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COMPUTER ORIENTED FINANCIAL MANAGEMENT

C-125

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UNIT–I INTRODUCTION TO ACCOUNTING

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STRUCTURE

1.0 LEARNING OBJECTIVES

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

- explain book-keeping.
- define accounting and its basic terminology.
- illustrate double entry system and GAAP.

1.1 INTRODUCTION

There is a need to ensure that business keeps proper records of its transaction and its impact on its profitability and financial position. In this sense, accounting is an important activity of business which records and reports the financial transaction of a company. The management of the company is able to take decisions on the basis of accounting reports like profit and loss account and balance sheet.

1.2 BOOK-KEEPING (*The Initial Step of Accounting*)

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.*

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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.**

1.3 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.*

Accounting is the systematic recorded presentation of the financial activities of the business/enterprise.

1.4 ACCOUNTANCY

Accountancy is the wider discipline greater than Book-keeping and Accounting. It absorbs both Book-keeping and Accounting. It refers to both the conceptual knowledge of the subject and its application part also. It requires both the knowledge of the subject and using that knowledge in the Practical maintenance of the books of Accounts. It also tells us, why and how to summarise accounting information and communicate it to Concerned Parties.

Book-keeping, Accounting and Accountancy

Book-keeping is the proper and systematic maintenance of the books of Accounts. It includes identifying, accounting transactions. Initial record, preparation of ledger Accounts and Trial Balance. **Accounting** is Book-keeping **plus** summarising and interpreting business transactions of financial nature. Accounting at present is accepted as information system and decision making activity. **Accountancy** is the systematic knowledge of Accounting. It refers to the conceptual knowledge of the subject and its proper application and communication to interested parties. Accountancy as such is Book-keeping plus Accounting **plus** summarising, interpreting and communicating Accounting information. The relation between Accountancy Accounting and Book-keeping can better be understood from the following picture.

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1.5 BASIC ACCOUNTING TERMINOLOGY

Every subject has got its own terminology. Accounting also, 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. This 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 :

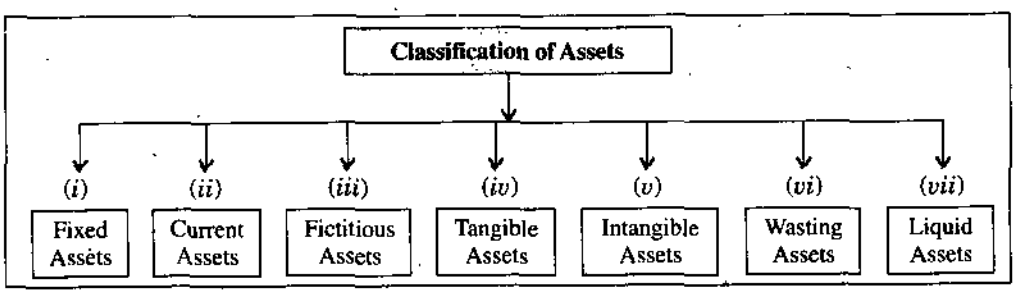
(*i*) Business transactions must be financial in nature.

(*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.

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 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.* These basic terms are discussed as under :



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 should need not necessarily be in cash. It may be in kind also. Capital is classified as fixed capital and working capital :

(*i*) Fixed capital.

(*ii*) Current floating capital.

(*iii*) Working capital.

Working Capital = Current Assets – Current Liabilities

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

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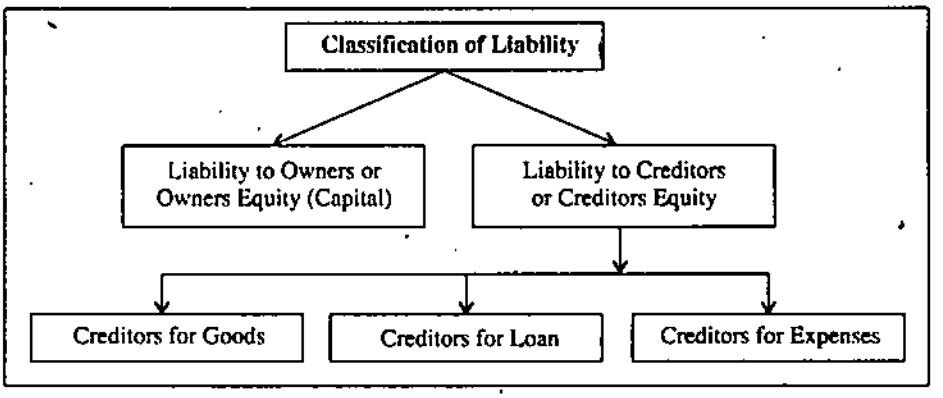
assets of the business. Creditors may be classified as creditors for goods and creditors for expenses. The business should have sufficient current assets to meet its current liabilities and reasonable amount of fixed assets to meet its fixed liability. Liabilities can be classified as under :



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

5. 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.*

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

7. Purchases. In its routine business, the firm has to either purchase finished goods for sale or purchase raw material for the manufacture of the article, being sold by the firm. The acquisition of these articles are purchases. The purchase of 10,000 metres of silk by Mohan, a cloth merchant is termed as purchases in the business. In the same way, the purchases of ten exhaust 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.

8. 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 Ahmad, a furnisher is sales but sale of old furniture by Sarin, a stationery dealer will not be a sale. Sales may be effected within the country or exported abroad.

9. 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.

10. 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.

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11. 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*, Mohan & Sons started their business on Jan. 1, 2008 and decided to close their books on 31st December every year. The firm will not have any opening stock on Jan. 1, 2008, because the business did not exist before Jan. 1, 2008. If the firm has goods worth Rs. 50,000 on 31st December, 2008, it will be the closing stock on this date. On January 1, 2009, the closing stock of December 31, 2008 will be the opening stock of the year 2009. 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.

(*ii*) Work in progress.

(*iii*) Stock of finished goods.

12. Revenues. Revenue in accounting means the amount realised or receivable from the sale of goods. Amount received from sale of assets or borrowing loan is not revenue. In wider sense, revenue is also used to mean receipt of rent, commission and discount etc. Such receipts should be revenue receipts. It should be concerned with the day-to-day affairs of the business. It should also be regular in nature. Other titles and sources of revenue are common to many businesses. According to **Finney** and **Miller,** *revenue is an inflow of assets which results in an increase of owners' equity*. Here, the term 'revenue' has been used in wider sense and confuses with income.

13. 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 is called 'expense'. 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 'expense' 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.*

14. 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.

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 'loss' 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.

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

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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 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. 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. For example, profit on sales of assets etc.

19. 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 ₹ 20,000 have been sold to Mahesh, he will continue to remain the debtor of the business so far he does not make the full payment. In case, he makes a payment of ₹ 16,000, he will remain to be debtor for ₹ 20,000 – 16,000 = 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'.

20. 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.

21. 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.

22. 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.

23. 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.

Proprietor is an individual in case of sole trade, partners in case of partnership firms and shareholders in case of company.

24. 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.

25. 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.

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26. 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.

27. 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.

1.6 ADVANTAGE 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 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. This is why, the court accepts these records as evidence.

5. Assisting in realisation of debts. We, in 'Accounts' 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 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.

1.7 USES OF FINANCIAL STATEMENTS

Every firm likes to measure the performance of its business operations in terms of profit or loss. It also likes to know the values of its assets and liabilities on the closing date of accounting period. In order to ascertain its income and also to assess the position of assets and liabilities statements prepared are known as Financial Statements. These statements are 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 statement is traditionally known as Trading, and Profit and Loss Account and position statements is known as Balance Sheet.

1.8 MEANING OF GAAP

Generally Accepted Accounting Principles (GAAP) are the set of rules and practices that are followed while recording transactions and preparing the financial statements, GAAP build sound theoretical foundation of Accounting.

According to **American Institute of Certified Public Accountants (AICPA).** GAAP have substantial authoritative support and general acceptability. GAAP must be relevant (meaningful), objective (reliable) and feasible (implemented without much cost and complexity.

1.9 BASIC ACCOUNTING CONCEPTS

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 :

Accounting Principles

A. Concepts or Assumptions

1. Business Entity
2. Money Measurement
3. Going Concern
4. Accounting Period
5. Cost
6. Dual Aspect
7. Revenue
8. Matching
9. Objectivity

B. Conventions

1. Full Disclosure
2. Consistency
3. Conservation
4. Materiality

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 :

A. 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 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. Reliance Industries, Tata Birla Industries, Tisco etc. are some examples of Business entity.

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 in terms 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 in terms of money and accordingly record them in the books of accounts. Recording transactions in monetary terms makes the information more meaningful. For example, statement which shows that the business was started with ₹ 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 ₹ 5,00,000, we can safely say that the business was started with ₹ 50,000 + 5,00,000 = 5,50,000, which will be meaningful.

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.*

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 ₹ 50,000 and at the end of its life the capital was ₹ 5,00,000 we can say that the firm earned a profit of ₹ 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.**

In order to make accounting meaningful, useful and legal accounting year concept cannot be ignored by any business house.

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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.

For example, Mr. A started business with a Capital of ₹ 5,00,000. Plant and Machinery of ₹ 1,00,000 and Furniture worth ₹ 50,000. During the year he borrowed a loan from outside of ₹ 1,80,000. In this case, each transaction would have double effect on assets, liability and capital.

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.** Revenue will be considered to have been realised when the transaction has entered and a liability to receive the amount has been **satisfied.**

8. Matching (*Matching Cost and Revenue*). According to this concept **income can be ascertained by matching revenue of the business with its costs.** Sales of ₹ 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 ₹ 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, ₹ 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.

9. 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.

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

B. CONVENTIONS

1. 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.

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.

2. 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.

3. 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 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.**

4. 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.

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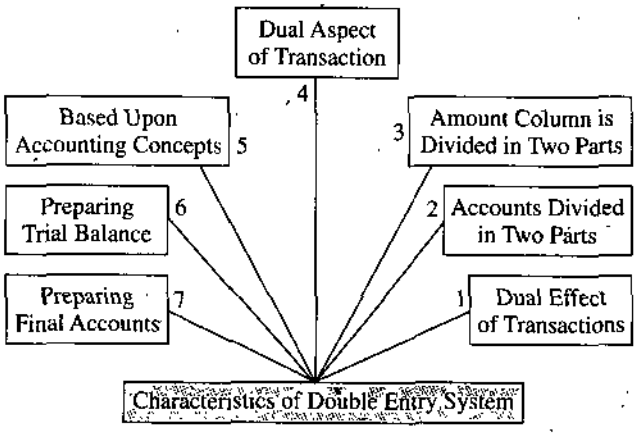
1.10 DOUBLE ENTRY BOOK-KEEPING SYSTEM

Business transactions are recorded in the books of account on the basis of Double Entry System. This system of accounting was **invented by 'Lucas Pacioli' of Italy in 1494 in Venice** but developed in England. The system is based upon the fact that there are two aspects of every business transaction. Every transaction involves at least two persons, parties or accounts. According to traditional English approach if there is receiver of goods, there must be giver of goods also. This is an established fact that there cannot be any receiver, unless there is a giver. In the same way, if someone purchases goods there will be definitely some other one to sell it. In other words, there will always be a purchase if there is a sale. To explain it further we can say that if something comes into the business, it will definitely go out from other business. In the same way, if there is loss for someone, it will definitely be gain for someone else. This proves an established truth 'somebody's loss 'is another body's gain'. Every business transaction has two aspects. *Recording dual aspects of business transactions in terms of 'Debit and Credit' is Double Entry System.*

According to modern American approach, every business transaction is concerned with assets, liabilities, capital, expense and revenue individually or collectively. Every business transaction increases or decreases one of them or increases one and decreases the other. Increase in assets and expenses are debited and decrease in assets and expense is credited. In the same way, decrease in capital, liability and revenue is debited and increase in them is credited. Every debit must have its corresponding credit of the same amount. *Recording business transactions in terms of debit and credit is Double Entry System.*



The double entry system has got the following important features :

1. Every Business Transaction Affects Two or More Accounts. There are two accounts involved in every business transaction. One of them is debited and the other is credited. Certain transactions may involve more than two accounts but the amounts of the accounts to be debited and credited will always be equal.

2. Every Account is Divided in Two Parts. All the ledger accounts prepared on the basis of books of original record *i.e.*, journal and subsidiary books have two sides. Left hand side is 'Debit' and the right hand side is 'Credit'.

3. Division of Amount Column as Debit and Credit. The amount column is also divided in two parts *i.e.*, Debit and Credit.

4. Dual Aspect of Every Transaction. The system is based upon this accounting truth that every debit has got its corresponding credit. This is why, all the business transactions are recorded simultaneously at the debit and credit side.

5. Based Upon Accounting Concepts and Conventions. The double entry system is based upon universally accepted accounting concepts and convention which we follow while maintaining our books of accounts.

6. Preparing Trial Balance. According to double entry system, business transactions are recorded first in the subsidiary books and journal proper. With these books of original record, we prepare ledger accounts, whose balances are used for preparing Trial Balance, which is test of arithmetical accuracy in accounting.

1.11 BOOKS OF ORIGINAL ENTRY

The book in which transactions are recorded for the first time is known as Journal or Book of original entry. All the business transactions may be recorded in the Journal and posting can be made to ledger Accounts therefrom. In practice business transactions are accommodated in the cash book and subsidiary books. If the transaction does not find a place here it is recorded in the Journal Proper. As such Books of original entry as consist of Cash book, Subsidiary books and Journal proper.

1.12 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.*

It should be noted that all debits are listed first in journal as per prescribed rules of debit and credit. Every transaction first recorded in journal and with the help of journal, ledger accounts, trial balance etc. are prepared. Journal entries are passed on the following format:

Format of Journal

Date	*Particulars*	*L.F.*	*Amount*	
			Debit ₹	Credit ₹

1.13 EXPLANATION OF IMPORTANT JOURNAL ENTRIES

Transaction 1

Start or commencer of business with ₹ 20,000.

Journal Entry :

Cash A/c	Dr.	20,000	
To Capital A/c			20,000
(Being commencement of the business)			

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Transaction 2

Goods purchased for ₹ 5,000. Or *Cash purchases ₹ 5,000.*

Or

Goods purchased from Mohan for Cash ₹ 5,000.

Journal Entry :

Purchases A/c	Dr.	5,000	
To Cash A/c			5,000
(Being goods purchased for cash)			

Transaction 3

(*a*) *Goods purchased from Mohan ₹ 3,000.* Or

Goods purchased from Mohan on credit ₹ 3,000 Or

Invoice received from Mohan ₹ 3,000.

Journal Entry :

Purchases A/c	Dr.	3,000	
To Mohan's A/c			3,000
(Being goods purchased from Mohan)			

(*b*) *Goods returned to Mohan* or *Mohan admitted our claim for ₹ 100*

Journal Entry :

Mohan	Dr.	100	
To Purchase Return A/c *Or*			
Returns outward A/c			100
(Being goods returned to Mohan)			

Transaction 4

Cash sales Or *Goods sold for cash* ₹ 7,000

Or

Goods sold to Mohan for cash

Journal Entry :

Cash Account	Dr.	7,000	
To Sales A/c			7,000
(Being goods sold for cash)			

Transaction 5

(*a*) *Goods sold to Mohan* Or ₹ 4,000

Goods sold to Mohan on credit Or ₹ 4,000

Invoice sent to Mohan ₹ 4,000

Journal Entry :

Mohan's A/c	Dr.	4,000	
To Sales A/c			4,000
(Being goods sold to Mohan)			

(b) Goods returned by Mohan Or *Mohan's claim admitted ₹ 100*

Journal Entry :

Sales Return A/c	Dr.	100	
Or Returns Inward A/c	Dr.		
To Mohan			100
(Being goods returned by Mohan)			

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Transaction 6

Furniture purchased for ₹ 3,000

Journal Entry :

Furniture A/c	Dr.	3,000	
To Cash A/c			3,000
(Being furniture purchased)			

Transaction 7

Machinery sold for ₹ 12,000

Journal Entry :

Cash A/c	Dr.	12,000	
To Machinery A/c			12,000
(Being machinery sold)			

Transaction 8

Salaries paid ₹. 3,200

Journal Entry :

Salaries A/c	Dr.	3,200	
To Cash A/c			3,200
(Being salaries paid)			

Transaction 9

Rent received ₹ 2,000

Journal Entry :

Cash A/c	Dr.	2,000	
To Rent A/c			2,000
(Being rent received)			

Transaction 10

Amount received from Mohan ₹ 990

Discount allowed ₹ 10

Journal Entry :

Cash A/c	Dr.	990	
Discount A/c	Dr.	10	
To Mohan's A/c			1,000
(Being amount received from Mohan and discount allowed)			

Transaction 11

Amount paid to Shyam ₹ 1,980

Discount allowed ₹ 20

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Journal Entry :

Shyam's A/c	Dr.	2,000	
To Cash A/c			1,980
To Discount A/c			20
(Being amount paid to Shyam and discount allowed)			

Transaction 12

Depreciation on furniture ₹ 2,000

Journal Entry :

Depreciation A/c	Dr.	2,000	
To Furniture A/c			2,000
(Being depreciation on furniture)			

Transaction 13

Interest on Capital ₹ 1,000

Journal Entry :

Interest on Capital A/c	Dr.	1,000	
To Capital A/c			1,000
(Being interest on capital)			

Transaction 14

Outstanding salaries ₹ 2,000

Or

Salaries owing

Journal Entry :

Salaries A/c	Dr.	2,000	
To Outstanding Salaries A/c			2,000
(Being salaries remaining unpaid)			

Transaction 15

Prepaid Insurance Or *Unexpired Insurance* ₹ 1,000

Or

Insurance paid in Advance

Journal Entry :

Prepaid Insurance A/c	Dr.	1,000	
To Insurance A/c			1,000
(Being insurance paid in advance)			

Transaction 16

Amount withdrawn by the proprietor for personal or domestic or private use ₹ 3,000

Journal Entry :

Drawings A/c	Dr.	3,000	
To Cash A/c			3,000
(Being amount withdrawn by the proprietor)			

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Transaction 17

Goods taken by the proprietor for Personal ₹ 3,000

Or

Private/Domestic use

Journal Entry :

Drawings A/c	Dr.	3,000	
To Purchases A/c			3,000
(Being goods taken by the proprietor)			

Transaction 18

Goods given as charity ₹ 750

Journal Entry :

Charity A/c	Dr.	750	
To Purchases A/c			750
(Being goods given as charity)			

Transaction 19

Mohan becomes bankrupt (insolvent). A first and final composition of 40 paise in a rupee is received out of a loan of ₹ 2,000 from official receiver.

Journal Entry :

Cash A/c	Dr.	800	
Bad Debts A/c	Dr.	1,200	
To Mohan			2,000
(Being Mohan became insolvent and a first and final composition @ 40 paise per rupee received)			

Explanation. Cash Account is an asset. It should be debited with the amount actually received *i.e.*, ₹ 800, as per rule. 'Debit increase in assets'. Mohan has been declared insolvent, so full amount cannot be received from his estate. We could receive only at the rate of 40 paise in a rupee. It means that we lost @ 60 paise in a rupee. As Mohan is now insolvent so the irrecoverable amount will be bad debts, which is loss to the business. Increase in loss is debited, so bad debts account will also be debited with ₹ 1,200 *i.e.*, ₹ 2,000 × $\frac{60}{100}$. Mohan, who has been our debtor will no longer remain the debtor after the payment has been made. The transaction will reduce debtors, an asset, as such Mohan's Account (Debtors Account) should be credited for the decrease in assets.

Transaction 20

An amount previously written off as Bad Debts has now been recovered from Mohan, the old debtor for ₹ 700.

Journal Entry :

Cash A/c	Dr.	700	
To Bad Debts Recovered A/c			700
(Being recovery of Bad debts previously written off)			

Transaction 21

Distribution of goods as free sample ₹ *100*

In order to boost its sales the business distributes certain goods as free sample. No

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doubt, it is not the sales of the business but an expense. As such, Free Samples or Advertising A/c will be debited because it is the Nominal Account and the rule for Nominal Account goes as "Debit the expenses". Such goods given as charity will be valued at cost price, so purchases account will be credited. The following entry will be passed for this transaction.

Free Samples *Or* Advertising A/c	Dr.	100	
To Purchases A/c			100
(Being distribution of goods as free samples)			

In case of **distribution of goods among employees,** Salaries A/c will be debited and Purchases A/c credited.

Transaction 22

Loss of Goods *₹ 1000*

Business is always subject to risks. Misfortunes and mishappening, such as loss of goods by theft, accident and fire can happen any moment. Such losses of goods may be classified in two parts :

(*i*) *Loss of Goods by Theft.* If theft is committed by the employee or any other person, there will be loss of goods and the business will have to suffer loss for the value of goods lost. Loss belongs to Nominal Account so for debiting or crediting the rules for Nominal A/c will be applied. Loss of goods by theft is loss, so it will be debited (Debit all losses). This is definitely not a sale, so the question of crediting Sales A/c does not arise. Goods lost will be valued at Cost price, so Purchases Account will be credited. The following journal entry will be passed for the transaction :

Loss by theft A/c	Dr.	1000	
To Purchases A/c			1000
(Being loss of goods by theft)			

(*ii*) *Loss of Goods by Fire.* It is just possible that some goods may catch fire and result in loss to the business. This is definitely Loss, so Loss of goods by Fire Account will be debited. Such goods have been destroyed, not sold, so their valuation will be made at cost price. So, Purchases Account will be credited. The journal entry for this transaction will be made as under :

Loss of goods by fire A/c	Dr.	1000	
To Purchases A/c			1000
(Being loss of goods by fire)			

(*iii*) *Loss of Cash by Fire.* In this transaction, Loss by Fire A/c will be debited and Cash A/c will be credited. The following journal entry will be passed :

Loss by fire A/c	Dr.	1000	
To Cash A/c			1000
(Being loss of cash by fire)			

(*iv*) *Cashier reported a loss of ₹ 70 from the Cash Box.*

Loss by theft A/c	Dr.	1000	
To Cash A/c			1000
(Being loss of cash by theft)			

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Certain Important Facts About Purchases A/c

Purchases Account always shows debit balance. It is debited for both cash and credit purchases. In the following cases, goods are valued at Cost or Purchase price, so Purchases A/c is credited :

(*i*) Goods given as charity. (*ii*) Goods taken/withdrawn by proprietor.

(*iii*) Loss of goods by theft. (*iv*) Loss of goods by fire.

(*v*) Free distribution of goods as sample. (*vi*) Distribution of goods to employees free sample.

Transaction 23

We receive valued order for ₹ 20,000 from Mohan for supply of goods and receive ₹ 12,000 as an advance together with order.

Journal Entry :

Cash A/c	Dr.	12,000	
To Advance from Mohan			12,000
(Being advance received from Mohan against the order)			

Transaction 24

Goods worth ₹ 20,000 supplied to Mohan against the order and advance, previously received from him.

Journal Entry :

Mohan A/c	Dr.	8,000	
Advance from Mohan A/c	Dr.	12,000	
To Sales A/c			20,000
(Being goods sold to Mohan against advance previously received)			

Transaction 25

(*a*) *Paid Income Tax amounting to ₹ 20,000 through cheque.*

Journal Entry :

Capital A/c	Dr.	20,000	
To Bank A/c			20,000
(Being payment of income tax through cheque vide receipts No. ....., dated .....)			

In case of Proprietorship and Partnership profit earned by the business unit is subject to income tax. Proprietor will bear income tax. This is why, proprietors Capital Accounts are debited.

(*b*) **Refund of Income Tax**

Cash A/c Dr.

To Capital

The amount received will increase Cash and Capital simultaneously. It is just possible that income tax paid in excess is refunded by Income Tax Department.

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(*c*) **Interest on Advance Payment of Income Tax Received**

Cash A/c Dr.

To Capital

Interest received on advance payment of tax will increase our Capital, so it will be credited to Capital, because tax was paid out of Capital and on that occassion Capital A/c was debited.

Transaction 26

Writing Back Discount Allowed and Discount Received A/c.

(*i*) *Received a cheque from Chandni for ₹ 9,900 against a debt of ₹ 10,000 in full settlement. The cheque was immediately deposited into the bank.*

(*ii*) *Bank intimated that Chandni's cheque has returned dishonoured.*

Journal Entry :

(*i*) Bank A/c	Dr.	9,900	
Discount A/c	Dr.	100	
To Chandni			10,000
(Being cheque received from Chandni in full settlement and deposited into the bank)			
(*ii*) Chandni	Dr.	10,000	
To Bank A/c			9,900
To Discount A/c			100
(Being Chandni's cheque for ₹ 9,900 has returned dishonoured and the Discount allowed, written back)			

Transaction 27

Amount received from sales of newspapers, magazines, scraps and wastes ₹ 200.

Journal Entry :

Cash A/c	Dr.	200	
To Miscellaneous Receipts A/c			200

Transaction 28

Subscribing for newspapers, magazines and periodicals ₹ 150

Journal Entry :

Miscellaneous Expenses A/c	Dr.	150	
To Cash A/c			150

Transaction 29

Treatment of Sales Tax

Sales tax is an indirect tax, whose incidence (burden) is shifted by the trader to customers. It is realised by the trader on the sales of those commodities, which are subject to sales tax from the purchaser of the commodity and paid to the Government. As such sales tax received is a liability for the business and this is why, sales tax account should be credited, whenever it is received by the trader. In case, the sales tax collected by the trader on behalf of the Government is paid to the Government, Sales Tax A/c will be debited simply because it will reduce our liability (Liabilities are debited on their reduction). If goods worth ₹ 2,000 were sold subject to the sales tax of 10% and later on it was paid to the Government, the following

journal entries will be passed. The Sales Tax A/c if appearing in the Trial Balance means Sales Tax collected but not yet paid to the Government. So, it will be shown at the Liabilities side of Balance Sheet.

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(*a*) **On Receipt of Sales Proceeds Including Sales Tax**

Cash A/c	Dr.	2,200	
To Sales A/c			2,000
To Sales Tax A/c			200
(*b*) Sales Tax	Dr.	200	
To Cash			200

Transactions 30

Value Added Tax (VAT)

Recently the Government of India has introduced Value Added Tax (VAT). It is optional for the state government to replace Sales Tax with the value added tax. Many states have introduced value added tax.

It is an indirect Tax like sales tax and its burden is passed onto the purchaser. The simple difference between sales tax and value added tax is that sales tax collected is paid to the government on due dates. On the other hand, VAT paid on purchases is adjusted on VAT collected on sales. The balance of VAT collected account is a liability payable to the government.

Let us explain journal entry regarding value added tax :

1. *When VAT is Paid at the Time of Purchases*

Purchases A/c	Dr.		
VAT paid A/c	Dr.		
To Cash/Bank A/c/Creditor			

2. *When VAT is Collected at the Time of Sales*

Cash/Bank/Debtors A/c	Dr.	xxx	
To Sales			xxx
To VAT Collected A/c			xxx

3. *When VAT Paid is Adjusted Against VAT Collected*

(*i*) VAT Collected A/c	Dr.	xxx	
To VAT paid			xxx

(This entry will be made with full amount of VAT paid)

4. *When VAT is Paid to the Government*

VAT Collected A/c	Dr.		
To Cash/Bank A/c			

Transaction 31

Received a VPP for goods worth ₹ 490. Sent an employee with ₹ 500 for collection of goods. The employee paid ₹ 5 for rickshaw charges and returned the balance.

Journal Entry :

Purchases A/c	Dr.	490	
Cartage A/c	Dr.	5	
To Cash A/c			495

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 Mohan*	₹ *980*
Discount allowed	₹ *20*
(*ii*) *Amount paid to Azhar*	₹ *2,920*
Discount allowed	₹ *80*

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

Journal Entries :

(*i*) Cash A/c	Dr.	1,980	
Discount A/c	Dr.	20	
To Mohan			2,000
(Being amount received from Mohan and discount allowed)			
(*ii*) Azhar	Dr.	3,000	
To Cash A/c			2,920
To Discount A/c			80
(Being amount paid to Azhar and discount allowed by 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.

Calculation of Hidden Capital/Goodwill

In certain cases the balance of certain assets and liabilities are hidden. In case, the total of liabilities fall short of the assets, the excess of assets over liabilities is supposed to be capital. If liabilities exceed the assets, the excess of liabilities over assets as termed as Goodwill. It indicates that the debit and credit total of opening entry has also to be made equal either by debiting Goodwill A/c (if the value of assets are lesser) or by crediting Capital A/c (if the total of liabilities side is lesser than the total of assets side).

It should be noted that opening Journal entries are made for personal and real accounts only, because the closing balances of these accounts are brought forward to the current year from the previous year.

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Calculation of Hidden Closing Stock

In certain cases closing stock may not be given. Closing stock is must in case of continuing business. If it is hidden, we will have to apply the following formula to dig it out.

(*a*) **Closing Stock**	= Opening stock
(*In case of Gross Profit*)	+ Net purchases
	+ Direct expenses
	+ Gross Profit
	(–) Sales

Or

(*b*) **Closing Stock**	= Opening stock
(*In case of Gross Loss*)	+ Net purchases
	+ Direct expenses
	(–) Sales
	(–) Gross Loss

It should be noted that stock is valued at cost price or market price, whichever is lesser. Generally, it is valued at cost price, because in most of the cases, sales are made at price higher than cost price. It is, therefore, necessary that in the absence of Gross Profit or Gross Loss, the margin of Gross Profit/Loss on the sales or cost of goods must be given.

Illustration 2. **The firm of M/s Simple and Dimple has the following balances in their different ledger accounts on January 1, 2008.**

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

Pass the Opening Journal Entry.

Solution. **Journal Entry**

Date	*Particulars*		*L.F.*	*Debit ₹*	*Credit ₹*
1.1.08	Cash A/c	Dr.		20,000	
	Goodwill A/c	Dr.		4,000	
	Stock A/c	Dr.		20,000	
	Building A/c	Dr.		60,000	
	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.

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Ledger Posting of Opening Journal Entries

Opening Journal entries as we know consist of assets and liabilities. Assets always have debit balance and liabilities have credit balance. As such, while preparing Assets accounts from the opening Journal entry, we shall record 'To Balance b/d' at the debit side of every asset's A/c as the first item. After this, all the other entries relating to individual asset will be posted in it. In the same way, while preparing liabilities A/c from the opening journal entry, we shall write 'By Balance b/d' as the first item at the Credit side of respective liabilities A/c. After this all the other relevant entries relating to specific liabilities will be recorded.

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, income and gain are closed by transfer to Trading and Profit and Loss Accounts. These transfer 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.

These entries are based upon Trial Balance and can be summarised as under :

1. *For Closing items appearing at the debit side of Trading A/c*

Trading A/c	Dr.
To Opening Stock	
To Purchases	
To Sales Return	
To Direct expenses (*individually by name*)	

2. *For Closing items Appearing at the Credit Side of Trading A/c*

Sales A/c	Dr.
Purchases Return A/c	Dr.
Closing Stock A/c	Dr.
To Trading A/c	

3. *For Transfer of Gross Profit to P/L A/c*

Trading A/c	Dr.
To Profit and Loss A/c	

4. *For Transfer of Gross Loss to P/L A/c*

Profit and Loss A/c	Dr.
To Trading A/c	

5. *For Closing Items (Indirect Expenses and Losses) Appearing at the Debit Side of P/L A/c*

P/L A/c	Dr.
To Indirect expenses and losses A/c	
(*Individual expenses A/c by name*)	

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6. *For Transfer of Income and Gains A/c*

Individual Income and Gains A/c Dr.

To Profit and Loss A/c

7. *For Transfer of Net Profit*

Profit and Loss A/c Dr.

To Capital A/c (*In case of Proprietorship and Partnership*)

Or

P/L Appropriation A/c (*In case of Company*)

8. *For Transfer of Net Loss*

Capital A/c or Dr.

P/L Appropriation A/c Dr.

To P/L A/c

Illustration 3. **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.

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 4. *On 1st January, 2001 the following were the balances of Rajan & Co. :*

Cash in hand ₹ 900 ; Cash at bank, ₹ 21,000 ; Soni (Cr.) ₹ 3,000 Zahir (Dr.), ₹ 2,400 ; Stock, ₹ 12,000 ; Prasad (Cr.), ₹ 6,000 ; Sharma (Dr.), ₹ 4,500 ; Lall (Cr.), ₹ 2,700.

Transactions during the month were—

2001		₹
Jan. 2	*Bought Goods from Prasad*	*2,700*
Jan. 3	*Sold to Sharma*	*3,000*
Jan. 5	*Sold to Lall goods for cash*	*3,600*
Jan. 7	*Took goods for personal use*	*200*
Jan. 13	*Received from Zahir in full settlement*	*2,350*
Jan. 17	*Paid to Soni in full settlement*	*2,920*
Jan. 22	*Paid cash for stationery*	*50*
Jan. 29	*Paid to Prasad by cheque*	*2,650*
	Discount allowed	*50*
Jan. 30	*Provide interest on capital*	*100*
	Rent due to landlord	*200*

Journalise the Above Transactions.

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Solution.

Journal Entries

Date	Particulars		L.F.	Debit ₹	Credit ₹
1.1.01	Cash A/c	Dr.		900	
	Bank A/c	Dr.		21,000	
	Zahir	Dr.		2,400	
	Sharma	Dr.		4,500	
	Stock A/c	Dr.		12,000	
	To Soni				3,000
	To Prasad				6,000
	To Lall				2,700
	To Capital A/c				29,100*
	(Being the various Assets and Liabilities are brought to new books)				
Jan. 2	Purchases A/c	Dr.		2,700	
	To Prasad A/c				2,700
	(Being goods purchased from Prasad)				
Jan. 3	Sharma	Dr.		3,000	
	To Sales A/c				3,000
	(Being goods sold to Sharma)				
Jan. 5	Cash A/c	Dr.		3,600	
	To Sales A/c				3,600
	(Being goods sold to Lall for cash)				
Jan. 7	Drawings A/c	Dr.		200	
	To Purchases A/c				200
	(Being goods taken for personal use)				
Jan. 13	Cash A/c	Dr.		2,350	
	Discount A/c	Dr.		50	
	To Zahir				2,400
	(Being cash received from Zahir in full settlement of the account)				
Jan. 17	Soni A/c	Dr.		3,000	
	To Cash A/c				2,920
	To Discount A/c				80
	(Being cash paid to Soni in full settlement of the account)				
Jan. 22	Stationery A/c	Dr.		50	
	To Cash A/c				50
	(Being stationery purchased)				
Jan. 29	Prasad	Dr.		2,700	
	To Bank A/c				2,650
	To Discount A/c				50
	(Being amount paid to Prasad by cheque and he allowed discount)				

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

NOTES

Jan. 30	Interest on Capital A/c	Dr.		100	
	To Capital A/c				100
	(Being interest on capital is provided)				
Jan. 30	Rent A/c	Dr.		200	
	To Rent Outstanding A/c				200
	(Being rent due to landlord)				

Advantages 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.

STUDENT ACTIVITY

1. Define accounting in your own words.

2. What is the rule of debiting and crediting asset accounts ?

NOTES

SUMMARY

- **Book-keeping** is the proper and systematic maintenance of the books of Accounts. It includes identifying accounting transactions. Initial record, preparation of ledger Accounts and Trial Balance.
- **Accountancy** is the systematic knowledge of Accounting. It refers to the conceptual knowledge of the subject and its proper application and communication to interested parties.
- Every firm likes to measure the performance of its business operations in terms of profit or loss. It also likes to know the values of its assets and liabilities on the closing date of accounting period. In order to ascertain its income and also to assess the position of assets and liabilities statements prepared are known as Financial Statements.
- Generally Accepted Accounting Principles (GAAP) are the set of rules and practices that are followed while recording transactions and preparing the financial statements, GAAP build sound theoretical foundation of Accounting.
- The book in which transactions are recorded for the first time is known as Journal or Book of original entry.

GLOSSARY

- **Accounting :** It is the systematic recorded presentation of the financial activities of the business or an enterprise.
- **Assets :** The valuable things owned by the business.
- **Equity :** Is the obligations or debts payable by the enterprise in future in the form of money or goods.
- **Revenue :** Is an inflow of assets which results in an increase of owners' equity.
- **Expense :** These are voluntarily incurred to generate income.
- **Double entry system :** Recording business transaction in terms of debit and credit.

REVIEW QUESTIONS

1. Distinguish between accountancy, accounting and book-keeping.
2. Write a short on the following :

   (*i*) Assets (*ii*) Capital (*iii*) Business Transaction.
3. What is the matching principle ? Why should this principle be followed by the business entity ?
4. What do you mean by Accounting concepts ? Explain the following concepts :

   (*a*) Accounting period concept (*b*) Going concern concept

   (*c*) Historical cost concept.
5. Explain the meaning and significance of the following :

   (*a*) Modifying principles of full disclosure (*b*) Revenue realisation concept

   (*c*) Dual concept (*d*) Principle of matching revenue with cost.

NOTES

6. What do you mean by 'Double Entry System' of Book-Keeping ? Explain it clearly. Enumerate its advantages and disadvantages.
7. Explain the rules of debit and credit in regards to the expenses and income with two examples each.
8. What are the different types of accounts ? Explain with examples their rules of debit and credit.
9. Explain the following terms :

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

   (*c*) Narration (*d*) Ledger folio.

PRACTICAL QUESTIONS

1. *Pass the opening journal entry with the following information :*

(*a*) Cash in hand	5,000	(*b*) Debtors	15,000
(*c*) Closing stock	20,000	(*d*) Furniture	3,000
(*e*) Building	40,000	(*f*) Creditors	12,000
(*g*) Bank overdraft	8,000	(*h*) Capital	63,000

2. *Ascertain goodwill with the following information and pass the opening journal entry :*

(*a*) Capital	1,00,000	(*b*) Creditors	20,000
(*c*) Bank overdraft	10,000	(*d*) Building	50,000
(*e*) Cash	5,000	(*f*) Debtors	15,000
(*g*) Closing stock	25,000	(*h*) Furniture	12,000

[**Ans.** ₹ 23,000]

3. *Calculate closing stock from the following information :*

(*a*) Opening Stock	20,000	(*b*) Purchases	60,000
(*c*) Sales	1,50,000	(*d*) Wages	16,000
(*e*) Carriage	14,000	(*f*) Fuel	10,000
(*g*) Gross Profit	37,000		

[**Ans.** ₹ 7,000]

4. *Pass the necessary journal entries with the following information :*

2007		₹
Jan. 1	Started business with cash	20,000
Jan. 3	Deposited into bank	10,000
Jan. 5	Purchased machinery for cash	5,000
Jan. 9	Purchased goods from C. & W. Ltd. at the list price of ₹ 5,000 They allowed 5% trade discount. Payment made by cheque.	
Jan. 11	Paid for electric charges	35
Jan. 11	Paid rent for January, 2007	125
Jan. 11	Stationery purchased	65
Jan. 11	Drew for private use	100
	(Payment in all cases made by cheque)	
Jan. 20	Sold goods to M/s Roy & Co.	3,500
Jan. 26	Paid rent for next three months up to April, 1999	375

Jan. 28	Received a cheque from M/s Roy & Co. for ₹ 3,275 in full settlement and sent the cheque to bank	
Jan. 29	Cheque of M/s Roy & Co. dishonoured	
Jan. 30	Salaries due to Clerk.	125
Jan. 31	Received a new cheque from M/s Roy & Co. of ₹ 3,275	
Jan. 31	Interest on capital	15

NOTES

FURTHER READINGS

- *'Book-keeping and Accountancy'*, by S.A. Siddiqui, University Science Press.
- *'Engineering Economics and Financial Accounting'*, by C. Elanchezhian, Dr. R. Kesavan and T. Sunder Seiwyn, Laxmi Publication (P) Ltd.
- *'Cost and Financial Management'*, by Dr. Mohammad Aarif, University Science Press.

UNIT–II ACCOUNTING MECHANICS

NOTES

STRUCTURE

NOTES

2.0 LEARNING OBJECTIVES

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

- define cash book.
- explain about single column cash book, and cash book with discount column.
- illustrate rules of debit and credit.
- discuss about general ledger and Bank reconcilation statement.

2.1 INTRODUCTION

Cash transactions of a business needs to be recorded in cash book. Cash book is original set of accounting books. In this unit, we will study with the help of illustrations different types of cash book.

2.2 CASH BOOK

According to **Andrew Munro**, *Cash book is used for recording the receipts and payments of money, whether in coins, notes, cheques, postal orders, bank drafts, etc.* Cash Book is the most important subsidiary book, because it keeps the initial record of cash transactions of the business. Cash Book is maintained by every business, whether small or large in size.

The Cash Book presents the true position of cash transactions. In case the Cash Book is not maintained by the business, there will be more chances for cheating, fraud, embezzlement and manipulation.

Cash Book—a Subsidiary Book and Principal Book of Accounts

Cash Book is both a principal book and subsidiary book. All cash transactions are recorded in cash book. When cash book is prepared, cash account in the ledger is not prepared. In this way, cash book as representative of cash account is the principal book of double entry system. On the other hand, all the cash transactions are recorded first in the cash book. It is, therefore, a subsidiary book, cash book is the most important book of recording business transactions. **It is both a subsidiary book and principal book.**

Types/Kinds of Cash Book

Every business differs from others as regards its size, nature and requirements. The business can use the following cash books :

1. Simple or Single Column Cash Book.
2. Double Column Cash Book.
3. Cash Book with Discount and Bank Columns (*Three Column Cash Book*).

2.3 SIMPLE OR SINGLE COLUMN CASH BOOK

Simple Cash Book records only cash transactions. It does not keep any record about banking transactions and cash discount. Simple cash book is also known as 'Single Column Cash Book'. Cash account is not prepared when simple cash book is prepared by the firm. It records systematically all cash receipts and cash payments. This cash book is used when all receipts and payments are in cash only. A specimen format of simple cash book is given as under :

NOTES

Simple or Single Column Cash Book

Dr. Cr.

Date	Particulars Receipts	L.F.	Amount ₹	P.	Date	Particulars Payments	L.F.	Amount ₹	P.
(1)	(2)	(3)	(4)		(5)	(6)	(7)	(8)	

The format of the simple cash book shows that it has been divided in two parts. The left hand side is technically known as 'Debit' which represents all cash receipts and the right hand side is 'Credit', showing all cash payments.

Illustration 1. **Enter the following transactions in a simple cash book :**

2002		₹
Jan. 1	*Cash in hand*	*11,200*
Jan. 5	*Received from Ramesh*	*300*
Jan. 7	*Paid Rent*	*30*
Jan. 8	*Sold Goods*	*300*
Jan. 10	*Paid Mohan*	*700*
Jan. 27	*Purchased Furniture*	*200*
Jan. 31	*Paid Salaries*	*100*

Solution.

Cash Book

Dr. Cr.

Date	Particulars	L.F.	Amount ₹	P.	Date	Particulars	L.F.	Amount ₹	P.
2002					2002				
Jan. 1	To Balance b/d		11,200	00	Jan. 7	By Rent A/c		30	00
Jan. 5	To Ramesh		300	00	Jan. 10	By Mohan		700	00
Jan. 8	To Sales A/c		300	00	Jan. 27	By Furniture A/c		200	00
					Jan. 31	By Salaries A/c		100	00
					Jan. 31	By Balance c/d		10,770	00
			11,800	00				11,800	00
Feb. 1	To Balance b/d		10,770	00					

Note. Sales of goods is assumed to be cash sales, because the name of purchaser must have been mentioned in case of credit purchases. In the same way, purchase of goods, payment of salaries, receipt of rent etc. are cash transactions. Credit transactions are specifically mentioned. The name of purchaser and seller is mentioned in credit transaction.

NOTES

2.4 CASH BOOK WITH DISCOUNT COLUMN (*Double Column Cash Book*)

It is a cash book with cash and discount columns. As the amount column both at the debit and credit side is divided in two columns *i.e.,* discount and cash column. So the cash book is known as Double Column Cash Book.

The additional discount column in the cash book records cash discount *i.e.,* discount allowed and discount received. Cash discount is allowed or received at the time of payment. Discount allowed is an expense so it is debited or recorded at the debit side of the cash book, because expenses are debited for increase. discount received. It is a revenue for the firm so it is credited or posted at the credit side of the cash book. *Discount columns are separately totalled.* The format of double column cash book is under :

Cash Book with Discount Column (*Double Column Cash Book*)

Dr. *Cr.*

Date	*Particulars*	*L.F.*	*Amount*		*Date*	*Particulars*	*L.F.*	*Amount*	
			Discount	*Cash*				*Discount*	*Cash*
			₹	₹				₹	₹

Illustration 2. **Prepare a double column cash book from the following transactions of Shri Ram Prakash Gupta :**

2002		₹
Jan. 1	*Cash in hand*	*4,000*
Jan. 6	*Cash purchases*	*2,000*
Jan. 10	*Wages paid*	*40*
Jan. 11	*Cash Sales*	*6,000*
Jan. 12	*Cash received from Suresh and*	*1,980*
	allowed him discount	*20*
Jan. 19	*Cash paid to Munna*	*2,470*
	and discount received	*30*
Jan. 27	*Cash paid to Radhey*	*400*
Jan. 28	*Purchased goods for cash*	*2,070*
	Rent	*30*
	Furniture	*700*

NOTES

Solution. Two Column (Cash and Discount) Cash Book of Shri Ram Prakash Gupta

Cash Book with Discount Column

Dr. *Receipts* *Payments* *Cr.*

Date	Particulars	L.F.	Amount		Date	Particulars	L.F.	Amount	
			Discount	Cash				Discount	Cash
			₹	₹				₹	₹
2002					2002				
Jan. 1	To Balance b/d			4,000	Jan. 6	By Purchases A/c			2,000
Jan. 11	To Sales A/c			6,000	Jan. 10	By Wages A/c			40
Jan. 11	To Suresh		20	1,980	Jan. 19	By Munna		30	2,470
					Jan. 27	By Radhey			400
					Jan. 28	By Purchases A/c			2,070
					Jan. 31	By Balance c/d			5,000
			20	11,980				30	11,980
Feb. 1	To Balance b/d			5,000					

Note. Balancing Cash Book. Every cash book of a going concern starts with an opening balance of cash on 1st date of the month and ends on the closing date of the month with closing balance.

Opening Balance. It is the closing balance of the previous month (if cash book is closed at the end of every month) or previous week (if cash book is closed at the end of every week). Opening balance may be given in one of the following ways :

In case of newly started business, there will be no opening balance. Cash will be introduced in the business as capital in the very beginning to start and carry out business activities. Introduction of capital in the beginning will bring cash, which will be shown at the debit side of the cash book as 'To Capital'. Learners of the subject should note that **Cash Book either starts with an opening balance of cash or with the amount introduced by the firm as Capital.**

Closing Balance. Cash book records the transactions of the month and is closed at the end of month to find out the available cash in hand on that date. The closing balance is the excess of debit side of the cash book over its credit side. It records actual cash receipts and payments. It does not record any anticipated receipt or payment of cash. Outstanding payments or receipts are not recorded. Cash book records all cash receipts and cash payments. It does not make any discrimination between revenue receipt or capital receipt and payment received for current or previous or next year. The cash column at the debit side of the cash book is totalled first. The total of the cash column at the credit side is supposed to be equal to the total of cash column at the debit side. The difference between the total of the debit side and credit side is the closing balance of the cash book. It is shown as 'By Balance c/d' on the closing date of the month. In the previous illustration ₹ 5,000 has been shown as the closing balance on January 31, 2008. This balance will be carried forward to the next month and will be shown as 'To Balance b/d' on February, 1, 2008 at the debit side of the cash book.

2.5 DISCOUNT

An allowance given in specific situations is termed as Discount. As such discount may be classified as under :

NOTES

1. Cash Discount. 2. Trade Discount.

1. Cash Discount. As the name points out this discount is used when there is cash receipt or cash payment. The discount is allowed to the parties making prompt or immediate payment. Cash discount is classified as discount allowed and discount received. The discount is allowed when payment is received or made so its entry is also passed with the entry of payment. The earlier payment, the more discount, is the philosophy of cash discount. *Cash discount motivates the debtor to make the payment at the earliest so that he will have to pay lesser and earn discount.*

2. Trade Discount. The purpose of every business is profit motive. In order to earn more profit, there should be more sales. The firm allows certain discount to purchasers, simply to attract them to make bulk purchases. Trade discount is allowed on purchases and sales. Normally rate of discount is increased with the increase in purchases. Offering festival discount, off season discount, new years discount, Diwali bumper discount, clearance sale etc. are the examples of trade discount. **The important feature of trade discount is that it is neither debited nor credited in the journal entry.** The amount of discount is deducted from the listed price of the article and the entry regarding purchases and sales is made with the reduced price of goods. Suppose, the sales of goods worth ₹ 10,000 was made and 10% was allowed as trade discount. The entry regarding sales will be made with ₹ 10,000 – 1,000 *i.e.,* 10,000 × 90/100 = ₹ 9,000. In the same way, purchaser of goods will pass journal entry regarding purchases with ₹ 9,000.

Recording Banking Transactions

Transaction 1

Opened Current A/c with the bank ₹ 12,000

Or

Amount deposited into the bank

Or

Amount paid into bank

Journal Entry :

Bank A/c	Dr.	12,000	
To Cash A/c			12,000
(Being amount deposited into bank)			

Transaction 2

Amount withdrawn from bank ₹ 3,000

Or

Amount withdrew for office use

Journal Entry :

Cash A/c	Dr.	3,000	
To Bank A/c			3,000
(Being amount withdrawn from bank)			

Transaction 3

Cheque received from Mohan ₹ 7,000

Journal Entry :

Cash A/c	Dr.	7,000	
To Mohan A/c			7,000
(Being cheque received from Mohan)			

NOTES

Note. Whenever cheque is received, it is treated as cash, unless it is specified that cheque has been received and deposited into the bank the same day.

Transaction 4

Cheque previously received from Mohan deposited into the bank the next day ₹ 7,000

Journal Entry :

Bank A/c	Dr.	7,000	
To Cash A/c			7,000

(Being Mohan's cheque deposited into the bank)

Transaction 5

Cheque previously received from Mohan, endorsed in favour of Shyam ₹ 7,000

Journal Entry :

Shyam	Dr.	7,000	
To Cash A/c			7,000

(Being Mohan's cheque endorsed in favour of Shyam)

Transaction 6

Cheque received from Mohan and deposited into the bank, the same day ₹ 7,000

Journal Entry :

Bank A/c	Dr.	7,000	
To Mohan			7,000

(Being cheque received from Mohan and deposited into the bank)

Transaction 7

Cheque issued or drawn in favour of Ramesh ₹ 3,000

Journal Entry :

Ramesh	Dr.	3,000	
To Bank A/c			3,000

(Being cheque issued in favour of Ramesh)

Transaction 8

Interest allowed or credited by bank ₹ 200

Journal Entry :

Bank A/c	Dr.	200	
To Interest A/c			200

(Being interest allowed by the bank)

Transaction 9

Interest charged or debited by bank ₹ 1,000

Or

Interest on overdraft

Journal Entry :

Interest A/c	Dr.	1,000	
To Bank A/c			1,000

(Being interest charged by bank)

The bank has charged interest on overdraft, so our bank balance will reduce with the amount of interest. Interest as an expense is increasing, so interest account will be debited. In the same way, cash at bank as an asset is decreasing, so it will be credited.

The transaction is not concerned with simple cash book because it does not involve cash in hand. It is concerned with the bank column of the two column cash book. As the bank balance is decreasing, so it will be posted at the credit side of the cash book as 'By Interest', and the amount will be written in the bank column.

Transaction 10

Bank Charges or collection charges ₹ 15

Journal Entry :

Bank Charges A/c	Dr.	15	
To Bank A/c			15
(Being expenses charged by the bank)			

2.6 CASH BOOK WITH DISCOUNT AND BANK COLUMNS (*Three Column Cash Book*)

This cash book has got three columns of amount *i.e.,* cash, discount and bank. The cash book is prepared in the same way as simple or single column cash books are prepared. Special feature of this book is bank column. The bank column at the debit side records those transactions which increase our bank balance.

Some Important Items

Contra Entries. Bank column cash book has two columns for amount. The purpose of contra entries is to indicate the transactions which effect the both cash and bank balances. It should be noted that these transactions are not posted to the ledger accounts. There are certain transactions which concern cash and bank. As the cash book represents cash and bank both so the transactions have to be recorded in both the cash and bank columns of the cash book. Contra transactions increase cash and decrease cash at bank or decrease cash in hand and increase cash at bank. These transactions are recorded on both sides of the cash book but in different columns. These transactions are as under :

1. Opening current account with the bank.
2. Depositing money into bank.
3. Depositing a cheque into the bank, received previously.
4. Withdrawing money for office use.

2.7 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.

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

NOTES

2.8 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. 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. 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 ₹	*Total ₹*
(1)	(2)	(3)	(4)	(5)	(6)

Illustration 3. **Record the following transactions in the purchases book :**

2006

Mar. 1 Purchased from Mohan Furnishers, Delhi (Invoice No. 516)

20 chairs @ ₹ 150 each

2 tables @ ₹ 400 each

Less : Trade Discount @ 10%

Mar. 7 Bought of Roy & Co., Hyderabad (Invoice No. 700)

2 stools @ ₹ 125 each

10 Collapsible chairs @ ₹ 20 each

Delivery and cartage ₹ 15

Mar. 21 Purchased from Karam Chand, Bareily (Invoice No. 909)

10 chairs @ ₹ 150 each

15 steel cabinets @ ₹ 150 each

Packing and delivery charges ₹ 25

Less : Trade Discount @ 10%

Mar. 25 Purchased from Ram & Sons. Chennai (Invoice No. 1000)

2 Typewriters @ ₹ 7750 for Office use.

NOTES

Solution.

Purchases Books/Purchases Journal

Date	*Invoice No.*	*Supplier's Name (Account to be credited)*	*L.F.*	*Amount* Details ₹	*Amount* Total ₹
2006					
Mar. 1	516	**Mohan Furnishers, Delhi**			
		20 chairs @ ₹ 150		3,000	
		2 tables @ ₹ 400		800	
				3,800	
		Less : Trade Discount @ 10%		380	
					3,420
Mar. 7	700	**Roy and Co., Hyderabad**			
		2 stools @ ₹ 125		250	
		10 Collapsible chairs @ ₹ 20		200	
				450	
		Add : Delivery and cartage		15	
					465
Mar. 21	909	**Karam Chand, Bareily**			
		10 chairs @ ₹ 150		1,500	
		15 steel cabinets @ ₹ 150		2,250	
				3,750	
		Less : Trade Discount @ 10%		375	
				3,375	
		Add : Packing and delivery charges		25	3,400
		Purchases A/c Dr.			7,285

Notes. 1. Purchases of typewriter will not be recorded in the purchases book, because typewriter is an asset for a firm dealing in furniture.

2. Trade discount is allowed on the purchase price of goods excluding delivery charges and cartage.

3. Delivery charges and cartage is direct expense, chargeable from purchaser, so added to amount payable.

2.9 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. 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.

NOTES

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.

Sales Book/Sales Journal

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

Illustration 4. **Enter the following transactions in the sales book of M/s Alam and Co., Mumbai :**

2001

May 4 Sold to Gupta Bros., New Delhi (Invoice No. 175)
10 dozen pencils @ ₹ 20 per dozen
14 gross rubbers ₹ 5 per dozen

May 14 Sold to M/s Fazal Mirza & Co., Mumbai (Invoice No. 200)
5 dozen gum bottles @ ₹ 5 per bottle
70 dozen rulers @ ₹ 15 per dozen
Less : 10% Trade Discount

May 17 Sold old newspapers for ₹ 200 (Invoice No. 215)

May 21 Sold to M/s Rajendra & Co., Ghaziabad (Invoice No. 255)
10 reams of paper @ ₹ 60 per ream
Less : Trade Discount @ 10%

May 25 Sold to M/s Dhyanchand & Co., Delhi for cash (Invoice No. 285)
10 dozens pens @ ₹ 120 per dozen for cash

May 30 Sold to Cheap Stores, New Delhi (Invoice No. 299)
10 dozens pencils @ ₹ 18 per dozen
Less : Trade Discount @ 10%

May 31 Sold old furniture to M/s Kashyapel Co., on credit for ₹ 1700. (Invoice No. 300)

Solution. **Sales Book/Sales Journal**

Date	*Invoice No.*	*Name of the Customers (Account to be credited)*	*L.F.*	*Amount*	
				Details ₹	*Total ₹*
2001					
May 4	175	**Gupta Bros., New Delhi**			
		10 dozens pencils @ ₹ 20 per dozen		200	
		14 gross rubbers @ ₹ 5 per dozen		840	1040

NOTES

May 14	200	**Fazal Mirza & Company Mumbai**			
		5 dozens gum bottles @ ₹ 5 per bottle		300	
		70 dozens rulers @ ₹ 15 per dozen		1050	
				1350	
		Less : Trade Discount @ 10%		135	1215
May 21	255	**Rajendra & Company, Ghaziabad**			
		10 reams paper @ ₹ 60 per ream		600	
		Less : Trade discount @ 10%		60	540
May 30	299	**Cheap Stores, New Delhi**			
		10 dozens pencils @ ₹ 18 per dozen		180	
		Less : Trade discount @ 10%		18	162
		Sales A/c Cr.			2,957

Notes. 1. Sale of newspaper will not be recorded in the sales book, because it is cash sales and the firm has been dealing in stationery, not newspaper. Sale of furniture will also be not recorded.

2. Cash sales is recorded in cash book, not sales book.

2.10 PURCHASES RETURN BOOK (*Or Purchases Return Journal*)

Goods purchased on credit may be returned to the seller in case of certain defect or voilation 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.

Illustration 5. **Prepare purchases return journal from the following transactions :**

2006

March 4 Returned to Roy & Co., Kolkata : (Debit Note No. 225)

2 Collapsible chairs @ ₹ 200 each

March 8 Returned to Mohan Furniture Delhi : (Debit Note No. 245)

4 Chairs @ ₹ 150 each

Less : 10% Trade Discount

March 15 Returned to Rao Ltd., Mumbai (Debit Note No. 315)

1 Steel Almirah of ₹ 4,000.

Solution.

Purchases Return Journal/Returns Outward Book

Date	*Invoice No.*	*Name of the Suppliers (Account to be debited)*	*L.F.*	*Amount*			
				Details		*Total*	
				₹	*P.*	*₹*	*P.*
2006							
Mar. 4	225	**Roy & Co. Kolkata**					
		2 Collapsible chairs @ ₹ 200				400	—
Mar. 8	245	**Mohan Furniture, Delhi**					
		4 chairs @ ₹ 150		600	—		
		Less : Trade Discount 10%		60	—		
						540	
Mar. 15	315	**Rao Ltd., Mumbai**					
		1 Steel Almirah				4,000	
		Purchases Returns A/c Cr.				4,940	—

NOTES

2.11 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 voilation 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.

Illustration 6. **Enter the following transactions in the sales returns book :**

2006

Jan. 9 Returned by Rajesh Goel & Co. (Credit Note No. 308)
20 bags Coffee @ ₹300 per bag
10 chests Tea @ ₹400 per chest

Jan. 17 Returned by Ashok Bros. (Credit Note No. 412)
15 tins Ghee @ ₹500 per tin
Less : Trade discount 10%.

Solution. **Sales Return Book/Journal**

Date	*Credit Note No.*	*Name of the Customer (Account to be credited)*	*L.F.*	*Amount*			
				Details		*Total*	
				₹	*P.*	₹	*P.*
2006							
Jan. 9	308	**Rajesh Goel and Co.**					
		20 bags Coffee @ ₹ 300 per bag		6,000	—		
		10 Chests Tea @ ₹ 400 per chest		4,000	—	10,000	—
Jan. 17	412	**Ashok Bros.**					
		15 tins Ghee @ ₹ 500 per tin		7,500	—		
		Less : Trade Discount @ 10%		750	—	6,750	—
		Sales return A/c Dr.			16,750	—	

2.12 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 tree sample
   (*f*) Loss of goods
   (*g*) Endorsement and dishonour of bills.

Note. The journal entry of all the above transactions have already been discussed in the earlier chapter.

2.13 MEANING OF LEDGER ACCOUNTS

We have discussed that business transactions of financial nature are recorded in the books of original records. These books are journal cash book, purchases book, sales book, purchases return book, sales return book. 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.** All the information regarding a particular account is collected from different subsidiary books and journal proper and presented under one heading, known as the ledger account. We may purchase furniture, sell a part of that, make additional purchases of furniture and charge depreciation on furniture. All these information regarding furniture will be presented in the Furniture A/c, which will show over, all view of the dealings in furniture and also its closing balance. 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.

NOTES

Format of Ledger Account

Page No. .....

Dr. **Name of Account (Title)** *Cr.*

Date	*Particulars*	*Folio*	*Amount* ₹	*Date*	*Particulars*	*Folio*	*Amount* ₹
(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.

FORMAT OF LEDGER ACCOUNT USED BY BUSINESS HOUSES

Name of the Account

Date	*Particulars*	*JF/ Reference*	*Debit*	*Credit*	*Dr./Cr.*	*Balance* ₹
(1)	(2)	(3)	(4)	(5)	(6)	(7)

Classification of Ledger Accounts

Ledger Accounts are classified into five categories. These categories are (*a*) Assets Accounts, (*b*) Liabilities Accounts (*c*) Capital Account (*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 and income and gains accounts at the credit side of P/L A/c.

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Uses/Utility/Advantages of Ledger Accounts

1. Separate accounts.
2. Requisite information at a glance.
3. Preparation of trial balance.
4. Facilitating the preparation of financial statements.

2.14 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 7. **Pass the following journal entries and post them in the ledger accounts :**

2005		*₹*
Jan. 1	*Started business with cash*	*20,000*
Jan. 3	*Purchased goods from Mohan*	*5,000*
Jan. 6	*Paid to Mohan*	*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 Ram*	*4,000*

Solution. **Journal Entries**

Date	*Particulars*		*L.F.*	*Debit ₹*	*Credit ₹*
1.1.05	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 Mohan				5,000
	(Being goods purchased from Mohan)				
Jan. 6	Mohan A/c	Dr.		5,000	
	To Cash A/c				4,900
	To Discount A/c				100
	(Being amount paid to Mohan 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)				

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Jan. 15	Cash A/c Dr. To Rent A/c (Being rent received)		500	500
Jan. 18	Ram A/c Dr. To Sales A/c (Being goods sold to Ram)		4,000	4,000

Ledger Posting

Cash Account

Dr. *Cr.*

Date	*Particulars*	*J.F.*	*Amount* ₹	*Date*	*Particulars*	*J.F.*	*Amount* ₹
Jan. 1	To Capital A/c		20,000	Jan. 6	By Mohan		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				

Capital Account

Dr. *Cr.*

Date	*Particulars*	*Amount* ₹	*Date*	*Particulars*	*Amount* ₹
31.1.05	To Balance c/d	20,000	31.1.05	By Cash A/c	20,000
		20,000			20,000
			Feb. 1	By Balance b/d	20,000

Explanation. Every increase in the capital account is shown at the credit side and so the decrease is shown at the debit side. We have credited capital account in the journal entry regarding commencement of business on January 1, 2005. As capital account has been credited, posting will be made at the credit side of capital account and the name of account will be the reverse account being debited with the capital. The account being debited is cash account, so we shall be writing 'By Cash A/c' at the credit side of capital account.

Purchases Account

Dr. *Cr.*

3.1.05	To Mohan's A/c	5,000	31.1.05	By Trading A/c (Transfer)	5,000
		5,000			5,000

Explanation. While purchasing goods from Mohan, we debited purchases account in the journal entry, so the posting will be made at the debit side. As we cannot write purchases account in purchases account itself, so the reverse account credited with the purchases account *i.e.*, Mohan's account will be written at the debit side as 'To Mohan's Account'. The account will be closed by transfer to trading account. Purchases account always shows debit balance, which is transferred to the debit side of the trading account.

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Mohan's A/c

Dr.					Cr.
6.1.05	To Cash A/c	4,900	3.1.05	By Purchases A/c	5,000
	To Discount A/c	100			
		5,000			5,000

Explanation. Mohan's account has been credited in the journal entry, so the posting will be made at the credit side regarding purchases on 3rd January, and we shall write reverse account *i.e.* purchases account. On January 6, Mohan's account has been debited so the posting will be made at the debit side and we shall be writing the opposite accounts credited against Mohan *i.e.*, cash account and discount account, because the total of cash and discount equals the amount of Mohan's account. Both the sides of Mohan's account are equal. It does not show any balance, so it will be closed.

Discount Account

Dr.							Cr.
31.1.05	To P/L A/c		100	6.1.05	By Mohan's A/c		100
			100				100

Explanation. Discount account has been credited, so the posting will be made at the credit side of the discount account. We will write 'By Mohan's A/c' in the discount account. The amount of discount allowed is ₹ 100, so we shall write ₹ 100 in the amount column.

The notable distinction should be noted that expenses' and revenues' accounts are closed by transfer to Trading or P/L A/c, whereas other accounts are closed as showing balance. Discount is revenue in this transaction, because we have to pay lesser, as such its balance has been transferred to P/L A/c.

Furniture Account

Dr.					Cr.
Date	*Particulars*	*Amount ₹*	*Date*	*Particulars*	*Amount ₹*
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			

Explanation. Furniture account has been debited, so the posting will be made at the debit side and we shall write the opposite account being credited *i.e.*, To 'Cash Account'. The account will show a closing balance of ₹ 2,000, which will be the opening balance of next accounting period. Furniture is an asset, as such it will always show a debit balance. Increase in furniture will be debited and any decrease in it will be credited.

Salaries Account

Dr.					Cr.
12.1.05	To Cash A/c	1,000	31.1.05	By P/L A/c (Transfer)	1,000
		1,000			1,000

Explanation. Salaries account has been debited in the journal, so the posting will be made at its debit side. As we cannot write salaries account in salaries account itself, so the reverse account being credited with salaries *i.e.*, cash account will be written as 'To Cash

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A/c'. As salaries account is nominal account or an expense, so it will be closed by transfer to P/L A/c. The account has been closed, so its balance will not be carried forward to next accounting period.

Rent Account

Dr. *Cr.*

31.1.05	To P/L A/c (Transfer)	500	15.1.05	By Cash A/c	500
		500			500

Explanation. Rent account has been credited in the journal entry, so the posting will be made at the credit side of the rent account as 'By Cash A/c'. The rent account being prepared was credited and its opposite account to be debited was cash account. This is why, cash account was written in the rent account. It is a nominal or revenue account, so its balance will be transferred to P/L A/c.

Ram's Account

Dr. *Cr.*

18.1.05	To Sales A/c	4,000	31.1.05	By Balance c/d	4,000
		4,000			4,000
1.2.05	To Balance b/d	4,000			

Explanation. Ram's account has been debited, so the posting will be made at the debit side of Ram's account. The opposite account credited together with Ram's account is sales account, so while posting we shall write 'To Sales A/c' at the debit side. As the account is a personal account or refers to an asset (Debtors) so it will be balanced.

Sales Account

Dr. *Cr.*

31.1.05	To Trading A/c (Transfer)	4,000	18.1.05	By Ram's A/c	4,000
		4,000			4,000

Explanation. Sales account has been credited in the journal entry, so the posting will be made at the credit side of the sales account. Instead of writing 'By Sales A/c' at the credit side, we shall be writing 'By Ram's A/c'. It will be balanced and closed by transfer to trading account.

2.15 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

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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. This is why, the rent, *discount and salaries accounts in the example have been closed by transfer to profit and* loss account.

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

2.16 LEDGER POSTING FROM CASH BOOK

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 8. **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		₹
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 Mohan*	*800*
Nov. 28	*Payment received from Mohan*	*800*
Nov. 29	*Goods purchased from Ram*	*3,000*
Nov. 30	*Payment made to Ram*	*3,000*

NOTES

Solution.

Cash Book

Dr. Cr.

Date	Particulars	J.F.	₹	Date	Particulars	J.F.	₹
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 Mohan's A/c		800	Nov. 30	By Ram'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 1. Sales of goods to Mohan has not been shown in the cash book, because it is credit sales and credit transactions are not recorded in the cash book.

2. Purchases of goods from Ram is a credit purchase, so it will also not be shown in the cash book. It should be once more noted that cash book records only cash transactions.

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 Mohan'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	₹	Date	Particulars	₹
Dec. 31	To Trading A/c (Transfer)	4,000	Nov. 1	By Cash A/c	4,000
		4,000			4,000

Explanation. Posting will be made at the credit side of all the accounts appearing at the debit side of the cash book, so we shall write 'By Cash A/c' at the credit side of the sales account which has been brought from the debit side of the cash book. This is also due to the fact that sales account must have been credited for cash sales, because goods account (here sales account) is always credited when it goes outside the business or decreases. Sales is revenue item, so it will be credited for increase. This account will be closed by transfer to trading account.

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Rent Account

Dr.					Cr.
31.12.06	To P/L A/c (Transfer)	700	15.11.06	By Cash A/c	700
		700			700

Explanation. Rent account has been posted at the debit side of the cash book, so the posting will be made at the credit side of the rent account as 'By Cash A/c'. Posting is made at the credit side of all those accounts which have been posted at the debit side of the cash book. Rent account is a revenue item. It will be credited for the increase in revenue. As we cannot write 'By Rent A/c' in the rent account itself, we shall be writing 'By Cash A/c' as the account has been brought from cash book. It will be closed by transfer to profit and loss account.

Mohan's Account

Dr.					Cr.
31.12.06	To Balance c/d	800	28.11.06	By Cash A/c	800
		800			800
			2000		
			Jan. 1	By Balance b/d	800

Explanation. Mohan's account is also posted at the debit side of the cash book, so the posting will be made at the credit side of Mohan's account. According to double entry system, posting of every transaction is made at the debit side of an account and at the same time posting is made at the credit side of the other account as the rule goes 'every debit has its corresponding credit'. We shall write at the credit side of Mohan's account as 'By Cash A/c'. As there is no other transaction involving Mohan's account, it will be closed and its balance will be transferred to the next accounting period.

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 Ram'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*	₹	*Date*	*Particulars*	₹
3.11.06	To Cash A/c	5,000	21.12.06	By Trading A/c (Transfer)	5,000
		5,000			5,000

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Explanation. Purchases account appears at the credit side of the cash book, so the posting will be made at the debit side of purchases account and we shall write 'To Cash A/c'. Purchases account is always debited in case of purchases, so posting is made at the debit side of the purchases account. The total of purchases book is also debited to the purchases account and its entire balance is transferred to the debit side of trading account.

Wages Account

Dr. *Cr.*

3.11.06	To Cash A/c	2,000	31.12.06	By Trading A/c (Transfer)	2,000
		2,000			2,000

Explanation. Wages account appears at the credit side of the cash book, so the posting will be made at the debit side of wages account. Wages are always expense, which is debited for increase, so in case of payment for wages posting will always be made at the debit side as 'To Cash A/c'.

Furniture Account

Dr. *Cr.*

20.11.06	To Cash A/c	1,000	31.12.06	By Balance c/d	1,000
		1,000			1,000
Jan. 1	By Balance b/d	1,000			

Explanation. Furniture account appears at the credit side of the cash book, so the posting will be made at the debit side of the furniture account. Assets are always debited for increase, so purchase of furniture will increase its value and thus posted at the debit side of furniture account. As furniture is an asset, its closing balance will be carried forward to the next period.

Ram's Account

Dr. *Cr.*

31.11.06	To Cash A/c		3,000	31.12.06	By Balance c/d		3,000
			3,000				3,000
1.1.07	By Balance b/d		3,000				

Explanation. Ram's account appears at the credit side of the cash book, so the posting will be made at the debit side of Ram's account. Personal accounts are always debited for payments made to them. Appearance of Ram's account at payment side (credit side) shows payment to Ram has been made, so posting will be made at the debit side of Ram's account as 'To Cash A/c'.

2.17 LEDGER POSTING FROM PURCHASES BOOK

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

2006

Dec. 1 Purchased from Laxmi Publications, Delhi :

100 Golden Accountancy for Class XII @ ₹ 80 each

50 Golden Commerce for Class XII @ ₹ 40 each

100 Golden Economics for Class XII @ ₹ 50 each

Trade Discount allowed @ 20%

Dec. 15 Purchased from Laxmi Kitab Ghar, Delhi :

100 Copies of English Guide for Class X @ ₹ 25 each

200 Copies of LKG Hindi Guide for Class X @ ₹ 20 each

Dec. 20 Cash purchases of books from Dhanpat Rai & Sons ₹ 300.

Solution. **Purchases Book/Purchases Journal**

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

Purchases Account

Dr. *Cr.*

Date	*Particulars*	*₹*	*Date*	*Particulars*	*₹*
31.12.06	To Total Amount as per Purchases Book	18,500	31.12.06	By Trading A/c (Transfer)	18,500
		18,500			18,500

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

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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.*

31.12.06	To Balance c/d		12,000	31.12.06	By Purchases A/c		12,000
			12,000				12,000
				1.1.07	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.*

31.12.06	To Balance c/d		6,500	31.12.06	By Purchases A/c		6,500
			6,500				6,500
				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.

2.18 LEDGER POSTING FROM SALES BOOK

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

2000

Dec. 1 Sold goods on credit to Mahabir Book Depot, Delhi

200 Copies of Golden Accountancy for Class XII @ ₹ 80 each

Dec. 5 Sold to Arya Book Depot books worth ₹ 2,000 for cash

Dec. 25 Sold to Raman Book Depot, Rajouri Garden

200 Copies of Golden Economics for Class XII @ ₹ 50 each

300 Copies of Golden Accountancy for Class XII @ ₹ 80 each

Trade discount allowed @ 20%.

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Solution.

Sales Book/Sales Journal

Date	Particulars	L.F.	Debit ₹	Credit ₹
1.12.05	**Mahabir Book Depot, Delhi :**			
	200 Copies of Golden Accountancy for Class XII @ ₹ 80 each			16,000
25.12.05	**Raman Book Depot, Rajouri Garden, Delhi :**			
	200 Copies of Golden Economics for Class XII @ ₹ 50 each		10,000	
	300 Copies of Golden Accountancy for Class XII @ ₹ 80 each		24,000	
			34,000	
	Less : Trade Discount @ 20%		6,800	
				27,200
	Sales A/c Cr.			43,200

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

Sales Account

Dr. *Cr.*

Date	Particulars	₹	Date	Particulars	₹
Dec. 31	To Trading A/c (Transfer)	43,200	Dec. 31	By Total amount as per Sales Book	43,200
		43,200			43,200

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.

Mahabir Book Depot Account

Dr. *Cr.*

1.12.05	To Sales A/c		16,000	31.12.05	By Balance c/d		16,000
			16,000				16,000
1.1.06	By Balance b/d		16,000				

Explanation. The account of Mahabir Book Depot appears in the sales book which shows a credit balance, so the posting will be made at the debit side of Mahabir Book

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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'.

Raman Book Depot Account

Dr. *Cr.*

25.12.05	To Sales A/c		27,200	31.12.05	By Balance c/d		27,200
			27,200				27,200
Jan. 1	To Balance b/d		27,200				

Explanation. Posting will be made at the debit side of Raman 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'. Raman Book Depot is the debtor of the firm, so the posting will be made at the debit side of Raman 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'.

2.19 LEDGER POSTING FROM SALES RETURN BOOK

It is just possible that goods sold may be returned to us due to violation of any agreement or goods being defective. Such return of goods to us is termed as 'sales return'. It will be proper to prepare a separate subsidiary book to record sales return or returns inward. Sales return is just the reverse of sales, so it shows a debit balance because sales account shows a credit balance. The parties returning goods will be credited as giver, so posting will be made to their credit side. The procedure of preparing ledger accounts from sales return book is explained as under.

Illustration 11. **Prepare a sales return or returns inward book from the following details :**

2005

Dec. 16 Goods returned by Sushil Gupta, Delhi
10 chairs @ ₹80 each less 10% discount.

Dec. 28 Goods returned by Alam & Bros., Delhi
100 stools @ ₹70 per stool.

Solution. **Sales Return Book**

Date	*Particulars*	*L.F.*	*Debit ₹*	*Credit ₹*
Dec. 16	**Sushil Gupta, Delhi :**			
	10 chairs @ ₹ 80 each		800	
	Less : Trade Discount @ 10%		80	720
Dec. 28	**Alam Bros., Delhi :**			
	100 stools @ ₹ 70 per stool			7,000
	Sales Return A/c Dr.			7,720

Sales return book records the return of goods sold on credit. Sales return account and the party's account returning goods are prepared through sales return book.

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Sales Return Account

Dr. Cr.

Date	Particulars	₹	Date	Particulars	₹
31.12.05	To Total amount as per Sales Return Book	7,720	31.12.05	By Trading A/c (Transfer)	7,720
		7,720			7,720

Explanation. The total of sales return book is posted at the debit side of sales returns account as 'To total amount as per Sales Return Book'. Sales return shows a debit balance, so it is posted at the debit side of sales return account. The balance of sales return account is transferred to trading account. *The total of the sales return account is deducted from sales* at the credit side of trading account. The account is closed by transfer to trading account.

Sushil Gupta's Account

Dr. Cr.

31.12.05	To Balance c/d	720	31.12.05	By Returns Inward A/c	720
		720			720
			1.1.06	By Balance b/d	720

Explanation. Sales return account always shows a debit balance, so posting will be made at the credit side of all the accounts appearing in the sales return book. As the goods have been returned by the customers, so their accounts will be credited. This is why, posting is made at the credit side of all those customer's accounts, who have returned goods. The closing balance of debtors account are transferred to the next period as opening balance.

Alam & Bros. Account

Dr. Cr.

31.12.05	To Balance c/d	7,000	28.12.05	By Sales Return A/c	7,000
		7,000			7,000
			1.1.06	By Balance b/d	7,000

Explanation. Posting will be made at the credit side of Alam & Bros. Account, because the firm's account appears at the sales return book. Posting is made at the credit side of all those accounts which appear in sales return book. Debtors accounts are credited, when they *return goods, earlier sold to them and thus posting* will be made at the credit side of debtor's account. The closing balance will be transferred to the next period.

2.20 LEDGER POSTING FROM PURCHASES RETURN BOOK

It is just possible that we may return certain goods to the supplier, if it is defective or not according to sample and specification or due to breach of the terms of the contract. Return of goods, purchased on credit to the suppliers is recorded in the purchases return book, also known as returns outward book. We make a posting in the purchases return account and suppliers account with the help of purchases return book. Returns outward is just the reverse of the purchases. As purchases show debit balance, so the purchases return

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will show a credit balance. This is why, posting in the purchases return account will be made at the debit side. Posting in the suppliers account, whom goods have been returned will be made at the debit side. The posting is explained with the help of the following illustration.

Illustration 12. **Prepare a purchase return book from the following transactions and make posting in the concerned accounts into the ledger :**

2004

Dec. 7 *Goods returned to Salwan Furnishers, New Delhi*
10 chairs @ ₹150 each
20 stools @ ₹100 each
Less : 5% discount.

Solution. **Purchases Return Book**

Date	*Particulars*	*L.F.*	*Debit ₹*	*Credit ₹*
7.12.04	**Salwan Furnishers, New Delhi**			
	10 chairs @ ₹ 150 each		1,500	
	20 stools @ ₹ 100 each		2,000	
			3,500	
	Less : Trade Discount @ 5%		175	
				3,325
	Purchases Return A/c Cr.			3,325

Ledger Posting

Purchases Return Account

Dr. *Cr.*

Date	*Particulars*	*₹*	*Date*	*Particulars*	*₹*
31.12.04	To Trading A/c (Transfer)	3,325	31.12.04	By Total amount as per Purchases Return Book	3,325
		3,325			3,325

Explanation. Purchases return shows a credit balance, so the posting will be made at the credit side of purchases return account. It is not useful to show individual supplier's account whom goods have been returned in purchases return account because detailed information regarding purchases return is available in purchases return book. Only the total of the purchases return book is posted at the credit side of purchases return account. The balance of purchases return account is transferred to trading account where they are deducted from purchases account.

Salwan Furnishers' Account

Dr. *Cr.*

Date	*Particulars*		*₹*	*Date*	*Particulars*		*₹*
Dec. 7	To Purchases Return A/c		3,325	Dec. 31	By Balance c/d		3,325
			3,325				3,325
Jan. 1	By Balance b/d		3,325				

Explanation. As purchases return book shows a credit balance, so the posting is made at the debit side of supplier's account, whom goods have been returned. This is why, we have made a posting at the debit side of Salwan Furnisher's account as 'To Purchases Return A/c'. The account will be balanced and its closing balance will be transferred to the next accounting period as opening balance.

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2.21 LEDGER POSTING FROM BILLS RECEIVABLE BOOK

The bills receivable book contains the details of bills drawn or bills receivable received. Posting from the Bills Receivable book will be made at the debit side of the B/R A/c as *To Total Amount as per bills receivable book.* Posting will also be made at the credit side of Drawee or debtor's A/c who has accepted or endorsed the bill as *By Bills Receivable A/c.*

2.22 LEDGER POSTING FROM BILLS PAYABLE BOOK

The Bills Payable Book contains details of Bills accepted. Posting from the Bills Payable Book will be made at the credit side of Bills Payable A/c as 'By total amount as per Bills Payable Book'. Posting will also be made at the Debit side of the Drawer or Creditor, who has drawn the Bill.

2.23 PREPARATION OF ASSETS, LIABILITIES, CAPITAL, REVENUE AND EXPENSE ACCOUNT

1. Preparation of Assets Account. Assets are the valuable things owned by the business. They are used for earning revenue in the business. These assets either increase or decrease in the firm. Assets accounts are debited for increases and credited for decreases. It means that all the increases in the assets are shown at the debit side and decreases are shown at the credit side of the assets account. Assets go on increasing with the purchases of assets or appreciation in the value of assets. On the other hand, assets decrease with their sales and depreciation in their values. We may now conclude that the debit side of an asset account records the purchases and appreciation in the value of assets and the credit side records the sale and depreciation of assets. It is clarified with an example.

Illustration 13. **Prepare Furniture Account with the following information :**

2006			₹
Jan.	*1*	*Furniture in hand*	*1,000*
Jan.	*1*	*Purchased furniture*	*2,000*
June	*30*	*Sold furniture*	*200*
Dec.	*31*	*Depreciate furniture including addition @ 10%*	

Solution. Depreciation on furniture has been calculated @ 10% on 1,000 + 2,000 = 3,000 for six months and on 3,000 – 200 = 2,800 at the same rate for another six months. Depreciation will amount to ₹ 150 + 140 = 290.

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Furniture Account

Dr. Cr.

Date	Particulars	J.F.	₹	Date	Particulars	J.F.	₹
1.1.06	To Balance b/d		1,000	30.6.06	By Cash A/c		200
1.1.06	To Cash A/c		2,000	31.12.06	By Depreciation A/c		290
				31.12.06	By Balance c/d		2,510
			3,000				3,000
1.1.07	By Balance b/d		2,510				

Explanation. Furniture as an asset shows debit balance, so its opening balance has been shown as 'To Balance b/d', in the same way as we showed the opening balance of cash while preparing cash book. Purchases of furniture on 1st January, will increase furniture, so it will be shown at the debit of the furniture account. As a general principle of accounting we do not show the name of the same account either at the debit side or at credit side of the account being prepared, so we shall be writing 'To Cash Account' for the purchase of furniture. In the same way, sale and depreciation of furniture will decrease the value of furniture, so they will be posted at the credit side of the furniture account and shall be shown as 'By Cash A/c' for sales and by depreciation account for depreciation on furniture.

While balancing furniture account we find that the total of the debit side, *i.e.*, ₹ 3,000 is more than the credit side so the total of the debit and credit side must be made equal *i.e.*, ₹ 3,000 and posted parallel to each other. The total of credit side is short by ₹ 2,510 *i.e.*, ₹ 3,000 – 490 (the total of the credit side). This difference of ₹ 2,510 will be written as 'By Balance c/d' on the closing date of accounting period. The closing balance will be carried forward to the first day of the next accounting period and will be written as 'To Balance b/d' at the debit side.

2. Preparation of Liabilities Account. While preparing liabilities account, we have to decide whether a particular account will be posted at the debit side or the credit side of the particular liabilities account. Liabilities as we know are debited for decrease and credited for increase. The previous balance of liabilities account is always a credit balance. Increase in liabilities will be posted at the credit side but the decrease will be posted at the debit side. Liability's account is prepared as under.

Illustration 14. **Prepare Mohan's Account from following details :**

2005			₹
July	*1*	*Credit balance of Mohan's account*	*2,000*
July	*15*	*Amount paid to Mohan*	*1,000*
Aug.	*15*	*Goods purchased from Mohan*	*4,000*
Oct.	*30*	*Paid to Mohan*	*1,980*
		Discount allowed	*20*
Nov.	*18*	*Goods purchased from Mohan*	*2,000*

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Solution. **Mohan's Account**

Dr. *Cr.*

Date	*Particulars*	₹	*Date*	*Particulars*	₹
July 1	To Cash A/c	1,000	July 1	By Balance b/d	2,000
Oct. 30	To Cash A/c	1,980	Aug. 15	By Purchases A/c	4,000
	To Discount A/c	20	Nov. 18	By Purchases A/c	2,000
Dec. 31	To Balance c/d	5,000			
		8,000			8,000
			2006		
			Jan. 1	By Balance b/d	5,000

Explanation. The credit balance of Mohan's account means that he is the creditor of the firm. It is the liability of the business, so the opening balance will be shown at the credit side as 'By Balance b/d'. Liability of the firm will increase with every credit purchase, so credit purchases will be shown at the credit side of Mohan's account. Payment to Mohan will decrease firm's liability towards Mohan, so it will be posted at the debit side as per the rule of debit and credit as regards liabilities.

3. Preparation of Capital Account. Capital is the proprietor's claim against the business. It is the liability of the firm. Like other liabilities it has a credit balance. Capital increases with profit and interest on capital. It decreases with net loss, drawings and interest on drawings. It has generally credit balance, because in most of the cases proprietor has got certain amount of capital in the business. In rare cases proprietor may withdraw more than the capital invested by him. In this case, the debit side of the capital account will be more than the credit side and the capital account will show debit balance.

4. Preparation of Revenue and Expenses Account. Revenue accounts are credited for increase and debited for decrease in the revenue. In the same way, expenses accounts are debited for increase and credited for decrease. The most important feature of revenues and expenses account is that they never shows a balance. In other words, we can say that it is never closed as 'By Balance c/d' or 'To balance c/d'. Revenues and expenses accounts are closed by transfer to profit and loss account, also known as P/L A/c or Trading account.

Illustration 15. **From the following particulars prepare proprietor's Capital Account :**

2004

			₹
Oct.	*1*	*Commenced business with cash*	*20,000*
Dec.	*31*	*Net Loss as per P & L A/c*	*1,800*
Dec.	*31*	*Drawings during the period*	*1,500*

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Solution. **Capital Account**

Dr. *Cr.*

Date	*Particulars*	₹	*Date*	*Particulars*	₹
Dec. 31	To Drawing A/c	1,500	Oct. 1	By Cash A/c	20,000
Dec. 31	To Profit & Loss A/c (Net Loss)	1,800			
Dec. 31	To Balance c/d	16,700			
		20,000			20,000
			2005		
			Jan. 1	By Balance b/d	16,700

2.24 BOOKS OF ORIGINAL ENTRY

Books of original entry also known as books of first or Primary entry consist of the following :

1. Journal

2. Cash Books (*a*) Simple (*b*) Bank Column and (*c*) Petty Cash Book

3. Other Subsidiary books :

(*a*) Purchases Book (*b*) Sales Book

(*c*) Purchases Return Book (*d*) Sales Return Book

(*e*) Bills Receivable Book and (*f*) Bills payable Book

2.25 JOURNAL ENTRIES FROM LEDGER ACCOUNTS

Ledger accounts are prepared from Journal. In the same way Journal entries can also be passed from Ledger Accounts. While passing Journal entries from Ledger Accounts, the following rules/procedures should be adopted :

If posting is made at the debit side of an account, the particular account should be debited and the account appearing at the debit side should be credited. In the same way, if posting is made at the credit side of an account, the particular account should be credited in the Journal entry and the account appearing at the credit side should be debited. This procedure is quite reverse to the procedure adopted while making ledger posting from Journal. Let us further explain it through the following Ledger Account of Ram.

Ram's A/c

Dr. *Cr.*

1.1.08	To Sales A/c	1,000	1.2.08	By Cash A/c	990
			1.2.08	*By Discount A/c*	*10*
		1,000			1,000

Sales A/c has been written at the debit side of Ram's A/c, so Ram's Account will be debited and the account appearing at the debit side of Ram's A/c *i.e.*, Sales A/c will be credited and the following Journal Entry will result.

Ram's A/c	Dr.	1,000	
To Sales A/c			1,000
(Being goods sold to Ram)			

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In the same way cash A/c and Discount A/c appearing at the credit side will be debited and Ram's A/c will be credited. The following Journal entry will be passed :

Cash A/c	Dr.	990	
Discount A/c	Dr.	10	
To Ram's A/c			1,000
(Being amount received from Ram, discount allowed)			

Balances of Certain Ledger Accounts

Assets A/c, Expenses A/c, Returns Inward A/c, Drawings A/c have debit balance.

Liabilities A/c, Revenue A/c, Capital A/c and Returns Outward A/c have credit balance.

Personal Accounts may have either debit or credit balance.

Expenses and Revenue Accounts are closed by transferring their balances to P/L A/c. While preparing Trial Balance and Final Accounts Expenses Accounts are assumed to have Debit balances, whereas Revenue Accounts are assumed to have credit balance.

2.26 MEANING OF BANK RECONCILIATION STATEMENT

Bank reconciliation statement is prepared with a view to find out the causes responsible for the difference between the balances of cash book and pass book and to reconcile their balance. The cash book is maintained and possessed by the firm itself but the pass book or statement of customer's account are prepared by the bank and sent to the customer for information. In this way, both the books are with the customers and he can compare them and verify records at its own convenience. Bank reconciliation statements are prepared by the firm regularly after certain interval. It may be prepared every month, every week or even daily depending upon the number of transactions and the size of firms. While preparing bank reconciliation statement the first step is to identify the transactions which cause difference between the balance of cash book and pass book.

2.27 NEED AND IMPORTANCE OF BANK RECONCILIATION STATEMENT

Bank reconciliation statement is the basic document of the accounting, needed by every business enterprise for having check and control on its dealings with the bank. It has got the following importance :

1. Pin pointing mistakes in the cash book and pass book. Bank Reconciliation statement is prepared by comparing the information of the cash book with the information of the pass book. The comparison discloses and identifies the entries which have been made in the cash book but omitted or wrongly entered in the pass book and vice versa.

2. Identifying delay in the clearance of cheques. The comparison of cash book with the Pass book or Bank statement issued by the bank reveals the date of depositing the

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cheque into the bank and the date of the clearance. In case there is substantial delay, causes for delay may be investigated and remedial measures can be applied.

3. Checking on embezzlement. The continuous comparison of the cash book with the pass book keeps check on employees trying to indulge in embezzlement and misappropriation of funds. As the balances of cash book and pass book are checked, compared and tallied while preparing Bank Reconciliation statement on monthly, weekly or even daily basis, misappropriation and embezzlement of funds becomes very difficult.

4. Checking the accuracy of cash book. The comparison of the Cash Book with the Pass Book satisfies the management, that the Cash Book is being maintained properly. If there is any inaccuracy in the posting the mistake is identified and rectified.

5. Technique of control. The preparation of Bank Reconciliation statement is an important technique of control. It prevents misappropriation in cheques, bank drafts and other transactions with the bank. The malpractices of dishonest employees dealing with cash and bank are controlled and effective measures are employed to plug the loopholes, if any.

2.28 PREPARATION OF BANK RECONCILIATION STATEMENT

While preparing Bank Reconciliation Statement let us first consider causes responsible for its Preparation :

Causes Responsible for the Difference Between the Balances of Cash book and Pass Book/Causes responsible for the preparation of Bank Reconciliation Statement

1. Cheque issued or drawn but not yet presented for payment or cashed by customers or debited in the pass book. It is a common practice of the business to issue cheques in favour of outside parties against the payment. These cheques are delivered to the parties, who are expected to collect the payment of the cheque from our bank. The firm will record the issue of cheques in the cash book on the date of the issue of cheques with the help of the counterfoils of the cheque book. As the payment of cheque may be collected within six or three months from the date of its issue, so the party receiving the cheque may not collect its payment the same day from the bank. It will mean that the issue of cheque has been recorded in the cash book but it does not find a place in ledger accounts of the bank or the pass book, maintained by the bank. The transaction will definitely reduce our bank balance as shown by the cash book, but the bank balance as shown by the pass book will remain the same *i.e.*, not reduced. There will be difference between the balance of cash book and pass book and the transaction will be identified for bank reconciliation statement.

Cheques issued but not cashed by the customers means that the cheque has not been presented by the customer and the payment has not been made by the bank. While issuing cheque, we credit bank account because cash at bank as an asset will reduce or the bank is giver. The bank on the other hand will debit our account after making payment of the cheque issued by us because the payment by the bank will reduce bank's liability towards us. Cheques, not debited by the bank will mean the same things *i.e.*, not presented or not cashed by customers.

2. Cheques debited or deposited or paid into the bank but not yet collected or cleared or credited by the bank. We may receive cheques from outside parties and deposit into the bank for collection. The firm will debit bank account at the time of depositing

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cheques, because cash at bank, as an asset will increase. By debiting bank account while sending the cheque to the bank means that our bank balance as per our cash book has been increased. The bank will credit our account or increase our balance, only when the bank actually collects the payment of the cheques, deposited with it. Collection of cheques is also known as clearance of cheque. After collection of cheques the bank increases our balance with it or credits customer's account.

The transaction increases our bank balance as per cash book at the time of depositing the cheque into bank, but the bank balance as per the pass book will increase, when the bank actually collects the payment of the cheque from the Drawer's bank. As the bank has not yet collected the payment and credited customer's account, bank balance as per pass book will be lesser than the balance as per cash book and the result will be the difference between the balances of cash book and pass book.

3. Cheques directly deposited by the debtors to our account in the bank. It is just possible that certain parties, instead of sending the cheque to us may deposit the same into our bank account directly. The transaction will increase our bank balance, as per the records maintained by the bank, because the payment has already been received by the bank. The firm does not have any knowledge of this direct deposit, so bank balance as per cash book will not increase. The transaction will be responsible for resulting in the difference between the balances of cash book and pass book. The balance of pass book will be more than the balance of cash book.

4. Interest paid or allowed or credited or collected by the bank. The bank may allow or pay interest on our deposits. It is just possible that we may instruct the bank to collect interest on our investment or loan advanced by us. The bank after collecting the interest, will credit the same into our account. As we do not have any knowledge of the interest credited by the bank into our account, there will be no entry of interest in the cash book. The result will be the difference between the balance as per cash book and pass book. The balance of pass book will be comparatively more than the balance of cash book.

5. Interest on overdraft or interest charged or debited by the bank. If we take an overdraft or borrow funds from the bank, interest will be charged by the bank on overdraft or loan advanced by the bank. The bank will debit the amount of interest to our account, thus our bank balance as per pass book will decrease or the amount of loan or overdraft will increase. The balance of the cash at bank will remain, unchanged as per cash book, because of the ignorance of the interest debited by the bank. There will be difference between the bank balance as per cash book and pass book, so far the interest charged by the bank is not entered into cash book.

6. Payment made by the bank on our behalf. The bank is also an agent of the customer, so the bank may be instructed to make the following payments on behalf of the customer :

(*a*) payment of insurance premium

(*b*) payment of instalment of loan

(*c*) payment of office or godown rent

(*d*) issue bank draft in favour of certain outside party

(*e*) make any transfer of money.

In all these cases, the bank debits the amount paid on behalf of his customer into his account and his bank balance as per pass book will decrease. As the customer has not been informed of these payments, it will not have been recorded in the cash book, so the balance of cash book will remain the same *i.e.*, lesser than the pass book.

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7. Dishonour of cheque and bills. The cheques received from outside parties are deposited with the bank. Deposits of cheques is recorded in the cash book at the time of depositing, it with bank and thus balance of cash book will increase. The bank could not collect the payment of the cheque, because it was dishonoured, so the amount will not have been credited by the bank into our account. As a result of the treatment of dishonoured cheque in the cash book and pass book the balances of the two books will differ.

While discounting the bills receivable, the bank will credit the customer's account and the same amount will be debited to the bank account by the customer. It means the transaction affects positively the balance of both the cash book and pass book with the same amount and cannot be identified as transaction for bank reconciliation statement. In case the bill is presented by the bank to the drawee of the bill and the payment is not received, the bank will immediately debit the amount of the bill into customer's account, causing decrease in bank balance as per pass book. Due to ignorance and lack of information, dishonour of the bill will not be recorded in the cash book and the result will be the difference between the balances of cash book and pass book.

8. Bank charges or collection charges. The bank may charge certain amount for the services rendered. The notable charge is collection charge, which is charged by the bank for collection of outstation cheques. These charges are debited by the bank in the customer's account, so they reduce bank balance as per pass book. The bank charges have not been entered in the cash book by the customer, because he was not informed of it as yet. The bank balance as per cash book will remain unchanged and thus there will be difference between the balance of cash book and pass book.

9. Cheques entered into cash book but omitted to be banked. The cheque received from outside parties if entered in the cash book will increase our bank balance as per our record but the question of increase in the bank balance as per the records of the bank does not at all arise, because the cheque has not yet been sent to the bank for collection. The transaction will increase bank balance as per cash book but the balance of pass book will remain unchanged *i.e.*, lesser as compared to cash book. The transaction will thus cause difference between the balances of cash book and pass book.

10. Cheques paid into bank but omitted to be entered in the cash book. The cheque received from outside party has been sent to the bank for collection, so the bank balance, as per ledger accounts of the bank will increase after the collection of the cheque. The cheque has not been recorded in the cash book by mistake, so the bank balance as per our record will remain unchanged. The transaction will result in the difference between the balances of cash book and pass book and will be identified as an item of bank reconciliation statement.

11. Cheques deposited into the bank but under-credited by the bank. It may sometimes happen that we may deposit a cheque for ₹ 50 in the bank but the bank may wrongly credit our account with ₹ 15 only. The transaction will cause a difference of ₹ 35 (*i.e.*, 50—15) between the balances of cash book and pass book, because the customer debited bank account with ₹ 50 whereas the bank credited customers account with ₹ 15 only.

12. Retiring a bill under rebate by the bank. In certain cases, we may send our bills payable to bank and instruct to make its payment. We shall be deducting the entire amount of the bills payable from our bank balance while sending the bill. The bank may retire the bill or make its payment before its due date and earn certain amount of cash discount for us. The bank will reduce lesser amount from our account *i.e.*, the amount of the bills *less* amount of discount, so there is going to be the difference between the balances of cash book and pass book.

13. Dividends and interest collected and credited by the bank. The bank may collect dividends on our investment in shares and also interest on our investments and loans as per our instruction. The bank will credit these dividends and interest collected in our account. This will increase our bank balance as per the records of the bank. The transaction will not be recorded in the cash book because we have not been informed of it as yet. The balance of cash book will, therefore be lesser than the balance of pass book.

2.29 STEPS FOR PREPARATION OF BANK RECONCILIATION STATEMENT

While preparing bank reconciliation statement, the following steps should be adopted :

1. Identification of the balance with which bank reconciliation statement has to be prepared. Bank reconciliation statement can be prepared either from the balance of cash book or pass Book. We have to prepare statement with the balance given. If the balance of cash book is given, we shall prepare the statement with the balance of cash book. If the balance of pass book is given, we shall start bank reconciliation statement with the balance of pass book. If the balance of both the cash book and pass book are given, we can prepare statement with either of the balance.

2. Identification of the plus and minus balance. While preparing Bank Reconciliation statement the amount column is divided into plus and minus columns. Plus balance with the bank means that the firm has financially sound position and has deposited more in the bank than what it has withdrawn. Minus balance means overdraft balance *i.e.,* drawn from the bank more than the deposits. On the following basis, we can identify plus and minus balance :

Plus Balance

The bank balance will be treated as plus balance in the following cases :

(*i*) *If the cash book shows a debit balance.* The debit balance of the cash book means excess of the debit side over the credit side of the cash book. The debit side represents amount deposited into the bank and the credit side shows the amount withdrawn from bank. Excess of deposits over the withdrawals shows that we have got certain plus balance in the bank.

(*ii*) *If the pass book shows a credit balance.* The accounting treatment in the pass book, maintained by the bank is quite reverse to the treatment of the transaction made in the cash book. In this way, the bank credits our account for deposits, whereas the same is debited in the cash book. Credit balance of pass book means excess of our deposits in the bank over the amount debited by the bank in our account and thus it is a plus balance.

(*iii*) *The balance of cash book or pass book, if not specified.* In case, it is not specified that the balance shown by the cash book or pass book is debit or credit, we will have to assume the balance as plus, because generally deposits increase the withdrawals from the bank. Most of the firms have plus balance, so it will be appropriate to assume balance as plus.

Minus Balance

It means financially unsound position of the firm, where bank has paid more on our account than what we have deposited in the bank. The balance will be treated as minus in the following cases :

(*i*) *If the cash book shows credit balance.* The credit balance of the cash book means that the credit side of the cash book, which represents payment made by bank on our behalf is more than the debit side, which shows our deposits into the bank. We debit bank account or make a posting at the debit side of the cash book in the bank column, while depositing

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money, whereas the posting is made at the credit side of the cash book when the bank makes payment of cheques drawn by us, or overdraft is sanctioned by the bank or charges made by the bank. In this way, excess of credit side of the cash book will mean more withdrawals than deposits and thus it is minus balance.

(*ii*) *If the pass book shows debit balance.* The debit balance of the pass book means the same as the credit balance of cash book. It shows that the bank has debited our account with more amount than what it has credited. Excess of debit over the credit will mean that we are the debtors of the bank or in other words, bank is our creditor. We have to pay to the bank the amount overdrawn, so it will be a minus balance.

(*iii*) *Overdraft balance as per cash book or pass book.* **Overdraft means the amount overdrawn from the bank. In such cases, the bank makes more payment on our account than the deposits received from us.** The word 'overdraft' itself means minus balance whether it is as per cash book or pass book. The credit balance of cash book or the debit balance of pass book both show overdraft balance. Amount over drawn from the bank is always a minus balance.

3. Determining the effect of the transaction. The statement can be prepared either from the balance of cash book or pass book. If it is prepared from the balance of cash book, the effect of the transaction will be studied on the pass book as compared to cash book. The item will be added, if the bank balance as per pass book increases and in the same way, the item will be deducted, if bank balance as per Pass book decreases. For example, the issue of cheque, not presented for payment will decrease the balance of cash book but as bank has not passed any entry, so the bank balance as per pass book will not decrease. In other words, we can say that the balance as per pass book will be more as compared to the balance as per cash book. We will have to add the item in order to bring the balance of cash book at par or equal to that of pass book. In case the statement is being prepared from the balance of pass book, we will have to study the effect of the transaction on the cash book. In the above example *i.e.,* due to issue of cheque, not presented by the customer, the balance of cash book has gone down but the balance of the pass book remains the same. As the statement is being prepared from pass book, so its effect will be studied on the cash book, whose balance has decreased, so the item will be deducted.

To illustrate it further, we can take another example of bank charges. The balance as per pass book will be lesser as compared to cash book, because the bank balance has already been reduced with the bank charges and it has not been recorded as yet in the cash book. We will have to deduct the item, if we prepare statement with the balance of cash book, because the balance as per pass book is lesser as compared to the balance of cash book. The item will be added if we prepare the statement from the pass book, because the balance of the reverse book *i.e.,* cash book is more than the pass book. The effect is summarised as under :

If the statement is prepared from the balance of cash book

(*a*) Add those items which have resulted in the increase of balance as per pass book.

(*b*) Deduct those items which have caused the decrease in the balance of pass book.

If the statement is prepared from the balance of pass book

(*a*) Add those items which have resulted in the increase of the bank balance as per cash book.

(*b*) Deduct those items which have caused the decrease of the balance as per cash book.

4. Considering the date of preparing the statement. Only those transactions which are entered in one of the book *i.e.,* cash book or pass book but not entered in either of the two by the date of preparing statement are identified as transactions for Bank Reconciliation statement. Suppose, if the date of preparing bank reconciliation statement is 30th June,

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2008, all those transactions which have been recorded in the cash book but not in the pass book or recorded in the pass book but not in the cash book by 30th June, 2008 will be entered in the bank reconciliation statement. If the transaction has been recorded in both the cash book and the pass book correctly the balance of both the books will either increase or decrease simultaneously with the same amount by 30th June, 2008. Such transactions will be ignored at the time of preparing bank reconciliation statement.

5. Balancing the statement. Final step will be to balance the plus and minus columns. If we started preparing statement with the balance of cash book, we shall be finding out the balance of the pass book. In the same way, if we started preparing statement from the balance of pass book, we shall find out the balance of the cash book. If the total of the plus items exceed the total of the minus items the balance ascertained will be plus. In the same way excess of minus items over plus items will show a minus balance.

The preparation of bank reconciliation statement may be summarised as under :

Bank Reconciliation Statement

S. No.	*Items*	*If prepared with the Balance of cash book*	*If prepared with the Balance of pass book*
1.	Cheque issued or drawn, but not yet presented for payment or cashed by the customers or debited in the pass book.	+	(–)
2.	Interest allowed or paid or collected or credited by the bank but not yet entered in the cash book or dividend directly collected by the bank.	+	(–)
3.	Cheques directly deposited by the customer into our account or the amount directly collected by the bank but not entered in the cash book.	+	(–)
4.	Cheques paid into bank but omitted to be entered in the cash book.	+	(–)
5.	Rebate on retiring of the bill by the bank.	+	(–)
6.	Cheques deposited or paid into bank but not yet collected or cleared or credited by the bank.	(–)	+
7.	Interest on overdraft or interest charged or debited by the bank but not yet entered into cash book.	(–)	+
8.	Bank charges or collection charges or locker's rent charged and debited by the bank in the pass book but not entered in the cash book.	(–)	+
9.	Insurance premium or the rent of the shop or issue of the bank draft by the bank on our instruction or any other payment made by the bank on our behalf but not entered in the cash book.	(–)	+
10.	Dishonour of cheque/Bill.	(–)	+
11.	Cheques entered in the cash book but omitted to be banked.	(–)	+
12.	Cheques deposited in the bank but under credited by the bank.	(–)	+
13.	Any amount wrongly debited by the bank in the pass book.	(–)	+

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Illustration 16. **Prepare bank reconciliation statement from the following information on 31st December, 2005 :**

Cash book showed a balance of ₹ 15,000 on 31st December, 2005. On comparing the same with the balance of pass book it was revealed that :

(i) A cheque of ₹ 2,000 issued in the month of December, 2005 has not been presented for payment to the bank.

(ii) The customer deposited cheques worth ₹ 3,000 but they have not been collected by the bank.

(iii) The bank has allowed ₹ 200 as interest.

(iv) Bank has charged ₹ 20 as commission for his services.

Solution. **Bank Reconciliation Statement**

(as on 31st December, 2005)

Particulars	*Amount*	
	Plus ₹	*Minus* ₹
Balance as per cash book	15,000	
Add : Cheque issued but not yet presented for payment	2,000	
Add : Interest allowed by the bank	200	
Less : Cheque deposited but not yet collected by the bank		3,000
Less : Bank charges		20
Balance as per pass book		14,180
	17,200	17,200

Explanation

(*i*) *Cash balance.* We have been given cash balance of ₹ 15,000. It has not been specified, whether it is a debit or credit or overdraft balance, so we will assume the balance to be plus. It is a general practice to assume the balance as plus, if not specified.

(*ii*) *Cheque issued but not presented for payment.* As we have been preparing statement with the given balance of cash book, so we shall have to study the effect of the transaction on bank balance as per pass book. As the cheque for ₹ 2,000 has not been presented to the bank or the bank has not made the payment of the cheque as yet, so the balance of pass book has not decreased and it will be comparatively more than the balance of cash book. We will add the item to bring the balance of the cash book to the balance of pass book.

(*iii*) *Cheque deposited but not yet collected.* The item will be deducted to bring down the balance of cash book equal to the balance of pass book. The balance of pass book is lesser than the balance of cash book because the cheque has not been collected by the bank.

(*iv*) *Bank charges.* The item will be deducted because the balance of pass book has gone down with the amount of bank charges.

Illustration 17. *The bank pass book of Mr. X showed an overdraft of ₹ 33,575 on 31st March, 2005. On going through the pass book, the accountant found the following :*

(i) A cheque of ₹ 1,080 credited in the pass book on March 28, is dishonoured and debited in the pass book on April 1, 2005. There was no entry in cash book about the dishonour of the cheque until 15th April.

(ii) Bank had credited his account with ₹ 2,800 for interest collected by them on his behalf but the same has not been entered in his cash book.

(iii) Out of ₹ 20,500 paid in by Mr. X in cash and by cheques on 31st March, cheques amounting to ₹ 7,500 were collected on 7th April.

(iv) Out of cheques amounting to ₹ 7,800 drawn by him on 27th March, a cheque for ₹ 2,500 was encashed on 3rd April.

Prepare bank reconciliation statement on March 31, 2005.

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Solution. **Bank Reconciliation Statement**

as on 31st March, 2005

Particulars	*Amount*	
	Plus ₹	*Minus* ₹
Overdraft as per pass book		33,575
Less : Interest collected and credited by the bank		2,800
Add : Cheques paid into bank but not yet collected	7,500	
Less : Cheques issued but not yet encashed		2,500
Overdraft as per cash book	31,375	
	38,875	38,875

Note. Item No. 1 of the question will not be shown in the statement because it has appeared in both the cash book and pass book before 31st March, 2005.

Explanation. The statement is to be prepared from the balance of pass book. Different transactions will be added or deducted after studying their effect on cash book. If the balance of cash book is comparatively more than the balance of pass book due to the effect of certain transaction, the item will be added. In the same way, transaction affecting decrease in the balance of cash book will be deducted.

The pass book shows overdraft balance, which will be written in the minus column, as overdraft balance is always a minus balance, whether it is from cash book or pass book. While preparing statement with plus and minus columns determination of items to be added or deducted will be made in the same way as if it has a plus balance. After putting overdraft balance in the minus, the treatment of other items will be made in the usual way.

STUDENT ACTIVITY

1. Mention the column of the cash book wherein you will write the amount of the cheque received and deposited into the bank the day.

2. How will the bank balance be effected if the amount is debited in the cash book and credited in the pass book?

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SUMMARY

- Cash book is used for recording the receipts and payments of money, whether in coins, notes, cheques, postal orders, bank drafts, etc. Cash Book is maintained by every business, whether small or large in size.
- An allowance given in specific situations is termed as Discount. As such discount may be classified as under :

  1. Cash Discount. 2. Trade Discount.
- 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.
- Collection of requisite information concerning a particular account and presenting them under one head is known as **ledger posting.** All the information regarding a particular account is collected from different subsidiary books and journal proper and presented under one heading, known as the ledger account.
- *Books of original entry also known as books of first or Primary entry consist of* the following :

  1. Journal

  2. Cash Books (*a*) Simple (*b*) Bank Column and (*c*) Petty Cash Book

  3. Other Subsidiary books :

  (*a*) Purchases Book (*b*) Sales Book

  (*c*) Purchases Return Book (*d*) Sales Return Book

  (*e*) Bills Receivable Book and (*f*) Bills payable Book
- Bank reconciliation statement is prepared with a view to find out the causes responsible for the difference between the balances of cash book and pass book and to reconcile their balance.

REVIEW QUESTIONS

1. The bank column of Cash Book may have both debit and credit balance. Mention either of the situations wherein it may be said to be Plus balance.
2. *What is the purpose of Contra Entries ?*
3. What do you mean by a cash book ? What are the different kinds of cash book ? Discuss briefly each of them.
4. Describe journal proper in five sentences.
5. Mention five transactions to be recorded in journal proper.
6. Take into consideration the following accounts mentioned below and point out whether their balance will be transferred to (*i*) Trading A/c (*ii*) P/L A/c or the account will be closed as balance c/d.
7. What do you mean by the debit and credit balance of an account ? Explain briefly.
8. Which accounts can be prepared on the basis of Purchases book and Sales book ? Explain the process of preparing these accounts.
9. *If Bank Reconciliation statement is prepared with the balance of Pass book, which book's* balance we shall get at the end ?

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10. If we deposit cheques worth Rs. 5,000 into the bank and find that cheques for Rs. 4,000 seem to have been cleared by the date of preparing statement, what amount you will add or deduct while preparing statement ?

11. Name the type of account holder in the bank, who is required to prepare Bank Reconciliation statement ?

PRACTICAL QUESTIONS

Simple Cash Book

(Simple or Single Column Cash Book)

1. *Enter the following transactions in the Simple Cash Book :*

2001		₹
Jan. 1	Cash in hand	14,000
Jan. 2	Cash received from Bihari Lal	2,000
Jan. 4	Paid wages	75
Jan. 8	Drew for personal use	500
Jan. 10	Sold goods to Mukesh for cash	1,000
Jan. 12	Paid for advertisement	50
Jan. 15	Cash purchases	575
Jan. 20	Purchased a cycle by proprietor for his son	325
Jan. 22	Purchased furniture for office use for cash	700
Jan. 25	Sold goods for cash	625
Jan. 31	Paid electricity charges	50
Jan. 31	Paid salaries to the manager	200
Jan. 31	Purchased stationery for cash	20

[**Ans.** Cash in hand ₹ 15,130]

Cash Book With Discount Column

(Double Column Cash Book)

2. *Enter the following transactions in Cash Book with Discount Column :*

2002		₹
Jan. 1	Commenced business with cash	30,000
Jan. 5	Purchased furniture for cash	4,000
Jan. 8	Sold goods to Manmohan for cash	3,000
Jan. 10	Paid for insurance	100
Jan. 15	Paid to Madan ₹ 625 in full settlement of ₹ 640	
Jan. 17	Paid ₹ 195 to Kanti Prasad from whom goods for ₹ 200 were purchased on credit	
Jan. 20	Paid for charity	50
Jan. 25	Received from Hari Prasad	495
	Discount allowed	5
Jan. 27	Drew cash for personal use	150
Jan. 30	Paid Delhi Mills their bill for ₹ 400 less 5% discount	
Jan. 31	Paid for stationery	50

[**Ans.** Cash in hand ₹ 27,945]

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Cash Book with Discount and Bank Column

(Three Column Cash Book)

3. *Compile a Bank Column Cash Book from the following transactions :*

		₹			₹
2001			2001		
June 1	Cash Balance	1,500	June 21	Drawn from bank	500
	Bank Balance	750	June 29	Paid office salaries in cash	400
June 5	Cash received from sale of shares	5,500	June 30	Sold goods for cash and banked the same	800
June 6	Paid into Bank	5,000	June 30	Paid rent by cheque	100
June 7	Paid S. Bose by cheque	1,250	June 30	Paid into Bank	750
June 9	Paid wages in cash	300			
June 20	Received from A. Mukerji by a cheque and sent to bank	600			

[**Ans.** Cash in hand ₹ 1,050.; Cash at Bank ₹ 6,050]

4. *Enter the following transactions in the Purchases Book :*

2001

Mar. 1 Purchased from Rajendra Bros., Mathura *(Invoice No. 324)*
50 tins Ghee @ ₹ 500 per tin
100 bags Sugar @ ₹ 900 per bag
Less : 10% Trade discount.

Mar. 2 Bought of Bharat Stores, Mumbai *(Invoice No. 325)*
20 bags Gram @ ₹ 300 per bag
10 bags Sugar @ ₹ 1000 per bag
15 bags Wheat @ ₹ 400 per bag
Less : 10% Trade discount.

Mar. 30 Bought of Harish Kumar Gupta, Kaithal *(Invoice No. 326)*
10 bags Sugar @ ₹ 1000 per bag
30 tins Ghee @ ₹ 400 per tin. [**Ans.** Total ₹ 1,45,300]

5. *Prepare Returns Books from the following information :*

2002

Dec. 1 Ram & Co. returned to us 20 chairs @ ₹ 200 per chair
Less : Trade discount 5%

Dec. 4 Returned to Sohan Lal 9 chairs @ ₹ 120 per chair being not of specified quality

Dec. 7 Received back from Singh & Co. ; 4 stools @ ₹ 40 each ; 20 almirahs @ ₹ 700 each

Dec. 8 M/s Lal & Bros. returned to us 2 Tables @ ₹ 300 each ; 5 broken almirahs @ ₹ 400 each

Dec. 10 Sent back one dining table to Balwant Singh for not being polished @ Rs. 600 and 8 chairs @ ₹ 200 each

Dec. 15 Returned 3 chairs @ ₹ 180 each and one stool of ₹ 40 to Ram Singh and Co.

[**Ans.** Returns Outward Book ₹ 3,860 ; Returns Inward Book ₹ 20,560]

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6. *Pass the journal entries from the following transactions and post them into ledger :*

2004		₹
Oct. 1	Started business with cash	20,000
Oct. 3	Opened a current account	12,000
Oct. 5	Purchased goods	4,000
Oct. 7	Sold goods to Mohan	3,000
Oct. 9	Amount received from Mohan	2,900
	Discount allowed	100
Oct. 14	Goods purchased from Shahid	1,000
Oct. 17	Paid to Shahid in full settlement	980
Oct. 25	Paid salaries	1,200
Oct. 31	Interest on capital	15
Oct. 31	Amount withdrew for office use	2,000

[**Ans.** Closing balance of cash ₹ 6,720]

7. *Post the following transactions in the simple cash book and post them into ledger :*

2004		₹
Nov. 1	Cash in hand	2,000
Nov. 8	Paid for wages	200
Nov. 12	Outstanding salaries	100
Nov. 15	Cash purchases	700
Nov. 28	Cash sales	400
Nov. 30	Interest on capital	20

[**Ans.** Closing balance of cash ₹ 1,500]

8. *Prepare a bank reconciliation statement from the following particulars :*

Messers Sunder Lal & Sons find that the bank balance shown by their cash book on 31st December, 2004 is ₹ 10,500 (credit) but the pass book shows a difference due to the following reasons :

(*a*) Cheque No. 51 for ₹ 540 favouring A, B and Co. has not yet been presented.

(*b*) A post-dated cheque for ₹ 300 has been debited in the bank column of the cash book but could not have been presented in any case.

(*c*) Four cheques totalling ₹ 1,200 sent to bank have not yet been collected, while a fifth cheque for ₹ 400 deposited in the account has been dishonoured.

(*d*) Fire insurance premium amounting to ₹ 50 paid by the bank under a standing order has not been entered in the cash book.

(*e*) A bill for ₹ 1,000 was retired by the bank under a rebate of ₹ 15 but the full amount of the bill was credited in the bank column of the cash book.

[**Ans.** Overdraft as per pass book = ₹ 11,895]

9. *Prepare a bank reconciliation statement from the following particulars :*

	₹
(*a*) Overdraft as per cash book on 31st Dec. 2004	8,000
(*b*) Cheques paid into the bank but not cleared before 31st December, 2004	2,000

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(*c*) Cheques issued but not cashed by the customer prior to 31st December, 2004 1,200

(*d*) Bank charges for the period 100

(*e*) Interest on overdraft charged by the bank 200

(*f*) Interest on debentures collected by the bank not shown in the cash book 500

[**Ans.** Overdraft balance as per pass book = ₹ 8,600]

FURTHER READINGS

- '*Accounting for Management*', by Dr. V.R. Palanivelu, University Science Press.
- '*Cost and Financial Management*' by Dr. Mohd. Aarif, Univeristy Science Press.

NOTES

UNIT-III PREPARATION OF FINANCIAL STATEMENT

STRUCTURE

3.0 LEARNING OBJECTIVES

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

- explain the meaning of financial statements.
- describe trading account, profit and loss account and balance sheet.
- illustrate the preparation of trial balance and preparation of financial statements. (Including adjustment).

3.1 INTRODUCTION

The final step of accounting process is preparation of final accounts including trading account, profit and loss account and balance sheet. In this chapter, we will study the preparation of final accounts.

3.2 MEANING OF FINANCIAL STATEMENTS

Every firm likes to measure the performance of its business operations in terms of profit or loss. It also likes to know the values of its assets and liabilities on the closing date of accounting period. In order to ascertain its income and also to assess the position of assets and liabilities statements prepared are known as Financial Statements. These statements are 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 statement is traditionally known as Trading and profit and loss account and position statements is known as balance sheet.

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3.3 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.

Every business likes to know, whether the firm has earned gross profit or suffered gross loss. Gross profit or loss is ascertained by preparing Trading Account. Excess of sales and closing stock over opening stock, purchases and direct expenses is known as the gross profit. Gross loss is the excess of opening stock, purchases and direct expenses over sales and closing stock. In other words, we can say that

Gross profit	= Net sales – Cost of goods sold
Net sales	= Sales – Sales return
Cost of goods sold *Or* Cost of sales	= Sales – Gross profit
Cost of sales	= Opening stock + Net purchases + Direct expenses (–) closing stock
Net purchases	= Purchases – Purchases return
Gross loss	= Cost of goods sold – Net sales

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.

Manufacturing concerns prepare manufacturing account before Trading account. Manufacturing account shows **cost of production** which is transferred to Trading account to ascertain gross profit or loss.

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Need/Importance and Purpose of Trading Account

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.

Proforma of Trading Account

Trading Account

(for the period ending December 31, 2006)

Dr. *Cr.*

Expenses/Losses	*Amount ₹*	*Revenue/Gain*	*Amount ₹*
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			
To Import duty, customs,			
Landing charges, clearing charges			

NOTES

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)			

Journal Entries for Preparing Trading Account (*Closing Journal Entries*)

1. **For Opening Stock.** It is transferred to the debit side of trading account.

Journal Entry

Trading A/c Dr.

To Opening Stock

(Being transfer of opening stock to trading account)

2. **For Purchases.** Purchases account is transferred to the debit side of trading account with the total of cash and credit purchases, *i.e.*, gross purchases.

Journal Entry

Trading A/c Dr.

To Purchases A/c

(Being transfer of purchases to trading account)

3. **For Purchases Return.** The balance of purchases return account is transferred to purchases or Trading account.

Journal Entry

Purchases Return A/c Dr.

To Purchases A/c or Trading A/c

(Being transfer of purchases return to purchases account or trading account)

4. **For Direct Expenses.** Direct expenses add to the cost of goods purchased or manufactured. They are posted at the debit side of trading account.

NOTES

Journal Entry

Trading A/c Dr.

To Individual Direct Expenses A/c

(Being transfer of direct expenses to trading account)

5. **For Sales.** Gross sales, *i.e.*, total of cash and credit sales is transferred to the credit side of trading account.

Journal Entry

Sales A/c Dr.

To Trading A/c

(Being transfer of sales to trading account)

6. **For Sales Return or Returns Inward.** The balance of sales return is transferred to sales or Trading account.

Journal Entry

Sales A/c or Trading A/c Dr.

To Sales Return A/c

(Being transfer of sales return to sales account or trading account)

7. **For Closing Stock.** The value of closing stock is transferred to trading account.

Journal Entry

Closing Stock A/c Dr.

To Trading A/c

(Being transfer of closing stock to trading account)

Closing stock is also shown at the assets side of the balance sheet.

The above entries are based upon the trial balance and can be summarised and grouped as two entries :

1. Trading A/c Dr.

To Opening Stock

To Purchases A/c

To Wages A/c

To Carriage or Cartage or Freight A/c

To Coal, Gas and Power A/c

To Manufacturing Expenses A/c

2. Sales A/c Dr.

Closing Stock A/c Dr.

To Trading A/c

The trading account is prepared in 'T' shape. It has got debit and credit side. The excess of the credit side over the debit side shows a gross profit, which is transferred from trading account to profit and loss account.

For Gross Profit/Loss

(*a*) Trading A/c Dr.

To Profit and Loss A/c

(Being transfer of gross profit to profit and loss account)

If the debit side of trading account exceeds the credit side, the excess is supposed to be gross loss and transferred to profit and loss account.

(*b*) Profit and Loss A/c Dr.

To Trading A/c

(Being transfer of gross loss to profit and loss account)

Note. It should be noted that closing entries are made for Nominal Accounts only, because these accounts need to be closed.

Illustration 1. **Following is the information from the books of Rajendra Bros. as on 31st Dec., 2004 Pass closing journal entries and prepare trading account.**

	₹		₹
Opening Stock	*5,000*	*Sales Return*	*400*
Sales A/c	*20,000*	*Manufacturing expenses*	*100*
Purchases Return	*200*	*Octroi*	*500*
Wages A/c	*4,000*	*Motive Power*	*700*
Carriage inward	*300*	*Purchases A/c*	*8,000*

Closing stock (31st Dec., 2004) ₹ 2,000

Solution. **Closing Journal Entries**

Date	*Particulars*		*Debit ₹*	*Credit ₹*
2004				
Dec. 31	Trading A/c	Dr.	18,600	
	To Opening Stock			5,000
	To Purchases			8,000
	To Wages			4,000
	To Carriage Inward			300
	To Manufacturing Expenses			100
	To Octroi			500
	To Motive Power			700
	(Being transfer of accounts to the debit side of trading A/c)			
Dec. 31	Purchases Return A/c	Dr.	200	
	To Purchases A/c			200
	(Being transfer of purchases return to purchases account)			
Dec. 31	Sales A/c	Dr.	20,000	
	Closing Stock A/c	Dr.	2,000	
	To Trading A/c			22,000
	(Being transfer of sales and closing stock to the trading account)			

NOTES

Dec. 31	Sales A/c Dr.	400	
	To Sales Return A/c		400
	(Being transfer of sales return to sales account)		

Trading Account of Rajendra Bros.

for the year ended Dec. 31, 2004

Dr. *Cr.*

Expenses/Losses		₹	*Revenue/Gain*		₹
To Opening Stock		5,000	By Sales	20,000	
To Purchases	8,000		*Less* : Sales return	400	
Less : Purchase return	200				19,600
		7,800	By Closing stock		2,000
To Wages		4,000			
To Carriage Inward		300			
To Manufacturing expenses		100			
To Octroi		500			
To Motive power		700			
To Gross profit transferred to P/L A/c		3,200			
		21,600			21,600

Note. Gross profit is the balancing figure, *i.e.*, excess of credit side over the debit side. It will be transferred to the credit of profit and loss account. Excess of the debit side over the credit side will be gross loss and transferred to the debit side of P/L A/c.

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.

3.4 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.
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.

NOTES

Proforma

Profit and Loss Account

for the year ending.....

Dr. *Cr.*

Expenses/Losses	₹	*Revenue/Gain*	₹
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)	
To Office expenses or establishment		*Or*	
To Miscellaneous, or sundry expenses		Interest on Investment	
To Insurance		*Or*	
To Stationery		Interest on fixed deposit	
To Printing and stationery		*Or*	
To Staff Welfare Expenses		Interest on Loans advanced	
To Lighting		*Or*	
To Water and Electricity		By Rent received	
To Establishment expenses		*Or*	
To Postage and telegrams		Rent (credit)	
To E-mail and Fax charges		*Or*	
To Courier Service charges		Rent from tenant	
To Telephone expenses		By Discount received	
To Law charges or law cost or litigation expenses or legal charges		*Or*	
To Repairs and renewal or Maintenance or upkeep		Discount (credit)	
To Distribution expenses		By Commission received	
To Travelling expenses/Conveyance		By Dividends Received	
To General expenses		By Profit from sale of assets	
To Stable expenses		By Refund of tax	
To Selling expenses		By Compensation received	
To Carriage or freight Outward		By Apprenticeship premium	
To Carriage on sales		By Difference in exchange (credit)	
To Indirect or unproductive wages		By Interest on drawings	
To Audit fee		By Discount on creditors	
To Entertainment expenses		By Bad debts recovered	
To Interest paid or interest (debit) or interest on overdraft or interest on loans borrowed		By Miscellaneous receipts	
To Discount allowed or discount on debtors		By Appreciation or increase in the value of assets	
To Bad debts or Bad debts written off		By Income from Investment	
		By Reserve for bad and doubtful debts (old reserve—if not treated at the debit side of P/L A/c	
		By *Net loss*—Transferred to Capital A/c (*If debit side exceeds credit side*)	

NOTES

To Reserve or provision for bad and doubtful debts (New reserve—in adjustment)		—Balancing Figure	
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 (Debit)			
To Net Profit—Transferred to Capital A/c (*If credit side exceeds debit side*) —Balancing Figure			

Expenses Not to be Shown in Profit and Loss Account

1. Direct expenses.
2. Capital expenditure.
3. Personal Income tax.
4. Private or domestic expenses.
5. Life insurance premium.

Closing Journal Entries Regarding Profit and Loss Account

Profit and loss account records selling and distribution expenses on the debit side and income at the credit side. Items regarding profit and loss account are transferred from Trial balance to it. For transfer of these items following closing journal entries are passed :

1. For Transfer to Selling, Distribution and Financial Expenses and Losses to Profit and Loss A/c.

Journal Entry :

Profit and Loss A/c	Dr.
To Sundry Expenses A/c	
To Salaries A/c	
To Rent A/c	
To Insurance A/c	
To Stationery A/c	

To Repairs A/c
To Advertising
To Audit fee
To Depreciation
To Miscellaneous Indirect Expenses (Individually)
(Being transfer of indirect expenses to the debit side of profit and loss account)

2. For Transfer of Sundry Income :

Rent received A/c	Dr.
Discount received A/c	Dr.
Interest received A/c	Dr.
Commission received A/c	Dr.
Interest on drawings A/c	Dr.
Miscellaneous income A/c	Dr.

(Individually)
(To Profit and Loss A/c)
(Being transfer of sundry income to profit and loss account)

3. For Transfer of Net Profit. If the credit side of profit and loss account exceeds the debit side of profit and loss account, the excess is assumed to be net profit and transferred to capital account.

Journal Entry :

Profit and Loss A/c Dr.
To Capital A/c
(Being transfer to net profit to capital account)

4. For Transfer to Net Loss. Excess of the debit side of profit and loss account over the credit side is the net loss and transferred to capital account.

Journal Entry :

Capital A/c Dr.
To Profit and Loss A/c
(Being transfer of net loss to capital account)

Profit is the reward for the risk taken by the proprietor, so it is transferred to the credit side of capital account and thus increasing the balance of capital account. If there is net loss it will be suffered by the proprietor (entreprenure) and debited to his capital account and thus decrease the balance of his capital account.

Gross profit or gross loss will also be transferred to profit and loss account. Closing entry regarding it has already been passed, while passing closing entries relating to Trading account. According to that entry gross profit (determined from trading account) will be posted as the first item at the credit side of profit and loss account. In the same way, Gross loss will be transferred to the debit side of profit and loss account as the first item. There will be either Gross profit or Gross loss to the firm.

Closing entries are passed to close the accounts appearing in the Trial balance at the end of accounting period while preparing Final accounts.

NOTES

3.5 MEANING OF NET PROFIT

Net profit is calculated by deducting non-operating expense from operating Profit and adding non-operating income. Hence, net profit takes into account both operating and non-operating expense and incomes.

Net Profit = Operating Profit – Non-operating expense + Non-operating income.

Non-operating expense includes loss due to fire accident, interest, tax etc.

Non-operating income includes gain on sale of assets, interest received dividend received etc.

Alternatively, net profit can also be calculated with the help of following formula :

Net profit = Net sale + Non-operating incomes – (Cost of goods sold + Operating expenses – non-operating expenses).

Illustration 2. **Prepare Profit and Loss A/c from the following information :**

	₹		₹
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 and 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 3. **Calculate Business income from the following information :**

Purchases (100 units)	*50,000*
Carriage and Freight	*6,000*
Rent and Advertising	*3,000*
Sales (75 units)	*54,000*

NOTES

Solution.

Trading Account

Dr. Cr.

Expenses/Losses	Amount	Revenue/Gain	Amount
To Purchases (100 units)	50,000	By Sales (75 units)	54,000
To Carriage and Freight	6,000	By Closing stock	14,000*
To Gross Profit transferred to P/L A/c	12,000		
	68,000		68,000

Profit and Loss Account

Dr. Cr.

Expenses/Losses	Amount	Revenue/Gain	Amount
To Rent and Advertisement	3,000	By Gross Profit	12,000
To Net Profit or Business income	9,000		
	12,000		12,000

Working Note. 25 units is unsold (Closing stock)

The cost of 25 units = 25 × 500 = 12,500

Add : Proportionate Direct Expenses = 6,000 × 25/100 = ₹ 1,500

Thus Closing stock = 12,500 + 1,500 = ₹ 14,000*.

Illustration 4. **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 ₹	Credit ₹
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
Bills Receivable and Bills Payable	1,500	700
Cash at bank	1,200	
Cash in hand	190	

Salaries	*800*	
	46,700	*46,700*

NOTES

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

Solution.

Trading and Profit and Loss Account of Sri Ram & Sons

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

Expenses/Losses		₹	*Revenue/Gain*		₹
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 and 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

3.6 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 known as position statement. We adopt double entry system of accounting, where every debit 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 liabilities. Liabilities consists of creditors equity (liability) and proprietor's equity. In other words, creditors and proprietor's claim againts the firm must be equal to its assets. If assets and liabilities of Balance sheet do not tally, there is definitely certain mistake. According to *Freeman "A Balance sheet is an itemwise list of assets, liabilities and proprietorship of a business at a certain date".*

Features/Characteristics of Balance Sheet

1. Balance sheet is a statement.
2. Prepared on a specified date.

NOTES

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.

Proforma

Balance Sheet

as on .....

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

		Patents and Trade Mark **Miscellaneous Expenses** Advertising suspense Discount on issue of shares Discount on issue of debentures	

3.7 POINTS TO BE CONSIDERED WHILE PREPARING 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.

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 5. **From the following Trial Balance extracted from the books of Mahinder Singh, prepare Trading and Profit and 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 and Machinery	*80,000*	
Debtors and 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*

Closing stock was valued at ₹ 50,000.

Solution.

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

Expenses/Losses		*Amount* ₹	*Revenue/Gain*		*Amount* ₹
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

NOTES

Balance Sheet

Liabilities		*Amount* ₹	*Assets*	*Amount* ₹
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

Note. 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.

3.8 ADJUSTMENTS/ADDITIONAL INFORMATION IN PREPARATION OF FINAL ACCOUNTS

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

Appreciation in the Value of Assets

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

Treatment 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 ₹ 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**

Dr.		*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.

Outstanding 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 expenses of the current year, so they must be debited and charged from the profit and loss account of the current year. The expenses remained unpaid so far during the current year,

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so they are the liability of the firm. For example, the firm pays ₹ 5,000 wages per month to its workers. Wages are paid on the 1st day of every month, *i.e.,* wages for the month of March, 2003 will be paid on April 1, 2003, the wages for October, 2003 will be paid on November 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 ₹ 55,000 have been actually paid on account of wages. Wages for the month of December, 2003 is still to be paid. It is outstanding. 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 outstanding 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 only 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 be 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 balance sheet.

Prepaid Expenses *or* Expenses Paid in Advance *or* Expenses Relating to the Next or Following Year or Unexpired Expenses

There are certain expenses which may have been paid in advance, *i.e.,* expenses for the next year have been paid during the current year. For example, insurance premium of ₹ 2,400 was paid on April 1, 2002 for the whole year. The accounting period ends on 31st December, 2002 but insurance premium has been paid upto 31st March, 2003. The period between Jan. 1 to March 31, 2003 belongs to the next year. It means that insurance premium paid for the 3 months of the next year is prepaid, *i.e.,* 1/4th of ₹ 2,400 or ₹ 600 has been paid for the year 2003. We will have to pass an adjusting entry for prepaid insurance as under :

Treatment in Final Accounts

(*i*) *If prepaid expenses appear in adjustments.* Prepaid insurance show a debit balance, so it will be shown at the assets side of Balance sheet. The amount of prepaid insurance 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 expenses relating to the current year have expired (benefit from the expenditure has been availed of). The part of expenditure relating to next year is still unexpired, *i.e.,* the benefit of the expenditure is to be availed of. Let us take an example. Rent for the whole year amounting to ₹ 12,000 has been paid on 1st May, 2004. The rent for eight months (May 1—Dec. 31) relates to the current year 2004, and the rest rent for four months, *i.e.,* (from Jan. 1 to April 30, 2005) are concerned with the next year. ₹ 4,000, the rent for four months is unexpired or the benefits of this rent are to be availed of, so it is an asset. The current year should bear only ₹ 8,000 for rent, so

₹ 4,000 will be deducted from the rent, *i.e.*, ₹ 12,000 at the debit side of profit and loss account. It will be shown in the profit and loss account and Balance sheet as under :

Profit and Loss Account **Balance Sheet**

Dr.		*Cr.*	*Liabilities*	*Assets*	
To Rent A/c	12,000			Prepaid Rent A/c	4,000
Less : Prepaid Rent	4,000			Prepaid Insurance	600
		8,000			
To Insurance	2,400				
Less : Prepaid Insurance	600				
		1,800			

(*ii*) *If prepaid expenses appear in Trial balance.* Sometimes items like unexpired rent or prepaid insurance may be given in the Trial balance. In such case, unexpired rent 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 due but not paid. For example, the firm advanced a loan of ₹ 20,000 at 12% interest on January 1, 2004. Interest on this loan for the month of November and December are accrued, *i.e.*, still to be received. In this case ₹ 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 ₹ 700. One quarter's rent (three months', rent) has not been received so far. ₹ 700 × 3 = ₹ 2,100 will be accrued income as rent.

Treatment in 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			

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(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 ₹ 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 :

Profit and Loss Account **Balance Sheet**

as on December 31, 2003

Dr.			*Cr.*	*Liabilities*	*Amount* ₹	*Assets*
	By Rent	36,000		Rent received in advance (Unearned Rent)	15,000	
	Less : Rent received in advance	15,000				
			21,000			
			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 ₹ 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 ₹ 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.

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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	

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, 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 6. *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 ₹ 350.

(ii) Create reserve for bad and doubtful debts @ 7%.

The balance of the sundry debtors as per Trial balance is ₹ 50,000 in both the cases.

Solution. (*a*) Provision for bad and doubtful debts = $50,000 \times \frac{7}{100}$ = **₹ 3,500.**

(*b*) ₹ 350 have proved to be bad debts, so the amount due from debtors will reduce by ₹ 350 and it is actually 50,000 – 350 = ₹ 49,650. Now, the provision will be made on ₹ 49, 650 not on ₹ 50,000.

Provision for bad and doubtful debts = $\frac{49,650 \times 7}{100}$ = ₹ 3,475.50.

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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.

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.

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Illustration 7. **The following balances were extracted from the books of Shri Brijesh Chandra on 30th June, 2003**

	₹		₹
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 ₹ 23,500.*

(*b*) *Write off a further of ₹ 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 ₹ 750 for outstanding interest on overdraft.*

Solution.

Trading and Profit and Loss Account of Sh. Brijesh Chandra

for the year ended 30th June, 2003

Dr. *Cr.*

Expenses/Losses		*Amount* ₹	*Revenue/Gain*	*Amount* ₹
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			

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	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* ₹	*Assets*		*Amount* ₹
Creditors		2,500	Cash		80
Bills Payable		3,850	Debtors	6,280	
Loan		7,880	*Less* : Written off	160	
Bank overdraft	3,300			6,120	
Add : Interest Outstanding	750		*Less* : Provision for B/D	306	
		4,050			5,814
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 ₹ 6,120, *i.e.*, 6,280 – 160.

Illustration 8. **The following is the trial balance of Mr. S. Kapur on 31st March, 2003.**

Name of Accounts	*Debit* ₹	*Credit* ₹
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*
₹	*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 ₹ 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 ₹ 3,000 were unpaid.*

(*d*) *Insurance includes a premium of ₹ 170 for the next year.*

(*e*) *Wages include a sum of ₹ 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.*

Solution.

Trading and Profit and Loss Account of Mr. S. Kapur

for the year ended 31st March, 2003

Dr. *Cr.*

Expenses/Losses		*Amount* ₹	*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			

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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

Balance Sheet of Mr. S. Kapur

as on 31st March, 2003

Liabilities		*Amount* ₹	*Assets*		*Amount* ₹
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.

3.9 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.

Special Features of Trial Balance

Trial balance has the following special features :

1. The trial balance is prepared on a specific date. This 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.

Objectives and Functions of Trial Balance

Trial balance have following objectives and functions :

1. Test of arithmetical accuracy.

2. Summarised information of ledger accounts.

3. Basis for preparing final accounts.

4. Helpful for making adjustments.

3.10 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 :

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Format of Trial Balance

Name of the Accounts	L.F.	Amount	
		Debit ₹	Credit ₹

3.11 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.

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.

Illustration 9. **Pass journal entries with the following information. Also prepare ledger accounts and trial balance :**

2005		₹
Jan. 1	*Pandu started business with cash*	*20,000*
Jan. 3	*He opened a current account in the bank*	*5,000*
Jan. 7	*Purchased goods on credit from Shakuni*	*4,000*
Jan. 10	*Paid to Shakuni in full settlement*	*3,900*
Jan. 13	*Machinery purchased*	*2,000*
Jan. 16	*Goods sold to Bracewel*	*3,000*
Jan. 18	*Amount received from Bracewel*	*1,000*
Jan. 20	*Salaries paid*	*700*
Jan. 23	*Rent received*	*300*

Jan. 28 Goods purchased from Srikant..... 4,000

Jan. 31 Interest on capital @ 10% for the month

Jan. 31 Depreciation on machinery..... 100

Solution.

NOTES

Journal Entries

	Particulars		L.F.	Debit ₹	Credit ₹
1.1.05	Cash A/c	Dr.		20,000	
	To Capital A/c				20,000
	(Being Pandu started business with cash)				
3.1.05	Bank A/c	Dr.		5,000	
	To Cash A/c				5,000
	(Being amount paid into Bank)				
7.1.05	Purchases A/c	Dr.		4,000	
	To Shakuni				4,000
	(Being goods purchased from Shakuni)				
10.1.05	Shakuni	Dr.		4,000	
	To Cash A/c				3,900
	To Discount Received A/c				100
	(Being amount paid to Shakuni who allowed discount)				
15.1.05	Machinery A/c	Dr.		2,000	
	To Cash A/c				2,000
	(Being purchase of machinery)				
16.1.05	Bracewel	Dr.		3,000	
	To Sales A/c				3,000
	(Being sale of goods to Bracewel)				
18.1.05	Cash A/c	Dr.		1,000	
	To Bracewel				1,000
	(Being amount received from Bracewel)				
20.1.05	Salaries A/c	Dr.		700	
	To Cash A/c				700
	(Being payment of salaries)				
23.1.05	Cash A/c	Dr.		300	
	To Rent A/c				300
	(Being rent received)				
28.1.05	Purchases A/c	Dr.		4,000	
	To Srikant A/c				4,000
	(Being goods purchased from Srikant)				
Jan. 31	Interest on Capital A/c	Dr.		167	
	To Capital A/c				167
	(Being Interest on Capital allowed)				
Jan. 31	Depreciation A/c	Dr.		100	
	To Machinery				100
	(Being depreciation on machinery)				

NOTES

Ledger Accounts

Cash Account

Dr. Cr.

Date	Particulars	₹	Date	Particulars	₹
1.1.05	To Capital A/c	20,000	3.1.05	By Bank A/c	5,000
18.1.05	To Bracewel	1,000	10.1.05	By Shakuni	3,900
23.1.05	To Rent A/c	300	13.1.05	By Machinery A/c	2,000
			20.1.05	By Salaries A/c	700
			31.1.05	By Balance c/d	9,700
		21,300			21,300
Feb. 1	To Balance b/d	9,700			

Bank A/c

Dr. Cr.

3.1.05	To Cash A/c	5,000	31.1.05	By Balance c/d	5,000
		5,000			5,000
1.2.05	To Balance b/d	5,000			

Purchase A/c

Dr. Cr.

7.1.05	To Shakuni	4,000	31.1.05	By Trading A/c	8,000
28.1.05	To Srikant	4,000			
		8,000			8,000

Shakuni's A/c

Dr. Cr.

10.1.05	To Cash A/c	3,900	7.1.05	By Purchase A/c	4,000
	To Discount A/c	100			
		4,000			4,000

Discount Received A/c

Dr. Cr.

31.1.05	To P/L A/c	100	10.1.05	By Shakuni	100
		100			100

Capital A/c

Dr. Cr.

31.1.05	To Balance c/d	20,167	1.1.05	By Cash A/c	20,000
			31.1.05	By Interest on Capital A/c	167
		20,167			20,167
			1.2.05	By Balance b/d	20,167

NOTES

Machinery A/c

Dr.					Cr.
13.1.05	To Cash A/c	2,000	31.1.05	By Depreciation A/c	100
				By Balance c/d	1,900
		2,000			2,000

Bracewel's A/c

Dr.					Cr.
16.1.05	To Sales A/c	3,000	18.1.05	By Cash A/c	1,000
			31.1.05	By Balance c/d	2,000
		3,000			3,000
1.2.05	To Balance b/d	2,000			

Salaries A/c

Dr.					Cr.
20.1.05	To Cash A/c	700	31.1.05	By P/L A/c (Transfer)	700
		700			700

Sales A/c

Dr.					Cr.
31.1.05	To Trading A/c (Transfer)	3,000	16.1.05	By Bracewel	3,000
		3,000			3,000

Rent A/c

Dr.					Cr.
31.1.05	To P/L A/c (Transfer)	300	23.1.05	By Cash A/c	300
		300			300

Srikant's A/c

Dr.					Cr.
31.1.05	To Balance c/d	4,000	28.1.05	By Purchase A/c	4,000
		4,000			4,000
			1.2.05	To Balance b/d	4,000

Interest on Capital A/c

Dr.					Cr.
31.1.05	To Capital A/c	167	31.1.05	By P/L A/c (Transfer)	167
		167			167

Depreciation A/c

Dr.					Cr.
31.1.05	To Machinery A/c	100	31.1.05	By P/L A/c (Transfer)	100
		100			100

NOTES

1. *Balance Method*

Trial Balance

as on January 31, 2005

Name of the Accounts	*L.F.*	*Amount*	
		Debit ₹	*Credit ₹*
Cash A/c		9,700	—
Capital A/c		—	20,167
Bank A/c		5,000	—
Purchases A/c		8,000	—
Discount A/c		—	100
Machinery A/c		1,900	—
Bracewel's A/c		2,000	—
Salaries A/c		700	—
Sales A/c		—	3,000
Rent A/c		—	300
Depreciation A/c		100	—
Srikant's A/c		—	4,000
Interest on Capital A/c		167	—
		27,567	27,567

2. *Total Method*

Trial Balance

as on January 31, 2005

Name of the Accounts	*L.F.*	*Amount*	
		Debit ₹	*Credit ₹*
Cash A/c		21,300	11,600
Capital A/c		—	20,167
Bank A/c		5,000	—
Purchases A/c		8,000	—
Shakuni's A/c		4,000	4,000
Discount A/c		—	100
Machinery A/c		2,000	100
Bracewel's A/c		3,000	1,000
Salaries A/c		700	—
Sales A/c		—	3,000
Rent A/c		—	300
Depreciation A/c		100	—
Srikant's A/c		—	4,000
Interest on Capital A/c		167	—
		44,267	44,267

NOTES

3. *Total and Balance Method*

Trial Balance

as on January 31, 2005

Name of the Accounts	*L.F.*	*Total Method*		*Balance Method*	
		Debit ₹	*Credit* ₹	*Debit* ₹	*Credit* ₹
Cash A/c		21,300	11,600	9,700	—
Capital A/c		—	20,167	—	20,167
Bank A/c		5,000	—	5,000	—
Purchases A/c		8,000	—	8,000	—
Shakuni's A/c		4,000	4,000	—	—
Discount A/c		—	100	—	100
Machinery A/c		2,000	100	1,900	—
Bracewel's A/c		3,000	1,000	2,000	—
Salaries A/c		700	—	700	—
Sales A/c		—	3,000	—	3,000
Rent A/c		—	300	—	300
Depreciation A/c		100	—	100	—
Srikant's A/c		—	4,000	—	4,000
Interest on Capital A/c		167	—	167	—
		44,267	44,267	27,567	27,567

STUDENT ACTIVITY

1. Give any two differences between Profit and Loss A/c and a Balance Sheet.

2. Where will you show unread income in the financial statements, if it appear in the Trial Balance ?

NOTES

SUMMARY

- In order to ascertain its income and also to assess the position of assets and liabilities statements prepared are known as Financial Statements. These statements are also known with their traditional name as Final Accounts.
- 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.
- 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.
- Net profit is calculated by deducting non-operating expense from operating Profit and adding non-operating income. Hence, net profit takes into account both operating and non-operating expense and incomes.
- 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.
- **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.
- **Gross Profit.** The access of revenue generated over cost of manufacture or purchase of a product is known as gross profit, whenever revenue falls short it is termed, as gross loss.
- **Profit and Loss Account.** 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.
- **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.

NOTES

- ***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.

- Trial balance is a statement, prepared with the debit and credit balances of ledger accounts to test the arithmetical accuracy of the books.

GLOSSARY

- **Gross Profit :** Excess of sales and closing stock over opening stock, purchases and direct expenses is known as the gorss profit.

  Gross profit = Net sales – Cost of goods sold.

- **Depreciation :** Loss in the value of assets due to its constant use is termed as depreciation.
- **Capital :** It is the liability of the business. The business assumes capital as amount as borrowed from the proprietors of the firm.

REVIEW QUESTIONS

1. Mention the account and side where the following items will be treated.

   (*a*) Carriage, (*b*) Carriage on Purchases, (*c*) Carriage on Sales, (*d*) Wages and Salaries, (*e*) Salaries and Wages, (*f*) Investments, (*g*) Discount on Creditors.
2. How will you show the following items ?

   (*i*) Drawing ; (*ii*) Returns inward (Bills returned) ; (*iii*) Returns outward.
3. Mention the stages of Final Accounts.
4. How will you treat expenses on acquiring goods ?
5. Where will you show goods in transit A/c ?
6. Mention two points of difference between Trial balance and balance sheet.
7. Differentiate between Gross Profit and Net Profit.
8. What is difference between Trade Discount and Cash Discount ?
9. Explain briefly the two characteristics of position statement.
10. Explain capital expenditure through suitable example.
11. Differentiate between Capital receipts and Revenue receipts.
12. What do you mean by Final accounts ? What are its constituents ? Name them and briefly explain the purpose of each of them.
13. Explain the importance and purpose of final accounts.
14. What are the limitations of financial statements ? Discuss briefly.
15. 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.
16. What adjusting entry will be passed for the prepaid rent ?
17. What journal entry will you pass for the recovery of bad debts previously written off ?
18. Point out any three points of difference between Profit and Loss Account and Balance Sheet.
19. Explain the importance and purpose of final accounts.

NOTES

20. Explain : (*a*) Current assets ; (*b*) Current liabilities : and (*c*) Working capital.
21. Explain compensating error with a suitable example.
22. State the meaning of Trial Balance.
23. What is the purpose of preparing Trial Balance ?
24. What is a trial balance ? What are the different columns of a trial balance ? Explain the different methods of preparing trial balance.
25. Bring out clearly the purpose and limitations of trial balance.
26. How will you locate errors in the trial balance ? What methods will you adopt ? Explain the procedures to be adopted with suitable illustration.
27. Discuss errors which remain undetected inspite of the agreement of the debit and credit columns of trial balance.
28. Discuss those errors which the trial balance will be able to locate. Give at least three illustrations to support your answer.

PRACTICAL QUESTIONS

1. *Prepare a Trading account from the following information :*

Name of Account	*Debit* ₹	*Credit* ₹
Opening Stock	28,000	
Purchases and Sales	42,000	58,000
Return Inward and Outward	2,000	3,000
Import duty	7,000	
Export duty	2,000	
Stores consumed	5,000	

Closing stock was valued at Rs. 8,000 [**Ans.** Gross loss = ₹ 15,000]

Final Accounts

2. The Trial balance of Bihari Lal on 31st March, 2003 revealed the following balances :

	₹		₹
Debit Balances :		*Debit Balances (Contd.) :*	
Plant and Machinery	90,000	Freight Outward	1,200
Purchases	58,000	Rent, Rates and Taxes	2,000
Sales Returns	1,000	Advertisement	2,000
Opening Stock	40,000	Cash at Bank	6,900
Discount Allowed	350	*Credit Balances :*	
Bank Charges	75	Capital Account	1,10,000
Sundry Debtors	45,000	Sales	1,27,000
Salaries	6,800	Purchases Return	1,275
Wages	10,000	Discount Received	800
Freight Inward	750	Sundry Creditors	25,000

The stock on 31st March, 2003 was valued at ₹ 13,262. *Prepare Trading and profit and loss account for the year ended 31st March, 2003 and Balance sheet as on that date.*

[**Ans.** Gross profit = ₹ 31,787 ; Net profit = ₹ 20,162 ;
Total of Balance Sheet = ₹ 1,55,162]

NOTES

3. Transactions during the month were :

2006		₹
May 2	Sold goods to Govind Cash Rs. 10,000 and credit	2,000
May 3	Sold to Sharma	11,000
May 5	Bought of Ram Lal	1,200
May 8	Sold to Zahir	500
May 15	Received from Govind	1,500
May 18	Received from Sharma	2,000
	Allowed him discount	50
May 20	Accepted Ram Lal's draft at three months	1,500
May 21	Sold goods to Sharma	800
May 22	Paid rent	150
May 24	Sold to Zahir	1,000
May 30	Paid salaries in cash	300

Post the above direct to the ledger and take out a trial balance.

[**Ans.** Total of Trial Balance ₹ 26,800]

4. Following balances of ledger accounts have been obtained, from which *you are required to prepare a trial balance :*

Cash ₹ 41,733 ; Expenses ₹ 12,150 ; Sales ₹ 1,46,616 ; Fixed Assets ₹ 12,000 ; Purchases ₹ 1,10,850 ; Accounts Receivables ₹ 24,436 ; Bills Payables ₹ 50,000 ; Creditors ₹ 8,553 ; Merchandise ₹ 4.000. [**Ans.** Total of Trial Balance ₹ 2,05,169]

FURTHER READINGS

- '*Cost and Financial Management*' by Dr. Mohd Aarif, University Science Press.
- '*Working Capital Management*' by M.K. Rastogi, University Science Press.

UNIT-IV CAPITAL BUDGETING AND WORKING CAPITAL MANAGEMENT

NOTES

STRUCTURE

4.0 LEARNING OBJECTIVES

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

- explain an overall view of working capital management.
- describe capital budgeting with its principles and techniques.

4.1 WORKING CAPITAL : AN INTRODUCTION

The first and foremost objective of the financial management is to maximise the wealth of shareholders. It is possible only when the company earns sufficient profit. The profitability of the organisation fully depends upon the magnitude of sales. However, sales are not converted into cash immediately. Because there is a time gap between the sale of goods and receipt of cash. During the time gap a certain amount is required to sustain the sales volume on a regular basis. That amount is known as working capital. Suppose adequate working capital is not available, the company will not be in a position to maintain the sales volume at an expected level.

Simply, working capital means circulating capital or revolving capital. In other words, working capital means amount required for the day-to-day expenses of the business activities.

According to **J.S.Mill,** the sum of current assets is the working capital of a business.

NOTES

"Working capital is the amount of funds necessary to cover the cost of operating the enterprise" says **Shubin.**

Gesterrberg defines, Working capital is the excess of current assets over current liabilities.

Simply, Net Working Capital = Current Assets - Current Liabilities.

Concepts of Working Capital

(*i*) Gross Working Capital (*ii*) Net Working Capital

(*i*) ***Gross Working Capital***

The Gross working capital refers to working capital which represents investment in current assets such as marketable securities, inventories and bills receivables.

(*ii*) ***Net Working Capital***

Net working capital refers to working capital. It is the excess of current assets over current Liabilities. This is the most commonly accepted definition.

Types of Working Capital

Working capital can be divided into two categories on the basis of time.

(*i*) Permanent working capital or core current assets

(*ii*) Temporary or variable working capital

(*i*) ***Permanent Working Capital***

Permanent working capital refers to that minimum amount of investment in all current assets which is required to carry out minimum level of business activities on a permanent basis. In other words, certain current assets which are retained by the organisation on a continuous basis is called permanent working capital or core current assets.

(*ii*) ***Temporary or Variable Working Capital***

Temporary working capital is an investment in current assets which are fluctuating from time to time on the basis of the operations of the business. The capital, required to meet the seasonal needs of a firm, is called seasonal working capital or temporary working capital. In other words, the amount of working capital which will vary from time to time depending upon the level of business activities, is known as variable working capital.

4.2 OPERATING CYCLE

Modern business enterprises face severe competitions. They produce goods based upon the demand. In this respect, all manufactured goods are not sold immediately. And at the same time, cash for sales is also not realised immediately. From the purchase of raw material to the conversion of cash, certain time gap is taken. This time gap is technically known as operating cycle of the business.

Stages of Operating Cycle

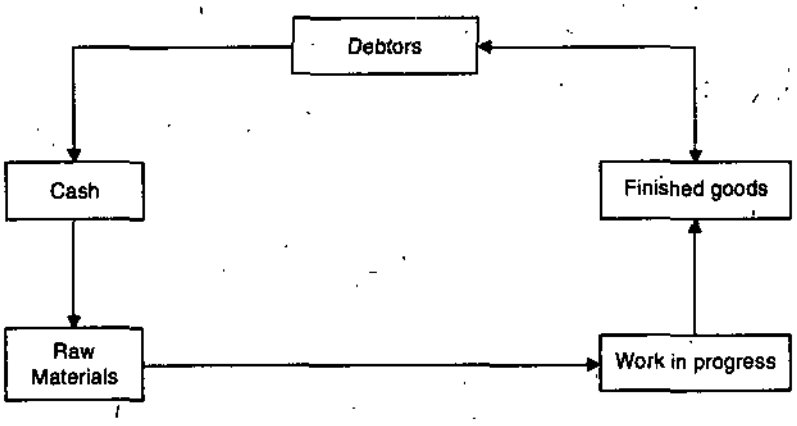
(*i*) Conversion of cash into raw materials

(*ii*) Conversion of raw materials into work in progress

(*iii*) Conversion of work in progress into finished goods

(*iv*) Conversion of finished goods into debtors

(*v*) Conversion of debtors into cash



Advantages or Importance of Working Capital

(*i*) Adequate working capital ensures the regular supply of raw materials and continued production.

(*ii*) Easy to get the loan from the banks and other financial institutions on easy and convenient terms

(*iii*) It enables the firm to avail cash discount facilities on the purchases, thus it reduces the costs.

(*iv*) To follow as a prompt payment policy helps in establishment of goodwill.

(*v*) It helps the organisation to meet the financial crisis during the periods of depression or any emergencies.

(*vi*) The expansion programme of a concern is highly successful and obtains higher profitability.

(*vii*) It improves high morale among employees and executives in the organisation.

(*viii*) To encourage research programme

(*ix*) To obtain the higher level of productivity due to effective utilisation of assets

(*x*) Enables to pay higher return to its owner. So automatically the firm possesses a financial soundness. In this way it helps to generate additional funds in future.

Disadvantages or Danger of Inadequate Working Capital

(*i*) A concern cannot pay its short term liabilities because of inadequate working capital. This leads to borrowing funds at higher rates of interest.

(*ii*) It may not take advantage of cash discount because the concern may find it difficult to buy its requirement in bulk quantities.

(*iii*) Low level liquidity position of the concern may lead to winding up of the firm.

(*iv*) Fixed assets could not be fully utilised on account of lack in sufficient working capital. So the rate of return on investment falls.

(*v*) It is very difficult to obtain favourable market conditions and any of the profitable business opportunities.

(*vi*) Credit worthiness and reputation of the organisation may be damaged.

(*vii*) It leads to under-utilisation of production facilities.

Disadvantages of Excessive Working Capital

(*i*) Unnecessary purchases and accumulation of inventories lead to chances of more losses and waste.

(*ii*) Due to huge amount of idle funds the rate of return on its investment automatically goes down.

(*iii*) It leads to overtrade and chances of heavy losses.

(*iv*) Difficult to maintain the cordial relationship with the bank and other financial institutions.

(*v*) Large amount of bad debts arise.

(*vi*) It encourages mass production which may not have matching demand.

Determinants of Working Capital : (or) Factors Determining Working Capital

(*i*) Nature of Business

(*ii*) Production Policies

(*iii*) Length of the Manufacturing Cycle

(*iv*) Terms of Purchases and Sales

(*v*) Seasonal Variation

(*vi*) Fluctuations in Supply

(*vii*) Dividend Policy

(*viii*) Requirements of Cash.

(*ix*) Other Factors.

(*i*) *Nature of Business.* Working capital of the organisation basically depends upon the nature of business. Public utility concerns like Railways, Electricity etc would need only very little amount of working capital. On the other hand, manufacturing and trading concerns need huge amount of working capital in their operations.

(*ii*) *Production Policies.* Production policy of the organisation is also an important factor for determining working capital. In case of labour intensive industry the quantum of working capital is required only in smaller amount. But highly automatic plants require huge amount of working capital.

(*iii*) *Length of the Manufacturing Cycle.* The amount of working capital needed is highly influenced by the length of manufacturing cycle. If the manufacturing process is long, huge amount of working capital will be required and vice versa. So utmost care should be taken to shorten the period of cycle in order to minimise the working capital requirements.

(*iv*) *Terms of Purchase and Sales.* If an organisation provides liberal credit facilities to its customers, large amount of working capital gets locked up in sundry debtors and bills receivable. And at the same time if continuous credit is allowed by the suppliers, it tends to cause not only postponement of payment but also payment out of sale proceeds of the goods produced. The period of credit allowed and received also determines the working capital requirements of the company.

(*v*) *Seasonal Variations.* Seasonal changes in the economy also affect the quantum of working capital. Huge amount of working capital is required during the periods of inflation and depression and the requirement declines during the other periods of economic cycle.

(*vi*) *Fluctuations in Supply.* Certain industries purchase raw material at huge level due to their irregular supply throughout the year. It is specifically applicable to the manufacturing organisation which requires an unusual type of raw material that can be purchased only with limited sources.

(*vii*) *Dividend Policy.* According to the new provisions of the SEBI, all the companies are compulsorily to declare the dividend to the shareholders. So the dividend policy has a dominant influence on the working capital position of the organisation. As per the new provisions, need for the working capital is met with retained earnings. Once dividend is declared and the same has to be paid in cash requires large amounts from the pool of working capital.

(*viii*) *Requirements of Cash.* Need for the working capital depends upon the amount of cash required by the company for its various purposes. If greater the requirements of cash, the higher will be the working capital needs of the company and vice versa.

(*ix*) *Other Factors.* Apart from the above points, some other factors also affect the working capital requirements. For example, lack of transport and communication facilities, tariff policies of government etc. also influence the requirements of working capital.

4.3 SOURCES OF WORKING CAPITAL

An efficient finance manager is always interested in maintaining the correct amount of working capital at the right time, at a reasonable cost and at the best possible favourable terms. The following are the important sources of working capital.

To obtain the working capital in the following two major divisions.

1. Long term sources
2. Short term sources

Long-term Sources

(*i*) Share capital
(*ii*) Sale of debentures
(*iii*) Ploughing back of profits
(*iv*) Sale of fixed assets
(*v*) Term loans.

Short-term Sources

I. ***Internal Sources :***

(*i*) *Depreciation funds*
(*ii*) *Provision for taxation*
(*iii*) *Accrued expenses.*

II. ***External Sources :***

(*i*) *Trade credit*
(*ii*) *Bank credit*
(*iii*) *Credit papers*
(*iv*) *Public deposits*
(*v*) *Government's assistance*
(*vi*) *Loans from directors etc.*
(*vii*) *Factoring.*

NOTES

4.4 FORECASTING TECHNIQUES OF WORKING CAPITAL

There are so many popular methods for forecasting the working capital requirements which are as follows.

(*i*) Cash Forecasting Method
(*ii*) Balance Sheet Method
(*iii*) Profit and Loss Adjustment Method
(*iv*) Percentage of Sales Method
(*v*) Operational Cycle Method
(*vi*) Regression Analysis Method.

(*i*) *Cash Forecasting Method.* Under this method, the working capital is to be determined on the basis of the closing balance of the cash, after considering the receipts and payments made during that period.

(*ii*) *Balance Sheet Method.* According to this method, a forecast is made of the various assets and liabilities of the concern. The difference between two is taken which will indicate either cash surplus or cash deficiency.

(*iii*) *Profit and Loss Adjustment Method.* Under this method, the forecasted Profits or Losses are to be adjusted on cash basis.

(*iv*) *Percentage of Sales Method.* Under this method, working capital is determined as a percentage of forecasted sales. It must be decided on the basis of past observations. This method is simple and easy to understand.

(*v*) *Operational Cycle Method.* Under this method, working capital is determined according to the operating cycle concept. In a manufacturing organisation the working capital cycle starts from the purchase of raw material and ends with the conversion of cash. It involves purchase of raw materials, work in progress, finished goods, sales, debtors and conversion of cash. This cycle will continue again and again. Each of the cycle stage is expressed in terms of number of days of relevant activity and requires a level of investment. The amount required for these stage- wise investments will be the total amount of the working capital of the organisation.

Following formula is used to express the framework of the operating cycle :

$$T = (r - c) + w + f + b$$

T = Stands for the total period of operating cycle in number of days.
r = Stands for the number of days of raw material and stores consumption requirements held in raw materials and stores
c = Number of days of credit allowed by creditors
W = Stands for the number of days of cost of production held in work in progress.
f = Finished stock storage period

or

T = Duration of operating cycle in number of days
r = Raw materials and storage period
c = Creditors payment period
w = Work in process period
f = Finished stock storage period
b = Debtors collection period

NOTES

(vi) *Regression Analysis Method.* According to this method, statistical formula is used to determine the working capital requirement. Projection of working capital is made after establishing the average relationship in the past years between sales and working capital *i.e.,* current assets.

Procedure for Computation of Working Capital

Current Assets		
Raw Material	xx	
Work in Progress	xx	
Finished Goods	xx	
Debtors	xx	
Cash	xx	
Total Current Assets		xx
Less : Current Liabilities		
Creditors	xx	
Wages	xx	
Any Other Expenses	xx	
Total Current Liabilities [TCA - TCL]		xx
Working Capital		xx
Add : Contingencies		xx
Amount of Working Capital required		xx

Workings:

(*i*) First of all uniformly we have to find out the number of units. It is the basis for computation of cost of all the elements.

(*ii*) Computation of finished goods

Raw Material Cost	xx
Labour Cost	xx
Overhead Cost	xx
Finished Goods	xx

(*iii*) Work in progress and finished goods value will be the same. But the production occurring evenly throughout the year given in the problem means we have to find out the work-in-progress value separately.

i.e.,	Raw Material Cost	xx
	Labour Cost (It is reduced to half)	xx
	Overhead Cost	xx
	Work in Progress	xx

Value of Debtors should be calculated either including profit element or excluding profit element.

Illustration 1. *From the following information, prepare a statement in column form showing the working capital requirements. (i) In total and (ii) As regards each constituent part of working capital.*

Budgeted sales (₹ 10 per unit) ₹ 2,60,000 p.a.

NOTES

Analysis of Costs	₹
Raw Materials	*3.00*
Direct Labour	*4.00*
Overheads	*2.00*
Total Cost	*9.00*
Profit	*1.00*
Sales	*10.00*

It is estimated that

(i) Raw materials are carried in stock for three weeks and finished goods for two weeks.

(ii) Factory processing will take three weeks.

(iii) Suppliers will give full five weeks credit.

(iv) Customers will require eight weeks credit.

It may be assumed that production and overheads accrue evenly throughout the year.

Solution : Statement of Working Capital Requirement

Current Assets		₹
Raw Materials 78,000 × 3/52	=	4,500
Work in Progress (Note)	=	9,000
Finished Goods 2,34,000 × 2/52	=	9,000
Debtors 2,60,000 × 8/52	=	40,000
		62,500
Less : Current Liabilities		
Trade Creditors (5 weeks) 5/52 × 78,000	=	7,500
Working Capital Required		55,000

Working Notes :

(*i*) Number of Units		=	26,000
(*ii*) Finished Goods			
Raw Materials	26,000 × 3	=	78,000
Direct Labour	26,000 × 4	=	1,04,000
Overheads	26,000 × 2	=	52,000
Finished Goods			2,34,000
(*iii*) Work in Progress			
Raw Material	78,000 × 3/52	=	4,500
Labour	1,04,000 × 3/52 × 1/2	=	3,000
Overhead	52,000 × 3/52 × 1/2	=	1,500
Work in Progress			9,000

Note : (*i*) Normally finished goods and work in progress are taken as same value. Suppose wages and overheads accrue evenly throughout the year given in the problem, we have to find out the work in progress value separately. At that time of computing work in progress labour, overhead value is reduced to half.

(*ii*) At the time of calculating working capital, debtor value will be taken as either including profit element or excluding profit element.

Illustration 2. *Prepare a working capital forecast from the following information :*

	₹
Issued share capital	*4,00,000*
12% Debentures	*1,50,000*

The fixed assets are valued at ₹ 3.00 lakhs. Production during the previous year is 1.00 lakh units. The same level of activity is intended to be maintained during the current year.

The expected ratios of cost to selling price are

Raw materials	*50%*
Direct Wages	*10%*
Overheads	*25%*

The raw materials ordinarily remain in stores for 2 months before production. Every unit of production remains in process for 2 months. Finished goods remain in the warehouse for 4 months. Credit allowed by creditors is 3 months from the date of delivery of raw materials and credit given to debtors is 3 months from the date of despatch.

Selling price is ₹ 6 per unit. Both the production and sales are in a regular cycle.

Solution : **Working Capital Statement**

	₹
Raw Materials	50,000
Work in Progress	67,500
Finished Goods	1,70,000
Debtors	1,27,500
	4,15,000
Less : Creditors	75,000
Working capital required	3,40,000

Working Notes :

Number of units = 1,00,000

Sales Value = 1,00,000 × 6 = 6,00,000

$$\text{Material} = 6{,}00{,}000 \times \frac{50}{100} = 3{,}00{,}000$$

$$\text{Labour} = 6{,}00{,}000 \times \frac{10}{100} = 60{,}000$$

$$\text{Overheads} = 6{,}00{,}000 \times \frac{25}{100} = 1{,}50{,}000$$

NOTES

(*i*) Finished Goods

Raw Materials	=	3,00,000
Direct Labour	=	60,000
Overheads	=	1,50,000
		5,10,000
i.e., 5,10,000 × 4/12	=	1,70,000

(*ii*) Work in Progress

Raw Materials = $3,00,000 \times \frac{2}{12}$	=	50,000
Direct Labour = $60,000 \times \frac{2}{12} \times \frac{1}{2}$	=	5,000
Overheads = $1,50,000 \times \frac{2}{12} \times \frac{1}{2}$	=	12,500
		67,500
(*iii*) Debtors = 5,10,000 × 3/12	=	1,27,500
(*iv*) Creditors = 3,00,000 × 3/12	=	75,000

4.5 CONCEPT OF CAPITAL EXPENDITURE

Capital expenditure is one which is intended for future periods and generally includes investment in fixed assets and other developmental projects. In other words, capital expenditure is that which has to be incurred for the purpose of obtaining benefit not only for the current year but also for the specific future periods.

4.6 CAPITAL BUDGETING—MEANING

Capital budgeting refers to long term planning for the proposed capital outlay and their financing. In other words, it is the process of making investment decisions regarding the capital expenditures. Capital budgeting is also known as investment decision making, capital expenditure decision, planning capital expenditure, etc.

Charles T Horngreen has defined capital budgeting as "Capital budgeting is long term planning for making and financing proposed capital outlays".

According to **Lynch** "Capital budgeting consists in planning development of available capital for the purpose of maximising the long term profitability of the concern."

Need and Importance of Capital Budgeting

(*i*) Capital budgeting decision normally involves huge capital. If wrong decision is taken by the firm, it may affect the survival of the firm. So, it is very important for the firm to plan and control capital expenditure.

(*ii*) Funds involved in capital expenditure are not only huge but more or less permanently blocked in the organisation. In this respect, it involves longer time and greater risk. So careful planning is essential.

(*iii*) Long term effect on profitability

(*iv*) National importance—generation of employment, economic activities and economic growth.

(*v*) Complications of investment decisions

Advantages of Capital Budgeting

(*i*) It is very useful to the concern for taking correct decision.

(*ii*) To determine the required quantum and the right source of funds for investment.

(*iii*) It influences the firm's growth in the future periods.

(*iv*) It informs about the right timings for the purchase of fixed assets.

(*v*) It guides the management for the effective utilisation of investment.

(*vi*) It minimises the risk of over-investment or under-investment of fund in fixed assets.

(*vii*) It acts as a tool for controlling capital expenditure.

(*viii*) It contributes a sound policy for depreciation and replacement of fixed assets.

Limitations of Capital Budgeting

(*i*) There may be controversial results among the application of various techniques.

(*ii*) There may be substantial loss in an investment of fund in the capital assets which are irreversible or reversible.

(*iii*) The application of capital budgeting techniques is normally a difficult task.

(*iv*) None of the various methods for evaluating profitability of the fixed assets or projects is free from drawbacks.

4.7 METHODS OF CAPITAL INVESTMENT PROPOSALS

Investment decisions of organisation may be classified in the following way :

(*i*) Independent investment proposals

(*ii*) Mutually exclusive proposals

(*iii*) Contingent or dependant proposals

(*iv*) Replacement and modernization schemes

(*v*) Cost reduction projects

The above said investment proposals are mostly profit-oriented and therefore they may be evaluated based on their cost and benefits.

Even though the investments are made wisely, the return would be difficult to measure on the following projects.

(*i*) Educational projects

(*ii*) Service projects

(*iii*) Research and Development

(*iv*) Welfare projects.

NOTES

4.8 RELEVANT COST FOR CAPITAL BUDGETING DECISIONS

Normally costs and benefits, in the form of cash inflows, are associated with the capital budgeting. The following costs are generally essential for different types of investment decisions.

(*i*) Future costs
(*ii*) Opportunity costs
(*iii*) Interest cost
(*iv*) Incremental or differential cost
(*v*) Depreciation and income tax.

4.9 CAPITAL BUDGETING PROCESS

The following steps are involved in capital budgeting process.

(*i*) The capital budgeting process starts with identification of suitable investment proposals and also estimates the total cash outlay.

(*ii*) To establish capital expenditure planning committee for the purpose of screening the various proposals received from various departments.

(*iii*) Evaluation of the different investment proposals on the basis of costs and expected returns.

(*iv*) To rank the various proposals and to establish the priorities after considering their risk and profitability.

(*v*) The proposals recommended by the budget committee are sent to the top management along with a detailed report for final approval.

(*vi*) Execution of the selected proposals with sufficient allocation of funds

(*vii*) Final stage of the capital budgeting process is an evaluation of the performance of the project after it has been fully implemented.

4.10 CAPITAL BUDGETING EVALUATION TECHNIQUES

An organisation may face a situation where various investment proposals are identified but it has to select one or some of the proposals either for shortage of funds or for some other reason. A number of project evaluation techniques are available. The most important and normally used methods are.

1. *Traditional Methods :*
   (*i*) Pay-back period or pay-out or pay off method
   (*ii*) Post pay back profitability methods
   (*iii*) Accounting rate of return method.
2. *Time Adjusted Methods or Accounting Methods :*
   (*i*) Net present value method
   (*ii*) Internal rate of return method
   (*iii*) Profitability index or cost benefit ratio method
   (*iv*) Discounted pay back method.

Traditional Methods

(i) *Pay-back Period Method*

It is a traditional method for evaluating the profitability of investment proposals. Pay back period is the period in which the project will generate necessary cash to recover original investment of the project. Normally, shorter pay back period of the project should be recommended.

Procedure for the calculation of pay back period :

(*a*) *In the case of even cash inflows*

$$\text{Pay back period} = \frac{\text{Orignal Cost}}{\text{Annual Cash inflow}}$$

Annual cash inflow = Net savings or net profit + Depreciations

Note :	Suppose cash inflow is given in the problem, then there is no need to find out cash inflow. If cash inflows are not given in the problem, we have to find out cash inflow.

(*b*) *In the case of uneven cash inflows*

If cash inflows are not uniform, the calculation of pay back period takes a cumulative way *i.e.*, arriving at net cash inflow until the total is equal to original cost of the project.

(ii) *Post Pay Back Profitability Method*

Calculation :

Total cash inflow from the Proposal during its economic life	x x
Less : original cost	x x
Post pay back profitability	x x

(iii) *Accounting Rate of Return Method [Accounting Method]*

This method is otherwise known as accounting rate return method or return on investment or average rate of return method. It can be expressed in the following ways.

(*i*) Average rate of return $= \dfrac{\text{Average annual profit}}{\text{Original investment}}$

(*ii*) Return Per unit of investment method

$$\text{Return per unit of investment} = \frac{\text{Total Profit}}{\text{Net investment}} \times 100$$

(*iii*) Rate of Return on average investment method

$$\text{Return on average investment} = \frac{\text{Profit after depreciation tax}}{\text{Average investment}}$$

$$\text{Average investment} = \frac{\text{Original investment}}{2}$$

(*iv*) Average return on average investment method

$$\text{Average return on average investment} = \frac{\text{Average annual profit}}{\text{Average investment}} \times 100$$

NOTES

(v) Rate of return on original investment method

$$\text{Return on original investment} = \frac{\text{Profit}}{\text{Original investment}}$$

Time Adjusted Method or Accounting Methods

(i) *Net Present Value Method*

This method is otherwise known as excess present value or net gain method or time adjusted method.

Sum of Discounted cash inflows	xx
Less : original cost	xx
Net present value	xx

If the present value of cash inflows is more than (or equal to) the present value of cash outflows, the project would be accepted. If it is less, the project will be rejected.

(ii) *Internal Rate of Return Method*

The internal rate of return for an investment proposal is the discount rate that equates the present value of initial cost of the investment with the present value of the expected net cash flows. In other words, it is the rate which discounts the cash flows to zero. Normally, the internal rate of return is found by trial and error method. It can be stated in the following way.

$$\frac{\text{Cash inflows}}{\text{Cash outflows}} = 1$$

Procedure for Calculation

(a) *Where cash inflows are uniform.* In any project, the cash inflows are uniform. The IRR can be calculated by locating the factor in annuity table. The factor is calculated as follows.

$$F = \frac{I}{C}$$

Where, F = Factor to be located
I = Initial Investment
C = Cash inflow per year

The factor, thus calculated, will be located in table II on the line, representing number of years corresponding to estimated useful life of the asset.

(b) *Where cash inflows are not uniform.* The internal rate of return is calculated by making trial and error method.

Procedure

(i) *First trial rate may be calculated in the following way.*

In order to have an approximate idea about the rate, it will be better to find out the factor to be calculated in the following formula.

$$F = \frac{I}{C}$$

The above factor is treated as first trial rate.

(*ii*) *The second trial rate and third trial rate are determined.*

(*iii*) *After applying the second and third trial rates, we have to apply the following formula for the purpose of arriving at exact IRR.*

$$\text{IRR} = \text{Lower trial rate} + \frac{\text{NPV at lower rate}}{\text{NPV at lower rate} - \text{NPV at higher rate}} \times \text{Difference between higher and lower trial rate}$$

(*iii*) ***Profitability Index Method***

It is a time adjusted method of evaluating profitability of the investment proposals. By calculating the profitability indices for various projects the financial manager can rank the projects according to their profitability.

$$\text{Profitability index} = \frac{\text{Present value of cash inflows}}{\text{Initial cash outlay}}$$

(Or)

$$= \frac{\text{Present value of future cash inflows}}{\text{Present value of future cash outflows}} \times 100$$

Decision Rule

Present value index of the project is equal to or more than 1 or 100% is to be selected.

(*iv*) ***Discounted Pay Back Method***

Under this method, the present values of all cash inflows and outflows are calculated at an appropriate discount factor. The present values of all inflows are cumulated in order of time. The cumulative present value of cash inflows equals the present value of cash outflows. It is known as discounted pay back period.

For example,

Project cost is xxx

Year	Cash inflow	P/V	DCF
1			
2			
3			
4			
5			

Sum of discounted cash flows equals the cash outflow. It is referred as discounted pay back period. Normally, the project which gives a shorter pay back period under the discounted cash flow is accepted.

4.11 CAPITAL RATIONING

Capital rationing situation thus arises when numerous projects may compete for limited resources. It may be defined as "A situation where a constraint is placed on the total size of capital investment during a particular period".

Factors Influencing the Capital Budgeting Decisions

The following factors influence the capital budgeting decisions of the organisation.

(*i*) Amount of investment

(*ii*) Cost of capital projects

NOTES

(iii) Degree of certainty
(iv) Product demand
(v) Future earnings
(vi) Relative importance of the profit
(vii) Opportunity cost
(viii) Cost of production.

4.12 RISK ANALYSIS IN CAPITAL BUDGETING

Some of the important techniques of risk analysis in capital budgeting are :

(a) *General techniques :*

(i) Risk adjusted discount rate
(ii) Certainty equivalent.

(b) *Quantitative techniques :*

(i) Sensitivity analysis
(ii) Probability assignment
(iii) Standard deviation
(iv) Co-efficient of variation
(v) Decision tree.

Illustration 3. *Each of the following projects requires a cash outlay of ₹ 10,000. You are required to suggest which project should be accepted if the standard pay back period is 5 years.*

Year	*Project X* ₹	*Project Y* ₹	*Project Z* ₹
1	*2500*	*4000*	*1000*
2	*2500*	*3000*	*2000*
3	*2500*	*2000*	*3000*
4	*2500*	*1000*	*4000*
5	*2500*	—	—

Solution :

All the three projects recovered their original capital ₹ 10,000 within the period of 4 years. Here project X has constant cash inflow. Project Y initially has higher cash inflows but gradually decreased.

Project Z initially has low cash inflows but it has gradually increased.

As per the constant return point of view, project X is recommended.

Illustration 4. *A Company has to choose one of the following two mutually exclusive projects. Both the projects have to be depreciated on straight line basis. The tax rate is 50%.*

Cash inflows (Profit before Depreciation and tax)

Year	*Project A* ₹	*Project B* ₹
0	*15,000*	*15,000*
1	*4,200*	*4,200*
2	*4,800*	*4,500*
3	*7,000*	*4,000*
4	*8,000*	*5,000*
5	*2,000*	*10,000*

You have to use pay-back period as the criterion.

Solution : **Project—A**

Year	*Profit* ₹	*(-) Depreciation* ₹	*Profit After Depreciation* ₹	*Tax* ₹	*PAT* ₹	*Add Depreciation* ₹	*Cash Inflows* ₹	*Cumulative Cash Inflows* ₹
1	4200	3000	1200	600	600	3000	3600	3600
2	4800	3000	1800	900	900	3000	3900	7500
3	7000	3000	4000	2000	2000	3000	5000	12500
4	8000	3000	4000	2000	2000	3000	5000	17500
5	2000	3000	– 1000	—	1000	3000	2000	19500

[PAT = Profit After Tax]

Pay back period = 3 years and 6 months

Working :

Investment is ₹ 15,000

Upto three years *i.e.,* first three years

Capital recovered is ₹ 12,500

Balance of ₹ 2500 recovered during the 4th year

I year	3,600
II year	3,900
III year	5,000
	12,500
Balance	2,500
	15,000

$$= \frac{12 \text{ months}}{5{,}000} \times 2{,}500 = \text{How many months ?}$$

Time taken for recovery of this amount of ₹ 2,500 = 6 months. Pay back period = 3 years 6 months.

NOTES

Project—B

Year	Profit ₹	(-) Depreciation ₹	Profit After Depreciation ₹	Tax ₹	PAT ₹	Add Depreciation ₹	Cash Inflows ₹	Cumulative Cash Inflows ₹
1	4200	3000	1200	600	600	3000	3600	3600
2	4500	3000	1500	750	750	3000	3750	7350
3	4000	3000	1000	500	500	3000	3500	10850
4	5000	3000	2000	1000	1000	3000	4000	14850
5	10000	3000	7000	3500	3500	3000	6500	21350

(PAT = Profit After Tax)

Note : If necessary only prepare cumulative cash inflows, otherwise there is no need.
Pay back period = 4 years and 8 days

Result and decision : Project A is preferable, because it has a shorter pay back period as compared to project A.

Workings Initial investment is ₹ 15,000

Its recovered :

I year	-	3,600
II year	-	3,750
III year	-	3,500
IV year	-	4,000
		14,850
Balance		150
		15,000

Time taken for recovery of this amount ₹ 150/- = 8 days.

For recovery of ₹ 6,500 in the 5th year.

Time required = 365 days.

For recovery of ₹ 150. in the 5th year.

Time required being $\frac{365}{6,500} \times 150 = 8$ days

Depreciation :

Project A

$$\frac{\text{Cost}}{\text{Life}} = \frac{15,000}{5 \text{ years}} = ₹\ 3,000$$

Project B

$$\frac{15,000}{5 \text{ years}} = ₹\ 3,000$$

Illustration 5. *A project costs ₹ 5,00,000 and yields annually a profit of ₹ 80,000 after depreciation at 12% p.a. but before tax of 50%. Calculate pay back period.*

Solution :

$$\text{Pay back period} = \frac{\text{Original Cost}}{\text{Annual Cash Inflows}}$$

NOTES

Initial investment = ₹ 5,00,000

Cash inflows = Profit after tax plus Depreciation.

	₹
Profit before Tax =	80,000
Less : Tax 50% =	40,000
profit after Tax =	40,000
Add : Depreciation =	60,000
Annual cash inflows =	1,00,000

$$\therefore \quad \text{Pay back period} = \frac{5,00,000}{1,00,000} = 5 \text{ years}$$

Note : Depreciation $= 5,00,000 \times \frac{12}{100} = 60,000.$

STUDENT ACTIVITY

1. What are the two main sources of working capital ?

2. Write about the steps involved in capital budgeting process.

NOTES

SUMMARY

- Working capital is the excess of current assets over current liabilities.
- Simply, Net Working Capital = Current Assets - Current Liabilities.
- Certain current assets which are retained by the organisation on a continuous basis is called permanent working capital or core current assets.
- The amount of working capital which will vary from time to time depending upon the level of business activities, is known as variable working capital.
- Capital budgeting refers to long term planning for the proposed capital outlay and their financing. In other words, it is the process of making investment decisions regarding the capital expenditures.
- Normally costs and benefits, in the form of cash inflows, are associated with the capital budgeting. The following costs are generally essential for different types of investment decisions.

  (*i*) Future costs
  (*ii*) Opportunity costs
  (*iii*) Interest cost.
  (*iv*) Incremental or differential cost
  (*v*) Depreciation and income tax.

GLOSSARY

- **Capital Expenditure :** This is one which is intended for future periods and generally includes investment in fixed assets and other developmental projects.
- **Internal rate of return :** It is an investment proposal of the discount rate which equates the present value of initial cost of the investment wtih the present value of the expected net cash flows.
- **Capital Rationing :** It is a situation where a constraint is placed on the total size of capital investment during a particular period.

REVIEW QUESTIONS

1. Define working capital.
2. List out the various kinds of working capital.
3. What is meant by Gross working capital ?
4. What is Net working capital ?
5. What is meant by core current assets ?
6. What is meant by variable working capital ?
7. Explain the concept of operating cycle.
8. Briefly explain the various advantages of working capital.
9. Explain the various disadvantages of working capital.
10. What are the sources of short-term working capital ?
11. What is meant by Capital Budgeting.
12. Explain the need and importance of Capital Budgeting.
13. Give a comparative description of net present value method and internal rate of return method.
14. "Capital budgeting is long-term planning for making and financing proposed capital outlays". Explain. What are the limitation of capital budgeting ?

NOTES

15. Briefly explain the steps involved in the control of capital expenditure in a large scale organizations.

PRACTICAL QUESTIONS

1. From the following estimates of Sethal Ltd you are required to prepare a forecast of working capital requirements.

(*i*) Expected level of production for the year 15,600 units
(*ii*) Cost per unit : Raw Materials ₹ 90, Direct labour ₹ 40, overheads ₹ 75.
(*iii*) Selling Price per unit ₹ 265
(*iv*) Raw Materials in stock on an average for 1 month
(*v*) Materials are in process on an average for 2 weeks.
(*vi*) Finished goods in stock on an average for 1 month.
(*vii*) Credit allowed by suppliers is one month.
(*viii*) Time lag in payment from debtors is 2 months.
(*ix*) Lag in payment of wages 1½ weeks.
(*x*) Lag in payment of overheads is one month. All sales are on credit.
(*xi*) Cash in hand and at Bank is expected to be ₹ 60,000.

It is assumed that production is carried on evenly throughout the year. Wages and overheads accrued evenly and a period of 4 weeks is equivalent to a month.

2. Prepare an estimate of working capital and projected Balance Sheet for the year ended on 31.12.2002 from the following information.

(*i*) Share capital ₹ 5,00,000, 15% Debentures of ₹ 2,00,000, Fixed assets at cost of ₹ 3,00,000.
(*ii*) The expected ratios of cost to selling price are Raw materials 60%, Labour 10%, Overheads 20%.
(*iii*) Raw materials are in stores for an average of 2 months.
(*iv*) Finished goods are kept in warehouse for 3 months.
(*v*) Expected level of production 1,20,000 units per year.
(*vi*) Each unit of production is expected to be in process for 1 month.
(*vii*) Credit given by suppliers is 2 months.
(*viii*) 20% of the output is sold against cash. Time lag in payment from debtors is 3 months.
(*ix*) Selling price is ₹ 5 per unit
(*x*) Labour and overheads will accrue evenly during the year.

3. XYZ Cements Ltd sells its products on a gross profit of 20% on sales. The following information is extracted from its annual accounts for the current year ended on 31st December.

	₹
Sales at 3 months' credit	40,00,000
Raw material	12,00,000
Finished goods : 2 months credit	32,00,000
Wages paid—average time lags 15 days	9,60,000
Manufacturing expenses paid one month in arrears	12,00,000
Administrative expenses paid one month in arrears	4,80,000
Sales promotion expenses payable	
Half-month in advance	2,00,000
Cash in hand	1,00,000

4. Calculate the net present value for a small sized project requiring an initial investment of ₹ 20,000 and which provides a net cash inflow of ₹ 6000 each year for six years. Assume the cost of funds to be 8% p.a. and that there is no scrap value.

5. The initial cost of an equipment is ₹ 3,00,000. Cash inflows for 5 years are estimated to be ₹ 2,00,000 per year. Desired rate of return is 15%. Calculate the net present value and excess present value index.

6. KVP Ltd is considering the purchase of a new machine for ₹ 1,20,000. It has a life of 4 years and an estimated scrap value of ₹ 20,000. The machine will generate an extra revenue of ₹ 4,00,000 p.a. and has an additional operating cost of ₹ 3,20,000 p.a. The company's cost of capital is 20% and tax rate 50%. Should the machine be purchased or not ?

7.

Initial outlay	₹ 50,000
Life of the asset	5 years
Estimated cash flows	₹ 12,500

Calculate internal rate of Return.

(Cash inflows are uniform).

8.

Initial Investment	:	₹ 60,000
Life of the asset	:	4 years

Estimated net annual Cash flows

I yr	₹ 15,000
II yr	₹ 20,000
III yr	₹ 30,000
IV yr	₹ 20,000

Calculate internal rate of return.

9. Balimer Ltd has a machine having an additional life of 5 years which costs ₹ 50,000 and which has a book value of ₹ 20,000. If it is sold, it will fetch ₹ 5,000. A new machine costing ₹ 1,00,000 is available. Though, its capacity is the same as that of the old machine. It will mean a saving in variable cost to the extent of ₹ 40,000 p.a. The life of machine will be 5 years at the end of which it will have a scrap value of ₹ 10,000. The rate of income tax is 50% and the company does not make an investment unless it must if it yields less than 12%. Advise the company whether the old machine should be replaced or not.

10. A project cost of ₹ 20,00,000 yielded annually a profit of ₹ 3,00,000 after depreciation @ 12½% and is subject to income tax @ 50%. Calculate pay back period.

11. Rank the projects according to their desirability under the pay back method and accounting rate of returns method assuming the cost of capital is 10%.

Project	*Initial Investment* ₹	*Annual cash flows* ₹	*Life in years*
A	*60,000*	*12,000*	*15*
B	*88,000*	*22,500*	*22*
C	*2150*	*1500*	*03*
D	*20,500*	*4500*	*10*
E	*4,25,000*	*2,25,000*	*20*

FURTHER READINGS

- '*Working capital management*', by M.K. Rastogi, University Science Press.
- '*Engineering Economics & Financial Management*', by C. Elanchezhian, Dr. R. Kesavan and T. Sunder Saiwyn.
- '*Cost and Financial Management*', by Dr. Mohd. Aarif, University Science Press.

NOTES

UNIT-V CAPITAL STRUCTURE : PLANNING AND ANALYSIS

STRUCTURE

5.0 LEARNING OBJECTIVES

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

- define the ratio analysis.
- explain objectives or advantages of accounting ratios, and profitability ratio.

5.1 INTRODUCTION

Analysis of financial Statements starts with ratio analysis. Ratio analysis helps in analysing the business performance both year on year and as compared to competitors business. We will have a detailed view of these ratios in this unit.

5.2 MEANING OF RATIO ANALYSIS

Ratio analysis refers to a technique of analysing the financial statements by computing various types of ratios. In simple words, it is a process of determining and interpreting

relationship between the items of financial statements to provide a meaningful result of the performance and financial position of a business. According to **Myeres,** *"Ratio analysis is a study of relationship among various financial factors in a business."*

Objectives or Advantages of Accounting Ratios

Accounting ratio are true test of the profitability, efficiency and financial soundness of the company. These ratios have the following objectives :

1. Measurement of the Profitability. We can measure the profitability of the business by calculating gross profit, net profit, expenses and other ratios. Profitability is the profit earning capacity of the business so profitability ratios indicate the actual performance of the business. If these ratios fall, effective corrective measures will be applied to improve the working of the business.

2. Judging the Operational Efficiency of Management. The operational efficiency of the business can be ascertained by calculating operating ratio. As the operating ratio shows the operational cost of the business so it will be in the interest of business if it is lower. We use operating net-profit for calculating operating net profit ratio, wherein non-operating expenses and incomes are not taken into consideration.

3. Assessing the Efficiency of the Business. We can ascertain whether the firm is solvent or not by calculating solvency ratios. Solvency ratios show relationship between liabilities and assets. If total assets are lesser than the outside liabilities it shows unsound position of the business. In such case the business will try its best to improve its solvency *i.e.*, ability to repay loans.

4. Measuring Short and Long Term Financial Position of the Company. We can know the short term and long term financial position of the business by calculating various ratios. Current and liquid ratios indicate short term financial position, whereas debt equity ratios, fixed assets ratios and proprietary ratios show long term financial position. In case of unhealthy short term or long term financial position, efforts are made to improve them.

5. Facilitating Comparative Analysis of the Performance. Every promising company has to compare its present performance with the previous performance and discover the plus and minus points. These points can be located by the calculation of different ratios. Causes responsible for poor performance have to be removed. Comparison with the performance of other competitive firms can also be made. Comparison tells, where the firm stands and what are its prospects. It enables both intra-firm and inter-firm comparison.

Limitations of Accounting Ratios/Ratio Analysis

Accounting ratios are insignificant alone. These ratios become meaningful when they are compared with the previous performance of the firm or with the performance of other firms. The ratios, though indicate profitability, efficiency and financial soundness, but they are not the solution of all problems. Accounting ratios suffer from the following limitations :

1. False Results. Ratios are based upon the financial statements. In case, financial statements are incorrect or the data upon which ratios are based is incorrect, ratios calculated will also be false and defective. The accounting system itself suffers from many inherent weaknesses, so the ratios based upon it cannot be said to be always reliable.

2. Limited Comparability. The ratio of the one firm can not always be compared with the performance of other firm, if uniform accounting policies are not adopted by them. The difference in the methods of calculation of stock or the methods used to record the depreciation on assets will not provide identical data, so they cannot be compared.

3. Absence of Standard Universally Accepted Terminology. Different meanings are given to particular term, such as some firms take profit before interest and after tax, others may take profit before interest and tax. Bank overdraft is taken as current liability but some firms may take it as non-current. The ratios can be comparable only when uniform terminology is adopted by both the firms.

4. Price Level Changes Affect Ratios. The comparability of ratios suffers, if the price of the commodities in two different years is not the same. Change in price affects the cost of production, sales and also the value of assets. It means that the ratio will be meaningful for comparison, if the prices do not change.

5. Ignoring Qualitative Factors. Ratio analysis is the quantitative measurement of the performance of the business. It ignores the qualitative aspect of the firm, howsoever important it may be. It shows that ratio is only one-sided approach to measure the efficiency of the business.

Classification of Accounting Ratios

Classification of ratios depends upon the objectives for which they are calculated. It may also depend upon the availability of data. Analysis of financial statement is made with a view to ascertain the efficiency and financial soundness of the company, as such ratios can be classified on the basis of profitability, turnover and financial capability. On the basis of purpose, ratios may be classified as under :

1. **Profitability Ratios :**
   - (*i*) Gross profit ratio
   - (*ii*) Operating ratio
   - (*iii*) Net profit ratio
   - (*iv*) Return on investment
   - (*v*) Earning per share
2. **Activity or Performance or Turnover Ratios :**
   - (*i*) Stock or inventory turnover ratio
   - (*ii*) Debtors turnover ratio
   - (*iii*) Working capital turnover
3. **Financial Ratios :**
   - (*a*) *Liquidity Ratios or Short Term Financial Ratios :*
     - (*i*) Current ratio
     - (*ii*) Liquidity ratio
   - (*b*) *Solvency Ratios or Long Term Financial Ratios :*
     - (*i*) Debt to equity ratio
     - (*ii*) Total assets to debt ratio
     - (*iii*) Proprietary ratio

5.3 PROFITABILITY RATIOS

Profitability refers to the ability of the business to earn profit. It shows the efficiency of the business. These ratios measure the profit earning capacity of the company. Profitability has direct link with sales. This is why, we calculate these ratios on the basis of sales. Return on investments and capital is calculated on the basis of capital employed. The profitability of the business can be measured with the following ratios.

1. Gross profit ratio 2. Net profit ratio 3. Operating ratio.

Gross Profit Ratio

It shows the relationship between the **gross profit and sales.** This ratio shows the **margin** of gross profit **on sales.** In order to calculate this ratio we require gross profit and net sales. Gross profit, if not given, can be calculated on the basis of the following formula :

$$\text{Gross Profit} = \text{Sales} + \text{Closing Stock} - (\text{Opening Stock} + \text{Net Purchases} + \text{Direct Expenses})$$

or

$$= \text{Sales} - \text{Cost of goods sold.}$$

Gross Profit can be ascertained by preparing Trading Account also. **The term net sales means sales less sales return. If sales return is not given sales will be assumed to be net sales.** The formula for its calculation is as under :

> In case Net Profit is given, Gross Profit will be calculated by **adding selling, distribution and financial expenses and deducting income.**

$$\textbf{Gross profit ratio} = \frac{\text{Gross Profit}}{\text{Net Sales}} \times 100$$

Illustration 1. **Calculate gross profit ratio if :**

Gross profit = 40,000
Sales = 2,20,000
Sales return = 20,000

Solution : Gross profit ratio $= \frac{\text{Gross Profit}}{\text{Net Sales}} \times 100 = \frac{40,000}{2,00,000} \times 100 = 20\%.$

> **Note.** Net Sales = Sales − Sales Return = 2,20,000 − 20,000 = Rs. 2,00,000.

Usefulness/Significance and Uses of Gross Profit Ratio

Gross profit ratio *reveals profit earning capacity of the business* with reference to its sale. Increase in gross profit ratio will mean reduction in cost of production or direct expenses or sale at reasonably good price and decrease in the ratio will mean increased cost of production or sales at lesser price. The true efficiency or profitability of the business cannot be understood by gross profit because profitability may be lesser, whereas gross profit is more. For example, if a firm earns a gross profit of ₹ 25,000 during the year when its sales is worth ₹ 1,00,000. In the next year the firm earned ₹ 40,000 as gross profit when its sales were ₹. 2,00,000. The example shows that profit in the next year has increased to ₹ 40,000 *i.e.*, an increase of ₹ 15,000 as compared to the previous year, whereas the gross profit ratio shows that the profitability of the firm during the first year was 25% and in the next year it has come down to 20%. It shows that we should calculate gross profit ratio in order to have the correct view of the business.

Illustration 2. **Calculate gross profit ratio in the following cases :**

(*a*) *Gross Profit*	₹	*30,000*
Sales	₹	*2,00,000*

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(*b*) *Gross Profit*	₹ *2,00,000*
Sales	₹ *10,08,000*
Sales Return	₹ *8,000*
(*c*) *Sales*	₹ *1,20,000*

Gross profit is 20% on cost

Solution : (*a*) **Gross profit ratio** $= \frac{\text{Gross Profit}}{\text{Net Sales}} \times 100$

$$= \frac{30,000}{2,00,000} \times 100 = \mathbf{15\%}.$$

(*b*) **Gross profit ratio** $= \frac{\text{Gross Profit}}{\text{Net Sales}} \times 100 = \frac{2,00,000}{10,00,000} \times 100 = \mathbf{20\%}.$

Note. Net Sales = 10,08,000 – 8,000 = 10,00,000

(*c*) Gross profit = 20% on cost

Let the cost price be = 100

Sale price = 100 + 20 = 120 [Sale price = Cost + Profit]

If the sale price is 120 gross profit = 20

If the sale price is 1 gross profit = 20/120

If the sale price is 1,20,000 gross profit = 20/120 × 1,20,000

Gross Profit = ₹ 20,000

Gross profit ratio $= \frac{\text{Gross Profit}}{\text{Net Sales}} \times 100 = \frac{20,000}{1,20,000} \times 100 = \mathbf{16.67\%}.$

Net Profit Ratios

It is classified as :

(*a*) Net profit ratio, and

(*b*) Operating net profit ratio.

Net Profit Ratio

This ratio establishes relationship between net profit and net sales. Net profit or net income is the gross profit less selling, distribution and financial expenses. Net profit, for calculating this ratio is picked up from the Profit and Loss A/c. It should be noted that the net profit is ascertained after adding operation and non-operating income to Gross Profit and deducting both operating and non-operating expenses therefrom. We can understand Net profit better in this way :

Net Profit = Gross Profit + Operating and Non-operating income (–) Operating and Non-operating expenses.

Operating Income. Income earned in the ordinary life of the business from trading activities such as Gross Profit, Discount on creditors, Interest on drawings and Sale of scraps etc.

Non-Operating Income. It includes income from non-trading operations, such as, refund of tax, interest and dividend received. Gain on sale of assets, compensation received etc.

Operating Expenses. It includes selling, administrative and distribution expenses incurred in the day to day affairs of the business.

Non-Operating Expenses. These expenses include all financial expenses such as interest on debentures dividend, depreciation, loss on sale of assets, abnormal loss such as loss by fire, discount or loss on issue of shares and debentures, goodwill and preliminary expenses written off, reserves, dividend and interest paid etc.

Net profit ratio can be calculated on the basis of the following formula :

$$\textbf{Net Profit Ratio} = \frac{\text{Net Profit}}{\text{Net Sales}} \times 100$$

Illustration 3. **Net Profit = ₹ 24,000**

Net Sales = ₹ 2,00,000, Calculate Net Profit Ratio.

Solution : Net profit ratio $= \frac{\text{Net Profit}}{\text{Net Sales}} \times 100 = \frac{24,000}{2,00,000} \times 100 =$ **12%.**

Operating Net Profit Ratio

The ratio establishes relationship between operating net profit and net sales. **Operating net profit** is ascertained as under :

Operating Net Profit = Net Profit as per P/L A/c
+ Non-operating expenses (named above)
− Non-operating income (named above)

Alternatively. Gross Profit
+ Operating income
− Operating expenses

Significance/Usefulness

Net profit ratio shows the operational efficiency of the business. Decrease in the ratio indicates managerial inefficiency and excessive selling and distribution expenses. In the same way, increase shows better performance. Increase or decrease in the ratio is determined in comparison to previous year's performance. In case of increase, performance of the management should be appreciated and plus points reinforced. In case of decline in the net profit ratio an investigation to find out causes for the decline in the net profit be made and corrective action should be taken to remove the causes responsible for the fall in the net profit ratio.

Illustration 4. **Calculate (*a*) Operating Net Profit ratio and (*b*) Net profit ratio in the following cases :**

	₹
(*i*) *Net Profit*	*15,000*
Net Sales	*80,000*
(*ii*) *Net Profit before interest*	*20,000*
Net Profit after interest	*17,000*
Net Sales	*2,00,000*

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(*iii*) **P/L A/c**

Dr. *Cr.*

Expenses/Losses	*Amount*	*Revenue/Gain*	*Amount*
To Sundry Expenses	*47,000*	*By Gross Profit*	*57,000*
To Loss on Sale of Furniture	*3,000*	*By Gain on Sale of Plant*	*3,000*
To Interest paid	*2,000*	*By Compensation for land acquired by Govt.*	*10,000*
To Reserve for Contingency	*1,000*		
To Net Profit	*17,000*		
	70,000		*70,000*

Sales = ₹ 60,000.

Solution : (*i*) (*a*) **Operating Net Profit Ratio** = $\frac{\text{Net Profit}}{\text{Net Sales}} \times 100$

$= \frac{15,000}{80,000} \times 100 =$ **18.75%.**

(*b*) Net Profit ratio will also be the same, because operating expenses and operating income are not given separately.

(*ii*) (*a*) **Operating Net Profit Ratio** = $\frac{\text{Net profit before interest}}{\text{Net Sales}} \times 100$

$= \frac{20,000}{2,00,000} \times 100 =$ **10%.**

Note. Interest excluded because it is non-operating expenses.

(*b*) **Net Profit Ratio** = $\frac{\text{Net profit after interest}}{\text{Net Sales}} \times 100$

$= \frac{17,000}{2,00,000} \times 100 =$ **8.5%**

(*iii*) (*a*) Operating Net Profit :

Net Profit		= 17,000
Add : Non-operating expenses :		
Interest paid	2,000	
Loss on Sale of Furniture	3,000	
Reserve for Contingency	1,000	6,000
		23,000
Less : Non-operating income :		
Gain on sale of plant	3,000	
Compensation Received	10,000	(–) 13,000
Operating Net Profit		10,000

Operating Net Profit Ratio = $\frac{\text{Operating Net Profit}}{\text{Net Sales}} \times 100 = \frac{10,000}{60,000} \times 100$

= **16.7%.**

(*b*) **Net Profit Ratio** = $\frac{\text{Net Profit}}{\text{Net Sales}} \times 100 = \frac{17,000}{60,000} \times 100 =$ **28.33%.**

NOTES

Note. In the absence of any specific instruction Net Profit Ratio should be assumed to be operating Net Profit ratio.

Operating Ratio

Operating ratio indicates the ratio of operational cost to the sales. Operating cost consists of cost of goods sold and other operating expenses. Operational efficiency of the business will be more in case of lesser operating ratio and *vice versa*. The ratio can be calculated on the basis of the following formula :

$$\textbf{Operating Ratio} = \frac{\text{Operating Cost}}{\text{Net Sales}} \times 100$$

Operating Cost = Cost of goods sold + Operating expenses.

Operating expenses do not include loss on sale of assets, depreciation, reserve maintained and goodwill written off etc. These expenses mean only those expenses which are concerned with the day-to-day affairs of the business.

Operating ratio is also related to net profit ratio. As such it can also be calculated by the following formula :

Operating ratio = 100% − Net profit ratio.

In other words :

Operating Ratio + Operating profit ratio = 100%

The true efficiency of the business is increasing net profit ratio and decreasing operating ratio. An increase in the operating ratio means increased operating cost, which is against the interest of the company.

Illustration 5. **Calculate operating ratio and net profit ratio and prove that operating ratio**

= 100% − Net Profit Ratio in the following case.

Sales (Net)	*2,00,000*
Cost of goods sold	*1,40,000*
Operating Expenses	*20,000*
Net Profit	*40,000*

Solution : Operating Ratio $= \dfrac{\text{Cost of goods sold + Operating Expenses}}{\text{Net Sales}} \times 100$

$$= \frac{(1,40,000 + 20,000)}{2,00,000} \times 100 = \frac{1,60,000}{2,00,000} \times 100$$

$$= 80\%$$

$$\textbf{Net Profit Ratio} = \frac{\text{Net Profit}}{\text{Net Sales}} \times 100 = \frac{40,000}{2,00,000} \times 100 = 20\%$$

Proof. Operating Ratio = 100% − Net Profit Ratio = 100% − 20% = 80%

NOTES

Significance/Usefulness

Operating ratio reveals the cost content and operational expenses absorbed in the sales. It measures the efficiency and profitability of the enterprise. In case the operating ratio is higher the business will have to identify the causes for its increase. Higher ratio indicates lower efficiency because a major part of sales is eaten up by operating cost. Every business should try to increase its net profit which is possible if the operating cost is reduced. Lower operating ratio is always in the interests of the enterprise.

Return on Investment or Return on Capital Employed or Yield on Capital

This is one of the most important ratios for the measure of overall profitability. It indicates the **relationship of net profit with capital employed in the business.** Here, return for calculating return on investment will **mean the net profit before interest, tax and preference dividend.** Net profit means net profit of the year **excluding** undivided profit and reserves. Investment, here means capital employed meaning **long term funds which consists of the following :**

Capital Employed = *Equity share capital + Preference share capital + Reserves*

+

(Permanent Capital) Accumulated profit + Long term loans :

(*i*) Loans from IFC

(*ii*) Loans from IBRD

(*iii*) Debentures etc.

(*iv*) Mortgages

(–) Fictitious assets like *underwriting commission, Discount or Loss on Issue of shares and Debentures Preliminary expenses miscellaneous Expenditure and non-operating assets, like investment.*

Or

= Net Fixed Assets + Working Capital

Net Fixed Assets = Fixed Assets – Depreciation

Working Capital = Current Assets – Current Liabilities and provisions.

To summarise, return on investment can be calculated on the basis of the following formula :

$$\textbf{Return on Investment} = \frac{\text{Net profit before tax, interest and preference dividend}}{\text{Capital employed}} \times 100$$

Illustration 6. **Find return on investment of Rajindra Ltd. from the following information :**

Balance Sheet

as on .....

Liabilities	₹	*Assets*	₹
Equity Share Capital	*15,00,000*	*Net Fixed Assets*	*18,00,000*
Preference Share Capital	*3,00,000*	*Current Assets*	*16,00,000*
Debentures	*2,00,000*		
Current Liabilities	*10,00,000*		
Profit of the year	*4,00,000*		
	34,00,000		*34,00,000*

Solution : Return on Investment

$$= \frac{\text{Net profit before tax, interest and preference dividend}}{\text{Capital employed}} \times 100$$

$$= \frac{4,00,000}{24,00,000} \times 100 = \mathbf{16.67\%}$$

Note : Capital employed = Equity share capital = 15,00,000
+ Preference share capital = 3,00,000
+ Debentures = 2,00,000
+ Profit of the year = 4,00,000
24,00,000

Or

Net Fixed Assets = 18,00,000
+ working capital *i.e.*, Current Assets – Current Liabilities + 6,00,000
i.e., (16,00,000 – 10,00,000)
24,00,000

Significance/Usefulness

Return on investment ratio measures, the operational efficiency and borrowing policy of the enterprise. It also shows how effectively the capital employed in the business is used. It shows the earning capacity of the net assets of the business. The ratio judges the performance of the business. It can be used for comparing the performance of even dissimilar business or different departments of the same business.

Earning per Share

The ratio measures the return per share but not payable by equity or ordinary shareholders. Equity shareholders are virtually the **owner** of the company. Dividend payable to them is ascertained **after deducting** operating and non-operating expenses and even the interest payable to debenture holders and dividend to preference shareholders. Earning per share is calculated on the basis of the following formula :

$$\text{Earning per share (E.P.S.)} = \frac{\text{Net profit} - \text{Preference dividend}}{\text{Number of Equity shares}}$$

NOTES

Net profit here means net profit after taxes, interest and dividend payable to preference shareholders.

Illustration 7. **Calculate Earning per Share of the folliowng :**

Net profit before preference dividend	*20,000*
Equity share capital	*1,00,000*
(10,000 shares of ₹ 10 each)	
10% Preference share capital	*50,000*

Solution : Earning per Share $= \dfrac{\text{Net profit} - \text{Preference dividend}}{\text{No. of equity shares}}$

$$= \frac{20,000 - 5,000}{10,000} = ₹\ \mathbf{1.50} \text{ per share.}$$

The ratio measures the market worth of the shares of the company. Higher earning per share shows better future prospects of the company.

Illustration 8. **Calculate return on investment and earning per share from the following information :**

Equity share capital (in shares of ₹ 10)	*10,00,000*
Reserve	*1,00,000*
Profit of the year	*4,00,000*

Solution :Return on Investment

$$= \frac{\text{Net profit before interest, taxes and preference dividend}}{\text{Capital employed}} \times 100$$

$$= \frac{4,00,000}{11,00,000} \times 100 = \mathbf{36.4\%.}$$

$$\textbf{Earning per Share} = \frac{\text{Net profit}}{\text{Number of equity shares}} = \frac{4,00,000}{1,00,000}$$

$$= ₹\ 4 \text{ per share}$$

Note. Capital employed = Equity share capital + Reserve

5.4 TURNOVER OR PERFORMANCE OR ACTIVITY RATIOS

Turnover means **'sales'**, so turnover ratios are related to sales. It is an accepted fact that sales has direct relationship with the performance of the business. Higher sales means better performance, which really means better efficiency and productivity of the business. Higher sales also means more production, which is undoubtedly the result of the best possible utilisation of physical resources *i.e.*, material, machine, and active participation of human resource. In this way, words turnover, performance and activity are synonymous. These three words carry the same sense. In other words, more sales means the business is more active and has better performance.

Lesser sale shows inactivity of the business, poor performance and lesser productivity. All business activities revolve round the sales. It is the sales budget, which is prepared first of all. Production budget is made to produce the desired quantity of goods, required for sale. Production concerns raw material workers, machines, tools, equipments and management. Every company should try to multiply its sales, because it is an indicator of all round development of the business.

Performance ratios also show, whether the total capital, working capital, fixed assets and stock of the business are profitability used.

Kinds of Turnover Ratios

Turnover ratios consist of the following important ratios :

(*i*) Stock turnover ratio

(*ii*) Working capital turnover ratio

(*iii*) Debtors turnover ratio

(i) Stock or Inventory Turnover Ratio

This ratio establishes relationship between cost of goods sold and average stock and reflects the speed of turning over the stock into sales.

Significance/Usefulness of Stock Turnover Ratio

This ratio measures how many times the average stock is sold during the year. Promptness of sale indicates better performance of the business. It also shows efficiency of the concern. Immediate sales of goods produced require further production which consequently activates the productive process and is responsible for rapid development of the business. Higher inventory turnover ratio is always beneficial to the concern.

Lower inventory turnover ratio shows that the stock is blocked and not immediately sold. It shows the poor performance of the business and inefficiency of the management. The ratio measures the effectiveness of the stock policy of the management. It should be the constant effort of the management to dispose of stock at the earliest.

This ratio establishes relationship between cost of goods sold and average stock. Every business has to keep optimum quantity of stock, so that production work may be carried on smoothly. If the average inventory kept during the year is more than ordinary requirement, the amount spent in its purchase will be unnecessarily blocked and there will also be the problem of storing it. In case the average stock is lesser than the ordinary requirement, the production work will suffer. It is always advisable to keep the required quantity of stock. This ratio is calculated as under :

$$\textbf{Stock Turnover Ratio} = \frac{\text{Cost of goods sold}}{\text{Average stock}}$$

$$\textbf{If cost of goods is not given then,}\ \text{Stock trunover ratio} = \frac{\text{Sales}}{\text{Average stock}}$$

Cost of goods sold is also known as cost of sales and is calculated as under :

Cost of goods sold = Opening stock + Purchases + Direct expenses – Closing stock

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Or

$$\text{Net Sales} - \text{Gross Profit}$$

$$\textbf{Average stock} = \frac{\text{Opening Stock} + \text{Closing Stock}}{2}$$

Purpose of Inventory Ratio

The purpose of this ratio is to calculate the number of times inventory is covered by the cost of goods sold or sales.

Illustration 9. *Stock turnover ratio is 2.5 times. Average stock is ₹ 20,000.* **Calculate cost of goods sold and also sales, if profit earned is 25% of cost.**

$$\textbf{Solution : Stock Turnover Ratio} = \frac{\text{Cost of goods sold}}{\text{Average stock}} = 2.5 \text{ times (given)}$$

It shows that cost of goods sold is 2.5 times of average stock, *i.e.,*

Cost of goods sold = 20,000 × 2.5 = ₹ **50,000**

Profit = 25% of cost

= 50,000 × 25/100 = ₹ 12,500

Sales = Cost of goods sold + Profit

= 50,000 + 12,500 = ₹ 62,500

Illustration 10. *Stock turnover ratio is 3 times. Cost of goods sold is ₹ 1,20,000. Stock in the beginning is ₹ 10,000 more than the stock in the end.* **Calculate stock in the beginning and at the end.**

$$\textbf{Solution : Stock Turnover Ratio} = \frac{\text{Cost of goods sold}}{\text{Average stock}} = 3 \text{ times (given)}$$

It shows that average stock will be 1/3rd of cost of goods sold, *i.e.,*

Average stock = 1,20,000 × 1/3 = 40,000

Total stock = 40,000 × 2 = 80,000

Let the stock in the beginning = x

Stock at the end = x − 10,000

Equation = $x + x - 10{,}000 = 80{,}000$

$2x = 80{,}000 + 10{,}000 = 90{,}000$

$x = \frac{90{,}000}{2}$ = **45,000 (Stock in the beginning)**

Stock at the end = 45,000 − 10,000 = **35,000.**

(ii) Working Capital Turnover Ratio

This ratio measures the relationship between working capital and sales. The ratio shows the number of times the working capital results, in sales. *Working capital as usual is the excess of current assets over the current liabilities.* The following formula is used to measure this ratio.

$$\textbf{Working Capital Turnover Ratio} = \frac{\text{Net Sales or Cost of Sales}}{\text{Working Capital}}$$

Usefulness/Significance

This ratio is very significant for non-manufacturing concerns where working capital is more than the fixed assets. It reflects the efficiency in the utilisation of working capital. This ratio must be normal. Excessive ratio shows overtrading and lower ratio shows undertaking. Both the situations of overtrading and undertrading show the weaknesses of the enterprise.

Purpose of Working Capital Turnover

The purpose of this ratio is to measure the working capital performance of the business in terms of total sales.

Illustration 11. **Calculate working capital turnover ratio from the following information :**

Balance Sheet

as on .....

Liabilities	₹	*Assets*	₹
Share Capital	*1,00,000*	*Fixed Assets*	*1,70,000*
12% Debentures	*80,000*	*Current Assets*	*1,00,000*
Reserve	*20,000*		
Current Liabilities	*70,000*		
	2,70,000		*2,70,000*

Net sales during the year is ₹ 3,00,000.

Solution : Working Capital Turnover Ratio $= \dfrac{\text{Net Sales}}{\text{Working Capital}} = \dfrac{3,00,000}{30,000}$

= 10 times.

Note. Working capital = Current Assets – Current Liabilities
= 1,00,000 – 70,000 = 30,000.

Illustration 12. **Calculate working Capital turnover ratio from the following information :**

Net capital employed ₹ 4,00,000; Total sales ₹ 7,00,000; Sales returns ₹ 1,00,000; Net Fixed Assets ₹ 2,50,000. There were no long term investment.

Solution : Working Capital Turnover Ratio $= \dfrac{\text{Net sales}}{\text{Net Working Capital}}$

$= \dfrac{6,00,000}{1,50,000}$ **= 4 times.**

Notes. Net Sales = Total Sales – Sales Return
= 7,00,000 – 1,00,000 = ₹ 6,00,000

Working Capital = Net Capital Employed – Net Fixed Assets
= 4,00,000 – 2,50,000 = ₹ 1,50,000.

(iii) Debtors Turnover Ratio

It is also known as receivable turnover ratio. It establishes relationship between credit sales and average debtors. This ratio is calculated on the basis of the following formula :

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$$\textbf{Debtors Turnover Ratio} = \frac{\text{Net credit sales}}{\text{Average debtors}}$$

Credit sales is separately given or it may be the difference **between total sales and cash sales.** Credit sales may also be calculated by preparing debtors Account. In other words, excess of the total of cash received from debtors, Sales Return, Bad Debts and bills drawn over the opening balance of debtors is credit sales.

$$\textbf{Average Debtors} = \frac{\text{Opening Debtors + Closing Debtors}}{2}$$

In case of receivable turnover ratio Debtors and B/R are added *together to* determine the receivable. In case of newly started business debtors in the beginning will not be available so debtors at the end will be supposed to be average debtors.

If the opening and closing balances of Debtors are known average debtors will be calculated. If the opening and closing balances of both the debtors and B/R are given, average receivable will be calculated. If only closing balances are there it will be used for the calculation of ratio.

Purpose of Debtors Turnover

The purpose is to measure the debtors coverage through total credit sales of the business.

Illustration 13. **Calculate debtors turnover ratio,**

if total sales are ₹ 2,50,000, cash sales ₹ 70,000. Debtors in the beginning are ₹ 16,000 and at the end is ₹ 8,000 more.

Solution : Credit sales = Total sales − Cash sales

= 2,50,000 − 70,000 = 1,80,000

Debtors in the beginning = 16,000

Debtors at the end = 16,000 + 8,000 = 24,000

$$\textbf{Average Debtors} = \frac{\text{Opening Debtors + Closing Debtors}}{2}$$

$$= \frac{16{,}000 + 24{,}000}{2} = 20{,}000$$

$$\textbf{Debtors Turnover Ratio} = \frac{\text{Credit sales}}{\text{Average debtors}} = \frac{1{,}80{,}000}{20{,}000} = \textbf{9 times.}$$

Significance/Usefulness

Debtors turnover ratio indicates the efficiency with which debts are collected during the year. It will be in the interest of business, if the ratio is higher, which will indicate that debts are collected quickly. This ratio also reflects the effectiveness of the credit sales policy of the management.

Illustration 14: **Calculate debtors turnover ratio from the following information :**

	₹
Credit sales of the year	*9,00,000*
Debtors	*90,000*
Bills Receivable	*60,000*

Solution :Debtors Turnover Ratio = $\frac{\text{Credit Sales}}{\text{Receivable}} = \frac{9,00,000}{1,50,000}$ = **6 times**

5.5 FINANCIAL RATIOS

There are two types of financial ratios :

1. Liquidity ratios
2. Solvency ratios.

Liquidity Ratios

The ratios, calculated to ascertain the short term solvency of the company are known as liquidity ratios. Short term financial position is calculated to adjudge, whether the current assets of the company are sufficient to meet its short term liabilities. It is an accepted fact that business should be able to meet its current or short term liabilities out of its short term financial resources. It will be suicidal for the business to arrange funds out of long term funds to meet its short term liabilities and to repay long term liabilities out short term or current assets. Following ratios are calculated to determine the liquidity or short term solvency of the company :

(*i*) Current ratio or Working capital ratio

(*ii*) Liquid ratio.

(*i*) *Current Ratio or Working Capital Ratio*

The ratio indicates the short term financial soundness of the company. It judges whether current assets are sufficient to meet the current liabilities or not. The company must be able to meet its current obligations out of the current assets. It should not depend upon its long term sources to pay its short term liabilities. The ratio is calculated on the basis of the following formula :

$$\textbf{Current Ratio} = \frac{\text{Current Assets}}{\text{Current Liabilities}}$$

Current assets are those assets which are converted into cash within a year. These assets are Cash in hand, Cash in Bank, Debtors or Book Debts, Bills or Notes Receivable, Stock or Inventory, Prepaid expenses, Tax paid in advance, Accrued income and short term investments etc. In the same way, **current liabilities** are those liabilities which are to be paid within a year. These liabilities are Creditors, Bills or Notes Payable, outstanding expenses, short term loans, Bank overdraft, cash credit, Provision for tax, Proposed dividend, Tax deducted at source and Unclaimed dividend. Current Assets, are those assets which can be realised within a year. In the same way, liabilities, which are to be paid within a year are current liabilities. Ordinary investment are non-current assets. Short term investments or trade investment or marketable securities are current assets. Loose tools, Patents, Goodwill and Fictitious assets are non-current assets. Loan, Bank loan or loan on mortgage are non-current liabilities etc.

Purpose of Current Ratio

The purpose of current ratio is to measure the liqudity position of the company in terms of its short term working capital requirement. This is a widely used ratio to analyse the short term solvency of the business.

(ii) *Liquid Ratio*

This ratio is also known as **Acid test ratio** or **Quick assets ratio.** The ratio shows liquidity of the business in real sense. According to **Soloman, J. Flink** *"Liquidity is the ability of the firm to meet its current obligations as they fall due."* **Liquid assets are current assets less stock and prepaid expenses.** These assets are called liquid assets, because they can be converted into cash promptly or very shortly. The following formula is used to calculate this ratio :

$$\textbf{Liquid Ratio} = \frac{\text{Liquid Assets}}{\text{Current Liabilities}}$$

Or

$$= \frac{\text{Current Assets} - (\text{Stock} + \text{Prepaid Exp.})}{\text{Current Liabilities}}$$

The standard liquid ratio is thought to be 1 : 1 *i.e.*, liquid assets should be equal to current liabilities. If the ratio is higher *i.e.*, current assets are more than the current liabilities, the short term financial position is supposed to be very sound.

Alternative Calculation of Current Assets and Current Liabilities :

Current Assets may also be calculated by adding working capital and Current Liabilities. Current Liabilities are excess of Current Assets over working capital. Current Liabilities may also be calculated by deducting long term debts from Total debts. It can be summarised as under :

Current Liabilities = Total Debts − Long Term Debts
Current Liabilities = Current Assets − Working Capital
Current Assets = Working Capital + Current Liabilities

Purpose of Liquid Ratio

The purpose of liquid ratio is to calculate the very short term (*i.e.*, 6 months) availability of cash to meet day to day requirement.

Illustration 15. **Calculate (*a*) Current ratio and (*b*) Liquid ratio from the following :**

Cash	*10,000*	*B/R*	*5,000*
Cash at Bank	*5,000*	*Stock*	*9,000*
Debtors	*20,000*	*Prepaid expenses*	*3,000*
Creditors	*16,000*	*Outstanding expenses*	*2,000*
B/P	*4,000*		

Solution : (*a*)**Current Ratio** $= \frac{\text{Current Assets}}{\text{Current Liabilities}} = \frac{52,000}{22,000} =$ **2.36 times.**

Current Assets = Cash + Cash at Bank + Debtors + Stock + B/R + Prepaid expenses
= 10,000 + 5,000 + 20,000 + 9,000 + 5,000 + 3,000 = ₹ 52,000

Current Liabilities = Creditors + B/P + Outstanding Exp.
= 16,000 + 4,000 + 2,000 = ₹ 22,000

(*b*) **Liquid Ratio** $= \frac{\text{Liquid Assets}}{\text{Current Liabilities}} = \frac{40,000}{22,000} =$ **1.8 times**

Liquid Assets = Current Assets − (Stock + Prepaid Expenses)
= 52,000 − (9,000 + 3,000) = ₹ 40,000

Comment. Short term financial position of the enterprise is sound because both the current and liquid ratios are 2.36 and 1.8 times respectively, which is more than the standard current ratio of 2 : 1 or 2 times and liquid ratio of 1 : 1.

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Significance/Usefulness of Current and Liquid Ratio

These ratios show short term financial soundness of the company. **The standard current ratio is supposed to be two times or 2 : 1 in a developing country like India** *i.e.*, Current assets should be two times of the current liabilities. The financial position is supposed to be very sound, if the current ratio is more than 2 : 1 *i.e.*, current assets are more than two times of current liabilities. In case, it is lesser than 2 : 1 short term financial position is not supposed to be very sound. In the same way, standard liquid ratio is 1 : 1. Higher ratio shows the better capacity of the business to meet its current obligation.

Current ratio is also said to be working capital ratio. In other words, it shows the position of current assets as compared to current liabilities *i.e.*, the ratio of current assets to current liabilities. The ideal current ratio should be around 2 : 1. In case it is very high, it will show the idleness of funds. If it is very low it will indicate short term financial scarcity. The logic behind traditional rule of the current ratio being 2 : 1 is that the firm can meet its short term obligation even if its Current Assets become half of their value.

Liquidity ratio shows very short term liquidity or capacity of the business to meet its obligation at short notice (ordinarily within a month).

Difference between Current Ratio and Quick Ratio

Points of Difference	*Current Ratio*	*Quick Ratio*
1. *Concerns*	It is concerned with current assets and current liabilities.	It is concerned with Quick assets and current liabilities.
2. *Measure*	It measures ability to meet current obligation.	It measures ability to meet current obligation without relying on sale and collection from debtors.
3. *Standard ratio*	2 : 1.	1 : 1.
4. *Inventory*	Current assets include inventory.	Quick assets exclude inventory.

Illustration 16. **Calculate current and liquid ratio from the following information :**

Balance Sheet

as on .....

Liabilities	₹	*Assets*	₹
Share Capital	*1,00,000*	*Fixed Assets*	*1,50,000*
Debentures	*1,15,000*	*Liquid Assets*	*1,20,000*
Current Liabilities	*65,000*	*Stock*	*10,000*
	2,80,000		*2,80,000*

Solution : (*i*)Current Ratio $= \dfrac{\text{Current Assets}}{\text{Current Liabilities}} = \dfrac{1,30,000}{65,000}$ **= 2 times.**

NOTES

$$\text{Current Assets} = \text{Liquid Assets} + \text{Stock}$$
$$= 1,20,000 + 10,000 = \text{Rs. } 1,30,000$$

(*ii*) $$\textbf{Liquid Ratio} = \frac{\text{Liquid Assets}}{\text{Current Liabilities}} = \frac{1,20,000}{65,000} = \textbf{1.9 times.}$$

Illustration 17. *A company had current assets worth ₹ 2,00,000. It paid a current liability of ₹ 40,000. After payment of current liability the ratio became 2 : 1.* **Calculate current liability and working capital after and before payment of current liability.**

Solution : Suppose current liability after payment is = x

$$\frac{2,00,000 - 40,000}{x} = 2$$

or $2x = 1,60,000$

or $x = 80,000$

Current Liability = 80,000

Working Capital after payment = 1,60,000 – 80,000 = ₹ 80,000

Working capital before payment = 2,00,000 – 1,20,000 = ₹ 80,000.

Explanation. The working capital before and after the payment of current liability will be the same, because the payment of current liability reduces both current assets and current liabilities with the same figure, so the difference between current assets and current liabilities will be the same.

Solvency Ratios

'Solvency' means the ability of the business to repay its outside liabilities. These liabilities may be categorised as short term liabilities and long term liabilities. Ratios concerning the short term solvency (financial soundness) of the business have been discussed under liquidity ratios. Here, the term solvency ratios has been used to mean long term financial position of the business. It is an accepted financial truth that the company must have sufficient long term funds to meet its long term liabilities. Long term funds include long term loans and shareholders' funds. Solvency ratios also measure the relationship between external equities and internal equities.

Objectives of Solvency Ratios

Solvency refers to the financial capability of the enterprise in honouring their long term commitments (obligation). These ratios serve our following purpose.

1. Ascertaining capability to honour long term obligations, such as repayment of loan and interest thereon.

2. Ensuring long term financial stability of the business.

3. Measuring relationship between internal and external equity.

Long term requirements must be met out of long term funds, such as funds for purchase of fixed assets *i.e.*, Land and Building; Plant and Machinery must be provided out of share capital or long term loans. These ratios indicating long term financial position are as under :

(*i*) Debt to Equity Ratio

(*ii*) Total Assets to Debt Ratio

(*iii*) Proprietary Ratio.

(i) Debt to Equity Ratio

This ratio is calculated to judge the long term financial policy of the business. The ratio establishes relationship between long term loans and owners' funds. Debt here in the ratio means long term loans consisting of :

> **Long Term Loans** = Debentures + Loans from specialised financial institutions, banks and corporations + Public deposits + Loans and mortgage + Term loans + Secured loans
>
> **Alternatively**
>
> **Long Term Loans** = Total Debt – Current Liabilities

> **Note.** Loans maturing for payment after one year are long term loans.

Equity here means owners'/shareholders' funds consisting of :

> **Shareholders' Funds** = Equity/ordinary share capital + Preference share capital + Reserve + Surplus + General reserve + Capital Reserve + Share Premium *less* accumulated losses (Debit balance of Profit and Loss A/c or P/L A/c appearing at the assets side of the balance sheet) and fictitious assets (Preliminary expenses, discount/loss/expenses on issue of shares and debentures, underwriting commission, miscellaneous expenditure etc.)
>
> **Alternatively**
>
> **Shareholders' Funds** = Total Assets – Total Debt.

The ratio is calculated as under :

$$\textbf{Debt to Equity Ratio} = \frac{\text{Debt}}{\text{Equity}} \text{ or } \frac{\text{Long term loans}}{\text{Shareholders' funds}}$$

The ideal debt equity ratio in India is accepted as 2 : 1, meaning that long term liabilities of the business should ideally be two times of shareholders' funds. In other words, shareholders' funds should be .5 times of long term loans. Higher debt equity ratio shows lesser margin for long term lenders. This ratio indicates to what extent the firm depends on outsiders' funds for existence. It also shows the cushion or cover of owners' funds available to creditors.

$$\textbf{Debt to Equity Ratio} = \frac{\text{Debt}}{\text{Equity}} \text{ or } \frac{\text{Long term loans}}{\text{Shareholders' funds}}$$

Illustration 18. **From the following calculate the Debt to Equity Ratio :**

	₹
10,000 Equity shares of ₹. 10 each	*1,00,000*
General Reserves	*45,000*
Accumulated Profit	*30,000*
Debentures	*75,000*
Sundry Trade Creditors	*40,000*
Outstanding Expenses	*10,000*

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Solution : Debt to Equity Ratio $= \dfrac{\text{Total Long term loans}}{\text{Shareholders' funds}} = \dfrac{₹\,75,000}{₹\,1,75,000}$

$= 3 : 7.$

Comment. Long term financial position of the company is sound, because total shareholders' funds are more than twice of long term loans.

Note. Shareholders' funds consist of capital, reserve and profit.

(ii) Total Assets to Debt Ratio

This ratio represents the relationship between Total Assets and Debt. Total Assets include all those assets which have been purchased from long term resources. **These assets do not include Fictitious Assets,** like, Preliminary Expenses, Underwriting Commission and Discount or loss on issue of shares and Debentures etc.

$$\textbf{Total Assets to Debt Ratio} = \frac{\text{Total Assets}}{\text{Long term Debts}}$$

Usefulness/Significance. The ratio is significant, because it informs the creditors that how far loans advanced by them are safe. It also provides knowledge regarding the protection provided by assets of the company to their debts. This ratio facilitates the lenders and investors to take a decision regarding grant of loans in future.

Note. The Standard Total Assets to Debt Ratio is 2 : 1.

Illustration 19. **Calculate Total Assets to Debt Ratio from the following information :**

Information : *Long term Debts ₹9,00,000, Short term Loans ₹5,00,000, Preliminary Expenses ₹2,35,000, Underwriting Commission ₹1,25,000, Loss on issue of Debentures ₹5,00,000, Sundry Assets ₹26,60,000.*

Solution : Total Assets to Debt Ratio $= \dfrac{\text{Total Assets}}{\text{Long term Debts}}$

$$= \frac{18,00,000}{9,00,000} = 2 : 1$$

Working Note : Total Assets = Sundry Assets – Preliminary Expenses
– Underwriting Commission
– Loss on issue of Debentures
= 26,60,000 – 2,35,000 – 1,25,000 – 5,00,000
= ₹ 18,00,000.

(iii) Proprietary Ratio

This ratio indicates the relationship between proprietors funds and total assets. The proprietor's funds include equity share capital, preference share capital, revenue, capital reserves and accumulated surplus. Total assets include fixed, current and fictitious assets.

Significance/Usefulness. This ratio is very important for the creditors, because they know the share of proprietors funds in the total assets and satisfy how far their loan is secured. The higher the ratio, the more safety will be to the creditors. The ratio also shows the general financial position of the company also. 50% is supposed to be the satisfactory proprietary ratio for the creditors. Lesser than 50% is the sign of risk for creditors. The following formula is used to calculate proprietary ratio :

$$\textbf{Proprietary Ratio} = \frac{\text{Proprietors' Funds}}{\text{Total Assets}}$$

Purpose of Proprietary Ratio

The purpose of this ratio is to calculate the consistency of proprietor's fund in the overall business profits. This is used to indicate the control of proprietors of the business.

Illustration 20. **Calculate proprietary ratio from the following information :**

	₹		₹
Equity share capital	*40,000*	*Fixed Assets*	*80,000*
Preference share capital	*30,000*	*Current Assets*	*30,000*
P/L A/c (Cr.)	*15,000*	*Goodwill*	*10,000*
Accumulated surplus	*5,000*		
Debentures	*10,000*		
Creditors	*10,000*		
B/P	*5,000*		
Outstanding expenses	*5,000*		
	1,20,000		*1,20,000*

$$\textbf{Solution : Proprietary Ratio} = \frac{\text{Proprietors' funds}}{\text{Total assets}} = \frac{90{,}000}{1{,}20{,}000}$$

= 3 : 4 or .75 times.

Comments. Creditor's loan is safe because proprietary ratio is .75 times as against the satisfactory ratio of 50% or .5 times.

5.6 FUNDS FLOW STATEMENT

Funds flow statement is a technical device designed to highlight the changes in the financial position of the business enterprise between two balance sheets. Funds Statement depicts the sources, wherefrom additional funds during the current year as compared to the previous year have been received and to what uses these funds have been applied.

The term, 'funds' as referred in 'the funds flow statement' means working capital which is the excess of current assets over the current liabilities. Current assets consist of cash in hand, cash at bank, B/R, debtors, stock, prepaid expenses, short term investments etc. and the current liabilities include creditors, B/P, bank over draft, outstanding expenses and short term loans. Working capital, known as 'Funds' here increases with the increase in current assets and decrease in current liabilities. In the same way, decrease in current assets and increase in current liabilities result in the decrease of working capital.

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Funds flow statement has two sides *i.e.*, inflow and outflow of funds. The left hand side shows the sources of inflow of funds and the right hand side shows outflow or uses or application of funds. As all the additional funds received during the year must be utilised somewhere, so the two sides are always equal.

The statement which is prepared to show the inflow (sources) and outflow (uses) of funds is termed as 'Funds flow Statement'. **This statement is also termed as :**

(*i*) Statement of sources and application of funds

(*ii*) Funds statement

(*iii*) Statement of changes in financial position

(*iv*) Statement of inflow and outflow of funds

(*v*) Statement of sources and uses of funds.

According to Mr. Robert N. Anthony. *"Funds flow statement describes the sources from which additional funds were derived and the uses to which these funds were applied."*

The specimen of the Funds Flow Statement, containing the items has been given as under :

Format of Funds Flow Statement

Sources	*Amount* ₹	*Application*	*Amount* ₹
1. Decrease in working capital 2. Funds from operation 3. Increase in capital or debentures or loans or mortgage 4. Decrease in the value or sale of fixed assets 5. Interest and dividend received.		1. Increase in working capital 2. Loss from operation 3. Decrease in capital or debentures or loan or Mortgage 4. Increase in the value or purchase of fixed assets 5. Payment of interest, dividend and taxes.	

Importance/Objective/Purposes of Funds Flow Statement

Funds flow statement is a tool of managing working capital. It reveals the inflow of additional funds during the current year as compared to the previous year and also the utilisation of funds. It is a supplement to the financial statements. It has also reliable information for determining future line of action. The purpose of preparing 'Funds Flow Statement' is mentioned below :

1. Effective Tool of Managing Working Capital. It is a technique to ascertain the funds received during the year and also a method to know the uses of these funds. Working capital, as we known is the excess of current assets over current liabilities. Here, in this chapter, the term working capital means funds. In this way, 'Funds Flow Statement' depicts inflow and outflow of working capital.

2. Knowledge of Change in the Working Capital. We can understand how much working capital has increased or decreased during the current year as compared to the previous year. We prepare schedule of changes in the working capital, which shows net increase or decrease in the working capital.

3. Knowledge of Funds From Operation. We are in a position to know the funds from operation. Income statement (Profit and Loss Account) shows net income or net profit, which is calculated after debiting both operating and non-operating expenses and also after crediting operating and non-operating income. Funds from operation avoids non-operating expenses and non-operating income. In this way, funds from operating or trading transactions is separately available for study and analysis.

4. Knowledge of Inflow of Funds. Sources side of the funds flow statement shows wherefrom and to what extent we have received funds from different sources. These sources may be :

(*i*) Funds from operation.

(*ii*) Decrease in working capital.

(*iii*) Increase in share capital, debentures and loans.

(*iv*) Sales of fixed assets.

(*v*) Amount received from dividends, interest etc.

By analysing the above receipts, we can understand the funds received from different sources. This will also reveal the funds received from current and non-current sources and we shall be able to plan our future operations in such a way that trading income should increase considerably.

5. Knowledge of Application of Funds. The outflow, uses or the application side of the funds flow statement shows the different purposes for which the funds have been used during the year. Funds may be utilised to meet :

(*i*) Losses from operation.

(*ii*) Increase in working capital.

(*iii*) Decrease in share capital, debentures loans and mortgages or their redemption.

(*iv*) Purchase of fixed assets.

(*v*) Payment of dividends, taxes etc.

The analysis of the above items will also show how much amount has been spent on the above heads separately.

6. Knowledge as to the Payment of Current Liabilities Out of Current Assets. It has been an accepted fact that all current liabilities must be paid out of current assets *i.e.,* current assets must be sufficient to meet current liabilities. In case current liabilities are paid out of non-current assets, it will be fatal to the business. As non-current assets can not be disposed off easily, so payment of current liabilities cannot be made. The business will have to suffer. It is also a wrong practice because disposal of non-current assets such as building, machinery, furniture etc. will mean that the firm cannot last long.

7. Knowledge as to the Purchase of Fixed Assets Out of Non-Current Source. Fixed assets must be purchased out of non-current sources *i.e., by* issue of shares or debentures or by long term loans. If fixed assets are purchased out of current sources the current assets will be exhausted and the payment of current liabilities will be difficult.

8. Knowledge of Supplementary Information. Funds Flow statement is prepared to supplement financial statements. As financial statements are incapable to tell exactly and precisely about funds from operation, changes in working capital, sources and application of funds, so funds flow statement is prepared to supply these information. These statements also show the financing and investing activities of the business.

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9. Helps Borrowings Operation. These days, banks and specialized financial institutions such as I.F.C., S.F.C and I.D.B.I. etc. have been asking the business firms to submit a copy of the funds flow statements with their application for loans. Lending institutions assess the credit worthiness of the institutions with these statements and decide whether loan should be granted or not, if granted then to what extent. The statement reveals the current sources and non-current sources of the business and enables them in making a decision regarding loans.

10. Acts as a Process of Budgeting. Funds flow statement reveals the plus and minus points in the management of working capital. The management plans and budgets its future activities in such a way that weakness should be removed and good points should be strengthened.

Changes in the Funds

All transactions do not result in the changes of funds. In other words every transaction does not result in the flow of funds. The following transactions affect funds of the business.

Transactions affecting flow of funds

It is not necessary that every transaction must make a change in the funds. Inflow or outflow of funds may not take place in all the transactions. Change of funds are involved in the following cases :

1. **Transactions Involving Current Assets and Fixed Assets.** All the transactions which change the balance of both the current and non-current category of assets change the funds. For example, purchase of furniture will reduce cash balance, a current asset and increase furniture, a non-current asset. This transaction will reduce funds. In the same way sale of plant will increase cash, a current asset and decrease value of plant, a non-current asset and the transaction will increase funds.

2. **Transactions Involving Current Assets and Non-Current Liability.** Any transaction, which changes both current assets and non-current liability will also change funds. For example, issue of shares and debentures will increase cash, a current assets and also increase share capital and debentures, non-current liability. This transaction will thus increase funds. In case of repayment of loan, cash will be reduced and loan will also be reduced and consequently funds will decrease.

3. **Transactions Involving Current Liability and Non-Current Liability.** Transactions of this type are uncommon. It may be conversion of creditors into long term loans or conversion of Bank overdraft into Bank loans. In both the cases creditors, a current liability is decreasing and being replaced by loans, a non-current liability. In this way, funds will be affected and change will take place. In case long term loans become due for payment during current year current liability will increase.

4. **Transactions Involving Current Liability and Non-Current Assets.** All transactions affecting current liabilities and non-current assets result in the change of funds. For example, purchase of furniture on credit will increase creditors, a current liability and also increase furniture a non-current asset and thus funds will change and decrease.

5. **Non-Trading Receipts.** All non-trading receipts like dividends and interest on *investment will change funds from operation, because funds will increase.* Cash as an current asset will increase the working capital.

To sum up, it should be noted that flow of funds will take place only when accounts of current and non-current categories are involved, whether it is current assets and non-current assets or current assets and non-current liability or current liability and non-current assets or current liability and non-current liability.

Transactions where flow of funds will not take place

(*i*) ***If Accounts Belong to Current Category Only.*** All those transactions which are between current assets and current liabilities do not cause flow of funds, such as payment to sundry creditors. This transaction will reduce both creditors, a current liability and cash, a current asset with the same amount, so flow of funds will not take place. Purchase of goods will increase stock, a current asset and decrease cash also a current asset with the same amount and cause no change in funds.

(*ii*) ***If Accounts Belong to Non-Current Category Only.*** Flow of funds will not take place, if accounts involved belong to non-current category only, such as issue of debentures to vendors against purchases of building. There will be no change in the funds with this transaction. Conversion of Debentures into Preference share capital will also not cause in funds, because one non-current liability is replaced by an other non-current liability and no cash passes.

Transactions resulting inflow, outflow and no change of funds (*Certain examples*)

Purchase of Typewriter for Office Use. The transaction involves typewriter, a non-current asset and cash a current asset. It will decrease cash balance, so outflow of funds will take place. It is further explained by the following journal entry :

Typewriter A/c Dr.
To Cash or Bank A/c

Issue of Shares in Exchange in Machine. Both the accounts involved, machines and share capital belong to non-current category. It does not result in any flow of funds, as no current asset is affected. Entry to be passed is as under :

Machinery A/c Dr.
To Share Capital A/c

Sale of Goods on Credit. It results in inflow of funds to the extent of the profit margin included or earned in it. Inflow in this case will be the excess of sale proceeds over the cost of goods sold. Entry to be passed is as under :

(*i*) Debtors A/c Dr.
To Sales A/c

(*ii*) Sales A/c Dr.
To Trading A/c (With profit margin)

Discounting a Pronote. *It does not result in any flow of funds because cash and* B/R A/c both belong to current category. Discount suffered is an expenses *involving* use of the funds. The funds will decrease with the amount of discount. The entry is as :

Cash A/c Dr.
Discount A/c Dr.
To P/Note or Bill Receivable A/c

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So, this discount is not to be added back to the profits earned while finding out *funds from business operations.*

Provision for Depreciation. *It does not involve any flow of funds.* The depreciation provided is an expenses or loss not involving any funds. Hence depreciation provided should be added back to the profits earned while finding out funds from operations.

Journal Entry to be Passed :

(*i*) Depreciation A/c Dr.
To Fixed Assets

(*ii*) P/L A/c Dr.
To Depreciation A/c
Or
P/L A/c Dr.
To Fixed Assets

As P/L A/c is non-current liability and Fixed Assets also non-current Assets, there will be neither inflow nor outflow of funds.

Short Term Loan Raised. No flow of funds is involved and neither inflow nor outflow will take place. The entry is :

Cash or Bank A/c Dr.
To Short term Loan A/c

Both the accounts are current accounts. Hence there will be no increase or decrease in net current assets.

5.7 SCHEDULE OF CHANGES IN WORKING CAPITAL

Funds flow statement is simply a statement, which shows the inflow and outflow of working capital, known as funds. During the current year working capital undergoes many changes, so it is always preferable to prepare a list of changes in the working capital *i.e.*, Current assets and current liabilities. The two constituent of working capital either increase or decrease during the current year as compared to the previous year. These changes are recorded at the increase (debit) side in case of increase in the current assets and decrease in the current liabilities. Decrease in current liability is recorded at the increase side which is virtually debit side because increase in liability is credited and decrease in the liability is debited. At the end of the year total of the increase and decrease side are matched and balance is determined. In case of excess of increase over the decrease, the balance is termed as Net increase of the working capital and the difference is put to the decrease side to make the totals of the two sides equal. The treatment is *vice versa* in case of excess of decrease side over the increase side.

List of current and non-current assets and liabilities have been mentioned here to facilitate their treatment.

Notes. (*i*) Provision for taxes and dividend or dividend payable may be treated as both current and non-current liabilities.

(*ii*) Any non-current liability payable within twelve months of the following (next) Accounting year should always be supposed as current liability.

(*iii*) If it is not mentioned in the question whether debtors are good or doubtful provision for bad and doubtful debts may be treated as both current or non-current liabilities. It is advised that students should write a note about their own treatment.

While preparing schedule of changes in the working capital, changes in current assets and current liabilities are studied to ascertain decrease or increase in working capital.

Working capital is the excess of current assets over the current liabilities. It can be put up in the form of formulas as under :

Working Capital = Current assets – Current liabilities
Current Assets = Current liabilities + Working capital
Current Liabilities = Current assets – Working capital.

On the basis of the above formula the effect of current assets and current liabilities on working capital can be summarised as under :

(*i*) Transactions affecting working capital

(*a*) Working capital increases with increase in current assets.

(*b*) Working capital decreases with the decrease in current assets.

(*c*) Working capital increases with the decrease in current liability.

(*d*) Working capital decreases with the increase in current liability.

(*ii*) Transactions not affecting working capital.

(*a*) An increase in current assets with the corresponding increase in current liability with the same amount.

(*b*) Decrease in current assets with the corresponding decrease in current liability with the same value.

Alternatively, the above discussion can be presented as the change in the working capital will take place, when interaction between current and non-current category of items takes place. In other words working capital will change if :

(*a*) There is no interaction between current and non-current assets such as purchasing or selling plant for cash.

(*b*) There is an interaction between current assets and non-current liability such as issue of shares or redemption of debentures.

(*c*) Current and non-current liabilities are involved in the transaction *i.e.*, change of long term loans into short term liability.

(*d*) Current liability and non-current assets are involved *i.e.*, purchase of furniture on credit.

There will not be any change in the working capital, if the transaction involves current assets and current liability *i.e.*, payment made to creditors. It will also not affect working capital if both items involved in the transaction belong to non-current assets and non-current liability, *i.e.*, issuing debentures against building etc.

The preparation of schedule can be explained with the help of following illustration :

Illustration 21. *From the following balance sheets,* **prepare a schedule of changes in the working capital.**

Particulars	*31st March*	
	2001	*2002*
Assets		
Cash in hand	*5,000*	*7,000*
Cash at Bank	*7,000*	*9,000*
Debtors or Book Debts	*12,000*	*11,000*
Stock or Inventory	*4,000*	*3,000*

Bills or Notes receivable	*2,000*	*1,500*
Prepaid or unexpired Expenses	*200*	*300*
Marketable securities or Short term or Temporary Investment	*5,000*	*8,000*
Accrued Interest on Interest receivable	*1,000*	*600*
Building/Premises/Leasehold building	*20,000*	*22,000*
Plant and Machinery	*9,000*	*6,000*
Furniture/Furniture and fixtures/fittings	*1,200*	*1,500*
	66,400	*69,900*
Liabilities		
Creditors or Accounts Payable	*8,000*	*6,000*
B/P or Notes Payable	*3,000*	*2,000*
Bank overdraft or Bank (credit)	*4,000*	*3,000*
Outstanding or owing expenses	*300*	*200*
Provision for bad debts/Allowances for bad debts	*500*	*700*
Capital/share capital	*20,000*	*20,000*
Loan/mortgage	*10,600*	*8,000*
Debentures	*20,000*	*30,000*
	66,400	*69,900*

Solution : **Schedule of Changes in the Working Capital**

Particulars	*Amount*		*Change in Working Capital*	
	31st March		*Increase (Debit)*	*Decrease (Credit)*
	2001 ₹	*2002* ₹	₹	₹
Current Assets :				
Cash	5,000	7,000	2,000	—
Debtors	12,000	11,000	—	1,000
Cash at Bank	7,000	9,000	2,000	—
Stock	4,000	3,000	—	1,000
B/R	2,000	1,500	—	500
Prepaid Expenses	200	300	100	—
Marketable securities	5,000	8,000	3,000	—
Accrued Interest	1,000	600	—	400
Total Current Assets	36,200	40,400		
Current Liabilities :				
Creditors	8,000	6,000	2,000	—
B/P	3,000	2,000	1,000	—
Bank Overdraft	4,000	3,000	1,000	—
Outstanding Expenses	300	200	100	—
Provision for Bad debts	500	700	—	200
Total Current Liabilities	15,800	11,900		
Working Capital (Current assets – Current liabilities)	20,400	28,500		
Net Increase in Working Capital	8,100	—		8,100
	28,500	28,500	11,200	11,200

Schedule of changes in working capital can also be prepared by two more columns of increase and decrease regarding non-current Assets and Liabilities. Working capital is the excess of current assets over current liabilities.

5.8 FUNDS FROM OPERATION

The 'funds' ordinarily means cash and wealth, but here in this unit it means cash in short term and working capital in long term. This is why, the term fund is used as 'cash' in cash flow statement and as 'working capital' in funds flow statement. The working capital is the excess of current assets over current liabilities. Current assets constitute of cash in hand, cash at bank, bills receivable, debtors, stock (inventory) prepaid expenses and short term investments. Current liabilities consist of creditors, B/P, bank overdraft, outstanding expenses, short term loans and provision. Generally, current assets are those assets which are disposable within a year. In the same way, current liabilities are to be repaid within a year. One more very important requirement for current liabilities is that it should preferably be paid out of current sources.

The term 'operation' means the day-to-day affairs of the business. It refers to those activities which are trading. Non-trading items, such as depreciation, loss on sale of assets, writing off of fictitious assets as goodwill, preliminary expenses, discount or loss on issue of shares and debentures are taken as non-operational. Non-trading gains *i.e.*, gain on sale of assets, refund of tax or receipt of compensation are not treated as operational.

Funds from operation is therefore as operating surplus. In other words, it may be calculated as :

Calculation of Funds from Operation :

Funds from operation will be calculated on the basis of information available on the following bases/approaches :

(*a*) **Backward Method**—Net Profit Approach

(*b*) **Forward Method**—Sales Approach

(*c*) **Capital Approach**

There are three approaches of calculating funds from operation. The choice of the approach depends upon the information given :

(*a*) ***Backward Method – Net Profit Approach (If Net Profit is Given)***

Net profit of the current year or excess of current year's profit over previous year.

(+) Non-Operating Expenses/Losses :

Depreciation/Amortisation
Loss on Sale of Assets
Discount on Issue of Shares or Debentures
Loss on Issue of Shares or Debentures
Premium on redemption of debentures
Goodwill written off/Decrease in the value of goodwill
Preliminary Expenses written off/Decrease in the value
Patents, trade marks and copy right written off/Decrease in value
Provision for taxes (If treated as non-current)
Reserves/General Reserve/Reserve fund/Retained earning/Contingency Reserve.
Dividends appropriated
Provision for doubtful debts (If debtors are supposed to be good)

(–) Non-Operating Income :

Gain or Profit on Sale of Assets
Refund of Taxes

NOTES

Receipt of Dividend
Interest received on Investments
Excess depreciation charged
Compensation received
Increase in the value of goodwill and patents. (It may alternatively be shown as application of fund).
(*a*) Profit on revaluation of assets
(*b*) Transfer fee
(*c*) Provision for Bad and doubtful debts (If debtors are declared good).

Alternatively, it may also be determined by preparing P/L A/c with operating expenses and operating income only. Non-operating expenses and income are excluded.

Adjusted P/L Account

To Operating Expenses	By Gross Profit
" Funds from Operation (Balancing Figure)	" *Operating or Trading Income*

Funds from operation shows the operational efficiency of the business. It avoids non operating expenses and gains. It takes into consideration only those income and expenditure which are trading or operating and belong to the current year. It will be advisable to prepare. Adjusted profit and loss A/c in complicated questions with additional information. The specimen of the account is as under :

Proforma of Adjusted P/L A/c

To Balance b/d (If opening balance is Loss)	By Balance B/d (Opening Balance of Profit)
To Depreciation	" Gain or profit on sale of Assets
" Loss on sale of assets	" Refund of taxes
" Discount on issue of shares and debentures	" Compensation received
" Loss on issue of shares and debentures	" Dividends received
" Premium on redemption of debentures	" Increase in the value of goodwill, patents and trade mark (It may alternatively be shown as application of funds)
" Goodwill written off/Decrease in value	" Profit on Revaluation of Assets
" Preliminary expenses written off/Decrease in value	" Transfer fees
" Underwriting Commission written off/Decrease	" Provision for Bad and Doubtful debts **(If debtors are declared good)**
" Provision for taxes made during the year	" Excess depreciation A/c
" Dividends or interim dividend declared (for current year)	" Balance c/d (Closing balance of loss)
" Reserves maintained	" *Funds from operation (Balancing Figure)*
" Provision for doubtful debts (If debtors are good)	
" Balance c/d (if closing balance of profit)	
" Loss from operation *(Balancing Figure if any)*	

It should be noted that in case of given comparative balance sheets net income for calculation of funds from operation will mean the excess of current year's profit over previous year's profit. *If current year's profit is lesser than the previous year's profit* the difference should be denoted as minus. The profit may be expressed by P/L A/c or P/L Appropriation A/c or retained earnings A/c. In case of general reserve and depreciation fund, excess of the current year's figure over the previous year's figure is added to the net income as non-operating charges. *Goodwill and Preliminary expenses may be written* off in certain years. Their amount of the current year is generally lesser than the previous year, so the shortage is supposed to be charged out of the P/L A/c during current year and thus added to net income to calculate funds from operation. We can also prepare all these accounts and transfer the balancing figure to P/L A/c. *Provision for taxes and*

dividend will be shown in the adjusted profit and loss A/c, if they are not treated as current liability.

5.9 NON-OPERATING EXPENSES/NON FUND CHARGES

NOTES

These expenses are not related to day to day affairs of the business. This is why, these expenses are also termed as non-trading expenses. In the terminology of statement of changes in the financial position, it may be treated as **non-fund item.** These expenses are charged from Profit and Loss Account, so they reduce our net profit. Non-operating expenses are not concerned with current assets and current liabilities, so working capital remains unaffected and outflow of funds does not take place. In order to ascertain the funds from operation, these non-fund charges are added. Non-operating expenses consist of the following items :

1. **Depreciation.** Depreciation is actually operating expense, because normal wear and tear in the assets is common and regular feature, but it is treated here as non-operating expenses because it is non-cash item *i.e.,* it reduces the net profit but cash does not pass for it. As we have not introduced non-cash term here in this unit, so it has been discussed under non-operational expenses. It is not a source of funds. Source of funds is constituted by those transactions, where one account belongs to current category and the other belongs to non-current category. In case of depreciation both items belong to non-current category, as such it does not make any change in the funds and is not a source of funds. In support of the answer journal entry regarding depreciation is presented herewith :

(*i*) Depreciation A/c Dr.
To Fixed Assets A/c

(*ii*) P/L A/c Dr.
To Depreciation A/c

Or

P/L A/c Dr.
To Fixed Assets A/c

P/L A/c is non-current liability and fixed assets are non-current assets. As both of them belong to non-current category, so depreciation is not a source of funds.

While calculating funds from operation from given net profit, depreciation will be added. While preparing adjusted Profit and Loss Account, it will be written at the debit side to find out funds from operation.

2. **Goodwill, Patent Rights and Trade Mark Written Off.** Intangible assets such as goodwill, patents rights and trade mark do not have real value, so they have to be written off at the earliest. These assets are written off against profit. In other words, they are placed at the debit side of Profit and Loss Account, whenever, they are written off. As a result of this treatment net profit reduces. These items do not involve working capital (funds) because both the accounts in the transaction are non-current. Items involved are profit and loss account and goodwill, both non-current items. It means that outflow of the funds will not take place. Thus goodwill, patents and trade marks appearing at the debit side of the profit and loss account or given in the additional information as written off are to be added to profit in order to ascertain funds from operation. In case of preparing adjusted Profit and Loss Account, these items will be posted at the debit side to find out funds from operation.

3. **Loss on Sale of Assets.** Loss on sale of fixed assets, such as plant and machinery, furniture, tools and long term investment in non-trading loss. It is posted at the debit side of P/L A/c, so net profit of the business is reduced. The transaction involves P/L A/c and fixed assets, both non-current items, so funds are not generated. The item will be added to net profit for the calculation of funds from operation.

4. **Preliminary Expenses and Discount or Loss on Issue of Shares or Debentures, Premium on Redemption of Debentures.** It is deferred revenue expenditure, *i.e.*, revenue expenditure capitalised for the time being. These assets do not have real value, so they have to be written off at the earliest. In case of writing off these expenses P/L is debited and net profit is reduced. Outflow of funds does not take place, because current assets or current liabilities are not involved in the transaction. While calculating funds from operation, these deferred revenue expenditures, are added to net profit.

5. **Appropriation of Profits.** Certain revenues and funds are maintained to meet known or unknown liabilities. These items are reserve, general reserve, reserve fund, sinking fund, dividend equalisation fund, workmen compensation fund etc. These funds are charged from P/L A/c, so the net profit is reduced. These items are not trading charges. Moreover, working capital also remains unchanged because both the items belong to non-current categories. Accounts involved are P/L A/c and reserve and funds. In order to calculate funds from operation these reserves and appropriation of profit are to be added. Dividend debited to P/L A/c and also added.

6. **Provision for Bad and Doubtful Debts (If Debtors are Good).** In case of debtors are good, full amount due will be collected from them and there will be no bad debts. As such the provision for bad and doubtful debts is no longer liability. It should be added to net profit or shown at the debit side of P/L A/c for the calculation of funds from operation.

5.10 NON-OPERATING INCOME

There are certain incomes, which either do not change working capital (funds) or do not concern trading income. These items are known as non-fund incomes. Funds do not increase with these items, whereas net profit is increased. In order to calculate funds from operation, these items are deducted. Non-operating income includes the following incomes :

1. **Profit or Gain on Sale of Fixed Assets.** This item is posted at the credit side of P/L A/c. It increases profit. This items is not a trading gain, because most of the firms do not deal in property. It may be trading income for property dealers. It has to be deducted from net profit in order to calculate funds from operation.

2. **Dividend and Interest Received or Receivable.** The firm may invest in debentures, shares and other securities and receive dividend or interest. It will, no doubt increase cash and net profit also. Generally, it is not operating (trading) income because the dividend and interest do not seem to have been earned out of routine activities of the business. If these items appear at the credit side of P/L A/c, they will be deducted from the net profit or posted at the credit side of the adjusted P/L A/c in order to calculate funds from operation.

3. **Retransfer of Excess Provision for Taxes, Depreciation and Doubtful Debts.** Excess provision for these accounts are posted at the credit side of P/L A/c. The net profit thus increases. It is not an operating income, so it should be deducted from the net profit or posted at the credit side of adjusted P/L A/c in order to calculation funds from operation.

4. **Appreciation in the Value of Assets.** Increase in the value of assets is posted at the credit side of P/L A/c. The net profit is increased. It is not operating income, so it should be deducted from net profit for the calculation of funds from operation.

5. **Compensation Received.** Sometimes the Govt. may acquire a part of the land and building of the firm in the public interest and pay certain amount as compensation. This amount will increase cash. It will also increase net profit, because it will be posted at the credit side of P/L A/c. It is not operating income earned through trading activities, so it will be deducted from net profit for the calculation of funds from operation.

6. **Excess Depreciation Charged.** If it is informed that excess depreciation has been charged previously or the credit side of Accumulated Depreciation A/c exceeds the debit side, the excess will be assumed to be excess depreciation. Normal depreciation is an item of the debit side of P/L A/c and added back to Net Profit to ascertain funds from operation. Excess depreciation is gain, so it appears at the credit side of Profit & Loss A/c. It is undoubtedly a non-operating income, so deducted from Net Profit to calculate funds from operation.

In case of adjustments regarding depreciation and sale of fixed assets and the balances of Accumulated depreciation given, the excess of Credit side over the debit side of accumulated depreciation A/c should be assumed to be depreciation on the fixed assets sold and transferred to the credit side of fixed assets to arrive at the purchase/sale of fixed assets.

Illustration 22. **Calculate funds from operation from the following profit and loss account :**

Profit and Loss Account

Particulars	₹	*Particulars*	₹
To Expenses paid and outstanding	*6,000*	*By Gross Profit*	*9,000*
" Depreciation	*1,400*	*" Gain on sale of land*	*1,200*
" Loss on sale of machine	*80*		
" Discount	*4*		
" Goodwill	*400*		
" Net Profit	*2,316*		
	10,200		*10,200*

Solution : Calculation of Funds from Operation

		₹
Net Profit		2,316
(+) Non-operating expenses :		
Depreciation	1,400	
Loss on sale of machine	80	
Goodwill	400	
		1,880
		4,196
(–) Non-operating income :		
Gain on sale of land		(–) 1,200
Funds from operation		2,996

Alternatively :

Adjusted Profit and Loss Account

	₹		₹
To Expenses paid and outstanding	6,000	By Gross Profit	9,000
" Discount	4		
" Funds from operation	2,996		
	9,000		9,000

Note. In the alternative method only operating expenses and income have been shown, whereas in a first method non-operating expenses which were debited to P/L A/c to ascertain net profit have been added and in the same way, non-operating income has been deducted. The purpose here is the same to determine funds from operation on the basis of operating expenses and income.

Discount has been supposed to be discount allowed to customers, as such it is an operating expense.

NOTES

5.11 SOURCES OF FUNDS

The firm in its routine activities earns certain funds *i.e.*, working capital. Funds are generated in the business through increase in working capital. Excess of current assets over current liabilities is working capital. It increases with the increase in current assets and decrease in current liabilities. In the same way, working capital decreases with the decrease in current assets and increase in current liabilities. Following items are the source of funds for the business :

1. **Decrease in Working Capital.** Decrease in working capital is the result of decrease in current asset or increase in current liabilities. In both the cases inflow of funds takes place. Suppose stock, a current asset reduces from ₹ 15,000 to ₹ 12,000, the decrease of ₹ 3,000 is assumed to be due to the disposal of stock which undoubtedly brings funds into the business. In the same way, increase in current liabilities means lesser payment, so retaining funds is also a source.

2. **Funds from Operation.** Business activities may result in profit. We calculate funds from operation by adding non-operating expenses and deducting non-operating income from net profit. Funds from operation is a source, because we receive funds from it.

3. **Issue of Shares and Debentures.** The Company issues shares and debentures to meet its financial requirements. These shares and debentures are subscribed for by the public and the funds are received. It is a source and thus recorded at the source side of funds flow statement. Increase in the value of shares and debentures is also assumed as their issue and thus it is source.

4. **Sale of Fixed Assets.** Amount received, from the sale of fixed assets, such as land, building, plant, machinery, tools equipments, vehicles and furniture etc. is source because funds received increases working capital. It involves cash, a current asset and fixed assets, the non-current assets, so the inflow of funds will take place.

5. **Increase in Loans and Mortgage.** The firm may borrow funds as loans and mortgages. It will bring cash, a current asset into the business and thus the working capital will increase. Increase in the balance of loans and mortgage during the current year also means borrowing additional funds which is source, an inflow of funds.

6. **Dividends and Interest Received.** Cash received from dividend and interest on investments made outside the business is source. Amount received will result in an inflow of funds. Thus, it will be written at the sources side of funds flow statement.

5.12 APPLICATION OF FUNDS

Funds received by the business are applied (used) in one way or the other. The funds may be applied for redemption of loans, debentures and mortgage. They may also be used for purchasing additional assets, goods, raw material or even making payment of expenses. Sometimes they are lost in the business operation, hence loss from operation is supposed to be application of funds.

'Application' means outflow or use of funds during the current year. The funds obtained during the year are put to different uses. These application funds may be in the following forms :

1. **Loss from operation.** The funds received may be lost, if there is a loss or business operations have been unsatisfactory. The loss suffered must be operating. In other words, loss from operation reduces funds and thus results in outflow of funds.

2. **Increase in the value or purchase of fixed assets.** Increase in the value of assets is supposed to be due to addition (purchase) of assets and the funds will undoubtedly be paid for acquiring them, hence it is an application.

3. **Repayment or Decrease in Share Capital, Debentures and Loans.** Decrease in share capital means redemption of preference share capital. In the same way, debentures will also decrease, if they are redeemed. Loans also decrease with their repayment. Funds are exhausted in all these payments and as such they are said to have been utilised and hence it is an application of funds.

4. **Increase in Working Capital.** Working capital is increased, if current assets increase and current liabilities decreases. Funds are required in both the cases *i.e.*, in order to acquire more current assets or paying current liabilities and thus funds are said to have been applied or used.

5. **Amount Withdrawn by the Proprietor.** Outflow of funds will also take place, if funds are withdrawn by the proprietors for their personal and private use. The business will have to pay certain amount. Cash with the business will reduce. It is therefore an application of funds.

6. **Payment of Dividends and Taxes.** Outflow of funds will also take place, if dividends and taxes are paid. As the funds are utilised for the redemption it is said to be application of funds. Declaration of dividend is not application of funds. Proposed dividends of the previous year are supposed to be paid during the current year, if it is not treated as current liability. The various items of sources and application are listed below :

Proforma of Funds Flow Statement

Sources of Funds	*Amount* ₹	*Application of Funds*	*Amount* ₹
1. Decrease in working Capital		1. Increase in working capital	
2. Funds from operation		2. Loss from operation	
3. Issue of shares and debentures		3. Redemption of shares and debentures	
4. Increase in share capital, securities premium, debentures, loans and mortgage		4. Decrease in share capital, securities premium, debentures, loans and mortgage	
5. Sale of fixed assets		5. Purchases of fixed assets	
6. Decrease in fixed assets		6. Increase in fixed assets	
7. Dividends received		7. Payment of taxes	
8. Interest received		8. Payment of dividend	
9. Donation, gifts and compensation received		9. Amount withdrawn by proprietors	

All the funds received form different sources are utilised in one way or the other, so the sources and application are always equal.

Illustration 23. *From the following Balance Sheet of Bharat Company prepare :*

(i) Statement showing changes in working capital.

(ii) Funds flow statement for 2001-2002.

NOTES

Balance Sheet

Particulars	*31st March, 2002 ₹*	*31st March, 2001 ₹*
Assets :		
Goodwill	*5,000*	*10,000*
Cash	*70,000*	*25,000*
Debtors	*90,000*	*98,000*
Closing stock	*1,20,000*	*87,000*
Long term investments	*10,000*	*15,000*
Land	*27,000*	*15,000*
Preliminary expenses	*3,000*	*5,000*
	3,25,000	*2,55,000*
Liabilities :		
Trade Creditors	*45,000*	*50,000*
Bills Payable	*35,000*	*20,000*
Loans payable (during June 2003)	*20,000*	—
Share Capital	*1,50,000*	*1,25,000*
Profit and Loss A/c	*75,000*	*60,000*
	3,25,000	*2,55,000*

Solution : (*i*) **Schedule of changes in Working Capital**

Particulars	*Amount ₹*		*Changes in Working Capital*	
	March 31 2001	*March 31 2002*	*Increase (Debit)*	*Decrease (Credit)*
Current Assets :				
Cash	25,000	70,000	45,000	—
Debtors	98,000	90,000	—	8,000
Closing Stock	87,000	1,20,000	33,000	—
	2,10,000	2,80,000		
Current Liabilities :				
Trade creditors	50,000	45,000	5,000	—
Bills Payable	20,000	35,000	—	15,000
	70,000	80,000		
Working Capital	1,40,000	2,00,000		
Increase in working Capital	60,000	—	—	60,000
	2,00,000	2,00,000	83,000	83,000

(*ii*) **Funds Flow Statement**

as on 31st March, 2002

Sources of Funds	₹	*Application of Funds*	₹
Funds from operation	22,000	Increase in working capital	60,000
Sale of investments	5,000	Land purchase	12,000
Issue of share capital	25,000		
Increase in loans payable	20,000		
	72,000		72,000

> **Notes.** 1. Working capital is the excess of current assets over the current liabilities of the year.
> 2. Loans payable within 12 months of the closing date of the current accounting period are supposed to be current liability so here, we have not treated loans payable as current liability.

Calculation of Funds from Operation

Preliminary Expenses A/c

To Balance b/d	5,000	By P/L A/c (*Balancing Figure*)	2,000
		By Balance c/d	3,000
	5,000		5,000

Adjusted P/L A/c

To Preliminary Exp.	2,000	By Balance b/d	60,000
To Goodwill	5,000	By Funds from operation (*Balancing Figure*)	22,000
To Balance c/d	75,000		
	82,000		82,000

Working Notes

Funds from Operation (*Alternative Method*)

Excess of Current year's profit (75,000 – 60,000)	15,000
+ Goodwill written off (10,000 – 5,000)	+ 5,000
+ Preliminary Expenses written off (5,000 – 3,000)	+ 2,000
	22,000

> **Note.** Any non-current liability payable within 12 months of the following Accounting year is treated as current liability and shown in the schedule.

In the present question loan has been treated as non-current liability, because it has to be paid during next year or the following year. The following Accounting year in this question falls between April 1, 2002 March 31, 2003 whereas the loan has to be paid during June, 2003.

5.13 TREATMENT OF ADJUSTMENTS OR ADDITIONAL INFORMATION

1. **Additional Information or Adjustment.** These information are available at the end of accounting period, so their double entry record has not been made so far. It is, therefore, necessary that double entry record of these adjustments be made. After completing two journal entries regarding every adjustment necessary posting in the concerned ledger accounts are made. The preparation of required ledger accounts will help us in digging out certain hidden or missing information.

NOTES

5.14 PREPARATION OF FIXED ASSETS A/C

In case of Funds Flow Statement certain information, such as assets purchased during the year, assets sold during the year or depreciation charged during the year are hidden. As such it is necessary that we should prepare assets A/c to dig out the missing information.

Fixed Assets A/c

To Balance b/d (Opening balance of assets A/c—*Generally given*)	*By Bank (With the amount received from sale of Asset—*May be given*)
To P/L A/c (Profit on sale of assets)	By P/L A/c (Loss on Sale of Assets)
*To Bank (Assets purchased during the year— *May be a balancing figure*)	*By Depreciation A/c (*May be given*)
	" Balance c/d (*Generally given*)

Explanation. Generally opening balance and closing balance of assets are given. Out of the remaining items (marked *) two items will be given and the third will be the balancing figure. Assets purchased during the year will be shown as application. Assets sold will be source and Depreciation charged during the year will be written at the debit side of profit and loss A/c to ascertain funds from operation.

In certain cases, the opening and closing balances of the provision for depreciation A/c against the asset are given in the additional information. The opening and closing balances of the particular asset A/c are also given in the Balance Sheet. As we know that assets accounts are prepared on the basis of Historical Cost, it is therefore, necessary that the opening balance of the asset should be ascertained by adding the opening balance of asset in the balance sheet and the opening balance of provision for depreciation A/c against asset mentioned in the additional information. In the same way, closing balance of the asset A/c will also be ascertained.

Example : The opening and closing balance of machinery in the balance sheet is given as ₹ 90,000 and 60,000 respectively. The provision for depreciation against machinery in the beginning of the year amounted to ₹ 30,000 and at the close of the year amounted to 40,000 as mentioned in the additional information.

While attempting the solution of the problem we shall be required to prepare Machinery A/c and Provision for depreciation A/c.

While Preparing Machinery A/c the opening balance will be assumed to be the total of the opening balance of machine given in the Balance Sheet plus opening balance of the provision for depreciation A/c *i.e.,* 90,000 + 30,000 = 1,20,000. In the same way, closing balance will amount to ₹ 60,000 + 40,000 = 1,00,000.

Provision for depreciation A/c will be prepared as usual with its exclusive opening and closing balance. The balancing figure of this account will be transferred to P/L A/c for ascertaining funds from operation.

Note. For further explanation refer illustration 17.

Illustration 24. **Prepare Furniture A/c from the following information :**

Balance of furniture as on April 1, 2002 ₹ 18,000 and on 31st March 2003 was ₹ 25,000. During the year a piece of furniture whose original cost was ₹ 3,000 (accumulated depreciation thereon ₹ 1,000) was sold for ₹ 1,500. Depreciation on furniture during the year amounted to ₹ 3,000. Find out the amount of furniture purchased during the year.

Solution : **Furniture A/c**

Particulars	₹	*Particular*	₹
To Balance b/d	18,000	By Depreciation A/c	3,000
" Bank (*Furniture Purchased—Balancing Figure*)	12,000	" Bank A/c	1,500
		" P/L (Loss on sale)	500
		" Balance c/d	25,000
	30,000		30,000

Explanation. We have been given information regarding depreciation, sale and opening and closing balance of furniture, so the excess of the credit side of the furniture A/c over its debit side will be supposed to be purchase of furniture.

Illustration 25. *The balance of machine as on April 1, 2003 was ₹ 20,000 and on March 31, 2004 was ₹ 28,000. During the year machine worth ₹ 18,000 was purchased. A piece of machine costing ₹ 5,000 was sold for ₹ 8,000.* **Calculate the amount of depreciation provided during the year.**

Solution : **Machinery A/c**

Particulars	₹	*Particulars*	₹
To Balance b/d	20,000	By Bank A/c	8,000
" Bank A/c	18,000	" Depreciation A/c (*Balancing Figure*)	5,000
" P/L A/c (Profit on sale of machinery)	3,000		
		" Balance c/d	28,000
	41,000		41,000

5.15 PREPARATION OF LIABILITIES ACCOUNT

Liabilities have always credit balance because according to rule of debit and credit regarding the Liabilities A/c, increase in liabilities are credited and Decrease in liabilities are debited. This is why, opening balance of liabilities is shown at its credit side as By balance b/d. The closing balance of liabilities will be shown at its debit side as To balance c/d. There are two possible adjustments regarding liabilities (*i*) Liabilities paid during the year (*ii*) Provision for payment of liabilities. In case of Capital A/c these items are called as Drawing and profit earned during the year. Out of the four items *i.e.*, opening balances, closing balances, provision for liabilities and payment of liabilities, three items are given and fourth is the balancing figure.

NOTES

In certain cases payment for liabilities is made more than its book value such as premium on redemption of debentures. Excess payment is loss and it will be shown at the debit side of P/L A/c. If payment for liabilities is made lesser than its book value, short payment shows gain, which will be shown at the credit side of P/L A/c.

The preparation of liabilities Account such as Capital Accounts, Provision for taxes Account and Proposed dividend Accounts have been discussed in the following pages.

Certain important adjustments are discussed herewith :

Additional Information

(*a*) Loss on sale of plant ₹ 2,500.

(*b*) Depreciation on furniture ₹ 700.

(*c*) Net profit earned during the year ₹ 45,000.

(*d*) Drawings by the proprietor ₹ 13,000.

(*e*) Machinery, whose book value was ₹ 12,000, accumulated depreciation being ₹ 7,000 was sold for ₹ 3,000.

(*f*) Debentures of ₹ 1,00,000 were redeemed at a premium of 5%.

Treatment of Adjustments or Additional Information. It will be advisable to pass journal entries regarding adjustments, so that its treatment can be easily understood and made. It should also be noted that adjustments are recorded at two places, because they have not yet gone through double entry records. The relevant accounts concerning additional information should be made to ascertain missing information.

(*a*) **Loss on Sale of Plant ₹ 2,500.** The requisite journal entry for this adjustment will be made as under :

(*i*) Loss on Sale of Plant A/c	Dr.	2,500	
To Plant A/c			2,500
(*ii*) P/L A/c	Dr.	2,500	
To Loss on Sale of Plant			2,500

In this case, Plant A/c will be prepared. Loss on sale of plant will be posted to its credit side. The balancing figure of plant account may be either purchase or sale. It will also be written at the debit side of P/L account and thus increase funds from operation. The ultimate effect of this transaction will be an increase of ₹ 2,500 at both the sources and application side of Funds Flow Statement.

(*b*) **Depreciation on Furniture Amounting to ₹ 700.** The requisite journal entry will be made as under :

(*i*) Depreciation A/c	Dr.	700	
To Furniture A/c			700
(*ii*) P/L A/c	Dr.	700	
To Depreciation A/c			700

With the help of above journal entry posting of depreciation account will be made at the credit side of furniture account which will show purchase or sale of furniture as balancing figure and will be shown at the application or sources side. Depreciation account will also be posted at the debit side of adjusted P/L account and thus increase

funds from operation as balancing figure. The net result will be an increase at both the sources and applications side of Funds Flow Statement.

(*c*) **Net Profit Earned During the Year ₹ 45,000.** Though the common practice is to show the net profit in the name of P/L account or P/L appropriation A/c in the comparative balance sheets. The excess of current year's profit over the previous year's profit is treated as funds from operation.

In case additional information regarding net profit is given, it is advisable to pass the following two journal entries :

Adjusted P/L A/c	Dr.	45,000	
To Net Profit or P/L A/c			45,000
Net Profit or P/L A/c	Dr.	45,000	
To Capital A/c			45,000

In this case capital account should be prepared to ascertain the amount withdrawn by proprietors. As the opening and closing balance of capital account are given, profit earned will also be transferred to the credit side of capital account. The balancing figure at the debit side will be the amount withdrawn. The specimen of the capital account is given as under :

5.16 PREPARATION OF CAPITAL ACCOUNT

Capital Account

To Bank (Amount withdrawn—*Balancing figure*)	25,000	By Balance b/d (opening balance given)	1,00,000
" Balance c/d (given)	1,20,000	" P/L A/c (Net Profit given)	45,000
	1,45,000		1,45,000

Profit earned is also a part of the funds from operation. The net profit will be added to capital account or posted at the credit side of capital account to determine amount withdrawn and added to funds from operation.

(*d*) **Drawings by the Proprietor ₹ 13,000.** The amount drawn by the proprietor is the use of funds and as such it will be shown at the application side of Funds Flow Statement. The requisite journal entry to be passed as under :

Proprietors' Capital A/c	Dr.	13,000	
To Bank A/c			13,000

Drawings will be posted to the debit side of the capital account and profit earned will be the balancing figure of the capital account. The form of capital account in this case will be :

Proprietor's Capital A/c

To Bank A/c (Drawings)	13,000	By Balance b/d (Opening Balance—given) 1,00,000 (given)	
" Balance c/d (Closing Balance—given)	1,20,000	" Profit and Loss A/c (Profit earned—*Balancing figure*)	33,000
	1,33,000		1,33,000

NOTES

The above account shows taxes provided during the year as balancing figure. It will be written at the debit side of adjusted profit and loss account to ascertain funds from operation. Taxes paid will be shown at the application side.

Note. If there is no adjustment regarding provision for taxes, it will be convenient to treat, it as current liability and show in the schedule of changes in working capital. In case there is certain adjustment, it will be advisable to prepare provision for taxation account, so that taxes paid or taxes provided during the year, whichever is not given may be ascertained. It is suggested that it should be treated as non-current, unless it is placed under the heading of current liability.

5.18 TREATMENT OF PROPOSED DIVIDEND

It may also be treated as both current and non-current liability. In case of its treatment as current liability, this item will be shown in the schedule. The excess of current year's proposed dividend over the previous year is written at the decrease or credit column of the schedule. In the same way, if current year's proposed dividend is lesser than the previous year's dividend, the shortage is written at the increase or the debit side of schedule. It will be convenient to treat it as non-current liability, if certain additional information or adjustments are given.

While treating proposed dividend as non-current liability, it is not shown in the schedule. Previous year's proposed dividend is supposed to have been paid during the current year, so it is shown at the application side. The current year's proposed dividend is supposed to have been charged out of current year's profit and loss account, as such it is added to Net profit to calculate funds from operation.

Adjustments Regarding Proposed Dividend

(*i*) **Dividend Paid During the Current Year.** In case of additional information regarding dividend paid, it is advisable to prepare proposed dividend account to ascertain dividend charged out of profit and loss account during the year. This account is prepared as under :

Proposed Dividend A/c

To Bank A/c (Dividend paid—given)	7,000	By Balance b/d (Opening Balance—given)	10,000
" Balance c/d (Closing Balance—given)	8,000	" P/L A/c (Dividend charged during the year—*Balancing Figure*)	5,000
	15,000		15,000

In the Funds Flow Statement, dividend paid amounting to 7,000 will be shown at the application side, because of payment during the year. ₹ 5,000 being the dividend charged during the year will be written at the debit side of adjusted profit and loss account to ascertain funds from operation or it will be added to the net income to ascertain funds from operation.

(*ii*) **Dividends Charged During the Year.** In case dividends charged during the year is given in the additional information, proposed dividend account should be prepared as above. This account will show the amount of dividends paid during the year as balancing figure. Dividends paid during the year will be shown at the application side. Dividends charged will be shown at the debit side of Adjusted Profit and Loss account or added to net income to calculate funds from operation.

NOTES

Illustration 26. *The Balance Sheets of B Ltd. as on March 31, 2002 and March 31, 2003 were as follows :*

Assets	*March 31, 2002* ₹	*March 31, 2003* ₹
Land and Buildings	*80,000*	*1,20,000*
Plant and Machinery	*5,00,000*	*8,00,000*
Stock	*1,00,000*	*75,000*
Sundry Debtors	*1,50,000*	*1,60,000*
Cash	*20,000*	*20,000*
	8,50,000	*11,75,000*
Liabilities and Capital		
Share Capital	*5,00,000*	*7,00,000*
Profit and Loss Account	*1,00,000*	*1,60,000*
General Reserve	*50,000*	*70,000*
Sundry Creditors	*1,53,000*	*1,90,000*
Bills Payable	*40,000*	*50,000*
Loan (Payable-January 2004)	*7,000*	*5,000*
	8,50,000	*11,75,000*

Additional Information :

(i) Rs. 50,000 depreciation has been charged to Plant and Machinery during the year 2003.

(ii) A piece of machinery was sold for ₹ 8,000 during 2003. It had cost ₹ 12,000, depreciation of ₹ 7,000 has been provided on it.

Prepare a schedule of changes in the working capital and a statement of funds Flow.

Solution : Schedule of Changes in Working Capital

Particulars	*Amount* ₹		*Effects on Working Capital*	
	March 2002	*March 2003*	*Increase (Debit)* ₹	*Decrease (Credit)* ₹
Current Assets :				
Stock	1,00,000	75,000	—	25,000
Debtors	1,50,000	1,60,000	10,000	—
Cash	20,000	20,000	—	—
Current Liabilities :				
Creditors	1,53,000	1,90,000	—	37,000
Bills Payable	40,000	50,000	—	10,000
Loan Payable	7,000	5,000	2,000	—
Decrease in Working Capital			60,000	—
			72,000	72,000

NOTES

Funds Flow Statement for the Year Ending 31st March, 2003

Sources of Funds	₹	*Application of Funds*	₹
Funds from operation	1,27,000	Purchase of Land and Buildings	40,000
Issue of Share Capital	2,00,000	Purchase of Plant and Machinery	3,55,000
Sale of Plant and Machinery	8,000		
Decrease in Working Capital	60,000		
	3,95,000		3,95,000

Working Notes :

1. **Adjusted Profit and Loss Account**

	₹		₹
To General Reserves	20,000	By Balances b/d	1,00,000
" Depreciation on Plant and Machinery	50,000	" Profit on sale of Plant and Machinery	3,000
" Balance c/d	1,60,000	" Funds from operations	1,27,000
	2,30,000		2,30,000

2. **Plant and Machinery Account**

	₹		₹
To Balance b/d	5,00,000	By Depreciation A/c	50,000
" Adjusted Profit and Loss A/c (Profit on sale of Mach.)	3,000	" Bank A/c (Sale of Machinery)	8,000
" Bank (Purchases) (Balancing figure)	3,55,000	" Balance c/d	8,00,000
	8,58,000		8,58,000

3. Loan has been treated as current liability, because it has to be paid during January, 2004, the month, which falls in the following accounting year *i.e.*, April 1, 2003 to March 31, 2004.

Illustration 27. *From the following Balance Sheets* **prepare (*i*) Statement of changes in the working capital (*ii*) Plant Account and (*iii*) Funds Flow Statement.**

Liabilities	*2002* ₹	*2003* ₹	*Assets*	*2002* ₹	*2003* ₹
Share Capital			***Non-Current Assets***		
Equity Capital	*10,00,000*	*10,00,000*	*Plant*	*6,80,000*	*6,00,000*
Preference Capital	*4,00,000*	—	*Building*	*5,00,000*	*5,00,000*
P/L A/c	—	*5,00,000*	*Profit and Loss A/c*	*1,20,000*	—
Non-current Liabilities			***Current Assets***		
18% Debentures	—	*2,00,000*	*Debtors*	*2,20,000*	*6,30,000*
Current Liabilities			*Stock*	*1,06,000*	*3,00,000*
Creditors	*1,40,000*	*1,80,000*	*Cash*	*70,000*	*40,000*
Provision for Doubtful debts	*20,000*	*30,000*			
Proposed dividend	*1,00,000*	*1,20,000*			
Provision for taxation	*36,000*	*40,000*			
	16,96,000	*20,70,000*		*16,96,000*	*20,70,000*

Additional Information :

(i) During the year preference shares were redeemed at a premium of 5%.

(ii) Plant was purchased for ₹ 3,60,000, Plant of the book value of ₹ 2,64,000 was sold for ₹ 2,10,000.

Solution : Schedule of Changes in the Working Capital

NOTES

Particulars	*2002* ₹	*2003* ₹	*Change in Working Capital*	
			Increase Debit	*Decrease Credit*
Current Assets				
Debtors	2,20,000	6,30,000	4,10,000	—
Stock	1,06,000	3,00,000	1,94,000	—
Cash	70,000	40,000	—	30,000
Current Liabilities				
Creditors	1,40,000	1,80,000	—	40,000
Provision for doubtful debts	20,000	30,000	—	10,000
Proposed dividend	1,00,000	1,20,000	—	20,000
Provision for taxation	36,000	40,000	—	4,000
Net Increase in Working Capital				5,00,000
			6,04,000	6,04,000

Funds Flow Statement

Sources	₹	*Application*	₹
Funds from Operation	8,70,000	Increase in Working Capital	5,00,000
Issue of Debentures	2,00,000	Payment of Preference share capital	4,20,000
Sale of Plant	2,10,000	Purchase of Plant	3,60,000
	12,80,000		12,80,000

Plant A/c

To Balance b/d	6,80,000	By Bank	2,10,000
" Bank A/c (Purchase)	3,60,000	" P/L A/c (Loss on Sale)	54,000
		" Depreciation (*Balancing Figure*)	1,76,000
		" Balance c/d	6,00,000
	10,40,000		10,40,000

Working Note : (*i*) **Calculation of Funds from Operation**

P/L A/c

To Balance b/d	1,20,000	By Funds from Operation (*Balancing Figure*)	8,70,000
" Loss on Sale of Plant	54,000		
" Depreciation	1,76,000		
" Premium on redemption of Deb.	20,000		
" Balance c/d	5,00,000		
	8,70,000		8,70,000

NOTES

(*ii*) Opening balance of P/L A/c appears at the assets side, which always shows debit balance. This is why, opening balance has been shown at the assets side as 'To Balance b/d'.

(*iii*) Preference Share Capital does not exist in 2,003, so entire preference share capital has been redeemed at a premium of 5%. The premium on payment will amount to be ₹ 20,000 and shown at the debit side of P/L A/c and payment of ₹ 4,20,000 will be shown at the application side.

(*iv*) The balancing figure of plant will be supposed to be the depreciation charged during the year; because the opening and closing balance, purchase and sales of the plant have already been given.

5.19 CASH FLOW STATEMENT

Cash flow statement is a statement which is prepared from the historical data showing the inflow and outflow of cash. It shows the sources and uses of cash between the two balance sheet dates. It clearly explains the causes for changes in cash position between two periods. Simply, it is a receipts and payments account in a summary form.

Uses of Cash Flow Statement

Cash flow statement is an important tool of financial analysis. It is vital to financial management. Its main uses are as follows :

(*i*) It gives guidance to the management in taking and implementing short-term financial policies.

(*ii*) It helps to strengthen the borrowing capacities of the firms. The financial institutions can easily assess the repaying capacities of the firms through the cash flow analysis.

(*iii*) It contributes significant role for the capital budgeting decisions.

(*iv*) It helps in short term financial decisions relating to liquidity.

(*v*) In order to find out the variation and take necessary remedial measures with the help of the comparison of actual cash flow statements with the projected cash flow statements.

(*vi*) To overcome the problem of meeting deficit cash or investment of surplus cash with the help of the projected cash flow statement. Thus, projected cash flow statement is usually prepared on the basis of past year's experience.

(*vii*) It explains the causes for poor cash position in spite of huge profits or surplus cash balance in spite of low profits.

(*viii*) It explains the major sources and uses of cash for the business concern during a particular period of time.

Limitations of Cash Flow Analysis

Cash flow statement is a systematic tool of financial analysis. However, it suffers from some limitations which are as follows :

1. A cash flow statement cannot be equated with the income statement. An income statement considers both cash and non-cash items. So cash does not mean net income of business.
2. The cash flow statement may not represent the real liquid position of the concern. Due to this aspect, postponing of purchases and payments could be developed.
3. Cash flow statement cannot replace the income statement or fund flow statement. Each and every statement has a separate function to perform.

4. Due to inflation, economic depression and other external factors, projected cash flow statement may not achieve its results.

Difference Between Cash Flow Analysis and Fund Flow Analysis

NOTES

1. Cash flow statement starts with the opening cash balance and ends with the closing cash balance by processing through various sources and uses. But there are no opening and closing balances in fund flow statement.
2. Cash from operation can be found out under the cash flow statement. But fund from operation can be found out under the fund flow statement.
3. Separate statements are prepared for the purpose of finding out increase or decrease in working capital under the fund flow statement. But no separate statements for increase or decrease in working capital are prepared in cash flow analysis.
4. A cash flow statement explains the causes for the changes in cash and bank balances *i.e.*, cash receipts and cash payments alone. But fund flow statement indicates the causes for the changes in net working capital.
5. Cash flow statement is suitable for short term financial planning and decision, while fund flow statement is appropriate for long term financial planning and decisions.
6. Cash flow analysis deals with the movement of actual or notional cash. But fund flow statement deals with not only cash but also the items constituting working capital. Cash is one of the components of working capital.
7. Whenever, wherever there is inflow of cash there will definitely be inflow of funds. But sound fund position need not be a sound cash position.

Steps in Preparation of Cash Flow Statement

Cash flow statement can be prepared on the same pattern on which fund flow statement is prepared. But here statement of changes in working capital does not need to be prepared. Remaining all other procedures were same in fund flow statement.

Cash flow statement is prepared on any one of the following assumptions :

— When all transactions are taken as cash transactions.

— When all transactions are not cash transactions.

Here we have to proceed with all the problems by treating all the transactions as cash transactions.

Steps

1. No need to prepare working capital statement
2. Preparation of cash flow statement
3. Preparation of profit & loss account-computation of cash from operation
4. Preparation of separate ledger if necessary
5. Treatment of adjustments

1. *No need to prepare the working capital statement*

Changes in current assets and current liabilities are adjusted in the cash flow statement itself. So separate statement is not necessary for the changes in working capital.

NOTES

2. **Cash Flow Statement (Proforma)**

Inflow of cash	*Amount* ₹	*Outflow of cash*	*Amount* ₹
Opening Cash Balance (including bank balance)	xx	Redemption of preference shares	xx
		Repayment debenture holders	xx
Issue of Shares	xx	Repayment of Loans	xx
Issue of Debentures	xx	Purchase of fixed assets	xx
Raising of loans	xx	Dividend paid	xx
Sale of fixed assets	xx	Income Tax paid	xx
Dividends received	xx	Cash from Operation (Lost in operation) Transfer from P&L A/c	xx
Share premium received	xx		
Cash from operation (Transfer from P&L A/c)		Closing balance (including bank balance)	
	xx		xx

3. *Preparation of Profit & Loss Account - Computation of cash from operation*

Cash from operations can be found out in two methods. One is statement form and another one is preparation of profit and loss account. Normally, cash from operation can be found out with the help of the preparation of profit and loss account because it is an easy and convenient method. Here profit and loss account is prepared in usual procedure.

Profit and Loss A/c

Dr. *Cr.*

	Amount ₹		*Amount* ₹
To Goodwill written off	xx	By Opening Balance b/d	xx
To General reserve	xx	By Dividends received	xx
To Preliminary expenses written off	xx	By Interest on investments	xx
		By Profit on sale of assets	xx
To Depreciation	xx	By Cash from operation *(Balancing figure)*	xx
To Loss on sale of fixed assets	xx		
To Loss on sale of Investments	xx		
To Patents & Trade mark *written off*	xx		
To Income tax provided	xx		
To Interim dividend paid	xx		
To Closing balance c/d	xx		
To Cash from operation *(Balancing figure)*	xx		
	xx		xx

4. *Preparation of Separate Ledger*

If information of any particular assets or liabilities are given in the adjustment, we have to prepare separate asset or liabilities account. Balances from this ledger can be transferred to cash flow statement.

NOTES

5. *Treatment of adjustments*

The additional information which are given apart from the balance sheet are, simply called as adjustment. All the adjustments will appear in two places. The following are the important adjustments and their treatment.

(*a*) Dividend paid	-	Cash flow statement - outflow side
	-	Profit & loss A/c - Debit side
(*b*) Depreciation	-	P.L.A/c - Debit side
		Respective asset A/c - credit side
(*c*) Loss on sale of assets	-	P.L.A/c - Debit side
		Respective asset A/c - credit side
(*d*) Income Tax provision	-	P.L.A/c - Debit side
	-	Income Tax - Credit side.

Note : The adjustments applicable for fund flow statements will also be applicable for cash flow statements.

STUDENT ACTIVITY

1. Name two ratio measuring profitability.

2. Why sources and appliaction of fund flow statement are equal to each other ?

NOTES

SUMMARY

- Ratio analysis refers to a technique of analysing the financial statements by computing various types of ratios.
- Profitability refers to the ability of the business to earn profit. It shows the efficiency of the business. These ratios measure the profit earning capacity of the company. The profitability of the business can be measured with the following ratios.
  1. Gross profit ratio 2. Net profit ratio 3. Operating ratio.
- The ratios, calculated to ascertain the short term solvency of the company are known as liquidity ratios. Short term financial position is calculated to adjudge, whether the current assets of the company are sufficient to meet its short term liabilities.
- Funds flow statement is a technical device designed to highlight the changes in the financial position of the business enterprise between two balance sheets.
- Funds flow statement has two sides *i.e.,* inflow and outflow of funds. The left hand side shows the sources of inflow of funds and the right hand side shows outflow or uses or application of funds. As all the additional funds received during the year must be utilised somewhere, so the two sides are always equal.
- Funds flow statement is simply a statement, which shows the inflow and outflow of working capital, known as funds. During the current year working capital undergoes many changes, so it is always preferable to prepare a list of changes in the working capital *i.e.,* Current assets and current liabilities.

GLOSSARY

- **Operating Income :** Income earned in the ordinary life of the business from trading activities such as gross profit, discount on creditors, interest on drawing and sale of scrape etc.
- **Current Assets :** Those assets which are converted into cash within a year. Such as cash in hand, cash in bank, accured income etc.
- **Current Liabilities :** The liabilities which are to be paid within a year. For example creditors, bills or note payable outstanding expesnes etc.
- **Non-fund Income :** The income which either do not change working caiptal or do not concern rading income.
- **Fund :** It means working capital which is the excess of current assets over the current liabilities.

REVIEW QUESTIONS

1. Name the classification of ratios on the basis of the purpose.
2. Explain the uses of Profitability ratios.
3. What do you mean by ratio analysis ?
4. Explain the various objectives or uses of ratio analysis.
5. What are the limitations of ratio analysis ? Describe these limitations.
6. Mention transactions where flow of funds will not take place.
7. Why is it useful to prepare schedule of changes in the working capital ?

NOTES

8. Explain the meaning of Funds Flow Statement.
9. What is the importance of Funds Flow Statement ? Discuss.
10. What is meant by cash flow statement ?
11. How will you prepare the cash flow statement ?
12. What is the purpose of preparing cash flow statement ?
13. What are the differences between cash flow and fund flow statement ?
14. Explain the advantages of cash flow statement.
15. What are the limitations of cash flow statement ?

PRACTICAL QUESTIONS

1. *Calculate gross profit ratio in the following cases :*

(*a*) Gross Profit	₹	60,000
Sales	₹	4,00,000
(*b*) Gross Profit	₹	3,00,000
Sales	₹	15,08,000
Sales Return	₹	8,000
(*c*) Sales	₹	1,20,000
Gross Profit is 25% on cost		
(*d*) Sales	₹	4,00,000
Gross Profit is 20% on sales		
(*e*) Sales	₹	4,00,000
Cost of goods sold	₹	3,60,000

[**Ans.** (*a*) 15%, (*b*) 20%, (*c*) 20%, (*d*) 20%, (*e*) 10%]

2. From the following information determine average stock :

Stock turnover	5 times
Total sales	₹ 2,00,000
Gross profit	25% of sales

If the closing stock is ₹ 4,000 more than the opening stock, *determine the opening and closing stock.*

[**Ans.** Average stock ₹ 30,000; Opening stock ₹ 28,000; Closing stock ₹ 32,000]

3. *Calculate working capital turnover ratio from the following information :*

Net capital employed ₹ 2,00,000, Total sales ₹ 3,50,000, Sales returns ₹ 50,000 Net Fixed Assets ₹ 1,25,000, there were no long term investment. [**Ans.** 4 times]

4. *Calculate debtors turnover ratio from the following data :*

	₹		₹
Total sales for the year	2,00,000	Debtors at the beginning of the year	20,000
Cash sales for the year	40,000	Debtors at the end of the year	60,000

State the significance of this ratio. [**Ans.** 4 times or 4 : 1]

Liquidity Ratios

5. From the following particulars, *calculate the following ratios, and give your comments thereon :*
   (*i*) *Current Ratio,*
   (*ii*) *Liquid Ratio.*

NOTES

Balance Sheet of *X* & *Y* Co. Ltd.

as on 31st March, 2003

Liabilities	₹	*Assets*	₹
Equity Share Capital	*2,00,000*	*Land and Buildings*	*1,50,000*
General Reserve	*90,000*	*Machinery*	*80,000*
Current Liabilities		*Stock*	*1,49,000*
(other than Overdraft)	*1,30,000*	*Sundry Debtors*	*71,000*
Bank Overdraft	*60,000*	*Bank Balance*	*20,000*
		Cash in hand	*10,000*
	4,80,000		*4,80,000*

[**Ans.** (*i*) 1.3 times or 1.3 : 1 or 25 : 19 (*ii*) .53 times or 101 : 190]

6. Current liabilities of a company are ₹ 1,50,000. Its current ratio is 3 : 1 and acid test ratio (liquid ratio) is 1 : 1. *Calculate the values of current assets, liquid assets and stock.*

[**Ans.** Current assets ₹ 4,50,000; Liquid assets ₹ 1,50,000; Stock ₹ 3,00,000]

7. From the following balance sheets of '*A* Ltd.' you are required to *prepare a schedule of changes in working capital :*

Liabilities	*March 31, 2001* ₹	*March 31, 2002* ₹
Capital	80,000	85,000
Profit and Loss Appropriation Account	14,500	24,500
Creditors	9,000	5,000
Mortgage	—	5,000
Provision for doubtful debts	1,000	1,300
	1,04,500	1,20,800

Assets	₹	₹
Land and Buildings	50,000	50,000
Plant and Machinery	24,000	34,000
Stock	9,000	7,000
Debtors	17,500	20,800
Cash at Bank	4,000	9,000
	1,04,500	1,20,800

[**Ans.** Increase in working capital = ₹ 10,000]

8. The following are the Balance Sheets of 'Quick Return Corporation' as on 31st March, 2002 and 2003 :

Balance Sheets of Quick Return Corporation

Capital and Liabilities	*31-03-02* ₹	*31-03-03* ₹	*Assets*	*31-03-02* ₹	*31-03-03* ₹
Capital	90,000	1,11,000	Bank	15,000	18,000
Accounts payable	60,000	54,000	Accounts Receivable	42,000	42,000
Accrued expenses	6,000	12,000	Inventory	66,000	24,000
Income tax payable	3,000	3,300	Prepaid Rent	450	300

NOTES

Retained earnings	37,950	40,950	Prepaid Insurance	600	750
			Prepaid property tax	900	1,200
			Land	12,000	24,000
			Building and Equipment	90,000	1,44,000
			(–) Accumulated Depreciation	(30,000)	(33,000)
	1,96,950	2,21,250		1,96,950	2,21,250

You are required to prepare a schedule of changes in Working Capital.

[**Ans.** Decrease in Working Capital ₹ 39,000]

Funds from Operation

9. From the following *calculate the Funds from Operation of the business :*

Profit and Loss Account

Particulars	₹	*Particulars*	₹
Expenses Paid	1,50,000	Gross Profit	8,00,000
Depreciation	35,000	Profit on sale of Land	30,000
Loss on Sale of Machine	2,000		
Goodwill	10,000		
Net Profit	6,33,000		
	8,30,000		8,30,000

[**Ans.** Funds from operation ₹ 6,50,000]

10. From the following Balance Sheets of N. Co. Ltd. as on 31st March, 2001 and 2002, *you are required to prepare* (*i*) *Schedule of Changes in Working Capital* and (*ii*) *Statement of Sources and Applications of Funds* for the year ended 31st March, 2002.

Balance Sheets

Liabilities	*2002* ₹	*2003* ₹	*Assets*	*2002* ₹	*2003* ₹
Share Capital	1,00,000	1,25,000	Land and Building	1,00,000	95,000
General Reverse	25,000	30,000	Plant	75,000	84,500
Profit and Loss A/c	15,250	15,300	Stock	50,000	37,000
Bank Loan	35,000	20,000	Debtors	40,000	32,100
Creditors	75,000	47,600	Cash	250	300
Provision for Taxation	15,000	17,500	Goodwill	—	6,500
	2,65,250	2,55,400		2,65,250	2,55,400

Additional Information :

(*a*) Dividend of ₹ 11,500 was paid

(*b*) Depreciation written off Plant ₹ 9,000

(*c*) Income tax paid during the year ₹ 16,500.

[**Ans.** Funds from operations ₹ 44,550; Net increase in working capital ₹ 6,550; New plant purchased ₹ 18,500; Tax provision made during the year ₹ 19,000; Funds Flow Statement total ₹ 74,550]

NOTES

11. *The Comparative Balance Sheets of Mr. Hitler for the two years are as follows.*

Liabilities	*2002* ₹	*2003* ₹	*Assets*	*2002* ₹	*2003* ₹
Loan from wife	—	20,000	Cash	11,000	15,000
Bills Payable	12,000	8,000	Debtors	40,000	35,000
Creditors	25,000	52,000	Stock	25,000	30,000
Loan from Bank	43,000	60,000	Machinery	20,000	14,000
Capital	66,000	34,000	Land & Buildings	50,000	80,000
	1,46,000	1,74,000		1,46,000	1,74,000

The following additional information is also available :

(*i*) Net Loss for the year 2003 amounted to ₹ 13,000.

(*ii*) During the year machine costing ₹ 5,000 (accumulated depreciation ₹ 2,000) was sold for ₹ 2,500. The provision for depreciation against machinery as on 31.12.2002 was ₹ 6,000 and on 31.12.2003 was ₹ 7,000.

12. *From the comparative balance sheets of Serial Engineering Ltd. As at 31.12.1998 and other information furnished, prepare a cash flow statement for the year ended on 31.12.1998.*

Liabilities	*2002* ₹	*2003* ₹	*Assets*	*2002* ₹	*2003* ₹
Equity Share			Fixed Assets	2,40,000	4,20,000
Capital	50,000	2,00,000	Investments	18,000	15,000
Redeemable Pref.			Stock	58,500	1,60,000
Share Capital	1,00,000	—	Sundry Debtors	1,37,000	92,000
Retained Earning	1,20,000	3,50,000	Cash at Bank	1,85,000	1,20,000
Unsecured Loan	1,25,000	—	Prepaid expenses	6,500	8,000
Bills payable	2,25,000	1,90,000			
Provision for Tax	25,000	75,000			
	6,45,000	8,15,000		6,45,000	8,15,000

The following additional information is also available :

(*i*) On 31.12.1998 accumulated depreciation on fixed assets amounted to ₹ 1,20,000 and on 31st December 1997 to ₹ 1,10,000.

(*ii*) Machinery costing ₹ 10,000 (Accumulated depreciation thereon being ₹ 5,000) was discarded and written off during 1998.

(*iii*) Depreciation written off during 1998 amounted to ₹ 15,000.

(*iv*) During the year 1998 investments costing ₹ 6,000 were sold for ₹ 7,000.

(*v*) Dividend paid during the year was ₹ 45,000.

(*vi*) Redeemable preference shares were redeemed out of profile during the year at a premium of 5%.

13. You have been asked by the management of a firm to project a Trading, Profit and Loss A/c and the Balance Sheet on the basis of the following estimated figures and ratios, for the next financial year.

NOTES

Ratio to gross profit	20%
Stock turnover ratio	5 times
Average debt collection period	3 Months
Creditors	3 Months
Current ratio	2
Proprietary ratio (fixed assets to capital employed)	75%
Capital gearing ratio (Preference shares and debentures to equity)	30%
Net profit to issued equity capital	10%
General Reserve and Profit and Loss to issued equity capital	25%
Preference share capital to debentures	2
Cost of sales consists of 50% for materials	
Gross profit	Rs. 6,25,000

FURTHER READINGS

- '*Accounting for Management*', by Dr. V.R. Palanivelu, University Science Press.
- '*Engineering Economics and Financial Acconting*', by C. Elanchezhian, Dr. R. Kesavan and T. Sunder Seiwyer, Laxmi Publications (P) Ltd.
- '*Working Capital Management*', by M.K. Rastogi, University Science Press.