analysing the accounting information.

(ii)Creditors: Creditors are the parties who supply goods or services on credit. Normally, a large amount of suppliers remain invested in credit purchases. Before granting credit, creditors satisfy themselves about the credit-worthiness of the business. The Financial Statements help them in making such an assessment.

(iii) Government and its Authorities: Government makes use of financial statements to compile national income accounts and other information. The information so available to it enables them to take policy decisions. Government levies varied taxes such as Excise Duty, VAT, Service Tax and Income Tax. These government authorities assess the correct tax dues from the financial statements.

(iv) Researchers: The information in financial statements helps researchers in studies or surveys related with a particular firm or industry.

(v) Product Pricing: Accounting information is required for establishing, correct pricing. Sometimes, prices of some products are fixed by the government, so it needs accounting information to fix fair prices of the products.

(vi) Public: They want to see the business running since it makes substantial contribution to the economy in many ways, e.g., employment of people, patronage to suppliers, etc. Thus, financial accounting provides useful financial information to various user groups for decision-making.

4.3 CLASSIFICATION OF CAPITAL AND REVENUE ITEMS

Trial Balance having been prepared, the accounts appearing therein are transferred either to the Trading Account (if it is prepared) or to the Profit and Loss Account or to the

Balance Sheet. Items appearing in the Trial Balance which are of revenue nature are transferred to Profit and Loss Account while items of capital nature are transferred to Balance Sheet.

Profit and Loss Account and Balance Sheet are prepared on the above basis. If an item of capital nature is transferred to Trading Account or Profit and Loss Account, i.e., treating it as of revenue nature or vice versa, then neither Profit and Loss Account will show correct profit or loss nor the Balance Sheet will show true and fair financial position of the business. It is, therefore, necessary to understand and classify correctly whether an item appearing in the Trial Balance is of revenue nature or of capital nature. Thereafter, the item should be transferred to the final accounts accordingly.

There are certain rules governing the classification of expenditure and receipts as revenue and capital. Let us discuss these rules or basis.

CAPITAL EXPENDITURE

Capital Expenditure gives benefit of enduring nature, i.e., the benefit extends to period or periods beyond the accounting period. Capital expenditure increases the earning capacity or reduces the operating expenses of a business.

Capital Expenditure is the amount incurred by an enterprise normally on purchase of fixed assets. Fixed assets are used in the business to earn income and are not intended for resale. Fixed assets purchased may be tangible or intangible.

Following types of expenditures are usually accounted as Capital Expenditure:

(i) Expenditure incurred for acquisition of fixed assets such as land, building, machinery, furniture, motor vehicle, etc.

(ii) Expenditure incurred for purchase, receipt or installation of a fixed asset: All expenses in addition to the purchase price incurred for getting the asset ready for use are capital expenditure and thus, are added to the cost of the asset. Examples of such expenses are wages paid to workers for installing the machinery, cost of the platform on which the machinery will be fixed, overhaul of second-hand machinery purchased, etc. It is to be noted that expenses incurred after the assets have been put to use, are not Capital Expenditure.

(iii) Expenditure for the extension of or improvement in fixed assets: Expenditure incurred on existing asset because of which the profit-earning capacity increases, through lowering costs or increasing output, the expenditure is a Capital Expenditure.

(iv) Expenditure incurred to acquire the right to carry on business: Expenses necessary for either establishing the business, like preliminary expenses for floating a company or obtaining licence are capital expenditure. Similarly, cost of a patent, i.e., the right to produce certain goods in a certain manner, is capital expenditure- only the initial expenditure is capital; renewal fee is revenue expenditure.

(v) Expenditure incurred for purchase of intangible assets such as goodwill, patents rights and trademark, copyright, etc.

(vi) Legal Expenses: Legal expenses incurred in connection with acquiring or defending suits for protecting fixed assets, rights, etc., are also capital expenditure.

Treatment of Capital Expenditure: Capital Expenditure is debited to fixed assets account and is shown in the Balance Sheet.

REVENUE EXPENDITURE

Revenue Expenditure is the amount incurred on running a business, i.e., benefit of such expenses are consumed or exhausted within the accounting period. In short, an expenditure which is not capital expenditure is revenue expenditure. The benefit of revenue expenditure is exhausted within the accounting period in which it is incurred. Examples of such expenses are:

(i) Expenses incurred in day-to-day running of the business such as rent, salaries, wages, power, fuel, etc.

(ii) Expenses incurred for repairs and maintenance of fixed assets.

(iii) Expenses incurred on purchase of stock of materials and goods to the extent that these are used up during the year; the remaining amount will be an asset.

(iv) Depreciation or the expired cost of fixed assets.

Revenue expenditure is accounted as an expense and is matched against revenues of the period to determine profit or loss of that period. It also includes that part of capital expenditure which expires or consumed within an accounting year (Depreciation).

We have discussed the basis for distinguishing Capital Expenditure from Revenue Expenditure. However, the distinction is not easy. Following expenses appear to be revenue expenses but they are capital expenses:

1. Expenses incurred on the repairs and whitewashing for the first time on the purchase of an old building, since these expenses are necessary to make the building useable.
2. Wages paid to workers to produce a tool to be used in the factory itself or to fix a machine.
3. Expenses incurred in connection with the purchase of land or building such as fees paid to lawyer or registration expenses.
4. Interest on loan raised to acquire an asset up to the point of time it is ready for use.

Treatment of Revenue Expenditure: Revenue expenditure is shown on the debit side of Trading or Profit and Loss Account.

Distinction between Capital Expenditure and Revenue Expenditure

Basis	***Capital Expenditure***	***Revenue Expenditure***
1. Purpose	It is incurred for acquisition of fixed assets for use in business.	It is incurred for running of business. '
2. Capacity	It increases earning capacity of the business.	It is incurred for earning profits.
3. Period	Its benefit extends to more than one year.	Its benefit is exhausted within the year.
4 Debited	It is debited to an Asset Account.	It is debited to an Expense Account.
5. Nature of Account	It is an Asset Account.	It is an Expense Account.
6.Depiction	It is shown in the Balance Sheet.	It is shown in the Trading or Profit and Loss Account.
7. Examples	(a) Cost of Plant and Machinery. *(b)* Cost of Land and Building. (c) Cost of Furniture and Fixtures.	(a) Depreciation on Plant and Machinery. *(b)* Rent. (c) Repairs and Insurance.

Improper Considerations in the Determination of Capital Expenditure and Revenue Expenditure

Whether any expenditure is capital or revenue can be determined only after considering nature of the expenditure. If an item of revenue expenditure is debited to asset account, it will overstate profit. *On the other hand, if an item of capital expenditure is debited to* *profit and loss account, it will understate profit of a particular period.*

To determine whether expenditure is a capital expenditure or revenue expenditure, following are not material:

(i) Amount of Payment: Usually the amount involved in capital expenditure is larger than in revenue expenditure. But it does not mean that if the amount is small, it is revenue expenditure and if the amount is large, it is a capital Expenditure.

(ii) Payment-Periodic or Lump Sum: Usually capital expenditure is not frequent and is made at a time, in lump sum. For example, purchase of land. On the other hand, revenue expenditure is paid periodically such as salary. It should not be concluded that if payment is made frequently, it is revenue expenditure. It is possible that payment for an asset purchased (which is a capital expenditure), is paid in installments.

(iii) Source of Payment: Mostly payment of capital expenditure is made out of the capital while revenue expenditure is paid out of revenue receipts. But it should not be considered as a general rule that expenses paid out of the capital are capital expenditure and expenses paid out of revenue receipts are always revenue expenditure.

(iv) Its Nature in the Hands of Recipient: Whether any expenditure is a capital expenditure or revenue expenditure, nature of payment in the hands of recipient is not material. It may be possible that an item, which is of revenue nature for the payee, is of capital nature for the payer. For example, for a car manufacturer, amount received from sale of car is a revenue receipt but for the purchaser, it is a capital expenditure.

Illustration 1. State whether following expenditures are capital or revenue in nature:

(i) Second-hand car was purchased for a sum of Rs. 50,000. A sum of Rs. 10,000 was spent on its overhauling.

(ii) Rs.2,500 paid for the installation of a new machine.

(iii) Repairs for Rs. 5,000 necessitated by negligence.

(iv) Cost of annual taxes paid and the annual insurance premium paid on the car mentioned above.

(v) Cost of air-conditioning of the office of the General Manager.

Solution:

(i) Total expenditure of Rs.60,000 is Capital Expenditure. A sum of Rs. 50,000 was spent on a capital asset while another Rs. 10,000 was spent for making the capital asset ready for use.

(ii) Cost of installing the new machine is a Capital Expenditure because the amount spent is up to the point when the asset is ready for use.

(iii) Repair charges are Revenue Expenditure since they are for maintaining an asset and not for improving the asset.

(iv) Annual taxes and annual premium paid on the car are Revenue Expenditure because they do not add to the value of the car and their benefit will be exhausted within the year.

(v) It is Capital Expenditure because the benefit of this expenditure will be available for a number of years.

Illustration 2. State with reasons whether following are Capital or Revenue Expenditures:

(i) Custom duty paid on import of a machinery.

(ii) Wages paid in connection with the erection of a new machinery.

(iii) Rs. 5,000 spent on repainting the factory.

(iv) Repairs for Rs. 2,000 necessitated by negligence of an operator of machine.

(v) Rs. 10,000 paid for electricity bill.

Solution:

(i) Custom duty paid on import of a machinery is a capital expenditure because it is incurred for the acquisition of a new asset.

(ii) Wages paid in connection with the erection of a new machinery is capital expenditure because it is in connection with the acquisition of new asset.

(iii) Rs. 5,000 spent on repainting the factory is revenue expenditure because it has been incurred to maintain the factory building.

(iv) Repairs for Rs. 2,000 necessitated by negligence of an operator of machine is revenue expenditure since it has not improved the asset (machine) in any way.

(v) 0Rs. 10,000 paid for electricity bill is revenue expenditure because it is a part of operating cost.

DEFERRED REVENUE EXPENDITURE

Deferred Revenue Expenditure is a revenue expenditure that is incurred during an accounting period but its benefit extends beyond that accounting period, i.e., is not exhausted within the accounting period. Such an expenditure is unusually larger than the normal expenditure under the head. An example of this is large expense, say on advertising a new product. The expenditure so incurred will give benefit in the periods beyond the accounting period in which the expenditure was incurred. It will thus, be proper to spread the expenditure over a period and not debit the entire amount to Profit and Loss Account for the year in which the expense is incurred.

It may be noted that the amount which has not been charged to Profit and Loss Account is shown in the Balance Sheet as an asset.

Sometimes even large loss, arising from an accident or other unforeseen circumstances, may be spread over three or four years instead of being charged wholly against the revenues of the year in which the loss is suffered. The loss of a building because of an earthquake may be treated in this manner. Such loss is also treated as Deferred Revenue Expenditure.

It should be noted that Deferred revenue expenditure and prepaid expenses are two different terms. In case of deferred revenue expenditure, benefits available cannot be precisely estimated but in case of prepaid expenses, like payment of rent in advance, benefits available can be precisely estimated.

Treatment of Deferred Revenue Expenditure: Amount not to be written off in the current year is shown on the assets side of Balance Sheet as fictitious asset.

Deferred Revenue Expenditure is a Fictitious Asset: Although it appears on the assets side of the Balance Sheet, it is not really an asset to the business.

CAPITAL RECEIPTS AND REVENUE RECEIPTS

Distinction between capital receipts and revenue receipts is also necessary as is in the case of expenditure.

Capital Receipts: Capital Receipts are the amounts received in the form of additional capital introduced in the business, loans received and sale proceeds of the fixed assets. You may observe that when loan is received, it increases the business liability. Thus, it is not treated as revenue receipt. Sale of any fixed asset reduces fixed assets, thus, the amount received is not revenue earned in the normal course of business. In fact, capital receipts do not affect profit or loss of the business. They either increase liabilities or reduce assets. Hence, these are shown in the Balance Sheet.

Revenue Receipts: These are the amounts received in the normal course of the business, mainly from sale of goods and services. An important feature of revenue receipts is that such receipts are incomes. Hence, these are shown on credit side of the Profit and Loss Account.

Distinction Between Capital Receipt & Revenue Receipt

Capital Receipts	*Revenue Receipt*
1. It is the amount realised by sale of fixed assets or receipt as capita! or loans taken.	1. It is the amount realised by sale of goods or rendering of services.
2. It is shown in Balance Sheet.	2. It is shown in Trading or Profit and Loss Account.
3. Capital Receipts are normally of non-recurring nature.	3. Revenue Receipts are normally of recurring nature.
4. Capital Receipts are the receipts which are not received in course of normal business activities.	4. Revenue Receipts are received in the course of normal trading operations.
5. Capital Receipts are normally not available for payment as profit to the owner of the business.	5. Revenue Receipts *i.e.,* net of revenue expenses and expired portion of Capital Expenditure/Deferred Revenue Expenditure are available for distribution to the owner of the business.

4.4 PREPARATION OF FINAL ACCOUNTS

Final Accounts

Final Accounts mean the Financial Statements prepared after Trial Balance is prepared. Financial Statements include:

1. Trading and Profit and Loss Account (Income Statement), and
2. Balance Sheet (Position Statement)

4.4.1 PREPARATION OF INCOME STATEMENT

Income Statement is a summary of accounts that affects the profit or loss of an enterprise. Many accounts shown in the Trial Balance relate to expenditure or income. These accounts either increase or decrease the profit. Accounts that increase the profit are shown on one (credit) side while accounts that decrease the profit, i.e., losses and expenses are shown on the other (debit) side. The statement so prepared is known as an **Income Statement.**

An Income Statement has two parts, namely,

1. *Trading Account:* It shows gross profit or gross loss for the accounting period; and
2. *Profit and Loss Account:* It shows net profit or net loss for the accounting period. Let us discuss these in detail.

TRADING ACCOUNT

Meaning

Trading Account is the first stage in the process of preparing the final accounts. Trading Account shows gross profit earned or gross loss incurred during the accounting year. It is credited with sales, services rendered and closing stock or inventory. Opening stock or inventory, purchases and other direct expenses are debited in the account. The difference in two sides is either gross profit or gross loss.

Features of Trading Account

1. It is the first stage in the preparation of final accounts of a trading concern.
2. It records only net sales and direct cost of goods sold.
3. The balance of this account shows gross profit or gross loss.
4. Gross Profit or Gross Loss is transferred to Profit and Loss Account.

Purpose of Trading Account

Trading Account is prepared to know the gross profit earned or gross loss incurred for the accounting period. This account is based on matching sales of goods and services with the cost of goods sold and services rendered.

Contents or Items Shown in Trading Account

Items shown on the Debit Side of the Trading Account

1. ***Opening Stock*** means Closing Stock of the previous year, which has been entered in the Opening Stock Account through an opening entry. Therefore, it is shown in the Trial Balance. This entry (item) is usually put as the first item on the debit side of the Trading Account. Of course, in the first year of a business there will be no Opening Stock. In case of a trading concern, Opening Stock is of different types of finished goods. In a manufacturing concern, Opening Stock is of raw materials, work-in-process and finished goods.

2. *Purchases and Purchases Return:* Purchases means purchase of goods and materials for the purpose of resale or to be used in production. Purchases Account always has a debit balance. It includes both cash and credit purchases. It is to be kept in mind that purchase of assets which are meant for permanent use in business such as machinery, furniture, etc., are not included in the purchases.

Purchases Return Account always has a credit balance showing the returns of goods or materials to the suppliers. On the debit side of the Trading Account, the net amount is shown as below(with assumed figures):

	Rs.
To Purchases	3,00,000
Less: Purchases Return	10,000
	2,90,000

Besides purchases return, following are also deducted from purchases:

(a) Goods taken by the proprietor for his personal use.

(b) Goods given as charity.

(c) Goods given as samples.

Let us discuss some issues relating to purchases for more clarity:

1. Goods withdrawn by the proprietor for personal use are accounted in the books by debiting 'Drawings Account' and crediting 'Purchases Account' at the purchase cost.
2. Goods received on consignment are accounted separately from purchases. They are not included in purchases because these goods are not owned by the firm.
3. Purchase of plant, furniture, stationery, etc., is also accounted separately, they being assets.
4. Goods may have been purchased in the last days of the year and also the firm received them but these are not accounted in the books of accounts. In such a situation, before preparing the Trading Account, such purchases are also accounted in the books. This amount is debited in Purchases Account and credited in the

Seller's Account.

5. If goods purchased are in transit, it is necessary to account them too. This amount is debited to 'Goods-in-Transit Account' and credited to Seller's Account. Goods-in-Transit are shown as purchases and also included in closing stock.

6. *Adjusted Purchases:* When opening and closing stocks are adjusted by preparing Purchases Account, following entries are passed:

(A) For Adjustment of Opening Stock:

Purchases A/c ...Dr.

To Opening Stock A/c

(B) For Adjustment of Closing Stock:

Closing Stock A/c ...Dr.

To Purchases A/c

If these adjustments are made, opening stock will not appear in the Trial Balance.

The amount in the Adjusted Purchases Account' is shown on the debit side of the Trading Account and the amount of closing stock on the assets side of the Balance Sheet.

Adjusted Purchases = Net Purchases + Opening Stock - Closing Stock

3. Direct Expenses: Direct Expenses are those expenses which are incurred on the goods purchased, till they are brought to the place of business for sale. Examples of such expenses are freight inwards, insurance, customs (import) duty, clearing charges, octroi duty, cartage, etc. In a manufacturing concern, besides the above, expenses incurred for purposes of production such as wages, power and fuel, factory rent, etc., are also Direct Expenses. Let us discuss Direct Expenses individually.

(i) Carriage or Freight or Cartage Inwards: It is the cost of bringing materials to the firm's godown and making them available for use. If any freight or carriage is paid on any asset, like machinery, it is added to the cost of the asset and not debited to Trading Account.

(ii) Manufacturing Wages: Wages paid to workers in the factory, including stores, are debited to the Trading Account; if any amount is outstanding it is accounted for so that the total wages for the period are debited to Trading Account. If wages are paid for installation of machinery, it is debited to Machinery Account. If the Trial Balance includes a single

amount for 'Wages and Salaries', it is assumed that the item includes the salaries of the supervisory staff in the factory. Therefore, the amount is shown in the Trading Account. But, if the item in the Trial Balance is shown as 'Salaries and Wages', it is shown in the Profit and Loss Account. It is assumed that the item includes the wages of office staff only.

(iii) *Power and Fuel:* Cost of coal used in the boiler or electricity consumed in running the machines is included under this head of accounts. Expenses incurred including not paid, i.e., outstanding expenses are debited to Trading Account.

(iv) *Factory Lighting:* Electricity consumed for providing light for running the factory is debited to Trading Account. If there is a common meter for the office and the factory, the total bill should be appropriately divided between the two-only the portion relating to the factory is debited to Trading Account; the other portion is debited to Profit and Loss Account.

(v) *Factory Rent and Rates:* Rent paid for the factory premises as well as the municipal taxes (which are called rates) or charges for water, etc., are debited to Trading Account. If the office and the factory are in the same premises, total rent and rates have to be suitably apportioned.

(vi) Duty on Purchases: Any duty (such as Octroi) paid in connection with the purchases of goods is debited to Trading Account, it being part of purchase cost.

(vii) *Royalties* are the payments which are made for acquiring the right to use patents. It is treated as a direct expense if it is based on the number of unit produced.

(viii) *Consumable Stores:* These are incurred to keep the machine in right condition and include engine oil, cotton waste, soft soap, oil grease and waste, consumed in a factory.

Stores consumed during the year = Opening Balance in Stores + Purchases of Stores during the year - Closing Balance of Stores.

Items shown on the Credit Side of the Trading Account

1. ***Sales and Sales Return:*** Sales means sale of goods dealt with by the business. Sales does not include sales tax or value added tax (VAT). Sales tax collected is a liability and shown in the Balance Sheet. VAT collected is adjusted against VAT Paid and shown in the Balance Sheet as a liability (if VAT collected is more) or as an asset (if VAT paid is more).

Sales Account always has a credit balance, showing the total sales made during the year. Sales Return Account always has a debit balance, showing the total of the amount of goods returned by customers. Net of the two amounts is called net sales and is entered on the credit side of the Trading Account.

2. *Closing Stock:* Closing Stock means the stock of unsold goods, i.e., raw material, semi-finished goods, finished goods or goods traded in at the end of the current accounting period. Closing Stock is taken and valued at the year end and is shown in Trading Account on the credit side.

According to the convention of conservatism, stock is valued at its cost or net realisable value (market value), whichever is lower.

Closing Stock is usually given outside the Trial Balance. It is recorded in the books by passing the following entry:

Closing Stock A/c ...Dr.

To Trading A/c

(Being the Closing Stock brought into books)

As a result, Closing Stock appears both on the credit side of the Trading Account and on the assets side of the Balance Sheet.

Closing Stock may not be given outside the trial balance as an adjustment. But, instead as a part of the trial balance. It means entry for Closing Stock has already been passed as follows:

Closing Stock A/c ...Dr.

To Purchases A/c

(Being the Closing Stock brought into books)

The effect of this entry is to reduce the debit in Purchases Account; Closing Stock is then not entered in the Trading Account. It *appears in the Trial Balance and is shown on the assets side of the Balance Sheet.*

Let us take an example. Suppose, an article of Rs. 100 is purchased. If this article is not sold up to the end of the year, its value will be taken as Rs. 100 at the time of valuation of the Closing Stock, notwithstanding the fact that its sales price is more than Rs. 100 at the end of the year. But, if at that time the sales price of this article is Rs. 95, in such a situation, its value will be taken as Rs. 95 only. It is so valued because of the Prudence or Conservatism Concept of Accounting.

But keep in mind that obsolete articles or articles not saleable are not included in Closing Stock.

In case of a trading concern, Closing Stock is of different types of finished goods. In case of a manufacturing concern, Closing Stock consists of raw materials, work-in-progress and finished goods.

Balancing of Trading Account

Gross Profit or Gross Loss: After recording the above items in respective sides of the Trading Account, balance is calculated to ascertain Gross Profit or Gross Loss. If total of the credit side is more than that of the debit side, excess is Gross *Profit.* If total of the debit side is more than that of the credit side, excess is Gross Loss.

Gross Profit is transferred to the credit side of the Profit and Loss Account and Gross Loss is transferred to the debit side of the Profit and Loss Account.

Note: While preparing a Trading Account, it should be kept in mind that closing Journal entries are passed in Journal Proper. The closing entries passed are as follows:

(i) For items on the debit side:

Trading A/c …….Dr.

To Opening Stock A/c

To Purchases A/c (Net)

To Direct Expenses A/c

(ii) For items on the credit side:

Sales A/c (Net) …..Dr.

Closing Stock A/c …Dr.

To Trading A/c

(iii) For Gross Profit:

Trading A/c ……Dr.

To Profit and Loss A/c

(iv) For Gross Loss:

Profit and Loss A/c …..Dr.

To Trading A/c

Format of a Trading Account

Format of a Trading Account is given below:

Dr. **TRADING ACCOUNT** ***for the year ended.*** **Cr.**

Particular	Rs.	Particular	Rs.
To Opening Stock To Purchases *Less:* Returns Outward To Wages and Salaries To Direct Expenses To Carriage Inwards To Freight, Octroi and Cartage To Gross Profit transferred to P & L A/c*		By Sales *Less:* Returns Inward By Scrap Sales By Closing Stock By Gross Loss transferred toP&L A/c*	

*Either Gross Profit or Gross Loss will appear.

Illustration 3. Prepare Trading Account for the year ended 31st March, 2014 from the following balances:

	Rs.		Rs.
Stock (1st April, 2013)	10,000	Purchases	1,00,000
Wages	5,000	Carriage Inwards	1,000
Sales (Inclusive of Sales Tax)	1,70,000	Returns Inward	5,000
Returns Outward	8,000	Sales Tax Paid	15,000
Freight	500	Octroi Duty	2,500

Closing Stock as on 31st March, 2014 was valued at Rs. 20,000. Also, pass the Closing Entries.

Solution: TRADING ACCOUNT

for the year ended 31st March

Particulars	**Dr. (Rs.)**	**Particulars**		**Cr. (Rs.)**
To Opening Stock	10,000	By Sales	1.70,000	
To Purchases 1,00,000		*Less:* Sates Tax	15,000	
Less: Returns Outward 8,000	92,000		1,55,000	
To Wages	5,000	*Less:* Returns Inward	5,000	1,50,000
To Carriage Inwards	1,000	By Closing Stock		20,000
To Freight	500			
To Octroi Duty	2,500			
To Profit and Loss A/c (Gross Profit)	59,000			
	1,70,000			1,70,000

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Date	Particulars	L.F.	Dr. (Rs.)	Cr.(Rs.)'
2014 March 31	Trading A/c ...Dr.		1,24,000	
	To Opening Stock A/c			10,000
	To Purchases A/c			1,00,000
	To Returns Inward A/c			5,000
	To Wages A/c			5,000
	To Carriage Inwards A/c			1,000
	To Freight A/c			500
	To Octroi Duty A/c			2,500
	(Being the transfer of accounts to the debit side of the Trading Account)			
March 31	Sales A/c ...Dr.		15,000	
	To Sales Tax A/c			15,000
	(Being the transfer of sales tax paid to the Sales Account)			
March 31'	Sales A/c ...Dr.		1,55,000	
	Returns Outward A/c ...Dr.		8,000	
	To Trading A/c			1,63,000
	(Being the transfer of sales (net of sates tax) and purchases return to Trading Account)			
March 31	Closing Stock A/c ...Dr.		20,000	
	To. Trading'A/c			20,000
	(Being the recording of Closing Stock)			
March 31	Trading A/c ...Dr.		59,000	
	To Profit and Loss A/c			
	(Being the transfer of gross profit to the Profit and Loss Account)			59,000

Illustration 4. Prepare Trading Account for the year ended 31st March, 2014 from the following balances:

Stock (1st April, 2013) 10,000

Sales 2,00,000

Purchases 2,00,000

Carriage Inwards 1,500

Freight Inwards 2,500

Sales Return 5,000

Clearing Charges 11,000

Purchases Return 2,500

Carriage Outwards 3,000

The Closing Stock of goods as on 31st March, 2014 is Rs. 20,000.

Solution:

TRADING ACCOUNT

Dr. ***for the year ended 31 st March, 2014*** ***Cr.***

Particulars	***Rs.***	**Particulars**	Rs.
To Opening Stock	10,000	By Sales 2,00,000	
To Purchases 2,00,000		*Less.* Returns 5,000	1,95,000
Less: Returns 2,500	1 97,500	By Closing Stock	20,000
To Carriage Inwards	1,500	By Gross Loss transferred to Profit and Loss A/c	7,500
To Freight Inwards	2,500		
To Clearing Charges	11,000		
	2,22,500		2,22,500

Note: Carriage outwards will be charged to Profit and Loss Account.

Illustration 5. From the following information, prepare Trading Account for the year ended 31st March, 2014:

Cash Purchases Rs.1,50,000; Credit Purchases Rs.9,00,000; Returns Inward Rs.20,000; Cash Sales Rs.1,60,000; Credit Sales Rs.11,00,000; Returns Outward Rs.10,000; Freight Inwards Rs.3,000; Carriage Inwards Rs.3,000; Wages and Salaries Rs.4,000; Opening Stock Rs.1,50,000; Closing Stock Rs. 88,000 but its market value is Rs.84,000.

Solution: TRADING ACCOUNT

Dr. for the year ended 31 st March, 2014 Cr.

Particular	**Rs.**	**Particular**	**Rs.**
To Opening Stock	1,50,000	By sales:	
To Purchases		Cash sales 1,60,000	
Cash Purchases 1,50,000		Credit sales 11,00,000	
Credit Purchases 9,00,000		12,60,000	
10,50,000		Less: returns inwards 20,000	12,40,000
Less: Return Outward 10,000	10,40,000		
To freight inwards	3,000	By closing stock	84,000
To carriage inwards	3,000		
To wages & salaries	4,000		
To gross profit tnfrd to P&L A/c	1,24,000		
	13,24,000		13,24,000

4.4.2 PREPRATION OF PROFIT & LOSS ACCOUNT

PROFIT AND LOSS ACCOUNT

Profit and Loss Account is prepared after Trading Account. Profit and Loss Account is prepared to determine net profit earned or net loss incurred by the business during an accounting period.

"A Profit and Loss Account is an account into which all gains and losses are collected in order to ascertain the excess of gains over the losses or vice versa."

-Prof. Carter

As discussed earlier, balance of the Trading Account (Gross Profit or Gross Loss as the case may be) is transferred to Profit and Loss Account. Thus, Profit and Loss Account starts with Gross Profit on the credit side. In case of Gross Loss, it starts with Gross Loss on the debit side. Due to this reason, Trading Account is said to be a part of Profit and Loss Account. Thereafter, indirect expenses and losses are transferred to the debit side of the Profit and Loss Account.

Indirect incomes are transferred to the credit of Profit and Loss Account. It means those expenses or incomes which have not been debited or credited to Trading Account are debited or credited in the Profit and Loss Account.

The difference of the two sides of this account is either net profit or net loss. If total of the credit side exceeds total of the debit side, the difference is net profit. In the reverse situation, difference means net loss. The difference (i.e., net profit or net loss) is transferred to the capital account of the proprietor. Net profit increases the capital and net loss decreases it.

Indirect Expenses are those expenses which are not directly associated with manufacture of goods. They include administrative, selling and distribution expenses such as salaries, rent and taxes, postage and stationery, insurance, depreciation, interest paid, office lighting, advertising, packing, carriage outwards, etc. Losses include items like loss by fire, loss by theft, etc.

Indirect Incomes are those incomes which are not directly associated with sale of goods, such as interest, dividends, profit on sale of fixed assets or investments.

Features of Profit and Loss Account

1. It is the second stage in the preparation of the final accounts.
2. It relates to a particular accounting period and is prepared at the end of that period.
3. Accrual basis of accounting is followed in the preparation of this account.
4. It is credited with the gross profit and income from other sources and debited with indirect expenses and losses.
5. Balance of this account is the net profit or net loss.
6. Capital of the owner increases or decreases by the balance of this account (Net Profit or Net Loss).

Format of Profit and Loss Account

PROFIT AND LOSST

Dr.	*for the year ended...*		*Cr.*
Particulars	**Rs.**	**Particulars**	**Rs.**
To Gross Loss transferred from Trading A/c*		By Gross Profit transferred from Trading A/c*	
To Salaries		By Rent	
To Rent, Rates and Taxes		By Discount Received	
To Stationery and Printing		By Commission Earned	
To Postage and Telegrams		By Interest	
To Audit Fees		By Bad Debts Recovered	
To Legal Charges		By Income from Investment	
To Telephone Expenses		By Dividends on Shares	
To Insurance Premium		By Miscellaneous Income	
To Business Promotion Expenses		By Income from any other source	
To Repairs and Renewal		By Net Loss transferred to Capital A/c**	
To Depreciation			
To Interest			
To Sundry Expenses			
To Conveyance			
To Bank Charges			
To Establishment Expenses			
To General Expenses			
To Car Running and Maintenance			
To Electricity Expenses			
To Loss by Fire, Theft			
To Commission			
To Advertisement			
To Freight and Carriage Outwards			
To Discount Allowed			
To Travelling Expenses ,			
To Bad Debts			
To Net Profit transferred to Capital A/c**			

* Either of the two will appear. ** Either of the two will appear.

Need :

The need for preparing Profit and Loss Account can briefly be summed up as under:

(i) *To Ascertain Net Profit or Net Loss:* Profit and Loss Account provides information about the net profit earned or net loss incurred by the business during the accounting period.

(ii) Comparison with the Previous Year's Profit: Profit amount ascertained by the Profit and Loss Account for the accounting period can be compared with that of the previous year's profit. It helps in ascertaining whether the business is being conducted efficiently or not.

(iii) Control Over Expenses: Analysis of various expenses included in the Profit and Loss Account and their comparison with the expenses of the previous period helps in taking steps for effective control over the expenses.

Items of Profit and Loss Account

It is desirable that Profit and Loss Account is prepared in such a manner as the user is able to form a correct view about the profit earned or loss incurred by the firm during the period, together with other significant factors.

Expenses and losses shown on the debit side of the Profit and Loss Account can be classified as follows:

(i) Administration and Office Management Expenses: Administration and Office Management Expenses include the following:

(i) Establishment Expenses or Charges; (ii) Office Salaries; (iii) Office Rent and Rates; (iv) Lighting; (v) Printing and Stationery; (vi) Postage and Telephone Charges; (vii) Legal Expenses; (viii) Audit Fee; and (ix) General or Trade Expenses.

(ii) Selling and Distribution Expenses: These will comprise the following:

(i) Salesmen's Salaries and Commission; (ii) Commission; (iii) Advertising; (iv) Godown Expenses; (v) Packing Expenses; (vi) Freight and Carriage on Sales; (vii) Vehicles Delivery Expenses; (ix) Insurance of Finished Goods, Stock and Goods in Transit; and (x) Bad Debts.

(iii) Finance Expenses: These are those expenses which are incurred in respect of arranging finance for business. Finance Expenses include:

(i) Interest on Loan; (ii) Interest on Capital; and (iii) Discount Allowed.

(iv) Abnormal Losses: Abnormal Losses such as loss of stock by fire not covered by insurance, loss on sale of fixed assets, loss by theft, cash defalcation, etc., may occur during the accounting period. Abnormal Losses are extraordinary expenses and debited and shown separately in the Profit and Loss Account. Following expenses are not shown in Profit and Loss Account:

1. Domestic expenses of the proprietor or partners, as they are personal expenses.

2. Drawings in the form of cash, goods by the proprietor or partners.

3. Personal income tax and life insurance premium paid by the firm on behalf of the proprietor or partners. *If income tax appears in the Trial Balance of a sole proprietorship concern, it is treated as drawings and deducted from capital.*

Incomes and items of profit which are shown on the credit side of Profit and Loss Account can be divided into the following groups:

(i) Income from Main Business: It refers to those profits and incomes which are received from the operations of the main business. It includes following types of profits and incomes:

(i) Gross Profit, (ii) Profit on Joint Venture, and (iii) Commission Receivable, etc.

(ii) Other Income: Income received from other sources except the main function of the business comes under this category. It includes:

(i) Interest, (ii) Income from Investments, (iii) Rent Received, (iv) Interest on Drawings, (v) Discount Received, and (vi) Profit on sale of fixed assets, etc.

Balances of the Profit and Loss Account

Net Profit or Net Loss: Balance in the Profit and Loss Account means net profit or net loss. If total of credit side is more than the total of debit side, it is net profit. If total of debit side is more than the total of credit side, it is net loss. Net Profit or Net Loss as is the case, is transferred to Capital Account.

Difference between Trading Account and Profit and Loss Account

Basis	***Trading Account***	***Profit and Loss Account***
1. Relation	Trading Account is a part of Profit and Loss Account.	Profit and Loss Account is the main account.
2. Nature	Gross Profit or Gross Loss is ascertained from Trading Account.	Profit and Loss Account is prepared to ascertain net profit or net loss of the business.
3. Transfer of Balance	Balance of the Trading Account is transferred to Profit and Loss Account.	Balance of the Profit and Loss Account is transferred to Capital Account of the proprietor.
4. Items	Items shown in the Trading Account are purchases, sales, stock, direct expenses, etc.	Items like indirect expenses related to sales, distribution, administration, finance, etc., are shown in the Profit and Loss Account.

Explanation Regarding Certain Items of Profit and Loss Account

1. ***Salary:*** Salary is an indirect expense. Combined Salaries and Wages Account is also treated as an indirect expense and, therefore, it is transferred to the Profit and Loss Account. As discussed earlier, combined Wages and Salaries Account is treated as a direct expense and transferred to the Trading Account.

2. ***Depreciation:*** Depreciation is the cost of the assets written off over their useful life. It is a fall in the value of an asset due to wear and tear, use or lapse of time. It is treated as business expense and is transferred to the Profit and Loss Account.

3. ***Discount:*** Discount Allowed Account and Discount Received Account are shown separately on the debit side and credit side of the Profit and Loss Account respectively.

4. ***Loss by Fire:*** Loss of goods by fire is a loss to the business. It is debited to the Profit and Loss Account.

5. ***Insurance:*** Generally, assets are insured to cover the risk of loss. Insurance premium is treated as a business expense and debited to the Profit and Loss Account.

6. ***Bad Debts and Bad Debts Recovered:*** When a customer does not pay the amount due from him it becomes irrecoverable, it is said to be a **bad debt.** It is a loss to the firm. Therefore, Bad Debts Account is debited to Profit and Loss Account.

If later the amount is recovered, it is accounted as a gain; it is not credited to the party paying it; it is credited to Bad Debts Recovered Account. It is written on the credit side of the Profit and Loss Account.

Closing Entries in respect of the Profit and Loss Account: Entries that are to be passed in the Journal for preparing the Trading and Profit and Loss Account, i.e., for, transferring various accounts to these two accounts, are known as Closing Entries. To complete the Profit and Loss Account, the under-mentioned three Closing Entries are necessary:

1. For items to be debited to the Profit and Loss Account, this account is debited and the various concerned accounts are credited. For example, Salaries Account, Rent Account, Interest Account are closed by transferring their balances to the debit side of Profit and Loss Account. The entry is:

Profit and Loss A/c ...Dr.

To Salaries A/c

To Rent A/c

To Interest A/c

To Advertising A/c

To Bank Interest A/c

To Bank Charges A/c

To Miscellaneous Expenses A/c

(Being the expenses transferred to Profit and Loss A/c and accounts closed)

2. Items of income or gain such as Interest Received Account, Miscellaneous Income Account are closed by transferring their balances to the credit side of the Profit and Loss Account. The entry passed is:

Interest Received A/c ...Dr.

Discount Received A/c ...Dr.

Miscellaneous Income A/c ...Dr.

To Profit and Loss A/c

(Being the income accounts transferred to Profit and Loss A/c and accounts closed)

These two entries close all the nominal accounts.

3. At this stage the Profit and Loss Account shows either net profit or net loss. Both are transferred to Capital Account. In case of net profit, i.e., when the credit side is bigger than the debit side, the entry is:

Profit and Loss A/c ...Dr.

To Capital A/c

(Being the net profit transferred to Capital A/c)

In the other case of net loss, the entry will be reverse, i.e.,

Capital A/c ...Dr.

To Profit and Loss A/c

(Being the net loss transferred to Capital A/c)

Now, let us see in the following illustration how the closing entries are passed for the various items given in the Trial Balance.

Illustration 6. Following is the Trial Balance of C. Wanchoo on 31st March, 2014. Pass closing entries and prepare Trading and Profit and Loss Account for the year ended 31st March, 2014.

TRIAL BALANCE

as on 31st March, 2014

Particulars	Dr. (Rs.)	Cr. (Rs.)
Capital a/c		10,000
Opening stock	2,000	
Cash in bank	1,000	
Cash at hand	440	
Machinery a/c	6,000	
Furniture & fitting a/c	1,360	
Purchases a/c	15,000	
Wages a/c	10,000	
Fuel & power a/c	3,000	
Factory lighting a/c	200	
Salaries a/c	7,000	
Discount allowed a/c	500	
Discount received a/c		300
Advertising a/c	5,000	
Sundry office expenses a/c	4,000	
Sales a/c		50,000
Sundry debtors a/c	8,500	
Sundry creditors		3,700
Total	64,000	64000

Value of Closing Stock as on 31st March, 2014 was Rs.2,700

Solution: Closing entries

Date	Particulars	L.F.	Dr.(Rs.)	Cr. (Rs.)
2014 March 31	Trading A/c ...Dr. To Stock A/c To Purchases A/c To Wages A/c To Fuel and Power A/c To Factory Lighting A/c (Being the accounts in the Trial Balance which have to be transferred to Trading Account, debit side are transferred)		30,200	 2,000 15,000 10,000 3,000 200
March 31	Sales A/c ...Dr. To Trading A/c (Being the amount of Sales transferred to the credit of the Trading Account)		50,000	 50,000
March 31	Stock (Closing) A/c ...Dr. To Trading A/c (Being the value of stock on hand on 31 st March, 2014)		2,700	 2,700
March 31	Trading A/c ...Dr. To Profit and Loss A/c (Being the transfer of gross profit)		22,500	 22,500
March 31	Profit and Loss A/c ...Dr. To Discount Allowed A/c To Salaries A/c To Advertising A/c To Sundry Office Expenses A/c (Being the various expenses accounts transferred to the debit of the Profit and Loss Account)		16,500	 500 7,000 5,000 4,000
March 31	Discount Received A/c ...Dr. To Profit and Loss A/c (Being the credit balance of discount received transferred to the Profit and Loss Account)		300	 300
March 31	Profit and Loss A/c ...Dr. To Capital A/c (Being the transfer of Net Profit to the Capital Account)		6,300	 6,300

C.Wanchoo

Dr. TRADING ACCOUNT for the year ended 31st March,2014 Cr.

Particular	**Rs.**	**Particular**	**Rs.**
To Stock	2,000	By Sales	50,000
To Purchases	15,000	By Closing Stock	2,700
To Wages	10,000		
To Fuel and Power	3,000		
To Factory Lighting	200		
To Gross Profit transferred to Profit and Loss A/c	22,500		
	52,700		52,700

PROFIT AND LOSS ACCOUNT

for the year ended 31st March, 2014

Particular	Rs.	Particulars	Rs.
To Salaries	7,000	By Gross Profit	22,500
To Discount Allowed	500	By Discount Received	300
To Advertising	5,000		
To Sundry Office Expenses	4,000		
To net Profit transferred to capital A/c	6,300		
	22,800		22,800

Illustration 7. From the following information, prepare Profit and Loss Account of a sole proprietor for the year ended 31st March, 2014:

Gross profit	2,00,000
Salaries & wages	10,000
Commission allowed	5,000
Commission received	2,500
Interest paid	3,500
Interest received	2,000
Carriage outwards	1,250
Freight outwards	750
Discount allowed	250
Discount received	1,250
Dividend received	1,900
Rent paid	3,000
Rent received	8,000
Bad debts recovered	6,000
Brokerage paid	1,500
General expenses paid	9,000
Miscellaneous income	7,000
Depreciation on machines	6,000
Postage & telegrams	4,000

Solution: **PROFIT AND LOSS ACCOUNT**

for the year ended 31st March, 2014

Dr. Cr.

Particulars	Rs.	Particulars	Rs.
To Salaries and Wages	10,000	By Gross Profit	2,00,000
To Commission Allowed	5,000	By Commission Received.	2,500
To interest Paid	3,500	By Interest Received	2,000
To Carnage Outwards	1,250	By Discount Received	1,250
To Freight Outwards	750	By Dividend Received	1,900
To Discount Allowed	250	By Rent Received	8,000
To Rent Paid	3,000	By Bad Debts Recovered	6,000
To Brokerage Paid	1,500	By Miscellaneous Income	7,000
To General Expenses	9,000		
To Depreciation on Machines	6,000		
To Postage and Telegrams	4,000		
To Net Profit transferred to Capital A/c	1,84,400		
	2,28,650		2,28,650

4.5 SUMMARY

Financial statements are organized summaries of detailed information about the financial position and performance of enterprises. The term financial statements are used to denote two basic statements i.e., trading account and profit & loss account. The information conveyed through financial statements are used by management present & prospective investors lenders short term creditors employees tax authorizes etc.

4.6 SELF ASSESSMENT QUESTIONS

1. What are the capital receipts?
2. What are revenue receipts?
3. What are deferred revenue expenditure?
4. What is the importance of financial statements?

4.7 IN-TEXT ACTIVITY

1. Who are the users of the financial statements.

2. What is the difference between capital expenditure and revenue expenditure?

3. What are the contents shown in the trading account?

4. What is the difference between gross profit and net profit?

4.8 FURTHER READING

1. Double Entry Book Keeping (Financial Accounting): T.S.Grewal
2. Financial Accounting for Busniess : A. K. Bhattacharya
3. Elements of Book Keeping : C.M.Juneja J.S.Arora & R.C.Chawla

OBJECTIVES

After going through this lesson, you will be able to understand:

- meaning of balance sheet
- classification of assets and liabilities
- horizontal and vertical presentation of financial statement
- need for adjustments in the final account of a business
- main adjustments like closing stock, outstanding expenses, prepaid expenses, accrued income, income received in advance, etc.

STRUCTURE

5.1 Introduction to Balance Sheet

5.2 Classification of Assets

5.3 Classification of Liabilities

5.4 Arrangement or Marshalling of Assets and Liabilities

5.5 Distinction between Balance Sheet and Trial Balance

5.6 Methods of Presentation of Financial Statement

5.7 Need for Adjustments in Preparing the Final Accounts

  5.7.1 Elementary Level of Adjustments

5.8 Summary

5.9 Self Assessment Questions

5.10 In-Text Activity

5.11 Further Reading

5.1 INTRODUCTION TO BALANCE SHEET

Balance sheet may be defined as "A statement which sets out the assets and liabilities of a firm or an institution as at a particular date." Having prepared the trading account and profit & loss account balance sheet is prepared. It is a statement prepared to show the financial position of the business on a particular date. The financial position of the business is shown by its assets and liabilities on a given date. Balance sheet is prepared from assets, liabilities and capital accounts. Balance sheet shows the assets owned by the enterprises and the claims of the creditors and owners against these assets.

The purpose of preparing the Balance Sheet is to ascertain the financial position of a business, i.e., to know what the business owes and what it owns at a certain date. This is why the Balance Sheet has the heading: Balance Sheet as at ... as against the heading of Trading Account and Profit and Loss Account which usually is for a year. Balance Sheet is true only at a particular point of time, since even a single transaction will make a difference to some of the assets or liabilities.

Need: Balance Sheet is prepared with a view to measure true financial position of a business at a particular point of time. *It is a method to show the financial position of a business in a systematic and standard form.* Through it the position of the business, at a particular point of time, can be understood at a glance. Just as a doctor will feel the pulse of a person and know whether he is enjoying good health or not, in the same manner by looking at the Balance Sheet one can know *whether the firm is solvent or not*. If the assets exceed liabilities, it is solvent; in the other case, it would be insolvent. *Debit and credit balances of those Ledger accounts not closed by transfer to Trading and Profit and Loss Account are shown in the Balance Sheet*. The debit balances are shown on the 'Assets' side and credit balances are shown on the 'Liabilities' side.

Total of assets should always be equal to the total of liabilities. You have already learnt this equality as 'accounting equation'. The assets and liabilities and capital are usually presented in a statement called the Balance Sheet.

It is a practice that assets are shown on right-hand side and liabilities and capital on left-hand side.

Form of Balance Sheet: The items normally found in the Balance Sheet are as follows:

BALANCE SHEET OF... as at...

Liabilities		Rs.	Assets	Rs.
Sundry or Trade Creditors			Cash in Hand	
Bills Payable			Cash at Bank	...
Bank Overdraft			Bills Receivable	
Employees Provident Fund			Sundry Debtors/Book Debts	
Loans (Cr.)			Loans (Dr.)	
Mortgage			Closing Stock	
Reserves or Reserve Fund			Loose Tools	
Capital	....		Investments	
Add: Interest on Capital ...	....		Furniture and Fittings	
Net Profit	....		Plant and Machinery	
			Land and Building	
Less: Drawings			Freehold/Leasehold Land	
Income Tax			Business Premises	
Interest on Drawings			Patents and Trademarks, etc.	
Net Loss	....		Goodwill	

Characteristics of Balance Sheet

The characteristics of Balance Sheet are:

(i) *It is prepared at a particular date and not for a particular period.*

(ii) *It is prepared after the preparation of Profit and Loss Account.* This is the reason why the Profit and Loss Account (including the Trading Account) and the Balance Sheet are together called the Final Accounts.

(iii) *It shows financial position of a business as a going concern.*

(iv) *Balance Sheet is not an account but only a statement of assets and liabilities*. On the left-hand side, the liabilities of business are shown whereas on the right-hand side assets of the business appear.

(v) Total of assets side must be equal to the total of liabilities side, i.e., two sides of the Balance Sheet must have same total. If total is not same, there is certainly an error.

5.2 CLASSIFICATION OF ASSETS

Assets in the Balance Sheet are divided into two parts as follows:

1. Fixed Assets: Fixed Assets are those assets that are acquired for continued use and not for resale. They may be tangible assets like land, building, plant and machinery, furniture and fixtures, etc., or intangible assets like goodwill, patents, etc.

(i) Tangible Fixed Assets are those fixed assets which can be seen and touched, e.g., Land and Building, Plant and Machinery, Furniture and Fixtures, etc.

(ii) Intangible Fixed Assets are those fixed assets which are not in a physical form, i.e., they can neither be seen nor touched, e.g., goodwill of a firm or the know-how which it possesses, patents, trade-marks, etc.

Note: Fixed assets are valued at cost less depreciation.

Distinction between Tangible Assets and Intangible Assets

Basis	***Tangible Assets***	***Intangible Assets***
1 **Physical Existence**	Tangible Assets are assets having a physical existence. *E.g.* Land & Building, Plant & Machinery, etc.	Intangible Assets are fixed assets having no physical existence. E.g. Goodwill, Patents, Trade-marks, etc.
2. **Fixed *vs.* Current**	TangibleAssets can be fixed or current, e.g., stock.	Intangible Assets usually fall in the category of fixed assets.
3. **Depreciation or v Amortisation**	Fixed Tangible Assets are depreciated.	Intangible Assets are amortised.
4. **Risk of Loss**	These assets may be lost due to fire.	These assets cannot be lost due to fire.
5 **Acceptance as Security**	Lenders accept such assets as security for providing loan.	Lenders usually do not accept these assets as security for providing loan.

Investments: Investments are capital expenditure incurred on purchase of shares, debentures, bonds, etc., to earn interest, dividend and other benefits, investment is shown separately in the Balance Sheet.

There is another category of assets called Fictitious Assets. In the real sense, they are losses yet to be written off. Examples of fictitious assets are Advertisement Suspense Account, Discount on Issue of Debentures, Profit and Loss Account (Debit Balance), etc.

2. Current Assets: These are those assets of the business which are held for resale or for converting into cash. These are the assets which are likely to be realised within a period of one year or during the period of normal operating cycle. A business earns profit by sale of these assets but not by keeping them in hand. Examples are unsold goods, debtors, bills receivable, bank balance, cash in hand, etc. These assets are temporary in nature and may change from time to time. These are sometimes referred to as floating or circulating assets.

Distinction between Fixed Assets and Current Assets

Basis	*Fixed Assets*	*Current Assets*
1. **Nature**	These are long-term resources of a business.	These are short-term resources of a business.
2. **Purpose of Holding**	These assets are used to operate the business and to earn profits.	These assets are realised in cash or consumed during the normal operating cycle of business.
3. **Valuation**	These assets are valued at cost *less* depreciation.	These assets are valued at cost or net realisable value (market price) whichever is less.
4. **Sources of Finance**	These assets are acquired out of long-term funds of the business	These assets are acquired out of short-term funds of the business.
.5. **Subject to Change**	These assets are not usually subject to change.	These assets are usually subject to change.
6. **Profit on Sale**	Profit on sale of these assets is capital profit.	Profit on sale of these assets is revenue profit.

5.3 CLASSIFICATION OF LIABILITIES

Liabilities are shown in the Balance Sheet on the left-hand side. They may be divided as follows:

(i) Non-Current Liabilities: These liabilities are those liabilities which are not payable by the business in the next year. They mainly include long-term loans, borrowings or debentures, etc. Funds from this source are used for acquiring fixed assets.

(ii) Current Liabilities: These liabilities are payable by the business within a year. Examples are trade creditors, bills payable, expenses outstanding, bank overdraft, etc.

(iii) Owner's Funds: The amount owing to the proprietors as capital is a class by itself. It includes undistributed profits and reserves besides capital. It is equal to the net assets of the business and is defined as the difference between assets and liabilities.

Contingent Liabilities: Contingent Liability is a liability that becomes payable on the happening of an event. In case, the event does not happen, no amount is payable. Such liabilities are not accounted and are not shown in the Balance Sheet; they are disclosed by way of a note. Examples of contingent liabilities are:

(i) Liabilities in Respect of Bills Discounted: If the firm got its bills receivable discounted with bank, the primary liability will be that of the acceptor. If the acceptor does not pay, then it becomes firm's liability.

(ii) Guarantee for Loan: If the firm has stood surety for a loan, it will be liable to pay the amount if the other person fails to meet his obligation.

(iii) Disputed Claims: If some other party has lodged a claim against the firm, the firm will be liable to pay if claim succeeds.

Following illustration show how financial statement (Trading, Profit & Loss Account and the balance sheet) are prepared from a given Trial Balance.

Illustration 1. From the following Trial Balance, prepare Trading and Profit & Loss Account for the year ended 31st March, 2014 and Balance Sheet as at that date:

Particulars	Rs	Particulars	Rs.
Debit Balances:		Rent, Rates and Taxes	800
Sundry Debtors	1,500	Salaries	2,000
Stock on 1st April, 2013	5,000	Drawings	2,000
Land and Building	10,000	Purchases	10,000
Cash in Hand	1,600	Office Expenses	2,500
Cash at Bank	4,000	Plant and Machinery	5,700
Wages	3,000	*Credit Balances:*	
Bills Receivable	2,000	Capital	25,000
Interest	200	Interest	600
Bad Debts	500	Sundry Creditors	7,000
Repairs	300	Sales	17,000
Furniture and Fixtures	1,500	Bills Payable	4,000
Depreciation	1,000		

On 31st March, 2014 the stock was valued at Rs.10,000.

Solution: TRADING AND PROFIT AND LOSS ACCOUNT

for the year ended 31st March, 2014

Dr. Cr.

Particulars	Rs.	Particulars	Rs.
To Opening Stock	5,000	By Sales	17,000
To Purchases	10,000	By Closing Stock	10,000
To Wages	3,000		
To Gross Profit transferred to Profit and Loss A/c	9,000		
	27,000		27,000
To Interest	200	By Gross Profit transferred from Trading A/c	9,000
To Bad Debts	500	By Interest	600
To Repairs	300		
To Depreciation	1,000		
To Rent, Rates and Taxes	800		
To Salaries	2,000		
To Office Expenses	2,500		
To Net Profit transferred to Capital A/c	2,300		
	9,600		9,600

BALANCE SHEET

as at 31st March, 2014

Liabilities		Rs.	Assets		Rs.
Current Liabilities			**Current Assets**		
Sundry Creditors	7,000		Cash in Hand	1,600	
Bills Payable	4,000	11,000	Cash at Bank	4,000	
			Bills Receivable	2,000	
Capital			Sundry Debtors	1,500	
Opening Balance	25,000		Closing Stock	10,000	19,100
Less: Drawings	2,000		**Fixed Assets**		
	23,000		Furniture and Fixtures	1,500	
Add: Net Profit	2,300	25,300	Plant and Machinery	5,700	
			Land and Building	10,000	17,200
		36,300			36,300

5.4 ARRANGEMENT OR MARSHALLING OF ASSETS AND LIABILITIES

Assets and liabilities should be shown in a certain order in the Balance Sheet. Therefore, they should be arranged in certain groups and in a particular order. This is called **Grouping** and **Marshalling** of the Balance Sheet.

'Grouping' *means putting items of a similar nature under a common accounting head. The arrangement of assets and liabilities in a particular order in the Balance Sheet is called* ***Marshalling****.*

Before we discuss the arrangement of assets and liabilities in the Balance Sheet, let us first understand what assets and liabilities mean. The term 'assets' means economic resources (property) of the business and includes all current and fixed assets. These are discussed subsequently. The term 'liabilities' means claims against the assets of the business and includes those of the outsiders (creditors) or those of the owners of the business. Assets and liabilities are shown in the Balance Sheet either in order of liquidity or in order of permanence.

(i) In Order of Liquidity: Liquidity means the facility with which the assets may be converted into cash; those assets which take more time to convert into cash are written last. Liabilities are to be shown first as short-term liabilities and then as long-term liabilities and last of all as capital. According to this arrangement, the format of a Balance Sheet is as follows:

Liabilities		Assets	
Bills Payable Sundry Creditors Bank Overdraft Loans Capital Opening Balance *Add:* Net Profit *Less:* Drawings		Cash in Hand Cash at Bank Bills Receivable Debtors Closing Stock Investment Furniture Plant and Machinery Land and Building Goodwill	

(ii) In Order of Permanence: Assets, which are to be used permanently in the business and are not meant to be sold are written first. Assets, which are most liquid such as cash in hand are written last. Liabilities may also be shown according to their performance arrangement. In this method, capital is shown first, then long-term liabilities and short-term liabilities, like amounts due to suppliers of goods or bills payable in the last. The form of a Balance Sheet under such an arrangement would be as follows:

BALANCE SHEET OF... as at

Liabilities		Assets	
Capital: Opening Balance *Add:* Net Profit ... *Less:* Drawings Loans Bank Overdraft Sundry Creditors Bills Payable		Goodwill Land and Building Plant and Machinery Furniture Investment Closing Stock Debtors Bills Receivable Cash at Bank Cash in Hand	

Illustration 2. Draw up the Balance Sheet of R Limited as at 31st March, 2010 from the following information in the order of permanence:

Cash in Hand Rs. 11,200; Sundry Creditors Rs. 28,800; Bills Payable Rs. 3,500; Bills Receivable Rs. 5,300; Sundry Debtors Rs. 18,000. Machinery as on 1st April, 2009 Rs. 85,000 and Depreciation provided for the year Rs. 8,500; Furniture and Fixtures as on 1st April, 2009 Rs. 21,000 and Depreciation provided for the year Rs. 2,100; Closing Stock Rs. 15,400. Proprietor's Capital Account Rs.90,000. His drawings during the year Rs. 8,000. Net Profit as per Profit and Loss Account is Rs. 31,000.

Solution: R Limited

BALANCE SHEET as on 31st March 2014

Liabilities		Rs.	Assets		Rs.
Capital	90,000		**Fixed Assets**		
Add: Net Profit	31,000		Machinery	85,000	
	1,21,000		*Less:* Depreciation	8,500	76,500
Less: Drawings	8,000		Furniture and Fixtures	21,000	
Current Liabilities		1,13,000	*Less:* Depreciation	2,100	18,900
Sundry Creditors			**Current Assets**		
Bills Payable		28,800	Stock		15,400
		3,500	Bills Receivable		5,300
			Sundry Debtors		18,000
			Cash in Hand		11,200
		1,45,300			1,45,300

5.5 DISTINCTION BETWEEN BALANCE SHEET AND TRIAL BALANCE

Basis	Balance Sheet	Trial Balance
1. **Purpose**	The purpose is to portray financial position.	The purpose is to establish arithmetical accuracy of the books of accounts.
2. **Information about Profits**	It provides information as to profitability and financial position of the firm.	No such information is possible from Trial Balance.
3. **Necessity**	It is essential to prepare Balance Sheet to complete the accounting process.	Though desirable, it may be possible to dispense with its preparation.
4. **Headings**	The two sides are headed as assets and liabilities.	The two columns are headed as debit and credit.
5. Coverage	Only personal and real accounts appear in the Balance Sheet.	In the Trial Balance all accounts must be written no account can be left out.
6. Closing Stock	This Account appears in the Balance Sheet.	Normally, a closing stock does not appear in the Trial Balance.
7. Period	Normally, it is prepared only at the end of the trading period.	A Trial Balance can be prepared at any time, even monthly or whenever required.
8. Adjustment	A Balance Sheet cannot be prepared without making adjustments for outstanding and prepaid items and without taking into account all events and transactions for the year.	A Trial Balance can be prepared at any stage, without even making adjustments.

5.6 METHODS OF PRESENTATION OF FINANCIAL STATEMENT

Trading and Profit & Loss Account and the Balance Sheet can be presented either in the Horizontal Form or in Vertical Form.

(i) *Horizontal Form:* Under this form of presentation the financial statements are presented in 'T' form, which we have already discussed in this chapter. The final accounts in the above illustrations have been prepared in horizontal form.

(ii) *Vertical Form:* Under this form of presentation, the financial statements are presented in a single column statement in a purposeful sequence.

1. Trading Account

The horizontal format of Trading Account and the usually appearing entries therein are shown below (using imaginary figures).

TRADING ACCOUNT OF Z

for the year ended 31st March, 2014

Particulars,		**Rs.**	**Particulars**		**Rs.**
To Opening Stock		80,000	By Sales	6,06,000	
To Purchases	3,50,000		*Less:* Returns Inward	6,000	6,00,000
Less: Returns Outward	10,000	3,40,000.	By Closing Stock		1,30,000
To Direct Expenses:					
Freight and Carriage	10,000				
Customs and Insurance	20,000				
Wages	60,000				
Gas, Water and Fuel	6,000				
Lighting and Heating	4,000				
Factory Expenses	10,000	1,10,000			
To Gross Profit c/*d*		2,00,000			
		7,30,000			7,30,000

The Vertical Format of a Trading Account is given below. This format is more commonly used for profit statements and reporting.

TRADING ACCOUNT OF Z

for the year ended 31st March, 2014

Particulars	Rs.	Rs.	Rs.
Sales			6,06,000
Less: Returns Inward			6,000
Opening Stock		80,000	6,00,000
Purchases	3,50,000		
Less: Returns Outward	10,000	3,40,000	
Direct Expenses:			
Freight and Carriage	10,000		
Customs and Insurance	20,000		
Wages	60,000		
Gas, Water and Fuel	6,000		
Lighting and Heating	4,000		
Factory Expenses	10,000	1,10,000	
		5,30,000	
Less: Closing Stock		1,30,000	
Cost of Goods Sold			4,00,000
Gross Profit			2,00,000

2. Profit and Loss Account

The Horizontal Format of a Profit and Loss Account is given on next page (using imaginary figures).

PROFIT AND LOSS ACCOUNT OF Z

Dr. *for the year ended 31 st March, 2014* *Cr.*

Particulars	Rs.	Particulars	Rs.
Management Expenses		**By Gross Profit** *b/d*	2,00,000
To Salaries (Administrative)	50,000	**Other Income**	
To Office Rent, Sales and Taxes	10,000	By Discount Received	24,000
To Printing and Stationery	1,000	By Commission Received	6,000
To Telephone Charges	3,000	**Non-Trading Income**	
To Insurance	3,000	By Bank Interest	26,000
To Audit Fee	2,000	By Rent of Property Let-out	32,000
To Legal Charges	1,000	**Abnormal Gains**	
To Electricity Charges	3,000	By Profit on Sale of Machinery	46,000
Maintenance Expenses		By Profit on Sale of Investment	46,000
To Repairs and Renewals	2,000		
To Depreciation on Machinery	2,000		
Selling and Distribution Expenses			
To Salaries (Selling Staff)	30,000		
To Advertisement	2,000		
To Godown Rent	2,400		
To Carriage Outwards	1,600		
To Bad Debts	1,000		
To Provision for Doubtful Debts	400		
To Selling Commission	3,600		
Financial Expenses			
To Bank Charges	200		
To Interest on Loans	400		
To Discount on Bills	600		
To Discount Allowed to Customers	800		
Abnormal Losses			
To Loss on Sale of Fixed Assets	Nil		
To Loss on Sale of Investment	Nil		
To Loss by Fire or Accident	Nil		
To Net Profit transferred to Capital A/c	2,60,000		
	3,80,000		3,80,000

Notes: 1. Gross Loss will appear on the debit side of the Profit and Loss Account.

2. Net loss will appear on the credit side of profit and loss account.

The Vertical Format of Profit & Loss Account is given below. This, too, is more commonly used for profit statement and reporting.

Profit and loss Account of Z
for the year ended 31st March, 2014

Particulars			
Gross Profit			2,00,000
Add: **OtherIncomes**			
Discount Received	24,000		
Commission Received	6,000	30,000	
Add: **Non-Trading Incomes**			
Bank Interest	26,000		
Rent of Property Let-out	32,000	58,000	
Add: **Abnormal Gains**			
Profit on Sale of Machinery	46,000		
Profit on Sale of Investments	46,000	92,000	1,80,000
Less **Management Expenses**			3,80,000
Salaries (Administrative)	50,000		
Office Rent, Sales and Taxes	10,000		
Printing and Stationery	1,000		
Telephone Charges	3,000		
Insurance	3,000		
Audit Fees	2,000		
Legal Charges	1,000		
Electricity Charges	3,000	73,000	
Less:**Maintenance Expenses**			
Repairs and Renewals	2,000		
Depreciation on Machinery	2,000	4,000	
Less:**Selling and Distribution Expenses**			
Salaries (Selling Staff)	30,000		
Advertisement	2,000		
Godown Rent	2,400		
Carriage Outwards	1,600		
Bad Debts	1,000		
Provision for Doubtful Debts	400		
Selling Commission	3,600	41,000	
Less:**Financial Expenses**			
Bank Charges	200		
Interest on Loans	400		
Discount on Bills	600		
Discount Allowed to Customers	800	2,000	
Less:**Abnormal Losses**			
Loss on Sale of Fixed Asset			
Loss on Sale of Investment			
Loss by Fire or Accident			1,20,000
Net Profit transferred to Capital A/c			2,60,000

3. Balance Sheet (Vertical Format)

The Balance Sheet presentation used so far in this Chapter is known as the Horizontal Format. Limitations with the said presentation include the fact that it does not show the value of the organisation. Net worth of an organisation to the owner is the value of the owner's capital. Vertical Format clearly shows the net worth of the business to the owner, i.e., the capital. This format also provides information about the amount of investments in the fixed assets and in the working capital, which is the difference between the current assets and current liabilities.

Vertical Format of a Balance Sheet is shown below (using imaginary figures):

BALANCE SHEET OF Z as at 31st March 2014

Particulars	*Rs.*	*Rs.*	*Rs.*
Fixed Assets			
Land		4,00,000	
Building		8,00,000	
Plant and Machinery		6,00,000	
Furniture		2,00,000	
Delivery Van		4,00,000	24,00,000
Current Assets			
Stock	3,00,000		
Debtors	5,00,000		
Bills Receivable	1,00,000		
Cash at Bank	70,000		
Cash in Hand	30,000	10,00,000	
Current Liabilities			
Creditors	2,00,000		
Bills Payable	1,80,000		
Outstanding Expenses	20,000	4,00,000	
Working Capital (Current Assets-Current Liabilities)			6,00,000
Net Assets Employed			30,00,000
Financed by			
Capital		27,40,000	
Add:Net Profit		2,60,000	30,00,0000

5.7 NEED FOR ADJUSTMENTS IN PREPARING THE FINAL ACCOUNTS

We have discussed earlier that accounting records are prepared on the basis of Going Concern Assumption. But the Final Accounts are prepared every year on the basis of Accounting Period Assumption, Revenue Recognition Assumption, Accrual Assumption and Matching Principle, besides others. The purpose is to make assessment of the affairs of the firm at the end of each financial year. Therefore, all expenses and incomes for the year for which accounts are being prepared are accounted. Therefore, it is necessary that:

(i) Expenditure incurred whether paid or not, are accounted,

(ii) Income earned whether received or not, are accounted,

(iii) Expenditure relating to the succeeding years are excluded, and

(iv) Income relating to the succeeding years are excluded.

Let us understand with the help of examples.

Suppose, a firm closes its books on 31st March and rent for the month of March has not yet been paid. This amount has to be paid in any case because the expense has been incurred. Therefore, it would be proper to include rent for this month along with other expenses for the year.

Take another example. Insurance premium has been paid for twelve months beginning 1st October. It is apparent that insurance protection will be available for six months this year and six months in the next year. Half the premium, therefore, should be accounted as expenses in the next year.

In a firm there are a number of transactions related to expenses and incomes, which have to be adjusted. If such items are not adjusted or brought into current year's books of account, Final Accounts will not show true and fair view of the results. All such items which need to be brought into books of account at the time of preparing the Final Accounts are called Adjustments. Journal entries are passed to effect the required Adjustments are known as Adjusting Entries.

At the time of making adjustments or bringing any transaction into the books, principles of double entry are followed. It means that it must be ensured that the amount is debited to one account and credited to another. Thus, in the Final Accounts, transaction should appear at two places: One representing the debit and the other representing the credit as only then the Balance Sheet will agree. As a general rule, every adjustment appears in two accounts: First, in the Trading or Profit and Loss Account and second, in the Balance Sheet.

5.7.1 Elementary Level of Adjustments

1. Closing Stock

Normally, all goods purchased or produced during the accounting year are not sold by the end of the year. The goods remaining unsold at the year end is Closing Stock. Since Closing Stock is known only at the end of the year, it is not included in Trial Balance. It is given outside the Trial Balance in the form of additional information. Gross profit or gross loss is known if Closing Stock is brought into the Final Accounts. Closing Stock is valued at cost or net realisable value (market price) whichever is lower. For total value of Closing Stock say Rs. 50,000, following adjusting entry will be passed at the end of the year:

Closing Stock A/c …… Dr. 50,000

To Trading A/c 50,000

(Being the Closing Stock recorded in the books)

Dr. Stock Account Cr.

Particulars	Rs.	Particulars	Rs.
To Trading Ac	50,000	By Balance *c/d*	50,000

Thereafter, Closing Stock is shown in the Final Accounts as follows:

1. It is shown on the credit side of Trading Account as a separate item, and

2. Stock being debit balance is shown on the assets side of the Balance Sheet as a separate item under Current Assets.

More clearly, the Closing Stock will appear in the Final Accounts as shown below:

Dr. TRADING A/C Cr.

'Particulars	Rs.	Particulars	Rs.
		By Closing Stock	50,000

BALANCE SHEET

Liabilities	Rs.	Assets	Rs.
		Current Assets Closing Stock	5,000

Adjusted Purchases and Closing Stock: Adjusted Purchases means that opening stock and closing stock have been adjusted in the purchases and one amount appears in the Trial Balance as 'Adjusted Purchases'. As a result of the entry, closing stock is accounted in the books of account and will appear in the Trial Balance whereas opening stock will not.

Adjusted Purchases means Net Purchases + Opening Stock - Closing Stock.

Adjusted Purchases are shown on the debit side of the Trading Account but Closing Stock is not shown on the credit side of the Trading Account because it already stands adjusted in purchases, i.e., deducted from the total amount of the Opening Stock and purchases. Closing Stock is shown on the assets side of the Balance Sheet under Current Assets.

In the beginning of the next accounting year, Closing Stock will become Opening Stock and will be brought into account by passing the reverse entry as under:

Trading …… Dr.

To Opening A/c

(Being the Closing Stock recorded in the books)

Note: *Closing Stock will appear on the assets side of the Balance Sheet in both the cases: (a) When it is shown in Trial Balance, and (b) when it is shown outside the Trial Balance. But it is shown in the Trading Account (Cr. side) when its adjustment is shown outside the Trial Balance.*

2. Outstanding Expenses

Expenses which have been incurred during the year and whose benefit has been consumed during the year but are not paid are called **Outstanding Expenses**. At the end of the accounting year, such expenses must be brought into the books, otherwise profit will be overstated. Examples, being outstanding wages, salaries, etc.

The adjusting entry for this is:

Expenses A/c ...Dr.

To Outstanding Expenses A/c

(Being the unpaid expenses provided)

Example 1: Salaries paid during the year are Rs. 1,10,000 (given in the Trial Balance). Salaries outstanding for the month of March at the end 31st March, 2014 are Rs. 10,000 (given in the additional information outside the Trial Balance). In this case, following adjusting entry will be passed:

Salaries A/c	...Dr.	Rs. 10,000	
To Salaries Outstanding A/c			Rs. 10,000

(Being the unpaid salary for the month of March, 2014 provided)

Salaries account (Rs. 1,20,000) is closed by transferring it to the Profit and Loss Account and Salaries Outstanding (Rs. 10,000) is shown as liability in the Balance Sheet as follows:

SALARIES OUTSTANDING A/C

Dr. Cr.

Particulars	Rs.	Particular	Rs.
To balance c/d	10,000	By Salaries	10,000
	10,000		10,000

SALARIES A/C

Dr. Cr.

Particulars	Rs.	Particular	Rs.
To Bank a/c To Salaries Outstanding	1,10,000 10,000	By Profit & Loss a/c	1,20,000
	1,20,000		

BALANCE SHEET

Liabilities	Rs.	Assets	Rs.
Salaries Outstanding	10,000		

Dr. PROFIT & LOSS ACCOUNT Cr.

Particulars	Rs.	Particular	Rs.
To Salaries 1,10,000 Add: Outstanding salaries 10,000	1,20,000		

Next year, at the time of payment, the Salaries Outstanding Account is debited.

The principle illustrated above applies to all outstanding expenses.

In case, Outstanding Expenses appear in the Trial Balance, it means that the adjusting entry has already been passed. In such a case, Outstanding Expenses are shown only in the Balance Sheet as a current liability.

3. Prepaid (Unexpired) Expenses

In some cases, benefit of the expense incurred is available in the next accounting year also. Such part of the expense is called Prepaid Expense. Common examples of such expenses are unexpired insurance, interest paid in advance, etc. Unexpired part of the expense, i.e., prepaid expense is carried forward to the next year so that correct profit for the year is determined and also true and fair financial position of the business is shown.

The adjusting entry for prepaid expenses is:

Prepaid Expenses A/c ...Dr.

To Expenses A/c

(Being the expenses relating to next year transferred to Prepaid Expenses A/c)

Example 2: Insurance premium of Rs. 4,000 is paid on 1st July, 2013 and the accounts are to be closed on 31st March, 2014. The benefit of the insurance policy will accrue up to 30th June, 2014; in other words, insurance benefit for three months, i.e., 1st April to 30th June, 2014 will be derived in the next accounting year, l/4th of the premium should therefore, be charged to the Profit and Loss Account for the next year. For this purpose, the entry to be passed is:

Prepaid Insurance Premium A/c	...Dr.	Rs.1,000	
To Insurance Premium A/c			Rs.1,000

(Being the insurance premium paid in advance transferred to Prepaid Insurance A/c)

Prepaid or unexpired insurance premium is treated in the Final Accounts as follows:

1. Unexpired part of the insurance premium, i.e., Rs. 1,000 is deducted from the insurance premium in the Profit and Loss Account.
2. Prepaid insurance premium is shown on the assets side of Balance Sheet as a separate item under Current Assets.

INSURANCE PREMIUM ACCOUNT

Dr. Cr.

Particulars	Rs.	Particular	Rs.
To Bank A/c	4,000	By Prepaid Ins. Premium A/c	1,000
		By Profit & Loss A/c	3,000

PREPAID INSURANCE PREMIUM ACCOUNT

Dr. Cr.

Particulars	Rs.	Particular	Rs.
To Insurance Premium A/c	1,000	By Balance c/d	1,000

Dr. PROFIT & LOSS ACCOUNT Cr.

Liabilities	Rs.	Assets	Rs.
To Insurance Premium 4,000 Less: Prepaid 1,000	3,000		

BALANCE SHEET

Particulars	Rs.	Particular	Rs.
		Current Account Prepaid ins. premium	1,000

Next year, Prepaid Insurance Premium Account is transferred to the Insurance Account. This principle applies to all expenses incurred during the year but whose benefit (partially or wholly) will accrue in the next year.

This principle is applied to all Prepaid (Unexpired) Expenses.

In case, Prepaid Expenses appear in the Trial Balance, it means that the adjusting entry is passed. In such a case, prepaid expenses are shown only in the Balance Sheet as current assets.

4. Accrued Income

Accrued Income is that income which has been earned during the accounting period but has not been received. Such income is also called Outstanding Income or Income Earned but not yet received. Examples of such incomes are commission receivable, Interest on investments due but not yet received, etc. As per the accrual concept of accounting, total income of the period, both received and yet to be received, should be shown in the Final Accounts otherwise both profit and assets will be understated.

Adjusting entry passed is:

Accrued Income A/c ...Dr.

To Concerned Income A/c

(Being the income earned but not received accounted in the books)

Thereafter, Accrued Income is treated in the Final Accounts as follows:

1. Accrued Income is added to the amount of concerned income in the Profit and Loss Account and

2. Accrued Income is shown on the assets side of the Balance Sheet as a separate item under Current Assets.

Accrued Income if given in the Trial Balance, means adjusting entry is already passed before the preparation of Trial Balance. Income account as shown in Trial Balance includes the accrued amount of income. In such a case, the Accrued Income is shown only in the Balance Sheet as an asset.

Example 3: Interest on investment received during the accounting year Rs. 20,000. Interest accrued but not received during the accounting year Rs. 5,000.

Entries required in this respect are:

Accrued Interest A/c	...Dr.	Rs. 5,000	
To Interest Received A/c			Rs. 5,000

(Being the interest earned but not received accounted)

Interest Received Account 25,000) will be closed by transferring to the credit side of the Profit and Loss Account and Accrued Interest (Rs. 5,000) will be shown as an asset in the Balance Sheet. This is shown below:

INTEREST RECEIVED ACCOUNT

Dr. Cr.

Particulars	Rs.	Particular	Rs.
To Profit & Loss A/c	25,000	By Bank A/c By Accrued Interest	20,000 5,000
	25,000		25,000

ACCRUED INTEREST ACCOUNT

Dr. Cr.

Particulars	Rs.	Particular	Rs.
To Interest A/c	5,000	By Balance c/d	5,000

Dr. PROFIT & LOSS ACCOUNT Cr.

Liabilities	Rs.	Assets	Rs.
		By Interest 20,000 Add: Accrued Interest 5,000	25,000

BALANCE SHEET

Particulars	Rs.	Particular	Rs.
		Accrued Interest	5,000

Next year, on receipt of accrued interest, Accrued Interest Account is credited.

This principle applies to all incomes earned during the year, but not received.

5. Income Received in Advance or Unearned Income

Income received in advance or Unearned Income is that income which is received in advance but against it either sale is yet to be made or service is yet to be rendered. Such income is carried forward in the Balance Sheet. It is accounted as income in the year when sale is made or service is rendered.

Adjusting entry for the income received in advance is as follows:

Income A/c ...Dr.

    To Income Received in Advance A/c

(Being the unearned income transferred to Income Received in Advance)

Example 4: Rent received during the accounting period is Rs. 36,000 including Rs. 6,000 for the next accounting period.

In this case, the rent of Rs.6,000 relates to next year and thus, should be credited to the Profit and Loss Account of that year. This will ensure that the income for the current year is not overstated. This requires following adjusting entry:

Rent Received A/c	...Dr.	Rs. 6,000	
To Rent Received in Advance A/c			Rs. 6,000

(Being the rent received in advance transferred to Rent Received in Advance A/c)

Rent Received Account (Rs.30,000) is transferred to the credit side of the Profit and Loss Account and Rent Received in Advance is shown as liability in the Balance Sheet. This is shown below:

RENT RECEIVED IN ADVANCE ACCOUNT

Dr. Cr.

Particulars	Rs.	Particular	Rs.
To Balance c/d	6,000	By Rent Received A/c	6,000
	6,000		

RENT RECEIVED ACCOUNT

Dr. Cr.

Particulars	Rs.	Particular	Rs.
To Rent Received in Advance A/c	6,000	By Bank A/c	36,000
To Profit & Loss A/c	30,000		
	36,000		36,000

Dr. PROFIT & LOSS ACCOUNT Cr.

Liabilities	Rs.	Assets	Rs.
		By Rent Received 36,000 Less: Advance 6,000	30,000

BALANCE SHEET

Particulars	Rs.	Particular	Rs.
Rent Received in Advance A/c	6,000		

Rent Received in Advance Account will be transferred to Rent Account next year.

This principle applies to all incomes which pertain wholly or partially to the next year. Income received in advance if shown in the Trial Balance, means adjusting entry is passed. It means income shown in the Trial Balance is net income received in advance. In such a situation, income received in advance is shown in the Balance Sheet as a liability.

6. Depreciation

The value of fixed assets falls year after year because of usage, efflux of time, obsolescence or accident. Fall or decrease in the value of assets is an expense or loss incurred in earning revenue and like other expenses or losses, is debited to Profit and Loss Account. If it is not debited to Profit and Loss Account, profit will be overstated. The value of the fixed asset is also reduced by the amount of Depreciation. It is important to note that Depreciation is not recognised on a day-to-day basis but is debited at the end of an accounting period. Depreciation is computed on the basis of useful life of the asset. Suppose, a machine costs Rs. 10,000 and has a life of 5 years. Then each year l/5th of the cost, i.e., Rs. 2,000, should be accounted as an expense; remaining value of machine (Fixed Asset) is shown in the Balance Sheet. The entries for charging Depreciation and transferring it to Profit and Loss Account are as follows:

(a) When Provision for Depreciation Account is not maintained:

(i) Depreciation A/c ...Dr.

To Asset A/c

(Being the depreciation provided)

(ii) Profit and Loss A/c ...Dr.

To Depreciation A/c

(Being the depreciation transferred to Profit and Loss A/c)

(b) When Provision for Depreciation Account is maintained:

(i) Depreciation A/c ...Dr.

To Provision for Depreciation A/c

(Being the provision for depreciation made)

(ii) Profit and Loss A/c ...Dr.

To Depreciation A/c

(Being the depreciation transferred to Profit and Loss A/c)

Accounting Treatment of Depreciation-when given as an adjustment, i.e., Outside the Trial Balance. Depreciation given as an adjustment means that depreciation is yet to be accounted in the books of accounts.

First Step is to calculate depreciation on the basis of rate and method of depreciation specified in the question.

Next Step is to pass the entry for depreciation. Thereafter, transfer depreciation to Profit and Loss Account and also deduct it from the asset account in the Balance Sheet to which the Depreciation relates. This process is followed if Provision for Depreciation Account is not maintained.

If Provision for Depreciation Account is maintained, amount of Depreciation is added to Provision for Depreciation Account and total accumulated Depreciation, is shown by way of deduction from the original cost of the asset.

Example 5: Following is an extract from the Trial Balance:

TRIAL BALANCE

	Rs.	Rs.
Machinery A/c	2,00,000	

Additional Information:

Charge Depreciation at 10% p.a. on machinery. Show the relevant extract from the Profit and Loss Account and the Balance Sheet.

Solution: **PROFIT AND LOSS ACCOUNT**

Dr. for the year ended.. Cr.

Particulars	**Rs**	Particulars	**Rs.**
To Depreciation on Machinery	20,000		

BALANCE SHEET
as at...

Liabilities	**Rs.**	Assets		**Rs.**
		Machinery *Less:* Depreciation	2,00,000 20,000	1,80,000

Example 6: Following is the extract from a Trial Balance:

TRIAL BALANCE
as on...

	Rs.	Rs.
Machinery A/c	2,00,000	
Furniture,A/c	1,00,000	
Provision for Depreciation: on Machinery		60,000
on Furniture		27,100

Additional Information:

Depreciation is to be charged on machinery at 10% p.a. on original cost and on Furniture at 10% p.a. by the diminishing balance method. Show relevant extract from the Profit and Loss Account and the Balance Sheet.

Solution: PROFIT AND LOSS ACCOUNT

Dr.		*for the year ended...*	*Cr.*
Particulars	**Rs.**	**Particulars**	**Rs.**
To Depreciation on Machinery (10% on Rs.2,00,000) 20,000 On Furniture 10/100 (Rs.1,00,000-Rs.27,100) 7,290	27,290		

BALANCE SHEET
as at...

Liabilities	**Rs.**	Assets		**Rs.**
		Machinery A/c	2,00,000	1,20,000
		Less:. Provision for Depreciation	80,000	
		Furniture	1,00,000	
		Less: Provision for Depreciation	34,390	65,610

Accounting Treatment of Depreciation - when given in the Trial Balance

Depreciation given in the Trial Balance means entry for depreciation is passed in the books of accounts. It, therefore, means that the concerned asset appears at its reduced value since the Depreciation amount is credited to it. Since entry for depreciation is already passed, no further adjustment is necessary; *Depreciation Account is transferred to the debit side of the Profit and Loss Account like other expenses.*

Example 7: Following is the extracts from a Trial Balance:

TRIAL BALANCE
as on…

	Rs.	**Rs.**
Machinery A/c	2,00,000	…..
Provision for Depreciation on Machinery A/c	…..	80,000
Depreciation on Machinery	20,000	…..
Furniture A/c	36,000	…..
Depreciation on Furniture	4,000	…..

Solution: PROFIT AND LOSS ACCOUNT
for the year ended…………..

Particulars	Rs.	Particular	Rs.
To Depreciation: on Machinery 20,000 on Furniture 4,000	24,000		

BALANCE SHEET

as at...

Liabilities	Rs.	Assets		Rs.
		Machinery	2,00,000	
		Less: Provision for Depreciation	80,000	1,20,000
		Furniture		36,000

When Depreciation appears in Trial Balance and Provision for Depreciation Account is maintained: It means depreciation is already charged and current year's depreciation is included in Provision for Depreciation Account. As such, Depreciation Account appears in Profit and Loss Account. Provision for Depreciation as shown in Trial Balance is deducted from Asset Account on the assets side of the Balance Sheet.

Example 8: Following is an extract from a Trial Balance:

Particulars	Dr. (Rs.)	Cr.(Rs.)
Machinery A/c	4,00,000	
Provision for Depreciation on Machinery A/c		1,20,000
Depreciation on Machinery A/c	40,000	

Show relevant extracts from the Profit and Loss Account and the Balance Sheet.

Solution: PROFIT AND LOSS ACCOUNT

Dr. *for the year ended...* *Cr.*

Particulars	Rs.	Particulars	Rs.
To Depreciation on Machinery	40,000		

BALANCE SHEET as at

Liabilities	Rs.	Assets		Rs.
		Machinery	4,00,000	
		less: Provision for Depreciation	1,20,000	2,80,000

Period for which Depreciation is Computed

Depreciation is computed for the period the asset is used. For example, a machine is purchased on 1st April, 2013 for Rs. 10,000 and another machine is purchased on 1st October, 2013 for Rs. 6,000; the rate of Depreciation is 25% p.a. The Depreciation for the year ended 31st March, 2014 shall be Rs. 4,000 as shown below:

	Rs.
On Rs. 10,000 for one year at 25%	2,500
On Rs. 6,000 for six months at 25%	1,500
	4,000

In some cases, mainly cattle, Depreciation is arrived at by comparing the value on two dates. Suppose, cattle were valued at Rs. 3,100 on 1st April, 2013 and at Rs. 2,900 on 31st March, 2014, the Depreciation will be Rs. 200.

Notes:

1. Depreciation is calculated as is required by the question. If it is required to charge Depreciation @ 10%, then the Depreciation is calculated ignoring time factor. But if it is required to charge Depreciation @ 10% p.a., then the Depreciation is calculated taking the time factor into consideration.

Example: Plant cost is Rs. 2,00,000 and accounts are prepared for 6 months then the Depreciation will be: (i) Rs. 20,000 if the rate of Depreciation is 10% and (ii) Rs. 10,000 if the rate is 10% p.a.

2. It is better to ignore Depreciation on sale of asset if the date of transaction is not given.

Illustration 3. From the following Trial Balance of Sri R. Rajan, prepare Trading and Profit and Loss Account for the year ended 31st March, 2014 and the Balance Sheet as at that date after taking into account the adjustments given below:

TRIAL BALANCE as on 31st March, 2014

Heads of Accounts	Dr. (Rs.)	Cr. (Rs.)
R..Rajan's Capital		2,90,000
R. Rajan's Drawings	7,600	
Purchases and Sales	89,000	1,50,000
Sales and Purchases Return -	2,800	4,500
Stock (1st April, 2013)	12,000	
Wages	8,000	
Building	2,20,000	
Freight and Carriage	20,000	
Trade Expenses	2,000	
Advertisement	2,400	
Interest		3,500
Taxes and Insurance	1,300	
Debtors and creditors	65,000	12,000
Bills receivable and bills payable	15,000	7,000
Cash at Bank	12,000	
Cash in Hand	1,900	
Salaries	8,000	
Total	4,67,000	4,67,000

Adjustments:

(i) Stock on 31st March, 2014 was valued at Rs. 15,000. (ii) Insurance was prepaid to the extent of Rs. 400. (iii) Outstanding liabilities were: Salaries Rs. 2,000 and Taxes Rs. 1,300. (iv) Depreciate Building at 2% p.a.

Solution: TRADING AND PROFIT AND LOSS ACCOUNT

Dr. for the year ended 31st March, 2014 Cr.

Particulars			Particulars		
To Opening Stock		12,000	By Sales	1,50,000	--
To Purchases	89,000		*Less:* Returns	2,800	1,47,200
Less: Returns	4,500	84,500	By Closing Stock		15,000
To Wages		8,000			
To Freight and Carriage		20,000			
To Gross Profit *c/d*		37,700			
		1,62,200			1,62,200
To Trade Expenses		2,000	By Gross Profit b/*d*		37,700
To Advertisement		2,400	By Interest		3,500
To Taxes and Insurance	1,300				
Add: Unpaid Taxes	1,300				
	2,600				
Less: Prepaid Insurance	400	2,200			
To Salaries	8,000				
Add: Unpaid Salaries	2,000	10,000			
To Depreciation on Building		4,400			
To Net Profit transferred to Capital A/c		20,200			
		41,200			41,200

BALANCE SHEET.

as at 31st March, 2014

Liabilities			Assets		
Current Liabilities			**Current Assets**		
Creditors		12,000	Cash in Hand		1,900
Bills Payable		7,000	Cash at Bank		12,000
Outstanding Liabilities:			Bills Receivable		15,000
Taxes	1,300		Debtors		65,000
Salaries	2,000	3,300	Prepaid Insurance		400
Capital			Closing Stock		15,000
Opening Balance	2,90,000		**Fixed Assets**		
Add: Net Profit	20,200		Building	2,20,000	
	3,10,200		*Less:* Depreciation	4,400	2,15,600
Less: Drawings	7,600	3,02,600			
		3,24,900			3,24,900

7. Bad Debts

Debts that become irrecoverable are called bad debts. A debt may become bad partially or fully. The debt becoming bad is a loss for the business. It is transferred to the account titled 'Bad Debts Account' by passing the entry as follows:

Bad Debts A/c ...Dr.

To Debtor's (by name) A/c

(Being the amount due from a debtor becoming bad transferred to bad debts)

At the end of the year, amount of bad debts is transferred to the debit of Profit and Loss Account. It is so because it is a loss of the business. The entry passed is:

Profit and Loss A/c ...Dr.

To Bad Debts A/c

(Being the Bad Debts Account transferred to Profit and Loss A/c)

Bad Debts appearing in the Trial Balance means entry for bad debts is already passed and further adjustment is not required. It also means that the amount of sundry debtors appearing in the Trial Balance is after deducting Bad Debts.

In case, the amount of Bad Debts is given *outside the Trial Balance, i.e.*, by way of adjustment, such Bad Debts are known as **further Bad Debts**. It means the amount of sundry debtors in the Trial Balance is prior to the amount of Bad Debts given as adjustment. In such case, an entry for such Bad Debts is not passed in the books of accounts. Like all adjustments, these also need to be adjusted in the Final Accounts and the adjusting entry will be same as given above.

Accounting treatment of further Bad Debts in the Final Accounts is as follows:

1. It is shown as addition to the Bad Debts already written off on the debit side of Profit and Loss Account.

2. It is deducted from Sundry Debtors in the Balance Sheet.

The difference in accounting treatment of Bad Debts given in the Trial Balance and outside the Trial Balance in the Balance Sheet is summarised below:

Both types of Bad Debts are charged to the Profit and Loss Account but only those Bad Debts are deducted from the Sundry Debtors in the Balance Sheet which are given outside the Trial Balance. This is because every adjustment is posted to two accounts following the Double Entry System.

Example 8: Following is the extract from a Trial Balance:

TRIAL BALANCE

as on...

Particular	Rs.	Rs.
Sundry debtors Bad debts	1,00,000 2,000	

Additional Information: Write off Rs. 1,000 as Bad Debts.

Show relevant extracts from the Profit and Loss Account and Balance Sheet.

Solution: PROFIT & LOSS ACCOUNT

Dr. for the year ended………….. Cr.

Particulars		Rs.	Particulars	Rs.
To Bad Debts	2,000			
Add: Further Bad Debts	1,000	3,000		

BALANCE SHEET

as at...

Liabilities	Rs.	Assets		Rs.
		Sundry Debtors	1,00,000	
		Less: Further Bad Debts	1 ,000	99,000

Accounting Treatment of Bad Debts Recovered: If the amount of Bad Debts earlier written off is later recovered wholly or partially the amount recovered is not credited to the debtor's personal account but to Bad Debts Recovered Account. It is a gain for the business. The entries are:

(i) Bad Debts Recovered A/c ...Dr.

To Profit and Loss A/c

(Being the bad debts recovered transferred to Profit and Loss Account)

(ii) Cash or Bank A/c ...Dr.

To Bad Debts Recovered A/c

(Being the bad debts recovered)

Illustration 4 Following Trial Balance is extracted from the books of Nikesh as on 31st March, 2014:

Debit Balances	Rs.	Credit Balance	Rs.
Stock (1.4.2013)	50,000	Capital	3,20,000
Furniture	16,000	Creditors	80,000
Building	1,60,000	Purchases Return	2,000
Debtors	60,000	Commission	1,000
Drawings	20,000	Sales	4,55,600
Plant And Machinery	1,20,000	Bad Debts Recovered	1,400
Additions To Plant and Machinery(1.10.2013)	20,000		
Wages	24,000		
Salaries:	40,000		
Bad Debts	2,000		
Purchases	2,40,000		
Electricity Charges	2,400		
Telephone Charges	4,800		
General Expenses	6,000		
Postage And Telegrams	3,600		
Sales Return	1,800		
Insurance Premium	3,000		
Cash In Hand	6,400		
Cash At Bank	80,000		

Prepare Trading and Profit and Loss Account for the year ended 31st March, 2014 and Balance Sheet as at that date after taking into account the following adjustments:

1. Stock on 31st March, 2014 Rs. 14,000.
2. Outstanding liabilities for Wages Rs. 1,200 and Salaries Rs. 2,800.
3. Depreciation @ 5% p.a. is to be provided on all fixed assets.
4. Write off Bad Debts Rs. 1,500.
5. Insurance premium paid in advance Rs. 400.
6. Accrued commission Rs. 500.

Solution TRADING AND PROFIT & LOSS ACCOUNT

Dr. for the year ended 31st March, 2014 Cr.

Particulars		Rs.	Particulars		Rs.
To Opening Stock		50,000	By Sales	4,55,600	
To Purchases	2,40,000		Less: Returns	1,800	4,53,800
Less: Purchases Return	2,000	2,38,000	By Closing Stock		14,000
To Wages	24,000				
Add: Outstanding	1,200	25,200			
To Gross Profit c/d		1,54,600			
		4,67,800			4,67,800
To Salaries	40,000		By Gross Profit *b/d*		1,54,600
Add: Outstanding Salaries	2,800	42,800	By Commission	1,000	
To Bad Debts	2,000		*Add:* Accrued Commission	500	1,500
Add:.Further Bad Debts	1,500	3,500	By Bad Debts Recovered		1.400
To Electricity Charges		2,400			
To Telephone Charges		4,800			
To General Expenses		6,000			
To Postage and Telegrams		3,600			
To Insurance Premium	3,000				
Less: Prepaid	400	2,600			
To Depreciation:					
Plant and Machinery					
(Rs. 1,20,000x5/100)	6,000				
(*Rs*. 20,000x5/100x6/12)	500				
Furniture (Rs. 16,000x5/100)	800				
Building (Rs. 1,60,000x5/10	8,000	15,300			
To Net Profit transferred to Capital A/c		76,500			
		1,57,500			1,57,500

BALANCE SHEET

as at 31st March,2014

Liabilities		Rs.	Assets		Rs.
Current Liabilities			**Current Assets**		
Creditors		80,000	Cash in Hand		6,400
WagesOutstanding		1,200	Cash at Bank		80,000
Salaries Outstanding		2,800	Prepaid Insurance Accrued		400
Capital			Commission		500
Opening Balance	3,20,000		Debtors	60,000	
Add: Net Profit	76,500		*Less:* Bad Debts	1,500	58,500
	3,96,500		Closing Stock		14,000
Less: Drawings	20,000	3,76,500	**Fixed Assets**		
			Machinery (1,20,000 + 20,000)	1,40,000	
			Less: Depreciation(6,000 + 500)	6,500	1,33,500
			Furniture	16,000	
			Less: Depreciation	800	15,200
			Building	1,60,000	
			Less: Depreciation	8,000	1,52,000

8. Provision for Doubtful Debts

Convention of Conservatism or Prudence is followed for recording transactions. The convention requires that provisions for expected losses should be made while expected profits and gains should not be accounted. A firm, therefore, makes provision at the end of the accounting year for possible Bad Debts in the next year. This is for the reason that out of the credit sales made during a particular year, some debts may become irrecoverable in the next year due to non-payments, i.e., they become doubtful of recovery. It is proper to provide for such possible Bad Debts every year. The entry for providing for doubtful debts is:

Profit and Loss A/c ....Dr.
To Provision for Doubtful Debts A/c
(Being the provision made for Doubtful Debts)

Debit to the Profit and Loss Account will reduce the year's profit by the amount of provision and the amount will be carried forward to the next year. Next year, when Bad Debts actually occur and are written off, Bad Debts Account will be debited to the Provision for Doubtful Debts Account. The amount of the Bad Debts will not be debited to the Profit and Loss Account since a debit was already given for it last year. It should be noted that the customer's account or Sundry Debtors Account is not affected by creating Provision for Doubtful Debts. Provision for Doubtful Debts Account is shown in the Balance Sheet by way of deduction from the amount of book debts. But, it should be borne in mind that the two accounts are separate. The Provision for Doubtful Debts Account may appear as follows (amounts assumed):

Dr. PROVISION FOR DOUBTFUL DEBTS ACCOUNT Cr.

	Particulars		Date	Particulars	
2013			2013		
Dec 31	To Bad Debts A/c	430	Jan 1	By Balance *b/d* (From last year)	500
Dec 31	To Balance *c/d* (Balance required)	650	Dec. 31	By Profit and Loss A/c (Amount required to make up to the balance)	580
		1,080			1,080
			2014 Jan. 1	By Balance *b/d*	650

Amounts in the account given above, as an illustration, means the following:

1. In the Profit and Loss A/c of 2012 a sum of Rs. 500 was debited and credited to Provision for Doubtful Debts A/c. Thus, this account opens with this balance.

2. During the year 2013 Bad Debts totaled Rs. 430; these have been debited to Provision for Doubtful Debts Account and not to Profit and Loss Account.

3. The balance required in the provision at the end of 2013 is Rs. 650. This has been put on the debit side, to be carried down to next year.

4. The credit side is now short by Rs. 580, indicating the debit now required to the Profit and Loss Account to make up the balance.

We may also put it differently. Out of the opening provision of Rs. 500, Rs. 430 has been used up, leaving a balance of Rs.70. The new balance required is Rs. 650; therefore, the Profit and Loss Account should be debited by Rs. 580, i.e., Rs. 650 - Rs. 70.

In the Profit and Loss Account for 2013, it will appear as follows:

To Provision for Bad and Doubtful Debts required	650
Add: Bad Debts during the year	430
	1080
Less: Existing Provision for Bad and Doubtful Debts	500
	580S

Illustration 5. The amount of sundry debtors in a Trial Balance is Rs.7,00,000. You are required to write off Rs. 5,000 as Bad Debts and make a provision for doubtful debts @ 10% on sundry debtors. Pass necessary Journal entries.

Solution JOURNAL

Date	Particulars	L.F.	Dr (Rs.).	Cr.(Rs.)
	Bad Debts A/c ...Dr. To Sundry Debtors A/c. (Being the bad debts written off)		5,000	5,000
	Profit and Loss A/c . . ...Dr. To Bad Debts A/c (Note) (Being the bad debts transferred to Profit and Loss Account)		5,000	5,000
	Profit and Loss A/c ...Dr. To Provision for Doubtful Debts A/c (Note 2) (Being the provisions made for doubtful debts @ 10% on sundry debtors)		69,500	69,500

Notes:

1. Bad Debts Account has been transferred to Profit and Loss Account because there is no existing provision for doubtful debts. The provision now created is meant for meeting Bad Debts to be written off in the next year.

2. Provision is made on Rs. 6,95,000 (i.e., Rs. 7,00,000 - Rs. 5,000 as bad debts written off). 10% of Rs. 6,95,000 = Rs. 69,500.

9. Provision for Discount on Debtors

Debtors outstanding at the end of the year make payment in the next year and cash discount may be allowed to them if they make the payment by the due date. Because the debt has arisen during the year, discount should be accounted as expense for the year. Thus, a Provision for Discount on Debtors is made.

The process is same as is for the provision for doubtful debts. The likely amount of the discount to be allowed is debited to Profit and Loss Account and credited to Provision for Discount Account. It is shown in the Balance Sheet on the assets side by way of deduction from debtors and is carried forward to the next year. Discount allowed to the existing debtors in the next year is debited to the Provision for Discount Account and not to the Profit and Loss Account. The debit reduces the balance in the provision account; it is made up to the required amount by a debit to the Profit and Loss Account and credit to the Provision for Discount on Debtors Account.

An important point to note is that discount is not allowed on debts that become bad. Therefore, provision for discount is made on good debts only. In other words, the amount of the Provision for Discount is calculated on sundry debtors after deducting bad debts and the provision for doubtful debts. Suppose, sundry debtors total Rs. 20,000; provision for doubtful debts is required at 5% and Provision for Discount at 2.5%. The provision for doubtful debts will be Rs. 1,000; the remaining amount is Rs. 19,000. The Provision for Discount will be 2.5% of Rs. 19,000, i.e., Rs. 475.

Accounting Treatment

(i) For Discount Allowed:

Discount Allowed A/c ...Dr.

To Debtors A/c

(Being the discount allowed to debtors)

(ii) *For transferring the amount of discount to Profit and Loss Account:*

Profit and Loss A/c ...Dr.

To Discount Allowed A/c

(Being the discount transferred to Profit and Loss A/c)

(iii) *If the existing provision appears in the books, then discount allowed is transferred to Provision for Discount on Debtors Account instead of the Profit and Loss Account. The entry is:*

Provision for Discount on Debtors A/c ...Dr.

To Discount Allowed A/c

(Being the discount transferred to Provision for Discount on Debtors A/c)

(iv) *For creating Provision for Discount on Debtors:*

Profit and Loss A/c ..Dr.

To Provision for Discount on Debtors A/c

(Being the balance of Provision for Discount on Debtors Account being charged to Profit and Loss A/c)

Illustration 6. Sundry Debtors of a firm on 31st March, 2013, were Rs. 40,000. On that date, it was decided to create Provision for Discount at 2% on Sundry Debtors. During the year ended 31st March, 2014, actual amount of discount allowed was Rs. 400. The debtors on 31st March, 2014 were Rs.30,000 and it was decided to create Provision for Discount on Debtors at 2%. Pass Journal entries and prepare Discount Account and Provision for Discount on Debtors Account for both the years.

Solution JOURNAL

Date	Particulars	L.F.	Dr.(Rs.)	Cr.(Rs.)
2013 March 31	Profit and Loss A/c ....Dr To Provision for Discount on Debtors A/c (Being the provision for discount on debtors created)		800	800
2014 March 31	Discount Allowed A/c ...Dr. To Sundry Debtors A/c (Being the discount allowed on payment received)		400	400
March 31	Provision for Discount on Debtors A/c ...Dr. To Discount Allowed A/c (Being the discount transferred to Provision Account)		400	400
March 31	Profit and Loss A/c ...Dr. To Provision for Discount on Debtors A/c (Being the provision created)		200	200

Dr. PROVISION FOR DISCOUNT ON DEBTORS ACCOUNT *Cr.*

Date	Particulars	J.F.		Date	Particulars	J.F.	
2013 March 31	To Balance *c/d*		800	2013 March 31	By Profit and Loss A/c		800
2014 March 31	To Discount Allowed A/c		400	2013 April 1	By Balance *b/d*		800
March 31	To Balance *c/d*		600	2014 March 31	By Profit and Loss A/c		200
			1,000				1,000
				2014 April 1	By Balance *b/d*		600

Dr. DISCOUNT ALLOWED ACCOUNT Cr.

Date	Particulars	J.F.		Date	Particulars	J.F.	
2014 March 31	To Sundry Debtors A/c		400	2014 March 31	By Provision for Discount on Debtors A/c		400

10. Manager's Commission

Sometimes, the Manager is entitled to a commission on profits which is usually calculated as a fixed percentage of profit. Suppose, profit earned by the firm is Rs. 80,000 without considering commission payable @ 5% of profit. Commission payable will be Rs. 4,000. Profit will be reduced to Rs. 76,000. As the amount of commission Rs. 4,000 is still to be paid, it is an outstanding expense. Accordingly, the entries are:

Manager's Commission A/c ...Dr.

To Commission Payable/Outstanding Commission A/c

(Being the commission payable to Manager provided)

Profit and Loss A/c ...Dr.

To Manager's Commission A/c

(Being the commission payable to Manager is transferred to Profit and Loss A/c)

Commission payable is a current liability and is shown in the Balance Sheet.

Commission may have to be calculated on profit remaining after commission payable to the Manager. If the rate of the commission is 5%, and the profit remaining after commission is Rs. 100, then the profit before commission should be Rs. 105. Thus, commission of Rs. 5 should be out of every Rs.105 of profit before commission.

The formula to calculate commission in such a case is:

$$\frac{\text{Percentage of the Commission}}{100 + \text{Percentage of the Commission}} \times \text{Net Profit before charging the Commission}$$

If profit before commission is Rs. 80,000 and the Manager is entitled to commission of 5% after deducting the commission, the amount of commission will be Rs. 3,810, i.e., Rs. 80,000 x 5/105. The amount of commission can be verified too. The profit after commission is Rs. 76,190 and Rs. 3,810 is 5% of this amount. One can see that to calculate it at 5% of Rs. 80,000 will be incorrect since Rs.4,000 is not 5% of Rs. 76,000.

Illustration 7. From the following balances of the year ended 31st March, 2014 and additional information, prepare Trading and Profit and Loss Account and Balance Sheet of M/s. Ram Lal and Sons:

	Rs.		**Rs.**
Capital	80,000	Insurance	600
Purchases	82,000	Salaries	12,500
Sales	1,10,000	Bad Debts	200
Returns Outward	1,000	Carriage on Purchases	200
Building	45,000	Commission (Cr.)	1,500
Opening Stock	15,000	Cash in Hand	5,000
Debtors	20,100	Cash at Bank	25,000
Creditors	28,000	Sales Tax Paid	5,000
Furniture	7,000	Sales Tax Collected	3,500
Wages	1,800	Interest on Investments	500
Rent	5,100		

Additional Information:

(a) Closing Stock was valued at Rs. 20,000.

(b) Provide Depreciation on building @ 5% and on furniture @ 10%.

(c) Outstanding salaries Rs. 1,000.

(d) Unexpired insurance Rs. 50.

(e) Accrued commission Rs. 300.

(f) Provide for Manager's Commission at 5% on net profit after charging such commission.

Solution

Dr. TRADING AND PROFIT & LOSS ACCOUNT Cr.

Particulars		*Rs.*	Particulars		Rs.
To Opening Stock		15,000	By Sales		1,10,000
To Purchases	82,000		By Closing Stock		20,000
Less: Returns Outward	1,000	81,000			
To Wages		1,800			
To Carriage on Purchases		200			
To Gross Profit c/d		32,000			\
		1,30,000			1,30,000
To Rent		5,100	By Gross Profit *b/d*		32,000
To Insurance	600		By Interest on Investments		500
Less: Prepaid Insurance	50	550	By Commission	1,500	
To Salaries*	12,500		*Add:* Accrued Commission	300	1,800
Add: Outstanding Salaries	1,000	13,500			
To Bad Debts		200			
To Depreciation on:					
Building	2,250				
Furniture	700	2,950			
To Manager's Commission (5/105 x Rs.12,000)		571			
To Net Profit (after Manager's Commission)		11,429			
		34,300			34,300

BALANCE SHEET as at 31ST March,2014

Liabilities			Assets			
Creditors		28,000	Cash in Hand			5,000
Outstanding Salary		1,000	Cash at Bank			25,000
Manager's Commission		571	Closing Stock			20,000
Payable Capital	80,000		Debtors			20,100
Add: Net Profit	11,429	91,429	Advance Sales Tax Paid (Sales Tax Paid - Sales Tax Collected)			1,500
			Accrued Commission			300
			Prepaid Insurance			50
			Building	45,000		
			Less: Depreciation	2,250		42,750
			Furniture		7,000	
			Less: Depreciation		700	6,300
		1,21,000				1,21,000

Implied Adjustment

While preparing the final accounts, it has to be ensured that all incomes and expenses for the year have been accounted. It is possible that complete information is not given for any income or expense yet adjustment has to be made on the basis of available information. It is known as **implied information.**

For example, when Loan Account is given in the Trial Balance, it needs to be ascertained that total amount of interest due on the loan has been paid or not. It is ascertained by calculating interest due, as per the given rate of interest and the date on which it was taken. Compare the amount of interest so calculated with the amount of interest given in the Trial Balance. It is possible that the amount of interest given in the Trial Balance, i.e., interest paid, is less than the total amount of interest due. In such a situation, the difference between the two is outstanding interest. Some examples of Implied Adjustment are given below:

TRIAL BALANCE as on 31st March,2011

1.10% Loan to.Mr. X (Granted on 1st August, 2010) [Explanation 1]	6,00,000	
2.8% Loan from Mr. Y (Taken on 1st November, 2010) [Explanation 2]		90,000
3. 12% Bank Loan (Taken on 1st June, 2010) [Explanation 3]		1,00,000
4. Interest on bank loan paid	2,500	
5. Leasehold premises (10 years to run from 1st April, 2010) [Explanation 4]	10,00,000	
6. Salaries 0-1 months) [Explanation 5]	1,10,000	
7. "Patent rights (5 years) [Explanation 6]	1,00,000	
8. Insurance Premium (including an annual premium of Rs.12,000 paid up to 30th June, 2011) [Explanation 7]	36,000	
9. 10% Investment (face value *X* 6,00,000 purchased on 1st July, 2010) [Explanation 8)	5,40,000	
10. Interest on Investment		30,000

Note: Financial Year is the Accounting Year.

Explanations:

1. Adjustment should be made for interest earned but not received on Rs. 6,00,000 @ 10% for 8 months (1st August, 2010 to 31st March, 2011)- Rs. 6,00,000 x 8/12 x 10/100 = Rs. 40,000.

The amount will be credited to Profit and Loss Account and shown on the assets side of the Balance Sheet.

2. Adjustment should be made for interest due not paid on Rs. 90,000 @ 8% for 5 months (1st November, 2010 to 31st March, 2011) = Rs. 3,000.

The amount will be debited to Profit and Loss Account and shown on the liabilities side of the Balance Sheet.

3. 10 months interest on bank loan (Rs. 1,00,000 x 12/100 x 10/12) or Rs. 10,000 will be debited to Profit and Loss Account as expense for the year. But out of this, Rs.

2,500 (see item 4 in Trial Balance) has been paid. The balance of Rs. 7,500 will be shown on the liabilities side of the Balance Sheet.

4. l/10th of the cost of lease, i.e., Rs. 1,00,000 will be debited to Profit and Loss Account as amortisation of lease and this will be shown as deduction from leasehold premises on the assets side of the Balance Sheet.

5. One month salary (Rs. 1,10,000 x 1/11) Rs. 10,000 is still outstanding. It must be added to salary on the debit side of the Profit and Loss Account and shown on the liabilities side of the Balance Sheet.

6. l/5th of the cost of patent rights, i.e., Rs. 20,000, will be debited to Profit and Loss Account as amortisation of patents right and the same will be shown as deduction from patents right on the assets side of the Balance Sheet.

7. Adjustment should be made for unexpired insurance or prepaid insurance for 3 months-Rs. 12,000 x 3/12 = Rs. 3,000.

This amount will be deducted from the insurance premium on the debit side of the Profit and Loss Account and shown on the assets side of the Balance Sheet.

8. Nine months' interest (Rs. 6,00,000 x 9/12 x 10/100) or Rs. 45,000 will be credited to Profit and Loss Account as income for the year. Out of this Rs. 30,000 has been received. The balance Rs. 15,000 will be shown on the assets side of the Balance Sheet as accrued income.

11. Abnormal or Accidental Losses

Such losses occur because of fire, earthquakes or accidents. These may destroy some fixed assets of the firm. In such a case, an Asset Account is credited and the Profit and Loss Account is debited.

Stock of goods may also be destroyed or damaged by fire or other causes. It is obvious that because of this, the value of stock will be lower than otherwise. This will reduce the amount of gross profit and net profit. It is, however, better to ascertain the gross profit which would have been earned without the loss since this enables the firm to assess its trading operations properly. To nullify the effect of loss of stock, the Trading Account is credited with the cost of the goods destroyed. If goods destroyed are not insured then the cost price of the goods destroyed is debited to Profit and Loss Account. If the goods are insured, then the claim admitted by the insurance company is deducted and the claim not admitted is debited to Profit and Loss Account. The adjusting entries are as follows:

(i) Accidental Loss of Stock A/c or Loss by Fire A/c ...Dr. [Total Value of Abnormal Loss]
To Trading A/c
(Being the accidental loss transferred to Trading A/c)

(ii) Insurance Claim or Insurance Co. ...Dr. [Amount of Insurance Claim]
Profit and Loss A/c ...Dr. [Value of Irrecovered Loss]
To Accidental Loss of Stock A/c [Total Value of Abnormal Loss]
(Being the accidental loss recoverable from insurance company and balance transferred to Profit and Loss A/c)

Insurance Company's Account will be shown as an asset in the Balance Sheet.

Note: *If stock is not insured, following entry will be passed:*

Profit and Loss A/c ...Dr. [Total Value of Abnormal Loss]
To Trading A/c
(Being the loss of stock transferred to Trading A/c)

Illustration 8. Trial Balance of M/s Taj & Co. as on 31st March,2014 was as follows:

Ledger Accounts	Dr. Balance Rs.	Ledger Accounts	Cr. Balance Rs.
Purchases	1,62,505	Sales	2,52,400
Sundry Debtors	50,200	Provision for Doubtful Debts	5,200
Opening Stock	26,725	Sundry Creditors	30,526
Wages	23,137	Bills Payable	3,950
Salaries	5,575	Outstanding Wages	2,000
Furniture	7,250	Trade Expenses Accrued but not Paid	700
Postage	4,226	Capital	10,000
Power and Fuel	1,350		
Trade Expenses	5,831		.
Bad Debts	525		
Loan to Suraj @ 10% p.a. (1st Dec, 2013)	3,000		
Cash at Bank	10,000		
.Drawings .	4,452		
	3,04,776		3,04,776

Prepare Trading and Profit and Loss Account for the year ended 31st March, 2014 and Balance Sheet after considering the following information:

(i) Depreciation on Furniture @ 10% to be charged.

(ii) Debtors include an item of Rs. 500 due from a customer who has become insolvent.

(iii) Provision for Doubtful Debts @ 5% on Sundry Debtors is to be maintained.

(iv) Goods valued at Rs. 1,500 destroyed by fire and insurance company admitted a claim for Rs. 1,000.

(v) Stock on 31st March, 2014 was Rs.12,550.

Solution

TRADING AND PROFIT AND LOSS ACCOUNT

for the year ended 31st March, 2014

Particulars	Rs.	Particulars	Rs.
To Opening Stock	26,725	By Sales	2,52,400
To Purchases	1,62,505	By Goods Lost by Fire A/c	1,500
To Wages	23,137	By Closing Stock	12,550
To Power and Fuel	1,350		
To Gross Profit *c/d*	52,733		
	2,66,450		2,66,450
To Depreciation on Furniture	725	By gross profit	
To Goods Lost by Fire (Rs.1.500 - Rs.1,000)	500	By provision for doubtful debts	
To Salaries	5,575	Existing 5,200	
To Postage	4,226	Less: Bad debts (525+500) 1,025	
To Trade Expenses	5,831	4,175	1,690
To Net Profit transferred to Capital A/c	37,666	Less: Prov. for bad debts	100
		Required (5% on Rs. 49,700) 2,485	
		By interest on loan	
		(Rs. 3,000x 10/100x4/12)	
	54,523		54,523

BALANCE SHEET

as on 31st March,2014

Liabilities	Rs.	Assets	Rs.
Capital		**Fixed Assets**	
Opening Balance 10,000		Furniture 7,250	
		Less: Depreciation 725	6,525
Less: Drawings 4,452		**Current Assets**	
5,548		Cash	10,000
Add: Net Profit 37,666	43,214	Insurance Claim	1,000
		Closing Stock	12,550
Current Liabilities		Sundry Debtors 50,200	
Outstanding Wages	2,000	*Less:* Bad Debts 500	
Trade Expenses not Paid	700	49,700	
Sundry Creditors	30,526	*Less:* Provision for Doubtful Debts	
Bills Payable	3,950	*(Rs.* 49,700x5/100) 2,485	47,215
		Loan 3,000	
		Add: Interest on Loan 100	3,100
	80,390		80,390

Note: 'Outstanding Wages' and 'Trade expenses accrued but not paid' appear on the credit side of the Trial Balance. It means that these outstanding amounts have already been adjusted to Wages Account and Trade Expenses Account. As double entry in respect of these adjustments is complete, these outstanding accounts will be taken straight to liabilities side of the Balance Sheet.

12. Goods Taken for Personal Use

Goods taken by the proprietor from the business for his personal use is drawing. Similarly, cash taken for personal use is drawing. Drawings have to be recorded in the books of accounts following the business entity concept, to show correct profit or loss and financial position of the business in the final accounts. The treatment of drawings of goods or cash by the proprietor in the Final Accounts is as follows:

1. Deduct drawing of goods (at cost) from purchases on the debit side of the Trading Account.

2. Deduct it either from capital or add to drawings on the liabilities side of the Balance Sheet.

Accounting Treatment of Drawings

Particulars	**Accounting Entries**
1. Drawings made by Cash	Drawings A/c ...Dr. To Cash/Bank A/c
	Capital A/c ...Dr. To Drawings A/c
2. Withdrawal of Goods by the Proprietor	Drawings A/c ...Dr. To Purchases A/c
	Capital A/c . ..Dr. To Drawings A/c
3. Income Tax Paid by the Sole Proprietor, out of the Entity's (Business's) Cash	Income tax A/c ...Dr. To Cash/Bank A/c
	Drawings A/c . ..Dr. To Income Tax A/c
	Capital A/c ...Dr. To Drawings A/c

13. Goods Distributed as Free Samples

Goods are distributed as free samples with the aim to promote sales. It is, therefore, an advertisement. For example, if goods worth Rs. 5,000 are distributed as free samples then it will be an advertisement for the concern but on the other hand the stocks will be less by goods of such value. In order to bring this into the books of accounts, the following entry is passed:

Advertisement A/c	...Dr.	[At Cost]
To Purchases A/c		

The two-fold effect of this entry will be:

1. It is deducted from purchases in the Trading Account.
2. It is shown on the debit side of the Profit and Loss Account as advertisement expenses.

Illustration 9. From the following Trial Balance, prepare Trading and Profit and Loss Account for the year ended 31st March, 2014 and Balance Sheet as at that date:

Debit Balances	Rs.	Credit Balances	Rs.
Salaries	10,223	Sales	66,420
Bills Receivable	6,377	Capital	50,000
Investments	40,000	Provision for Doubtful Debts	2,500
Furniture	12,000	10% Loan (1.10.2013)	10,000
Opening Stock	4,500	Discount Received	400
Purchases	30,000	Sundry Creditors	9,300
Sundry Debtors	20,000	Bills Payable	5,000
Interest on Loan	400	Outstanding Salaries	500
Insurance Premium	900	Bad Debts Recovered	200
Wages	4,600	Interest on Investments	2,000
Rent	1,520	Trading Commission	7,000
Bad Debts	1,200		
Carriage Outwards	600		
Cash at Bank	10,000		
Depreciation on Furniture	2,500		
Accrued Commission	1,000		
Advertisement	7,500		
	1,53,320		1,53,320

Adjustments:

(i) Closing Stock-Rs. 6,000.

(ii) Goods costing Rs. 1,000 were distributed as free samples while goods costing Rs. 500 were taken by the proprietor for personal use.

(iii) A credit sale of Rs. 2,000 was not recorded in the Sales Book.

(iv) Closing Stock included goods costing Rs. 1,000 which were sold and recorded as sales but not delivered to the customer.

(v) Maintain provision for Doubtful Debts @ 5%.

Solution TRADING AND PROFIT AND LOSS ACCOUNT

for the year ended 31st March, 2014

Particulars	Rs.	Particulars	Rs.
To Opening Stock	4,500	By Sales 66,420	
To Purchases 30,000		Add: Credit Sales 2,000	68,420
Less: Free Samples 1,000		By Closing Stock 6,000	
29,000		Less: Cost of Goods Sold	
Less: Drawing of Goods 500	28,500	but not delivered 1,000	5,000
To Wages	4,600		
To Gross Profit *c/d*	35,820		
	73,420		73,420
To Salaries	10,223	By Gross Profit	35,820
To Interest on Loan 400		By Old prov. for doubtful debts 2,500	
Add: Outstanding Interest on Loan 100	500	Less: Bad debts 1,200	
To Insurance Premium	900	1,300	
To Rent	1,520	Less: New Provision 1,100	200
To Carriage Outwards	600		
To Depreciation on Furniture	2,500	By Discount Received	400
To Advertisement	7,500	By Bad Debt Recovered	200
To Free Samples	1,000	By Interest on Investment	2,000
To NetProfit transferred to Capital A/c	20,877	By Trading Commission	7,000
	45,620		45,620

BALANCE SHEET

as on 31st March,2014

Liabilities	Rs.	Assets	Rs.
Capital 50,000		Investment	40,000
Add: Net Profit 20,877		Furniture	12,000
70,877		Debtors 20,000	
Less: Drawing 500	70,377	Add: Credit Sales not recorded 2,000	
10% Loan	10,000	22,000	
Outstanding Interest on Loan	100	Less: New Provision 1,100	20,900
Creditors	9,300	Bills Receivables	6,377
Bills Payable	5,000	Accrued Commission	1,000
Outstanding Salaries	500	Closing Stock	5,000
		Bank	10,000
	95,277		95,277

Illustration : 10 From the following Trial Balance, extracted from the books of MMN, prepare Trading and Profit and Loss Account for the year ended 31st March, 2014 and Balance Sheet as at that date :

Head of Accounts	Dr. Rs.	Cr. Rs.
Capital	....	90,000
Drawings	6,480	...
Land and Building	25,000	...
Plant and Machinery	14,270	...
Furniture and Fixtures	1,250	...
Carriage Inwards	4,370	...
Wages	21,470	...
Salaries	4,670	...
Provision for Bad Debts	....	2,470
Sales	....	91,230
Sales Retrun	1,760	...
Bank Charges	140	...
Coal, Gas and Water	720	...
Rates and Taxes	840	...
Discount	.....	120
Purchases	42,160	...
Purchases Return	...	8,460
Bill Receivable	1,270	...
Trade Expenses	1,990	...
Sundry Debtors	37,800	...
	...	12,170
Stock (1st Apri, 2013)	26,420	...
Apprentice Premium	...	500
Fire Insurance	490	...
Cast in Bank	13,000	...
Cash in Hand	850	....
Total	2,04,950	2,04,950

Adjustments :

Charge Depreciation on Land and Building at 1½%, on Plant and Machinery Account at 10% and on Furniure and Fixtures at 10%. Make provision of 5% on debtors for Doubtful Debts. Carry forward the following unexpired amounts :

(i) Fire Insurances Rs. 125

(ii) Rates and Taxes Rs. 240

(iii) Apprentice Premium Rs. 400

(iv) Closing Stock Rs. 29,390

Solution :

TRADING AND PROFIT AND LOSS ACCOUNT
for the year ended 31st March, 2014

Dr. Cr.

Particulars		Rs.	Particulars		Rs.
To Opening Stock		26,420	By Sales	91,230	
			Less : Sales Return	1,760	89,470
To Purchases	42,160		By Closing Stock		29,390
Less. Purchases Return	8,460	33,700			
To Wages		21,470			
To Carriage Inwards		4,370			
To Coal, Gas and Water		720			
To Gross Profit c/d		32,180			
		1,18,860			1,18,860
To Salaries		4,670	By Gross Profit b/d		32,180
To Bank Charges		140	By Discount		120
To Rates and Taxes	840		By Apprentice Premium	500	
Less. Prepaid	240	600	Less : Unexpired	400	100
To Trade Expenses		1,990	By Old Provision for Doubtful Debts		2,470
To Fire Insurance	490				
Less Prepaid	125	365			
To Provision for Doubtful Debts		1,890			
To Depreciation on :					
Land and Building	625				
Plant and Machinery	1,427				
Furniture and Fixtures	125	2,177			
To Gross Profit transferred to Capital A/c		23,038			
		34,870			34,870

BALANCE SHEET
as at 31st March, 2014

Liabilities		Rs.	Assets		Rs.
Capital	90,000		Land and Building	25,000	
Add : Net Profit	23,038		Less : Depreciation	625	24,375
	1,13,038		Plant and Machinery	14,20	
Less : Drawings	6,480	1,06,558	Less : Depreciation	1,427	12,843
Sundry Creditors		12,170	Furniture and Fixtures	1,250	
Apprentice Premium Received in Advance		400	Less : Depreciation	125	1,125
			Debtors	37,800	
			Less : Provision for Doubtful Debits	1,890	35,910
			Bills Receivable		1,270
			Closing Stock		28,990
			Prepaid Fire Insurance		125
			Prepaid Rates and Taxes		240
			Cash at Bank		13,000
			Cash in Hand		850
		1,19,128			1,19,128

Illustration 11 : On 31st March, 2014 the following Trial Balance was extracted from the books of a merchant"

	Rs.	**Debit Balances (Contd.)**	Rs.
Debit Balances		Rates, Taxes and Insurance	2,891
Drawings	3,000	Advertisement	3,264
Sundry Debtors	20,100	General expenses	3,489
Interest on Loan	300	Bills Receivable	6,882
Cash in Hand	2,050	Credit Balances	
Stock on 1stt April, 2013	6,839	Capital	28,000
Motor Vehicles	10,000	Sundry Creditors	10,401
Cash at Bank	3,555	Loan on Mortgage	9,500
Building	12,000	Provision for Doubtful Debts	710
Bad Debts	525	Sales	1,10,243
Purchases	66,458	Purchases Return	1,346
Sales Return	7,821	Discounts	540
Carriage Outwards	2,404	Bills Payable	2,614
Carriage Inwards	2,929	Rent Received	250
Salaries	9,097		

Prepare Trading andd Profit and Loss Account for the year ended 31st March, 2014 and Balance Sheet as at that date, after making adjustments for the following :

(i) Deprecciate Building at 2½% and Motor Vehicles at 20%.

(ii) Interest on Loan at 6% p.a. is unpaid for six months.

(iii) Salaries amounted to Rs. 750 and rates amounted to Rs. 350 are outstanding.

(iv) Prepaid Insurance amounted to Rs. 150.

(v) Provision for Doubtful Debts is to be maintained at 5% on Sundry Debtors.

(vi) Provide for Manager's Commission at 10% on net profits after charging such commission.

(vii) Stock in Hand on 31st March, 2014 was valued at Rs. 6,250.

Solution.

TRADING AND PROFIT AND LOSS ACCOUNT

Dr. *for the year ended 31st march, 2014* Cr.

Particulars		Rs.	Particulars		Rs.
To Opening Stock		6,839	By Sales	1,10,243	
To Purchases	66,458		Less : Returns	7,821	1,02,422
Less : Returns	1,346	65,112	By Closing Stock		6,250
To Carriage Inwards		2,929			
To Gross Profit c/d		33,792			
		1,08,672			1,08,672
To Interest on Loan		585	By Gross Profit b/d		33,792
To Carriage Outwards		2,404	By Discount		540
To Rates, Taxes and			By Rent		250
Insurance	2,891				
Add : Unpaid Rates	350				
	3,241				
Less : Prepaid Insurance	150	3,091			
To advertisement		3,264			
To General Expenses		3,489			
To Salaries	9,097				
Add : Salaries Outstanding	750	9,847			
To Bad Debts	525				
Add : Provision for					
Doubtfful Debts required	1005				
	1,530				
Less : Existing Provision	710	820			
To Depreciation on					
Building @ 2½%		300			
Motor Vehicles @ 20%		2,000			
To Manager's Commission (Note)		798			
To Net Profit transferred to					
Capital A/c		7,984			
		34,582			34,582

BALANCE SHEET
as at 31st March, 2014

Liabilities		Rs.	Assets		Rs.
Current Liabilities			**Current Assets**		
Bills Payable		2,614	Cash in Hand		2,050
Sundry Creditors		10,401	Cash at Bank		3,555
Outstanding Expenses		1,385	Bills Receivable		6,882
Manager's Commission Payable		798	Sundry Debtors	20,100	
Long-term Liabilities			Less : Provision for Doubtful Debts	1,105	19,095
Loan on Mortgage		9,500	Closing Stock		6,250
Capital		798	Prepaid Insurance		150
Opening Balance	28,000		**Fixed Assets**		
Less : Drawings	3,000		Motor Vehicles	10,000	
	25,000		Less : Depreciation	2,000	8,000
Add. Net Profit	7,984	32,984	Building	12,000	
			Less : Depreciation	300	11,700
		57,682			57,682

Note : Manager's Commission on net profit at 10/110 of Rs. 8,782

Illustration 12 : Given below is the Trial Balance of M/s Gupta & Sons as on 31st March, 2014.

Heads of Accounts		Dr. Balance Rs.	Cr. Balance Rs.
Capital	....	.....	7,20,000
Drawings	....	40,000	.....
Sales	....	.....	10,15,000
Purchases	....	6,20,000	.....
Stock - in - Trade (1.4.2013)	....	20,000	.....
Sales Return	....	12,000	.....
Purchases Return	....	.....	15,000
Sundry Debtors	....	80,000	.....
Sundry Creditors	....	.....	30,000
Rent	....	22,000	.....
Electricity	....	16,000	.....
Other Expenses	....	32,000	.....
Wages	....	1,12,000	.....
Cash in Hand	....	1,22,000	.....
Cash at Bank	....	6,32,000	.....
Advance to Supplier	....	72,000	.....
Total		17,80,000	17,80,000

Additional Information :

(i) On scrutiny it is found that bank balance as per Current Acccount Statement on 31st March, 2014 was Rs. 5,78,000. A cheque of Rs. 70,000 was collected from a debtor returned dishonoured and a cheque of Rs. 16,000 was deposited by another debtor directly.

(ii) Closing stock as on 31st March, 2014 was Rs. 40,000

(iii) Purchases Return Rs. 2,000 was wrongly posted as Sales Return butt correctly debited to Supplier's Account.

(iv) Purchases Book is found overcast by Rs. 6,000.

(v) Sales Book is found undercast by Rs. 2,000.

You are requested to (1) redraft Trial Balance and (2) prepare. Final Accounts of M/s. Gupta & Sons.

Solution

Heads of Accounts	Debit Rs.	Credit Rs.
Capital	.....	7,20,000
Drawings	40,000	.....
Sales (Rs. 10,15,000+ Rs. 2,000)	.....	10,17,000
Purchases (Rs. 6,20,000 - Rs. 6,000)	6,14,000	.....
Stock - in - Trade (1.4.2013)	20,000	.....
Sales Return (Rs. 12,000 - Rs. 2,000)	10,000	.....
Purchases Return (Rs. 15,000 + Rs. 2,000)	.....	17,000
Sundry Debtors (Rs. 80,000 + Rs. 70,000 - Rs. 16,000)	1,34,000	.....
Sundry Creditors	.....	30,000
Rent	22,000	.....
Electricity	16,000	.....
Other Expenses	32,000	.....
Wages	1,12,000	.....
Cash in Hand	1,22,000	.....
Cash at Bank (Rs. 6,32,000 - Rs. 70,000 + Rss. 16,000)	5,78,000	.....
Advance to Supplier	72,000	.....
Susspense A/c	12,000	.....
Total	17,80,000	17,80,000

TRADING AND PROFIT AND LOSS ACCOUNT
for the year ended 31st March, 2014

Dr. Cr.

Particulars		Rs.	Particulars		Rs.
To Opening Stock		20,000	By Sales	10,17,000	
To Purchases	6,14,000		Less : Returns	10,000	10,07,000
Less : Returns	17,000	5,97,000	By Closing Stock		40,000
To Wages		1,12,000			
To Gross Profit c/d		3,18,000			
Long-term Liabilities		10,47,000			10,47,000
To Rent		22,000	By Gross Profit b/d		3,18,000
To Electricity		16,000			
To Other Expenses		32,000			
To Capital A/c (Net Profit transferred)		2,48,000			
		3,18,000			3,18,000

BALANCE SHEET as at 31st March, 2014

Liabilities		Rs.	Assets	Rs.
Sundry Creditors		30,000	Cash in Hand	1,22,000
Capital :			Cash at Bank	5,78,000
Balance	7,20,000		Sundry Debtors	1,34,000
Add. Net Profit	2,48,000		Closing Stock	40,000
	9,68,000		Advance to Supplier	72,000
Less : Drawings	40,000	9,28,000	Suspense A/c	12,000
		9,58,000		9,58,000

Note : The existence of Suspence Account in the rectified Tril Balance implies that errors still exist

RECTIFICATION ENTRIES

Date	Particulars		L.F.	Dr. (Rs.)	Rs.
1	Debtors To Bank A/c (Being the cheque dishonoured)	....Dr.		70,000	70,000
2	Bank A/c To Debtors (Being the amount deposited into bank directly by debtor)	....Dr.		16,600	16,600
3	Suspense A/c To Purchases Return A: To Sales Return A/c (Being the purchases return wrongly recorded as sales return, now rectified)	....Dr.		4.000	2,000 2,000
4	Suspenses A/c To Purchases A/c (Being the overcasting in purchases book, now rectified)	....Dr.		6,000	6,000
5	Suspense A/c To Sales A/c (Being the undercasting of sales book, now rectified)	....Dr.		2,000	2,000

Illustration : 13 From the books of M/s Shyam Traders following Traders following Trial Balance has been prepared on 31st March, 2014 :

Debit Balances	Rs.	Credit Balances	Rs.
Purchass (Adjust by Stock A/c)	1,93,500	Sales	3,00,000
Wages	23,250	Sales Tax Collected	24,500
Carriage on Purchases	18,000	Interest on Investments	700
Prepaid Insurance (1st April, 2013)	625	Provision for Doubtful Debts	2,500
Bad Debts	600	Cash Discount	4,500
Rent	5,500	Capital	71,175
Insurance	2,250	Creditors	18,750
Salary	13,500	Outstanding Wages	900
Debtors	37,500		
Stock (31st March, 2014)	20,500		
Investments	10,000		
Cash	14,500		
Accured Interest (31st March, 2014)	800		
Furniture	10,500		
Rent of Factory	50,000		
Income Tax	22,000		
	4,23,025		4,23,025

Prepare Tranding and Profit and Loss Account for the year ended 31st March, 2014 and Balance Sheet as at the that date, taking into consideration the adjustment given below:

(i) On 1st October, 2013 plant worth Rs. 10,000 was purchased on credit but no entry has been passed.

(ii) Outstanding Expenses : Rent Rs. 500, Salary : Rs. 600

(iii) Prepaid Expenses : Insurance Rs. 250, Wages Rs. 400

(iv) Goods Worth Rs. 2,750 were taken for personal use by the owner but no entry has been made.

(v) Write off Depreciation on Plant and Furniture @ 10% p.a.

(vi) Write off Rs. 500 from Debtors as Bed Debts and create Provision for Doubtful Debts @ 5% and 2% Provision for Discount on Debtors.

Solution :

TRADING AND PROFIT AND LOSS ACCOUNT
for the year ended 31st March, 2014

Dr. Cr.

Debit Balances		Rs.	Credit Balances	Rs.
To Purchases (Adjusted)	1,93,500		By Sales	3,00,000
Less : Drawings	2,750	1,90,750		
To Wages	23,250			
Less : Prepaid	400	22,850		
To Carriage		18,000		
To Gross Profit c/d		68,400		
		3,00,000		3,00,000
To Salaries	13,500		By Gross Profit b/d	68,400
Add : Outstanding	600	14,100	By Interest on Investments	700
To Rent	5,500		By Cash Discount	4,500
Add : Oustanding Rent	500	6000		
To Insurance	2,250			
Less : Prepaid	250			
	2,000			
Add : Prepaid (1.4.2013)	625	2,625		
To Bad Debts :	600			
Add : Further Bad Debts	500			
Provision (New)	1,850			
	2,950			
Less : Provision (Old)	2,500	450		
To Provision for Discount on Debtors		703		
To Depreciation on :				
Plant	5,500			
Furniture	1,050	6,550		
To Net Profit trid to Capital A/c		43,172		
		73,600		73,600

Note : Depreciation on Plant = Rs. 5,000 (i.e. Rs. 50,000 x Rs. 10/100) + Rs. 500 (i.e. Rs. 10,000 x Rs. 10/100 Rs. 6/12) = Rs. 5,500.

BALANCE SHEET as at 31st March, 2014

Liablities		Rs.	Assets		Rs.
Current Liabilities			**Current Assets**		
Creditors		18,750	Cash		14,500
Supplier (Plant)		10,000	Accrued Interest		800
Sales Tax collected (Note I)		24,500	Stock		20,500
Outstanding Expenses : Wages	900		Prepaid Insurance		250
Rent	500		Prepaid Wages		400
Salaries	600	2000			
Capital			Debtors	37,500	
Opening Balance	71,175		Less : Bad Debts	500	
Add. Net Profit	43,172			37,000	
	1,14,347		Less : Provision for Doubtful Debts	1,850	
Less : Drawings	2,750			35,150	
	1,11,597		Less : Provision for Discount	703	34,447
Less : Income Tax (Note 2)	22,000	89,597	Investments		
			Fixed Assets		10,000
			Furniture	10,500	
			Less : Depreciation	1,056	9,444
			Plant (Rs. 50,000+ Rs 10,00)	60,000	
			Less : Depreciation	5,500	54,500
		1,44,847			1,44,847

Notes :

1. Sales Tax collected is not a revenue for the business, however, it is a receipt collected on behalf of the Government, so it should be considered as liability for the business till it is paid off to the Government.
2. Income Tax to be taken as drawings.

Illustration 14 : Following is the Trial Balance of Ram as on 31st March, 2014 :

Head of Accounts		Dr. Rs.	Cr. Rs.
Purchases	....	1,50,000	....
Debtors	....	2,00,000	....
Interest earned	....	...	4,000
Salaries	....	30,000	....
Sales	....	...	3,21000
Purchase Return	....	...	5,000
Wages	....	20,000	.....
Rent	....	15,500	....
Sales Return	....	10,000	....
Bad Debts Written off	....	7,000	....
Creditors	....	....	1,20,000
Capitol	....	....	1,00,000
Provision for Doubtful Debts	....	24,000	...
Printing and Stationery	....	...	6,000
Insurance	....	8,000	...
Opening Stock	....	12,000	...
Office Expenses	....	50,000	...
Furniture and Fittings	....	12,000	...
Provision for Depreciation	....	20,000	...
		...	2,000
Total		5,58,000	5,58,000

Prepare Trading and Profit and Loss Account for the year ended 31st March, 2014 and Balance Sheet as at that date for making the following adjustments.

(i) Depreciate Furniture and Fittings by 10% on original cost.

(ii) Make a Provision for Doubtful Debts equal to 5% of Debtors.

(iii) Salaries for the month of March amounted to Rs. 3,000 were unpaid which must be provided for. The balance in the account includes Rs. 2,000 paid in advance.

(iv) Insurance is prepaid to the extent of Rs. 2,000.

(v) Provide Rs. 8,000 for office expenes.

(vi) Stock valued at Rs. 6,000 were put by Ram for his personal use, the cost of which has not been adjusted in the books of accounts.

(vii) Closing Stock valued at Rs. 68,000 (Net Realisable Value Rs. 60,000.

Solution :

TRADING AND PROFIT AND LOSS ACCOUNT

Dr. for the year ended 31st March, 2014 Cr.

Debit Balances		Rs.	Credit Balances		Rs.
To Opening Stock		50,000	By Sales	3,21,000	
To Purchases	1,50,000		Less : Return	10,000	3,11,000
Less : Returns	5,000		By Closing Stock		60,000
	1,45,000				
Less : For Personal use	6,000	1,39,000			
To Wages		20,000			
To Gross Profit c/d		1,62,000			3,71,000
		3,71000			
			By Gross Profit b/d		1,62,000
In Salaries	30,000		By Interest learned		4,000
Add : Oustanding Salaries	3,000				
	33,000	31,000			
Less : Paid in Advance	2,000	15,000			
To Rent					
To Bad Debts	7,000				
Add : New Provision	10,000				
	17,000				
Less : Old Provision	6,000	11,000			
To Printing and Stationery		8,000			
To Insurance	12,000				
Less : Prepaid	2,000	10,000			
To Office Expenses	12,000				
Add : Outstanding	8,000	20,000			
To Provision for Depreciation					
on Furniture and Fittings		2,000			
To net Profit trid. to Capital A/c		69,000			
		1,66,000			1,66,000

BALANCE SHEET

as at 31st March, 2014

Liabilities			Rs.	Assets		Rs.
Current Liabilities				**Current Assests**		
Sundry Creditors			1,20,000	Stock (Note)		60,000
Outstanding Salaries			3,000	Debtors	2,00,000	
Outstanding Office Expenses			8,000	Less : Provision for		
Capital				Doubtful/ Debts	10,000	1,90,000
Opening Balance		1,00,000		Prepaid Salaries		2,000
Add : Net Profit		69,000		Prepaid Insurance		2,000
		1,69,000		**Fixed Assets**		
Less : Drawings	24,000			Furniture an Fittings	20,000	
Stock for				Less : Provision for Depreciation	4,000	16,000
Personal Use	6,000	30,000	1,39,000	(Rs. 2,000 + Rs 2,000)		
			2,70,000			2,70,000

Note : According to Accounting Standard-2 issued by ICAI Closing Stock is valued at lower of cost of net realisable value.

Illustration 15 : Following were the balance extracted from the books of Yogita as on 31st March, 2010 :

Debit Balances	Rs.	Credit Balances	Rs.
Cash in Hand	540	Sales	98,780
Cash at Bank	2,630	Returns Outward	500
Purchase	40,675	Capital Account	62,00
Returns Inward	680	Sundry Creditors	6,300
Wages	8,480	Rent	9,000
Fuel and Power	4,730		
Carriage on Sales	3,200		
Carriage on Purchases	2,040		
Opening Stock	5,760		
Building	32,000		
Freehold Land	10,000		
Machinery	20,000		
Salaries	15,000		
Patents	7,500		
General Expenses	3,000		
Insurance	600		
Drawings	5,245		
Sundry Debtors	14,500		

Taking into account the following adjustments, prepare Trading and Profit and Loss Account and Balance Sheet as at 31st March, 2010:

(i) Stock in Hand on 31st March, 2010 was Rs. 6,800.

(ii) Machinery is to be depreciated @ 10% and Patents @ 20%.

(iii) Salaries for the month of March, 2010 amounting to Rs. 1,500 were outstanding.

(iv) Insurance includes a premium of Rs. 170 on a policy expiring on 30th September, 2010.

(v) Further Bad Debts are Rs. 725. Create a provision of 5% on Debtors.

(vi) Rent receivable Rs. 1,000.

Solution :

Yogita's Books

TRADING AND PROFIT AND LOSS ACCOUNT
for the year ended 31st March, 2010

Dr. Cr.

Particulars		Rs.	Particulars		Rs.
To Stock		5,750	By Sales	98,780	
To Purchases	40,675		Less : Return	680	98,100
Less : Returns	500	40,175	By Stock		6,800
To Wages		8,480			
To Fuel and Power		4,730			
To Carriage on Purchases		2,040			
To Gross Profit c/d		43,715			3,71,000
		1,04,900			
			By Gross Profit b/d		43,715
To Carriage on Sales		3,200	By Rent	9,000	10,000
To Salaries	15,000		Add : Receivable	1,000	
Add : Outstanding	1,500	16,500			
To General Expenses		3,000			
To Insurance					
Less : Unexpired	600				
To Bad Debts	85	515			
To Provision for Bad Debts		725			
(5% on Rs. 13,775)					
To Depreciation on Machinery		689			
To Depreciation on Patents		2,000			
To Net Profit trd. To Capital A/c		1,500			
		25,586			
		53,715			53,715

BALANCE SHEET
as at 31st March, 2010

Dr. Cr.

Liabilities		Rs.	Assets		Rs.
Creditors		6,300	Cash in Hand		540
Salaries Outstanding		1,500	Cash at Bank		2630
Capital :			Stock		6,800
Balance	62,000		Sundry Debtors	14,500	
Add : Net profit	25,586		Less : Bad Debts	725	
	87,586			13,775	
Less : Drawings	5,245	82,341	Less : Provision for Bad Debts	689	13,086
			Rent Receivable		1000
			Insurance Prepaid		85
			Patents	7,500	
			Less : Deprciation	1,500	6,000
			Freehold Land		10,000
			Building		32,000
			Machinery	20,000	
			Less : Depreciation	2,000	18,000
		90,141			90,141

5.8 SUMMARY

Balance Sheet is a statement which sets out the assets and liabilities of a firm or an institution as at a certain date. It is true on that particular date as every transaction has an impact on the Balance Sheet. Marshalling refers to arrangement of liabilities and assets in a particular order in the Balance Sheet. Assets may be arranged in form of liquidity or permanence. The Trading and Profit & Loss A/c and the Balance Sheet can be presented either in Horizontal Form or in Vertical Form. Accrual basis of accounting requires that revenue be recognised as it is earned and expenses be recognised as they are incurred. Therefore, expenses whether paid or not, income whether received or not, prepaid expenses and unearned incomes need to be adjusted. Adjustments are made for (i) matching of cost with revenue for ascertaining true and fair view of the profit earned or loss incurred by the business entity for the accounting period and (ii) for showing the true and fair value of assets and liabilities of the business as on the last date of the accounting period. Adjustments is recorded on the basis of the Dual Aspect Concept meaning every adjustment must appear at two places one representing the debit and the other representing the credit.

5.9 SELF ASSESSMENT QUESTION

1. On 28th March, 2104, stocks worth Rs. 80,000 were destroyed by fire. The stock was insured and the insurance company admitted a claim of Rs. 60,000 only. Give necessary Journal entries and show how it will be treated in the Final Accounts.

2. Following is the Trial Balance of Mrs. S.S. on 31st December, 2005:

Heads of Accounts	Dr.(Rs.)	Cr. (Rs.)
Cash in Hand	1,080	
Cash at Bank	5,260	
Purchases........	81,350	
Returns Outward........		1,000
Sales		1,97,560
Returns Inward........	1,360	
Wages	20,960	
Fuel & Power........	9,460	
Carriage on Sales	6,400	
Carriage on Purchases........	4,080	
Stock (1.1.2005)........	11,520	
Building	60,000	
Freehold Land	20,000	
Machinery	40,000	
Salaries........	30,000	
Patents........	15,000	
General Expenses	6,000	
Insurance	1,200	
Capital		1,42,000
Drawing	10,490	
Sundry Debtors	29,000	
Sundry Creditors		12,600
Total	3.53,160	3,53,160

5.10 IN-TEXT ACTIVITY

1. What is balance sheet?

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2. What is the difference between profit & loss a/c and balance sheet?

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3. What is the difference between balance sheet and trial balance?

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4. A manager is entitled to a commission of 10% on net profit before charging such commission. Net profit before charging such commission is Rs. 1,00,000. Find out the commission payable to the manager.

5.11 FURTHER READING

1. Double Entry Book Keeping (Financial Accounting): T.S.Grewal
2. Financial Accounting for Business : A. K. Bhattacharya
3. Elements of Book Keeping : C.M.Juneja J.S.Arora & R.C.Chawla