Bachelor of Commerce

BCOM 101

FINANCIAL ACCOUNTING-I

Directorate of Distance Education
Guru Jambheshwar University of Science & Technology
HISAR-125001

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Course: **Financial Accounting-I**	
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1.0 Learning Objectives

After going through this lesson, the learner should be able to:

- Know the meaning, types and process of accounting.
- Distinguish between book-keeping, accounting and accountancy.
- Understand the advantages and limitations of accounting.
- Know the Cash Basis and Accrual Basis of accounting.
- Understand the Double Entry System.

1.1 Introduction

Accounting is a business language which explains the various kinds of transactions during the given period of time. Accounting is used by business entities for keeping records of their money or financial transactions. A businessman who invested money in his business would like to know whether his business is making profit or incurring loss, the position of his assets and liabilities and whether his capital in the business has increased or decreased during a particular period. The main object of a business house is to earn profit. Accounting is the medium of recording the business activities and it considered as a language of business. To find out the results of a business, the information relating to the cost of the products and revenues from the products is collected. Then the costs and revenues are compared to find out the profit or loss of the business. If volume of sales of the products is high and the number of transaction of the business is very high, it is impossible to keep all these transactions in the mind of a business man. Thus a need of recording of all these business transactions rose. The recording of business transactions or activities is done through a process of accounting.

1.2 Meaning of Accounting

Accounting is the art of recording, classifying, summarising and analysing the business transactions and interpreting the results thereof. In accounting, only those transactions and events are recorded which can be measured in terms of money. The basic objective of accounting is to provide the desired information to the owner as well as to all other interested parties i.e. investors, creditors, employees, financial institutions, government etc. In short, we can say that accounting is the language of business by which all the financial and other information are communicated to various interested parties.

Definition of Accounting

1. The definition given by the American Institute of Certified Public Accountants ('AICPA') clearly brings out the meaning of accounting. According to it, accounting is "the art of recording, classifying and summarizing in a significant manner and in terms of money, transactions and events which are, in part at least, of a financial character and interpreting the results thereof".

2. As per Robert N. Anthony – "Accounting system is a means of collecting, summarizing, analyzing and reporting, in monetary terms, information about the business".

3. As per Smith and Ashburne "Accounting is the science of recording and classifying business transactions and events, primarily of a financial character and the art of making significant summaries, analysis and interpretations of these transactions and events and communicating the results to persons who must take decisions or form judgment."

4. As per R.N. Anthony "Nearly every business enterprise has accounting system, it is a means of collecting, summarising and reporting in monetary terms, information about business."

Book-Keeping

Book-keeping includes recording of Journal, posting in Ledgers and balancing of accounts. All the records before the preparation of Trial Balance are the whole subject matter of book-keeping. Thus, Book-Keeping may be defined as the science and art of recording transactions in money or money's worth so accurately and systematically, in a certain set of books, regularly that the true state of businessman's affairs can be correctly ascertained. Here it is important to note that only those transactions related to business are recorded which can be expressed in terms of money.

According to **R.N. Carter** "Book-Keeping is the science and art of correctly recording in books of account all those business transactions that result in the transfer of money or money's worth".

Book-Keeping and Accounting

Book-keeping and accounting are often used interchangeably but they are different from each other. Accounting is a broader and more analytical subject. It includes the design of accounting systems which the book-keepers use, preparation of financial statements, audits, cost studies, income-tax work and analysis and interpretation of accounting information for internal and external end-users as an aid to making business decisions. This work requires more skill, experience and imagination. The larger the firm, the greater is the responsibility of the accountant. It can be said that accounting begins where book-keeping ends. Book-keeping provides the basis for accounting.

Difference between Book-Keeping and Accounting:

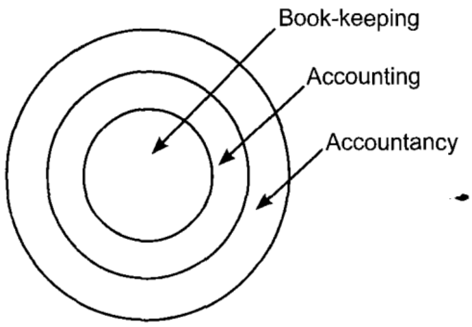
Book-keeping	**Accounting**
Recording of transactions in books of original entry only.	To examine these recorded transactions in order to find out their accuracy.
To make posting in ledger.	To examine this posting in order to ascertain its accuracy.
To make total of the amount in Journal and accounts of ledger. To ascertain balance in all the accounts.	To prepare trail balance with the help of balances of ledger accounts.
Preparation of trading, Profit & loss account and balance sheet is not book-keeping.	Preparation of trading, profits and loss account and balance sheet is included in it.
It does not require any special skill and knowledge as in advanced countries this work is done by machines.	It requires special skill and knowledge.
A book-keeper is not liable for accountancy work.	An accountant is liable for the work of book-keeper.

Accountancy

Accounting is an art of recording, classifying, summarising, analysing and interpreting business transactions whereas accountancy includes some common principles and techniques which are followed to record the transactions in a better way. Accountancy deals with the rules of recording the transactions in books, classifying them, summarising them and presenting the information to various interested parties. We can say that accountancy is the systematic knowledge of accounting.

According to Kohler,"Accountancy refers to the entire body of the theory and practice of accounting."

Accounting is the part of accountancy. The relationship among book-keeping, accounting and accountancy has been depicted in the given diagram.



1.2.1 Characteristics of Accounting

1. Accounting is an art which it helps us in attaining our aim of ascertaining the financial results, that is, operating profit and financial position. Analysis and interpretation of financial data require special knowledge, experience and judgement.

2. In accounting the financial transactions are recorded in the Journal. With the help of Journal, the recorded data are classified into ledger under appropriate heads. Then with the help of ledger the trial balance and financial statements are prepared.

3. It records only those transactions and events which are of financial character: If a transaction has no financial character then it will not be measured in terms of money and not recorded.

4. It records transactions in terms of money. All transactions are recorded in terms of common measure i.e. money.

5. On account of recording of business transactions in a systematic manner, it is also called a science. First the business transactions are recorded in the primary books i.e. Journal, for classification the ledger is prepared. With the help of ledger the Trial Balance, Profit and Loss account and Balance Sheet

is prepared. Profit and Loss account is prepared after a period to find the result of the business and Balance Sheet to know the financial position of the business.

1.2.2 Qualitative Characteristics of Accounting Information

Some qualitative characteristics which make financial information more useful are given below:

1. Relevance: Financial information obtained through financial statements should be according to the objectives of the organisation. The objective-oriented information helps the investors, managers and creditors to take decisions about the business. The information should be given according to the priorities and needs of each and every interested party.

2. Reliability: Financial Information should be based on the facts which can easily be verified. Financial information can be verifiable if it is based on original source documents. Source documents include cash memo, purchase invoice, sales invoice, property transfer papers and written agreements etc.

3. Understand ability: Financial information should be presented in a simple and easy way so that the users i.e. investors, debenture holders, employees and government officials can understand it easily. It should be simple enough even for a person who is not aware about the rules and terms used in accounting. Some explanatory notes should be given so as to make the information more understandable.

4. Comparability: The financial statements must show corresponding information for preceding year(s) so that the users may be able to compare the financial performance, position and cash flows of different years. The measurement and display of the net financial effects of the similar type of transactions must be treated in a consistent form.

1.2.3 Concept of Accounting Process

Accounting process is the complete sequence of accounting procedures which begin with the recording of business transactions from source documents in the Journal or in subsidiary books, as the case may be, and end with the preparation of two basic financial statements, namely Income Statement (or profit and loss account) and Balance Sheet. In the case of Limited Liability Companies, the Cash Flow Statement is also prepared.

The essential steps in the Accounting Process are:

- To enter the transactions in the source documents such as purchase invoice, sales invoice, cash receipts, bank pay-in-slips etc.
- To record or enter the transactions in the Journal or in subsidiary books, as the case may be.
- Classifying the transactions (i.e., the entries found in the Journal or Subsidiary Books) to post or transfer those entries in the appropriate accounts in the ledger.
- To enter the adjustments, if any, in the Journal.
- To balance the various accounts in the ledger to prepare the trial balance in order to check the arithmetical accuracy of the ledger accounts.
- To prepare the final accounts or final statements in the form of trading and profit and loss account (i.e., income statement) and Balance Sheet from the Trial Balance, at the end of the accounting period to ascertain profit or loss of the business for the accounting period and the financial position of the business at the end of the accounting period.

1.2.4 Objectives of Accounting

(i) Maintaining systematic records: Business transactions are properly recorded, classified under appropriate accounts and summarized into financial statement.

(ii) **Communicating the financial results:** Accounting is used to communicate financial information in respect of net profits (or loss), assets, liabilities etc., to the interested parties.

(iii) **Meeting legal needs:** The provisions of various laws such as Companies Act, Income Tax and GST Acts require the submission of various statements, i.e., annual account, income tax returns and so on.

(iv) **Accounting assists the management in the task of** planning, control and coordination of business activities.

(v) **Stewardship:** In the case of limited companies, the management is entrusted with the resources of the enterprise. The managers are expected to act true trustees of the funds and the accounting helps them to achieve the same.

(vi) **Fixing responsibility:** Accounting helps in the computation of the profits of different departments of an enterprise which help in fixing the responsibility of departmental heads.

1.2.5 Users of accounting information

1. Owners/Shareholders: The primary aim of accounting is to provide necessary information to the owners related to business.

2. Managers*:* In large business organisations and in corporations, there is separation of ownership and management functions. The management of such business are more concerned with the accounting information because they are answerable to the owners.

3. Prospective Investors: The person who is contemplating an investment in a business will like to know about its profitability and financial position. They derive this information from the accounting reports of the concern.

4. Creditors, Bankers and other Lending Institutions: Trade creditors, bankers and other lending institutions would like to be satisfied that they will be paid on time. The financial statements help them in judging such position. Banks and other lending agencies rely heavily upon accounting statements for determining the acceptability of a loan application.

5. Government*:* The Government is interested in the financial statements of business enterprise on account of taxation, labour and corporate laws.

6. Employees: Employees are interested in financial statements on accounts because their wage increase and payment of bonus depend on the size of the profit earned.

7. Customers: Customers may also have either short-term or long-term interest in the reporting entity or long-term interest in the reporting entity and they may be satisfied with the profitability, liquidity and solvency position.

1.2.6 Basis of Accounting

The primary purpose of using accountancy is to find out the profit made or loss incurred by an enterprise from business activities at the end of the accounting period. For this purpose accountants use either cash basis of accounting or accrual basis of accounting.

(i) Cash basis of accounting: In this basis of accounting, the income is calculated as the excess of actual cash receipts in respect of sale of goods, services, properties, etc., over actual cash payments regarding purchase of goods, expenses on rent, electricity, salaries, etc. Credit transactions are not considered at all including adjustments for outstanding expenses and accrued income items. This method is useful for professional people like doctors, engineers, advocates, chartered accountants, brokers and small traders. It is simple to adopt because there are no adjustment entries. But this basis does not disclose the true profits because it does not consider the income and expense items which relate to the accounting period but not paid in cash.

Advantages or Merits

(i) This basis is simple to use and does not require technical knowledge of accountancy.

(ii) There is no scope for estimates or personal judgements because cash transactions are recorded only when actual cash is received or paid.

(iii) This basis is suitable for business firms having most of the transactions in cash.

Disadvantages or Demerits

(i) Cash basis does not give a true and fair picture of profit or loss and the financial position of the business enterprise. The reason is that it does not take into consideration outstanding expenses, prepaid expenses; unearned income and income received in advance which may play more important role in some cases in the calculation of actual profit or loss.

(ii) There is no scope for matching principle because the purchase of fixed asset is treated as complete expense in the year of purchase rather than the periods which benefit from the use of fixed assets.

(iii) There is enough possibility of manipulating (or wrong calculation of) the profit figure. It may either by delaying the payments or making payments earlier than the due date. Similarly receipts or income may be postponed or collected early.

(iv) As capital and revenue items are treated at par there is no consistency in the profit or loss figure of different accounting periods.

(v) Cash basis of accounting is not recognised by the Companies Act.

(ii) Accrual basis of accounting: Under this method the items of income (revenue) are recognized when they are earned and not when the money is actually received later on. Similarly expense items are recognized when incurred and not when actual payments are made for them. It means revenue and expenses arc taken into consideration for the purpose of income determination on the basis of the accounting period to which they relate. The accrual basis makes a distinction between actual receipts of cash and the right to receive cash for revenues and the actual payments of cash and legal obligations to pay expenses. It means that income accrued in the current year becomes the income of current year whether the cash for that item of income is received in the current year or it was received in the previous year or it will be received in the next year. The same is true of expense items. Expense item is recorded if it becomes payable in the current year whether it is paid in the current year or it was paid in the previous year or it will be paid in the next year.

Advantages or Merits

(i) It is based on all business transactions of the year in respect of income and expense items and not simply relating to cash transactions. Thus it discloses correct profit or loss.

(ii) This basis of accounting can be (and in fact is) used in all types of business enterprises.

(iii) It is more suitable for the application of matching principle i.e. matching of revenue and expense items.

(iv) It is more scientific and rational basis of accounting.

(v) There is a consistency in the computation of profit or loss of different years because it makes distinction between capital and revenue expenditures.

(vi) It is recognized by the Companies Act.

Difference between Cash Basis and Accrual Basis of Accounting

Points of Difference	**Cash Basis**	**Accrual Basis**
1. Cash v/s. Credit transactions	There is no recording of outstanding and prepaid income or expenses. The basis of records is only cash transactions,	It includes both cash and credit transactions. Hence items like outstanding expenses and income and prepaid income and expenses are to be found in the balance sheet.
2. Effect of the prepaid	Income statement or profit and	Income statement will show

expenses and accrued income	loss account will show lower income if there are items of prepaid expenses and accrued income.	relatively higher income if there are items of prepaid expenses and accrued incomes.
3. Effect of outstanding expenses and unearned income	Income statement will show higher income if there are items of outstanding expenses and income received in advance.	Income statement will show lower income if there are items of outstanding expenses and income received in advance.
4. Simple v/s. Technical	Cash basis of accounting is simple to adopt since no technical knowledge is required in recording cash receipts and cash payments.	Accrual basis of accounting is technical in nature since income is computed after taking into account outstanding and accrued items in the calculation of profit or loss account
5. Unreliable v/s. Reliable	It is unreliable basis of accounting for income determination because cash basis of accounting does not make distinction between revenue and capital items.	Accrual basis of accounting is reliable basis because income determination is done on the basis of revenue items only.
6. Options regarding valuation of Inventories and Depreciation technical method	An accountant has no option to value inventories at cost or market, whichever is less. Also there is no choice regarding the method of depreciation	An accountant has the option to follow alternative methods of inventory valuation like LIFO, FIFO or Weighted average method and alternative methods of depreciation like SLM, WDV

		etc..
7. Legal Position	It is not recognized under the Companies Act.	Accrual basis of accounting is recognized under the Companies Act.
8. Preference	Enterprises with mostly cash transactions prefer this basis of accounting.	Enterprises with cash and credit transactions adopt accrual basis of accounting.
9. Suitability	Cash basis of accounting is suitable only for professional people like doctors, advocates, chartered accountants etc.	Accrual basis of accounting is appropriate for enterprises with profit motive.

(iii) Mixed or Hybrid basis of accounting: Under this method revenues (items of income) are recognized on cash basis while the expenses are recorded on accrual basis. The purpose is to remain cautious, safe and hundred per cent certain for revenues items and make adequate provisions for expenses.

1.2.7 Branches or Divisions of Accounting

Accountants tend to specialise in various types of accounting work and this has resulted in the development of different branches of accounting. Some of the divisions of accounting are given as:

(i) Financial accounting: Accounting designed or meant for outsiders is known as financial accounting. It is concerned with the recording of business transactions and the periodic preparation of income statement, balance sheet and cash flow statement from such records.

(ii) Management accounting: It is concerned with the interpretation of accounting information to guide the management for future planning, decision-making, control, etc. Management accounting, therefore, serves the information needs of the insiders, e.g., owners, managers and employees.

(iii) Cost accounting: It has been developed to ascertain the costs incurred for carrying out various business activities and to help the management to exercise strict cost control.

(iv) Tax accounting: This branch of accounting has grown in response to the difficult tax laws such as relating to income tax, sales tax, excise duties, customs duties, etc. An accountant is required to be fully aware of various tax legislations.

(v) Social accounting: This branch of accounting is also known as social reporting or social responsibility accounting. It discloses the social benefits created and the costs incurred by the enterprise. Social benefits include such facilities as medical, housing, education, canteen, provident fund and so on while the social costs may include such matters as extra hours worked by employees without payment, environment pollution, unreasonable terminations, etc..

(vi) Human resource accounting: It is concerned with the human resources of an enterprise. Accounting methods are applied to evaluate the human resources in money terms so that the society might judge the total work of the business enterprises including, its non-human assets. It is, therefore, an accounting for the people of the organisation. Unfortunately no objectively verifiable method has been developed for universal application.

(vii) National accounting: The accounting for the resources of the nation as a whole. It is generally not concerned with the accounting of individual business entities and is not based on generally accepted accounting principles. It has been developed by the economists and the statisticians.

(viii) Green accounting: The concept of green accounting is related to the calculation of national income in which standard measures of income and output are Gross National Product (GNP) Gross Domestic Product (GDP) Gross National Income (GNP) etc. In simple words, Green Accounting is a kind of accounting that tries to take into consideration the environmental costs in the calculation of operating income of an enterprise. The Green Accounting discloses or emphasizes more clearly about the quality of economic growth in terms of sustainable development.

(ix) Creative accounting: It is the primary duty of the persons in accounting professions, the accountants, to report a true and fair view of the financial statements, namely: the profit and loss account and the balance sheet. Creative accounting is nothing but the manipulation of the operating results and financial position of the company, of course, within the confines (limits) of the accounting standards.

(x) Forensic accounting: Financial scams and frauds in accounting practices have drawn attention of the users of the accounting information supplied by business enterprises. Even the well-governed multinational companies like Enron and other World companies have not escaped from the fraudulent accounting practices. Auditors who are also qualified accountants have the increased responsibility of detecting the frauds and scams in the corporate world.

1.2.8 Methods of Accounting

Single Entry: It is incomplete system of recording business transactions. The business organization maintains only cash book and personal accounts of debtors and creditors. So the complete recording of transactions cannot be made and trail balance cannot be prepared.

Double Entry System: The double entry system is based on scientific principles and is, therefore, used by most of the business houses. The system recognises the fact that every transaction has two aspects and records both aspects of each and every transaction. Under this system, in every transaction an account is debited and other account is credited. The crux of accountancy lies in finding out which of the two accounts are affected by a particular transaction and out of these two accounts which account is to be debited and which account is to be credited.

Merits of Double Entry System:

As we know that double entry system of accounting is a systematic and scientific system of accounting, so it offers a number of advantages. The following are the most important advantages of the system:

1. **Complete record of transactions:** Under this system, recording of all transactions is done whether related to personal or impersonal accounts.

2. **Ascertainment of profit or loss:** Under this system of accounting complete profit and loss account can be prepared by which profit or loss of a particular period can be ascertained.

3. **Mathematical check on accuracy:** Every debit has a credit, so it is an accurate system as far as mathematical accuracy is concerned which may be proved by preparing trial balance.

4. Check for fraud: Scope of fraud is limited as it minimizes the chances of fraud because of scientific system.

5. Ascertainment and knowledge of financial position of the business: Under this system, it is possible to know the financial position of the business at any time. For this purpose Balance Sheet can be prepared any time.

6. Possibility of full control over business: Under this system full information is available which enables the management to exercise full control over the business.

7. Possibility of comparative study: Under this system, it is possible to prepare comparative statement and also compare the previous year's results with the current year's result and take corrective steps as and when necessary to improve the operational results.

Types of Accounts

(I) Personal accounts: These accounts show the transactions with customers, suppliers, money lenders, the banks and the owner. Personal accounts can take the following forms:

(a) Natural Personal Accounts: The term natural persons mean human beings who are the creation of God.

(b) Artificial Personal Accounts: These accounts include accounts of corporate bodies or institutions which are recognized as persons in business dealings. For example, any limited company's account, bank account, insurance company's account, any firm's account, any club's account, etc.

(c) Representative Personal Accounts: These are accounts which represent a certain person or group of persons. In books, the names of the parties will appear. Since these accounts are many in number but are of the same nature, they are added and put under a common title. For example, salary is outstanding towards 15 employees, the amount may be shown against one name 'Salary Outstanding' representing all the 15 employees.

(II) Real accounts: Real account normally belongs to the property of the business and may be of the following types:

(a) Tangible Real Accounts: These are accounts of such things as are tangible i.e. can be seen, touched or felt physically. Examples– land, building, furniture, cash etc. (Note: please note that bank account is a personal account and is not a real account because bank account is the account of some banking company which is an artificial person).

(b) Intangible Real Accounts: These accounts represent such things as cannot be touched but can be measured in terms of money. are goodwill, trademarks, patent rights etc.

(III) Nominal Accounts: Nominal accounts are opened in the books to explain the expenses and incomes. For example, in a business- salary is paid to the employees, rent is paid to the landlord, wages are paid to the workers, and commission is paid to the salesmen, wherein cash goes. Examples are salary account, rent account, commission account etc. Nominal accounts include accounts of all expenses, losses, income and gains. They are known as nominal as at the end of year these accounts transferred to Trading or P/L Account.

1.2.9 Advantages of Accounting

1. Helpful in the determination of financial results and presentation of financial position: Accounting is very useful in the determination of the profit and loss of a business and showing the financial position of the business.

2. Comparison of results: Accounting information when properly recorded can be used to compare the results of one year with those of earlier years so that the significant changes can be analyzed.

3. Assistance to management: The accounting information helps the management to plan its future activities by preparing budgets in respect of sales, production, expenses, cash, etc. Accounting helps in coordination of various activities in different departments by providing financial details of each department. The managerial control is achieved by analyzing in money terms the departures from the planned activities and by taking corrective measures to improve the situation in future.

4. Helpful in assessing the tax liability: Generally, a businessman has to pay corporate tax, VAT and excise duty, etc. Therefore, it is necessary that proper accounts should be maintained to compute the tax liability of the business.

5. Helpful in the case of insolvency: Sometimes the businessman becomes the insolvent. If he has properly maintained the accounts, he will not face the problems in explaining few things in the court.

6. Provides information to interested parties: Interested parties like owners, creditors, management, employees, customers, government, etc. are interested in accounting information.

7. Raising of funds become easy: It helps in raising funds from investors or financial institutions by promising investors a fixed claim (interest payments) on the cash flows generated by the assets, with a limited or no role in the day-to-day running of the business.

1.2.10 Limitation of Accounting

1. Recording of monetary items only: In accounting only those transactions, which have the monetary value, are recorded. And those transactions which do not have the financial value whether those are important in business are not recorded in the accounting.

2. Effect of inflation: In accounting the transactions are recorded at the historical cost. Accordingly the assets of the business are shown at cost in the balance sheet. Thus the balance sheet prepared on the basis of historical cost ignores the price-level changes (inflation). In this way the balance sheet of the business does not present the true and fair picture of the business.

3. Accounting information may be biased: Accounting information is not without personal influence or bias of the accountant. In measuring income, accountant has a choice between different methods of inventory valuation, deprecation methods, treatment of capital and revenue items etc. Hence, due to the lack of objectivity income arrived at may not be correct in certain cases.

4. Conflict between accounting principles: In accounting, one accounting principle conflicts another. For instance, inventory should be valued on the basis of 'least of the cost and market price' as per the principle of the conservatism.

1.3 Check Your Progress

A. State whether the following statements are True or False

1. Accounting as a language of business is used by a company organisation only.
2. All the transactions in a business enterprise are recorded on cash basis.
3. Accounting and book-keeping are two terms which have different meaning.
4. Accounting is an art s well as science.

B. Fill in the blanks

1. Accountancy refers to the entire body of the theory and practice of ________________.
2. ________________ serves the information needs of insiders i.e. owners, managers and employees.
3. ______________ is prepared to check the arithmetical accuracy of accounts.

1.4 Summary

Accounting is the art of recording, classifying, summarising and analysing the business transactions and interpreting the results thereof. In accounting, only those transactions and events are recorded which can be measured in terms of money. Book-keeping and accounting are often used interchangeably but they are different from each other. Accounting is a broader and more analytical subject. It includes the design of accounting systems which the book-keepers use, preparation of financial statements, audits, cost studies, income-tax work and analysis and interpretation of accounting information for internal and external end-users as an aid to making business decisions. Users of accounting information are owners, managers, government, customers, shareholders, debenture holders etc. There are different types of accounting like financial accounting, cost accounting, management accounting, forensic accounting, green accounting and social accounting etc.

1.5 Keywords

Financial Accounting; A branch of accounting used to record business transactions for a certain period called Accounting Period.

Income Statement: Statement showing the results of business operations.

Balance Sheet: Statement showing the financial position of a business organization.

Book-Keeping: Art and science of recording transactions which can be expressed in terms of money.

Double Entry System: System of accounting in which every transaction and event have effect on two accounts.

1.6 Self-Assessment Test

1. What do you mean by Accounting? Discuss the characteristics of accounting in detail.
2. Define the term Accountancy. How it differs from accounting? Also discuss the users of accounting information.
3. Elaborate the advantages and limitations of Accounting.
4. What do you mean by Double Entry System? How it differs from Single Entry System? Explain the merits of Double Entry System.

5. Distinguish between Cash Basis of Accounting and Accrual Basis of Accounting.

1.7 Answers to Check Your Progress

Check Your Progress A

1. False
2. False
3. True
4. True

Check Your Progress B

1. Accounting
2. Management Accounting
3. Trial Balance

1.8 References/Suggested Readings

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Course: **Financial Accounting-I**	
Course Code: **BCOM 101**	Author: Dr. B.S. Bodla
Lesson No: **2**	SLM Conversion By: Ms. Chand Kiran

ACCOUNTING CONCEPTS AND CONVENTIONS

Structure

2.0 Learning Objectives

After studying this lesson, you should be able to-

- Appreciate the need for a conceptual framework of accounting principles.
- Explain the various accounting concepts and accounting conventions.

- Know the importance and advantages of uniformity in accounting policies and practices.

2.1 Introduction

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

2.2 Meaning and Features of accounting Principles

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

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

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

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

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

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

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

2.2.1 Kinds of Accounting Principles

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

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

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

2.2.1.1 Accounting Concepts

The more important accounting concepts are briefly described as follows:

1. Separate Business Entity Concept

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

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

2. Money Measurement Concept

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

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

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

3. Dual Aspect Concept

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

Assets = Liabilities + Owners Equity …(1)

Owners Equity = Assets- Liabilities …(2)

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

4. Going Concern Concept

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

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

5. Accounting Period Concept

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

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

6. Cost Concept

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

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

7. The Matching concept

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

8. Accrual Concept

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

9. Realisation Concept

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

2.2.1.2 Accounting Conventions

Following are the accounting conventions:

1. Convention of Materiality

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

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

2. Convention of Conservatism

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

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

3. Convention of Consistency

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

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

Accounting standards

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

a) provide a basic framework for preparing financial statements to be uniformly followed by all business enterprises,

b) make the financial statements of one firm comparable with the other firm and the financial statements of one period with the financial statements of another period of the same firm,

c) make the financial statements credible and reliable, and

d) create general sense of confidence among the outside users of financial statements.

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

In order to harmonise varying accounting policies and practices, the Institute of Chartered Accountants of India (ICAI) formed the Accounting Standards Board (ASB) in April, 1977. ASB includes representatives from industry and government. The main function of the ASB is to formulate accounting standards. This Board of the Institute of Chartered Accountants of India has so far formulated 39 Accounting Standards, the list of these accounting standards is furnished. Regarding the position of Accounting standards in India, it has been stated that the standards have been developed without first establishing the essential theoretical framework. As a result, accounting standards lack direction and coherence. This type of limitation also existed in UK and USA but it was remedied long back.

International Financial Reporting Standards are standards for Financial Reporting issued by the International Accounting Standards Board keeping in specifying broad guidelines on how financial reporting around the globe should be done. As the world is squeezing into one global market, it's imperative to have certain standards of financial reporting for easy understanding and comparison of various financial statements.

Modern economies rely on cross-border transactions and the free flow of international capital. More than a third of all financial transactions occur across borders, and that number is expected to grow. Investors seek diversification and investment opportunities across the world, while companies raise capital, undertake transactions or have international operations and subsidiaries in multiple countries.

In the past, such cross-border activities were complicated by different countries maintaining their own sets of national accounting standards. This patchwork of accounting requirements often added cost, complexity and ultimately risk both to companies preparing financial statements and investors and others using those financial statements to make economic decisions.

Applying national accounting standards meant amounts reported in financial statements might be calculated on a different basis. Unpicking this complexity involved studying the minutiae of national accounting standards, because even a small difference in requirements could have a major impact on a company's reported financial performance and financial position—for example, a company may recognize profits under one set of national accounting standards and losses under another.

2.3 Check your Progress

A. Fill in the blanks:

1. ______________ are those rules of action or conduct which are adopted by the accountants universally while recording accounting transactions.
2. ______________ means assumption and ideas which are fundamental to accounting practice.
3. Only those business transactions are recorded in accounting which can be expressed in terms of ______________.
4. According to dual Aspect Concept, every business transaction has ______________ effect.

B. State whether the following statements are True or False:

1. Going concern concept requires the life of business should be divided into appropriate segments for studying the financial results.
2. Matching concept is based on the accounting period concept.
3. Cost concept means that all assets remain on the accounting records at their original cost for all times to come.
4. Convention of materiality states that items of small significance must be given strict theoretically correct treatment.

2.4 Summary

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

2.5 Keywords

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

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

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

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

Depreciation: Decrease in the value of fixed assets.

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

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

2.6 Self assessment Tests

1. State whether the following statements are true or false:

   a) The ‘materiality concept’ refers to the state of ignoring small items and values from accounts.

b) Accounting principles are rules of action or conduct which are adopted by the accountants universally while recording accounting transactions.

c) The 'separate entity concept' of accounting is not applicable to sole trading concerns and partnership concerns.

d) The 'dual aspect' concept result in the accounting equation: Capital+Liabilities = Assets.

e) The 'conservatism concept' leads to the exclusion of all unrealised profits.

f) The balance sheet based on 'Cost concept' is of no use to a potential investor.

g) Accounting standards are statements prescribed by government regulatory bodies.

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

i) Accounting concepts are broad assumptions.

2. Choose the correct answer from the alternations given:

(I) Accounting standards are statements prescribed by

a) Law

b) Bodies of shareholders

c) Professional accounting bodies

(II) Accounting Principles are generally based on

a) Practicability

b) Subjectivity

c) Convenience in recording

(III) The Policy of 'anticipate no profit and provide for all possible losses' arises due to convention of

a) Consistency

b) Disclosure

c) Conservatism

(IV) Which is the accounting concept that requires the practice of crediting closing stock to the trading account

a) Going concern

b) Cost

c) Matching

(V) The convention of conservatism, when applied to the balance sheet, results in

a) understatement of assets liabilities

b) understatement of

c) understatement of capital.

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

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

5. Write short notes on:

a) Going concern concept

b) Dual aspect concept

c) Business entity concept

d) Convention of materiality

e) Convention of conservatism.

6. Why accounting practices should be standardised? Explain.

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

2.7 ANSWER TO CHECK YOUR PROGRESS

Check your Progress A

1. Accounting Principles

2. Accounting Postulates
3. Money
4. Dual

Check your Progress B

1. False
2. True
3. False
4. False

2.8 References/suggested readings

1. R. Narayanaswamy, “Financial Accounting”, Prentice Hall of India, New Delhi.
2. Ashok Banerjee, “Financial Accounting”, Excel Book, New Delhi.
3. George Foster, “Financial Statement Analysis”, Pearson Education.
4. S.P. Jain, “Corporate Accounting”, Kalayani Publishers, New Delhi.

EXHIBIT-I

International Financial Reporting Standard

1. IFRS1: First-time Adoption of International Financial Reporting Standards
2. IFRS 2: Share-based Payment
3. IFRS 3: Business Combinations
4. IFRS 4: Insurance Contracts
5. IFRS 5: Non-current Assets Held for Sale and Discontinued Operations
6. IFRS 6: Exploration for and Evaluation of Mineral Resources
7. IFRS 7: Financial Instruments: Disclosures
8. IFRS 8: Operating Segments
9. IFRS 9: Financial Instruments
10. IFRS 10: Consolidated Financial Statements

11. IFRS 11: Joint Arrangements
12. IFRS 12: Disclosure of Interests in Other Entities
13. IFRS 13: Fair Value Measurement
14. IFRS 14: Regulatory Deferral Accounts
15. IFRS 15: Revenue from Contracts with Customers
16. IFRS 16: Leases
17. IFRS 17: Insurance Contracts

EXHIBIT-II

INDIAN ACCOUNTING STANDARDS (Ind AS) ISSUED

1. Indian Accounting Standard (Ind AS) 101: First-time Adoption of Indian Accounting Standards
2. Indian Accounting Standard (Ind AS) 102: Share-based Payment
3. Indian Accounting Standard (Ind AS) 103: Business Combinations
4. Indian Accounting Standard (Ind AS) 104: Insurance Contracts
5. Indian Accounting Standard (Ind AS) 105: Non-current Assets Held for Sale and Discontinued Operations
6. Indian Accounting Standard (Ind AS) 106: Exploration for and Evaluation of Mineral Resources
7. Indian Accounting Standard (Ind AS) 107: Financial Instruments: Disclosures
8. Indian Accounting Standard (Ind AS) 108: Operating Segments
9. Indian Accounting Standard (Ind AS) 109: Financial Instruments
10. Indian Accounting Standard (Ind AS) 110: Consolidated Financial Statements
11. Indian Accounting Standard (Ind AS) 111: Joint Arrangements
12. Indian Accounting Standard (Ind AS) 112: Disclosure of Interests in Other Entities

13. Indian Accounting Standard (Ind AS) 113: Fair Value Measurement

14. Indian Accounting Standard (Ind AS) 114: Regulatory Deferral Accounts

15. Indian Accounting Standard (Ind AS) 115: Revenue from Contracts with Customers

16. Indian Accounting Standard (Ind AS) 1: Presentation of Financial Statements

17. Indian Accounting Standard (Ind AS) 2: Inventories

18. Indian Accounting Standard (Ind AS) 7: Statement of Cash Flows

19. Indian Accounting Standard (Ind AS) 8: Accounting Policies, Changes in Accounting Estimates and Errors

20. Indian Accounting Standard (Ind AS) 10: Events after the Reporting Period

21. Indian Accounting Standard (Ind AS) 12: Income Taxes

22. Indian Accounting Standard (Ind AS) 16: Property, Plant and Equipment

23. Indian Accounting Standard (Ind AS) 17: Leases

24. Indian Accounting Standard (Ind AS) 19: Employee Benefits

25. Indian Accounting Standard (Ind AS) 20: Accounting for Government Grants and Disclosure of Government Assistance

26. Indian Accounting Standard (Ind AS) 21: The Effects of Changes in Foreign Exchange Rates

27. Indian Accounting Standard (Ind AS) 23: Borrowing Costs

28. Indian Accounting Standard (Ind AS) 24: Related Party Disclosures

29. Indian Accounting Standard (Ind AS) 27: Separate Financial Statements

30. Indian Accounting Standard (Ind AS) 28: Investments in Associates and Joint Ventures

31. Indian Accounting Standard (Ind AS) 29: Financial Reporting in Hyperinflationary Economies

32. Indian Accounting Standard (Ind AS) 32: Financial Instruments: Presentation

33. Indian Accounting Standard (Ind AS) 33: Earnings per Share

34. Indian Accounting Standard (Ind AS) 34: Interim Financial Reporting
35. Indian Accounting Standard (Ind AS) 36: Impairment of Assets
36. Indian Accounting Standard (Ind AS) 37: Provisions, Contingent Liabilities and Contingent Assets
37. Indian Accounting Standard (Ind AS) 38: Intangible Assets
38. Indian Accounting Standard (Ind AS) 40: Investment Property
39. Indian Accounting Standard (Ind AS) 41: Agriculture

Course: **Financial Accounting-I**	
Course Code: **BCOM 101**	Author: **Prof. M.C. Garg**
Lesson No: **3**	SLM Conversion By: Ms. Chand Kiran

RECORDING OF TRANSACTIONS- VOUCHER SYSTEM, ACCOUNTING PROCESS, JOURNAL

Structure

3.0 Learning Objectives

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

- Understand the meaning and steps of accounting process.

- Explain the meaning of Journal and narrate its importance.
- Know the rules of journalising.

3.1 Introduction

A business enterprise generally prepares the following two basic financial statements namely Profit and Loss Account to ascertain the profit earned or loss incurred during an accounting period; and Balance Sheet to ascertain the financial position of the business as on a particular date.

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

1. Identification of transaction

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

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

(i) Mr. Mondal started business with capital (brought in cash) ₹ 40,000.

(ii) Paid salaries to staff ₹ 5,000.

(iii) Purchased machinery for ₹ 20,000 in cash.

(iv) Placed an order with Sen & Co. for goods for ₹ 5,000.

(v) Opened a Bank account by depositing ₹ 4,000.

(vi) Received pass book from bank.

(vii) Appointed Sohan as Manager on a salary of ₹ 4,000 per month.

(viii) Received interest from bank ₹ 500.

(ix) Received a price list from Lalit.

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

(i) It is a transaction, because it changes the financial position of Mr. Mondal's business. Cash will increase by ₹ 40,000 and Capital will increase by ₹ 40,000.

(ii) It is a transaction, because it changes the financial position of Mr. Mondal's business. Cash will decrease by ₹ 5,000 and Salaries (expenses) will increase by ₹ 5,000

(iii) It is a transaction, because it changes the financial position of Mr. Mondal's business. Machinery comes in and cash goes out.

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

(v) It is a transaction, because it changes the financial position of the business. Bank balance will increase by ₹ 4,000 and cash will decrease by ₹ 4,000.

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

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

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

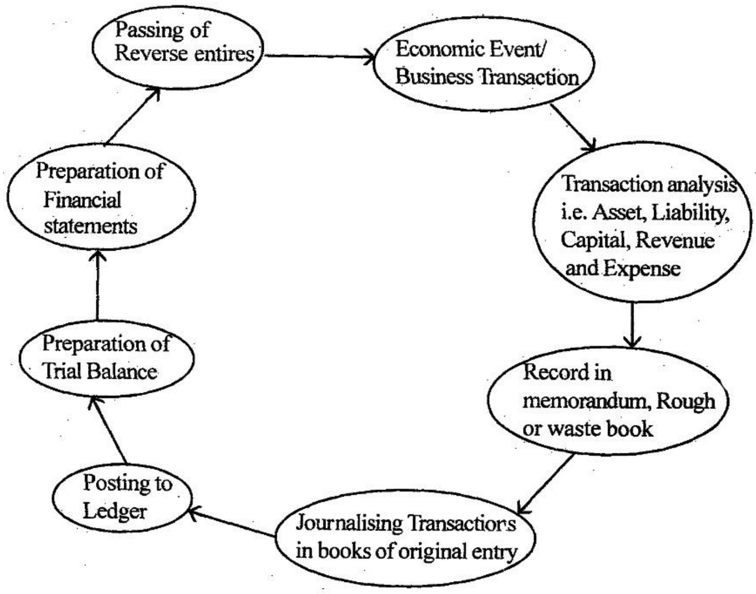
(ix) It is not a transaction, because it does not change the financial position of the business of Mr. Mondal.

2. Recording the transaction

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

3. Classifying

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



Accounting Process

4. Summarising

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

5. Analysis and Interpretation

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

6. Presentation or reporting of financial information

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

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

3.2 Voucher

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

(i) Payment voucher;

(ii) Receipt voucher; and

(iii) Transfer voucher.

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

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

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

3.3 Journal

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

Journal Entry

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

The performa of Journal is shown as follows:

JOURNAL

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

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

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

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

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

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

Advantages of Using Journal

Journal is used because of the following advantages:

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

bicycle represents ordinary goods or machinery. Further any amount paid is debited to bicycle account and credited to cash account.

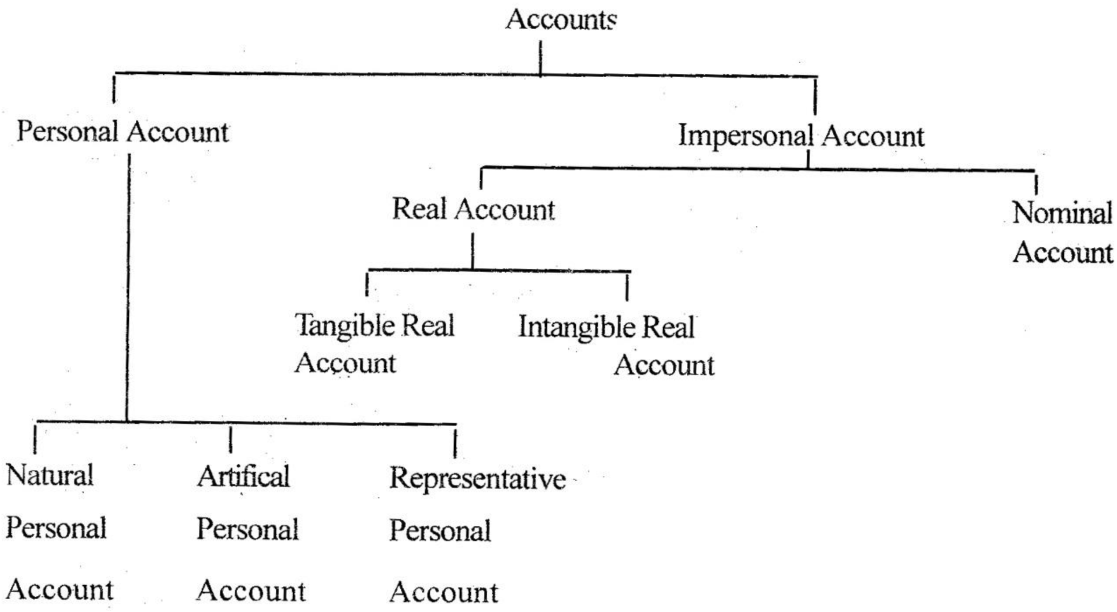
- The use of journals avoids omission or duplication of transactions or parts of transaction. Without the journal the accountant would be forced to got to the individual account to enter debits and credits. Therefore it is possible for accountant to miss part of a transaction, duplicate all or part of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

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

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

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

3.3.1 Classification of Accounts



1. Personal Account

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

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

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

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

2. Real Account

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

3. Nominal Account

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

RULES FOR DEBIT AND CREDIT

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

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

(i) Investments

(ii) Freehold Premises

(iii) Accrued Interest

(iv) Punjab Agro Industries Corporation

(v) Janata Allied Mechanical Works

(vi) Salary Accounts

(vii) Loose Tools Accounts

(viii) Purchases Account

(ix) Indian Bank Ltd.

(x) Capital Account

(xi) Brokerage Account

(xii) Toll Tax Account

(xiii) Dividend Received Account

(xiv) Royalty Account

(xv) Sales Account

Solution

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

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

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

Journalizing

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

(i) Find out what accounts are involved in business transaction.

(ii) Ascertain what is the nature of accounts involved?

(iii) Ascertain the golden rule of debit and credit applicable for each of the accounts involved.

(iv) Find out which account is to be debited which is to be credited.

(v) Record the date of transaction in the "Date Column".

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

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

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

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

Illustration: Analyse the following transactions.

(a) Ramesh started his business with cash

(b) Borrowed from Nikhil

(c) Purchased furniture

(d) Purchased furniture from Mohan on credit

(e) Purchased goods for cash

(f) Purchased goods from Ram on credit

(g) Sold goods for cash

(h) Sold goods to Hari on credit

(i) Received cash from Hari

(j) Paid cash to Ram

(k) Deposited into bank

(l) Withdrew cash for personal use

(m) Withdrew from bank for office use

(n) Withdrew from bank for personal use

(o) Received cash from a customer, Shyam

(p) Paid salary by cheque

(q) Received donation in cash

(r) Paid to Ram by cheque

(s) Paid salary

(t) Paid rent by cheque

(u) Goods withdrawn for personal use

(v) Paid an advance to suppliers of goods

(w) Received an advance from customers

(x) Paid interest on loan

(y) Paid instalment of loan

(z) Interest allowed by bank.

Solution

ANALYSIS OF TRANSACTIONS

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

Transaction	Accounts involved	Nature of accounts	How affected	Whether to be debited or credited
(i)	Cash A/c	Real	Cash is coming in	Debit
	Hari's A/c	Personal	Hari is the giver	Credit
(j)	Ram's A/c	Personal	Ram is the receiver	Debit
	Cash A/c	Real	Cash is going out	Credit
(k)	Bank A/c	Personal	Bank is the receiver	Debit
	Cash A/c	Real	Cash is going out	Credit
(l)	Drawings A/c	Personal	Ramesh is the receiver	Debit
	Cash A/c	Real	Cash is going out	Credit
(m)	Cash A/c	Real	Cash is coming in	Debit
	Bank A/c	Personal	Bank is the giver	Credit
(n)	Drawings A/c	Personal	Ramesh is the receiver	Debit
	Bank A/c	Personal	Bank is the giver	Credit
(o)	Cash A/c	Real	Cash is coming in	Debit
	Shyam's A/c	Personal	Shyam is the giver	Credit
(p)	Salary A/c	Nominal	Salary is an expense	Debit
	Bank A/c	Personal	Bank is the receiver	Credit
(q)	Cash A/c	Real	Cash is coming in	Debit
	Donation A/c	Nominal	Donation is a gain	Credit
(r)	Ram's A/c	Personal	Ram is the receiver	Debit

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

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

2017		₹	2017		₹

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

Solution

IN THE BOOKS OF K.K. CO.

Journal

			Dr.	**Cr.**
Date	**Particulars**	**L.F.**	`	`
2017 Dec. 1.	Cash A/c Dr. To Capital A/c (Being business started with capital)		50,000	50,000
6.	Bank A/c Dr. To Cash A/c (Being cash paid into bank)		20,000	20,000
8.	Purchase A/c Dr. To Cash A/c (Being goods purchased for cash)		4,000	4,000

9.	Ram A/c Dr. To Cash A/c To Discount Received A/c (Being cash paid to Ram and discount received ₹ 20)		2,000	 1,980 20
10.	Cash A/c Dr. To Sales A/c (Being goods sold for cash)		3,000	 3,000
12.	Cash A/c Dr. To Sales A/c (Being goods sold for cash)		2,000	 2,000
15	Purchases A/c Dr. To Ram A/c (Being goods purchased from Ram)		4,000	 4,000
18.	Wages A/c Dr. To Cash A/c (Being wages paid)		300	 300
20.	Cash A/c Dr. Discount Allowed A/c Dr. To Pankaj A/c (Being cash received from Pankaj and allowed him discount ₹ 50)		1,000 50	 1,050
22.	Cash A/c Dr. To Bank A/c		3,000	 3,000

	(Being cash withdrawn from bank)			
25.	Ram A/c Dr. To Bank A/c (Being paid by cheque)		500	 500
31.	Drawings A/c Dr. To Cash A/c (Being withdrawn for personal use)		200	 200
	Grand Total		**90,050**	**90,050**

3.3.2 Goods Account

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

Sub-Division of Goods Accounts

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

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

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

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

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

Opening Entry

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

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

Assets = Liabilities + Capital

Capital = Assets- Liabilities

Illustration: On 1st April 2018, Singh's assets and liabilities stood as follows:

Assets: Cash ₹ 6,000,

Bank ₹ 17,000,

Stock ₹ 3,000;

Bills receivable ₹ 7,000;

Debtors ₹ 3,000;

Building ₹ 70,000;

Investments ₹ 30,000;

Furniture ₹ 4,000

Liabilities: Bills payable ₹ 5000,

Creditors ₹ 9000,

Ram's loan ₹ 13,000

Pass on opening Journal entry

Solution

Date	Particulars		L.F.	Debit Amount (`)	Credit Amount (`)
2018					
April 1	Cash Account	Dr.		6,000	
	Bank Account	Dr.		17,000	
	Stock Account	Dr.		3,000	
	Bills receivable Account	Dr.		7,000	
	Debtors Account	Dr.		3,000	
	Building Account	Dr.		70,000	
	Investment Account	Dr.		30,000	
	Furniture	Dr.		4,000	
	To Bills payable Account				5,000
	To Creditor's Account				9,000
	To Ram's loan Account				13,000
	To Singh's capital				1,13,000
	(Being the opening balances of assets and liabilities)				
				1,40,000	1,40,000

3.3.3 Important Considerations for Recording the business Transactions

Following are the important considerations for recording the business transactions:

1. Trade Discount

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

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

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

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

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

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

(Being Cash paid and discount received)

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

(Being cash received and discount allowed)

3. Goods distributed as free samples

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

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

4. Interest on capital

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

Interest on Capital Account Dr.

To Capital Account

5. Interest charged on Drawings

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

Drawing Account or Dr.

Capital Account Dr.

To Interest on Drawing Account

6. Depreciation charged on Fixed Assets

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

Depreciation Account Dr.

To Asset Account

7. Bad Debts

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

Bad Debts Account Dr.

To Debtor's Account

8. Bad Debts Recovered

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

Cash Account Dr.

To Bad Debts Recovered Account

9. Purchase and Sale of investment

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

Investment Account Dr.

To Cash Account

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

Cash Account Dr.

To Investment Account

10. Loss of Goods by Fire/Accident/theft

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

Loss by fire/Accident/theft Account Dr (for loss)

Insurance Company Account Dr. (for insurance claim admitted)

To Purchases Account

11. Income Tax Paid

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

Capital Account Dr.

Drawing Account Dr.

To Cash Account

12. Bank Charges

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

Bank Charges Account Dr.

To Bank Account

13. Drawings Account

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

Drawings Account Dr.

To Cash Account

To Purchases Account

14. Personal expenses of the proprietor

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

Capital/Drawings Account Dr.

To Cash/Bank

15. Sale of Asset/Property

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

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

Cash/Bank Account Dr.

To Asset/Property Account

To Profit on sale of Asset Account

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

Cash/Bank Account Dr.

Loss on sale of Asset Account Dr.

To Asset Account

16. Amount paid or Received on behalf of customer

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

Customer/Debtor's Account Dr.

To Cash/Bank Account

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

Cash/Bank Account Dr.

To Customer/Debtor's Account

17. Amount paid on behalf of creditors

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

Suppliers/Creditors Account Dr.

To Cash/Bank Account

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

(i) On 1st January 2018 placed on order to Geeta & Sons for the supply of goods worth ₹ 1,00,000.

(ii) Babanjot, a B.Com. graduate has been appointed Sales Assistant on a salary of ₹ 5,000 p.m. on Jan., 2017.

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

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

19. Paid wages/installation charges for erection of machinery

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

Machinery Account Dr.

To Cash/Bank Account

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

Illustration: Journalise the following transactions for the month of January 2018:

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

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

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

4 Carriage ₹ 25 and freight ₹ 70 were paid by the proprietor for the above goods but which are to be charged to Mr. Love Account.

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

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

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

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

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

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

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

Solution

JOURNAL

Dr. Cr.

Date	**Particulars**	**L.F.**	`	`
2018				
Jan. 1	Investment Account Dr.		2,000	

	To Cash Account (Being purchase of shares of Tata Cotton Mills Ltd. paid in cash)			2,000
2	No entry is passed as "placing of an order is not a business transaction."			
3	Mr. Love's Account Dr. To Sales Account (Being the entry for credit sale of goods to Mr. Love at a trade discount of 2%)		980	980
4.	Mr. Love's Account Dr. To Cash Account (Being payment of freight and carriage on behalf of Mr. Love)		95	95
5	Rent Account Dr. To Sales Account (Being rent paid to the landlord in the form of goods, instead of in cash)		150	150
6	Mr. Gobind Account Dr. To Sales account (Being goods sold to Mr. Govind but delivered to A. Merchants as per instructions)		700	700
7	Cash Account Dr. To Love's Account (Being in amount received in cash from Love)		500	500

7	Purchases Account Dr. To Cash Account (Being entry for goods purchased from Mr. Deepu from in cash received from Love)		500	 500
8	Cash Account Dr. To Proprietor's Capital Account (Being amount invested in business out of the sale process of the owner's personal car)		5,000	 5,000
9	Proprietor's Capital Account/Drawing A/c Dr. To Cash Account (Being the amount paid to Manpreet for goods purchased for his personal use)		180	 180
10	Cash Account Dr. Bad Debts Account Dr. To Gobind's Account (Being the amount received from Gobind in full settlement of his debts)		450 250	 700
11	Narinder Dr. To Mohinder (Being cash paid by Mohinder to Narinder)		2,000	 2,000

3.4 Check Your Progress

State whether the following statements are True or False:

1. Journal is a historical record of business transaction or events.
2. Drawings Account is not personal account of the proprietor.

3. Interest paid on capital is an expense.
4. The opening entry is passed by debiting all assets and crediting all liabilities including capital.
5. Sales Account is opened for the goods sold on cash only.

3.5 Summary

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

3.6 Keywords

Transaction: It is an event which can be expressed in terms of money and which brings change in the financial position of a business enterprise.

Receipt Voucher: A Receipt voucher is a document which is issued against cash receipts.

Journal Entry: It is recording the business transactions in the Journal.

Personal Account: Accounts relating to individuals, firms, companies are called personal account.

Journalizing: This is the process of recording journal entries in the Journal.

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

3.7 Self assessment Test

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

2. What is Journal? Distinguish between Journal and Journalising.
3. How you will classify the accounts? State the rules of journalising with respect to each class of accounts.
4. What will be the Journal entry in the following cases:
   (i) Loss of goods by theft
   (ii) Loss of cash from the cash box
   (iii) Sale and purchase of investments
   (iv) Goods taken by the proprietor for his private use.
   (v) Amount paid/received on behalf of others by the business entity
   (vi) Satinder, a marketer appointed at a salary of ₹ 3000 p.m.
5. Mr. Ravindra's position as on 1st Jan. 2018 is follows:

   Property and Assets: Buildings ₹ 15,000
   Furniture ₹ 1,500
   Stock of Goods ₹ 20,000
   Cash at Bank ₹ 5,000
   Cash in hand ₹ 1,000, and
   Customer's Accounts ₹ 15,000.

   Liabilities: Suppliers Accounts ₹ 12,500 and
   Loan Account ₹ 30,000.

   Pass necessary entries to record the above.
6. Miss Twinkle Punia started a restaurant investing ₹ 5,00,000 on Jan. 1, 2018 and further submits the details of the transactions:

2018

Jan.5:	She purchased furniture for ₹ 2,75,000; Crockery ₹ 75,000 and cooking utensils ₹ 38,000
Jan. 10:	She paid ₹ 1,00,000 as Salami for taking the shop on lease for ten years at Daryaganj, Delhi.
Jan. 15:	She took a temporary loan of ₹ 75,000 from her brother Rupinder, a financier.
Jan. 25:	She took a bank loan of ₹ 50,000 and repaid the loan taken from her brother, Rupinder partly.
Jan. 31:	She appointed Lavina as a manager at a salary of ₹ 5000 p.m. and took from her a security deposit of ₹ 50,000.

Pass Journal entire in the books of Twinkle Punia.

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

			`	`
a)	Cash Account	Dr.	4,200	
	To Anil Kumar Account			4,200
	(Received cash from Ajit Kumar on behalf of his friend Ramesh Chandra)			
b)	Goods Account	Dr.	3,000	
	To Dinesh Singh Account			3,000
	(Bought goods from Dinesh Singh for cash)			
c)	Salary Account	Dr.	450	
	To Gopal Krishan Account			450
	(Paid salary to Gopal Krishan)			
d)	Landlord Account	Dr.	600	
	To Bank Account			600

(Paid rent to Landlord by cheque)

e)	Furniture Account	Dr.	1150	
	To Cash Account			150
	(Paid for repairs of Furniture)			

8. Journalise the following transactions:

2018			₹
July	2	Commenced business with Cash	25,000
	4	Purchased furniture for cash	2,000
	4	Cash purchases	14,500
	7	Bought of Somal	2,600
	7	Sold of Monica	808
	9	Rent for two years paid in advance	2,400
	9	Drawings by the proprietor for household expenses	400
	9	Goods taken out by the proprietor for domestic use	50
	9	Cash withdrawn from Bank	2,700
	10	Sold to Manohar	985
	11	Purchases made, payment through cheque	290
	14	Cash received from Popli on account	1,000
	14	Cash paid to Somal after deduction of discount ₹ 130	2,470
	17	Cash received from Manohar in full settlement of his account	975

18	Monica becomes insolvent. A dividend of ₹ 50 paise in a rupee is received.	404
18	Purchase of a scooter for cash	13,000
20	Sold goods to Amrik	864
20	Sold to Neena	378
24	Electricity bill paid	510
24	Cartage paid in cash	5
24	Repairs to scooter, payment not yet made	17
26	Payment of cash for petrol	115
26	Purchases of goods for cash	1,200
26	Purchases of office equipment for cash	1,250
27	Repairs bill paid in cash	17
28	Amrik returns goods	40
31	Depreciation of furniture	110
31	Depreciation of Scooter	220
31	Adjustment for the month's rent	180
31	Bank charges for the month	5
31	Interest on capital for the month	125
31	Salary to be credited to proprietor	200
31	Sonal agrees to take some defective goods purchased from him and immediately refunds the money.	70

9. Journalise the following transactions:

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

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

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

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

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

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

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

(viii) Discounted N's acceptance for ₹ 585 at ₹ 570.

(ix) Sold goods to Murthi and he endorsed M's bill to us.

(x) Bank collected interest on our investments ₹ 95.

(xi) Received dividend on shares of A & Co. Ltd. ₹ 137.

(xii) Received a cheque for ₹ 93 for commission due to us.

(xiii) Invested in Government securities ₹ 5,000.

(xiv) Bought shares in Best & Co. Ltd. for ₹ 3,000.

(xv) Purchased Plant and Machinery for ₹ 15,500.

(xvi) Interest allowed by bank on our current account ₹ 15.

(xvii) Bank charges made by bank ₹ 17.

(xviii) Paid for an insertion in "The Hindu" ₹ 15.

(xix) Bought goods from Seth & Co. for ₹ 750 accepted their bill for ₹ 500 and gave them a cheque for ₹ 250.

(xx) Sold goods to John and Co. for ₹ 650, received their acceptance for ₹ 500 and gave them a cheque for ₹ 250.

(xxi) Returned goods to A.A. ₹ 75.

(xxii) B.B. returned goods to us ₹ 94.

(xxiii) Bought of C & Co., goods for cash ₹ 500.

(xxiv) Received dividend on shares ₹ 55.

(xxv) Bought Prize Bonds of Indian Government for ₹ 150.

(xxvi) Bought National Savings Certificates for ₹ 100.

(xxvii) Paid by cheque A. Anand's bills for repairs to machinery ₹ 120.

(xxviii)Received a cheque for ₹ 350 from B. Balu to be credited to M. Mani's account.

(xxvix) Received from D. Datta ₹ 970.

(xxx) Bank returned D. Datta's cheque dishonoured.

(xxxi) Borrowed for the bank ₹ 5,0000.

(xxxii) Repaid M's loan of ₹ 500 with interest ₹ 25.

3.8 ANSWERS TO CHECK YOUR PROGRESS

1. True
2. False
3. True
4. True
5. False

3.9 References/Suggested readings

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4. Aggarwal, M.P., "Analysis of Financial Statements", Natioanl Publishing House, New Delhi.
5. Michael Tones, "Accounting for Non-Specialists", John Wiley & Sons, Singapore.

Course: Financial Accounting-I	
Course Code: **BCOM 101**	**Author: Karam Pal Singh**
Lesson No: **4**	SLM Conversion By: Ms. Chand Kiran

LEDGER POSTING AND TRIAL BALANCE

Structure

4.0 Learning Objectives

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

- Know the meaning and importance of ledger.
- Understand the rules regarding posting.

- Describe the meaning and objectives of trial balance.

4.1 Introduction

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

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

- Bound Ledger; and
- Loose Leaf Ledger.

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

4.2 Posting

The term 'Posting' means transferring the debit and credit items from the Journal to their respective accounts in the ledger. It is important to note that the exact names of accounts used in the Journal should be carried to the ledger. For example, if in the Journal, Salary Account has been debited, it would not be correct to debit the Outstanding Salary Account in the Ledger. Therefore, the correct course would be to use the same account in both the Journal and Ledger.

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

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

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

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

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

DALMIA'S A/C

Dr. **Cr.**

Date	**Particular**	**J.F.**	**Amount (₹)**	**Date**	**Particular**	**J.F.**	**Amount (₹)**

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

4.2.1 Rules Regarding Posting

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

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

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

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

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

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

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

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

SALARIES ACCOUNT

Dr.			Cr.
Cash A/c	₹ 10,000		

CASH ACCOUNT

Dr.			Cr.

		Salaries A/c	Rs. 10,000

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

Difference between Journal and Ledger

Following are the differences between Journal and Ledger:

(i) The transactions are recorded first in the journal and then they are posted to the ledger. Thus journal is the book of first or original entry while the ledger is the book of second entry.

(ii) The journal is the book of chronological record while the ledger is the book of the analytical record.

(iii) The process of recording transaction in journal is termed as "Journalising" while the process of recording transactions in the ledger is known as 'Posting'.

4.2.2 Balancing of an Account

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

The following steps are followed for balancing the accounts:

(i) Total the amounts of debit and credit entries in the account.

(ii) If the debit and credit sides are equal then there is no balance. The account stands automatically balanced or closed.

(iii) If the debit side total is more, put the difference on the credit side amount column, by writing the words in particulars column "By Balance c/d". If the credit side total is more, put the difference on the debit side amount column by writing the words in the particulars column "To Balance c/d".

(iv) After putting the difference in the appropriate side of the account, add both sides of the account and draw a thin line above and below the total.

(iv) Bring down the debit balance on the debit side by writing the words in particulars column "To Balance b/d". Similarly bring down the credit balance on the credit side by writing the words in the particulars column "By Balance b/d".

This will be clear with the help of the following illustration.

Illustration 1: Journalise the following transactions, post them in the Ledger and balance the accounts as on 31st March, 2018.

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

9. He received cash from Suresh ₹ 1,000

Solution

JOURNAL

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

	To Cash A/c (Being payment of cash to Mohan)			1,000
	Suresh A/c Dr. To Sales A/c (Being goods sold to Suresh)		2,000	2,000
	Cash A/c Dr. To Suresh A/c (Being cash received from Suresh)		1,000	1,000
			24,000	24,000

LEDGER

CASH ACCOUNT

Dr. Cr.

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

CAPITAL ACCOUNT

		₹			`
Mar. 31	To Balance c/d	10,000		By Cash A/c	10,000
		10,000			10,000

			Apr. 1	By Balance b/d	10,000

PURCHASE ACCOUNT

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

MOHAN

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

SURESH ACCOUNT

		₹			`
	To Sales A/c	2,000		By Cash A/c	3,000
	To Sales A/c	2,000		By Cash A/c	1,000
		4,000			4,000

SALES ACCOUNT

		₹			`
Mar. 31	To Balance c/d	4,000		By Suresh A/c	2,000
				By Suresh A/c	2,000

		4,000			4,000
			April. 1	By Balance b/d	4,000

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

4.3 Trial Balance

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

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

Objectives of Preparing a Trial Balance

Following are the objectives of preparing a Trial Balance:

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

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

(ii) Basis for financial statements

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

(iii) Summarised ledger

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

Methods of Preparing the Trial Balance

(i) *Totals Method*: In this method, the totals of debit and credit sides of the ledger accounts are shown in the trial balance. The sum totals of debit and credit columns of the trial balance must be equal. This is less popular method.

(ii) *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 totals are taken out. The total of balances in the debit column must be equal to the total balances in the credit column of the trial balance.

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

Debit Balances as on Jan. 1, 2018: Cash in hand ₹ 8,000; Cash at Bank ₹ 25,000; Stock of goods ₹ 20,000; Furniture ₹ 2,000; Building ₹ 10,000; Sundry Debtors-Vijay ₹ 2,000, Anil ₹ 1,000 and Madhu ₹ 2,000.

Credit Balances on Jan. 1, 2018: Sundry Creditors- Anand ₹ 5,000; Loan from Bablu ₹ 10,000.

The following were further transactions in the month of Jan, 2018:

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

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

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

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

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

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

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

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

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

Jan. 26: Interest received from Madhu ₹ 200.

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

Jan. 31: Sold goods for cash ₹ 500.

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

Solution

JOURNAL

Date	Particulars		L.F.	Debit (`)	Credit (`)
2018					
Jan. 1	Cash A/c	Dr.		8,000	
	Bank A/c	Dr.		25,000	
	Stock A/c	Dr.		20,000	
	Furniture A/c	Dr.		2,000	
	Building A/c	Dr.		10,000	
	Vijay	Dr.		2,000	
	Anil	Dr.		1,000	
	Madhu	Dr.		2,000	
	To Anand				5,000

	To Bablu's Loan A/c To Capital A/c (Being balances brought forward from last year)			10,000 55,000
Jan.1	Purchase A/c Dr. To Cash A/c To Discount A/c (Being purchase of goods on discount)		4,000	 3,800 200
Jan. 4	Cash A/c Dr. Discount A/c Dr. To Vijay (Being cash received from Vijay, allowed discount ₹ 20)		1,980 20	 2,000
Jan. 6	Purchase A/c Dr. To Bharat (Being goods purchased)		5,000	 5,000
Jan. 8	Plant A/c Dr. To Mukesh To Cash A/c (Being plant purchased and payment of charges of ₹ 300)		5,300	 5,000 300
Jan. 12	Rahim To Sales A/c (Being sale of goods to Rahim)	Dr.	600	 600
Jan. 15	Cash A/c Dr. Bad Debts A/c Dr. To Rahim (Being cash received from Rahim) 50 paise in a rupee		300 300	 600
Jan. 18	Cash A/c Dr. To Sales A/c (Being cash sale)		1,000	 1,000
Jan. 20	Salary A/c Dr. To Cash A/c		2,000	 2,000

	(Being salary paid)			
Jan. 21	Anand Dr. To Cash A/c To Discount A/c (Being cash paid to Anand and discount received ₹ 200)		5,000	 4800 200
Jan. 26	Cash A/c Dr. To interest A/c (Being receipt of interest)		200	 200
Jan. 28	Interest on Loan Dr. To cash A/c (Being payment of interest on loan)		500	 500
Jan. 31 Jan. 31	Cash A/c Dr. To Sales A/c (Being cash sale) Drawings A/c Dr. To Purchase A/c (Being goods withdrawn for personal use)		500 200	 500 200
	Total		96,900	96,900

Ledger Posting

CASH ACCOUNT

Dr. Cr.

Date	Particulars	L.F.	Amount (₹)	Date	Particular	L.F.	Amount (₹)
2018				2018			
Jan.1	To Balance b/d		8,000	Jan.1	By Purchase A/c		3,800
Jan.4	To Vijay		1,980	Jan. 8	By Plant A/c		300
Jan.15	To Rahim		300	Jan.20	By Salary A/c		2,000
Jan.18	To Sales A/c		1,000	Jan.21	By Anand		4,800
Jan. 26	To Interest A/c		200	Jan. 28	By Interest on loan A/c		500

Jan. 31	To Sales A/c		500	Jan. 31	By Balance c/d		580
			11,980				11,980
Feb. 1	To Balance b/d		580				

INTEREST ACCOUNT

Dr. Cr.

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

BANK ACCOUNT

Dr. Cr.

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

STOCK ACCOUNT

Dr. Cr.

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

FURNITURE ACCOUNT

Dr. Cr.

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

BUILDING ACCOUNT

Dr. Cr.

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

VIJAY ACCOUNT

Dr. Cr.

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

ANIL ACCOUNT

Dr. Cr.

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

MADHU ACCOUNT

Dr. Cr.

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

ANAND ACCOUNT

Dr. Cr.

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

		5,000			5,000

CAPITAL ACCOUNT

Dr. Cr.

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

BABU'S LOAN ACCOUNT

Dr. Cr.

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

PURCHASE ACCOUNT

Dr. Cr.

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

DISCOUNT ACCOUNT

Dr. Cr.

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

		400			400
			Feb. 1	By Balance	380

BHARAT ACCOUNT

Dr. Cr.

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

PLANT ACCOUNT

Dr. Cr.

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

INTEREST ON LOAN ACCOUNT

Dr. Cr.

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

MUKESH ACCOUNT

Dr. Cr.

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

SALES ACCOUNT

Dr. Cr.

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

RAHIM ACCOUNT

Dr. Cr.

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

BAD DEBTS ACCOUNT

Dr. Cr.

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

SALARY ACCOUNT

Dr. Cr.

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

DRAWING ACCOUNT

Dr. Cr.

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

TRIAL BALANCE

(AS ON 31ST JANUARY, 2018)

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

4.4 CHECK YOUR PROGRESS

Fill in the blanks

1. Classification of the recorded transactions is made in the ________.
2. Trial Balance helps in knowing the __________ accuracy of the accounting entries.
3. Separate accounts should be opened in the Ledger for _______ transactions relating to different accounts recorded in the Journal.
4. The Ledger Folio (L.F.) column in the ________ is used at the time when debits and credits are posted to the Ledger.

4.5 Summary

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

4.6 Keywords

Posting: It means transferring the debit and credit items from the Journal to their respective accounts in the ledger.

Trial Balance: This is a statement containing the various ledger balances on a particular date.

Ledger: It is a book which contains various accounts.

4.7 Self assessment TEST

1. Explain the rules regarding posting of transactions into the Ledger.
2. What is a Trial Balance? Explain its objectives.

3. Discuss and differentiate between Journal and Ledger.

4. Journalise the following transactions and post them into Ledger:

2018

September	1	Started business with ₹ 50,000, out of which pad into Bank ₹ 20,000.
September	2	Bought furniture for ₹ 5,000 and machinery for ₹ 10,000.
September	3	Purchased goods for ₹ 14,000.
September	6	Sold goods for ₹ 8,000.
September	8	Purchased goods from Malhotra and Co. ₹ 11,000.
September	10	Paid telephone rent for the year by cheque ₹ 500.
September	11	Bought one typewriter for ₹ 2,100 from Universal Typewriter Co. on credit.
September	15	Sold goods to Keshav Ram for ₹ 12,000.
September	17	Sold goods to Rajesh Kumar for ₹ 2,000 for cash.
September	19	Amount withdrawn from bank for personal use ₹ 1,500.
September	21	Received cash from Keshav Ram ₹ 11,900, discount allowed ₹ 100.
September	22	Paid into bank ₹ 5,800.
September	23	Bought 50 shares in X Y and Co. Ltd at ₹ 60 per share, brokerage paid ₹ 20.
September	25	Goods worth ₹ 1,000 found defective were returned to Malhotra and Co. and the balance of the amount due to them settled by issuing a cheque in their favour.
September	28	Sold 20 shares of X Y and Co. Ltd. at ₹ 65 per share, brokerage paid ₹ 20.
September	28	Brought goods worth. 2,100 from Ramesh and supplied them to Suresh at ₹ 3,000.
September	30	Suresh returned goods worth ₹ 100, which in turn were sent to Ramesh.

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

5. Prepare Journal, Ledger and Trial Balance from the following information. On 1st January, 2018, the following were the ledger balances of Rajan and Co.: Cash in hand ₹ 900; Cash at bank ₹ 21,000; Soni (Cr.) ₹ 3,000; Zahir (Dr.) ₹ 2,400; Stock ₹ 12,000; Prasad (Cr.) ₹ 6,000.

Transactions during the month were:

2018		`	2018		`
Jan. 2	Bought goods from Prasad	2,700	Jan.22	Paid cash for stationery	50
Jan.3	Sold to Sharma	3,000	Jan.29	Paid to Prasad by cheque	2,650
Jan.5	Bought goods from Lall for cash paid by cheque	3,600			
Jan.7	Took goods for personal use	200	Jan. 30	Provide interest on capital	100
Jan.13	Received from Zahir in full		Jan. 30	Rent due to landlord	200
	Settlement	2,350			
Jan.17	Paid to Soni in full settlement	2,920			

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

January 1, 2018 *Assets*: Furniture ₹ 5,000; Machinery ₹ 10,000; Stock ₹ 4,000; Cash in hand ₹ 550; Cash at bank ₹ 7,450; Amount due from Ramesh and Co. ₹ 1,000 and amount due from Suresh ₹ 2,000.

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

2018		`	2018		`
Jan 1	Purchased goods from Ajay	4,500	Jan.25	Cash purchases	16,500
Jan 3	Sold goods for cash	1,500	Jan.27	Goods worth ₹ 500 were damaged in transit; a claim was made on the railway authorities for the same.	
Jan 5	Paid to Himanshu by cheque	5,500			
Jan 10	Deposited in bank	2,800	Jan.28	Suresh is declared insolvent and a dividend of 50 paise in the rupee is received from him in full settlement	
Jan 13	Sold goods on credit to Mukesh	1,700	Jan. 28	Bought a horse for ₹ 2,600 and a carriage for ₹ 1,200 for delivering goods to customers, paid by cheque	
Jan 15	Paid for postage	100	Jan.30	The horse bought on Jan. 29 dies, and its carcase was sold for ₹ 1,000	
Jan 16	Received cash from Rakesh	2,200	Jan.31	Allowed interest on capital @ 10% p.a. for one month	

Jan 17	Paid telephone charges	250	Jan. 31	Paid Salaries ₹ 150	
Jan 18	Cash sales	1,500			
Jan 20	Purchased Govt. Securities	500			
Jan 22	Purchased goods worth trade discount and 5% cash discount from Mahesh and Co. for cash and supplied them to Ramesh and Co. at list price less 10% trade discount				

4.8 ANSWERS TO CHECK YOUR PROGRESS

1. Ledger
2. Arithmetical
3. Posting
4. Journal

4.9 References/suggested readings

1. Ashish K. Bhattacharyya, "Financial Accounting for Business Managers", Prentice Hall of India Pvt. Ltd., New Delhi.
2. P.C. Tulsian, "Financial Accounting", Tata McGraw Hill, New Delhi.
3. S.N. Maheshwari, "Management Accounting and Financial Control", Sultan Chand and Sons, New Delhi.
4. George Foster, "Financial Statement Analysis", Pearson Education.

Course: **Financial Accounting-I**	
Course Code: **BCOM 101**	Author: **Prof. M. C. Garg**
Lesson No: **5**	SLM Conversion By: Ms. Chand Kiran

RECTIFICATION OF ERRORS

Structure

5.0 learning Objectives

After going through this lesson, you should be able:

- To know the meaning and types of accounting errors.

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

5.1 Introduction

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

a) Presenting correct accounting records;

b) Ascertaining correct profit or loss for the accounting period; and

c) Exhibiting a true financial position of the concern on a particular date.

5.2 Accounting errors and rectification

5.2.1 Classification of ACCOUNTING errors

The errors can be classified as follows:

- Clerical Errors
- Errors of Principle

5.2.1.1 Clerical errors

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

a) Errors of omission

b) Errors of commission

c) Compensating errors

a) Errors of Omission

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

b) Errors of Commission

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

c) Compensating Errors

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

5.2.1.2 Errors of Principle

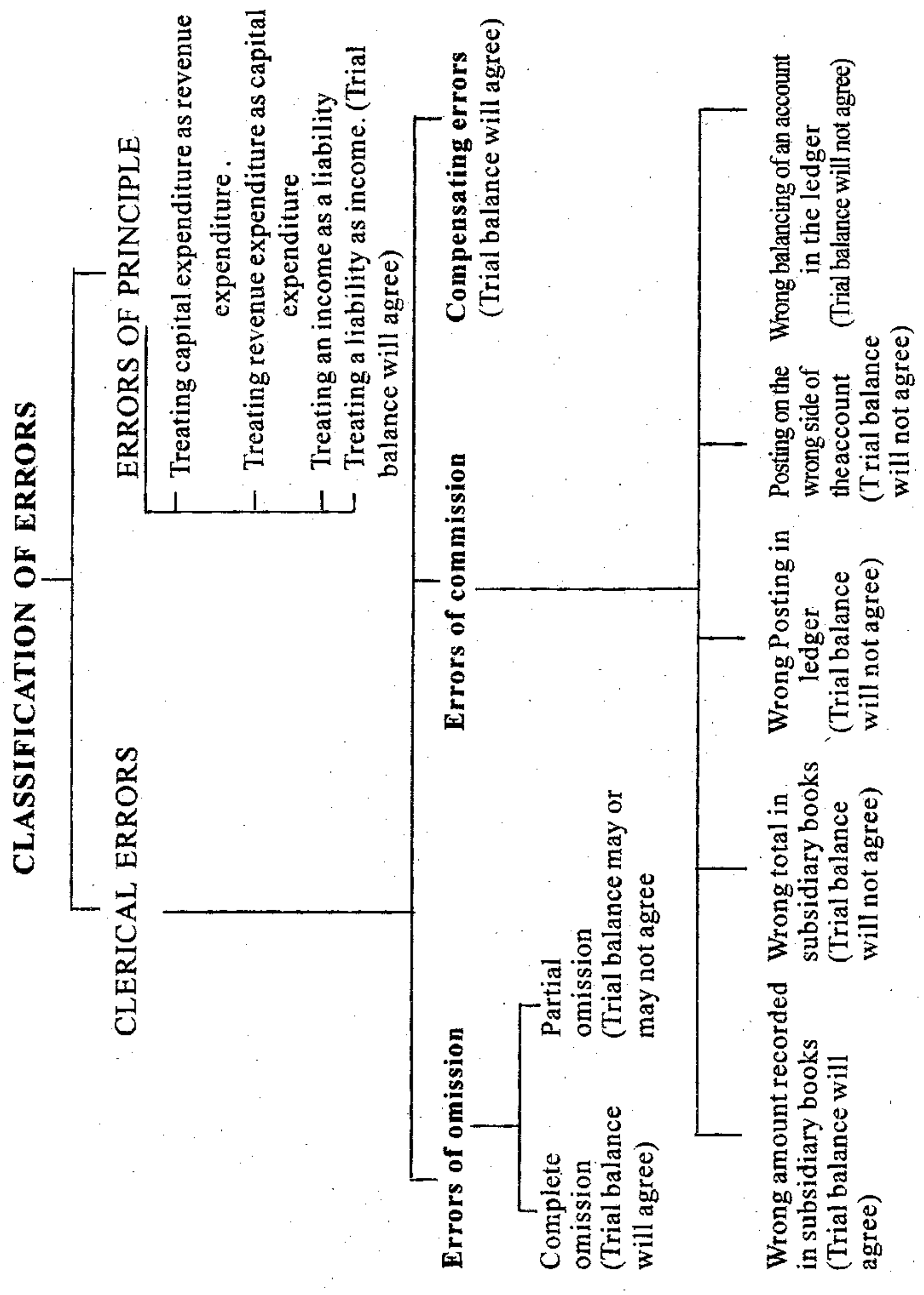
When a transaction is recorded against the fundamental principles of accounting, it is an error of principle. These errors arise because of the failure to differentiate between capital and revenue items i.e. a capital expenditure is taken as a revenue expenditure or vice-versa. Similarly, a capital receipt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

5.2.2 Location of errors

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

5.2.2.1 Errors which do not affect the agreement of Trial Balance

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



5.2.2.2 Errors which affect the agreement of Trial Balance

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

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

ii) Make sure that the balances of cash and bank is included.

iii) The difference of the two sides of the trial balance should be found and be divided by two and then find out whether a figure equal to the same (i.e. half the difference) appears in the trial balance. This procedure would enable to locate the amount placed on the wrong side.

iv) If the error remains undetected, divide the exact difference by 9. If it is divisible by 9, this will mean that there may be transposition error or slide error. A transposition error is committed when the digit of an amount is misplaced. For example, machinery account has a balance of ₹ 5689, but it has been written as ₹ 5869 in the trial balance. The resulting error is ₹ 180, which is divisible by 9. A slide error is committed when the decimal point is placed incorrectly. For example, ₹ 3670 is copied as ₹ 36.70. The resulting error is ₹ 3633.30 which is also divisible by 9.

v) See that there is no mistake in balancing of the various accounts.

vi) The schedules of debtors and creditors should be scrutinised so as to find out that all the debtors and creditors have been included in these schedules; their totals are correct.

vii) If the difference is of a substantial amount, compare the figures of trial balance of the current year with the trial balance of the preceding year and see whether there is any abnormal difference between the balances of important accounts of the two trial balances.

viii) The total of subsidiary books should be checked and it should be seen whether posting has been done from these books correctly to respective accounts in the ledger or not.

ix) It should be checked that opening balances have been correctly brought forward in the current year's books.

x) If the difference is still not traced, check thoroughly the books of original entry and their posting into the ledger and finally the balancing of various accounts.

xi) If the error still remains undetected, repeat the above steps with the help of other members of the staff, who are not involved in maintaining the books of accounts.

5.2.3 Rectification of errors

From the point of view of rectification of errors, these can be divided into two groups:

a) Errors affecting one account only.

b) Errors affecting two or more accounts.

5.2.3.1 Errors affecting One Account

The following errors affect only one account:

(a) Errors of posting

(b) Carry forward

(c) Balancing

(d) Omission from trial balance

(e) Casting

Such errors should first of all be located and rectified. These are rectified either with the help of journal entry or by giving an explanatory notes in the account concerned and not by simply crossing the wrong amount and inserting the right one.

5.2.3.2 Errors affecting two or more accounts

The following errors affect two or more accounts:

(a) Errors of omission

(b) Posting to wrong account

(c) Principle

As these errors affect two or more accounts, rectification of such errors is done with the help of a journal entry.

5.2.4 Stages of rectification of errors

All types of errors can be rectified at two stages:

i) Before the Preparation of Final Accounts.

ii) After the Preparation of Final Accounts.

5.2.4.1 Rectification of errors before the preparation of Final Accounts

If the error is located before the preparation of final accounts, it is either rectified by recording or posting the necessary amount in the respective account or by recording the necessary journal entry to rectify that error. If the error is one sided, it can be rectified by recording or posting the necessary amount in that account. If it is two sided, the necessary journal entry is recorded.

a) Rectification of One sided errors

These are the errors which affect one account and will affect the agreement of trial balance. Such errors are rectified by debiting or crediting the affected account in the ledger. For example:

i) Purchase Book has been undercast by ₹ 2,000.

The error is only in Purchases Account. If ₹ 2000 is now posted in the debit side of Purchase Account as "To undercasting of Purchase Book", the error will be rectified.

ii) Amount of ₹ 1000 paid to Hari not debited to his personal account.

This error is affecting the personal account of Hari and its debit side is less by ₹ 1000 because of omission to post the amount paid. We shall now write on the debit side of Hari Account as "To Cash (omitted to be posted) ₹ 1000 to rectify this error.

iii) Goods sold to Khan wrongly debited in Sales Account.

This error is affecting the Sales Account only as the amount which should have been posted on the credit side has been wrongly placed on the debit side of the same account. By putting double the amount of transaction on the credit side of Sales Account by writing "By sales to Khan wrongly debited previously", this error shall be rectified.

b) Rectification of two sided errors

As these errors affect two or more accounts, rectification of such errors can often be done with the help of a journal entry. These types of errors do not affect the agreement of trial balance. For example, if furniture purchased has been recorded through purchase book, two accounts viz. Purchases Account and Furniture Account are affected. Thus, rectification will be made by taking these two accounts. When such errors are to be rectified, the following procedure should be followed:

1. What has been done? The journal entry which has been recorded:

Purchase Account	Dr.	Incorrect entry
To Supplier's Account		

2. What should have been done? The correct entry which was to be recorded:

Furniture Account	Dr.	
To Supplier's Accounts		Correct entry

3. What should now be done? The rectifying entry which is now to be recorded:

Furniture Account	Dr.	Journal entry relating to
To Purchases Account		rectification of an error

Illustration 1: An amount of ₹ 4000 paid to R. Ramesha has been credited to the account of S. Ramesha.

It is obvious that the credit, placed wrongly to the account of S.Ramesha, should be transferred to the account of R. Ramesha. The correcting entry is:

		₹	₹
S. Ramesha's Account	Dr.	4,000	
To R.Ramesha's Account			4,000

5.2.4.2 Rectification of errors after the preparation of Final Accounts

The rectification of errors after the preparation of final accounts depends upon the nature of error. If an error is a one sided error, it can be corrected by passing a rectifying entry with the help of the Suspense

Account and if the error is two sided, it is rectified by passing a rectifying entry in both the affected accounts and such errors are not rectified through Suspense Account.

Suspense account

In case, the accountant is not in a position to locate the difference in the totals of the trial balance and he is in a hurry to close the books of accounts, he may transfer the difference to an account known as "Suspense Account". After transferring the difference, the trial balance is totalled and balanced. On locating the errors in the beginning or during the course of next year, suitable accounting entries are passed and the Suspense Account is closed. However, the Suspense Account should be opened only when the accountant has failed to locate the errors in spite of his best efforts. It should not be by way of a normal practice, because the very existence of the Suspense Account creates doubt about the authenticity of the books of accounts.

a) Rectification of one sided errors

It may be noted that one sided errors affect the agreement of trial balance. Hence, one sided errors are rectified through the Suspense Account. For example:

i) An item of ₹ 68 was posted as ₹ 86 in the Sales Account.

In this case, the Sales Account has been credited by ₹ 86 instead of ₹ 68, so the entry with the help of Suspense Account shall be as follows:

		₹	₹
Sales A/c	Dr.	18	
To Suspense A/c			18
(Being Sales account wrongly credited with ₹ 86 instead of ₹ 68, now corrected)			

ii) The total of purchase book has been taken ₹ 9 short.

In this case, the purchase book has been undercast by ₹ 9 so we should further debit the Purchase Account by Rs. 9.

		₹	₹
Purchases A/c	Dr.	9	
To Suspense A/c			9
(Being total of purchase book now corrected)			

iii) A sum of ₹ 102 written off as depreciation on furniture has not been posted to Depreciation Account.

In this case, Depreciation Account has not been debited, so the entry shall be:

		₹	₹
Depreciation A/C	Dr.	102	
To Suspense A/C			102

(Being depreciation on furniture not posted previously now posted)

b) Rectification of two sided errors

As already stated, two sided errors do not affect the agreement of trial balance. These errors are rectified by means of journal entries in the affected account. The procedure for rectification of two sided errors is same whether they are located either before the preparation of final accounts or after the preparation of final accounts.

5.3 Effect of errors on final accounts

It is desirable to know the effect of errors on the final accounts i.e. on the Trading and Profit and Loss Account and the Balance Sheet. Some of the errors affect the Trading and Profit and Loss Account while others affect the Balance Sheet. How these two statements will be affected depends upon the nature of the accounts in which the error lies. If the error affects the nominal account/accounts, it will increase or decrease the profit because all nominal accounts are transferred to Trading and Profit and Loss Account. In this regard, the following points are to be noted:

1. Profit will increase or loss will reduce if a transaction is omitted to be posted to the debit side of a nominal account. On rectification of such a type of error, profit will decrease or loss will increase. For example salary paid to an employee is wrongly posted to his personal account and consequently salary

paid is omitted to be posted to Salary Account. This error will increase the profit or reduce the loss because salary paid will not be transferred to Profit and Loss Account. At the time of the rectification of error, Salary Account will be debited and consequent thereupon, profit will decrease or loss will increase.

2. Similarly, profits will reduce or loss will increase if a nominal account is wrongly debited. With the rectification of such an error, profit will increase or loss will decrease. For example, an amount of ₹ 2000 spent on erection of machinery wrongly debited to Repairs Account instead of Machinery Account will reduce net profit by ₹ 2000 On rectification of this error, Machinery Account will be given debit and Repairs Account will be credited and consequently profit will increase or loss will decrease.

3. Profit will increase or loss will decrease if a nominal account is wrongly credited. With the rectification of this type of error, profit will decrease or loss will increase. For example, if ₹ 5000 received on account of sale of old furniture was posted to Sales Account instead of Furniture Account, the error will increase profit or decrease loss because sales will be shown at an increased amount of ₹ 5000 on the credit side of the Trading and Profit and Loss Account. At the time of the rectification of error, Sales Account will be given debit. As a result, profit will decrease or loss will increase.

4. Profit will decrease or loss will increase if an item is omitted to be posted to the credit side of a nominal account. With the rectification of the error, profit will increase or loss will decrease. For example, interest on debentures of ₹ 2,000, received is omitted to be posted to the credit side of the Interest on Debentures Account. This error will decrease profit or increase loss because interest on debentures received will not be transferred to the credit side of the Profit and Loss Account as an item of income. At the time of the rectification of the error, Interest on Debentures Account will be given a credit and, as a result, profit will increase or loss will decrease.

5. Due to increase or decrease in profit/loss by the errors in nominal accounts, the Capital Account will also, be increased or decreased. Thus, the errors in nominal accounts will also affect the Balance Sheet because the Capital Account is shown on the liability side of the Balance Sheet. So, an error in a nominal account will affect both the Profit and Loss Account and the Balance Sheet.

6. If there is an error in the personal accounts of the debtors or creditors of the business concern, their respective accounts will be increased or decreased. This will have its effect on the Balance Sheet only because debtors and creditors are shown in the Balance Sheet as Assets and Liabilities

respectively. Similarly, if an error is in a real account, such as Plant and Machinery Account, Cash Account, Land and Building Account, the Balance Sheet alone will be affected because assets are shown in the Balance Sheet only.

Illustration 2: The trial balance of a trader has agreed but the following errors are discovered after the preparation of the final accounts:

i) ₹ 500 posted to the Depreciation Account as Depreciation on Plant and Machinery was not posted to the Plant and Machinery Account.

ii) Return Outward Book is overcast by ₹ 10.

iii) Purchases Book is overcast by ₹ 4,000.

iv) An amount of ₹ 1,000 received as dividend on shares has been posted to the debit of the Interest Account.

v) Furniture was purchased from Rahim for ₹ 9,600 but the entry was passed for ₹ 6,900.

vi) ₹ 1,200 received from Anil Kapoor in settlement of account, posted to the credit of the Sales Account.

vii) Outstanding interest on loan ₹ 500 omitted to be recorded.

viii) ₹ 600 paid for the purchase of office stationery was wrongly debited to the Purchases Account.

ix) Sales of ₹ 6,000 to Mushtaq omitted to be posted to his account.

x) ₹ 200 paid for repairs were written as ₹ 20 in the Repairs Account.

xi) Discount Received ₹ 50, omitted to be posted to the Discount Received Account.

Show the effect of these errors on the Final Accounts.

Solution

EFFECT OF ERRORS ON THE FINAL ACCOUNTS

	Trading and Profit and Loss Account		Balance Sheet
1.	No effect because depreciation has been posted to the Depreciation Account and hence already debited to the Profit and Loss Account.	1.	Plant and Machinery Account is overstated by ₹ 500 because depreciation has not been deducted from the Plant and Machinery Account.
2.	Gross Profit is overcasted by ₹ 10, so net Profit is also overstated by ₹ 10.	2.	Capital Account is overstated by ₹ 10 because of the increase in Profit.
3.	Gross Profit is understated by ₹ 4,000 and net profit has also been understated by ₹ 4,000.	3.	Capital Account is understated by ₹ 4,000 because of the decrease in Net Profit.
4.	Net Profit is understated by ₹ 2,000 because Interest Account has been debited instead of being credited.	4.	Capital Account is understated by ₹ 2,000 because of the decrease in Net Profit.
5.	No effect because the error relates to a Personal and real Accounts.	5.	Creditors and Furniture have been understated by ₹ 2,700.
6.	Gross Profit and Net Profit overstated by ₹ 1,200 because of higher sales shown in the Trading Account.	6.	Capital Account and Sundry Debtors are overstated by ₹ 1,200.
7.	Net Profit has been overstated by ₹ 500.	7.	Capital Account is overstated by ₹ 500 and creditors understated by ₹ 500.
8.	Gross Profit understated by ₹ 600. No effect on Net Profit.	8.	No effect on Balance Sheet.
9.	No effect on Gross Profit and Net Profit.	9.	Sundry Debtors are understated by ₹ 6,000.

	Trading and Profit and Loss Account		Balance Sheet
10.	Net Profit has been overstated by ₹ 180 because Repairs Account is posted with ₹ 20 instead of ₹ 200.	10.	Capital Account has been overstated by ₹ 180 because of decrease in Net Profit.
11.	Net profit has been understated by ₹ 50 because Discount Received Account is omitted to be posted.	11.	Capital Account has been understated by ₹ 50 because of the decrease in Net Profit.

5.4 Check Your Progress

A. State whether the following statements are True/False

1. The basic information for the preparation of final accounts is supplied by the Balance Sheet.
2. Clerical errors are those errors which are committed by the clerical staff during the course of recording the business transactions in the books of accounts.
3. Errors of commission take place when some transactions are incorrectly recorded in the books of accounts.
4. Compensating Errors are of a non-neutralizing nature.

B. Fill in the blanks

1. When a transaction is recorded against the fundamental principles of accounting, it is an____________.
2. The rectification of errors after the preparation of final accounts depends upon the nature of ______.
3. _____________ should be opened only when the accountant has failed to locate the errors in spite of his best efforts.
4. Two sided errors do not affect the _________ of trial balance.

5.5 Summary

Trial balance in which the total of the debits equal the total of credits is not a conclusive proof of accuracy of the records. Certain errors may not affect the agreement of a trial balance as the errorneous entries may not violate the dual aspect concept. It, therefore, becomes utmost important to locate such errors and rectify them so that the true financial position of the business may be ascertained. So whenever errors in accounting records come to notice, they should be rectified. The errors can be clerical errors or errors of principle. The clerical errors are those errors which are committed by the clerical staff during the course of recording the business transactions in the books of accounts, e.g., errors of omission, errors of commission and compensating errors. Error of principle includes those transactions which are recorded against the fundamental principles of accounting. Suspense account is opened when the accountant is not in a position to locate the differences in the totals of the Trial Balance. It should not be by way of a normal practice, because the very existence of the Suspense Account creates doubt about the authenticity of the books of accounts.

5.6 Keywords

Trial Balance: A statement which is prepared to check the arithmetical accuracy in the accounting system.

Rectifying Entry: A journal entry which is passed to remove the effect of errors.

Two-sided Errors: Errors which affects two accounts simultaneously.

One-sided Errors: Errors which affects only one account.

Suspense Account: An account created to balance the total of Trial Balance.

5.7 Self assessment Test

1. What are the various kinds of errors? Which of these affect the agreement of trial balance?
2. What is suspense account? How is it prepared?
3. Is the agreement of trial balance a conclusive proof of the accuracy of the books of accounts? Discuss.

4. State which of the following errors will affect the agreement of the Trial Balance and which will not. Give rectifying journal entries wherever relevant assuming the difference in Trial Balance has been placed to Suspense Account.

   i) Purchase of a second-hand Motor Car for ₹ 15,000 has been debited to Motor Car Maintenance Account.

   ii) A sale of ₹ 5,000 to Shriram has been wrongly entered in the Sales Day Book ₹ 500.

   iii) An entry in the Purchases Returns Book of ₹ 2,000 has been omitted to be posted in the account of Shri Ramji, the supplier.

   iv) An amount of ₹ 2,000 received from Shrikant has been posted to the credit of Shriman as ₹ 200.

   v) The total of the Sales Day Book for the month of July ₹ 1,50,000 has been omitted to be posted in the ledger.

5. Messers Modern Chemicals were unable to agree the Trial Balance on 30th June 2018 and have raised a Suspense Account for the difference. Later the following errors were discovered and rectified and the Suspense Account was balanced.

   a) The addition of the "Sundry Purchases" column in the Tabular Purchases Journal was short by ₹ 150 and other totals were in order.

   b) A Bill of Exchange (received from Gupta) for ₹ 2,000 had been returned by the Bank as dishonoured and had been credited to the Bank and debited to Bills Receivable Account.

   c) Goods of the value of ₹ 105 returned by the customer, Thomas had been posted to the debit of Thomas and also to the Sales Returns.

   d) Sundry items of Furniture sold ₹ 3,000 had been entered in the Sales Day Book, the total of which had been posted to Sales Account.

   e) An amount of ₹ 600 due from Vaz, a customer, had been omitted from the Schedule of Sundry Debtors.

f) Discount amounting to ₹ 30 allowed to a customer had been dully posted in his account, but not posted to Discount Account.

g) Insurance premium of ₹ 450 paid on 30th June, 2018 for the year ended 30th June 2018 had not been brought forward.

You are requested to (i) pass Journal Entries to rectify the above mistakes; (ii) draw up the Suspense Account after rectifying the above mistakes; and (iii) explain how the above errors affect the book profits for the year ended 30th June, 2018.

6. The following errors are detected in the books of Pradeep Kumar. Pass necessary journal entries for their rectification.

   i) ₹ 400 paid on account of the tuition fee of the proprietor's daughter, Miss Reena, has been debited to General Expenses Account.

   ii) ₹ 1,450 paid as Salary to a clerk posted as ₹ 1,250 to the Salary Account.

   iii) An item of ₹ 750 for goods sold to Aruna debited to Kruna.

   iv) ₹ 2,000 received in respect of bad debts but posted as cash sales.

   v) Discount ₹ 50 allowed by Rajesh omitted to be entered in the discount column of the Cash Book.

   vi) ₹ 200 received as commission, debited to Commission Account.

   vii) A credit purchase of ₹ 375 from Mohit and Co. has been entered in Purchases Book but the payment subsequently made to them has been debited to their personal account.

5.8 ANSWERS TO CHECK YOUR PROGRESS

Check Your Progress A

1. False
2. True
3. True
4. False

Check Your Progress B

1. Error of principle
2. Error
3. Error of principle
4. Agreement

5.9 References/Suggested Readings

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3. P.C. Tulsian, “Financial Accounting”, Tata McGraw Hill, New Delhi.
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Course: **Financial Accounting-I**	
Course Code: **BCOM 101**	Author: **Dr. Suresh K. Mittal**
Lesson No: **6**	

Capital and Revenue: Receipts & Expenditure

STRUCTURE:

6.0 Learning Objectives

After going through this lesson, the learner should be able to:

- Know the meaning of capital expenditures and revenue expenditures.
- Understand the deferred revenue expenditures.

- Know the meaning of capital and revenue profits.
- Know the meaning of capital and revenue losses.

6.1 Introduction

The concepts of capital and revenue are of fundamental importance to the correct determination of accounting profit for a period and recognition of business assets at the end of that period. The distinction affects the measurement of profit in a number of accounting periods. The profit or loss of a business can be ascertained by matching business revenues against the cost of the same period. Therefore, a clear understanding between capital and revenue (expenditures and receipts) is necessary for the correct ascertainment of profit or loss. It may be noted that revenue items are included only in income statement or profit or loss account and capital items form part of balance sheet figures. Let us examine the features of capital and revenue items in the accounting parlance.

6.1.1 Capital Expenditures and Revenue Expenditures: Meaning

Capital Expenditure: The outflow of funds to acquire an asset that will benefit the business for more than one accounting period. A capital expenditure takes place when an asset or service is acquired or improvement of a fixed asset is affected. These assets are expected to provide benefits to the business in more than one accounting period and are not intended for resale in the ordinary course of business. In short, it is an expenditure on assets which is not written off completely against income in the accounting period in which it is acquired. For example, the purchase of a car to be use to deliver goods is capital expenditure. Included in capital expenditure are such costs as: Delivery of fixed assets; Installation of fixed assets; Improvement (but not repair) of fixed assets; Legal costs of buying property etc. In simple words, Capital expenditure is money spent on the purchase of permanent or fixed assets for use in the business for long period and not for immediate resale or on the permanent improvement of or addition to or extension of an existing asset with a view to increase the earning capacity of the business enterprise.

Examples of capital expenditures fall into four groups:

(i) Tangible fixed assets such as plant and machinery, land, building, furniture, fixtures and fittings, motor vehicles, office equipment (e.g., typewriters, calculating machines, and computers). Legal expenses paid in connection with the purchase of assets (e.g., registration charges) and expenses of delivering or installing fixed assets like machinery are included in the cost of fixed assets.

(ii) Intangible fixed assets like goodwill, trademarks, patents, copyrights etc.

(iii) Investments in shares and debentures of other companies for a long period.

(iv) Cost of financing a fixed asset (i.e., interest paid on loans to purchase a fixed asset) is added to its cost only for the period up to the time or before the asset is put to use.

Revenue Expenditure: The outflow of funds to meet the running expenses of a business and it will be of benefit for the current period only. Revenue expenditure is incurred to carry on the normal course of business or maintain the capital assets in a good condition. It may be pointed out here that expenditure need not necessarily be a payment made to somebody in cash - it may be made by the exchange of another asset, or by assuming a liability. For example, the cost of petrol or diesel for cars is revenue expenditure, Maintenance of Fixed Assets; Administration of the business; Selling and distribution expenses. Revenue expenditure is money spent on materials and services which are used by a business enterprise in carrying out normal business activities and maintenance of fixed assets and to maintain productivity and earning capacity (and not to increases) of firms. The direct benefit of such expenditure is available in the accounting period itself or one year at the most. The examples of revenue expenditures are given below:

(a) The cost of finished goods or materials used in the manufacture of goods intended for resale.

(b) Establishment costs that is, rent, rates, heat, light, repairs to property etc.

(c) Administrative costs, that is, wages, salaries, telephone, postage, stationery etc.

(d) The costs of selling and distributing the goods, that is, commission, advertising, carriage outwards etc..

(e) Financial costs, that is, cash discount, interest on borrowings.

(J) All expenses incurred for maintaining the efficiency or upkeep of fixed assets by means of repairs, replacement, renewable and insurance.

Revenue expenditure gives benefit for the current accounting period or at the most for one year only.

Basis of Distinction between Capital and Revenue Expenditures

(i) **Nature of spending:** Capital expenditure is the amount spent on acquiring a permanent asset while revenue expenditure is incurred for carrying on business and maintaining the fixed assets efficiently.

(ii) **Earning capacity:** Capital expenditure increases the revenue earning capacity of the business. But revenue expenditure does not do so e.g., an expenditure incurred to increasing the seating capacity of a cinema theatre is capital expenditure since it will increase the earning capacity.

(iii) **Value addition:** Capital expenditure may add to the value of an existing asset while the revenue expenditure will not add any value to net assets.

(iv) **Disclosure:** Capital expenditure is shown in the balance sheet while the revenue expenditure is transferred to trading or profit and loss account.

Revenue Expenditures to be Treated as Capital Expenditures

There are certain types of revenue expenditures which become capital expenditures depending upon the nature of the transactions as explained below:

(i) **Wages:** Normally “wages” constitute a revenue item. But when wages are paid to a workman to install a new machine they are added to the cost of the machine making it a capital expenditure. Similarly wages paid to workers engaged in the construction of a fixed asset such as building, bridge etc. are treated as a cost of the relevant fixed asset.

(ii) **Repairs:** The money spent on repairs of a second hand machine amounts to capital expenditure since the repairs are necessary to put the machine to use. However repairs done later on for efficient running of the machine are treated as revenue expenditure.

(iii) **Legal expenses** incurred in the purchase of fixed assets must be treated as part of the cost of the asset.

(iv) **Transportation costs** incurred in moving a new machine or a second hand machine from the place of manufacturer to the business premises are added to the cost of machine or any other fixed asset.

(v) **Raw materials and stores consumed** in the construction or making of a fixed asset are also treated as cost of the asset.

(vi) Interest on capital paid during the construction works or machine or building must be treated as capital expenditures.

(vii) Development expenditures: In certain enterprises such as tea, coffee, rubber plantations and mines, considerable money has to be spent on development work before production starts. All such expenditures are called development expenditures and must be treated as capital expenditures.

Considerations in Determining Capital and Revenue Expenditures:

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

(a) Nature of Business: For a trader dealing in furniture, purchase of furniture is revenue expenditure but for any other trade, the purchase of furniture should be treated as capital expenditure and shown in the balance sheet as asset. The nature of business is a very important criterion in separating expenditure between capital and revenue.

(b) Recurring nature of expenditure: It the frequency of an expense is quite often in an accounting year then it is said to be an expenditure of revenue nature while non-recurring expenditure is infrequent in nature and do not occur often in an accounting year.

(c) Purpose of expenses: Expenses for repairs of machine may be incurred in course of normal maintenance of the asset. Such expenses are revenue in nature. On the other hand, expenditure incurred for major repair of the asset so as to increase its productive capacity is capital in nature.

(d) Effect on revenue generating capacity of business: The expenses which help to generate income/ revenue in the current period are revenue in nature and should be matched against the revenue earned in the current period. On he other hand, if expenditure helps to generate revenue over room than one accounting period, it is generally called capital expenditure.

(e) Materiality of the amount involved: Relative proportion of the amount involved is another important consideration in distinction between revenue and capital.

Difference between Capital and Revenue Expenditure:

Capital Expenditure	**Revenue Expenditure**
Capital expenditure is incurred in acquiring or improving permanent assets	Revenue expenditure is a routine expenditure incurred in the normal course

which are not meant for resale.	of business and includes cost of sales.
Capital expenditure seeks to improve the earning capacity of the business.	Revenue expenditure is incurred to maintain the earning capacity of the business.
Capital expenditure is normally a non-recurring outlay.	Revenue expenditure is usually a recurring feature.
Capital expenditure produces benefits over several years. Hence, only a small part is charged as depreciation to income statement and the rest appears in the balance sheet.	Revenue expenditure is consumed within an accounting year and the entire amount is charged to the (current year's) income statement.

Illustration 1: State whether the following are capital or revenue expenditure.

(i) Paid a bill of Rs.10, 000 of Mr. Kumar, who was engaged as the erection engineer to set up a new automatic machine costing Rs.20, 000 at the new factory site.

(ii) Incurred Rs.26, 000 expenditure on varied advertisement campaigns under taken yearly, on a regular basis, during the peak festival season.

(iii) In accordance with the long-term plan of providing a well- equipped Labour Welfare Centre, spent Rs.90, 000 being the budgeted allocation for the year.

Solution:

(i) Expenses incurred for erecting a new machine should be treated as a Capital Expenditure.

(ii) Advertisement expenses during peak festival season should be treated as a Revenue Expenditure.

(iii) Expenses incurred for Labour Welfare Centre should be treated as a Capital Expenditure.

Illustration 2: For each of the cases numbered below, indicate whether the income/expenditure is capital or revenue.

(i) Payment of wages to one's own employees for building a new office extension.

(ii) Regular hiring of computer time for the preparation of the firm's accounts.

(iii) The purchase of a new computer for use in the business.

(iv) The use of motor vehicle, hired for five years, but paid at every six months.

Solution:

(i) Payment of wages for building a new office extension should be treated as a Capital Expenditure.

(ii) Computer hire charges should be treated as a Revenue Expenditure.

(iii) Purchase of computer for use in the business should be treated as a Capital Expenditure.

(iv) Hire charges of motor vehicle should be treated as a Revenue Expenditure.

Illustration 3:

Classify the following between capital and revenue giving reasons for the same

(i) ` 5,000 spent towards additions to the machinery.

(ii) Repairs for ` 1,000 necessitated by negligence.

(iii) ` 500 spent to remove a worn out part and replace it with a new one.

(iv) ` 100 wages paid in connection with the erection of a new machinery.

(v) Old machinery of book value ` 7,500 worn out, dismantled at a cost of ` 1,000 and scrap realised for ` 100.

(vi) Second hand motor car purchased for ` 10,000 and spent ` 1,000 for repairs immediately.

(vii) Employees State Insurance premium ` 600 paid.

(viii) Insurance claim of ` 5,000 received from the insurance company for loss of goods by fire of ` 6,000.

Solution:

(i) Capital expenditure since it will result in an increase in the earning capacity of the business.

(ii) Revenue expenditure since it is not going to improve the asset any way.

(iii) Revenue expenditure since the expenditure is in the nature of repairs and maintenance. It will only maintain the existing capacity of the asset.

(iv) Capital expenditure because the amount spent is upto the point an asset is ready for use.

(v) Old machinery with value of ` 7,500 less ` 100 realised on selling of scrap will be treated as revenue along with dismantled charges of ` 1,000. The amount realised from sale of scrap is capital receipt.

(vi) Capital expenditure. Motor car purchased for ` 10,000 whether second hand or new will be treated as capital expenditure, and also the amount spent for its repairs is a capital expenditure so as to make it ready for use.

(vii) Revenue expenditure since it is purely a business expenditure.

(viii) Revenue expenditure i.e., ` 1,000.

Illustration4:

Show by giving reasons whether the following items of expenditure are capital or revenue

(i) Damages paid on account of breach of contract to supply certain goods.

(ii) Cost of pulling down an old building preparatory to building a new one.

(iii) Cost of cleaning and levelling land purchased for business use.

(iv) Premium paid for a lease.

(v) Canal irrigation charges paid to Government.

(vi) A Tractor standing in the books at ` 15,000 was sold for ` 30,000.

(vii) ` 5,00,000 received from an issue of further shares, the expenses of issue being ` 5,000.

Solution:

(i) Damages paid on account of the breach of contract to supply certain goods are revenue expenditures incurred in the ordinary course of business.

(ii) The cost of pulling down an old building preparatory to building a new one is capital expenditure as it is a part of the cost of the new building.

(iii) The cost of cleaning and levelling land purchased for business use is capital expenditure as it has been incurred for making the land ready for use.

(iv) Capital expenditure since leasehold property is a fixed asset.

(v) Revenue expenditure as it represents the cost of cultivation.

(vi) ` 30,000 received from the sale of a Tractor is a capital receipt, and ` 15,000 is a capital profit as it results from the sale of a fixed asset.

(vii) ` 5,00,000 is a capital receipt and ` 5,000 being the cost of issue is a deferred revenue expenditure because no asset is created.

Capitalised Expenditure

Where expenditure is incurred as an important part of an asset such as in the construction or installation of an asset or expenditure is required to increase the earning capacity, such expenditures are treated as part of the asset and are added to the cost of the asset. This process is called capitalisation of the expenditure. Some of the examples of capitalised expenditure may be noted as:

(i) Expenses on the formation of a joint stock company.

(ii) Cost of issuing shares and debentures such as legal expenses, underwriting commission etc.

(iii) Expenses on installation of assets.

Thus capitalised expenditures are added to the cost of fixed assets to increase its total cost.

6.1.2 Deferred Revenue Expenditures

Deferred revenue expenditures represent certain types of an asset whose usefulness does not expire in the year of their occurrence but generally expires in the near future. These types of expenditures are carried forward and are written off in future accounting periods. For example a business can pay insurance premium in advance, say, for a 3 year period. The right does not expire in the accounting period in which it is paid but will expire within a fairly short period of time (3 years). Only a portion of the total premium paid should be treated as a revenue expenditure (portion pertaining to the current period) and the balance should be carried forward as an asset to be written off in subsequent years. Thus, deferred revenue expenditure is revenue in character but –

(i) the benefit of which is not exhausted in the year of expenditure, or

(ii) is applicable either wholly or in part to the future years, or

(iii) is accidental with heavy amount and it is not prudent to charge it against the profit of one year.

There are certain expenditures which are primarily revenue in nature but the benefit from which is not consumed in the year in which the expenditure is incurred. Such expenditures are called deferred revenue expenditures. Such expenditures are carried forward or spread over a number of accounting periods during which the business is expected to benefit from the same.

Types: Deferred revenue expenditures are of following types:

(i) **Expenses which are wholly paid in advance** and for which the benefit is received in future, e.g., prepaid insurance, prepaid salaries, prepaid rent, prepaid subscriptions and so on.

(ii) **Expenses which provide part of the benefit during the current accounting period itself and the remaining benefit in the subsequent or future accounting periods.** For example a business enterprise spends ` 2,00,000 on advertisement campaign in 2011 and its benefit is estimated to be available for five years. In this case only a proportionate amount, that is, ` 40,000 (one-fifth of ` 2,00,000) would be charged against the profits of the year 2011 and the balance will be shown as a temporary asset in the balance sheet.

(iii) **Expenses which are incurred once a while or very rarely.** Such expenses are not incurred in the normal course of business but for a special purpose. For example: expenses incurred on the formation of company called preliminary expenses; expenses incurred on the issue of shares and debentures; development expenditures like market research and so on.

Distinction between Capital Expenditure and Deferred Revenue Expenditure

The distinction between capital expenditure and revenue expenditure is difficult to make and one has to do it not on any sound reasons but rather arbitrarily:

(i) The main characteristics of capital expenditure is that it results in a benefit which will accrue to the business enterprise for a long time, e.g., purchase of a machine likely to be used for say 10 years. Deferred revenue expenditure also results in a benefit which will accrue in future period but generally for 3 to 5 years.

(ii) Furthermore, the capital expenditure is usually capable of being reconverted into cash though may be at a loss. This is not possible in case of deferred revenue expenditure; for instance the benefit of a heavy advertising campaign may be available for the next five years but the business enterprise cannot sell the advertising results to another firm.

(iii) Sometimes heavy losses such as due to an earthquake are also treated as deferred revenue expenditure in the sense that they are written off over 3 to 4 years. Such a loss cannot be termed as capital expenditure.

Illustration 5:

State whether the following expenses are capital, revenue or deferred revenue expenditure:

(i) A Ltd. spent Rs. 2,00,000 for overhauling the machinery which improved the capacity utilization and saved running expenditure by Rs. 15,000 p.a.

(ii) Compensation paid to undesirable employees.

(iii) M/s Durga & Co. spent Rs. 2,50,000 for organising an Inter-school Cricket Tournament in Delhi. This was held for advertising their new school bag and other books and stationery which they want to market.

(iv) Rs. 12,000 paid to Mahanagar Telephone Nigam Ltd. for installing telephone in the office.

(v) Damages paid on account of breach of contract to supply certain goods.

(vi) Rs. 25,000 has accrued during the year on term loan obtained and utilised for the construction of factory building and purchase of machineries, however, the production has not commenced till the last date of the year.

(vii) Imported goods worth Rs. 1,75,000 confiscated by customs authorities for non-disclosure of material facts.

(viii) Rs. 20,000 spent for the trial run of newly installed machinery.

Solution:

(i) Expenses for overhauling the machinery increases capacity utilisation which contributes to increase the revenue generating capacity. Also saving in revenue expenditure for more than one accounting period will accrue from this overhauling which will increase future profit. Hence, this expense is capital in nature.

(ii) Compensation paid to retrench undesirable employees is expected to increase revenue earning capacity of the business because such undesirable employees would either waste resources or time with adverse effect on profit. The expenditure is capital in nature.

(iii) The purpose of expenses incurred for organising the Inter-School Cricket Tournament is to advertise for some new products. This advertisement has some enduring effect so far as the marketability of the new product is concerned. The expense may be treated as deferred revenue expenditure.

(iv) The money deposited with Mahanagar Telephone Nigam Ltd. for acquiring telephone connection is treated as an asset; hence it is a capital expenditure.

(v) Damages paid on account of the breach of contract to supply certain goods are treated as revenue expenditure incurred in the ordinary course of the business.

(vi) Interest accrued on term loan obtained and utilised for the construction of factory building and purchase of machinery should be treated as capital expenditure since commercial production has not started till the last date of the accounting year.

(vii) The confiscation of imported goods by the customs authorities is a loss arisen on account of negligence and is abnormal nature. It is appropriate to write it off to profit and loss account over a period of 2 to 5 years treating it as deferred revenue expenditure.

(viii) Expenses incurred for trial run of newly installed machinery is capital expenditure in nature.

6.1.3 Capital Receipts and Revenue Payments: Meaning

Capital Receipts: Receipts comprising of payments or contributions into the business by the proprietor, partners or other shareholders towards the capital of the firm and also any sum received from debenture holders, any loans and the proceeds of sale of any fixed assets of a business enterprise. Capital receipts do not have any effect on the profits earned or losses incurred during the course of a year. In other words, Capital receipts are contributions into the business by the proprietor, partners or shareholders (in the case of a joint stock company) towards the capital of the firm. And also any sums received from debenture holders, any loans and the proceeds of sale of any fixed assets of a business enterprise and not being in the nature of a normal sale.

Revenue receipts or incomes are the moneys received from firm's activity in the normal course of business such as sales revenue, commissions and fees receive for services rendered, interest on any investment, discounts received etc..

The following guidelines are helpful in deciding about capital or revenue receipt:

(a) The nature of the receipt is to be decided from the point of the person receiving it and not the source by which the payment was made. For example, the payment of interest out of capital by a company, when it is yet to commence its business is a capital expenditure for the company but it is a revenue receipt for the person receiving it.

(b) The intention of the owner of the property is also material in deciding the nature of the receipt especially in a single transaction. For example, the receipt from the sale of securities (e.g., shares) held on as investment - is a capital receipt but if the securities are held for speculative purpose, the sale proceed constitutes revenue receipt.

(c) Sale of fixed assets like machinery, building or furniture is a capital receipt while the sale of inventories is a revenue receipt.

(d) A receipt in lieu of source of income is capital receipt, e.g., compensation received on death or permanent disability because such receipt is a substitution of source of income.

(e) When a sum is received for the surrender of certain right, it is a capital receipt e.g., compensation paid by Municipal Corporation on acquisition of agricultural land for the construction of roads or bridges. It is capital receipt since it is in lieu of the right to work on the farm. But where the sum received is in the nature of compensation for the loss of future profit, it is a revenue receipt.

Revenue Receipts: A receipt of money is considered as revenue receipt when it is received from customers for goods supplied or fees received for services rendered in the ordinary course of business, which is a result of the firm's activity in the current period. Revenue receipts must be set off against the revenue expenses in order to calculate the profit or loss of the business in an accounting period. Receipts of money in the revenue nature increase the profits or decrease the losses of a business. Expenditure is the full amount actually incurred whether paid or outstanding, whilst payment refers to the amount actually paid. Thus capital payment is an amount actually paid on account of some capital expenditure and revenue payment is an amount actually paid on account of some revenue expenditure. For example, if a Motor Van is purchased for ` 50,000 paying ` 20,000 immediately and ` 30,000 on a later date, ` 50,000 is a capital expenditure while ` 20,000 is a capital payment. Similarly, if goods are purchased from 'A as to ` 2,000 in cash and ` 3,000 on credit, ` 5,000 is revenue expenditure but only ` 2,000 is revenue payment. Now the actual process of preparing the final accounts begins in the subsequent paragraphs.

Difference between Capital Receipts and Revenue Receipts:

Capital Receipts	**Revenue Receipts**
It is shown in the Balance Sheet on the liability side.	It is shown in profit and loss account on the credit side, as an income for the year
It has long-term effect. The benefit is enjoyed for many years in future.	It has short-term effect. The benefit is enjoyed within one accounting period.
Sometimes expenses of revenue nature are to be incurred for such receipt e.g. on obtaining loan (a capital receipt) interest is paid until its repayment.	Sometimes, expenses of capital nature are to be incurred for revenue receipt, e.g. purchase of shares of a company is capital expenditure but dividend received on shares is a revenue receipt.
Amount received for surrender of certain rights under an agreement is a capital receipt, because a capital asset is being given up in the form of these rights.	Amount received as compensation under an agreement for the loss of future profits is a revenue receipt.
Capital receipt, when invested, produces revenue receipt e.g. when capital is invested by the owner, business gets revenue receipt (i.e. sale proceeds of goods etc.).	It does not produce capital receipt.

6.2 Capital and Revenue Profits: Meaning

If profit arises out of an ordinary nature, being the outcome of the ordinary function and object of the business, it is termed as ‘Revenue Profit’. But when a profit arises out of a casual and non-recurring transaction, it is termed as Capital Profit. Capital Profit arises from:-

(a) Profit prior to incorporation;

(b) Premium received on issue of shares;

(c) Profit made on re-issue of forfeited shares;

(d) Redemption of Debenture at a discount;

(e) Profit made on sale or revaluation of a Fixed Asset.

Capital profits are those which are earned as a result of selling some fixed assets, or in connection with raising capital for the firm. For instance, a machinery purchased for Rs. 1, 50,000 was subsequently sold for Rs. 2,00,000, this Rs. 50,000 will be profit of capital nature. Similarly when a company issues its shares of the face value Rs. 100 for Rs. 105 each, it is said that shares have been issued at premium which is capital profit. Capital profits are either capitalized i.e. transferred to capital account or transferred to capital reserve account which may be utilized for meeting capital losses. Profits earned on account of sale of fixed assets or in connection with share capital are termed as capital profits. For example, when a machinery purchased for ` 1,00,000 is sold for ` 1,20,000, the excess of ` 20,000 will be capital profit. Similarly when shares are issued at premium, the amount of security premium is capital profit. Revenue profits on the other hand are those which are earned in the ordinary course of business e.g., sale of goods or stock costing ` 10,000 for ` 15,000, ` 5,000 being the difference between sale price and cost price constitutes revenue profit.

6.3 Capital and Revenue Losses

Revenue losses are the losses which arise during the normal course of business whereas capital losses are those which occur when selling fixed assets or raising share capital. If a building purchased for Rs. 70,000 is sold for Rs. 50,000, there will be capital loss of Rs. 20,000. Similarly when shares of the face value of Rs. 100 are issued at Rs. 95 i.e. at a discount of Rs. 5, the amount of discount will be capital loss. Treatment of capital losses is same as that of capital profits. Capital losses arising out of sale of fixed assets generally appear in the Profit and Loss Account (being deducted from the net profit). But other capital losses are adjusted against the capital profits. Where the capital losses are substantial, the treatment is different. These losses are generally shown on the balance sheet as fictitious assets and the common practice is to spread that over a number of accounting years as a charge against revenue profits till the amount is fully exhausted. Examples of revenue losses are: loss of stock by fire, bad debts, misappropriation or embezzlement of cash by employees etc. And any loss which cannot be classified as revenue loss would be capital loss. It may be added that the loss incurred in the course of business activity and is incidental to it is a revenue loss.

6.4 Check Your Progress

A. State whether the following statements are True or False

1. Overhaul expenses of plant and machinery are capital expenditure.
2. Legal fee to acquire fixed assets is Revenue Expenditure.
3. Every expenditure of large amount is a capital expenditure.
4. Heavy expenditure on advertising campaign is a deferred revenue expenditure.

B. Fill in the blanks

1. All items of revenue nature are shown in the _____________.
2. Any expenditure whose benefit is spread over a number of years is called_____________.
3. Amount spent on purchasing a patent is treated as____________________.

6.5 Summary

Capital expenditure means outflow of funds to acquire an asset that will benefit the business for more than one accounting period. A capital expenditure takes place when an asset or service is acquired or improvement of a fixed asset is affected where the Revenue Expenditure is outflow of funds to meet the running expenses of a business and it will be of benefit for the current period only. Revenue expenditure is incurred to carry on the normal course of business or maintain the capital assets in a good condition. Capital Receipts comprises of payments or contributions into the business by the proprietor, partners or other shareholders towards the capital of the firm and also any sum received from debenture holders, any loans and the proceeds of sale of any fixed assets of a business enterprise where the Revenue Receipts are money received from customers for goods supplied or fees received for services rendered in the ordinary course of business.

6.6 Keywords

Capital Expenditure: Expenses incurred in acquiring, extending or improving fixed assets.

Revenue Expenditure: Expenditure incurred in the course of regular business transactions.

Revenue Receipts: Receipts arising out of services rendered or goods sold.

Deferred Revenue Expenditure: Heavy amount revenue expenditure whose benefit is likely to spread over a number of years.

Revenue Losses: Losses that occur in the regular course of business.

6.7 Self-Assessment Test

1. What do you mean by Capital Expenditure? Discuss the characteristics and accounting treatment of capital expenditure.
2. What do you mean by Revenue Expenditure? Discuss the characteristics and accounting treatment of Revenue expenditure.
3. Elaborate the Capital Receipts and Revenue Receipts with suitable examples.
4. Write a detailed note on Capital and Revenue prifts in detail.
5. Define the term Deferred Revenue Expenditure? Also expalin the characteristics and accounting treatment of deferred revenue expenditure.

6.8 Answers to Check Your Progress

Check Your Progress A

1. True
2. False
3. False
4. True

Check Your Progress B

1. Profit & Loss Account
2. Capital Expenditure
3. Capital Expenditure

6.9 References/suggested readings

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ACCOUNTING FOR DEPRECIATION

Structure

7.0 learning Objectives

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

- Know the meaning, need and causes of depreciation.
- Know the different methods of charging depreciation.
- Understand the accounting treatment of charging depreciation.

7.1 Introduction

The term ‘depreciation’ refers to the reduction in or loss of quality or value of a fixed asset through wear or tear in use, effusion of time, obsolescence through technology and market changes or from any other cause. Depreciation take place in case of all fixed assets with certain possible exceptions e.g. land and antiques etc, although the process may be invisible or gradual. Depreciation does take place irrespective of regular repairs and proper maintenance of assets. The word ‘depreciation’ is closely related to the concept of business income. Unless it is charged against revenues, we cannot say that the business income has been ascertained properly. This is because of the fact that the use of long-term assets tend to consume their economic value and at some point of time these assets become useless. The economic value so consumed must be recovered from the revenue of the firm to have a proper measure of its income. Hence, the reader’s must understand that the process of charging depreciation is the technique used by accountants for recovering the cost of fixed assets over a period.

The following definition will make the understanding of the concept of depreciation more convenient to the learner’s. According to IAS-4, “Depreciation is the allocation of the depreciable amount of an asset over its estimated useful life,”

According to AS-6, “depreciation is a measure of wearing out, consumption or other of value of a depreciable asset arising from use, effusion of time or obsolescence through technology and market changes. Depreciation is allocated so as to charge a fair proportion of the depreciable amount in each accounting period during the expected useful life of the assets. Depreciation includes amortisation of assets whose useful life is pre determined.”

The American Institute of Certified Public Accountants (AICPA) employed the definition as given below:

"Depreciation Accounting is a system of accounting which aims to distribute the cost or other basic value of tangible capital assets, less salvage value (if any) over the estimated useful life of unit (which may be a group of assets) in a systematic and rational manner. It a process of allocation not of valuation. Depreciation for the year is the portion of the total charge under such a system that is allocated to the year."

From the above definitions, it is clear that each accounting period must be charged with a fair proportion of the depreciable amount of the asset, during the expected useful life of the asset. Depreciable amount of an asset is its historical cost less the estimated residual value. Finally, it could be concluded that depreciation is a gradual reduction in the economic value of an asset from any cause.

Depreciation, Depletion and Amortisation: The terms 'depreciation', 'depletion' and 'amortisation' are used often interchangeably. However, these different terms have been developed in accounting usage for describing this process for different types of assets. These terms have been described as follows:

Depreciation: Depreciation is concerned with charging the cost of man made fixed assets to operation (and not with determination of asset value for the balance sheet). In other words, the term 'depreciation' is used when expired utility of physical asset (building, machinery, or equipment) is to be recorded.

Depletion: This term is applied to the process of removing an available but irreplaceable resource such as extracting coal from a coal mines or oil out of an oil well. Depletion differs from depreciation in that the former implies removal of a natural resource, while the latter implies a reduction in the service capacity of an asset.

Amortisation: The process of writing off intangible assets is termed as amortisation. The intangible assets like patents, copyrights, leaseholds and goodwill are recorded at cost in the books of account. Many of these assets have a limited useful life and are, therefore, written off.

Obsolescence: It refers to the decline in the useful life of an asset because of factors like (i) technological advancements, (ii) changes in the market demand of the product, (iii) legal or other restrictions, or (iv) improvement in production process.

7.2 Accounting for depreciation

7.2.1 Causes of Depreciation

The depreciation occurs because of the following:

1. **Constant use**: The constant use of assets results into their wear and tear, which in turn reduces their working capacity. Hence, a decrease in the value of assets may be seen due to reduced capacity. The value of assets like, machinery, furniture, etc., declines with the constant use of them.

2. **Passage of Time**: Many fixed assets lose their value with the passage of time. This holds true in case of intangible fixed assets such as patents, copy rights, lease hold properties, etc. The term "amortisation" is generally used to indicate the reduction in the value of such assets.

3. **Depletion**: Depletion also causes decline in the value of certain assets. This is true in case of wasting assets such as mines, oil wells and forest-stands. On account of continuous extraction of minerals or oils, these assets go on declining in their value and finally they gets completely exhausted.

4. **Obsolescence**: There may not be any physical deterioration in the asset itself. Despite of this, there may be reduction in the utility of an asset that results from the development of a better method, machine or process. For example, an old machine which is still in good working condition may have to be replaced by a new machine because of the later being more economical as well as efficient. In fact, new inventions, developments in production processes, changes in demand for product or services, etc. make the asset out of date.

5. **Accidents**: An asset may get reduction in its value if it meets an accident.

6. **Permanent Fall in the Market Value**: Certain assets may get permanent fall in their value and this decline in their value is treated as depreciation. For example, a permanent decline in the market value of securities and investment may be assumed as depreciation

7.2.2 Need For Providing Depreciation

The need for providing depreciation arises on account of the following points:

1. **To Ascertain the Profits or Losses**: The true profits or losses could be ascertained when all costs of earning revenues have been properly charged against them. Fixed assets like building, plant and machinery, furniture, motor vehicles etc. are important tool in earning business income. But the cost of the fixed asset is not charged to profit and loss of the accounting period in which the asset is purchased. Therefore, the cost of the fixed asset less its salvage value must be allocated rationally to the periods that receive benefit from the use of the asset. Thus, depreciation is an item of business expense and must be provided for a proper matching of costs with the revenue.

2. **To show the Asset as its Reasonable Value**: The assets get decrease in their value over a period of time on account of various such as passage of time, constant use, accidents, etc. Therefore, if the depreciation is not charged then the asset will appear in the balance sheet at the over stated value. This practice is unfair as the Balance Sheet fail to present the true financial position.

3. **Replacement of assets**: Business assets become useless at the expiry of their life and, therefore, need replacement. The cash resources of the concern are saved from being distributed by way of dividend by providing for depreciation. The resources so saved, if set aside in each year, may be adequate to replace it at the end of life of the asset.

4. **To Reduce Income Tax**: If tax is paid on the business income without providing for depreciation then it will be in excess to the actual income tax. This is a loss to the business man. Thus, for calculating tax, depreciation should be deducted be from income similar to the other expenses.

7.2.3 Basic Elements of Depreciation

In order to assess depreciation amount to be charged in respect of an asset in an accounting period, the following three important factors should be considered:

1. **Cost of the asset**: The knowledge about the cost of the asset is very essential for determining the amount of depreciation to be charged to the Profit and Loss Account.

The cost of the asset includes the invoice price of the asset less any trade discount plus all costs essential to make the asset usable. Cost of transportation and transit insurance are included in acquisition cost. However, the financial charges such as interest on money borrowed for the purchase for the purchase of the asset should not be included in the cost of the asset.

2. **Estimated life of the asset**: Estimated life generally means that for how many years or hours an asset could be used in business with ordinary repairs for generating revenues. For estimating useful life of an asset, one must begin with the consideration of its physical life and the modifications, if any, made, factors of obsolescence and experience with similar assets. In fact, the economic life of an asset is shorter than its physical life. The physical life is based mostly on internal policies such as intensity of use, repairs, maintenance and replacements. The economic life, on the other hand, is based mostly on external factors such as obsolescence from technological changes.

3. **Scrap Value of the Asset**: The salvage value of the asset is that value which is estimated to be realised on account of the sale of the asset at the end of its useful life. This value should be calculated after deducting the disposal costs from the sale value of the asset. If the scrap value is considered as insignificant, it is normally regarded as nil

7.2.4 Methods of recording depreciation

There are two methods of recording depreciation in the books of accounts:

7.2.4.1 When a provision for depreciation account is maintained

The following journal entries are passed in case. This method is followed:

i) Depreciation account Dr.

To Provision for Depreciation Account

(For providing depreciation)

ii) Profit and Loss Account Dr.

To Depreciation Account

(For closing depreciation account)

iii) Provision for Depreciation Account Dr.

To Asset Account

(Entry on sale of an asset)

iv) Any amount realised on account of sale of the asset is credited to the Asset Account. The balance, if any, in the Asset Account is transferred to the Profit and Loss Account.

7.2.4.2 When a provision for depreciation account is not maintained

The following journal entries are passed in this method:

i) Depreciation Account Dr.

To Asset Account

(Entry for providing depreciation)

ii) Profit and Loss Account Dr.

To Depreciation Account

(Entry for closing Depreciation Account)

iii) In case the asset is sold, the amount realised is credited to the Asset Account. Any profit or loss on sale of the asset is transferred to the Profit and Loss Account.

7.2.5 Methods of calculating depreciation

The following are various methods of depreciation in use:

1. Fixed instalment method or straight line method.
2. Machine hour rate method.
3. Diminishing Balance method.
4. Sum of years digits method
5. Annuity method
6. Depreciation Fund Method
7. Insurance Policy Method

8. Depletion Method.

The detailed description of all these methods is as follows:

1. Straight Line Method

This is also known as fixed instalment method. Under this method, the depreciation is charged on the uniform basis year after year. When the amount of depreciation charged yearly under this method is plotted on a graph paper, we shall get a straight line. Thus, the straight line method assumes that depreciations is a function of time rather than use in the sense that each accounting period received the same benefit from using the asset as every other period. The formula for calculating depreciation charge for each accounting period is:

Amount of annual Depreciation =

$$\frac{\text{Original cost of the fixed assets} - \text{Residual value}}{\text{Estimated Life in years}}$$

For example, if an asset cost ₹ 50,000 and it will have a residual value of ₹ 2000 at the end of its useful life of 10 years, the amount of annual depreciation will be ₹ 4800 and it will be calculated as follow:

Depreciation = $\frac{50{,}000 - 2000}{10 \text{ Years}} = 4800$

This method has many shortcomings. First, it does not take into consideration the seasonal fluctuations, booms and depression. The amount of depreciation is the same in that year in which the machine is used day and night to that in another year in which it is used for some months. Second, it ignores the interest on the money spent on the acquisition of that asset. Third, the total charge for use of asset (i.e., depreciation and repairs) goes on increasing form year to year though the assets might have been use uniformly from year to year. For example, repairs cost together with depreciation charge in the beginning years is much less than what it is in the later year. Thus, each subsequent year is burdened with greater charge for the use of asset on account of increasing cost on repairs.

Illustration 1: H. Ltd. purchased a machinery on 1st January 2010 for ₹ 29000 and spent ₹ 2000 on its carriage and ₹ 1,000 on its erection. Machinery is estimated to have a scrap value of ₹ 5000 at the end of its useful life of 5 year. The accounts are closed every year on 31st December. Prepare the machinery account for five years charging depreciation according to straight line method.

Solution

MACHINERY ACCOUNT

Date	Particular	₹	Date	Particular	₹
2010 Jan. 1	To Bank	22000	2010 Dec. 31	By Depreciation	4000
	To Bank	2000		By Balance c/d	21000
	To Bank	1000			
		25000			25000
2011 Jan.1	To Balance b/d	21000	2011 Dec.31	By Depreciation	4000
				Balance c/d	17000
		21000			21000
2012 Jan.1	To Balance b/d	17000	2012 Dec. 31	By Depreciation	4000
				By Balance c/d	13000
		17000			17000
2013 Jan.1	To Balance b/d	13000	2013 Dec.31	By Depreciation	4000
				By Balance c/d	9000
		13000			13000
2014 Jan.1	To Balance b/d	9000	2014 Dec.31	By Depreciation	4000
				By Balance c/d	

					5000
		9000			9000

This method is very suitable particularly in case of those assets which get depreciated more on account of expire of period e.g. lease hold properties, patents, etc.

2. Machine Hour Rate Method

In case of this method, the running time of the asset is taken into account for the purpose of calculating the amount of depreciation. It is suitable for charging depreciation on plant and machinery, air-crafts, gliders, etc. The amount of depreciation is calculated as follows:

$$= \frac{\text{Acquisition cost of the assets} - \text{Scrap value}}{\text{Life of the Asset in hours}}$$

For example, if machinery has been purchased for ₹ 20000 and it will have a scrap value of ₹ 1000 at the end of its useful life of 1900 hours, the amount of depreciation per hour will be computed as follows:

$$\text{Depreciation} = \frac{\text{Acquisition cost of the assets} - \text{Scrap value}}{\text{Life of the Asset in hours}}$$

$$= \frac{20{,}000 - 1{,}000}{1900\,\text{hours}}$$

= ₹ 10 per hour

If in a particular year, the machine runs for 490 hours, the amount of depreciation will be ₹ 4900 (i.e., ₹ 10x490). It is obvious from this example that under machine hour rate method, the amount of depreciation is closely related with the frequency of use of an asset. The simplicity in calculations and understanding is the main advantage of this methods. However, it can be used only in case of those assets whose life can be measured in terms of working time.

3. Diminishing Balance Method

This is also known as Written Down Value method [WDV]. Under the diminishing balance method, depreciation is charged at fixed rate on the reducing balance (i.e., cost less depreciation) every year. Thus, the amount of depreciation goes on decreasing every year. Under this method also, the amount of depreciation is transferred to Profit and Loss Account in each of the year and in the Balance Sheet the asset is shown at book value after reducing depreciation from it. For example, if an asset is purchased for ₹ 10,000 and depreciation is to be charged at 20% p.a. on reducing balance system, then the depreciation for the first year will be ₹ 2000. In the second year, it will ₹ 1600 (i.e. 20% of 8000), in the third year ₹ 1280 (i.e. 20% of 6400) and so on. The rate of depreciation under this method can be computed by using the following formula:

$$\text{Depreciation rate} = -1\sqrt{\frac{\text{Net scrap value}}{\text{Acquisition cost}}}$$

For example, if the cost of an asset is ₹ 27000, scrap value ₹ 3375, economic life 3 year, the rate of depreciation would be:

$$\text{Depreciation Rate} \quad = 1 - 3\sqrt{\frac{3375}{27000}}$$

$$= 1 - \frac{15}{30} = 50\%$$

Merits of Diminishing Balance Method

(i) It is very easy to understand and calculate the amount of depreciation despite the early variation in the book value after depreciation (ii) This method put an equal burden for use of the asset on each subsequent year since the amount of depreciation goes on decreasing for each subsequent year while the charge for repairs goes on increasing for each subsequent year. (iii) This method has also been approved by the Income Tax Act applicable in India (iv) Asset is never reduced to zero.

Demerit

(i) It ignores the interest on the capital committed to purchase that asset. (ii) It does not provide adequately for replacing the asset at the end of its life. (iii) The calculation of rate of depreciation is not so simple. (iv) The formula for calculating the rate of depreciation can be applied only when there is some residual of the asset.

Suitability

This method is suitable in those cases where the receipts are expected to decline as the asset gets older and, it is believed that the allocation of depreciation of depreciation ought to be related to the pattern of assets expected receipts.

Illustration 2: A company purchases Machinery on 1st April 2010 for ₹ 20,000. Prepare the machinery account for three years charging depreciation @ 25% p.a. according to the Written Down Value Method.

MACHINERY ACCOUNT

Date	**Particular**	**₹**	**Date**	**Particular**	**₹**
2010 Apr. 1	To Bank	20000	2010 Mar. 31	By Depreciation By Balance c/d	5000 15000
		20000			20000
2011 Apr.1	To Balance b/d	15000	2011 Mar.31	By Depreciation By Balance c/d	3750 11250
		15000			15000
2012 Apr 1	To Balance b/d	11250	2012 Mar.31	By Depreciation By Balance c/d	2812.5 8437.5
		11250			11250

4. Sum of Years Digits (SYD) Method

Under this method also, the amount of depreciation goes on diminishing in the future years similar to that under diminishing balance method.

For calculating the amount of depreciation to be charged to the Profit and Loss Account, this method takes into account cost, scrape value, and life of the asset. The following formula is used for determining depreciation:

$$\frac{\text{Remaining life of the Assets at the end of the year} + 1}{\text{Sum of the digits representing the life of the asset}} \times \text{Acquisition Cost}$$

For example, an asset having an effective life of 5 years is purchased at a cost of ₹ 20,000. It is estimated that its scrap value at the end of its effective life will be ₹ 2000. The depreciation on this asset, if SYD method is followed, will be calculated as follows from one to five years:

Year Depreciation Amount

1 = $\frac{5}{15} \times 18000 = ₹\ 6000$

2 = $\frac{4}{15} \times 18000 = ₹\ 4800$

3 = $\frac{3}{15} \times 18000 = ₹\ 3600$

4 = $\frac{2}{15} \times 18000 = ₹\ 2400$

5 = $\frac{1}{15} \times 18000 = ₹\ 1200$

5. Annuity Method

So far we have described such methods of charging depreciation which ignore the interest factor. Also, sometimes it becomes inconvenient for a company to follow any of the methods discussed earlier. Under such circumstances, the company may use some special depreciation systems. Annuity method is one of these special systems of depreciation. Under this system, the depreciation is charged on the basis that besides losing the acquisition cost of the asset the business also loses interest on the amount used for purchasing the asset. Here, interest refers to that income which the business would have earned otherwise if the money used in buying the asset would have been committed in some other profitable investment. Therefore, under the annuity method, the amount of total depreciation is determined by adding the cost and interest thereon at an expected rate. The annuity table is used to help in the determination of the amount of depreciation. A specimen of Annuity Table is as follows:

ANNUITY TABLE

Year	**3%**	**4%**	**5%**	**6%**
4	0.269027	0.275490	0.282012	0.288591
5	0.218335	0.224627	0.230975	0.237376
6	0.184598	0.190762	0.197012	0.203363
7.	0.160506	0.166610	0.172820	0.179135

8.	0.142456	0.148528	0.154722	0.161036
9.	0.128434	0.134493	0.140690	0.147022
10.	0.117231	0.12391	0.129505	0.135868

In case depreciation is charged according to this method, the following accounting entries are passed:

(i) Purchase of an asset

Asset Account Dr.

To Bank A/c

(ii) For charging interest

Asset Account Dr.

To Interest Account

(iii) For charging depreciation:

Depreciation Account Dr.

To Asset Account

Evaluation of Annuity Method

Merits

(i) This method keep into account interest on money spent on the purchase of the asset.

(ii) The value of the asset becomes zero at the end of life.

Demerits

(i) This method is comparatively more difficult than the methods discussed so far.

(ii) It makes no arrangement of money to replace the old asset with the new one at the expiry of its life.

(iii) Under this method the burden on the profit and loss account is no similar in each year because the depreciation remains constant year after year but the interest goes on decreasing.

Illustration 3: On 1st January, 2010 a firm purchased a leasehold property for 4 year at a cost of ₹ 24000. It decides to depreciate the lease by Annuity Method by charging interest at 5% per annum. The Annuity Table shows that the annual necessary to write off ₹ 1 at 5% ₹ 0.282012. You are required to prepare the lease Hold Property Account for four years and show the net amount to be charged to the Profit and Loss Account for these four years.

Solution

LEASE HOLD PROPERTY ACCOUNT

Date	**Particular**	**₹**	**Date**	**Particular**	**₹**
2010 Jan. 1	To Bank	24000.00	2010 Dec. 31	By Depreciation	6768.29
	To interest	1200.00	Dec.31	By balance c/d	18431.71
		25200.00			25200.00
2011 Jan.1	To balance b/d	18431.71	2011 Dec.31	By Depreciation	6768.29
Dec.31	To Interest	921.59	Dec.31	By Balance c/d	12585.01
		19353.30			19353.30
2012 Jan.1	To balance b/d	12585.01	2012 Dec.31	By Depreciation	6768.29
Dec. 31	To Interest	629.25	Dec.31	By Balance c/d	6445.97
		13214.26			13214.26
2013	To balance b/d	6445.97	2013	By Depreciation	6768.29
Jan.1			Dec.31	By Balance c/d	9000
Dec.31	To Interest	322.30			13000
		6768.27			6768.27

NET AMOUNT CHARGEABLE TO THE PROFIT AND LOSS ACCOUNT

Year	Depreciation Debited	Interest Credited	Net Charge against Profit
2010	6768.29	1200.00	5568.29
2011	6768.29	921.59	5846.70
2012	6768.29	629.25	6139.04
2013	6768.29	322.30	6445.99
₹	27073.16	3073.14	24000.02

6. Depreciation Fund Method

Business assets become useless at the expiry of their life and therefore, need replacement. However, all the methods of depreciation discussed above do not help in accumulating the amount which can be readily available for the replacement of the asset when its useful life comes to an end. Depreciation fund method takes care of such a contingency as it incorporates the benefits of depreciating the asset as well as accumulating the necessary amount for its replacement. Under this method, the amount of depreciation charged from the Profit and Loss Account is invested in certain securities carrying a particular rate of interest. The interest received on the investment in such securities is also invested every year together with the amount of annual depreciation. In the last of the life of asset, the depreciation amount is set aside interest is received as usual. But the amount is not invested because the amount is immediately needed for the purchase of new asset. Rather all the investments so far accumulated are sold away. Cash realised on the sale of investments is utilised for the purchase of new asset. The following accounting entries are generally made in order to work out this system of depreciation.

1. **At the end of the first year**

   (i) *For setting aside the amount of depreciation:* The amount to be charge by way of depreciation is determined on the basis of sinking Fund Table given as an Appendix at the end of every book of accounting.

Depreciation Account Dr.

To Depreciation Fund Account (or Sinking Fund A/c)

(ii) For investing the amount charged by way of depreciation:

Depreciation Fund Investment A/c Dr.

To Bank A/c

2. In the second and subsequent years

(i) *For receiving interest.* The interest on the balance of Depreciation Fund Investment outstanding in the beginning of each year will be received by the end of the year. This entry is:

Bank Account Dr.

To Depreciation Fund Account

(ii) For setting aside the amount of depreciation

Profit and Loss A/c Dr.

To Depreciation Fund A/c

(iii) For investing the amount

Depreciation Fund Investment A/c Dr.

To Bank A/c

(Annual instalment of depreciation and interest received invested)

3. In the last year

(i) For receiving interest:

Bank A/c Dr.

To Depreciation Fund A/c

(ii) For setting aside the amount of depreciation

Profit and loss A/c Dr.

To depreciation Fund A/c

Note: In the last year no investment will be made, because the amount is immediately required for the purchase of new asset.

(iii) For the sale of investment:

Bank A/c Dr.

To Depreciation Fund Investment A/c

(iv) For the transfer of profit or loss on sale on investments: The profit or loss on the sale of these investments is transferred to the Depreciation Fund Account.

The entry for loss:

Depreciation Fund A/c Dr.

To Depreciation Fund Investment A/c

The entry for profit

Depreciation Fund Investment A/c

To Depreciation Fund A/c

(v) For the sale of old asset:

Bank A/c Dr.

To Asset A/c

(vi) The depreciation fund is transferred to Asset Account and any balance left in the asset account is transferred to Profit and Loss Account. The entry is:

Depreciation Fund A/c. Dr.

To asset A/c

(vii) The balance in Asset Account represents profit or loss. Therefore it will be transferred to the Profit and Loss Account.

(viii) The cash realised on the sale of investments and the old asset is utilised for the purchase of new asset.

Illustration 4: Amitabh Company Ltd. purchased 4 year lease on January 1, 2010 for ₹ 60,000. The company decided to charge depreciation according to depreciation fund method. It is expected that investments will earn interest @5% p.a. Sinking Fund Table shows that ₹ 0.232012 invested each year will produce ₹ 1 at the end of 4 years at 5% p.a. At the expiry of lease, the Depreciation Fund Investments were sold for ₹ 45200. A new lease is purchased for ₹ 70,000 on 1.1.2014. Show the journal entries and prepare the necessary accounts in the book the company.

JOURNAL

Date	**Particular**	**Debit**	**Credit**
1.1.2010	Lease A/c Dr.	60,000	
	To Bank A/c		60,000
	(Being the purchase of lease)		
31.12.10	Depreciation A/c Dr.	13920.7	
	To Depreciation Fund A/c		13920.7
	(Being annual amount of depreciation as per sinking fund tables)		
31.12.10	Depreciation Fund Investment A/c Dr.	13920.7	
	To Bank A/c		13920.7
	(Being purchase of the investments against the depreciation fund)		
31.12.11	Bank A/c Dr.	696.0	
	To depreciation fund A/c		696.0
	(Being the receipt of interest on depreciation fund investment A/c transfer to depreciation fund A/c		
31.12.11	Depreciation A/c Dr.	13920.7	
	To Depreciation Fund A/c		13920.7
	(Being annual depreciation set-aside)		
31.12.11	Depreciation Fund Investment A/c Dr.	14616.7	
	To Bank A/c		14616.7
	(Being purchase of the investments against the depreciation fund)		
31.12.12	Bank Account Dr.	1426.9	
	To depreciation fund A/c		1426.9
	Being receipt of interest and its transfer to depreciation fund A/c)		

31.12.12	Depreciation A/c Dr. To depreciation fund A/c (Being annual depreciation set aside)	13920.7	 13920.7
31.12.12	Depreciation Fund Investment A/c Dr. To Bank A/c (Being purchase of investments)	15347.6	 15347.6
31.12.13	Bank A/c Dr. To depreciation fund A/c (Being receipt of interest on depreciation fund investment)	2194.3	 2194.3
31.12.13	Depreciation A/c Dr. To depreciation A/c (Being annual depreciation set aside)	13920.7	 13920.7
31.12.13	Bank A/c Dr. To depreciation fund investment A/c (Being sale of Dep fund investment A/c)	45200	 45200
31.12.13	Depreciation Fund Investment A/c Dr. To Depreciation fund A/c (Being profit on sale investment transferred)	1315.0	 1315.0
31.12.13	Depreciation fund A/c Dr. To Lease A/c (Being the transfer of depreciation fund A/c to lease A/c)	61315.0	 61315.0
31.12.13	Lease A/c Dr. To Profit and Loss A/c (Being Balance of lease A/c transferred to Profit and Loss Account)	1315.0	 1315.0
1.1.14	Lease A/c Dr. To Bank A/c (Being new lease)	70000.0	 70000.0

DEPRECIATION FUND ACCOUNT

Date	Particular	₹	Date	Particular	₹
31.12.10	By Balance c/d	13920.7	31.12.10	By Dep. a/c	13920.7
		13920.7			13920.7
31.12.11	To Balance c/d	28537.4	1.1.11	By Balance b/d	13920.7
			31.12.11	By Bank A/c Int.	696.0
			31.12.11	By Dec. a/c	13920.4
		28537.4			28537.4
31.12.12	By Balance c/d	43885.0	1.1.12	By Balance c/d	28537.4
			31.12.12	By Bank A/c Int.	1426.9
			31.12.12	By Dep. A/c	13920.7
		43885.0			43885.0
31.12.13	To Lease A/c	61315.0	1.1.13	By Balance b/d	43885.0
			31.12.13	By Bank Interest	3194.3
			31.12.13	By Dep. A/c	61315.0
		61315.0			61315.0

LEASE ACCOUNT

Date	Particular	₹	Date	Particular	₹
1.1.10	To Bank A/c	60000	31.12.10	By Balance c/d	60000
		60000			60000
1.1.11	To Balance b/d	60000	31.12.11	By Balance c/d	60000
		60000			60000

1.1.12	To Balance b/d	60000	31.12.12	By Balance c/d	60000
		60000			60000
1.1.13	To Balance b/d	60000	31.12.13	By Depreciation Fund c/d	61315
					61315
31.12.13	To P & L A/c	1315			
	(Profit)	61315			61315

DEPRECIATION FUND INVESTMENT A/C

Date	Particular	₹	Date	Particular	₹
31.12.10	To Bank A/c	13920.7	31.12.10	By Balance c/d	13920.7
		13920.7			13920.7
1.1.11	To Balance b/d	13920.7	31.12.11	By Balance c/d	28537.4
31.12.12	To Bank A/c	14616.7			
		28537.4			28537.4
1.1.12	To Balance b/d	28537.4	31.12.12	By Balance c/d	43885.0
31.12.12	To Bank A/c	15347.6			
		43885.0			43885.0
1.1.13	To Balance b/d	43885.0	31.12.13	By Bank A/c	45200.0
	To Dep. Fund A/c	1315.0			
		45200.0			45200.0

7. Insurance Policy Method

Under this method, instead of investing the money in securities an insurance policy for the required amount is taken. The amount of the policy is such that it is adequate to replace the asset when it is worn out. A fixed sum equal to the amount do depreciation is paid as premium every year. Company receiving premium allows a small rate of interest on compound basis. At the maturity of the policy, the insurance company pays the agreed amount with which the new asset can be purchased. Accounting entries will be made as follows.

1. First and every subsequent years

(a) Depreciation Insurance Policy A/c Dr.

To Bank A/c

(Entry in the beginning of the year for payment of insurance premium)

(b) Profit and Loss Account A/c Dr.

To Depreciation Fund A/c

(Entry at the end of the year for providing depreciation)

2. Last year

(a) Bank A/c Dr.

To Depreciation Policy A/c

(Entry for the amount of policy received)

(b) For transfer of profit on insurance policy:

Depreciation Insurance Policy A/c Dr.

To Depreciation Fund A/c

(c) For transfer of accumulated depreciation to the asset account:

Depreciation Fund A/c Dr.

To Asset A/c

(d) On purchase of new asset:

On purchase of new asset:

New Asset A/c Dr.

To Bank A/c

Illustration 5: On 1.1.2013, a firm purchased a lease for four years for ₹ 50,000. It decided to provide for its replacement by means of an insurance policy for ₹ 50,000. The annual premium is ₹ 11,000. On 1.1.2017, the lease is renewed for a further period of 4 years for the same amount. Show the necessary ledger accounts.

LEASE ACCOUNT

Date	Particular	₹	Date	Particular	₹
1.1.13	To Bank A/c	50000	31.12.13	By Balance c/d	50000
1.1.14	To Balance b/d	50000	31.12.14	By Balance c/d	50000
1.1.15	To Bank A/c	50000	31.12.15	By Balance c/d	50000
1.1.16	To Bank A/c	50000	31.12.16	By Balance c/d	50000
				Fund a/c	

DEPRECIATION INSURANCE POLICY A/C

Date	Particular	₹	Date	Particular	₹
1.1.13	To Balance A/c	11000	31.12.13	By Balance c/d	11000
1.1.14	To Balance b/d	11000	31.12.14	By Balance c/d	22000
	To Bank A/c	11000			
		22000			22000
1.1.15	To Balance b/d	22000	31.12.15	By Balance c/d	33000
	To Bank A/c	11000			
		33000			33000
1.1.16	To Balance b/d	33000	31.12.16	By Bank	50000
	To Bank	11000			
31.12.16	To profit	6000			
	Transferred to				

	Dep. Fund A/c				
		50000			50000

DEPRECIATION FUND ACCOUNT

Date	Particular	₹	Date	Particular	₹
1.1.13	To Balance c/d	11000	31.12.13	By P & L c/c	11000
1.1.14	To Balance c/d	22000	31.12.14	By Balance b/d	11000
			31.12.14	By P & L A/c	11000
		22000			22000
1.1.15	To Balance c/d	33000	31.12.15	By Balance b/d	22000
			31.12.15	By P & L A/c	11000
		33000			33000
1.1.16	To Lease A/c	50000	31.12.16	By Balance b/d	33000
			31.12.16	By P & L A/c	11000
			31.12.16	By Dep. Insurance Policy A/c	6000
		50000			50000

8. Depletion Method

This is also known as productive output method. In this method it is essential to make an estimate of the units of output the asset will produce in its life time. This method is suitable in case of mines, queries etc. where it is possible to make an estimate of the total output likely to be available. Depreciation is calculated per unit of output. Formula for calculating the depreciation rate is as under:

$$r = \frac{\text{Acquisition cost} - \text{Scrap value}}{\text{Units of output}}$$

Example: If a mine is purchased for 50,000 and it is estimated that the total quantity of mineral in the mine is 1,00,000 tonnes, the rate of depreciation would be:

$$r = \frac{50,000}{1,00,000} = ₹\ 0.5$$

Hence, the rate of depreciation is 50 paise per tonne. In case output in a year is 20,000 tonnes, the amount of depreciation to be charged to the Profit and Loss Account would be ₹ 10,000 (i.e., 20,000 tonnes × ₹ 0.50).

This method is useful where the output can be measured effectively and the utility of the asset is directly related to its production use. Thus, the method provides the benefit of correlating the amount of depreciation with the productive use of asset.

7.2.6 Sale of an Asset

An enterprise may sell an asset either because of obsolescence or inadequacy or even for other reasons. In case an asset is sold during the course of the year, the amount realised should be credited to the Asset Account. The amount of depreciation for the period of which the asset has been used should be written off in the usual manner. Any balance in the Asset Account will represent profit or loss on disposal of the asset. This balance in the Asset Account should be transferred to the profit and loss account.

Illustration 6: A company purchased a machinery costing ₹ 60,000 on 1.4.2010. The accounting year of the company ends on 31st December every year. The company further purchased machinery on 1st October, 2010 costing ₹ 40,000. On 1st January 2012, one-third of the machinery which was installed on 1.4.2010, became obsolete and was sold for ₹ 5000. Show how the machinery account would appear in the books of the company. The depreciation is to be charged at 10% p.a. on written down value method.

Solution

MACHINERY ACCOUNT

Date	Particular	₹	Date	Particular	₹
1.4.10	To Bank A/c	60000	31.12.10	By Depreciation A/c	45000
1.10.10	To Bank A/c	40000		on ₹ 60000 for 9 month on ₹	1000

				40000 for 3 month	
			31.12.10	By Balance c/d	94500
		100000			100000
1.1.11	To Balance b/d	94500	31.12.91	By Depreciation on ₹ 94500 for 1 year	9450
			31.12.11	By Balance c/d	85050
		94500			94500
1.1.12	To Balance b/d	85050	1.1.12	By Bank (sale) A/c	5000
			1.1.12	By Profit and Loss Account loss on sale (16650-5000)	11650
			31.12.12	By Depreciation A/c	6840
			31.12.12	By Balance c/d	61560
		85050			85050

*Total written down value as on Jan. 1, 2012	85050
Less: written down value of 1/3 of Machinery sold (2000-(1500+1850)	16650
	68400
Depreciation at 10% on ₹ 68400	6840

7.3 Change of Depreciation Method

To ensure comparability of results from year to year, it is essential that once a method of depreciation is selected by the management it should be followed consistently. However, sometimes a change in the method of depreciation may be required. The change may be required either because of statutory compulsion or required by an accounting standard or change would result in more appropriate presentational the financial statements.

The change in the method of depreciation may be desired from the current year onwards. In such a case, depreciation will be charged according to the new method from the current year.

Illustration 7: Om Ltd. purchased a computer for ₹ 50,000 on 1.1.2013. It has five years life and a salvage value of ₹ 5,000. Depreciation was provided on straight line basis. With effect from 1.1.2015, the company decided to change the method of depreciation to Diminishing Balance method @20% p.a. Prepare computer account from 2013 to 2016. Assume, the company prepare final accounts on 31st December every year.

COMPUTER ACCOUNT

Date	**Particular**	**₹**	**Date**	**Particular**	**₹**
1.1.13	To Cash A/c	50000	31.12.13	By Depreciation	9000
			"	By Balance c/d	41000
		50000			50000
1.1.14	To Balance b/d	41000	31.12.14	By Depreciation	9000
			"	By Balance c/d	32000
		41000			41000
1.1.15	To Balance b/d	32000	31.12.15	By Depreciation	6400
			"	By Balance c/d	25600
		32000			32000
1.1.16	To Balance b/d	25600	31.12.16	By Depreciation	5120
			"	By Balance c/d	20480
		25600			25600

Working Notes

1) Depreciation on straight line basis

$$= ₹\ \frac{50,000 - 5,000}{5} = ₹\ 9000$$

2) Depreciation on written down value basis during 2015

(Book value ₹ 32000)

$$= \frac{32000 \times 20}{100} = ₹\ 6400$$

Change in the Method of Depreciation from a back date

Sometimes a change in the method of depreciation is effected retrospectively. In such a case, the following steps are required:

(i) Find out the depreciation which has already been charged according to the old method or at the old rate.

(ii) Compute the amount of depreciation that is to be charged according to the new method form the back date upto the end of the previous year.

(iii) Find the difference, if any, under (i) and (ii) mentioned above.

(iv) In the current year in addition to the depreciation for the current year, charge also the difference found under step (iii).

Illustration 8: Taking the facts as in the illustration 7, prepare computer account for 2015 and 2016, if the firm decides on 1.1.2015 to charge depreciation according to Diminishing Balance Method. Assume the change in the depreciation policy is effected by the firm since the date of purchase.

Solution

COMPUTER ACCOUNT

Date	**Particular**	**₹**	**Date**	**Particular**	**₹**
1.1.15	To Balance	32000	31.12.15	By Depreciation	
				Difference for	Nil
				earlier year (1)	
				Current year (2)	6400
			31.12.15	By Balance c/d	25600

		32000			32000
1.1.16	To Balance	25600	31.12.16	By Depreciation	5150
			31.12.16	By Balance	20480
		25600			25600

Working Notes

1) 1.1.2015 Acquisition cost of computer 50000

31.12.2015 Depreciation @ 20% p.a. on 50000 10000

1.1.2014 Balance 40000

31.12.2014 Depreciation @ 20% on ₹ 40000 8000

Depreciation according to Diminishing Balance 18000

Less: Depreciation according to straight line basis 18000

(9000+9000)

Difference Nil

2) 1.12015 Balance 32000

31.12.2015 Depreciation @ 20% p.a. on 32000 6400

1.1.2016 Balance 25600

31.12.2016 Depreciation @ 20% on 25600 5120

31.12.2016 Balance 20480

7.4 Check your progress

Answer the following fill in the blanks:

1. Depreciation is considered as a part of ____________ of goods.
2. Depreciation is ________ for the business.

3. Depreciation is changed in case of _____________.
4. Depreciation is not changed in case of ______________.
5. ________ on sales of machinery will be created to machinery a/c.

7.5 Summary

Depreciation refers to the reduction or loss of quality or value of a fixed asset through wear or tear, in use, effusion of time, obsolescence through technology and market changes or from any other cause. The terms depreciation, depletion and amortization are used often interchangeably. However, these different terms have been developed in accounting usage for describing this process for different type of assets. The term 'depreciation' is concerned with charging the cost of man-made fixed assets, 'depletion' applied to the process of removing an available but irreplaceable resource such as coal mines or oil well, and 'amortisation refers' to the process of writing off intangible assets. The main objectives of charging depreciation are to ascertain the true profits or losses and to show the assets at its reasonable value. The amount of depreciation to be charged depends upon cost of the asset, estimated life of the asset and scrap value of the asset. There are different methods of charging depreciation, i.e., fixed instalment method, machine hour rate method, diminishing balance method, sum of years digits method, annuity method, depreciation fund method, insurance policy method and depletion method.

7.6 Keywords

Fixed Assets: Those assets which have been purchased for continuous use in the business.

Depreciation Rate: A percentage applied to the historical cost or the substituted amount of a depreciable asset.

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

Depletion: A measure of exhaustion of a wasting asset represented by periodic write-off of cost.

Obsolescence: Diminution in the value of an asset by the reason of its becoming out-of-date due to technological changes.

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

7.7 Self assessment Test

1. Why is it necessary to calculate depreciation? Discuss various factors which are considered for calculating depreciation

2. Distinguish between the following:

   (a) Straight Line Method and Diminishing Balance Method.

   (b) Annuity Method and Depreciation Fund Method.

   (c) Depreciation and Depletion

3. Explain the circumstances under which different methods of depreciation can be employed.

4. Discuss the advantages and disadvantage of Insurance Policy Method and Straight Line Method.

5. What is sum of the year digits method of depreciation? In what way does it differ from Sinking Fund Method of depreciation?

6. A firm purchases a plant for a sum of ₹ 10,000 on 1st January 2010. Installation charges are ₹ 2,000. Plant is estimated to have a scrap value of ₹ 1,000 at the end of its useful life of five years. You are required to prepare the plant account for five years charging depreciation according to Straight Line Method

7. A plant is purchased for ₹ 20,000. It is depreciated at 5% per annum on reducing balance for five years when it becomes obsolete due to new method of production and is scrapped. The scrap produces ₹ 5,385. Show the plant account in the ledger.

8. The machinery account of a factory showed a balance of ₹ 1,90,000 on 1st January 2012. Accounts were made up on 31st December each year and depreciation is written off at 10% p.a. under the Diminishing Balance Method.

   On 1st June 2012, New Machinery is acquired at a cost of ₹ 28,000 and installation charges incurred in erecting the machines works out to ₹ 892 on the same date. On 1st June 2012 a machine which had cost ₹ 6,000 on 1st January 2013 was sold for ₹ 750, another machine which had cost ₹ 600 on 1st January 2014, was scrapped on the same date and it realised nothing.

Write up plant and Machinery Account for the year 2014, allowing the same rate of depreciation as in the past calculating Depreciation to the nearest multiple of a Rupee.

9. A company purchased a four years lease on January, 1, 2010 for ₹ 20,150. It is decided to provide for the replacement of the lease at the end of four years by setting up a Depreciation Fund. It is expected that investments will fetch interest at 4 per cent. Sinking Fund tables show that to provide the requisite sum at 4percent at the end of four years, an investment of ₹ 4,745.02 is required. Investments are made to the nearest rupee.

   On December 31, 2013, the investments are sold for ₹ 14,830 On 1st January, 2014, the same lease is renewed for a further period of 4 years by payment of ₹ 22,000.

   Show journal entries and give the important ledger account to record the above.

10. Chillies Ltd, acquired a long-term lease of property on payment of ₹ 60,000. A leasehold Redemption Policy was taken out on which an annual premium of ₹ 1,440 was payable. The surrender value of the policy on 31st March, 2010 was ₹ 12,896 to which amount the policy account stood adjusted. Next premium was paid on 20th December, 2010 and the surrender value on 31st March, 2011 was ₹ 14,444.

    (i) Show the Redemption fund account and the policy account for the year ended 31st March, 2011

    (ii) Assuming that of maturity, a sum of ₹ 60,100 was received and the balance in policy account then stood at ₹ 59,920 give the ledger accounts showing the entries necessary to close the accounts concerned.

11. Machinery account of CSI Ltd. showed debit balance of ₹ 32,400 on 1st January, 2012. Depreciation was provided at 10% per annum. On 1st July 2012, a part of the machinery purchased for ₹ 10,000 on 1st January 2010 was sold for ₹ 7,000 and on the same date a new machinery which cost ₹ 20,000 was purchased. On 31st Dec. 2012 the company decided to change the method of depreciation from Diminishing Balance

Method to Fixed Instalment Method with effect from 1st January, 2010, depreciation remaining at 10% per annum. Show Machinery account.

7.8 answers to check your progress

1. Cost of production
2. Loss
3. Fixed asset
4. Amortization
5. Loss

7.9 references/suggested readings

1. P.C. Tulsian, “Financial Accounting”, Tata McGraw Hill, New Delhi.
2. Ashok Banerjee, “Financial Accounting”, Excel Book, New Delhi.
3. Michael Tones, “Accounting for Non-Specialists”, John Wiley & Sons, Singapore.
4. Aggarwal, M.P., “Analysis of Financial Statements”, National Publishing sHouse, New Delhi.

Course: **Financial Accounting-I**	
Course Code: **BCOM 101**	Author: **Prof. M.C. Garg**
Lesson No: **8**	SLM Conversion By: Ms. Chand Kiran

PREPARATION OF PROFIT AND LOSS ACCOUNT AND BALANCE SHEET

Structure

8.0 learning Objectives

After going through this chapter, you should be able-

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

8.1 Introduction

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

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

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

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

8.2 Preparation of final accounts

8.2.1 Trading account

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

TRADING ACCOUNT

FOR THE YEAR ENDED 31ST MARCH, 2018

Particulars	**Amount ₹**	**Particulars**	**Amount ₹**
To Opening Stock		By Sales	
To Purchases		*Less* Sales Returns	
Less Purchases Returns		By Closing Stock	
To Direct Expenses:		By Gross Loss	
To Carriage Inward		transferred to	
To Wages		P & L A/c	
To Fuel, Power and Lighting			
To Expenses			
To Manufacturing Expenses			
To Coal, Water and Gas			
To Motive Power			
To Octroi			
To Import Duty			
To Custom Duty			

To Consumable Stores To Freight and Insurance To Royalty on manufactured To Goods To Packing charges To Gross Profit transferred to P & L A/c			

8.2.1.1 Important points regarding Trading Account

1. Stock

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

(a) Opening stock

(b) Closing stock

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

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

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

2. Purchases

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

(a) Purchases Returns or Return Outwards.

(b) Goods withdrawn by proprietor for his personal use.

(c) Goods received on consignment basis or on approval basis or on hire purchase.

(d) Goods distributed by way of free samples.

(e) Goods given as charity.

3. Direct Expenses

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

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

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

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

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

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

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

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

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

4. Sales

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

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

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

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

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

8.2.1.2 Closing entries for Trading Account

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

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

Trading A/c Dr.

To Stock (Opening) A/c

To Purchases A/c

To Direct Expenses A/c

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

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

Sales A/c Dr.

Stock (Closing) A/c Dr.

To Trading A/c

(Being sales, closing stock transferred to Trading Account)

3. (a) For Gross Profit

Trading A/c Dr.

To Profit & Loss A/c

(Being gross profit transferred to Profit and Loss Account)

(b) For Gross Loss

Profit & Loss A/c Dr.

To Trading A/c

(Being gross loss transferred to Profit and Loss Account)

Illustration 1: From the following balances extracted from the books of Mr. Bansi Lal, prepare the Trading Account for the year ending 31st March, 2018.

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

Power	300		

The value of stock unsold is ₹ 12,000.

Solution

TRADING ACCOUNT

FOR THE YEAR ENDED 31ST MARCH, 2018

To Opening stock		10,000	By Sales	67,500	
To Purchases	42,500		*Less* returns	50	67,450
Less returns	200	42,300	By Closing Stock		12,000
To Manufacturing exp.		1,950			
To Carriage inwards		100			
To Freight and duty		5,000			
To Stores consumed		200			
To Power		300			
To Wages		5,000			
To Gross Profit transferred To Profit & Loss A/c		14,600			
		79,450			79,450

8.2.2 Manufacturing account

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

The proforma of Manufacturing Account is given as under:

MANUFACTURING ACCOUNT

FOR THE YEAR ENDING...................

Dr. Cr.

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

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

TRADING ACCOUNT

FOR THE YEAR ENDING..............

Dr. Cr.

	₹		₹
To Opening Stock of Finished Goods		By Sales *less* Returns	

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

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

Important Points Regarding Manufacturing Account

1. Raw Materials Consumed

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

		₹
Opening Stock of raw materials	....	
Add Purchases of raw materials	....	....
Less Purchase return of raw materials		....
Less Closing stock of raw materials		....
Cost of raw material consumed		

2. Direct Expenses

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

3. Factory Overheads

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

4. Cost of Production

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

Difference between Trading Account and Manufacturing Account

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

8.2.3 Profit and loss account

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

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

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

PROFIT AND LOSS A/C

FOR THE YEAR ENDED....................

	₹		₹
To Gross Loss b/d		By Gross Profit b/d	
To *Selling and Distribution Expenses*:		By *Other Income*:	
Advertisement		Discount received	
Travellers' Salaries		Commission received	
Expenses & Commission		By Non-trading Interest:	
Godown Rent		Bank Interest	
Export Expenses		Rent of property let-out	
Carriage Outwards		Dividend from shares	
Bank Charges		By *Abnormal Gains*:	
Agent's Commission		Profit on sale of machinery	
Upkeep of Motor Lorries		Profit on sale of investment	
To *Management Expenses*:		By Net Loss transferred to Capital Account	
Rent, Rates and Taxes			
Heating and Lighting			
Office Salaries			
Printing & Stationary			

Postage & Telegrams Telephone Charges Legal Charges Audit Fees Insurance General Expenses To *Depreciation and Maintenance*: Depreciation Repairs & Maintenance To *Financial Expenses*: Discount Allowed Interest on Loans Discount on Bills To *Abnormal Losses*: Loss by fire (not covered by Insurance) Loss on Sale of Fixed Assets Loss on Sale of Investments To Net profit transferred to Capital A/c			

8.2.3.1 Important points in Profit and Loss Account

1. Selling and Distribution Expenses

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

2. Management Expenses

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

3. Maintenance Expenses

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

4. Financial Expenses

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

5. Abnormal Losses

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

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

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

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

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

6. Gross Profit

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

7. Other Income

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

8. Non-trading Income

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

9. Abnormal Gains

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

8.2.3.2 Closing entries for Profit and Loss Account

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

Profit and Loss A/c Dr.

To Various Expenses A/c

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

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

Various Incomes & Gains A/c Dr.

To Profit & Loss A/c

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

(iii) (a) For Net Profit

Profit & Loss A/c Dr.

To Capital A/c

(Being Net Profit transferred to capital)

(b) For Net Loss

Capital A/c Dr

To Profit & Loss A/c

(Being Net Loss transferred to Capital Account)

Illustration 2: From the following balances extracted at the close of year ended 31 March, 2018, prepare Profit and Loss Account as at that date:

	₹		₹
Gross Profit	51,000	Discount (Dr.)	500

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

Solution:

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

FOR THE YEAR ENDED 31ST MARCH, 2018

Dr. Cr.

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

Distinction between Trading Account and Profit and Loss Account

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

8.2.4 Balance sheet

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

A Balance Sheet is also described as a "Statement showing the Sources and Application of Capital". It is a statement and not an account and prepared from real and personal accounts. The left hand side of the Balance Sheet may be viewed as description of the sources from which the business has obtained the capital with which it currently operates and the right hand side as a description of the form in which that capital is invested on a specified date.

Characteristics

The characteristics of a Balance Sheet are summarised as under:

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

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

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

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

8.2.4.1 Classification of assets and liabilities

Assets

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

(a) Fixed Assets

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

(b) Current Assets

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

(c) Tangible Assets

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

(d) Intangible Assets

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

(e) Fictitious Assets

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

(f) Wasting Assets

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

(g) Contingent Assets

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

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

Liabilities

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

(a) Long Term Liabilities

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

(b) Current Liabilities

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

(c) Contingent Liabilities

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

8.2.4.2 Marshalling of assets and liabilities

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

(a) In order of liquidity.

(b) In order of permanence.

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

BALANCE SHEET (A)
(IN ORDER OF LIQUIDITY)

Liabilities	**₹**	**Assets**	**₹**
Bills payable		Cash in hand	
Loans		Cash at bank	
Sundry creditors		Investments	
Outstanding expenses		Sundry debtors	
Reserves		Bills receivable	
Capital		Stock-in-trade	
Add Net Profit		Loose tools	
Add Interest		Fixtures and fittings	

Less Drawings		Plant and machinery Building Land Goodwill	

BALANCE SHEET (B)

(IN ORDER OF PERMANENCE)

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

Illustration 3: The following balances are extracted from the books of Kautilya & Co. on 31st March, 2018. You are required prepare the Trading and Profit and Loss Account and a Balance Sheet as on that date.

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

The closing stock was valued at ₹ 12,500.

Solution:

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

FOR THE YEAR ENDED 31ST MARCH, 2018

Particular		**₹**	**Particular**	**₹**	**₹**
To Opening stock		500	By Sales	25,000	
To Purchases	19,500		Less returns	650	24,350
Less returns	250	19,250	By Closing Stock		12,500
To Wages		1,400			

To Carriage Inwards	400		
To Gross Profit c/d	15,300		
	36,850		36,850
To Insurance	550	By Gross Profit b/d	15,300
To Commission	400	By Commission	200
To Interest on Capital	350		
To Stationary	225		
To Trade Expenses	100		
To Rent and Taxes	550		
To Carriage Outwards	725		
To Net Profit transferred to Capital A/c	12,600		
	15,500		15,500

BALANCE SHEET OF KAUTILYA & CO

AS ON 31ST MARCH, 2018

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

8.3 Adjustments

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

1. Closing Stock

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

Closing Stock Account Dr.

To Trading Account

(Being closing stock brought in to books)

Treatment in final accounts

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

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

2. Outstanding Expenses

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

Rent A/c Dr.

To Outstanding Rent A/c

(Being rent outstanding for 8 months)

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

3. Prepaid Expenses

There are certain expenses which have been paid in advance or paid for the future period which is not yet over or not yet expired. The benefit of such expenses is to be enjoyed during the next accounting period. Since, such expenses have already been paid, they have also recorded in the books of account of that period for which they do not relate. For example, insurance premium paid for one year ₹ 3,600 on 1st July, 2017. The final accounts are prepared on 31st March, 2018. The benefit of the insurance premium for the period from 1st April to 30th June, 2018 is yet to expire. Therefore, the insurance premium paid for the period from 1st April 2018 to 30th June, 2018, i.e. for 3 months, shall be treated as "Prepaid Insurance Premium".

The adjustment entry for prepaid expenses is as under:

Prepaid Expenses Account Dr.

To Expenses Account

(Being the adjustment entry for prepaid expenses)

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

4. Accrued Income

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

Accrued Income A/c Dr.

To Income A/c

(Being the adjustment entry for accrued income)

Treatment in final accounts

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

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

5. Income Received in Advance

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

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

The two-fold effect of this adjustment will be:

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

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

6. Depreciation

Depreciation is the reduction in the value of fixed asset due to its use, wear and tear or obsolescence. When an asset is used for earning purposes, it is necessary that reduction due to its use, must be charged to the Profit and Loss account of that year in order to show correct profit or loss and to show the asset at its correct value in the Balance Sheet. There are various methods of charging depreciation on fixed assets. Suppose machinery for ₹ 10,000 is purchased on 1.1.2018, 20% p.a. is the rate of depreciation. Then ₹ 2,000 will be depreciation for the year 2018 and will be brought into account by passing the following adjusting entry:

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

The two-fold effect of depreciation will be:

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

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

7. Interest on Capital

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

Calculation of Interest on Capital

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

Interest on Capital Account Dr.

To Capital Account

(Being the adjustment entry for interest on capital)

Treatment in final accounts

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

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

8. Interest of Drawings

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

Drawings A/c Dr. ₹ 500

To Interest on Drawings A/c ₹ 500

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

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

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

9. Bad Debts

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

Bad Debts A/c Dr.

To Sundry Debtors A/c

(Being the adjustment entry for bad debts)

Treatment in final accounts

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

10. Provisions for Doubtful Debts

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

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

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

For example, sundry debtors on 31.12.2017 are ₹ 55,200. Further bad debts are ₹ 200. Provision for doubtful debts @ 5% is to be made on debtors. In order to bring the provision for doubtful debts of ₹ 2,750, i.e., 5% on ₹ 55,000 (55,200-200), the following entry will be made:

Profit and Loss A/c Dr. ₹ 2,750

To Provision for Doubtful Debts A/c ₹ 2,750

(Being Provision for Doubtful Debts provided)

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

Treatment in final accounts

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

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

11. Provision for Discount on Debtors

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

Profit and Loss Account Dr.

To Provision for discount on debtors account

(Being provision for discount on debtors provided)

Treatment in final accounts

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

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

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

12. Reserve for Discount on Creditors

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

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

Reserve for Discount on Creditors Account Dr.

To Profit and Loss Account

(Being the adjustment entry for discount on creditors)

Treatment in final accounts

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

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

13. Loss of Stock by Fire

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

(a) all the stock is fully insured.

(b) the stock is partly insured.

(c) the stock is not insured at all.

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

Insurance Co. A/c Dr.

To Trading A/c

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

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

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

Insurance Co. A/c Dr.

Profit and Loss A/c Dr.

To Trading A/c

(Being the adjustment entry for loss of goods)

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

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

Profit and Loss A/c Dr.

To Trading A/c

(Being the adjustment entry for loss of goods)

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

14. Manager's Commission

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

Profit and Loss A/c Dr.

To Commission Payable A/c

(Being the adjustment entry for manager's commission)

Treatment in final accounts

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

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

Illustration 4: The following adjustments are to be made in the final accounts being made as on 31st March, 2018.

i) Closing Stock in hand ₹ 20,000.

ii) Salaries amounting to ₹ 1,000 outstanding.

iii) Depreciate Plant and Machinery @10%. The value of Plant and Machinery on 31st March, 2018 was at ₹ 40,000.

iv) Prepaid insurance ₹ 150.

v) Accrued income from investment ₹ 1,500.

You are required to pass adjustment entries.

Solution

JOURNAL

Date	Particulars	L.F.	₹	₹
2018				
Mar 31	Closing Stock A/c Dr.		20,000	
	To Trading A/c		20,000	
	(Being the adjustment entry for closing stock)			
Mar 31	Salaries A/c Dr.			1,000
	To Outstanding Salaries A/c			1,000
	(Being the adjustment entry for outstanding Salaries)			
Mar 31	Depreciation A/c Dr.		4,000	
	To Plant and Machinery A/c			4,000
	(Being the adjustment entry for Depreciation)			
Mar 31	Prepaid Insurance A/c Dr.		150	
	To Insurance A/c			150
	(Being the adjustment entry for prepaid insurance)			
Mar 31	Accrued Income A/c		1,500	
	To Income on Investment A/c			1,500
	(Being the adjustment entry for accrued income)			

Illustration 5: From the following Trial Balance of Mr. Garg as on 31st March, 2018, prepare Trading Account, Profit and Loss Account and Balance Sheet.

TRIAL BALANCE

Debit Balance	**₹**	**Credit Balance**	**₹**
Stock on 1st April, 2017	500	Capital	2,000
Purchases	1,500	Sales	3,500
Land and Building	2,000	Sunday Creditors	750
Bills Receivable	300	Commission	50
Wages	300	Bills payable	300
Machinery	800	Loan	600
Carriage Inward	100		
Carriage Outward	100		
Power	150		
Salaries	200		
Discount Allowed	30		
Drawings	100		
Insurance Premium	20		
Cash at Bank	500		
Cash in Hand	100		
Investments	500		
	7,200		7,200

Adjustments

1. Stock as on 31st March 2018 is valued at ₹ 200.
2. Provide depreciation @ 10% on Machinery and @ 5% on Land and Building.

3. Outstanding salaries amounted to ₹ 50.

4. Insurance premium is paid in advance to the extent of ₹ 10.

5. Allow interest on Capital @ 6% per annum.

6. Interest on loan @ 12% per annum is due for one year.

Solution

TRADING & PROFIT AND LOSS A/C

FOR THE YEAR ENDED 31ST MARCH, 2018

Particulars		**₹**	**Particulars**	**₹**
To Opening stock		500	By Sales	3,500
To Purchases		1,500	By Closing Stock	200
To Wages		300		
To Carriage Inward		100		
To Power		150		
To Gross Profit c/d		1,150		
		3,700		3,700
To Salaries	200		By Gross Profit b/d	1,150
Add Outstanding Salaries	50	250	By Commission	50
To Carriage Inward		100		
To Insurance Premium	20			
Less prepaid Ins.	10	10		
To Discount allowed		30		
To Depreciation on:				
Machinery	80			
Land and Building	100	180		

To Interest on Loan	72		
To Interest on Capital	120		
To Net Profit (Transferred to capital account)	435		
	1,200		1,200

BALANCE SHEET AS ON 31ST MARCH 2018

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

8.4 CHECK YOUR PROGRESS

A. State whether the following statements are True or False

1. Balance sheet shows the financial position of the business on a given date.
2. The main objective of preparing the Trading Account is to ascertain net profit or gross loss during the accounting period.
3. Closing stock refers to the stock of unsold goods at the end of the current accounting period.

4. Overhead includes direct material, indirect labour and indirect expenses.

B. Fill in the blanks

1. Profit and Loss Account measures net income by matching revenues and expenses according to the____________.
2. All types of abnormal losses are treated as extra ordinary expenses and debited to_________.
3. A __________ is a statement of financial position of a business concern at a given date.
4. A contingent liability is one which is not an _____ liability.
5. Accrued income means income which has been earned during the current _________ and has become due but not received by the end of the current accounting period.

8.5 Summary

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

8.6 Keywords

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

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

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

Bad debt: Debts owed to enterprises which are considered to be irrecoverable.

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

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

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

8.7 ANSWERS TO CHECK YOUR PROGRESS

Check Your Progress A

1. True
2. False
3. True
4. False

Check Your Progress B

1. Accounting principles
2. Profit and Loss Account
3. Balance Sheet
4. Actual
5. Accounting year

8.8 Self assessment test

1. Distinguish between Trading Account and Profit and Loss Account. Give a specimen of Trading and Profit and Loss Account with imaginary figures.
2. What is a Balance Sheet? What do you understand by Marshalling used in the balance Sheet? Illustrate the different forms of marshalling.
3. What are closing entries? Give the closing entries which are passed at the end of the accounting period.
4. What are adjustment entries? Why are these necessary for preparing final account.
5. Prepare a Trading Account of a businessman for the year ending 31st December, 2018 from the following data:

	₹
Stock on 1.1.2018	2,40,000
Cash purchases for the year	2,08,000
Credit purchases for the year	4, 00,000
Cash sales for the year	3,50,000
Credit sales for the year	6,00,000
Purchases returns during the year	8,000
Sales returns during the year	10,000
Direct expenses incurred:	
Freight	10,000
Carriage	2,000
Import Duty	8,000
Clearing Charges	12,000
Cost of goods distributed as free samples during the year	5,000
Goods withdrawn by the trader for personal use	2,000
Stock damaged by fire during the year	13,000

The cost of unsold stock on 31st December, 2018 was ₹ 1,20,000 but its market value was ₹ 1,50,000.

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

TRADING & PROFIT AND LOSS A/C

FOR THE YEAR ENDED 31ST MARCH, 2018

Particulars	**₹**	**Particulars**	**₹**
To Opening stock of raw	7,352	By Closing stock of raw	9,368

material		material	
To Purchases	63,681	By Sales	1,70,852
To Sundry creditors	25,375	By Sundry debtors	40,659
To Carriage inwards	2,654	By Gross loss c/d	8,182
To Carriage outwards	394		
To Salaries	24,370		
To Wages	51,963		
To Rent, Rates & Taxes	3,981		
To Repairs to factory	35,68		
To Insurance	13,923		
	2,29,061		2,29,061

PROFIT & LOSS ACCOUNT

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

7. Prepare Manufacturing, Trading and Profit & Loss Account for the year ended 31st December, 2018 and Balance Sheet as at that date of Shri S. Singh, manufacturer, from the following Trial Balance and information.

Particular	₹	Particular	₹
Advertising	1,660	Salaries Office	7,380
Bad Debts	1,210	Stock 1.1.2018	
Bank Charges	240	Raw Materials	10,460
Drawings	16,000	Finished Goods	14,760
Factory Power	7,228	Work in Progress	3,340
Furniture	1,800	Wages Factory	41,400
General Expenses: Factory	410	Debtors	21,120
Office	692	Cash in Hand	350
Insurance	1,804	Cash at Bank	7,852
Light and Heat	964	Credit Balances:	
Plant & Machinery (1.1.2018)	30,000	Bad Debts Provision	2,000
Plant & Mach. bought on 30.6.2017	4,000	Capital	70,000
Purchases	67,336	Current Account	3,246
Packing & Transport	2,170	Discount	824
Rent & Rates	2,972	Sales	1,58,348
Repairs to Plant	1,570	Creditors	12,300

Stock on 31st December, 2018 were: (a) Raw Materials ₹ 7,120; Work in Progress ₹ 3,480; Finished Goods ₹ 19,300 and Packing Materials ₹ 250. The Liabilities to be provided for: (b) Factory Power ₹ 1,124 ; (c) Rent and Rates ₹ 772; (d) Light and Heat ₹

320; (e) General Expenses-Factory ₹ 50, Office ₹ 80. Insurance Prepaid ₹ 340. Provide Depreciation at 10% p.a. on plant & machinery and 5% p.a. on furniture. Increase the Bad Debts Provision by ₹ 1,000. Five-Sixth of Rent and Rates, Light & Heat and Insurance are to be allotted to the Factory and one-sixth to the Office.

8. Following is the Trial Balance of Mr. Naresh for the year ended 31st March, 2017:

Particular	**Dr.**	**Cr.**
	₹	₹
Capital	-	3,50,000
Stock on 1st April, 2018	30,000	-
Sales	-	2,00,000
Carriage	4,000	-
Freight and Customs Duty	6,000	-
Purchases	1,90,000	-
Salaries	15,000	-
Income Tax	10,000	-
Sundry Debtors and Sundry Creditors	24,000	14,000
Cash at Bank	20,200	-
Cash in Hand	5,000	-
Furniture	1,800	-
Life Insurance premium	5,000	-
Sales Tax	5,000	-
Building	1,80,000	-
Drawings	68,000	-
Office Expenses	2,000	-

Discount Received	-	2,000
	5,66,000	5,66,000

Prepare Trading and Profit and Loss Account for the period ending 31st March, 2018 and a Balance Sheet as on that date after taking following information into consideration.

1. Closing stock ₹ 80,200 (including stationery stocks ₹ 200).
2. Office expenses include stationery purchased ₹ 800.
3. Sundry Debtors include ₹ 3,000 receivable from Reeta and Sundry Creditors include ₹ 1,000 payable to Reeta.
4. A sum of ₹ 5,000 has been received from a debtor as deposit which has been credited to his account.
5. ₹ 500 was written off as bad debts in previous year and this amount has been received during the current year and has been credited to Debtors Account.
6. Some employees are residing in the premises of business due to their nature of service, the rent of such portion is ₹ 1,000 per month.
7. Salaries include a sum of ₹ 500 which is advance salary.
8. On 1st April, 2017 books contain such furniture of ₹ 600 which was sold for ₹ 290 on 30th Sept., 2017 and in exchange of it a new furniture of ₹ 520 was acquired, its net invoice of ₹ 230 was recorded in purchase books.
9. Depreciate Buildings @ 5% p.a. and Furniture @ 10% p.a.
10. Goods worth ₹ 2,000 were in transit on the last day of the accounting year.

8.9 References/suggested readings

1. Anthony N. Robert, “Accounting Principles”, AITBS Publishers, New Delhi.
2. Aggarwal, M.P., “Analysis of Financial Statements”, National Publishing House, New Delhi.
3. Ashok Banerjee, “Financial Accounting”, Excel Book, New Delhi.

4. R. Narayanaswamy, “Financial Accounting”, Prentice Hall of India, New Delhi.

Course: Financial Accounting-I	
Course Code: **BCOM 101**	Author: **Dr. B.S. Bodla**
Lesson No: **9**	SLM Conversion By: Ms. Chand Kiran

ACCOUNTS FOR NON-PROFIT MAKING ORGANISATIONS

Structure

9.0 learning Objectives

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

- Know the meaning and objectives of non-profit making organisations.
- Know the meaning and features of Receipts and Payments Account, Income and Expenditure Account and Balance Sheet of non-profit making organisation.
- Understand the preparation of Income and Expenditure Account and Balance Sheet of non-profit making organisation.

9.1 Introduction

Non-profit making organisations, also known as non-trading institutions or organisations, include such voluntary associations of persons as are formed for the purpose of providing recreational facilities to its members or to promote art, culture, education, commerce, science, religion and other social and charitable purposes. There is no purchase or manufacture of goods for trading purposes in these non-profit making organisations. The primary object of these institutions is to render a service to their members (or society) or to satisfy members' common needs. The examples of such organisations include sport clubs, educational institutions, hospitals, libraries, temples, churches, gurudwaras, masjids. Similarly, the associations of manufacturers or traders and professionals are also non-profit making organisations and include medical councils, banker's association, teachers association, The Institute of Chartered Accountants of India, The Institute of Cost and Works Accountants of India, The Institute of Company Secretaries of India. All these entities are formed for the purpose of promotion and protection of their professional interests. The non-trading organisations too like trading organisations have to prepare the financial statements at the end of the accounting year. The non-trading institutions are different from the trading institutions in several respects. They have not to purchase and sell goods, accept or receive bills of exchange nor do they have too many credit transactions. Most of their transactions are cash transactions and, therefore, they need not maintain as many books of accounts as trading institutions have to maintain. However, they do maintain a cash book and minimum number of such other books which may be required for their purposes. For example, a Register of Members, a Minutes Book are maintained in case of a club or a society, a student fee register is maintained in case of a school or a college, a summary record of outstanding fees may be kept by an Advocate or a Chartered Accountant.

At the end of the accounting period, a non-trading institution also prepares its final accounts, which include the following:

(i) Receipts and Payments Account,

(ii) Income and Expenditure Account, and

(iii) Balance Sheet.

9.2 Accounts for Non-profit Organisation

9.2.1 Receipts and Payments Account

Receipts and Payments Account is a summary of cash transactions for a given period. All the receipts, by cash or by cheque, are entered on the debit side, whereas all the payments, by cash or by cheque, are shown on the credit side. It begins with an opening balance (Cash or/and Bank) and is debited with all the items of receipts irrespective of whether they are of capital or revenue nature or whether they pertain to the accounting period or not. The payments are recorded on the credit side without making any distinction between items of capital and revenue nature and irrespective of the fact whether they belong to the accounting period or not. Moreover, this account is not used to record outstanding items of receipts and payments since these are non-cash items. At the end of the accounting period, this account is balanced to ascertain the balance of cash in hand or at the bank or the overspent amount or bank overdraft.

Features

The main features of the Receipts and Payments Account can be summarised as follows:

(a) It is a real account, i.e., it is a summarised copy of cash receipts and cash payments.

(b) Its form is similar to Cash Book (without discount and bank columns) with debit and credit sides. Receipts are recorded on the debit side while payments being entered on the credit side.

(c) It records all receipts and payments irrespective of the distinction between capital and revenue items. In other words, both capital and revenue receipts and payments are included.

(d) Only actual receipts and payments during the accounting period, whether relating to previous or current or succeeding years are recorded in it.

(e) The opening and closing balances in it mean cash in hand/bank in the beginning and at the end respectively. The balance of Receipts and Payments Account must be debit being cash on hand and/or at bank, unless there is a bank overdraft.

Illustration 1: From the following particulars taken from the Cash Book of a Club, prepare a Receipts and Payments Account.

Opening Balance:	₹
Cash in hand	100
Cash at bank	500
Receipts:	
Subscriptions	3,300
Donations	260
Payments:	
Rent paid	1400
General expenses	210
Postage & stationary	70
Sundry expenses	30
Closing Cash Balance	200

Solution:

RECEIPTS AND PAYMENTS ACCOUNT

FOR THE YEAR ENDED...........

Dr. **Cr.**

Receipts	**Amount (₹)**	**Payments**	**Amount (₹)**
To Balance b/d		By Rent	1400
Cash in hand 100		By Sundry Expenses	30
Cash at Bank 500	600	By General Expenses	210
		By Postage & Stationary	70
To Subscriptions	3,300	By Balance c/d:	
To Donations	260	Cash in hand 200	
		Cash at Bank (Balancing figure) 2,250	2,450
		4,160	4,160

9.2.2 Income and Expenditure Account

It is a nominal account of non-trading institutions equivalent to the Profit and Loss Account of the business concerns. It shows the classified summary of incomes, expenses and losses for current accounting period along with the excess of income over expenditure (i.e. surplus) or excess of expenditure over income (i.e. deficit) which is transferred to Capital Fund in the Balance Sheet. It is generally prepared from a given Receipts and Payments Account after making necessary adjustments. An Income and Expenditure Account being itself a nominal account includes only nominal accounts or revenue items. All items of revenue nature (nominal accounts) pertaining to relevant accounting period and, which appear on the debit side of the Receipts and Payments Account are entered on the credit side (i.e. income side) of the Income and Expenditure Account with necessary adjustments for prepaid or outstanding figures. Similarly, all the revenue items (nominal accounts) appearing on the credit side of the Receipts and Payments Account will be entered on the debit side (i.e. expenditure side) of the Income and Expenditure Account with necessary adjustments as to prepaid or outstanding items. Thus, items of capital nature, such as purchase of machinery, building, furniture, etc. shall appear in the Balance Sheet. The end balance of the Income and Expenditure Account, which may be either excess of income over expenditure or excess of expenditure over income would be added to or deducted from, as the case may be, the Capital Fund on the liabilities side of the Balance Sheet. The essential features of Income and Expenditure Account can be put as follows:

(a) It is debited with the expenses and losses.

(b) It is credited with the incomes.

(c) It records only those incomes, expenses and losses which are of revenue nature.

(d) It records only those incomes, expenses and losses which relates to current accounting year.

(e) It records non-cash items also (e. g. depreciation).

(f) Its balance at the end which represents either the net surplus (if credit side exceeds debit side) or net deficit (if debit side exceeds credit side) is transferred to the Capital Fund in the Balance Sheet.

Illustration 2: From the information given in Illustration 1, prepare an Income and Expenditure Account.

Solution

INCOME AND EXPENDITURE ACCOUNT

FOR THE YEAR ENDING ON..........

Dr. **Cr.**

Expenditure	**Amount (₹)**	**Income**	**Amount (₹)**
To Rent	1400	By Subscriptions	3,300
To General Expenses	210	By Donations	260

To Postage & Stationary To Sundry Expenses To Excess of Income over Expenditure	70 30 1,850		
	3,560		3,560

Distinction between Receipts and Payments Account and Income and Expenditure account

1. Receipts and Payments Account is a summarised statement of cash receipts and cash payments during a particular period, whereas Income and Expenditure Account is the substitute of Profit and Loss Account for non-trading concerns.
2. While Receipts and Payments Account, just like cash book, commences with opening cash balance/bank balance and closes with closing cash balance/bank balance, Income and Expenditure Account has nothing to do with opening or closing cash/bank balances.
3. Receipts and Payments Account concerns itself with actual cash received or paid during the period and ignores outstanding expenses as well as income accrued whereas Income and Expenditure Account includes all income even if not received and all expenses even if not paid.
4. Though Receipts and Payments Account includes both capital and revenue items, Income and Expenditure Account include revenue items only.
5. While Receipts and Payments Account shows receipts on the debit side and payments on the credit side, Income and Expenditure Account shows income on the credit side and expenses on the debit side.
6. Receipts and Payments Account includes items relating to preceding as well as succeeding years. Income and Expenditure Account, on the other hand, concerns itself, only with income and expenditure of the period to which it relates.
7. In Receipts and Payments Account, difference between two sides will represent closing cash/bank balance. In Income and Expenditure Account, the difference will mean either excess of income over expenditure or vice-versa.

8. Receipts and Payments Account is generally accompanied by Statement of Affairs, whereas Income and Expenditure Account is always accompanied by Balance Sheet.

9. Receipts and Payments Account belongs to the category of real accounts, but Income and Expenditure Account belongs to the family of nominal accounts.

9.2.3 Balance Sheet

Balance Sheet of a non-trading concern is prepared in the usual way and contains particulars of all assets on right-hand side and liabilities on left-hand side of the concern on the date on which it is prepared. The excess of total assets over total outside liabilities is known as Capital Fund. While preparing the Balance Sheet, the excess of income over expenditure is added to the opening Capital Fund and the excess of expenditure over the income is deducted from the opening Capital Fund. Sometimes, two balance sheets may have to be prepared (i) Balance Sheet in the beginning of the accounting year to ascertain the amount of Capital Fund in the beginning of the accounting year, and (ii) Balance Sheet at the end of the accounting year to show the financial position of the concern as on that date.

Items Peculiar to Non-profit making organisations

The technique of preparing the final accounts of a non-trading concern is similar to that of preparing final accounts of a trading concern. However, there are certain peculiar items in case of non-trading institutions. The accounting treatment of these items and their presentation in the final accounts is as follows:

1. Legacy

Legacy refers to the amount which one gets on account of a will. The amount received on account of a legacy appears on the receipts side of Receipts and Payments Account. It should not be treated as an income because it is not of recurring in nature but should be treated as capital receipt, i.e., credited to Capital Fund Account.

2. Donations

This is very common receipt for non-trading institutions. It is a sort of gift in cash or property from some person, firm or a company. It appears on the receipts side of the Receipts and Payments Account, if received in cash. Donations can be for specific purposes or for general purposes. The accounting treatment for these is as follows:

(a) Specific donation: In case a donation has been received for a specific purpose, the donation is termed as a specific donation. For example, an institution may receive donation for construction of building or for giving prizes to best artist. The amount of such donation cannot, therefore, be used for general purpose. It should be taken to the Balance Sheet on the liabilities side and be used only for the purpose which it is meant, irrespective of the amount.

(b) General donation: A donation not received for a specific purpose is termed as general donation. In case, the general donation is of a big or large amount, it can fairly taken for granted that such donation is of a non-recurring nature and, therefore, should be taken to the Balance Sheet on the liabilities side. However, if the donation is of a small amount and not meant for a specific purpose, it can be taken to credit side of the Income and Expenditure Account. Whether the donation is of big amount or small amount would depend on the facts of each case. For example, in case of an educational institution, a sum of ₹ 11,000 can be taken as a small donation, but for a drama club, a sum of ₹ 11,000 is quite substantial and, therefore, it will be proper to take the amount of such donation received to the Balance Sheet.

Illustration 3: Following are the extracts from the Receipts and Payments Account of a sports club. You are required to show the different items in the Income and Expenditure Account and Balance Sheet of the club after taking into account the additional information given.

RECEIPTS AND PAYMENTS ACCOUNT

FOR THE YEAR ENDING 31ST MARCH, 2018

	₹
To Donations for Pavilion	5,000
To Subscriptions for Governor's Party	2,000
To Donations	1,000

Additional Information

(i) Amount spent on Pavilion ₹ 1,000.

(ii) Outstanding subscriptions for Governor's Party ₹ 500.

Solution

INCOME AND EXPENDITURE ACCOUNT

FOR THE YEAR ENDING 31ST MARCH, 2018

Dr. Cr.

Expenditure	₹	Income	₹
		By Donations	1,000

BALANCE SHEET

AS ON 31ST MARCH, 2018

Liabilities	Amount (₹)	Assets	Amount (₹)
Fund for Pavilion (donations received)	5,000	Outstanding Subscriptions for Governor's Party	500
Subscriptions for Governor's Party (including outstanding)	2,500	Pavilion (cost incurred)	1,000

3. Subscriptions

This is the major source of revenue income of a non-trading institution. Subscriptions are the amounts paid by the members of such entity to maintain their membership. Subscriptions may be paid periodically (usually on yearly basis) or as a lump sum for life-membership. Periodical subscriptions are treated as revenue receipts, whereas life membership subscriptions are usually treated as capital receipts and, thus, are transferred to the Capital Fund. The Receipts and Payments Account records the amount of actual subscriptions received while the Income and Expenditure Account records only the subscriptions which relate to the accounting period, whether received or not. Adjustments may, therefore, be required to be made to find out the actual amount of income from subscription. The following illustration is being given to clarify this point:

Illustration 4: From the following extracts of Receipts and Payments Account and the additional information, you are required to calculate the Income from Subscriptions for the year ending 31

December, 2017 and show them in the Income and Expenditure Account, and the Balance Sheet of a Club.

RECEIPTS AND PAYMENTS ACCOUNT

FOR THE YEAR ENDING 31ST DECEMBER 2018

Dr. Cr.

Receipts			**₹**	**Payments**	**₹**
To Subscriptions					
	2016	5,000			
	2017	30,000			
	2018	6,000	41,000		

Additional Information

(i) Subscription outstanding on 31.12.2016 ₹ 6,000

(ii) Subscription outstanding on 31.12.2017 ₹ 5,000

(iii) Subscription received in advance on 31.12.2016 ₹ 6,000

Solution

INCOME AND EXPENDITURE ACCOUNT

FOR THE YEAR ENDED 31ST DEC., 2017

Dr. Cr.

Expenditure	**₹**	**Income**	**₹**
		By Subscription	40,000

BALANCE SHEET

AS ON 31-12-2017

Liabilities	**₹**	**Assets**		**₹**
Subscription in advance	6,000	Subscription Outstanding		

		for 2016 (6000-5000) for 2017 (5000-1000)	1,000 4,000	 5,000

Working Note: Calculation of Subscription Income for 2017-

a) Subscription received during 2017 for 2017 ₹ 30,000

b) Subscription received during 2016 for 2017 ₹ 6,000

c) Subscription outstanding for 2017 as on 31.12.2017 ₹ 4,000

₹ 40,000

4. Entrance fee or Admission fee

This is the amount of fee usually charged by a club or a society or an educational institution from the new entrants. It is usually taken as an item of income. There are arguments that since it is paid only once for all and of non-recurring nature and, therefore, should be capitalised and taken to the liabilities side of the Balance Sheet. But another argument is that though it is paid by each member only once, the club or institution receives it regularly because of frequent changes in its membership for one reason or the other. Accordingly, it should be treated as revenue income and credited to Income and Expenditure Account. In the absence of any specific instructions about entrance fee in the question, any one of the above treatment may be followed but students should append a note justifying their treatment.

5. Sale of old newspapers and periodicals

The sale proceeds of old newspapers and periodicals is of a recurring nature and should, therefore, be taken as income in the Income and Expenditure Account.

6. Sale of old fixed assets

The sale proceeds of old fixed assets are treated as capital receipts and, thus, are credited to the respective fixed assets account. However, the profit or loss on sale of fixed assets is shown in the Income and Expenditure Account.

7. Sale of sports material

Sale of sports material is a regular feature of clubs and the amount received is treated as an ordinary or revenue income. It is, therefore, shown in the credit side of the Income and Expenditure Account.

8. Endowment Fund

It is a fund arising from a bequest or gift, the income of which is devoted for a specific purpose. Thus, endowment fund is a capital receipt and is shown in the liabilities side of the Balance Sheet.

9. Payment of Honorarium

This is the payment to a person for his specific services rendered by him not as a regular employee. For example, the payment made to a Professor to deliver lecture on a topic or to a Television artist for his/her specific performance, is termed as honorarium. This is an item of expense and is shown in the debit side of the Income and Expenditure Account.

10. Special Funds

An institution may keep special funds for some special purposes. For example, a sports club may keep a special fund for meeting sports expenses or for awarding of sports prizes. In case such special funds, all incomes relating to such funds should be added to these funds in the Balance Sheet on the liabilities side. Similarly, all expenses on account of these funds should be deduced from these funds. In case of a deficit, the amount should be met out from the Income and Expenditure Account. In case of surplus, it will be better on account of convention of conservatism, to keep it in the Balance Sheet or merge it with the Capital Fund.

Illustration 5: Following is the information given in respect of certain items of a sports club. You are required to show them in the Income and Expenditure Account and prepare the Balance Sheet of the club.

	₹
Sports Fund as on 1.1.2018	10,000
Sports Fund Investments	10,000
Interest on Sports Fund Investments	1,000
Donation for Sports Fund	4,000
Sports Prizes awarded	3,000
Expenses on sports events	1,000

General Fund	30,000
General Fund Investments	30,000
Interest on General Fund Investments	4,000

Solution

INCOME AND EXPENDITURE ACCOUNT

FOR THE YEAR ENDING 31ST DECEMBER, 2018

Dr. Cr.

Expenditure	**₹**	**Income**	**₹**
		By interest on General Fund Investments	4,000

BALANCE SHEET

AS ON 31ST DECEMBER, 2018

Liabilities		**Amount ₹**	**Assets**	**Amount ₹**
Sports Fund	10,000		Sports Fund Investments	10,000
Add Interests on			General Fund Investments	30,000
Sports Fund	1,000			
Investments				
Sports Fund Donations	4,000			
	15,000			
Less Sports Prizes awarded	3,000			
	12,000			
Less Expenses on				
Sports events	1,000	11,000		
General Fund		30,000		

9.3 Preparation of Accounts

9.3.1 Preparation of Accounts Income and Expenditure Account

The practical steps involved in the preparation of an Income and Expenditure Account from the Receipts and Payments Account are as under:

Step I Ignore opening and closing cash/bank balances appearing in the Receipts and Payments Account.

Step II Eliminate all items of capital receipts and payments.

Step III Ascertain the revenue income of the relevant period by excluding from the total receipts, the income received on account of previous and future years.

Then add income accrued in the year but not received.

Step IV Make adjustments as per additional information such as depreciation, bad debts, etc., if any,

Step V Calculate the difference between the total of debit side and the total of credit side. If the total of credit side exceeds the total of debit side, show the excess of income over expenditure (surplus) on the debit side. If the total of debit side exceeds the total of credit side, the excess of expenditure over income (deficit) on the credit side of Income and Expenditure Account.

If surplus, add it to the Capital Fund and if deficit deduct from Capital Fund in the Balance Sheet.

Illustration 6: From the following details and notes attached relating to the Haryana Tennis Club, prepare the final accounts of the year ended 31st December 2018.

On January 1, 2018 the club's assets are:

Freehold Club house ₹ 20,000; Equipment ₹ 1,400; club subscription in arrear ₹ 160; The club owed ₹ 800 to a firm for Christmas 2017 dance catering.

Solution

SUMMARY OF RECEIPT AND PAYMENTS FOR 2018

Receipts	₹	Payments	₹
To Cash in hand	1,520	By Catering-2017 dance	800
To Subscriptions	3,280	By 2018-dances and socials	1,900
To Locker Rent	200	By Band fees-2018 dances	500
To Receipts from dances and socials	2,780	By New lawn-mover	1,060
To Sale of used match tennis balls	300	By Repairs to tennis nets	380
To Sale of old lawn-mover	160	By Match tennis balls	620
		By Match expenses	340
		By Repairs and decoration of club house	1,300
		By Balance c/d	1,340
	8,240		8,240

Notes

(i) The book value on 1 January 2018 of the old lawn mover sold during the year was ₹ 60.

(ii) The club has 40 members and the subscription is ₹ 80 each per annum. The subscriptions received in 2018 included those in arrear for 2017.

(iii) On 31 December, 2018 ₹ 220 was owed to Playfair Ltd. for tennis balls supplied.

(iv) Equipment as at 31 December 2018 to be depreciated by 15% p. a.

v) Tennis balls are regarded as revenue expenditure.

Solution

INCOME AND EXPENDITURE ACCOUNT

FOR THE YEAR ENDING ON 31 DECEMBER 2018

Expenditure	₹	Income		₹
To Band fees	500	By Subscriptions	3,280	
To Repairs to tennis nets	380	Less: Outstanding(2017)	160	

To Tennis balls	620			3,120	
Add: Outstanding	220	840	Add: Outstanding (2018)	80	3,200
To Match expenses		340	By Locker rents		200
To Repairs and decorations		1,300	By Receipts from dance	2,780	
To Depreciation on Equipment			Less: Expenses	1,900	880
(15% of 2,400)		360	By Sale of used match tennis balls		300
To Excess of income over expenditure		960	By Profit on sale of lawn mover		100
		4,680			4,680

BALANCE SHEET

AS ON 1.1.2018

Owing for catering	800	Cash in hand	1,520
Capital Fund (Balancing figure)	22,280	Equipment	1,400
		Freehold club house	20,000
		Subscriptions in arrear	160
	23,080		23,080

BALANCE SHEET

AS ON 31 DECEMBER 2018

Owing for Tenis balls		220	Cash in hand		1,340
Capital Fund	22,280		Equipment	2,400	
Add: Surplus	960	23,240	Less: Depreciation	360	2,040
			Freehold club house		20,000
			Subscriptions in arrear		80
		23,460			23,460

Notes

(i) Equipment includes lawn mover.

(ii) Since there are 40 members each paying ₹ 80 as yearly subscription, the club ought to have received ₹ 3,200 as total subscriptions. Hence, ₹ 80 are outstanding for subscription.

9.3.2 Preparation of Receipts and Payments Account from Income and Expenditure Account

The practical steps involved in the preparation of a Receipts and Payments Account from an Income and Expenditure Account are:

Step I Put the 'opening balances' of cash/bank as the first item on the 'Receipts side' and 'closing balances' of cash/bank as the last item on the 'Payments side' of the Receipts and Payments Account.

If one of the two balances are given, the other balance will have to be ascertained.

Step II Ascertain 'Revenue Receipts' received during the current accounting period as under and show it on the receipts side of Receipts and Payments Account:

Revenue Income (account-wise) for the current year as per Income and Expenditure Account.

Add Income received in advance at the end of current year.

Add Income outstanding in the beginning of current year.

Less Income outstanding at the end of current year.

Less Income received in advance in the beginning of the current year.

Step III Ascertain 'Revenue Payments' made during the current accounting period as under and show it on the payments side of Receipts and Payments Account:

Revenue expenses (account-wise) for the current year as per Income and Expenditure Account

Add Expenses outstanding in the beginning of current year.

Add Expenses prepaid at the end of current year.

Less Expenses outstanding at the end of current year.

Less Expenses prepaid in the beginning of current year.

Step IV Ascertain all capital receipts and capital payments from the additional information or Balance Sheets or by preparing the accounts of capital items and show the capital receipts on the 'Receipts side' and the capital payments on the 'Payments side' of the Receipts and Payments Account.

Illustration 7: The Income and Expenditure Account of Star Club is as follows:

INCOME AND EXPENDITURE ACCOUNT

FOR THE YEAR ENDED 31ST DECEMBER, 2017

Dr. Cr.

Expenditure	**₹**	**Income**	**₹**
To Salaries	1,400	By Subscriptions	1,600
To General expenses	400	By Donations	840
To Depreciation	240		
To Surplus	400		
	2,440		2,440

The Secretary of the Club informs you that the above account was prepared after making the following adjustments:

(i) Subscriptions were outstanding on 1st January 2017 (for 2016) ₹ 160 out of which ₹ 144 were received in 2017.

(ii) As on 1st January 2017 subscriptions received in advance amounted to ₹ 40, whereas on 31st December 2017 subscriptions received in advance ₹ 32. Also ₹ 56 worth subscriptions (for 2017) were outstanding as on Dec. 31, 2017.

(iii) General Expenses were outstanding on 1st January 2017 ₹ 64 and on 31st December 2017 ₹ 72. Prepaid expenses amounted to ₹ 88 in the beginning and at close ₹ 144.

(iv) Sundry assets as on 1st January 2017 ₹ 2,080 and after providing depreciation for the year 2017 the value of sundry assets was ₹ 2,160.

(v) Cash in hand on 31st December 2017 was ₹ 480.

You are required to prepare Receipts and Payments Account.

Solution

RECEIPTS AND PAYMENTS ACCOUNT

FOR THE YEAR ENDED 31ST DECEMBER, 2017

Dr. Cr.

Receipts	**₹**	**Payments**	**₹**
To Cash Balance b/d (1)	128	By Salaries	1,400
To Donations	840	By General expenses (2)	448
To Subscriptions (3)	1,680	By Sundry assets (4)	320
		By Cash Balance c/d	480
	2,648		2,648

Working Notes

1. Opening cash balance is the balancing figure of the Receipts and Payments Account.

2. Actual amount paid in respect of general expenses has been arrived at as follows:

		₹
Expenses as per Income and Expenditure Account	400	
Add outstanding in the beginning i.e. as on 1.1.2017 (paid for 2016)	64	
Add prepaid at the end i.e. as on 31.12.2017 (paid for 2018)	144	
		608
Less outstanding at the end i.e. as on 31.12.2017 (unpaid)	72	
Less prepaid in the beginning i.e. as on 1.1.2017 (paid in 2016)	88	160

General expenses-actual cash paid		448

3. Actual amount received in respect of subscriptions has been arrived at as follows:

		₹
Subscriptions as per Income and Expenditure Account	1,600	
Add received in advance as on 31-12-2017	32	
Add Received on account of 2016 (outstanding total 160 but received only 144)	144	
		1,776
Less Outstanding at the end (i.e. not received)	56	
Less Received in 2016 for 2017 (Received in advance)	40	96
Subscriptions-actual cash received		₹ 1,680

4. Amount spent for the purchase of sundry assets has been arrived at as follows:

		₹
Sundry assets as on 31-12-2017	2,160	
Add Depreciation charged as per Income and Expenditure Account	240	
		2,400
Less Sundry assets as on 1.1.2017		2,080
Sundry assets purchased during 2017		320

Illustration 8: The Income and Expenditure Account of Yogi's Club for the year 2018 is as follows:

Expenditure	**₹**	**Income**	**₹**
To Salaries and wages	9,500	By Subscriptions	15,000
To Misc. expenses	1,000	By Entrance fees received	500

To Audit fees		500	By Profit on annual sports meet:		
To Chief executive's honorarium		2,000	Receipts	3,000	
To printing & Stationery		900	Expenses	1,500	1,500
To Annual day celebration					
Expenses	3,000				
Less donations	2,000	1,000			
To Interest on bank loan		300			
To Depreciation on sports equipment		600			
To Excess of income over expenditure		1,200			
		17,000			17,000

Prepare (i) Receipts and Payments Account for the year 2018 and (ii) Balance Sheet as at the end of 2018 from the following information:

(i)	Subscriptions: Outstanding as on 31-12-2017	1,200
	Received in advance as on 31-12-2018	900
	Received in advances as on 31-12-2018	540
	Outstanding as on 31-12-2018	1,500
(ii)	Salaries: Outstanding as on 31-12-2017	800
	Outstanding as on 31-12-2018	900

(iii) Audit fees: The fees for 2018 were outstanding on 31-12-2018. But during 2018, audit fees for 2017 amounting to ₹ 400 were paid.

(iv) Prepaid insurance as on 31-12-2018 was ₹ 120.

(v) The club had owned grounds having a book value of ₹ 20,000. The sports equipment as on 31-12-2017 and as on 31-12-2018 after depreciation amounted to ₹ 5,200 and ₹ 5,400 respectively.

(vi) In 2017 the club had raised a bank loan of ₹ 4,000 which was outstanding throughout 2018.

(vii) On 31st December 2018 cash in hand amounted to ₹ 3,200.

Solution

YOGI'S CLUB

RECEIPTS AND PAYMENTS ACCOUNT

FOR THE YEAR ENDED 31-12-2018

	₹		**₹**
To Cash Balance b/d	2,780	By Salaries and wages (3)	9,400
(Balancing figure) (1)		By Misc. expenses (including insurance) (4)	1,120
To Subscriptions (2)	14,340	By Audit fees	400
To Entrance fees receipts	500	By Chief executive's remuneration	2,000
To Annual sports meet receipts	3,000	By Printing and stationery	900
To Annual day celebrations donations	2,000	By Annual day celebration expenses	3,000
		By Interest on bank loan	300
		By Annual sports meet expenses	1,300
		By Sports equipment (5)	800
		By Cash Balance c/d	3,200
	22,620		22,620

BALANCE SHEET

AS ON DECEMBER 31, 2018

Liabilities		**₹**	**Assets**		**₹**
Salaries outstanding		900	Sports grounds		20,000
Audit fees outstanding		500	Sports equipment	5,200	
Subscription received in advance		540	*Add* Purchases	800	
Bank loan		4,000		6,000	
Capital funds as on			*Less* Depreciation	600	5,400
1-1-2018 (6)	23,080		Subscription outstanding		1,500
Add excess of income			Prepaid insurance		120
over expenditure	1,200	24,280	Cash in hand		3,200
		30,220			30,220

Working Notes

1. Cash Balance (Opening): This is the balancing figure of the Receipts and Payments Account.
2. Subscriptions received:

		₹
Subscriptions income as per Income and Expenditure Account		15,000
Add Subscription received in advance		540
Add Subscriptions outstanding (at the beginning)		1,200
		16,740
Less Subscriptions outstanding	1,500	
Less Subscriptions received in advance	900	2,400

	14,340
3. Salaries and wages:	
As per Income and Expenditure Account	9,500
Add Outstanding (beginning) paid in 2018 for 2017	800
	10,300
Less Outstanding not paid in 2018	900
	9,400
4. Misc. expenses:	
As per Income and Expenditure Account	1,000
Add Paid in 2018 for 2019	120
	1,120
5. Sports equipment:	
Value of sports equipment at the end (31-12-2018)	5,400
Add Depreciation	600
	6,000
Less Value of sports equipment in the beginning	5,200
Excess representing purchase of equipment during the year	800

6. Capital Fund as on 1-1-2018

BALANCE SHEET

AS ON 1-1-2018

Liabilities	**₹**	**Assets**	**₹**
Bank loan	4,000	Cash	2,780
Advance subscription	900	Grounds	20,000

Salaries outstanding	800	Sports equipment	5,200
Audit fee outstanding	400	Subscriptions outstanding	1,200
Capital Fund (balancing figure)	23,080		
	29,180		29,180

9.4 Check your progress

Answers the following fill up:

1. Receipt and payment account generally represents ____________.
2. _____________ Account records transactions of revenue nature.
3. Income and expenditure reveals _______________.
4. Subscription received by a school for organising a school function is treated as ______________.
5. Receipt and payment account is a summary of _________________.

9.5 Summary

Non-profit making organizations include such voluntary associations of persons as are formed for the purpose of providing recreational facilities to its members or to promote art, culture, education, commerce, science, religion and other social and charitable purposes. At the end of accounting period, a non-profit making organisation also prepare its final accounts, which include namely (i) Receipts and Payments Account; (ii) Income and Expenditure Account; (iii) Balance Sheet. Receipts and Payments Account is a summary of cash transactions for a given period. All the receipts are entered on the debit side and all the payments are shown on credit side. At the end of accounting period, this account is balanced to ascertain the balance of cash in hand or at the bank or the overspent amount or bank overdraft. Income and Expenditure account of non-trading institutions equivalent to the Profit and Loss Account of the business concerns. It shows the classified summary of incomes, expenses and losses for current accounting period along with the excess of income over expenditure (i.e. Surplus) or excess of expenditure over income (i.e. deficit). The surplus or deficit is being transferred to capital fund in the

Balance Sheet. Balance Sheet of a non-profit making organisation is prepared in the usual way and contains all assets on right-hand side and liabilities on left-hand side.

9.6 Keywords

Endowment Fund: It is a fund arising from a bequest or gift, the income of which is devoted for a specific purpose.

Subscriptions: These are the amounts paid by the members of such entity to maintain their membership.

Legacy: It refers to the amount which one gets on account of a will.

Receipts and Payments Account: This is a summary of cash transactions for a given period.

Income and Expenditure Account: It is a nominal account of non-trading institutions equivalent to the profit and loss account of the business concerns.

9.7 Self-assessment test

1. What is Receipts and Payments Account? What are its features?
2. What is an Income and Expenditure Account? Who prepares it and why?
3. Distinguish between Receipts and Payments Account and Income and Expenditure Account. What steps are required for converting (a) Receipts and Payments Account into Income and Expenditure Account and (b) Income and Expenditure Account into Receipts and Payments Account.
4. Explain the meaning of the following terms and show how will you deal with them while preparing final accounts of a club. Support your answers with suitable examples.

   (a) Donations, (b) Entrance fee, (c) Life membership fee, (d) Receipts for a sports fund and (e) Legacy
5. The following is the Receipts and Payments Account of Hisar Football Association for the first year ending 31 December 2017:

   RECEIPTS AND PAYMENTS ACCOUNT

Dr. Cr.

	₹		₹
Donation	50,000	Pavilion offices (constructed)	40,000
Reserve Fund (Life membership fees and		Expenses in connection with matches	900
entrance fees received)	4,000	Furniture	2,100
Receipts from football matches	8,000	Investment at cost	16,000
Revenue Receipts		**Revenue Payments**	
Subscriptions	5,200	Salaries	1,800
Locker Rents	50	Wages	600
Interest on Securities	240	Insurance	350
Sundries	350	Telephone	250
		Electricity	110
		Sundry expenses	210
		Balance on hand	5,520
	67,840		67,840

Additional Information

(i) Subscriptions outstanding for 2017 are ₹ 250

(ii) Salaries unpaid for 2017 are ₹ 170

(iii) Wages unpaid for 2017 are 90.

(iv) Outstanding Bill for sundry expenses are ₹ 40

(v) Donations received have to be capitalised.

Prepare from the details given above, an Income and Expenditure Account for the year ended 31.12.2017 and the Balance Sheet on the Association as on 31.12.2017

6. The following particulars relate to the Delhi Sports Club:

INCOME AND EXPENDITURE ACCOUNT

FOR THE YEAR ENDED 31ST MARCH, 2018

Expenditure	₹	Income	₹
To Salaries	15,000	By Entrance fee	1,05,000
To Printing & Stationery	22,000	By Subscriptions	1,56,000
To Advertising	16,000	By Rent	40,00
To Audit Fee	5,000		
To Fire Insurance	10,000		
To Depreciation on sports equipment	90,000		
To Excess of income over expenditure	1,43,00		
	3,01,000		3,01,000

RECEIPTS AND PAYMENTS ACCOUNT

FOR THE YEAR ENDED 31ST MARCH 2018

Receipts	₹	Payments	₹
To Balance b/f	42,000	By Salaries	10,000
To Entrance fee	1,05,000	By Printing & Stationery	26,000
To Subscriptions		By Advertising	16,000
2016-17	6,000	By Fire insurance	12,000
2017-18	1,50,000	By Investment	2,00,000
2018-19	4,000	By Balance c/f	78,000
To Rent	35,000		
	3,42,000		3,42,000

The assets on 1st April, 2017 included club grounds and pavilions ₹ 4,40,000; sports equipment ₹ 2,50,000; and furniture and fixtures ₹ 40,000. Subscriptions in arrears on that date were ₹ 8,000. Prepare the Balance Sheet as on 31st March, 2018.

7. The Income and Expenditure Account of Sunday Samsad of the year 2018 is as follows:

Expenditure	₹	Income	₹
To Salaries	9,500	By Subscription	15,000
To General Expenses	1,000	By Entrance Fee	500
To Audit Fee	500	By Contribution to Annual Dinner	2,000
To Secretaries Honorarium	1,500	By Surplus of Annual sports meet	1,000
To Printing & Stationary	900		
To Annual Dinner expenses	3,000		
To Bank charges	300		
To Depreciation	600		
To Excess of Income over Expenditure	1,200		
	18,500		18,500

This Account had been prepared after the following adjustments:

Subscription outstanding at the end of 2017 ₹ 1,200

Subscription received in advance on 31.12.2017 ₹ 900

Subscription outstanding on 31.12.2018 ₹ 1,500

Subscription received in advance on 31.12.2018 ₹ 540

Salaries outstanding at the beginning of 2018 and at the end of 2018 were ₹ 800 and ₹ 900 respectively. General expenses include Insurance prepaid to the extent of ₹ 120. Audit fee for

2018 is as yet unpaid. During 2018 Audit fee for 2017 was paid amounting to ₹ 4,000. This was outstanding throughout 2018. On 31.12.2018, Cash in hand was ₹ 3200.

Prepare the Receipts and Payments Account for the year 2018 and Balance Sheet as on 31.12.2018.

9.8 Answers to check your progress

1. Debit Balance

2. Income and Expenditure Account

3. Surplus or Deficit

4. Capital Receipt

5. Cash Receipt and Payment

9.9 References/suggested readings

1. Ashish K. Bhattacharyya, “Financial Accounting for Business Managers”, Prentice Hall of India Pvt. Ltd., New Delhi.
2. R. Narayanaswamy, “Financial Accounting”, Prentice Hall of India, New Delhi.
3. Ashok Sehgal, “Fundamentals of Financial Accounting”, Taxmann’s Publishers, New Delhi.
4. Aggarwal, M.P., “Analysis of Financial Statements”, National Publishing House, New Delhi.

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