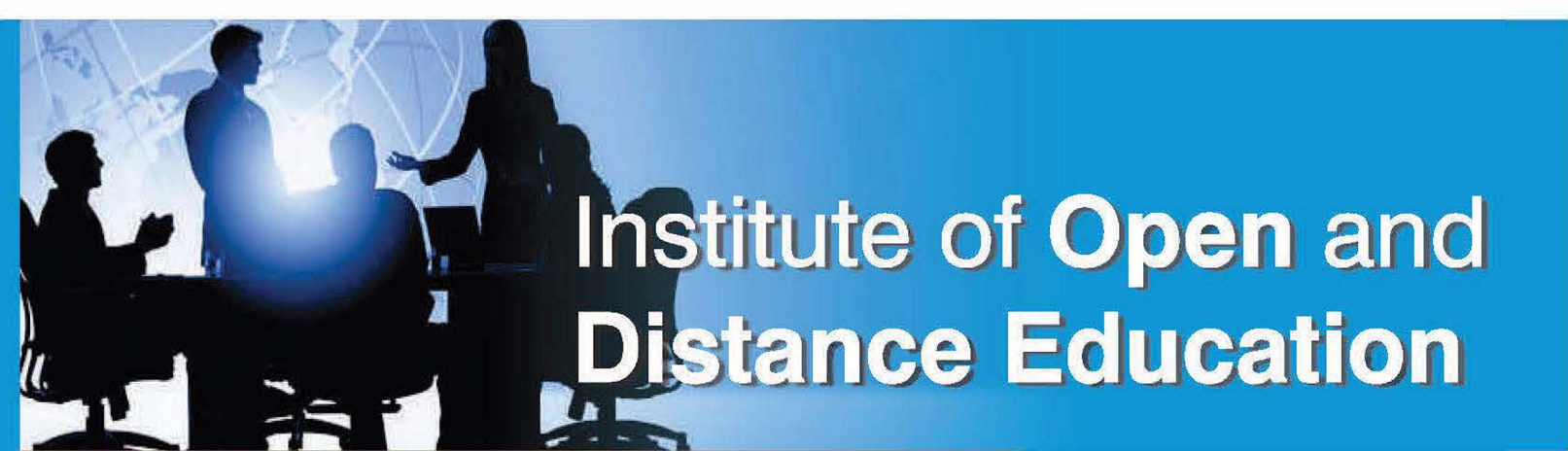




Introduction to Accountancy



# Institute of Open and Distance Education

Faculty of Management

## Introduction to Accountancy



2BBA4



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**Chhattisgarh, Bilaspur**

A STATUTORY UNIVERSITY UNDER SECTION 2(F) OF THE UGC ACT

**2BBA4**

**Introduction to Accountancy**



## Introduction to Accountancy

**Credit 4**

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## BLOCK – I

**The Unit Covers :**

- 1.1 INTRODUCTION
- 1.2 NEED FOR ACCOUNTING
- 1.3 MEANING OF ACCOUNTING
- 1.4 FEATURES OF ACCOUNTING
- 1.5 ACCOUNTING CYCLE OR PROCESS
- 1.6 OBJECTIVES OF ACCOUNTING
- 1.7 ACCOUNTING INFORMATION
- 1.8 ADVANTAGES OF ACCOUNTING
- 1.9 LIMITATION OF ACCOUNTING
- 1.10 ACCOUNTING AS AN INFORMATION SYSTEM
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## INTRODUCTION

A businessman carries out many transactions in his day-to-day activities. He may make a number of sales or purchases of a number of items during the year. All these transactions are needed to be recorded down lest the businessman may forget when a specific item was bought or sold. He may give out goods on credit to his customers and he may not remember all of them. Thus he must put down the transaction in a recorded form. That is why keeping of accounts in a business is important.



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Accounting becomes mandatory when you run a business. It plays an important role in keeping your business organized especially financially and you become aware of each bit and byte of your business progress. This lets you know if your business is going upward or downward.

This chapter serves you an elementary information on what this means, why it is required and how it is done.

## 1.2 NEED FOR ACCOUNTING

Accounting is considered to be the language of business. Accounting is as old as money itself. However, the act of accounting was not as developed as it is today, because in the early stage of civilization, business was very small, simple and manageable by only one person i.e. the owner himself.

In the recent years large-scale productions, developed methods of production, cut-throat competition and changes in the technology have brought remarkable changes in the field of accounting. Profit calculation now is no longer a simple comparison of financial values at the beginning and end of a transaction or a series of transactions.

It is very important for any person or a firm to spend money carefully. There are certain sources from which the firm receives money like sales of goods and interest from banks and in turn it has to spend money on payments, maintenance of the firm etc. It has to be seen that affairs are managed in such a way that the firm should earn more than it spends. If the expenses are more than a firm's income, it will have to meet its expenses from the amount invested in the firm by the owner. i.e. capital.

Suppose the owner invests Rs. 10,00,000 in the firm. He purchases 100 units of goods at the rate of Rs 10,000 per unit and he sells them for Rs. 9,500 per unit. This loss of Rs. 500 per unit which for 100 units becomes Rs. 50,000 will have to be met from the owner's capital. Owing to this loss the owner's capital will be reduced to Rs. 9,50,000. If this loss is incurred repetitively, a time will come when the firm will become insolvent. Insolvency is the condition when the firm does not have enough funds to meet its liabilities.

Therefore, a firm has to manage its affairs in such a way that it sells the goods for Rs. 10,500 per unit, thus incurring a profit of Rs. 50,000 which further increases the owner's capital to 10,50,000. Thus, it can be said that a profit increases the firm's capital and a loss reduces it.

If the proprietor of the firm is wise he will try to sell the goods at such a price as will enable the firm to not only meet all expenses from the profit but also keep some profit for development and expansion of business. Attempts should be made to keep expenses low and the sales should be kept sufficiently high so that expenses including maintenance of the firm are paid from the profit and the owner's capital remains invested and increase if possible.

Thus, every firm or institution should be very careful and vigilant about its financial position. The firm, at the end of each year, ascertains its earnings and financial position in terms of capital invested and assets of the business firm.

For providing such information, accounting came into existence. It provides information on earnings, expenses, assets, liabilities, debts etc.

### 1.3 MEANING OF ACCOUNTING

Every person, businessman or otherwise, concerned with money matters cannot fully rely upon his memory. The amount, volume and the duration of such money matters make it necessary to create a record of the different transaction during a period. A businessmen need such record for two purpose :-

1. ascertaining the working results of his business;
2. the increase in his net assets.

These purposes can be served by a systematic record of all monetary transactions, relating to his business. For other person also a record of the financial matters is necessary to quantity, the surplus of income over expenditure and of assets over liabilities. This systematic record is accounting.

**ACCOUNTING:** a detailed report of the financial state or transactions of a firm.

The theory and system of setting up, maintaining, and auditing the books of a firm; art of analyzing the financial position and operating results of a business house from a study of its sales, purchases, overhead, etc. is accounting.

It is not easy to provide a concise definition of accounting since the word has a broad application within businesses and applications.

It is said that accounting is the language of the business. So in order to understand the affairs of a firm financial statements should be very accurate.

In the words of the committee on terminology of the American Institute of Certified Public Accountants:

*"Accounting is the art of recording, classifying and summarising in terms of money transactions and events of financial character and interpreting the result thereof."*

— AICPA Committee

Accounting is a process-oriented task that follows a prescribed series of steps in order to keep track of, and record, the balances of the various accounts. Accounting is the method in which financial information is gathered, processed, and summarized into financial statements and reports.

When a business makes a transaction, the effect of that transaction is recorded in the accounting system. Accounting is the process of keeping track of the changes, which are brought out by the new transactions, recording and then reporting them.

#### Definition of Accounting

- "Nearly every business enterprise has accounting system. It is a means of collection summarising, analysing and reporting in monetary terms, and of informations about business." — R.N. Anthony



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- "Accounting is the science of recording and classifying business transactions and events, primarily of a financial character and the art of making significant summaries, analysis and interpretation of these transactions and events and communicating the results to persons who must make decisions or firm judgement."

— *Smith and Ashburne*

- "Accounting is a discipline which provides financial and other information essential to efficient conduct and evaluation of the activities of any organisations."

— *American Institute of Certified Public Accountants*

## 1.4 FEATURES OF ACCOUNTING

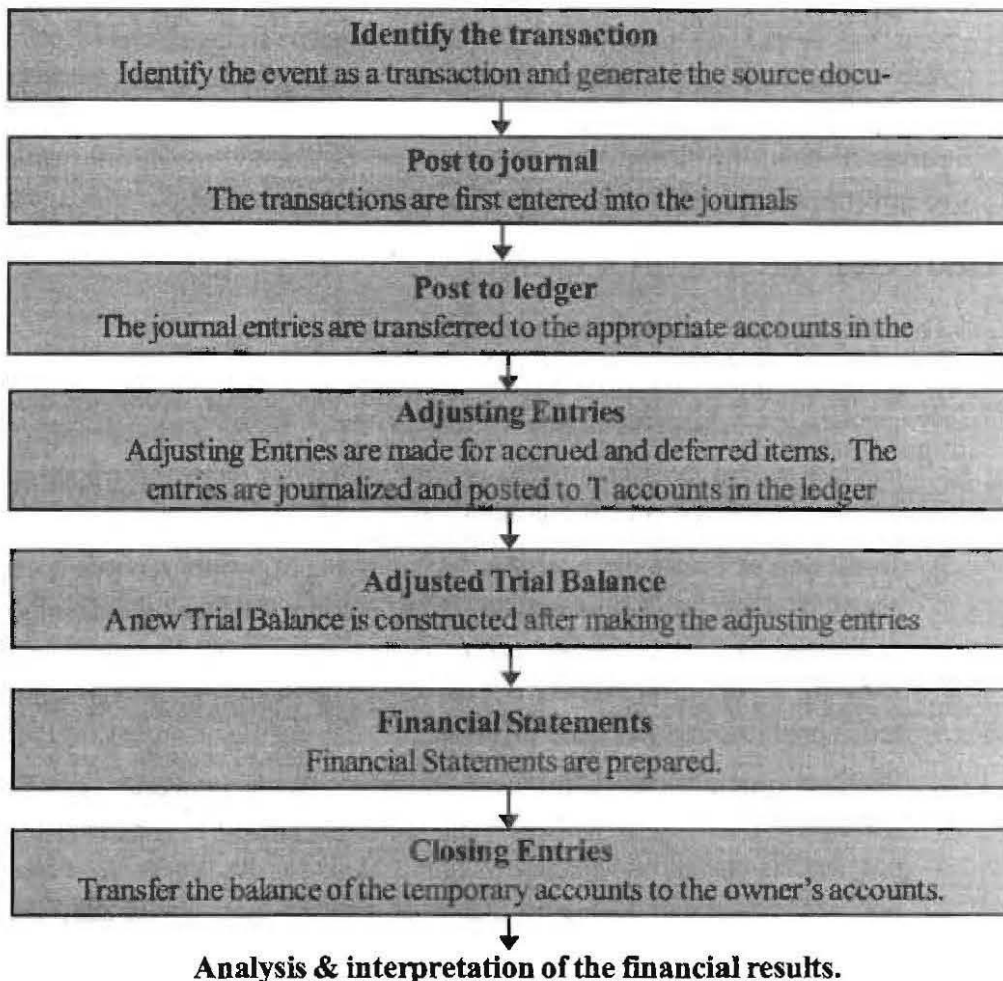
1. **...Accounting is the art...:** Accounting records transactions according to the size and nature of business and the type of transaction, thus it enables us to achieve the financial result by showing the best way of recording, classifying and summarising the business transactions. Thus, accounting is an art.
2. **It is the art of recording:** Accounting is an art of recording business transactions in the books of account in a systematic manner soon after their occurrence.
3. **It is the art of classifying:** it is the process of grouping transactions or entries of one nature at one place. Similar transactions relating to a particular account for a given period are brought together.
4. **Summarising business transactions:** It is the art of making the activities of the business as classified in the ledger understandable and useful to management and other interested parties.
5. **It records events of financial character:** Events which are of financial character will be recorded in terms of money. If a transaction has no financial character then it can not be measured in terms of money and will not be recorded.
6. **It records transactions in terms of money:** In order to make the transactions more meaningful they are expressed in terms of money. For example: if the business has 15 machines, 5 buildings etc., it is not possible to add them and use them for comparison or any other purpose unless they are expressed in terms of money.
7. **...and interpreting the result thereof...:** accounting creates data through recording, classifying and summarising events and then utilises the information for interpreting. The information so provided helps the management to judge performance of the business and for future planning. The result is then communicated to all the interested parties.

## 1.5 ACCOUNTING CYCLE OR PROCESS

The sequence of activities beginning with the occurrence of a transaction is known as the Accounting cycle or Accounting Process.

NOTES

### Steps in the Accounting cycle



### ACCOUNTING PROCESS

- Every accounting entry is based on a business transaction, which is usually evidenced by a business document, such as a check or a sales invoice.
- A *journal* is a book to record the transactions of a business. The typical journals used to record the chronological day-to-day transactions are sales and cash receipts journals and a cash disbursement journal. A general journal is used to record special entries at the end of an accounting period.
- While a journal records transactions as they happen, a ledger groups records of transactions according to their type, based on the accounts they affect. The general ledger is a collection of all balance sheets, income, and expense accounts used to keep a business's accounting records. At the end of an accounting period, all journal entries are summarized and transferred to the general ledger accounts. This procedure is called "*posting*."



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- A trial balance is prepared at the end of an accounting period by adding up all the account balances in general ledger. The sum of the debit balances should equal the sum of the credit balances. If total debits don't equal total credits, it respects error in process.
- Finally, financial statements are prepared from the information in trial balance.

Accounting records are important because the resulting financial statements and reports help in planning and making decisions. They may be used by some third parties (bankers, investors, or creditors) and are needed to provide information to government agencies, such as the Income Tax Department.

## 1.6 OBJECTIVES OF ACCOUNTING

The following are the main objectives of accounting:

1. **Maintaining Systematic Business Records.** Accounting enables business firms to maintain systematic records of all financial transactions. It includes proper recording of transactions, classifying them under appropriate accounts and summarising them into financial statements.
2. **Depiction of Financial position.** Maintenance of proper records is necessary to show firm's possessions and the amount the firm owes to others at the end of a particular period. A businessman would be interested in knowing at periodical intervals the net result of business operations i.e. how much profit or loss has been incurred.

Such information is useful for the management, lenders, investors etc. The management can know whether the policies adopted by it were fruitful or not, lenders can know whether the firm is likely to earn profits in future or not. Investors can decide on this basis whether they should keep their money invested in the firm.

3. **Availability of information to interested parties.** Apart from proprietors and owners various other parties are interested in the accounting information. These are creditors, tax authorities, potential customers, employees, etc. They want to assess the profitability and the financial soundness of the firm. They get this information from the annual reports and financial statements.
4. **Ascertainment of working results.** The working of business ultimately results into profit or loss. To measure the real working performance of an enterprise, profit and loss account must be prepared which help in ascertaining the current costs and current revenues during a particular accounting period. A systematic record of incomes and expenses facilitates the preparation of the income statements that reveals working results of the firm.
5. **Meeting legal requirements.** Yet another objective of accounting is to devise such a system as will meet the legal requirements. Accounting system aims at fulfilling the requirement of law.

## Subsidiary Objectives of Accounting

Accounting systems are designed mainly to provide information that managers and outsiders can use in decision making. Some of its subsidiary objects are as follows :

- (1) Accounting also server other purposes like producing operating documents, protecting the company's assets, to provide data for company tax returns, and, in some cases, providing the basis for reimbursement of costs by clients or customers.
- (2) The Accounting organization is responsible for preparing documents that contain instructions for a variety of tasks, such as payment of customer bills or preparing employee payrolls. It also must prepare documents that serve what might be called private information purposes, such as the employees' own records of their salaries and wages.
- (3) Accounting systems must provide means of reducing the chance of losses of assets due to carelessness or dishonesty on the part of employees, suppliers, and customers. Asset protection devices are often very simple; for example, many restaurants use numbered meal checks so that waiters will not be able to submit one check to the customer and another, with a lower total, to the cashier.
- (4) The accounting system must also provide data for use in the completion of the company's tax returns.
- (5) Accounting systems in some companies must provide cost data in the forms required for submission to customers who have agreed to reimburse the companies for the costs they have incurred on the customers' behalf.
- (6) Making decision concerning the use of limited resources including identification of crucial decision areas and determination of objectives & goals.
- (7) Effectively directing the controlling of an organisation's human and material resources.
- (8) Maintaining and reporting on the custodianship of resources.

### 1.7 ACCOUNTING INFORMATION

Accounting is the theory and system of setting up, maintaining, and auditing the books of a firm; an art of analyzing the financial position and operating results of a business house from a study of its sales, purchases, overhead, etc. and the systematic development and analysis of information about the economic affairs of an organization. This information may be used in a number of ways:- by the organization's managers to help them plan and control the organization's operations, by owners and legislative or regulatory bodies to help them appraise the organization's performance and make decisions as to its future; by owners, lenders, suppliers, employees and others to help them decide how much time or money to devote to the orga-

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nization; by governmental bodies to determine how much tax the organization must pay; and occasionally by customers to determine the price to be paid when contracts call for cost-based payments.

Accounting provides information for all these purposes through the maintenance of files of data, analysis and interpretation of these data, and the preparation of various kinds of reports. Most accounting information is historical that is, the accountant observes the things that the organization does, records their effects, and prepares reports summarizing what have been recorded; the rest consists of forecasts and plans for current and future periods.

Accounting information can be developed for any kind of organization, not just for privately owned, profit-seeking businesses.

Financial reporting should provide information that is:

- *useful to enable potential investors, creditors and other users to make rational investment, credit, and other financial decisions.*
- *helpful to enable potential investors, creditors and other users to assess the amounts, timing, and uncertainty of prospective cash receipts.*
- *about economic resources, the claims to those resources, and the changes in them.*

The accounting information expected by its users is provided through financial statements.

There are two main purposes of financial statements:

(1) **Information relating to profit.**

(2) **Information relating to financial position.**

1. **Information relating to profit.** Information about the profit earned or loss incurred as a result of operations during an accounting period is made available to the interested users. The income statement provides information about Gross Profit through Trading Account and about Profit through Profit and Loss Account. Gross Profit is the amount of difference between the sales revenue or the proceeds of goods sold and/or services rendered less the direct cost of goods sold and/or services rendered.

The Excise and the Sales Tax Department compute the taxes due to them on the basis of Trading Account.

Net Profit is the profit earned after allowing for all the expenses. In case the expenses are more than the revenue, it is net loss. A financial statement informs about the profit or loss suffered during an accounting period.

2. **Information relating to Financial Position.** It makes available the information about the financial wellbeing of the firm. The Position Statement provides the information about the assets owned by the firm, amounts receivable and the



cash and bank balance held by it. The information along with the Income Statement after further analysis helps the owner in determining the security of their investment. Similarly investors, lenders and creditors decide about investment, lending and making the credit available from this information.

## 1.8 ADVANTAGES OF ACCOUNTING

The advantages of accounting can be enumerated as follows:

1. *Maintenance of business records.* All financial transactions are recorded in a systematic manner in books of accounts. It is not possible to remember all the daily operations of business. The records provide the necessary information as and when required.
2. *Preparation of financial statements.* Records enable the preparation of financial statements to calculate profit or loss during a particular period and that of balance sheet to state the financial position of the business on a particular date.
3. *Assessment of results.* Profit of one year is compared with those of earlier years to know the significant facts about the changes.
4. *Decision making.* Management is faced at times with a number of problems requiring an appropriate decision. For making such decisions, only accounting can provide the relevant information.
5. *Evidence in courts.* Records of business transactions are treated as satisfactory evidence in the courts of law.
6. *Planning and controlling operations.* Planning of operations like sales, production, cash requirements for next accounting periods is achieved. Management is also interested in observing that the operations in the business are going on according to plan and all departments are spending within the specified limit.
7. *Provides information to interested groups.* Parties like owners, creditors, management, employees, government, consumers and creditors are interested in accounting information related to sales, profits, production, etc.
8. *Taxation problems.* In settlement of taxation matters, systematic records are of great help.
9. *Valuation of business.* Accounting records kept in a proper way enable a business unit to determine the purchase or sale price.
10. *Assistance to an Insolvent person.* An insolvent person is able to explain the past transactions if proper records are maintained.

### Attributes of Accounting Information

- **Relevant:** relevant information makes a difference in a decision. It also helps users make predictions about past, present and future events (it



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has predictive value). Relevant information helps users confirm or correct prior expectations (it has feedback value). It must also be available on time, that is before decisions are made.

- **Reliable:** reliable information is verifiable (when independent auditors using the same methods get similar results), neutral (free from bias), and demonstrate representational faithfulness (what really happened or existed).
- **Comparable:** information must be measured and reported in a similar manner for different enterprises (allows financial statements to be compared between different companies).
- **Consistent:** the same accounting methods should be applied from period to period and all changes in methods should be well explained and justified.
- **Understandability:** information must be presented in such a simple and logical manner that a person who has no knowledge of accounting can also understand it. This can be done by giving relevant explanatory notes to explain the information given in financial statements.

## 1.9 LIMITATION OF ACCOUNTING

The limitations of accounting may include :

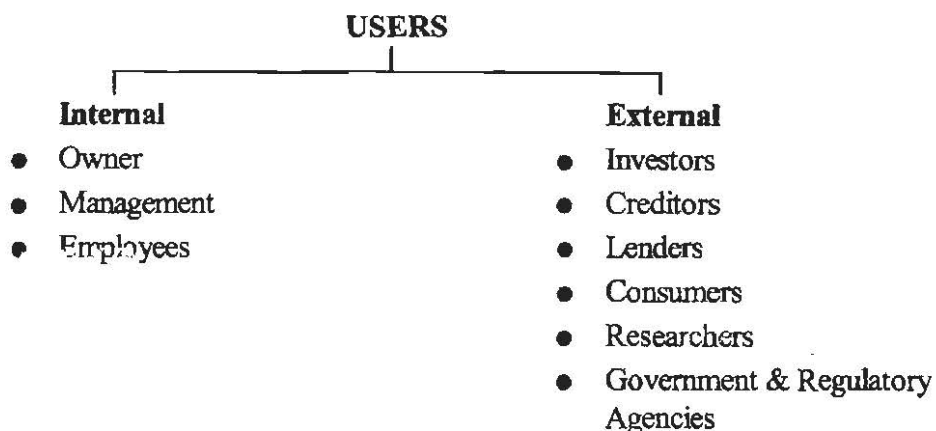
- (1) **Omission of Qualitative Information :** Accounts contain only the information which can be expressed in terms of money and thus non-monetary items are ignored. For example, changes in management, reputation of business, efficiency of management, satisfaction of firm's customer etc. cannot be recorded.
- (2) **Based on Historical Costs :** Accounts are prepared on the basis of historical (original) cost and thus the figures given in financial statements do not show the effect of changes in price level.
- (3) **Influenced by Personal Judgements :** Accounting is not an exact science and an accountant has to exercise his personal judgement in respect of various items, for example, selection of method of depreciation, valuation of stock, provision for doubtful debts etc. Hence, the figure of profit cannot be taken as an exact figure.
- (4) **Unrealistic :** Accounting information may not be realistic as accounting statements are prepared by following basic concepts and conventions, these are flexible in nature.

## 1.10 ACCOUNTING AS AN INFORMATION SYSTEM

Accounting provides useful information about the activities of an entity to various users for their use in making informed judgements and decisions. These users

use accounting information in order to satisfy some of their varied needs for information.

Following are some of the users :



1. **Owners :** Owners expect reasonable return on their funds and safety of their investment. Thus, they want to know about profitability and financial soundness of the business. They find out the profits/losses, costs of fixed and floating assets etc. from financial statements.
2. **Management :** Management needs to decide continuously what to do, how to do it and whether the actual results tally the original plans and targets. Accounting provides timely and useful information to management for planning, control, performance measurement, decision-making and for performing functions in the company. The accounting information provides "eyes and ears to the management".
3. **Employees :** Employees and their representative groups are interested in information about the stability and profitability of the employers. They are also interested in information which enables them to assess the ability of the enterprise to pay remuneration, retirement benefits and to provide employment opportunities.
4. **Investors :** Investors have invested their wealth in a business enterprise, so they are interested in knowing periodically about the profitability of the enterprise, soundness of their investment and growth prospects of the enterprise. They need information to judge the future prospects of their investment and to determine whether they should buy, hold or sell the shares.
5. **Creditors, Bankers and the Other Lending Institutions :** They want to be sure that the concern will not experience any difficulty in making their payment in time. It can be decided by calculating current and liquidity ratios and ascertaining short term solvency.
6. **Consumers :** Consumers want accounting information for finding out the possibility of reduction of cost and in return reduction in selling price. They

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use data in estimating the value of a warranty or in predicting the availability of the supporting services and supply of goods.

7. **Government and Regulatory Agencies** : Government and other agencies are interested in the allocation of resources and therefore the activities of enterprise. They also require information in order to regulate the activities of enterprise and to determine taxation policies and on the basis of these the national income and similar statistics.

## 1.11 BRANCHES OF ACCOUNTING

The main branches of accounting are :

- \* **Financial Accounting**
- \* **Social Responsibility Accounting**
- \* **Cost Accounting**
- \* **Tax Accounting**
- \* **Management Accounting**
- \* **Human Resource Accounting**

With increases in the scale of business operations and social awareness, management requires various types of information to perform its functions more efficiently. To meet the increasing requirement of management, various specialised branches of accounting have come into existence such as financial accounting, cost accounting, tax accounting etc. These branches are explained as under :

**Financial Accounting** : The accounting system that is concerned only with the financial state of affairs is called Financial Accounting. It includes ascertainment of profit earned or loss incurred and position of the business at the end of the accounting period. It also provides financial information required by the management and other parties interested in them.

**Cost Accounting** : The field of accounting that measures, classifies, and records costs. It is a systematic procedure for determining the unit cost of output produced or services rendered. The primary functions of cost accounting are ascertaining cost of a product and helping the management in the control of cost. Cost Accounting is that branch of accounting which deals with the classification, recording, allocation, summarization and reporting of current and prospective cost. A cost accountant, for example, might be required to establish a system for identifying and segmenting various production costs so as to assist a firm's management in making prudent operating decisions.

**Management Accounting** : Management accounting is the term used to describe the accounting methods, systems and techniques which, coupled with special knowledge and ability, assist management in its task of maximizing profit or minimising losses. Management accounting is the blend of financial accounting, cost accounting and all aspects of financial management.



**Tax Accounting :** The branch of accounting which is used for tax purpose is called Tax Accounting. Income tax and Sales tax are computed and recorded under this head of accounting.

**Social Responsibility Accounting :** Social responsibility accounting is the process of identifying, measuring and communicating the contribution of a business to the society. The contribution of a business to the society consists of providing employment to underprivileged, providing financial and man power support to public programmers, environmental contribution, product safety, product durability, customer satisfaction etc. For example, Nokia company changed BL5C batteries free for various mobile sets for safety of its customers.

**Human Resource Accounting :** It is a method of putting a value on human resources of business as a vital asset and showing it as part of or along with financial statements. However, there is no agreed and generally accepted methodology available so far.

## 1.12 BOOK- KEEPING Vs ACCOUNTING

Basis of Difference	Book-Keeping	Accounting
1. Definition	Book-keeping is an art of recording in books of accounts the monetary aspects of commercial or financial transactions.	Accounting is the art of recording, classifying and summarizing in terms of money transactions and events of financial character and interpreting the result there of.
2. Posting	Making posting in the ledger.	Examining the posting in order to ensure accuracy.
3. Nature of work	It is clerical.	It is analytical and needs skill.
4. Scope of work	It is limited up to an extent.	It is quite wide and involves preparation of final accounts and their analysis.
5. Dependence	It is an independent work.	It is dependent on Book-keeping.
6. Special knowledge	It does not require very high skill and knowledge.	It requires special skills and knowledge.
7. Status	Usually by junior employee.	Usually by senior officer.
8. Time of transaction	Made on the same day of transaction.	Done at the end of financial or calendar year.
9. Liability	Book-keeper is not liable for accountancy work.	Accountant is liable for work of book-keeper.
10. Adjustments & Rectification of error	Adjustment & rectification of errors are not part of Book-keeping.	Adjustment & rectification of errors are necessary for complete accounting. C
11. Total and balance	It includes ledger total and its balancing.	reate Trial balance from ledger balances.
12. Trading, P&L a/c & Balance-sheet	Do not include Financial statements.	Incomplete without Trading, P&L a/c and Balance-sheet



**1.13 IMPORTANT TERMS****NOTES**

1. **Business.** Any trade, manufacture or some work of enterprise which is meant to earn profit.
2. **Transaction.** The act of exchanging goods/services for a valuable consideration.
3. **Goods.** These are the commodities which are dealt in business transactions. They may be raw material, manufactured goods or services.
4. **Discount.** Discount is the amount deduction allowed by a businessman to increase the sale of a product. Discount is of two types :
  - (a) **Trade discount** – The discount allowed by a seller to its customers at a fixed percentage on the listed price of goods is termed as Trade discount.
  - (b) **Cash discount** – This discount is allowed to the debtors for making prompt payment within a fixed period
5. **Bad debts.** Person to whom goods have been sold on credit are known as 'Debtors'. Sometimes due to dishonesty, death or insolvency of a debtor, full or partial amount can not be recovered which is known as 'Bad debts'.
6. **Liability.** Those items that the concern business owes to the outside world are known as liability. Liabilities are debts and are amount owned to creditors. It can be expressed as :

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

Examples of liabilities are Loans, Creditors, Bills payable, Debentures etc. Liabilities may be classified into two parts :

- (i) **Long-term/fixed liabilities** – These refer to those liabilities which are due for payment in a relatively long period (normally after more than one year). For example : Debentures, Long term, loans etc.
  - (ii) **Current Liabilities** – These refer to those liabilities which are to be paid in near future (normally within one year). For example : Bills payable, Creditors, Bank Overdrafts, Outstanding expenses & short term loans etc.
7. **Assets.** Any thing which is in the possession or is the property of business enterprise including the amount due to it from others, is called an asset. In other words, anything which will enable a business enterprise to get cash or a benefit in future is an asset. For example : Building, Land, Furniture, Debtors, Goodwill etc. Assets can be classified in following category :
    - (a) **Fixed Asset** : The assets which are purchased for long-term use in business or production are known as fixed assets. Generally, such assets are not purchased for the purpose of sale. Such assets are not valued at market price. Example-Machinery, Land, Furniture etc.

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- (b) **Floating/Current/Active Assets** : Those assets which are meant for sale or which the management want to convert in cash within one year. Such assets are Debtors, Stock, Bill receivable etc.
- (c) **Wasting Assets** : Those assets which are consumed through being worked or used, such as mines. As soon as all the minerals have been extracted the mine becomes valueless. Other examples are Oil-wells, Patents, Trademarks, Leasehold properties etc.
- (d) **Nominal or Fictitious Asset** : The assets which are not material assets and carries no market value but are mentioned in the assets side of balance-sheet are known as fictitious assets. Examples- Goodwill, Prepaid expenses etc.
8. **Debtors**. A person who owes money to the firm generally on account of credit sales of goods is called a debtor. A debtor pays the price of goods he purchases in future. He is called a debtor because he owes the money to the firm.
9. **Stock**. The term 'stock' includes goods lying unsold on a particular date. To ascertain the value of closing stock, it is necessary to make a complete list of all the items in the store together with quantities. The stock may be opening and closing stock. The term 'opening stock' means goods lying unsold in the beginning of the accounting year whereas the term 'closing stock' includes goods lying unsold at the end of the accounting year.
10. **Receivables**. The amount that is receivable by the firm, other than the amount due from the debtors.
11. **Creditors**. A person to whom the firm owes money is called a creditor.
12. **Payables**. The term payables is used for the amount payable by the firm, other than the amount due to creditors.
13. **Losses**. Loss means something against which the firm receives no benefit like theft.
14. **Proprietor**. The person who makes the investment and bears all the risks connected with the business is called the proprietor.
15. **Drawings**. It is the amount of money or the value of goods which the proprietor takes for his domestic or personal use.
16. **Revenue**. Revenue means the amount which, as a result of operations, is added to the capital. Revenue is an inflow of assets which results in an increase in the owner's equity.
17. **Expense**. It is the 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.
18. **Income**. Income is the profit earned during a period of time. In other words the difference between revenue and expense is called income.

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19. **Gain.** It is the term used to describe profit of an irregular nature, for example capital gains.
20. **Purchases.** The amount of goods purchased by a business for selling purposes or sale or consumption is called purchases. Purchases may be on cash or credit basis. In the latter case the payment is made at a future date.
21. **Sales.** These are goods sold out by the business. Sales may be cash sales or credit sales. In the latter case, the customers do not pay cash immediately but promise to pay in future.
22. **Gross Profit.** It is the difference between the sales revenue or the proceeds of goods sold and/or services rendered over its direct cost.
23. **Net Profit.** It is the profit made after allowing for all expenses. In case, expenses are more than the revenue, it is net loss.
24. **Cost of goods sold.** It is the direct costs of the goods or services sold.
25. **Equity:** The net worth of your company. Also called owner's equity or capital. Equity comes from investment in the business by the owners, plus accumulated net profits of the business that have not been paid out to the owners.
26. **Capital :** The resources of a business entity funded by the proprietors are known as capital.

#### 1.14 ACCOUNTING CONCEPTS

Accounting statements disclose the profitability and solvency of the business to various parties. Thus, it is necessary that these statements should be prepared as per some standard language and set rules. These rules are usually called 'Generally Accepted Accounting Principles (GAAP)'. These principles have been generally accepted by accountants all over the world as general guidelines for preparing the accounting statements of course, the principles are not static and are, bound to change with the passage of time in response to the changing needs of the business.

This chapter explains different accounting concepts and conventions. Generally accepted principles of accounting have also been elaborated with a view to provide entire framework of accounting at one place. The fundamental rules for entering business transaction into books of accounts have along with accounting equation to enable students know how different transactions affect the financial statements.

#### 1.15 ACCOUNTING PRINCIPLES

Since various parties use the financial statements of the business, it becomes necessary to have a uniform and generally accepted approach to record and report the business transactions else the accountants may choose their non approach which would limitise the value and importance of such statements. Moreover, flexibility and freedom in selecting ones own approach would make these statement uncorporate and difficult to understand. Hence, a need of standardised language that gives similar



understanding of accounting records arises. The accounting bodies, authors in accounting and practitioners have therefore, developed over a period of time certain generally accepted accounting principles. These principles are not static and are bound to change in response to the needs of business and society. Since there principles are based on general acceptance from their users, they are alternatively called as concepts, conventions and postulates.

**Definitions :** The Canadian Institute of chartered accountants have defined accounting principles as the body of doctrines commonly associated with the theory and procedure of accounting serving as an explanation of current practices and as a guide for the selection of conventions or procedures where alternative exist. Rules governing the formation of accounting axioms and the principles derived from them have arisen from common experience, historical precedent, statements by individuals and professional bodies and regulations of governmental agencies.

1. They are man-made, so they do not have the authoritativeness as universal principles.
2. They are the result of experience, business practices and customs, ideas and beliefs of users of financial statements, government agencies, etc.
3. They are not static in nature and keep on changing with changing needs of business.
4. The general acceptance of an accounting principle usually depends on three criteria, objectivity, feasibility and relevance.

Accounting principles are grouped into :

1. Accounting Concepts (Postulates)
2. Accounting Conventions

#### ACCOUNTING PRINCIPLES

##### Accounting Concepts

1. Business Entity
2. Dual Aspect
3. Going concern
4. Accounting Period
5. Money measurement
6. Cost
7. Revenue
8. Matching
9. Verifiable objective evidence
10. Realization
11. Accrual

##### Accounting Conventions

1. Full Disclosure
2. Materiality
3. Consistency
4. Conservatism/Prudence



## ACCOUNTING CONCEPTS

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The term 'concept' is used to connote the accounting postulates. In other words concepts refers to necessary assumptions which are fundamental to accounting practice. To make the accounting language convey the same meaning to all people and to make it meaningful there are a number of concepts which are followed in the preparation of financial statements. These concepts are not specifically stated because their use and acceptance are usually assumed.

#### (1) Business Entity Concept / Business Entity Assumption

According to this concept, the business is an entity that is separate and distinct from its owners, hence the funds of the firm are not mixed with the funds of the owners. All the transactions of the business are recorded in the books of the business from the point of view of the business. When the proprietor invests money in the business, it is deemed that the proprietor has given money and the business has received money. Revenues and expenses are kept separate from personal expenses. This applies for all forms of business like partnership sole proprietorship and corporate.

#### (2) Dual Aspect Concept / Duality principle

It is the basis or foundation of accounting. According to this principle, every transaction has a dual aspect, i.e. two-fold effect. Every receiver is also a giver and every giver is also a receiver. For Example, Mr. X purchases machinery for a cash of Rs. 25,000, he receives machinery on one hand and pays Rs. 25,000 cash on the other. Thus, two-fold effect as increase in one asset i.e., machinery and decrease in other asset i.e., cash. Thus, receiving and giving are the two aspects of every business transaction.

#### (3) Going Concern Concept / Going Concern Assumption

It holds that the business is going to be operated for the foreseeable future. It is assumed that business will exist for an indefinite period of time and therefore transactions are recorded from that point of view. This validates the methods of asset capitalization, depreciation, and amortization. Only when liquidation is certain this assumption will not be applicable. A firm is said to be a going concern when there is neither the intention nor the necessity to wind up its affairs. In other words, it would continue to operate at its present scale in near future.

#### (4) Accounting Period Concept / Accounting Period Assumption

Life of the business is assumed to be indefinite, if the proprietor has to take any corrective measure he will have to wait till the time of liquidation but by that time it will be too late and the resources will remain underutilized. Therefore accountants choose some shorter and convenient time for the measurement of income. A period of twelve months, which is called accounting period, is normally adopted for this purpose.

The net income of a business can be measured by comparing the assets of the business existing at the beginning of accounting period with those existing at the end of the same.

#### **(5) Money Measurement Concept / Money Measurement Assumption**

Only those transactions and events are recorded in accounting which can be expressed in terms of money. It omits to record those transactions which can not be measured in terms of money no matter how much they affect the earning capacity of the business. This explains the need of expressing every transaction in monetary terms.

The second limitation is that it does not consider changes in purchasing power of money. Due to quick changes in the purchasing power of money, the financial statements may present misleading results of the business.

#### **(6) Cost Concept / Historical Cost Principle**

The underlying idea of cost concept is that all assets should be recorded at the price paid to acquire it-that is, at cost. This cost is the basis for all subsequent accounting for the asset. The assets recorded at cost price at the time of purchase are systematically reduced by the process called depreciation. These assets disappear from the balance sheet when their economic life is over.

It states that the benefit of providing the financial information should also be weighed against the cost of providing it.

#### **(7) Revenue Concept / Principle of Revenue Recognition**

The revenue principle holds that revenue is realized when everything that is necessary to earn the revenue has been completed i.e., revenue is considered to have been realized.

This assumption recognizes the assets, liabilities, incomes and expenses as and when transactions relating to it are entered into. This assumption makes available the information as to what amount he owes to the outsiders (liabilities) or how much he owns (assets). Besides this it also informs about profit earned or loss suffered.

#### **(8) Matching Concept / The Matching Principle**

It matches revenues and expenses in the period earned and incurred. It provides the guidelines as to how the expense be matched with revenue. For matching expenses with revenue, first revenues should be recognized and then costs associated with these revenues should be identified. In revenue or accrual basis of accounting, revenue is recognized when sale is complete or services are rendered rather than when cash is received. Only if no connection with revenue can be established, cost can be charged as expenses to the current period (e.g. office salaries and other administrative expenses). This principle allows evaluation of actual profitability and performance (shows how much was spent to earn

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revenue). Depreciation and cost of goods sold are good examples of application of this principle.

Expenses are recognized when assets or services have been used to generate revenues during a period.

### **(9) Verifiable Objective Evidence Concept / Verifiability & Objectivity of Evidence Principle**

It means that all accounting transactions should be supported with business documents for making accounting entries and for verification by auditors. The evidence substantiating the business transaction should be objective evidence, i.e., it should state facts without bias towards the other side.

### **(10) Realization concept / Principle of Revenue Realization**

It deals with the determination of the point of time when revenues are earned. According to this concept, revenue is realised when goods or services produced or rendered by a business enterprise are transferred to a customer either for cash or some other asset or for a promise to pay cash in future. It should be remembered that revenue is recognized and earned when a firm actually sells goods to a customer.

### **(11) Accrual Concept / Accrual Assumption**

Many small businesses utilize an accounting system that recognizes revenue and expenses on a cash basis, meaning that neither revenue nor expenses are recognized until the cash associated with them actually is received. Larger businesses, however, use the accrual method.

Under the accrual method, revenues and expenses are recorded exactly to when they are earned and incurred, not necessarily when the cash is received or paid. For example, an expense is recognized when the bill is received, not when payment is made.

Under accrual accounting, even though employees may be paid in the next accounting period for work performed near the end of the present accounting period, the expense still is recorded in the current period since the current period is when the expense was incurred.

This assumption is important because it recognizes the assets, liabilities, incomes and expenses as and when the transactions relating to it are entered into.

## **1.16 ACCOUNTING CONVENTIONS**

The term 'convention' denotes traditions or customs which guide the accountants while preparing the accounting statements. The common conventions include :

### **(1) Convention of Full Disclosure / Principle of Full Disclosure**

All of the information about the business entity that is needed by users is disclosed in understandable form. The purpose of this principle is to communi-



cate all relevant facts concerning financial position and the results of operations to the users. If any fact does not find place in accounting statements, it should be appended as note. e.g. contingent liability, market value of investments etc.

### **(2) Convention of Materiality / Principle of Materiality**

It refers to the relative importance of an item or event. Materiality of an item depends on its amount and nature.

Unimportant items are either left out or merged with other items. Sometimes the items are shown as footnotes or in parentheses according to their relative importance. Deciding what is material in accounting is a matter of judgement and not of applying specific rules. An item should be regarded as material if there is reason to believe that knowledge of it would influence the decision of informed stakeholder.

### **(3) Convention of Consistency / Principle of Consistency**

The Consistency approach holds that accounting procedures and practices being followed shall remain same year after year. If the practices followed do not remain consistent, the results of one year shall not remain comparable with that of another year.

This concept is particularly important when alternative accounting practices are equally acceptable. For example, depreciation may be charged on Straight Line Method or Written Down Value Method. If the change becomes necessary the change and its effect on the results should be clearly stated.

### **(4) Convention of Conservatism or Prudence / Principle of Conservatism**

It takes into consideration all prospective losses and leaves all prospective profits. Valuing stock at cost or market price whichever is lower and creating provision for doubtful debts are the good examples of the application of the principle of conservatism. This is the policy of playing safe. It is necessary from the point of view of not only shareholders but also of society, point of view in general. Conservatism states that while choosing between two solutions, the one that will be least likely to overstate assets and income should be picked.

## **1.17 ACCOUNTING STANDARDS**

Accounting standards are the norms of accounting policies and practices by way of codes and guidelines to direct as to how the items which go to make up the financial statements should be dealt with in account and disclosed in the annual reports of performance. The main object of setting standards is to harmonise the diverse and flexible policies and practices adopted by different enterprises and to ensure consistency in the reported information from year to year. The need for the common accounting principle is becoming more apparent when the chaotic conditions take place as a result of following different practices by different accountants about the measurement of revenues and expenses. The Institute of Chartered Accountants of India, recognizing the need to harmonize the diverse accounting policies and practices,

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constituted an Accounting Standard Board (ASB) on 21st April, 1977. The Accounting Standard Board carries out the responsibility of bringing out new accounting standard and revision of current standards in the light of changing international business and accounting environment. The board has issued 28 accounting standards so far.

These standards are as follows :

AS No.	Title
AS-1	Disclosure of Accounting Policies
AS-2	Valuation of Inventory
AS-3	Cash flow statement
AS-4	Contingencies and events occurring after the Balance Sheet date (Revised)
AS-5	Prior Period and extraordinary items and changes in Accounting Policies.
AS-6	Depreciation Accounting (Revised)
AS-7	Accounting for construction contracts
AS-8	Accounting for Research & Development
AS-9	Revenue Recognition
AS-10	Accounting for Fixed Assets
AS-11	Accounting for the effects of changes in foreign exchange rates (Revised)
AS-12	Accounting for Government Grants
AS-13	Accounting for Investments
AS-14	Accounting for Amalgamations
AS-15	Accounting for retirement benefits
AS-16	Borrowing Cost
AS-17	Segment Reporting
AS-18	Related parties Disclosures
AS-19	Leases
AS-20	Earning per share
AS-21	Consolidated financial statements
AS-22	Accounting for Taxes on Income.
AS-23	Accounting for Investments in associates in consolidated financial statements
AS-24	Discontinuing Operations
AS-25	In term financial reporting
AS-26	Intangible Assets
AS-27	Financial Reporting of interests in Joint Venture
AS-28	Impairment of Assets

## 1.18 ACCOUNTING EQUATION

### NOTES

All transactions of a business have a dual aspect. According to this basic concept, every business transaction has a two-fold effect i.e., every receiver is also a giver and every giver is also a receiver.

The resources controlled by a business are referred to as its assets. For a new business, those assets originate from two possible sources:

- Investors who buy ownership in the business
- Creditors who extend loans to the business

Those who contribute assets to a business have legal claims on those assets. Since the total assets of the business are equal to the sum of the assets contributed by investors and the assets contributed by creditors.

At any point of time, the resources of a business firm must be equal to the claims of the parties who have financed the resources. The resources are provided by its proprietors and some outside parties. The claims of the proprietors is called capital whereas the claims of the outside parties are known as liabilities.

This fact is expressed in the form of following equation :

$$\begin{array}{lclcl} \text{Assets} & = & \text{Liabilities} & + & \text{Owner's Equity} \\ \text{Resources} & = & \text{Claims on the resources} & & \end{array}$$

It is called the fundamental accounting equation because every transaction that takes place in a business firm influences its accounting equation in one way or the other.

Initially, owner equity is affected by capital contributions such as the issuance of stock. Once business operations commence, there will be income (revenues minus expenses, and gains minus losses) and perhaps additional capital contributions and withdrawals such as dividends. At the end of the reporting period, these items will impact the owner's equity as follows:

$$\begin{array}{lclcl} \text{Assets} & = & \text{Liabilities} & + & \text{Owner's Equity} \\ & & & + & \text{Revenues} \\ & & & - & \text{Expenses} \\ & & & + & \text{Gains} \\ & & & - & \text{Losses} \\ & & & + & \text{Contributions} \\ & & & - & \text{Withdrawals} \end{array}$$

The accounting equation holds at all times over the life of the business. When a transaction occurs, the total assets of the business may change, but the equation will remain in balance. The accounting equation serves as the basis for the balance sheet.

**Assets :** It is an expenditure for acquiring valuable resources which benefit the future activities of the concern. Land, building, debtors, cash in hand, etc. are some of the assets.



**Capital :** The proprietor of the business brings capital into the business out of which the business purchases assets for its use. The amount of assets of the business is equal to the owner's capital.

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

**Creditors :** when the capital contributed by the proprietor is insufficient, the business takes to borrowings from other sources. In hat case

$$\text{Capital} + \text{liabilities (Equity)} = \text{Assets}$$

The term 'equities' denotes the claims of various parties against the assets. Equities are of two types: Owner's equity and outsider's equity. Owner's equity is called the capital of the business which is the claim of the owners against the assets of the business. Payments which have to be made to the outsiders are called liabilities.

The equality of total assets and total liabilities is called Accounting equation.

### Owners' equity

This is the difference between assets and liabilities. If it's positive, i.e., assets exceed liabilities, we have a positive owners' equity.

Capital is what remains to the owner when all outside claims have been settled from the assets of the firm.

<b>Capital</b>	+	<b>Liabilities</b>	=	<b>Assets</b>
		(Loans, Bank Overdraft,		(Buildings, land,
		Creditors, Bills Payable,		Machinery, Furniture,
		Outstanding Expenses,		Stock-in-trade,
		Bank overdraft, Loan.)		Debtors, Cash,
				Bills receivable, Bank)

Any change in the amount of assets or the liabilities will bring corresponding change in owner's capital. If asset increases and liabilities do not, the capital will increase; a reduction in the amount of asset or an increase in the amount of liabilities means reduction in the amount of capital.

**We shall follow the following procedure to work out an accounting equation.**

- (i) Transactions are analysed in terms of variables as assets, liabilities, capital, revenues and expenses.
- (ii) Effect of transactions is decided in terms of increase or decrease on variables, then
- (iii) Effect on the relevant side of equation is recorded.

**Example 1.** Suppose (1) The owner A commences business with Rs. 30,000.

It means that the firm has an asset of Rs. 30,000 in the form of capital and the claims against the firm are also Rs. 30,000 in the form of capital.

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

$$30,000 = 0 + 30,000$$

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- (2) The business purchases a table for Rs. 400 in cash. This will reduce the cash by Rs. 400 but a new asset has been acquired so the total of the assets remain unchanged.

	<b>Assets</b>		<b>= Liabilities + Capital</b>	
	Cash + Furniture(table)			
Old balance	30,000	+ 0	= 0	+ 30,000
New transaction	-400	+ 400	= -	+ -
New balance	29,600	+ 400	= 0	+ 30,000

- (3) Business purchases raw material of Rs. 2,000 in cash, we see that the cash balance will be lowered by 2,000 and another asset, i.e., raw material has come into existence, but the total of assets remain unchanged. The equation will be as follows:

	<b>Assets</b>			<b>= Liabilities + Capital</b>	
	Cash + Furniture + Raw Material				
Old balance	29,600	+ 400	+ 0	= 0	+ 30,000
New transaction	-2,000	+ 0	+ 2,000	= 0	+ 0
New balance	27,600	+ 400	+ 2,000	= 0	+ 30,000

- (4) The business purchases raw material of Rs. 4000 on credit. It will increase raw material by Rs. 4,000 making the total asset to Rs. 34,000. Now, Rs.4,000 is due to be paid to the supplier of the raw material.

	<b>Assets</b>			<b>= Liabilities + Capital</b>	
	Cash + Furniture + Raw material				
Old balance	27,600	+ 400	+ 2,000	= 0	+ 30,000
New transaction	0	+ 0	+ 4,000	= 4,000	+ 0
New balance	27,600	+ 400	+ 6,000	= 4,000	+ 30,000

- (5) The business sells goods on credit for Rs. 4,000; the cost of goods is Rs. 3,000.

On account of this credit transaction, the accounting equation is maintained, i.e., debtors, has come into existence to the extent of Rs. 4,000. But the raw material will be reduced only by Rs. 3,000, being the cost of goods sold. The net increase in assets, Rs.1, 000 i.e., Rs. 4,000 – Rs. 3,000; is profit and will be added to the capital.

	<b>Assets</b>				<b>= Liabilities + Capital</b>	
	Cash+Furniture+Raw M.+Debtors				Creditors + A's	
Old balance	27,600	+ 400	+ 6,000	+ 0	= 4,000	+ 30,000
New transaction	0	+ 0	- 3,000	+ 4,000	= 0	+ 1,000
New balance	27,600	+ 400	+ 3,000	+ 4,000	= 4,000	+ 31,000

The total of assets will be equal to the total of liabilities and the capital.

**Example 2:**

Mr. 'A' had the following transactions. Use accounting Equation to show their effects on his assets, liabilities and capital:

**NOTES**

- (i) Invested Rs. 1,00,000 in cash.
- (ii) Purchased equity shares for cash in worth Rs. 15,000.
- (iii) Purchased a land for Rs. 15,000, giving Rs.5,000 in cash and balance through a loan.
- (iv) Sold Equity shares costing Rs. 2,000, for Rs. 2,500.
- (v) Purchased an old car for Rs. 10,000 cash.
- (vi) Received a cash of Rs. 4,000 as commission.
- (vii) Paid cash Rs. 1,000 for loan and Rs. 100 for interest.
- (viii) Paid a cash Rs. 500 for domestic expenses.
- (ix) Received a cash of Rs. 200 for dividend on shares.

**Solution :**

Transactions	Assets	=	Liabilities	+	Owner Equity
(i) Invested Rs. 1,00,000 cash	1,00,000	=	0	+	1,00,000
(ii) Purchased Equity shares in A Co. Ltd. for Rs. 15,000	-15,000 +15,000	= =	0 0	+	0
(iii) Purchased land for Rs. 15,000 giving Rs. 5,000 in cash and balance through a loan	1,00,000 (+)15,000 (-) 5,000	= = =	0 0 10,000	+	1,00,000 0 0
(iv) Sold equity shares of Rs.2,000 for Rs.2,500	1,10,000 (+)2,500 (-) 2,000	= = =	10,000 0 0	+	1,00,000 500 0
(v) Purchased an old car for Rs. 10,000 in cash	1,10,500 (+) 10,000 (-) 10,000	= = =	10,000 0 0	+	1,00,500 0 0
(vi) Received cash as commission Rs. 4,000	1,10,500 (+) 4,000	= =	10,000 0	+	1,00,500 (+)4,000
(vii) Paid cash of Rs. 1,000 for loan and Rs. 100 for interest.	1,14,500 (-)1,000 (-)100	= = =	10,000 (-)1,000 0	+	1,04,500 0 (-) 100
(viii) Paid cash for domestic expenses Rs. 500	1,13,400 (-) 500	= =	9,000 0	+	1,04,400 (-) 500
(ix) Received cash for dividend on shares Rs. 200	1,12,900 (+) 200	= =	9,000 0	+	1,03,900 (+) 200
	1,13,100	=	9,000	+	1,04,100



## 1.19 RULES OF DEBIT AND CREDIT- JOURNAL & LEDGER

### *Double entry system*

A business transaction involves an exchange between two accounts. Each transaction is recorded in its two-fold aspects. For example, for every asset there exists a claim on that asset, either by those who own the business or by those who lend money to the business. Similarly, the sale of a product affects both the amount of cash held by the business and the inventory held. The fundamental principle is that every transaction has two aspects. Under the double-entry system, both these aspects, receiving and giving, are recorded in terms of account. This is called 'Dual Aspect Analysis' in accounting.

**Double-entry accounting :** The cardinal rule of double-entry accounting is that the total amount debited to one or more accounts must equal the amount credited to different account(s). Because debits equal credits, double-entry accounting prevents some common book-keeping errors. Errors that do occur are easier to find. In double-entry accounting, every transaction in business affects at least two accounts, since there is at least one debit and one credit for each transaction. Entries that are not made to a balance sheet account are made to an income or expense account. Income and expenses affect the net profit of the business, which affects owner's equity and ultimately the balance-sheet.

*Thus, it can be seen that under double entry system, the total of the debit entries and credit entries on the various accounts must be equal.* Each debit entry has a corresponding credit and each credit has a corresponding debit entry.

Under the double entry system, both the aspects of all the transactions are recorded and thus, complete and reliable records of all the transactions are provided, based on which the management gets a position to take proper decisions. A trial balance is drawn to check accuracy of the books of accounts. Profit and loss account indicates correct profit or loss made during a particular accounting period, while the balance sheet presents the true financial position of the business on a particular date.

### **Advantages of double entry system.**

- Accurate calculation of profit and loss in complex organizations.
- Inclusion of assets and liabilities in the book-keeping accounts.
- Preparation of financial statements directly from the accounts.
- Easier detection of errors and frauds.
- Complete and reliable records of all business transactions since it records both the aspects of a transaction.
- A trial balance can be prepared and arithmetical accuracy can easily be verified.
- The balance sheet of the business can be prepared to ascertain the financial position of a firm.

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**Single entry system** does not record the two fold effect of each and every transaction. The accounts are prepared in a defective and unscientific manner and thus are not so reliable. It is suited for small sized concerns which are personally supervised by the owners. In single entry system trial balance cannot be extracted and arithmetical accuracy cannot be checked.

### **Different between Double entry system and single entry system of book keeping**

- Under the double entry system both the aspects, i.e., debit and credit, of all the transactions are recorded. Under single entry system, some transactions are recorded only in one of their aspects whereas some other transactions are recorded in both of their aspects.
- Under double entry system, various subsidiary books like sales book, purchases book, etc. are maintained. Under single entry system, no subsidiary books except cash book, which is also considered as a part of ledger, is maintained.
- Under double entry system there is a ledger which contains personal, real and nominal accounts. But under single entry system, the ledger contains some personal accounts only.

### **Account**

*An account is a summarized record of relevant transactions at one place relating to a particular head.*

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 to the opening balance of cash we add all increases and then deduct the total of all decreases, closing balance can be ascertained.

## **1.20 MECHANICS OF AN ACCOUNT**

An account maintained in the ledger has two sides. Conventionally the left side is known as debit side whereas the right side is known as credit side. This way the form of account seems like 'T' and, therefore, it is also known as T Account. A sample format of an account is here below :

Name of Account			
	Rs.		Rs.
Debit Side		Credit Side	

T-Accounts are used as a tool to illustrate business transactions, debits and credits, double entry book-keeping, and the purpose of accounts. It is called this because

it has the form of the letter T. On the top of the horizontal bar there is the account title (name). Increases and Decreases are placed on the side of the vertical bar, depending on whether the account type is an asset, liability or equity account. The left side of the T-account is called Debit, and the right side is called Credit. These terms are often abbreviated as Dr. and Cr.

The difference between the debit and the credit side of an account (total increases less total decreases) is called the account balance.

### Example 3 :

Open an account for furniture and write the following on the proper side.

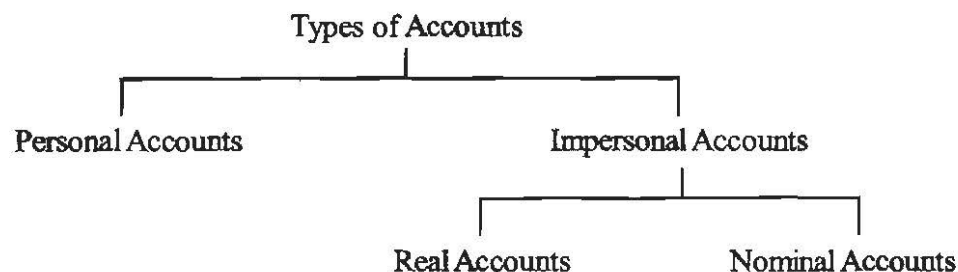
1. Furniture purchased for Rs 20,000
2. Furniture sold costing Rs. 5,000
3. Furniture again purchased for Rs. 8,000
4. Old furniture discarded for Rs. 2,500
5. Value of furniture was reduced by Rs. 2,000

### Solution :

Dr.		Furniture Account		Cr.	
Recorded Increase in furniture			Recorded decrease in furniture		
	1.	20,000		2.	5,000
	3.	8,000		4.	2,500
				5.	2,000
	Total	28,000		Total	9,500
				Balance	18,500
		28,000			28,000

## 1.21 CLASSIFICATION OF ACCOUNTS

Transactions of a business can be classified into the following three categories:



- Transactions relating to persons, individuals or organisations – Personal accounts;
- Transactions relating to property, assets or possessions – Real accounts;
- Transactions relating to incomes and expenses- Nominal accounts;

Real and nominal accounts are categorized as impersonal accounts.



**PERSONAL ACCOUNTS****NOTES**

Personal accounts record the dealings of a *trader* with persons or firms. A separate account is opened for each such person or firm for recording transactions. The account of each person or firm is debited when it receives any benefit and is credited with any benefit such person or firm imparts.

For Example, Proprietor's account, Suppliers' accounts, Receivers' accounts (like Mohan's A/c), bank account, any firm's account, any government's account, any institution's account, Unexpired insurance account, Rent prepaid account, etc.

**REAL ACCOUNT**

The real accounts represent items which are more or less permanent. It deals with property, assets and possessions. A separate account is kept for each class of property such as furniture, cash, equipment, machinery etc. so that by recording particulars of each asset received or given away, the businessman can find value of each asset on hand on any particular date. For example, Accounts of things which can be touched, felt, measured, purchased, sold etc. like land account, building account, furniture account etc and also accounts of things which are difficult to touch in the physical sense but can be measured, like: Goodwill, Trademarks and patent rights.

**NOMINAL ACCOUNTS**

They are used to define the nature of transactions i.e., expenses and gains of traders. For example, if in a factory the manager gets salary, the commission agents get commission, the worker gets wages, in fact they all get cash. Cash is the real thing which exists and salary, commission, wages etc., are only ways of describing the nature of heads for which cash has been paid.

Thus, a separate account is opened for each head of expenditure or income such as rent, salaries, commission, etc. Each such account is debited when an expense or loss is incurred and is credited when there is any gain.

**Examples of Different****Types of Accounts**

Personal Accounts	Real Accounts	Nominal Accounts
Capital a/c	Purchase a/c	Interest a/c
Drawings a/c	Sales a/c	Discount a/c
Ram a/c	Stock a/c	Salary a/c
Rotary club a/c	Purchase Return a/c	Repairs a/c
HDFC Bank a/c	Cash a/c	Insurance a/c
Makhan Lal Chaturvedi	Land a/c	Advertisement a/c
University a/c	Goodwill a/c	Commission a/c
Prepaid Rent a/c	Machinery a/c	Trade Exp. a/c
Outstanding Salary a/c	Oil wells a/c	Charity a/c
Unexpired Insurance a/c	Mines a/c	Sales Tax a/c
	Patents a/c	Depreciation a/c

## RULES OF DEBIT AND CREDIT

### NOTES

Each transaction has two aspects; one aspect is the receiving or the 'debit' aspect. Another aspect is giving or the 'credit' aspect. Debit and credit aspects of a transaction form the basis of double entry system.

Rules of double entry are framed on the basis of these two aspects in each of the business transactions.

The two sides are put together in 'T' form, the left side is called the 'debit' side and the right side is called the 'credit' side. Rules can be obtained as –

Debit	Credit
<b>Increase in assets</b> (e.g., purchase of machinery of Rs. 10,000 will be debited, because of increase in the amount of asset)	<b>Decrease in assets</b> (e.g., sale of machinery)
<b>Decrease in liabilities</b> (e.g., if a firm borrows from X and the loan is repaid)	<b>Increase in liabilities</b> (e.g., when a firm borrows from Mohan his account will be credited)
<b>Decrease in capital</b> (e.g., withdrawal of money from capital account)	<b>Increase in capital</b> (e.g., introduction of capital by the proprietor)
<b>Increase in Expenses and Losses is debited</b>	<b>Decrease in Expenses and losses is credited.</b>
<b>Decrease in revenues or incomes is debited.</b>	<b>Increase in revenues or incomes (Profits) is credited</b>

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

### Transaction Analysis of various accounts

Account Type	Debit	Credit	Normal Account Balance
Assets	Increase	Decrease	Debit Balance
Liabilities	Decrease	Increase	Credit Balance
Owner's Equity	Decrease	Increase	Credit Balance
Revenue	Decrease	Increase	Credit Balance
Expense	Increase	Decrease	Debit Balance

### How To Use and Apply The Debit and Credit Rules:

- (1) Determine the type of account(s) the transactions affect-asset, liability, revenue, or expense account.

## NOTES

- (2) Determine if the transaction increases or decreases the account's balance.
- (3) Apply the debit and credit rules based on the type of account and whether the balance of the account will increase or decrease.

We can understand these rules in another manner:

**1. Debit the receiver and credit the giver.**

One who receives should be debited and one who gives credited.

**2. Debit what comes in and credit what goes out.**

This rule is mainly applicable to asset accounts like furniture etc. When cash comes in Cash account should be debited; on payments this account will be credited.

**3. Debit all losses (and expenses) and credit all gains (and profits).**

Whenever money is paid because of an expense, the debit should be to an account showing the nature of the expense and not to the personal account of the receiver. Similarly, when cash is received on account of an income or gain, the credit should be to an account indicating the fact.

The three rules can be stated as:

**1. Debit the receiver and credit the giver in case of personal account.**

**2. Debit what comes in and credit what goes out in case of Real Account.**

**3. Debit all expenses and losses and credit all gains and profits in case of Nominal account.**

**(i) Rule for personal accounts.**

Debit that person's account who receives something from the business and credit that person's account who gives something to the business.

**(ii) Rule for real account.**

Debit what comes into the business and credit what goes out of the business.

**(iii) Rule for nominal account.**

Debit all expenses and losses and credit all gains and incomes.

## **1.22 SIGNIFICANCE OF DEBIT AND CREDIT IN ACCOUNTS**

**(i) Personal accounts.**

Whenever the business sells goods on credit to a customer, the account of the customer is debited. Debit in personal accounts means that the person whose account is being debited becomes a debtor or that he owes a certain sum to the business. Whenever the business purchases



NOTES

goods on credit from suppliers the account of the suppliers is credited. A further credit in the account of supplier implies increase on the credit side. If the account of a debtor is credited, it implies decreases in the debt of customers.

(ii) **Real accounts.**

Debit in a real account implies purchase of an asset. Any further debit in real account means more acquisitions of the asset and this will increase the value. Any credit in real account implies that some part or whole of the asset has been sold off.

(iii) **Nominal accounts.**

Debit implies that expenditure has been incurred or some loss has taken place. When any expenditure on account of salary, rent, interest, commission is incurred, these nominal accounts will be debited. Credit in a nominal account signifies that income or profit has taken place or some expenditure or loss has decreased by the amount of credit.

**EXAMPLE 4 :**

State the nature of account (nominal, real or personal) and show which account will be debited and which account will be credited:

- (i) Rent paid
- (ii) Interest received
- (iii) Building purchased
- (iv) Machinery sold
- (v) Discount allowed
- (vi) Capital introduced

**Solution :**

Account	Nature of account	Debited/ Credited
Rent paid account	Nominal	Debited
Interest received account	Nominal	Credited
Building account	Real	Debited
Machinery account	Real	Credited
Discount allowed account	Nominal	Debited
Capital account	Personal	Credited

**EXAMPLE 5 :** On what side the decrease in the following accounts will be recorded?

Also mention the nature of account:

- (1) Ram account, the proprietor
- (2) Cartage account

**NOTES**

- (3) Power account
- (4) Bank account
- (5) Land account
- (6) Bills payable account
- (7) Salary outstanding account
- (8) A (a supplier)
- (9) X (a customer)

**Solution:**

- (1) Debit- Capital or Personal
- (2) Credit- Expense or Nominal
- (3) Credit- Expense or Nominal
- (4) Credit- Asset or Personal
- (5) Credit- Asset or Real
- (6) Debit- Liability or Personal
- (7) Debit- Liability or Personal
- (8) Debit- Liability or Personal
- (9) Credit- Asset or Personal

**SUMMARY**

- Accounting is the backbone of the business in financial world.
- It is very important for any person or a firm to spend money carefully. There are certain sources from which the firm receives money like sales of goods and interest from banks and in turn it has to spend money on payments, maintenance of the firm etc.
- Attempts should be made to keep expenses low and the sales should be kept sufficiently high, so that expenses including maintenance of the firm are paid from the profit and the owner's capital remains invested.
- Accounting is a process-oriented task that follows a prescribed series of steps in order to keep track of and record the changes which are brought out by the new transactions.
- "Accounting is the art of recording, classifying and summarizing in terms of money transactions and events of financial character and interpreting the result thereof"
- Accounting is an art of recording business transactions in the books of account in a systematic manner soon after their occurrence.
- It is the process of grouping transactions or entries of one nature at one place.
- It is the art of making the activities of the business classified in the ledger so that it is understandable and useful to management and other interested parties.

NOTES

- Every accounting entry is based on a business transaction, which is usually evidenced by a business document, such as a check or a sales invoice.
- A journal is a book to record the transactions of a business.
- The general ledger is a collection of all balance sheets, income, and expense accounts used to keep accounting records of a business.
- Financial reporting should provide information about economic resources, the claims to those resources, and the changes therein.
- The income statement provides information about Gross Profit through Trading Account and about Net Profit through Profit and Loss Account. Gross Profit is the amount of difference between the sales revenue or the proceeds of goods sold and/or services rendered less the direct cost of goods sold and/or services rendered.
- Net Profit is the profit earned after allowing for all the expenses.
- The accounting system that is concerned only with the financial state of affairs is called Financial Accounting.
- Cost Accounting is that branch of accounting which deals with the classification, recording, allocation, summarization and reporting of current and prospective cost.
- Management accounting is the blend of financial accounting, cost accounting and all aspects of financial management.
- Book-Keeping is the work or skill of keeping account books or systematic recording of money transactions.
- The uniformity in understanding of accounting records is possible only when some standard language is used.
- The accounting language is a standard language in which certain accounting principles and concepts have been developed.
- According to separate entity concept, the business is an entity that is separate and distinct from its owners, so that the finances of the firm are not mixed with the finances of the owners. All the transactions of the business are recorded in the books of the business from the point of view of the business.
- Dual Aspect Concept is the basis or foundation of accounting. According to this principle, every transaction has a dual aspect.
- The net income of a business can be measured by comparing the assets of the business existing at the time of its commencement with those existing at the time of its liquidation.
- Only those transactions and events are recorded in accounting which can be expressed in terms of money.
- All accounting transactions should be supported with business documents for making accounting entries and for verification by auditors.

NOTES

- Realization concept deals with the determination of the point of time when revenues are earned.
- Double-entry accounting : Debits must always equal credits.
- Single entry system does not record the two fold effect of each and every transaction.
- Personal accounts record the dealings of a trader with persons or firms. A separate account is opened for each such person or firm for recording transactions.
- The real accounts represent items which are more or less permanent. It deals with property, assets and possessions. A separate account is kept for each class of property such as furniture, cash, equipment, machinery etc.
- Nominal Accounts are used to define the nature of transactions i.e., expenses and gains of traders. For example if in a factory the manager gets salary, the commission agents get commission, the worker gets wages, in fact they all get cash. Cash is the real thing which exists and salary, commission, wages etc. are only ways of describing the nature of heads for which cash has been paid.

**EXERCISE**

1. What is Accounting Cycle or Process ?
2. Explain in brief the meaning of Book Keeping.
3. What is Cost Accounting ?
4. What is Management Accounting ?
5. What is the difference between Book Keeping and Accounting ?
6. Define accounting and elaborate its characteristics.
7. Classify different types of accounting.
8. What is Financial Accounting ? What are its advantages and limitations ?
9. How accounting works as information system ? who are the different users of accounting information ?
10. Distinguish between Real Account and Nominal Account.
11. What are the Rules of Debit and Credit ?
12. What is classification of Accounts ?
13. What are the various Accounting Concepts ?
14. What is the difference between double entry system and single entry system of book-keeping?
15. What are T-accounts ?
16. What is Accounting Equation ?
17. What do you understand by double entry system ? Write the advantage of double entry system.



## **1.23 REFERENCES / SUGGESTED READING**

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## **The Unit Covers :**

- 2.1 INTRODUCTION**
- 2.2 JOURNAL**
- 2.3 RULES OF JOURNALISING**
- 2.4 COMPOUND JOURNAL ENTRY**
- 2.5 ENTRIES OF DISCOUNT**
- 2.6 TRANSACTIONS REGARDING BAD DEBTS AND  
BED DEBTS RECOVERY**
- 2.7 LEDGER**
- 2.8 RELATION BETWEEN JOURNAL AND LEDGER**
- 2.9 RULES FOR POSTING TRANSACTIONS**
- 2.10 BALANCING THE ACCOUNT**
- 2.11 REFERENCES / SUGGESTED READING**

## **2.1 INTRODUCTION**

Journal is something you start with your accounting process. Accounting in other terms, starts from here and goes to finalising the accounts. The book in which a transaction is recorded for the first time from a source document are called 'Books of Original Entry'. Journal is one of the basic books of original entry in which transactions are recorded in a chronological (day-to-day) order according to the principles of double entry system. This chapter introduce us to journal and journalising our account in a systematic manner. By the end of this chapter you will be in a position to hawk journalasing of your transactions.

## 2.2 JOURNAL

### NOTES

The Journal is called the book of original entry and the process of recording transactions in the journal is called journalising. It is a book of original entry wherein transactions are recorded chronologically, showing date, amounts and accounts to be debited and credited and an explanation on the transaction. With the growth in the business activities several journals are required for recording the large number of activities e.g., sales journal etc. These journals are called *special journals*.

**According to Cortex**— "The Journal, or 'Daily Record' as originally used was a book of primary entry in which transactions were copied in order of date, from a Memorandum or waste Book. The entries as they were copied, were classified into debits and credits so as to facilitate their being correctly posted afterwards in the ledger."

### Object / Importance of Journal

- (1) One can have a clear picture of the business by study of its journal book.
- (2) A journal makes the postings of transactions in ledger very easy.
- (3) It shows us all effects of a transaction.
- (4) It plays an important role in solving business disputes.
- (5) Journal reduces the possibility of errors. The two sides can be compared easily and it can be seen whether they are equal or not.
- (6) It provides an explanation to the transaction.
- (7) It provides a chronological record of all transactions and, therefore, record of any transaction can be searched out easily.

### STEPS FOR JOURNALISING

The following are the steps for journalising transactions:

- The year is recorded at the top of the page and the month and the date are recorded on the first line in the first column of the date section. This information is repeated for every new journal page.
- The name of the account(s) to be debited is entered in the particulars column and the amount of the debit is recorded in the Debit column. When more than two accounts are involved in the transaction the entry is called a compound entry.
- The name of the account(s) to be credited is entered on the next line and indented. The amount of the credit is recorded in the Credit column.
- An explanation of the transaction is included in the particulars column on the line below the credit entry.

## JOURNAL

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

## NOTES

- (1) **Date :** The date on which transaction has taken place is written in this column.
- (2) **Particulars :** Every transaction has two effects-Debit & Credit, which are recorded in it. This is accomplished by a debit description of the deal known as Narration and a line is drawn at the end.
- (3) **L.F./Ledger Folio :** This column contains the folio number of ledger where the account is opened.
- (4) **Amount :** This column is divided into two parts : (a) Debit, (b) Credit. In these two columns debit & credit amounts are recorded respectively.

**Important points to be kept in mind at the time of Journalising**

- (1) Before recording a Journal entry, it is essential to analyse a transaction in order to determine the two accounts which are affected. Then, on the basis of the rules of journalising it must be debited or credited.
- (2) The name of the account to be debited is written first and the word 'Dr.' is also written towards the end of the column.
- (3) The credit account starts with the word of 'To', a few space away from the margin to make it distinct from the debit account.
- (4) It is necessary to write the narration after each entry and should be short, complete and clear.
- (5) After every Journal entry, a line should be drawn in particulars column, so that each entry is separated from the preceding one.
- (6) Two words 'For'/'Being' are customarily used before starting to write down narration.
- (7) It is not necessary to use the word 'Account' or A/C after the personal accounts.
- (8) At the end of each page, both the Dr. and Cr. columns are totalled up just in front of each other.

These totals must be equal because the amount debited in each entry equals the amount credited. These totals are carried forward to the next page progressively upto the end of accounting period.



**2.3 RULES OF JOURNALISING****NOTES**

- (1) **Personal Accounts** : "Debit the receiver and credit the giver" for e.g. :  
Cash of Rs. 2000 is given to Gopal.

Gopal	.....Dr.	2,000
To cash a/c		2,000
(To cash paid to Gopal)		

**Note** : Here Gopal is debited as he is the one who received cash

- (2) **Real Accounts** : "Debit what comes in and credit what goes out". In the above e.g. cash goes out to Gopal. So cash is credited. Again if machinery is bought for Rs. 10,000 then Machinery came to business and cash went out of business.

Machinery a/c	.....Dr.	10,000
To cash a/c		10,000
(For Machinery purchased for cash)		

- (3) **Nominal Account** : "Debit all expenses & losses and credit all Incomes & gains" for e.g. : Paid salary of Rs. 2,000 and received rent of Rs. 5,000. Here Salary is an expense, so debited where as rent is an income thus credited.

Salary a/c	.....Dr.	2,000
To cash a/c		2,000
(For Salary paid)		
Cash a/c	.....Dr.	5,000
To Rent a/c		5,000
(For Rent received)		

**Example 1.** Transactions of Shyam for the month of June are given below. Journalise them.

2003	Rs.	
June 1	Shyam started business with cash	1,00,000
June 2	Cash deposited in bank	25,000
June 3	Bought raw material for cash	5000
June 4	Drew cash from bank for office	1000
June 13	Sold to Ram goods on credit	1500
June 20	Bought from Mohan raw material on credit	225
June 24	Received cash from Ram	1500

June 28	Paid cash to Mohan and discount allowed	215
		10
June 30	Paid rent	50
June 30	Cash sales for the month	800
June 30	Paid salary to Ashok	100

JOURNALS &  
LEDGER

NOTES

**Solution 1 :**

No.	Transactions	Affected A/C	Types of A/C	Dr.	Cr.
June 1	Commenced Business (Owner brings capital, cash comes in)	Cash A/C & Capital A/C	Real Personal	Cash A/C	Capital A/C
2	Deposited in bank (Bank is receiver & cash goes out)	Bank A/C & Cash A/C	Personal Real	Bank A/C	Cash A/C
3.	Goods purchased for cash (Goods comes in & cash goes out)	Purchase A/C & Cash A/C	Real Real	Purchase A/C	Cash A/C
4.	Withdrew cash from bank (cash comes in & bank is giver)	Bank A/C & Cash A/C	Personal Real	Cash A/C	Bank A/C
13	Sold goods to Ram on credit [Ram is receiver & goods goes out]	Ram & Goods	Personal Real	Ram	Sales A/C
20	Purchase Material from Mohan on Credit [Mohan is giver goods comes in]	Mohan Goods	Personal Real	Purchase A/C	Mohan
24	Cash paid by Ram [cash comes in, Ram is giver]	Ram Cash A/C	Personal Real	Cash A/C	Ram
28	Cash paid to Mohan [cash goes out, Mohan is receiver and discount profit is given]	Mohan Cash A/C Discount A/C	Personal Real Nominal	Mohan	Cash A/C Discount A/C
30	Rent paid in cash [Rent (expenses) paid, cash goes out]	Rent A/C Cash A/C	Nominal Real	Rent A/C	Cash A/C
30	Goods sold for cash [Goods goes out, cash comes in]	Goods A/C Cash A/C	Real Real	Cash A/C	Sales A/C
30	Salary paid [expenses paid, cash goes out]	Salary A/C Cash A/C	Nominal Real	Salary A/C	Cash A/C

**JOURNAL ENTRIES (In the books of Shyam)****NOTES**

Date	Particulars	L.F.	Debit Rs.	Credit Rs.
2003				
June 1	Cash A/c .....Dr. To Capital A/c (Being the amount invested by Shyam in the business as capital)		1,00,000	1,00,000
June 2	Bank A/c .....Dr. To Cash A/c (Being the amount deposited in bank)		25,000	25,000
June 3	Purchases A/c .....Dr. To Cash A/c (Being raw material purchased for cash)		5,000	5,000
June 4	Cash A/c .....Dr. To Bank A/c (Being cash withdrawn from bank)		1,000	1,000
June 13	Ram A/c .....Dr. To Sales A/c (Being goods sold to Ram on credit)		1,500	1,500
June 20	Purchases A/c .....Dr. To Mohan (Being goods bought from Mohan on credit)		225	225
June 24	Cash A/c .....Dr. To Ram (Being cash received from Ram)		1,500	1,500
June 28	Mohan.... Dr. To Cash A/c To Discount A/c (Being cash paid to Mohan discount received)		225	215 10



June 30	Cash A/c	....Dr.	800	
	To Sales A/c			800
	(Being goods sold for cash)			
June 30	Rent A/c	....Dr.	50	
	Salaries A/c	....Dr.	100	
	To Cash A/c			150
	(Being amount paid for rent and salary)			
	Total		1,35,400	1,35,400

JOURNAL ENTRIES

NOTES

## 2.4 COMPOUND JOURNAL ENTRY

When two or more transactions of the same nature take place on the same date, a compound journal entry is passed for them. Thus total number of book-keeping entries may be reduced.

Sometimes, on the same date several similar dealings take place or transactions related to a single account take place. In such, cases in place of passing different entries, consolidated entry is passed. This is known as compound entry.

In a compound entry, either only one account is debited and several other accounts are credited or vice-versa. The total amount debited should be equal to the total of the accounts credited and all these transactions should take place on the same day.

In a compound journal entry there may be:

- (1) One account to be debited and two or more accounts to be credited. For example, if X pays to his creditor, Mr. Z Rs. 5,000 and Z allows X a discount of Rs. 500, then the entry will be,

Z's account	Dr.	5,000	
To Cash account			4,500
To Discount Account			500

(Being payment of cash to Mr. Z, discount received Rs. 500)

This compound entry is a result of two individual entries :

- (i) Z' Dr 4,500  
To Cash account 4,500  
(Being payment of cash to Mr. Z)
- (ii) Z' Dr 500  
To discount account 500  
(Being discount received)

- (2) Two or more accounts to be debited and only one to be credited. For example, if on the last day of the month, Rs. 15,000 is paid as rent and one of the partner, X withdraws Rs. 8,000 cash for private use,

## NOTES

Rent account	....Dr.	Rs. 15,000	
Drawings account	....Dr.	Rs. 8,000	
	To Cash account		Rs. 23,000
(Being rent paid, drawings for private use made in cash)			

**Example 2 : Pass enteries in the Journal of Shri Ashish Jain :**

2007		Rs.
Aug 1.	Started Business with :	
	Cash	15,000
	Goods	3,500
	Furniture	500
Aug 2.	Bought Goods :	
	Cash	500
	From Kumar	300
	From Triloki	700
Aug 12.	Paid wages	10
	Paid to Triloki	500
	Paid to Kumar	200
Aug 16	Sold goods for cash	600
	Sold goods to Rajan	250
	Sold to Vishwas on credit	350
Aug 25	Received cash from Rajan	245
	Discount allowed to him	5
Aug 31	Paid to kumar in full settlement	90
Aug 31	Furniture purchased	100
	Paid for Repairs	25
	Cleared Triloki's a/c	90
	Discount Received from Triloki	10

**Solution 2 :**

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LEDGER

**Journal of Shri Ashish Jain**

Date	Particulars	L.F.	Amount	Amount
			Dr.	Cr.
2007				
Aug 1	Cash A/C Dr. Furniture A/C Dr. Purchase A/C Dr. To Capital A/C (for commencement of business for cash furniture and goods)		15,000 500 3,500	19,000
Aug 2	Purchase A/C Dr. To Cash A/C To Kumar To Triloki (for purchase of goods for cash and credit)		1,500	500 300 700
Aut 12	Wages A/C Dr. Triloki A/C Kumar A/C Dr. To Cash A/C (For payment of wages and cash to Triloki and Kumar)		10 Dr. 200	500 710
Aug 16	Cash A/C Dr. Rajan A/C Dr. Vishwas A/C Dr. To Sales a/c (Being goods sold on cash & credit)		600 250 350	1200
Aut 25	Cash A/C Dr. Discount A/C Dr. To Rajan (for receipt of cash and discount allowed)		245 5	250
Aug 31	Kumar A/C Dr. To Cash A/C To Discount A/C (for amount paid and discount received)		100	90 10
Aug 31	Furniture A/C Dr. Repairs A/C Dr. Triloki Dr. To Cash A/C To Discount A/C (for payment of cash and receipt of discount)		100 25 200	315 10
	Total Rs.		23,085	23,085

NOTES



## 2.5 ENTRIES OF DISCOUNT

Discount is of two types :

### NOTES

(1) Trade Discount, and

(2) Cash Discount

- (1) **Trade Discount** : The discount allowed by seller to its customer at a fixed percentage on the listed price of goods is known as Trade Discount. No separate entry is made for it. The amount of transaction is reduced by the amount of trade discount. For example, Goods of list price Rs. 10,000 sold at a trade discount of 20%.

List price	10,000
(-)Trade discount (20%)	2,000
	8,000

Now entry will be :

Cash A/C	Dr.	8,000
To Sales A/c		8,000

- (2) **Cash Discount** : This discount is allowed only if the customers are ready to make prompt payment. This is also offered to customer to induce them to pay early. In entry it is debited if it is allowed to customer and credited when it is received.

### Example 3 :

Journalise the following transaction

2007

- July 1      Vikas commenced business with Rs. 15000.
- July 2      Bought goods of the list price Rs. 6000 from Anupam, less 10% trade discount and 5% cash discount for cash.
- July 9      Withdrew goods worth Rs. 200 and Rs. 300 in cash for private use.
- July 13     Sold goods worth Rs. 1,000 less 5% trade discount & 2% cash discount to Ram for cash.
- July 19     Sold goods worth Rs. 5,000 less 5% trade discount to Asit.
- July 21     Asit returned goods worth Rs. 800.
- July 31     Paid rent, salary & expenses of Rs. 200, Rs. 350 and Rs. 50 respectively.

**Solution 3 :**

 JOURNALS &  
LEDGER

**Journal of Vikas**

Date	Particulars	L.F.	Amount	Amount
			Dr.	Cr.
2007			Rs.	Rs.
July 1	Cash A/C Dr. To Capital A/C [For amount introduced as capital]		15,000	15,000
July 2	Purchase A/C Dr. To Cash A/C *1 To Discount A/C [For goods worth Rs. 6000 bought at a trade discount 10% & cash discount 5%]		5,400	5,130 270
July 9	Drawings A/C Dr. To Purchase A/C To Cash A/C [For goods and cash taken for personal use]		500	200 300
July 13	Cash A/C *2 Dr. Discount A/C Dr. To Sales A/C [For goods worth Rs. 1000 sold for cash at a trade discount 5% and cash discount 2%]		931 19	950
July 19	Asit *3 To Sales A/C [For goods worth Rs. 5000, sold at a trade discount of 5%]		Dr. 4,750	4,750
July 22	Sales Return A/C *4 Dr. To Asit [For goods worth Rs. 800 returned by him after deducting 5% trade discount]		760	760
July 31	Rent A/C Dr. Salary A/C Dr. Expenses A/C Dr. To Cash A/C [For amount paid for rent, salary, expenses]		200 350 50	600
	Total Rs.		27,960	27,960

NOTES

$$= 6000 - 600 = \text{Rs. } 5,400$$
$$= 5400 - 270 = \text{Rs. } 5,130$$
$$= 1000 - 50 = \text{Rs. } 950$$
$$= 950 - 19 = \text{Rs. } 931$$
$$= 5000 - 250 = \text{Rs. } 4750$$
$$= 800 - 40 = \text{Rs. } 760.$$

Ledger is supposed to be a permanent and organized book for all the transactions occurred in a company. This chapter serves you a lot of information on Ledger. The chapter introduces you to the meaning of ledger and posting. It enables you to compare between ledgers and journals. In addition, you will know about the rules for posting transactions. By the end of the chapter, we will likely to be in position to get a detailed knowledge of Ledger.

**Meaning of Ledger.** Ledger is a set of account. It is a book which contains accounts is known as the ledger. It is defined as a "book or register which contains, in a summarized and classified form, a permanent record of all the transactions." It is the most important book of accounts, since final position pertaining to the financial status of a business emerges only from them. Hence, the ledger is called the Principal Book.

Its sources of information are the books of original entry, called journals. When a customer purchases goods from a firm on different dates, his transactions are recorded on different pages in the journal. It is not possible to know at a glance what amount is owed by a customer unless all the entries relating to his account are brought together in the form of an account. Ledger is kept keeping in view of this objective.

A General Ledger is just a formal set of T-Accounts. Each account that is to be tracked and kept up has a separate page or pages maintained in a record book called the General Ledger. The general ledger's major sections are Assets, Liabilities, Owner's Equity, Revenues, Expenses, and Drawings.

For each item (account) in General Ledger, the increases and decreases for a period (usually a month) are measured and its ending balance is calculated. The ending balance of the account is easily determined by adding the increases and subtracting the decreases from the account's beginning period balance.

**Ending Account Balance = Beginning Balance + Increases - Decreases**

Simply stated a General Ledger is just a book containing the summarized financial transactions and balances of the accounts for all assets, liabilities, equity, revenue, and expense accounts of business.

#### **Objectives :**

1. To ascertain how much amount is due from each customer or how much amount the firm has to pay to each supplier.
2. To ascertain how much is the amount of purchase or sale during a particular period.
3. To ascertain how much amount has been spent on each head of expenses and amount has been earned on account.

#### **Importance of ledger :**

1. It helps in preparation of final account of organisation.



## NOTES

2. It helps to find true position of debtors & creditors.
3. It saves time.
4. It act as a proof in case of any dispute.
5. It show the ultimate position of assets and liabilities.
6. In ledger all transactions pertaining to a person or thing will be parted at one place which will provide a complete picture of all transactions relating to them at a glance.

**Form of ledger.** The accounts in the ledger are kept in specific form is given below:

Dr.				Name of account				Cr.			
Date	Particulars	J.F.	Amount	Date	Particulars	J.F.	Amount	Date	Particulars	J.F.	Amount

There are two sides of a ledger account. The left-hand side is known as debit side while the right-hand side is known as credit side. The words 'Dr.' and 'Cr.' are used to denote Debit and Credit.

The name of the account is written in the middle of the account. On each side, there are columns for date, particulars, journal folio and amount. 'J.F.' denotes folio or page number on which the journal entry may be found.

### **What is posting?**

Posting is the process of entering in the ledger the information given in the journals. Posting from the journal or book is done periodically, may be weekly or fortnightly or monthly as per the convenience of the business. The posting of a journal entry to the general ledger accounts is a purely mechanical process using information already in the journal entry and requiring no additional analysis.

## **2.8 RELATION BETWEEN JOURNAL AND LEDGER**

The journal and the ledger are the most important books of the double entry system of accounting and are indispensable for a proper system. Following are the points of comparison between these two types of books:

- (i) The Journal is the book of original entry and the ledger is the book of second entry.
- (ii) The Journal is the book for chronological record and the ledger is the book for analytical record.
- (iii) The Journal, as a book of source entry, has greater weight as legal evidence than the ledger.
- (iv) The unit of classification of data within the ledger is the account; the unit of classification of data within the Journal is the transaction.

JOURNALS &  
LEDGER

- ## NOTES

(d) In the 'folio' column, the page number of the journal from where the entry is transferred to ledger account is written.

**EXAMPLE :**

March 6	Machinery A/c	.....Dr.	Rs. 25,000
	To Amron A/c		Rs. 25,000

The amount of Rs. 25,000 will be debited to the Machinery Account and credited to Amron. The manner will be: in the Machinery Account in the particulars column we shall write "To Amron". In the account of Amron "By Machinery Account" will be written. The two accounts will thus appear as:-

Dr.				MACHINERY ACCOUNT				Cr.			
Date	Particulars	J.F.	Amount		Date	Particulars	J.F.	Amount			
March 6	To Amron	35	25,000								

J.F.				AMRON ACCOUNT			
Dr.						Cr.	
Date	Particulars	J.F.	Amount	Date	Particulars	J.F.	Amount
				March 6	By Machinery A/c	35	25,000

## 2.10 BALANCING ACCOUNT

After completion of posting of all transactions, accounts are balanced every year or after a certain period. Balancing of account means the total of both the sides of an account are equal and to write the difference in the side whose total is short. For example, if total of credit side is more than the debit side of any account the difference of amount will be recorded as Balance c/d on debit side and vice versa on the credit side. If the total of debit side of any account is greater, that account will reveal a debit balance and if total of credit side of any account is more it will show credit balance. The total of debit side and credit side of some accounts may be equal, those accounts will not display any balance.

## NOTES

Balancing a ledger account involves the following important steps:

- The first step is to total the debit and credit entries.
- If the totals of both the sides are equal then the account is considered to be balanced or closed.
- If the debit total is greater than the credit total or the credit total is greater than the debit total, then the balance or difference is placed on the shorter side, so that total of both the sides are equal.
- If the difference is placed on the debit side, then 'To Balance c/d' is written. The word c/d refers to carried down to next period. Similarly, if difference is placed on the credit side, 'By Balance c/d' is written.
- The totals of both the sides, which are equal, are placed at the bottom of both the sides.
- At the beginning of the next period, the closing balance will appear as the opening balance in the opposite side as 'To balance b/d.' or 'By Balance b/d'. The word b/d refers to 'brought down from the previous period'.

The balance thus obtained can be of two types:

- *Opening balance.* The balance can be opening debit balance or opening credit balance. These balances are shown as debit balance on the debit and credit balance on the credit side.
- *Closing balance.* There are two closing balances- closing debit balance and closing credit balance. These balances can be shown as debit balance on the credit side and credit balance on the debit side.
- *Significance of variance balances to Accounts.* Ledger provides necessary information regarding various accounts. Personal accounts in ledger show how much money the firm owes to his creditors and the amounts it can recover from its debtors. The real accounts show the values of properties and also the value of stock. Nominal accounts reflect the sources of income and also the amount spent on various items. The financial position of the business concern can be ascertained easily at any time with the help of ledger.

**EXAMPLE 1:** Journalise the following transactions and post them to ledger, also balance the accounts.

**2007**

- Dec 11 Ram commences business with Rs. 2,00,000 in cash.  
 12 He buys goods of Rs. 1,50,000 from Darshan on credit.  
 15 He buys machinery for Rs. 50,000 from Nathan on credit.  
 18 He pays Nathan Rs. 25,000  
 20 He pays Darshan Rs. 50,000.  
 22 Cash sales Rs. 1,00,000.  
 31 He sells goods to Rakesh on credit Rs. 7,000.



**Solution:**

**JOURNAL**

Date	Particulars	L.F.	Dr. Amount	Cr. Amount
2007 Dec 11	Cash account Dr. To Ram's capital account (Being the capital invested in cash)		2,00,000	2,00,000
12	Purchases account Dr. To Darshan account (Being goods purchased on credit)		1,50,000	1,50,000
15	Machinery account Dr. To Nathan account (Being machinery purchased on credit)		50,000	50,000
18	Nathan account Dr. To Cash account (Being cash paid to Nathan)		25,000	25,000
20	Darshan account Dr. To Cash account (Being cash paid to Darshan)		50,000	50,000
22	Cash account Dr. To Sales account (Being goods sold for cash)		1,00,000	1,00,000
31	Rakesh account Dr. To Sales account (Being goods sold on credit to Rakesh)		7,000	7,000

NOTES

**LEDGER  
CASH ACCOUNT**

Date	V. No.	Particulars	L.F.	Dr. Amount	Date	V. No.	Particulars	L.F.	Cr. Amount
2007 Dec 11		To Ram's Capital		2,00,000	2007 Dec 18		By Nathan		25,000
Dec 22		To Sales Account		1,00,000	Dec 20		By Darshan		50,000
					Dec 31		By Balance c/d		2,25,000
				3,00,000					3,00,000
2008 Jan 1		To Balance b/d		2,25,000					



## NOTES

## RAM'S CAPITAL ACCOUNT

Dr.				Cr.			
Date	Particulars	L.F.	Amount	Date	Particulars	L.F.	Amount
2007 Dec 31	To Balance c/d		2,00,000	2007 Dec 11	By Cash		2,00,000
			<u>2,00,000</u>				<u>2,00,000</u>
				2008 Jan 1	By Balance b/d		2,00,000

## PURCHASES ACCOUNT

Dr.				Cr.			
Date	Particulars	L.F.	Amount	Date	Particulars	L.F.	Amount
2007 Dec 12	To Darshan		1,50,000	2007 Dec 31	By Balance c/d		1,50,000
			<u>1,50,000</u>				<u>1,50,000</u>
2008 Jan 1	To Balance b/d		1,50,000				

## MACHINERY ACCOUNT

Dr.				Cr.			
Date	Particulars	L.F.	Amount	Date	Particulars	L.F.	Amount
2007 Dec 15	To Nathan		50,000	2007 Dec 31	By balance c/d		50,000
			<u>50,000</u>				<u>50,000</u>
2008 Jan 1	To Balance b/d		50,000				

## NATHAN A/C

Dr.				Cr.			
Date	Particulars	L.F.	Amount	Date	Particulars	L.F.	Amount
2007 Dec 18	To Cash		25,000	2007 Dec 15	By Machinery A/c		50,000
Dec 31	To Balance c/d		25,000				<u>20,000</u>
			<u>50,000</u>				
				2008 Jan 1	By Balance b/d		25,000

## DARSHAN A/C

Dr.				Cr.			
Date	Particulars	L.F.	Amount	Date	Particulars	L.F.	Amount
2007 Dec 20	To Cash		50,000	2007 Dec 12	By Purchases A/c		1,50,000
Dec 31	To Balance c/d		1,00,000				<u>1,50,000</u>
			<u>1,50,000</u>				
				2008 Jan 1	By Balance b/d		1,00,000

## RAKESH A/C

Dr.				Cr.			
Date	Particulars	L.F.	Amount	Date	Particulars	L.F.	Amount
2007 Dec 31	To Sales A/c		7,000	2007 Dec 31	By Balance c/d		7,000
			7,000				7,000
2008 Jan 1	To Balance b/d		7,000				

## SALES ACCOUNT

Dr.				Cr.			
Date	Particulars	L.F.	Amount	Date	Particulars	L.F.	Amount
2007 Dec 31	To Balance c/d		1,07,000	2007 Dec 22	By Cash		1,00,000
				Dec 31	By Rakesh		7,000
			1,07,000				1,07,000
				2008 Jan 1	By Balance b/d		1,07,000

NOTES

## SUMMARY

- The Journal is called the book of original entry and the process of recording transactions in the journal is called journalising. It is a book of original entry wherein transactions are recorded chronologically, showing date, amounts and accounts to be debited and credited an explanation to the transaction. With the growth in the business activities several journals are required for recording the large number of activities e.g., sales journal etc. These journals are called special journals.
- First step is to ascertain the increase or decrease in business assets, liabilities, proprietor's capital and income and expenditure on account of a business transaction.
- The details of the transaction is written in the particulars column called "narration".
- When two or more transactions of the same nature take place on the same date, a compound journal entry is passed for them. Thus total number of book-keeping entries may be reduced.
- When a debtor, fails to pay the whole amount due to him the unrealized amount is called 'bad debts'. If this unrealized amount is recovered at any time in future, it is called bad-debts recovered.
- Journal reduces the possibility of error.
- It provides an explanation to the transaction.
- It provides a chronological record of all transactions.
- Ledger is defined as a "book or register which contains, in a summarized and classified form, a permanent record of all the transactions." It is the most important book of accounts, as final position pertaining to the financial

## NOTES

status of a business emerges only from them. Hence, the ledger is called the Principal Book.

- Its sources of information are the books of original entry, called journals. When a customer purchases goods from a firm on different dates, his transactions are recorded on different pages in the journal. It is not possible to know at a glance what amount is owed by a customer unless all the entries relating to his account are brought together in the form of an account. Ledger is kept keeping in view of this objective.
- A General Ledger is just a formal set of T-Accounts. Each account that is to be tracked and kept up has a separate page or pages maintained in a record book called the General Ledger. The general ledger's major sections are Assets, Liabilities, Owner's Equity, Revenues, Expenses, and Drawings.
- Ledger is the most important book of account. It is the principal book of account which contains all the information regarding business.
- Posting is the process of entering in the ledger the information given in the journals. Posting from the journal or book is done periodically, may be weekly or fortnightly or monthly as per the convenience of the business.
- After completion of posting of all transactions, accounts are balanced every year or after a certain period. Balancing of account means the total of both the sides of an account are equal and to write the difference in the side whose total is short.
- Opening balance can be opening debit balance and opening credit balance. These balances are shown as debit balance on the debit side and credit balance on the credit side.
- Closing balances could be of two types : closing debit balance and closing credit balance. These balances can be shown as debit balance on the credit side and credit balance on the debit side.

**EXERCISE**

1. How does the Journal entries take place in the books ? Explain
2. What do you understand by 'Journal' ? Give rules of Journalising in connection with different types of account.
3. What are the objects and importance of Journal ?
4. What is Journal ? What are the Advantages of Journal ?
5. What is Compound Journal Entry ?
6. Write the Main advantages of Journal.
7. Write the rules of Posting in Ledger.
8. Write the need and importance of Ledger.
9. What is the difference between Ledger and Posting ?
10. What is Posting ?

11. What is the relation between Journal and Ledger ?
12. What are the rules for Posting a Transaction ?

### PRACTICAL QUESTIONS

### NOTES

1. Journalise the following transactions :

2007	Rs.	
Oct 1	Commenced Business	20,000
Oct 1	Goods purchased for cash	10,000
Oct 2	Purchased goods from Ram	5,000
Oct 3	Sold goods to Ravi	3,000
Oct 5	Goods purchased from Prakash for cash	1,500
Oct 7	Paid wages	70
Oct 8	Sold goods to Brijesh	2,000
Oct 9	Received from Ravi	2,950
Oct 10	Paid to Ram	1,000
Oct 12	Rent paid	200
Oct 14	Goods purchased from Neeru	2,000
Oct 15	Goods sold to Yogendra	1,000
Oct 17	Paid for office expenses	500
Oct 20	Received payment from Yogendra	500
Oct 23	Paid for sundry expenses	50
	Paid for salary	1,000
	Donation in cash	51
	Charity in goods	100
Oct 30	Withdrew from Bank for office use	500

**[Ans. : Total of Journal Rs. 51,421]**

2. Pass the Journal entries in the books of Krishna :

2007	
March 1	Commenced business with cash Rs. 10,000 and goods Rs. 5,000.
March 8	Sold goods for Rs. 2,000 at 10% trade discount and 5% cash discount.
March 15	Paid to Mohan Rs. 575 in full payment of Rs. 600/-
March 20	Purchased goods worth Rs. 1,000 from Ravi at 5% trade discount.
March 30	Withdrew for personal use Rs. 500 cash and goods of Rs. 100.

**[Ans. : Total of Journal Rs. 18,950]**



## 3. Record the following transaction in Shyam's Journal

## NOTES

2007	Rs.	
July 1	Shyam commenced business	
	Cash	30,000
	Loan from 'Sanjay'	20,000
July 4	Purchased Furniture	2,500
	Motorcycle	12,000
July 6	Received order for goods from 'A'	1,400
July 10	Sold goods to 'B'	4,500
July 11	Returned goods by 'B'	1,500
July 18	Received Cash from 'B' and discount allowed to 'B'	2,950
		50
July 20	Purchased goods	8,000
	Purchased Furniture	900
July 26	Sold goods to 'Ram' for cash	1,500
	Sold goods to 'Ram' on credit	400
July 30	Paid Rent	900
	Paid Salary	750
	Paid Wages	200
July 30	Sent goods to 'A'	1,400

**[Ans. : Total of Journal- Rs. 87,350]**

## Note - (i)

July 1 - Cash A/C	Dr.	50,000
	To Capital A/C	30,000
	To Loan from Sanjay	20,000

- (ii) Order for goods costing Rs. 1,400/- received from A on 6th July, But neither cash was paid nor goods were sent. hence the transaction is not entered in the Journal.

## 4. Record the following transactions of M/S Mahipal Bros. into the Ledger :

2007

Nov 1	Commenced business with cash Rs.2,00,000
Nov 2	Deposited into Bank Rs. 1,75,000
Nov 4	Purchased goods from Mr. D for Rs. 40,000 at Trade discount 20%
Nov 6	Gave a cheque to Mr. D for Rs. 16,800 and cash discount allowed by him Rs. 200
Nov 8	Goods bought from Nilesh for cash Rs. 14,000

- Nov 10 Accepted a bill at 2 months for Rs. 15,000 drawn by Dilip.
- Nov 11 Bought goods from Suresh Rs. 75,000
- Nov 13 Paid to Suresh a cheque of Rs. 58,800 after receiving discount of 2%
- Nov 15 Cash Sales made to Jyoti Rs. 8,000
- Nov 16 Sold goods to Mohinder for Rs. 20,000
- Nov 17 Goods returned by Mohinder for Rs 1,500
- Nov 18 Received from Mohinder Rs. 7,900 after allowing a discount of 1.25%
- Nov 20 Goods sold to Banerjee Rs. 50,000
- Nov 21 Deposited into Bank Rs. 20,000
- Nov 25 Drawings (Goods) - Rs. 2,000  
Purchased furniture - Rs. 40,000, Typewriter Rs. 10,000 and paid by cheque.  
Sold goods to Anu Rs. 30,000
- Nov 27 Received full payment from Banerjee by cheque, sent it to Bank, Discount allowed 2%.
- Nov 28 Acceptance received from Anu at 30 days for the amount due from him.
- Nov 29 Paid for stationery Rs. 400 and for postage Rs. 200
- Nov 30 Rent of proprietor's house paid by cheque Rs. 2,500.

**[Ans. : Dr. Balances : Cash Rs. 58,600; Bank Rs. 1,15,900;  
Purchases Rs. 1,05,000;  
Mohinder Rs 10,500; Sales Return Rs 1,500; Discount Rs 1,100;  
Drawings Rs. 4,500; B/R Rs. 30,000; Furniture Rs. 40,000;  
Typewriter Rs 10,000; Stationery Rs. 400; Postage Rs. 200  
Cr. Balances : Capital Rs 2,00,000; Discount Received Rs. 1,400,  
B/P Rs. 15,000; Suresh Rs. 15,000; Sales Rs. 1,17,000]**

Q5. Journalise the following transaction, Post them into ledger, balance the accounts and prepare a Trial Balance :

2007		Rs.
Dec 1	Abhinav Jain commenced business with cash	80,000
Dec 2	Purchased goods for cash	36,000
Dec 4	Machinery purchased for cash	4,000
Dec 5	Purchased goods from: Mr. R	22,000
	Mr. D	30,000
Dec 6	Returned goods to Mr. R	4,000
Dec 8	Paid to Mr. R, in full settlement of his account	17,500

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Dec 10	Sold goods to Mohan & Co. for Rs. 32,000 at 5% trade discount.	32,800
Dec 13	Received cash from Mohan & Co.	19,800
	Discount allowed	200
Dec 15	Paid cash to Mr. D	14,850
	Discount received	150
Dec 20	Sold goods for cash	25,000
Dec 24	Sold goods for cash to Sudhir Ltd.	18,000
Dec 25	Paid for rent	1500
Dec 26	Received for commission	2,000
Dec 28	Withdrew cash by Abhinav for his personal use	5,000
Dec 28	Purchased a fan for Abhinav's house	1,200

[Ans. : Total of Trial Balance Rs. 1,74,850

**Dr. Balances :** Cash Rs. 6,250; Purchases Rs. 106,000; Machinery Rs. 4000;

Mohan & Co. Rs. 10,400; Rent Rs. 1,500 and Drawings Rs. 6,200.

**Cr. Balances :** Capital Rs. 80,000; Mr. D. Rs. 15,000, Purchases Returns Rs. 4,000; Discount (Received), Rs. 450; Sales, Rs. 55,400 and commission Rs. 2,000

## 2.11 REFERENCES / SUGGESTED READING

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**The Unit Covers :**

- 3.1 INTRODUCTION**
- 3.2 SPECIAL PURPOSE SUBSIDIARY BOOKS OR SPECIAL JOURNALS**
- 3.3 SALES BOOK**
- 3.4 PURCHASES BOOK**
- 3.5 PURCHASES RETURN BOOK**
- 3.6 SALES RETURN BOOK**
- 3.7 BILLS PAYABLE BOOK**
- 3.8 BILLS RECEIVABLE BOOK**
- 3.9 JOURNAL PROPER**
- 3.10 REFERENCES / SUGGESTED READING**

**3.1 INTRODUCTION**

We have already studied in preceding chapters that only one journal book is maintained for all transactions. Theoretically, it may be said that all transactions can be entered in one journal book but this is not possible in practice, because in large commercial enterprises, thousands of transactions take place everyday and one person cannot write down all in a single journal simultaneously. So, we make sub-divisions of journals into a number of 'Special Journals'. These are also known as 'Special Purpose Subsidiary Books' or the 'Books of Original Entry'.

The chapter on subsidiary books is an attempt to make students familiar with additional books of Accounting. This chapter delivers the information on special purpose subsidiary books, purchases books, purchases return books and sales returns book and how to do postings in these books has been explained.



## 3.2 SPECIAL PURPOSE SUBSIDIARY BOOKS OR

### SPECIAL JOURNALS

#### NOTES

#### Meaning

If the size of the business is large the system of book-keeping should be easy and simple to follow, and should be such as to allow division and sub-division of duties and speedy working. If the size of the business is a small one, then it is possible to enter each and every transaction in the journal, commonly known as books of original record or primary record. But when size of the business grows, it is no longer possible to record all the transactions in one general journal, but the main journal is split into a number of separate journals or Day Books. A separate Day Book is used for each type of transaction. These transactions are usually numerous. These journals are prepared almost everyday and are of specialized character as they include transactions relating to one type of transactions. They are, therefore, known as special journals. They may also be called **special purpose subsidiary books**.

**Subsidiary Books** may be defined as books where transactions are entered first for the purpose of record. In a large business, the subsidiary books generally used are:

- (1) Purchase Journal or Purchases Book,
- (2) Sales Journal or Sales Book,
- (3) Purchase Returns Journal or Purchases Returns Book,
- (4) Sales Returns Journal or Sales Returns Book.
- (5) Bills Payable Book
- (6) Bills Receivable Book
- (7) Journal Proper

#### Advantages

1. All transactions of one nature are collected at one place. It facilitates the posting to the impersonal account with the total.
2. Special journals facilitate the division of labour. The work of posting can be entrusted to several assistants at the same time and thus the ledger of a large business can be written up in a very short time. Internal check can also be introduced.
3. When transactions of similar nature are collected at one place a careful survey of the trend and pattern of distribution and other factors can be of help in day-to-day decisions of management. For example, a careful study of sales returns journal might reveal the cause of return, loss due to such return on.

4. Division of work results in increased efficiency. Each person of accounting staff is required to write upon only one class of transactions, therefore it develops proficiency of work.
5. It results in saving of time.
6. It makes information available regarding each particular class of transactions.
7. At the time of preparing trial balance the checking is easier because books being many different persons can carry out the job.

## NOTES

### 3.3 SALES BOOK.

Sales Book is used for recording sales of goods on credit. If there are cash sales, they are recorded in cash receipts journal (cash book) and not in sales journal. Thus, it will be seen that the use of sales journal is very much limited to the recording of only credit sales of goods.

The entries in the sales book are made from the copies of the invoices which have been sent to the customers along with the goods. Such copies of the invoices may be termed as 'Outward Invoice'.

The format of sales journal is as follows :

SALES BOOK

Date	Particulars	Invoice No.	L.F.	Details Rs.	Amount Rs.

The particulars column is meant to record the name of the supplier, name of the articles and quantities sold. The amount in respect of each article is entered in the details column. After totalling the various amounts included in a single sale, the amount for packing, or other charges is added and the amount for trade discount is deducted. The net amount is entered in the extreme right-hand column. The total in this column will show the total credit sales for a period. The number of invoice or bill is mentioned in respective column. In L.F. column the folio number of ledger is written where the concerned account has been opened.

#### EXAMPLE 1 :

The following are some of the transactions of X. Make out their Sales Book:

Sold to A on credit :            20 Tables @ Rs. 100  
    30 Chairs @ Rs. 200  
    Less: Trade Discount @ 10%

Sold old furniture to B on credit Rs.1,000.

Sold 25 Tables on credit to C @ Rs. 100 each for cash.

Sold on credit to D:

100 Table @ Rs. 175.

10 doors @ Rs. 500

Less: Trade Discount @ 10%

## NOTES

## Solution 1 :

## SALES BOOK OF X

Date	Particulars	Invoice No.	L.F.	Details Rs.	Amount Rs.
Date of Transaction	<b>A</b>				
	20 Tables @ Rs. 100			2,000	
	30 Chairs @ Rs. 200			6,000	
				8,000	
	Less : Trade Discount @ 10%			800	
	Sales as per invoice No...dated...				7,200
	<b>C</b>				
	25 Tables @ Rs. 100				
	Sales as per invoice No...dated...				2,500
	<b>D</b>				
	100 Tables @ Rs. 175			17,500	
	10 Doors @ Rs. 500			5,000	
				22,500	
	Less: Trade Discount @ 10%			2,250	
	Sales as per invoice No...dated...				20,250
	Sales A/c ...Cr.				29,950

**Posting of Sales book.** The names appearing in the sales book are of those parties which have received the goods on credit. 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.

The amount put on the credit side is equal to the total of the amounts put on the debit side. Thus, the double entry principle is followed strictly.

## Ledger of X

Dr.				Cr.			
Date	Particulars	Folio	Amount	Date	Particulars	Ledger	Amount
	To Sales		7,200				
B							
	To Sales		2,500				
C							
	To Sales		20,250				

## SALES ACCOUNT

					By Sales	29,950
					As per Sales Book for the month of.	



### 3.4 PURCHASES BOOK

## NOTES

Purchases journal is used for recording purchase of goods purchased on credit basis. Credit purchases of goods dealt in or materials used for production in the factory are recorded in a separate register, called the purchases book or the purchase journal. When we purchase goods on credit we receive a statement from the suppliers giving the particulars of the goods supplied by him. This statement is called an 'Inward Invoice'. The proforma of a purchase book is given below:

PURCHASES BOOK

Date	Particulars	Invoice No.	L.F.	Details Rs.	Amount Rs.

**Source of Recording :** The entries in the Purchases Book are made from the invoices received from the suppliers with the amounts arrived after deducting trade discount.

Cash purchases are not entered since they are entered in the cash book; only credit purchases of goods traded in or material used for production in factory should be recorded in a purchase book. Credit purchases of Asset are also not recorded in it.

In the particulars column, the name of the supplier and the name of the articles and quantities purchased are recorded. 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 of trade discount is deducted. The net amount is entered in the extreme right-hand column. The total in this column will show the total purchases made in a period. The number of invoice or bill is mentioned in respective column.

**Trade Discount.** The amount of the purchase made is always arrived at after deducting the trade discount, i.e., only the net amount is considered.

**Sales Tax.** The amount of sales tax charged by the supplier of goods is added to the amount of purchases. If trade discount is also given, first deduct trade discount and then calculate sales tax on remaining balance.

**Posting of Purchases Book.** The book shows the names of the parties from whom goods have been purchased on credit. These parties are, now in accounting terminology, creditors. Their accounts have to be credited for the respective amounts shown in the total purchases made in a period. This amount is debited to the Purchases Account to indicate receipt of goods.

**Example 2 :** Enter the following transaction in the Purchase Book of PVR. & Co., Kota :



2007

## NOTES

June 2 Purchased goods from Shreekant, Gumanpura on credit :

100 Dozen Bulbs @ Rs. 50 per Dozen

25 Fans @ Rs. 200 each

10 Heaters @ Rs. 50 each

Trade Discount 15%.

June 20 Purchased goods from Ram Mohan &amp; Co., Talwandi, on credit :

60 Dozen Bulbs @ Rs. 50 per Dozen

10 Tubelights @ Rs. 60 each

Trade Discount 10%

Solution :

## PURCHASE BOOK

Date	Particulars	Invoice No.	L.F.	Details Rs.	Amount Rs.
2007	Shreekant, Gumanpura				
June 2	100 Dozen Bulbs @ Rs. 50 per dozen			5,000	
	25 Fans @ Rs. 200 each			5,000	
	10 Heaters @ Rs. 50 each			500	
				<u>10,500</u>	
	Less : Trade Discount 15%			1,575	8,925
June 20	Ram Mohan & Co., Talwandi				
	60 Dozen Bulbs @ Rs. 50 per Dozen			3,000	
	10 Tubelights @ Rs. 60 each			600	
				<u>3600</u>	
	Less : Trade Discount 10%			360	3,240
					<u>12,165</u>
June 30	Purchase A/C Dr.				

## 3.5 PURCHASES RETURN BOOK

This journal is used for recording transactions relating to return of such goods as were purchased on *credit* basis. It contains details related to return of goods purchased by the firm for which no cash is paid. It is also called Returns Outward Book. It is so called because goods are returned and go out of business to the suppliers.

The form of Purchase Return Book is given below:

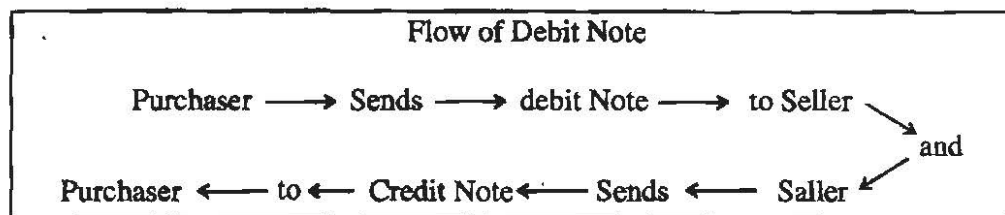
## PURCHASE RETURN BOOK

Date	Debit Note No.	Particulars	L.F.	Details Rs.	Amount Rs.

**Debit Note:** It is a note made out with a carbon duplicate. The duplicate copy is for office record and the original one is sent to the party to whom the goods

are returned. It is called a debit note because the party's account is debited with the amount written in this note. The same note is termed as credit note from the receiving party's point of view because he will credit the account of the party from which he has received the note together with goods. The Purchaser sends a debit note to seller and the seller sends the credit note to the purchaser.

## NOTES

**Posting from purchase return book.**

- (a) Individual amounts are posted immediately on the happening of event to the debit of party's account; and
- (b) Monthly total of the journal is credited to the purchases return account.

**Example 3 :** Enter the following transactions in the Purchase Return Book of Shri Pravin Jain :

2007

- Nov. 7 Return goods to RJ & Sons for Rs. 2,000. Trade Discount 10%.
- Nov. 15 Return goods to Housefull store for Rs. 5,000 as the goods were not according to sample.
- Nov. 25 Allowance claimed from Nyati Builders, on account of mistake in the invoice Rs. 3,500.

**Solution :**

**PURCHASE RETURN BOOK**

Date	Debit Note No.	Particulars	L.F.	Details	Amount
2007					
Nov. 7		RJ & Sons		2,000	
		Less : Trade Discount 10%		200	1,800
Nov. 15		Housefull Store			5,000
Nov. 25		Nyati Builders			3,500
Nov. 30		Purchase Return A/C	Cr.		10,300

**3.6 SALES RETURN BOOK**

This journal is used for recording transactions relating to return of such goods as were sold by the firm to its customers on credit basis. It contains details regarding return of goods purchased by customers for which no cash is received. This is also called Returns Inward Book or Sales Return Book because goods returned by customers come in the business.

The form of Sales Return Book is given below:

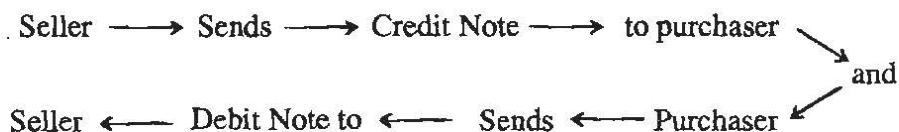
## SALES RETURN BOOK

Date	Credit Note No.	Name of the Customer	L.F.	Details Rs.	Amount Rs.

## NOTES

**Credit Note.** It is made with a carbon duplicate- the duplicate copy being for office use. The original copy is sent to the party from which goods are received. From the point of view of business which receives goods, this note is called a credit note because the party's account is credited with the amount written in this note. The same note is called a debit note by the party who returns goods because that party uses this note for debiting the account of the party to whom goods have been returned. The Seller sends a credit note to the purchaser and the purchaser sends a debit note to the seller.

## Flow of Debit Note



## Posting from Sales Return Journal.

- (a) Individual amounts are posted immediately on the happening of event to the *credit* of party's account; and
- (b) Monthly total of the journal is debited to sales return account.

**Example 4 :** Enter the following transactions in the Sales Return Book :

2007

June 7 Goods returned by M/s Brown & Co :

6 fans @ Rs. 600 each

Trade Discount 10%

June 23 M/s Carol. & Co. returned 1 lamp of Rs. 500.

**Solution :**

## SALES RETURN BOOK

Date	Particulars	L.F.	Details Rs.	Amount Rs.
2007				
June 7	M/s Brown & Co. 6 fans @ Rs. 600 Less : Trade Discount @ 10%		3,600 <u>360</u>	3,240
June 23	M/s Carol & Co. 1 lamp			500
June 30	Sales Return A/c Dr.			3,740



## 2.7 BILLS PAYABLE BOOK

When goods are sold on credit, a bill of exchange, payable after sometime may be drawn by a seller (creditor) on the purchaser (debtor). The bill of exchange is then, accepted by the debtor indicating that he would pay the amount written there in on the expiry of the period mentioned on the bill. After accepting the bill is returned to the creditor. To the Creditor, the bill is termed as 'Bills Receivable' since he is to receive it, while the same bill is termed as 'Bills Payable' to the Debtor since he is to pay the amount mentioned in it at a future date.

Whenever a bill of exchange is accepted its particulars are entered in a separate book called bills payable book. Its format is given below :

Date of Acceptance	To whom given	Period of Bill	Due date	L.F.	Amount Rs.	How disposed

### Posting

The periodical total of the bills payable book is posted to the credit of the bills payable account in the ledger. Each entry in the book is posted to the debit of the individual account from whom the bill is granted.

**Example 5 :** Record the following transactions in the Bills Payable Book :

2007

- Oct 1 Accepted a bill of Rs. 20,000 for 2 months drawn by M/s Babli & Sons.
- Oct 20 Gave acceptance to Mahavir & Co. for Rs. 10,000 payable 1 month after the date.
- Oct 28 A bill at 45 days for Rs. 9,000 drawn by Arihant & Co. was accepted on this day.

**Solution :**

### BILLS PAYABLE BOOK

Date of Acceptance	To Whom Given	Period of Bill	Due Date	L.F.	Amount Rs.	How disposed
2007						
Oct 1	M/s Babli & Sons	2 Month	3 Dec.		20,000	
Oct 20	Mahavir & Co.	1 Month	3 Nov.		10,000	
Oct 28	Arihant & Co.	45 days	15 Jan.		9,000	
Oct 31	Bills Payable A/C			Cr.	39,000	



### 3.8 BILLS RECEIVABLE BOOK

Whenever a bill of exchange is received its particulars are entered in a separate book called Bills Receivable Book. This book is also a book of original entry. Its format is given as :

NOTES

Date of Receipt	From Whom Received	Period of the Bill	Due Date	L.F.	Amount Rs.	How disposed

#### Posting

The periodical total of the bills receivable book is posted to the debit of the bills receivable account in the ledger. Each enter in the book is posted to the credit of the individual account from whom the bill is received.

**Example 6 :** Record the following transactions in the Bills Receivable Book :

2008

Jan 5 Received from Shreekant his acceptance at 3 months for Rs. 10,000

Jan 18 Acceptance received from Taranjeet for Rs. 50,000 for 60 days.

**Solution :**

#### BILLS RECEIVABLE BOOK

Date of Receipt	From Whom Received	Period of Bill	Due Date	L.F.	Amount Rs.	How disposed
2008						
Jan 5	Shreekant	35 days	Feb. 12		10,000	
Jan 18	Taranjeet	60 days	March 22		50,000	
Jan 31	Bills Receivable A/C			Dr.	60,000	

### 3.9 JOURNAL PROPER

After the sub-division of journal into various subsidiary books, journal remains only a residuary book in which only those transactions are recorded which cannot be recorded in any other subsidiary book. In such a case, journal is called journal proper.

The following types of transactions are recorded in Journal proper.

(1) Opening Entries

(2) Closing Entries

(3) Transfer Entries

(4) Adjustment Entries

(5) Rectifying Entries

(6) Other Entries – Purchase or sale of asset on credit, Endorsement, Cancellation &amp; dishonour of Bill, etc.

## NOTES

**Example 7 :** Enter the following transaction of Kumar & Sons in appropriate Subsidiary Book.

2007

Jan 1 Assets : Cash in hand Rs. 5,400, Due from Sanjay Rs. 7000/-, Due from Dheeraj Rs. 20,000; Stock Rs. 80,000; Furniture Rs. 25,000

Liabilities – Bank Overdraft Rs. 36,200. Due to Sun Rs. 9200.

Jan 3 Purchased from Laxman & Sons 10 Bags of tea @720 each less 10% trade discount.

Jan 5 Purchased from Dass 20 tins of coffee @ Rs. 480/-, less 5% trade discount. Half the payment is made in cash and half by cheque.

Jan 6. Purchased Machinery for Rs. 10,000 from Praful on credit.

Jan 8. Received Cash from Sanjay Rs. 6,800 in full settlement of their account.

Jan 10. Deposited from Bank Rs. 5,000/-

Jan 12. Sold to Sen & Co. goods as follows –

4 bags of coffee @ Rs. 950 each

12 tins of coffee @ Rs. 700 each

Jan 15. Returned to Laxman & sons 1 bag of tea.

Jan 16. Sold to Shankar 20 bags of tea @ Rs. 1,000 each less 5% trade discount.

Jan 17. Shankar returned 1 bag of tea.

Jan 18. Shankar accepted a bill for 1 month for the amount due from him.

Jan 20. Received a cheque of Rs. 10,000 from Sen & Co. The cheque is immediately deposited into bank.

Jan 21. Purchased from Vijay & Co. 20 bags of tea @ Rs. 800 each and 5 tins of coffee @ Rs. 500 each.

Jan 22. 2 bags of tea costing Rs. 700 each are taken by Mr. Kumar for personal use.

## NOTES

- Jan 24. Returned to Vijay & Co. 2 bags of tea and 1 tin of coffee.
- Jan 25. Acceptance given to Vijay & Co. for 2 months for the amount due to them.
- Jan 27. Acceptance received from Sen. & Co. for Rs. 2,200 for 30 days.
- Jan 28. Withdrew from Bank for personal use of Rs. 4,000 and for office use Rs. 6,000.
- Jan 30. Paid rent by cheque Rs. 4,000.

Solution :

## Purchase Book

Date	Particulars (Name of Suppliers)	Invoice No.	L. F.	Details	Amount
2007 Jan 3.	Laxman & Sons 10 bags of tea @ Rs. 720 each (-) 10% Trade discount			7,200 720	6,480
Jan 21.	Vijay & Co. 20 bag of tea @ Rs. 800 each 5 tins of coffee @ Rs. 500 each			16,000 2,500	18,500
Jan 31	Purchase A/c Dr.				24,980

## Sales Book

Date	Particulars (Name of Customers)	Invoice No.	L. F.	Details	Amount
2007 Jan 12.	Sen & co. 4 bags of coffee @ Rs. 950 each 12 tins of coffee @ Rs. 700 each			3,800 8,400	12,200
Jan 16.	Shankar 20 bags of tea @ Rs. 1000 each Less : Trade discount 5			20,000 1,000	19,000
Jan 31.	Sales A/c Cr.				31,200

## Purchases Return Book

Date	Particulars (Name of Customers)	Debit Note No.	L. F.	Details	Amount
2007 Jan 15.	Laxman & Sons 1 bag of tea @ 720 Less : 10% Trade Discount			720 72	648
Jan 24.	Vijay & Co. 2 bags of tea @ Rs. 800 1 Tin of coffee @ Rs. 500			1,600 500	2100
Jan 31.	Purchase Return A/c Cr.				2,748

### Sales Return Book

Date	Particulars	Debit Note No.	L. F.	Details	Amount
2007 Jan 17	Shankar 1 bag of tea @ Rs 1000 Less : 5% Trade Discount			1000 50	950
Jan 31	Sales Return A/C Dr.				950

### Bills Payable Book

Date	To Whom Given	Period of Bill	Due Date	L.F.	Amount	How disposed
2007 Jan 25	Vijay & Co.	2 Month	March 28		16,400	
Jan 31	Bills Payable A/C Cr.				16,400	

### Bills Receivable Book

Date	For Whom Given	Period of Bill	Due Date	L.F.	Amount	How disposed
2007 Jan 18	Shankar	1 Month	Feb 21		18,050	
Jan 27	Sen & Co.	30 days	March 1		2,200	
Jan 31	Bills Receivable A/C Cr.				20,250	

### Journal Proper

Date	Particulars	L.F.	Dr.	Cr.
2007 Jan 1	Cash A/C Dr. Sanjay A/C Dr. Dheeraj Dr. Stock A/C Dr. Furniture A/C Dr. To Bank Overdrafts A/C To Sun To Capital A/C (Balancing figure) (for opening balances brought forward)		Rs. 5,400 7,000 20,000 80,000 25,000	Rs.     36,200 9,200 92,000
Jan 6	Machinery A/C Dr. To Praful A/C (for machinery purchased on credit)		10,000	10,000
Jan 8	Discount A/C Dr. To Sanjay A/C (for discount allowed to Sanjay in full settlement)		200	200
Jan 22	Drawings A/C Dr. To purchases A/C (for 2 bags of tea costing Rs. 700 each taken for personal use)		1,400	1,400

NOTES

## SUMMARY

- If the size of the business is large the system of book-keeping should be easy and simple to follow so as to allow division and sub-division of duties and speedy working. If the size of the business is a small one, then it is



## NOTES

possible to enter each and every transaction in the journal, commonly known as books of original record or primary record.

- All transactions of one nature are collected at one place.
- Special journals facilitate the division of labour.
- When transactions of similar nature are collected at one place a careful survey of the trend and pattern of distribution and other factors can be of help in day-to-day decisions by management.
- Sales journal is used for recording sales of goods on credit.
- Purchases journal is used for recording purchase of goods purchased on credit basis. Credit purchases of goods dealt in or materials used for production in the factory are recorded in a separate register, called the purchases book or the purchase journal.
- The entries in the purchases book are made from the invoices received from the suppliers with the amounts arrived at after deducting trade discount. Cash purchases are not entered since they are entered in the cash book; only credit purchases of goods traded in or material used for production in a factory should be recorded in a purchase book.
- Trade Discount is the discount which is allowed if the customer purchases goods above a certain quantity or above a certain amount.
- Posting of purchases Book shows the names of the parties from whom goods have been purchased on credit.
- Purchases Return Book is used for recording transactions relating to return of such goods as were purchased on credit basis.
- Debit note is a note made out with a carbon duplicate. The duplicate copy is for office record and the original one is sent to the party to whom the goods are returned. It is called a debit note because the party's account is debited with the amount written in this note.
- Sales Return Book is used for recording transactions relating to return of such goods as were sold by the firm to its customers on credit basis. It contains details regarding return of goods purchased by customers for which no cash is received. This is also called Returns Inward Book or Sales Return Book because goods returned by customers come in the business.
- Credit Note is made with a carbon duplicate- the duplicate copy being for office use. The original copy is sent to the party from which goods are received. From the point of view of business which receives goods, this note is called a credit note because the party's account is credited with the amount written in this note.

- All receipts of bills are entered in the book called bills receivable. The details of the bills accepted by a trader are recorded in a book known as Bills Payable Book.

## EXERCISE

## NOTES

1. What are Subsidiary Books ?
2. Write the names of Subsidiary Books of Journals.
3. What are Subsidiary Books and their advantages ?
4. Write any 3 advantages of Subsidiary Books ?
5. What is Purchase Book ?
6. What is Sales Returns Book ?
7. What is the difference between Purchases Book and Sales Return Book ?

## PRACTICAL QUESTION :

Q1. Following transactions were recorded in the books of Shri Karwar :

2007

March 1 Sold to Kamal light Center :

50 Tubelights @ Rs. 60 each less 20%

20 Heaters @ Rs. 120 each less 25%

March 5 Purchased from Ram Shyam & Co. :

25 Table Fans @ Rs. 600 each

20 Ceiling Fans @ Rs. 800 each

March 10 Goyal & Sons purchased from us :

80 dozen bulbs @ Rs. 90 per dozen

March 12 Purchases from Ram Shyam & Co.

Typewriter for Rs. 6000 on credit for office use.

March 16 Sri Ram & Sons sold us :

10 Electric Boards @ Rs. 180 less 10%

March 20 Kamal Light Center returned :

5 Tube lights sold on March 1.

March 22 Sold goods to Nirma & Co. for cash Rs. 10,000.

You are required to prepare (i) Purchase Book (ii) Sales Book  
(iii) Purchase Return Book (iv) Sales Return Book

## NOTES

***[Ans. : Total of purchase book Rs. 39, 820, Total of Sales Book Rs. 4200,  
Total of Purchase Return Book Rs. 324, Total of Sales Return Book  
Rs. 240  
Purchase of Typewriter should be entered in Journal proper***

**3.10 REFERENCES / SUGGESTED READING**

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## **BLOCK – II**



**The Unit Covers :****4.1 INTRODUCTION****4.2 TRIAL BALANCE****4.2.1 MAIN CHARACTERISTICS AND USES OF A TRIAL BALANCE****4.2.2 FUNCTIONS OF A TRIAL BALANCE****4.2.3 LIMITATION OF A TRIAL BALANCE****4.2.4 PREPARATION OF TRIAL BALANCE****4.3 ERRORS****4.3.1 REASONS FOR DISAGREEMENT OF A TRIAL BALANCE****4.3.2 ERRORS DISCLOSED BY TRIAL BALANCE****4.3.3 TYPES OF ERRORS****4.4 STEPS TO LOCATE THE ERRORS****4.5 EFFECT OF ERRORS ON TRIAL BALANCE****4.6 RECTIFICATION OF ERRORS****4.7 SUSPENSE ACCOUNT****4.8 REFERENCES / SUGGESTED READING****4.1 INTRODUCTION**

Books of accounts are often closed at the end of the year, but they may be closed at any time according to the requirement of the businessman, wherever books are closed, balances are found out in various accounts and then these balances are recorded in a statement called trial balance.

The chapter on Trial Balance serves detailed information on Trial Balance and its associated facts. By the end of this chapter you will know many crucial points related with trial balance. You will know the importance of trial balance, errors in trial balance and most importantly how to locate errors and rectify them.

**4.2 TRIAL BALANCE, ERROR AND THEIR RECTIFICATION****NOTES****Meaning**

A basic rule of double-entry accounting is that for every credit there must be an equal debit amount. Trial Balance is a statement of accounts which appeared in the ledger showing either the balances or total amounts of debit and credit items. The trial balance is prepared after posting the journal entries into the ledger and balancing the accounts. All the debit entries are written on one side and all the credit entries on the other side. The total of the debit side of trial balance must be equal to that of the credit side. If debits do not equal credits, then it reflects that an error has occurred. The Trial Balance is a tool for detecting such errors.

The trial balance is prepared by putting the balances of all the ledger accounts in a list. The account balances are used because the balance summarizes the net effect of all of the debits and credits in an account.

The preparation of a Trial balance is an essential part of the process because if totals of both the sides are the same then it is proved that books are at least arithmetically correct.

The trial balance is a worksheet where all general ledger accounts and their debit or credit balance appear. It is a tool that is used to detect errors in the books. The total debits must equal the total credits. At the end of the accounting period three trial balances are prepared:

- A preliminary trial balance is prepared using general ledger account balances before making adjusting entries.
- An adjusted trial balance is prepared after passing adjustment entries and posting them to general ledger. This will ensure that the books used to prepare financial statements are in balance.
- A post-closing trial balance is prepared after posting closing entries. This trial balance, which contains only balance sheet accounts, will guarantees that the books are in balance for the beginning of the new accounting period.

**4.2.1 Main characteristics and uses of a trial balance**

Following are the main characteristics of a trial balance –

1. It is a statement prepared in a tabular form. It has two columns – one for debit balances and another for credit balances.
2. Closing balances, are the balances at the end of the period as shown by ledger accounts.
3. Trial balance is only a statement of balances.
4. It can be prepared on any date provided accounts are balanced.

5. It is a consolidated list of all ledger balances at the end of a period at one place.
6. It is a method of verifying the arithmetical accuracy of entries made in the ledger. The agreement of the trial balance means that the total of the debit column agrees with the total of the credit column of the trial balance.
7. It is a big help in preparation of Trading A/c, Profit and Loss A/c and the Balance Sheet at the end of the period which exhibit the financial position of the firm.

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**4.2.2 Functions of a Trial Balance.**

The functions of a Trial Balance are:

1. To ascertain arithmetical accuracy by checking that both the sides are in balance.
2. It provides a summarized version of the position of each account and enables one to know the asset and liability of a firm.
3. Preparation of financial statements and various adjustments can be made on the basis of trial balance.
4. Error in journals, posting to ledger accounts and balancing the ledger accounts can be detected easily.
5. Enables the auditor to check whether any corrections were made after the accounts were checked.

**4.2.3 Limitations of a Trial Balance.**

If the trial balance agrees, it does not mean that now there are absolutely no errors in the books. Even if trial balance agrees, some errors may remain undetected and may not be disclosed by the trial balance. This is the major limitation of a trial balance. The errors which are not disclosed by a trial balance are as under:

- (i) *Omission of an entry in the original book* : If an entry has not been recorded in the original or subsidiary book at all, then both the aspects of the transaction will be omitted and the trial balance will not be affected.
- (ii) *Wrong recording in original books* : If wrong entry for any transaction has been passed into the original books, the trial balance will agree because both the sides will be affected equally.
- (iii) *Posting an item on the correct side but to the wrong account* : If, suppose, cash has been received on account from A, but this transaction has been credited to B's A/c, the amount being correct, the trial balance will agree and it will not reveal this error.
- (iv) *Compensating errors* : These are errors arising from the excess- debits or under- debits of accounts being neutralized by the excess- credit or under-



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credit to the same extent of some other accounts. It is very rare that such errors of equal amounts arise on the debit as well as on the credit sides of the ledger accounts. Such errors do not affect the agreement of a trial balance.

- (v) *Error of principle* : Whenever any amount is not properly allocated between capital and revenue or some double entry principles are violated the error so made is known as error of principle. If wages paid for erection of machinery are debited to wages account, then this is an error of principle.

When a trial balance disagrees and the difference between debit and credit balances is quite large, it would never be safe to allow these errors to remain undetected. All possible efforts should be made to localize the cause of the difference. Final accounts must not be prepared unless and until trial balance agrees, otherwise final accounts will not present true picture of final state of affairs. In very exceptional circumstances, if the preparation of final accounts cannot be further delayed due to requirements of law, then after due careful effort to locate errors, the difference may be temporarily transferred to a Suspense Account and shown accordingly in the Balance Sheet. If it has a debit balance, it will be shown on assets side, otherwise on liabilities side.

#### 4.3.1 Reasons for disagreement of a Trial Balance.

The reasons for disagreement of a trial balance may be enumerated as under:

- Error in bringing forward proper or correct balances from the previous year's books.
- Errors in additions of items in accounts and carry forwards of total to next page.
- Cash balance or bank balance may be omitted to be recorded in trial balance.
- Posting of entries to wrong sides of accounts.
- Balance of personal accounts placed on wrong sides in trial balance.
- Omission of any monthly totals of the Purchases Journal, Sales Journal, Returns Journal, Bills journal to be posted in the ledger.
- Omission of any balance from the nominal accounts, e.g., salary, rent, etc. in the trial balance.
- Wrong posting of the totals of discount columns from the cash book to the trial balance.

All possible steps must be taken to locate the errors and then to rectify them before proceeding to prepare final accounts.

#### 4.3.2 Errors disclosed by Trial Balance.

Trial Balance, in general, discloses any error which affects one side of the account. Some of the examples are as follows:



- (i) An item omitted to be posted from subsidiary records.
- (ii) Error in casting the books of subsidiary records.
- (iii) Error in balancing an account.
- (iv) A wrong amount posted to the correct account.
- (v) Error in additions of ledger accounts, unless they are of compensating nature.
- (vi) Forgetting to take the balance of an account in the trial balance.
- (vii) Error in preparing the list of Debtor's and Creditor's balances.

#### 4.2.4 PREPARATION OF A TRIAL BALANCE

There are two methods of preparing the Trial Balance:

##### Total Method :

- The first method is known as the 'totals' method. In this method, the totals of debit and credit sides of the ledger accounts are shown in the trial balance. Balance of ledger accounts is not taken. The sum totals of debit and credit columns of the trial balance must be equal. Then the trial balance is said to agree.

**Ram's Books**  
TRIAL BALANCE as on March 31, 2007

S.No.	Title of accounts	L.F.	Debit total Rs.	Credit total Rs.
1.	Cash account		3,00,000	75,000
2.	Ram's capital account			2,00,000
3.	Purchases account		1,50,000	
4.	Machinery account		50,000	
5.	Nathan		25,000	50,000
6.	Darshan		50,000	1,50,000
7.	Rakesh		7,000	
8.	Sales account			1,07,000
	Total		<u>5,82,000</u>	<u>5,82,000</u>

##### Balance Method :

- The second method is known as 'Balances' method. In this method, the balances of ledger accounts are taken to respective debit and credit columns of the trial balance and then grand total is taken out. The total of balances in the debit column must be equal to the total of balances in the credit column of the trial balance. Then only, the trial balance is said to agree.

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S.No.	Title of accounts	L.F.	Debit total Rs.	Credit total Rs.
1.	Cash account		2,25,000	
2.	Ram's capital account			2,00,000
3.	Purchases account		1,50,000	
4.	Furniture account		50,000	
5.	Nathan			1,00,000
6.	Darshan			25,000
7.	Rakesh		7,000	
8.	Sales account			1,07,000
	Total		4,32,000	4,32,000

The agreement of a trial balance provides a very useful check upon the posting into the ledger. It is thus ascertained that both the aspects of each transaction, debit and credit, have been recorded and that the books are arithmetically accurate. But it is not a conclusive proof. Thus, a trial balance may agree arithmetically yet there may be a number of errors in book-keeping.

**4.3 ERRORS****TYPES OF ERRORS**

Errors can broadly be divided into the following categories:

- (a) Errors of Principle
  - (b) Errors of Omission
    - Errors of complete omission
    - Errors of partial omission
- (c) Errors of Commission
- (d) Compensating errors

Errors (b), (c) and (d) can also be termed as clerical error.

**Errors of Principle**

An error of principle is one where a transaction is not recorded as per the accounting rules of debit and credit or in violation of some other basic principle. Error of principle is involved whenever the amount received or spent is not properly allocated between revenue and capital. This distinction between capital and revenue is of great importance because any incorrect adjustment or allocation in this respect would alter the final result.

Examples of such errors are:

1. Furniture purchased on credit wrongly recorded in Purchases Journal instead of Journal Proper. This means that Purchases account has been

wrongly debited instead of Furniture account. This is an error of principle because the item of capital expenditure (i.e. furniture) has been treated as revenue expenditure (i.e., purchase of goods.)

2. Sale of a fixed asset has been passed through the Sales Journal. This way, the Sales account has wrongly been credited instead of the fixed asset account.
3. Commission paid for purchase of land is debited to commission account instead of land account.

### Errors of omission

When a transaction has been omitted to be recorded in the books of account- either wholly or partially. Thus, it is of the following two types:

- (a) **Complete omission.** Here the transaction is completely omitted from the books. If a transaction is not recorded in the books of account or a transaction recorded in the journal is not posted in the ledger such error arises. Such errors do not affect the trial balance.

Example:

Failure to record credit sales transaction in Sales Journal.

- (b) **Partial omission.** This means that the transaction is entered in the subsidiary books but it is not posted in the ledger. This can happen in relation to any subsidiary book. Such errors result in trial balance being not tallied.  
Example: A credit purchase is entered in the Purchase Journal but not posted to the credit of the supplier's or creditor's account.

Such errors do affect the agreement of trial balance. Trial balance would not agree due to such errors, there would be either short debit or short credit.

### Errors of Commission

These are the most common type of errors. Here the error is the result of commission, i.e., something being done which ought not to be done. Amounts wrongly written in the subsidiary book or in the ledger or posting into wrong account or wrong balancing are the cases of errors of commission. These mistakes are committed because of ignorance, lack of proper accounting knowledge, and carelessness of the ledger clerks. These are committed while recording transactions.

Examples of such errors are:

- Wrong amount entered in subsidiary books, e.g., a purchase of Rs. 7,500 entered in the Purchases Journal as Rs. 5,700.
- Entering the transaction in a wrong subsidiary book, e.g., a purchase transaction entered in the Sales Journal and a sales transaction entered in Purchases Journal.

**Compensating Errors**

These are the errors those cancel out the impact of each other, and thus, these types of error are the most difficult errors to detect. They may be dissimilar in nature, but are of a similar amount.

Example:

Underposting of the Purchases Journal may be compensated or cancelled out with the undercasting of the Sales Journal by a similar amount.

**NOTES****STEPS TO LOCATE THE ERRORS**

Even if there is only a small difference in the Trial balance, the errors leading to it must be located and rectified as a small difference may be the result of a number of errors. The following steps will be useful in locating errors:

1. The two columns of the Trial balance should be totalled again. If in the 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, for example, the list of sundry debtors.
2. It should be seen that the cash and bank balances have also been written in the Trial Balance.
3. The exact difference in the Trial Balance should be established. The ledger should be gone through; 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 a balance equal to half the difference has been written in the wrong column.
4. The ledger accounts should be balanced again.
5. The casting of subsidiary books should be checked again.
6. Check the totals, specially if the difference is of 1, 10, 100 and so on.
7. If the difference is divisible by 9, it is possible that some figures have been transposed.
8. If the difference is big, the balance in the various accounts should be compared with the corresponding accounts in the previous period. If the figures differ materially, the causes should be seen; it is possible that an error has been committed.
9. Posting of the amounts equal to the difference or half of 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.
10. 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.



**Example 1 :** The following is the Trial Balance prepared by an inexperienced accountant. Redraft it in a correct form and give necessary notes.

SUBSIDIARY BOOKS

### TRIAL BALANCE

For the year ending 30th June 2007

NOTES

Name of Accounts	Balance Dr.	Balance Cr.
Debtors	12,200	
Creditors		9,200
Stock (1-7-2006)	15,600	
Purchase	53,500	
Purchases Returns	2,100	
Cash	11,000	
Machinery	40,200	
Goodwill		10,000
Sales		86,200
Sales Returns		7,800
Loan from Raman	20,000	
Interest on Raman's Loan	3,000	
Bills Receivable		6,400
Capital		57,000
Life Insurance Premium	5,000	
Carriage	600	
Advertisement	2,500	
Discount received	1,500	
Investments	8,000	
Interest on Investments	800	
	1,76,000	1,76,000

**Solution :**

#### Trial Balance

(As on 30th June, 2007)

Name of Accounts	Balance Dr.	Balance Cr.
Debtors	12,200	
Creditors		9,200
Opening Stock	15,600	

NOTES

Purchase &	53,500	
Purchases Returns		2,100
Cash	11,000	
Machinery	40,200	
Goodwill	10,000	
Sales		86,200
Sales Returns	7,800	
Loan from Raman		20,000
Interest on Raman's Loan	3,000	
Bills Receivable	6,400	
Capital		57,000
Life Insurance Premium	5,000	
Carriage	600	
Advertisement	2,500	
Discount received		1,500
Investments	8,000	
Interest on Investments		800
Suspense A/C	1,000	
	1,76,800	1,76,800

## EFFECT OF ERRORS ON TRIAL BALANCE

All possible errors in accounting based on their effect on trial balance, can be categorized in two parts :

**A. Errors which affect the trial balance.** The following are the errors due to which the trial balance does not agree. These are the errors which are disclosed by the trial balance. Trial balance, in general, discloses any error which affects one side of the account. Examples are:

- (a) Error in casting the books of subsidiary records.
- (b) Error in carrying forward the total of one page to another page.
- (c) Error in posting from the books of subsidiary record to ledger.
- (d) Error in balancing the account.
- (e) Error in preparation of debtors schedule and creditors schedule.
- (f) Forgetting to carry forward a balance of an account to the trial balance.
- (g) Omission of casting.
- (h) Error in totalling the trial balance.

(i) Forgetting to write cash book balance in the trial balance.

**B. Errors which do not affect the trial balance.** Following are some of the errors which will not affect the agreement of the trial balance. These are the errors which are not disclosed by the trial balance:

(a) *Omission in recording the transaction in the books of original entry.*

If a transaction is not recorded, then both debit and credit effects of that transaction will be omitted and trial balance will not be affected.

(b) *Wrong recording in the original books.* Trial balance will not be affected because the same amount will be shown on both sides of the trial balance.

(c) *Posting to wrong account with correct amount and on correct side.*

If credit of Rs. 6,000 to Ram is wrongly posted to the credit (side is correct) of Ram's account Rs. 6,000 (amount is correct), trial balance will remain unaffected.

(d) *Compensating errors.* Such errors also do not affect the agreement of a trial balance. Forgetting to post Rs. 350 on the credit side of a certain account may be compensated by overposting of Rs. 350 on the credit side in some other account.

## RECTIFICATION OF ERRORS

Amount are considered to be authentic proof of true financial position of a concern. But inspite of best efforts there are certain transactions which are omitted to be recorded or entered wrongly in the books 'Such error affect the financial accounts. An accountant should therefore try to locate such errors and rectify them before the preparation of final accounts.

Error should never be converted by overwriting or erasing because it reduces the authenticing of accounting record. So, error should be corrected by passing a suitable journal entry, called rectifying entry.

**Stages of rectification of errors.** Rectification of errors can be carried out through the following three stages:

(a) *Before the preparation of trial balance.* Errors are normally corrected before the preparation of final trial balance. If it is done then the correction is carried out without the help of Suspense Account.

(b) *Before the preparation of final accounts.* If correction is carried out at this stage then Suspense Account is required.

(c) *After the preparation of final accounts.* Errors which affect the trading and profit and loss account are corrected with the help of Profit and Loss adjustment account or capital account. Suspense account is also used wherever necessary.

**Classification of errors from rectification point of view.**

Errors can be classified into two broad categories:

- (1) Errors which affect one account / One Sided Errors; and
- (2) Errors which affect two or more accounts / Two Sided Errors

**Errors which affect one account :** Errors which affect one account can be errors of

- (a) Casting,
- (b) Carry forwarding
- (c) Posting,
- (d) Balancing,
- (e) Forgetting to show in the trial balance.

Such errors should first be located and then rectified by giving an explanatory note or by giving a journal entry with the help of a suspense account.

**Rectification of errors of casting and carry forwarding :** The process of totalling the transaction at the end of the period is called casting. Error of casting means mistake in getting the total.

**Errors of casting** are of two types, i.e., undercasting and overcasting. In the case of undercasting, the correction is carried out by putting the amount on that side of the account on which usual posting is made. But in the case of overcasting the amount in excess is put on the opposite side. In order to rectify the error of casting an explanatory note is given.

**Rectification of errors of posting :** Error of posting can be recognized by setting any of the three key words:

- Posted
- Credited
- Debited

In case the word *posted* is used then the side of the account on which the amount is to be posted is always taken as *correct*. What is correct side is determined by the merit of the case. Word '*debited*' and '*credited*' stand for debit side and credit of the account respectively.

**Rectification of errors of balancing.** When a mistake occurs in calculating the balance of a ledger account it leads to wrong copying of the balance in the trial balance. Correction is carried out by means of an explanatory note either on the debit or credit side of the account wherever necessary.

**Example 2 :**

Rectify the following errors:

- (a) Sales to Ram Rs. 4,000 Debited to his account as Rs. 400.
- (b) Sales to Rajesh Rs. 3,400 posted to his account as Rs. 4,300.

**Solution :** These errors will be rectified as follows :

- (a) There is a short debit to Ram's account of Rs. 3,600. This error will be rectified by giving a note on the debit side of Ram's account;

"To short debit for sales (error rectified) Rs. 3,600."



- (b) More debit has been given to Rajesh's account by Rs. 900. Rs. 900 (4,300-3,400) will be written on the credit side by giving a note.

"By excess debit on account of sales (now rectified) Rs. 900."

### Errors affecting two or more accounts.

- Error of omission
- Error of recording
- Error of posting to wrong account
- Error of principle

### NOTES

**Error of Omission;** Error of omission stands for omission of recording the transaction in the books of subsidiary records. Omission of a transaction from a subsidiary record affects two accounts. Because of omission the transaction does not appear in the book and monthly casting of the books becomes wrong, which in turn, affects that account where the total of the book is taken. The omission also affects the individual account because in the absence of any record in the book posting to that account is done. For example, if a Sale to Ajit of Rs. 5,000 is not recorded then the monthly total of the Sale book will be short of Rs. 5,000 and thus purchases account will be affected. Ajit's account will also be wrong because no posting will be made to this account. Rectification of such omission is done by making a journal entry.

**Example 3 :** Following errors were committed. Rectify them.

- (1) Sales to Mohan of Rs. 6,000 were not recorded.
- (2) Purchases from Rajesh of Rs. 1,500 were omitted from the books.

**Solution:**

		Rs.	Rs.
1. Mohan	Dr.	6,000	
	To Sales		6,000
2. Purchases	Dr.	1,500	
	To Rajesh		1,500

**Error of recording :** Recording is the first stage of book-keeping and any mistake at this stage means an error in the subsidiary book. This error also affects two accounts. First, wrong recording affects the casting of the book which, in turn affects the impersonal account where the total is posted, and secondly, the individual account is incorrectly posted.

If recording is done with the less amount, then the original entry is passed with the difference amount and reverse entry is passed in case of recording with excess amount.

**Example 4 :** Rectify the following errors:

1. Sales to Harsh of Rs. 5,500 were recorded as Rs. 5,050.
2. Sales to Harsh of Rs. 5,050 were recorded as Rs. 5,500.

**Solution :****NOTES**

	Particulars	L.F.	Rs.	Rs.
1.	Harsh .....Dr. To Sales A/c (Being entry passed with the difference because the amount recorded is less than the correct amount)		500	500
2.	Sales A/c .....Dr. To Harsh ( Being reverse entry passed with the difference because the recording has been done with the excess amount)		450	450

**Error of posting to wrong account.** This error is committed when the posting is done to wrong account. It can be in any one of the following ways:

- wrong account, but correct side and correct amount,
- wrong account, correct side but wrong amount,
- wrong account, wrong side and wrong amount.
- wrong account, wrong side but correct amount.

In order to rectify such errors, it is not always possible to pass a journal entry. Under such circumstances an explanatory note can be given.

**Example 5 :** Rectify the following errors:

1. Sales to A of Rs. 5,000 posted to B's account.
2. Sales to A of Rs. 5,000 debited to B's account.
3. Sales to A of Rs. 5,000 credited to B's account.

**Solution :**

1.     A .....Dr.                      Rs. 5,000  
                    To B                                      Rs. 5,000

(Being the cancellation of wrong debit to B's account)

2.     A .....Dr.                      Rs. 5,000  
                    To B                                      Rs. 5,000

(Being cancellation of wrong debit to B's account and installation of correct debit to A's account)

3. A's account will be debited by Rs. 5,000 and B's account will also be debited by Rs. 5,000.

**Error of principle :** It involves incorrect allocation of expenditure or receipt between capital and revenue. For rectification of such errors, some important cases are given below in the form of rules.

**When asset is purchased :**

1. When asset is purchased- debit asset account and not purchases account.

2. When asset is purchased and any expense is incurred in purchasing that asset, the asset account is debited and not the expense account.
3. When a second-hand asset is purchased and is repaired before bringing it in use then the repair charges are debited to the asset account and not to repairs account.

**When asset is sold :**

1. When asset is sold, credit asset account and not sales account. If by mistake sales account has been credited then debit the sales account (to cancel the wrong credit) and credit the asset account.
2. When asset is sold and some expenses are incurred, debit asset account and cash account or party's account. In no case expense account is debited.

**Example 6 : Rectify the following errors :**

1. Paid cartage for the newly purchased machinery Rs. 500, posted to cartage account.
2. Sold old furniture for Rs. 5,000 passed through the sales book.

**Solution :**

**RECTIFYING JOURNAL ENTRIES.**

Date	Particulars	L.F.	Dr. amount Rs.	Cr. Amount Rs.
1.	Machinery A/c .....Dr. To Cartage A/c (Being cartage paid for newly purchased machinery wrongly posted to cartage account, now rectified)		500	500
2.	Sales A/c ..... Dr. To Furniture A/c (Being sale of old furniture wrongly passed through the Sales book, now rectified)		5,000	5,000

**SUSPENSE ACCOUNT**

**Meaning**

All the errors which affect one account, affect the agreement of trial balance at the end of the year, and ultimately delay the preparation of final accounts. In order to avoid the delay in the preparation of final accounts, the difference in the trial balance is put to suspense account. For Example, if the debit side of trial balance exceeds the credit side, then difference is put on the credit side and suspense account shows a credit balance. When errors are located entries are passed with the help of

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suspense account and thus when all errors affecting the trial balance are located suspense account stands closed. If suspense account still shows a balance, then it is taken to the balance sheet.

The suspense account will appear as an asset on the assets side of the balance sheet if it has a debit balance. Debit balance in the suspense account means that the credit side of the trial balance total is more than the debit side total. It will appear as a liability on the liabilities side of the balance sheet if it has a credit balance. Credit balance in the suspense account means that the debit side of the trial balance total is more than the credit side total. Efforts are made early in the next period to detect the errors. When the errors are detected, they will be duly corrected and the suspense account will be closed. The debit or credit balance in suspense account indicates the net effect of all the errors having effect on the trial balance. That is why, when correction of errors is done, the suspense account stands closed. Whenever any error is rectified, some part of suspense account is reduced (or may increase also). If the rectification needs debiting or crediting an account, the credit or debit goes to suspense account. If an error requires rectification by means of a journal entry, it does not affect suspense account. The reason is that such an error did not cause disagreement of the trial balance and hence did not contribute to the suspense figure.

**Example 7 :**

Write out the journal entries to rectify the following errors using a Suspense Account:

1. A sum of Rs. 850 received from A was posted to his debit as Rs. 580.
2. The total of the Sales Return Book has been added Ten Rupees short.
3. A discount of Rs. 350 allowed to a customer has been credited to his account as Rs. 300.

**Solution :**

## RECTIFYING JOURNAL ENTRIES

Date	Particulars	L.F.	Dr. Amount Rs.	Cr. Amount Rs.
1.	Suspense A/c .....Dr. To A A/c (Being amount Rs. 850 received from 'A' posted to his debit as Rs. 580, now rectified)		1,430	1,430
2.	Returns Inward A/c .....Dr. To Suspense A/c (Being the undercasting of Sales Returns Book rectified)		10	10
3.	Suspense A/c .....Dr. To Customer's A/c (Being the short posting in Customer's A/c rectified)		50	50



## Difference in Trial Balance :

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Trial balance is affected only by those errors which are rectified with the help of suspense account. Therefore, in order to calculate the difference of suspense account, a table is prepared and if suspense account is debited in the rectification entry, the amount is put on the debit side, and if suspense account is credited, the amount is put on the credit side of the table. The balance is calculated and is reversed for suspense account, that is, if credit side exceeds, difference is put on the debit side of suspense account (not on the credit side) and vice versa.

#### SUSPENSE ACCOUNT

Dr.			Cr.		
Particulars	L.F.	Amount Rs.	Particulars	L.F.	Amount Rs.
To A's A/c		1,430	By Return Inward A/c		1,470
			By Balance, difference in the trial balance		10
To Customer's A/c		50			
		<u>1,480</u>			<u>1,480</u>

## Effect on Net Profit :

In order to calculate the effect of errors on net profit, it is essential to understand that only those accounts which are taken to trading account or profit and loss account affects profits. For example, purchases account, wages, salaries, etc., affect the net profit because they are shown either in trading account or profit and loss account. If any one of these accounts is debited in the rectification entry, it reduces the profit and if any of these accounts is credited then it increases the profit. Accounts which are shown in the balance sheet do not affect net profit.

## Correction in the Next Accounting Period :

Since it is desirable to ascertain profit or loss of each accounting period separately, it becomes necessary to rectify errors in such a way that they do not affect the current period's incomes, expenses, profit or losses. For this objective, a separate account namely 'Profit & Loss Adjustment Account' is opened and all debits and credit in respect of nominal accounts for errors committed in the previous accounting period are passed through that account. The balance of this account is finally transferred to the capital account.

This method is used only in respect of nominal accounts and that too in case when rectifications are carried out in the next accounting period.

**SUMMARY****NOTES**

- A basic rule of double-entry accounting is that for every credit there must be an equal debit amount. Trial Balance is a statement of accounts which appeared in the ledger showing either the balances or total amounts of debit and credit items. All the debit entries are written on one side and all the credit entries on the other side.
- The trial balance is also by putting the balances of all the ledger accounts. The account balances are used because the balance summarizes the net effect of all of the debits and credits in an account.
- A post-closing trial balance is prepared after posting closing entries. This trial balance, which contains only balance sheet accounts, guarantees that the books are in balance for the beginning of the new accounting period.
- It is a method of verifying the arithmetical accuracy of entries made in the ledger. The agreement of the trial balance means that the total of the debit column agrees with the total of the credit column of the trial balance.
- If an entry has not been recorded in the original or subsidiary book at all, then both the aspects of the transaction will be omitted and the trial balance will not be affected.
- Compensating errors are errors arising from the excess- debits or under-debits of accounts being neutralized by the excess- credit or under- credit to the same extent of some other accounts.
- An error of principle is one where a transaction is not recorded as per the accounting rule of debit and credit or in violation of some other basic principle. Error of principle is involved whenever the amount received or spent is not properly allocated between revenue and capital.
- Sale of a fixed asset has been passed through the Sales Journal. This way, the Sales account has wrongly been credited instead of the fixed assets account.
- If a transaction is not recorded in the books of account or a transaction recorded in the journal is not posted in the ledger such an error is called complete omission error.
- Partial omission infers that transaction is entered in the subsidiary books but it is not posted in the ledger.
- Compensating Errors : These are the errors those cancel each other impact, and because of this they are rather not simple to discover. They may be dissimilar in nature, but are of a similar amount.
- Errors are normally corrected before the preparation of final trial balance. If it is done then the correction is carried out without the help of Suspense Account.

- Errors which affect the trading and profit and loss account are corrected with the help of Profit and Loss adjustment account or capital account. Suspense account is also used wherever necessary.
- The process of totalling the transaction at the end of the period is called casting.
- Error of omission stands for omission of recording the transaction in the books of subsidiary records. Omission of a transaction from a subsidiary record affects two accounts.
- Recording is the first stage of book-keeping and any mistake at this stage means an error in the subsidiary book. This error also affects two accounts.
- Error of principle involves incorrect allocation of expenditure or receipt between capital and revenue.
- All the errors which affect one account, affect the agreement of trial balance at the end of the year, and ultimately delay the preparation of final accounts. In order to avoid the delay in the preparation of final accounts, the difference in the trial balance is put to suspense account.
- Trial balance is affected only by those errors which are rectified with the help of suspense account. Therefore, in order to calculate the difference of suspense account, a table is prepared and if suspense account is debited in the rectification entry, the amount is put on the debit side, and if suspense account is credited, the amount is put on the credit side of the table. The balance is calculated and is reversed for suspense account, that is, if credit side exceeds, difference is put on the debit side of suspense account (not on the credit side) and vice versa.
- In order to calculate the effect of errors on net profit, it is essential to understand that only those accounts which are taken to trading account or profit and loss account affects profits. For example, purchases account, wages, salaries, etc., affect the net profit because they are shown either in trading account or profit and loss account. If any one of these accounts is debited in the rectification entry, it reduces the profit and if any of these accounts is credited then it increases the profit. Amounts which are shown in the balance sheet do not affect net profit.

## EXERCISE

1. What is Trial Balance ? Why is it prepared ? Describe the importance of Trial Balance.
2. What is Trial Balance ? Why is it prepared ?
3. What are the main characteristics and uses of a Trial Balance ?
4. What are the Limitations of Trial Balance ?

## NOTES

5. What are the functions of Trial Balance ?
6. What is Suspense Account ?
7. What is the method of preparation of Trial Balance ?
8. What are the types of errors in Trial Balance ?

**PRACTICAL QUESTIONS**

Q1. Classify the under-mentioned errors into :

- (a) Error of Omission,
  - (b) Error of Commision,
  - (c) Compensating Error, and
  - (d) Error of Principle :
- (1) Purchased goods from Bhardwaj on credit for Rs. 6,000 but were recorded in purchase Book as Rs. 60,000.
  - (2) Amount paid for the proprietor life Insurance premium of Rs. 5,000 was debited to 'General Expenses Account'.
  - (3) Goods amounting to Rs. 20,000 have been returned to Chetan, but no entry has been made in the books.
  - (4) Goods sold to Suresh for Rs. 650 were recorded as Rs. 560 in the Sales Book.
  - (5) Goods for Rs. 500 have been taken by the proprietor for his personal use, for which no entry has been passed in the books.

**[Ans. Error of Commision - 14,**

**Error of Principle - 2**

**Error of Omission - 3,5]**

Q.2 Prepare a Trial Balance from the following balances as on 31st March, 2007.

	Rs.		Rs.
Stock (1-4-2006)	28,800	Sales Return	7,500
Purchases	82,000	Purchase Return	5,600
Sales	1,60,000	Carriage Inwards	1,640
Wages	16,160	Carriage Outwards	3,200
Salaries	6,400	Furniture	12,000
Repairs	500	Motor Car	80,000
Commission received	800	Cash	4,700
Sundry debtors	24,200	Bank Overdraft	25,400
Sundry Creditors	7,300	Investment	20,000
Capital	90,000	Interest on	2,400
Drawings	4,400	Investment (Cr.)	



**Q.3. Rectify the following errors :**

- (1) The Purchase Book was undercast by Rs. 100.
- (2) The Sales Book was overcast by Rs. 10.
- (3) Rs. 540 received from M. Chawhan were posted to the debit of his a/c.
- (4) The total of the credit of Bhim's a/c has been over added by Rs. 200.
- (5) A discount of Rs. 92.75 allowed to a customer has been credited to his account as Rs. 29.57.
- (6) Goods of Rs. 270 returned to Mr. Singh entered in the return book has not been posted to his accounts.

**NOTES**

**[Ans. (1) Purchase a/c = Dr., Suspense a/c = Cr.**

**(2) Sales a/c = Dr., Suspense a/c = Cr.**

**(3) Suspense a/c = Dr., M Chawhan a/c = Cr.**

**(4) Bhim a/c = Dr., Suspense a/c = Cr.**

**(5) Suspense a/c = Dr., Customer's a/c = Cr. by  
Rs. 63.18 (92.75 – 29.57)**

**(6) Singh a/c = Dr., Suspense a/c = Cr. ]**

**Q.4. A book keeper finds the difference in the Trial Balance amounting to Rs. 70 and puts it in the Suspense Account. Rectify these and prepare the Suspense Account.**

- (1) Purchased goods from Lala Rs. 3000 passed through Sales Book.
- (2) Received one bill from Arjun Rs. 5000, passed through Bills Payable Book.
- (3) An item of Rs. 250 relating to prepaid rent was omitted to be brought forward.
- (4) Rs. 500 paid to Harish Brothers against our acceptance were debited to Rammohan Account
- (5) An item of Rs. 90 in respect purchase returns, instead of being debited to personal account from Return onward Book, had been wrongly entered in the Purchase Book and posted there from wrongly to the debit of personal account.

Ans. :

**SUSPENSE ACCOUNT**

NOTES

<i>To difference in T.B.</i>	<i>70</i>	<i>By Prepaid Rent</i>	<i>250</i>
<i>To Purchase a/c</i>	<i>90</i>		
<i>To Purchase return a/c</i>	<i>90</i>		
	<i>250</i>		<i>250</i>

**4.8 REFERENCES / SUGGESTED READING**

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**The Unit Covers :**

- 5.1** INTRODUCTION
- 5.2** DEFINITION
- 5.3** CHARACTERISTICS OF DEPRECIATION
- 5.4** CAUSES OF DEPRECIATION
- 5.5** NEED/IMPORTANCE/OBJECT
- 5.6** DIFFERENCES
- 5.7** DEPRECIATION, DEPLETION, AMORTISATION AND
- 5.8** OBSOLESCENCE
- 5.9** METHODS OF CALCULATING DEPRECIATION
  - 5.9.1** – STRAIGHT LINE METHOD
  - 5.9.2** – REDUCING BALANCE METHOD
- 5.10** DEPRECIATION ON VARIOUS ASSETS
- 5.11** REFERENCES / SUGGESTED READING

**INTRODUCTION**

Generally, the term 'depreciation' is used to denote a decrease in value but in accounting, it is used to denote a decrease in the book value of a fixed asset. Depreciation means a decrease or decline in the quality, quantity or value of an asset due to its constant use in the business. In other words, depreciation is the permanent and gradual decrease in the value of an asset. The net result of an asset's depreciation is that Sooner or later the asset will become useless.

## NOTES

**Meaning**

The word 'Depreciation' has been derived from the Latin word 'Dep-retium' which means 'decline in price' or 'value'. The word 'Depreciation' relates to fixed assets which lose value on account of usage. Therefore, 'Depreciation' means decline in the value of fixed assets on account of use. The word depreciation is used to express two meanings – In a broad sense, depreciation means the decrease in the value of an asset whatever the reason may be. In a narrow sense, depreciation means a decrease in value of an asset due to the regular use of the asset.

**DEFINITIONS**

Some of the well-known definitions of depreciation are given below :

1. "Depreciation is the gradual and permanent decrease in the value of an asset from any cause" – R.N. Carter.
2. "Depreciation is the measure of the exhaustion of the effective life of an asset from any cause during a given period." – Spicer & Peglar.
3. "It is a matter of common knowledge that all fixed assets such as plant, machinery, building furniture etc. gradually diminish in value as they get older and become worn out by constant use in the business" - J.R. Batliboi.

**CHARACTERISTICS OF DEPRECIATION**

1. It is charged on tangible fixed assets and not on floating assets.
2. The value of fixed asset diminishes permanently as a result of depreciation.
3. It always relates to the book value of fixed assets.
4. Continuous diminution in value is witnessed in depreciation.
5. The diminution in value takes place gradually.
6. The diminution in value may be qualitative or quantitative or both.
7. It is an essential expenditure of a business.
8. Provision for depreciation is necessary in spite of complete repair of an asset.
9. It is a process of spreading the burden of cost of an asset over the period of its effective life.
10. It is charged due to continuous use, wear and tear, depletion etc.

**CAUSES OF DEPRECIATION**

The main causes of depreciation are as follows :

1. **Physical wear and tear** – When the fixed assets are put to use, the value of such assets may decrease. such decrease in the value of assets is said to be due to physical wear and tear.
2. **Efflux of time and with the passage of time** – When the assets are exposed to the force of nature like weather, winds, rains etc., the value of such assets may decrease even if they are not put to any use.



3. **Accident** – An asset may meet with an accident and get damaged. The accident thus causes depreciation.
4. **Obsolescence** – Quite often, due to new inventions and improved techniques the old assets become obsolete and may have to be discarded even if they can be put to use physically.
5. **Exhaustion** – Assets like mines get exhausted while the mineral is exhausted, thus, extraction of mineral would result in mine getting exhausted over a number of years depending upon the capacity of mine and quantity of mineral extracted every year.
6. **Fall in Market Price** – The value of assets gets reduced due to permanent fall in the market price of an asset. Such reduction is treated as depreciation.
7. **Natural Causes** – There are also natural causes resulting in the reduction in the value of asset e.g. flood, earthquake etc. also causes depreciation.
8. **Expiration of Legal Rights** – There are certain assets which have a definite span of life such as Lease. For example, if a lease has been obtained for 20 years for Rs. 5,00,000, it will lose  $1/20^{\text{th}}$ , i.e. Rs. 25,000 of its value each year whether utilised or not, so that at the end of 20<sup>th</sup> year its value is reduced to zero.

#### NEED/IMPORTANCE/OBJECTS OF PROVIDING DEPRECIATION.

1. **For ascertaining the true profit and loss** – Depreciation is an operating expenses and true profit of a business can be ascertained only when all expenses, whether cash or non-cash, are incurred for the purpose of earning revenue.
2. **True and Fair view of the Financial Position** – If depreciation is not provided for values then as a result, the Balance sheet will not show a true and fair picture of the financial position.
3. **Cost of Production** – As asset is issued for production purpose and cost of use of an asset forms the part of the cost of production. Thus, to find out the correct cost of production, depreciation must be taken into consideration.
4. **Income Tax Saving** – This expense is allowed by the Income-tax law and helps in enjoying income tax benefit.
5. **To provide Fund for replacement of Assets** – The object of providing depreciation is not to reduce the value of an asset to its realisable value but to set aside a certain sum of money every year to replace that asset when its economic life is over.
- (6) **To prevent the distribution of profit** – The real object of providing depreciation is to keep the asset intact by distributing the loss in its value over a number of years when it is in use.

**Factors Determining the Amount of Depreciation –**

- |                                   |                                 |
|-----------------------------------|---------------------------------|
| (a) Cost of an asset              | (b) Economic life of an asset   |
| (c) Salvage value of asset        | (d) Possibility of obsolescence |
| (e) Repairs and Renewals of asset | (f) Use of asset                |
| (g) Interest on Investment        | (h) Nature of Asset             |

**10.6 DIFFERENCE BETWEEN DEPRECIATION AND FLUCTUATION.**

	Basis of Difference	Depreciation	Fluctuation
1.	Meaning	A permanent loss of quality, quantity and value of an asset supply for an asset.	A change in market value due to increase or decrease in demand
2.	Asset	It is charged on fixed Asset.	It may be in fixed asset or floating asset.
3.	Nature	Permanent diminution	Temporary Nature.
4.	Relationship	Relates to the book value of fixed asset	Relates to the market value.
5.	Tendency	Gradual diminution	Sudden change in value.
6.	Certainty	Always certain	Always uncertain.
7.	Working Efficiency	Decreases the working efficiency	No direct relation with working efficiency.
8.	Accounting	Legal compulsion	No legal compulsion.
9.	Forecast	Can be forecasted	No forecast can be made.
10.	Reason	It occurs due to continuous use, wear & tear, diffusion of time etc,	It occurs due to change in demand and supply of an asset.

**DIFFERENCE BETWEEN DEPRECIATION AND OBSOLESCENCE.**

	Basis	Depreciation	Obsolescence
1.	Meaning	It represents loss in the value of an asset consequent upon wear & tear, diffusion of time and permanent fall in book value.	It is induced by new inventions and improvement which render an asset out of use.
2.	Tendency	It takes place gradually	It takes place all of a sudden.
3.	Forecasting	It can be forecasted.	No forecasting can be made.
4.	Market value	It is charged on the book value.	It is related to market value.

5.	Transfer of Loss	Loss due to depreciation is transferred to Profit and Loss Account	Loss due to obsolescence is treated as capital loss and it is not transferred to Profit and Loss Account.
6.	Replacement	Depreciation is provided to ensure replacement of asset after its economics life.	Immediate replacement of asset is necessary.

### Is depreciation a charge on business ?

It is said to be a charge on business due to the following reasons –

- (1) It is a consideration paid for the services of the fixed assets.
- (2) The Profit of business is decreased by depreciation like other expenses.
- (3) The provision for depreciation is necessary even if the profits of business are not sufficient.
- (4) Depreciation is not a voluntary contribution towards the profit of business but it is a charge on business.
- (5) It must be provided for the services of the fixed assets like salaries to be paid to the employees.

### DEPRECIATION, DEPLETION, AMORTISATION AND OBSOLESCENCE

**Depreciation :** This term is used when expired utility of a physical asset is to be recorded.

**Depletion:** This term is applied to the process of recording the exhaustion of natural resources like mines, oil wells etc. It involves removal of natural resource.

**Amortisation :** It is used to describe the process of writing down the intangible investments like patents, copyrights, goodwill, trade marks etc.

**Obsolescence :** 'Obsolescence refers to reduction in the useful life of the asset arising from different factors like. Change in technology, change in market demand, legal restrictions etc.

### METHODS OF CALCULATING DEPRECIATION.

The following are the various methods for providing depreciation :

- (1) Fixed Instalment Method or Straight Line Method.
- (2) Diminishing Balance Method.
- (3) Annuity Method.
- (4) Depreciation Fund Method.
- (5) Depreciation, Repairs and Renewals Fund Method.

## NOTES

- (6) Insurance Fund Method.
- (7) Revaluation Method.
- (8) Renewals Method.
- (9) Depletion Method.
- (10) The sum of year Digits Method.
- (11) The sum of Mileage Method.
- (12) Global Method
- (13) Compound Interest Method.
- (14) Replacement Cost Method
- (15) Machine Hour Rate Method.

**(1) Fixed Instalment Method/Straight Line Method/  
Original Cost Method/Equal Instalment Method.**

In this method, a fixed part of the original cost of the asset is transferred to P&L A/c every year as depreciation. The amount transferred as depreciation is fixed and remain same for the entire life of asset. This is the easiest of all methods. It is calculated as –

$$\text{Amount of Depreciation} = \frac{\text{Cost of Asset} - \text{Scrap value}}{\text{Life of the asset}}$$

If depreciation is calculated by percentage –

$$\text{Amount of Depreciation} = \frac{\text{Original Cost of Asset} \times \% \text{ of depreciation}}{100}$$

**Accounting Treatment**

Following entries are passed in this method –

- (1) Entry for purchase of Asset –  
Assets A/c Abbreviation of Account is written as A/c (small 'c') ..... Dr.  
To Cash/Bank A/c
- (2) Entry for providing depreciation at the end of each year –  
Depreciation A/c ..... Dr.  
To Asset A/c
- (3) Entry for the amount realised on sale of Asset –  
Cash/Bank A/c ..... Dr.  
To Asset A/c
- (4) Entry in case of profit on sale of Asset –  
Asset A/c ..... Dr.



(5) Entry in case of loss on sale of Asset –

Profit & Loss A/c ..... Dr.

To Asset A/c

NOTES

### Merits of straight line method

- (1) It is very easy to calculate depreciation by this method and is widely popular also.
- (2) The amount of depreciation remains even and it is not required to be calculated every year.
- (3) At the end of the life of asset, the balance of asset becomes zero or its residual value.
- (4) It is suitable for those assets whose service remains uniform every year i.e. furniture and fixtures etc.
- (5) The total amount of depreciation can easily be known from the balance sheet.

### Demerits

- (1) The value of the asset goes on decreasing but the same amount of depreciation for each year sounds impractical.
- (2) The increases in the amount invested on the asset by way of repairs is not paid attention too.
- (3) When machinery is sold or purchased in the middle of a year charging of depreciation for the whole year is not proper.
- (4) This method does not take into account the seasonal fluctuation boom and depression.

### Calculation of Depreciation by Formulas

**Example 1 :** On 1st Jan., 2004 a business man purchased a plant for Rs. 18,600 and paid Rs. 1,200 for its erection. The estimated life is of 10 years and its residual value will be 2,000. Prepare plant account for three years on fixed instalment method.

<b>Solution –</b>	Value of Plant =	18,600	
	(+) Erection charge	1,200	
		19,800	
	(-) Residual value	2,000	
		17,800	
	(÷) Life of Plant	10	
	Depreciation = $\frac{\text{value}}{\text{life of plant}}$	$\frac{17,800}{10}$	= 1,780

## NOTES

Date	Particulars	Amount	Date	Particulars	Amount
2004			2004		
Jan 1	To Bank A/c	18,600	Dec 31	By Depreciation A/c	1,780
Jan 1	To Bank A/c (exp)	1,200	Dec 31	By balance c/d	18,020
		19,800			19,800
2005			2005		
Jan 1	To balance b/d	18,020	Dec 31	By Depreciation A/c	1,780
		18,020	Dec 31	By balance c/d	16,240
					18,020
2006			2006		
Jan 1	To balance b/d	16,240	Dec 31	By Depreciation A/c	1,780
		16,240	Dec 31	By balance c/d	14,460
					16,240
2007					
Jan 1	To balance b/d	14,460			

**Example 2 :** A firm purchased on 1st January 2004 a machinery for Rs. 2,25,000. It is estimated that it will be sold for Rs. 25,000 after five years. On 1st July, 2005 and on 1st January, 2005 machinery for Rs. 56,000 (Scrap after 5 years Rs. 6,000) and for Rs. 33,000 (Scrap value after five years Rs. 3,000) were purchased. Prepare Machinery account for three years charging depreciation by Straight Line Method.

**Solution :**

	Machine 1	Machine 2	Machine 3
Value of Machine	2,25,000	56,000	33,000
(-) Scrap value	25,000	6,000	3,000
	2,00,000	50,000	30,000
Life of Machine	5 year	5 year	5 year
Depreciation	$2,00,000/5 = \text{Rs. } 40,000$	$50,000/5 = \text{Rs. } 10,000$	$30,000/5 = \text{Rs. } 6,000$

## Machinery Account

Dr.			Cr.		
Date	Particular	Amount	Date	Particular	Amount
2004			2004		
Jan 1	To Cash a/c (Machine 1)	2,25,000	Dec 31	By Depreciation A/c (Machine 1)	40,000
			Dec 31	By Balance c/d *1	1,85,000
		2,25,000			2,25,000
2005			2005		
Jan 1	To balance b/c (Machine 1)	1,85,000	Dec 31	By Depreciation A/c	
				Machine 1 -	40,000
				Machine 2 -	5,000
July 1	To Cash a/c (Machine 2)	56,000	Dec 31	By Balance c/d *2	45,000
				Machine 1 -	1,45,000
				Machine 2 -	51,000
		2,41,000			1,96,000
					2,41,000
2006			2006		
Jan 1	To Balance b/d		Dec 31	By Depreciation A/c	
	Machine 1 - 145,000			Machine 1 -	40,000
	Machine 2 - 51,000	1,96,000		Machine 2 -	10,000
				Machine 3 -	6,000
Jan 1	To Cash A/c (Machine 3)	33,000	Dec 31	By Balance c/d	56,000
				Machine 1 -	10,50,000
				Machine 2 -	41,000
				Machine 3 -	27,000
		2,29,000			1,73,000
					2,29,000

*1 =	2,25,000	-	40,000	=	1,85,000
*2 =	1,85,000	-	40,000	=	1,45,000
	56,000	-	5,000	=	51,000
*3 =	1,45,000	-	40,000	=	1,05,000
	51,000	-	10,000	=	41,000
	33,000	-	6,000	=	27,000

**Example 3 :** A Company whose accounting year is the calendar year, purchased on 1st April, 2004 a machinery costing Rs. 30,000. It purchased further machinery on 1st October, 2004 at a cost of Rs. 20,000 and on 1st July 2005 costing Rs. 10,000. On 1st January 2006, 1/3rd of the machinery installed on 1st April 2004 become obsolete and was sold for Rs. 3000. Show how Machinery Account would appear in the books of the company, it being given that machinery was depreciated by Fixed Instalment Method at 10% per annum. What would be the balance of Machinery Account on 1st January, 2007?

**Solution –**

Machinery A/c					
Dr.			Cr.		
Date	Particulars	Amount	Date	Particular	Amount
2004			2004		
1 April	To Bank A/c (I)	30,000	Dec 31	By Depreciation A/c *1 I - 2,250 II - 500	2,750
1 Oct	To Bank A/c (II)	20,000	Dec 31	By balance c/d *2 I - 27,750 II - 19,500	47,250
		<u>50,000</u>			<u>50,000</u>
2005			2005		
Jan 1	To Balance b/d I - 27,750 II - 19,500	47,250	Dec 31	By Depreciation A/c *3 I - 3,000 II - 2,000 III - 500	5,500
July 1	To Bank A/c (III)	10,000	Dec 31	By balance c/d *4 I - 24,750 II - 17,500 III - 9,500	51,750
		<u>57,250</u>			<u>57,250</u>
2006			2006		
Jan 1	To Balance b/d I - 24,750 II - 17,500 III - 9,500	51,750	Jan 1	By Bank A/c	3,000
			Dec 31	By Profit & Loss A/c *5	5,250
			Dec 31	By Depreciation *6 I - 2,000 II - 2,000 III - 1,000	5,000
			Dec 31	By Balance c/d *7 I - 14,500 II - 15,500 III - 8,500	38,500
		<u>51,750</u>			<u>51,750</u>
2007					
Jan 1	To Balance b/d I - 14,500 II - 15,500 III - 8,500	38,500			

## NOTES

$$*1 \quad I = \frac{30,000 \times 9 \times 10}{12 \times 100} = 2,250$$

$$II = \frac{20,000 \times 10 \times 10}{12 \times 100} = 500$$

$$*2 \quad 50,000 - 2250 = 27,250$$

$$20,000 - 150 = 19,500$$

$$*3 \quad I = 30,000 \times \frac{10}{100} = 3,000$$

$$II = 20,000 \times \frac{10}{100} = 2,000$$

$$III = 10,000 \times \frac{10}{100} \times \frac{6}{12} = 500$$

$$*4 \quad 27250 - 3000 = 24,750$$

$$19500 - 2000 = 17,500$$

$$1000 - 500 = 9,500$$

$$*5 \quad \frac{1}{3} \text{ of machine is } \left( 30,000 \times \frac{1}{3} \right) = 10,000$$

$$(-) \quad \text{Depreciation for 2004 for 9 month } \left( 10000 \times \frac{10}{100} \times \frac{9}{12} \right) = 750$$

$$(-) \quad \text{Depreciation for 2005 for one year } \left( 10000 \times \frac{10}{100} \right) = 1,000$$

$$\text{W.D.V.} = 8,250$$

$$\text{Less : Sale Proceeds} = 3,000$$

$$\text{Loss in 2006} = 5,250$$

$$*6 \quad I = 30000 - 10000 = 20000 \times \frac{10}{100} = 2,000$$

$$II = 20000 \times \frac{10}{100} = 2,000$$

$$III = 10000 \times \frac{10}{100} = 1,000$$

$$*7 \quad I = 24,750 - 3000 - 5,250 - 2,000 = 14,500$$

**Example 4 :** A Transport company purchases 5 trucks at Rs 4,00,000 each on 1 April, 2004. The company writes off depreciation @ 20% p.a. on original cost and observes calendar year as its accounting year. On October 1, 2006 one of the truck is involved in an accident and is completely destroyed. Insurance

company pays Rs. 1,80,000 in full settlement of the claim. On the same day the company purchases a truck for Rs. 2,00,000 and spends Rs. 40,000 on its over hauling. Prepare Truck Account for the three years ending on December 2006.

DEPRECIATION

NOTES

Solution –

Truck Account

Dr			Cr		
Date	Particulars	Amount(Rs.)	Date	Particulars	Amount(Rs.)
2004			2004		Rs.
April 1	To Bank A/c	20,00,000	Dec. 31	By Depreciation A/c *1	3,00,000
			Dec. 31	By Balance c/d *2	17,00,000
		20,00,000			<u>20,00,000</u>
2005			2005		
Jan 1	To Balance	17,00,000	Dec. 31	By Depreciation A/c *3	4,00,000
			Dec. 31	By Balance c/d *4	13,00,000
		17,00,000			<u>17,00,000</u>
2006			2006		
Jan 1	To Balance b/d	13,00,000	Oct. 1	By Depreciation *5	60,000
				(1 Truck for 9 months)	
Oct. 1	To Bank A/c	2,00,000	Oct. 1	By Bank A/c (claim)	1,80,000
Oct. 1	To Bank A/c	40,000	Oct. 1	By P&L A/c *6 (loss truck)	20,000
	(Over hauling)		Dec. 31	By Dep A/c on 4 Truck	3,20,000
				On New Truck (3 months)	12,000
				By Balance c/d 4 trucks	7,20,000
				New truck	2,28,000
		15,40,000			<u>15,40,000</u>

$$*1 = 20,00,000 \times \frac{20}{100} \times \frac{9}{12} = 3,00,000$$

$$*2 = 20,00,000 - 3,00,000 = 17,00,000$$

$$*3 = 20,00,000 \times \frac{20}{100} = 4,00,000$$

$$*4 = 17,00,000 - 4,00,000 = 13,00,000$$

$$*5 = 4,00,000 \times \frac{20}{100} \times \frac{9}{12} = 60,000$$

$$*6 \text{ Balance as on 1.1.2006} = 13,00,000 \div 5 = 2,60,000$$

(-) Depreciation to date of accident =

$$\left( 400000 \times \frac{20}{100} \times \frac{9}{12} \right) = 60,000$$

$$\text{Amount received as claim} = \underline{1,80,000} \quad \underline{2,40,000}$$

$$\underline{\underline{20,000}}$$



## NOTES

**(2) Diminishing Balance Method/Written Down Value Method/Reducing Instalment Method –**

Under this method, a fixed rate percent is written off the diminishing book value of the asset each year so as to reduce the asset to its salvage value at the end of its life. This method is commonly adopted for the depreciation of asset which have some residual value, e.g. Plant & Machinery, furniture etc. If the rate of depreciation is not given, we can obtain rate by following equation –

$$\text{Residual value} = \text{Value of Asset} \times \frac{(100 - \text{Rate of Depreciation})^{\text{Years}}}{100}$$

$$R.V = P \times \left( \frac{100 - r}{100} \right)^n$$

**Characteristics :**

- (1) Depreciation is calculated on the opening balance of an asset.
- (2) The rate of depreciation remains same.
- (3) The amount of depreciation goes on decreasing year by year.
- (4) It is a scientific method.
- (5) The combined burden of repairs and depreciation on P&L account is even every year as the burden of repairs is light in the initial years which keeps on increasing every year.

**Merits :**

- (1) It is easy to calculate and widely used.
- (2) The total burden on P&L account in respect of depreciation and repairs put together remains almost equal year after year.
- (3) The depreciation in first few years should be more in comparison to the later years.
- (4) This method ensures that the asset is never reduced to zero.
- (5) This method is permissible under Income Tax regulations.
- (6) The depreciation is charged according to working capacity of asset each year.

**Demerits :**

- (1) The value of asset is not reduced to zero, thus not suitable for assets which have no residual value.
- (2) Calculation of Profit & Loss becomes a bit complicated.
- (3) This method does not take into consideration the loss of interest on the amount invested in the asset.
- (4) The rate of depreciation can not be easily decided.

(5) There is no provision for creation of fund to replace the asset under this method.

**Note :** If per annum clause is not mentioned depreciation must be calculated for the whole year irrespective of the date of purchase of asset. Similarly if an asset is sold in the mid of the accounting year, no depreciation will be calculated in case per annum clause is not mentioned.

NOTES

### Difference between Fixed Instalment Method & Diminishing Balance Method

Basis of Difference	Fixed Instalment Method	Diminishing Balance Method
1. Calculation of depreciation	It is calculated on the original cost of asset.	It is calculated on the reducing balance of asset.
2. Amount of depreciation	The amount of depreciation is even every year	The amount of depreciation goes on decreasing every year.
3. Value at the end of the life	The book value of the asset is reduced to zero.	The book value of the asset can never reduced to zero.
4. Suitability	It is suitable for assets of low cost and short life.	It is suitable for assets of high cost and long life.
5. Rate	Generally the rate of depreciation is low.	Generally the rate of depreciation is high.
6. Recognition	It has not been recognised by Income Tax Department.	It has been recognised by Income Tax Department.
7. Justification	It is not justified as the depreciation is not commensurate with the working efficiency of asset.	It is justified as the depreciation is commensurate with the working efficiency of asset.
8. Combined effect of depreciation and repairs on P & L A/c	Combined burden on account of depreciation and repairs will be lighter in earlier years and heavier during the later years.	Combined burden on account of depreciation and repairs will be almost equal over different years.

### Calculation of Depreciation by Diminishing Balance Method

**Example 5 :** On 1-1-2004 A Co. Ltd. Purchased a Machinery for Rs 4,00,000. On 1-7-2005, additions were made to the amount of Rs. 2,00,000. On 31-3-2006, Machinery purchased on 1-7-2005, costing Rs. 60,000 was sold for Rs. 55,000 and on 30-6-2006, Machinery purchased on 1-1-2004, costing Rs. 1,60,000 was sold for Rs. 1,33,500. On 1-10-2006 additions were made to the amount of Rs. 1,00,000. Depreciation was provided at 10% p.a. on the diminishing balance method. Show the Machinery Account for three years from 2004 to 2006 year ended on 31<sup>st</sup> December.

## Solution :

## NOTES

Dr.			Cr.		
Date	Particulars	Amount	Date	Particulars	Amount
2004			2004		
1 Jan.	To Bank A/c	4,00,000	31 Dec.	By Depreciation A/c *1	40,000
			31 Dec.	By Balance c/d *2	3,60,000
		4,00,000			4,00,000
2005			2005		
Jan 1	To Balance b/d	3,60,000	Dec. 31	By Depreciation A/c *3	46,000
July 1	To Bank A/c	2,00,000	Dec. 31	By Balance c/d *4	5,14,000
	(additions)	5,60,000			5,60,000
2006			2006		
Jan 1	To Balance b/d	5,14,000	Mar 31	By Bank A/c (sale)	55,000
June 30	To Profit on sale A/c *1	10,380	Mar 31	By Loss on sale *5	575
Oct. 1	To Bank A/c		Mar 31	By Depreciation A/c	1,425
	(additions)	1,00,000	June 30	By Bank A/c (sale)	1,33,500
			June 30	By Depreciation A/c *6	6,480
			Dec. 31	By Depreciation A/c *7	35,240
			Dec. 31	By Balance c/d *8	3,92,160
2007		6,24,380			6,24,380
Jan 1	To Balance b/d	3,92,160			

$$*1. 4,00,000 \times \frac{10}{100} = 40,000$$

$$*2. 4,00,000 - 40,000 = 3,60,000$$

$$*3. 3,60,000 \times \frac{10}{100} + 2,00,000 \times \frac{10}{100} \times \frac{6}{12} = 36,000 + 10,000 = 46,000$$

$$*4. 3,60,000 + 2,00,000 - 46,000 = 5,14,000$$

\*5 W.D.V. of Machine sold on 31.3.2005 is  $(60,000 - 3,000) = 57,000$  which was actually sold for Rs. 55000 amounting to a loss of Rs. 575  $[55,000 - (57,000 - 1,425)]$

\*6 W.D.V. of Machine costing 1,60,000 purchased on 1.1.2004 was Rs. 1,29,600 (i.e.  $1,60,000 - 16,000 - 14,400$ ) which was sold for Rs. 1,33,500, resulting a profit of Rs 10,380 (i.e. Rs.  $1,33,500 - \text{Rs. } (1,29,600 - 6,480)$ )

\*7 Depreciation as on 31.12.2006

(a) Machinery purchased on 1.1.2004 for

Rs.  $[(4,00,000 - 1,60,000) = 2,40,000 - 24,000 = 2,16,000$ , now  $2,16,000 - 21,600 = 1,94,400$ , now  $1,94,400 \times 10\% = 19,440$

(b) Machinery 1-7-2005 for Rs.  $[1,40,000 (2,00,000 - 60,000) - 7,000] = 1,33,000 @ 10\% = 13,300$

(c) Machinery purchased on 1.10.2006 for Rs. 1,00,000 @ 10% for 3 months = 2,500

Total Depreciation =  $19,440 + 13,300 + 2,500 = 35,240$

$$\begin{aligned}
 *8 &= 5,14,000 + 10,380 - (55,000 + 575 + 1425 + 1,33,500 + 6,480 + 35,240) \\
 &= 3,82,160
 \end{aligned}$$

**Example 6 :** In Aug. 2004 a company purchased a machine for Rs 7,80,000 and spent Rs 20,000 on its installation. It decided to provide depreciation @ 15% per annum, using written down value method. On November 30, 2007 the machine was dismantled at a cost of Rs 10,000 and then sold for Rs 2,00,000. On December 2007 the company dequired a new machine at a total cost of Rs 15,20,000. Depreciation on this new machine was provided on the same basis as had been used is the case of the earlier machine. The company closes its books on March 31 Every year.

Prepare Machinery Account for the period of Aug. 2004 to March 31, 2008.

**Solution :**

Machinery Account					
1/8/04	To Bank A/c	7,80,000	31/3/05	By Depreciation A/c	80,000
1/8/04	To Bank A/c			(@ 15% for 8 months)	
	(Installation Expenses)	20,000		By Balance c/d	7,20,000
		800,000	31/3/05		800,000
1/4/05	To Balance b/d	7,20,000	31/3/06	By Depreciation A/c	
				(on Rs 720,000 @ 15%)	1,08,000
			31/3/06	By Balance c/d	6,12,000
		7,20,000			7,20,000
1/4/06	To Balance b/d	6,12,000	31/3/07	By Depreciation A/c	
				(on Rs.6,12,000 @ 15%)	91,800
			31/3/07	By Balance c/d	5,20,200
		6,12,000			6,12,000
2007				By Depreciation A/c	
1/4/07	To Balance b/d	5,20,200	30/11/07	(on Rs 5,20,200 @ 15%	52,020
30/11/07	To Bank		30/11/07	p.a. for 8 months)	
	(dismantling charges)	10,000		By Bank (sale proceeds)	2,00,000
1/12/07	To Bank	15,20,000	30/11/07	By Profit & Loss A/c	
	(Cost of new machine)			(loss on disposal)	2,78,180
			31/3/08	By Depreciation A/c	
				(On 15,20,000 @ 15 %	
				p.a. for 4 months)	76,000
				By Balance c/d	14,44,000
		20,50,200			20,50,200

**Working Notes :**

Computation of loss on disposal of machine :

W.D.V. of machine on April 1, 2007	5,20,200
Less : Depreciation for 8 months	52,020
WDV of machine on Nov. 30, 2007	4,68,180
Add : Dismantling charges	10,000
	4,78,180
Less : Sale Proceeds of machine	2,00,000
Loss on sale of machine	2,78,180

## Change of Method

## NOTES

**Example 7 :** A firm purchased an old machinery for Rs. 37,000 as on 1.1.2003 and spent Rs. 3,000 on its overhauling. On 1<sup>st</sup> July 2004, another machine was purchased for Rs. 10,000. On 1<sup>st</sup> July, 2005 the machinery which was purchased on 1<sup>st</sup> January 2003, was sold for Rs. 28,000 and the same day a new machine costing Rs. 25,000 was purchased.

On 1<sup>st</sup> July, 2006, the machine which was purchased on 1<sup>st</sup> July, 2004 was also sold for Rs. 2,000. Depreciation is charged @ 10% p.a. on fixed instalment method. The firm changed the method and adopted diminishing balance method with effect from 1<sup>st</sup> January 2004 and the rate was increased to 15% p.a. Prepare Machinery Account for four years from 1<sup>st</sup> January, 2003.

**Solution :**

Machinery Account					
Dr.			Cr.		
Date	Particulars	Amount	Date	Particulars	Amount
2003			2003		
Jan 1	To Cash A/c	37,000	Dec. 31	By Depreciation A/c *1	4,000
Jan 1	To Cash A/c (expensess)	3,000	Dec. 31	By Balance c/d	36,000
		40,000			40,000
2004			2004		
Jan 1	To Balance b/d	36,000	Dec. 31	By Depreciation A/c *2	6,150
July 1	To cash A/c	10,000	Dec. 31	By Balance c/d *3	39,850
		46,000			46,000
2005			2005		
Jan 1	To Balance b/d	39,850	July 1	By Cash A/c	28,000
July 1	To Cash A/c	25,000	July 1	By P & L A/c *4	305
			Dec. 31	By Depreciation A/c *5	2,295
			Dec. 31	By Depreciation A/c *6	3,263
			Dec. 31	By Balance c/d *7	30,987
		64,850			64,850
2006			2006		
Jan 1	To Balance b/d	30,987	July 1	By Cash a/c	2,000
			July 1	By P & L A/c *8	5,273
			July 1	By Depreciation A/c *9	589
			Dec. 31	By Depreciation A/c *10	3,469
			Dec. 31	By Balance c/d *11	19,656
		30,987			30,987
2007					
Jan 1	To Balance b/d	19,656			

\*1 40,000 @ 10% = 4,000

\*2 15% on Rs. 36,000 = 5,400

15% on R 10,000 for 6 months 750

$\left( 10,000 \times \frac{15}{100} \times \frac{6}{12} \right)$	6,150
---	-------



$$*3 \quad 46,000 - 6,150 = 39,850$$

or

$$36,000 - 5,400 = 30,600$$

$$10,000 - 750 = 9,250$$

$$\underline{\underline{39,850}}$$

$$*4 \quad (30,600 - 2,295 - 28,000) = 305$$

$$*5 \quad 15\% \text{ on Rs. } 30,600 \text{ for 6 months} = 30,600 \times \frac{15}{100} \times \frac{6}{12} = 2,295$$

$$*6 \quad 15\% \text{ on Rs. } 9,250 = 1,388$$

$$(+)\ 15\% \text{ on Rs. } 2,50,000 \text{ for 6 months} = 1875 = 3,263$$

$$*7 \quad (9,250 - 1,388) + (25,000 - 1,875) = 30,987$$

$$*8 \quad 9250 - 1388 = 7,862 - (15\% \text{ on } 7862 \text{ for 6 months})$$

$$= 7,862 - (7,862 \times \frac{15}{100} \times \frac{6}{12})$$

$$= 7,862 - (589)$$

$$= 5,273$$

$$*9 \quad 7,862 \times \frac{15}{100} \times \frac{6}{12} = 589$$

$$*10 \quad 25,000 - 1,875 = 23,125 \times \frac{15}{100} = 3,469$$

$$*11 \quad 23,125 - 3,469 = 19,656$$

NOTES

**Example 8 :** A Company purchased on 1<sup>st</sup> January, 2000 second hand plant for Rs. 60,000 and immediately spent Rs. 40,000 in overhauling it. On 1<sup>st</sup> July 2000 additional machinery of cost of Rs. 50,000 was purchased. On 1<sup>st</sup> July, 2002 the plant purchased on 1<sup>st</sup> January, 2000 became obsolete and was sold for Rs. 20,000. On that date new machinery was purchased at a cost of Rs. 1,20,000. Depreciation was provided annually on 31<sup>st</sup> December, at 10% p.a. on the original cost of asset. In 2003, however, the company changed this method of providing for depreciation and adopted the method of writing off 15% on diminishing value w.e.f. 1<sup>st</sup> Jan, 2000. Show the Plant & Machinery Account as it would appear in the books of the company for the year 2000 to 2005.

## Plant &amp; Machinery Account

NOTES

Dr.			Cr.		
Date	Particulars	Amount	Date	Particulars	Amount
1.1.2000	To Bank a/c (I)	60,000	31.12.2000	By Depreciation a/c	12,500
1.1.2000	To Bank a/c (over handling)	40,000	31.12.2000	By Balance c/d	1,37,500
1.7.2000	To Bank A/c (II)	50,000			
		<u>1,50,000</u>			<u>1,50,000</u>
1.1.2001	To balance b/d	1,37,500	31.12.2001	By Depreciation A/c	15,000
		<u>1,37,500</u>	31.12.2001	By Balance c/d	1,22,500
					<u>1,37,500</u>
1.1.2002	To balance b/d	1,22,500	1.7.2002	By Bank A/c	20,000
1.7.2002	To Bank A/c	1,20,000	1.7.2002	By Depreciation A/c	5,000
			1.7.2000	By Loss on sale of Plant A/c *1	55,000
			31.12.2002	By Depreciation A/c	11,000
			31.12.2002	By Balance c/d	1,51,500
		<u>2,42,500</u>			<u>2,42,500</u>
1.1.2003	To Balance c/d	1,51,500	1.1.2003	By P&L Adjustment A/c*2	7,084
			31.12.2003	By Depreciation A/c	21,662
			31.12.2003	By Balance c/d	1,22,754
		<u>1,51,500</u>			<u>1,51,500</u>
1.1.2004	To Balance b/d	1,22,754	31.12.2004	By Depreciation A/c	18,414
		<u>1,22,754</u>	31.12.2004	By Balance c/d	1,04,340
					<u>1,22,754</u>
1.1.2005	To Balance b/d	1,04,340	31.12.2005	By Depreciation A/c	15,650
		<u>1,04,340</u>	31.12.2005	By Balance c/d	88,690
					<u>1,04,340</u>
1.1.2006	To Balance c/d	88,690			

*1	Calculation for loss on sale of plant value on 1.1.2000	1,00,000
	Less : Depreciation for 2000	10,000
		<u>90,000</u>
	Less : Depreciation for 2001	10,000
		<u>80,000</u>
	Less : Depreciation for six months (2002)	5,000
		<u>75,000</u>
	Less : Sale price	20,000
		<u>55,000</u>

\*2 It is assumed that the company changes method of depreciation from 1.1.2003. Calculation of depreciation due to change method of depreciation is as under

	value on 1.1.2003	(Old method)				(New method)			
		2000	2001	2002	Total	2000	2001	2002	Total
Plant2	37,500	2,500	5,000	5,000	12,500	3,750	6,938	5,896	16,584
Plants	1,14,000	—	—	6,000	6,000	—	—	9,000	9,000
					18,500				25,584

## DEPRECIATION ON VARIOUS ASSETS

The following general recommendation have been made to deal with depreciation of various types of assets :

- (i) **Land** : No depreciation is charged. Any amount written off should be shown in accounts separately.
- (ii) **Buildings** : Plant & Machinery, Equipments etc : depreciation may be charged by either straight line method or Diminishing value method. However, diminishing value method is preferred as it is allowed by the income tax regulations and it does not reduce the value of asset to zero as well.
- (iii) **Leasehold asset** : The straight line method to write off the cost of asset and dilapidation within its life.
- (iv) **Goodwill** : No depreciation is charged. However prudent firms tend to write off goodwill once a number of years. The amount written off should be shown separately in profit & loss A/c.
- (v) **Patents, Trade marks etc.** : These assets should be depreciated by the Straight line Method so as to write off its entire cost during its useful life whichever is shorter.
- (vi) **Loose Tools** : Depreciation is charged based on their revaluation.

## SUMMARY

- Depreciation is charged on fixed asset
- Under Fixed Instalment method, the amount of depreciation is even every year. It is calculated on original cost.
- Under Diminishing Balance Method, depreciation is calculated on book value standing on the first day of every year.
- If nothing is mentioned, depreciation should be calculated according to Diminishing Balance method.

## EXERCISE

1. What is Depreciation ? Why is depreciation made ?
2. What is meant by Depreciation ? What are its characteristics ? What factors are to be kept in mind while determining depreciation ?

3. Describe the different methods of depreciation.
4. Distinguish between :
  - (a) Depreciation and fluctuation
  - (b) Depreciation and Obsolescence
  - (c) Fixed Instalment method and Diminishing Balance Method

### PRACTICAL QUESTIONS

**Q.1.** On 1st April, 2004 Machinery for Rs. 10,000. Prepare Machinery purchased a Account providing depreciation at the rate of 10% per annum by fixed Instalment method for the first 3 years.

**[Ans. : Balance at the end = Rs. 7,250]**

**Q.2.** A firm whose accounting year is the calender year, purchased on 1st April, 2004 a machinery costing Rs. 28,000 and spent Rs. 2,000 on its erection. It purchased another machinery on 1st October, 2004 for Rs. 19,000 and spent Rs. 1,000 on its erection on 1st July, 2005, again a machine costing Rs. 10,000 was purchased. On 1st January, 2006 one third of the machinery which was erected on 1st April, 2004 became obsolete and was sold for Rs. 3,000. Depreciation is charged @ 10% p.a. on Fixed Instalment Method Prepare Machinery Account from 2004 to 2006.

**[Ans. : Balance on 31.12.2006 – Rs. 38,500, Lass on 1.1.2006 Rs. 5,250]**

**Q.3.** On 1 January, 2004 a machine was purchased for Rs. 20,400 and Rs. 600 were spent on its carriage and fitting. It was decided to provide annual depreciation at 10% on reducing instalment basis : Prepare Machinery Account for first three years.

**[Ans. : Balance Rs. 15,309]**

**Q.4.** A company purchased on 1st July, 2004 a machine costing Rs. 20,000 1st January, 2005 another machine costing Rs. 12,000 was purchased in 1st April, 2006 the machine which was purchased on 1st July, 2004 was sold for Rs. 16,500 and the same day a new machine costing Rs. 10,000 was purchased. On 31st December, 2007 the machinery which was purchased on 1st January, 2005 was sold for Rs. 8,900. Depreciation is charged @ 10% p.a. on Diminishing Balance Method. Prepare Machinery Account for the four years.

**[Ans. : Balance – Rs. 8,325,  
Loss on Sale 2007 Rs. 172.50,  
Profit on sale of 2008 Rs. 152]**

**Q.5.** A Company purchased a machinery in 2003 for Rs. 25,000 and charged depreciation @ 15% p.a. on Diminishing Balance Method. At the end of 2006, the company decided to write off depreciation @ 15% on Fixed Instalment Method which was done for 2006 also. The accounts are closed on 31st December each year, Prepare Machinery Account upto 2006.

**[Ans. : Balance on 31st Dec. 2006 – Rs. 10,000]**

## **5.11 REFERENCES / SUGGESTED READING**

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**The Unit Covers :**

- 6.1** INTRODUCTION
- 6.2** PROVISION
- 6.3** RESERVES
- 6.4** TYPES OF RESERVES
- 6.5** INVESTMENT OF RESERVES
- 6.6** ACCOUNTING FOR RESERVES & PROVISIONS
- 6.7** REFERENCES / SUGGESTED READING

**INTRODUCTION**

In every business there is always a chance of incurring losses or unexpected expenses in the future. So, it is advisable desirable that the entire profits should not be distributed among their owners. The arrangement made to adjust unknown losses in future – provisions and reserves are created. They are quite distinct from each other and cannot be used interchangeably.

## PROVISION

### NOTES

According to the Indian Companies Act, 1956 the term provision refers to :

- (a) The amount written off by way of providing depreciation, renewals or diminution in value of asset;

Or

- (b) The amount retained by way of providing for any known liability of which the amount cannot be determined with substantial accuracy.

**Examples** – Provision for Depreciation, Repairs and Renewals of Assets, Provision for Taxation, Provision for Bad and Doubtful Debts, Provision for Discount on Debtors, Provision for Fluctuations in the value of investment etc.

### Characteristics :

- (1) Provision is made to meet a known liability
- (2) The liability is known but the amount of such liability cannot be determined with reasonable accuracy.
- (3) It is a charge against profits.

### Object or Importance :

- (1) To ascertain the true net profit of the business.
- (2) To ascertain the true financial position of the business.
- (3) To provide for known losses in the future.
- (4) For the equitable distribution of expenses over the years.

### Provisions for Bad and Doubtful Debts

Bad Debts are the amounts which cannot be recovered. Doubtful Debts are the amounts whose recovery is doubtful. Even after deducting the amount of actual bad-debts from the debtors, the list of debtors at the end of year may include some debts which are either bad or doubtful. As the amount of actual loss on account of current bad-debts would be known only in the next year, when the amount is realised from debtors, a provision is created to cover any possible loss on account of bad-debts likely to occur in future. Such a provision is created at a fixed percentage on debtors every year and is called 'Provision for Bad and Doubtful Debt's. The amount of provision for doubtful debts on the one hand is shown on the debit side of the Profit and Loss account and on the other hand, is deducted from sundry debtors on the Asset side of the Balance Sheet.

### Provisions for Discount on Debtors

Normally, businessman allows cash discount to those debtors from whom the payment is received promptly or on fixed period. Discount thus allowed will be an expense of the business and is therefore debited to the Profit & Loss account. Since

## NOTES

there will be certain debtors who will make early payment in the next accounting year and will be allowed with. Such discount is treated in the current year itself. The process of creating a provision for discount is the same as of the provision for doubtful debts. The amount of provision is shown on the debit side of the Profit & Loss account and is also deducted from sundry debtors on the Assets side of the Balance sheet.

### Provision for Taxation

Income tax on profits is treated as charge against the profits of the accounting year. Since the actual amount will be known after the preparation of the Profit & Loss Account, the liability for taxes has to be estimated and provided for on that basis. The estimated amount of tax liability is debited to Profit & Loss account and credited to Provision for Taxation account. When actual tax is determined, Provision for Taxation Account is debited with the amount of tax as assessed and Bank Account or Advance payment of Tax Account is credited with the concerned amount. If the actual liability for taxation is more or less than the provision made in the previous year the difference should be adjusted through Profit & Loss Appropriation Account.

## RESERVES

Reserves means the amount of money which has been put aside out of profits or other surpluses which are not meant to cover any liability contingency, commitment or depreciation on the value of assets. The purpose of all these resource is to enable the firm to tide over a difficult financial period and not to meet any particular contingency. Creation of reserves does not reduce profits but only reduces the divisible profits.

### Examples –

General Reserve, Capital Reserve, Reserve for Expansion, Reserve for Equalisation of Dividends etc.

### Characteristics :

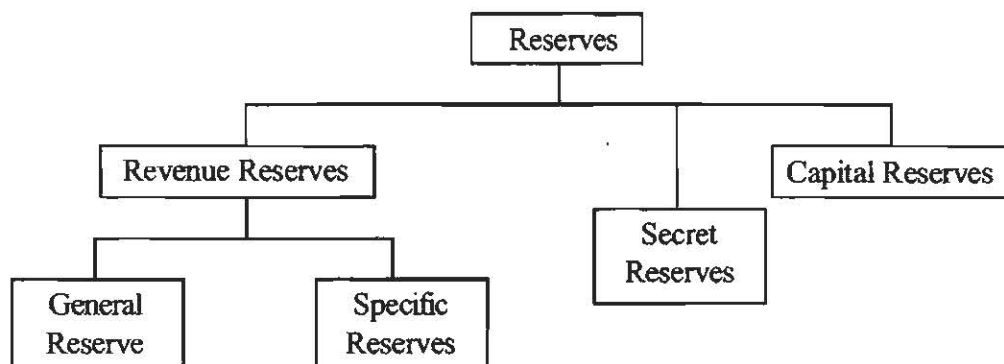
- (1) It is created out of net profit or divisible profit.
- (2) It is not a legal necessity to create it.
- (3) It is not created to meet any known liability.
- (4) Reserves represent accumulated or undistributed profits.

### Object or Importance :

- (1) Helpful in meeting the unforeseen liability/ loss.
- (2) Enables firm to tide over a difficult financial period.
- (3) Helpful in strengthening the financial position of the business.

**DIFFERENCE BETWEEN PROVISION & RESERVE****NOTES**

Basis	Provision	Reserve
1. Creat	To meet a known liability	To meet an unknown liability.
2. Legal Necessity	Compulsary.	Discretionary.
3. Mode of creation	Is a charge against profits.	Is an appropriation of profits
4. Shown on/as	It is shown as deduction from the respective asset.	It is shown on the liability side of the Balance Sheet.
5. Utilisation for dividend	Cannot be utilised for dividend	Can be utilised for dividend.
6. Utilisation for other purpose	It is created to provide for a specific purpose and hence can only be used for meeting that purpose (loss).	It is not created for a special loss and therefore, can be utilised for any unknown liability

**TYPES OF RESERVES****Revenue Reserves :**

These reserves come into existence out of profits which have been earned in the course of day to day business operations.

- (a) **General Reserve** : A forward looking company should transfer a part of its profits to a reserve meant to meet unforeseen future uncertainties; such reserves are known as general reserve. It is also termed as 'Contingency Reserves' and 'Free Reserves'. It may be created meeting unforeseen losses, strengthening financial position of business, expansion of business etc. It is not compulsory to maintain such reserves. General Reserves are shown on the liabilities side of the Balance Sheet under the head 'Owner's Equity'.
- (b) **Specific Reserves** : Such a reserve is created for a special purpose and be utilised only for that purpose. It is created out of divisible profit. Example are :

1. Dividend Equalisation Reserves to equalize dividends over the years.
2. Asset Replacement Reserves to ensure timely replacement of asset.

Notes  
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### **Secret Reserves :**

NOTES

These are reserves which are not known to the ordinary members of the company. Usually, when such reserves exist, the financial position of the company is sound compared to what is shown in the Balance Sheet. As against secret reserves, a hidden reserve is one where an item of profit is described in a manner indicating liability. Similarly, inner reserves are such reserves as are openly made in the P&L A/c but are not shown separately in the Balance sheet, being grouped with other liabilities.

The reserve may be created as :

- (i) Writing off excessive depreciation.
- (ii) Under valuation of closing stock.
- (iii) Suppression of sales.
- (iv) Showing asset as a contingent asset.
- (v) Showing a contingent liability as actual liability.
- (vi) Charging capital expenditure to P & L Account.
- (vii) Crediting revenue receipts to an asset.

### **Objectives of secret reserves :**

- (1) To strength financial position.
- (2) To maintain goodwill by off-setting unexpected loss.
- (3) To discourage business competition
- (4) To maintain working capital.

### **Objections of secret reserves :**

- (1) Do not portray true and fair view of financial position.
- (2) Does not show correct profit.
- (3) Conceal losses arising out of careless management approach.
- (4) Reduction in value of share.

### **Capital Reserves :**

The Companies Act says, any limited company may decide the amount of uncalled capital from the public. This must be endorsed by a special resolution of the members. Such capital will be called only in the event of being wound-up of a company.



## NOTES

This capital is what is commonly known as capital reserve. These reserve are created out of capital profit Following are the sources of capital profit :

- (1) Profit on Sale or Revaluation of Fixed Asset.
- (2) Profit on the purchase of a running business.
- (3) Profit prior to the incorporation of a company.
- (4) Profit on redemption of debentures etc.
- (5) Profit an issue of shares or debentures.
- (6) Profit an forfeiture of shares.

These reserves are used to write off capital losses or for the issue of fully paid bonus shares. Some capital reserves can be utilized to distribute dividend among share holding in certain canmditions like:

- (1) Articles of the company must not from prohibit such dividend.
- (2) Capital profit must have been realised in cash.
- (3) Such profit remains after a fair revaluation of asset and liabilities.

When a profit becomes available ofr dividend, it should better be transferred to General Reserve.

However, some capital profits can be disposed of only in accordance with the Companies Act, 1956.

## INVESTMENT OF RESERVES

The reserves can be invested either in outside securities or be kept invested in the business it self. There is a controversy between the two ways of utilising reserves. The sinking funds created for specific purposes should definitely be invested in outside securities those are safe and marketable. However, general reserve should be invested within the business only to provide funds for expansion of business unless the business itself has no need of funds.

## ACCOUNTING FOR RESERVES & PROVISION

**Illustration 1 :** It is estimated by M/s Pragya Publication will require a sum of Rs. 3,00,000 after 3 years to replace its existing plant. It created a reserve for it and appropriated Rs. 1,00,000 to this reserve at the of each year. New plant was purchased for Rs. 3,00,000 after 3 years. Prepare necessary Journal entries and ledger accounts.

Solution 1 :		Journal Entries		Dr.	Cr.
Date	Particulars	L.F.	Amount Rs.	Amount Rs.	
1st year 31 Dec.	Profit & Loss Appropriation A/c ..... Dr. To Plant Rreplacement Reserve A/c (For the amount transferred out of divisible profit)		1,00,000		1,00,000

Ind year	Profit & Loss Appropriation A/c	Dr.	1,00,000	
31 Dec.	To Plant Replacement Reserve A/c			1,00,000
	(For the amount transferred out of divisible profit)			
III year	Profit & Loss Appropriation A/c	Dr.	1,00,000	
31 Dec.	To Plant Replacement Reserve A/c			1,00,000
	(For the amount transferred out of divisible profit)			
31 Dec.	New Plant A/c	Dr.	3,00,000	
	To Bank A/c			3,00,000
	(For new purchased)			
31 Dec.	Plant Replacement Reserve A/c	Dr.	3,00,000	
	To General Reserve A/c			3,00,000
	(For the balance of plant replacement A/c to General Reserve A/c)		300,000	

Provision &  
Reserves

## NOTES

Ledger Account					
Dr.			Cr.		
Date	Particulars	Amount	Date	Particulars	Amount
I year		Rs.	I year		Rs.
31 Dec.	To Balance c/d	1,00,000	31 Dec.	By P&L App. A/c	1,00,000
II year					
31 Dec.	To Balance c/d	2,00,000	II year	By Balance b/d	1,00,000
				By P&L App A/c	1,00,000
		2,00,000			2,00,000
III year			III year		
31 Dec.	To General Reserve A/c	3,00,000	31 Dec.	By Balance b/d	2,00,000
				By P&L App A/c	1,00,000
		3,00,000			3,00,000

New Plant Account					
III year		Rs.			Rs.
31 Dec.	To Bank A/C	3,00,000			

## Illustrations 2 :

### EXTRACTS OF TRIAL BALANCE

As on 31st December, 2007

	Dr.	Cr.
	Rs.	Rs.
Bad-Debts Account	8,000	
Provision for Doubtful Debts (1-1-2007)		25,000
Debtors	8,00,000	

## Adjustment :

Create a Provision for Doubtful Debts @ 5% on Debtors. Pass the Journal Entries and show the necessary Ledger Accounts and Balance Sheet.

## NOTES

## Solution 2 :

## Journal

Dr.

Cr.

2007 Dec. 31	Provision for Doubtful Debts To Bad-debts A/c (for Baddebts transferred to old provision)	Dr.		8,000	8,000
Dec. 31	Profits & Loss A/c *1 To provision for Doubtful debts A/c (for net amount charged from P&L A/c)	Dr.		23,000	

*1	Bad debts	8,000
	(+) New provision (5% on 8,00,000)	<u>40,000</u>
		48,000
	(-) Old Provision	<u>25,000</u>
		<u>23,000</u>

## LEDGER ACCOUNTS

## BAD-DEBTS A/C

2007 Dec 31	To Balance b/d (As per T.B.)	Rs. 8,000	2007 Dec 31	By provision for Doubtful Debts A/C	Rs. 8,000
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## PROVISION FOR DOUBTFUL DEBTS A/C

2007 Dec 31	To Bad debts A/c	8,000	2007 Jan 1	By Balance b/d (Old provision)	25,000
Dec 31	To Balance c/d (New provision) *1	40,000	Dec 31	By Profit & Loss A/c	23,000
		<u>48,000</u>			<u>48,000</u>
			2007 Jan 1	By Balance b/d	<u>40,000</u>

Dr.		PROFIT & LOSS A/C		Cr.	
		Rs.			Rs.
	To Bad debts	8,000			
	(+) New provision	<u>40,000</u>			
		48,000			
	(-) Old provision	<u>25,000</u>	23,000		

## BALANCE-SHEET

Liabilities	Amount Rs.	Assets	Amount Rs.
		Debtors	8,00,000
		Less : New provision	<u>40,000</u>
		(5% on 8,00,000)	7,60,000

## Illustration 3 :

## EXTRACT OF TRIAL BALANCE

	Dr. Rs.	Cr. Rs.
Provision for Doubtful Debts (1-1-2007)		1,50,000
Provision for Discount on Debtors (1-1-2007)		57,000
Bad-Debts Account	82,000	
Discount Account	32,000	
Sundry Debtors	20,46,000	

**Adjustement :** Write off further and Bad-Debts Rs. 46,000 and a Provision for Doubtful Debts and Provision for Discount on Debtors @ 5% and 2% respectively.

Provision &  
Reserves

**Solution 3 :**

**NOTES**

**BAD DEBTS A/C**

2007			2007		
Dec. 31	To Balance b/d	82,000	Dec. 31	By Provision for	
Dec. 31	To Sundry Debtors	46,000		Doubtful Debts A/c	1,28,000
		<u>1,28,000</u>			<u>1,28,000</u>

**DISCOUNT A/C**

2007			2007		
Dec. 31	To Balance b/d	32,000	Dec. 31	By Provision for	
				Discount on Debtors A/c	32,000

**PROVISION FOR DOUBTFUL DEBTS A/C**

2007			2007		
Dec. 31	To Bad-Debts A/c	1,28,000	Jun 1	By Balance b/d	1,50,000
Dec. 31	To Balance c/d		Dec. 31	By P&L A/c	
	(5% on 20,00,000)	1,00,000		(Balancing figure)	78,000
	(20,46,000-46,000)				
		<u>2,28,000</u>			<u>2,28,000</u>

**PROVISION FOR DISCOUNT ON DEBTORS A/C**

2007			2007		
Dec. 31	To Discount A/c	32,000	Jan. 1	By Balance b/d	57,000
Dec. 31	To Balance c/d		Dec. 31	By P&L A/c	13,000
	(2% on 19,00,000)	38,000		(Balancing figure)	
		<u>70,000</u>			<u>70,000</u>

**SUNDRY DEBTORS A/C**

2007			2007		
Dec. 31	To Balance b/d	20,46,000	Dec. 31	By Bad-Debts A/c	46,000
			Dec. 31	By Balance c/d	20,00,000
		<u>20,46,000</u>			<u>20,46,000</u>

**PROFIT & LOSS A/C**

To Bad debts	82,000			
(+) Further Bad debts	46,000			
	<u>1,28,000</u>			
(+) New provision	1,00,000			
	<u>2,28,000</u>			
(-) old provision	1,50,000	78,000		
To Discount	32,000			
(+) New provision	38,000			
	<u>70,000</u>			
(-) old provision	57,000	13,000		

**BALANCE-SHEET****NOTES**

Liabilities	Amount	Assets	Amount
	Rs.		Rs.
		Sundry Debtors	20,46,000
		(-) Bad debts	46,000
			20,00,000
		(-) New provision	1,00,000
			19,00,000
		(-) Provision for Discount	38,000
			18,62,000

**Illustration 4 :** The following particulars are available from the books of a public company having a large fleet of transport vehicles :

	Rs
Balance of Repair & Renewals Reserve A/c	2,30,000
As on march 31, 2006	
Annual Repair charges incurred during the	
year ended march 31, 2006	1,50,000
year ended march 31, 2007	64,000

The company transfers annually a sum of Rs 80,000 to the Repairs and Renewals Reserve Account. Draw up the Repairs & Renewals A/c for the years 2005-06 and 2006-07.

**Solution : Repairs and Renewals Reserve Account**

March 31 2006	To Repairs & Renewals A/c	1,50,000	April 1 2005	By Balance hold	3,00,000
	To Balance c/d	2,30,000	March 31 2006	By Profit & Loss A/c	80,000
		<u>3,80,000</u>			<u>3,80,000</u>
March 31 2007	To Repairs & Renewals A/c	64,000	April 1 2006	By Balance b/c	2,30,000
	To Balance c/d	2,46,000	March 31	By Profit & Loss A/c	80,000
		<u>3,10,000</u>			<u>3,10,000</u>



## SUMMARY

- If any excess provision is made knowingly or intentionally, the amount in excess of the actual need will be created as 'reserve'.
- Reserves means the amounts set aside out of profits and other surpluses, which are not earmarked in any way to meet any particular liability, known to exist on the date of Balance Sheet.
- Reserves are classified in Revenue Reserve, Capital Reserve & Secret Reserve.
- Revenue Reserve is designed to meet any unforeseen Contingency in future or to be utilised for expansion of business. If created for a special purpose, it is known as specific reserve
- Reserve created out of capital profit is known as capital reserve.
- A secret reserve is that which is not disclosed in the Balance-Sheet.

## NOTES

## EXERCISE

1. What do you understand by Provisions ? Explain their importance ?
2. What are reserves ? What is their importance ? What are the differences between provision and reserves ?
3. What are the types of reserves ? Explain ?

## PRACTICAL QUESTIONS

**Q.1.** It is estimated by Z Co., that it will require an additional sum of Rs. 1,00,000 after 5 years to replace its existing plant. It created a specific reserve for the replacement of its plant and appropriated Rs. 20,000 to this reserve each year on 31st Dec. New Plant is purchased for Rs. 1,00,000 after five years. Give necessary Journal Entries and Ledger Accounts.

**Q.2.** Following are the extracts of a Trial Balance as on 31st Dec. 2007.

### EXTRACTS OF TRIAL BALANCE

AS ON 31ST DEC. 2007

	Dr.	Cr.
Debtors	50,000	

**Adjustment** – Create a provision for Doubtful Debts@ 2½% on Debtors. Pass necessary entry and show these items in P&L A/c and Balance-Sheet.

**EXTRACT OF TRIAL BALANCE  
AS ON 31-3-2007**

**NOTES**

	Dr.	Cr.
	Rs	Rs
Provision for Doubtful Debts 1-4-2007		35,000
Bad debts	16,000	
Sundry Debtors	5,00,000	

**Adjustment :** (i) Written off further Bad-debts Rs. 10,000.

(ii) Create a provision for Doubtful Debts at 6% on Sundry Debtors.

Pass the Journal Entries, prepare necessary account and show the effects on Final Accounts.

[Ans – Amount debited to P&L A/c – Rs. 20,400]

### 6.7 REFERENCES / SUGGESTED READING

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## **BLOCK – III**

## **The Unit Covers :**

- 7.1** INTRODUCTION
- 7.2** USERS OF FINANCIAL STATEMENT
- 7.3** INCOME STATEMENT
  - 7.3.1** TRADING ACCOUNT
  - 7.3.2** PROFIT & LOSS ACCOUNT
- 7.4** PREPARATION OF TRADING ACCOUNT
- 7.5** PREPARATION OF PROFIT & LOSS ACCOUNT
- 7.6** STATEMENT OF FINANCIAL STATUS (BALANCE SHEET)
- 7.7** POINTS TO BE NOTED FOR PREPARATION OF FINAL ACCOUNTS
- 7.8** LIMITATION OF FINAL STATEMENTS/FINAL ACCOUNTS ADJUSTMENTS
- 7.9** REFERENCES / SUGGESTED READING

## **INTRODUCTION**

Financial statements refer to such statements which reports the profitability and the financial position of business at the end of accounting period. The term financial statements includes at least two basic statements which are as under :

- (i) Income Statements (Trading and Profit & Loss Account)
- (ii) Statement of Financial Position (Balance Sheet)

These two financial statements are also termed as 'Final Accounts'.

In the words of John. N. Myer- "The financial statements provide a summary of the accounts of a business enterprise, the balance sheet reflecting the assets, liabilities and capital as on a certain date and the income statement showing the results of operations during a certain period."

## USERS OF FINANCIAL STATEMENTS

### NOTES

- (1) **Management** : It helps the management in assessing the profitability of various activities and departments. Management can review the progress of the business and take decisions for controlling the non-profitable activities.
- (2) **Employees** : They can judge as to how much bonus and increase in their wages are possible from the profits of the enterprise.
- (3) **Investors** : They can assess the short term & long term soundness by studying the future growth of enterprise.
- (4) **Government** : To study the profit margin of various industries to introduce or withdraw various concessions and to increase or decrease the excise duty.
- (5) **Taxation Authorities** : They use the financial statements for the purpose of assessment of income tax, sales tax etc.
- (6) **Other Users** : Such as creditors, researchers, trade associations, consumer agencies etc.

## INCOME STATEMENT

It is divided into two parts :

- (i) Trading Account
- (ii) Profit & Loss Account

The fundamental principle of preparing the Trading and profit & loss A/c is that the expenses and incomes for the full trading period, but only for the trading period, are taken to their account.

- (i) **Trading Account** : Trading Account is prepared for calculating the gross profit or gross loss arising or incurred as a result of the trading activities of a business. In other words, it records the amount of purchases of goods and also the expenses which are incurred in bringing that commodity to a saleable state. All expenses related to purchase of material or manufacturing of goods (Direct Expenses) are recorded in the Trading Account.

According to Carter "Trading Account is the account which is prepared to determine gross profit or gross loss."

According to J.R. Batliboi - "The Trading Account shows the results of buying and selling of goods. In preparing the accounts, the general charges are ignored and only the transactions in goods are included."

### Objects / Importance of Trading Account :

- (1) To find out Gross Profit or Gross Loss.
- (2) To compare last year's items with that of current year
- (3) To scrutinise the reasons for increase or decrease in sales.
- (4) To find out the percentage of Gross Profit or Gross Loss on sales.
- (5) To find out the expenses incurred on purchase of goods.
- (6) To simplify the method of valuation of closing stock.



## PREPARATION OF TRADING ACCOUNT

FINAL ACCOUNTS

Trading Account is a Nominal Account and all expenses which relate to either purchase or manufacturing of goods are written on the Dr. side of the Trading Account.

NOTES

### Items written on the Dr. side

- (1) **Opening Stock** : The stock of goods remaining unsold at the end of the last year is termed as the opening stock of the current year. Opening stock includes Raw Material, Work-in-progress and Finished goods.
- (2) **Net Purchases** – Net purchases refers to the net amount of purchases after deducting purchase returns out of ie.
- (3) **Direct Expenses** - All expenses related to purchase of goods, bringing them to godowns and manufacturing of goods are called direct expenses. For example- Wages, Freight, Carriage Inwards, Factory expenses, Insurance of purchase, Direct Taxes on Purchase.

### Items written on the Cr. side

- (1) **Net Sales** – Net sales refers to gross sales less sales returns.
- (2) **Closing Stock** - The goods remaining unsold at the end of the current year is known as closing stock.

It is valued at cost price or market price whichever is less. It includes the closing stock of raw material, work-in-progress and finished.

Normally, the closing stock is given outside the Trial Balance. But if it is given inside the Trial Balance, it will not be shown in the Trading Account but on the Asset side of the Balance-sheet only.

### SPECIMEN OF TRADING ACCOUNT

Dr.		Cr.	
(for the year ending .....			
Particulars	Amount	Particulars	Amount
To Opening Stock	.....	By Sales	.....
To Purchases	.....	Less : Sales Return or	.....
Less : Purchase Return or	.....	Return Inward	.....
Return outward	.....	By Closing stock	.....
To wages	.....	By Gross Loss	.....
To wages & Salaries	.....	(if any) transferred to	
To carriage	or	Profit and Loss A/c	
To carriage Inward	or	(Balancing figure)	
To carriage on purchase	.....		
To Direct Expenses	.....		
To Freight, Octroi and cartage	.....		
To Gas, Fuels & Power	.....		
To Manufacturing Expenses	.....		
or productive Expenses	.....		
To Factory Expenses, such as	.....		
Factory lighting	.....		
Factory Rent etc.	.....		
To Dock charges and clearing charges	.....		
To Import Duty or Custom Duty	.....		
To Excise Duty	.....		
To Royalty	.....		
To Gross Profit	.....		
transferred to P&L A/c	.....		
(Balancing figure)	.....		

**CLOSING ENTRIES RELATING TO TRADING ACCOUNT****(1) For the items of Dr. side of Trading Account**

NOTES

Trading A/c

Dr.

To Opening Stock A/c  
 To Purchases A/c  
 To Sales Return A/c  
 To Wages A/c  
 To Direct Expenses A/c  
 To Carriage A/c  
 To Gas, Fuel & Power A/c  
 To Manufacturing Expenses A/c  
 To Factory Rent & Lighting A/c  
 To Custom Duty A/c  
 To Royalty A/c

(For the transfer of above accounts to the Dr. side of Trading A/c)

**(2) For the items of Cr. side of Trading account**

Sales A/c Dr.  
 Closing stock A/c Dr.  
 Purchase Return A/c Dr.  
 To Trading A/c

(For the transfer of above accounts to the cr. side of Trading A/c)

**(3) For Gross Profit**

Trading A/c Dr.  
 To Profit & Loss A/c

(For the transfer of Gross Profit to the Cr. side of P&amp;L A/c)

**(4) For Gross Loss**

Profit & Loss A/c Dr.  
 To Trading A/c

(For the transfer of gross loss to the Debit side of P&amp;L A/c)

**(ii) Profit & Loss Account**

A business incurs a number of expenses which are directly not related to buying and selling goods and thoutore, they are not taken to trading account. Hence a business man is more interested in knowing the profit earned or net loss incurred during the year. As such, a Profit & Loss Account prepared which contains all the items of losses and gains pertaining to the accounting period. This account is prepared from Nominal accounts and its balance is transferred to capital account.

According to Prof. Carter – "A Profit & Loss Account is an account into which all gains and losses are collected, in order to ascertain the excess of gains over the losses or vice-versa."

**Objects/Importance of Profit & Loss Account**

- (1) To ascertain the Net Profit or Net Loss
- (2) To Compare current year and previous year profits

- (3) To ascertain whether business is being conducted efficiently or not.
- (4) Helps in taking concrete steps for controlling expenses.
- (5) Helpful in the preparation of Balance-sheet

## PREPARATION OF PROFIT & LOSS ACCOUNT

Profit & Loss account is a Nominal Account and all the expenses and losses are shown on its debit side and all the incomes and gains are shown on its credit side. These expenses include administrative expenses, selling expenses, distribution expenses etc. These are called indirect expenses.

### Items written on the Dr. side :

- (i) **Gross Loss** – Gross Loss brought down from the Trading account.
- (ii) **Office and Administrative Expenses** – Such as salary, office expenses, office rent, lighting and electricity, Rates & Taxes, Insurance, Telephone, Postage, Stationery, Legal expenses, Trade Expenses, Repairs, audit fees etc.
- (iii) **Selling & Distribution, Carriage Outward, Bad-debts, Delievery van expenses etc.**
- (iv) **Miscellaneous Expenses** : Such as Discount, Depreciation, Charity, Interest on Loan, Interest on capital, donation etc.

### Items written on the Cr. Side :

- (1) **Gross Profit** – Gross profit brought down from the Trading Account.
- (2) **Other Incomes & gains** – Income from Investment, Interest on drawings, Rent received, Discount received, Commission received etc.

**Specimen of Profit & Loss Account**  
(for the year, ending .....)

Particulars	Amount	Particulars	Amount
To Gross Loss b/d	.....	By Gross Profit b/d	.....
To Salaries	.....	By Rent (Cr.)	.....
To Salaries & wages	.....	By Discount (Cr.)	.....
To Rent, Rates & taxes	.....	By Commission received	.....
To Printing & Stationery	.....	By interest on investments	.....
To Postage & Telegram	.....		.....
To Insurance Premium	.....	By Bad-debts Recovered	.....
To Telephone Charges	.....	By Apprentice Premium	.....
To Legal Charges	.....	By Profit on sale of Assets	.....
To Audit fees	.....		.....
To Travelling expenses	.....	By Discount on purchases	.....
To Establishment Expenses	.....	By Rent of subletting	.....
To Trade Expenses	.....	By income from	.....
To General Expenses	.....	other sources	.....
To Carriage outward or	.....	By Net loss (if any)	.....
Carriage on sale	.....	transferred to	.....
To Unproductive wages	.....	capital A/c	.....
To Advertisement	.....		
To Commission	.....		
To Brokerage	.....		
To Bad-debts	.....		
To Packing charges	.....		

## NOTES

To Delivery van expenses	.....	
To Stable Expenses	.....	
To Discount	.....	
To Sales tax		
To Repairs		
To Depreciation		
To Interest (Dr.)		
To Bank Charges		
To charity & Donation		
To entertainment Expenses		
To Conveyance Expenses		
To Loss on sale of Asset		
To Net Profit transferred to Capital A/c		
	.....	.....

**Note :** Domestic and household expenses of the proprietor, Income-tax and life Insurance premium etc. are known as drawings deducted from capital at the Liabilities side of the Balance-sheet.

### Closing entries relating to Profits & Loss A/c

(1) Transfer of expenses and losses

Profit & Loss A/c	Dr.
To Salaries A/c	
To Rent, Rates Taxes A/c	
To General Expenses A/c	

(For the transfer of Indirect Expenses to Profit & Loss A/c)

(2) Transfer of Incomes and Gains

Interest Received A/c	Dr.
Commission Received A/c	Dr.
To Profit & Loss A/c	

(For transfer of income & gains to Profit & Loss A/c)

(3) Transfer of profit balance.

Profit & Loss A/c	Dr.
To Capital A/c	

(For the transfer of net profit to Capital A/c)

(4) Transfer of Loss balance

Capital A/c	Dr.
To Profit & Loss A/c	

(For the transfer of net Loss to Capital A/c)

### Distinction between Trading and Profit & Loss A/C

FINAL ACCOUNTS

S.No.	Trading A/C	Profit & Loss A/c
1.	It is prepared as part of P&L A/c	It is prepared as an independent and principal account.
2.	Direct expenses are recorded in it.	Indirect expenses are recorded in it.
3.	This account gives the amount of Gross Profit/Loss.	This shows the amount of Net Profit/Loss.
4.	Balance of this account is transferred to Profit & Loss A/c	Balance of this account is transferred to Balance Sheet
5.	The number of items to be recorded in the Trading Account are generally very less.	The number of items to be recorded in this account are generally quite large.
6.	Prepared before Profit & Loss Account.	Prepared after Trading Account.

NOTES

**Example 2 :** From the following particulars of Shri Kanha Traders in respect of the year ending 31<sup>st</sup> March 2007, prepare Trading and Profit & Loss A/c.

Opening Stock	16,000	
Purchases	1,00,000	
Purchases Returns		600
Return Inwards	1200	
Sales		1,64,000
Carriage Inward	400	
Wages	1,000	
Rent & Taxes	600	
Trade Expenses	1,200	
Discount	80	
Discount on Purchases		100
Commission	20	
Salaries	4,000	
Legal Expenses	100	
Audit fees	120	
Bank charges	80	
Sales Tax	100	
Interest on Drawing		120
Interest from Investments		400
Repairs & Renewals	520	

Closing Stock Rs. 2,000/-



**Solutions :****Trading and Profit & Loss Account (For the year ending on 31 March 2007)****NOTES**

Particulars	Amount	Particulars	Amount
To opening stock	16,000	By Sales 1,64,000	
To Purchases 1,00,000		Less : Returns 1,200	1,62,800
Less : Return 600	99,400	By Closing Stock	2,000
To wages	1,000		
To Carriage inward	400		
To Gross Profit c/d	48,000		
	1,64,800		1,64,800
To Salaries	4,000	By Gross profit b/d	48,000
To Discount	80	By Discount on Purchases	100
To Commission	20	By Interest on Investment	400
To Legal Expenses	100	By Interest on Drawings	120
To Audit fees	120		
To Bank charges	80		
To Sales tax	100		
To Repairs and Renewals	520		
To Rent and Rates	600		
To Trade expenses	1,200		
To Net Profit transferred to Capital A/c	41,800		
	48,620		48,620

**Manufacturing Account**

The business concerns those manufacture goods would like to ascertain or may like to ascertain the cost of producing the total output. The ordinary Trading and Profit & Loss Account are not capable of providing the same. Some concerns, engaged in manufacturing, prepare separate 'Manufacturing Account' to which all expenses incurred in the factory as the production of goods are debited. The total of such expenses after adjustments of value of stocks of raw materials and work in progress shown the total cost of the output during the accounting period. This figure is then, transferred to the debit of the Trading Account which reflects the gross profit made by the concen. Trading and Profit & Loss Accounts are prepared as usual leaving the items taken into Manufacturing account : Opening balance of raw materials and work in progress are shown on the debit side of the account and closing balances on the credit side. Raw material consumed during the accounting period is written on debit side of the account, which is ascertained as follows :

Openint stock	***
Add : Purchases	***
Less : Cosing stock	***
Raw Material consumed	***

**Example – 1**

Following are the balances as on March 31, 2007 taken from the books of Velocin Brothers. You are required to prepare (a) Manufacturing Account, (b)

Trading Account, and (c) Profit & Loss account

FINAL ACCOUNTS

Sales	2,40,000
<b>Opening stock :</b>	
Raw material	8,000
Work in Progress	12,000
Finished goods	18,000
<b>Closing stock :</b>	
Raw Material	6,000
Work in Progress	16,000
Finished goods	12,000
Raw Material Purchases	60,000
<b>Factory Expenses :</b>	
Wages	48,000
Carriage Inwards	2,000
Rent	6,400
Factory Repairs	8,400
Plant Repairs	15,600
Supervisor's Remuneration	20,000
Work manager's salary	5,600
<b>Administration Overheads :</b>	
Salaries	8,000
Other expenses	12,000
<b>Selling Overheads :</b>	
salaries	4,000
Commision	16,000
Advertising	10,000
Other Expenses	3,200
<b>Distribution Overheads :</b>	
Van expenses	3,600
Wages	2,000

NOTES

**Manufacturing Account**  
(For the year ended March 31, 2007)

NOTES

Particulars	Rs	Particulars	Rs
<b>Direct Material :</b>		Net works cost of production (transferred to Trading A/c)	1,64,000
Opening stock	8000		
Purchases	60,000		
	68000		
less: Closing stock	6,000		
Raw Material consumed	62,000		
<b>Direct wages :</b>			
Factory wages	48,000		
<b>Direct Expenses :</b>			
Carriage Inwards	2,000		
Prime cost	1,12,000		
<b>Factory Overheads :</b>			
Factory Rent	6,400		
Factory Repairs	8,400		
Plant Repairs	15,600		
Supervisor's wages	20,000		
Work manager's salary	5,600		
Works cost	56,000		
	1,68,000		
<b>Add : Opening work in progress</b>	12,000		
<b>Less : Closing work in progress</b>	16,000		
	1,64,000		1,64,000

**Trading and Profits & Loss Account (for the year ended March 31, 2007)**

Opening stock of finished goods	18,000	Sales	2,40,000
Net cost of production	1,64,000		
	1,82,000		
Less: Closing stock of finished goods	12,000		
Cost of goods sold	1,70,000		
Gross profit c/d	70,000		
	2,40,000		2,40,000
<b>Administration overheads :</b>		Gross profit	70,000
Salaries	8,000		
Other expenses	12,000		
	20,000		
<b>Selling overheads :</b>			
Salaries	4,000		
Commission	16,000		
Advertising	10,000		
Other expenses	3200		
	33200		
<b>Distribution Overheads :</b>			
Van expenses	3,600		
Wages	2,000		
	5,600		
Net Profit	11,200		
	70,000		70,000

# STATEMENT OF FINANCIAL STATUS OR BALANCE-SHEET

## NOTES

The Trading and Profit & Loss account show only the net profit or net Loss of a business for a certain trading period. But the businessman may also like to know the financial position of the business at the end of the trading period. For this purpose, he prepares a statement of his assets and liabilities as on the closing date of the trading period. This statement is known as Balance-sheet. A Balance-Sheet is a sheet containing the balances of real and personal accounts of a business. The name, balance-sheet is derived from the fact that these accounts must always be in balance i.e. Assets must equal the sum of liabilities, internal and external as well.

According to J.R. Batliboi – "A Balance-sheet is a statement that measures the exact financial position of a business on a certain fixed date."

### Need and Importance of Balance-Sheet

- (1) To ascertain the true financial position of the business at a particular point of time.
- (2) To ascertain the nature and cost of various assets of the business.
- (3) To determine the nature and amount of various liabilities of business.
- (4) To provide information about the exact amount of capital at the end of year and the addition/deduction in the current year.
- (5) To find out whether the firm is solvent or not.
- (6) To help in preparing the opening entries at the beginning of the next year.

### Marshalling of Assets & Liabilities

Marshalling is the arrangement of various assets and liabilities in a proper order. Though the order is not fixed, still to create uniformity in the Balance-Sheets following two methods are used :

- (1) Liquidity method
- (2) Fixity or Permanence method

#### (1) In order of Liquidity :

An asset which is most easily convertible into cash is written first and then will follow those assets which are comparatively less easily convertible. In the same way, those liabilities which are to be paid early are written first and then the fixed and long term liabilities.

## NOTES

**BALANCE-SHEET**

(As on .....)

Liabilities	Amount	Assets	Amount
Current Liabilities	.....	Current Assets	.....
Bank Overdraft	.....	Cash in hand	.....
Bills Payable	.....	Cash at Bank	.....
Sundry Creditors	.....	Bills Receivable	.....
Outstanding Expenses	.....	Short term Investment	.....
Bank Loan (Short-term)	.....	Sundry Debtors	.....
Unearned Income	.....	Closing Stock	.....
Fixed Liabilities	.....	Prepaid Expenses	.....
Long term loan	.....	Accrued Income	.....
Reserves	.....	Fixed Assets -	.....
Capital	.....	Furniture	.....
(+) Net Profit	.....	Motor Vehicles	.....
(-) Net Loss	.....	Long term Investment	.....
(-) Drawings	.....	Plant & Machinery	.....
(-) Income Tax & LIP ....	.....	Land & Building	.....
	.....	Patents	.....
	.....	Goodwill	.....

**Suitability** – Sole Proprietors and partnership firms prepare their Balance-sheet in the order of liquidity.

- (2) **In order of Fixity or Permanence** – Assets which are most difficult to be converted into cash (Goodwill) are written first and the assets which are most liquid (cash) are written last. Liabilities which are to be paid last (capital) are written first and current liabilities in last.

**BALANCE-SHEET**

(As On .....)

Liabilities	Amount	Assets	Amount
Capital	.....	Fixed Asset -	.....
(+) Net Profit	.....	Good will	.....
(-) Net Loss	.....	Patents	.....
(-) Drawings	.....	Lands & Building	.....
(-) Income tax & LIP	.....	Plants & Machinery	.....
Fixed Liabilities -	.....	Long term Investment	.....
Long term loans	.....	Motor Vehicles	.....
Reserves	.....	Loose Tools	.....
Current Liabilities -	.....	Furniture	.....
Unearned Income	.....	Current Assets -	.....
Outstanding expenses	.....	Accrued Income	.....
Bank loan (short-term)	.....	Prepaid expenses	.....
Sundry Creditors	.....	Closing Stock	.....
Bills Payable	.....	Sundry debtors	.....
Bank overdraft	.....	Short term Investments	.....
	.....	Bills Receivable	.....
	.....	Cash at Bank	.....
	.....	Cash in hand	.....

**Suitability** – Joint stock companies are required to prepare their Balance-sheet in the order of permanence.

**Resemblance in Trial Balance and Balance-sheet :**





## POINTS SHOULD BE NOTED FOR PREPARING FINAL ACCOUNTS

### NOTES

1. If a trial balance is not given in the question, it is better to prepare a Trial Balance first of all. If there is a difference in the Trial Balance, the difference is placed to a 'Suspense A/c' and shown in the Balance Sheet.
2. Items which appear in the Trial Balance should be shown only once.
3. Items which appear outside the Trial Balance known as Adjustments, have to be shown at two places.
4. Items appearing on debit side of Trial Balance should be shown at Dr. side of Trading and profit & loss A/c or Assets side of Balance-sheet.
5. Items appearing on the credit side of Trial Balance should be shown at Cr. side of Trading and Profit & Loss A/c or Liabilities side of Balance-Sheet.
6. All accounts relating to goods are written in the Trading Account where as all the remaining expenses or the balances are shown in the Profit & Loss Account.
7. The balances of Personal and Real Accounts are always shown in the Balance-sheet and balances of Nominal Accounts in the Trading and Profit & Loss A/c.
8. The totals of both sides of the Balance sheet will always be equal.
9. If the expenses are in respect of factory they will be shown in the Trading Account else they will be shown in Profit & Loss Account.
10. If a Trial Balance is not given in the question, and if it is not clearly stated whether a particular items is expense or income, it will be treated as expense such as Discount, Commission, Brokerage or Rent etc.

## LIMITATION OF FINANCIAL STATEMENTS/ FINAL ACCOUNTS

1. They are mainly statements of historical costs and do not show the current worth.
2. Most of the times, costs are allocated on arbitrary and subjective basis.
3. Assets show cost of acquisition less depreciation and do not show current value.
4. They reflect a composite of historical costs, current costs and estimates.
5. They do not reflect certain important qualitative elements like competency and reputation of the management, morale and deficiency of employees etc.
6. They also show certain deferred charges to future income which have no real value as assets.

**Example 3 :** From the following Trial Balance of Mahavir & Co, prepare a Trading and Profit & Loss A/c and Balance-Sheet for the year ending. 31-Dec., 2006.

NOTES

**Trial Balance**  
(As on 31.12.2006)

Particulars	Amount	Particulars	Amount
Opening Stock	3,800	Sales	14,000
Purchases	7,200	Creditors	2,000
Sales return	120	Purchase Returns	80
Wages	1400	Capital	4320
Salaries	600		
Rent	200		
Discount	200		
Tax	120		
Drawing	1,600		
Debtors	2,240		
Cash in Hand	200		
Cash at Bank	2,320		
Furniture	400		
	20,400		20,400

Stock on 31st Dec., 2006 was valued at Rs. 2,000.

**Solutions :**

**Mahavir & Co.**  
**Trading and Profit & Loss Account**  
for the year ending 31st Dec. 2006

Dr.			Cr.
Particulars	Amount Rs.	Particulars	Amount Rs.
To opening stock	3,800	By Sales 14,000	13,880
To purchases 7,200		Less : Return 120	
Less : Returns 80	7120	By Closing stock	2,000
To wages 1400			
To Gross Profit c/d (Transferred to P&L A/c)	3,560		
	15880		15,880
To Salaries 600		By Gross Profit b/d	3,560
To Rent 200			
To Discount 200			
To Tax 120			
To Net profit 2,440			
[Transferred to Capital A/c]	3,560		3,560

**Balance-Sheet**  
(As on 31<sup>st</sup> Dec. 2006)

Liabilities	Amount	Assets	Amount
Capital 4,320		Furniture 400	
(+) Net profit 2,440		Debtors 2,240	
		Closing Stock 2,000	
(-) Drawings 1,600	5,160	Cash at Bank 2,320	
Creditors 2,000		Cash in Hand 200	
	7,160		7,160

**Example 4 :** From the following Balances, prepare a Trading, Profit & Loss Account and Balance sheet.**NOTES**

Dr.			Cr.
Carriage on purchase	8,000	Supplier's A/c	61,000
Carriage on sales	3,500	Banker's	30,000
Manufacturing Expenses	42,000	Interest on Investment	4,500
Advertisement	7,000	Capital A/c	1,00,000
Excise Duty	4,400	Sales less Return	5,20,000
Lighting	6,000	Discount on Purchase	3,400
Customer's A/c	80,000		
Duty & Clearing Charges	5,200		
Postage & Telegram	800		
Fire Insurance premium	3,600		
Potent	12,000		
Income Tax	10,000		
Life Insurance Premium	14,000		
Office Exp.	7,200		
Commission on Purchase	2,000		
Purchase less Return	1,60,000		
Cash in Hand	2,500		
Motor Car	60,000		
Drawings	8,000		
Audit fees	2,700		
Repairs	2,200		
Closing stock	76,000		
Trade Exp.	3,200		
Investment	30,000		
Sales tax	12,000		
Discount	2,700		
Plant	1,53,900		
	7,18,900		7,18,900

**Solutions :****Trading and Profit & Loss Account  
(for the year ending .....)**

Dr.			Cr.
Particulars	Amount	Particulars	Amount
To Purchase less Return	1,60,000	By Sales less Return	5,20,000
To Carriage on purchase	8,000		
To Commission on Purchase	2,000		
To Manufacturing Exp.	42,000		
To Excise Duty	4,400		

To Duty & Cleaning Charges	5,200		
To Gross Profit c/d transferred to P&L A/c	2,98,400		
	<u>5,20,000</u>		<u>5,20,000</u>
To Carriage on sale	3,500	By Gross Profit b/d	2,98,400
To Advertisement	7,000	transferred from trading A/c	
To Lighting	6,000	By Interest on Investments	4,500
To Postage & Telegram	800	By Discount on	
To Fire Insurance Premium	36,600	Purchases	3,400
To office Expenses	7,200		
To Audit fees	2,700		
To Repairs	2,200		
To Trade Expenses	3,200		
To Sales Tax	12,000		
To Discount paid	2,700		
To Net Profit transferred to capital A/c	2,55,400		
	<u>3,06,300</u>		<u>3,06,300</u>

**BALANCE-SHEET**

as on .....

Liabilities		Amount	Assets		Amount
Banker's		30,000	Cash in hand		2,500
Supplier's A/c		61,000	Customer's A/c		80,000
Capital	1,00,000		Closing Stock		76,000
(+) Net Profit	<u>2,55,400</u>		Investments		30,000
	3,55,400		Motor Car		60,000
Less : Drawings	<u>8,000</u>		Plant		1,53,900
	3,47,400				
Less : Income Tax	<u>10,000</u>		Patents		12,000
	3,37,400				
Less : Life Insurance Premium	<u>14,000</u>				
		3,23,400			
		<u>4,14,400</u>			<u>4,14,400</u>

**Note :** If closing stock appears inside the trial balance, it will be shown only at one place, i.e. only on the assets side of the Balance sheet.

**ADJUSTMENTS**

While preparing final accounts it must be detected whether there is a transaction :

- (1) which has been omitted to be recorded in the books, or
- (2) which has wrongly been recorded in the books, or



## NOTES

- (3) of which only one aspect has been recorded in the books. Entries passed for such transactions are called '**adjustment entries**'.

- (1) **Closing stock** – The amount of goods unsold at the end of the year is called closing stock. It is valued at cost price or market price, whichever is less. The entry will be :

Closing stock A/c	Dr.
To Trading A/c	

(For closing stock transferred to Trading A/c)

**Effect** – It will be shown at two places, i.e., on the credit side of the Trading A/c and on the Assets side of the Balance-sheet.

- (2) **Outstanding expenses or expenses due but not paid** – These are the expenses which have been incurred during the year but have been left unpaid on the date of preparation of final accounts. For example, a firm pays rent @ 5000 per month. If during the accounting year ending on 31 Dec., only 11 months rent amounting to Rs. 55,000 has been paid, rent for one month of Rs. 5,000 will remain outstanding at the end of the year. The entry will be :

Rent A/c	Dr. 5,000
To Outstanding Rent	5,000

(For outstanding rent of one month)

**Effect** : Added to the concerned expenses on the debit side of Trading or Profit & Loss. Account and on the other hand, will also be shown on the Liabilities side of the Balance-Sheet.

- (3) **Prepaid Expenses or Unexpired Expenses or Expenses paid in advance** – These are the expenses which have been paid in advance for the next year during the current year itself. In other words, the benefit of such payments will be available in the next accounting year. Prepaid insurance amounted to Rs. 1000.

Prepaid Insurance A/c	Dr. 1,000
To Insurance A/c	1,000

(For Prepaid Insurance is to Insurance A/C)

**Effect** : It will be deducted from the concerned expenses on the debit side of Trading or Profit and Loss Account and on the other hand, will also be shown on the Asset side of the Balance-sheet.

- (4) **Depreciation** – Depreciation is the loss or fall in value of fixed assets due to their constant use and expiry of time. For example : Machinery of Rs. 60,000 is to be depreciated @ 10% p.a. Entry will be :

Depreciation A/c	Dr. 6,000
------------------	-----------

(For Depreciation charged)

**Effect :** It will be shown on the debit side of the Profit & Loss A/C and will be deducted from the value of the concerned asset on the Asset side of Balance Sheet.

NOTES

- (5) **Accrued Income or Income Receivable** – Income earned during the current year but have not been actually received by the end of the current year. Such incomes are known as 'Accrued Incomes' or 'Earned Incomes'. For example, commission earned in December (at the end of year) and received in January of Rs. 300 then commission accrued is Rs. 300.

Accrued commission A/c	Dr.	300
To Commission A/c		300

(For commission receivable)

**Effect :** Such incomes will be added in the concern in income on the credit side of the Profit & Loss Account and on the other hand, will be shown on the Asset side of the Balance-sheet.

- (6) **Unearned Income or Income Received in Advance** – Certain Income is received in the current year but the whole amount of it does not belong to the current year. Such Income is known as 'Unearned Income' or 'Income Receivable'. For e.g. – Rent received on 1<sup>st</sup> April, 2006 Rs. 28,000 @ Rs. 2,000 P.M. This rent is from 1<sup>st</sup> April 2006 to 30 May 2007. Accounting year is from 1<sup>st</sup> April, 2006 to 31<sup>st</sup> March, 2007. In such case, 2 month rent (April 07 & May 07) is advance income, entry will be.

Rent a/c	Dr.	4,000
To Rent received in Advance a/c		4,000

(For adjustment of unearned Rent)

**Effect :** It will be deducted from the concerned income on the credit side of Profit & Loss Account and also be shown on the liabilities side of the Balance-sheet.

- (7) **Interest on Capital** – Capital invested by the proprietor is treated as a loan to the business earning interest at a fixed rate. If this amount had not been invested in the capital, it would even then have earned some interest outside. As such the proprietor wants interest for his capital and profit for the risk undertaken by him, for example, if 5% interest is to be allowed on the capital of Rs. 1,00,000, the entry will be :

Interest on capital A/c	Dr.	5,000
To Capital A/c		5,000

(For Interest allowed on capital)

## NOTES

**Effect :** Interest on capital is shown on the debit side of Profit & Loss Account and added to capital in Balance-sheet.

- (8) **Interest on Drawings** – The proprietor draws cash or goods for his personal use. Such with-drawals are termed as Drawings. If the firm pays interest on Capital, it is fully justified that it should also charge interest on drawings. For example : Proprietor has drawn 10,000 for personal use and interest is @ 3%. Its entry will be :

Drawings A/c	Dr.	300
	To Interest on Drawings	300
(For Interest charged on Drawings)		

**Effects :** Interest on drawing is shown on the credit side of Profit & Loss Account & deducted from capital in Balance-Sheet.

- (9) **Interest on Loan** – Loan is a liability of the firm and interest on such loan will be an expense. If up-to-date interest has not been paid on the loan, the unpaid interest will have to be calculated and will be treated just like outstanding expenses i.e. For example, Interest on loan is charged @ 10% & the amount of loan is 2,00,000.

Interest on Loan A/c	Dr.	20,000
	To Outstanding Interest A/c	
	(For interest charged on loan)	20,000

**Effect :** Unpaid interest on loan is added in the Interest on loan written on debit side of P&L a/c and on the other hand added to the loan from Bank in liabilities side or the Balance Sheet.

- (10) **Bad Debts** – When it becomes certain that a particular amount will not be recovered from debtors, it is known as Bad debts. For example : written off Bad debts of Rs. 1,000. Entry will be

Bad debts A/c	Dr.	1,000
	To Debtors A/c	1,000
(for Bad debts deducted from debtors)		

**Effect :** It will come in debit side of the P&L a/c and the amount will be deducted from Debtors on the Asset side of the Balance-sheet.

- (11) **Provision for Bad and Doubtful Debts** – As the amount of actual loss on account of current year bad-debts would be known only in the next year when the amount is realised from Debtors, a provision is created to cover any possible loss on account of bad-debts likely to occur in future. Such a provision is created at a fixed percentage on Debtors every year and is called 'Provision for Bad & Doubtful Debt' For example : Debtors are of Rs. 60,000 and provision is made on it @ 5%. Its entry:

To Provision for Bad and

3,000

Doubtful Debts

(for creation of reserve @ 5% on Debtors)

## NOTES

**Effect :** It will come on debit side of P&L a/c and amount is deducted from Debtors on the Asset side of Balance-Sheet.

**(12) Provision for discount on Creditors** – Many a time discount is received from the creditors. A reserve is created for possible discount in the future. For example, Creditors are of Rs. 20,000 and created provision@ 2%, its entry will be :

Provision for discount from creditors A/c .....Dr. 400

To Profit &amp; Loss A/c

400

**Effect :** It will come towards the credit side of Profit & Loss A/c and will be deducted from creditors in Balance-Sheet.

**Example 5 :** From the following Trial balance of Salman & sons, prepare Trading A/c, and Profit & Loss A/c for the year ending 31<sup>st</sup> March, 2007 and a Balance-sheet as on that date.

Trial Balance (As on 31-3-2007)			
Dr.			Cr.
Particulars	Amount	Particulars	Amount
Opening stock	5,200	Capital	16,000
Purchases	15,500	Creditors	2,000
Sales Return	300	Sales	20,000
Debtors	4,000	Commission	3,140
Building	5,000	Rent	2,000
Furniture	1,600		
Machinery	4,000		
Bills Receivable	2,000		
Salaries	1,600		
Tax	200		
Insurance	300		
Carriage on purchases	900		
Trade Expenses	300		
Travelling Expenses	440		
Wages	1000		
Cash	800		
	43,140		43,140

**Adjustment :**

(1) Closing stock Rs. 12,000, (2) Accrued Rent Rs. 500, (3) Unearned commission of Rs. 140, (4) Depreciation@10% p.a. on Machinery & Furniture.

**Solution :**

**Trading and Profit & Loss Account**  
(for the year ended 31<sup>st</sup> March, 2007)

## NOTES

Dr.			Cr.
Particulars	Amount	Particulars	Amount
To Opening Stock	5,200	By Sales 20,000	
To Purchases	15,500	less : Return 300	19,700
To Carriage	900	By Closing Stock	12,000
To Wages	1,000		
To Gross Profit c/d transferred to P&L A/c	9,100		
	31,700		31,700
To Salaries	1,600	By Gross Profit b/d transfers A/c	9,100
To Tax	200	By Commission 3,140	
To Insurance	300	Less : Unearned 140	3,000
To Trade Expenses	300		
To Travelling Expenses	440	By Rent 2,000	
To Dep. on Machinery *1	400	(+) Accrued 500	2,500
To Dep. on Furniture *2	160		
To Net profit transferred to capital a/c	11,200		
	14,600		14,600

$$*1 \quad 4000 \times \frac{10}{100} = 400$$

$$*2 \quad 1600 \times \frac{10}{100} = 160$$

**Balance-Sheet**  
(As on 31st March, 2007 )

Liabilities	Amount	Assets	Amount
Creditors	2,000	Cash	800
Unearned Commission	140	B/R	2,000
Capital 16,000		Debtors	4,000
Add : Net profit 11,200	27,200	Closing stock	12,000
		Accrued Rent	500
		Furniture 1600	
		Less : Dep 160	1,440
		Machinery 4000	
		Less : Dep 400	3,600
		Building	5,000
	29,340		29,340

**Example 6 :** From the following Trial balance of Mr. Jain, prepare Trading, Profit & Loss A/c and Balance sheet for the year ending 31<sup>st</sup> Dec., 2007.

**Trial Balance**  
(As on 31<sup>st</sup> Dec., 2007)

Dr.			Cr.
Particulars	Amount	Particulars	Amount
Opening stock	1,60,000	Bank loan	44,000
Building	2,40,000	Creditors	1,16,000
Debtors	1,70,000	Capital	3,20,000
Machinery	1,00,000	Sales	13,00,000
Drawings	40,000	Discount	4,000
Purchases	9,00,000	Purchase Returns	8,000
Insurance and Tax	15,000	Commission	7,500
Trade Expenses	36,000	Bad Debts Reserve	4,000
Sales Return	6,000	Bills Payable	20,000
Salaries	82,000		
Carriage inwards	12,500		
Bad debts	3,000		
Bills Receivable	45,000		
Cash	14,000		
	18,23,500		18,23,500



**Adjustments :**

- (1) Stock on 31 Dec., 2007 is Rs. 1,20,000
- (2) 5% Interest is to be charged on capital.
- (3) Outstanding salary is Rs. 8000
- (4) Prepaid Insurance Premium is Rs. 1500.
- (5) Depreciate Building by 2% and Machinery by 10%.
- (6) The Bad Debts Reserve is to be maintained at 5% on debtors.
- (7) The accrued commission is amounted to Rs. 2000.

**NOTES**

**Trading and Profit & Loss Account**  
(for the year ending 31<sup>st</sup> Dec., 2007)

Dr.		Cr.	
Particulars	Amount	Particulars	Amount
To Opening stock	1,60,000	By Sales	13,00,000
To Purchase	9,00,000	Less : Sales Return	6,000
Less : Purchase Return	8,000	By closing stock	1,20,000
To Carriage Inwards	12,500		
To Gross Profit c/d			
(Transferred to P&L A/c)	3,49,500		
	1,41,4000		14,14,000
To Salaries	82,000	By Gross Profit b/d	3,49,500
Add : Outstanding	8,000	By Discount	4,000
To Insurance	15,000	By Commission	7,500
Less : Prepaid	1,500	Add : Accrued	2,000
To Trade Expenses	36,000		9,500
To Bad debts	3,000		
Add : New Provision *1	8,500		
	11,500		
Less : Old Provision	4,000		
To Interest on capital *2	16,000		
To Depreciation on			
Machinery *3	10,000		
Building *4	4,800		
To Net Profit			
(Transferred to Capital A/c)	1,85,200		
	3,63,000		3,63,000

$$*1 \quad 1,70,000 \times \frac{5}{100} = 8500$$

$$*2 \quad 3,20,000 \times \frac{5}{100} = 16,000$$

$$*3 \quad 1,00,000 \times \frac{10}{100} = 10,000$$

$$*4 \quad 2,40,000 \times \frac{2}{100} = 4,800$$

**Balance-Sheet**  
(As on 31<sup>st</sup> March, 2007 )

**NOTES**

Liabilities		Amount	Assets		Amount
Capital	3,20,000		Building	2,40,000	
Add : Interest	16,000		Less : Dep	4,800	2,35,200
Add : Net Profit	1,85,200		Machinery	1,00,000	
	5,21,200		Less : Dep	10,000	90,000
			Closing Stock		1,20,000
Less : Drawings	4,000	4,81,200	Debtor	1,70,000	
Outstanding Salaries		8,000	(-) Provision for		1,61,500
			Bad debts	8,500	
Bank Loan		44,000	Accrued Commission		2,000
Bills Payable		20,000	Prepaid Insurance		1,500
Creditors		1,16,000	Bills Receivable		45,000
			Cash		14,000
		6,69,200			6,69,200

**Example 7 :** From the following Trial Balance extracted at the end of a trading year ended on 31<sup>st</sup> March, 2007. Prepare Trading and Profit & Loss A/c as well as Balance-Sheet on the date and also show the necessary journal entries to give effect to the adjustment.

**Trial Balance (As on ....)**

Particulars	Dr.	Cr.
	Amount	Amount
Capital A/c	—	5,00,000
Stock (1st April, 2006)	80,000	—
Purchases	2,00,000	—
Sales	—	8,00,000
Sales Return	15,000	
Purchase Return	—	4,000
Carriage Inwards	12,000	
Carriage Outwards	25,000	
Wages	33,000	
Salaries	55,000	
Rent	11,000	
Freight & dock Charges	24,000	
Fire Insurance Premium	9,000	
Bad Debts	21,000	
Discount	5,000	
Apprenticeship Premium		15,000
Printing & Stationery	2,500	
Taxes & Rates	3,500	
Travelling Expenses	1,500	
Trading Expenses	2,000	
Premises	5,50,000	
Furniture	25,000	
Bills Receivable	35,000	
Bills Payable		25,000
Debtors	2,00,000	
Creditors		1,58,000
Packing Machinery	45,000	

Smith's Loan A/c	50,000	
Investment	30,000	
Cash in Hand	2,500	
Cash at Bank	35,000	
Drawings	30,000	
	15,02,000	15,02,000

FINAL ACCOUNTS

NOTES

### Adjustment :

- (1) Stock on 31<sup>st</sup> March, 2007 is Rs. 70,000.
- (2) Outstanding wages – Rs. 3000, Outstanding salaries – Rs. 5,000, Rent – Rs. 1,000 and Stationery– Rs. 300
- (3) Fire Insurance Premium of Rs. 6,000 is related to the period upto 31<sup>st</sup> March, 2007.
- (4) Apprenticeship Premium is for three years, paid in advance on 1<sup>st</sup> April, 2006.
- (5) Depreciate : Premises by 5%, Furniture by 10% and Packing Machinery by 10%
- (6) Create a Reserve on Debtors for doubtful debts @ 5% and for discount @ 3%
- (7) Create a Reserve on creditors for discount@3%
- (8) Interest on Smith's loan for one year has accrued@7%
- (9) Interest on Investment @5% for the half year has accrued.
- (10) Interest on capital to be allowed @5% for the year.
- (11) Interest on Drawings is Rs. 800 for the year.

### Solution :

#### Trading and Profit & Loss Account (for the year ending 31<sup>st</sup> March, 2007)

Dr.		Cr.	
Particulars	Amount	Particulars	Amount
To opening stock	80,000	By Sales	8,00,000
To Purchase	2,00,000	(-) Return	15,000
(-) Return	4,000	By Closing stock	70,000
To Carriage Inwards	12,000		
To Freight and Dock Charges	24,000		
To wages	33,000		
Add : Outstanding wages	3,000		
To Gross Profit c/d			
(Transferred to P&L A/c)	5,07,000		
	8,55,000		8,55,000
To Salaries	55,000	By Gross Profit b/d	5,07,000
Add : outstanding	5,000	By Reserves for discount on creditors	4,740
To Rent	11,000	By Interest accrued on loan *6	3,500
Add : Outstanding	1,000	By Interest accrued on Investment *7	750
To Fire Insurance Premium	9,000		
Less : Prepaid Premium	3,000		
	6,000		

## NOTES

To Carriage outward		25,000	By Interest on		
To Bad debts	21,000		Drawings *8		800
Add : Reserve *4	<u>10,000</u>	31,000	By Apprenticeship		
To Discount		5,000	Premium	15,000	
To Printings			Less : Advance		
Stationery	2,500		premium	<u>10,000</u>	5,000
Add : Outstanding	<u>300</u>	2,800			
To Rent & Taxes		3,500			
To Travelling Expenses		1,500			
To Trading Expenses		2,000			
To Dep on					
Premises *1	27,500				
Furniture *2	2,500				
Packing Machine *3	<u>4,500</u>	34,500			
To Reserve for discount					
on debtors *9		5,700			
To Interest on Capital *5		25,000			
To Net Profit					
(Transferred to		3,07,790			
Capital A/c)					
		<u>5,21,790</u>			<u>521790</u>

$$*1 \quad 5,50,000 \times \frac{5}{100} = 27500$$

$$*2 \quad 25,000 \times \frac{10}{100} = 2,500$$

$$*3 \quad 45,000 \times \frac{10}{100} = 4500$$

$$*4 \quad 2,00,000 \times \frac{5}{100} = 10,000$$

$$*5 \quad 5,00,000 \times \frac{5}{100} = 25000$$

$$*6 \quad 50,000 \times \frac{7}{100} = 3,500$$

$$*7 \quad 30,000 \times \frac{5}{100} \times \frac{6}{12} = 750$$

$$*8 \quad \text{Given in adjustment}$$

$$*9 \quad 2,00,000 - 10,000 = 1,90,000 \times \frac{3}{100} = 5,700$$

**Balance-Sheet**  
(As on 31st March, 2007)

FINAL ACCOUNT

NOTES

Liabilities		Amount	Assets		Amount
Sundry Creditors	1,58,000		Cash in hand		2,500
Less : Provision for discount	4,740	1,53,260	Cash at Bank		35,000
Outstanding Expenses			Bills Receivable		35,000
Wages	3,000		Investment	30,000	
Salaries	5,000		Add : Int. Accrued	750	30,750
Rent	1,000		Debtors	2,00,000	
Stationery	300	9,300	Less : Reserve for	10,000	
			Doubtful Debts	1,90,000	
Bills Payable		25,000	Less : Reserve for discount	5,700	1,84,300
Advance paid			Smith's Loan	50,000	
Apprenticeship Premium		10,000	Add : Interest accrued	3,500	53,500
			Prepaid Insurance premium		3,000
Capital	5,00,000		Closing stock		70,000
(+) Interest	25,000		Furniture	25,000	
(+) N.P.	3,07,790		Less : Depreciation	2,500	22,500
	8,32,790		Packing Machine	45,000	
			Less : Depreciation	4,500	40,500
(-) Drawings	30,000		Premises	5,50,000	
(+) Interest on drawings	800	(-) 30,800	Less : Depreciation	27,500	5,22,500
		8,01,990			
		9,99,550			9,99,550

**Necessary Adjustment Entries**

Date	Particulars	L.F.	Amount	Amount
			Rs.	Rs.
31 March 07	Closing Stock A/c Dr. To Trading A/c (Closing stock taken into account)		70,000	70,000
	Wages A/c Dr. Salaries A/c Dr. Rent A/c Dr. Stationery A/c Dr. To outstanding Liabilities for expenses A/c (Adjustment of outstanding expense)		3,000 5,000 1,000 300 9,300	
	Prepaid Insurance A/c Dr. To Fire Insurance A/c (Adjustment of Prepaid Insurance)		3,000	3,000
	Apprenticeship Premium A/c Dr. To Apprenticeship Premium received in advance (Adjustment of prepaid Premium)		10,000	10,000
	Depreciation A/c Dr. To Furniture A/c To Premises A/c To Packing Machine A/c (Depreciation of assets)		34,500	2,500 27,500 4,500
	Profit & Loss A/c Dr. To Reserve for Doubtful Debts To Reserve for discount for Debtors A/c (Adjustment of reserves for debtors)		15,700	10,000 5,700



## NOTES

Reserve for discount on creditors A/c	Dr.	4,740	
To Profit & Loss A/c			4,740
(Adjustment of Reserve for discount on creditors)			
Accrued Interest A/c	Dr.	3,500	
To Interest A/c			3,500
(Adjustment of Accrued Interest)			
Interest A/c	Dr.	25,000	
To Capital A/c			25,000
(Adjustment of Interest on capital A/c)			
Drawings A/c	Dr.	800	
To Interest A/c			800
(Adjustment of Interest on Drawings A/c)			

## SUMMARY

- Financial statements provide a concise picture of profitability and financial position of the business.
- The interested parties are management, shareholders, creditors, government, employees customers etc.
- Financial statement includes Trading, Profit & Loss A/c as well as Balance-sheet.
- Trading Account is a Nominal Account and all expenses related to either purchase, sales or manufacturing of goods are written in it. Dr. side of trading account includes opening stock, purchases & purchase return, Direct expenses where as Cr. side includes sales & sales return, closing stock etc. If total of Cr. side is more than that of Dr. side, the balancing figure will be Gross profit and if total of Dr. side is more than that of Cr. side, the balancing figure is Gross Loss.
- Profits & Loss Account shows the net profit or net loss of a business for a particular trading period. It takes all expenses, selling & distribution, administrative, financial expenses etc.
- The Balance sheet is a statement at a particular date showing on one side the trader's asset (property & possessions) and on the other side the liabilities (loan & credits). Balance sheet is Marshalled in order of Liquidity (for sole proprietors and partnership firm) and Permanace (for Joint stock companies.)
- Unrecorded transaction, not entered while preparing Balance sheet, are known as adjustment Entries.

	Entry	Final Accounts
(1)	Outstanding Salary A/c expenses To Outstanding Salary A/c	Dr. P&L A/c (+) Debit side B/S – Liabilities
(2)	Accrued Accrued Rent A/c Incomes To Rent A/c	Dr. P&L A/c (+) Debit side B/S – Asset

## NOTES

(3)	Prepaid Expenses	Prepaid Wages A/c To Wages A/c	Dr. Trading A/c – (–) Debit side B/S – Asset
(4)	Unearned Income	Income Ac To Unearned Income A/c	Dr. P&L A/c (–) Credit side B/S – Liabilities
(5)	Closing Stock	Closing Stock A/c To Trading A/c	Dr. Trading A/c – Credit side B/S – Asset
(6)	Depreciation	Depreciation A/c To Asset A/c	Dr. P & L – Debit side B/S – Deduct from Particular Asset
(7)	Interest on capital	Interest on capital A/c To Capital A/c	Dr. P & L – Debit side B/S – Deduct out of Capital in Liabilities side
(8)	Interest	Drawings A/c To Interest on Drawings A/c	Dr. P&L – Credit side B/S – Add in Capital in Liabilities side
(9)	Interest on Loan	Interest on Loan A/c To Outstanding Interest A/c	Dr. P & L – (+) Debit side B/S – Add in Loan in Liabilities side
(10)	Bad debts	Bad debts A/c To Debtors	Dr. P & L – Debit side B/S – Deduct from Debtors in Assets side
(11)	Provision for Bad & Doubtful Debts	Profit & Loss A/c To Provision for Bad & Doubtful debts	Dr. P & L – Debit side B/S – Deduct from debtors in Assets side
(12)	Provision for Discount on creditors	Provision for Discount on Creditors A/c To Profits Loss A/c	Dr. P & L – Credit side B/S – Deduct from Creditors in Liabilities side

## EXERCISE

- What do you understand by Final Accounts ?
- Distinguish between –
  - Trading Account and Profit & Loss Account
  - Trial Balance and Balance-sheet
- What important points are kept in mind while preparing Final Accounts ?
- What do you understand by 'Adjustment' Entries ? Why are they necessary for preparing Final Account.
- Write short notes on :
  - Interest on Capital
  - Interest on Drawings
  - Accrued Income
  - Unearned Income
  - Bad debts
  - Outstanding Expenses

**NUMERICALS**

1. Following is the Trial Balance of Bharat on 31.12.2006, prepare Trading, Profit & Loss A/c and Balance sheet.

**Trial Balance**  
**As on 31.12.2006**

NOTES

	Dr. (Rs.)	Cr. (Rs.)
Capital A/c		20,000
Plant & Machinery	10,000	
Fixture & Fittings	450	
Manufacturing expenses	1,000	
Carriage Inwards	150	
Salaries	200	
Opening Stock	5,720	
Bills Receivable	5,000	
Cash in hand	120	
Cash at Bank	450	
Debtors	6,000	
Purchases	9,500	
Petty wages	160	
Rent and Taxes	350	
Drawings	1,400	
Sales		16,000
Creditors		4,500
Total	40,500	40,500

**Adjustments :**

- (i) Closing stock is Rs. 3,200
- (ii) Depreciate Plant & Machinery by 5% and Fixtures and Fittings by 10%.
- (iii) Create 5% Reserve for Bad and Doubtful debts on debtors.
- (iv) Rent and Taxes amounting to Rs. 80 were outstanding, salaries & wages amounting to Rs. 150 and Rs. 60 respectively are yet to be paid

[Ans. Gross profit- Rs. 2,610/-,

Net Profit Rs. 985/-

Total of Balance-sheet - Rs. 24,375]

2. From the following balance, prepare Final Accounts of the books of Mr. A for the year ending 31st March, 2007.

	Rs.		Rs.
Capital	24,500	Loan	7,880
Drawings	2,000	Sales	65,360
General Expenses	2,500	Purchases	47,000
Building	11,000	Motorcar	2,000
Plant	9,340	Bad Debts Reserve	900
Opening stock	16,200	Commission (Cr.)	1,320

Coal & Power	2,240	Car's Expenses	1,800
Taxes & Insurance	1,315	Bills Payable	3,850
Wages	7,200	Cash in hand	80
Debtors	6,280	Bank Overdraft	3,300
Creditors	2,500	Donation	105
Discount (Dr.)	550		

**Adjustments :**

- (i) Stock on 31 March, 2007 is valued for Rs. 23,500.
- (ii) Write off Rs. 160 for Bad Debts and make a reserve of 5% for bad and doubtful debts on debtors.
- (iii) Depreciation on Plant by 10% and Motor Car by 12%.
- (iv) The motor car is partly used for business and partly for private use of the proprietor. Hence 1/3 of the depreciation, and car expenses are to be charged to the proprietors.
- (v) Interest of Rs. 750 was outstanding on Bank overdraft.
- (vi) It is decided that Rs. 250 be transferred every year to create donation reserve.

[Ans. : Gross Profit – Rs. 16,220; Net Profit – Rs. 10,210 and B/s – Rs. 50,560]

[Note : Treat 1/3 of depreciation and car expenses as Drawings]

3. From the following Trial Balance extracted from the books of A, prepare Trading & Profit & Loss A/c for the year ending 31<sup>st</sup> December, 2007 and a Balance-sheet on that date.

	Dr. (Rs.)	Cr. (Rs.)
Furniture	6,400	
Loose Tools	62,500	
Building	75,000	
Capital Account		1,25,000
Bad debts	1,250	
Sundry Debtors and Creditors	38,000	25,000
Stock (1.1.2007)	34,600	
Purchases and Sales	54,750	1,54,500
Bank Overdraft		28,500
Sales and Purchase Return	2,000	1,250
Stationery	4,500	
Interest Account	1,180	
Commission		3,750
Cash in hand	6,500	
Taxes and Insurance	12,500	
General Expenses	7,820	
Salaries	33,000	
Provision for Bad debts		2,000
	3,40,000	3,40,000

## NOTES

**Adjustments :**

- (1) Stock on 31 December 2007 was Rs. 32,500
  - (2) Depreciate Building to 5% and Furniture at 10%. Loose Tools are revalued at Rs. 50,000 at the end of the year.
  - (3) It was decided to place Rs. 1,000 to Bonus fund for staff.
  - (4) Salaries of Rs. 3,000 and taxes of Rs. 1,200 are outstanding.
  - (5) Insurance amounting to Rs. 1,000 is prepaid.
  - (6) Written off a further Rs. 1000 as Bad-Debts and Provision for Doubtful Debts is to be made equal to 5% on Sundry Debtors.
  - (7) Half of the stationery was used by the Proprietor for his personal purposes
- [Ans – Gross Profit – Rs. 96,900; Net Profit Rs. 11,710 and B/S Total – Rs. 2,02,160]

[Note : (1) Depreciation on loose tools will be Rs. 6,250 – Rs. 50,000 = Rs. 12,500

(2) Bonus payable to staff will be treated as outstanding expenses]

**7.9 REFERENCES / SUGGESTED READING**

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**The Unit Covers :****8.1 INTRODUCTION****8.1.1 – RECEIPT & PAYMENT ACCOUNT****8.1.2– INCOME & EXPENDITURE ACCOUNT****8.1.3– BALANCE-SHEET****8.2 PREPARATION OF INCOME AND EXPENDITURE****8.3 ACCOUNT FROM RECEIPT AND PAYMENT ACCOUNT****8.4 IMPORTANT ITEMS OF INCOME AND EXPENDITURE  
ACCOUNT****8.5 INCOME & EXPENDITURE ACCOUNT FOR PROFESSIONAL  
PEOPLE****8.6 ACCOUNTING FOR INCOMPLETE RECORDS****8.7 INSURANCE ACCOUNTING****8.8 REFERENCES / SUGGESTED READING****INTRODUCTION**

Non-Trading Institutions are the associations which are established for the purpose of rendering service or for promotion of art, culture, literature, education, science etc. They do not aim at making profits like a trading concern. The institutions like clubs, libraries, hospitals, educational institutions, charitable institutions, literary societies etc. are non-trading concerns.

Following books are normally kept by the non-trading concerns :

- (1) Register of members to record the names, addresses and other details of members.
- (2) Minute Book to record proceedings of meetings.
- (3) Cash Receipts Journal

(4) Cash Payments Journal

(5) Ledger, and

(6) Journal for recording the transactions which cannot be recorded anywhere.

**NOTES**

The non-trading concerns also prepare final accounts at the end of year which consist of:

- (i) Receipt and Payment Account
- (ii) Income and Expenditure Account, and
- (iii) Balance sheet

**(i) Receipt and Payment Account** – A Receipt and Payment Account is a summary of the Cash Book or of Cash and Bank transactions relating to a given period of time. This is another name given to summary of Cash Book. It includes all receipts and payments whether they are of revenue or capital nature. Such an account must definitely show a debit balance because one cannot spend more cash than what one has received. All receipts are shown on the debit side and all payments are shown on the credit side. Opening balances of cash in hand and at bank are put on the debit side. If there is a bank overdraft, it would be put on the credit side.

**Features of Receipt and Payment A/c :**

- (1) This account starts with the opening balance of cash in hand and cash at Bank.
- (2) It is a real account.
- (3) All cash receipts are recorded on the debit side while all cash payments are recorded on the credit side.
- (4) It contains all capital and revenue incomes and all capital and revenue expenditures.
- (5) Only actual receipts and payments are recorded.
- (6) All non cash items e.g. – depreciation, outstanding expenses and incomes are ignored
- (7) Profit & Loss cannot be found out by this account.
- (8) The account is balanced at the end of the accounting year with the closing amount of cash in hand and cash at bank or bank overdraft.

**FORMAT OF RECEIPT AND PAYMENT ACCOUNT**

**Receipts and Payment Account**  
(For the year ending .....)

Receipts		Payments	
Particulars	Amount	Particulars	Amount
	Rs.		Rs.
To balance b/d	.....	By Rent and Rates	.....
To Entrance fees	.....	By Salaries	.....
To Life Membership fees	.....	By Electricity	.....
To Subscription	.....	By Furniture	.....
To Donations	.....	By Office Expenses	.....
To Income from lectures	.....	By Printing and Stationery	.....
		By Library Books	.....

To Interest on Investment	.....	By Investment purchased	.....
To Income from concent	.....	By Repairs	.....
To Sale of sold news paper	.....	By Electric Installation	.....
To Sale of Furniture	.....	By Sundry Expenses	.....
To Profit from Entertainment	.....	By balance c/d	.....
To Rent	.....		
To Loan from Govt.	.....		
To Other Receipts	.....		
Rs.	.....	Rs.	.....

Accounts of Non  
Trading Institution

## NOTES

(ii) **Income and Expenditure Account** – The trading concerns carry on their business with an object of making profits. So they prepare Profit & Loss Account. But the non-trading concerns are formed with an object of rendering service to the society. They are not motivated at profits. Therefore, the non-trading concerns do not prepare a Profit & Loss account. They prepare an account called Income and Expenditure Account with a view to know any surplus or Deficit generated from their activities.

### Features of Income and Expenditure A/c :

- (1) It is a nominal Account.
- (2) Only items of revenue nature are recorded in it.
- (3) Adjustment related to depreciations and Provision for Bad debts are recorded in it.
- (4) Only current year revenue, income and expenditure are recorded in it.
- (5) No opening and closing balance of cash or bank are included in it.
- (6) This account is prepared in the same manner in which a Profit & Loss Account is prepared.
- (7) The closing balance of this statement reveals surplus or deficit.

### FORMAT OF INCOME AND EXPENDITURE ACCOUNT

#### Income and Expenditure Account

(For the year ended .....)

Expenditure	Amount	Income	Amount
	Rs.		Rs.
To Rent, Rates & Taxes	.....	By Subscription	.....
To Advertisement	.....	By Donation	.....
To Salaries	.....	By Legency	.....
To Insurance premium	.....	By Proceeds from	.....
To Telephone charges	.....	Charity Show	.....
To Maintenance	.....	By Interest of Investment	.....
To General Expenses	.....	By Donation	.....
To Depreciation	.....	By Profit on sale of Asset	.....
To Excess of income	.....	By Entrance fees	.....
over expenditure (Surplus)	.....	By Excess of expenditure	.....
(if any)	.....	over income (Deficit)	.....
	.....	(if any)	.....

**Difference between Receipt & Payment and Income & Expenditure Account****NOTES**

Basis of Difference	Receipt & Payment Account	Income & Expenditure Account
1. Nature	It is a real account	It is a nominal account
2. Form	It is like cash account	It is like Profit & Loss Account.
3. Items	It contains capital as well as revenue items.	It contains only revenue items.
4. Transaction	Only cash transaction finds place in it.	Transactions other than cash transaction also find place in it
5. Institutions	This account is kept by professional persons eg. : Doctor, Auditor etc.	This account is kept in non trading concerns eg.: Clubs, Hospitals
6. Opening Balance	It starts with opening balance of cash & bank.	It has no opening balance.
7. Adjustments	Adjustments are not recorded in it.	Adjustments are recorded in it.
8. Closing balance	Represents the closing cash in hand and at bank or overdraft at bank and is transferred to receipt & payment account of next year.	Indicates the surplus or deficit and such surplus/ deficit is transferred to the capital fund of Balance sheet.
9. Capital and Revenue items	It records receipts & payments of both capital and revenue nature.	It records Expenses & Incomes of revenue nature only.
10. Balance-sheet	It is an independent account and no Balance-sheet is required after it.	Balance-sheet is prepared after this account.

**PREPARATION OF INCOME AND EXPENDITURE ACCOUNT FROM RECEIPT AND PAYMENT ACCOUNT**

Certain steps are to be as follows :

- (1) No record of opening and closing balance of Receipt and Payment account is made in Income and Expenditure Account.
- (2) The revenue incomes relating to the current year should be identified from the debit side of the Receipt and Payment account. Add any amounts outstanding and deduct all amounts received in advance or recovery of arrears, then show the Adjusted incomes on the credit side of the Income and Expenditure account.
- (3) In the same way revenue expenditure should be identified from the credit side of the Receipt and Payment Account relating to the current year. Add outstanding amount to them and deduct from them any amounts prepaid or paid for arrears. Show the adjusted expenses on the debit side of the Income and Expenditure Account.

- (4) Items of capital nature appearing in Receipt and Payment Account are not recorded in Income and Expenditure Account but they are taken to Balance-sheet which is prepared after this account.
- (5) Previous year expenditure or income already recorded in Receipt and Payment Account, should be recorded in Income and Expenditure Account.
- (6) If some adjustments are traced out which belong to current accounting period, then they should be recorded in Income and Expenditure Account.
- (7) Adjustments relating to provision for bad debts and depreciation on fixed assets should be shown on the debit side of the Income and Expenditure Account.
- (8) The Income and Expenditure Account should be balanced. A credit balance shows surplus or excess of income over expenditure while a debit balance shows deficit or excess of expenditure over income.

## NOTES

### IMPORTANT ITEMS OF INCOME AND EXPENDITURE ACCOUNT

- (1) **Entrance Fees** – Entrance fee or Admission fee is usually charged by a club or a society or an educational institution from the new entrants. It may be treated as a revenue income, wholly capitalised or treated partly as revenue and partly capitalized, depending upon the policy of the organisation. If it is collected once, it is treated as capital receipt, where as if received periodically it is treated as revenue income. In absence of any specific information it should be treated as revenue income.
- (2) **Subscription** – It is a main source of income of a non-profit entity. for eg. a club receives subscription from its members. The Receipt and Payment Account records the amount of actual subscription received as a whole, where as Income and Expenditure Account records only the subscription which relates to the current accounting period.

Total Subscription received during the year	.....
Add : Subscription outstanding at the end of this year	.....
Less : Subscription outstanding at the end of previous year	.....
Add : Subscription received in advance at the end of previous year	.....
Less : Subscription received in advance at the end of this year	.....
Subscription to be shown in Income & Expenditure Account	.....

## NOTES

- (3) **Donations** – Donations are amount given by members or by outsiders for the general functioning of the unit or for a particular purpose. Donation can be classified as :
- (i) **Specific Donation** – When donation is received for a specific purpose i.e. for Building, Land etc. It is capitalised and is shown on the liability side of the Balance Sheet.
  - (ii) **General Donation** –
    - (a) of big amount – It is of non-recurring nature and shown on the liability side of the Balance-sheet.
    - (b) of small amount – It is shown on the credit side of the Income & Expenditure Account.
- (4) **Legacy** – Legacy refers to the amount that organization gets on account of a will. The amount of legacy is treated as donation and is generally of non-recurring nature. It appears to the debit side of Receipt & Payment Account and should be taken to the Balance-Sheet on the liabilities side.
- (5) **Life Membership fees** – In order to become a member of an organisation for the whole of the life, some members pay lumpsum, i.e. once in their life time, such a receipt is of a capital nature and thus taken to the liabilities side of the Balance sheet.
- (6) **Endowment Fees/Fund** – It is a fund arising from a bequest or a gift, the income of which is devoted for a specific purpose. It is shown in the liabilities side of Balance-Sheet.
- (7) **Special fund** – If a fund has been kept for special purpose like building or charity etc, then it is known as special fund. It is recorded in the liability side of Balance-Sheet and the expenses related to it are deducted from this fund in the liability side of Balance-sheet, and these expenses are not recorded in the expenditure side.
- (8) **Sale of Sport Material/Old Newspapers** – It appears on the debit side of Receipt & Payment Account and is transferred to the credit side of Income and Expenditure Account.
- (9) **Sale of old asset** – It appears on the debit side of Receipt and Payment Account and should not be transferred to Income and Expenditure Account (because it is of capital nature). However, profit or loss from such sale of asset is recorded in Income & Expenditure Account.
- (10) **Payment of Honorarium** – The amount paid to a person who is not an employee of the institution is called Honorarium and is debited to the Income and Expenditure Account.



### III) Balance-Sheet

Accounts of Non-  
Trading Institution

#### NOTES

Liabilities	Amount	Assets	Amount
Capital Fund	.....	Cash	.....
Entrance fees	.....	Furniture	.....
Life membership fees	.....	Building	.....
Creditors	.....	Sport Material	.....
Endowment Fund	.....	Stock	.....
Special Fund	.....	Prepaid Expenses	.....
Creditors	.....	Outstanding Subscription	.....
Outstanding Expenses	.....		
Advance Subscription	.....		
	.....		.....

### INCOME & EXPENDITURE ACCOUNT AND BALANCE-SHEET

**Example 1 :** Given below is the Receipt and Payment Account of Lions club for the year ended on 31 December, 2006.

#### Receipt and Payment Account of Lions club for the year ended on 31st Dec., 2006

Particulars	Amount Rs.	Particulars	Amount Rs.
To balance b/d	5,125	By Salaries	3,000
To subscription		By General Expenses	375
2005	200	By Taxes	200
2006	10,250	By Newspapers	750
2007	300	By Charity	1,750
To Donations	2,700	By Drama Exp.	2,250
To Sales of		By Investment	10,000
Drama Tickets	4,750	By Electric charges	725
To Sale of old		By Balance c/d	4,500
Newspaper	225		
	23,550		23,550

Prepare Income & Expenditure Account for the year ending on 31st December 2006 and a Balance Sheet as on that date taking the following information into account :

- (1) There are 500 members, each paying an annual subscription of Rs. 25, Rs. 250 being in arrear for 2005.
- (2) Donation promised during the year but not received amounted to Rs. 500.
- (3) Taxes amounting to Rs. 200 per annum have been paid up to 31<sup>st</sup> March, 2007 and Rs. 250 for salaries is outstanding.
- (4) Building stands for Rs. 25,000 and it is required to write off depreciation at 5% per annum.
- (5) .5% per annum interest is accrued on investment for 5 months.

(for the year ending on 31<sup>st</sup> Dec., 2006)

## NOTES

Dr.			Cr.	
Particulars	Amount		Particulars	Amount
To Salaries 3,000			By Subscription 10,250	
(+) outstanding salaries 250			Add : outstanding at the end 2250	12,500
	3,250		By Donation 2,700	
To General Expenses 375			Add : outstanding 500	3,200
To Newspapers 750			By Sale of Drama Ticket 4,750	
To Taxes 200	150		Less : Drama Exp. 2,250	2,500
Less : Prepaid *1 50	50		By Sale of Old Newspaper	225
To charity 1,750			By Interest Accrued *3	125
To Electric Charges 725				
To Depreciation *2 1,250				
To Surplus of Income Over Expenses 10,300				
	18,550			18,550

$$*1 \quad 200 \times \frac{3}{12} \text{ (from 1-1-2007 to 31-3-2007)} = 50$$

$$*2 \quad 25,000 \times \frac{5}{100} = 1,250$$

$$*3 \quad 10,000 \times \frac{3}{100} \times \frac{5}{12} = 125$$

**Balance-Sheet**  
(as on 31st Dec., 2006)

Liabilities	Amount	Assets	Amount
	Rs		Rs.
Subscription received in advance 300		Cash 4,500	
Salaries Outstanding 250		Investment 10,000	
Capital fund *5 30,575		Accrued Interest 125	
(1.1.2006)		Subscription outstanding *4 2,500	
Add : Surplus for 2006 10,300	40,875	Donation outstanding 500	
		Prepaid Tax 50	
		Building 25,000	
		Less : Dep. 1,250	23,750
	41,425		41,425

$$*4 \quad 2,250 + 250 = 2,500$$

$$*5 \quad \text{Subscription outstanding (1.1.2006)} \quad 450$$

$$\text{Cash on 1.1.2006} \quad 5,125$$

$$\text{Building} \quad 25,000$$

$$30,575$$

$$\text{Less : Liabilities on 1.1.2006} \quad \text{NIL}$$

$$30,575$$

**Example 2 :** From the following Receipt and Payment Account of a cricket club and the additional information, prepare an Income and Expenditure account for the year ended 31-12-2006 and a Balance Sheet as on that date :

Account of ...  
Ending ...

# NOTES

	Rs.		Rs.
To balance b/d		By Crockery Purchased	2,650
Cash	3,520	By Maintenance	6,820
Bank	27,380	By Match Expenses	13,240
Fixed deposit @ 6% p.a.	30,000	By Salaries	11,000
To Membership Subscription (including Rs. 6000 for 2005)	40,000	By Conveyance	820
To Entrance Fees	2,750	By Upkeep of Lawn	4,240
To Donation	5,010	By Postage Stamps	1,050
To Interest on fixed deposit	900	By Purchase of Cricket Equipment	9,720
To Tournament fund	20,000	By Sundry Expenses	2,000
To Sale of Crockery	2,000	By Investment	5,700
(Book value Rs. 1200)		By Tournament Expenses	18,800
		By Balance c/d	
		Cash	2,200
		Bank	23,320
		Fixed deposit @ 6% p.a.	3,000
	1,31,560		55,520
			1,31,560

## Information :

- Monthly salary is Rs. 1,000.
- The value of unused postage stamps :  
31-12-2005 = Rs. 750  
31-12-2006 = Rs. 900
- Stock of cricket equipment :  
31-12-2005 = Rs. 3,210  
31-12-2006 = Rs. 2,800
- Arrear of membership subscriptions :  
31-12-2005 = Rs. 6,600  
31-12-2006 = Rs. 8,000
- Donation and Entrance fees are not to be capitalised.

## Solution :

### Opening Balance-Sheet (As on 31-12-2005)

Liabilities	Amount	Asset	Amount
Capital Fund		Cash in Hand	3,520
(Balancing Figure)	72,660	Cash at Bank	27,380
		Fixed deposit at 6% p.a.	30,000
		Unused Postage Stamp	750
		Stock of Cricket Equipment	3,210
		Subscription Outstanding	6,600
		Crockery	1,200
	72,660		72,660

## NOTES

## Income &amp; Expenditure Account

Expenditure	Amount Rs.	Income	Amount Rs.
To Maintenance	6,820	By Subscription	40,000
To Match Expenses	13,240	Less : Outstanding for 2005	34,000
To Salaries	11,000		– 6000
			8,000
Add : Outstanding	1,000	Add : Outstanding for 2006	42,000
To Conveyance	820		
To Upkeep of Lawn	4,240	By Entrance Fees	2,750
To Postage Consumed :		By Donation	5,010
Opening stock	750	By Interest on Fixed Deposit	900
Add : Purchases	1,050	Add : Accrued Interest	900
	1800	By Profit on sale of crockery	800
Less : Closing stock	900		
To Cricket goods consumed :			
Opening Stock	3,210		
Add : purchases	9,720		
	12,930		
Less : Closing Stock	2800		
To Sundry Expenses	2,000		
To Excess of Income Over Expenditure	2,210		
	52,360		52,360

**Balance Sheet**  
(As on 31<sup>st</sup> Dec., 2006)

Liabilities	Rs.	Asset	Rs.
Outstanding salaries	1,000	Cash in Hand	2,200
Tournament Fund		Cash at Bank	23,320
		Fixed deposit at 6% p.a.	30,000
Less : Tournament Expenses			
	18,800	Unused Postage Stamps	900
Capital Fund (2005)	72,660	Stock of Cricket Equipment	2,800
Add : Excess of Income Over Exp,	2,210	Subscription Outstanding (600 + 8,000)	8,600
	74,870	Crockery	2,650
		Investments	5,700
		Accrued Interest	900
	77,070		77,070

**Example 3 :** The following Receipt and Payment Account is related to Meenakshi club for the year ending 31<sup>st</sup> Dec. 2006 :

Receipts	Amount	Payments	Amount
To Balance b/d	6,000	By Salaries	12,450
To Subscriptions :		By Stationery	2,400
Arrear	240	By Rates & Taxes	3,600
Current	12,660	By Telephone Expenses	600
Advance	480	By Investment	7,500
	13,380	By Advertisement	1,050
To Profit from canteen	9,000	By Postages	1,000
To Miscellaneous	450	By Sundry Expenses	5,000
To Sale of old newspapers	1,120	By Balanced c/d	17,20
To Dividends	4,850		
To Donation	10000		
To Entrance Fees	6,000		
	50,800		50,800

You are required to prepare Income and Expenditure Account and Balance sheet after making the following adjustments :

NOTES

- (1) There are, 450 members, each paying an annual subscription of Rs. 30; Rs. 270 being arrear for 2005 at the beginning of this year
- (2) A donation of Rs. 2,000 was wrongly included in subscription of the current year.
- (3) Entire donation and 3/4 of entrance fees are to be capitalised.
- (4) Stock of Stationery on 31-12-2005 was Rs. 300 and on 31-12-2006 is Rs. 540.
- (5) Cost of Building is Rs. 60,000. Depeciate it at 5%.

**Solution :**

**Balance-Sheet**  
(As on 1st January 2005)

Liabilities	Amount	Assets	Amount
	Rs.		Rs.
Capital Fund		Cash balance	6,000
(Balancing Figure)	66,570	Outstanding Subscription	270
		Stock of Stationery	300
		Building	60,000
	66,570		66,570

**INCOME AND EXPENDITURE ACCOUNT**  
(For the year ending 31<sup>st</sup> December, 2006 )

Dr.				Cr.
Particulars	Amount	Particulars	Amount	
To Salaries	12,450	By subscription		
To Stationery	2,400	(12,660 – 2,000)	10,660	
Add : Opening stock	300	Add : Outstanding	2,840	
	2,700	for current years		13,500
Less : Closing stock	540	By Profit from Canteen		9,000
	2,160	By Miscellaneous		450
To Rates & Taxes	3,600	By Sales of old newspaper		1,120
To Telephone expenses	600	By Dividend		4,850
To Advertisement	1,050	By Entrance fees *2		1,500
To Postage	1,000			
To Sundry Expenses	5,000			
To Depreciation on Building *3	3,000			
To Excess of Income over Expenditure	1,560			
	30,420			30,420

\*1 Total members are 450 and each member pays on annual subscription of Rs. 30.

Therefore, the total subscription receivable during the year 2006:  $450 \times 30 = 13,500$

Less : Amount received during the year 2006 10,660

Outstanding subscription for the year 2006 2,840

$$\text{*2 Entrance fees} = 6,000 \times \frac{1}{4} = 1,500$$

$$\text{*3 Depreciation} = 60,000 \times \frac{5}{100} = 3,000$$

**NOTES**

**BALANCE SHEET**  
(As on 31<sup>st</sup> December 2006)

Liabilities	Amount	Assets	Amount
Subscription received in Advance	480	Cash Balance	17,200
Capital fund (1-1-2006)	66,570	Outstanding subscription (Rs. 30 + Rs 2840)	2,870
Add : Donation *4	12,000	Stock of stationery	540
Add : Excess of Income over Expenditure	1,560	Building	60,000
	84,630	Less : Depreciation	3,000
	85,110	Investments	7,500
			85,110

**INCOME & EXPENDITURE ACCOUNT, RECEIPT  
& PAYMENT ACCOUNT AND BALANCE-SHEET**

**Example 4 :** From following particulars for the year 2006, prepare Receipt and Payment Account, Income and Expenditure Account and Balance Sheet of Pune club.

	Rs.
Cash and Bank Balance (31-12-2005)	1,432
Member entrance fees received	22,000
Subscription receipts	8,800
Hall Hire charges (credit)	6,900
Receipts from canteen Sales	31,465
Purchase of provision etc. for canteen	31,386
Building repairs, painting etc.	2,875
Ground Maintenance	4,500
Donation for club Building fund	10,000
Advance for Building contractor for construction of club	1,100
Payments for Bats, Balls etc.	1,200
Lighting and other facilities for members	2,700
Payment to M/s Sai Furniture Mart	8,600

As per laws of the club, 50% of the Entrance fees is to be capitalised. The capital fund and the Building fund for club at the beginning of the year were Rs. 36,700 and Rs. 25,000 respectively. Depreciate Building by 5% and Furniture by 10%;



## Other Information :

	31-12-2005 Rs.	31-12-2006 Rs.
Sundry Creditors		
for Bats and Balls	182	
for furniture	2,300	1,700
Subscription due from members	850	1,350
Building (W.D.V.)	27,500	
Furniture (W.D.V.)	11,000	
Bats and Balls (revaluated)	900	1,200

## Solution :

**Receipt and Payment Account**  
(for the year ending 31-12-2006)

Receipts	Amount	Payments	Amount
To Balance b/d	1,432	By Purchase of Provisions	31,386
To Entrance Fees	22,000	By Building Repairs, Painting etc.	2,875
To Subscription	8,800	By Ground Maintenance	4,500
To Hall Hire charges	6,900	By Advance to Building contractor	1,100
To Receipt from Canteen sales	31,465	By Payment of Bats, Balls etc.	1,200
To Donation for club		By Lighting & other facilities for members	2,700
Building Fund	10,000	By+ Payment to M/S Sai Furniture Mart	8,600
		By balance c/d	28,236
	<u>80,597</u>		<u>80,597</u>

**INCOME AND EXPENDITURE ACCOUNT**  
(For the year ending on 31<sup>st</sup> Dec., 2006)

Dr.			Cr.
Particulars	Amount	Particulars	Amount
To Purchase of Provisions	31,386	By Entrance fees	22,000
To Building Repairs, Painting etc.	2,875	Less : Capitalised	<u>11,000</u>
To Ground Maintenance	4,500	By Hire Charges	6,900
To Light and other facilities to members	2,700	By Receipts from canteen sales	31,465
To Bats, Balls written off *1	718	By Subscription	8,800
To Dep. on Building *2	1,375	Add : outstanding at end of year	<u>1,350</u>
To Dep. on furniture *3	1,900		<u>10,150</u>
To Surplus carried to Balance-sheet	13,211	Less : Outstanding opening	<u>850</u>
	<u>58,665</u>		9,300
			<u>58,665</u>

**BALANCE SHEET**  
(As on 31<sup>st</sup> Dec., 2006)

Liabilities	Amount	Assets	Amount
Creditors for Furniture	1,700	Cash	28,236
Club Building 2,500		Advance to Contractor	1,100
Add : Donation <u>10,000</u>	12,500	Subscription Outstanding	13,500
Capital fund 36,700		Bats & Balls 900	
Add : Entrance fees capitalised <u>11,000</u>		Additions <u>1,018</u>	
47,700		<u>1,918</u>	
Add : Surplus from		Less : Written off <u>718</u>	1,200
Income Expenditure Bill		Building 27,500	
A/c <u>13,211</u>	60,911	Less : Dep. <u>1,375</u>	26,125
		Furniture 11,000	
		Addition <u>8,000</u>	
		<u>19,000</u>	
		Less : Dep. <u>1,900</u>	17,100
	<u>75,111</u>		<u>75,111</u>

## NOTES

## NOTES

*1.	Payment for Bats and Balls	1,200
	Less : Creditors for Bats and Balls	182
	Bats and Balls purchased during 2006	1,018
	Add : Bats and Balls on 31-12-2005	900
		1,918
	Less : Bats and Balls on 31.12.2006	1,200
	Amount written off	718
*2	$27,500 \times \frac{5}{100} = 1,375$	
*3	Payment to M/s Sai Furniture Mart	8,600
	Add : Creditors for Furniture on 31.12.2006	1,700
		10,300
	Less : Creditors for Furniture on 31.12.2005	2,300
	Furniture purchased during 2006	8,000
	Add : W.D.V. of furniture on 31.12.2005	11,000
	Book value of Furniture	19,000
	Depreciation of Furniture = $19,000 \times \frac{10}{100} = 1,900$	

**RECEIPT & PAYMENT ACCOUNT AND BALANCE SHEET**

**Example 5 :** From the following Income and Expenditure Account of Rotary Club for the year ended on 31<sup>st</sup> March, 2006, and Balance sheet as on 31<sup>st</sup> March, 2006, prepare Receipt and Payment Account for the year ended on 31<sup>st</sup> March, 2007 and Balance sheet as on 31<sup>st</sup> March, 2007.

To Salaries	Rs. 5,000	By Subscription	Rs. 9,400
To Rent	1,100	By Entrance fees	600
To Travelling exp.	50	By Donation	1,000
To Printing & Stationery	100	By Interest	500
To General Charges	150		
To Periodicals	50		
To Excess of Income over expenditure	5,050		
	11,500		11,500
<b>Balance-Sheet (As on 31.03.2006)</b>			
<b>Liabilities</b>	<b>Amount Rs.</b>	<b>Assets</b>	<b>Amount Rs.</b>
General Fund	17,250	Furniture	4,000
Liabilities Outstanding		Sports Equipment	2,000

Expenses		Investments	10,000
Rent	100	Subscription Receivable	500
Salaries	650	Interest Receivable	100
		Bank Balance	1,400
	<u>18,000</u>		<u>18,000</u>

Accounts of Non-  
Trading Institution

## NOTES

Other Information (31.3.2007)

	Rs.
Outstanding Subscription	800
Outstanding Salaries	400
Outstanding Rent	200

### Solution :                      Receipt And Payment Account (For the year ended on 31st March, 2007)

Particulars	Amount Rs.	Particulars	Amount Rs.
To balance b/d	1,400	By Salaries *1	5,250
To Subscription *3	9,100	By Rent *2	1,000
To Entrance Fees	600	By Travelling Exp.	50
To Donation	1,000	By Printing & Stationery	100
To Interest * 5	600	By General Charges	150
		By Periodicals	50
		By Balance c/d	6,100
	<u>12700</u>		<u>12,700</u>

### Balance Sheet (As on 31<sup>st</sup> Dec., 2007)

Liabilities	Amount	Assets	Amount
Capital fund	17,250	Furniture	4,000
Add : Excess of		Sports equipments	2,000
Income over expenditure	5,050	Investments	10,000
Liabilities (outstanding Exp)		Subscription Receivable	800
Salaries	400	Bank Balance	6,100
Rent	200		
	<u>22,900</u>		<u>22,900</u>

*1 Salaries	5,000
Add : Outstanding of Last year	650
	<u>5,650</u>
Less : Outstanding of Current year	400
	<u>5,250</u>
*2 Rent	1,100
Add : Outstanding of last year	100
	<u>1,200</u>
Less : Outstanding of current year	200
	<u>1,000</u>
*3 Subscription	9,400
Add : Outstanding of last year	500
	<u>9,900</u>
Less : Outstanding of current year	800
	<u>9,100</u>
*4 Interest	500
Add : Accrued Interest of last year	100
	<u>600</u>

## NOTES

**ACCOUNTING FOR INCOMPLETE RECORDS:**

Accountants are all too often faced with the problem of preparing accounts from incomplete records. The statement refers primarily to business undertakings, but may also be applicable in appropriate circumstances to the accounts of various types of non-trading concerns.

It is hoped that for those engaged in this type of work, this discussion may be useful as a summary of considerations which should be kept in mind when preparing accounts from incomplete records and of procedures which have been found helpful in practice.

*Incomplete records* means the state of affairs which exists when there is lacking some or the entire prime accounting information from which in the normal way the books of a business are written up and final accounts prepared. It is not, for instance, applicable where an adequate system exists for supplying the accountant with information in a suitable form for writing up his client's books or otherwise collating the essential information and subsequently preparing final accounts.

**Preparation of accounts from incomplete records**

The steps in the preparation of the accounts of a trading concern from incomplete records may be summarized as follows:

1. drawing up an opening balance sheet where one is not available;
2. preparing summary cash and bank accounts;
3. scheduling debtors and creditors;
4. ascertaining, in consultation with the client, that the amount at which stock is to be stated appears reasonable, having regard to the nature of the trade and the circumstances of the business;
5. making year end adjustments for provisions, transfers, etc.;
6. preparing the final accounts from the information thus assembled.

**Summary cash and bank accounts**

Before beginning to build up and analyze the summary cash and bank accounts, it is important to obtain the client's assurance that he has made available all the requisite information pertaining to his business, and that no business receipts or expenses have been passed through other bank, deposit or petty cash accounts. Failing this, it is desirable to examine such other bank statements.

The adequacy of the final accounts depends largely on the care with which summary cash and bank accounts are prepared. Normally at least some records are available (bank statements, some vouchers, possibly a cash book) but by definition they will be incomplete because either (a) items have been recorded but are unexplained and unsupported, or (b) items have been wholly omitted.

## NOTES

Any unexplained items remaining after analysis of the bank statement require examination to determine whether they relate to private or business transactions and in the latter case whether these are capital or revenue. Payments into the bank should also be scrutinized to ensure that any non-trading receipts such as dividends, rents from private properties or capital items are segregated from trading items. Unusually large receipts or payments will generally stand out clearly from the normal level of trading items, and will prompt inquiry. They may be attributable, inter-alia, to the introduction of new capital, loans or the realization of business assets, or, if they are outgoings, to loans, purchases of new equipment, or personal drawings.

In preparing the summary cash account the usual procedure is to attempt to reduce the likelihood of omissions by inquiring into those payments which are known to be of a recurring nature. Some are fixed or semi-fixed in amount and may be readily accounted for: rent, rates and insurance, for example, or in some businesses, wages and salaries. Other payments, while variable, are known to recur, and omissions may be remedied by inquiry or reasonable estimate. Thus inquiry can be made as to whether telephone, gas and electricity charges have been paid when due and properly accounted for, or whether a monthly account with a major supplier has been regularly discharged; if necessary it may be possible to obtain duplicate statements. By concentrating attention on cash outgoings (which will normally include payments on private account and drawings), assistance is often obtained in arriving at the figure for business takings where no record of these is available. Similar inquiries should be made so as to ensure that recurring income (such as rents receivable) is fully accounted for.

If after full inquiry any cash difference revealed by the foregoing procedure remains unexplained it is normally treated, in the absence of evidence to the contrary, as unrecorded sales in the case of a cash excess (that is, where cash disbursements exceed cash receipts) and as unrecorded disbursements in the case of a shortage. If there is nothing to indicate that any business outgoings have been omitted then the shortage would normally be dealt with as drawings. Before taking these steps, however, the unexplained difference should be fully discussed with the client and the effect of the proposed treatment made clear to him. The possibility should not be overlooked that even an immaterial difference may be the net result of material errors on both sides of the account.

**Debtors and Creditors:**

In preparing schedules of debtors and creditors the accountant will draw on such evidence as is available, supported by personal observation and his knowledge of the client's business. Usually the client keeps some form of record of debtors and care should be taken to separate business from private debtors and guard against omissions. Reference to banking and any record of cash receipts after the end of the client's accounting year may serve to indicate whether any material items have been omitted. In the same way the schedule of creditors may be drawn up or tested by reference to payments made after the year end. Comparison with the previous

## NOTES

year's schedule, if available, may indicate whether a regular supplier's account has been omitted and past experience may be of assistance in suggesting creditors who would normally be expected at the year end or who are lax in presenting accounts. Information regarding prepayments and accruals should be noted so that the normal adjustments may be made in preparing the accounts.

### **Stock and Work-in-progress:**

The amount at which stock and work in progress is to be stated in the accounts should be ascertained in the light of such supporting evidence as is available, the objects being to ascertain that it appears consistent with the circumstances of the business and to ensure that it is appropriately described in the accounts. Examination of the schedule of year end creditors may help to indicate material omissions or over-statements, and regard should be had to any relevant trade customs, such as the post-dating of invoices. In respect of business trading in stocks with a high unit value it is desirable, where possible, to prove the closing stock figure by reconciling unit purchases and sales for the period under review with opening stock. Consideration should be given by the accountant to attendance at stocktaking whilst it is in progress whenever practicable and to the performance of such other tests as he may deem necessary. This is especially important where stock and work in progress is a material factor in relation to the total assets of the business.

Particular inquiry should be made as to the basis used to arrive at the amount at which stock is stated. This should be appropriate to the circumstances of the business, and should be consistently applied from year to year.

Sometimes stocktaking is carried out by professional valuers. It may be advisable for the accountant to consult with the valuer to ascertain the treatment of items which present special problems, such as goods received but not invoiced at the stocktaking date and goods on sale or return.

The extent to which the amount at which stock is stated can be reasonably verified will determine its description in the accounts. The description should concisely indicate the basis used in arriving at the stock figure; for example, where it proves necessary to accept stock at an amount as estimated by the proprietor the narrative should make this clear.

### **Provisions, transfers and year end adjustments**

**Depreciation:** An adequate amount should be charged for the depreciation of fixed assets employed in the business.

**Taxation:** Various methods of dealing with tax in accounts prepared from incomplete records may be adopted, and the amount so charged should be disclosed separately in the drawings or capital account. Whatever treatment is adopted, it is important that the basis on which tax has been charged is made clear in the accounts, and that the client understands the liabilities pending and likely to arise on his current profits.



## NOTES

**Personal benefits from the business, etc:** A number of adjustments may have to be made before completing the final accounts in respect of such items as private accommodation in business premises, private use of car and private consumption of trading goods. Other transfers may involve charging the business a notional rent for the use of business premises owned by the proprietor or making a charge for the use of various private facilities provided by the trader. Where the relevant proportions have been agreed with the Inland Revenue Department it may be found convenient to adopt the same proportions in the accounts in order to avoid adjustments in the tax computation.

**Contra accounts:** In certain circumstances transactions may be settled by the exchange of goods, cash passing only to the extent of the difference in value. For example, it is common practice for motor vehicles to be purchased and sold on a part exchange basis. There may be no adequate record of such transactions, and the problem may be made more acute by the set-off of trading against private items. Where such transactions are known to be customary or probable the accountant should inquire into them and ensure that they are properly accounted for.

**Critical review**

Once the final accounts have been prepared they should be subjected to a critical review, with the object of ensuring, so far as possible, that they present a true and fair view, the accountant bringing to bear his professional skill and judgment in reviewing the figures in the light of the circumstances of the business and his knowledge of the way it works.

It is normal procedure to make comparisons with previous years' figures and gross profit percentages; the latter should also be compared with such information as is available concerning other similar businesses. Variations do not necessarily indicate accounting inconsistencies, but should be inquired into until an adequate explanation has been obtained. If the nature of the business permits, a quantity reconciliation of stocks, purchases and sales should be made.

The capital account should also be scrutinized to see whether the drawings shown in it appear consistent with the client's circumstances (after allowing for other sources of income) and to ascertain the sources of any new capital introduced. It is usual to show separately such items as taxation, life assurance premiums, investment purchases and details of cash introduced. The treatment and description of such items will depend on the particular circumstances of each case.

Having completed his critical review, the accountant will probably have a number of queries arising on the draft accounts which will necessitate an interview with the client. It is important to discuss the accounts with the client to ensure that they accord with his knowledge of the facts, and the opportunity may be taken to draw attention to a number of less obvious points revealed by the accounts, which may prove of help to the client in directing his business and encourage him to recognize the practical use to which reliable accounts may be put.

NOTES

### **Capital computation method of estimating profits**

Sometimes records and information are so inadequate that it proves impossible to prepare accounts in the normal way. It may then be necessary to use the capital computation method to arrive at the estimated business profits. The net assets at the beginning and the end of each relevant financial period are compared, the difference indicating the variation in the client's business capital over the period. This figure is then adjusted to arrive at the profits of the business for the period, allowance being made for the amount of known or estimated outgoings of a non-trading nature: for example, drawings and other payments on private account such as holiday or medical expenses, salaries tax payments, etc. A contrary adjustment is made to eliminate receipts of a non-trading character such as income from private investments, legacies, moneys arising from the realization of private assets, etc. The resulting figure will be the estimated business profits for the period under review.

### **INSURANCE ACCOUNTING:**

Term insurance is designed to provide pure life cover and so will provide benefit on death during the term of a policy. The policy can be purchased for any selected time period. The insurer pays the policyholder's estate if s/he dies during the term of the policy, but if s/he survives s/he will receive nothing. Term insurance is a protection product, for example it is commonly written in conjunction with repayment mortgages to provide a form of repayment protection.

### **WHOLE LIFE ASSURANCE**

A whole life policy has no fixed term and there will always be a benefit (contractual amount, adjusted for items such as policy loans and dividends, if any) at the death of the insured. For example: whole life policies are sometimes used to provide a benefit on death to enable beneficiaries to pay the Inheritance Tax Liability on the estate.

### **ENDOWMENT ASSURANCE**

An endowment assurance policy will pay the policyholder a sum after a fixed period or on death before the period is completed. Unlike term assurance and whole life assurance the policyholder can receive the benefit. Endowment policies are generally used as investment/saving products. For example: repayment of the capital amount owing on a mortgage. Many whole life and endowment policies are written as 'with-profit' policies whereby the policyholders are entitled to share in surpluses arising on the business. In a proprietary company such surpluses are often divided on the basis of 90% to policyholders and 10% to shareholders.

### **MAXIMUM INVESTMENT CONTRACTS**

Certain contracts are designed to provide minimal life cover and are principally investment products, for example, unit linked policies. Benefits may take the form of a capital sum on maturity which is often partly guaranteed (they are typically subject to market value adjusters, so that the return is reduced if the investment return

obtained by the life company is not sufficient to support the guarantee) or may be paid as income through the period of the policy. As investments, these products will be in direct competition with other forms of medium term deposits, such as building society deposits or unit trusts.

## NOTES

### Unit Linked Policies

With a unit-linked policy the policyholder buys units in a pooled investment fund and therefore participates directly in the investment performance of the underlying funds. The return arising from a unit linked policy is determined by reference to the value of a particular fund of investments. The performance of the contract is objectively linked to the investment performance of the fund investments rather than being at the discretion of the insurer and thus the investment risk is passed on to the policyholder.

A unit linked policy differs from a conventional policy in that:

- A guaranteed percentage of each premium is allocated to units in the life fund.
- The capital growth, and frequently the income of the fund, is re-invested in the fund, and is reflected in the increased value of the units. The policyholder benefits directly from the total investment growth and income.
- The basis of the charges by the life company is normally fixed at the outset of any policy.

Companies that write only unit linked policies tend to be subsidiaries of banks ('bancassurers').

### ANNUITIES

An annuity policy provides for payments to be made at regular intervals, starting at a specified date, and usually continuing until the death of the policyholder. The amount of the payment is specified by the policy, and may be constant throughout the annuity period, or may increase at a prescribed rate.

### PENSIONS

Pension policies involve paying regular or single premiums to create a stream of income (starting at retirement), usually also with the option of paying a capital sum. In essence, these policies are savings contracts, leading to a deferred annuity and a capital payment. They are distinguished from other life policies in the UK by their taxation treatment, both for the policyholder and the insurer. For example, the premiums paid and the investment income generated is tax deductible and exempt from tax respectively.

### PERMANENT HEALTH INSURANCE (PHI)

A permanent health policy provides for income to be paid in the event of the insured falling ill. The sum paid depends on the particular contract, and may be either fixed or escalating, and for a limited period or paid indefinitely.

NOTES

## Premiums

A premium is a sum paid to the life office to assure the benefit specified by the policy.

### PAYMENT OF PREMIUMS

#### Single premium contracts

These contracts require the payment of a single amount by the policyholder at the start of the contract term.

#### Regular premium contracts

The policyholder is contractually obliged to make payments at regular periods to the insurer over the term of the policy, e.g. monthly, annually.

#### Recurring single premium

Neither the timing nor the amount is determined in advance. Pension policies are often structured in this manner so as to allow the policyholder maximum flexibility in making contributions, for example by reference to the level of his/her income in any year.

### THE CALCULATION OF THE PREMIUM

Insurance companies need to set a price for the cover given which is sufficient to pay:

- a) the cost of any benefits which may be paid to the policyholder,
- b) the commission paid to salespersons or intermediaries,
- c) the costs of administering the policy, and
- d) the target profit.

Calculating the level of premium for a particular type of policy involves the expertise of a company's actuary. There are four main factors the actuary must consider when setting the level of premium:

- Mortality
- Current and Future Investment Income ('Interest')
- Current and Future Expenses
- A Contingency Factor

#### Mortality

The actuary will refer to 'mortality tables', and from these, on the basis that the policy will be sold to a sufficiently large number of policyholders, the actuary can determine the appropriate premium to be charged to someone of a given age, sex and state of health. For example: statistically women have a higher life expectancy and generally pay lower premiums for life cover.

## NOTES

Thus for a person aged 55 who requires Rs.1,00,000 cover for a period of one year, the premium required for purely mortality risk might be Rs.1000. However for a person aged 25, the premium required might be only Rs.200. Thus the 55 year old policyholder pays a higher premium because of the increasing probability of death with advancing age.

So if life assurance was taken out on an annual basis, premiums would have to increase year by year as the risk of the policyholder dying increases. In practice such a system would be unworkable since a) as the policyholder gets older the annual increases in premiums would get greater and greater until they eventually became prohibitive; and b) in order to assess accurately the life assured's risk of dying in the next year other factors would be relevant, for example: the general health of the policyholder. Thus the insurance company would have to require the policyholder to submit to a medical examination prior to yearly premiums being set. This would substantially increase the costs of administering the policy and premiums would have to be boosted still further.

Thus life assurance companies have generally adopted the practice of writing long-term contracts whereby a level premium is paid throughout the duration of the policy. The premium paid in the early years is therefore higher than is needed to cover the cost of a claim in those years. The balance at the end of the year is kept in a fund in order to meet the cost of claims in the later years when the premiums will be lower than required to cover the mortality risk.

### **Investment Income**

Premiums received by the company earn investment income in the form of dividends and interest from the shares and other investments owned by the company and additional profit may result from eventually selling the shares at a higher price than they originally cost. Thus the actuary will need to consider likely future rates of interest and allow for this within the calculation of the premium.

### **Expenses**

Some margin must be added to cover the life assurance company's future expense levels to be experienced in administering the policy. These include: agents' and brokers' initial and renewal commissions, overhead expenses, staff salaries, advertising, etc. The expense loading to a premium is not simply a matter of sharing out the total expenses to each policyholder since each policy does not give rise to the same types or amounts of expenses. Therefore the expense loading must reflect in some equitable manner the expenses the particular type of policy gives rise to.

### **Contingency Factor**

Actuaries are very conservative in their assumptions on mortality, interest and expenses and include a contingency factor to give a safety margin to meet any unforeseen results. They also allow for the probable rate of lapses or early surrenders of policies before their term.

## NOTES

**Summary**

In determining premium rates the actuary will consider, *inter alia*:

- 1) the sum assured;
- 2) the age of the policyholder, his/her general health and life style e.g. smoker/non-smoker;
- 3) future investment returns;
- 4) future expense levels in administering the policy;
- 5) allowance for contingencies given the uncertainties involved;
- 6) the target profit;
- 7) the price at which similar products are being sold by other companies.

**ACCOUNTING PREMIUMS****Regular Premiums**

The accounting entries to recognize a Rs. 50 renewal premium on a regular premium policy in the month in which the premium **falls due** would be:

Policyholder/Intermediary Debtor (Balance sheet)	Dr.	50	
Premiums Written (Technical Account)			50

When the premium is actually received the following entries will be made:

Cash	Dr.	50	
Policyholder/Intermediary Debtor			50

If a debit balance remains on the policyholder/intermediary debtor account this will indicate that a premium has not been received and either the policy may have lapsed or the intermediary has not yet settled the account.

**Single premiums and initial premiums**

Under these cases the cash is usually required when the policy proposal is made and the accounting entry would be:

Cash	Dr.	50	
Premiums Written			50

**CLAIMS**

The amount of claim that is paid to the policyholder depends the type of policy written, and in particular whether it is without or with profit. It is paid either on death or on the maturity of an endowment type policy.

**Without-profit Policies:** The only benefit derived by the policyholder (or his/her estate) is payment of the sum assured. This amount is determined by the original terms of the policy.



**With-profit Policies:** This term is used to describe policies where the policyholders are eligible to participate in the surpluses established. Thus the claim amount is dependent on:

- 1) the investment performance;
- 2) the expenses;
- 3) the mortality experience;
- 4) the rate of lapses or surrenders of policies; and
- 5) taxation.

The policyholder therefore bears much of the risk and only a small proportion of the claim is represented by any guaranteed sum assured.

**Unit-Linked Policies:** The claim amount is determined by reference to the value of the specified fund of investments.

**Reversionary and terminal bonuses:** Apart from the guaranteed death benefits assurance companies give the 'with-profits' policyholders bonuses during the policy period which are allocations of surplus arising from the life fund. There are usually two types of bonuses: reversionary bonuses and terminal bonuses. Reversionary bonuses are declared, often annually, during the policy term, normally as a proportion of the sum assured (simple reversionary bonuses) or as a proportion of the sum assured and previously declared bonuses (compound reversionary bonuses). They increase the policyholders' claim entitlement but are actually paid only when a claim arises.

Terminal bonuses are paid in addition to the ordinary reversionary bonuses and are allocated only to policies becoming claims by death or maturity.

Some assurance policies include what are known as 'guaranteed bonuses', which form part of the contractual obligations that are allowed for in determining the original premium and are not strictly bonuses at all.

Outside the UK, these additional payments to policyholders often primarily represent refunds of premiums where these have traditionally been set at levels in excess of those required to cover expected costs and claims.

**Surrenders:** Since many of the assurance policies are used, in part or whole, as a savings vehicle, policyholders may wish not to continue with premium payments, so the insurer builds into the contract a provision for its surrender for a cash sum prior to the end of the policy term. The amount payable will generally be less than the total premiums already paid by the policyholder.

### **Accounting for Death Claims**

Notification of the death of a policyholder will be received by the assurance company. For example if the sum assured is Rs.1,00,000, the insurer will immediately set up a provision for this amount.

### **NOTES**

Claims Paid (Technical Account)	Dr.	2,000
Claims Outstanding (Balance Sheet)		2,000

## NOTES

The company will then require a death certificate prior to paying the beneficiaries. Once this is received the following entries will be made:

Claims Outstanding (Balance Sheet)	Dr.	2,000
Cash		2,000

**Accounting for Surrenders/Maturities**

For surrenders or a maturity no accounting entries will normally be made until the payment is authorized.

For example: Rs.50,000 surrender or maturity would be:

Claims Paid (Technical Account)	Dr.	1,000
Cash		1,000

Although the maturity could be previously foreseen, no entry for the liability is made in the accounts as the amount will have previously been allowed for in the actuarial estimate of the 'technical' provision for the long term business.

**COMMISSIONS**

Commissions are paid to brokers or agents ('intermediaries') as an incentive to sell policies and maintain and expand the life company's business. They are usually at very high levels ranging from 5% to over 100% of the premiums paid. Commission can therefore amount to a very considerable expense in the technical account of the life company. There are two types of commission: initial commission on new policies and renewal commissions for subsequent periods. The commission paid to the agents arises in the form of a large initial payment but the insurer generally has the right to recover some of this money if the policy lapses within the period over which the commission is earned.

**REINSURANCE**

Companies normally 'lay-off' a proportion of the risk by reinsuring with other insurance, or specialist reinsurance, companies. The accounting for the reinsurance premiums paid, claims reimbursements received and commissions paid is effectively the mirror image of the accounting for the direct insurance.

**LONG TERM BUSINESS PROVISION**

The revenue items entered in each year's life technical account do not in themselves match, and in order to give a proper view of the financial position of the company an adjustment is needed for the long term liabilities, as there is usually a significant period between the inception of a policy and the receipt of premiums, and the final payment of benefit. The cost of providing the benefit has to be allocated to a number of accounting periods. It is therefore necessary to make provision, at the

end of each accounting period, for the future liability to pay the ultimate benefits to the policyholders. As this is a long term liability, the amount of which will depend on a range of factors, an actuarial estimate of the final amount to be paid needs to be carried out.

## THE ACCOUNTS

A life assurance company, like any other body incorporated under the Companies Acts, is required to publish statutory accounts annually. In a life assurance company the interests of the shareholders and policyholders are in potential conflict because profit to one group may represent a loss to the other and vice versa. It is the actuary's responsibility to monitor the split of profits and losses between shareholders and policyholders. Therefore the statutory accounts have to be for the benefit of both groups. These accounts comprise a balance sheet and profit and loss account together with notes and other statements required by Accounting Standards. The profit and loss account has three sections; a technical account for non-life insurance business, a technical account for life assurance business and a non-technical account. The EU Insurance Accounts Directive has introduced these standardized formats for the accounts, based on the Fourth Directive formats but adapted to the special circumstances of insurance companies. As under the

Fourth Directive, the accounts are now required to give a 'true and fair view' (see Horton, J. and Macve, R., *Accounting Principles for Life Insurance*, ICAEW, 1995). The ABI is currently developing a revised Statement of Recommended Accounting Practice ('SORP') to reflect the changes introduced by the Directive.

## PROFIT AND LOSS ACCOUNT

The profit or loss of a proprietary company is mainly comprised, *inter alia*, of the underwriting results (being the balances of the life and non-life technical accounts), the income and expenditure relating to shareholders' other business, and the investment income on both shareholders' funds and non-life insurance

funds, dividends paid to shareholders and the balance of inappropriate profits which is added to the retained profits and reserves. The taxation relating to the shareholders' profits is shown as the tax charge in the non technical section of the profit and loss account.

## BALANCE SHEET

The balance sheet of an insurance company will include, *inter alia*, the investments (which in the EU can either be stated at market value or at original cost); amounts receivable and payable; deferred acquisition costs and technical provisions for insurance liabilities - for example unearned premiums, outstanding claims, and life business technical provisions.

## CONCLUSIONS

The major differences in accounting for life insurance as compared with other industries derive from the long time period between receipt of premiums and the payment

## NOTES

of claims. This gives rise to the need for actuarial estimates of the liability in order to determine both the solvency and the profitability of life business.

## SUMMARY

### NOTES

- Non-trading organisations exist with a primary motive of providing service.
- They prepare Receipt & Payment Account, Income & Expenditure Account and Balance sheet.
- Receipt and Payment Account is mere a summary of the cash transactions. It includes all revenue as well as capital nature of expenses and incomes.
- Income and expenditure account is similar to the P&L A/c and records all current accounting period's expenses and incomes of revenue nature only.
- Incomplete records means the state of affairs which exists when there is lacking some or the entire prime accounting information from which in the normal way the books of a business are written up and final accounts prepared.
- Term insurance is designed to provide pure life cover and so will provide benefit on death during the term of a policy. The policy can be purchased for any selected time period.
- An endowment assurance policy will pay the policyholder a sum after a fixed period or on death before the period is completed. Unlike term assurance and whole life assurance the policyholder can receive the benefit. Endowment policies are generally used as investment/saving products.
- With a unit-linked policy the policyholder buys units in a pooled investment fund and therefore participates directly in the investment performance of the underlying funds. The return arising from a unit linked policy is determined by reference to the value of a particular fund of investments.
- An annuity policy provides for payments to be made at regular intervals, starting at a specified date, and usually continuing until the death of the policyholder.
- A premium is a sum paid to the life office to assure the benefit specified by the policy.
- Commissions are paid to brokers or agents ('intermediaries') as an incentive to sell policies and maintain and expand the life company's business.
- Companies normally 'lay-off' a proportion of the risk by reinsuring with other insurance, or specialist reinsurance, companies.

## EXERCISE

1. Explain the difference between Receipt & Payments Account and Income &

## NOTES

2. Describe the main sources of Income and Expenditure of non-trading concerns.
3. How will you convert the Receipt & Payment Account into Income & Expenditure Account ? What additional information will you need for this ?
4. Write Short notes on :
  - (1) Subscription
  - (2) Donation
  - (3) Endowment Fund
  - (4) Entrance Fees
5. What do you mean by Incomplete Records? Give the procedure to prepare accounts for Incomplete Records.
6. Briefly describe Insurance Accounting.
7. What factors an actuary must consider when setting the level of premium?

**PRACTICAL QUESTIONS**

1. The following particulars are related to the Murali Club for the year ended on 31<sup>st</sup> December, 2007 and you are required to prepare an Income and Expenditure Account and a Balance sheet.

**Receipt and Payment Account**

To Balance b/d	23,500	By Salaries	12,000
Entrance fees	3,000	By Electricity	1,200
To Subscription		By News paper	5,250
2006	500	By Fixed Deposit	25,000
2007	35,000	By Utensils	2,000
2008	750	By Creditors	10,000
To Profit from refreshment	1,000	By Balance c/d	11,500
To Locker Rent	2,000		
To Sundry Income	1,200		
	<u>66,950</u>		<u>66,950</u>

The Assets and Liabilities on 1 Jan.2007 were : Utensils Rs. 8,000, Furniture Rs. 25,000, Consumable Stores Rs. 3,500, Creditors Rs. 12,000. On 31 Dec., 2007, the value of the consumable stores was Rs. 7000, creditors Rs. 5500, Subscription Outstanding Rs. 750, Accrued Interest was Rs. 250.

[Ans. Surplus Rs. 24,750, Capital Fund, Rs. 48,500, B/S Total Rs. 79,500]

**2 :** The following is the Receipt and Payment account of the Mathura club for the year ended on March 31, 2007.

**NOTES**

Receipts	Amount	Payments	Amount
To Cash at Bank	2,800	By Salaries	500
To Subscription	10,500	By Printing and Stationery	300
To Annual day Receipt	5,400	By Annual day expenses	400
To Mushaira Receipts	4,600	By Mushaira Expenses	2,200
To Dividend on shares	400	By Telephone charges	500
		By Sundry Expenses	500
		By Share Purchased	15,400
		By Postage & Telegram	440
		By Building Maintenance	1,308
		By Cash at Bank	2,152
	23,700		23,700

The following further information is furnished :

- (i) The value of the building owned by the club stood at Rs. 10,000 as on 1<sup>st</sup> April, 2006, Depreciation at 5% has to be provided.
- (ii) There were 200 members paying subscription at the rate of Rs. 50 per annum each.
- (iii) As on 1-4-2006 no subscription had been received in advance but subscriptions were outstanding to an extent of Rs. 200. As on 31<sup>st</sup> March, 2006, Subscriptions outstanding were Rs. 300.
- (iv) Postage stamps worth Rs. 70 were with secretary at the beginning of the year and the stamps at the end of the year were of the value of Rs. 20.
- (v) The investment in shares at the beginning of the year was to the extent of Rs. 1400.
- (vi) An amount of Rs. 40 in respect of the annual day receipts was yet to be received.
- (vii) The rent of the theatre amounting to Rs. 600, where the Mushaira was held, is still to be paid.
- (viii) Hire of telephone to the extent of Rs. 50 is paid in advance.

You are required to prepare the Income and Expenditure Account for the year, ended on March 31, 2007 and Balance Sheet as on 1-4-2006 and 31-3-2007.

[Ans. – Surplus – 13,192,  
Balance-sheet (2006) – 14,470,  
Balance-sheet (2007) – 28,8620



**Note :** Subscription in advance. Rs. 600, Postage Rs. 490/-

Accounts of Non-  
Trading Institution

**3 : The Goyal Dispensary of Vrandavan had the following balance on 31st December 2007.**

**NOTES**

Liabilities	Amount	Asset	Amount
	Rs.		Rs.
Salaries payable	6,000	Cash	3,000
Subscriptions received in advance	1,000	Equipments	16,000
Capital Fund		Stock on medicines	3,200
As on 1.1.2007		Fittings and Fixtures	12,000
Add :	22,400	Subscriptions due and receivable	4,000
Life Membership	5,000		
Surplus	3,800		
	38,200		38,200

The accompanying Income and Expenditure Account was the following :

**Income and Expenditure Account**  
(For the year ended on 31<sup>st</sup> December 2007)

Dr.			Cr.
Particulars	Amount	Particulars	Amount
To Salaries	70,000	By Entrance Fees	600
To Cost of Medicines used	13,400	By Subscription	72,200
To Depreciation on Equipment	1,200	By Miscellaneous Receipts	300
To Miscellaneous Expenses	3,000	By Profit on Sale of Old Furniture (Book value Rs. 3,000)	400
To Surplus	3,800	By Grant from Municipal Corpn	17,900
	91,400		91,400

On 31-12-2006, equipment stood at Rs. 2,000. Subscriptions due and received to-talled Rs. 15,000 where as subscriptions already received for 2007 were Rs. 1,400, Stock of Medicines on 31-12-2006 was Rs. 2200. Prepare Receipt and Payment Account of the Dispensary for the year ended on 31-12-2007 and the Opening Balance sheet as on 1<sup>st</sup> January, 2007.

[Ans.: Balance of Receipt and Payment Account – Rs. 3,000/-, Balance-sheet – Rs. 23,800]

[Hint : Subscription = Rs. 72,800 (72,200 + 5,000 – 400 + 1,000 – 4,000)]

**Example 4 :** From the following Income and Expenditure Account, prepare Receipt and Payment Account for the year ended on Dec. 31, 2006.

**Income & Expenditure Account**  
**(For the year ended on 31-12-2006)**

**NOTES**

To Salaries	100	By Donations	200
To expenses	150	By Subscription	500
To Rates & Taxes	25		
To Depreciation	45		
To excess of Income over Expenditure	380		
	700		700

**Additional Information :**

	As on 1.1.2006	As on 31.12.2006
Fixed Assets	450	500
Subscription outstanding	100	150
Subscription received in advance	—	75
Outstanding Expenses	5	10
Cash in hand	50	?
Cash in Bank	5	355

[Ans – Receipt & Payment Balance – Rs. 415.]

[Hint : Expenses = 150 + 5 – 10 = 145; Subscription = 500 + 100 – 150 + 75 = 525, Closing Bank Balance to be included]

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## **BLOCK – IV**

**The Unit Covers :**

- 9.1** ISSUE OF SHARES
- 9.2** SHARE CAPITAL:
- 9.3** MEANING, NATURE AND TYPES OF SHARES:
- 9.4** PREFERENCE SHARES:
- 9.5** EQUITY SHARES:
- 9.6** SUBSCRIPTION OF SHARES:
- 9.7** ACCOUNTING RECORD REGARDING ISSUE OF SHARES:
- 9.8** ISSUE OF SHARES AT PREMIUM
- 9.9** ISSUE OF SHARES AT A DISCOUNT:
- 9.10** CALLS- IN- ARREARS:
- 9.11** CALLS-IN-ADVANCE:
- 9.12** FORFEITURE OF SHARES
- 9.13** REFERENCES / SUGGESTED READING

**ISSUE OF SHARES**

**Meaning of company:** A company is an artificial person created by law, having a separate corporate and legal entity from its members, perpetual succession and a common seal.

**According to Lord Justice Hanay,** “A Company is an artificial person created by law with a perpetual succession and a common seal.

**Salient Features of A Company:**

Following are some of the important features of a company:

- It is an incorporated association.
- It is an artificial person created by law.

NOTES

- It has a separate legal entity.
- It has a perpetual existence because the existence of a company is independent of its members.
- It has a common seal.

### SHARE CAPITAL:

**Share capital** refers to the portion of a capital that has been obtained by issuing the shares to the shareholder. The amounts invested by the shareholders towards the face value of shares are collectively known as **share capital**.

**Types of Share Capital:** Share capital of a company is divided into following categories:

- **Authorized Share Capital:** Authorized capital refers to that amount which is stated in the 'Capital Clause' of the 'Memorandum of Association' as the share capital of company. It is the maximum amount of share capital, which a company is authorized to raise through issue of shares. It is also known as registered capital or nominal capital.
- **Issued Share Capital:** A company may not issue total authorized capital. Issued capital refers to that portion of authorized capital which is issued by the company. Issued capital will always be less than or equal to the authorized capital.
- **Subscribed Share Capital:** It is that portion of issued capital which has actually been subscribed by the public and has been allotted to them. It is also known as allotted capital. If all issued capital is fully subscribed, then the term 'issued capital' and 'subscribed capital' carry the same meaning.
- **Called up Share Capital:** The portion of the subscribed capital which a company has demanded or called from the shareholders is known as Called -up capital and the balance, which the company has decided to demand in future, may be referred to as Uncalled Capital.
- **Paid up Share Capital:** It is the part of called up capital which is paid by the shareholders. Sometimes shareholders fail to pay the amount demanded from them as call, that amount is known as 'unpaid call' or 'call in arrears'. Thus, call in arrears means the amount not paid although it has been demanded by the company. To calculate paid up capital, the amount of call in arrears is deducted from called up capital.
- **Reserve Share Capital:** According to Section 99 of the Companies Act, 1956, a company may decide by passing a special resolution that a certain portion of its subscribed uncalled capital can be called only in the event of winding up of the company. Thus, the portion of uncalled capital which a company has decided to call only in case of liquidation of the company is called Reserve Liability or Reserve Capital. It is not necessary to create reserve

## MEANING, NATURE AND TYPES OF SHARES:

**Meaning:** A share is a fractional part of the capital which provides the basis of ownership. As per Section 2(46) of the companies act, 1956, a share means share in company's share capital and includes stock except where a distinction between stock and share is expressed or implied.

**According to Justice Farewell,** "A share is the interest of shareholder in the company measured by a sum of money for the purpose of liability in the first place and of interest(dividend) in the second."

The persons who hold share in their names are known as shareholders.

### Nature of Share:

- Share is a movable property in the eyes of law.
- Share offers some right to and imposes some liabilities on the shareholders.
- Share is transferable.

### Types of Shares:

As per the provision of Companies Act, 1956, a company can issue following two types of shares,

- **Preference Shares**
- **Equity Shares**

The share capital consisting from preference shares is called preference share capital and that consisting from equity shares is called equity share capital.

## PREFERENCE SHARES:

According to section 85 of the Companies Act, 1956, persons holding preference shares are called preference shareholders. A preference share is one which has the following two rights:

- A right to receive dividend at a stipulated rate or a fixed amount before any dividend is paid on equity shares,
- A right to receive repayment of capital in the event of winding up of the company.

### Types of Preference Shares:

The preference shares may be of the following types:

1. **Cumulative Preference Shares:** When profits of the company are distributed amongst the shareholders, the holder of these shares is entitled to get dividend at a fixed rate. If in any year the company does not pay dividend and the preference shares are cumulative, the dividends on such shares will

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## NOTES

get accumulated. Such dividend is called arrears of dividend. The company must pay such arrears in future, before the other shareholders participate in the profits. These shares are called cumulative preference shares because dividend for the years of non-payment goes on accumulating. The arrears of dividend on cumulative preference shares are shown as a contingent liability in the Balance Sheet.

2. **Non-Cumulative Preference Shares:** Holders of such shares are entitled to take dividend only out of current year's profits. In case no dividend is declared in a year due to any reason, the right to receive such dividend for that particular year expires. It implies that the holder of such a share is not entitled to arrears of dividend in future.
3. **Participating Preference Shares:** A participating preference share is a share which carries the right of sharing surplus profit which remains after paying equity and preference dividends at specified rates.
4. **Non-participating Preference Shares:** A non participating preference share is the share which does not carry the right to share in the surplus profit after paying specified dividend to preference and equity shareholders. Unless otherwise specified, the preference shares are generally non-participating.
5. **Redeemable Preference Shares:** If a company is authorized by its Article of Association, it may issue Redeemable Preference Shares. Redeemable Preference Shares are those shares which are to be redeemed either at the fixed date or after a certain period of time during the life time of the company. After the commencement of The Companies (Amendment) Act 1988, no company can issue any preference share which is irredeemable. In India, companies can now issue only this category of preference shares.
6. **Convertible Preference Shares:** These shares give the right to the holder to get them converted into equity shares according to the terms and conditions of their issue.
7. **Non-Convertible Preference Shares:** If the right of conversion is not available to preference shareholders, the shares are called non-convertible preference shares. Unless otherwise stated, a preference share is always deemed to be a non-convertible one.

### EQUITY SHARES:

According to section 85(2) of the Indian Companies Act, 1956 equity shares are those shares, which are not the preference shares. In other words, they do not enjoy any preferential right in the matter of payment of dividend or repayment of capital. Equity shares do not carry a fixed rate of dividend. The rate of dividend on equity shares is recommended by the Board of Directors and may vary from year to year. These shares carry voting rights. If the company issued only one type of share-capital, then it is known as equity share capital irrespective of the fact whether the word 'equity' appears in the name of share capital or not.

**Issue of Shares for Cash:** A public company issues a prospectus inviting general public to subscribe for its shares. In most of the cases, issue price of the share is demanded in various installments and each installment is called by a standard name. For example, first installment is known as 'Application Money' and the second one is termed as 'Allotment Money'. Subsequent installments are called as 'first call', 'second call' and so on. The number of last call should be suffixed by the word 'and final call'. For example, if there is only one call, it will be termed as 'first and final call' and if second call happens to be the last call, it will be expressed as "second and final call" and so on.

#### **Procedure for Share Issue:**

- **Share Application:**

Any person willing to purchase shares of that company has to fill a printed application form and send it with necessary money directly to the company. The amount payable with application form is called share application money. Application Money cannot be less than 5% of the face-value of shares.

- **Share Allotment:**

After receipt of application for shares, allotment of shares is made in accordance with the terms mentioned in the application form. After allotment, the applicant becomes the shareholder and there becomes a contract between shareholder and company.

- **Share-Calls:**

After receipt of application money and allotment of shares, the company collects the balance amount unpaid on shares allotted in accordance with the terms of issue. Whatever amount is demanded after allotment is known as 'call-money'.

#### **SUBSCRIPTION OF SHARES:**

**Meaning of over subscription:** Shares are said to be over subscribed when the number of shares applied is more than the number of shares offered. For example, a company offered 5000 shares to the public but the public applied for 6000 shares, it is called the case of over-subscription.

**Meaning of Under-subscription:** Shares are said to be under-subscribed when the number of shares applied is less than the number of shares offered. For example, if a company offered 5000 shares to the public but the public applied for 4500 shares only, it is the case of under-subscription. In such a case, it must be ensured that the company has received the minimum subscription.

**Meaning of Minimum Subscription:** The term minimum subscription refers to the amount which, in the opinion of the Board of Directors, must be raised by the issue of shares. A company cannot make any allotment of shares unless the amount of minimum subscription stated in the prospectus has been subscribed and the sum

payable as application money on such shares has been paid to and received by the company. The amount of minimum subscription is disclosed in the prospectus by the Board of Directors taking into account the following:

**NOTES**

- Preliminary expenses of the company,
- Commission payable on issue of shares,
- Cost of fixed assets purchased or to be purchased,
- Working Capital requirements of the company

**ACCOUNTING RECORD REGARDING ISSUE OF SHARES:****(ISSUE AT PAR):**

When a share is issued at its nominal or face value, it is known as issue of shares at par. For example, if a share of Rs. 10 is issued at Rs. 10, it is said that the share has been issued at par. The issue price of a share may be payable either in lump sum with the application or in installments.

**Journal Entries:**

The accounting entries will be as follows:

1. On receipt of application money:
 

Bank A/c	Dr.
To Share Application A/c	
2. On transferring Application Money to Capital Account:
 

Share Application A/c	Dr.
To Share Capital A/c	
3. On making Allotment Money due:
 

Share Allotment A/c	Dr.
To Share Capital A/c	
4. On Receipt of Allotment Money:
 

Bank A/c	Dr.
To Share Allotment A/c	
5. On making first call:
 

Share First Call A/c	Dr.
To Share Capital A/c	
6. On receipt of first call money;
 

Bank A/c	Dr.
To Share First Call A/c	
7. On making second and final call:
 

Share second and final call A/c	Dr.
To Share Capital a/c	

8. On receipt of share second and final call money:

Issue of Shares

Bank A/c

Dr.

To Share second and final call A/c

**Issue of Equity Shares at Par:**

**NOTES**

**Example 1:**

The authorized capital of Agarwal Limited is Rs. 4,00,0000, which is divided into 40,000 equity shares of Rs. 10 each. Out of these, 24,000 equity shares have been issued to the public and it is payable as: Rs. 2 on application, Rs. 4 on allotment, Rs. 2 on first call and Rs. 2 on second and final call. Pass the necessary journal entries and prepare Balance Sheet in the books of the Company.

**Solution:**

**Journal Entries**

Date	Particulars	L.F.	Rs.	Rs.
	Bank A/c Dr.		48000	
	To Equity Share Application A/c (Being application amount received)			48000
	Equity Share Application A/c Dr.		48000	
	To Equity Share Capital A/c (Being transfer of application amount to Capital A/c)			48000
	Equity Share Allotment A/c Dr.		96000	
	To Equity Share Capital A/c (Being allotment money due)			96000
	Bank A/c Dr.		96000	
	To Equity Share Allotment A/c (Being receipt of allotment amount)			96000
	Equity Share First call A/c Dr.		48000	
	To Equity Share Capital A/c (Being first call due)			48000
	Bank A/c Dr.		48000	
	To Equity First call A/c (Being receipt of the amount of first call)			48000
	Equity Second and Final A/c Dr.		48000	
	To Equity Share Capital A/c (Being Second and Final call due)			48000
	Bank A/c Dr.		48000	
	To Equity second and final call A/c (Being receipt of the amount of second and final call)			48000

**BALANCE SHEET**

Share Capital:		Bank	2,40,000
Authorized capital:			
40,000 equity shares of Rs.10			
Each	4,00,000		
Issued, Subscribed, Called-up			
And Paid-up Capital:			
24000 Equity Shares of Rs.10			
Each	2,40,000		
	2,40,000		2,40,000

## NOTES

According to Section 78 of the Companies Act 1956, the Securities Premium Account may be applied by the company for the following purposes:

- To write-off preliminary expenses of the company.
- To issue fully paid bonus shares to the members of the company.
- To write-off expenses of, or the commission paid or discount allowed on any issue of shares.
- To pay premium on the redemption of any redeemable preference shares or any debentures of the company.

**Journal Entries:**

**1. When premium is payable with application' money:**

- a) Bank A/c Dr. (Total application money + premium)  
To Share Application A/c (Amount received)
- b) When shares are allotted:  
Share application A/c Dr. (Total money on application)  
To Share capital A/c (application money due on shares allotted)  
To Securities Premium A/c (amount of premium on shares allotted)

**2. When premium is payable with allotment money:**

- c) When it is due:
- |                           |     |
|---------------------------|-----|
| Share Allotment A/c       | Dr. |
| To Share Capital A/c      |     |
| To Securities Premium A/c |     |
- d) When money due on allotment is received:
- |                        |     |
|------------------------|-----|
| Bank A/c               | Dr. |
| To Share Allotment A/c |     |
3. When premium is payable with call money:
- e) Share call A/c
- |                           |     |
|---------------------------|-----|
| To Share Capital A/c      | Dr. |
| To Securities Premium A/c |     |
- f) When money due on call is received:
- |          |     |
|----------|-----|
| Bank A/c | Dr. |
|----------|-----|

**Example 2:**

Goyal Co. Ltd issued 50,000 equity shares of Rs.10 each at a premium of 50% payable per share as under:

On Application Rs. 2.50

On allotment Rs. 7.50 including premium.

Balance amount is received on first call. Pass necessary journal entries to record the above transaction.

**Solution:****GOYAL COMPANY LIMITED****Journal**

Date	Particulars	LF	Amount	Amount
	Bank A/c Dr.		1,25,000	
	To Equity Share Application A/c			1,25,000
	(Being Application money on 50000 equity shares @ Rs.2.5 received)			
	Equity share Application A/c Dr.		1,25,000	
	To Equity Share Capital A/c			1,25,000
	(Being Transfer of share application money to equity Share capital A/c)			
	Equity Share Allotment A/c Dr.		3,75,000	
	To Equity Share Capital A/c			1,25,000
	To Securities Premium A/c			2,50,000
	(Being Allotment Money due on 50,000 shares @ Rs. 7.5 including premium of Rs.5)			
	Bank A/c Dr.		3,75,000	
	To Equity Share Allotment A/c			3,75,000
	(Being receipt of allotment plus premium money)			
	Equity Share First Call A/c Dr.		2,50,000	
	To Equity share capital A/c			2,50,000
	(Being first call money due)			
	Bank A/c Dr.		2,50,000	
	To Equity Share First call A/c			2,50,000
	(Being receipt of first call money)			

**ISSUE OF SHARES AT A DISCOUNT:**

When share issued at a price lower than the face value, it is said to be an issue of shares at a discount. The excess of the nominal value over the issue price represents discount on the issue of shares. Thus, when a share of nominal value of Rs.100 is issued at Rs.98, it is said that share issued at a discount of 2%.

According to Section 79, a company is allowed to issue shares at a discount if following conditions are satisfied:

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## NOTES

- I. The issue of shares at a discount is authorized by a resolution passed by the company in general meeting and approved by the Company Law Board.
- II. The resolution must specify the maximum amount of discount at which the shares are to be issued but the rate of discount must not exceed 10% of the nominal value of shares.
- III. At least one year has elapsed since the company was entitled to commence the business.
- IV. The shares are issued within two months from the date of receiving approval from the Company Law Board.
- V. The shares must belong to a class which is already issued. In other words, new class of shares cannot be issued at a discount even by existing or old company.
- VI. A new company cannot issue shares at a discount.

**Accounting Record for Discount:**

Whenever shares are issued at a discount the amount of discount is brought into the books at the time of allotment by debiting an account called 'Discount on the issue of shares account'. Thus, the journal entry to record discount on the issue of shares is as given below:

Share Allotment A/c	Dr.
Discount on the issue of Shares A/c	Dr.
To Share Capital A/c	

**Note-** Record for discount is mostly made at the time of allotment in the absence of contrary information. The amount of discount may be written off from capital profits or revenue profits and the unwritten off balance is shown in the asset side of Balance Sheet.

**Example: 3**

ABC Limited issued 10,000 equity shares of Rs. 10 each at a discount of Re.1 per share payable as Rs.2 on application, Rs.3 on allotment, Rs.3 on first call and the balance on second call. Pass the necessary journal entries in the books of ABC Ltd.

**Solution:****Journal Entries**

Date	Particulars	LF	Amount	Amount
	Bank A/c Dr.		20,000	
	To Equity Share Application A/c			20,000
	(Being receipt of application money)			
	Equity Share Application A/c Dr.		20,000	
	To Equity Share Capital A/c			20,000
	(Being transfer of application amount to capital A/c)			
	Equity Share Allotment A/c Dr.		20,000	
	Discount on issue of shares A/c Dr.		10,000	
	To Equity Share Capital A/c			30,000
	(Being allotment due and discount allowed)			

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Bank A/c	Dr.	20,000	20,000
To Equity Share allotment A/c (Being allotment amount received)			
Equity Share First Call A/c	Dr.	30,000	30,000
To Equity Share Allotment A/c (Being First call due)			
Bank A/c	Dr.	30,000	30,000
To Equity Share First Call A/c (Being amount of first call received)			
Equity Share Second Call A/c	Dr.	20,000	20,000
To Equity Share Capital A/c (Being Second Call due)			
Bank A/c	Dr.	20,000	20,000
To Equity Share Second Call A/c (Being amount of Second Call received)			

**Example 4:**

XY Ltd. offered 50,000 shares of Rs.10 each payable as follows:

On application Rs.6 and balance on allotment.

You are required to pass necessary journal entries in each of the following cases:

- If public applied for 47,000 shares,
- If public applied for 55,000 shares. The application for 5000 shares is rejected and the application money is returned.
- If public applied for 55,000 shares and the surplus money is utilized for allotment.

**Solution:**

- It is a case of under-subscription since the number of shares applied is less than the number of offered.

**Journal of XY Ltd**

Date	Particulars	LF	Amount	Amount
	Bank A/c	Dr.	2,82,000	2,82,000
	To Share Application A/c (Being the application money received)			
	Share Application A/c	Dr.	2,82,000	2,82,000
	To Share Capital A/c (Being transfer of application money to share capital A/c)			
	Share Allotment A/c	Dr.	1,88,000	1,88,000
	To Share Capital A/c (Being the amount due on allotment.)			
	Bank A/c	Dr.	1,88,000	1,88,000
	To Share Allotment A/c (Being the allotment money received.)			

- b) It is a case of over-subscription where some applications are rejected and the application money is returned.

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## Journal of XY Ltd

Date	Particulars	LF	Amount	Amount
	Bank A/c Dr. To Share Application A/c (Being the application amount on 55,000 shares received)		3,30,000	3,30,000
	Share Application A/c Dr. To Share capital A/c (Being transfer of application money on 50,000 shares to Share capital A/c)		3,00,000	3,00,000
	Share Application A/c Dr. To Bank A/c (Being the amount of excess application on 5000 shares returned.)		30,000	30,000
	Share Allotment A/c Dr. To Share Capital A/c (Being the allotment money due)		2,00,000	2,00,000
	Bank A/c Dr. To Share Allotment A/c (Being the allotment money received)		2,00,000	2,00,000

- c). It is a case of over-subscription where surplus money is utilized for allotment:

## Journal entries

Date	Particulars	LF	Amount	Amount
	Bank a/c Dr. To Share Application A/c (Being the share application amount on 55,000 shares received.)		3,30,0000	3,30,000
	Share Application A/c Dr. To Share capital A/c (Being transfer of share application amount of 50,000 shares to Share capital A/c.)		3,00,000	3,00,000
	Share Allotment A/c Dr. To Share Capital A/c (Being amount due on allotment of 50,000 shares.)		2,00,000	2,00,000
	Bank A/c Dr. Share Application A/c Dr. To Share Allotment A/c (Being Allotment money received and excess of application money is adjusted with allotment.)		1,70,000 30,000	2,00,000

## CALLS- IN- ARREARS:

Sometimes shareholders fail to pay the amount due on installments or calls. Thus, Calls-in-arrears refers to the total unpaid amount, called by the company which has not yet been paid by the shareholders till the last day fixed for the payment thereof.

Such amount illustrates the uncollected amount of capital from the shareholders; hence, it is shown by way of deductions from the 'called-up capital' to arrive at paid-up value of shares capital. The balance of calls in arrear is shown as deduction from called up capital in the liability side of Balance Sheet.

For recording 'Calls-in-arrear', the following journal entry is recorded.

Calls-in-Arrears A/c	Dr. (Amount of Unpaid Calls)
To Share Allotment A/c	
To Shares Calls A/c	

The Article of Association of a company authorizes the directors to charge interest at a fixed rate on calls-in-arrears. But if the Articles have no information regarding the interest, then Table A will be applicable which empowers the Board of Directors to charge interest at a rate not exceeding 5% p.a. on unpaid calls for the period intervening between the due dates of the call and the time of actual payment.

The accounting treatment of interest on Calls-in-arrear is as follows:

I. For interest receivable on calls-in-arrear-

Shareholder's A/c	Dr.
To interest on calls-in-arrear A/c	

II. For receipt of interest-

Bank A/c	Dr.
To Shareholder's A/c	

### Example 5-

D Ltd issued 2000 equity shares of Rs.10 each. The amount of on these shares was payable as Rs. 2 on application, Rs. 3 on allotment, and Rs.5 on first call. All the amounts were duly received but Mr.Shukla who holds 100 equity shares did not pay allotment and first call money, and Prakash, who holds 50 shares did not pay first call money. Pass the necessary journal entries in the books of D Ltd.

### Solution 5

Analysis Table

Particulars	Amount Due	Amount Record	Call in Arrears
On application	$2000 \times 2 = 4000$	Rs.4000	Nil
On Allotment	$2000 \times 3 = 6000$	$2000 - 100 = 1900$ shares $1900 \times \text{Rs.}3 = \text{Rs.}5700$	$100 \times 3 = 300$
On First call	$2000 \times 5 = 10000$	$2000 - (100 + 50) = 1850$ shares $1850 \times \text{Rs.}5 = \text{Rs.} 9250$	$100 \times 5 = 500$ $50 \times 5 = 250$

## Journal Entries

## NOTES

Date	Particulars	LF	Amount	Amount
	Bank A/c Dr.		4000	
	To Equity Share Application A/c (Being application amount received)			4000
	Equity Share Application A/c Dr.		4000	
	To Equity Share Capital A/c (Being transfer of application amount to capital A/c)			4000
	Equity Share Allotment A/c Dr.		6000	
	To Equity Share Capital A/c (Being amount due on allotment)			6000
	Bank A/c Dr.		5700	
	Calls-in-arrear A/c		300	
	To Equity Share Allotment A/c (Being allotment amount received)			6000
	Equity Share First Call A/c Dr.		10,000	
	To Equity Share Capital A/c (Being amount due on first call)			10,000
	Bank A/c Dr.		9250	
	Calls-in-arrear A/c		750	
	To Equity Share First Call A/c (Being amount of first call received)			10,000

**CALLS-IN-ADVANCE:**

Calls-in-advance refer to the amount paid by the shareholders in excess of the amount due upon them. A Company may accept Calls-in-advance only if the company is authorized by its Article of Association. According to Table A, interest at the rate of 6% is to be paid on such calls-in-advance. The following are the journal entries in respect of calls-in-advance:

- i. When calls-in-advance is received,

Bank A/c	Dr.
Calls-in-arrear A/c	

- ii. When amount of the concerned call is received,

Calls-in-Advance A/c	Dr.
Concerned Call A/c	

The amount received as calls-in-advance is not a part of paid up capital. Calls-in-advance Account is shown as a separate item on the liabilities side of the company's balance sheet under the heading 'Share Capital' but it is not added to the amount of paid-up capital.

The accounting treatment of interest on Calls-in-Advance is as follows:

- I. Interest due on calls-in-advance:

Interest on Calls-in-Advance A/c	Dr.
To Shareholder's A/c	

## II. Payment of Interest on Calls-in-Advance:

Issue of Shares

Shareholder's A/c

Dr.

To Bank A/c

(Interest paid on calls-in-advance)

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### Example 6:

A limited Company, issued for subscription 2,000 shares @ Rs.100 payable at Rs. 25 per share on application, Rs.30 per share on allotment, Rs.20 per share on first call after three months of allotment, and the balance as and when required.

The subscription list closed on March 31, 2010 when application money on 2000 shares was duly received and all allotment was made on May 1, 2010.

The allotment amount was received in full but, when the first call was made, one shareholder failed to pay the amount on 100 shares held by him and another shareholder with 50 shares paid the entire on his shares.

Pass the necessary journal entries in the books of the A Ltd Company, assuming that all amounts due was received within one month of the date they were called.

### Solution-

#### Journal Entries

Date	Particulars	LF	Amount	Amount
Mar 31	Bank A/c Dr. To Equity Share Application A/c (Being amount received on application)		50,000	50,000
May 1	Equity Share Application A/c Dr. To Equity Share Capital A/c (Being transfer of application money to Capital A/c)		50,000	50,000
May 1	Equity Share Allotment A/c Dr. To Equity share capital A/c (Being amount due on allotment)		60,000	60,000
June 1	Bank A/c Dr. To Equity Share Allotment A/c (Being allotment money received)		60,000	60,000
July 1	Equity Share First Call A/c Dr. To Equity Share Capital A/c (Being first call money due)		40,000	40,000
July 1	Bank A/c Dr. Calls-in-Arrears A/c Dr. To Equity Share First Call A/c To Calls-in-Advance A/c (Being first call money received on 1900 shares @ Rs.20 per share)		39,250 2000	40,000 1250

## FORFEITURE OF SHARES

The term 'forfeit' means taking away of property on breach of a condition. According to the Companies Act, 1956 Schedule I, Table A (29): If a shareholder fails to pay their allotment or any call money on the due dates, the company has authority



## NOTES

to forfeit his shares. The result of the forfeiture is that the shareholder ceases to be member of the company. Forfeiture of shares is the action taken by a company to cancel the shares. The Directors are usually empowered by the Articles of Association to forfeit shares by serving proper notice to the defaulting shareholders.

**Procedure of Forfeiture of Shares:** At least fourteen day's notice is to be given for making payment. If shareholders do not make payment even after this notice, ordinarily one more notice is sent to the shareholders for making payment. If after this notice no payment is made, Board of Directors pass a resolution for forfeiture of shares.

Forfeiture of shares means to forfeit that amount of the share which a company has already received from the concerned shareholders.

Normally, rules of forfeiture are mentioned in Articles of Association of the company. If no rules are given in Articles, the provision of Table A regarding forfeiture applies.

### Accounting Records for Forfeiture:

#### Case I: Forfeiture of shares originally issued at par:

Share Capital A/c	Dr. (No. of shares forfeited x called-up amount per share)
To Share Allotment A/c	(Amount not received on allotment)
To Share Call (each) A/c	(Amount not received on each call)
To Forfeited Shares A/c	(Amount already paid on shares Forfeited)

#### Example 7:

Gupta Ltd forfeits 500 shares of Rs. 10 each on which a shareholder has paid only Rs.2 on application but failed to pay Rs. 3 on allotment and Rs.5 on first and final call. Pass necessary journal entries for forfeiture.

#### Solution:

##### Journal Entries

Date	Particulars	LF	Amount	Amount
	Share Capital A/c	Dr.	5000	
	To Share Allotment A/c			1500
	To Share First and Final Call A/c			2500
	To Forfeited Shares A/c			1000
	(Forfeiture of 500 shares for non-payment of Allotment and call-moneys)			

#### Case II: Forfeiture of Shares issued at premium:

- 1) If the amount of premium has already received by the company, then the accounting entry would be same as mentioned in the case of shares issued at par.

- 2) If premium has not been received but it has been credited on due basis, then entry will be

Share Capital A/c	Dr. (No. of shares forfeited x called-up amount per share)
Securities Premium A/c	(Amount of premium unpaid on Forfeited shares)
To Share Allotment A/c	(unpaid money on allotment)
To Share Calls A/c	(unpaid money on calls)
To Forfeited Shares A/c	(amount already paid on forfeited shares)

NOTES

**Example 8:**

ABC Ltd, forfeited 700 equity shares of Rs.10 each fully called-up which were issued at premium of 20%. Amount payable on shares was as follows:

On application Rs.2

On allotment Rs. 5 (including premium)

On First and Final Call Rs.5

Only application money was paid by the shareholders in respect of these shares. Pass necessary journal entries for the forfeiture.

**Solution:**

**Journal Entries**

Date	Particulars	LF	Amount	Amount
	Share Capital A/c	Dr.	7000	
	Securities Premium A/c	Dr.	1400	
	To Share Allotment A/c			3500
	To Share First and Final Call A/c			3500
	To Forfeited Shares A/c			1400
	(Forfeiture of shares which are issued at premium of 20% for non-payment of allotment and call-money)			

**Case III: Forfeiture of Shares issued at Discount:**

At the time of entry for forfeiture, when shares are issued at discount, 'Discount on issue of shares' will be credited. Therefore the entry on forfeiture will be:

Share Capital A/c	Dr. (No. of shares forfeited x called-up amount per Share)
To Discount on issue of shares A/c	(No. of shares forfeited x discount per share)
To Shares Allotment A/c	(Unpaid allotment money)
To Share Calls A/c	(Unpaid call money)
To Forfeited Shares A/c	(amount paid on these shares)

**Example 9 :**

Agarwal Ltd. Company forfeited 1000 Equity Shares of Rs. 10 each for the non-payment of final call @Rs.2 per share. These shares were originally issued at a discount of 10%. Application, allotment, and first call money per share is Rs. 2, Rs.3, and Rs.2 respectively. Pass journal entries for forfeiture of shares.

**NOTES****Solution:****Journal Entries**

Date	Particulars	LF	Amount	Amount
	Share Capital A/c <span style="float: right;">Dr.</span>		10000	
	To Equity Share Final Call A/c			2000
	To Forfeited Shares A/c			7000
	To Discount on issue of shares A/c			1000
	(Forfeiture of 1000 shares of Rs.10 each for non-payment of final call money)			

**Re-issue of Forfeited Shares:**

A Company can re-issue the forfeited shares in accordance with the provisions contained in the Articles of the company. These shares can be re-issued at any price so long as the amount received from selling of these shares and the amount forfeited on these shares is not less than the called-up value of shares on the date when they are re- issued. It means a company can re-issue forfeited shares at discount, though there is no restriction to re-issue them at par or at premium.

**Accounting Entries on Re-issue of Forfeited Shares**

- 1). When all forfeited shares are re-issued at par.  
(Whether these shares are issued at par, premium or discount)
  - a) On re-issue of forfeited shares  
     Bank A/c Dr. (amount received on re-issue)  
         To Share Capital A/c
  - b) On transfer of Forfeited Shares A/c to Capital Reserve  
     Forfeited Shares A/c Dr. (total forfeited amount)  
         To Capital Reserve A/c
- 2). When all forfeited shares are re-issued at premium.  
(Whether these shares are issued at par, premium or discount)
  - a) On re-issue of forfeited shares  
     Bank A/c Dr. (total amount received on re-issue)  
         To Share Capital A/c (paid-up value of shares)  
         To Securities Premium A/c (amount of premium)
  - b) On transfer of Forfeited Shares A/c to Capital Reserve A/c  
     Forfeited Shares A/c Dr. (total forfeited amount)  
         To Capital Reserve A/c
- 3). When all forfeited shares are re-issued at discount.

(Whether these shares are issued at par or premium)

a) On re-issue of Forfeited Shares

Bank A/c	Dr. (amount received on re-issue)
Forfeited Shares A/c	Dr. (discount allowed on re-issue)
To Share Capital A/c	(Paid-up amount)

**Note:** The amount of discount in this case must not exceed the amount forfeited.

b). If all forfeited shares are re-issued and the amount of discount allowed on re-issue is less than the forfeited amount, the balance of the Forfeited shares A/c will be transferred to Capital reserve A/c.

Forfeited Shares A/c	Dr.
To Capital Reserve A/c	

4). When forfeited shares are re-issued at discount (loss)

(Originally also issued at discount)

a). On re-issue of forfeited shares

Bank A/c	Dr. (amount received on re-issue)
Discount on issue of shares A/c	Dr. (amount of discount originally allowed)
Forfeited Shares A/c	Dr. (amount of discount allowed on re-issue)
To Share capital A/c	(paid-up amount)

b). On transfer of balance of forfeited shares account

Forfeited Shares A/c	Dr.
To Capital Reserve A/c	

**Example 10:**

A Ltd. re-issued 100 equity shares of Rs. 10 each at Rs. 7 per share. These shares were issued originally at a discount of 10%. Give journal entries for re-issue.

**Journal Entries**

Date	Particulars	LF	Amount	Amount
	Bank A/c	Dr.	700	
	Discount on issue of shares A/c	Dr.	100	
	Forfeited Shares A/c	Dr.	200	
	To Equity Share capital A/c			1000
	(Being the re-issue of 100 shares @Rs.7 per share)			

**Example 11:**

Sunny Co. Ltd. issued 5000 equity shares of Rs. 10 each payable as Rs.3 per share on application, Rs.5 per share (including Rs. 2 as premium) on allotment and Rs.4 per share on call. Money due on these shares was fully received excepting Rahul, holding 100 shares, failed to pay the allotment and call money and Sunil, holding 150 shares, failed to pay call money. The Company was forfeited all these 250 shares and re-issued to Ram as fully paid-up at a discount of 10% per share.

Pass the necessary journal entries regarding forfeiture and re-issue of shares.

**Solution :**

**Journal Entries**

Date	Particulars	LF	Amount	Amount
	Equity Share Capital A/c (250 x 10) Dr.		2500	
	Securities Premium A/c (100 x 2) Dr.		200	
	To Equity Share Allotment A/c (100 x 5)			500
	To Equity Share Call A/c (250 x 4)			1000
	To Forfeited Shares A/c			1200
	(Being forfeiture of 250 shares for non payment of allotment and call money on 100 shares and for non-payment of call money on 150 shares)			
	Bank A/c Dr.		2250	
	Forfeited Shares A/c Dr.		250	
	To Equity Share Capital A/c			2500
	(Being re-issue of 250 shares @Rs.9 per share )			
	Forfeited Shares A/c Dr.		950	
	To Capital Reserve A/c			950
	(Being profit on re-issue transferred to Capital Reserve A/c)			

**Working Notes:** Calculation of amount to be transferred to Capital Reserve A/c:

Amount Forfeited per share of Ram	Rs.3	Amount forfeited per share of Sunil	Rs.6
Less: Loss on re-issue per shares	Re.1	Less: Loss on re-issue per shares	Re.1
Surplus	Rs.2	Surplus	Rs.5

Transferred to Capital Reserve A/c:

Rahul's Share (100 x Rs.2)	= 200
Sunil's Share (150 x Rs.5)	= 750

**Total Rs. 950**

**Example 12:**

Prakash Ltd. issued a prospectus inviting applications for 40,000 shares of Rs.10 each at a premium of Rs.2 per share payable as follows: On application Rs.2, on allotment Rs.5 including premium, Rs. 5 on first call and final call. Applications were received for 50,000 shares and allotment was made on pro-rata to the applications of 48000 shares. Money paid on application 2000 shares was fully paid back. Money was paid on application was employed on allotment. Ram, who was the holder of 200 shares, failed to pay the allotment, and call money. Rohit, the holder of 400 shares failed to pay the call money. The shares were forfeited and re-issued to Rajesh at Rs.10.50 per share. Pass necessary journal entries in the books of company.

**Note:** 'Pro-rata allotment' means allotment in proportion of shares applied for. For Example, a company offers to the public 10,000, shares for subscription. The company receives applications for 12,000 shares. If the shares are to be allotted on pro-rata basis, applicants for 12000 shares are to be allotted 10,000 shares i.e., on the 12,000:10,000 or 6:5 ratio. Any applicant who has applied for 6 shares will be allotted 5 shares.

NOTES

Solution:

## Journal Entries

Issue of Shares

Date	Particulars	LF	Amount	Amount
	Bank A/c Dr.		1, 00,000	
	To Share Application A/c			1, 00,000
	(Being application money received)			
	Share Application A/c Dr.		4000	
	To Bank A/c			4000
	(Being application money for 2000 shares refunded)			
	Share Application A/c Dr.		80,000	
	To Share Allotment A/c			80,000
	(Being application money of 40,000 shares transferred to Share-capital A/c)			
	Share Allotment A/c Dr.		2, 00,000	
	To Share Capital A/c			1, 20,000
	To Security Premium A/c			80,000
	(Being allotment including premium due)			
	Bank A/c Dr.		1, 83,080	
	Share Application A/c Dr.		16,000	
	To Share Allotment A/c			1, 99,080
	(Being excess money adjusted on allotment and balance received except on 200 shares)			
	Share First Call A/c Dr.		2, 00,000	
	To Share Capital A/c			2, 00,000
	(Being first and final call due on 40,000 shares)			
	Bank A/c Dr.		1, 97,000	
	To Share First Call A/c			1, 97,000
	(Being first and final call money received except on 200 shares and 400 shares)			
	Equity Share Capital A/c Dr.		6000	
	Securities Premium A/c Dr.		1200	
	To Equity Share Allotment A/c			920
	To Equity Share First and Final Call A/c			3000
	To Forfeited Shares A/c			3280
	(Being 200 shares of Ram and 400 shares of Rohit forfeited)			
	Bank A/c Dr.		6300	
	To Equity Share Capital A/c			6000
	To Securities Premium A/c			300
	(Being 600 forfeited shares re-issued at Rs.10.5)			
	Share Forfeiture A/c Dr.		3280	
	To Capital Reserve A/c			3280
	(Being share forfeiture A/c transferred to Capital Reserve A/c)			

## NOTES

## Working Notes:

- 1). Each Shareholder has been allotted 40 shares in respect of 48 shares applied for. In other words, Rs.16, 000 received on 8,000 shares (48,000 – 40,000) has been adjusted on allotment.
- 2). Ram has 200 shares; hence, he would applied for 240 shares (200 x 48/40). Thus, Rs.80 is the excess money on application. On allotment Rs.1000 (200 x 5) should have been paid with premium. Now Rs. 1000 – 80 = 920 has not been paid on allotment.
- 3). On allotment, Rs. 2, 00,000 is due to be received. However, Rs.16,000 excess money received on application has to adjusted at the time of allotment. Ram has not paid Rs. 920. Thus, amount received at the time of allotment is Rs.1,83,080 (2,00,000 – 16000 – 920).



- 4). Total amount forfeited is 3280 ( $240 \times 2 + 400 \times 7$ ). This amount is transferred to Capital Reserve A/c.

### SUMMARY:

#### NOTES

- A company is an artificial person created by law, having a separate corporate and legal entity from its members, perpetual succession and a common seal.
- Share capital refers to the portion of a capital that has been obtained by issuing the shares to the shareholder.
- A share is a fractional part of the capital which provides the basis of ownership.
- As per the provision of Companies Act, 1956, a company can issue two types of shares: Preference Shares and Equity Shares.
- A preference share is one which has two rights: A right to receive dividend at a stipulated rate or a fixed amount before any dividend is paid on equity shares, a right to receive repayment of capital in the event of winding up of the company.
- equity shares are those shares, which are not the preference shares.
- Shares are said to be over subscribed when the number of shares applied is more than the number of shares offered.
- Shares are said to be under-subscribed when the number of shares applied is less than the number of shares offered.
- The term minimum subscription refers to the amount which, in the opinion of the Board of Directors, must be raised by the issue of shares.
- When a share is issued at its nominal or face value, it is known as issue of shares at par.
- When a company issues its shares (securities) at a price more than the face-value, it is said to be an issue of shares at a premium.
- When share issued at a price lower than the face value, it is said to be an issue of shares at a discount.
- Calls-in-arrears refers to the total unpaid amount, called by the company which has not yet been paid by the shareholders till the last day fixed for the payment thereof.
- Calls-in-advance refer to the amount paid by the shareholders in excess of the amount due upon them.
- The term 'forfeit' means taking away of property on breach of a condition.

### QUESTIONS:

- 1) Explain the term 'share capital'. What are different types of share capital?
- 2) Define preference shares and its types.
- 3) How shares are subscribed?
- 4) Write a short note on:
 

i) Issue of shares at premium	ii) Issue of shares at discount
iii) Call-in arrears	iv) Calls-in-advance
- 5) Explain the procedure of forfeiture of shares.
- 6) How forfeited shares are re-issued?

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# REDEMPTION OF PREFERENCE SHARES AND DEBENTURES

**The Unit Covers :**

- 10.1** ACCOUNTING TREATMENT
- 10.2** REDEMPTION OF PREFERENCE SHARES OUT OF DIVISIBLE PROFITS
- 10.3** ISSUE OF DEBENTURE
- 10.4** DIFFERENCE BETWEEN DEBENTURE & SHARES
- 10.5** ISSUE OF DEBENTURES
- 10.6** REDEMPTION OF DEBENTURES
- 10.7** ACCOUNTING ENTRIES FOR ISSUE OF REDEEMABLE DEBENTURES
- 10.8** REFERENCES / SUGGESTED READING

Under Section 80 of the Companies Act, a company limited by shares can issue redeemable preference shares if so authorized by its Article of Association. Such shares may be redeemed either on a specified date or earlier at the option of the Company.

**Conditions of Redemption:** Section 80 of the Act has imposed the following conditions in respect of the redemption of preference shares:

- (i) **Preference Shares must be fully paid-up:** Section 80 states that only fully paid-up redeemable preference shares can be redeemed.

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(ii) Redeemable Preference Shares can be redeemed only out of the following sources:

- a) Divisible or distributable profits,
- b) Proceeds of the fresh issue of shares (whether equity or preference) made for the purpose of redemption.
- c) Combination of both (a) & (b)

**ACCOUNTING TREATMENT**

1. For making partly paid redeemable preference shares as fully paid:

a) For making call money due:

Share Final call A/c	Dr.
To Preference Share Capital A/C	

b) On receipt of call money:

Bank A/c	Dr.
To Share Final call A/c	

2) When redemption is to be made fully or partly out of the proceeds of fresh issue. Entry for issued shares will be:

a) When issue at par

Bank A/c	Dr.
To Share Capital A/c	

b) When issue at discount

Bank A/c	Dr.
Discount on issue of shares	Dr.
To Share Capital A/c	

c) When issue at premium

Bank A/c	Dr.
To Share Capital A/c	
To Premium A/c	

3. On transfer of redeemable preference shares capital to preference shareholder A/c:

a) If redeemable at par:

Redeemable Preference Share Capital A/c	Dr.
To Preference Share Capital A/c	

b) If redeemable at premium:

Redeemable Preference Share Capital A/c	Dr.
Premium on Redemption of Shares A/c	Dr.
To Preference Shareholders A/c	

4. On making payment to Preference Shareholders:

Preference Shareholders A/c	Dr.
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To Bank A/c.

5. If redemption is made by using divisible profits then amount of profit which is used for redemption would be transferred to capital redemption reserve A/c i.e.

Profit & Loss A/c Dr.

General Reserve A/c Dr.

Dividend Equalisation Fund A/c Dr.

To Capital Redemption Reserve A/c

6. For making adjustment of premium on redemption:

Profit & Loss A/c Dr.

Securities Premium A/c Dr.

To Premium on Redemption of

Preference shares A/c

## REDEMPTION OF PREFERENCE SHARES OUT OF DIVISIBLE PROFITS:

### Example-1:

Garg Ltd. issued 20,000 8% Redeemable Preference Shares of Rs. 10 each (fully paid-up) on 1st January, 2005. These shares are redeemable on 31st December, 2009. Pass the necessary entries in the books of Garg Ltd. for annual provision and for redemption of shares assuring a provision of Rs. 50,000/- profits for redemption of these shares.

### Solution:

#### Journal Entries

Date	Particulars		Rs.	Rs.
2006 Dec. 31	Profit & Loss Appropriation A/c.... Dr. To Capital Redemption Reserve A/c (Being annual provision out of profits)		50,000	50,000
2007 Dec.31	Profit & Loss Appropriation A/c Dr. To Capital Redemption Reserve A/c (Being annual provision out of profits)		50,000	50,000
2008 Dec.31	Profit & Loss appropriation A/c Dr. To capital Redemption Reserve A/c (Being annual provision out of profits)		50,000	50,000
2009 Dec.31	Profit & Loss Appropriation A/c Dr. To Capital Redemption Reserve A/c (Being annual provision out of profit)		50,000	50,000
	8% Redeemable Pref. Share Capital A/c Dr. To 8% Redeemable Pref. Shareholders A/c (Being the transfer of the amount of 8% Redeemable Pref. Share capital A/c to 8% Preference Shareholders A/c)		2,00,000 2,00,000	

8% Redeemable Preference share holders A/c Dr	2,00,000	
To Bank A/c		2,00,000
(Being repayment of 8% Redeemable Preference Shares)		

## NOTES

**Example-2:**

Neha Ltd. issued on 1.1.1999 20,000 8% Redeemable Preference Shares of Rs. 100 each redeemable on 1st January, 2009 at a premium of Rs. 10 each. In order to meet this obligation the company decides to issue 1,00,000 equity shares of Rs. 10 each at Rs. 15 and 10,000 9% Preference shares of Rs. 100 at Rs. 110. The whole amount is received in cash and 8% Preference shares are redeemed.

Show the necessary journal entries in the books of the company.

**Solution:****Journal Entries**

Date	Particulars		Rs.	Rs.
	Bank Ac Dr		26,00,000	
	To Equity Share Capital A/c			10,00,000
	To 9% Pref. Share Capital A/c			10,00,000
	To Securities Premium A/c			6,00,000
	(Being issue of 1,00,000 equity shares at premium and 10,000 9% Preference Shares at premium)			
	8% Redeemable Pref. Share Capital A/c Dr		20,00,000	
	Premium on Redemption of Share A/c Dr		2,00,000	
	To Preference Shareholders A/c			22,00,000
	(Being amount of preference share capital plus premium transferred to preference shareholders A/c)			
	Preference Shareholders A/c Dr		22,00,000	
	To Bank A/c			22,00,000
	(Being payment to Redemption shareholders)			
	Securities Premium A/c Dr		2,00,000	
	To Premium on Redemption A/c			2,00,000
	(Being premium on Redemption written-off)			

**ISSUE OF DEBENTURE:****Meaning of Debenture:**

Debenture is a written instrument issued by a company under its common seal, acknowledging a debt and containing provisions for the repayment of the principal sum and the payment of interest at a pre-decided rate.

According to Sec. 2(12) of the Companies Act, 1956, "Debenture includes debenture stock, bonds and any other securities of company, whether constituting a charge on the assets of the Company or not."



**According to Justice Whity, "Debenture is a document which either creates a debt or acknowledges it."**

### **Features of Debenture:**

Following are the features of the debenture:

1. Debenture is a document, which evidences a loan taken by a company.
2. A debenture contains provision for payment of interest.
3. It also contains provision for repayment of principal sum on a fixed date.
4. It is issued under the common seal of the company.
5. It may or may not create a charge on the assets of the company as security.
6. Debenture holders do not have any voting rights in the general meeting of the shareholders.

### **DIFFERENCE BETWEEN DEBENTURE & SHARES**

Basis of Difference	Debenture	Share
1. Capital or Loan	Debenture constitutes a loan.	Share forms a part of Capital
2. Ownership	Debenture holders are creditors of the company	Share holders are the owners of the company.
3. Dividend and Interest	Interest is payable, whether there is profit or not.	Dividend is payable on shares only out of profit.
4. Rate of Interest and Dividend	The payment of interest is made at the pre-determined rate.	In case of equity shares, rate of dividend fluctuates according to the profitability of the company.
5. Convertibility	Debentures can be converted into shares as per the terms of issue of debentures.	Shares cannot be converted into debentures in any circumstances.
6. Priority as to payment of interest/dividend	Payment of interest gets priority over the payment of dividend.	Payment of dividend gets no priority over the payment of interest.

### **Type of Debentures:**

1. **Registered Debentures:** The registered debentures are those which are payable to the persons whose name appears in the Register of Debenture holders. They are not easily transferable. These can be transferred only by executing a transfer deed.
2. **Bearer Debentures:** A bearer debenture is one which can be transferred by mere delivery and the holder of debentures is entitled to receive payment of interest and principal debt.
3. **Secured or Mortgaged Debentures:** The debentures that are secured by a charge on the assets of the company are known as **secured or mortgaged debentures**. This charge may be either fixed or floating. A fixed charge is a mortgage on specific assets. These assets cannot be sold without the consent

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of the debenture holders. A floating charge generally covers all the assets of the Company.

4. **Simple, Naked or Unsecured Debentures:** These debentures are unsecured since they have no charge on the assets of the company. A company merely promises to pay interest on due dates and to repay the amount due on maturity date. Such debentures are only acknowledgment of indebtedness of the company under its common seal.
5. **Redeemable Debenture:** Redeemable Debentures are those which are repaid after a specified period.
6. **Irredeemable Debenture:** These debentures are not repayable during the life time of the company. These are also called perpetual debentures. These are repaid only at the time of liquidation of the company.
7. **Convertible Debentures:** Convertible debentures are those which can be converted into equity shares (either at par or premium or discount) after a certain period of time from the date of its issue. These debentures may be fully or partly convertible.
8. **Non-Convertible Debentures:** The debentures which cannot be converted into shares are called non-convertible debentures.

### ISSUE OF DEBENTURES:

- i. **Issue of Debenture at par:** When debentures are issued at their nominal value, they are said to be issued at par. For Example: When a debenture of Rs. 100 is issued at Rs. 100 this issue is called 'at par'.

#### Example-3:

Prakash Ltd. issued 5000, 5% debentures of Rs. 100 each payable Rs. 10 on application Rs. 30 on allotment and the balance on first and final call. All amounts were duly realized. Pass the necessary journal entries in the books of Prakash Ltd.

**Solution :**

#### Journal Entries

Date	Particulars		Rs.	Rs.
	Bank A/c Dr. To 5% Debenture Application A/c (Being the amount received on 5% debenture application)		50,000	50,000
	5% Debenture Application A/c Dr. To 5% Debenture A/c (Being transfer of the amount of 5% debenture application to 5% debenture account)		50,000	50,000
	5% Debenture Allotment A/c Dr. To 5% Debenture A/c (Being 5% debenture allotment due)			1,50,000 1,50,000
	Bank A/c Dr. To 5% Debenture Allotment A/c (Being the receipt of amount on 5% debenture allotment)		1,50,000	1,50,000

5% Debenture first and final Call A/c To 5% Debentures A/c (Being the amount of first and final call on 5% debenture due)	Dr.	3,00,000	3,00,000
Bank A/c To 5% Debenture First & Final Call A/c (Being the receipt of the amount of first and final call of 5% debentures)	Dr.	3,00,000	3,00,000

**ii. Issue of Debenture at Premium:** When debenture are issued at more amount than their face value it is said that they are issued at premium.

**For Example:** When a debenture of Rs. 100 is issued at more than Rs. 100 i.e. at Rs. 110 this issue of debenture is at premium and the amount of premium is Rs. 10. In this case Premium on debentures A/c is credited.

**Example-4**

Y Ltd. issued 1000, 7% debentures of Rs. 100 each at a premium of 10% payable Rs. 20 on application and balance with premium on allotment. Expenses on issue of debentures are Rs. 400. Pass the necessary journal entries in the book of Y Ltd.

**Solution:**

**Journal Entries in the book of Y Ltd.**

Date	Particulars		Rs.	Rs.
	Bank A/c To 7% Debenture Application A/c (Being the amount received on 5% debenture application)	Dr.	20,000	20,000
	7% Debenture Application A/c To 7% Debenture A/c (Being transfer of appl. amount to 7% debentures A/c)	Dr.	20,000	20,000
	7% Debenture Allotment A/c To 7% Debenture A/c To Premium on issue of 7% Debentures A/c (Being amount on 5% debenture allotment and premium due)	Dr.	90,000	80,000 10,000
	Bank A/c To 7% Debenture Allotment A/c (Being the amount due on allotment of 7% Debentures received)	Dr.	90,000	90,000
	Expenses on issue of 7% debentures A/c To Bank A/c (Being payment of expenses)	Dr.	400	400
	Premium on issue of 5% debentures A/c To Expenses on issue of 5% Deb. A/c To Capital Reserve A/c (Being written off. expss. from premium and balance transfer to Capital Reserve A/c)	Dr.	10,000	400 9600

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**iii. Issue of Debenture at Discount:** When debentures are issued at less than their face value, it is said that they are issued at discount. For example, when debenture of Rs. 100 is issued at less than Rs. 100 i.e. at Rs. 98, this issue of debenture is at discount.

**Example-5:**

X Ltd. issued 8,000, 5% debentures of Rs. 100 each at a discount of 10% payable Rs. 30 on application and the balance on allotment pass the necessary journal entries in the books of X Ltd.

**Solution:****Journal Entries**

Date	Particulars		Rs.	Rs.
	Bank A/c To 5% Debenture Application A/c (Being the amount of 5% deb. application of 5% deb. application received)	Dr.	2,40,000	2,40,000
	5% Debenture Application A/c To 5% Debentures A/c (Being transfer of appl. amount to 5% Debentures A/c)	Dr.	2,40,000	2,40,000
	5% Debenture Allotment A/c Discount on issue of 5% Deb. A/c To 5% Debentures A/c (Being amount due on allotment)	Dr. Dr.	4,80,000 80,000	5,60,000
	Bank A/c To 5% debenture allotment A/c (Being the amount received due on allotment)	Dr.	4,80,000	4,80,000

**REDEMPTION OF DEBENTURES:**

**Redemption of Debentures:** A company may issue redeemable as well as irredeemable debentures. But debentures issued by companies are usually redeemable debentures. There are two important ways of redeeming the debentures according to the term of the issue.

**Redemption of Debentures on a Fixed Date:** In this method, payment to debenture holder is made at the expiry of the stated period. A "Sinking Fund" is created by debiting the "Profit & Loss Appropriation Account". The amount so credited in the sinking fund account is invested in the gilt edged securities. These securities are sold at the date of redemption of debentures. The sinking fund or debenture fund account is then transferred to the General Reserve. Some companies take up sinking fund insurance policy to redeem the debentures.

**Redemption of Debentures on annual installments:** In this method, payment is made year after year, after a certain portion of the total debentures by drawings. As such the revenue account is debited with the annual drawings and the Redemption Fund Account are credited.

**Sinking Fund:** It is a kind of reserve by which a provision is made to reduce a liability, e.g. redemption of debentures or repayment of a loan. A sinking fund is a form of specific reserve set aside for the redemption of a long term debt. The main purpose of creating a sinking fund is to have a certain sum of money accumulated for a future date by setting aside a certain sum of money every year. It is a kind of specific reserve.

Whatever the object or the method of creating such a reserve may be, every year certain sum of money is invested in such a way that with compound interests, the exact amount to wipe off the liability or replace the wasting asset or to meet the loss will be available. The amount to be invested every year can be known from the compound interest annuity tables.

Alternatively an endowment policy may be taken out which matures on the date when the amount required will be paid by the insurance company. The advantage of this method is that a definite amount will be available, while in the case of investment of fund in securities, the exact amount may not be available on account of fall in the value of securities. After the liability is redeemed the sinking fund is no longer required as it is the undistributed profit it may be distributed to the shareholders or may be transferred to the General Reserve Account.

**Debenture Redemption Reserve:** The newly introduced Section 117C in the Companies Act, 1956 by Companies (Amendment) Act, 2000 has made a bold step in protecting the interests of debenture holders by making it mandatory for the company to create security and debenture redemption reserve. Accordingly, it shall now be mandatory for the companies to create a debenture redemption reserve for the redemption of debentures. The company shall have to credit adequate amount from out of its profits every year till such debentures are redeemed.

The debenture reserve shall be used by the company only for the redemption of debentures. Such redemption shall be in accordance with the terms and conditions of the issue of debentures. The company shall pay interest due on outstanding debentures as per the terms and conditions of the issue only.

If a company fails to redeem the debenture on due dates or on maturity, any or more than one or all the debenture holders can make an application to the Tribunal and then Tribunal on hearing all the parties concerned may direct by way of an order to redeem the debentures forthwith by payment of principal and interest due on such debentures.

If default is made in complying with the order of the Tribunal, every officer of the company who is in default shall be punishable with imprisonment which may extend to 3 years and shall also be liable to a fine of not less than Rs. 500 for every day during which such default continues.

### **Accounting Entries for Issue Redeemable Debenture**

Issue of redeemable debentures can be categorized into the following situations:-

- (i) Debentures are issued at par and repayable at par:

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- a) On issue of debentures

Bank A/c

Dr.

To Debentures A/c.

- b) On redemption

Debentures A/c

Dr.

To Bank A/c

- (ii) Debentures are issued at premium and repayable at par

- a) On issue of debentures

Bank A/c

Dr.

To Debentures A/c

To Premium on issue of debenture

- b) On redemption

Debentures A/c

Dr.

To Bank A/c

- (iii) Debentures are issued at discount and repayable at par

- a) On issue of debentures

Bank A/c

Dr.

Discount on issue of debentures A/c

Dr.

To Debentures A/c

- b) On redemption

Debenture A/c.

Dr.

To Bank A/c

- (iv) Debentures are issued at par and repayable at premium.

In this case, the issue price is same as par value but the redemption value is more than the par value, therefore redemption premium is recorded as a loss on issue of debenture.

- a) On issue of debenture -

Bank A/c

Dr.

Loss on issue of debentures A/c

Dr.

To Debentures A/c

To premium on redemption of debentures A/c

- b) On redemption

Debentures A/c.

Dr.



Premium on redemption of debentures A/c

Dr.

To Bank A/c

REDEMPTION OF  
PREFERENCE SHARES  
AND DEBENTURES

(v) Debentures issued at discount but repayable at premium -

In this situation the issue price is less than par value but redemption value is more than par value. The difference between the redemption price and the issue price is treated as discount/loss on issue of debenture.

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a) On issue of debentures

Bank A/c

Dr.

Loss on issue of debentures A/c

Dr.

(with discount & premium on redemption)

To Debentures A/c

To Premium on redemption of debentures A/c

b) On redemption

Debentures A/c

Dr.

Premium on Redemption of debentures A/c

Dr.

To Bank A/c

**SUMMARY:**

- Under Section 80 of the Companies Act, a company limited by shares can issue redeemable preference shares if so authorized by its Article of Association.
- Debenture is a written instrument issued by a company under its common seal, acknowledging a debt and containing provisions for the repayment of the principal sum and the payment of interest at a pre-decided rate.
- Debenture is a document, which evidences a loan taken by a company.
- A debenture contains provision for payment of interest.
- It also contains provision for repayment of principal sum on a fixed date.
- Debenture holders do not have any voting rights in the general meeting of the shareholders.
- The registered debentures are those which are payable to the persons whose name appears in the Register of Debenture holders.
- A bearer debenture is one which can be transferred by mere delivery and the holder of debentures is entitled to receive payment of interest and principal debt.
- The debentures that are secured by a charge on the assets of the company are known as secured or mortgaged debentures.

## NOTES

- Simple, Naked or Unsecured Debentures are unsecured since they have no charge on the assets of the company.
- Redeemable Debentures are those which are repaid after a specified period.
- These debentures are not repayable during the life time of the company.
- The debentures which cannot be converted into shares are called non-convertible debentures.
- Sinking Fund is a kind of reserve by which a provision is made to reduce a liability, e.g. redemption of debentures or repayment of a loan. A sinking fund is a form of specific reserve set aside for the redemption of a long term debt.

## EXERCISE

1. How preference shares are redeemed?
2. Explain the term 'debenture'. Discuss its various types.
3. Give necessary journal entries for the issue of Redeemable Debentures.
4. Write a short note on:
  - Sinking Fund
  - Debenture Redemption Reserve

## 10.8 REFERENCES / SUGGESTED READING

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