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SYLLABUS

FINANCIAL ACCOUNTING

SECTION-A : FUNDAMENTAL OF ACCOUNTING

Unit –1 : Meaning and Scope of Accounting

Need, Development and Definition of Accounting; Book-Keeping and Accounting; Persons *interested in Accounting; Disclosures; Branches of Accounting;* Objectives of Accounting.

Unit –2 : Accounting Principles

International Accounting Standards (Only Outlines); Accounting Principles; Accounting standards in India.

Unit – 3 : Accounting Transactions

Accounting Cycle; Journal; Rules of debit and credit; Compound Journal Entry; Opening Entry; Relationship between Journal and Ledger, Rules Regarding Posting; Trail balance; Sub Division of Journal.

SECTION-B : CONCEPTS OF INCOME AND DEPRECIATION

Unit – 1 : Capital and Revenue

Classification of Income; Classification of Expenditure; Classification Receipts. Accounting Concept of Income; Accounting Concepts and Income Measurement; Expired Cost and Income Measurement.

Final Accounts; Profit and Loss account; Balance Sheet; Adjustment entries. Rectification of Errors; Classification of Errors; Location of Errors; Rectification of Errors; Suspense Account; Effect on Profit.

Unit – 2 : Depreciation Provisions and Reserves

Concept of Depreciation; Causes of Depreciation; Depreciation, Depletion, Amortization and Dilapidation; Depreciation Accounting; methods of Recording Depreciation; methods for *Providing Depreciation; Depreciation of Different Assets;* Depreciation of Replacement Cost; Depreciation Policy as per Accounting Standard : u; Depreciation Accounting; Provisions and Reserves.

Unit – 3 : Accounts of Non – Trading Institutions

Introduction, Financial Statements of Not-for-Profit organizations, Income and Expenditure Account, Steps in Preparation of Balance Sheet, Incidental trading Activity.

FINANCIAL ACCOUNTING

PART—1

BLOCK-1
FUNDAMENTALS OF ACCOUNTS

UNIT 1 MEANING AND SCOPE OF ACCOUNTING

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★ STRUCTURE ★

1.1 Objectives
1.2 Introduction
1.3 Book-Keeping
1.4 Accounting
1.5 Development of Accounting
1.6 Objectives of Accounting
1.7 Need of Accounting
1.8 Types *or* Sub-Fields/Branches of Accounting Information
1.9 Persons/Parties Interested in Accounting
1.10 Basic Accounting Terminology
1.11 Summary

1.1 OBJECTIVES

At the end of this unit you should be able to :

- Understand the meaning of Book-Keeping and Accounting and differentiate between the two.
- Discuss the development, objective and need of accounting.
- Explian the branches of accounting.
- Categorise the persons/parties interested in accounting.
- Understand the basic accounting terminology such as, Business transaction, Assets, Capital, Equity or Liability, Financial Statements, Accounting Equation, Goods, Cost, Purchases, Sales Purchases and Sales Returns, Stock, Expenses, Losses, Profit, Debtors, Creditors, Receivables, Payables, Proprietor, Drawings, Accounting year, Entry, Vouchers, Insolvent, Solvent, Gain, Expenditure.

1.2 INTRODUCTION

Accounting is a process of identifying, analyzing, summarizing and recording business transactions. Accounting is the key function of any organization whether it is large or small organization, making profits or losses. It keeps track of the happening in the business on day-to-day basis interms of business transactions and translates it into the category of expenses, income, assets and liabilities etc.

From business administration perspective, it is necessary for the managers to understand the process of accounting. It will help them to understand the impact of their decision making on the financial health of the organization. In this chapter, we will study the various aspects of accounting to familiarize the students of the concept and scope of accounting.

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1.3 BOOK-KEEPING

Meaning

Book-keeping is the proper and systematic keeping or maintenance of the books of accounts. Book-keeping starts from the identification of business transactions. These transactions must be supported by the documents and they must be financial in nature. For example, selling goods for cash is an accounting transaction, because cash is received and goods are going outside the business. The transaction will increase cash and reduce goods.

It will affect the finances of the business. There will also be documentary proof of the transaction because cash memo must have been issued for sale. The book-keeper after identification of the accounting transaction will record it in the proper books of accounts.

Definition

Book-keeping may be defined as the science and art of identifying and recording accounting transactions systematically in the proper books of accounts.

According to **North Cott,** "*Book-keeping is the art of recording in the books of accounts the monetary aspect of commercial or financial transactions.*"

Prof. R.N. Carter defines, "*Book-keeping as the science and art of correctly recording in the books of accounts all those business transactions that result in the transfer of money or money's worth.*"

Book-keeping is concerned with the proper maintenance of the books of accounts *i.e.,* journal, ledger, cash book and other subsidiary books. *It is not concerned with disclosing or interpreting the results of the business.* Book-keeping involves the following process :

1.4 ACCOUNTING

Accounting is an art of identifying, classifying, recording, summarising and interpreting business transactions of financial nature.

Definition of Accounting

In the words of **Smith and Ashburne,** "*Accounting is a means of measuring and reporting the results of economic activities.*"

In the opinion of **Bierman** and **Derbin,** "*Accounting may be defined as the identifying, measuring, recording and communicating of financial information.*"

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Difference between Book-keeping and Accounting

Points of difference	*Book-keeping*	*Accounting*
1. *Objective*	The objective of book-keeping is to prepare original books of accounts. It is restricted to journal, subsidiary books and ledger accounts only.	The objective of accounting is to record, analyse and interpret the business transactions.
2. *Scope*	It has limited scope and is concerned with the recording of business transactions.	It has wider scope as compared to book-keeping.
3. *Level of work*	It is restricted to low level of work. Clerical work is involved in it.	It is concerned with low level, medium level and even top level management. Low level clerks prepare the accounts, medium level report it and top level interpret it.
4. *Mutual dependence*	Book-keeping is only the art of recording transactions, so it has to depend upon accounting which makes it more meaningful and purposeful.	Accounting is based upon book-keeping which is its initial and vital part. It depends upon book-keeping.
5. *Result of the business*	It does not show the net result of the financial position of business.	Accounting shows the net result of the business. It tells us about the profit earned and also about the assets and liabilities of the business.
6. *Principles of Accounting*	In book-keeping, accounting concepts and conventions are followed.	The methods of reporting and interpretation in accounting may vary from firm to firm.

1.5 DEVELOPMENT OF ACCOUNTING

The role of accounting has changed from that of a mere record keeping during the Ist decade of 20th Century to the present stage, when it is accepted as **information system and decision making activity**.

The term accounting is becoming gradually broader. It is evident from **definitions of accounting** arranged in historical order :

(*i*) **1941.** The American Institute of Certified Public Accountants (AICPA) defined accounting as :

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

(*ii*) **1966.** The American Accounting Association (AAA) defined accounting as :

The process of identifying, measuring and communicating economic information to permit informed judgements and decisions by uses of the information.

(*iii*) **1970.** Accounting Principles Board (APB) and AICPA states :

The function of Accounting is to provide quantitative information primarily financial in nature, about economic entities, that is intended to be useful in making economic decisions.

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The above statements about Accounting show that the role of Accounting is gradually widening.

The rôle of accounting at present is assumed :

(*i*) To provide information for judging management ability to utilise resources effectively in achieving goals.

(*ii*) To provide factual and interpretative information by disclosing underlying assumptions on matters, subject to interpretation, evaluation, prediction or estimation and

(*iii*) To provide information or activities affecting society.

Accounting in this way, identifies business transactions, records them in proper subsidiary books and journal proper and prepares ledger accounts. Trial balance is prepared with the balance of ledger accounts and finally financial statements are prepared, reported and communicated to parties concerned.

1.6 OBJECTIVES OF ACCOUNTING

Followings are the objectives of accounting :

1. **Maintaining proper record of business transaction.** The main purpose of accounting is to identify business transactions of financial nature and enter them into appropriate books of accounts. Business transactions are classified as, assets, liabilities, capital, revenues, expenses and accordingly passed through books. The accounting records should be made properly and systematically, so that requisite information may be obtained at a glance from the books of accounts.
2. **Calculation of profit or loss.** One of the main object of accounting is to calculate the profit or loss of the business. Income statements are prepared with the help of trial balance (prepared with the balances of ledger accounts). At the end of accounting period, we prepare Trading Account and ascertain gross profit or gross loss. Afterwards Profit and Loss Account is prepared to calculate net profit or net loss. Accounting in this way, is the source to evaluate the performance of the business interms of profit.
3. **Depiction of the financial position.** At the end of accounting period, we prepare position statement. The value of assets and liabilities are depicted in the balance sheet, also known as position statement.

   The assets side of the balance sheet shows the position of various assets such as cash in hand, cash at bank, sundry debtors, closing stock, building, machinery, furniture, etc. The liabilities side shows creditors' claim as creditors' for goods, bills payable, loans, outstanding expenses and proprietor's claim as capital, net profit and reserves. Balance Sheet is said to be a mirror, reflecting the true position of assets and liabilities on a particular date.
4. **Providing effective control over the business.** Accounting reveals the actual performance of the business interms of production, sales, profit, loss, cost of production and the book value of sundry assets. The actual performance can be compared with the planned or desired performance of the business. It can also be compared with the previous performance. Comparison reveals deviation in terms of weaknesses and plus points. Causes responsible for the poor performance are identified and efforts are made to remove them. Causes responsible for better performance are reinforced. Accounting, in this way, enables the management to adopt effective control over the business.

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5. **Making information available to various groups.** Business, these days is a social institution. In addition to the owners of the business various groups, such as, creditors, lenders, investors, researchers, government and even workers and consumers have an interest in the performance of business. Accounting makes information available to all these interested parties. Proprietors have interest in the profit or dividend, debenture holders, lenders and investors are concerned with the safety of money advanced by them to the business and interest thereon. Financial soundness of the business makes their loans secured. Employees have an interest in their increased wages and bonus. The object of the accounting is to provide meaningful information to all these interested groups.

1.7 NEED OF ACCOUNTING

1. **Replacing memory.** Business transactions are innumerable, varied and complex, as such it is quite impossible to memorise each and every transaction. Accounting records these transactions in writing and thus it is not necessary that the businessman should memorise all the transactions.
2. **Assisting the performance of the business.** Accounting keeps proper and systematic record of all business transactions. Income statements are prepared with these records and we are able to know the profit earned and the loss suffered by the business. Trading Account is prepared to find out gross profit or loss of the enterprise. Net profit or net loss can be known by preparing Profit and Loss Account.
3. **Assessing the financial status of the business.** Financial position of the business is displayed through position statement *i.e.,* Balance Sheet of the business. The statement is prepared at the end of the accounting year and reflects the true position of assets and liabilities of the business on a particular date.
4. **Documentary evidence.** Accounting records can also be used as an evidence in the court to substantiate the claim of the business. These records are based on documentary proof. Every entry is supported by authentic vouchers. That is why, the court accepts these records as evidence.
5. **Assisting in realisation of debts.** In 'Accounts' we prepare personal ledger accounts of all the parties. The personal account shows the exact amount due from the debtors. We can send the debtors their statement of accounts and thus enable them to verify entries and also to make early payment of the amount due. The account can also be used to prove the claim of the business against the debtors in the court.
6. **Facilitating the sale of the business.** The position statement of the business shows the value of assets and liabilities of the business. We can calculate the 'Net Worth' of the business on the basis of these statements. Accounting facilitates in the calculation of the consideration for which the business should be sold.
7. **Preventing and detecting frauds.** The proper accounting system and effective arrangement of internal check prevents leakage of goods and cash. In case, cheating takes place, theft or embezzlement is made and fraud is committed, accounting helps in detection of these losses and also fixes responsibility for it. Proper accounting prevents employees from committing fraud.
8. **Helpful to management.** Accounting is useful to the management in various ways. It enables the management to assess the achievements of its performance. Actual performance can be compared with the desired performance or with the

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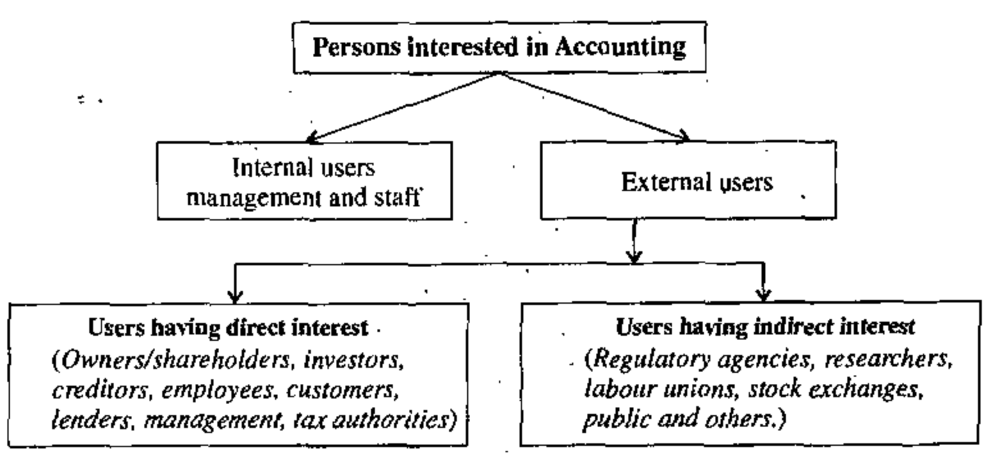
performance of previous years. The weaknesses of the business can be identified and corrective measures can be applied to remove them. Various profitability, sales and liquidity ratios can be calculated, the actual performance can be evaluated and effective line of action can be decided for the future. Funds flow statement can also be prepared to understand the additional funds earned during the year and their application.

1.8 TYPES *OR* SUB-FIELDS/BRANCHES OF ACCOUNTING INFORMATION

Accounting has at present three sub-fields or branches, mentioned as under :

1. **Financial accounting.** Accounting is a wider and comprehensive concept. It is *an art of identifying, classifying, recording, summarising* and interpreting business transactions of financial nature. Accounting work involves low, medium and even top level employees. Accounting as such is Book-keeping plus preparation of financial statements, reporting the results of the business and interpreting the accounting information in the forms of ratios, funds and cash flow statements, schedules, charts and diagrams.
2. **Cost accounting.** It is that branch of accounting, which deals with cost of production and its various constituents. It is concerned with the classification, *allocation, recording, summarising and reporting current and prospective costs.* Cost accounting, like financial accounting serves the needs of proprietors, managers and interested outsiders. Cost accounting is the systematic process of determining unit cost at different levels of production.
3. **Management accounting.** Management in the business is concerned with decision making for the efficient working of the enterprise, so management accounting is a system to assemble and furnish the useful material and summarised accounting information to the management. Management accounting as such is the effective blending of financial and cost accounting *together with financial management.* The ultimate end of management is to maximise profit at the minimum cost and sacrifice. The management accounting serves as an effective tool for determining right line of action in future.

1.9 PERSONS/PARTIES INTERESTED IN ACCOUNTING



1. **Internal users.** Top, middle and bottom level of management executives are the internal users of accounting information. They need it for making their decisions. These users are interested in the profitability, operational efficiency and financial soundness of the business. The top level management is concerned with accounting information relating to planning, the middle level is interested in planning and controlling and the lower level with operational affairs.
2. **External users.** External users may have direct interest or indirect interest.

(*i*) *External users having direct financial interest.* The existing and the prospective creditors and investors have direct interest in the accounting information. The sources of information for external users are financial statements and reports of directors and auditors. Investors assess the financial worth of the business so that they may decide about buying, selling or holding investment in the business. Creditors, such as banks, lenders, debenture holders and financial institutions assess the risk involved in granting loans to the business.

(*ii*) *External users having indirect interest.* These users, such as Department of Company Affairs, Registrar of Joint Stock Companies, sales tax and income tax authorities, labour unions, customers, stock exchanges, trade associations and others are also interested in the affairs of the business. They have to make their own decision on the basis of the financial reports of the business.

1.10 BASIC ACCOUNTING TERMINOLOGY

Every subject has got its own terminology. Accounting, as a subject has got its own terms. These terms have their specific meaning in Accounting and used to express financial nature of the business.

1. Business Transactions

The economic event that relates to a business entity is called business transaction.

Every business activity is not an Accounting activity. That is why, every activity is not recorded in the books of accounting. We record only business transactions in Financial Accounting. The first step in the accounting process is the identification of business transaction. *Every activity of financial nature having documentary evidence, capable of being presented in numerical, monetary term causing effect on assets, liabilities, capital, revenue and expenses is termed as business transactions.*

Special features of business transactions are as under :

(*i*) Business transactions must be financial in nature.

(*ii*) Business transactions must be supported by documentary evidence.

(*iii*) Business transactions must be presented in numerical monetary terms.

(*iv*) Business transactions must cause an effect on assets, liabilities, capital, revenue and expenses.

Business transactions as such refer to business activities involving transfer of money or goods or services between two parties or two accounts. Purchase and sale of goods, receipts of income, etc. are business transactions. Business transactions may be both cash or credit.

2. Assets

The valuable things owned by the business are known as assets. These are the properties owned by the business. Assets are the economic resources of an enterprise

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which can be expressed in monetary terms. In the words of **Prof. R.N. Anthony,** "*Assets are valuable resources owned by a business which were acquired at a measurable money cost.*" The most important assets are :

(*a*) **Fixed assets**

These assets are acquired for long term use in the business. They are not meant for sale. These assets increase the profit earning capacity of the business. Expenditure on these assets is not regular in nature. Land and building, plant and machinery, vehicles and furniture, etc. are some of the examples of fixed assets.

(*b*) **Current assets**

These assets, also known as circulating, fluctuating or floating assets. They change their values constantly. In the words of **Institute of Certified Public Accountants, USA,** "*Current assets include cash and other assets or resources, commonly identified as those which are reasonably expected to be realised in cash or sold or consumed during the normal operating circle of the business.*" It should be noted that certain assets, which are popularly known as fixed may prove to be current by virtue of their specific use such as :

(*i*) **Land** will be current assets in the hands of land developers and property dealers.

(*ii*) **Building** with the builders and property dealers.

(*iii*) **Plant and Machinery** with the manufacturers and dealers of plant and machinery.

(*iv*) **Furniture** with the furniture dealers and furnishers.

(*v*) **Shares and Debentures** with the dealers in securities.

It should be taken care of that assets meant for regular purchase and sale are always current assets.

(*c*) **Fictitious assets**

Fictitious assets are those assets, which do not have physical form. They do not have any real value. Actually, they are not the real assets but they are called assets on legal and technical ground. These assets are the revenue expenditure of capital nature which are also termed as deferred revenue expenditure. The example of these assets are loss on issue of shares, advertising suspense and preliminary expenses, etc. Fictitious assets do not have real value, so they are written off in the future.

(*d*) **Tangible assets**

Traditional View : Assets having physical existence which can be seen and touched are known as tangible assets. These assets are land, building, plant, equipment, furniture, stock etc.

Alternative View : In a court testimony in USA, it was argued that tangible assets should not be allowed to mean assets having physical construction only because there are certain assets, such as cash, cash equivalent and receivables which do not have physical construction but even then treated as tangible assets. It finally emerged that all assets where revenue generation is certain should be treated as tangible assets. The examples of these assets are building, plant, equipment, furniture, stock, receivable cash, cash equivalents such as treasury bills, commercial papers and money market funds.

On the other hand, in the case of assets like goodwill, patent or copyright the revenue generation is assumed to be uncertain. That is why, they are put in the category of intangible assets.

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(*e*) **Intangible assets**

These are the assets which are not normally purchased and sold in the open market such as goodwill and patents. It does not mean that these assets are never purchased and sold. They may be purchased and sold in special circumstances. Payment for patents can be made to reputed manufacturers of the country and abroad. Payments for patents is mostly made in case of medicines. While purchasing the business of other firms payment for goodwill is made. Goodwill may also be raised in case of admission or retirement of partner. It is also preferable to write off goodwill and patents accounts and not to show in the balance sheet.

(*f*) **Wasting assets**

Assets, whose value goes on declining with the passage of time are known as wasting assets. Mines, patents and assets taken on lease are its examples.

(*g*) **Liquid assets**

Liquidity refers to convertibility in cash. Liquid assets, therefore are those assets, which can be converted into cash at short notice. The examples of liquid assets are cash in hand, cash at bank, debtors, bills receivable, etc. In other words, liquid assets are current assets less stock *i.e.*,

Liquid Assets = Current Assets – (Stock + Prepaid Expenses)

3. Capital

It is that part of wealth which is used for further production and thus capital consists of all current assets and fixed assets. Cash in hand, cash at bank, building, plant and furniture, etc. are the capital of the business. Capital need not necessarily be in cash. It may be in kind also. Capital may be classified as follows.

(*a*) **Fixed capital**

The amount invested in acquiring fixed assets is called fixed capital. The money is blocked in fixed assets and not available to meet the current liabilities. The amount spent on purchase or extension or addition to the fixed assets is fixed capital. Plant and machinery, vehicle, furniture and building, etc. are some of the examples of fixed capital.

(*b*) **Floating capital**

Assets purchased with the intention of sales, such as stock and investments are termed as floating capital.

(*c*) **Working capital**

The part of capital available with the firm for day-to-day working of the business is known as working capital. Sufficient funds are required for purchasing goods and incurring direct and indirect expenses. Operational expenses are met with working capital. Current assets and current liabilities constitute working capital. Current assets consist of cash in hand, cash at bank, bills receivable, debtors, stock in hand, etc. and creditors, bills payable, short term loan, income received in advance and outstanding expenses are the current liabilities. Working capital can also be expressed as under :

Working Capital = Current Assets – Current Liabilities

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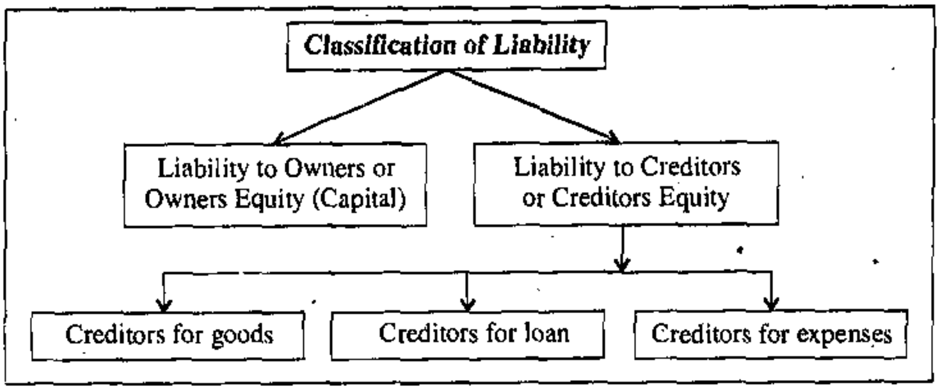
4. Equity or Liability

Liabilities are the obligations or debts payable by the enterprise in future in the form of money or goods. It is the proprietors' and creditors' claim against the assets of the business. Creditors may be classified as creditors for goods and creditors for expenses. The business should have sufficient current assets to meet its current liabilities and reasonable amount of fixed assets to meet its fixed liability. Liabilities can be classified as under :



Note. *Accountants in USA use the term equity to denote liabilities and capital.*

(*a*) **Liability to owners.** It is the owner's claim against the assets of the business, generally known as capital. It is technically known as internal equity or shareholder's funds. It may also be expressed as under :

Owner's equity or Internal equity = Capital + Profit earned + Retained earning
(Shareholders' funds) + *Undistributed profit* + *Interest on Capital*
− Drawings − Expenses.

(*b*) **Creditors' equity**. It is creditors' claim against the assets of the business. These creditors may be creditors for goods and creditors for expenses :

(*i*) *Creditors for goods.* Business has to purchase goods on credit, so the suppliers of goods to the business on credit are known as creditors for goods. They may be called as creditors and bills payable.

(*ii*) *Creditors for loan.* These creditors are the parties, banks and other financial institutions. The liability is named as Bank loan, Bank overdraft, Loan from Industrial Finance Corporation, Industrial Development Bank of India and World Bank.

(*iii*) *Creditors for expenses.* Certain expenses may concern the accounting period but may remain unpaid. These expenses may be outstanding salaries, rent due and wages unpaid. It is the current liability of the business.

Liabilities can also be classified as fixed, current and contingent liabilities.

(*a*) *Fixed liability.* These liabilities are paid after a long period. Capital, loans, debentures, mortgage, etc. are its examples. These are not current liabilities.

(*b*) *Current liabilities.* Liabilities payable within a year are termed as current liabilities. The value of these liabilities goes on changing. Creditors, bills payable and outstanding expenses, etc. are current liabilities.

(*c*) *Contingent liabilities.* These are not the real liabilities. Future events can only decide whether it is really a liability or not. Due to their uncertainty, these liabilities are termed as contingent (doubtful) liabilities. Important examples of contingent liabilities are as under :

(i) Value of bills discounted.

(ii) Cases pending in the court of law.

(iii) Guarantees undertaken.

The value of contingent liabilities is not shown in the amount column at the liabilities side of balance sheet. It is clearly mentioned as a note inside/outside the balance sheet.

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Liabilities are also classified as long term liabilities and short term liabilities :

(a) *Long term liabilities.* Liabilities payable after a period of one year such as term loans and debentures are long term liabilities.

(b) *Short term liabilities.* Obligations payable within a period of one year, such as creditors, bills payable and overdraft, etc., are short term liabilities.

5. Financial Statements/Final Accounts

Statements prepared by an enterprise at the end of accounting year to assess the status of income and assets is termed as Financial Statement/Final Accounts. It is categorised as Income Statement and Position Statement traditionally known as Profit and Loss Account and Balance Sheet.

6. Accounting Equation

Accounting rotates around three basic terms. These terms are Assets, Liabilities and Capital. The true inter-relationship between these terms is represented as Accounting Equations *i.e.*,

$$\boxed{\textbf{Assets = Liabilities + Capital}}$$

7. Goods

Articles purchased for sale at profit or processing by the business or for use in the manufacture of certain other goods as raw material are known as goods. In other words, goods are the commodities, in which the business deals. Furniture will be goods for the firm dealing in furniture but it will be an asset for the firm dealing in stationery. *Americans use the term 'merchandise' for goods.*

8. Cost

Expenditures incurred in acquiring, manufacturing and processing goods to make it sale worthy are termed as cost of goods. It includes purchases of tradeable goods, raw materials and direct expenses incurred in acquiring and manufacturing goods.

9. Purchases

In its routine business, the firm has to either purchase finished goods for sale or purchase of raw material for the manufacture of the article, being sold by the firm. The acquisition of these articles are purchases. The purchases of 10,000 metres of silk by Shyam, a cloth merchant is termed as purchases in the business. In the same way, the purchases of ten fans by Ram, a dealer in electrical appliances for use in the cooler being assembled in his factory will also be the purchases. It is immaterial whether goods have been purchased for cash or on credit. They may be purchased within the country or imported from abroad. *Purchases of assets, are not the purchases in accounting terminology* as these assets are not meant for sale.

Proper, complete and systematic record of the purchases is essential as the cost price of goods is based upon it. Purchases must be made at competitive rates.

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10. Sales

The ultimate end of the goods purchased or manufactured by the business is their sales. It includes both cash and credit sales. In accounting terminology, sales means the sale of goods, never the sale of assets, sales should have a regular feature. The sales of ten sofa sets by Wasim, a furniture is sales but sale of old furniture by Jai, a stationery dealer will not be a sale. Sales may be effected within the country or exported abroad.

The maintenance of proper and complete record of sales is necessary, because the profit or loss is associated with the amount of sales. It should be the sincere effort of every business to purchase goods at competitive rates and make sales at reasonably higher rates to earn more profit.

11. Purchases return or Returns outward

It is that part of the purchases of goods, which is returned to the seller. This return may be due to unnecessary, excessive and defective supply of goods. It may also result, if the supplier violates the terms and conditions of the order and agreement. In order to calculate net purchases, purchases return is deducted from purchases. Purchases returns are also known as returns outward, because it is the return of goods outside the business.

12. Sales return or Returns inward

It is that part of sales of goods which is actually returned to us by purchasers. This return may also be due to excessive, unnecessary and defective supply of goods or violation of terms of agreement. Sales return, also known as returns inward is deducted from sales, in order to calculate net sales.

13. Stock

The goods available with the business for sale on a particular date is termed as stock. It varies *i.e.,* increases or decreases and goes on changing. In accounting, we use the term stock widely as opening and closing stock. In case of business which is being carried on for the last so many years, the value of goods on the opening day of the accounting year is known as opening stock. In the same way, the value of goods on the closing day of the accounting year will be closing stock. For example, Naresh and Sons started their business on Jan. 1, 2006 and decided to close their books on 31st December every year. The firm will not have any opening stock on Jan. 1, 2006, because the business did not exist before Jan. 1, 2006. If the firm has goods worth Rs. 50,000 on 31st December, 2006, it will be the closing stock on this date. On January 1, 2007, the closing stock of December 31, 2006 will be the opening stock of the year 2007. It should always be kept in mind that stock is valued at cost price or market price, whichever is lower.

In case of manufacturing enterprises stock is classified as under :

(*i*) **Stock of raw material.** Raw material required for manufacturing of the product in which the business deals is known as stock of raw material. Cotton in case of cotton mill is its example.

(*ii*) **Work in progress.** It is the stock of partly finished or partly manufactured goods just as price of thread and unfinished cloth in case of cotton mill.

(*iii*) **Stock of finished goods.** Manufactured and finished goods ready for sale are known as stock of finished goods. Finished cloth is its example.

14. Expenses

Expenses are cost incurred by the business in the process of earning revenues. Generating income is the foremost objective of every business. The firm has to use certain goods and services to produce articles, sold by it. Payment for these goods and services are called expenses. Cost of raw material for the manufacture of goods or the cost of goods purchased for sale, expenses incurred in manufacturing or acquiring goods, such as wages, carriage, freight and amount spent for selling and distributing goods such as salaries, rent, advertising and insurance, etc. are known as expenses in accounting terminology. According to **Finney** and **Miller,** "*Expense is the cost of use of things or services for the purpose of generating revenue. Expenses are voluntarily incurred to generate income*".

15. Losses

Losses are unwanted burden which the business is forced to bear. Loss of goods due to theft or fire, or flood or storm or accidents are termed as losses in accounting. Losses are different from expenses in the sense that expenses are voluntarily incurred to generate income where losses are forced to bear.

Losses may be classified as normal and abnormal. Normal loss is due to the inherent weakness in the commodities *i.e.*, coal, cement, oil, ghee, ice, petrol. There will be shortage in their weight due to leakage, meltage, evaporation, spoilage and wastage during the journey. Abnormal loss on the other hand, is an extra ordinary loss due to earthquake, fire, flood, storm, theft and accidents.

Losses adversely affect the profit of the business, so it should be the sincere effort of every firm to adopt preventive measures to minimise losses.

16. Profit

Excess of revenue over expense is termed as profit. In other words, excess of sale proceeds over cost of goods sold is income. Here, sales means net sales *i.e.*, sales *less* sales return. Cost of goods sold, also known as cost of sales is opening stock plus net purchases plus direct expenses less closing stock. Income must be regular in nature. It must concern routine activities of the business. It is always the part of revenue receipt. It must relate to the business of the current year. It is shown at the credit side of profit and loss A/c. Profit is generated through business activities.

17. Income

Increase in the net worth of the enterprise either from business activities or other activities is termed as income. Income is a wider term, which includes profit also. From accounting point of view, *income is the positive change in the wealth of the enterprise over a period of time.*

18. Debtors

The term 'debtors' represents the persons or parties who have purchased goods on credit from us and have not paid for the goods sold to them. They still owe to the business. For example, if goods worth Rs. 20,000 have been sold to Suresh, he will continue to remain the debtor of the business so far as he does not make the full payment. In case, he makes a payment of Rs. 16,000, he will remain to be debtor for Rs. 20,000 – Rs. 16,000 = Rs. 4,000.

In case, the firm is a service institution and the payment for service still remains to be realised, beneficiaries of the service will also be known as 'debtors'.

19. Creditors

In addition, to cash purchases the firm has to make credit purchases also. The sellers of goods on credit to the firm are known as its creditors for goods. Creditors are the liability of the business. They will continue to remain the creditors of the firm *so far the full payment is not made to them*. Liability to creditors will reduce with the payment made to them.

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Creditors may also be known as creditors for expenses. In case, certain expenses such as salaries, rent, repairs, etc. remain unpaid during the accounting *period, it will* be termed as outstanding expenses. Parties rendering these services will be our creditors. Creditors are current liability so the firm should have sufficient current assets to make their timely payment.

20. Receivables

Receivable means, what business has to receive from outside parties on revenue account. When we sell goods on credit, purchasers are known as debtors. Certain debtors accept bills drawn by us and become part of bills receivable. The total of Debtors and Bills Receivable is known as Receivables. These are current assets and realised within a year. Receivables are shown at the assets side of the Balance Sheet.

21. Payables

Payable means, what the business *has to pay to outside parties. When we purchase* goods on credit, sellers are known as creditors. We accept bills drawn by certain creditors, which becomes a part of Bills Payable. The total of Creditors and Bills Payable is termed as Payables. *It is shown at the liabilities side of the Balance Sheet.*

22. Proprietor

An individual or group of persons who undertake the risk of the business are known as proprietor. They invest their funds into the business as capital. Proprietors are adventurous persons who make arrangement of land, labour, capital and organisation. They pay wages to labour, rent to land, interest to capital and salary to organisation. After meeting all the expenses of business, if there remains any surplus, it is known as profit. The proprietor is rewarded with profit for the risk undertaken by him. If expenses exceed revenue the deficit is a loss to be borne by the proprietor.

In case of profit, proprietor's capital increases and in case of loss the capital decreases. Proprietor is an individual in case of sole trade, partners in case of partnership firms and shareholders in case of company.

23. Drawings

Amount or goods withdrawn by the proprietor for his private or personal use is termed as drawing. The cost of using business assets *for private or domestic use* is also drawing. Use of business car for domestic use or use of business premises for residential purpose is also drawing. Acquiring personal assets with business funds is also drawing. Certain examples of drawings are as under :

(*i*) Amount withdrawn by proprietor for personal use.
(*ii*) Goods taken by the proprietor for domestic use.
(*iii*) Purchasing pocket transistor for proprietor's son.
(*iv*) Using business vehicles for domestic use.
(*v*) Using business premises for residential purpose.

24. Accounting Year

Books of accounts are closed annually. From the balances of different ledger accounts *we prepare income statement and position statement.* Income statement shows gross and net income of the business. Position statement, traditionally known as Balance Sheet is a mirror, which reflects the true value of assets and liabilities on a particular date. *There is no legal restriction about the accounting year of sole* proprietorship and partnership firm. They may adopt the accounting year of their choice. It may be between January 1st to December 31st of the same year or July 1st of the year to June 30th of the *next year or between two Diwalis or even financial* year, *i.e.*, April 1st to March 31st of the next year. The only restriction is that the accounting period must consist of 12 months.

Companies must adopt financial year as their accounting year.

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25. Entry

An entry is the systematic record of business transactions in the books of accounts. While passing entries, the principle 'every debit has got its corresponding credit' is adopted. Different accounts are debited and credited in the entry with the same amount.

26. Vouchers

Accounting transactions must be supported by documents. These documentary proofs in support of the transactions are termed as vouchers. It may be a receipt, cash memo, invoice, wages bill, salaries bill, deeds or any document as an evidence of transaction having taken place. The contents of vouchers are date, amount paid, purpose of the payment, payment passed by competent authority, payment made and cancelled. Vouchers are the basis of accounting records. They facilitate accounting. Vouchers are also used for verification and auditing of business records. Vouchers may also be used for detecting embezzlement and frauds.

27. Insolvent

All business firms who have been suffering losses for the last many years and are not even capable of meeting their liabilities out of their assets are financially unsound. Only the court can declare the business firm as insolvent if it is satisfied that the continuation of the firm will be against the interest of the public or creditors. No firm can declare itself as insolvent. In case of solvency, the assets of the business are sold and liabilities paid with the funds realised from the sale of assets. If the funds realised fall short of the liabilities creditors are paid proportionately.

28. Solvent

Solvent are those persons and firms who are capable of meeting their liabilities out of their own resources. Solvent firms have sufficient funds and assets to meet proprietors' and creditors' claim. Solvency shows the financial soundness of the business.

29. Gain

Change in the net worth (equity) due to change in the form and place of goods and holding of assets for a long period, whether realised or unrealised is termed as gain. It may either be of capital nature or revenue nature or both.

30. Expenditure

Expenditure is the amount of resources consumed. It is long term in nature. It is the benefit to be derived in future. It is the amount spent for the purchase of assets. Expenditures can be made through cash, or exchanged for other assets or commodities or a promise to make the payment is made. Expenditures increase the profit earning capacity of the business and profit is expected from them in future. Expenditures are incurred to acquire assets of the business.

1.11 SUMMARY

Book-Keeping

Proper and systematic keeping or maintenance of the books of accounts is known as Book-Keeping.

Accounting

It is a means of measuring and reporting the results of economic activities.

Points of difference between Book-Keeping and Accounting

(1) Objective (2) Scope (3) Level of work (4) Mutual dependence (5) Result of the business (6) Principles of Accounting.

Development of Accounting

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The role of accounting has changed from that of a mere record keeping during the Ist decade of 20th Century to the present stage, when it is accepted as **information system and decision making activity**.

Objectives of Accounting

(1) Maintaining proper record of business transactions (2) Calculation of profit or loss (3) Depiction of the financial position (4) Providing effective control over the business (5) Making information available to various groups.

Need of Accounting

(1) Replacing memory (2) Assisting the performance of the business (3) Assessing the financial status of the business (4) Documentary evidence (5) Assisting in realisation of debts (6) Facilitating the sale of the business (7) Preventing and detecting frauds (8) Helpful to management.

Types *or* Sub-fields/Branches of Accounting

(1) Financial Accounting (2) Cost Accounting (3) Management Accounting.

Persons/Parties Interested in Accounting

Internal Users. Management and Staff.

Having Direct Interest. Owners, Shareholders, Investors, Creditors, Employees, Customers, Lenders, Management and tax authorities.

External Users. *Having indirect interest.* Regulatory agencies, Researchers, Labour unions, Stock exchanges, Public and others.

Basic Accounting Terminology

(1) Business transactions (2) Assets (3) Capital (4) Equity *or* Liability (5) Financial statements (6) Accounting equation (7) Goods (8) Cost (9) Purchases (10) Sales (11) Purchases return (12) Sales return (13) Stock (14) Expenses (15) Losses (16) Profit (17) Debtors (18) Creditors (19) Receivables (20) Payables (21) Proprietor (22) Drawings (23) Accounting year (24) Entry (25) Vouchers (26) Insolvent (27) Solvent (28) Gain (29) Expenditure.

REVIEW QUESTIONS

A. Very Short Answer Type Questions :

1. Define accountancy.
2. What is the accounting year of the company ?
3. Mention two advantages of accounting.
4. Name the document, which is used as a source document for recording business transactions.
5. State the meaning of Book-keeping.

B. Short Answer Type Questions :

1. Define Book-keeping.
2. Mention the objectives of Accounting in about 50 words.
3. Describe the steps in Book-keeping process.

C. Long Answer Type Questions :

1. What is accounting ? Explain its objectives.
2. What is meant by Book-keeping ? In what respects book-keeping is different from accounting ?
3. Explain whether accounting is science or art or both.
4. Explain briefly the advantages of accountancy.

UNIT 2 ACCOUNTING PRINCIPLES

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★ STRUCTURE ★

2.1 Objectives
2.2 Introduction
2.3 Accounting Standard
2.4 Basic Accounting Concepts/Principles
2.5 Summary

2.1 OBJECTIVES

At the end of this unit you should be able to :

- Understand Generally Accepted Principles GAAP)
- Explain the concept of Accounting Standard.
- Understand the different Accounting Principles.

2.2 INTRODUCTION

Like every branch of knowledge, Accounting is also governed by a set of principles which have evolved over a long period of time. These principles are necessary in terms of bringing a standardized way of preparing accountings of the organizations which will help in inter and intra firm comparisons. In the absence of these principles, different organizations would follow different set of rules which will make it difficult to analyze the accounting in a better way. It should be noted that these principles are recommendatory in nature and they have some amount of flexibility also interms of different industries and business dynamics they are applied into.

For the students of BBA, it is important to learn these principles through which they can appreciate the way accounting works in different business situations. They will also be able to figure out any practice followed in accounting which is not based on standard principles and would harm the interest of the organization. In this chapter, we will briefly look into both International and Indian Accounting Standards.

2.3 ACCOUNTING STANDARD

Concept of Accounting Standard

The uniform, definite and universally accepted accounting rules developed by International Accounting Standards Committee (IASC) are known as Accounting Standard. It was felt that there were different accounting concepts, conventions, customs, traditions and rules prevailing in different nations leading to misunderstanding, uncertainty and often resulting in scandal. Confusion prevailed at the national level also. Accounting terminology was not standardised. It was left to the users of accounting to interpret the accounting terms suiting their interest. It was therefore, the urgent need to develop universally accepted and internationaly standardised accounting terminology, commonly known as Accounting Standard. *Introduction of Accounting Standard* was necessary to prevent financial scandals and business failures.

Development of International Accounting Standard

The absence of internationaly standardised accounting terminology was always felt. It was only in 1973 that an International Accounting Standards Committee was formed with *sixteen* accounting bodies from nine nations as founder member. The committee agreed to formulate and publish in public interest standards to be observed in the presentation of audited financial statements and to promote their worldwide acceptance and observance.

International Accounting Standard (IAS) issued by IASC

IAS—1 : Disclosure of Accounting Policies
IAS—2 : Valuation and Presentation of Inventories
IAS—3 : Consolidated Financial Statements .
IAS—4 : Depreciation Accounting
IAS—5 : *Information to be disclosed in Financial Statements*
IAS—6 : Accounting responses to Changing Prices.
IAS—7 : Statement of changes in Financial Position and so on ......

Development of Accounting Standard in India

In India, Indian Institute of Chartered Accountants of India works as the counterpart of International Accounting Standard Committee. The institute has formulated and issued accounting standard of recommendatory nature. These standards are known as Accounting Standard (AS).

ACCOUNTING STANDARD (AS) ISSUED BY INSTITUTE OF CHARTERED ACCOUNTANTS OF INDIA (ICAI) ON FEBRUARY 8, 2002

AS—1 : Disclosure of Accounting Policies. (Effective from 1-4-1991)
AS—2 : Valuation of Inventories. (Effective. from 1-4-1999)
AS—3 : Cash Flow Statement. (1-4-1997)
AS—4 : *Contingencies and events occurring after balance sheet date.* (1-4-1995)
AS—5 : Prior period and Extra ordinary items and changes in Accounting Policies. (1-4-1996)
AS—6 : Depreciation Accounting. (1-4-1995)
AS—7 : Accounting for construction contracts. (1-4-1999)
AS—8 : Accounting for Research and Development. (1-4-1991)
AS—9 : Revenue Recognition. (1-4-1991)
AS—10 : Accounting for Fixed Assets. (1-4-1991)
AS—11 : Accounting for the effects of changes in Foreign exchange rates. (1-4-1995)
AS—12 : Accounting for Government grants. (1-4-1994)
AS—13 : Accounting for Investments. (1-4-1995)
AS—14 : Accounting for Amalgamations. (1-4-1995)
AS—15 : Accounting for retirement benefits in the Final Statements of employers. (1-4-1995)

AS—16 : Borrowings Cost. (1-4-2000)

AS—17 : Segment reporting. (1-4-2001)

AS—18 : Related Party disclosure. (1-4-2001)

AS—19 : Leases (1-4-2001)

AS—20 : Earning Per Share. (1-4-2000)

AS—21 : Consolidated Financial Statements. (1-4-2001)

AS—22 : Accounting for taxes on income (1-4-2001)

AS—23 : Accounting for Investments Associates in Consolidated Financial Statements. (1-4-2002)

AS—24 : Discontinued operations. (8-02-2002)

AS—25 : Interim Financial Reporting

AS—26 : Intangible Assets

AS—27 : Financial Reporting of Interests in Joint Ventures.

AS—28 : Impairment of Assets.

AS—29 : Provisions, Contingent Liabilities and Contingent Assets.

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2.4 BASIC ACCOUNTING CONCEPTS/PRINCIPLES

The fundamental ideas or basic concepts underlying the theory and practice of financial accounting and broad working rules for all accounting activities, developed by professionals are listed and discussed below :

BASIC ACCOUNTING CONCEPTS

1. Business Entity.
2. Money Measurement.
3. Going Concern.
4. Accounting Period.
5. Cost.
6. Dual Aspect (*or Duality*).
7. Revenue Recognition (*Realisation*).
8. Matching.
9. Full Disclosure.
10. Consistency.
11. Conservatism (*Prudence*).
12. Materiality.
13. Objectivity.

These concepts are the foundation of systematic and proper accounting. Every business enterprise must adopt these concepts, popularly known as pillars upon which the sound structure of accounting stands. Let us discuss these basic concepts :

1. Business Entity

In accounts, we distinguish between the business and its proprietors. Business is assumed to have distinct entity *i.e.*, existence other than the existence of its proprietors

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and other business units. As an accountant, we are concerned with the business not the businessman. We have to record business transactions from firm's point of view and never from the viewpoint of proprietors. We record transactions in the books of shop, establishment, factory, firm, company and enterprise and never in the books of proprietor, partners and shareholders. While making decisions regarding asset, liability, capital, revenue and expense, business viewpoint is taken into consideration.

The capital introduced by the proprietor in its own business is considered liability from business point of view. It will not be a liability if proprietor's viewpoint is taken. The logic behind treatment of capital as liability is that the firm has borrowed funds from its own proprietors instead of borrowing it from outside parties. It would have been a liability if the funds would have been borrowed from outside agency, then why not, if it is being invested by the proprietor himself. We also allow interest on capital to the proprietors because capital is supposed to be a liability. Interest on capital is an expense of the business, therefore, it will reduce the profit of the firm. It is at the same time proprietor's claim against the business, so it will increase his capital. Amount withdrawn by the proprietor for personal use, known as drawings is assumed to be the assets of the business and at the same time a liability to the proprietor.

Legally, a sole proprietor or the partner of a partnership firm are not separate from their business units but in Accounting the business units are assumed to have distinct entity. Accounting entity is different from business entity. Accounting entity is wider term including business, clubs, institutions, public enterprises, local bodies and government etc.

2. Money Measurement

In accounting, we identify and record only those business transactions which are financial in nature. Accounting transactions must have their monetary value. The worth of the transaction must be measured interms of money. In all the accounting records, we have amount column showing rupees and paise. There is never any accounting record in metres, litres, kilograms and quintals. We evaluate the value of the commodities interms of money and accordingly record them in the books of accounts. Recording transactions in monetary terms makes the information more meaningful. For example, statement that the business was started with Rs. 50,000 cash and 20,000 metres of silk is meaningless and fails to tell us the capital of the business. If the value of 20,000 metres of silk is estimated to be Rs. 5,00,000, we can safely say that the business was started with Rs. 50,000 + 5,00,000 = 5,50,000, which will be meaningful.

The concept of money measurement is not free from problems when we integrate the financial statements of an entity having operations in more than one nation.

3. Going Concern

While recording business transactions in the books of accounts, we assume that the **business will be carried on indefinitely**. This is why, the business purchases fixed assets like land and building, plant and machinery, vehicles and furniture etc. If the concept of going concern may not have been there, we would have hired these assets and not purchased. These assets have been acquired for use and not for sale, so we maintain individual assets account and charge necessary depreciation on it.

According to *International Accounting Standard, The enterprise is normally viewed as a going concern, that is as continuing in operation for the foreseable future.* It is viewed that the enterprise has an intention to be carried on for longer period. The concept of assets, liabilities, capital, revenue and expenses used in the accounting operation prove that the firm has to last long. Planning, organising and personnel policies substantiate the fact that the business has been assumed to be going entity. It is binding upon every accountant to treat business activity as a continuing process and record transactions accordingly.

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4. Accounting Period

Strictly speaking, the result of the business can be had at the end of its life. If a firm was started with a capital of Rs. 50,000 and at the end of its life the capital was Rs. 5,00,000 we can say that the firm earned a profit of Rs. 4,50,000 *i.e.*, 5,00,000 – 50,000 during its life. In this way, business as a going entity will continue indefinitely and we will have to wait for a very long period to estimate the financial result of the business. It will be too late to wait for the results, so the life span of accounting should be split into shorter and convenient period. At present, accounting periods are regarded as twelve months. According to the Companies Act and Banking Regulation Act, accounting period should consist of twelve months. The period of twelve months is regarded as ideal and convenient period for accounting.

Proprietorship and partnership can choose their own accounting period but the difference between the closing date of two final accounts should not exceed twelve months. This period makes a calendar year *i.e.*, 1st Jan. to 31st Dec. of the year, an assessment year *i.e.*, 1st April to 31st March of the next year or even Diwali to Diwali but always restricted to one year *i.e.*, 12 months. In this way, accounting period concept may also be known as accounting year concept. In case of companies, accounting year must be the financial year *i.e.*, 1st April to 31st March of the next year. **The concept of accounting period facilitates the business in assessing its worth after a year.**

5. Cost (*Historical Cost*)

According to this concept **all business transactions must be recorded in the books of Accounts at their monetary cost of acquisition.** The concept is called historical, because the balance of assets and liabilities is carried forward from year to year at its acquisition cost, irrespective of increase or decrease in the market value of assets. Historical approach of presenting assets and liabilities has clear advantage over other approaches of valuation, because it is reliable, verifiable and definite. The use of historical cost as the basis provides verifiable and objective accounting information.

6. Dual Aspect *or* Duality

Every business transaction has double effect. There are two sides of every transaction. This is evident when we study the accounting term *i.e.*, assets, capital and liabilities.

The relationship between assets, liabilities and capital is at present known as *Accounting Equation* which can also be expressed as under :

Assets = Capital + Liabilities

Or

Capital = Assets – Liabilities

Or

Liabilities = Assets – Capital

We record all the business transactions on the basis of dual aspect and call the system as *double entry system.*

7. Revenue Recognition (*Realisation*)

In accounting terminology, 'revenue' is the amount received or receivable from the sale of goods. The concept explains, when we should assume revenue to have been earned. It will enable us to identify the period for which the revenue has been earned. According to accounting period concept revenue must be concerned with the specific accounting period. We can determine the revenue as realised on the following basis :

(*i*) Sales basis

(*ii*) Cash basis

(*iii*) Production basis.

(*i*) **Sales basis.** Sales is supposed to be complete when title of goods is passed to the buyer and payment or promise to make payment is received from him in exchange. The principle explains that mere transfer of possession is not sale, as in the case of consignment, where transfer of goods to the consignee, the agent is not a sale. In the same way, all the payment received or receivable are not the revenue. Revenue will result only if there is an exchange of title to goods or services and payment is received or receivable. For revenue the sale must be complete in the eyes of Indian Sales of Goods Act. Revenue is supposed to have been realised even if the payment becomes legally due to the buyer of goods or beneficiary of services.

(*ii*) **Cash basis.** Revenue is supposed to have been realised when actual payment is received. The cash basis is adopted when there is doubt regarding realisation of the payment. In case of sales on hire purchase and instalment basis, payment is made in certain instalments, split over a period of certain years. Sales in these cases will be supposed to be complete for the part of goods whose payment has been received. Accounts of professional people and government are also prepared on cash basis.

(*iii*) **Production basis.** Revenue is supposed to be realised for part of work completed. Sale of goods or realisation of sales proceeds is not the criteria according to production basis. This basis of ascertaining revenue is adopted. when sales basis and cash basis fail to identify revenue. In construction works, revenue is determined on production basis. The contractor engaged in construction of a multi-storeyed building is not paid the full value of work completed by him during the accounting period, so he prefers to determine his revenue on the basis of the work completed by him during the year.

Accounting is the historical record of transactions. It records what has happened. It does not anticipate events. This is why, in most of the cases we determine revenue on sales basis. Revenue is supposed to be realised if actual payment has been received or customers' legal liability to make payment has been assumed.

8. Matching (***Matching Cost and Revenue***)

Reasonable profit is the object of every business enterprise. The whole business structure is based upon the desire to earn profit. It has been the duty of accountants all over the world to evolve principle of calculating exact and accurate profit. The result of these efforts was the introduction of the principle of matching cost and revenue. According to this concept **income can be ascertained by matching revenue of the business with its costs.** Sales of Rs. 20,00,000 is revenue of the business but not the profit. We cannot determine profit or loss if only one information *i.e.,* sales is given. We require cost of goods sold to calculate profit. In the above information regarding sales, if it is mentioned that the cost of goods sold is Rs. 16,00,000, we shall compare and match the sales (revenue) with the cost of goods sold (expense) and the result will be gross income. In this case, Rs. 20,00,000 – 16,00,000 = 4,00,000 is the gross income. Net income will be calculated after deducting selling and distribution expenses from the gross income.

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9. Full Disclosure

The concept is also known as convention of full disclosure. **Accounting must disclose all material information**. It should be honestly prepared, free from any bias, favour or prejudice. Figures should not be manipulated. It should be the sincere effort of the accountant to present facts, keeping in view the various accounting assumptions. No material information should be concealed. Material information means the information capable of changing the results of the business. Enterprises have their existence separate from their proprietors. In case of companies, there is a divorce between ownership and management. In this context it becomes binding upon the management to disclose all material information in accounts to its owners and other interested parties.

Disclosure of material facts does not mean leaking out the business secrecy, but disclosing all information of proprietors' and investors', interest. According to this principle, certain unimportant items are left and some of them are merged with other items. The intention is not to over burden Accounting with information but present facts without any malafide intention.

10. Consistency

It is also known as convention of consistency. Business is a going concern. It has to continue indefinitely. Important conclusions are drawn by comparing accounting statements of the current year with statements of the previous years. Accurate comparisons can be made, if the methods and practice of recording and presentation of accounts does not change. If the business has been charging depreciation on its fixed assets according to straight line method, it should go on charging depreciation with the same method every year according to the principle of consistency.

The convention of consistency does not mean that the business cannot switch over to better and up-to-date methods. If the business deviates from the previous practices and changes method, the fact should be disclosed with reasons.

The concept of consistency will be supposed to be applied in certain cases, where there is apparently inconsistency. For example, stock and investments are valued at cost or market price, whichever is lower. It may be just possible that stock would have been valued at cost price during the previous year but during the current year stock is valued at market price because market price is lower than the cost price. Such valuation seems to be inconsistent but actually it is in accordance with the principle of consistency because the principle remains constant. The concept states that financial reports should be prepared on the basis, consistent with the preceding reports.

11. Conservatism (Prudence)

The business according to this concept adopts a very safe policy. It accounts for all the prospective losses but leaves aside all the prospective profits. Prudence in financial statements demands that we should avoid uncertainties and make sufficient provisions for unforeseen losses. For example, we value stock at cost price or market

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price whichever is lower. We go on depreciating land and building, though there may be *appreciation in its value. It shows* that the business has been adopting the policy of playing safe. Application of the principle of conservatism is evident from the following facts :

(*i*) Valuation of stock at cost or market price whichever is lower.

(*ii*) Valuation of investment at cost or market price whichever is lower.

(*iii*) Creation of investment fluctuation fund.

(*iv*) Maintaining provision for bad and doubtful debts.

(*v*) Showing depreciation on fixed assets and not appreciation.

(*vi*) Ignoring discount on creditors.

According to this principle **business transactions should be recorded in such way that profits should not be over stated.**

Accounting is criticised for adopting the policy of conservatism. It does not accord equal treatment to prospective losses and prospective profits. It ignores prospective and expected income but highlights even the distant possibilities of losses.

12. Materiality

Accounting should disclose all the material information. Materiality, here means the information which would have changed the results of the business, if it would have been disclosed. It does not mean that accounting should be over burdened with information. Certain unimportant information may be avoided and others may be merged with important information. *Certain information may also be furnished* in footnotes. Most common information given in footnotes are :

(*i*) Information regarding contingent liabilities.

(*ii*) Information regarding market price of investments.

The accountant should always keep in mind that materiality does not mean leaking business secrets. It stresses not to conceal vital information with malafide intention. The principle of materiality is a modifying principle because the material information for one business unit may not be material for the other. Materiality will differ with the size, nature and traditions of the business.

13. Objectivity

The concept of verifiable objectives means that **every business record must be based and supported by documentary evidence**. We do not pass any entry or make any posting in the subsidiary books unless there is a voucher for it. Receipts, bills, invoices, cash memos, salary bills and deeds are some of the vouchers used as documents for recording business transactions. These documents contain the amount of payment, date of payment, person to whom payment is made, purpose of the payment, the executive authorising payment and the stamp for payment and cancellation of the voucher so that double payment on the same voucher cannot be made.

Objectivity of the documents means that these vouchers contain facts presented in an unbiased way. They neither show favour nor prejudice to either the party making payment or the party receiving the payment. Verifiability, here means examination or the scrutiny of the documents before they are recorded in the books of accounts. After accounting of the transaction, entries and postings in the books of accounts are checked with reference to the vouchers by auditors. The value of assets are also verified by auditors. The concept of verifiable objectives is always followed by all the accountants. Accounting can never be accepted to be true and accurate if there are no documentary proof for every record in the books of accounts.

According to the **concept of objectivity, accounting should be definite, verifiable and free from manipulation and personal bias.**

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2.5 SUMMARY

Generally Accepted Accounting Principles *(GAAP)*

Accounting rules derived from experience and practice having proved and accepted as useful and correct become Generally Accepted Accounting Principles (*GAAP*).

Basic Accounting Concepts

Basic concepts are the foundation stone of systematic and proper accounting. Every business enterprise must adopt these concepts.

1. Business Entity

Business is assumed to have distinct entity other than its owners. Business transactions are to be recorded in the books of the enterprise. Identification of items, whether assets, liabilities, revenue or expense are made from business point of view.

2. Money Measurement

Accounting transactions must be capable of being measured interms of money. These transactions must be financial in nature.

3. Going Concern

Accounting assumes business enterprise to last long and carried on indefinitely. The business enterprise is viewed as going concern that is continuing operation for the foreseable future.

4. Accounting Period

The performance of the business enterprise must be assessed and measured after an accounting period, *i.e.*, 12 months.

5. Cost

Expenditure incurred on acquiring, manufacturing and processing goods is termed as cost. All business transactions must be recorded in the books of Accounts at their monetary cost of acquisition.

6. Dual Aspect (*or Duality*)

Every accounting transaction must have dual aspect *i.e.*, every debit must have its corresponding credit. If there is receiver, there must be giver. If someone is purchaser, someone must be seller. If something is received, something must be given and loss for somebody must be gain for someone.

In the same way, according to modern accounting equation approach every asset has got its corresponding liability *i.e.*, **Assets** = Liabilities + Capital.

7. Revenue Recognition (*Realisation*)

(*i*) *Sales basis.* Revenue should be recognised when title of goods is passed to the buyer and the payment or the promise to make the payment is received.

(*ii*) *Cash basis.* Revenue is recognised when actual payment is received. In case of hire purchase and accounts of professionals, this basis is followed.

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(iii) *Production basis.* Revenue is supposed to have been realised for the part of work completed. This approach is followed in construction works.

8. Matching

According to this principle income can be ascertained by matching revenue of the business with its cost. According to this principle :

Gross income = Revenue – Expenses or Net sales – Cost of goods sold

9. Full Disclosure

Accounting must disclose all material information.

10. Consistency

According to this principle the methods and practices of accounting and its reporting must be consistent so that accurate comparisons can be made and correct decisions can be taken.

11. Conservatism *(Prudence)*

According to this principle the business must always play safe. The principle stresses that business transactions should be recorded in such way that profit should not be overstated.

12. Materiality

Accounting should disclose all the material information. Material, here means the information, which would have changed the result of the business, if it would have been disclosed.

13. Objectivity

Every business record must be based and supported by documentary evidence. According to this principle accounting should be definite, verifiable and free from manipulation and personal bias.

REVIEW QUESTIONS

A. Very Short Answer Type Questions :

1. Give an example of a transaction which may be an expense for business and income for the businessman.
2. *Business units last indefinitely*. Mention the concept on which the statement is based.
3. Name the concept, wherein revenue and cost is matched to identify profit of the business.
4. Mention the full form of GAAP.
5. Differentiate between comparability and consistency.
6. Explain the convention of consistency.

B. Short Answer Type Questions :

1. What do you mean by the term "material facts in Accounting" ? Explain.
2. Why do accounting principles emphasise the use of historical cost as a basis for evaluating assets ?
3. What are the general rule of revenue recognition ?
4. What is the matching principle ? Why should this principle be followed by the business entity ?

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C. Long Answer Type Questions :

1. What do you mean by Accounting concepts ? Explain the following concepts :
   (*a*) Money measurement concept
   (*b*) Accounting period concept
   (*c*) Going concern concept
   (*d*) Historical cost concept.
2. Explain the meaning of 'revenue'. Explain briefly the bases on which the revenue is ascertained.
3. Explain the meaning and significance of the following :
   (*a*) Modifying principles of full disclosure
   (*b*) Revenue realisation concept
   (*c*) Modifying principles of industrial practice
   (*d*) Dual concept
   (*e*) Principle of matching revenue with cost.
4. Explain the meaning and importance of matching cost.
5. Explain the meaning and significance of concepts and conventions in Accounting.
6. Explain the following convention (Modifying Principles)
   (*a*) Convention of disclosure
   (*b*) Consistency convention
   (*c*) Materiality convention
   (*d*) Principle of conservatism.
7. Explain the following with examples :
   (*a*) Money measurement concept
   (*b*) Principle of full disclosure
   (*c*) Principle of consistency.

UNIT 3 RULES OF DEBIT AND CREDIT —JOURNAL

NOTES

★ STRUCTURE ★

3.1 Objectives
3.2 Introduction
3.3 Accounting Cycle/Process
3.4 Definition of Debit and Credit (*Modern American Approach*)
3.5 Rules for Debit and Credit (*Accounting Equation Approach*) [*Modern American Approach*]
3.6 Traditional Rules of Debit and Credit (*English Approach*)
3.7 Meaning of Journal
3.8 Types of General
3.9 Summary

3.1 OBJECTIVES

At the end of this unit, you should be able to :

- *Define Debit and Credit.*
- Understand the modern American of branch of debit and credit.
- Debit and Credit Assets, Liabilities, Capital, Revenue and expenses as per modern approach.
- Analyse various accounts as personal, real and account.
- Debit and credit personal, real and nominal accounts as per english traditional approach.
- Explain compound, opening and closing journal entries.
- Enumerate Subsidiary books and classify non-cash transactions.
- *Explain the advantages of Subsidiary books or Sub-division of Journal.*
- Draw format of Purchases book with its complete columns and prepare Purchases book practically.
- Draw format of Sales book, with its complete columns and prepare Sales book practically.
- Prepare Purchases Return and Sales Return books.
- Understand and prepare Debit Note and Credit Note.

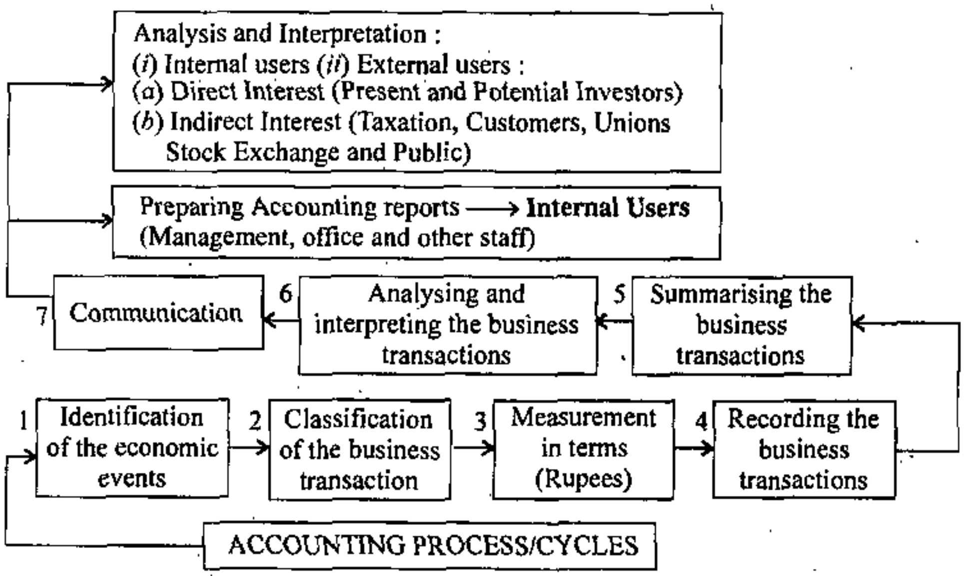
3.2 INTRODUCTION

Accounting or business transactions constitute the basic information on the basis of which accounting process takes place. It is the starting point of the accounting process. These transactions are evidenced by documentary evidence which makes the accounting process transparent and capable of being audited later on. The documentary evidence may be in the form of vouchers, invoice, receipts etc. An accountant needs to analyze these transactions and decide on the type journal entries to be posted to give effect of these transactions on the accounts of the company. In the double entry book-keeping system, every transaction has at least two impacts in the form of debit and credit. We will study in detail these concepts in this chapter.

As a business administrator. Students should have thorough knowledge of these transactions and their impacts on accounting so that they can take analyze the impact of each transaction on accounting and resultant profit or loss of the organization. In this chapter, we will discuss this in detail like rules of debit and credit, Accounting cycle etc.

3.3 ACCOUNTING CYCLE/PROCESS

Accounting Process follows the under mentioned routes :



1. Identification of the economic events. Of many events that surface in business routine, the events which have financial implications and which are relevant for accounting should be identified. This decision is based on materiality of an event.

2. Classification of the business transactions. This process involves careful segregation of the transactions as regards its implication on accounting variables like assets, liabilities, expense, income etc. This helps in deciding the treatment of the transaction in accounting books.

3. Measurement interms of rupees. As accounting is concerned only with monetary value of transactions, non-monetary transactions should be measured interms of money. For example, calculation of depreciation on assets as a measure of its fall in value due to its constant use.

4. Recording the business transactions. Business transactions should be recorded in the books according to their accounting implications. Accounting principles, policies and procedures should be followed to reflect the proper treatment of the transactions.

5. Summarising the business transactions. Accounting information should be recorded in a summarised manner. It should not be very comprehensive so as to expose the business to the competition. Summarising also involves brief reflection of business transaction which is easy to interpret. Journal entries, ledger accounts, trial balance, P/L A/C and Balance Sheet are summarised versions of business transaction.

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6. Analysing and interpreting the business transactions. Analysis and interpretation invovles preparation of various reports like sales report, purchase report, expense report etc. It also includes relative measurement of variables like sales, profit, expense etc. in terms of ratios and percentages. *An account should be efficient enough to provide indepth* analysis for decision making process.

7. Communication. Accounting information should be made available to internal and external users. Internal users include the top, middle and lower level managerial personnel. External users include direct users like Investors. Creditors etc. as well as direct users like Income Tax, Sales Tax and other regulatory authorities.

3.4 DEFINITION OF DEBIT AND CREDIT *(Modern American Approach)*

Debit means decrease in proprietor's equity and credit means increase in proprietor's equity. Business is the creation of the businessman. In other words, business is the representative of the proprietors of the business. Whatever the business earns, has to be paid to its proprietors. It will increase proprietor's claim against the business or proprietor's equity or capital and thus it has to be credited. In this way, we can say that income increases proprietor's equity, therefore it is to be credited. The word 'credit' refers to the word 'creditor', whose short form is known as 'Cr'. Creditors are those persons and parties whom payment has to be made. In case of income proprietor is the creditor of the business because the income earned by business, the representative of the proprietor belongs to the owner of the business. *It increases proprietor's capital as such it is to be credited.* All the expenses are incurred by the business on behalf of the proprietors, therefore, proprietors are liable to bear these expenses. *It will decrease their equity and thus debited in the books of accounts.* The word 'debit' refers to the word 'Debtor', whose short from is 'Dr'. The proprietor is the debtor for all expenses, and thus he is rightly debited.

Conventional approach towards 'Debit' and 'Credit'

In addition to accounting concepts and assumptions, there are certain accounting conventions which we have to follow to make accounting uniform, comparable and meaningful. We follow certain conventions regarding 'Debit and Credit' which are as under :

(*i*) The left hand side of every account is debit and the right hand side of the account is credit.

(*ii*) In case of Journal and Trial Balance the amount column is divided in two parts. The left part of the amount column is Debit and the right part is Credit.

(*iii*) While passing journal entries, we use the term 'Dr', the short form of 'Debit', 'Debtor' against the accounts debited but do not use the word credit against accounts credited.

(*iv*) All receipts are debited and all payments are credited.

(*v*) All expenses and losses are debited but income and gains are credited.

(*vi*) Increase in the assets is debited, whereas increase in liability is credited.

(*vii*) The assets side of the Balance Sheet represents debit, whereas the liabilities side shows credit.

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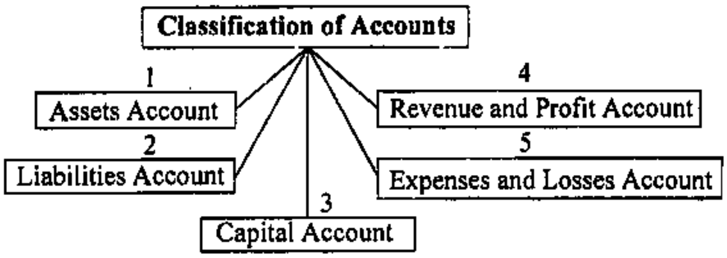
3.5 RULES OF DEBIT AND CREDIT (Accounting Equation Approach) [*Modern American Approach*]



1. Assets

Every business owns and possesses assets. The various assets and their value will differ on the basis of size and nature of business. Generally firms own cash in hand, cash at bank, stock of goods, building, plant, machinery, furniture, vehicles and debtors, etc. The business makes use of these assets for earning income. There are certain dealings in these assets and the result is either increase in the value of assets or decrease in their value. The increase or decrease in the assets must be recorded systematically and scientifically, so that true financial position of the business may be assessed.

Business is the representative of the proprietors of the business. Whatever the business spends, the proprietors have to reimburse and repay it back. In other words, proprietors become liable for expenditure on acquiring assets and their capital will be reduced. In this way, increase in assets will be debited because it will reduce proprietor's equity and debit means decrease in the proprietor's share in the business. In the same way, decrease in the assets will increase proprietors' equity and thus credited. The fact can be presented as under :

Assets

Debit	Credit
Increase (+)	Decrease (–)

While recording business transactions, we have to identify whether the transaction relates to assets, liabilities, capital, expenses or losses and revenues or profits. If the transaction relates to assets, we have to ascertain that the transaction increases assets or decreases it. If it increases, the increase is debited and if it decreases, the decrease is credited. It can be summarised as under :

Debit increase in the assets
Credit decrease in the assets

It has been an accepted fact that assets either increase or decrease. The increase in the assets are debited and the decrease in the assets are credited. In case of commencement of the business cash will increase, so cash account will be debited. While purchasing furniture for business use, furniture will increase and thus furniture account will be debited. At the same time as the payment for furniture has been made in cash, therefore, it will decrease cash and thus cash account will be credited. In the same way, if a part of machinery is sold, cash will increase because the payment has been received in cash and thus debited. The

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balance of machinery will decrease as such machinery account will be credited. In case of depreciation on fixed assets, the balance of assets will reduce and thus credited. While recording, we have to identify assets account in the transaction and then satisfy ourselves whether, there has been an increase in the assets or decrease in it. The assets, whose value has increased will be debited with the amount of increase and the assets decreasing in the value will be debited with the amount of decrease.

2. Liability

The liability of the business, like its assets either increases or decreases. An increase in the liability will increase proprietor's claim against the business because the amount borrowed has been received on behalf of the proprietor and will definitely increase proprietor's equity as such, *increase in the liability is to be credited and decrease in it will be debited.* The fact regarding rules of 'Debit' and 'Credit' in case of liabilities can also be presented as under :

Liabilities

Debit	Credit
Decrease (–)	Increase (+)

In case of borrowing Rs. 7,000 from Mhabemo, firm's liability will increase, therefore Mhabemo's account will be credited. If the payment is made to Mhabemo, liability of the business towards him will reduce and thus his account will be debited. The rule can be summarised as under :

Debit decrease in the liability
Credit increase in the liability

3. Capital

Capital represents proprietor's account. Amount introduced by the proprietor as capital *will increase his claim against the business and thus capital account representing increase* in proprietor's equity will be credited. In the same way, amount withdrawn by the proprietor will reduce capital and thus debited. The rule regarding capital can be presented as under :

Capital

Debit	Credit
Decrease (–)	*Increase (+)*

In case of commencement of the business the proprietor introduces capital. He may also bring additional amount of capital in the business. He may also be allowed interest on capital. *His capital balance will increase with the initial investment, additional funds and* even with the interest on capital so capital account will be credited in these cases. If there is any loss or drawings made by the proprietor the capital will reduce and thus capital account will be debited. The rule can also be summarised as under :

Debit decrease in capital
Credit increase in capital

4. Revenue and Profit

Proprietor's equity increases due to increase of revenue, so revenue account is credited with the increase. Decrease in the revenue will decrease proprietors' claim against business, so revenue account will be debited with the decrease. Receiving interest is a revenue gain. It will increase proprietor's capital, so interest account will be credited. At the end of accounting period, interest account will be closed by transfer to profit and loss account and *thus in this case interest account* will be debited. Decrease in the revenue or increase in the expenses are synonymous. In both cases proprietors equity decreases so increase in expenses and decrease in revenue are debited. This rule of debit and credit can also be displayed as under :

Revenue and Profit

Debit	Credit
Decrease (–)	Increase (+)

Revenue received and profit earned is the liability of the business. The amount of profit is to be credited to proprietor's account, because profit is the reward for the risk taken by the proprietor, so profit will be credited. The rule can be summarised as under :

Debit decrease in revenue and profit
Credit increase in revenue and profit

5. Expenses and Losses

Expenses and losses reduce proprietors' claim against business so these accounts are debited when they increase. Reduction in expenses or losses will increase proprietors' equity, as such it has to be credited. The rule regarding debit and credit concerning expenses and losses can also be presented as under :

Expenses and Losses

Debit	Credit
Increase (+)	Decrease (–)

In case of payment of salaries to employees, salaries, as an expense will increase and thus debited. The salaries amount will be closed by transfer to Profit and Loss Account. The transfer will reduce or close salaries account and thus it will be credited. It can be summarised as under :

Debit increase in expenses and losses
Credit decrease in expenses and losses

All business transactions can be classified as assets, liability, revenue, expense and capital. All the business transactions either increase or decrease them. The increase and decrease is either debited or credited on the basis of rules explained for different items. The above rules can be put together as under :

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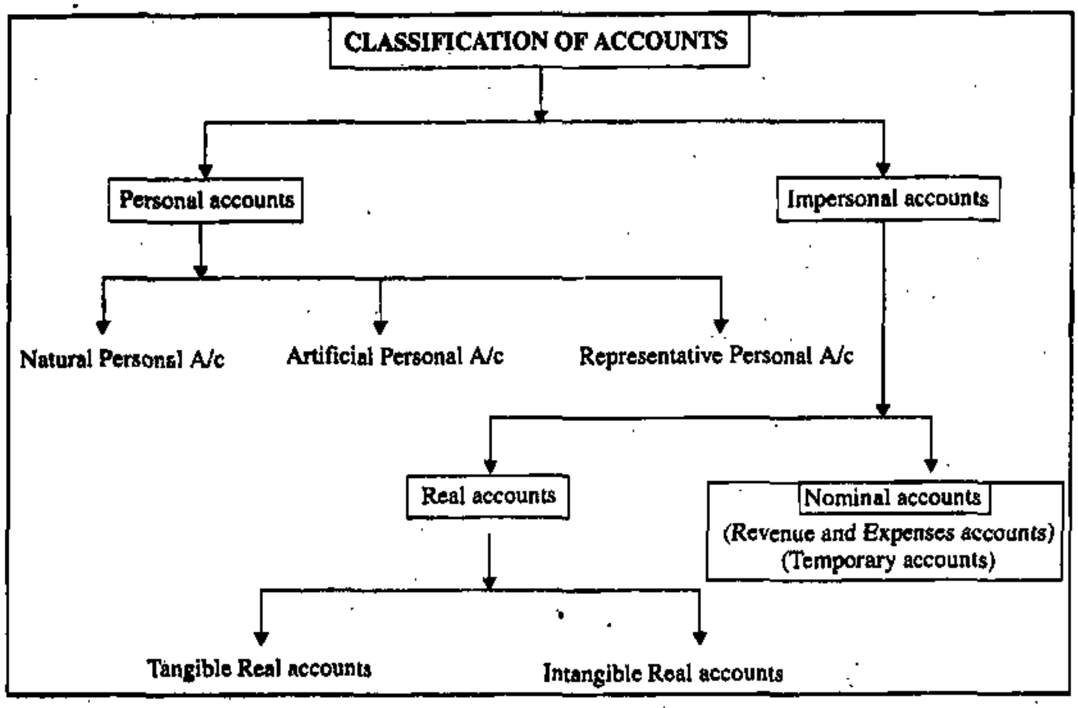
3.6 TRADITIONAL RULES OF DEBIT AND CREDIT *(English Approach)*

In the conventional approach, accounts were classified as personal, real and nominal and different rules of debit and credit for different accounts were developed. The classification of accounts and rules of debit and credit are discussed as under :



Meaning of Account

An account is the systematic presentation of all material information regarding a particular heading at one place, under one head. Transactions recorded in the account also show the nature and direction of the information.

Personal Accounts

There are two types of persons *i.e.,* natural and artificial. Accounts is related to both these types of persons. Natural persons mean human beings, such as John, Jack, David and James. Artificial persons do not have physical construction as human beings but they work as personal accounts. These accounts are related to firms, companies, institutions, factories and establishments, such as Gupta & Sons Account, Michael & Bros Account, Bank of India Account, Congress Party's Account, Bata Shoe Company's Account and Nagaland Sporting Club's Account, Debtor's Account, Creditor's Account, Capital Account and Drawings Account.

Representative Personal Accounts represent a particular person and group of persons, such as outstanding wages A/c. Here, instead of using the names of workers whose wages is outstanding, we shall be crediting outstanding wages A/c which represents workers, whose wages are payable. In this way, Outstanding salaries, Prepaid expenses, Accrued and unearned income are Representative Personal Accounts.

Rules of Debit and Credit

Personal accounts either receive something or give something in the business. When goods are sold to them or amount paid to them, they are the receiver. In the same way, personal accounts are giver, when goods are purchased from them or amount is received from them. According to this nature of personal account, the rule of 'debit and credit' in the personal account are as under :

Debit the receiver
Credit the giver

Illustration. Goods sold to Kunal. Here, in this transaction, Kunal is a personal account as being the name of human beings. He is receiving goods because it has been sold to him. He will be debited in the entry as receiver. In the same way, in case of goods purchased from Kishore, the giver of goods *i.e.,* Kishore will be credited. Bank A/c will be debited in case of deposits into the Bank, because Bank will be the receiver of the deposit. If the amount is withdrawn from Bank, the amount will be given by the Bank. The Bank will be the giver, as such credited in the book. It shows that we have to identify the personal account, which will be in the name of persons, firms, companies and institutions. After that, it should be verified, whether the account is a receiver or giver in the transaction. If it is a receiver, it should be debited and in case of giver, it should be credited.

Examples :

Transactions

(*i*) *Goods sold to Kunal for Rs. 10,000*

Kunal A/c	Dr.	10,000	
To Sales A/c			10,000
(Being goods sold to Kunal)			

Note. Here Kunal's A/c has been debited as per rule of personal A/c. (Debit the Receiver)

(*ii*) *Goods purchased from Kishore for Rs. 8,000*

Purchases A/c	Dr.	8,000	
To *Kishore A/c*			8,000
(Being goods purchased from Kishore)			

Note. Here Kishore's A/c has been credited as per rule of personal A/c. (Credit the Giver)

(*iii*) *Amount deposited into the Bank Rs. 20,000*

Bank A/c	Dr.	20,000	
To Cash A/c			20,000
(Being amount deposited into the bank)			

Note. Here Bank A/c has been debited as per rule of personal A/c. (Debit the Receiver)

(*iv*) *Amount withdrawn from the Bank Rs. 4,000*

Cash A/c	Dr.	4,000	
To *Bank A/c*			4,000
(Being amount withdrawn from the bank)			

Note. Here Bank A/c has been credited as per rule of personal A/c. (Credit the Giver)

We should also take into consideration the following rule in case of Personal Accounts.

Debit the debtor
Credit the creditor

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The traditional rule of debiting and crediting personal accounts may sometimes prove to be incorrect. It is, therefore, advised that learners should develop an attitude for applying the modern *American Accounting equation* approach for journalising transactions.

In order to debit or credit representative personal accounts, the rule of Debiting the Debtor and Crediting the Creditor is applied. For example, in case of outstanding salaries, salaries will be payable to those employees, whose salaries for the current year is due. They are our creditors, so outstanding salaries A/c, representative of such employees will be credited. *In the same way, prepaid expenses, representing* those parties who have been paid expenses in advance will be debited, because they are our debtors. As prepaid expenses represent the debtors, so prepaid expenses A/c will be debited. According to American approach prepaid expenses are assets, so it will be debited, because it is increasing (Debit the increase in assets).

Examples :

Transactions

(*i*) *Goods sold to Vijay for cash Rs. 10,000*

Cash A/c	Dr.	10,000	
To Sales A/c			10,000
(Being goods sold to Vijay for cash)			

Note. Here Vijay's A/c has not been debited because we have sold goods to him for cash and Vijay is not our debtor, though he is the receiver of the goods.

(*ii*) *Goods purchased from Fernandes for cash Rs. 8,000*

Purchases A/c	Dr.	8,000	
To *Cash A/c*			*8,000*
(Being goods purchased from Fernandes for cash)			

Note. Here Fernandes's A/c has not been credited because he has made cash purchases and is not our creditor, though he is the giver of the goods.

It should be noted that if any prefix or suffix *i.e.*, outstanding, due, unpaid, owing, prepaid, unexpired, accrued, unearned etc. is added to nominal account, it becomes personal A/c as commission accrued A/c, unearned rent A/c, unexpired insurance and wages owing A/c.

Impersonal Accounts

All those accounts, which are not personal accounts are termed as *impersonal* accounts. These accounts may be related to assets, losses, expenses, incomes and gains. In other words, impersonal account may be classified as Real and Nominal Accounts.

Real Accounts. It is classified as (*a*) Tangible and (*b*) Intangible.

(*a*) *Tangible Real Accounts.* This account is related to property. In other words, tangible real accounts are generally those accounts which are concerned with the things which really exist. All those things which can be seen, touched and have physical construction, shape, *form and size are* Real Accounts. *In this way,* Cash A/c, Building A/c, Plant A/c, Furniture A/c, Goods A/c, Machinery A/c etc. are real accounts.

(*b*) *Intangible Real Accounts.* These real accounts are intangible *i.e.,* they do not have any physical construction, form, size, shape. They can neither be seen nor touched. The value of these accounts are measured in pecuniary terms. Goodwill, trade marks and patent rights are its example.

Rules of Debit and Credit

Real accounts are related to lifeless properties which cannot do anything at their will. They are either purchased or sold. They either come into the business or go outside the business. On the basis of this nature of real account, the following rules have been ascertained :

Debit what comes in
Credit what goes out

According to this rule, whenever any property comes into the business *i.e.,* owned by the business, it is debited and property account is credited, when it goes outside the business. In case of purchasing furniture for cash, furniture will be coming under the ownership of the firm, therefore, furniture account will be debited but cash account will be credited because cash is going outside the business against the payment for furniture.

Examples :

Transactions

(*i*) *Furniture purchased for cash Rs. 15,000*

Furniture A/c	Dr.	15,000	
To *Cash A/c*			15,000
(Being furniture purchased for cash)			

Note. Here furniture A/c has been debited and cash A/c has been credited as per rule of Real Account.

(*ii*) *Machinery sold for Rs. 5,000*

Cash A/c	Dr.	5,000	
To Machinery A/c			5,000
(Being amount received from the sale of machinery)			

Note. Here cash A/c has been debited and machinery A/c credited as per rule of Real Account.

Nominal Account

This account is just reverse to the Real account. Real accounts generally have existence, but Nominal accounts do not have any existence. These accounts do not have any form, shape and physical construction. In other words, these accounts are related to Income and Expenditure or Gains and Losses. Wages A/c, Salaries A/c, Rent A/c, Interest A/c, Discount A/c and Advertisement A/c are some of its examples.

Nominal Accounts are also known as *Revenue and Expenses Accounts*, because they deal with revenue and expenses. These accounts are also known as *Temporary Accounts,* specially in America because these accounts are closed at the end of every accounting year by transfer to Trading or Profit and Loss A/c. These accounts do not have any opening or closing balance.

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Rules of Debit and Credit

Nominal accounts are expenses or losses and incomes or gains. According to this nature of Nominal accounts, the following rules for their debit and credit have been determined :

Debit all expenses or losses
Credit all incomes or gains

According to the above rule, wages A/c, salaries A/c, insurance A/c and interest A/c etc. are debited when these expenses are met. Discount A/c, commission A/c, interest A/c, etc. are credited, whenever they are received. In case of payment of salaries to workers, salaries are an expense, so salaries account will be debited. While receiving rent from the tenant, rent will be gain and thus credited in the books of accounts.

Examples :

Transactions

(i) Salaries paid Rs. 25,000			
Salaries A/c	Dr.	25,000	
To Cash A/c			25,000
(Being salaries paid)			

Note. Here salaries A/c has been debited as per rule of Nominal Account. (Expenses are debited)

(ii) Rent received Rs. 5,000			
Cash A/c	Dr.	5,000	
To *Rent A/c*			5,000
(Being rent received)			

Note. Here rent A/c has been credited as per rule of Nominal Account. (Income is credited).

3.7 MEANING OF JOURNAL

The word 'Journal' has been derived from the French word 'JOUR' meaning daily records. *Journal is a book of prime record* for small firms. Big concerns prepare Cash Book, Purchases Book, Sales Book and other subsidiary books in addition to Journal proper. Small firms record their business transactions in Journal and post them to the concerned ledger accounts. Big concerns record their business transactions in subsidiary books and Journal and post them from these prime books to respective ledger accounts.

According to **Professor Cartor**, "*The Journal is originally used, as a book of prime entry in which transactions are copied in order of date from a memorandom or waste book. The entries as they are copied are classified into debits and credits, so as to facilitate them being correctly posted, afterwards in the ledger*".

Business transactions of financial nature are studied and classified as assets, liabilities, capital, revenues and expenses and accordingly debited or credited in the Journal. Accounts are debited or credited according to rules of debit and credit applicable to the specific account. Journal entries are passed on the following format :

Format of Journal

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

The journal is sub-divided into five columns. These columns as per above format are Date, Particulars, Ledger Folio, Amount (Debit), Amount (Credit) and narration. These columns show the following informations :

1. Date

This is the first column of the Journal. It records the date of the transaction with its month and year. We need not repeat the year against every entry because the year is almost the same. In the same way, months should also not be repeated but the date should change because the dates of transactions ordinarily differ. The sequence of the dates and months should be strictly maintained *i.e.,* transaction taking place on January 1, 2005 will be recorded in Journal first and afterward the transaction taking place on January 2, 2005. In the same way, transaction for the month of January, 2005 will be recorded before the transactions of February, 2005. Date should be recorded in the Journal as under :

Date	
2005	
Jan.	1
"	20
Feb.	1

2. Particulars

This column is used for recording the details of the business transaction. As we know every transaction has got double effect and there are always two or more accounts to be debited and credited. We write the name of account to be debited and also write 'Dr' against the account. Account to be credited is written below the account to be debited. The credit account starts after leaving certain space and we do not write 'Cr' against this account. After the Journal Entry 'Narration' is written, just to explain the journal entry. If furniture is purchased, furniture account will be debited, because the transaction will increase the value of furniture and cash account will be credited because cash will decrease due to the payment for furniture. This transaction will be recorded in the Particulars column of the journal as under :

Particulars	
Furniture A/c	Dr.
To Cash A/c	
(Being furniture purchased)	

The important feature of the above Journal entry are using 'Dr' against Furniture A/c, leaving space while writing Cash A/c and not using 'Cr' against Cash A/c. Narration is preceded by the words 'Being', 'For' can also be used instead of 'Being'. Presenting Journal

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entry as above is the convention of Accounting. It should be honoured to establish norms of the subject and to bring uniformity in the presentation.

3. Ledger Folio (*L.F.*)

Journal is the original record of the business transactions. On the basis of journal entries posting in the ledger accounts are made. It shows that journal and ledger are inter-related and the ledger posting is based upon Journal. It is, therefore, necessary that there should be certain reference as regards the page number of ledger, where the account in the journal is being posted. This will facilitate in understanding and checking the ledger posting at a glance. In the above journal, if we write '7' in the L.F. column against furniture, it will mean that the Furniture A/c is prepared at page '7' of the ledger. We can turn page '7' of the ledger and check the posting in the ledger account. The posting can be verified from the Journal and if necessary from the source document, wherefrom the Journal is recorded.

4. Amount (*Debit*) and (*Credit*)

Every transaction has got debit and its corresponding credit of the same amount. It is therefore, necessary that the amount column should be divided into debit and credit columns. The amount of the account debited is written against the debit column of the amount and the amount of the account credited is written at the credit column of the amount.

5. Narration

After passing journal entry, we have to explain briefly the transaction for which the entry has been passed. It enables everyone going through the journal entry to have an idea about the transaction. It is customary to start the statement with the word '*Being*' or '*For*' denoting the reason for which entries have been passed. This statement is known as '**narration**' meaning description, because it narrates briefly the transaction for which the entry has been passed. It is also customary to write the narration within small brackets. After the narration, horizontal line is drawn in the particulars column only just to separate the journal entry from the other entry.

Compound or Composite Journal Entries

Sometimes a particular transaction involves more than two accounts. Many transactions are related to specific account on a particular date. There may be certain transactions of the same nature on a certain date. In these cases, we prefer to pass only one entry instead of passing two or more entries. Such entries can be passed in either of the following three ways :

(*a*) By debiting one account and crediting two or more accounts.

(*b*) By crediting one account and debiting two or more accounts.

(*c*) By debiting two or more accounts and crediting two or more accounts.

Illustration 1. *Pass necessary Journal entries in the following cases :*

(*i*) Amount received from James	Rs. 1,980	
Discount allowed		Rs. 20
(*ii*) Amount paid to John	Rs. 2,920	
Discount received		Rs. 80

(*iii*) *Salaries amounting to Rs. 3,000 and wages amounting to Rs. 5,000 were paid on 31st Dec. 2001.*

Journal Entries :

(*i*) Cash A/c	Dr.	1,980	
Discount A/c	Dr.	20	
To James A/c			2,000
(Being amount received from James and discount allowed)			
(*ii*) Adi A/c	Dr.	3,000	
To Cash A/c			2,920
To Discount received A/c			80
(Being amount paid to Adi and discount received from him)			
(*iii*) Salaries A/c	Dr.	3,000	
Wages A/c	Dr.	5,000	
To Cash A/c			8,000
(Being payment of salaries and wages)			

Opening Journal Entry

Business, according to going concern concept is supposed to be carried on indefinitely. At the end of the accounting year different accounts are closed but the business has to be carried on, so previous year's assets and liabilities are to be brought into account of the current year. Passing journal entry in the beginning of the current year with the balances of assets and liabilities of the previous year is opening journal entry. In this entry assets accounts are debited because assets always show debit balance. Liabilities and capital accounts are credited because they show credit balance.

Illustration 2. *The firm of M/s Garg and Gupta has the following balances in their different ledger accounts on January 1, 2006.*

Cash	*Rs. 20,000*
Closing Stock	*Rs. 20,000*
Building	*Rs. 60,000*
Debtors	*Rs. 20,000*
Creditors	*Rs. 16,000*
Capital	*Rs. 1,08,000*

Pass the opening Journal Entry.

Solution.

Journal Entry

Date	*Particulars*		*L.F.*	*Amount* Debit Rs.	*Amount* Credit Rs.
2006					
Jan. 1	Cash A/c	Dr.		20,000	
	Goodwill A/c (difference)	Dr.		4,000	
	Stock A/c	Dr.		20,000	
	Building A/c	Dr.		60,000	

NOTES

	Debtors A/c Dr.		20,000	
	To Creditors A/c			16,000
	To Capital A/c			1,08,000
	(Being previous year's balance brought into books)			

Note. Excess of credit over debit has been assumed to be Goodwill.

Illustration 3. *Journalise the following transactions :*

2002

Jan. 1 Started business with cash Rs. 10,000 and goods Rs. 5,000.

Jan. 3 Paid into Current Account Rs. 4,000.

Jan. 5 Sold goods to Neeraj Rs. 2,000.

Jan. 9 Goods returned by Neeraj Rs. 200.

Jan. 12 Goods purchased from Kapoor Rs. 3,000.

Jan. 15 Goods returned to Kapoor Rs. 150.

Jan. 18 Purchased goods from John for Rs. 10,000.
He allowed 10% Trade discount.

Jan. 21 Received a V.P.P. from Prem for Rs. 1,000.
Sent a worker to collect it who paid Rs. 7 as cartage.

Jan. 22 Paid interest on loan Rs. 30.

Solution.

Journal Entries

Date	*Particulars*	*L.F.*	*Amount*	
			Debit *Rs.*	*Credit* *Rs.*
2002				
Jan. 1	Cash A/c Dr.		10,000	
	Goods A/c Dr.		5,000	
	To Capital A/c			15,000
	(Being started business with cash Rs. 10,000 and goods Rs. 5,000)			
Jan. 3	Bank A/c Dr.		4,000	
	To Cash A/c			4,000
	(Being amount deposited into bank)			
Jan. 5	Neeraj A/c Dr.		2,000	
	To Sales A/c			2,000
	(Being goods sold to Neeraj)			
Jan. 9	Sales Return A/c Dr.		200	
	To Neeraj A/c			200
	(Being goods returned by Neer.			
Jan. 12	Purchases A/c Dr.		3,000	
	To Kapoor A/c			3,000
	(Being goods purchased from Kapo‹.)			

Jan. 15	Kapoor A/c Dr. To Purchases Return A/c (Being goods returned to Kapoor)		150	150
Jan. 18	Purchases A/c Dr. To John A/c (Being goods purchased from John Rs. 10,000. He allowed 10% trade discount)		9,000	9,000
Jan. 21	Purchases A/c Dr. Cartage A/c Dr. To Cash A/c (Being V.P.P. received and cartage paid)		1,000 7	1,007
Jan. 22	Interest on Loan A/c Dr. To Cash A/c (Being payment of interest on loan)		30	30
	Total		34,387	34,387

NOTES

Illustration 4. *Record the following transactions in journal :*

(*i*) *Goods worth Rs. 500 given as charity.*

(*ii*) *Received Rs. 975 from Mahesh in full settlement of his account for Rs. 1,000.*

(*iii*) *Received a first and final dividend of 60 paise in a rupee from the Official Receiver of Mr. Mahesh, who owed us Rs. 1,000.*

Solution.

Journal Entries

Date	*Particulars*	*L.F.*	*Amount*	
			Debit Rs.	*Credit Rs.*
(*i*)	Charity A/c Dr. To Purchases A/c (Being goods given as charity)		500	500
(*ii*)	Cash A/c Dr. Discount A/c Dr. To Mahesh A/c (Being amount received from Mahesh and discount allowed)		975 25	1,000
(*iii*)	Cash A/c Dr. Bad Debts A/c Dr. To Mahesh A/c (Being 60% received from David in full settlement of account)		600 400	1,000

Notes. (*i*) Goods given as charity must have been charged at cost price, so they will reduce purchases. This is why, Purchases Account has been credited instead of Sales Account.

(*ii*) Rs. 25, received lesser from Mahesh is discount allowed. It is an expense, so debited.

NOTES

Illustration 5. *Pass necessary journal entries for the following transactions :*

(*i*) *Rs. 1000 was stolen from the safe of the firm.*

(*ii*) *Received an order from Miss Ape for the supply of goods worth Rs. 40,000. In this connection we received Rs. 20,000 as advance.*

(*iii*) *Goods sold for cash Rs. 10,000. Also received 7% sales tax.*

(*iv*) *Given as charity : Cash Rs. 1000, Goods Rs. 3,000 and a Sofa-set worth Rs. 4,000.*

(*v*) *Goods worth Rs. 700 stolen by an employee.*

(*vi*) *Purchased two horses worth Rs. 20,000 for the business.*

(*vii*) *Goods given to proprietor's daughter Rs. 300.*

(*viii*) *Goods worth Rs. 1,000 destroyed by fire.*

(*ix*) *Goods worth Rs. 2,000 distributed as sample.*

(*x*) *Bricks worth Rs. 1,00,000 purchased for the construction of building.*

(*xi*) *Received cash from Kiwalo against bad debts written off last year, Rs. 3,300.*

Solution.

Journal Entries

Date	*Particulars*	*L.F.*	*Amount* Debit Rs.	*Amount* Credit Rs.
(*i*)	Loss by theft A/c Dr.		1,000	
	To Cash A/c			1,000
	(Being cash stolen from the safe of the firm)			
(*ii*)	Cash A/c Dr.		20,000	
	To Advances from Miss Ape A/c			20,000
	(Being amount received from Miss Ape in advance)			
(*iii*)	Cash A/c Dr.		10,700	
	To Sales A/c			10,000
	To Sales Tax A/c			700
	(Being goods sold for cash and sales tax received)			
(*iv*)	Charity A/c Dr.		8,000	
	To Cash A/c			1,000
	To Purchases A/c			3,000
	To Furniture A/c			4,000
	(Being charity given as cash, goods and furniture)			
(*v*)	Loss by theft A/c Dr.		700	
	To Purchases A/c			700
	(Being loss of goods by theft)			

(vi)	Livestock A/c Dr. To Bank A/c (Being purchases of two horses)		20,000	20,000
(vii)	Drawings A/c Dr. To Purchases A/c (Being goods given to proprietors daughter)		300	300
(viii)	Loss by fire A/c Dr. To Purchases A/c (Being goods lost by fire)		1,000	1,000
(ix)	Free samples A/c Dr. To Purchases A/c (Being goods distributed as sample)		2,000	2,000
(x)	Building A/c Dr. To Bank A/c (Being purchase of bricks for the construction of building)		1,00,000	1,00,000
(xi)	Cash A/c Dr. To Bad Debts Recovered A/c (Being amount received from Kiwalo against bad debts previously written off)		3,300	3,300

NOTES

Illustration 6. *Journalise the following transactions :*

(i) *Sold furniture to M/s Satish & Sons at the list price of Rs. 20,000 and allowed them 5% trade discount. We deal in furniture.*

(ii) *M/s Satish & Sons cleared the account and we allowed them 3% cash discount.*

(iii) *Furniture costing Rs. 2,000 was used in furnishing the office of the firms, we deal in furniture.*

(iv) *Sold goods to Sony at the list price of Rs. 12,000, allowed trade discount @ 10% and cash discount at the rate of 5%. Sony cleared the account.*

(v) *Supplied goods costing Rs. 4,000 to Jimmy at 20% above the cost price and allowed 10% trade discount.*

(vi) *Paid sweeper's salary Rs. 3,000.*

(vii) *Received interest on loan Rs. 250 from Anshu, the debtor.*

(viii) *Goods used personally by the proprietor Rs. 350.*

(ix) *Purchased postcards Rs. 100 and envelopes Rs. 200.*

(x) *Paid cash to Mrs. Andrews on behalf of Mr. Andrews Rs. 1,050.*

(xi) *Received an order from Ramesh for supply of goods for Rs. 50,000 and received Rs. 15,000 as an advance.*

(xii) *Purchased bullocks of Rs. 4,000 for the business.*

NOTES

Solution. **Journal Entries**

Date	Particulars		L.F.	Amount Debit Rs.	Amount Credit Rs.
(i)	M/s Satish & Sons A/c	Dr.		19,000	
	To Sales A/c				19,000
	(Being furniture sold to M/s Satish & Sons)				
(ii)	Cash A/c	Dr.		18,430	
	Discount allowed A/c	Dr.		570	
	To M/s Satish & Sons A/c				19,000
	(Being amount received and allowed discount)				
(iii)	Furniture and Fittings A/c	Dr.		2,000	
	To Purchases A/c				2,000
	(Being furniture used in furnishing the office of the firm)				
(iv)	(a) Sony A/c	Dr.		10,800	
	To Sales A/c				10,800
	(Being goods sold to Sony)				
	(b) Cash A/c	Dr.		10,260	
	Discount allowed A/c	Dr.		540	
	To Sony A/c				10,800
	(Being amount received from Sony and discount allowed)				
(v)	Jimmy A/c	Dr.		4,320	
	To Sales A/c				4,320
	(Being goods sold to Jimmy)				
(vi)	Salaries A/c	Dr.		3,000	
	To Cash A/c				3,000
	(Being salaries paid to sweeper)				
(vii)	Cash A/c	Dr.		250	
	To Interest on Loan A/c				250
	(Being interest on loan received)				
(viii)	Drawings A/c	Dr.		350	
	To Purchases A/c				350
	(Being goods used by the proprietor personally)				
(ix)	Postage A/c	Dr.		300	
	To Cash A/c				300
	(Being purchases of postcards and envelops)				

(*x*)	Mr. Andrews A/c Dr. To Cash A/c (Being amount paid to Mrs. Andrews on behalf of Mr. Andrews)		1,050	1,050
(*xi*)	Cash A/c Dr. To Ramesh A/c (Being amount received from Ramesh as an advance against the order for the supply of goods worth Rs. 50,000)		15,000	15,000
(*xii*)	Livestock A/c Dr. To Bank A/c (Being purchased bullocks for the business)		4,000	4,000

Closing Journal Entries

At the end of the accounting period, all ledger accounts pertaining to goods *i.e.*, purchases, sales, purchases return, sales return, stock and other accounts concerning expenses, losses, incomes and gains are closed by transferring to Trading and Profit and Loss Accounts. These transferred entries are termed as closing entries. In other words, the closing entries concern all the items of the debit and credit side of Trading and Profit and Loss A/c *i.e.*, Nominal Accounts.

It should be noted that closing entries are made for Nominal Accounts only.

Presentation of Journal Entries

Transactions	*Journal Entry*	*Rule Applicable*
1. Commenced business	Cash A/c Dr. To Capital A/c	Increase in assets is debited. Increase in capital is credited.
2. Cash purchases or Goods purchased for cash	Purchases A/c Dr. To Cash A/c	Increase in expense or assets is debited. Decrease in assets is credited.
3. Purchased goods on credit or Credit purchases	Purchases A/c Dr. To Supplier's A/c	Increase in expenses or assets is debited. Increase in liability is credited.
4. Cash sales	Cash A/c Dr. To Sales A/c	Increase in assets is debited. Decrease in revenue or assets is credited.
5. Credit sales	Debtors A/c Dr. To Sales A/c	Increase in assets is debited. Decrease in or assets is credited.
6. Purchases return	Supplier's A/c Dr. To Purchases return A/c or Returns outward A/c	Decrease in liability is debited. Decrease in assets is credited.

NOTES

7. Sales return	Sales return A/c Dr. or Returns inward A/c Dr. To Debtors A/c	Decrease in revenue is debited. Decrease in assets is credited.
8. *Purchase of assets*	Assets A/c Dr. To Cash A/c	Increase in assets is debited. Decrease in assets is credited.
9. Sale of assets	Cash A/c Dr. To Assets A/c	Increase in assets is debited. Decrease in assets is credited.
10. Payment of expenses	Expenses A/c Dr. To Cash A/c	Increase in expenses is debited. *Decrease in assets is credited.*
11. Receipt of income	Cash A/c Dr. To Income A/c	Increase in assets is debited. Increase in revenue is credited.
12. Collection from debtors (Discount allowed)	Cash A/c Dr. Discount A/c Dr. To Debtors A/c	Increase in assets is debited. Increase in expense is debited Decrease in assets is credited.
13. Payment to creditors *(Discount Received)*	Suppliers A/c Dr. *To Cash A/c* To Discount A/c	Decrease in liability is debited. *Decrease in assets is credited.* Increase in revenue is credited.
14. Depreciation on assets	Depreciation A/c Dr. To Assets A/c	Increase in expenses is debited. Decrease in assets is credited.
15. Interest on capital	Interest on capital A/c Dr. To Capital A/c	Increase in expenses is debited. Increase in capital is credited.
16. Outstanding expenses	Expenses A/c Dr. To Outstanding expenses A/c	Increase in expenses is debited. Increase in liability is credited.
17. Prepaid expenses	Prepaid expenses A/c Dr. To Expenses A/c	Increase in assets is debited. Decrease in expenses is credited.
18. Withdrawal of cash *for personal use*	Drawings A/c Dr. *To Cash A/c*	Decrease in capital is debited. *Decrease in assets* is credited.
19. Withdrawal of goods for personal use	Drawings A/c Dr. To Purchases A/c	Decrease in capital is debited. Decrease in expense or assets is credited.
20. Goods given as charity	Charity A/c Dr. To Purchases A/c	Increase in expenses is debited. Decrease in expenses or assets is credited.
21. Insolvency of debtors	Cash A/c Dr. Bad Debts A/c Dr. To Debtors A/c	Increase in assets is debited. Increase in expenses is debited. Decrease in assets is credited.
22. Bad Debts recovered	Cash A/c Dr. To Bad Debts recovered A/c	Increase in assets is debited. Increase in revenue is credited.
23. Distribution of goods as free samples	Free Samples or Advertising A/c Dr. To Purchases A/c	Increase in expense is debited. Decrease in expense or assets is credited.

24. Loss of goods by theft/fire	Loss by theft A/c Dr. or Loss by fire A/c Dr. To Purchases A/c	Increase in expenses is debited. Increase in expense is debited. Decrease in expense or assets is credited.
25. Loss of cash by theft/fire	Loss by theft A/c Dr. or Loss by fire A/c Dr. To Cash A/c	Increase in expense is debited. Increase in expense is debited. Decrease in assets is credited.
26. Income Tax paid	Capital A/c Dr. To Bank/Cash A/c	Decrease in capital is debited. Decrease in assets is credited.
27. Refund of Income Tax	Cash A/c Dr. To Capital A/c	Increase in assets is debited. Increase in capital is credited.
28. Interest received on (Income Tax surplus)	Cash A/c Dr. To Capital A/c	Increase in assets is debited. Increase in capital is credited.
29. Bills drawn	Bills Receivable A/c Dr. To Drawee's A/c	Increase in assets is debited. Decrease in assets (Debtors) is credited.
30. Bills accepted	Drawer's A/c Dr. To Bills Payable A/c	Decrease in liability is debited. Increase in liability is credited.
31. Payment of the bill received	Cash A/c Dr. To Bills receivable A/c	Increase in assets (cash) is debited. Decrease in assets (B/R) is credited.
32. Payment of the bill made	Bills Payable A/c Dr. To Cash A/c	Decrease in liability (B/P) is debited. Decrease in assets (cash) is credited.
33. Bills Receivable dishonoured	Drawee's A/c Dr. To Bills receivable A/c or Bank A/c or Endorsee's A/c	Increase in assets is debited. Decrease in assets is credited. Decrease in assets is credited Increase in liability is credited.
34. Bills Payable dishonoured	Bills payable A/c Dr. To Drawer's A/c	Decrease in liability is debited. Increase in liability is credited.
35. Sale of Assets for more than the book value	Cash A/c Dr. To Assets A/c To Profit on Sale of Assets A/c	Increase in assets (cash) is debited. Decrease in assets is credited. Increase in revenue is credited.
36. Sale of Assets for lesser than the book value	Cash A/c Dr. Profit & Loss A/c Dr. To Assets A/c	Increase in assets is debited. Increase in expenses is debited. Decrease in assets is credited.
37. Amount deposited into Bank/opened a Bank Account	Bank A/c Dr. To Cash A/c	Increase in assets is debited. Decrease in assets is credited.

NOTES

38. Amount withdrawn from Bank	Cash A/c Dr. To Bank A/c	Increase in assets is debited. Decrease in assets is credited.
39. *Cheque received and retained*	*Cash A/c* Dr. To Debtors A/c	Increase in assets is debited. Decrease in assets is credited.
40. Cheque received previously deposited into Bank	Bank A/c Dr. To Cash A/c	Increase in assets is debited. Decrease in assets is credited.
41. Cheque received previously and endorsed	Endorsee's A/c Dr. To Cash A/c	Decrease in liabilitiy is debited. Decrease in assets is credited.
42. Cheque received and deposited into Bank	Bank A/c Dr. To Debtors A/c	Increase in assets is debited. Decrease in assets is credited.
43. Cheque issued	Creditors A/c Dr. To Bank A/c	Decrease in liability is debited. Decrease in assets is credited.
44. Interest allowed or Credited by bank	Bank A/c Dr. To Interest A/c	*Increase in assets is debited.* Increase in revenue is credited.
45. Interest charged or Debited by bank	Interest A/c Dr. To Bank A/c	Increase in expenses is debited. Decrease in assets is credited.
46. Bank charges or collection charges	Bank Charges A/c Dr. To Bank A/c	Increase in expenses is debited. Decrease in assets is credited.
47. Dishonour of cheques, Discounted earlier	Drawee's A/c Dr. To Bank A/c	Increase in assets is debited. Decrease in assets is credited.
48. Sale of wastes or scrap	Cash A/c Dr. To Miscellaneous Receipts A/c	Increase in assets is debited. Increase in revenue is credited.
49. Subscribing newspaper	Miscellaneous Expenses A/c Dr. To Cash A/c	Increase in expenses is debited. Decrease in assets is credited.
50. Treatment of Sales Tax	(a) Cash A/c Dr. To Sales A/c To Sales Tax A/c (b) Sales Tax A/c Dr. To Cash A/c	Increase in assets is debited. Decrease in assets, revenue is credited. Increase in liability is credited. Decrease in liability is debited. Decrease in cash as assets is credited.
51. Receipt of VPP (value payable post)	Purchases A/c Dr. To Cash A/c	Increase in assets or expenses is debited. Decrease in assets is credited.

Illustration 7. *Classify the following under three different types of accounts :*

(i) Stock *(ii) Loan* *(iii) Fixture*
(iv) Cash *(v) Drawings* *(vi) Salaries*
(vii) Current Accounts of a partner *(viii) Insurance*
(ix) Banks.

NOTES

Solution.

Personal Account :

(*i*) Loan

(*ii*) Drawings

(*iii*) Bank A/c

(*iv*) Current A/c of a Partner.

Real Account :

(*i*) Stock A/c

(*ii*) Fixture A/c

(*iii*) Cash A/c

Nominal Account :

(*i*) Salaries A/c

(*ii*) Insurance A/c.

Illustration 8. *On 1st January, 2006 the following were the balances of Garg & Co. :*

Cash in hand Rs. 900 ; Cash at bank Rs. 21,000 ; Gopi (Cr.) Rs. 3,000 Anu (Dr.) Rs. 2,400 ; Stock Rs. 12,000 ; Dharmendra (Cr.) Rs. 6,000 ; Keshav (Dr.) Rs. 4,500 ; Kunal (Cr.) Rs. 2,700.

Transactions during the month were—

2001		*Rs.*
Jan. 2	*Bought goods from Dharmendra*	*2,700*
Jan. 3	*Sold to Keshav*	*3,000*
Jan. 5	*Sold to Kunal goods for cash*	*3,600*
Jan. 7	*Took goods for personal use*	*200*
Jan. 13	*Received from Anu in full settlement*	*2,350*
Jan. 17	*Paid to Gopi in full settlement*	*2,920*
Jan. 22	*Paid cash for stationery*	*50*
Jan. 29	*Paid to Dharmendra by cheque*	*2,650*
	Discount allowed	*50*
Jan. 30	*Provide interest on capital*	*100*
	Rent due to landlord	*200*

Journalise the above transactions.

Solution.

Journal Entries

Date	*Particulars*		*L.F.*	*Amount* Debit Rs.	*Amount* Credit Rs.
2006					
Jan. 1	Cash A/c	Dr.		900	
	Bank A/c	Dr.		21,000	
	Anu A/c	Dr.		2,400	
	Keshav A/c	Dr.		4,500	
	Stock A/c	Dr.		12,000	
	To Gopi A/c				3,000
	To Dharmendra A/c				6,000
	To Kunal A/c				2,700
	To Capital A/c				29,100*
	(Being the various assets and liabilities are brought to new books)				

NOTES

Jan. 2	Purchases A/c Dr. To Dharmendra A/c (Being goods purchased from Dharmendra)		2,700	 2,700
Jan. 3	Keshav A/c Dr. To Sales A/c (Being goods sold to Keshav)		3,000	 3,000
Jan. 5	Cash A/c Dr. To Sales A/c (Being goods sold to Kunal for cash)		3,600	 3,600
Jan. 7	Drawings A/c Dr. To Purchases A/c (Being goods taken for personal use)		200	 200
Jan. 13	Cash A/c Dr. Discount allowed A/c Dr. To Anu A/c (Being cash received from Anu in full settlement of the account)		2,350 50	 2,400
Jan. 17	Gopi A/c Dr. To Cash A/c To Discount received A/c (Being cash paid to Gopi in full settlement of the account)		3,000	 2,920 80
Jan. 22	Stationery A/c Dr. To Cash A/c (Being stationery purchased)		50	 50
Jan. 29	Dharmendra A/c Dr. To Bank A/c To Discount received A/c (Being amount paid to Naro by cheque and she allowed discount)		2,700	 2,650 50
Jan. 30	Interest on Capital A/c Dr. To Capital A/c (Being interest on capital is provided)		100	 100
Jan. 30	Rent A/c Dr. To Rent Outstanding A/c (Being rent due to landlord)		200	 200

*Excess of debit opening balances over credit opening balances will be assumed to be capital.

Alternate of Illustration No. 8

Analysis of Transactions

S.No.	*Transactions*	*Related Account*	*According to Accounting Equation (American Approach)*		*According to Traditional Classification (English Approach)*			
			Nature of Account	*How Effected*	*Kind of Accounts*	*Effect of Rule*	*Account to be debited*	*Account to be credited*
1.	Commenced business with cash	Cash	Asset	Increased	Real	Cash comes in	Cash	—
		Capital	Capital	Increased	Personal	Proprietor is giver	—	Capital
2.	Goods purchased on credit from Avi	Goods	Asset	Increased	Real	Goods comes in	Goods	—
		Avi	Liability	Increased	Personal	Avi is giver	(Purchase)	Avi
3.	Received Interest	Cash	Asset	Increased	Real	Cash comes in	Cash	—
		Interest	Income	Increased	Nominal	Interest is income	—	Interest
4.	Purchased machinery for cash	Machinery	Asset	Increased	Real	Machine comes in	Machinery	—
		Cash	Asset	Decreased	Real	Cash goes out		Cash
5.	Rent Paid	Rent	Expense	Increased	Nominal	Rent expense	Rent	—
		Cash	Asset	Decreased	Real	Cash goes out	—	Cash
6.	Rent Received	Cash	Asset	Increased	Real	Cash comes in	Cash	—
		Rent	Revenue	Increased	Nominal	Income	—	Interest
7.	Sold goods to Kevi	Kevi	Asset	Increased	Personal	Receiver	Kevi	—
		Goods	Asset	Decreased	Real	Goods goes out	—	Goods (Sales)
8.	Depreciation on Machinery	Depreciation	Expense	Increased	Nominal	Expenses	Deprecia-	—
		Machinery	Asset	Decreased	Real	Goes outside	ation	
						(Decreasing in value)	—	Machinery

Note. Analysis of transactions and their Accounting treatment to the Modern American approach and Traditional English approach as per above statement shows the same Accounting treatment. Learners of the subject should base their understanding on Accounting Equation Approach in order to develop scientific outlook towards Accounting. It may also be noted that purchases A/c can also be treated as an expense and sales A/c can be treated as revenue. According to this approach, rule of debit and credit regarding expense and revenue will apply in case of purchases and sales but lead to the same entry as discussed above.

NOTES

Illustration 9. *Record the following transactions in the Journal of NOIDA Furniture Mart :*

2006

Jan. 1 *Started business with cash Rs. 10,000.*

Jan. 2 *Deposited into bank Rs. 9,000.*

Jan. 3 *Purchased machinery for Rs. 5,000 from Miss Jolly and gave her a cheque for the amount.*

Jan. 15 *Paid installation charges of machinery Rs. 100.*

Jan. 20 *Purchased timber from Romi of the list price of Rs. 2,000. He allowed 10% Trade Discount.*

Jan. 23 *Furniture costing Rs. 500 was used in furnishing the office.*

Jan. 25 *Sold furniture to Ramesh of the list price of Rs. 1,000 and allowed him 5% Trade Discount.*

Jan. 31 *Paid wages Rs. 350 and rent Rs. 200.*

Solution.

Journal Entries

Date	*Particulars*		*L.F.*	*Amount*	
				Debit Rs.	*Credit Rs.*
2006					
Jan. 1	Cash A/c	Dr.		10,000	
	To Capital A/c				10,000
	(Being business started with cash)				
Jan. 2	Bank A/c	Dr.		9,000	
	To Cash A/c				9,000
	(Being amount deposited into Bank)				
Jan. 3	Machinery A/c	Dr.		5,000	
	To Bank A/c				5,000
	(Being machinery purchased and paid by cheque)				
Jan. 15	Machinery A/c	Dr.		100	
	To Cash A/c				100
	(Being installation charges of machinery)				
Jan. 20	Purchases A/c	Dr.		1,800	
	To Romi A/c				1,800
	(Being timber purchased from Romi Rs. 2,000 at a trade discount of 10%)				
Jan. 23	Office Furniture A/c	Dr.		500	
	To Purchase A/c				500
	(Being furniture costing Rs. 500 used in furnishing the office)				

Jan. 25	Ramesh A/c Dr.		950	
	To Sales A/c			950
	(Being furniture sold to Ramesh for Rs. 1,000 and allowed him 5% trade discount)			
Jan. 31	Wages A/c Dr.		350	
	Rent A/c Dr.		200	
	To Cash A/c			550
	(Being amount paid for wages and rent)			
	Grand Total		27,900	27,900

Notes. (*i*) Installation charges on machinery is capital expenditure. It will increase the value of machinery, so it will be debited to machinery account not charges account.

(*ii*) Timber will be treated as goods, because West Point Furniture Mart, the firm concerned has been dealing in furniture.

(*iii*) No entry regarding Trade Discount is passed.

Advantages/need of Journal

Journal has got the following advantages :

1. Reducing the chances of error. The double effect of every transaction is recorded in the same journal entry at the same place. It becomes easier to check and compare it. In case, direct posting is made, there is possibility of omission, posting at the wrong side and writing wrong amount in the two accounts.

2. Permanent Record. *The Journal has permanent record.* It has date-wise record of every transaction and can be used for auditing, whenever required.

3. Narration. Journal entries bear narration, which provides complete information about the transaction. It enables us to understand the entry.

4. Convenient distribution of work. Division of Journal into subsidiary books helps the administration in the distribution of work among employees.

5. Location of errors. Errors can be easily located through journal.

Limitations of Journal

Journal inspite of its above advantages suffers from the following limitations :

1. Huge and bulky size. A single journal for the entire business will be bulky and difficult to operate and handle.

2. Balance of accounts at a glance not available. The actual position of ledger balances as purchases, sales, returns, bills etc. is not known on a particular date from journal.

3. Difficulty in reconciling cash balance. In case all transactions including cash transactions are recorded in the journal and no cash book is maintained, it will be very difficult to reconcile daily cash balance.

In order to overcome the limitations of Journal, business units sub-divide the journal into convenient parts and prepare subsidiary books *i.e.,* Purchases book, Sales book, Returns Inward and Outward book, Bills receivable and Payable book. Other transactions which do not find a place in the subsidiary books are recorded in journal.

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3.8 TYPES OF JOURNAL

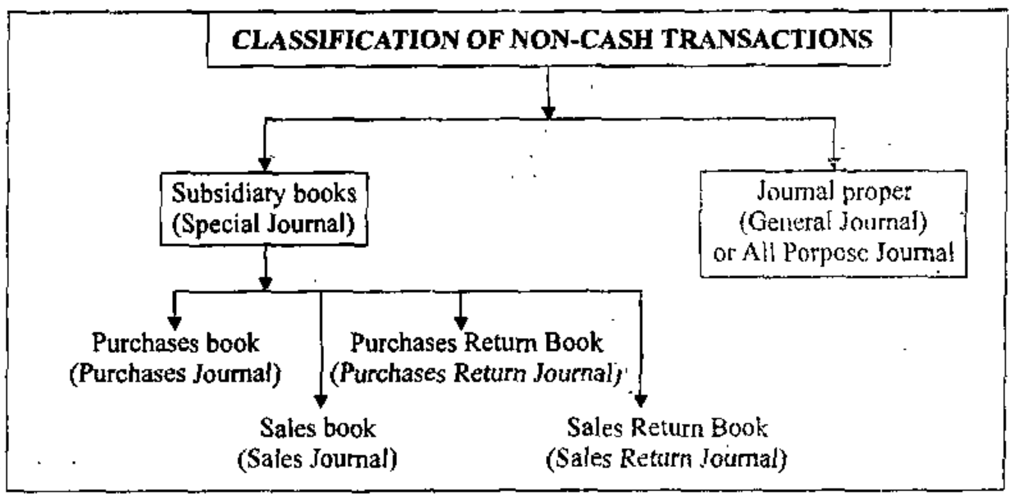
Subsidiary Books

We know that all cash transactions are recorded in the cash book. In addition to these cash *transactions, there are innumerable credit transactions.* These credit transactions are classified as credit purchases of goods, credit sales of goods, purchases returns of goods and sales returns of goods. Instead of over-burdening journal with all the credit transactions of goods, we prepare subsidiary books separately. These subsidiary books are Purchases Book, Sales Book, Purchases Return Book, Sales Return Book.

Business, these days have been greater in size. They have got innumerable transactions. It is quite impossible to record all the transactions in journal or ledger direct, because this approach will not allow division and sub-division of work and speedy working. The easy, convenient, speedy and appropriate maintenance of accounts requires that journal *should be sub-divided in convenient* and requisite parts. Separate books should be used for each type of transaction. **These books are known as special journal or books of primary record or books of primary entry or subsidiary books.**

These subsidiary books having non-cash transactions may be enumerated as under :

1. Purchases book or Purchases Journal
2. Sales book or Sales Journal
3. Purchases return or returns outward book
4. Sales return or returns inward book



All non-cash transactions are recorded in *subsidiary books or journal proper. If the* transaction does not find a place in subsidiary books, it is recorded in the journal proper.

Special Journal (*Subsidiary Books*)

Special Journal, also known as Subsidiary Books or Day Books consists of Cash Book, Purchase Book, Sales Book, Returns Inward and Returns Outward Book. These are subsidiary books having their own unique and specific features.. All transactions concerning these books are recorded therein. *In general, there are lot of transactions concerning* these books so, these books are separately prepared in our financial accounting and special treatment is accorded to them.

Few transactions which do not find a place such as opening, closing, transfer, rectifying and adjusting entries are recorded in General Journal.

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Purchase Book (*Or Purchase Journal*)

It is one of the most important book, which **records credit purchases of goods.** As we know, all cash purchases are recorded in the cash book. Credit purchases cannot be recorded in the cash book. The business wants to know the information about the credit purchases of goods at a glance. The information can be made available, when purchases of goods on credit are separately recorded. Purchases book does not keep record of the purchases of assets even though it is on credit. **Purchases of goods on credit only is recorded in the purchases book.** Goods, here means the articles in which the firm is dealing. In other words, it is the item, which is purchased for regular sales. For example, furniture will be treated as goods in case of the firm dealing in furniture. For other firms, which are not dealing in furniture, it will be an asset for them. Plant and machinery are generally assets but if there is a firm which has been dealing in plant and machinery, it will be goods for the firm. While recording transactions in the purchases book, we must ascertain that the credit purchases is related to the articles in which the firm is dealing. Purchases book is prepared on the following format :

Specimen format of Purchases Book/Purchases Journal

Date	*Invoice No.*	*Name of Suppliers (Account to be credited)*	*L.F.*	*Amount*	
				Details *Rs.*	*Total* *Rs.*
(1)	(2)	(3)	(4)	(5)	(6)

Sales Book (*Or Sales Journal*)

Sales book records credit sale of goods only. It does not record cash sales of goods. Cash sales is recorded in the cash book. All the credit sales are not recorded in it. Credit sales of assets are also not recorded in the sales book. We can summarise that :

1. Cash sales is not recorded in sales book.
2. All sales are not recorded in it.
3. Credit sales of assets are not recorded.
4. *Only credit sales of goods is recorded.*

Goods means the articles in which the firm has been dealing. Goods are purchased for regular sales. Raw materials used for manufacture of the articles, sold by the firm is also goods. Articles produced, assembled, manufactured or purchased for sales are all goods.

The date column of the sales book shows the date of credit sales. Particulars column contains the name of party purchasing goods or the party whom goods have been sold. It also shows the details of goods as regards its quantity, specifications and also the rate of trade discount allowed. L.F. column shows the page number of debtors account in the ledger. The details column is used for additions and subtractions, if any. The total column

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bears the net amount payable by individual customers. The format of the sales book is as under :

Specimen Format of Sales Book/Sales Journal

Date	*Invoice No.*	*Name of the Customer (Account to be debited)*	*L.F.*	*Amount*			
				Details		*Total*	
				Rs.	*P.*	*Rs.*	*P.*
(1)	(2)	(3)	(4)	(5)		(6)	

Purchases Return Book (*Or Purchases Return Journal*)

Goods purchased on credit may be returned to the seller in case of certain defect or violation of certain conditions. They may be returned, if they are not according to sample and specification or if goods have been supplied more than what they have been ordered.

Purchases return book *is made in the same fashion as purchases book is prepared.* In the details column, it contains the names of those parties, whom goods have been returned. It also contains the details of goods returned. If the supplier had allowed trade discount at the time of purchases, it will also be shown at the time of returning goods. Purchases return is also known as returns outward because goods brought inside the business at the time of purchases are being sent outside the business to supplier. *This is the return of goods outside* the business, so it is also known as returns outward. In case of goods returned to supplier we send a Debit Note to the supplier indicating that the Supplier's A/c has been debited with price of goods returned. While preparing Purchases Return Book the Debit Note No. is mentioned.

Sales Return Book (*Or Sales Return Journal*)

Goods sold on credit to customers may be returned to us in the following cases :

1. Due to the defect in the goods.
2. Due to delay in the dispatch of goods.
3. Due to over-supply of goods.
4. Due to goods not being in accordance with the sample and specifications.
5. Due to violation of the terms of the contract.

Goods returned by the customers to us may also be known as 'Returns Inward' because goods once sent outward with the sales have been returned back and coming inside the business.

Sales return book has got almost the same columns as sales book. This book records the return of goods sold on credit only. This is not concerned with the return of assets or return of goods sold for cash. After accepting the goods returned by customer. We issue a Credit Note to him indicating that the customer's A/c has been credited for the goods returned by him. While Preparing Sales Return Book Cr dit Note No. is also referred, therein. The preparation of sales return book has been explained with the help of following illustration.

Journal Proper (*Or General Journal*)

Business firms of smaller size may record all their transactions in the journal, but in practice most of the firms record their transactions in subsidiary books including cash book. If the transaction does not find a place in the subsidiary books, it is recorded in the journal proper. There are certain transactions, which cannot be recorded in either of the subsidiary books, such as purchases of furniture on credit. If it would have been cash purchases of furniture, it would have been recorded in the cash book. As purchases book records credit purchases of goods only, so the purchases of furniture, an asset will not be shown in the purchases book. The purchases of furniture will thus be recorded in the journal proper. The following transactions are recorded in the journal proper :

1. Opening entries
2. Closing entries
3. Adjusting entries
4. Rectifying entries
5. Transfer entries
6. *Special items, which do not find a place in any subsidiary book :*
   (*a*) Purchases of assets on credit
   (*b*) Sales of assets on credit
   (*c*) Interest on capital
   (*d*) Goods taken by the proprietor for personal use
   (*e*) Goods given as charity or free sample
   (*f*) Loss of goods
   (*g*) Endorsement and dishonour of bills.

Debit Note and Credit Note

In case of purchases return and sales return, adjustment is required in the amount payable or receivable. These adjustments are made through notes, known as debit note and credit note.

Debit Note. In case of purchases return, the purchases will reduce the amount payable to seller. When goods are purchased, the purchaser credits the seller's account. If certain part of goods are returned to the seller, the value of goods returned will not be paid to the seller or will be deducted from the amount payable to seller or technically seller's account will be debited with the value of goods returned to him. In this case the purchaser will send a 'Debit Note' to the seller meaning that the seller's account is being debited for the value of goods returned to him. The seller after receiving the goods returned to him and the enclosed debit note will send a credit note to the purchaser, which will mean that the seller has credited purchaser's account with the value of goods returned to him. Debit note can be sent by the seller to the purchaser also, if the total of the invoice is **cast short** or the price of certain goods is not included by mistake or price calculated at lesser rates. In all these cases, the seller will charge amount over and above the invoice value from the purchaser, so he will send a debit note to the purchaser, who will send a credit note to the seller in return.

We have got a separate column for Debit Note Numbers in our Purchases Return Book indicating the details of goods returned to supplier.

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Credit Note. In case of sales return, goods are received back, so allowance is to be given to the purchaser for the value of goods returned by him. At the time of sales, purchaser A/c is debited for the value of invoice sent to him. As certain part of goods is being returned by the purchaser, so the value of goods returned by him should be deducted from the invoice value of goods or technically credited to the purchaser's A/c. The seller in this case will send a credit note, so to adjust the amount debited in excess at the time of recording sales. The purchaser will send debit note against the credit note sent by the seller. The seller will also send credit note to the purchaser to rectify mistakes in the following cases :

1. If the total of the invoice has been wrongly added more.
2. If the price of certain goods has been charged, which was not sent.
3. If goods have been charged at more than their price.
4. If certain part of goods prove to be defective.

The purchaser will send debit note on receiving credit note from the seller. The debit and credit notes are exchanged between purchaser and seller for adjustments of amount payable or receivable. If one party sends debit note, the other party sends credit note and *vice versa*.

We have got a separate column for Credit Note Number in our Sales Return Book indicating the details of goods returned by customer.

A specimen of debit and credit note is given below :

Name of the Firm Issuing the Note
Address of the Firm
Date of Issue

No.

DEBIT NOTE

Against : Supplier's Name
Goods returned as per Delivery Challan No. — Amount (Rs.)
(Details of goods returned)
(Rupees .... Only)
Signature of the Manager with date

Name of the Firm Issuing the Note
Address of the Firm
Date of Issue

No.

CREDIT NOTE

Against : Customer's Name
Goods returned by the customer Challan No. — Amount (Rs.)
(Details of goods received)
(Rupees .... Only)
Signature of the Manager with date

3.9 SUMMARY

NOTES

Rules of Debit and Credit—Journal

Concept of Debit

Debit means decrease in Proprietor's Equity. In case of increase in assets and expenses decrease in liability, capital and income proprietors equity decreases, because business as representative of proprietor has to make payment. This is why, these accounts are debited.

Concept of Credit

Credit means increase in Proprietor's Equity. In case of decrease in assets and expenses, increase in liability, capital and income, business as the representative of the proprietor receives amount, which increases proprietors equity. This is why, these items are credited.

Rules of Debit and Credit—Accounting Equation [Modern *(American)* Approach]

1.	**Assets :**	Debit the increase in assets
		Credit the decrease in assets.
2.	**Liability :**	Debit the decrease in the liability
		Credit the increase in the liability.
3.	**Capital :**	Debit the decrease in capital
		Credit the increase in capital.
4.	**Revenue and Profit :**	Debit decrease in revenue and profit
		Credit increase in revenue and profit.
5.	**Expenses and Losses :**	Debit the increase in expenses and losses
		Credit the decrease in expenses and losses.

Traditional Rules *(English approach)* of Debit and Credit

1.	**Personal Account :**	Debit the receiver (debtor)
		Credit the giver (creditor).
2.	**Real Account :**	Debit what comes in
		Credit what goes out.
3.	**Nominal Account :**	Debit all expenses and losses
		Credit all income and gains.

Journal Entry

Journal is used originally as a book of prime entry in which transactions are recorded in order of date from waste book. The entries made are classified as Debit and Credit. It facilitates the preparation of ledger accounts.

Columns of Journal

(1) Date (2) Particulars (3) Ledger Folio (L.F.) (4) Amount (Debit and Credit) and (5) Narration.

Compound or Composite Journal Entries

Debiting one account and crediting two or more accounts or debiting two or more accounts and crediting one account debiting two or more accounts and also crediting two or more accounts forms compound entry.

NOTES

Opening Entry

Passing journal entry with the opening balances of accounts on the first day of the current accounting year is known as opening entry. These balances are the closing balances of the last day of the previous accounting year.

Closing Entry

Journal entry, passed with the closing balances of accounts on the last day of the current accounting year is known as closing entry. These transfer entries are termed as closing entry.

Advantages of Journal

(1) Reducing the chances of error (2) Permanent record (3) Narration (4) Convenient distribution of work (5) Location of errors.

Limitations of Journal

(1) Huge and bulky size (2) Balance of accounts at a glance not available (3) Difficulty in reconciling cash balance.

Non-Cash Transactions—Introduction

Transactions which do not involve immediate cash receipts or cash payments are known as non-cash transactions. These business transactions of financial nature are recorded in Subsidiary books or Journal Proper.

Examples of Subsidiary Books having Non-Cash Transactions

(*i*) Purchases Book or Purchases Journal
(*ii*) Sales Book or Sales Journal
(*iii*) Purchases Return/Journal or Returns Outward Book
(*iv*) Sales Return/Journal or Returns Inward Book

Classification of Non-Cash Transactions

(*i*) Subsidiary Books, (*ii*) Journal Proper.

Subsidiary Books

Purchases Book *(Purchases Journal)*

Purchases book records only credit purchases of goods. It means that the purchases must be on credit and relate to the goods in which the business unit is dealing. The total of the Purchases book is transferred to pruchases Account. Posting is made at the credit side of the Suppliers Account appearing in the Purchases Book.

Sales Book *(Sales Journal)*

Sales book records credit sale of goods only. It means that the sales must be on credit and relate to the goods in which the business is dealing. The total of the sales book is transferred to the credit side of the Sales Account. Posting is made at the debit side of Debtors Accounts appearing in the Sales Book.

Purchases Return Book *(Purchases Return Journal)* **and Sales Return Book** *(Sales Return Journal)*

Purchases return book records goods returned to suppliers. Its total is transferred to Purchases return A/c. Purchases return is deducted from Purchases to ascertain Net Purchases. Sales return book records goods returned by debtors. Its balance is transferred to Sales return A/c. Sales return is deducted from sales to ascertain Net Sales.

Debit Note

The document issued by the seller to the purchaser or by the purchaser to the seller to reduce the amount to be paid is termed as Debit Note.

Credit Note

The document issued by the seller to the purchaser or by the purchaser to the seller to increase the amount payable is termed as Credit Note.

Journal Proper

All those transactions, which do not find a place in the subsidiary books are recorded in the Journal proper *such as opening, closing, transfer, adjustment and rectifying entries etc.*

REVIEW QUESTIONS

A. Very Short Answer Type Questions :

1. Name the types of Personal Accounts.
2. What is the classification of Impersonal Account ?
3. Every transaction has two aspects debit and credit. How is it true in case of Nominal Accounts ?
4. Write short notes on any two of the following (*a*) Compound entries, (*b*) Opening entries, (*c*) Trade discount.
5. State to which class of account does each of the following belong ?

   (*i*) Trade mark (*ii*) Commission received in advance (*iii*) Accrued commission (*iv*) Commission received.
6. Where will you record the following transactions :
   - (*i*) Credit purchases of goods
   - (*ii*) Credit sales of goods
   - (*iii*) Credit sales of assets
   - (*iv*) Credit purchases of assets
   - (*v*) Sale of furniture by M/s Ram & Sisters, furnishers, Delhi.

B. Short Answer Type Questions :

1. Name basic accounting terms which are debited for increase.
2. Mention basic accounting terms which are debited for decrease.
3. Name and state three types of accounts.
4. Explain the meaning and purpose of the ledger folio (L.F.).
5. Why are the rules of debit and credit same for both liability and capital ?
6. Enumerate the causes responsible for the return of goods from the purchaser to sellers.
7. Name the books, which record non-cash transactions.
8. Explain briefly the difference between purchases book and purchases account.
9. Differentiate between sales book and sales account.
10. Explain the term 'Debit Note' and 'Credit Note' in five sentences.
11. Describe journal proper in five sentences.

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C. Long Answer Type Questions :

1. What are the different types of accounts ? Explain with examples their rules of debit and credit.
2. Explain the term :

   (a) Opening journal entry (b) Compound journal entry

   (c) Narration (d) Ledger folio.
3. 'Every debit must have its corresponding credit.' Discuss this statement.
4. Explain the procedure of recording the journal entries in a journal. Give specimen of a journal with five transactions recorded in it.
5. What is meant by sub-division of journal ? What are its advantages ?
6. Explain purchases book and sales book with their format. Why does a trader keep these books ?
7. What purpose do the purchases return and sales return books serve ? How are they prepared ? In what respects they are different from each other ?
8. Write notes on :

   (a) Debit note (b) Credit note.
9. Enumerate the possible causes for which goods are returned to the seller.
10. Enumerate books, where non-cash transactions are recorded. Explain the various columns used in any one of them.

UNIT 4 LEDGER ACCOUNTS

NOTES

★ STRUCTURE ★

4.1 Objectives
4.2 Introduction
4.3 Meaning of Ledger Accounts
4.4 Classification of Ledger Accounts
4.5 Importance/Advantages of Ledger Accounts
4.6 Relationship Between Journal and Ledger
4.7 Ledger Posting from Journal Entries
4.8 Balancing of Ledger Accounts
4.9 Distinction between Journal and Ledger
4.10 Meaning of Trial Balance
4.11 Purpose and Functions of Trial Balance
4.12 Preparation of Trial Balance
4.13 Methods of Preparing of Trial Balance
4.14 Summary

4.1 OBJECTIVES

At the end of this unit, you should be able to :

- Classify ledger accounts as permanent and temporary accounts.
- *Draw format of classroom account and business house account.*
- Prepare assets, liabilities, capital, income and expenses accounts.
- Discuss the utility and advantages of ledger accounts and relation between ledger and Journal.
- Make ledger posting from Journal entries.
- Make ledger posting from the debit and credit sides of cash book.
- Make ledger posting from Purchases, Sales, Returns, Bills receivable and bills payable book.
- Pass journal entries from ledger posting.
- Distinguish between journal and ledger.
- Balance ledger accounts.
- Understand the meaning of Trial Balance.
- Explain the objectives and functions of Trial Balance.
- Draw format of Trial Balance with its complete columns.
- Prepare Trial Balance according to Total, Balance and Total and Balance method.
- Detect errors in the Trial Balance and redraft correct Trial Balance.

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4.2 INTRODUCTION

Ledger accounts indicate the state of individual account in terms of its debit and credit impact and balance standing at the end of accounting period. The step of preparation of ledger accounts starts once the journal entries have been posted in the books of accounts. Ledger accounts help in giving a summarized view of the individual accounts of the organization. Without ledger accounts trial balance and financial statements (Balance Sheet and Profit & Loss Accounts) cannot be prepared. Hence, it is very important step of the accounting process.

Preparation of trial balance takes place once the ledger accounts are finalized. At this stage of the accounts process, it can be checked whether the accounting transactions are properly recorded or not. The basic rule of preparation of Trial Balance is that the Debit and Credit balances should match. If they do not tie then there is an error in the accounting due to which it is not matching. This means that an accountant needs to be very careful while preparation of the Trial balance as any error at this stage will reflect in the balance sheet and profit & loss account of the organization.

In this chapter, we will study the various facts of ledger accounts and trial balance to make students aware of the process ledger accounts.

4.3 MEANING OF LEDGER ACCOUNTS

We have discussed that business transactions of financial nature are recorded in the books of original records. These books are cash book, purchases book, sales book, purchases return book, sales return book, bills receivable book, bills payable book and journal. Business transactions are first recorded in these books. The proprietor of the business expects from accounting to let him know the position of individual debtors and creditors account. He would also like to know the value of individual assets and other material information. The answers to these questions cannot be given unless, we prepare individual party's and assets accounts separately. **Collection of requisite information concerning a particular account and presenting them under one head is known as ledger posting.** In the words of **Carter**, *"An Account is a ledger record in a summarised form of all the transactions that have taken place with the particular person or things specified."*

Ledger accounts are prepared on the following format.

4.4 CLASSIFICATION OF LEDGER ACCOUNTS

Ledger Accounts are classified into five categories. These categories are (*a*) Assets Accounts, (*b*) Liabilities Accounts (*c*) Capital Accounts (*d*) Revenue Accounts and (*e*) Expenses Accounts. These ledger accounts may be grouped as : (*i*) Permanent Ledger Accounts and (*ii*) Temporary Ledger Accounts. Permanent Ledger Accounts have their opening balances except in case of newly started business. These accounts show a closing balances at the end of accounting year and are also carried forward to the next accounting year. Temporary Ledger Accounts do not have any opening and closing balance. These accounts are closed at the end of the accounting year by transfer to Trading or Profit and Loss Accounts. Purchases, Sales and Direct Expenses Accounts are closed by transfer to Trading A/c. Selling, Distribution, Indirect Expenses and Losses Accounts are transferred to the debit side of income and gains accounts at the credit side of Profit and Loss A/c.

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Format of Ledger Account

Name of Account (Title) **Page No. ......**

Dr. *Cr.*

Date	*Particulars*	*Folio*	*Amount Rs.*	*Date*	*Particulars*	*Folio*	*Amount Rs.*
(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
	To ....A/c				By ...... A/c		

This format of Ledger Account resembles English Capital letter 'T', so it is sometimes called **'T' shape** account. As teachers generally use this type of Ledger Account while taking classes, so this account is also known as **'Classroom Account'.** *Practically 'T' shape Ledger Accounts are not used in business houses.*

Ledger Accounts are divided in two parts. The left hand side is debit side and the right hand side is the credit side. All business transactions are classified as assets, liabilities, revenue, expense and capital. While preparing these ledger accounts, we have to apply the rules of debit and credit applicable to the particular category of account.

4.5 IMPORTANCE/ADVANTAGES OF LEDGER ACCOUNTS

Ledger Accounts are the most important record of business accounting. Every business transaction whether it is recorded in journal or cash book or subsidiary books must be posted into Ledger Accounts. Its importance are summarised herewith :

1. Separate accounts. There are separate ledger accounts for different parties and heads, so the information regarding every account is collected at one place. For example, if we prepare Ram's A/c, information regarding Ram's purchases, sales, payments and bills drawn and accepted etc. will be brought to Ram's A/c from purchases book, sales book, cash book, bills payable book and bills receivable book etc.

2. Requisite information at a glance. The correct position and status of every account can be ascertained at a glance by going through it. In case of personal accounts, we know what we have to receive or pay to the particular party. Information regarding purchases, sales and returns are easily available from their ledger accounts.

3. Preparation of trial balance. Ledger accounts facilitate the preparation of trial balance, which is the test of examining arithmetical accuracy in the books of accounts. Trial balance is prepared with the balances of ledger accounts.

4. Facilitating the preparation of financial statements. Ledger Accounts supply information for the preparation of Trading, Profit & Loss A/c and Balance Sheet. They also help in identifying adjustments, which are incorporated in Final Accounts.

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4.6 RELATIONSHIP BETWEEN JOURNAL AND LEDGER

Accounting transactions need to be recorded in the books of accounts. The first step is to record journal entry of the transaction which is also known as original entry for the transaction. Once journal entry is prepared, it is posted in the ledger account.

In double entry book keeping, every transaction will have debit and credit effect. Ledger accounts are prepared for both debit and credit accounts. For example, goods purchased from Ram for Rs. 3,000. The journal entry for this transaction is as follows :

Purchases A/c	Dr.	×××	
To Ram			×××

From the above journal entry two ledger accounts will be prepared namely purchases A/c and Ram's A/c. This indicates that there is back to back relationship between journal entry and ledger accounts where in ledger accounts are prepared after the journal entry is made for the transaction. Journal entry is transaction specific and ledger account is based on individual account.

4.7 LEDGER POSTING FROM JOURNAL ENTRIES

Journal is the book of original record. In case of small firms, all business transactions are recorded in the journal. Big firms record their transactions in subsidiary books and those transactions which do not find a place in subsidiary books are recorded in the journal. We cannot ascertain the position of different accounts at a glance through journal. It is, therefore, necessary that we should prepare ledger accounts with the help of journal entries. Let us take an example to explain ledger posting from journal entries.

Illustration 1. *Pass the following journal entries and post them in the ledger accounts:*

2005		*Rs.*
Jan. 1	*Started business with cash*	*20,000*
Jan. 3	*Purchased goods from Vivek*	*5,000*
Jan. 6	*Paid to Vivek*	*4,900*
	Discount allowed	*100*
Jan. 9	*Purchased furniture*	*2,000*
Jan. 12	*Paid salaries*	*1,000*
Jan. 15	*Rent received*	*500*
Jan. 18	*Sold goods to Vineet*	*4,000*

Solution.

NOTES

Journal Entries

Date	Particulars		L.F.	Amount Debit Rs.	Amount Credit Rs.
2005					
Jan. 1	Cash A/c	Dr.		20,000	
	To Capital A/c				20,000
	(Being commencement of business)				
Jan. 3	Purchases A/c	Dr.		5,000	
	To Vivek A/c				5,000
	(Being goods purchased from Vivek)				
Jan. 6	Vivek's A/c	Dr.		5,000	
	To Cash A/c				4,900
	To Discount received A/c				100
	(Being amount paid to Vivek who allowed discount)				
Jan. 9	Furniture A/c	Dr.		2,000	
	To Cash A/c				2,000
	(Being furniture purchased)				
Jan. 12	Salaries A/c	Dr.		1,000	
	To Cash A/c				1,000
	(Being payment of salaries)				
Jan. 15	Cash A/c	Dr.		500	
	To Rent A/c				500
	(Being rent received)				
Jan. 18	Vineet's A/c	Dr.		4,000	
	To Sales A/c				4,000
	(Being goods sold to Vineet)				

Ledger Posting

Cash Account

Dr. *Cr.*

Date	Particulars	J.F.	Amount Rs.	Date	Particulars	J.F.	Amount Rs.
2005				**2005**			
Jan. 1	To Capital A/c		20,000	Jan. 6	By Vivek A/c		4,900
Jan. 15	To Rent A/c		500	Jan. 9	By Furniture A/c		2,000
				Jan. 12	By Salaries A/c		1,000
				Jan. 31	By Balance c/d		12,600
			20,500				20,500
Feb. 1	To Balance b/d		12,600				

NOTES

Capital Account

Dr. *Cr.*

Date	Particulars	J.F.	Amount Rs.	Date	Particulars	J.F.	Amount Rs.
2005				2005			
Jan. 31	To Balance c/d		20,000	Jan. 1	By Cash A/c		20,000
			20,000				20,000
				Feb. 1	By Balance b/d		20,000

Purchases Account

Dr. *Cr.*

Date	Particulars	J.F.	Amount Rs.	Date	Particulars	J.F.	Amount Rs.
2005				2005			
Jan. 3	To Vivek's A/c		5,000	Jan. 31	By Balance c/d		5,000
			5,000				5,000
Feb. 1	To Balance b/d		5,000				

Vivek's Account

Dr. *Cr.*

Date	Particulars	J.F.	Amount Rs.	Date	Particulars	J.F.	Amount Rs.
2005				2005			
Jan. 6	To Cash A/c		4,900	Jan. 3	By Purchases A/c		5,000
	To Discount received		100				
			5,000				5,000

Discount Received Account

Dr. *Cr.*

2005				2005			
Jan. 31	To Balance c/d		100	Jan. 6	By Vivek's A/c		100
			100				100
				Feb. 1	By Balance b/d		100

Furniture Account

Dr. *Cr.*

Date	Particulars	J.F.	Amount Rs.	Date	Particulars	J.F.	Amount Rs.
2005				2005			
Jan. 9	To Cash A/c		2,000	Jan. 31	By Balance c/d		2,000
			2,000				2,000
Feb. 1	To Balance b/d		2,000				

NOTES

Salaries Account

Dr. Cr.

2005				**2005**			
Jan. 12	To Cash A/c		1,000	Jan. 31	By Balance c/d		1,000
			1,000				1,000
Feb. 1	To Balance b/d		1,000				

Rent Account

Dr. Cr.

2005				**2005**			
Jan. 31	To Balance c/d		500	Jan. 15	By Cash A/c		500
			500				500
				Feb. 1	By Balance b/d		500

Vineet's Account

Dr. Cr.

2005				**2005**			
Jan. 18	To Sales A/c		4,000	Jan. 31	By Balance c/d		4,000
			4,000				4,000
Feb. 1	To Balance b/d		4,000				

Sales Account

D Cr.

2005				**2005**			
Jan. 31	To Balance c/d (Transfer)		4,000	Jan. 18	By Vineet A/c		4,000
			4,000				4,000
				Feb. 1	By Balance c/d		4,000

Explanation

We have been making cash, an asset's account, which is debited for increase and credited for decrease. All the transactions resulting in the increase of cash will be posted at the debit side of the cash book and those resulting in decrease will be posted at the credit side of the cash book. *Alternatively following rules of posting should be noted :*

1. We never use the name of the same account which we have been preparing either at the debit or credit side of the account. It should be verified from the previous cash account that we have not written 'To Cash A/c' or 'By Cash A/c' in it anywhere.

2. It should be seen that the account being prepared has been debited or credited. If the account has been debited, posting will be made at the debit side of the account and if the account being prepared is credited in the journal entry the posting will be made at the credit side of the account.

NOTES

3. We write the name of reverse account at the debit or credit side of the account, as we do not use name of the same account. This is why, while making posting of the first journal entry in the cash account, we shall write capital account, which is opposite to the cash account being prepared. It means that we write the name of account to be credited for the debit of the account being prepared. While preparing an account being debited in the journal entry the name of the account credited in the entry will be written. In the same way, while preparing an account being credited, in the journal entry the name of the account being debited in the entry will be written. This fact can be verified from the previous cash account.

4. In case of compound entries the amount written against the account being prepared will be written. With reference to journal entry on Jan. 6, we have written Rs. 4,900 in the cash account and while preparing discount we shall write Rs. 100, the amount written against *discount account*.

4.8 BALANCING OF LEDGER ACCOUNTS

Ledger Posting of Opening Journal Entry

Opening Journal entry as we know is passed to bring the previous year's closing balances of assets and liabilities to the current year. While making ledger accounts of assets and liabilities appearing in the opening journal entry opening balances as represented in the journal entry must be shown in the beginning of the ledger account as 'To Balance b/d' at the debit side for assets and 'By Balance b/d' at the credit side of liabilities. Remaining posting in the concerned A/c will be made as usual.

Ledger accounts are categorised as assets, liabilities, capital, revenue and expenses according to Modern American Approach. The first three of them *i.e.*, assets, liabilities and capital account have certain closing balance at the end of accounting period, so their values are to be carried forward to the next accounting period. This is why, they are closed as 'By Balance c/d' or 'To Balance c/d'. In the previous ledger accounts, cash account, capital account, furniture and Ram's account have been closed in this way. The balances of these accounts are carried forward to the next accounting period, because the firm has to carry on its business with these assets, liabilities and capital in hand. While closing these accounts we write the word 'Balance **c/d**' to show the closing balance of the account. We can write **c/d** both at the debit or credit side, while closing personal and real accounts, **c/d** here means carried down to the next period. We can also use the word **c/f** which means carried forward or **c/o** which means carried over. All these words c/d or c/f or c/o are synonymous and carry the same meaning. It should be noted once more that the word **c/d** is not restricted to the debit or credit side. It can be used on both the debit and credit side.

The closing balance of the previous period *i.e.*, balance **c/d** is brought forward to the next accounting period as balance **b/d,** which means brought down from the previous period. We can also use the word **b/f,** meaning brought forward or **b/o** which means brought over. These words *i.e.*, **b/d** or **b/f** or **b/o** can be used both at the debit or credit side of personal and real accounts to show the opening balance of the account.

While closing nominal accounts or those accounts which are either an expense or revenue, we do not use the word balance **c/d** because the balance of these accounts need not be carried forward to the next period. Whatever has been paid on account of expenses has been paid once and forever. This is the expense of the business, so it should be directly posted to the debit side of the profit and loss account or trading account. In the same way, accounts relating to income or gain or revenues are also closed by transfer to profit and loss account. Receipts *i.e.*, rent, interest and discount are revenue of the business, so while closing these accounts their balance will be transferred to profit and loss account. That is why, rent, discount and salaries accounts in the example have been closed by transfer to profit and loss account.

NOTES

It should be noted that outstanding or prepaid expenses accounts and accrued or unearned Income Accounts are Representative Personal Accounts. That is why, these accounts are closed as Balance c/d.

Ledger Posting from Cash Book

Cash book is the book of original record. All cash receipts and cash payments are recorded in the cash book. Cash account need not be prepared when cash book is maintained but all the other accounts from whom payment has been received or those accounts whom payment has been made will be prepared with the help of cash book. Posting in all the accounts appearing in the cash book is made through cash book. The procedure of posting is explained with the following illustration.

Illustration 2. *Prepare a cash book from the following transactions and post them into concerned ledger accounts. Also explain the rule and procedure of preparing ledger accounts with the help of cash book.*

2006		Rs.
Nov. 1	*Cash in hand*	*10,000*
Nov. 3	*Cash purchases*	*5,000*
Nov. 6	*Cash sales*	*4,000*
Nov. 9	*Payment of wages*	*2,000*
Nov. 15	*Rent received*	*700*
Nov. 20	*Furniture purchased*	*1,000*
Nov. 25	*Goods sold to David*	*800*
Nov. 28	*Payment received from David*	*800*
Nov. 29	*Goods purchased from John*	*3,000*
Nov. 30	*Payment made to John*	*3,000*

Solution.

Cash Book

Dr. *Cr.*

Date	*Particulars*	*J.F.*	*Amount Rs.*	*Date*	*Particulars*	*J.F.*	*Amount Rs.*
2006				**2006**			
Nov. 1	To Balance b/d		10,000	Nov. 3	By Purchases A/c		5,000
Nov. 6	To Sales A/c		4,000	Nov. 9	By Wages A/c		2,000
Nov. 15	To Rent A/c		700	Nov. 20	By Furniture A/c		1,000
Nov. 28	To David's A/c		800	Nov. 30	By John's A/c		3,000
				Nov. 30	By Balance c/d		4,500
			15,500				15,500
Dec. 1	To Balance b/d		4,500				

NOTES

Notes.

(*i*) Sales of goods to David has not been shown in the cash book, because it is credit sales and credit transactions are not recorded in the cash book.

(*ii*) Purchases of goods from John is a credit purchases, so it will also not be shown in the cash book. It should be once more noted that *cash book records only cash transactions.*

1. Ledger Posting from the Debit Side of the Cash Book

The *debit side of the cash* book records all cash receipts. The posting will be made in all the ledger accounts appearing at the debit side of the cash book. Cash has been received through these accounts, therefore cash account must have been debited. The debit side of cash book shows that cash account has been debited for all these receipts, so the accounts appearing at the debit side of the cash book must have been credited at the time of receiving cash. It is, therefore, suggested that posting in the *accounts appearing at the debit side* will be made at the credit side of the accounts as 'By Cash A/c'. This is due to the fact that we cannot use the name of the same account in its own ledger account. In the previous cash book *sales account, rent account and David's account* have been posted at the debit side of the cash book, so we shall be preparing these accounts through cash book and the posting will be made as under :

Sales Account

Dr. *Cr.*

Date	*Particulars*	*J.F.*	*Amount Rs.*	*Date*	*Particulars*	*J.F.*	*Amount Rs.*
2006				**2006**			
Dec. 31	To Balance c/d		4,000	Nov. 1	By Cash A/c		4,000
			4,000				4,000
				2007			
				Jan. 1	By Balance b/d		4,000

Rent Account

Dr. *Cr.*

2006				**2006**			
Dec. 31	To Balance c/d		700	Nov. 15	By Cash A/c		700
			700				700
				2007			
				Jan. 1	By Balance b/d		700

David's Account

Dr. *Cr.*

Date							
2006				**2006**			
Dec. 31	To Balance c/d		800	Nov. 28	By Cash A/c		800
			800				800
				2007			
				Jan. 1	By Balance b/d		800

NOTES

2. Ledger Posting from the Credit Side of the Cash Book

All accounts appearing at the credit side of cash book will be separately prepared. Posting will be made to the debit side of these accounts to complete double entry record. Credit side of the cash book shows cash payment to the accounts appearing at the credit side of the cash book. Purchases account, wages account, furniture account and John's account must have been debited when payment would have been made to them, so the posting will be made at the debit side of these accounts. While making posting from cash book, it should be seen, whether the particular account has been posted at the debit side or the credit side of cash book. If it is posted at the debit side of the cash book, posting will be made at credit side of the account appearing there and *vice versa.*

Purchases Account

Dr. *Cr.*

Date	*Particulars*	*J.F.*	*Amount Rs.*	*Date*	*Particulars*	*J.F.*	*Amount Rs.*
2006				**2006**			
Nov. 3	To Cash A/c		5,000	Dec. 31	By Balance c/d		5,000
			5,000				5,000
2007							
Jan. 1	To Balance b/d		5,000				

Wages Account

Dr. *Cr.*

2006				**2006**			
Nov. 3	To Cash A/c		2,000	Dec. 31	By Balance c/d		2,000
			2,000				2,000
2007							
Jan. 1	By Balance b/d		2,000				

Furniture Account

Dr. *Cr.*

2006				**2006**			
Nov. 20	To Cash A/c		1,000	Dec. 31	By Balance c/d		1,000
			1,000				1,000
2007							
Jan. 1	By Balance b/d		1,000				

John's Account

Dr. *Cr.*

2006				**2006**			
Nov. 31	To Cash A/c		3,000	Dec. 31	By Balance c/d		3,000
			3,000				3,000
2007							
Jan. 1	By Balance b/d		3,000				

Ledger Posting from Purchases Book

NOTES

Purchases book records only credit purchases of goods. Cash purchases are recorded in the cash book. It is, therefore, necessary that purchases account showing the position of total purchases both cash and credit should be prepared. Posting to purchases account will be made through purchases book. *It contains the names of those persons and parties from* whom goods have been purchased on credit, so the posting will also be made in these personal accounts. The procedure of posting is explained with the help of following illustration.

Illustration 3. *Prepare a purchases book from the following details and also prepare concerned ledger accounts :*

2006

Dec. 1 Purchased from Laxmi Publications, New Delhi :
100 Golden Accountancy for Class XII @ Rs. 80 each
50 Golden Commerce for Class XII @ Rs. 40 each
100 Golden Economics for Class XII @ Rs. 50 each
Trade Discount allowed @ 20%

Dec. 15 Purchased from Laxmi Kitab Ghar, Sonepat :
100 English Guide for Class X @ Rs. 25 each
200 Hindi Guide for Class X @ Rs. 20 each

Dec. 20 Cash purchases of books from Ankita & Sisters Rs. 300.

Solution.

Purchases Book/Purchases Journal

Date	*Particulars*	*L.F.*	*Amount*	
			Debit Rs.	*Credit Rs.*
2006				
Dec. 1	**Laxmi Publications, New Delhi :**			
	100 Golden Accountancy for Class XII @ Rs. 80 each		8,000	
	50 Golden Commerce for Class XII @ Rs. 40 each		2,000	
	100 Golden Economics for Class XII @ Rs. 50 each		5,000	
			15,000	
	Less : Trade Discount @ 20%		3,000	
				12,000
Dec. 15	**Laxmi Kitab Ghar, Sonepat :**			
	100 English Guide for Class X @ Rs. 25 each		2,500	
	200 Hindi Guide for Class X @ Rs. 20 each		4,000	
				6,500
	Purchases A/c Dr.			18,500

NOTES

Purchases Account

Dr. *Cr.*

Date	Particulars	J.F.	Amount Rs.	Date	Particulars	J.F.	Amount Rs.
2006				**2006**			
Dec. 31	To Total Amount as per Purchases Book		18,500	Dec. 31	By Balance c/d		18,500
			18,500				18,500
2007							
Jan. 1	To Balance b/d		18,000				

Explanation. The total of the purchases book is posted to the purchases account. The total of the purchases book represents the total of all credit purchases of goods. We need not show every credit purchases individually in the purchases account. The total will be posted at the debit side as 'To Total Amount as per Purchases Book'. Cash purchases are also posted at the debit side of purchases account. The balance of this account will be transferred to the debit side of Trading account.

Laxmi Publications Account

Dr. *Cr.*

2006				**2006**			
Dec. 31	To Balance c/d		12,000	Dec. 1	By Purchases A/c		12,000
			12,000				12,000
				2007			
				Jan. 1	By Balance b/d		12,000

Explanation. Laxmi Publications Account appears in the purchases book. As the purchases book has a debit balance, so the posting will be made at the credit side of parties accounts appearing in the purchases book. The name of the supplier of goods on credit is recorded in the purchases book, so all the accounts appearing therein are suppliers. Sellers of goods on credit or suppliers are always credited for supplying goods, so posting is made at the credit side of Laxmi Publications Account as 'By Purchases Account'. The closing balance of the account will be carried forward to next period.

Laxmi Kitab Ghar's Account

Dr. *Cr.*

2006				**2006**			
Dec. 31	To Balance c/d		6,500	Dec. 15	By Purchases A/c		6,500
			6,500				6,500
				2007			
				Jan. 1	By Balance b/d		6,500

Explanation. The account of Laxmi Kitab Ghar appears in the purchases book which shows a debit balance, so the posting will be made at the credit side of firm's account. Posting will be made at the credit side of all the accounts appearing in the purchases book. Laxmi Kitab Ghar is the supplier of goods on credit. The firm is our creditor, so the posting will be made at the credit side and we shall be writing 'By Purchases A/c'. The firm's account will show a credit balance so its closing balance will be transferred to the next accounting period as 'By Balance b/d' and treated as opening balance of the next period.

Ledger Posting from Sales Book

NOTES

Sales book records credit sales of goods only. Cash sales are recorded in the cash book. It is, therefore, necessary that sales account should be prepared to show the overall picture of sales. It should include cash and credit sales. Sales has always a credit balance, so posting in case of sales will be made at the credit side. The persons and parties, whom goods have been sold must have been debited, so posting will be made at their debit side. Sales account will be closed by transfer to trading account but personal accounts will show a balance and closed as 'By Balance c/d'. The procedure of posting to personal accounts through sales book is explained as under :

Illustration 4. *Prepare a sales book from the following information and post them into concerned accounts :*

2000

Dec. 1 Sold goods on credit to Novelty Book Depot, Chandigarh
200 Copies of Golden Acbountancy for Class XII @ Rs. 80 each

Dec. 5 Sold to Standard Book Depot books worth Rs. 2,000 for cash

Dec. 25 Sold to Azhar Book Depot, Chandigarh
200 Copies of Golden Economics for Class XII @ Rs. 50 each
300 Copies of Golden Accountancy for Class XII @ Rs. 80 each
Trade discount allowed @ 20%

Solution.

Sales Book/Sales Journal

Date	*Particulars*	*L.F.*	*Amount*	
			Debit *Rs.*	*Credit* *Rs.*
2005				
Dec. 1	**Novelty Book Depot, Chandigarh :**			
	200 Copies of Golden Accountancy for Class XII @ Rs. 80 each			16,000
Dec. 25	**Azhar Book Depot, Chandigarh :**			
	200 Copies of Golden Economics for Class XII @ Rs. 50 each		10,000	
	300 Copies of Golden Accountancy for Class XII @ Rs. 80 each		24,000	
			34,000	
	Less : Trade Discount @ 20%		6,800	
				27,200
	Sales A/c Cr.			43,200

Note. Sales to Standard Book Depot is not credit sales, so it will not be shown in the sales book.

NOTES

Sales Account

Dr.							Cr.
Date	Particulars	J.F.	Amount Rs.	Date	Particulars	J.F.	Amount Rs.
2005				2005			
Dec. 31	To Balance c/d		43,200	Dec. 31	By Total amount as per Sales Book		43,200
			43,200				43,200
				2006			
				Jan. 1	By Balance b/d		43,000

Explanation. The total of sales book is transferred to the credit of sales account. Sales book always shows a credit balance, so its posting will be made at the credit side of sales account. Sales book records all credit sales of goods. Cash sales are recorded in the cash book. Both credit sales as per sales book and cash sales as per cash book are posted at the credit side of sales account, which shows total sales of the period. The balance of sales account is transferred to the credit side of trading account.

Novelty Book Depot Account

Dr.							Cr.
2005				2005			
Dec. 1	To Sales A/c		16,000	Dec. 31	By Balance c/d		16,000
			16,000				16,000
2006							
Jan. 1	To Balance b/d		16,000				

Explanation. The account of Novelty Book Depot appears in the sales book which shows a credit balance, so the posting will be made at the debit side of Novelty Book Depot's Account. Posting in all the accounts appearing in the sales book will be made at the debit side. Parties appearing in sales book are the debtors of the firm, as credit sales was made to them. Debtors as assets have debit balance so the posting will be made at the debit side as 'To Sales A/c'.

Azhar Book Depot Account

Dr.							Cr.
2005				2005			
Dec. 25	To Sales A/c		27,200	Dec. 31	By Balance c/d		27,200
			27,200				27,200
2006							
Jan. 1	To Balance b/d		27,200				

Explanation. Posting will be made at the debit side of Azhar Book Depot's Account because it appears in the sales book as the rule goes. 'Posting will be made at the debit side, of every account appearing in the sales book'. Azhar Book Depot is the debtor of the firm, so the posting will be made at the debit side of Azhar Book Depot. The account will show a debit balance and its balance will be transferred to the next period as opening balance and shown as 'To Balance b/d'.

NOTES

Rules of Posting from Subsidiary Books

1. **Posting from the debit side of the cash book.** Posting in all the accounts appearing at the debit side of the cash book is made at the credit side of the account. No cash account is prepared, if cash book is maintained by the firm.
2. **Posting from the credit side of the cash book.** Posting in all accounts appearing at the credit side of the cash book will be made at the debit side as 'To Cash A/c'. Cash account is not prepared, if cash book is maintained by the firm.
3. **Posting from purchases book.** Posting from purchases book is made in the purchases account and supplier's account from whom goods have been purchased. Posting in the suppliers account is made at the credit side as 'By Purchases A/c' and in purchases account posting is made at the debit side as total amount as per Purchase Book.
4. **Posting from sales book.** Posting is made at the debit side of debtors' account, whom goods have been sold on credit and which appear in the sales book. The posting in the sales account is made at the credit side as By Total Amount as Per Sales Book.
5. **Posting from purchases return book.** Posting is made at the debit side of suppliers' accounts which appear in the purchases return book. Posting is also made at the credit side of the purchases return account.
6. **Posting from sales return book.** Posting is made at the credit side of the debtors accounts whose account appear in the sales return book. Posting in the sales return account is made at the debit side.

4.9 DISTINCTION BETWEEN JOURNAL AND LEDGER

All business transactions are recorded in the subsidiary books. If the transaction does not find a place in subsidiary books, it is recorded in the journal proper. With the help of subsidiary books and Journal, Ledger Accounts are prepared. **Ledger Accounts are known as Principal books.** Ledger Accounts are maintained with the help of Journal, which is of the initial record of business transactions. This is why, **Journal is known as the initial book of original record.** Though Journal and Ledger both keep the record of business transactions but, even then they are different from each other in the following respects :

Difference between Journal and Ledger

Points of Difference	*Journal*	*Ledger*
1. *Primary record*	Journal is the primary record of business transactions.	It is the principal book of business transactions, not primary record.
2. *Information*	Information regarding different Accounts are shown at one place.	Information regarding particular Account is shown at one place.
3. *Basis*	Ledger Accounts are prepared taking Journal entries and subsidiary books as basis.	Ledger Accounts are used as a basis for preparing Trial Balance.

4.10 MEANING OF TRIAL BALANCE

Trial balance is a statement, prepared with the debit and credit balances of ledger accounts to test the arithmetical accuracy of the books. It may also be prepared with debit and credit totals of ledger accounts and also with the balances and totals of ledger accounts. Books of accounts are maintained according to the **'Double Entry System'**, where every debit has its corresponding credit, so the total of the debit and credit columns of the amount column must tally. If the total of debit and credit amount column is equal, we assume our books of accounts to be arithmetically correct, but it should not be taken it as the conclusive proof of arithmetical accuracy.

NOTES

Special Features of Trial Balance

Trial balance has the following special features :

1. The trial balance is prepared on a specific date. That is why, we use the word 'as on......' with its heading.
2. Trial balance contains the list of all ledger accounts including cash account.
3. Trial balance may be prepared with the balances or totals or balances and totals of ledger accounts.
4. The total of the debit and credit column of the amount must be equal.
5. In case the debit and credit side of the trial balance are equal, we assume that the principles of 'Double Entry System' and the assumptions of accounting equation have been observed.
6. The difference between the debit and credit side of the trial balance points out that certain mistakes have been committed somewhere.
7. If both the debit and credit sides have the same total, it does not mean that there is no mistake in accounting.

4.11 PURPOSE AND FUNCTIONS OF TRIAL BALANCE

The Trial balance is prepared with the following purpose :

1. **Test of arithmetical accuracy.** Trial balance is the test of accuracy of arithmetical calculations. If correct posting has been made from subsidiary books and ledger accounts and correct figures have been recorded and copied, the debit and credit total of the trial balance must tally.
2. **Summarised information of ledger accounts.** Trial balance contains a list of all ledger accounts. It presents the names of ledger accounts and the amount of their debit or credit balance. The summarised position of ledger accounts can be obtained at a glance from the trial balance. It would have been very difficult to assess the position of different ledger accounts from subsidiary books and ledger accounts.
3. **Basis for preparing final accounts.** The ultimate end of maintaining books of accounts is to ascertain the result of the business interm of profit and the value of different assets and liabilities. For this purpose, we prepare a profit and loss account and balance sheet on the basis of information supplied by the trial balance. It is, in this way, a source statement for preparing final accounts.
4. **Helpful for making adjustments.** While making final accounts certain adjustments regarding closing stock, outstanding and prepaid expenses, accrued and unearned income are to be made. While identifying items for adjustments, we will have to study the information furnished by the trial balance.

4.12 PREPARATION OF TRIAL BALANCE

The preparation of trial balance is the third step of recording business transactions in the books of accounts. The first step is to record the business transactions in subsidiary books and journal proper. The second step is to prepare ledger accounts on the basis of subsidiary books and journal. Trial balance is prepared on the following format :

NOTES

Format of Trial Balance

Name of the Accounts	*L.F.*	*Amount*	
		Debit Rs.	*Credit Rs.*
(1)	*(2)*	*(3)*	*(4)*

Explanation of Columns

(1) **Name of the account.** This column contains list of all ledger accounts. Names of accounts are written in this column. Accounts should not be omitted. Omission of any account will throw trial balance out.

(2) **L.F. (Ledger Folio).** This column contains the page number of the different ledger accounts in the ledger. If salaries account is prepared at page 17 of the ledger, 17 will be written in the folio column against salaries account.

Amount column. All accounts in the ledger must be enlisted in the trial balance and their total or balance or both should be written in the amount column against them.

(3) **Debit column.** The amount column is divided as debit and credit. If the trial balance is prepared by total method, the debit total of every account or debit balance of ledger accounts (in case the trial balance is prepared according to balance method) is written in the amount column. Debit balance means excess of debit side of an account over its credit side.

(4) **Credit column.** If the ledger account shows a credit balance *i.e.*, credit side exceeds the debit side, the amount will be shown in the credit column (In case trial balance is prepared according to balance method). We will have to write the total of the credit side of the account if the trial balance is being prepared according to total method.

4.13 METHODS OF PREPARING TRIAL BALANCE

There are three methods of preparing trial balance. The total of both the debit and credit columns of the trial balance must be equal in all the methods. The following methods can be used for preparing trial balance :

1. Balance method
2. Total method
3. Total and Balance method

1. **Balance Method**

Trial balance, as its name itself points out is prepared with the balance of ledger accounts. Every ledger account has got the debit and credit side. At the end of a certain period, ledger accounts are balanced. Excess of the total of the debit side of an account over its credit side is known as debit balance and written in the debit column of the trial balance. In the same way, excess of credit side of an account over its debit side shows credit balance and will be written at the credit side of the trial balance. The total of both the debit and credit side must be equal.

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2. **Total Method**

According to this method, the total of the debit and credit side of every account is separately written in the debit and credit column of the trial balance. The total of both the debit and credit must be equal. If it is not equal, there are definitely certain errors which should be located and rectified.

3. **Total and Balance Method**

This method presents both the balance and total method in the same trial balance. The amount column is divided between total and balance methods. Each method has further two columns of debit and credit. The total of the debit and credit under each method must be equal. There will be different totals according to the different methods but the total of debit and credit of each method will be equal.

4.14 SUMMARY

Meaning of Ledger Account

Collection of requisite information concerning a particular account and presenting them under one head is known as Ledger Posting. Information are collected from Journal proper and subsidiary books.

Ledger Account

An account is a ledger record in a summarised form of all the transactions, that have taken place with the particular person or things specified.

Classification of Ledger Accounts

(*a*) (*i*) Assets A/cs (*ii*) Liabilities A/cs (*iii*) Capital Accounts (*iv*) Revenue A/cs and (*v*) Expense A/cs.

(*b*) (*i*) Permanent Ledger Accounts (*ii*) Temporary Ledger Accounts.

(*c*) (*i*) Classroom Ledger Account (*ii*) Business houses Ledger Account.

Utility/Advantages of Ledger Account

(1) Separate Accounts (2) Requisite information at a glance (3) Preparation of trial balance (4) Facilitating preparation of financial statements.

Ledger Posting from Journal Entries

(*a*) Ledger Posting of Accounts Debited in the Journal

While preparing Ledger Accounts debited in the Journal, posting will be made at the debit side of the account. We shall be writing the name of the Account credited, preceded by 'To' as 'To Cash A/c'

(*b*) Ledger Posting of Accounts Credited in the Journal

While preparing Accounts credited in the Journal, Posting will be made at the credit side of the Account. We shall be writing the name of Accounts debited in the Journal preceded by 'By' as 'By Cash A/c'.

Balancing of Ledger Accounts

Ledger Accounts are categorised as Assets, Liabilities, Capital, expenses and Revenue. The total of first three accounts at the debit and credit does not tally generally and they are

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said to have balance. If the credit side exceeds, the difference is put at the debit side and shown as 'To Balance c/d'. If the debit side exceeds the difference is put at the credit side and shown as 'By Balance c/d'. These are closing balances of the period and become opening balances in the next year and shown as By or To Balance b/d.

The balances of Nominal Accounts *i.e.*, expenses, losses, revenue, income are transferred to P/L Accounts.

These accounts do not show any balance. Their difference between the debit and credit is transferred to profit and loss A/c and closed.

Ledger posting from Cash Book

(1) Ledger Posting from the Debit Side of the Cash Book

While preparing ledger of the accounts appearing at the debit side of Cash Book, write at the credit side of the account as *'By Cash or Bank A/c.*

(2) Ledger Posting from the Credit Side of the Cash Book

While preparing ledger of the accounts appearing at the credit side of the Cash Book, write at the debit side of the account as To Cash or Bank A/c.

Ledger Posting from Purchases Book

Purchases Book records credit purchases of goods. It represents only debit side, so its balance is always Debit. While preparing purchases Account we shall be transferring the total of the Purchases book as 'To Total as per purchases Book' at the debit side of the account.

While preparing suppliers Accounts, appearing in the purchases book, we shall be writing as 'By Purchases A/c' at the credit side of the account.

Ledger Posting from Sales Book

Sales Book records credit sales of goods only, so its balance is always credit. While preparing sales A/c, posting is made at the credit side as 'By Total as per Sales Book'.

While preparing Debtors A/c from Sales Book we shall be writing as 'To Sales A/c at the debit side of Debtors A/c.

Ledger Posting from Sales Return Book

Sales Return Book has debit balance, so its total is posted at the debit side of Sales Return A/c as 'To Total as per Sales Return Book'. While preparing Debtors Accounts, we write 'By Sales Return A/c, at the credit side of Debtors appearing in the Sales Return Book.

Meaning of Trial Balance

The statement prepared with the debit and credit balances of ledger accounts to test the arithmetical accuracy of books of Accounts is known as Trial Balance.

Special Features of Trial Balance

(1) Prepared on specific date (2) *Containing list of ledger accounts* (3) Prepared with balances or totals or Balances and totals of ledger accounts (4) Totals of debit and credit columns must tally (5) Trial balance is the test of arithmetical accuracy (6) The difference between debit *and credit side of Trial balances shows that there is mistake* (7) There may be mistakes even if the debit and credit sides are equal to each other.

Objectives/Functions of Trial Balance

1. Test of arithmetical accuracy
2. Summarised information of ledger Accounts

3. Basis for preparing final accounts
4. Helpful for making adjustments

Limitations of Trial Balance (*Errors not Affecting or Undetected by Trail Balance*)

(1) Errors of ommission in the books of original record (2) Errors of principle (3) Compensating errors (4) Incorrect account in the original books (5) posting to wrong account

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Methods for Preparing Trial Balance

1. Balance Method
2. Total Method
3. Total and Balance Method.

REVIEW QUESTIONS

A. Very Short Answer Type Questions :

1. Mention the balance of Sales A/c and Purchases A/c. How are these accounts closed ?
2. What is meant by 'Net Purchases' ?
3. What is the balance of Sales A/c and where its balance is transferred ?
4. What is meant by Trial Balance.

B. Short Answer Type Questions :

1. Prepare the format of an account.
2. Is the balance of Nominal Accounts calculated, if not ? How is it closed ?
3. "Ledger is the principal book of business ?" Explain.
4. What is the meaning of an account ?
5. What is the purpose of a ledger ?

C. Long Answer Type *Questions* :

1. What is meant by Ledger Posting ? Explain its importance in Accounting.
2. Explain the procedure for preparing Ledger Accounts through Journal entry.
3. How are Ledger Accounts of items appearing at the credit side of Cash Book prepared ?
4. Why is it necessary to prepare Ledger Accounts, when there are Subsidiary Books and Journal ?
5. Which accounts can be prepared on the basis of Purchases book and Sales book ? Explain the process of preparing these accounts.
6. Explain the meaning and objective of trial balance.

FINANCIAL ACCOUNTING
PART—2

BLOCK—2
CONCEPTS OF INCOME AND DEPRECIATION

UNIT 1 CLASSIFICATION OF INCOME, EXPENDITURE AND RECEIPTS

NOTES

★ STRUCTURE ★

1.1 Objectives
1.2 Introduction
1.3 Classification of Income
1.4 Classification of Expenditure
1.5 Classification of Receipts
1.6 Accounting Concepts of Income
1.7 Summary

1.1 OBJECTIVES

At the end of this unit, you should be able to :

- Classify Income, Expenditure and Receipts as Capital and Reserve.
- Explain the meaning and concepts of Capital and Revenue, income, expenditure and receipts.
- Explain the accounting concept of income and, accounting concepts and Income Measurement and expired cost of Income Measurement.

1.2 INTRODUCTION

The similarity between the concept of Capital and reserve lies in the fact that both have the credit balances and reflect at the Liabilities side of the balance sheet. Capital and Reserve belong to the shareholders or owners of the company and business is liable to return capital and reserve to the owner once it is closed or wound up. The Capital is contributed from the owners or shareholders of the company whereas reserve is maintained out of the profit and loss account of the company to meet future fund requirements for expansion and growth of the business.

In this chapter, we will discuss this concept in detail and how it impacts the financials of the company and owner's stake in the business. For the students of BBA, it is an important concept as they will have to analyze the impact of increase and decrease in capital on the owner's equity.

1.3 CLASSIFICATION OF INCOME

Income can be broadly classified into two heads :

(1) Capital income (2) Revenue income

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(1) Capital Income

In this case, any irregular income earned will be classified as capital income. For example, a huge amount of donation received in the case of non-profit orga...isation. Also in the case of profit-making organisations, if some capital assets is sold and a large amount of gain is realised on that sale. It will be classified as capital income.

(2) Revenue Income

This refers to regular business income by sale of goods and services in the market. For example, if a television manufacturing company sells T.V. sets then income realised on that sale will be known as revenue income.

1.4 CLASSIFICATION OF EXPENDITURE

Expenditure incurred in the business are classified as :

(1) Capital expenditure   (2) Revenue expenditure

(3) Deferred revenue expenditure.

(1) **Capital Expenditure.** *Expenses incurred in acquiring and increasing the value of fixed assets are termed as capital expenditure.* Amount spent on the purchase of land and building, plant and machinery, vehicles, furniture etc., is capital expenditure. The expenses incurred for addition and extension of fixed assets are also capital expenditure. Special features of capital expenditure is as under :

Special Features :

(*i*) Capital expenditure is made for acquiring fixed assets.

(*ii*) This expenditure increases the value of assets.

(*iii*) These expenditures increase the profit earning capacity of business.

(*iv*) These expenditures are casually incurred.

(*v*) The assets acquired through these expenditures are not meant for sales.

(*vi*) These expenditures are shown at the assets side of the Balance Sheet.

Certain examples of Capital Expenditure :

(*i*) Purchasing fixed assets.

(*ii*) Purchase of material for construction of building.

(*iii*) Payment of wages for construction or extension of building.

(*iv*) Payment of wages for addition of rooms or erection of sheds in the building.

(*v*) Carriage, cartage and freight paid on acquiring assets such as plant and machinery, furniture etc.

(*vi*) Installation charges of plant and machine.

(*vii*) Repairs of assets, purchased se d hand.

(*viii*) Payment for goodwill.

Accounting Treatment of Capital Expend ture. On acquiring or increasing, the value of fixed assets through capital expenditure assets account is debited because these expenses increase the value of assets. (Assets are always debited for increase). These assets are shown at the asests side of the balance sheet. These expenses are not shown at the debit side of profit and loss account. The distinction between capital and revenue expenditure is important because revenue expenditures are debited to profit and loss account and capital expenditures are assets recorded in the Balance sheet.

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(2) Revenue Expenditure. These expenses are incurred as routine business expense. They are concerned with our day-to-day transactions. These expenses are incurred usually in the ordinary life of business. They maintain the assets but do not increase their value. Special features of these expenditure is as follows :

Special Features :

(*i*) These are routine expenses.

(*ii*) These expenses are usually incurred.

(*iii*) These expenses do not add to the value of assets but maintain it, *i.e.*, white-washing and repairs.

(*iv*) Revenue expenditure does not increase the profit earning capacity of the firm but simply maintains it.

(*v*) Current assets acquired through these expenditures are meant for sale.

(*vi*) Revenue expenses are shown at the debit side of the trading and profit and loss A/c.

Certain examples of Revenue Expenditure :

(*i*) Purchase of goods.

(*ii*) Payment of expenses in acquiring or manufacturing goods, *i.e.*, carriage and wages etc.

(*iii*) Payment of selling and distribution expenses.

(*iv*) Repairs and maintenance of plant, machines, furniture, equipments etc.

(*v*) White-washing of building.

> It must be understood that expenditure is a wider term and includes expenses as well as assets. There is a difference between expenditure and expense. Expenditure is any outlay made or incurred by the firm. The part of expenditure, which is perceived to have been used or consumed in the current year, is termed as Expense of the current year.

Accounting Treatment of Revenue Expenditure. Expenses accounts are debited for these expenditures. These accounts are shown at the debit side of Trading account or Profit and loss account. For example, purchases account is debited for purchasing goods and shown at the debit side of Trading account. Other accounts concerning direct expenses, *i.e.*, Carriage, cartage, freight, manufacturing expenses are recorded at the debit side of Trading account salaries, rent insurance, printing, stationery and other selling, administrative and financial expenses are shown at the debit side of profit and loss account. Revenue expenditures vitally affect our Gross Profit and Net profit, so they should be distinguished from capital expenditure.

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Distinction between Capital Expenditures and Revenue Expenditures

Points of Distinction	*Capital Expenditures*	*Revenue Expenditures*
1. *Meaning*	Expenses incurred in acquiring and increasing the value of fixed assets are termed as capital expenditure.	Expenses incurred as routine business expenses are known as Revenue Expenditure.
2. *Purpose*	These are incurred in purchasing of fixed assets.	These are incurred for conducting of business affairs.
3. *Where are they shown ?*	These are shown at the assets side of the Balance Sheet.	These are shown at the debit side of trading profit and loss account.
4. *Capacity*	It increases the earning capacity of the business.	These are incurred for earning profit.
5. *Period*	Its benefits extend to more than one year.	Its benefits are restricted to only one year.

(3) **Deferred revenue Expenditure.** *The expenditures which are incurred likely to give benefit for more than one accounting period are termed as deferred revenue expenditure.* These are revenue expenditures of capital nature. Expenses are very huge, so instead of charging the whole amount of expenditure in the year of the actual expense, the expenditure is split and written off over certain period. Preliminary expenses and advertising suspense are its examples.

Special Features :

(*i*) Expenditures for developments, improvement and alterations are revenue expenditure but treated as capital expenditure.

(*ii*) These expenditures are not immediately writen off in the year of actual expenditure but split over a period of certain years as per the decisions and policies of the management.

(*iii*) These expenditures are treated as assets and shown at the assets side of Balance sheet.

Certain examples of deferred Revenue Expenditures :

(*i*) Advertising suspense—Huge expenditure on advertising, benefits of which will be availed of during certain following years.

(*ii*) Preliminary expenses.

(*iii*) Underwriting commission.

(*iv*) Discount on issue of shares or debentures.

(*v*) Loss on issue of shares or debentures.

(*vi*) Cost of issue of shares and debentures.

Accounting Treatment of Deferred Revenue Expenditure. These expenditures are capitalised, so they are treated as assets in the Balance sheet like other assets. As these assets are not tangible, therefore, they will have to be written off over a certain period. Whenever a part of these expenditures will be charged out of profit and loss account, we shall debit profit and loss account and credit specific assets account. The amount written off will also be deducted from the book value of assets. The treatment will be made just as we treat depreciation on assets.

1.5 CLASSIFICATION OF RECEIPTS

NOTES

Receipts are also classified as :

(1) Capital receipts

(2) Revenue receipts

(1) Capital receipts. *Amount received from sale of fixed assets is capital receipts.* Amount received through capital, long-term loans or by issue of shares and debentures is capital receipts. Capital receipts are not current liabilities. These receipts show a credit balance, they are capitalised and shown at the liabilities side.

(2) Revenue receipts. These are the routine receipts of the business just as receipt from sale of goods. Routine receipt of rent discount, interest, commission is also revenue receipts. **These receipts are shown either at the credit side of *Trading account or profit and loss account.***

Distinction between Capital Receipts and Revenue Receipts

Point of Distinction	*Capital Receipts*	*Revenue Receipts*
1. *Meaning*	The amount received in form of capital introduced, loans taken and sale proceeds of the fixed assets is known as Capital Receipts.	The amount received mainly by selling of goods and services is known as Revenue Receipts.
2. *Nature*	These receipts are capital in nature.	These receipts are Revenue (*i.e.*, day to day activities) in nature.
3. *Where are these shown ?*	These receipts are shown in the Liabilities side of Balance Sheet only.	These receipts are shown at the credit of either trading account or Profit and Loss account.
4. *Examples*	Sale of fixed assets, capital contribution and loans taken etc.	Profit on sale of assets, sale of goods, interest received on loans (advanced), royalty etc.

Illustration 1. *Point out whether the following transactions are capital expenditure or revenue expenditure and also explain the treatment of these transactions in the final accounts :*

(*i*) *Purchase of new material for the construction of factory building Rs. 2,00,000.*

(*ii*) *Payment of wages amounting to Rs. 2,50,000 for construction of building.*

(*iii*) *Cost of furnishing the newly constructed building Rs. 20,000.*

(*iv*) *Cost of electrical installation in the new building Rs. 30,000.*

(*v*) *Expenses in connection with obtaining the licence for the factory Rs. 10,000.*

(*vi*) *Cost of acquiring machines Rs. 1,00,000.*

(*vii*) *Payment of fire insurance premium Rs. 1,260.*

(*viii*) *Renewal fee of licence Rs. 200.*

(*ix*) *Distribution of free goods costing Rs. 40,000 to introduce the goods in the market.*

(*x*) *Cost of purchasing old machinery for Rs. 12,000 and cost of its repair Rs. 10,000. The machinery was installed in the factory at a cost of Rs. 3,000.*

(*xi*) *Cost of white-washing building and maintenance of machinery Rs. 12,000.*

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Solution.

(*i*) **Cost of material for construction of building Rs. 2,00,000.** Cost of material will form part of the value of building, so it is a capital expenditure and will be shown at the assets side of the Balance sheet.

(*ii*) **Payment of wages for construction of building.** Wages are the part of the value of building so it is a capital expenditure and thus added to the value of building and treated as an asset.

(*iii*) **Cost of furnishing new building.** The value of building will increase with cost of the furniture so it will be capital expenditure and treated as an asset.

(*iv*) **Cost of electrical installation in the new building.** Electrical installation will add to the value of new building, so it is a capital expenditure and will be shown at assets side.

(*v*) **Expenses for obtaining licence of the factory.** It is capital expenditure, because benefits of this expenditure are not restricted to the current year only. The expense was necessary for the formation of factory. It will be treated as an asset.

(*vi*) **Cost of acquiring machines.** It is capital expenditure and shown at assets side.

(*vii*) **Payment of fire insurance premium** is revenue expenditure, because the expense will be paid regularly every year. It will be shown at the debit side of P/L A/c.

(*viii*) **Renewal fee of the licence.** It is revenue expenditure and posted at the debit side of profit and loss account. Renewal fee is regularly paid whenever due.

(*ix*) **Cost of distribution of free goods.** Cost of distribution of free goods with a view to introduce the item in the market is a type of advertising, Rs. 40,000 the cost of goods should be capitalised, treated as assets and written off within next 3 to 5 years.

(*x*) **Cost of purchasing repairing and installing of old machinery.** It is capital expenditure and treated as an asset. Amount spent in the repairs and erection of old machinery will add to its value. It should be noted here that normal repairs and maintenance are revenue expenditure.

(*xi*) **Cost of white-washing of Building and maintenance of machinery.** It is revenue expenditure, so it will be debited to profit and loss account. It is normal, regular and usual expenditure incurred with a view to maintain building and machinery.

Illustration 2. *Identify whether following receipts are capital or revenue. How will they be treated in final accounts :*

(*i*) *Sale proceeds of goods Rs. 20,000.*

(*ii*) *Commencement of business with Rs. 60,000.*

(*iii*) *Rent received from premises sublet Rs. 4,000.*

(*iv*) *Profit on sale of land and building Rs. 5,000.*

(*v*) *Amount received from sale of assets Rs. 80,000.*

(*vi*) *Amount received from sale of scraps, i.e., newspapers, boxes, grass, bottles etc. Rs. 300.*

Solution.

(*i*) **Sale proceeds of goods.** It is revenue receipt and credited to Trading account. Sales of goods is normal and regular feature.

(*ii*) **Commencement of business with Rs. 60,000.** It is capital receipt and shown at the liabilities side of the Balance sheet.

(*iii*) **Rent received from premises sublet.** It is revenue receipt, because it is a regular income. It will be posted at the credit side of profit and loss account.

(*iv*) **Profit on sale of land and building.** It is revenue receipts and posted at the credit side of profit and loss account. It should not be treated as operating income.

(*v*) **Sale proceeds of assets.** Amount received from the sale of an asset is capital receipt. Excess of amount received over the book value of asset is revenue receipt. Loss on sale of asset is treated as revenue loss.

(*vi*) **Sale proceeds from scraps.** It is revenue receipts and posted at the credit side of profit and loss account because its amount, is very nominal and it is routine affair.

1.6 ACCOUNTING CONCEPTS OF INCOME

Concept of income from the point of view of accounting process requires an accountant to understand when an income should be recognised. Income refers to the receipts in cash or outstanding receipts from both care and non-core activities of the business. This means that income may be in the form of cash receipts or outstanding income due to be received in future. Income derived from core activities of the business is known as revenue whereas income from non-core activities will be called other income. For example, in a business of selling computers, the income realised from sale of computers will be the income generated from core activities. On the other hand, if the business earns some dividend or interest income from investment in shares of other companies or govt. securities, it will be known as other income generated from non-core activities.

Expired Cost and Income Measurement

The concept of expired cost relates to the principle of deferred cost or amortisation in accounting. Deferred cost means heavy expenditure incurred in an accounting period, the benefit of which will be realised over the next few years. For example, Heavy Advertisement Expenditure incurred in the initial period of the launch of the product in the market. The benefit of this heavy advertising will be realised in the next few years. Suppose, TATA Sky spends Rs. 100 crores in the year 2008 on its advertisement in T.V. and Newspapers. The expected benefit of this advertisement will be realised in the next five years. In accounting, this Rs. 100 crores is divided in next five years and debited to profit and loss account for Rs. 20 crores each over the next five years. After the expiry of 2013, the five years period will end and the advertisement cost of Rs. 100 crores will be called expired cost. From year 2008 to year 2013, it will be called unexpired cost because full Rs. 100 crores is not debited to profit and loss acount.

The concept of expired cost is closely related to the concept of income measurement because it affect the income of the organisation over a long period of time. In the above example, we saw that Rs. 20 crores each was debited to profit and loss account which affected the income measurement of each year.

1.7 SUMMARY

Classification of Income

(1) **Capital Income.** Any irregular income earned is known as Capital Income.

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(2) Revenue Income. If refers to regular business income by sale of goods and services in the market.

Classification of Expenditures

(1) Capital Expenditures. Expenses incurred in acquiring and increasing the value of fixed assets are termed as Capital Expenditure.

(2) Revenue Expenditure. The expenses which are incurred as routine business expenses are known as Revenue Expenditure.

(3) Deferred Revenue Expenditure. The expenditures which are incurred likely to give benefit for more than one accounting period are termed as Deferred Revenue Expenditure.

Classification of Receipts

(1) Capital Receipts. Amount received through capital, long-term loans or by issue of shares and debentures is capital receipts.

(2) Revenue Receipts. These are the routine receipts of the business just as receipt from sale of goods.

Distinction between Capital and Revenue Expenditure

Points of Distinction. (1) Meaning (2) Nature (3) Where are these shown ? (4) Example.

Accounting Concepts of Income.

Income refers to the receipts in cash or outstanding receipts from both core and non-core activities of the business.

Expired Cost and Income Measurement

The concept of expired cost relates to the principles of deferred cost or amortisation in accounting.

REVIEW QUESTIONS

A. Very Short Answer Type Questions :

1. What is meant by Capital Income ?
2. What do you mean by deferred revenue expenditure ?
3. Give an example of capital receipts.

B. Short Answer Type Questions :

1. Explain the meaning of capital expenditure. Give its examples.
2. Mention some features of capital expenditure.
3. Classify different types of receipts.
4. Distinguish between capital receipts and revenue receipts.

C. Long Answer Type Questions :

1. Distinguish between capital expenditure and revenue expenditure.
2. Explain the accounting concept of income.
3. Write a note on expired cost and income measurement.

UNIT 2 FINAL ACCOUNTS

NOTES

★ STRUCTURE ★

2.1 Objectives
2.2 Introduction
2.3 Final Accounts
2.4 Trading Account
2.5 Profit and Loss Account
2.6 Balance Sheet
2.7 Preparation of Final Accounts
2.8 Adjustments/Additional Information in Preparation of Final Accounts
2.9 Summary

2.1 OBJECTIVES

At the end of this unit, you should be able to :

- Understand the meaning of Trading and Profit and Loss Account and Balance Sheet.
- Identify direct, indirect, operating and non-operating expenses.
- Explain need, importance and Purpose of Trading A/c and Profit and Loss A/c.
- Prepare Trading and Profit and Loss A/c.
- Identify expenses not to be shown in the Profit and Loss A/c.
- Define Balance Sheet, explain its characteristics and objective.

2.2 INTRODUCTION

The ultimate aim of accounting process is to finalize the Financial Statements of the company. Financial Statements comprise of the Balance Sheet and Profit and Loss Accounts of the company. Financial Statements are used by both the external parties to the business and internal management for the decision making purposes. It is important that Financial Statements reflect the true and fair view of the financial position of the company. These statements are audited by Chartered Accountants to certify the correctness of the accounting. Accountants should be careful in preparation of these statements as any error or omission may not reflect well on the internal business controls.

As a business administrator, we should be able to understand the process of preparation of financial statements and how it impacts the present and future growth prospects of the business. Also, these financial statements should be analyzed to understand the financial health of the business and future decision-making purposes.

2.3 FINAL ACCOUNTS

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Every firm likes to measure the performance of its business operations in terms of profit or loss. It also likes to know the value of its assets and liabilities on the closing date of accounting period. Inorder to ascertain its income and also to assess the position of assets and liabilities statements prepared are known as Financial Statement. These statements aer also known with their traditional name as 'Final Accounts'.

Financial statements are divided in two parts, *i.e.*, income statements and position statements. The term income statements is traditionally known as trading and profit and loss account and position statements is known as balance sheet.

Business transactions are recorded in our original books, *i.e.,* subsidiary books and journal proper. With the help of these original books of record, we prepare ledger accounts. Trial balance is prepared with the balances of ledger accounts. With the help of trial balance we prepare final accounts or financial statements. Final accounts consists of Trading account, profit and loss account and balance sheet. Trading account shows gross profit or gross loss, net profit or net loss is available from profit and loss account. The balance sheet exhibits the position of assets and liabilities on a particular date.

Limitations of Final Accounts/Financial Statements

Inspite of being very useful to the business financial statements suffer from the following limitation :

1. **Ignores qualitative aspect.** The notable weakness of financial statements is to present quantitative facts of the business in terms of money. Qualitative aspect however important are completely ignored. Administrative efficiency of the management and harmonious relations between management and labour are very significant factors in the success of the business but do not find a place in financial statements.
2. **Based upon convention and practices.** Financial statements are prepared according to the practices adopted by individual firms. Different identical firms may adopt different methods of charging depreciation. Different methods of depreciation will depict different performance in the identical situations. Methods of valuating stock may also differ. Accounting is criticised for its convention of conservatism *i.e.,* showing expected losses but ignoring expected income. **Stock is valued at cost price or market price whichever is lower.** In the same way, we do not show appreciation in the assets generally but we do not miss to show depreciation.
3. **Ignores human resource.** Human element is essential, active and sensitive factor of production. Physical factors, *i.e.,* land, material, money, machines and equipments are meaningless without human factor. Financial statements do not accord any weightage to human reosurces.
4. **Ignores price level changes.** Change in the price affects cost of production, sales and value of assets. Changes in the price are quite obvious under inflation but financial statements ignore it. Changes are not incorporated in financial statements.
5. **Ignores interest of all concerned parties.** Financial statements are prepared taking into considerations proprietors interest. The Interest of other interested parties such as workers, investors, debenture holders, creditors, stock exchanges, economists and taxation authorities is ignored.

Preparation of Final Accounts (Financial Statements)

There are three following stages of preparing final accounts of a trading concern :

1. Trading account 2. Profit & Loss Account and 3. Balance Sheet.

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2.4 TRADING ACCOUNT

Meaning

An Income statement prepared with cost of raw material, purchases and direct expenses (expenses on acquiring and manufacturing goods) with a view to ascertain gross Profit or Loss is known as Trading Account.

Direct Expenses

(*i*) **Expenses on acquiring goods**

Carriage and cartage (inward)
Freight inward
Octroi and local taxes
Excise duty
Import duty, landing and clearing charges.

(*ii*) **Expenses on manufacturing goods**

Coal, gas, water and fuel
Wages (Productive)
Fuel, power and motive power
Consumable stores
Manufacturing expenses
Factory expenses.

Direct expenses form part of the cost of goods purchased or manufactured. It does not include selling and distribution expenses.

Need/Importance and Purpose of Trading Account

The purpose and importance of preparing trading account is summarised as under :

1. **Ascertaining gross profit/gross loss.** The main purpose of preparing Trading account is to ascertain gross profit or gross loss. Excess of credit side over the debit side of Trading account is gross profit and the excess of debit side over the credit side is gross loss. The gross profit ratio between 20% to 30% is treated as standard. Gross profit should be sufficient to cover selling and distribution expenses. The adequacy of gross profit is measured with reference to sales.
2. **Ascertaining ratio of direct expenses to gross profit.** Trading account shows the details of direct expenses incurred in acquiring and manufacturing goods. Cost of production increases with the increase in direct expenses. The margin and the amount of profit is vitally affected by direct expenses. The ratio of direct expenses to gross profit is calculated and compared with the desired and previous performance and efficiency is measured.
3. **Ascertaining ratio between purchases and direct expenses.** Relationship between purchases and direct expenses is ascertained through Trading account. The amount of purchases and direct expenses are available from Trading account. Direct expenses add to the cost of purchases.

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The relationship between purchases and direct expenses indicates how far direct expenses are reasonable and adequate.

4. **Calculation of cost of goods sold.** Gross profit or loss is based upon cost of goods sold. It is based upon the information available from Trading account. Cost of goods sold is ascertained by adding opening stock, purchases and direct expenses and deducting closing stock from it. It can also be calculated by deducting gross profit from sales. Cost of goods sold helps us in calculating profit of the firm.
5. **Calculation of gross profit ratio.** The firm calculates gross profit ratio and measures the efficiency of its performance. Gross profit ratio is calculated by comparing gross profit to net sales. Gross profit ratio should be sufficient to cover expenses. The ratio is compared with the desired ratio or with the ratio of previous year and performance evaluated.

Proforma of Trading account

Trading Account

(for the period ending December 31, 2006)

Dr. *Cr.*

Expenses/Losses	*Amount Rs.*	*Revenue/Gain*	*Amount Rs.*
To Opening Stock		By Sales	
Or		*Less* : Sales return	
Stock (1-1-2003 or opening date		*Or*	
of accounting period) *or*		Returns inward	
Stock in the beginning *or*		By Closing stock	
To Stock :		*Or*	
Raw material................		Stock on 31-12-2003	
Work in progress *or*		*Or*	
Semi finished goods *or*		Stock at the end of the year	
Partly manufactured goods		*Or*	
Finished Goods		By Stock :	
To Purchases		Raw material	
Less : Purchases return		Work in progress	
Or		Finished goods	
Returns outward		By Gross loss—transferred to P/L	
Less : Goods taken by proprietor		A/c	
(*if in adjustment*)		(*If debit side exceeds the credit side*)	
Less : Goods given as charity			
(*if in adjustment*)			
Less : Goods given as free sample			
(*if in adjustment*)			
To Carriage or cartage *or*			
Carriage inward *or*			
Carriage on purchases *or*			
Carriage and freight			
To Octroi or local taxes			

NOTES

To Import duty, customs, Landing charges, clearing charges			
To Wages or productive Wages or manufacturing Wages or direct wages or wages and salaries			
To Coal gas and water			
To Fuel			
To Heating and Lighting			
To Power or motive power			
To Manufacturing expenses			
To Consumable stores			
To Packing charges			
To Assembling expenses			
To Direct expenses			
To Factory Expenses			
To Productive expenses			
To Royalty			
To Gross Profit transferred to P/L A/c. *(If credit side exceeds the debit side)*			

Illustration 3. *Prepare trading account only from the following Trial balance of Chinese Corner Hotel as on 31st March, 2003 :*

	Dr. Rs.	Cr. Rs.
Purchases	*15,750*	
Sales		*21,000*
Returns inward	*600*	
Opening stock	*13,000*	
Freight outward	*65*	
Carriage inward	*50*	
Salaries and wages	*572*	
Rent and taxes	*226*	
Travelling expenses	*187*	
Discount	*115*	
Commission	*108*	
Bank A/c	*6,647*	
Trade Creditors		*2,700*
Sundry debtors	*4,380*	
Capital A/c		*20,000*
Drawings A/c	*2,000*	
	43,700	*43,700*

Closing Stock was estimated at Rs. 12,000.

NOTES

Solution.

Trading Account of Chinese Corner Hotel

for the year ended 31st March, 2003

Dr.					Cr.
Expenses/Losses	*Amount Rs.*	*Revenue/Gain*			*Amount Rs.*
To Opening Stock	13,000	By Sales		21,000	
To Purchases	15,750	*Less* : Returns		600	
To Carriage Inward	50				20,400
To Gross Profit transferred to P/L A/c	3,600	By Closing Stock			12,000
	32,400				32,400

Explanation. Information contained in the Trial balance refer to assets, liabilities and indirect expenses, so these accounts have been omitted and not transferred to Trading account. Freight outward, salaries and wages, rent and taxes, travelling expenses and commission are indirect expenses. They are concerned with selling of goods. These expenses will be transferred to the debit side of profit and loss account.

Bank and debtors are assets and these accounts will be posted at the assets side of Balance sheet. Drawings will be shown as deducted from capital at the liabilities side.

Creditors and capital represent liabilities so they will also be entered at the liabilities side.

2.5 PROFIT AND LOSS ACCOUNT

Meaning

The income statement prepared with the items of expenses, losses, income and gain with a view to ascertain the amount of Net Profit or Loss in the business is known as Profit and Loss Account.

Need/Purpose and Importance of Profit and Loss Account

The purpose and the importance of preparing profit and loss account is as under :

1. **Knowledge of net profit or net loss.** The purpose of preparing profit and loss account is to ascertain the amount of net profit or loss. This is the actual profit available to the proprietor and credited to his capital account. In case of net loss proprietor's capital account will be debited. The net profit is calculated after charging all indirect expenses.
2. **Ascertaining ratio between net profit and net sales.** We get net profit from profit and loss account. This net profit is matched with the net sales to calculate net profit ratio. This ratio is compared with the desired net profit ratio and if there is any short coming, that will be removed. This ratio can also be compared with the ratio of previous years and effective future line of action can be taken.
3. **Calculation of expenses ratio to sales.** Expenses ratio to sales is calculated. We can calculate individual expenses to sales ratio and compare it with desired expenses ratio

and with the ratio of previous years. It will always be in the interest of the firm that the expenses ratio should be the minimum.

4. **Comparison of actual performance with desired performance.** The actual performance of the business is available with the profit and loss account as regards net profit, individual expenses and individual income. We compare our actual performance with our planned and desired performance, identify weaknesses and try to remove them.
5. **Maintaining provision and reserves.** We have to maintain certain reserves and provision to meet our future uncertainties. The amount of provisions, reserves and funds to be maintained depends upon net profit earned by the firm. It is necessary to prepare profit and loss account to determine the net profit, so that effective provision for uncertain future could be maintained.

Proforma

Profit and Loss Account

for the year ending......

Dr. *Cr.*

Expenses/Losses	*Amount Rs.*	*Revenue/Gain*	*Amount Rs.*
To Gross loss—transferred from trading A/c (if any)		By Gross profit transferred from trading A/c	
To Salaries *Or* Salaries and wages		By Interest received	
To Rent, rates and taxes or office rent		*Or*	
To Godown rent or storage or warehousing		Interest (credit)	
		Or	
To Office expenses or establishment		Interest on Investment	
To Miscellaneous, or sundry expenses		*Or*	
To Insurance		Interest on fixed deposit	
To Stationery		*Or*	
To Printing and stationery		Interest on Loans and advanced	
To Staff Welfare Expenses		*Or*	
To Lighting		By Rent received	
To Water and Electricity		*Or*	
To Establishment expenses		Rent (credit)	
To Postage and telegrams		*Or*	
To E-mail and Fax charges		Rent from tenant	
To Courier Services charges		By Discount received	
To Telephone expenses		*Or*	
To Law charges or law cost or litigation expenses or legal charges		Discount (credit)	
		By Commission received	
To Repairs and renewal or Maintenance or upkeep		By Dividends Received	
		By Profit from sale of assets	
To Distribution expenses		By Refund of tax	
To Travelling expenses/Conveyance		By Compensation received	
To General expenses		By Apprenticeship premium	

NOTES

To Stable expenses		By Difference in exchange (credit)	
To Selling expenses		By Interest on drawings	
To Carriage or freight Outward		By Discount on creditors	
To Carriage on sales		By Bad debts recovered	
To Indirect or unproductive wages		By Miscellaneous receipts	
To Audit fee		By Appreciation or increase in the value of assets	
To Entertainment expenses		By Income from Investment	
To Interest paid or interest (debit) or interest on overdraft or interest on loans borrowed		By Reserve for bad and doubtful debts (old reserve—if not treated at the debit side of P/L A/c	
To Discount allowed or discount on debtors		By *Net loss*—Transferred to Capital A/c (*If debit side exceeds credit side*) —Balancing Figure	
To Bad debts or Bad debts written off			
To Reserve or provision for bad and doubtful debts (New reserve—in adjustment)			
To Depreciation			
To Interest on Capital			
To Discounting charges			
To Bank charges or Collection charges			
To Export charges			
To Trade expenses			
To Administrative expenses			
To Financial expenses			
To Commission paid			
To Advertisement			
To Charity and Donation			
To Sample expenses			
To Licence fee			
To Delivery charges			
To Brokerage			
To Sales tax paid			
To Loss on sale of assets			
To Loss by fire/theft/accident			
To Upkeep or Maintenance of assets			
To Commission			
To Net Profit—Transferred to Capital A/c (*If credit side exceeds debit side*) —Balancing Figure			

NOTES

Illustration 4. *Prepare Profit and Loss A/c from the following information :*

	Rs.		Rs.
Carriage on Purchase	*2,000*	*Salaries-factory's manager*	*2200*
Carriage on Sales	*1,000*	*Office manager*	*1,500*
Duty on Exports	*2020*	*Gross Profit*	*15,200*
Lighting	*1050*	*Rent received*	*1500*
Water and electricity	*2120*	*Rent paid*	*500*
Advertisement	*100*	*Commission (Cr.)*	*1200*

Solution. **Profit & Loss A/c**

Dr. *Cr.*

Expenses/Losses	*Amount*	*Revenue/Gain*	*Amount*
To Carriage on sales	1,000	By Gross Profit	15,200
To Duty on Exports	2,020	By Rent received	1,500
To Lighting	1,050	By Commission	1,200
To Water and electricity	2,120		
To Advertisement	100		
To Salaries—Office	1,500		
To Rent paid	500		
To Net profit transferred to capital A/c	9,610		
	17,900		17,900

Illustration 5. *From the following Trial balance of Sri Ram & Sons, prepare the Trading and profit and loss account for the year ended 31st March, 2002.*

Trial Balance

as on 31st March, 2002

Name of Account	*Debit* Rs.	*Credit* Rs.
Ram's Capital		29,000
Ram's Drawings	*760*	
Purchases and Sales	*8,900*	*15,000*
Sales and Purchases Return	*280*	*450*
Stock (1-4-2001)	*1,200*	
Wages	*800*	
Building	*22,000*	
Freight and Carriage	*2,000*	
Trade Expenses	*200*	
Advertisement	*240*	
Interest		*350*
Taxes and Insurance	*130*	
Debtors and Creditors	*6,500*	*1,200*

NOTES

Bills Receivable and Bills Payable	*1,500*	*700*
Cash at bank	*1,200*	
Cash in hand	*190*	
Salaries	*800*	
	46,700	*46,700*

Adjustments. (i) Stock on 31st March, 2002 was valued at Rs. 1,500.

Solution.

Trading and Profit and Loss Account of Sri Ram & Sons

Dr. *for the year ended 31st March, 2002* *Cr.*

Expenses/Losses		*Amount Rs.*	*Revenue/Gain*		*Amount Rs.*
To Stock (1-4-2001)		1,200	By Sales	15,000	
To Purchases	8,900		*Less* : Returns	280	14,720
Less : Returns	450	8,450	By Closing Stock		1,500
To Wages		800			
To Freight & Carriage		2,000			
To Gross Profit c/d		3,770			
		16,220			16,220
To Trade Expenses		200	By Gross Profit b/d		3,770
To Advertisement		240	By Interest		350
To Taxes and Insurance		130			
To Salaries		800			
To Net Profit transferred to Capital A/c		2,750			
		4,120			4,120

Explanation. Purchases and sales have been given under one head purchases have debit balance, so Rs. 8,900 placed at the debit side of Trial balance is purchases and Rs. 15,000 will be the amount of sales, because it is given at the credit side of Trial balance (sales have credit balance) sales and purchases return have also been given under one head. Purchases return shows credit balance and sales return shows debit balance. This is why, Rs. 280 represents sales return and Rs. 450 is purchases return.

2.6 BALANCE SHEET

Meaning

Balance sheet is a mirror which reflects the true position of assets and liabilities on a particular date. Trading and profit and loss account shows gross profit or gross loss and net profit or net loss respectively. These accounts deal with expenses, income and receipts, *i.e.*, revenue receipts and payment. The firm also makes certain capital expenditure and gets capital receipts. It owns certain assets and also certain liabilities. These assets and liabilities show that the financial position of the firm. This is why, Balance sheet is also

NOTES

ıown as position statement. We adopt double entry system of accounting, where every ebit has got its corresponding credit. According to our accounting equation also :

Assets = Liabilities + Capital.

It means that the total of the assets side of Balance sheet must be equal to the total of abilities. Liabilities consists of creditors equity (liability) and proprietor's equity. In other ords, creditors and proprietor's claim againts the firm must be equal to its assets. If assets nd liabilities of Balance sheet do not tally, there is definitely certain mistake. According to reeman *"A Balance sheet is an itemwise list of assets, liabilities and proprietorship of a usiness at a certain date".*

eatures/Characteristics of Balance Sheet

Balance sheet is the position statement which shows the position of assets and liabilies. It has got the following special features :

1. **Balance sheet is a statement.** Though Balance sheet is an integral part of double entry system, but it is not an account. It has got the balance of certain ledger accounts. The balance of all ledger accounts are not shown in it.
2. **Prepared on a specified date.** Balance Sheet is prepared on a specific date, *i.e.,* at the end of accounting period. It is common practice and also legal requirement to prepare Balance sheet together with Trading and profit and loss account at the end of the accounting year. It may be prepared after every six months if the proprietors so desire. Accounting year may consist of calender year or assessment year or its own accounting year. Companies are required to adopt assessment year (April 1 to 31st March) as per legal requirement. Sole proprietorship and partnership can adopt accounting year which suits them, *i.e.,* Diwali to Diwali or Dussehra to Dussehra or assessment or calender year.
3. **It is a statement of assets and liabilities.** Though the Balance sheet has debit and credit balance but its sides are named as assets and liabilities. The left hand side is a liability representing credit balance. Right hand side is assets representing debit balances.
4. **Knowledge about the nature of assets and liabilities.** Balance sheet categorise assets as liquid assets, current assets, fixed assets and fictitious assets. Knowledge of liabilities as current liabilities, fixed liabilities and reserve and funds can be gained from Balance sheet.
5. **Knowledge of financial position.** Balance sheet depicts true financial position of the business. The position can be ascertained by study of the Balance sheet. We can calculate short-term and long-term financial ratios, proprietory and other ratios to have the knowledge of the financial soundness of the business.
6. **Assets and liabilities tally each other.** The total of assets must be equal to liabilities. According to accounting equation, assets are always equal to creditors, and proprietor's equity. If the total of assets and liabilities are not equal, there is likely to be certain mistake.

ed and Purpose of Balance Sheet

Balance sheet is a vital part of final account. It has to be compulsorily prepared as per al provisions. Objects of the Balance sheet have been summarised as under :

NOTES

Main objectives of Balance Sheet

The main object of Balance sheet is to assess the financial position of the firm. It is list of assets and liabilities of the firm on a specific date. The short-term and long-te financial position of the firm can be obtained from the analysis of the Balance sheet.

Balance sheet is rightly said to be a mirror reflecting the true value of assets and liab ties on a particular date.

***Difference between Profit and loss accounts** (Income Statement) **and Balance sh** (Position Statement)*

Income statement (Trading and profit and loss account) and position statements (B ance sheet) can be differentiated as under :

Points of Difference	*Profit and Loss Account*	*Balance Sheet*
1. *Types of account*	Only nominal accounts are entered in profit and loss account.	It records personal and real a counts.
2. *Objective*	The objective of preparing profit and loss account is to ascertain the net profit or loss of the business.	The purpose of preparing balan sheet is to understand the financi position of the firm.
3. *Sides*	The left hand side of the profit and loss account is the debit and the right hand side is credit.	It has liabilities at its left hand si and assets at right hand side.
4. *Nature*	Profit and loss account is an account. We use the word 'To' before accounts at the debit side and 'By' at the credit side.	Balance sheet is not an account, is a statement. We do not use 'To or 'By' in it.
5. *Balancing figure*	The balancing figure of the profit and loss account is either net profit or net loss. Excess of credit side is net profit and the excess of debit side is net loss.	It does not show any balancing fi ure. The total of assets and liabil ties are always equal.
6. *Specific date/ period*	Profit and loss account shows the position of the accounting period, generally a year.	Balance sheet shows the positio of assets and liabilities on a partic lar date.
7. *Types of expenditure*	Revenue expenditures are recorded in the profit and loss account.	Capital expenditures are entered the assets side of the Balance Shee

Proforma

Balance Sheet

as on ......

Liabilities	*Amount Rs.*	*Assets*	*Amour Rs.*
Current Liabilities		**Current Assets**	
Creditors		Cash in hand	
Bills payable		Cash at bank	
Bank overdraft		Debtors or sundry Debtors	

Outstanding expenses		or book debts	
Income received in advance		Stock or inventory	
Short-term loans		Goods sent on consignment	
Fixed Liabilities		Bills or Notes Receivable	
Loan		Short-term or Trade	
Mortgage		investment	
Loan from financial institutions		Prepaid expenses	
Debentures		Accrued income	
		Sales Tax Collected	
Capital		**Investments**	
Add : Net Profit		Details of investment :	
Add : Interest on capital		Long-term investment	
(if in adjustment)		Loans granted	
Add : Remuneration, *i.e.,* salaries,		**Fixed Assets**	
commission, fee payable to		Land and building	
proprietors		*Or*	
(if in adjustment)		Freehold premises	
Less : Drawings		Machinery	
Less : Interest on drawings		*Or*	
Less : Net loss		Plant and Machinery	
Less : Income tax		Equipments	
Reserves and Funds		*Or*	
General reserve		Tools and Equipments or	
Reserve funds		loose tools	
Contingency reserve		Furniture or Fixtures	
Provident fund		*Or*	
Employees compensation fund		Furniture and fittings	
Provision for taxation		*Or*	
		Fixtures and fittings	
		Vehicles—truck, car, vans,	
		tempo, scooter, cycle etc.	
		Horses and carts	
		Live-stock (animals)	
		Goodwill	
		Patents and Trade Mark	
		Miscellaneous Expenses	
		Advertising suspense	
		Discount on issue of shares	
		Discount on issue of	
		debentures	

2.7 PREPARATION OF FINAL ACCOUNTS

1. **Preparation of Trial balance.** Trial balance should be prepared before preparing Balance sheet. If the debit and credit sides of trial balance do not tally the difference should be provisionally transferred to suspense account and the suspense account should be shown in the Balance sheet.

NOTES

2. **Showing items from Trial balance at one place.** All the items appearing in the trial balance are shown at one place only whether at the debit side of trading account or profit and loss account or assets or at the credit side of trading account or profit and loss account or liabilities.
3. **Posting from Trial balance.** Accounts appearing at the debit side of Trial balance are shown at the debit side of Trading account or profit and loss or at the assets side of the Balance sheet. In the same way, accounts appearing at the credit side of trial balance are shown at the credit side of Trading or profit and loss account or at the liabilities side.
4. **Posting of expenses.** All direct expenses, *i.e.*, expenses for manufacturing and acquiring goods are written in Trading account. Indirect expenses and losses regarding selling and distribution of goods are written in profit and loss account.
5. **Personal and Real accounts.** All the personal and real accounts are recorded in the Balance sheet.
6. **Factory and office expenses.** All factory expenses are direct expenses. They are written at the debit side of Trading account. Office expenses are indirect expenses and they are written at the debit side of Profit and loss account.
7. **Treatment of rent, discount, interest and commission.** Rent, discount, interest and commission may be an income or an expense. If these expenses are paid they are our expenses. If they are received it will be an income and posted at the credit side of Profit and loss account. If there is no Trial balance or no specific word as allowed or received these items should be treated as expense and posted to be debit of profit and loss account.

Illustration 6. *From the following Trial Balance extracted from the books of Mahinder Singh, prepare Trading and Profit & Loss A/c for the year ending March 31st, 2004 and the Balance sheet as on that date.*

Name of Account	*Debit Balances*	*Credit Balances*
Drawing and Capital	*20,000*	*1,99,000*
Plant & Machinery	*80,000*	
Debtors & creditors	*70,000*	*50,000*
Purchases and sales	*1,10,000*	*2,20,000*
Returns	*10,000*	*7,000*
Wages	*40,000*	
Cash in hand	*5,000*	
Cash at Bank	*10,000*	
Salaries	*30,000*	
Repairs	*8,000*	
Stock	*45,000*	
Rent	*10,000*	
Manufacturing Expenses	*7,000*	
Bill receivable	*12,000*	
Bill Payable		*20,000*
Bad debts	*5,000*	

Carriage	*9,000*	
Furniture	*15,000*	
Income tax	*10,000*	
	4,96,000	*4,96,000*

NOTES

Closing stock was valued at Rs. 50,000.

Solution.

Dr. **Trading and Profit and Loss Account** *Cr.*

Expenses/Losses		*Amount Rs.*	*Revenue/Gain*		*Amount Rs.*
To Opening Stock		45,000	By Sales	2,20,000	
To Purchases	1,10,000		*Less* : Returns	10,000	2,10,000
Less : Returns	7,000	1,03,000	By Closing stock		50,000
To Manufacturing Expenses		7,000			
To Carriage		9,000			
To Wages		40,000			
To Gross Profit c/d		56,000			
		2,60,000			2,60,000
To Salaries		30,000	By Gross Profit b/d		56,000
To Repairs		8,000			
To Rent		10,000			
To Bad debts		5,000			
To Net Profit transferred to Capital A/c		3,000			
		56,000			56,000

Balance Sheet

Liabilities		*Amount Rs.*	*Assets*	*Amount Rs.*
Capital	1,99,000		Plant & Machinery	80,000
Add : Net Profit	3,000		Furniture	15,000
	2,02,000		Bills receivable	12,000
Less : Drawings	20,000		Sundry Debtors	70,000
	1,82,000		Closing stock	50,000
Less : Income tax	10,000	1,72,000	Cash at bank	10,000
Sundry creditors		50,000	Cash in hand	5,000
Bills payable		20,000		
		2,42,000		2,42,000

Notes. It should be noted that Drawings, debtors and returns inward have debit balance, so the amount of these items should be picked from the debit side of Trial balance. In the same way Capital, creditors and returns outward have credit balance, so picked up from the credit side of Trial balance.

2.8 ADJUSTMENTS/ADDITIONAL INFORMATION IN PREPARATION OF FINAL ACCOUNTS

NOTES

Business is going concern. It has to be carried on indefinitely. We cannot wait indefinitely for the assessment of the performance of the business, so we distribute the life of the business in equal and uniform periods, generally a year. At the end of every accounting year, we prepare Trading and profit and loss account and measure the performance of business in terms of Gross profit and Net profit. We also prepare a Balance sheet at the end of the year to assess the value of assets and liabilities.

While preparing Final accounts at the end of every accounting period, we come across certain problems. The expenses of the current year are still payable or the expenses of the next year have been paid during the current year. Sometimes, income of the current year remains still receivable and the income of the next year has been received during the current year. Depreciation on assets, interest on capital and provision for bad and doubtful debts of the current year has not been recorded in the books as yet. We are required to adjust these amounts in the final accounts of the current year so that the correct profit or loss of the business may be ascertained. We will have to pass adjusting journal entries for all these items, errors and omissions, not yet recorded in the books. These items do not appear in the Trial balance. They are adjusted at two places in the final accounts.

Depreciation in the Value of Assets

The assets acquired in the business are continuously used. They will naturally be losing their utility, value and usefulness. In other words, there will be wear and tear. *Loss in the value of assets due to its constant use is termed as depreciation.* It is necessary that loss due to depreciation must be accounted for. Certain provisions should be made, so that the assets may be replaced without much financial problems.

Treatment in Final Accounts

(*i*) **If depreciation account appears in Trial balance.** It will be posted to the debit side of profit and loss account only, as it is an item from Trial balance. (Items from Trial balance are posted only at one place).

(*ii*) **If depreciation is an item of adjustments.** We shall first of all calculate the amount of depreciation on the specific assets at the given rate. An adjusting entry (mentioned as above) will be passed. Depreciation account will be transferred to the debit side of Profit and Loss account. It will also reduce the value of the concerned asset, so the value of asset will be shown at reduced price in the Balance sheet. Depreciation on furniture (mentioned in the above example) will be shown as under in the profit and loss account and Balance sheet.

Profit and Loss Account — **Balance Sheet**

Dr.		*Cr.*	*Liabilities*	*Assets*		
To Depreciation on Furniture	1,000			Furniture	10,000	
				Less : Depreciation	1,000	9,000

ppreciation in the Value of Assets

It is just possible that value of certain assets such as land and building may increase. 'his increase in the value is gain, so it will be credited. It will also increase the value of -ssets, so assets account will be debited as the rule for assets goes 'debit the increase'.

NOTES

'reatment in Final Accounts

(*i*) **If appreciation appears in Trial balance.** It will be shown at the credit side of profit and loss account only, because it is gain.

(*ii*) **If appreciation appears in adjustment.** All the items appearing in adjustments are shown at two places in the final accounts. Appreciation is a gain so it will be shown at the credit side of profit and loss account on the one hand, and on the other hand, it will be added to the value of concerned assets in the Balance sheet. If land and building worth Rs. 1,00,000 appreciated @ 15% the following entry will be passed.

It will be shown in the Profit and loss account and Balance sheet as under :

Profit and Loss Account **Balance Sheet**

)r.	Cr.		Liabilities	Assets		
	By Increase in the value of land and building	15,000		Land and building	1,00,000	
				Add : Appreciation	15,000	
						1,15,000

> **Note.** As a convention of conservatism firms generally do not show the increase in the value of their assets, as such appreciation is casual item, whereas depreciation is an usual item.

)utstanding Expenses *or* Accrued Expenses *or* Expenses Owing *or* Unpaid *or* Due

These expenses are related to the current year but remain unpaid. As they are the ex- ›enses of the current year, so they must be debited and charged from the profit and loss ccount of the current year. The expenses remained unpaid so far during the current year, o they are the liability of the firm. For example, the firm pays Rs. 5,000 wages per month o its workers. Wages are paid on the 1st day of every month, *i.e.,* wages for the month of Aarch, 2003 will be paid on April 1, 2003, the wages for October, 2003 will be paid on Vovember 1, 2003 so the wages of December, 2003 will be paid on January 1, 2004. The accounting period ends on 31st December, 2003 but only Rs. 55,000 have been actually ›aid on account of wages. Wages for the month of December, 2003 is still to be paid. It is)utstanding. It is a liability. It has to be paid.

Treatment in final accounts

Outstanding expenses account may be available at two places. It may be given in the Trial balance or it may be mentioned outside the Trial balance, *i.e.,* adjustments. If out- standing salaries or wages owing account have been mentioned in the trial balance, they will be shown at the liabilities side only (accounts appearing in the trial balance are shown)nly at one place in the final accounts).

In case, outstanding expenses are in the adjustment, they will be shown at two places all items appearing in the adjustments are shown at two places). Outstanding expenses will)e added to the concerned expense at the debit side of trading or profit and loss account such as outstanding wages will be added to wages account at the debit side of trading account and outstanding salaries will be added to salaries account at the debit side of profit and loss account. Outstanding expenses will also be shown at the liabilities side of the)alance sheet.

NOTES

Prepaid Expenses *or* Expenses Paid in Advance *or* Expenses Relating to the Next Following Year *or* Unexpired Expenses

There are certain expenses which may have been paid in advance, *i.e.*, expenses for t next year have been paid during the current year. For example, insurance premium Rs. 2,400 was paid on April 1, 2002 for the whole year. The accounting period ends on 31 December, 2002 but insurance premium has been paid upto 31st March, 2003. The peri between Jan. 1 to March 31, 2003 belongs to the next year. It means that insurance pr mium paid for the 3 months of the next year is prepaid, *i.e.*, 1/4th of Rs. 2,400 or Rs. 6 has been paid for the year 2003. We will have to pass an adjusting entry for prepaid insu ance as under :

Treatment in the Final Accounts

(*i*) **If prepaid expenses appear in adjustments.** Prepaid insurance show a debit balanc so it will be shown at the assets side of Balance sheet. The amount of prepaid insu ance will be deducted from insurance at the debit side of profit and loss account.

Prepaid expenses are also known as unexpired expenses, because the part of e penses relating to the current year have expired (benefit from the expenditure h been availed of). The part of expenditure relating to next year is still unexpired, *i.* the benefit of the expenditure is to be availed of. Let us take an example. Rent for t whole year amounting to Rs. 12,000 has been paid on 1st May, 2004. The rent f eight months (May 1—Dec. 31) relates to the current year 2004, and the rest rent f four months, *i.e.*, (from Jan. 1 to April 30, 2005) are concerned with the next yea Rs. 4,000, the rent for four months is unexpired or the benefits of this rent are to availed of, so it is an asset. The current year should bear only Rs. 8,000 for rent, Rs. 4,000 will be deducted from the rent, *i.e.*, Rs. 12,000 at the debit side of pro and loss account. It will be shown in the profit and loss account and Balance sheet under :

Profit and Loss Account

Dr.			*Cr.*
To Rent A/c	12,000		
Less : Prepaid Rent	4,000		
		8,000	
To Insurance	2,400		
Less : Prepaid Insurance	600		
		1,800	

Balance Sheet

Liabilities	*Assets*	
	Prepaid Rent A/c	4,00
	Prepaid Insurance	600

(*ii*) **If prepaid expenses appear in Trial balance.** Sometimes items like unexpired re or prepaid insurance may be given in the Trial balance. In such case, unexpired re and prepaid expenses will be shown at the assets side only.

Accrued *or* Outstanding Income *or* Income Due but not Received

Sometimes income of the current year may be due but not received just as expenses du but not paid. For example, the firm advanced a loan of Rs. 20,000 at 12% interest on Janu ary 1, 2004. Interest on this loan for the month of November and December are accrued, *i.e.*, still to be received. In this case Rs. 400, *i.e.*, $20{,}000 \times \frac{12}{100} \times \frac{2}{12}$ will be accrued interest. In the same way, if a portion of the building has been sublet on a monthly rent of Rs. 700. One quarter's rent (three months', rent) has not been received so far. Rs. 700 × 3 = Rs. 2,100 will be accrued income as rent.

Treatment in the Final Accounts

(*i*) **If accrued income is in adjustment.** Accrued income is the income of the current year. The income has not been received so far, but it will be treated as income according to our accrual concept. It will be added to the concerned income at the credit side of profit and loss account and also shown at the assets side, because the amount is to be received by the current year. Journal entry for accrued interest and rent as mentioned in the example will be passed as under :

The treatment of accrued income will be made in the profit and loss account and balance sheet as under :

Profit and Loss Account — **Balance Sheet**

Dr.			*Cr.*	*Liabilities*	*Assets*	
	By Interest	2,000			Accrued Interest	400
	Add : Accrued Interest	400			Accrued Rent	2,100
			2,400			
	By Rent	6,300				
	Add : Accrued Rent	2,100				
			8,400			

(*ii*) **If accrued income appears in Trial Balance.** Accrued income will be shown at the assets side only because current year's income is still receivable (whatever is receivable is an asset). As items from Trial balance are shown at one place only, so it is enough to show it at the assets side.

Unearned Income *or* Income Received in Advance

It is just possible that we may receive the income of the next year during the current year. Such income is also known as unearned, because the income has not been earned by the current year. It relates to the next year, though received during the current year. It will be deducted from concerned income at the credit side of profit and loss account and also shown as a liability.

Treatment in Final Accounts

(*i*) **If unearned income appears in the adjustment.** All the items appearing in the adjustments are shown at two places, so unearned income will also be shown at two places. Unearned rent amounting to Rs. 15,000 referred to in the above example will be deducted from the rent at the credit side of profit and loss account and also shown at the liabilities side. The treatment of this rent received in advance will be made in the profit and loss account and the Balance sheet as under :

NOTES

Profit and Loss Account | **Balance Sheet** *as on December 31, 2003*

Dr.		*Cr.*	*Liabilities*	*Amount Rs.*	*Assets*
	By Rent 36,000 *Less* : Rent received in advance 15,000	21,000	Rent received in advance (Unearned Rent)	15,000	
		21,000			

Rent received account is debited, so it will reduce the amount of rent received at the credit side of profit and loss account. Unearned rent account shows a credit balance so it will be shown at the liabilities side (liabilities have credit balance).

(*ii*) **If unearned income appears in Trial balance.** Appearing in the Trial balance means that it has been routed through double entry record (journal entries have already been passed for it) so it will be shown only at one place. That only place for it will be the liabilities side, simply because it shows a credit balance and the amount received in advance has to be paid by the current year to the next year.

Interest on Capital

Capital is the liability of the business. It is proprietor's claim against the firm. The business assumes capital as amount borrowed from the proprietors of the firm. Interest payable on this liability will be an expense of the business. It will, therefore, be debited to profit and loss account. Interest on capital at the same time will increase the balance of proprietor's capital, so it should also be added to capital account at the liabilities side. For example, the firm started its business on January 1, 2004 with Rs. 2,00,000. It was decided to charge interest on capital at the rate of 12%. The total interest on capital due to proprietors will be Rs. 24,000, *i.e.*, $2,00,000 \times \frac{12}{100}$.

Interest on capital has been debited as an expense, so it will be posted at the debit side of profit and loss account. Capital account has been credited in the journal entry, so capital will also increase with the amount of interest on capital at the liabilities side of the Balance Sheet.

If interest on capital account appears in the Trial balance, it will be posted to the debit side of profit and loss account only.

Interest on Drawings

The owners of business may sometimes draw cash or goods for their private or personal or domestic use. Drawings, in this way, is the amount advanced by the firm to its proprietors. If the firm pays interest on capital, the funds invested by the proprietor, it is fully justified that it should also charge interest on the amount withdrawn by the proprietors from business. Interest on drawing will be received by the business, so it is an income. It should, therefore, be credited. The capital will reduce with the interest on drawing, so capital account should be debited. In case of drawing and interest on drawing it will be preferable to debit. Drawings account instead of capital account.

Interest on drawings will be posted at the credit side of profit and loss account, because it is an income of the business. It will also be deducted from the capital at the liabilities side of the Balance sheet. *This treatment will be made if it is an item in the adjustment.*

If the item of interest on drawings is given in the Trial balance, it will mean that the balance of capital account has already been adjusted. Now, interest on drawings account will be shown as income at the credit side of profit and loss account only.

Interest and Dividend on Investment

Investment is an asset of the firm. Funds of the firm may be invested outside in shares, debentures and securities of other companies. The firm will receive dividends on shares and interest on debentures, loan and other securities. Interest/Dividend received is undoubtedly an income, so it will be posted at the credit side of profit and loss account. If the *interest/dividend has been received during the year* in cash, the item will appear at the credit of Trial balance and will be posted at the credit side of profit and loss account only.

If interest on investment is due for certain months, it will be treated as accrued income. The item will appear in the adjustment and will be shown at two places in the final accounts. Outstanding interest on investment is the revenue of the current year so it will be credited. The value of investment will also increase with the amount of accrued interest, so investment account will be debited.

Interest on investment, *if it is an item of adjustment will be shown at two places.* These places will be credit side of profit and loss account and the assets side of the Balance sheet, where it will be added to the value of investment, appearing in the Trial balance.

Interest on investment will be shown at the credit side of profit and loss account only, if it is an item from Trial balance.

Interest on Loan

Loan is an ambiguous item. It may be borrowed or it may also be lent. **If loan appears at the debit side of Trial balance, it will mean that the funds have been advanced to outsiders. It is an asset.** The interest received on it will be gain and thus credited to profit and loss account. If this item appears in the trial balance, it will be shown at the credit side of profit and loss account only. In case the item belongs to adjustment it will be shown at two places. It will be shown at the credit side of profit and loss account and also added to loan at the assets side of the Balance sheet.

Interest on loan borrowed, will be shown at the debit side of the profit and loss account only, if it is an item from Trial balance.

Interest on loan account will be shown at the credit side of profit and loss account and will also be added to loan account at the assets side of Balance sheet.

Bad debts (not in Adjustment)

It is just possible that debts may not be fully recovered from debtors. Certain amounts may prove to be bad. The irrecoverable amount is termed as bad debts. It is undoubtedly a loss, so posted at the debit side of profit and loss account. *If bad debts is declared during the year* the following journal entry will be passed :

Bad debts A/c	Dr.
To Sundry Debtors A/c	

NOTES

The above journal entry reveals that the amount of sundry debtors has been reduced by amount of bad debts, so debtors in the balance sheet will be shown at their value mentioned in the Trial balance. Bad debts account will appear in the trial balance. It will show debit balance and be posted at the debit side of profit and loss account only.

Provision for Bad and Doubtful Debts (Adjustment)

It has been the experience of businessmen that certain amount out of the entire amount of debtors will definitely prove to be bad. Amount may remain irrecoverable due to the dishonesty or unsound financial position of the debtors. In such circumstance, it is advisable to firms that they should make certain provisions out of the profit and loss account of the current year, so that the next year may not suffer the loss of bad debts relating to the current year. It is possible that current year's debtors may prove to be bad in the next year. Decision regarding maintenance for provisions of bad and doubtful debts is taken at the end of year, so it is an item from adjustment. For making provision for probable bad and doubtful debts and following journal entry will be passed :

Profit and Loss A/c	Dr.
To Provision for bad and doubtful debts	
(Being maintenance of provision for bad and doubtful debts)	

Provision for bad and doubtful debts account will be shown at the liabilities side, as it shows a credit balance. It may also be deducted from sundry debtors at the assets side of Balance sheet. It will also be shown at the debit side of profit and loss account.

Further Bad Debts (Adjustment)

It may be ascertained at the end of accounting period that certain amount have been declared as bad. The following adjusting entry will be passed :

Bad debts A/c	Dr.
To Sundry Debtors A/c	

The above journal entry reveals that bad debts account has been debited and it will be closed by transferring to profit and loss account. In other words, it will be posted at the debit side of profit and loss account. The item belongs to adjustment, so it will also be shown at one more place, *i.e.,* deducted from debtors at the assets side of the Balance sheet. If there is already an item of bad debts in the trial balance, further bad debts will be added to it at the debit side of profit and loss account.

Provision for Bad and Doubtful Debts (given in the Trial Balance)

We maintain provision for bad and doubtful debts every year. Provision maintained is the amount likely to prove bad. It is not the actual bad debts. If bad debts is lesser than the amount of provision for bad and doubtful debts, there will remain a credit balance in the provision for bad and doubtful debts account. The amount will appear in the trial balance,

NOTES

so it will be shown at one place only. It will be either shown at the credit side of profit and loss account or it will be deducted from the total of bad debts, further bad debts and new provision at the debit side of profit and loss account. It may also be shown at the liability side. Only one of the three treatments will be made.

Calculation of Provision for Bad and Doubtful Debts

Provision for bad and doubtful debts is calculated on sundry debtors at given rate. In certain cases, there are further bad debts in the adjustments and the provision is also to be calculated at certain rate. In these cases, provision for bad and doubtful debts will be calculated on debtors after deducting the amount of bad debts or further bad debts (given in the adjustment). Calculation is explained as under.

***Illustration** 7. Calculate provision for bad debts in the following cases :*

(a) Create or maintain or make provision for bad and doubtful debts @ 7%.

(b) (i) There was a further bad debts of Rs. 350.

(ii) Create reserve for bad and doubtful debts @ 7%.

The balance of the sundry debtors as per Trial balance is Rs. 50,000 in both the cases.

Solution. (*a*) Provision for bad and doubtful debts $= 50{,}000 \times \frac{7}{100}$ = **Rs. 3,500.**

(*b*) Rs. 350 have proved to be bad debts, so the amount due from debtors will reduce by Rs. 350 and it is actually 50,000 – 350 = Rs. 49,650. Now, the provision will be made on Rs. 49, 650 not on Rs. 50,000.

Provision for bad and doubtful debts $= \frac{49{,}650 \times 7}{100}$ = Rs. 3,475.50.

Provision for Discount on Debtors

It is common practice of the business to allow its debtors, cash discount, so that they may be encouraged to make early and immediate payment. Discount is allowed to debtors. We shall be receiving lesser amount from debtors after allowing them discount. It is, therefore, a loss and debited to profit and loss account. If discount allowed appears in the Trial balance, it will be shown at debit side of Profit and loss account only. *It may be noted that provision for discount on debtors is made only on good debtors.*

We may be asked to make a provision for discount on debtors in the adjustment. In this case, discount on debtors will be calculated at the given rate on debtors. It will be shown at the debit side of profit and loss account and also deducted from debtors at the assets side of Balance sheet.

Calculation of discount on debtors

Discount on debtors is allowed to only those debtors, who are going to make us payment. It means that it will exclude those debtors, who have become bad and also those who are doubtful. Suppose we have been given further bad debts, and asked to create a provision for bad and doubtful debts in addition to discount on debtors. We shall deduct the amount of further bad debts from debtors to calculate provision for bad and doubtful debts. Discount on debtors will be calculated after deducting further bad debts and provision for doubtful debts both from debtors.

If we are asked to create a provision for bad and doubtful debts and also discount on debtors, we shall calculate provision for doubtful debts first, deduct its amount from debtors and calculate discount on debtors on deducted amount of debtors. Calculation and treatment of discount on debtors is illustrated herewith.

NOTES

Relationship between Bad Debts and Provision for Bad Debts

Bad debts and bad debts provision are inter-related and interdependent. Bad debts provision is maintained to meet the loss due to bad debts. This is why, bad debts account is closed by transfer to profit and loss account. Provision for bad debts account shows the amount to be charged out of profit and loss account. The balancing figure of this account is transferred to profit and loss account. Maintenance of these accounts has been illustrated as under :

Closing Stock

It is also an item of adjustment. Closing stock does not appear in the Trial balance. Following adjusting entry is passed for closing stock.

Closing Stock A/c	Dr.
To Trading A/c	

It will be clear from the above journal entry that closing stock will be posted at the credit side of Trading account. Closing stock account, if prepared will show debit balance (every asset has a debit balance) and as such it will also be written at the assets side of the balance sheet.

Closing stock may be in Trial balance, if it so, the closing stock will be written only at one place *i.e.*, Assets side of the Balance sheet.

Illustration 8. *The following balances were extracted from the books of Shri Brijesh Chandra on 30th June, 2003*

	Rs.		*Rs.*
Capital	*24,500*	*Bad debts*	*550*
Drawings	*2,000*	*Loan*	*7,880*
General expenses	*2,500*	*Sales*	*65,360*
Buildings	*11,000*	*Purchases*	*47,000*
Machinery	*9,340*	*Scooter*	*2,000*
Stock	*16,200*	*Bad debts, provision*	*900*
Power	*2,240*	*Commission (Cr.)*	*1,320*
Taxes and Insurance	*1,315*	*Scooter Expenses*	*1,800*
Wages	*7,200*	*Bills payable*	*3,850*
Debtors	*6,280*	*Cash*	*80*
Creditors	*2,500*	*Bank Overdraft*	*3,300*
Charity	*105*		

Prepare final accounts for the year ended 30th June, 2003 after giving effect to the following adjustments :

(*a*) *Stock on 30th June, 2003 was valued at Rs. 23,500.*

(*b*) *Write off a further of Rs. 160 as bad debts and maintain the provision for bad debts at 5% on debtors.*

(c) *Depreciate machinery at 10% and scooter 12%.*

(d) *Provide Rs. 750 for outstanding interest on overdraft.*

Solution.

NOTES

Trading and Profit and Loss Account of Sh. Brijesh Chandra

for the year ended 30th June, 2003

Dr. Cr.

Expenses/Losses		*Amount Rs.*	*Revenue/Gain*	*Amount Rs.*
To Opening Stock		16,200	By Sales	65,360
To Purchases		47,000	By Closing Stock	23,500
To Power		2,240		
To Wages		7,200		
To Gross Profit transferred to Profit and Loss A/c		16,220		
		88,860		88,860
To General expenses		2,500	By Gross Profit transferred from Trading A/c	16,220
To Taxes and Insurance		1,315	By Commission A/c	1,320
To Charity		105		
To Scooter expenses		1,800		
To Bad debts	500			
Add : Further Bad Debts	160			
Add : Provision for bad debts	306			
	1,016			
Less : Old reserve	900	116		
To Depreciation on :				
Machinery	934			
Scooter	240	1,174		
To Interest Outstanding		750		
To Net Profit transferred to Capital account		9,780		
		17,540		17,540

Balance Sheet of Sh. Brijesh Chandra

as on 30th June, 2003

Liabilities		*Amount Rs.*	*Assets*		*Amount Rs.*
Creditors		2,500	Cash		80
Bills Payable		3,850	Debtors	6,280	
Loan		7,880	*Less* : Written off	160	
				6,120	
Bank overdraft	3,300		*Less* : Provision for B/D	306	
Add : Interest Outstanding	750	4,050			5,814

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Capital	24,500		Closing Stock		23,500
Add : Net Profit	9,780		Buildings		11,000
			Machinery	9,340	
	34,280		*Less* : Depreciation	934	
Less : Drawings	2,000				8,406
		32,280	Scooter	2,000	
			Less : Depreciation	240	
					1,760
		50,560			50,560

Note. Provision for bad debts has been calculated on Rs. 6,120, *i.e.*, 6,280 – 160.

Illustration 9. *The following is the trial balance of Mr. S. Kapur on 31st March, 2003.*

Name of Accounts	*Debit Rs.*	*Credit Rs.*
Cash in hand	*1,080*	
Cash in bank	*5,260*	
Purchases	*81,350*	
Sales account		*1,97,560*
Returns inward	*1,360*	
Return outwards		*1,000*
Wages	*20,960*	
Fuel and power	*9,460*	
Carriage on sales	*6,400*	
Carriage on purchases	*4,080*	
Stock (1-4-2002)	*11,520*	
Buildings	*60,000*	
Freehold land	*20,000*	
Machinery	*40,000*	
Salaries	*30,000*	
Patents	*15,000*	
General expenses	*6,000*	
Insurance	*1,200*	
Capital		*1,42,000*
Drawings	*10,490*	
Sundry debtors	*29,000*	
Sundry creditors		*12,600*
Rs.	*3,53,160*	*3,53,160*

Taking into account the following adjustments, prepare Trading and Profit and loss account and the Balance sheet :

(a) *Stock in hand on 31st March, 2003 is Rs. 13,600.*

(b) *Machinery is to be depreciated at the rate of 10% and patents at the rate of 20%.*

(c) *Salaries for the month of March, 2003 amount to Rs. 3,000 were unpaid.*

(d) *Insurance includes a premium of Rs. 170 for the next year.*

(e) *Wages include a sum of Rs. 4,000, spent on the erection of cycle-shed for employees and customers.*

(f) *A provision for bad and doubtful debts is to be created to the extent of 5% on sundry debtors.*

NOTES

Solution.

Trading and Profit and Loss Account of Mr. S. Kapur

for the year ended 31st March, 2003

Dr. *Cr.*

Expenses/Losses		*Amount Rs.*	*Revenue/Gain*		*Amount*
To Opening Stock		11,520	By Sales	1,97,560	
To Purchases	81,350		*Less* : Return	(–) 1,360	1,96,200
Less : Return	(–) 1,000	80,350			
To Carriage on Purchases		4,080	By Closing Stock		13,600
To Wages	20,960				
Less : Erection of a cycle shed	(–) 4,000	16,960			
To Fuel and Powers		9,460			
To Gross Profit transferred to P/L A/c		87,430			
		2,09,800			2,09,800
To Carriage Outward		6,400	By Gross Profit transferred from trading A/c		87,430
To Salaries	30,000				
Add : Outstanding	3,000	33,000			
To General expenses		6,000			
To Insurance	1,200				
Less : Pre-paid Insurance	170	1,030			
To Depreciation on :					
Machinery	4,000				
Patents	3,000	7,000			
To Provision for bad and doubtful debts		1,450			
To Net Profit transferred to Capital A/c		32,550			
		87,430			87,430

NOTES

Balance Sheet of Mr. S. Kapur

as on 31st March, 2003

Liabilities		*Amount* Rs.	*Assets*		*Amount* Rs.
Creditors		12,600	Cash in hand		1,080
Outstanding Salaries		3,000	Cash at Bank		5,260
Capital	1,42,000		Debtors	29,000	
Add : Net Profit	32,550		*Less* : Provision	1,450	
					27,550
	1,74,550		Insurance Prepaid		170
Less : Drawings	10,490		Closing Stock		13,600
		1,64,060	Building	60,000	
			Add : Cost of erection of a cycle shed	4,000	
					64,000
			Land		20,000
			Machinery	40,000	
			Less : Depreciation	4,000	
					36,000
			Patents	15,000	
			Less : Depreciation	3,000	
					12,000
		1,79,660			1,79,660

Note. Wages paid for erection of a cycle shed is capital expenditure. Cycle shed is a part of building. It will increase the value of building, so wages paid for construction of shed should be added to the value of building. As it has been wrongly included in the wages, so it should be subtracted from wages at the debit side of Trading account.

Illustration 10. *From the following Trial Balance of M/s Shradha & Sons as on 31st December, 2003, prepare Trading and Profit & Loss Account and Balance Sheet :*

Name of Accounts	*Dr. (Rs.)*	*Cr. (Rs.)*
Drawing and Capital	*18,000*	*80,000*
Purchases and Sales	*82,600*	*1,55,000*
Stock (1.1.2003)	*42,000*	
Return outward		*1,600*
Carriage Inward	*1,200*	
Wages	*4,000*	
Power	*6,000*	
Machinery	*50,000*	
Furniture	*14,000*	
Rent	*22,000*	
Salary	*15,000*	
Insurance	*3,600*	
8% Bank Loan		*25,000*
Debtors	*20,600*	
Creditors		*18,900*
Cash in hand	*1,500*	
	2,80,500	*2,80,500*

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Adjustments :

(a) *Closing stock Rs. 64,000.*

(b) *Wages Outstanding Rs. 2,400.*

(c) *Bad debts Rs. 600 and make Provision for bad and doubtful debts to be 5%.*

(d) *Rent is paid for 11 months.*

(e) *Loan from the bank was taken on 1st July, 2003.*

(f) *Provide depreciation on machine @ 10% & on furniture @ 5%.*

Solution.

Trading and Profit and Loss Account

for the year ended 31st December, 2003

Dr. *Cr.*

Particulars		*Amount Rs.*	*Particulars*	*Amount Rs.*
To Opening Stock		42,000	By Sales	1,55,000
To Purchases	82,600		By Closing Stock	64,000
Less : Returns	– 1,600	81,000		
To Power		6,000		
To Wages	4,000			
Add : Outstanding	2,400	6,400		
To Carriage Inward		1,200		
To Gross Profit c/d		82,400		
		2,19,000		2,19,000
To Rent	22,000		By Gross Profit b/d	82,400
Add : Outstanding	2,000	24,000		
To Salary		15,000		
To Insurance	3600			
Less : Prepaid	600	3,000		
To Depreciation on :				
Furniture	700			
Machinery	5,000	5,700		
To Interest on Bank Loan Outstanding		1,000		
To Bad debts		600		
To Provision for bad debts		1,000		
To Net Profit transferred to Capital A/c		32,100		
		82,400		82,400

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Balance Sheet of M/s Shradha & Sons

as on 31st December, 2003

Liabilities		Amount Rs.	Assets		Amount Rs.
Creditors		18,900	Cash in hand		1,500
Outstanding Expenses			Debtors	20,600	
Rent	2,000		*Less* : Bad debts	600	
Wages	2,400	4,400		20,000	
			Less : Provision for B/D	(1000)	19,000
8% Bank Loan	25,000		Closing Stock		64,000
Add : Unpaid Interest	1,000	26,000	Prepaid Insurance		600
			Machinery	50,000	
Capital	80,000		*Less* : Depreciation	5,000	45,000
Less : Drawings	18,000		Furniture	14,000	
	62,000		*Less* : Depreciation	700	13,300
Add : Net Profit	32,100	94,100			
		1,43,400			1,43,400

Notes. (*i*) Rent has been paid amounting to Rs. 22,000 for eleven months. It means that the rent for one month amounting to Rs. 22,000 ÷ 11 = Rs. 2,000 is still outstanding. This is why, it has been added to Rent at the debit side of P/L A/c and also shown as liability in the Balance sheet.

(*ii*) The Trial Balance does not contain any amount of interest on Bank Loan, which is undoubtedly due for six months *i.e.*, July 1, 2003 to Dec. 31, 2003 @ 8%. It amounts to

$$25{,}000 \times \frac{8}{100} \times \frac{6}{12} = \text{Rs. } 1{,}000$$ and treated as outstanding interest on loan.

(*iii*) Provision for Bad debts will be calculated on 20,600 – 600 = Rs. 20,000 @ 5%. It will amount to Rs. 1,000. This is based upon the logic that, why should provision be made on the amount which has been declared as bad.

PRESENTATION OF ADJUSTMENT

Adjustments at a Glance

Adjustments	*Journal Entry*	*Adjustment in Trading and P/L A/c*	*Adjustment in Balance Sheet*
1. **Closing Stock**	Closing Stock A/c Dr. To Trading A/c	Posted at the credit side of Trading A/c	Shown at the assets side
2. **Depreciation**	Depreciation A/c Dr. To Asset A/c	Posted at the debit side of P/L A/c	Shown as deducted from concerned assets

3. **Appreciation**	Asset A/c Dr. To Appreciation A/c	Posted at the credit side of P/L A/c	Shown as added to concerned asset
4. **Outstanding expenses**	Expenses A/c Dr. To Outstanding Expenses A/c	Added to the concerned expense at the debit side of P/L or Trading A/c	Shown at the liabilities side
5. **Prepaid expense**	Prepaid Expenses A/c Dr. To Expense A/c	Deducted from the concerned expense at the debit side of P/L A/c	Shown at the assets side
6. **Accrued income**	Accrued Income A/c Dr. To Income A/c	Added to the concerned income at the credit side of P/L A/c	Shown at the assets side
7. **Unearned income**	Income A/c Dr. *To Unearned Income A/c*	Deducted from concerned income at the credit side	Shown at the liabilities side
8. **Interest on capital**	Interest on Capital A/c Dr. To Capital A/c	Posted at the debit side of P/L A/c	Added to capital at the liabilities side
9. **Interest on drawings**	Drawings A/c Dr. To Interest on Drawings	Posted at the credit side of P/L A/c	Deducted from capital at the liabilities side
10. **Interest on investment**	Investment A/c Dr. To interest on Investment	Posted at the credit side of P/L A/c	Added to investment at the assets side
11. ***Interest on* loans (borrowed)**	*Interest on loans A/c* Dr. To Loan A/c	Posted at the debit side of P/L A/c	Added to loan at the liabilities side
12. **Interest on loans (advanced)**	Loans A/c Dr. To Interest on Loans A/c	Posted at the credit side of P/L A/c	Added to loan at the assets side
13. **Bad debts**	Bad Debts A/c Dr. To Debtors A/c	Posted at the debit side of P/L A/c	Deducted from debtors at the assets side
14. **Provision for bad debts**	P/L A/c Dr. To Provision for Bad debts A/c	Posted at the debit side of P/L A/c	Deducted from debtors at the assets side
15. **Provision for discount on debtors**	P/L A/c Dr. To Provision for discount on debtors	Posted at the debit side of P/L A/c	Deducted from debtors at the assets side
16. **Provision for discount on creditors**	Provision for Discount on creditors A/c Dr. To P/L A/c	Posted at the credit side of P/L A/c	Deducted from creditors at the liabilities side
17. **Accidental loss of stock**	Loss of Stock A/c Dr. To Trading A/c or To Purchases A/c	Deducted from Purchases or Posted at the credit side of Trading A/c and also at the debit side of P/L A/c	No Effect

18. **Accidental loss of goods (*If Insured*) (Partial admission of claim)**	Insurance Co. A/c Dr. Loss of Stock A/c Dr. To Trading A/c	Insurance Co. A/c will be shown with the amount of claim admitted by Co., loss of stock will be shown with the amount of the claim not admitted at the credit side of Trading A/c. Loss of the stock will also be shown at the debit side of P/L A/c	Insurance Co. A/c will be shown at the Assets side with the amount of claim admitted as debtor
19. **Loss of Assets by fire (*If not insured*)**	Loss by fire A/c Dr. To Asset A/c	Loss by fire A/c will be shown at the debit side of P/L A/c	Loss will be deducted from the concerned asset at the assets side
20. **Accidental loss of Assets (*if insured*) (Partial admission of claim)**	Insurance Co. A/c Dr. Loss by fire A/c Dr. To Assets A/c	Loss by fire A/c will be shown at the debit side of P/L A/c	Insurance Co. A/c will be shown at the assets side. Loss by fire A/c will be deducted from the Assets
21. **Outstanding Manager's commission**	P/L A/c Dr. To Outstanding manager's commission	Manager's commission A/c will be shown at debit side of P/L A/c	Shown at the liabilities side of Balance sheet
22. **Goods sent on sale or return basis treated as sales (cost of goods Rs. 6000 inclued in sales Rs. 8000)**	Sales A/c Dr. 8000 To Debtors A/c 8000 *and* Stock A/c Dr. 6000 To Trading A/c 6,000	Rs. 8000 will be deducted from sales and Rs. 6000 will be added to closing stock at the credit side of Trading A/c	Rs. 8,000 deducted from debtors and Rs. 6,000 added to stock at the assets side
23. **Goods taken by the proprietor for personal use**	Drawing A/c Dr. To Purchases A/c	Amount of goods taken by the proprietor will be deducted from purchases in Trading A/c	Amount of goods taken by the proprietor will be deducted from capital at the liabilities side.
24. **Goods given as charity**	Charity A/c Dr. To Purchases A/c	Deducted from purchase at the debit side of trading A/c	Deducted from capital at the liabilities side
25. **Goods distributed as free samples**	Advertising A/c Dr. or Free Samples A/c Dr. To Purchases A/c	Posted at the debit side of P/L A/c Also deducted from purchases A/c	No effect
26. **Wages paid for construction of building was debited to wages A/c**	Building A/c Dr. To Wages A/c	The amount will be deducted from wages at the debit side of Trading A/c	The amount will be added to building at the assets side

27. Goods in transit (Goods were not received although titles to goods were received)	Goods in Transit A/c Dr. To Supplier's A/c	No effect	Goods in transit A/c will be shown at the assets side. Supplier's A/c will be shown at liabilities side.
28. Remuneration *paid to employee* was debited to his personal A/c	Salaries A/c Dr. *To Employee's Personal A/c*	Added to salaries at the debit side of P/L A/c	Deducted from debtors at the assets side
29. Deferred Revenue *expenditure* paid for future benefits (*e.g.*, Advertisement expenditure)	(*i*) Advertising A/c Dr. To Bank (with total amount) (*ii*) P/L A/c Dr. To Advertising (with instalment amortised or written off)	Debited to P/L A/c (with the amortised value)	Shown at the assets side with unamortised amount.

2.9 SUMMARY

Financial Statements

Statements prepared at the end of Accounting Period to assess the financial status *i.e.*, Profit or loss and assets and liabilities of an enterprise are known as Financial Statements. Traditionally, these are known as Final Accounts. Financial statements are classified as 'Income Statement and Position Statement'. Traditional classification of Final Accounts are known as Trading and Profit & Loss A/c and Balance Sheet.

Trading Account

The statement prepared to ascertain the Gross Profit/Loss of the business enterprise is known as Trading A/c.

Gross Profit = Net Sales – Cost of goods sold.

Gross Loss = Cost of goods sold – Net Sales

Cost of goods sold = *Net Sales – Gross Profit Or*

Opening Stock + Net Purchases + Direct Expenses – Closing Stock.

Need/Importance and Purpose of Trading A/c

(1) Ascertaining gross Profit/Gross loss (2) Ascertaining ratio of direct expenses to gross profit (3) Ascertaining ratio between purchases and direct expenses (4) Calculation of cost of goods sold (5) Calculation of gross profit ratio (6) Comparison of stock with the stock of previous year (7) Comparing the actual performance with desired performance (8) Comparing actual performance with previous performance.

Gross Profit

The access of revenue genearted over cost of manufacture or purchase of a product is knwon as gross profit, whenever revenue falls short it is termed, as gross loss.

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Profit and Loss Account

Meaning. The income statement prepared with the items of expenses, losses income and gain with a view to ascertain amount of net profit or loss in the business is known as profit and loss account.

Need/Purpose and Importance of Profit and Loss A/c

(1) Knowledge of Net Profit/Loss (2) Ascertaining ratio between net profit and net sales (3) Calculation of expenses ratio to sales (4) Comparison of actual performance with desired performance (5) Maintaining provision and reserves (6) Determining future line of action.

Expenses not to be shown in Profit and Loss A/c

(1) Direct expenses (2) Capital expenditure (3) Personal income tax (4) Proprietor's private, domestic and personal expenses (5) Life insurance premium of proprietor's personal life.

Operating Fit Project

It is the profit earned through the normal operations and activities of the business. It is the profit earned before interest and tax (FBIT).

Operating profit = Gross profit – Operating expenses.

Net Profit

It is calculated by deducting non-operating expenses from operating profit and adding non-operating income.

Net profit = Operating profit – Non operating expenses + Non operating income.

Position statement or Balance Sheet

Statement prepared to ascertain the status of assets and liabilities of the business enterprise on a particular date is termed as Position Statement of Balance Sheet.

Features/Characteristics of Balance Sheet

(1) Balance Sheet is a statement (2) Prepared on a specified date (3) It is a statement of assets and liabilities (4) Knowledge about the nature of assets and liabilities (5) Knowledge of financial position (6) Assets and liabilities tally each other.

Points of difference between Profit and Loss Account and Balance Sheet

(1) Types of Account (2) Objectives (3) Sides (4) Nature (5) Balancing figure (6) Specific date/period (7) Types of expenditure.

Points to be considered while preparing Final Accounts

(1) Preparation of Trial Balance (2) Showing items from Trial Balance at one place (3) Posting from trial balance (4) Posting of expenses (5) Personal and Real accounts (6) Factory and office expenses (7) Treatment of rent, discount, interest and commission.

REVIEW QUESTIONS

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A. Very Short Answer Type Questions :

1. How will you show the following items :

   (*i*) Drawing ; (*ii*) Returns Inward (Bills returned) ; (*iii*) Returns outward.
2. Mention the stages of Final Accounts.
3. How will you treat expenses on acquiring goods ?
4. Where will you show goods in transit A/c ?
5. Give any two difference between Profit & Loss A/c and a Balance Sheet.
6. Where will you show unearned income in the financial statements, if it appear in the Trial Balance ?
7. How will you treat wages owing in Final Accounts if it appears in the Trial Balance ?
8. Name the account and its side, where from we may pick up the item of Net Loss. Also mention its treatment in the Balance Sheet.
9. What adjusting entry will be passed for the prepaid rent ?
10. What journal entry will you pass for the recovery of bad debts previously written off ?

B. Short Answer Type Questions :

1. Point out any three points of difference between Profit and Loss Account and Balance Sheet.
2. Mention the two formulae (except the preparation of trading Account) for the calculation of Gross Profit.
3. Explain briefly the object of Trading Account.
4. Describe briefly three objectives of preparing Profit and Loss A/c.
5. Explain briefly the two characteristics of position statement.
6. Name any three current assets and four fixed assets.
7. Mention items to be added to and deducted from capital at the liabilities side.
8. Mention situation in which purchases A/c is credited.

C. Long Answer Type Questions :

1. What do you mean by Final accounts ? What are its constituents ? Name them and briefly explain the purpose of each of them.
2. Explain the importance and purpose of final accounts.
3. Explain : (*a*) Current assets ; (*b*) Current liabilities : and (*c*) Working capital.
4. Explain the following statements :

   (*a*) Balance sheet is not an account but it is the list of assets and liabilities.

   (*b*) Balance sheet and profit and loss account are inter-dependent.
5. What do you mean by adjusting entries ? Why is it necessary to pass adjusting entries at the time of preparing final accounts ?
6. Why is it necessary to create provision for bad and doubtful debts ? How is it treated in final accounts ?
7. Explain the treatment of accidental loss of goods in the final accounts, if

   (*a*) Goods are not insured (*b*) Goods are insured and full claim is admitted by the Insurance Company.
8. Write short notes on the following :

   (*a*) Expenses owing (*b*) Unearned income (*c*) Discount on creditors (*d*) Interest on drawings (*e*) Unexpired insurance (*f*) Increase in the value of assets.
9. Explain the rationale of making adjustments at the time of preparing the final accounts ? Mention any three important adjustments that are made for the preparation of the profit and Loss Account.

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UNIT 3 ERRORS AND THEIR RECTIFICATION

★ STRUCTURE ★

3.1 Objectives
3.2 Introduction
3.3 Errors of Omission
3.4 Errors of Commission
3.5 Errors in the Subsidiary Books and Their Rectification
3.6 Errors of Principles
3.7 Treatment of Revenue Expenditure/Income
3.8 Errors in the Treatment of Proprietor's Withdrawal
3.9 Compensating Errors
3.10 Errors of Posting at Wrong Side of an Account
3.11 Suspense Account
3.12 Effects of Suspense Account on Profit
3.13 Rectification of Errors (*Before Ledger Accounts are Closed*)
3.14 Effects of Errors
3.15 Rectification of Errors (*After Final Accounts are Prepared*)
3.16 Summary

3.1 OBJECTIVES

At the end of this unit, you should be able to :

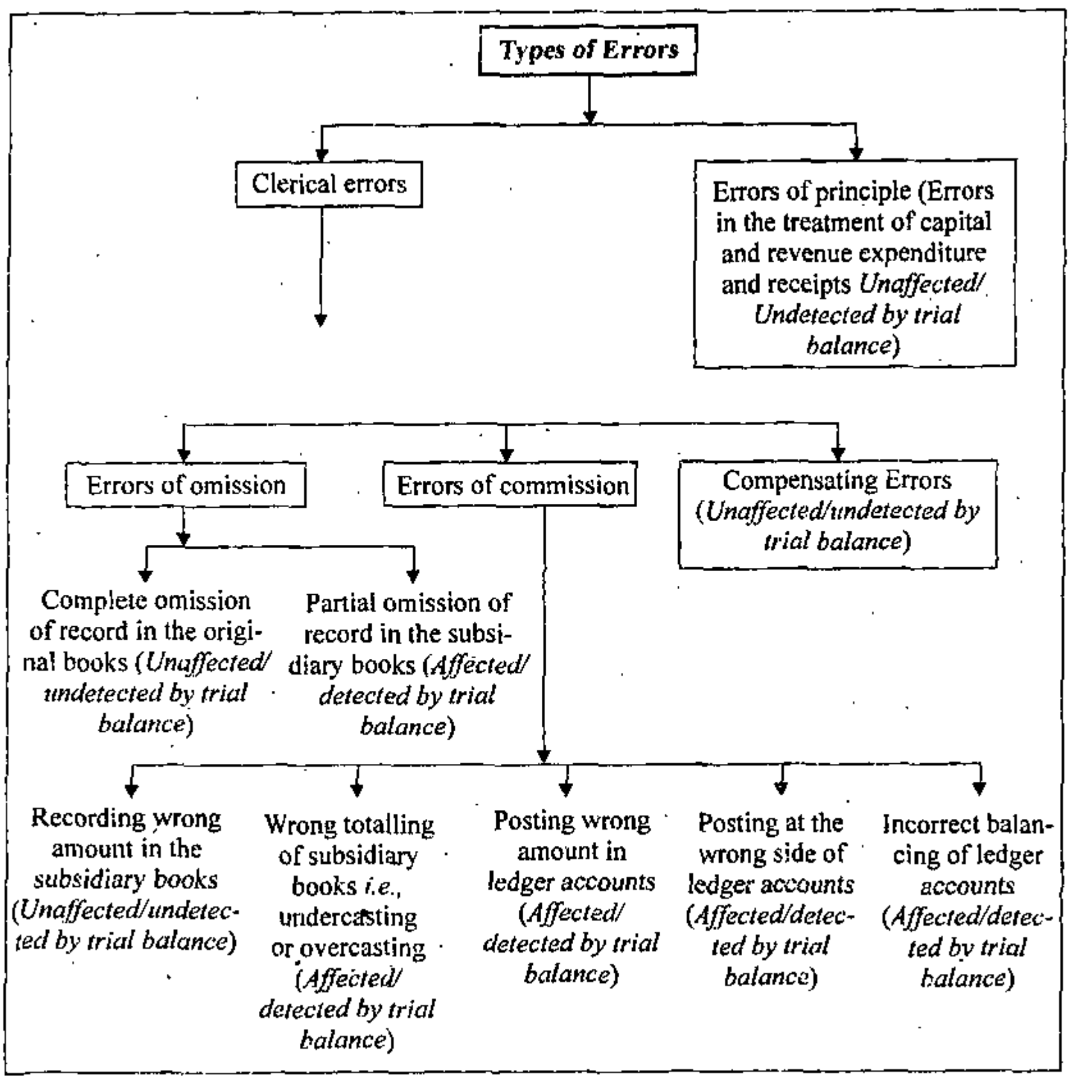
- Understand the meaning of errors and its different types.
- Understand the errors detected and undetected by Trial Balance.
- Locate errors in the Trial Balance.
- *Understand the errors of omission and commission and rectify them.*
- Understand errors of principles regarding capital and revenue expenditure and receipts and pass rectifying entries.
- Identify compensating errors and pass rectifying entries.
- Use Suspense Account appropriately in rectifying errors and prepare Suspense Account.
- Rectify errors before and after preparation of Final Accounts.
- Rectify errors regarding proprietors withdrawal.

3.2 INTRODUCTION

"To err is human". This old statement is also true for accounting also. We, as a human being are likely to commit mistakes of omission, commission and principles in maintaining books of accounts. We may omit the entire transaction from being recorded wholly or partially. We may commit mistakes in calculation, *i.e.*, addition, subtraction, division and *multiplication.* Mistakes may also be committed in carrying forward total from one page to other page, posting from subsidiary books to ledger accounts. Sometimes capital expenditure may be recorded as revenue expenditure or revenue expenditure may be recorded as capital expenditure. These mistakes are likely to be committed in the books of accounts.

Mistakes committed in the books of accounts must be rectified at the earliest. It should be noted that errors in accounts are not *rectified by removing mistakes by ink remover* or rubbing it off or by over-writing or cutting or even by tearing off the page. Once errors are committed, we boldly accept it and rectify the mistake by passing a rectifying entry. The rectified entry will neutralise the effect of wrong entry and also bring the correct effect of the transaction. Rectification of errors should be made at the earliest. While passing rectifying entry we will have to take *into consideration the nature and type of errors.*

TYPES OF ERRORS



3.3 ERRORS OF OMISSION

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Errors of omission is classified into two parts, *i.e.*, errors of complete omission and errors of partial omission :

(a) Errors of Complete Omission

The complete transaction escapes from being recorded. The accountant forgets to record these transactions in the subsidiary books or in the journal proper. Omission to record goods sold to Mohan or goods purchased from Ram, or goods returned by Wahid or goods returned to Brown in the subsidiary books and credit purchase of furniture in the journal proper are the examples of errors of complete omission.

Errors of complete omission can be rectified by passing the correct entry on the old assumption that "It is never too late to mend".

(b) Errors of Partial Omission

In case of partial omission, the transaction is recorded at the debit side of an account but corresponding credit is omitted to be recorded. For example, goods purchased from Fahim was recorded in the purchases book but omitted to be recorded in Fahim's personal account. In the same way, goods sold to Malik was recorded in the sales book but it was omitted from being recorded in the Malik's account. These errors are known as errors of partial omission.

Partial errors affect only one account, so they will be rectified by opening suspense account. These errors can also be rectified without opening suspense account. Rectification of errors of omission is explained with the help of the following illustration.

Illustration 1. *Rectify the following errors :*

1. Goods worth Rs. 2,000 returned by Keshwani were taken into stock but the transaction was not recorded in the books.

2. Goods of the value of Rs. 1,000 returned to Brown but omitted to record the transaction in the books of accounts.

3. Goods purchased from Darbara Singh was recorded in the purchases book but no entry was made in Darbara Singh's account. The purchases were worth Rs. 7,000.

4. Goods sold to Rao for Rs. 700 was not recorded in the Rao's account.

Solution.

Journal Entry

Date	*Particulars*	*L.F.*	*Amount* *Debit* *Rs.*	*Amount* *Credit* *Rs.*
1.	Returns Inward A/c Dr. To Keshwani's A/c (Being goods returned by Keshwani was not passed through books, now recorded)		2,000	2,000
2.	Brown's A/c Dr. To Returns Outward A/c (Being goods returned to Brown, omitted to record in the books, now recorded)		1,000	1,000

3.	Suspense A/c Dr. To Darbara Singh's A/c (Being purchases of goods from Darbara Singh was not recorded in Darbara Singh's A/c, now rectified)		7,000	7,000
4.	Rao's A/c Dr. To Suspense A/c (Being goods sold to Rao was not recorded in the Rao's A/c, now rectified)		700	700

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3.4 ERRORS OF COMMISSION

These errors may be regarding wrong totalling of subsidiary books or writing wrong amount in the subsidiary books or posting wrong amount in the ledger accounts or incorrect balancing of ledger accounts. These errors are also concerned with errors in calculation.

(*a*) Recording wrong amount in the subsidiary books

Sometimes transactions are recorded in the subsidiary books with wrong amount. For example, purchases of goods worth Rs. 1,000 from Ram was recorded in the purchases book with Rs. 100. The error has been committed in purchase book, so posting will be made at the credit side of Ram's account with Rs. 100 only. Both the debit record in the purchases book and credit posting at the credit of Ram's account has been with Rs. 100, so the error cannot be detected by trial balance. Rectification of error will require that correct entry with the amount short written or excess written be passed again.

(*b*) Wrong totalling of subsidiary books

Subsidiary books either show debit balance or credit balance. Purchases book, returns inward book and bills receivable book show debit balance. Sales book, returns outward book and bills payable book show credit balance. Errors in the subsidiary books may also be regarding totalling. Sometimes, we total short or undercast subsidiary books and sometimes we overcast them. Errors of undercasting and overcasting affect either debit or credit side so their rectification can be made by raising suspense account and also without raising suspense account. These errors are discovered by trial balance. If such errors of totalling in the subsidiary books are there, trial balance will not tally.

(*c*) Posting wrong amount in the ledger accounts

We prepare ledger accounts with the help of subsidiary books and journal proper. It is just possible that the wrong amount may be carried forward to ledger accounts. For example, sales of Rs. 2,000 to Mohan was correctly posted in the sales book but debited to Mohan's account with Rs. 200 only. Rectification will require that Mohan's account should be debited with Rs. 1,800 again. The error will be detected by trial balance because credit side has Rs. 2,000 (as per sales book) and the debit side of Mohan's accounts has only Rs. 200.

(*d*) Posting at the wrong side of ledger account

Sometimes posting from subsidiary books and journal proper may be made at wrong side. For example, goods worth Rs. 3,000 was returned by Sohan. The transaction was correctly recorded in sales return book but was posted at the debit side of Mohan. In case of sales return, debtors accounts are credited or posting from sales return book is made at the credit side of debtors account. This mistake will cause difference between the debit and credit total of trial balance with the amount, double of the original amount. The above errors will cause a difference of Rs. 6,000 in the balance. These errors are detected by trial balance.

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(e) Incorrect balancing of ledger accounts

If ledger accounts are not correctly balanced, there will be difference in the debit and credit total of the trial balance. Rectification of the error will require that the specific account should be debited in case debit balance is cast short. In the same way, the specific account will be credited if the credit balance is short cast.

ERRORS IN THE SUBSIDIARY BOOKS AND THEIR RECTIFICATION

Errors may also be committed in subsidiary books, such as purchases book, sales book, purchases return and sales return books. Common errors in the subsidiary books may be categorised as under :

1. Errors of omission—forgetting to record the entire transaction in the subsidiary books.
2. Overcasting in subsidiary books.
3. Undercasting in subsidiary books.

Errors of complete omission can be rectified by passing the correct entry which was omitted to be passed as the old proverb goes. "It is never too late to mend". For example, if goods returned by Mohan were taken into stock but no entry was passed through books, the rectification of the transaction will be to pass the correct entry for return of goods.

Subsidiary books do not have both the debit and credit sides. They simply have either debit or credit balance. The mistakes in subsidiary books are, therefore, restricted to totals only. Sometimes it may be totalled short (undercast) or totalled more (overcast). The mistake can be rectified by taking into consideration the type and nature of subsidiary book. Errors of undercasting and overcasting in the subsidiary books are discussed in detail as under :

Purchases Book

It records credit purchases of goods only. Whenever goods are purchased, purchases account is debited. In all cases of purchases, goods comes into the business, so purchases account has to be debited. It is an accepted accounting truth that *purchases book has a debit balance.* Undercasting purchase book will mean that purchases book has been added short or technically debited short. The rectification of the error will be done by debiting purchases account. If the purchases book has been overcast, it will mean that it has been totalled more or debited more. For rectification of this error, purchases account will be credited which will reduce the total of the purchases book. The error affects only one account, *i.e.,* purchases account in both the cases of undercasting or overcasting, so the rectification can be made in the following ways :

Illustration 2. *Rectify the following errors :*

1. Purchases book was undercast by Rs. 1 000.

2. Purchases book was overcast by Rs. 10

Solution. (*a*) Without raising suspense account

1. Following posting will be made at the debit side of purchases account.

   "To undercast of the purchases book" Rs. 1,000.

2. Following posting will be made at the credit side of the purchases account.

   "By overcast of the purchases book" Rs. 100.

(*b*) By raising suspense account :

1.	Purchases A/c	Dr.	1,000	
	To Suspense A/c			1,000
	(Being undercasting of purchases book, now rectified)			
2.	Suspense A/c	Dr.	100	
	To Purchases A/c			100
	(Being purchases book overcast, now rectified)			

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Sales Book

Sales book records only credit sale of goods. It does not record cash sales of goods or credit sales of assets. Sales account is always credited for sale, so the *sales book always shows a credit balance*. As the sales book has got only credit side, the mistakes therein are restricted to overcasting or undercasting. In case of undercasting, the total of sales book is short cast or in other words credited short. Its rectification will be to credit sales account or make a posting at the credit side of the sales account. In the same way, overcasting of sales book will mean overcrediting the sales, so for rectification of the error, sales account will be debited to set right the amount excess credited. The mistake of undercasting or overcasting the sales book can be rectified by posting at the debit or credit side of the sales account or by opening suspense account. Rectification is illustrated as under.

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

1. Sales book was undercast by Rs. 150.

2. Sales book was overcast by Rs. 100.

Solution. Without opening suspense account

1. Following posting will be made at the credit side of sales account.

   "By undercast of sales book" Rs. 150.

2. Following posting will be made at the debit of the sales account.

   "To overcast of sales book" Rs. 100.

By raising suspense account

1.	Suspense A/c	Dr.	150	
	To Sales A/c			150
	(Being undercasting of sales book, now rectified)			
2.	Sales A/c	Dr.	100	
	To Suspense A/c			100
	(Being overcasting of sales book, now rectified)			

Purchases Return or Returns Outward Book

Return of goods, purchased on credit is recorded in the purchases return book. Purchases book shows a debit balance, so the purchases return book will definitely show a

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credit balance, because purchases return is entirely reverse to purchases. Undercasting in the purchases return book will mean under crediting *or crediting short. In order to rectify* the mistake, we shall be crediting purchases return account or returns outward account. In the same way, overcasting in the returns outward book will require purchase return account to be debited. The rectification of error is illustrated as under :

Illustration 4. *Rectify the following errors :*

1. Returns outward book was undercast by Rs. 1,000.

2. Purchases return book was overcast by Rs. 100.

Solution. Without raising suspense account

1. Following posting will be made at the credit side of purchases return account.

   "By undercast of returns outward book" Rs. 1000.

2. Following posting will be made at the debit side of the purchases return account.

   "To overcast in the purchases return book" Rs. 100.

By raising suspense account

1.	Suspense A/c	Dr.	1,000	
	To Purchases return A/c			1,000
	(Being undercasting of purchases return book, now rectified)			
2.	Purchases Return A/c	Dr.	100	
	To Suspense A/c			100
	(Being purchases return book overcast, now rectified)			

Sales Return or Returns Inward Book

Sales return means the return of goods to us by our debtors. *Sales return book shows a debit balance* as it is reverse to the sales, which has credit balance. Error of undercasting in the sales return book is underdebiting it or debiting it with lesser amount. The rectification of this error will require debiting *sales returns account. In the same way, we shall* be crediting sales return account for overcasting. The mistake of undercasting and overcasting can be rectified without raising suspense account or by opening suspense account. Rectification of these errors is illustrated as under :

Illustration 5. *Rectify the following errors :*

1. Sales return book was undercast by Rs. 100.

2. Returns inward book was overcast by Rs. 1,000.

Solution. Without raising suspense account

1. Following posting will be made at the debit side of sales return account.

   "To undercast of sales return book" Rs. 100.

2. Following posting will be made at the credit side of sales return account.

   "By overcast of sales return book" Rs. 1,000.

By raising suspense account

1.	Returns Inward A/c	Dr.	100	
	To Suspense A/c			100
	(Being returns inward book undercast, now rectified)			

2. Suspense A/c	Dr.	1,000	
To Returns Inward A/c			1,000
(Being returns Inward book overcast, now rectified)			

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Bills Receivable Book

Bills receivable book records the details of the bills drawn by us on our debtors. The bill is accepted by our debtors. After accepting the bill 'debtors' account is replaced by an other assets known as bills receivable accounts. It shows a debit balance like other assets. Undercasting bills receivable book in this way, will mean writing lesser amount at the debit side, so the error can be rectified by debiting bills receivable account. In the same way, overcasting of the book will require crediting bills receivable account. The mistake can be rectified without raising suspense account or by raising suspense account. Rectification is illustrated as under :

Illustration 6. *Rectify the following errors :*

1. Bills receivable book was undercast by Rs. 200.

2. Bills receivable book was overcast by Rs. 300.

Solution. Without raising suspense account

1. Following posting will be made at the debit side of the bills receivable account. "To undercast in the bills receivable book" Rs. 200.
2. Following posting will be made at the credit side of bills receivable account. "By overcast in the bills receivable book" Rs. 300.

By raising suspense account

1. Bills receivable A/c	Dr.	200	
To Suspense A/c			200
(Being bills receivable book undercast, now rectified)			
2. Suspense A/c	Dr.	300	
To Bills receivable A/c			300
(Being overcasting of bills receivable book, now rectified)			

Bills Payable Book

Bills payable are drawn by our creditors and accepted by us. It is our liability and has credit balance. Undercasting in the bills payable book will mean crediting it with lesser amount, so while rectifying the error bills payable account will be credited. In case of overcasting, bills payable book would have been credited with more amount, so rectification will require bills payable account to be debited. The error can be rectified without raising suspense account and also by raising suspense account which is illustrated as under :

Illustration 7. *Rectify the following errors :*

1. Bills payable book was undercast by Rs. 1,000.

2. Bills payable book was overcast by Rs. 600.

Solution. Without raising suspense account

1. The following posting will be made in case of undercasting at the credit side of bills payable account.

"By undercast in bills payable book" Rs. 1,000.

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2. The following entry will be made at the debit side of bills payable account.

"To overcast in bills payable book" Rs. 600.

By raising suspense account

1.	Suspense A/c	Dr.	1,000	
	To Bills payable A/c			1,000
	(Being bills payable book undercast, now rectified)			
2.	Bills Payable A/c	Dr.	600	
	To Suspense A/c			600
	(Being bills payable book overcast, now rectified)			

It should be noted that if errors are located before ledger accounts are closed, rectification will be made without raising suspense account. If errors have been located after trial balance has been prepared and difference placed in the suspense account, rectification of errors will be made by opening suspense account. In examination questions, it is not generally mentioned whether errors have been located before preparation of trial balance or after the preparation of trial balance. In such cases, errors are assumed to have been located after the preparation of trial balance and rectification through suspense account is advised. It will be different treatment if students are instructed to rectify errors without raising suspense account.

3.6 ERRORS OF PRINCIPLES

Sometimes errors are committed due to incomplete knowledge of accounting. The accountant fails to discriminate between capital and revenue expenditure. For example, payment of wages for construction of building may be wrongly debited to wages account instead of building account or purchases account may be debited in case of purchasing machinery. These mistakes may also be due to faulty treatment of revenue receipts and capital receipts. For example, crediting sales account, instead of furniture account in case of sale of furniture.

These mistakes do not affect trial balance, because both the debit and credit record is complete. As double entry record is complete, trial balance will tally inspite of the error.

Treatment of Capital and Revenue Expenditure

Capital Expenditure. These expenses are incurred for acquiring fixed assets such as building, plant, machinery, furniture and vehicles etc. Assets acquired are not meant for sales. These are purchased to retain and use in the business. This expenditure increases profit earning capacity of the business. It is causally incurred and does not have regularity in its payment.

The important feature of this expenditure from accounting point is that we debit assets account which have been acquired not expenses account. In case, expenses account are debited it will be an error of principle and require to be rectified. Accounting treatment of capital expenditure is illustrated as under :

Building account will be debited in the following cases :

1. Purchases of building.

2. Purchases of raw material for the construction of building.

3. Payment of wages for construction of building.
4. Payment of wages for addition to building.
5. Payment of wages for extension of building.
6. Payment of wages for erection of shed or canteen or verandah in the building.
7. Repair to second hand building.
8. Payment for registration fee or other expenses while purchasing building.

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In the above cases, if wages account or certain other expenses accounts are debited instead of building account, it will be an error of principle and will require to be rectified.

Illustration 8. *Rectify the following errors :*

1. *Purchases of building was passed through purchases book amounting to Rs. 80,000.*
2. *Wages paid for construction of building was debited to wages account with Rs. 20,000.*
3. *Expenses of errection of shed was debited to trade expenses account amounting to Rs. 3,000.*
4. *Wages paid for extension of building was debited to wages account amounting to Rs. 7,000.*
5. *Repair to second hand building was debited to repairs account with Rs. 18,000.*
6. *Materials purchased for construction of building was debited to purchases account amounting to Rs. 28,000.*
7. *Expenses for construction of new canteen were debited to miscellaneous expenses account with Rs. 1,600.*

Solution.

Rectified Journal Entries

Date	*Particulars*	*L.F.*	*Amount* Debit Rs.	*Amount* Credit Rs.
1.	Building A/c Dr. To Purchases A/c (Being purchase of building wrongly debited to purchase account, now rectified)		80,000	80,000
2.	Building A/c Dr. To Wages A/c (Being wages paid for construction of building was wrongly debited to wages account, now rectified)		20,000	20,000
3.	Building A/c Dr. To Trade expenses A/c (Being expenses for erection of shed was wrongly debited to trade expenses account, now rectified)		3,000	3,000
4.	Building A/c Dr. To Wages A/c (Being payment of wages for extension of building was wrongly debited to wages account, now rectified)		7,000	7,000

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5.	Building A/c Dr. To Repairs A/c (Being repairs to second hand building was wrongly debited to repairs account, now rectified)		18,000	18,000
6.	Building A/c Dr. To Purchases A/c (Being material purchased for construction of building was wrongly debited to purchases account, now rectified)		28,000	28,000
7.	Building A/c Dr. To Miscellaneous Expenses A/c (Being cost of construction of new canteen wrongly debited to miscellaneous expenses account, now rectified)		1,600	1,600

Machinery account will be debited in the following cases :

1. Purchases of machinery.
2. Repair to second hand machinery.
3. Payment of freight and cartage on new machinery.
4. Payment of installation or erection charges on the new machinery.

In this way, furniture account, vehicles account and other assets accounts are debite when they are acquired or purchased. Expenses incurred as freight, cartage and any oth expenses which add to the cost of the assets are debited to the assets account. When an c or second hand asset is purchased, major repairs therein is must. Such repairs will make t asset intact and thus will add to its cost. This is why, assets account is debited. If repairs assets are made as a routine, simply to maintain the efficiency of the asset, so repairs accou will be debited.

Amount received from sale of assets are known as capital receipts. In case of sale assets, assets accounts are credited, crediting sales account for sale of assets will be incorre

3.7 TREATMENT OF REVENUE EXPENDITURE/INCOME

This expenditure is incurred to meet day-to-day requirement of the business such payment of wages, salaries, rent and insurance etc. It is also incurred for the maintenance assets such as repairs, renewals and maintenance of building, plant, machinery, furnitu and vehicles etc. Regularity in the payment of expenditure is its distinct feature. Expens are usually incurred throughout the year. These expenses do not add to profit earning c pacity of the business. These are simply incurred as a part of routine business activit These expenses accounts are debited, when they are paid. For example, it will be incorre to debit the workers' accounts in case of making payment of wages to them. In this wa salaries account is debited for making payment of salaries. It will be incorrect to debit t account of the employee/who has been receiving salaries. In the same way, while maki payment of rent to landlord, rent account will be debited not the landlord's account. should be noted that when expenses are paid, concerned expenses account will be debit and not account of person or parties whom payment is made.

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In the same way, regular receipt of income as routine business receipt is revenue in-ome, such as receipt of commission, interest, discount rent etc. While passing Journal ntry, Revenue A/c will be credited instead of the person or party from whom it has been eceived.

Illustration 9. Rectify the following errors :

1. Payment of wages to Ram Lal was debited to his personal account with Rs. 3,000.

2. Payment of salaries to Srikant, the manager amounting to Rs. 7,000 was debited to rikant's account.

3. Rent paid to landlord was debited to his personal account with Rs. 2,000.

4. Interest received from Rajeev was credited to Rajeev's account with Rs. 700.

5. Commission received from M/s Sharma Bros., was credited to their account with Rs. 300.

6. Repair charges amounting to Rs. 1,000 were paid to Salim, the motor mechanic were debited to his account.

Solution.

Rectified Journal Entries

Date	Particulars	L.F.	Amount	
			Debit Rs.	Credit Rs.
1.	Wages A/c Dr. To Ram Lal's A/c (Being wages paid to Ram Lal wrongly debited to his account, now rectified)		3,000	3,000
2.	Salaries A/c Dr. To Srikant's A/c (Being payment of salaries to Srikant was wrongly debited to his personal account, now rectified)		7,000	7,000
3.	Rent A/c Dr. To Landlord's Personal A/c (Being payment of rent to landlord was wrongly debited to his personal account, now rectified)		2,000	2,000
4.	Rajeev's A/c Dr. To Interest A/c (Being interest received from Rajeev was wrongly credited to Rajeev's account, now rectified)		700	700
5.	M/s Sharma Bros. A/c Dr. To Commission A/c (Being commission received from M/s. Sharma Bros. was wrongly credited to their account, now rectified)		300	300
6.	Repairs A/c Dr. To Salim's A/c (Being repair charges paid were wrongly debited to Salim, the mechanic's account, now rectified)		1,000	1,000

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Explanation. In case of 1, 2, 3 and 6th error, personal accounts have been wrong debited for expenses paid instead of specific expense account. This is why, expenses a counts have now been debited (which should have been correctly done) and personal a count credited to neutralise the effect of these accounts unnecessarily debited. In the sar way, in case of 4th and 5th errors personal accounts have been debited and income accou credited.

3.8 ERRORS IN THE TREATMENT OF PROPRIETOR'S WITHDRAWAL

It is a common practice that proprietors of the business withdraw funds or goods fro the business for their personal and domestic use. Sometimes they avail of the services business assets themselves, such as use of business car for private purpose. Private asse may also be purchased and payment made through business. Certain equipments many al be purchased for proprietor's son, daughter and wife etc. All these payments on account the proprietor are termed as withdrawals and charged to proprietor account. We use th term drawings account for all the withdrawal made by the proprietor.

Drawings account will be debited in the following cases :

1. Amount withdrawn by the proprietor for personal or private use.
2. Goods taken by the proprietor from the business for domestic use.
3. Payment for the rent of proprietor's residence.
4. Payment for the use of business car, vehicles and equipments for private purpose
5. Purchasing certain equipments such as calculator, pocket transistor etc., for pro prietor's son, daughter and other relatives.

In the above cases 'drawings account' will be debited. It will be wrong and incorrect t debit other accounts. If any other account, except drawings account has been debited it wi be an error and will require to be rectified. It is common error to debit trade expense account or sundry expenses account or miscellaneous expenses account instead of drav ings A/c. The error needs rectification.

Illustration 10. *Rectify the following errors :*

1. Amount of Rs. 2,000 withdrawn by the proprietor for personal use was wrongl debited to trade expenses account.

2. Mohan & Sons, dealers in furniture, took a sofa set from the firm for their drawin room. The cost of the sofa was Rs. 4,000. The transaction was not recorded in the books.

3. Pocket transistor purchased for proprietor's son was debited to sundry expense account. The price of transistor was Rs. 400.

4. Business car is used by the proprietor for his personal trip to Nainital. Petrol charge amounting to Rs. 1,150 were debited to car expenses account.

5. Rent amounting to Rs. 3,000 was paid for proprietor's residence. The amount wa debited to rent account.

6. Purchased an air ticket for proprietor's daughter visiting London for higher studies Charges amounting to Rs. 5,000 were paid by the business and debited to travelling ex penses account.

7. Paid Rs. 300 to Atma Ram Dubey, the purohit of proprietor's family for performing marriage of proprietor's son was debited to his personal account.

Solution.

Date	Particulars	L.F.	Amount Debit Rs.	Amount Credit Rs.
1.	Drawing A/c Dr. To Trade expenses A/c (Being withdrawal by the proprietor was debited to trade expenses account, now rectified)		2,000	2,000
2.	Drawings A/c Dr. To Purchases A/c (Being omission of an entry regarding sofa set taken by the proprietor for his residential use, now rectified)		4,000	4,000
3.	Drawings A/c Dr. To Sundry expenses A/c (Being purchases of pocket transistor for proprietor's son was wrongly debited to sundry expenses account, now rectified)		400	400
4.	Drawings A/c Dr. To Car expenses A/c (Being petrol charges for private trip to Nainital wrongly debited to car expenses account, now rectified)		1,150	1,150
5.	Drawings A/c Dr. To Rent A/c (Being rent of proprietor's residence was wrongly debited to rent account, now rectified)		3,000	3,000
6.	Drawings A/c Dr. To Travelling Expenses A/c (Being air charges for the journey of proprietor's daughter wrongly to travelling expenses account, now rectified)		5,000	5,000
7.	Drawings A/c Dr. To Atma Ram Dubey's A/c (Being payment to Atma Ram Dubey for performing marriage ceremony of proprietor's son wrongly debited to his personal account, now rectified)		300	300

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3.9 COMPENSATING ERRORS

There may be certain cases, where the effect of an error may be neutralised by an other wrong error. For example, goods sold to Mohan for Rs. 1,000 was posted to the debit side of Mohan's account with Rs. 100 only. The error will reduce the debit total of the trial balance by Rs. 900. Per chance, receipt of Rs. 1,000 from Shyam was wrongly credited to Shyam's account by Rs. 100. Here, Rs. 900 have been written short at the credit side. The

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error will reduce Rs. 900 from the credit side of trial balance. The first error reduced debit total by Rs. 900 and the second error also reduced credit total by Rs. 900. Both the errors neutralised the effect of each other. The error will not affect the total of trial balance. It will not be detected by trial balance.

3.10 ERRORS OF POSTING AT WRONG SIDE OF AN ACCOUNT

Posting to ledger accounts is made through subsidiary books and journal proper. The *total of purchases book, returns inward book and bills receivable book is posted to the debit* side of their account. Posting is made at the credit side of the parties accounts which appear in these books. The mistake may be committed in posting to the debit side of parties account, who have supplied goods to us or returned goods to us or accepted our bill. In the same way, it will be wrong to make posting at the credit side of the parties account appearing in the sales book or returns outward book or bills payable book.

Rectification of posting at the wrong side of an account is made with the total of the correct and wrong amount. For example, Mohan's account which was to be debited with Rs. 205 for goods sold to him has been wrongly credited. In this case, mistake is worth Rs. 205 + 205 = 410, so Mohan's account will be debited with Rs. 410 in the rectified entry. Rs. 205 for not debiting to Mohan's account with this amount and Rs. 205 for crediting Mohan's account which should have been debited. Suppose you are asked to go ten steps right but you go ten steps left, instead of going right. Now you will have to walk twenty steps to obey the original instruction. Suppose it again that instead of going ten steps right you go seven steps left, *now you will have to go 10 + 7 = 17 steps to obey the original instruction.* Rectification of these errors is illustrated with the following examples :

Illustration 11. *Rectify the following errors :*

1. Rent amounting to Rs. 900 paid was credited to rent account.

2. Rent amounting to Rs. 770 was received but was debited to rent account with Rs. 77.

3. Goods worth Rs. 650 were returned to Azhar. It was correctly recorded in the returns outward book but was credited to Azhar's account.

4. Discount amounting to Rs. 70 were allowed to Mohan. It was correctly entered in the cash book but credited to discount received account.

5. Goods amounting to Rs. 1,100 were purchased from Kiran Rai but it was posted to the debit side of her account with Rs. 110.

6. Goods returned by Gavaskar were taken into stock. The return was recorded in the sales return book with Rs. 440 but it was written at the debit side of Gavaskar's account.

Solution.

Date	Particulars	L.F.	Amount Debit Rs.	Amount Credit Rs.
1.	Rent A/c Dr. To Suspense A/c (Being rent paid was wrongly credited to rent account, now rectified)		1,800	1,800
2.	Suspense A/c Dr. To Rent A/c (Being rent received amounting to Rs. 770 was debited to rent account with Rs. 77, now rectified)		847	847
3.	Azhar's A/c Dr. To Suspense A/c (Being rectification of goods returned to Azhar but wrongly credited him)		1,300	1,300
4.	Discount Allowed A/c Dr. Discount Received A/c Dr. To Suspense A/c (Being discount allowed was credited to discount received account, now rectified)		70 70	140
5.	Suspense A/c Dr. To Kiran Rai's A/c (Being rectification of purchases from Kiran Rai wrongly debited to her account)		1,210	1,210
6.	Suspense A/c Dr. To Gavaskar A/c (Being goods returned by Gavaskar were debited to him, now rectified)		880	880

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Notes. In all the above cases the amount of journal entry has been ascertained by adding the correct amount of the transaction with the amount of wrong posting. In case the wrong posting at the wrong side has been made with the same amount, the rectified journal entry will be made with the double amount.

Errors of recording in incorrect subsidiary books

Sometimes errors are committed, when the transaction is recorded in an incorrect subsidiary book. Purchases of goods on credit should be recorded in the purchases book but it may wrongly be recorded in the sales book. Sales of goods on credit may be wrongly recorded in purchases book. In the same way, the transaction of bills receivable book may be wrongly recorded in the bills payable book. The error involves two subsidiary books, the one in which posting has not been made and the other wherein posting has been wrongly made. Personal accounts may also be involved, if correct posting has not been made in the personal account. Rectification of these errors is illustrated as under :

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Illustration 12. *Rectify the following errors :*

1. Goods sold to Mohan for Rs. 3,700 was wrongly passed through purchases book.

2. Goods sold to Mohan for Rs. 3,700 was wrongly passed through purchased book but correctly posted at the debit side of Mohan's account.

3. Goods purchased from Masood for Rs. 300 was passed through sales book.

4. Goods purchased from Masood for Rs. 300 was passed through sales book but correctly credited to Masood's account.

5. Goods returned by Kapil Dev. for Rs. 150 were passed through returns outward book.

6. Bills drawn on Ayub for Rs. 2,000 was passed through bills payable book.

7. Bills payable worth Rs. 1,500 accepted in favour of Snedon, was passed through bills receivable book with Rs. 150 and Snedon's account was correctly debited.

8. Goods returned to Hirwani for Rs. 600 was passed through sales book.

9. Goods purchased from Ram Babu for Rs. 110 was passed through return inward book.

Solution.

Date	*Particulars*		*L.F.*	*Amount Debit Rs.*	*Amount Credit Rs.*
1.	Mohan's A/c	Dr.		7,400	
	To Purchases A/c				3,700
	To Sales A/c				3,700
	(Being sales of goods to Mohan wrongly passed through purchases book, now rectified)				
2.	Suspense A/c	Dr.		7,400	
	To Sales A/c				3,700
	To Purchases A/c				3,700
	(Being goods sold to Mohan, wrongly passed through purchases book but correctly debited to Mohan's account, now rectified)				
3.	Purchases A/c	Dr.		300	
	Sales A/c	Dr.		300	
	To Masood A/c				600
	(Being goods purchased from Masood wrongly passed through sales book, now rectified)				
4.	Purchases A/c	Dr.		300	
	Sales A/c	Dr.		300	
	To Suspense A/c				600
	(Being goods purchased from Masood wrongly passed through sales book but correctly credited to Masood, now rectified)				

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5.	Returns Inward A/c Dr. Returns Outward A/c Dr. To Kapil Dev A/c (Being goods returned by Kapil Dev wrongly passed through purchases return book, now rectified)	150 150	 300
6.	Bills Receivable A/c Dr. Bills Payable A/c Dr. To Ayub A/c (Being bills drawn on Ayub was passed through bills payable book, now rectified)	2,000 2,000	 4,000
7.	Suspense A/c Dr. To B/P A/c To B/R A/c (Being acceptance of B/P was recorded in the bills receivable book, now rectified)	1,650	 1,500 150
8.	Sales A/c Dr. To Purchases Return A/c (Being goods returned to Hirwani was wrongly passed through sales book, now rectified)	600	 600
9.	Purchases A/c Dr. To Returns Inward A/c (Being goods purchased from Ram Babu was wrongly passed through returns inward book, now rectified)	110	 110

Explanation. It should be noted that an error in the subsidiary book means an error also in the personal accounts of the parties concerned. For example, if purchases from Ram Das Gupta has not been recorded in the purchases book, it will also mean that it has not been credited to the account of Ram Das Gupta too. If this transaction has been recorded in the sales book, it will also mean that Das Gupta's account must have been debited through sales book. While rectifying this mistake, purchase account will be debited because it was omitted to be debited, sales account will also be debited to neutralise the effect of it being incorrectly and unnecessarily credited. Das Gupta's account which should have been credited through purchases book has been wrongly debited through sales book. It is, therefore, necessary that Das Gupta's account should now be credited with double amount.

In certain cases, it is specifically mentioned that the mistake has been committed in the subsidiary book and parties accounts have been correctly posted. In these cases, rectification will be made in the subsidiary books only. Parties accounts need not be rectified. For example, purchases of goods from Azhar for Rs. 700 was passed through sales book but Azhar's account was correctly credited. Azhar's account will neither be debited nor credited in the rectifying entry, because there is no mistake in it. While rectifying this error purchase account will be debited, because it was not debited by mistake. Sales account will also be debited because it was unnecessarily credited. As both purchases and sales accounts have been debited and there is no other account to be credited, suspense account will be credited in the rectifying entry.

In certain cases, transaction is omitted from a subsidiary book having debit balance and by mistake entered in an other subsidiary book having also debit balance, it will be assumed that parties accounts have been posted correctly. This fact has been illustrated in the errors

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numbers 8 and 9. In the 8th error goods returned to Hirawani was posted to sales book. Hirawani's account which should have been debited through purchases return book has still been debited through sales book. Hirawani's account will, therefore be neither debited nor credited in the rectifying entry. While rectifying the error purchases return account will be credited because it was not credited and sales account will be debited because it was unnecessarily credited. Recording in the sales book means that sales account has been credited.

3.11 SUSPENSE ACCOUNT

Meaning of Suspense Account

While maintaining books of accounts, we are likely to commit certain errors of omission *or principles or errors in* calculation. In case of certain errors, the debit and credit side of trial balance do not tally each other. As final accounts are to be presented on the closing day of the accounting period, we cannot wait for long to discover mistakes and delay preparation of final accounts. It is, therefore, necessary that certain temporary measures should be adopted to overcome the problem. We, therefore, transfer the difference in the trial balance to '*Suspense Account' which is an imaginary account is used as temporary solution to the problem.* Later on, accounting treatment of transactions are checked and errors located. These errors are rectified. After the rectification of all errors, suspense account is automatically closed.

If the errors are detected before closing ledger accounts, we may rectify these errors by making a posting at the debit or credit side of the concerned account, wherever it is necessary. These errors will not be rectified by opening suspense account. It may be noted that Suspense A/c is used to rectify those errors, which have been located after Trial Balance has been prepared.

If errors are detected after the ledger accounts are closed, trial balance prepared and the difference transferred to suspense account, rectification of errors will be made through suspense account.

Treatment of Suspense A/c Balance

Suspense A/c is prepared after the Trial balance is prepared. In case the debit and credit side of the Trial Balance does not tally, the difference is temporarily transferred to Suspense Account. After the preparation of Trial balance, thorough checking of books of accounts is made. Mistakes are detected and rectified. If all the mistakes are rectified the Suspense Account is closed and no balance is left. Therefore, the question of its transfer anywhere does not arise.

If all errors are not rectified, Suspense A/c will show balance. In case the debit side of Suspense A/c exceeds the credit side, the excess is known as Debit balance, which is shown at the Assets side of the balance sheet. In case credit side is more than the debit side the difference is known as credit balance and shown at the liabilities side of the Balance Sheet.

After the Balance Sheet is prepared showing debit or credit balance of Suspense A/c, efforts are continued to detect or rectify the errors.

3.12 EFFECTS OF SUSPENSE ACCOUNT ON PROFIT

Suspense account has negative impact on the profit and loss account. This is because, suspense account consists of unidentified errors in the accounting system. If these errors are not identified then they will be either debited or credited to the profit and loss account which may increase or decrease profit figures of the company. Ideally suspense account should not be maintained as it indicates faulty accounting systems of the company. Even if there is a suspense account which has certain amount it needs to be throughly investigated and corrected otherwise it will affect the profit figure of the company.

Illustration 13. *A book-keeper while balancing his books found that there was a difference of Rs. 86.12 in the trial balance. Being required to prepare the final accounts he placed this difference to a newly opened suspense account, which was carried forward to the next year when the following errors were discovered :*

(*a*) *Goods bought from a merchant for Rs. 5.31 had been posted to the credit of his account as Rs. 55.*

(*b*) *A dishonoured bill receivable for Rs. 200 returned by the bank had been credited to bank account and debited to B/R Account.*

(*c*) *An item of Rs. 10.63 entered in the sales returns book has been posted to the debit of the customer who returned the goods.*

(*d*) *Sundry items of plant sold for Rs. 260 had been entered in the sales book, the total of that book had been posted to sales account.*

(*e*) *Rs. 60 owing by a customer had been omitted from the schedule of sundry debtors.*

(*f*) *Rs. 2.31 discount received from a creditor had been duly entered in his account, but not posted to discount account.*

Give journal entries necessary to correct these errors and prepare the suspense account.

Solution.

Rectifying Journal Entries

Date	Particulars		L.F.	Amount Debit Rs.	P	Amount Credit Rs.	P
(*a*)	Merchant's A/c	Dr.		49	69		
	To Suspense A/c					49	69
	(Being Rs. 55 posted to Merchant's credit in place of Rs. 5.31, now corrected)						
(*b*)	Acceptor's A/c	Dr.		200	00		
	To Bills Receivable A/c					200	00
	(Being dishonoured bills wrongly debited to B/R A/c, now rectified)						
(*c*)	Suspense A/c	Dr.		21	26		
	To Customer's A/c					21	26
	(Being sales return of Rs. 10.63 wrongly posted to debit of customer, now corrected)						
(*d*)	Sales A/c	Dr.		260	00		
	To Plant A/c					260	00
	(Being sale of plant wrongly credited to general sales, now corrected)						
(*e*)	Sundry Debtors A/c	Dr.		60	00		
	To Suspense A/c					60	00
	(Being omission from sundry debtors, now rectified)						

(f)	Suspense A/c Dr.		2	31		
	To Discount received A/c				2	31
	(Being omission to record discount received, now rectified)					

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Suspense A/c

Dr. Cr.

Date	Particulars	J.F.	Amount Rs.	P.	Date	Particulars	J.F.	Amount Rs.	P.
	To Balance b/d		86	12		By Merchant's A/c		49	69
	To Customers A/c		21	26		By Debtor's A/c		60	00
	To Discount A/c		2	31					
			109	69				109	69

3.13 RECTIFICATION OF ERRORS (*Before Ledger Accounts are Closed*)

Maintenance of accounts and its auditing is a continuous process. Every firm tries to check and verify the accounting records through accountants, specialists and sometimes by the proprietor himself. Reputed firms have got their internal audit section, which examines the books of accounts with reference to vouchers and verify the value of assets. The errors detected are rectified immediately. These errors are discovered before ledger accounts are closed, so their rectification is made without raising suspense account. Suspense Account is opened while preparing trial balance in case the debit and credit side of trial balance does not tally.

Errors are discovered and accounts are identified, wherein the mistake lies. If the mistake lies at the debit side of an account, rectifying entry is made at the debit side of the account. In the same way, if the mistake lies at the credit side of the account rectifying entry will be made at the credit side of the account. For example, if purchases book is undercast by Rs. 1,000, rectifying entry will be made at the debit side of purchases account. In case, wages for construction of building has been debited to wages account, for rectification of the mistake posting will be made at the debit side of building account. Wages account has been wrongly debited. In order to correct this mistake rectifying entry will also be made at the credit side of wages account.

Illustration 14. **Correct the following errors discovered by the trader's accountant without opening suspense account :**

1. Goods purchased for Rs. 1,150 have been wrongly posted to the debit of the supplier Mohan.

2. The total of sales book has been overcast Rs. 2,000.

3. The total of purchases book has been undercast Rs. 1,000.

4. The total of sales return book has been undercast by Rs. 500.

5. Discount allowed to Ram Lal Rs. 100 has not been entered into discount column of the cash book, but it has been posted to his personal account.

Solution.

1. Following posting will be made on the credit side of Mohan's account :
   "By error in posting to the wrong side Rs. 2,300".
2. Following posting on the debit side of sales account will be made :
   "To overcast of sales book Rs. 2000".
3. Following posting on the debit side of purchases account will be made :
   "To undercast of purchases book Rs. 1,000".
4. Following posting on the debit side of sales return account will be made :
   "To undercast of sales return book Rs. 500".
5. Following posting at the debit side of discount column of cash book will be made :
   "To omission of entry in cash book Rs. 100."

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Illustration 15. *Shri Krishan closes his accounts every year on 31st March. When he prepared the trial balance on 31st May, 2006, it did not tally. He did not open a suspense account and on 7th June discovered the following errors :*

(*i*) *The total of sales book was Rs. 100 short.*

(*ii*) *Rs. 2,800 spent on repairs of building were debited to the building account.*

(*iii*) *Discount of Rs. 200 allowed to Balram was not posted to his account.*

Rectify these errors without opening a suspense account.

Solution.

(*i*) Following posting on the credit side of sales account will be made :

"By undercast of the sales books Rs. 100".

(*ii*) Repair account should have been debited by Rs. 2,800 but building account has been debited by Rs. 2,800. The error can be rectified by a debit to repair account and credit to building account as :

(*a*) In repair account :

"To omission in posting of Rs. 2,800".

(*b*) In building account :

"By wrong posting of Rs. 2,800".

(*iii*) Shri Balram's account has been omitted to be credited for discount, allowed to him amounting to Rs. 200, so the following posting on the credit side of Shri Balram's account will be made :

"By omission in posting the amount of discount of Rs. 200".

3.14 EFFECTS OF ERRORS

There are certain errors which affect profit and loss and certain other errors affect balance sheet. Sometimes certain errors do not affect either profit and loss account or balance sheet. Rectification of errors may also affect profit and loss account and balance sheet. Errors affecting profit and loss account may be regarding wages, salaries, rent, insurance, commission, purchases and sales account etc. If the above accounts are debited in the rectifying entry profit will be reduced. In the same way, if these account are credited in the rectifying journal entry profit will be increased. If errors are committed in those accounts which are entered in the balance sheet, profit and loss account will remain unaffected. The effect of errors is explained as under :

1. Error of debiting expenses account with more amount

Effect before rectification. The error will decrease profit, because expenses appearin at the debit side of trading or profit and loss account will be increased and the resulta profit will decrease.

Effect after rectification. In the rectifying entry expenses account will be credited, s the profit will increase.

Note. The decrease in profit will also decrease capital. In the same way, increase in profit after rectification will also increase capital.

2. Error of debiting expenses account with lesser amount

Effect before rectification. As expenses have been recorded with lesser amount th profit will increase, so the balance of capital will also increase. It should be noted, "Th more expenses the lesser profit and the lesser expenses the more profit."

Effect after rectification. In the rectifying journal entry, expenses account will be deb ited again, so the profit and also the capital will reduce.

3. Error of crediting income account with more amount

Effect before rectification. If any account representing income has been recorded wit more amount, the profit will increase and the capital will also increase.

Effect after rectification. In the rectifying entry, income account will be debited, so th profit will reduce and the capital will also decrease.

4. Errors of omitting income account or writing lesser amount

Effect before rectification. The profit will decrease because the income has been omi ted to be recorded or recorded with lesser amount. The capital will also reduce.

Effect after rectification. In the rectifying entry, income account will be credited, so th profit and the capital will also increase.

5. Error of undercasting purchases book or sales return book

Effect before rectification. Undercasting purchases book will reduce cost of goods sol so the profit will increase. In the same way, undercasting sales return means increasin sales, so the profit will also increase. The capital will also increase with the increase o profit.

Effect after rectification. After rectification, purchases will be increased, so the prof will decrease. In the same way, sales will also decrease and the profit in this case will als decrease. The capital will also decrease with the decrease of profit.

6. Error of overcasting purchases book and *returns inward book*

Effect before rectification. Overcasting in the purchase book will increase purchases so the profit will reduce. Increase in sales return will decrease sales, so the profit wil decrease. The capital will also decrease with the decrease of profit.

Effect after rectification. After rectification the purchases will be reduced, so the profi will increase. The sales will also increase and the profit will therefore be increased. Th increase of profit will increase capital also.

7. Errors of undercasting *sales book* and *purchases* return book

Before rectification. The error will reduce sales, so the profit will decrease. In the sam way, undercasting of purchase return book will increase purchases and the profit will re duce. The reduction in profit will reduce capital also.

After rectification. Sales will increase afte. rectification, so the profit will also increase Undercasting of purchases return, when rectified will reduce purchases and thus profit wil increase.

8. Amount withdrawn by the proprietor was wrongly debited to trade expenses account

Effect of error before rectification. The profit decreased because trade expenses account was debited. An increase in expenses means decrease in profit. The error will also increase capital because drawing was omitted.

Effect after rectification. The profit will increase and the capital will decrease.

> *In case of questions asked in the examination effect on the profit and loss account and balance sheet should be supposed after rectifying entries have been passed, unless effect before rectification is specifically asked.*

Illustration 16. *The trial balance extracted from the books of Anil on 31st March 2005 had not agreed. The difference was transferred to suspense account. During 2005-2006 the following errors were discovered :*

(*i*) *The total of purchases book was short by Rs. 100.*

(*ii*) *The total of one page of the sales book was carried forward to the next page as Rs. 2,785 instead of Rs. 2,587.*

(*iii*) *Goods returned by Ajai were not entered in the books at all Rs. 500.*

(*iv*) *A sale of Rs. 480 to Ram was entered in the sales book as Rs. 840.*

(*v*) *Rs. 1,000 spent on repairs to the building was debited to the building account.*

Pass the necessary rectifying journal entries and show how the profit of the business will be affected.

Solution. **Rectifying Journal Entries**

Date	*Particulars*		*L.F.*	*Amount Debit Rs.*	*Amount Credit Rs.*
1.	Purchases A/c	Dr.		100	
	To Suspense A/c				100
	(Being undercasting of purchases book by Rs. 100, now rectified)				
2.	Sales A/c	Dr.		198	
	To Suspense A/c				198
	(Being total wrongly carried forward of sales book, now rectified)				
3.	Returns Inward A/c	Dr.		500	
	To Ajai				500
	(Being goods returned by Ajai omitted to be recorded, now rectified)				
4.	Sales A/c	Dr.		360	
	To Ram				360
	(Being sale of Rs. 480 entered as Rs. 840 in sales book, now rectified)				
5.	Repairs A/c	Dr.		1,000	
	To Building A/c				1,000
	(Being buildings account wrongly debited instead of repairs account, now rectified)				

NOTES

Effect of entries on net profit :

S. No.	*(Increase)* *Rs.*	*(Decrease)* *Rs.*
(*i*)	—	100
(*ii*)	—	198
(*iii*)	—	500
(*iv*)	—	360
(*v*)	—	1,000
	—	Total = 2,158

Illustration 17. *The annual accounts of Kothari Enterprises prepared on 31st December, 2006 disclosed a net profit of Rs. 48,576 and the balance sheet total of Rs. 1,35,427. The following matters were, however, ignored before arriving at these figures :*

(a) Goods valued at Rs. 750 were purchased, received and taken into stock, but were not recorded in the books.

(b) Expenses outstanding : Wages Rs. 650 ; Salaries Rs. 450 ; Advertisement Rs. 250 ; Law Charges Rs. 100 ; Electricity Charges Rs. 175.

(c) Interest accrued on investments : Rs. 375.

(d) Goods costing Rs. 250 were taken away by the trader for his personal use.

(e) Depreciation to be written off ; Building Rs. 2,500 ; machinery Rs. 12,500 ; Motor Vehicle Rs. 3,500 ; Furniture Rs. 300.

(f) A Provision of Rs. 800 is to be created for bad and doubtful debts.

(g) Rs. 650 cash stolen by an ex-employee stood debited to a suspense account.

Give journal entries to record these matters and show how they would affect the net profit and the total of balance sheet.

Solution. **Rectifying Journal Entries**

Date	*Particulars*		*L.F.*	*Amount*	
				Debit *Rs.*	*Credit* *Rs.*
2006 Dec. 31					
(*a*)	Purchases A/c	Dr.		750	
	To Creditor's A/c				750
	(Being goods purchased and taken into stock but omitted to be recorded, now recorded)				
(*b*)	Wages A/c	Dr.		650	
	Salaries A/c	Dr.		450	
	Advertising A/c	Dr.		250	
	Law Charges A/c	Dr.		100	
	Electricity Charges A/c	Dr.		175	
	To Outstanding Expenses A/c				1,625
	(Being outstanding expenses unpaid and omitted to be recorded, now recorded)				

(*c*)	Accrued Interest A/c Dr.		375	
	To Interest A/c			375
	(Being interest accrued on investment)			
(*d*)	Drawings A/c Dr.		250	
	To Purchases A/c			250
	(Being goods taken away by proprietor, now recorded)			
(*e*)	Depreciation A/c Dr.		18,800	
	To Building A/c			2,500
	To Machinery A/c			12,500
	To Motor Vehicles A/c			3,500
	To Furniture A/c			300
	(Being rectification of depreciation on assets now recorded)			
(*f*)	Profit & Loss A/c Dr.		800	
	To Provision for bad and doubtful debts A/c			800
	(Being provision made for bad and doubtful debts)			
(*g*)	Profit & Loss A/c Dr.		650	
	To Suspense A/c			650
	(Being cash stolen by an ex-employee which was charged to suspense account, now rectified)			
(*h*)	Capital A/c Dr.		22,000	
	To Profit & Loss A/c			22,000
	(Being balance of profit and loss account transferred to capital account)			

NOTES

Effect of the above Entries (*after rectification*)

S. No.	*Profit & Loss Account*		*Balance Sheet*			
	Net Profit		*Assets*		*Liabilities*	
	Increase *Rs.*	*Decrease* *Rs.*	*Increase* *Rs.*	*Decrease* *Rs.*	*Increase* *Rs.*	*Decrease* *Rs.*
(*a*)	—	750	—	—	750	750
(*b*)	—	1,625	—	—	1,625	1,625
(*c*)	375	—	375	—	375	—
(*d*)	250	—	—	—	250	250
(*e*)	—	18,800	—	18,800	—	18,800
(*f*)	—	800	—	800	—	800
(*f*)	—	650	—	650	—	650
Total	625	22,625	375	20,250	3,000	22,875
		– 22,000		– 19,875		– 19,875

Thus net profit = Rs. 48,576 – Rs. 22,000 = Rs. 26,576.

Balance Sheet total = Rs. 1,35,427 – Rs. 19,875 = Rs. 1,15, 552.

Effect of the rectifying entries on net profit	Rs.
Net profit before rectification	48,576
Less : Decrease of profit after rectification	(–) 22,000
Rectified Net Profit	26,576

NOTES

Effect on the total of Balance Sheet	Rs.
Balance Sheet total before rectification	1,35,427
Less : Decrease in total	(–) 19,875
Total of the Balance Sheet (after rectification)	1,15,552

3.15 RECTIFICATION OF ERRORS (*After Final Accounts are Prepared*)

The profit or loss of each accounting period should be separately calculated. It is, therefore, necessary that the rectification of the errors relating to the previous year should be made in such a way that it should not affect the profit or loss of the current year. In order to achieve this objective profit and loss adjustment account is opened. This account represents the accounts appearing in the trading and profit and loss account. The balance of this profit and loss adjustment account is transferred to capital account. In this way, profit or loss of the current year remains unaffected from errors of the previous year.

Illustration 18. *The following errors of the previous year were discovered during the current year after the preparation of final accounts of the previous year.* **Rectify these errors :**

1. Purchases from Anzar was not recorded in the books amounting to Rs. 700.

2. Sales to Ramesh amounting to Rs. 1,000 was wrongly passed through sales book with Rs. 100.

3. Wages paid to Mohan was debited to Mohan with Rs. 1,000.

Solution. **Rectifying Journal Entries**

Date	*Particulars*		*L.F.*	*Amount*	
				Debit Rs.	*Credit Rs.*
1.	Profit & Loss Adjustment A/c	Dr.		700	
	To Anzar				700
	(Being decrease in the profit of last year)				
2.	Ramesh's A/c	Dr.		900	
	To Profit & Loss Adjustment A/c				900
	(Being increase in the profit of the last year)				
3.	Profit & Loss Adjustment A/c	Dr.		1,000	
	To Mohan's A/c				1,000
	(Being decrease in profit of the last year)				
4.	Capital A/c	Dr.		800	
	To Profit & Loss Adjustment A/c				800
	(Being transfer of the balance of profit and loss adjustment account to capital account)				

Summarised Presentation of Errors and Their Logical Rectification

S. No.	*Transactions*	*Wrong Treatment (Has been done)*	*Correct Treatment (Should have been done)*	*Rectified Entry*	*Reasoning*
	Errors of Omission				
1.	*Goods worth Rs. 2,000 returned by Keshwani were taken into stock but the transactions was not recorded in the books.*	No Entry	Returns Inward A/c Dr. 2,000 To Keshwani's A/c 2,000	Returns Inward A/c Dr. 2,000 To Keshwani's A/c 2,000	Entry was omitted, correct entry will be passed.
2.	*Goods purchased from Darbara Singh was recorded in the purchases book but no entry was made in Darbara Singh's account. The purchases was worth Rs. 7,000*	Entry in Darbara Singh's A/c is omitted	Purchases A/c Dr. 7,000 To Darbara Singh's A/c 7,000	Suspense A/c Dr. 7,000 To Darbara Singh's A/c 7,000	Credit in Darbara Singh's A/c was omitted, now rectified. Suspense A/c debited because there is no other Wrong A/c
	Errors In The Subsidiary Books				
3.	*Purchases Book was undercast by Rs. 1,000*	Undercasting of purchases book	It should have been correctly totalled.	Purchases A/c Dr. 1,000 To Suspense A/c 1,000	Debiting Purchases A/c will complete the total. Credited Suspense A/c in the absence of any other Wrong A/c
4.	*Purchases Book was overcast by Rs. 100*	Overcasting of purchases book	It should have been correctly totalled.	Suspense A/c Dr. 100 To Purchases A/c 100	Crediting purchases A/c reduces the total, Suspense A/c debited because there is no other Wrong A/c to be debited.
5.	*Sales Book was undercast by Rs. 150*	Undercasting of sales book	It should have been correctly totalled.	Suspense A/c Dr. 150 To Sales A/c 150	Crediting Sales will increase its total. Suspense A/c debited because there is no other Wrong A/c to be debited.
6.	*Sales Book was overcast by Rs. 150*	Overcasting of sales book	It should have been correctly totalled.	Sales A/c Dr. 150 To Suspense A/c 150	Debiting Sales A/c will decrease its balacne. Suspense A/c credited because there is no Wrong A/c to be credited.

S. No.	Transactions	Wrong Treatment (Has been done)	Correct Treatment (Should have been done)	Rectified Entry	Reasoning
7.	*Returns Outward book was undercast by Rs. 1,000*	Undercasting of Returns outward book	It should have been correctly totalled.	Suspense A/c Dr. 1,000 To Returns Outward A/c 1,000	Crediting Returns Outward A/c will increase total
8.	*Purchases Return book was overcast by Rs. 100*	Overcasting of purchases return book	It should have been correctly totalled.	Purchases Return A/c Dr. 100 To Suspense A/c 100	Debiting Purchases Return A/c will reduce the total
9.	*Sales Return book was undercast by Rs. 100*	Undercasting of Sales Return book	It should have been correctly totalled.	Return Inward A/c Dr. 100 To Suspense A/c 100	Debiting Returns Inward A/c will increase the total
10.	*Sales Return book was overcast by Rs. 1,000*	Overcasting of Sales Return book	It should have been correctly totalled.	Suspense A/c Dr. 1,000 To Sales Return A/c 1,000	Crediting Sales Return A/c will decrease the total
11.	*Bills Receivable book was undercast by Rs. 200*	Undercasting of Bills Receivable book	It should have been correctly totalled.	Bills Receivable A/c Dr. 200 To Suspense A/c 200	Debiting Bill Receivable A/c will increase the total
12.	*Bills Receivable book was overcast by Rs. 300*	Overcasting of Bills Receivable book	It should have been correctly totalled.	Suspense A/c Dr. 300 To Bills Receivable A/c 300	Crediting Bills Receivable A/c will reduce the total
13.	*Bills Payable book was undercast by Rs. 1,000*	Undercasting of Bills Payable book	It should have been correctly totalled.	Suspense A/c Dr. 1,000 To Bills Payable A/c 1,000	Crediting Bills Payable A/c will increase the total
14.	*Bills Payable book was overcast by Rs. 600*	Undercasting of Bills Payable book	It should have been correctly totalled.	Bills Payable A/c Dr. 600 To Suspense A/c 600	Debiting Bills Payable A/c will decrease the total

S. No.	Transactions	Wrong Treatment (Has been done)	Correct Treatment (Should have been done)	Rectified Entry	Reasoning
	Errors of Principles				
15.	*Purchases of building was passed through purchases book amounting to Rs. 80,000*	Purchases A/c Dr. 80,000 To Bank A/c 80,000	Building A/c Dr. 80,000 To Bank A/c 80,000	Building A/c Dr. 80,000 To Purchases A/c 80,000	Building A/c is debited as per requirement of correct entry. Purchases A/c was wrongly debited, so credited to rectify the mistake
16.	*Wages for the construction of building was debited to wages account with Rs. 20,000*	Wages A/c Dr. 20,000 To Cash A/c 20,000	Building A/c Dr. 20,000 To Cash A/c 20,000	Building A/c Dr. 20,000 To Wages A/c 20,000	Building A/c is debited as per requirement of correct entry. Wages A/c credited as it was wrongly and unnecessarily debited
17.	*Repairs to second hand building was debited to repairs account with Rs. 18,000*	Repairs A/c Dr. 18,000 To Cash A/c 18,000	Building A/c Dr. 18,000 To Cash A/c 18,000	Building A/c Dr. 18,000 To Repair A/c 18,000	Building A/c debited as per requirement of correct entry. Repair A/c credited because it was wrongly debited.
18.	*Payment of wages to Ram Lal was debited to his personal account with Rs. 3,000*	Ram Lal's A/c Dr. 3,000 To Cash A/c 3,000	Wages A/c Dr. 3,000 To Cash A/c 3,000	Wages A/c Dr. 3,000 To Ram Lal's A/c 3,000	Wages as an expenses will be debited. Ram Lal's A/c will be credited, because it was wrongly debited.
19.	*Rent paid to land lord was debited to his personal account with Rs. 2,000*	Landlord's Personal A/c 2,000 To Cash A/c 2,000	Rent A/c Dr. 2,000 To Cash A/c 2,000	Rent A/c Dr. 2,000 To Landlord's Personal A/c 2,000	Rent as an expense should be correctly debited. Landlord's A/c credited because it was wrongly debited.

NOTES

S. No.	*Transactions*	*Wrong Treatment (Has been done)*	*Correct Treatment (Should have been done)*	*Rectified Entry*	*Reasoning*
20.	*Interest Received from Rajeev was credited to Rajeev's account with Rs. 300*	Cash A/c Dr. 300 To Rajeev's A/c 300	Cash A/c Dr. 300 To Interest A/c 300	Rajeev's A/c Dr. 300 To Interest A/c 300	Rajeev's A/c debited, because it was wrongly credited. Interest as revenue should be correctly credited.
21.	*Amount of Rs. 2,000 withdrawn by the proprietor for personal use was wrongly debited to trade expenses account.*	Trade Expenses A/c Dr. 2,000 To Cash A/c 2,000	Drawings A/c Dr. 2,000 To Cash A/c 2,000	Drawings A/c Dr. 2,000 To Trade Expenses A/c 2,000	Drawings should be debited for goods withdrawn by the proprietor. Trade Expenses A/c is credited because it was unnecessarily deb-
22.	*Mohan & Sons, dealers in furniture took a sofa set from the firm for their drawingroom. The cost of the sofa was Rs. 4,000. The transaction was not recorded in the books.*	No Entry	It should have been recorded in the books	Drawings A/c Dr. 4,000 To Purchases A/c 4,000	The entry was omitted at all, so correct entry will be passed.
23.	**Errors of Posting at wrong side of an Account** *Rent amounting to Rs. 900 paid was credited to Rent Account.*	Rent A/c credited instead of being debited	Rent A/c Dr. 900 To Cash A/c 900	Rent A/c Dr. 1,800 To Suspense A/c 1,800	Rent A/c debited with double amount because, it was wrongly credited instead of being debited. Crediting Cash A/c correct so Suspense A/c has been credited
24.	*Discount amounting to Rs. 70 were allowed to Mohan. It was correctly entered in the cash book but credited to discount received account.*	Discount A/c credited instead of debited	Discount A/c Dr. 70 To Mohan A/c 70	Discount Allowed A/c Dr. 70 Discount Received A/c Dr. 70 To Suspense A/c 140	Discount Allowed A/c should be correctly debited. Discount Received A/c should be debited because it was wrongly credited.

S. No.	*Transactions*	*Wrong Treatment (Has been done)*	*Correct Treatment (Should have been done)*	*Rectified Entry*	*Reasoning*
	Errors of recording in incorrect subsidiary books				
25.	*Goods sold to Mohan for Rs. 3,700 was wrongly passed through purchases book.*	Purchases A/c Dr. 3,700 To Mohan A/c 3,700	Mohan A/c Dr. 3,700 To Sales A/c 3,700	Mohan's A/c Dr. 7,400 To Purchases A/c 3,700 To Sales A/c 3,700	Mohan's A/c debited with double amount because it was wrongly credited through purchase book, whereas it should have been debited through Sales Book. Purchases A/c credited because it was wrongly debited. Sales A/c credited because it should have been correctly credited.
26.	*Goods purchased from Masood for Rs. 300 was passed through sales book.*	Masood's A/c Dr. 300 To Sales A/c 300	Purchases A/c Dr. 300 To Masood's A/c 300	Purchases A/c Dr. 300 Sales A/c Dr. 300 To Masood's A/c 600	Purchases A/c correctly debited. Sales A/c is also debited, because it was wrongly credited. Masood's A/c credited with double amount because it was debited instead of being credited.
27.	*Goods returned by Kapil Dev for Rs. 150 were passed through returns outward book.*	Kapil Dev A/c Dr. 150 To Returns Outward A/c 150	Returns Inward A/c Dr. 150 To Kapil Dev's A/c 150	Returns Inward A/c Dr. 150 Returns Outward A/c Dr. 150 To Kapil Dev's A/c 300	Returns Inward correctly debited. Return Outward was wrongly credited so debited here Kapil Dev's A/c credited with the total.
28.	*Goods returned to Hirwani for Rs. 600 was passed through sales book.*	Hirwani's A/c Dr. 600 To Sales A/c 600	Hirwani's A/c Dr. 600 To Returns Outward A/c 600	Sales A/c Dr. 600 To Returns Outward A/c 600	Sales A/c debited because it was wrongly credited Returns Outward A/c is credited because it should have been correctly credited but omitted.

S. No.	*Transactions*	*Wrong Treatment (Has been done)*	*Correct Treatment (Should have been done)*	*Rectified Entry*	*Reasoning*
29.	**Posting wrong amount in subsidiary books** *A sale of Rs. 480 to Ram was entered in the sales book as Rs. 840.*	Ram A/c Dr. 840 To Sales A/c 840	Ram's A/c Dr. 480 To Sales A/c 480	Sales A/c Dr. 360 To Ram's A/c Dr. 360	Ram's A/c was over debited so credited with the excess. Sales A/c was over credited so debited the excess to correct the amount.
30.	*An amount of Rs. 670 due from Abidur Rehman. Written off as bad in a previous year was recovered and credited to the personal account of Abidur Rehman.*	Cash A/c Dr. 670 To Abidur Rehman's A/c 670	Cash A/c Dr. 670 To Bad Debt Recovered A/c 670	Abidur Rehman's A/c Dr. 670 To Bad Debts Recovered A/c 670	Abidur Rehman's A/c must have been closed, because it was written off as Bad Debts. It was wrongly credited, so debited here. Bad Debts Recovered as revenue is being credited.
31.	*Bills payable worth Rs. 1,500 accepted in favour of Snedon was passed through Bills Receivable book with Rs. 150 and Snedon's account was correctly debited.*	Bills Receivable A/c debited instead of Bills Payable A/c being credited	Snedon's A/c Dr. 1500 To Bills Payable A/c 1500	Suspense A/c Dr. 1,650 To Bills Receivable A/c Dr. 150 To Bills Payable A/c 1,500	B/P should be rightly credited. B/R credited because it was wrongly debited. Snedon's A/c need not be disturbed because it is rightly debited.
32.	*The total of one page of the sales book was carried forward to the next page as Rs. 2,785 instead of Rs. 2,587.*	Total wrongly carried forward	It should hae been correctly carried forward	Sales A/c Dr. 198 To Suspense A/c s 198	Sales A/c will be debited with the excess it was credited. Suspense A/c credited as there is no other wrong account.

3.16 SUMMARY

NOTES

Errors and their Rectification

Mistakes committed in the accounting treatment knowingly or unknowingly are known as Errors. These errors may be regarding omission, commission and principles.

Errors affecting Trial Balance

(1) Errors of additions and substractions (2) Posting at the wrong side of an account (3) Entering incorrect amount : (*a*) Incorrect copying : (*i*) Transposing figure (*ii*) Sliding the figure (*iii*) Doubling wrong figure. (*b*) Duplicate Posting (4) Errors of omission (5) Wrong Posting in the Trial Balance.

Limitations of Trial Balance (*Errors not affected or undetected by Trial Balance*)

(1) Errors of omission in the books of original record (2) Errors of principles (3) Compensating errors (4) Incorrect account in the original record (5) Posting to wrong account.

1. Errors of Omission

If the entire transaction escapes from being recorded or transactions are partially recorded, it is known as Errors of omission.

2. Errors of Commission

Following errors constitute errors of commission :

(*a*) Recording wrong amount in the subsidiary books (*b*) Wrong totalling of subsidiary books (*c*) Posting wrong amount in the ledger accounts (*d*) Posting at the wrong side of ledger accounts (*e*) Incorrect balancing of ledger accounts.

3. Errors in the Subsidiary Books and their Rectification

(*a*) Errors of omission in the subsidiary books.

(*b*) Over-casting of subsidiary books.

(*c*) Under-casting of subsidiary books.

Errors in the subsidiary books can be rectified by opening Suspense A/c or without opening Suspense A/c. Suspense A/c is debited or credited in place of missing account or for accounts having shorter balance as compared to their opposite corresponding account at the debit or credit side.

4. Errors of Principles

Errors committed because of having incomplete and poor knowledge of Accounting are known as Errors of Principles. Generally these errors relate to the treatment of capital expenditure and receipts as revenue expenditure or receipts and vice-versa.

While rectifying these errors following rules must be observed :

Building A/c should be debited for purchase of building, registration fee, purchase of raw material for construction of building, payment of wages for construction, addition to and extension of building and for repair to second hand building.

Machinery A/c is debited for purchase of machinery, freight and cartage on new machinery, installation charges of machinery and repair to second hand machinery.

In case of revenue expenditure, expenses A/c are debited instead of assets A/c such as routine repairs renewals and maintenance of assets.

NOTES

In case of revenue income, Revenue A/c will be credited instead of the person or party from whom it has been received.

Errors in the Treatment of Proprietors Withdrawal

Drawings A/c should be debited in the following cases :

Amount or goods withdrawn/taken by the proprietor for personal, private, domestic and residential use, payment from the business for expenses incurred for the benefit of the proprietor or any other member of his family.

5. Compensating Errors

If the effect of an error is neutralised by another error, it is said to be compensating error.

While passing rectifying entries regarding errors in the subsidiary books the following points must be taken into consideration :

If the mistake has been committed in the subsidiary book, personal accounts mentioned in the subsidiary book must be wrong, because posting in the Personal Accounts is made through subsidiary books. If mistake has been committed in the Personal Accounts the subsidiary books may be correct.

Suspense Account

It is an imaginary account used as a temporary measure to rectify mistakes. Later on books of accounts are checked, errors are located, rectifying entries are passed and Suspense Account is closed. It should be noted that Suspense A/c is used to rectify those errors which have been located after the trial balance has been prepared.

Utility of Suspense A/c.

(*i*) Suspense A/c enables timely preparation of final accounts.

(*ii*) Suspense A/c facilitates passing of rectifying entries.

(*iii*) Suspense Account facilitate completion of trial balance Suspense A/c as such is *the temporary panacea* of all accounting troubles.

Rectification of errors before ledger accounts are closed

Maintenance and auditing of accounts is a continuing process. If errors are detected before ledger accounts are closed, rectification of the error is made in the concerned account by debiting or crediting as per requirement. It should be noted that Suspense A/c is not used for rectifying these types of error.

Rectification of errors after final accounts are prepared

Errors discovered after preparation of final accounts are rectified in such a way, that profit or loss of the current year is not affected. In order to *achieve this objective profit and* loss adjustment is debited or credited as the case may be. The final balance of Suspense A/c is transferred to Capital Account, without disturbing current year's profit.

REVIEW QUESTIONS

A. Very Short Answer Type Questions :

1. Where will you transfer the total of Purchases book ?
2. Name the subsidiary books, whose balance is always debit.

3. Give two examples of errors of Principle.
4. Give two examples of Compensating errors.
5. Name four errors which cannot be disclosed by preparing Trial Balance.

B. Short Answer Type Questions :

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1. Explain the errors of principle and give two examples of such errors.
2. What is the purpose of preparing suspense account ?
3. Explain with example the meaning of error of principle.
4. What is meant by errors of ommission ? Give any one example.
5. What is Suspense Account ? When is it opened ?

C. Long Answer Type Questions :

1. Explain five errors regarding proprietor's withdrawal.
2. Explain errors which are not detected by trial balance.
3. What is one sided error ? Give two examples.
4. What is a suspense account ? When is it opened and how is it closed ?
5. Explain errors of commission and give two examples of such errors with measures to rectify them.

UNIT 4 DEPRECIATION

NOTES

★ STRUCTURE ★

4.1 Objectives
4.2 Introduction
4.3 Methods of Calculating Depreciation
4.4 Provision
4.5 Reserves
4.6 Summary

4.1 OBJECTIVES

At the end of this unit, you should be able to :

- Understand the meaning of Depreciation, Obsolescence, Depletion, amortisation and fluctuations.
- Understand the causes responsible for depreciation and appreciate provision for depreciation.
- Understand the straight line method of providing depreciation, calculate depreciation and make its accounting treatment.
- Explain advantages, disadvantages and uses of straight line method.
- Understand the reducing balance method, calculate depreciation according to this method and make its accounting treatment.
- Explain advantages, disadvantages and uses of reducing balance method.
- Differentiate between fixed instalment and reducing balance method.
- Understand the meaning and types of Provision and reserve.
- Differentiate between Provision and Reserve.

4.2 INTRODUCTION

The concepts of Depreciation, Provisions and Reserves impact the accounting of the company. It is important to understand them better so that they are properly treated in the accounting process. There is a scope on committing mistakes regarding these aspects of accounting. Hence, an accountant should be fairly comfortable to understand and treat these items in the books of accounts. The complexity with these items is that they differ in their calculation and treatment in different industry and businesses.

We will study these concepts in this chapter and their impact on the accounting. We will also look into the fact that what precautions should be taken in accounting for these items to avoid mistakes.

Business is established for indefinite period. This is why, it acquires fixed assets for its use. These assets increase the profit earning capacity. Fixed assets are constantly used in

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the business. The assets lose their value gradually due to their constant use. *Loss in the value and utility of assets due to their constant use and expiry of time is termed as depreciation.* It has been our own experience that the furniture purchased for our own use in 2004 will lose a part of its value and lustre in 2005. Its value will further decrease in 2006 and so its effectiveness and value will go on decreasing with the passage of time. This 'wear and tear' is known as 'Depreciation' in accounting :

Meaning and Definition

According to **R.N. Carter,** *"Depreciation is gradual and permanent decrease in the value of an asset from any cause".*

According to **Accounting Standard,** *"Depreciation is a measure of the wearing out, consumption or other loss of value of a depreciable asset arising from use, effluxion of time or obsolescence through technology and market changes".*

According to **Institute of Cost and Management Accounting London (ICMA) terminology.** *"The depreciation is the diminution in intrinsic value of the asset due to use and/ or lapse of time".*

According to Accounting Standard-6 issued by the Institute of Chartered Accountants of India (in November 1987) every company is liable to make provision for depreciation on its fixed assets.

Special Features of Depreciation

1. Depreciation is loss in the value of assets.

2. Loss should be gradual and constant.

3. Depreciation is the exhaution of the effective life of business.

4. Depreciation is the normal feature.

5. Maintenance of assets is not depreciation.

6. It is continuing decrease in the value of assets.

7. It is the allocation of cost of assets to the period of its life.

Accountants have developed certain specific words to denote the loss in the value of particular assets, other than depreciation. These words are as under :

1. Obsolescence/Dilapidation

Sometimes new inventions throw away the existing machines and equipments as obsolete (useless) although the old machines and equipments are not completely useless. The firm will have to replace the old machine and equipment with the latest, up-to-date and newly invented machine and equipment. Loss due to the obsolescence of the old machine and equipment is known as 'obsolescence'.

2. Depletion

The firm may possess certain mineral wealth such as coal, oil, iron ore etc. The more we extract mineral wealth from these mines the more mines are depleted. Decrease in mineral wealth of the mines is termed as depletion.

3. Amortisation

The word 'amortisation' is used to show loss in the value of intangible assets. These assets are goodwill, patents and preliminary expenses etc. These assets are written off over certain period.

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4. Fluctuation

Increase and decrease in the market value of assets is known as fluctuation. As we record the value of these assets on historical basis, we do not pass any entry for the fluctuations in the market value of assets. In case of permanent fall in the value of investments fluctuation may be recorded.

Causes for Depreciation

1. **By constant use.** The loss in the value, efficiency and utility of fixed assets due to its constant use is termed as depreciation.
2. **By expiry of time.** The effective life of assets goes on decreasing with the passage of time. If certain lease has been obtained for 20 years for Rs. 1,00,000, it will lose its $\frac{1}{20}$th, *i.e.*, $\left(\frac{1}{20} \times 1{,}00{,}000\right)$ = Rs. 5,000 value at the end of the first year and so on.

   At the end of 20th year it will become valueless.
3. **By obsolescence.** The old assets will become obsolete due to new inventions, improved techniques and technological advancements.
4. **By depletion.** Loss of mineral wealth due to constant working of mines is also depreciation, but specifically known as 'depletion'. Suppose a particular mine has got 1,00,000 tons of coal during 1st year, coal worth 5,000 tons have been extracted. The loss of 5,000 tons of coal from mines is loss due to depletion. This is why, we charge depreciation on these mineral wealth according to depletion method.
5. **Permanent fall in price.** Though fluctuations in the market value of fixed assets is not recorded in the books. Sometimes we have to account for this loss such as permanent fall in the value of investments.
6. **By abnormal factors.** Depreciation may also be due to the loss in the value of assets by accidents and damage.

Depreciation in the value of assets in all the above cases is accounted for in the books of accounts.

Objectives of Charging Depreciation

Recording depreciation in the books of accounts is essential due to the following reasons :

1. **For determination of net profit or net loss.** Loss in the value of assets is undoubtedly a business expense. It must be recorded and shown at the debit side of the profit and loss account for the correct calculation of net profit or net loss. The ultimate objective of accounting is to determine the correct net income. This objective will not be achieved, unless we account for depreciation in the books of accounts.
2. **For showing assets at fair and true value in the Balance Sheet.** If depreciation is not charged, the assets will be shown at value more than its actual value. The purpose of recording assets is to show them at their true value. Provision for depreciation reduces the value of assets with the amount of depreciation and assets are shown at their true and fair value.
3. **Provision of funds for replacement of assets.** The assets acquired and used in the business will become useless after expir of its estimated life or even before that, we will have to replace the obsolete assets with another fresh asset. The replacement will

require funds. Proper method of depreciation will make the funds available for the purchase of fresh assets.

4. **Ascertaining accurate cost of production.** Depreciation on factory plant and machinery is factory overhead. It will increase the cost of production and the price of the commodity will be fixed at higher rates. In the absence of provision for depreciation, the sales price of the commodity will be fixed at lower rates, because cost of production will also be lower due to ignorance of depreciation. Profit will thus be reduced.
5. **Distribution of dividend out of profit only.** Depreciation is charged out of Profit and loss account, so the profit after charging depreciation will be lesser. Shareholders will get dividend out of this profit. If depreciation is not charged, the profit will be more and the excess dividend will be paid out of capital, which should have been paid out of profit.
6. **Avoiding over payment of income tax.** If depreciation is not charged, profit and loss account will show more profit. We will have to pay more income tax on this profit. In this way, the payment of tax will be definitely more than what it should have actually been. The profit will reduce with the amount of depreciation, so lesser or the actual income tax due will be paid. Provision for depreciation in this way, avoids over payment of income tax.

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Factors Affecting the Amount of Depreciation

It is quite impossible to calculate the actual and accurate amount of depreciation. It can always be estimated, though we try our best to be more accurate and correct. Following factors have to be considered before estimation of the amount of depreciation.

1. **Total cost of the assets.** Value of assets is determined after adding all expenses of acquiring, installing and constructing the assets. We should take into consideration the total cost of assets for determining the rate and the amount of depreciation.
2. **Estimated useful life of assets.** The estimated working life of the assets may be measured in terms of years, months, hours, output (units) or kilometres (for trucks). In case of depreciation the value of assets is allocated over the estimated useful life of the asset. If expected life is more, the rate of depreciation will be lesser and *vice versa*.

   Useful life of asset depends upon the following factors

   (*i*) Predetermined by legal or contractual limits *e.g.*, in case of leasehold asset, the useful life is the period of lease.

   (*ii*) The number of shifts for which asset is to be used.

   (*iii*) Repair and maintenance policy of the business organisation.

   (*iv*) Technological obsolescence.

   (*v*) Innovation/improvement in production method.

   (*vi*) Legal or other restrictions.
3. **Estimated scrap value.** It is the residual value, which is expected to be realised even if the asset becomes obsolete. We shall have to make provision of the amount which is the value of assets less its scrap value. Suppose we purchase a machine for Rs. 10,000, whose expected life is ten years. If the scrap value is Rs. 1,000, we will have to arrange Rs. 9,000, *i.e.*, 10,000 – 1,000 in ten years. Every year will bear a depreciation of Rs. 900, *i.e.*, 9,000/10. If the scrap value in the above case is Rs. 2,000 depreciation to be charged will be Rs. 800 only.

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4. **Chances to obsolescence.** *If the asset acquired is expected to be obsolete within* 5 years, we will have to split its value over 5 years. If it will be obsolete within fou years the value will be split over four years. It shows that the amount of depreciatio charged every year will decrease with comparatively remote chances of obsolescence
5. **Addition to assets.** Depreciation should be charged on the additions to the assets also. *If book value of furniture on Jan. 1, 2006 is* Rs. 10,000 and additions worth Rs 5,000 are made on July 1, 2006. Depreciation is to be charged @ 10%. We shall be calculating depreciation on Rs. 10,000 for the whole year and on 5,000 for six months
6. **Legal provisions.** The rate and method of depreciation being used must be subject to legal provisions. Companies have to honour the legal provision with regard to depre*ciation.*

DEPRECIATION

Causes	Objectives	Factors Affecting
1. By constant use	1. For determination of net profit or net loss	1. Total cost of the Assets
2. By expiry of time	2. For showing asset at fair and true value in the Balance Sheet	2. Estimated useful life of the assets
3. By obsolescence	3. Provision of funds for replacement of assets	3. Estimated scrap value
4. By depletion	4. Ascertaining accurate cost of production	4. Chances to *obsolescence*
5. Parmanent fall in price	5. Distribution of dividend out of profit only	5. Addition to assets
6. By abnormal factors	6. Avoiding over payment of Income Tax	6. Legal Provision

4.3 METHODS OF CALCULATING DEPRECIATION

1. Fixed or Equal Instalment or Straight Line Method or Depreciation on Original Cost

It is the simplest method of charging depreciation. The original cost of the asset is divided by the estimated life period of the asset. For example, *if the value of asset is Rs.* 20,000 and its useful life is estimated to be 10 years, the amount of depreciation to be charged every year will be Rs. 2,000 *i.e.*,20,000/10. Depreciation to be charged every year will be Rs. 2,000 or in other words, it will be fixed at Rs. 2,000 for every year. If we draw a graph of depreciation of 10 years, we shall find it to be a straight line because depreciation every year is the same *i.e.,* Rs. 2,000.

In certain cases, we are also given the scrap or residual value of the assets. The term residual or scrap value means the amount realised from the sale of obsolete asset.

In these cases, we use the following formula for the calculation of depreciation :

Annual depreciation

$$= \frac{\text{Cost of asset - Scrap value or Residual value or Breakup or salvage value}}{\text{Expected or estimated life of asset}}$$

Under straight line method, depreciation may also be determined by applying a fixed rate to the original cost of the asset.

Explanation of formula

Cost of the assets. Cost of the assets means the original cost or the historical cost of the asset. The cost includes the purchase price and the expenses incurred in acquiring (carriage, cartage, freight on newly purchased asset), installation charge (in case of fixtures, plant and machinery) construction charges (in case of building).

Scrap or residual or breakup or salvage value. The asset being used will definitely become obsolete sooner or latter. The asset can be disposed off, even if it is obsolete (useless) as a scrap. The amount fetched by scrapped asset is known as its residual value.

Estimated life of the asset. Whenever asset is acquired, the manufacturer generally mentions the estimated working life of the asset. It may be in years, months, days or hours (in case of machines and equipments) in tons (in case of coal mines) in kilometres (in case of truck) so on. If the estimated life is not mentioned by the manufacturer we can assume it on the basis of our past experience or any scientific method.

Advantages of Straight Line Method

Straight line method of providing depreciation has got the following advantages :

1. **Simplicity.** This is the simplest method of providing depreciation. This can be easily understood even by ordinary person. Calc lation of depreciation according to this method is also very simple.
2. **Assets can be completely written off.** According to this method, assets can be written off to zero. The depreciation is calculated on the original cost of the asset at the specified rate, so the value of asset is fully split over the useful life of asset.
3. **Knowledge of total depreciation charged.** The amount of total depreciation charged can be easily known by multiplying the yearly amount of depreciation with number of years, the asset has been used.
4. **Suitable for small firms.** Straight line method is the most suitable method for small firms. These firms use this method, because it is easy, simple and suitable to the size of the firms.
5. **Suitable for firms having large number of old and new machines.** The weaknesses of this method are removed, if the firm has both old and new machines. More maintenance charges on old machines and lesser on the new machines balance each other.
6. **Useful for assets having lesser value.** This method is the most suitable for charging depreciation on assets of lesser value such as furniture, fixture and patents etc.

Disadvantages or Limitations of Straight Line Method

Straight line method suffers from the following weaknesses :

1. **Undue pressure on final years.** The final years of the life of the asset have to bear more repairs and maintenance charges and also the same amount of depreciation, whereas initial years have to suffer lesser repair charges.

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2. **No provision for replacement.** The amount charged as depreciation is retained in the business and used in the routine affairs. The firm has to bother for making arrangement of funds for the replacement of assets although depreciation has been charged every year.
3. **Loss of interest.** The amount of depreciation charged every year is not invested outside the firm, so no interest is received. In certain methods of depreciation, the amount of depreciation is invested outside the business in securities and interest is received.
4. **Illogical method.** It seems illogical to charge depreciation on the original cost of the asset every year when the balance of the asset is declining year after year.
5. **Unsuitable for assets having long-life and more value.** This method is not suitable for those assets which are subject to additions and extension from time to time, such as land and building and plant and machinery. It is not suitable for assets having more value also.

Uses of Straight Line Method

Straight line method is suitable for those assets, which require lesser expenses on repairs and maintenance. The method is also useful for assets of lesser value such as patents, furniture etc. This method is also useful for those big manufacturing concerns who have got a large number of machines. Some assets are very old and some of them are fresh. The combined result of the depreciation on both the old and new machines and also repairs and maintenance charges balance each other. In case of old machines, maintenance charges are more but in case of new machines charges are lesser. More maintenance charges on old machines and lesser repairs on new balance each other.

The method is very simple, so most appropriate for small firms and assets of small value.

Its Accounting treatment is as under :

According to this method following journal entries are passed :

1. **For purchase of assets**

Assets A/c	Dr.
To Bank or Cash A/c	

2. **For depreciation on assets**

Depreciation A/c	Dr.
To Assets A/c	

3. **For sale of assets**

Bank or Cash A/c	Dr.
To Assets A/c	

4. **For loss on sale of assets**

P/L A/c	Dr.
To Assets A/c	

The third and fourth entry regarding sale of asset or loss can be combined together :

Bank or Cash A/c	Dr.
Loss on Sale of Assets A/c	Dr.
To Assets A/c	

Loss on sale of assets account will be closed by transfer to profit and loss account :

5. **For profit on sale of assets**

Assets A/c	Dr.
To P/L A/c	

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Illustration 1. (Straight Line Method : When rate is given). *The purchase of furniture amounted to Rs. 4,000 and it is decided to write off 5 per cent on the original cost as depreciation at the end of each year. Show the ledger account as it will appear during the first four years. Pass journal entries also.*

Solution.

Journal Entries

Date	*Particulars*	*L.F.*	*Amount* Debit Rs.	*Amount* Credit Rs.
Ist year Jan. 1	Furniture A/c Dr. To Bank A/c (Being purchase of furniture)		4,000	4,000
Dec. 31	Depreciation A/c Dr. To Furniture A/c (Being depreciation on furniture @ 5% on Rs. 4,000)		200	200
2nd year Dec. 31	Depreciation A/c Dr. To Furniture A/c (Being depreciation charged on furniture @ 5% on Rs. 4,000)		200	200
3rd year Dec. 31	Depreciation A/c Dr. To Furniture A/c (Being depreciation charged on furniture @ 5% on Rs. 4,000)		200	200
4th year Dec. 31	Depreciation A/c Dr. To Furniture A/c (Being depreciation charged on furniture @ 5% on Rs. 4,000)		200	200

Explanation. As per the instructions of question, depreciation on furniture has to be charged @ 5% on original cost. The original cost of the furniture is Rs. 4,000, so depreciation on furniture will be charged every year on its original value, *i.e.*, Rs. 4,000. This is why, every year Rs. 200 has been charged as depreciation.

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Fixed Instalment Method

Furniture Account

Dr. Cr.

Date	Particulars	J.F.	Amount Rs.	Date	Particulars	J.F.	Amount Rs.
Ist year				Ist year			
Jan. 1	To Bank A/c		4,000	Dec. 31	By Depreciation A/c		200
					By Balance c/d		3,800
			4,000				4,000
2nd year				2nd year			
Jan. 1	To Balance b/d		3,800	Dec. 31	By Depreciation A/c		200
					By Balance c/d		3,600
			3,800				3,800
3rd year				3rd year			
Jan. 1	To Balance b/d		3,600	Dec. 31	By Depreciation A/c		200
					By Balance c/d		3,400
			3,600				3,600
4th year				4th year			
Jan. 1	To Balance b/d		3,400	Dec. 31	By Depreciation A/c		200
					By Balance c/d		3,200
			3,400				3,400
5th year							
Jan. 1	To Balance b/d		3,200				

Illustration 2. (Straight Line Method : Original cost, expected life and scrap value). *On January 1, 2003 M/s Ram & Sons purchased a Machinery for Rs. 2,00,000. They spent Rs. 12.000 on its freight and Rs. 8,000 for its installation. The expected life of the machine is 10 years. It is expected that the machine will be sold for Rs. 20,000 after its useful life. Prepare machinery account and depreciation account for 3 years. Books of Accounts are closed on December 31, every year.*

Solution.

Machine Account

Dr. Cr.

Date	Particulars	J.F.	Amount Rs.	Date	Particulars	J.F.	Amount Rs.
2003				2003			
Jan. 1	To Bank A/c		2,20,000	Dec. 31	By Depreciation A/c		20,000
				Dec. 31	By Balance c/d		2,00,000
			2,20,000				2,20,000
2004				2004			
Jan. 1	To Balance b/d		2,00,000	Dec. 31	By Depreciation A/c		20,000
				Dec. 31	By Balance c/d		1,80,000
			2,00,000				2,00,000

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2005				2005			
Jan. 1	To Balance b/d		1,80,000	Dec. 31	By Depreciation A/c		20,000
				Dec. 31	By Balance c/d		1,60,000
			1,80,000				1,80,000
2006							
Jan. 1	To Balance b/d		1,60,000				

Depreciation Account

Dr. *Cr.*

Date	*Particulars*	*J.F.*	*Amount Rs.*	*Date*	*Particulars*	*J.F.*	*Amount Rs.*
2003				2003			
Dec. 31	To Machine A/c		20,000	Dec. 31	By P/L A/c		20,000
2004				2004			
Dec. 31	To Machine A/c		20,000	Dec. 31	By P/L A/c		20,000
2005				2005			
Dec. 31	To Machine A/c		20,000	Dec. 31	By P/L A/c		20,000

Working Note :

Calculation of Depreciation :

$$\frac{\text{Cost of machine - Scrap value}}{\text{Expected life of machinery}} = \frac{2,20,000 - 20,000}{10} = \textbf{Rs. 20,000.}$$

Illustration 3. (Straight Line Method : Additions to assets). *On 1st January, 2001 a Company bought Plant and Machinery costing Rs. 35,000. It is estimated that its working life is 10 years, at the end of which it will fetch Rs. 5,000. Additions are made on 1st January, 2002 to the value of Rs. 20,000 (Residual value Rs. 2,000). More additions are made on July 1, 2003 to the value of Rs. 10,000. (Breakup value Rs. 1,000). The working life of both the additional Plants and Machinery is 20 years.*

Show the Plant and Machinery account for the first four years, if depreciation is written off according to Straight Line Method. The accounts are closed on 31st December every year.

Solution.

Plant and Machinery Account

Dr. *Cr.*

Date	*Particulars*	*J.F.*	*Amount Rs.*	*Date*	*Particulars*	*J.F.*	*Amount Rs.*
2001				2001			
Jan. 1	To Bank A/c		35,000	Dec. 31	By Depreciation A/c		3,000
				Dec. 31	By Balance c/d		32,000
			35,000				35,000

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2001			2002			
Jan. 1	To Balance b/d	32,000	Dec. 31	By Depreciation A/c		
Jan. 1	To Bank A/c	20,000		(i) Rs. 3,000		
				(ii) Rs. 900	3,900	
			Dec. 31	By Balance c/d		
				(i) Rs. 29,000		
				(ii) Rs. 19,100	48,100	
		52,000			52,000	
2003			2003			
Jan. 1	To Balance b/d		Dec. 31	By Depreciation A/c		
	(i) Rs. 29,000			(i) Rs. 3,000		
	(ii) Rs. 19,100			(ii) Rs. 900		
		48,100		(iii) Rs. 225		
July 1	To Bank A/c	10,000		(for 6 months	4,125	
			Dec. 31	By Balance c/d		
				(i) Rs. 26,000		
				(ii) Rs. 18,200		
				(iii) Rs. 9,775	53,975	
		58,100			58,100	
2004			2004			
Jan. 1	To Balance b/d		Dec. 31	By Depreciation A/c		
	(i) Rs. 26,000			(i) Rs. 3,000		
	(ii) Rs. 18,200			(ii) Rs. 900		
	(iii) Rs. 9,775	53,975		(iii) Rs. 450	4,350	
			Dec. 31	By Balance c/d		
				(i) Rs. 23,000		
				(ii) Rs. 17,300		
				(iii) Rs. 9,325	49,625	
		53,975			53,975	
2005						
Jan. 1	To Balance b/d					
	(i) Rs. 23,000					
	(ii) Rs. 17,300					
	(iii) Rs. 9,325	49,625				

Notes 1. Calculation of Depreciation $= \dfrac{\text{Cost of Plant and Machinery - Residual value}}{\text{Working life}}$

$$(1) = \frac{\text{Rs. } 35,000 - \text{Rs. } 5,000}{10 \text{ years}} = \frac{30,000}{10} = \text{Rs. } 3,000 \text{ per year.}$$

$$(2) = \frac{\text{Rs. } 20,000 - \text{Rs. } 2,000}{20 \text{ years}} = \frac{18,000}{20} = \text{Rs. } 900 \text{ per year}$$

$$(3) = \frac{\text{Rs. } 10,000 - \text{Rs. } 1,000}{20 \text{ years}} = \frac{9,000}{20} = \text{Rs. } 450 \text{ per year.}$$

2. The amount of depreciation on all the three machines will be ascertained separately as above.

Illustration 4. (Straight Line Method : Sale of assets). *On 1st July 2003 Raj & Co., purchased machinery worth Rs. 40,000. On 1st July, 2005 it buys additional machinery worth Rs. 10,000. On 30th June, 2006 half of the machinery purchased on 1st July, 2003 is sold for Rs. 9,500. The company writes off 10% on the original cost. The accounts are closed every year on 31st December.*

Show the machinery account for four years, Accounts are closed on December 31, every year.

Solution.

Machinery Account

Dr. *Cr.*

Date	*Particulars*	*J.F.*	*Amount Rs.*	*Date*	*Particulars*	*J.F.*	*Amount Rs.*
2003				2003			
July 1	To Bank A/c		40,000	Dec. 31	By Depreciation (On 40,000 for six months)		2,000
				Dec. 31	By Balance c/d		38,000
			40,000				40,000
2004				2004			
Jan. 1	To Balance b/d		38,000	Dec. 31	By Depreciation (On 40,000 for one year)		4,000
				Dec. 31	By Balance c/d		34,000
			38,000				38,000
2005				2005			
Jan. 1	To Balance b/d		34,000	Dec. 31	By Depreciation (On 40,000 for one year and on 10,000 for six months)		4,500
July 1	To Bank A/c		10,000	Dec. 31	By Balance c/d		39,500
			44,000				44,000
2006				2006			
Jan. 1	To Balance b/d		39,500	June 30	By Bank A/c		9,500
					By Depreciation (On 20,000 for six months)		1,000
					By profit and Loss		4,500
				Dec. 31	By Depreciation (On 20,000 for one year + On 10,000 for one year)		3,000
				Dec. 31	By Balance c/d		21,500
			39,500				39,500
2007							
Jan. 1	To Balance b/d		21,500				

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Notes. (*i*) **Calculation of loss on sale of Machinery :**

			Rs.
Book value of full machine (on July 1, 2003)	$= 40{,}000$		
Book value of half machinery (on July 1, 2003)	$= 40{,}000 \times \frac{1}{2} =$		20,000
Less : Depreciation on half machinery @ 10% on straight line method :			
2003 (July 1—Dec. 31)	1,000		
2004 (for full year)	2,000		
2005 (for full year)	2,000		
2006 (Jan. 1—June 30)	1,000		6,000
Book value as on June 30, 2006			14,000
Less : Amount received from sale			9,500
Loss on sale of machinery			4,500

(*ii*) **Journal entry for sale of machinery :**

2006				
June 30,	Bank A/c	Dr.	9,500	
	Profit and Loss A/c	Dr.	4,500	
	Depreciation A/c	Dr.	1,000	
	To Machinery A/c			15,000

Calculation of Depreciation on Additions to Asset

Business is a continuing activity, so we may purchase additional assets or we may add to the existing assets. Addition to the fixed assets, such as land and building, plant and machinery, vehicles and furniture etc., are capital expenditure. It will increase the value of assets, *so depreciation will also be charged on these additions.* Depreciation on additions will be charged since the date of additions at the specified rate.

For example, if addition to machinery worth Rs. 20,000 on July 1, 2005, will be depreciated at the rate of 10% (specified) for six months together with the depreciation on the book value of old machinery, depreciation on the additions during the first year will be the same under straight line or written down value method.

Treatment of Sale of Asset

The firm may sell asset, if it is obsolete. It may also be sold when it is not in perfect order. The disposal of asset will take place, when purchase of fresh, up-to-date asset is made and the old asset becomes unwanted. In any case, the sale of asset has to be accounted for. The treatment of asset in case of sale will be made as under :

Treatment of Sale of Asset

(*i*) **If asset is sold at the book value**

Bank A/c	Dr.
To Asset A/c	

(*ii*) **If the asset is sold at lesser than book value (loss)**

Bank A/c	Dr.
Profit and Loss A/c	Dr.
To Asset A/c	

(*iii*) **If the asset is sold for more than the book value**

Bank A/c Dr.

To Asset A/c

To Profit and Loss A/c

NOTES

2. Diminishing or Written Down Balance Method

This method has been developed to remove the short comings of straight line method. Equal amount of depreciation is charged every year under straight line method. The method is criticised for showing disfavour to final years of the life of the assets. During final years repairs and maintenance charges are more but the depreciation is the same. It shows that the final years are over burdened with charges. Diminishing balance method was developed to remedy the weakness of straight line method.

Under the diminishing balance method, the value of asset upon which depreciation is to be calculated goes on diminishing, so the amount of depreciation to be charged every year also goes on declining. For example, if a machine has been acquired for Rs. 1,00,000 and depreciation is charged @ 10% according to written down value method the depreciation to be charged will be made as under :

1st year on Rs. 1,00,000 @ 10% = $\frac{10}{100} \times 1{,}00{,}000$ = Rs. 10,000

2nd year on Rs. 90,000, *i.e.*, Rs. 1,00,000 – 10,000 = $90{,}000 \times \frac{10}{100}$ = Rs. 9,000

3rd year on Rs. 81,000, *i.e.*, Rs. 90,000 – 9,000 = $81{,}000 \times \frac{10}{100}$ = Rs. 8,100

4th year on Rs. 72,900, *i.e.*, Rs. 81,000 – 8,100 = $72{,}900 \times \frac{10}{100}$ = Rs. 7,290.

and so on.

It will be observed from the above calculation that the balance of machine upon which depreciation is being calculated goes on diminishing or reducing or it is being written down. It should also be noted that the amount of depreciation goes on declining year after year. In the first year it was Rs. 10,000, in the second year, it came down to Rs. 9,000. It reduced further to Rs. 8,100 in the third year. In the 4th year, it remained only Rs. 7,290. In this way, depreciation will go on declining year after year.

Advantages of Diminishing Balance/Written Down Value Method

Diminishing balance method has got the following advantages :

1. **Easy calculation.** Calculation of depreciation is easier as compared to other methods of calculating depreciation except straight line method. Depreciation is calculated every year on the opening balance of asset. Depreciation on additions is separately calculated.

2. **Balanced effect on the profit and loss account of different years.** In the initia years depreciation is more and the maintenance charges are lesser. In the final years depreciation is lesser but repairs and maintenance charges are more, so every year bears the charges almost the same as regards depreciation and maintenance.

NOTES

3. **Approved method by income tax authorities.** The method is approved by income tax authorities.

4. **Logical method.** It seems logical even to layman that the value of asset goes on diminishing year after year, so the depreciation should also be charged on the reducing balances.

5. **Suitable for assets having long-life.** This method is suitable for those assets which have long-life. It is also suitable for those assets, where additions and extensions are common feature, such as land, building and plant and machinery.

Disadvantages or Limitation of the Diminishing Balance Method

Diminishing balance method of providing depreciation suffers from following weaknesses :

1. **The value of asset cannot be reduced to zero.** It is very difficult to determine the rate by which the value of asset could be written down to zero.

2. **No funds for replacement.** Though depreciation is charged every year but the amount charged is retained in the business and used in routine business operations. At the time of replacing assets, firm has to bother for making arrangement of funds, although it has charged depreciation every year.

3. **Loss of interest.** The amount charged as depreciation is not invested outside the business, so no interest is received. In certain methods, the amount is invested outside the business in securities and interest is received.

4. **Higher rate of depreciation.** The rate of depreciation in this method is higher, because it will require longer period to write off the asset, if the rate is lower and the assets may become useless earlier.

5. **Inequal burden on profit and loss account.** The amount of depreciation goes on declining year after year, whereas the asset is used equally by every year.

Uses of Diminishing Balance Method

Diminishing balance is the method for assets having long-life. It is also suitable for those assets which are subject to additions and extensions from time to time, such as land and building, plant and machinery etc.

Difference between Straight Line and Diminishing Balance Method

Difference between straight line and diminishing balance method can be made as under :

Points of Difference	*Straight Line Method*	*Diminishing Balance Method*
1. *Amount of Depreciation*	Equal amount of depreciation is charged every year.	The amount of depreciation goes on reducing year after year.
2. *Calculation of Depreciation*	Depreciation is calculated on the original cost of the assets.	Depreciation is calculated on the reducing balance of asset.

NOTES

3. *Zero level*	The value of assets can be written down to zero.	The value of assets cannot be written down to zero.
4. *Effect on profit and loss account*	The initial years of the life of the asset bear lesser amount as depreciation and repairs but final years bear the same amount of depreciation but no repairs and maintenance charges.	Every year bears almost the same charges. Depreciation goes on declining, whereas repairs and maintenance charges go on increasing.
5. *Suitability*	This method is useful for assets of lesser value such as patents, furniture and fixtures etc.	The method is suitable for assets having longer life and more value such as land and building, plant and machinery etc.
6. *Recognition by Income tax law*	Straight line method is not recognised by Income tax law.	Written down value method is recognised by Income tax law.

Illustration 5. (Diminishing Balance Method) : Sale of assets). *Kaushal Traders purchased a second hand machinery on 1st January, 2002 for Rs. 23,000 and spent Rs. 2,000 on its repairs. It was decided to depreciate the machinery at 20% every year, according to diminishing balance method. Prepare the machinery account from 2002 to 2004 and show profit or loss as it was sold on 31st December, 2004 for Rs. 10,800. The accounts are closed on December 31 every year.*

Solution. **Diminishing Balance Method**

Machinery Account

Dr. *Cr.*

Date	*Particulars*	*J.F.*	*Amount Rs.*	*Date*	*Particulars*	*J.F.*	*Amount Rs.*
2002				2002			
Jan. 1	To Bank A/c		23,000	Dec. 31	By Depreciation A/c		5,000
	To Bank A/c (Repairs)		2,000	Dec. 31	By Balance c/d		20,000
			25,000				25,000
2003				2003			
Jan. 1	To Balance b/d		20,000	Dec. 31	By Depreciation A/c		4,000
					By Balance c/d		16,000
			20,000				20,000
2004				2004			
Jan. 1	To Balance b/d		16,000	Dec. 31	By Depreciation A/c		3,200
				Dec. 31	By Bank A/c		10,800
				Dec. 31	By Profit & Loss (Loss on sale)		2,000
			16,000				16,000

NOTES

Note. The amount of depreciation has been calculated @ 20% on diminishing (reducing) balances of machinery. In 2002, depreciation has been calculated on 25,000. Amount spent on repairs to second hand machinery is capital expenditure. It was necessary to bring the old machinery in working order. It is the part of the cost of machinery, so it has been added to its cost. The balance of machinery reduced to Rs. 20,000 in 2003 and further reduced to Rs. 16,000 in 2004, so depreciation for 2003 has been calculated on 20,000 and for 2004 on Rs. 16,000.

Loss on sale of machinery has been calculated as under :

Book value of machinery as on January 1, 2002		Rs. 25,000
Less : Depreciation :		
2002 (for full year)	5,000	
2003 (for full year)	4,000	
2004 (for full year)	3,200	
		12,200
Book value of machinery as on December 31, 2004		12,800
Less : Amount received from sale of machinery		10,800
Loss on sale of machinery		2,000

Illustration 6. (Diminishing Balance : Assets sold partly). *A company whose accounting year is the calendar year purchased on 1st April, 2001 machinery costing Rs. 30,000.*

It further purchased machinery on 1st October, 2001 costing Rs. 20,000 and on 1st July, 2002 costing Rs. 10,000.

On 1st January, 2003 one-third of the machinery which was installed on 1st April, 2001 became obsolete and was sold for Rs. 3,000.

Show how the machinery account would appear in the books of company. The depreciation is charged at 10% p.a. on Written Down Value Method.

Solution. **Written Down Value Method**

Machinery Account

Dr. *Cr.*

Date	*Particulars*	*J.F.*	*Amount Rs.*	*Date*	*Particulars*	*J.F.*	*Amount Rs.*
2001				2001			
April 1	To Bank A/c		30,000	Dec. 31	By Depreciation A/c		2,750
Oct. 1	To Bank A/c		20,000	Dec. 31	By Balance c/d		47,250
			50,000				50,000
2002				2002			
Jan. 1	To Balance b/d		47,250	Dec. 31	By Depreciation A/c		5,225
July 1	To Bank A/c		10,000		By Balance c/d		52,025
			57,250				57,250
2003				2003			
Jan. 1	To Balance b/d		52,025	Jan. 1	By Bank A/c		3,000
				Jan. 1	By P & L A/c (Loss)		5,325
				Dec. 31	By Depreciation A/c		4,370
				Dec. 31	By Balance c/d		39,330
			52,025				52,025
2004							
Jan. 1	To Balance b/d		39,330				

NOTES

Working Notes :

(*i*) Calculation of depreciation for year 2003 :	Rs.
Total Written Down Value as on January 1, 2003	52,025
Less : Written Down Value of 1/3rd of plant sold (10,000 – 750 – 925)	– 8,325
Written down value of remaining machine	43,700
Depreciation at 10% on Written Down Value $\left(43{,}700 \times \frac{10}{100}\right)$	4,370
(*ii*) Calculation of loss on sale of machinery :	
Book value of 1/3rd machinery purchased on April 1, 2001 as on January 1, 2003 (10,000 – 750 – 925)	8,325
Less : Amount received from sale	(–) 3,000
Loss on sale of machinery	5,325

Illustration 7. (Diminishing Balance : Sale of assets). *A manufacturing concern, whose books are closed on 31st December, purchased machinery for Rs. 50,000 on 1- 1-2000. Additional machinery was acquired for Rs. 10,000 on 1-7-2001 and for Rs. 16,061 on 1-1-2004. Certain machinery purchased for Rs. 10,000 on 1-1-2000 was sold for Rs. 5,000 on 30-6-2003.*

Give the machinery account for 5 years. Depreciation is written off at 10% per annum on written down value method.

Solution. **Written Down Value Method**

Machinery Account

Dr. *Cr.*

Date	*Particulars*	*J.F.*	*Amount Rs.*	*Date*	*Particulars*	*J.F.*	*Amount Rs.*
2000				2000			
Jan 1	To Bank A/c		50,000	Dec. 31	By Depreciation A/c		5,000
				Dec. 31	By Balance c/d		45,000
			50,000				50,000
2001				2001			
Jan. 1	To Balance b/d		45,000	Dec. 31	By Depreciation A/c		5,000
July 1	To Bank A/c		10,000	Dec. 31	By Balance c/d		50,000
			55,000				55,000
2002				2002			
Jan. 1	To Balance b/d		50,000	Dec. 31	By Depreciation A/c		5,000
				Dec. 31	By Balance b/d		45,000
			50,000				50,000
2003				2003			
Jan. 1	To Bank b/d		45,000	June 30	By Bank A/c		5,000
				June 30	By Profit & Loss A/c		1,925
				Dec. 31	By Depreciation A/c		4,136

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				Dec. 31	By Balance b/d		33,939
			45,000				45,000
2004				2004			
Jan 1	To Balance b/d		33,939	Dec. 31	By Depreciation A/c		5,000
Jan 1	To Bank A/c		16,061	Dec. 31	By Balance c/d		45,000
			50,000				50,000
2005							
Jan. 1	To Balance b/d		45,000				

Working Notes

		Rs.
(i) Calculation of loss on sale of machinery :		Rs.
Book value of machinery as on January 1, 2000		10,000
Less : Depreciation according to diminishing balance method :		
2000 (for full year)	1,000	
2001 (for full year)	900	
2002 (for full year)	810	
2003 (for six months)	365	
		3,075
Book Value of Machine sold as on June 30, 2003		6,925
Less : Amount received from sale		(–) 5,000
Loss on sale of machine		1,925
(ii) Calculation of depreciation for the year 2003 :		
Book value of all machineries as on January 1, 2003		45,000
Less : Book value of machinery to be sold as on January, 1, 2003		(–) 7,290
		37,710
Depreciation on 37,710 @ 10% for full year	3,771	
Add : Depreciation on 7,290 @ 10% for six months	365	
Total depreciation for 2003	4,136	

Replacement Cost Method

Under this method an asset is depreciated over a period of time and a fund is maintained for the replacement of that asset by the amount of decreasing its value. For example, if there is an asset purchased on 1st Jan. 2008 for Rs. 10,00,000 and straight line method is applied at 10% then at the end of the year 2008 the depreciation will be Rs. 1,00,000. The company will maintain a fund for the replacement of the asset with Rs. 1,00,000 as balance at the end of the year 2008. This means that the amount depreciated is set aside in the form of a fund for future replacement of the asset.

4.4 PROVISION

Provision is a charge against profit to meet certain known liabilities or contingencies. It is an specific reserve and must be maintained, whether there is profit or loss. Provision is created for a definite object such as :

Special Features of Provision : It is maintained :

(*i*) *To meet known losses, e.g.,* depreciation, heavy repairs and renewals.

(*ii*) *To meet expected contigency, e.g.,* doubtful debts, discount on debtors, liability for disputed claim, any contingent liability under Workmen's Compensation Act.

(*iii*) *To meet an outstanding liability* such as outstanding salaries, wages, rent and income tax etc.

Provision or Specific reserve is not surplus. It is not represented by any asset. Provision is not available for distribution among shareholders. If the provision exceeds the required amount the excess is treated as reserve.

Provisions or specific reserve is deducted from the assets in the Balance Sheet. Depreciation is deducted from concerned assets. Provision for bad debts and discounts are deducted from debtors. Reserve for outstanding liabilities such as outstanding expenses are shown at the liabilities side.

1. Provision for bad and doubtful debts. It is created to meet any future loss, if the debtors fail to pay the whole or part of the debt, owing by them. The amount set aside for this provision is charged out of the current year's profit and loss account. *The logic behind it is that debtors also belong to current year and we are conservative in this matter.*

Provision for doubtful debts is posted at the debit side of profit and loss account. This provision for doubtful debts is also deducted from sundry debtors at the assets side of the Balance Sheet. In the next year, if there is actual bad debts, it will be charged from the provision for doubtful debts.

2. Provision for discount on debtors. *It is a trade practice that when debtors make* immediate payment or payment at an early date, we allow them discount at certain rate. As it is customary trade practice, it seems to be judicious that we should make provision for discount on debtors. As the provision for discount on debtors relates to current year's debtors so it should be charged out of current year's profit and loss account. The provision for discount on debtors will be deducted from sundry debtors at the assets side of the Balance Sheet.

It may also be argued that provision of discount on debtors should not be maintained at the end of the year because debtors may not take advantage cf this cash discount. Moreover, discount is allowed to those debtors who make payment before the due date.

The amount of the provision for discount on debtors is calculated on debtors. If further bad debts and provision for doubtful debts are also to be created, this provision will be calculated after deducting both further bad debts and provision for bad debts from debtors.

3. Provision for taxation. Taxes have to be paid to the Government on the profit of the current year in the following assessment year. It seems necessary that certain specific amount for this known liability must be set aside out of the profit and loss account of the current year to make payment of the taxes. The amount set a side for this purpose will be debited to profit and loss account. It will also be shown at the liability side of the current year, because the amount is still payable.

During the next year, taxes of the current year will be paid. For making payment of taxes, we shall debit provision for taxes account and credit Bank account. The balance of provision for taxation account will be shown at the liabilities, so far its balance exists.

Provision for taxation may be treated as both, the current or non-current liability. If it is assumed to be non-current liability previous year's provision for taxation will be paid during the current year. Taxes payable on the profits of the current year will be charged out of the profit and loss account of the current year.

Accounting Treatment of Provisions

Provisions are charged against profit. Provisions are created by debiting profit and loss account for specific and known contingency or expected loss; *e.g.*, provision for doubtful debts, provision for discount on debtors and provision for taxation etc. A definite sum is charged every year out of profit and loss account to meet the known contingency. Provisions account should be compulsorily posted at the debit side of profit and loss account, whether the firm earns profit or suffers loss.

The provisions are generally shown at the assets side of Balance Sheet by way of deducting it from concerned assets. Provision for doubtful debts and provision for discount on debtors are shown by way of deduction from debtors on the assets side of the Balance Sheet. It may sometimes be shown at the liabilities side also, *i.e.*, provision for taxation.

Making provision is must but making reserves is discretionary as a matter of financial prudence and subject to profit.

Provision for doubtful debts generally has old balance. The old provision is deducted from the total of bad debts and new provision at the debit side of profit and loss account. In case old provision exceeds the total of bad debts and new provision, the treatment should preferably be made at the credit side of profit and loss account, where the total of bad debts and new provision should be deducted from old provision.

4.5 RESERVES

Generally an ordinary person understands by the term "reserve" that something has been kept a part for emergency. From accountancy point of view "reserve" means the part of profit retained for any known or unknown contingency, liability or decrease in the value of asset. *American Institute of Accounting* views, "The use of the term reserve be limited to indicate that an undivided part of the asset is being held or retained for general or specific reserve".

It is the appropriation of profit. It is created out of undistributed profit. General reserve is also known as "free reserve" or "revenue reserve". It is created to meet unforeseen future uncertainties. The general reserve is maintained to meet unknown liability or contingency or commitment.

General reserve is a source of internal financing. It is the retained profit and technically known as 'ploughing back of profit'. If the reserve would not have been maintained the profit would have been distributed among shareholders as dividend and the amount would have gone outside the business. In case of general reserve profit and loss account shows a credit balance. The debit balance of profit and loss account (loss) and general reserve cannot exist simultaneously.

It is not compulsory and binding upon business to maintain general reserve. The companies act does not make it obligatory to set aside a certain sum of money for general reserve. It may be created if the management thinks it advisable and the profit are sufficient. It should once more be noted that *it is the appropriation of profit not a charge.*

Broad classification of Reserve

Reserves are broadly classified as (1) Capital Reserve (2) Revenue Reserve (3) General Reserve (4) Specific Reserve and (5) Secret Reserve.

1. Capital Reserve. *Capital Reserve is a gain which arises either on sale of long term assets or in the settlement of liabilities. The transaction is of capital nature. Capital Re-*

serve acts as an accounting mechanism for conserving profits. It imparts an element of stability to the overall finance of a business enterprise. Allocation of revenue reserve may be made to capital reserve due to legal obligations. Capital reserve does not include any free balance which might be used for distribution of profits.

NOTES

Capital profits arises from the following :

—Issue of shares at premium

—Profits emerging from revaluation of fixed assets after observing all restrictions.

—Profits accruing on sale of fixed assets.

—Premium on issue of shares and debentures

—Profit on redemption of debenture

— Balance of forfeited shares A/c

—Profit prior to incorporation

—Creation of Capital Redemption reserve upon the redemption of preference shares.

2. Revenue Reserve. These reserves are created out of revenue profit which are usually distributable profits. In other words, it is the profit which has been withheld from paying dividend out of the total distributable profit.

Examples of Revenue Reserve are :

—*General reserve*

—Dividend equalization reserve

—Debenture redemption reserve.

Distinction between Revenue Reserve and Capital Reserve

Basis	*Revenue Reserve*	*Capital Reserve*
1. *Source*	It is created out of revenue profit.	It is created out of capital gains.
2. *Dividend*	It can be used for distribution of dividend.	It cannot be used for distribution of dividend.
3. *Objective*	It is created to meet future contingencies or for some specific purpose.	It is created as a legal requirement or accounting practice.
4. *Usage*	It can be used for revenue as well as capital purposes.	It can only be used for setting off capital losses or other purposes specified by law.

3. General Reserve. It is that portion of profit, which is retained for the improvement of the overall financial status of an enterprise and to improve its health in general.

The creation and maintenance of general reverse helps in realizing certain well recognized purposes especially from the view point of financial management. *In other words, the reserve, which is not created for any specific purpose is known as General Reserve.* For example Reserve, general reserve. Reserve Fund and Contigency reserve etc.

Importance of General Reserve

— Improvement of the general financial position of the business by conserving resources.

—Arrangement for meeting unforeseen and abnormal losses irrespective of their nature.

NOTES

Disadvantages or Limitation of Written Down Value Method

(1) The value of assets cannot be reduced to zero (2) No funds for replacement (3) Loss of interest (4) Higher rate of depreciation (5) Inequal burden on Profit and Loss account.

Points of Difference between Straight Line and Reducing Balance Method

(1) Amount of depreciation (2) Calculation of depreciation (3) Zero level (4) Effect on Profit and Loss A/c (5) Suitability (6) Recognisation by Income tax law.

Method of Recording Depreciation

A. By charging depreciation to assets Account or not maintaining Provision for depreciation A/c.

B. By creating or maintaining provision for depreciation A/c or Accumulated Depreciation A/c.

Provision

Charge against *Profit to meet certain known liabilities or contingencies* is known as Provision. It is a specific reserve and must be maintained, whether there is Profit or loss. Provision is created for definite purpose, such as :

(*i*) Known losses (*ii*) Expected contingency (*iii*) Outstanding liability.

Examples :

(1) Provision for bad and doubtful debts

(2) Provision for discount on debtors

(3) Provision for taxation.

(4) Provision for outstanding liabilities.

Reserve

Reserve means part of profit retained for any known or unknown contingency, liability or decrease in the value of asset. It is appropriation of Profit.

Broad Classification of Reserve

(*a*) **Capital Reserve.** Gain arising either on sale of long term asset or settlement of liabilities is known as capital reserve. It consists of securities premium, Profit on revaluation or sale of fixed assets, profit prior to incorporation, profit on redemption of debentures, balance of forfeited shares A/c etc.

(*b*) **Revenue Reserve.** Reserves created out of distributable profit to meet unforeseen future contingencies are known as Revenue reserve. Examples of these reserve are General reserve, Dividend equalisation reserve and debenture redemption reserve.

Points of Distinction between Revenue Reserve and Capital Reserve.

(1) Source (2) Dividend (3) Objective (4) Usage.

(*c*) **General Reserve.** The reserve, which is not maintained for any specific and specified purpose is known as General Reserve, such as reserve, Reserve fund and contingency Reserve.

(*d*) **Specific Reserve.** The reserve created for certain specific and specified purpose is known as specific reserve such as Dividend Equalisation Reserve and Investment Fluctuation Reserve.

(*e*) **Secret Reserve.** The reserve, which is not placed in the Balance Sheet is known as 'Secret Reserve' or 'Hidden Reserve or Inner Reserve'.

REVIEW QUESTIONS

NOTES

A. Very Short Answer Type Questions :

1. *Mention any three important features of depreciation.*
2. Mention names of three factors affecting the amount of depreciation.
3. Mention the formula for calculating depreciation under straight line method.
4. What is depreciation ?
5. A pharmaceutical manufacturer has just developed and registered a patent for a rare medicine. Which term will appear in its profit and loss account regarding the cost of patent written off.
6. *Define Reserve and Provision.*

B. Short Answer Type Questions :

1. Explain the following terms :
   (*a*) Obsolescence (*b*) Depletion
   (*c*) Fluctuation (*d*) Amortisation.
2. What are the different causes of depreciation ? Explain them briefly.
3. You are looking at the profit and loss account of three business enterprises. You find the term *depreciation in first, depletion in case of second and* amortisation in case of third enterprise. State the type of business each of the enterprise is into.
4. There are two dentists Dr. Aggarwal and Dr. Mehta in your locality who are competitors. Both of them have recently bought machine for patients. Dr. Aggarwal has decided to write off an equal amount of depreciation every year while Dr. Mehta wants to write off a larger *amount in earlier years.* They do not know anything about the methods of depreciation. Can you inform them more about the methods of depreciation they are applying even without knowing anything about accounting in formal. Who is more wise in your opinion ? Give reasons in support of your answer.

C. Long Answer Type Questions :

1. *Explain the meaning of depreciation.* Enumerate different methods of depreciation. Explain straight line method.
2. Why is it necessary to provide for depreciation ? Explain the effect of depreciation on Profit and loss account and Balance Sheet.
3. Differentiate between straight line method and written down value method of providing *depreciation.*
4. Discuss the advantages and disadvantages of fixed instalment method and diminishing balance method.
5. Explain the following :
   (*a*) Obsolescence, (*b*) Amortisation, (*c*) Depletion, (*d*) Fluctuation.

UNIT 5 ACCOUNTS OF NON-TRADING INSTITUTIONS

NOTES

★ STRUCTURE ★

5.1 Objectives
5.2 Introduction
5.3 Financial Statements *or* Final Accounts of Not-For-Profit Organisations
5.4 Receipts and Payments Account
5.5 Income and Expenditure Account
5.6 Relevant Items of Income and Expenditure Account
5.7 Preparation of Income and Expenditure Account
5.8 Steps in the Preparation of Balance Sheet
5.9 Incidental Trading Activity
5.10 Summary

5.1 OBJECTIVES

At the end of this unit, you should be able to :

- Understand non-profit entities and state its meaning.
- Differentiate between profit entities and non-profit entities.
- Explain the concept of fund accounting.
- Differentiate between fund accounting and non-fund accounting.
- Understand Receipt and payment account, its features and limitations.
- Understand Income and Expenditure Account and its features.
- Identify the items for the preparation of Income and Expenditure Account.
- Differentiate between Receipts and Payment Account and Income and Expenditure Account..
- Prepare Income and Expenditure Account with the given receipts and payment account and additional information.
- Prepare Receipts and Payment Account from the given Income and Expenditure Account and additional information.

5.2 INTRODUCTION

Non-Trading Institutions are not for profit organizations like charity hospitals, sports clubs, public library etc. The accounting for these organizations is different from profit making organizations.These institutions are primarily incorporated to promote a particular social cause like promotion of education amongst poor, promotion of sports activities in the society etc. The types of receipts and payments of these organizations is also different from the profit making institutions like receipt of Donation, subscription etc. An accountant should be aware of the treatment of these items in the books of accounts.

In this chapter, we will study the accounting of non trading institutions. As a business administrator of these types of organization, one should be aware of the accounting so that they can analyze better.

Meaning of Not-for-Profit Organisation

Voluntary organisations formed to promote certain cultural recreational, religious, political, educational, medical and professional activities are known as non-profit or not-for-profit organisations. These institutions are formed with service motive. Certain **examples** of these institutions are as under :

1. Madras Sports Club
2. Free Aid Medical Society
3. National Club
4. Association of Chartered Accountants
5. Cricket Club
6. Mohammedan Sporting Club
7. Modern Educational Society
8. Cricket Club of India
9. Delhi Nursing Society
10. Government School Teachers Association
11. Delhi University Students Union.

Features/Characteristics of Not-for-Profit Organisations

1. Not-for-profit organisations are formed *to provide services* to a specific group or public in general.
2. These are organised by *Charitable* trusts/societies and subscriber to such organisation are called members.
3. *Subscription, donations and income* from investment are the main sources of these organisations.
4. The surplus generated from income and expenditure account is *not distributed.* It is simply added in the capital fund.
5. These organisations *do not follow the complete process of accounting.*
6. These organisations *prepare Income and Expenditure account* instead of Trading and Profit and Loss account.
7. The accounting information provided by such organisations is meant for the present and potential contributors meet the *statutory requirement.*

5.3 FINANCIAL STATEMENTS *OR* FINAL ACCOUNTS OF NOT-FOR-PROFIT ORGANISATIONS

As we discussed above that not-for-profit organisations are not required to maintain a large set of books of accounts but they have to prepare financial statements at the end of every accounting year. Although these organisations are non-profit seeking institutions and they are not required to prepare Trading and Profit and Loss Account, but it is necessary for these organisations to know whether the income during the year was sufficient to meet expenses or not. Not only that, they have to provide the necessary financial information to their members, donors and contributors and also to the Registrar of Societies. For this purpose, such organisations have to prepare financial statments at the end of accounting year and the general principles of accounting are fully followed. The financial statements of not-for-profit organisations consist of the following :

(1) Income and Expenditure Account and

(2) Balance Sheet.

5.4 RECEIPTS AND PAYMENTS ACCOUNT

Receipts and payments account is merely a summary of cash and bank transactions. It may be said to be synonymous to the cash book. It records only cash transactions. It has got two sides. The left hand side shows receipts and the right hand side shows payments. Actual cash received is posted at the debit side and actual cash paid is recorded

NOTES

at the credit side. This account starts with the opening balance of cash and ends as showing the closing balance of cash.

Special Features of Receipts and Payments Account

(*i*) Receipts and payments account is a *'real account'*. While making posting in the account rule of debit and credit regarding real accounts are used.

(*ii*) Whenever amount is received, cash account is debited. This is why, all cash receipts are recorded at the debit side.

(*iii*) Cash account is credited for all payments, so all cash payments are shown at the payment side.

(*iv*) Receipts and payments account is closed as showing the closing cash balance of the year, which is shown as the first item at the debit side.

(*v*) Receipts and payments account is closed as showing the closing balance of the period which is available as the last item at the credit side.

(*vi*) Receipts and payments account records all cash receipts, whether it is capital receipt or revenue receipt. Amount received from subscription and also amount received from sale of building are shown at the receipt side. No distinction is made between capital receipts and revenue receipts.

(*vii*) All cash expenditure whether capital or revenue are shown at the payment side. Both cash payment for salaries and furniture are shown in this account. This account does not differentiate between capital and revenue expenditure.

(*viii*) All cash receipts, whether belonging to the current year or previous year or next year are recorded as receipts.

(*ix*) All cash payments whether concerning current year or previous year or next year are recorded at the payment side.

(*x*) This account does not show net income or net loss.

(*xi*) No adjustments are made in it.

(*xii*) We cannot prepare Balance Sheet on the basis of this account.

Format of Receipts and Payment Account

For the Period ending........

Receipts *Actual cash receipts irrespective of period (Present, Past and Future) (Both Revenue and Capital)*	*Amount Rs.*	*Payments* *Actual cash payments irrespective of Period (Present, Past and Future) (Both Revenue and Capital)*	*Amount Rs.*
To Balance b/d :		**Revenue Payments**	
Cash in hand	....	By Printing and stationery	
Cash at bank	....	By News papers, magazines periodicals	
Revenue receipts (Actual cash receipts)	....	By Postage	
To Subscriptions	....	By Repairs and Renewal	
To General donations	....	By Advertisement	
To General grant	....	By Charity	
To Income from lectures	....	By Audit fee	
To Proceeds from entertainment	....	By Maintenance	
To Interest or Dividends on general investment	....	By Salaries, fee	
		By Entertainment expenses	
To Sales of newspapers or grass and scraps	....	By Rent paid	
		By Insurance	

To Rent Received	....	By Honorarium	
To Miscellaneous receipts	....		
Capital Receipts (Actual cash		By Municipal taxes	
receipts)		By Bar expenses	
To Endowment fund receipts		*By Bar purchases*	
To Legacies		By Gardening	
To Entrance fee		By Prices paid	
To Life membership fee	....	By Conveyance charges	
To Subscriptions for specified		**Capital Payments**	
Purposes	....	By Books	
To Donation and grant for		By Building Purchased	
specified purposes	....	By Building Construction	
To Receipts on account of		By Sports Equipments	
special funds *i.e.*, prize		By Cost of land	
fund, match fund,		By Investment	
Tournament fund etc.	....	By Govt. loan	
To Sales of fixed assets *i.e.*,		By Furniture	
furniture, sports equipments		By Drawings	
investments etc.	....	By Balance c/d (closing	
To Interest on special funds	....	balance)	
		Cash in hand	
		Cash at bank	

It may be noted that the receipts side of the Receipts and Payment Account gives a list of revenue receipts (for past, current and future or next year) as well as capital receipts. Similarly, the payments side of the Receipts and Payments Accounts lists the revenue payments (for past, current and future or next year) as well as capital payments.

Limitations of Receipts and Payments Account

The Receipts and Payments A/c shows *cash position only.* It has got the following limitations :

(*i*) It does not show the income or expenditure of the current year.

(*ii*) It is not prepared on accrual basis. According to this basis income due but not received (accrued) is also not treated as income.

(*iii*) It does not tell us the surplus (excess of income over expenditure or the deficit (excess of expenditure over income).

(*iv*) It does not take into consideration non-cash items such as outstanding expenses, prepaid expenses, accrued income and unearned income *i.e.,* adjustments are not taken into consideration.

(*v*) It begins with the opening balance of cash in hand and cash at bank or overdraft and closed at the end of the year with closing balance of cash in hand and cash at bank.

(*vi*) It includes all receipts and payments of revenue as well as capital nature.

(*vii*) Balance Sheet, also known as position statement cannot be prepared on its basis.

The above limitations of the Receipts and Payments account show that it has got very limited scope. It may be used by small institutions having very limited number of transactions of cash nature. In this way, this account will not meet the purpose of institutions of bigger size having certain credit transactions. We can not recommend these institutions to prepare all set of books and also trading and profit and loss account. The system will be burdensome and uneconomical to them. In order to overcome these problems, clubs maintain a separate account, which is known as **'Income and Expenditure Account'.**

Difference between Receipt and Payment Account and Cash Account

NOTES

Basis for Difference	*Receipt and Payment A/c*	*Cash A/c*
1. *Period*	It is prepared at the end of accounting period.	Cash account is maintained daily.
2. *Date*	Transactions are not recorded in the order of date. There is not date column.	Transactions are recorded in order of dates. There is date column.
3. *Institutions*	It is prepared by non-trading institutions.	It is prepared by all trading institutions.
4. *Sides*	Left hand side is receipt and the right hand side is payment.	Left hand side is debit and the right hand side is credit.
5. *Folio*	It does not *have any folio column.*	It has folio column.
6. *Number of Pages*	Few pages are sufficient to prepare it.	It has got large number of pages.

Steps in the Preparation of Receipts and Payments Account

1. Take the opening balance of cash and bank and write them on the debit side of this account. In case of bank overdraft at the beginning of the year, write the same on the credit side of this account.
2. Show the total receipts on the debit side of this account without considering their nature (whether revenue or capital) and year/periods (whether past, current or future/next year).
3. Show the total payment on the credit side of this account without taking into consideration their nature (whether revenue or capital) and year/periods (whether past, current or future/next year).
4. Neither receivable income nor payable expenses are to be shown in this account because they do not involve inflow or outflow of cash.
5. Ascertain the difference between the total of debit side and the total of credit side of this account and write the same on the credit side as the closing balance of cash in hand and cash at bank. In case of excess of credit side over debit side *i.e.,* the total of credit side is more than the total of debit side, show the difference on the debit side of this account as bank overdraft and close the account.

Illustration 1. *From the information given below* **draft receipts and payments account of Friends Club, Delhi for the year ended December 31, 2004 :**

Cash on 1-1-2004 Rs. 440; Subscriptions Rs. 3,760; Donations Rs. 800; Entrance Fees Rs. 430; Rent realised from club hall Rs. 525; Electric charges Rs. 344; Taxes Rs. 50; Salaries and wages Rs. 2,150; honorarium to secretary Rs. 250; Interest received on Investments Rs. 295; Printing and stationery Rs. 35; Petty cash payments Rs. 90; Insurance Premium paid Rs. 31.

Solution.

Friends Club Delhi

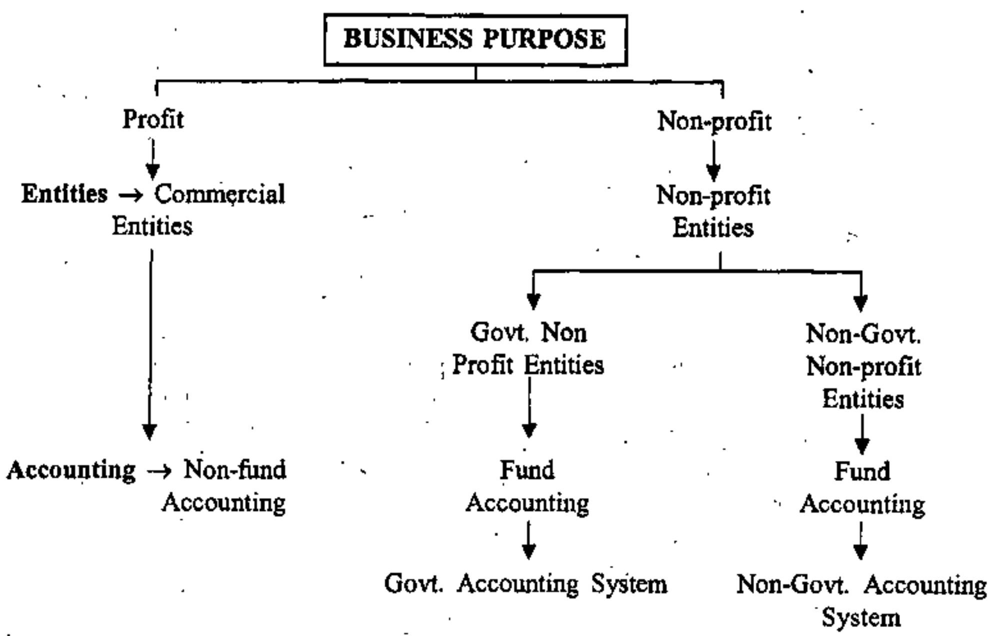
Receipts and Payments Account

Dr. *For the year ended 31st Dec. 2004* *Cr.*

Receipts	*Amount Rs.*	*Payments*	*Amount Rs.*
To Balance b/d on 1.1.2004		By Electric Charges	344
Cash in hand	440	By Taxes	50
To Subscriptions	3,760	By Salaries and Wages	2,150
To Donations	800	By Honorarium to Secretary	250
To Entrance Fees	430	By Printing and Stationery	35
To Rent	525	By Petty Cash Payments	90
To Interest on Investment	295	By Insurance Premium	31
		By Balance on 31.12.2004	
		Cash in hand	3,300
		(*Balancing Figure*)	
	6,250		6,250

Concept of Fund and Non-Fund Accounting

Non-Fund and Fund Accounting. The method of Accounting used by organisations depends upon the purpose, for which they are formed. It may be classified as under :



Entities

Commercial Entities

These are the business organisations whose main objective is to earn profit by selling goods or providing services. For example, Manufacturing, Mining, Farming/Fishing, Trading, Agency Services, Financing, Banking, Insurance, Professional Services etc.

NOTES

Non-Profit Entities

Organisations formed to promote certain cultural, recreational, religious, political, educational, *medical and professional activities are known as non-profit organisations.* These are of two kinds :

1. **Govt. Non-Profit Entities.** It includes central, state, local, universities, institutions, colleges, schools etc.
2. **Non Govt. Non-Profit Organisations.** It includes Trusts, hospitals, clubs, religious institutions, private educational institutions etc.

Distinction between Commercial Entity and Non-Profit Entity

Basis of Difference	*Commercial Entity*	*Non-Profit Entity*
1. *Motive*	Primary motive is to earn profit.	Primary motive is to promote social causes like education, sports, etc.
2. *Proprietorship*	Individuals or group of individuals who have taken risk of carrying business are the owners.	Subscribers to the institutions are members and owners of the organisation.
3. *Profit sharing*	Profit belongs to owners.	Profit if any, belongs to members of the institution.
4. *Financial statements*	Trading, Profit & Loss Account and Balance Sheet is prepared.	Receipt & Payment, Income & Expenditure Account and Balance is prepared.

Accounting

Non-Fund Accounting (applicable to Commercial Entities)

The accounting is based on matching revenue and cost principle. Profit & Loss account is prepared to calculate profit or loss earned during a period. Apart from this Balance Sheet is prepared to reflect financial position of the company. Double Entry book system on accrual system of accounting is followed under this method.

Fund Accounting (applicable to Non-Profit Organisations)

Meaning. A system of accounting where fund is taken as an independent fiscal and accounting entity with a self balancing set of accounts. These accounts are used to record cash, assets, liabilities etc. for the purpose of specific activities sought to be achieved out of the fund. For example, in the case of a sports club, the capital will be treated as a fund which can be used only for the activities related to promotion of sports and related assets & liabilities generated out of club activities. That is why capital in this type of accounting is called capital fund.

Special Features of Fund Accounting

Following are the features of fund accounting :

1. The system of accounting is used by non-profit organisations.
2. Fund is treated as separate entity and accounted for accordingly.
3. Specific funds have to be used according to predetermined purpose and income & expenditure arising out of the activities will be charged to these funds.
4. Budget approval and appropriation is the basis of income generation and spending.
5. There are general funds also which can be used for general organisational purposes.

5.5 INCOME AND EXPENDITURE ACCOUNT

Income and expenditure account is the summary of income and expenditure of the current year. It is just like Profit and Loss A/c and also prepared in a fashion, as Profit and Loss account is prepared. Special features of this account are as under :

Special Features of Income and Expenditure A/c

(*i*) Income and expenditure account is *Nominal Account* for which the rule of debit and credit, is debit all expenses or losses and credit all income or gain.

(*ii*) Expenditures are recorded at the debit side and income is posted at the credit side of this account.

(*iii*) It records only revenue expenditure, **capital expenditures are not recorded in it.**

(*iv*) Only revenue receipts are recorded in it. Capital receipts do not find a place in it.

(*v*) Expenditure of revenue nature relating to the current year only are recorded in it. **If the expenditure includes any expenditure relating to the previous or next year, it is deducted.** Current year's outstanding expenditures are added.

(*vi*) Revenue receipts of **current year only** are recorded in it.

(*vii*) Income and expenditures are shown on accrual basis.

(*viii*) Excess of income over expenditure is known as surplus. In case of profit and loss account, it is said as net income.

(*ix*) If the expenditure side exceeds the income side, the excess is supposed to be deficit (excess of expenditure over income).

(*x*) Balance Sheet can be prepared on the basis of this account.

Difference between Income and Expenditure Account and Profit and Loss Account

Basis for Difference	*Income and Expenditure A/c*	*Profit and Loss A/c*
1. *Institutions*	It is prepared by non-trading institutions.	It is prepared by trading institutions.
2. *Object*	Its object is to find out surplus *i.e.*, excess of income over expenditure or deficit *i.e.*, excess of expenditure over income.	Its object is to find out net profit or net loss.
3. *Preparation*	It is prepared on the basis of Receipts and payments account and additional information.	It is prepared on the basis of Trial balance.
4. *Opening item*	It does not have any opening item of the previous period.	It starts with gross profit or gross loss as shown by Trading account.

Difference between Receipt and Payment Account and Income and Expenditure Account

NOTES

- Difference between the two is summarised as under :

Basis for Difference	*Receipt and Payment Account*	*Income and Expenditure Account*
1. *Form*	It is a summary of cash book.	It is a summary of profit and loss account.
2. *Nature of Account*	It is a real account.	It is nominal account.
3. *Sides*	Its left hand side is receipts and right hand side is payment.	The left hand side is expenditure and the right hand side is income.
4. *Balance*	It starts with opening balance of cash and ends as showing closing balance of cash.	It does not start with opening balance of cash and does not show closing balance of cash.
5. *Capital and Revenue Items*	It records receipts and payments of both capital and revenue nature.	It records income and expenditure of revenue nature only.
6. *Amount*	It records all the cash receipts and payments, whether relating to current year or previous year or next year.	It records all income and expenditure of the current year on accrual basis.

5.6 RELEVANT ITEMS OF INCOME AND EXPENDITURE ACCOUNT

Income. Income for purpose of making Income and Expenditure account must satisfy the following conditions :

(*i*) It should *concern the current year* whether received or accrued (receivable).

(*ii*) It should be of *recurring nature.*

(*iii*) It is not meant for specific use.

While applying the above rule in identifying income we should take into consideration the peculiarity of the following items concerning non-trading organisations.

1. **Subscription.** It is recurring income for non-trading institutions, so generally we take it as income. It is generally routine source of income. In certain cases it may be a liability. Subscription will be treated as liability if :
   (*i*) *It is of non-recurring nature.*
   (*ii*) It is received, for certain specific purpose such as :
      (*a*) Subscription for Tournament fund
      (*b*) Subscription for Governor's party
      (*c*) Subscription for Building fund
      (*d*) Subscription for Construction of Science Block
      (*e*) Subscription for Construction of Pavilion
      (*f*) Subscription for Purchase of plant machine or any other fixed assets
      (*g*) Subscription received for any specific drama exhibition, Bhagwati Jagaran fete or any other programme
      (*h*) If there is any instruction to capitalise any part of subscription

2. **Donation.** It is the amount received from an individual, firms, companies and institutions as a gift. This item appears at the receipts side of Receipts and Payments account. Donation may be classified as specific donation and general donation :

 (*i*) *Specific donation.* Donation received for certain specific purpose is capital receipt. It should be capitalised and posted at the liabilities side of the Balance Sheet. These specific donations may be for tournament fund, construction of building hall, lawn, pavilion, library or Governor's party etc.

 (*ii*) *General donation.* General donations may be classified as :

  (*a*) *General donation of big amount.* It is a donation of non-recurring nature, so it should be capitalised, and shown at the liabilities side of the Balance Sheet.

  (*b*) *General donation of small amount.* This donation is of a recurring nature. It is expected that such donation, will be received every year. It is a revenue receipt, so it should be treated as income and recorded at the income side of Income and Expenditure account.

Treatment of donation can be summarised as :

(*i*) All specific donations are liability.

(*ii*) General donations of big amount are liability.

(*iii*) General donations of small amounts are treated as income.

Note : Whether the amount of donation is big or small depends upon the facts and nature of circumstances.

3. **Grant.** Grant received from central, state or local government for routine expenses of these institutions is revenue receipt and treated as income. Specific grant for specific purpose is liability *i.e.*, grant for purchase of X-ray equipments.

4. **Legacy.** It is the amount received from individuals as per will. It is a receipt of non-recurring nature, so it should be capitalised and shown at the liabilities side. Legacy of small amount may be treated as income. It is recorded at the debit side of Receipts and Payment account.

5. **Endowment Fund.** Funds providing permanent means of support are known as endowment fund. It is a capital receipt, because the fund provides permanent source of income. It should be capitalised and shown at the liabilities side. It is shown at the debit side of Receipt and Payments account.

6. **Entrance Fee.** It appears at the receipts side of Receipt and Payment account. It may be treated as an income or liability.

 (*a*) *Arguments in favour of treating it as income.* Entrance fee is received every year, whenever new members are admitted. In case of schools and colleges admissions are the regular feature and thus entrance fee should be treated as income.

 (*b*) *Arguments in favour of capitalising.* Entrance fee is received from every member once forever. It is not of recurring nature, so it should not be treated as income.

 In the absence of specific instruction, students may treat it either as an income or a liability and give a note in support of their treatment.

NOTES

7. **Sale of old Assets.** Amount received from sale of assets is capital receipt, so it w not be shown in Income and Expenditure account. If there is loss on the sale asset, it will be shown at the expenditure side of Income and Expenditure accou In the same way, excess of sale proceeds over the book value of assets is incor and it will be shown at the Income side. For example, sale of furniture foı Rs. 3,0 (book value of Rs. 4,700) shows that there is loss of Rs. 1,700 *i.e.,* 4,700 – 3,0 on the sale of furniture, so Rs. 1,700 will be shown at the expenditure side Income and Expenditure account. In the same way, if furniture is sold for Rs. 5,0 (book value Rs. 4,700) it shows a profit of Rs. 300 *i.e.,* Rs. 5,000 – 4,700. T profit of Rs. 300 on the sale of furniture will be shown at the income side of Incor and Expenditure account.

   Actual amount received from sale of asset will be shown at the receipt side Receipts and Payments account. Amount received from sale of assets will not shown as separate item in the Balance Sheet. Cash receipt will increase the closi balance of cash, which will be automatically shown at the assets side.

8. **Sale of Newspapers.** Sale of newspapers, magazines and periodicals is regul feature, so it is treated as income. The amount received is nominal, so it cannot capitalised.

   Amount received from sale of newspapers is shown at the debit side of Receipts a Payments account.

9. **Sale of used old sports material.** Sale of used sports materials such as old ba balls, nets and rackets etc., is the regular feature of club. These used sports materia bring small amount also. It is therefore treated as income and shown at the incor side of Income and Expenditure account.

   It is a cash receipt so it is also shown at the debit side of the Receipts and Paymer account.

10. **Sale of Scraps.** Amount received from sale of scraps such as bottles, boxes, guni bags and grass etc. are income. It is shown at the income side of Income a Expenditure account. The logic behind this treatment is its regular feature a nominal amount.

    Actual cash received is also shown at the debit side of Receipts and Paymen account.

11. **Sale of Grass.** It is revenue, shown at Income side.

12. **Life membership fee.** It is capital receipts of irregular nature received once fro the member throughout his life. It is capitalised and shown at the liabilities sid

13. **Payment of honorarium.** It is an expense payable to a person for the specif services rendered by him. The person receiving honorarium is not the regul employee. For example, payment made to artist *i.e.,* singers, dancers, radio, T artists. It is an expense, so it will be shown at the expenditure side.

14. **Receipts from consumable items.** In certain cases clubs/hospitals sell, certai items of regular consumption such as medicines, cigarettes, playing cards, b materials etc. These receipts are revenue receipts, so they are shown at Income sid

15. **Purchase of consumable items.** Payments made for the purchase of consumabl items is revenue payments, so because they represent cost of these items. This why, it will be shown at expenditure side. In actual practice the value of consumabl stores is calculated and shown at the expenditure side.

16. **Payment for the purchase of following items are shown at the assets side :**

(*i*) Library books (*ii*) Sport equipment

(*iii*) Crockery utensils (*iv*) Furnishing, furniture

(*v*) Investments—shares, debentures and bonds.

Payment for above items are not revenue expenditure. They are capital expenditure, so shown at the assets side. Cash payment in these cases will be shown at the credit side of Receipts and payment account.

17. **Special Funds.** Sometime certain special funds such as 'match fund', 'sports fund' and 'prize funds' are created by not-for-profit organisations for a specific purpose. These organisations invest these funds in securities and earn income on them *but the income earned on such investments is added to the concerned fund, not credited to Income and Expenditure Account. In the same way, expenses incurred on such specific purpose are also deducted from the concerned fund.* For example, A school may maintain a special fund for prize. In this situation, the interest received on prize fund will be added to it and all expenses incurred on prize awarded will be deducted from prize fund. It can better be understood from the following example :

Example : *Show how would you deal with the following items in the preparation of financial statements of APG school.*

Particulars	*Amount Rs. Debit*	*Amount Rs. Credit*
Prize fund	—	*40,000*
Investment of prize fund in securities	*40,000*	—
Interest on prize fund investment	—	*4,000*
Prize awarded	*3,000*	—

Solution :

Balance Sheet

as on ....

Liabilities		*Amount Rs.*	*Assets*	*Amount Rs.*
Prize fund	40,000		Investment of prize fund in	
Add : Interest on investment	4,000		securities	40,000
	44,000			
Less : Prize awarded	3,000	41,000		

Precautions to be taken while preparing Income and Expenditure A/c

Income and expenditure account of a particular year should show the income and expenditure of the same year. It should not show, income and expenditure of the previous or next year. While preparing Income and Expenditure account the following points should be taken into consideration.

1. We should pick up the income and expenditure of the **current year,** if it is separately given.
2. If current year's receipts of certain income includes the income of the **previous or next year,** it will **be deducted.** If any amount remains outstanding **regarding current year** that will be added.

NOTES

3. If current year's payment includes the expenditure of **previous or next year** that should be deducted. If there is any outstanding expenditure of the **current year** it will be added.
4. Generally we assume that outstanding expenses of the previous year must have been paid during the current year. In the same way outstanding income of the previous year must have been received during the current year.
5. If certain income has been received in advance during the previous year it should be added to the income of the current year.
6. Income received in advance should be deducted from the current year's income. In the same way, prepaid expenses should also be deducted from current year's expenditure.

Format of Income & Expenditure Account

for the year ending.......

Expenditure	*Amount Rs.*	*Income*	*Amount Rs.*
It contains all revenue expenses of the current year whether paid or due		**It contains all income of revenue nature of the current year, whether received or accrued**	
Certain difficult treatments		*Certain difficult treatments*	
To Expenses (*suppose rent*)		By Income Account (*suppose subscription*)	
Total Rent paid during the year		Total amount of subscription received during the year	
Add : Outstanding at the end of the year		*Add* : Outstanding at the end of the year	
Less : Outstanding in the beginning of the year or Actual amount of last year paid		*Less* : Outstanding in the beginning of the year	
Add : Advance paid in the Previous year		*Or* Actual amount of subscription of last year, received this year	
Less : Advance paid for rent in the current year		*Add* : Advance received last year	
Rent for the year	....	*Less* : Advance received this year	....
To Loss on the sale of assets : Book value of assets sold		By Profit on sale of assets Sale price of assets.	
Less : sales price	....	*Less* : Book value of assets sold	
To Depreciation		By Receipt from specific items say cinema show	
To **Expenses on Consumable materials** (*suppose stationery*)		Amount received	
Opening stock of stationery		*Less* : Amount spent	....
Add : Purchases during the year		By Miscellaneous income and gains of revenue nature	
Less : Creditors for stationery in the beginning		By *Deficit-excess of Expenditure over income*	....
Add : Creditors for stationery at the end			
Add : Advance payment for stationery last year			

Less : Advance payment for stationery in the current year			
Less : Stock of stationery at the end			
Value of stationery-Actually consumed	....		
To *Surplus-Excess of Income over expenditure*			

NOTES

Identifying subscription as income of the current year

Income side

Total subscription received during the year	....
Add : Subscription outstanding of the current year	....
Add : Subscription received in advance during previous year	....
Less : Subscription of previous year, if included in current year's subscription	....
Less : Subscription received in advance during current year	....

Calculation of depreciation. The rate of depreciation is specified. *In the absence of specified rate* it is ascertained as under :

Opening balance of asset	....
Add : Additions during the year	....
Less : Book value of asset sold	....
Less : Closing balance of asset	....
Depreciation or assets used or consumed	....

Illustration 2. *Subscriptions received during the year ending 31st December, 2003 are as follows :*

	Rs.
For 2002	*180*
2003	*4,220*
2004	*160*
	4,560

There are 45 members, each paying annual subscription of Rs. 100. Rs. 190 were in arrears for 2002 at the beginning of 2003. Calculate what amount will be posted to Income and Expenditure account.

Solution. Total subscriptions received during 2003		4,560
Less : Total subscription received for 2002	180	
Less : Total subscription received for 2004	160	
		(–) 340
		4,220
Add : Outstanding subscription for 2003 [(45 × 100) – 4,220]		280
		4,500

Note : Total subscriptions for 2003 will be Rs. 4,500 as there are 45 members and each of them are paying Rs. 100 but subscription received for 2003 amounts to Rs. 4,220 only so outstanding subscription for 2003 will be Rs. 4,500 – 4,220 = Rs. 280.

NOTES

5.7 PREPARATION OF INCOME AND EXPENDITURE ACCOUNT

Following are the points that would help you in preparing an income and expenditure account :

1. Read the Receipts and Payments Account carefully.
2. Avoid the opening and closing balances of cash in hand and cash at bank because these balances are not income.
3. Avoid all capital receipts and capital payments because these receipts will be shown in the Balance Sheet.
4. Take into consideration only revenue receipts and revenue payments. Some of these need to be adjusted as per the additional information provided relating to them.
5. Consider the following items not appearing in the Receipts and Payments Account that need to be adjusted for ascertaining the surplus/deficit for the current year :
   (*i*) Depreciation of fixed assets.
   (*ii*) Provision for doubtful debts, if any.
   (*iii*) Profit or loss on sale of any asset.
6. Any income (even revenue nature *i.e.,* subscription, donation, entrance fees etc.) which is said to be capitalised (partly or fully) or which have specific purpose such as donation for building, subscription for land etc., will not be shown in income and expenditure account because these are liabilities and will be shown at the liabilities side of Balance Sheet.

5.8 STEPS IN THE PREPARATION OF BALANCE SHEET

The following are the steps to prepare a Balance Sheet of Not-for-Profit Organisations :

1. Take the Capital Fund (also known as General Fund) as per the opening balance sheet and add the surplus generated from the Income and Expenditure Account. In case of deficit, it will be deducted from capital fund.
2. Show all the capitalised income (capital receipts) such as donation for building, legacies and life membership fees etc., at the liabilities side of the Balance Sheet.
3. Show all the fixed assets (except sold or discarded or destroyed during the year) with additions after charging depreciation (if any).
4. Compare the payments side of Receipts and Payments Account with expenditure side of income and expenditure account. This comparison will tell us the amounts of outstanding expenses, prepaid expenses, purchase of assets during the year, depreciation on fixed assets, stock of consumables like stationery in hand, closing balance of cash and bank and so on.
5. Compare the receipts side of the Receipts and Payments Account with income side of Income and Expenditure Account. It will tell us, subscription due but not yet received, income received in advance, sale of assets, items to be capitalised (*i.e.,* these will directly be shown in the Balance Sheet).

NOTES

Format of Balance Sheet

as on..............

Liabilities	*Amount Rs.*	*Assets*	*Amount Rs.*
Capital Fund		**Fixed Assets**	
Add :Surplus if Excess of income over expenditure		Last balance	
Less : Deficit if Excess of expenditure over income	....	*Add* : Purchases of assets	
		Less : Book value of asset sold	
		Less : Depreciation	....
Life membership fee		**Stock of consumable material :**	
Capitalised value of :		Last balance	
Donation/grant		*Add* : Purchases	
subscription for		*Less* : Value consumed	....
specified purpose	....	**Accrued/outstanding Income**	
Legacy		Last balance	
Endowment fund	....	*Less* : received during the year	
Entrance fees	....	Prepaid expenses (if any)	....
Special funds		Cash at bank :	
(Suppose Tournament/match fund)		Current A/c	....
Last balance, if any		Fixed Deposit	....
Add : Received during the year		Saving Bank Account	....
Add : Income earned on fund investment		Cash in hand	....
Less : Expenses paid out of fund	....		
Bank overdraft	....		
Income received in advance	....		
Outstanding Expenses	....		
Creditors	....		

A. Preparation of Income and Expenditure A/c from Receipts and Payment A/c

Illustration 3. *Prepare an income and expenditure account relating to 2003 from the figures given below :*

Dr. *Cr.*

Receipts	*Amount Rs.*	*Payments*	*Amount Rs.*
To Opening Balance	*1,800*	*By Salaries*	*4,800*
To Subscriptions	*19,000*	*By Rent*	*500*
To Sales of Investments	*2,000*	*By Stationery*	*200*
To Sale of old furniture		*By Defence Bonds*	*13,000*
(Book value Rs. 400)	*300*	*By Furniture purchased*	*2,000*
To Donations	*100*	*By Bicycle purchased*	*300*
		By Balance c/d	*2,400*
	23,200		*23,200*

NOTES

Solution.

Income and Expenditure Account

Dr. *For the year ending December 31, 2003* *Cr*

Expenditure	*Amount Rs.*	*Income*	*Amount Rs.*
To Salaries	4,800	By Subscriptions	19,000
To Rent	500	By Donation	100
To Stationery	200		
To Loss on Sale of Furniture	100		
To Surplus—Excess of Income over Expenditure	13,500		
	19,100		19,100

Explanation

1. It should be noted from the above income and expenditure account that expenditure and income of revenue nature only have been recorded in it.
2. Capital expenditure *i.e.*, purchase of defence bonds, furniture and bicycle have no- been shown in it.
3. Capital receipts from the sale of investments and furniture have not been showr- in it.
4. Loss on sale of furniture has been shown at the expenditure side.
5. Donation has been treated as a revenue receipt *i.e.*, income because of its nominal value. Receiving donations of small amounts is the regular feature of a club.

Illustration 4. *Convert the following 'Receipts and Payments Account' of the 'Delhi Nursing Society' for the year ended 30th June, 2003 into an 'Income and Expenditure Account'.*

Dr. *Cr.*

Receipts	*Amount Rs.*	*Payments*	*Amount Rs.*
Balance at Bank (1.7.2002)	*2,010*	*Salaries of Nurses*	*656*
Subscriptions	*1,115*	*Board, Laundry and Domestic Help*	*380*
Fees from Non-members	*270*	*Rent, Rates and Taxes*	*200*
Municipal Grant	*1,000*	*Cost of car*	*2,000*
Donations for building fund	*1,560*	*Expenses of Car*	*840*
Interest	*38*	*Drugs and Incidental Expenses*	*670*
		Balance c/d	*1,247*
	5,993		*5,993*

A donation for Rs. 100 received for building fund was wrongly included in subscription account. A bill of medicines purchased during the year amounting to Rs. 128 was outstanding.

Solution.

Income and Expenditure A/c of Delhi Nursing Society
for the year ending June 30, 2003

Dr. *Cr.*

Expenditure		*Amount* Rs.	*Income*		*Amount* Rs.
To Salaries of Nurses		656	By Subscription	1,115	
To Board, Laundry and Domestic help		380	*Less* : Donation for Building Fund	100	1,015
To Rent, Rate and Taxes		200	By Fees from Non-members		270
To Car Expenses		840	By Municipal Grant		1,000
To Drugs and Incidental Expenses	670		By Interest		38
Add : Outstanding Bills of medicines	128	798	By Deficit—Excess of Expenditure over income		551
		2,874			2,874

Notes :

(*i*) Donation for building fund is a capital receipt which should be recorded at the liabilities side. It is wrongly included in the subscription, so it will be deducted from subscription.

(*ii*) Payment for drugs and incidental expenses is a revenue expenditure for a hospital, so it will be shown as expenditure and outstanding bill for it will also be added.

(*iii*) Municipal grant is for general purpose, so it has been treated as income.

(*iv*) Cost of car is capital expenditure. Car is an asset, so it will be shown at the assets side. Car expenses are recurring in nature, so treated as expenditure.

Illustration 5. *From the following Receipts and Payments account of a club and from the information supplied, prepare an Income and Expenditure account for the year ended 31st December, 2003 and a Balance Sheet as on that date :*

Receipts and Payments Account

Dr. *Cr.*

Receipts	*Amount* Rs.	*Payments*	*Amount* Rs.
To Balance b/d	*2,300*	*By Salaries*	*4,500*
To Subscriptions	*6,000*	*By Office expenses*	*1,500*
To Rent of the hall	*2,000*	*By Sports equipment*	*1,000*
To Sale of grass	*200*	*By Machine*	*2,000*
To Sale of old furniture (Book Value Rs. 200)	*100*	*By 6% Investments*	*1,000*
		By Balance c/d	*600*
	10,600		*10,600*

Other Information :

Subscriptions received included Rs. 1,000 for 2002 and Rs. 500 for 2004. Outstanding subscriptions for 2003 amounted to Rs. 800. Sports Equipment on hand on 31st December, *2002 was of Rs. 3,000. The value placed on this equipment on hand on 31st December, 2003 was Rs. 3,100. The machine was purchased on 1st July, 2003 and is to be depreciated at 20 per cent per annum. Salaries Rs. 200 for 2003 are yet to be paid. Interest on investments is accrued of 6 months.*

NOTES

On 1st January, 2003, club owned land and building valued at Rs. 1,500 and furniture at Rs. 600.

Solution.

Income and Expenditure Account

for the year ended 31st Dec. 2003

Dr. *Cr.*

Expenditure		*Amount Rs.*	*Income*		*Amount Rs.*
To Salaries	4,500		By Subscription	6,000	
Add : Outstanding	200		*Less* : for 2002	1,000	
		4,700			
To Office expenses		1,500		5,000	
To Loss on sale of furniture		100	*Less* : for 2004	500	
To Dep. on Sports Equipment		900			
To Dep. on Machinery		200		4,500	
To Surplus—Excess of Income			*Add* : Outstanding	800	
over expenditure		130			5,300
			By Interest accrued on		
			Investment (1/2 year)		30
			By Rent of hall		2,000
			By Sale of grass		200
		7,530			7,530

Balance Sheet

as on 31st Dec. 2003

Dr. *Cr.*

Liabilities		*Amount Rs.*	*Assets*		*Amount Rs.*
Subscription received in Advance		500	Cash in hand		600
Salaries Outstanding		200	Investment	1,000	
Capital Fund	8,400		*Add* : Interest	30	
Add : Surplus	130				1,030
		8,530	Subscription Outstanding		800
			Sports Equipments	3,000	
			Add : Purchases	1,000	
				4,000	
			Less : Depreciation	900	
					3,100
			Machinery	2,000	
			Less : Depreciation	200	
					1,800
			Land and Building		1,500

		Furniture 600 *Less* : Sales (Book value) 200	400
	9,230		9,230

Working Notes :

(*i*) **Calculation of capital fund as on January 1, 2003.**

Balance Sheet

as on January 1, 2003

Dr. *Cr.*

Liabilities	*Amount Rs.*	*Assets*	*Amount Rs.*
Capital Fund (*Balancing Figure*)	8,400	Cash in hand	2,300
		Land and Building	1,500
		Furniture	600
		Outstanding Subscription	1,000
		Sports Equipments	3,000
	8,400		8,400

(*ii*) **Subscription**

(*a*) Subscription amounting to Rs. 1,000 relating to the previous year *i.e.*, 2002 will be deducted from the amount of subscriptions received during the current year. It is an asset of the previous year, so it will also be shown at the assets of the Balance sheet for 2002.

(*b*) Rs. 500 received as subscription for the next year *i.e.*, 2004 is not the income of the current year, so it will be deducted from the amount of subscription received during the current year. It is also a liability for the current year, as the amount is payable to the next year, so it will also be shown as a liability.

(*c*) Subscription amounting to Rs. 800 are outstanding for the current year 2003. As the income has accrued, so it will be shown at the assets side of current year's Balance Sheet and added to the subscription of the current year.

(*iii*) **Calculation of depreciation on sports equipment**

	Rs.
Book value of sports equipment as on Dec. 31, 2002	3,000
(+) Additional sports equipment purchased during 2003	1,000
	4,000
(–) Book value of sports equipment as on Dec. 31, 2003	3,100
Depreciation on sports equipment	900

(*iv*) **Calculation of depreciation on Machinery.** Machinery has been purchased on July 1, 2003, so depreciation on machinery will be calculated for six months only.

(*v*) Sale of grass is an income.

(*vi*) Loss on sale of furniture = Book value – Sale proceeds

= 200 – 100 = **Rs. 100.**

NOTES

Illustration 6. From the following information of a Club, prepare Income and Expenditure account for the year ending 31st March, 2004 and a Balance Sheet as on that date :

Cash Book

	Rs.		Rs.
To Member's Subscription	*5,000*	*By Upkeep of pavilion*	*2,000*
To Member's Admission Fees	*300*	*By Expenses regarding tournament*	*700*
To Sale of old balls, bats etc.	*50*	*By Rates and Insurance*	*200*
To Hire of ground	*300*	*By Telephone*	*50*
To Subscription for tournament	*1,000*	*By Printing and stationery*	*100*
To Drawn from bank	*4,000*	*By General charges*	*50*
To Donations	*10,000*	*By Secretary's honorarium*	*170*
		By Grass seeds	*20*
		By Bats, balls etc.	*710*
		By Lodgings in Bank	*16,650*
	20,650		*20,650*

	Rs.
Assets on 1-4-2003 :	
Cash at Bank	*3,000*
Stock of balls and bats etc.	*1,500*
Printing and Stationery (stock)	*200*
Subscription due	*500*

Liabilities :

Donations and surplus on account of tournament should be kept in reserve for a permanent pavilion. Subscriptions due on 31st March, 2003 was Rs. 750. Write off 50 per cent of bats, balls account and 25 per cent of printing and stationery account.

Solution.

Income and Expenditure Account of the Club

for the year ended 31st March, 2004

Dr. *Cr.*

Expenditure	*Amount Rs.*	*Income*		*Amount Rs.*
To Upkeep of pavilion	2,000	By Subscription	5,000	
To Rates and insurance	200	*Less* : For 2003	500	
To Telephones	50			
To General charges	50		4,500	
To Secretary's honorarium	170	*Add* : Outstanding	750	
To Grass seeds	20			5,250
To Depreciation on bats and balls		By Admission fees		300
@ 50% on opening balance +		By Old bats, balls etc.		50
additions)		By Hire of a ground		300
	1,105			

To Printing and stationery 100 *Add* : Stock on 1-4-2003 200 300 *Less* : Stock on 31-3-2004 225	75			
To Surplus—Excess of income over expenditure	2,230			
	5,900			5,900

Balance Sheet of the Club
as on 31st March, 2004

Liabilities		*Amount Rs.*	*Assets*	*Amount Rs.*
Reserve for permanent pavilion		10,300	Cash at Bank	15,650
Capital Fund	5,200		Stock of Bats, Balls etc.	1,105
Add : Surplus	2,230		Printing and Stationery	225
		7,430	Subscription due	750
		17,730		17,730

Notes : (*i*) Calculation of Capital Fund.

Balance Sheet
as on April 1, 2003

Liabilities	*Amount Rs.*	*Assets*	*Amount Rs.*
Capital Fund (*Balancing Figure*)	5,200	Cash at bank	3,000
		Stock of balls and bats	1,500
		Printing and stationery	200
		Subscription due	500
	5,200		5,200

(*ii*) Calculation of Closing Bank Balance :

	Rs.
Opening balance of cash at bank	3,000
+ Amount lodged (deposited)	16,650
	19,650
(–) Amount drawn	(–) 4,000
Closing Balance	15,650

(*iii*) Calculation of Reserve for Permanent Pavilion :

Donation	10,000
+ Subscription for tournament	+ 1,000
	11,000
(–) Expenses regarding tournament	700
	10,300

NOTES

(*iv*) **Depreciation on Printing and Stationery has been calculated as under :**

	Rs.
Reserve for permanent pavilion (to be shown at the liability side)	
Opening balance of printing and stationery	200
+ *Additional purchase*	+ 100
	300

Depreciation = $300 \times \frac{25}{100}$ = Rs. 75

(*v*) **Depreciation on bats and balls has been calculated as under :**

	Rs.
Opening balance of bats and balls	1,500
+ *Additions during the year*	710
	2,210

Depreciation @ 50% = $2{,}210 \times \frac{50}{100}$ = **Rs. 1,105.**

***Illustration** 7. The Income and Expenditure Account of Modern Club shows amount of subscriptions for 2003 as Rs. 20,000. Additional information is given as follows :*

Subscription for 2003 unpaid on 1st January, 2003 was Rs. 2,000; Rs. 1,800 of which was received in 1992.

Balance of subscriptions paid in advance on 1st January, 2003	*Rs. 500*
Balance of subscriptions paid in advance on 31st December, 2003	*Rs. 400*
Balance of subscriptions for 2003 unpaid on 31st December, 2003	*Rs. 700*

Determine the amount of subscriptions received during 2003.

Solution.

Subscription Amount

Dr. *Cr.*

Date	*Particulars*	*J.F.*	*Amount Rs.*	*Date*	*Particulars*	*J.F.*	*Amount Rs.*
2003				**2003**			
Jan. 1	To Balance b/d		2,000	Jan. 1	By Balance b/d		500
Dec. 31	To Balance (2004 paid in advance) c/d		400	Dec. 31	By Balance (2002 unpaid) c/d		200
	To Income and expenditure A/c		20,000		By Balance (2003 unpaid) c/d		700
					By Cash received		21,000
			22,400				22,400

Alternatively :

		Rs.
Subscription as per Income and Expenditure Account		20,000
Add : Subscription outstanding of previous year	2,000	
Add : Subscription paid in advance during current year	400	
		2,400
		22,400

Less : Subscription outstanding for current year	700	
Less : Subscription paid in advance during previous year	500	
Less : Subscription still unpaid (2,000 – 1,800)	200	
		1,400
Amount of subscription received during the year		21,000

NOTES

5.9 INCIDENTAL TRADING ACTIVITY

Sometimes, a non-profit organisation runs Chemist shop, Bar, Canteen etc. to provide some facilities to its member or public in general to meet its expenses. In such a situation, these organisations need to prepare trading account to find out profit/loss of this trading activity. The profit from this trading activity is used to meet the main objective for which the organisation was formed and this profit is transferred to Income and Expenditure Account. It can better be understood through following illustration :

Illustration 8. *The Accountant of Diana Club furnishes you the following Receipts and Payments account for the year ending 30th September, 2003.*

Receipts	*Amount Rs.*	*Payments*	*Amount Rs.*
Opening Balance :		*Honoraria to Secretary*	*9,600*
Cash and Bank	*16,760*	*Misc. Expenses*	*3,060*
Subscriptions	*21,420*	*Rates and Taxes*	*2,520*
Sale of Old Newspapers	*4,800*	*Groundman's Wages*	*1,680*
Entertainment Fees	*8,540*	*Printing and Stationery*	*940*
Bank Interest	*460*	*Telephone Expenses*	*4,780*
Bar Receipts	*14,900*	*Payment for Bar Purchases*	*11,540*
		Repairs	*640*
		New car (Less-sale Proceeds of Old Car Rs. 6,000)	*25,200*
		Closing Balance :	
		Cash and Bank	*6,920*
	66,880		*66,880*

Additional Information :

	01.10.2002 Rs.	*30.09.2003 Rs.*
(i) Subscription due (not received)	*2,400*	*1,960*
(ii) Cheques issued, but not presented for payment of printing	*180*	*60*
(iii) Club premises at cost	*58,000*	—
(iv) Depreciation on club premises provided so far	*37,600*	—
(v) Car at cost	*24,380*	—

NOTES

(vi) Depreciation on car	20,580	—
(vii) Value of Bar stock	1,420	1,740
(viii) Amount unpaid for bar purchases	1,180	860

(ix) Depreciation is to be provided @ 5% p.a. on the written down value of the club premises and @ 15% p.a. on car for the whole year.

Required : *Prepare an Income and Expenditure Account of Diana Club for the year ending 30th September, 2003 and Balance Sheet as on that date.*

Solution.

Income and Expenditure Account

for the year ending 30th September 2003

Dr. *Cr.*

Expenditure		*Amount Rs.*	*Income*		*Amount Rs.*
To Honoraria to Secretary		9,600	By Subscription	21,420	
To Miscellaneous Expenses		3,060	(–) Due on 1.10.2002	2,400	
To Rates and Taxes		2,520		19,020	
To Groundman's Wages		1,680	(+) Due on 30.9.2003	1,960	20,980
To Printing and Stationery		940	By Sale of old newspapers		4,800
To Telephone Expenses		4,780	By Entertainment fees		8,540
To Repairs		640	By Bank interest		460
To Depreciation on :			By Profit from Bar Trading		
Premises	1,020		Account		4,000
Car	4,680	5,700	By Profit on sale of car		2,200
To Surplus		12,060			
		40,980			40,980

Balance Sheet

as on 30th September 2003

Liabilities		*Amount Rs.*	*Assets*		*Amount Rs.*
Capital Fund	43,600		Cash and Bank		6,920
(+) Surplus	12,060	55,660	Subscription due (not received)		1,960
Amount unpaid for Bar Purchases		860	Club Premises	20,400	
			(–) Depreciation	1,020	19,380
			Car	31,200	
			(–) Depreciation	4,680	26,520
			Bar Stock		1,740
		56,520			56,520

NOTES

Working Notes :

1. Balance Sheet

as on 1.10.2002

Liabilities	*Amount Rs.*	*Assets*	*Amount Rs.*
Capital Fund (*Balancing figure*)	43,600	Cash and Bank	16,760
Depreciation on Club Premises	37,600	Subscription due (*not received*)	2,400
Depreciation on Car	20,580	Club Premises at Cost	58,000
Amount unpaid for Bar Purchases	1,180	Car at Cost	24,380
		Bar Stock	1,420
	1,02,960		1,02,960

2. Bar Trading Account

Particulars	*Amount Rs.*	*Particulars*	*Amount Rs.*
To Opening Stock	1,420	By Bar Receipts	14,900
To Purchases	11,220	By Closing Stock	1,740
To Profit (transferred to Income and Expenditure A/c)	4,000		
	16,640		16,640

3. Amount unpaid for Bar Purchases Account

Particulars	*Amount Rs.*	*Particulars*	*Amount Rs.*
To Bank A/c (Paid)	11,540	By Balance b/d	1,180
To Balance c/d	860	By Purchases (*Balancing figure*)	11,220
	12,400		12,400

4. Calculation of Profit/Loss on Sale of Car :

Cost of Car = ~~Rs. 24,380~~

Less : Accumulated Depreciation = 20,580

Book value of Car = 3,800

Profit on sale of Car = Sales proceeds – Book value

= 6,000 – 3,800 = Rs. 2,200

5. Depreciation on New Car :

Cost of new Car = 25,200 + 6,000 = Rs. 31,200

Depreciation on new Car $= 31,200 \times \frac{15}{100} =$ Rs. 4,680

6. Depreciation on Club Premises :

Cost of Premises = Rs. 58,000

Less : Accumulated Depreciation = 37,600

Written down value of Premises = 20,400

Depreciation on Premises $= 20,400 \times \frac{5}{100} =$ Rs. 1,020

NOTES

Illustration 9. *The following is the Receipts and Payments Account of Caiso Club for the year ended on 31st March, 2002.*

Receipts	Amount Rs.	Payments	Amount Rs.
Opening Balances :		Salaries	1,20,000
Cash	10,000	Creditors	15,20,000
Bank	3,850	Printing and Stationery	70,000
Subscription Received	2,02,750	Postage	40,000
Entrance Donation	1,00,000	Telephones and Telex	52,000
Interest Received	58,000	Repairs and Maintenance	48,000
Sale of an Asset	8,000	Glass and Table Linen	12,000
Miscellaneous Income	9,000	Crockery and Cutlery	14,000
Receipts at :		Garden Unkeep	8,000
Coffee Room	10,70,000	Membership Fees	4,000
Wines and Spirits	5,10,000	Insurance	5,000
Swimming Poll	80,000	Electricity	28,000
Tennis Court	1,02,000	Closing Balances :	
		Cash	8,000
		Bank	2,24,600
	21,53,600		21,53,600

The Assets and Liabilities as on 1.4.2001 were as follows :

Fixed Assets (net) : Rs. 5,00,000; Stock : Rs. 3,80,000; Investment in 12% Tax free Government Securities : Rs. 5,00,000; Outstanding Subscription : Rs. 12,000; Prepaid Insurance : Rs. 1,000; Sundry Creditors : Rs. 1,12,000; Subscription received in advance : Rs. 15,000; Entrance Donation Received pending membership : Rs. 1,00,000; Gratuity Fund : Rs. 1,50,000.

The following adjustments are to be made while drawing up the Accounts :

(a) Subscription received in advance as on 31st March, 2002 was Rs. 18,000.

(b) Outstanding Subscription as on 31st March, 2002 was Rs. 7,000.

(c) Outstanding Expenses are : Salaries : Rs. 8,000 and Electricity : Rs. 15,000.

(d) 50% of the Entrance Donation was to be capitalised. There was no pending membership as on 31st March, 2002.

(e) The cost of asset sold net as on 1.4.2001 was Rs. 10,000.

(f) Depreciation is to be provided at the rate of 10% on assets.

(g) A sum of Rs. 20,000 received in October 2001 as Entrance Donation from an applicant was to be refunded as he had not fulfilled the requisite membership qualifications. The refund was made on 3.6.2002.

(h) Purchases made during the year amounted to Rs. 15,00,000.

(i) The value of closing stock was Rs. 2,10,000.

(j) The club as a matter of policy charges off to Income and Expenditure Account all purchases made on Account of crockery, cutlery, glass and linen in the year of purchase.

You are required to prepare an Income and Expenditure Account for the year ended on 31st March, 2002 and the Balance Sheet as on 31st March, 2002 alongwith necessary workings.

Solution.

NOTES

Income and Expenditure Account
for the year ended on 31st March 2002

Dr. *Cr.*

Expenditure		*Amount Rs.*	*Income*		*Amount Rs.*
To Salaries	1,20,000		By Subscription	2,02,750	
(+) Outstanding	8,000	1,28,000	(–) Outstanding on 1.4.2001		
				12,000	
To Loss on sale of assets		2,000		1,90,750	
To Printing and Stationery		70,000	(+) Received in advance		
To Postage		40,000	on 1.4.2001	15,000	
To Telephone and Telex		52,000		2,05,750	
To Repair and Maintenance		48,000	(–) Received in advance		
To Glass and Table Linen		12,000	on 31.3.2002	18,000	
To Corckery and Cutlery		14,000		1,87,750	
To Garden Unkeep		8,000	(+) Outstanding on		
To Membership Fees		4,000	31.3.2002	7,000	1,94,750
To Electricity	28,000		By Entrance Donation		90,000
(+) Outstanding	15,000	43,000	(See W. No.)		
To Insurance	5,000		By Interest Received	58,000	
(+) Prepaid	1,000	6,000	*Add* : Accrued interest	2,000	60,000
To Depreciation of Fixed Assets		49,000	[Amount of total interest		
			5,00,000 × 12/100 = Rs. 60,000]		
			By Miscellaneous Income		9,000
			By Profit from Trading Account		92,000
			By Deficit		30,250
		4,76,000			4,76,000

Balance Sheet
as on 31st March 2002

Liabilities		*Amount Rs.*	*Assets*		*Amount Rs.*
Capital Fund	10,29,850		Cash		8,000
(–) Deficit	30,250	9,99,600	Bank		2,24,600
Sundry Creditors (See W. No. 5)		92,000	Fixed Assets	4,90,000	
Subscription Received in Advance		18,000	(–) Depreciation	49,000	4,41,000
Entrance Donation (Capitalised Amount)		90,000	Stock		2,10,000
Gratuity Fund		1,50,000	Investment	5,00,000	
Outstanding Salaries		8,000	(+) Accrued Interest	2,000	5,02,000
Outstanding Electricity		15,000	Outstanding Subscription		7,000
Refundable Entrance Donation		20,000			
		13,92,600			13,92,600

NOTES

Working Notes :

1. Calculation of Capital Fund

Balance Sheet
as on 1.4.2001

Liabilities	*Amount Rs.*	*Assets*	*Amount Rs.*
Capital Fund (*Balancing figure*)	10,29,850	Fixed Assets (Net)	5,00,000
Sundry Creditors	1,12,000	Stock	3,80,000
Subscription Received in Advance	15,000	Outstanding Subscription	12,000
Entrance Donation Received		Prepaid Insurance	1,000
Pending Membership	1,00,000	Cash	10,000
Gratuity Fund	1,50,000	Bank	3,850
		Investment	5,00,000
	14,06,850		14,06,850

2. Calculation of Entrance Donation of the Current Year

	Rs.
Entrance donation received as per Receipts and Payment A/s	1,00,000
Add : Advance Entrance Donation (See Balance Sheet as on 1.4.2001)	1,00,000
	2,00,000
Less : Refundable Donation	20,000
Total Donation for the Current Year	1,80,000
Less : 50% to be Capitalised [1,80,000 × 50/100]	90,000
	90,000

3. Trading Account of Caiso Club

Dr. *Cr.*

Particulars	*Amount Rs.*	*Particulars*		*Amount Rs.*
To Opening Stock (See Balance Sheet as on 1.4.2001)	3,80,000	By Receipts at :		
		Coffee Room	10,70,000	
To Purchase A/c	15,00,000	Swimming Poll	80,000	
To Profit	92,000	Tennis Court	1,02,000	
		Wine and Spirits	5,10,000	17,62,000
		By Closing Stock		2,10,000
	19,72,000			19,72,000

4. Calculation of Closing Balance of Sundry Creditors

Sundry Creditors Account

Dr. *Cr.*

Particulars	*Amount Rs.*	*Particulars*	*Amount Rs.*
To Bank A/c (Paid)	15,20,000	By Balance b/d	1,12,000
To Balance b/d (*Balancing figure*)	92,000	By Purchases A/c	15,00,000
	16,12,000		16,12,000

B. Preparation of Receipt and Payment Account from Income Expenditure A/c and *Additional Information*

NOTES

We are required to prepare Receipts and Payments account from Income and Expenditure account and additional informations. Receipts and Payments account records all cash receipts and cash payments of both capital and revenue nature. Whatever is received in cash and paid in cash is posted to this account irrespective of the fact that it relates to the previous year or current year or next year. Items of receipts can be identified by the following procedure.

Procedure for identifying receipts

			Rs.
	Subscriptions as per the Income and Expenditure Account of current year		4,500
Add	: Outstanding subscription of the previous year		100
Add	: Subscription received in advance during the current year		300
			4,900
Less	: Outstanding subscription of the current year	150	
Less	: Subscription received in advance at the end of the previous year	200	
		350	
	Cash receipt of subscription during the current year to be shown at the debit side of Receipts and Payment account		4,550

Procedure for identifying payment

	Salaries as per Income and Expenditure account of the current year		1,500
Add	: Outstanding salaries of the previous year	100	
Add	: Salaries paid in advance (*prepaid*) during the current year	50	
		150	
			1,650
Less	: Salaries outstanding at the end of the current year	150	
Less	: Salaries prepaid during the previous year	300	
		(–) 450	
	Salaries to be shown at the payment side		1,200

NOTES

Illustration 10. *Rehman Cricket Club gives you the following information :*

Income and Expenditure Account

Dr. *for the year ended 31st December, 2003* Cr.

Expenditure	Amount Rs.	Income		Amount Rs.
To Remuneration to coaches	18,000	By Donation and subscription		1,02,000
To Salaries and Wages	24,000	By Bar Room :		
To Rent	12,000	Receipts	24,000	
To Repairs	11,000	Expenses	(–) 20,000	
To Miscellaneous expenses	7,000			4,000
To Honorarium to Secretary	18,000	By Bank Interest		2,000
To Depreciation on equipment	5,000	By Hire of Club hall		12,000
To Surplus	25,000			
	1,20,000			1,20,000

Balance Sheet
as on 31st December, 2003

Liabilities		Amount Rs.	Assets	Amount Rs.
Capital Fund as on 31-12-2003			Equipment	20,000
	48,000		Subscriptions Receivable	8,000
Entrance Fees	10,000		Cash in hand	4,000
Surplus	25,000		Cash at bank	10,000
		83,000	Fixed deposit	50,000
Subscriptions received in advance		3,000		
Outstanding Liabilities :				
Miscellaneous Expenses		1,000		
Salary and Wages		3,000		
Honorarium to Secretary		2,000		
		92,000		92,000

Balance Sheet
as on December 31, 2002

Liabilities	Amount Rs.	Assets	Amount Rs.
Capital	48,000	Equipment	25,000
Subscriptions Received in advance	4,000	Subscription receivable	6,000
Outstanding miscellaneous expenses	1,500	Cash at bank	2,500
		Fixed deposit	20,000
Outstanding Salaries	2,000	Cash in hand	5,000
Outstanding honorarium	3,000		
	58,500		58,500

Prepare the Receipts and Payments account of the Club for the year ended 31st December, 2003.

Solution.

Rehman Cricket Club
Receipts and Payment Account
for the year ending 31st December, 2003

NOTES

Dr. *Cr.*

Receipts	*Amount Rs.*	*Payments*	*Amount Rs.*
To Balance b/d		By Remuneration to coaches	18,000
Cash	5,000	By Rent	12,000
Bank	2,500	By Repairs	11,000
To Donations and subscription	99,000	By Miscellaneous expenses	7,500
To Entrance fees	10,000	By Salaries and wages	23,000
To Bar receipts	24,000	By Honorarium to Secretary	19,000
To Bank interest	2,000	By Fixed deposit	30,000
To Hire of Club hall	12,000	By Bar expenses	20,000
		By Balance c/d :	
		Cash	4,000
		Bank	10,000
	1,54,500		1,54,500

Working Notes :

(*i*) Donations and Subscriptions	*Rs.*	*Rs.*
As per Income and Expenditure A/c		1,02,000
Add : Received for 2002	6,000	
Add : Received in advance 2004	3,000	
		9,000
		1,11,000
Less : Received in 2002 for 2003	4,000	
Less : Outstanding for 2003	8,000	
		12,000
Subscriptions received during the year		99,000

(*ii*) Miscellaneous Expenses :	*Rs.*
As per Income and Expenditure A/c	7,000
Add : Paid in 2003 for 2002	1,500
	8,500
Less : Outstanding for 2003	1,000
Expenses paid during the year	7,500

NOTES

(iii)	Salaries and wages :	Rs.
	As per Income and Expenditure A/c	24,000
	Add : Paid in 2003 for 2002	2,000
		26,000
	Less : Outstanding for 2003	3,000
	Salaries paid during the year	23,000
(iv)	Honorarium to Secretary :	Rs.
	As per Income and Expenditure A/c	18,000
	Add : Paid in 2003 for 2002	3,000
		21,000
	Less : Outstanding for 2003	2,000
	Honorarium paid during the year	19,000

5.10 SUMMARY

Not-for-Profit Organisations

Organisations formed promoting certain cultural recreational, religious, political, educational, medical, oscial and professional activities are known as Not-for-Profit Organizations.

Receipts and Payment Account

It is merely a summary of cash book. The left hand side of this account presents receipts, whereas right hand side shows payments. This account starts with the opening balance of cash and closes with the closing balance of cash.

Limitations of Receipts and Payment A/c

1. Does not show income or expenditure.
2. It is prepared on realisation basis not on accrual basis.
3. It does not tell us about surplus or deficit.
4. No adjustment is made.
5. Balance sheet cannot be prepared.

Points of difference bewteen Receipts and Payment A/c and Cash Account

(1) Period (2) Date (3) Institutions 4) Sides (5) Folio (6) Number of Pages.

Income and Expenditure A/c

The summary of income and expenditure of current year is known as Income and Expenditure Account. It is just like Profit and Loss Account. It is prepared by non-profit institutions.

Points of difference between Income and Expenditure A/c and Profit and Loss A/c

(1) Institutions (2) Object (3) Preparation (4) Opening item.

Points of difference between Receipts and Payments Account and Income and Expenditure Account

(1) Form (2) Nature of account (3) Sides (4) Balance (5) Capital and revenue items (6) Amount (7) Adjustment (8) Net Income/Loss (9) Closing balance (10) Balance Sheet.

Relevant Items of Income and Expenditure Account

NOTES

Income. Income, for the purpose of Income and Expenditure Account must be routine, recurring, general and must relate to current year.

(1) **Subscription.** (*i*) Recurring, routine and current year's subscription is Income.

(*ii*) Subscription received for certain specific purpose is liability.

(*iii*) *Subscription for life membership fee is a liability.*

(*iv*) Capitalised part of subscription is liability.

(2) **Donation**

(*i*) Specific donation is liability.

(*ii*) General donation for bigger amount is also liabiilty.

(*iii*) General donation for smaller amount is Income.

(3) Grant. Grants received for general purpose is income. Grants received for certain specific purpose is liability.

(4) Legacy. It is the amount received from individual as per will. It should be treated as liability.

(5) Endowment Fund. It is a receipt of non-recurring nature, so it is treated as a liability.

(6) Entrance fee. It may be treated as both income or liability. Students are advised to make a note of their treatment.

(7) Amount received from sale of fixed assets is not income. If the amount received exceeds book value, the excess is income. If it falls short of the book value the shortage should be treated as expenditure.

(8) Sale of old magazines, newspapers, wastes, scraps bottles, bags, boxes, and grass is income.

(9) Life membership fee is liability.

***(10)** Books, crockery, utensils and shares purchased are assets.*

(11) Subscription for newspapers and magazines is expenditure.

(12) Purchase of routine consumable stores are expenditure. Sale of these stores are income.

(13) Stationery should be treated as asset, if its opening and closing stock is given.

Types of Non-Profit entities

(*a*) Commercial entity and (*b*) Non-Profit entity.

Points of difference between commercial entity and non-profit entity

(1) Motive (2) Proprietorship (3) Profit sharing and (4) Accounting.

Non-Fund Accounting

It is based upon matching revenue with cost and used by commercial entities.

Fund Accounting

It is used by non-profit organisations. Capital, known here as capital fund is taken as independent entity. This system of Accounting is used by non-profit organisations. Relevant income and expenditure are charged to these funds. Income and Expendituer A/c is prepared to ascertain excess of income over expenditure or excess of expenditure over income.

Points of difference between Fund and Non-fund Accounting

(1) Basis (2) Funds (3) Economic interest (4) Accountability (5) Financial statements (6) Usual earning (7) Budget (8) Entity of accounting.

REVIEW QUESTIONS

NOTES

A. Very Short Answer Type Questions :

1. Explain the meaning of capitalising income.
2. How will the capital balance be affected with the surplus of income over expenditure and *vice versa* ?
3. Amount received from the sale of machine. Is it an income or asset ?
4. Not-for-profit organisations have some distinguishing features from that of profit organisations. State any one of them.
5. Name the account which shows the classified summary of transactions of a Cash Book in a not-for-profit organisation.

B. Short Answer Type Questions :

1. Describe briefly the limitations of Receipts and Payment account.
2. Mention items to be added and deducted while calculating subscription of the current year.
3. What is the relationship and distinction between the subscription, donation and grant ?
4. How do you calculate Capital Fund ?
5. Give four items each of Capital Receipts and Revenue Receipts.

C. Long Answer Type Questions :

1. Differentiate between commercial entities and Non-profit entities ?
2. What are key features of Government Accounting ? What is the purpose of Government Accounting System.
3. Explain method of Government Accounting ?
4. What is a Receipts and payments account ? By whom it is prepared ?
5. Distinguish between Receipt and Payment Account and Income and Expenditure Account on the basis of : (*a*) Object (*b*) Nature (*c*) Form and (*d*) Balance.