

CHAPTER

1



THEORETICAL FRAMEWORK



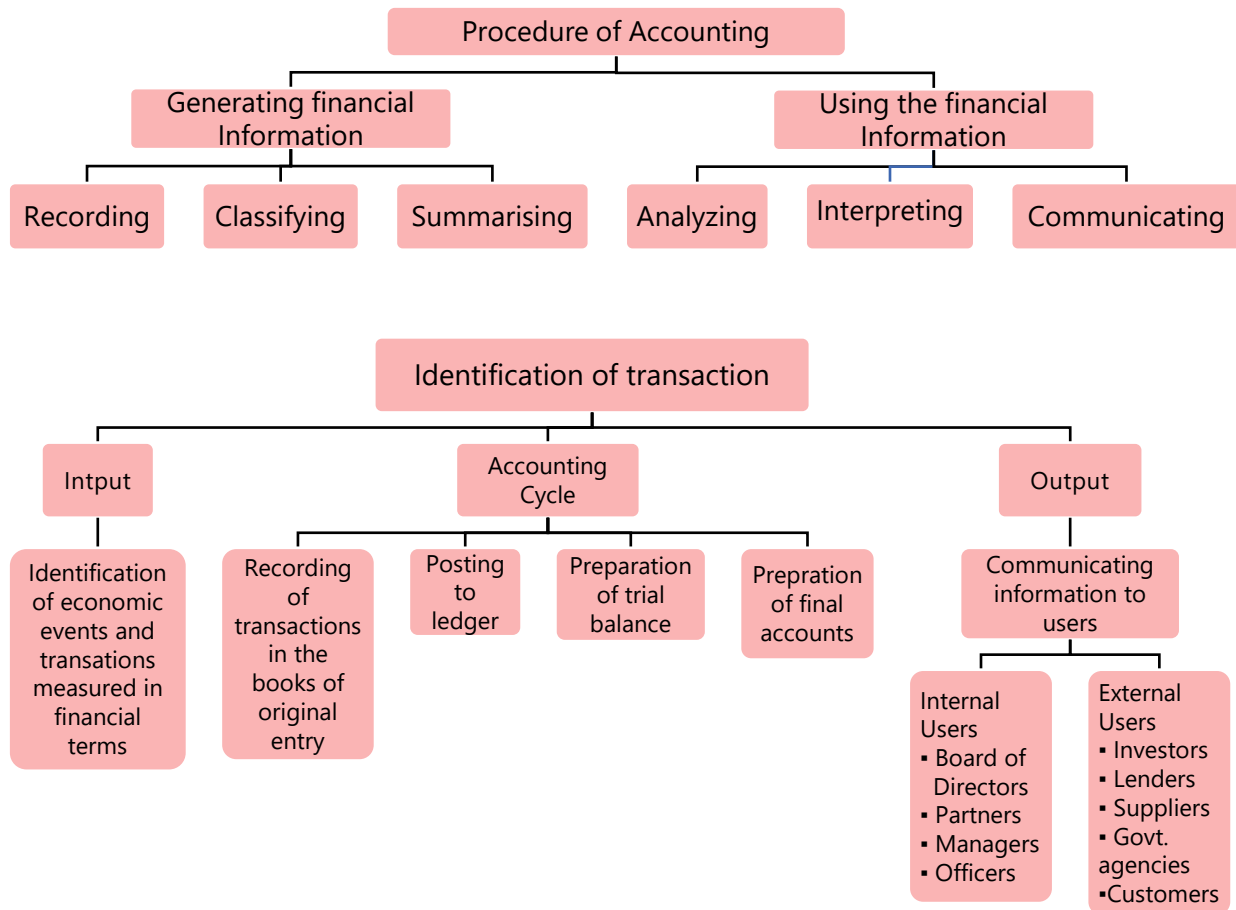
UNIT - 1 MEANING AND SCOPE OF ACCOUNTING

LEARNING OUTCOMES

After studying this unit, you would be able to:

- ◆ Understand the meaning and significance of accounting.
- ◆ Understand the meaning of book-keeping and the distinction of accounting with book-keeping.
- ◆ Appreciate the evolutionary process of accounting as a social science.
- ◆ Explain sub-fields of accounting.
- ◆ Identify the various user groups for whom accounting information is to be generated.
- ◆ Understand the relationship of Accounting with Economics, Statistics, Mathematics, Law and Management.
- ◆ Explain the limitations of accounting.
- ◆ Appreciate the enlarged boundary of accounting profession and the areas where in a chartered accountant plays an important role of rendering useful services to the society.

UNIT OVERVIEW



1.1 INTRODUCTION

Every individual performs some kind of economic activity. A salaried person gets salary and spends to buy provisions and clothing, for children's education, construction of house, etc. A sports club formed by a group of individuals, a business run by an individual or a group of individuals, a company running a business in telecom sector, a local authority like Calcutta Municipal Corporation, Delhi Development Authority, Governments, either Central or State, all are carrying some kind of economic activities. Not necessarily all the economic activities are run for any individual benefit; such economic activities may create social benefit i.e. benefit for the public, at large. Anyway, such economic activities are performed through '**transactions and events**'. **Transaction** is used to mean 'a business, performance of an act, an agreement' while **event** is used to mean 'a happening, as a consequence of transaction(s), a result.'

Example 1

An individual invests ₹ 2,00,000 for running a stationery business. On 1st January, he purchases goods for ₹ 1,15,000 and sells for ₹ 1,47,000 during the month of January. He pays shop rent for the month ₹ 5,000 and finds that still he has goods worth ₹ 15,000 in hand. The individual performs an economic activity. He carries on a few transactions and encounters with some events. Is it not logical that he will want to know the result of his activity?

We see that the individual, who runs the stationery business, earns a surplus of ₹ 42,000.

		₹
Goods sold		1,47,000
Goods in hand		15,000
		1,62,000
Less : Goods purchased	1,15,000	
Shop rent paid	5,000	(1,20,000)
Surplus		42,000

Earning of ₹ 42,000 surplus is an event; also having the inventories in hand is another event, while purchase and sale of goods, investment of money and payment of rent are transactions.

Similarly, a municipal corporation got government grant ₹ 500 lakhs for adult education; it spent ₹ 250 lakhs for purchasing literacy kits, paid ₹ 200 lakhs to the tutors and is left with a balance of ₹ 50 lakhs. These are also transactions and events.

Similarly, the Central Government raised money through taxes, paid salaries to the employees, and spent on various developmental activities. Whenever receipts of the Government are more than expenses it has surplus, but if expenses are more than receipts it runs in deficit. Here raising money through various sources can be termed as transaction and surplus or deficit at the end of the accounting year can be termed as an event.

A telecom company would need to ensure that it is providing the services for its millions of users for post-paid and pre-paid connections. Each activity done by a user (call, message, data usage) results into an economic event. The entity needs to keep appropriate and timely records to be able to collect money from post-paid connection users for the services availed by them. Likewise, the company will need to ensure that pre-paid connection customers are provided the support and the records confirm how much balance still remains to be utilized.

So, everybody wants to keep records of all transactions and events and to have adequate information about the economic activity as an aid to decision-making. Accounting discipline has been developed to serve this purpose as it deals with the measurement of economic

activities involving inflow and outflow of economic resources, which helps to develop useful information for decision-making process.

Accounting has universal application for recording transactions and events and presenting suitable information to aid decision-making regarding any type of economic activity ranging from a family function to functions of the national government. But hereinafter we shall concentrate only on business activities and their accounting because the objective of this study material is to provide a basic understanding on accounting for business activities. Nevertheless, it will give adequate knowledge to think coherently of accounting as a field of study for universal application.

The growth of accounting discipline is closely associated with the development of the business world. Thus, to understand accounting as a field of study for universal application, it is best identified with recording of business transactions and communication of financial information about business enterprise to facilitate decision-making. The aim of accounting is to meet the information needs of the rational and sound decision-makers, and thus, called the **language of business**.



1.2 MEANING OF ACCOUNTING

The Committee on Terminology set up by the American Institute of Certified Public Accountants formulated the following definition of accounting in 1961:

“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 result thereof.”

As per this definition, accounting is simply an art of record keeping. The process of accounting starts by first identifying the events and transactions which are of financial character and then be recorded in the books of account. Continuing with the same example of the telecom company, which needs to capture all transactions (transactions made by the user, raising invoice to the customer, receipt of money, payment towards salaries, marketing etc.). Likewise, the individual running the stationery business, would need to record all business transactions.

This recording is done in Journal or subsidiary books, also known as primary books. Every good record keeping system includes suitable classification of transactions and events as well as their summarisation for ready reference. For example, the telecom company performing thousands of transactions on a daily basis, is not expected to publish all those transactions for the users to be able to make a decision. Surely, those transactions need to be summarized appropriately.

After the transactions and events are recorded, they are transferred to secondary books, i.e., Ledger. In ledger, transactions and events are classified in terms of income, expense, assets and liabilities according to their characteristics and summarised in profit and loss account and balance sheet.

Essentially the transactions and events are to be measured in terms of money. Measurement in terms of money means measuring at the ruling currency of a country, for example, rupee in India, dollar in U.S.A. and like. The transactions and events must have at least in part, financial characteristics. The inauguration of a new branch of a bank is an event without having financial character, while the business disposed of by the branch is an event having financial character. Accounting also interprets the recorded, classified and summarized transactions and events. However, the above-mentioned definition does not reflect the present day accounting function. According to the above definition, accounting ends with interpretation of the results of the financial transactions and events but in the modern world with the diversification of management and ownership, globalization of business and society gaining more interest in the functioning of the enterprises, the importance of communicating the accounting results has increased.

Therefore, this requirement of communicating and motivating informed judgement has also become the part of accounting as defined in the widely accepted definition of accounting, given by the American Accounting Association in 1966 which treated accounting as:

“The process of identifying, measuring and communicating economic information to permit informed judgments and decisions by the users of accounts.”

In 1970, the Accounting Principles Board (APB) of American Institute of Certified Public Accountants (AICPA) enumerated the functions of accounting as follows:

“The function of accounting is to provide quantitative information, primarily of financial nature, about economic entities, that is needed to be useful in making economic decisions.”

Thus, accounting may be defined as the process of recording, classifying, summarising, analysing and interpreting the financial transactions and communicating the results thereof to the persons interested in such information.

The above definition requires accountants to assume a bigger responsibility than to merely do book-keeping. Accountants need to be ready to provide the information ready for the intended users to be able to make economic decisions.

1.2.1 Procedural aspects of Accounting

On the basis of the above definitions, procedure of accounting can be basically divided into two parts:

- (i) Generating financial information and
- (ii) Using the financial information.

Generating Financial Information

1. **Recording** – This is the basic function of accounting. All business transactions of a financial character, as evidenced by some documents such as sales bill, pass book, salary slip etc. are recorded in the books of account. Recording is done in a book called "Journal." This book may further be divided into several subsidiary books according to the nature and size of the business. Students will learn how to prepare journal and various subsidiary books in chapter 2.
2. **Classifying** – Classification is concerned with the systematic analysis of the recorded data, with a view to group transactions or entries of one nature at one place so as to put information in compact and usable form. The book containing classified information is called "Ledger". This book contains on different pages, individual account heads under which, all financial transactions of similar nature are collected. For example, there may be separate account heads for Salaries, Rent, Printing and Stationeries, Advertisement etc. All expenses under these heads, after being recorded in the Journal, will be classified under separate heads in the Ledger. This will help in finding out the total expenditure incurred under each of the above heads. Students will learn how to prepare ledger books in chapter 2.
3. **Summarising** – It is concerned with the preparation and presentation of the classified data in a manner useful to the internal as well as the external users of financial statements. This process leads to the preparation of the financial statements.
4. **Analysing** – The term 'Analysis' means methodical classification of the data given in the financial statements. The figures given in the financial statements will not help anyone unless they are in a simplified form. For example, all items relating to fixed assets are put at one place while all items relating to current assets are put at another place. It is concerned with the establishment of relationship between the items of the Profit and Loss Account and Balance Sheet i.e. it provides the basis for interpretation. Students will learn this aspect of financial statements in the later stages of the Chartered Accountancy Course.
5. **Interpreting** – This is the final function of accounting. It is concerned with explaining the meaning and significance of the relationship as established by the analysis of accounting data. The recorded financial data is analysed and interpreted in a manner that will

enable the end-users to make a meaningful judgement about the financial condition and profitability of the business operations. The financial statement should explain not only what had happened but also why it happened and what is likely to happen under specified conditions.

6. **Communicating** – It is concerned with the transmission of summarised, analysed and interpreted information to the end-users to enable them to make rational decisions. This is done through preparation and distribution of accounting reports, which include besides the usual profit and loss account and the balance sheet, additional information in the form of accounting ratios, graphs, diagrams, fund flow statements etc. Students will learn this aspect of financial statements in the later stages of the Chartered Accountancy Course.

The first two procedural stages of the process of generating financial information along with the preparation of trial balance are covered under book-keeping while the preparation of financial statements and its analysis, interpretation and also its communication to the various users are considered as accounting stages. Students will learn the term book-keeping and its distinction with accounting, in the coming topics of this unit.

Using the Financial Information

There are certain users of accounts. Earlier it was viewed that accounting is meant for the proprietor or owner of the business, but changing social relationships diluted the earlier thinking. Since earlier businesses were simple and not scaled, probably that view could hold true for those.

It is now believed that besides the owner or the management of the business enterprise, users of accounts include the investors, employees, lenders, suppliers, customers, government and other agencies and the public at large. For example, if an airlines company borrows money from a bank, buys oil from oil companies, sells tickets to the customers, has staff to be paid salaries to, all these group of people and entities are key stakeholders in that airlines business. They would like to know and understand whether the business of the company is going well or there are challenges for the company to run the business. Accounting provides the art of presenting information systematically to the users of accounts.

Accounting data is more useful if it stresses economic substance rather than technical form. Information is useless and meaningless unless it is relevant and material to a user's decision. The information should also be free of any biases. The users should understand not only the financial results depicted by the accounting figures, but also should be able to assess its reliability and compare it with information about alternative opportunities and the past experience. The owners or the management of the enterprise, commonly known as internal users, use the accounting information in an analytical manner to take the valuable decisions for

the business. So the information served to them is presented in a manner different to the information presented to the external users. Even the small details which can affect the internal working of the business are given in the management report while financial statements presented to the external users contains key information regarding assets, liabilities and capital which are summarised in a logical manner that helps them in their respective decision-making.



1.3 EVOLUTION OF ACCOUNTING AS A SOCIAL SCIENCE

History & Development of Accounting

Accounting finds its roots as early as around 4000 BC, where Egyptians used some form of accounting for their treasuries. The in-charge of treasuries had to send day wise reports to their superiors known as Wazirs and monthly reports were sent to kings. Babylonia, known as the city of commerce, used accounting for business to identify the losses that took place due to frauds and lack of efficiency. Greece used accounting to divide the revenues received among treasuries, maintaining receipts, payments and balance of government financial transactions. Romans used memorandum or daybook where in receipts and payments were recorded. (700 B.C to 400 A.D).

China used sophisticated form of government accounting as early as 2000 B.C. Accounting practices in India could be traced back to a period where, Kautilya, a minister in Chandragupta's kingdom wrote a book named Arthashastra, which also described how accounting records had to be maintained.

Luca Pacioli's, a Franciscan friar (merchant class), book *Summa de Arithmetica, Geometria, Proportion at Proportionality* (Review of Arithmetic and Geometric proportions) in Venice (1494) is considered as the first book on double entry bookkeeping. A portion of this book contains knowledge of business and book-keeping. He used the terms Debit (Dr.) and Credit (Cr.) in his books. These were the concepts used in Italian terminology. Debit comes from the Italian *debito* which comes from the Latin *debita* and *debeo* which means owed to the proprietor. Credit comes from the Italian *credito* which comes from the Latin 'credo' which means trust or belief (in the proprietor or owed by the proprietor).

In explaining double entry system, Pacioli wrote that 'All entries... have to be double entries, that is if you make one creditor, you must make some debtor'. He also mentioned that a merchant's responsibility is to give glory to God in their enterprises, to be ethical in all business activities and to earn a profit. He discussed the details of memorandum, journal, ledger and specialised accounting procedures.

In its oldest form, accounting aided the stewards to discharge their stewardship function. The wealthy men employed stewards to manage their property; the stewards in turn rendered an account periodically of their stewardship. This 'Stewardship Accounting' was the root of financial accounting system. Although double-entry system was followed, 'stewardship accounting' served the purpose of businessmen and wealthy persons at that time. In most of the countries, stewardship accounting was prevalent till the emergence of large-scale enterprises in the form of public limited companies.

In the second phase, the idea of financial accounting emerged with the concept of joint stock company and divorce of ownership from the management. To safeguard the interest of the shareholders and investors, disclosure of financial statements (mainly, profit and loss account and balance sheet) and other accounting information was moulded by law. Financial statements give periodic performance report by way of profit and loss account and financial position at the end of the period by way of Balance Sheet. It got the legal status due to changing relationships between the owners, economic entity and the managers. With the democratisation of society, the relationships between the enterprise on the one hand, the investors, employees, managers and governments on the other, have also undergone a sea-change. Also, the prospective investors and other business contact groups want to know a lot about the business before entering into transactions. Thus, financial accounting emerged as an information system to identify, measure and communicate useful information for informed judgements and decisions by a broad group of users. In the third phase, accounting information was generated to aid management decision-making in particular. It contributed a lot to improve the quality of management decisions. This new dimension of accounting is called Management Accounting and it is the development of 20th Century only. It is pervasive enough to cover all spheres of management decisions.

Lastly, Social Responsibility Accounting is in the formative process, which aims at accounting for the social cost incurred by business as well as the social benefit, created by it. It emerges from the growing social awareness about the undesirable by-products of economic activities. While earning profit, an enterprise incurs numerous social costs like pollution, using the resources of society like materials, land, labour etc. To compensate for this social cost, in today's world, an enterprise is expected to generate some social benefits also like employment opportunities, recreation activities, more choice to customers at reasonable price, better quality products etc. Therefore, it is demanded that the accounting system should produce a report measuring the social cost incurred and social benefits generated.

Social Science study man as a member of society; they concern about social processes and the results and consequences of social relationships. The usefulness of accounting to society as a whole is the fundamental criterion to treat it as a social science. Although individuals may

benefit from the availability of accounting information, the accounting system generates information for social good. It serves social purpose, it contributes for social progress; also it is being adapted to keep pace with social progress. So, accounting is treated as a social science.

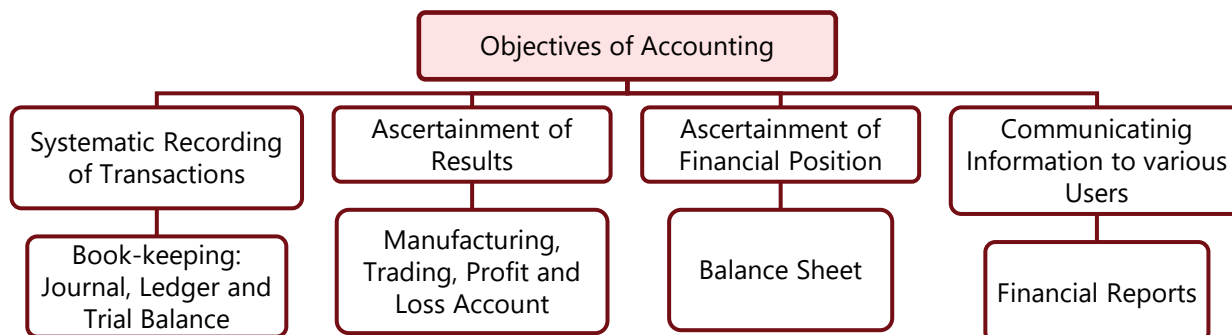


1.4 OBJECTIVES OF ACCOUNTING

The objectives of accounting can be given as follows:

1. **Systematic recording of transactions** – Basic objective of accounting is to systematically record the financial aspects of business transactions, i.e., book-keeping. These recorded transactions are later on classified and summarized logically for the preparation of financial statements and for their analysis and interpretation.
2. **Ascertainment of results of above recorded transactions** – Accountant prepares profit and loss account to know the results of business operations for a particular period of time. If revenue (Sales) exceeds expenses then it is said that business is running profitably but if expenses exceed revenue, then it can be said that business is running under loss. The profit and loss account helps the management and different stakeholders in taking rational decisions. For example, if business is not proved to be remunerative or profitable, the cause of such a state of affair can be investigated by the management for taking remedial steps.
3. **Ascertainment of the financial position of the business** – A businessman is not only interested in knowing the results of the business in terms of profits or loss for a particular period but is also anxious to know that what he owes (liability) to the outsiders and what he owns (assets) on a certain date. To know this, accountant prepares a financial position statement popularly known as Balance Sheet. The balance sheet is a statement of assets and liabilities of the business at a particular point of time and helps in ascertaining the financial health of the business.
4. **Providing information to the users for rational decision-making** – Accounting as a 'language of business' communicates the financial results of an enterprise to various stakeholders by means of financial statements. Accounting aims to meet the information needs of the decision-makers and helps them in rational decision-making.
5. **To know the solvency position** – By preparing the balance sheet, management not only reveals what is owned and owed by the enterprise, but also it gives the information regarding concern's ability to meet its liabilities in the short run (liquidity position) and also in the long-run (solvency position) as and when they fall due.

An overview of objectives of accounting is depicted in the chart given below:



1.5 FUNCTIONS OF ACCOUNTING

The main functions of accounting are as follows:

- (a) **Measurement:** Accounting measures past performance of the business entity and depicts its current financial position.
- (b) **Forecasting:** Accounting helps in forecasting future performance and financial position of the enterprise using past data and analysing trends.
- (c) **Decision-making:** Accounting provides relevant information to the users of accounts to aid rational decision-making.
- (d) **Comparison & Evaluation:** Accounting assesses performance achieved in relation to targets and discloses information regarding accounting policies and contingent liabilities which play an important role in predicting, comparing and evaluating the financial results.
- (e) **Control:** Accounting also identifies weaknesses of the operational system and provides feedbacks regarding effectiveness of measures adopted to check such weaknesses.
- (f) **Government Regulation and Taxation:** Accounting provides necessary information to the government to exercise control on the entity as well as in collection of tax revenues.



1.6 BOOK-KEEPING

Book-keeping is an activity concerned with the recording of financial data relating to business operations in a significant and orderly manner. It covers procedural aspects of accounting work and embraces record keeping function. Obviously, book-keeping procedures are governed by the end product, the financial statements. The term 'financial statements' means Profit and Loss Account, Balance Sheet and cash flow statements including Schedules and Notes forming part of Accounts.

Book-keeping also requires suitable classification of transactions and events. This is also determined with reference to the requirement of financial statements. A book-keeper may be responsible for keeping all the records of a business or only of a minor segment, such as position of the customers' accounts in a departmental store. Accounting is based on a careful and efficient book-keeping system.

The essential idea behind maintaining book-keeping records is to show correct position regarding each head of income and expenditure. A business may purchase goods on credit as well as in cash. When the goods are bought on credit, a record must be kept of the person to whom money is owed. The proprietor of the business may like to know, from time to time, what amount is due on credit purchase and to whom. If proper record is not maintained, it is not possible to get details of the transactions in regard to the income and expenses. At the end of the accounting period, the proprietor wants to know how much profit has been earned or loss has been incurred during the course of the period. For this lot of information is needed which can be gathered from a proper record of the transactions. Therefore, in book-keeping, the proper maintenance of books of account is indispensable for any business.

At this level, the major concern of the curriculum is with book-keeping and preparation of financial statements. It seems important to mention at this point that book-keeping and preparation of financial statements have legal implications also. Maintenance of books of accounts and the preparation of financial statements of a company are guided by the Companies Act, banks and insurance companies by special Acts governing these institutions and so on. However, for sole-proprietorship and partnership business, there is no specific legislation regarding maintenance of books of accounts and preparation of financial statements.

1.6.1 Objectives of Book-keeping

1. **Complete Recording of Transactions** – It is concerned with complete and permanent record of all transactions in a systematic and logical manner to show its financial effect on the business.
2. **Ascertainment of financial Effect on the Business** – It is concerned with the combined effect of all the transactions made during the accounting period upon the financial position of the business as a whole.



1.7 DISTINCTION BETWEEN BOOK-KEEPING AND ACCOUNTING

Some people mistake book-keeping and accounting to be synonymous terms, but in fact they are different from each other. Accounting is a broad subject. It calls for a greater understanding of records obtained from book-keeping and an ability to analyse and interpret the information provided by book-keeping records. Book-keeping is the recording phase while accounting is

concerned with the summarising phase of an accounting system. Book-keeping provides necessary data for accounting and accounting starts where book-keeping ends.

S. No.	Book-keeping	Accounting
1.	It is a process concerned with recording of transactions.	It is a process concerned with summarising of the recorded transactions.
2.	It constitutes as a base for accounting.	It is considered as a language of the business.
3.	Financial statements do not form part of this process.	Financial statements are prepared in this process on the basis of book-keeping records.
4.	Managerial decisions cannot be taken with the help of these records.	Management takes decisions on the basis of these records.
5.	There is no sub-field of book-keeping.	It has several sub-fields like financial accounting, management accounting etc.
6.	Financial position of the business cannot be ascertained through book-keeping records.	Financial position of the business is ascertained on the basis of the accounting reports.

Relationship of Accounting and Book-keeping can be depicted in the following chart as





1.8 SUB-FIELDS OF ACCOUNTING

The various sub-fields of accounting are:

- (i) **Financial Accounting** – It covers the preparation and interpretation of financial statements and communication to the users of accounts. It is historical in nature as it records transactions which had already been occurred. The final step of financial accounting is the preparation of Profit and Loss Account and the Balance Sheet. It primarily helps in determination of the net result for an accounting period and the financial position as on the given date.
- (ii) **Management Accounting** – It is concerned with internal reporting to the managers of a business unit. To discharge the functions of stewardship, planning, control and decision- making, the management needs variety of information. The different ways of grouping information and preparing reports as desired by managers for discharging their functions are referred to as management accounting. A very important component of the management accounting is cost accounting which deals with cost ascertainment and cost control. Management Accounting will be dealt with at higher levels of the Chartered Accountancy Course.
- (iii) **Cost Accounting** – The terminology of Cost Accounting published by the Institute of Cost and Management Accountants of England defines cost accounting as:
“the process of accounting for cost which begins with the recording of income and expenditure or the bases on which they are calculated and ends with the preparation of periodical statements and reports for ascertaining and controlling costs.”
- (iv) **Social Responsibility Accounting** – The demand for social responsibility accounting stems from increasing social awareness about the undesirable by-products of economic activities. As already discussed earlier, social responsibility accounting is concerned with accounting for social costs incurred by the enterprise and social benefits created.
- (v) **Human Resource Accounting** – Human resource accounting is an attempt to identify, quantify and report investments made in human resources of an organisation that are not presently accounted for under conventional accounting practice.



1.9 USERS OF ACCOUNTING INFORMATION

Generally users of accounts are classified into two categories, (a) internal users and (b) external users. Management accounting is concerned with identifying information requirements as well as methods of providing such information to management while information requirements of the outside users are generally served by financial statements. Following are the various users of accounting information:

- (i) **Investors:** They provide risk capital to the business. They need information to assess whether to buy, hold or sell their investment. Also they are interested to know the ability of the business to survive, prosper and to pay dividend. In non-corporate sector, where ownership and management are not essentially separated, the owners still need information about performance of the business and its financial position to decide whether to continue or shut down.
- (ii) **Employees:** Growth of the employees is directly related to the growth of the organisation and therefore, they are interested to know the stability, continuity and growth of the enterprise and its ability to provide remuneration, retirement and other benefits and to enhance employment opportunities.
- (iii) **Lenders:** They are interested to know whether their loan-principal and interest will be paid back when due.
- (iv) **Suppliers and Creditors:** They are also interested to know the ability of the enterprise to pay their dues, that helps them to decide the credit policy for the relevant concern, rates to be charged and so on. Sometimes, they also become interested in long-term continuation of the enterprise if their existence becomes dependent on the survival of that business.
- (v) **Customers:** Customers are also concerned with the stability and profitability of the enterprise because their functioning is more or less dependent on the supply of goods, suppose, a company produces some chemicals used by pharmaceutical companies and supplies chemicals on three month's credit. If all of a sudden it faces some trouble and is unable to supply the chemical, the customers will also be in trouble.
- (vi) **Government and their agencies:** They regulate the functioning of business enterprises for public good, allocate scarce resources among competing enterprises, control prices, charge excise duties and taxes, and so they have continued interest in the business enterprise.
- (vii) **Public:** The public at large is interested in the functioning of the enterprise because it may make a substantial contribution to the local economy in many ways including the number of people employed and their patronage to local suppliers.
- (viii) **Management:** Management as whole is also interested in the accounts for various managerial decisions. On the basis of the accounts, management determines the effects of their various decisions on the functioning of the organisation. This helps them to make further managerial decisions.



1.10 RELATIONSHIP OF ACCOUNTING WITH OTHER DISCIPLINES

Accounting is closely related with several other disciplines and thus to acquire a good knowledge in accounting one should be conversant with the relevant portions of such disciplines. In many cases they overlap accounting. The accountant should have a working knowledge of the related disciplines so that he can understand such overlapping areas and apply the knowledge of other disciplines in his own work wherever possible, or he can take the expert advice.

- (a) **Accounting and Economics:** Economics is viewed as a science of rational decision-making about the use of scarce resources. It is concerned with the analysis of efficient use of scarce resources for satisfying human wants. This may be viewed either from the perspective of a single firm or of the country as a whole.

Accounting is viewed as a system, which provides data to the users to permit informed judgement and decisions. Some non-accounting data are also relevant for decision-making.

Accounting overlaps economics in many respects. It contributed a lot in improving the management decision-making process. But, economic theories influenced the development of the decision-making tools used in accounting.

However, there exists a wide gulf between economists' and accountants' concepts of income and capital. Accountants got the ideas of value, income and capital maintenance from economists, but brushed suitably to make them usable in practical circumstances. Accountants developed the valuation, measurement and decision-making techniques which may owe to the economic theorems for origin but these are moulded in the work environment and suitably tempered with reference to relevance, verifiability, freedom from bias, timeliness, comparability, reliability and understandability.

An example may be given to explain the nexus between accounting and economics. Economists think that value of an asset is the present value of all future earnings which can be derived from such assets. Now think about a plant whose working life is more than one hundred years. How can you estimate future stream of earnings? So accountants developed the workable valuation base – the acquisition cost i.e., the price paid to acquire the assets.

At the macro-level, accounting provides the database over which the economic decision models have been developed; micro-level data arranged by the accounting system is summed up to get macro-level database.

Non-overlapping zones of accounting are not negligible. Development of the systems of recording, classifying and summarising transactions and events, harmonising the systems by uniform rules and communicating the data is essentially a non-overlapping area of accounting.

- (b) **Accounting and Statistics:** The use of statistics in accounting can be appreciated better in the context of the nature of accounting records. Accounting information is very precise; it is exact to the last paisa. But, for decision-making purposes such precision is not necessary and hence, the statistical approximations are sought.

In accounts, all values are important individually because they relate to business transactions. As against this, statistics is concerned with the typical value, behaviour or trend over a period of time or the degree of variation over a series of observations. Therefore, wherever a need arises for only broad generalisations or the average of relationships, statistical methods have to be applied in accounting data.

Further, in accountancy, the classification of assets and liabilities as well as the heads of income and expenditure has been done as per the needs of financial recording to ascertain financial results of various operations. Other types of classification like the geographical and historical ones and ad hoc classification are done depending on the purpose to make such classification meaningful.

Accounting records generally take a short-term view of events and are confined to a year while statistical analysis is more useful if a longer view is taken for the purpose. For example, to fit the trend line a longer period will be required. However, statistical methods do use past accounting records maintained on a consistent basis.

The functional relations showing mathematical relations of one variable with one or more other variables are based on statistical work. These relations are used widely in making cost or price estimates for some estimated future values assigned to the given independent variables. For example, given the functional relation of total cost to the price of an input, the effect of changes in future prices on the cost of production can be calculated.

In accountancy, a number of financial and other ratios are based on statistical methods, which help in averaging them over a period of time. Several accounting and financial calculations are based on statistical formulae.

Statistical methods are helpful in developing accounting data and in their interpretation. For example, time series and cross-sectional comparison of accounting data is based on statistical techniques. Now- a-days multiple discriminate analysis is popularly used to identify symptoms of sickness of a business firm. Therefore, the study and application of statistical methods would add extra edge to the accounting data.

- (c) **Accounting and Mathematics:** Double Entry book-keeping can be converted in algebraic form; in fact the first known book on this subject was part of a treatise on algebra. The fundamental accounting equation will be discussed in detail under 'Dual Aspect Concept' of this chapter.

Knowledge of arithmetic and algebra is a pre-requisite for accounting computations and measurements. Calculations of interest and annuity are the examples of such fundamental uses. While computing depreciation, finding out installments in hire-purchase and instalments payment transactions, calculating amount to be set aside for repayment of loan and replacement of assets and calculating lease rentals, mathematical techniques are frequently used. Accounting data are also presented in ratio form.

With the advent of the computer, mathematics is becoming a vital part of accounting. Instead of writing accounts in traditional fashion, the transactions and events can be recorded in the matrix form and the rules of matrix algebra can be applied for classifying and summarising data.

Now-a-days statistics and econometric models are largely used for developing decision models for the users of accounts. Also, Operations Research Techniques provide lot of decision models. Since accounting is meant for providing information to the users, to be effective, accounting data should feed the information requirements of such statistical, econometric and operations research models. Understanding mathematics has become a must to grasp the decision models framed by statisticians, econometricians and the O.R. experts.

Presently graphs and charts are being extensively used for communicating accounting information. In addition to statistical knowledge, knowledge in geometry and trigonometry seems to be essential to have a better understanding about the accounting communications system.

- (d) **Accounting and Law:** An economic entity operates within a legal environment. All transactions with suppliers and customers are governed by the Contract Act, the Sale of Goods Act, the Negotiable Instruments Act, etc. The entity itself is created and controlled by laws. For example, a company is created by the Companies Act and also controlled by Companies Act.

Similarly, every country has a set of economic, fiscal and labour laws. Transactions and events are always guided by laws of the land. Very often the accounting system to be followed has been prescribed by the law. For example, the Companies Act has prescribed the format of financial statements for companies.

Banking, insurance and electric supply undertakings may also have to produce financial statements as prescribed by the respective legislations controlling such entities.

However, legal prescription about the accounting system is the product of developments in accounting knowledge. That is to say, legislation about accounting system cannot be enacted unless there is a corresponding development in the accounting discipline. In that way accounting influences law and is also influenced by law.

- (e) **Accounting and Management:** Management is a broad occupational field, which comprises many functions and encompasses application of many disciplines including those mentioned above. Accountants are well placed in the management and play a key role in the management team. A large portion of accounting information is prepared for management decision-making. Although management relies on other data sources, accounting data are used as basic source documents. In the management team, an accountant is in a better position to understand and use such data. In other words, since an accountant plays an active role in management, he understands the data requirements. So the accounting system can be moulded to serve the management purpose.



1.11 LIMITATIONS OF ACCOUNTING

There are certain misconceptions regarding financial statements. A common man presumes that an income statement shows the correct income or loss of the enterprise and that a balance sheet depicts a perfectly true and fair picture of financial standing of that enterprise. It must be recognised that the accounting as a language has its own limitations. The figures of profit or loss generated by the accounting process are subject to various constraints within which the accounting works. The assumptions and conventions, on which the accounting is based, become the limitations of accounting. The financial statements are never free from subjectivity factor as these are largely the outcome of personal judgement of the accountant with regard to the adoption of the accounting policies. Following are certain instances:

1. The factors which may be relevant in assessing the worth of the enterprise don't find place in the accounts as they cannot be measured in terms of money. The Balance sheet cannot reflect the value of certain factors like loyalty and skill of the personnel which may be the most valuable asset of an enterprise these days.
2. Balance Sheet shows the position of the business on the day of its preparation and not on the future date while the users of the accounts are interested in knowing the position of the business in the near future and also in long run and not for the past date.
3. Accounting ignores changes in some money factors like inflation etc.

4. There are occasions when accounting principles conflict with each other.
5. Certain accounting estimates depend on the sheer personal judgement of the accountant, e.g., provision for doubtful debts, method of depreciation adopted, recording certain expenditure as revenue expenditure or capital expenditure, selection of method of valuation of inventories and the list is quite long.
6. Financial statements consider those assets which can be expressed in monetary terms. Human resources although the very important asset of the enterprise are not shown in the balance sheet. There is no generally accepted formula for the valuation of human resources in money terms.
7. Different accounting policies for the treatment of same item adds to the probability of manipulations. Though through various laws and Accounting Standards, efforts are made to reduce these options to minimum but certainly could not be reduced to one.

In nutshell, it can be said that the language of accounting has certain practical limitations and, therefore, the financial statements should be interpreted carefully keeping in mind all various factors influencing the true picture.



1.12 ROLE OF ACCOUNTANT IN THE SOCIETY

There are only a few types of profession in the world which are held in high esteem in public eyes and there is no denying the fact that the accounting profession is one of them. Goethe had called the accountant's profession as 'the fairest invention of the human mind'. At the core of all types of learned profession, there is the desire of public good and of finding the best way to serve society. By the use of the science of accountancy and under the spell of its art, a dynamic pattern which assists business in planning its future is woven by accountants out of the inert mass of non-speaking silent figures. This is what makes their profession an instrument of socio-economic change and welfare of the society.

An accountant with his education, training, analytical mind and experience is best qualified to provide multiple need-based services to the ever growing society. The accountants of today can do full justice not only to matters relating to taxation, costing, management accounting, financial lay-out, company legislation and procedures but they can delve deep into the fields relating to financial policies, budgetary policies and even economic principles. The area of activities which can be undertaken by the accountants is not limited but it can also cover many additional facets.

1.12.1 Areas of Service

The practice of accountancy has crossed its usual domain of preparation of financial statements, interpretation of such statements and audit thereof. Accountants are presently taking active role in company laws and other corporate legislation matters, in taxation laws matters (both direct and indirect) and in general management problems. Some of the services rendered by accountants to the society are briefly mentioned hereunder:

- (i) **Maintenance of Books of Accounts:** An accountant is able to maintain a systematic record of financial transactions in order to establish the net result of the transactions entered into during a period and to state the financial position of the concern as at a particular date.

For the fulfillment of the twin objective of ascertaining the profit earned or loss suffered and the financial position, it is necessary that all transactions be recorded in a systematic manner, which can be done only by an accountant. Proper maintenance of books of accounts assists management in planning, decision-making, controlling functions.

- (ii) **Statutory Audit:** Every limited company is required to appoint a chartered accountant or a firm of chartered accountants as their auditor who are statutorily required to report each year whether in their opinion the balance sheet shows a true and fair view of the state of affairs on the balance sheet date, and the profit and loss account shows a true and fair view of the profit or loss for the year.

Auditing is not confined to the accounts of companies; other organisations may also have their accounts audited, either because the law so requires (for example, the Co-operative Societies Act, the Income-tax Act, etc.) or because the proprietors wisely decided so (for example, a partnership firm or an individual trader).

- (iii) **Internal Audit:** It is a management tool whereby an internal auditor thoroughly examines the accounting transactions and also the system, according to which these have been recorded with a view to ensure the management that the accounts are being properly maintained and the system contains adequate safeguards to check any leakage of revenue or misappropriation of property or assets and the operations have been carried out in conformity with the plans of management.

Now-a-days internal auditing has developed as a service to management. The internal auditor constructively contributes in improving the operational efficiency of the business through an independent review and appraisal of all business operations.

- (iv) **Taxation:** An accountant can handle taxation matters of a business or a person and he can represent that business or person before the tax authorities and settle the tax liability

under the statute prevailing. He can also assist in avoiding or reducing tax burden by proper planning of tax affairs.

Accountants also have a social obligation to express their views on broad tax policy, on the effect of tax rate on business and the economy in general and on all other aspects of taxation in which they have knowledge superior to that of the general public.

- (v) **Management Accounting and Consultancy Services:** Management accountant performs an advisory function. He is largely responsible for internal reporting to the management for planning and controlling current operations, decision-making on special matters and for formulating long-range plans. His job is to collect, analyse, interpret and present all accounting information which is useful to the management. Accountant provides management consultancy services in the areas of management information system, expenditure control and evaluation of appraisal techniques for new investments and divestments, working capital management, corporate planning etc.
- (vi) **Financial Advice:** Many people need help and guidance in planning their personal financial affairs. An accountant who knows about finances, taxation and family problems is well placed to give such advice. Some of the areas in which an accountant can render financial advice are:
 - (a) **Investments:** An accountant can explain the significance of the formidable documents which shareholders receive from companies and help in making decisions relating to their investments.
 - (b) **Insurance:** An accountant can provide information to his clients on various insurance policies and helps in choosing appropriate policy.
 - (c) **Business Expansion:** As businesses grow in size and complexity and mergers are being considered, accountants are in the forefront in interpreting accounts, making suggestions as to the form of schemes and the fairness of proposals considering cost and financial consequences and generally advising their clients. They also advise on how to set about the problem of borrowing money or whether this is an appropriate method of finance. Accountants can render extremely useful service in connection of negotiations with foreign collaborators.
 - (d) **Investigations:** Financial investigations are required for a variety of purposes. Examples are:
 - (i) To ascertain the financial position of a business, for the information of interested parties in connection with an issue of capital, the purchase or sale of the business or a reconstruction or amalgamation.

- (ii) To help the management to decide whether it is cheaper to manufacture an article or to buy out.
- (iii) To ascertain why profits have fallen.
- (iv) To achieve greater efficiency in management.
- (v) To ascertain whether fraud has occurred and if so, its nature and extent and to make suggestions which will help to prevent a recurrence.
- (vi) To value businesses and shares in private companies for purposes such as purchase, sale, estate duty or wealth tax etc.

For such problems requiring financial investigation, you need an accountant. His task as an independent professional is to establish the facts fairly and clearly for the benefit of those who have to make decisions and to give advice in many areas in which he has competence and experience.

- (e) Pension schemes: Specialist advice from actuaries, insurance agents or insurance company is needed before launching or amending a provident fund or pension scheme in a business. But before making a final decision, an accountant has to be consulted. Later on, his help may be needed for managing the scheme or obtaining tax relief.

(vii) Other Services

- (a) Secretarial Work: Companies, clubs, and associations indeed, virtually all organisations involve secretarial work. Accountants frequently do this work.
- (b) Share Registration Work: Accountants are often used by many companies to undertake the work involved in registering share transfers and new issues.
- (c) Company Formation: In conjunction with legal advisers, accountants help in the formation of a company or advise against doing so.
- (d) Receiverships, Liquidations, etc.: An accountant has to sometimes take on the onerous duties of liquidator when a company is being wound up or receiver when a debenture holder exercises a right to recover a loan on which the borrower has defaulted. Accountant is just the man for the job. He is also just the man to help you to keep insolvency away if you consult him in time.
- (e) Arbitrations: At times, accountants are invited by parties to act as arbitrators in a dispute or settle disputes of various kinds.
- (f) As regards the Cost Accounts: A cost accountant's job is to continuously report cost data and related information at frequent intervals to the management.

- (g) Accountant and Information Services: An accountant will be effective in his role if he supplies the information promptly and in an unambiguous language. He should develop a system by which there is a regular flow of information both horizontally and vertically.

The information system should be such that comparability of financial statement is possible both business-wise and year-wise so that it benefits both the management and the investors. Dependence on data from the computerised information system will put new responsibilities on an accountant but his product will command greater attention and respect.

1.12.2 Chartered Accountant in Industry

An accountant, though he is a part of the highest planning team is not a planner in an industry. He works with the functional departments and translates the organisation's aims in terms of financial expectations. Therefore, he has to make a thorough study of the business and of individuals in the functional departments, whether they are engineers or salesmen. A qualified accountant will be able to play an important role in performing important functions of a business relating to accounting, costing and budgetary control, estimating and treasury.

1.12.3 Chartered Accountant in Public Sector Enterprises

Both in the developed and developing countries, public sector enterprises have become a special feature of the national economy. The system of financial and budgetary control and of accounting, auditing and reporting has, therefore, become a matter of interest and concern to the nation, and does not remain confined merely to a limited number of shareholders. The form of accounting followed by these corporations or companies is different from that of ordinary government accounting. It is the duty of the accountants to prepare the accounts and reports of these public corporations in such a way that they enable the general public to know how far the items appearing in the various types of records and financial statements justify their existence.

1.12.4 Chartered Accountant in Framing Fiscal Policies

Accountants have a positive role to play in the determination of proper fiscal policies and advancement of trade, commerce and industry. They should develop new techniques and prepare themselves for new fields of service towards their commitment to the concept of the public goods and services. A business enterprise can be successful in the commercial sense only if accounting and business knowledge are pooled together. It is a social obligation for both accountants in industry and in practice to disclose greater information regarding the corporate results. The state of affairs of the economy can be ascertained only when such consolidated corporate information is disclosed.

1.12.5 Chartered Accountant and Economic Growth

In the present times accountants should conceive their duties as broadly as the conditions might require and do not restrict them to only literal compliance of the law. Their aim should be not to allow any individual to gain at the cost of the nation. Accountants have to accept a positive role and do their best to encourage efficiency in individual business units and encourage those social objectives which form the main foundation of a welfare state.

SUMMARY

- ◆ "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 result thereof."
- ◆ Accounting procedure can be basically divided into two parts:
 - (i) Generating financial information and
 - (ii) Using the financial information.
- ◆ The objectives of accounting can be given as follows:
 - (i) Systematic recording of transactions
 - (ii) Ascertainment of results of above recorded transactions
 - (iii) Ascertainment of the financial position of the business
 - (iv) Providing information to the users for rational decision-making
 - (v) To know the solvency position

The main functions of accounting are as follows:

(i) Measurement	(ii) Forecasting
(iii) Decision-making	(iv) Comparison & Evaluation
(v) Control	(vi) Government Regulation and Taxation
- ◆ Objectives of Book-keeping:
 - (i) Complete Recording of Transactions and
 - (ii) Ascertainment of Financial Effect on the Business
- ◆ The various sub-fields of accounting are:
 - (i) Financial Accounting
 - (ii) Management Accounting

- (iii) Cost Accounting
- (iv) Social Responsibility Accounting
- (v) Human Resource Accounting

♦ The various users of accounting information:

- (i) Investors
- (ii) Employees
- (iii) Lenders
- (iv) Suppliers and Creditors
- (v) Customers
- (vi) Government and their agencies
- (vii) Public
- (viii) Management

♦ Accounting is closely related with several other disciplines and thus to acquire a good knowledge in accounting one should be conversant with the relevant portions of such disciplines.

An accountant with his education, training, analytical mind and experience is best qualified to provide multiple need-based services to the ever growing society. The accountants of today can do full justice not only to matters relating to taxation, costing, management accounting, financial lay-out, company legislation and procedures but they can delve deep into the fields relating to financial policies, budgetary policies and even economic principles.

TEST YOUR KNOWLEDGE

True and False

1. *There is no difference between book keeping and accounting, both are same.*
2. *Management Accounting covers the preparation and interpretation of financial statements and communication to the users of accounts.*
3. *Financial accounting is concerned with internal reporting to the managers of a business unit.*
4. *Customers of business should not be considered as users of accounts prepared by business. They are not interested to know performance of the business*
5. *Summarising is the basic function of accounting. All business transactions of a financial characters evidenced by some documents such as sales bill, pass book, salary slip etc. are recorded in the books of account.*
6. *Balance sheet shows the position of the business on the day of its preparation and not on the future date.*
7. *Objectives of book-keeping are complete recording of transactions & ascertainment of financial effect on the business.*

Multiple Choice Questions

1. Which of the following is not a subfield of accounting?
 - (a) Management accounting.
 - (b) Cost accounting.
 - (c) Book-keeping
2. Purposes of an accounting system include all the following except
 - (a) Interpret and record the effects of business transaction.
 - (b) Classify the effects of transactions to facilitate the preparation of reports.
 - (c) Dictate the specific types of business enterprise transactions that the enterprises may engage in.
3. Book-keeping is mainly concerned with
 - (a) Recording of financial data.
 - (b) Designing the systems in recording, classifying and summarising the recorded data.
 - (c) Interpreting the data for internal and external users.
4. All of the following are functions of Accounting except
 - (a) Decision making.
 - (b) Ledger posting.
 - (c) Forecasting.
5. Financial statements are part of
 - (a) Accounting.
 - (b) Book-keeping.
 - (c) Management Accounting.
6. Financial position of the business is ascertained on the basis of
 - (a) Records prepared under book-keeping process.
 - (b) Trial balance.
 - (c) Balance Sheet.
7. Users of accounting information include
 - (a) Creditors/Suppliers

- (b) *Lenders/Customers*
 - (c) *Both (a) and (b)*
8. *Financial statements do not consider*
- (a) *Assets expressed in monetary terms.*
 - (b) *Liabilities expressed in monetary terms.*
 - (c) *Assets and liabilities expressed in non-monetary terms*
9. *On January 1, Sohan paid rent of ₹5,000. This can be classified as*
- (a) *An event.*
 - (b) *A transaction.*
 - (c) *A transaction as well as an event.*
10. *On March 31, 2022 after sale of goods worth ₹2,000, he is left with the closing inventory of ₹10,000. This is*
- (a) *An event.*
 - (b) *A transaction.*
 - (c) *A transaction as well as an event.*
11. *Which of the following is not a business transaction?*
- (a) *Bought a machine of ₹10,000 for business*
 - (b) *Paid towards salaries of employees ₹5,000*
 - (c) *Paid son's fees from her personal bank account ₹8,000*
12. *Which qualitative characteristics of accounting information is reflected when accounting information is clearly presented?*
- (a) *Understandability*
 - (b) *Relevance*
 - (c) *Comparability*

Theoretical Questions

1. *Define accounting. What are the sub-fields of accounting?*
2. *Who are the users of accounting information?*
3. *Discuss briefly the relationship of accounting with*

(i) Economics (ii) Statistics (iii) Law

4. Discuss the limitations which must be kept in mind while evaluating the Financial Statements.
5. What services can a Chartered Accountant provide to the society?

ANSWER/HINTS

True and False

1. False: Book-keeping and accounting are different from each other. Accounting is a broad subject. It calls for a greater understanding of records obtained from book-keeping and an ability to analyse and interpret the information provided by book-keeping records.
Book-keeping is the recording phase while accounting is concerned with the summarizing phase of an accounting system.
2. False: Financial accounting covers the preparation and interpretation of financial statements and communication to the users of accounts.
3. False: Management accounting is concerned with internal reporting to the managers of a business unit.
4. False: Customers are also concerned with the stability and profitability of the enterprise because their functioning is more or less dependent on the supply of goods
5. False: Recording is the basic function of accounting. Summarising is concerned with the preparation and presentation of the classified data in a manner useful to the internal as well as the external users of financial statements
6. True: Balance Sheet is a statement of the financial position of an enterprise at a given date.
7. True: Book-keeping is concerned with complete recording and combined effect of transactions made during the accounting period.

Multiple Choice Questions

1.	(c)	2.	(c)	3.	(a)	4.	(b)	5.	(a)	6.	(c)
7.	(c)	8.	(c)	9.	(b)	10.	(a)	11.	(c)	12.	(a)

Theoretical Questions

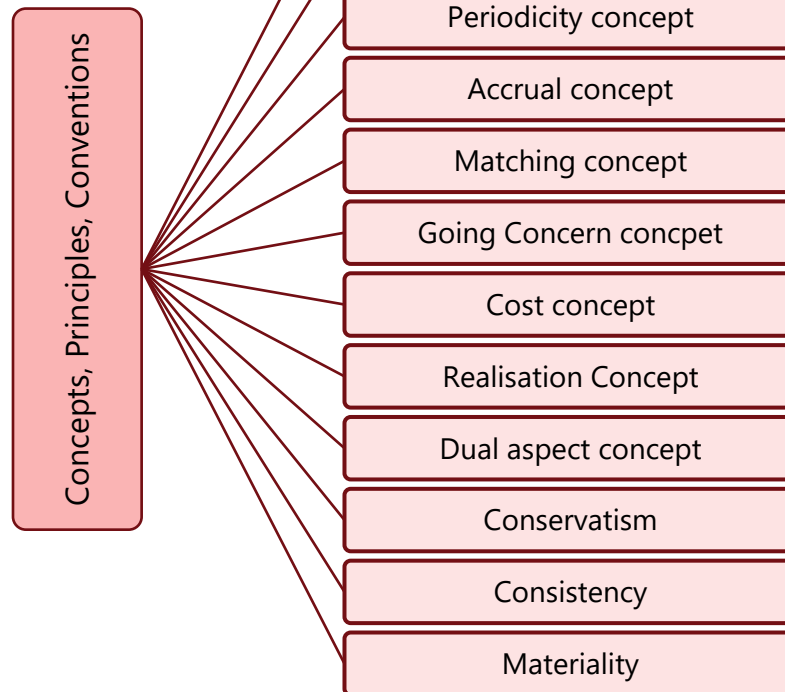
1. Accounting is the art of recording, classifying, and summarising in a significant manner and in terms of money, transactions and events which are, in part at least, of a financial character, and interpreting the result thereof. Various subfields of accounting are listed as: Financial Accounting; Management Accounting; Cost Accounting; Social Responsibility Accounting and Human Resource Accounting.
2. Users of accounts can be listed as Investors, Employees, Lenders, Suppliers and Creditors, Customers, Govt. and their agencies, public and Management.
3. Refer para 1.10 for understanding the relationship of Accounting with Economics, Statistics and Law.
4. Limitations which must be kept in mind while evaluating the Financial Statements are as follows:
 - ♦ The factors which may be relevant in assessing the worth of the enterprise don't find place in the accounts as they cannot be measured in terms of money.
 - ♦ Balance Sheet shows the position of the business on the day of its preparation and not on the future date while the users of the accounts are interested in knowing the position of the business in the near future and also in long run and not for the past date.
 - ♦ Accounting ignores changes in some money factors like inflation etc.
 - ♦ There are occasions when accounting principles conflict with each other.
 - ♦ Certain accounting estimates depend on the sheer personal judgement of the accountant.
 - ♦ Different accounting policies for the treatment of same item adds to the probability of manipulations.
5. The practice of accountancy has crossed its usual domain of preparation of financial statements, interpretation of such statements and audit thereof. Accountants are presently taking active role in company laws and other corporate legislation matters, in taxation laws matters (both direct and indirect) and in general management problems. For details, refer Para 1.12.

UNIT – 2 ACCOUNTING CONCEPTS, PRINCIPLES AND CONVENTIONS

LEARNING OUTCOMES

After studying this unit, you would be able to:

- ◆ Grasp the basic accounting concepts, principles and conventions and observe their implications while recording transactions and events.
- ◆ Identify the three fundamental accounting assumptions:
 - Going Concern
 - Consistency
 - Accrual
- ◆ Understand the qualitative characteristics that will help to develop the skill in course of time to prepare financial statements.

UNIT OVERVIEW**2.1 INTRODUCTION**

Let us imagine a situation where you are a proprietor and you take copies of your books of account to five different accountants. You ask them to prepare the financial statements on the basis of the above records and to calculate the profits of the business for the year. After few days, they are ready with the financial statements and all the five accountants have calculated five different amounts of profits and that too with very wide variations among them. Guess in such a situation what impact would it leave on you about accounting profession. To avoid this, a generally accepted set of rules have been developed. This generally accepted set of rules provides unity of understanding and unity of approach in the practice of accounting and also in better preparation and presentation of the financial statements.

Accounting is a language of the business. Financial statements prepared by the accountant communicate financial information to the various stakeholders for decision-making purpose. Therefore, it is important that financial statements prepared by different organizations should

be prepared on uniform basis. Also, there should be consistency over a period of time in the preparation of these financial statements. If every accountant starts following his own norms and notions for accounting of different items, then there will be an utter confusion.

To avoid confusion and to achieve uniformity, accounting process is applied within the conceptual framework of 'Generally Accepted Accounting Principles' (GAAPs). The term GAAPs is used to describe rules developed for the preparation of the financial statements and are called concepts, conventions, postulates, principles etc. These GAAPs are the backbone of the accounting information system, without which the whole system cannot even stand erectly. These principles are the ground rules, which define the parameters and constraints within which accounting reports are generated. Accounting principles are basic norms and assumptions on which the whole accounting system has been developed and established. Accountant also adheres to various accounting standards issued by the regulatory authority for the standardization of accounting policies to be followed under specific circumstances. These conceptual frameworks, GAAPs and accounting standards are considered as the theory base of accounting. Globally, for achieving the standardization, countries use the framework under International Financial Reporting Standards (IFRS). However, countries may apply their respective GAAPs and related conceptual frameworks. For example, in India, companies are required to use AS or Ind-AS frameworks as applicable.



2.2 ACCOUNTING CONCEPTS

Accounting concepts define the assumptions on the basis of which financial statements of a business entity are prepared. Certain concepts are perceived, assumed and accepted in accounting to provide a unifying structure and internal logic to accounting process. The word concept means idea or notion, which has universal application. Financial transactions are interpreted in the light of the concepts, which govern accounting methods. Concepts are those basic assumptions and conditions, which form the basis upon which the accountancy has been laid. Unlike physical science, accounting concepts are only result of broad consensus. These accounting concepts lay the foundation on the basis of which the accounting principles are formulated.



2.3 ACCOUNTING PRINCIPLES

"Accounting principles are a body of doctrines commonly associated with the theory and procedures of accounting serving as an explanation of current practices and as a guide for selection of conventions or procedures where alternatives exist."

Accounting principles must satisfy the following conditions:

1. They should be based on real assumptions;

2. They must be simple, understandable and explanatory;
3. They must be followed consistently;
4. They should be able to reflect future predictions;
5. They should be informational for the users.



2.4 ACCOUNTING CONVENTIONS

Accounting conventions emerge out of accounting practices, commonly known as accounting principles, adopted by various organizations over a period of time. These conventions are derived by usage and practice. The accountancy bodies of the world may change any of the convention to improve the quality of accounting information. Accounting conventions need not have universal application.

In the study material, the terms 'accounting concepts', 'accounting principles' and 'accounting conventions' have been used interchangeably to mean those basic points of agreement on which financial accounting theory and practice are founded.



2.5 CONCEPTS, PRINCIPLES AND CONVENTIONS - AN OVERVIEW

Now we shall study in detail the various accounting concepts on which accounting is based. The following are the widely accepted accounting concepts:

- (a) **Entity concept:** Entity concept states that business enterprise is a separate identity apart from its owner. Accountants should treat a business as distinct from its owner. Business transactions are recorded in the business books of accounts and owner's transactions in his personal books of accounts. The practice of distinguishing the affairs of the business from the personal affairs of the owners originated only in the early days of the double-entry book-keeping. This concept helps in keeping business affairs free from the influence of the personal affairs of the owner. This basic concept is applied to all the organizations whether sole proprietorship or partnership or corporate entities.

Entity concept keeps the business separate from its owner. In a way, the entity concept helps to ascertain how much amount of money is due to the owner in form of his capital and share of profits earned. It also helps to perform accounting from the point of view of the business and not that of the owner. For example, if a person runs a business and pays money from his own pocket for his son's school fee, it will not constitute a transaction in the books of the business. However, if the person withdraws

money from the business to pay for his son's school fee it will constitute a transaction to be recorded in the books of the business as amount withdrawn by the owner.

Entity concept means that the enterprise is liable to the owner for capital investment made by the owner. Since the owner invested capital, which is also called risk capital, he has claim on the profit of the enterprise. A portion of profit which is apportioned to the owner and is immediately payable becomes current liability in the case of corporate entities.

Example 1: Mr. X started business investing ₹ 7,00,000 with which he purchased machinery for ₹ 5,00,000 and maintained the balance in hand. The financial position of the will be as follows:

	₹
Capital	7,00,000
Machinery	5,00,000
Cash	2,00,000

This means that the enterprise owes to Mr. X ₹ 7,00,000. Now if Mr. X spends ₹ 5,000 to meet his family expenses from the business fund, then it should not be taken as business expenses and would be charged to his capital account (i.e., his investment would be reduced by ₹ 5,000). Following the entity concept the revised financial position would be

Liability	₹	₹
Capital	7,00,000	
Less : Drawings	(5,000)	6,95,000
Machinery		5,00,000
Cash		1,95,000

- (b) **Money measurement concept:** As per this concept, only those transactions, which can be measured in terms of money are recorded. Since money is the medium of exchange and the standard of economic value, this concept requires that those transactions alone that are capable of being measured in terms of money be only to be recorded in the books of accounts. Transactions, even if, they affect the results of the business materially, are not recorded if they are not convertible in monetary terms.

For example, a business owning a factory on a piece of 1 acre of land, with an office building with 2 floors, having 20 computers, and 10 units of machine cannot show these items under different measurement units. These items need to be expressed in monetary terms. The factory price might be 50 Cr, cost of land might be 30 Cr, building

with a cost of 15 Cr, computers at a cost of 10 lac and machines with a cost of 10 Cr need to be recorded.

However, the concept has its own limitations. Transactions and events that cannot be expressed in terms of money are not recorded in the business books. For example; employees of the organization are, no doubt, the assets of the organizations but their measurement in monetary terms is not possible therefore, not included in the books of account of the organization. Measuring unit for money is taken as the currency of the ruling country i.e., the ruling currency of a country provides a common denomination for the value of material objects.

It may be mentioned that when transactions occur across the boundary of a country, one may see many currencies. Suppose a businessman sells goods worth ₹ 50 lakhs at home and he also sells goods worth of 1 lakh Euro in the United States. What is his total sales? ₹ 50 lakhs plus 1 lakh Euro.

These are not amenable to even arithmetic treatment. So, transactions are to be recorded at uniform monetary unit i.e. in one currency. Suppose EURO 1 = ₹ 71.

Total Sales = ₹ 50 lakhs plus 71 lakhs = ₹ 121 lakhs. Money Measurement Concept imparts the essential flexibility for measurement and interpretation of accounting data.

This concept ignores that money is an inelastic yardstick for measurement as it is based on the implicit assumption that purchasing power of the money is not of sufficient importance as to require adjustment. For example, a unit of land purchased 10 years ago for 40 Cr and a similar unit of land purchased now for 90 Cr will still be shown at the respective values, i.e., total of 130 Cr. Though in real world, the true value of the units together might be 180 Cr (90 + 90). Accordingly, accounting does not give a true and fair view of the affairs of the business.

As mentioned earlier, many material transactions and events are not recorded in the books of accounts just because they cannot be measured in monetary terms. Yet it is used for accounting purposes because it is not possible to adopt a better measurement scale.

Entity and money measurement are viewed as the basic concepts on which other procedural concepts hinge.

- (c) **Periodicity concept:** This is also called the concept of definite accounting period. As per going concern' concept an indefinite life of the entity is assumed. For a business entity it causes inconvenience to measure performance achieved by the entity in the ordinary course of business.

If a textile mill lasts for 100 years, it is not desirable to measure its performance as well as financial position only at the end of its life.

So, a small but workable fraction of time is chosen out of infinite life cycle of the business entity for measuring performance and looking at the financial position. Generally, one year period is taken up for performance measurement and appraisal of financial position. However, it may also be 6 months or 9 months or 15 months.

According to this concept accounts should be prepared after every period & not at the end of the life of the entity. Usually, this period is one calendar year. We generally follow from 1st April of a year to 31st March of the immediately following year.

Thus, for performance appraisal it is not necessary to look into the revenue and expenses of an unduly long time-frame. This concept makes the accounting system workable and the term 'accrual' meaningful. If one thinks of indefinite time-frame, nothing will accrue. There cannot be unpaid expenses and non- receipt of revenue. Accrued expenses or accrued revenue is only with reference to a finite time-frame which is called accounting period.

Thus, the periodicity concept facilitates in:

- (i) Comparing of financial statements of different periods
- (ii) Uniform and consistent accounting treatment for ascertaining the profit and assets of the business
- (iii) Matching periodic revenues with expenses for getting correct results of the business operations

(d) Accrual concept: Under accrual concept, the effects of transactions and other events are recognised on mercantile basis i.e., when they occur (and not as cash or a cash equivalent is received or paid) and they are recorded in the accounting records and reported in the financial statements of the periods to which they relate. Financial statements prepared on the accrual basis inform users not only of past events involving the payment and receipt of cash but also of obligations to pay cash in the future and of resources that represent cash to be received in the future.

To understand accrual assumption knowledge of revenues and expenses is required. Revenue is the gross inflow of cash, receivables and other consideration arising in the course of the ordinary activities of an enterprise from sale of goods, from rendering services and from the use by others of enterprise's resources yielding interest, royalties and dividends. **For example,** (1) Mr. X started a cloth merchandising. He invested ₹ 50,000, bought merchandise worth ₹ 50,000. He sold such merchandise for ₹ 60,000. Customers paid him ₹ 50,000 cash and assure him to pay ₹ 10,000 shortly. His revenue

is ₹ 60,000. It arose in the ordinary course of cloth business; Mr. X received ₹ 50,000 in cash and ₹ 10,000 by way of receivables.

Take another example; (2) an electricity supply undertaking supplies electricity spending ₹ 16,00,000 for fuel and wages and collects electricity bill in one month ₹ 20,00,000 by way of electricity charges. This is also revenue which arose from rendering services.

Lastly, (3) Mr. A invested ₹ 1,00,000 in a business. He purchased a machine paying ₹ 1,00,000. He rented it for ₹ 20,000 annually to Mr. B. ₹ 20,000 is the revenue of Mr. A; it arose from the use of the enterprise's resources.

Expense is a cost relating to the operations of an accounting period or to the revenue earned during the period or the benefits of which do not extend beyond that period.

In the first example, Mr. X spent ₹ 50,000 to buy the merchandise; it is the expense of generating revenue of ₹ 60,000. In the second instance ₹ 16,00,000 are the expenses. Also whenever any asset is used it has a finite life to generate benefit. Suppose, the machine purchased by Mr. A in the third example will last for 10 years only. Then ₹ 10,000 is the expense every year relating to the cost of machinery.

Accrual means recognition of revenue and costs as they are earned or incurred and not as money is received or paid. The accrual concept relates to measurement of income, identifying assets and liabilities.

Example: Mr. J D buys clothing of ₹ 50,000 paying cash ₹ 20,000 and sells at ₹ 60,000 of which customers paid only ₹ 50,000.

His revenue is ₹ 60,000, not ₹ 50,000 cash received. Expense (i.e., cost incurred for the revenue) is ₹ 50,000, not ₹ 20,000 cash paid. So the accrual concept based profit is ₹ 10,000 (Revenue – Expenses).

As per Accrual Concept: Revenue – Expenses = Profit

Accrual Concept provides the foundation on which the structure of present-day accounting has been developed.

Alternative as per Cash basis

Cash received in ordinary course of business – Cash paid in ordinary course of business = profit.

Timing of revenue and expense booking could be different from cash receipt or paid.

(i) when cash received before revenue is booked	- a liability is created when cash is received in advance

- (ii) when cash received after revenue is booked - an asset called Trade receivables is created
- (iii) when cash paid before expense is booked - creates an asset called Trade Advance when cash is paid in advance
- (iv) when cash paid after expense is booked - creates a liability called payables or Trade payables or outstanding liabilities

(e) Matching concept: In this concept, all expenses matched with the revenue of that period should only be taken into consideration. In the financial statements of the organization if any revenue is recognized then expenses related to earn that revenue should also be recognized.

This concept is based on accrual concept as it considers the occurrence of expenses and income and do not concentrate on actual inflow or outflow of cash. This leads to adjustment of certain items like prepaid and outstanding expenses, unearned or accrued incomes.

It is not necessary that every expense identify every income. Some expenses are directly related to the revenue and some are time bound. For example:- selling expenses are directly related to sales but rent, salaries etc are recorded on accrual basis for a particular accounting period. In other words periodicity concept has also been followed while applying matching concept.

Mr. P K started cloth business. He purchased 10,000 pcs. garments @ ₹ 100 per piece and sold 8,000 pcs. @ ₹ 150 per piece during the accounting period of 12 months 1st January to 31st December, 2022. He paid shop rent @ ₹ 3,000 per month for 11 months and paid ₹ 8,00,000 to the suppliers of garments and received ₹ 10,00,000 from the customers.

Let us see how the accrual and periodicity concepts operate.

Periodicity Concept fixes up the time-frame for which the performance is to be measured and financial position is to be appraised. Here, it is January 2022 - December, 2022. Therefore, revenues and expenses are to be measured for the year 2022 and assets and liabilities are to be ascertained as on 31st December, 2022.

Accrual Concept operates to measure revenue of ₹ 12,00,000 (arising out of sale of garments 8,000 Pcs × ₹ 150) which accrued during 2022, not the cash received ₹ 10,00,000 and also the expenses correctly. Shop rent for 12 months is an expense item amounting to ₹ 36,000, not ₹ 33,000 the cash paid.

Should the accountant treat ₹ 10,00,000 as expenses for purchase of merchandise? And should he treat ₹ 1,64,000 as profit? (Revenue ₹ 12,00,000-Merchandise ₹ 10,00,000. Shop Rent ₹ 36,000). Obviously, the answer is No. Matching links revenue with expenses.

Revenue – Expenses = Profit

But this unqualified equation may create misconception.

It should be defined as: Periodic Profit = Periodic Revenue – Matched Expenses

From the revenue of an accounting period such expenses are deducted which are expended to generate the revenue to determine profit of that period.

In the given example revenue relates to only sale of 8,000 pcs. of garments. Therefore, the cost of 8,000 pcs of garments should be treated as expenses.

	₹	₹
Thus, Profit = Revenue		12,00,000
Less Expenses:		
Merchandise	8,00,000	
Shop Rent	36,000	(8,36,000)
		3,64,000
Assets:		
Inventory (2,000 pcs x ₹100)		2,00,000
Trade receivables		2,00,000
Cash (Cash Receipts ₹10,00,000 – cash payments ₹ 8,33,000)		1,67,000
		5,67,000
Liabilities:		
Trade Payables		2,00,000
Expenses Payables		3,000
Capital (Profit)		3,64,000
		5,67,000

Thus, accrual, matching and periodicity concepts work together for income measurement and recognition of assets and liabilities.

- (f) **Going Concern concept:** The financial statements are normally prepared on the assumption that an enterprise is a going concern and will continue in operation for the foreseeable future. Hence, it is assumed that the enterprise has neither the intention nor the need to liquidate or curtail materially the scale of its operations; if such an

intention or need exists, the financial statements may have to be prepared on a different basis and, if so, the basis used needs to be disclosed.

The valuation of assets of a business entity is dependent on this assumption. Traditionally, accountants follow historical cost in majority of the cases.

Suppose Mr. X purchased a machine for his business paying ₹ 5,00,000 out of ₹ 7,00,000 invested by him. He also paid transportation expenses and installation charges amounting to ₹ 70,000. If he is still willing to continue the business, his financial position will be as follows:

BALANCE SHEET

Liability	₹	Assets	₹
Capital	7,00,000	Machinery	5,70,000
		Cash	1,30,000
	7,00,000		7,00,000

Now if he decides to back out and desires to sell the machine, it may fetch more than or less than ₹ 5,70,000. So his financial position should be different. If going concern concept is taken, increase/ decrease in the value of assets in the short-run is ignored. The concept indicates that assets are kept for generating benefit in future, not for immediate sale; current change in the asset value is not realisable and so it should not be counted.

This can be understood differently with some examples we may have come across in real life. Recently during pandemic, many businesses were shutting down due to heavy losses. If the financial statement of these entities does not reveal the fact of winding up due to losses, it will mislead the stakeholders. And, a sudden news of the business shutting down would be a setback to those stakeholders.

Therefore, entities need to assess at the time of preparation of financial statements, whether they are likely to continue to operate their business. If the Going Concern assumption is under question, the same information should be communicated to the stakeholders.

- (g) **Cost concept:** By this concept, the value of an asset is to be determined on the basis of historical cost, in other words, acquisition cost. Although there are various measurement bases, accountants traditionally prefer this concept in the interests of objectivity. When a machine is acquired by paying ₹ 5,00,000, following cost concept the value of the machine is taken as ₹ 5,00,000. It is highly objective and free from all bias. Other measurement bases are not so objective. Current cost of an asset is not easily determinable. If the asset is purchased on 1.1.1995 and such model is not available in

the market, it becomes difficult to determine which model is the appropriate equivalent to the existing one. Similarly, unless the machine is actually sold, realisable value will give only a hypothetical figure. Lastly, present value base is highly subjective because to know the value of the asset one has to chase the uncertain future.

However, the cost concept creates a lot of distortion too as outlined below:

- (a) In an inflationary situation when prices of all commodities go up on an average, acquisition cost loses its relevance. For example, a piece of land purchased on 1.1.1995 for ₹ 2,000 may cost ₹ 1,00,000 as on 1.1.2022. So if the accountant makes valuation of asset at historical cost, the accounts will not reflect the true position.
- (b) Historical cost-based accounts may lose comparability. Mr. X invested ₹ 1,00,000 in a machine on 1.1.1995 which produces ₹ 50,000 cash inflow during the year 2022, while Mr. Y invested ₹ 5,00,000 in a machine on 1.1.2005 which produced ₹ 50,000 cash inflows during the year. Mr. X earned at the rate 50% while Mr. Y earned at the rate 10%. Who is more efficient? Since the assets are recorded at the historical cost, the results are not comparable. Obviously, it is a corollary to (a).
- (c) Many assets do not have acquisition costs. Human assets of an enterprise are an example. The cost concept fails to recognise such asset although it is a very important asset of any organization.

Many other controversial issues have arisen in financial accounting that revolves around the cost concept which will be discussed at the advanced stage. However, later on we shall see that in many circumstances, the cost convention is not followed. See conservatism concept for an example, which will be discussed later on in this unit.

- (h) **Realisation concept:** It closely follows the cost concept. Any change in value of an asset is to be recorded only when the business realises it. When an asset is recorded at its historical cost of ₹ 5,00,000 and even if its current cost is ₹ 15,00,000 such change is not counted unless there is certainty that such change will materialize.

However, accountants follow a more conservative path. They try to cover all probable losses but do not count any probable gain. That is to say, if accountants anticipate decrease in value they count it, but if there is increase in value they ignore it until it is realised. Economists are highly critical about the realisation concept. According to them, this concept creates value distortion and makes accounting meaningless.

Example: Mr. X purchased a piece of land on 1.1.1995 paying ₹ 2,000. Its current market value is ₹ 1,02,000 on 31.12.2022. Should the accountant show the land at ₹ 2,000 following cost concept and ignoring ₹1,00,000 value increase since it is not realised? If he does so, the financial position would be:

BALANCE SHEET

Liabilities	₹	Asset	₹
Capital	2,000	Land	2,000
	2,000		2,000

Is it not proper to show it in the following manner?

BALANCE SHEET

Liabilities	₹	Asset	₹
Capital	2,000	Land	1,02,000
Unrealised Gain	1,00,000		
	1,02,000		1,02,000

Now-a-days the revaluation of assets has become a widely accepted practice when the change in value is of permanent nature. Accountants adjust such value change through creation of revaluation (capital) reserve.

Thus, the going concern, cost concept and realization concept gives the valuation criteria.

(i) **Dual aspect concept:** This concept is the core of double entry book-keeping. Every transaction or event has two aspects:

- (1) It increases one Asset and decreases other Asset;
- (2) It increases an Asset and simultaneously increases Liability;
- (3) It decreases one Asset, increases another Asset;
- (4) It decreases one Asset, decreases a Liability.

Alternatively:

- (5) It increases one Liability, decreases other Liability;
- (6) It increases a Liability, increases an Asset;
- (7) It decreases Liability, increases other Liability;
- (8) It decreases Liability, decreases an Asset.

Example :**BALANCE SHEET**

Liabilities	₹	Assets	₹
Capital	1,50,000	Machinery	2,00,000
Bank Loan	75,000	Cash	1,00,000
Other Loan	75,000		
	3,00,000		3,00,000

Transactions:

- A new machine is purchased paying ₹ 50,000 in cash.
- A new machine is purchased for ₹ 50,000 on credit, cash is to be paid later on.
- Cash paid to repay bank loan to the extent of ₹ 50,000.
- Raised bank loan of ₹ 50,000 to pay off other loan.

Effect of the Transactions:

- Increase in machine value and decrease in cash balance by ₹ 50,000.

BALANCE SHEET (1 & 3)

Liabilities	₹	Assets	₹
Capital	1,50,000	Machinery	2,50,000
Bank Loan	75,000	Cash	50,000
Other Loan	75,000		
	3,00,000		3,00,000

- Increase in machine value and increase in Creditors by ₹ 50,000.

BALANCE SHEET (2 & 6)

Liabilities	₹	Assets	₹
Capital	1,50,000	Machinery	2,50,000
Creditors for machinery	50,000	Cash	1,00,000
Bank Loan	75,000		
Other Loan	75,000		
	3,50,000		3,50,000

- (c) Decrease in bank loan and decrease in cash by ₹ 50,000.

BALANCE SHEET (4 & 8)

Liabilities	₹	Assets	₹
Capital	1,50,000	Machinery	2,00,000
Bank Loan	25,000	Cash	50,000
Other Loan	75,000		
	2,50,000		2,50,000

- (d) Increase in bank loan and decrease in other loan by ₹ 50,000.

BALANCE SHEET (5 & 7)

Liabilities	₹	Assets	₹
Capital	1,50,000	Machinery	2,00,000
Bank Loan	1,25,000	Cash	1,00,000
Other Loan	25,000		
	3,00,000		3,00,000

We may conclude that every transaction and event has two aspects.

This gives basic accounting equation :

Equity (E) + Liabilities (L) = Assets (A)

or

Equity (E) = Assets (A) – Liabilities(L)

Or, Equity + Long Term Liabilities + Current Liabilities = Fixed Assets + Current Assets

Or, Equity + Long Term Liabilities = Fixed Assets + (Current Assets – Current Liabilities)

Or, Equity = Fixed Assets + Working Capital – Long Term Liabilities

ILLUSTRATION 1

Develop the accounting equation from the following information: -

Particulars	March 31, 2021 (₹)	March 31, 2022 (₹)
Capital	1,00,000	?
12% Bank Loan	1,00,000	1,00,000

Trade Payables	75,000	70,000
Fixed Assets	1,25,000	1,10,000
Trade Receivables	75,000	80,000
Inventory	70,000	80,000
Cash & Bank	5,000	6,000

Required

Find the profit for the year & the Balance sheet as on 31/3/2022.

SOLUTION**For the year ended March 31, 2021:**

Equity = Capital ₹ 1,00,000

Liabilities = Bank Loan + Trade Payables
 ₹ 1,00,000 + ₹ 75,000 = ₹ 1,75,000

Assets = Fixed Assets + Trade Receivables + Inventory + Cash & Bank
 ₹ 1,25,000 + ₹ 75,000 + ₹ 70,000 + ₹ 5,000 = ₹ 2,75,000
 Equity + Liabilities = Assets
 ₹ 1,00,000 + ₹ 1,75,000 = ₹ 2,75,000

For the year ended March 31, 2022:

Assets = ₹ 1,10,000 + ₹ 80,000 + ₹ 80,000 + ₹ 6,000 = ₹ 2,76,000

Liabilities = ₹ 1,00,000 + ₹ 70,000 = ₹ 1,70,000

Equity = Assets – Liabilities = ₹ 2,76,000 – ₹ 1,70,000 = ₹ 1,06,000
 Profits = New Equity – Old Equity = ₹ 1,06,000 – ₹ 1,00,000 = ₹ 6,000

- (j) **Conservatism:** Conservatism states that the accountant should not anticipate any future income however they should provide for all possible losses. When there are many alternative values of an asset, an accountant should choose the method which leads to the lesser value. Later on, we shall see that the golden rule of current assets valuation - 'cost or market price whichever is lower' originated from this concept.

The Realisation Concept also states that no change should be counted unless it has materialised. The Conservatism Concept puts a further brake on it. It is not prudent to count unrealised gain but it is desirable to guard against all possible losses.

For this concept there should be at least three qualitative characteristics of financial statements, namely,

- (i) *Prudence*, i.e., judgement about the possible future losses which are to be guarded, as well as gains which are uncertain.
- (ii) *Neutrality*, i.e., unbiased outlook is required to identify and record such possible losses, as well as to exclude uncertain gains,
- (iii) *Faithful representation of alternative values*.

This concept is of wider importance to investors since they would need to take a decision about their money being invested in the business. Recording future profits when these have not been earned would suggest that the business is booming, and the investors would be tempted to put more money into the same. However, eventually if the profit is not earned, the investors are likely to lose their investments. At the same time, if the entity expects to make a loss in future, it is prudent to show that loss in the books in present itself. This acts as a safeguard for the investors as they would be prudent to make the investment decisions. For example: Mr. X runs a business of computers. He purchased 10 computers at a cost of ₹ 20,000 each and is expecting to be able to sell these computers at the current market price of ₹ 25,000 each. Note that the conservatism principle does not allow to recognise the profit on the computers unless the sale has been made. Since, this is a future profit, Mr. X needs to follow a prudent approach while recording the transactions in his books and ignore the profit until it is earned

However, before sale, the market price of the computers declines to ₹ 17,000 each. Under the conservatism approach, Mr. X needs to recognise that loss of ₹ 3,000 per computer, even though the sale has not been made.

Many accounting authors, however, are of the view that conservatism essentially leads to understatement of income and wealth and it should not be the basis for the preparation of financial statements.

- (k) **Consistency:** In order to achieve comparability of the financial statements of an enterprise through time, the accounting policies are followed consistently from one period to another; a change in an accounting policy is made only in certain exceptional circumstances.

The concept of consistency is applied particularly when alternative methods of accounting are equally acceptable. For example, a company may adopt any of several methods of depreciation such as written-down-value method, straight-line method, etc. Likewise, there are many methods for valuation of inventories. But following the principle of consistency it is advisable that the company should follow consistently

over years the same method of depreciation or the same method of valuation of Inventories which is chosen. However, in some cases though there is no inconsistency, they may seem to be inconsistent apparently. In case of valuation of Inventories if the company applies the principle 'at cost or market price whichever is lower' and if this principle accordingly results in the valuation of Inventories in one year at cost price and the market price in the other year, there is no inconsistency here. It is only an application of the principle.

But the concept of consistency does not imply non-flexibility as not to allow the introduction of improved method of accounting.

An enterprise should change its accounting policy in any of the following circumstances only:

- a. To bring the books of accounts in accordance with the issued Accounting Standards.
- b. To comply with the provision of law.
- c. When under changed circumstances, it is felt that new method will reflect a true and fair picture in the financial statement.

(I) **Materiality:** Materiality principle permits other concepts to be ignored, if the effect is not considered material. This principle is an exception to full disclosure principle. According to materiality principle, all the items having significant economic effect on the business of the enterprise should be disclosed in the financial statements and any insignificant item which will only increase the work of the accountant but will not be relevant to the users' need should not be disclosed in the financial statements.

The term materiality is the subjective term. It is on the judgement, common sense and discretion of the accountant that which item is material and which is not. For example, stationary purchased by the organization though not used fully in the accounting year purchased still shown as an expense of that year because of the materiality concept. Similarly, depreciation on small items like books, calculators etc. is taken as 100% in the year of purchase though used by the entity for more than a year. This is because the amount for books or calculator is very small to be shown in the balance sheet though it is the asset of the company.

The materiality depends not only upon the amount of the item but also upon the size of the business, nature and level of information, level of the person making the decision etc. Moreover, an item material to one person may be immaterial to another person. What is important is that omission of any information should not impair the decision-making of various users.



2.6 FUNDAMENTAL ACCOUNTING ASSUMPTIONS

There are three fundamental accounting assumptions:

- (i) Going Concern
- (ii) Consistency
- (iii) Accrual

All the above three fundamental accounting assumptions have already been explained in para 2.5.

If nothing has been written about the fundamental accounting assumption in the financial statements then it is assumed that they have already been followed in their preparation of financial statements. However, if any of the above-mentioned fundamental accounting assumption is not followed then this fact should be specifically disclosed.



2.7 FINANCIAL STATEMENTS

The aim of accounting is to keep systematic records to ascertain financial performance and financial position of an entity and to communicate the relevant financial information to the interested user groups. The financial statements are basic means through which the management of an entity makes public communication of the financial information along with selected quantitative details. They are structured financial representations of the financial position and the performance of an enterprise. To have a record of all business transactions and also to determine whether all these transactions resulted in either 'profit or loss' for the period, all the entities will prepare financial statements viz., balance sheet, profit and loss account, cash flow statement etc. by following various accounting concepts, principles, and conventions which have been already discussed in detail.

2.7.1 Qualitative Characteristics of financial Statements

Qualitative characteristics are the attributes that make the information provided in financial statements useful to users. The following are the important qualitative characteristics of the financial statements:

1. **Understandability:** An essential quality of the information provided in financial statements is that it must be readily understandable by users. For this purpose, it is assumed that users have a reasonable knowledge of business, economic activities and accounting and study the information with reasonable diligence. Information about complex matters that should be included in the financial statements because of its relevance to the economic decision-making needs of users should not be excluded merely on the ground that it may be too difficult for certain users to understand.

2. **Relevance:** To be useful, information must be relevant to the decision-making needs of users. Information has the quality of relevance when it influences the economic decisions of users by helping them evaluate past, present or future events or confirming, or correcting, their past evaluations.

The predictive and confirmatory roles of information are interrelated. For example, information about the current level and structure of asset holdings has value to users when they endeavour to predict the ability of the enterprise to take advantage of opportunities and its ability to react to adverse situations. The same information plays a confirmatory role in respect of past predictions about, for example, the way in which the enterprise would be structured or the outcome of planned operations.

Information about financial position and past performance is frequently used as the basis for predicting future financial position and performance and other matters in which users are directly interested, such as dividend and wage payments, share price movements and the ability of the enterprise to meet its commitments as they fall due. To have predictive value, information need not be in the form of an explicit forecast. The ability to make predictions from financial statements is enhanced, however, by the manner in which information on past transactions and events is displayed. For example, the predictive value of the statement of profit and loss is enhanced if unusual, abnormal and infrequent items of income and expense are separately disclosed.

3. **Reliability:** To be useful, information must also be reliable, Information has the quality of reliability when it is free from material error and bias and can be depended upon by users to represent faithfully that which it either purports to represent or could reasonably be expected to represent.

Information may be relevant but so unreliable in nature or representation that its recognition may be potentially misleading. For example, if the validity and amount of a claim for damages under a legal action against the enterprise are highly uncertain, it may be inappropriate for the enterprise to recognise the amount of the claim in the balance sheet, although it may be appropriate to disclose the amount and circumstances of the claim.

4. **Comparability:** Users must be able to compare the financial statements of an enterprise through time in order to identify trends in its financial position, performance and cash flows. Users must also be able to compare the financial statements of different enterprises in order to evaluate their relative financial position, performance and cash flows. Hence, the measurement and display of the financial effects of like transactions and other events must be carried out in a consistent way throughout an enterprise and over time for that enterprise and in a consistent way for different enterprises.

An important implication of the qualitative characteristic of comparability is that users be informed of the accounting policies employed in the preparation of the financial statements, any changes in those policies and the effects of such changes. Users need to be able to identify differences between the accounting policies for like transactions and other events used by the same enterprise from period to period and by different enterprises. Compliance with Accounting Standards, including the disclosure of the accounting policies used by the enterprise, helps to achieve comparability.

The need for comparability should not be confused with mere uniformity and should not be allowed to become an impediment to the introduction of improved accounting standards. It is not appropriate for an enterprise to continue accounting in the same manner for a transaction or other event if the policy adopted is not in keeping with the qualitative characteristics of relevance and reliability. It is also inappropriate for an enterprise to leave its accounting policies unchanged when more relevant and reliable alternatives exist.

Users wish to compare the financial position, performance and cash flows of an enterprise over time. Hence, it is important that the financial statements show corresponding information for the preceding period(s).

The four principal qualitative characteristics are understandability, relevance, reliability and comparability.

5. **Materiality:** The relevance of information is affected by its materiality. Information is material if its misstatement (i.e., omission or erroneous statement) could influence the economic decisions of users taken on the basis of the financial information. Materiality depends on the size and nature of the item or error, judged in the particular circumstances of its misstatement. Materiality provides a threshold or cut-off point rather than being a primary qualitative characteristic which the information must have if it is to be useful.
6. **Faithful Representation:** To be reliable, information must represent faithfully the transactions and other events it either purports to represent or could reasonably be expected to represent. Thus, for example, a balance sheet should represent faithfully the transactions and other events that result in assets, liabilities and equity of the enterprise at the reporting date which meet the recognition criteria.

Most financial information is subject to some risk of being less than a faithful representation of that which it purports to portray. This is not due to bias, but rather to inherent difficulties either in identifying the transactions and other events to be measured or in devising and applying measurement and presentation techniques that can convey messages that correspond with those transactions and events. In certain

cases, the measurement of the financial effects of items could be so uncertain that enterprises generally would not recognise them in the financial statements; for example, although most enterprises generate goodwill internally over time, it is usually difficult to identify or measure that goodwill reliably. In other cases, however, it may be relevant to recognise items and to disclose the risk of error surrounding their recognition and measurement.

7. **Substance over Form:** If information is to represent faithfully the transactions and other events that it purports to represent, it is necessary that they are accounted for and presented in accordance with their substance and economic reality and not merely their legal form. The substance of transactions or other events is not always consistent with that which is apparent from their legal or contrived form. For example, where rights and beneficial interest in an immovable property are transferred but the documentations and legal formalities are pending, the recording of acquisition/disposal (by the transferee and transferor respectively) would in substance represent the transaction entered into.
8. **Neutrality:** To be reliable, the information contained in financial statements must be neutral, that is, free from bias. Financial statements are not neutral if, by the selection or presentation of information, they influence the making of a decision or judgement in order to achieve a predetermined result or outcome.
9. **Prudence:** The preparers of financial statements have to contend with the uncertainties that inevitably surround many events and circumstances, such as the collectability of receivables, the probable useful life of plant and machinery, and the warranty claims that may occur. Such uncertainties are recognised by the disclosure of their nature and extent and by the exercise of prudence in the preparation of the financial statements. Prudence is the inclusion of a degree of caution in the exercise of the judgments needed in making the estimates required under conditions of uncertainty, such that assets or income are not overstated and liabilities or expenses are not understated. However, the exercise of prudence does not allow, for example, the creation of hidden reserves or excessive provisions, the deliberate understatement of assets or income, or the deliberate overstatement of liabilities or expenses, because the financial statements would then not be neutral and, therefore, not have the quality of reliability.
10. **Full, fair and adequate disclosure:** The financial statement must disclose all the reliable and relevant information about the business enterprise to the management and also to their external users for which they are meant, which in turn will help them to take a reasonable and rational decision. For it, it is necessary that financial statements are prepared in conformity with generally accepted accounting principles i.e the information is accounted for and presented in accordance with its substance and

economic reality and not merely with its legal form. The disclosure should be full and final so that users can correctly assess the financial position of the enterprise.

The principle of full disclosure implies that nothing should be omitted while principle of fair disclosure implies that all the transactions recorded should be accounted in a manner that financial statement purports true and fair view of the results of the business of the enterprise and adequate disclosure implies that the information influencing the decision of the users should be disclosed in detail and should make sense.

This principle is widely used in corporate organizations because of separation in management and ownership. The Companies Act in pursuant of this principle came out with the format of balance sheet and profit and loss account. The disclosures of all the major accounting policies and other information are to be provided in the form of footnotes, annexures etc. The practice of appending notes to the financial statements is the outcome of this principle.

11. **Completeness:** To be reliable, the information in financial statements must be complete within the bounds of materiality and cost. An omission can cause information to be false or misleading and thus unreliable and deficient in terms of its relevance.

Thus, if accounting information is to present faithfully the transactions and other events that it purports to represent, it is necessary that they are accounted for and presented in accordance with their substance and economic reality, not by their legal form. For example, if a business enterprise sells its assets to others but still uses the assets as usual for the purpose of the business by making some arrangement with the seller, it simply becomes a legal transaction. The economic reality is that the business is using the assets as usual for deriving the benefit. Financial statement information should contain the substance of this transaction and should not only record going by legality. In order to be reliable, the financial statements information should be neutral i.e., free from bias. The preparers of financial statements however, have to contend with the uncertainties that inevitably surround many events and circumstances, such as the collectability of doubtful receivables, the probable useful life of plant and equipment and the number of warranty claims that many occur. Such uncertainties are recognised by the disclosure of their nature and extent and by exercise of prudence in the preparation of financial statements. Prudence is the inclusion of a degree of caution in the exercise of judgement needed in making the estimates required under condition of uncertainty such that assets and income are not overstated and loss and liability are not understated.

SUMMARY

- ◆ Accounting concepts define the assumptions on the basis of which financial statements of a business entity are prepared.

The following are the widely accepted accounting concepts:

(a) Entity concept	(b) Money measurement concept
(c) Periodicity concept	(d) Accrual concept
(e) Matching concept	(f) Going Concern concept
(g) Cost concept	(h) Realisation concept
(i) Dual aspect concept	(j) Conservatism
(k) Materiality	
- ◆ Accounting principles are a body of doctrines commonly associated with the theory and procedures of accounting serving as an explanation of current practices and as a guide for selection of conventions or procedures where alternatives exist."
 - ◆ Accounting conventions emerge out of accounting practices, commonly known as accounting principles, adopted by various organizations over a period of time.
 - ◆ There are three fundamental accounting assumptions:

(i) Going Concern	(ii) Consistency	(iii) Accrual
 - ◆ Qualitative characteristics are the attributes that make the information provided in financial statements useful to users. Understandability, Relevance, Reliability, Comparability, Materiality, Faithful Representation, Substance over Form, Neutrality, Prudence, Full, fair and adequate disclosure and Completeness are the important qualitative characteristics of the financial statements.

TEST YOUR KNOWLEDGE

True and False

1. *The concept helps in keeping business affairs free from the influence of the personal affairs of the owner is known as the matching concept.*
2. *Entity concept means that the enterprise is liable to the owner for capital investment made by the owner.*
3. *Accrual means recognition as money is received or paid and not of revenue and costs as they are earned or incurred.*

4. *The Conservatism Concept states that no change should be counted unless it has materialized.*
5. *The concept of consistency implies non-flexibility as not to allow the introduction of improved method of accounting.*
6. *The materiality depends only upon the amount of the item and not upon the size of the business, nature and level of information, level of the person making the decision etc.*
7. *Accrual basis of accounting is the method of recording transactions by which revenues and costs and assets and liabilities are reflected in the accounts in the period in which actual receipts or actual payments are made.*

Multiple Choice Questions

1. (i) *All the following items are classified as fundamental accounting assumptions except*
 - (a) *Consistency.*
 - (b) *Business entity.*
 - (c) *Going concern.*
- (ii) *Two primary qualitative characteristics of financial statements are*
 - (a) *Understandability and materiality.*
 - (b) *Relevance and reliability.*
 - (c) *Neutrality and understandability.*
- (iii) *Kanika Enterprises follows the written down value method of depreciating machinery year after year due to*
 - (a) *Comparability.*
 - (b) *Convenience.*
 - (c) *Consistency.*
- (iv) *A purchased a car for ₹ 5,00,000, making a down payment of ₹ 1,00,000 and signing a ₹ 4,00,000 bill payable due in 60 days. As a result of this transaction*
 - (a) *Total assets increased by ₹ 5,00,000.*
 - (b) *Total liabilities increased by ₹ 4,00,000.*
 - (c) *Total assets increased by ₹ 4,00,000 with corresponding increase in liabilities by ₹ 4,00,000.*

- (v) Mohan purchased goods for ₹15,00,000 and sold 4/5th of the goods amounting ₹18,00,000 and met expenses amounting ₹ 2,50,000 during the year, 2022. He counted net profit as ₹ 3,50,000. Which of the accounting concept was followed by him?
- (a) Entity.
 - (b) Periodicity.
 - (c) Matching.
- (vi) A businessman purchased goods for ₹25,00,000 and sold 80% of such goods during the accounting year ended 31st March, 2022. The market value of the remaining goods was ₹ 4,00,000. He valued the closing Inventory at cost. He violated the concept of
- (a) Money measurement.
 - (b) Conservatism.
 - (c) Cost.
- (vii) Capital brought in by the proprietor is
- (a) Increase in asset and increase in liability
 - (b) Increase in liability and decrease in asset
 - (c) Increase in asset and decrease in liability
- (viii) During the life-time of an entity, accounting provides financial statements in accordance with which basic accounting concept:
- (a) Conservatism
 - (b) Matching
 - (c) Accounting period
- (ix) A concept that a business enterprise will not be liquidated in the near future is known as :
- (a) Going concern
 - (b) Economic entity
 - (c) Monetary unit

2. (i) *Assets are held in the business for the*
- (a) *Resale.*
 - (b) *Conversion into cash*
 - (c) *Earning revenue.*
- (ii) *Revenue from sale of products, is generally, realised in the period in which*
- (a) *Cash is collected.*
 - (b) *Sale is made*
 - (c) *Products are manufactured.*
- (iii) *The concept of conservatism when applied to the balance sheet results in*
- (a) *Understatement of assets.*
 - (b) *Overstatement of assets.*
 - (c) *Overstatement of capital.*
- (iv) *Decrease in the amount of trade payables results in*
- (a) *Increase in cash.*
 - (b) *Decrease in bank over draft account.*
 - (c) *Decrease in assets.*
- (v) *The determination of expenses for an accounting period is based on the principle of*
- (a) *Objectivity.*
 - (b) *Materiality.*
 - (c) *Matching.*
- (vi) *Economic life of an enterprise is split into the periodic interval to measure its performance is as per*
- (a) *Entity.*
 - (b) *Matching.*
 - (c) *Periodicity.*
3. (i) *If an individual asset is increased, there will be a corresponding*
- (a) *Increase of another asset or increase of capital.*
 - (b) *Decrease of another asset or increase of liability.*
 - (c) *Decrease of specific liability or decrease of capital.*

- (ii) *Purchase of machinery for cash*
- (a) *Decreases total assets.*
- (b) *Increases total assets.*
- (c) *Retains total assets unchanged.*
- (iii) *Consider the following data pertaining to Alpha Ltd.:*

<i>Particulars</i>	<i>₹</i>
<i>Cost of machinery purchased on 1st April, 2021</i>	<i>10,00,000</i>
<i>Installation charges</i>	<i>1,00,000</i>
<i>Market value as on 31st March, 2022</i>	<i>12,00,000</i>

While finalizing the annual accounts, if the company values the machinery at ₹ 12,00,000. Which of the following concepts is violated by the Alpha Ltd.?

- (a) *Cost.*
- (b) *Matching.*
- (c) *Accrual.*

Theoretical Questions

- Write short notes on:*
 - Fundamental accounting assumptions.*
 - Periodicity concept.*
 - Accounting conventions.*
- Distinguish between:*
 - Money measurement concept and matching concept*
 - Going concern and cost concept*
- Briefly explain the qualitative characteristics of the financial statements.*

ANSWERS/HINTS

True and False

1. False: Under matching concept all expenses matched with the revenue of that period should only be taken into consideration. In the financial statements of the organization if any revenue is recognized then expenses related to earn that revenue should also be recognized.
2. True: Since the owner invested capital, he has claim on the profits of the enterprise.
3. False: Under accrual concept, the effects of transactions and other events are recognised on mercantile basis i.e., when they occur (and not as cash or a cash equivalent is received or paid) and they are recorded in the accounting records and reported in the financial statements of the periods to which they relate.
4. False: The Realisation Concept states that no change should be counted unless it has materialised.
5. False: The concept of consistency does not imply non-flexibility as not to allow the introduction of improved method of accounting.
6. False: As per materiality principle, all the items having significant economic effect on the business of the enterprise should be disclosed in the financial statements.
7. False: Cash Basis of Accounting is the method of recording transactions by which revenues and costs and assets and liabilities are reflected in the accounts in the period in which actual receipts or actual payments are made.

Multiple Choice Questions

1.(i)	(b)	(ii)	(b)	(iii)	(c)	(iv)	(c)	(v)	(c)	(vi)	(b)
(vii)	(a)	(viii)	(c)	(ix)	(a)	2.(i)	(c)	(ii)	(b)	(iii)	(a)
(iv)	(c)	(v)	(c)	(vi)	(c)	3.(i)	(b)	(ii)	(c)	(iii)	(a)

Theoretical Questions

1. (i) **Fundamental accounting assumptions:** There are three fundamental accounting assumptions: Going Concern; Consistency and Accrual. If nothing has been written about the fundamental accounting assumption in the financial statements then it is assumed that they have already been followed in their preparation of financial statements.
 (ii) **Periodicity concept:** According to this concept accounts should be prepared after every period & not at the end of the life of the entity. For details, refer para 2.5.

- (iii) **Accounting conventions:** Accounting conventions emerge out of accounting practices, commonly known as accounting principles, adopted by various organizations over a period of time. For details, refer para 2.4.

2. (i) **Distinction between Money measurement concepts and matching concept**

As per **Money Measurement concept**, only those transactions, which can be measured in terms of money are recorded. Since money is the medium of exchange and the standard of economic value, this concept requires that those transactions alone that are capable of being measured in terms of money be only to be recorded in the books of accounts. Transactions and events that cannot be expressed in terms of money are not recorded in the business books.

In **Matching concept** all expenses matched with the revenue of that period should only be taken into consideration. In the financial statements of the organization if any revenue is recognized then expenses related to earn that revenue should also be recognized.

(ii) **Distinction between Going concern and cost concept**

Going Concern Concept

The financial statements are normally prepared on the assumption that an enterprise is a going concern and will continue in operation for the foreseeable future.

Cost concept

By this concept, the value of an asset is to be determined on the basis of historical cost, in other words, acquisition cost. For details refer para 2.5.

3. Qualitative characteristics are the attributes that make the information provided in financial statements useful to users. For details, refer para 2.7.1.

UNIT – 3 CAPITAL AND REVENUE EXPENDITURES AND RECEIPTS

LEARNING OUTCOMES

After studying this unit, you will be able to:

- ◆ Learn the criteria for identifying Revenue Expenditure and distinguishing from Capital Expenditure
- ◆ Learn the distinction between capital and revenue receipts.
- ◆ Understand the linkage of such distinction with the preparation of final accounts.

UNIT OVERVIEW

Capital

- Payments
- Receipts

Revenue

- Payments
- Receipts



3.1 INTRODUCTION

Accounting aims in ascertaining and presenting the results of the business for an accounting period. For ascertaining the periodical business results, the nature of transactions should be analyzed whether they are of capital or revenue nature. Revenue Expense relates to the operations of the business of an accounting period or to the revenue earned during the period or the items of expenditure, benefits of which do not extend beyond that period. Capital Expenditure, on the other hand, generates enduring benefits and helps in revenue generation over more than one accounting period. Revenue Expenses must be associated with a physical activity of the entity. Therefore, whereas production and sales generate revenue in the earning process, use of goods and services in support of those functions causes expenses to occur.

Expenses are recognised in the Profit & Loss Account through matching principle which tells us when and how much of the expenses to be charged against revenue. A part of the expenditure can be capitalised only when these can be traced directly to definable streams of future benefits.

The distinction of transaction into revenue and capital is done for the purpose of placing them in Profit and Loss account or in the Balance Sheet. For example: revenue expenditures are shown in the profit and loss account as their benefits are for one accounting period i.e., in which they are incurred while capital expenditures are placed on the asset side of the balance sheet as they will generate benefits for more than one accounting period and will be transferred to profit and loss account of the year on the basis of utilisation of that benefit in particular accounting year. Hence, both capital and revenue expenditures are ultimately transferred to profit and loss account.

Revenue expenditures are transferred to profit and loss account in the year of spending while capital expenditures are transferred to profit and loss account of the year in which their benefits are utilised. Therefore, we can conclude that it is the time factor, which is the main determinant for transferring the expenditure to profit and loss account. Also, expenses are recognized in profit and loss account through matching concept which tells us when and how much of the expenses to be charged against revenue. However, distinction between capital and revenue creates a considerable difficulty. In many cases borderline between the two is very thin.



3.2 CONSIDERATIONS IN DETERMINING CAPITAL AND REVENUE EXPENDITURES

The basic considerations in distinction between capital and revenue expenditures are:

- (a) **Nature of business:** For a trader dealing in furniture, purchase of furniture is revenue expenditure but for any other trade, the purchase of furniture should be treated as capital expenditure and shown in the balance sheet as asset. Therefore, the nature of business is a very important criteria in separating an expenditure between capital and revenue.
- (b) **Recurring nature of expenditure:** If the frequency of an expense is quite often in an accounting year then it is said to be an expenditure of revenue nature while non-recurring expenditure is infrequent in nature and do not occur often in an accounting year. Monthly salary or rent is the example of revenue expenditure as they are incurred every month while purchase of assets is not the transaction done regularly therefore, classified as capital expenditure unless materiality criteria defines it as revenue expenditure.

- (c) **Purpose of expenses:** Expenses for repairs of machine may be incurred in course of normal maintenance of the asset. Such expenses are revenue in nature. On the other hand, expenditure incurred for major repair of the asset so as to increase its productive capacity is capital in nature. However, determination of the cost of maintenance and ordinary repairs which should be expensed, as opposed to a cost which ought to be capitalised, is not always simple.
- (d) **Effect on revenue generating capacity of business:** The expenses which help to generate income/ revenue in the current period are revenue in nature and should be matched against the revenue earned in the current period. On the other hand, if expenditure helps to generate revenue over more than one accounting period, it is generally called capital expenditure.
- When expenditure on improvements and repair of a fixed asset is done, it has to be charged to Profit and Loss Account if the expected future benefits from fixed assets do not change, and it will be included in book value of fixed asset, where the expected future benefits from assets increase.
- (e) **Materiality of the amount involved:** Relative proportion of the amount involved is another important consideration in distinction between revenue and capital.



3.3 CAPITAL EXPENDITURES AND REVENUE EXPENDITURES

As we have already discussed, capital expenditure contributes to the revenue earning capacity of a business over more than one accounting period whereas revenue expense is incurred to generate revenue for a particular accounting period. The revenue expenses either occur in direct relation with the revenue or in relation with accounting periods, for example cost of goods sold, salaries, rent, etc. Cost of goods sold is directly related to sales revenue whereas rent is related to the particular accounting period. Capital expenditure may represent acquisition of any tangible or intangible fixed assets for enduring future benefits. Therefore, the benefits arising out of capital expenditure last for more than one accounting period whereas those arising out of revenue expenses expire in the same accounting period.

3.3.1 Key differences between Capital and Revenue Expenditures

Key Differences	Capital Expenditure	Revenue Expenditure
Period of benefit	Any expenditure incurred to provide a benefit over a long-term period is capital expenditure.	Any expenditure incurred to provide a benefit during the current period is revenue expenditure.

Enhancement Maintenance	vs	Capital expenditure is incurred for the purpose of increasing the capacity of the business. Alternatively, it also includes an expenditure to reduce the costs of the business.	Revenue expenditure is incurred to maintain the earning capacity of the business.
Examples		Purchase of machine, car, furniture, etc.	Repairs and maintenance, salary of accounting staff, etc.

ILLUSTRATION 1

State with reasons whether the following statements are 'True' or 'False'.

- (1) *Overhaul expenses of second-hand machinery purchased are Revenue Expenditure.*
- (2) *Money spent to reduce working expenses is Revenue Expenditure.*
- (3) *Legal fees to acquire property is Capital Expenditure.*
- (4) *Amount spent as lawyer's fee to defend a suit claiming that the firm's factory site belonged to the plaintiff's land is Capital Expenditure.*
- (5) *Amount spent for replacement of worn out part of machine is Capital Expenditure.*
- (6) *Expense incurred on the repairs and white washing for the first time on purchase of an old building are Revenue Expenses.*
- (7) *Expenses in connection with obtaining a license for running the cinema is Capital Expenditure.*
- (8) *Amount spent for the construction of temporary huts, which were necessary for construction of the Cinema House and were demolished when the cinema house was ready, is Capital Expenditure.*

SOLUTION

- (1) **False:** Overhaul expenses are incurred to put second-hand machinery in working condition to derive enduring long-term advantage. So it should be capitalised.
- (2) **False:** It may be reasonably presumed that money spent for reducing revenue expenditure would have generated long-term benefits to the entity. So this is capital expenditure.
- (3) **True:** Legal fee paid to acquire any property is part of the cost of that property. It is incurred to possess the ownership right of the property and hence a capital expenditure.

- (4) **False:** Legal expenses incurred to defend a suit claiming that the firm's factory site belongs to the plaintiff is maintenance expenditure of the asset. By this expense, neither any endurable benefit can be obtained in future in addition to that what is presently available nor the capacity of the asset will be increased. Maintenance expenditure in relation to an asset is revenue expenditure.
- (5) **False:** Amount spent for replacement of any worn out part of a machine is revenue expense since it is part of its maintenance cost.
- (6) **False:** Repairing and white washing expenses for the first time of an old building are incurred to put the building in usable condition. These are the part of the cost of building. Accordingly, these are capital expenditure.
- (7) **True:** The Cinema Hall could not be started without license. Expenditure incurred to obtain the license is pre-operative expense which is capitalised. Such expenses are amortised over a period of time.
- (8) **True:** Cost of temporary huts constructed which were necessary for the construction of the cinema house is part of the construction cost of the cinema house. Therefore such costs are to be capitalised.

ILLUSTRATION 2

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

- (1) *Expenses incurred in connection with obtaining a license for starting the factory for ₹10,000.*
- (2) *₹1,000 paid for removal of Inventory to a new site.*
- (3) *Rings and Pistons of an engine were changed at a cost of ₹5,000 to get fuel efficiency.*
- (4) *Money paid to Mahanagar Telephone Nigam Ltd. (MTNL) ₹8,000 for installing telephone in the office.*
- (5) *A factory shed was constructed at a cost of ₹1,00,000. A sum of ₹5,000 had been incurred in the construction of temporary huts for storing building material.*

SOLUTION

- (1) Money paid ₹ 10,000 for obtaining license to start a factory is a capital expenditure. This is an item of expenditure incurred to acquire the right to carry on business.
- (2) ₹ 1,000 paid for removal of Inventory to a new site is revenue expenditure. This is neither bringing enduring benefit nor enhancing the value of the asset.

- (3) ₹ 5,000 spent in changing Rings and Pistons of an engine to get fuel efficiency is capital expenditure. This is an expenditure on improvement of a fixed asset. It results in increasing profit-earning capacity of the business by cost reduction.
- (4) Money deposited with MTNL for installation of telephone in office is not expenditure. This is treated as an asset and the same is adjusted over a period of time against actual telephone bills.
- (5) Cost of construction of building including cost of temporary huts is capital expenditure. Building is fixed asset which will generate enduring benefit to the business over more than one accounting period. Construction of temporary huts is incidental to the main construction. Such cost is also capitalised with the cost of building.

ILLUSTRATION 3

Best Tech Solutions buys and sells computers as a part of its business. It purchased 20 computers for resale to its customers. Cost of each computer is ₹ 20,000. It also purchased a computer costing ₹ 24,000 for its accountant to be able to maintain the accounting records and printing of invoices. Suggest whether above transactions qualify as capital expenditure or revenue expenditure transactions?

SOLUTION

Best Tech Solutions is in the business of buying and selling of computers. Any computers purchased for resale to its customers will qualify as revenue expenditure. Hence, a purchase of $20,000 \times 20 = ₹ 4,00,000$ will be a part of revenue expenditure.

At the same time, the computer purchased for maintaining the records and invoicing is to be able to operate the business for a longer period of time. Therefore, the purchase of ₹ 24,000 qualifies as a capital expenditure. This amount will be a part of assets in the Balance Sheet.



3.4 CAPITAL RECEIPTS AND REVENUE RECEIPTS

Just as a clear distinction between Capital and Revenue expenditure is necessary, in the same manner capital receipts must be distinguished from revenue receipts.

Receipts which are obtained in course of normal business activities are revenue receipts (e.g., receipts from sale of goods or services, interest income etc.). On the other hand, receipts which are not revenue in nature are capital receipts (e.g., receipts from sale of fixed assets or investments, secured or unsecured loans, owners' contributions etc.). Revenue and capital receipts are recognised on accrual basis as soon as the right of receipt is established. Revenue receipts should not be equated with the actual cash receipts. Revenue receipts are credited to the Profit and Loss Account.

On the other hand, Capital receipts are not directly credited to Profit and Loss Account. For example, when a fixed asset is sold for ₹ 92,000 (cost ₹ 90,000), the capital receipts ₹ 92,000 is not credited to Profit and Loss Account. Profit or Loss on sale of fixed assets is calculated and credited to Profit and Loss Account as follows:

Sale Proceeds	₹ 92,000
Cost	(₹ 90,000)
Profit	<u>₹ 2,000</u>

ILLUSTRATION 4

State with reasons whether the below items relating to the business of AB td are capital or revenue receipts?

- A machine with a book value of ₹ 10 lakh is sold for ₹ 12 lakh.*
- Premium amounting to ₹ 1 Lakh received on issue of shares*
- An amount of ₹ 20,000 received from goods sold in cash.*
- An amount of ₹ 5 lac received on the maturity of fixed deposit from bank. Also, an interest of ₹ 40,000 was received in addition to the maturity amount of the fixed deposits.*

SOLUTION

- The amount of ₹ 12 lac is a capital receipt. There is a profit on sale of the machine to the extent of ₹ 2 lac (12 – 10)
- Premium received on issue of shares is an example of capital receipt.
- Amount received from cash sale is a revenue receipt.
- Amount received on the maturity of fixed deposit is the recovery of the deposit amount, and is a capital receipt. Interest income is an example of revenue receipt.

ILLUSTRATION 5

Good Pictures Ltd., constructs a cinema house and incurs the following expenditure during the first year ending 31st March, 2022.

- Second-hand furniture worth ₹ 9,000 was purchased; repainting of the furniture costs ₹ 1,000. The furniture was installed by own workmen, wages for this being ₹ 200.*
- Expenses in connection with obtaining a license for running the cinema worth ₹ 20,000. During the course of the year the cinema company was fined ₹ 1,000, for contravening rules. Renewal fee ₹ 2,000 for next year also paid.*
- Fire insurance, ₹ 1,000 was paid on 1st October, 2021 for one year.*

- (4) *Temporary huts were constructed costing ₹ 1,200. They were necessary for the construction of the cinema. They were demolished when the cinema was ready.*

Point out how you would classify the above items.

SOLUTION

- (1) The total cost of the furniture should be treated as ₹ 10,200 i.e., all the amounts mentioned should be capitalised since without such expenditure the furniture would not be available for use. If ₹ 1,000 and ₹ 200 have been respectively debited to the Repairs Account and the Wages Account, these accounts will be credited to the Furniture Account.
- (2) License for running the cinema house is necessary, hence its cost should be capitalised. But the fine of ₹ 1,000 is revenue expenditure. The renewal fee for the next year is also revenue expenditure but pertains to the next year; hence, it is a prepaid expense.
- (3) Half of the insurance premium pertains to the year beginning on 1st April, 2021. Hence such amount should be treated as prepaid expense. The remaining amount is revenue expense for the current year.
- (4) Since the temporary huts were necessary for the construction, their cost should be added to the cost of the cinema hall and thus capitalised.

ILLUSTRATION 6

State with reasons, how you would classify the following items of expenditure:

- (1) *Overhauling expenses of ₹25,000 for the engine of a motor car to get better fuel efficiency.*
- (2) *Inauguration expenses of ₹25 lacs incurred on the opening of a new manufacturing unit in an existing business.*
- (3) *Compensation of ₹2.5 crores paid to workers, who opted for voluntary retirement.*

SOLUTION

- (1) Overhauling expenses are incurred for the engine of a motor car to derive better fuel efficiency. These expenses will reduce the running cost in future and thus the benefit is in form of enduring long-term advantage. So this expenditure should be capitalised.
- (2) Inauguration expenses incurred on the opening of a new unit may help to explore more customers. This expenditure is in the nature of revenue expenditure, as the expenditure may not generate any enduring benefit to the business over more than one accounting period.
- (3) The amount paid to workers on voluntary retirement is in the nature of revenue expenditure. Since the magnitude of the amount of expenditure is very significant, it may be better to defer it over future years.

ILLUSTRATION 7

Classify the following expenditures and receipts as capital or revenue:

- (i) ₹ 10,000 spent as travelling expenses of the directors on trips abroad for purchase of capital assets.
- (ii) Amount received from Trade receivables during the year.
- (iii) Amount spent on demolition of building to construct a bigger building on the same site.
- (iv) Insurance claim received on account of a machinery damaged by fire.

SOLUTION

- (i) Capital expenditure.
- (ii) Revenue receipt.
- (iii) Capital expenditure.
- (iv) Capital receipt.

ILLUSTRATION 8

Are the following expenditures capital in nature?

- (i) M/s ABC & Co. run a restaurant. They renovate some of the old cabins. Because of this renovation some space was made free and number of cabins was increased from 10 to 13. The total expenditure was ₹20,000.
- (ii) M/s New Delhi Financing Co. sold certain goods on installment payment basis. Five customers did not pay installments. To recover such outstanding installments, the firm spent ₹10,000 on account of legal expenses.
- (iii) M/s Ballav & Co. of Delhi purchased a machinery from M/s Shah & Co. of Ahmedabad. M/s Ballav & Co. spent ₹40,000 for transportation of such machinery. The year ending is 31st Dec, 2022.

SOLUTION

- (i) Renovation of cabins increased the number of cabins. This has an effect on the future revenue generating capability of the business. Thus, the renovation expense is capital expenditure in nature.
- (ii) Expense incurred to recover installments due from customer do not increase the revenue generating capability in future. It is a normal recurring expense of the business. Thus, the legal expenses incurred in this case is revenue expenditure in nature.
- (iii) Expenses incurred on account of transportation of fixed asset is capital expenditure in nature.

SUMMARY

- ◆ Revenue expenditures are shown in the profit and loss account while capital expenditures are placed on the asset side of the balance sheet since they generate benefits for more than one accounting period.
- ◆ Prepaid expenses are future expenses that have been paid in advance. These are shown in the balance sheet as an asset.
- ◆ Receipts obtained should be classified between revenue receipts and capital receipts.

TEST YOUR KNOWLEDGE

True and False

1. *The nature of business is not an important criteria in separating an expenditure between capital and revenue.*
2. *Expenditure incurred for major repair of the asset so as to increase its productive capacity is Revenue in nature.*
3. *Amount spent as lawyer's fee to defend a suit claiming that the firm's factory site belonged to the plaintiff's land is Capital Expenditure.*
4. *Amount spent for replacement of worn-out part of machine is Capital Expenditure.*
5. *Legal fees to acquire property is Capital Expenditure.*
6. *Amount spent for the construction of temporary huts, which were necessary for construction of the cinema house and were demolished when the cinema house was ready, is Capital Expenditure.*

Multiple Choice Questions

1. *Money spent ₹ 10,000 as traveling expenses of the directors on trips abroad for purchase of capital assets is*
 - (a) *Capital expenditures*
 - (b) *Revenue expenditures*
 - (c) *Prepaid revenue expenditures*

2. *Amount of ₹5,000 spent as lawyers' fee to defend a suit claiming that the firm's factory site belonged to the plaintiff's land is*
 - (a) *Capital expenditures*
 - (b) *Revenue expenditures*
 - (c) *Prepaid revenue expenditures*
3. *Entrance fee of ₹2,000 received by Ram and Shyam Social Club is*
 - (a) *Capital receipt*
 - (b) *Revenue receipt*
 - (c) *Capital expenditures*
4. *Subsidy of ₹ 40,000 received from the government for working capital by a manufacturing concern is*
 - (a) *Capital receipt*
 - (b) *Revenue receipt*
 - (c) *Capital expenditures*
5. *Insurance claim received on account of*
 - (a) *Capital receipt*
 - (b) *Revenue receipt*
 - (c) *Capital expenditures*
6. *Interest on investments received from*
 - (a) *Capital receipt*
 - (b) *Revenue receipt*
 - (c) *Capital expenditures*
7. *Amount received from IDBI as a medium term loan for augmenting working capital is*
 - (a) *Capital expenditures*
 - (b) *Revenue expenditures*
 - (c) *Capital receipt*
8. *Revenue from sale of products, ordinarily, is reported as part of the earning in the period in which*
 - (a) *The sale is made.*
 - (b) *The cash is collected.*
 - (c) *The products are manufactured.*

9. *If repair cost is ₹25,000, whitewash expenses are ₹5,000, (both these expenses relate to presently used building) cost of extension of building is ₹2,50,000 and cost of improvement in electrical wiring system is ₹19,000; the amount to be expensed is*
- (a) ₹2,99,000.
(b) ₹44,000.
(c) ₹30,000.

Theoretical Questions

1. *What are the basic considerations in distinguishing between capital and revenue expenditures?*
2. *Define revenue receipts and give examples. How are these receipts treated?*

ANSWERS/HINTS

True and False

1. False: The nature of business is a very important criteria in separating an expenditure between capital and revenue. For example- For a trader dealing in furniture, purchase of furniture is revenue expenditure but for any other trade, the purchase of furniture should be treated as capital expenditure and shown in the balance sheet as asset. .
2. False: Expenditure incurred for major repair of the asset so as to increase its productive capacity is capital in nature.
3. False: Legal expenses incurred to defend a suit claiming that the firm's factory site belongs to the plaintiff is maintenance expenditure of the asset. By this expense, neither any enduring benefit can be obtained in future in addition to that what is presently available nor the capacity of the asset will be increased. Maintenance expenditure in relation to an asset is revenue expenditure.
4. False: Amount spent for replacement of any worn out part of a machine is revenue expense since it is part of its maintenance cost.
5. True: Legal fee paid to acquire any property is a part of cost of that property. It is incurred to possess the ownership right of the property and hence a capital expenditure.
6. True: Since temporary huts were necessary for the construction, their cost should be added to the cost of the cinema hall and thus capitalised.

Multiple Choice Questions

1.	(a)	2.	(b)	3.	(a)	4.	(b)	5.	(a)	6.	(b)
7.	(c)	8.	(a)	9.	(c)						

Theoretical Questions

- The basic considerations in distinction between capital and revenue expenditures are:
 - Nature of business.
 - Recurring nature of expenditure.
 - Purpose of expenses.
 - Effect on revenue generating capacity of business.
 - Materiality of the amount involved.
- Receipts which are obtained in course of normal business activities are revenue receipts (e.g., receipts from sale of goods or services, interest income etc.).
Revenue receipts should not be equated with the actual cash receipts. Revenue receipts are credited to the Profit and Loss Account.

UNIT – 4 CONTINGENT ASSETS AND CONTINGENT LIABILITIES

LEARNING OUTCOMES

After studying this Unit, you will be able to:

- ◆ Understand the meaning of the terms 'Contingent Assets' and 'Contingent Liabilities'.
- ◆ Distinguish 'Contingent Liabilities' with 'Liabilities' and 'Provisions'

UNIT OVERVIEW

Contingent Asset

A possible asset arises from past events and their existence will be confirmed only after occurrence or non-occurrence of one or more uncertain future events.

Contingent Liability

A possible obligation arising from past events and may arise in future depending on the occurrence or non-occurrence of one or more uncertain future events.



4.1 CONTINGENT ASSET

A contingent asset may be defined as a possible asset that arises from past events and whose existence will be confirmed only after occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the enterprise. It usually arises from unplanned or unexpected events that give rise to the possibility of an inflow of economic benefits to the business entity. For example, a claim that an enterprise is pursuing through legal process, where the outcome is uncertain, is a contingent asset.

As per the concept of prudence as well as the present accounting standards, an enterprise should not recognise a contingent asset. These assets are uncertain and may arise from a claim which an enterprise pursues through a legal proceeding. There is uncertainty in realisation of claim. It is possible that recognition of contingent assets may result in recognition of income that may never be realised. However, when the realisation of income is virtually certain, then the related asset no longer remains as contingent asset.

A contingent asset need not be disclosed in the financial statements. A contingent asset is usually disclosed in the report of the approving authority (Board of Directors in the case of a company, and the corresponding approving authority in the case of any other enterprise), if an inflow of economic benefits is probable. Contingent assets are assessed continually and if it has become virtually certain that an inflow of economic benefits will arise, the asset and the related income are recognised in the financial statements of the period in which the change occurs.



4.2 CONTINGENT LIABILITIES

The term 'Contingent liability' can be defined as

- "(a) a **possible obligation** that arises from past events and the existence of which will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the enterprise; or
- (b) a **present obligation** that arises from past events but is not recognised because:
 - (i) it is not probable that an outflow of resources embodying economic benefits will be required to settle the obligation; or
 - (ii) a reliable estimate of the amount of the obligation cannot be made."

For example- Mr. X sells a machine to Mr. Y. Any damages incurred by Mr. Y while using the machine need to be compensated by Mr. X. A few days later from the date of sale of machine, Mr. X received a notice from Mr. Y who is claiming damages of ₹ 20 lac. The notice mentioned that a worker met with an accident during the use of the machine and is required to be compensated.

The receipt of this notice does not suggest that Mr. X is liable to pay the amount, although this needs to be investigated and confirmed, as whether the damage arose due to any defect in the machine or it is due to negligence while operating the machine. Although, the receipt of the notice results into an event which requires recognition of a contingent liability since **there is a possible obligation**, and that can only be confirmed in future.

Taking another example let us assume Mr. AB sells cars to its customers. One of the cars caught fire due to malfunctioning of a faulty part during the test drive by one of the customers. The customer has filed a court case seeking a claim of ₹ 50 lac due to the incidence.

While Mr. AB acknowledges that there is a **present obligation**, it is not certain that whether he is expected to pay for any damages. The final outcome will only be known during the court proceedings.

A contingent liability is a possible obligation arising from past events and may arise in future depending on the occurrence or non-occurrence of one or more uncertain future events [part (a) of the definition]. A contingent liability may also be a present obligation that arises from past events [(part (b) of the definition)].

An enterprise should not recognise a contingent liability in balance sheet, however it is required to be disclosed in the notes to accounts, unless possibility of outflow of a resource embodying economic benefits is remote. These liabilities are assessed continually to determine whether an outflow of resources embodying economic benefits has become probable.

If it becomes probable that an outflow or future economic benefits will be required for an item previously dealt with as a contingent liability, a provision is recognised in financial statements of the period in which the change in probability occurs except in the extremely rare circumstances where no reliable estimate can be made.



4.3 DISTINCTION BETWEEN CONTINGENT LIABILITIES AND LIABILITIES

The distinction between a liability and a contingent liability is generally based on the judgement of the management. A liability is defined as the present financial obligation of an enterprise, which arises from past events. The settlement of a liability results in an outflow from the enterprises of resources embodying economic benefits. On the other hand, in the case of contingent liability, either outflow of resources to settle the obligation is not probable or the amount expected to be paid to settle the liability cannot be measured with sufficient reliability.

Examples of contingent liabilities are claims against the enterprise not acknowledged as debts, guarantees given in respect of third parties, liability in respect of bills discounted and statutory liabilities under dispute etc. In addition to present obligations that are recognized as liabilities in the balance sheet, enterprises are required to disclose contingent liability in their balance sheets by way of notes.



4.4 DISTINCTION BETWEEN CONTINGENT LIABILITIES AND PROVISIONS

Provision means “any amount written off or retained by way of providing for depreciation, renewal or diminution in the value of assets or retained by way of providing for any known liability of which the amount cannot be determined with substantial accuracy”.

It is important to know the difference between provisions and contingent liabilities. The distinction between both of them can be explained as follows:

	Provision	Contingent liability
(1)	Provision is a present liability of uncertain amount, which can be measured reliably by using a substantial degree of estimation.	A Contingent liability is a possible obligation that may or may not crystallise depending on the occurrence or non-occurrence of one or more uncertain future events.
(2)	A provision meets the recognition criteria.	A contingent liability fails to meet the same.
(3)	Provision is recognised when (a) an enterprise has a present obligation arising from past events; an outflow of resources embodying economic benefits is probable, and (b) a reliable estimate can be made of the amount of the obligation.	Contingent liability includes present obligations that do not meet the recognition criteria because either it is not probable that settlement of those obligations will require outflow of economic benefits, or the amount cannot be reliably estimated.
(4)	If the management estimates that it is probable that the settlement of an obligation will result in outflow of economic benefits, it recognises a provision in the balance sheet.	If the management estimates, that it is less likely that any economic benefit will outflow the firm to settle the obligation, it discloses the obligation as a contingent liability.

Let us take an example to understand the distinction between provisions and contingent liabilities. The Central Excise Officer imposes a penalty on Alpha Ltd. for violation of a provision in the Central Excise Act. The company goes on an appeal. If the management of the company estimates that it is probable that the company will have to pay the penalty, it recognises a provision for the liability. On the other hand, if the management anticipates that the judgement of the appellate authority will be in its favour and it is less likely that the company will have to pay the penalty, it will disclose the obligation as a contingent liability instead of recognising a provision for the same.

SUMMARY

- ◆ A contingent asset may be defined as a possible asset that arises from past events and whose existence will be confirmed only after occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the enterprise.
- ◆ A contingent liability is a possible obligation arising from past events and may arise in future depending on the occurrence or non-occurrence of one or more uncertain future events.
- ◆ A liability is the present financial obligation of an enterprise, which arises from past events whereas contingent liability is a possible obligation arising from past events.
- ◆ Provision is a present liability of uncertain amount, which can be measured reliably by using a substantial degree of estimation whereas Contingent liability is a possible obligation that may or may not crystallise depending on the occurrence or non-occurrence of one or more uncertain future events.

TEST YOUR KNOWLEDGE

True and False

1. *A contingent liability need not be disclosed in the financial statements.*
2. *A Provision fails to meet the recognition criteria.*
3. *A claim that an enterprise is pursuing through legal process, where the outcome is uncertain, is a contingent liability.*
4. *When it is probable that the firm will need to pay off the obligation, this gives rise to Contingent liability.*
5. *Present financial obligation of an enterprise, which arises from past event is termed as contingent liability.*

Multiple Choice Questions

1. *Contingent asset usually arises from unplanned or unexpected events that give rise to*
 - (a) *The possibility of an inflow of economic benefits to the business entity.*
 - (b) *The possibility of an outflow of economic benefits to the business entity.*
 - (c) *Either (a) or (b).*

2. *If an inflow of economic benefits is probable then a contingent asset is disclosed*
- (a) *In the financial statements.*
 - (b) *In the report of the approving authority (Board of Directors in the case of a company, and the corresponding approving authority in the case of any other enterprise).*
 - (c) *In the cash flow statement.*
3. *In the case of _____, either outflow of resources to settle the obligation is not probable or the amount expected to be paid to settle the liability cannot be measured with sufficient reliability.*
- (a) *Liability*
 - (b) *Provision*
 - (c) *Contingent liabilities*
4. *Present liability of uncertain amount, which can be measured reliably by using a substantial degree of estimation is termed as _____.*
- (a) *Provision.*
 - (b) *Liability.*
 - (c) *Contingent liability.*
5. *In the financial statements, contingent liability is*
- (a) *Recognised.*
 - (b) *Not recognised.*
 - (c) *Adjusted.*

Theoretical Questions

Differentiate between:

- (i) *Provision and Contingent Liability.*
- (ii) *Liability and Contingent liability.*

ANSWERS/HINTS

True and False

1. False: A Contingent liability is required to be disclosed unless possibility of outflow of a resource embodying economic benefits is remote.
2. False: A contingent liability fails to meet the recognition criteria.
3. False: A claim that an enterprise is pursuing through legal process, where the outcome is uncertain, is a contingent asset
4. False: When it is probable that the firm will need to pay off the obligation, this gives rise to provision.
5. False: Present Financial obligation of an enterprise, which arises from past events is termed as liability,

Multiple Choice Questions

1.	(a)	2.	(b)	3.	(c)	4.	(a)	5.	(b)		

Theoretical Questions

1. Provision is a present liability of uncertain amount, which can be measured reliably by using a substantial degree of estimation. On the other hand, a Contingent liability is a possible obligation that may or may not crystallize depending on the occurrence or non-occurrence of one or more uncertain future events.
2. A liability is defined as the present financial obligation of an enterprise, which arises from past events. On the other hand, in the case of contingent liability, either outflow of resources to settle the obligation is not probable or the amount expected to be paid to settle the liability cannot be measured with sufficient reliability.

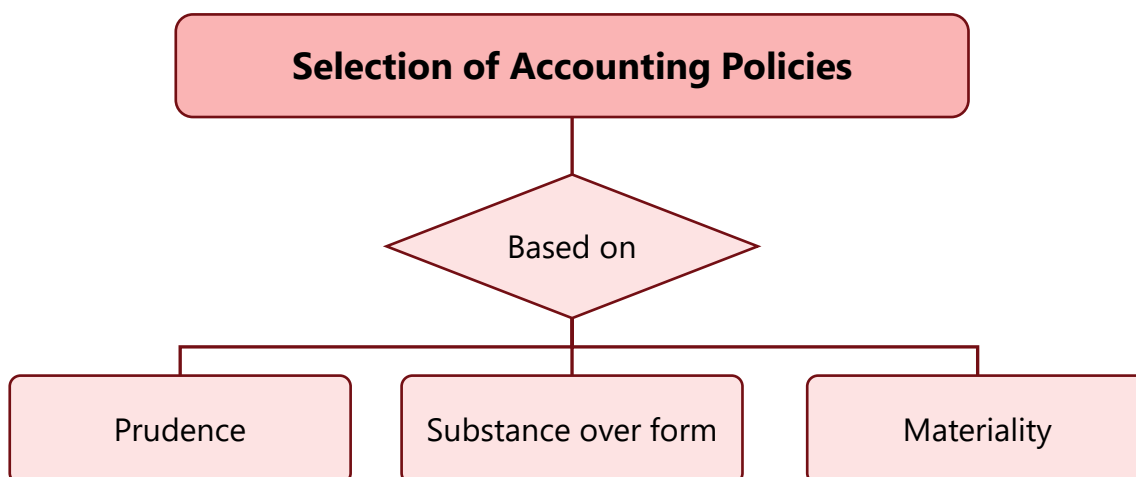
UNIT – 5 ACCOUNTING POLICIES

LEARNING OUTCOMES

After studying this Unit, you will be able to:

- ◆ Understand the meaning of 'Accounting Policies'.
- ◆ Familiarize with the situations under which selection from different accounting policies is required.
- ◆ Grasp the conditions where change in accounting policy can be made and the consequences arising from such change.

UNIT OVERVIEW





5.1 MEANING OF ACCOUNTING POLICIES

Accounting Policies refer to specific accounting principles and methods of applying these principles adopted by the enterprise in the preparation and presentation of financial statements. Policies are based on various accounting concepts, principles and conventions that have already been explained in Unit 2 of Chapter 1. There is no single list of accounting policies, which are applicable to all enterprises in all circumstances. Enterprises operate in diverse and complex environmental situations and so they have to adopt various policies. The choice of specific accounting policy appropriate to the specific circumstances in which the enterprise is operating, calls for considerate judgement by the management. ICAI has been trying to reduce the number of acceptable accounting policies through Guidance Notes and Accounting Standards in its combined efforts with the government, other regulatory agencies and progressive managements. Already it has achieved some progress in this respect.

The areas wherein different accounting policies are frequently encountered can be given as follows:

- (1) Valuation of Inventories;
- (2) Valuation of Investments.

This list should not be taken as exhaustive but is only illustrative. As the course will progress, students will see the intricacies of the various accounting policies.

Suppose an enterprise holds some investments in the form of shares of a company at the end of an accounting period. For valuation of shares, the enterprise may adopt FIFO, average method etc. The method selected by that enterprise for valuation is called an accounting policy.



5.2 SELECTION OF ACCOUNTING POLICIES

Choice of accounting policy is an important policy decision which affects the performance measurement as well as financial position of the business entity. Selection of inappropriate accounting policy may lead to understatement or overstatement of performance and financial position. Thus, accounting policy should be selected with due care after considering its effect on the financial performance of the business enterprise from the angle of various users of accounts.

It is believed that no unified and exhaustive list of accounting policies can be suggested which has universal application. Three major characteristics which should be considered for the purpose of selection and application of accounting policies. viz., Prudence, Substance over form, and Materiality. The financial statements should be prepared on the basis of such accounting policies, which exhibit true and fair view of state of affairs of Balance Sheet and the Profit & Loss Account.

Examples wherein selection from a set of accounting policies is made, can be given as follows:–

1. Inventories are valued at cost except for finished goods and by-products. Finished goods are valued at lower of cost or market value and by-products are valued at net realizable value.
2. Investments (long term) are valued at their acquisition cost. Provision for permanent diminution in value has been made wherever necessary.

Sometimes a wrong or inappropriate treatment is adopted for items in Balance Sheet, or Profit & Loss Account, or other statement. Disclosure of the treatment adopted is necessary in any case, but disclosure cannot rectify a wrong or inappropriate treatment.



5.3 CHANGE IN ACCOUNTING POLICIES

A change in accounting policies should be made in the following conditions:

- (a) It is required by some statute or for compliance with an Accounting Standard
- (b) Change would result in more appropriate presentation of financial statement

Change in accounting policy may have a material effect on the items of financial statements. For example, if cost formula used for inventory valuation is changed from weighted average to FIFO, or if interest is capitalized which was earlier not in practice, or if proportionate amount of interest is changed to inventory which was earlier not the practice, all these may increase or decrease the net profit. Unless the effect of such change in accounting policy is quantified, the financial statements may not help the users of accounts. Therefore, it is necessary to quantify the effect of change on financial statement items like assets, liabilities, profit/loss.

For example, Omega Enterprises revised its accounting policy relating to valuation of inventories to include applicable production overheads. It intends to do as it believes that such change would result in a more appropriate presentation of its financial statements.

SUMMARY

- ◆ Accounting Policies refer to specific accounting principles and methods of applying these principles adopted by the enterprise in the preparation and presentation of financial statements. Policies are based on various accounting concepts, principles and conventions.
- ◆ Three major characteristics which should be considered for the purpose of selection and application of accounting policies. viz., Prudence, Substance over form, and Materiality.

- ◆ A change in accounting policies should be made in the following conditions:
 - (a) It is required by some statute or for compliance with an Accounting Standard.
 - (b) Change would result in more appropriate presentation of financial statement.

TEST YOUR KNOWLEDGE

True and False

1. *There is a single list of accounting policies, which are applicable to all enterprises in all circumstances.*
2. *Selection of accounting policy doesn't impact financial performance and financial position of the business*
3. *A change in accounting policies should be made as and when business like to show result as per their choice.*
4. *Choosing FIFO or weighted average method for inventory valuation is selection of accounting policy.*
5. *Selection of an inappropriate accounting policy decision will overstate the performance and financial position of a business entity every time.*

Multiple Choice Questions

1. *A change in accounting policy is justified*
 - (a) *To comply with accounting standard and law.*
 - (b) *To ensure more appropriate presentation of the financial statement of the enterprise.*
 - (c) *Both (a) and (b).*
2. *Accounting policy for inventories of Xeta Enterprises states that inventories are valued at the lower of cost determined on weighted average basis or net realizable value. Which accounting principle is followed in adopting the above policy?*
 - (a) *Materiality.*
 - (b) *Prudence.*
 - (c) *Substance over form.*

3. *The areas wherein different accounting policies can be adopted are*
 - (a) *Providing depreciation.*
 - (b) *Valuation of inventories.*
 - (c) *Both the option.*
4. *Selection of an inappropriate accounting policy decision may*
 - (a) *Overstate the performance and financial position of a business entity.*
 - (b) *Understate/overstate the performance and financial position of a business entity.*
 - (c) *Overstate the performance of a business entity.*
5. *Accounting policies refer to specific accounting*
 - (a) *Principles.*
 - (b) *Methods of applying those principles.*
 - (c) *Both (a) and (b).*

Theoretical Questions

1. *Define Accounting Policies in brief. Identify few areas wherein different accounting policies are frequently encountered.*
2. *"Change in accounting policy may have a material effect on the items of financial statements." Explain the statement with the help of an example.*

ANSWERS/HINTS

True and False

1. False: There cannot be single list of accounting policies, which are applicable to all enterprises in all circumstances. There would always be different policies chosen by different industries under different circumstances.
2. False: Accounting policy has big impact on value of items goes under financial statements, hence it impacts financial performance and financial position of the business.
3. False: A change in accounting policies should be made in the following conditions:
 - (a) It is required by some statute or for compliance with an Accounting Standard.
 - (b) Change would result in more appropriate presentation of financial statement.

4. True: An enterprise may adopt FIFO or weighted average method for inventory valuation and the method selected for valuation is called an accounting policy.
5. False: It could understate/overstate the performance and financial position of a business entity.

Multiple Choice Questions

1.	(c)	2.	(b)	3.	(b)	4.	(b)	5.	(c)		
7.	(c)	8.	(a)	9	(c)						

Theoretical Questions

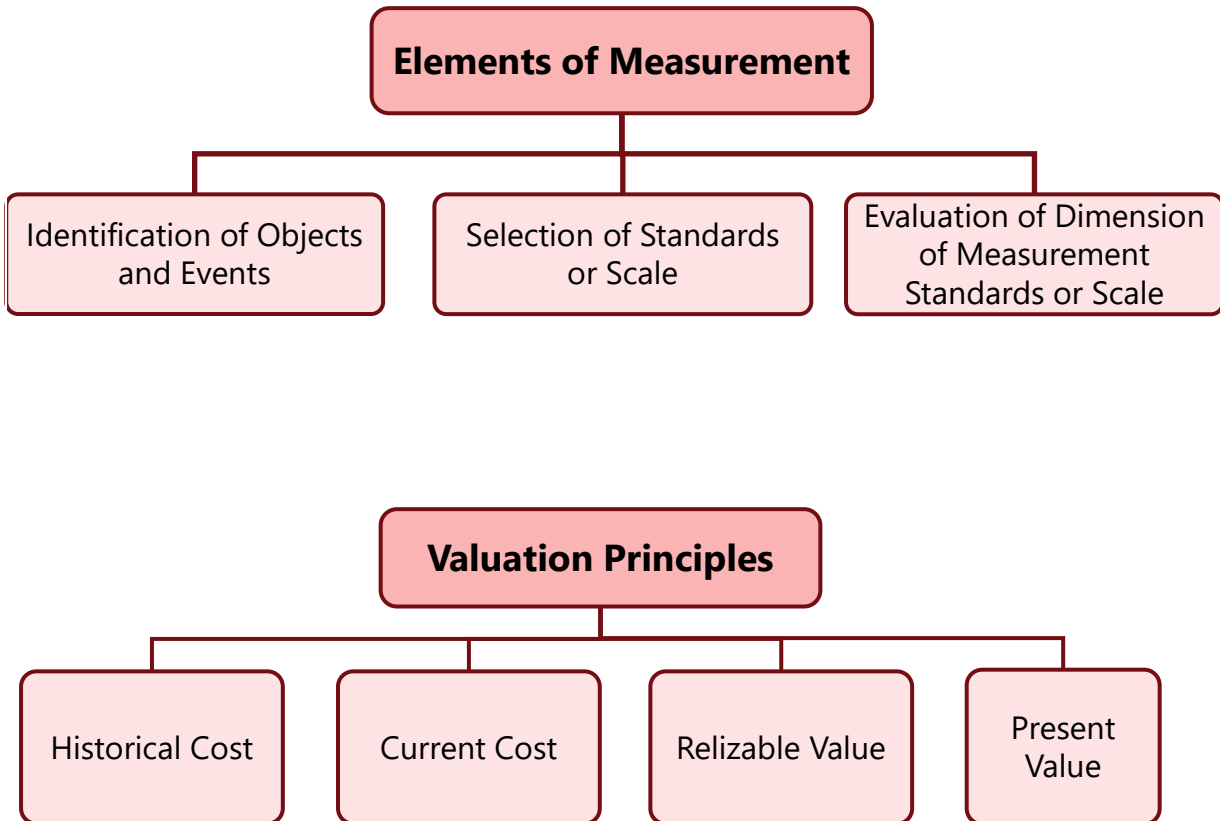
1. Accounting Policies refer to specific accounting principles and methods of applying these principles adopted by the enterprise in the preparation and presentation of financial statements. For details, refer para 5.1.
2. Change in accounting policy may have a material effect on the items of financial statements. For example, if cost formula used for inventory valuation is changed from weighted average to FIFO. Unless the effect of such change in accounting policy is quantified, the financial statements may not help the users of accounts.

UNIT – 6 ACCOUNTING AS A MEASUREMENT DISCIPLINE – VALUATION PRINCIPLES, ACCOUNTING ESTIMATES

LEARNING OUTCOMES

After studying this Unit, you will be able to:

- ◆ Understand the meaning of measurement and its basic elements.
- ◆ Know how far accounting is a measurement discipline if considered from the standpoint of the basic elements of measurement.
- ◆ Distinguish measurement from valuation.
- ◆ Learn the different measurement bases namely historical cost, realizable value and present value.
- ◆ Understand the measurement bases which can give objective and valuation to transactions and events.
- ◆ Understand that the traditional accounting system mostly uses historical cost as measurement base, although in some cases other measurement bases are also used.

UNIT OVERVIEW**6.1 MEANING OF MEASUREMENT**

Measurement is vital aspect of accounting. Primarily transactions and events are measured in terms of money. Any measurement discipline deals with three basic elements of measurement viz., identification of objects and events to be measured, selection of standard or scale to be used, and evaluation of dimension of measurement standards or scale.

Prof. R. J. Chambers defined 'measurement' as "assignment of numbers to objects and events according to rules specifying the property to be measured, the scale to be used and the dimension of the unit". (R.J. Chambers, Accounting Evaluation and Economic Behaviour, Prentice Hall, Englewood Cliffs, N.J. 1966, P.10).

Kohler defined measurement as the assignment of a system of ordinal or cardinal numbers to the results of a scheme of inquiry or apparatus of observations in accordance with logical or mathematical rules – [A Dictionary of Accountant].

Ordinal numbers, or ordinals, are numbers used to denote the position in an ordered sequence: first, second, third, fourth, etc., whereas a cardinal number says 'how many there are': one, two, three, four, etc.

Chambers' definition has been widely used to judge how far accounting can be treated as a measurement discipline.

According to this definition, the three elements of measurement are:

- (1) Identification of objects and events to be measured;
- (2) Selection of standard or scale to be used;
- (3) Evaluation of dimension of measurement standard or scale.



6.2 OBJECTS OR EVENTS TO BE MEASURED

We have earlier defined Accounting as the process of identifying, measuring and communicating economic information to permit informed judgements and decisions by the users of the information. So accounting essentially includes measurement of 'information'.

Decision makers need past, present and future information. For external users, generally the past information is communicated.

There is no uniform set of events and transactions in accounting which are required for decision making. For example, in cash management, various cash receipts and expenses are the necessary objects and events. Obviously, the decision makers need past cash receipts and expenses data along with projected receipts and expenses. For giving loan to a business one needs information regarding the repayment ability (popularly called debt servicing) of principal and interest. This also includes past information, current state of affairs as well as future projections. It may be mentioned that past and present objects and events can be measured with some degree of accuracy but future events and objects are only predicted, not measured. Prediction is an essential part of accounting information. Decision makers have to take decisions about the unseen future for which they need suitable information.



6.3 STANDARD OR SCALE OF MEASUREMENT

In accounting, money is the scale of measurement (see money measurement concept), although now-a-days quantitative information is also communicated along with monetary information.

Money as a measurement scale has no universal denomination. It takes the shape of currency ruling in a country. For example, in India the scale of measurement is Rupee, in the U.K. Pound-Sterling (£), in Germany Deutschmark (DM), in the United States Dollar (\$) and so on. Also there is no constant exchange relationship among the currencies.

If one businessman in India took loan \$5,000 from a businessman of the U.S.A., he would enter the transaction in his books in terms of ₹ Suppose at the time of loan agreement exchange rate was US \$ = ₹ 50. Then loan amounted to ₹ 2,50,000. Afterwards the exchange rate has been changed to \$ 1 = ₹ 55. At the changed exchange rate the loan amount becomes ₹ 2,75,000. So money as a unit of measurement lacks universal applicability across the boundary of a country unless a common currency is in vogue. Since the rate of exchange fluctuates between two currencies over the time, money as a measurement scale also becomes volatile.



6.4 DIMENSION OF MEASUREMENT SCALE

An ideal measurement scale should be stable over time. For example, if one buys 1 kg. cabbage today, the quantity he receives will be the same if he will buy 1 kg. cabbage one year later. Similarly, length of 1 metre cloth will not change if it is bought a few days later. That is to say a measurement scale should be stable in dimension. Money as a scale of measurement is not stable. There occurs continuous change in the input output prices. The same quantity of money may not have the ability to buy same quantity of identical goods at different dates. Thus information of one year measured in money terms may not be comparable with that of another year. Suppose production and sales of a company in two different years are as follows:

Year 1		Year 2	
Qty.	₹	Qty.	₹
5,000 pcs	5,00,000	4,500 pcs	5,40,000

Looking at the monetary figures one may be glad for 8% sales growth. In fact there was 10% production and sales decline. The growth envisaged through monetary figures is only due to price change. Let us suppose further that the cost of production for the above mentioned two years is as follows:

Year 1		Year 2	
Qty.	₹	Qty.	₹
5,000 pcs	4,00,000	4,500 pcs	4,50,000

Take Gross profit = Sales – Cost of Production. Then in the first year profit was ₹ 1,00,000 while in the second year the profit was ₹ 90,000. There was 10% decline in gross profit.

So, money as a unit of measurement is not stable in the dimension.

Thus, Accounting measures information mostly in money terms which is not a stable scale having universal applicability and also not stable in dimension for comparison over the time. So it is not an exact measurement discipline.



6.5 ACCOUNTING AS A MEASUREMENT DISCIPLINE

How do you measure a transaction or an event? Unless the measurement base is settled we cannot progress to the record keeping function of book-keeping. It has been explained that accounting is meant for generating information suitable for users' judgments and decisions. But generation of such information is preceded by recording, classifying and summarising data. By that process it measures performance of the business entity by way of profit or loss and shows its financial position. Thus, measurement is an important part of accounting discipline. But a set of theorems governs the whole measurement sub-system. These theorems should be carefully understood to know how the cogs of the 'accounting-wheel' work. Now-a-days accounting profession earmarked three theorems namely going concern, consistency and accrual as fundamental accounting assumptions, i.e., these assumptions are taken for granted. Also while measuring, classifying, summarising and also presenting, various policies are adopted. Recording, classifying summarising and communication of information are also important part of accounting, which do not fall within the purview of measurement discipline. Therefore, we cannot simply say that accounting is a measurement discipline.

But in accounting money is the unit of measurement. So, let us take one thing for granted that all transactions and events are to be recorded in terms of money only. Quantitative information is also required in many cases but such information is only supplementary to monetary information.



6.6 VALUATION PRINCIPLES

There are four generally accepted measurement bases or valuation principles. These are:

- (i) Historical Cost;
- (ii) Current Cost;
- (iii) Realizable Value;
- (iv) Present Value.

Let us discuss these principles in detail.

- (i) *Historical Cost:* It means acquisition price. For example, the businessman paid ₹ 7,00,000 to purchase the machine and spend ₹1,00,000 on its installation, its acquisition price including installation charges is ₹ 8,00,000. The historical cost of machine would be ₹8,00,000.

According to this base, assets are recorded at an amount of cash or cash equivalent paid at the time of acquisition. Liabilities are recorded at the amount of proceeds received in exchange for the obligation. In some circumstances a liability is recorded at the amount of cash or cash equivalent expected to be paid to satisfy it in the normal course of business.

When a businessman, takes ₹ 5,00,000 loan from a bank @ 10% interest p.a., it is to be recorded at the amount of proceeds received in exchange for the obligation. Here the obligation is the repayment of loan as well as payment of interest at an agreed rate i.e. 10%. Proceeds received are ₹ 5,00,000 - it is historical cost of the transactions.

Take another case regarding payment of income tax liability. You know every individual has to pay income tax on his income if it exceeds certain minimum limit. But the income tax liability is not settled immediately when one earns his income. The income tax authority settles it some time later, which is technically called assessment year. Then how does he record this liability? As per historical cost base it is to be recorded at an amount expected to be paid to discharge the liability.

Companies usually apply historical cost method in case of long-term assets like machinery, furniture, licenses etc.

- (ii) *Current Cost:* Take that Mr. X purchased a machine on 1st January, 2011 at ₹ 7,00,000. As per historical cost base he has to record it at ₹ 7,00,000 i.e. the acquisition price. As on 1.1.2022, Mr. X found that it would cost ₹ 25,00,000 to purchase that machine. Take also that Mr. X took loan from a bank as on 1.1.2011 ₹ 5,00,000 @ 18% p.a. repayable at the end of 15th year together with interest. As on 1.1.2022 the bank announces 1% prepayment penalty on the loan amount if it is paid within 15 days starting from that day. As per historical cost the liability is recorded at ₹ 5,00,000 at the amount or proceeds received in exchange for obligation and asset is recorded at ₹ 7,00,000.

Current cost gives an alternative measurement base. Assets are carried out at the amount of cash or cash equivalent that would have to be paid if the same or an equivalent asset was acquired currently. Liabilities are carried at the undiscounted amount of cash or cash equivalents that would be required to settle the obligation currently.

So as per current cost base, the machine value is ₹ 25,00,000 while the value of bank loan is ₹ 5,05,000.

- (iii) *Realisable Value:* Suppose Mr. X found that he can get ₹ 20,00,000 if he would sell the machine purchased, on 1.1.2011 paying ₹ 7,00,000 and which would cost ₹ 25,00,000 in case he would buy it currently. Take also that Mr. X found that he had no money to pay off the bank loan of ₹ 5,00,000 currently.

As per realisable value, assets are carried at the amount of cash or cash equivalents that could currently be obtained by selling the assets in an orderly disposal. Haphazard disposal may yield something less. Liabilities are carried at their settlement values; i.e. the undiscounted amount of cash or cash equivalents expressed to be paid to satisfy the liabilities in the normal course of business.

So, the machine should be recorded at ₹ 20,00,000 the realisable value in an orderly sale while the bank loan should be recorded at ₹ 5,00,000 the settlement value in the normal course of business.

Realisable value concept is commonly applied in case of inventories. Inventories are measured at the lower of cost and net realisable value.

- (iv) *Present Value:* Suppose we are talking as on 1.1.2022 - take it as time for reference. Now think the machine purchased by Mr. X can work for another 10 years and is supposed to generate cash @ ₹ 1,00,000 p.a. Also take that bank loan of ₹ 5,00,000 taken by Mr. X is to be repaid as on 31.12.2028. Annual interest is ₹ 90,000.

As per present value, an asset is carried at the present discounted value of the future net cash inflows that the item is expected to generate in the normal course of business. Liabilities are carried at the present discounted value of future net cash outflows that are expected to be required to settle the liabilities in the normal course of business.

The concept of Present Value is common in case of accounting for investments and loans.

The term 'discount', 'cash inflow' and 'cash outflow' need a little elaboration. ₹ 100 in hand as on 1.1.2022 is not equivalent to ₹ 100 in hand as on 31.12.2022. There is a time gap of one year. If Mr. X had ₹ 100 as on 1.1.2022 he could use it at that time. If he received it only on 31.12.2022, he had to sacrifice his use for a year. The value of this sacrifice is called 'time value of money'. Mr. X would sacrifice i.e. he would agree to take money on 31.12.2022 if he had been compensated for the sacrifice. So a rational man will never exchange ₹ 100 as on 1.1.2022 with ₹ 100 to be received on 31.12.2022. Then ₹ 100 of 1.1.2022 is not equivalent to ₹ 100 of 31.12.2022. To make the money receivable at a future date equal with the money of the present date it is to be devalued. Such devaluation is called discounting of future money.

Perhaps you know the compound interest rule: $A = P (1 + i)^n$

A = Amount

P = Principal

i = interest / 100

n = Time

This equation gives the relationship between present money, principal and the future money amount. If A, i and n are given, to find out P, the equation is to be changed slightly.

$$P = \frac{A}{(1+i)^n}$$

Using the equation one can find out the present value if he knows the values of A, i and n.

Suppose i = 20%, now what is the present value of ₹ 1,00,000 to be received as on 31.12.2022 (Take 1.1.2022 as the time of reference).

$$P = \frac{1,00,000}{(1+20)^1} = ₹ 83,333$$

Similarly,

Time of Receipt	Money Value ₹	Present Value ₹
31.12.2023	1,00,000	69,444
31.12.2024	1,00,000	57,870
31.12.2025	1,00,000	48,225
31.12.2026	1,00,000	40,188
31.12.2027	1,00,000	33,490
31.12.2028	1,00,000	27,908
31.12.2029	1,00,000	23,257
31.12.2030	1,00,000	19,381
31.12.2031	1,00,000	16,150

Total of all these present values is ₹ 4,19,246. Since the machine purchased by Mr. X will produce cash equivalent to ₹ 4,19,246 in terms of present value, it is to be valued at such amount as per present value measurement basis.

Here, Mr. X will receive ₹ 1,00,000 at different points of time-these are cash inflows. In the other example, he has to pay interest and principal of bank loan-these are cash outflows.

Perhaps you also know the annuity rule:

Present value of an Annuity or Re. A for n periods is

A = Annuity

i = interest

t = time 1, 2, 3, ...n.

$$\frac{A}{i} \left[1 - \frac{1}{(1+i)^n} \right]$$

Applying this rule one can derive the present value of ₹ 1,00,000 for 10 years @ 20% p.a.

$$\frac{1,00,000}{0.20} \left[1 - \frac{1}{(1+0.20)^{10}} \right] = ₹ 4,19,246$$

Similarly, the present value of bank loan is

$$\frac{90,000}{0.20} \left[1 - \frac{1}{(1+0.20)^5} \right] + \frac{5,00,000}{(1+0.20)^5}$$

$$= ₹ 2,69,155 + ₹ 2,00,939 = ₹ 4,70,094$$

Thus, we get the four measurements as on 1.1.2022:

	Historical cost ₹	Current cost ₹	Realisable value ₹	Present value ₹
Asset: Machine	7,00,000	25,00,000	20,00,000	4,19,246
Liability: Bank Loan	5,00,000	5,05,000	5,00,000	4,70,094

The accounting system which we shall discuss in the remaining chapters is also called historical cost accounting. However, this need not mean that one shall follow only historical cost basis of accounting. In the later stages of the CA course, we shall see that the accounting system uses all types of measurement bases although under the traditional system most of the transactions and events are measured in terms of historical cost.



6.7 MEASUREMENT AND VALUATION

Value relates to the benefits to be derived from objects, abilities or ideas. To the economist, value is the utility (i.e.; satisfaction) of an economic resource to the person contemplating or enjoying its use. In accounting, to mean value of an object, abilities or ideas, a monetary surrogate is used. That is to say, value is measured in terms of money. Suppose, an individual purchased a car paying ₹ 2,50,000. Its value lies in the satisfaction to be derived by that individual using the car in future. Economists often use ordinal scale to indicate the level of satisfaction. But accountants use only cardinal scales. If the value of car is taken as ₹ 2,50,000 it is only one type of value called acquisition cost or historical cost. So value is indicated by measurement. In accounting the value is always measured in terms of money.



6.8 ACCOUNTING ESTIMATES

Earlier in this unit we have learned how to measure a transaction, which had already taken place and for which either some value/money has been paid or some valuation principles are to be adopted for their measurement. But there are certain items, which have not occurred therefore cannot be measured using valuation principles still they are necessary to record in the books of account, for example, provision for doubtful debts. For such items, we need some value. In such a situation reasonable estimates based on the existing situation and past experiences are made.

The measurement of certain assets and liabilities is based on estimates of uncertain future events. As a result of the uncertainties inherent in business activities, many financial statement items cannot be measured with precision but can only be estimated. Therefore, the management makes various estimates and assumptions of assets, liabilities, incomes and expenses as on the date of preparation of financial statements. Such estimates are made in connection with the computation of depreciation, amortisation and impairment losses as well as, accruals, provisions and employee benefit obligations. Also estimates may be required in determining the bad debts, useful life and residual value of an item of plant and machinery and inventory obsolescence. The process of estimation involves judgements based on the latest information available.

An estimate may require revision if changes occur regarding circumstances on which the estimate was based, or as a result of new information, more experience or subsequent developments. Change in accounting estimate means difference arises between certain parameters estimated earlier and re-estimated during the current period or actual result achieved during the current period.

Few examples of situations wherein accounting estimates are needed can be given as follows:

1. A company incurs expenditure of ₹ 10,00,000 on development of patent. Now the company has to estimate that for how many years the patent would benefit the company. This estimation should be based on the latest information and logical judgement.
2. A company dealing in long-term construction contracts, uses percentage of completion method for recognizing the revenue at the end of the accounting year. Under this method the company has to make adequate provisions for unseen contingencies, which can take place while executing the remaining portion of the contract. Since provisioning for unseen contingencies requires estimation, there may be excess or short provisioning, which is to be adjusted in the period when it is recognised.
3. A company has to provide for taxes which is also based on estimation as there can be some interpretational differences on account of which tax authorities may either accept the expenditure or refuse it. This will ultimately lead to different tax liability.
4. Company XY Ltd purchases a machine for ₹ 10 lac in 2021. The procurement head suggested that the machine is expected to offer benefits up to next 10 years. After 3 years of its use, the machine has become obsolete as new technologies are now available providing better productivity than the existing machine. Hence, it is now expected that the machine can only offer benefits for further 3 years. This is a change in estimate in the useful life of the machine.

SUMMARY

- ◆ Measurement is vital aspect of accounting. Primarily transactions and events are measured in terms of money.
- ◆ There are three elements of measurement:
 - (i) Identification of objects and events to be measured;
 - (ii) Selection of standard or scale to be used;
 - (iii) Evaluation of dimension of measurement standard or scale.
- ◆ There are four generally accepted measurement bases or valuation principles. These are:
 - (i) Historical Cost;
 - (ii) Current Cost;
 - (ii) Realizable Value;
 - (iv) Present Value.

TEST YOUR KNOWLEDGE

True and False

1. *There are four generally accepted measurement bases.*
 - (i) *Historical Cost;*
 - (ii) *Current Cost;*
 - (iii) *Realizable Value;*
 - (iv) *Future Value.*
2. *Historical Cost means price paid at time acquisition.*
3. *As per future value, assets are carried at the amount of cash or cash equivalents that could currently be obtained by selling the assets in an orderly disposal.*
4. *At Present value, liabilities are carried at the value of future net cash outflows that are expected to be required to settle the liabilities in the normal course of business.*
5. *ABC purchased a machinery amounting ₹10,00,000 on 1st April, 2001. On 31st March, 2022, similar machinery could be purchased for ₹20,00,000. Historical cost of machine is 20,00,000*
6. *ABC purchased a machinery amounting ₹10,00,000 on 1st April, 2001. On 31st March, 2022, similar machinery could be purchased for ₹20,00,000. Current cost of machine is ₹ 20,00,000*
7. *Change in accounting estimate has to be given retrospective effect.*

Multiple Choice Questions

1. (i) *Measurement discipline deals with*
 - (a) *Identification of objects and events.*
 - (b) *Selection of scale.*
 - (c) *Both (a) and (b)*
- (ii) *All of the following are valuation principles except*
 - (a) *Historical cost.*
 - (b) *Present value.*
 - (c) *Future value.*

- (iii) Book value of machinery on 31st March, 2022 ₹ 10,00,000
Market value as on 31st March, 2022 if sold ₹ 11,00,000
As on 31st March, 2022, if the company values the machinery at ₹ 11,00,000, which of the following valuation principle is being followed?
- (a) Historical Cost.
 - (b) Present Value.
 - (c) Realisable Value.
2. Mohan purchased a machinery amounting ₹ 10,00,000 on 1st April, 2001. On 31st March, 2022, similar machinery could be purchased for ₹ 20,00,000 but the realizable value of the machinery (purchased on 1.4.2001) was estimated at ₹ 15,00,000. The present discounted value of the future net cash inflows that the machinery was expected to generate in the normal course of business, was calculated as ₹ 12,00,000.
- (i) The current cost of the machinery is
 - (a) ₹ 10,00,000.
 - (b) ₹ 20,00,000.
 - (c) ₹ 15,00,000.
 - (ii) The present value of machinery is
 - (a) ₹ 10,00,000.
 - (b) ₹ 20,00,000.
 - (c) ₹ 12,00,000.
 - (iii) The historical cost of machinery is
 - (a) ₹ 10,00,000.
 - (b) ₹ 20,00,000.
 - (c) ₹ 15,00,000.
 - (iv) The realizable value of machinery is
 - (a) ₹ 10,00,000.
 - (b) ₹ 20,00,000.
 - (c) ₹ 15,00,000.

Theoretical Questions

1. Define Measurement in brief. Explain the significant elements of measurement.
2. Describe in brief, the alternative measurement bases, for determining the value at which an element can be recognized in the balance sheet or statement of profit and loss.

ANSWER/HINTS

True and False

- False: There are four generally accepted measurement bases .
 (i) Historical Cost;
 (ii) Current Cost;
 (iv) Realizable Value;
 (iv) Present Value.
- True: Historical cost means the acquisition price.
- False: At Realisable value, assets are carried at the amount of cash or cash equivalents that could currently be obtained by selling the assets in an orderly disposal.
- False: Liabilities are carried at the present discounted value of future net cash outflows that are expected to be required to settle the liabilities in the normal course of business.
- False: Historical cost is ₹10,00,000.
- True: Since similar machine is purchased at 20,00,000, the current cost of machine is ₹ 20,00,000.
- False: Change in accounting estimate has not to be given retrospective effect.

Multiple Choice Questions

1. (i)	(c)	(ii)	(c)	(iii)	(c)	2.(i)	(b)	(ii)	(c)	(iii)	(a)
(iv)	(c)										

Theoretical Questions

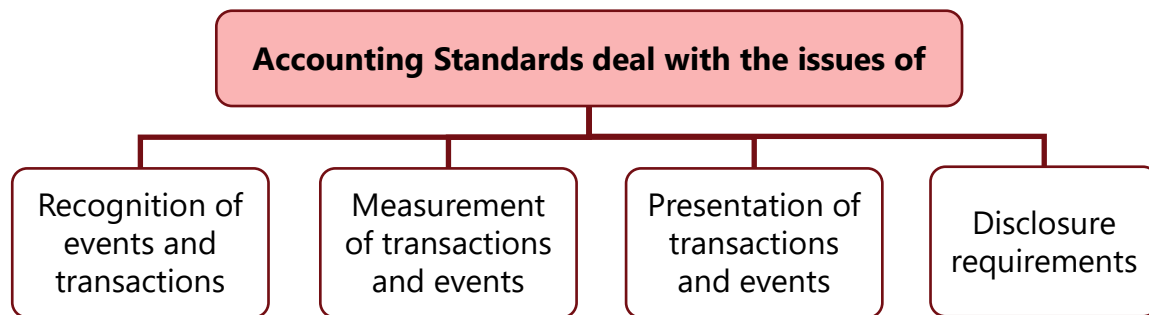
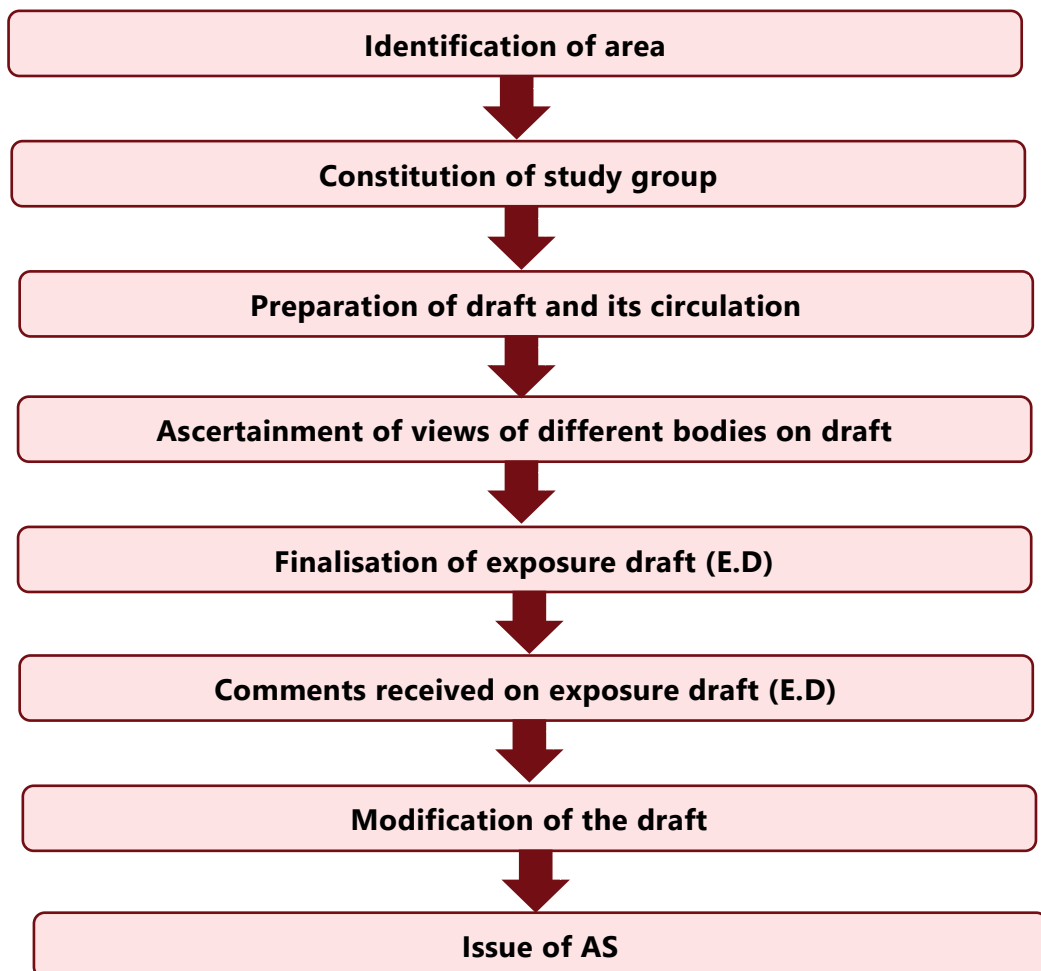
- Measurement is vital aspect of accounting. Primarily transactions and events are measured in terms of money. Three elements of measurement are: (1) Identification of objects and events to be measured; (2) Selection of standard or scale to be used; (3) Evaluation of dimension of measurement standard or scale.
- Alternative measurement bases are: (i) Historical Cost; (ii) Current cost (iii) Realisable (Settlement) Value and (iv) Present Value. Refer para 6.6 for details.

UNIT – 7 ACCOUNTING STANDARDS

LEARNING OUTCOMES

After studying this unit, you will be able to:

- ◆ Understand the significance of issuance of Accounting Standards.
- ◆ Grasp the objectives, benefits and limitations of Accounting Standards.
- ◆ Learn the process of formulation of Accounting Standards by the Council of the Institute of Chartered Accountants of India.
- ◆ Familiarize with the list of applicable Accounting Standards in India.

UNIT OVERVIEW**Formulation of Accounting Standards**



7.1 INTRODUCTION OF ACCOUNTING STANDARDS

Accounting as a 'language of business' communicates the financial results of an enterprise to various stakeholders by means of financial statements. If the financial accounting process is not properly regulated, there is possibility of financial statements being misleading, tendentious and providing a distorted picture of the business, rather than the true. To ensure transparency, consistency, comparability, adequacy and reliability of financial reporting, it is essential to standardize the accounting principles and policies. Accounting Standards (ASs) provide framework and standard accounting policies for treatment of transactions and events so that the financial statements of different enterprises become comparable.

Accounting standards are written policy documents issued by the expert accounting body or by the government or other regulatory body covering the aspects of recognition, measurement, presentation and disclosure of accounting transactions and events in the financial statements. The ostensible purpose of the standard setting bodies is to promote the dissemination of timely and useful financial information to investors and certain other parties having an interest in the company's economic performance. The accounting standards deal with the issues of -

- (i) recognition of events and transactions in the financial statements;
- (ii) measurement of these transactions and events;
- (iii) presentation of these transactions and events in the financial statements in a manner that is meaningful and understandable to the reader; and
- (iv) the disclosure requirements which should be there to enable the public at large and the stakeholders and the potential investors in particular, to get an insight into what these financial statements are trying to reflect and thereby facilitating them to take prudent and informed business decisions.



7.2 OBJECTIVES OF ACCOUNTING STANDARDS

The whole idea of accounting standards is centered around harmonisation of accounting policies and practices followed by different business entities so that the diverse accounting practices adopted for various aspects of accounting can be standardised. Accounting Standards standardise diverse accounting policies with a view to:

- (i) eliminate the non-comparability of financial statements and thereby improving the reliability of financial statements; and
- (ii) provide a set of standard accounting policies, valuation norms and disclosure requirements.

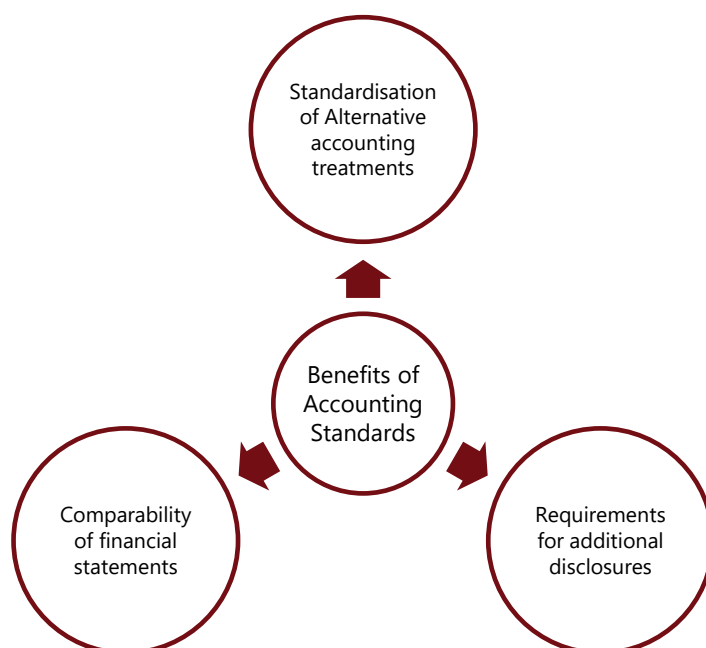
Accounting standards reduce the accounting alternatives in the preparation of financial statements within the bounds of rationality, thereby ensuring comparability of financial statements of different enterprises.



7.3 BENEFITS AND LIMITATIONS OF ACCOUNTING STANDARDS

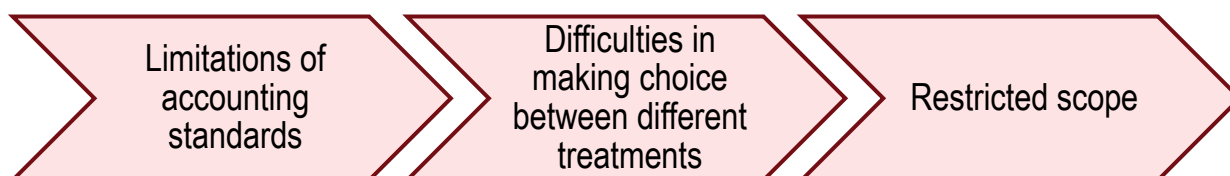
Accounting standards seek to describe the accounting principles, the valuation techniques and the methods of applying the accounting principles in the preparation and presentation of financial statements so that they may give a true and fair view. By setting the accounting standards, the accountant has following benefits:

- (i) Standards reduce to a reasonable extent or eliminate altogether confusing variations in the accounting treatments used to prepare financial statements.
- (ii) There are certain areas where important information are not statutorily required to be disclosed. Standards may call for disclosure beyond that required by law.
- (iii) The application of accounting standards would, to a limited extent, facilitate comparison of financial statements of companies situated in different parts of the world and also of different companies situated in the same country. However, it should be noted in this respect that differences in the institutions, traditions and legal systems from one country to another give rise to differences in accounting standards adopted in different countries.



However, there are some limitations of accounting standards:

- (i) **Difficulties in making choice between different treatments:** Alternative solutions to certain accounting problems may each have arguments to recommend them. Therefore, the choice between different alternative accounting treatments may become difficult.
- (ii) **Restricted scope:** Accounting standards cannot override the statute. The standards are required to be framed within the ambit of prevailing statutes.



7.4 PROCESS OF FORMULATION OF ACCOUNTING STANDARDS IN INDIA

The Institute of Chartered Accountants of India (ICAI), being a premier accounting body in the country, took upon itself the leadership role by constituting the Accounting Standards Board (ASB) in 1977. The ICAI has taken significant initiatives in the setting and issuing procedure of Accounting Standards to ensure that the standard-setting process is fully consultative and transparent. The ASB considers International Financial Reporting Standards (IFRSs) while framing Indian Accounting Standards (ASs) in India and try to integrate them, in the light of the applicable laws, customs, usages and business environment in the country. The composition of ASB includes, representatives of industries (namely, ASSOCHAM, CII, FICCI), regulators, academicians, government departments etc. Although ASB is a body constituted by the Council of the ICAI, it (ASB) is independent in the formulation of accounting standards and Council of the ICAI is not empowered to make any modifications in the draft accounting standards formulated by ASB without consulting with the ASB.

The standard-setting procedure of Accounting Standards Board (ASB) can be briefly outlined as follows:

- ◆ Identification of broad areas by ASB for formulation of AS.
- ◆ Constitution of study groups by ASB to consider specific projects and to prepare preliminary drafts of the proposed accounting standards. The draft normally includes objective and scope of the standard, definitions of the terms used in the standard, recognition and measurement principles wherever applicable and presentation and disclosure requirements.

- ◆ Consideration of the preliminary draft prepared by the study group of ASB and revision, if any, of the draft on the basis of deliberations.
- ◆ Circulation of draft of accounting standard (after revision by ASB) to the Council members of the ICAI and specified outside bodies such as Department of Company Affairs (DCA), Securities and Exchange Board of India (SEBI), Comptroller and Auditor General of India (C&AG), Central Board of Direct Taxes (CBDT), Standing Conference of Public Enterprises (SCOPE), etc. for comments.
- ◆ Meeting with the representatives of the specified outside bodies to ascertain their views on the draft of the proposed accounting standard.
- ◆ Finalisation of the exposure draft of the proposed accounting standard and its issuance inviting public comments.
- ◆ Consideration of comments received on the exposure draft and finalisation of the draft accounting standard by the ASB for submission to the Council of the ICAI for its consideration and approval for issuance.
- ◆ Consideration of the final draft of the proposed standard and by the Council of the ICAI, and if found necessary, modification of the draft in consultation with the ASB is done.
- ◆ The accounting standard on the relevant subject (for non-corporate entities) is then issued by the ICAI. For corporate entities the accounting standards are issued by The Central Government of India.



7.5 LIST OF ACCOUNTING STANDARDS IN INDIA

The 'Accounting Standards' issued by the Accounting Standards Board establish standards which have to be complied by the business entities so that the financial statements are prepared in accordance with generally accepted accounting principles.

Following is the list of applicable Accounting Standards:

List* of Accounting Standards

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

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

*** Note: The list of accounting standards given above does not form part of syllabus. It has been given here for the knowledge of students only.**

SUMMARY

- ◆ Accounting Standards (ASs) provide framework and standard accounting policies for treatment of transactions and events so that the financial statements of different enterprises become comparable. Accounting Standards standardise diverse accounting policies with a view to:
 - (i) eliminate the non-comparability of financial statements
 - (ii) provide a set of standard accounting policies, valuation norms and disclosure requirements
- ◆ By setting the accounting standards, the accountant has following benefits:
 - (i) Comparability of financial statements
 - (ii) Requirements of additional disclosures
- ◆ Following are the limitations of accounting standards
 - (i) Difficulties in making choice between different treatments.
 - (ii) Accounting standards cannot override the statute

TEST YOUR KNOWLEDGE

True and False

1. *Accounting standards are written policy documents issued by the expert accounting body or by the government or other regulatory body covering the aspects of recognition, measurement, presentation and disclosure of accounting transactions and events in the financial statements.*
2. *Accounting standards can override the statute.*
3. *Difficulties in making choice between different treatments is one of the benefits of accounting standards.*
4. *Requirements for additional disclosures is limitation of accounting standards.*
5. *ASB stands for Accounting standardisation benchmarking.*
6. *There are no limitation to accounting standards.*

Multiple Choice Questions

1. *Accounting Standards for Non-Corporate entities in India are issued by*
 - (a) *Central Govt.*
 - (b) *State Govt.*
 - (c) *Institute of Chartered Accountants of India.*
2. *Accounting Standards*
 - (a) *Harmonise accounting policies.*
 - (b) *Eliminate the non-comparability of financial statements.*
 - (c) *Both the above.*
3. *It is essential to standardize the accounting principles and policies in order to ensure*
 - (a) *Transparency.*
 - (b) *Consistency.*
 - (c) *Both the above.*

Theoretical Questions

1. *Explain the objective of "Accounting Standards" in brief.*
2. *State the advantages of setting Accounting Standards.*

ANSWERS/HINTS

True and False

1. True: Accounting standards are documents covering recognition, measurement, presentation and disclosure of accounting transactions and events in the financial statements.
2. False: Accounting standards can never override the statute. The standards are required to be framed within the ambit of prevailing statutes.
3. False: Difficulties in making choice between different treatments is one of the limitation of accounting standard.
4. False: Benefits of accounting standards are:
 - Standardisation of alternative accounting treatments

- Comparability of financial statements
 - Requirements for additional disclosures.
5. False: ASB stands for Accounting Standard Board.
 6. False: limitations of accounting standards
 - Difficulties in making choice between different treatments
 - Restricted scope

Multiple Choice Questions

1.	(c)	2.	(c)	3.	(c)						

Theoretical Questions

1. Accounting Standards are selected set of accounting policies or broad guidelines regarding the principles and methods to be chosen out of several alternatives. The main objective of Accounting Standards is to establish standards which have to be complied with, to ensure that financial statements are prepared in accordance with generally accepted accounting principles. Accounting Standards seek to suggest rules and criteria of accounting measurements. These standards harmonize the diverse accounting policies and practices at present in use in India.
2. The main advantage of setting accounting standards is that the adoption and application of accounting standards ensure uniformity, comparability and qualitative improvement in the preparation and presentation of financial statements. The other advantages are: Reduction in variations; Disclosures beyond that required by law and Facilitates comparison.

NOTES

[illegible]



ACCOUNTING PROCESS



UNIT -1 BASIC ACCOUNTING PROCEDURES – JOURNAL ENTRIES

LEARNING OUTCOMES

After studying this unit, you will be able to:

- ◆ Understand meaning and significance of Double Entry System.
- ◆ Familiarize with the term 'account' and understand the classification of accounts into personal, real and nominal.
- ◆ Note the utility of such classification and sub-classifications.
- ◆ Understand how debits and credits are determined from transactions and events.
- ◆ Observe the points to be taken care of while recording a transaction in the journal.

UNIT OVERVIEW

Source Documents

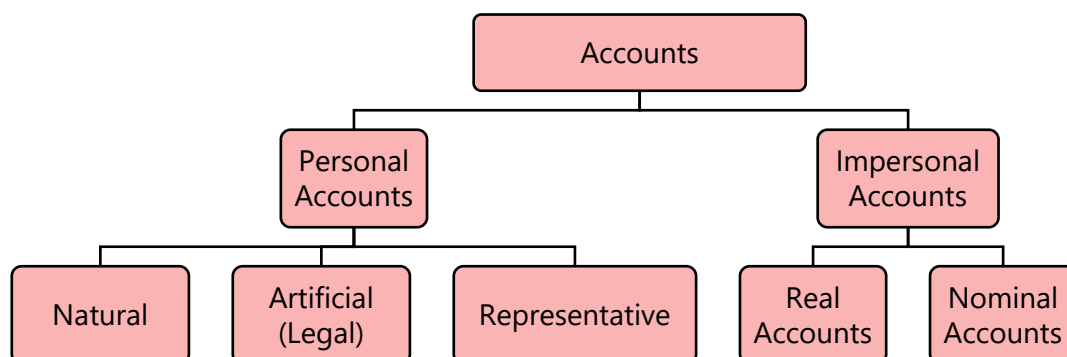
- All documents in records which contain financial records and act as evidence of transactions.

Books of original entry and Ledger Accounts

- Purchase day book, Cash book, Sales day book and Purchases return book
- Accounts where information relating to a particular asset/liability, capital, income and expenses are recorded.

Trial Balance

- It contains the totals from various ledger accounts and act as preliminary check on accounts before producing financial statements.



1.1 DOUBLE ENTRY SYSTEM

Double entry system of accounting is more than 500 years old. "Luca Pacioli" an Italian friar & mathematician published Summa de Arithmetica, Geometria, Proportioni, et Proportionalita ("Everything about Arithmetic Geometry and proportions"). The first book that described a double entry accounting system. Double entry system of book-keeping has emerged in the process of evolution of various accounting techniques. It is the only scientific system of accounting. According to it, every transaction has two-fold aspects—debit and credit and both the aspects are to be recorded in the books of accounts. Therefore, in every transaction at least two accounts are effected.

For example, on purchase of furniture either the cash balance will be reduced or a liability to the supplier will arise and new asset furniture is acquired. This has been made clear already, the Double Entry System records both the aspects. It may be defined as the system which recognises and records both the aspects of transactions. This system has proved to be

systematic and has been found of great use for recording the financial transactions for all kind of entities requiring use of money.



1.2 ADVANTAGES OF DOUBLE ENTRY SYSTEM

This system affords the under mentioned advantages:

- (i) By the use of this system the accuracy of the accounting work can be established, through the device of the trial balance.
- (ii) The profit earned or loss incurred during a period can be ascertained together with details.
- (iii) The financial position of the entity or the institution concerned can be ascertained at the end of each period, through preparation of the financial statements.
- (iv) The system permits accounts to be kept in as much details as necessary and, therefore provides significant information for the purpose of control and reporting.
- (v) Result of one year may be compared with those of previous years and reasons for the change may be ascertained.

In view of the above, the advantages of double entry system has been used extensively in all countries.



1.3 ACCOUNT

We have seen how the accounting equation becomes true in all cases. A person starts his business with say, ₹ 10,00,000 as capital with corresponding balance of cash ₹ 10,00,000. For example, transactions entered into by the entity will alter the cash balance in two ways, one will increase the cash balance and other will reduce it. Payment for goods purchased, salaries paid and rent expense paid, etc., will reduce the cash balance whereas sales of goods for cash and collection from customers will increase it.

We can change the cash balance with every transaction but this will be cumbersome. Instead it would be better if all the transactions that lead to an increase are recorded in one column and those that reduce the cash balance in another column; then the net result can be ascertained. If we add all increases to the opening balance of cash and then deduct the total of all decreases, we shall know the closing balance. In this manner, significant information will be available relating to cash.

The two columns which we referred above are put usually in the form of an account, called the 'T' form. This is illustrated below by taking imaginary figures:

CASH

Particular		Increase (Receipt) ₹	Particular	Decrease (Payment) ₹
Opening Balance	(1)	10,00,000		(7) 1,00,000
	(2)	2,50,000		(8) 3,00,000
	(3)	2,00,000		(9) 2,00,000
	(4)	5,00,000		(10) 5,00,000
	(5)	1,35,000		
	(6)	4,00,000		(11) 12,00,000
			New or Closing Balance	1,85,000
		24,85,000		24,85,000

Since, each T-account shows only amounts and not transaction descriptions, we record each transaction in some way, such as by numbering used in this illustration. However, one can use date also for this purpose.

What we have done is to record the increase of cash on the left hand side and the decrease on the right hand side; the closing balance has been ascertained by deducting the total of payments, ₹ 23,00,000 from the total of the left - hand side. Such a treatment of receipts and payments of cash is very convenient.

Here we talked about only one account namely cash, now let us see how to make T-accounts when assets as well as liabilities are effected from a particular transaction.

Now, let us take some more examples:-

Transaction 1:

Initial investment by owners ₹ 25,00,000 in cash.

This will effect two accounts namely cash and capital. The asset cash increases and the stock holders' equity paid up capital also increases.

CASH

	Increase		Decrease
(1)	25,00,000		

CAPITAL

	Decrease		Increase
		(1)	25,00,000

Transaction 2:

Paid cash to the creditors ₹ 14,00,000

This will effect cash account which will decrease and creditors account which is a liability will also decrease.

CASH

	Increase		Decrease
		(2)	14,00,000

CREDITORS

	Decrease		Increase
(2)	14,00,000		

The proper form of an account is as follows:

Account

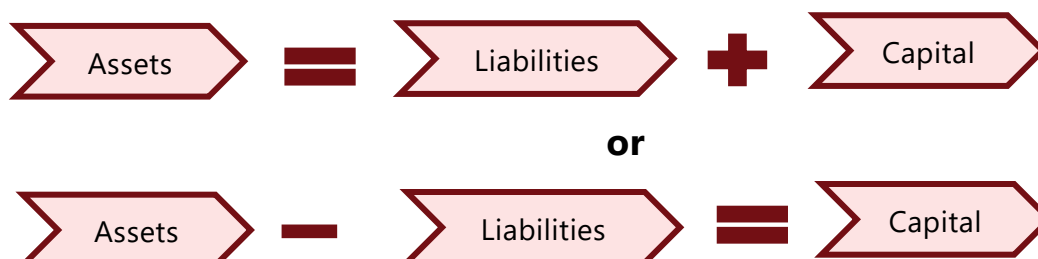
Date	Particulars	Amount	Date	Particulars	Amount
		₹			

The columns are self-explanatory.

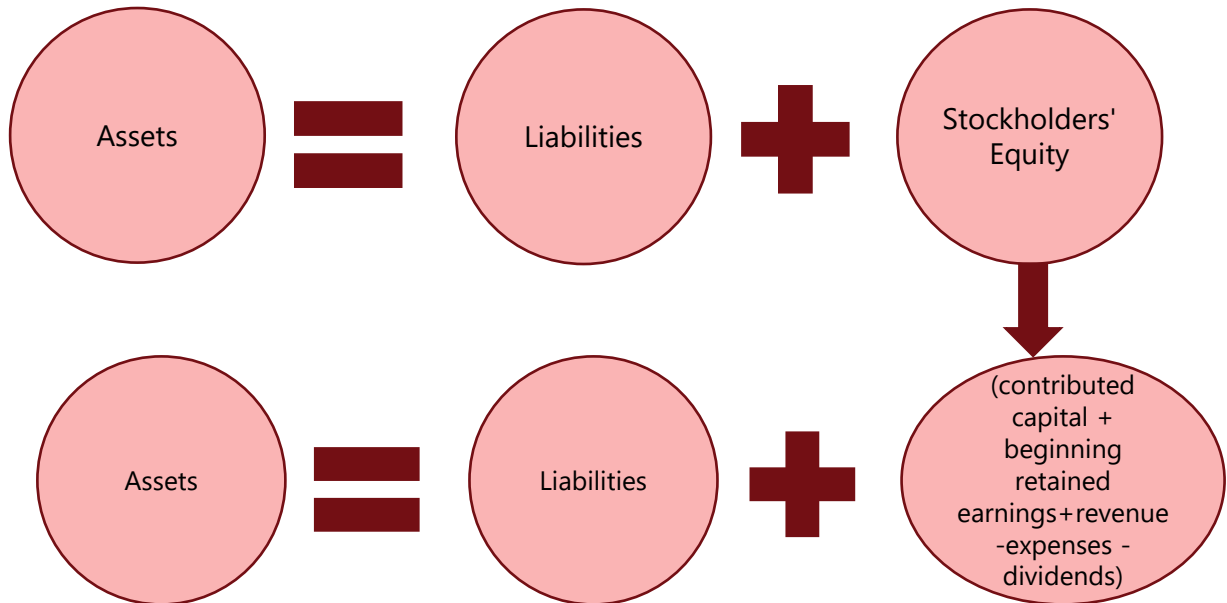
1.4 DEBIT AND CREDIT

We have seen that in T-accounts increase and decrease entries are made on the left and right side of the accounts for assets respectively and vice-versa for liabilities. But, formally accountants use the term Debit (Dr.) to denote an entry on the left side of any account and Credit (Cr.) to denote an entry on the right side of any account.

We know that by deducting the total of liabilities from the total of assets the amount of capital is ascertained, as is indicated by the accounting equation.



To understand the equation better, let us expand it:-



Here,

Contributed capital = the original capital introduced by the owner.

Beginning retained earnings = previous earnings not distributed to the shareholders.

Revenue = generated from the ongoing activities of the business

Expenses = cost incurred for the operations of the company.

Dividends = earnings distributed to the shareholders of the company

We have also seen that if there is any change on one side of the equation, it is bound to be similar change on the other side of the equation or amongst items covered by it or an opposite change on the same side of the equation. This is illustrated below:

Transactions	Total Assets ₹	= Liabilities ₹	+ Owner's Capital ₹
(1) Started business with cash ₹ 10,00,000	10,00,000		10,00,000
(2) Borrowed ₹ 5,00,000	+ 5,00,000	+ 5,00,000	
(3) Withdrew cash from business ₹ 2,00,000	- 2,00,000		- 2,00,000
(4) Loan repaid to the extent of ₹ 1,00,000	- 1,00,000	- 1,00,000	
(5) Bought furniture worth ₹ 3,00,000 with Cash	+3,00,000 <u>- 3,00,000</u>		
Balance	12,00,000	= 4,00,000	+ 8,00,000

As has been seen previously, what has been given above is suitable only if the number of transactions is small. But if the number is large, a different procedure of putting increases and decreases in different columns will be useful and this will also yield significant information. The transactions given above are being shown below according to this method.

Total Assets		= Liabilities		+ Owner's Capital	
Increase ₹	Decrease ₹	Decrease ₹	Increase ₹	Decrease ₹	Increase ₹
(1) 10,00,000					10,00,000
(2) 5,00,000			5,00,000		
(3)	2,00,000			2,00,000	
(4)	1,00,000	1,00,000			
Total 15,00,000	3,00,000	1,00,000	5,00,000	2,00,000	10,00,000
Balance 12,00,000			4,00,000		+ 8,00,000

It is a tradition that:

- (i) increases in assets are recorded on the left-hand side and decreases in them on the right-hand side; and
- (ii) in the case of liabilities and capital, increases are recorded on the right-hand side and decreases on the left-hand side.

When two sides are put together in T form, the left-hand side is called the 'debit side' and the right hand side is 'credit side'. When in an account a record is made on the debit or left-hand side, one says that one has debited that account; similarly to record an amount on the credit or right-hand side, it is said the account has been credited.

From the above, the following rules can be obtained:

- (i) When there is an increase in the amount of an asset, its account is debited; the account will be credited if there is a reduction in the amount of the asset concerned: Suppose a firm purchases furniture for ₹ 8,00,000, the furniture account will be debited by ₹ 8,00,000 since the asset has increased by this amount. Suppose later the firm sells furniture to the extent of ₹ 3,00,000 the reduction will be recorded by crediting the furniture account by ₹ 3,00,000.

FURNITURE

	Increase		Decrease
(1) To Cash	8,00,000	(2) By Cash	3,00,000
		Balance	5,00,000

- (ii) If the amount of a liability increases, the increase will be entered on the credit side of the liability account, i.e. the account will be credited: similarly, a liability account will be debited if there is a reduction in the amount of the liability. Suppose a firm borrows ₹ 5,00,000 from Mohan; Mohan's account will be credited since ₹ 5,00,000 is now owing to him. If, later, the loan is repaid, Mohan's account will be debited since the liability no longer exists.

MOHAN

	Decrease		Increase
(2) To Cash	5,00,000	(1) By Cash	5,00,000

- (iii) An increase in the owner's capital is recorded by crediting the capital account: Suppose the proprietor introduces additional capital, the capital account will be credited. If the owner withdraws some money, i.e., makes a drawing, the capital account will be debited.
- (iv) Profit leads to an increase in the capital and a loss to reduction: According to the rule mentioned in (iii) above, profit & incomes may be directly credited to the capital account and losses & expenses may be similarly debited.

However, it is more useful to record all incomes, gains, expenses and losses separately. By doing so, very useful information will be available regarding the factors which have contributed to the year's profits and losses. Later the net result of all these is ascertained and adjusted in the capital account.

- (v) Expenses are debited and Incomes are credited: Since incomes and gains increase capital, the rule is to credit all gains and incomes in the accounts concerned and since expenses and losses decrease capital, the rule is to debit all expenses and losses. Of course, if there is a reduction in any income or gain, the account concerned will be debited; similarly, for any reduction in an expenses or loss the concerned account will be credited.

The rules given above are summarised below:

- Increases in assets are debits; decreases are credits;
- Increases in liabilities are credits; decreases are debits;
- Increases in owner's capital are credits; decreases are debits;
- Increases in expenses are debits; decreases are credits; and
- Increases in revenue or incomes are credits; decreases are debits.

The terms debit and credit should not be taken to mean, respectively, favourable and unfavourable things. They merely describe the two sides of accounts.

Whether an entry is to the debit or credit side of an asset depends on the type of account and the transactions

Debit	Credit
Increase in Purchases	Increase in Sales
Increase in Expenses	Increase in revenue and Incomes
Increase in Assets	Increase in Liabilities and Owners' Capital

In the same way, decrease in purchases, expenses and assets are credits and decrease in sales, income, liabilities and owners' capital are debit.

ILLUSTRATION 1

Following are the transactions entered into by R after he started his business. Show how various accounts will be affected by these transactions:

2022 April		(₹ in 000)
1.	R started business with	5,000
2.	He purchased furniture for	1,200
3.	Paid salary to his clerk	1,100
4.	Paid rent	1,150
5.	Received interest	2,000

SOLUTION

2022 April	Explanation	Accounts Involved	Nature of Accounts	How affected	Debit (₹ in 000)	Credit (₹ in 000)
1.	₹ 5,000 cash invested in business	Bank and R's Capital	Asset Capital	Increased Increased	5,000	5,000
2.	Purchased furniture for ₹ 1,200	Furniture and Bank	Asset Asset	Increased Decreased	1,200	1,200
3.	Paid ₹ 1,100 to employee for salary	Salary & Bank	Expense Asset	Increased Decreased	1,100	1,100
4.	Paid Rent ₹ 1,150	Rent & Bank	Expense Asset	Increased Decreased	1,150	1,150
5.	Received interest ₹ 2,000	Cash & Interest	Asset Income	Increased Increased	2,000	2,000

**1.5 TRANSACTIONS**

In the system of book-keeping, students can notice that transactions are recorded in the books of accounts. A transaction is a type of event, which is generally external in nature and can be determined in terms of money. In an accounting period, every business has huge number of transactions which are analysed in financial terms and then recorded individually, followed by classification and summarisation process, to know their impact on the financial statements. A transaction is a two-way process in which value is transferred from one party to another. In it either a party receives a value in terms of goods etc. and passes the value in terms of money or vice versa. Therefore, one can easily make out that in a transaction, a party receives as well as passes the value to other party. For recording transaction, it is very important that they are supported by a substantial document like purchase invoices, bills, pay-slips, cash-memos, passbook etc.

Transactions analysed in terms of money and supported by proper documents are recorded in the books of accounts under double entry system. To analyse the dual aspect of each transaction, two approaches can be followed:

- (1) Accounting Equation Approach.
- (2) Traditional Approach.



1.6 ACCOUNTING EQUATION APPROACH

The relationship of assets with that of liabilities and owners' equity in the equation form is known as 'Accounting Equation'. Basic accounting equation comes into picture when sum total of capital and liabilities equalises assets, where assets are what the business owns and capital and liabilities are what the business owes. Under double entry system, every business transaction has two-fold effect on the business enterprise where each transaction affects changes in assets, liabilities or capital in such a way that an accounting equation is completed and equated. This accounting equation holds good at all points of time and for any number of transactions and events except when there are errors in accounting process.

Let us suppose that an individual started business by contributing ₹ 50,00,000 and taking loan of ₹10,00,000 from a bank to be repayable, after 5 years. He purchased furniture costing ₹ 10,00,000, and merchandise worth ₹ 50,00,000. For purchasing the merchandise he paid ₹ 40,00,000 to the suppliers and agreed to pay balance after 3 months.

The contribution by the owner is termed as capital; the loans are termed as liabilities. Whenever the loan is repayable in the short-run, say within one year, it is called short-term loan or liability. On the other hand, if the loan is repayable atleast after one year, it would be termed as long term loan or liability.

Some other short-term liabilities relating to credit purchase of merchandise are popularly called as trade payables, and for other purchases and services received on credit as expense payables. The short-term liabilities are also termed as current liabilities and long term liabilities are termed as non-current liabilities.

On the other hand, money raised has been invested in two types of assets—fixed assets and current assets. Furniture is a fixed asset, if it lasts long, say more than one year, and has utility to the business, while inventory and cash balance will not remain fixed for long as soon as the business starts to roll—these are current assets.

Often the owner's claim or fund in the business is called equity. Owner's claim implies capital invested plus any profit earned minus any loss incurred.

Now we have an equation:

Equity + Liabilities = Assets or, Equity + Long-Term Liabilities = Fixed Assets + Current Assets - Current Liabilities

Check : L.H.S.	(₹ in '000)
Equity	₹ 5,000
Long-term Liabilities	₹ 1,000
Current Liabilities	<u>₹ 1,000</u>
	₹ 7,000

Check : R. H. S.	(₹ in '000)
Assets	
Fixed Assets:	
Furniture	₹ 1,000
Current Assets:	
Inventory	₹ 5,000
Cash	<u>₹ 1,000</u>
	₹ 7,000

$$\begin{aligned}\text{Cash} &= \text{Capital} + \text{Loan} - \text{Furniture} - \text{Payment to Trade payables (₹' 000)} \\ &= ₹ 5,000 + ₹ 1,000 - ₹ 1,000 - ₹ 4,000 = ₹ 1,000\end{aligned}$$

Let us use E_0 , L_0 and A_0 to mean Equity, Liabilities and Assets respectively at t_0 . Thus the basic accounting equation becomes

$$E_0 + L_0 = A_0$$

$$\text{or } E_0 = A_0 - L_0 \dots (\text{Eq. 1})$$

(₹' 000)

Now, let us suppose that at the end of period inventory valuing ₹ 2,500 is in hand, cash ₹ 2,000; trade payables ₹ 500; bank loan ₹ 1,000 (interest was properly paid); furniture ₹ 800 {₹ 200 is taken as loss of value due to use (also known as depreciation)}. So at t_1 -

Assets:	(₹' 000)
Fixed assets	
Furniture	₹ 800
Current assets	
Inventory	₹ 2,500
Cash	<u>₹ 2,000</u>
(A_1)	<u>₹ 5,300</u>
Liabilities:	
Long-term Liabilities	₹ 1,000
Current Liabilities	<u>₹ 500</u>
(L_1)	<u>₹ 1,500</u>
Equity ($A_1 - L_1$)	₹ 3,800

Equity = Assets - Liabilities

$$\text{i.e., } E_1 = A_1 - L_1$$

$$\text{or } E_1 + L_1 = A_1 \quad \dots(\text{Eq. 2})$$

Let us compare E_1 with E_0 . Equity is reduced by ₹ 12,00,000 (50,00,000 - 38,00,000). Reduction in equity is termed as loss incurred.

Since the business has incurred loss during the period, E_1 becomes less than E_0 .

$E_1 < E_0$ implies loss during t_{01}

Similarly, $E_2 < E_1$ implies loss during t_{12} and so on.

On the other hand, $E_1 > E_0$ implies profit earned by business during t_{01} , $E_2 > E_1$ implies profit earned during $t_{2\&1}$ and so on.

So if $E_n > E_{n-1}$, in general terms, equity has increased, while $E_n < E_{n-1}$ implies that equity has decreased. Increase in equity is termed as profit while decrease in equity is termed as loss.

ILLUSTRATION 2

Develop the accounting equation from following information available at the beginning of accounting period:

Particulars	(₹ in '000)
Capital	51,000
Loan	11,500
Trade payables	5,700
Fixed Assets	12,800
Inventory	22,600
Trade receivables	17,500
Cash and Bank	15,300

At the end of the accounting period the balances appear as follows:

	₹
Capital	?
Loan	11,500
Trade payables	5,800
Fixed Assets	12,720

Inventory	22,900
Trade receivables	17,500
Cash at Bank	15,600

- (a) Reset the equation and find out profit.
 (b) Prepare Balance Sheet at the end of the accounting period.

SOLUTION

(All the figures in solution are in '000)

- (a) Accounting equation is given by

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

Let us use E_0 , L_0 and A_0 to mean equity, liabilities and assets respectively at the beginning of the accounting period.

$$E_0 = ₹ 51,000$$

$$\begin{aligned} L_0 &= \text{Loan} + \text{Trade payables} \\ &= ₹ 11,500 + ₹ 5,700 = ₹ 17,200 \end{aligned}$$

$$\begin{aligned} A_0 &= \text{Fixed Assets} + \text{Inventories} + \text{Trade receivables} + \text{Cash at Bank} \\ &= ₹ 12,800 + ₹ 22,600 + ₹ 17,500 + ₹ 15,300 = ₹ 68,200 \end{aligned}$$

So, at the beginning of accounting period

$$E_0 + L_0 = A_0$$

$$\text{i.e., } ₹ 51,000 + ₹ 17,200 = ₹ 68,200$$

Let us use E_1 , L_1 , A_1 to mean equity, liabilities and assets respectively at the end of the accounting period.

$$\begin{aligned} L_1 &= \text{Loan} + \text{Trade payables} \\ &= ₹ 11,500 + ₹ 5,800 = ₹ 17,300 \end{aligned}$$

$$\begin{aligned} A_1 &= \text{Fixed Assets} + \text{Inventories} + \text{Trade receivables} + \text{Cash at Bank} \\ &= ₹ 12,720 + ₹ 22,900 + ₹ 17,500 + ₹ 15,600 = ₹ 68,720 \end{aligned}$$

$$E_1 = A_1 - L_1 = ₹ 68,720 - ₹ 17,300 = ₹ 51,420$$

$$\text{Profit} = E_1 - E_0 = ₹ 51,420 - ₹ 51,000 = ₹ 420$$

(b)

Balance Sheet

Liabilities	₹	₹	Assets	₹
Capital			Fixed Assets	12,720
Balance	51,000		Inventories	22,900
Add: Profit	<u>420</u>	51,420	Trade receivables	17,500
Loan		11,500	Cash at Bank	15,600
Trade payables		<u>5,800</u>		_____
		68,720		68,720

ILLUSTRATION 3

Mr. Dravid. has provided following details related to his financials. Find out the missing figures:

Particulars	(₹ in '000)
Profits earned during the year	5,000
Assets at the beginning of year	A
Liabilities at the beginning of year	12,000
Assets at the end of the year	B
Liabilities at the end of the year	C
Closing capital	35,000
Total liabilities including capital at the end of the year	50,000

SOLUTION

Computing opening capital:

(All figure in ₹' 000)

Closing capital - profits earned during the year (35,000 - 5,000) = 30,000

We also know:

Assets = liabilities + capital

Therefore, opening assets (A) (12,000 + 30,000) = 42,000

Computation of liabilities at the end of the year:

Total liabilities including capital - closing capital (C) (50,000 – 35,000) = 15,000

Also assets at the end of the year (B)= closing capital + liabilities at the end of the year
= 35,000 + 15,000 = 50,000



1.7 TRADITIONAL APPROACH

Under traditional approach of recording transactions one should first understand the term debit and credit and their rules. The term debit and credit have already been explained in para 1.4 of this Unit.

Transactions in the journal are recorded on the basis of the rules of debit and credit only. For the purpose of recording, these transactions are classified in three groups:

- (i) Personal transactions.
- (ii) Transactions related to assets and properties.
- (iii) Transactions related to expenses, losses, income and gains.

1.7.1 Classification of Accounts

- (i) **Personal Accounts:** Personal accounts relate to persons, trade receivables or trade payables. Example would be the account of Ram & Co., a credit customer or the account of Jhaveri & Co., a supplier of goods. The capital account is the account of the proprietor and, therefore, it is also personal but adjustment on account of profits and losses are made in it. This account is further classified into three categories:
 - (a) **Natural personal accounts:** It relates to transactions of human beings like Ram, Rita, etc.
 - (b) **Artificial (legal) personal accounts:** For business purpose, business entities are treated to have separate entity. They are recognised as persons in the eye of law for dealing with other persons. For example: Government, Companies (private or limited), Clubs, Co-operative societies etc.
 - (c) **Representative personal accounts:** These are not in the name of any person or organisation but are represented as personal accounts. For example: outstanding liability account or prepaid account, capital account, drawings account.
- (ii) **Impersonal Accounts:** Accounts which are not personal such as machinery account, cash account, rent account etc. These can be further sub-divided as follows:
 - (a) **Real Accounts:** Accounts which relate to assets of the firm but not debt. For example, accounts regarding land, building, investment, fixed deposits etc., are real accounts. Cash in hand and Cash at the bank accounts are also real.
 - (b) **Nominal Accounts:** Accounts which relate to expenses, losses, gains, revenue, etc. like salary account, interest paid account, commission received account. The net result of all the nominal accounts is reflected as profit or loss which is transferred to the capital account. Nominal accounts are, therefore, temporary.

1.7.2 Golden Rules of Accounting

All the above classified accounts have two rules each, one related to Debit and one related to Credit for recording the transactions which are termed as golden rules of accounting, as transactions are recorded on the basis of double entry system.

Types of Account	Account to be Debited	Account to be Credited
Personal Account	Receiver	Giver
Real Account	What comes in	What goes out
Nominal Account	Expense and losses	Income and gains

Example:-

From the following information, state the nature of account and state which account will be debited and which will be credited.

1. Started business with a capital of ₹ 50,00,000.
2. Wages and salaries paid ₹ 50,000
3. Rent received ₹ 2,00,000
4. Purchased goods on credit ₹ 9,00,000
5. Sold goods for ₹ 8,16,000 and received payment in cheque.

SOLUTION

Transaction	ACCOUNTS INVOLVED	NATURE	DEBIT OR CREDIT	Journal Entry
Started business with capital of ₹ 50,00,000	Bank account Capital account	Personal Personal	Debit (Receiver) Credit (giver)	Bank A/c Dr. To Capital A/c
Wages and salaries paid	Wages/salaries Bank	Nominal Personal	Debit (expense) Credit (giver)	Wages/ Salaries Dr. To Bank A/c
Rent received	Bank Rent	Personal Nominal	Debit (Receiver) Credit (income)	Bank A/c Dr. To Rent A/c
Purchases made on credit	Purchases Creditor	Nominal Personal	Debit (expense) Credit (giver)	Purchases A/c Dr. To Creditor A/c
Goods sold and payment received in cheque	Bank Sales	Personal Nominal	Debit (Receiver) Credit (gains)	Bank A/c Dr. To Sales A/c



1.8 MODERN CLASSIFICATION OF ACCOUNTS

Real, nominal and personal accounts is the traditional classification of accounts. Now, let us see the modern and more acceptable classification of accounts:-

Types of account	Normal balance of account	Account to be debited when there is:	Account to be credited when there is:
Asset account	Debit	Increase	Decrease
Liabilities account	Credit	Decrease	Increase
Capital account	Credit	Decrease	Increase
Revenue account	Credit	Decrease	Increase
Expenditure account	Debit	Increase	Decrease
Withdraw account	Debit	Increase	Decrease

Let us solve the same example with the modern approach now:-

Accounts involved	Nature	Debit/Credit	Reason
Cash	Asset	Debit	Increase
Capital	Liability	Credit	Increase
Wages/salaries paid	Expense	Debit	Increase
Cash	Asset	Credit	Decrease
Rent received	Revenue	Credit	Increase
Purchase	Expense	Debit	Increase
Creditor	Liability	Credit	Increase
Cash	Asset	Debit	Increase
Sales	Revenue	Credit	Increase



1.9 JOURNAL

Transactions are first entered in this book to show which accounts should be debited and which credited. Journal is also called subsidiary book. Recording of transactions in journal is termed as journalizing the entries. It is the book of original entry in which transactions are entered on a daily basis in a chronological order.

1.9.1 Journalising Process

All transactions may be first recorded in the journal as and when they occur; the record is chronological; otherwise it would be difficult to maintain the records in an orderly manner. Debits and credits are listed along with the appropriate explanations. There are basically two types of journals:-

1. General journal
2. Specialized journal

The latter is used when there are many repetitive transactions of the same nature. The form of the journal is given below:

JOURNAL

Date	Particulars	Ledger Folio (L.F.)	Amount Dr.	Amount Cr.
			₹	₹
(1)	(2)	(3)	(4)	(5)

The columns have been numbered only to make clear the following but otherwise they are not numbered. The following points should be noted:

- (1) In the first column the date of the transaction is entered-the year is written at the top, then the month and in the narrow part of the column the particular date is entered.
- (2) In the second column, the names of the accounts involved are written; first the account to be debited, with the word "Dr" written towards the end of the column. In the next line, after leaving a little space, the name of the account to be credited is written preceded by the word "To" (the modern practice shows inclination towards omitting "Dr." and "To"). Then in the next line the explanation for the entry together with necessary details is given-this is called narration.
- (3) In the third column the number of the page in the ledger on which the account is written up is entered.
- (4) In the fourth column the amounts to be debited to the various accounts concerned are entered.
- (5) In the fifth column, the amount to be credited to various accounts is entered.

1.9.2 Points to be taken into account while recording a transaction in the Journal

1. Journal entries can be single entry (i.e. one debit and one credit) or compound entry (i.e. one debit and two or more credits or two or more debits and one credit or two or more debits and credits). In such cases, it is important to check that the total of both debits and credits are equal.
2. If journal entries are recorded in several pages then both the amount column of each page should be totalled and the balance should be written at the end of that page and also that the same total should be carried forward at the beginning of the next page.

An entry in the journal may appear as follows:

			₹	₹
May 5	Bank Account	Dr.	14,50,000	
	To Mohan			14,50,000
	(Being the amount received from Mohan in payment of the amount due from him)			

We will now consider some individual transactions.

- (i) Mohan commences business with ₹ 50,00,000 in his bank account. This means that the firm has ₹ 50,00,000 in bank. According to the rules given above, the increase in an asset has to be debited. The firm also now owes ₹ 50,00,000 to the proprietor, Mohan as capital. The rule given above also shows that the increase in capital should be credited. Therefore, the journal entry will be:

Bank Account	Dr.	₹ 50,00,000	
To Capital Account			₹ 50,00,000
(Being capital introduced by Mohan)			

- (ii) Out of the above, ₹ 25,000 is withdrawn from the bank. By this transaction the bank balance is reduced by ₹ 25,000 and another asset, cash account, comes into existence. Since increase in assets is debited and decrease is credited, the journal entry will be:

Cash Account	Dr.	₹ 25,000	
To Bank Account			₹ 25,000
(Being cash withdrawn in Bank)			

- (iii) Furniture is purchased for ₹ 12,00,000. Applying the same reasoning as above the entry will be:

Furniture Account	Dr.	₹ 12,00,000	
To Bank Account			₹ 12,00,000
(Being Furniture purchased vide voucher No....)			

- (iv) Purchased goods for ₹ 4,00,000. The student can see that the required entry is:

Purchases Account	Dr.	₹ 4,00,000	
To Bank Account			₹ 4,00,000
(Being goods purchased vide voucher No....)			

- (v) Purchased goods for ₹ 10,00,000 on credit from M/s Ram Narain Bros. Purchase of merchandise is an expense item so it is to be debited. ₹ 10,00,000 is now owing to the supplier; his account should therefore be credited, since the amount of liabilities has increased. The entry will be:

Purchases Account	Dr.	₹ 10,00,000	
To M/s Ram Narain Bros.			₹ 10,00,000
(Being goods purchased on credit vide Bill No.....)			

- (vi) Sold goods to M/s Ram & Co. for ₹ 6,00,000. Amount is received in cheque. The amount of bank increases and therefore, the bank amount should be debited; sale of merchandise is revenue item so it is to be credited. The entry will be:

Bank Account	Dr.	₹ 6,00,000	
To Sales Account			₹ 6,00,000
(Being goods sold vide sales invoice No....)			

- (vii) Sold goods to Ramesh on credit for ₹ 13,00,000. The Inventories of goods has decreased and therefore, the goods account has to be credited. Ramesh now owes ₹ 13,00,000; that is an asset and therefore, Ramesh should be debited. The entry is:

Ramesh	Dr.	₹ 13,00,000	
To Sales Account			₹ 13,00,000
(Being goods sold vide Bill No....)			

- (viii) Received cheque from Ramesh ₹ 13,00,000. The amount of bank increased therefore the bank account has to be debited. Ramesh's liability towards firm has decreased in fact in this case he no longer owes any amount to the firm now, i.e., this particular form of assets has disappeared; therefore, the account of Ramesh should be credited. The entry is:

Bank Account	Dr.	₹ 13,00,000	
To Ramesh			₹ 13,00,000
(Being amount received vide cheque No.....against sales invoice No....)			

- (x) Paid rent ₹ 1,00,000. The bank balance has decreased and therefore, the bank account should be credited. No asset has come into existence because the payment is for services enjoyed and is an expense. Expenses are debited. Therefore, the entry should be:

Rent Account	Dr.	₹ 1,00,000	
To Bank Account			₹ 1,00,000
(Being rent paid for the month of)			

- (xi) Paid ₹ 22,000 to the clerk as salary. Applying the reasons given in (x) above, the required entry is:

Salary Account	Dr.	₹ 22,000	
To Bank Account			₹ 22,000
(Being salary paid to Mr..... for the month of)			

- (xii) Received ₹ 2,20,000 interest. The bank account should be debited since there is an increase in the bank balance. There is no increase in any liability; since the amount is not returnable to any one, the amount is an income, incomes are credited. The entry is:

Bank Account	Dr.	₹ 2,20,000	
To Interest Account			₹ 2,20,000
(Being interest received from.....for the period)			

When transactions of similar nature take place on the same date, they may be combined while they are journalised. For example, entries (x) and (xi) may be combined as follows:

Rent Account	Dr.	₹ 1,00,000	
Salary Account	Dr.	₹ 22,000	
To Bank Account (Being expenses done as per detail attached)			₹ 1,22,000

When journal entry for two or more transactions are combined, it is called composite journal entry. Usually, the transactions in a firm are so numerous that to record the transactions for a month will require many pages in the journal. At the bottom of one page the totals of the two columns are written together with the words "Carried forward" in the particulars column. The next page is started with the respective totals in the two columns with the words "Brought forward" in the particulars column.

ILLUSTRATION 4

Analyse transactions of M/s Sahil & Co. for the month of March, 2022 on the basis of double entry system by adopting the following approaches:

- (A) Accounting Equation Approach.
- (B) Traditional Approach.

Transactions for the month of March, 2022 were as follows (figures are in '000):

- Sahil introduced capital through bank of ₹ 4,000.
- Cash withdrawn from the City Bank ₹ 200.
- Loan of ₹ 500 taken from Mr. Y.
- Salaries paid for the month of March, 2022, ₹ 300 and ₹ 100 is still payable for the month of March, 2022.
- Furniture purchased ₹ 500.

Required

What conclusions one can draw from the above analysis?

SOLUTION

- (A) Analysis of Business Transaction: Accounting Equation Approach

The accounting equation is

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

(₹ in '000)

ASSETS						=	CAPITAL	+	LIABILITIES
	CASH	+	BANK	+	FURNITURE	=	CAPITAL	+	LIABILITIES
(a)	-	+	4,000	+	-	=	4,000	+	-
(b)	+200	+	-200	+	-	=	-	+	-
(c)	-	+	500	+	-	=	-	+	500
(d)	-	+	-300	+	-	=	-400	+	100
(e)	-	+	-500	+	500	=	-	+	-
Balance	200	+	3,500	+	500	=	3,600	+	600
			4,200				4,200		

(B) Analysis of Business Transactions: Traditional Approach

Transaction	Analysis	Account Affected and Nature of Account	Rule	Entry
Introduction of ₹ 4,000 through bank by the proprietor	Bank has received the money; Owner has given Bank balance	Bank–Personal Capital–Personal	Debit the receiver Credit the giver	Debit Bank Credit Capital
Cash Withdrawn from Bank ₹ 200	Cash comes into business; Bank gives out cash	Cash–Real Bank–Personal	Debit what comes in Credit the giver	Debit Cash Credit Bank
Loan from Y ₹ 500	Bank receives the amount : Y pays through bank	Bank–Personal Y's Loan–Personal	Debit the receiver Credit the giver	Debit Bank Credit Y's Loan
Salary paid ₹ 300 and still payable ₹ 100	Cost of services used ₹ 400; Bank gives out ₹300; Still payable or outstanding for services received ₹ 100	Salary Nominal Bank–Personal Salary Outstanding–Personal	Debit all expenses Credit the giver Credit the giver	Debit Salary (₹ 400) Credit Bank (₹ 300) Credit Salary outstanding (₹ 100)

Furniture purchased ₹ 500	Furniture is purchased; Bank gives out money	Furniture Real Bank–Personal	Debit what comes in Credit the giver	Debit Furniture Credit Bank

Conclusion:

It is evident from above analysis that procedure for analysis of transactions, classification of accounts and rules for recording business transactions under accounting equation approach and traditional approach are different. But the accounts affected and entries entered/passed remains the same under both approaches. Thus, the recording of transactions in affected accounts on the basis of double entry system is independent of the method of analysis followed by a business enterprise. In other words, accounts to be debited and credited to record the dual aspect remains the same under both the approaches.

ILLUSTRATION 5

Journalise the following transactions. Also state the nature of each account involved in the Journal entry.

Following figures are given in ('00)

- December 1, 2022, Ajit started business with capital ₹ 4,00,000*
- December 3, he withdrew cash for business from the Bank ₹ 2,000.*
- December 5, he purchased goods by making payment through bank ₹ 15,000.*
- December 8, he sold goods for ₹ 16,000 and received payment through bank.*
- December 10, he purchased furniture and paid by cheque ₹ 2,500.*
- December 12, he sold goods to Arvind ₹ 2,400.*
- December 14, he purchased goods from Amrit ₹ 10,000.*
- December 15, he returned goods to Amrit ₹ 500.*
- December 16, he received from Arvind ₹ 2,300 in full settlement.*
- December 18, he withdrew goods for personal use ₹ 1,000.*
- December 20, he withdrew cash from business for personal use ₹ 2,000.*
- December 24, he paid telephone charges ₹ 110.*
- December 26, amount paid to Amrit in full settlement ₹ 9,450.*
- December 31, paid for stationery ₹ 200, rent ₹5,000 and salaries to staff ₹ 2,000 from bank.*

15. December 31, goods distributed by way of free samples ₹ 2,000.

SOLUTION

JOURNAL

(₹ in '00)

Sl. No	Date	Particulars		Nature of Account	L.F.	Dr.	Cr.
						Debit (₹)	Credit (₹)
1.	Dec. 1	Bank Account To Capital Account (Being commencement of business with capital)	Dr.	Personal A/c Personal A/c		4,00,000	4,00,000
2.	Dec. 3	Cash Account To Bank Account (Being cash withdrawn from the Bank)	Dr.	Real A/c Personal A/c		2,000	2,000
3.	Dec. 5	Purchases Account To Bank Account (Being purchase of goods for cash)	Dr.	Nominal A/c Personal A/c		15,000	15,000
4.	Dec. 8	Bank Account To Sales Account (Being goods sold for cash)	Dr.	Personal A/c Nominal A/c		16,000	16,000
5.	Dec. 10	Furniture Account To Bank Account (Being purchase of furniture, paid by cheque)	Dr.	Real A/c Personal A/c		2,500	2,500
6.	Dec. 12	Arvind To Sales Account (Being sale of goods on credit)	Dr.	Personal A/c Nominal A/c		2,400	2,400

7.	Dec. 14	Purchases Account To Amrit (Being purchase of goods from Amrit)	Dr.	Nominal A/c Personal A/c		10,000	10,000
8.	Dec. 15	Amrit To Purchases Returns Account (Being goods returned to Amrit)	Dr.	Personal A/c Nominal A/c		500	500
9.	Dec. 16	Bank Account Discount Account To Arvind (Being amount received from Arvind in full settlement and allowed him ₹ 100 as discount)	Dr. Dr.	Personal A/c Nominal A/c Personal A/c		2,300 100	2,400
10.	Dec. 18	Drawings Account To Purchases Account (Being withdrawal of goods for personal use)	Dr.	Personal A/c Nominal A/c		1,000	1,000
11.	Dec. 20	Drawings Account To Cash Account (Being cash withdrawal from the business for personal use)	Dr.	Personal A/c Real A/c		2,000	2,000
12.	Dec. 24	Telephone Expenses Account To Bank Account (Being telephone expenses paid)	Dr.	Nominal A/c Personal A/c		110	110

13.	Dec 26	Amrit To Bank Account To Discount Account (Being cash paid to Amrit and he allowed ₹ 50 as discount)	Dr.	Personal A/c Personal A/c Nominal A/c		9,500	9,450 50
14.	Dec. 31	Stationery Expenses Rent Account Salaries Account To Bank Account (Being expenses paid)	Dr. Dr. Dr.	Nominal A/c Nominal A/c Nominal A/c Personal A/c		200 5,000 2,000	7,200
15.	Dec. 31	Advertisement Expenses Account To Purchases Account (Being distribution of goods by way of free samples)	Dr.	Nominal A/c Real A/c		2,000	2,000

ILLUSTRATION 6

Show the classification of the following Accounts under traditional and accounting equation approach:

(a) Building; (b) Purchases; (c) Sales; (d) Bank Fixed Deposit; (e) Rent; (f) Rent Outstanding; (g) Cash; (h) Adjusted Purchases; (i) Closing Inventory; (j) Investments; (k) Trade receivables; (l) Sales Tax Payable, (m) Discount Allowed; (n) Bad Debts; (o) Capital; (p) Drawings; (q) Interest Receivable account; (r) Rent received in advance account; (s) Prepaid salary account; (t) Bad debts recovered account; (u) Depreciation account, (v) Personal income-tax account.

SOLUTION**Nature of Account**

Sl. No.	Title of Account	Traditional Approach	Accounting Approach	Equation
(a)	Building	Real	Asset	
(b)	Purchases	Nominal	Expense	
(c)	Sales	Nominal	Revenue	

(d)	Bank Fixed Deposit	Personal	Asset
(e)	Rent	Nominal	Expense
(f)	Rent Outstanding	Personal	Liability
(g)	Cash	Real	Asset
(h)	Adjusted Purchases	Nominal	Expense
(i)	Closing Inventory	Real	Asset
(j)	Investment	Real	Asset
(k)	Trade receivables	Personal	Asset
(l)	GST Payable	Personal	Liability
(m)	Discount Allowed	Nominal	Expense
(n)	Bad Debts	Nominal	Expense
(o)	Capital	Personal	Capital
(p)	Drawings	Personal	Capital - Drawings
(q)	Interest receivable	Personal	Asset
(r)	Rent received in advance	Personal	Liability
(s)	Prepaid salary	Personal	Asset
(t)	Bad debts recovered	Nominal	Gain
(u)	Depreciation	Nominal	Expense
(v)	Personal Income Tax	Personal (Drawing)	Capital - Drawings

ILLUSTRATION 7

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

2022			₹
April	1	Ramesh started business with	10,00,000
"	3	Bought goods for cash	50,000
"	5	Drew cash from bank	10,000
"	13	Sold to Krishna- goods on credit	1,50,000
"	20	Bought from Shyam goods on credit	2,25,000
"	24	Received from Krishna	1,45,000
"		Allowed him discount	5,000

"	28	<i>Paid Shyam cash</i>	<i>2,15,000</i>
"		<i>Discount allowed</i>	<i>10,000</i>
"	30	<i>Cash sales for the month</i>	<i>8,00,000</i>
		<i>Paid Rent</i>	<i>50,000</i>
		<i>Paid Salary</i>	<i>1,00,000</i>

SOLUTION**JOURNAL**

Date 2022	Particulars		L.F.*	Amount (Dr.)	Amount (Cr.)
April 1	Bank Account To Capital Account (Being the amount invested by Ramesh in the business as capital)	Dr.	1 4	10,00,000	10,00,000
" 3	Purchases Account To Bank Account (Being goods purchased for cash)	Dr.	7 1	50,000	50,000
" 5	Cash Account To Bank Account (Being cash withdrawn from bank)	Dr.	5 1	10,000	10,000
" 13	Krishna To Sales Account (Being goods sold to Krishna on credit)	Dr.	9 11	1,50,000	1,50,000
" 20	Purchases Account To Shyam (Being goods bought from Shyam on credit)	Dr.	7 10	2,25,000	2,25,000
" 24	Bank Account Discount Account To Krishna (Being cash received from Krishna and discount allowed to him)	Dr. Dr.	1 12 9	1,45,000 5,000	1,50,000

" 28	Shyam	Dr.	10	2,25,000	
	To Bank Account		1		2,15,000
	To Discount Account		12		10,000
	(Being cash paid to Shyam and discount allowed by him)				
" 30	Bank Account	Dr.	1	8,00,000	
	To Sales Account		11		8,00,000
	(Being sales for the month of April 2022)				
" 30	Rent Account	Dr.	15	50,000	
	Salaries Account	Dr.	14	1,00,000	
	To Bank Account		1		1,50,000
	(Being the amount paid for rent and salary)				
	Total			27,60,000	27,60,000

***Ledger Folio imaginary****1.10 ADVANTAGES OF JOURNAL**

In journal, transactions recorded on the basis of double entry system, fetch the following advantages:

1. As transactions are recorded in chronological order, one can get complete information about the business transactions on timely basis.
2. Entries recorded in the journal are supported by a note termed as narration, which is a precise explanation of the transaction for the proper understanding of the entry. One can know about the transactions through these narrations.
3. Journal forms the basis for posting the entries in the ledger and reduces the chances of error.



1.11 ACCOUNTING FOR GST

1.11.1 Introduction to GST

Goods and Services Tax (GST) is a comprehensive Indirect Tax* which has subsumed multiple Indirect Taxes in India such as State Value added Tax (VAT) which was levied on sale of goods, Excise Duty, which was levied on manufacture or production of goods, Service Tax which was levied on provision of services etc. GST is a single tax on the supply of goods and services, right from the manufacturer to consumer.

* An indirect tax is a tax whose incidence is borne by the consumers who ultimately consume the product or service. The immediate liability to pay the tax may fall upon another person such as a manufacturer or provider of service or seller of goods, but the same is collected from the person purchasing the goods (recipient of goods or services).

Pre-GST scenario:

Prior to introduction of GST, the following duties were levied:

- (a) On manufacture of goods: Excise Duty (levied by Central Government)
- (b) On sale of goods within the State: State Value Added Tax (VAT)
- (c) On sale of goods outside the State: Central Sales Tax (levied by Central Government)
- (d) On provision of services provided: Service Tax (levied by Central Government)

Since the taxes were levied by different authorities (central and state authorities), it was not possible to take the benefit of credit of taxes paid at different stages. For instance, when a trader received goods (say costing ₹ 1,00,000) from the manufacturer, excise duty (say @ 18% = ₹ 18,000) was levied on the goods sold by the manufacturer. When such trader would sell the goods to the customer, he would charge VAT (assume 18%). However, the trader could not avail the benefit of the credit of the excise duty of ₹ 18,000 paid in respect of the goods purchased from the manufacturer. Accordingly, the 'cost' of the goods to the trader would be ₹ 1,00,000 + ₹ 18,000 = ₹ 1,18,000, on which the trader would add his profit margin and levy VAT while selling to the consumer. This created a scenario wherein a tax (in our example, VAT) was levied on the tax (in our example, excise duty) also, in addition to the tax levied on the goods. This cascading effect (tax-on-tax) increased the price of the product, and resulted in an unjust enrichment at the cost of the ultimate consumer.

Post-GST scenario:

On introduction of GST, the tax to be levied at all stages right from manufacture up to final consumption was a single tax- GST, with credit of taxes paid at previous stages available as setoff. Thus, in the example above, the GST (erstwhile excise duty) of ₹ 18,000 paid by the

trader could be availed as a credit (an asset), for set off against the tax charged by the trader (a liability for the trader, which would be received from the consumer). Hence, the cost of the goods to the trader would be ₹ 1,00,000 only, as ₹ 18,000 can be set off against the GST charged by the trader to the consumer. The tax levied by the manufacturer to the trader becomes 'input tax' for the trader, since the goods are purchased by him (it is his input). The tax levied by the manufacturer to the trader, or the trader to the consumer is known as 'output tax' (since it is output for both the manufacturer and trader) both for the manufacturer and trader. The 'input tax' cannot be added to the cost of the goods or services procured, as it will be adjusted against the 'output tax' liability. In a nutshell, since the input tax is availed as a credit, only the value addition (i.e., the profit margin levied by the trader to the consumer in our example) will be taxed, with the burden of tax being borne by the final consumer.

1.11.2 Salient features of GST

- GST is levied on supply i.e., manufacture or sale of goods and provision of services. In other words, supply is taxable event which on its occurrence creates or attracts the liability to pay tax.
- Under GST, tax is levied only on the value added at each stage of the supply chain.
- GST is a destination-based consumption tax, i.e. the tax is levied at the place where the goods or services are consumed, rather than the place where they are produced.
- There is no **tax on tax** or cascading of taxes under GST system.
- Under GST, there is a harmonization of laws, procedures and rates of tax across the country.

1.11.3 Types of Taxes under GST

Before going through the types of taxes under GST, it is important to understand the concept of intra-State supply and inter-State supply under GST which determines the type of tax to be charged by the supplier.

The Concept of intra-state supply and inter-state supply depends upon on the location of the supplier and place of supply (place of supply is the place where goods/services are consumed).

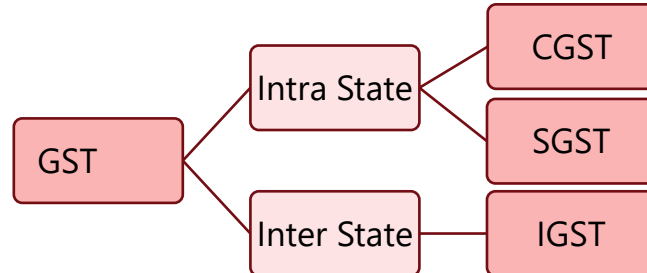
As a general rule, where the location of the supplier and the place of supply of goods or services are in the same State/Union territory, it is treated as **intra-State supply** of goods or services respectively.

Similarly, where the location of the supplier and the place of supply of goods or services are in (i) two different States or (ii) two different Union Territories or (iii) a State and a Union territory, it is treated as **inter-State supply** of goods or services respectively.

GST has a dual aspect with the Centre and States simultaneously levying on a common tax base. There are three main components of GST which are:

- (i) **Central Goods and Service Tax (CGST)** is levied and collected by the Centre on the “**Intra -State**” supply of goods and services.
- (ii) **State Goods and Services Tax (SGST)** is levied and collected by the State Governments (including Union Territories with legislature, for example Delhi, Pondicherry, Jammu and Kashmir) on “**Intra state**” supply of goods and services
- (iii) **Union Territory Goods and Service Tax (UTGST)** is levied and collected by Union Territories without Legislatures [i.e. Andaman and Nicobar Islands, Lakshadweep, Ladakh, Dadra and Nagar Haveli & Daman and Diu and Chandigarh] on “intra-state” supply of goods and services.
- (iv) **Integrated Goods and services tax (IGST):** It is the GST levied on the “**inter state**” supply of goods and services and is collected by the Centre. IGST is equivalent to the sum total of CGST and SGST.

GST is a “Consumption Based Tax” i.e. the tax is received by the State in which the goods or services are consumed and not by the state in which the goods and services are manufactured.



1.11.4 Input and Output GST

The tax paid by the recipient on procurement of goods /services is called **Input tax**. An entity at each stage is permitted to avail credit of GST paid on the purchase of goods and /or avilment of services and can set off this credit against the GST payable on the goods and/or services supplied by him. Thus, the final consumer bears the GST charged in the supply chain, with set-off benefits at all the previous stages. Hence, the tax will be levied only on the value added, which results in avoiding double taxation. For example, if tax payable by a manufacturer on the output, i.e. final product is ₹750 and he has already paid tax on ₹500 on input, i.e. purchases, then he can claim ‘Input Credit’ of ₹500 and he needs to deposit only ₹250 in cash.

Output tax means the GST charged on supply of goods or services made by a supplier.

Input tax means the credit of Input tax already paid.

Utilisation of Input Tax Credit under GST

Tax credit of CGST, SGST and IGST can be utilized in the following manner:

- Utilization of IGST Credit: IGST credit has to be first utilized against IGST liability and if any balance is still available, the same can be utilized against CGST or/and SGST in any order and in any proportion.
- Utilization of CGST Credit: CGST credit has to be first utilized against CGST liability and if any balance is available, same can be utilized against IGST. However, CGST credit cannot be utilized against SGST.
- Utilization of SGST Credit: SGST credit has to be first utilized against SGST liability and if any balance is available, same can be utilized against IGST. However, SGST credit cannot be utilized against CGST.

	Input GST (credit can be availed, hence asset)	Output GST (charged to the consumer, payable by the supplier, hence liability)
Nature	At the time of purchases of goods (including fixed assets) or services, input GST A/c (CGST and SGST or IGST) is debited.	At the time of sale of goods/assets or supply of services, Output GST A/c (CGST and SGST or IGST) is credited.
Intra-state transaction	CGST paid is debited to "Input CGST Account" and SGST paid is debited to Input SGST".	CGST charged is credited to "Output CGST Account" and SGST charged is credited to "Output SGST Account "
Inter-state transaction	IGST paid is debited to "Input IGST Account".	IGST charged is credited to "Output IGST Account"
Reversal of GST	Input GST paid at the time of purchase are reversed in the following situations: (i) Purchases Return (ii) Drawings (iii) Goods distributed as free samples (iv) Goods distributed as gift (if the same does not qualify as "supply under GST").	Output GST charged is reversed when the goods are returned by the purchaser.

	(v) Goods lost in fire or theft. (vi) Input tax credit of supplies which are not allowed to be availed by recipient.	
Utilization of Input tax credit	Input GST A/c is credited when tax is paid by utilizing input tax.	

Double entry book-keeping with GST

The Double entry book-keeping records need to show the GST values separately so that the purchases, expenses and sales are posted net i.e. without the addition of GST.

Journal entry in case of Sales of Goods or services

Account Receivable/Debtors A/c	Dr.	Gross Amount (including GST)	
To Sales A/c		Net Amount (excluding GST)	
To Output GST		Amount of GST	

Journal entry in case of Purchase of Goods or services

Purchases A/c	Dr.	Net Amount (excluding GST)	
Input GST A/c	Dr.	Amount of GST	
To Account Payable/Creditors		Gross Amount (including GST)	

Journal entry in case of Utilization of Input Tax Credit towards payment of Output Tax

Output CGST A/c	Dr.	Amount of GST liability	
Output SGST A/c	Dr.	Amount of GST liability	
Output IGST A/c	Dr.	Amount of GST liability	
To Input CGST A/c		Amount of output GST liability paid utilizing Input CGST	
To Input SGST A/c		Amount of output GST liability paid utilizing Input SGST	
To Input IGST A/c		Amount of output GST liability paid utilizing Input IGST	

ILLUSTRATION 8

Journalise the following transactions in the books of Mr. Rohit:

- (i) Purchased goods from Sahil for ₹ 50,000 plus CGST and SGST @ 9% each.
- (ii) Purchased goods from Sam for ₹ 40,000 at a trade discount of 10% plus CGST and SGST @ 9% each. ₹ 20,000 was paid immediately and balance payable after 3 months.
- (iii) Goods costing ₹ 20,000 withdrawn for personal use. Such goods were purchased by paying CGST and SGST @ 9% each.
- (iv) Paid rent to Gagandeep for ₹ 30,000 plus CGST and SGST @ 6% each.
- (v) Goods costing ₹ 5,000 (before trade discount of 10%) returned to Sam. Such goods were purchased by paying CGST and SGST @ 9% each.
- (vi) Purchased furniture for ₹ 44,800 including IGST @ 12%.
- (vii) Purchased machinery from M/s Symphony industries for ₹ 1,40,000 plus CGST and SGST @ 9% each. Paid ₹ 1,00,000 immediately and balance to be paid after two months.

SOLUTION**In the books of Mr. Rohit**

Date	Particulars	L.F.	Dr. (₹)	Cr. (₹)
(i)	Purchases A/c Dr. Input CGST A/c (50,000 x 9%) Dr. Input SGST A/c (50,000 x 9%) Dr. To Sahil's A/c (Being goods purchased from Sahil, CGST and SGST paid @ 9% each)		50,000 4,500 4,500	59,000
(ii)	Purchases A/c (40,000 x 90%) Dr. Input CGST A/c (36,000 x 9%) Dr. Input SGST A/c (36,000 x 9%) Dr. To Sam's A/c To Bank A/c (Being goods purchased from Sam, CGST and SGST payable @ 9% each)		36,000 3,240 3,240	22,480 20,000
(iii)	Drawings A/c* Dr. To Purchase A/c		23,600	20,000

	To Input CGST A/c (20,000 x 9%)			1,800
	To Input SGST A/c (20,000 x 9%)			1,800
	(Being goods withdrawn for personal use and input GST and input SGST debited at the time of purchase reversed)			
(iv)	Rent A/c Dr.	30,000		
	Input CGST A/c (30,000 x 6%) Dr.	1,800		
	Input SGST A/c (30,000 x 6%) Dr.	1,800		
	To Gagandeep A/c			33,600
	(Being rent paid to Gagandeep)			
(v)	Sam's A/c Dr.	5,310		
	To Purchases Return A/c ** (5,000 – 10% trade Discount)			4,500
	To Input CGST A/c (4,500 x 9%)			405
	To Input SGST A/c (4,500 x 9%)			405
	(Being goods returned to Sam and input IGST debited at the time of purchases reversed)			
(vi)	Furniture A/c (WN 1) Dr.	40,000		
	Input IGST A/c Dr.	4,800		
	To Bank A/c			44,800
	(Being furniture purchased paid IGST @ 12%)			
(vii)	Machinery A/c Dr.	1,40,000		
	Input CGST A/c (1,40,000 x 9%) Dr.	12,600		
	Input SGST A/c (1,40,000 x 9%) Dr.	12,600		
	To Bank A/c			1,00,000
	To Symphony Industries			65,200
	(Being machinery purchased and paid ₹ 1,00,000 immediately, CGST and SGST @ 9% each)			

* The input tax availed earlier is reversed, because these goods are 'consumed' by Mr. Rohit himself. Since he cannot 'sell' goods to himself and charged output tax, the input tax thereon is reversed, since in this case Mr. Rohit himself is the ultimate consumer of those goods.

** Since goods are returned to the supplier, the input tax credit availed earlier on those goods is to be reversed, since these goods are no longer available to be sold.

Working Note.

1. Furniture purchased is including IGST @ 12%. So, value of furniture excluding IGST = ₹ 44,800 × 100/112 = ₹ 40,000. IGST = ₹ 40,000 × 12% = ₹ 4,800.

ILLUSTRATION 9

Journalise the following transactions in the books of Ms. Nidhi traders

July, 2022

- 3 Sold Goods for ₹ 50,000, charged CGST and SGST @ 6% each.
- 4 Sold goods to Surjeet for ₹ 28,000 including CGST and SGST @ 6% each.
- 5 Received ₹ 25,200 from Surjeet in full settlement of his account of ₹ 28,000.
- 6 Sold goods to Kapil for ₹ 30,000 charged IGST @ 12%. Received ₹ 12,000 immediately and balance to be received after one month.
- 10 Kapil was allowed rebate of ₹ 5,000 as goods supplied to him were defective. These goods were sold by charging IGST @ 12%.
- 12 Sold goods to Manpreet for ₹ 1,00,000 at trade discount of 20% and charged IGST @ 12%
- 13 Goods of list price ₹ 20,000 returned by Manpreet.
- 17 Received commission of ₹ 15,000, charged CGST and SGST @ 6% each.

SOLUTION

In the Books of Ms. Nidhi Journal

Date July, 2022	Particulars	L.F.	Dr. (₹)	Cr. (₹)
3	Bank A/c Dr. To Sales A/c To Output CGST A/c To Output SGST A/c (Being goods sold for cash, charged CGST and SGST @ 6% each)		56,000	50,000 3,000 3,000
4	Surjeet's A/c Dr. To Sales A/c		28,000	25,000

5	To Output CGST A/c			1,500
	To Output SGST A/c			1,500
	(Being goods sold to Surjeet, charged CGST and SGST @ 6% each)(refer W.N.)			
5	Bank A/c	Dr.	25,200	
	Discount Allowed A/c	Dr.	2,800	
	To Surjeet A/c			28,000
	(Being amount received from Surjeet in full settlement of ₹ 28,000 after allowing him discount of ₹ 2,800)			
6	Bank A/c	Dr.	12,000	
	Kapil's A/c	Dr.	21,600	
	To Sales A/c			30,000
	To Output IGST A/c			3,600
	(Being goods sold to Kapil, charged IGST @ 12% and received ₹ 12,000 in cash and balance receivable after one month)			
10	Rebate A/c *	Dr.	5,000	
	Output IGST A/c	Dr.	600	
	To Kapil's A/c			5,600
	(Being rebate allowed on goods sold to Kapil, Output IGST charged at the time of sales, now reversed)			
12	Manpreet's A/c	Dr.	89,600	
	To Sales A/c (1,00,000 x 80%)			80,000
	To Output IGST A/c (80,000 x 12%)			9,600
	(Being goods sold to Manpreet at trade discount of 20% and charged IGST @ 12%)			
13	Sales Return A/c	Dr.	16,000	
	Output IGST A/c	Dr.	1,920	
	To Manpreet A/c			17,920
	(Being goods returned by Manpreet and Output IGST charged at the time of sales now reversed)			

17	Cash A/c	Dr.	16,800	
	To Commission A/c			15,000
	To Output CGST A/c (15,000 x 6%)			900
	To Output SGST A/c (15,000 x 6%)			900
	(Being commission received charged CGST and SGST @ 6% each)			

*Since rebate is on account of defective goods which cannot be sold/utilized further by Kapil, the output GST charged thereon is also reversed. This treatment is like that of Sales Return. If rebate was on account of other reasons (such as prompt payment), Output IGST would not be reversed.

Working Note:

Goods sold to Surjeet is including CGST and SGST @ 6% each. So, sales excluding CGST and SGST = ₹ 28,000 × 100/112 = ₹ 25,000. CGST and SGST = ₹ 25,000 × 6% = ₹ 1,500 each.

ILLUSTRATION 10

Record the following transactions in a Journal, assuming CGST and SGST@ 6% each.

- (i) Sold goods to Mukesh at the list price of ₹ 50,000 less 20% trade discount.
- (ii) Sold goods to Mukesh at the list price of ₹ 1,00,000 less 20% trade discount and 5% cash discount.
- (iii) Sold goods to Mukesh at the list price of ₹ 1,50,000 less 20% trade discount. Out of the amount due 60% is received out of which three-fourth is received by cheque.

SOLUTION

Journal

Date	Particulars	L.F.	Dr. (₹)	Cr. (₹)
(i)	Mukesh A/c	Dr.	44,800	
	To Sales A/c			40,000
	To Output CGST A/c			2,400
	To Output SGST A/c			2,400
	(Being goods sold to Mukesh at a trade discount of 20% charged CGST and SGST @ 6% each)			

(ii)	Discount Allowed A/c	Dr.	4,000	
	Bank A/c		85,600	
	To Sales A/c			80,000
	To Output SGST A/c			4,800
	To Output SGST A/c			4,800
	(Being goods sold to Mukesh at a trade discount of 20% and 5% cash discount, charged CGST and SGST @ 6% each)*			
(iii)	Bank A/c	Dr.	60,480	
	Cash A/c	Dr.	20,160	
	Mukesh's A/c (refer W. N.)	Dr.	53,760	
	To Sales A/c (1,50,000 x 80%)			1,20,000
	To Output CGST A/c (1,20,000 x 6%)			7,200
	To Output SGST A/c (1,20,000 x 6%)			7,200
	(Being goods sold to Mukesh at a trade discount of 20% and received 60%, charged CGST and SGST @ 6% each)			

***Note :** After allowing cash discount of ₹ 4,000 (₹ 80,000 × 5%), the balance of ₹ 85,600 is received. Since discount is on account of prompt payment, output CGST and SGST is computed on value determine after deducting trade discount.

Working Note: After allowing trade discount of ₹ 30,000 on ₹ 1,50,000 = ₹ 1,20,000, 60% of the balance amount i.e. ₹ 1,34,400 (₹ 1,20,000 + 12% GST ₹ 14,400) is paid in cash and by cheque.

Hence, the amount paid in cash and cheque = ₹ 1,34,400 × 60% = ₹ 80,640.

Amount paid by cheque = ₹ 80,640 × 3/4 = ₹ 60,480

Amount paid in cash = ₹ 80,640 × 1/4 = ₹ 20,160

Mukesh's A/c = (₹ 1,20,000 + ₹ 14,400 – ₹ 60,480 – ₹ 20,160) = ₹ 53,760

SUMMARY

- ♦ The accounting process starts with the recording of transactions in the form of journal entries.
- ♦ The recording is based on double entry system. This book or register called journal is the book of first or original entry.
- ♦ Next step is to post the entries in the ledger which is covered in the next unit.

TEST YOUR KNOWLEDGE

True and False

1. *In accounting equation approach, equity + Long-term liabilities = fixed asset + current assets – current liabilities.*
2. *In the traditional approach, for an entity a debtor will be receiver after sale of goods.*
3. *The rule of nominal account states that all expenses & losses are recorded on credit side.*
4. *Journal proper is also called a subsidiary book.*
5. *Capital account has a debit balance.*
6. *Purchase account is a nominal account.*
7. *All the personal & real account are recorded in P&L A/c.*
8. *Asset side of balance sheet contains all the personal & nominal accounts.*
9. *Capital account is a personal account.*
10. *Journal is also known as the book of original entry.*

Multiple Choice Question

1. *The rent paid to landlord is credited to*
 - (a) *Landlord's account.*
 - (b) *Rent account.*
 - (c) *Cash account.*
2. *In case of a debt becoming bad, the amount should be credited to*
 - (a) *Trade receivables account.*
 - (b) *Bad debts account.*
 - (c) *Cash account.*

3. A Ltd. has a ₹ 35,000 account receivable from Mohan. On January, 22, Mohan makes a partial payment of ₹ 21,000 to A Ltd. The journal entry made on January, 22 by A Ltd. to record this transaction includes:
- (a) A credit to the cash received account of ₹ 21,000.
 - (b) A credit to the Accounts receivable account of ₹ 21,000.
 - (c) A debit to the cash account of ₹ 14,000.
4. Which financial statement represents the accounting equation -
 $\text{Assets} = \text{Liabilities} + \text{Owner's equity}$:
- (a) Income Statement
 - (b) Statement of Cash flows
 - (c) Balance Sheet.
5. Which account is the odd one out?
- (a) Office furniture & Equipment.
 - (b) Freehold land and Buildings.
 - (c) Inventory of materials.
6. The debts written off as bad, if recovered subsequently are
- (a) Credited to Bad Debts Recovered Account
 - (b) Credited to Trade Receivables Account.
 - (c) Debited to Profit and Loss Account.
7. In Double Entry System of Book-keeping every business transaction affects:
- (a) Two accounts
 - (b) Two sides of the same account.
 - (c) The same account on two different dates.
8. A sale of goods to Ram for cash should be debited to:
- (a) Ram
 - (b) Cash
 - (c) Sales

Theory Questions

1. Write short note on classification of accounts.
2. Distinguish between Real account and nominal account.

Practical Questions

1. Show the classification of the following Accounts under traditional and accounting equation approach:

a	Rent outstanding	g	Capital
b	Closing Inventory	h	Sales Tax Payable
c	Sales	i	Trade receivables
d	Bank Fixed Deposit	j	Depreciation
e	Cash	k	Drawings
f	Bad Debts		

2. Pass Journal Entries for the following transactions in the books of Gamma Bros.

- (i) Employees had taken inventory worth ₹ 1,00,000 (Cost price ₹ 75,000) on the eve of Deepawali and the same was deducted from their salaries in the subsequent month.
- (ii) Wages paid for erection of Machinery ₹ 18,000.
- (iii) Income tax liability of proprietor ₹ 17000 was paid out of petty cash.
- (iv) Purchase of goods from Naveen of the list price of ₹ 2,00,000. He allowed 10% trade discount, ₹ 5,000 cash discount was also allowed for quick payment.

3. Calculate the missing amount for the following.

	Assets	Liabilities	Capital
(a)	15,00,000	2,50,000	?
(b)	?	1,50,000	75,000
(c)	14,50,000	?	13,75,000
(d)	57,00,000	- 2,80,000	?

4. Show the effect of increase = (+), decrease = (-) and no change=(0) on the assets of the following transactions:

- a. Purchased office furniture, payment to be made next month.

- b. Collected cash for repair services
- c. Goods sold on credit.
- d. Withdrawal of cash by the owner for personal use.
- e. Hired an employee as sales manager of the north wing.
- f. Returned goods worth ₹ 50,000.
- g. One of our debtor agreed to pay his dues to Mr. C who is a creditor of the company with the same amount being due to him.
- h. Entered into an agreement with Mehta & Co. to purchase all raw materials from their company from next year.

Also give reasons for your answers.

5. Following is the information provided by Mr. Gopi pertaining to year ended 31st March 2022. Find the unknowns, showing computation to support your answer:

Particulars	₹	Particulars	₹
Machinery	12,00,000	Trade Receivables	B
Accounts Payable	1,00,000	Loans	C
Inventory	60,000	Closing Capital	D
Total Liabilities including capital	14,15,000	Opening Capital	10,00,000
Cash	A	Loss incurred during the year	35,000
Bank	80,000	Capital Introduced during the year	1,00,000

Additional Information: During the year sales of ₹ 15,55,000 was made of which ₹ 15,00,000 have been received.

ANSWERS/HINTS

True and False

1. True: As per the modern accounting equation approach- it is the basic formula in the accounting process
2. False: In the traditional approach, a debtor will be giver since he will be paying money for the sale of goods by the entity.

3. False: The rule of nominal account states that all expenses & losses are recorded on debit side.
4. True: It is one of the book where in the transactions not entered in the other books are entered in this book.
5. False: Capital account has a credit balance.
6. True: As it is considered as an expense.
7. False: All the personal & real account are recorded in balance sheet.
8. False: Asset side of balance sheet contains all the personal & real accounts.
9. True: As it is in the name of the proprietor who is bringing in the capital to the business.
10. True: As the transactions are entered first in this book as a first hand record.

Multiple Choice Questions

1.	(c)	2.	(a)	3.	(b)	4.	(c)	5.	(c)	6.	(a)
7.	(a)	8.	(b)								

Theoretical Questions

1. a. Accounts are broadly classified into assets, liabilities and capital. The basic accounting equation specifies broad categories, which are as follows:
 - (i) **Assets:** These are resources controlled by the enterprise as a result of past events and from which future economic benefits are expected to flow to the enterprise, namely cash, stock of goods, land, buildings, machinery etc.
 - (ii) **Liabilities:** These are financial obligations of an enterprise other than owner's equity namely long term loans, creditors, outstanding expenses etc.
 - (iii) **Capital:** It generally refer to the amounts invested in an enterprise by its owner(s), the accretion to it or a reduction in it. Since capital is affected by expenses and incomes of revenue nature, there are two more categories of accounts, namely expenses and incomes. The difference between incomes and expenses are taken into capital account.
 - **Expenses:** These represents those accounts which show the amount spent or even lost in carrying on operations.

- **Incomes:** These represent those accounts which show the revenue amounts earned by the enterprise.

However, traditionally accounts are classified as follows:

- (i) **Personal Accounts:** These accounts relate to persons, institutions, debtors or creditors.
- (ii) **Impersonal Accounts:** These represent accounts which are not personal. These can be further sub-divided as follows:
 - **Real Accounts:** These accounts relate to assets of the firm but not debt e.g. accounts relating to land, buildings, cash in hand etc.
 - **Nominal accounts:** These accounts relate to expenses, losses, gains, revenues etc.

2. A real account is an account relating to properties and assets, other than personal accounts of the firm. Examples are land, buildings, machinery, cash, investments etc. Nominal accounts relate to expenses or losses, incomes and gains. Examples are: wages, salaries, rent, depreciation etc. The net result of all the nominal accounts is reflected as profit or loss which is transferred to the capital account. Nominal accounts are therefore, temporary. The real accounts are shown in the balance sheet along with personal accounts.

Practical Problems

1. Nature of Account

Sl. No.	Title of Account	Traditional Approach	Accounting Approach	Equation
a	Rent Outstanding	Personal	Liability	
b	Closing Inventory	Real	Asset	
c	Sales	Nominal	Revenue	
d	Bank Fixed Deposit	Personal	Asset	
e	Cash	Real	Asset	
f	Bad Debts	Nominal	Expense	
g	Capital	Personal	Capital	
h	Sales Tax Payable	Personal	Liability	
i	Trade receivables	Personal	Asset	
j	Depreciation	Nominal	Expense	
k	Drawings	Personal	Capital -Drawings	

2.

Journal Entries in the books of Gamma Bros.

	Particulars		Dr. Amount ₹	Cr. Amount ₹
(i)	Salaries A/c To Purchase A/c (Being entry made for inventory taken by employees)	Dr.	75,000	75,000
(ii)	Machinery A/c To Bank A/c (Being wages paid for erection of machinery)	Dr.	18,000	18,000
(iii)	Drawings A/c To Petty Cash A/c (Being the income tax of proprietor paid out of business money)	Dr.	17,000	17,000
(iv)	Purchase A/c To Naveen A/c (Being goods purchased from Naveen)	Dr.	1,80,000	1,80,000
	Naveen A/c To Bank To Discount Received A/c (Being amount paid for the goods purchased from Naveen for ₹ 2,00,000. 10% trade discount and cash discount of ₹ 5,000 allowed by him)	Dr.	1,80,000	1,75,000 5,000

Note:

- Here wages paid on erection of machinery have been capitalised therefore machinery account has been debited directly instead of wages being recorded as an expenditure.
- The students may also note that trade discount is allowed on the list price of goods. It is deducted to compute the invoice amount of the goods to be recorded in the books. Cash discount is a discount allowed in case of early payments to the seller. The entry is made in the books of accounts for cash discount.

3. (a) 12,50,000
 (b) 2,25,000
 (c) 75,000
 (d) 59,80,000

These have been solved using the Accounting Equation:

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

4.

S. No.	Increase (+) / Decrease (-) / No Change (0) in Assets	Reasons
(a)	+	Furniture has been purchased making it an increase in assets and also it being purchased on credit it increases liability and there is no outflow of assets like cash or bank.
(b)	+	Cash has flowed in for services provided making it an increase in assets.
(c)	+	For goods sold, it is a decrease in inventory (assets) but correspondingly there is an increase in debtors. However, there will be a net increase in assets because goods sold on profit. Though if goods are sold at cost; it will result in no change whereas if sold at below cost; it will result in decrease in assets.
(d)	-	Here cash has been withdrawn from business resulting in decrease in assets and capital.
(e)	0	Only hiring of employee has been done resulting in no change in assets.
(f)	-	Outflow of goods has resulted in decrease in assets while money owed to creditors reduce on the liability side.
(g)	-	Both assets and liabilities reduced by same amounts meaning a decrease in assets.
(h)	0	Only a purchase agreement has been entered into with no transaction taking place yet.

5. Trade Receivable Balance (B) = Sales- Amount received during the year
 = ₹ (15,55,000 – 15,00,000)
 = ₹ 55,000.

Since, we know Assets = Capital + Liabilities

Therefore, balance of assets is also ₹ 14,15,000

So, total assets:

Particulars	₹
Total Assets	14,15,000
Less: Machinery	(12,00,000)
Less: Inventory	(60,000)
Less: Bank	(80,000)
Less: Receivables	(55,000)
Cash (A)	20,000

Computation of Closing Capital (D):

Particulars	₹
Opening Capital	10,00,000
Add: Introduced during the year	1,00,000
Less: Loss incurred during the year	(35,000)
Closing Capital	10,65,000

So, Loan amount (C) = Total Liabilities and capital - Closing Capital - Trade Payables
 = ₹ (14,15,000 - 10,65,000 - 1,00,000) = ₹ 2,50,000

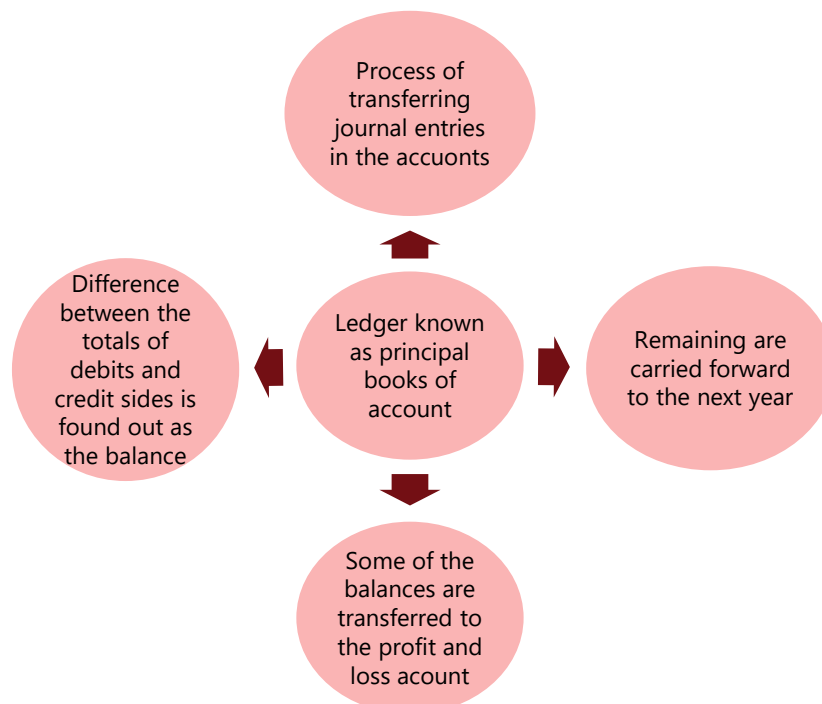
UNIT 2 : LEDGERS

LEARNING OUTCOMES

After studying this unit, you will be able to:

- ◆ Understand the concept of Ledgers.
- ◆ Learn the technique of ledger posting and how to balance an account.
- ◆ Learn the technique of opening accounts each year taking closing balances of the previous year. Note also the use of term 'balance c/d' and 'balance b/d'

UNIT OVERVIEW





2.1 INTRODUCTION

After recording the original transactions in the journal, recorded entries are classified and grouped into by preparation of accounts. The book which contains all set of accounts (viz. personal, real and nominal accounts), is known as Ledger. It is known as principal books of account in which account-wise balance of each account is determined.



2.2 SPECIMEN OF LEDGER ACCOUNTS

A ledger account has two sides-debit (left side of the account) and credit (right side of the account). Each of the debit and credit side has four columns. (i) Date (ii) Particulars (iii) Journal folio i.e. page from where the entries are taken for posting and (iv) Amount.

Dr.				Account				Cr.			
Date	Particulars	J.F.	Amount (₹)	Date	Particulars	J.F.	Amount (₹)	Date	Particulars	J.F.	Amount (₹)



2.3 POSTING

The process of transferring the debit and credit items from journal to classified accounts in the ledger is known as posting.

2.3.1 Rules regarding Posting of Entries in the Ledger

1. Separate account is opened in ledger book for each distinct account and entries from Journal are posted to respective account accordingly.
2. It is a practice to use words 'To' and 'By' while posting transactions in the ledger. The word 'To' is used in the particular column with the accounts written on the debit side while 'By' is used with the accounts written in the particular column of the credit side. These 'To' and 'By' do not have any meanings but are used to the account debited and credited.
3. The concerned account debited in the journal should also be debited in the ledger but reference should be of the respective credit account.



2.4 BALANCING AN ACCOUNT

At the end of each month or year or any particular reporting period, it may be necessary to ascertain the balance in an account. Suppose a person has bought goods worth ₹1,000 and has paid only ₹ 850; he owes ₹150 and that is the balance in his account. To ascertain the balance in any account, both the sides of the account is totalled and smaller amount is deducted from the bigger amount to ascertain the difference. If the credit side is bigger than the debit side, it is a credit balance and vice a versa. The credit balance is written on the debit side as, "To Balance c/d"; c/d means "carried down". By doing this, two sides will be equal. The totals are written on the two sides opposite one another.

Then the credit balance is written on the credit side as "By balance b/d (i.e., brought down)". This is the opening balance for the new period. The debit balance similarly is written on the credit side as "By Balance c/d", the totals then are written on the two sides as shown above and then the debit balance written on the debit side as, "To Balance b/d", as the opening balance of the new period.

It should be noted that nominal accounts are not balanced; the balance in the end are transferred to the profit and loss account. Only personal and real accounts balances are ultimately shown in the balance sheet at the end of the accounting period. The capital account is adjusted for profit or loss (i.e net of nominal accounts) at the end of accounting period.

ILLUSTRATION 1

Prepare the Stationery Account of a firm for the month of Jan. 2022 duly balanced off, from the following details:

2022		₹
Jan. 1	Inventory of stationery	480
Jan. 5	Purchase of stationery by cheque	800
Jan. 15	Purchase of stationery on credit from Five Star Stationery Mart	1,280

SOLUTION

Dr.			Cr.		
Stationery Account					
Date	Particulars	₹	Date	Particulars	₹
1.1.2022	To Balance b/d	480	31.1.2022	By Balance c/d	2,560
5.1.2022	To Bank A/c	800			
15.1.2022	To Five Star Stationery				

	Mart A/c	1,280			
		2,560			2,560
1.2.2022	To Balance b/d	2,560			

ILLUSTRATION 2

Prepare the ledger accounts on the basis of following transactions in the books of a trader.

Debit Balances on January 1, 2022:

Cash in Hand ₹ 8,000, Cash at Bank ₹ 25,000, inventory of Goods ₹ 20,000, Building ₹ 10,000.
Trade receivables: Vijay ₹ 2,000 and Madhu ₹ 2,000.

Credit Balances on January 1, 2022:

Trade payables: Anand ₹ 5,000 and Kapil ₹ 7,000, Capital ₹ 55,000

Following were further transactions in the month of January, 2022:

- Jan. 1 Purchased goods worth ₹ 5,000 (payable at later date) for cash less 20% trade discount and 5% cash discount.
- Jan. 4 Received ₹ 1,980 from Vijay and allowed him ₹ 20 as discount.
- Jan. 8 Purchased plant from Mukesh for ₹5,000 and paid ₹100 as cartage for bringing the plant to the factory and another ₹200 as installation charges.
- Jan. 12 Sold goods to Rahim on credit ₹600.
- Jan. 15 Rahim became insolvent and could pay only 50 paise in a rupee.
- Jan. 18 Sold goods to Ram for cash ₹1,000.

SOLUTION

Dr.				Cr.			
Date 2022	Particulars	J.F.	₹	Date 2022	Particulars	J.F.	₹
Jan. 1	To Balance b/d		8,000	Jan. 1	By Purchases A/c		3,800
Jan. 4	To Vijay		1,980	Jan. 8	By Plant A/c		300
Jan. 15	To Rahim		300	Jan. 31	By Balance c/d		7,180
Jan. 18	To Sales A/c		1,000				
			11,280				11,280
Feb. 1	To Balance b/d		7,180				

Dr. **Bank Account** Cr.

Date	Particulars	J.F.	₹	Date	Particulars	J.F.	₹
Jan. 1	To Balance b/d		25,000	Jan. 31	By Balance c/d		25,000
			25,000				25,000
Feb. 1	To Balance b/d		25,000				

Dr. **Inventory Account** Cr.

Date	Particulars	J.F.	₹	Date	Particulars	J.F.	₹
Jan. 1	To Balance b/d		20,000	Jan. 31	By Balance c/d		20,000
			20,000				20,000
Feb. 1	To Balance b/d		20,000				

Dr. **Building Account** Cr.

Date	Particulars	J.F.	₹	Date	Particulars	J.F.	₹
Jan. 1	To Balance b/d		10,000	Jan. 31	By Balance c/d		10,000
			10,000				10,000
Feb. 1	To Balance b/d		10,000				

Dr. **Vijay** Cr.

Date	Particulars	J.F.	₹	Date	Particulars	J.F.	₹
Jan. 1	To Balance b/d		2,000	Jan. 4	By Cash A/c		1,980
					By Discount A/c		20
			2,000				2,000

Dr. **Madhu** Cr.

Date	Particulars	J.F.	₹	Date	Particulars	J.F.	₹
Jan. 1	To Balance b/d		2,000	Jan. 31	By Balance c/d		2,000
			2,000				2,000
Feb. 1	To Balance b/d		2,000				

Dr. **Anand** Cr.

Date	Particulars	J.F.	₹	Date	Particulars	J.F.	₹
Jan. 31	To Balance c/d		5,000	Jan. 1	By Balance b/d		5,000
			5,000				5,000
				Feb. 1	By Balance b/d		5,000

Dr.

Kapil

Cr.

Date	Particulars	J.F.	₹	Date	Particulars	J.F.	₹
Jan. 31	To Balance c/d		7,000	Jan. 1	By Balance b/d		7,000
			7,000				7,000
				Feb. 1	By Balance b/d		7,000

Dr.

Capital Account

Cr.

Date	Particulars	J.F.	₹	Date	Particulars	J.F.	₹
Jan. 31	To Balance c/d		55,000	Jan. 1	By Balance b/d		55,000
			55,000				55,000
				Feb. 1	By Balance b/d		55,000

Dr.

Purchases Account

Cr.

Date	Particulars	J.F.	₹	Date	Particulars	J.F.	₹
Jan. 1	To Cash		3,800				
Jan. 1	To Cash Discount		200	Jan. 31	By Balance c/d		4,000
			4,000				4,000
Feb. 1	To Balance b/d		4,000				

Dr.

Discount Account

Cr.

Date	Particulars	J.F.	₹	Date	Particulars	J.F.	₹
Jan. 4	To Vijay		20	Jan. 1	By Purchases A/c		200
Jan. 31	To Balance c/d		180				200
			200				200
				Feb. 1	By Balance b/d		180

Dr.

Plant Account

Cr.

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

Dr. **Mukesh** Cr.

Date	Particulars	J.F.	₹	Date	Particulars	J.F.	₹
Jan. 31	To Balance c/d		5,000	Jan. 8	By Plant A/c		5,000
			5,000				5,000
				Feb. 1	By Balance b/d		5,000

Dr. **Sales Account** Cr.

Date	Particulars	J.F.	₹	Date	Particulars	J.F.	₹
Jan. 31	To Balance c/d		1,600	Jan. 12	By Rahim		600
				Jan. 18	By Cash A/c		1,000
			1,600				1,600
				Feb. 1	By Balance b/d		1,600

Dr. **Rahim** Cr.

Date	Particulars	J.F.	₹	Date	Particulars	J.F.	₹
Jan. 12	To Sales A/c		600	Jan. 15	By Cash A/c		300
				Jan. 15	By Bad Debts A/c		300
			600				600

Dr. **Bad Debts Account** Cr.

Date	Particulars	J.F.	₹	Date	Particulars	J.F.	₹
Jan. 15	To Rahim		300	Jan. 31	By Balance c/d		300
			300				300
Feb. 1	To Balance b/d		300				

ILLUSTRATION 3

The following data is given by Mr. S, the owner, with a request to compile only the two personal accounts of Mr. H and Mr. R, in his ledger, for the month of April, 2022.

- 1 Mr. S owes Mr. R ₹ 15,000; Mr. H owes Mr. S ₹ 20,000.
- 4 Mr. R sold goods worth ₹ 60,000 @ 10% trade discount to Mr. S.
- 5 Mr. S sold to Mr. H goods prices at ₹ 30,000.

- 17 Record a purchase of ₹ 25,000 net from R, which were sold to H at a profit of ₹15,000.
- 18 Mr. S rejected 10% of Mr. R's goods of 4th April.
- 19 Mr. S issued a cash memo for ₹10,000 to Mr. H who came personally for this consignment of goods, urgently needed by him.
- 22 Mr. H cleared half his total dues to Mr. S, enjoying a ½% cash discount (of the payment received, ₹ 20,000 was by cheque).
- 26 R's total dues (less ₹10,000 held back) were cleared by cheque, enjoying a cash discount of ₹1,000 on the payment made.
- 29 Close H's Account to record the fact that all but ₹ 5,000 was cleared by him, by a cheque, because he was declared bankrupt.
- 30 Balance R's Account.

SOLUTION**In the books of Mr. S**

Dr.			Mr. H Account			Cr.		
Date	Particulars	₹	Date	Particulars	₹			
1.4.2022	To Balance b/d	20,000	22.4.2022	By Bank A/c	20,000			
5.4.2022	To Sales A/c	30,000	22.4.2022	By Cash A/c (Note 2)	24,775			
17.4.2022	To Sales A/c	40,000	29.4.2022	By Discount Allowed A/c	225			
			29.4.2022	By Bank A/c	40,000			
			29.4.2022	By Bad Debts A/c	5,000			
		90,000			90,000			

Dr.			Mr. R Account			Cr.		
Date	Particulars	₹	Date	Particulars	₹			
18.4.2022	To Purchase Returns A/c	5,400	1.4.2022	By Balance b/d	15,000			
			4.4.2022	By Purchases A/c	54,000			
26.4.2022	To Bank A/c	77,600	17.4.2022	By Purchases A/c	25,000			
26.4.2022	To Discount Received A/c	1,000						
30.4.2022	To Balance c/d	10,000						
		94,000			94,000			
			1.5.2022	By Balance b/d	10,000			

Working Notes:

- (1) Sale of ₹ 10,000 on 19th April is a cash sales, therefore, it will not be recorded in the Personal Account of Mr. H; and
- (2) On 22nd April, Mr. H owes Mr. S ₹ 90,000, amount paid by Mr. H $\frac{1}{2}$ of ₹ 90,000 less $\frac{1}{2}\%$ discount i.e., ₹ 45,000 – ₹ 225 = ₹ 44,775. Out of this amount, ₹ 20,000 paid by cheque and the balance of ₹ 24,775 in cash.

Note: The balance of all nominal accounts is transferred to Profit and Loss account at the time of preparation of financial statements as the nominal Accounts are in the nature of revenue/incomes/gains or expenses/losses. Thus, the net result of all nominal accounts is reflected in profit and loss Account for an accounting period which is transferred to Capital Account. The balance of all the accounts relating to assets and liabilities (personal and real) are reflected in the Balance Sheet at the end of accounting period.

SUMMARY

- ♦ Process of transferring journal entries in the accounts opened in Ledger is called posting.
- ♦ Ledger is known as principal books of accounts and it provides full information regarding all the financial transactions pertaining to any individual account.
- ♦ The difference between the totals of debits and credit sides is found out as the balance. Some of these balances (i.e nominal accounts) are transferred to the profit and loss account and some are carried forward to the next period/year i.e., shown in the balance sheet, depending upon the nature of the account.

TEST YOUR KNOWLEDGE**True and False**

1. *A ledger is also known as the principal book of accounts.*
2. *Cash account has a debit balance.*
3. *Posting is the process of transferring the accounts from ledger to journal.*
4. *At the end of the accounting year, all the nominal accounts of the ledger book are balanced.*
5. *Ledger records the transactions in a chronological order.*

6. *If the total debit side is greater than the total of credit side, we get a credit balance as opening balance.*
7. *Ledger accounts of assets will always be debited when they are increased.*

Multiple Choice Questions

1. *The process of transferring the debit and credit items from a Journal to their respective accounts in the ledger is termed as*
 - (a) *Posting*
 - (b) *Purchase*
 - (c) *Balancing of an account*
2. *The technique of finding the net balance of an account after considering the totals of both debits and credits appearing in the account is known as*
 - (a) *Posting*
 - (b) *Purchase*
 - (c) *Balancing of an account*
3. *Journal and ledger records transactions in*
 - (a) *A chronological order and analytical order respectively.*
 - (b) *An analytical order and chronological order respectively.*
 - (c) *A chronological order only*
4. *Ledger book is popularly known as*
 - (a) *Secondary book of accounts*
 - (b) *Principal book of accounts*
 - (c) *Subsidiary book of accounts*
5. *At the end of the accounting year all the nominal accounts of the ledger book are*
 - (a) *Balanced but not transferred to profit and loss account*
 - (b) *Not balanced and also the balance is not transferred to the profit and loss account*
 - (c) *Not balanced and their balance is transferred to the profit and loss account.*

Theory Questions

- 1 *What do you mean by principal books of accounts?*
- 2 *What are the rules of posting of journal entries into the Ledger?*

Practical Questions

1. *Journalize the following transactions, post them in the Ledger and balance the accounts on 31st December.*
 1. *X started business with a capital of ₹ 20,000*
 2. *He purchased goods from Y on credit ₹ 4,000*
 3. *He paid cash to Y ₹ 2,000*
 4. *He sold goods to Z ₹ 4,000*
 5. *He received cash from Z ₹ 6,000*
 6. *He further purchased goods from Y ₹ 4,000*
 7. *He paid cash to Y ₹ 2,000*
 8. *He further sold goods to Z ₹ 4,000*
 9. *He received cash form Z ₹ 2,000*

ANSWERS/HINTS

True and False

1. *True: Since it classifies all the amounts related to a particular account and then it is used as the base for preparing the Trial balance, a ledger is also known as principal books of accounts.*
2. *True: Being an asset under the modern equation approach, cash account has a debit balance.*
3. *False: Posting is the process of transferring the balances from journal to ledger.*
4. *False: At the end of the accounting year, all the nominal accounts of the ledger book are totaled and transferred to P&L A/c.*
5. *False: Ledger records the transactions in analytical order. But journal records the transactions in a chronological order.*

6. *False: If the total of debit side is greater than the total of credit side, we get a debit balance as the opening balance.*
7. *True: The increase to an asset shall be debited since the original balance is also debit.*

Multiple Choice Questions

1.	(a)	2.	(c)	3.	(a)	4.	(b)	5.	(c)		

Theoretical Questions

- Ledger is known as principal books of accounts and it provides full information regarding all the transactions pertaining to any individual account. Ledger contains all set of accounts (viz. personal, real and nominal accounts).*
- Rules regarding posting of entries in the ledger:*
 - Separate account is opened in ledger book for each account and entries from the Journal are posted to respective accounts accordingly.*
 - It is a practice to use words 'To' and 'By' while posting transactions in the ledger. The word 'To' is used in the particular column with the accounts written on the debit side while 'By' is used with the accounts written in the particular column of the credit side. These 'To' and 'By' do not have any meanings but are used to the account debited and credited.*
 - The concerned account debited in the journal should also be debited in the ledger but reference should be of the respective credit account.*

Practical Questions

1. **Journal**

Particulars	L.F.	Debit ₹	Credit ₹
Cash A/c Dr. To Capital A/c (Being commencement of business)		20,000	20,000
Purchase A/c Dr. To Y (Being purchase of goods on credit)		4,000	4,000
Y Dr. To Cash (Being amount paid to Y)		2,000	2,000

Z	Dr.		4,000	
To Sales A/c				4,000
(Being goods sold to Z)				
Bank A/c	Dr.		6,000	
To Z				6,000
(Being amount received from Z)				
Purchase A/c	Dr.		4,000	
To Y				4,000
(Being purchase of goods on credit from Y)				
Y	Dr.		2,000	
To Cash A/c				2,000
(Being amount paid to Y)				
Z	Dr.		4,000	
To Sales A/c				4,000
(Being goods sold to Z)				
Cash A/c	Dr.		2,000	
To Z				2,000
(Being cash received from Z)				
TOTAL			48,000	48,000

Dr.

Cash Account

Cr.

Date	Particulars	₹	Date	Particulars	₹
	To Capital A/c	20,000		By Y	2,000
	To Z	6,000		By Y	2,000
	To Z	2000		By Balance c/d	24,000
		28,000			28,000
Feb. 1	To Balance b/d	24,000			

Dr.

Capital Account

Cr.

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

Dr. **Purchase Account** Cr.

Date	Particulars	₹	Date	Particulars	₹
	To Y	4,000	Jan 31.	By Balance c/d	8,000
	To Y	4,000			
		8,000			8,000
Feb.1	To Balance b/d	8,000			

Dr. **Y's Account** Cr.

Date	Particulars	₹	Date	Particulars	₹
	To Cash	2,000		By Purchases	4,000
	To Cash	2,000		By Purchases	4,000
Jan. 31	To Balance c/d	4,000			
		8,000			8,000
				By Balance b/d	4,000

Dr. **Z's Account** Cr.

Date	Particulars	₹	Date	Particulars	₹
	To Sales	4,000		By Cash A/c	6,000
	To Sales	4,000		By Cash A/c	2,000
		8,000			8,000

Dr. **Sales Account** Cr.

Date	Particulars	₹	Date	Particulars	₹
Jan. 31	To Balance c/d	8,000		By Z	4,000
				By Z	4,000
		8,000			8,000
			Feb. 1	By Balance b/d	8,000

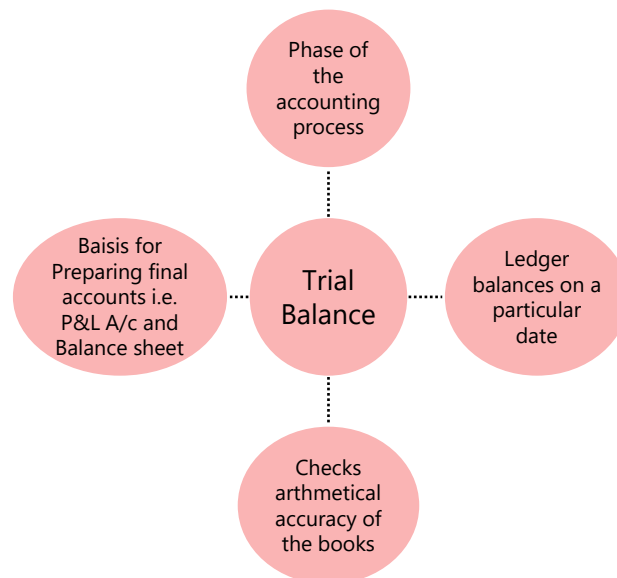
UNIT 3 : TRIAL BALANCE

LEARNING OUTCOMES

After studying this unit, you will be able to:

- ◆ Learn the technique of taking balances from ledger accounts to prepare trial balance.
- ◆ Understand what is trial balance and what purposes it can serve..

UNIT OVERVIEW



Trial balance contains various ledger balances on a particular date. It forms the basis for preparing the financial statement i.e. profit and loss account and balance sheet. If it tallies, it means that the accounts are arithmetically accurate but certain errors may still remain undetected. Therefore, it is very important to carefully journalise and post the entries, following the rules of accounting.



3.1 INTRODUCTION

Preparation of trial balance is the third phase in the accounting process. After posting the accounts in the ledger, a statement is prepared to show separately the debit and credit balances. Such a statement is known as the trial balance. It may also be prepared by listing each and every account and entering in separate columns the totals of the debit and credit sides. Whichever way it is prepared, the totals of the two columns should agree. An agreement indicates arithmetic accuracy of the accounting work; if the two sides do not agree, then there is simply an arithmetic error(s).

This follows from the fact that under the Double Entry System, the amount written on the debit sides of various accounts is always equal to the amounts entered on the credit sides of other accounts and vice versa. Hence the totals of the debit sides must be equal to the totals of the credit sides. Also total of the debit balances will be equal to the total of the credit balances. Once this agreement is established, there is reasonable confidence that the accounting work is free from clerical errors, though it is not a proof of cent per cent accuracy, because some errors of principle and compensating errors may still remain. Generally, to check the arithmetic accuracy of accounts, trial balance is prepared at monthly intervals. But because double entry system is followed, one can prepare a trial balance any time. Though a trial balance can be prepared any time but it is preferable to prepare it at the end of the reporting period which may be month end/quarter end/year end to ensure the arithmetic accuracy of all the accounts before the preparation of the financial statements. It may be noted that trial balance is a statement and not an account.



3.2. OBJECTIVES OF PREPARING THE TRIAL BALANCE

The preparation of trial balance has the following objectives:

- (i) Trial balance enables one to establish whether the posting and other accounting processes have been carried out without committing arithmetical errors. In other words, the trial balance helps to establish arithmetical accuracy of the books of accounts.
- (ii) Financial statements are normally prepared on the basis of agreed trial balance; otherwise the financial statements will not give true and fair picture of the financial transactions.
- (iii) The trial balance serves as a summary of what is contained in the ledger; the ledger may have to be seen only when details are required in respect of an account.

The form of the trial balance is simple as shown below:

Trial Balance

as at.....

S.No	Ledger Accounts	Dr. Amount	Cr. Amount
		(Total or Balance)	(Total or Balance)
		₹	₹

The under mentioned points may be noted:

- (i) A trial balance is prepared as on a particular date which should be mentioned at the top.
- (ii) In the second column the name of the account is written.
- (iii) In the third column the total of the debit side of the account concerned or the debit balance, if any is entered.
- (iv) In the fourth column, the total of the credit side or the credit balance is written.
- (v) The third and fourth columns are totalled at the end.



3.3 LIMITATIONS OF TRIAL BALANCE

One should note that the agreement of Trial Balance is not a conclusive proof of accuracy. In other words, in spite of the agreement of the trial balance some errors may remain. These may be of the following types:

- (i) Transaction has not been entered at all in the journal.
- (ii) A wrong amount has been written in both columns of the journal.
- (iii) A wrong account has been mentioned in the journal.
- (iv) An entry has not at all been posted in the ledger.
- (v) Entry is posted twice in the ledger.

Still, the preparation of the trial balance is very useful; without it, the preparation of financial statements, would be difficult.



3.4 METHODS OF PREPARATION OF TRIAL BALANCE

1. TOTAL METHOD

Under this method, every ledger account is totalled and that total amount (both of debit side and credit side) is transferred to trial balance. In this method, trial balance can be prepared as soon as ledger account is totalled. Time taken to balance the ledger accounts is saved under this method as balance can be found out in the trial balance itself. The difference of totals of each ledger account is the balance of that particular account. This method is not commonly used as for the preparation of the financial statements, only net balance of the ledger account is required. Therefore, the trial balance compiled under this method cannot be used directly for preparation of the financial statements.

ILLUSTRATION 1

Given below is a ledger extract relating to the business of X and Co. as on March, 31, 2022. You are required to prepare the Trial Balance by the Total Amount Method.

Dr. **Cash Account** Cr.

Particulars	₹	Particulars	₹
To Capital A/c	10,000	By Furniture A/c	3,000
To Ram's A/c	25,000	By Salaries A/c	2,500
To Cash Sales	500	By Shyam's A/c	21,000
		By Cash Purchases	1,000
		By Capital A/c	500
		By Balance c/d	7,500
	35,500		35,500

Dr. **Furniture Account** Cr.

Particulars	₹	Particulars	₹
To Cash A/c	3,000	By Balance c/d	3,000
	3,000		3,000

Dr. **Salaries Account** Cr.

Particulars	₹	Particulars	₹
To Cash A/c	2,500	By Balance c/d	2,500
	2,500		2,500

Dr.

Shyam's Account

Cr.

Particulars	₹	Particulars	₹
To Cash A/c	21,000	By Purchases A/c	25,000
To Purchase Returns A/c	500	(Credit Purchase)	
To Balance c/d	3,500		—
	25,000		25,000

Dr.

Purchases Account

Cr.

Particulars	₹	Particulars	₹
To Cash A/c (Cash Purchases)	1,000	By Balance c/d	26,000
To Sundries as per Purchases Book (Credit Purchases)	25,000		—
	26,000		26,000

Dr.

Purchases Returns Account

Cr.

Particulars	₹	Particulars	₹
To Balance c/d	500	By Sundries as per Purchases Return Book	500
	500		500

Dr.

Ram's Account

Cr.

Particulars	₹	Particulars	₹
To Sales A/c (Credit Sales)	30,000	By Sales Returns A/c	100
		By Cash A/c	25,000
		By Balance c/d	4,900
	30,000		30,000

Dr.

Sales Account

Cr.

Particulars	₹	Particulars	₹
To Balance c/d	30,500	By Cash A/c (Cash Sales)	500
		By Sundries as per Sales Book (Credit Sales)	30,000
	30,500		30,500

Dr.

Sales Returns Account

Cr.

Particulars	₹	Particulars	₹
To Sundries as per Sales Returns Book	100	By Balance c/d	100
	100		100

Dr.

Capital Account

Cr.

Particulars	₹	Particulars	₹
To Cash A/c	500	By Cash A/c	10,000
To Balance c/d	9,500		
	10,000		10,000

SOLUTION**Trial Balance of X and Co. as at 31.03.2022**

Sl. No.	Name of Account	Total Debit ₹	Total Credit ₹
1.	Cash A/c	35,500	28,000
2.	Furniture A/c	3,000	
3.	Salaries A/c	2,500	
4.	Shyam's A/c	21,500	25,000
5.	Purchases A/c	26,000	
6.	Purchases Returns A/c		500
7.	Ram's A/c	30,000	25,100
8.	Sales A/c		30,500
9.	Sales Returns A/c	100	
10.	Capital A/c	500	10,000
		1,19,100	1,19,100

2. BALANCE METHOD

Under this method, every ledger account is balanced and those balances only are carried forward to the trial balance. This method is used commonly by the accountants and helps in the preparation of the financial statements. Financial statements are prepared on the basis of the balances of the ledger accounts.

ILLUSTRATION 2

Taking the same information as given in Illustration 1, prepare the Trial Balance by Balance Method.

SOLUTION**Trial Balance of X and Co. as at 31.03.2022**

Sl. No.	Name of Account	Debit Balance ₹	Credit Balance ₹
1.	Cash A/c	7,500	
2.	Furniture A/c	3,000	
3.	Salaries A/c	2,500	
4.	Shyam's A/c		3,500
5.	Purchases A/c	26,000	
6.	Purchases Returns A/c		500
7.	Ram's A/c	4,900	
8.	Sales A/c		30,500
9.	Sales Returns A/c	100	
10.	Capital A/c		9,500
		44,000	44,000

3. TOTAL AND BALANCE METHOD

Under this method, the above two explained methods are combined. This has been explained with the help of the following example:

Trial Balance of X as at 31.03.2022

Sl. No.	Heads of Account	Debit Balance (₹)	Credit Balance (₹)	Debit Total (₹)	Credit Total (₹)
1.	Cash Account	7,500		35,500	28,000
2.	Furniture Account	3,000		3,000	
3.	Salaries Account	2,500		2,500	
4.	Shyam's Account		3,500	21,500	25,000

5.	Purchases Account	26,000		26,000	
6.	Purchase Returns Account		500		500
7.	Ram's Account	4,900		30,000	25,100
8.	Sales Account		30,500		30,500
9.	Sale Returns Account	100		100	
10.	Capital Account		9,500	500	10,000
	Total	44,000	44,000	1,19,100	1,19,100



3.5 ADJUSTED TRIAL BALANCE (THROUGH SUSPENSE ACCOUNT)

If the trial balance does not agree after transferring the balance of all ledger accounts including cash and bank balance and also errors are not located timely, then the trial balance is tallied by transferring the difference of debit and credit side to an account known as suspense account. This is a temporary account opened to proceed further and to prepare the financial statements timely.



3.6 RULES OF PREPARING THE TRIAL BALANCE

While preparing the trial balance from the given list of ledger balances, following rules should be taken into account:

1. The balances of all (i) assets accounts (ii) expenses accounts (iii) losses (iv) drawings are placed in the debit column of the trial balance.
2. The balances of all (i) liabilities accounts (ii) income accounts (iii) gains (iv) capital are placed in the credit column of the trial balance.

ILLUSTRATION 3

From the following ledger balances, prepare a trial balance of Anuradha Traders as on 31st March, 2022:

Account Head	₹
Capital	1,00,000
Sales	1,66,000
Purchases	1,50,000

<i>Sales return</i>	1,000
<i>Discount allowed</i>	2,000
<i>Expenses</i>	10,000
<i>Trade receivables</i>	75,000
<i>Trade payables</i>	25,000
<i>Investments</i>	15,000
<i>Cash at bank and in hand</i>	37,000
<i>Interest received on investments</i>	1,500
<i>Insurance paid</i>	2,500

SOLUTION**Trial Balance of Anuradha Traders as on 31.03.2022**

Particulars	Dr. balance ₹	Particulars	Cr. balance ₹
Purchases	1,50,000	Capital	1,00,000
Sales return	1,000	Sales	1,66,000
Discount allowed	2,000	Trade payables	25,000
Expenses	10,000	Interest received on investments	1,500
Trade receivables	75,000		
Investments	15,000		
Cash at bank and in hand	37,000		
Insurance paid	2,500		
Total	2,92,500		2,92,500

ILLUSTRATION 4

One of your clients, Mr. Singhania has asked you to finalise his accounts for the year ended 31st March, 2022. Till date, he himself has recorded the transactions in books of accounts. As a basis for audit, Mr. Singhania furnished you with the following statement.

	Dr. Balance (₹)	Cr. Balance (₹)
<i>Singhanian's Capital</i>		1,556
<i>Singhanian's Drawings</i>	564	
<i>Leasehold premises</i>	750	
<i>Sales</i>		2,750
<i>Dues from customers</i>		530
<i>Purchases</i>	1,259	
<i>Purchases return</i>	264	
<i>Loan from bank</i>		256
<i>Trade payables</i>	528	
<i>Trade expenses</i>	700	
<i>Cash at bank</i>	226	
<i>Bills payable</i>	100	
<i>Salaries and wages</i>	600	
<i>Inventories (1.4.2021)</i>		264
<i>Rent and rates</i>	463	
<i>Sales return</i>	_____	<u>98</u>
	5,454	5,454

The closing inventory on 31st March, 2022 was valued at ₹ 574. Mr. Singhanian claims that he has recorded every transaction correctly as the trial balance is tallied. Check the accuracy of the above trial balance.

SOLUTION

Corrected Trial Balance of Mr. Singhanian as on 31st March, 2022

Particulars	Dr. Amount ₹	Cr. Amount ₹
Singhanian's Capital		1,556
Singhanian's Drawings	564	
Leasehold premises	750	
Sales		2,750

Dues from customers (refer note 1 below)	530	
Purchases	1,259	
Purchases returns (refer note 2 below)		264
Loan from Bank		256
Trade payables (refer note 3 below)		528
Trade expenses	700	
Cash at Bank	226	
Bills payable (refer note 4 below)		100
Salaries and Wages	600	
Inventory (1.4.2021) (refer note 5 below)	264	
Rent and rates	463	
Sales return (refer note 6 below)	98	
	5,454	5,454

Notes:

1. Dues from customers is an asset, so its balance will be a debit balance.
2. Purchases return account always shows a credit balance because assets go out.
3. Balance in Trade payables is a liability, so its balance will be a credit balance.
4. Bills payable is a liability, so its balance will be a credit balance.
5. Inventory (opening) represents assets, so it will have a debit balance.
6. Sales return account always shows a debit balance because assets come.

ILLUSTRATION 5

The following trail balance as on 31st March, 2022 was drawn from the books of fintech traders:

	L.F.	Dr. Balance (₹)	Cr. Balance (₹)
<i>Building</i>		60,000	-
<i>Machinery</i>		17,000	-
<i>Return Outward</i>		2,600	-
<i>Bad Debts</i>		2,800	-
<i>Cash</i>		400	-

Discount Received		3,000	-
Bank Overdraft		10,000	-
Creditors		50,000	-
Purchases		1,00,000	-
Capital		-	73,600
Fixtures		-	5,600
Sales		-	1,04,000
Debtors		--	60,000
Interest Received		-	2,600
Input CGST A/c		-	3,000
Input SGST A/c		-	3,000
Input IGST A/c		-	4,800
Output CGST A/c		5,400	-
Output SGST A/c		5,400	-
Total		2,56,600	2,56,600

Even though the debit and credit sides agree, the trial Balance contains certain errors. Check the accuracy of trial balance.

SOLUTION

Corrected Trial Balance of Fintech traders as on 31st March, 2022

	L.F.	Dr. Balance (₹)	Cr. Balance (₹)
Building		60,000	-
Machinery		17,000	-
Return Outward		-	2,600
Bad Debts		2,800	-
Cash		400	-
Discount Received		-	3,000
Bank Overdraft		-	10,000
Creditors		-	50,000
Purchases		1,00,000	-
Capital		-	73,600

Fixtures		5,600	-
Sales		-	1,04,000
Debtors		60,000	-
Interest Received		-	2,600
Input CGST A/c		3,000	-
Input SGST A/c		3,000	-
Input IGST A/c		4,800	-
Output CGST A/c		-	5,400
Output SGST A/c		-	5,400
		2,56,600	2,56,600

SUMMARY

- ◆ Trial balance contains various ledger balances on a particular date.
- ◆ It forms the basis for preparing financial statement i.e. profit and loss account and balance sheet.
- ◆ If it tallies, it means that the accounts are arithmetically accurate but certain errors may still remain undetected.
- ◆ It is very important to carefully journalize and post the entries, following the rules of accounting.

TEST YOUR KNOWLEDGE

True and False

1. *Preparing trial balance is the third phase of accounting process.*
2. *Trial balance forms a base for the preparation of Financial statement.*
3. *Agreement of trial balance is a conclusive proof of accuracy.*
4. *A trial balance will tally in case of compensating errors.*
5. *A trial balance can find the missing entry from the journal.*
6. *Suspense account opened in a trial balance is a permanent account.*
7. *The balance of purchase returns account has a credit balance.*

Multiple Choice Questions

1. A trial balance will not balance if _____
 - (a) Correct journal entry is posted twice.
 - (b) The purchase on credit basis is debited to purchases and credited to cash.
 - (c) ₹ 500 cash payment to creditor is debited to Trade payables for ₹ 50 and credited to cash as ₹ 500.
2. ₹ 1, 500 received from sub-tenant for rent and entered correctly in the cash book is posted to the debit of the rent account. In the trial balance _____
 - (a) The debit total will be greater by ₹ 3,000 than the credit total.
 - (b) The debit total will be greater by ₹ 1,500 than the credit total.
 - (c) Subject to other entries being correct the total will agree.
3. After the preparation of ledgers, the next step is the preparation of _____
 - (a) Trading accounts
 - (b) Trial balance
 - (c) Profit and loss account
4. After preparing the trial balance the accountant finds that the total of debit side is short by ₹ 1,500. This difference will be _____
 - (a) Credited to suspense account
 - (b) Debited to suspense account
 - (c) Adjusted to any of the debit balance account

5.	S.No.	Account heads	Debit (₹)	Credit (₹)
	1.	Sales		15,000
	2.	Purchases	10,000	
	3.	Miscellaneous expenses	2,500	
	4.	Salaries		2,500
		Total	12,500	17,500

The difference in trial balance is due to _____

- (a) Wrong placing of sales account
- (b) Wrong placing of salaries account
- (c) Wrong placing of miscellaneous expenses account

Theory Questions

- What is the trial balance? And how it is prepared?
- Explain objectives of preparation of trial balance.
- Even if the trial balance agrees, some errors may remain. Do you agree? Explain.

Practical Question

- An inexperienced bookkeeper has drawn up a Trial Balance for the year ended 30th June, 2022.

	Debit (₹)	Credit (₹)
Provision for Doubtful Debts	200	–
Bank Overdraft	1,654	–
Capital	–	4,591
Trade payables	–	1,637
Trade receivables	2,983	–
Discount Received	252	–
Discount Allowed	–	733
Drawings	1,200	–
Office Furniture	2,155	–
General Expenses	–	829
Purchases	10,923	–
Returns Inward	–	330
Rent & Rates	314	–
Salaries	2,520	–
Sales	–	16,882
Inventory	2,418	–
Provision for Depreciation on Furniture	364	–
Total	24,983	25,002

Required:

Draw up a 'Corrected' Trial Balance, debiting or crediting any residual errors to a Suspense Account.

ANSWERS/HINTS

True and False

1. *True: Preparing trial balance is the third phase of accounting process which forms the base for the preparation of the final accounts.*
2. *True: Based on trial balance only, we can prepare financial statement.*
3. *False: Agreement of trial balance gives only arithmetical accuracy, there can still be errors in preparing the trial balance.*
4. *True: Since compensating errors cancel out due to their compensating nature of the amounts, hence the Trial balance tallies.*
5. *False: A trial balance cannot find the missing entry from the journal.*
6. *False: Suspense account opened in a trial balance is a temporary account*
7. *True: As purchases is debited, any returns shall be credited (treated in opposite way).*

Multiple Choice Questions

1.	(c)	2.	(a)	3.	(b)	4.	(b)	5.	(b)		

Theoretical Questions

1. Preparation of trial balance is the third phase in the accounting process. After posting the accounts in the ledger, a statement is prepared to show separately the debit and credit balances. Such a statement is known as the trial balance.

Trial balance contains various ledger balances on a particular date. It forms the basis for preparing the financial statements i.e. profit and loss account and balance sheet. If it tallies, it means that the accounts are arithmetically accurate but certain errors may still remain undetected. Therefore, it is very important to carefully journalise and post the entries, following are rules of accounting.
2. The preparation of trial balance has the following objectives:
 - (i) Trial balance enables one to establish whether the posting and other accounting processes have been carried out without committing arithmetical errors. In other words, the trial balance helps to establish arithmetical accuracy of the books of accounts.
 - (ii) Financial statements are normally prepared on the basis of agreed trial balance.
 - (iii) The trial balance serves as a summary of what is contained in the ledgers.

3. In spite of the agreement of the trial balance some errors may remain. These may be of the following types:
- (i) Transaction has not been entered at all in the journal.
 - (ii) A wrong amount has been written in both columns of the journal.
 - (iii) A wrong account has been mentioned in the journal.
 - (iv) An entry has not at all been posted in the ledger.
 - (v) Entry is posted twice in the ledger.

Practical Question

1. **Trial Balance as on 30th June, 2022**

Heads of Accounts	Debit ₹	Credit ₹
Provision for Doubtful Debts	–	200
Bank overdraft	–	1,654
Capital	–	4,591
Trade payables	–	1,637
Trade receivables	2,983	–
Discount Received	–	252
Discount allowed	733	–
Drawings	1,200	–
Office furniture	2,155	–
General Expenses	829	–
Purchases	10,923	–
Returns Inward	330	–
Rent & Rates	314	–
Salaries	2,520	–
Sales	–	16,882
Inventory	2,418	–
Provision for Depreciation on Furniture	–	364
Suspense Account (Balancing figure)	1,175	–
Total	25,580	25,580

UNIT – 4 SUBSIDIARY BOOKS

LEARNING OUTCOMES

After studying this unit, you will be able to:

- ◆ Understand the techniques of recording transactions in Purchase Book, Sales Book; Returns Inward Book and Returns Outward Book; Bills Receivable and Bills Payable Book.
- ◆ Learn the technique of posting from Subsidiary Books to Ledger.
- ◆ Understand that even if subsidiary books are maintained, journalisation is required for many other transactions and events.
- ◆ Learn the difference between the subsidiary books and principal books.

UNIT OVERVIEW

Principle books

- Ledger
- Cash books

Subsidiary books

- Purchases and Sales book, Purchase and Sales return books
- Bill payable and Bills receivable books
- Journal Proper



4.1 INTRODUCTION

In a business, most of the transactions generally relate to receipts and payments of cash, sale of goods and their purchase. It is convenient to keep a separate register for each such class of transactions one for receipts and payments of cash, one for purchase of goods and one for sale of goods. A register of this type is called a book of original entry or of prime entry. The transactions recorded in such books will not require journal entries. The system by which transactions of a class are first recorded in the specified book, specially meant for it and on the basis of which ledger accounts are then prepared is known as the Practical System of Book keeping or even the English System. It should be noted that in this system, there is no departure from the rules of the double entry system.

These books of original or prime entry are also called subsidiary books since ledger accounts are prepared on their basis without further processing of ledger posting. Normally, the following subsidiary books are used in a business:

- (i) Cash Book to record receipts and payments of cash, including receipts into and payments out of the bank.
- (ii) Purchases Book to record credit purchases of goods dealt in or of the materials and stores required in the factory.
- (iii) Purchase Returns Book to record the returns of goods and materials previously purchased.
- (iv) Sales Book to record the sales of the goods dealt in by the firm.
- (v) Sale Returns Book to record the returns of goods made by the customers sold to them earlier.
- (vi) Bills Receivable Book to record the receipts of promissory notes or hundies from various parties.
- (vii) Bills Payable Book to record the issue of the promissory notes or hundies to other parties.
- (viii) Journal (proper) to record the transactions which cannot be recorded in any of the seven books mentioned above.

It may be noted that in all the above cases the word "Journal" may be used for the word "book".

Advantages of Subsidiary Books

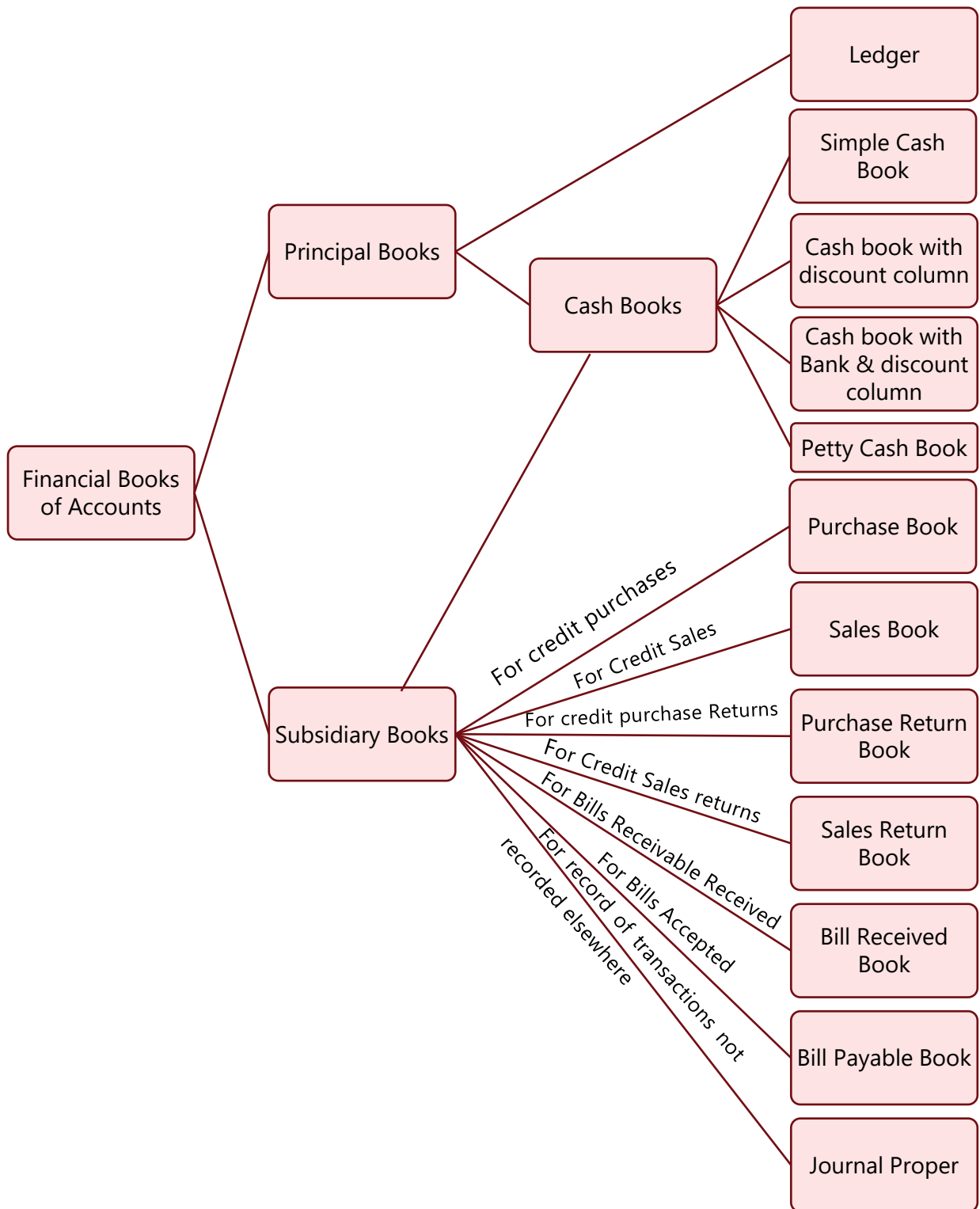
The use of subsidiary books affords the undermentioned advantages:

- (i) **Division of work:** Since in the place of one journal there will be so many subsidiary books, the accounting work may be divided amongst a number of clerks.
- (ii) **Specialization and efficiency:** When the same work is allotted to a particular person over a period of time, he acquires full knowledge of it and becomes efficient in handling it. Thus the accounting work will be done efficiently.
- (iii) **Saving of the time:** Various accounting processes can be undertaken simultaneously because of the use of a number of books. This will lead to the work being completed quickly.
- (iv) **Availability of information:** Since a separate register or book is kept for each class of transactions, the information relating to each class of transaction be available at one place.
- (v) **Facility in checking:** When the trial balance does not agree, the location of the error or errors is facilitated by the existence of separate books. Even the commission of errors and frauds will be checked by the use of various subsidiary books.



4.2 DISTINCTION BETWEEN SUBSIDIARY BOOKS AND PRINCIPAL BOOKS

The books in which transactions are first recorded to enable further processing are called subsidiary books. The ledger and the cash book are the principle books since they furnish information for preparation of the trial balance and financial statements. The following chart will help you in understanding the difference between Subsidiary Books and Principal Books.





4.3 PURCHASES BOOK

To record the credit purchases of goods dealt in or materials used in the business, a separate register called the Purchases Book or the Purchases Journal, is usually maintained by firms. The format is given below:

Date	Particulars	Details ₹	Amount ₹

It should be remembered that:

- (i) Cash purchases are not entered in this book since these will be entered in the cash book; and
- (ii) Credit purchases of items other than goods or materials, such as office furniture or typewriters are journalised - they are not entered in the Purchases Book.

The particulars column is meant to record the name of the supplier and name of the articles purchased and the respective quantities. The amount in respect of each article is entered in the details column. After totalling the various amounts included in a single purchase, the amount for packing, or other charges is added and the amount for trade discount is deducted. The net amount is entered in the amount column. The total in the amount column shows the total purchase made in a period.

ILLUSTRATION 1

The Rough Book of M/s. Narain & Co. contains the following :

2022

- Feb.**
1. Purchased from Brown & Co. on credit :
 5 gross pencils @ ₹100 per gross,
 1 gross register @ ₹240 per doz.
 Less : Trade Discount @ 10%
 2. Purchased for cash from the Stationery Mart;
 10 gross exercise books @ ₹300 per doz.
 3. Purchased computer for office use from M/s. office
 Goods Co. on credit for ₹30,000.
 4. Purchased on credit from The Paper Co.
 5 reams of white paper @ ₹100 per ream.

10 reams of ruled paper @ ₹150 per ream.

Less : Trade Discount @ 10%

5. Purchased one dozen gel pens @ ₹15 each from
M/s. Verma Bros. on credit.

Make out the Purchase Book of M/s. Narain & Co.

SOLUTION

Purchases Book

Date	Particulars	Details	Amount
2022		₹	₹
Feb. 1	M/s. Brown & Co.		
	5 gross pencils @ ₹ 100 per gross	500.00	
	1 gross register @ ₹ 240 per doz.	<u>2880.00</u>	
		3380.00	
	Less : 10% trade discount	<u>(338)</u>	3,042
"4	The Paper Co.		
	5 reams white paper @ ₹ 100 per ream	500.00	
	10 reams ruled paper @ ₹ 150 per ream	<u>1500.00</u>	
		2,000.00	
	Less : 10% trade discount	<u>(200.00)</u>	1,800
5	M/s. Verma Bros.		
	1 doz. gel pens @ ₹ 15 each	180	<u>180</u>
		Total	5022

Note : Purchases of cash and purchase of computer are not recorded in the Purchase Book.

ILLUSTRATION 2

Enter the following transactions in Purchase Book and post them into ledger.

2022

- April 4 Purchased from Ajay Enterprises, Delhi
100 Doz. Rexona Hawai Chappal @ ₹ 120 per doz.
200 Doz. Palki Leather Chappal @ ₹ 300 per Doz.

Less : Trade discount @ 10%

Freight charged ₹ 150.

April 15 Purchased from Balaji Traders, Delhi

50 doz. Max Shoes @ ₹ 400 per doz.

100 pair Sports Shoes @ ₹ 140 per pair.

Less : Trade discount @ 10%.

Freight charged ₹ 200.

April 28 Purchased from Tripti Industries, Bahadurgarh

40 pair leather shoes @ ₹ 400 per pair

100 doz. Rosy Hawai Chappal @ ₹ 180 per doz.

Less : Trade discount @ 10%.

Freight charged ₹ 100.

SOLUTION

Purchase Book

Date 2022	Particulars	Details	Gross Amount	Trade Discount	Net Price	Freight	Total Amount
April 4	Ajay Enterprises						
	100 doz Rexona Hawai chappal @ ₹ 120 per doz - ₹ 12,000	12,000					
	200 doz Palki Leather Chappal @ ₹ 300 per doz - ₹ 60,000	60,000					
	Less: trade discount @ 10%		72,000	7,200	64,800	150	64,950
April 15	Balaji Traders, Delhi						
	50 doz max Shoes @ ₹ 400 per doz - ₹ 20,000	20,000					
	100 pair Sports shoes @ ₹ 140 per pair - ₹ 14,000	14,000					
	Less: Trade discount @ 10%		34,000	3,400	30,600	200	30,800

April 28	Tripti Industries, Bahadurgarh						
	40 pair Leather shoes @ ₹ 400 per pair - ₹ 16,000	16,000					
	100 doz Rosy Hawai Chappal: @ ₹ 180 per doz - ₹ 18,000	18,000					
	Less: Trade discount @ 10%		<u>34,000</u>	<u>3,400</u>	<u>30,600</u>	<u>100</u>	<u>30,700</u>
			1,40,000	14,000	1,26,000	450	1,26,450

LedgersDr. **Purchases A/c** Cr.

2022		₹	2022		₹
April 30	To amount as per purchase book	1,26,000			

Dr. **Freight A/c** Cr.

2022		₹	2022		₹
April 30	To amount as per purchase book	450			

Dr. **Ajay Enterprises** Cr.

2022		₹	2022		₹
			April 4	By Purchase A/c (From Purchase Book)	64,800
				By Freight A/c (From Purchase Book)	150

Dr. **Balaji Traders** Cr.

2022		₹	2022		₹
			April 15	By Purchase A/c (From Purchase Book)	30,600
				By Freight A/c (From Purchase Book)	200

Dr.

Tripathi Industries

Cr.

2022		₹	2022		₹
			April 28	By Purchase A/c (From Purchase Book)	30,600
				By Freight A/c (From Purchase Book)	100

POSTING THE PURCHASES BOOK

The Purchases Book shows the names of the parties from whom goods have been purchased on credit. These parties are now trade payables. Their accounts have to be credited for the respective amounts shown in the purchase book. The total of the amounts column shows the credit purchases made in a period. The amount is debited to the Purchase Account to indicate receipt of goods. In Illustration 1, the Purchases Account is debited by ₹ 5,022, M/s. Brown & Co. is credited by ₹ 3,042, The Paper Company by ₹1,800 and M/s. Verma Bros. by ₹180. The total of the amounts put on the credit side equals the debit. Thus the double entry is completed.



4.4 SALES BOOK

The Sales Book is a register specially kept to record credit sales of goods dealt in by the firm, cash sales are entered in the Cash Book and not in the Sales Book. Credit sales of items other than the goods dealt in by the firm are not entered in the Sales Book rather they are journalised. The rules are the same as for the Purchases Book.

Entries in the Sales Book are also made in the same manner as in the Purchase Book. The particulars column will record the name of the customers concerned together with particulars and quantities of the goods sold. For each item, the amount is entered in the details column; after totalling the amounts for one sale, charges for packing etc; are added and the trade discount, if any is deducted: the net amount is put in the outer column. The total of this column will show the total credit sales for a period.

ILLUSTRATION 3

The following are some of the transaction of M/s Kishore & Sons of the year 2022 as per their Waste Book. Make out their Sales Book.

Sold to M/s. Gupta & Verma on credit:

30 shirts @ ₹ 800 per shirt.

20 trousers @ ₹1,000 per trouser.

Less : Trade Discount @ 10%

Sold furniture to M/s. Sehgal & Co. on credit ₹8,000.

Sold 50 shirts to M/s. Jain & Sons @ ₹800 per shirt.

Sold 13 shirts to Cheap Stores @ ₹750 each for cash.

Sold on credit to M/s. Mathur & Jain.

100 shirts @ ₹750 per shirt

10 overcoats @ ₹5,000 per overcoat.

Less: Trade Discount @ 10%

SOLUTION

Sales Book

Date	Particulars	Details ₹	Amount ₹
2022	M/s. Gupta & Verma		
	30 shirts @ ₹800	24,000	
	20 Trousers @ ₹1,000	20,000	
		44,000	
	Less : 10%	(4,400)	
	Sales as per invoice no. dated		39,600
	M/s. Jain & Sons 50 shirts @ ₹800		
	Sale as per invoice no. dated		40,000
	M/s Mathur & Jain		
	100 shirts @ ₹750	75,000	
	10 overcoats @ ₹5,000	50,000	
		1,25,000	
	Less : 10%	(12,500)	
	Sales as per invoice no. dated.....		1,12,500
		Total	1,92,100

Note : Cash sale and sale of furniture are not entered in Sales Book.

POSTING THE SALES BOOK

The names appearing in the Sales Book are of those parties which have received the goods. The accounts of the parties have to be debited with the respective amounts. The total of the Sales Book shows the credit sales made during the period concerned; the amount is credited to the Sales Account. In the Illustration 3, ₹ 1,92,100 is credited to the Sales Account; ₹39,600 is debited to M/s. Gupta and Verma ₹40,000 to M/s Jain and Sons and ₹1,12,500 to M/s Mathur & Jain. The amount put on the credit side is equal to the total of the amount put on the debit side. Thus, the double entry principle is followed correctly.



4.5 SALES RETURNS BOOK OR RETURNS INWARD BOOK

If customers frequently return the goods sold to them, it would be convenient to record the returns in a separate book, which is named as the Sales Returns Book or the Returns Inward Book. The rules of the book is similar to the Sales Book and entries are also made in the same manner. The following, assumed figures, will illustrate this:

Returns Inward Book

Date	Particulars	Details	L.F.	Amount
2022				₹
June 7	Sunil Bank & Co.			
	6 Copies-Double Entry			
	Bookkeeping by T.S. Grewal @ ₹ 7	42.00		
	Less : Trade Discount 10%	(4.20)		37.80
	Kailash & Co.			
	1 Copy-Business Methods by R.K. Gupta			<u>3.50</u>
		Total		41.30



4.6 PURCHASE RETURNS OR RETURNS OUTWARD BOOK

Such a book conveniently records return of goods or material purchased to the suppliers. However, if the returns are not frequent, it may be sufficient to record the transaction in the journal. The rules of the Purchase Returns or Returns Outward Book is similar to that of the Purchase Book; entries are also similarly made, as the illustration given below shows:

Returns Outward Book

Date 2022	Particulars	₹	Amount ₹
June 2	Premier Electric Co.		175.00
	One 36" Usha Ceiling Fan		
" 28	Mohan Electric Co.		
	Ten Iron Heaters	150.00	
	Less : Discount	<u>(15.00)</u>	<u>135.00</u>
	Total		310.00

POSTING OF THE RETURN BOOKS

The Sales Return Book will show the total of the returns made by customers. The total of the sales returns is in reduction of the sales. Therefore, the amount may be debited to the Sales Account but, usually, a separate account called Returns Inward Account is opened and the total of the sales returns is debited to this accounts. The customers who have returned the goods are credited with the respective amounts.

It should be noted that on goods being received and accepted back from the customers, a credit note is issued to the customers concerned. This shows the amount to be credited to the customer's account.

Similarly, when goods are returned to suppliers they will issue the necessary credit note; also the firm returning the goods will issue a debit note to the supplier, indicating the amount for which the supplier account is being debited.

The total of Returns Outwards Book shows the total purchase returns made. The amount can be credited to the Purchase Account, but in practice, it is credited to a separate account called Purchase Returns or Returns Outward Account. The suppliers whose names appear in the Book have received the goods, so their accounts are debited. This is shown in the illustration given below:

ILLUSTRATION 4

Post the following into the ledger

Returns Outward Book

Date 2022	Particulars	Details ₹	Amount ₹
Nov. 20	Rajindra Prakash & Sons		
	One 36" Usha Ceiling Fan	200.00	
	Less : Trade Discount @ 10%	<u>(20.00)</u>	180.00
" 30	Modern Electric Company		100.00
	Total		280.00

SOLUTION**Ledger**

Dr. **Rajindra Parkash & Sons** Cr.

Date 2022	Particulars	Folio	Amount	Date	Particulars	Folio	Amount
Nov. 20	To Returns Outward A/c (From Returns Outward Book)		180.00				

Dr. **Modern Electric Co.** Cr.

Date 2022	Particulars	Folio	Amount	Date	Particulars	Folio	Amount
Nov. 30	To Returns Outward A/c (From Returns Outward Book)		100.00				

Dr. **Returns Outward Account** Cr.

Date 2022	Particulars	Folio	Amount	Date	Particulars	Folio	Amount
				Nov. 30	By Sundries as per Returns Outward Book		280.00

BILLS RECEIVABLE BOOKS AND BILLS PAYABLE BOOKS

If the firm usually receives a number of promissory notes or hundies, it would be convenient to record the transaction in a separate book called the Bills Receivable Book. Similarly, if promissory notes or hundies are frequently issued, the Bills Payable Book will be convenient. This will be discussed later.



4.7 IMPORTANCE OF JOURNAL

Students are now familiar with the journal. They also know that :

- (i) Cash transactions are recorded in the cash book;
- (ii) Credit purchases of goods or materials are recorded in the purchases book;
- (iii) Credit sales of goods are recorded in the sales book;
- (iv) Returns from customers are recorded in the sale returns book; and
- (v) Returns to suppliers are entered in the purchase returns book.

Bill received or accepted transactions are entered in the bills receivable books or the bills payable books, if these are maintained. Apart from the transactions mentioned above, there are other entries also which have to be recorded. For them the proper place is the journal. In fact, if there is no special book meant to record a transaction, it is recorded in the journal (proper). The role of the journal is thus restricted to the following types of entries:

- (i) **Opening entries** : When books are started for the new year, the opening balance of assets and liabilities are journalised.
- (ii) **Closing entries** : At the end of the year, the profit and loss account is prepared. For this purpose, the nominal accounts are transferred to profit and loss account. This is done through journal entries called closing entries.
- (iii) **Rectification entries** : If an error has been committed, it is rectified through a journal entry.
- (iv) **Transfer entries** : If some amount is to be transferred from one account to another, the transfer will be made through a journal entry.
- (v) **Adjusting entries** : At the end of the year the amount of expenses or income may have to be adjusted for amounts received in advance or for amounts not yet settled in cash. Such an adjustment is also made through journal entries. Usually, the entries pertain to the following:
 - (a) Outstanding expenses, i.e., expenses incurred but not yet paid;

- (b) Prepared expenses, i.e., expenses paid in advance for future period;
- (c) Interest on capital, i.e., the interest on proprietor's investment in the business; and
- (d) Depreciation, i.e., fall in the value of the assets used on account of wear and tear.

For above type of transactions/events, journal entries are necessary.

(vi) Entries on dishonour of Bills : If someone who accepted a promissory note (or bill) is not able to pay in on the due date, a journal entry will be necessary to record the non-payment or dishonour of bills.

(vii) Miscellaneous entries : The following entries will also require journalising:

- (a) Credit purchase of items other than goods dealt in or materials required for production of goods e.g. credit purchase of furniture or machinery will be journalised.
- (b) An allowance to be given to the customers or a charge to be made to them after the issue of the invoice.
- (c) Receipt or issue of promissory notes, if separate bill books have not been maintained.
- (d) If an amount becomes irrecoverable, say, because, of the customer becoming insolvent.
- (e) Effects of accidents such as loss of property by fire.
- (f) Transfer of net profit to capital account.

ILLUSTRATION 5

From the following transactions, prepare the Purchases Returns Book of Alpha & Co., a saree dealer :

Date	Debit Note No.	Particulars
04.01.2022	101	Returned to Goyal Mills, Surat - 5 polyester sarees @ ₹ 1,000.
09.01.2022		Garg Mills, Kota - accepted the return of goods (which were purchased for cash) from us - 5 Kota sarees @ ₹ 400.
16.01.2022	102	Returned to Mittal Mills, Bangalore - 5 silk sarees @ ₹ 2,600.
30.01.2022		Returned one computer (being defective) @ ₹ 35,000 to B & Co.

SOLUTION**Purchase Returns Book**

Date	Debit Note No.	Name of supplier	L.F.	Amount
2022				
Jan. 4	101	Goyal Mills, Surat		5,000
Jan. 16	102	Mittal Mills, Bangalore		13,000
Jan. 31		Purchases Returns Account (Cr.)		18,000

SUMMARY

- ◆ Instead of recording all journal entries in one register, it is better to categorize the entries on the basis of type of transactions.
- ◆ Various subsidiary books are maintained so as to record transactions of one type in each register. These are also called books of original entry or prime entry.
- ◆ Example of subsidiary books are purchases book, sales book, purchase returns books, sales returns book, bills receivable book, bills payable book etc. On the basis of these subsidiary books, the ledger accounts are prepared.

TEST YOUR KNOWLEDGE**True and False**

1. *Transactions recorded in the purchase book include only purchases of goods on credit transactions.*
2. *Transactions regarding the purchase of fixed asset are recorded in the purchase book.*
3. *Cash sales are recorded in the sales book.*
4. *Subsidiary books are also known as the books of original entry.*
5. *Bills receivable book is a subsidiary book.*
6. *Return inward book is also known as purchase return book.*
7. *Purchase of a second hand machinery will be recorded in purchase book.*
8. *Total of sales return book may be posted to the debit side of sales account.*
9. *If the sales are on a frequent basis, the transactions are recorded in the sales book.*

Multiple Choice Questions

1. In Purchases Book, the record is in respect of _____
 - (a) Cash purchase of goods.
 - (b) Credit purchase of goods dealt in.
 - (c) All purchases of goods.
2. The Sales Returns Book records _____
 - (a) The return of goods purchased.
 - (b) Return of anything purchased.
 - (c) Return of goods sold.
3. The Sales Book _____
 - (a) Is a part of journal.
 - (b) Is a part of the ledger.
 - (c) Is a part of the balance sheet.
4. The weekly or monthly total of the Purchase Book is _____
 - (a) Posted to the debit of the Purchases Account.
 - (b) Posted to the debit of the Sales Account.
 - (c) Posted to the credit of the Purchases Account.
5. The total of the Sales Book is posted to _____
 - (a) Credit of the Sales Account.
 - (b) Credit of the Purchases Account.
 - (c) Credit of the Capital Account.
6. In which book of original entry, will you record an allowance of ₹50 which was offered for an early payment of cash of ₹1,050 _____.
 - (a) Sales Book
 - (b) Cash Book
 - (c) Journal Proper (General Journal)

7. A second hand motor car was purchased on credit from B Brothers for ₹10,000 will be recorded in _____.
- (a) Journal Proper (General Journal)
 - (b) Sales Book
 - (c) Cash Book
 - (d) Purchase Book
8. In which book of original entry, will you record a bills receivable of ₹1,000, which was received from a debtor in full settlement for a claim of ₹1,100, is dishonoured _____.
- (a) Purchases Return Book
 - (b) Bills Receivable Book
 - (c) Journal Proper (General Journal)

Theory Questions

- 1 Which subsidiary books are normally used in a business?
- 2 What are the advantages of subsidiary books?

Practical Questions

- 1 Enter the following transactions in Sales Book of M/s. Pranat Engineers Ltd., Delhi.
2022
Jan. 2. Sold to M/s. Ajanta Electricals, Delhi 5 pieces of Ovens @ ₹6,000/- each less Trade discount @ 10%.
8 Sold to M/s. Electronics Plaza, 10 pieces of Tablets @ ₹8,000/- each less trade discount 5%.
15 Sold to M/s. Haryana Traders, 5 pieces of Juicers @ ₹3,500/- each less trade discount @ 10%.
- 2 Post into the ledger, the entries of Sales Book prepared in Question 1.

ANSWERS/HINTS

True and False

1. True: Since cash purchases are taken to the cash book , it is only credit transactions that are recorded in the purchases book.
2. False: Transactions regarding the purchase of fixed asset are not recorded in the purchase book, only the credit purchases of goods are recorded in it.
3. False: Credit sales are recorded in the sales book.
4. True: Subsidiary books are maintained as an alternate to the journal.
5. True: Bills receivable is one of the subsidiary book.
6. False: Return inward book is also known as sales return book.
7. False: Purchase of a second hand machinery will not be recorded in purchase book.
8. True: Since sales return is reduction from the total sales value, it is debited in the sales account.
9. True: When there are numerous transactions then there are subsidiary books like the sales book where there are recorded instead of regular journal entries.

Multiple Choice Questions

1.	(b)	2.	(c)	3.	(a)	4.	(a)	5.	(a)	6.	(b)
7.	(a)	8.	(c)								

Theoretical Questions

1. Refer para 4.1 of this unit for subsidiary books normally mainlined in a business.
2. For advantages of Subsidiary Books, refer para 4.1 of this unit.

Practical Problems

1. Sales Book

Date	Particulars	Gross Amount (₹)	Trade Discount (₹)	Net Price (₹)
2022 Jan. 2	M/s. Ajanta Electricals			

8	5 pieces of Ovens @ ₹ 6,000 each Less: 10% discount	30,000	3,000	27,000
	M/s. Electronics Plaza			
15	10 pieces of Tablets @ ₹ 8,000 each, less 5% trade discount	80,000	4,000	76,000
	M/s. Haryana Traders			
	5 pieces of Juicers @ ₹ 3,500 each, less 10% trade discount	<u>17,500</u>	<u>1,750</u>	<u>15,750</u>
		1,27,500	8,750	1,18,750

2. Ledger

M/s. Ajanta Electricals

Date 2022	Particulars	L.F.	Amount (₹)	Date 2022	Particulars	L.F.	Amount (₹)
Jan. 2	To Sales A/c (From Sales Book)		27,000				

M/s. Electronics Plaza

Date 2022	Particulars	L.F.	Amount (₹)	Date 2022	Particulars	L.F.	Amount (₹)
Jan. 8	To Sales A/c (From Sales Book)		76,000				

M/s. Haryana Traders

Date 2022	Particulars	L.F.	Amount (₹)	Date 2022	Particulars	L.F.	Amount (₹)
Jan. 15	To Sales A/c (From Sales Book)		15,750				

Sales Account

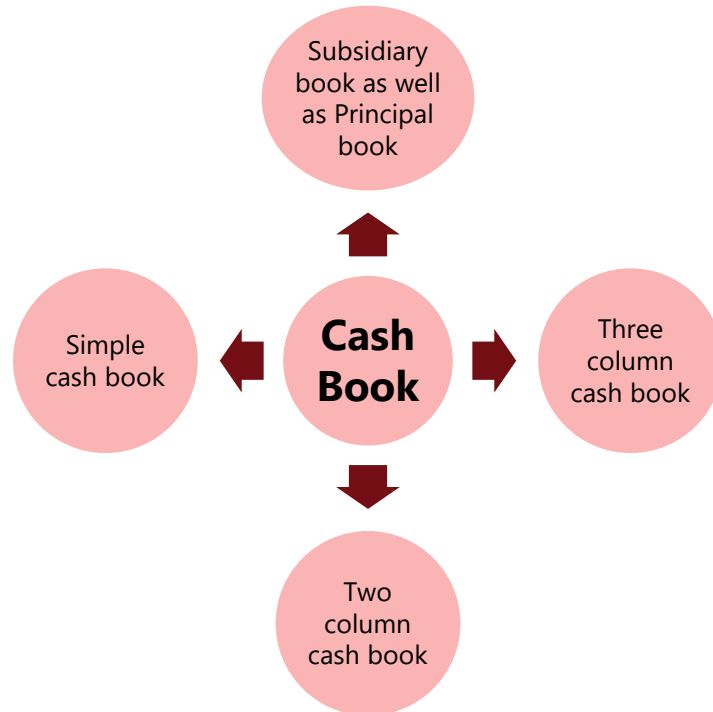
Date 2022	Particulars	L.F.	Amount (₹)	Date 2022	Particulars	L.F.	Amount (₹)
				Jan. 31	By Sundries (As per Sales Book)		1,18,750

UNIT 5 : CASH BOOK

LEARNING OUTCOMES

After studying this unit, you will be able to:

- ◆ Understand that a Cash Book is a type of subsidiary book but treated as a principal book.
- ◆ Be familiar with various kinds of Cash Books, viz., Simple Cash Book, Two-column Cash Book and Three-column Cash Book.
- ◆ Learn the technique of preparation of Simple Cash Book and how to balance it.
- ◆ See how Double-Column Cash Book is prepared adding discount column alongwith cash column.
- ◆ Understand the techniques of preparing Three-column Cash Book.
- ◆ Understand what is a Petty Cash Book and the Imprest System of Petty Cash.
- ◆ Note the advantages of the Petty Cash Book.
- ◆ Learn how to maintain a Petty Cash Book and how to post the entries of the Petty Cash Book in the ledger.
- ◆ Understand the accounting of credit/debit sales transactions.

UNIT OVERVIEW

5.1 CASH BOOK - A SUBSIDIARY BOOK AND A PRINCIPAL BOOK

Cash transactions are straightaway recorded in the Cash Book and on the basis of such a record, ledger accounts are prepared. Therefore, the Cash Book is a subsidiary book. But the Cash Book itself serves as the cash account and the bank account; the balances are entered in the trial balance directly. The Cash Book, therefore, is part of the ledger also. Hence, it has also to be treated as the principal book. The Cash Book is thus both a subsidiary book and a principal book.



5.2 KINDS OF CASH BOOK

The main Cash Book may be of the three types:

- (i) Simple Cash Book;
- (ii) Two-column Cash Book;
- (iii) Three-column Cash Book.

In addition to the main Cash Book, firms also generally maintain a petty cash book but that is purely a subsidiary book.

SIMPLE CASH BOOK

Such a cash book appears like an ordinary account, with one amount column on each side. The left-hand side records receipts of cash and the right-hand side the payments.

Balancing: The cash book is balanced like other accounts. The total of receipts column is always greater than total of payments column. The difference is written on the credit side as 'By balance c/d'. The totals are then entered in the two columns opposite one another and then on the debit side the balance is written as "To Balance b/d", to show cash balance in hand in the beginning of next period.

ILLUSTRATION 1

Enter the following transactions in a Simple Cash Book:

2022		₹
Jan. 1	Cash in hand	1,200
" 5	Received from Ram	300
" 7	Paid Rent	30
" 8	Sold goods for cash	300
" 10	Paid to Shyam	700
" 27	Purchased Furniture	200
" 31	Paid Salaries	100
" 31	Rent due, not yet paid, for January	30

SOLUTION

Dr.				Cr.			
Cash Book							
Date 2022	Receipts	L.F.	Amount ₹	Date 2022	Payments	L.F.	Amount ₹
Jan. 1	To Balance b/d		1,200	Jan. 07	By Rent A/c		30
" 5	To Ram A/c		300	" 10	By Shyam A/c		700
" 8	To Sales A/c		300	" 27	By Furniture A/c		200

				" 31	By Salaries A/c		100
				" 31	By Balance c/d		770
			1,800				1,800
2022							
Feb. 1	To Balance b/d		770				

Note :

- (i) In the simple cash book only the cash receipts and cash payments are recorded.
- (ii) The total of debit side is always greater than the total of credit side since the payment cannot exceed the available cash.
- (iii) The simple cash book is like an ordinary account.
- (iv) Rent due not yet paid for January has not been recorded in the cash book because no cash has been paid, hence it will be recorded through normal Journal entry.

DOUBLE-COLUMN CASH BOOK

If along with column for "Amount" to record cash receipts and cash payments another column is added on each side to record the cash discount allowed or the discount received, or a column on the debit side showing bank receipts and another column on the credit side showing payments through bank. It is a double-column cash book.

Cash discount is an allowance which often accompanies cash payments. For example, if a customer owes ₹ 500 but is promised that 2% will be deducted if payment is made within a certain period, the customer can clear his account by paying promptly ₹ 490. Cash received will be ₹ 490 and ₹ 10 will be the discount for the firm receiving the payment and discount is a loss; for the person making the payment it is a gain. Since cash discount is allowed only if cash is paid, it is convenient to add a column for discount allowed on the receipt side of the cash book and a column for discount received on the payment side of the cash book.

Balancing: It should be noted that the discount columns are not balanced. They are merely totalled. The total of the discount column on the receipts side shows total discount allowed to customers and is debited to the Discount Account. The total of the column on the payments side shows total discount received and is credited to the Discount Account. The Cash columns are balanced, as already shown. The bank columns are also balanced and the balancing figure is called bank balance. Thus a double column cash book should have two columns on each side comprising of either cash and discount transaction or cash and bank transactions.

In the cash column on the debit side, actual cash received is entered; the amount of the discount allowed, if any, to the customer concerned is entered in the discount column. Similarly, actual cash paid is entered in the cash column on the payments side and discount received in the discount column. Also the bank column on the debit side records all receipts through bank and the same column on the credit side shows payment through bank.

ILLUSTRATION 2

Ganesh commenced business on 1st April, 2022 with ₹ 2,000 as capital. He had the following cash transactions in the month of April 2022:

		₹			₹
April 1	Purchased furniture and paid cash	250	April 7	Paid for petty expenses	15
" 2	Purchased goods	500	" 8	Cash purchases	150
" 4	Sold goods for cash	950			
			13	Paid for labour	1,000
" 5	Paid cash to Ram Mohan	560			
" 6	He allowed discount	10	" "	Paid Ali & Sons	400
" 6	Received cash from Krishna & Co.	600	" "	They allowed discount	8
	Allowed discount	20			

Make out the two-column Cash Book (Cash and discount column) for the month of April, 2022.

SOLUTION**Cash Book**

Dr. Date 2022	Receipts	L.F.	Discount ₹	Amount ₹	Date 2022	Payments	L.F.	Discount ₹	Cr. Amount ₹
April 1	To Capital A/c			2,000	April 1	By Furniture A/c			250
" 4	To Sales A/c			950	" 2	By Purchases A/c			500
" 6	To Krishna A/c		20	600	" 5	By Ram Mohan		10	560
					" 7	By Petty Expenses A/c			15

				" 8	By Purchases A/c			150
				" 13	By wages A/c			1,000
				" 13	By Ali & Sons		8	400
				" 30	By Balance c/d			675
			20	3,550			18	3,550
May 1	To Balance b/d			675				

To summarise:

- (i) the discount columns in the cash book are totalled;
- (ii) they are not balanced; and
- (iii) their totals are entered in the discount received/paid account in the ledger.

Note: The person who pays, is credited by both the cash paid by him and the discount allowed to him. Similarly, the person to whom payment is made, is debited with both the amount paid and the discount allowed by him.

THREE-COLUMN CASH BOOK

A firm normally keeps the bulk of its funds at a bank; money can be deposited and withdrawn at will if it is current account. Probably payments into and out of the bank are more numerous than strict cash transactions. There is only a little difference between cash in hand and money at bank. Therefore, it is very convenient if, on each side in the cash book, another column is added to record cash deposited at bank (on the receipt side of the cash book) and payments out of the bank (on the payment side of the cash book).

For writing up the three-column cash book the under mentioned points should be noted:

1. While commencing a new business, the amount is written in the cash column if cash is introduced and in the bank column if it is directly put into the bank with the description "To Capital Account". If a new cash book is being started for an existing business, the opening balances are written as : "To Balance b/d".
2. All receipts are written on the receipts side, cash in the cash column and cheques in the bank column. If any discount is allowed to the party paying the amount, the discount is entered in the discount column. In the particulars column the name of the account in respect of which payment has been received is written.
3. All payments are written on the payments side, cash payment in the cash column and payments by cheques in the bank column. If some discount has been received from the party receiving the payment, it is entered in the discount column.

4. *Contra Entries:* Often cash is withdrawn from bank for use in the office. In such a case the amount is entered in the bank column on the payments side and also in the cash column on the receipts side. In the reverse case of cash being sent to the bank, the amount is recorded in the bank column on the receipts side and in cash column on payment side. Against such entries, the letter "C" should be written in the L.F column, to indicate that these are contra transaction and no further posting is required for them.

Note: If initially cheques received are entered in the cash column and then sent to the bank, the entry is as if cash has been sent to the bank.

While recording contra entries, the basic but important rules should be followed -

(a)	The Receiver	Dr.
	The Giver	Cr.
(b)	All what comes in	Dr.
	All what goes out	Cr.

e.g. where a Cash Book with separate columns for Bank Account is maintained.

(a)	If cash is deposited in Bank Account, the Bank will be the Receiver, hence it will be Debited and as the cash is going out, cash will be credited.
(b)	If cash is withdrawn from the Bank Account, the Bank will be the Giver, hence it will be Credited and, as the cash is coming in, cash will be Debited.
5. If some cheque sent to the bank is dishonoured, i.e., the bank is not able to collect the amount, it is entered in the bank column on the credit side with the name of the concerned party in the particulars column.
6. If some cheque issued by the firm is not paid on presentation, it is entered in the Bank column on the debit side with the name of the party to whom the cheque was given.
7. In a rare case, a cheque received may be given to some other party, i.e., endorsed. On receipt, it must have been entered in the bank column on the debit side; on endorsement the amount will be written in the bank column on the credit side.

The advantages of such type of Cash Book are that -

- (a) the Cash Account and the Bank Account are prepared simultaneously, therefore the double entry is completed in the Cash Book itself. Thus the contra entries can be easily cross-checked in Cash column in one side and the Bank column in the other side of the Cash Book. Also the chances of error are reduced.

- (b) the information regarding Cash in Hand and the Bank Balance can be obtained very easily and quickly as there is no need to prepare Ledger of the Bank Account.

In case of maintaining more than one Bank Account, separate column can be add for each Bank Account. Transactions between these two or more Bank Accounts can be recorded and tallied with a much less effort.

Suppose, there are two Bank Accounts namely PNB Current Account and SBI-Cash Credit Account. Now, if a cheque is issued from PNB cheque Book to SBI Account, the receiver - i.e., SBI Account will be debited and the giver i.e. the PNB Account shall be credited.

Balancing: The discount columns are totalled but not balanced. The cash columns are balanced exactly in the same manner as indicated for the simple cash book. The process is similar for balancing the bank columns also. It is possible, however, that the bank may allow the firm to withdraw more than the amount deposited i.e., to have an overdraft, In such a case, the total of the bank column on the credit side is bigger than the one on the debit side. The difference is written on the debit side as "To Balance c/d." Then the totals are written on the two sides opposite one another, the balance is then entered on the credit side as "By Balance b/d."

However, in usual cases debits into the bank will exceed the withdrawals or payments out of the bank. Then the bank columns are balanced just like the cash columns.

ILLUSTRATION 3

Enter the following transactions in Cash Book with Discount and Bank Columns. Cheques are first treated as cash receipt.

2022		₹
Jan.1	Chandrika commences business with Cash	20,000
" 3	He paid into Current A/c	19,000
" 4	He received cheque from Kirti & Co. on account	600
" 7	He pays in bank Kirti & Co.'s cheque	600
" 10	He pays Rattan & Co. by cheque and is allowed discount ₹ 20	330
" 12	Tripathi & Co. pays into his Bank A/c	475
" 15	He receives cheque from Warshi and allows him discount ₹ 35	450

"	20	He receives cash ₹ 75 and cheque ₹ 100 for cash sale	
"	25	He pays into Bank, including cheques received on 15th and 20th	1,000
"	27	He pays for cash purchase	275
"	30	He pays sundry expenses in cash	50

SOLUTION

Dr.

Cash Book

Cr.

Date	Receipts	L.F.	Discount ₹	Cash ₹	Bank ₹	Date	Payments	L.F.	Discount ₹	Cash ₹	Bank ₹
2022						2022					
Jan. 1	To Capital A/c			20,000		Jan. 3	By Bank A/c	C		19,000	
3	To Cash	C			19,000	7	By Bank A/c	C		600	
4	To Kirti & Co.			600		10	By Ratan & Co.		20		330
7	To Cash	C			600	25	By Bank A/c	C		1,000	
12	To Tripathi & Co.				475	27	By Purchases A/c			275	
15	To Warshi		35	450		30	By S. Exp. A/c			50	
20	To Sales A/c			175							
25	To Cash	C			1,000	31	By Balance c/d			300	20,745
			35	21,225	21,075				20	21,225	21,075
Feb. 1	To Balance b/d			300	20,745						

**5.3 POSTING THE CASH BOOK ENTRIES**

Students would have seen that the cash columns in the cash book is actually the cash account and the bank column is actually bank account. Also, the discount columns are memorandum columns, meant only to provide information about the total discount allowed and total discount received.

The debit side columns for cash and bank indicate receipts. Therefore, the amounts debited in the cash book should be put to the credit of the account in respect of which cash or cheque has been received. For instance, in the cash book given above we see that ₹175 have been received for sale of goods. For posting, the amount is credited to the Sales Account as "By Cash ₹175." We also see M/s. Warsi have paid ₹450 and also they have been allowed ₹ 35 as discount; thus they have discharged a debt of ₹485. In the account of M/s. Warsi, the posting is on the credit side as

By Cash	₹ 450
By Discount	₹ 35
or as:	
By Sundries	₹ 485

All payments are recorded on the credit side. The particulars columns show on what account payments have been made. In the ledger accounts concerned the amount is put on the debit side. For example, the cash book shows that a cheque for ₹ 330 has been issued to M/s. Ratan & Co. and also that they have allowed a discount of ₹ 20; thus an obligation of ₹ 350 has been met. In the account of M/s. Ratan & Co. the posting is:

To Bank	₹ 330
To Discount	₹ 20
Or	
To Sundries	₹ 350

The rule thus develops: From the debit side of the cash book, credit the various accounts with their respective amounts (including any discount that may have been allowed); from the credit side of cash book, the posting will be to the debit of the accounts mentioned in the particular column with their respective amounts (including the discount which may have been received).

As has been shown already, the total of the discount columns on the debit side is debited to the discount account; the total of the column discount on the credit side is credited to the discount account. From the cash book given on the previous page ₹ 35 is debited and ₹ 20 be credited to the discount account.



5.4 PETTY CASH BOOK

In the firm a number of small payments, such as for telegrams, taxi fare, cartage, etc., have to be made. If all these payments are recorded in the cash book, it will become unnecessarily heavy. Also, the main cashier will be overburdened with work. Therefore, it is usual for firms to appoint a person as 'Petty Cashier' and to entrust the task of making small payments say below ₹ 200, to him. Of course he will be reimbursed for the payments made. Later, on an analysis, the respective account may be debited.

IMPREST SYSTEM OF PETTY CASH

It is convenient to entrust a definite sum of money to the petty cashier in the beginning of a period and to reimburse him for payments made at the end of the period. Thus, he will have

again the fixed amount in the beginning of the new period. Such a system is known as the imprest system of petty cash.

The system is very useful specially if an analytical Petty Cash Book is used. The book has one column to record receipt of cash (which is only from the main cashier) and other columns to record payments of various types. The total of the various columns show why payments have been made and then the relevant accounts can be debited.

- (i) The amount fixed for petty cash should be sufficient for the likely small payments for a relatively short period, say for a week or a fortnight.
- (ii) The reimbursement should be made only when petty cashier prepares a statement showing total payments supported by vouchers, i.e., documentary evidence and should be limited to the amount of actual disbursements.
- (iii) The vouchers should be filed in order.
- (iv) No payment should be made without proper authorisation. Also, payments above a certain specified limit should be made only by the main cashier.
- (v) The petty cashier should not be allowed to receive any cash except for reimbursement.

In the petty cash book the extreme left-hand column records receipts of cash. The money column towards the right hand side shows total payments for various purposes; a column is usually provided for sundries to record infrequent payments. The sundries column is analysed. At the end of the week or the fortnight the petty cash book is balanced. The method of balancing is the same as for the simple cash book.

ILLUSTRATION 4

Prepare a Petty Cash Book on the imprest System from the following:

2022			₹
Jan.	1	Received ₹100 for petty cash	
"	2	Paid bus fare	.50
"	2	Paid cartage	2.50
"	3	Paid for Postage	5.00
"	3	Paid wages for casual labourers	6.00
"	4	Paid for stationery	4.00
"	4	Paid Bus charges	2.00
"	5	Paid for the repairs to chairs	15.00
"	5	Bus fare	1.00

"	5	Cartage	4.00
"	6	Postage	7.00
"	6	Bus charges	3.00
"	6	Cartage	3.00
"	6	Stationery	2.00
"	6	Refreshments to customers	5.00

SOLUTION**Petty Cash Book**

Receipts ₹	Date 2022	V. No.*	Particulars	Total ₹	Con- veyance ₹	Cartage ₹	Statio- nery ₹	Postage ₹	Wages ₹	Sundries ₹
100	Jan.1		To Cash							
	2	1	By Conveyance	.50	.50					
		2	By Cartage	2.50		2.50				
	3	3	By Postage	5.00				5.00		
		4	By Wages	6.00					6.00	
	4	5	By Stationery	4.00			4.00			
		6	By Conveyance	2.00	2.00					
	5	7	By Repairs to Furniture	15.00						15.00
		8	By Conveyance	1.00	1.00					
		9	By Cartage	4.00		4.00				
	6	10	By Postage	7.00				7.00		
	"	11	By Conveyance	3.00	3.00					
	"	12	By Cartage	3.00		3.00				
	"	13	By Stationery	2.00			2.00			
	"	14	By General Expenses	5.00						5.00
				60.00	6.50	9.50	6.00	12.00	6.00	20.00
			By Balance c/d	40.00						
100				100.00						
40.00			To Balance b/d							
60.00	8		To Cash							

* Voucher Numbers

ADVANTAGES OF PETTY CASH BOOK

There are mainly three advantages:

- (i) Saving of time of the chief cashier;
- (ii) Saving in labour in writing up the cash book and posting into the ledger; and
- (iii) Control over small payments.

POSTING THE PETTY CASH BOOK

In the ledger, a petty cash account is maintained, when an amount is given to the petty cashier, the petty cash account is debited. Each week or fortnight, the total of the payments made is credited to this account. The petty cash account will then show the balance in the hand of the cashier; on demand he should be able to produce it for counting. At the end of the period/year, the balance is shown in the balance sheet as part of cash balance.

Of course, the payments must be debited to their respective accounts as shown by the petty cash book. For this two methods may be used:

- (i) From the petty cash book the total of the various columns may be directly debited to the concerned accounts; or
- (ii) A journal entry may first be prepared on the basis of the petty cash book, debiting the accounts shown by the various analysis columns, and crediting the total of the payment of the petty cash accounts.

For Illustration 4 the journal entry and relevant accounts are as follows:

2022		Dr. ₹	Cr. ₹
Jan. 6	Conveyance Account	6.50	
	Cartage Account	9.50	
	Stationery Account	6.00	
	Postage Account	12.00	
	Wages Account	6.00	
	Repairs Account	15.00	
	General Expenses Account	5.00	
	To Petty Cash Account		60.00
	(Being the analysis of the Petty Cash Book for the week ending Jan. 6)		

Entry for cash handed over to the Petty Cashier		
Petty Cash Account	60	
To Cash Account		60
(Being Cash received)		

Petty Cash Account

Date 2022	Particulars	Folio	Amount ₹	Date 2022	Particulars	Folio	Amount ₹
Jan.1	To Cash		100.00	Jan. 6	By Sundries:		
"6	To Cash		60.00		Conveyance		6.50
					Cartage		9.50
					Stationery		6.00
					Postage		12.00
					Wages		6.00
					Repairs		15.00
					General Expenses		5.00

ILLUSTRATION 5

Enter the following transaction in Cash Book with Discount and Bank columns. Cheques are first treated as cash receipts –

2022		₹
March 1	Cash in Hand	15,000
	Overdraft in Bank	500
2	Cash Sales	3,000
3	Paid to Sushil Bros. by cheque	3,400
	Discount received	100
5	Sales through credit card	2,800
6	Received cheque from Srijan	6,200
7	Endorsed Srijan's cheque in favour of Adit	
9	Deposit into Bank	6,800
10	Received cheque from Aviral and deposited the same into Bank by allowing discount of ₹ 50	3,600

12	Adit informed that Srijan's cheque is dishonoured. Now cash is received from Srijan and amount is paid to Adit through own cheque	
15	Sales through Debit Card	3,200
24	Withdrawn from Bank	1,800
28	Paid to Sanchit by cheque	3,000
30	Bank charged 1% commission on sales through Debit/Credit Cards	

SOLUTION

Dr. **Cash Book** Cr.

Date	Particulars	L.F.	Discount ₹	Cash ₹	Bank ₹	Date	Particulars	L.F.	Discount ₹	Cash ₹	Bank ₹
2022						2022					
March 1	To Balance b/d			15,000		March 1	By Balance b/d				500
2	To Sales			3,000		3	By Sushil Bros.		100		3,400
5	To Sales				2,800	7	By Adit			6,200	
6	To Srijan			6,200		9	By Bank	C		6,800	
9	To Cash A/c	C			6,800	12	By Adit				6,200
10	To Aviral		50		3,600	24	By Cash A/c	C			1,800
12	To Srijan			6,200		28	By Sanchit				3,000
15	To Sales A/c				3,200	30	By Commission				60
24	To Bank A/c	C		1,800		31	By Balance c/d			19,200	1,440
			50	32,200	16,400				100	32,200	16,400

Note: If the received cheque is endorsed to the other party on the same day, then no entry is required. However, in the above case posting has been done through cash column as the endorsement is done on next day.



5.5 ENTRIES FOR SALE THROUGH CREDIT/DEBIT CARDS

Now-a-days sales through Credit/Debit Cards are issued by almost every Bank in India either directly or with collaboration of some other agencies. HSBC Card, SBI Card, BOB Card, ICICI Bank Card, HDFC Card and Andhra Bank Card are some of the popular Cards.

The procedure for issuing Credit/Debit Cards are as follows -

1. A small Plastic Card, called Credit Card is issued by the bank to a prospective customer, after verifying his credibility, which is generally measured by his income sources. Debit Card is issued by bank to a customer who has an account with the bank. Now a days ATM Card issued by the bank can also be used as Debit Card. This card would contain an embossed 16 digit number and also the name of the cardholder.
2. Generally Bank charges annual subscription fees from the credit card holder. No fee is charged in case of Debit Card, though some banks charge a nominal fee on Debit Card also.
3. When the Card holder intends to buy some goods or services through Credit or Debit Card, the seller insert the customer's debit/credit card in the card machine and inputs the amount of sales and gives back to customers for feeding the password (i.e Personal Identification Number – PIN) for authorising the transactions. One copy of the receipt is given to the customer and other once is kept by the seller for its record.
4. The seller sums up the different amounts sold like this and submits, generally everyday, to his bank all the forms. The amount is credited by the bank to the seller's account and debited to the account of the Bank or the company issuing the Credit/Debit Card.
5. The bank issuing the Card, charges commission for each such transaction, which varies between 1% to 4% and is immediately debited to seller's bank account.
6. The bank sends a monthly statement to the card holder. In case of Debit Card the account is immediately debited to the card holder's account, whereas in case of Credit Card, card holder has to pay the amount in full or part. However, if not paid in full, the interest is charged.

ACCOUNTING FOR CREDIT/DEBIT CARD SALE

From the seller's point of view, this type of sale is equivalent to a cash sale. Commission charged by the bank will be treated as selling expenses. The following journal entries will be made in the seller's books of accounts.

1. Bank A/c Dr.
 To Sales Account
 (Sales made through Credit/Debit Card)
2. Commission Account Dr.
 To Bank Account
 (Commission charged by bank)

SUMMARY

- ♦ Cash book contains cash transactions and also bank transactions, if it has a separate book column. It is both a subsidiary book and a principal book.
- ♦ Cash book can be prepared with discount column also.
- ♦ For small payments, petty cash book is maintained separately for recording the particulars of payment and its amount. The fixed amount is given to the petty cashier for making small payments in the beginning of the period. The amount spent is replenished so that he will have again the fixed sum in the beginning of the next period. This system is known as imprest system of petty cash book.

TEST YOUR KNOWLEDGE

True and False

1. *Cash book is a subsidiary book as well as a principal book.*
2. *Two column cash book consists of two columns cash column & bank column.*
3. *Discount column of cash book is never balanced.*
4. *Contra entry is passed in a two column cash book.*
5. *If the bank column is showing the opening balance on credit side, it is an overdraft.*
6. *A cash book records cash transactions as well as credit transactions.*
7. *Discount column of cash book records the trade discount.*

Multiple Choice Questions

1. *The total of discounts column on the debit side of the cash book, recording cash discount deducted by customers when paying their accounts, is posted to the _____*
 - (a) *Credit of the discount allowed account.*
 - (b) *Debit of the discount allowed account*
 - (c) *Credit of the discount received account.*
2. *Cash book is a type of _____ but treated as a _____ of accounts.*
 - (a) *Subsidiary book, principal book*
 - (b) *Principal book, subsidiary book*
 - (c) *Subsidiary book, subsidiary book*

3. Which of the following is not a column of a three-column cash book?
 - (a) Cash column
 - (b) Bank column
 - (c) Petty cash column
4. Contra entries are passed only when _____
 - (a) Double-column cash book is prepared
 - (b) Three-column cash book is prepared
 - (c) Simple cash book is prepared
5. The Cash Book records _____
 - (a) All cash receipts
 - (b) All cash payments
 - (c) All cash receipts and payments
6. The balance in the petty cash book is _____
 - (a) An expense
 - (b) A profit
 - (c) An asset
7. If Ram has sold goods for cash, the entry will be recorded _____
 - (a) In the Cash Book
 - (b) In the Sales Book
 - (c) In the Journal

Theory Questions

1. Is cash book a subsidiary book or a principal book? Explain.
2. What are the various kinds of cash book?
3. What are the advantages of a three column cash book?

Practical Questions

1. Shri Ramaswamy maintains a Columnar Petty Cash Book on the Imprest System. The imprest amount is ₹500. From the following information, show how his Petty Cash Book would appear for the week ended 12th September, 2022:

7-9-2022	Balance in hand	134.90
	Received Cash reimbursement to make up the imprest	365.10
	Stationery	49.80
8-9-2022	Miscellaneous Expenses	20.90
9-9-2022	Repairs	156.70
10-9-2022	Travelling	68.50
11-9-2022	Stationery	71.40
12-9-2022	Miscellaneous Expenses	6.30
13-9-2022	Repairs	48.30

[illegible]

Theoretical Questions

- Cash transactions are straightaway recorded in the Cash Book and on the basis of such a record, ledger accounts are prepared. Therefore, the Cash Book is a subsidiary book. But the Cash Book itself serves as the cash account and the bank account, if bank column is also included; the balances are entered in the trial balance directly. The Cash Book, therefore, is part of the ledger also. Hence, it is also treated as the principal book. The Cash Book is thus both a subsidiary book and a principal book.
- The main Cash Book may be of the three types:
 - Simple Cash Book;
 - Two-column Cash Book;
 - Three-column Cash Book.

In addition to the main Cash Book, firms also generally maintain a petty cash book but that is purely a subsidiary book.
- The advantages of three column Cash Book are that -
 - the Cash Account and the Bank Account are prepared simultaneously, therefore the double entry is completed in the Cash Book itself. Thus the contra entries can be easily cross-checked in Cash column in one side and the Bank column in the other side of the Cash Book. The chances of error are also reduced.
 - the information regarding Cash in Hand and the Bank Balance can be obtained very easily and quickly as there is no need to prepare Ledger of the Cash and Bank Account.

Practical Problems

1. Petty Cash Book

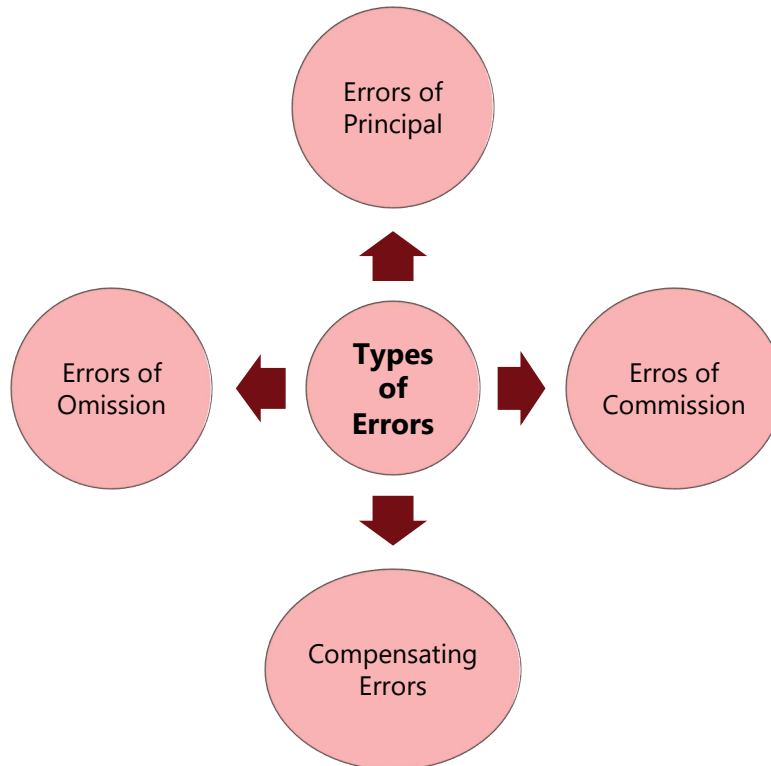
Date 2022	Receipts	Amount ₹	Date 2022	Payments	Total Amount ₹	Stationery ₹	Travelling ₹	Misc Exps. ₹	Repairs ₹
Sept. 7	To Balance b/d	134.90	7	By Stationery	49.80	49.80			
	To Reimbursement	365.10	8	By Misc. Expenses	20.90			20.90	
			9	By Repairs	156.70				156.70
			10	By Travelling	68.50		68.50		
			11	By Stationery	71.40	71.40			
			12	By Misc. Expenses	6.30			6.30	
			13	By Repairs	48.30				48.30
					421.90	121.20	68.50	27.20	205.00
				By Balance c/d	78.10				
		500.00			500.00				
	To Balance b/d	78.10							

UNIT 6 : RECTIFICATION OF ERRORS

LEARNING OUTCOMES

After studying this unit, you will be able to:

- ◆ Understand different types of errors which may occur in the course of recording transactions and events.
- ◆ Be familiar with the steps involved in locating errors.
- ◆ Learn the nature of one-sided errors and two-sided errors.
- ◆ Understand why suspense account is opened for rectification of errors.
- ◆ Understand the technique of correcting errors of one period in the next accounting period.

UNIT OVERVIEW**6.1 INTRODUCTION**

Unintentional omission or commission of amounts and accounts in the process of recording the transactions are commonly known as errors. These various unintentional errors can be committed at the stage of collecting financial information/data on the basis of which financial statements are drawn or at the stage of recording this information. Also errors may occur as a result of mathematical mistakes, mistakes in applying accounting policies, misinterpretation of facts, or oversight. To check the arithmetic accuracy of the journal and ledger accounts, trial balance is prepared. If the trial balance does not tally, then it can be said that there are errors in the accounts which require rectification thereof. Some of these errors may affect the Trial Balance and some of these do not have any impact on the Trial Balance although such errors may affect the determination of profit or loss, assets and liabilities of the business.

Illustrative Case of Errors and their Nature

We have seen that after preparing ledger accounts a trial balance is taken out where debit and credit balances are separately listed and totalled. If the totals of debit and credit do not

agree, it is definite that there are some errors. We shall now study the types of errors which may be committed and how they may be rectified. For this purpose, the working of the following illustrative cases should be carefully seen.

Illustrative Cases of Errors

- (a) **Wrong Entry:** Let us start from the first phase of the accounting process. Where wrong amount of transactions and events are recorded in the subsidiary books, Journal Proper and Cash Book.

Example 1: Credit purchases ₹17,270 are entered in the Purchases Day Book as ₹17,720. Credit sales of ₹15,000 gross less 1% trade discount are wrongly entered in Sales Day Book at ₹15,000. Cheque issued ₹19,920 are wrongly entered in the credit of bank column in the Cash Book as ₹19,290.

- (b) **Wrong casting of subsidiary books:** Subsidiary books are totalled periodically and posted to the appropriate ledger accounts. There may be totalling errors. Totalling errors may arise due to wrong entry or simply these may be independent errors.

Example 2: For the month of January, 2022 total of credit sales are ₹1,75,700, this is wrongly totalled as ₹1,76,700 and posted to sales account as ₹1,76,700.

- (c) **In case of cash book,** wrong castings will result in wrong calculation of the balance c/d.

Example 3: The following cash transactions of M/s. Tularam & Co. occurred:

2023

Jan. 1	Balance - cash ₹1,200 bank ₹16,000;
Jan. 2	Cheque issued to M/s. Bholaram & Co., a supplier, for ₹22,500;
Jan. 6	Cheque collected from M/s. Scindia & Bros. ₹42,240 and deposited for clearance;
Jan. 7	Cash sales ₹27,200 and paid wages ₹12,400;
Jan. 8	Cash sales ₹ 37,730 and cash deposited to bank ₹ 35,000.

The following Cash Book entries are passed:

Dr.				Cr.			
				Cash Book			
Date	Particulars	Cash	Bank	Date	Particulars	Cash	Bank
2023		₹	₹	2023		₹	₹
Jan. 1	To Balance b/d	1,200	16,000	Jan. 2	By M/s Bholaram & Co. A/c		22,500

Jan. 6	To M/s. Scindia & Bros. A/c		42,420		By Wages A/c	12,200	
Jan. 7	To Sales A/c	27,200			By Bank A/c	34,500	
Jan. 8	To Sales A/c	37,370			By Balance c/d	19,070	71,420
Jan. 8	To Cash A/c		34,500				
		65,770	93,920			65,770	93,920

Wrong entries and wrong casting are shown in bold prints. However, errors of cash entries generally are not carried. Usually cash balances are tallied daily. So errors are identified at an early stage. But bank balance cannot be checked daily and thus errors may be carried until bank reconciliation is done. In the above example, there are four wrong entries and one wrong casting. Bank and cash balances are affected by these errors.

- (d) **Wrong posting from subsidiary books:** In this case, the wrong amount may be posted to the ledger account or the amount may be posted to the wrong side or to the wrong account. For example, purchases from A may be posted to B's account.
- (e) **Wrong casting of ledger balances:** Likewise Cash Book, any ledger account balance may be casted wrongly. Obviously wrong postings make the balance wrong; but that is not wrong casting of balances. Whenever there arises independent casting error as in the case of bank column in the Cash Book of example (4), that is called wrong casting to ledger balances.

Example 4: The following are the credit purchases of M/s. Ballav Bros.:

2023

Jan. 1 Purchases from M/s. Saurabh & Co.- gross ₹1,00,000 less 1% trade discount.

Jan. 3 Purchases from M/s. Netai & Co.- gross ₹ 70,000 less 1% trade discount.

Jan. 6 Purchases from M/s. Saurabh & Co.- gross ₹ 60,000 less 1% trade discount

Let us cast M/s. Saurabh & Co.'s Account:

Dr. **M/s Saurabh & Co. Account** Cr.

Date	Particulars	Amount ₹	Date	Particulars	Amount ₹
2023			2023		
Jan. 1	To Balance c/d	1,55,400	Jan. 1	By Purchases A/c	99,000
			Jan. 6	By Purchases A/c	59,400
		1,55,400			*1,55,400

*While casting the credit side, an error has been committed and so the account is wrongly balanced.

Example 5: Goods are purchased on credit from M/s. Saurabh & Co. for ₹ 27,030 and from M/s. Karnataka Suppliers for ₹ 28,050. The following Purchase Day Book is prepared:

Purchases Day Book

Date	Particulars	Amount
		₹
	M/s. Saurabh & Co.	27,050
	M/s. Karnataka Suppliers	28,030
		55,080

In the above Purchase Day Book, both the transactions are entered wrongly but the first error has been compensated by the second. Even if these errors are not rectified Trial Balance would tally.

Trial Balance

Particulars	Dr.	Cr.
	₹	₹
M/s. Saurabh & Co.		27,050
M/s. Karnataka Suppliers		28,030
Purchases Account	55,080	
	55,080	55,080



6.2 STAGES OF ERRORS

Errors may occur at any of the following stages of the accounting process:

AT THE STAGE OF RECORDING THE TRANSACTIONS IN JOURNAL

Following types of errors may happen at this stage:

- (i) Errors of principle,
- (ii) Errors of omission,
- (iii) Errors of commission.

AT THE STAGE OF POSTING THE ENTRIES IN LEDGER

- (i) Errors of omission:
 - (a) Partial omission,
 - (b) Complete omission.
- (ii) Errors of commission:
 - (a) Posting to wrong account,
 - (b) Posting on the wrong side,
 - (c) Posting of wrong amount.

AT THE STAGE OF BALANCING THE LEDGER ACCOUNTS

- (i) Wrong Totalling of accounts,
- (ii) Wrong Balancing of accounts.

AT THE STAGE OF PREPARING THE TRIAL BALANCE

- (i) Errors of omission,
- (ii) Errors of commission:
 - (a) Taking wrong account,
 - (b) Taking wrong amount,
 - (c) Taking to the wrong side.

On the above basis, we can classify the errors in four broad categories:

Errors of Principle	Errors of Omission	Errors of Commission	Compensating Errors

**6.3 TYPES OF ERRORS**

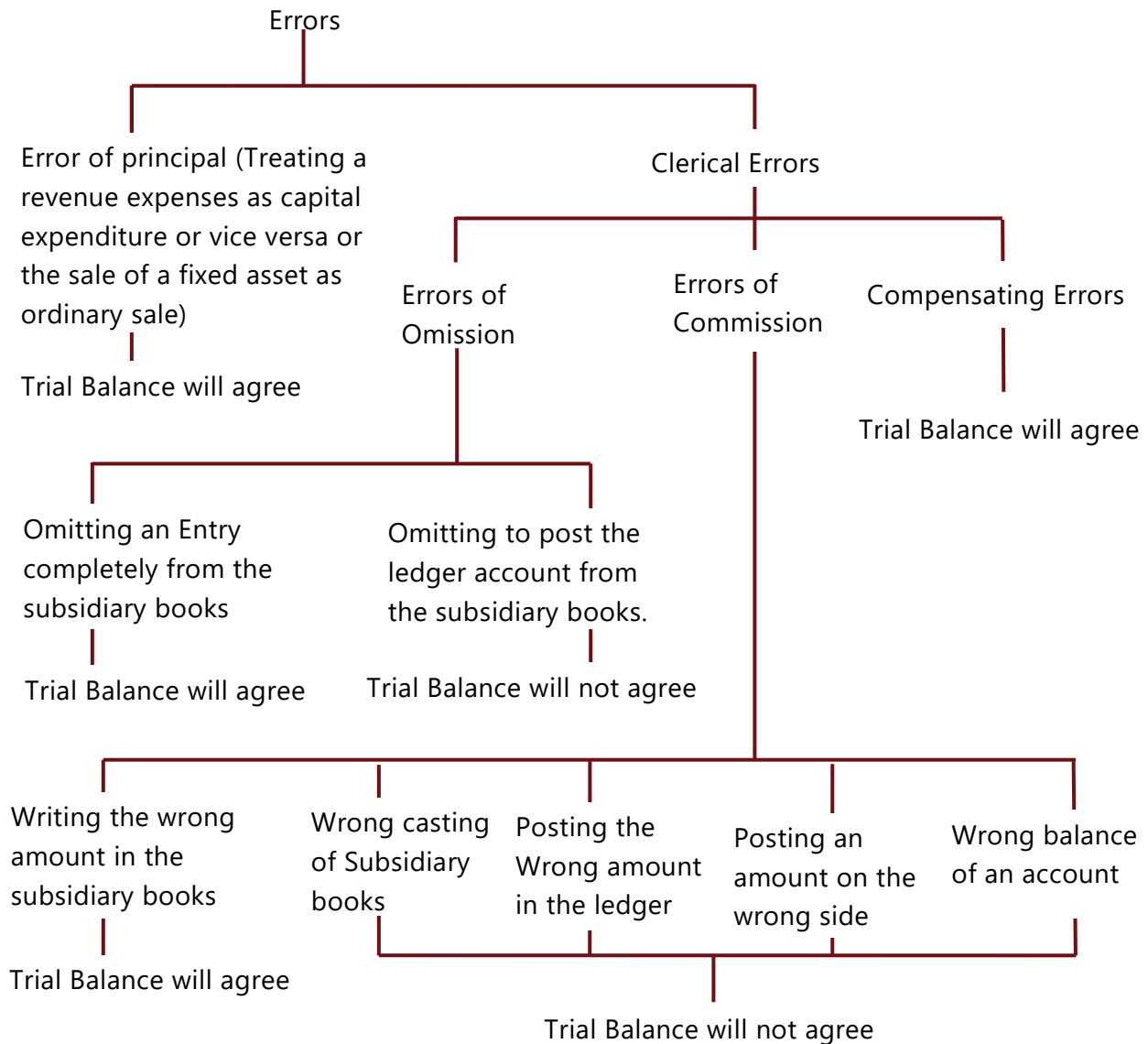
Basically errors are of two types:

- (a) **Errors of principle:** When a transaction is recorded in contravention of accounting principles, like treating the purchase of an asset as an expense, it is an error of principle. In this case, there is no effect on the trial balance since the amounts are placed on the correct side, though in a wrong account. Suppose on the purchase of a computer, the office expenses account is debited; the trial balance will still agree.

- (b) **Clerical errors:** These errors arise because of mistake committed in the ordinary course of the accounting process. These are of three types:
- (i) *Errors of Omission:* If a transaction is completely or partially omitted from the books of account, it will be a case of omission. Examples would be: not recording a credit purchase of furniture or not posting an entry into the ledger.
 - (ii) *Errors of Commission:* If an amount is posted in the wrong account or it is written on the wrong side or the totals are wrong or a wrong balance is struck, it will be a case of "errors of commission."
 - (iii) *Compensating Errors:* If the effect of errors committed cancel out, the errors will be called compensating errors. The trial balance will agree. Suppose an amount of ₹10 received from A is not credited to his account and the total of the sales book is ₹10 in excess. The omission of credit to A's account will be made up by the increased credit to the Sales Account.

From another point of view, error may be divided into two categories:

- (a) Those that affect the trial balance - because of these errors, trial balance does not agree; these are the following:
 - (i) Wrong casting of the subsidiary books.
 - (ii) Wrong balancing of an account.
 - (iii) Posting an amount on the wrong side.
 - (iv) Posting the wrong amount.
 - (v) Omitting to post an amount from a subsidiary book.
 - (vi) Omitting to post the totals of subsidiary book.
 - (vii) Omitting to write the cash book balances in the trial balance.
 - (viii) Omitting to write the balance of an account in the trial balance.
 - (ix) Writing a balance in wrong column of the trial balance.
 - (x) Totalling the trial balance wrongly.
- (b) The errors that do not affect the trial balance are the following:
 - (i) Omitting an entry altogether from the subsidiary book.
 - (ii) Making an entry with the wrong amount in the subsidiary book.
 - (iii) Posting an amount in a wrong account but on the correct side, e.g., an amount to be debited to A is debited to B, the trial balance will still agree.



6.4 STEPS TO LOCATE ERRORS

Even if there is only a very small difference in the trial balance, the errors leading to it must be located and rectified. A small difference may be the result of a number of errors. The following steps will be useful in locating errors :

- (i) The two columns of the trial balance should be totalled again. If in place of a number of accounts, only one amount has been written in the trial balance the list of such accounts should be checked and totalled again. List of Trade receivables is the example from which Trade receivable balance is derived.

- (ii) It should be seen that the cash and bank balances have been written in the trial balance.
- (iii) The exact difference in the trial balance should be established. The ledger should be gone through again; it is possible that a balance equal to the difference has been omitted from the trial balance. The difference should also be halved; it is possible that balance equal to half the difference has been written in the wrong column.
- (iv) The ledger accounts should be balanced again.
- (v) The casting of subsidiary books should be checked again, especially if the difference is ₹ 1, ₹ 100 etc.
- (vi) If the difference is very big, the balance in various accounts should be compared with the corresponding accounts in the previous period. If the figures differ materially, those cases should be further scrutinised; it is possible that an error has been committed. Suppose the sales account for the current year shows a balance of ₹ 32,53,000 whereas it was ₹ 36,45,000 last year; it is possible that there is an error in the Sales Account.
- (vii) Postings of the amounts equal to the difference or half the difference should be checked. It is possible that an amount has been omitted to be posted or has been posted on the wrong side.
- (viii) If there is still a difference in the trial balance, a complete checking will be necessary. The posting of all the entries including the opening entry should be checked. It may be better to begin with the nominal accounts.



6.5 RECTIFICATION OF ERRORS

Errors should never be corrected by overwriting. The correction should be made by making another suitable entry, called as rectification entry. In fact the rectification of an error depends on at which stage it is detected. An error can be detected at any one of the following stages:

- (a) Before preparation of Trial Balance.
- (b) After Trial Balance but before the final accounts are drawn.
- (c) After final accounts, i.e., in the next accounting period.

6.5.1 Before preparation of Trial Balance

There are some errors which affect one side of an account or which affect more than one account in such a way that it is not possible to pass a complete rectification entry. In other words, there are some errors which can be corrected, if detected at this stage, by making rectification statement in the appropriate side(s) of concerned account(s). It is important to

note here that such errors may involve only one account or more than one account. Read the following illustrations:

- (i) The sales book for November is undercast by ₹ 200. The effect of this error is that the Sales Account has been credited short by ₹ 200. Since the account is posted by the total of the sales book, there is no error in the accounts of the customers since they are posted with amounts of individual sales. Hence only the Sales Accounts is to be corrected. This will be done by making an entry for ₹ 200 on the credit side: "By undercasting of Sales Book for November ₹ 200".
- (ii) While posting the discount column on the debit side of the cash book the discount of ₹ 10 allowed to Ramesh has not been posted. There is no error in the cash book, the total of discount column presumably has been posted to the discount account on the debit side. The error is in not crediting Ramesh by ₹ 10. This should now be done by the entry "By omission of posting of discount on ----- ₹10".
- (iii) ₹ 200 received from Ram has been entered by mistake on the debit side of his account. Since the cash book seems to have been correctly written, the error is only in the account of Ram - he should have been credited and not debited by ₹ 200. Not only the wrong debit is to be removed but also a credit of ₹ 200 is to be given. This can be done now by entering ₹ 400 on the credit side of his account. The entry will be "By Posting on the wrong side - ₹ 400".
- (iv) ₹ 50 was received from Mahesh and entered on the debit side of the cash book but was not posted to his account. By the error, which affects only the account of Mahesh, ₹ 50 has been omitted from the credit side of his account. The rectification will be by the entry. "By Omission of posting on the ₹ 50."
- (v) ₹ 51 paid to Mohan has been posted as ₹15 to the debit of his account. Mohan has been debited short by ₹ 36. The rectifying entry is "To mistake in posting on ₹ 36".
- (vi) Goods sold to Ram for ₹1,000 was wrongly posted from sales day book to the debit of purchase account. Ram has however been correctly debited. Here the error affects two accounts, viz., purchases account and sales account but we cannot pass a journal entry for its rectification because both the accounts need to be credited. The rectification will be done by the entry "By wrong posting on ₹ 1,000" in the credit of purchases account and also "By omission of posting on - ₹ 1,000" in the credit sales account.
- (vii) Bills receivable from Mr. A of ₹ 500 was posted to the credit of Bills payable Account and also credited to A account. Here also although two accounts are involved we cannot pass a complete journal entry for rectification. The rectification will be done by the entry "To wrong posting on ₹ 500" in debit of Bills payable Account and also "To omission of posting on ₹ 500" in the debit of Bills Receivable Account.

- (viii) Goods purchased from Vinod for ₹ 1,000 was wrongly credited to Vimal account by ₹ 100. Again we cannot pass a complete journal entry for rectification even though two accounts are involved. The rectification will be done by the entry "To wrong posting on ₹100" in the debit of Vimal account and "By omission of posting on ₹ 1,000" in the credit of Vinod account.

Thus, from the above illustrations, it is clear that the general rule of errors affecting two accounts can be corrected by a journal entry does not hold true always.

ILLUSTRATION 1

How would you rectify the following errors in the book of Rama & Co.?

1. *The total to the Purchases Book has been undercast by ₹ 100.*
2. *The Returns Inward Book has been undercast by ₹ 50.*
3. *A sum of ₹ 250 written off as depreciation on Machinery has not been debited to Depreciation Account.*
4. *A payment of ₹ 75 for salaries (to Mohan) has been posted twice to Salaries Account.*
5. *The total of Bills Receivable Book ₹ 1,500 has been posted to the credit of Bills Receivable Account.*
6. *An amount of ₹151 for a credit sale to Hari, although correctly entered in the Sales Book, has been posted as ₹ 115.*
7. *Discount allowed to Satish ₹ 25 has not been entered in the Discount Column of the Cash Book. the amount has been posted correctly to the credit of his personal account.*

SOLUTION

1. The Purchases Account should receive another debit of ₹100 since it was debited short previously:
"To Undercasting of Purchases Book for the month of --- ₹100."
2. Due to this error the Returns Inward Account has been posted short by ₹ 50 : the correct entry will be:
"To Undercasting of Returns Inward Book for the month of --- ₹50."
3. The omission of the debit to the Depreciation Account will be rectified by the entry:
"To Omission of posting on ₹ 250".
4. The excess debit will be removed by a credit in the Salaries Account by the entry:
"By double posting on ₹ 75".

5. ₹1,500 should have been debited to the Bills Receivable Account and not credited. To correct the mistake, the Bills Receivable Account should be debited by ₹ 3,000 by the entry:
"To Wrong posting of B/R received on ₹ 3,000"
6. Hari's personal A/c is debited ₹ 36 short. The rectification entry will be:
"To Wrong posting ₹ 36".
7. Due to this error, the discount account has been debited short by ₹ 25. The required entry is :
"To Omission of discount allowed to Satish on ₹ 25."

So far we have discussed the correction of errors which affected only one Account or more than one account but for which rectifying entries were not complete journal entries. We shall now take up the correction of errors which affect more than one account in such a way that complete journal entries are possible for their rectification. Read the following illustrations:

- (i) The purchase of machinery for ₹ 2,000 has been entered in the purchases book. The effect of the entry is that the account of the supplier Ram & Co. has been credited by ₹ 2,000 which is quite correct. But the debit to the Purchases Account is wrong : the debit should be to Machinery Account. To rectify the error, the debit in the purchases Account has to be transferred to the Machinery Account. The correcting entry will be to Credit Purchases Account and debit the Machinery Account. Please see the three entries made below: the last entry rectifies the error:

Particulars	Debits ₹	Credits ₹
Wrong Entry:		
Purchases Account	2,000	
To Ram & Co.		2,000
Correct Entry:		
Machinery Account	2,000	
To Ram & Co.		2,000
Rectifying Entry:		
Machinery Account	2,000	
To Purchases Account		2,000

- (ii) ₹100 received from Kamal Kishore has been credited in the account of Krishan Kishore. The error is that there is a wrong credit in the account of Krishan Kishore and omission of credit in the account of Kamal Kishore; Krishan Kishore should be debited and Kamal Kishore be credited. The following three entries make this clear:

Particulars	Debits ₹	Credits ₹
Wrong Entry:		
Cash Account	100	
To Krishan Kishore		100
Correct Entry:		
Cash Account	100	
To Kamal Kishore		100
Rectifying Entry:		
Krishan Kishore	100	
To Kamal Kishore		100

- (iii) The sale of old machinery, ₹1,000 has been entered in the sales book. By this entry the account of the buyer has been correctly debited by ₹1,000. But instead of crediting the Machinery Account. Sales Account has been credited. To rectify the error this account should be debited and the Machinery Account credited. See the three entries given below:

Particulars	Debits ₹	Credits ₹
Wrong Entry:		
Buyer's Account	1,000	
To Sales Account		1,000
Correct Entry:		
Buyer's Account	1,000	
To Machinery Account		1,000
Rectifying Entry:		
Sales Account	1,000	
To Machinery Account		1,000

ILLUSTRATION 2

The following errors were found in the book of Ram Prasad & Sons. Give the necessary entries to correct them.

- (1) ₹ 500 paid for furniture purchased has been charged to ordinary Purchases Account.
- (2) Repairs made were debited to Building Account for ₹ 50.
- (3) An amount of ₹100 withdrawn by the proprietor for his personal use has been debited to Trade Expenses Account.
- (4) ₹100 paid for rent debited to Landlord's Account.
- (5) Salary ₹ 125 paid to a clerk due to him has been debited to his personal account.
- (6) ₹ 100 received from Shah & Co. has been wrongly entered as from Shaw & Co.
- (7) ₹ 700 paid in cash for a typewriter was charged to Office Expenses Account.

SOLUTION**Journal**

Sr. No.	Particulars	Dr. ₹	Cr. ₹
(1)	Furniture A/c To Purchases A/c (Correction of wrong debit to Purchases A/c for furniture purchased)	500	500
(2)	Repairs A/c To Building A/c (Correction of wrong debit to building A/c for repairs made)	50	50
(3)	Drawings A/c. To Trade Expenses A/c (Correction of wrong debit to Trade Expenses A/c for cash withdrawn by the proprietor for his personal use)	100	100
(4)	Rent A/c To Landlord's Personal A/c (Correction of wrong debit to landlord's A/c for rent paid)	100	100

(5)	Salaries A/c To Clerk's (Personal) A/c (Correction of wrong debit to Clerk's personal A/c for salaries paid)	125	125
(6)	Shaw & Co. To Shah & Co. (Correction of wrong credit to Shaw & Co. Instead of Shah & Co.)	100	100
(7)	Typewriter A/c To Office Expenses A/c (Correction of wrong debit to Office Expenses A/c for purchase of typewriter)	700	700

ILLUSTRATION 3

Give journal entries to rectify the following:

- (1) A purchase of goods from Ram amounting to ₹150 has been wrongly entered through the Sales Book.
- (2) A Credit sale of goods amounting ₹120 to Ramesh has been wrongly passed through the Purchase Book.
- (3) On 31st December, 2022 goods of the value of ₹ 300 were returned by Hari Saran and were taken into inventory on the same date but no entry was passed in the books.
- (4) An amount of ₹ 200 due from Mahesh Chand, which had been written off as a Bad Debt in a previous year, was unexpectedly recovered, and had been posted to the personal account of Mahesh Chand.
- (5) A Cheque for ₹ 100 received from Man Mohan was dishonoured and had been posted to the debit of Sales Returns Account.

SOLUTION**Journal**

Sr.No.	Particulars	Dr.(₹)	Cr.(₹)
(1)	Purchases A/c	150	
	Sales A/c	150	
	To Ram		300
	(Correction of wrong entry in the sales Book for a purchases of goods from Ram)		

(2)	Ramesh	240	
	To Purchases A/c		120
	To Sales A/c		120
	(Correction of wrong entry in the Purchases Book of a credit sale of goods to Ram)		
(3)	Returns Inwards A/c	300	
	To Hari Saran		300
	(Entry of goods returned by him and taken in inventory omitted from records)		
(4)	Mahesh Chand	200	
	To Bad Debts Recovered A/c		200
	(Correction of wrong credit to Personal A/c in respect of recovery of previously written off bad debts)		
(5)	Man Mohan	100	
	To Sales Return A/c		100
	(Correction of wrong debit to Sales Returns A/c for dishonour of cheque received from Man Mohan)		

Thus, it can be said that errors detected before the preparation of trial balance can be rectified either through rectification statements (not entries) or through rectification entries.

6.5.2 After Trial Balance but before Final Accounts

The method of correction of error indicated so far is appropriate when the errors have been located before the end of the accounting period. After the corrections, the trial balance will agree. Sometimes the trial balance is artificially made to agree despite of errors by opening a suspense account and putting the difference in the trial balance to the account - the suspense account will be debited if the total of the credit column in the trial balance exceeds the total of the debit column and vice versa.

One must note that such agreement of the trial balance is not real. Effort must be made to locate the errors.

The rule of rectifying errors detected at this stage is simple. Those errors for which complete journal entries were not possible in the earlier stage of rectification (i.e., before trial balance) can now be rectified by way of journal entry(s) with the help of suspense account, for it these errors which gave rise to the suspense account in the trial balance. The rectification entry for other type of error i.e. error affecting more than one account in such a way that a complete

journal entry is possible for its rectification, can be rectified in the same way as in the earlier stage (i.e. before trial balance).

In a nutshell, it can be said that each and every error detected at this stage can only be corrected by a complete journal entry. Those errors for which journal entries were not possible at the earlier stage will now be rectified by a journal entry(s), the difference or the unknown side is being taken care of by suspense account. Those errors for which entries were possible even at the first stage will now be rectified in the same way.

Suppose, the sales book for November, 2022 is casted short by ₹100 ; as a consequence the trial balance will not agree. The credit column of the trial balance will be ₹100 short and a Suspense Account will be credited by ₹100. To rectify the error the Sales Account will be credited (to increase the credit to the right figure. Now one error remains, the Suspense Account must be closed by debiting the Suspense Account. The entry will be:

Suspense Account	₹100	
To Sales Account		₹100
(Correction of error of undercasting the sales Book for November 2022)		

ILLUSTRATION 4

Correct the following errors (i) without opening a Suspense Account and (ii) opening a Suspense Account:

- The Sales Book has been totalled ₹100 short.
- Goods worth ₹150 returned by Green & Co. have not been recorded anywhere.
- Goods purchased ₹250 have been posted to the debit of the supplier Gupta & Co.
- Furniture purchased from Gulab & Bros, ₹1,000 has been entered in Purchases Day Book.
- Discount received from Red & Black ₹15 has not been entered in the Discount Column of the Cash Book.
- Discount allowed to G. Mohan & Co. ₹18 has not been entered in the Discount Column of the Cash Book. The account of G. Mohan & Co. has, however, been correctly posted.

SOLUTION

If a Suspense Account is not opened.

- Since sales book has been casted ₹100 short, the Sales Account has been similarly credited ₹100 short. The correcting entry is to credit the Sales Account by ₹100 as "By wrong totalling of the Sales Book ₹100".

- (b) To rectify the omission, the Returns Inwards Account has to be debited and the account of Green & Co. credited. The entry:

Returns Inward Account	Dr.	₹150	
To Green & Co.			₹150
(Goods returned by the firm, previously omitted from the Returns Inward Book)			

- (c) Gupta & Co. have been debited ₹250 instead of being credited. This account should now be credited by 500 to remove the wrong debit and to give the correct credit. The entry will be on the credit side... "By errors in posting ₹500".
- (d) By this error Purchases Account has to be debited by ₹1,000 whereas the debit should have been to the Furniture Account. The correcting entry will be:

Furniture Account	Dr.	₹1,000	
To Purchases Account			₹1,000
(Correction of the mistake by which of the Furniture Account)			

- (e) The discount of ₹15 received from Red & Black should have been entered on the credit side of the cash book. Had this been done, the Discount Account would have been credited (through the total of the discount column) and Red & Black would have been debited. This entry should not be made:

Red & Black	Dr.	₹15	
To Discount Account			₹15
(Rectification of the error by which the discount allowed by the firm was not entered in Cash Book)			

- (f) In this case the account of the customer has been correctly posted; the Discount Account has been debited ₹18 short since it has been omitted from the discount column on the debit side of the cash book. The discount account should now be debited by the entry; "To Omission of entry in the Cash Book ₹18."

If a Suspense Account is opened :

	Particulars	Dr.(₹)	Cr.(₹)
(a)	Suspense Account	100	
	To Sales Account		100
	(Being the correction arising from under- casting of Sales Day Book)		

(b)	Return Inward Account To Green & Co (Being the recording of unrecorded returns)	150	150
(c)	Suspense Account To Gupta & Co. (Being the correction of the error by which Gupta & Co. was debited instead of being credited by ₹ 250).	500	500
(d)	Furniture Account To Purchases Account (Being the correction of recording purchase of furniture as ordinary purchases)	1,000	1,000
(e)	Red & black To Discount Account (Being the recording of discount omitted to be recorded)	15	15
(f)	Discount Account To Suspense Account (Being the correction of omission of the discount allowed from Cash Book customer's account already posted correctly).	18	18

Suspense Account

Dr. Date	Particulars	Amount ₹	Date	Particulars	Cr. Amount ₹
	To Sales A/c	100		By Difference in	
	To Gupta & Co.	500		Trial Balance	582
				By Discount A/c	18
		600			600

Notes:

- (i) One should note that the opening balance in the Suspense Account will be equal to the difference in the trial balance.
- (ii) If the question is silent as to whether a Suspense Account has been opened, the student should make his assumption, state it clearly and then proceed.

ILLUSTRATION 5

Correct the following errors found in the books of Mr. Dutt. The Trial Balance was out by ₹ 493 excess credit. The difference thus has been posted to a Suspense Account.

- (a) An amount of ₹100 was received from D. Das on 31st December, 2022 but has been omitted to enter in the Cash Book.
- (b) The total of Returns Inward Book for December has been casted short by ₹100.
- (c) The purchase of an office table costing ₹ 300 has been passed through the Purchases Day Book.
- (d) ₹ 375 paid for Wages to workmen for making show-cases had been charged to "Wages Account".
- (e) A purchase of ₹ 67 had been posted to the trade payables' account as ₹ 60.
- (f) A cheque for ₹ 200 received from P. C. Joshi had been dishonoured and was passed to the debit of "Allowances Account".
- (g) ₹ 1,000 paid for the purchase of a motor cycle for Mr. Dutt for his personal use had been charged to "Miscellaneous Expenses Account".
- (h) Goods amounting to ₹100 had been returned by customer and were taken into inventory, but no entry in respect thereof, was made into the books.
- (i) A sale of ₹ 200 to Singh & Co. was wrongly credited to their account. Entry was correctly made in sales book.

SOLUTION**(a)****Journal Entries**

Particulars		L.F.	₹	₹
(a)	Cash Account Dr.		100	
	To D. Das (Being the amount received)			100
(b)	Returns Inward Account Dr.		100	
	To Suspense Account (Being the mistake in totalling the Returns Inward Book corrected)			100

(c)	Furniture Account	Dr.	300	
	To Purchases Account			300
	(Being the rectification of mistake by which purchase of furniture was entered in Purchases book and hence now corrected by crediting the Purchases Account)			
(d)	Furniture Account	Dr.	375	
	To Wages Account			375
	(Being the wages paid to workmen for making show-cases which should have been capitalised and not to be charged to Wages Account)			
(e)	Suspense Account	Dr.	7	
	To Creditors (personal) Account			7
	(Being the mistake in crediting the Trade payables Account less by ₹ 7, now corrected)			
(f)	P.C. Joshi	Dr.	200	
	To Allowances Account			200
	(Being the cheque of P.C. Joshi dishonoured, previously debited to Allowances Account)			
(g)	Drawings Account	Dr.	1,000	
	To Miscellaneous Expenses			1,000
	(Being the motor cycle purchased for Mr. Dutt debited to his Drawings Account instead of Miscellaneous Expenses Account as previously done by mistake)			
(h)	Returns Inward Account	Dr.	100	
	To Debtors (Personal) Account			100
	(Correction of the omission to record return of goods by customers)			
(i)	Singh & Co.	Dr.	400	
	To Suspense Account			400
	(Being the correction of mistake by which the account of Singh & Co. was credited by ₹ 200 instead of being debited)			

Suspense Account

Dr.					Cr.
Date	Particulars	Amount	Date	Particulars	Amount
2022		₹	2022		₹
Dec.31	To Difference in Trial Balance	493	Dec. 31	By Returns Inwards A/c	100
" "	To Trade Payables A/c	<u>7</u>	" "	By Singh & Co.	<u>400</u>
		500			500

ILLUSTRATION 6

The following errors, affecting the account for the year 2022 were detected in the books of Jain Brothers, Delhi:

- (1) Sale of old Furniture ₹ 150 treated as sale of goods.
- (2) Receipt of ₹ 500 from Ram Mohan credited to Shyam Sunder.
- (3) Goods worth ₹ 100 brought from Mohan Narain have remained unrecorded so far.
- (4) A return of ₹ 120 from Mukesh posted to his debit.
- (5) A return of ₹ 90 to Shyam Sunder posted as ₹ 9 in his account.
- (6) Rent of proprietor's residence, ₹ 600 debited to rent A/c.
- (7) A payment of ₹ 215 to Mohammad Sadiq posted to his credit as ₹ 125.
- (8) Sales Book casted short by ₹ 900 .
- (9) The total of Bills Receivable Book ₹ 1,500 left unposted.

You are required to pass the necessary rectifying entries and show how the trial balance would be affected by the errors.

SOLUTION

Journal

	Particulars	L.F.	Dr. Amount ₹	Cr. Amount ₹
(1)	Sales Account Dr. To Furniture Account (Rectification of sales of furniture treated as sales of goods)		150	150

(2)	Shyam Sunder To Rama Mohan (Rectification of a receipt from Ram Mohan credited to Shyam Sunder)	Dr.		500	500
(3)	Purchases Account To Mohan Narain (Purchases of goods from Mohan Narain unrecorded, now corrected)	Dr.		100	100
(6)	Drawing Account To Rent Account (Rectification of Payment of rent of proprietor's residence treated as payment of office rent)	Dr.		600	600

N.B. : For 4, 5, 7, 8, 9 no journal entry can be passed as they affect a single account. The correction will be as under:

- (4) Credit Mukesh's Account with ₹ 240.
- (5) Debit the account of Shyam Sunder by ₹ 81.
- (7) Debit the account of Mohammad Sadiq by ₹ 340.
- (8) Credit Sales Account by ₹ 900.
- (9) Debit Bills Receivable Account with ₹ 1,500.

Effect of the Errors on Trial Balance

1. No effect
2. No effect
3. No effect
4. Trial Balance credit total short by ₹ 240.
5. Trial Balance debit total short by ₹ 81.
6. No effect
7. Trial Balance debit total short by ₹ 340.
8. Trial Balance credit total short by ₹ 900.
9. Trial Balance debit total short by ₹ 1,500.

ILLUSTRATION 7

Write out the Journal Entries to rectify the following errors, using a Suspense Account.

- (1) Goods of the value of ₹ 100 returned by Mr. Sharma were entered in the Sales Day Book and posted therefrom to the credit of his account;
- (2) An amount of ₹150 entered in the Sales Returns Book, has been posted to the debit of Mr. Philip, who returned the goods;
- (3) A sale of ₹ 200 made to Mr. Ghanshyam was correctly entered in the Sales Day Book but wrongly posted to the debit of Mr. Radheshyam as ₹ 20; and
- (4) The total of "Discount Allowed" column in the Cash Book for the month of September, 2022 amounting to ₹ 250 was not posted.

SOLUTION**Journal**

	Particulars		L.F.	Dr. ₹	Cr. ₹
(1)	Sales Account Sales Returns Account To Suspense Account (The value of goods returned by Mr. Sharma wrongly posted to Sales and omission of debit to Sales Returns Account, now rectified)	Dr. Dr.		100 100	200
(2)	Suspense Account To Mr. Philip (Wrong debit to Mr. Philip for goods returned by him, now rectified)	Dr.		300	300
(3)	Mr. Ghanshyam To Mr. Radheshyam To Suspense Account (Omission of debit to Mr. Ghanshyam and wrong credit to Mr. Radhesham for sale of ₹ 200, now rectified)	Dr.		200	20 180
(4)	Discount Account To Suspense Account (The total of Discount allowed during September, 2022 not posted from the Cash Book; error now rectified)	Dr.		250	250

6.5.3 Correction in the next Accounting Period

Rectification of errors discussed so far assumes that it was carried out before the books were closed for the concerned year. However, sometimes, the rectification is carried out in the next year, carrying forward the balance in the Suspense Account or even transferring it to the Capital Account. Suppose, the Purchase Book was cast short by ₹1,000 in December, 2022 and a Suspense Account was opened with the difference in the trial balance. If the error is rectified next year and the entry passed is to debit Purchase Account (and credit Suspense Account), it will mean that the Purchases Account for year 2023 will be ₹1,000 more than the amount relating to year 2023 and thus the profit for year 2023 will be less than the actual for that year. Thus, correction of errors in this manner will 'falsify' the Profit and Loss Account.

To avoid this, correction of all amounts concerning nominal accounts, i.e., expenses and incomes should be through a special account styled as "Prior Period Items" or "Profit and Loss Adjustment Account". The balance in the account should be transferred to the Profit and Loss Account. However, these Prior Period Items should be charged after deriving the profit of the current year. 'Prior Period items' are material income or expenses which arise in the current period as a result of errors or omissions in the preparation of the financial statements of one or more prior periods. Prior Period Items should be separately disclosed in the current statement of profit and loss together with their nature and amount in a manner that their impact on current period profit or loss can be perceived.

ILLUSTRATION 8

Mr. Roy was unable to agree the Trial Balance last year and wrote off the difference to the Profit and Loss Account of that year. Next Year, he appointed a Chartered Accountant who examined the old books and found the following mistakes:

- (1) *Purchase of a scooter was debited to conveyance account ₹3,000.*
- (2) *Purchase account was over-cast by ₹10,000.*
- (3) *A credit purchase of goods from Mr. P for ₹2,000 was entered as a sale.*
- (4) *Receipt of cash from Mr. A was posted to the account of Mr. B ₹1,000.*
- (5) *Receipt of cash from Mr. C was posted to the debit of his account, ₹500.*
- (6) *₹500 due by Mr. Q was omitted to be taken to the trial balance.*
- (7) *Sale of goods to Mr. R for ₹2,000 was omitted to be recorded.*
- (8) *Amount of ₹2,395 of purchase was wrongly posted as ₹2,593.*

Mr. Roy used 10% depreciation on vehicles. Suggest the necessary rectification entries.

SOLUTION**Journal Entries in the books of Mr. Roy**

Sr. No.	Particulars	Dr.(₹)	Cr.(₹)
(1)	Motor Vehicles Account To Profit and Loss Adjustment A/c (Purchase of scooter wrongly debited to conveyance account now rectified-capitalisation of ₹ 2,700, i.e., ₹ 3,000 less 10% depreciation)	2,700	2,700
(2)	Suspense Account To Profit & Loss Adjustment A/c (Purchase Account overcast in the previous year; error now rectified).	10,000	10,000
(3)	Profit & Loss Adjustment A/c To P's Account (Credit purchase from P ₹ 2,000, entered as sales last year; now rectified)	4,000	4,000
(4)	B's Account To A's Account (Amount received from A wrongly posted to the account of B; now rectified)	1,000	1,000
(5)	Suspense Account To C's Account (₹ 500 received from C wrongly debited to his account; now rectified)	1,000	1,000
(6)	Trade receivables To Suspense Account (₹ 500 due by Q not taken into trial balance; now rectified)	500	500
(7)	R's Account To Profit & Loss Adjustment A/c (Sales to R omitted last year; now recorded)	2,000	2,000

(8)	Suspense Account To Profit & Loss Adjustment A/c (Excess posting to purchase account last year, ₹ 2,593, instead of ₹ 2,395, now adjusted)	198	198
(9)	Profit & Loss Adjustment A/c To Roy's Capital Account (Balance of Profit & Loss Adjustment A/c transferred to Capital Account)	10,898	10,898
(10)	Roy's Capital Account To Suspense Account (Balance of Suspense Account transferred to the Capital Account)	10,698	10,698

Note : Entries No. (2) and (8) may even be omitted; but this is not advocated.

Profit and Loss Adjustment Account

(Prior Period Items)

	₹		₹
To P	4,000	By Motor Vehicles A/c	2,700
To Roy's Capital (transfer)	10,898	By Suspense A/c	10,000
		By R	2,000
		By Suspense Account	198
	14,898		14,898

Suspense Account

	₹		₹
To Profit & Loss Adjustment A/c	10,000	By Trade Receivables (Q)	500
To C	1,000	By Roy's Capital A/c (Transfer)	10,698
To Profit & Loss Adjustment A/c	198		
	11,198		11,198

SUMMARY

- ◆ Unintentional omission or commission of amounts and accounts in the process of recording the transactions are commonly known as errors.
- ◆ Accounting errors are generally of four types-
 - (a) Errors of Principle;
 - (b) Errors of Omission;
 - (c) Errors of Commission;
 - (d) Compensating Errors.
- ◆ Some errors may affect the Trial Balance and some of these do not.
- ◆ The method of rectification of errors depends on the stage at which the errors are detected. If the error is detected before the preparation of trial balance, rectification is carried out by making the statement in the appropriate side of the concerned account.
- ◆ In case of the errors detected after the preparation of the trial balance, we open a suspense account with the amount of difference in the trial balance. Then complete journal entries can be passed for rectifying the errors.
- ◆ For rectifying the errors detected in the next accounting period, a special account 'Profit and Loss Adjustment Account' is opened for correction of amounts relating to expenses and incomes.

TEST YOUR KNOWLEDGE

True and False

1. *The method of rectification of errors depends on the stage at which the errors are detected.*
2. *In case of error of complete omission, the trial balance does not tally.*
3. *When errors are detected after preparation of trial balance, suspense account is opened.*
4. *When purchase of an asset is treated as an expense, it is known as error of principle.*
5. *Trial balance agrees in case of compensating errors.*
6. *When amount is written on wrong side, it is known as an error of principle.*
7. *On purchase of old furniture, the amount spent on repairs should be debited to repairs account.*

8. *'Profit & Loss adjustment account' is opened to rectify the errors detected in the current accounting period.*
9. *Rent paid to landlord of the proprietors house, must be debited to 'Rent account'.*
10. *If the errors are detected after preparing trial balance, then all the errors are rectified through suspense account.*

Multiple Choice Questions

1. *Goods purchased from A for ₹10,000 passed through the sales book. The error will result in*
 - (a) *Increase in gross profit.*
 - (b) *Decrease in gross profit.*
 - (c) *No effect on gross profit.*
2. *If a purchase return of ₹1,000 has been wrongly posted to the debit of the sales returns account, but has been correctly entered in the suppliers' account, the total of the*
 - (a) *Trial balance would show the debit side to be ₹1,000 more than the credit.*
 - (b) *Trial balance would show the credit side to be ₹ 1,000 more than the debit.*
 - (c) *The debit side of the trial balance will be ₹ 2,000 more than the credit side.*
3. *If the amount is posted in the wrong account or it is written on the wrong side of the account, it is called*
 - (a) *Error of omission.*
 - (b) *Error of commission.*
 - (c) *Error of principle.*
4. *₹ 200 paid as wages for erecting a machine should be debited to*
 - (a) *Repair account.*
 - (b) *Machine account.*
 - (c) *Capital account.*
5. *On purchase of old furniture, the amount of ₹1,000 spent on its repair should be debited to*
 - (a) *Repair account.*
 - (b) *Furniture account.*
 - (c) *Cash account.*

6. Goods worth ₹50 given as charity should be credited to
 - (a) Charity account.
 - (b) Sales account.
 - (c) Purchase account.
7. Goods worth ₹100 taken by proprietor for domestic use should be credited to
 - (a) Sales account.
 - (b) Proprietor's personal expenses.
 - (c) Purchases account.
8. Sales of office furniture should be credited to
 - (a) Sales Account.
 - (b) Furniture Account.
 - (c) Purchase Account.
9. The preparation of a trial balance is for:
 - (a) Locating errors of commission.
 - (b) Locating errors of principle.
 - (c) Locating clerical errors.
10. ₹ 200 received from Smith whose account, was written off as a bad debt should be credited to:
 - (a) Bad Debts Recovered account.
 - (b) Smith's account.
 - (c) Cash account.
11. Purchase of office furniture ₹1,200 has been debited to General Expense Account. It is:
 - (a) A clerical error.
 - (b) An error of principle.
 - (c) An error of omission.

Theory Questions

1. How does errors of omission differ from errors of commission?
2. What is error of principle and how does it affect Trial Balance?
3. When and how is Suspense account used to rectify errors?

Practical Questions

1. The trial balance of Mr. W & H failed to agree and the difference ₹20,570 was put into suspense account pending the investigation which disclosed that:
- (i) Purchase returns day book had been correctly entered and totalled at ₹6,160, but had not been posted to the ledger.
 - (ii) Discounts received ₹1,320 had been debited to discounts allowed.
 - (iii) The Sales account had been under added by ₹10,000.
 - (iv) A credit sale of ₹1,470 had been debited to a customer account at ₹1,740.
 - (v) A vehicle bought originally for ₹7,000 four years ago and depreciated to ₹1,200 had been sold for ₹1,500 in the beginning of the year but no entries, other than in the bank account had been passed through the books.
 - (vi) An accrual of ₹560 for telephone charges had been completely omitted.
 - (vii) A bad debt of ₹1,560 had not been written off and provision for doubtful debts should have been maintained at 10% of Trade receivables which are shown in the trial balance at ₹23,390 with a credit provision for bad debts at ₹2,320.
 - (viii) Tools bought for ₹1,200 had been inadvertently debited to purchases.
 - (ix) The proprietor had withdrawn, for personal use, goods worth ₹1,960. No entries had been made in the books.

You are required to give rectification entries without narration to correct the above errors before preparing annual accounts.

2. On going through the Trial balance of Ball Bearings Co. Ltd. you find that the debit is in excess by ₹150. This was credited to "Suspense Account". On a close scrutiny of the books, the following mistakes were noticed:
- (1) The totals of debit side of "Expenses Account" have been casted in excess by ₹50.
 - (2) The "Sales Account" has been totalled in short by ₹100.
 - (3) Supplier account has been overcasted by 225.
 - (4) The sale return of ₹100 from a party has not been posted to that account though the Party's account has been credited.
 - (5) A cheque of ₹500 issued to the Suppliers' account (shown under Trade payables) towards his dues has been wrongly debited to the purchases.
 - (6) A credit sale of ₹50 has been credited to the Sales and also to the Trade receivables Account.

You are required to

- (i) Pass necessary journal entries for correcting the above;
 - (ii) Show how they affect the Profits; and
 - (iii) Prepare the "Suspense Account" as it would appear in the ledger.
3. Mr. A closed his books of account on September 30, 2021 in spite of a difference in the trial balance. The difference was ₹830 the credits being short; it was carried forward in a Suspense Account. In 2022 following errors were located:
- (i) A sale of ₹2,300 to Mr. Lala was posted to the credit of Mrs. Mala.
 - (ii) The total of the Returns Inward Book for July, 2021 ₹1,240 was not posted in the ledger.
 - (iii) Freight paid on a machine ₹5,600 was posted to the Freight Account as ₹6,500. 10% Depreciation is charge on this machines.
 - (iv) While carrying forward the total in the Purchases Account to the next page, ₹65,590 was written instead of ₹56,950.
 - (v) A sale of machine on credit to Mr. Mehta for ₹9,000 on 30th sept. 2021 was not entered in the books at all. The book value of the machine was ₹6,750.

Pass journal entries to rectify the errors. Have you any comments to make?

4. A merchant's trial balance as on June 30, 2022 did not agree. The difference was put to a Suspense Account. During the next trading period, the following errors were discovered:
- (i) The total of the Purchases Book of one page, ₹4,539 was carried forward to the next page as ₹4,593.
 - (ii) A sale of ₹573 was entered in the Sales Book as ₹753 and posted to the credit of the customer.
 - (iii) A return to a creditor, ₹510 was entered in the Returns Inward Book; however, the creditor's account was correctly posted.
 - (iv) Cash received from C. Dass, ₹620 was posted to the debit of G. Dass.
 - (v) Goods worth ₹840 were despatched to a customer before the close of the year but no invoice was made out.
 - (vi) Goods worth ₹1,000 were sent on sale or return basis to a customer and entered in the Sales Book. At the close of the year, the customer still had the option to return the goods. The sale price was 25% above cost.

You are required to give journal entries to rectify the errors in a way so as to show the current year's profit or loss correctly.

ANSWERS/HINTS

True and False

1. True: There are 3 different stages when the mistakes are identified and then the rectification depends on the stage of identification of errors.
2. False: In case of error of complete omission, the trial balance tallies.
3. True: In order to balance the difference of balances in the trial balance suspense account is opened.
4. True: Where the accounts being debited is principally incorrect it is termed as error of principle.
5. True: Compensating errors cancel out each other when Trial balance is prepared as the mistake pertains to the same amount being credited and later debited on account of two different mistakes.
6. False: When amount is written on wrong side, it is known as an error of commission.
7. False: On purchase of furniture, the amount spent on repairs should be debited to furniture account as it is a capital expense.
8. False: 'Profit & Loss adjustment account' is opened to rectify the errors detected in the next accounting period.
9. False: Rent paid to land lord of the proprietors house, must be debited to 'Drawings account'.
10. False: If the errors are detected after preparing trial balance, then all the errors are not rectified through suspense account. There may be principal errors, which can be rectified without opening a suspense account.

Multiple Choice Questions

1.	(a)	2.	(c)	3.	(b)	4.	(b)	5.	(b)	6.	(c)
7.	(c)	8.	(b)	9.	(c)	10.	(a)	11.	(b)		

Theoretical Questions

1. (i) Errors of Omission: If a transaction is completely or partially omitted from the books of account, it will be a case of omission. Examples would be: not recording a credit purchase of furniture or not posting an entry into the ledger.

- (ii) Errors of Commission: If an amount is posted in the wrong account or it is written on the wrong side or the totals are wrong or a wrong balance is struck, it will be a case of "errors of commission."

2. Errors of principle: When a transaction is recorded in contravention of accounting principles, like treating the purchase of an asset as an expense, it is an error of principle. In this case there is no effect on the trial balance since the amounts are placed on the correct side, though in a wrong account. Suppose on the purchase of a typewriter, the office expenses account is debited; the trial balance will still agree.

The method of correction of error indicated so far is appropriate when the errors have been located before the end of the accounting period. After the corrections, the trial balance will agree. Sometimes the trial balance is artificially made to agree inspite of errors by **opening a suspense account** and putting the difference in the trial balance to the account - the suspense account will be debited if the total of the credit column in the trial balance exceeds the total of the debit column; it will be credited in the other case. Each and every error detected after preparation of trial balance can only be corrected by a complete journal entry. Those errors for which journal entries were not possible at the earlier stage will now be rectified by a journal entry(s), the difference or the unknown side is being taken care of by suspense account. Those errors for which entries were possible even at the first stage will now be rectified in the same way.

Practical Questions

1.

	Particulars	Dr.	Cr.
(i)	Suspense Account To Return Outward A/c	6,160	6,160
(ii)	Suspense Account To Discount Allowed Account To Discount Received Account	2,640	1,320 1,320
(iii)	Suspense Account To Sales Account	10,000	10,000
(iv)	Suspense Account To Customer Account	270	270
(v)	Suspense Account To Vehicle Account To Profit on Sale of Vehicle Account	1,500	1,200 300

(vi)	Telephone Charges Account	560	
	To Outstanding Expenses Account		560
(vii)	Bad Debts Account (refer W.N 1)	1,560	
	To Trade receivables Account		1,560
	Provision for Doubtful Debts Account (refer W.N. 2)	164	
	To Profit and Loss Account		164
(viii)	Loose Tools Account	1,200	
	To Purchases Account		1,200
(ix)	Drawings Account	1,960	
	To Purchases Account		1,960

Notes:

1. Bad debts will be debited in the profit and loss account.
2. Provision @ 10% of ₹ 21,560 i.e. 2,156; Excess provision ₹164 (2320 - 2156 = 164).

Working Notes :

(i)	Trade receivables as per books		23,390
	Deduction vide item (iv) 270	270	
	Bad Debts	<u>1,560</u>	<u>1,830</u>
			21,560

(ii)**Suspense Account**

	₹		₹
To Return outward Account	6,160	By balance b/d	20,570
To Discount allowed Account	1,320		
To Discount Received Account	1,320		
To Sales Account	10,000		
To Customers Account	270		
To Vehicles Account	1,200		
To Profit on Sale of Vehicle	300		
	<u>20,570</u>		<u>20,570</u>

2.

Journal Entries

Particulars		L.F.	Dr. ₹	Cr. ₹
Suspense Account To Expenses Account (Being the mistake in totalling of Expenses Account, rectified)	Dr.		50	50
Suspense Account To Sales Account (Being the mistake in totalling of Sales Accounts rectified)	Dr.		100	100
Supplier To Suspense Account (Being the mistake in posting from Day Book to Ledger rectified)	Dr.		225	225
Sales Returns Account To Suspense Account (Being the sales return from a party not posted to "Sales Returns" now rectified)	Dr.		100	100
Trade payables Account To Purchases Account (Being the payments made to supplier wrongly posted to purchases now rectified)	Dr.		500	500
Trade receivables Account To Suspense Account (Being the sales wrongly credited to Customer's Account now rectified)	Dr.		100	100

Suspense Account

	Dr. ₹		Cr. ₹
To Expenses Account	50	By Difference in Trial Balance	150
To Sales Account	100	By Trade payables	225
To Balance c/d	425	By Sales Returns Account	100
		By Trade receivables	100
	575		575
		By Balance b/d	425

Since the Suspense Account does not balance, it is clear that all the errors have not been traced. As a result of the above corrections the Net Profit will be:

	Increased by ₹	Decreased by ₹
Mistake in totalling in "Expenses"	50	
Mistake in totalling in "Sales"	100	
Mistake in posting from day book to Ledger under "Purchases"	500	
Omission in posting under "Sales Returns"		100
	650	100
Net Increase	550	

As a result of these adjustments, the Profits will be increased by ₹550.

3.

Journal of Mr. A

Date	Particulars	Dr. ₹	Cr. ₹
2022 (i)	Mrs. Mala Mr. Lala To Suspense A/c (Correction of error by which a sale of ₹ 2,300 to Mr. Lala was posted to the Credit of Mrs. Mala)	2,300 2,300	4,600
(ii)	Profit and Loss Adjustment A/c To Suspense A/c (Rectification of omission to post the total of Returns Inward Book for July, 2021)	1,240	1,240
(iii)	(a) Machinery A/c Suspense A/c To Profit & Loss Adjustment A/c (Correction of error by which freight paid for a machine ₹ 5,600 was posted to Freight Account at ₹ 6,500 instead of capitalising it)	5,600 900	6,500
	(b) Profit & Loss Adjustment A/c	560	

(iv)	To Plant and Machinery A/c (Depreciation @ 10% charged on freight paid on a machine capitalised)	8,640	560
	Suspense A/c To Profit & Loss Adjustment A/c (Correction of wrong carry forward of total in the purchase Account to the next page ₹ 65,590 instead of ₹ 56,950)		8,640
(v)	Mr. Mehta To Plant & Machinery A/c To Profit & Loss Adjustment A/c (Correction of omission of a sale of machine on credit to Mr. Mehta for ₹ 9,000)	9,000	6,750 2,250

Comments

The Suspense Account will now appear as shown below:

Suspense Account

Date	Particulars	Dr. Amount ₹	Date	Particulars	Cr. Amount ₹
2022	To Profit and Loss Adjustment A/c	900	2022 Oct. 1	By Balance b/d	830
	To Profit and Loss Adjustment A/c	8,640		By Sundries Mrs. Mala	2,300
				Mr. Lala	2,300
				By Profit and Loss Adjustment A/c	1,240
				By balance c/d	2,870
		9,540			9,540

Since the Suspense Account still shows a balance, it is obvious that there are still some errors left in the books.

Profit & Loss Adjustment A/c**(For Prior Period Items)**

Date 2022	Particulars	Dr. Amount ₹	Date 2022	Particulars	Cr. Amount ₹
	To Suspense A/c	1,240		By Machinery A/c	5,600
	To Plant and Machinery A/c	560		By Suspense A/c	900
	To Balance c/d	15,590		By Suspense A/c	8,640
				By Mr. Mehta	2,250
		17,390			17,390

4.

Journal Entries

	Particulars	Dr. ₹	Cr. ₹
(i)	Suspense Account Dr. To Profit and Loss Adjustment A/c (Correction of error by which Purchase Account was over debited last year- ₹4,593 carried forward instead of ₹4,539)	54	54
(ii)	Profit & Loss Adjustment A/c Dr. Customer's Account Dr. To Suspense Account (Correction of the entry by which (a) Sales A/c was over credited by ₹180 (b) customer was credited by ₹753 instead of being debited by ₹573)	180 1,326	1,506
(iii)	Suspense Account Dr. To Profit & Loss Adjustment A/c (Correction of error by which Returns Inward Account was debited by ₹510 instead of Returns Outwards Account being credited by ₹ 510)	1,020	1,020

(iv)	Suspense Account	Dr.	1,240	
	To C. Dass			620
	To G. Dass			620
	(Removal or wrong debit to G. Dass and giving credit to C. Dass from whom cash was received).			
(v)	Customer's Account	Dr.	840	
	To Profit & Loss Adjustment A/c			840
	(Rectification of the error arising from non-preparation of invoice for goods delivered)			
(vi)	Profit & Loss Adjustment A/c	Dr.	200	
	Inventory Account	Dr.	800	
	To Customer's Account			1,000
	(The Customer's A/c credited with ₹ 1,000 for goods not yet purchased by him; cost of the goods debited to inventory and "Profit" debited to Profit & Loss Adjustment Account)			
(vii)	Profit & Loss Adjustment A/c	Dr.	1,534	
	To Capital Account			1,534
	(Transfer of Profit & Loss Adjustment A/c balance to the Capital Account)			

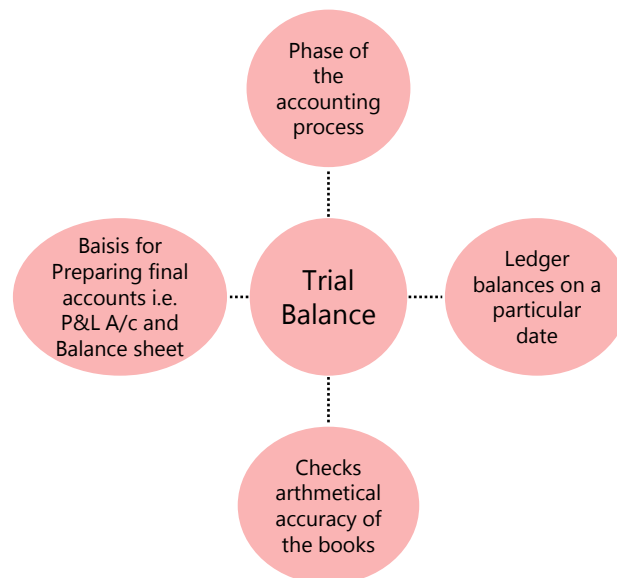
UNIT 3 : TRIAL BALANCE

LEARNING OUTCOMES

After studying this chapter, you will be able to:

- ◆ Learn the technique of taking balances from ledger accounts to prepare trial balance.
- ◆ Understand what is trial balance and what purposes it can serve..

UNIT OVERVIEW



Trial balance contains various ledger balances on a particular date. It forms the basis for preparing the financial statement i.e. profit and loss account and balance sheet. If it tallies, it means that the accounts are arithmetically accurate but certain errors may still remain undetected. Therefore, it is very important to carefully journalise and post the entries, following the rules of accounting.



3.1 INTRODUCTION

Preparation of trial balance is the third phase in the accounting process. After posting the accounts in the ledger, a statement is prepared to show separately the debit and credit balances. Such a statement is known as the trial balance. It may also be prepared by listing each and every account and entering in separate columns the totals of the debit and credit sides. Whichever way it is prepared, the totals of the two columns should agree. An agreement indicates arithmetic accuracy of the accounting work; if the two sides do not agree, then there is simply an arithmetic error(s).

This follows from the fact that under the Double Entry System, the amount written on the debit sides of various accounts is always equal to the amounts entered on the credit sides of other accounts and vice versa. Hence the totals of the debit sides must be equal to the totals of the credit sides. Also total of the debit balances will be equal to the total of the credit balances. Once this agreement is established, there is reasonable confidence that the accounting work is free from clerical errors, though it is not a proof of cent per cent accuracy, because some errors of principle and compensating errors may still remain. Generally, to check the arithmetic accuracy of accounts, trial balance is prepared at monthly intervals. But because double entry system is followed, one can prepare a trial balance any time. Though a trial balance can be prepared any time but it is preferable to prepare it at the end of the reporting period which may be month end/quarter end/year end to ensure the arithmetic accuracy of all the accounts before the preparation of the financial statements. It may be noted that trial balance is a statement and not an account.



3.2. OBJECTIVES OF PREPARING THE TRIAL BALANCE

The preparation of trial balance has the following objectives:

- (i) Trial balance enables one to establish whether the posting and other accounting processes have been carried out without committing arithmetical errors. In other words, the trial balance helps to establish arithmetical accuracy of the books of accounts.
- (ii) Financial statements are normally prepared on the basis of agreed trial balance; otherwise the financial statements will not give true and fair picture of the financial transactions.
- (iii) The trial balance serves as a summary of what is contained in the ledger; the ledger may have to be seen only when details are required in respect of an account.

The form of the trial balance is simple as shown below:

Trial Balance

as at.....

S.No	Ledger Accounts	Dr. Amount	Cr. Amount
		(Total or Balance)	(Total or Balance)
		₹	₹

The under mentioned points may be noted:

- (i) A trial balance is prepared as on a particular date which should be mentioned at the top.
- (ii) In the second column the name of the account is written.
- (iii) In the third column the total of the debit side of the account concerned or the debit balance, if any is entered.
- (iv) In the fourth column, the total of the credit side or the credit balance is written.
- (v) The third and fourth columns are totalled at the end.



3.3 LIMITATIONS OF TRIAL BALANCE

One should note that the agreement of Trial Balance is not a conclusive proof of accuracy. In other words, in spite of the agreement of the trial balance some errors may remain. These may be of the following types:

- (i) Transaction has not been entered at all in the journal.
- (ii) A wrong amount has been written in both columns of the journal.
- (iii) A wrong account has been mentioned in the journal.
- (iv) An entry has not at all been posted in the ledger.
- (v) Entry is posted twice in the ledger.

Still, the preparation of the trial balance is very useful; without it, the preparation of financial statements, would be difficult.



3.4 METHODS OF PREPARATION OF TRIAL BALANCE

1. TOTAL METHOD

Under this method, every ledger account is totalled and that total amount (both of debit side and credit side) is transferred to trial balance. In this method, trial balance can be prepared as soon as ledger account is totalled. Time taken to balance the ledger accounts is saved under this method as balance can be found out in the trial balance itself. The difference of totals of each ledger account is the balance of that particular account. This method is not commonly used as for the preparation of the financial statements, only net balance of the ledger account is required. Therefore, the trial balance compiled under this method cannot be used directly for preparation of the financial statements.

ILLUSTRATION 1

Given below is a ledger extract relating to the business of X and Co. as on March, 31, 2022. You are required to prepare the Trial Balance by the Total Amount Method.

Dr. **Cash Account** Cr.

Particulars	₹	Particulars	₹
To Capital A/c	10,000	By Furniture A/c	3,000
To Ram's A/c	25,000	By Salaries A/c	2,500
To Cash Sales	500	By Shyam's A/c	21,000
		By Cash Purchases	1,000
		By Capital A/c	500
		By Balance c/d	7,500
	35,500		35,500

Dr. **Furniture Account** Cr.

Particulars	₹	Particulars	₹
To Cash A/c	3,000	By Balance c/d	3,000
	3,000		3,000

Dr. **Salaries Account** Cr.

Particulars	₹	Particulars	₹
To Cash A/c	2,500	By Balance c/d	2,500
	2,500		2,500

Dr. **Shyam's Account** Cr.

Particulars	₹	Particulars	₹
To Cash A/c	21,000	By Purchases A/c	25,000
To Purchase Returns A/c	500	(Credit Purchase)	
To Balance c/d	3,500		—
	25,000		25,000

Dr. **Purchases Account** Cr.

Particulars	₹	Particulars	₹
To Cash A/c (Cash Purchases)	1,000	By Balance c/d	26,000
To Sundries as per Purchases Book (Credit Purchases)	25,000		—
	26,000		26,000

Dr. **Purchases Returns Account** Cr.

Particulars	₹	Particulars	₹
To Balance c/d	500	By Sundries as per Purchases Return Book	500
	500		500

Dr. **Ram's Account** Cr.

Particulars	₹	Particulars	₹
To Sales A/c (Credit Sales)	30,000	By Sales Returns A/c	100
		By Cash A/c	25,000
		By Balance c/d	4,900
	30,000		30,000

Dr. **Sales Account** Cr.

Particulars	₹	Particulars	₹
To Balance c/d	30,500	By Cash A/c (Cash Sales)	500
		By Sundries as per Sales Book (Credit Sales)	30,000
	30,500		30,500

Dr. **Sales Returns Account** Cr.

Particulars	₹	Particulars	₹
To Sundries as per Sales Returns Book	100	By Balance c/d	100
	100		100

Dr. **Capital Account** Cr.

Particulars	₹	Particulars	₹
To Cash A/c	500	By Cash A/c	10,000
To Balance c/d	9,500		
	10,000		10,000

SOLUTION

Trial Balance of X and Co. as at 31.03.2022

Sl. No.	Name of Account	Total Debit ₹	Total Credit ₹
1.	Cash A/c	35,500	28,000
2.	Furniture A/c	3,000	
3.	Salaries A/c	2,500	
4.	Shyam's A/c	21,500	25,000
5.	Purchases A/c	26,000	
6.	Purchases Returns A/c		500
7.	Ram's A/c	30,000	25,100
8.	Sales A/c		30,500
9.	Sales Returns A/c	100	
10.	Capital A/c	500	10,000
		1,19,100	1,19,100

2. BALANCE METHOD

Under this method, every ledger account is balanced and those balances only are carried forward to the trial balance. This method is used commonly by the accountants and helps in the preparation of the financial statements. Financial statements are prepared on the basis of the balances of the ledger accounts.

ILLUSTRATION 2

Taking the same information as given in Illustration 1, prepare the Trial Balance by Balance Method.

SOLUTION**Trial Balance of X and Co. as at 31.03.2022**

Sl. No.	Name of Account	Debit Balance ₹	Credit Balance ₹
1.	Cash A/c	7,500	
2.	Furniture A/c	3,000	
3.	Salaries A/c	2,500	
4.	Shyam's A/c		3,500
5.	Purchases A/c	26,000	
6.	Purchases Returns A/c		500
7.	Ram's A/c	4,900	
8.	Sales A/c		30,500
9.	Sales Returns A/c	100	
10.	Capital A/c		9,500
		44,000	44,000

3. TOTAL AND BALANCE METHOD

Under this method, the above two explained methods are combined. This has been explained with the help of the following example:

Trial Balance of X as at 31.03.2022

Sl. No.	Heads of Account	Debit Balance (₹)	Credit Balance (₹)	Debit Total (₹)	Credit Total (₹)
1.	Cash Account	7,500		35,500	28,000
2.	Furniture Account	3,000		3,000	
3.	Salaries Account	2,500		2,500	
4.	Shyam's Account		3,500	21,500	25,000

5.	Purchases Account	26,000		26,000	
6.	Purchase Returns Account		500		500
7.	Ram's Account	4,900		30,000	25,100
8.	Sales Account		30,500		30,500
9.	Sale Returns Account	100		100	
10.	Capital Account		9,500	500	10,000
	Total	44,000	44,000	1,19,100	1,19,100



3.5 ADJUSTED TRIAL BALANCE (THROUGH SUSPENSE ACCOUNT)

If the trial balance does not agree after transferring the balance of all ledger accounts including cash and bank balance and also errors are not located timely, then the trial balance is tallied by transferring the difference of debit and credit side to an account known as suspense account. This is a temporary account opened to proceed further and to prepare the financial statements timely.



3.6 RULES OF PREPARING THE TRIAL BALANCE

While preparing the trial balance from the given list of ledger balances, following rules should be taken into account:

1. The balances of all (i) assets accounts (ii) expenses accounts (iii) losses (iv) drawings are placed in the debit column of the trial balance.
2. The balances of all (i) liabilities accounts (ii) income accounts (iii) gains (iv) capital are placed in the credit column of the trial balance.

ILLUSTRATION 3

From the following ledger balances, prepare a trial balance of Anuradha Traders as on 31st March, 2022:

Account Head	₹
Capital	1,00,000
Sales	1,66,000
Purchases	1,50,000

<i>Sales return</i>	1,000
<i>Discount allowed</i>	2,000
<i>Expenses</i>	10,000
<i>Trade receivables</i>	75,000
<i>Trade payables</i>	25,000
<i>Investments</i>	15,000
<i>Cash at bank and in hand</i>	37,000
<i>Interest received on investments</i>	1,500
<i>Insurance paid</i>	2,500

SOLUTION**Trial Balance of Anuradha Traders as on 31.03.2022**

Particulars	Dr. balance ₹	Particulars	Cr. balance ₹
Purchases	1,50,000	Capital	1,00,000
Sales return	1,000	Sales	1,66,000
Discount allowed	2,000	Trade payables	25,000
Expenses	10,000	Interest received on investments	1,500
Trade receivables	75,000		
Investments	15,000		
Cash at bank and in hand	37,000		
Insurance paid	2,500		
Total	2,92,500		2,92,500

ILLUSTRATION 4

One of your clients, Mr. Singhania has asked you to finalise his accounts for the year ended 31st March, 2022. Till date, he himself has recorded the transactions in books of accounts. As a basis for audit, Mr. Singhania furnished you with the following statement.

	Dr. Balance (₹)	Cr. Balance (₹)
<i>Singhanian's Capital</i>		1,556
<i>Singhanian's Drawings</i>	564	
<i>Leasehold premises</i>	750	
<i>Sales</i>		2,750
<i>Dues from customers</i>		530
<i>Purchases</i>	1,259	
<i>Purchases return</i>	264	
<i>Loan from bank</i>		256
<i>Trade payables</i>	528	
<i>Trade expenses</i>	700	
<i>Cash at bank</i>	226	
<i>Bills payable</i>	100	
<i>Salaries and wages</i>	600	
<i>Inventories (1.4.2021)</i>		264
<i>Rent and rates</i>	463	
<i>Sales return</i>	_____	<u>98</u>
	5,454	5,454

The closing inventory on 31st March, 2022 was valued at ₹ 574. Mr. Singhanian claims that he has recorded every transaction correctly as the trial balance is tallied. Check the accuracy of the above trial balance.

SOLUTION

Corrected Trial Balance of Mr. Singhanian as on 31st March, 2022

Particulars	Dr. Amount ₹	Cr. Amount ₹
Singhanian's Capital		1,556
Singhanian's Drawings	564	
Leasehold premises	750	
Sales		2,750

Dues from customers (refer note 1 below)	530	
Purchases	1,259	
Purchases returns (refer note 2 below)		264
Loan from Bank		256
Trade payables (refer note 3 below)		528
Trade expenses	700	
Cash at Bank	226	
Bills payable (refer note 4 below)		100
Salaries and Wages	600	
Inventory (1.4.2021) (refer note 5 below)	264	
Rent and rates	463	
Sales return (refer note 6 below)	98	
	5,454	5,454

Notes:

1. Dues from customers is an asset, so its balance will be a debit balance.
2. Purchases return account always shows a credit balance because assets go out.
3. Balance in Trade payables is a liability, so its balance will be a credit balance.
4. Bills payable is a liability, so its balance will be a credit balance.
5. Inventory (opening) represents assets, so it will have a debit balance.
6. Sales return account always shows a debit balance because assets come.

ILLUSTRATION 5

The following trail balance as on 31st March, 2022 was drawn from the books of fintech traders:

	L.F.	Dr. Balance (₹)	Cr. Balance (₹)
<i>Building</i>		60,000	-
<i>Machinery</i>		17,000	-
<i>Return Outward</i>		2,600	-
<i>Bad Debts</i>		2,800	-
<i>Cash</i>		400	-

<i>Discount Received</i>		3,000	-
<i>Bank Overdraft</i>		10,000	-
<i>Creditors</i>		50,000	-
<i>Purchases</i>		1,00,000	-
<i>Capital</i>		-	73,600
<i>Fixtures</i>		-	5,600
<i>Sales</i>		-	1,04,000
<i>Debtors</i>		--	60,000
<i>Interest Received</i>		-	2,600
<i>Input CGST A/c</i>		-	3,000
<i>Input SGST A/c</i>		-	3,000
<i>Input IGST A/c</i>		-	4,800
<i>Output CGST A/c</i>		5,400	-
<i>Output SGST A/c</i>		5,400	-
<i>Total</i>		2,56,600	2,56,600

Even though the debit and credit sides agree, the trial Balance contains certain errors. Check the accuracy of trial balance.

SOLUTION

Corrected Trial Balance of Fintech traders as on 31st March, 2022

	<i>L.F.</i>	<i>Dr. Balance (₹)</i>	<i>Cr. Balance (₹)</i>
Building		60,000	-
Machinery		17,000	-
Return Outward		-	2,600
Bad Debts		2,800	-
Cash		400	-
Discount Received		-	3,000
Bank Overdraft		-	10,000
Creditors		-	50,000
Purchases		1,00,000	-
Capital		-	73,600

Fixtures		5,600	-
Sales		-	1,04,000
Debtors		60,000	-
Interest Received		-	2,600
Input CGST A/c		3,000	-
Input SGST A/c		3,000	-
Input IGST A/c		4,800	-
Output CGST A/c		-	5,400
Output SGST A/c		-	5,400
		2,56,600	2,56,600

SUMMARY

- ◆ Trial balance contains various ledger balances on a particular date.
- ◆ It forms the basis for preparing financial statement i.e. profit and loss account and balance sheet.
- ◆ If it tallies, it means that the accounts are arithmetically accurate but certain errors may still remain undetected.
- ◆ It is very important to carefully journalize and post the entries, following the rules of accounting.

TEST YOUR KNOWLEDGE

True and False

1. *Preparing trial balance is the third phase of accounting process.*
2. *Trial balance forms a base for the preparation of Financial statement.*
3. *Agreement of trial balance is a conclusive proof of accuracy.*
4. *A trial balance will tally in case of compensating errors.*
5. *A trial balance can find the missing entry from the journal.*
6. *Suspense account opened in a trial balance is a permanent account.*
7. *The balance of purchase returns account has a credit balance.*

Multiple Choice Questions

1. A trial balance will not balance if _____
 - (a) Correct journal entry is posted twice.
 - (b) The purchase on credit basis is debited to purchases and credited to cash.
 - (c) ₹ 500 cash payment to creditor is debited to Trade payables for ₹ 50 and credited to cash as ₹ 500.
2. ₹ 1, 500 received from sub-tenant for rent and entered correctly in the cash book is posted to the debit of the rent account. In the trial balance _____
 - (a) The debit total will be greater by ₹ 3,000 than the credit total.
 - (b) The debit total will be greater by ₹ 1,500 than the credit total.
 - (c) Subject to other entries being correct the total will agree.
3. After the preparation of ledgers, the next step is the preparation of _____
 - (a) Trading accounts
 - (b) Trial balance
 - (c) Profit and loss account
4. After preparing the trial balance the accountant finds that the total of debit side is short by ₹ 1,500. This difference will be _____
 - (a) Credited to suspense account
 - (b) Debited to suspense account
 - (c) Adjusted to any of the debit balance account

5.	S.No.	Account heads	Debit (₹)	Credit (₹)
	1.	Sales		15,000
	2.	Purchases	10,000	
	3.	Miscellaneous expenses	2,500	
	4.	Salaries		2,500
		Total	12,500	17,500

The difference in trial balance is due to _____

- (a) Wrong placing of sales account
- (b) Wrong placing of salaries account
- (c) Wrong placing of miscellaneous expenses account

Theory Questions

1. What is the trial balance? And how it is prepared?
2. Explain objectives of preparation of trial balance.
3. Even if the trial balance agrees, some errors may remain. Do you agree? Explain.

Practical Question

1. An inexperienced bookkeeper has drawn up a Trial Balance for the year ended 30th June, 2022.

	Debit (₹)	Credit (₹)
Provision for Doubtful Debts	200	—
Bank Overdraft	1,654	—
Capital	—	4,591
Trade payables	—	1,637
Trade receivables	2,983	—
Discount Received	252	—
Discount Allowed	—	733
Drawings	1,200	—
Office Furniture	2,155	—
General Expenses	—	829
Purchases	10,923	—
Returns Inward	—	330
Rent & Rates	314	—
Salaries	2,520	—
Sales	—	16,882
Inventory	2,418	—
Provision for Depreciation on Furniture	364	—
Total	24,983	25,002

Required:

Draw up a 'Corrected' Trial Balance, debiting or crediting any residual errors to a Suspense Account.

ANSWERS/HINTS

True and False

1. *True: Preparing trial balance is the third phase of accounting process which forms the base for the preparation of the final accounts.*
2. *True: Based on trial balance only, we can prepare financial statement.*
3. *False: Agreement of trial balance gives only arithmetical accuracy, there can still be errors in preparing the trial balance.*
4. *True: Since compensating errors cancel out due to their compensating nature of the amounts, hence the Trial balance tallies.*
5. *False: A trial balance cannot find the missing entry from the journal.*
6. *False: Suspense account opened in a trial balance is a temporary account*
7. *True: As purchases is debited, any returns shall be credited (treated in opposite way).*

Multiple Choice Questions

1.	(c)	2.	(a)	3.	(b)	4.	(b)	5.	(b)		

Theoretical Questions

1. Preparation of trial balance is the third phase in the accounting process. After posting the accounts in the ledger, a statement is prepared to show separately the debit and credit balances. Such a statement is known as the trial balance.

Trial balance contains various ledger balances on a particular date. It forms the basis for preparing the financial statements i.e. profit and loss account and balance sheet. If it tallies, it means that the accounts are arithmetically accurate but certain errors may still remain undetected. Therefore, it is very important to carefully journalise and post the entries, following are rules of accounting.
2. The preparation of trial balance has the following objectives:
 - (i) Trial balance enables one to establish whether the posting and other accounting processes have been carried out without committing arithmetical errors. In other words, the trial balance helps to establish arithmetical accuracy of the books of accounts.
 - (ii) Financial statements are normally prepared on the basis of agreed trial balance.
 - (iii) The trial balance serves as a summary of what is contained in the ledgers.

3. In spite of the agreement of the trial balance some errors may remain. These may be of the following types:
- (i) Transaction has not been entered at all in the journal.
 - (ii) A wrong amount has been written in both columns of the journal.
 - (iii) A wrong account has been mentioned in the journal.
 - (iv) An entry has not at all been posted in the ledger.
 - (v) Entry is posted twice in the ledger.

Practical Question

1. **Trial Balance as on 30th June, 2022**

Heads of Accounts	Debit ₹	Credit ₹
Provision for Doubtful Debts	–	200
Bank overdraft	–	1,654
Capital	–	4,591
Trade payables	–	1,637
Trade receivables	2,983	–
Discount Received	–	252
Discount allowed	733	–
Drawings	1,200	–
Office furniture	2,155	–
General Expenses	829	–
Purchases	10,923	–
Returns Inward	330	–
Rent & Rates	314	–
Salaries	2,520	–
Sales	–	16,882
Inventory	2,418	–
Provision for Depreciation on Furniture	–	364
Suspense Account (Balancing figure)	1,175	–
Total	25,580	25,580

UNIT – 4 SUBSIDIARY BOOKS

LEARNING OUTCOMES

After studying this chapter, you will be able to:

- ◆ Understand the techniques of recording transactions in Purchase Book, Sales Book; Returns Inward Book and Returns Outward Book; Bills Receivable and Bills Payable Book.
- ◆ Learn the technique of posting from Subsidiary Books to Ledger.
- ◆ Understand that even if subsidiary books are maintained, journalisation is required for many other transactions and events.
- ◆ Learn the difference between the subsidiary books and principal books.

UNIT OVERVIEW



Principle books

- Ledger
- Cash books

Subsidiary books

- Purchases and Sales book, Purchase and Sales return books
- Bill payable and Bills receivable books
- Journal Proper



4.1 INTRODUCTION

In a business, most of the transactions generally relate to receipts and payments of cash, sale of goods and their purchase. It is convenient to keep a separate register for each such class of transactions one for receipts and payments of cash, one for purchase of goods and one for sale of goods. A register of this type is called a book of original entry or of prime entry. The transactions recorded in such books will not require journal entries. The system by which transactions of a class are first recorded in the specified book, specially meant for it and on the basis of which ledger accounts are then prepared is known as the Practical System of Book keeping or even the English System. It should be noted that in this system, there is no departure from the rules of the double entry system.

These books of original or prime entry are also called subsidiary books since ledger accounts are prepared on their basis without further processing of ledger posting. Normally, the following subsidiary books are used in a business:

- (i) Cash Book to record receipts and payments of cash, including receipts into and payments out of the bank.
- (ii) Purchases Book to record credit purchases of goods dealt in or of the materials and stores required in the factory.
- (iii) Purchase Returns Book to record the returns of goods and materials previously purchased.
- (iv) Sales Book to record the sales of the goods dealt in by the firm.
- (v) Sale Returns Book to record the returns of goods made by the customers sold to them earlier.
- (vi) Bills Receivable Book to record the receipts of promissory notes or hundies from various parties.
- (vii) Bills Payable Book to record the issue of the promissory notes or hundies to other parties.
- (viii) Journal (proper) to record the transactions which cannot be recorded in any of the seven books mentioned above.

It may be noted that in all the above cases the word "Journal" may be used for the word "book".

Advantages of Subsidiary Books

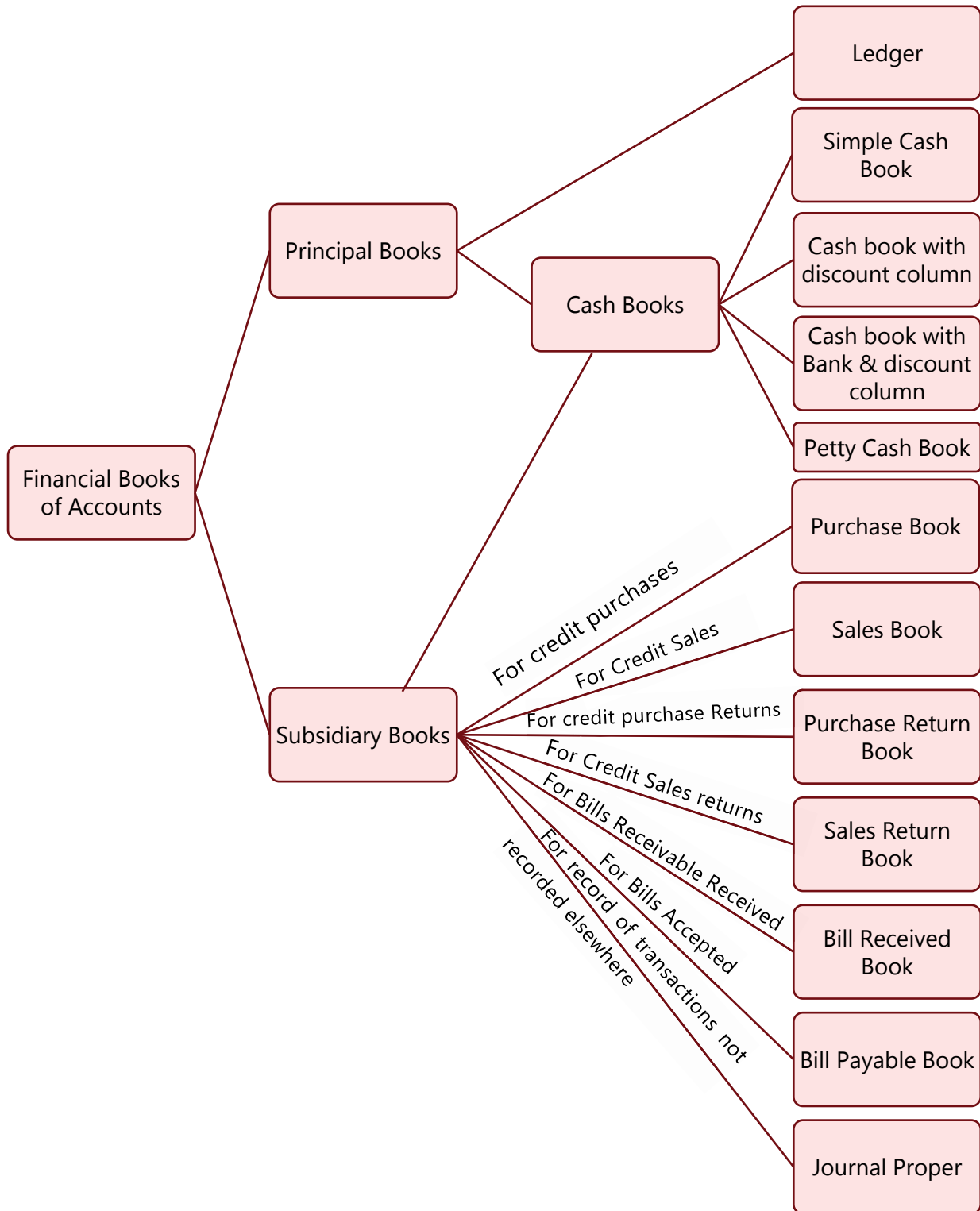
The use of subsidiary books affords the undermentioned advantages:

- (i) **Division of work:** Since in the place of one journal there will be so many subsidiary books, the accounting work may be divided amongst a number of clerks.
- (ii) **Specialization and efficiency:** When the same work is allotted to a particular person over a period of time, he acquires full knowledge of it and becomes efficient in handling it. Thus the accounting work will be done efficiently.
- (iii) **Saving of the time:** Various accounting processes can be undertaken simultaneously because of the use of a number of books. This will lead to the work being completed quickly.
- (iv) **Availability of information:** Since a separate register or book is kept for each class of transactions, the information relating to each class of transaction be available at one place.
- (v) **Facility in checking:** When the trial balance does not agree, the location of the error or errors is facilitated by the existence of separate books. Even the commission of errors and frauds will be checked by the use of various subsidiary books.



4.2 DISTINCTION BETWEEN SUBSIDIARY BOOKS AND PRINCIPAL BOOKS

The books in which transactions are first recorded to enable further processing are called subsidiary books. The ledger and the cash book are the principle books since they furnish information for preparation of the trial balance and financial statements. The following chart will help you in understanding the difference between Subsidiary Books and Principal Books.





4.3 PURCHASES BOOK

To record the credit purchases of goods dealt in or materials used in the business, a separate register called the Purchases Book or the Purchases Journal, is usually maintained by firms. The format is given below:

Date	Particulars	Details ₹	Amount ₹

It should be remembered that:

- (i) Cash purchases are not entered in this book since these will be entered in the cash book; and
- (ii) Credit purchases of items other than goods or materials, such as office furniture or typewriters are journalised - they are not entered in the Purchases Book.

The particulars column is meant to record the name of the supplier and name of the articles purchased and the respective quantities. The amount in respect of each article is entered in the details column. After totalling the various amounts included in a single purchase, the amount for packing, or other charges is added and the amount for trade discount is deducted. The net amount is entered in the amount column. The total in the amount column shows the total purchase made in a period.

ILLUSTRATION 1

The Rough Book of M/s. Narain & Co. contains the following :

2022

- Feb.**
1. Purchased from Brown & Co. on credit :
 5 gross pencils @ ₹100 per gross,
 1 gross register @ ₹240 per doz.
 Less : Trade Discount @ 10%
 2. Purchased for cash from the Stationery Mart;
 10 gross exercise books @ ₹300 per doz.
 3. Purchased computer for office use from M/s. office
 Goods Co. on credit for ₹30,000.
 4. Purchased on credit from The Paper Co.
 5 reams of white paper @ ₹100 per ream.

10 reams of ruled paper @ ₹150 per ream.

Less : Trade Discount @ 10%

5. Purchased one dozen gel pens @ ₹15 each from
M/s. Verma Bros. on credit.

Make out the Purchase Book of M/s. Narain & Co.

SOLUTION

Purchases Book

Date	Particulars	Details	Amount
2022		₹	₹
Feb. 1	M/s. Brown & Co.		
	5 gross pencils @ ₹ 100 per gross	500.00	
	1 gross register @ ₹ 240 per doz.	<u>2880.00</u>	
		3380.00	
	Less : 10% trade discount	<u>(338)</u>	3,042
"4	The Paper Co.		
	5 reams white paper @ ₹ 100 per ream	500.00	
	10 reams ruled paper @ ₹ 150 per ream	<u>1500.00</u>	
		2,000.00	
	Less : 10% trade discount	<u>(200.00)</u>	1,800
5	M/s. Verma Bros.		
	1 doz. gel pens @ ₹ 15 each	180	<u>180</u>
		Total	5022

Note : Purchases of cash and purchase of computer are not recorded in the Purchase Book.

ILLUSTRATION 2

Enter the following transactions in Purchase Book and post them into ledger.

2022

- April 4 Purchased from Ajay Enterprises, Delhi
100 Doz. Rexona Hawai Chappal @ ₹ 120 per doz.
200 Doz. Palki Leather Chappal @ ₹ 300 per Doz.

Less : Trade discount @ 10%

Freight charged ₹ 150.

April 15 Purchased from Balaji Traders, Delhi

50 doz. Max Shoes @ ₹ 400 per doz.

100 pair Sports Shoes @ ₹ 140 per pair.

Less : Trade discount @ 10%.

Freight charged ₹ 200.

April 28 Purchased from Tripti Industries, Bahadurgarh

40 pair leather shoes @ ₹ 400 per pair

100 doz. Rosy Hawai Chappal @ ₹ 180 per doz.

Less : Trade discount @ 10%.

Freight charged ₹ 100.

SOLUTION

Purchase Book

Date 2022	Particulars	Details	Gross Amount	Trade Discount	Net Price	Freight	Total Amount
April 4	Ajay Enterprises						
	100 doz Rexona Hawai chappal @ ₹ 120 per doz - ₹ 12,000	12,000					
	200 doz Palki Leather Chappal @ ₹ 300 per doz - ₹ 60,000	60,000					
	Less: trade discount @ 10%		72,000	7,200	64,800	150	64,950
April 15	Balaji Traders, Delhi						
	50 doz max Shoes @ ₹ 400 per doz - ₹ 20,000	20,000					
	100 pair Sports shoes @ ₹ 140 per pair - ₹ 14,000	14,000					
	Less: Trade discount @ 10%		34,000	3,400	30,600	200	30,800

April 28	Tripti Industries, Bahadurgarh						
	40 pair Leather shoes @ ₹ 400 per pair - ₹ 16,000	16,000					
	100 doz Rosy Hawai Chappal: @ ₹ 180 per doz - ₹ 18,000	18,000					
	Less: Trade discount @ 10%		<u>34,000</u>	<u>3,400</u>	<u>30,600</u>	<u>100</u>	<u>30,700</u>
			1,40,000	14,000	1,26,000	450	1,26,450

LedgersDr. **Purchases A/c** Cr.

2022		₹	2022		₹
April 30	To amount as per purchase book	1,26,000			

Dr. **Freight A/c** Cr.

2022		₹	2022		₹
April 30	To amount as per purchase book	450			

Dr. **Ajay Enterprises** Cr.

2022		₹	2022		₹
			April 4	By Purchase A/c (From Purchase Book)	64,800
				By Freight A/c (From Purchase Book)	150

Dr. **Balaji Traders** Cr.

2022		₹	2022		₹
			April 15	By Purchase A/c (From Purchase Book)	30,600
				By Freight A/c (From Purchase Book)	200

Dr. **Tripati Industries** Cr.

2022		₹	2022		₹
			April 28	By Purchase A/c (From Purchase Book)	30,600
				By Freight A/c (From Purchase Book)	100

POSTING THE PURCHASES BOOK

The Purchases Book shows the names of the parties from whom goods have been purchased on credit. These parties are now trade payables. Their accounts have to be credited for the respective amounts shown in the purchase book. The total of the amounts column shows the credit purchases made in a period. The amount is debited to the Purchase Account to indicate receipt of goods. In Illustration 1, the Purchases Account is debited by ₹ 5,022, M/s. Brown & Co. is credited by ₹ 3,042, The Paper Company by ₹1,800 and M/s. Verma Bros. by ₹180. The total of the amounts put on the credit side equals the debit. Thus the double entry is completed.



4.4 SALES BOOK

The Sales Book is a register specially kept to record credit sales of goods dealt in by the firm, cash sales are entered in the Cash Book and not in the Sales Book. Credit sales of items other than the goods dealt in by the firm are not entered in the Sales Book rather they are journalised. The rules are the same as for the Purchases Book.

Entries in the Sales Book are also made in the same manner as in the Purchase Book. The particulars column will record the name of the customers concerned together with particulars and quantities of the goods sold. For each item, the amount is entered in the details column; after totalling the amounts for one sale, charges for packing etc; are added and the trade discount, if any is deducted: the net amount is put in the outer column. The total of this column will show the total credit sales for a period.

ILLUSTRATION 3

The following are some of the transaction of M/s Kishore & Sons of the year 2022 as per their Waste Book. Make out their Sales Book.

Sold to M/s. Gupta & Verma on credit:

30 shirts @ ₹ 800 per shirt.

20 trousers @ ₹1,000 per trouser.

Less : Trade Discount @ 10%

Sold furniture to M/s. Sehgal & Co. on credit ₹8,000.

Sold 50 shirts to M/s. Jain & Sons @ ₹800 per shirt.

Sold 13 shirts to Cheap Stores @ ₹750 each for cash.

Sold on credit to M/s. Mathur & Jain.

100 shirts @ ₹750 per shirt

10 overcoats @ ₹5,000 per overcoat.

Less: Trade Discount @ 10%

SOLUTION

Sales Book

Date	Particulars	Details ₹	Amount ₹
2022	M/s. Gupta & Verma		
	30 shirts @ ₹800	24,000	
	20 Trousers @ ₹1,000	20,000	
		44,000	
	Less : 10%	(4,400)	
	Sales as per invoice no. dated		39,600
	M/s. Jain & Sons 50 shirts @ ₹800		
	Sale as per invoice no. dated		40,000
	M/s Mathur & Jain		
	100 shirts @ ₹750	75,000	
	10 overcoats @ ₹5,000	50,000	
		1,25,000	
	Less : 10%	(12,500)	
	Sales as per invoice no. dated.....		1,12,500
		Total	1,92,100

Note : Cash sale and sale of furniture are not entered in Sales Book.

POSTING THE SALES BOOK

The names appearing in the Sales Book are of those parties which have received the goods. The accounts of the parties have to be debited with the respective amounts. The total of the Sales Book shows the credit sales made during the period concerned; the amount is credited to the Sales Account. In the Illustration 3, ₹ 1,92,100 is credited to the Sales Account; ₹39,600 is debited to M/s. Gupta and Verma ₹40,000 to M/s Jain and Sons and ₹1,12,500 to M/s Mathur & Jain. The amount put on the credit side is equal to the total of the amount put on the debit side. Thus, the double entry principle is followed correctly.



4.5 SALES RETURNS BOOK OR RETURNS INWARD BOOK

If customers frequently return the goods sold to them, it would be convenient to record the returns in a separate book, which is named as the Sales Returns Book or the Returns Inward Book. The rules of the book is similar to the Sales Book and entries are also made in the same manner. The following, assumed figures, will illustrate this:

Returns Inward Book

Date	Particulars	Details	L.F.	Amount
2022				₹
June 7	Sunil Bank & Co.			
	6 Copies-Double Entry			
	Bookkeeping by T.S. Grewal @ ₹ 7	42.00		
	Less : Trade Discount 10%	(4.20)		37.80
	Kailash & Co.			
	1 Copy-Business Methods by R.K. Gupta			<u>3.50</u>
		Total		41.30



4.6 PURCHASE RETURNS OR RETURNS OUTWARD BOOK

Such a book conveniently records return of goods or material purchased to the suppliers. However, if the returns are not frequent, it may be sufficient to record the transaction in the journal. The rules of the Purchase Returns or Returns Outward Book is similar to that of the Purchase Book; entries are also similarly made, as the illustration given below shows:

Returns Outward Book

Date 2022	Particulars	₹	Amount ₹
June 2	Premier Electric Co.		175.00
	One 36" Usha Ceiling Fan		
" 28	Mohan Electric Co.		
	Ten Iron Heaters	150.00	
	Less : Discount	<u>(15.00)</u>	<u>135.00</u>
	Total		310.00

POSTING OF THE RETURN BOOKS

The Sales Return Book will show the total of the returns made by customers. The total of the sales returns is in reduction of the sales. Therefore, the amount may be debited to the Sales Account but, usually, a separate account called Returns Inward Account is opened and the total of the sales returns is debited to this accounts. The customers who have returned the goods are credited with the respective amounts.

It should be noted that on goods being received and accepted back from the customers, a credit note is issued to the customers concerned. This shows the amount to be credited to the customer's account.

Similarly, when goods are returned to suppliers they will issue the necessary credit note; also the firm returning the goods will issue a debit note to the supplier, indicating the amount for which the supplier account is being debited.

The total of Returns Outwards Book shows the total purchase returns made. The amount can be credited to the Purchase Account, but in practice, it is credited to a separate account called Purchase Returns or Returns Outward Account. The suppliers whose names appear in the Book have received the goods, so their accounts are debited. This is shown in the illustration given below:

ILLUSTRATION 4

Post the following into the ledger

Returns Outward Book

Date 2022	Particulars	Details ₹	Amount ₹
Nov. 20	Rajindra Prakash & Sons		
	One 36" Usha Ceiling Fan	200.00	
	Less : Trade Discount @ 10%	<u>(20.00)</u>	180.00
" 30	Modern Electric Company		100.00
	Total		280.00

SOLUTION**Ledger**

Dr. **Rajindra Parkash & Sons** Cr.

Date 2022	Particulars	Folio	Amount	Date	Particulars	Folio	Amount
Nov. 20	To Returns Outward A/c (From Returns Outward Book)		180.00				

Dr. **Modern Electric Co.** Cr.

Date 2022	Particulars	Folio	Amount	Date	Particulars	Folio	Amount
Nov. 30	To Returns Outward A/c (From Returns Outward Book)		100.00				

Dr. **Returns Outward Account** Cr.

Date 2022	Particulars	Folio	Amount	Date	Particulars	Folio	Amount
				Nov. 30	By Sundries as per Returns Outward Book		280.00

BILLS RECEIVABLE BOOKS AND BILLS PAYABLE BOOKS

If the firm usually receives a number of promissory notes or hundies, it would be convenient to record the transaction in a separate book called the Bills Receivable Book. Similarly, if promissory notes or hundies are frequently issued, the Bills Payable Book will be convenient. This will be discussed later.



4.7 IMPORTANCE OF JOURNAL

Students are now familiar with the journal. They also know that :

- (i) Cash transactions are recorded in the cash book;
- (ii) Credit purchases of goods or materials are recorded in the purchases book;
- (iii) Credit sales of goods are recorded in the sales book;
- (iv) Returns from customers are recorded in the sale returns book; and
- (v) Returns to suppliers are entered in the purchase returns book.

Bill received or accepted transactions are entered in the bills receivable books or the bills payable books, if these are maintained. Apart from the transactions mentioned above, there are other entries also which have to be recorded. For them the proper place is the journal. In fact, if there is no special book meant to record a transaction, it is recorded in the journal (proper). The role of the journal is thus restricted to the following types of entries:

- (i) **Opening entries :** When books are started for the new year, the opening balance of assets and liabilities are journalised.
- (ii) **Closing entries :** At the end of the year, the profit and loss account is prepared. For this purpose, the nominal accounts are transferred to profit and loss account. This is done through journal entries called closing entries.
- (iii) **Rectification entries :** If an error has been committed, it is rectified through a journal entry.
- (iv) **Transfer entries :** If some amount is to be transferred from one account to another, the transfer will be made through a journal entry.
- (v) **Adjusting entries :** At the end of the year the amount of expenses or income may have to be adjusted for amounts received in advance or for amounts not yet settled in cash. Such an adjustment is also made through journal entries. Usually, the entries pertain to the following:
 - (a) Outstanding expenses, i.e., expenses incurred but not yet paid;

- (b) Prepared expenses, i.e., expenses paid in advance for future period;
- (c) Interest on capital, i.e., the interest on proprietor's investment in the business; and
- (d) Depreciation, i.e., fall in the value of the assets used on account of wear and tear.

For above type of transactions/events, journal entries are necessary.

(vi) Entries on dishonour of Bills : If someone who accepted a promissory note (or bill) is not able to pay in on the due date, a journal entry will be necessary to record the non-payment or dishonour of bills.

(vii) Miscellaneous entries : The following entries will also require journalising:

- (a) Credit purchase of items other than goods dealt in or materials required for production of goods e.g. credit purchase of furniture or machinery will be journalised.
- (b) An allowance to be given to the customers or a charge to be made to them after the issue of the invoice.
- (c) Receipt or issue of promissory notes, if separate bill books have not been maintained.
- (d) If an amount becomes irrecoverable, say, because, of the customer becoming insolvent.
- (e) Effects of accidents such as loss of property by fire.
- (f) Transfer of net profit to capital account.

ILLUSTRATION 5

From the following transactions, prepare the Purchases Returns Book of Alpha & Co., a saree dealer :

Date	Debit Note No.	Particulars
04.01.2022	101	Returned to Goyal Mills, Surat - 5 polyester sarees @ ₹ 1,000.
09.01.2022		Garg Mills, Kota - accepted the return of goods (which were purchased for cash) from us - 5 Kota sarees @ ₹ 400.
16.01.2022	102	Returned to Mittal Mills, Bangalore - 5 silk sarees @ ₹ 2,600.
30.01.2022		Returned one computer (being defective) @ ₹ 35,000 to B & Co.

SOLUTION**Purchase Returns Book**

Date	Debit Note No.	Name of supplier	L.F.	Amount
2022				
Jan. 4	101	Goyal Mills, Surat		5,000
Jan. 16	102	Mittal Mills, Bangalore		13,000
Jan. 31		Purchases Returns Account (Cr.)		18,000

SUMMARY

- ◆ Instead of recording all journal entries in one register, it is better to categorize the entries on the basis of type of transactions.
- ◆ Various subsidiary books are maintained so as to record transactions of one type in each register. These are also called books of original entry or prime entry.
- ◆ Example of subsidiary books are purchases book, sales book, purchase returns books, sales returns book, bills receivable book, bills payable book etc. On the basis of these subsidiary books, the ledger accounts are prepared.

TEST YOUR KNOWLEDGE**True and False**

1. Transactions recorded in the purchase book include only purchases of goods on credit transactions.
2. Transactions regarding the purchase of fixed asset are recorded in the purchase book.
3. Cash sales are recorded in the sales book.
4. Subsidiary books are also known as the books of original entry.
5. Bills receivable book is a subsidiary book.
6. Return inward book is also known as purchase return book.
7. Purchase of a second hand machinery will be recorded in purchase book.
8. Total of sales return book may be posted to the debit side of sales account.
9. If the sales are on a frequent basis, the transactions are recorded in the sales book.

Multiple Choice Questions

1. In Purchases Book, the record is in respect of _____
 - (a) Cash purchase of goods.
 - (b) Credit purchase of goods dealt in.
 - (c) All purchases of goods.
2. The Sales Returns Book records _____
 - (a) The return of goods purchased.
 - (b) Return of anything purchased.
 - (c) Return of goods sold.
3. The Sales Book _____
 - (a) Is a part of journal.
 - (b) Is a part of the ledger.
 - (c) Is a part of the balance sheet.
4. The weekly or monthly total of the Purchase Book is _____
 - (a) Posted to the debit of the Purchases Account.
 - (b) Posted to the debit of the Sales Account.
 - (c) Posted to the credit of the Purchases Account.
5. The total of the Sales Book is posted to _____
 - (a) Credit of the Sales Account.
 - (b) Credit of the Purchases Account.
 - (c) Credit of the Capital Account.
6. In which book of original entry, will you record an allowance of ₹50 which was offered for an early payment of cash of ₹1,050 _____.
 - (a) Sales Book
 - (b) Cash Book
 - (c) Journal Proper (General Journal)

7. A second hand motor car was purchased on credit from B Brothers for ₹10,000 will be recorded in _____.
- (a) Journal Proper (General Journal)
 - (b) Sales Book
 - (c) Cash Book
 - (d) Purchase Book
8. In which book of original entry, will you record a bills receivable of ₹1,000, which was received from a debtor in full settlement for a claim of ₹1,100, is dishonoured _____.
- (a) Purchases Return Book
 - (b) Bills Receivable Book
 - (c) Journal Proper (General Journal)

Theory Questions

- 1 Which subsidiary books are normally used in a business?
- 2 What are the advantages of subsidiary books?

Practical Questions

- 1 Enter the following transactions in Sales Book of M/s. Pranat Engineers Ltd., Delhi.
2022
Jan. 2. Sold to M/s. Ajanta Electricals, Delhi 5 pieces of Ovens @ ₹6,000/- each less Trade discount @ 10%.
8 Sold to M/s. Electronics Plaza, 10 pieces of Tablets @ ₹8,000/- each less trade discount 5%.
15 Sold to M/s. Haryana Traders, 5 pieces of Juicers @ ₹3,500/- each less trade discount @ 10%.
- 2 Post into the ledger, the entries of Sales Book prepared in Question 1.

ANSWERS/HINTS

True and False

1. True: Since cash purchases are taken to the cash book, it is only credit transactions that are recorded in the purchases book.
2. False: Transactions regarding the purchase of fixed asset are not recorded in the purchase book, only the credit purchases of goods are recorded in it.
3. False: Credit sales are recorded in the sales book.
4. True: Subsidiary books are maintained as an alternate to the journal.
5. True: Bills receivable is one of the subsidiary book.
6. False: Return inward book is also known as sales return book.
7. False: Purchase of a second hand machinery will not be recorded in purchase book.
8. True: Since sales return is reduction from the total sales value, it is debited in the sales account.
9. True: When there are numerous transactions then there are subsidiary books like the sales book where there are recorded instead of regular journal entries.

Multiple Choice Questions

1.	(b)	2.	(c)	3.	(a)	4.	(a)	5.	(a)	6.	(b)
7.	(a)	8.	(c)								

Theoretical Questions

1. Refer para 4.1 of this unit for subsidiary books normally maintained in a business.
2. For advantages of Subsidiary Books, refer para 4.1 of this unit.

Practical Problems

1. Sales Book

Date	Particulars	Gross Amount (₹)	Trade Discount (₹)	Net Price (₹)
2022 Jan. 2	M/s. Ajanta Electricals			

8	5 pieces of Ovens @ ₹ 6,000 each Less: 10% discount	30,000	3,000	27,000
	M/s. Electronics Plaza			
15	10 pieces of Tablets @ ₹ 8,000 each, less 5% trade discount	80,000	4,000	76,000
	M/s. Haryana Traders			
	5 pieces of Juicers @ ₹ 3,500 each, less 10% trade discount	<u>17,500</u>	<u>1,750</u>	<u>15,750</u>
		1,27,500	8,750	1,18,750

2. Ledger

M/s. Ajanta Electricals

Date 2022	Particulars	L.F.	Amount (₹)	Date 2022	Particulars	L.F.	Amount (₹)
Jan. 2	To Sales A/c (From Sales Book)		27,000				

M/s. Electronics Plaza

Date 2022	Particulars	L.F.	Amount (₹)	Date 2022	Particulars	L.F.	Amount (₹)
Jan. 8	To Sales A/c (From Sales Book)		76,000				

M/s. Haryana Traders

Date 2022	Particulars	L.F.	Amount (₹)	Date 2022	Particulars	L.F.	Amount (₹)
Jan. 15	To Sales A/c (From Sales Book)		15,750				

Sales Account

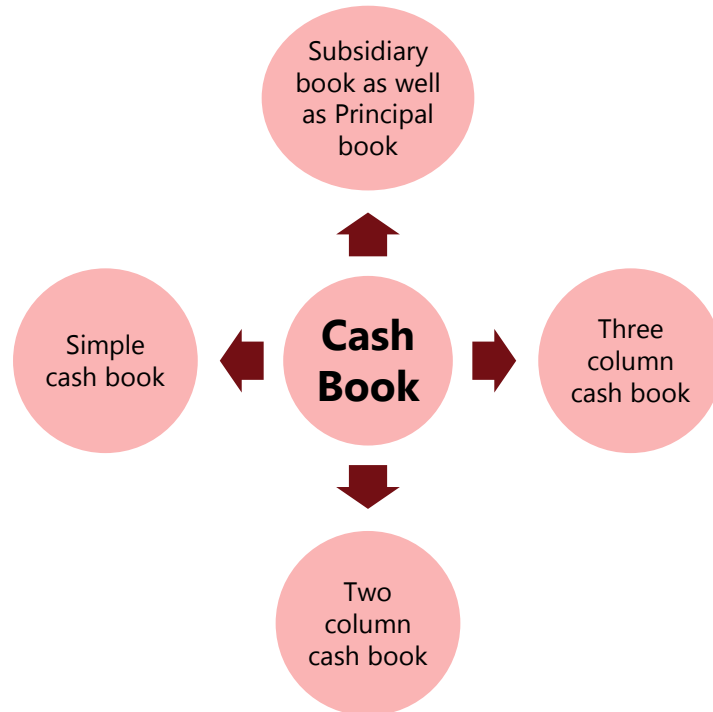
Date 2022	Particulars	L.F.	Amount (₹)	Date 2022	Particulars	L.F.	Amount (₹)
				Jan. 31	By Sundries (As per Sales Book)		1,18,750

UNIT 5 : CASH BOOK

LEARNING OUTCOMES

After studying this chapter, you will be able to:

- ◆ Understand that a Cash Book is a type of subsidiary book but treated as a principal book.
- ◆ Be familiar with various kinds of Cash Books, viz., Simple Cash Book, Two-column Cash Book and Three-column Cash Book.
- ◆ Learn the technique of preparation of Simple Cash Book and how to balance it.
- ◆ See how Double-Column Cash Book is prepared adding discount column alongwith cash column.
- ◆ Understand the techniques of preparing Three-column Cash Book.
- ◆ Understand what is a Petty Cash Book and the Imprest System of Petty Cash.
- ◆ Note the advantages of the Petty Cash Book.
- ◆ Learn how to maintain a Petty Cash Book and how to post the entries of the Petty Cash Book in the ledger.
- ◆ Understand the accounting of credit/debit sales transactions.

UNIT OVERVIEW

5.1 CASH BOOK - A SUBSIDIARY BOOK AND A PRINCIPAL BOOK

Cash transactions are straightaway recorded in the Cash Book and on the basis of such a record, ledger accounts are prepared. Therefore, the Cash Book is a subsidiary book. But the Cash Book itself serves as the cash account and the bank account; the balances are entered in the trial balance directly. The Cash Book, therefore, is part of the ledger also. Hence, it has also to be treated as the principal book. The Cash Book is thus both a subsidiary book and a principal book.



5.2 KINDS OF CASH BOOK

The main Cash Book may be of the three types:

- (i) Simple Cash Book;
- (ii) Two-column Cash Book;
- (iii) Three-column Cash Book.

In addition to the main Cash Book, firms also generally maintain a petty cash book but that is purely a subsidiary book.

SIMPLE CASH BOOK

Such a cash book appears like an ordinary account, with one amount column on each side. The left-hand side records receipts of cash and the right-hand side the payments.

Balancing: The cash book is balanced like other accounts. The total of receipts column is always greater than total of payments column. The difference is written on the credit side as 'By balance c/d'. The totals are then entered in the two columns opposite one another and then on the debit side the balance is written as "To Balance b/d", to show cash balance in hand in the beginning of next period.

ILLUSTRATION 1

Enter the following transactions in a Simple Cash Book:

2022		₹
Jan. 1	Cash in hand	1,200
" 5	Received from Ram	300
" 7	Paid Rent	30
" 8	Sold goods for cash	300
" 10	Paid to Shyam	700
" 27	Purchased Furniture	200
" 31	Paid Salaries	100
" 31	Rent due, not yet paid, for January	30

SOLUTION

Dr.				Cr.			
Cash Book							
Date 2022	Receipts	L.F.	Amount ₹	Date 2022	Payments	L.F.	Amount ₹
Jan. 1	To Balance b/d		1,200	Jan. 07	By Rent A/c		30
" 5	To Ram A/c		300	" 10	By Shyam A/c		700
" 8	To Sales A/c		300	" 27	By Furniture A/c		200

				" 31	By Salaries A/c		100
				" 31	By Balance c/d		770
			1,800				1,800
2022							
Feb. 1	To Balance b/d		770				

Note :

- (i) In the simple cash book only the cash receipts and cash payments are recorded.
- (ii) The total of debit side is always greater than the total of credit side since the payment cannot exceed the available cash.
- (iii) The simple cash book is like an ordinary account.
- (iv) Rent due not yet paid for January has not been recorded in the cash book because no cash has been paid, hence it will be recorded through normal Journal entry.

DOUBLE-COLUMN CASH BOOK

If along with column for "Amount" to record cash receipts and cash payments another column is added on each side to record the cash discount allowed or the discount received, or a column on the debit side showing bank receipts and another column on the credit side showing payments through bank. It is a double-column cash book.

Cash discount is an allowance which often accompanies cash payments. For example, if a customer owes ₹ 500 but is promised that 2% will be deducted if payment is made within a certain period, the customer can clear his account by paying promptly ₹ 490. Cash received will be ₹ 490 and ₹ 10 will be the discount for the firm receiving the payment and discount is a loss; for the person making the payment it is a gain. Since cash discount is allowed only if cash is paid, it is convenient to add a column for discount allowed on the receipt side of the cash book and a column for discount received on the payment side of the cash book.

Balancing: It should be noted that the discount columns are not balanced. They are merely totalled. The total of the discount column on the receipts side shows total discount allowed to customers and is debited to the Discount Account. The total of the column on the payments side shows total discount received and is credited to the Discount Account. The Cash columns are balanced, as already shown. The bank columns are also balanced and the balancing figure is called bank balance. Thus a double column cash book should have two columns on each side comprising of either cash and discount transaction or cash and bank transactions.

In the cash column on the debit side, actual cash received is entered; the amount of the discount allowed, if any, to the customer concerned is entered in the discount column. Similarly, actual cash paid is entered in the cash column on the payments side and discount received in the discount column. Also the bank column on the debit side records all receipts through bank and the same column on the credit side shows payment through bank.

ILLUSTRATION 2

Ganesh commenced business on 1st April, 2022 with ₹ 2,000 as capital. He had the following cash transactions in the month of April 2022:

		₹			₹
April 1	Purchased furniture and paid cash	250	April 7	Paid for petty expenses	15
" 2	Purchased goods	500	" 8	Cash purchases	150
" 4	Sold goods for cash	950			
			13	Paid for labour	1,000
" 5	Paid cash to Ram Mohan	560			
" 6	He allowed discount	10	" "	Paid Ali & Sons	400
" 6	Received cash from Krishna & Co.	600	" "	They allowed discount	8
	Allowed discount	20			

Make out the two-column Cash Book (Cash and discount column) for the month of April, 2022.

SOLUTION**Cash Book**

Dr. Date 2022	Receipts	L.F.	Discount ₹	Amount ₹	Date 2022	Payments	L.F.	Discount ₹	Cr. Amount ₹
April 1	To Capital A/c			2,000	April 1	By Furniture A/c			250
" 4	To Sales A/c			950	" 2	By Purchases A/c			500
" 6	To Krishna A/c		20	600	" 5	By Ram Mohan		10	560
					" 7	By Petty Expenses A/c			15

				" 8	By Purchases A/c			150
				" 13	By wages A/c			1,000
				" 13	By Ali & Sons		8	400
				" 30	By Balance c/d			675
			20	3,550			18	3,550
May 1	To Balance b/d			675				

To summarise:

- (i) the discount columns in the cash book are totalled;
- (ii) they are not balanced; and
- (iii) their totals are entered in the discount received/paid account in the ledger.

Note: The person who pays, is credited by both the cash paid by him and the discount allowed to him. Similarly, the person to whom payment is made, is debited with both the amount paid and the discount allowed by him.

THREE-COLUMN CASH BOOK

A firm normally keeps the bulk of its funds at a bank; money can be deposited and withdrawn at will if it is current account. Probably payments into and out of the bank are more numerous than strict cash transactions. There is only a little difference between cash in hand and money at bank. Therefore, it is very convenient if, on each side in the cash book, another column is added to record cash deposited at bank (on the receipt side of the cash book) and payments out of the bank (on the payment side of the cash book).

For writing up the three-column cash book the under mentioned points should be noted:

1. While commencing a new business, the amount is written in the cash column if cash is introduced and in the bank column if it is directly put into the bank with the description "To Capital Account". If a new cash book is being started for an existing business, the opening balances are written as : "To Balance b/d".
2. All receipts are written on the receipts side, cash in the cash column and cheques in the bank column. If any discount is allowed to the party paying the amount, the discount is entered in the discount column. In the particulars column the name of the account in respect of which payment has been received is written.
3. All payments are written on the payments side, cash payment in the cash column and payments by cheques in the bank column. If some discount has been received from the party receiving the payment, it is entered in the discount column.

4. *Contra Entries*: Often cash is withdrawn from bank for use in the office. In such a case the amount is entered in the bank column on the payments side and also in the cash column on the receipts side. In the reverse case of cash being sent to the bank, the amount is recorded in the bank column on the receipts side and in cash column on payment side. Against such entries, the letter "C" should be written in the L.F column, to indicate that these are contra transaction and no further posting is required for them.

Note: If initially cheques received are entered in the cash column and then sent to the bank, the entry is as if cash has been sent to the bank.

While recording contra entries, the basic but important rules should be followed -

(a)	The Receiver	Dr.
	The Giver	Cr.
(b)	All what comes in	Dr.
	All what goes out	Cr.

e.g. where a Cash Book with separate columns for Bank Account is maintained.

(a)	If cash is deposited in Bank Account, the Bank will be the Receiver, hence it will be Debited and as the cash is going out, cash will be credited.
(b)	If cash is withdrawn from the Bank Account, the Bank will be the Giver, hence it will be Credited and, as the cash is coming in, cash will be Debited.
5. If some cheque sent to the bank is dishonoured, i.e., the bank is not able to collect the amount, it is entered in the bank column on the credit side with the name of the concerned party in the particulars column.
6. If some cheque issued by the firm is not paid on presentation, it is entered in the Bank column on the debit side with the name of the party to whom the cheque was given.
7. In a rare case, a cheque received may be given to some other party, i.e., endorsed. On receipt, it must have been entered in the bank column on the debit side; on endorsement the amount will be written in the bank column on the credit side.

The advantages of such type of Cash Book are that -

- (a) the Cash Account and the Bank Account are prepared simultaneously, therefore the double entry is completed in the Cash Book itself. Thus the contra entries can be easily cross-checked in Cash column in one side and the Bank column in the other side of the Cash Book. Also the chances of error are reduced.

- (b) the information regarding Cash in Hand and the Bank Balance can be obtained very easily and quickly as there is no need to prepare Ledger of the Bank Account.

In case of maintaining more than one Bank Account, separate column can be add for each Bank Account. Transactions between these two or more Bank Accounts can be recorded and tallied with a much less effort.

Suppose, there are two Bank Accounts namely PNB Current Account and SBI-Cash Credit Account. Now, if a cheque is issued from PNB cheque Book to SBI Account, the receiver - i.e., SBI Account will be debited and the giver i.e. the PNB Account shall be credited.

Balancing: The discount columns are totalled but not balanced. The cash columns are balanced exactly in the same manner as indicated for the simple cash book. The process is similar for balancing the bank columns also. It is possible, however, that the bank may allow the firm to withdraw more than the amount deposited i.e., to have an overdraft, In such a case, the total of the bank column on the credit side is bigger than the one on the debit side. The difference is written on the debit side as "To Balance c/d." Then the totals are written on the two sides opposite one another, the balance is then entered on the credit side as "By Balance b/d."

However, in usual cases debits into the bank will exceed the withdrawals or payments out of the bank. Then the bank columns are balanced just like the cash columns.

ILLUSTRATION 3

Enter the following transactions in Cash Book with Discount and Bank Columns. Cheques are first treated as cash receipt.

2022		₹
Jan. 1	Chandrika commences business with Cash	20,000
" 3	He paid into Current A/c	19,000
" 4	He received cheque from Kirti & Co. on account	600
" 7	He pays in bank Kirti & Co.'s cheque	600
" 10	He pays Rattan & Co. by cheque and is allowed discount ₹ 20	330
" 12	Tripathi & Co. pays into his Bank A/c	475
" 15	He receives cheque from Warshi and allows him discount ₹ 35	450

"	20	He receives cash ₹ 75 and cheque ₹ 100 for cash sale	
"	25	He pays into Bank, including cheques received on 15th and 20th	1,000
"	27	He pays for cash purchase	275
"	30	He pays sundry expenses in cash	50

SOLUTION

Dr.

Cash Book

Cr.

Date	Receipts	L.F.	Discount ₹	Cash ₹	Bank ₹	Date	Payments	L.F.	Discount ₹	Cash ₹	Bank ₹
2022						2022					
Jan. 1	To Capital A/c			20,000		Jan. 3	By Bank A/c	C		19,000	
3	To Cash	C			19,000	7	By Bank A/c	C		600	
4	To Kirti & Co.			600		10	By Ratan & Co.		20		330
7	To Cash	C			600	25	By Bank A/c	C		1,000	
12	To Tripathi & Co.				475	27	By Purchases A/c			275	
15	To Warshi		35	450		30	By S. Exp. A/c			50	
20	To Sales A/c			175							
25	To Cash	C			1,000						
						31	By Balance c/d			300	20,745
			35	21,225	21,075				20	21,225	21,075
Feb. 1	To Balance b/d			300	20,745						

**5.3 POSTING THE CASH BOOK ENTRIES**

Students would have seen that the cash columns in the cash book is actually the cash account and the bank column is actually bank account. Also, the discount columns are memorandum columns, meant only to provide information about the total discount allowed and total discount received.

The debit side columns for cash and bank indicate receipts. Therefore, the amounts debited in the cash book should be put to the credit of the account in respect of which cash or cheque has been received. For instance, in the cash book given above we see that ₹175 have been received for sale of goods. For posting, the amount is credited to the Sales Account as "By Cash ₹175." We also see M/s. Warsi have paid ₹450 and also they have been allowed ₹ 35 as discount; thus they have discharged a debt of ₹485. In the account of M/s. Warsi, the posting is on the credit side as

By Cash	₹ 450
By Discount	₹ 35
or as:	
By Sundries	₹ 485

All payments are recorded on the credit side. The particulars columns show on what account payments have been made. In the ledger accounts concerned the amount is put on the debit side. For example, the cash book shows that a cheque for ₹ 330 has been issued to M/s. Ratan & Co. and also that they have allowed a discount of ₹ 20; thus an obligation of ₹ 350 has been met. In the account of M/s. Ratan & Co. the posting is:

To Bank	₹ 330
To Discount	₹ 20
Or	
To Sundries	₹ 350

The rule thus develops: From the debit side of the cash book, credit the various accounts with their respective amounts (including any discount that may have been allowed); from the credit side of cash book, the posting will be to the debit of the accounts mentioned in the particular column with their respective amounts (including the discount which may have been received).

As has been shown already, the total of the discount columns on the debit side is debited to the discount account; the total of the column discount on the credit side is credited to the discount account. From the cash book given on the previous page ₹ 35 is debited and ₹ 20 be credited to the discount account.



5.4 PETTY CASH BOOK

In the firm a number of small payments, such as for telegrams, taxi fare, cartage, etc., have to be made. If all these payments are recorded in the cash book, it will become unnecessarily heavy. Also, the main cashier will be overburdened with work. Therefore, it is usual for firms to appoint a person as 'Petty Cashier' and to entrust the task of making small payments say below ₹ 200, to him. Of course he will be reimbursed for the payments made. Later, on an analysis, the respective account may be debited.

IMPREST SYSTEM OF PETTY CASH

It is convenient to entrust a definite sum of money to the petty cashier in the beginning of a period and to reimburse him for payments made at the end of the period. Thus, he will have

again the fixed amount in the beginning of the new period. Such a system is known as the imprest system of petty cash.

The system is very useful specially if an analytical Petty Cash Book is used. The book has one column to record receipt of cash (which is only from the main cashier) and other columns to record payments of various types. The total of the various columns show why payments have been made and then the relevant accounts can be debited.

- (i) The amount fixed for petty cash should be sufficient for the likely small payments for a relatively short period, say for a week or a fortnight.
- (ii) The reimbursement should be made only when petty cashier prepares a statement showing total payments supported by vouchers, i.e., documentary evidence and should be limited to the amount of actual disbursements.
- (iii) The vouchers should be filed in order.
- (iv) No payment should be made without proper authorisation. Also, payments above a certain specified limit should be made only by the main cashier.
- (v) The petty cashier should not be allowed to receive any cash except for reimbursement.

In the petty cash book the extreme left-hand column records receipts of cash. The money column towards the right hand side shows total payments for various purposes; a column is usually provided for sundries to record infrequent payments. The sundries column is analysed. At the end of the week or the fortnight the petty cash book is balanced. The method of balancing is the same as for the simple cash book.

ILLUSTRATION 4

Prepare a Petty Cash Book on the imprest System from the following:

2022			₹
Jan.	1	Received ₹100 for petty cash	
"	2	Paid bus fare	.50
"	2	Paid cartage	2.50
"	3	Paid for Postage	5.00
"	3	Paid wages for casual labourers	6.00
"	4	Paid for stationery	4.00
"	4	Paid Bus charges	2.00
"	5	Paid for the repairs to chairs	15.00
"	5	Bus fare	1.00

"	5	Cartage	4.00
"	6	Postage	7.00
"	6	Bus charges	3.00
"	6	Cartage	3.00
"	6	Stationery	2.00
"	6	Refreshments to customers	5.00

SOLUTION**Petty Cash Book**

Receipts ₹	Date 2022	V. No.*	Particulars	Total ₹	Con- veyance ₹	Cartage ₹	Statio- nery ₹	Postage ₹	Wages ₹	Sundries ₹
100	Jan.1		To Cash							
	2	1	By Conveyance	.50	.50					
		2	By Cartage	2.50		2.50				
	3	3	By Postage	5.00				5.00		
		4	By Wages	6.00					6.00	
	4	5	By Stationery	4.00			4.00			
		6	By Conveyance	2.00	2.00					
	5	7	By Repairs to Furniture	15.00						15.00
		8	By Conveyance	1.00	1.00					
		9	By Cartage	4.00		4.00				
	6	10	By Postage	7.00				7.00		
	"	11	By Conveyance	3.00	3.00					
	"	12	By Cartage	3.00		3.00				
	"	13	By Stationery	2.00			2.00			
	"	14	By General Expenses	5.00						5.00
				60.00	6.50	9.50	6.00	12.00	6.00	20.00
			By Balance c/d	40.00						
100				100.00						
40.00			To Balance b/d							
60.00	8		To Cash							

* Voucher Numbers

ADVANTAGES OF PETTY CASH BOOK

There are mainly three advantages:

- (i) Saving of time of the chief cashier;
- (ii) Saving in labour in writing up the cash book and posting into the ledger; and
- (iii) Control over small payments.

POSTING THE PETTY CASH BOOK

In the ledger, a petty cash account is maintained, when an amount is given to the petty cashier, the petty cash account is debited. Each week or fortnight, the total of the payments made is credited to this account. The petty cash account will then show the balance in the hand of the cashier; on demand he should be able to produce it for counting. At the end of the period/year, the balance is shown in the balance sheet as part of cash balance.

Of course, the payments must be debited to their respective accounts as shown by the petty cash book. For this two methods may be used:

- (i) From the petty cash book the total of the various columns may be directly debited to the concerned accounts; or
- (ii) A journal entry may first be prepared on the basis of the petty cash book, debiting the accounts shown by the various analysis columns, and crediting the total of the payment of the petty cash accounts.

For Illustration 4 the journal entry and relevant accounts are as follows:

2022		Dr. ₹	Cr. ₹
Jan. 6	Conveyance Account	6.50	
	Cartage Account	9.50	
	Stationery Account	6.00	
	Postage Account	12.00	
	Wages Account	6.00	
	Repairs Account	15.00	
	General Expenses Account	5.00	
	To Petty Cash Account		60.00
	(Being the analysis of the Petty Cash Book for the week ending Jan. 6)		

Entry for cash handed over to the Petty Cashier		
Petty Cash Account	60	
To Cash Account		60
(Being Cash received)		

Petty Cash Account

Date 2022	Particulars	Folio	Amount ₹	Date 2022	Particulars	Folio	Amount ₹
Jan.1	To Cash		100.00	Jan. 6	By Sundries:		
"6	To Cash		60.00		Conveyance		6.50
					Cartage		9.50
					Stationery		6.00
					Postage		12.00
					Wages		6.00
					Repairs		15.00
					General Expenses		5.00

ILLUSTRATION 5

Enter the following transaction in Cash Book with Discount and Bank columns. Cheques are first treated as cash receipts –

2022		₹
March 1	Cash in Hand	15,000
	Overdraft in Bank	500
2	Cash Sales	3,000
3	Paid to Sushil Bros. by cheque	3,400
	Discount received	100
5	Sales through credit card	2,800
6	Received cheque from Srijan	6,200
7	Endorsed Srijan's cheque in favour of Adit	
9	Deposit into Bank	6,800
10	Received cheque from Aviral and deposited the same into Bank by allowing discount of ₹ 50	3,600

12	Adit informed that Srijan's cheque is dishonoured. Now cash is received from Srijan and amount is paid to Adit through own cheque	
15	Sales through Debit Card	3,200
24	Withdrawn from Bank	1,800
28	Paid to Sanchit by cheque	3,000
30	Bank charged 1% commission on sales through Debit/Credit Cards	

SOLUTION

Dr. **Cash Book** Cr.

Date	Particulars	L.F.	Discount ₹	Cash ₹	Bank ₹	Date	Particulars	L.F.	Discount ₹	Cash ₹	Bank ₹
2022 March 1	To Balance b/d			15,000		2022 March 1	By Balance b/d				500
2	To Sales			3,000		3	By Sushil Bros.		100		3,400
5	To Sales				2,800	7	By Adit			6,200	
6	To Srijan			6,200		9	By Bank	C		6,800	
9	To Cash A/c	C			6,800	12	By Adit				6,200
10	To Aviral		50		3,600	24	By Cash A/c	C			1,800
12	To Srijan			6,200		28	By Sanchit				3,000
15	To Sales A/c				3,200	30	By Commission				60
24	To Bank A/c	C		1,800		31	By Balance c/d			19,200	1,440
			50	32,200	16,400				100	32,200	16,400

Note: If the received cheque is endorsed to the other party on the same day, then no entry is required. However, in the above case posting has been done through cash column as the endorsement is done on next day.



5.5 ENTRIES FOR SALE THROUGH CREDIT/DEBIT CARDS

Now-a-days sales through Credit/Debit Cards are issued by almost every Bank in India either directly or with collaboration of some other agencies. HSBC Card, SBI Card, BOB Card, ICICI Bank Card, HDFC Card and Andhra Bank Card are some of the popular Cards.

The procedure for issuing Credit/Debit Cards are as follows -

1. A small Plastic Card, called Credit Card is issued by the bank to a prospective customer, after verifying his credibility, which is generally measured by his income sources. Debit Card is issued by bank to a customer who has an account with the bank. Now a days ATM Card issued by the bank can also be used as Debit Card. This card would contain an embossed 16 digit number and also the name of the cardholder.
2. Generally Bank charges annual subscription fees from the credit card holder. No fee is charged in case of Debit Card, though some banks charge a nominal fee on Debit Card also.
3. When the Card holder intends to buy some goods or services through Credit or Debit Card, the seller insert the customer's debit/credit card in the card machine and inputs the amount of sales and gives back to customers for feeding the password (i.e Personal Identification Number – PIN) for authorising the transactions. One copy of the receipt is given to the customer and other once is kept by the seller for its record.
4. The seller sums up the different amounts sold like this and submits, generally everyday, to his bank all the forms. The amount is credited by the bank to the seller's account and debited to the account of the Bank or the company issuing the Credit/Debit Card.
5. The bank issuing the Card, charges commission for each such transaction, which varies between 1% to 4% and is immediately debited to seller's bank account.
6. The bank sends a monthly statement to the card holder. In case of Debit Card the account is immediately debited to the card holder's account, whereas in case of Credit Card, card holder has to pay the amount in full or part. However, if not paid in full, the interest is charged.

ACCOUNTING FOR CREDIT/DEBIT CARD SALE

From the seller's point of view, this type of sale is equivalent to a cash sale. Commission charged by the bank will be treated as selling expenses. The following journal entries will be made in the seller's books of accounts.

1. Bank A/c Dr.
 To Sales Account
(Sales made through Credit/Debit Card)
2. Commission Account Dr.
 To Bank Account
(Commission charged by bank)

SUMMARY

- ◆ Cash book contains cash transactions and also bank transactions, if it has a separate book column. It is both a subsidiary book and a principal book.
- ◆ Cash book can be prepared with discount column also.
- ◆ For small payments, petty cash book is maintained separately for recording the particulars of payment and its amount. The fixed amount is given to the petty cashier for making small payments in the beginning of the period. The amount spent is replenished so that he will have again the fixed sum in the beginning of the next period. This system is known as imprest system of petty cash book.

TEST YOUR KNOWLEDGE

True and False

1. *Cash book is a subsidiary book as well as a principal book.*
2. *Two column cash book consists of two columns cash column & bank column.*
3. *Discount column of cash book is never balanced.*
4. *Contra entry is passed in a two column cash book.*
5. *If the bank column is showing the opening balance on credit side, it is an overdraft.*
6. *A cash book records cash transactions as well as credit transactions.*
7. *Discount column of cash book records the trade discount.*

Multiple Choice Questions

1. *The total of discounts column on the debit side of the cash book, recording cash discount deducted by customers when paying their accounts, is posted to the _____*
 - (a) *Credit of the discount allowed account.*
 - (b) *Debit of the discount allowed account*
 - (c) *Credit of the discount received account.*
2. *Cash book is a type of _____ but treated as a _____ of accounts.*
 - (a) *Subsidiary book, principal book*
 - (b) *Principal book, subsidiary book*
 - (c) *Subsidiary book, subsidiary book*

3. Which of the following is not a column of a three-column cash book?
 - (a) Cash column
 - (b) Bank column
 - (c) Petty cash column
4. Contra entries are passed only when _____
 - (a) Double-column cash book is prepared
 - (b) Three-column cash book is prepared
 - (c) Simple cash book is prepared
5. The Cash Book records _____
 - (a) All cash receipts
 - (b) All cash payments
 - (c) All cash receipts and payments
6. The balance in the petty cash book is _____
 - (a) An expense
 - (b) A profit
 - (c) An asset
7. If Ram has sold goods for cash, the entry will be recorded _____
 - (a) In the Cash Book
 - (b) In the Sales Book
 - (c) In the Journal

Theory Questions

1. Is cash book a subsidiary book or a principal book? Explain.
2. What are the various kinds of cash book?
3. What are the advantages of a three column cash book?

Practical Questions

1. Shri Ramaswamy maintains a Columnar Petty Cash Book on the Imprest System. The imprest amount is ₹500. From the following information, show how his Petty Cash Book would appear for the week ended 12th September, 2022:

₹

7-9-2022	Balance in hand	134.90
	Received Cash reimbursement to make up the imprest	365.10
	Stationery	49.80
8-9-2022	Miscellaneous Expenses	20.90
9-9-2022	Repairs	156.70
10-9-2022	Travelling	68.50
11-9-2022	Stationery	71.40
12-9-2022	Miscellaneous Expenses	6.30
13-9-2022	Repairs	48.30

ANSWERS/HINTS

True and False

1. True: Since the balance is directly taken to the Trial balance from cash book. Hence, it is a subsidiary book as well as principal book.
2. True: Two column cash book consists of two columns either cash column & discount column or cash column & bank column.
3. True: Discount column is totalled and transferred to the discount allowed or received account.
4. False: Contra entry is passed in a three column cash book which includes bank and cash columns.
5. True: The debit side of opening balance shows a favourable balance, whereas the credit balance is an unfavourable balance and treated as overdraft.
6. False: A cash book records only cash transactions.
7. False: Discount column of cash book records the cash discount. Trade discount is not shown in the books of accounts.

Multiple Choice Questions

1.	(b)	2.	(a)	3.	(c)	4.	(b)	5.	(c)	6.	(c)
7.	(a)										

Theoretical Questions

1. Cash transactions are straightaway recorded in the Cash Book and on the basis of such a record, ledger accounts are prepared. Therefore, the Cash Book is a subsidiary book. But the Cash Book itself serves as the cash account and the bank account, if bank column is also included; the balances are entered in the trial balance directly. The Cash Book, therefore, is part of the ledger also. Hence, it is also treated as the principal book. The Cash Book is thus both a subsidiary book and a principal book.
2. The main Cash Book may be of the three types:
 - (i) Simple Cash Book;
 - (ii) Two-column Cash Book;
 - (iii) Three-column Cash Book.

In addition to the main Cash Book, firms also generally maintain a petty cash book but that is purely a subsidiary book.

3. The advantages of three column Cash Book are that -
 - (a) the Cash Account and the Bank Account are prepared simultaneously, therefore the double entry is completed in the Cash Book itself. Thus the contra entries can be easily cross-checked in Cash column in one side and the Bank column in the other side of the Cash Book. The chances of error are also reduced.
 - (b) the information regarding Cash in Hand and the Bank Balance can be obtained very easily and quickly as there is no need to prepare Ledger of the Cash and Bank Account.

Practical Problems

1. Petty Cash Book

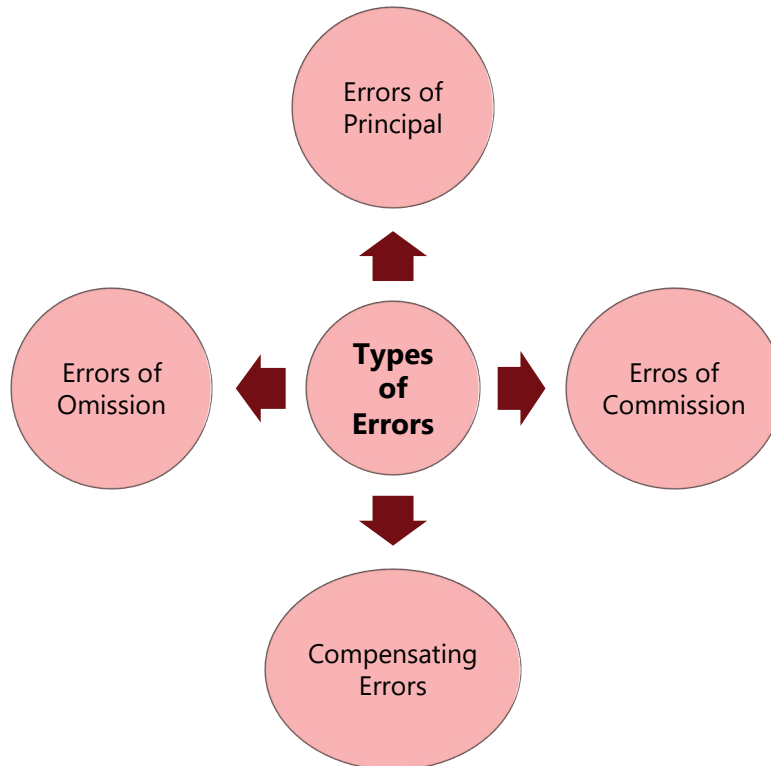
Date 2022	Receipts	Amount ₹	Date 2022	Payments	Total Amount ₹	Stationery ₹	Travelling ₹	Misc Exps. ₹	Repairs ₹
Sept. 7	To Balance b/d	134.90	7	By Stationery	49.80	49.80			
	To Reimbursement	365.10	8	By Misc. Expenses	20.90			20.90	
			9	By Repairs	156.70				156.70
			10	By Travelling	68.50		68.50		
			11	By Stationery	71.40	71.40			
			12	By Misc. Expenses	6.30			6.30	
			13	By Repairs	48.30				48.30
					421.90	121.20	68.50	27.20	205.00
				By Balance c/d	78.10				
		500.00			500.00				
	To Balance b/d	78.10							

UNIT 6 : RECTIFICATION OF ERRORS

LEARNING OUTCOMES

After studying this unit, you will be able to:

- ◆ Understand different types of errors which may occur in the course of recording transactions and events.
- ◆ Be familiar with the steps involved in locating errors.
- ◆ Learn the nature of one-sided errors and two-sided errors.
- ◆ Understand why suspense account is opened for rectification of errors.
- ◆ Understand the technique of correcting errors of one period in the next accounting period.

UNIT OVERVIEW**6.1 INTRODUCTION**

Unintentional omission or commission of amounts and accounts in the process of recording the transactions are commonly known as errors. These various unintentional errors can be committed at the stage of collecting financial information/data on the basis of which financial statements are drawn or at the stage of recording this information. Also errors may occur as a result of mathematical mistakes, mistakes in applying accounting policies, misinterpretation of facts, or oversight. To check the arithmetic accuracy of the journal and ledger accounts, trial balance is prepared. If the trial balance does not tally, then it can be said that there are errors in the accounts which require rectification thereof. Some of these errors may affect the Trial Balance and some of these do not have any impact on the Trial Balance although such errors may affect the determination of profit or loss, assets and liabilities of the business.

Illustrative Case of Errors and their Nature

We have seen that after preparing ledger accounts a trial balance is taken out where debit and credit balances are separately listed and totalled. If the totals of debit and credit do not

agree, it is definite that there are some errors. We shall now study the types of errors which may be committed and how they may be rectified. For this purpose, the working of the following illustrative cases should be carefully seen.

Illustrative Cases of Errors

- (a) **Wrong Entry:** Let us start from the first phase of the accounting process. Where wrong amount of transactions and events are recorded in the subsidiary books, Journal Proper and Cash Book.

Example 1: Credit purchases ₹17,270 are entered in the Purchases Day Book as ₹17,720. Credit sales of ₹15,000 gross less 1% trade discount are wrongly entered in Sales Day Book at ₹15,000. Cheque issued ₹19,920 are wrongly entered in the credit of bank column in the Cash Book as ₹19,290.

- (b) **Wrong casting of subsidiary books:** Subsidiary books are totalled periodically and posted to the appropriate ledger accounts. There may be totalling errors. Totalling errors may arise due to wrong entry or simply these may be independent errors.

Example 2: For the month of January, 2022 total of credit sales are ₹1,75,700, this is wrongly totalled as ₹1,76,700 and posted to sales account as ₹1,76,700.

- (c) **In case of cash book,** wrong castings will result in wrong calculation of the balance c/d.

Example 3: The following cash transactions of M/s. Tularam & Co. occurred:

2023

Jan. 1	Balance - cash ₹1,200 bank ₹16,000;
Jan. 2	Cheque issued to M/s. Bholaram & Co., a supplier, for ₹22,500;
Jan. 6	Cheque collected from M/s. Scindia & Bros. ₹42,240 and deposited for clearance;
Jan. 7	Cash sales ₹27,200 and paid wages ₹12,400;
Jan. 8	Cash sales ₹ 37,730 and cash deposited to bank ₹ 35,000.

The following Cash Book entries are passed:

Dr.				Cr.			
				Cash Book			
Date	Particulars	Cash	Bank	Date	Particulars	Cash	Bank
2023		₹	₹	2023		₹	₹
Jan. 1	To Balance b/d	1,200	16,000	Jan. 2	By M/s Bholaram & Co. A/c		22,500

Jan. 6	To M/s. Scindia & Bros. A/c		42,420		By Wages A/c	12,200	
Jan. 7	To Sales A/c	27,200			By Bank A/c	34,500	
Jan. 8	To Sales A/c	37,370			By Balance c/d	19,070	71,420
Jan. 8	To Cash A/c		34,500				
		65,770	93,920			65,770	93,920

Wrong entries and wrong casting are shown in bold prints. However, errors of cash entries generally are not carried. Usually cash balances are tallied daily. So errors are identified at an early stage. But bank balance cannot be checked daily and thus errors may be carried until bank reconciliation is done. In the above example, there are four wrong entries and one wrong casting. Bank and cash balances are affected by these errors.

- (d) **Wrong posting from subsidiary books:** In this case, the wrong amount may be posted to the ledger account or the amount may be posted to the wrong side or to the wrong account. For example, purchases from A may be posted to B's account.
- (e) **Wrong casting of ledger balances:** Likewise Cash Book, any ledger account balance may be casted wrongly. Obviously wrong postings make the balance wrong; but that is not wrong casting of balances. Whenever there arises independent casting error as in the case of bank column in the Cash Book of example (4), that is called wrong casting to ledger balances.

Example 4: The following are the credit purchases of M/s. Ballav Bros.:

2023

Jan. 1 Purchases from M/s. Saurabh & Co.- gross ₹1,00,000 less 1% trade discount.

Jan. 3 Purchases from M/s. Netai & Co.- gross ₹ 70,000 less 1% trade discount.

Jan. 6 Purchases from M/s. Saurabh & Co.- gross ₹ 60,000 less 1% trade discount

Let us cast M/s. Saurabh & Co.'s Account:

Dr. **M/s Saurabh & Co. Account** Cr.

Date	Particulars	Amount ₹	Date	Particulars	Amount ₹
2023			2023		
Jan. 1	To Balance c/d	1,55,400	Jan. 1	By Purchases A/c	99,000
			Jan. 6	By Purchases A/c	59,400
		1,55,400			*1,55,400

*While casting the credit side, an error has been committed and so the account is wrongly balanced.

Example 5: Goods are purchased on credit from M/s. Saurabh & Co. for ₹ 27,030 and from M/s. Karnataka Suppliers for ₹ 28,050. The following Purchase Day Book is prepared:

Purchases Day Book

Date	Particulars	Amount
		₹
	M/s. Saurabh & Co.	27,050
	M/s. Karnataka Suppliers	28,030
		55,080

In the above Purchase Day Book, both the transactions are entered wrongly but the first error has been compensated by the second. Even if these errors are not rectified Trial Balance would tally.

Trial Balance

Particulars	Dr.	Cr.
	₹	₹
M/s. Saurabh & Co.		27,050
M/s. Karnataka Suppliers		28,030
Purchases Account	55,080	
	55,080	55,080



6.2 STAGES OF ERRORS

Errors may occur at any of the following stages of the accounting process:

AT THE STAGE OF RECORDING THE TRANSACTIONS IN JOURNAL

Following types of errors may happen at this stage:

- (i) Errors of principle,
- (ii) Errors of omission,
- (iii) Errors of commission.

AT THE STAGE OF POSTING THE ENTRIES IN LEDGER

- (i) Errors of omission:
 - (a) Partial omission,
 - (b) Complete omission.
- (ii) Errors of commission:
 - (a) Posting to wrong account,
 - (b) Posting on the wrong side,
 - (c) Posting of wrong amount.

AT THE STAGE OF BALANCING THE LEDGER ACCOUNTS

- (i) Wrong Totalling of accounts,
- (ii) Wrong Balancing of accounts.

AT THE STAGE OF PREPARING THE TRIAL BALANCE

- (i) Errors of omission,
- (ii) Errors of commission:
 - (a) Taking wrong account,
 - (b) Taking wrong amount,
 - (c) Taking to the wrong side.

On the above basis, we can classify the errors in four broad categories:

Errors of Principle	Errors of Omission	Errors of Commission	Compensating Errors

**6.3 TYPES OF ERRORS**

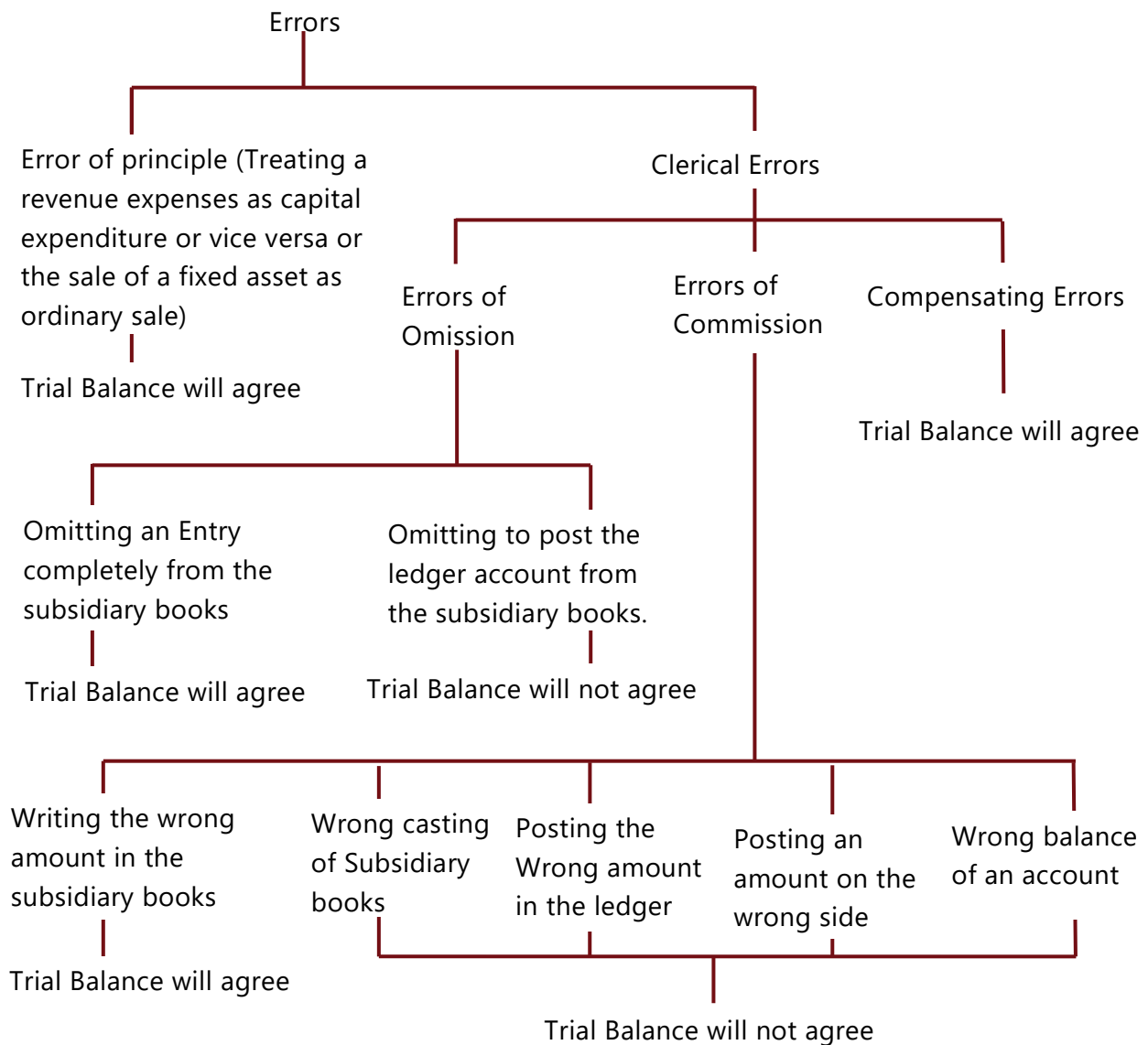
Basically errors are of two types:

- (a) **Errors of principle:** When a transaction is recorded in contravention of accounting principles, like treating the purchase of an asset as an expense, it is an error of principle. In this case, there is no effect on the trial balance since the amounts are placed on the correct side, though in a wrong account. Suppose on the purchase of a computer, the office expenses account is debited; the trial balance will still agree.

- (b) **Clerical errors:** These errors arise because of mistake committed in the ordinary course of the accounting process. These are of three types:
- (i) *Errors of Omission:* If a transaction is completely or partially omitted from the books of account, it will be a case of omission. Examples would be: not recording a credit purchase of furniture or not posting an entry into the ledger.
 - (ii) *Errors of Commission:* If an amount is posted in the wrong account or it is written on the wrong side or the totals are wrong or a wrong balance is struck, it will be a case of "errors of commission."
 - (iii) *Compensating Errors:* If the effect of errors committed cancel out, the errors will be called compensating errors. The trial balance will agree. Suppose an amount of ₹10 received from A is not credited to his account and the total of the sales book is ₹10 in excess. The omission of credit to A's account will be made up by the increased credit to the Sales Account.

From another point of view, error may be divided into two categories:

- (a) Those that affect the trial balance - because of these errors, trial balance does not agree; these are the following:
 - (i) Wrong casting of the subsidiary books.
 - (ii) Wrong balancing of an account.
 - (iii) Posting an amount on the wrong side.
 - (iv) Posting the wrong amount.
 - (v) Omitting to post an amount from a subsidiary book.
 - (vi) Omitting to post the totals of subsidiary book.
 - (vii) Omitting to write the cash book balances in the trial balance.
 - (viii) Omitting to write the balance of an account in the trial balance.
 - (ix) Writing a balance in wrong column of the trial balance.
 - (x) Totalling the trial balance wrongly.
- (b) The errors that do not affect the trial balance are the following:
 - (i) Omitting an entry altogether from the subsidiary book.
 - (ii) Making an entry with the wrong amount in the subsidiary book.
 - (iii) Posting an amount in a wrong account but on the correct side, e.g., an amount to be debited to A is debited to B, the trial balance will still agree.



6.4 STEPS TO LOCATE ERRORS

Even if there is only a very small difference in the trial balance, the errors leading to it must be located and rectified. A small difference may be the result of a number of errors. The following steps will be useful in locating errors :

- (i) The two columns of the trial balance should be totalled again. If in place of a number of accounts, only one amount has been written in the trial balance the list of such accounts should be checked and totalled again. List of Trade receivables is the example from which Trade receivable balance is derived.

- (ii) It should be seen that the cash and bank balances have been written in the trial balance.
- (iii) The exact difference in the trial balance should be established. The ledger should be gone through again; it is possible that a balance equal to the difference has been omitted from the trial balance. The difference should also be halved; it is possible that balance equal to half the difference has been written in the wrong column.
- (iv) The ledger accounts should be balanced again.
- (v) The casting of subsidiary books should be checked again, especially if the difference is ₹ 1, ₹ 100 etc.
- (vi) If the difference is very big, the balance in various accounts should be compared with the corresponding accounts in the previous period. If the figures differ materially, those cases should be further scrutinised; it is possible that an error has been committed. Suppose the sales account for the current year shows a balance of ₹ 32,53,000 whereas it was ₹ 36,45,000 last year; it is possible that there is an error in the Sales Account.
- (vii) Postings of the amounts equal to the difference or half the difference should be checked. It is possible that an amount has been omitted to be posted or has been posted on the wrong side.
- (viii) If there is still a difference in the trial balance, a complete checking will be necessary. The posting of all the entries including the opening entry should be checked. It may be better to begin with the nominal accounts.



6.5 RECTIFICATION OF ERRORS

Errors should never be corrected by overwriting. The correction should be made by making another suitable entry, called as rectification entry. In fact the rectification of an error depends on at which stage it is detected. An error can be detected at any one of the following stages:

- (a) Before preparation of Trial Balance.
- (b) After Trial Balance but before the final accounts are drawn.
- (c) After final accounts, i.e., in the next accounting period.

6.5.1 Before preparation of Trial Balance

There are some errors which affect one side of an account or which affect more than one account in such a way that it is not possible to pass a complete rectification entry. In other words, there are some errors which can be corrected, if detected at this stage, by making rectification statement in the appropriate side(s) of concerned account(s). It is important to

note here that such errors may involve only one account or more than one account. Read the following illustrations:

- (i) The sales book for November is undercast by ₹ 200. The effect of this error is that the Sales Account has been credited short by ₹ 200. Since the account is posted by the total of the sales book, there is no error in the accounts of the customers since they are posted with amounts of individual sales. Hence only the Sales Accounts is to be corrected. This will be done by making an entry for ₹ 200 on the credit side: "By undercasting of Sales Book for November ₹ 200".
- (ii) While posting the discount column on the debit side of the cash book the discount of ₹ 10 allowed to Ramesh has not been posted. There is no error in the cash book, the total of discount column presumably has been posted to the discount account on the debit side. The error is in not crediting Ramesh by ₹ 10. This should now be done by the entry "By omission of posting of discount on ----- ₹10".
- (iii) ₹ 200 received from Ram has been entered by mistake on the debit side of his account. Since the cash book seems to have been correctly written, the error is only in the account of Ram - he should have been credited and not debited by ₹ 200. Not only the wrong debit is to be removed but also a credit of ₹ 200 is to be given. This can be done now by entering ₹ 400 on the credit side of his account. The entry will be "By Posting on the wrong side - ₹ 400".
- (iv) ₹ 50 was received from Mahesh and entered on the debit side of the cash book but was not posted to his account. By the error, which affects only the account of Mahesh, ₹ 50 has been omitted from the credit side of his account. The rectification will be by the entry. "By Omission of posting on the ₹ 50."
- (v) ₹ 51 paid to Mohan has been posted as ₹15 to the debit of his account. Mohan has been debited short by ₹ 36. The rectifying entry is "To mistake in posting on ₹ 36".
- (vi) Goods sold to Ram for ₹1,000 was wrongly posted from sales day book to the debit of purchase account. Ram has however been correctly debited. Here the error affects two accounts, viz., purchases account and sales account but we cannot pass a journal entry for its rectification because both the accounts need to be credited. The rectification will be done by the entry "By wrong posting on ₹ 1,000" in the credit of purchases account and also "By omission of posting on - ₹ 1,000" in the credit sales account.
- (vii) Bills receivable from Mr. A of ₹ 500 was posted to the credit of Bills payable Account and also credited to A account. Here also although two accounts are involved we cannot pass a complete journal entry for rectification. The rectification will be done by the entry "To wrong posting on ₹ 500" in debit of Bills payable Account and also "To omission of posting on ₹ 500" in the debit of Bills Receivable Account.

- (viii) Goods purchased from Vinod for ₹ 1,000 was wrongly credited to Vimal account by ₹ 100. Again we cannot pass a complete journal entry for rectification even though two accounts are involved. The rectification will be done by the entry "To wrong posting on ₹100" in the debit of Vimal account and "By omission of posting on ₹ 1,000" in the credit of Vinod account.

Thus, from the above illustrations, it is clear that the general rule of errors affecting two accounts can be corrected by a journal entry does not hold true always.

ILLUSTRATION 1

How would you rectify the following errors in the book of Rama & Co.?

1. *The total to the Purchases Book has been undercast by ₹ 100.*
2. *The Returns Inward Book has been undercast by ₹ 50.*
3. *A sum of ₹ 250 written off as depreciation on Machinery has not been debited to Depreciation Account.*
4. *A payment of ₹ 75 for salaries (to Mohan) has been posted twice to Salaries Account.*
5. *The total of Bills Receivable Book ₹ 1,500 has been posted to the credit of Bills Receivable Account.*
6. *An amount of ₹151 for a credit sale to Hari, although correctly entered in the Sales Book, has been posted as ₹ 115.*
7. *Discount allowed to Satish ₹ 25 has not been entered in the Discount Column of the Cash Book. the amount has been posted correctly to the credit of his personal account.*

SOLUTION

1. The Purchases Account should receive another debit of ₹100 since it was debited short previously:
"To Undercasting of Purchases Book for the month of --- ₹100."
2. Due to this error the Returns Inward Account has been posted short by ₹ 50 : the correct entry will be:
"To Undercasting of Returns Inward Book for the month of --- ₹50."
3. The omission of the debit to the Depreciation Account will be rectified by the entry:
"To Omission of posting on ₹ 250".
4. The excess debit will be removed by a credit in the Salaries Account by the entry:
"By double posting on ₹ 75".

5. ₹1,500 should have been debited to the Bills Receivable Account and not credited. To correct the mistake, the Bills Receivable Account should be debited by ₹ 3,000 by the entry:
"To Wrong posting of B/R received on ₹ 3,000"
6. Hari's personal A/c is debited ₹ 36 short. The rectification entry will be:
"To Wrong posting ₹ 36".
7. Due to this error, the discount account has been debited short by ₹ 25. The required entry is :
"To Omission of discount allowed to Satish on ₹ 25."

So far we have discussed the correction of errors which affected only one Account or more than one account but for which rectifying entries were not complete journal entries. We shall now take up the correction of errors which affect more than one account in such a way that complete journal entries are possible for their rectification. Read the following illustrations:

- (i) The purchase of machinery for ₹ 2,000 has been entered in the purchases book. The effect of the entry is that the account of the supplier Ram & Co. has been credited by ₹ 2,000 which is quite correct. But the debit to the Purchases Account is wrong : the debit should be to Machinery Account. To rectify the error, the debit in the purchases Account has to be transferred to the Machinery Account. The correcting entry will be to Credit Purchases Account and debit the Machinery Account. Please see the three entries made below: the last entry rectifies the error:

Particulars	Debits ₹	Credits ₹
Wrong Entry:		
Purchases Account	2,000	
To Ram & Co.		2,000
Correct Entry:		
Machinery Account	2,000	
To Ram & Co.		2,000
Rectifying Entry:		
Machinery Account	2,000	
To Purchases Account		2,000

- (ii) ₹100 received from Kamal Kishore has been credited in the account of Krishan Kishore. The error is that there is a wrong credit in the account of Krishan Kishore and omission of credit in the account of Kamal Kishore; Krishan Kishore should be debited and Kamal Kishore be credited. The following three entries make this clear:

Particulars	Debits ₹	Credits ₹
Wrong Entry:		
Cash Account	100	
To Krishan Kishore		100
Correct Entry:		
Cash Account	100	
To Kamal Kishore		100
Rectifying Entry:		
Krishan Kishore	100	
To Kamal Kishore		100

- (iii) The sale of old machinery, ₹1,000 has been entered in the sales book. By this entry the account of the buyer has been correctly debited by ₹1,000. But instead of crediting the Machinery Account. Sales Account has been credited. To rectify the error this account should be debited and the Machinery Account credited. See the three entries given below:

Particulars	Debits ₹	Credits ₹
Wrong Entry:		
Buyer's Account	1,000	
To Sales Account		1,000
Correct Entry:		
Buyer's Account	1,000	
To Machinery Account		1,000
Rectifying Entry:		
Sales Account	1,000	
To Machinery Account		1,000

ILLUSTRATION 2

The following errors were found in the book of Ram Prasad & Sons. Give the necessary entries to correct them.

- (1) ₹ 500 paid for furniture purchased has been charged to ordinary Purchases Account.
- (2) Repairs made were debited to Building Account for ₹ 50.
- (3) An amount of ₹100 withdrawn by the proprietor for his personal use has been debited to Trade Expenses Account.
- (4) ₹100 paid for rent debited to Landlord's Account.
- (5) Salary ₹ 125 paid to a clerk due to him has been debited to his personal account.
- (6) ₹ 100 received from Shah & Co. has been wrongly entered as from Shaw & Co.
- (7) ₹ 700 paid in cash for a typewriter was charged to Office Expenses Account.

SOLUTION**Journal**

Sr. No.	Particulars	Dr. ₹	Cr. ₹
(1)	Furniture A/c To Purchases A/c (Correction of wrong debit to Purchases A/c for furniture purchased)	500	500
(2)	Repairs A/c To Building A/c (Correction of wrong debit to building A/c for repairs made)	50	50
(3)	Drawings A/c. To Trade Expenses A/c (Correction of wrong debit to Trade Expenses A/c for cash withdrawn by the proprietor for his personal use)	100	100
(4)	Rent A/c To Landlord's Personal A/c (Correction of wrong debit to landlord's A/c for rent paid)	100	100

(5)	Salaries A/c To Clerk's (Personal) A/c (Correction of wrong debit to Clerk's personal A/c for salaries paid)	125	125
(6)	Shaw & Co. To Shah & Co. (Correction of wrong credit to Shaw & Co. Instead of Shah & Co.)	100	100
(7)	Typewriter A/c To Office Expenses A/c (Correction of wrong debit to Office Expenses A/c for purchase of typewriter)	700	700

ILLUSTRATION 3

Give journal entries to rectify the following:

- (1) A purchase of goods from Ram amounting to ₹150 has been wrongly entered through the Sales Book.
- (2) A Credit sale of goods amounting ₹120 to Ramesh has been wrongly passed through the Purchase Book.
- (3) On 31st December, 2022 goods of the value of ₹ 300 were returned by Hari Saran and were taken into inventory on the same date but no entry was passed in the books.
- (4) An amount of ₹ 200 due from Mahesh Chand, which had been written off as a Bad Debt in a previous year, was unexpectedly recovered, and had been posted to the personal account of Mahesh Chand.
- (5) A Cheque for ₹ 100 received from Man Mohan was dishonoured and had been posted to the debit of Sales Returns Account.

SOLUTION**Journal**

Sr.No.	Particulars	Dr.(₹)	Cr.(₹)
(1)	Purchases A/c	150	
	Sales A/c	150	
	To Ram		300
	(Correction of wrong entry in the sales Book for a purchases of goods from Ram)		

(2)	Ramesh	240	
	To Purchases A/c		120
	To Sales A/c		120
	(Correction of wrong entry in the Purchases Book of a credit sale of goods to Ram)		
(3)	Returns Inwards A/c	300	
	To Hari Saran		300
	(Entry of goods returned by him and taken in inventory omitted from records)		
(4)	Mahesh Chand	200	
	To Bad Debts Recovered A/c		200
	(Correction of wrong credit to Personal A/c in respect of recovery of previously written off bad debts)		
(5)	Man Mohan	100	
	To Sales Return A/c		100
	(Correction of wrong debit to Sales Returns A/c for dishonour of cheque received from Man Mohan)		

Thus, it can be said that errors detected before the preparation of trial balance can be rectified either through rectification statements (not entries) or through rectification entries.

6.5.2 After Trial Balance but before Final Accounts

The method of correction of error indicated so far is appropriate when the errors have been located before the end of the accounting period. After the corrections, the trial balance will agree. Sometimes the trial balance is artificially made to agree despite of errors by opening a suspense account and putting the difference in the trial balance to the account - the suspense account will be debited if the total of the credit column in the trial balance exceeds the total of the debit column and vice versa.

One must note that such agreement of the trial balance is not real. Effort must be made to locate the errors.

The rule of rectifying errors detected at this stage is simple. Those errors for which complete journal entries were not possible in the earlier stage of rectification (i.e., before trial balance) can now be rectified by way of journal entry(s) with the help of suspense account, for it these errors which gave rise to the suspense account in the trial balance. The rectification entry for other type of error i.e. error affecting more than one account in such a way that a complete

journal entry is possible for its rectification, can be rectified in the same way as in the earlier stage (i.e. before trial balance).

In a nutshell, it can be said that each and every error detected at this stage can only be corrected by a complete journal entry. Those errors for which journal entries were not possible at the earlier stage will now be rectified by a journal entry(s), the difference or the unknown side is being taken care of by suspense account. Those errors for which entries were possible even at the first stage will now be rectified in the same way.

Suppose, the sales book for November, 2022 is casted short by ₹100 ; as a consequence the trial balance will not agree. The credit column of the trial balance will be ₹100 short and a Suspense Account will be credited by ₹100. To rectify the error the Sales Account will be credited (to increase the credit to the right figure. Now one error remains, the Suspense Account must be closed by debiting the Suspense Account. The entry will be:

Suspense Account	₹100	
To Sales Account		₹100
(Correction of error of undercasting the sales Book for November 2022)		

ILLUSTRATION 4

Correct the following errors (i) without opening a Suspense Account and (ii) opening a Suspense Account:

- The Sales Book has been totalled ₹100 short.
- Goods worth ₹150 returned by Green & Co. have not been recorded anywhere.
- Goods purchased ₹250 have been posted to the debit of the supplier Gupta & Co.
- Furniture purchased from Gulab & Bros, ₹1,000 has been entered in Purchases Day Book.
- Discount received from Red & Black ₹15 has not been entered in the Discount Column of the Cash Book.
- Discount allowed to G. Mohan & Co. ₹18 has not been entered in the Discount Column of the Cash Book. The account of G. Mohan & Co. has, however, been correctly posted.

SOLUTION

If a Suspense Account is not opened.

- Since sales book has been casted ₹100 short, the Sales Account has been similarly credited ₹100 short. The correcting entry is to credit the Sales Account by ₹100 as "By wrong totalling of the Sales Book ₹100".

- (b) To rectify the omission, the Returns Inwards Account has to be debited and the account of Green & Co. credited. The entry:

Returns Inward Account	Dr.	₹150	
To Green & Co.			₹150
(Goods returned by the firm, previously omitted from the Returns Inward Book)			

- (c) Gupta & Co. have been debited ₹250 instead of being credited. This account should now be credited by 500 to remove the wrong debit and to give the correct credit. The entry will be on the credit side... "By errors in posting ₹500".
- (d) By this error Purchases Account has to be debited by ₹1,000 whereas the debit should have been to the Furniture Account. The correcting entry will be:

Furniture Account	Dr.	₹1,000	
To Purchases Account			₹1,000
(Correction of the mistake by which of the Furniture Account)			

- (e) The discount of ₹15 received from Red & Black should have been entered on the credit side of the cash book. Had this been done, the Discount Account would have been credited (through the total of the discount column) and Red & Black would have been debited. This entry should not be made:

Red & Black	Dr.	₹15	
To Discount Account			₹15
(Rectification of the error by which the discount allowed by the firm was not entered in Cash Book)			

- (f) In this case the account of the customer has been correctly posted; the Discount Account has been debited ₹18 short since it has been omitted from the discount column on the debit side of the cash book. The discount account should now be debited by the entry; "To Omission of entry in the Cash Book ₹18."

If a Suspense Account is opened :

	Particulars	Dr.(₹)	Cr.(₹)
(a)	Suspense Account	100	
	To Sales Account		100
	(Being the correction arising from under- casting of Sales Day Book)		

(b)	Return Inward Account To Green & Co (Being the recording of unrecorded returns)	150	150
(c)	Suspense Account To Gupta & Co. (Being the correction of the error by which Gupta & Co. was debited instead of being credited by ₹ 250).	500	500
(d)	Furniture Account To Purchases Account (Being the correction of recording purchase of furniture as ordinary purchases)	1,000	1,000
(e)	Red & black To Discount Account (Being the recording of discount omitted to be recorded)	15	15
(f)	Discount Account To Suspense Account (Being the correction of omission of the discount allowed from Cash Book customer's account already posted correctly).	18	18

Suspense Account

Dr. Date	Particulars	Amount ₹	Date	Particulars	Cr. Amount ₹
	To Sales A/c	100		By Difference in	
	To Gupta & Co.	500		Trial Balance	582
				By Discount A/c	18
		600			600

Notes:

- (i) One should note that the opening balance in the Suspense Account will be equal to the difference in the trial balance.
- (ii) If the question is silent as to whether a Suspense Account has been opened, the student should make his assumption, state it clearly and then proceed.

ILLUSTRATION 5

Correct the following errors found in the books of Mr. Dutt. The Trial Balance was out by ₹ 493 excess credit. The difference thus has been posted to a Suspense Account.

- (a) An amount of ₹100 was received from D. Das on 31st December, 2022 but has been omitted to enter in the Cash Book.
- (b) The total of Returns Inward Book for December has been casted short by ₹100.
- (c) The purchase of an office table costing ₹ 300 has been passed through the Purchases Day Book.
- (d) ₹ 375 paid for Wages to workmen for making show-cases had been charged to "Wages Account".
- (e) A purchase of ₹ 67 had been posted to the trade payables' account as ₹ 60.
- (f) A cheque for ₹ 200 received from P. C. Joshi had been dishonoured and was passed to the debit of "Allowances Account".
- (g) ₹ 1,000 paid for the purchase of a motor cycle for Mr. Dutt for his personal use had been charged to "Miscellaneous Expenses Account".
- (h) Goods amounting to ₹100 had been returned by customer and were taken into inventory, but no entry in respect thereof, was made into the books.
- (i) A sale of ₹ 200 to Singh & Co. was wrongly credited to their account. Entry was correctly made in sales book.

SOLUTION**(a)****Journal Entries**

Particulars		L.F.	₹	₹
(a)	Cash Account Dr.		100	
	To D. Das (Being the amount received)			100
(b)	Returns Inward Account Dr.		100	
	To Suspense Account (Being the mistake in totalling the Returns Inward Book corrected)			100

(c)	Furniture Account Dr. To Purchases Account (Being the rectification of mistake by which purchase of furniture was entered in Purchases book and hence now corrected by crediting the Purchases Account)		300	300
(d)	Furniture Account Dr. To Wages Account (Being the wages paid to workmen for making show-cases which should have been capitalised and not to be charged to Wages Account)		375	375
(e)	Suspense Account Dr. To Creditors (personal) Account (Being the mistake in crediting the Trade payables Account less by ₹ 7, now corrected)		7	7
(f)	P.C. Joshi Dr. To Allowances Account (Being the cheque of P.C. Joshi dishonoured, previously debited to Allowances Account)		200	200
(g)	Drawings Account Dr. To Miscellaneous Expenses (Being the motor cycle purchased for Mr. Dutt debited to his Drawings Account instead of Miscellaneous Expenses Account as previously done by mistake)		1,000	1,000
(h)	Returns Inward Account Dr. To Debtors (Personal) Account (Correction of the omission to record return of goods by customers)		100	100
(i)	Singh & Co. Dr. To Suspense Account (Being the correction of mistake by which the account of Singh & Co. was credited by ₹ 200 instead of being debited)		400	400

Suspense Account

Dr.					Cr.
Date	Particulars	Amount	Date	Particulars	Amount
2022		₹	2022		₹
Dec.31	To Difference in Trial Balance	493	Dec. 31	By Returns Inwards A/c	100
" "	To Trade Payables A/c	<u>7</u>	" "	By Singh & Co.	<u>400</u>
		500			500

ILLUSTRATION 6

The following errors, affecting the account for the year 2022 were detected in the books of Jain Brothers, Delhi:

- (1) Sale of old Furniture ₹ 150 treated as sale of goods.
- (2) Receipt of ₹ 500 from Ram Mohan credited to Shyam Sunder.
- (3) Goods worth ₹ 100 brought from Mohan Narain have remained unrecorded so far.
- (4) A return of ₹ 120 from Mukesh posted to his debit.
- (5) A return of ₹ 90 to Shyam Sunder posted as ₹ 9 in his account.
- (6) Rent of proprietor's residence, ₹ 600 debited to rent A/c.
- (7) A payment of ₹ 215 to Mohammad Sadiq posted to his credit as ₹ 125.
- (8) Sales Book casted short by ₹ 900 .
- (9) The total of Bills Receivable Book ₹ 1,500 left unposted.

You are required to pass the necessary rectifying entries and show how the trial balance would be affected by the errors.

SOLUTION

Journal

	Particulars	L.F.	Dr. Amount ₹	Cr. Amount ₹
(1)	Sales Account Dr. To Furniture Account (Rectification of sales of furniture treated as sales of goods)		150	150

(2)	Shyam Sunder To Rama Mohan (Rectification of a receipt from Ram Mohan credited to Shyam Sunder)	Dr.		500	500
(3)	Purchases Account To Mohan Narain (Purchases of goods from Mohan Narain unrecorded, now corrected)	Dr.		100	100
(6)	Drawing Account To Rent Account (Rectification of Payment of rent of proprietor's residence treated as payment of office rent)	Dr.		600	600

N.B. : For 4, 5, 7, 8, 9 no journal entry can be passed as they affect a single account. The correction will be as under:

- (4) Credit Mukesh's Account with ₹ 240.
- (5) Debit the account of Shyam Sunder by ₹ 81.
- (7) Debit the account of Mohammad Sadiq by ₹ 340.
- (8) Credit Sales Account by ₹ 900.
- (9) Debit Bills Receivable Account with ₹ 1,500.

Effect of the Errors on Trial Balance

1. No effect
2. No effect
3. No effect
4. Trial Balance credit total short by ₹ 240.
5. Trial Balance debit total short by ₹ 81.
6. No effect
7. Trial Balance debit total short by ₹ 340.
8. Trial Balance credit total short by ₹ 900.
9. Trial Balance debit total short by ₹ 1,500.

ILLUSTRATION 7

Write out the Journal Entries to rectify the following errors, using a Suspense Account.

- (1) Goods of the value of ₹ 100 returned by Mr. Sharma were entered in the Sales Day Book and posted therefrom to the credit of his account;
- (2) An amount of ₹150 entered in the Sales Returns Book, has been posted to the debit of Mr. Philip, who returned the goods;
- (3) A sale of ₹ 200 made to Mr. Ghanshyam was correctly entered in the Sales Day Book but wrongly posted to the debit of Mr. Radheshyam as ₹ 20; and
- (4) The total of "Discount Allowed" column in the Cash Book for the month of September, 2022 amounting to ₹ 250 was not posted.

SOLUTION**Journal**

	Particulars		L.F.	Dr. ₹	Cr. ₹
(1)	Sales Account Sales Returns Account To Suspense Account (The value of goods returned by Mr. Sharma wrongly posted to Sales and omission of debit to Sales Returns Account, now rectified)	Dr. Dr.		100 100	200
(2)	Suspense Account To Mr. Philip (Wrong debit to Mr. Philip for goods returned by him, now rectified)	Dr.		300	300
(3)	Mr. Ghanshyam To Mr. Radheshyam To Suspense Account (Omission of debit to Mr. Ghanshyam and wrong credit to Mr. Radhesham for sale of ₹ 200, now rectified)	Dr.		200	20 180
(4)	Discount Account To Suspense Account (The total of Discount allowed during September, 2022 not posted from the Cash Book; error now rectified)	Dr.		250	250

6.5.3 Correction in the next Accounting Period

Rectification of errors discussed so far assumes that it was carried out before the books were closed for the concerned year. However, sometimes, the rectification is carried out in the next year, carrying forward the balance in the Suspense Account or even transferring it to the Capital Account. Suppose, the Purchase Book was cast short by ₹1,000 in December, 2022 and a Suspense Account was opened with the difference in the trial balance. If the error is rectified next year and the entry passed is to debit Purchase Account (and credit Suspense Account), it will mean that the Purchases Account for year 2023 will be ₹1,000 more than the amount relating to year 2023 and thus the profit for year 2023 will be less than the actual for that year. Thus, correction of errors in this manner will 'falsify' the Profit and Loss Account.

To avoid this, correction of all amounts concerning nominal accounts, i.e., expenses and incomes should be through a special account styled as "Prior Period Items" or "Profit and Loss Adjustment Account". The balance in the account should be transferred to the Profit and Loss Account. However, these Prior Period Items should be charged after deriving the profit of the current year. 'Prior Period items' are material income or expenses which arise in the current period as a result of errors or omissions in the preparation of the financial statements of one or more prior periods. Prior Period Items should be separately disclosed in the current statement of profit and loss together with their nature and amount in a manner that their impact on current period profit or loss can be perceived.

ILLUSTRATION 8

Mr. Roy was unable to agree the Trial Balance last year and wrote off the difference to the Profit and Loss Account of that year. Next Year, he appointed a Chartered Accountant who examined the old books and found the following mistakes:

- (1) *Purchase of a scooter was debited to conveyance account ₹3,000.*
- (2) *Purchase account was over-cast by ₹10,000.*
- (3) *A credit purchase of goods from Mr. P for ₹2,000 was entered as a sale.*
- (4) *Receipt of cash from Mr. A was posted to the account of Mr. B ₹1,000.*
- (5) *Receipt of cash from Mr. C was posted to the debit of his account, ₹500.*
- (6) *₹500 due by Mr. Q was omitted to be taken to the trial balance.*
- (7) *Sale of goods to Mr. R for ₹2,000 was omitted to be recorded.*
- (8) *Amount of ₹2,395 of purchase was wrongly posted as ₹2,593.*

Mr. Roy used 10% depreciation on vehicles. Suggest the necessary rectification entries.

SOLUTION

Journal Entries in the books of Mr. Roy

Sr. No.	Particulars	Dr.(₹)	Cr.(₹)
(1)	Motor Vehicles Account To Profit and Loss Adjustment A/c (Purchase of scooter wrongly debited to conveyance account now rectified-capitalisation of ₹ 2,700, i.e., ₹ 3,000 less 10% depreciation)	2,700	2,700
(2)	Suspense Account To Profit & Loss Adjustment A/c (Purchase Account overcast in the previous year; error now rectified).	10,000	10,000
(3)	Profit & Loss Adjustment A/c To P's Account (Credit purchase from P ₹ 2,000, entered as sales last year; now rectified)	4,000	4,000
(4)	B's Account To A's Account (Amount received from A wrongly posted to the account of B; now rectified)	1,000	1,000
(5)	Suspense Account To C's Account (₹ 500 received from C wrongly debited to his account; now rectified)	1,000	1,000
(6)	Trade receivables To Suspense Account (₹ 500 due by Q not taken into trial balance; now rectified)	500	500
(7)	R's Account To Profit & Loss Adjustment A/c (Sales to R omitted last year; now recorded)	2,000	2,000

(8)	Suspense Account To Profit & Loss Adjustment A/c (Excess posting to purchase account last year, ₹ 2,593, instead of ₹ 2,395, now adjusted)	198	198
(9)	Profit & Loss Adjustment A/c To Roy's Capital Account (Balance of Profit & Loss Adjustment A/c transferred to Capital Account)	10,898	10,898
(10)	Roy's Capital Account To Suspense Account (Balance of Suspense Account transferred to the Capital Account)	10,698	10,698

Note : Entries No. (2) and (8) may even be omitted; but this is not advocated.

Profit and Loss Adjustment Account

(Prior Period Items)

	₹		₹
To P	4,000	By Motor Vehicles A/c	2,700
To Roy's Capital (transfer)	10,898	By Suspense A/c	10,000
		By R	2,000
		By Suspense Account	198
	14,898		14,898

Suspense Account

	₹		₹
To Profit & Loss Adjustment A/c	10,000	By Trade Receivables (Q)	500
To C	1,000	By Roy's Capital A/c (Transfer)	10,698
To Profit & Loss Adjustment A/c	198		
	11,198		11,198

SUMMARY

- ◆ Unintentional omission or commission of amounts and accounts in the process of recording the transactions are commonly known as errors.
- ◆ Accounting errors are generally of four types-
 - (a) Errors of Principle;
 - (b) Errors of Omission;
 - (c) Errors of Commission;
 - (d) Compensating Errors.
- ◆ Some errors may affect the Trial Balance and some of these do not.
- ◆ The method of rectification of errors depends on the stage at which the errors are detected. If the error is detected before the preparation of trial balance, rectification is carried out by making the statement in the appropriate side of the concerned account.
- ◆ In case of the errors detected after the preparation of the trial balance, we open a suspense account with the amount of difference in the trial balance. Then complete journal entries can be passed for rectifying the errors.
- ◆ For rectifying the errors detected in the next accounting period, a special account 'Profit and Loss Adjustment Account' is opened for correction of amounts relating to expenses and incomes.

TEST YOUR KNOWLEDGE

True and False

1. *The method of rectification of errors depends on the stage at which the errors are detected.*
2. *In case of error of complete omission, the trial balance does not tally.*
3. *When errors are detected after preparation of trial balance, suspense account is opened.*
4. *When purchase of an asset is treated as an expense, it is known as error of principle.*
5. *Trial balance agrees in case of compensating errors.*
6. *When amount is written on wrong side, it is known as an error of principle.*
7. *On purchase of old furniture, the amount spent on repairs should be debited to repairs account.*

8. *'Profit & Loss adjustment account' is opened to rectify the errors detected in the current accounting period.*
9. *Rent paid to landlord of the proprietors house, must be debited to 'Rent account'.*
10. *If the errors are detected after preparing trial balance, then all the errors are rectified through suspense account.*

Multiple Choice Questions

1. *Goods purchased from A for ₹10,000 passed through the sales book. The error will result in*
 - (a) *Increase in gross profit.*
 - (b) *Decrease in gross profit.*
 - (c) *No effect on gross profit.*
2. *If a purchase return of ₹1,000 has been wrongly posted to the debit of the sales returns account, but has been correctly entered in the suppliers' account, the total of the*
 - (a) *Trial balance would show the debit side to be ₹1,000 more than the credit.*
 - (b) *Trial balance would show the credit side to be ₹ 1,000 more than the debit.*
 - (c) *The debit side of the trial balance will be ₹ 2,000 more than the credit side.*
3. *If the amount is posted in the wrong account or it is written on the wrong side of the account, it is called*
 - (a) *Error of omission.*
 - (b) *Error of commission.*
 - (c) *Error of principle.*
4. *₹ 200 paid as wages for erecting a machine should be debited to*
 - (a) *Repair account.*
 - (b) *Machine account.*
 - (c) *Capital account.*
5. *On purchase of old furniture, the amount of ₹1,000 spent on its repair should be debited to*
 - (a) *Repair account.*
 - (b) *Furniture account.*
 - (c) *Cash account.*

6. Goods worth ₹50 given as charity should be credited to
 - (a) Charity account.
 - (b) Sales account.
 - (c) Purchase account.
7. Goods worth ₹100 taken by proprietor for domestic use should be credited to
 - (a) Sales account.
 - (b) Proprietor's personal expenses.
 - (c) Purchases account.
8. Sales of office furniture should be credited to
 - (a) Sales Account.
 - (b) Furniture Account.
 - (c) Purchase Account.
9. The preparation of a trial balance is for:
 - (a) Locating errors of commission.
 - (b) Locating errors of principle.
 - (c) Locating clerical errors.
10. ₹ 200 received from Smith whose account, was written off as a bad debt should be credited to:
 - (a) Bad Debts Recovered account.
 - (b) Smith's account.
 - (c) Cash account.
11. Purchase of office furniture ₹1,200 has been debited to General Expense Account. It is:
 - (a) A clerical error.
 - (b) An error of principle.
 - (c) An error of omission.

Theory Questions

1. How does errors of omission differ from errors of commission?
2. What is error of principle and how does it affect Trial Balance?
3. When and how is Suspense account used to rectify errors?

Practical Questions

1. The trial balance of Mr. W & H failed to agree and the difference ₹20,570 was put into suspense account pending the investigation which disclosed that:
- (i) Purchase returns day book had been correctly entered and totalled at ₹6,160, but had not been posted to the ledger.
 - (ii) Discounts received ₹1,320 had been debited to discounts allowed.
 - (iii) The Sales account had been under added by ₹10,000.
 - (iv) A credit sale of ₹1,470 had been debited to a customer account at ₹1,740.
 - (v) A vehicle bought originally for ₹7,000 four years ago and depreciated to ₹1,200 had been sold for ₹1,500 in the beginning of the year but no entries, other than in the bank account had been passed through the books.
 - (vi) An accrual of ₹560 for telephone charges had been completely omitted.
 - (vii) A bad debt of ₹1,560 had not been written off and provision for doubtful debts should have been maintained at 10% of Trade receivables which are shown in the trial balance at ₹23,390 with a credit provision for bad debts at ₹2,320.
 - (viii) Tools bought for ₹1,200 had been inadvertently debited to purchases.
 - (ix) The proprietor had withdrawn, for personal use, goods worth ₹1,960. No entries had been made in the books.

You are required to give rectification entries without narration to correct the above errors before preparing annual accounts and also prepare suspense account.

2. On going through the Trial balance of Ball Bearings Co. Ltd. you find that the debit is in excess by ₹150. This was credited to "Suspense Account". On a close scrutiny of the books, the following mistakes were noticed:
- (1) The totals of debit side of "Expenses Account" have been casted in excess by ₹50.
 - (2) The "Sales Account" has been totalled in short by ₹100.
 - (3) Supplier account has been overcasted by 225.
 - (4) The sale return of ₹100 from a party has not been posted to that account though the Party's account has been credited.
 - (5) A cheque of ₹500 issued to the Suppliers' account (shown under Trade payables) towards his dues has been wrongly debited to the purchases.
 - (6) A credit sale of ₹50 has been credited to the Sales and also to the Trade receivables Account.

You are required to

- (i) Pass necessary journal entries for correcting the above;
 - (ii) Show how they affect the Profits; and
 - (iii) Prepare the "Suspense Account" as it would appear in the ledger.
3. Mr. A closed his books of account on September 30, 2021 in spite of a difference in the trial balance. The difference was ₹830 the credits being short; it was carried forward in a Suspense Account. In 2022 following errors were located:
- (i) A sale of ₹2,300 to Mr. Lala was posted to the credit of Mrs. Mala.
 - (ii) The total of the Returns Inward Book for July, 2021 ₹1,240 was not posted in the ledger.
 - (iii) Freight paid on a machine ₹5,600 was posted to the Freight Account as ₹6,500. 10% Depreciation is charge on this machines.
 - (iv) While carrying forward the total in the Purchases Account to the next page, ₹65,590 was written instead of ₹56,950.
 - (v) A sale of machine on credit to Mr. Mehta for ₹9,000 on 30th sept. 2021 was not entered in the books at all. The book value of the machine was ₹6,750.

Pass journal entries to rectify the errors. Have you any comments to make?

4. A merchant's trial balance as on June 30, 2022 did not agree. The difference was put to a Suspense Account. During the next trading period, the following errors were discovered:
- (i) The total of the Purchases Book of one page, ₹4,539 was carried forward to the next page as ₹4,593.
 - (ii) A sale of ₹573 was entered in the Sales Book as ₹753 and posted to the credit of the customer.
 - (iii) A return to a creditor, ₹510 was entered in the Returns Inward Book; however, the creditor's account was correctly posted.
 - (iv) Cash received from C. Dass, ₹620 was posted to the debit of G. Dass.
 - (v) Goods worth ₹840 were despatched to a customer before the close of the year but no invoice was made out.
 - (vi) Goods worth ₹1,000 were sent on sale or return basis to a customer and entered in the Sales Book. At the close of the year, the customer still had the option to return the goods. The sale price was 25% above cost.

You are required to give journal entries to rectify the errors in a way so as to show the current year's profit or loss correctly.

ANSWERS/HINTS

True and False

1. True: There are 3 different stages when the mistakes are identified and then the rectification depends on the stage of identification of errors.
2. False: In case of error of complete omission, the trial balance tallies.
3. True: In order to balance the difference of balances in the trial balance suspense account is opened.
4. True: Where the accounts being debited is principally incorrect it is termed as error of principle.
5. True: Compensating errors cancel out each other when Trial balance is prepared as the mistake pertains to the same amount being credited and later debited on account of two different mistakes.
6. False: When amount is written on wrong side, it is known as an error of commission.
7. False: On purchase of furniture, the amount spent on repairs should be debited to furniture account as it is a capital expense.
8. False: 'Profit & Loss adjustment account' is opened to rectify the errors detected in the next accounting period.
9. False: Rent paid to land lord of the proprietors house, must be debited to 'Drawings account'.
10. False: If the errors are detected after preparing trial balance, then all the errors are not rectified through suspense account. There may be principal errors, which can be rectified without opening a suspense account.

Multiple Choice Questions

1.	(a)	2.	(c)	3.	(b)	4.	(b)	5.	(b)	6.	(c)
7.	(c)	8.	(b)	9.	(c)	10.	(a)	11.	(b)		

Theoretical Questions

1. (i) Errors of Omission: If a transaction is completely or partially omitted from the books of account, it will be a case of omission. Examples would be: not recording a credit purchase of furniture or not posting an entry into the ledger.

- (ii) Errors of Commission: If an amount is posted in the wrong account or it is written on the wrong side or the totals are wrong or a wrong balance is struck, it will be a case of "errors of commission."

- 2. Errors of principle:** When a transaction is recorded in contravention of accounting principles, like treating the purchase of an asset as an expense, it is an error of principle. In this case there is no effect on the trial balance since the amounts are placed on the correct side, though in a wrong account. Suppose on the purchase of a typewriter, the office expenses account is debited; the trial balance will still agree.

The method of correction of error indicated so far is appropriate when the errors have been located before the end of the accounting period. After the corrections, the trial balance will agree. Sometimes the trial balance is artificially made to agree inspite of errors by **opening a suspense account** and putting the difference in the trial balance to the account - the suspense account will be debited if the total of the credit column in the trial balance exceeds the total of the debit column; it will be credited in the other case. Each and every error detected after preparation of trial balance can only be corrected by a complete journal entry. Those errors for which journal entries were not possible at the earlier stage will now be rectified by a journal entry(s), the difference or the unknown side is being taken care of by suspense account. Those errors for which entries were possible even at the first stage will now be rectified in the same way.

Practical Questions

1.

	Particulars	Dr.	Cr.
(i)	Suspense Account To Return Outward A/c	6,160	6,160
(ii)	Suspense Account To Discount Allowed Account To Discount Received Account	2,640	1,320 1,320
(iii)	Suspense Account To Sales Account	10,000	10,000
(iv)	Suspense Account To Trade Receivable Account	270	270
(v)	Suspense Account To Vehicle Account To Profit on Sale of Vehicle Account	1,500	1,200 300

(vi)	Telephone Charges Account	560	
	To Outstanding Expenses Account		560
(vii)	Bad Debts Account (refer W.N 1)	1,560	
	To Trade receivables Account		1,560
(viii)	Provision for Doubtful Debts Account (refer W.N. 2)	1,396	
	To Profit and Loss Account		1,396
(ix)	Loose Tools Account	1,200	
	To Purchases Account		1,200
(ix)	Drawings Account	1,960	
	To Purchases Account		1,960

Suspense Account

	₹		₹
To Return outward Account	6,160	By balance b/d	20,570
To Discount allowed Account	1,320		
To Discount Received Account	1,320		
To Sales Account	10,000		
To Customers Account	270		
To Vehicles Account	1,200		
To Profit on Sale of Vehicle	300		
	20,570		20,570

Working Notes :

(i)	Balance of Trail Balance for Computation of Provision for Doubtful Debts		
	Trade receivables as per books		23,390
	Deduction vide item (iv) 270	270	
	Bad Debts	<u>1,560</u>	<u>1,830</u>
			<u>21,560</u>
(ii)	Amount Charge to Profit & Loss on Account of Provision for Doubtful Debts		
	Opening of Provision for Doubtful Debts		2,320
	Less: Bed debts		1,560
			760
	Closing Balance of Provision for Doubtful Debts		2,156
	Charge to Profit and Loss A/c		1,396

2.

Journal Entries

Particulars		L.F.	Dr. ₹	Cr. ₹
Suspense Account To Expenses Account (Being the mistake in totalling of Expenses Account, rectified)	Dr.		50	50
Suspense Account To Sales Account (Being the mistake in totalling of Sales Accounts rectified)	Dr.		100	100
Supplier To Suspense Account (Being the mistake in posting from Day Book to Ledger rectified)	Dr.		225	225
Sales Returns Account To Suspense Account (Being the sales return from a party not posted to "Sales Returns" now rectified)	Dr.		100	100
Trade payables Account To Purchases Account (Being the payments made to supplier wrongly posted to purchases now rectified)	Dr.		500	500
Trade receivables Account To Suspense Account (Being the sales wrongly credited to Customer's Account now rectified)	Dr.		100	100

Suspense Account

	Dr. ₹		Cr. ₹
To Expenses Account	50	By Difference in Trial Balance	150
To Sales Account	100	By Trade payables	225
To Balance c/d	425	By Sales Returns Account	100
		By Trade receivables	100
	575		575
		By Balance b/d	425

Since the Suspense Account does not balance, it is clear that all the errors have not been traced. As a result of the above corrections the Net Profit will be:

	Increased by ₹	Decreased by ₹
Mistake in totalling in "Expenses"	50	
Mistake in totalling in "Sales"	100	
Mistake in posting from day book to Ledger under "Purchases"	500	
Omission in posting under "Sales Returns"		100
	650	100
Net Increase	550	

As a result of these adjustments, the Profits will be increased by ₹550.

3.

Journal of Mr. A

Date	Particulars	Dr. ₹	Cr. ₹
2022 (i)	Mrs. Mala Mr. Lala To Suspense A/c (Correction of error by which a sale of ₹ 2,300 to Mr. Lala was posted to the Credit of Mrs. Mala)	2,300 2,300	4,600
(ii)	Profit and Loss Adjustment A/c To Suspense A/c (Rectification of omission to post the total of Returns Inward Book for July, 2021)	1,240	1,240
(iii)	(a) Machinery A/c Suspense A/c To Profit & Loss Adjustment A/c (Correction of error by which freight paid for a machine ₹ 5,600 was posted to Freight Account at ₹ 6,500 instead of capitalising it)	5,600 900	6,500
	(b) Profit & Loss Adjustment A/c	560	

(iv)	To Plant and Machinery A/c (Depreciation @ 10% charged on freight paid on a machine capitalised)	8,640	560
	Suspense A/c To Profit & Loss Adjustment A/c (Correction of wrong carry forward of total in the purchase Account to the next page ₹ 65,590 instead of ₹ 56,950)		8,640
(v)	Mr. Mehta To Plant & Machinery A/c To Profit & Loss Adjustment A/c (Correction of omission of a sale of machine on credit to Mr. Mehta for ₹ 9,000)	9,000	6,750 2,250

Comments

The Suspense Account will now appear as shown below:

Suspense Account

Date	Particulars	Dr. Amount ₹	Date	Particulars	Cr. Amount ₹
2022	To Profit and Loss Adjustment A/c	900	2022 Oct. 1	By Balance b/d	830
	To Profit and Loss Adjustment A/c	8,640		By Sundries Mrs. Mala	2,300
				Mr. Lala	2,300
				By Profit and Loss Adjustment A/c	1,240
				By balance c/d	2,870
		9,540			9,540

Since the Suspense Account still shows a balance, it is obvious that there are still some errors left in the books.

Profit & Loss Adjustment A/c**(For Prior Period Items)**

Date 2022	Particulars	Dr. Amount ₹	Date 2022	Particulars	Cr. Amount ₹
	To Suspense A/c	1,240		By Machinery A/c	5,600
	To Plant and Machinery A/c	560		By Suspense A/c	900
	To Balance c/d	15,590		By Suspense A/c	8,640
				By Mr. Mehta	2,250
		17,390			17,390

4.

Journal Entries

	Particulars	Dr. ₹	Cr. ₹
(i)	Suspense Account Dr. To Profit and Loss Adjustment A/c (Correction of error by which Purchase Account was over debited last year- ₹4,593 carried forward instead of ₹4,539)	54	54
(ii)	Profit & Loss Adjustment A/c Dr. Customer's Account Dr. To Suspense Account (Correction of the entry by which (a) Sales A/c was over credited by ₹180 (b) customer was credited by ₹753 instead of being debited by ₹573)	180 1,326	1,506
(iii)	Suspense Account Dr. To Profit & Loss Adjustment A/c (Correction of error by which Returns Inward Account was debited by ₹510 instead of Returns Outwards Account being credited by ₹ 510)	1,020	1,020

(iv)	Suspense Account	Dr.	1,240	
	To C. Dass			620
	To G. Dass			620
	(Removal or wrong debit to G. Dass and giving credit to C. Dass from whom cash was received).			
(v)	Customer's Account	Dr.	840	
	To Profit & Loss Adjustment A/c			840
	(Rectification of the error arising from non-preparation of invoice for goods delivered)			
(vi)	Profit & Loss Adjustment A/c	Dr.	200	
	Inventory Account	Dr.	800	
	To Customer's Account			1,000
	(The Customer's A/c credited with ₹ 1,000 for goods not yet purchased by him; cost of the goods debited to inventory and "Profit" debited to Profit & Loss Adjustment Account)			
(vii)	Profit & Loss Adjustment A/c	Dr.	1,534	
	To Capital Account			1,534
	(Transfer of Profit & Loss Adjustment A/c balance to the Capital Account)			



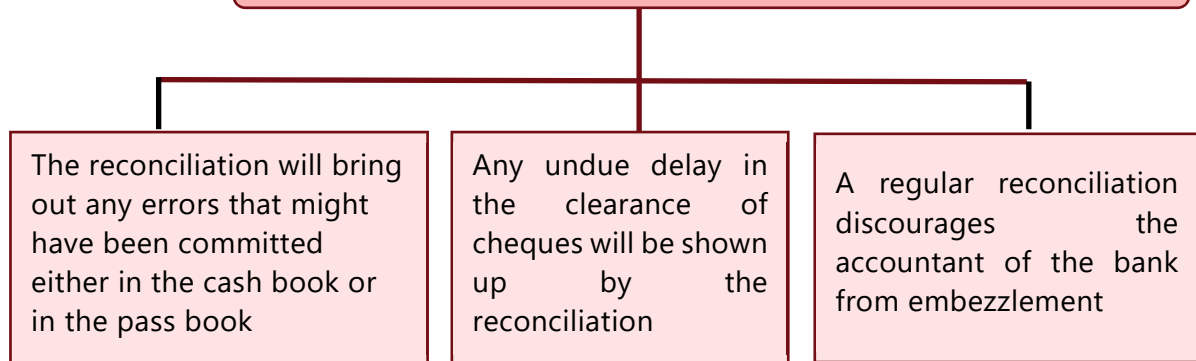
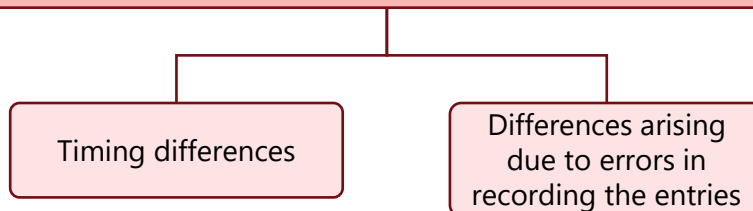
BANK RECONCILIATION STATEMENT



LEARNING OUTCOMES

After studying this chapter, you will be able to:

- ◆ Learn the design of a Bank Pass Book.
- ◆ Understand the reasons for difference between Cash Book balance and Pass Book balance and try to ascertain the amount of such differences.
- ◆ Learn, how to resolve such difference in a systematic manner.
- ◆ Understand the purpose for preparing the bank reconciliation statement and its utility.

UNIT OVERVIEW**Salient Features of Bank Reconciliation Statement****Causes of difference in the balances of pass book and cash book****1. INTRODUCTION**

Banks are essential institutions in a modern society. With the increase in volume of trade, commerce and business, business entities faced difficulty in transacting in cash for each business activity. They discovered that dealing through bank, on regular basis, would be the better and safer option and finally large business entities switched over to banking transactions instead of dealing in cash. Now-a-days, most of the transactions of the business are done through bank whether it is a receipt or a payment. Rather, it is legally necessary to operate the transactions through bank after a certain limit.

A Bank accepts from people, in general, deposits in various forms, and lends funds to those who need; it also invests some funds in profitable investments. Thus, money which would have been otherwise idle is put to use and is made available to those who need it. Those who deposit the money are able to withdraw it according to the settled terms and conditions. Apart

from receiving deposits from and handling cash transactions on behalf of its customers, the bank also renders some other useful services as indicated below:

- (i) The bank discounts promissory notes or hundies, i.e., it enables a customer to receive the cash before the due date in consideration of a small charge called discount.
- (ii) The bank allows overdraft to its good customers so that they can make payments even when they do not have sufficient balance in the bank. Of course, the overdraft facility is generally secured and must be cleared later.
- (iii) The bank grants different types of loans (eg. Working capital, term loan) for a specific period say a year or so, to its customers for smooth functioning of their operations in case of lack of self-funding available with customers'. Such financial assistance is of great help for business.
- (iv) The bank on behalf of the customer collects the amount of dividend warrants or interest on securities etc.
- (v) On instruction of the customer, the bank makes payments of insurance premium, rent etc. on the due dates.
- (vi) The bank sells and purchases shares, debentures or government securities on behalf of its customers.
- (vii) Money can be remitted to another place or persons through the bank at a low cost.
- (viii) The bank in return, for a consideration, furnishes security or guarantee for its customers whose credit is good.
- (ix) The bank also issues letter of credit or travellers' cheque to facilitate commerce or travel.
- (x) The bank also provides international banking services such as currency exchange, remittance from abroad, cross country payments, foreign letters of credit, export and import credit, etc.



2. BACKGROUND

In the past, many corporate frauds have incurred by the companies through manipulating entries either in bank statements or in cash book. For e.g. –A company's financial statement may present incorrect bank balance to mislead the stakeholders. Such kind of instances has made reconciliation of bank and cash balances an integral part of internal control maintained by management.

Over the period, reconciling the accounts became an important activity for businesses because it gives an opportunity to check for fraudulent activity happening in the organization and

helps to prevent the financial statement errors. Reconciliation is typically done at regular intervals, such as monthly or quarterly, as part of normal accounting procedures, however, frequency is largely dependent on the size of organization and the number of transactions that occur.



3. BANK PASS BOOK

Bank pass book is merely a copy of the customer's account in the books of a bank. The bank either sends periodical statements of account or gives a pass book to its customer in which all deposits and withdrawals made by the customer during the particular period is recorded. Both represent almost a copy of the ledger account of the customer in the books of the bank. Thus, it is the bank's way of keeping the customers informed of the entries made in his account. It is the customer's duty to check the entries and immediately inform the bank of any error that he may notice. These days, customers can easily access their bank statement online any time as facilitated by Net Banking. The form of the pass book is given below:

PASS BOOK

Messers.....

in account with

Punjab National Bank

Daryaganj, New Delhi-110002

Account number –

Transaction Period -

Date	Particulars / Transaction	Cheque No.	Withdrawals Dr.	Deposits Cr.	Balance
					Dr. or Cr.
			₹	₹	₹

The bank statement of account also has a similar form except that it is on loose sheets or can be in an online format. The bank itself sends the statements to customers but if the customer wants to maintain a pass book then it is their duty to send the pass book to the bank periodically so that it is updated by the bank. These days, many banks' ATMs have the automated machines where one can get the passbook updated without any manual intervention and without visiting the branch of the bank.

Business houses should also obtain at the end of the year a certificate from the bank duly stamped and signed, showing the balance which, the firm carries with the bank as of date. The

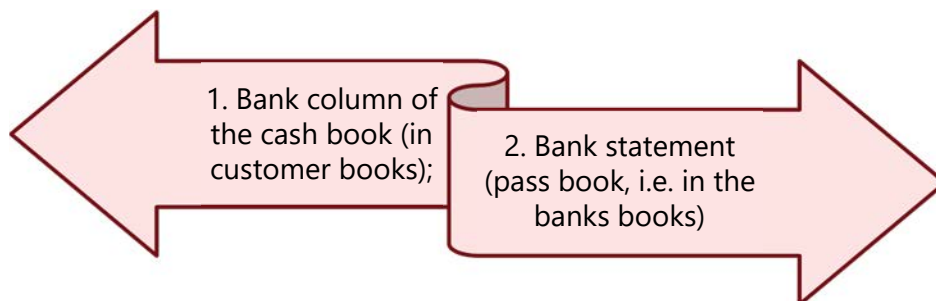
bank balance shown in the passbook is known as pass book balance for reconciliation purpose. The credit balance as per pass book at a particular point of time is the deposit made by the customer while debit balance as per pass book is the overdraft balance for the customer (i.e. customer owes to bank).

Students may note here that the nature of balance shown by passbook (in the books of bank) and cash book (in the books of customer) is quite different. The debit balance in the pass book represents the credit balance as per the cash book and vice-versa because the business enterprise treats the bank as a debtor/Trade receivable and bank treats the business enterprise as a creditor/Trade payable.



4. BANK RECONCILIATION STATEMENT

To reconcile means to identify or find out the difference between two different sources and eliminating that difference. Whenever we deposit or withdraws money from banks, it is always recorded at two places:-



The cash book is maintained by the person having the bank account whereas the bank statement is prepared by the bank. Therefore, the balance in both the books should be equal and opposite in nature. For eg:- if Mr. A deposited ₹ 1,00,000 in his bank account it will be recorded on the Dr. side of his cash book, but for the bank it's a receipt so it will be recorded as a Cr. Entry in the bank statement or the pass book.

But most of the times these two balances do not match. The reasons for difference in balances can be many and are explained later in this chapter. It is possible to eliminate this difference by matching all the facts and figures of the two statements. The process of eliminating this difference and bringing the two statements in line with each other is known as "Reconciliation", and the statement which reconciles the bank balance as per cash book with the balance as per the pass book by showing all the causes of difference is known as "BANK RECONCILIATION STATEMENT".



5. IMPORTANCE OF BANK RECONCILIATION STATEMENT

Bank reconciliation statement is a very important tool for internal control of cash flows. It helps in detecting errors, frauds and irregularities occurred, if any, at the time of passing entries in the cash book or in the pass book, whether intentionally or unintentionally. Since frauds can be detected on the preparation of bank reconciliation statement therefore accountants are careful while preparing and maintaining the records of the business enterprise. Hence it works as an important mechanism of internal control. Following are the salient features of bank reconciliation statement:

- (i) The reconciliation will bring out any errors that may have been committed either in the cash book or in the pass book;
- (ii) Any undue delay in the clearance of cheques will be shown up by the reconciliation;
- (iii) A regular reconciliation discourages the accountant of the bank from embezzlement of funds. There have been many cases when the cashiers merely made entries in the cash book but never deposited the cash in the bank; they were able to get away with it only because of lack of reconciliation.
- (iv) It helps in finding out the actual or true position of the bank balance by incorporating the effect of any uncleared funds as well.
- (v) It will ensure accounting of all the financial transactions incurred by the company during a particular financial year.

CAUSES OF DIFFERENCE

The difference in the both balances (bank balance as per cash book and pass book) may arise because of the following reasons:-

1. **TIMING:-** Sometimes a transaction is recorded at two different times in cash book and the pass book. This may happen in the following cases:-
 - ♦ Mr. A has issued a cheque to PQR Ltd., now it will be recorded in his cash book immediately but the bank will recognize this transaction only when the same cheque will be presented to it by PQR Ltd.
 - ♦ Similarly for PQR Ltd, entry in the cash book will be made immediately as the cheque is received from Mr. A but the bank account will be credited when it collects money in respect of that cheque.
2. **TRANSACTIONS:-** There are various transactions which the bank carries out by itself without intimating the customer. For e.g.:- interest received on a savings bank account,

it will be credited by the bank immediately but the entry in the cash book will be made only when the customer comes to know about it, which is usually at a later stage. Similar is the case with Bank charges (which are debited from the customer account by bank).

3. **ERRORS:-** Mistakes or errors made in preparing the accounts either by the bank or the customer can also result in disagreement of the two statements. For e.g. omission of cheques issued. For this reason rectification of errors is required to be done in both the statements before preparing any Bank Reconciliation Statement.

SOME OF THE ITEMS THAT FREQUENTLY CAUSE A DIFFERENCE:-

When bank balance as per Cash Book > Pass Book	When bank balance as per Cash Book < Pass Book
i) Cheques deposited with the bank but not cleared	i) Cheques issued but not presented for payment
ii) Interest and expenses charged by the bank	ii) Interest allowed by bank
iii) Direct payments by the bank	iii) Interest and dividends collected by the bank
iv) Dishonour of a bill discounted with the bank	iv) Direct payment into the bank by a customer
	v) Bills collected by the bank on behalf of the customer

Above each scenario is explained in detail below along with examples:

- (i) **Cheques issued but not presented for payment:** The entry in the cash book is made immediately on issue of cheque but naturally entry will be made by the bank only when the cheque is presented for payment. Thus there will be a gap of some days between the entry in the cash book and in the pass book.

Example 1: The balance as per Cash Book and Pass Book are ₹10,000. Cheque of ₹ 2,000 is issued but not presented for payment. Then the balances as per cash book and pass book will be as follows:

Cash book (bank column only)

Particulars	₹	Particulars	₹
To balance b/f	10,000	By Vendor A/c (to whom cheque is issued)	2,000
		By balance c/f	8,000
	10,000		10,000

Bank statement (pass book)

Date	Particulars	Dr. (withdrawn)	Cr. (deposited)	Balance
	Balance b/f			10,000(cr.)

On the issue of aforesaid cheque, the bank account in Cash Book is credited by ₹2,000 and so balance is reduced to ₹ 8,000. Whereas balance in the Pass Book remains ₹10,000 until the cheque is presented for payment.

(ii) Cheques deposited with the bank but not cleared: As soon as cheques are sent to the bank (i.e. deposited with bank), entries are made on the debit side of the bank column of the cash book. But usually banks credit the customer's account only when they have received the payment from the bank concerned- in other words, when the cheques have been cleared. Again, there will be some time gap between the deposit of the cheques and the credit given by the bank.

Example 2 : The balance as per Cash book and Pass Book are ₹ 12,000. Cheque of ₹ 3,000 is deposited but not cleared.

Cash book

Particulars	₹	Particulars	₹
To balance b/f	12,000	By balance c/f	15,000
To Vendor A/c	3,000		
	15,000		15,000

Bank statement (Pass Book)

Date	Particulars	Dr. (withdrawn)	Cr. (deposited)	Balance
	Balance b/f			12,000 (cr.)

When cheque is deposited into bank, the bank account in Cash Book is increased to ₹ 15,000, but the balance in the Pass Book remains ₹ 12,000 until the cheque is cleared.

(iii) Interest allowed by bank : If the bank has allowed interest to the customer, the entry will normally be made in the customer's account and later shown in the pass book. The customer usually comes to know the amount of the interest by pursuing the pass book and only then he makes relevant entry in the cash book.

Example 3: The balance as per Cash Book and Pass Book are ₹ 10,000. The bank has allowed ₹ 1,000 interest on saving account to customer.

Cash book

Particulars	₹	Particulars	₹
To balance b/f	10,000	By balance c/f	10,000
	10,000		10,000

Bank statement (Pass Book)

Date	Particulars	Dr. (withdrawn)	Cr. (deposited)	Balance
	Balance b/f			10,000 (cr.)
	Interest		1,000	11,000(cr.)

Because of such interest, balance of Pass Book is increased to ₹11,000. Whereas balance in the Cash Book remains ₹10,000 until information reaches to the customer and he records such transaction.

(iv) Interest and expenses charged by the bank: Like (iii) above, the interest charged by the bank and the amount of the bank charges are entered in the customer account and later in the pass book. The customer makes the required entries only after he sees the pass book or bank statement. These are debited to customer account by bank therefore till such entry is passed in cash book, bank balance as per pass book is less than bank balance as per cash book.

(v) Interest and dividends collected by the bank: Sometimes investments are left with the bank in the safe custody; the bank itself sees to it that the interest or the dividend is collected on the due dates. Entries are made as indicated in (iii) above.

Example 4: The balance as per Cash Book and Pass Book are ₹15,000. The bank has collected dividend of ₹ 2,000.

Cash book

Particulars	₹	Particulars	₹
To balance b/f	15,000	By balance c/f	15,000
	15,000		15,000

Bank statement (Pass Book)

Date	Particulars	Dr. (withdrawn)	Cr. (deposited)	Balance
	Balance b/f			15,000(cr.)
	Dividend		2,000(Cr.)	17,000(cr.)

On collection of dividend bank credits the amount to customer's account, so balance in Pass Book is increased to ₹ 17,000. Whereas balance in the Cash Book remains ₹ 15,000 until the information of such dividend collection reaches to the customer and he records such transaction.

(vi) Direct payments by the bank: The bank may be given standing instructions for certain payments such as insurance premium, equated monthly installments of loan (EMIs). In these cases also, the customer comes to know of the payment only after viewing the pass book or bank statement. The entries in the pass book and in the cash book may thus be on different dates.

Example 5: The balance as per Cash Book and Pass Book of Mr. X are ₹ 20,000. The bank has instruction to pay insurance premium of ₹ 1,500 directly to insurance company at the end of each month.

Cash book

Particulars	₹	Particulars	₹
To balance b/f	20,000	By balance c/f	20,000
	20,000		20,000

Bank statement (pass book)

Date	Particulars	Dr. (withdrawn)	Cr. (deposited)	Balance
	Balance b/f			20,000 (cr.)
	Insurance premium	1,500		18,500 (cr.)

On payment of insurance premium bank debits the customer's account by ₹ 1,500 so balance in Pass Book is decreased to ₹ 18,500. Whereas balance in the Cash Book remains ₹ 20,000 until the information of such payment reaches to the customer and he records such transaction.

(vii) Direct payment into the bank by a customer: If such a payment is received by the bank, it will be entered in the customer's account and also in the pass book; the account holder may come to know of the amount only when he sees the pass book. (e.g. Customers' these days prefers using banking facilities like NEFT, RTGS to transfer funds online)

(viii) Dishonour of a bill discounted with the bank: If the bank is not able to receive payment on promissory notes discounted by it, it will debit the customer's account together with the charges it may have incurred. The customer will naturally make the entry only when he sees the pass book.

Example 6: The balances as per Cash Book and Pass Book of Mr. X are ₹ 20,000. Mr. X deposited a cheque of ₹ 3,000 and debited to his bank account ₹ 3,000 immediately. But bank will credit X's account on realization of amount. Now the cheque is dishonoured for non-payment. Bank charges ₹ 100 in this connection.

Cash book

Particulars	₹	Particulars	₹
To balance b/f	20,000	By balance c/f	23,000
To bank a/c	3,000		
	23,000		23,000

Bank statement (Pass Book)

Date	Particulars	Dr. (withdrawn)	Cr. (deposited)	Balance
	Balance b/f			20,000 (cr.)
	Bank charges	100		19,900 (cr.)

Thus, balance of Mr. X's account in Pass Book stands ₹ 19,900 after this transaction while balance as per Cash Book stand ₹ 23,000. So Mr. X should deduct ₹ 3,000 the amount of dishonoured cheque, plus ₹ 100 the amount of bank charges for reconciliation.

(ix) Bills collected by the bank on behalf of the customer: If goods are sold, the documents may be sent through the bank. If the bank is able to collect the amount, it will credit the customer's account. The customer may make the entry only on receiving the pass book.

All these timing differences will lead to difference in balances as shown by the cash book and the pass book.

Following is the table summarising in brief the timings of different transactions:

Sl. No.	Transaction	Time of recording in cash book	Time of recording in pass book
1.	Payment done by the account holder through issuing a cheque	At the time of issuing the cheque	At the time of presenting the cheque to the bank for payment or clearing of funds.
2.	Receipt by the account holder through a cheque	At the time of depositing the cheque into the bank .	At the time of collection of amount from the account of the issuing party.

3.	Collection of bills/cheque directly on behalf of the account holder	When the entry posted in the pass book comes into notice.	When the amount is collected by the bank.
4.	Direct payment to the third party on behalf of the account holder	When the entry posted in the pass book comes into notice.	When the amount is paid by the bank
5.	Dishonour of cheque/bills receivable.	When the entry posted in the pass book comes into notice.	When the cheque is dishonoured.
6.	Bank charges levied by the bank	When the entry posted in the pass book comes into notice.	When charges are levied by the bank
7.	Interest and dividend credited by the bank	When the entry posted in the pass book comes into notice.	When interest or dividend is allowed or collected by the bank.
8.	Interest debited by the bank	When the entry is posted in the pass book comes into notice.	When interest is charged by the bank

To illustrate this, we give below an extract from a pass book and the bank column of the cash book in Illustration 1:

ILLUSTRATION 1

Messer's Tall & Short, Faiz Bazar, New Delhi-110002

in account with Punjab National Bank, Daryaganj, New Delhi-110002

PASS-BOOK

Date		Particulars	Withdrawals ₹	Deposits ₹	Dr. or Cr.	Balance ₹
2022						
Jan.	2	By Cash		4,00,000	Cr.	4,00,000
"	4	To Furniture Dealers Ltd.	60,000		Cr.	3,40,000
"	4	To Das & Co.	1,25,000		Cr.	2,15,000
"	10	By J. Johnson & Co.'s cheque		35,000	Cr.	2,50,000
"	12	To Roy & James	1,00,000		Cr.	1,50,000

BANK RECONCILIATION STATEMENT

3.13

"	15	By B. Babu & Co's cheque		76,000	Cr.	2,26,000
"	16	By Cash		30,000	Cr.	2,56,000
"	20	To Cash	50,000		Cr.	2,06,000
"	26	By J. Rai & Bros cheque		43,000	Cr.	2,49,000
"	31	To Premium paid as per standing instructions	25,000		Cr.	2,24,000
	31	To Bank Charges	1,000		Cr.	2,23,000
	31	By Interest collected on Government Securities		20,000	Cr.	2,43,000

CASH-BOOK (Bank column only)

Date	Particulars	Amount ₹	Date	Particulars	Amount ₹
2022			2022		
Jan. 1	To Cash	4,00,000	Jan. 2	By Furniture Dealers Ltd.	60,000
Jan. 2	To J. Johnson & Co.	35,000	Jan. 2	By Roy & James	1,00,000
Jan. 8	To B. Babu & Co.	76,000	Jan. 2	By Das & Co.	1,25,000
Jan. 10	To Cash	30,000	Jan. 4	By K. Nagpal & Co.	73,000
Jan. 16	To J. Rai & Bros.	43,000	Jan. 17	By Cash	50,000
Jan. 20	To M. Mohan & Co.	1,05,000	Jan. 20	By B. Babu & Co.	78,000
Jan. 22	To N. Nandy & Sons	34,000	Jan. 31	By Balance c/d	2,37,000
		7,23,000			7,23,000
Feb. 1	To Balance b/d	2,37,000			

It will be seen that whereas the pass book shows a credit balance of ₹ 2,43,000, the cash-book shows a debit balance of ₹ 2,37,000. We shall compare the two to establish the reasons for the difference. The reconciliation of the two statements can be done in two ways:-

1. Arrive at pass book balance from cash book.
2. Arrive at cash book balance from pass book.

Let us start with the pass book balance and arrive at the balance as per cash book.

Step: 1. Compare the debit side of cash book with the deposits column of pass book:-

We find that the following cheques are recorded in the cash book but not in the pass book. Therefore if we enter these two cheques in the deposit side of the pass book the balance becomes:-

Existing balance	2, 43,000
Add:- M Mohan & Co.	1,05,000
N. Nandy & Sons	34,000
Total	3,82,000

Step: 2 Compare the credit side of the cash book with the withdrawal column of the pass book

We find that the following cheques are not recorded. Therefore, if we enter these two cheques on the withdrawal side of the pass book the balance becomes: -

Existing balance	3,82,000
Less:- K Nagpal & Co.	(73,000)
B Babu & Co.	(78,000)
Total	2,31,000

There is an item 'Interest on Government Securities' which appears on the deposit side of the pass book but not in the debit side of the cash book, so this item should be deducted from pass book balance:-

Existing balance	2,31,000
Less:- Interest on govt. securities	(20,000)
Total	2,11,000

Further, there are two items which appear on the withdrawal side of the pass book i.e. they have been deducted from the bank balance but not on the credit side of the cash book, so these items should be added in order to reconcile the balance:-

Existing balance:-	2,11,000
Add: Insurance premium	25,000
Add: Bank charges	1,000
Total	2,37,000

Therefore, we have arrived at the balance as per the cash book from the pass book.

This process shows that the difference between the two balance arise only because there are some entries made in the cash-book but not in the pass book and some entries which are made in the pass book but not in the cash book. A comparison of the two shows up such entries and then, on that basis, the reconciliation is prepared. To illustrate it again, let us proceed from the cash book balance of ₹ 2,37,000. Since cheques totalling ₹ 1,39,000 have not been entered in the pass book, let us assume that they are also omitted from the cash book, this will reduce the cash book balance to ₹ 98,000. Cheques totalling ₹ 1,51,000 have been entered on the credit side of the cash book but not in the pass book their omission from the cash book will increase the cash book balance to ₹ 2,49,000. Amounts totalling ₹ 26,000 have been entered in the withdrawals column of the pass book but not in the cash book; an entry on the credit side of the cash book for these amounts will reduce the balance to ₹ 2,23,000. The deposits column shows an entry of ₹ 20,000 not found on the debit side of the cash book; the entry made in the cash book will increase balance to ₹ 2,43,000 as shown in the pass book.

(x) Errors: While recording the entries errors can occur both in the cash book and in the pass book. A bank rarely makes an error but if it does, the balance in the pass book will naturally differ from cash book. Similarly if any error is committed in the cash book then it's balance will be different from that of the pass book.

Some of the errors include commission of entry, recording of an incorrect amount, recording of entry on the wrong side of the book, wrong totalling of the account or wrong balancing of the book and recording of transactions of other party.

Example 7: Mr. A's cash book shows following transactions:

CASH-BOOK (Bank column only)

Date	Particulars	Amount ₹	Date 2022	Particulars	Amount ₹
			Mar 31	By balance c/d	1,00,000
April 7	To Wayne Ltd.	60,000	Apr 1	By balance b/d	10,000
April 11	To Cash A/c	80,000	April 29	By Cash A/c	2,000
				By Balance c/d	1,28,000
		1,40,000			1,40,000

PASS-BOOK

Date		Particulars	Withdrawals ₹	Deposit ₹	Balance ₹ (cr.)
2022					
April	1	Balance b/d			1,00,000

April	7	By Wayne Ltd.		60,000	1,60,000
April	11	By Cash		80,000	2,40,000
April	13	To Vandy Ltd.	90,000		3,30,000
April	29	To Cash A/c	2,000		3,28,000

Here there are several errors made by accountant:

April 1: Balance should be have bought down in debit side as ₹ 1,00,000

April 13: Also a cheque issued to Vandy Ltd. has been omitted in the books of ₹ 90,000

So, on correcting these entries balance as per Cash Book will be:

Existing Balance		₹ 1,28,000
Add: Correct Opening Balance		₹ 1,00,000
Add: Incorrect Opening Balance (Since it was bought down on credit side it will be added back)		₹ 10,000
Less: Cheque issued not recorded		<u>₹ 90,000</u>
Closing Balance as per Cash Book		₹ 1,48,000
Balance as per Pass Book	3,28,000	
Less: Cheque to Vandy Ltd wrongly added to existing balance instead of being subtracted	<u>1,80,000</u>	<u>₹ 1,48,000</u>
Difference in balances between cash book and pass book		Nil



6. PROCEDURE FOR RECONCILING THE CASH BOOK BALANCE WITH THE PASS BOOK BALANCE

Before proceeding further, students must understand that 'Dr. balance as per cash book' means deposits in the bank or cash at bank or Cr. balance as per pass book. Similarly, 'Cr. balance as per cash book' means excess amount over deposits withdrawn by the account holder or overdraft balance or Dr. balance as per pass book.

It means that students can be required to start bank reconciliation from any of the following four balances as may be given in the question:

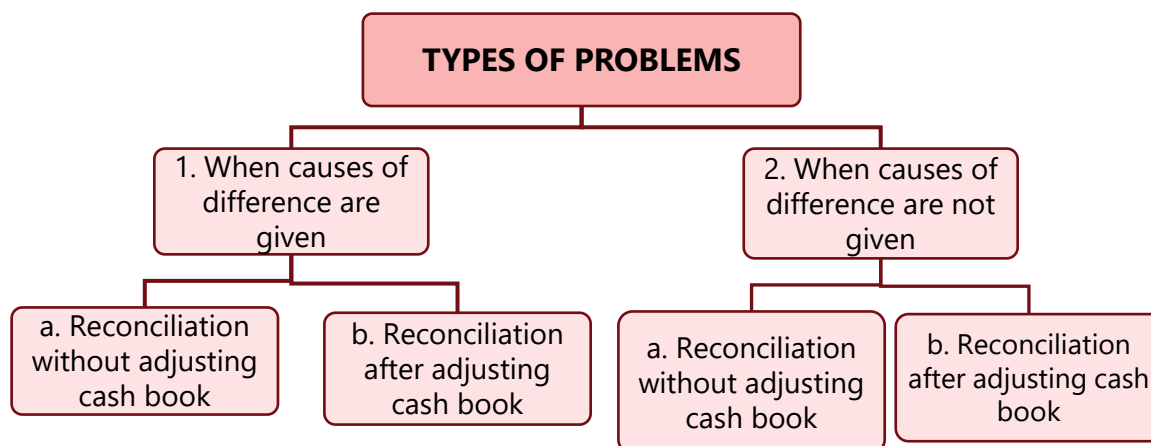
Dr. balance as
per cash book

Cr. balance as
per cash book

Dr. balance as
per pass book

Cr. balance as
per pass book

While doing reconciliation, the following types of problems can be given:-



When causes of differences are known then students can start reconciliation by taking any of the balance stated above and proceed further with the causes. Given the causes of disagreement, the balance of the other book can be either more or less on account of the said causes. If the balance of the other book is more on account of the said causes, then add the amount. If the balance of the other book is less on account of the said causes, then subtract the amount.

For example, if the reconciliation is initiated with Dr. balance as per the cash book and there is a cheque deposited in the bank but not yet cleared, then on account of non-clearance of the cheque, the Cr. balance of the pass book would be less. In this case, the amount of cheque should be subtracted from the cash book balance to arrive at the balance as per the pass book. Similarly, after making all the adjustments the balance as per the other book is obtained. It is necessary to note here that if a student starts from debit balance of cash book and after all adjustments the balance arrived is positive then it is known as Cr. balance as per the pass book and if the balance is negative then it is said to be Dr. balance as per the pass book and vice-versa.

But **if causes of differences are not known** then one has to compare the debit entries of cash book with the credit entries of the pass-book and vice-versa. The entries, which do not tally in the course, are the causes of difference in the balances of both the books. Once the causes are located their effects on both the books are analysed and then reconciliation statement is prepared to arrive at the actual bank balance.

In this procedure students, should also take into care that whether opening balance of both the books at particular point of time from where the books are compared, tallies or not. If opening balances are not same then unticked items are divided into two categories i.e., one relating to reconciliation of opening balance and other relating to reconciliation of closing balance.

Example 8: Jolly Ltd has following entries in its cash book and pass book:

CASH-BOOK (Bank column only)

Date 2022	Particulars	Amount ₹	Date 2022	Particulars	Amount ₹
May 1	To Balance b/d	70,000	May 15	By Richa Ltd.	20,000
May 9	To Avengers Ltd.	50,000			
May 13	To Cash A/c	80,000			
		<u>2,00,000</u>	May 30	By Balance c/d	<u>1,80,000</u>
					2,00,000

PASS-BOOK

Date	Particulars	Withdrawals ₹	Deposits ₹	Dr. or Cr.	Balance ₹
2022					
May 1	Balance b/d			Cr.	1,00,000
May 7	To Mr. A	30,000		Cr.	70,000
May 12	By Avengers Ltd.		50,000	Cr.	1,20,000
May 13	By Cash A/c		80,000	Cr.	2,00,000
May 23	To Richa Ltd.	20,000		Cr.	1,80,000
May 29	Bank Charges	2,000		Cr.	1,78,000

Here when we compare Cash Book and Pass Book we found that following 2 entries remain unticked in pass book i.e. they don't appear in cash book:

Cheque to Mr. A - ₹ 30,000

Bank Charges - ₹ 2,000

Excess withdrawals as per pass book - ₹ 32,000

However if we notice that difference between closing balances of two books is only ₹ 2,000 but at the same time there is a difference of ₹30,000 in opening balances as well. Thus, we need to bifurcate the unticked items as:

Regarding Opening Balance	Regarding Closing Balance
Cheque to Mr. A - ₹ 30,000 This is an item which must have been recorded in Cash book during previous month when cheque would have been issued and would have appeared as a reconciling item in BRS of that month. Since, it has been presented to bank by Mr. A in April, it has been recorded now by the bank.	Bank Charges - ₹ 2,000 These have been charged by the bank but not recorded in books.



7. METHODS OF BANK RECONCILIATION

There are following two methods of reconciling the bank balances:

7.1 Bank Reconciliation Statement without Preparation of adjusted Cash-Book

For reconciliation purposes students can take any of the four balances as the starting point and can proceed further with the causes of differences.

Based on the earlier explanation the following table has been prepared for student's ready reference when reconciliation is done on the basis of 'Balance' presentation. The final balance, which will come after addition and subtraction, will be the balance as per the other book (on the opposite side).

Causes of differences	Favourable balance (Dr.) as per cash- book	Unfavourable balance (Cr.) as per cash- book	Favourable balance (Cr.) as per pass- book	Unfavourable balance (Dr.) as per pass- book
Cheque deposited but not cleared	Subtract	Add	Add	Subtract
Cheque issued but not presented to bank	Add	Subtract	Subtract	Add
Cheque directly deposited in bank by a customer	Add	Subtract	Subtract	Add
Income (e.g., interest from UTI) directly received by bank	Add	Subtract	Subtract	Add
Expenses (e.g., telephone bills, Insurance charges) directly paid by bank on standing instructions	Subtract	Add	Add	Subtract
Bank charges levied by bank	Subtract	Add	Add	Subtract
Locker rent levied by bank	Subtract	Add	Add	Subtract
Wrong debit in the cash book	Subtract	Add	Add	Subtract
Wrong credit in the cash book	Add	Subtract	Subtract	Add

Wrong debit in the pass book	Subtract	Add	Add	Subtract
Wrong credit in pass book	Add	Subtract	Subtract	Add
Undercasting of Dr. side of bank account in the cash book	Add	Subtract	Subtract	Add
Overcasting of Dr. side of bank account in cash book	Subtract	Add	Add	Subtract
Undercasting of Cr. side of bank account in cash book	Subtract	Add	Add	Subtract
Overcasting of Cr. side of bank account in cash book	Add	Subtract	Subtract	Add
Bill receivable collected directly by bank	Add	Subtract	Subtract	Add
Interest on bank overdraft charged	Subtract	Add	Add	Subtract
Final Balance	If answer is positive then favourable balance (Cr.) as per pass-book and if negative then unfavourable balance (Dr.) as per pass-book.	If answer is positive then Unfavourable balance (Dr.) as per pass-book and if negative then Favourable balance (Cr.) as per pass-book	If answer is positive then favourable balance (Dr.) as per cash-book and if negative then unfavourable balance (Cr.) as per cash-book	If answer is positive then Unfavourable balance (Cr.) as per cash-book and if negative then Favourable balance (Dr.) as per cash-book

It is proper to prepare a neat statement showing the reconciliation of the two balances. Taking the example given in the illustration 1, the statement may be prepared as follows:

1. 'Balance' presentation.
2. 'Plus & Minus' presentation.

1. As per Balance Presentation:

Bank Reconciliation Statement as on 31st January, 2022

Particulars	Details(₹)	Amount(₹)
Balance as per Pass Book		2,43,000
Add: Cheques deposited but not yet credited:		
M. Mohan & Co.	1,05,000	
N. Nandy & Sons	34,000	1,39,000
Add: Premium paid and bank charges entered in the Pass Book but not yet entered in the Cash-Book		26,000
		4,08,000
Less: Cheques issued but not yet presented		
K. Nagpal & Co.	73,000	
B. Babu & Co.	78,000	1,51,000
Less: Interest credited by bank but not yet entered in the Cash Book		2,57,000
		20,000
Balance as per Cash Book		2,37,000
OR		
Balance as per Cash Book		2,37,000
Add: Cheques issued but not yet presented:		
K. Nagpal & Co.	73,000	
B. Babu & Co.	78,000	1,51,000
Add: Interest entered in the Pass Book, but not yet in the Cash Book		20,000
		4,08,000
Less: Cheques deposited but not yet credited:		
M. Mohan & Co.	1,05,000	
N. Nandy & Sons	34,000	1,39,000
Less: Premium paid and bank charges entered in the Pass Book but not yet in the Cash Book		26,000
Balance as per Pass Book		2,43,000

2. As per Plus-Minus Presentation:

Bank Reconciliation Statement as on 31st January, 2022

Particulars	Plus Amount (₹)	Minus Amount (₹)
Balance as per Cash Book	2,37,000	
Cheques issued but not yet presented:		
K. Nagpal & Co.	73,000	
B. Babu & Co.	78,000	
Interest entered in pass book but not yet entered into cash book	20,000	
Cheques deposited but not yet credited:		
M. Mohan & Co.		1,05,000
N. Nandy & Sons		34,000
Premium paid and bank charges entered in pass book		26,000
Balance as per pass book		2,43,000
	4,08,000	4,08,000

ILLUSTRATION 2

From the following particulars, prepare a Bank Reconciliation Statement for Jindal offset Ltd.

- (1) Balance as per cash book is ₹ 2,40,000
- (2) Cheques issued but not presented in the bank amounts to ₹ 1,36,000.
- (3) Cheques deposited in bank but not yet cleared amounts to ₹ 90,000.
- (4) Bank charges amounts to ₹ 300.
- (5) Interest credited by bank amounts to ₹ 1,250.
- (6) The balance as per pass book is ₹ 2,86,950.

SOLUTION

Bank Reconciliation Statement

Particulars	Amount ₹
Balance as per Cash Book	2,40,000
Add: Cheque issued but not presented	1,36,000
Interest credited by bank	<u>1,250</u>
	3,77,250

Less : Cheque deposited but not yet cleared	(90,000)
Bank charges debited by bank	<u>(300)</u>
Balance as per Pass Book	2,86,950

ILLUSTRATION 3

On 31st March 2022, the Bank Pass Book of Namrata showed a balance of ₹ 1,50,000 to her credit while balance as per cash book was ₹ 1,12,050. On scrutiny of the two books, she ascertained the following causes of difference:

- She has issued cheques amounting to ₹ 80,000 out of which only ₹ 32,000 were presented for payment.
- She received a cheque of ₹ 5,000 which she recorded in her cash book but forgot to deposit in the bank.
- A cheque of ₹ 22,000 deposited by her has not been cleared yet.
- Mr. Gupta deposited an amount of ₹ 15,700 in her bank which has not been recorded by her in Cash Book yet.
- Bank has credited an interest of ₹ 1,500 while charging ₹ 250 as bank charges.

Prepare a bank reconciliation statement.

SOLUTION**Bank Reconciliation Statement as on 31st March, 2022**

Particulars	Details (₹)	Amount (₹)
Balance as per Pass Book (Cr.)		1,50,000
Add: Cheque deposited but not yet cleared	22,000	
Add: Cheque recorded in Cash Book but not yet deposited	5,000	
Add: Bank Charges debited by bank	250	27,250
Less: Cheque issued but not yet presented	48,000	
Less: Amount deposited but not recorded in Cash Book	15,700	
Less: Interest allowed by bank	1,500	65,200
Balance as per Cash Book		1,12,050

ILLUSTRATION 4

From the following particulars ascertain the balance that would appear in the Bank Pass Book of A on 31st December, 2022.

- (1) The bank overdraft as per Cash Book on 31st December, 2022 ₹ 6,340.
- (2) Interest on overdraft for 6 months ending 31st December, 2022 ₹ 160 is entered in Pass Book.
- (3) Bank charges of ₹ 400 are debited in the Pass Book only.
- (4) Cheques issued but not cashed prior to 31st December, 2022, amounted to ₹ 11,68,000.
- (5) Cheques paid into bank but not cleared before 31st December, 2022 were for ₹ 22,17,000.
- (6) Interest on investments collected by the bank and credited in the Pass Book ₹ 12,00,000.

SOLUTION**Bank Reconciliation Statement**

As on 31st December, 2022

Particulars	Amount ₹
Overdraft as per Cash Book	6,340
Add: Interest debited in the Pass Book but not yet entered in the Cash Book	160
Add: Bank charges debited in the Pass Book but not entered in the Cash Book	400
Add : Cheques deposited but not yet credited in the Pass Book	22,17,000
	22,23,900
Less: Cheques issued but not yet presented	(11,68,000)
Less: Interest collected and credited by bank but not yet entered in Cash Book	(12,00,000)
Balance as per Pass Book (Credit/Favourable balance)	(1,44,100)

The above illustration can also be presented with the column for "Plus" and "Minus."

Particulars	Plus Amount ₹	Minus Amount ₹
Overdraft as per Cash Book		6,340
Interest debited in Pass Book but not yet in Cash Book		160
Cheque issued but not yet presented	11,68,000	
Cheques paid in but not yet credited by the Bank		22,17,000

Bank charges		400
Interest collected and credited by the Bank in the Pass Book but not yet entered in Cash Book	12,00,000	
Balance as per Pass Book		1,44,100
Total	23,68,000	23,68,000

7.2 Bank Reconciliation Statement after the Preparation of adjusted Cash-Book

7.2.1 Meaning of adjusted cash book

When the balance in the cash book is first adjusted for certain adjustments before taking it to the bank reconciliation statement, then it is known as adjusted cash book balance. Adjusting the cash-book before preparing the bank reconciliation statement is completely optional, if reconciliation is done during different months. But if reconciliation is done at the end of the accounting year or financial year, the cash-book must be adjusted so as to reflect the correct bank balance in the balance sheet.

While adjusting the cash-book the following adjustments are considered:-

1. All the errors (like incorrect amount recorded in the cash-book, entry posted twice in the cash-book, over/undercasting of the balance etc.) and
2. Omissions (like bank charges recorded in the pass-book only, interest debited by the bank, direct receipt or payment by the bank, dishonour of cheques/bills etc.) by the cash-book are taken into care

Only above transactions are considered for adjusting cash book. Apart from this, any delay in recording in the pass-book due to difference in timing (like cheque issued but not presented for payment, cheque deposited but not cleared) is taken to bank reconciliation statement. This adjusted cash-book balance is taken to bank reconciliation statement.

Errors occurring in the pass-book are not to be adjusted in the cash book. All the adjustments considered in the adjusted cash-book are not carried again to the Bank Reconciliation Statement.

ILLUSTRATION 5

On 30th September, 2022, the bank account of X, according to the bank column of the Cash-Book, was overdrawn to the extent of ₹4,062. On the same date the bank statement showed a credit balance of ₹20,758 in favour of X. An examination of the Cash Book and Bank Statement reveals the following:

1. A cheque for ₹ 13,14,000 deposited on 29th September, 2022 was credited by the bank only on 3rd October, 2022.
2. A payment by cheque for ₹ 16,000 has been entered twice in the Cash Book.
3. On 29th September, 2022, the bank credited an amount of ₹ 1,17,400 received from a customer of X, but the advice was not received by X until 1st October, 2022.
4. Bank charges amounting to ₹ 580 had not been entered in the Cash Book.
5. On 6th September, 2022, the bank credited ₹ 20,000 to X in error.
6. A bill of exchange for ₹ 1,40,000 was discounted by X with his bank. This bill was dishonoured on 28th September, 2022 but no entry had been made in the books of X.
7. Cheques issued upto 30th September, 2022 but not presented for payment upto that date totalled ₹ 13,26,000.

You are required :

- (a) to show the appropriate rectifications required in the Cash Book of X, to arrive at the correct balance on 30th September, 2022 and
- (b) to prepare a bank reconciliation statement as on that date.

SOLUTION

(a) Cash Book (Bank Column)

Date 2022	Particulars	Amount ₹	Date 2022	Particulars	Amount ₹
Sept. 30	To Party A/c	16,000	Sept. 30	By Balance b/d	4,062
	To Customer A/c			By Bank charges	580
	(Direct deposit)	1,17,400		By Customer A/c	
	To Balance c/d	11,242		(B/R dishonoured)	1,40,000
		1,44,642			1,44,642

(b) Bank Reconciliation Statement as on 30th September, 2022

Particulars	Amount ₹
Overdraft as per Cash Book	11,242
Add: Cheque deposited but not collected upto 30th September, 2022	13,14,000
	13,25,242

Less: Cheques issued but not presented for payment upto 30th September, 2022	(13,26,000)
Credit by Bank erroneously on 6th September	(20,000)
Credit balance as per bank statement	20,758

Note: Bank has credited X by 20,000 in error on 6th September, 2022. If this mistake is rectified in the bank statement, then this will not be deducted in the above statement along with ₹ 13,26,000 resulting in credit balance of ₹ 758 as per pass-book.

ILLUSTRATION 6

On 30th December, 2022 the bank column of A. Philip's cash book showed a debit balance of ₹ 4,610. On examination of the cash book and bank statement you find that:

1. Cheques amounting to ₹ 6,30,000 which were issued to trade payables and entered in the cash book before 30th December, 2022 were not presented for payment until that date.
2. Cheques amounting to ₹ 2,50,000 had been recorded in the cash book as having been paid into the bank on 30th December, 2022, but were entered in the bank statement on 1st January, 2023.
3. A cheque received for ₹ 73,000 had been dishonoured prior to 30th December, 2022, but no record of this fact appeared in the cash book.
4. A dividend of ₹ 3,80,000, paid direct to the bank had not been recorded in the cash book.
5. Bank interest and charges amounting to ₹ 4,200 had been charged in the bank statement but not entered in the cash book.
6. No entry had been made in the cash book for a trade subscription of ₹ 10,000 paid vide banker's order in November, 2022.
7. A cheque for ₹ 27,000 drawn by B. Philip had been charged to A. Philip's bank account by mistake in December, 2022.

You are required:

- (a) to make appropriate adjustments in the cash book bringing down the correct balance, and
- (b) to prepare a statement reconciling the adjusted balance in the cash book with the balance shown in the bank statement.

SOLUTION

(a)

A. Philip

Dr.		Cash Book (Bank column)		Cr.	
Date 2022	Particulars	Amount ₹	Date 2022	Particulars	Amount ₹
Dec. 30	To Balance b/d	4,610	Dec. 30	By Trade receivables-	73,000
	To Dividend received	3,80,000		Cheque dishonoured	
				By Bank interest and charges	4,200
				By Trade Subscription	10,000
			Dec. 31	By Balance c/d	2,97,410
		3,84,610			3,84,610
2023					
Jan. 1	To Balance b/d	2,97,410			

(b)

Bank Reconciliation Statement as at 30th December, 2022

Particulars	Amount ₹
Balance per cash book	2,97,410
Add: Cheques not yet presented	6,30,000
	9,27,410
Less: Lodgement not yet recorded by bank	(2,50,000)
	6,77,410
Less: Cheque wrongly charged	(27,000)
Balance as per the bank statement	6,50,410

ILLUSTRATION 7

From the following information, prepare a Bank reconciliation statement as at 31st December, 2022 for Messrs New Steel Limited :

₹

(1)	Bank overdraft as per Cash Book on 31st December, 2022	22,45,900
(2)	Interest debited by Bank on 26th December, 2022 but no advice received	2,78,700
(3)	Cheque issued before 31st December, 2022 but not yet presented to Bank	6,60,000
(4)	Transport subsidy received from the State Government directly by the Bank but not advised to the company	14,25,000
(5)	Draft deposited in the Bank, but not credited till 31st December, 2022	13,50,000
(6)	Bills for collection credited by the Bank till 31st December, 2022 but no advice received by the company	8,36,000
(7)	Amount wrongly debited to company account by the Bank, for which no details are available	7,40,000

SOLUTION**M/s. New Steel Ltd.****Bank Reconciliation Statement as on 31st Dec, 2022**

Particulars	Details ₹	Amount ₹
Overdraft as per Cash Book		22,45,900
Add : Interest charged by the bank	2,78,700	
Draft deposited in bank but not yet credited	13,50,000	
Wrong debit by the bank, under verification	7,40,000	23,68,700
		46,14,600
Less: Cheque issued but not yet presented	(6,60,000)	
Transport subsidy not yet recorded in the Cash Book	(14,25,000)	
Bills for collection credited in the bank not yet entered in the cash book	(8,36,000)	(29,21,000)
Overdraft as per bank statement		16,93,600

ILLUSTRATION 8

The Cash Book of Mr. Gadbadwala shows ₹ 8,36,400 as the balance at Bank as on 31st December, 2022, but you find that it does not agree with the balance as per the Bank Pass Book. On scrutiny, you find the following discrepancies:

- (1) On 15th December, 2022 the payment side of the Cash Book was undercast by ₹ 10,000.
- (2) A cheque for ₹ 1,31,000 issued on 25th December, 2022 was not taken in the bank column.
- (3) One deposit of ₹ 1,50,000 was recorded in the Cash Book as if there is no bank column therein.
- (4) On 18th December, 2022 the debit balance of ₹ 15,260 as on the previous day, was brought forward as credit balance in the Cash book.
- (5) Of the total cheques amounting to ₹ 11,514 drawn in the last week of December, 2022, cheques aggregating ₹ 7,815 were encashed in December.
- (6) Dividends of ₹ 25,000 collected by the Bank and subscription of ₹ 1,000 paid by it were not recorded in the Cash Book.
- (7) One out-going Cheque of ₹ 3,50,000 was recorded twice in the Cash Book. Prepare a Reconciliation Statement.

SOLUTION

(If the books are not closed on 31st December, 2022)

Bank Reconciliation Statement of Mr. Gadbadwala as on 31st Dec., 2022

Particulars		Details ₹	Amount ₹
Balance as per the Cash Book			8,36,400
Add : Mistake in bringing forward ₹ 15,260 debit balance as credit balance on 18th Dec., 2022		30,520	
Cheques issued but not presented :			
Issued	11,514		
Cashed	7,815	3,699	
Dividends directly collected by bank but not yet entered in the Cash Book		25,000	
Cheque recorded twice in the Cash Book		3,50,000	
Deposit not recorded in the Bank column		1,50,000	5,59,219
			13,95,619
Less : Wrong casting in the Cash Book on 15th Dec.		10,000	

BANK RECONCILIATION STATEMENT**3.31**

Cheques issued but not entered in the Bank column		1,31,000	
Subscription paid by the bank directly not yet recorded in the Cash Book		1,000	(1,42,000)
Balance as per the Pass Book			12,53,619

If the books are to be closed on 31st December, then adjusted cash book will be prepared as given below:

Cash Book (Bank Column)

Particulars	Amount (₹)	Particulars	Amount (₹)
To Balance b/d	8,36,400	By wrong casting	10,000
To error for wrong posting	30,520	By cheques not entered	1,31,000
To dividends collected by bank	25,000	By subscription	1,000
To cheques recorded twice	3,50,000	By balance c/d	12,49,920
To deposit not recorded	1,50,000		
	13,91,920		13,91,920

Bank Reconciliation Statement

Particulars	₹
Balance as per the Cash Book (corrected)	12,49,920
Add: Cheques issued but not yet presented	3,699
Balance as per the Pass Book	12,53,619

ILLUSTRATION 9

The following are the Cash Book (bank column) and Pass Book of Jain for the months of March, 2022 and April, 2022:

Cash Book (Bank Column only)

Date	Particulars	Amount Dr. ₹	Date	Particulars	Amount Cr. ₹
01/3/2022	To Balance b/d	60,000	03/3/2022	By Cash A/c	2,00,000
06/3/2022	To Sales A/c	3,00,000	07/3/2022	By Modi	60,000
10/3/2022	To Ram	65,000	12/3/2022	By Patil	30,000
18/3/2022	To Singhal	2,70,000	18/3/2022	By Suresh	40,000

25/3/2022	To Goyal	33,000	24/3/2022	By Ramesh	1,50,000
31/3/2022	To Patel	65,000	30/3/2022	By Balance c/d	3,13,000
		7,93,000			7,93,000

Pass Book

Date	Particulars	Amount Dr. ₹	Amount Cr. ₹	Dr. or Cr.	Balance ₹
1/4/2022	By Balance b/d		3,65,000	Cr.	3,65,000
3/4/2022	By Goyal		33,000	Cr.	3,98,000
5/4/2022	By Patel		65,000	Cr.	4,63,000
7/4/2022	To Naresh	2,80,000		Cr.	1,83,000
12/4/2022	To Ramesh	1,50,000		Cr.	33,000
15/4/2022	To Bank Charges	200		Cr.	32,800
20/4/2022	By Usha		17,000	Cr.	49,800
25/4/2022	By Kalpana		38,000	Cr.	87,800
30/4/2022	To Sunil	6,200		Cr.	81,600

Reconcile the balance of cash book on 31/3/2022.

SOLUTION

- On scrutiny of the debit side of the Cash Book of March 2022 and receipt side of the Pass Book of April, 2022 reveals that two cheques deposited in Bank (Goyal ₹ 33,000 and Patel ₹ 65,000) in March were not credited by the Bank till 31/3/2022.
- On scrutiny of the credit side of the cash book and payment side of the Pass Book reveals that a cheque issued to Ramesh for ₹ 1,50,000 in March 2022, had not been presented for payment in Bank till 31/3/2022. Therefore the Bank Reconciliation statement on 31/3/2022 will appear as follows :

Bank Reconciliation Statement as on 31st March, 2022

Particulars	Amount (₹)
Balance as per the Cash Book	3,13,000
Add : Cheque issued but not presented for payment	1,50,000
	4,63,000
Less : Cheque deposited but not credited by Bank	(98,000)
Balance as per the Pass Book	3,65,000

ILLUSTRATION 10

When Nikki & Co. received a Bank Statement showing a favourable balance of ₹ 10,39,200 for the period ended on 30th June, 2022, this did not agree with the balance in the cash book.

An examination of the Cash Book and Bank Statement disclosed the following :

1. A deposit of ₹ 3,09,200 paid on 29th June, 2022 had not been credited by the Bank until 1st July, 2022.
2. On 30th March, 2022 the company had entered into hire purchase agreement to pay by bank order a sum of ₹ 3,00,000 on the 10th of each month, commencing from April, 2022. No entries had been made in Cash Book.
3. A customer of the firm, who received a cash discount of 4% on his account of ₹ 4,00,000 paid the firm a cheque on 12th June. The cashier erroneously entered the gross amount in the bank column of the Cash Book.
4. Bank charges amounting to ₹ 3,000 had not been entered in Cash-Book.
5. On 28th June, a customer of the company directly deposited the amount in the bank ₹ 4,00,000, but no entry had been made in the Cash Book.
6. ₹ 11,200 paid into the bank had been entered twice in the Cash Book.
7. A debit of ₹ 11,00,000 appeared in the Bank Statement for an unpaid cheque, which had been returned marked 'out of date'. The cheque had been re-dated by the customer and paid into Bank again on 5th July, 2022.

Prepare Bank Reconciliation Statement on 30 June, 2022.

SOLUTION**Bank Reconciliation Statement on 30th June, 2022**

Particulars	Details (₹)	Amount (₹)
Balance as per the Pass Book		10,39,200
Add: Deposited with bank but not credited	3,09,200	
Payment of Hire Purchase installments not entered in the Cash Book (₹ 3,00,000 x 3)	9,00,000	
Discount allowed wrongly entered in bank column	16,000	
Bank charges not entered in the Cash Book	3,000	
Deposit entered in the Cash Book twice	11,200	
Cheque returned 'out of date' entered in the Cash Book	11,00,000	23,39,400

		33,78,600
Less: Direct deposit by customer not entered in the Cash Book		(4,00,000)
Balance as per the Cash Book		29,78,600

ILLUSTRATION 11

Mr. Manoj is employed by Century Rayon and Carpets Pvt Ltd. as their cashier. The main responsibility of Mr. Manoj is to maintain the company's cash book and prepare a bank reconciliation statement at the end of each month. The cash book (only bank column) is set out below together with a copy of the bank statement for the month of February 2022.

You are required to :

- Reconcile the cash book with the bank statement.
- Make necessary entries to update the cash book.
- Start with the balance as per cash book, list any unpresented cheques and sub-total on the reconciliation statement.

Century Rayon and Carpets Pvt Ltd**Cash Book (Bank Column only)**

Date	Particulars	Amount Dr. ₹	Date	Particulars	Amount Cr. ₹
01/02/2022	To Balance b/d	1,42,500	03/02/2022	By Bhagwandas	1,980
01/02/2022	To Blue and Co	1,570	07/02/2022	By Maruti Ltd (400460)	1,500
04/02/2022	To GM Ltd	2,430	12/02/2022	By Jackson Ltd (400461)	54,000
08/02/2022	To Robinson Ltd	910	18/02/2022	By PC computers (400462)	1,420
13/02/2022	To Donald	750	24/02/2022	By Shiv garage (400463)	49,000
20/02/2022	To Avenue Super mart	4,200	30/02/2022	By Petty cash (400465)	1,500
28/02/2022	To Sleep Well Ltd	940		By Shweta & Co (400464)	2,100
				By AV Partners (400466)	5,200
				By Balance c/d	36,600
		1,53,300			1,53,300

Customer: Century Rayon and Carpets Pvt Ltd

Account No – xxxxx0439

Account Statement for the month of February 2022

Date	Particulars	Amount Dr.	Amount Cr.	Dr. or Cr.	Balance ₹
1/02/2022	Balance b/d				1,42,500
3/02/2022	Cheques		1,570	Cr.	1,44,070
5/02/2022	Maruti Ltd	1,500		Dr.	1,42,570
7/02/2022	Bhagwandas	1,980		Dr.	1,40,590
12/02/2022	GM Ltd		2,430	Cr.	1,43,020
15/02/2022	Robinson Ltd		910	Cr.	1,43,930
20/02/2022	Premium of New India Insurance Ltd	3,800		Dr.	1,40,130
14/02/2022	Donald		750	Cr.	1,40,880
14/02/2022	400463	49,000		Dr.	91,880
23/02/2022	cheques		4,200	Cr.	96,080
26/02/2022	Savita	1,030		Dr.	95,050
26/02/2022	400465	1,500		Dr.	93,550
27/02/2022	Shreya		2,200	Cr.	95,750
28/02/2022	Bank charges	2,538		Dr.	93,212

SOLUTION

In the books of Century Rayon and Carpets Pvt Ltd

a) Journal entries to be posted:

Bank A/c	Dr 2200	
To Shreya A/c		2200

Bank Charges A/c	Dr 2538	
Insurance premium A/c	Dr 3800	
Savita A/c	Dr 1030	
To Bank A/c		7368

After posting above entries, following will be the updated book of the company.

Cash Book (Bank Column)

Particulars	Amount (₹)	Particulars	Amount (₹)
To balance b/d	36,600	By bank charges	2,538
To direct receipt in bank	2,200	By insurance premium	3,800
		By direct payment to Savita	1,030
		By balance c/d	31,432
	38,800		38,800

Bank Reconciliation Statement as on February 28, 2022

Particulars	Details	Amount ₹
Updated Balance as per Cash book		31,432
<i>Add:</i> Cheques issued but not yet presented for payment		
Jackson Ltd	54,000	
P C Computers	1,420	
Shweta & Co	2,100	
A.V. Partners	5,200	62,720
		94,152
<i>Less:</i> Cheques deposited but not yet credited		
Sleep Well Ltd	940	940
Balance as per the bank statement		93,212

SUMMARY

- ♦ Bank pass book is merely a copy of the customer's account in the books of bank.
- ♦ Bank reconciliation statement is a statement which reconciles the balance as per cash book with the balance as per bank pass book by showing all causes of difference between the two.
- ♦ The salient features of bank reconciliation statement:
 - ✦ The reconciliation will bring out any errors that may have been committed either in the cash book or in the pass book;

- ✦ Any undue delay in the clearance of cheques will be shown up by the reconciliation;
- ✦ A regular reconciliation discourages the accountant of the bank from embezzlement. There have been many cases when the cashiers merely made entries in the cash book but never deposited the cash in the bank; they were able to get away with it only because of lack of reconciliation.
- ✦ It helps in finding out the actual position of the bank balance.
- ◆ The difference in the balances of both the books can be because of the following reasons:
 1. Timing differences,
 2. Transactions;
 3. Errors.
- ◆ Bank reconciliation can be started from any of the following four balances given in the question:
 1. Dr. balance as per cash book
 2. Cr. balance as per cash book
 3. Dr. balance as per pass book
 4. Cr. balance as per pass book
- ◆ There are two methods of reconciling the bank balances :
 1. Bank reconciliation statement without preparation of adjusted cash-book.
 2. Bank reconciliation statement after the preparation of adjusted cash-book.

TEST YOUR KNOWLEDGE

True or False

1. *Bank Reconciliation is the process of reconciling cash column of the cash book and bank column of the cash book.*
2. *There are 3 types of differences between cash book and pass book namely Timing, Transactions & Errors.*
3. *Adjusting the cash book for any errors and/or omissions before preparing bank reconciliation is optional when the reconciliation is done at the end of the financial year.*
4. *Debit balance in cash book is same as overdraft as per pass book.*

5. *Bank charges debited by the bank is an example of timing difference for the purposes of bank reconciliation.*
6. *Overcasting of the debit side of the cash book is an example of a difference that is due to error.*
7. *When we start bank reconciliation with a debit balance in cash book, then cheques issued but not yet presented should be added back to arrive at the balance as per pass book.*
8. *The bank charges charged by the bank should be deducted when bank reconciliation statement is being prepared starting from a credit balance of pass book.*
9. *When the causes of differences between pass book balance and cash book is not known, then the bank reconciliation statement can be prepared by matching the two books and identifying any unticked items in both sets.*
10. *While preparing the bank reconciliation statement starting with debit balance as per pass book or bank statement, the deposited cheques that are not yet cleared need not be adjusted.*
11. *Cash book shows a debit balance of ₹ 50,000 and the only difference from the balance as shown in pass book relates to cheques issued for ₹ 60,000 but not yet presented for payment. The balance as per pass book should be ₹ 1,10,000.*
12. *Overcasting of credit side of the cash book shall result in a higher bank balance in cash book when compared with pass book balance.*
13. *A cheque for ₹ 25,000 that was issued and was also presented for payment in same month but erroneously recorded on debit side of the cash book would cause a difference of ₹ 50,000 from the balance in pass book.*
14. *A direct debit by bank on account of any payment as may be instructed by customer should be recorded on credit side of cash book.*
15. *Bank Reconciliation Statement can be prepared in two formats – "Balance" presentation and "Plus & Minus" presentation.*
16. *The difference between cash book & pass book that relates to errors are those mostly made by Bank.*
17. *A cheque for ₹ 80,000 that was discounted from bank was dishonoured and the bank charged ₹ 1,600 as the charges on account of same. While starting with debit balance in cash book for preparing bank reconciliation statement, we need to deduct ₹ 78,400 to reconcile with pass book.*
18. *Interest on savings bank that is allowed or credited by bank is generally recorded in cash book prior to it being recorded by bank.*

19. *A regular bank reconciliation discourages the accountants to be involved in any kind of funds embezzlement.*
20. *Timing difference relates the transactions that are recorded in the same period in both cash book and also the bank pass book.*

Multiple Choice Questions

1. *When the balance as per Cash Book is the starting point, direct deposits by customers are:*
 - (a) *Added*
 - (b) *Subtracted*
 - (c) *Not required to be adjusted.*
2. *A debit balance in the depositor's Cash Book will be shown as:*
 - (a) *A debit balance in the Bank Statement.*
 - (b) *A credit balance in the Bank Statement.*
 - (c) *An overdrawn balance in the Bank Statement.*
3. *When balance as per Pass Book is the starting point, interest allowed by Bank is*
 - (a) *Added*
 - (b) *Subtracted*
 - (c) *Not required to be adjusted*
4. *A Bank Reconciliation Statement is prepared with the help of:*
 - (a) *Bank statement and bank column of the Cash Book.*
 - (b) *Bank statement and cash column of the Cash Book*
 - (c) *Bank column of the Cash Book and cash column of the Cash Book.*
5. *The cash book showed an overdraft of ₹ 1,50,000, but the pass book made up to the same date showed that cheques of ₹ 10,000, ₹ 5,000 and ₹ 12,500 respectively had not been presented for payments; and the cheque of ₹ 4,000 paid into account had not been cleared. The balance as per the pass book will be:*
 - (a) *₹ 1,10,000*
 - (b) *₹ 2,17,500*
 - (c) *₹ 1,26,500*

6. When drawing up a Bank Reconciliation Statement, if you start with a debit balance as per the Bank Statement, the unpresented cheques should be:
- (a) Added;
 - (b) Deducted;
 - (c) Not required to be adjusted.
7. When drawing up a BRS if you start with a Dr. Balance as per Bank Statement, the following are added:
- 1. Cheque issued but not presented to bank
 - 2. B/R collected directly by bank
 - 3. Overcasting of the Dr. Side of bank A/c in the cash book.
- (a) only 1
 - (b) only 1 & 2
 - (c) all of the above
8. A bank reconciliation statement is mainly prepared to:
- (a) Reconcile the cash balance of the cash book
 - (b) Reconcile the difference between the bank balance shown by the cash book and bank passbook
 - (c) both a & b

Theory Questions

- 1. Write short note on Bank reconciliation statement.
- 2. State the causes of difference between the balance shown by the pass book and the cash book.

Practical Questions

- 1. From the following particulars prepare a bank reconciliation statement as on 31st December 2022:
 - (i) On 31st December, 2022 the cash-book of a firm showed a bank balance of ₹ 60,000 (debit balance).
 - (ii) Cheques had been issued for ₹ 15,00,000, out of which cheques worth ₹ 4,00,000 only were presented for payment.

- (iii) *Cheques worth ₹ 11,40,000 were deposited in the bank on 28th December, 2022 but had not been credited by the bank. In addition to this, one cheque for ₹ 5,00,000 was entered in the cash book on 30th December, 2022 but was banked on 3rd January, 2023.*
 - (iv) *A cheque from Susan for ₹ 4,00,000 was deposited in the bank on 26th December 2022 but was dishonoured and the advice was received on 2nd January, 2023.*
 - (v) *Pass-book showed bank charges of ₹ 2000 debited by the bank.*
 - (vi) *One of the debtors deposited a sum of ₹ 5,00,000 in the bank account of the firm on 20th December, 2022 but the intimation in this respect was received from the bank on 2nd January, 2023.*
 - (vii) *Bank pass-book showed a debit balance of ₹ 3,82,000 on 31st December, 2022.*
2. *According to the cash-book of Gopi, there was a balance of ₹ 44,50,000 in his bank on 30th June, 2022. On investigation you find that:*
- (i) *Cheques amounting to ₹ 6,00,000 issued to creditors have not been presented for payment till the date.*
 - (ii) *Cheques paid into bank amounting to ₹ 11,05,000 out of which cheques amounting to ₹ 5,50,000 only collected by the bank up to 30th June 2022.*
 - (iii) *A dividend of ₹ 40,000 and rent amounting to ₹ 6,00,000 received by the bank and entered in the pass-book but not recorded in the cash book.*
 - (iv) *Insurance premium (up to 31st December, 2022) paid by the bank ₹ 27,000 not entered in the cash book.*
 - (v) *The payment side of the cash book had been under casted by ₹ 5,000.*
 - (vi) *Bank charges ₹ 1,500 shown in the pass book had not been entered in the cash book.*
 - (vii) *A bill payable of ₹ 2,00,000 had been paid by the bank but was not entered in the cash book and bill receivable for ₹ 60,000 had been discounted with the bank at a cost of ₹ 1,000 which had also not been recorded in cash book.*

Required:

- (a) *to make the appropriate adjustments in the cash book, and*
- (b) *to prepare a statement reconciling it with the bank pass book.*

3. Prepare a bank reconciliation statement as on 30th September, 2022 from the following particulars:

Particulars	₹
Bank balance as per pass-book	10,00,000
Cheque deposited in the bank, but no entry was passed in the Cash-Book	5,00,000
Cheque received, but not sent to bank	11,20,000
Credit side of the bank column cast short	2,000
Insurance premium paid directly by the bank under the standing advice	60,000
Bank charges entered twice in the cash book	2,000
Cheque issued, but not presented to the bank for payment	5,00,000
Cheque received entered twice in the cash book	10,000
Bills discounted dishonoured not recorded in the cash book.	5,00,000

4. Prepare a bank reconciliation statement from the following particulars on 31st March, 2022:

Particulars	₹
Debit balance as per bank column of the cash book	37,20,000
Cheque issued to creditors but not yet presented to the bank for payment	7,20,000
Dividend received by the bank but not yet entered in the cash book	5,00,000
Interest allowed by the bank	12,500
Cheques deposited into bank for collection but not collected by bank up to this date.	15,40,000
Bank charges	2,000
A cheque deposited into bank was dishonoured, but no intimation received	3,20,000
Bank paid house tax on our behalf, but no information received from bank in this connection.	3,50,000

5. Prepare a bank reconciliation statement from the following particulars on 31st March, 2022 and show the balance as per cash book:
- Overdraft as per passbook on March 31, 2022, is ₹ 3,00,000.
 - Interest on bank overdraft not entered in the cash book Rs. 36,500

- iii) *Insurance premium of Rs. 17,950 was due and paid by the bank but same has not been accounted in the books.*
- iv) *Cheques drawn in the last week of March, 2022, but not cleared till date for ₹ 13,000 and Rs. 23,500.*
- v) *Cheques deposited into bank on February, 2022, but yet to be credited on dated March 31, 2022 Rs. 56,000.*
- vi) *Amount of Rs. 20,500 is wrongly debited by the bank*
- vii) *Interest on Investment Rs. 83,800 collected and credited by bank but the same has not been entered in the Cash Book.*

ANSWERS/HINTS

True and False

1. False : Bank Reconciliation Statement reconciles bank column of cash book with the balance in the pass book i.e. customer account in the books of bank.
2. True : These are the three broad categories.
3. False : Adjusting the cash book is mandatory when bank reconciliation is done at the end of the financial year.
4. False : Debit balance as per cash book should be represented by credit or favourable balance in pass book.
5. False : Bank charges are example of the transactions that bank carries out by itself and the same has not been recorded in the cashbook until statement is obtained from the bank.
6. True : Overcasting is an example of an error.
7. True : Since the cheques issued would have been recorded as payments and bank balance was credited in cash book, we need to add it back as the same is not yet deducted from our bank balance.
8. False : Bank charges should be added when we start with credit or favourable balance in pass book as bank would have debited the charges.
9. True : Since, we don't know the causes of difference, matching the two statements is only efficient way to identify the difference.
10. False : Cheques deposited but not yet cleared should be subtracted from debit or unfavourable balance in pass book.

11. True : Cheques issued but not yet presented should be added back to a debit balance in cash book to arrive at pass book balance i.e. ₹ 50,000 + ₹ 60,000 = ₹ 1,10,000.
12. False : Overcasting of credit side means excessive payments are recorded and hence would lower the bank balance.
13. True: ₹ 25,000 payment is recorded as a receipt and hence it will have to be adjusted twice (once to nullify and then once to record actual payment) hence causing the difference of double amount.
14. True : It is an example of a payment instructed by customer to be directly debited by bank, and hence credited in the cash book.
15. True : Reconciliation statement can be prepared in either of the two formats.
16. False : Bank rarely makes mistakes, and hence differences that relate to errors are generally made in cash book.
17. False : We need to deduct ₹ 81,600 (i.e. both cheque returned & charges) from debit balance in cash book to arrive at balance as per pass book.
18. False : Interest allowed by bank is mostly recorded in cash book after the entry has been made in the pass book or bank statement.
19. True : In absence of any reconciliation, the accountants can mis-utilize the funds temporarily by recording the entry without actual depositing the cash.
20. False : Timing differences relate to the transactions that are recorded in cash book and pass book in two different periods.

Multiple Choice Questions

1.	(a)	2.	(b)	3.	(b)	4.	(a)	5.	(c)	6.	(a)
7.	(b)	8.	(b)								

Theoretical Questions

1. Bank reconciliation statement is prepared as on a particular date to reconcile and explain the causes of difference between the bank balance as per cash book and the same as per savings bank pass book or current account statement. At the end of each month, the bank balance as per cash book and that as per pass book /bank statement should be compared and, if there is disagreement, these balances should be reconciled stating exact reasons of disagreement. The reconciliation is made in a statement called the bank reconciliation statement.

2. The difference between the balance shown by the passbook and the cashbook may arise on account of the following:
- (i) Cheques issued but not yet presented for payment.
 - (ii) Cheques deposited into the bank but not yet cleared.
 - (iii) Interest allowed by the bank.
 - (iv) Interest and expenses charged by the bank.
 - (v) Interest and dividends collected by the bank.
 - (vi) Direct payments by the bank.
 - (vii) Direct deposits into the bank by a customer.
 - (viii) Dishonour of a bill discounted with the bank.
 - (ix) Bills collected by the bank on behalf of the customer.
 - (x) An error committed in cash book or by the bank etc.
 - (xi) Undercasting or Overcasting in cashbook.

Practical Questions

1. **Bank Reconciliation Statement**
as on 31st December, 2022

	₹	₹
Bank balance (Dr.) as per cash book		60,000
<i>Add:</i> Cheques issued but not yet presented for payment	11,00,000	
Cheques directly deposited by a customer not yet recorded in cash book	5,00,000	16,00,000
		16,60,000
<i>Less:</i> Cheques deposited but not yet credited by bank	11,40,000	
Cheque received and recorded in cash book but not yet banked	5,00,000	
Cheque dishonoured by the bank; the dishonour entry not yet passed in cash book	4,00,000	
Bank charges not recorded in cash book	2,000	(20,42,000)
Bank balance (Dr.) as per pass book		(3,82,000)

2.

Cash Book (Bank Column)

Receipts	₹	Payments	₹
To Balance b/d	44,50,000	By Insurance premium A/c	27,000
To Dividend A/c	40,000	By Correction of errors	5,000
To Rent A/c	6,00,000	By Bank charges	1,500
To Bill receivable A/c	59,000	By Bill payable	2,00,000
		By Balance c/d	49,15,500
	51,49,000		51,49,000

Bank Reconciliation Statement**as on 30th June, 2022**

	₹
Adjusted balance as per cash book (Dr.)	49,15,500
Add: Cheques issued but not presented for payment till 30th June, 2022	6,00,000
Less: Cheques paid into bank for collection but not collected till 30th June, 2022	(5,55,000)
Balance as per pass book	49,60,500

3.

Bank Reconciliation Statement as on 30th September, 2022

	₹	₹
Bank balance as per pass book		10,00,000
Add: Cheque received but not sent to the bank	11,20,000	
Credit side of the bank column cast short	2,000	
Insurance premium paid directly not recorded in the cash book	60,000	
Cheque received entered twice in the cash book	10,000	
Bills dishonoured not recorded in the cash book	5,00,000	16,92,000
		26,92,000
Less: Cheque deposited into the bank but no entry was passed in the cash book	5,00,000	
Bank charges recorded twice in the cash book	2,000	
Cheque issued but not presented to the bank	5,00,000	(10,02,000)
Bank balance as per cash book		16,90,000

**4. Bank Reconciliation Statement
as on 31st March, 2022**

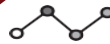
	₹	₹
Debit balance as per cash book		37,20,000
<i>Add:</i> Cheque issued but not yet presented to bank for payment	7,20,000	
Dividend received by bank not entered in cash book	5,00,000	
Interest allowed by bank	12,500	12,32,500
		49,52,500
<i>Less:</i> Cheques deposited into bank but not yet collected	15,40,000	
Bank charges	2,000	
A cheque deposited into bank was dishonoured	3,20,000	
House tax paid by bank	3,50,000	(22,12,000)
Credit balance as per pass book		27,40,500

5. Bank Reconciliation Statement as on 31st March, 2022

	₹	₹
Balance as per bank statement (Overdraft)		3,00,000
<i>Add:</i> Cheques drawn but not cleared	36,500	
Interest collected on investments directly credited by bank	83,800	1,20,300
		4,20,300
<i>Less:</i> Interest on bank overdraft not entered in the cash book	36,500	
Cheques deposited but not yet cleared	56,000	
Insurance premium paid by bank	17,950	
Amount wrongly debited by bank	20,500	1,30,950
Overdraft as per cash book		289,350

NOTES

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INVENTORIES

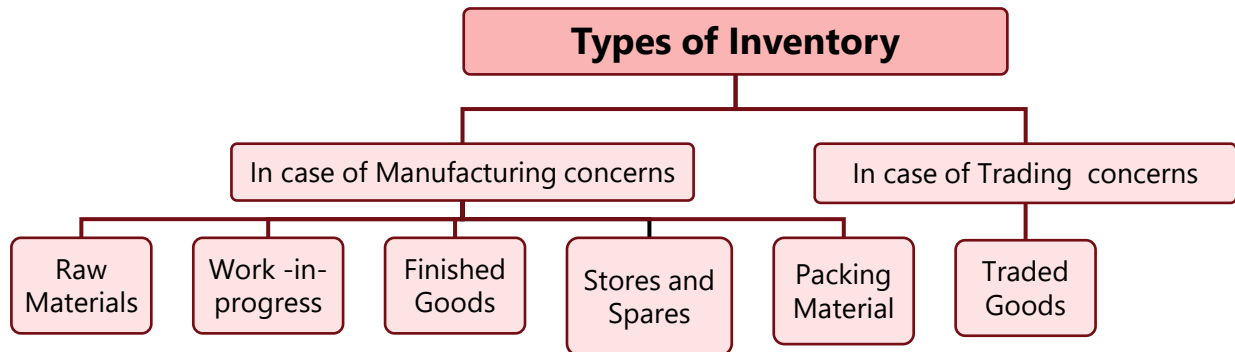


LEARNING OUTCOMES

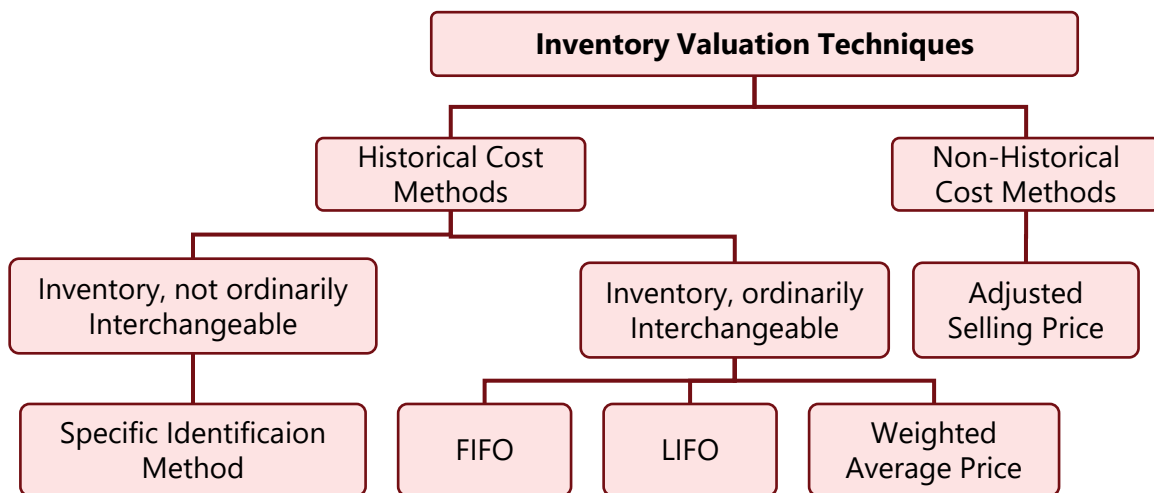
After studying this chapter, you will be able to:

- ◆ Understand the meaning of term 'Inventory'.
- ◆ Learn the technique of Specific Identification Method, FIFO, Average Price, Weighted Average Price and Adjusted Selling Price methods of inventory valuation.
- ◆ Understand the methods of inventory record keeping and comprehend the intricacies relating to Inventory taking.

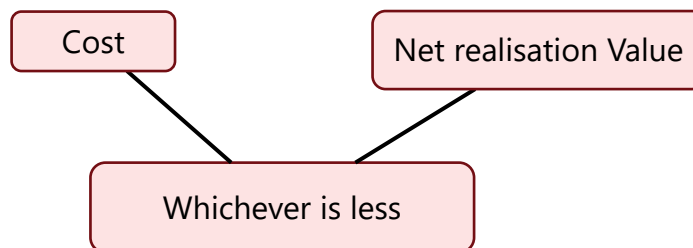
CHAPTER OVERVIEW



Formulae for Determining Cost of Inventory



Basis of Inventory Valuation





1. MEANING

Inventory can be defined as assets held

- ♦ for sale in the ordinary course of business, or
- ♦ in the process of production for such sale, or
- ♦ for consumption in the production of goods or services for sale, including maintenance supplies and consumables other than machinery spares, servicing equipment and standby equipment.

There can be different types of inventory based on nature of business of an enterprise. The inventories of a trading concern consist primarily of products purchased for resale in their existing form. It may also have an inventory of supplies such as wrapping paper, cartons, and stationery. The inventories of manufacturing concern consist of several types of inventories: raw material (which will become part of the goods to be produced), work-in-process (partially completed products in the factory) and finished products. In manufacturing concerns inventories will also include maintenance supplies, consumables, loose tools and spare parts. However, inventories do not include spare parts, servicing equipment and standby equipment which can be used only in connection with an item of fixed asset and whose use is expected to be irregular; such machinery spares are generally accounted for as fixed assets. Similarly, in an enterprise engaged in construction business, projects under construction are also considered as inventory.

At the year-end (or any period for which books are closed) every business entity needs to ascertain the closing balance of Inventory which comprise of Inventory of raw material, work-in-progress, finished goods and other consumable items. Value of closing Inventory is put at the credit side of the Trading Account and asset side of the Balance Sheet. So, before preparation of final accounts, the accountant should know the value of Inventory of the business entity. However, we shall restrict our discussion on inventory valuation of a manufacturing concern and goods of a trading concern.



2. INVENTORY VALUATION

A primary issue in accounting for inventories is the determination of the value at which inventories are carried in the financial statements until the related revenues are recognized. Inventory is generally the most significant component of the current assets held by a trading or manufacturing enterprise. It is widely recognized that inventory is one of the major assets that affects efficiency of operations. Both excess of inventory and its shortage affects the production activity, and the profitability of the enterprise whether it is a manufacturing or a trading business. Proper valuation of inventory has a very significant bearing on the

authenticity of the financial statements. The significance of inventory valuation arises due to various reasons as explained in the following points:

(i) Determination of Income

The valuation of inventory is necessary for determining the true income earned by a business entity during a particular period. To determine gross profit, cost of goods sold is matched with revenue of the accounting period. Cost of goods sold is calculated as follows:

Cost of goods sold = Opening inventory + Purchases + Direct expenses - Closing inventory.

Inventory valuation will have a major impact on the income determination if merchandise cost is large fraction of sales price. The effect of any over or under statement of inventory may be explained as:

If the value of.....		Then net income will be.....	
Closing inventory overstated		Overstated	
Opening inventory overstated		Understated	
Closing inventory understated		Understated	
Opening inventory understated		Overstated	

The effect of misstatement of inventory figure on the net income is always through cost of goods sold. Thus, proper calculation of cost of goods sold and for that matter, proper valuation of inventory is necessary for determination of correct income.

(ii) Ascertainment of Financial Position

Inventories are classified as **current assets**. The value of inventory on the date of balance sheet is required to determine the financial position of the business. In case the inventory is not properly valued, the balance sheet will not disclose the truthful financial position of the business.

Usually, slow-moving or non-moving inventory is the basic reason for poor financial performance as well as financial position of an enterprise. To identify such items, the first step is to value the inventory in the appropriate manner.

(iii) Liquidity Analysis

Inventory is classified as a current asset, it is one of the components of net working capital which reveals the liquidity position of the business. Current ratio which studies the relationship between current assets and current liabilities is significantly affected by the value of inventory. Bankers rely on the current ratio which is denoted as current

assets divided by current liabilities. If inventory is a major part of the current assets then, naturally, the next set of questions that arise would be:

- a) Whether the inventory is properly valued based on consistently applied principles?
- b) Are there any items of inventory that are either slow-moving or non-moving ?
- c) How often an external auditor has verified the inventories to make the valuation reliable?

Studies have shown that poor management of inventories, is one of the reasons of losses of small manufacturing enterprises which eventually leads to shutting down of such business units.

(iv) Statutory Compliance

Schedule III to the Companies Act, 2013 requires valuation of each class of goods i.e. raw material, work-in-progress and finished goods under broad head to be disclosed in the financial statements. As per the requirements of the Accounting Standards, the financial statements should disclose:

- (a) the accounting policies adopted in measuring inventories, including the cost formula used, and
- (b) the total carrying amount of inventories and its classification appropriate to the enterprise.

The common classification of inventories are raw materials; work-in-progress; finished goods; stores-in-trade (in respect of goods acquired for trading) and spares and loose tools.



3. BASIS OF INVENTORY VALUATION

Inventories should be generally **valued at the lower of cost or net realizable value**. This principle is governed by 'Principle of Conservative Accounting' under which any expenses or losses from transactions entered or event occurred are to be recognized immediately, however, any gains or profits are not recognized until it becomes due or are actually realized. Under the principle of 'lower of cost or net realizable value' any loss due to decrease in sales price of the inventory below its cost is recognized immediately as it is anticipated that the enterprise will make losses whenever it will sell.

Cost: As per **Accounting Standards**, Cost of inventories should comprise

1. all cost of purchase,
2. costs of conversion (primarily for finished goods and work - in progress) and
3. other costs incurred in bringing the inventories to their present location and condition.

Cost of purchase consist of purchase price including duties and taxes (other than those subsequently recoverable by the enterprise from the taxing authorities), freight inwards and other expenditure directly attributable to the acquisition. Trade discounts, rebates, duty drawbacks and other similar items are deducted in determining costs of purchase. In other words, cost includes any amount paid to the seller reduced by any discounts/rebates given by the seller. Similarly, any duties paid to the supplier will be part of cost of the inventory unless the enterprises can recover these taxes duties from the authorities.

For example- Raw material required for making a product is bought at ₹100 per unit plus GST at 18%. 100 units of raw material are bought.

So, the amount that needs to be paid is ₹100 x 100 units = ₹10,000+GST at 18% = ₹11,800/-

However, since the GST on purchase is available as credit, it won't be counted as the cost of purchase. Hence, the cost of purchase will be ₹10,000 only and not ₹11,800/-

Costs of conversion of inventories include costs directly related to the units of production, such as direct labour. They also include a systematic allocation of fixed and variable overheads.

Continuing the above example – for the conversion of 100 units of raw material into finished goods, direct labour cost incurred is ₹3,000. Then, the cost of conversion will be ₹3,000 and thus the value of inventory at this stage is ₹13,000 (for 100 units)

Other Costs may include administrative overheads incurred to bring the inventory into present location and condition or any cost specifically incurred on inventory of a specified customer. Interest and other borrowing costs are generally not included in the cost of inventory. However, in some circumstances where production process is longer and it is required to carry inventory for a long period e.g. wine, rice and timber it may be appropriate to consider interest and other borrowing cost also part of cost of inventory.

In the same example let us assume that ₹200 is paid as unloading charges for the raw material from the truck to the storage place in the factory, in that case ₹200 shall NOT be accounted as unloading charges separately as expenses, but shall be accounted as other costs to bring the inventory to present location. And hence the cost of inventory of 100 units at this stage shall be ₹13,200/-

Exclusions from cost of inventories: Following expenses are generally not included in the costs of inventories:

- (a) abnormal amounts of wasted materials, labour or other production overheads;
- (b) storage costs, unless those costs are necessary in the production process prior to further production stage;
- (c) administrative overheads that do not contribute to bringing the inventories to their present location and condition; and
- (d) selling and distribution costs

Brief explanation about the exclusions from the cost of inventories:

- (a) Normal wastage of material or labour cost is included in the cost of inventory. However, abnormal wastage is excluded for the reason that it occurs either due to inefficiency or abnormal factors that won't justify considering those wastages as part of inventory cost.
- (b) Storage costs are normally the cost of doing business. For example, rent of warehouse or storage area is considered as overheads already and hence not considered as cost of inventory. However, if special storage is required as part of the production process, then such storage cost is considered as cost of inventory. For example, in wine making process, requires the raw material is stored in a particular condition for fermentation for a long time (usually years together), such cost of storage is accounted as cost of inventory.
- (c) Administrative overheads do not usually add any specific value to inventories and hence excluded.
- (d) Selling and distribution costs are part of selling and general administration costs and hence excluded.

Net realizable value: This is the estimated selling price in the ordinary course of business less the estimated costs of completion and the estimated costs necessary to make the sale. In case of finished goods and traded goods net realizable value will generally mean selling price which is reduced by selling and distribution expenses. In case of work in progress, expenses and overheads required to be incurred to convert work -in progress into finished goods and making it ready for sale will also be reduced from selling price. In case of raw materials, replacement cost is generally considered as net realizable value.

An assessment is made of as at each balance sheet date. Inventories are usually written down to net realizable value on an item-by-item basis. In some circumstances, however, it may be appropriate to group similar or related items e.g. in case of interchangeable items it may not be possible to identify cost and net realizable value of each item separately.

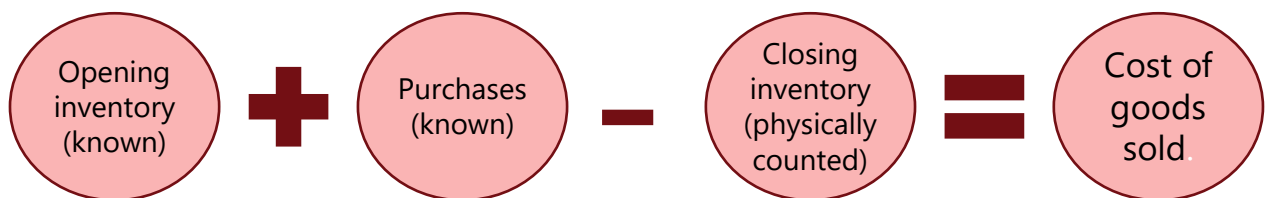


4. INVENTORY RECORD SYSTEMS

There are two principal systems of determining the physical quantities and monetary value of inventories sold and in hand. One system is known as 'Periodic Inventory System' and the other as the 'Perpetual Inventory System'. The periodic system is less expensive to use than the perpetual method. But the useful information obtained from perpetual system is more than cost incurred on it. These systems are distinguished on the basis of the actual records kept to ascertain the cost of goods sold and the closing inventory valuations.

4.1 PERIODIC INVENTORY SYSTEM

Periodic inventory system is a method of ascertaining inventory by taking an **actual physical count (or measure or weight)** of all the inventory items on hand at a **particular date** on which inventory is valued. It is because of actual physical count that the system is also called physical inventory system. The cost of goods sold is determined as shown below:



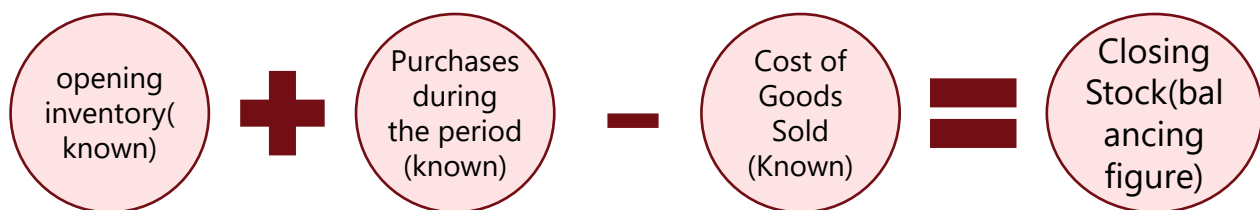
Periodic inventory system is simple and less expensive than the perpetual system. In this system, inventory account is adjusted at the end of the accounting period to determine cost of goods sold. This system suffers from various limitations:

- (i) Physical inventory taking is required more than once a year for preparation of quarterly or half yearly financial statements thereby making this system more expensive.
- (ii) Physical count of goods requires closure of normal operations of business.
- (iii) As cost of goods sold is taken as residual figure, it is not possible to identify loss of goods due to pilferage, damage or even fraud.
- (iv) Inventory control is not possible under this system.
- (v) Books of accounts does not reflect inventory in hand and its value therefore, it is difficult to plan operations e.g. how much or when to order/manufacture.

This system is used by small enterprises where it is easy to control physical inventory. This system is not considered suitable for medium or larger enterprises which generally use Perpetual Inventory system.

4.2 PERPETUAL INVENTORY SYSTEM

Perpetual inventory system is a system of **recording inventory balances after each receipt and issue**. In order to ensure accuracy of perpetual inventory records, physical inventory should be checked and compared with recorded balances. Under this system, cost of goods issued is directly determined and inventory of goods is taken as residual figure with the help of inventory ledger in which flow of goods is recorded on continuous basis. The basic feature of this system is the maintenance of inventory ledger to have records of goods on continuous basis. Under perpetual inventory system, closing inventory is determined as follows:



Perpetual inventory system helps to overcome the limitations of periodic system. As inventory is taken as residual figure, it includes loss of goods. However, the main limiting factor is the high cost of using this system.

4.3 DISTINCTION BETWEEN PERIODIC INVENTORY SYSTEM AND PERPETUAL INVENTORY SYSTEM

Both the systems - Periodic Inventory System and Perpetual Inventory System are not mutually exclusive and complementary in nature. Distinction between both the systems can be explained as follows:

S. No.	Periodic Inventory System	Perpetual Inventory System
1.	This system is based on physical verification.	It is based on book records.
2.	This system provides information about inventory and cost of goods sold at a particular date.	It provides continuous information about inventory and cost of sales.
3.	This system determines inventory and takes cost of goods sold as residual figure.	It directly determines cost of goods sold and computes inventory as balancing figure.

4.	Cost of goods sold includes loss of goods as goods not in inventory are assumed to be sold.	Closing inventory includes loss of goods as all unsold goods are assumed to be in Inventory.
5.	Under this method, inventory control is not possible.	Inventory control can be exercised under this system.
6.	This system is simple and less expensive.	It is costlier method.
7.	Periodic system requires closure of business for counting of inventory.	Inventory can be determined without affecting the operations of the business.



5. FORMULAE/METHODS TO DETERMINE COST OF INVENTORY

5.1 Historical Cost Methods

There is no unique formula for determination of historical cost of inventories. The different techniques for valuation of inventory have been discussed below:

(i) Specific Identification Method

Pricing under this method is based on actual physical flow of goods. It attributes specific costs to identified goods and requires keeping different lots purchased separately to identify the lot out of which units in inventories are left. The historical costs of such specific purpose inventories may be determined on the basis of their specific purchase price or production cost.

This method is generally used to ascertain the cost of inventories of items that are not ordinarily interchangeable and their value is high like expensive medical equipment, otherwise it requires the use of FIFO (First in first out) or weighted average price/average price formula.

ILLUSTRATION 1

Surekha Ltd deals in 3 products P, Q & R, which are neither similar nor interchangeable. At the end of a financial year, the Historical Cost and NRV of items of Closing Stock are given below. Determine the value of Closing Stock.

Items	Historical Cost (in ₹ Lakhs)	Net Realisable Value (in Lakhs)
P	38	42
Q	29	29
R	17	14

SOLUTION

Inventories are to be valued at the lower of cost and Net Realisable Value (NRV). Inventories are usually written down to NRV on an item-by-item basis. The Value of Closing Stocks is determined as under:

Items	Historical Cost (in ₹ Lakhs)	Net Realisable Value (in ₹ Lakhs)	Valuation = Least of Cost or NRV
P	38	42	38
Q	29	29	29
R	17	14	14
Total			81

(ii) FIFO (First in first out) Method

This method is based on the assumption that cost should be charged to revenue in the order in which they are incurred, that is, it is assumed that the issue of goods is usually from the earliest lot on hand. The inventory of goods on hand therefore, consists of the latest consignments. Thus, the closing inventory is valued at the price paid for such consignments.

The FIFO formula assumes that the items of inventories which were purchased or produced first are consumed or sold first and consequently items remaining in the inventory at the end of the period are those most recently purchased or produced. This assumption is in line with the good business practice to disposing goods in the order of their acquisition especially in the case of perishable goods and items with frequent technological changes. It must be kept in mind that this assumption of cost flow or goods flow need not be true as a physical fact i.e. not necessary goods are physically also sold or issued in the chronological order of their purchase or production. It relates only to the method of accounting and not to the actual physical movement of goods.

Now, let us take an example to understand the application of FIFO method.

ILLUSTRATION 2

A manufacturer has the following record of purchases of a condenser, which he uses while manufacturing radio sets:

Date	Quantity (units)	Price per unit
Dec. 4	900	50
Dec. 10	400	55

Dec. 11	300	55
Dec. 19	200	60
Dec. 28	800	47
	2,600	

1,600 units were issued during the month of December till 18th December. Calculate the value of closing inventory.

SOLUTION

The closing inventory is 1,000 units and would consist of:

800 units received on 28th December; and

200 units received on 19th December as per FIFO

	₹
The value of 800 units @ ₹ 47	37,600
The value of 200 units @ ₹ 60	12,000
Total	49,600

(iii) LIFO (Last in first out) Method

As the name suggests, the LIFO formula assigns to cost of goods sold, the cost of goods that have been purchased last though the actual issues may be made out of the earliest lot on hand to prevent unnecessary deterioration in value. The closing inventory then is assumed to consist of earlier consignments and its value is then calculated according to such consignments. Under this basis, goods issued are valued at the price paid for the latest lot of goods on hand which means inventory of goods in hand is valued at price paid for the earlier lot of goods. In the absence of details of issue, the price paid for the earliest consignments is used for valuing closing inventory. LIFO method is based on the principle of matching current cost with current revenue as cost of recently purchased or produced goods are charged to cost against each sale. The cost of goods sold under this method represents the cost of recent purchases resulting that there is better matching of current costs with current sales.

ILLUSTRATION 3

In the previous example assume that following issues were made during the month of December:

Record of issues

Date	Quantity (units)
Dec. 5	500
Dec. 20	600
Dec. 29	500
Total	1,600

SOLUTION

Computation of closing stock under perpetual inventory system

Using LIFO method, following will be stock ledger:

Date	Receipts			Issues			Balance inventory		
Dec.	Qty.	Rate	Amount	Qty	Rate	Amount	Qty.	Rate	Amount
4	900	50	45,000	-	-	-	900	50	45,000
5	-	-	-	500	50	25,000	400	50	20,000
10	400	55	22,000	-	-	-	400	50	20,000
							400	55	22,000
11	300	55	16,500	-	-	-	400	50	20,000
							400	55	22,000
							300	55	16,500
19	200	60	12,000	-	-	-	400	50	20,000
							400	55	22,000
							300	55	16,500
							200	60	12,000
20	-	-	-	200	60	12,000			
	-	-	-	300	55	16,500			
	-	-	-	100	55	5,500	400	50	20,000
							300	55	16,500
28	800	47	37,600	-	-	-	400	50	20,000
							300	55	16,500

28							800	47	37,600
29	-	-	-	500	47	23,500	400	50	20,000
							300	55	16,500
							300	47	14,100

Therefore, cost of closing inventory of 1,000 pcs will be ₹ 50,600.

Computation under periodic inventory system

In the above example, if the entity followed periodic inventory valuation, closing inventory of 1,000 pcs. will be valued as follows:

800 pcs. @ ₹ 47 each (purchased on Dec. 28th)	=	₹ 37,600
200 pcs. @ ₹ 60 each (purchased on Dec. 19th)	=	₹ 12,000
Total 1,000 pcs.	=	₹ 49,600

We can see that cost of closing inventory has changed following LIFO method based on perpetual inventory method and periodic inventory method.

"LIFO method is based on an irrational assumption that inventories entering last in the stores are issued or consumed first. However, the flow of goods which is generally observed in business entities is contradictory to this assumption. It should be noted that while applying LIFO, there will be difference in cost of goods sold and value of closing inventory, if the entity follows periodic as against perpetual method of inventory valuation. (Periodic and Perpetual methods have been explained later in this chapter). Therefore, LIFO method is no longer adopted for valuing inventories. Accounting Standards also does not permit the usage of LIFO Method. Generally, in practice, FIFO and Weighted Average Price Method are popular among the business entities and both these methods are also permitted by Accounting Standards."

(iv) Simple Average Price Method

Simple Average price for computing value of inventory is a very simple approach. All the different prices are added together and then divided by the number of prices. The closing inventory is then valued according to the price ascertained. This method is generally followed by the entities using periodic inventory method as it does not require efforts of identifying that closing inventory belongs to which consignments or lots.

ILLUSTRATION 4

In the same example of a manufacturer of radio sets given earlier, let us calculate the value of closing inventory using Average Price Method:

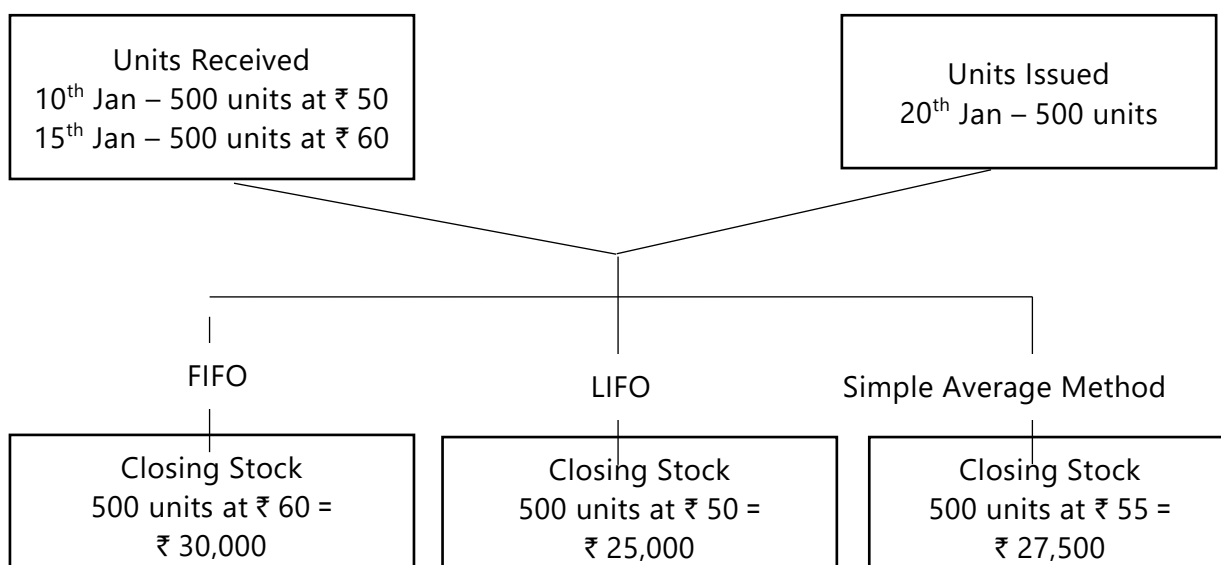
SOLUTION

The simple average in this question is:

$$[(50 + 55 + 55 + 60 + 47)/5] = 267/5 = ₹ 53.4$$

1,000 units valued at ₹ 53.4 would be ₹ 53,400

Let us try to analyse the impact of FIFO, LIFO and Simple Average Price Method with the help of the following chart:



Thus, we see that value of inventories changes based on different cost formula used.

(v) Weighted Average Price Method

Simple average price does not consider quantities purchased in various lots. However, it is more logical to compute weighted average price using the quantities purchased in a lot as weights. Under weighted average price method, cost of goods available for sale during the period is aggregated and then divided by number of units available for sale during the period to calculate weighted average price per unit. Thus

$$\text{Weighted average price per unit} = \frac{\text{Total cost of goods available for sale during the period}}{\text{Total number of units available for sale during the period}}$$

$$\text{Closing inventory} = \text{No. of units in inventory} \times \text{Weighted average price per unit}$$

$$\text{Cost of goods sold} = \text{No. of units sold} \times \text{Weighted average price per unit.}$$

ILLUSTRATION 5

On the basis of the data given in illustration 2 and 3, calculate the weighted average price and also the value of closing inventory by weighted average price method.

SOLUTION

The computation of weighted average price in the referred example is shown below:

A new average rate would be calculated on receiving a fresh consignment. Answer on that basis would be as under:

Date	Receipts			Issues			Balance inventory		
	Qty	Rate	Amount	Qty	Rate	Amount	Qty	Rate	Amount
Dec. 4	900	50	45,000	-	-	-	900	50	45,000
Dec. 5	-	-	-	500	50	25,000	400	50	20,000
Dec. 10	400	55	22,000	-	-	-	800	52.5	42,000
Dec. 11	300	55	16,500	-	-	-	1,100	53.18	58,500
Dec. 19	200	60	12,000	-	-	-	1,300	54.23	70,500
Dec. 20	-	-	-	600	54.23	32,538	700	54.23	37,962
Dec. 28	800	47	37,600	-	-	-	1,500	50.37	75,562
Dec. 29	-	-	-	500	50.37	25,185	1,000	50.37	50,377

Perpetual and Periodic Inventory System and Average Methods of Cost of Inventory

Both Simple Average Method and Weighted Average Method are applied differently in case the entity uses periodic inventory taking or Perpetual inventory taking. In case of periodic inventory, taking inventory available for sale during the period is considered together and an average rate is computed and closing inventory is valued using that rate. In case perpetual inventory records, average rate of inventory is computed on each new purchase and next issue is recorded using new average rate.

Illustration 5 above is an example of Weighted average method used in perpetual inventory recording system. In case the entity would have been using periodic inventory recording system, closing inventory would have been valued as below:

Details of purchases/receipt during the period

Date	Qty.	Rate	Value
Dec. 4	900	50	45,000
Dec. 10	400	55	22,000
Dec. 11	300	55	16,500
Dec. 19	200	60	12,000
Dec. 28	800	47	37,600
Total	2,600	51.19	133,100

Accordingly, closing stock of 1,000 pcs. would have been valued at 51,190 @ ₹ 51.19 per unit.

5.2 Non-Historical Cost Methods

Non-historical cost methods do not consider the historical cost incurred to acquire the goods. Non-historical cost methods include Adjusted Selling Price method and Standard Cost method. Adjusted Selling Price method can be explained as follows:

(i) Adjusted selling price method

This method is also called retail inventory method. It is used widely in retail business or in business where the inventory comprises of items, the individual costs of which are not readily ascertainable. The use of this method is appropriate for measuring inventories of large numbers of rapidly changing items that have similar margins and for which it is impracticable to use other costing methods. The cost of the inventory is determined by reducing from the sales value of the inventory an appropriate percentage of gross margin. The percentage used takes into consideration inventory which has been marked below its original selling price. An average percentage for each retail department is often used. The calculation of the estimated gross margin of profit may be made for individual items or groups of items or by departments, as may be appropriate to the circumstances.

ILLUSTRATION 6

M/s X, Y and Z are in retail business, following information are obtained from their records for the year ended 31st March, 2022:

Goods received from suppliers (subject to trade discount and taxes)	₹	15,75,500
Trade discount 3% and GST 11%		
Packaging and transportation charges	₹	87,500
Sales during the year	₹	22,45,500
Sales price of closing inventories	₹	2,35,000

Find out the non-historical cost of inventories using adjusted selling price method.

SOLUTION

Determination of cost of purchases:

Goods received from suppliers	15,75,500
Less: Trade discount 3%	(47,265)
	15,28,235

Add: GST 11%	₹ 1,68,106
	₹ 16,96,341
Add: Packaging and transportation charges	₹ 87,500
	₹ 17,83,841

Determination of estimated gross profit margin:

Sales during the year	₹ 22,45,500
Closing inventory at the selling price	₹ 2,35,000
	24,80,500
Less: Purchases	₹ (17,83,841)
Gross profit	₹ 6,96,659
Gross profit margin	28.09%
Inventory valuation:	
Selling price of closing inventories	₹ 2,35,000
Less: Gross profit margin 28.09%	₹ (66,012)
	₹ 1,68,988

ILLUSTRATION 7

From the following information, calculate the non historical cost of closing inventories using adjusted selling price method:

	₹
Sales during the year	2,00,000
Cost of purchases	2,00,000
Opening inventory	Nil
Closing inventory at selling price	50,000

SOLUTION**Calculation of gross margin of profit:**

	₹
Sales	2,00,000
Add: Closing inventory (at selling price)	50,000
Selling price of goods available for sale:	2,50,000
Less: Cost of goods available for sale	2,00,000
Gross margin	50,000

$$\text{Rate of gross margin} = \frac{50,000}{2,50,000} \times 100 = 20\%$$

$$\text{Cost of closing inventory} = 50,000 \text{ less } 20\% \text{ on ₹ } 50,000 = ₹ 40,000$$

(ii) **Standard cost method**

This method is used when there is frequent change in the price per unit of the goods and goods are purchased frequently by the business e.g. crude oil. Based on the experience a standard cost is determined on the basis of frequent changes in prices and inventory is valued on that price per unit.



6. INVENTORIES TAKING

Normally all operations are suspended for one or two days during the financial year and physical inventory is taken for everything in the godown or the store periodically. For the year-end inventory valuation, physical inventory taking is done during the last week of the financial year or during the first week of next financial year. If inventory taking is finished on 26th March, whereas accounting year ends on 31st March purchases and sales between 26th and 31st March are then separately adjusted. Later, a value is put on each item. The principle of cost or Net realizable value, whichever is lower, is applied either for the inventory as a whole or item by item.

Normally, enterprises prefer to perform inventory taking on the closing day, however, sometimes inventory taking cannot be carried out on the closing day. It is carried out a few days later or sometimes even a few days earlier. In such a case, the actual value of the inventory must be so adjusted as to relate it to the end of the year concerned. For doing so, it will be necessary to take into account the goods that have come in (purchases and sales returns) and those that have gone out (sales and purchase returns) during the interval between the close of the year and the date of actual inventory taking.

Further, the adjustment of all goods must be on the basis of cost or NRV whichever is lower. Suppose, a firm that closes its books on 31st December, carried out the inventory taking on the 7th January next year and actual inventory was of the cost of ₹ 7,85,000, during the period January 1 to 7 purchases were ₹ 1,53,000 and sales ₹ 2,50,000, the mark up being 25% on cost. The inventory on 31st December would be ₹ 8,32,000 as shown below:

	₹
Inventory ascertained on January 7	7,85,000
Less: Purchases during the period Jan. 1 to 7	1,53,000
	6,32,000

Add: Cost of goods sold during the period:	
2,50,000 × (100/125)	2,00,000
	8,32,000

ILLUSTRATION 8

From the following particulars ascertain the value of Inventories as on 31st March, 2022:

	₹
Inventory as on 1.4.2021	1,42,500
Purchases	7,62,500
Manufacturing Expenses	1,50,000
Selling Expenses	60,500
Administrative Expenses	30,000
Financial Charges	21,500
Sales	12,45,000

At the time of valuing inventory as on 31st March, 2021, a sum of ₹ 17,500 was written off on a particular item, which was originally purchased for ₹ 50,000 and was sold during the year for ₹ 45,000. Barring the transaction relating to this item, the gross profit earned during the year was 20 % on sales.

SOLUTION**Statement of Inventory in trade as on 31st March, 2022**

	₹	₹
Inventory as on 1st April, 2021	1,42,500	
Less: Book value of abnormal inventory (₹ 50,000 - ₹ 17,500)	32,500	1,10,000
Add: Purchases		7,62,500
Manufacturing Expenses		1,50,000
		10,22,500
Less: Cost of goods sold:		
Sales as per books	12,45,000	
Less: Sales of abnormal item	45,000	
	12,00,000	
Less: Gross Profit @ 20%	2,40,000	9,60,000
Inventory in trade as on 31st March, 2022		62,500

ILLUSTRATION 9

A trader prepared his accounts on 31st March, each year. Due to some unavoidable reasons, no stock taking could be possible till 15th April, 2022 on which date total cost of goods in his godown came to ₹ 50,000. The following facts were established between 31st March and 15th April, 2022.

- (i) Sales ₹ 41,000 (including cash sales ₹ 10,000).
- (ii) Purchases ₹ 5,034 (including cash purchases ₹ 1,990).
- (iii) Sales return ₹ 1,000.
- (iv) On 15th March, goods of the sale value of ₹ 10,000 were sent on sale or return basis to a customer, the period of approval being four weeks. He returned 40% of the goods on 10th April, approving the rest; the customer was billed on 16th April.
- (v) The trader had also received goods costing ₹ 8,000 in March, for sale on consignment basis. 20% of the goods had been sold by 31st March, and another 50% by the 15th April. These sales are not included in above sales.

Goods are sold by the trader at a profit of 20% on sales.

You are required to ascertain the value of inventory as on 31st March, 2022.

SOLUTION**Statement of Valuation of Stock on 31st March, 2022**

	₹	₹
Value of stock as on 15th April, 2022		50,000
Add: Cost of sales during the period from 31st March, 2022 to 15 th April, 2022:		
Sales (₹ 41,000-₹ 1,000)	40,000	
Less: Gross profit (20% of ₹ 40,000)	<u>8,000</u>	32,000
Cost of goods sent on approval basis (80% of ₹ 6,000)		<u>4,800</u>
		86,800
Less: Purchases during the period from 31st March, 2022 to 15th April, 2022	5,034	
Unsold stock out of goods received on consignment basis (30% of ₹ 8,000)	2,400	7,434
		<u>79,366</u>

ILLUSTRATION 10

Inventory taking for the year ended 31st March, 2022 was completed by 10th April 2022, the valuation of which showed a inventory figure of ₹ 16,75,000 at cost as on the completion date. After the end of the accounting year and till the date of completion of inventory taking, sales for the next year were made for ₹ 68,750, profit margin being 33.33 % on cost. Purchases for the next year included in the inventory amounted to ₹ 90,000 at cost less trade discount 10 %. During this period, goods were added to inventory at the mark up price of ₹ 3,000 in respect of sales returns. After inventory taking it was found that there were certain very old slow-moving items costing ₹ 11,250, which should be taken at ₹ 5,250 to ensure disposal to an interested customer. Due to heavy flood, certain goods costing ₹ 15,500 were received from the supplier beyond the delivery date of customer. As a result, the customer refused to take delivery and net realizable value of the goods was estimated to be ₹ 12,500 on 31st March. Compute the value of inventory for inclusion in the final accounts for the year ended 31st March, 2022.

SOLUTION

**Statement showing the valuation of Inventory
as on 31st March, 2022**

	₹
Value of Inventory as on 10th April	16,75,000
Add: Cost of goods sold after 31st March till Inventory taking (₹ 68,750 – ₹ 17,190)	51,560
Less: Purchases for the next period (net)	(81,000)
Less: Cost of Sales Returns	(2,250)
Less: Loss on revaluation of slow-moving inventories	(6,000)
Less: Reduction in value on account of default	(3,000)
Value of Inventory on 31st March	16,34,310

Note: Profit margin of 33.33 % on cost means 25 % on sales price.

ILLUSTRATION 11

The following are the details of a spare part of Sriram mills:

1-1-2022	Opening Inventory	Nil
1-1-2022	Purchases	100 units @ ₹ 30 per unit
15-1-2022	Issued for consumption	50 units

1-2-2022	Purchases	200 units @ ₹ 40 per unit
15-2-2022	Issued for consumption	100 units
20-2-2022	Issued for consumption	100 units

Find out the value of Inventory as on 31-3-2022 if the company follows First in first out basis.

SOLUTION

First-in-First out basis

Sriram Mills Calculation of the value of Inventory as on 31-3-2022

Date	Receipts			Issues			Balance		
	Units	Rate	Amount	Units	Rate	Amount	Units	Rate	Amount
		₹	₹		₹	₹		₹	₹
1-1-2022	Balance							Nil	
1-1-2022	100	30	3,000				100	30	3,000
15-1-2022				50	30	1,500	50	30	1,500
1-2-2022	200	40	8,000				50	30	1,500
							200	40	8,000
15-2-2022				50	30	1,500			
				50	40	2,000	150	40	6,000
20-2-2022				100	40	4,000	50	40	2,000

Therefore, the value of Inventory as on 31-3-2022: 50 units @ ₹ 40 = ₹ 2,000

ILLUSTRATION 12

Continuing with the information given in illustration 11, find out the value of Inventory as on 31-3-2022 if the company follows Weighted Average basis.

SOLUTION

Weighted Average basis

Sriram Mills Calculation of the value of Inventory as on 31-3-2022

Date	Receipts			Issues			Balance		
	Units	Rate	Amount	Units	Rate	Amount	Units	Rate	Amount
		₹	₹		₹	₹		₹	₹
1-1-2022	Balance							Nil	
1-1-2022	100	30	3,000				100	30	3,000
15-1-2022				50	30	1,500	50	30	1,500

1-2-2022	200	40	8,000				250	38	9,500
15-2-2022				100	38	3,800	150	38	5,700
20-2-2022				100	38	3,800	50	38	1,900

Therefore, the value of Inventory as on 31-3-2022 = 50 units @ ₹ 38 = ₹ 1,900

SUMMARY

- ◆ Inventory can be defined as assets held for sale in the ordinary course of business, or in the process of production for such sale, or for consumption in the production of goods or services for sale, including maintenance supplies and consumables other than machinery spares.
- ◆ The inventories of manufacturing concern consist of several types of inventories: raw material (which will become part of the goods to be produced), parts and factory supplies, work-in-process (partially completed products in the factory) and, of course, finished products.
- ◆ Proper valuation of inventory has a very significant bearing on the authenticity of the financial statements.
- ◆ Cost of goods sold is calculated as follows:

$$\text{Cost of goods sold} = \text{Opening Inventory} + \text{Purchases} + \text{Direct expenses} - \text{Closing Inventory}.$$
- ◆ Inventories should be generally valued at the lower of cost or net realizable value.
- ◆ Inventory Valuation Techniques:
 - Historical Cost Methods
 - ✓ Specific Identification Method
 - ✓ FIFO (First in first out) Method
 - ✓ LIFO (Last in first out) Method
 - ✓ Average Price Method
 - ✓ Weighted Average Price Method
 - Non-Historical Cost Methods
 - ✓ Adjusted selling price method
 - ✓ Standard cost method

There are two principal systems of determining the physical quantities and monetary value of inventories sold and in hand. One system is known as 'Periodic Inventory System' and the other as the 'Perpetual Inventory System'.

TEST YOUR KNOWLEDGE

True and False

1. *Inventories are stocks of goods and materials that are maintained for mainly the purpose of revenue generation.*
2. *A building is considered inventory in a construction business.*
3. *Inventory is valued as carrying cost less percentage decreases.*
4. *Management has daily information about the quantity and valuation of closing stock under physical Inventory System.*
5. *Periodic Inventory System is more suitable for small enterprises.*
6. *When closing inventory is overstated, net income for the accounting period will be understated.*
7. *Closing inventory = Opening inventory + Purchases + Direct expenses + Cost of goods sold.*
8. *Cost of inventories should comprise all cost of purchase.*
9. *Inventory by-products, should be valued at net realisable value where cost of by products can be separately determined.*
10. *Abnormal amounts of wasted materials, labour or other production overheads expenses are included in the costs of inventories.*
11. *Perpetual system requires closure of business for counting of inventory.*
12. *Periodic inventory system is a method of ascertaining inventory by taking an actual physical count.*
13. *The value of closing inventory under simple average price method is realistic as compare to LIFO.*
14. *The value of stock is shown on the assets side of the balance-sheet as fixed assets.*
15. *Under inflationary conditions, FIFO will not show lowest value of cost of goods sold.*
16. *Under LIFO, valuation of inventory is based on the assumption that costs are charged against revenue in the order in which they occur.*
17. *Valuation of inventory, at cost or net realisable value, whichever less, is based on the principle of Conservatism.*
18. *Finished goods are normally valued at cost or market price whichever is higher.*

Multiple Choice Questions

1. The amount of purchase if
Cost of goods sold is ₹ 80,700
Opening Inventory ₹ 5,800
Closing Inventory ₹ 6,000
(a) ₹ 80,500
(b) ₹ 74,900
(c) ₹ 80,900.
2. Average Inventory = ₹ 12,000. Closing Inventory is ₹ 3,000 more than opening Inventory. The value of closing Inventory = _____.
(a) ₹ 12,000
(b) ₹ 24,000
(c) ₹ 13,500.
3. While finalizing the current year's profit, the company realized that there was an error in the valuation of closing Inventory of the previous year. In the previous year, closing Inventory was valued more by ₹ 50,000. As a result
(a) Previous year's profit is overstated and current year's profit is also overstated
(b) Previous year's profit is overstated and current year's profit is understated
(c) Previous year's profit is understated and current year's profit is also understated
4. Consider the following for Q Co. for the year 2021-22:
Cost of goods available for sale ₹ 1,00,000
Total sales ₹ 80,000
Opening inventory of goods ₹ 20,000
Gross profit margin on sales 25%
Closing inventory of goods for the year 2021-22 as
(a) ₹ 80,000
(b) ₹ 60,000
(c) ₹ 40,000

5. *If the profit is 25% of the cost price then it is*
- (a) *25% of the sales price*
 - (b) *33% of the sales price*
 - (c) *20% of the sales price*
6. *Goods purchased ₹ 1,00,000. Sales ₹ 90,000. Margin 20% on cost. Closing Inventory =?*
- (a) *₹ 20,000*
 - (b) *₹ 10,000*
 - (c) *₹ 25,000*
7. *A company is following weighted average cost method for valuing its inventory. The details of its purchase and issue of raw-materials during the week are as follows:*
- 1.12.2022 opening Inventory 50 units value ₹ 2,200.*
- 2.12.2022 purchased 100 units @ ₹47.*
- 4.12.2022 issued 50 units.*
- 5.12.2022 purchased 200 units @ ₹ 48.*
- The value of inventory at the end of the week and the unit weighted average costs is*
- (a) *₹ 14,200 – ₹ 47.33*
 - (b) *₹ 14,300 – ₹ 47.67*
 - (c) *₹ 14,000 – ₹ 46.66*
8. *The cost of sales is equal to*
- (a) *Opening stock plus purchases*
 - (b) *Purchases minus Closing stock*
 - (c) *Opening stock plus purchases minus closing stock*
9. *Inventory is disclosed in financial statements under:*
- (a) *Fixed Assets*
 - (b) *Current Assets*
 - (c) *Current Liabilities*
10. *Accounting Standards do not permit following method of inventory valuation*
- (a) *FIFO*

- (b) *Average cost*
 - (c) *LIFO*
11. *Which inventory costing formula calculates value of closing inventory considering that inventory most recently purchased has not been sold?*
- (a) *FIFO*
 - (b) *LIFO*
 - (c) *Weighted average cost*
12. *Valuing inventory at cost or net releasable value is based on which principle*
- (a) *Consistency*
 - (b) *Conservatism*
 - (c) *Going concern*
13. *Under inflationary trend, which of the methods will show highest value of inventory?*
- (a) *FIFO*
 - (b) *Weighted average*
 - (c) *LIFO*
14. *Which of the following methods does not consider historical cost of inventory?*
- (a) *Weighted average*
 - (b) *FIFO*
 - (c) *Retail price method*

Theory Questions

1. *Write short notes on:*
 - (i) *Adjusted Selling Price method of determining cost of stock.*
 - (ii) *Principal methods of ascertainment of cost of inventory.*
2. *Distinguish between:*
 - (i) *LIFO and FIFO basis of costing of stock.*
 - (ii) *FIFO and weighted average price method of stock costing.*
3. *Define inventory. Explain the importance of proper valuation of inventory in the preparation of statements of the business entity.*

Practical Questions

1. *X who was closing his books on 31.3.2022 failed to take the actual stock which he did only on 9th April, 2022, when it was ascertained by him to be worth ₹ 2,50,000.*

It was found that sales are entered in the sales book on the same day of dispatch and return inwards in the returns book as and when the goods are received back. Purchases are entered in the purchases day book once the invoices are received.

It was found that sales between 31.3.2022 and 9.4.2022 as per the sales day book are ₹ 17,200. Purchases between 31.3.2022 and 9.4.2022 as per purchases day book are ₹ 1,200, out of these goods amounting to ₹ 500 were not received until after the stock was taken.

Goods invoiced during the month of March, 2022 but goods received only on 4th April, 2022 amounted to ₹ 1,000. Rate of gross profit is 33-1/3% on cost.

Ascertain the value of physical stock as on 31.3.2022.

2. *From the following information, ascertain the value of stock as on 31.3.2022:*

	₹
Value of stock on 1.4.2021	7,00,000
Purchases during the period from 1.4.2021 to 31.3.2022	34,60,000
Manufacturing expenses during the above period	7,00,000
Sales during the same period	52,20,000

At the time of valuing stock on 31.3.2021 a sum of ₹ 60,000 was written off a particular item which was originally purchased for ₹ 2,00,000 and was sold for ₹ 1,60,000. But for the above transaction the gross profit earned during the year was 25% on cost.

3. *The Profit and loss account of Hanuman showed a net profit of ₹ 6,00,000, after considering the closing stock of ₹ 3,75,000 on 31st March, 2022. Subsequently the following information was obtained from scrutiny of the books:*

- (i) *Purchases for the year included ₹ 15,000 paid for new electric fittings for the shop.*
- (ii) *Hanuman gave away goods valued at ₹ 40,000 as free samples for which no entry was made in the books of accounts.*
- (iii) *Invoices for goods amounting to ₹ 2,50,000 have been entered on 27th March, 2022, but the goods were not included in stock.*
- (iv) *In March, 2022 goods of ₹ 2,00,000 sold and delivered, were taken in the sales for April, 2022.*

- (v) Goods costing ₹ 75,000 were sent on sale or return in March, 2022 at a margin of profit of $33\frac{1}{3}\%$ on cost. Though approval was given in April, 2022 these were taken as sales for March, 2022.

Calculate the value of stock on 31st March, 2022 and the adjusted net profit for the year ended on that date.

4. Physical verification of stock in a business was done on 23rd June, 2022. The value of the stock was ₹ 48,00,000. The following transactions took place between 23rd June to 30th June, 2022:

- (i) Out of the goods sent on consignment, goods at cost worth ₹ 2,40,000 were unsold.
- (ii) Purchases of ₹ 4,00,000 were made out of which goods worth ₹ 1,60,000 were delivered on 5th July, 2022.
- (iii) Sales were ₹ 13,60,000, which include goods worth ₹ 3,20,000 sent on approval. Half of these goods were returned before 30th June, 2022.
- (iv) Goods are sold at cost plus 25%. However, goods costing ₹ 2,40,000 had been sold for ₹ 1,20,000.

Determine the value of stock on 30th June, 2022.

ANSWERS / HINTS

True and False

1. True: Inventories refers to stocks of goods and materials that are maintained in business for revenue generation.
2. True: For a construction business, a building under construction will be inventory. The building is being built in the normal course of business and will eventually be sold as inventory.
3. False: Inventory is valued at lower of cost or net realizable value.
4. False: Under Perpetual Inventory System management have daily information of closing stock.
5. True: A periodic inventory system is suitable to small and micro enterprises, where physical counting of inventory is not a tedious process.
6. False: When closing inventory is overstated, net income for the accounting period will be overstated.

7. False: Closing stock = Cost of goods sold - (Opening inventory + Purchases + Direct expenses).
8. False: Cost of inventories should comprise all cost of purchase, costs of conversion and other costs incurred in bringing the inventories to their present location and condition.
9. False: Inventory by-products, should be valued at net realisable value where cost of by products cannot be separately determined. .
10. False: Abnormal amounts of wasted materials, labour or other production overheads expenses are generally not included in the costs of inventories.
11. False: Periodic system requires closure of business for counting of inventory.
12. True: Under Periodic inventory system actual physical count of inventory is taken of all the inventory on hand at a particular date.
13. True: Value of Closing stock as per average method is more realistic then LIFO.
14. False: The value of stock is shown on the assets side of the balance-sheet as current assets. As it is realisable within 12 months.
15. False: Under inflationary conditions, LIFO and weighted average will not show lowest value of cost of goods sold.
16. False: Under FIFO, valuation of inventory is based on the assumption that costs are charged against revenue in the order in which they occur.
17. True: The conservatism concept states that one shall not account for anticipated profits but shall provide all prospective losses. Valuing inventory at cost or net realisable value whichever is less, therefore is based on principle of Conservatism.
18. False: Finished goods are normally valued at cost or market price whichever is lower.

Multiple Choice Questions

1.	(c)	2.	(c)	3.	(b)	4.	(c)	5.	(c)	6.	(c)
7.	(a)	8.	(c)	9.	(b)	10.	(c)	11.	(a)	12.	(b)
13.	(a)	14.	(c)								

Theoretical Questions

- 1 (i) Adjusted selling method is also called retail inventory method. It is used widely in retail business or in business where the inventory comprises of items, the individual costs of which are not readily ascertainable. The historical cost of inventory is estimated by calculating it in the first instance at selling price and then deducting an amount equal to the estimated gross margin of profit on such stocks.
- (ii) The specific identification method, First-In–First-Out (FIFO) and weighted average cost formulae are the principal methods of ascertaining the cost of inventory. The cost of inventories of items that are not ordinarily interchangeable and goods or services produced and segregated for specific projects should be assigned by specific identification of their individual costs under the specific identification method.
2. (i) Under FIFO method of inventory valuation, inventories purchased first are issued first. The closing inventories are valued at latest purchase prices and inventory issues are valued at corresponding old purchase prices. In other words, under FIFO method, costs are assigned to the units issued in the same order as the costs entered in the inventory. During periods of rising prices, cost of goods sold are valued at older and lower prices if FIFO is followed and consequently reported profits rise due to lower cost of goods sold.

On the other hand, under LIFO method of inventory valuation, units of inventories issued should be valued at the prices paid for the latest purchases and closing inventories should be valued at the prices paid for earlier purchases. In other words, closing inventories are valued at old purchase prices and issues are valued at corresponding latest purchase prices.
- (ii) Under the First-In-First-Out (FIFO) method of valuation of stock, the actual issue of goods is usually the earliest lot on hand. Hence, the stock in hand will therefore consist of the latest consignments. The closing stock is valued at the price paid for such consignments.

The weighted average price method is not a simple average price method. Under this method of valuation of stock, a stock ledger is maintained, recording receipts and issues on daily basis. A new average would be calculated on receiving fresh consignment. The average price thus calculated after considering arrival of new consignment with the previous value of stock and

dividing the preceding stock value and the cost of new arrival with the total units of preceding and new arrival will give the weighted average price.

3. Inventory can be defined as assets held

- ♦ for sale in the ordinary course of business, or
- ♦ in the process of production for such sale, or
- ♦ for consumption in the production of goods or services for sale, including maintenance supplies and consumables other than machinery spares.

The significance of inventory valuation arises due to the following reasons:

- (i) Determination of Income
- (ii) Ascertainment of Financial Position
- (iii) Liquidity Analysis
- (iv) Statutory Compliance

Practical Questions

1. Statement of Valuation of Physical Stock as on 31st March, 2022

		₹
Value of stock as on 9th April, 2022		2,50,000
<i>Add:</i> Cost of sales during the intervening period		
Sales made between 31.3.2022 and 9.4.2022	17,200	
<i>Less:</i> Gross profit @25% on sales	(4,300)	12,900
		2,62,900
<i>Less:</i> Purchases actually received during the intervening period:		
Purchases from 1.4.2022 to 9.4.2022	1,200	
<i>Less:</i> Goods not received upto 9.4.2022	(500)	700
		2,62,200
<i>Less:</i> Purchases during March, 2022 received on 4.4.2022		1,000
Value of physical stock as on 31.3.2022		2,61,200

2. Statement of Valuation of Stock as on 31st March, 2022

		₹
Value of stock as on 1st April, 2021		7,00,000
Add: Purchases during the period from 1.4.2021 to 31.3.2022		34,60,000
Add: Manufacturing expenses during the above period		7,00,000
		48,60,000
Less: Cost of sales during the period:		
Sales	52,20,000	
Less: Gross profit	10,32,000	41,88,000
Value of stock as on 31.3.2022		6,72,000

Working Note:

	₹
Calculation of gross profit:	
Gross profit on normal sales $20/100 \times (52,20,000 - 1,60,000)$	10,12,000
Gross profit on the particular (abnormal) item $1,60,000 - (2,00,000 - 60,000)$	20,000
	10,32,000

Note: The value of closing stock on 31st March, 2022 may, alternatively, be found out by preparing Trading Account for the year ended 31st March, 2022.

3. Profit and Loss Adjustment Account

Particulars	₹	Particulars	₹
To Advertisement (samples)	40,000	By Net profit	6,00,000
To Sales (goods approved in April to be taken as April sales: (75,000 + 25,000))	1,00,000	By Electric fittings	15,000
To Adjusted net profit	10,40,000	By Samples	40,000
		By Stock (purchases of March not included in stock)	2,50,000
		By Sales (goods sold in March wrongly taken as April sales)	2,00,000

		By Stock (goods sent on approval basis not included in stock)	75,000
	11,80,000		11,80,000

Calculation of value of inventory on 31st March, 2022

	₹
Stock on 31st March, 2022 (given)	3,75,000
Add: Purchases of March, 2022 not included in the stock	2,50,000
Goods lying with customers on approval basis	75,000
	7,00,000

4. Statement of Valuation of Stock on 30th June, 2022

		₹
Value of stock as on 23rd June, 2022		48,00,000
Add: Unsold stock out of the goods sent on consignment	2,40,000	
Purchases during the period from 23rd June, 2022 to 30th June, 2022	2,40,000	
Goods in transit on 30th June, 2022	1,60,000	
Cost of goods sent on approval basis (80% of ₹ 1,60,000)	1,28,000	7,68,000
		55,68,000
Less: Cost of sales during the period from 23rd June, 2022 to 30 th June, 2022		
Sales (₹ 13,60,000 - ₹ 1,60,000)	12,00,000	
Less: Gross profit	96,000	
		11,04,000
Value of stock as on 30th June, 2022		44,64,000

Working Notes:

1. Calculation of normal sales:		
Actual sales		13,60,000
Less: Abnormal sales	1,20,000	
Return of goods sent on approval	1,60,000	2,80,000
		10,80,000
2. Calculation of gross profit:		
Gross profit or normal sales $20/100 \times ₹ 10,80,000$		2,16,000
Less: Loss on sale of particular (abnormal) goods (₹ 2,40,000-₹ 1,20,000)		1,20,000
Gross profit		96,000



DEPRECIATION AND AMORTISATION

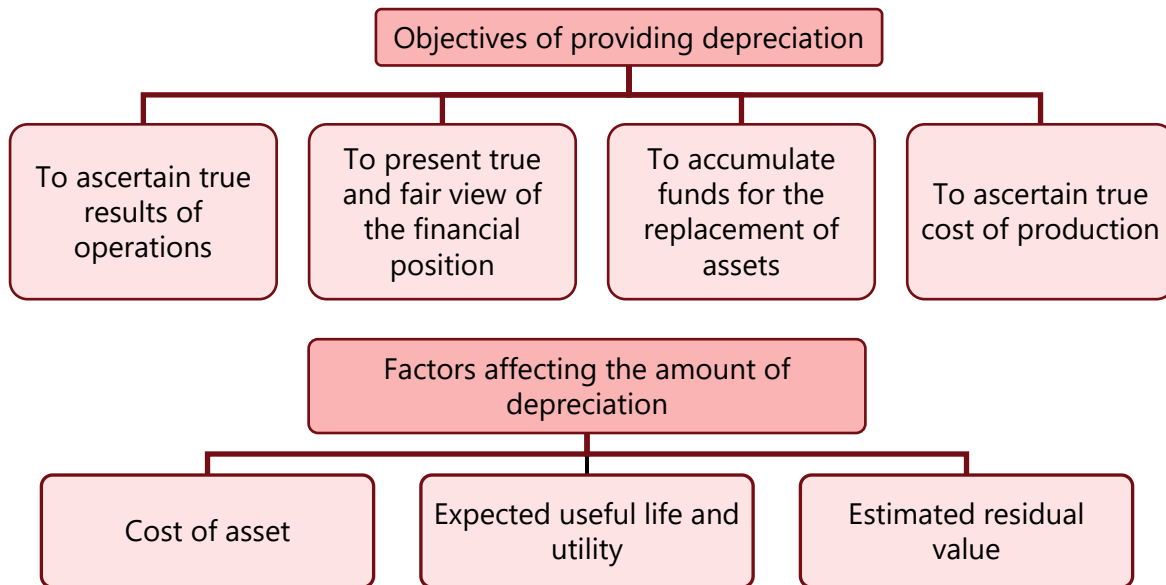


LEARNING OUTCOMES

After studying this chapter, you will be able to:

- ◆ Understand the meaning and nature of depreciation.
- ◆ Understand how to determine the amount of depreciation from the total value of Property, Plant and Equipment and its useful life.
- ◆ Understand various methods of depreciation and learn advantages and disadvantages of such methods.
- ◆ Understand how to calculate the amount of profit or loss resulting from the sale/disposal of Property, Plant and Equipment.
- ◆ Familiarize with the accounting treatment for change in the method of depreciation from Straight Line Method to Reducing Balance method.
- ◆ Familiarize with the accounting treatment for change in estimated useful life and residual value of property, plant and equipment.
- ◆ Understand the meaning and nature of intangible assets and its amortisation.

CHAPTER OVERVIEW



1. INTRODUCTION

1.1 Concept of Depreciation

Tangible Assets are assets that have a physical substance i.e., they can be seen and touched, held for use in the production or supply of goods or services, for rental to others, or for administrative purposes. Useful life of tangible asset is based on expected usage.

Property, plant and equipment are tangible items that:

- (a) are held for use in the production or supply of goods or services, for rental to others, or for administrative purposes; and
- (b) are expected to be used during more than a period of twelve months.

These are also called fixed assets in common parlance. When a fixed asset is purchased, it is recorded in books of account at its original or acquisition/purchase cost. However fixed assets are used to earn revenues or save costs for several accounting periods in future with the same acquisition cost until the concerned fixed asset is sold or discarded. For example, acquisition of a machinery expected to be in use for 10 years in the production of finished goods will earn revenues over the next 10 years. Similarly, an ATM machine installed by a bank will result in cost savings over the expected life of such ATM machines for the bank in terms of not requiring to employ personnel to dispense cash for customers. Since the life of such assets exceeds one year, it is therefore necessary that a part of the acquisition cost of such fixed

assets be treated or allocated as an expense in each of the accounting period in which the asset is utilized. The amount or value of fixed assets allocated in such manner to respective accounting period is called depreciation. Value of such assets decreases with passage of time mainly due to following reasons.

1. Wear and tear due to its use in business
2. Efflux of time (even when it is not being used)
3. Obsolescence due to technological or other changes
4. Decrease in market value
5. Depletion mainly in case of mines and other natural reserves

It is important to account for value of portion of property, plant and equipment utilized for generating revenue during an accounting year to ascertain true income. In other words, against the income/cost savings generated during a period, it is essential to book a portion of the cost of the asset utilized in generating such income/cost savings. This portion of cost of Property, Plant & Equipment allocated to an accounting year is called depreciation.

As per Schedule II under the Companies Act, 2013, Depreciation is the systematic allocation of the depreciable amount of an asset over its useful life. The depreciable amount of an asset is the cost of an asset or other amount substituted for cost (i.e., in case of revaluation of assets, such revalued amount), less its residual value. The useful life of an asset is the period over which an asset is expected to be available for use by an entity, or the number of production or similar units expected to be obtained from the asset by the entity.

Thus, there are 3 important factors for computing depreciation:

- Estimated useful life of the asset
- Cost of the asset
- Residual value of the asset at the end of the of its estimated useful life

Depreciation of an asset begins when it is available for use, i.e., when it is in the location and condition necessary for it to be capable of operating in the manner intended by management. Thus it is not necessary that an asset must be used to be depreciated. There is decrease in value of assets due to normal wear and tear or obsolescence even when these are not physically used. Accordingly, value of such wear and tear should be estimated and accounted for.

Depreciation is allocated so as to charge a fair proportion of the depreciable amount in each accounting period during the expected useful life of the asset. Depreciation for a period helps to charge that portion of the cost of the asset against the revenues earned, which is expired

for that period and hence follows matching principle. In other words the total cost of the asset is reflected in form of a) Expired cost (depreciation) and b) Unexpired Cost which shall be the written down value of the asset being reflected in balance sheet. Also, charging depreciation every year reduces the distributable profits thereby ensuring the availability of funds whenever the replacement is required.

The depreciation is a type of loss in the value of assets employed for carrying on a business. Being an essential element of business expenditure, it is necessary to calculate the amount of such loss and to make a provision, and therefore, arrive at the amount of profit or loss made by the business.

Basically, the cost of an asset used for purpose of business has to be written off over its economic (not physical) life which must be estimated. A point to remember is that usually, at the end of the economic life, an asset has some value as scrap or otherwise. The amount to be written off in each year should be as such which will reduce the book value of the asset, at the end of its economic life, to its estimated scrap value.

1.2 Depreciation on components of an assets

It may be noted that Accounting Standards as well as the Companies Act, 2013 requires depreciation to be charged on a component basis. Each part of an item of Property, Plant and Equipment with a cost that is significant in relation to the total cost of the item should be depreciated separately. An enterprise should allocate the amount initially recognised in respect of an item of property, plant and equipment to its significant parts/components and should depreciate each such part separately based on the useful life and residual value of each particular component. For Example- Aircraft is a classic example of such an asset. The airframe (i.e. the body of the aircraft), the engines and the interiors have different individual useful lives. If the life of the airframe (being the longest of the individual lives of the three major types of components) is taken as the life of the aircraft, it is important that other two major components i.e. engine and interiors are depreciated over their respective useful life and not over the life of airframe. Other components (usually small and low value) which will require replacement very frequently may be depreciated over the useful life of airframe and their frequent replacement cost may be charged to expense as and when it is incurred.

Here it is important to note that a part of Property, Plant & Equipment to be identified as a separate component should have both

- (a) significant cost when compared to overall cost of item of property, plant and equipment and
- (b) an estimated useful life or depreciation method different from rest of the parts of the property plant and equipment.

A significant part of an item of property, plant and equipment may have a useful life and a depreciation method that are the same as the useful life and the depreciation method of

another significant part of that same item. Such parts may be grouped in determining the depreciation charge.

1.3 Objectives for Providing Depreciation

Prime objectives for providing depreciation are:

- (1) *Correct income measurement:* Depreciation should be charged for proper estimation of periodic profit or loss. In case an enterprise does not account for depreciation on Property, Plant & Equipment, it will not be considering loss in value of property, plant & equipment due to their use in production or operations of the enterprise and will not result in true profit or loss for the period.
- (2) *True position statement:* Value of the Property, Plant & Equipment should be adjusted for depreciation charged in order to depict the actual financial position. In case depreciation is not accounted for appropriately, the property, plant and equipment would be disclosed in financial statements at a value higher than their true value. We should always present the same at its unexpired cost which is after charging the expired cost as depreciation.
- (3) *Funds for replacement:* Generation of adequate funds in the hands of the business for replacement of the asset at the end of its useful life. Depreciation is a good indication of the amount an enterprise should set aside to replace a fixed asset after its economic useful life is over. However, the replacement cost of a fixed asset may additionally be impacted by inflation or other technological changes.
- (4) *Ascertainment of true cost of production:* For ascertaining the cost of the production, it is necessary to charge depreciation as an item of cost of production.

Further depreciation is a non-cash expense and unlike other normal expenditure (e.g. wages, rent, etc.) does not result in any cash outflow. Further depreciation by itself does not create funds it merely draws attention to the fact that out of gross revenue receipts, a certain amount should be retained for replacement of assets used for carrying on operation which is achieved by charging depreciation that reduces the distributable profits.



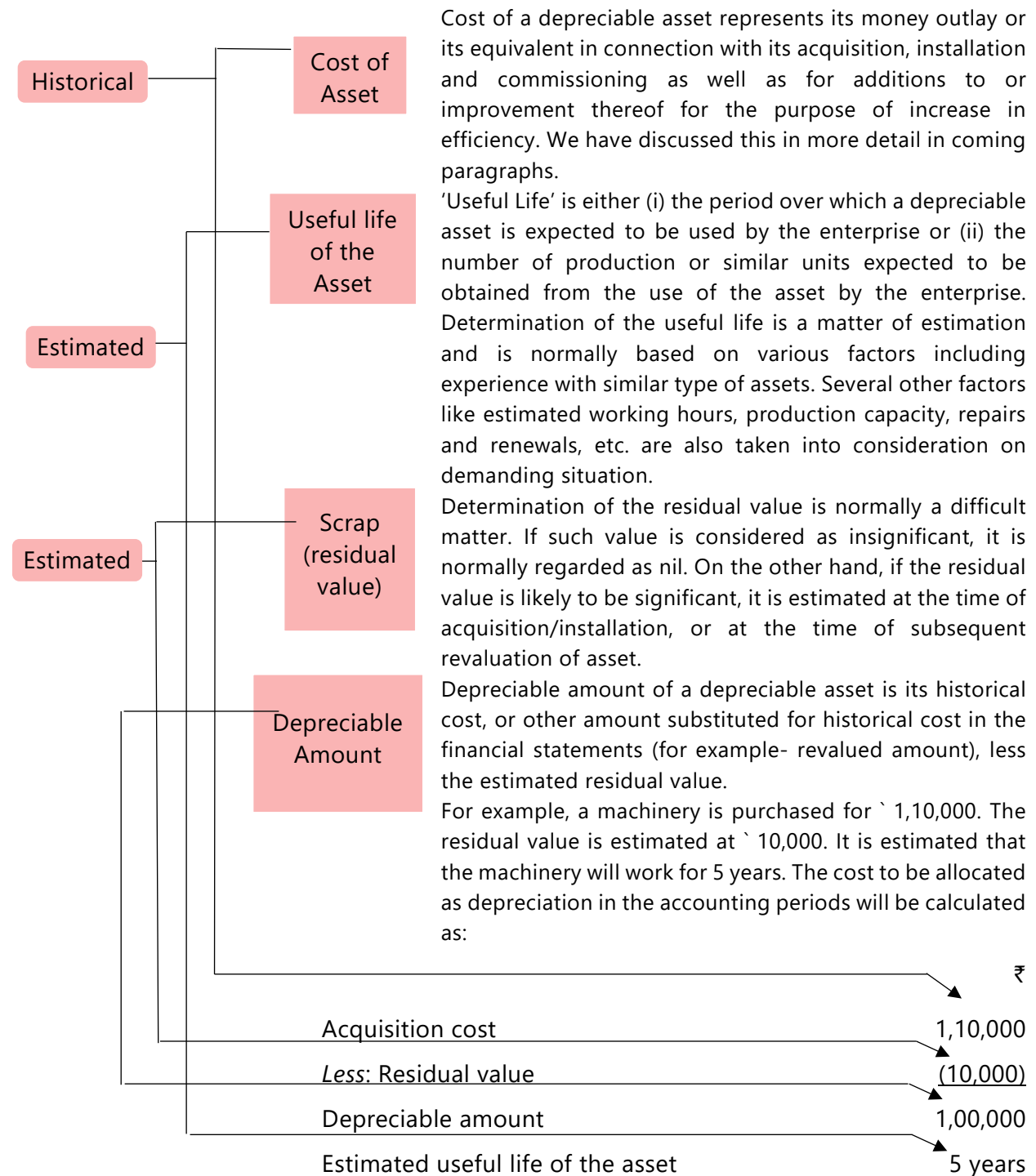
2. FACTORS IN THE MEASUREMENT OF DEPRECIATION

Estimation of exact amount of depreciation is not easy as it involves lot of estimation. Generally following factors are taken into consideration for calculation of depreciation.

1. Cost of asset including expenses for installation, commissioning, trial run etc.
2. Estimated useful life of the asset (both in terms of time & also utility/units).

3. Estimated scrap value (if any) at the end of useful life of the asset.

The above mentioned factors can be explained, in detail, as follows:



$$\text{Depreciation} = \frac{\text{Depreciable amount}}{\text{Estimated useful life}} \text{ i.e. } ₹ 1,00,000 / 5 = ₹ 20,000 \text{ per year}$$

Cost of Property, Plant and Equipment comprises:

- (a) its purchase price, including non-refundable import duties and purchase taxes, after deducting trade discounts and rebates.
- (b) any cost directly attributable to bring the asset to the location and condition necessary for it to be capable of operating in a manner intended by the enterprise.
- (c) the initial estimate of the costs of dismantling, removing, the item and restoring the site on which an asset is located.

Examples of directly attributable costs are:

- (a) cost of employee benefits arising directly from acquisition or construction of an item of property, plant and equipment.
- (b) cost of site preparation
- (c) initial delivery and handling costs
- (d) installation and assembly costs
- (e) cost of testing whether the asset is functioning properly, after deducting the net proceeds from selling the items produced while testing (such as samples produced while testing)
- (f) professional fees e.g. engineers hired for helping in installation of a machine

Thus, all the expenses which are necessary for the asset to bring it in condition and location of desired use will become part of cost of the asset. However, following expenses should not become part of cost of asset:

- (a) costs of opening new facility or business, such as inauguration costs;
- (b) cost of introducing new product or service (for example cost of advertisement or promotional activities).
- (c) cost of conducting business in a new location or with a new class of customer (including cost of staff training); and
- (d) administration and other general overhead costs.

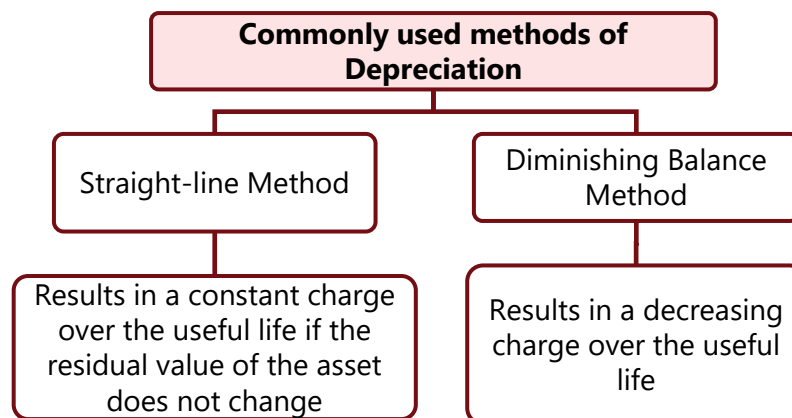
Once an asset has been brought to its intended condition and location of use, no cost should be recognized as part of cost of the asset unless there is major repair or addition which increases the useful life of the asset or improves the production capacity of the asset. Accordingly, cost incurred while an item is capable of operating in intended manner but it is not yet put to use or is used at less than full capacity should not be capitalized as part of cost of the asset. Similarly, cost of relocation of an asset should not be capitalized.

Any additions made to a particular item of property, plant and equipment after it is initially put to use are depreciated over the remaining useful life of the asset. Any addition or extension which has a separate identity and is capable of being used after the existing asset is disposed of, is accounted for separately. Therefore, it is important to maintain an asset register capturing asset wise details of cost, rate of depreciation, date of capitalization etc. All these details need to be captured for any additions to existing assets as well. In the absence of the adequate information, it will be very difficult to compute depreciation expense year on year. Also, at the time of disposal or discard of a particular asset, it will not be possible to compute gain or loss on such disposal/discard.



3. METHODS FOR PROVIDING DEPRECIATION

Generally, methods for providing depreciation are based on formula, developed on a study of the behavior of the assets over a period of years for readily computing the amount of depreciation suffered by different forms of assets. Each of the methods, however, should be applied only after carefully considering nature of the asset and the conditions under which it is being used.



The Income Tax Rules, however, prescribe the Diminishing Balance Method except in the case of assets of an undertaking engaged in generation and distribution of power.

3.1 Straight Line Method

According to this method, an equal amount is written off every year during the working life of an asset so as to reduce the cost of the asset to nil or its residual value at the end of its useful life. The advantage of this method is that it is simple to apply and gives accurate results especially in case of leases, and also in case of plant and machinery. This method is also known as Fixed Instalment Method.

$$\text{Straight Line Depreciation} = \frac{\text{Cost of Asset} - \text{Scrap Value}}{\text{Useful life}}$$

$$\text{Straight Line Depreciation Rate} = \frac{\text{Straight Line Depreciation}}{\text{Cost of Asset}} \times 100$$

The underlying assumption of this method is that the particular tangible asset generates equal utility during its lifetime. But this cannot be true under all circumstances. The expenditure incurred on repairs and maintenance will be low in earlier years, whereas the same will be high as the asset becomes old. Apart from this the asset may also have varying capacities over the years, indicating logic for unequal depreciation provision. However, many assets have insignificant repairs and maintenance expenditures for which straight line method can be applied.

While using this method the period of use of an asset in a particular year should also be considered. In the year of purchase of an asset it may have been available for use for part of the year only, accordingly depreciation should be proportioned to reflect the period for which it was available for use. For example, if an asset was purchased on March 1, 2022 and the enterprise prepares financial statements for the year ending on March 31, 2022 depreciation will be provided for a period of 1 month only. Similar situation will arise in the year in which an asset is retired from its intended use or is sold.

3.2 Reducing or Diminishing Balance Method or Written Down Value (WDV) Method

Under this system, a fixed percentage of the diminishing value of the asset is written off each year so as to reduce the asset to its residual value at the end of its life. Repairs and small renewals are charged to revenue. This method is commonly used for plant, fixtures, etc. Under this method, the annual charge for depreciation decreases from year to year, so that the earlier years suffer to the benefit of the later years. Also, under this method, the value of asset can never be completely extinguished, which happens in the earlier explained Straight Line Method. This method is based on the assumption that cost of repairs will increase as the asset gets old, therefore, depreciation in earlier years should be high when the repair cost is expected to be low and depreciation in later years should be low when the repair cost is expected to be high. Therefore, this method will result in almost equal burden in all the years of use of the asset as depreciation will reduce with increase in repair costs will increase with every passing year. On the other hand, under the Straight Line Method, the charge for depreciation is constant, while repairs tend to increase with the life of the asset. Among the disadvantages of this method is the danger that too low a percentage may be adopted as depreciation with the result that over the life of the asset full depreciation may not be provided; also if assets are grouped in such a way that individual assets are difficult to identify,

the residue of an asset may lie in the asset account even after the asset has been scrapped. The last mentioned difficulty could be, however, overcome if a Plant register is maintained.

The rate of depreciation under this method may be determined by the following formula:

$$1 - \sqrt[n]{\frac{\text{Residual Value}}{\text{Cost of Assets}}} \times 100$$

where, n = useful life

Similar to straight line method, in this method also period of use in a particular year e.g. year of purchase or sale an item of property plant and equipment needs to be considered while computing the depreciation amount.

Accounting Entries under Straight Line and Reducing Balance Methods:

There are two alternative approaches for recording accounting entries for depreciation.

First Alternative

A provision for depreciation or Accumulated Depreciation account is opened to accumulate the balance of depreciation and the assets are carried at historical cost. This method is preferred by most of the organizations as it presents both the gross investment and the current value of the assets.

Accounting entry

Depreciation Account	Dr.
To Provision for Depreciation Account or Accumulated Depreciation	
Profit and Loss Account	Dr.
To Depreciation Account	

Second Alternative

Amount of Depreciation is credited to the Asset Account every year and the Asset Account is carried at historical cost less depreciation.

Accounting entries:

Depreciation Account	Dr.
To Asset Account	
Profit and Loss Account	Dr.
To Depreciation Account	

ILLUSTRATION 1

Jain Bros. acquired a machine on 1st July, 2021 at a cost of ₹ 14,00,000 and spent ₹ 1,00,000 on its installation. The firm writes off depreciation at 10% p.a. of the original cost every year. The books are closed on 31st December every year.

Required

Show the Machinery Account and Depreciation Account for the year 2021 and 2022.

Machinery Account

Date	Particulars	₹	Date	Particulars	₹
2021			2021		
July 1	To Bank A/c	14,00,000	Dec. 31	By Depreciation A/c	
July 1	To Bank A/c - Installation Expenses	1,00,000		10% on ₹ 15,00,000 for 6 months	75,000
			Dec. 31	By Balance c/d	14,25,000
		15,00,000			15,00,000
2022			2022		
Jan. 1	To Balance b/d	14,25,000	Dec. 31	By Depreciation A/c	
				10% on ₹ 15,00,000	1,50,000
			Dec. 31	By Balance c/d	12,75,000
		14,25,000			14,25,000

Depreciation Account

Date	Particulars	₹	Date	Particulars	₹
2021			2021		
Dec. 31	To Machinery A/c	75,000	Dec. 31	By Profit & Loss A/c	75,000
2022			2022		
Dec. 31	To Machinery A/c	1,50,000	Dec. 31	By Profit & Loss A/c	1,50,000

ILLUSTRATION 2

Jain Bros. acquired a machine on 1st July, 2021 at a cost of ₹ 14,00,000 and spent ₹ 1,00,000 on its installation. The firm writes off depreciation at 10% p.a. every year. The books are closed on 31st December every year.

Required

Show the Machinery Account on diminishing balance method for the year 2021 and 2022.

SOLUTION

As per Reducing Balance Method

Machinery Account

Date	Particulars	₹	Date	Particulars	₹
2021			2021		
July 1	To Bank A/c	14,00,000	Dec. 31	By Depreciation A/c	75,000
July 1	To Bank A/c -	1,00,000		(₹ 15,00,000 x 10% x 6/12) for 6 months	
			Dec. 31	By Balance c/d	14,25,000
		15,00,000			15,00,000
2022			2022		
Jan. 1	To Balance b/d	14,25,000	Dec. 31	By Depreciation A/c	1,42,500
				(₹ 14,25,000 x 10%)	
			Dec. 31	By Balance c/d	12,82,500
		14,25,000			14,25,000

3.3 Sum of Years of Digits Method

It is a variation of the "Reducing Balance Method". In this case, the annual depreciation is calculated by multiplying the original cost of the asset less its estimated scrap value by the fraction represented by:

The number of years (including the present year) of remaining life of the asset

Total of all digits of the life of the asset (in years)

Suppose the estimated life of an asset is 10 years; the total of all the digits from 1 to 10 is 55 i.e., 10 + 9 + 8 + 7 + 6 + 5 + 4 + 3 + 2 + 1, or by the formula:

$$\frac{n(n+1)}{2} = \frac{10 \times 11}{2} = 55$$

The depreciation to be written off in the first year will be 10/55 of the cost of the asset less estimated scrap value; and the depreciation for the second year will be 9/55 of the cost of asset less estimated scrap value and so on.

The method is not yet in vogue; and its advantages are the same as those of the Reducing Balance Method.

ILLUSTRATION 3

M/s Akash & Co. purchased a machine for ₹ 10,00,000. Estimated useful life and scrap value were 10 years and ₹ 1,20,000 respectively. The machine was put to use on 1.1.2017.

Required

Show Machinery Account and Depreciation Account in their books for 2022 by using sum of years digits method.

SOLUTION**In the books of M/s Raj & Co.****Machinery Account**

Date	Particulars	₹	Date	Particulars	₹
2022 Jan. 1	To Balance b/d (w.n.2)	3,60,000	2022 Dec. 31	By Depreciation A/c (w.n.3)	80,000
			Dec. 31	By Balance c/d	2,80,000
		3,60,000			3,60,000
2023 Jan.1	To Balance b/d	2,80,000			

Depreciation Account

		₹			₹
2022 Dec. 31	To Machinery A/c	80,000	2022 Dec. 31	By Profit and Loss A/c	80,000
		80,000			80,000

Working Notes:**(1) Total of sum of digit of depreciation for 2017-21**

$$= (\text{₹ } 10,00,000 - \text{₹ } 1,20,000) \times \frac{10+9+8+7+6}{\frac{10(10+1)}{2}} = \text{₹ } 8,80,000 \times \frac{40}{55} = \text{₹ } 6,40,000$$

(2) Written down value as on 1-1-2022

$$\text{₹ } 10,00,000 - \text{₹ } 6,40,000 = \text{₹ } 3,60,000$$

(3) Depreciation for 2022

$$(\text{₹ } 10,00,000 - \text{₹ } 1,20,000) \times \frac{5}{55} = \text{₹ } 80,000.$$

3.4 Machine Hour Method

Where it is practicable to keep a record of the actual running hours of each machine, depreciation may be calculated on the basis of hours that the concerned machine worked. The machine hour rate of the depreciation, is calculated after estimating the total number of hours that machine would work during its whole life; however, it may have to be varied from time to time, on a consideration of the changes in the economic and technological conditions which might take place, to ensure that the amount provided for depreciation corresponds to that considered appropriate in the changed circumstances. It would be observed that the method is a variation of the Straight Line Method under which depreciation is calculated per year. Under this method it is calculated for each hour the machine works.

Schedule II to the Companies Act 2013 which prescribes estimated useful life of different assets for companies also recognizes this method to some extent. It prescribes that depreciation should be charged using estimated useful life suggested in it; however, in certain category of plant and machinery it prescribes charging higher amount of depreciation if these assets are used for 2 shifts or 3 shifts. In a way, schedule II combines straight line method and machine hour method.

ILLUSTRATION 4

A machine was purchased for ₹ 30,00,000 having an estimated total working of 24,000 hours. The scrap value is expected to be ₹ 2,00,000 and anticipated pattern of distribution of effective hours is as follows :

Year

1 – 3 3,000 hours per year

4 - 6 2,600 hours per year

7 - 10 1,800 hours per year

Required

Determine Annual Depreciation under Machine Hour Rate Method.

SOLUTION

Statement of Annual Depreciation under Machine Hours Rate Method

Year	Annual Depreciation
1 - 3	$\frac{3,000}{24,000} \times (\text{₹ } 30,00,000 - \text{₹ } 2,00,000) = \text{₹ } 3,50,000$

4 - 6	$\frac{2,600}{24,000} \times (\text{₹ } 30,00,000 - \text{₹ } 2,00,000) = \text{₹ } 3,03,333$
7 - 10	$\frac{1,800}{24,000} \times (\text{₹ } 30,00,000 - \text{₹ } 2,00,000) = \text{₹ } 2,10,000$

3.5 Production Units Method

Under this method depreciation of the asset is determined by comparing the annual production with the estimated total production. The amount of depreciation is computed by the use of following method:

$$\text{Depreciable Amount} \times \frac{\text{Production during the period}}{\text{Estimated total production}}$$

The method is applicable to machines producing product of uniform specifications.

ILLUSTRATION 5

A machine is purchased for ₹ 20,00,000. Its estimated useful life is 10 years with a residual value of ₹ 2,00,000. The machine is expected to produce 1.5 lakh units during its life time. Expected distribution pattern of production is as follows:

Year	Production
1-3	20,000 units per year
4-7	15,000 units per year
8-10	10,000 units per year

Required

Determine the value of depreciation for each year using production units method.

SOLUTION

Statement showing Depreciation under Production Units Method

Year	Annual Depreciation
1-3	$\frac{20,000}{1,50,000} \times (\text{₹ } 20,00,000 - \text{₹ } 2,00,000) = \text{₹ } 2,40,000$
4-7	$\frac{15,000}{1,50,000} \times (\text{₹ } 20,00,000 - \text{₹ } 2,00,000) = \text{₹ } 1,80,000$
8-10	$\frac{10,000}{1,50,000} \times (\text{₹ } 20,00,000 - \text{₹ } 2,00,000) = \text{₹ } 1,20,000$

3.6 Depletion Method

Depletion is the allocation of the cost of wasting natural resources such as oil, gas, timber, and minerals to the production process. This method is used in case of mines, quarries etc. containing only a certain quantity of product. The depreciation rate is calculated by dividing the cost of the asset by the estimated quantity of product likely to be available to be extracted. Annual depreciation will be the quantity extracted multiplied by the rate per unit.

ILLUSTRATION 6

M/s Surya & Co. took lease of a quarry on 1-1-2019 for ₹ 1,00,00,000. As per technical estimate the total quantity of mineral deposit is 2,00,000 tonnes. Depreciation was charged on the basis of depletion method. Extraction pattern is given in the following table:

Year Quantity of Mineral extracted

2019 2,000 tonnes

2020 10,000 tonnes

2021 15,000 tonnes

Required

Show the Quarry Lease Account and Depreciation Account for each year from 2019 to 2021.

SOLUTION

Quarry Lease Account

		₹			₹
2019			2019		
Jan.	To Bank A/c	1,00,00,000	Dec. 31	By Depreciation A/c [(2,000/2,00,000) × ₹ 1,00,00,000]	1,00,000
			Dec. 31	By Balance c/d	99,00,000
		1,00,00,000			1,00,00,000
2020			2020		
Jan. 1	To Balance b/d	99,00,000	Dec. 31	By Depreciation A/c	5,00,000
			Dec. 31	By Balance c/d	94,00,000
		99,00,000			99,00,000
2021			2021		
Jan. 1	To Balance b/d	94,00,000	Dec. 31	By Depreciation A/c	7,50,000
			Dec. 31	By Balance c/d	86,50,000
		94,00,000			94,00,000

Depreciation Account

		₹			₹
2019			2019		
Dec. 31	To Quarry lease A/c	1,00,000	Dec. 31	By Profit & Loss A/c	1,00,000
		1,00,000			1,00,000
2020			2020		
Dec. 31	To Quarry lease A/c	5,00,000	Dec. 31	By Profit & Loss A/c	5,00,000
		5,00,000			5,00,000
2021			2021		
Dec. 31	To Quarry lease A/c	7,50,000	Dec. 31	By Profit & Loss A/c	7,50,000
		7,50,000			7,50,000



4. PROFIT OR LOSS ON THE SALE/DISPOSAL OF PROPERTY, PLANT AND EQUIPMENT

Whenever any depreciable asset is sold during the year, depreciation is charged on it for the period it has been used in the sale year. The written down value after charging such depreciation is used for calculating the profit or loss on the sale of that asset. The resulting profit or loss on sale of the asset is ultimately transferred to profit and loss account. Thus, all entries related to sale and profit or loss on sale of asset are posted in the respective asset account. Alternatively, a new account titled Asset disposal Account may also be opened in the ledger for the purpose of calculating profit or loss on sale of asset. In that case the book value of the asset will be transferred from the asset account to the asset disposal account and all entries related to sale like sale proceeds and calculation of profit or loss on sale will be posted in the Asset disposal account.

For example: The book value of the asset as on 1st January, 2022 is ₹ 50,00,000. Depreciation is charged on the asset @10%. On 1st July 2022, the asset is sold for ₹ 32,00,000. In such a situation, profit or loss on the sale will be calculated as follows:

	₹
Book value as on 1st Jan., 2022	50,00,000
Less: Depreciation for 6 months @10% (from 1st Jan., 2022 to 30th June, 2022)	(2,50,000)
Written down value as on 1st July, 2022	47,50,000

Less: Sale proceeds as on 1st July, 2022	(32,00,000)
Loss on sale of the asset	15,50,000

ILLUSTRATION 7

A firm purchased on 1st January, 2020 certain machinery for ₹ 5,82,000 and spent ₹ 18,000 on its erection. On July 1, 2020 another machinery for ₹ 2,00,000 was acquired. On 1st July, 2021 the machinery purchased on 1st January, 2020 having become obsolete was auctioned for ₹ 3,86,000 and on the same date fresh machinery was purchased at a cost of ₹ 4,00,000.

Depreciation was provided for annually on 31st December at the rate of 10 per cent p.a. on written down value.

Required

Prepare machinery account.

SOLUTION**Machinery Account**

Date	Particulars	₹	Date	Particulars	₹
2020			2020		
Jan. 1	To Bank A/c	5,82,000	Dec. 31	By Depreciation A/c	70,000
Jan. 1	To Bank A/c – erection charges	18,000		By Balance c/d	7,30,000
July 1	To Bank A/c	2,00,000			
		8,00,000			8,00,000
2021			2021		
Jan. 1	To Balance b/d	7,30,000	July 1	By Depreciation on sold machine	27,000
July 1	To Bank A/c	4,00,000		By Bank A/c	3,86,000
				By Profit and Loss A/c	1,27,000
			Dec. 31	By Depreciation A/c	39,000
				By Balance c/d	5,51,000
		11,30,000			11,30,000

Working Note:**Book Value of Machines**

	Machine I ₹	Machine II ₹	Machine III ₹
Cost	6,00,000	2,00,000	4,00,000
Depreciation for 2020	(60,000)	(10,000)	
Written down value	5,40,000	1,90,000	
Depreciation for 2021	(27,000)	(19,000)	(20,000)
Written down value	5,13,000	1,71,000	3,80,000
Sale Proceeds	(3,86,000)		
Loss on Sale	1,27,000		

ILLUSTRATION 8

On April 1, 2019 Shubra Ltd. purchased a machinery for ₹ 12,00,000. On Oct 1, 2021, a part of the machinery purchased on April 1, 2019 for ₹ 80,000 was sold for ₹ 45,000 and a new machinery at a cost of ₹ 1,58,000 was purchased and installed on the same date. The company has adopted the method of providing 10% p.a. depreciation on the written down value of the machinery.

Required : Show the necessary ledger accounts for the years ended 31st March, 2020 to 2022 assuming that (a) 'Provision for Depreciation Account' is not maintained (b) Provision for Depreciation Account is maintained.

SOLUTION

(a) When 'Provision for Depreciation Account' is not maintained.

Dr.			Machinery Account			Cr.	
Date	Particulars	₹	Date	Particulars	₹		
01.04.2019	To Bank A/c	12,00,000	31.03.2020	By Depreciation A/c	1,20,000		
				By Balance c/d	10,80,000		
		12,00,000			12,00,000		
01.04.2020	To Balance b/d	10,80,000	31.03.2021	By Depreciation A/c	1,08,000		
				By Balance c/d	9,72,000		
		10,80,000			10,80,000		

01.04.2021	To Balance b/d	9,72,000	01.10.2021	By bank A/c	45,000
01.10.2021	To Bank A/c	1,58,000		By Profit & Loss A/c	16,560
				By Depreciation A/c	3,240
			31.3.2021	By Depreciation A/c (7,900+ 90,720)	98,620
				By Balance c/d (8,16,480 + 1,50,100)	9,66,580
		11,30,000			11,30,000

(b) When 'Provision for Depreciation Account' is maintained

Dr. Machinery Account (at original cost)			Cr.		
Date	Particulars	₹	Date	Particulars	₹
01.04.2019	To Bank A/c	12,00,000	31.03.2020	By Balance c/d	12,00,000
01.04.2020	To Balance b/d	12,00,000	31.03.2021	By Balance c/d	12,00,000
01.04.2021	To Balance b/d	12,00,000	01.10.2021	By Machinery Disposal A/c	80,000
01.10.2021	To Bank A/c	1,58,000	31.03.2022	By Balance c/d	12,78,000
		13,58,000			13,58,000

Dr. Provision for Depreciation Account			Cr.		
Date	Particulars	₹	Date	Particulars	₹
31.03.2020	To Balance c/d	1,20,000	31.03.2020	By Depreciation A/c	1,20,000
31.03.2021	To Balance c/d	2,28,000	1.04.2020	By Balance b/d	1,20,000
			31.03.2021	By Depreciation A/c	1,08,000
		2,28,000			2,28,000
01.10.2021	To Machinery Disposal A/c	18,440	01.04.2021	By Balance b/d	2,28,000
31.03.2022	To Balance c/d	3,11,420	01.10.2021	By Depreciation A/c	3,240
			31.03.2022	By Depreciation A/c	98,620
		3,29,860			3,29,860

Dr. Machinery Disposal Account			Cr.		
Date	Particulars	₹	Date	Particulars	₹
01.10.2021	To Machinery Disposal A/c	80,000	01.10.2021	By Provision for Depreciation A/c	18,440
				By Bank A/c	45,000
				By Profit and Loss A/c	16,560
		80,000			80,000

Working Notes:**(1) Calculation of Profit/Loss on Sale of Machinery**

Particulars	₹
A. Original Cost	80,000
B. Less : Depreciation @ 10% WDV p.a. for 2 ½ years	18,440
C. Book Value as on date of Sale (A – B)	61,560
D. Less : Sale proceeds	45,000
E. Loss on Sale (C – D)	16,560

(2) Calculation of Depreciation for Current Year on Machines (other than sold)

Particulars	₹
A. On Old Machines of ₹ 9,07,200 for 1 year (10% WDV)	90,720
B. On New Machine of ₹ 1,58,000 for ½ year	7,900
	98,620

ILLUSTRATION 9

A firm purchased second hand machinery on 1st January, 2019 for ₹ 3,00,000, subsequent to which ₹ 60,000 and ₹ 40,000 were spent on its repairs and installation, respectively. On 1st July, 2020 another machinery was purchased for ₹ 2,60,000. On 1st July, 2021, the first machinery having become outdated was auctioned for ₹ 3,20,000 and on the same date, another machinery was purchased for ₹ 2,50,000.

On 1st July, 2022, the second machinery was also sold off and it fetched ₹ 2,30,000.

Depreciation was provided on machinery @ 10% on the original cost annually on 31st December, under the straight line method.

Required

Prepare the following accounts in the books of the company: (i) Machinery Account for the years ending Dec. 31, 2019 to 2022 and (ii) Machinery Disposal Account.

SOLUTION

Dr.			Machinery Account			Cr.		
Date	Particulars	₹	Date	Particulars	₹			
01.01.2019	To Bank A/c (A) – Cost	3,00,000	31.12.2019	By Depreciation (A)	40,000			
	- Repairs	60,000		By Balance c/d (A)	3,60,000			
	- Installation	40,000						
		4,00,000			4,00,000			
01.01.2020	To Balance b/d	3,60,000	31.12.2020	By Depreciation (A) 40,000				
				(B) <u>13,000</u>	53,000			
01.07.2020	To Bank A/c (B)	2,60,000		By Balance c/d (A) 3,20,000				
				(B) <u>2,47,000</u>	5,67,000			
		6,20,000			6,20,000			
01.01.2021	To Balance b/d	5,67,000	01.07.2021	By Machinery Disposal A/c (A)	3,00,000			
01.07.2021	To Bank A/c (C)	2,50,000		By Depreciation A/c (A) 20,000				
				(B) 26,000				
				(C) <u>12,500</u>	58,500			
				By Balance c/d (B) 2,21,000				
				(C) <u>2,37,500</u>	4,58,500			
		8,17,000			8,17,000			
01.01.2022	To Balance b/d	4,58,500	01.07.2022	By Machinery Disposal A/c (B)	2,08,000			
				By Depreciation A/c (B) 13,000				
				(C) <u>25,000</u>	38,000			
				By Balance c/d	2,12,500			
		4,58,500			4,58,500			

Machinery Disposal Account

Date	Particulars	₹	Date	Particulars	₹
01.07.2021	To Machinery A/c (A)	3,00,000	01.07.2021	By Bank A/c	3,20,000
	To Profit Loss A/c (Profit)	20,000			
		3,20,000			3,20,000
01.07.2022	To Machinery A/c (B)	2,08,000	01.07.2022	By Bank A/c	2,30,000
	To P & L A/c (Profit)	22,000			
		2,30,000			2,30,000

**5. CHANGE IN THE METHOD OF DEPRECIATION**

The depreciation method applied to an asset should be reviewed at least at each financial year-end and, if there has been a significant change in the expected pattern of consumption of the future economic benefits embodied in the asset, the method should be changed to reflect the changed pattern. Whenever any change in depreciation method is made, such change in method is treated as change in accounting estimate as per Accounting Standards. Its effect needs to be quantified and disclosed separately. A change in an accounting estimate may affect the current period only or both the current period and future periods.

Example:

Cost of Machine ₹ 10,50,000
 Residual Value ₹ 50,000
 Useful life 10 years.

The company charges depreciation on straight line method for the first two years and thereafter decides to adopt written down value method by charging depreciation @ 25% (calculated based on useful life). You are required to calculate depreciation for the 3rd year.

Depreciation already charged for the first 2 years as per straight line method is ₹ 2,00,000. Therefore, WDV for 2nd year is ₹ 8,50,000

Therefore, in the profit and loss account of the 3rd year, the depreciation of ₹ 2,12,500 (25% of ₹ 850,000) should be debited. In case the entity would have continued with Straight Line Method, depreciation for 3rd year would have been ₹ 1,00,000.

ILLUSTRATION 10

M/s Anshul & Co. commenced business on 1st January 2017, when they purchased plant and equipment for ₹ 7,00,000. They adopted a policy of charging depreciation at 15% per annum on diminishing balance basis and over the years, their purchases of plant have been:

Date	Amount ₹
1-1-2018	1,50,000
1-1-2021	2,00,000

On 1-1-2021 it was decided to change the method and rate of depreciation to straight line basis. On this date remaining useful life was assessed as 6 years for all the assets purchased before 1.1.2021 with no scrap value and 10 years for the asset purchased on 1.1.2021.

Required

Calculate the difference in depreciation to be adjusted in the Plant and Equipment Account for the year ending 31st December, 2021.

SOLUTION**Depreciation on written down value basis**

		Purchased on Jan. 1, 2017 ₹	Purchased on Jan. 1, 2018 ₹	Total Depreciati on ₹
2017	Cost	7,00,000		
	Depreciation	(1,05,000)		1,05,000
	Written Down Value (WDV)	5,95,000		
2018	Cost	-	1,50,000	
	Depreciation	(89,250)	(22,500)	1,11,750
	W.D.V.	5,05,750	1,27,500	
2019	Depreciation	(75,863)	(19,125)	94,988
	W.D.V.	4,29,887	1,08,375	

2020	Depreciation	(64,483)	(16,256)	80,739
	W.D.V.	3,65,404	92,119	
2021	Depreciation	(60,900)	(15,353)	76,253
		3,04,504	76,766	

Plant and Equipment Account

		₹			₹
2021			2021		
Jan. 1	To Balance b/d	4,57,523	Dec. 31	By Depreciation	96,253
	To Bank	2,00,000		(60,900+15,353+20,000)	
				By Balance c/d	5,61,270
		6,57,523			6,57,523
2022					
Jan. 1	To Balance b/d	5,61,270			



6. REVISION OF THE ESTIMATED USEFUL LIFE OF PROPERTY, PLANT AND EQUIPMENT

The residual value and the useful life of an asset should be reviewed at least at each financial year-end and, if expectations differ from previous estimates, the change(s) should be accounted for as a change in an accounting estimate in accordance with Accounting Standards.

Whenever there is a revision in the estimated useful life of the asset, the written down value or the balance depreciable amount should be charged over the revised remaining estimated useful life of the asset.

ILLUSTRATION 11

A Machine costing ₹ 6,00,000 is depreciated on straight line basis, assuming 10 years working life and Nil residual value, for three years. The estimate of remaining useful life after third year was reassessed at 5 years.

Required

Calculate depreciation for the fourth year.

SOLUTION

Depreciation per year = ₹ 6,00,000 / 10 = ₹ 60,000

Depreciation on SLM charged for three years = ₹ 60,000 x 3 years = ₹ 1,80,000

Book value of the computer at the end of third year = ₹ 6,00,000 – ₹ 1,80,000 = ₹ 4,20,000.

Remaining useful life as per previous estimate = 7 years

Remaining useful life as per revised estimate = 5 years

Depreciation from the fourth year onwards = ₹ 4,20,000 / 5 = ₹ 84,000 per annum



7. REVALUATION OF PROPERTY, PLANT AND EQUIPMENT

After recognizing an asset initially, the asset whose fair value could be reliably measured could be carried at the revalued amount, being the fair value at revaluation date and reduced by successively accumulated depreciation and successive accumulated impairment losses (permanent decline in value) (if any). If an entity opts for revaluation:

- (a) Revaluations must be made at adequate intervals (say yearly) for ensuring that carrying amount doesn't differ substantially from that which would be determined if fair value at end of the reporting period is used
- (b) In case an item of PPE is revalued, whole class of such PPE to which such asset belongs should be revalued
- (c) In case the carrying amount of an asset increases due to revaluation, such increase should be credited to revaluation surplus and should be accumulated in equity. However, such increase should be recognized in Profit and Loss statement to the extent of reversal of a previous decrease of that asset that was recognized in the Profit and Loss statement.
- (d) In case the carrying amount of an asset is decreased due to revaluation, such decrease should be recognized in the Profit and Loss account. However, such decrease should be debited to the revaluation surplus to the extent of reversal of a previous increase that was recognized in revaluation surplus for that asset.
- (e) The Revaluation Surplus may be transferred directly to retained earnings when the asset is derecognized. This may involve transferring the whole of the surplus when the asset is retired or disposed of. Such transfer from Revaluation Surplus to Retained Earnings cannot be made through the Profit or Loss.

- (f) Alternatively, where there is an upward revaluation, the excess depreciation on account of such upward revaluation may be transferred from Revaluation Surplus to Retained Earnings. Such transfer from Revaluation Surplus to Retained Earnings cannot be made through the Profit or Loss.

It may be pertinent to note that revaluation of Property, Plant and Equipment is an accounting policy choice, and not mandatory under the accounting standards or the Companies Act, 2013.

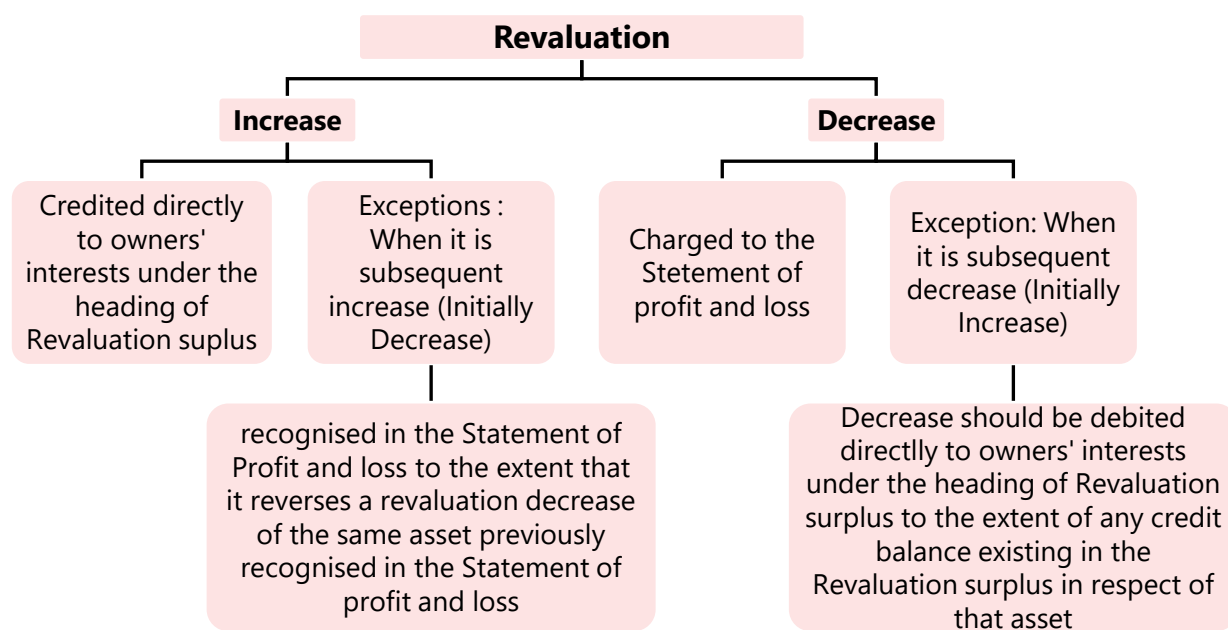


ILLUSTRATION 12

A machine of cost ₹ 12,00,000 is depreciated straight-line assuming 10 year working life and zero residual value for three years. At the end of third year, the machine was revalued upwards by ₹ 60,000 the remaining useful life was reassessed at 9 years.

Required

Calculate depreciation for the fourth year.

SOLUTION

Depreciation per year charged for three years = ₹ 12,00,000 / 10 = ₹ 1,20,000

WDV of the machine at the end of third year = ₹ 12,00,000 – ₹ 1,20,000 × 3 = ₹ 8,40,000.

Depreciable amount after revaluation = ₹ 8,40,000 + ₹ 60,000 = ₹ 9,00,000

Remaining useful life as per previous estimate = 7 years

Remaining useful life as per revised estimate = 9 years

Depreciation for the fourth year onwards = ₹ 9,00,000 / 9 = ₹ 1,00,000.



8. INTANGIBLE ASSETS

An intangible asset is an identifiable non-monetary asset, without physical substance, held for use in the production or supply of goods or services, for rental to others, or for administrative purposes. Examples of intangible assets include:

- (a) Streaming rights of movies / TV shows / web series on platforms like Netflix, Disney Hot Star, Amazon Prime / Sony LIV etc.
- (b) Broadcasting rights of events such as the Cricket World Cup, the Indian Premier League, the Pro Kabaddi League etc.
- (c) Landing rights / time slots at airports which permit aircrafts to land or take-off during a particular time frame
- (d) Patents
- (e) Trademarks
- (f) Copyrights
- (g) Distribution rights for motion pictures in theatres
- (h) Long-term customer contracts
- (i) Customer data collected by the entities such as customer contact numbers / email IDs and spending data at stores like Pantaloons, Westside etc. could be a major intangible asset for these entities.
- (j) Goodwill (purchased)
- (k) Computer Software

Intangible assets comprise a major portion of the balance sheet. It may be noted that it can also be the case that intangible assets could make the entities far more valuable than the tangible assets. For instance, a multi-year customer contract guaranteeing more than 75% of the revenue for the company is a major asset, which on occasions could be more valuable than the tangible assets themselves. Similarly, when Air India was up for acquisition, the tangible assets comprised of several old planes which needed overhauling and maintenance. However, one of the major reasons that made Air India a desirable target was the prime landing slots (intangible asset) that it had at airports across the world

Intangible assets can be recognized in the financial statements provided they meet the following conditions:

- (i) The intangible asset is **identifiable**. Being identifiable means the entity could rent, sell, exchange or distribute the specific future economic benefits attributable to the asset

without disposing of future economic benefits that flow from other assets used in the same revenue earning activity.

- (ii) The enterprise can **exercise control** over such intangible asset. Control means the power available with the enterprise to obtain economic benefits from the asset and at the same time, can restrict access of others to those benefits.
- (iii) It is probable that the future economic benefits attributable to the asset will flow to the enterprise; and
- (iv) The cost of the intangible asset can be measured reliably.

An intangible asset acquired separately usually measured at cost, as cost can be measured reliably in such cases. The cost of the intangible asset would comprise of:

- Purchase price
- Any import duties and taxes (other than those subsequently recoverable by the enterprise from the tax authorities)
- Any directly attributable expenditure on making the asset ready for its intended use e.g., professional fees towards legal services. Any trade discounts and rebates are deducted in arriving at the cost.

As can be seen above, the cost of an intangible asset is similar to the manner in which the cost of a tangible asset is determined.

Intangible assets acquired as part of acquisition, government grants, internally generated goodwill / intangible assets, or on exchange of assets are dealt separately at the intermediate level.

An intangible asset should be derecognised (eliminated from the balance sheet) on disposal or when no future economic benefits are expected from its use and subsequent disposal.

Gains or losses arising from the retirement or disposal of an intangible asset should be determined as the difference between the net disposal proceeds and the carrying amount of the asset and should be recognised as income or expense in the statement of profit and loss.

Difference between Tangible and Intangible Assets

Tangible Assets	Intangible Assets
These are assets that have a physical substance i.e., they can be seen and touched, held for use in the production or supply of goods or services, for rental to others, or for administrative purposes.	These are identifiable assets that do <u>NOT</u> have a physical substance, held for use in the production or supply of goods or services, for rental to others, or for administrative purposes.

Tangible Assets have a finite life based on expected usage.	Intangible Assets have a finite life based on contractual terms. In some cases, intangible assets could also have an indefinite life e.g. purchased goodwill.
Useful life is based on expected usage, with no presumption laid down for the same.	Useful life of Intangible Assets is presumed not to exceed 10 years unless evidence exists to the contrary.
Tangible Assets are depreciated over the useful life. In other words, writing off the value of tangible assets on an annual basis is known as depreciation.	Intangible Assets are amortised over the useful life. In other words, writing off the value of intangible assets on an annual basis is known as amortisation.
Examples include Property, Machinery, Vehicles etc.	Examples include software, streaming rights, landing rights, trademarks, patents etc.



9. AMORTISATION

The concept of amortisation in case of intangible assets is similar to the concept of depreciation in case of tangible assets. In other words, 'depreciation of an intangible asset' is called **AMORTISATION**.

Amortisation can be defined as 'the systematic allocation of the depreciable amount of an intangible asset over its useful life'. Depreciable amount is the cost of an asset less its residual value.

Useful life is either:

- the period of time over which an asset is expected to be used by the enterprise; or
- the number of production or similar units expected to be obtained from the asset by the enterprise.

Residual value is the amount which an enterprise expects to obtain for an asset at the end of its useful life after deducting the expected costs of disposal.

The depreciable amount of an intangible asset should be allocated on a systematic basis over the best estimate of its useful life. Amortisation should commence when the asset is available for use. It is presumed that the useful life of an intangible asset will not exceed ten years from the date when the asset is available for use unless evidence exists to the contrary. For instance, given the rapid changes in technology, computer software and many other intangible assets are susceptible to technological obsolescence. Therefore, it is likely that their useful life will

be short. Similarly, intangible assets with contractual rights for a period exceeding ten years, will be amortised over such extended period rather than the presumed period of ten years.

Similar to depreciation, the amortisation method used should reflect the pattern in which the asset's economic benefits are consumed by the enterprise. If that pattern cannot be determined reliably, the straight-line method should be used. The amortisation charge for each period should be recognised as an expense unless permitted or required to be included in the carrying amount of another asset.

Given the nature of intangible assets, the residual value of an intangible asset should be assumed to be zero unless:

- (a) there is a commitment by a third party to purchase the asset at the end of its useful life; or
- (b) there is an active market for the asset and:
 - (i) residual value can be determined by reference to that market; and
 - (ii) it is probable that such a market will exist at the end of the asset's useful life.

The amortisation period and the amortisation method should be reviewed at least at each financial year end. If the expected useful life of the asset is significantly different from previous estimates, the amortisation period should be changed accordingly. If there has been a significant change in the expected pattern of economic benefits from the asset, the amortisation method should be changed to reflect the changed pattern.

ILLUSTRATION 13

Kumar R&D Co. registered a patent (the patent meets the criteria of an intangible asset) on 1st July, 2021 developed at a cost of ₹ 28,00,000 and spent ₹ 2,00,000 towards legal fees and registration. The patent is granted for a period of 10 years. The books are closed on 31st December every year.

Required

Show the Patent Account and Amortisation Account for the year 2021 and 2022.

SOLUTION

Useful Life: 10 years from 1 July, 2021

Residual Value: NIL

Value of patent = ₹ 30,00,000 (₹ 28,00,000 cost + ₹ 2,00,000 legal expenses and registration fees)

Therefore, annual depreciation: ₹ 30,00,000 ÷ 10 years = ₹ 3,00,000

Patent Account

		₹			₹
2021			2021		
July 1	To Bank A/c	28,00,000	Dec. 31	By Amortisation A/c: ₹ 3,00,000 x 6/12	1,50,000
July 1	To Bank A/c - Legal & Reg. Exp.	2,00,000			
			Dec. 31	By Balance c/d	28,50,000
		30,00,000			30,00,000
2022			2022		
Jan. 1	To Balance b/d	28,50,000	Dec. 31	By Amortisation A/c	3,00,000
			Dec. 31	By Balance c/d	25,50,000
		28,50,000			28,50,000

Amortisation Account

		₹			₹
2021			2021		
Dec. 31	To Patent A/c	1,50,000	Dec. 31	By Profit & Loss A/c	1,50,000
2022			2022		
Dec. 31	To Patent A/c	3,00,000	Dec. 31	By Profit & Loss A/c	3,00,000

ILLUSTRATION 14

Prime Streaming Co. acquired the streaming rights of a movie for ₹ 18,00,000 with the contracted duration of the streaming period being 10 years. At the beginning of the fourth year, based on the decline in viewership, Prime Streaming Co. decided to stream the movie only for the next 5 years.

Required

Calculate amortisation for the fourth year.

SOLUTION

Amortisation per year = ₹ 18,00,000 / 10 = ₹ 1,80,000

Amortisation on SLM charged for three years = ₹ 1,80,000 x 3 years = ₹ 5,40,000

Carrying Amount of the Streaming Rights at the end of third year = ₹ 18,00,000 – ₹ 5,40,000 = ₹ 12,60,000.

Remaining useful life as per previous estimate = 7 years

Remaining useful life as per revised estimate = 5 years

Amortisation from the fourth year onwards = ₹ 12,60,000 / 5 = ₹ 2,52,000 per annum

SUMMARY

- ♦ Depreciation is the systematic allocation of the depreciable amount of an asset over its useful life.
- ♦ Objectives for providing depreciation are:
 - ✦ Correct income measurement by matching the charge for the year
 - ✦ True financial position statement by showing PP&E at their current value
 - ✦ Funds for replacement
 - ✦ Ascertainment of true cost of production.
- ♦ Factors in the measurement of depreciation:
 - ✦ Cost of asset
 - ✦ Estimated useful life of the asset
 - ✦ Estimated scrap value (if any) at the end of useful life of the asset.
- ♦ Methods for providing depreciation:
 - ✦ Straight line method
 - ✦ Reducing balance method
 - ✦ Sum of years of digits method
 - ✦ Machine hour method
 - ✦ Production units' method
 - ✦ Depletion method
- ♦ The resulting profit or loss on sale of the tangible asset is ultimately transferred to profit and loss account.
- ♦ The depreciation method residual value & useful life applied to an asset should be reviewed at least at each financial year-end and, if there has been a significant change in the expected pattern of consumption of the future economic benefits embodied in the asset, on account of the above, they should be changed to reflect the changed pattern.

- ♦ Whenever there is a revision in the estimated useful life of the asset, the balance depreciable amount should be charged to the asset over the revised remaining estimated useful life of the asset.
- ♦ Whenever the depreciable asset is revalued, the depreciation should be charged on the revalued amount on the basis of the remaining estimated useful life of the asset.
- ♦ An intangible asset is an identifiable non-monetary asset, without physical substance, held for use in the production or supply of goods or services, for rental to others, or for administrative purposes.
- ♦ Amortisation is the systematic allocation of the depreciable amount of an intangible asset over its useful life.

TEST YOUR KNOWLEDGE

True and False

1. *Increase in market value of a fixed asset is one of the reasons for depreciation being charged.*
2. *Depreciation is a cash expenditure like other normal expenses..*
3. *Cost of property, plant and equipment includes purchase price, refundable taxes & import duties after deducting any discount or rebate.*
4. *Cost of fixed asset should also include cost of opening a new facility such as inauguration costs.*
5. *Depreciation is charged with a constant amount under straight line method and charged with a constant percentage under diminishing balance method.*
6. *In case an item of Property, Plant & Equipment is revalued, whole class of assets to which that asset being revalued belongs should be revalued.*
7. *In case the carrying amount of an asset is decreased due to revaluation, such decrease should always be recognized in the Profit and Loss account.*
8. *Akash purchased a machine for ₹ 12,00,000. Estimated useful life is 10 years and scrap value is ₹ 1,00,000. Depreciation for the first year using sum of the years digit method shall be ₹ 2,00,000.*
9. *Depreciation cannot be provided in case of loss, in a financial year.*
10. *Providing for depreciation also helps in providing for accumulation of funds to facilitate the replacement at the end of its useful life.*

11. *If the equipment account has a balance of ₹ 12,50,000 and the accumulated depreciation account has a balance of ₹ 4,00,000, the written down value of same shall be ₹ 16,50,000.*
12. *Sum of the years digit method is an example of accelerated method of charging depreciation.*
13. *Over the life of an asset subject to depreciation, the accelerated method will result in less Depreciation Expense in early years and more depreciation in later years of its life.*
14. *While depreciating land cost, Straight line method shall give more depreciation than the written down value.*
15. *Provision for depreciation account is debited at the time of recording the depreciation on an asset.*
16. *If adequate maintenance expenditure is incurred with relation to running repairs of an asset, we need not charge any depreciation.*
17. *When a property, plant or equipment is sold then provision for depreciation account is debited, asset account is credited and any gain or loss is recorded to profit and loss account.*
18. *While calculating the depreciation as per diminishing balance method, the salvage value of the asset at the end of its life is reduced from its cost.*
19. *Any change in the estimated useful life of an asset should be accounted for as a change in an accounting estimate in accordance with Accounting Standards.*
20. *An intangible asset is a non identifiable, non monetary asset.*

Multiple Choice Questions

1. *Original cost = ₹ 12,60,000; Salvage value = Nil; Useful life = 6 years. Depreciation for the first year under sum of years digits method will be*
 - (a) ₹ 3,60,000
 - (b) ₹ 1,20,000
 - (c) ₹ 1,80,000
2. *Obsolescence of a depreciable asset may be caused by:*
 - I. *Technological changes.*
 - II. *Improvement in production method.*

- III. *Change in market demand for the product or service output.*
- IV. *Legal or other restrictions.*
 - (a) *Only (I) above*
 - (b) *Both (I) and (II) above*
 - (c) *All (I), (II), (III) and (IV) above*
- 3. *The number of production of similar units expected to be obtained from the use of an asset by an enterprise is called as*
 - (a) *Unit life*
 - (b) *Useful life*
 - (c) *Production life*
- 4. *If a concern proposes to discontinue its business from March 2018 and decides to dispose of all its plants within a period of 4 months, the Balance Sheet as on March 31, 2018 should indicate the plants at their*
 - (a) *Historical cost*
 - (b) *Net realizable value*
 - (c) *Cost less depreciation*
- 5. *In the case of downward revaluation of a plant which is for the first time revalued, the account to be debited is*
 - (a) *Plant account*
 - (b) *Revaluation Reserve*
 - (c) *Profit & Loss account*
- 6. *The portion of the acquisition cost of the tangible asset, yet to be allocated is known as*
 - (a) *Written down value*
 - (b) *Accumulated value*
 - (c) *Realisable value*
- 7. *The main objective of providing depreciation is to*
 - (a) *Create secret reserve*
 - (b) *Reduce the book value of assets*
 - (c) *Allocate cost of the assets*

8. Original cost of a machine was ₹ 25,20,000 salvage value was ₹ 1,20,000, useful life was 6 years. Annual depreciation under Straight Line Method
- (a) ₹ 4,20,000
 - (b) ₹ 4,00,000
 - (c) ₹ 3,00,000
9. The cost of a machine is ₹ 20,00,000. Two years later the book value is ₹ 10,00,000. The Straight-line percentage depreciation is
- (a) 50%
 - (b) 33-1/3%
 - (c) 25%
10. A machinery with original cost of ₹ 10,00,000 and Nil Salvage value acquired on 1st April 2019 with 4 years useful life was depreciated using Straight Line Method. It was decided to sell the machinery on 1st October 2022 for ₹ 1,20,000. What shall be the gain or (loss) on the sale of Machinery?
- (a) Loss of ₹ 1,30,000
 - (b) Gain of ₹ 1,20,000
 - (c) Loss of ₹ 5,000
11. Which of the following assets does not depreciate?
- (a) Machinery and equipment
 - (b) Patents
 - (c) Land
12. A company purchased a machinery on April 01, 2017, for ₹ 15,00,000. It is estimated that the machinery will have a useful life of 5 years after which it will have no salvage value. The depreciation charged during the year 2021-22 was
- (a) ₹ 5,00,000
 - (b) ₹ 4,00,000
 - (c) ₹ 3,00,000
13. If the equipment account has a balance of ₹ 22,50,000 and the accumulated depreciation account has a balance of ₹ 14,00,000, the book value of the equipment is
- (a) ₹ 36,50,000

- (b) ₹ 8,50,000
- (c) ₹ 14,00,000
14. A plant with original cost of ₹ 50,00,000 was revalued after 2 years resulting in credit to Revaluation Surplus account of ₹ 4,00,000. Towards the year end of 2019-20, due to COVID-19 the plant value had gone down by ₹ 5,00,000 and accordingly management decided to revalue the same. What shall be the impact of this downwards revaluation on the Profit & Loss Account ?
- (a) Debit of ₹ 5,00,000
- (b) Debit of ₹ 1,00,000
- (c) Credit of ₹ 5,00,000
15. In respect of intangible assets, there is a presumption that the useful life of an intangible asset will not exceed
- (a) 2 years
- (b) 3 years
- (c) 10 years
16. A company developed a technology to enhance the battery life of mobile phones. The cost of development have been capitalized as an intangible asset at ₹ 5,00,000. The company estimates the life of the technology developed to be 3 years. The company has forecasted that 50% of sales will be in year 1, 35% in year 2 and 15% in year 3. What should be the amortisation charge in third year?
- (a) ₹ 2,50,000
- (b) ₹ 75,000
- (c) ₹ 1,75,000
17. An intangible asset is an asset
- (a) with no physical existence
- (b) generated internally by the business
- (c) cannot be sold

Theory Questions

1. Distinguish between Straight line method of depreciation and Written down value method of depreciation.
2. Write short note on Depletion method of depreciation.

3. What factors are considered for calculation of depreciation of a plant?
4. What are intangible assets. Explain with the help of examples.

Practical Questions

1. A firm's plant and machinery account at 31st December, 2021 and the corresponding depreciation provision account, broken down by year of purchase are as follows:

Year of Purchase	Plant and Machinery at cost ₹	Depreciation Provision ₹
2005	2,00,000	2,00,000
2011	3,00,000	3,00,000
2012	10,00,000	9,50,000
2013	7,00,000	5,95,000
2020	5,00,000	75,000
2021	3,00,000	15,000
	30,00,000	21,35,000

Depreciation is at the rate of 10% per annum on cost. It is the Company's policy to assume that all purchases, sales or disposal of plant occurred on 30th June in the relevant year for the purpose of calculating depreciation, irrespective of the precise date on which these events occurred.

During 2022 the following transactions took place:

1. Purchase of plant and machinery amounted to ₹ 15,00,000
2. Plant that had been bought in 2011 for ₹ 170,000 was scrapped.
3. Plant that had been bought in 2012 for ₹ 90,000 was sold for ₹ 5,000.
4. Plant that had been bought in 2013 for ₹ 2,40,000 was sold for ₹ 15,000.

You are required to:

Calculate the provision for depreciation of plant and machinery for the year ended 31st December, 2022. In calculating this provision you should bear in mind that it is the company's policy to show any profit or loss on the sale or disposal of plant as a completely separate item in the Profit and Loss Account. You are also required to prepare the following ledger accounts during 2022.

- (i) Plant and machinery at cost;

- (ii) Depreciation provision;
 - (iii) Sales or disposal of plant and machinery.
2. The Machinery Account of a Factory showed a balance of ₹ 19,00,000 on 1st January, 2022. Its accounts were made up on 31st December each year and depreciation is written off at 10% p.a. under the Diminishing Balance Method.
- On 1st June 2022, a new machinery was acquired at a cost of ₹ 2,80,000 and installation charges incurred in erecting the machine works out to ₹ 8,920 on the same date. On 1st June, 2022 a machine which had cost ₹ 4,37,400 on 1st January 2020 was sold for ₹ 75,000. Another machine which had cost ₹ 4,37,000 on 1st January, 2021 was scrapped on the same date and it realised nothing.
- Write a machinery account for the year 2022, allowing the same rate of depreciation as in the past, calculating depreciation to the nearest multiple of a Rupee.
3. The LG Transport company purchased 10 trucks at ₹ 45,00,000 each on 1st April 2019. On October 1st, 2021, one of the trucks is involved in an accident and is completely destroyed and ₹ 27,00,000 is received from the insurance in full settlement. On the same date another truck is purchased by the company for the sum of ₹ 50,00,000. The company write off 20% on the original cost per annum. The company observe the calendar year as its financial year.
- Give the motor truck account for two year ending 31 Dec, 2022.
4. A Machinery costing ₹ 20,00,000 is depreciated on straight line assuming 10 years working life and nil salvage value for four years. At the end of the fourth year, the machinery was revalued upwards by ₹ 80,000. The remaining useful life of the machinery was also reassessed as 8 years at the end of the fourth year. Calculate the depreciation for 5th Year.
5. Amazing group had Property, Plant & Equipment (PP&E) with a book value of ₹ 35,00,000 on 31st December, 2022. The balance in Revaluation Surplus on that date was ₹ 3,00,000. As part of their practice of revaluing the assets on yearly basis, another revaluation was carried out on 31st December, 2022. Evaluate the impact of Revaluation if the Fair Value as a result of Revaluation done on 31st December, 2022 was (a) ₹ 37,00,000 (b) ₹ 33,00,000 and (c) ₹ 31,00,000. Also, give the journal entries.
6. On April 1, 2019 a firm purchased a machinery for ₹ 2,00,000. On 1st October in the same accounting year, additional machinery costing ₹ 1,00,000 was purchased. On 1st October, 2020, the machinery purchased on 1st April 2019, having become obsolete was sold off for ₹ 90,000. On October 1, 2021, new machinery was purchased for ₹ 2,50,000 while the machinery purchased on 1st October 2019 was sold for ₹ 85,000 on

the same day. The firm provides depreciation on its machinery @ 10% per annum on original cost on 31st March every year. Show Machinery Account, Provision for Depreciation Account and Depreciation Account for the period of three accounting years ending March 31, 2022.

ANSWERS/HINTS

True and False

1. False : It is the decrease in market value as one of the reasons for depreciation. Increase in market value may result in Revaluation.
2. False: Depreciation is not a cash expenditure like other normal expenses as it does not result in any cash outflow.
3. False : Non refundable taxes & duties form part of the cost.
4. False : Inauguration costs shouldn't be part of cost.
5. True : SLM method results in same amount and diminishing method involves same rate of depreciation.
6. True : Revaluation should be done for the whole class of the asset.
7. False : Any decrease in value of asset on account of revaluation should be first debited to Revaluation Reserve, if any, and then to Profit & Loss account.
8. True : Sum of years digit method depreciation is calculated as $10/55 \times (12,00,000 - 1,00,000) = 2,00,000$
9. False: Depreciation is a charge against profit and not an appropriation of profit. Therefore, depreciation has to be provided for, even in case of loss in a financial year.
10. True : Depreciation being non cash expense reduces the distributable profits and hence facilitates replacement of asset when required.
11. False : $WDV = ₹ 12,50,000 - ₹ 4,00,000 = ₹ 8,50,000$
12. True : Higher depreciation is charged in earlier years under sum of the years digit method.
13. False : It is vice versa as under diminishing balance method; higher depreciation is charged in beginning.
14. False : Land is not depreciated.
15. False : Provision for Depreciation account is credited while charging the depreciation.

16. False : Depreciation is allocation of the cost of an asset over its useful life. Regular repairs may be required during its life are expensed and depreciation has to be charged anyways.
17. True : At the time of sale of an asset, respective asset account is credited with provision for depreciation account being debited and any resulting gain or loss being charged to profit & loss account.
18. False: Under diminishing balance method, salvage value is not considered initially as it assumes that at the end of the asset's life the remaining value shall be its salvage value.
19. True : Any change in useful life of an asset is accounted for as a change in estimate.
20. False : An intangible asset is an identifiable non-monetary asset, held for use in production and supply of goods and services.

Multiple Choice Questions

1.	(a)	2.	(c)	3.	(b)	4.	(b)	5.	(c)	6.	(a)
7.	(c)	8.	(b)	9.	(c)	10.	(c)	11.	(c)	12.	(c)
13.	(b)	14.	(b)	15.	(c)	16.	(b)	17.	(a)		

Theoretical Questions

1. Under straight line method an equal amount is written off each year throughout the working life of the depreciable tangible asset so as to reduce the cost of the asset to nil or to its scarp value at the end. Under reducing balance method, a fixed percentage is charged on the diminishing balance of the asset each year so as to reduce the value of the asset to its scarp value at the end of useful life. The basic distinction between these two methods are as follows:

Under straight line method, annual depreciation charge is equal throughout the life of the asset; but under reducing balance method, depreciation charge is reduced over the years as the asset grows old.

Under straight-line method, the asset can be fully depreciated but under reducing balance method asset can never be fully depreciated.

Under straight line method the charge for depreciation is constant while repair charges increase with the life of the asset, so the total charge throughout the life of the asset will not be uniform. To the contrary, under reducing balance method, depreciation charges become high in the initial years but generally repair remains low. As the asset grows old depreciation charge reduces but repair expenses increase. Thus under

reducing balance method depreciation and repairs are more or less evenly distributed throughout the life of the asset.

2. Natural resources include physical assets like mineral deposits, oil and gas resources and timber. These natural resources exhaust by exploitation.

Depletion per unit is calculated as

$$\frac{\text{Acquisition cost-Residual Value}}{\text{Estimate life in terms of production units}}$$

3. The factors considered for calculation of depreciation are as: (i) Cost of asset including expenses for installation, commissioning, trial run etc. (ii) Estimated useful life of the asset and (iii) Estimated scrap value (if any) at the end of useful life of the asset.
4. Refer para 8

Practical Questions

1. Calculation of provision for depreciation of plant and machinery for the year ended 31st December, 2022.

Plant purchased in:		₹	₹
2005		nil	
2011		nil	
2012			50,000
2013	1/2 year at 10% on ₹ 2,40,000	12,000	
	1 year at 10% on ₹ 4,60,000	46,000	58,000
2020	10% on ₹ 5,00,000		50,000
2021	10% on ₹ 3,00,000		30,000
2022	1/2 year at 10% on ₹ 15,00,000		75,000
			2,63,000

Plant and Machinery Account (for 2022) at Cost

	₹		₹
To Balance b/d	30,00,000	By Disposals account:	
To Bank A/c	15,00,000	Scrapped	1,70,000
		Sold	3,30,000

		By Balance c/d	40,00,000
	45,00,000		45,00,000

Depreciation Provision Account (for 2022)

		₹		₹
To Disposal Account :			By Balance b/d	21,35,000
Scrapped - 2011 assets	1,70,000		By Profit and Loss Account	2,63,000
Sold - 2012 assets	90,000			
Sold - 2013 assets	2,16,000	4,76,000		
To Balance c/d		19,22,000		
		23,98,000		23,98,000

Sale or disposal of Plant and Machinery Account (for 2022)

		₹		₹
To Plant and Machinery :			By Provision for Depreciation	4,76,000
Scrapped	1,70,000		By Cash-Sales Proceeds	20,000
Sold	3,30,000		By Loss on sales	4,000
	5,00,000			5,00,000

2.

Plant and Machinery Account

		₹			₹
2022			2022		
Jan. 1	To Balance b/d	19,00,000	June 1	By Bank (Sales)	75,000
June. 1	To Bank (2,80,000 + 8,920)	2,88,920		By Depreciation (on sold machine)	14,762
				By Loss on sale	2,64,532
				By Loss on scrapping the machine	3,76,912
				By Depreciation (on scrapped machinery)	16,388
				By Depreciation (Note iii)	1,32,094
				By Balance c/d	13,09,232
		21,88,920			21,88,920

Working Note :

(i) Calculation of loss on sale of machine on 1-6-2022			₹
Cost on 1-1-2020			4,37,400
Less : Depreciation @ 10% on ₹ 4,37,400			(43,740)
W.D.V. on 31-12-2020			3,93,660
Less : Depreciation @ 10% on ₹ 3,93,660			(39,366)
W.D.V. on 31-12-2021			3,54,294
Less : Depreciation @ 10% on ₹ 3,54,294 for 5 months			(14,762)
			3,39,532
Less : Sale proceeds on 1-6-2022			(75,000)
Loss			2,64,532
(ii) Calculation of loss on scrapped machine			₹
Cost on 1-1-2021			4,37,000
Less : Depreciation @ 10% on ₹ 4,37,000			(43,700)
W.D.V. on 1-1-2022			3,93,300
Less : Depreciation @ 10% on ₹ 3,93,300 for 5 months			(16,388)
Loss			3,76,912
(iii) Depreciation			
Balance of machinery account on 1-1-2022			19,00,000
Less : W.D.V of machinery sold	3,54,294		
W.D.V. of machinery scrapped	3,93,300		(7,47,594)
W.D.V. of other machinery on 1-1-2022			11,52,406
Depreciation @ 10% on ₹ 11,52,406 for 12 months			1,15,240
Depreciation @ 10% on ₹ 2,88,920 for 7 months			16,854
			1,32,094

3.

Date	Particulars	Amount	Date	Particulars	Amount
2021			2021		
Jan-01	To balance b/d	2,92,50,000	Oct-01	By bank A/c	27,00,000
Oct-01	To Profit & Loss A/c		Oct-01	By Depreciation on lost assets	6,75,000

	(Profit settlement on of Truck)	4,50,000	Dec-31	By Depreciation A/c	83,50,000
Oct-01	To Bank A/c	50,00,000	Dec-31	By balance c/d	2,29,75,000
		3,47,00,000			3,47,00,000
2022			2022		
Jan-01	To balance b/d	2,29,75,000	Dec-31	By Depreciation A/c	91,00,000
			Dec-31	By balance c/d	1,38,75,000
		2,29,75,000			2,29,75,000

Working Note:

1. Profit on settlement of truck

	₹
Original cost as on 1.4.2019	45,00,000
Less: Depreciation for 2019	(6,75,000)
	38,25,000
Less: Depreciation for 2020	(9,00,000)
	29,25,000
Less: Depreciation for 2021 (9 months)	(6,75,000)
	22,50,000
Less: Amount received from Insurance company	(27,00,000)
	4,50,000

4. Depreciation per year for first 4 years = ₹ 20,00,000 / 10 = ₹ 2,00,000

Thus, WDV of the Machinery at end of the 4th year = ₹ 20,00,000 – (₹ 2,00,000 x 4) = ₹ 12,00,000

Revalued Amount i.e. New Depreciable Amount shall be = ₹ 12,00,000 + ₹ 80,000 = ₹ 12,80,000

Original remaining useful life is (10-4) = 6 Years whereas it is reassessed as 8 Years.

Hence, depreciation for 5th Year = ₹ 12,80,000 / 8 = ₹ 1,60,000

5. (a) Fair Value: ₹ 37,00,000

Since this is an upward revaluation and the group had a balance in revaluation surplus (i.e. there was an upward movement earlier), hence this will result in an additional credit of ₹ 2,00,000 to Revaluation Surplus and hence the total

Revaluation Surplus balance (part of other comprehensive income in Equity) shall increase to ₹ 5,00,000. The Accounting journal entry shall be:

Property, Plant & Equipment A/c	Dr	2,00,000	
To Revaluation Surplus A/c			2,00,000

(b) Fair Value : ₹ 33,00,000

Since this is a downward revaluation and the group had a balance in revaluation surplus (i.e. there was an upward movement earlier), hence this will result in a reduction or a debit to Revaluation Surplus to the extent of balance therein and any excess shall be debited to Profit & Loss A/c. In this case, there is a reduction in fair value of ₹ 2,00,000 (35,00,000 – 33,00,000) and hence the entire amount shall be debited to Revaluation Surplus. Hence, the total Revaluation Surplus balance (part of other comprehensive income in Equity) shall decrease to ₹ 1,00,000. The Accounting journal entry shall be:

Revaluation Surplus A/c	Dr	2,00,000	
To Property, Plant & Equipment A/c			2,00,000

(c) Fair Value : ₹ 31,00,000

Since this is also a downward revaluation and the group had a balance in revaluation surplus (i.e. there was an upward movement earlier), hence this will result in a reduction or a debit to Revaluation Surplus to the extent of balance therein and any excess shall be debited to Profit & Loss A/c. In this case, there is a reduction in fair value of ₹ 4,00,000 (35,00,000 – 31,00,000) and hence the Revaluation Surplus A/c shall be debited by ₹ 3,00,000 and the balance ₹ 1,00,000 shall be debited to Profit & Loss A/c. Hence, the total Revaluation Surplus balance (part of other comprehensive income in Equity) shall become Nil. The Accounting journal entry shall be:

Revaluation Surplus A/c	Dr	3,00,000	
Profit & Loss A/c	Dr	1,00,000	
To Property, Plant & Equipment A/c			4,00,000

6. Dr. Machinery Account Cr.

Date	Particulars	₹	Date	Particulars	₹
01.04.2019	To Bank A/c	2,00,000	31.03.2020	By Balance c/d	3,00,000
01.10.2019	To Bank A/c	1,00,000			
		3,00,000			3,00,000

01.04.2020	To Balance b/d	3,00,000	01.10.2020	By Bank A/c	90,000
				By Provision for Depreciation A/c	30,000
				By Profit and Loss A/c	80,000
			31.3.2021	By Balance c/d	1,00,000
		3,00,000			3,00,000
01.04.2021	To Balance b/d	1,00,000	01.10.2021	By Bank A/c	85,000
01.10.2021	To Bank A/c	2,50,000		By Provision for Depreciation A/c	20,000
	To Profit and Loss A/c	5,000	31.3.2022	By Balance c/d	2,50,000
		3,55,000			3,55,000

Depreciation Account

Date	Particulars	₹	Date	Particulars	₹
31.03.2020	To provision for Depreciation A/c	25,000	31.03.2020	By Profit and Loss A/c	25,000
		25,000			25,000
01.10.2020	To Provision for Depreciation A/c	10,000	31.03.2021	By Profit and Loss A/c	20,000
31.03.2021	To Provision for Depreciation A/c	10,000			20,000
		20,000			20,000
01.10.2021	To Provision for Depreciation A/c	5,000	31.03.2022	By Profit and Loss A/c	17,500
31.03.2022	To Provision for Depreciation A/c	12,500			17,500
		17,500			17,500

Dr.

Provision for Depreciation Account

Cr.

Date	Particulars	₹	Date	Particulars	₹
31.03.2020	To Balance c/d	25,000	31.03.2020	By Depreciation A/c (₹ 20,000 + ₹ 5,000)	25,000
		25,000			25,000
01.12.2020	To Machinery A/c (₹ 20,000 + ₹ 10,000)	30,000	01.04.2020	By Balance b/d	25,000

31.03.2021	To Balance c/d	15,000	01.10.2020	By Depreciation A/c	10,000
			31.03.2021	By Depreciation A/c	10,000
		45,000			45,000
01.10.2021	To Machinery A/c (₹ 5,000 + ₹ 10,000 + ₹ 5,000)	20,000	01.04.2021	By Balance b/d	15,000
31.03.2022	To Balance c/d	12,500	01.10.2021	By Depreciation A/c	5,000
			31.03.2022	By Depreciation A/c	12,500
		32,500			32,500



BILLS OF EXCHANGE AND PROMISSORY NOTES

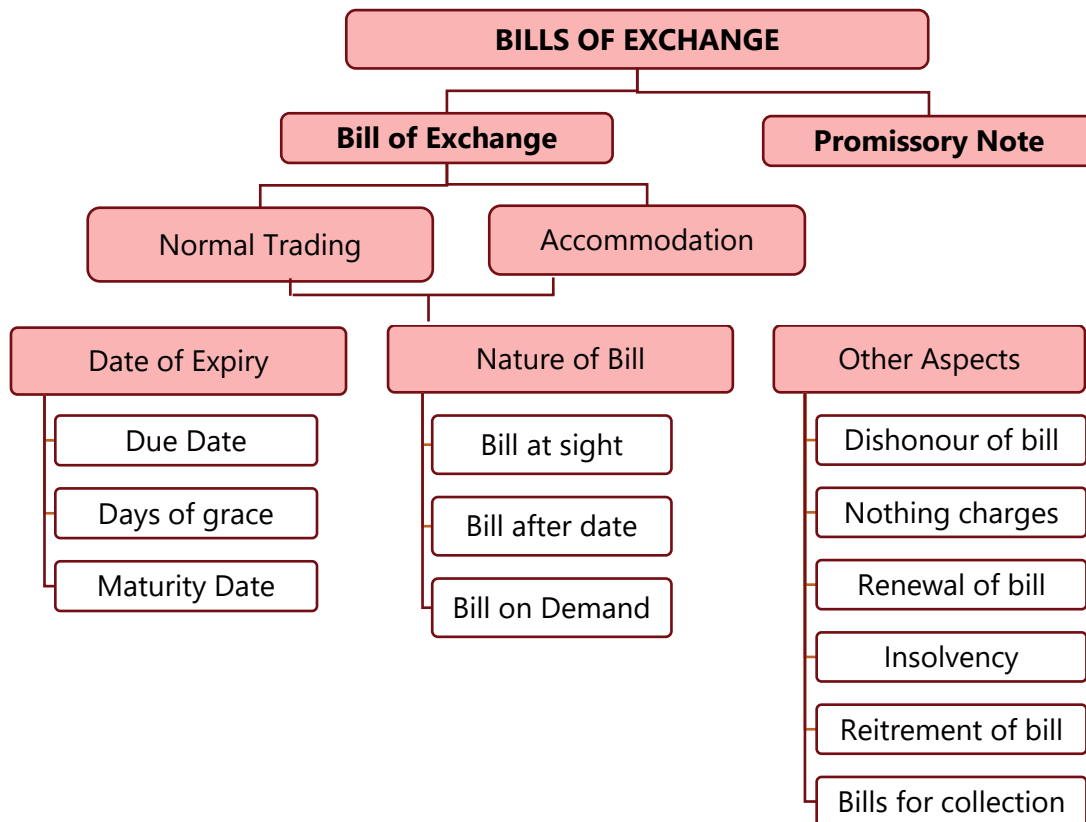


LEARNING OUTCOMES

After studying this chapter, you would be able to:

- ◆ Understand the meaning of Bills of Exchange and Promissory Notes and also try to grasp their underlying features.
- ◆ Understand the accounting treatments relating to issue, acceptance, discounting, maturity and endorsement of bills in the books of drawer and drawee.
- ◆ Learn the technique of accounting relating to accommodation bills.
- ◆ Learn the special treatment needed in case of insolvency as well as early retirement of bill.

CHAPTER OVERVIEW



1. BILLS OF EXCHANGE

It is general practice that when goods are sold or services are provided, the seller extends a credit period to buyer. Sometimes, the seller may not be in a position to offer credit period and the purchase is not in a position to pay immediately. In such circumstances the seller would like that the purchaser should give a definite promise in writing to pay the amount of the goods on a certain date which he can use to generate immediate funds. Commercial practice has developed to treat these written promises into valuable instruments of credit that when a written promise is made in proper form and is properly stamped, it is expected that the buyer discharges his debt and the seller receives payment. This is because written promises are often accepted by banks and money is advanced against them. Also, they can be endorsed, i.e., passed on from person to person. The written promise is either in the form of a Bill of Exchange or in the form of a promissory note.

A Bill of Exchange has been defined as an “instrument in writing containing an unconditional

order signed by the maker directing certain person to pay a certain sum of money only to or to the order of a certain person or to the bearer of the instrument". When such an order is accepted in writing on the face of the order itself, it becomes a valid bill of exchange. Suppose A orders B to pay ₹50,000 for three months after date and B accepts this order by signing his name, then it will be a bill of exchange.

A Bill of Exchange has the following characteristics:

1. It must be in writing.
2. It must be dated.
3. It must contain an order to pay a certain sum of money.
4. The promise to pay must be unconditional.
5. The money must be payable to a definite person or to his order or to the bearer.
6. The draft must be accepted for payment by the party to whom the order is made.
7. It should be properly stamped (except in case of bills payable "on demand")
8. Payment must be in legal currency of the country.

The party which makes the order is known as the **drawer**. The party which accepts the order is known as the **acceptor** and the party to whom the amount has to be paid is known as the **payee**. The drawer and the payee can be the same.

A Bill of Exchange can be passed on to another person by endorsement. Endorsement on a bill of exchange is made exactly as it is done in the case of a cheque. The primary liability on a bill of exchange is that of the acceptor. If he does not pay, a holder can recover the amount from any of the previous endorsers or the drawee.

Sometimes, it may happen that a bill of exchange is drawn for foreign trade operations. Such a bill is known as "**Foreign Bill of Exchange**". A foreign bill of exchange is one which is drawn in one country and is payable in another. It is generally drawn up in triplicate wherein each copy is sent by separate post so that at least one copy reaches the intended party. Payment will be made only on one of the copies and when such payment is made the other copies become useless. Section 12 of the Negotiable Instruments Act provides that all instruments, which are not inland instrument, are foreign.

A specimen of foreign bill of exchange is given below:

	₹ 11,50,000 New Delhi July, 2022
Ninety days after date of this First Bill of Exchange (Second and Third of the same tenure and date being unpaid) Pay to the order of M/s Vencent John & Associates, London the sum of Rupees Eleven lakh Fifty thousand only, value received.	
To, Wallis Sons M/a IONX Birmingham, UK	Accepted (Wallis Sons) Stamp Drawee

The following are examples of foreign bills:

1. A bill drawn in India on a person resident outside India and made payable outside India.
2. A bill drawn outside India on a person resident outside India.
3. A bill drawn outside India and made payable in India.
4. A bill drawn outside India and made payable outside India.



2. PROMISSORY NOTES

A promissory note is an instrument in writing, not being a bank note or currency note containing an unconditional undertaking signed by the maker to pay a certain sum of money only to or to the order of a certain person. Under Section 31(2) of the Reserve Bank of India Act a promissory note cannot be made payable to bearer.

A promissory note has the following characteristics:

1. It must be in writing.
2. It must contain a clear promise to pay. Mere acknowledgement of a debt is not a promissory note.

3. The promise to pay must be unconditional. "I promise to pay `50,000 as soon as I can" is not an unconditional promise.
4. The promiser or maker must sign the promissory note.
5. The maker must be a certain person.
6. The payee (the person to whom the payment is promised) must also be certain.
7. The sum payable must be certain. "I promise to pay `50,000 plus all fine" is not certain.
8. Payment must be in legal currency of the country.
9. It should not be made payable to the bearer.
10. It should be properly stamped.
11. It does not require any acceptance.

Specimen of promissory note :

Specimen of a Promissory Note		
₹ 10,00,000/- only		Rohan 77, Sector-12, Ghaziabad March 01, 2022
Three months after date I promise to pay Priya or his order the sum of ₹ Ten lakh only, for value received.		
To, Priya S-11, Rohini, Delhi.	Stamp	(Rohan)
Payee		Maker



3 DIFFERENCES - BILL OF EXCHANGE AND PROMISSORY NOTE

Bill of Exchange	Promissory Note
A bill contains an order to pay	A promissory note contains only a promise to pay certain sum of money
There are generally 3 parties (Drawer, Drawee and Payee) in bill of exchange	There are 2 parties (Maker and Payee) in promissory note

A bill is paid by acceptor	A promissory note is paid by maker
A bill is drawn by creditor	A promissory note is made by debtor
The drawer and payee may be same person in case of bill of exchange	In promissory note maker and payee cannot be same person
In a bill of exchange the liability of drawer is secondary and conditional. He will be liable only in case the acceptor does not honour the bill.	In a promissory note the liability of a maker is primary and absolute.
A bill of exchange can be accepted conditionally	A promissory note cannot be made conditionally
In a bill of exchange, notice of dishonour must be given	Notice of dishonour is not required in case of promissory note
In case of dishonour, a bill of exchange must be noted and protested	Noting and protest is not required in case of dishonour of a promissory note.



4. RECORD OF BILLS OF EXCHANGE AND PROMISSORY NOTES

A party which receives a Promissory Note or receives an accepted Bill of Exchange will treat it as a new asset under the name of Bills receivable. A party which issues a Promissory Note or accepts a Bill of Exchange will treat it as new liability under the heading of Bills Payable. We shall first deal with the entries in the books of the party which receives promissory notes or bills. (When we talk of bills, we include promissory notes also).

On receipt of Bill, the payee makes the following entry in his books of accounts:

Bills Receivable Account Dr.

To Drawee/Maker of the note

- (1) A accepts a Bill of exchange drawn on him by B. In the books of B the entry will be :

Bills Receivable Account Dr.

To A

- (2) A sends to B the acceptance of D. In this case also, the entry in the books of B will be:

Bills Receivable Account Dr.

To A

The person who receives the bill has three options. These are:

- (i) He can hold the bill till maturity. (Naturally in this case no further entry is passed until the date of maturity arrives).
- (ii) The bill can be endorsed in favour of another party say Z. In this case, the entry will be to debit the party which now receives the bill and to credit the Bills Receivable Account.

Z

Dr.

To Bills Receivable Account

- (iii) The Bill of Exchange can be discounted with bank. The bank will deduct a small sum of money as discount and pay rest of the money.

Bank Account

Dr. (with the amount actually received)

Discount Account

Dr. (with the amount of loss or discount)

To Bills Receivable Account

On the date of maturity there will be two possibilities:

- (a) The first is that the bill will be paid, that is to say, *met* or *honoured*. The entries for this will depend upon what was done to the bill during the period of maturity. If the bill was kept, the cash will be received by the party which originally received the bill. In his books, therefore, the entry will be :

Bank Account

Dr.

To Bills Receivable Account

But if he has already endorsed the bill in *favour* of his creditor or if the bill has been discounted with the bank he will not get the amount; it will be the creditor or the bank which will receive the money. Therefore, in these two cases, no entry will be made in the books of the party which originally received the bill.

- (b) The second possibility is that the bill will be *dishonoured*, that is to say, the bill will not be paid. If the bill is *dishonoured*, the bill becomes useless and the party from whom the bill was received will be liable to pay the amount (and also the expenses incurred by the party).

Therefore, the following entries will be made :

- 1. If the bill was kept till maturity then :

Drawee / Maker Account

Dr.

To Bills Receivable Account

2. If the bill was endorsed in favour of a creditor, the entry is :

Drawee / Maker Account	Dr.
To Creditor Account	

3. If the bill was discounted with the bank :

Drawee / Maker Account	Dr.
To Bank Account	

Thus, it will be seen that in case of dishonour, the party which gave the bill has to be debited (because he has become liable to pay the amount). The credit entry is in Bills Receivable Account (if it was retained) or the Creditor or the bank (if it was endorsed/discounted in their favour).



5. TERM OF A BILL

The term of bill of exchange may be of any duration. Usually the term does not exceed 90 days from the date of the bill.

- ♦ When a bill is drawn **after sight**, the term of the bill begins to run from the date of 'sighting', i.e., when the bill is accepted.
- ♦ When a bill is drawn **after date**, the term of the bill begins to run from the date of drawing the bill.



6. EXPIRY / DUE DATE OF A BILL

The date on which the term of the bill terminates is called as 'Expiry/Due Date of the bill'.



7. DAYS OF GRACE

Every instrument payable otherwise than on demand is entitled to three days of grace.



8. DATE OF MATURITY OF BILL

The date which comes after adding three days of grace to the expiry/due date of a bill, is called the date of maturity.

The maturity of a promissory note or bill of exchange is the date at which it falls due. Every promissory note or bill of exchange gets matured on the third day after the day on which it is expressed to be payable, except when it is expressed to be payable:

- (i) on demand,
- (ii) at sight, or
- (iii) on presentment



9. BILL AT SIGHT

Bill at Sight means the instruments in which no time for payment is mentioned. A cheque is always payable on demand. A promissory note or bill of exchange is payable on demand-

- (a) when no time for payment is specified, or
- (b) when it is expressed to be payable on demand, or at sight or on presentment.

Notes:

- (i) "At sight" and "presentment" means on demand.
- (ii) An instrument payable on demand may be presented for payment at any time.
- (iii) Days of grace is not to be added to calculate maturity for such types of bill.



10. BILL AFTER DATE

Bill after date means the instrument in which time for payment is mentioned. A promissory note or bill of exchange is a time instrument when it is expressed to be payable-

- (a) after a specified period.
- (b) on a specific day
- (c) after sight
- (d) on the happening of event which is certain to happen

Notes:

- (i) *The expression 'after sight' means-*
 - (a) *in a promissory note, after presentment for sight*
 - (b) *in a bill of exchange, after acceptance or noting for non-acceptance or protest for non-acceptance.*
- (ii) *A cheque cannot be a time instrument because the cheque is always payable on demand. Though a cheque can be post dated and which can be presented on or after such date. A cheque has validity of 90 days from its date after that it becomes void, normally termed as 'Stale Cheque' as bank will not honour such cheque.*



11. HOW TO CALCULATE DUE DATE OF A BILL

The due date of each bill is calculated as follows:

Case	Due Date
(a) When the bill is made payable on a specific date.	(a) That specific date will be the due date.
(b) When the bill is made payable at a stated number of months(s) after date.	(b) That date on which the term of the bill shall expire will be the due date. Note: The term shall expire on that day of the month which corresponds with the day on which the bill is dated. If the month in which the period terminates has no corresponding day, the period shall be deemed to expire on the last day of such a month. For example a bill signed on January 31st payable after 3 months will be due on May 3 rd .
(c) When the bill is made payable at a stated number of days after date.	(c) That date which comes after adding stated number of days to the date of bill, shall be the due date. Note: The date of Bill is excluded.
(d) When the due date is a public holiday.	(d) The preceding business day will be the due date.
(e) When the due date is an emergency/unforeseen holiday.	(e) The next following day will be the date.

Note: The term of a **Bill after sight** commences from the date of acceptance of the bill whereas the term of a **Bill after date** commences from the date of drawing of bill.



12. NOTING CHARGES

It is necessary that the fact of dishonour and the causes of dishonour should be established. If the acceptor can prove that the bill was not properly presented to him for payment, he may escape liability. Therefore, if there is dishonour, or fear of dishonour, the bill will be given to a public official known as "**Notary Public**". These officials present the bill for payment and if the money is received, they will hand over the money to the original party. But if the bill is dishonoured they will note the fact of dishonour, with the reasons and give the bill back to

their client. For this service they charge a small fee. This fee is known as **noting charges**. The amount of noting charges is recoverable from the party which is responsible for dishonour.

Suppose X received from Y a bill for ₹1,000. On Maturity the bill is dishonoured and ₹10 is paid as noting charges. The entry in this case will be

	₹	₹
Y	Dr. 1,010	
To Bills Receivable Account		1,000
To Bank A/c		10

Suppose X had endorsed this bill in favour of Z. In that case entry for dishonoured bill would have been

Y	Dr. 1,010	
To Z		1,010

This is because Z will claim ₹1,010 from X and X has the right of recovering ₹1,010 from Y. Similarly, if the bill has been discounted with a bank, entry will be :

Y	Dr. 1,010	
To Bank A/c		1,010



13. RENEWAL OF BILL

Sometimes the acceptor is unable to pay the amount and he himself moves that he should be given extension of time and in consideration agrees to bear interest for the extended time period (calculated from the date of maturity of old bill till the date of expected settlement). In such a case a new bill will be drawn and the old bill will be cancelled. If this happens entries should be passed for cancellation of the old bill. This is done exactly as already explained for dishonour. When the new bill is received entries for the receipt of the bill will be repeated. The amount of the new bill may represent any of the following:

- (i) *Where the drawee pays nothing:* Total of amount of original bill as well as the interest for the extended time period.
- (ii) *Where the drawee pays the interest amount at the time of renewal:* Amount of the Original bill.
- (iii) *Where the drawee makes part payment of the original bill or interest amount or both:* Unpaid part of total of amount of original bill as well as the interest for the extended time period on such amount.



14. RETIREMENT OF BILLS OF EXCHANGE & REBATE

We have seen that renewal of a bill of exchange is made when a person does not have sufficient fund to pay for the bill of exchange on the due date and he requires a further period of credit. Many a time instances do arise when the acceptor has spare funds much before the maturity date of the bill of exchange accepted by him. In such circumstances he approaches the payee of the bill of exchange and asks him whether the payee is prepared to accept cash before the maturity date. In such cases the acceptor gets a certain **rebate** or interest or discount for premature payment. The rebate becomes the income of the acceptor and expense of the payee. It is a consideration of premature payment.

ILLUSTRATION 1

Ms. Sujata receives two bills from Ms. Aruna dated 1st January 2022 for 2 months. The first bill is for 10,200 and the second bill is for ₹ 15,000. The First bill is discounted immediately with the bank for ₹ 10,000 and the second bill was endorsed in favour of Mr. Sree on 3rd January 2022. Pass the necessary journal entries in the books of Ms. Sujata.

SOLUTION

In the books of Sujata Journal Entries

Date	Particulars	L.F.	DR. (₹)	CR. (₹)
01/01/2022	Bills receivables A/c Dr. To Aruna A/c (Being 2 bills receivable from Aruna)		25,200	25,200
01/01/2022	Bank A/c Dr. Discount charges A/c Dr. To Bills receivable A/c (Being the bills receivable discounted with the bank at a charge of ₹ 200)		10,000 200	10,200
03/01/2022	Sree A/c Dr. To Bills receivable A/c (Being bill endorsed in favour of Mr. Sree)		15,000	15,000

ILLUSTRATION 2

Vijay sold goods to Pritam on 1st September, 2022 for ₹1,06,000. Pritam immediately accepted a three months bill. On due date Pritam requested that the bill be renewed for a fresh period of

two months. Vijay agrees provided interest at 9% p.a. was paid immediately in cash. To this Pritam was agreeable. The second bill was met on due date. Give Journal entries in the books of Vijay and Pritam.

SOLUTION
**Books of Vijay
Journal**

2022			₹	₹
1 Sept.	Pritam Dr.		1,06,000	
	To Sales Account			1,06,000
	(Sales of goods to Pritam as per Invoice No...)			
	Bills Receivable Account Dr.		1,06,000	
	To Pritam			1,06,000
	(3 months acceptance received from Pritam for the amount due from him)			
Dec. 4	Pritam Dr.		1,06,000	
	To Bills Receivable Account			1,06,000
	(Pritam acceptance cancelled because of renewal)			
	Pritam Dr.		1,590	
	To interest			1,590
	(Interest @ 9% on ₹1,06,000 due from Pritam for 2 months because of renewal)			
	Bills Receivable Account Dr.		1,06,000	
	Cash Account Dr.		1,590	
	To Pritam			1,07,590
	[New acceptance for 2 months for ₹106,000 and Cash (for interest) received from Pritam]			
2023				
Feb. 7	Cash Account Dr.		1,06,000	
	To Bills Receivable Account			1,06,000
	(Cash received against Pritam's second acceptance)			

**Books of Pritam
Journal**

2022			₹	₹
1 Sept.	Purchase Account Dr.		1,06,000	
	To Vijay A/c			1,06,000
	(Purchase of goods from Vijay as per Invoice No...)			
	Vijay A/c Dr.		1,06,000	
	To Bills Payables Account			1,06,000
	(3 months acceptance given to Vijay for the amount)			
Dec. 4	Bills Payable Account Dr.		1,06,000	
	To Vijay A/c			1,06,000
	(Cancellation of bill because of renewal)			
	Interest Account Dr.		1,590	
	To Vijay			1,590
	(Interest @ 9% on ₹1,06,000 due to Vijay for 2 months because of renewal)			
	Vijay Account Dr.		1,07,590	
	To Cash Account			1,590
	To Bills Payable Account			1,06,000
	[New acceptance for 2 months for ₹106,000 and Cash (for interest) paid to Vijay]			
2023				
Feb. 7	Bills Payable Account Dr.		1,06,000	
	To Cash Account			1,06,000
	(Cash paid against second bill)			

ILLUSTRATION 3

On 1st January, 2022, Ankita sells goods for ₹5,00,000 to Bhavika and draws a bill at three months for the amount. Bhavika accepts it and returns it to Ankita. On 1st March, 2022, Bhavika retires her acceptance under rebate of 12% per annum. Record these transactions in the journals of Ankita and Bhavika.

SOLUTION**Journal Entries in the books of Ankita**

Date 2022	Particulars	₹	₹
Jan. 1	Bhavika's account Dr. To Sales account (Being the goods sold to Bhavika on credit)	5,00,000	5,00,000
	Bills receivable account Dr. To Bhavika's account (Being the acceptance of bill received)	5,00,000	5,00,000
Mar.1	Bank account Dr. Rebate on bills account Dr. To Bills receivable account (Being retirement of bill by Bhavika one month before maturity, the rebate being given to her at 12% p.a.)	4,95,000 5,000	5,00,000

Journal Entries in the books of Bhavika

Date 2022	Particulars	₹	₹
Jan. 1	Purchases account Dr. To Ankita Account (Being the goods purchased from Ankita on credit)	5,00,000	5,00,000
	Ankita Account Dr. To Bills Payable Account (Being the acceptance of bill)	5,00,000	5,00,000
Mar .1	Bills Payable Account Dr. To Rebate Income Account To Bank Account (Being retirement of bill one month before maturity, the rebate being received at 12% p.a.)	5,00,000	5,000 4,95,000

ILLUSTRATION 4

Journalise the following transactions in K. Katrak's books:

- (i) Katrak's acceptance to Basu for ₹ 2,500 discharged by a cash payment of ₹ 1,000 and a new bill for the balance plus ₹ 50 for interest.
- (ii) G. Gupta's acceptance for ₹ 4,000 which was endorsed by Katrak to M. Mehta was dishonoured. Mehta paid ₹ 20 noting charges. Bill withdrawn against cheque.
- (iii) D. Dalal retires a bill for ₹ 2,000 drawn on him by Katrak for ₹10 discount.
- (iv) Katrak's acceptance to Patel for ₹ 5,000 was discharged by endorsing Mody's acceptance to Katrak for a similar amount.

SOLUTION

Books of K. Katrak
Journal Entries

			₹	₹
(i)	Bills Payable Account	Dr.	2,500	
	Interest Account	Dr.	50	
	To Cash A/c			1,000
	To Bills Payable Account			1,550
	(Bills Payable to Basu discharged by cash payment of ₹1,000 and a new bill for ₹1,550 including ₹50 as interest)			
(ii)	(a) G. Gupta	Dr.	4,020	
	To M. Mehta			4,020
	(G. Gupta's acceptance for ₹4,000 endorsed to M. Mehta dishonoured, ₹20 paid by M. Mehta as noting charges)			
	(b) M. Mehta	Dr.	4,020	
	To Bank Account			4,020
	(Payment to M. Mehta on withdrawal of bill earlier received from Mr. G. Gupta)			
(iii)	Bank Account	Dr.	1,990	
	Discount Account	Dr.	10	
	To Bills Receivable Account			2,000
	(Payment received from D. Dalal against his acceptance for ₹2,000. Allowed him a discount of ₹10)			

(iv)	Bills Payable Account	Dr.	5,000	
	To Bills Receivable Account			5,000
	(Bills Receivable from Mody endorsed to Patel in settlement of bills payable issued to him earlier)			

ILLUSTRATION 5

On 1st January, 2022, Vilas draws a bill of exchange for ₹10,000 due for payment after 3 months on Eknath. Eknath accepts to this bill of exchange. On 4th March, 2022 Eknath retires the bill of exchange at a discount of 12% p.a. You are asked to show the journal entries in the books of Eknath.

SOLUTION**Journal entries in the books of Eknath**

Date 2022	Particulars	Debit ₹	Credit ₹
Jan. 1	Vilas A/c Dr. To Bills Payable A/c (Being the bill draws by him accepted)	10,000	10,000
Mar. 4	Bills Payable A/c Dr. To Bank A/c To Interest A/c (Discount A/c) (Being retirement of acceptance 1 month before maturity, interest allowed at 12% p.a.)	10,000	9,900 100

ILLUSTRATION 6

On 1st January, 2022, Vilas draws a Bill of Exchange for ₹10,000 due for payment after 3 months on Eknath. Eknath accepts to this bill of exchange. On 4th March, 2022. Eknath retires the bill of exchange at a discount of 12% p.a. You are asked to show the journal entries in the books of Vilas.

SOLUTION**Journal entries in the books of Vilas**

Date 2022	Particulars	Debit ₹	Credit ₹
Jan. 1	Bills Receivable A/c Dr. To Eknath A/c (Being bill of exchange drawn on Eknath due for payment on 4 th April 2022)	10,000	10,000

Mar. 4	Bank A/c	Dr.	9,900	
	Interest A/c (Discount) A/c	Dr.	100	
	To Bills Receivable A/c			10,000
	(Being retirement of bill of exchange due for maturity on 4 th April, 2022 by Eknath 1 month before maturity, the rebate being given to him at 12% p.a.)			



15. INSOLVENCY

Insolvency of a person means that he is unable to pay his liabilities. This means that bills accepted by him will be dishonoured. Therefore, when it is known that a person has become insolvent, entry for dishonour of his acceptance must be passed. Later on, something may be received from his estate. When and if an amount is received, cash account will be debited and the personal account of the debtor will be credited. The remaining amount will be irrecoverable and, therefore, should be written off as bad debt. The students should be careful to calculate the amount actually received from an insolvent's estate and amount to be written off only after preparing his account.

In the books of drawee of the bill, the amount not ultimately paid by him due to insolvency, should be credited to **Deficiency Account**.

ILLUSTRATION 7

Mr. David draws two bills of exchange on 1.1.2022 for ₹6,000 and ₹10,000. The bills of exchange for ₹6,000 is for two months while the bill of exchange for ₹10,000 is for three months. These bills are accepted by Mr. Thomas. On 4.3.2022, Mr. Thomas requests Mr. David to renew the first bill with interest at 18% p.a. for a period of two months. Mr. David agrees to this proposal. On 20.3.2022, Mr. Thomas retires the acceptance for ₹10,000, the interest rebate i.e. discount being ₹100. Before the due date of the renewed bill, Mr. Thomas becomes insolvent and only 50 paise in a rupee could be recovered from his estate.

You are to give the journal entries in the books of Mr. David.

SOLUTION

Journal Entries in the books of Mr. David

2022			(₹)	(₹)
Jan. 1	Bills receivable (No. 1) A/c	Dr.	6,000	
	Bills receivable (No. 2) A/c	Dr.	10,000	

4-Mar	To Mr. Thomas's A/c (Being drawing of bills receivable No. 1 due for maturity on 4.3.2022 and bills receivable No. 2 due for maturity on 4.4.2022)		16,000
	Mr. Thomas's A/c Dr.	6,000	
	To Bills receivable (No.1) A/c (Being the reversal entry for bill No.1 on agreed renewal)		6,000
4-Mar	Bills receivable (No. 3) A/c Dr.	6,180	
	To Interest A/c To Mr. Thomas's A/c (Being the drawing of bill of exchange no. 3 due for maturity on 7.5.2022 together with interest at 18%p.a. in lieu of the original acceptance of Mr. Thomas)		180 6,000
20-Mar	Bank A/c Dr.	9,900	
	Discount A/c Dr.	100	
	To Bills receivable (No. 2) A/c (Being the amount received on retirement of bills No.2 before the due date)		10,000
7-May	Mr. Thomas's A/c Dr.	6,180	
	To Bills receivable (No. 3) A/c (Being the amount due from Mr. Thomas on dishonour of his acceptance on presentation on the due date)		6,180
7-May	Bank A/c Dr.	3,090	
	To Mr. Thomas's A/c (Being the amount received from official assignee of Mr. Thomas at 50 paise per rupee against dishonoured bill)		3,090
May 7	Bad debts A/c Dr.	3,090	
	To Mr. Thomas's A/c (Being the balance 50% debt in Mr. Thomas's Account arising out of dishonoured bill written as bad)		3,090

ILLUSTRATION 8

Rita owed ₹1,00,000 to Siriman. On 1st October, 2021, Rita accepted a bill drawn by Siriman for the amount at 3 months. Siriman got the bill discounted with his bank for ₹99,000 on 3rd October, 2021. Before the due date, Rita approached Siriman for renewal of the bill. Siriman agreed on the conditions that ₹50,000 be paid immediately together with interest on the remaining amount at 12% per annum for 3 months and for the balance, Rita should accept a new bill at three months. These arrangements were carried out. But afterwards, Rita became insolvent and 40% of the amount could be recovered from his estate.

Pass journal entries (with narration) in the books of Siriman.

SOLUTION

In the books of Siriman
Journal Entries

Particulars		₹	₹
Bills Receivable A/c To Rita (Being a 3 month's bill drawn on Rita for the amount due)	Dr.	1,00,000	1,00,000
Bank A/c Discount A/c To Bills Receivable A/c (Being the bill discounted)	Dr. Dr.	99,000 1,000	1,00,000
Rita To Bank A/c (Being the bill cancelled up due to Rita's inability to pay it)	Dr.	1,00,000	1,00,000
Rita To Interest A/c (Being the interest due on ₹ 50,000 @ 12% for 3 months)	Dr.	1,500	1,500
Bank A/c To Rita (Being the receipt of a portion of the amount due on the bill together with interest)	Dr.	51,500	51,500
Bills Receivable A/c To Rita (Being the new bill drawn for the balance)	Dr.	50,000	50,000

Rita	Dr.	50,000	
To Bills Receivable A/c			50,000
(Being the dishonour of the bill due to Rita's insolvency)			
Bank A/c	Dr.	20,000	
Bad Debts A/c	Dr.	30,000	
To Rita			50,000
(Being the receipt of 40% of the amount due on the bill from Rita's estate)			



16. ACCOMMODATION BILLS

Bills of Exchange are usually drawn to facilitate trade transmission, that is, bills are meant to finance actual purchase and sale of goods. But the mechanism of bill can be utilised to raise finance also. Suppose Boss needs finance for three months. In that case he may persuade his friend Kapoor to accept his draft. The bill of exchange may then be taken by Boss to his bank and get it discounted there. Thus, Boss will be able to make use of funds. When the three months period expires, Boss will send the requisite amount to Kapoor and Kapoor will meet the bill. Thus, Boss is able to raise money for his use. If both Boss and Kapoor need money, the same device can be used. Either Boss accepts a bill of exchange or Kapoor does. In either case, the bill will be discounted with the bank and the proceeds divided between the two parties according to mutual agreement. The discounting charges must also be borne by the two parties in the same ratio in which the proceeds are divided. On the due date the acceptor will receive from the other party his share. The bill will then be met. When bills are used for such a purpose, they are known as accommodation bills.

However, it may so happen that the drawer is not able to remit the proceeds to drawee on the due date. In such a case, the drawee may draw a bill on the drawer, and get it discounted with the bank to honour the first bill. If the new drawer (drawee of the first bill) also remits some proceeds of the new bill to new drawee (drawer of the first bill), then the proportion of discount to be borne by the new drawee will be based upon the proceeds remitted as well as the benefit obtained by him on the first bill (i.e., by not paying the amount due to the original drawee on due date).

Entries are passed in the books of two parties exactly in the way already pointed out for ordinary bills. The only additional entry to be passed is for sending the remittance for one party to the other party and also debiting the other party with the shared amount of discount.

ILLUSTRATION 9

On 1st July, 2022 Gorge drew a bill for ₹1,80,000 for 3 months on Harry for mutual accommodation. Harry accepted the bill of exchange. Gorge had purchased goods worth ₹1,81,000 from Jack on the same date. Gorge endorsed Harry's acceptance to Jack in full settlement. On 1st September, 2022, Jack purchased goods worth ₹1,90,000 from Harry. Jack endorsed the bill of exchange received from Gorge to Harry and paid ₹ 9,000 in full settlement of the amount due to Harry. On 1st October, 2022, Harry purchased goods worth ₹2,00,000 from Gorge. Harry paid the amount due to Gorge by cheque. Give the necessary Journal Entries in the books of Harry, Gorge and Jack.

SOLUTION

In the books of Harry
Journal Entries

Date	Particulars		₹	₹
1.7.2022	Gorge's account Dr. To Bills payable account (Acceptance of bill drawn by Gorge)		1,80,000	1,80,000
1.9.2022	Jack's account Dr. To Sales account (Sales made to Jack)		1,90,000	1,90,000
1.9.2022	Bills receivable account Dr. Bank account Dr. Discount account Dr. To Jack's account (Acceptance received from Jack's endorsement of bill received from Gorge for ₹ 1,80,000 and ₹ 9,000 received in full settlement of the amount due)		1,80,000 9,000 1,000	1,90,000
1.9.2022	Bills payable account Dr. To Bills receivable account (Own acceptance received from Jack's endorsement, cancelled)		1,80,000	1,80,000
1.10.2022	Purchase account Dr. To Gorge's account (Purchases made from Gorge)		2,00,000	2,00,000

	Gorge's account	Dr.	20,000	
	To Bank account			20,000
	(Amount paid to Gorge after adjusting ₹180,000 for accommodation extended to him)			

**In the books of Gorge
Journal Entries**

Date	Particulars		₹	₹
1.7.2022	Purchases Account	Dr.	1,81,000	
	To Jack Account			1,81,000
	(Purchase of goods from Jack)			
1.7.2022	Bills Receivable Account	Dr.	1,80,000	
	To Harry Account			1,80,000
	(Acceptance by Harry of bill drawn on him)			
1.7.2022	Jack's account	Dr.	1,81,000	
	To Rebate Account			1,000
	To Bills Receivable Account			1,80,000
	(Harry's bill endorsed to Jack)			
1.10.2022	Harry Account	Dr.	2,00,000	
	To Sales account			2,00,000
	(Sales to Harry)			
1.10.2022	Bank Account	Dr.	20,000	
	To Harry account			20,000
	(Amount received from Gorge after adjusting ₹180,000 for accommodation extended by him)			

**In the books of Jack
Journal Entries**

Date	Particulars		₹	₹
1.7.2022	Gorge Account	Dr.	1,81,000	
	To Sales Account			1,81,000
	(Sold goods to Gorge)			

1.7.2022	Bills Receivable Account	Dr.	1,80,000	
	Rebate Account	Dr.	1000	
	To Gorge Account			1,81,000
	(Being Harry's acceptance received from Gorge)			
1.9.2022	Purchase Account	Dr.	1,90,000	
	To Harry Account			1,90,000
	(Purchase of goods from Harry)			
1.9.2022	Harry Account	Dr.	1,90,000	
	To Bills Receivable Account			1,80,000
	To Bank Account			9,000
	To Discount Account			1000
	(Endorsement of bill received from Gorge for Rs. 1,80,000 to Harry and Rs. 9,000 paid in full settlement of the amount due)			

ILLUSTRATION 10

X draws on Y a bill of exchange for ₹ 30,000 on 1st April, 2022 for 3 months. Y accepts the bill and sends it to X who gets it discounted for ₹ 28,800. X immediately remits ₹ 9,600 to Y. On the due date, X, being unable to remit the amount due, accepts a bill for ₹ 42,000 for three months which is discounted by Y for ₹ 40,110. Y sends 6,740 to X. Before the maturity of the bill, X becomes bankrupt, his estate paying fifty paise in the rupee. Give the journal entries in the books of X and Y.

SOLUTION

In the books of X
Journal Entries

Date	Particulars	DR. (in ₹)	CR. (in ₹)
1/4/2022	Bills receivables A/c	Dr.	
	To Y A/c		30,000
	(Being bill of exchange drawn on Mr. Y)		
1/4/2022	Bank A/c	Dr.	
	Discount charges A/c	Dr.	
	To Bills receivable A/c		30,000
	(Being the bills receivable discounted with the bank at a charge of ₹ 1,200)		

1/4/2022	Y A/c To Bank A/c To Discount charges (Being the amount remitted to Y along with his share of the bank charges)	Dr.	10,000	9,600 400
4/7/2022	Y A/c To Bills payable A/c (Being the bills drawn by Y, due to non-payment of earlier bill)	Dr.	42,000	42,000
4/7/2021	Bank A/ c Discount charges A/c $\left[\frac{20,000 + 6,740}{40,110} \times 1,890 \right]$ To Y A/c (Being the amount discounted and sent it by Y to X)	Dr. Dr.	6,740 1,260	8,000
	Bills payable A/c To Y's A/c (Being the bill due dishonoured due to bankruptcy)	Dr.		42,000
	Y A/c To Bank A/c To Deficiency account (Being the amount due to Y discharged by payment of 50 paise in a rupee)	Dr.	28,000	14,000 14,000

In the books of Y
Journal Entries

Date	Particulars		DR. (in ₹)	CR. (in ₹)
1/4/2022	X A/c To Bills payable A/c (Being bill of exchange accepted and sent to Mr. X)	Dr.	30,000	30,000
1/4/2022	Bank A/c Discount charges A/c	Dr. Dr.	9,600 400	

4/7/2022	To X A/c (Being the amount received from X on account of the bills receivable)		10,000
	Bills receivable A/c Dr.	42,000	
4/7/2022	To X A/c (Being the bills accepted by X)		42,000
	Bank A/c Dr.	40,110	
	Discount charges A/c Dr.	1,890	
	To Bills receivable A/c (Being X acceptance discounted with bank)		42,000
	Bills payable A/c Dr.	30,000	
	To Bank A/c (Being the amount met on the due date)		30,000
	X A/c Dr.	8,000	
	To Bank A/c To Discount account (Being the amount received and the discount debited to X)		6,740 1,260
	X A/c Dr.	42,000	
	To Bank A/c (Being X's acceptance which was discounted dishonoured due to X's bankruptcy)		42,000
	Bank A/c Dr.	14,000	
	Bad debts A/c Dr.	14,000	
	To X A/c		28,000
	(The amount received from X and the balance being written off as debt)		



17. BILLS OF COLLECTION

When a person receives a bill of exchange, he may decide to retain the bill till the date of maturity. But in order to ensure safety, he may send it to bank with instructions that the bill should be retained till maturity and should be realised on that date. This does not mean discounting because the bank will not credit the client until the amount is actually realised. If the bill is sent to the bank with such instructions it is known as "Bill sent for collection".

It is better to make a record of this also in books by passing following entry:

Bills for Collection Account	Dr.
To Bills Receivable Account	

When the amount is realised the entry will be

Bank Account	Dr.
To Bills for Collection Account	

When the amount is not honoured, the entry will be

Drawee's A/c (from whom the bill was received)	Dr.
To Bills for collections A/c	



18. BILLS RECEIVABLE AND BILLS PAYABLE BOOKS

Bills receivable and bills payable books are journals (Day Books) to record in a chronological order the details of bills receivable and bills payable. When large number of bill transactions take place in an organization, it is convenient to maintain these books. Wherein any bill transaction takes place, the same is entered in the Day Books in the first instance. Postings to individual Debtors or Creditors accounts are made from the Day Books. Also totals of bills received or accepted are posted periodically to Bills Receivable Account and Bills Payable Account respectively.

Bills receivable book and bills payable book are very useful for following up the status of outstanding bills. When there are large number of bills and these bills fall due on different dates, some of these bills may not be honoured on maturity due to varied reasons. It is possible from these Day Books to trace the details of the outstanding bills and to identify the reasons for not honouring the bills. Given below are forms of Day Books for both bills receivable and bills payable:

Bills Receivable Book (Folio No . . .)

Date of receipt	Voucher No.	Party from whom Received	Accept or	Date of Bill	Due Date	Place of Payment	Amt. ₹	L.F.	Mode of Disposal

Bills Payable Book (Folio No . . .)

Date of Acceptance	Drawer	Payee	Date of Bill	Due Date	Place of Payment	Amt. ₹	L.F.	Mode of Disposal

SUMMARY

- ♦ A Bill of Exchange is defined as an “instrument in writing containing an unconditional order signed by the maker directing a certain person to pay a certain sum of money only to or to the order of a certain person or to the bearer of the instrument”.
- ♦ A promissory note is an instrument in writing, not being a bank note or currency note containing an unconditional undertaking signed by the maker to pay a certain sum of money only to or to the order of a certain person. Under Section 31(2) of the Reserve Bank of India Act a promissory note cannot be made payable to bearer.
- ♦ A party which receives a Promissory Note or receives an accepted Bill of Exchange will treat it as a new asset under the name of Bills receivable. A party which issues a Promissory Note or accepts a Bill of Exchange will treat it as new liability under the heading of Bills Payable.

TEST YOUR KNOWLEDGE**True and False**

1. Bills payable account is a nominal account.
2. Promise to pay is included in a bill of exchange.
3. Days of rebate are added to the due date to arrive at the maturity date.
4. Discount at the time of retirement of a bill is a gain for the drawee.
5. Foreign bill is drawn in the country and payable outside the country.
6. Promissory note is different from bill of exchange because the amount is paid by the maker in case of former and by the acceptor in the later.

7. *A has drawn a bill on B. B accepts the same and endorses the bill to C.*
8. *A bill given to a creditor is called bills payable.*

Multiple Choice Questions

1. *On 1.1.2022, A draws a bill on B for ₹1,20,000 for 3 months' maturity date of the bill will be:*
 - (a) 1.4.2022
 - (b) 3.4.2022
 - (c) 4.4.2022
2. *On 16.6.2022 P draws a bill on Q for ₹1,25,000 for 30 days. 19th July is a public holiday, maturity date of the bill will be:*
 - (a) 19th July
 - (b) 18th July
 - (c) 17th July
3. *PQ draws a bill on XY for ₹130,000 on 1.1.2022. XY accepts the same on 4.1.2022 for period of 3 months after date. What will be the maturity date of the bill:*
 - (a) 4.4.2022
 - (b) 3.4.2022
 - (c) 7.4.2022
4. *A draws a bill on B. A endorsed the bill to C. The payee of the bill will be*
 - (a) A
 - (b) B
 - (c) C
5. *A bill of ₹ 120,000 was discounted by Saras with the banker for ₹1,18,800. At maturity, the bill returned dishonoured, noting charges ₹ 200. How much amount will the bank deduct from Saras's bank balance at the time of such dishonour?*
 - (a) ₹1,20,000
 - (b) ₹1,18,800
 - (c) ₹1,20,200

6. *X draws a bill on Y for ₹300,000 on 1.1.2022 for 3 months after sight, date of acceptance is 6.1.2022. Maturity date of the bill will be:*
- (a) 8.4.2022
 - (b) 9.4.2022
 - (c) 10.4.2022
7. *X sold goods to Y for ₹ 5,00,000. Y paid cash ₹4,30,000. X will grant 2% discount on balance, and Y request X to draw a bill for balance, the amount of bill will be:*
- (a) ₹ 98,000
 - (b) ₹ 68,000
 - (c) ₹ 68,600
8. *On 1.1.2022, X draws a bill on Y for ₹ 5,00,000 for 3 months. X got the bill discounted 4.1.2022 at 12% rate. The amount of discount on bill will be:*
- (a) ₹ 15,000
 - (b) ₹ 16,000
 - (c) ₹ 18,000
9. *Mr. Jay draws a bill on Mr. John for ₹ 3,00,000 on 1.1.2022 for 3 months. On 4.2.2022, John got the bill discounted at 12% rate. The amount of discount will be:*
- (a) ₹ 9,000
 - (b) ₹ 6,000
 - (c) ₹ 3,000
10. *XZ draws a bill on YZ for ₹ 2,00,000 for 3 months on 1.1.2022. The bill is discounted with banker at a charge of ₹1,000. At maturity the bill return dishonoured. In the books of XZ, for dishonour, the bank account will be credited by:*
- (a) ₹199,000
 - (b) ₹ 200,000
 - (c) ₹ 201,000
11. *On 1.1.2022, XA draws a bill on YB for ₹ 1,00,000. At maturity YB request XA to renew the bill for 2 months at 12% p.a. interest. Amount of interest will be:*
- (a) ₹ 2,000
 - (b) ₹ 1,500
 - (c) ₹ 1,800

12. *A bill of exchange is drawn by a*
 - (a) *Creditor*
 - (b) *Debtor*
 - (c) *Debenture holder*
13. *At the time of drawing a bill, the drawer credits*
 - (a) *Bills Receivables A/c*
 - (b) *Bills Payable A/c*
 - (c) *Debtor's A/c*
14. *A promissory note is made by a*
 - (a) *Seller*
 - (b) *Purchaser*
 - (c) *Endorsee*
15. *A bill of exchange contains*
 - (a) *An unconditional order*
 - (b) *A promise*
 - (c) *A request to deliver the goods*
16. *A promissory note contains*
 - (a) *An unconditional order*
 - (b) *A promise*
 - (c) *A request to deliver the goods*
17. *The rebate on the bill shows that*
 - (a) *It has been endorsed*
 - (b) *It has been paid after the date of maturity*
 - (c) *It has been paid before the date of maturity*
18. *Notary Public may charge his fee from the*
 - (a) *Holder of bill of exchange*
 - (b) *Drawer*
 - (c) *None*

Theoretical Questions

1. Write short notes on:
 - (a) Accommodation bill.
 - (b) Renewal of bill.
 - (c) Noting charges.
2. What is bill of exchange? How does it differ from Promissory Note?

Practical Questions

1. On 1st January, 2022, A sells goods for ₹10,000 to B and draws a bill at three months for the amount. B accepts it and returns it to A. On 1st March, 2022, B retires his acceptance under rebate of 12% per annum. Record these transactions in the journals of B.
2. A draws upon B three Bills of Exchange of ₹ 3,000, ₹ 2,000 and ₹ 1,000 respectively. A week later his first bill was mutually cancelled, B agreeing to pay 50% of the amount in cash immediately and for the balance plus interest ₹100, he accepted a fresh Bill drawn by A. This new bill was endorsed to C who discounted the same with his bankers for ₹1,500. The second bill was discounted by A at 5%. This bill on maturity was returned dishonoured (nothing charge being ₹30). The third bill was retained till maturity when it was duly met.

Give the necessary journal entries recording the above transactions in the books of A.

3. Journalize the following in the books of Don:
 - (i) Bob informs Don that Ray's acceptance for ₹ 3,000 has been dishonoured and noting charges are ₹40. Bob accepts ₹ 1,000 cash and the balance as bill at three months at interest of 10%. Don accepts from Ray his acceptance at two months plus interest @ 12% p.a.
 - (ii) James owes Don ₹ 3,200; he sends Don's own acceptance in favour of Ralph for ₹ 3,160; in full settlement.
 - (iii) Don meets his acceptance in favour of Singh for ₹ 4,500 by endorsing John's acceptance for ₹ 4,450 in full settlement.
 - (iv) Ray's acceptance in favour of Don retired one month before due date, interest is taken at the rate of 6% p.a.

ANSWERS/HINTS

True and False

1. False: The bills payable account is a personal account that represents a liability.
2. False: Bill of exchange contains an order to pay the required amount and not a mere promise to pay.
3. False: 3 Days of grace are added to the due date to arrive at the maturity date.
4. True: Discount at the time of retirement of a bill is a gain for the drawee and loss for the drawer.
5. True: When a bill is drawn in the country and is payable outside the country it is termed as a foreign bill.
6. True: In case of the promissory note, it is generally the maker who makes the payment, but in case of the bill of exchange, the person accepting the bill shall be liable to make the payment to the holder of the bill.
7. False: B cannot endorse the bill to C as he is a drawee. Only A, the drawer can do so.
8. True: A bill given to a creditor is called Bills Payable as the debtor commits to pay by giving a bill to creditor.

Multiple Choice Questions

1.	(c)	2.	(b)	3.	(a)	4.	(c)	5.	(c)	6.	(b)
7.	(c)	8.	(a)	9.	(b)	10.	(b)	11.	(a)	12.	(a)
13.	(c)	14.	(b)	15.	(a)	16.	(b)	17.	(c)	18.	(a)

Theoretical Questions

1. (a) Bills of Exchange are usually drawn to facilitate trade transmission, that is, bills are meant to finance actual purchase and sale of goods. But the mechanism of bill can be utilised to raise finance also. When bills are used for such a purpose, they are known as accommodation bills.
- (b) When the acceptor of a bill finds himself in financial straits to honour the bill on the due date, then he may request the drawer to cancel the original bill and draw on him a fresh bill for another period. And if the drawer agrees, a new bill in place of the original bill may be accepted by the drawee for another period. This is called the renewal of bill.

- (c) The charges paid to Notary public for notify the dishonour are noting charges. Refer para 1.12 for details.
2. A bill of exchange has been defined as "an instrument in writing containing an unconditional order signed by the maker directing a certain person to pay a certain sum of money only to or to the order of certain person or to the bearer of the instrument". When such an order is accepted by the drawee, it becomes a valid bill of exchange. A promissory note is an instrument in writing (not being a bank note or a government currency note) containing an unconditional undertaking, signed by the maker, to pay a certain sum of money only to, or to the order of, a certain person, or to the bearer of the instrument.

A promissory note needs no acceptance, as the debtor himself writes the document promising to pay the stated amount. Like bills of exchange, promissory notes are also negotiable instruments, and can be transferred by endorsement. In case of bill of exchange, the drawer and the payee may be the same person but in case of a promissory note, the maker and the payee cannot be the same person.

Practical Questions

1. Journal Entries in the books of B

Date	Particulars	Debit	Credit
2022		₹	₹
Jan. 1	Purchases account Dr. To A's account (Being the goods purchased from A on credit)	10,000	10,000
	A's account Dr. To Bills payable account (Being the acceptance of bill given to A)	10,000	10,000
1-Mar	Bills payable account Dr. To Bank account To Rebate on bills account (Being the bill discharged under rebate @ 12% p.a.)	10,000	9,900 100

Working Note :

Calculation of rebate:

$$₹10,000 \times 12/100 \times 1/12 = ₹100$$

2.

Journal of A

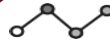
		₹	₹
Bills Receivable A/c To B (Three bills for ₹3,000, ₹2,000 and ₹1,000 drawn on B and duly accepted by him received)	Dr.	6,000	6,000
B To Bills Receivable A/c (Bill received from B cancelled for renewal)	Dr.	3,000	3,000
Cash Account Bill Receivable Account To B To Interest Account (Amount received on cancellation of the first bill, 50% along with a new bill for 50% of the amount plus interest ₹100)	Dr. Dr.	1,500 1,600	3,000 100
C To Bills Receivable A/c (A's acceptance endorsed in favour of C)	Dr.	1,600	1,600
Bank A/c Discount A/c To Bills Receivable A/c (Second Bill for ₹ 2,000 discounted with the bank @ 5%)	Dr. Dr.	1,900 100	2,000
B To Bank A/c (Second Bill for ₹2,000 discounted with the Bank dishonoured, noting charges ₹30 paid by the Bank)	Dr.	2,030	2,030
Bank A/c To Bills Receivable A/c (Amount received on maturity of the third bill)	Dr.	1,000	1,000

Note: It is assumed that the bill for ₹1,600 has not yet fallen due for payment.

3.

Books of Don

			₹	₹
(i)(a)	Ray Dr. To Bob (Ray's acceptance endorsed to Bob dishonoured on due date nothing charges paid by Bob ₹40)		3,040	3,040
(b)	Bob Dr. Interest Dr. To Cash To Bills Payable A/c (Amount payable to Bob ₹3,040 settled by cash payment ₹1,000 and issue of new bill for ₹2,091 including interest ₹ 51 for three months on ₹2,040 @ 10% p.a.)		3,040 51	1,000 2,091
(c)	Bills Receivable A/c Dr. To Ray To Interest (Bill received from Ray for ₹3,040 due against earlier acceptance dishonoured plus ₹ 60.80 interest for two months @ 12% p.a.)		3,100.80	3,040.00 60.8
(ii)	Bills Payable A/c Dr. Discount A/c Dr. To James (Cancellation of bills payable to Ralph for ₹3,160 in settlement of ₹3,200 due from James)		3,160 40	3,200
(iii)	Bills payable A/c Dr. To Bills Receivable A/c To Discount A/c (Settlement of acceptance issued to Mr. Singh by endorsement of John's Acceptance for ₹4,450)		4,500	4,450 50
(iv)	Bank A/c Dr. Discount A/c Dr. Total Bills Receivable A/c (Amount received from Ray in settlement of Bills Payable, retired one month before due date)		3,085.30 15.5	3,100.80



PREPARATION OF FINAL ACCOUNTS OF SOLE PROPRIETORS

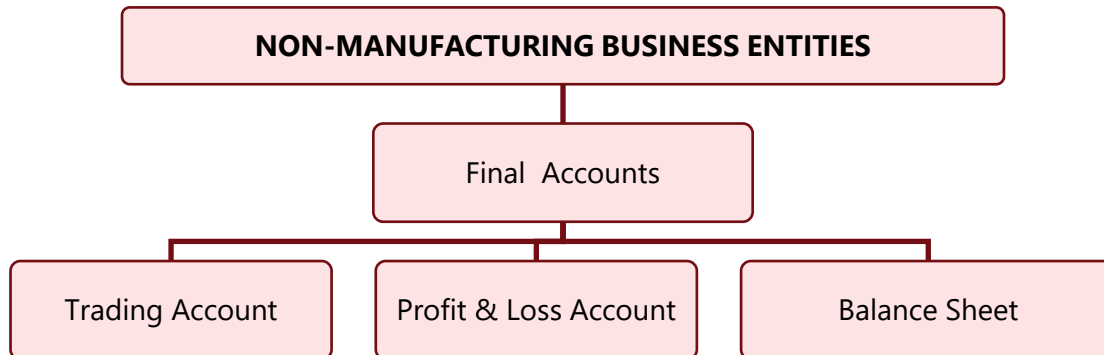


UNIT – 1 FINAL ACCOUNTS OF NON-MANUFACTURING ENTITIES

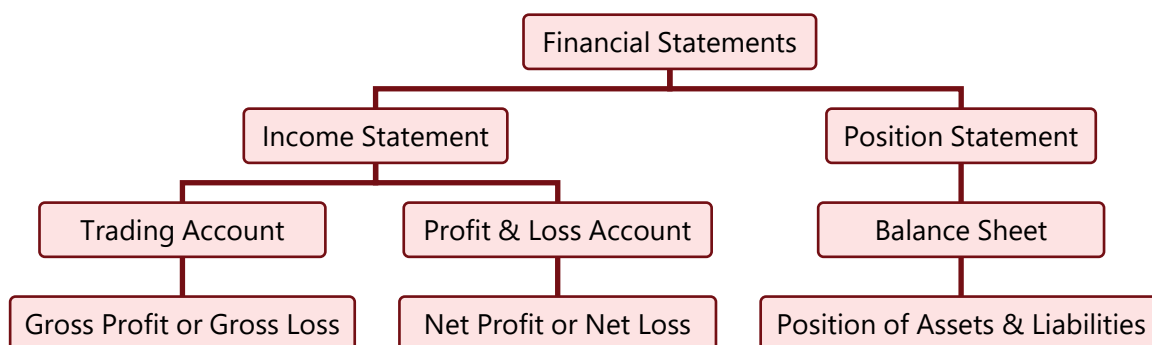
LEARNING OUTCOMES

After studying this unit, you would be able to:

- ◆ Draw final Accounts of Non- manufacturing entities.
- ◆ Learn the relationship between Profit and Loss Account and Balance Sheet.
- ◆ Understand the Trading Account items. This will help you to learn which of the transactions and events should be shown in the Trading Account.
- ◆ Understand the items shown in the Profit and Loss Account. By that you will learn the technique of preparing Profit and Loss Account and deriving the Profit and Loss balance.
- ◆ Learn how to adjust outstanding and pre-paid expenses, accrued income and income received in advance.
- ◆ Understand the items to be shown in the balance sheet. Also learn the classification of assets and liabilities and the order by which they are presented in the Balance Sheet.

UNIT OVERVIEW**1.1 INTRODUCTION**

Non-manufacturing entities are the trading entities, which are engaged in the purchase and sale of goods for profit without changing the form/ underlying use of such goods. In other words, non-manufacturing entities do not process the goods purchased rather sell them in their original form. Meanwhile the entity indulges in some liabilities, makes some assets and also incurs some expenses like salaries, stationery expenses, advertisement, rent etc. to run the business. At the end of the accounting year, the entity must be interested in knowing the results of the business. To ascertain the final outcome of the business i.e., the income and financial position, they prepare financial statements at the end of the accounting year.



Financial Statements are the systematically organized summary of all the ledger account heads and presented in such a manner that it gives detailed information about the financial position and the performance of the entity. As seen above, through categorization of Financial Statements into Income & Position Statement, the profit or loss is measured at two levels:

- (a) Gross Profit or Gross Loss
- (b) Net Profit or Net Loss

The profit or loss of the enterprise is obtained through the preparation of **Income Statement i.e. Trading and Profit & Loss A/c**

The financial position of the business enterprise is assessed by measuring the assets, liabilities and capital of the enterprise and the same is communicated to the users of financial statements. Financial position of the enterprise can be known through the preparation of the **Position Statement i.e Balance Sheet.**

Comparison between Income Statement and Position Statement

Income Statement	Position statement
Profit or loss is presented in the Income Statement prepared at the close of the financial year	It exhibits assets and liabilities of the business as at the close of the financial year.
Income Statement is sub-divided into following two parts for a non-manufacturing concern: (i) Trading account; and (ii) Profit and Loss account	Apart from balance sheet, to assess the financial position of the business, sometimes additional statements are also prepared like cash flow statement, statement of changes in equity etc. which is not mandatory for non-corporate entities. These additional statements are prepared for the better understanding of the financial position of the business.
Income Statement discloses net profit or net loss of the business after adjusting from the income earned during the year, all the expenditures of the business incurred in that year.	Position statement discloses the assets and liabilities position as on a particular date.



1.2 PREPARATION OF FINAL ACCOUNTS

The principal function of final accounts (Trading Account, Profit and Loss Account and the Balance Sheet) is to exhibit truly and fairly the performance and the financial position of the business to which they relate. In order that these may be properly drawn up, it is essential that a proper record of transactions entered into by the business during a particular accounting period should be maintained. The **BASIC PRINCIPLES** in regard to accumulation of accounting period data are:

- (i) a distinction should be made between capital and revenue receipts and payments.
- (ii) income and expenses relating to a period of account should be separated from those of another period.

- (iii) different items of income and expenditure should be accumulated under significant heads so as to disclose the sources from which capital has been procured and the nature of liabilities, which are outstanding for payment.

Having regard to these basic principles, the various matters to which attention should be paid for determining the different aspects of transactions, a record of which should be kept, and the different heads of account under which various items of income and expenditure should be accumulated, are stated below:

- (a) **Distinction between personal and business income:-** Since the final statements of account are intended to show the profitability of the business and not that of its proprietors, it is essential that all personal income and expenditure should be separated from business income and expenditure.
- (b) **Distinction between capital and revenue expenditure:-** A distinction should be made between capital and revenue, both receipts and expenditure. Different types of income and expenditure should be classified under separate heads. Assets should be included in the Balance Sheet by following accounting principles and accounting standards. Likewise, a provision for expenses which have accrued but not paid, should be made by estimation or otherwise on the same basis as in the previous year.
- (c) **All material information to be disclosed:-** Every information, considered material for evaluating the performance of the business or its financial position, should be disclosed. For example, when the labour charges have increased substantially on account of bonus having been paid to workmen, the amount of bonus paid should be disclosed. Similarly, If there are substantial write-offs in inventory due to any reason, it should be shown separately.
- (d) **Record only current period transactions:-** Though the record of transactions should be maintained continuously, at the end of each accounting period, the transactions of the closing accounting period should be cut off from those of the succeeding period.
- (e) **Only transactions completed before close of accounts should be given effect:-** It should be seen that only the effect of transactions, which were concluded before the close of period of account, has been adjusted in the accounts of the year. For example, when a sale of goods is to take place only after the goods have been inspected by the purchaser and the inspection had not been made before the close of the year, it would be incorrect to treat the goods as a sale in the accounts of the year.

Inter-relationship of the two statements

One of the points to be remembered is that of total expenditure incurred some type of expenditure appears in the Profit and Loss Account and some in the Balance Sheet. Consider few examples,

- Salaries paid for current year is shown on the Dr. side of Profit and Loss Account but outstanding salaries is shown on liabilities side of Balance Sheet and is added to Salaries paid and shown under Profit and Loss Account.

Profit & Loss A/c

Particulars	Amount ₹	Particulars	Amount ₹
To Salaries paid 25,000			
Add: Outstanding Salaries <u>1,500</u>	26,500		

Balance Sheet

Liabilities	Amount ₹	Assets	Amount ₹
Outstanding Salaries	1,500		

- When a machine is purchased, that part of it which is attributable to the year considered as depreciation is debited to the Profit and Loss Account and the balance amount after reducing the amount of depreciation is shown in the Balance Sheet as an asset.

Profit & Loss A/c

Particulars	Amount ₹	Particulars	Amount ₹
To Depreciation	50,000		

Balance Sheet

Liabilities	Amount ₹	Assets	Amount ₹
		Fixed Assets 5,00,000	
		Less:- Depreciation <u>(50,000)</u>	4,50,000

These illustrations show that the two statements, the Profit and Loss Account and the Balance Sheet, are thoroughly inter-related. The assets shown in the Balance Sheet are mostly only the remainder of the expenditure incurred after a suitable amount has been charged to the Profit

and Loss Account or the Trading Account. For preparing the two statements properly, it is of the greatest importance that the amounts to be charged to the Profit and Loss Account should be properly determined otherwise both statements will show an incorrect position. The principle that governs this concept is called the **Matching Principle**.

Matching Principle

This principle demands that expenses incurred to earn the revenue should be properly matched. This means the following:

- (a) If a certain revenue and income is entered in the Trading / Profit and Loss Account all the expenses relating to it, whether or not payment has been actually made, should be debited to the Trading / Profit and Loss Account. This is why at the end of the year an entry is recorded to bring into account the outstanding expenses. That is also the reason why the opening inventory of goods is debited to the Trading Account since the relevant sale is credited in the same account.
- (b) If some expense has been incurred but against it sale will take place in the next year or income will be received next year, the expense should not be debited to the current year's Profit and Loss Account but should be carried forward as an asset and shown in the Balance Sheet. It will be debited to the Profit and Loss Account only when the relevant income will also be credited. The same reason applies to depreciation of assets also. The part of the cost which is used to earn current year revenue is debited in same year.
- (c) If an income or revenue is received in the current year but the work against it has to be done and the cost in respect of it has to be incurred next year, i.e. income received in advance, such income or the revenue is considered to be of next year. It should be shown in the Balance Sheet on the liabilities side as "income received in advance" and should be credited to the Profit and Loss Account of the next year. E.g. Newspapers or magazines usually receive subscriptions in advance for a year. The part of subscription that covers copies to be supplied in the next year is treated as income received in advance.

An exception

There appears to be one exception to the rule that only such costs as have yielded or is expected to yield revenue should only be debited to Profit and Loss Account. For example, if a fire has occurred and has damaged the firm's property the loss must be debited to the Profit and Loss Account to the extent it is not covered by insurance. A loss, resulting from the fall of selling price below the cost or from some debts turning bad, must similarly be debited to the Profit and Loss Account. If this is not done the profit will be over-stated.

(NOTE: - The relevant entries and adjustments regarding the above three items are discussed in detail later in this unit.)



1.3 TRADING ACCOUNT

At the end of the year, as has been seen above, it is necessary to ascertain the net profit or the net loss. For this purpose, it is first necessary to know the gross profit or gross loss. Gross Profit is the difference between the selling price and the cost of the goods sold. For a trading firm, the cost of goods sold can be ascertained by adjusting the cost of goods still on hand at the end of the year against the purchases. It is done as follow:-

Opening Stock	***
Add:- Purchases (Net)	**
Add:- Direct Expenses	<u>**</u>

Less:- Cost of Goods Sold	<u>(**)</u>
Closing Stock	<u>***</u>

Suppose, in the first year, the net purchases (that is after deducting returns) total ₹1,00,000 and that ₹15,000 worth of goods (at cost) were not sold at the end of the year. The cost of the goods sold will then be ₹ 85,000. If in the next year purchases are ₹1,50,000, direct expenses are ₹10,000 and the cost of goods sold is ₹ 1,45,000 the closing stock will be ₹ 30,000 calculated as follows:

	₹
Cost of unsold goods at the beginning of the year	15,000
Purchases during the year	1,50,000
Direct Expenses	<u>10,000</u>
	1,75,000
Less: Cost of sold goods during the year	<u>1,45,000</u>
Closing Stock	<u>(30,000)</u>

Gross profit is usually ascertained by preparing a Trading account. The format of Trading Account can be shown as below:-

Trading Account of.....for the year ended.....

		₹			₹
To Opening Stock		XXX	By Sales	XXX	XXX
To Purchases	XXX		Less: Returns Inwards	XXX	XXX
Less: Returns outwards	XXX	XXX	By Closing Stock		
To Direct expenses:		XXX	By Gross Loss c/d*		
Freight & Carriage		XXX			
Customs & Insurance	XXX				
Wages	XXX				
Gas, Water & Fuel	XXX				
Factory Expenses	XXX				
Royalty on production	XXX	XXX			
		XXX			XXX

To Gross Profit c/d*

*Only one will appear

If in the above example net sales, i.e., after adjustment for sales returns, is ₹ 2,00,000 then the gross profit will be ₹ 55,000, i.e., ₹2,00,000 – ₹ 1,45,000. This profit is called gross profit since from it indirect expenses have still to be deducted for knowing the net profit. Now, for the same example Trading account will appear as follows:-

Trading Account for the year ending

	₹		₹
To Opening Inventory	15,000	By Sales Account	2,00,000
To Purchase Account	1,50,000	By Closing Inventory	30,000
To Direct Expenses	10,000		
To Gross Profit carried to P & L A/c	55,000		
	2,30,000		2,30,000

Point to Remember:-

- ◆ The opening inventory and purchases are written on the debit side.
- ◆ Sales and the closing inventory are entered on the credit side.
- ◆ If there are any direct expenses then they should also be written on the debit side of the Trading account.
- ◆ If the balances of credit side is more, the difference is written on the debit side as gross profit. This amount will also be carried forward to the Profit and Loss Account on the credit side.
- ◆ In case of gross loss, i.e., when the debit side of the Trading Account exceeds the credit side, the amount will be written on the credit side of the Trading Account and transferred to the debit side of the Profit and Loss Account.

Trading Account Items

In a trading firm like a wholesaler, the main business consists of buying and selling the same goods. In addition to the amount of the opening inventory, the trading account will also be debited with all expenses incurred in bringing the goods to the godown of the firm (i.e. to the present condition and location) and in making them ready for sale.

For example, freight paid on purchases, cartage, octroi, etc. will all be debited to the Trading Account. The rule is that this account will be debited with all expenses incurred in bringing the goods to their present location and condition.

We shall now consider individual items:

- (1) **Opening Inventory:** Since this was closing inventory of the last year, it must have been entered in the opening inventory account, through the opening entry. Therefore, it will be found in the trial balance. This 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 inventory.

Trading A/c	Dr.
To Opening Stock A/c	

- (2) **Purchases and Purchase Returns:** The purchases account will have debit balance, showing the gross amount of purchases made of the materials. The purchase returns account will have credit balance showing the return of materials to the supplier. On the debit side of the trading account the net amount is shown as indicated (with assumed figures) :

	₹
To Purchases	3,00,000
Less : Purchase Returns	<u>(10,000)</u>
	2,90,000

Closing entry for this purpose is follows:

Purchases Return A/c	Dr.
To Purchases A/c	
(This Net Purchases is transferred to Trading account)	
Trading a/c	Dr.
To Purchase a/c	

It happens sometimes that goods are received but the relevant invoice is not received from the supplier. On the date of the closing of the account, an entry must be passed to debit the purchases account and credit the supplier with the cost of goods.

- (3) **Carriage or Freight Inwards/Freight:** This item should also be debited to the Trading Account, as it is incurred to bring the materials to the firm's godown and make them available for use. However, if any freight or cartage is paid on any asset, like machinery, it should be added to the cost of the asset and not debited to the Trading Account.

Trading a/c	Dr.
To Carriage or Freight Inwards	

- (4) **Wages:** Wages paid to workers in the godown/stores, should be debited to the Trading Account. If any amount is outstanding, it must be brought into books so that full wages for the period concerned are charged to the Trading Account. However, if wages are paid for installation of a fixed asset, it should be added to the cost of the asset.

Trading a/c	Dr.
To Wages	

- (5) **Sales and Sales Returns:** The sales account will have a credit balance indicating the total sales made during the year. The sales return account will have a debit balance, showing the total amount of goods returned by customer. The net of the two amounts is entered on the credit side of the Trading Account.

Sales A/c	Dr.
To Sales return	
To Trading A/c	

Sometimes, goods are sold on approval basis that is when the customer has the right to return the goods within stipulated period in that case the sale entry should be reversed. It is discussed later in detail.

- (6) Closing Inventory and its valuation:** Usually there is no account to show the value of goods lying in the godown at the end of the year. However, to correctly ascertain the gross profit, the closing Inventories must be properly taken and valued.

The entry is

Closing Inventory Account	Dr.
To Trading Account	

Alternatively, Closing Inventory can be adjusted with purchases :

Closing Inventory Account	Dr.
To Purchases Account	

The effect of this entry is to reduce the debit in the Purchases Account. The closing inventory is also shown in balance sheet on Assets side.

If Closing Stock appears in the Trial balance:-

The closing inventory is then not entered in the trading account, it is shown only in the balance sheet. This is because it has already been adjusted to arrive at Cost of Goods Sold.

To ascertain value of the closing inventory, it is necessary to make a complete inventory or list of all the items in the godown together with quantities. Of course, damaged or obsolete items are separately listed. To the list of finished goods, one should also add the goods lying with agents sent to them on consignment basis and also the goods sent on approval to customer.

The valuation principle is cost or net realisable value whichever is lower.

Taking inventory is quite a lengthy process. Strictly, immediately at the end of the year the taking of inventory should be completed. Sometimes, however this is done either a few weeks before or a few weeks after the closing. In such a case the value of the inventory thus taken must be adjusted to relate it to the closing date. The adjustment will be necessary because, in the meantime, purchases and sales must have been made. The main point to remember is that in respect of sales their cost has been established. Cost will be sales less gross profit.

Below is the summary for all transfer / closing entries to Trading a/c:

(1) Trading Account	Dr.
To Opening Inventory Account	

To Purchases Account

To Wages Account

To Freight on Purchases Account, etc.

(2) Sales Account Dr.

Closing Inventory Account Dr.

To Trading Account

At this stage Trading Account will reveal the gross profit, if the credit side is more, or gross loss if the credit side is less. The gross profit will be transferred to the Profit and Loss Account by the entry:

Trading Account Dr.

To Profit and Loss Account

The entry for gross loss, if there be any is :

Profit and Loss Account Dr.

To Trading Account

ILLUSTRATION 1

Trial Balance for the financial year (FY) ended 31st March 2022 of M/s Deepakshi shows following details:

Particulars	Debit (₹)	Credit (₹)
<i>Purchase & Sales</i>	<i>10,00,000</i>	<i>12,00,000</i>
<i>Debtors & Creditors</i>	<i>5,00,000</i>	<i>4,00,000</i>
<i>Opening Stock</i>	<i>2,00,000</i>	
<i>Closing Stock</i>	<i>3,00,000</i>	
<i>Other Expenses & Incomes</i>	<i>7,00,000</i>	<i>9,00,000</i>
<i>Fixed Assets & Long Term Liabilities</i>	<i>25,00,000</i>	<i>6,00,000</i>
<i>Capital</i>		<i>21,00,000</i>
	<i>52,00,000</i>	<i>52,00,000</i>

Additional Information: Creditors balance as on 1st April, 2021 is ₹ 3,00,000.

You are required to calculate cost of goods sold and amount paid to creditors during the year.

SOLUTION

i) **Calculation of Cost of Goods sold:**

Particulars	₹
Opening Stock	2,00,000
Add: Purchases (Closing stock already adjusted)*	10,00,000
Cost of Goods Sold	12,00,000

*Since, closing stock appears in Trial Balance, it means following entry has already been passed in books:

Closing Stock A/c	Dr.	3,00,000
To Purchases A/c		3,00,000

So, we can see purchases have already been reduced by the amount of unsold stock, therefore no more adjustment needs to be made on account of closing stock for computing Cost of goods sold (COGS).

ii) **Calculation of amount paid to creditors:**

Date	Particulars	₹	Date	Particulars	₹
31.3.22	To Bank A/c (Balancing Figure)	12,00,000	1.4.21	By Balance b/d	3,00,000
31.3.22	To Balance c/d	4,00,000		By Purchases A/c (Note:1)	13,00,000
		16,00,000			16,00,000

Note: 1) Purchases made during the year can be computed as:

Particulars	₹
Purchases as per Trial Balance	10,00,000
Add: Closing Stock already adjusted	3,00,000
Purchases made during the year	13,00,000

Students may note that in case Closing Stock is not mentioned in Trial Balance, then it means Opening Stock and Purchases appearing in Trial Balance include the value of unsold stock. Since, we prepare our financial statements using matching concept such unsold stock should not form part of cost and therefore is deducted. Therefore, in this case to compute Cost of goods sold (COGS) we will have to use:

COGS = Opening Stock + Purchases – Closing Stock – Purchase Returns

ILLUSTRATION 2

	₹
Opening Inventory	1,00,000
Purchases	6,72,000
Carriage Inwards	30,000
Wages	50,000
Sales	11,00,000
Returns inward	1,00,000
Returns outward	72,000
Closing Inventory	2,00,000

Required

From the above information, prepare a Trading Account of M/s. ABC Traders for the year ended 31st March, 2022 and Pass necessary closing entries in the journal proper of M/s. ABC Traders

SOLUTION**In the books of M/s. ABC Traders****Trading Account for the year ended 31st March, 2022**

Particulars		Amount	Particulars		Amount
	₹	₹		₹	₹
To Opening Inventory		1,00,000	By Sales	11,00,000	
To Purchases	6,72,000		Less : Returns Inward	(1,00,000)	10,00,000
Less: Returns outward	(72,000)	6,00,000	By Closing Inventory		2,00,000
To Carriage Inwards		30,000			
To Wages		50,000			
To Gross profit (Balancing Figure)		4,20,000			
		12,00,000			12,00,000

Journal Proper in the Books of M/s. ABC Traders (Closing entries)

Date 2022	Particulars	Amount ₹	Amount ₹
Mar. 31	Returns outward A/c Dr. To Purchases A/c (Being the transfer of returns to purchases account)	72,000	72,000
	Sales A/c Dr. To Returns Inward A/c (Being the transfer of returns to sales account)	1,00,000	1,00,000
	Sales A/c Dr. To Trading A/c (Being the transfer of balance of sales account to trading account)	10,00,000	10,00,000
	Trading A/c Dr. To Opening Inventory A/c To Purchases A/c To Wages A/c To Carriage Inwards A/c (Being the transfer of balances of opening Inventory, purchases and wages accounts)	7,80,000	1,00,000 6,00,000 50,000 30,000
	Closing Inventory A/c Dr. To Trading A/c (Being the incorporation of value of closing Inventory)	2,00,000	2,00,000
	Trading A/c Dr. To Gross Profit (Being the amount of gross profit)	4,20,000	4,20,000
	Gross profit Dr. To Profit and Loss A/c (Being the transfer of gross profit to Profit and Loss Account)	4,20,000	4,20,000



1.4 PROFIT AND LOSS ACCOUNT

The Profit and Loss Account starts with gross profit on the credit side. If there is gross loss, it will be written on the debit side. After that all those expenses and losses, which have not been entered in the Trading Account, will be written on the debit side of Profit and Loss Account. Incomes and gains, other than sales, will be written on the credit side.

If we understand word 'expenses' properly, there should be no difficulty in distinguishing between items that will be debited to the Profit and Loss Account and those that will be shown as Assets in the balance sheet. Further, it may be noted that the expenses which are personal in nature will not be charged to Profit and Loss A/c. Only those revenue expenses and losses which are related to the current year, are debited to Profit and Loss Account.

It is desirable, according to modern thinking that the Profit and Loss Account should be prepared in such a manner as will enable the reader to form a correct idea about the profit earned or loss incurred by the firm during the period together with the significant factor. Too many details will prevent a person from knowing properly the factors leading to the profit earned. Therefore, items should be according to the various functions, such as administrations, selling and financing. The profit/loss A/c appears as follows:-

Dr. Profit and Loss Account for the year ended Cr.

Particulars	₹	Particulars	₹
To Gross Loss b/d		By Gross Profit b/d	
Management expenses		Other Income	
To Salaries (administrative)		By Discount Received	
To Office rent, rates and taxes		By Commission Received	
To Printing and stationery		Non-trading Income	
To Telephone charges		By Bank Interest	
To Postage		By Rent of property let-out	
To Insurance		By Dividend from investment in shares	
To Audit Fees		Abnormal Gains	
To Legal Charges		By Profit on sale of machinery	
To Electricity Charges		By Profit on sale of investment	

Maintenance expenses To Repairs & renewals To Depreciation on: Office Equipment Office Furniture Office Buildings Selling and Distribution expenses To Salaries (selling staff) To Advertisement To Godown rent To Carriage Outward To Bad Debts To Provision for bad debts To Selling commission Financial expenses To Bank charges To Interest on loans To Discount on bills To Discount allowed to customers Abnormal Losses To Loss on sale of machinery To Loss on sale of investment To Loss by fire To Net Profit (transferred to Capital A/c)	By Net Loss (transferred to capital A/c)	

Note:

- (i) Gross loss appears in the debit side of the Profit and Loss Account at the top; while Gross Profit on the credit side.

- (ii) Net loss appears in the credit side of the Profit and Loss Account; while Net profit on debit side as balancing figures.

It will be good idea to either show these expenses in a separate schedule or to indicate the total of these prominently in the Profit and Loss Account. This rule should be followed wherever the number of items is rather large.

CLOSING ENTRIES

The entries that have to be made in the journal for preparing the Trading and the Profit and Loss Account that is for transferring the various accounts to these two accounts are known as closing entries. We have already seen the entries required for preparing the Trading Account and for transferring the gross profit to the profit and Loss Account. Now to complete the Profit and Loss Account, the under mentioned three entries will be necessary.

- (a) For items to be debited to the Profit and Loss Account this account will be debited and the various accounts concerned will be credited. For example,

Profit and Loss Account	Dr.
To Salaries Account	
To Rent Account	
To Interest Account	
To Other Expenses Account	

- (b) Items of income or gain such as interest received or miscellaneous income will be credited to Profit and Loss Account.

Discount Received Account	Dr.
Bad debts Recovered Account	Dr.
To Profit and Loss Account	

- (c) At this stage, the Profit and Loss Account will show net profit or net loss. Both have to be transferred to the 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 Account	Dr.
To Capital Account	

In the case of net loss, the entry will be

Capital Account	Dr.
To Profit and Loss Account	

Entries in detail

There may be other income such as interest received, discount received, rent from subletting of premises, miscellaneous incomes such as from sale of junk material etc., It would be desirable to show the totals only under each of the main categories of income. However, interest on fixed deposits, interests or income from investments and other interest should be shown separately. Similarly, items which have to be debited/credited to the proprietor should be segregated from other items. Examples would be interest charged on drawings, interest allowed on capital and charges for services rendered by the firm to the proprietor personally.

We shall now consider a few items individually:

- (i) **Drawings:** Drawings are not expenses for the firm but reduction of capital and therefore should not be debited to the Profit and Loss Account but to Capital account of the proprietor.

Capital A/c

Dr.

To Drawings

If the proprietor has enjoyed some benefit personally, like use of the firm's car, a suitable amount should be treated as drawing and to that extent the charge to the Profit and Loss Account will be reduced, Drawings are debited to the proprietor's capital account.

- (ii) **Income Tax:** In case of companies, the income tax payable is treated like other expenses. But in the case of sole proprietorship, income tax is treated as a personal expense. It is debited to the Capital Account and not to the Profit and Loss Account.

Capital A/c

Dr.

To Income Tax A/c

This is because the amount of the tax will depend on the total income of the partners or proprietor besides the profit of the firm. In case of partnership business, firm's tax liability is to be debited to profit and loss account of the firm but partners' tax liability are not to be borne by the firm. Therefore if the firm pays income tax on behalf of partners, such payment of personal income tax should be treated as drawings.

- (iii) **Discount received and allowed:** We have already seen that discount is of two types. Trade discount and Cash discount. Trade discount is allowed when the order for goods is not below a certain figure. It is deducted from the invoice. Only the net amount of invoice is entered in books. There is no further treatment of the trade discount. Cash discount is allowed to a customer if he makes the payment before a certain date. It is allowance made to him for prompt payment and is recorded in the books. Therefore,

Trade discount is not debited to P/L account because it is already adjusted in sales, but cash discount is debited to P/L account.

Discount received is a gain and is credited to the Profit and Loss Account while discount allowed is a loss and debited to Profit and Loss Account.

Profit/Loss A/c Dr.

To Discount Allowed A/c

Discount Received A/c Dr.

To Profit/Loss A/c

- (iv) **Rebate:** It is the allowance given to a customer when his purchases during a period, say one year, total upto a certain figure. Suppose a firm allows a rebate of 4% to those customers whose purchases during the year are at least ₹ 5,000. One Customer's purchases are ₹ 4,500, he will not get any rebate. Another customer's purchases total ₹ 5,100, he will get a rebate of ₹ 204. The entry for rebate is made only at the end of the year. The Rebate Account is debited and is later written in the profit and Loss Account on the debit side. Various customers who have earned the rebate are credited.

Initially when Rebate is given

Rebate A/c Dr.

To Customer A/c

At the year end closing entry

Profit/Loss A/c Dr.

To Rebate A/c

- (v) **Bad Debts:** When a customer does not pay the amount due from him and all hopes of recovering the amount are lost, it is said to be a bad debt. It is a loss to the firm. Therefore, the bad debts account is debited, which is later on transferred in the Profit and Loss Account on the debit side. Since it is no use showing the amount due still as an asset, the account of the customer concerned is closed by being credited. The entry

Bad Debts Account Dr.

To Debtor's / Customer (by name) Account

Profit/Loss Account Dr.

To Bad Debts A/c

In case the Provision for Bad debts has already been prepared then bad debts should be written off first from it. Entry for it will be:

*Provision for Bad Debts A/c

Dr.

To Bad Debts A/c

If later on, the amount is recovered, it should be treated as a gain. It should not be credited to the party paying it. It should be credited to Bad Debts Recovered Account. It will be entered in the Profit and Loss Account on the credit side.

Bad Debts Recovered Account

Dr.

To Profit/Loss Account

For detailed understanding of Provision of Bad Debts please refer Point (6) topic Adjustments of Provision of Bad and Doubtful Debts .

ILLUSTRATION 3

Revenue, Expenses and Gross Profit Balances of M/s ABC Traders for the year ended on 31st March 2022 were as follows:

Gross Profit ₹4,20,000, Salaries ₹1,10,000, Discount (Cr.), ₹18,000, Discount (Dr.) ₹19,000, Bad Debts ₹17,000, Depreciation ₹65,000, Legal Charges ₹25,000, Consultancy Fees ₹32,000, Audit Fees ₹1,000, Electricity Charges ₹17,000, Telephone, Postage and Telegrams ₹12,000, Stationery ₹27,000, Interest paid on Loans ₹70,000.

Required

Prepare Profit and Loss Account of M/s ABC Traders for the year ended on 31st March, 2022. Show necessary closing entries in the Journal Proper of M/s. ABC Traders also.

SOLUTION

In the Books of M/s. ABC Traders

Profit and Loss Account for the year ended 31st March, 2022

Particulars	Amount ₹	Particulars	Amount ₹
To Salaries	1,10,000	By Gross Profit	4,20,000
To Legal Charges	25,000	By Discount received	18,000
To Consultancy Fees	32,000		
To Audit Fees	1,000		
To Electricity Charges	17,000		
To Telephone, Postage & Telegrams	12,000		
To Stationery	27,000		

To Depreciation	65,000		
To Discount Allowed	19,000		
To Bad Debts	17,000		
To Interest	70,000		
To Net Profit (b/f)	43,000		
	4,38,000		4,38,000

Journal Proper in the Books of M/s. ABC Traders (Closing Entries)

Date 2022	Particulars		Amount ₹	Amount ₹
March 31	Profit & Loss Account	Dr.	3,95,000	
	To Salaries A/c			1,10,000
	To Legal Charges A/c			25,000
	To Consultancy Fees A/c			32,000
	To Audit Fees A/c			1,000
	To Electricity Charges A/c			17,000
	To Telephone, Postage & Telegrams A/c			12,000
	To Stationery A/c			27,000
	To Depreciation A/c			65,000
	To Discount Allowed A/c			19,000
	To Bad Debts A/c			17,000
	To Interest A/c			70,000
	(Being the transfer of balances of various expenses accounts)			
	Discount Received A/c	Dr.	18,000	
	To Profit & Loss A/c			18,000
	(Being the transfer of discount received account balance)			
	Gross Profit A/c	Dr.	4,20,000	

	To Profit & Loss A/c (Being the transfer of gross profit from Trading Account)			4,20,000
	Profit & Loss A/c To Net Profit A/c (Being the ascertainment of net profit)	Dr.	43,000	43,000
	Net Profit A/c To Capital A/c (Being the transfer of net profit to Capital A/c)	Dr.	43,000	43,000

Adjustments

The fundamental principle of accounting is that the period to which various items of income and expenditure pertain should be co-extensive with the period of account. As such before final accounts are drawn up, it must be ensured that the accounts which require adjustment on this consideration have been adjusted, both by providing for expense accrued and including income outstanding and excluding expenses the benefit of which extends beyond the year of account as well as the income received in advance. The entries that must be passed for adjusting various accounts of income and expenditure are shown below:

- (1) Expenses accrued and accruing, e.g., Rent, Interest, Local Taxes, Wages etc.

Appropriate Expense Account Dr.

To Expenses Accrued/outstanding Account

For Example, if Rent Paid is ₹ 50,000 for a year and Outstanding Rent is ₹ 14,000. It will be treated as follows:-

Profit/Loss Account

Particulars	Amount ₹	Particulars	Amount ₹
To Rent paid 50,000			
Add: Outstanding Rent <u>14,000</u>	64,000		

Balance Sheet

Liabilities	Amount ₹	Assets	Amount ₹
Outstanding Rent	14,000		

- (2) Income accrued and accruing, e.g., Interest on Government Loans, Discounts on Bill, Professional fees, Rents and Premiums on leases, etc.

Interest/Fees etc. Accruing Account Dr.

To Appropriate Income Account

Suppose interest received is ₹ 1,50,000 and accrued interest for the same period is ₹ 45,000. It will be treated as follows:-

Profit/Loss Account

Particulars	Amount ₹	Particulars	Amount ₹
		By interest received 1,50,000	
		<i>Add:</i> Accrued Interest <u>45,000</u>	1,95,000

Balance Sheet

Liabilities	Amount ₹	Assets	Amount ₹
		Accrued Interest	45,000

Notes:

(1) The term "accrued" signifies that an amount has been incurred as expense or earned as income, the due date of payment of which falls in the next accounting period. If the due date of payment occurs in the current accounting period the term used should be "outstanding" or "accrued and due".

(2) The expression accrued and accruing' signifies items which though not due for payment but pertain to the period of account, a provision for which has been made. Converse is the position so far as items of income are concerned.

- (3) **Carrying forward income received in advance e.g.,** Subscription in the case of a club or fees in case of professional person.

Appropriate Income Account Dr.

To Income Received in Advance Account

7.25

Profit/Loss Account

Balance Sheet

(4) Carrying forward of payments made in advance e.g., Telephone, Rent, Insurance etc.,
Expenses Prepaid Account Dr.

To Appropriate Expenses Account

Suppose out of the total Rent of ₹ 50,000 paid, ₹ 14,000 pertains to the next year.

Particulars	Amount ₹	Particulars	Amount ₹
To Rent paid 50,000			
Less: Prepaid Rent (14,000)	36,000		

Liabilities	Amount ₹	Assets	Amount ₹
		Prepaid Rent	14,000

- (5) **Adjustment of Inventory of materials in hand**, e.g., Stationery, Advertisement, Material, Manufacturing Stores, etc., the cost whereof already has been debited to expense account.

Inventory of Materials Dr.

To Appropriate Expenses Account

For Example, if opening stock of stationery is ₹ 15,000 and direct expenses on it is ₹ 1,700. It is also given outside the Trial Balance. Closing stock of stationery is ₹ 5,000. The treatment is as follow:-

Particulars	Amount ₹	Particulars	Amount ₹
To Stationery:			
Opening stock 15,000			
Add: Expenses 1,700			
Less: Closing Stock <u>(5,000)</u>	11,700		

Liabilities	Amount ₹	Assets	Amount ₹
		Closing Stock	5,000

(6) **Provision for Bad and doubtful Debts:** When it is feared that some of the amount due from customers will not be collected it is prudent to recognise the expected loss by reducing the current year's profit and placing the amount to the credit of a special account called "Provision for Bad and Doubtful Debts Account". The entry is;

To Provision for Bad and doubtful Debts Account

Bad Debts Account	Dr.

To Customer's A/c

Bad Debts when written off are debited to the provision in this respect where such a provision exists or directly to the Profit and Loss Account the corresponding credit being given (ultimately) to the trade receivable's account. If, on the other hand, a provision is required to be created, the amount of provision is also debited to the Profit and Loss Account. Where an examination problem requires that certain bad debts should be written off and a provision for doubtful debts made, the amount of bad debts to be written off should be first debited against the existing balance of the provision and the resulting balance in the account afterwards should be raised to the required figure. The method is illustrated below:

ILLUSTRATION 4

On 1st April 2021 provision for Doubtful Debts existed at ₹ 40,000. Trade receivables on 31.03.2021 were ₹ 15,00,000; bad debts totaled ₹ 1,00,000. It is required to write off the bad debts and create a provision equal to 5% of the Trade receivables' balances.

Show how you would compute the amount debited to the Profit and Loss Account.

SOLUTION

PARTICULARS	₹
Opening Provision (Cr.)	40,000
Bad Debts written off (Dr.)	<u>1,00,000</u>
Short Provision	60,000
Provision required (Dr.) (5% of ₹14,00,000)	<u>70,000</u>
Additional amount required for debit to the Profit and Loss Account (Dr.)	1,30,000

The account will appear as follows:

Provision for Doubtful Debts Account

		₹			₹
March 31, 2022	To Bad Debts	1,00,000	April 1, 2021	By Balance b/d	40,000
	To Balance c/d (required)	70,000	March 31, 2022	By Profit and Loss A/c (Balancing Figure)	1,30,000
		1,70,000			1,70,000
			April 1, 2022	By Balance b/d	70,000

- (7) **Provision for Discount:** This provision is created in the same manner, discussed above but the amount of provision is required to be calculated after deducting the Provision for Bad Debts from the total trade receivables. This is because Provision for discount is created only on good debtors.

For Example, if Trade Receivables is ₹ 5,20,000 and provision for doubtful debt is ₹ 1,20,000. You are required to create a 10% provision for discount on debtors.

Profit/Loss Account

Particulars	Amount ₹	Particulars	Amount ₹
To Provision for Discount (10% of 4,00,000)	40,000		

Balance Sheet

Liabilities	Amount ₹	Assets	Amount ₹
		Debtors 5,20,000	
		Less:- Provision for Doubtful debts (1,20,000)	
		Less:- Provision for Discount (40,000)	
			3,60,000

- (8) **Provision for Depreciation:** It is made either by debiting Depreciation Account and crediting the Provision for depreciation account concerned and afterwards closing of the Depreciation Account by transfer to the Profit and Loss Account or by directly debiting the profit and loss Account and crediting provision for depreciation account and explaining the nature of adjustment by recording a detailed narration in the Journal.

Profit/Loss account

Dr.

To Depreciation/Provision for depreciation.

The amount of depreciation is deducted from the concerned asset and is then shown in the Balance sheet.

For Example if machinery Cost ₹ 15,00,000 and 10% depreciation is to be provided. The treatment is as follow:-

Depreciation a/c	Dr.	₹ 1,50,000
To Provision for Depreciation a/c		₹ 1,50,000

Depreciation is now charged to P&L a/c as:

Profit/Loss account	Dr.	₹ 1,50,000
To Depreciation		₹ 1,50,000

Profit/Loss Account

Particulars	Amount ₹	Particulars	Amount ₹
To Depreciation	1,50,000		

Balance Sheet

Liabilities	Amount ₹	Assets	Amount ₹
		Machinery 15,00,000	
		Less: Provision for Depreciation <u>(1,50,000)</u>	13,50,000

- (9) **Other Provisions:** Whenever it is expected that a loss, the amount of which is not certain will occur, the proper course is to create a provision for meeting the loss if and when it occur. This would be the case, for example, if proprietor expects that compensation will be paid for the late delivery of goods. The entry is to debit the Profit and Loss Account and credit an account suitably named.

All accounts showing provisions may appear in the Balance Sheet on the liability side but it should be noted that:

- (i) The provision for Bad and Doubtful Debts and the Provision for Discount on Trade receivables are deducted from the total book debts; and
 - (ii) The provision for Depreciation is deducted from the cost of the assets concerned.
- (10) **Transfers, involving correction of errors,** are made by debit or credit to the accounts affected, the corresponding effect being recorded either in a Suspense Account of some other account.

Transfers in respect of special charges to the Profit and Loss Account e.g., partner's salaries, interest, etc., and in respect of appropriation of profits are recorded by debit to the Profit and Loss Account and credit to the parties concerned.

While making adjustments, it is important to remember that every entry has a two-fold aspect, debit and credit. For example, if an adjustment is required to be made on account of prepaid insurance charges, the Insurance Charges Account would be credited, and, to complete the double entry, Prepaid Expenses Account is debited with the same amount. The last mentioned balance would be included on the debit side of the Trial Balance.

Students should, as a matter of course, record on the rough working sheets, adjustments in respect of various items stated in a question and then give their effect in the Trial Balance, before proceeding to draw up the Final Accounts.



1.5 CERTAIN ADJUSTMENTS AND THEIR TREATMENTS

- Abnormal loss of Inventory by accident or fire:** Sometimes loss of goods occurs due to fire, theft, etc. If due to accident or fire, a portion of Inventory is damaged, the value of loss is first to be ascertained. Thereafter, Abnormal Loss Account is to be debited and Purchase Account or Trading Account is to be credited.

Abnormal Loss Account is to be transferred to Profit & Loss Account. If amount of loss is recoverable from insurance company, then insurance company is to be debited instead of Profit & Loss Account. Till the money is not received from the insurance company, Insurance Company's Account will be shown in the Assets side of the Balance Sheet. If any part of the loss is recoverable from the insurance company, then the portion not compensated by the insurance company should be debited to Profit & Loss Account. For example, if goods worth ₹ 6,000 are destroyed by fire and the insurance company admits the claim for ₹ 4,500, the Journal entries will be:-

(i)	Loss by Fire Account	Dr.	6,000	
	To Purchases/Trading Account			6,000
(ii)	Insurance Company's A/c (Insurance Claim)	Dr.	4,500	
	Profit & Loss A/c	Dr.	1,500	
	To Loss by Fire A/c			6,000

Profit/Loss Account

Particulars	Amount ₹	Particulars	Amount ₹
To Loss by Fire (The amount not compensated by insurance company)	1,500		

Balance Sheet

Liabilities	Amount ₹	Assets	Amount ₹
		Insurance Claim	4,500

In the Trading Account, Purchases will be reduced by 6,000.

- 2. Goods sent on Approval basis:** Sometimes goods are sold to customers on sale or return basis or on approval basis. It should not be treated as actual sale till the time it is not approved by the customer. When goods were sold we have passed the entry for actual sales. Therefore, at the year end, if the goods are still lying with the customers for approval, following entries are to be passed:

For example -

Goods costing ₹10,000 sent to a customer on sale or return basis for ₹12,000. The entry for such unapproved sale shall be-

(i) Sales A/c	Dr.	12,000	
To Trade receivables A/c			12,000
(i) Stock on approval A/c	Dr.	10,000	
To Trading A/c			10,000

These goods should now be included in the amount of Closing Stock at their cost price.

- 3. Goods used other than for sale:** Sometimes goods are used for some other purposes, such as distributed as free samples, used in construction of any assets or used by proprietor for personal use. In such cases the amount used for other purposes is subtracted from Purchases A/c and depending upon the specific use done, the suitable account head is debited.

For example:-

When goods are given away as donation-

Donation A/c	Dr.
To Purchases A/c	

When goods are used by the proprietor for his personal use-

Drawings A/c	Dr.
To Purchases A/c	

When goods are distributed as free samples :-

Free Samples / Advertisement A/c	Dr.
To Purchases A/c	

When goods are used in business for construction of Building or the Machinery :-

Building A/c / Plant & Machinery A/c	Dr.
To Purchases A/c	

When goods are used for maintenance of business premises/ Machinery: -

Repair & Maintenance A/c Dr.
 To Purchases A/c

4. **Commission based on profit:** Sometimes commission is payable to manager based on net profit; in such a case calculation is done as follows:

- (i) Commission on net profit **before** charging such commission =

$$\text{Profit before commission} \times \frac{\text{Rate of commission}}{100}$$

- (ii) Commission on net profit **after** charging such commission =

$$\text{Profit before commission} \times \frac{\text{Rate of commission}}{100 + \text{Rate of commission}}$$

Commission is recorded by following journal entry

Commission A/c Dr.
 To Commission Payable A/c

(Being commission payable to Mr @% on net profit after charging such commission, net profit before charging commission being ₹.....)

Commission will be debited in the Profit & Loss Account and Commission Payable Account will be shown in the Balance Sheet on liability side.

Profit/Loss Account Dr.
 To Commission A/c

For example if Net profit before Commission is ₹ 1,00,000 and Manager is entitled to a Commission of 10% of Net Profit before charging such commission. The amount of Commission is = ₹ 10,000 (10% of ₹ 1,00,000). It will be shown as follow:-

Profit/Loss Account

Particulars	Amount ₹	Particulars	Amount ₹
To Commission	10,000		
To Net Profit transferred to Capital A/c	90,000		

Balance Sheet

Liabilities	Amount ₹	Assets	Amount ₹
Commission Payable	10,000		

Now, let us assume that 10% commission is payable on Net Profit after charging such commission. The amount of commission now is = 9,090.90 or 9091 (approx) (₹ 1,00,000 x 10/110)

ILLUSTRATION 5

The following is the Trial Balance of C. Wanchoo on 31st March, 2022.

Trial Balance on 31st March , 2022

Particulars	₹	₹
<i>Capital Account</i>		10,00,000
<i>Inventories as on 1st April,2021</i>	2,00,000	
<i>Cash in hand</i>	1,44,000	
<i>Machinery Account</i>	7,36,000	
<i>Purchases Account</i>	18,20,000	
<i>Wages Account</i>	10,00,000	
<i>Salaries Account</i>	10,00,000	
<i>Discount Allowed A/c</i>	50,000	
<i>Discount Received A/c</i>		30,000
<i>Sundry Office Expenses Account</i>	6,00,000	
<i>Sales Account</i>		50,00,000
<i>Sums owing by customer (Trade receivables)</i>	8,50,000	
<i>Trade payables (sums owing to suppliers)</i>		3,70,000
Total	64,00,000	64,00,000

Value of Closing Inventory on 31st March, 2022 was ₹ 2,70,000

Prepare closing entries for the above items and Prepare Trading and Profit and Loss Account.

SOLUTION

Date	Particulars	₹	₹
2022			
March 31	Trading Account Dr. To Inventory Account To Purchase A/c To Wages A/c (Being the accounts in the Trial Balance which have to be transferred to the Trading Account debit side)	30,20,000	2,00,000 18,20,000 10,00,000
March 31	Sales Account Dr. To Trading A/c (Being the amount of Sales transferred to the credit of Trading Account)	50,00,000	50,00,000
March 31	Inventory (Closing) A/c Dr. To Trading A/c (Being the value of Inventory on hand on 31st March, 2022)	2,70,000	2,70,000
March 31	Trading A/c Dr. To Profit and Loss A/c (Being the transfer of gross profit.)	22,50,000	22,50,000
March 31	Profit and Loss A/c Dr. To Discount Allowed Account To Salaries A/c To Sundry Office Expenses A/c (Being the various expense accounts transferred to the P & L Account)	16,50,000	50,000 10,00,000 6,00,000
March 31	Discount Received A/c Dr. To P & L Account (Being the credit balance of discount received transferred to Profit and Loss A/c)	30,000	30,000

PREPARATIONS OF FINAL ACCOUNTS OF SOLE PROPRIETORS

7.35

March 31	Profit and Loss A/c	Dr.	6,30,000	
	To Capital A/c			6,30,000
	(Being the transfer to Net Profit to the Capital Account)			
			1,28,50,000	1,28,50,000

C. WANCHOO

Trading Account of the year ended March 31, 2022

Particulars	₹	Particulars	₹
To Inventory A/c	2,00,000	By Sales A/c	50,00,000
To Purchases	18,20,000	By Inventory (Closing)	2,70,000
To Wages	10,00,000		
To Gross profit transferred to P & L A/c	22,50,000		
	52,70,000		52,70,000

Profit and Loss Account for the year ended March 31, 2022

Particulars	₹	Particulars	₹
To Salaries	10,00,000	By Gross profit transferred from the Trading Account	22,50,000
To Discount Allowed	50,000	By Discount Received	30,000
To Sundry Office Expenses	6,00,000		
To Net Profit transferred to Capital A/c	6,30,000		
	22,80,000		22,80,000



1.6 BALANCE SHEET

The balance sheet may be defined as *"a statement which sets out the assets and liabilities of a firm or an institution as at a certain date."* Since even a single transaction will make a difference to some of the assets or liabilities, the balance sheet is true only at a particular point of time. That is the significance of the word "as at."

The assets are shown on the right hand side and liabilities and capital on the left hand side.

CHARACTERISTICS

The balance sheet has certain characteristics, which should be noted. These are the following:

- (i) It is prepared at a particular date, rather the close of a day and not for a period. It is true only on that date and not later. Suppose, in the example given above, a part of the goods were sold on 1st April, 2021. This will mean that the value of the Inventory will be reduced, the cash in hand will increase and the capital account will be reduced or increased depending upon loss or profit on sale.
- (ii) The balance sheet is prepared only after the preparation of the 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 Final Accounts (of course, the Balance Sheet is not an account, the two sides are not the debit and the credit sides.) Without being accompanied by the Profit and Loss Account, the Balance Sheet will not be able to throw adequate light on the financial position of the firm. For that purpose an appreciation of the profits of the firm is necessary.
- (iii) Since capital always equals the difference between assets and liabilities and since the capital account will independently arrive at this figure, the two sides of the Balance Sheet must have the same totals. If it is not so, there is certainly an error somewhere.

In the illustration no. 5 worked out above it will be seen that the under mentioned accounts have not been closed even after preparation of the Profit and Loss Account and the transfer of the net profit to the capital account.

	₹	
Cash in Hand	1,44,000	Debit balance
Capital Accounts (₹ 10,00,000+ ₹ 6,30,000)	16,30,000	Credit balance
Machinery Account	7,36,000	Debit balance
Trade receivables	8,50,000	Debit balance
Trade payables	3,70,000	Credit balance
Inventories	2,70,000	Debit balance

Looking at these accounts, one would know that various assets: Cash balance in hand, cash at bank, machinery, furniture etc. that the firm possesses and the amounts that are owing as liability to trade payables and to the proprietor as capital. The capital, of course, will be the difference between the total of assets and of liabilities. The assets, liabilities and capital are usually presented in a statement called the Balance Sheet. This is given below for the accounts mentioned above.

C. WANCHOO

Balance Sheet as at March 31, 2022

Liabilities	Amount	Assets	Amount
	₹		₹
Trade payables	3,70,000	Cash in Hand	1,44,000
Capital	16,30,000	Trade receivables	8,50,000
		Inventories	2,70,000
		Machinery	7,36,000
	20,00,000		20,00,000

ARRANGEMENTS OF ASSETS AND LIABILITIES

(1) **Assets:** Assets may be grouped in one of the following two ways:

- (i) **Liquidity:** Under this approach, the asset, which can be converted into cash first, is presented first. Those assets, which are most difficult in this respect, are presented at the bottom. As per Liquidity the balance sheet can be prepared as follow:-

Balance Sheet as at...

Liabilities	Amount	Assets	Amount
	₹		₹
Bills Payable		Cash in Hand	
Trade Creditors		Cash at Bank	
Loans		Government Securities	
Outstanding Expenses		Other Investments	
Reserves & Surplus		Bills Receivable	
Capital		Sundry Debtors	
		Stock	
		Furniture & Fixtures	
		Plant & Machinery	
		Land and Building	

- (ii) **Permanence:** Assets, which are to be used, for long term in the business and are not meant to be sold are presented first. Assets, which are most liquid, such as cash in hand, are presented at the bottom.

Balance Sheet as at...

Liabilities	Amount	Assets	Amount
	₹		₹
Capital		Land and Building	
Reserves & Surplus		Plant & Machinery	
Outstanding Expenses		Furniture & Fixtures	
Loans		Stock	
Trade Creditors		Sundry Debtors	
Bills Payable		Bills Receivable	
		Other Investments	
		Government Securities	
		Cash at Bank	
		Cash in Hand	

Note:- Some of the assets may be capable of being sold easily like investment in government securities or shares of some companies. They should be treated as liquid or permanent according to the intention of the firm.

- (2) **Liabilities:** Liabilities may also be shown according to the urgency with which payment has to be made. One way is to first show the capital, then long-term liabilities and last of all short term liabilities like amounts due to suppliers of goods or bills payable. The other way is to start with short-term liabilities and then show long term liabilities and last of all capital.

CLASSIFICATION OF ASSETS AND LIABILITIES

Assets are basically of following types:

Current Assets: - these assets are meant to be converted into cash as quickly as possible. Generally, within one year. For example:- Cash in hand, Cash at Bank, Trade receivables, Inventories.

Long Term Assets: - Those that are meant to be used by the firm over a long period and not sold the former type of assets is also called fixed assets. For example:- Machinery, Building, Long term Investment.

Intangible Assets: - the assets which have no physical existence and cannot be seen or touched are called as Intangible Assets. For example :- Patents, Copyrights etc.

It is desirable that in the balance sheet the two types of assets should be shown separately and prominently. This would give meaningful and logical information.

Liabilities to outsider will be of two types:

Current Liabilities: - this liability must be settled in one year or less. It is also called as short-term liability. For example: - Creditors, Bills Payable etc.

Long Term Liability: - those liabilities which exists for more than one year are Long term liabilities. For example long term loans from banks. Of course, it will include undistributed profits also.

Sole proprietors generally present Balance Sheet in a horizontal form with "Capital and Liabilities" on the left hand side and 'Assets' on the right-hand side. In the Balance Sheet the various items should be grouped suitably as indicated below:

Balance Sheet as on.....

Liabilities	Amount	Assets	Amount
	₹		₹
Capital A/c: Balance <i>Add</i> : Net Profit/Less: Net Loss <i>Less</i> : Drawings Long Term Loans : Term Loans Other Loans Short Term Loans : Cash Credit Overdrafts Other Loans Current Liabilities : Trade payables Outstanding Expenses Advances Taken Provision :		Tangible Fixed Assets : Land and Building Plant and Machinery Furniture and Fixture Vehicles Intangibles : Goodwill Patent Rights Designs and Brand Names Investments : Long term investments Current Assets : Inventory in Trade Trade receivables Short term investments Prepayments	

Provision for Bad debts		Advances	
Provision for Retirement Benefits		Bank Balances	
Provision for Taxation		Cash In Hand	

In course, there is no hard and fast rule regarding presentation of assets, liabilities and equities in the Balance sheet. However, the model presentation shown above has been designed considering the nature of Balance Sheet elements and categorizing them appropriately.

Proper presentation of Balance Sheet items improves understandability of the information desired to be communicated to the users of account.

ILLUSTRATION 6

Given below Trial Balance of M/s Dayal Bros. as on 31st March, 2022 :

Particulars	Debit Balances	Credit Balances
	₹	₹
Capital A/c		7,00,000
Land and Building	3,00,000	
14% Term Loan		4,00,000
Loan from M/s. D & Co.		4,60,000
Trade receivables	4,20,000	
Cash in hand	20,000	
Inventories in Trade	6,00,000	
Furniture	2,00,000	
Trade payables		40,000
Advances to Suppliers	1,00,000	
Net Profit		1,00,000
Drawings	60,000	
	17,00,000	17,00,000

Required

Prepare Balance Sheet as on 31st March, 2022.

SOLUTION

In the Books of M/s Dayal Bros.

Balance Sheet as at 31st March, 2022

Liabilities		Amount	Assets	Amount
	₹	₹		₹
Capital: Balances	7,00,000		Land & Building	3,00,000
Add: Net Profit	1,00,000		Furniture	2,00,000
	8,00,000		Inventories in Trade	6,00,000
Less: Drawings	(60,000)	7,40,000	Trade receivables	4,20,000
14% Term Loan (<i>loan taken at year end</i>)		4,00,000	Advances to Suppliers	1,00,000
Loan from M/s D & Co.		4,60,000	Cash in Hand	20,000
Trade payables		40,000		
		16,40,000		16,40,000

ILLUSTRATION 7

The balance sheet of Thapar on 1st April, 2021 was as follows:

Liabilities	Amount ₹	Assets	Amount ₹
Trade payables	15,00,000	Plant & Machinery	30,00,000
Expenses Payable	1,50,000	Furniture & Fixture	3,00,000
Capital	50,00,000	Trade receivables	14,00,000
		Cash at Bank	6,50,000
		Inventories	13,00,000
	66,50,000		66,50,000

During 2021-22, his Profit and Loss Account revealed a net profit of ₹ 18,30,000. This was after allowing for the following :

- (a) Rent received from property let out ₹ 3,00,000.
- (b) Depreciation on Plant and Machinery @ 10% and on Furniture and Fixtures @ 5%.
- (c) A provision for Doubtful Debts @ 5% of the trade receivables as at 31st March, 2022.

But while preparing the Profit and Loss Account he had forgotten to provide for (1) outstanding expenses totaling ₹ 1,80,000 and (2) prepaid insurance to the extent of ₹ 20,000.

His current assets and liabilities on 31st March, 2022 were: Inventories ₹ 14,50,000; Trade receivables ₹ 20,00,000; Cash at Bank ₹ 10,35,000 and Trade payables ₹ 11,40,000.

During the year he withdrew ₹ 6,00,000 for domestic use.

Required

Draw up his Balance Sheet at the end of the year.

SOLUTION

Profit and Loss Account (Revised)

Particulars	₹	Particulars	₹
To Outstanding expenses	1,80,000	By Balance b/d	18,30,000
To Net profit	16,70,000	By Prepaid insurance	20,000
	18,50,000		18,50,000

Balance Sheet of Thapar as at 31st March, 2022

Liabilities		₹	Assets	₹	₹
Capital	50,00,000		Cash at Bank		10,35,000
Add: Net Profit	16,70,000		Trade receivables	20,00,000	
	66,70,000		Less: Provision for doubtful debts	(1,00,000)	19,00,000
Less : Drawings	(6,00,000)	60,70,000	Plant and Machinery	30,00,000	
Outstanding expenses		1,80,000	Less: Depreciation	(3,00,000)	27,00,000
Trade payables		11,40,000	Furniture & Fixtures	3,00,000	
			Less: Depreciation	(15,000)	2,85,000
			Inventories		14,50,000
			Prepaid insurance		20,000
		73,90,000			73,90,000



1.7 SEQUENCE OF ACCOUNTING PROCEDURE OR THE ACCOUNTING CYCLE

What has been done so far shows that the accounting process in the following order :

- (i) recording the transactions in the journal or journalising;
- (ii) preparing ledger accounts on the basis of the journal or posting into the ledger;
- (iii) taking out the trial balance to check arithmetical accuracy;
- (iv) preparing the trading and profit and loss account or the income statement for the period concerned; and
- (v) preparing the balance sheet to show the financial position at the end of the period.



1.8 OPENING ENTRY

We have seen that on commencing a new business one debits the cash account and credits the capital account with the amount introduced. A firm closes the books of account at the end of each year and starts new books in the beginning of each year. The first entry in the journal is to record the closing balances of various assets and liabilities at the end of the previous year as the opening balances in the beginning of the new year. The balance sheet prepared at the end of the year records these balances and is the basis for this first entry. It is called the opening entry.

The assets shown in the balance sheet are debited and the liabilities and the capital account credited.

ILLUSTRATION 8

Balance Sheet as at 31st March, 2022

Liabilities	₹	Assets	₹
Mahendra & Sons	5,60,000	Cash in hand	43,000
Capital	20,00,000	Cash at Bank	2,67,500
		Trade receivables	7,49,500
		Closing Inventory	9,00,000
		Machinery and Equipment	6,00,000
	25,60,000		25,60,000

From the above given balance sheet prepare the relevant opening entry.

SOLUTION

The Opening Entry :01-04-2022

		Dr. ₹	Cr. ₹
Cash A/c	Dr.	43,000	
Bank A/c	Dr.	2,67,500	
Trade receivables	Dr.	7,49,500	
Inventory A/c	Dr.	9,00,000	
Machinery and Equipment A/c	Dr.	6,00,000	
To Mahendra & Sons A/c			5,60,000
To Capital A/c			20,00,000
(Being the balances brought forward)		25,60,000	25,60,000

Posting the Opening Entry

All the assets show debit balance. Such accounts are opened and the relevant amounts written on the debit side as "To Balance b/d". Following is the cash account arising from the entry given above.

Cash Account

Date 2022	Particulars	Amount ₹	Date	Particulars	Amount ₹
April 1	To Balance b/d	43,000			

Similarly account should be opened for all other assets and relevant amount should be posted on the Dr. side.

The accounts of liabilities show credit balances. An account for each liability is opened and the relevant account is written on the credit side as "By Balance b/d". This is shown below by opening the accounts of Mahendra & Sons mentioned in the entry given above.

Mahendra & Sons

Date	Particulars	Amount ₹	Date 2022	Particulars	Amount ₹
			April 1	To Balance b/d	5,60,000

By posting the opening entry completely all the accounts of assets and liabilities in the beginning are opened. We illustrate below a complete cycle of journalising, posting and trial balance.

Students should work through the following illustration given by way of practice on the method of making adjustments in some of the accounts contained in a Trial Balance and afterwards preparing the final Account.

ILLUSTRATION 9

Shri Mittal gives you the following Trial Balance and some other information:

Trial Balances as on 31st March, 2022

Particulars	Dr. ₹	Cr. ₹
Capital		8,70,000
Purchases and Sales	6,05,000	12,10,000
Opening Inventory	72,000	
Trade receivables and Trade payables	90,000	1,70,000
14% Bank Loan (loan taken at year end)		2,00,000
Overdrafts (overdraft taken at year end)		1,12,000
Salaries	2,70,000	
Advertisements	1,10,000	
Other expenses	60,000	
Returns	40,000	30,000
Furniture	4,50,000	
Building	8,90,000	
Cash in Hand	2,000	
Input CGST	9,000	
Input SGST	9,000	
Output IGST		15,000
	26,07,000	26,07,000

Closing Inventory on 31st March, 2022 was valued at ₹ 1,00,000.

Required

Prepare final accounts of Shri Mittal for the year ended 31st March, 2022.

SOLUTION

In the books of Shri Mittal

Trading Account for the year ended 31st March, 2022

Particulars		Amount	Particulars		Amount
		₹			₹
To Opening inventory		72,000	By Sales	12,10,000	
To Purchases	6,05,000		Less: Returns	(40,000)	11,70,000
Less: Returns	(30,000)	5,75,000	By Closing inventory		1,00,000
To Gross Profit		6,23,000			
		12,70,000			12,70,000

Profit and Loss Account for the year ended 31st March, 2022

Particulars	Amount (₹)	Particulars	Amount (₹)
To Salaries	2,70,000	By Gross profit	6,23,000
To Advertisement	1,10,000		
To Other expenses	60,000		
To Net profit	1,83,000		
	6,23,000		6,23,000

Balance Sheet as at 31st March, 2022

Liabilities		Amount (₹)	Assets	Amount (₹)
Capital	8,70,000		Building	8,90,000
Add: Net profit	1,83,000	10,53,000	Furniture	4,50,000
14% Bank Loan		2,00,000	Trade receivables	90,000
Trade payables		1,70,000	Closing inventory	1,00,000
Overdrafts		1,12,000	Cash in hand	2,000
		15,35,000	Input SGST (W.N.)	3,000
				15,35,000

Note: As loan and overdraft taken at year end so no interest shown.**Working Note:**

Output IGST liability is paid by utilizing Input CGST of ₹ 9,000 and Input SGST of ₹ 6,000. Thereafter, closing balance of Input SGST of ₹ 3,000 is reported in Balance Sheet.

ILLUSTRATION 10

Mr. Mohan gives you the following trial balance and some other information:

Trial Balance as on 31st March, 2022

Particulars	₹	₹
Capital		6,50,000
Sales		9,70,000
Purchases	4,30,000	
Opening Inventory	1,10,000	
Freights Inward	40,000	
Salaries	2,10,000	
Other Administration Expenses	1,50,000	
Furniture	3,50,000	
Trade receivables and Trade payables	2,10,000	1,90,000
Returns	20,000	12,000
Discounts	19,000	9,000
Bad Debts	5,000	
Investments in Government Securities	1,00,000	
Cash in Hand and Cash at Bank	1,89,000	
Input CGST	10,000	
Input SGST	10,000	
Output CGST		8,000
Output SGST		8,000
Output IGST		6,000
	18,53,000	18,53,000

Other Information:

- (i) Closing Inventory was ₹ 1,80,000;
- (ii) Depreciate Furniture @ 10% p.a.

Required

Prepare Trading and Profit and Loss Account for the year ended on 31.3.2022 and Balance Sheet of Mr. Mohan as on that date.

SOLUTION

In the books of Mr. Mohan
Trading Account for the year ended 31st March, 2022

Particulars		Amount	Particulars		Amount
		₹			₹
To Opening Inventory		1,10,000	By Sales	9,70,000	
To Purchases	4,30,000		Less: Returns	(20,000)	9,50,000
Less: Returns	(12,000)	4,18,000	By Closing Inventory		1,80,000
To Freight Inwards		40,000			
To Gross profit		5,62,000			
		11,30,000			11,30,000

Profit and Loss Account for the year ended 31st March, 2022

Particulars	₹	Particulars	₹
To Depreciation	35,000	By Gross profit	5,62,000
To Salaries	2,10,000	By Discount received	9,000
To Administration expenses	1,50,000		
To Discount allowed	19,000		
To Bad debts	5,000		
To Net profit	1,52,000		
	5,71,000		5,71,000

Balance Sheet as at 31st March, 2022

Liabilities		Amount	Assets		Amount
		₹			₹
Capital	6,50,000		Furniture	3,50,000	
Add: Net profit	1,52,000	8,02,000	Less: Depreciation	(35,000)	3,15,000
Trade payables		1,90,000	Closing Inventory		1,80,000
Output IGST		2,000	Trade receivables		2,10,000

			Investment in Govt Securities		1,00,000
			Cash in Hand and Cash at Bank		1,89,000
		9,94,000			9,94,000

Working Note:

Summary of Output and Input GST liability (as per Trial Balance)

	OUTPUT GST (₹)	INPUT GST (₹)
IGST	6,000	
CGST	8,000	10,000
SGST	8,000	10,000

Output liability (Tax head)	Tax Payable	Paid through ITC			Tax paid in cash
		IGST	CGST	SGST	
IGST	6,000		2,000	2,000	2,000
CGST	8,000		8,000		
SGST	8,000			8,000	

In the above solution, it is assumed that balance IGST liability of ₹ 2,000 (after utilising CGST and SGST) is not paid off in cash.

Alternatively, students may assume that the balance liability of ₹ 2,000 is paid off in cash. Accordingly, Output IGST liability of ₹ 2,000 shall not appear under liability side of the balance sheet and amount of cash at bank is reported as ₹ 1,87,000

ILLUSTRATION 11

The Balance Sheet of Mr. Popatlal, a merchant on 31st March, 2022 stood as below:

Liabilities	Amount	Assets	Amount
	₹		₹
Capital	2,40,000	Fixed Assets	1,25,600
Trade payables	1,64,000	Inventories	2,06,400

Bank Overdraft	1,46,000	Trade receivables	1,88,000	
		Less: Provision	(6,200)	1,81,800
		Cash		36,200
	5,50,000			5,50,000

Required

Show opening journal entry on 1st April, 2022 in the books of Mr. Papatlal.

SOLUTION**Opening entry**

			(Dr.) ₹	(Cr.) ₹
1.4.2022	Fixed Assets A/c	Dr.	1,25,600	
	Inventories A/c	Dr.	2,06,400	
	Trade receivables A/c	Dr.	1,88,000	
	Cash A/c	Dr.	36,200	
	To Trade payables A/c			1,64,000
	To Bank Overdraft A/c			1,46,000
	To Provision for Doubtful Debts A/c			6,200
	To Capital A/c			2,40,000

ILLUSTRATION 12

The following is the schedule of balances as on 31.3.22 extracted from the books of Shri Gavaskar, who carries on business under the same name and style of Messrs Gavaskar Viswanath & Co., at Mumbai:

Particulars	Dr.	Cr.
	₹	₹
Cash in hand	14,000	
Cash at bank	26,000	
Sundry Debtors	8,60,000	
Stock on 1.4.2021	6,20,000	
Furniture & fixtures	2,14,000	

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Office equipment	1,60,000	
Buildings	6,00,000	
Motor Car	2,00,000	
Sundry Creditors		4,30,000
Loan from Viswanath		3,00,000
Provision for bad debts		30,000
Purchases	14,00,000	
Purchase Returns		26,000
Sales		23,00,000
Sales Returns	42,000	
Salaries	1,10,000	
Rent for Godown	55,000	
Interest on loan from Viswanath	27,000	
Rates & Taxes	21,000	
Discount allowed to Debtors	24,000	
Discount received from Creditors		16,000
Freight on purchases	12,000	
Carriage Outwards	20,000	
Drawings	1,20,000	
Printing and Stationery	18,000	
Electricity Charges	22,000	
Insurance Premium	55,000	
General office expenses	30,000	
Bad Debts	20,000	
Bank charges	16,000	
Motor car expenses	36,000	
Capital A/c		16,20,000
TOTAL	47,22,000	47,22,000

Prepare Trading and Profit and Loss Account for the year ended 31st March, 2022 and the Balance Sheet as at that date after making provision for the following:

1. Depreciate: (a) Building used for business by 5 percent; (b) Furniture and fixtures by 10 percent; One steel table purchased during the year for ₹ 14,000 was sold for same price but the sale proceeds were wrongly credited to Sales Account; (c) Office equipment by 15 percent; Purchase of a typewriter during the year for ₹ 40,000 has been wrongly debited to purchase; and (d) Motor car by 20%.
2. Value of stock at the close of the year was ₹ 4,40,000.
3. Two month's rent for godown is outstanding.
4. Interest on loan from Viswanath is payable at 12 percent per annum, this loan was taken on 1.5.2021.
5. Provision for bad debts is to be maintained at 5 percent of Sundry Debtors.
6. Insurance premium includes ₹ 40,000 paid towards proprietor's life insurance policy and the balance of the insurance charges cover the period from 1.4.2021 to 30.6.2022.

SOLUTION**M/s Gavaskar Viswanath & Co.****Trading for the year ended 31st March, 2022**

Particulars	Details	Amount ₹	Particulars	Details	Amount ₹
To opening Stock		6,20,000	By Sales	23,00,000	
To Purchases	14,00,000		Less: Sale of furniture included in sale	14,000	
Less: Typewriter included in purchases	40,000		Less: Sales Returns	<u>42,000</u>	22,44,000
Less: Purchase Returns	26,000	13,34,000	By Closing Stock		4,40,000
To Freight on purchase		12,000			
To Gross Profit c/d		7,18,000			
		26,84,000			26,84,000

M/s Gavaskar Viswanath & Co.**Profit/Loss Account for the year ended 31st March, 2022**

Particular	Details	Amount ₹	Particular	Details	Amount ₹
To Salaries		1,10,000	By Gross profit b/d		7,18,000
To Rent for Godown	55,000				

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Add: Outstanding	11,000	66,000	By Discount received		16,000
To provision for doubtful debts(4)		33,000			
To Rent and Taxes		21,000			
To Discount Allowed		24,000			
To Carriage outwards		20,000			
To printing and stationery		18,000			
To Electricity charges		22,000			
To Insurance premium (1)		12,000			
To Depreciation (2)		1,20,000			
To general office expenses		30,000			
To Bank Charges		16,000			
To interest on loan	27,000				
Add: Outstanding (3)	6,000	33,000			
To Motor car expenses		36,000			
To Net Profit transferred to Capital a/c		1,73,000			
		7,34,000			7,34,000

Balance Sheet of M/s Gavaskar Vishwanath & Co.

as at 31st March, 2022

Liabilities	Details	Amount ₹	Assets	Details	Amount ₹
Capital	16,20,000		Building	6,00,000	
Add: Net Profit	1,73,000		Less: Dep.	(30,000)	5,70,000
Less: Drawings	(1,20,000)				
Less: Insurance Premium	(40,000)	16,33,000	Motor Car	2,00,000	
			Less: Dep.	(40,000)	1,60,000
Loan from Vishwanath	3,00,000				
Add: Outstanding	6,000	3,06,000	Office equipment	2,00,000	
			Less: Dep.	(30,000)	1,70,000
Sundry Creditors		4,30,000			
Outstanding rent		11,000	Furniture & Fixture	2,00,000	

			Less: Dep.	(20,000)	1,80,000
			Stock in Trade		4,40,000
			Sundry Debtors	8,60,000	
			Less: Provision for doubtful debts	(43,000)	8,17,000
			Cash at hand		26,000
			Cash in bank		14,000
			Prepaid insurance (1)		3,000
		23,80,000			23,80,000

Working Notes :**(1) Insurance premium**

	₹
Insurance premium as given in trial balance	55,000
Less: Personal premium	(40,000)
Less: Prepaid for 3 months $\left(\frac{15,000}{15} \times 3 \right)$	(3,000)
Transfer to Profit & Loss a/c	12,000

(2) Depreciation

Building @ 5% on 6,00,000	30,000
Motor Car @ 20% on 2,00,000	40,000
Furniture & Fittings @ 10% on 2,00,000 (2,14,000-14,000)	20,000
Office Equipment @ 15% on 2,00,000 (1,60,000 + 40,000)	30,000
Total	1,20,000

(3) Interest on Loan

Interest on Loan (3,00,000 x 12% x 11/12)	33,000
Less : Interest as per Trial Balance	(27,000)
Profit & Loss account (Outstanding)	6,000

(4) Provision for bad debts a/c

Particulars	Amount ₹	Particulars	Amount ₹
To bad debts a/c	20,000	By balance b/d	30,000
To balance c/d	43,000	By P&L a/c	33,000
	63,000		63,000

- (5)** Purchase of a typewriter during the year for ₹ 40,000 which was wrongly debited to purchase added to office equipment.



1.9 PROVISIONS AND RESERVES

Provision means "any amount written off or retained by way of providing for depreciation, renewal or diminution in the value of assets or retained by way of providing for any known liability of which the amount cannot be determined with substantial accuracy". A provision is a liability which can be measured only by using a substantial degree of estimation.

Thus, a provision may be either in respect of loss in the value of an asset provided or written off on the basis of an estimate or the one in respect of a liability for expenses incurred in respect of a claim which is disputed i.e. when it is a contingent liability. On the occurrence of a diminution in asset values due to some of them having become irrecoverable or Inventory items are lost as a result of some natural calamity, amounts contributed or transferred from profit to make good the diminution also are described as provision.

The following are instances of amount retained in the business out of earning for different purposes that are described as provisions.

- (1) Amount provided for meeting claims which are admissible in principle, but the amount whereof has not been ascertained.
- (2) An appropriation made for payment of taxes still to be assessed.
- (3) Amount set aside for writing off bad debts or payment of discounts.

The portion of earnings, receipts or other surplus of an enterprise (whether capital or revenue) appropriated by the management for a general or a specific purpose other than a provision for depreciation or diminution in the value of assets or for a known liability is known as reserves. The reserves are primarily of two types: capital reserves and revenue reserves. Also provisions in excess of the amount considered necessary for the purposes these were originally made, are to be considered as reserves. ***It is thus evident that provisions are a charge against profits, while reserve is an appropriation of profits.*** Also provisions that

ultimately prove to be in excess of amounts required or have been made too liberally are reserves. Such a distinction is essential for disclosing truly in the Balance Sheet the amount by which the equity of shareholders has increased with the accumulation of undistributed profits.

Reserve Fund: It signifies the amount standing to the credit of the reserve that is invested outside the business in securities which are readily realisable e.g., when the amounts set apart for replacement of an asset are invested periodically, in government securities or shares. The account to which these amounts are annually credited is described as the Reserve Fund.

ILLUSTRATION 13

Crimpson traders profit and loss account for the year ended 31st March, 2022 includes the following information:

	₹
(i) Depreciation	57,500
(ii) Bad debts written off	21,000
(iii) Increase in provision for doubtful debts	18,000
(iv) Retained profit for the year	20,000
(v) Liability for tax	4,000

Required

State which one of the items (i) to (vi) above are – (a) transfer to provisions; (b) transfer to reserves; and (c) neither related to provisions nor reserves.

SOLUTION

- (a) Transfer to provisions - (i), (iii) (v)
- (b) Transfer to reserves - (iv)
- (c) Neither related to provisions nor reserves - (ii),.

A summary of all adjustments are as follows:

Adjustment	If Given in Trial Balance	If Not Given in Trial Balance
1. Closing stock	Balance Sheet – Asset Side	(a) Trading A/c – Credit Side (b) Balance Sheet – Asset Side
2. Outstanding Expenses	Balance Sheet – Liability Side	(a) Trading/Profit & Loss A/c Debit Side. Add to the concerned expenses.

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		(b) Balance Sheet – Liability Side
3. Prepaid Expenses	Balance Sheet – Asset Side	(a) Trading/Profit & Loss A/c Debit Side. Deduct from the concerned expense.
		(b) Balance Sheet - Asset
4. Income Outstanding	Balance Sheet – Asset Side	(a) Profit & Loss A/c – Credit Side. Add to the concerned income.
		(b) Balance Sheet – Asset Side.
5. Incomes Received in Advance	Balance Sheet – Liability Side	(a) Profit & Loss A/c – Credit Side. Deduct from concerned income.
		(b) Balance Sheet – Liability Side
6. Bad Debts	Profit & Loss A/c – Debit Side	(a) Profit & Loss A/c – Debit Side.
		(b) Balance Sheet – Asset Side. Deduct from debtors .
7. Provision for Bad or Doubtful debts	Profit & Loss A/c – Debit Side	(a) Profit & Loss A/c – Debit Side.
		(b) Balance Sheet – Asset Side. Deduct from Debtors after additional bad debts, if any.
8. Provision for Discount on Debtors	Balance Sheet – Asset Side Deduct from Debtors.	(a) Profit & Loss A/c – Debit Side.
		(b) Balance Sheet – Asset Side. Deduct from debtors after providing for provision for bad debts
9. Depreciation	Profit & Loss A/c – Debit Side	(a) Profit & Loss A/c – Debit Side.
		(b) Balance Sheet – Asset Side. Deduct from Respective Asset.
10. Interest on Capital	Profit & Loss A/c – Debit Side	(a) Profit & Loss A/c – Debit Side.
		(b) Balance Sheet – Liability Side. Add to Capital.
11. Interest on Drawings	Profit & Loss A/c – Credit Side	(a) Profit & Loss A/c – Credit Side.
		(b) Balance Sheet – Liability Side. Deduct from Capital.

12. Loss by Fire	Profit & Loss A/c – Debit Side	(a) Trading A/c – Credit Side (with full amount of loss)
		(b) Profit & Loss A/c – Debit Side (Actual loss, if any) [adjusted with insurance claim if any]
		(c) Balance Sheet – Asset Side (with insurance claim admitted by Insurance Co.)
13. Goods withdrawn for personal use	Trading A/c - Credit Side	(a) Trading A/c – Credit Side or Deduct from Purchases.
		(b) Balance Sheet – Liability Side (Deduct from Capital as Drawings)
14. Goods Distributed as free Samples	Profit & Loss A/c – Debit Side	(a) Trading A/c – Credit Side or Deduct from Purchases
		(b) Profit & Loss A/c – Debit Side
15. Sale of Goods on Approval Basis, approval not yet received	Usually it is not given in Trial Balance	(a) Trading A/c – Credit Side. Deduct from Sales the selling price of goods sold and add to stock at cost price.
		(b) Balance Sheet – Asset Side. Deduct from Debtors the selling price of such sales and show the cost price of such sales along with closing stock.



1.10 LIMITATIONS OF FINANCIAL STATEMENTS

Financial statements suffer from a number of limitations. These must, therefore, be studied with care, in order that correct inferences may be drawn. The limitations are less serious if the objective is only to appraise the performance of a single company over a period of year. Where, however, a comparison of the working of different companies for the same period is to be made. It can be misleading unless the companies concerned have followed the same system and basis of accounting. On the account, a comparison of the performance of different industries on the basis of financial statements, should be undertaken only if it is not practicable to make such a comparison on any other basis.

The principal limitations affecting financial statements are the following:

- (a) **Historical Cost:** Accounting records and, on that account, the financial statements are prepared only on the basis of the money value prevailing at the time the transaction were entered into. Thus, the effect of subsequent changes in the value of money is not taken into account. At times this has the effect of making the statements of account quite misleading. Take the obvious example of a house built in 1980, say at the cost of ₹15,000, in 2022 the benefit receivable from its occupation will be as much as that of a house created in 2022, say at a cost of ₹30,00,000. If the house were included in the financial statements at its original cost, as normally it would not convey a true picture except to a knowledgeable person.

The limitations can be serious in the case of other fixed assets that have been working over a long period over which prices have changed radically. It is, however, not easy to get over this difficulty, since revaluation of fixed assets, apart from being costly is not practicable when the value of money is continuously falling. On this account, historical cost continues to be the accepted basis for the preparation of financial statements. Though it may not be possible to do much to remove the limitation mentioned above, one must always remember to read the balance sheet and the profit and loss account in the light of what they cannot reveal as well as what they do.

- (b) **Intangible strengths and weaknesses:** A company may have a number of strengths and weaknesses which cannot be shown in the balance sheet e.g., the loyalty and calibre of its staff. These must be kept in mind while judging the financial position of the company.
- (c) **Perpetual continuity and periodical account:** Financial statements ordinarily are drawn up at the end of each year but the accounting record is maintained on the assumption that the business undertaking shall continue to exist forever on the basis of going concern assumption. In consequence, much of the expenditure other than revenue expenditure has to be distributed arbitrarily over a number of years during which benefit of the expenditure is expected to arise. As a result, financial statements of account are not absolutely correct.
- (d) **Different accounting policies:** It is permissible for a company within certain limits to adopt different policies for the preparation of accounts, valuation of various assets and distribution of expenditure over different periods of account. For example, a company may decide to provide annually for payment of pensions and gratuities to staff and thus build up a 'fund' out of which payments will be made ultimately whereas another company may deal with these only when actual payments are made. Similarly, a company may decide whether or not to include intangible assets amongst its assets or manner in which the amounts thereof should be written off.
- (e) **Management policies:** Management can have different accounting policies for welfare of the staff and public at large.

SUMMARY

- ◆ Non-manufacturing entities are the trading entities, which are engaged in the purchase and sale of goods at profit without changing the form of the goods.
- ◆ For accounting, profit is measured at two levels:
 - (a) Gross Profit
 - (b) Net Profit
- ◆ The principal function of final statements of account (Trading Account, Profit and Loss Account and the Balance Sheet) is to exhibit truly and fairly the profitability and the financial position of the business to which they relate. In order that these may be properly drawn up, it is essential that a proper record of transactions entered into by the business during a particular accounting period should be maintained.
- ◆ At the end of the year, it is necessary to ascertain the net profit or the net loss. For this purpose, it is first necessary to know the gross profit or gross loss. Gross Profit is the difference between the selling price and the cost of the goods sold. For a trading firm, the cost of goods sold can be ascertained by adjusting the cost of goods still on hand at the end of the year against the purchases.

TEST YOUR KNOWLEDGE

True and False

1. *The income statement shows either net profit or net loss for a particular period.*
2. *Gains from the sale or exchange of assets are not considered as the revenue of the business.*
3. *The salary paid in advance is not an expense because it neither reduces assets or nor increase liabilities.*
4. *A loss is an expenditure which does not bring any benefit to the concern.*
5. *All liabilities which become due for payment within the year are classified as long-term liabilities.*
6. *The term current asset is used to designate cash and other assets or resources which are reasonably expected to be realized or sold or consumed within one year.*
7. *An asset gives rise to expenditure when it is acquired and to an expense when it is consumed.*

8. *If the balance of an account on the debit side of the trial balance where the benefit has already expired then it is treated as an expense.*
9. *Sales less cost of goods sold = gross profit.*
10. *If the debit side of the trading account exceeds its credit side then the balance is termed as gross profit.*
11. *The provision for bad debts is debited to Sundry Debtors Account.*
12. *The provision for discount on creditors is often not provided in keeping with the principle of conservatism.*
13. *The debts written off as bad, if recovered subsequently are credited to Debtors Account.*
14. *The adjustment entry in respect of income received in advance is debit Income received in advance account and credit income account.*
15. *Premium paid on the life policy of a proprietor is debited to profit and loss account.*
16. *Depreciation account appear in the trial balance is taken only to profit and loss account.*
17. *Personal purchases included in the purchases day book are added to the sales account in the Trading account.*
18. *Medicines given to the office staff by a manufacturer of medicines will be debited to salaries account.*
19. *Goods worth ₹ 600 taken by the proprietor for personal use should be credited to Capital Account.*
20. *If Closing Stock appears in the Trial Balance, the Closing inventory is then not entered in Trading Account. It is only shown in the Balance Sheet.*

Multiple Choice Questions

- (1) *A debit to an account may*
 - (a) *increase expense*
 - (b) *decrease an asset.*
 - (c) *increase a liability.*
- (2) *Prepayment of insurance premium will appear in the Balance Sheet and in the Insurance Account respectively as:*
 - (a) *a liability and a debit balance.*

- (b) *an asset and a debit balance.*
- (c) *an asset and a credit balance.*
- (3) *Gross profit is the difference between:*
 - (a) *sales and purchases*
 - (b) *sales and cost of sales.*
 - (c) *sales and total expenses.*
- (4) *Payment made to a creditor subject to cash discount will :*
 - (a) *reduce a liability, reduce an asset and add to expenses.*
 - (b) *reduce a liability, add to an asset, and add to revenue.*
 - (c) *reduce an asset, reduce a liability, and add to revenue.*
- (5) *A customer returns goods already charged to him. We should:*
 - (a) *debit his account.*
 - (b) *credit his account.*
 - (c) *make no entry on his account.*
- (6) *Capital is the difference between*
 - (a) *Income and expenses*
 - (b) *Sales and Cost of goods sold*
 - (c) *Assets and liabilities*
- (7) *The capital of a sole trader would change as a result of:*
 - (a) *A creditor being paid his account by cheque.*
 - (b) *Raw materials being purchased on credit.*
 - (c) *Wages being paid in cash.*
- (8) *A decrease in the provision for doubtful debts would result in:*
 - (a) *An increase in liabilities.*
 - (b) *A decrease in working capital.*
 - (c) *An increase in net profit.*
- (9) *A Company wishes to earn a 20% profit margin on selling price. Which of the following is the profit mark up on cost, which will achieve the required profit margin?*
 - (a) *33%*

- (b) 25%
- (c) 20%
- (10) If sales is ₹ 2,000 and the rate of gross profit on cost of goods sold is 25%, then the cost of goods sold will be
- (a) ₹ 2,000.
- (b) ₹ 1,500.
- (c) ₹ 1,600.
- (11) Sales for the year ended 31st March, 2022 amounted to ₹ 10,00,000. Sales included goods sold to Mr. A for ₹ 50,000 at a profit of 20% on cost. Such goods are still lying in the godown at the buyer's risk. Therefore, such goods should be treated as part of
- (a) Sales.
- (b) Closing Inventory.
- (c) Goods in transit.
- (12) If sales revenues are ₹ 4,00,000; cost of goods sold is ₹ 3,10,000 and expenses are ₹ 60,000, the gross profit is
- (a) ₹ 30,000.
- (b) ₹ 90,000.
- (c) ₹ 3,40,000.

Theoretical questions

1. Write shorts notes on:
 - (a) Balance sheet.
 - (b) Trading account
 - (c) Closing entries
2. Distinguish between Provision and reserve fund.

Practical questions

1. From the following particulars extracted from the books of Ganguli, prepare trading and profit and loss account and balance sheet as at 31st March, 2022 after making the necessary adjustments:

	₹		₹
Ganguli's capital account (Cr.) as on 1.4.2021	5,40,500	Interest received	7,250
Stock on 1.4.2021	2,34,000	Cash with Traders Bank Ltd.	40,000
Sales	14,48,000	Discounts received	14,950
Sales return	43,000	Investments (at 5%) as on 1.4.2021	25,000
Purchases	12,15,500	Furniture as on 1-4-2021	9,000
Purchases return	29,000	Discounts allowed	37,700
Carriage inwards	93,000	General expenses	19,600
Rent	28,500	Audit fees	3,500
Salaries	46,500	Fire insurance premium	3,000
Sundry debtors	1,20,000	Travelling expenses	11,650
Sundry creditors	74,000	Postage and telegrams	4,350
Loan from Dena Bank Ltd. (at 12%)	1,00,000	Cash in hand	1,900
Interest paid	4,500	Deposits at 10% as on 1-4-2021 (Dr.)	1,50,000
Printing and stationery	17,000	Drawings	50,000
Advertisement	56,000		

Adjustments:

- (1) Value of stock as on 31st March, 2022 is ₹ 3,93,000. This includes goods returned by customers on 31st March, 2022 to the value of ₹ 15,000 for which no entry has been passed in the books.
- (2) Purchases include furniture purchased on 1st January, 2022 for ₹10,000.
- (3) Depreciation should be provided on furniture at 10% per annum.
- (4) The loan account from Dena bank in the books of Ganguli appears as follows:

		₹			₹
31.3.2022	To Balance c/d	1,00,000	1.4.2021	By Balance b/d	50,000
			31.3.2022	By Bank	50,000
		1,00,000			1,00,000

- (5) Sundry debtors include ₹ 20,000 due from Robert and sundry creditors include ₹ 10,000 due to him.

- (6) Interest paid include ₹ 3,000 paid to Dena bank.
- (7) Interest received represents ₹ 1,000 from the sundry debtors (due to delay on their part) and the balance on investments and deposits.
- (8) Provide for interest payable to Dena bank and for interest receivable on investments and deposits.
- (9) Make provision for doubtful debts at 5% on the balance under sundry debtors. No such provision need to be made for the deposits.
2. Sengupta & Co. employs a team of eight workers who were paid ₹30,000 per month each in the year ending 31st March, 2021. At the start of financial year 2021-2022, the company raised salaries by 10% to ₹33,000 per month each.
- On October 1, 2021 the company hired two trainees at salary of ₹21,000 per month each. The work force are paid salary on the first working day of every month, one month in arrears, so that the employees receive their salary for January on the first working day of February etc.
- You are required to calculate:
- (i) Amount of salaries which would be charged to the profit and loss for the year ended 31st March, 2022.
- (ii) Amount actually paid as salaries during 2021-22
- (iii) Outstanding Salaries as on 31st March, 2022.
3. You are required, prepare a Trading and Profit and Loss Account for the year ending 31st March, 2022 and a Balance Sheet as on that date from the Trial Balance given below:

Particulars	₹	Particulars	₹
<i>Debit Balance:</i>			
Trade receivables	3,50,000	Salaries	2,20,000
Inventory 1st April, 2021	5,00,000	Purchases	12,50,00
Cash in Hand	5,60,000	Plant and Machinery	15,70,000
Wages	3,00,000	<i>Credit Balance:</i>	
Bad Debts	50,000	Capital	25,00,000
Furniture and Fixtures	1,50,000	Trade payables	9,00,000
Depreciation	1,50,000	Sales	17,00,000

On 31st March, 2022 the Inventory was valued at ₹10,00,000.

4. Mr. Kotriwal is engaged in business of selling magazines. Several of his customers pay money in advance for subscribing his magazines. Information related to year ended 31st March 2022 has been given below:

On 1.4.2021 he had a balance of ₹ 2,00,000 advance from customers of which ₹ 1,50,000 is related to year 2021-22 while remaining pertains to year 2022-23. During the year 2021-22 he made cash sales of ₹ 5,00,000. You are required to compute:

- (i) Total income for the year 2021-22.
 - (ii) Total money received during the year if the closing balance in advance from customers account is ₹ 1,70,000.
5. Mr. Birla is a proprietor engaged in business of trading electronics. An excerpt from his Trading & P&L account is as follows:

Trading and P&L A/c for the year ended 31st March, 2022

Particulars	₹	Particulars	₹
To Cost of Goods Sold	45,00,000	By Sales	C
To Gross Profit c/d	<u>D</u>		
	E		E
To Rent A/c	26,00,000	By Gross Profit b/d	<u>D</u>
To Office Expenses	13,00,000	By Miscellaneous Income	E
To Selling Expenses	B		
To Commission to Manager (on Net Profit before charging such commission)	2,00,000		
To Net Profit	<u>A</u>		
	G		<u>60,00,000</u>

Commission is charged at the rate of 10%.

Selling Expenses amount to 1% of total sales.

You are required to compute the missing figures.

ANSWERS/HINTS

True and False

1. True: Profit and loss account shows either net profit or net loss for a particular period.
2. False: Gains from the sale or exchange of assets are considered as the revenue of the business. But this revenue not in the ordinary course of business so it is capital receipts.
3. True: The salary paid in advance is an asset it is not an expense because it neither reduces assets or nor increase liabilities.
4. True: A loss is an expenditure of the business which does not bring any gain to the business.
5. False: All liabilities which become due for payment within one year are classified as current liabilities.
6. True: Current assets are all the assets which are expected to be realized or sold or consumed within one year.
7. True: When an asset is purchase capital expenditure is incurred and when the asset is put to use expenses are incurred in consumption.
8. True: Debit balance of accounts are treated as expenses whose benefit is already received or expired.
9. True: Gross profit is obtained by deducting cost of goods sold from sales.
10. False: If the debit side of the trading account exceeds its credit side then the balance is termed as gross loss.
11. False: The provision for bad debts is debited to Profit and loss Account, in Balance Sheet it is shown either on liability side or deducted from the head Debtors.
12. True: According to the provision of conservatism provision is maintained for the losses to be incurred in future. Discount on creditors is an income so provision is not maintained.
13. False: The debts written off as bad, if recovered subsequently are credited to Bad Debts Recovered Account and becomes an income.
14. False: Income received in advance reduces it from the concerned income in profit and loss account. And, it is shown as a liability in the current balance sheet under the head Current Liabilities.
15. False: Premium paid on the life policy of a proprietor is to be debited to capital account, as it is personal expense.

16. True: Depreciation is charge on each of the asset on a certain percentage. Depreciation is a charge to profit and loss account and should be debited to profit & loss account by crediting the respective assets. If it appears in trial balance then it is taken only to profit and loss account.
17. False: Personal purchases included in the purchases day book are deducted from the purchases account in the Trading account.
18. True: Any benefit given to the staff is debited to the salary account.
19. False: Goods taken by the proprietor for personal use should be credited to Purchase Account as less goods are left in the business for sale.
20. True: The closing Stock appears in the trial balance only when it is adjusted against purchases by passing the entry. In this case, closing stock is not entered in Trading Account and is shown only in Balance Sheet.

Multiple Choice Questions

1.	(a)	2.	(c)	3.	(b)	4.	(c)	5.	(b)	6.	(c)
7.	(c)	8.	(c)	9.	(b)	10.	(c)	11.	(a)	12.	(b)

Theoretical Questions

1.
 - (a) The balance sheet may be defined as "a statement which sets out the assets and liabilities of a firm or an institution as at a certain date." Since even a single transaction will make a difference to some of the assets or liabilities, the balance sheet is true only at a particular point of time. That is the significance of the word "as at."
 - (b) At the end of the year, it is necessary to ascertain the net profit or the net loss. For this purpose, it is first necessary to know the gross profit or gross loss with the helps to Trading A/c. Gross Profit is the difference between the selling price and the cost of the goods sold.
 - (c) Closing entries: The entries that have to be made in the journal for preparing the Trading and the Profit and Loss Account that is for transferring the various accounts to these two accounts are known as closing entries.
2. Provision means "any amount written off or retained by way of providing for depreciation, renewal or diminution in the value of assets or retained by way of providing for any known liability of which the amount cannot be determined with substantial accuracy".

Reserve Fund: It signifies the amount standing to the credit of the reserve that is invested outside the business in securities which are readily realisable e.g., when the amounts set apart for replacement of an asset are invested periodically, in government securities or shares. The account to which these amounts are annually credited is described as the Reserve Fund.

Practical Questions

1. In the books of Ganguli

Trading and Profit & Loss Account for the year ended 31st March, 2022

	₹	₹		₹	₹
To Opening stock		2,34,000	By Sales	14,48,000	
To Purchases	12,15,500		Less: Returns	(58,000)	13,90,000
Less: Transfer to furniture A/c	(10,000)		By Closing stock		3,93,000
	12,05,500				
Less: Returns	(29,000)	11,76,500			
To Carriage inwards		93,000			
To Gross profit c/d		2,79,500			
		17,83,000			17,83,000
To Salaries		46,500	By Gross profit b/d		2,79,500
To Rent		28,500	By Interest		17,250
To Advertisement		56,000	By Discount received		14,950
To Printing & stationery		17,000			
To Interest		7,500			
To Discount allowed		37,700			
To General expenses		19,600			
To Travelling expenses		11,650			
To Fire insurance premium		3,000			
To Postage & telegrams		4,350			
To Provision for doubtful debts (W.N.I)		4,750			

To Depreciation on furniture		1,150			
To Audit fees		3,500			
To Capital A/c (Net profit transferred)		70,500			
		3,11,700			3,11,700

Balance Sheet as at 31st March,2022

Liabilities	₹	₹	Assets	₹	₹
Capital account:			Furniture	9,000	
Balance on 1st April,2021	5,40,500		Additions during the year	10,000	
Add: Net profit	70,500			19,000	
	6,11,000		Less: Depreciation	(1,150)	17,850
Less: Drawings	(50,000)	5,61,000	Investments		25,000
Loan from Dena Bank Ltd.		1,00,000	Deposits		1,50,000
Insurance accrued on bank loan (W.N.2)		3,000	Interest accrued on investment & deposits (W.N.3)		10,000
Sundry creditors		64,000	Stock in trade		3,93,000
			Sundry debtors	95,000	
			Less: Provision	(4,750)	90,250
			Cash with Traders Bank Ltd.		40,000
			Cash in hand		1,900
		7,28,000			7,28,000

Working Notes:

1. Calculation of provision for doubtful debts:	₹
Sundry debtors as per trial balance	1,20,000
Less: Sales returns not recorded	(15,000)
	1,05,000

	Less: Cancellation against sundry creditors	(10,000)
	Adjusted balance of sundry debtors	<u>95,000</u>
	Provision for doubtful debts @ 5%	4,750
2.	Accrued interest on bank loan:	
	Annual interest @12%	6,000
	Less: Interest paid to Dena bank	<u>(3,000)</u>
	Accrued interest	<u>3,000</u>
3.	Interest accrued on investments and deposits:	
	Annual interest on investments @ 5%	1,250
	Annual interest on deposits @ 10%	<u>15,000</u>
		16,250
	Less: Interest received on investments and deposits	<u>(6,250)</u>
	Accrued interest	<u>10,000</u>
2.		₹
(i)	Salaries to be charged to profit and loss account for the year ended 31st March, 2022:	
	Salaries of 8 employees for full year @ ₹ 33,000 per month each	31,68,000
	Salaries of 2 trainees for 6 months @ ₹ 21,000 p.m.	<u>2,52,000</u>
		<u>34,20,000</u>
(ii)	Salaries actually paid in 2021-22	
	March, 2021 salaries paid in April, 2021 (8 x 30,000)	2,40,000
	Salaries of 8 employees for April 2021 to March, 2022 paid in May 2021 to March 2022 @ ₹ 33,000 for 11 months	29,04,000
	Salaries of 2 trainees for October 2021 to February 2022 paid in November 2021 to March 2022 @ ₹ 21,000 for 5 months	<u>2,10,000</u>
		<u>33,54,000</u>
(iii)	Outstanding salaries as at 31st March, 2022	
	8 employees @ ₹ 33,000 each for 1 month	2,64,000
	2 trainees @ ₹ 21,000 each for 1 month	<u>42,000</u>
		<u>3,06,000</u>

3. Trading and Profit and Loss Account for the year ending 31st March, 2022

Particulars	₹	Particulars	₹
To Opening Inventory	5,00,000	By Sales	17,00,000
To Purchases	12,50,000	By Closing Inventory	10,00,000
To Wages	3,00,000		
To Gross Profit	6,50,000		
	27,00,000		27,00,000
To Bad Debts	50,000	By Gross Profit	6,50,000
To Depreciation	1,50,000		
To Salaries	2,20,000		
To Net Profit transferred. to Capital A/c	2,30,000		
	6,50,000		6,50,000

Balance Sheet as at 31st March, 2022

Liabilities	₹	₹	Assets	₹	₹
Trade payables		9,00,000	Cash in Hand	5,60,000	
Capital:			Trade receivables	3,50,000	
Previous Balance	25,00,000		Closing Inventory	10,00,000	19,10,000
Add : Net Profit	2,30,000	27,30,000			
			Furniture & Fixtures	1,50,000	
			Plant & Machinery	15,70,000	17,20,000
		36,30,000			36,30,000

4. (i) Computation of Income for the year 2021-22:

	₹
Money received during the year related to 2021-22	5,00,000
Add: Money received in advance during previous years	1,50,000
Total income of the year 2021-22	6,50,000

(ii) **Advance from Customers A/c**

Date	Particulars	₹	Date	Particulars	₹
	To Sales A/c	1,50,000	1.4.2021	By Balance b/d	2,00,000
	(Advance related to current year transferred to sales)			By Bank A/c (Balancing Figure)	1,20,000
31.3.22	To Balance c/d	1,70,000			
		3,20,000			3,20,000

So, total money received during the year is:

	₹
Cash Sales during the year	5,00,000
Add: Advance received during the year	1,20,000
Total money received during the year	6,20,000

5. A) Computation of Net Profit:

Commission Manager = Rate of Commission X Net Profit before charging such commission

So, Commission to manager = 10/100 X Net Profit before charging such commission

= ₹ 2,00,000 = 10/100 X Net Profit before charging such commission

= Net Profit before charging such commission = ₹ 20,00,000

=> Net Profit (A) = ₹ (20,00,000 - 2,00,000) = ₹18,00,000

B) Computation of Selling Expenses:

Total income appearing in P&L A/c = ₹ 60,00,000

Total expenses other than selling expenses = ₹(26,00,000 + 13,00,000 + 2,00,000)= ₹ 41,00,000

So, Selling Expenses + Remaining Expenses + Net Profit = Total Income

= Selling Expenses = ₹ 60,00,000 - ₹ 41,00,000 - ₹ 18,00,000

= Selling Expenses = ₹ 1,00,000

C) Computation of Sales:

We have been given selling expenses amount to 1% of Sales

$$\text{So, Sales} = \frac{\text{Selling Expenses}}{1} \times 100 = \frac{1,00,000}{1} \times 100 = ₹ 100,00,000$$

D) Computation of Gross Profit:

In Trading A/c

Particulars	₹	Particulars	₹
To COGS	45,00,000	By Sales (from C above)	100,00,000
To Gross Profit (Balancing Figure)	55,00,000		
Total (F)	100,00,000	Total (F)	100,00,000

So, Gross Profit (D) = ₹ 55,00,000

E) Miscellaneous Income

= Total Income in P&L - Gross Profit

$$= ₹ (60,00,000 - 55,00,000) = ₹ 5,00,000$$

F) = ₹ 100,00,000 (As computed in D above)

G) = ₹ 60,00,000 (Total of both sides of P&L is equal after balancing has been done)

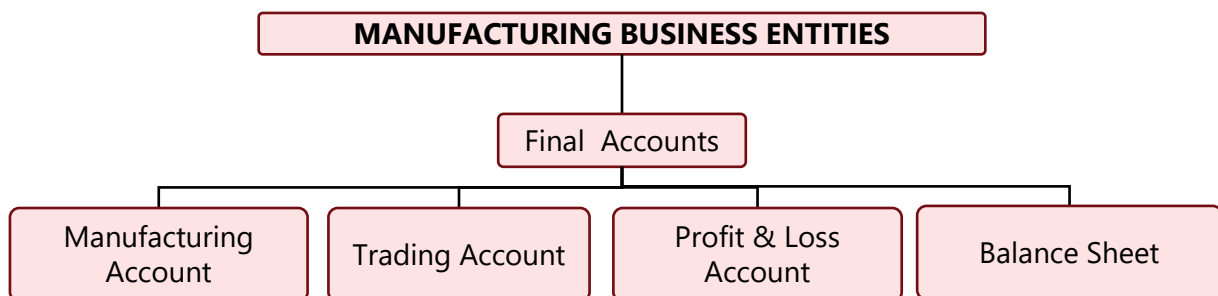
UNIT – 2 FINAL ACCOUNTS OF MANUFACTURING ENTITIES

LEARNING OUTCOMES

After studying this unit, you would be able to:

- ◆ Understand the purpose of preparing Manufacturing Account.
- ◆ Learn the items to be included in the Manufacturing Account
- ◆ Draw Manufacturing accounts of Manufacturing entities

UNIT OVERVIEW



2.1 INTRODUCTION

The manufacturing entities generally prepare a separate Manufacturing Account as a part of Final accounts in addition to Trading Account, Profit and Loss Account and Balance Sheet. The objective of preparing Manufacturing Account is to determine manufacturing costs of finished goods for assessing the cost effectiveness of manufacturing activities. Manufacturing costs of finished goods are then transferred from the Manufacturing Account to Trading Account.

- (a) Trading account shows Gross Profit while Manufacturing Account shows cost of goods sold which includes direct expenses.
- (b) Manufacturing account also deals with the raw materials, and work in progress while the trading account would deal with finished goods only.



2.2 PURPOSE

A manufacturing account serves the following functions:

- (1) It shows the total cost of manufacturing the finished products and sets out in detail, with appropriate classifications, the constituent elements of such cost. It is, therefore, debited with the cost of materials, manufacturing wages and expenses incurred directly or indirectly to manufacture.
- (2) It provides details of factory cost and facilitates reconciliation of financial books with cost records. It also serves as a basis of comparison of manufacturing operations from period to period.
- (3) The Manufacturing Account may also be used for various other purposes. For example, if the output is carried to the Trading Account at market prices, it shows the profit or loss on manufacture. Similarly, it may also be used to fix the amount of production linked bonus when such schemes are in force.



2.3 MANUFACTURING COSTS

Manufacturing costs are classified into:

+ Raw Material Consumed	
+ Direct Manufacturing Wages	
+ Direct Manufacturing Expenses	
+ Direct Manufacturing Cost	
+ Indirect Manufacturing expenses or	
+ Manufacturing Overhead	
Total Manufacturing Cost	_____

Raw Material consumed is arrived at after adjustment of opening and closing Inventory of raw materials:

$\text{Raw Material Consumed} = \text{Opening inventory} + \text{Purchases} - \text{Closing inventory}$ of Raw Materials of Raw Materials

If there remain unfinished goods at the beginning and at the end of the accounting period, cost of such unfinished goods (also termed as Work-In-Process) is shown in the Manufacturing Account.

Opening inventory of Work-in-Process is posted to the debit of the Manufacturing Account and closing inventory of Work-in-Process is posted to the credit of the Manufacturing Account.

DIRECT MANUFACTURING EXPENSES

Direct manufacturing expenses are costs, other than material or wages, which are incurred for a specific product or saleable service.

Examples of direct manufacturing expenses are (i) Royalties for using license or technology if based on units produced, (ii) Hire charge of the plant and machinery used on hire, if based on units produced, etc.

When royalty or hire charges are based on units produced, these expenses directly vary with production.

ILLUSTRATION 1

1,00,000 units were produced in a factory. Per unit material cost was ₹ 10 and per unit labour cost was ₹ 5. That apart it was agreed to pay royalty @ ₹ 3 per unit to the Japanese collaborator who supplied technology.

Required

Calculate Manufacturing Cost.

SOLUTION

In this case Manufacturing Cost comprises of –

Raw Material consumed	(1,00,000 × ₹ 10)	₹ 10,00,000
Direct Wages	(1,00,000 × ₹ 5)	₹ 5,00,000
Direct Expenses	(1,00,000 × ₹ 3)	₹ 3,00,000
		₹ 18,00,000

INDIRECT MANUFACTURING EXPENSES OR OVERHEAD EXPENSES

These are also called Manufacturing overhead, Production overhead, Works overhead, etc. Overhead is defined as total cost of indirect material, indirect wages and indirect expenses.

$$\text{Overhead} = \text{Indirect Material} + \text{Indirect Wages} + \text{Indirect Expenses}$$

Indirect material means materials which cannot be linked directly with the units produced, for example, stores consumed for repair and maintenance work, small tools, fuel and lubricating oil, etc.

Indirect wages are those which cannot be directly linked to the units produced, for example, wages for maintenance works, holding pay, etc.

Indirect expenses are those which cannot be directly linked to the units produced, for example, training expenses, depreciation of plant and machinery, depreciation of factory shed, insurance premium for plant and machinery, factory shed, etc.

Accordingly, indirect manufacturing expenses comprise indirect material, indirect wages and indirect expenses of the manufacturing division.

BY-PRODUCTS

In most manufacturing operations, the production of the main product is accompanied by the production of a subsidiary product which has a value on sale. For example, the production of hydrogenated vegetable oil is accompanied by the production of oxygen gas and the production of steel yields scrap. The subsidiary product is termed as a by-product because its production is not consciously undertaken but results out of the production of the main product. It is usually very difficult to ascertain the cost of the product. Moreover, its value usually forms a very small percentage of the main product.

By-product is a secondary product. This is produced from the same raw materials, which are used for producing the main product and without incurring any additional expenses from the same production process in which the main product is produced. Some examples of by-product are given below:

- (i) Molasses is the by-product in sugar manufacturing;
- (ii) Butter milk is the by-product of a dairy which produces butter and cheese, etc.

By-products generally have insignificant value as compared to the value of main product. They are **generally valued at net realizable value**, if their costs cannot be separately identified. It is often treated, as "Other Operating income" but the correct treatment would be to credit the sale value of the by-product to Manufacturing Account so as to reduce to that extent, the cost of manufacture of main product.



2.4 DESIGN OF A MANUFACTURING ACCOUNT

There is no standardized design for the presentation of a Manufacturing Account. Given below is a format covering various elements:

Manufacturing Account

Particulars	Units	Amount	Particulars	Units	Amount
		₹			₹
To Raw Material Consumed:			By By-products at net		
Opening inventory			realizable value		
Add: Purchases			By Closing Work-in- Process		
Less: Closing inventory			By Trading A/c		
To Direct Wages			Cost of production		
To Direct expenses:					
Prime cost					
To Factory overheads:					
Royalty					
Hire charges					
To Indirect expenses:					
Repairs & Maintenance					
Depreciation					
Factory cost					
To Opening Work-in-process					

Tutorial Note: Frequently, problems are set, in which all the ledger balances are not given. Instead, details are given regarding the number of items in Inventories, quantity manufactured etc. the figures for Inventories, sales etc., would therefore have to be worked out independently from the data given.

The following general rules may be observed.

- (a) The Manufacturing Account should have columns showing the quantities and values. Frequently, all the quantities are not given and the quantities applicable to one or more of the items would have to be worked out. For example, if the question does not state the total number of items sold, the quantity can be worked out by adding opening inventory and units manufactured and deducting closing inventory. It is, therefore, useful to have quantity columns in the account so that it can be seen that both sides balance.

(b) The Manufacturing Account will show the quantity of raw materials in inventory at the beginning and at the end of the year and the purchases during the year. As regards finished goods, it will only show the quantity manufactured and, as regards work-in-progress, the opening and closing amounts.

(c) The Trading Account will show the quantities of finished goods manufactured and sold and the opening and closing inventory. It will not show the quantity of raw materials or work-in-progress.

(d) For determining the value of closing inventory, in the absence of specific instruction to the contrary, it must be assumed that sales have been on "first in-first out" basis, that is, the closing inventory consists as far as possible of goods produced during the year, the opening inventory being sold out.

It may be mentioned here that nowadays no manufacturing business entity prepares manufacturing account as part of its final set of accounts. Even the items of manufacturing account are shown either in trading account (in case of non-corporate entities) or in Statement of profit and loss (in case of corporate entities).

The procedure of preparation of Trading Account, Profit and Loss Account and Balance Sheet have already been explained in Unit 1 of this chapter. Students should refer the earlier unit for attempting the problems based on the preparation of complete set of final accounts of a sole proprietor.

ILLUSTRATION 2

Mr. Vimal runs a factory which produces soaps. Following details were available in respect of his manufacturing activities for the year ended on 31.3.2022:

	₹
<i>Opening Work-in-Process (10,000 units)</i>	<i>16,000</i>
<i>Closing Work-in-Process (12,000 units)</i>	<i>20,000</i>
<i>Opening inventory of Raw Materials</i>	<i>1,70,000</i>
<i>Closing inventory of Raw Materials</i>	<i>1,90,000</i>
<i>Purchases</i>	<i>8,20,000</i>
<i>Hire charges of machine @ ₹ 0.60 per unit manufactured</i>	
<i>Hire charges of factory</i>	<i>2,20,000</i>

PREPARATIONS OF FINAL ACCOUNTS OF SOLE PROPRIETORS

7.81

Direct wages-Contracted @ ₹ 0.80 per unit manufactured and @ ₹ 0.40 per unit of Closing W.I.P.	
Repairs and Maintenance	1,80,000
Units produced – 5,00,000 units	

Required

Prepare a Manufacturing Account of Mr. Vimal for the year ended 31.3.2022.

SOLUTION

In the Books of Mr. Vimal

Manufacturing Account for the Year ended 31.3.2022

Particulars		Units	Amount	Particulars	Units	Amount
			₹			₹
To Opening Work- in- Process		10,000	16,000	By Closing Work- in-Process	12,000	20,000
To Raw Materials Consumed:				By Trading A/c – Cost of finished goods transferred	5,00,000	19,00,800
Opening inventory	1,70,000					
Add: Purchases	8,20,000					
	9,90,000					
Closing Inventory	(1,90,000)		8,00,000			
To Direct Wages – W.N. (1)			4,04,800			
To Direct expenses:						
Hire charges on Machinery – W.N. (2)			3,00,000			
To Indirect expenses:						
Hire charges of Factory Shed			2,20,000			
Repairs Maintenance			1,80,000			
			19,20,800			19,20,800

Working Notes:

(1) Direct Wages – 5,00,000 units @ ₹ 0.80 =	₹ 4,00,000
12,000 units @ ₹ 0.40 =	₹ 4,800
	<u>₹ 4,04,800</u>
(2) Hire charges on Machinery (5,00,000 units @ ₹ 0.60)	₹ 3,00,000

ILLUSTRATION 3

On 31st March, 2022 the Trial Balance of Mr. White were as follows:

Trial Balance as on 31st March, 2022

Particulars	Dr. ₹	Particulars	Cr. ₹
Stock on 1st April 2021			
Raw Materials	21,000	Sundry Creditors	15,000
Work in Progress	9,500	Bills Payable	7,500
Finished goods	15,500	Sale of Scrap	2,500
Sundry Debtors	24,000	Commission Received	450
Carriage on Purchases	1,500	Provision for doubtful debts	1,650
Bills Receivable	15,000	Capital Account	1,00,000
Wages	13,000	Sales	1,67,200
Salaries	10,000	Bank Overdraft	8,500
Telephone, Postage etc.	1,000		
Repairs to Office Furniture	350		
Cash at Bank	17,000		
Office Furniture	10,000		
Repairs to Plant	1,100		
Purchases	85,000		
Plant and Machinery	70,000		
Rent	6,000		
Lighting	1,350		
General Expenses	1,500		
	<u>3,02,800</u>		<u>3,02,800</u>

The following additional information is available:

Stocks on 31st March, 2022 were:

Raw Materials ₹ 16,200

Finished goods ₹ 18,100

Semi-finished goods ₹ 7,800

Salaries and wages unpaid for March 2022 were respectively, ₹ 900 and ₹ 2,000

Machinery is to be depreciated by 10% and office furniture by 7 1/2 %

Provision for doubtful debts is to be maintained @ 1% of sales

Office premises occupy 1/4 of total area.

Lighting is to be charged as to 2/3 to factory and 1/3 to office.

Prepare the Manufacturing Account Trading Account, Profit and Loss Account and the Balance Sheet relating to 31st March 2022.

SOLUTION

**In the books of Mr. White
Manufacturing Account for the year ended 31st March, 2022**

Particulars		₹	Particulars	₹
Raw material consumed:			By Closing Stock of Work in Progress	7,800
To Opening Stock of Raw Materials	21,000		By Sale of Scrap	2,500
Add: Purchases	85,000		By Cost of goods Manufactured	
Less: Closing Stock	16,200	89,800	(Transferred to Trading Account)	1,19,000
To Opening Stock of WIP		9,500		
To Wages	13,000			
Add: Outstanding Wages	2,000	15,000		
To Carriage on Purchases		1,500		
To Repairs to Plant		1,100		
To Rent (3/4)		4,500		

To Lighting (2/3)		900		
To Depreciation of Plant		7,000		
		1,29,300		1,29,300

Trading Account for the year ended 31st March, 2022

Particulars	₹	Particulars	₹
To Opening Stock of finished goods	15,500	By Sales	1,67,200
To Cost of goods transferred from Manufacturing A/c	1,19,000	By Closing Stock of finished goods	18,100
To Gross Profit c/d	50,800		
	1,85,300		1,85,300

Profit and Loss Account for the year ended 31st March, 2022

Particulars		₹	Particulars	₹
To Salaries	10,000		By Gross Profit b/d	50,800
Add: Outstanding	900	10,900	By Commission	450
To Telephone & Postage		1,000		
To Repairs to Furniture		350		
To Depreciation of furniture		750		
To Rent (1/4)		1,500		
To Lighting (1/3)		450		
To General Expenses		1,500		
To Provision for doubtful Debts: Required (1 % of ₹1,67,200)	1,672			
Less: Existing Provision	1,650	22		
To Net Profit		34,778		
		51,250		51,250

Balance Sheet as at 31st March, 2022

Capital and Liabilities		₹	Assets		₹
Capital Account	1,00,000		Plant & Machinery	70,000	
Add: Net Profit	34,778	1,34,778	Less: Depreciation	7,000	63,000
Bank Loan		8,500	Office Furniture	10,000	
Sundry Creditors		15,000	Less: Depreciation	750	9,250
Bills Payable		7,500	Closing Stock		
Salary Payable		900	Raw Materials		16,200
Wages Payable		2,000	Work in Progress		7,800
			Finished Goods		18,100
			Sundry Debtors	24,000	
			Less: Provision for Bad & Doubtful Debts	1,672	22,328
			Bills Receivable		15,000
			Cash at Bank		17,000
		1,68,678			1,68,678

NOTE: The ICAI has, through technical guide (issued in June, 2022) provided guidance on the formats of financial statements for non-corporate entities. This would enable these entities to communicate their financial performance and financial position in standardised formats thereby enhancing their consistency and comparability. The said format of financial statements has been given as **Annexure – I** at the end of the chapter for awareness of students. It may be noted that this format does not form part of syllabus and has been given here for the knowledge of students only.

SUMMARY

- ◆ Direct manufacturing expenses are costs, other than material or wages, which are incurred for a specific product or saleable service.
- ◆ Indirect Manufacturing expenses these are also called Manufacturing overhead, Production overhead, Works overhead, etc.
- ◆ Overhead is defined as total cost of indirect material, indirect wages and indirect expenses.
- ◆ Indirect material means materials which cannot be linked directly with the units produced, for example, stores consumed for repair and maintenance work, small tools, fuel and lubricating oil, etc. In most manufacturing operations, the production of the main product is accompanied by the production of a subsidiary product which has a value on sale.
- ◆ By-product is a secondary product. This is produced from the same raw materials, which are used for producing the main product and without incurring any additional expenses from the same production process in which the main product is produced.

TEST YOUR KNOWLEDGE

True and False

1. *By-products valued at cost or net realisable value whichever is lower.*
2. *The manufacturing account is prepared to ascertain the profit or loss on the goods produced.*
3. *If there remain unfinished goods at the beginning and at the end of the accounting period, cost of such unfinished goods is shown in the Manufacturing Account.*
4. *Raw Material Consumed = Opening inventory of Raw Materials + Purchases – Closing inventory of Raw Materials.*
5. *The Trading Account will show the quantities of finished goods, raw materials and work-in-progress.*
6. *Overhead is defined as total cost of direct material, direct wages and direct expenses.*
7. *Manufacturing A/c is prepared by an enterprise engaged in trading activities.*

Multiple Choice Questions

1. *Under-statement of closing work in progress in the period will*
 - (a) *Understate cost of goods manufactured in that period.*
 - (b) *Overstate current assets.*
 - (c) *Understate net income in that period.*
 - (d) *None of the three.*
2. *Sales is equal to*
 - (a) *Cost of goods sold – Gross profit.*
 - (b) *Cost of goods sold + Gross profit.*
 - (c) *Gross profit – Cost of goods sold.*
 - (d) *Net profit + cost of goods sold.*
3. *Indirect Manufacturing expenses are also called*
 - (a) *Manufacturing overhead.*
 - (b) *Production overhead.*
 - (c) *Works overhead.*
 - (d) *All the three.*
4. *Sale value of the by-product is credited to*
 - (a) *Manufacturing account.*
 - (b) *Capital account.*
 - (c) *Overheads account.*
 - (d) *Trading account.*
5. *Manufacturing account shows*
 - (a) *Total cost of manufacturing the finished products.*
 - (b) *It provides details of factory cost.*
 - (c) *It facilitates reconciliation of financial books with cost records.*
 - (d) *All the three.*

Theoretical Questions

1. Write short note on by-products.
2. Differentiate between Direct Manufacturing Expenses and Indirect Manufacturing expenses.

Practical Questions

1. Mr. Pankaj runs a factory which produces motor spares of export quality. The following details were obtained about his manufacturing expenses for the year ended on 31.3.2022.

			₹
W.I.P.	- Opening		3,90,000
	- Closing		5,07,000
Raw Materials	- Purchases		12,10,000
	- Opening		3,02,000
	- Closing		3,10,000
	- Returned		18,000
	- Indirect material		16,000
Wages	- direct		2,10,000
	- indirect		48,000
Direct expenses	- Royalty on production		1,30,000
	- Repairs and maintenance		2,30,000
	- Depreciation on factory shed		40,000
	- Depreciation on plant & machinery		60,000
By-product at selling price			20,000

You are required to prepare Manufacturing Account of Mr. Pankaj for the year ended on 31.3.2022.

2. Following are the Manufacturing A/c, Creditors A/c and Trading A/c provided by Ms. Shivi related to 2021-22. There are certain figures missing from these accounts.

Raw Material A/c

Date	Particulars	Amount ₹	Date	Particulars	Amount ₹
	To Opening Stock A/c	1,00,000		By Raw Material Consumed	
	To Creditors A/c			By Closing Stock A/c	

Creditors A/c

Date	Particulars	Amount ₹	Date	Particulars	Amount ₹
	To Bank A/c	22,00,000		By Balance b/d	15,00,000
	To Balance c/d	6,00,000			

Manufacturing A/c

Particulars	Amount ₹	Particulars	Amount ₹
To Raw Material Consumed		By Trading A/c	17,94,000
To Wages	3,50,000		
To Depreciation	2,00,000		
To Direct Expenses	2,44,000		

Additional Information:

- 1) Purchase of machinery worth ₹ 10,00,000 has been omitted. Machinery are chargeable at a depreciation rate of 10%.
- 2) Wages include the following
 - Paid to Factory Workers - ₹ 3,00,000
 - Paid to labour at office - ₹ 50,000
- 3) Direct Expenses include following:
 - ♦ Electricity charges of ₹ 80,000 of which 30% pertained to office.
 - ♦ Fuel Charges of ₹ 20,000
 - ♦ Freight Inwards of ₹ 35,000
 - ♦ Delivery charges to customers - ₹ 20,000.

You are required to prepare revised Manufacturing A/c, and Raw Material A/c.

3. The following is the trial balance of Mr. Pandit for the year ended 31st March, 2022:

Trial Balance as on 31st March 2022

Particulars	Dr. ₹	Particulars	Cr. ₹
Opening Stock:			
Raw Materials	1,50,000	Sundry Creditors	50,000
Finished goods	75,000	Purchase Returns	5,000
Purchase of Raw Materials	5,00,000	Capital	1,00,000
Land & Building	1,00,000	Bills Payable	24,000
Loose tools	30,000	Long-Term Loan	2,00,000
Plant & Machinery	30,000	Provision for Bad and Doubtful Debts	2,000
Investments	25,000	Sales	8,50,000
Cash in Hand	20,000	Bank Overdraft	23,000
Cash at Bank	5,000		
Furniture & Fixtures	15,000		
Bills Receivable	15,000		
Sundry Debtors	40,000		
Drawings	20,000		
Salaries	20,000		
Coal and Fuel	15,000		
Factory rent & rates	20,000		
General Expenses	4,000		
Advertisement	5,000		
Sales Return	10,000		
Bad Debts	4,000		
Direct Wages (Factory)	80,000		
Power	30,000		
Interest Paid	7,000		
Discount Allowed	3,000		

Carriage Inwards	15,000		
Carriage Outwards	7,000		
Commission Paid	9,000		
	12,54,000		12,54,000

Additional Information

Stock of finished goods at the end of the year ₹1,00,000.

A provision for doubtful debts is to be created. at 5% on Sundry Debtors. Depreciation on building ₹ 1,000 and ₹ 3,000 on Plant & Machinery to be provided.

Accrued commission of ₹ 12,500 is to be received for the year. Interest has accrued on investment ₹ 15,000.

Salary Outstanding ₹ 2,000 and Prepaid Interest ₹ 1,500.

You are required to prepare Manufacturing, Trading and Profit and Loss Account for the year ended 31st March, 2022.

ANSWERS/HINTS

True and False

1. False: By-products generally have insignificant value as compared to the value of main product. Therefore, they are generally valued at net realizable value.
2. False: The objective of preparing Manufacturing Account is to determine manufacturing costs of finished goods for assessing the cost effectiveness of manufacturing activities.
3. True: Manufacturing account deals with the raw material and work in progress.
4. True: Raw Material consumed is arrived at after adjustment of opening and closing inventory of raw materials and purchases.
5. False: The Trading Account will show the quantities of finished goods manufactured and sold and the opening and closing inventory. It will not show the quantity of raw materials or work-in-progress.
6. False: Overhead is defined as total cost of indirect material, indirect wages and indirect expenses.

7. False: Manufacturing A/c is prepared by the entities engaged in manufacturing activities.

Multiple Choice Questions

1.	(c)	2.	(b)	3.	(d)	4.	(a)	5.	(d)		

Theoretical Questions

- By-products generally have insignificant value as compared to the value of main product. They are **generally valued at net realisable value**, if their costs cannot be separately identified. It is often treated, as "Miscellaneous income" but the correct treatment would be to credit the sale value of the by-product to Manufacturing Account so as to reduce to that extent, the cost of manufacture of main product.
- Direct manufacturing expenses** are costs, other than material or wages, which are incurred for a specific product or saleable service.

Indirect Manufacturing expenses are also called Manufacturing overhead, Production overhead, Works overhead, etc. Overhead is defined as total cost of indirect material, indirect wages and indirect expenses.

For detail, refer para 2.3

Practical Problems

1. **In the Books of Mr. Pankaj**

Manufacturing Account for the year ended on March 31,2022

Particulars		Amount	Particulars	Amount
	₹	₹		₹
To Opening W.I.P.		3,90,000	By Closing W-I-P	5,07,000
To Raw Material Consumed:			By by products	20,000
Opening inventory	3,02,000		By Trading A/c-	17,81,000
Purchases	12,10,000		Cost of finished	
	15,12,000		goods transferred	
Less: Return	(18,000)			
	14,94,000			

PREPARATIONS OF FINAL ACCOUNTS OF SOLE PROPRIETORS

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Less: Closing inventory	(3,10,000)	11,84,000		
To Direct Wages		2,10,000		
To Direct expenses:				
Royalty		1,30,000		
To Manufacturing Overhead:				
Indirect Material	16,000			
Indirect Wages	48,000			
Repairs & Maintenance	2,30,000			
Depreciation on Factory Shed	40,000			
Depreciation on Plant & Machinery	60,000	3,94,000		
		23,08,000		23,08,000

2. **Manufacturing A/c**

Particulars	Amount ₹	Particulars	Amount ₹
To Raw Material Consumed (Balancing Figure)	10,00,000	By Trading A/c (W.N. 4)	18,00,000
To Wages (W.N. 2)	3,00,000		
To Depreciation (W.N. 1)	3,00,000		
To Direct Expenses (W.N. 3)	2,00,000		
	18,00,000		18,00,000

Raw Material A/c

Date	Particulars	Amount ₹	Date	Particulars	Amount ₹
	To Opening Stock A/c	1,00,000		By Raw Material Consumed (from Trading A/c above)	10,00,000

To Creditors A/c (W.N. 5)	13,00,000	By Closing Stock A/c (Balancing Figure)	4,00,000
	14,00,000		14,00,000

Working Notes:

- 1) Since purchase of Machinery worth ₹ 10,00,000 has been omitted.
So, depreciation omitted from being charged = ₹ 10,00,000 X 10%
= ₹ 1,00,000
Correct total depreciation expense = ₹ (2,00,000 + 1,00,000)
= ₹ 3,00,000
- 2) Wages worth ₹ 50,000 will be excluded from manufacturing account as they pertain to office and hence will be charged P&L A/c.
- 3) Expenses to be excluded from direct expenses:
- | | |
|--|---------------|
| Office Electricity Charges (80,000 X 30%) | 24,000 |
| Delivery Charges to Customers | <u>20,000</u> |
| Total expenses not part of Direct Expenses | <u>44,000</u> |
- => Revised Direct Expenses = ₹ (2,44,000 - 44,000) = ₹ 2,00,000
- Fuel charges are related to factory expenses and also freight inwards are incurred for bringing goods to factory/ godown so they are part of direct expenses.

4) Revised Balance to be transferred to Trading A/c:

Particulars	Amount ₹
Current Balance transferred	17,94,000
Add: Depreciation charges not recorded earlier	1,00,000
Less: Wages related to Office	(50,000)
Less: Office Expenses	(44,000)
Revised balance to be transferred	18,00,000

5) Creditors A/c

Date	Particulars	Amount ₹	Date	Particulars	Amount ₹
	To Bank A/c	22,00,000		By Balance b/d	15,00,000
	To Balance c/d	6,00,000		By Raw Materials A/c (Bal. figure)	13,00,000
		28,00,000			28,00,000

3. In the books of Mr. Pandit

Manufacturing Account for the year ended 31st March, 2022

Particulars		₹	Particulars	₹
To Opening Stock of Raw Materials		1,50,000	By Cost of Manufactured goods transferred to Trading A/c	8,08,000
To Purchase	5,00,000			
Less: Purchase Return	5,000	4,95,000		
To Carriage Inwards		15,000		
To Direct Wages		80,000		
To Power		30,000		
To Coal and fuel		15,000		
To Factory Rent and Rates		20,000		
To Depreciation on Machinery		3,000		
		8,08,000		8,08,000

Trading Account for the year ended 31st March, 2022

Particulars	₹	Particulars	₹
To Opening Stock of finished goods	75,000	By Sales	8,50,000
To Cost of goods transferred from Manufacturing A/c	8,08,000	Less: Sales Return	<u>10,000</u>
To Gross Profit c/d	57,000	By Closing Stock	1,00,000
	9,40,000		9,40,000

Profit and Loss Account for the year ended 31st March 2022

Particulars		₹	Particulars	₹
To Carriage Outward		7,000	By Gross Profit b/d	57,000
To Discount Allowed		3,000	By Accrued Commission	12,500
To Commission Paid		9,000	By Accrued Interest	15,000
To General Expenses		4,000		
To Advertisement		5,000		
To Salaries	20,000			
Add: Outstanding	2,000	22,000		
To Interest Paid	7,000			
Less: Prepaid	1,500	5,500		
To Provision for Bad & Doubtful Debts	2,000			
Add: Bad Debts	4,000			
Less: Old Provision for Doubtful Debts	2,000	4,000		
To Depreciation on Building		1,000		
To Net Profit c/d		24,000		
		84,500		84,500

Balance Sheet as at 31st March, 2022

Capital and Liabilities		₹	Assets		₹
Capital	1,00,000		Plant & Machinery	30,000	
Add: Net Profit	24,000		Less: Depreciation	3,000	27,000
	1,24,000		Land & Building	1,00,000	
Less: Drawings	20,000	1,04,000	Less: Depreciation	1,000	99,000
Bills Payable		24,000	Furniture & Fixtures		15,000
Sundry Creditors		50,000	Investments		25,000
Salary Outstanding		2,000	Closing Stock		1,00,000
Long-Term Loans		2,00,000	Loose Tools		30,000

**PREPARATIONS OF FINAL ACCOUNTS OF
SOLE PROPRIETORS**

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Bank Overdraft		23,000	Sundry Debtors	40,000	
			<i>Less: Provision for Bad & Doubtful Debts</i>	2,000	38,000
			Bills Receivable		15,000
			Accrued Commission		12,500
			Accrued Interest		15,000
			Prepaid Interest		1,500
			Cash in Hand		20,000
			Cash at Bank		5,000
		4,03,000			4,03,000

NOTES

[illegible]

ANNEXURE-I

FORMATS OF FINANCIAL STATEMENTS FOR NON-CORPORATE ENTITIES

PART I – Form of BALANCE SHEET

Name of the Non-Corporate Entity.....

Balance Sheet as at

(Rupees in.....)

	Particulars	Note No	Figures as at the end of (Current reporting period) (in Rs.) _____ (DD/MM/YYYY)	Figures as at the end of (Previous reporting period) (in Rs.) _____ (DD/MM/YYYY)
	1	2	3	4
I.	EQUITY AND LIABILITIES			
	(1) Owners' Fund			
	(a) Owners Capital Account			
	(b) Reserves and surplus			
(2)	Non-current liabilities			
	(a) Long-term borrowings			
	(b) Deferred tax liabilities (Net)			
	(c) Other Long term liabilities			
	(d) Long-term provisions			
(3)	Current liabilities			
	(a) Short-term borrowings			
	(b) Trade payables:-			
	(A) total outstanding dues of micro, small and medium enterprises and			
	(B) total outstanding dues of creditors other than micro, small and medium enterprises.			

	(c) Other current liabilities			
	(d) Short-term provisions			
	TOTAL			
II.	ASSETS			
(1)	Non-Current Assets			
	(a) Property, Plant and Equipment and Intangible assets			
	(i) Property, Plant and Equipment			
	(ii) Intangible assets			
	(iii) Capital work-in-progress			
	(iv) Intangible assets under development			
	(b) Non-current investment			
	(c) Deferred tax assets (net)			
	(d) Long-term loans and advances			
	(e) Other non-current assets			
(2)	Current assets			
	(a) Current investments			
	(b) Inventories			
	(c) Trade receivables			
	(d) Cash and bank balances			
	(e) Short-term loans and advances			
	(f) Other current assets			
	TOTAL			

See accompanying notes which form part of the financial statements

Notes

GENERAL INSTRUCTIONS FOR PREPARATION OF BALANCE SHEET

1. An asset shall be classified as current when it satisfies any of the following criteria:
 - (a) it is expected to be realized in, or is intended for sale or consumption in, the company's normal operating cycle;
 - (b) it is held primarily for the purpose of being traded;
 - (c) it is expected to be realized within twelve months after the reporting date; or
 - (d) it is cash or cash equivalent unless it is restricted from being exchanged or used to settle a liability for at least twelve months after the reporting date.

All other assets shall be classified as non-current.

2. An operating cycle is the time between the acquisition of assets for processing and their realization in cash or cash equivalents. Where the normal operating cycle cannot be identified, it is assumed to have a duration of 12 months.
3. A liability shall be classified as current when it satisfies any of the following criteria:
 - (a) it is expected to be settled in the company's normal operating cycle;
 - (b) it is held primarily for the purpose of being traded;
 - (c) it is due to be settled within twelve months after the reporting date; or
 - (d) the Non-Corporate entity does not have an unconditional right to defer settlement of the liability for at least twelve months after the reporting date. Terms of a liability that could, at the option of the counterparty, result in its settlement by the issue of equity instruments do not affect its classification.

All other liabilities shall be classified as non-current.

4. A receivable shall be classified as a 'trade receivable' if it is in respect of the amount due on account of goods sold or services rendered in the normal course of business.
5. A payable shall be classified as a 'trade payable' if it is in respect of the amount due on account of goods purchased or services received in the normal course of business.
6. A Non-Corporate entity may disclose the following in the Notes to Accounts:

A. Owners Funds

For each owner following items for the year to be disclosed separately:

- (a) opening balance;
- (b) capital Introduced/Contributed during the year;

- (c) remuneration for the year;
- (d) interest for the year;
- (e) withdrawals during the year;
- (f) share of profit or loss for the year (share in % and amount);
- (g) closing balance.

B. Reserves and Surplus

- (i) Reserves and Surplus may be classified as:
 - (a) Capital Reserves;
 - (b) Revaluation Reserve;
 - (c) Other Reserves – (specify the nature and purpose of each reserve and the amount in respect thereof);
 - (d) Undistributed Surplus i.e. balance in Statement of Profit and Loss.
- (ii) Debit balance of statement of profit and loss shall be shown as a negative figure under the head 'Undistributed Surplus'. Similarly, the balance of 'Reserves and Surplus', after adjusting negative balance of surplus, if any, shall be shown under the head 'Reserves and Surplus' even if the resulting figure is in the negative.

C. Long-Term Borrowings

- (i) Long-term borrowings may be classified as:
 - (a) Term loans
 - From banks
 - From other parties
 - (c) Deferred payment liabilities.
 - (d) Loans and advances from related parties.
 - (e) Long term maturities of finance lease obligations
 - (f) Other loans and advances (specify nature).
- (ii) Borrowings may further be sub-classified as secured and unsecured. Nature of security shall be specified separately in each case.

- (iii) Where loans have been guaranteed by partners/proprietor/owners or others, the aggregate amount of such loans under each head shall be disclosed.
- (iv) Terms of repayment of term loans and other loans may be stated.

D. Long-term provisions

The amounts may be classified as:

- (a) Provision for employee benefits.
- (b) Others (specify nature).

E. Short-term borrowings

- (i) Short-term borrowings may be classified as:
 - (a) Loans repayable on demand
 - From banks
 - From other parties
 - (b) Loans and advances from related parties.
 - (b) Other loans and advances (specify nature).
- (ii) Borrowings may further be sub-classified as secured and unsecured. Nature of security shall be specified separately in each case.
- (iii) Where loans have been guaranteed by partners/proprietor/ owners or others, the aggregate amount of such loans under each head shall be disclosed.
- (iv) current maturities of Long term borrowings may be disclosed separately.

F. Trade Payables

The following details relating to Micro, Small and Medium Enterprises shall be disclosed in the notes:-

- (a) the principal amount and the interest due thereon (to be shown separately) remaining unpaid to any supplier at the end of each accounting year;
- (b) the amount of interest paid by the buyer in terms of section 16 of the Micro, Small and Medium Enterprises Development Act, 2006, along with the amount of the payment made to the supplier beyond the appointed day during each accounting year;

- (c) the amount of interest due and payable for the period of delay in making payment (which have been paid but beyond the appointed day during the year) but without adding the interest specified under the Micro, Small and Medium Enterprises Development Act, 2006;
- (d) the amount of interest accrued and remaining unpaid at the end of each accounting year; and
- (e) the amount of further interest remaining due and payable even in the succeeding years, until such date when the interest dues above are actually paid to the small enterprise, for the purpose of disallowance of a deductible expenditure under section 23 of the Micro, Small and Medium Enterprises Development Act, 2006.

Explanation.-The terms 'appointed day', 'buyer', 'enterprise', 'micro enterprise', 'small enterprise' and 'supplier', shall have the same meaning assigned to those under clauses (b), (d), (e), (h), (m) and (n) respectively of section 2 of the Micro, Small and Medium Enterprises Development Act, 2006.

G. Other current liabilities

The amounts may be classified as:

- (a) Current maturities of finance lease obligations;
- (b) Interest accrued but not due on borrowings;
- (c) Interest accrued and due on borrowings;
- (d) Income received in advance;
- (e) Other payables (specify nature);

H. Short-term provisions

The amounts may be classified as:

- (a) Provision for employee benefits.
- (b) Others (specify nature).

I. Property, Plant and Equipment

- (i) Classification may be given as:
 - (a) Land.
 - (b) Buildings.
 - (c) Plant and Equipment.

- (d) Furniture and Fixtures.
 - (e) Vehicles.
 - (f) Office equipment.
 - (g) Others (specify nature).
- (ii) Assets under lease may be separately specified under each class of asset.
- (iii) A reconciliation of the gross and net carrying amounts of each class of assets at the beginning and end of the reporting period showing additions, disposals acquisitions through business combinations, amount of change due to revaluation (if change is 10% or more in the aggregate of the net carrying value of each class of Property, Plant and Equipment) and other adjustments and the related depreciation and impairment losses/reversals shall be disclosed separately.

J. Intangible assets

- (i) Classification may be given as:
- (a) Goodwill.
 - (b) Brands /trademarks.
 - (c) Computer software.
 - (d) Mastheads and publishing titles.
 - (e) Mining rights.
 - (f) Copyrights, and patents and other intellectual property rights, services and operating rights.
 - (g) Recipes, formulae, models, designs and prototypes.
 - (h) Licenses and franchise.
 - (i) Others (specify nature).
- (ii) A reconciliation of the gross and net carrying amounts of each class of assets at the beginning and end of the reporting period showing additions, disposals, acquisitions through business combinations, amount of change due to revaluation (if change is 10% or more in the aggregate of the net carrying value of each class of intangible assets) and other adjustments and the related amortisation and impairment losses or reversals shall be disclosed separately.

K. Non-current investments

- (i) Non-current investments shall be classified as trade investments and other investments and further classified as:
 - (a) Investment property;
 - (b) Investments in Equity Instruments;
 - (c) Investments in preference shares;
 - (d) Investments in Government or trust securities;
 - (e) Investments in debentures or bonds;
 - (f) Investments in Mutual Funds;
 - (g) Investments in partnership firms;
 - (h) Other non-current investments (specify nature)

Under each classification, details may be given of names of the entities (indicating separately whether such entities are joint ventures or controlled special purpose entities) in whom investments have been made (showing separately investments which are partly-paid). In regard to investments in the capital of partnership firms, the names of the firms (with the names of all their partners, total capital and the shares of each partner) may be given.

- (ii) Investments carried at other than at cost should be separately stated specifying the basis for valuation thereof.
- (iii) The following shall also be disclosed:
 - (a) Aggregate amount of quoted investments and market value thereof;
 - (b) Aggregate amount of unquoted investments;
 - (c) Aggregate provision for diminution in value of investments.

L. Long-term loans and advances

- (i) Long-term loans and advances may be classified as:
 - (a) Capital Advances;
 - (b) Loans and advances to related parties (giving details thereof);
 - (c) Other loans and advances (specify nature).

- (ii) The above may also be separately sub-classified as:
 - (a) Secured, considered good;
 - (b) Unsecured, considered good;
 - (c) Doubtful.
- (iii) Allowance for bad and doubtful loans and advances shall be disclosed separately.

M. Other non-current assets

Other non-current assets may be classified as:

- (i) Security Deposits;
- (ii) Bank deposits with more than 12 months maturity;
- (ii) Others (specify nature).

N. Current Investments

- (i) Current investments shall be classified as:
 - (a) Investments in Equity Instruments;
 - (b) Investment in Preference Shares;
 - (c) Investments in government or trust securities;
 - (d) Investments in debentures or bonds;
 - (e) Investments in Mutual Funds;
 - (f) Investments in partnership firms;
 - (g) Other investments (specify nature).

Under each classification, details may be given of names of the entities (indicating separately whether such entities are joint ventures or controlled special purpose entities) in whom investments have been made (showing separately investments which are partly-paid). In regard to investments in the capital of partnership firms, the names of the firms (with the names of all their partners, total capital and the shares of each partner) may be given.

- (ii) The following shall also be disclosed:
 - (a) The basis of valuation of individual investments;

- (b) Aggregate amount of quoted investments and market value thereof;
- (c) Aggregate amount of unquoted investments;
- (d) Aggregate provision made for diminution in value of investments.

O. Inventories

- (i) Inventories shall be classified as:
 - (a) Raw materials;
 - (b) Work-in-progress;
 - (c) Finished goods;
 - (d) Stock-in-trade (in respect of goods acquired for trading);
 - (e) Stores and spares;
 - (f) Loose tools;
 - (g) Others (specify nature).
- (ii) Goods-in-transit may be disclosed under the relevant sub-head of inventories.
- (iii) Mode of valuation may be stated.

P. Trade Receivables

- (i) Aggregate amount of trade receivables outstanding for a period exceeding six months from the date they are due for receipt may be stated separately.
- (ii) Trade receivables may be sub-classified as:
 - (a) Secured, considered good;
 - (b) Unsecured considered good;
 - (c) Doubtful.
- (iii) Allowance for bad and doubtful debts shall be disclosed separately.

Q. Cash and bank balances

- (i) Cash and cash equivalents shall be classified as:
 - (a) Balances with banks;
 - (b) Cheques, drafts on hand;

- (c) Cash on hand;
 - (d) Others (specify nature).
- (ii) Other bank balances shall be classified as
 - (a) Bank Deposits - Earmarked balances with banks.
 - (b) Margin money or deposits under lien shall be disclosed separately.
 - (c) Bank deposits with original maturity for more than 3 months but less than 12 months from reporting date.
 - (d) others (specify nature)

R. Short-term loans and advances

- (i) Short-term loans and advances may be classified as:
 - (a) Loans and advances to related parties (giving details thereof);
 - (b) Others (specify nature).
- (ii) The above may also be sub-classified as:
 - (a) Secured, considered good;
 - (b) Unsecured, considered good;
 - (c) Doubtful.
- (iii) Allowance for bad and doubtful loans and advances may be disclosed under the relevant heads separately.

S. Other current assets (specify nature).

This is an all-inclusive heading, which incorporates current assets that do not fit into any other asset categories.

T. Contingent liabilities (to the extent not provided for)

- (i) Contingent liabilities may be classified as:
 - (a) Claims against the non-corporate entity not acknowledged as debt;
 - (b) Guarantees;
 - (c) Other money for which the non-corporate entity is contingently liable.

PART II – Form of STATEMENT OF PROFIT AND LOSS

Name of the Non-Corporate Entity.....

Statement of Profit and Loss for the year ended

(Rupees in.....)

	Particulars	Note	Figures for the current reporting period (in) From _____ (DD/MM/YYYY) To _____ (DD/MM/YYYY)	Figures for the previous reporting period (in) From _____ (DD/MM/YYYY) To _____ (DD/MM/YYYY)
	1	2	3	4
I.	Revenue from operations		xxx	xxx
II.	Other income		xxx	xxx
III.	Total Income (I + II)		xxx	xxx
IV.	Expenses			
(a)	Cost of Goods Sold			
(b)	Employee benefits expense		xxx	xxx
(c)	Depreciation and amortization expense		xxx	xxx
(d)	Finance Cost		xxx	xxx
(e)	Other expenses		xxx	xxx
	Total expenses		xxx	xxx
V	Profit before exceptional and extraordinary items		xxx	xxx
	and tax (III-IV)			
VI	Exceptional items		xxx	xxx
VII	Profit before extraordinary items and tax (V - VI)		xxx	xxx
VIII	Extraordinary Items		xxx	xxx

IX	Profit before tax (VII- VIII)		xxx	xxx
X	Tax expense:			
(i)	Current tax		xxx	xxx
(ii)	Deferred tax		xxx	xxx
XI	Profit (Loss) for the period from continuing operations (IX-X)		xxx	xxx
XII	Profit/(loss) from discontinuing operations		xxx	xxx
XIII	Tax expense of discontinuing operations		xxx	xxx
XIV	Profit/(loss) from Discontinuing operations (after tax) (XII-XIII)		xxx	xxx
XV	Profit/ (Loss) (XI + XIV)		xxx	xxx

See accompanying notes which form part of the financial statements

GENERAL INSTRUCTIONS FOR PREPARATION OF STATEMENT OF PROFIT AND LOSS

1. The provisions of this Part may be applied to the income and expenditure account in like manner as they apply to a statement of profit and loss.
2. **(A)** Revenue from operations may disclose separately in the notes revenue from—
 - (a) Sale of products;
 - (b) Sale of services;
 - (c) Grants or donations received;
 - (d) Other operating revenues;
 - (e) Less: Excise duty**(B)** In respect of a finance Non-Corporate entity, revenue from operations may include revenue from—
 - (a) Interest; and
 - (b) Other financial services.
3. **Cost of Goods Sold**
Costs of Goods Sold shall be classified as:
 - (a) Cost of materials consumed;
 - (b) Purchases of Stock-in-Trade;
 - (c) Changes in inventories of finished goods;
 - (d) Work-in-progress and Stock-in-Trade.
4. **Finance Costs**
Finance costs may be classified as:
 - (a) Interest expense;
 - (b) Other borrowing costs;
 - (c) Applicable net gain/loss on foreign currency transactions and translation.
5. **Other income**
Other income shall be classified as:
 - (a) Interest Income;
 - (b) Dividend Income;
 - (c) Net gain/loss on sale of investments;

- (d) Other non-operating income (net of expenses directly attributable to such income).
- 6.** Following may be disclosed by way of notes regarding aggregate expenditure and income on the following items:—
- (i)**
 - (a) Employee Benefits Expense showing separately (i) salaries and wages, (ii) Contribution to provident and other funds, (iii) staff welfare expenses;
 - (b) Any item of income or expenditure which exceeds one per cent of the revenue from operations or Rs.1,00,000 whichever is higher;
 - (c) Adjustments to the carrying amount of investments;
 - (d) Net gain or loss on foreign currency transaction and translation (other than considered as finance cost);
 - (e) Details of items of exceptional and extraordinary nature;
 - (f) Prior period items.
 - (ii)** Expenditure incurred on each of the following items, separately for each item:—
 - (a) Consumption of stores and spare parts;
 - (b) Power and fuel;
 - (c) Rent;
 - (d) Repairs to buildings;
 - (e) Repairs to machinery;
 - (f) Insurance;
 - (g) Rates and taxes, excluding, taxes on income;
 - (h) Miscellaneous expenses.

NOTES

[illegible]

