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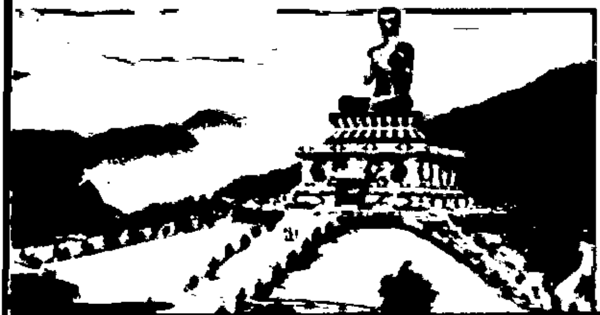

The Pathways
To Higher Studies

Accountancy

Class-XII

ACCOUNTANCY
CLASS 12

Developed & Published by:
Board of Open Schooling and Skill Education

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Syllabus

Module-I Basic Accounting

Accounting - An Introduction 2. Accounting Concepts 3. Accounting Conventions and Standards 4. Accounting for Business Transactions 5. Journal 6. Ledger 7. Cash book

Module-II Trial Balance and Computers

8. Trial balance 9. Bank Reconciliation Statement 10. Errors and Their Rectification

Module-III Financial Statements

11. Depreciation 12. Provision and Reserves 13. Financial Statement - An Introduction 14. Financial Statements – II 15. Not for Profit Organizations - An Introduction 16. Financial Statements (Not for Profit Organization)

Module-IV Partnership Accounts

17. Partnership - An Introduction 18. Admission of Partners 19. Retirement and Death of a Partner 20. Dissolution of Partnership Firm

Module-V Company Accounts

21. Company - An Introduction 22. Issue of Shares 23. Forfeiture of Shares 24. Reissue of Forfeited Shares 25. Issue of Debentures

Module-VI Analysis of Financial Statements

26. Accounting Ratios – I 27. Accounting Ratios - II 28. Cash Flow Statement

Module-VII Application of Computers in Financial Accounting

29. Electronic Spread Sheet 30. Use of Spreadsheet in Business Application 31. Graphs And Charts for Business 32. Data Base Management System for Accounting

1 ACCOUNTING

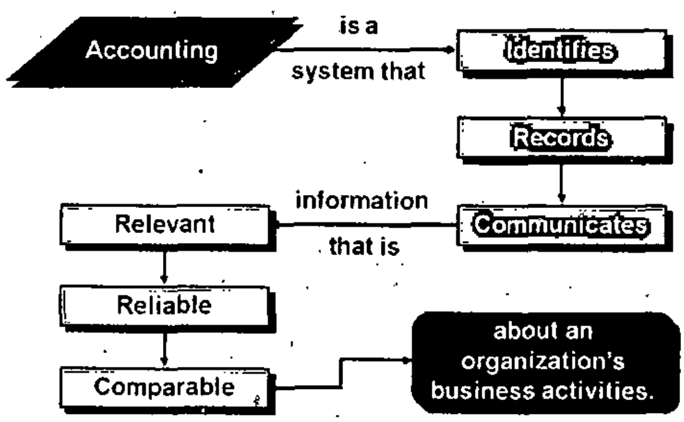
Introduction

Introduction; Accounting- **an Overview**

American Accounting Association has defined accounting as "the process of identifying, measuring and communicating economic information to permit informed judgments and decisions by users of the information".

American Institute of Certified Public Accountants (AICPA) which defines accounting as "the art of recording, classifying and summarizing in a significant manner and in terms of money, transactions and events, which are, in part at least, of a financial character and interpreting the results thereof".

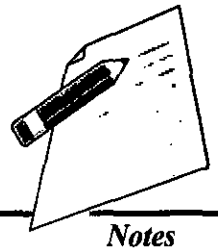
Accounting can, therefore, be defined as the process of identifying, measuring, recording and communicating the required information relating to the economic events of an organization to the interested users of the information.



Features of accounting

Following are the characteristics features of Financial Accounting:

1) **Monetary Transactions:** In financial accounting only transactions in monetary terms are considered. Transactions not expressed in monetary terms do not find any place in financial accounting, howsoever important they may be from business point of view.
2) **Historical Nature:** Financial accounting considers only those transactions which are of historical nature i.e. the transaction which have already taken place. No futuristic transactions find any place in financial accounting, howsoever important they may be from business point of view.



Notes

3) **Legal Requirement:** Financial accounting is a legal requirement. It is necessary to maintain the financial accounting and prepare financial statements there from. It is also obligatory to get these financial statements audited.
4) **External Use:** Financial accounting is for those people who are not part of decision-making process regarding the organization like investors, customers, suppliers, financial institutions etc. Thus, it is for external use.
5) **Disclosure of Financial Status:** It discloses the financial status and financial performance of the business as a whole.
6) **Interim Reports:** Financial statements which are based on financial accounting are interim reports and cannot be the final ones.
7) **Financial Accounting Process:** The process of financial accounting gets affected due to the different accounting policies followed by the accountants. These accounting policies differ mainly in two areas: Valuation of inventory and Calculation of depreciation.

Scope and Functions of Accounting

Individuals engaged in such areas of business as finance, production, marketing, personnel and general management need not be expert accountants but their effectiveness is no doubt increased if they have a good understanding of accounting principles. Everyone engaged in business activity, from the bottom level employee to the chief executive and owner, comes into contact with accounting. The higher the level of authority and responsibility, the greater is the need for an understanding of accounting concepts and terminology.

A study conducted in united states revealed that the most common background of chief executive officers in united states corporations was finance and accounting. Interviews with several corporate executives drew the following comments:

"...... my training in accounting and auditing practice has been extremely valuable to me throughout". "a knowledge of accounting carried with it understanding of the establishment and maintenance of sound financial controls- is an area which is absolutely essential to a chief executive officer".

Though accounting is generally associated with business, it is not only business people who make use of accounting but also many individuals in non-business areas that make use of accounting data and need to understand accounting principles and terminology. For e.g. An engineer responsible for selecting the most desirable solution to a technical manufacturing problem may consider cost accounting data to be the decisive factor. Lawyers want accounting data in tax cases and damages from breach of contract. Governmental agencies rely on an accounting data in evaluating the efficiency of government operations and for approving the feasibility of proposed taxation and spending programs. Accounting thus plays an important role in modern society and broadly speaking all citizens are affected by accounting in some way or the other.

Accounting which is so important to all, discharges the following vital functions:

Keeping Systematic Records:

This is the fundamental function of accounting. The transactions of the business are properly recorded, classified and summarized into final financial statements – income statement and the balance sheet.

Protecting the Business Properties:

The second function of accounting is to protect the properties of the business by maintaining proper record of various assets and thus enabling the management to exercise proper control over them.

Communicating the Results:

As accounting has been designated as the language of business, its third function is to communicate financial information in respect of net profits, assets, liabilities, etc., to the interested parties.

Meeting Legal Requirements:

The fourth and last function of accounting is to devise such a system as will meet the legal requirements. The provisions of various laws such as the companies act, income tax act, etc., require the submission of various statements like income tax returns, annual accounts and so on. Accounting system aims at fulfilling this requirement of law

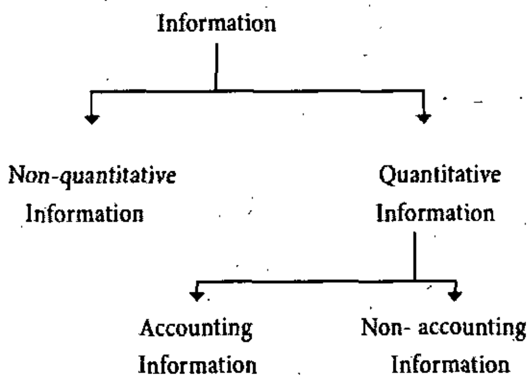
It may be noted that the functions stated above are those of financial accounting alone. The other branches of accounting, about which we are going to see later in this lesson, have their special functions with the common objective of assisting the management in its task of planning, control and coordination of business activities. Of all the branches of accounting, management accounting is the most important from the management point of view.

As accounting is the language of business, the primary aim of accounting, like any other language, is to serve as a means of communication. Most of the world's work is done through organizations – groups of people who work together to accomplish one or more objectives. In doing its work, an organization uses resources – men, material, money and machine and various services. To work effectively, the people in an organization need information about these sources and the results achieved through using them. People outside the organization need similar information to make judgments about the organization. Accounting is the system that provides such information.

Any system has three features, viz., input, processes and output. Accounting as a social science can be viewed as an information system, since it has all the three features i.e., inputs (raw data), processes (men and equipment) and outputs (reports and information). Accounting information is composed principally of financial data about business transactions. The mere records of transactions are of little use in making "informed judgments and decisions". The recorded data must be sorted and summarized before significant analysis can be prepared. Some of the reports to the enterprise manager and to others who need economic information may be made frequently; other reports are issued only at longer intervals. The usefulness of reports is often enhanced by various types of percentage and trend analyses. The **"basic raw materials"** of accounting are composed of business transactions data. Its "primary end products" are composed of various summaries, analyses and reports.

The information needs of a business enterprise can be outlined and illustrated with the help of the following chart:

Chart Showing Types Of Information



The chart clearly presents the different types of information that might be useful to all sorts of individuals interested in the business enterprise. As seen from the chart, accounting supplies the quantitative information. The special feature of accounting as a kind of a quantitative information and as distinguished from other types of quantitative information is that it usually is expressed in monetary terms.

In this connection it is worthwhile to recall the definitions of accounting as given by the American institute of certified and public accountants and by the American accounting principles board.

Objectives of Accounting

Following are the objectives of accounting:

a. To keep a systematic record of financial transactions and events
b. To ascertain the profit or loss of the business enterprise
c. To ascertain the financial position or status of the enterprise
d. To provide information to various stakeholders for their requirements
e. To protect the properties of an enterprise and

To ascertain the solvency and liquidity position of an enterprise

Basic Accounting terminologies

Accounting is a versatile system which serves a large number of purposes in the modern business world. Hence, the following terminologies need to be understood.

Transaction	An activity which involves transfer of money or money's worth (goods, services, ideas) from one person to another.
Cash transaction	It is a transaction which involves immediate cash receipt or immediate cash payment.
Credit transaction	It is a transaction in which cash is not received or paid immediately, but will be received or paid later.
Account	It is the basic unit for measurement in accounting. It is used for identifying a person. or an item in accounting. An account is opened individually for a person. asset, expense, income, etc. In ledger, an account is a summary of transactions under a head.
Capital	It is the amount invested by the owner or proprietor in an organisation.
Drawings	It is the amount of cash or value of goods, assets, etc., withdrawn from the business by the owner for the personal use of the owner.
Voucher	Any written or printed document in support of a business transaction is called a voucher. Examples: cash receipt, invoice, cash memo, bank pay-in- slip, etc.
Invoice	It is a statement prepared by a seller of goods to be sent to the buyer. It shows details of quantity, price, value, etc. of the goods and any discount given, finally showing the net amount payable by the buyer.
Goods	It includes articles, things or commodities in which a business is dealing with. Example: Furniture will be goods for those who deal in furniture.

Purchases	Buying of goods with the intention of resale is called purchases.
Purchases returns or returns outward	When goods bought are returned to the suppliers, it is known as purchases returns or returns outward.
Sales	When goods meant for resale are sold, it is called sales.
Sales returns or returns inward	When goods sold are returned by the customers, it is called as sales returns or returns inward.
Stock	Unsold goods lying in a business on a particular date are known as stock.
Income	It is the amount receivable or realised from sale of goods and earnings from interest, dividend, commission, etc.
Expense	It is the amount incurred in order to produce and sell the goods and services.
Solvency	Solvency is the capability of a person or an enterprise to pay the debts.
Insolvency	Insolvency is the incapability of a person or an enterprise to pay the debts.
Asset	Any physical thing or right owned that has a monetary value is called asset.
Liability	It refers to the financial obligation of the business.
Debtor	A person who receives a benefit without giving money or money's worth immediately, but liable to pay in future or in due course of time.
Creditor	A person who gives a benefit without receiving money or money's worth immediately but to claim in future.
Depreciation	It refers to the gradual reduction in the value of fixed assets due to usage and passage of time.
Bad debt	It is a loss to the business arising out of failure of a debtor to pay the dues. It is irrecoverable debt.

Book-keeping-An introduction

The first step in the accounting process is identifying and recording of transactions in the books of accounts. This is necessary for any business as the transactions happening in a business entity must be recorded so that the information is available for further analysis.

Book-keeping forms the base for the preparation of financial statements and interpretation which are the important functions of accounting. In a broad sense, accounting includes book-keeping also. In a small business, the entire accounting work may be performed by a single accountant. In a large firm, there may be a separate person or department for book-keeping work.

Meaning of book-keeping

Book-keeping is the process of recording financial transactions in the books of accounts. It is the primary stage in the accounting process. It includes recording the transactions and classifying the same under proper heads. Book-keeping work is of routine nature. Transactions may be recorded in the accounting note books and ledgers or may be recorded in a computer.

Advantages of Book-keeping

Book-keeping has the following advantages:

i. Transactions are recorded systematically in chronological order in the book of accounts. Thus, book-keeping provides a permanent and reliable record for all business transactions.
ii. Book-keeping is useful to get the financial information.
iii. It helps to have control over various business activities.
iv. Records provided by business serve as a legal evidence in case of any dispute.
v. Comparison of financial information over the years is possible. Also comparison of financial information of different business units is facilitated.

Limitations of book-keeping

Book-keeping has the following limitations:

i. Only monetary transactions are recorded in the books of accounts.
ii. Effects of price level changes are not considered.
iii. Financial data recorded are historical in nature, i.e., only past data are recorded.

Relationship among Book-keeping, Accounting and Accountancy

Book-keeping is part of Accounting. It is the primary stage in accounting. It is the process of recording transactions in the books of accounts. Accounting is part of Accountancy. Accounting is the process of recording, classifying, analysing and interpreting of financial data. Accountancy is the systematic knowledge of accounting process and contains the standards, principles, policies and procedures to be followed in accounting.

Accountancy

Accounting

Book-keeping

Book-keeping Vs. Accounting

Following are the differences between book-keeping and accounting:

S. No	Basis of distinction	Book-keeping	Accounting
1	Scope	It is concerned with recording and classifying the business transactions.	It is concerned with recording, classifying, summarising, analysing and interpreting the financial data.
2	Stage	Book-keeping is the primary stage in accounting. It is the base for accounting.	Apart from the primary stage, it includes secondary stage of analysis and interpretation..
3	Nature of job	It is routine and clerical in nature.	It is analytical in nature.
4	Knowledge required	It requires basic knowledge of the principles of journalising and posting.	It requires thorough knowledge of accounting principles, procedures and practices.
5	Skill required	Analytical skill is not required for book-keeping.	It requires analytical skill.

Approaches of recording transactions

There are two approaches for recording transactions, namely, i) Accounting equation approach and ii) Traditional approach.

1. Accounting equation approach

The relationship of assets with that of liabilities to outsiders and to owners in the equation form is known as accounting equation.

Under the double entry system of book keeping, every transaction has two-fold effect, which causes the changes in assets and liabilities or capital in such a way that an accounting equation is completed and equated.

Capital + Liabilities = Assets

Capital can also be called as owner's equity and liabilities as outsider's equity.

Accounting equation is a mathematical expression which shows that the total of assets is equal to the total of liabilities and capital. This is based on the dual aspect concept of accounting. This means that total claims of outsiders and the proprietor against a business enterprise will always be equal to the total assets of the business enterprise

As the revenues and expenses will affect capital, the expanded equation may be given as under:

Assets = Liabilities + Capital + Revenues – Expenses

Therefore, under this approach, accounts are classified into five categories: (i) Asset account, (ii)

Liability account, (iii) Capital account, (iv) Revenue account and (v) Expense account as follows:

Account

Asset | Liability | Capital | Revenue | Expense

i. Asset account

Any physical thing or right owned that has a monetary value is called asset. The assets are grouped and shown separately; for example, Land and Buildings account, Plant and Machinery account.

ii. Liability account

Financial obligations of the enterprise towards outsiders are shown under separate heads as liabilities; for example, creditors account, expenses outstanding account.

iii. Capital account

Financial obligations of a business enterprise towards its owners are grouped under this category; for example, capital contributed by owner.

iv. Revenue account

Accounts relating to revenues of an enterprise are grouped under this category, for example; revenues from sale of goods, rent received.

v. Expense account

Expenses incurred and losses suffered for earning revenue are grouped under this category; for example, purchase of goods, salaries paid.

A transaction may have the effect on either side of the equation by the same amount or it may have the effect on one side of the equation only, by both increasing and decreasing it by an equal amount.

Recording of transactions as per accounting equation approach is explained below:

(a) Increase in capital and increase in asset

Commenced business with cash Rs. 1,00,000

Effects:

(i) Cash comes in → Increase in asset

(ii) Capital provided by the owner → Increase in capital of owner

Capital = Assets

Capital = Cash

(+) Rs. 1, 00,000 = (+) Rs. 1, 00,000

(b) Decrease in liability and decrease in asset

Paid creditors Rs. 10,000

Effects: (i) Cash goes out → Decrease in asset

Creditors are paid → Decrease in liability

Liabilities = Assets

Creditors = Cash

(–) Rs. 10,000 = (–) Rs. 10,000

(c) Decrease in one asset and increase in another asset

Bought furniture costing Rs. 5,000 by paying cash

Effects:

(i) Furniture comes in → Increase in asset

(ii) Cash goes out → Decrease in asset

Liabilities = Assets

Liabilities = Cash + Furniture

= (–) Rs. 5,000 (+) Rs. 5,000

(d) Decrease in one liability and increase in another liability

Accepted a bill drawn by creditors for Rs. 20,000

Effects:

(i) Bills payable arises → Increase in liability

(ii) Reduction in creditors → Decrease in liability

Liabilities = Assets

+ Bills payable – Creditors = Assets

(+) Rs. 10,000 (–) Rs. 10,000 = Assets

Illustration 1

Complete the missing items.

	Assets ₹ =	Liabilities ₹ +	Capital ₹
(a)	30,000	20,000	?
(b)	60,000	25,000	?
(c)	?	25,000	30,000
(d)	?	10,000	80,000
(e)	25,000	?	15,000
(f)	40,000	?	30,000

Solution

	Assets ₹ =	Liabilities ₹ +	Capital ₹
(a)	30,000	20,000	10,000
(b)	60,000	25,000	35,000
(c)	55,000	25,000	30,000
(d)	90,000	10,000	80,000
(e)	25,000	10,000	15,000
(f)	40,000	10,000	30,000

Notes

Illustration 2

Show the accounting equation on the basis of the following transactions for Rani, who is dealing in automobiles.

(i) Started business with cash 80,000

(ii) Goods bought on credit from Ramesh Rs. 10,000

(iii)Purchased furniture for cash Rs. 6,000

(iv)Paid creditors by cash Rs. 8,000

Solution

Solution

In the books of Rani

Transaction	Assets				Capital ₹	Creditors ₹
	Cash ₹	Stock ₹	Furniture ₹			
(i) Started business with cash	+80,000				+80,000	
Equation	+80,000			=	+80,000	
(ii) Credit purchases		+10,000				+10,000
Equation	+80,000	+10,000		=	+80,000	+10,000
(iii) Cash purchase of furniture	–6,000		+6,000			
Equation	+74,000	+10,000	+6,000	=	+80,000	+10,000
(iv) Paid creditors by cash	–8,000					–8,000
Equation	+66,000	+10,000	+6,000	=	+80,000	+2,000

Illustration 3

Show the accounting equation on the basis of the following:

(a) Started business with cash 60,000

(b) Purchased goods for cash Rs. 20,000

(c) Sold goods for cash costing Rs. 10,000 for Rs. 15,000

(d) Paid rent by cash : : Rs. 500

Solution

Solution

Transaction	Assets			Capital ₹
	Cash ₹	Stock ₹		
(a) Started business with cash	+60,000		=	+60,000
Equation	+60,000			+60,000
(b) Cash purchases	-20,000	+20,000		
Equation	+40,000	+20,000	=	+60,000
(c) Sold goods for cash	+15,000	-10,000		+5,000
Equation	+55,000	+10,000	=	+65,000
(d) Paid rent by cash	-500			-500
Equation	+54,500	+10,000	=	+64,500

Illustration 4

Selvi is a dealer in furniture. Show the accounting equation for the following transactions.

(i) Started business with cash Rs. 1,00,000

(ii) Deposited cash into bank Rs. 60,000

(iii)Borrowed loan from bank Rs. 25,000

(iv)Bought goods and paid by cheque Rs. 10,000

(v) Cash withdrawn for personal use Rs. 5,000

(vi)Cash withdrawn from bank for office use Rs. 3,000

Solution

In the books of Selvi

Transaction	Assets				Capital ₹	Bank loan ₹
	Cash ₹	Stock ₹	Bank ₹			
(i) Started business with cash	+1,00,000			=	+1,00,000	
Equation	+1,00,000				+1,00,000	
(ii) Deposited cash with bank	– 60,000		+60,000			
Equation	+40,000		+60,000	=	+1,00,000	
(iii) Borrowed loan from bank			+25,000			+25,000
Equation	+40,000		+85,000	=	+1,00,000	+25,000
(iv) Bought goods and paid by cheque		+10,000	-10,000			
Equation	+40,000	+10,000	+75,000	=	+1,00,000	+25,000
(v) Cash withdrawn for personal use	– 5,000				-5,000	
Equation	+35,000	+10,000	+75,000	=	+95,000	+25,000
(vi) Cash withdrawn from bank for office use	+3,000		-3,000			
Equation	+38,000	+10,000	+72,000	=	+95,000	+25,000

Illustration 5

Show the effect of following business transactions on the accounting equation.

(i) Anbu started business with cash Rs. 20,000; goods Rs. 12,000 and machine Rs. 8,000

(ii) Purchased goods from Ramani on credit Rs. 7,000

(iii)Payment made to Ramani in full settlement Rs. 6,900

(iv)Sold goods to Rajan on credit costing Rs. 5,400 for Rs. 6,000

Received from Rajan Rs. 5,800 in full settlement of his account

(vi) Wages outstanding Rs. 400

Solution

Solution

Transaction	Assets					Capital	Liabilities
	Cash ₹	Stock ₹	Machine ₹	Debtors ₹		₹	₹
(i) Started business with cash, stock & machine	+20,000	+12,000	+8,000			+40,000	
Equation	+20,000	+12,000	+8,000		=	+40,000	
(ii) Credit purchases		+7,000					+7,000
Equation	+20,000	+19,000	+8,000		=	+40,000	+7,000
(iii) Payment made to Ramani in full settlement	-6,900					+100	-7,000
Equation	+13,100	+19,000	+8,000		=	+40,100	
(iv) Credit sales		-5,400		+6,000		+600	
Equation	+13,100	+13,600	+8,000	+6,000	=	+40,700	
(v) Cash receipt from Rajan. in full settlement	+5,800			-6,000		-200	
Equation	+18,900	+13,600	+8,000		=	+40,500	
(vi) Wages outstanding						-400	+400
Equation	+18,900	+13,600	+8,000		=	+40,100	+400

Illustration 6

Veena is a dealer in textiles. On January 1, 2018, her business showed the following balances: Cash in hand: Rs. 20,000; Bank balance: Rs. 70,000; Stock: Rs. 15,000.

Following are the transactions made during January 2018. Show the effect of the transactions on accounting equation.

(a) Purchased goods (readymade shirts) on credit from Subbu Rs. 20,000

(b) Goods returned to Subbu and no cash is received Rs. 5,000

(c) Goods (shirts) costing Rs. 1,600 was sold to Janani on credit Rs. 2,000

(d) Janani returned 1 shirt of sales value Rs. 500

(e) Janani deposited the money due in cash deposit machine in a bank Rs. 1,500

(f) Insurance on building paid through net banking Rs. 1,000

(g) Of the insurance paid, prepaid during the year is Rs. 100

Solution

Transaction	Assets							
	Cash ₹	Bank ₹	Stock ₹	Debtors ₹	Prepaid insurance ₹		Capital ₹	Creditors ₹
To Balance b/d	+20,000	+70,000	+15,000				+1,05,000	
Equation	+20,000	+70,000	+15,000			=	+1,05,000	
(a) Purchased goods on credit			20,000					+20,000
Equation	+20,000	+70,000	+35,000			=	+1,05,000	+20,000
(b) Goods returned and no cash received			-5,000					-5,000
Equation	+20,000	+70,000	+30,000			=	+1,05,000	+15,000
(c) Goods sold on credit			-1,600	2,000			+400	
Equation	+20,000	+70,000	+28,400	+2,000		=	+1,05,400	+15,000
(d) Sales return the cost of which is ₹ 400 and no cash paid			+400	-500			-100	
Equation	+20,000	+70,000	+28,800	+1,500		=	+1,05,300	+15,000
(e) Customer deposited the money in CDM		+1,500		-1,500				
Equation	+20,000	+71,500	+28,800			=	+1,05,300	+15,000
(f) Insurance premium paid through net banking		-1,000					-1,000	
Equation	+20,000	+70,500	+28,800			=	+1,04,300	+15,000
(g) Prepaid insurance					+100		+100	
Equation	+20,000	+70,500	+28,800		+100	=	+1,04,400	+15,000

2. Traditional approach

Under this approach, the two-fold aspects (debit and credit) in each transaction are recorded in the journal by following double entry system. For the purpose of recording the transactions, accounts are classified into personal and impersonal accounts.

1. Classification of accounts:

Under double entry system of book keeping, for the purpose of recording the various financial transactions, the accounts are classified as personal accounts and impersonal accounts.

Classification of account

- Account
  - Personal
    - Natural
    - Artificial
    - Representative
  - Impersonal
    - Real
      - Tangible
      - Intangible
    - Nominal

i. **Personal account:** Account relating to persons is called personal account. The personal account may be natural, artificial or representative personal account.

- **Natural person's account:** Natural person means human beings. Example: Vinoth account, Malini account.
- **Artificial person's account:** Artificial person refers to the persons other than human beings recognised by law as persons. They include business concerns, charitable institutions, etc. Example: BHEL account, Bank account.
- **Representative personal accounts:** These are the accounts which represent persons natural or artificial or a group of persons. Example: Outstanding salaries account, Prepaid rent account. When expenses are outstanding, it is payable to a person. Hence, it represents a person.

ii. **Impersonal accounts:** All accounts which do not affect persons are called impersonal accounts. These are further classified into a) Real accounts and b) Nominal accounts.

a. **Real account:** All accounts relating to tangible and intangible properties and possessions are called real accounts.

- **Tangible real accounts:** These include accounts of properties and possessions which can be seen and touched. These have physical existence. Example: Plant, Machinery, Building, Furniture, Stock.
- **Intangible real accounts:** These include accounts of properties and possessions which cannot be seen and touched. These do not have physical existence. Example: Goodwill, Patents, Copy rights.

b. **Nominal account:** The accounts relating to expenses, losses, revenues and gains are called nominal accounts. Example: Salaries, wages, rental income, interest income, etc. These are temporary accounts and are transferred to Trading and Profit and Loss account depending on whether these are direct or indirect respectively.

Accounting rules

All the above classified accounts have two rules each, one related to debit and another related to credit for recording the transactions which are termed as golden rules of accounting or rules of double entry system.

Golden rules of double entry system

Personal account	Debit the receiver	Credit the giver
Real account	Debit what comes in	Credit what goes out
Nominal account	Debit all expenses and losses	Credit all incomes and gains

Illustration

Classify the following into personal, real and nominal accounts.

(a) Capital
(b) Building
(c) Carriage inwards
(d) Cash
(e) Commission received
(f) Bank
(g) Purchases
(h) Chandru
(i) Outstanding wages

Solution

Sl. No.	Items	Classification
(a)	Capital	Personal account
(b)	Building	Real account
(c)	Carriage inwards	Nominal account
(d)	Cash	Real account
(e)	Commission received	Nominal account
(f)	Bank	Personal account
(g)	Purchases	Nominal account
(h)	Chandru	Personal account
(i)	Outstanding wages	Personal account

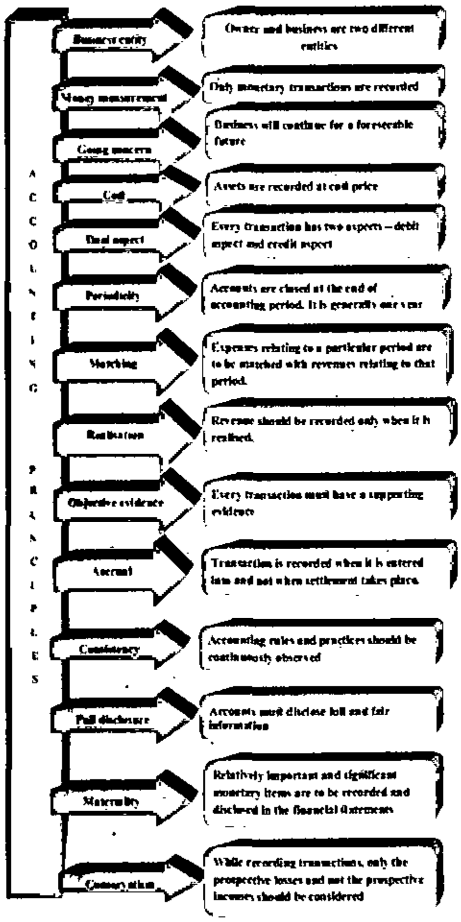
2 GENERALLY ACCEPTED ACCOUNTING PRINCIPLES (GAAP)

Generally Accepted Accounting Principles (GAAP).

Accounting Principles

Accounting principles are the basic norms and assumptions developed and established as the basis for accounting system. These principles are adopted by the accountants universally. These accounting principles provide uniformity and consistency in the accounting methods and process. Such accounting principles are known as Generally Accepted Accounting Principles (GAAP).

Accounting concepts are the basic assumptions or conditions upon which accounting has been laid. Accounting concepts are the results of broad consensus. The word concept means a notion or abstraction which is generally accepted. Accounting concepts provide unifying structure to the accounting process and accounting reports.



The important accounting concepts and conventions are discussed below:

(i) Business entity concept

This concept implies that a business unit is separate and distinct from the owner or owners, that is, the persons who supply capital to it.

Based on this concept, accounts are prepared from the point of view of the business and not from the owner's point of view. Hence, the business is liable to the owner for the capital contributed by him/her.

According to this concept, only business transactions are recorded in the books of accounts. Personal transactions of the owners are not recorded. But, their transactions with the business such as capital contributed to the business or cash withdrawn from the business for the personal use will be recorded in the books of accounts. It implies that the business itself owns assets and owes liabilities.

(ii) Money measurement concept

This concept implies that only those transactions, which can be expressed in terms of money, are recorded in the accounts. Since, money serves as the medium of exchange transactions expressed in money are recorded and the ruling currency of a country is the measuring unit for accounting.

Transactions which do not involve money will not be recorded in the books of accounts. For example, working conditions in the work place, strike by employees, efficiency of the management, etc. will not be recorded in the books, as they cannot be expressed in terms of money.

It helps in understanding of the state of affairs of the business as money serves as a common measure by means of which heterogeneous facts about the business are recorded. For example, if a business has 5 computers, 2 tables and 3 chairs, the assets cannot be added to give useful information, unless, they are expressed in monetary terms Rs.1,00,000 for computers, Rs. 10,000 for tables and Rs. 1,500 for chairs.

(iii) Going concern concept

It is the basic assumption that business is a going concern and will continue its operations for a foreseeable future. Going concern concept influences accounting practices in relation to valuation of assets and liabilities, depreciation of the fixed assets, treatment of outstanding and prepaid expenses and accrued and unearned revenues. For example, assets are generally valued at historical cost. Any increase or decrease in the value of assets in the short period is ignored.

(iv) Cost concept

An asset is recorded in the books on the basis of the historical cost, that is, the acquisition cost. Cost of acquisition will be the base for all further accounting. It does not mean that the asset will always be shown at cost. It is recorded at cost at the time of its purchase, but is systematically reduced in its book value by charging depreciation.

The cost concept has the following limitations:

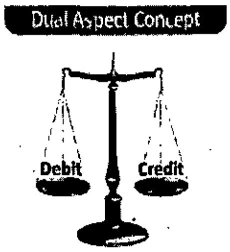
a. In an inflationary situation, when prices of commodities increase, valuing the assets at historical cost may not represent the true position of the business.

b. The results of business units established at different dates are not comparable if assets are recorded on historical basis.

c. Assets which do not have acquisition cost such as human resources are not recognised under this concept.

(v) Dual aspect concept

According to this concept, every transaction or event has two aspects, i.e., dual effect. For example, when Arun starts a business with cash Rs. 5,00,000, on the one hand, the business gets cash of Rs. 5,00,000 and on the other hand, a liability arises, that is, the business has to pay Arun a sum of Rs. 5,00,000.



This is the concept which recognises the fact that for every debit, there is a corresponding and equal credit. This is the basis of the entire system of double entry book-keeping.

From this concept arises the basic accounting equation, that is,

Capital + Liabilities = Assets

(vi) Periodicity concept

This concept deals with preparing accounts for a particular period. As the proprietors, investors, creditors, employees and the government are interested in knowing the performance of the business unit periodically, it becomes necessary to select a particular period, normally one year for measuring performance. Hence, financial statements are prepared after every accounting period and not at the end of its life.

This concept helps the business in distribution of income to the owners and comparing and evaluating performance of different periods.

(vii) Matching concept

According to this concept, revenues during an accounting period are matched with expenses incurred during that period to earn the revenue during that period. This concept is based on accrual concept and periodicity concept. Periodicity concept fixes the time frame for measuring performance and determining financial status.

All expenses paid during the period are not considered, but only the expenses related to the accounting period are considered.

On the basis of this concept, adjustments are made for outstanding and prepaid expenses and accrued and unearned revenues. Also, due provisions are made for depreciation of the fixed assets, bad debt, etc., relating to the accounting period. Thus, it matches the revenues earned during an accounting period with the expenses incurred during that period to earn the revenues before sharing any profit or loss.

(viii) Realisation concept

According to realisation concept, any change in value of an asset is to be recorded only when the business realises it. When assets are recorded at historical value, any change in value is to be accounted only when it realises.

(ix) Objective evidence concept

Objective evidence concept requires that all accounting transactions recorded should be based on objective evidence. The objective evidence includes documentary evidence like cash receipts, invoices, etc. It ensures authenticity, accuracy and reliability of transactions entered in the books of accounts.

(x) Accrual concept

According to accrual concept, the effects of the transactions are recognised on mercantile basis, i.e., when they occur and not when cash is paid or received. Revenue is recognised when it is earned and expenses are recognised when they are incurred. All expenses and revenues related to the accounting period are to be considered irrespective of the fact that whether revenues are received in cash or not and whether expenses are paid in cash or not. For example, i) Credit sale is recognised as sale though the amount has not been received immediately. ii) Rent for the month of March-2018 has not been paid and if the accounting period is 1.4.2017 to 31.3.2018, it will still be recorded as an expense for the accounting year 2017-2018 because it had become due.

(xi) Convention of consistency

The consistency convention implies that the accounting policies must be followed consistently from one accounting period to another. The results of different years will be comparable only when same accounting policies are followed from year to year. For example, if a firm follows the straight-line method of charging depreciation since its purchase or construction, the method should be followed without any change. However, it does not mean that changes are not possible. Change in accounting policy can be incorporated in the following circumstances:

a. To comply with the provision of law
b. To comply with accounting standards issued and
c. To reflect true and fair view of state of affairs of the business.

(xii) Convention of full disclosure

It implies that the accounts must be prepared honestly and all material information should be disclosed in the accounting statement. This is important because the management is different from the owners in most of the organisations.

The disclosure should be full, fair and adequate so that the users of the financial statements can make correct assessment about the financial position and performance of the business unit.

(xiii) Convention of materiality

According to this convention, financial statements should disclose all material items which might influence the decisions of the users of financial statements. Hence, any item which is not significant and is not relevant to the users need not be disclosed in the financial statements.

This principle is basically an exception to the full disclosure principle. The term materiality is subjective in nature. Materiality depends on the amount involved in the transaction, size of the business, nature of information, requirements of the person making decision, etc. An item material to one person may be immaterial to another person.

(xiv) Convention of conservatism or prudence

It is a policy of caution or playing safe. While recording the business transactions one has to anticipate no income but provide for all possible losses.

For example, the closing stock in the factory is valued at Rs. 35,000 at cost price and Rs. 25,000 at its realisable price. But while recording in the books the value of Rs. 25,000 will be considered being the lower of the two. According to realisation concept, any increase in value is not to be accounted unless it has materialised. The conservatism convention puts further restriction on it. Any unrealised gain is not to be anticipated but provision can be made against all possible losses.

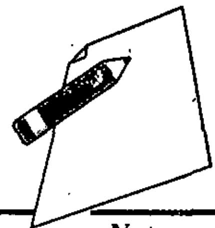
Accounting Standards (AS)

Accounting Standards provide the framework and norms to be followed in accounting so that the financial statements of different enterprises become comparable. It is necessary to standardise the accounting principles to ensure consistency, comparability, adequacy and reliability of financial reporting.

Student activity

Think: In your school, there are some basic rules to be followed by every student. What are they? What will happen if there is no such rule?

In the words of Kohler, "Accounting standards are codes of conduct imposed by customs, law or professional bodies for the benefit of public accountants and accountants generally"



Thus, Accounting Standards are written policy documents issued by the expert accounting body or by government or other regulatory body covering the aspects of recognition, measurement, treatment, presentation and disclosure of accounting transactions and events in the financial statements.

Need for accounting standards

The need for accounting standards is as follows:

i. To promote better understanding of financial statements

ii. To help accountants to follow uniform procedures and practices

iii. To facilitate meaningful comparison of financial statements of two or more entities.

iv. To enhance reliability of financial statements

v. To meet the legal requirements effectively

Accounting Standards in India

In India, Standards of Accounting is issued by the Institute of Chartered Accountants of India (ICAI). The Council of the Institute of Chartered Accountants of India constituted Accounting Standards Board (ASB) on 21st April, 1977 recognising the need for Accounting Standards in India. ASB formulates Accounting Standards so that such standards may be established by the Council of the Institute in India. The ASB will consider the applicable law, custom, usage, business environment and the International Accounting Standards while framing Accounting Standards (AS) in India.

Due to globalisation, the accounts prepared in India must be compatible with accounts prepared in other countries. This has resulted in the existing AS being converged with the IFRS. This convergence has resulted in what is known as Ind AS. Ind AS are basically the International Accounting Standards which have been modified in accordance with Indian accounting practices, customs and traditions. Presently, all big companies have to follow Ind AS rules, but smaller business units are allowed to continue using AS. In future, it is expected that all business entities in India will migrate to Ind AS.

Applicability of IND AS – Indian Accounting Standards

The Ministry of Corporate Affairs (MCA), in 2015, had notified the Companies (Indian Accounting Standards (IND AS)) Rules 2015, which stipulated the adoption and applicability of IND AS in a phased manner beginning from the Accounting period 2016-17. The MCA has since issued three Amendment Rules, one each in year 2016, 2017, and 2018 to amend the 2015 rules.

The IND AS are basically standards that have been harmonized with the IFRS to make reporting by Indian companies more globally accessible. Since Indian companies have a far wider global reach now as compared to earlier, the need to converge reporting standards with international standards was felt, which has led to the introduction of IND AS.

Phases of adoption

MCA has notified a phase-wise convergence to IND AS from current accounting standards. IND AS shall be adopted by specific classes of companies based on their Net worth and listing status. Let's see the each of the phases in detail below:

Phase I

Mandatory applicability of IND AS to all companies from 1st April 2016, provided:

- It is a listed or unlisted company
- Its Net worth is greater than or equal to Rs. 500 crores*

*Net worth shall be checked for the previous three Financial Years (2013-14, 2014-15, and 2015-16).

Phase II

Mandatory applicability of IND AS to all companies from 1st April 2017, provided:

- It is a listed company or is in the process of being listed (as on 31.03.2016)
- Its Net worth is greater than or equal to Rs. 250 crores but less than Rs. 500 crores (for any of the below mentioned periods).

Net worth shall be checked for the previous four Financial Years (2014-14, 2014-15, 2015-16, and 2016-17)

Phase III

Mandatory applicability of IND AS to all Banks, NBFCs, and Insurance companies from 1st April 2018, whose:

- Net worth is more than or equal to INR 500 crore with effect from 1st April 2018.

IRDA (Insurance Regulatory and Development Authority) of India shall notify the separate set of IND AS for Banks & Insurance Companies with effect from 1st April 2018. NBFCs include core investment companies, stock brokers, venture capitalists, etc. Net Worth shall be checked for the past 3 financial years (2015-16, 2016-17, and 2017-18)

Phase IV

All NBFCs whose Net worth is more than or equal to INR 250 crore but less than INR 500 crore shall have IND AS mandatorily applicable to them with effect from 1st April 2019.

Please Note:

If IND AS become applicable to any company, then IND AS shall automatically be made applicable to all the subsidiaries, holding companies, associated companies, and joint ventures of that company, irrespective of individual qualification of such companies.

In case of foreign operations of an Indian Company, the preparation of stand-alone financial statements may continue with its jurisdictional requirements and need not be prepared as per the IND AS.

However, these entities will still have to report their IND AS adjusted numbers for their Indian parent company to prepare consolidated IND AS accounts.

Net Worth Calculation

Net worth will be determined based on the stand-alone accounts of the company as on 31st March 2014, or the first audited period ending after that date. Net Worth is the total of Paid-up share Capital and all reserves out of profit & securities premium account, after deducting accumulated losses, deferred expenditure, and miscellaneous expenditure not written off. Only capital Reserve arising out of Promoters Contribution and Government Grants received can be included. Reserves created out of revaluation of assets and written back depreciation cannot be included.

Voluntary adoption

Companies can voluntarily choose to incorporate IND AS in their reports for accounting periods beginning on or after April 01, 2015. While reporting, such companies must include a comparative report for the periods ending 31 March 2015 or thereafter, where IND AS have been incorporated to present a comparative view. However, once a company has started reporting as per the IND AS, it cannot change to reporting as per previous laws.

SEBI Clarification

For all the issuer companies whose offer documents are filed with SEBI on or after 1st April 2016, SEBI has issued a clarification on the applicability of the Indian Accounting Standards (IND AS) and disclosures to be made in the offer documents. Typically, SEBI requires issuer companies to disclose financial information for the previous 5 financial years immediately preceding the year of filing of the offer document, while following uniform accounting policies for each of the financial years. For those issuer companies filing an offer document these points can be noted:

1. Up to March 31, 2017, all of the financial statements filed by them can be under Indian GAAP.
2. Between April 1, 2017 and March 31, 2018, disclosures in the previous three financial years immediately preceding the relevant financial year will have to be made under the IND AS principles, while disclosures for the remaining two financial years may be done under Indian GAAP.
3. Between April 1, 2018, and March 31, 2019, disclosures in the previous three financial years immediately preceding the relevant financial year will have to be made under the IND AS principles, while disclosures for the remaining two financial years may be done under Indian GAAP.

4. Between April 1, 2019 and March 31, 2020, disclosures in the previous four financial years immediately preceding the relevant financial year will have to be made under the IND AS principles, while disclosures for the remaining one financial year may be done under Indian GAAP.
5. On or after April 1, 2020, disclosures in all the previous five financial years will have to be made as per the IND AS principles.

SEBI has also provided discretion to issuer companies to present financial statements for all five financial years under IND AS on a voluntary basis. This clarification does not apply to issuer companies making rights issue.

The major standards are listed here below:

Ind AS 101	First-time adoption of Ind AS
Ind AS 102	Share Based payments
Ind AS 103	Business Combination
Ind AS 104	Insurance Contracts
Ind AS 105	Non-Current Assets Held for Sale and Discontinued Operations
Ind AS 106	Exploration for and Evaluation of Mineral Resources
Ind AS 107	Financial Instruments: Disclosures
Ind AS 108	Operating Segments
Ind AS 109	Financial Instruments
Ind AS 110	Consolidated Financial Statements
Ind AS 111	Joint Arrangements
Ind AS 112	Disclosure of Interests in Other Entities
Ind AS 113	Fair Value Measurement
Ind AS 114	Regulatory Deferral Accounts
Ind AS 115	Revenue from Contracts with Customers
Ind AS 1	Presentation of Financial Statements
Ind AS 2	Inventories Accounting
Ind AS 7	Statement of Cash Flows
Ind AS 8	Accounting Policies, Changes in Accounting Estimates and Errors
Ind AS 10	Events after Reporting Period
Ind AS 11	Construction Contracts

Ind AS 12	Income Taxes
Ind AS 16	Property, Plant and Equipment
Ind AS 17	Leases
Ind AS 18	Revenue
Ind AS 19	Employee Benefits
Ind AS 20	Accounting for Government Grants and Disclosure of Government Assistance
Ind AS 21	The Effects of Changes in Foreign Exchange Rates
Ind AS 23	Borrowing Costs
Ind AS 24	Related Party Disclosures
Ind AS 27	Separate Financial Statements
Ind AS 28	Investments in Associates and Joint Ventures
Ind AS 29	Financial Reporting in Hyperinflationary Economies
Ind AS 32	Financial Instruments: Presentation
Ind AS 33	Earnings per Share
Ind AS 34	Interim Financial Reporting
Ind AS 36	Impairment of Assets
Ind AS 37	Provisions, Contingent Liabilities and Contingent Assets
Ind AS 38	Intangible Assets
Ind AS 40	Investment Property
Ind AS 41	Agriculture

SUMMARY

Financial accounting is a specialized branch of accounting that keeps track of a company›s financial transactions. Using standardized guidelines, the transactions are recorded, summarized, and presented in a financial report or financial statement such as an income statement or a balance sheet. Companies issue financial statements on a routine schedule. The statements are considered external because they are given to people outside of the company, with the primary recipients being owners/stockholders, as well as certain lenders. If a corporation›s stock is publicly traded, however, its financial statements (and other financial reporting) tend to be widely circulated, and information will likely reach secondary recipients such as competitors, customers, employees, labour organizations, and investment analysts.

Because external financial statements are used by a variety of people in a variety of ways, financial accounting has common rules known as **accounting standards** and as **generally accepted accounting principles (GAAP)**. In the U.S., the Financial Accounting Standards Board (FASB) is the organization that develops the accounting standards and principles. Corporations whose stock is publicly traded must also comply with the reporting requirements of the Securities and Exchange Commission (SEC), an agency of the U.S. government.

EXERCISE

Multiple choice Questions

1. Accounting provides information on

(A) Cost and income for managers

(B) Company's tax liability for a particular year

(C) Financial conditions of an institution

(D) All of the above

(Ans: D)

2. The long-term assets that have no physical existence but are rights that have value is known as

(A) Current assets

(B) Fixed assets

(C) Intangible assets

(D) Investments

(Ans: C)

3. The assets that can be converted into cash within a short period (i.e. 1 year or less) are known as

(A) Current assets

(B) Fixed assets

(C) Intangible assets

(D) Investments

(Ans: A)

4. Patents, Copyrights and Trademarks are
   (A) Current assets
   (B) Fixed assets
   (C) Intangible assets
   (D) Investments
   (**Ans:** C)

5. The following is not a type of liability
   (A) Short term
   (B) Current
   (C) Fixed
   (D) Contingent
   (**Ans:** A)

Review Questions

1. Define Accounting?
2. What is the main objective of financial statements?
3. Name the two main underlying assumptions of accounting?
4. Name and explain the four elements of financial Statement?
5. Define accounting Cycle and Name the steps of Accounting Cycle.
6. What are the various branches of accounting
7. What are the various limitation of financial accounting
8. Explain GAAP
9. What is the difference between Profit and Gain
10. What is the difference between Expense and Loss

3 JOURNAL

Introduction

Journal entries

The word journal has been derived from the French word 'Jour' which means day. So, journal means daily. Transactions are recorded daily in the journal as and when the transactions take place. As soon as a transaction takes place, its debit and credit aspects are analysed and recorded in the journal together with a short description called narration. This facilitates making entries in the ledger. Since transactions are first recorded in the journal, it is called book of original entry or prime entry or primary entry or preliminary entry, or first entry. Journalising is the beginning of the accounting process for the financial transactions.

Meaning

Journal is the book of original entry in which business transactions are recorded in chronological order, that is, in the order of occurrence. Transactions are recorded for the first time in the journal. Entries are made in the journal based on source documents. Record of business transactions in the journal is known as Journal entry. The process of recording the transactions in journal is called as journalising.

Format of Journal

The format of journal is given below:

In the books of.......... Journal

In the books of..........

Journal

Date	Particulars	L.F.	Debit ₹	Credit ₹

A journal contains five columns; Date, Particulars, L.F., Debit and Credit.

Date column: In this column the date of the transaction is recorded.

Particulars column: The accounts involved in the transaction are recorded in this column. The account debited is recorded first with the word 'Dr.' entered towards the end of the row and the account credited is entered in the next line after leaving a little space on the left and preceded by the word 'To'.

Leder Folio column (L.F.): The page number of ledgers in which the accounts debited and credited are maintained is recorded here. Folio means page and ledger folio means page number of ledgers. This L.F. helps in cross verification of accounts in the ledger and helps in audit of accounts.

Debit column: The amount to be debited is recorded in this column. The unit of measurement, that is, amount expressed in the currency of the country is recorded in this column. For example, in India amount is recorded in rupees (Rs.).

Credit column: The amount to be credited is recorded in this column. The unit of measurement, that is, the currency of the country is written in this column. For example, in India amount is recorded in rupees (Rs.).

Narration: A short description of each transaction is written under each entry which is called narration.

Tutorial note

- While entering the date, the year may be written at the top, then the month and then the particular date.
- The narration must be simple and complete. The words 'Being' or 'For' may also be prefixed before the narration.
- ·t is customary to write 'Dr' and 'To' in the journal entries.
- L.F. column is filled when the transaction is posted to the ledger. In computerised accounting, it is the reference number.
- The amount columns of a journal may be totalled at the end of each page and the grand total may be given at the end of the month.
- To show each journal entry separately, a line may be drawn after narration in particulars column.
- When transactions of similar nature take place on the same date, they may be combined while they are journalised.

Steps in journalising

The process of analysing the business transactions under the heads of debit and credit and recording them in the journal is called journalising. An entry made in the journal is called a journal entry. The following steps are followed in journalising:

- Analyse the transactions and identify the accounts (based on aspects) which are involved in the transaction.
- Classify the above accounts under Personal account, Real account or Nominal account
- Apply the rules of debit and credit for the above two accounts.
- Find which account is to be debited and which account is to be credited by the application of rules of double entry system Record the date of transaction in the date column.

- Enter the name of the account to be debited in the particular's column very close to the left-hand side of the particular's column followed by the abbreviation 'Dr.' at the end in the same line. Against this, the amount to be debited is entered in the debit amount column in the same line.
- Write the name of the account to be credited in the second line starting with the word 'To' prefixed a few spaces away from the margin in the particular's column. Against this, the amount to be credited is entered in the credit amount column in the same line.
- Write the narration within brackets in the next line in the particular's column.

Different types of journal entries

The journal entries may be of the following types:

a. Single entry
b. Compound entry
c. Opening entry
d. Closing entry
e. Rectifying entry
f. Adjusting entry
g. Transferring entry

Single entry: Single entry is an entry in which only two accounts are involved, one account is debited and another is credited.

Compound entry: Compound entry is an entry in which more than two accounts are involved. Either more than one account is debited or more than one account is credited or both.

Opening entry: Through opening entry the balances of assets and liabilities at the end of the previous accounting year are brought forward to the current accounting year. This is dealt in chapter 6.

Closing entry: At the end of the accounting period, the nominal accounts are closed by transferring to trading account or profit and loss account. All direct expenses and direct revenues are transferred to Trading Account. All indirect expenses and indirect revenues are transferred to Profit and Loss Account. This is dealt in chapter 6.

Rectifying entry: Rectifying entries are passed to make correction of errors in accounting. This is dealt in chapter 9.

Adjusting entry: Adjusting entry is the entry made for the transactions which remain unrecorded or require adjustment after closing the accounts for the accounting year. This is dealt in chapter 13.

Transfer entry: Transfer entry is the entry through which amount is transferred from one account to another account.

Notes

Analysis of transactions

Example 1

Transaction: Somu commenced printing business with cash Rs. 50,000.

Analysis: This is a cash transaction as cash is involved.

Transaction	Accounts involved	Nature of accounts	How affected in business	Debit / Credit
Somu commenced business with cash ₹ 50,000	Cash A/c	Real A/c	Cash comes in	Debit
	Somu's capital A/c	Personal A/c	Somu is the giver	Credit

Journal entry

Date	Particulars	L.F.	Debit ₹	Credit ₹
	Cash A/c Dr.		50,000	
	To Somu's capital A/c			50,000
	(Somu commenced business with capital)			

Example 2

Transaction: Bought goods for cash Rs. 4,000

Analysis: This is a cash transaction as cash is involved.

Transaction	Accounts involved	Nature of accounts	How affected in business	Debit / Credit
Bought goods for cash ₹ 4,000	Purchases A/c	Nominal A/c	Expenses made	Debit
	Cash A/c	Real A/c	Cash goes out	Credit

Journal entry

Date	Particulars	L.F.	Debit ₹	Credit ₹
	Purchases A/c Dr.		4,000	
	To Cash A/c			4,000
	(Cash purchase made)			

Example 3

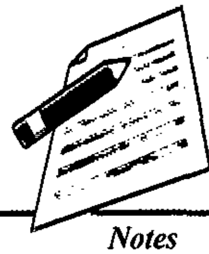
Transaction: Purchased goods from Rahul for Rs. 10,000 on credit

Analysis: This is a credit transaction.

Transactions	Accounts involved	Nature of accounts	How affected in business	Debit / Credit
Purchased goods from Rahul for ₹ 10,000 on credit	Purchases A/c	Nominal A/c	Expenses made	Debit
	Rahul A/c	Personal A/c	Rahul is the giver	Credit

Journal entry

Date	Particulars	L.F.	Debit ₹	Credit ₹
	Purchases A/c Dr.		10,000	
	To Rahul A/c			10,000
	(Bought goods from Rahul on credit)			



Example 4

Transaction: Cash paid to Rahul Rs. 4,000

Analysis: This is a cash transaction as cash is involved.

Transaction	Accounts involved	Nature of accounts	How affected in business	Debit / Credit
Paid Rahul ₹ 4,000	Rahul A/c	Personal A/c	Rahul is the receiver	Debit
	Cash A/c	Real A/c	Cash goes out	Credit

Journal entry

Date	Particulars		L.F.	Debit ₹	Credit ₹
	Rahul A/c	Dr.		4,000	
	To Cash A/c				4,000
	(Paid Rahul)				

Example 5

Transaction: Withdrew cash for personal use Rs. 8,000

Analysis: This is a cash transaction as cash is involved.

Transactions	Accounts involved	Nature of accounts	How affected in business	Debit / Credit
Withdrew cash for personal use ₹ 8,000	Drawings A/c	Personal A/c	Propreitor is the receiver	Debit
	Cash A/c	Real A/c	Cash goes out	Credit

Journal entry

Date	Particulars		L.F.	Debit ₹	Credit ₹
	Drawings A/c	Dr.		8,000	
	To Cash A/c				8,000
	(Cash withdrawn for personal use)				

Advantages of journal

Following are the advantages of journal:

- Complete information about the business transactions can be obtained on time basis as the transactions are recorded in chronological order.
- Correctness of the entry can be checked through narration.
- Journal forms the basis for posting the entries in the ledger.

SUMMARY

A journal entry is a record of the business transactions in the accounting books of a business. A properly documented journal entry consists of the correct date, amounts to be debited and credited, description of the transaction and a unique reference number. A journal entry is the first step in the accounting cycle. A journal details all financial transactions of a business and makes a note of the accounts that are affected. Since most businesses use a double-entry accounting system, every financial transaction impact at least two accounts, while one account is debited, another account is credited. This means that a journal entry has equal debit and credit amounts.

EXERCISE

MCQ

1. Among these transactions, which transaction will have no impact on stockholders' equity?
   (a) Net loss
   (b) Investment of cash by stockholders
   (c) Dividends to stockholders
   (d) Purchase of the land from the proceeds of bank loan
   Answer: d

2. Amount invested by the proprietor in the business should be credit to:
   (a) A/c payable
   (b) Capital
   (c) Cash
   (d) Drawing
   Answer: b

3. Transactions are first recorded in which book/account?
   (a) Book of Original Entry
   (b) T Accounts
   (c) Accounting Equation
   (d) Book of Final Entry
   Answer: a

4. Customer goods returned will be credited to which account?
   (a) Purchases A/C
   (b) Return outward
   (c) Customer's A/C
   (d) Return inward
   Answer: d

5. Journal is also called a?
   (a) A day book
   (b) History book
   (c) Ledger book
   (d) An entry book
   Answer: a

Notes

Review Quartinos

Problem 1:

On ***April 01, 2016*** Anees started business with Rs. 100,000 and other transactions for the month are:

- ***2.*** Purchase Furniture for Cash Rs. 7,000.
- ***8.*** Purchase Goods for Cash Rs. 2,000 and for Credit Rs. 1,000 from Khalid Retail Store.
- ***14.*** Sold Goods to Khan Brothers Rs. 12,000 and Cash Sales Rs. 5,000.
- ***18.*** Owner withdrew of worth Rs. 2,000 for personal use.
- ***22.*** Paid Khalid Retail Store Rs. 500.
- ***26.*** Received Rs. 10,000 from Khan Brothers.
- ***30.*** Paid Salaries Expense Rs. 2,000

Problems 2:

Prepare general journal entries for the following transactions of a business called Pose for Pics in 2016:

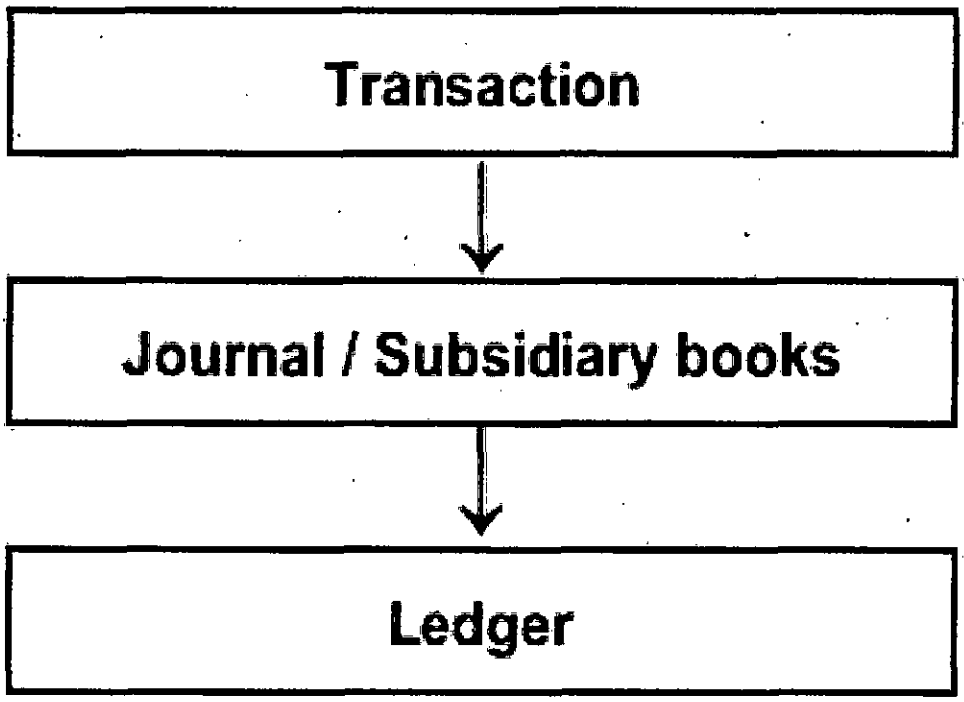
- ***Aug. 1:*** Hashim Khan, the owner, invested Rs. 57,500 cash and Rs. 32,500 of photography equipment in the business.
- ***04:*** Paid Rs. 3,000 cash for an insurance policy covering the next 24 months.
- ***07:*** Services are performed and clients are billed for Rs. 10,000.
- ***13:*** Purchased office supplies for Rs. 1,400. Cash paid Rs. 400 and remaining outstanding.
- ***20:*** Received Rs. 2,000 cash in photography fees earned previously.
- ***24:*** The client immediately pays Rs. 15,000 for services to be performed at a later date.
- ***29:*** The business acquires photography equipment. The purchase price is Rs. 100,000, pays Rs. 25,000 cash and signs a note for the balance.

4 LEDGER

LEDGER

Introduction

Ledger account is a summary statement of all the transactions relating to a person, asset, liability, expense or income which has taken place during a given period of time and it shows their net effect. From the transactions recorded in the journal, the ledger account is prepared. Ledger is known as principal book of accounts. It is a book which contains all sets of accounts, namely, personal, real and nominal accounts. Account wise balance can be determined from the ledger. The ledger accounts are prepared based on journal entries passed.



Ledger may be maintained in the business enterprises in the form of a bound register or in the form of loose sheets with spiral binding. Normally one page or one sheet may be provided for one account. An index is provided in the beginning of the ledger giving details of the accounts contained in it such as specific code for each account, page number, etc. Where computerised accounting is followed, once the transactions are recorded in the journal, ledger accounts are automatically prepared.

Format of ledger account

The ledger account is prepared in T format. It is divided into two parts.

Format of ledger account

The ledger account is prepared in T format. It is divided into two parts. Left side is debit side and right side is credit side. Each side contains four columns. The name or title of the account is placed at the top middle and the details are entered in the ledger. The format of ledger account is given below:

Dr. **Name of the ledger account** **Cr.**

Date	Particulars	J.F.	Amount ₹	Date	Particulars	J.F.	Amount ₹

Following are the details contained in the various columns in the ledger:

Date: Date of the transaction is recorded in this column.

Particulars: The account debited or credited is recorded in this column. On the debit side, the entries are made starting with 'To' and on the credit side, entries are made starting with 'By'.

Journal Folio (J.F.): In this column, the page number of the journal or subsidiary books from which the entry has been posted to the ledger is noted.

Amount: The amount of the transaction is recorded in this column.

RULES FOR POSTING IN TO LEDGER

Posting the entries from day books to ledger is very important work. An accountant must keep in his mind the following rules while posting the entries: -

1. Entries must be posted from the day books or journal only.
2. Posting of the entries must be date wise.
3. Date of entry in day books must be the date of entry in ledger.
4. All amounts shown in debit side in journal must be posted in debit side of a particular account. In **'particulars'** column of ledger, the name of the other account as shown in journal, relating to same entry, must be written and the account head must start with 'To'.
5. All amounts shown in credit side in journal must be posted in credit side of a particular account. In **'particulars'** column of ledger, the name of the other account as shown in journal, relating to same entry, must be written and the account head must start with 'By'.
6. After the entry, page number of journals from where the entry is posted, must be written in L/F column of account and the page number of ledger account must be written in L/F column of journal or day book.
7. Then the balancing of the ledger should be done. Balancing is may be done as running or can be done after doing the totals of debit and credit side. If the total

of debit side is more than credit side then the balance should be shown as debit balance in balance column and if the total of credit side is more than the total of debit side then balance should be shown as credit balance in balance column. If the totals of debit and credit sides are equal then the balance should be shown as 'nil' in balance column.

Illustration 1

Pass journal entries for the following transactions and post them in the ledger accounts.

2017

June 1	Basu started business with cash Rs. 50,000
June 4	Purchased furniture by paying cash for Rs. 6,000
June 7	Purchased machinery on credit from Harish Rs. 10,000
June 10	Bought goods for cash Rs. 4,000
June 18	Paid insurance premium Rs. 100

Solution

In the books of Basu

Journal entries

Date	Particulars		L.F.	Debit ₹	Credit ₹
2017	Cash A/c	Dr.		50,000	
June 1	To Basu's capital A/c				50,000
	(Started business with cash)				
June 4	Furniture A/c	Dr.		6,000	
	To Cash A/c				6,000
	(Furniture bought for cash)				
June 7	Machinery A/c	Dr.		10,000	
	To Harish A/c				10,000
	(Machinery bought on credit from Harish)				
June 10	Purchases A/c	Dr.		4,000	
	To Cash A/c				4,000
	(Goods bought for cash)				
June 18	Insurance premium A/c	Dr.		100	
	To Cash A/c				100
	(Insurance premium paid)				

Ledger accounts

Dr. **Cash account** **Cr.**

Date	Particulars	J.F.	₹	Date	Particulars	J.F.	₹
2017				2017			
June 1	To Basu's capital A/c		50,000	June 4	By Furniture A/c		6,000
				10	By Purchases A/c		4,000
				18	By Insurance premium A/c		100

Dr. **Basu's Capital account** Cr.

Date	Particulars	J.F.	₹	Date	Particulars	J.F.	₹
				2017			
				June 1	By Cash A/c		50,000

Dr. **Furniture account** Cr.

Date	Particulars	J.F.	₹	Date	Particulars	J.F.	₹
2017							
June 4	To Cash A/c		6,000				

Dr. **Machinery account** Cr.

Date	Particulars	J.F.	₹	Date	Particulars	J.F.	₹
2017							
June 7	To Harish A/c		10,000				

Dr. **Harish account** Cr.

Date	Particulars	J.F.	₹	Date	Particulars	J.F.	₹
				2017			
				June 7	By Machinery A/c		10,000

Dr. **Purchases account** Cr.

Date	Particulars	J.F.	₹	Date	Particulars	J.F.	₹
2017							
June 10	To Cash A/c		4,000				

Dr. **Insurance premium account** Cr.

Date	Particulars	J.F.	₹	Date	Particulars	J.F.	₹
2017							
June 18	To Cash A/c		100				

Posting of opening journal entry

In case of existing business enterprises, opening entry is made at the beginning of the accounting period to bring into account the balances of accounts which were not closed in the preceding accounting period. The accounts not closed are capital, liabilities and assets appearing in the balance sheet of the previous year. The entry passed is as follows:

Assets A/c (individually) Dr. xxx

To Liabilities A/c (individually) xxx

To Capital A/c xxx

While posting the opening entry in the individual ledgers, the term balance brought down (balance b/d) is used. The steps involved in posting the opening entry are as follows:

Step 1: The items debited in the opening entry are entered on the debit side of respective accounts. The words 'To Balance b/d' are written in the particular's column with respective amounts in the amount column, date being the first day of the accounting period.

Step 2: The items credited in the opening entry are entered on the credit side of respective accounts. The words 'By Balance b/d' are written in the particular's column with respective amounts in the amount column, date being the first day of the accounting period.

Illustration 2

Prepare necessary ledger accounts in the books of Joy from the following opening entry:

In the books of Joy Journal entries

In the books of Joy

Journal entries

Date	Particulars		L.F.	Debit ₹	Credit ₹
2017					
Jan 1	Cash A/c	Dr.		45,000	
	Stock A/c	Dr.		50,000	
	Sohan A/c	Dr.		35,000	
	Furniture A/c	Dr.		50,000	
	To Ram A/c				20,000
	To Joy's capital A/c				1,60,000
	(Balances of assets and liabilities brought forward)				

Solution

Ledger accounts

Dr. **Cash account** Cr.

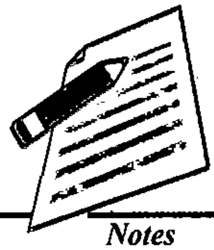
Date	Particulars	J.F.	₹	Date	Particulars	J.F.	₹
2017							
Jan 1	To Balance b/d		45,000				

Dr. **Stock account** Cr.

Date	Particulars	J.F.	₹	Date	Particulars	J.F.	₹
2017							
Jan 1	To Balance b/d		50,000				

Dr. **Sohan account** Cr.

Date	Particulars	J.F.	₹	Date	Particulars	J.F.	₹
2017							
Jan 1	To Balance b/d		35,000				



Notes

Dr. **Furniture account** Cr.

Date	Particulars	J.F.	₹	Date	Particulars	J.F.	₹
2017							
Jan 1	To Balance b/d		50,000				

Dr. **Ram account** Cr.

Date	Particulars	J.F.	₹	Date	Particulars	J.F.	₹
				2017			
				Jan 1	By Balance b/d		20,000

Dr. **Joy's capital account** Cr.

Date	Particulars	J.F.	₹	Date	Particulars	J.F.	₹
				2017			
				Jan 1	By Balance b/d		1,60,000

Posting of compound journal entry

When a journal entry has more than one debit or more than one credit or both, it is called a compound entry. For items debited in the compound entry, entries are made on the debit side in the respective accounts with the respective amount debited. For items credited in the compound entry, entries are made on the credit side in the respective accounts with the respective amount credited. Posting of such entries to ledger accounts is explained in illustrations 3 and 4.

Illustration 3

Journalise the following transactions and post them to ledger. On May 20, 2018, Ram paid salaries Rs. 15,000; Electricity charges Rs. 8,000 and wages Rs. 2,000.

Solution

In the books of Ram

Journal entries

Date	Particulars	L.F.	Debit ₹	Credit ₹
2018				
May 20	Salaries A/c Dr.		15,000	
	Electricity charges A/c Dr.		8,000	
	Wages A/c Dr.		2,000	
	To Cash A/c			25,000
	(Expenses paid)			

Ledger accounts

Dr. **Salaries account** **Cr.**

Date	Particulars	J.F.	₹	Date	Particulars	J.F.	₹
2018							
May 20	To Cash A/c		15,000				

Dr. **Electricity charges account** **Cr.**

Date	Particulars	J.F.	₹	Date	Particulars	J.F.	₹
2018							
May 20	To Cash A/c		8,000				

Dr. **Wages account** **Cr.**

Date	Particulars	J.F.	₹	Date	Particulars	J.F.	₹
2018							
May 20	To Cash A/c		2,000				

Dr. **Cash account** **Cr.**

Date	Particulars	J.F.	₹	Date	Particulars	J.F.	₹
				2018			
				May 20	By Salaries A/c		15,000
					By Electricity charges A/c		8,000
					By Wages A/c		2,000

Illustration 4

On 15th March, 2017, Ramesh paid Rs. 13,800 in full settlement of his account Rs. 15,000 due to his creditor Dinesh. Pass journal entry and prepare ledger accounts.

Solution

In the books of Ramesh

Journal entry

In the books of Ramesh

Journal entry

Date	Particulars		L.F.	Debit ₹	Credit ₹
2017					
March 15	Dinesh A/c	Dr.		15,000	
	To Cash A/c				13,800
	To Discount received A/c				1,200
	(Paid Dinesh in full settlement of his account)				

Notes

Ledger accounts

Ledger accounts

Dr. **Dinesh account** **Cr.**

Date	Particulars	J.F.	₹	Date	Particulars	J.F.	₹
2017							
March 15	To Cash A/c		13,800				
	To Discount received A/c		1,200				

Dr. **Cash account** **Cr.**

Date	Particulars	J.F.	₹	Date	Particulars	J.F.	₹
				2017			
				March 15	By Dinesh A/c		13,800

Dr. **Discount received account** **Cr.**

Date	Particulars	J.F.	₹	Date	Particulars	J.F.	₹
				2017			
				March 15	By Dinesh A/c		1,200

Student activity

Think: What will happen to the ledger account postings? Do you think that it will continue for an indefinite period of time? Where will the accounting process stop?

Notes

5 CASH BOOK

Cash Book – A subsidiary book and principal book of accounts

All the cash transactions are recorded first in the cash book. It is therefore a subsidiary book. When cash book is maintained, there is no need for preparing cash account and bank account in the ledger because in the cash book cash receipts and cash payments are compared and the cash and bank balances at the end are arrived at. Thus, it serves as a ledger account also. Hence, the cash book, unlike any other subsidiary book, is both a subsidiary book and a principal book.

Importance of cash book

Importance of cash book is discussed below:

Serves as both journal and ledger

When cash book is maintained, it is not necessary to open a separate cash account in the ledger. Thus, cash book serves the purpose of a journal and a ledger.

Saves time and labour

When cash transactions are recorded through journal entries, a lot of time and labour will be involved. To avoid this, all cash transactions are straightaway recorded in the cash book, which saves time and labour.

Shows the cash and bank balance

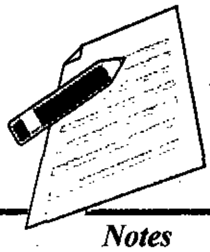
It helps to know the cash and bank balance at any point of time by comparing the total cash receipts and cash payments.

Benefit of division of labour

As cash book is a separate subsidiary book, an independent person can maintain it. Hence, business can get the benefit of division of labour.

Effective cash management

Cash book provides all information regarding total receipts and payments of the business concern during a particular period. It helps in formulating effective policy for cash management.



Prevents errors and frauds

Balance as per cash book and the balance in the cash box can be compared daily. If there is any deficit or surplus, it can be found easily. It helps in preventing any fraud or error in cash dealings.

Types of cash book

The main cash book may be of various types and following are the three most common types.

i. Simple or single column cash book (only cash column)

ii. Cash book with cash and discount column (double column cash book)

iii. Cash book with cash, discount and bank columns (three column cash book).

Apart from the main cash book, petty cash book may also be prepared to enter the petty expenses, i.e., expenses involving small amount.

Single column cash book

Single column cash book or simple cash book, like a ledger account has only one amount column, i.e., cash column on each side. Only cash transactions are recorded in this book. All cash receipts and payments are recorded systematically in this book. The format of simple cash book is given as under:

Dr. **Simple Cash Book** **Cr.**

Date	Receipts	R.N.	L.F.	Amount ₹	Date	Payments	V.N.	L.F.	Amount ₹
(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)

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

Columns (1) and (6) – Date: Date of receiving cash is recorded in the debit side and date of paying cash is recorded in the credit side.

Column (2) Receipts: Receipts column shows name of persons or parties from whom cash has been received, income received, sale of asset like plant, cash sales and other receipts.

Column (3) Receipt Number (R.N.): This column contains the serial numbers of the cash receipts.

Columns (4) and (9) – Ledger Folio (L.F.): This column is provided both on the debit and credit side of the cash book. It is used for reference. The Ledger page number of every account in the cash book is recorded in this column. This column facilitates vouching and verification of transactions recorded.

Columns (5) and (10) – Amount: This is the last column of the cash book on both the debit and credit sides. In case of cash receipt, the amount of actual cash receipts and in case of payments, the amount of actual cash payment is recorded. The opening balance of cash is recorded on the debit side and the closing balance is the balancing figure on the credit side. Opening balance or capital contributed by cash in case of new business is the first item on the debit side and the closing balance is the last item on the credit side.

The word 'To' is conventionally used before different accounts at the debit side of cash book in particulars column. The word 'By' is used before the different accounts at the credit side of the cash book in particulars column.

Column (7) Payments: The accounts to which payments are made are recorded here, such as names of persons to whom payment has been made, expenses paid, assets purchased, cash purchases, etc.

Column (8) Voucher Number (V.N.): This column contains the serial number of the voucher towards which payment is made.

Student activity

Think: Credit transactions are not recorded in the cash book. Where will they be recorded?

1. Balancing of single column cash book

Since the cash book serves as cash account, it must be balanced regularly. The balancing procedure is the same like any other ledger account. It must be remembered that one cannot pay more cash than what one has received. Therefore, the total of receipts is always more than (or at least equal to, but never less than) the credit total (payments) and the cash book always shows a debit balance (or nil balance, but never credit balance).

Illustration 1

Enter the following transactions in a simple cash book of Kunal:

2017

Jan.		Rs.
1	Cash in hand	11,200
5	Received from Ramesh	300
7	Paid rent	30
8	Sold goods for cash	300
10	Paid Mohan	700
27	Purchased furniture for cash	200
31	Paid salaries	100

Notes

Solution

In the books of Kunal

Dr. **Cash Book (Single column)** **Cr.**

Date	Receipts	L.F.	Amount ₹	Date	Payments	L.F.	Amount ₹
2017				2017			
Jan 1	To Balance b/d		11,200	Jan 7	By Rent A/c		30
Jan 5	To Ramesh A/c		300	Jan 10	By Mohan A/c		700
Jan 8	To Sales A/c		300	Jan 27	By Furniture A/c		200
				Jan 31	By Salaries A/c		100
				Jan 31	By Balance c/d		10,770
			11,800				11,800
Feb 1	To Balance b/d		10,770				

Explanation

Jan 1: Cash in hand is the opening balance with the firm. This would have been the closing balance on 31st December, 2017. Cash account always has debit balance so it has been shown in the debit side of the cash book.

Jan 5: It is a receipt from Ramesh, so it has been recorded in receipt side (debit side) of the cash book.

Jan 7: Payment of rent will decrease cash, so it has been recorded in payment side (credit side) of the cash book.

Jan 8: Cash sales of goods will bring cash and increases the cash balance, so it has been recorded in the debit side of the cash book.

Jan 10: Payment to Mohan decreases cash, so it has been recorded in the credit side.

Jan 27: Purchase of furniture for cash reduces cash, so it has been recorded in credit side.

Jan 31: Payment of salaries in cash reduces cash, so it has been recorded in the credit side of cash book.

Illustration 2

Enter the following transactions in a single column cash book of Pradeep for April, 2017

April Rs.

1 Commenced business with cash 27,000

5 Bought goods for cash 6,000

10 Goods sold for cash 11,000

13 Paid into bank 5,000

14 Goods sold to Sangeetha for cash 9,000

17 Goods purchased from Preethi on credit 13,000

21 Purchased stationery by cash 200

25 Paid Murugan by cash 14,000

26 Commission paid by cash 700

29 Drew from bank for office use 4,000

30 Rent paid by cheque 3,000

Solution

In the books of Pradeep

Dr. **Cash Book (Single column)** **Cr.**

Date	Receipts	L.F.	Amount ₹	Date	Payments	L.F.	Amount ₹
2017				2017			
April 1	To Pradeep's capital A/c		27,000	April 5	By Purchases A/c		6,000
10	To Sales A/c		11,000	13	By Bank A/c		5,000
14	To Sales A/c		9,000	21	By Stationery A/c		200
29	To Bank A/c		4,000	25	By Murugan A/c		14,000
				26	By Commission A/c		700
				30	By Balance c/d		25,100
			51,000				51,000
May 1	To Balance b/d		25,100				

Note: The transaction dated April 17th will not be recorded in the cash book as it is a credit transaction. The transaction on 30th is not recorded as the payment is made through bank which does not involve cash.

Double column cash book (Cash book with cash and discount column)

It is a cash book with cash and discount columns. As there are two columns, i.e., discount and cash columns, both on debit and credit sides, this cash book is known as 'double column cash book'.

The double column cash book is prepared on the lines of simple cash book. It has only one additional column, i.e., discount column on each side. Discount column represents discount allowed on the debit side and discount received on the credit side. The format of double column cash book is given below:

Dr. **Cash book with cash and discount columns** **Cr.**

Date	Receipts	R.N	L.F	Amount ₹		Date	Payments	R.N	L.F.	Amount ₹	
				Discount	Cash					Discount	Cash

Student activity

Think: Cash account cannot have a credit balance. Why?

Balancing the double column cash book

The cash columns should be balanced as usual and the balance should be carried forward to the next date or period.

However, discount columns are not to be balanced. They are to be totalled on the debit side and credit side separately. The total of discount column on the debit side represents total discount allowed to customers and is debited to discount allowed account. Total of discount column on the credit side represents total discount received and is credited to discount received account. The periodical totals of discount columns are posted as under:

- Debit Discount allowed account as 'To Sundry Accounts as per Cash book', with the periodical total of the discount allowed column.
- Credit Discount received account as 'By Sundry Accounts as per Cash Book' with the periodical total of the discount received column.

Three column cash books (Cash book with cash, discount and bank column)

A three-column cash book includes three amount columns on both sides, i.e., cash, bank and discount. This cash book is prepared in the same way as simple and double column cash books are prepared. The transactions which increase the cash and bank balance are recorded on the debit side of the cash and bank columns respectively. Opening balance of cash and favourable bank balance appear as the first item on the debit side of the three-column cash book in case of existing business. If the business is a new one, capital contributed in cash and/or bank deposit appear as the first item on the debit side.

1. Format

Format of three column cash book is as follows:

Dr. Cash book with cash, discount and bank columns or three column cash book Cr.

Date	Receipts	L.F	Amount ₹			Date	Payments	L.F.	Amount ₹		
			Discount	Cash	Bank				Discount	Cash	Bank

Tutorial note

- If a business entity has more than one bank account, columns may be provided in the cash book for each bank account separately.

Notes

- Treatment of cheques: In addition to cash dealings every business may use cheques as a means of payment. For the purpose of accounting, cheques received are treated as cash received. When cheques received are banked on the same day the amount is to be directly debited to the bank account. When payments is made by cheque, the bank account is credited

2. Contra entry

When the two accounts involved in a transaction are cash account and bank account, then both the aspects are entered in cash book itself. As both the debit and credit aspects of a transaction are recorded in the cash book, such entries are called contra entries.

Example

- When cash is paid into bank, it is recorded in the bank column on the debit side and in the cash column on the credit side of the cash book.
- When cash is drawn from bank for office use, it is entered in cash column on the debit side and in the bank column on the credit side of the cash book.

To denote that there are contra entries, the alphabet 'C' is written in L.F. column on both sides. Contra means that particular entry is posted on the other side (contra) of the same book, because Cash account and Bank account are there in the cash book only and there are no separate ledger accounts needed for this purpose. The alphabet 'C' indicates that no further posting is required and the relevant account is posted on the opposite side.

Illustration 4

Prepare three column cash books in the books of Thiru Durairaj.

2017 Rs.

March 1 Cash in hand 12,000

Cash at bank 15,000

2 Cash paid into bank 11,000

3. Goods sold Rs. 18,500. Half of it is received in cash and half of it is received by cheque which is immediately deposited in the bank

4 Sold on credit to Jayaraj for 7,000

8 Jayaraj sent a cheque in full settlement 6,900

12 Jayaraj's cheque was sent to bank

14 Bought goods from Iqbal and issued a cheque to him Immediately 8500

15 Bought goods from Murali on credit 4,000

19 Received a cheque from Kannappan in full settlement of his account 2000 1975

20 Drew cash Rs. 3,000 and by cheque Rs. 5,000 for personal use

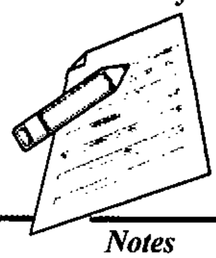
25 Paid Vinod by cheque in full settlement of his account of Rs. 2,000 1,850

In the books of Durairaj

Three-column cash book

Dr. **Cr.**

Date	Particulars	R.N	L.F	Amount ₹ Discount Allowed	Amount ₹ Cash	Amount ₹ Bank	Date	Particulars	V.N	L.F.	Amount ₹ Discount Received	Amount ₹ Cash	Amount ₹ Bank
2017							2017						
Mar 1	To Balance b/d				12,000	15,000	Mar 2	By Bank A/c		C		11,000	
2	To Cash A/c		C			11,000	12	By Bank A/c		C		6,900	
3	To Sales				9,250	9,250	14	By Purchases A/c					8,500
8	To Jayaraj A/c			100	6,900		20	By Drawings A/c				3,000	5,000
12	To Cash A/c		C			6,900	25	By Vinod A/c			150		1,850
19	To Kannappan A/c			25	1,975		31	By Balance c/d				9,225	26,800
				125	30,125	42,150					150	30,125	42,150
Apr 1	To Balance b/d				9,225	26,800							



Notes

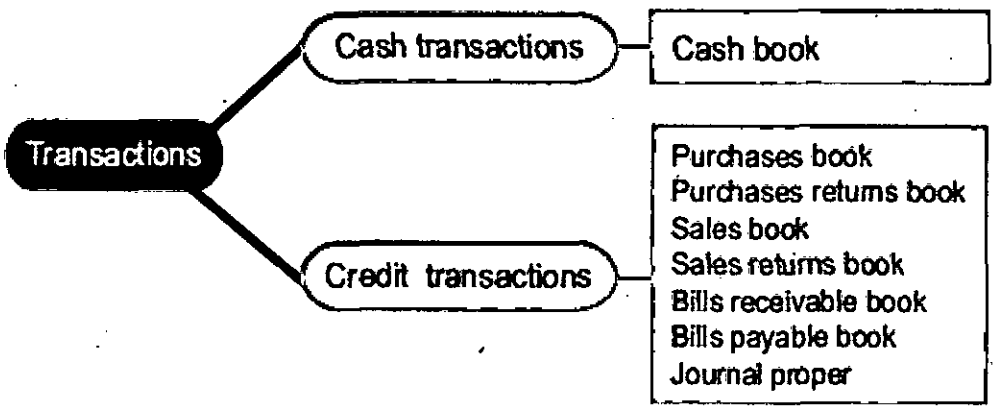
6 SUBSIDIARY BOOKS

Meaning of subsidiary books

Subsidiary books are sub-divisions of journal in each of which transactions of similar nature are recorded. These are the books of prime entry. Instead of recording in one journal, the transactions are recorded in a number of prescribed books.

Types of subsidiary books

The number of subsidiary books may vary according to the requirements of each business. Based on the nature of business and the volume of transactions, the following subsidiary books are maintained:



Purchases book

Purchases book is a subsidiary book in which only credit purchases of goods are recorded. When business wants to know the information about the credit purchases of goods at a glance, the information can be made available if purchases of goods on credit are separately recorded.

Goods here mean the items in which the business entity is dealing. In other words, it is the item which is purchased for regular sales. For example, furniture will be treated as goods in the case of the firm dealing in furniture. For other firms, which are not dealing in furniture it will be an asset. Hence, while recording transactions in the purchases book, it must be ascertained whether the credit purchase is related to the item in which the firm is dealing. Purchases of assets and purchase of goods for cash are not entered in purchases book.

Format of purchases book / purchases journal

Date	Particulars (Name of the suppliers and details of goods purchased)	Invoice No.	L.F.	Amount ₹	
				Details	Total
(i)	(ii)	(iii)	(iv)	(v)	(vi)
	Purchase A/c Dr.				

i. **Date**

In the date column, the date of purchases of goods on credit is recorded.

ii. **Particulars**

In this column the name of the supplier from whom goods have been purchased and details of goods purchased are given. It contains the name, quantity, quality and rate of goods purchased, trade discount and any other specification and specialties of the goods are recorded in this column.

iii. **Invoice number**

Invoice is the statement prepared by the seller of goods. It contains details about the goods, its price and other expenses incurred. The invoice number is entered in this column.

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

The page number of the ledger in which the supplier's account appears is recorded in this column. Purchases of goods must be posted to the personal accounts of suppliers. Purchases book contains the page number of supplier's account in the ledger. It helps in posting and also in checking the records.

v. **Amount column (Details)**

Amount column is divided into two parts, i.e., details and total. The details column is used to record the amount of various individual items purchased from a particular supplier. The amount of trade discount allowed is deducted. This column is used for adjustment of additions and subtractions.

vi. **Total amount column (Total)**

The net amount payable to the supplier of goods is recorded in the total amount column.

1. Invoice

Entries in the purchase's day book are made from invoices which are popularly known as bills. Invoice is a business document or bill or statement, prepared and sent by the seller to the buyer giving the details of goods sold, such as quantity, quality, price, total value, etc. Thus, the invoice is a source document of prime entry both for the buyer and the seller.

2. Trade discount

Trade discount is a deduction given by the supplier to the buyer on the list price or catalogue price of the goods. It is given as a trade practice or when goods are purchased in large quantities. It is shown as a deduction in the invoice. Trade discount is not recorded in the books of accounts. Only the net amount is recorded. Example: Suppose the sale of goods for Rs.10,000 was made and 10% was allowed as trade discount, the entry regarding sales will be made for Rs. 9,000 (10,000 – 10 per cent of 10,000). In the same way, purchaser of goods will also record purchases as Rs. 9,000).

Illustration 1

Record the following transactions in the purchases book of Shanthi Furniture Mart:

2017

March 1

Purchased from Mohan Furniture Mart, Madurai 20 chairs @ Rs. 450 each

2 tables @ Rs. 1,000 each

Less: Trade discount @ 10%

March 7

Bought from Ramesh & Co., Royapettah

2 stools @ Rs. 500 each

10 rolling chairs @ Rs. 200 each

Delivery charges and cartage Rs. 150

March 21

Purchased from Kamal & Co., Karaikkal

10 chairs @ Rs. 750 each

15 steel cabinets @ Rs. 1,500 each

Packing and delivery charges Rs. 250

Less: Trade discount @ 10%

March 25

Purchased from Jemini & Sons, Chennai

2 typewriters @ Rs. 7,750 for office use

Solution

Student activity

Think: Is trade discount the same as cash discount?

In the books of Shanthi Furniture Mart

Purchases book / Purchases journal

Date	Particulars	Invoice No.	L.F.	Amount ₹	
				Details	Total
2017	Mohan Furniture Mart, Madurai				
March 1	20chairs@ ₹450 each			9,000	
	2 tables@ ₹ 1,000 each			2,000	
				11,000	
	Less: Trade discount @ 10%			1,100	9,900
March 7	Ramesh & Co., Royapettah				
	2 stools @ ₹ 500 each			1,000	
	10 rolling chairs @ ₹ 200 each			2,000	
				3,000	
	Add: Delivery charges and cartage			150	3,150
March 21	Kamal & Co., Karaikal				
	10 chairs @ ₹ 750 each			7,500	
	15 steel cabinets @ ₹ 1,500 each			22,500	
				30,000	
	Less: Trade discount @ 10%			3,000	
				27,000	
	Add: Packing and delivery charges			250	27,250
	Purchases A/c Dr.				40,300

Tutorial note

- Trade discount is allowed on the purchase price of goods excluding delivery charges and cartage.
- Delivery charges and cartage are direct expenses, chargeable from purchaser, so they are added to the amount payable.

Illustration 2

Record the following transactions in the purchases book of Raja Furniture:

2017

May 4

Purchased from Kasi Furnitures,Kanyakumari 10 chairs @ Rs. 300 each 4 tables @ Rs. 800 each

Notes

May 6

Purchased for cash from Welcome Furniture, Vellore 2 almirahs @ Rs. 2,000 each 4 chairs @ Rs. 200 each

Less: Trade discount 5%

May 10

Bought furniture from Murugan Furniture Mart, Nagapattinam 10 chairs @ Rs. 250 each

5 tables @ Rs. 750 each

Delivery and packing charges Rs. 150

May 20

Purchased 2 computers for office use from Anandan & Co., Adyar on credit for Rs.15,550 each

May 25

Purchased from Gowtham & Co., Chennai

10 chairs @ Rs. 550 each

15 steel cabinets @ Rs. 2,000 each

Delivery charges Rs. 200

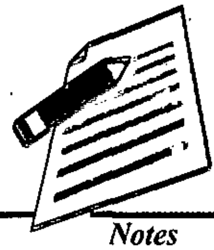
Less: Trade discount 10%

Solution

In the books of Raja Furniture

Purchases Book / Purchases Journal

Date	Particulars	Invoice No.	L.F.	Amount ₹ Details	Amount ₹ Total
2017					
May 4	Kasi Furnitures, Kanyakumari				
	10 chairs @ ₹ 300 each			3,000	
	4 tables @ ₹ 800 each			3,200	6,200
May 10	Murugan Furniture Mart, Nagapattinam				
	10 chairs @ ₹ 250 each			2,500	
	5 tables @ ₹ 750 each			3,750	
				6,250	
	Add: Delivery and packing charges			150	6,400
May 25	Gowtham & Co., Chennai				
	10 chairs @ ₹ 550 each			5,500	
	15 steel cabinets @ ₹ 2,000 each			30,000	
				35,500	
	Less: Trade discount @ 10%			3,550	
				31,950	
	Add: Delivery charges			200	32,150
	Purchases A/c Dr.				44,750



Note:

- Purchases on 6th May, 2017 will not be recorded in the purchases book, because it is cash purchases.
- Purchases of computers on 20th May, 2017 will not be recorded in the purchases book, because computer is an asset for the firm dealing in furniture and it is for office use.

Purchases returns book

After purchases of goods, the business unit may find that some of the goods are not up to the satisfactory level because of the following reasons:

- Goods may be defective.
- They might have been damaged in transit.
- Quantities delivered may not agree with the invoice.
- They might have been received quite late (off-season).
- They might not be as per the samples or specifications.
- There may be a breach of agreement.

Therefore, the buyer may return them to the suppliers.

Purchases returns book is a subsidiary book in which transactions relating to return of previously purchased goods to the suppliers, for which cash is not immediately received are recorded. Since goods are going out to the suppliers, they are also known as returns outward and the book is called as 'returns outward book or returns outward journal'. This book is prepared like purchases book and details are entered as mentioned in the format given below:

Format

Format

Purchases returns book

Date	Particulars	L.F.	Debit Note No.	Amount ₹		Remarks
				Details	Total	
Date of return	Names of persons to whom goods are returned and the details of goods returned Purchases Returns A/c Cr.	Posting reference		Detailed calculations		

1. Posting from the purchases returns book

After the transactions are recorded in the purchases returns book, posting them to ledger involves two steps:

Step 1: **Posting to personal accounts of creditors:** Every day, each entry in purchases returns book is posted to the debit side of the respective personal account of the creditor by writing the words 'To Purchases Returns account'.

Step 2: Posting to Purchases returns account: At the end of the month, the aggregate of the purchases returns is ascertained. It is the total purchases returns for the month and is posted to the credit side of purchases returns account by debiting 'Sundry creditors account'.

2. Debit note – the source document for returns outward

A 'debit note' is a document, bill or statement sent to the person to whom goods are returned. This statement informs that the supplier's account is debited to the extent of the value of goods returned. It contains the description and details of goods returned, name of the party to whom goods are returned and net value of the goods so returned with reason for return.

2. Credit note – Source document for returns inward

A credit note is prepared by the seller and sent to the buyer when goods are returned indicating that the buyer's account is credited in respect of goods returned. Credit note is a statement prepared by a trader who receives back from his customer the goods sold. It contains details such as the description of goods returned by the buyer, quantity returned and also their value.

Format

Format

Sales returns book

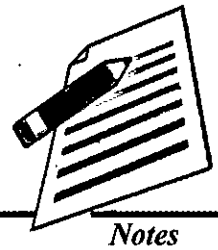
Date	Name of suppliers	L.F.	Credit Note No.	Amount ₹		Remarks
				Details	Total	
Date of return	Names of persons from whom goods are received back and details of goods returned	Posting reference		Detailed calculations	Net amount of the invoice	
	Sales returns A/c Dr.					

Illustration 6

Enter the following transactions in returns inward book of Magesh a textile dealer:

Enter the following transactions in returns inward book of Magesh a textile dealer:

2017 April 6	Returned by Shankar 30 shirts each costing ₹ 150 due to inferior quality.
April 8	Amar Tailors returned 10 T-shirts, each costing ₹ 100, on account of being not in accordance with their order.
April 21	Prema Stores returned 12 Salwar sets each costing ₹ 200, being not in accordance with order.



Notes

Solution

In the books of Magesh

Sales returns book

Date	Particulars	L.F.	Credit Note No.	Amount Details ₹	Amount Total ₹	Remarks
2017						
April 6	Shankar					
	30 Shirts @ ₹ 150			4,500		Due to inferior quality
April 8	Amar Tailors					
	10 T-Shirts @ ₹ 100			1,000		Not in accordance with the order
April 21	Prema Stores					
	12 Salwar sets @ ₹200			2,400	7,900	Not in accordance with the order
	Sales Returns A/c Dr.				7,900	

Ledger Accounts

Dr. Sales returns A/c Cr.

Date	Particulars	J.F.	Amount ₹	Date	Particulars	J.F.	Amount ₹
2017 April 30	To Sundry debtors A/c		7,900				

Dr. Shankar A/c Cr.

Date	Particulars	J.F.	Amount ₹	Date	Particulars	J.F.	Amount ₹
				2017 April 6	By Sales returns A/c		4,500

Dr. Amar Tailors A/c Cr.

Date	Particulars	J.F.	Amount ₹	Date	Particulars	J.F.	Amount ₹
				2017 April 8	By Sales returns A/c		1,000

Dr. Prema Stores A/c Cr.

Date	Particulars	J.F.	Amount ₹	Date	Particulars	J.F.	Amount ₹
				2017 April 21	By Sales returns A/c		2,400

Bills payable book

Details recorded in the bills payable book are the names of the parties whose bills are accepted, date of the bills payable, due date, amount, etc. The individual accounts of the parties whose bills are accepted will be debited with the corresponding amount in the bills payable book. The specimen of bills payable book is given below:

Notes

Format

Bills payable book

Format

Bills payable book

Date of acceptance of the bill	To whom acceptance is given	Term of the bill	Due date of the bill	L.F.	Amount of the bill ₹	Remark
(i)	(ii)	(iii)	(iv)	(v)	(vi)	(vii)

These columns record almost the same particulars which are recorded in the bills receivable book. When there is credit purchases of goods, the business entity may accept a bill drawn by the supplier or creditor. It is called bills payable for the business entity. Where there are large number of such bills payable, a separate bills payable book may be maintained. Thus, bills payable book is a subsidiary book maintained to record the details of bills payable.

Bills receivable book

Bills receivable refers to bills drawn, the payment for which has to be received. In case of credit sales of goods, the entity may draw a bill on the buyer (debtor), for a certain period. This is called bills receivable for the business entity and bills payable for the debtor who has accepted the bill. Where number of bills receivable is large, then a separate bills receivable book may be maintained by a business entity to record the details of bills receivable. Such bills are drawn on debtor for a specified amount payable at sight on or after specified period. Bills receivable book contains the details of bills drawn and its disposal. The format of the bills receivable book is given below:

Format

Bills receivable book

Format

Bills receivable book

Date of receipt of bill	From whom bill is received	Term of the bill	Due date of the bill	L.F.	Amount of the Bill ₹	Remark
(i)	(ii)	(iii)	(iv)	(v)	(vi)	(vii)

Date: In this column, the date of the acceptance of the bill is recorded.

From whom received: In this column, the name of the debtor, who has accepted the bill and promised to make its payment, is recorded. The bill legally comes into existence after its acceptance.

Term or period: The bill is drawn for a specified period. This period may be one month, two months, three months, etc. or even 60 days, 90 days, 120 days, etc. Period of the bill for which the bill has been drawn is mentioned here.

Due date: Due date is the date on which the payment of the bill is actually due. It is also known as date of maturity. In order to calculate the due date, three days of grace is added to the term of the bill

Ledger Folio (L.F.): This column contains the page number of the ledger in which the account of the acceptor of the bill appears.

Amount of the bill: The actual amount of the bill is recorded in this column.

Remark: This column contains the details of disposal of the bill, whether the bill has been discounted or endorsed, honoured or dishonoured etc.

Journal proper

Journal proper is a residuary book which contains record of transactions, which do not find a place in the subsidiary books such as cash book, purchases book, sales book, purchases returns book, sales returns book, bills receivable book and bills payable book. Thus, journal proper or general journal is a book in which the residual transactions which cannot be entered in any of the sub divisions of journal are entered. The usual entries that are passed through this journal are given below:

- Opening journal entry
- Closing journal entry
- Adjusting entries
- Transfer entries
- Rectifying entries
- Miscellaneous entries

(i) Opening journal entry

At the end of the accounting year, all nominal accounts are closed but the business has to be carried on with previous year's assets and liabilities. Hence, these accounts are to be brought into the accounts of the current year. Journal entry made 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, asset accounts are debited, liabilities and capital accounts are credited.

Example

Ramnath carried forward the following items. Make the opening entry in journal proper as on 1st January, 2017.

Cash	30,000	Stock	Rs. 15,000
Furniture	Rs. 3,000	Sundry Creditors	Rs. 10,000

Opening Entry

Date	Particulars		L.F.	Debit ₹	Credit ₹
2017	Cash A/c	Dr.		30,000	
Jan 1	Stock A/c	Dr.		15,000	
	Furniture A/c	Dr.		3,000	
	To Sundry creditors A/c				10,000
	To Capital A/c				38,000
	(Balance of assets and liabilities brought forward)				

(ii) Closing journal entry

At the end of the accounting period, all the ledger accounts relating to purchases, sales, purchases returns, sales returns, stock and other accounts concerning expenses, losses, incomes and gains are closed by transfer to trading and profit and loss account so that financial statements can be prepared. It should be noted that closing entries are made for nominal accounts only.

Example: Salaries account Rs. 10,000. The closing entry as on 31st December, 2017 is:

Closing Entry

Date	Particulars	L.F.	Debit ₹	Credit ₹
2017	Profit and Loss A/c Dr.		10,000	
December 31	To Salaries A/c			10,000
	(Salaries A/c transferred to Profit and Loss A/c)			

iii) Adjusting entries

After preparing the trial balance, but before preparing the final accounts, if any adjustment is required in the accounts for items or transactions left out, adjusting entries are made.

Example

Book value of the machinery as on 1st January, 2017 Rs. 1,00,000. Rate of depreciation is 10% p.a. Adjusting entry as on 31st December, 2017 is:

Adjusting Entry

Date	Particulars	L.F.	Debit ₹	Credit ₹
2017	Depreciation A/c (1,00,000 × 10%) Dr.		10,000	
Dec 31	To Machinery A/c			10,000
	(Depreciation written off)			

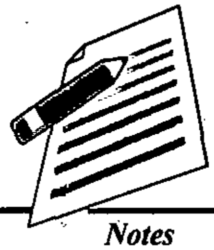
(iv) Transfer entries

Transfer entries are passed in the journal proper for transferring an item entered in one account to another account. For example, transferring net profit of Rs. 5,000 to capital account, the following entry is passed:

Transfer Entry

Transfer Entry

Date	Particulars	L.F.	Debit ₹	Credit ₹
	Profit and Loss A/c Dr.		5,000	
	To Capital A/c			5,000
	(Net profit transferred to capital account)			



Notes

(v) Rectifying entries

Rectifying entries are passed for rectifying errors which are committed in the books of accounts. **Example**

Purchase of furniture by a stationery dealer for Rs. 10,000 was debited to purchases account.

Pass rectifying entry on December 31, 2017.

Rectifying Entry

Date	Particulars		L.F.	Debit ₹	Credit ₹
2017	Furniture A/c	Dr.		10,000	
Dec 31	To Purchases A/c				10,000
	(Wrong debit to purchases account rectified)				

(vi) Miscellaneous entries

These are entries which do not occur frequently such as:

- Credit purchases and credit sale of assets which cannot be recorded through purchases or sales book.
- Endorsement, renewal and dishonour of bill of exchange which cannot be recorded through bills book.
- Other adjustments like interest on capital, bad debts, reserves, etc.
- Goods withdrawn by the owner for personal use.
- Loss of goods by fire, theft and spoilage.

SUMMARY

Ledger is a book that contains the accounts. Any financial statement related to the financial position of the company emerges only from the accounts. Thus, this ledger is known as the principal book. So, the result of all this is that it is necessary to relate all the information for any account available is from the ledger. This book of accounts is the most important book for any business and that is why it is known as the king of all books. Also, the ledger book is also known as the book of the final entry. The Ledger account is thought of the book that has all the accounting information of the company.

EXERCISE

MCQ

1. A ledger is called a book of
   (a) Primary entry
   (b) Final entry
   (c) Original entry
   (d) None of the above
   Answer: b

2. From which of the following is a ledger account prepared?
   (a) Transactions
   (b) Journal
   (c) Events
   (d) None of the above

   Answer: b

3. The process of transferring of items from a journal to their respective ledger accounts is called as?
   (a) Entry
   (b) Arithmetic
   (c) Balancing
   (d) Posting

   Answer: d

4. The ledger column that links the entry with the journal is called as?
   (a) J.F column
   (b) L.F column
   (c) Credit column
   (d) Debit column

   Answer: a

5. The left-hand side of the ledger account is referred to as?
   (a) Footing
   (b) Credit side
   (c) Debit side
   (d) Balance

   Answer: c

Review Questions

Q: Mr. Robert commenced business on 1st January, 2011 with a capital of $100,000 in cash. On the same date he opened the bank account in ADCB and deposited $20,000. During the month of January 2011, the following transactions took place:

Jan 1 Bought goods for cash 70,000

2 Sold goods to Steve Co. (Credit) 38,000

15 Sold goods for cash 9,000

21 Steve Co. paid by cheque 35,000

22 Stationery bill paid by cheque 2,000

22 Telephone bill by cash 500

31 Paid rent by cash 2,000

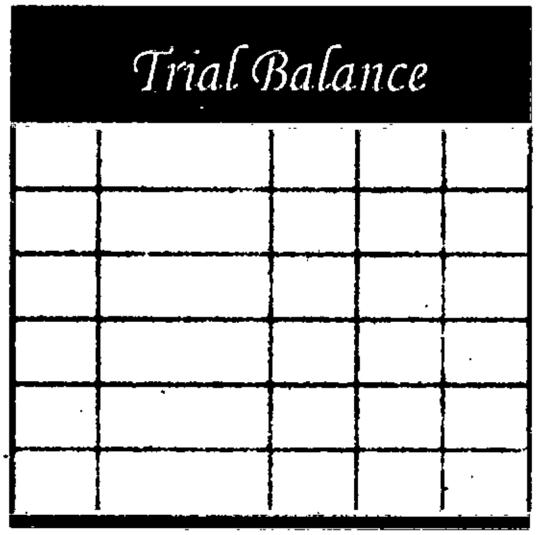
Paid salaries by cash 3,000

Withdrew cash personal use 5,000

Required:

Record journal entries for the transactions and post them to ledgers.

1 TRIAL BALANCE



The statement which is prepared at a particular date with the **ledger account** balances to test the arithmetical accuracy of the ledger accounts and also to facilitate **preparation of financial statements** is called a trial balance.

It is to be noted that trial balance is not an account; it is a mere a statement.

A trial balance contains the columns – serial number of ledger accounts,

Account titles, Ledger folio, debit balance, and credit balance.

If a trial balance agrees i.e. a total of debit money column and a total of credit money column are equal, it proves that the ledger accounts are arithmetically accurate.

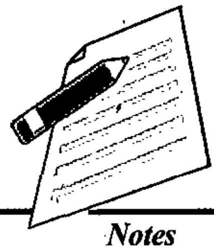
The famous writer R.N. Carter says;

A trial balance is a schedule or a list of balances both debit and credit extracted from the accounts in the ledger and including the cash and bank balances from the cash book.

Characteristics of Trial Balance

It appears from the definitions of trial balance that the trial balance contains the following features;

1. The trial balance is neither an account nor a part of it. It is a statement containing all balances of ledger accounts.
2. It is not recorded in any book of account. The trial balance is prepared in a separate sheet or paper.



3. The trial balance is prepared with the balances of accounts at the end of a particular accounting period. A trial balance is prepared before the preparation of financial statements at the end of the accounting period.
4. The statement contains all kinds of accounts, irrespective of their classifications, such as assets liabilities, income-expenses etc. It helps to test the arithmetical accuracy of accounts.

Objects of Trial Balance

Although trial balance is not an account, it is prepared to fulfil the following objects;

- The main object of the trial balance is to proof the arithmetical accuracy of accounts.
- It is prepared to check whether the debit and credit accounts of each transaction have been recorded properly.
- For the convenient preparation of financial statements, the trial balance is prepared to bring debit and credit ledger balances together.
- To proof accurate balancing of a ledger account.
- To detect mistakes in the process of accounts, if any.
- To provide information to the proper authority in time.
- To compare the balances of various ledger accounts of the current year with those of previous year.

Why do both Sides of Trial Balance Agree

According to **double entry system** every **transaction is recorded in journal** debiting one account and crediting the other for the same amount of money with an explanation.

At the time of posting of the transaction from journal to ledger debit account of the journal is debited in the same account and credit account of the journal is credited in the same account in the ledger.

As a result, a total of debit balance of ledger accounts becomes equal to the total credit balance of ledger accounts.

Therefore, According to double entry principle;

If all correctly drawn ledger accord balance is recorded in trial balance in debit and credit money columns properly, the totals of both columns of trial balance become equal.

Preparing Trial Balance from Journal and Ledger (How To)

To prepare a trial balance, first, we need to know to make sure the transactions are journalized and have been posted to ledgers.

The final balance from the ledger needs to be properly placed on the debit and credit column while preparing the trial balance, to make sure the **accounting process** is correct.

How to Prepare a Trial Balance

Business transactions are first recorded in the **journal** and thereafter these are posted in the **ledger** under different heads of accounts.

It may be mentioned that transactions may directly be posted in the ledger accounts without recording them in the journal.

At the end of a particular accounting period, a trial balance is prepared in a separate sheet of prescribed form recording debit ledger balance, in debit column and credit ledger balances in credit money column.

Besides ledger balances, cash balance and bank balance of cash book of that particular date are also included in the trial balance.

Thereafter total of debit and credit money columns of a trial balance is calculated. Agreement of trial balance is the conclusive evidence of the accuracy of the ledger and trial balance.

The format for Preparing Trial Balance

A short description of the format of the trial balance is given below:

Trail Balance
31st December 2013

Account Serial NO.	Account Tittle	L.F.	Balance	
			Debit	Credit
			$	$

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1. **Titles:** In the middle of the format name of the company, the trial balance and date of preparation are written.
2. **Accounts serial number:** In this column, the serial numbers of ledger accounts are written.
3. **Account Titles:** The serial number of that account of the ledger which has been written in the first column, the full title of that account is written in this column. For example, Capital account, Furniture account, Cash account etc.
4. **Ledger Folio:** The number of the ledger page from where ledger balances are brought is written in this column.
5. **Debit balance:** All debit balances of ledger accounts are written in this column.
6. **Credit balance:** All credit balances of ledger accounts are written in this column.

Ledger Account Balance and Trial Balance

Rules for recording debit ledger account balances and credit ledger account balances in debit money column and credit money column of trial balance in absence of ledger account:

Ledger account balances to be recorded in debit money column	Ledger account balances to be recorded in credit money column
All assets Land, building, leasehold property, machinery, furniture, investment, notes receivable, accounts receivable, cash, stock, goodwill, patents, trademarks, etc..	**External liabilities** The loan, mortgage loan, accounts payable, notes payable, debenture, bank overdraft, etc..
All expenses Wages expense, salary expense, supplies expense, advertisement expense, rent expense, repair expense, interest expense, commission expense, depreciation expense, bad debt expense, discount expense, Items for which payment is made: Owner's goods withdrawal, merchandise purchase.	**All Incomes** Rent revenue, discount income, interest income, apprenticeship premium income etc..
Prepaid expense Prepaid insurance, prepaid rent, prepaid advertisement, salary advance etc..	**Expense payable** Salaries payable, rent payable.
Accrued income Interest on investment accrued, interest on bank balance accrued, interest accrued on notes receivable and accounts receivable.	**Losses** Cash lost; goods lost etc.
Unearned income Unearned rent, unearned premium, etc..	**All types of reserves and provisions** General reserve, provision for doubtful debts. Provision for discount on accounts receivable, etc..
Other items Sales return, reserve for, discount on accounts payable.	**Other items** Purchase return, capital, bad debt recovered.

Important to remember:

1. Opening cash and bank balance is not shown in the trial balance as these are included in closing cash and bank balances.
2. Closing stock is not shown in the trial balance because this remains included with opening stock and purchase of the accounting year. But if opening stock and

purchase remain absent in trial balance and adjusted purchase is shown in the trial balance, in that case, the closing stock is shown in the debit money column of the trial balance.

SUMMARY

Let's say you record all your activities in a diary. At month end you summarize your diary and classify it into various categories. Now you make a sheet and divide the categories into productive / non-productive. That's exactly what businesses do.

- Recording of transaction is a Journal entry.
- Summarizing them and categorizing them are Ledgers.
- Creating a worksheet and classifying the ledgers is a Trial Balance.

A trial balance is a sheet recording all the ledger balances categorized into debit and credit. A typical trial balance will have name of ledger and the balances. This is prepared as at a particular date which can be financial year end or calendar year.

EXERCISE

MCQ

1. Trial balance is used to check the accuracy of
   A) Balance sheet balances
   B) Ledger accounts balances
   C) Cash flow statement balances
   D) Income statement balances
   Answer: B
2. In the books of account if a transaction is completely deleted, will it affect the trial balance?
   A) No
   B) Yes
   C) A transaction cannot be omitted
   Answer: A
3. What is used in preparing trial balance?
   A) Specialised Journals
   B) Balance Sheet
   C) Ledger Accounts
   D) General Journal
   Answer: C
4. What is the trial balance used?
   A) It is a financial statement
   B) Its records balances of a balance sheet

C) It doesn't contribute to the accounting cycle

D) Its records balances of accounts

Answer: D

5. When debit balance is equal to credit balance then the trial balance means

A) Account balances are correct

B) Mathematically Capital+Liabilities=Assets

C) No mistake in recording transactions

D) No mistake in posting entries to ledger accounts

Answer: B

Review Questions

Problems 1:

Prepare a Trial Balance for Shining Brothers Pvt. Ltd. at March 31st, 2017?

Description	*Amount*	*Description*	*Amount*	*Description*	*Amount*
Bank Loan	Rs. 14,000	Insurance Expense	Rs. 7.300	Equipments	Rs. 40,000
Marketable Security	6.500	Owner's Investments	95,000	Maintenance Exp.	5.000
Bill Payable	1.000	Rent & Rates Expense	400	Miscellaneous Expenses	4,800
Unearned Revenue	3.500	Acc. Dep. _ Equipments	14,000	Accrued Expenses	1,500
Sundry Debtors	12,000	Accrued Revenue	15,000	Dep. Exp. _ Equipments	2,000
Outstanding Salaries	2.500	Machinery	25,000	Unexpired Insurance	8,500
Prepaid Rent	2,000	Drawings	3,500	Vendor's Payables	500

Problem 2:

There are several Mistakes in the Umer & Brothers (Pvt.) Ltd. Trial Balance. You are requested to identify Errors and make corrected Trial Balance?

S. No	*Heads of Accounts*	*Ref*	*Debit*	*Credit*
1	Umer Owner Equity			1,551
2	Umer Drawings		560	
3	Equipments		2.850	
4	Sales			2.850
5	Due from Customers			530
6	Purchases		1,260	
7	Purchase Return		364	
8	Bank Loan			996
9	Creditors		528	
10	Taxes		720	
11	Cash in Hand		226	
12	Note Payable		680	
13	Inventory			264
14	Repair		461	
15	Return Inward			98
	Total		**Rs. 7,649**	**Rs. 6,289**

2 BANK RECONCILIATION STATEMENT (BRS)

Bank Reconciliation Statement (BRS)

If every entry in the cash book matches with the bank statement, then bank balance will be the same in both the records. But practically it may not be possible. When the balances do not agree with each other, the need for preparing a statement to explain the causes arises. This statement is called bank reconciliation statement (BRS). The bank reconciliation statement is a statement that reconciles the balance as per the bank column of cash book with the balance as per the bank statement by giving the reasons for such difference along with the amount. As a result of this, internal record of a business (bank column of cash) can be reconciled with external record (bank statement).

Need for bank reconciliation statement

It is important to compare the bank statement and bank column of cash book. If the two balances do not match, it is necessary to reconcile them to explain why the differences have occurred. It may be prepared every month, every week or even daily depending on the number of transactions and the needs of the business.

Balance as per cash book / bank statement — **Balance as per cash book / bank statement**

The need for bank reconciliation statement is as follows:

- To identify the reasons for the difference between the bank balance as per the cash book and bank balance as per bank statement.
- To identify the delay in the clearance of cheques.
- To ascertain the correct balance of bank column of cash book.
- To discourage the accountants of the business as well as bank from misusing funds.

Reasons why bank column of cash book and bank statement may differ

The need for reconciliation arises only when there are differences in entries recorded in the cash book and bank statement. Sometimes, the bank balance as per both the records may be the same, but the entries may not match. In such cases also, bank reconciliation statement is to be prepared. But, before preparing the bank reconciliation statement, it is necessary to find out the reasons for the disagreement.

Difference between the two records (bank column of cash book and bank statement) generally occur because of the following reasons:

Timing differences – The different times at which the same items are entered

Errors in recording - Difference arising due to errors in recording the entries

Timing differences

- cheques issued but not yet presented for payment
- bank charges and interest on loan and overdraft
- interest and dividends collected by the bank
- dishonour of cheques and bills
- payment made directly by the bank to others
- bills collected by the bank on behalf of its customer

Errors in recording

- errors committed in recording the transactions by the business in the cash book
- errors committed in recording the transactions by the bank.

1. Timing differences

(a) Cheques issued but not yet presented for payment

When the cheques are issued by the business, it is immediately entered on the credit side of the cash book by the business. But this may not be entered in the bank statement on the same day. It will be entered in the bank statement only after it is presented with the bank.

For example, the balances as per cash book and bank statement are Rs. 20,000 for X & Co. X & Co. issued a cheque in favour of Y & Co for Rs. 10,000, on 27th March 2017. So, X & Co's cash book is credited with Rs. 10,000 on 27th March 2017. But the cheque is presented to bank on 2nd April 2017. In case, bank sends a statement to X & Co, up to 31st March 2017, it will not contain this transaction. As a result, there will be a difference of Rs. 10,000, between balance shown as per cash book and balance as per bank statement. As a result of this,

↑ Balance as per bank statement (₹ 20,000) is more than balance as per cash book

↓ Balance as per cash book (₹ 10,000) is less than balance as per bank statement

(b) Cheques deposited into bank but not yet credited

When the cheques are deposited into bank, the amount is debited in the cash book on the same day. But these may not be shown in the bank pass book on the same day because these will be entered in the bank statement only after the collection of the cheques.

For example, the balances as per cash book and bank statement are Rs. 20,000 for X & Co. X & Co. receives a cheque on 25th March 2016, from ABC Limited for Rs. 5,000. On the same day, X & Co, debits its cash book with Rs. 5,000. But bank credits X & Co's account only when the cheque is collected from ABC Limited's bank. This shows that is a time gap between depositing the cheque by the customer (X & Co) and collection of cheque by the bank. As a result of this,

Balance as per cash book (₹ 25,000) is more than balance as per bank statement

Balance as per bank statement (₹ 20,000) is less than balance as per cash book

(c) Bank charges and interest on loan and overdraft charged by the bank

The bank has to cover the cost of running the customer's account. So debit is given to the account of the business towards bank charges. Also, if the business had taken any loan or overdrawn, interest has to be paid by the business. These entries for bank charges and interest are made in the bank statement. But the entry is made in the cash book only when the bank statement is received by the business. Till then, the cash book shows more balance than bank statement.

For example, the opening balance as per cash book and the bank statement as on 1st March 2017 is Rs. 7,000. Bank debits for bank charges Rs. 300 as on 27th March 2017. But there is no entry for the same in the cash book as on such date. As a result of this,

Balance as per cash book (₹ 7,000) is more than balance as per bank statement

Balance as per bank statement (₹ 6,700) is less than balance as per cash book

(d) Interest and dividends collected by the bank

The bank may collect dividends on its customer's investment in shares and also interest on any investment. The entry for this will be made in the bank statement on the date of collection. But the entry is made in the cash book only when the bank statement is received by the customer. Till then, the cash book shows less balance than the bank statement.

For example, the balances as per cash book and bank statement are Rs.15,000. The bank has collected dividends of Rs.1,000. As a result of this, the balance as per bank statement is increased to Rs.16,000, whereas until the customer receives such information and records the same, balance as per cash book is lesser by Rs.1000. As a result of this,

Balance as per bank statement (₹ 16,000) is more than balance as per cash book

Balance as per cash book (₹ 15,000) is less than balance as per bank statement

(e) Dishonour of cheques and bills

When the cheque is received from outside parties, it is deposited with the bank and debited in the cash book. If the cheque is dishonoured, the bank cannot collect the amount of such cheque from outside parties' bank. It is not credited in the bank statement. As a result of this, the two records would differ.

While discounting the bills receivables, in the cash book it is entered in the debit side and in the bank statement it is credited. When the bill is presented by the bank to the drawee of the bill and the payment is not received, the bank debits the same to cancel the credit. But credit is made in the cash book only when the customer gets the entries made in the bank statement is received. The bank may also charge some amount for such dishonour.

For example, opening balance as per cash book and bank statement is Rs. 5,000 as on 1st January, 2017. A cheque for Rs. 1,000 deposited by the business into bank on 25th January, 2017 is dishonoured and no entry for such transaction is made in the cash book as on that date. As a result of this,

Balance as per cash book (₹ 6,000) is more than balance as per bank statement

Balance as per bank statement (₹ 5,000) is less than balance as per cash book

(f) Amount paid by parties directly into the bank

Sometimes, debtors or the customers of the business may directly deposit the money into bank account of the business. It may be done by directly visiting the branch of the bank by paying cash (including NEFT, RTGS) or swiping debit or credit or business card or depositing the money in cash deposit machine or transfer through online banking facility. This will be credited in the banker's book. But the entry is made in the cash book only when the bank statement is received by the customer. Until then, the cash book shows less balance than bank statement.

For example, as on 1st January, 2017, the balance as per cash book and the balance as per bank statement show the same balance of Rs. 10,000, but on 22nd January, a debtor directly deposits 5,000 into the bank account of the business. But no entry is made in the cash book as on that date. As a result of this,

Balance as per bank statement (₹ 15,000) is more than balance as per cash book

Balance as per cash book (₹ 10,000) is less than balance as per bank statement

(g) Amount paid directly by the bank to others

Sometimes the bank may be instructed to make payments such as, insurance premium, instalment of loan, etc., as an agent of the customer on behalf of its customer. In all such cases, debit is made in bank statement. But the entry is made in the cash book only when the bank statement is received by the customer. Till then, the cash book shows more balance than bank statement.

For example, on 1st, March, 2017, balance as per cash book and balance as per bank statement show the same amount of Rs.12,000. But, as per the standing instruction of its customer the bank pays Rs. 2,000 as insurance premium as on 28th March, 2017. But, no entry for such transaction is made in the cash book as on such date. As a result of this, Balance as per cash book (₹ 12,000) is more than balance as per bank statement

Balance as per bank statement (₹ 10,000) is less than balance as per cash book

(h) Bills collected by the bank on behalf of its customers

When goods are sold by the business, the documents may be sent through the bank. When the bank collects the amount, it is credited in bank records. But the entry is made in the cash book only when the bank statement is received by the business. Till then, the bank statement shows more balance than cash book.

Balance as per bank statement is more than balance as per cash book

Balance as per cash book is less than balance as per bank statement

2. Errors in recording

(a) Errors committed in recording the transactions by the business in the cash book

Sometimes, errors may be committed in the cash book. For example, omission or wrong recording of transaction relating to cheques deposited or issued, wrong balancing, etc. In these cases, obviously, there will be differences between bank balance as per bank statement and bank balance as per cash book.

For example, the cheque received for Rs. 10, 000 is not entered in the cash book, but has been deposited with the bank. As a result, on collecting the money the balance as per bank statement will be more by Rs. 10, 000.

(b) Errors committed in recording the transactions by the bank

Sometimes errors may be committed in the banker's book. For example, omission or wrong recording of transaction relating to cheques deposited and wrong balancing. In these cases, obviously, there will be differences between bank balance as per bank statement and bank balance as per cash book.

For example, the cheque deposited for Rs. 50000, wrongly entered by the bank as Rs. 15, 000. This will lead to a difference of Rs. 35, 000 between the cash book balance and the balance as per bank statement.

In a nutshell, based on the differences,

the cash book balance will be more than bank statement balance when:

1. Amounts deposited into bank but not yet credited
2. No entry made in cash book for
   a) Bank charges and bank interest
   b) Dishonoured cheques
   c) Amount paid directly by the bank to others
   d) Debit made in the pass book
3. Any error in addition to these in the cash book or bank statement which has the effect of high balance as per cash book

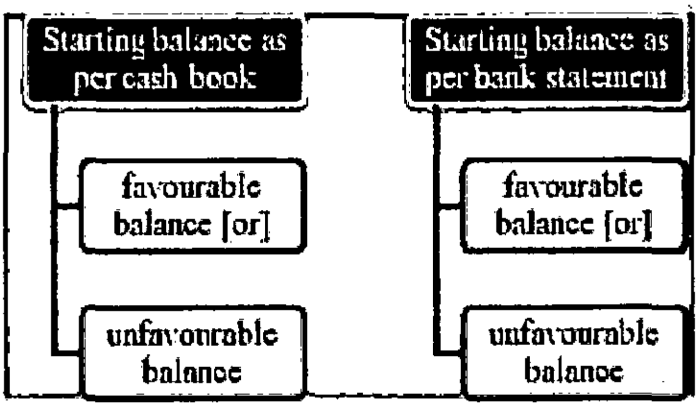
the cash book balance will be less than the bank statement balance when:

1. Cheques issued but not yet presented
2. No entry made in cash book for
   a) Interest and dividends collected by the bank
   b) Amount paid by customer of the business directly in to the bank
   c) Bills collected by the bank on behalf of the customer
3. Any error in addition to these in the cash book or bank statement which has the effect of low balance as per cash book

Preparation of bank reconciliation statement

After having identified the causes of differences, the reconciliation may be done in the following way:

Bank reconciliation statement can be prepared either from the balance as per cash book or bank statement. If it is prepared from the balance of cash book, the effect of the transaction will be studied on the balance as per bank statement. If it is prepared from the balance as per bank statement, the effect of the transaction will be studied on the balance as per cash book.



Given the causes of disagreement, the balance of one record (cash book or bank statement) can be either more or less compared to the other record (cash book or bank statement).

Student activity

Think: Think on the following causes. Complete the following table (Two transactions are done for you):

Reasons for the differences between cash book balance and balance as per bank statement	Effect on bank statement	How to find out balance as per bank statement from cash book balance?
(1) Cheques are issued by the business, but not yet presented for payment	Bank statement balance > cash book balance	Add
(2) Cheque deposited into bank but not yet credited by the bank	Bank statement balance < cash book	Less
(3) Bank charges not yet informed by the bank to the customer		
(4) Rent paid by bank as per standing instruction		
(5) Dividend directly collected by the bank on behalf of the customer		
(6) Debtor directly paid the amount into bank		
(7) Cheque dishonoured		
(8) Wrong credit in the bank statement		
(9) Wrong debit in the bank statement		

For example, if the reconciliation is started with debit balance as per cash book and there is a cheque deposited in the bank, but not cleared, the balance as per bank statement will be less. In this case, the amount of cheque should be subtracted from the cash book balance to arrive at the balance as per bank statement. Similarly, after making all the adjustments the balance as per the other book is obtained. It is important to note that the debit balance as per cash book means the credit balance as per bank statement and vice-versa.

To illustrate it further, take an example of bank charges. The balance as per bank statement will be lesser as compared to cash book. This is because, the bank balance has already been reduced with the bank charges, but, it has not yet been recorded in the cash book. In this case, if balance as per cash book is taken to prepare the reconciliation statement, the amount of bank charges has to be subtracted, because the balance as per bank statement is lesser than cash book balance.

Bank reconciliation statement can be prepared on the basis of 'Balance' presentation, or 'Plus & Minus' presentation

1. Balance presentation method

When balance of cash book or bank statement is given:

Format

Format

Bank Reconciliation Statement as on ------------------

Particulars	Amount ₹	Amount ₹
Balance as per cash book (favourable balance)		xxx
Add:		
1. Cheques issued but not presented	xxx	
2. Credits in the pass book only		
(a) Interest credited in bank statement	xxx	
(b) Dividend and other income	xxx	
(c) Direct deposit by a party	xxx	
3. Any error in cash book/ bank statement which has the effect of increasing the balance as per bank statement	xxx	xxx
Less:		xxx
1. Cheques deposited but not credited	xxx	
2. Cheques dishonoured but not entered in cash book	xxx	
3. Debits in bank statement only		
(a) Interest debited	xxx	
(b) Insurance premium, loan instalment, etc., paid as per standing instructions	xxx	
(c) Direct payment by banker	xxx	
4. Any error in cash book/ bank statement which has the effect of decreasing the balance as per bank statement	xxx	xxx
Balance as per bank statement		xxx

The abridged version of the above statement is given below:

Bank Reconciliation Statement as on ______________

Particulars	Amount ₹	Amount ₹
Balance as per cash book		
Add: The transactions which increase the balance as per bank statement	---------	---------
Less: The transactions which decrease the balance as per bank statement	---------	---------
Balance as per bank statement		---------

If unfavourable balance as per cash book is the starting point, then reverse is the procedure for preparing bank reconciliation statement. This means that, items that are added are to be subtracted and items that are subtracted are to be added.

Based on the earlier explanation the following table has been prepared for ready reference when reconciliation is done on the basis of 'balance presentation'. The final balance, which is obtained after addition and subtraction, will be the balance as per the other book.

Sl. No	Causes of differences	Favourable balance (Dr.) as per cash book	Unfavourable balance (Cr.) as per cash book	Favourable balance (Cr.) as per bank statement	Unfavourable balance (Dr.) as per bank statement
1	Cheque issued but not presented to bank	Add	Subtract	Subtract	Add
2	Cheque directly deposited in bank by a customer	Add	Subtract	Subtract	Add
3	Income directly received by bank	Add	Subtract	Subtract	Add
4	Wrong credit in the cash book	Add	Subtract	Subtract	Add
5	Under casting of debit side of bank column of the cash book	Add	Subtract	Subtract	Add

6	Over casting of credit side of bank column of the cash book	Add	Subtract	Subtract	Add
7	Bill receivable collected directly by bank	Add	Subtract	Subtract	Add
8	Cheque deposited but not cleared	Subtract	Add	Add	Subtract
9	Expenses directly paid by bank on standing instructions	Subtract	Add	Add	Subtract
10	Bank charges levied by bank	Subtract	Add	Add	Subtract
11	Locker rent levied by bank	Subtract	Add	Add	Subtract
12	Wrong debit in the cash book	Subtract	Add	Add	Subtract
13	Wrong debit in the bank statement	Subtract	Add	Add	Subtract
14	Over casting of debit side of bank column of the cash book	Subtract	Add	Add	Subtract
15	Under casting of credit side of bank column of the cash book	Subtract	Add	Add	Subtract
16	Interest on bank overdraft charged	Subtract	Add	Add	Subtract
17	Final balance	If answer is positive, then favourable balance (Cr.) as per bank statement and If, negative then unfavorable balance (Dr.) as per bank statement	If answer is positive, then unfavourabe balance (Dr.) as per bank statement and If, negative then favorable balance (Cr.) as per bank statement	If answer is positive, then favourable balance (Dr.) as per cash book and If, negative then unfavorable balance (Cr.) as per cash book	If answer is positive, then unfavourabe balance (Cr.) as per cash book and If, negative then favorable balance (Dr.) as per cash book

When balances of cash book and/or bank statement is given:

Illustration 1 (When balance as per cash book is favourable)

From the following information, prepare bank reconciliation statement to find out balance as per bank statement on 31st March, 2017.

Particulars	₹
i) Cheques deposited but not yet collected by the bank	500
ii) Cheque issued but not yet presented for payment	1,000
iii) Bank interest charged	100
iv) Rent paid by bank as per standing instruction	200
vi) Cash book balance	300

Solution

Bank reconciliation statement as on 31st March, 2017

Particulars	Amount ₹	Amount ₹
Balance as per cash book		300
Add: Cheque issued but not yet presented for payment		1,000
		1,300
Less: Cheques deposited but not yet collected by the bank	500	
Bank interest charged	100	
Rent paid by bank as per standing instruction	200	800
Balance as per bank statement		500

Illustration 2

On 31st March, 2018, the bank column of the cash book of Senthamarai Traders showed a debit balance of Rs. 40,200. On examining the cash book and the bank statement, it was found that:

- A cheque for Rs. 2,240 deposited on 29th March, 2018 was credited by the bank only on 4th April, 2018.
- A payment made through net banking for Rs. 180 has been entered twice in the cash book.
- A bill of exchange for Rs. 1,000 was discounted by Senthamarai Traders with its bank. This bill was dishonoured on 30th March, 2018 but no entry had been made in the books of Senthamarai Traders.
- Cheques amounting to Rs. 500 which were issued to trade payables and entered in the cash book before 31st March, 2018 were not presented for payment until that date.
- Cheque amounting to Rs. 2,000 had been recorded in the cash book as having been deposited into the bank on 30th March, 2018, but was entered in the bank statement on 3rd April, 2018.
- Transport subsidy amounting to Rs. 3,000 received from the Government of Tamilnadu directly by the bank, but not advised to the Senthamarai Traders.
- A sum of Rs. 1,500 was wrongly debited to Senthamarai Traders by the bank, for which no details are available.
- On 31st March, 2018 the payment side of the cash book was undercast by Rs. 1,200

Notes

Solution

Bank reconciliation statement of Senthamarai traders as on 31st March, 2018

Bank reconciliation statement of Senthamarai traders as on 31st March, 2018

Particulars	Amount ₹	Amount ₹
Balance as per cash book		40,200
Add:		
Net payment entered twice in the cash book	180	
Cheques issued to trade payables not yet presented	500	
Transport subsidy collected by bank	3,000	3,680
Less:		43,880
Cheques deposited but not yet credited by bank	2,240	
Bill of exchange dishonoured	1,000	
Cheques deposited but not yet credited by bank	2,000	
Wrong debit by bank	1,500	
Undercasting of credit side of cash book	1,200	7,940
Balance as per bank statement		35,940

Illustration 3 (When balance as per cash book shows overdraft)

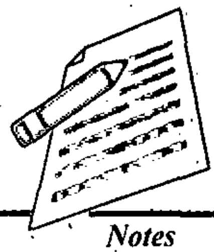
From the following information, prepare bank reconciliation statement as on 31st December,2017 to find out the balance as per bank statement.

Particulars	₹
(i) Overdraft as per cash book	10,000
(ii) Cheques deposited but not yet credited	5,000
(iii) Cheque issued but not yet presented for payment	1,000
(iv) Payment received from the customer directly by the bank	500
(v) Interest on overdraft debited by bank	1,000
(vi) Amount wrongly debited by bank	300

Solution

Bank reconciliation statement as on 31st December, 2017

Particulars	Amount ₹	Amount ₹
Overdraft as per cash book		10,000
Add: Cheques deposited but not yet credited	5,000	
Interest on overdraft debited by bank	1,000	
Amount wrongly debited by bank	300	6,300
		16,300
Less: Cheque issued but not yet presented for payment	1,000	
Payment received from the customer directly by the bank	500	1,500
Overdraft balance as per bank statement		14,800



SUMMARY

It's not compulsory to prepare a BRS and there's no fixed date for preparing BRS. BRS is prepared on a periodical basis for checking that bank related transactions are recorded properly in cash book's bank column and also by the bank in their books. BRS helps to detect errors in recording transactions and determining the exact bank balance as on a specified date.

How to prepare a BRS

1. The first step is to compare opening balances of both the bank column of the cash book as well as bank statement; these could be different due to un-credited or un-presented cheques from a previous period.
2. Now, compare credit side of the bank statement with debit side of the bank column of cash book and debit side of the bank statement with the credit side of the bank column of the cash book. Place a tick against all the items appearing in both the records.
3. Analyse the entries both in the bank column of the cash book as well as pass book and look for entries which have been missed to be posted in the bank column of the cash book. Make a list of such entries and make the necessary adjustments in the cash book.
4. Correct if any mistakes or errors appear in cash book.
5. Calculate the corrected and revised balance of cash book's bank column.
6. Now, start bank reconciliation statement with updated cash book balance.
7. Add the un-presented cheques (cheques which are issued by the business firm to its creditors or suppliers but not presented for payment – Expense) and deduct un-credited cheques (Cheques paid into the bank but not yet collected – Income).
8. Make all the necessary adjustments for the bank errors. In case the bank reconciliation statement begins with the debit balance as per bank column of the cash book, add all the amounts erroneously credited by the bank and deduct all the amounts erroneously credited by the bank. Do vice-versa in case its start with the credit balance.
9. The resultant figure must be equal to the balance as per the bank statement.

EXERCISE

MCQ

1. In cash book, the favourable balance indicates

A) Credit Balance

B) Debit Balance

C) Bank Overdraft

D) Adjusted Balance

Answer: B

2. On the bank statement, cash deposited by the company is known as
   A) Credit
   B) Debit
   C) Liability
   D) Expenses

   Answer: A
3. Bank reconciliation statement compares a bank statement with ________
   A) Cash payment journal
   B) Cash receipt journal
   C) Financial statements
   D) Cashbook

   Answer: D
4. What is "Deposit in transit" in bank reconciliation?
   A) Added to Bank Balance
   B) Subtracted From Bank Balance
   C) Subtracted From the Cash Book Balance
   D) Added to Cashbook Balance

   Answer: A
5. 'NSF' marked in cheque sent back by the bank indicates
   A) Cheque has been forged
   B) A bank couldn't verify the identity
   C) No sufficient money
   D) A cheque cannot be cashed because it's illegal

   Answer: C

Review Questions

Problem 1:

From the following particulars prepare a Bank Reconciliation Statement to find out the causes of difference in two balances as on August 31st, 2016 for Four Star (Pvt.) Ltd.

(i) Bank Overdraft as per Bank Statement 17,000

(ii) Check issued but not encashed during the August 2,200

(iii) Dividends on shares collected by banker 2,300

(iv) Interest charged by the bank recorded twice in the Cash Book 500

(v) Check deposited as per Bank Statement not entered in Cash Book 3,400

(vi) Credit side of the Bank column in Cash Book cast short 1,000

(vii) Clubs dues paid by bank as per standing instruction not recorded in Cash Book ... 1,200

(viii) Uncredited check due to outstation 3,900

3 RECTIFICATION OF ERRORS

RECTIFICATION OF ERRORS

Introduction

The very purpose of maintaining accounting records is to know the profit made or the loss incurred by a business entity and its financial position at the end of every accounting year. Accuracy is assured only when there are no errors in the books of accounts. To ensure accuracy, errors are identified and rectified. Many business enterprises have shifted from manual accounting to computerised accounting. Yet, errors in accounting are unavoidable. Hence, errors are to be located and rectified to find out the real profit or loss and financial position i.e., assets and liabilities at different periods, usually at the end of each financial year.

Meaning of errors

Error means recording or classifying or summarising the accounting transactions wrongly or omissions to record them by a clerk or an accountant unintentionally.

Errors at different stages of accounting

In the accounting process, errors may occur in any of the following stages:

A) At the stage of journalising

At this stage, the following types of errors may occur:

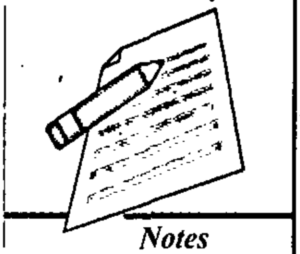
a. Error of omission
b. Error of commission
c. Error of principle

B) At the stage of posting

At this stage, the following types of errors may occur:

Errors of omission

(a) Error of complete omission
(b) Error of partial omission



Error of commission

(a) Posting to wrong account

(b) Posting of wrong amount

(c) Posting to the wrong side

C) At the stage of balancing

At this stage, the following types of errors may occur:

a. Wrong totalling of accounts

b. Wrong balancing of accounts

D) At the stage of preparing trial balance

At this stage, following types of errors may occur:

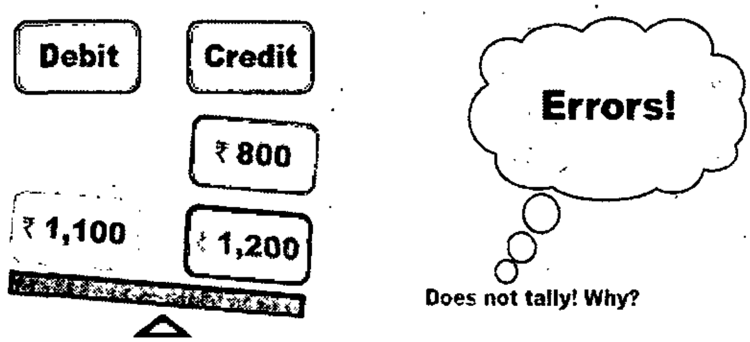
Error of omission

Error of commission

(a) Entering to wrong account

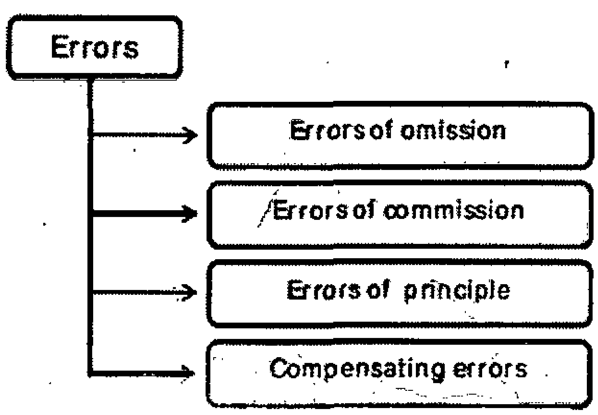
(b) Entering wrong amount

(c) Entering to the wrong side of trial balance, etc.



Classification of errors

The errors can be classified into four types as follows:



1. Error of omission

The failure of the accountant to record a transaction or an item in the books of accounts is known as an error of omission. It can be complete omission or partial omission.

(i) Error of complete omission

It means the failure to record a transaction in the journal or subsidiary book or failure to post both the aspects in ledger. This error affects two or more accounts.

Examples

a	Purchase of a machine from Aadhavan & Co. on credit is not recorded in the journal.
b	Sale of goods to Arivuchelvan on credit not recorded in the sales book.
c	Goods taken by the proprietor from the business for his personal use recorded in the journal but not posted in the ledger.

(ii) Error of partial omission

When the accountant has failed to record a part of the transaction, it is known as error of partial omission. This error usually occurs in posting. This error affects only one account.

Examples

a	Cash received from Ponnarasan recorded in the cash book but not posted to Ponnarasan's account in the ledger.
b	Goods sold to Cheran on credit recorded in the sales book but not posted to Cheran's account in the ledger.
c	Purchase of furniture from Thendral & Co. on credit recorded in the journal and posted to furniture account but not posted to Thendral & Co. account.

Student activity

Think: Is there any way to avoid the error of partial omission?

2. Error of commission

When a transaction is incorrectly recorded, it is known as error of commission. It usually occurs due to lack of concentration or carelessness of the accountant.

The following are the possibilities of error of commission:

i. Entering a wrong amount in a correct subsidiary book

Examples

a	Goods sold to Kumanan on credit for ₹ 234 entered in the sales book as ₹ 243.
b	Goods of the value of ₹ 125 returned by Manimaran entered in the sales returns book as ₹ 152.

ii. Entering a correct amount in a wrong subsidiary book

Examples

a	Goods sold to Athiyamaan on credit for ₹ 500 entered in the purchases book.
b	Goods of the value of ₹ 200 returned by Senguttuvan were entered in the purchases returns book.

iii. Entering a wrong amount in a wrong subsidiary book

Examples

a	Goods sold to Palanisamy for ₹ 2,450 entered in the purchases book as ₹ 2,540.
b	Bought goods from Ramamurthy for ₹ 800 entered in the sales book as ₹ 8,000.

iv. Over-casting or under-casting in a subsidiary book

Examples

a	Purchases book was undercast by ₹ 500, i.e., ₹ 500 less than the correct total.
b	Sales returns book was overcast by ₹ 100, i.e., ₹ 100 more than the correct total.

v. Posting a correct amount to the wrong side of an account in the Ledger

Examples

a	The total of purchases returns book ₹ 10,500 were posted to the debit side of purchases returns account.
b	Bought goods from Sakthivel on credit correctly recorded in the purchases book but posted to the debit of Sakthivel's account.

vi. Posting a wrong amount to the correct side of an account

Examples

a	The total of sales returns book ₹ 7,200 were posted to the debit side of the sales returns account as ₹ 2,700.
b	Goods sold to Nagaraj on credit for ₹ 2,460 was entered in the sales book and posted to the debit side of Nagaraj's account as ₹ 2,640.

vii. Posting a wrong amount to the wrong side of an account

Examples

a	The total of sales book ₹ 9,240 was debited in the sales account as ₹ 9,420.
b	Goods of the value of ₹ 842 returned by Kumararaja was entered in the sales returns book correctly but was wrongly debited to Kumararaja's account as ₹ 824..

viii. Posting a correct amount to a wrong account

Examples

a	The total of purchases book ₹ 5,500 was credited to the purchases returns account.
b	Goods of the value of ₹ 275 returned by Seetharaman were entered in the sales returns book correctly but was wrongly credited to Sethuraman's account..

ix. Posting a wrong amount to a wrong account

Examples

a	Goods sold to Naveen on credit for ₹ 545 was entered in the sales book and posted to Praveen's account as ₹ 554.
b	Goods of the value of ₹ 998 returned to Anil was entered in the purchases returns book and posted to Akil's account as ₹ 989.

x. Double posting in an account

Example

Goods sold to Parimalam on credit for ₹ 500 entered in the sales book and posted twice to Parimalam's account.

xi. Entering a transaction twice in the journal

Examples

a	Goods sold to Mohanambal for ₹ 2,000 was entered twice in the sales book.
b	Cash received from Radhamani ₹ 700 was entered twice in the cash book.

xii. Errors arising in carrying forward from one page to the next page of an account

While carrying forward the total of one page of a ledger account to the next page, the wrong amount may be recorded

a	The total of page No.15 of the sales account of ₹ 5,765 is carried forward to page No.16 as ₹ 5,675.
b	The total of page No. 65 of the purchases book of ₹ 7,000 is carried forward to page No. 66 as ₹ 70,000.

(xiii) Error arising in the balancing of an account

Sometimes, at the time of balancing a ledger account, the wrong balance may be written.

3. Error of principle

It means the mistake committed in the application of fundamental accounting principles in recording a transaction in the books of accounts.

The following are the possibilities of error of principle:

i. Entering the purchase of an asset in the purchases book

Example

Machinery purchased on credit for ₹ 10,000 by M/s. Anbarasi garments manufacturing company entered in the purchases book.

ii. Entering the sale of an asset in the sales book

Example

Sale of old furniture on credit for ₹ 500 was entered in the sales book.

iii. Treating a capital expenditure as a revenue expenditure

Examples

a	An amount of ₹ 3,000 spent on the construction of an additional room is debited to repairs account.
b	Wages of ₹ 600 paid for installation of a new machine is debited to wages account.

iv. Treating a revenue expenditure as a capital expenditure

Example

An amount of ₹ 2,000 paid for repairs to a machine is debited to machinery account.

4. Compensating errors

The errors that make up for each other or neutralise each other are known as compensating errors. These errors may occur in related or unrelated accounts. Thus, excess debit or credit in one account may be compensated by excess credit or debit in some other account. These are also known as offsetting errors.

Examples

a	Purchases book and sales book are overcast by ₹ 1,000 each.
b	Purchases returns book and sales returns book are undercast by ₹ 100 each.

Errors disclosed by the trial balance and errors not disclosed by the trial balance

Generally, one-sided errors are revealed by trial balance. They will cause disagreement of totals of debit balances and credit balances. Two-sided errors are not revealed by trial balance. Thus, the errors can be classified on the basis of their effect on the trial balance as follows:

1. Errors disclosed by the trial balance

Certain errors affect the agreement of trial balance. If such errors have occurred in the books of accounts, the total of debit and credit balances will not be the same. The trial balance will not tally. Error of partial omission and error of commission affect the agreement of trial balance. Examples of such errors are follows:

(i)	Entered in the journal but posted to one account and omitted to be posted to the other.
(ii)	Posting an amount to the wrong side of a ledger account.
(iii)	*Posting twice in a ledger account*
(iv)	Over-casting or Under-casting in a subsidiary book
(v)	Posting a wrong amount to the correct side of an account
(vi)	Posting a wrong amount to the wrong side of an account
(vii)	Errors arising in carrying forward the page total from one page to the next page of an account or subsidiary book.
(viii)	Errors arising in the balancing of an account.
(ix)	Omission to post an entry from a subsidiary book.

2. Errors not disclosed by the trial balance

Certain errors will not affect the agreement of trial balance. Though such errors occur in the books of accounts, the total of debit and credit balance will be the same. The trial balance will tally. Errors of complete omission, error of principle, compensating error, wrong entry in the subsidiary books are not disclosed by the trial balance. Examples of such errors are as follows:

(i)	Treating revenue expenditure as capital expenditure
(ii)	Omitting a transaction completely
(iii)	Entering a transaction in a wrong subsidiary book
(iv)	Entering a transaction twice in a subsidiary book or journal
(v)	Entering the amount of a transaction wrongly in the journal
(vi)	Entering the amount of a transaction wrongly in a subsidiary book

Steps to locate errors

Errors can be located by going through various steps. Such steps are as follows:

1. Location of errors before preparation of trial balance

Errors may be located before preparing the trial balance either spontaneously or by intentional scrutiny of books of accounts.

The following are the steps to be followed to locate errors before preparing trial balance:

(i)	Scrutiny of entries made in the journal proper
(ii)	Scrutiny of entries made in the subsidiary books
(iii)	Checking the totals of the subsidiary books
(iv)	Scrutiny of postings made to the ledger accounts
(v)	Scrutiny of balancing of ledger accounts

The errors located at this stage are rectified by debiting or crediting the relevant accounts in the books.

2. Location of errors after the preparation of trial balance

While preparing trial balance, if it does not tally, it is an indication of presence of errors in the books of accounts. The difference in trial balance is transferred to suspense account and then errors are to be located and rectified.

The following are the steps to be followed to locate errors after preparing trial balance:

(i)	The totals of debit and credit columns of trial balance are to be checked.
(ii)	The balances of various ledger accounts shown in the trial balance are to be checked to ensure whether they are shown in the respective columns (debit or credit).
(iii)	The difference in the trial balance must be halved and compared with balances of ledger to verify whether any ledger balance is recorded on the wrong side of the trial balance.
(iv)	The totals of all the subsidiary books are to be checked, especially if the difference is ₹ 1, ₹ 100 etc.
(v)	If the difference is divisible by '9', the difference may be due to transposition of figures in the books. (Writing ₹ 127 as ₹ 172). Hence, the possibilities of transposition of figures shall be checked.
(vi)	The accounts of all the creditors and debtors are to be verified.
(vii)	Postings from the subsidiary books to different accounts in the ledger are to be checked.
(viii)	The correctness of the balances of various ledger accounts is to be ensured.
(ix)	All the amounts carried forward from one page to the next are to be verified.
(x)	If the difference still exists, as a final step all the entries in the journals should be verified.

Suspense account

1. Meaning of suspense account

When the trial balance does not tally, the amount of difference is placed to the debit (when the total of the credit column is higher than the debit column) or credit (when the total of the debit column is higher than the credit column) to a temporary account known as 'suspense account'.

2. Preparation of suspense account

Suspense account will remain in the books until the location and rectification of errors. After rectifying the errors and posting the rectification entries to the respective ledger accounts, the suspense account appearing in the ledger is to be balanced. If all the errors are located and rectified, the suspense account gets closed.

CLASS-12 Accountancy | Rectification of err

Illustration 2 (Errors in casting)

The following errors were detected before preparation of trial balance. Rectify them

a. Purchases returns book is undercast by Rs. 500.

b. Purchases returns book is overcast by Rs. 600.

c. Sales returns book is undercast by Rs. 700.

d. Sales returns book is overcast by Rs. 800.

Solution

a	Purchases returns account should be credited with ₹ 500
b	Purchases returns account should be debited with ₹ 600
c	Sales returns account should be debited with ₹ 700
d	Sales returns account should be credited with ₹ 800

Illustration 3 (Errors in carry forward)

The following errors were detected before preparation of trial balance. Rectify them

a. The total of purchases book is carried forward to the next page Rs. 100 shorts.

b. The total of purchases returns book is carried forward to the next page Rs. 20
excess.

c. The total of sales book is carried forward to the next page Rs. 300 excess.

d. The total of sales returns book is carried forward to the next page Rs. 400 sho

Solution

a	Purchases account should be debited with ₹ 100.
b	Purchases returns account should be debited with ₹ 200.
c	Sales account should be debited with ₹ 300.
d	Sales returns account should be debited with ₹ 400.

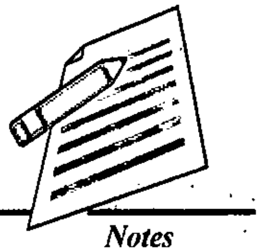
SUMMARY

Financial accounting deals with recording and maintaining every monetary transac
of an organization. However, sometimes, a few entries might be either incorrect or
at the wrong place. In financial accounting, the process of correcting such mist
is known as **Rectification of Errors**.

Types of Errors

Two most common types of errors, which are usually occurred at the t
preparation of Financial Statements are discussed below.

Error which Effects only One Account



Notes

- Omission of posting of balance in a Trial Balance.
- Error of carried forward of balance.
- Error of casting and posting.

EXERCISE

MCQ

1. Suspense account is opened when ____ does not tally

A. Balance sheet B. Trial balance

C. Profit and loss D. Trading account

Answer: Trial balance

2. Which of the following is not an error of principle

A. Repair or the over hauling of machinery purchased debited to repairs account

B. Cash paid to Karan posted to salary

C. Sale of old car credited to sales account

D. Purchase of furniture debited to purchase account

Answer: Cash paid to Karan posted to salary

3. Which of the following is not an error of commission

A. Wrong balancing of machinery account

B. Credit sales to Pawan Rs.5000 credited to his account

C. Cash sales not recorded in cash book

D. Overcasting of sales book

Answer: Cash sales not recorded in cash book

4. Which of the following error will be rectified through suspense account

A. Purchase return to Vishal Rs.1000 not recorded

B. Purchase return to Vishal Rs.1000 recorded through Sales return book

C. Purchase return book under cast by 1000

D. Purchase return to Vishal Rs.1000 recorded as Rs.100

Answer: Purchase return book under cast by 1000

5. Trial balance is equal from both sides but still there is some error. It indicate that:

A. There may be one sided error in the book

B. There is no error in the book

C. There may be two-sided error in the book

D. There may be two sided and one-sided error in the book

Answer: There may be two-sided error in the book

Review Question

Make corrected Trial Balance after anticipating hidden errors for Star Ltd. Financial year for this company is July 1st, 2015 to June 30th, 20116:

Abid Siddique

Trial Balance

As on 30th June, 2016

S. No	Heads of Accounts	Ref	Amount (Rs.) Dr	Amount (Rs.) Cr
1	Purchases			35,000
2	Factory Overhead (Applied)			1,000
3	Octri and Taxes			100
4	Rebate received			500
5	Trade Mark			55,000
6	Sales		80,000	
7	Share Capital			50,000
8	Return Outward			1,600
9	Bills Owed			6,500
10	Carriage Outward			3,700
11	Inventory (1.07.2015)		10,500	
12	Motor Van		25,000	
13	Claims Receivables		1,500	
14	Sundry Debtors		9,000	
15	Return Inward		2,000	
16	Leasehold Premises		3,000	
17	Discount on Sales			2,000
18	Petty Cash		800	
19	Stock (30-06-2016)		33,300	
20	Sundry Creditors		10,000	
21	Suspense Account			19,700
	Total		**Rs. 175,100**	**Rs. 175,100**

Errors in Trial Balance:

- Machinery bought Rs. 3,000 posted to as Trade Mark account
- Credit sales of worth Rs. 1,200 was omitted to record in the book of original entry
- Repairs to Motor Van Rs. 1,500 have been debited to Motor Van account
- Unearned Sales of Rs. 15,000 was incorrectly credited to Sales Account

Following accounts are used for correction and adjusting the transactions.

1 DEPRECIATION

Depreciation Accounting

Depreciation

The non-trading fixed assets of a business-like land, building, machinery, furniture etc. maybe get depreciated in value due to various reasons. In other words, the value of such assets reduces each year due to use. Such gradual ad permanent reduction in the value of the assets due to wear and tear or from any other causes is called Depreciation. The word depreciation is derived from a Latin work 'Depretium' which is composed of two words 'De' and 'Pretium', where 'De' denotes decrease and 'Pretium' denotes price. Thus, the word depreciation means decrease in the price. It indicates a failure in the value of an asset which is a loss or an expense for a business and shown in the debit side of profit and loss account. It must be deducted from the respective assets in the balance sheet.

According to **J.R. Batliboi**, "Depreciation means permanent decline in the value of assets due to wear and tear or from any other cause."

According to **R.G. Williams**, "Depreciation may be defined as a gradual deterioration in value of assets due to use."

Causes of Depreciation

1. **Wears and Tears:** The value of an asset declines due to its constant use in the business. Generally, fixed assets are depreciated due to wear and tears which means reduction in the efficiency and value of an asset caused from vibration, friction, accident, movement, erosion etc.
2. **Innovation:** Due to the development of science and technology, the new and improved automatic machines may be invented. Such invention reduces in the value of old and existing machinery.
3. **Expiry of Time:** The value of some assets like patent right, copy-right, lease hold property etc. decrease with the passage of time. The right of such assets is predetermined for certain duration. After its expiry, there is no value even it is not used.
4. **Exhaustion:** The value of some assets like mines and quarries go on declining with the continuous use.

5. **Fall in market price:** Another reason of depreciation is permanent fall in the price of an asset. The value of asset reduces as the market price of an asset continuously goes on declining.

Objectives for providing depreciation

1. **For the replacement of assets:** The fund equal to the amount of the depreciation is created which will remain in the firm. After the expiry of the life of asset, the same fund can be utilized to replace the new asset.
2. **For the determination of true profit or loss:** Depreciation is also an expense like repair and maintenance which must be included in profit and loss account to ascertain the correct profit or loss of a business for the year.
3. **For the presentation of assets in the balance sheet at their proper value:** Depreciation must be charged to each fixed asset for the true and fair presentation of assets in the balance sheet. The depreciation is deducted from the cost or book value of assets each year.
4. **For the determination of correct cost of production:** Correct cost of production cannot be ascertained if the depreciation is not charged to the fixed assets. Thus, it is necessary to include amount of depreciation in the calculation of cost of each product.

Methods of providing depreciation:

The two methods of depreciation are

1. Fixed percentage on original cost or straight-line method
2. Fixed percentage on diminishing balance or written down value method

Straight Line Method

According to this method, a fixed and equal amount is charged as depreciation for every accounting period during the life time of an asset. This method is based on the assumption of equal usage of time over asset's entire useful life. Hence, the amount of depreciation is same from period to period over the life of the asset.

Depreciation amount can be calculated by using the following formula:

- If the asset has a residual value at the end of its useful life, the amount to be written of every year is as follows:
- Depreciation = Cost of asset – Estimated net residual value / No. of years of expected life
- If the annual depreciation amount is given then we can calculate the rate of depreciation as follows:
- Rate of depreciation = Annual depreciation amount / Cost of asset * 100

Advantages of Straight-Line Method

1. Simple to calculate the depreciation amount
2. Assets can be depreciated up to the estimated scrap value
3. Easy to understand the amount of depreciation
4. Every year, the same amount of depreciation is debited to profit and loss account, and hence the effect on profit and loss account will remain the same.

Disadvantages of Straight-Line Method

1. Interest on capital invested in assets is not provided in this method.
2. Over the years, the work efficiency of assets decreases and repair expenses increases. Therefore, there is burden on the profit and loss account.
3. Book value of the assets becomes zero but still the assets are used in the business.

Written Down Value Method

In this method depreciation is charged on the book value of the asset and the amount of depreciation reduces year after year. It implies that a fixed rate on the written down value of the asset is charged as depreciation every year over the expected useful life of the asset. The rate of depreciation is applicable to the book value but not to the cost of asset.

Rate of depreciation can be ascertained on the basis of cost; scrap value and useful life of the asset as follows:

$$R = 1 - n\sqrt{\frac{S}{C}} = 100$$

Where, R is the rate of depreciation in percent, n is the useful life of the asset; S is the scrap value at the end of useful life and C is the cost of the asset.

Advantages of Written Down Value Method

1. The profit and loss account of depreciation and repair expenses has same weightage throughout the useful life of asset because depreciation decreases with an increase in repair expenses.
2. Since the benefits from asset keep on decreasing, the cost of asset is allocated rationally.
3. This method is most favourable for those assets which require increased repairs and maintenance expenses over the years.
4. This method is widely accepted under the Income Tax Act.

Disadvantages of Written Down Value Method

1. The value of assets can never be zero even though it is discarded.
2. In this method, it is difficult to calculate depreciation.
3. There is no provision of interest on capital invested in use of assets.

Recording depreciation

1. When Depreciation is Charged or Credited to the Assets Account

In this method, depreciation is deducted from the asset value and charged (debited) to profit and loss account. Hence the asset value is reduced by the amount of depreciation.

Journal entries for recording under this method are as follows:	
Asset A/c To Cash/Bank A/c (Being the asset purchased and the cost of an asset including installation expenses and freight)	Dr.
Depreciation A/c To Asset A/c (Being the amount of depreciation charged)	Dr.
Profit and Loss A/c To Depreciation A/c (Being the depreciation amount transferred to profit and loss account)	Dr.

In the Balance sheet, asset appears at its written down value which is cost less depreciation charged till date. In this method, the original cost of an asset and the total amount of depreciation which has been charged cannot ascertain from this balance sheet.

2. When Depreciation is Credited to Provision for Depreciation Account

In this method, depreciation is credited to the provision for depreciation account or accumulated depreciation account every year. Depreciation is accumulated in a separate account instead of adjusting into the asset account at the end of each accounting period. In the balance sheet, the asset will continue to appear at the original cost every year. Thus, the balance sheet shows the original cost of the asset and the total amount of depreciation charged on asset.

Journal entries for recording under this method are as follows:	
Asset A/c To Cash/Bank/Vendor A/c (Being the asset purchased and the cost of an asset including installation expenses and freight)	Dr.
Depreciation A/c To Provision for Depreciation A/c (Being the amount of depreciation charged)	Dr.
Profit and Loss A/c To Depreciation A/c (Being the depreciation amount to transferred profit and loss account)	Dr.

Numerical Questions

1. On April 01, 2010, Bajrang Marbles purchased a Machine for □ 2,80,000 and spent □ 10,000 on its carriage and □ 10,000 on its installation. It is estimated that its working life is 10 years and after 10 years its scrap value will be □ 20,000.

   (a) Prepare Machine account and Depreciation account for the first four years by providing depreciation on straight line method. Accounts are closed on March 31st every year.

   (b) Prepare Machine account, Depreciation account and Provision for depreciation account (or accumulated depreciation account) for the first four years by providing depreciation using straight line method accounts are closed on March 31 every year.

Solution:

Books of Bajrang Marbles
Machinery Account

Dr. Cr.

Date	Particulars	J.F.	Amount ₹	Date	Particulars	J.F.	Amount ₹
2010				2011			
Apr 01	To Bank A/c		3,00,000	Mar31	By Depreciation A/c		28,000
				Mar31	By Balance c/d		2,72,000
			3,00,000				3,00,000
2011				2012			
Apr01	To Balance b/d		2,72,000	Mar31	By Depreciation A/c		28,000
				Mar 31	By Balance c/d		2,44,000
			2,72,000				2,72,000
2012				2013			
Apr 01	To Balance b/d		2,44,000	Mar 31	By Depreciation A/c		28,000
				Mar 31	By Balance c/d		2,16,000
			2,44,000				2,44,000
2013				2014			
Apr 01	To Balance b/d		2,16,000	Mar 31	By Depreciation A/c		28,000
				Mar 31	By Balance c/d		1,88,000
			2,16,000				2,16,000

Depreciation Account

Dr. Cr.

Date	Particulars	J.F.	Amount ₹	Date	Particulars	J.F.	Amount ₹
2011				2011			
Mar 31	To Machinery A/c		28,000	Mar 31	By Profit and Loss A/c		28,000
			28,000				28,000
2012				2012			
Mar 31	To Machinery A/c		28,000	Mar 31	By Profit and Loss A/c		28,000
			28,000				28,000
2013				2013			
Mar 31	To Machinery A/c		28,000	Mar 31	By Profit and Loss A/c		28,000
			28,000				28,000
2014				2014			
Mar 31	To Machinery A/c		28,000	Mar 31	By Profit and Loss A/c		28,000
			28,000				28,000

Working notes :

1. Calculation of annual depreciation

Depreciation p.a. = Cost-Scrap Value/Estimated Life of Assets(years)

= (2,80,000+10,000+10,000)-20,000/10

= □ 28,000 per annum

Books of Bajrang Marbles

Machinery Account

Dr. Cr.

Date	Particulars	J.F.	Amount ₹	Date	Particulars	J.F.	Amount ₹
2010 Apr 01	To Bank A/c		3,00,000	2011 Mar 31	By Balance c/d		3,00,000
			3,00,000				3,00,000
2011 Apr 01	To Balance b/d		3,00,000	2012 Mar 31	By Balance c/d		3,00,000
			3,00,000				3,00,000
2012 Apr 01	To Balance b/d		3,00,000	2013 Mar 31	By Balance c/d		3,00,000
			3,00,000				3,00,000
2013 Apr 01	To Balance b/d		3,00,000	2014 Mar 31	By Balance c/d		3,00,000
			3,00,000				3,00,000

Provision for Depreciation Account

Dr. Cr.

Date	Particulars	J.F.	Amount ₹	Date	Particulars	J.F.	Amount ₹
2011 Mar 31	To Balance c/d		28,000	2011 Mar.31	By Depreciation A/c		28,000
			28,000				28,000
2012 Mar 31	To Balance c/d		56,000	2011 Apr 01	By Balance b/d		28,000
				2012 Mar 31	By Depreciation A/c		28,000
			56,000				56,000
2013 Mar 31	To Balance c/d		84,000	2012 Apr 01	By Balance b/d		56,000
				2013 Mar 31	By Depreciation A/c		28,000
			84,000				84,000
2014 Mar 31	To Balance c/d		1,12,000	2013 Apr 01	By Balance b/d		84,000
				2014 Mar 31	By Depreciation A/c		28,000
			1,12,000				1,12,000

Depreciation Account

Dr. Cr.

Date	Particulars	J.F.	Amount ₹	Date	Particulars	J.F.	Amount ₹
2011 Mar 31	To Provision for Depreciation A/c		28,000	2011 Mar 31	By Profit and Loss A/c		28,000
			28,000				28,000
2012 Mar 31	To Provision for Depreciation A/c		28,000	2012 Mar 31	By Profit and Loss A/c		28,000
			28,000				28,000
2013 Mar 31	To Provision for Depreciation A/c		28,000	2013 Mar 31	By Profit and Loss A/c		28,000
			28,000				28,000
2014 Mar 31	To Provision for Depreciation A/c		28,000	2014 Mar 31	By Profit and Loss A/c		28,000
			28,000				28,000

2. On July 01, 2010, Ashok Ltd. Purchased a Machine for □ 1,08,000 and spent □ 12,000 on its installation. At the time of purchase, it was estimated that the effective commercial life of the machine will be 12 years and after 12 years its salvage value will be □ 12,000.

Prepare machine account and depreciation Account in the books of Ashok Ltd. For first three years, if depreciation is written off according to straight line method. The accounts are closed on December 31st, every year.

Solution:

Books of Ashok Ltd.
Machinery Account

Dr. Cr.

Date	Particulars	J.F.	Amount ₹	Date	Particulars	J.F.	Amount ₹
2010				2010			
Jul01	To Bank A/c		1,20,000	Dec 31	By Depreciation A/c		4,500
				Dec 31	By Balance c/d		1,15,500
			1,20,000				1,20,000
2011				2011			
Jan 01	To Balance b/d		1,15,500	Dec 31	By Depreciation A/c		9,000
				Dec 31	By Balance c/d		1,06,500
			1,15,500				1,15,500
2012				2012			
Jan 01	To Balance b/d		1,06,500	Dec 31	By Depreciation A/c		9,000
				Dec 31	By Balance c/d		97,500
			1,06,500				1,06,500
2013							
Jan 01	To Balance b/d		97,500				

Depreciation Account

Dr. Cr.

Date	Particulars	J.F.	Amount ₹	Date	Particulars	J.F.	Amount ₹
2010				2010			
Dec 31	To Machinery A/c		4,500	Dec 31	By Profit and Loss A/c		4,500
			4,500				4,500
2011				2011			
Dec 31	To Machinery A/c		9,000	Dec 31	By Profit and Loss A/c		9,000
			9,000				9,000
2012				2012			
Dec 31	To Machinery A/c		9,000	Dec 31	By Profit and Loss A/c		9,000
			9,000				9,000

Working Notes:

1. Calculation of annual depreciation

Depreciation p.a.

= Cost-Scrap Value/Estimated Life of Asset (Years)

= (1,08,000+12,000)-12,000/12 Years

= □ 9,000 per annum

3. Reliance Ltd. Purchased a second-hand machine for □ 56,000 on October 01, 2011 and spent □ 28,000 on its overhaul and installation before putting it to operation. It is expected that the machine can be sold for □ 6,000 at the end of its useful life of 15 yea□ Moreover an estimated cost of □ 1,000 is expected to be incurred to recover the salvage value of □ 6,000. Prepare machine account and Provision for depreciation account for the first three years charging depreciation by fixed instalment Method. Accounts are closed on December 31, every year.

Solution:

Books of Reliance Ltd
Machinery Account

Dr. Cr.

Date	Particulars	J.F.	Amount ₹	Date	Particulars	J.F.	Amount ₹
2011 Oct 01	To Bank A/c		84,000	2011 Dec 31	By Balance c/d		84,000
			84,000				84,000
2012 Jan 01	To Balance b/d		84,000	2012 Dec 31	By Balance c/d		84,000
			84,000				84,000
2013 Jan 01	To Balance b/d		84,000	2013 Dec 31	By Balance c/d		84,000
			84,000				84,000

Provisions for Depreciation Account

Dr. Cr.

Date	Particulars	J.F.	Amount ₹	Date	Particulars	J.F.	Amount ₹
2011 Dec 31	To Balance c/d		1,316	2011 Dec 31	By Depreciation A/c		1,316
			1,316				1,316
2012 Dec 31	To Balance c/d		6,583	2012 Jan 01 Dec 31	By Balance b/d By Depreciation A/c		1,316 5,267
			6,583				6,583
2013 Dec 31	To Balance c/d		11,850	2013 Jan 01 Dec 31	By Balance b/d By Depreciation A/c		6,583 5,267
			11,850				11,850
				2013 Jan.01	By Balance b/d		11,850

4. Berlia Ltd. Purchased a second-hand machine for Rs.56,000 on July 01, 2011 and spent Rs.24,000 on its repair and installation and Rs.5,000 for its carriage. On September 01, 2012, it purchased another machine for Rs.2, 50,000 and spent Rs.10,000 on its installation.

Depreciation is provided on machinery @10% p.a. on original cost method annually on December 31. Prepare machinery account and depreciation account from the year 2011 to 2014.

Prepare machinery account and depreciation account from the year 2011 to 2014, if depreciation is provided on machinery @10% p.a. on written down value method annually on December 31.

Solution:

Books of Berlia Ltd.

Machinery Account (Original Cost Method)

Dr. Cr.

Date	Particulars	J.F.	Amount ₹	Date	Particulars		J.F.	Amount ₹
2011				2011				
Jul 01	To Bank A/c		85,000	Dec 31	By Depreciation A/c			
	(56,000 + 24,000 + 5,000)				Machine 1 (6m)	4,250		4,250
				Dec 31	By Balance c/d			80,750
			85,000					85,000
2012				2012				
Jan 01	To Balance b/d		80,750	Dec 31	By Depreciation A/c			
Sep 01	To Bank A/c		2,60,000		Machine 1	8,500		
	(2,50,000 + 10,000)				Machine 2 (4m)	8,667		17,167
				Dec 31	By Balance c/d			3,23,583
			3,40,750					3,40,750
2013				2013				
Jan 01	To Balance b/d		3,23,583	Dec 31	By Depreciation A/c			
					Machine 1	8,500		
					Machine 2	26,000		34,500
				Dec 31	By Balance c/d			2,89,083
			3,23,583					3,23,583
2014				2014				
Jan 01	To Balance b/d		2,89,083	Dec 31	By Depreciation A/c			
					Machine 1	8,500		
					Machine 2	26,000		34,500
				Dec 31	By Balance c/d			2,54,583
			2,89,083					2,89,083

Depreciation Account

Dr. Cr.

Date	Particulars	J.F.	Amount ₹	Date	Particulars	J.F.	Amount ₹
2011 Dec 31	To Machinery A/c		4,250	2011 Dec 31	By Profit and Loss A/c		4,250
			4,250				**4,250**
2012 Dec 31	To Machinery A/c		17,167	2012 Dec 31	By Profit and Loss A/c		17,167
			17,167				**17,167**
2013 Dec 31	To Machinery A/c		34,500	2013 Dec 31	By Profit and Loss A/c		34,500
			34,500				**34,500**
2014 Dec 31	To Machinery A/c		34,500	2014 Dec 31	By Profit and Loss A/c		34,500
			34,500				**34,500**

Working Notes :

Calculation of Annual Depreciation	
1.	Depreciation (p.a.) on Machinery Purchased on July 01.2011
	Depreciation p.a.=Cost-Scrap Value/Estimated Life of Asset (years)
	=(56,000+24,000+5,000)*10%
	=₹8,500 per annum
2.	Depreciation on Machinery purchased on July 01, 2011 for the year 2011 (6 month)
	=₹8,500p.a. *6/12
	=₹4,250
3.	Depreciation (p.a.) Machinery purchased on September 01.2012
	Depreciation p.a.=Cost-Scrap Value/Estimated Life of Asset (years)
	=(2,50,000+10,000)*10%
	=₹26,000 per annum
4.	Depreciation on Machinery purchased on September 01,2012 for the year 2012 (4 month)
	=₹26,000*4/12
	=₹8667

Books of Berlia Ltd.
Machinery Account (Written Down value method)

Dr. Cr.

Date	Particulars	J.F.	Amount ₹	Date	Particulars		J.F.	Amount ₹
2011				2011				
Jul 01	To Bank A/c		85,000	Dec 31	By Depreciation A/c			4 250
	(56,000 + 24,000 + 5,000)			Dec 31	By Balance c/d			80,750
			85,000					85,000
2012				2012				
Jan 01	To Balance b/d		80,750	Dec 31	By Depreciation A/c			
Sep 01	To Bank A/c							
	(2,50,000+10,000)				(80750*10%)	8,075		
					Machine 2 (260,000*10%*4/12)	8,667		16,742
				Dec 31	By Balance c/d			
					Machine 1 (80,750-8,075)	72,675		
					Machine 2 (2,60,000-8,667)	2,51,333		3,24,008
			3,40,750					3,40,750
2013				2013				
Jan 01	To Balance b/d		3,24,008	Dec 31	By Depreciation A/c			
					Machine 1 (72,675*10%)	7,268		
					Machine 2 (2,51,333*10%)	25,133		32,401
				Dec 31	By Balance c/d			
					Machine 1 (72,675-7,268)	65,407		
					Machine 2 (2,51,333-25,133)	2,26,200		2,91,607
			3,24,008					3,24,008
2014				2014				
Jan 01	To Balance b/d		2,91,607	Dec 31	By Depreciation A/c			
					Machine 1 (65,407*10%)	6,541		
					Machine 2 (2,26,200*10%)	22,620		29,161
				Dec 31	By Balance c/d			
					Machine 1 (65,407-6,541)	58,866		
					Machine 2 (2,26,200-22,620)	2,03,580		2,62,446
			2,91,607					2,91,607

Depreciation Account

Dr.							Cr.
Date	**Particulars**	**J.F.**	**Amount ₹**	**Date**	**Particulars**	**J.F.**	**Amount ₹**
2011 Dec 31	To Machinery A/c		4,250	2011 Dec 31	By Profit and Loss A/c		4,250
			4,250				4,250
2012 Dec 31	To Machinery A/c		16,742	2012 Dec 31	By Profit and Loss A/c		16,742
			16,742				16,742
2013 Dec 31	To Machinery A/c		32,401	2013 Dec 31	By Profit and Loss A/c		32,401
			32,401				32,401
2014 Dec 31	To Machinery A/c		29,161	2014 Dec 31	By Profit and Loss A/c		29,161
			29,161				29,161

Change in Method of Depreciation

At the end of each financial year, management should review the method of depreciation. When there is a significant change in the pattern of the future economic benefits from the asset then the method of depreciation should also be changed.

As per the Accounting Standard 1- Disclosure of Accounting Policies, the change in the method of depreciation is a change in the accounting estimate. Thus, it requires quantification and full disclosure in the footnotes. Also, the justification and financial effects of the change needs to be disclosed.

Thus, the method of depreciation can be changed without retrospective effect or with retrospective effect. Without retrospective effect means no adjustment will be made for past entries and only in the future depreciation shall be charged by the new method. While with retrospective effect implies that the amount of depreciation to be charged is adjusted from the date of purchase of the asset.

Solved Example

Q. On 1st April 2015, Zenith Ltd. purchased a building for □2000000. It was decided to charge depreciation @10% p.a. using the Written Down Value Method (WDV). However, on 31st March 2018, it was decided to change the method of depreciation to Straight-line Method. The remaining useful life of the building is estimated to be 5 years with a residual value of □100000. You are required to prepare Building A/c.

Ans

Building A/c

Date	Particulars	Amount	Date	Particulars	Amount
2015-16			2015-16		
1 Apr	To Bank A/c	2000000	31 Mar	By Depreciation A/c	200000
			31 Mar	By Balance c/d	1800000
		2000000			2000000
2016-17			2016-17		
1 Apr	To Balance b/d	1800000	31 Mar	By Depreciation A/c	200000
			31 Mar	By Balance c/d	1600000
		1800000			1800000
2017-18			2017-18		
1 Apr	To Balance b/d	1600000	31 Mar	By Depreciation A/c	300000
			31 Mar	By Balance c/d	1300000
		1600000			1600000
2018-19			2018-19		
1 Apr	To Balance b/d	1300000			

Calculation of depreciation on 31st March 2018:

Depreciation = (Written-down value – Residual Value) / Remaining Useful Life

= (1600000 – 100000) / 5

= 300000

2 PROVISION AND RESERVES

Provisions

- Provision is to be made is respect of a liability, which is certain to be incurred, but its accurate amount is not known.
- It is charged in the Profit and loss Account on estimate basis. It Should be clearly understood that if the amount of a known liability can be determined with reasonable accuracy, it can not a provision.

Notes: Provision is a charge against profits it means provision has to be made irrespective of business enterprise it earning enough profits or incurring losses.

Examples of Provisions: Provision for Depreciation on assets, Provision for Repairs and Renewals of assets. Provision for Taxation, Provision for Discount on Debtors, Provision for Bad and Doubtful Debts.

Reserves

- Reserves are the amount set aside out of profits. It is an appropriation of profits and not a charge on the profits.
- The amount of profit retained is used in the business when difficult time comes. Since reserves are neither expenses nor losses, so these are not charged to profit & loss Account rather these are debited to Profit & Loss Appropriation Account which is prepared after Profit and Loss Account.
- Reserves are also known as 'Plough Back of Profits'.
- Reserves are created to strengthening the financial positions of the business enterprise.
- Examples are General Reserves, Dividend Equalization Reserve etc.
- If the amount of reserve is invested outside the business then, it is called 'Reserve Fund'.
- Creation of reserve does not reduce the not profit but only reduced the divisible profits.

DIFFERENCE BETWEEN PROVISIONS AND RESERVE

	Basis	Provision	Reserve
1.	**Meaning**	It is created to meet a known liability	It is created to strengthen the financial position of business enterprise
2.	**Charge or Appropriation**	Provisions are charge against profits	Reserve is an appropriation of profit.
3.	**Objective**	The object is to provide for known liability cannot be calculated accurately	It is created to strengthen the but financial position and to meet unforeseen liability
4.	**Effect on Profit & Loss A/c**	It is debited to the Profit Hence, profit is reduced.	Reserve reduces divisible profits.
5.	**Creation**	Provisions are to be created even if there are insufficient profits	Reserve is created out of adequate are profits only
6	**Mode of creation**	Provisions are created by debiting the Profit & loss account	It is created through Profit & Loss Appropriation Account
7	**Investment**	It cannot be invested outside the business	Reserve can be invested outside the business
8	**Necessity**	Creation of provision is necessary as per law	Its creation is not necessary. It is created as a matter of prudence

Types of Reserve

General Reserve/Revenue Reserves: If the purpose of creating the reserve is to meet any unforeseen contingency (Liability which is not known) in future, the reserve is called 'General Reserve'. These are retained for strengthening the financial position of the enterprise. These reserves are also known as Revenue Reserves.

Specific Reserves: Specific reserves are those reserves which are created for a specific purpose and can be utilized only for that purpose. 'Dividend Equalization Reserve' and 'Reserve for Replacement of Asset' are the examples of Specific Reserve.

Capital Reserve: In addition to the normal profits, capital profits are also earned in the business from many sources. Reserves created out of capital profits which are.

1. Not of recurring nature.
2. Not readily available for distribution as dividend among the shareholders.
3. These reserves can be utilized for writing off capital losses.

Capital Reserves may be created out of profits such as Profit on sale of any fixed asset, Profit on revaluation of assets, Profit from forfeiture of shares, Profit prior to incorporation of company.

SUMMARY

Financial accounting is a specialized branch of accounting that keeps track of a company›s financial transactions. Using standardized guidelines, the transactions are recorded, summarized, and presented in a financial report or financial statement such as an income statement or a balance sheet.

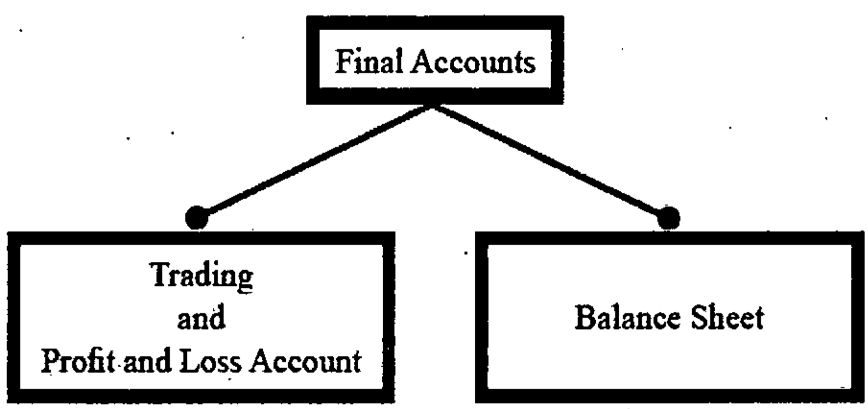
Companies issue financial statements on a routine schedule. The statements are considered external because they are given to people outside of the company, with the primary recipients being owners/stockholders, as well as certain lenders. If a corporation›s stock is publicly traded, however, its financial statements (and other financial reporting's) tend to be widely circulated, and information will likely reach secondary recipients such as competitors, customers, employees, labour organizations, and investment analysts.

It's important to point out that the purpose of financial accounting is not to report the value of a company. Rather, its purpose is to provide enough information for others to assess the value of a company for themselves.

3 FINANCIAL STATEMENTS

Introduction to final accounts

Business entities raise funds, acquire assets and incur various expenses for the purpose of carrying on business operations and earning income from such operations. These transactions are first recorded in the journal and then classified under common heads in the ledger. Preparation of trial balance from ledger balances helps to verify the arithmetical accuracy of entries made in the books of accounts, but it is not the end in itself. The business entities are interested in knowing periodically the results of business operations carried on and the financial soundness of the business. In other words, they want to know the profitability and the financial position of the business. These can be ascertained by preparing the final accounts or financial statements. The final accounts are usually prepared at the end of the accounting period on the basis of balances of ledger accounts shown by the trial balance.



Trading account

Trading refers to buying and selling of goods with the intention of making profit. The trading account is a nominal account which shows the result of buying and selling of goods for an accounting period. According to J. R. Batliboi, "The trading account shows the results of buying and selling of goods. In preparing this account, the general establishment charges are ignored and only the transactions in goods are included."

Trading account is prepared to find out the difference between the revenue from sales and cost of goods sold. Cost of goods sold refers to directly related cost. Direct cost includes the purchase price of goods purchased and all other expenses which are incurred to bring the goods to the business premises or godown and to make these ready for sale. All the goods purchased during the accounting period may not be sold during the same accounting period. Hence, it is necessary to calculate the cost of goods sold during the period. Matching principle is applied here. Hence, the cost of stock not sold must be deducted, i.e., value of closing stock must be deducted. But if there is any opening stock of goods that will be sold during the accounting period, it is to be added to the cost of purchases made during the period. If there is cost of goods manufactured, it must also be added to find out the cost of goods sold.

Cost of goods sold = Opening stock + Net purchases + Direct expenses – Closing stock

If the amount of sales exceeds the cost of goods sold, the difference is gross profit. On the other hand, the excess of cost of goods sold over the amount of sales results in gross loss.

Sales – Cost of goods sold = Gross profit

Sales – Gross profit = Cost of goods sold

Format of trading account

Dr. **Trading account for the year ended . . .** **Cr.**

Particulars	₹	₹	Particulars	₹	₹
To Opening stock		xxx	By Sales	xxx	
To Purchases	xxx		Less: Sales returns	xxx	xxx
Less: Purchases returns	xxx	xxx	By Closing stock		xxx
To Direct expenses:			By Gross loss c/d*		xxx
Carriage/Freight inwards		xxx			
Wages		xxx			
Dock charges		xxx			
Octroi		xxx			
Royalty		xxx			
Import duty		xxx			
To Cost of goods manufactured		xxx			
To Gross profit c/d*		xxx			
		xxx			xxx

The heading of the trading account contains the words 'for the year ended......' as it discloses the sales and cost of goods sold of the business for the whole accounting year.

Illustration 1

From the following information, prepare trading account for the year ended 31.12.2016.

Particulars	₹
Opening stock (1.1.2016)	10,000
Purchases	26,100
Sales	40,600
Closing Stock (31.12.2016)	13,500

Solution

Dr. Trading account for the year ended 31st December, 2016 Cr.

Particulars	₹	Particulars	₹
To Opening stock	10,000	By Sales	40,600
To Purchases	26,100	By Closing stock	13,500
To Gross profit c/d	18,000		
	54,100		54,100

Illustration 2

From the following balances extracted from the books of M/s. Lavanya and sons, prepare trading account for the year ended 31st March, 2017:

Particulars	₹	Particulars	₹
Opening stock	16,500	Carriage inwards	1,200
Purchases	45,000	Wages	4,800
Sales	72,000	Fuel and power	3,200
Purchases returns	500	Closing stock	18,000
Sales returns	1,500		

Solution

In the books of M/s. Lavanya and sons

Dr. Trading account for the year ended 31st March, 2017 Cr.

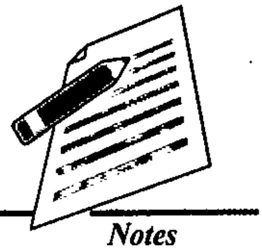
Particulars	₹	₹	Particulars	₹	₹
To Opening stock		16,500	By Sales	72,000	
To Purchases	45,000		Less: Sales returns	1,500	70,500
Less: Purchases returns	500	44,500	By Closing stock		18,000
To Carriage inwards		1,200			
To Wages		4,800			
To Fuel and power		3,200			
To Gross profit c/d*		18,300			
		88,500			88,500

Illustration 3

Prepare trading account for the year ended 31st December, 2017, from the following balances:

Particulars	₹	Particulars	₹
Opening stock	4,00,000	Purchases returns	1,20,000
Purchases	20,00,000	Carriage on purchases	2,00,000
Net sales	48,00,000	Carriage on sales	1,00,000
Freight and octroi	65,000	Advertisement	1,20,000
Selling expenses	1,10,000	Office rent	75,000
Coal, gas and water	22,000	Import duty on goods purchased	7,28,000

Closing stock is valued at ₹ 6, 00,000.



Solution

Dr. **Trading account for the year ended 31st December, 2017** Cr.

Particulars	₹	₹	Particulars	₹	₹
To Opening stock		4,00,000	By Net sales		48,00,000
To Purchases	20,00,000		By Closing stock		6,00,000
Less: Purchases returns	1,20,000	18,80,000			
To Freight and Octroi		65,000			
To Carriage on purchases		2,00,000			
To Coal, gas and water		22,000			
To Import duty		7,28,000			
To Gross Profit c/d		21,05,000			
		54,00,000			54,00,000

Note: Selling expenses, carriage on sales, advertisement and office rent will not appear in trading account, as they are indirect expenses.

Note: Selling expenses, carriage on sales, advertisement and office rent will not appear in trading account, as they are indirect expenses.

Illustration 4

Following is the extract of a trial balance as on 31st December, 2017. Prepare trading account.

Particulars	Dr. ₹	Cr. ₹
Closing stock	25,000	
Adjusted purchases	70,000	
Freight inwards	5,700	
Royalty on goods purchased	4,300	
Sales		1,70,000
Wages	8,000	
Octroi on purchase of goods	4,000	

Solution

Dr. **Trading account for the year ended 31st December, 2017** Cr.

Particulars	₹	₹	Particulars	₹	₹
To Adjusted purchases		70,000	By Sales		1,70,000
To Freight inwards		5,700			
To Royalty on goods Purchased		4,300			
To Wages		8,000			
To Octroi on purchase of goods		4,000			
To Gross profit c/d		78,000			
		1,70,000			1,70,000

Note: Closing stock will not appear in trading account as it is adjusted with purchases, it will appear in balance sheet.

Illustration 5

From the following information, prepare trading account for the year ending 31st December, 2017.

Particulars	₹	Particulars	₹
Opening stock	50,000	Dock charges on purchases	4,000
Cost of goods manufactured	12,000	Import duty on purchases	3,500
Cash purchases	60,000	Wages	11,000
Cash sales	85,000	Sales returns	3,000
Purchases returns	2,000	Credit purchases	35,000
Carriage inwards	4,000	Credit sales	60,000
Freight outwards	3,000	Other direct expenses	7,000
Coal and fuel	2,500		

Solution

Dr. **Trading account for the year ended 31st December, 2017** Cr.

Particulars	₹	₹	Particulars	₹	₹
To Opening stock		50,000	By Sales:		
To Cost of goods			Cash	85,000	
manufactured		12,000	Credit	60,000	
To Purchases:				1,45,000	
Cash	60,000		Less: Sales returns	3,000	1,42,000
Credit	35,000		By Gross loss c/d		45,000
	95,000				
Less: Purchases returns	2,000	93,000			
To Carriage inwards		4,000			
To Coal and fuel		2,500			
To Dock charges on					
Purchases		4,000			
To Import duty on					
Purchases		3,500			
To Wages		11,000			
To Other direct expenses		7,000			
		1,87,000			1,87,000

Note: Freight outwards will not appear in trading account as it is not a direct expense.

Profit and loss account

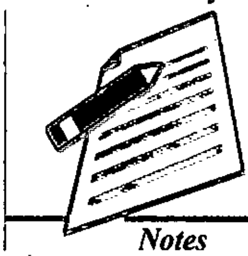
Profit and loss account is the second part of income statement. It is a nominal account in nature. A business entity is interested in knowing not only the gross profit or loss but also the net profit earned or net loss incurred during the year. Hence, profit and loss account is prepared to ascertain the net profit or net loss during the year. Profit and loss account contains all the items of indirect expenses and losses and indirect incomes and gains in addition to gross profit or gross loss pertaining to the accounting period. The difference is net profit or net loss.

Format of profit and loss account

Dr. Profit and loss account for the year ended ……. Cr.

Particulars	₹	Particulars	₹
To Gross loss b/d	xxx	By Gross profit b/d	xxx
To Office and administrative expenses:		By Indirect incomes:	
Salaries	xxx	Rent earned	xxx
Rent, rates and taxes	xxx	Discount received	xxx
Printing and stationery	xxx	Commission earned	xxx
Postage	xxx	Interest on investments	xxx
Legal charges	xxx	Dividend on shares	xxx
Audit fees	xxx	Bad debts recovered	xxx
Establishment expenses	xxx	Profit on sale of fixed assets	xxx
Trade expenses	xxx	Apprenticeship premium	xxx
General travelling expenses	xxx	Miscellaneous receipts	xxx
Lighting	xxx	By Net loss*	xxx
Insurance premium	xxx	(transferred to capital account)	
To Selling and distribution expenses:			
Carriage outwards	xxx		
Advertisement	xxx		
Commission	xxx		
Brokerage	xxx		
Bad debts or provision for bad debts	xxx		
Export duty	xxx		
Packing charges	xxx		
To Other expenses and losses:			
Repairs	xxx		
Depreciation	xxx		
Interest charges	xxx		
Discount allowed	xxx		
Provision for discount on debtors	xxx		
Bank charges	xxx		
Interest on capital	xxx		
Donation and charity	xxx		
Loss on sale of fixed assets	xxx		
Abnormal loss due to fire, theft etc. not covered by insurance	xxx		
To Net profit*	xxx		
(transferred to capital account)			
	xxx		xxx

* The balance will be either net profit or net loss.



Notes

Illustration 8

From the following information, prepare profit and loss account for the year ended 31st March, 2018.

Particulars	₹	Particulars	₹
Gross profit b/d	1,50,000	Advertisement expenses	3,800
Carriage outward	25,500	Bad debts	8,500
Office rent	7,000	Dividend received	9,000
Office stationery	3,500	Discount received	4,600
Distribution expenses	2,000	Rent received	7,000

Solution

Dr. **Profit and Loss Account for the year ended 31st March, 2018** Cr.

Particulars	₹	Particulars	₹
To Carriage outward	25,500	By Gross profit b/d	1,50,000
To Office rent	7,000	By Dividend received	9,000
To Office stationery	3,500	By Discount received	4,600
To Distribution expenses	2,000	By Rent received	7,000
To Advertisement expenses	3,800		
To Bad debts	8,500		
To Net profit transferred to capital account	1,20,300		
	1,70,600		1,70,600

Illustration 9

From the following information, prepare profit and loss account for the year ended 31st December, 2017.

Particulars	₹	Particulars	₹
Gross profit b/d	60,000	Interest received	2,100
Freight outward	15,000	Financial charges	4,000
Packing charges (on sales)	12,000	Repairs on vehicles used in office	8,000
Salesmen commission paid	1,300	Depreciation on vehicles used in office	3,000
Promotional expenses	10,200	Interest paid	9,000
Office telephone expenses	22,400	Rent received	7,000
Bad debts recovered	4,000	Carriage inwards	4,000

Solution

Dr. Profit and Loss Account for the year ended 31st December, 2017 Cr.

Particulars	₹	Particulars	₹
To Freight outward	15,000	By Gross profit b/d	60,000
To Packing charges	12,000	By Bad debts recovered	4,000
To Salesmen commission	1,300	By Interest received	2,100
To Promotional expenses	10,200	By Rent received	7,000
To Office telephone expenses	22,400	By Net loss transferred to	
To Financial charges	4,000	capital account	11,800
To Repairs on vehicles	8,000		
To Depreciation on vehicles	3,000		
To Interest paid	9,000		
	84,900		84,900

Note: Carriage inwards will not appear in profit and loss account as it is a direct expense.

Balance sheet

Balance sheet is a statement which gives the position of assets and liabilities on a particular date. Assets are the resources owned by the business. Liabilities are the claims against the business. After ascertaining the net profit or net loss of the business enterprise, a business person would like to know the financial position of the business. For this purpose, balance sheet is prepared which contains amounts of all the assets and liabilities of the business enterprise as on a particular date. The statement so prepared is called 'balance sheet' because it gives the balances of ledger accounts which are still there, after the closure of all nominal accounts by transferring to the trading and profit and loss account. Balances of all the personal and real accounts are grouped into assets and liabilities. In the balance sheet, liabilities are shown on the left-hand side and assets on the right-hand side.

According to J.R. Batliboi, "A Balance Sheet is a statement prepared with a view to measure the exact financial position of a business on a certain fixed date."

Grouping and Marshalling of assets and liabilities in a balance sheet

The assets and liabilities shown in the balance sheet are grouped and presented in a particular order. The term 'grouping' means showing the items of similar nature under a common heading. For example, the amount due from various customers will be shown under the head 'Sundry debtors.' Similarly, under the head 'Current assets', the balance of cash, bank, debtors, stock and other current assets will be shown.

'Marshalling' is the arrangement of various assets and liabilities in a proper order. Marshalling can be made in one of the following two ways:

(a) In the order of liquidity

According to this method, an asset which is most easily convertible into cash, i.e., cash in hand is shown first and then will follow those assets which are comparatively less easily convertible, so that the least liquid asset i.e., goodwill is shown last. In the same way, the liabilities which are to be paid at the earliest will be shown first. In other words, current liabilities are shown first, then fixed or long-term liabilities and finally the proprietor's capital.

(b) In the order of permanence

This method is exactly the reverse of the first method. Asset which is more permanent, i.e., goodwill is shown first followed by assets which are less permanent. Similarly, those liabilities which are to be paid last will be shown first. In other words, the proprietor's capital is shown first, then fixed or long-term liabilities and lastly the current liabilities. Joint stock companies are required under the Companies Act to prepare their balance sheet in the order of permanence.

Methods of drafting a balance sheet

The balance sheet of business concern can be presented in the following two forms.

a. Horizontal form

b. Vertical form

a) Horizontal form of balance sheet

In the horizontal form, assets are shown on right hand side of the balance sheet and the liabilities are shown on the left-hand side of the balance sheet.

Balance sheet of ... as on...

Liabilities	₹	₹	Assets	₹	₹
Capital	xxx		**Fixed assets:**		
Add: Net profit/ Less: Net loss	xxx		**i) Intangible assets**		
	xxx		Goodwill		xxx
Less: Drawings	xxx	xxx	Patent rights		xxx
Reserves		xxx	Copy rights		xxx
Long term loans		xxx	Trade marks		xxx
Current liabilities:			Computer software		xxx
Bank overdraft, Cash credit	xxx		**ii) Tangible assets**		
Outstanding expenses	xxx		Land		xxx
Unearned income	xxx		Buildings	xxx	
Short term loans from banks	xxx		Less: Depreciation	xxx	xxx
Sundry creditors	xxx		Plant and machinery	xxx	
Bills payable	xxx	xxx	Less: Depreciation	xxx	xxx
Provisions			Vehicles	xxx	
Provision for employee benefits		xxx	Less: Depreciation	xxx	xxx
Provision for tax		xxx	Furniture and Fittings	xxx	
			Less: Depreciation	xxx	xxx
			Investments		xxx
			Current assets		
			Stock		xxx
			Advances given		xxx
			Sundry debtors		xxx
			Bills receivable		xxx
			Prepaid expenses		xxx
			Accrued income		xxx
			Cash at bank		xxx
			Cash in hand		xxx
			Fictitious assets		
			Preliminary expenses		xxx
			Miscellaneous expenses		xxx
		xxx			xxx

b) Vertical form of balance sheet

The balance sheet of a sole proprietor can be presented in a vertical statement form as given below:

WW
Balance sheet of ... as on...

Particulars	₹	₹
Current assets:		
Stock in trade	xxx	
Sundry debtors	xxx	
Marketable securities	xxx	
Prepaid expenses	xxx	
Accrued income	xxx	
Bills receivable	xxx	
Advances given	xxx	
Cash at bank	xxx	
Cash in hand	xxx	
Total Current assets		xxx
Less: Current liabilities:		
Sundry creditors	xxx	
Bills payable	xxx	
Bank overdraft	xxx	
Short term loans	xxx	
Outstanding expenses	xxx	
Total current liabilities		xxx
Net working capital		xxx
Add: Long term investments		xxx
Add: Fixed Assets:		
Goodwill	xxx	
Land and building	xxx	
Plant and machinery	xxx	
Furniture	xxx	
Total fixed assets		xxx
Capital Employed (both owner's funds and outsiders' funds)		xxx
Less: Long term liabilities:		
Loans	xxx	
Total long term liabilities		xxx
Net Assets		xxx
Represented by:		
Owners' Capital	xxx	
Reserves and surplus	xxx	xxx
Proprietor's fund		xxx

Adjustment entries and accounting treatment of adjustments

Meaning of adjustment entries

Adjustment entries are the journal entries made at the end of the accountiWng period to account for items which are omitted in trial balance and to make adjustments for outstanding and prepaid expenses and revenues accrued and received in advance.

Adjustments and adjustment entries

The following are the common adjustments and adjustment entries which are made while preparing the final accounts.

(i) Closing stock

The unsold goods in the business at the end of the accounting period are termed as closing stock. As per AS-2 (Revised), the stock is valued at cost price or net realisable value, whichever is lower.

Adjusting entry

Particulars	L.F.	Debit ₹	Credit ₹
Stock (closing) A/c Dr. To Trading A/c (Closing stock brought into account)		xxx	 xxx

Presentation in final accounts

In the Trading Account	Shown on the credit side.
In the Balance Sheet	Shown on the assets side under current assets.

Tutorial notes

Closing stock is the opening stock for the next accounting period. At the beginning of the next accounting period this entry is reversed to bring into account the opening stock.

Example

The value of closing stock shown as adjustment on 31st March, 2016 is Rs. 10,000. The adjusting entry is:

Adjusting entry

Adjusting entry

Date	Particulars	L.F.	Debit ₹	Credit ₹
2016 March 31	Stock - in trade (closing) A/c Dr. To Trading A/c (Closing stock brought into account)		10,000	 10,000

In final accounts, it is presented as follows:

Dr. Trading Account for the year ended 31st March, 2016 Cr.

Particulars	₹	₹	Particulars	₹	₹
			By Closing stock		10,000

Balance Sheet as on 31st March, 2016

Liabilities	₹	₹	Assets	₹	₹
			Stock-in-trade		10,000

Tutorial note

If closing stock is already adjusted, adjusted purchases account and closing stock will appear in trial balance. Adjusted purchases account will be shown on the debit side of the trading account and closing stock will be shown on the assets side of the balance sheet.

(ii) Outstanding expenses

Expenses which have been incurred in the accounting period but not paid till the end of the accounting period are called outstanding expenses. In other words, if certain benefits or services are received during the year but payment is not made for the services received and utilised, these are termed as outstanding expenses. Outstanding expense account is a representative personal account and expense account is a nominal account.

Adjusting entry

Particulars	L.F.	Debit ₹	Credit ₹
Concerned expense A/c Dr. To Outstanding expense A/c (Expense outstanding adjusted)		xxx	 xxx

Presentation in final accounts

In the Trading A/c or Profit and loss A/c	Amount outstanding is added to particular expense account in the trading account if it is direct expense and in the profit and loss account if it is an indirect expense.
In the Balance Sheet	Amount of outstanding expense is a current liability and is shown on the liabilities side of the balance sheet.

Tutorial note

- If outstanding expenses account appears in the trial balance with credit balance, it means that journal entry has been made already for outstanding expenses. Hence, the outstanding expenses account will be shown only in the liabilities side of balance sheet. No adjustment is therefore necessary in expenses account as already expenses would have been adjusted.

Presentation in final accounts

In Profit and loss A/c	Amount accrued is added to particular income.
In Balance Sheet	Amount of accrued income is shown on the assets side under current assets.

Tutorial note

- If accrued income account appears in the trial balance with debit balance, it means that journal entry has been made already for accrued income. Hence, the accrued income account will be shown only in the assets side of balance sheet. No adjustment is necessary in income account as already it would have been adjusted.
- At the beginning of the next accounting period, the above entry is reversed to bring into account accrued income at the beginning, so that it is reduced from amount of income in the next year.

v. Income received in advance

Income received in advance refers to income or portion of income received in an accounting year which is not earned in the accounting period. It is also known as unearned income or unexpired income. Though the amount is received in the current accounting year, the benefit is yet to be offered to the concerned person in the next accounting year.

Adjusting entry

Particulars		L.F.	Debit ₹	Credit ₹
Concerned income A/c	Dr.		xxx	
To Income received in advance A/c				xxx
(Income received in advance adjusted)				

Presentation in final accounts

In Profit and loss A/c	Amount received in advance is deducted from particular income.
In Balance Sheet	Amount of income received in advance being current liability is shown on the liabilities side of the balance sheet.

Tutorial note

- If income received in advance account appears in the trial balance with credit balance, it means that journal entry has been made already for income received in advance. Hence, the income received in advance account will be shown only in the liabilities side of balance sheet. No adjustment is necessary in income account as already it would have been adjusted.
- At the beginning of the next accounting period, the above entry is reversed to bring into account income received in advance at the beginning, so that it is added to the amount of income in the next year.

(vi) Interest on capital

According to separate entity concept business and proprietor are two separate entities. Capital contributed by proprietor is a liability to the business. Hence, interest may be provided on capital contributed by proprietor. It is treated as a business expense. The purpose is to know the true profit of the business.

Adjusting entry

Particulars	L.F.	Debit ₹	Credit ₹
Interest on capital A/c Dr.		xxx	
To Capital A/c			xxx
(Interest on capital provided)			

Transfer entry

Particulars	L.F.	Debit ₹	Credit ₹
Profit and Loss A/c Dr.		xxx	
To Interest on capital A/c			xxx
(Interest on capital transferred)			

Presentation in final accounts

In Profit and loss A/c	Amount of interest on capital is shown on the debit side.
In Balance Sheet	Amount of interest on capital is added to capital on the liabilities side of the balance sheet.

Tutorial note

Interest on capital is calculated on the opening balance of capital if there is no change in the capital account during the accounting year. If there is any additional capital introduced or capital withdrawn, then interest on capital is to be calculated proportionately on the balance outstanding.

(vii) Interest on drawings

Drawings represent the amount or goods withdrawn by the proprietor from the business for his personal use. As business is separate from owner, interest charged on drawings, if any, is to be treated as business income.

Adjusting entry

Particulars	L.F.	Debit ₹	Credit ₹
Capital A/c Dr.		xxx	
To Interest on drawings A/c			xxx
(Interest on drawings provided)			

Transfer entry

Particulars		Debit ₹	Credit ₹
Interest on drawings A/c To Profit and loss A/c (Interest on drawings transferred)	Dr.	xxx	xxx

Presentation in final accounts

In Profit and loss A/c	Amount of interest on drawings is shown on the credit side as it is an income / gain.
In Balance Sheet	Amount of interest on drawings is deducted from the capital on the liabilities side of the balance sheet.

Example

The trial balance on 31st March, 2016 shows capital as Rs. 1,50,000 and drawings as Rs. 10,000.

Adjustment: Charge interest on drawings at 4%.

Interest on drawings = Rs. 10,000 × 4/100 = Rs. 400. The adjusting entry is:

Adjusting entry

Date	Particulars		L.F.	Debit ₹	Credit ₹
2016 March 31	Capital A/c To Interest on drawings A/c (Interest on drawings provided)	Dr.		400	400

Transfer entry

Date	Particulars		L.F.	Debit ₹	Credit ₹
2016 Marh 31	Interest on drawings A/c To Profit and loss A/c (Interest on drawings transferred)	Dr.		400	400

In final accounts, it is presented as follows:

viii) Interest on loan

Business entities may have loans borrowed from banks and other financial institutions, private money lenders, etc. If any interest is payable on loan and not yet provided at the time of preparation of trial balance, it is necessary to provide for outstanding interest on loan. It is an outstanding expense.

Adjusting entry

Particulars		L.F.	Debit ₹	Credit ₹
Interest on loan A/c To Outstanding interest on loan A/c (Interest on loan outstanding)	Dr.		xxx	xxx

Presentation in final accounts

In Profit and loss A/c	Amount outstanding is added to interest on loan on the debit side.
In Balance Sheet	Amount of interest outstanding is added to loan on the liabilities side as it is payable along with the loan.

Tutorial note

- If the trial balance contains loan account specifying the percentage of interest and date of borrowing and interest paid appears in the trial balance, it is to be checked whether interest for the whole year is paid. If it is not paid, outstanding interest must be adjusted.
- Similar to any other expenses outstanding, this entry also will be reversed at the beginning of the next accounting period.

(ix) Interest on investment

Business entities may have investments in outside securities carrying specified rate of interest. If interest is due but not yet received, adjustment is to be made for the same in the accounting records before preparation of final accounts. Interest receivable on any investments in the form of shares, deposits, etc. made outside the business is called accrued interest. It is an accrued income.

Adjusting entry

Particulars	L.F.	Debit ₹	Credit ₹
Accrued interest on investment A/c Dr.		xxx	
To Interest on investment A/c			xxx
(Interest on investment due adjusted)			

Presentation in final accounts

In Profit and loss A/c	Amount accrued is added to interest on investment on the credit side.
In Balance Sheet	Amount of accrued interest being current asset is shown on the assets side of the balance sheet.

(x) Depreciation

The decrease in book value of fixed assets due to usage or passage of time is called depreciation. It is a loss to the business. Therefore, it must be written off from the value of asset. Generally, a certain percentage on the value of the asset is calculated as the amount of depreciation.

Adjusting entry

Particulars	L.F.	Debit ₹	Credit ₹
Depreciation A/c Dr.		xxx	
To Concerned fixed asset A/c			xxx
(Depreciation provided)			

Transfer entry

Particulars	L.F.	Debit ₹	Credit ₹
Profit and loss A/c Dr.		xxx	
To Depreciation A/c			xxx
(Depreciation transferred)			

Presentation in final accounts

In Profit and loss A/c	Depreciation is shown on the debit side.
In Balance Sheet	Amount of depreciation is deducted from concerned fixed asset on the assets side.

Tutorial note

When depreciation already appears in trial balance, it means journal entry is already made and asset account has been already reduced to the extent of depreciation. Hence, depreciation will be shown only in profit and loss account.

(xi) Bad debts

When it is definitely known that amount due from a customer (debtor) to whom goods were sold on credit, cannot be realised at all, it is treated as bad debts. In other words, debts which cannot be recovered or irrecoverable debts are called bad debts. It is a loss for the business and should be charged against profit.

Adjusting entry

Particulars	L.F.	Debit ₹	Credit ₹
Bad debts A/c Dr.		xxx	
To Sundry debtors A/c			xxx
(Bad debts written off)			

Transfer entry
(If provision for bad and doubtful debts account is not maintained)

Particulars	L.F.	Debit ₹	Credit ₹
Profit and Loss A/c Dr.		xxx	
To Bad debts A/c			xxx
(For transfer of bad debts)			

Transfer entry
(If provision for bad and doubtful debts account is maintained)

Particulars	L.F.	Debit ₹	Credit ₹
Provision for bad and doubtful debts A/c Dr.		xxx	
To Bad debts A/c			xxx
(Bad debts transferred)			

Presentation in final accounts

In Profit and loss A/c	Amount of bad debt is shown on the debit side.
In Balance Sheet	Amount of bad debts is deducted from sundry debtors on the assets side.

Tutorial note

When bad debts already appears in the trial balance it means journal entry is already made, i.e., debtors is already reduced. Hence, bad debt is taken only to debit side of *profit and loss account.*

If there is bad debt in trial balance as well as in adjustments, total bad debt is debited in profit and loss account. Additional bad debt only is deducted from debtors in the balance sheet.

(xii) Provision for bad and doubtful debts

Provision for bad and doubtful debts refers to amount set aside as a charge against profit to meet any loss arising due to bad debt in future. At the end of the accounting period, there may be certain debts which are doubtful, i.e., the amount to be received from debtors may or may not be received. The reason may be incapacity to pay the amount or deceit.

This is according to the convention of conservatism. Moreover, according to matching principle, all costs related to earning revenue in a period must be charged in the relevant period itself. Hence, it is appropriate that provision is created in the current year against debtors of current year.

Adjusting entry

Particulars		L.F.	Debit ₹	Credit ₹
Profit and loss A/c	Dr.		xxx	
To Provision for bad and doubtful debts A/c				xxx
(Provision for bad and doubtful debts created)				

Presentation in final accounts

In Profit and loss A/c	Amount of provision for bad and doubtful debts is shown on the debit side.
In Balance Sheet	Amount of provision for bad and doubtful debts is deducted from sundry debtors on the assets side.

(xiii) Provision for discount on debtors

Cash discount is allowed by the suppliers to customers for prompt payment of amount due either on or before the due date. A provision created on sundry debtors for allowing such discount is called provision for discount on debtors. This provision is a charge against profit and hence profit and loss account is debited.

Provision for discount on debtors is made on the basis of past experience at an estimated rate on sundry debtors. Discount should be calculated on sundry debtors after deducting bad debts and provision for bad debts.

Adjusting entry

Particulars	L.F.	Debit ₹	Credit ₹
Profit and loss A/c Dr.		xxx	
To Provision for discount on debtors A/c			xxx
(Provision for discount on debtors created)			

Presentation in final accounts

In Profit and loss A/c	Amount of provision for discount on debtors is shown on the debit side.
In Balance Sheet	Amount of provision for discount on debtors is deducted from sundry debtors on the assets side.

(xiv) Income tax paid

As per the Indian Income Tax Act, 1961, business income of the sole proprietor is not assessed and taxed separately. It is the sole proprietor who is assessed to tax for his total income including the business income. Hence, income tax paid by the business is not a business expenditure and is treated as drawings.

Adjusting entry

Particulars	L.F.	Debit ₹	Credit ₹
Drawings A/c Dr.		xxx	
To Bank A/c			xxx
(Income tax of the proprietor paid)			

Presentation in final accounts

Trading / Profit and loss account	Not shown.
In Balance Sheet	Shown as deduction from capital on the liabilities side. Shown as a deduction from bank balance on the assets side.

Example

Trial balance of Sibi as on 31st December, 2017 shows the capital as Rs. 1,05,000 and cash at bank as Rs. 80,000.

Adjustment: Income tax paid Rs. 15,000. The adjusting entry is:

Adjusting entry

Date	Particulars	L.F.	Debit ₹	Credit ₹
2017 Dec. 31	Drawings A/c Dr.		15,000	
	To Bank A/c			15,000
	(Income tax paid)			

In final accounts, it is presented as follows:

Balance Sheet as on 31st December, 2017

Liabilities	₹	₹	Assets	₹	₹
Capital	1,05,000		Cash at bank	80,000	
Less: Drawings (income tax)	15,000	90,000	Less: Income tax	15,000	65,000

(xv) Manager's commission

Sometimes the manager is given commission as a percentage on profit of the business. It may be given at a certain percentage on the net profit before charging such commission or after charging such commission. Calculation procedure is explained below:x

$$\text{Commission} = \text{Net profit before charging commission} \times \frac{\text{Rate of commission}}{100}$$

$$\text{Commission} = \text{Net profit before charging commission} \times \frac{\text{Rate of commission}}{(100+ \text{Rate of commission})}$$

The purpose of giving such commission may be to motivate the managers to work with their full potential, to reward the managers for their efficiency and to retain the efficient managers by rewarding them sufficiently. Such commission can be calculated only at the end of the accounting period after calculating net profit. Hence, it remains outstanding at the end of the accounting period.

Adjusting entry

Particulars	L.F.	Debit ₹	Credit ₹
Manager's Commission A/c Dr.		xxx	
To Outstanding Manager's commission A/c			xxx
(Manager's commission on profit provided)			

Transfer entry

Particulars	L.F.	Debit ₹	Credit ₹
Profit and loss A/c Dr.		xxx	
To Manager's commission A/c			xxx
(Commission on profit transferred)			

Presentation in final accounts

In Profit and loss account	Commission being an indirect expense is shown on the debit side of profit and loss account.
In Balance Sheet	Commission outstanding being a current liability is shown on the liabilities side of the balance sheet.

SUMMARY

Final accounts are those accounts that are prepared by a joint stock company at the end of a fiscal year. The purpose of creating final accounts is to provide a clear picture of the financial position of the organisation to its management, owners, or any other users of such accounting information.

Final account preparation involves preparing a set of accounts and statements at the end of an accounting year. The final account consists of the following accounts:

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

EXERCISE

MCQ

1. Business is said to be in a profit when

A) Expenditure exceeds income

B) Income exceeds expenditure

C) Income exceeds liability

D) Assets exceed expenditure

Answer: B

2. As per the accounting double-entry system, an account that receives the benefit is

A) No need to show as an accounting record

B) Income

C) Debit

D) Credit

Answer: D

3. What does the term "credit" mean in business?

A) It depends upon items

B) Provides benefits

C) It has no effect on business

D) Receiving benefits

Answer: D

4. When a Liability is decreased or reduced, it is registered on the
   A) Debit side or left side of the account
   B) Credit side or right side of the account
   C) Debit side or right side of the account
   D) Credit side or left side of the account

   Answer: A

5. When there is an increase in capital by an amount, it is registered on the
   A) Credit or right side of the account
   B) Debit or left side of the account
   C) Credit or left side of the account
   D) Debit or right side of the account

   Answer: A

Review Questions

Following is the trial balance of Brijesh. Prepare final accounts for the year ended on 31st March, 2016.

Particulars	Debit ₹	Credit ₹
Stock as on 01-04-2015	2,00,000	
Purchases and Sales	22,00,000	33,00,000
Returns	1,00,000	80,000
Carriage inwards	50,000	
Salaries	2,60,000	
Insurance	1,20,000	
Wages	80,000	
Bad debts	10,000	
Furniture	7,00,000	
Capital		7,50,000
Printing and stationery	80,000	
Cash at bank	3,15,000	
Petty cash	5,000	
Commission	10,000	
	41,30,000	41,30,000

Adjustments:

- Stock on 31st March, 2016 was valued at Rs. 4,00,000.
- Depreciate furniture @ 10% p.a.
- Insurance of Rs. 60,000 was paid in advance
- Commission receivable Rs. 50,000.

4 NOT-FOR-PROFIT ORGANISATIONS

Not-for-profit organisations

Features of not-for-profit organisations

Following are the features of not-for-profit organisations:

1. Not-for-profit organisations are the organisations which function without any profit motive.
2. Their main aim is to provide services to a specific group or the public at large.
3. Generally, they do not undertake business or trading activities.
4. Their main sources of income include subscription from members, donations, grant-in-aid and legacies.

At the end of the accounting period, the following final accounts are prepared by not-for- profit organisations:

(i) Receipts and payments account,

(ii) Income and expenditure account and

(iii) Balance sheet

Not-for-profit organisations registered under Section 8 of the Indian Companies Act, 2013 are required to prepare their Income and Expenditure account and Balance Sheet as per Schedule III to the Indian Companies Act, 2013.

Receipts and Payments Account

Receipts and Payments account is a summary of cash and bank transactions of not-for-profit organisations prepared at the end of each financial year.

It is a real account in nature. The receipts and payments account begins with the opening balances of cash and bank and ends with closing balances of cash and bank. All cash receipts are shown on the debit side and all cash payments are shown on the credit side of this account. All cash receipts and cash payments whether of capital or revenue nature will be recorded in the receipts and payments account. They may relate to the current year or the previous years or the subsequent years. It means that irrespective of the period for which the amount is received or paid, it is recorded if cash is received or paid during the year.

Non-cash items such as depreciation, outstanding expenses and accrued income are not shown in receipts and payments account.

1. Steps in preparation of receipts and payments account

Following are the steps involved in the preparation of receipts and payments account:

a) Record the opening balance of cash in hand and favourable bank balance on the debit side of receipts and payments account. If there is bank overdraft, it must be recorded on the credit side.

b) Actual cash receipts during the year are recorded on the debit side and actual cash payments during the year are recorded on the credit side.

c) While recording cash receipts and payments, no distinction needs to be made between revenue and capital items. Similarly, no distinction needs to be made whether the amount received or paid relates to the current period, previous period or future period.

d) If the total of the debit side is more than the credit side, the balancing figure will appear on the credit side. It represents the closing balance of cash or bank.

e) If the total of the credit side is more than the debit side, the balancing figure will appear on the debit side. It represents bank overdraft.

Format of Receipts and Payment Account

Dr. Receipts and Payments Account of .... for the year ending ....

Format of Receipts and Payment Account

Dr. Receipts and Payments Account of .... for the year ending .... Cr.

Receipts	₹	₹	Payments	₹	₹
To Balance b/d			By Balance b/d		
Cash in hand	xxx		Bank overdraft		xxx
Cash at bank	xxx	xxx			
Revenue receipts:			**Revenue payments:**		
To Subscription		xxx	By Salaries		xxx
To Entrance fees		xxx	By Rent paid		xxx
To General donations		xxx	By Electricity charges		xxx
To Grant-in-aid		xxx	By Postage		xxx
To Sale of old newspapers		xxx	By Rent and taxes		xxx
To Interest on investment		xxx	By Insurance		xxx
To Dividend		xxx	By Advertisement		xxx
To Locker rent received		xxx	By Telephone charges		xxx
To Rent received		xxx	By Entertainment expenses		xxx
To Sundry receipts		xxx	By Audit fees		xxx
			By Repairs		xxx
Capital receipts:			By Upkeep of ground		xxx
To Life membership fees		xxx	By Conveyance charges		xxx
To Donation for			By Newspapers and		
specific purpose		xxx	periodicals		xxx
To Legacies		xxx	By Office expenses		xxx
To Endowment fund		xxx	By Gardening expenses		xxx
To Sale of fixed assets		xxx	By Sundry expenses		xxx
To Sale of investments		xxx			
To Receipt for specific			**Capital Payments:**		
purpose or fund		xxx	By Fixed assets		xxx
To Interest on specific			By Investments		xxx
fund investments		xxx	By Repayment of loan		xxx
To Balance c/d		xxx	By Balance c/d		
(Bank overdraft)			Cash in hand	xxx	
			Cash at bank	xxx	xxx
		xxx			xxx

Illustration 1

From the following particulars of Tamil Educational Society, prepare Receipts and Payments account for the year ended 31st March, 2019.

Particulars	₹	Particulars	₹
Opening cash balance as on 1.4.2018	18,000	Building purchased	2,10,000
Rent paid	6,000	Staff salary	55,000
Scholarship given	15,200	Subscription received	2,65,000
Entrance fees received	18,500		

Solution

In the books of Tamil Educational Society

Dr. Receipts and Payments Account for the year ended 31st March, 2019

In the books of Tamil Educational Society

Dr. Receipts and Payments Account for the year ended 31st March, 2019 Cr.

Receipts	₹	Payments	₹
To Balance b/d		By Rent paid	6,000
Cash in hand	18,000	By Scholarship given	15,200
To Entrance fees	18,500	By Building purchased	2,10,000
To Subscription received	2,65,000	By Staff salary	55,000
		By Balance c/d	
		Cash in hand	15,300
	3,01,500		3,01,500

Illustration 2

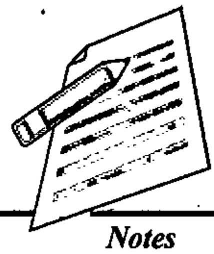
From the following particulars of Trichy Educational Society, prepare Receipts and Payments account for the year ended 31st December, 2018.

Particulars	₹	Particulars	₹
Opening cash balance as on 1.1.2018	20,000	Locker rent received	12,000
Investments made	80,000	Sale of furniture	5,000
Honorarium paid	3,000	General expenses	7,000
Donation received	80,000	Postage	1,000
Audit fees paid	2,000	Subscription received	10,000

Solution

In the books of Trichy Educational Society

Dr. Receipts and Payments Account for the year ended 31st December, 2018



In the books of Trichy Educational Society

Dr. Receipts and Payments Account for the year ended 31st December, 2018 Cr.

Receipts	₹	Payments	₹
To Balance b/d		By Investments made	80,000
Cash in hand	20,000	By Honorarium paid	3,000
To Donation received	80,000	By Audit fees	2,000
To Locker rent received	12,000	By General expenses	7,000
To Sale of furniture	5,000	By Postage	1,000
To Subscription	10,000	By Balance c/d	
		Cash in hand	34,000
	1,27,000		1,27,000

Illustration 3

From the following particulars of Chennai Sports Club, prepare Receipts and Payments account for the year ended 31st March, 2018.

Particulars	₹	Particulars	₹	₹
Opening cash balance as on 1.4.2017	10,000	Subscriptions received		
Opening bank balance as on 1.4.2017	15,000	2016 - 2017	4,500	
Interest paid	5,000	2017 - 2018	65,000	
Telephone expenses	7,000	2018 - 2019	5,000	74,500
Upkeep of grounds	22,500	Tournament expenses		12,500
Life membership fees received	5,500	Tournament fund receipts		15,000
Bats and balls purchased	13,000	Closing balance of cash (31.3.2018)		5,000

Solution

In the books of Chennai Sports Club

Dr. Receipts and Payments Account for the year ended 31st March, 2018

In the books of Chennai Sports Club

Dr. Receipts and Payments Account for the year ended 31st March, 2018 Cr.

Receipts	₹	₹	Payments	₹	₹
To Balance b/d:			By Interest paid		5,000
Cash	10,000		By Telephone expenses		7,000
Bank	15,000	25,000	By Upkeep of grounds		22,500
To Life membership fees		5,500	By Bats and balls purchased		13,000
To Tournament fund receipts		15,000	By Tournament expenses		12,500
To Subscriptions received			By Balance c/d		
2016 - 2017	4,500		Cash	5,000	
2017 - 2018	65,000		Bank (Bal. fig)	55,000	60,000
2018 - 2019	5,000	74,500			
		1,20,000			1,20,000

Illustration 4

From the following particulars of Poompuhar Literary Association, prepare Receipts and Payments account for the year ended 31st March, 2019.

Particulars	₹	Particulars	₹
Opening cash in hand as on 1.4.2018	5,000	Subscriptions received	20,000
Bank overdraft as on 1.4.2018	4,000	Repairs and renewals	2,500
Printing and stationery	1,500	Conveyance paid	2,750
Interest paid	3,250	Books purchased	10,000
Sale of investments	1,000	Insurance premium paid	4,000
Purchase of refreshments	1,500	Sundry receipts	750
Outstanding salary	2,000	Government grants received	6,000
Endowment fund receipts	2,000	Sale of refreshments	1,500
Lighting charges	1,300	Depreciation on buildings	2,000
		Cash at bank on 31.03.2019	2,000

Solution

In the books of Poompuhar Literary Association

Dr. Receipts and Payments Account for the year ended 31st March, 2019

In the books of Poompuhar Literary Association

Dr. Receipts and Payments Account for the year ended 31st March, 2019 Cr.

Receipts	₹	Payments	₹
To Balance b/d		By Balance b/d	
Cash in hand	5,000	Bank overdraft	4,000
To Sale of investments	1,000	By Printing and stationery	1,500
To Endowment fund receipts	2,000	By Interest paid	3,250
To Subscriptions received	20,000	By Purchase of refreshments	1,500
To Sundry receipts	750	By Lighting charges	1,300
To Government grants received	6,000	By Repairs and renewals	2,500
To Sale of refreshments	1,500	By Conveyance paid	2,750
		By Books purchased	10,000
		By Insurance premium paid	4,000
		By Balance c/d	
		Cash at bank	2,000
		Cash in hand	3,450
	36,250		36,250

Note: As outstanding salary and depreciation are non-cash items, both are to be excluded in receipts and payments account.

Illustration 5

From the following particulars of Vellore Recreation Club, prepare Receipts and Payments account for the year ended 31st March, 2017.

Particulars	₹	Particulars	₹
Opening cash balance as on 1.4.2016	3,000	Receipts from entertainment	20,000
Opening bank balance as on 1.4.2016	12,000	Admission fees received	1,000
Furniture purchased	11,000	Municipal taxes	22,000
Sports equipment purchased	11,000	Expenses of charity show	2,000
Donation received for pavilion	8,000	Billiards table purchased	15,000
Sale of old tennis balls	1,500	Construction of new tennis court	18,000
Newspapers bought	500	Receipts from charity show	2,500
Travelling expenses	4,500	Closing balance of cash in hand	8,000

Solution

In the books of Vellore Recreation Club

Dr. Receipts and Payments Account for the year ended 31st March, 2017

In the books of Vellore Recreation Club

Dr. Receipts and Payments Account for the year ended 31st March, 2017 Cr.

Receipts	₹	₹	Payments	₹
To Balance b/d			By Furniture purchased	11,000
Cash in hand	3,000		By Sports equipment	
Cash at bank	12,000	15,000	purchased	11,000
To Donation received for pavilion		8,000	By Newspapers bought	500
To Sale of old tennis balls		1,500	By Travelling expenses	4,500
To Receipts from entertainment		20,000	By Municipal taxes	22,000
To Admission fees		1,000	By Expenses of charity show	2,000
To Receipts from charity show		2,500	By Billiards table purchased	15,000
To Balance c/d		44,000	By Construction of new	
(Bank overdraft)			tennis court	18,000
			By Balance c/d	
			Cash in hand	8,000
		92,000		92,000

Items peculiar to not–for–profit organisations

Distinction between revenue and capital items will be helpful while preparing the final accounts of not–for–profit organisations. Revenue items will be recorded in income and expenditure account while capital items will be recorded in the balance sheet. Items peculiar to not–for– profit organisations and their accounting treatment in that context is given below:

(i) Subscription

Not–for–profit organisations usually collect subscriptions periodically from their members. These may be collected monthly, quarterly, half-yearly or yearly. In addition, some special subscriptions, for example, subscription for tennis, billiards, etc., are collected from the concerned members playing tennis or billiards as the case may be. All these subscriptions are revenue receipts.

(ii) Interest on investment

For investments made, the organisation may receive interest. It is a revenue receipt.

(iii) Sale of old sports materials

The sale proceeds of old sports materials like balls, bats, etc. are revenue receipts.

(iv) Sale of old newspapers

The sale proceeds of old newspapers are revenue receipts.

(v) Life membership fee

Amount received towards life membership fee from members is a capital receipt as it is non-recurring in nature.

(vi) Legacy

A gift made to a not–for–profit organisation by a will, is called legacy. It is a capital receipt.

(vii) Admission fee or Entrance fee

It is a fee collected from every member only once at the time of his or her admission into the organisation. It may be treated as a revenue receipt as it is a recurring income from new members admitted every year and may be used to meet the expenses at the time of admission. It may also be treated as a capital receipt.

(viii) Grants from government and other organisations

Not–for–profit organisations may receive different forms of grant from government and other organisations.

Grants received towards construction of buildings, acquisition of assets, etc., are treated as capital receipts as they are non-recurring in nature.

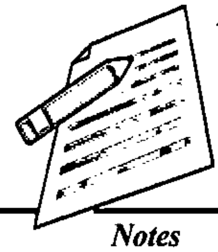
Grants received towards maintenance of assets, payment of salaries, etc., are treated as revenue receipts as they are recurring in nature.

(ix) Donations

These are the amounts received by not–for–profit organisations as a gift. It may be general donation or specific donation.

General donation: If the donation is received without any specific condition, then it is a general donation. It is a revenue receipt.

Specific donation: If the donation is received with a specific condition for a particular purpose like donations for sports fund, prize fund etc., it is known as specific donation. It is a capital receipt.



Notes

(x) Honorarium

It is the remuneration paid to a person who is not a regular employee of the organisation. It is a revenue expenditure.

(xi) Purchase of sports materials

Sports materials such as balls, bats, nets, etc. are consumable items. Amount of consumed sports materials are taken as revenue expenditure and value of unconsumed sports materials (stock) are shown as asset in the balance sheet.

(xii) Purchase of sports equipment

It is a capital expenditure. Examples: Purchase of Table tennis table, Billiards table, etc.

(xiii) Purchase of books for library

Books purchased for library is a capital expenditure.

Few examples of capital and revenue items peculiar to not–for–profit organisations are given below:

Revenue receipts	Capital receipts	Revenue or capital receipt (as per the practice of the organisation)
Subscription	Life membership fees	Admission fee or Entrance fee
Interest on investment	Legacies	Donations
Interest on fixed deposit	Specific donations	Special fees
Sale of (old) sports materials	Sale of fixed assets	Grants from government and other organisations
Sale of (old) newspapers	Special funds	
Collection or receipts relating to	Tournament fund	
a) Tournament	Prize fund	
b) Sports		
c) Matches		
d) Entertainments		
e) Dinner		

Note: In this unit, entrance fees or admission fees, donations, special fees and grants from government and other organisations have been treated as revenue receipts even though these may also be treated as capital receipts.

Capital expenditure	Revenue expenditure
Purchase of sports equipment	Honorarium
Purchase of books for library	Charity
	Audit fees
	Purchase of sports materials
	Printing and stationery
	Postage and courier charges
	Expenses relating to
	a) Tournament, b) Sports, c) Matches, d) Entertainments, e) Dinner

Income and Expenditure Account

Income and expenditure account is a summary of income and expenditure of a not–for–profit organisation prepared at the end of an accounting year. It is prepared to find out the surplus or deficit pertaining to a particular year.

It is a nominal account in nature in which items of revenue receipts and revenue expenditure, relating to the current year alone are recorded. It is prepared following the accrual basis of accounting.

It is just like preparing a profit and loss account. In this account, incomes are shown on the credit side and expenses are shown on the debit side. Apart from cash items, non-cash items such as income accrued but not received, loss or gain on sale of fixed assets, depreciation, etc. will also be recorded.

It helps to enable the members to know the working of the organisation and to know whether its income is sufficient to meet its expenses. It can be prepared from a given receipts and payments account.

1. Steps in preparation of income and expenditure account from receipts and payments account

Following are the steps to be followed in preparing income and expenditure account from receipts and payments account:

i. Opening and closing balances of cash and bank accounts in receipts and payments account must be excluded.

ii. Capital receipts and capital expenditures must be excluded.

iii. Only revenue receipts pertaining to the current year should be taken to the credit side of income and expenditure account. Due adjustments should be made for income received in advance, income accrued for the current year and for the amount relating to the previous year or years.

iv. Similarly, revenue expenditure relating to the current year only must be taken in the debit side of income and expenditure account. Adjustments must be made for outstanding expenses of the previous year and current year and for the prepaid expenses of the previous year and current year.

v. Any income or expense relating to specific fund must not be taken to income and expenditure account.

vi. Non-cash items such as bad debts, depreciation, loss or gain on sale of assets, etc., which are not recorded in receipts and payments account must be recorded in income and expenditure account.

vii. The balancing figure of income and expenditure account is either surplus or deficit and will be transferred to capital fund in the balance sheet. If the total of credit side of income and expenditure account is more than the total of debit side (excess of income over expenditure), the difference represents surplus. If the total of debit side of income and expenditure account is more than the total of credit side (excess of expenditure over income), the difference represents deficit.

2. Format of Income and Expenditure Account

Name of the club / Institution

Name of the club / Institution

Dr. Income and Expenditure Account for the year ended .... Cr.

Expenditure	₹	Income	₹
To Salaries	xxx	By Subscription	xxx
To Charities	xxx	By Donation received	xxx
To Rent	xxx	By Admission fee received	xxx
To Donation paid	xxx	By Grant received	xxx
To Stationery	xxx	By Rent received	xxx
To Loss on sale of asset	xxx	By Interest received	xxx
To Depreciation	xxx	By Profit on sale of asset	xxx
To Surplus*	xxx	By Deficit*	xxx
(Excess of income over expenditure)		(Excess of expenditure over income)	
	xxx		xxx

* Note: The balancing figure may be either surplus or deficit.

Illustration 6

From the following Receipts and Payment Account of Ooty Recreation Club, prepare Income and Expenditure Account for the year ended 31.03.2018.

Receipts	₹	Payments	₹
To Opening balance		By Sports materials purchased	10,000
Cash in hand	5,000	By Stationery paid	7,000
To Rent received	10,000	By Computer purchased	25,000
To Sale of investments	8,000	By Salaries	20,000
To Subscription received	54,000	By Closing balance	
		Cash in hand.	15,000
	77,000		77,000

Solution

In the books of Ooty Recreation Club

In the books of Ooty Recreation Club

Dr. Income and Expenditure Account for the year ended 31st March, 2018 Cr.

Expenditure	₹	Income	₹
To Sports materials purchased	10,000	By Rent received	10,000
To Stationery paid	7,000	By Subscription received	54,000
To Salaries	20,000		
To Surplus	27,000		
(Excess of income over expenditure)			
	64,000		64,000

Illustration 7

From the following Receipts and Payment Account of Trichy Recreation Club, prepare Income and Expenditure Account for the year ended 31.03.2018.

Receipts	₹	Payments	₹
To Opening balance		By Furniture purchased	10,000
Cash in hand	11,000	By Rent	2,800
To Dividend received	27,600	By Secretary's honorarium	15,000
To Sale of old newspaper	3,000	By Postage	1,700
To Members' subscription	31,000	By General expenses	4,350
To Locker rent	8,000	By Printing and Stationery	45,000
To Interest on investments	1,250	By Audit fees	5,000
To Sale of furniture	5,000	By Closing balance	
(Book value ₹ 4,400)		Cash in hand	3,000
	86,850		86,850

Solution

In the books of Trichy Recreation Club

Dr. Income and Expenditure Account for the year ended 31st March, 2018 Cr.

Expenditure	₹	Income	₹
To Rent	2,800	By Dividend received	27,600
To Secretary's honorarium	15,000	By Sale of old newspaper	3,000
To Postage	1,700	By Members' subscription	31,000
To General expenses	4,350	By Locker rent	8,000
To Printing and stationery	45,000	By Interest on Investments	1,250
To Audit fees	5,000	By Profit on sale of furniture	600
		(5,000 - 4,400)	
		By Deficit	2,400
		(Excess of expenditure over income)	
	73,850		73,850

3. Differences between receipts and payments account and income and expenditure account

Basis	Receipts and Payments Account	Income and Expenditure Account
1. Purpose	It is prepared to know the cash receipts and cash payments.	It is prepared to know whether there is an excess of income over expenditure (surplus) or an excess of expenditure over income (deficit) during the current period.
2. Nature of account	It is a real account. It is a summary of cash account. Cash receipts are recorded on the debit side and cash payments are recorded on the credit side.	It is a nominal account. It is similar to profit and loss account. Expenses are recorded on the debit side and incomes are recorded on the credit side.
3. Basis of accounting	It is based on cash system of accounting. Non-cash items are not recorded.	It is based on accrual system of accounting. Non-cash items like outstanding expenses, depreciation, etc. are also recorded.
4. Opening and closing balance	It commences with an opening balance of cash and bank and ends with closing balance of cash and bank.	There is no opening balance. It ends with surplus or deficit.
5. Nature of items	It contains actual receipts and payments irrespective of revenue or capital items in nature.	It contains only revenue items, that is, only revenue expenses and revenue incomes.
6. Period	All cash receipts and payments made during the year pertaining to the past period, current period and subsequent period are recorded.	It contains only the items relating to the current period.

Balance Sheet

A Balance sheet is a statement showing the financial position of an organisation. The preparation of balance sheet of a not–for–profit organisation is more or less similar to that of a trading concern. Assets and liabilities, as on the last date of the accounting period are taken to the balance sheet (liabilities are taken on the left side and assets on the right side of the balance sheet).

Important points in the preparation of a balance sheet of a not–for–profit organisation

(a) Capital fund also called as general fund or accumulated fund is taken to the liabilities side. Surplus in the income and expenditure account is added to the capital fund and deficit is subtracted from the capital fund in the balance sheet.

Tutorial Note

If capital fund of the organisation is not given in the problem, the opening balance sheet should be prepared to ascertain the opening capital fund. The difference between the total of assets and the total of liabilities as at the beginning of the year is the opening capital fund.

Opening capital fund = Assets at the beginning– Liabilities at the beginning

Illustration 16

Compute capital fund of Karur Social Club as on 31.03.2018.

Particulars as on 31.03.2018	₹
Furniture	50,000
Buildings	40,000
Subscription outstanding for 2017-18	10,000
Subscription received in advance for 2018-19	5,000
Loan borrowed	10,000
Investments	20,000
Cash in hand	4,000
Cash at bank	6,000

Solution

Balance sheet as on 31st March, 2018

Liabilities	₹	Assets	₹
Capital fund	1,15,000	Buildings	40,000
(Balancing figure)		Furniture	50,000
Loan borrowed	10,000	Investments	20,000
Subscription received in advance	5,000	Subscription outstanding	10,000
		Cash at bank	6,000
		Cash in hand	4,000
	1,30,000		1,30,000

(b) While preparing the balance sheet as at the end of the accounting year, the closing balances of cash and bank should be taken to the assets side of the balance sheet. If there is bank overdraft, that should be taken to the liabilities side of the balance sheet.

(c) Assets appearing in the previous year's balance sheet, that is, in the opening balance sheet, should be taken on the assets side of the current year balance sheet and adjustments must be made for any change taking place during the year. While taking such assets, additional assets purchased should be added and assets sold should be subtracted. Depreciation on such assets should also be adjusted.

Tutorial note: New assets purchased or assets sold are to be found out by referring to the receipts and payments account.

(d) Prepaid expenses and accrued incomes as at the end of the current year should be taken to the assets side of the balance sheet.

(e) Outstanding expenses at the end of the current year and any income received in advance during the current year should be taken to the liabilities side of the balance sheet.

(f) If there are any specific funds such as tournament fund, prize fund, etc., these funds should be shown on the liabilities side of the balance sheet separately. Any income to the fund should be added to the fund account and expenses relating to the fund should be subtracted from the fund account in the balance sheet.

(g) If there is any specific fund investment, that should be taken to the assets side of the balance sheet.

Comprehensive problems

Illustration 17

From the following Receipts and Payments Account of Friends Football club, for the year ending 31st March, 2017, prepare Income and Expenditure Account for the year ending 31st March, 2017 and the Balance sheet as on that date.

In the books of Friends Football Club

Dr. Receipts and Payments Account for the year ended 31st March, 2017 Cr.

Receipts	₹	₹	Payments	₹	₹
To Balance b/d			By Furniture		7,000
Cash	1,000		By Sports materials purchased		800
Bank	10,000	11,000	By Special dinner expenses		1,500
To Subscriptions		5,000	By Electricity charges		900
To Legacies		6,000	By Balance c/d		
To Collection for special			Cash in hand	1,800	
dinner		2,000	Cash at bank	12,000	13,800
		24,000			24,000

Additional information:

(i) The club had furniture of □ 12,000 on 1st April 2016. Ignore depreciation on furniture.

(ii) Subscription outstanding for 2016-2017 □ 600.

(iii) Stock of sports materials on 31.03.2017 □ 100.

(iv) Capital fund as on 1st April 2016 was □ 23,000.

Solution

In the books of Friends Football Club
Income and Expenditure Account
Dr. *for the year ended* 31st March, 2017 Cr.

Expenditure	₹	₹	Income	₹	₹
To Sports materials					
consumed			By Subscription	5,000	
Purchases	800		Add: Outstanding for 2016-17	600	5,600
Less: Closing stock	100	700	By Collection for special dinner		2,000
To Special dinner expenses		1,500			
To Electricity charges		900			
To Excess of income					
over expenditure (surplus)		4,500			
		7,600			7,600

Balance sheet as on 31st March, 2017

Liabilities	₹	₹	Assets	₹	₹
Capital fund	23,000		Furniture	12,000	
Add: Excess of income			Add: Additions	7,000	19,000
over expenditure (surplus)	4,500	27,500	Stock of sports materials		100
Legacies		6,000	Subscription outstanding		
			for 2016-17		600
			Cash at bank		12,000
			Cash in hand		1,800
		33,500			33,500

SUMMARY

Concept of Not-for-Profit Organisations:

i. These are the institutions/organisations that are set-up with general or specific objectives for rendering services and providing other social activities to enhance the welfare of general or a particular group of people.

ii. The aim of such institutions is not to earn profit, however, the organisations are capable of earning profit.

iii. A separate legal entity not owned by any individual or an enterprise. iv. Examples of such organisations are schools, colleges, public hospitals, literacy societies for promoting sports, arts, culture, etc.

EXERCISE

MCQ

1. Receipts and Payments Account generally shows:

   (A) A Debit balance (B) A Credit balance

   (C) Surplus or Deficit (D) Capital Fund

   Answer: A

2. Income and Expenditure Account records transactions of:

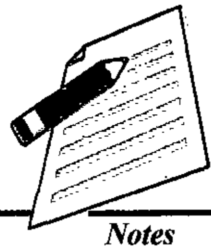
   (A) Revenue nature only

   (B) Capital nature only

   (C) Both revenue and capital nature

   (D) Income of only revenue nature and expenditure of revenue and capital nature.

   Answer: A



Notes

3. Income and Expenditure Account reveals:
   (A) Surplus or Deficiency (B) Cash in Hand
   (C) Net Profit (D) Capital Account

   Answer: A

4. The amount of 'Subscription received from members' by a Non-profit organisation is shown in which of the following?
   (A) Debit side of Income and Expenditure Account
   (B) Credit side of Income and Expenditure Account
   (C) Liability side of Balance Sheet
   (D) Assets side of Balance Sheet

   Answer: B

5. Donation received for a special purpose:
   (A) Should be credited to Income and Expenditure Account
   (B) Should be credited to separate account and shown in the Balance Sheet
   (C) Should be shown on the assets side
   (D) Should not be recorded at all.

   Answer: B

Review Questions

1. XYZ club has a bar that maintains a separate trading account for its trading activities. Which of the following is the treatment of profit or loss on bar trading activities?
   1. Profit and loss is credit in income statement
   2. Profit and loss to be presented in Receipt and payment account
   3. Profit and loss is added to capital fund.
   4. Profit and loss to be transferred as income and expenditure A/c.
2. Calculate the sports material to be debited to Income & Expenditure a/c. For the yr. ended 31-3-2007 on the basis of the following information. Amount paid for sports material during the yr. was Rs.19, 000

Particulars	1=4=2006 (Rs.)	31.3.2007 (Rs.)
Stock of sports material	7,500	6,400
Creditors for sports material	2,00	2,600

Rs.20300

1. Rs.20700
2. Rs.20000
3. Rs.20500

3. A non-profit organization received Rs.10,000 as the entrance fee of a new member. If 20% of the fee has to be capitalized, what is the amount of fee needs to be shown in the income and expenditure account?
   1. Rs.9000
   2. Rs.8000
   3. Rs.2000
   4. Rs.5000
4. Prize fund Rs.10000, Interest on prize fund investments Rs.1000, Prize paid Rs.2000, Prize fund investment Rs.8000. What will be its treatment
   1. Rs.20000 on liability side, Rs. 8000 on Assets side
   2. Rs.1000 on liability side, Rs. 8000 on Assets side
   3. Rs.1700 on liability side, Rs. 8000 on Assets side
   4. Rs.9000 on liability side, Rs. 8000 on Assets side
5. Belle, a nongovernmental not-for-profit organization, received funds during its annual campaign that were specifically pledged by the donor to another nongovernmental not-for-profit health organization. How should Belle record these funds?
   1. Increase in assets and increase in revenue
   2. Increase in assets and increase in liabilities
   3. Increase in assets and increase in deferred revenue.
   4. Decrease in assets and decrease in fund balance.
6. Not-for-profit organisations have some distinguishing features from that of profit organisations. State any one of them.
7. What is the capital of a Non-Profit Organization generally known as?
8. Name any two accounts required to be prepared in Financial Statements by Not-For-Profit Organizations at the end of the year.
9. State the main aim of a not-for-profit organisation.
10. Write any four features of Receipt and Payment Account?
11. From the following information, calculate the amount of subscriptions to be credited to the income and expenditure account for the year 2007—08.

	Amt (Rs.)
Subscriptions received during the year	50,000
Subscriptions outstanding on 31st March, 2007	20,000
Subscriptions outstanding on 31st March, 2008	6,000
Subscriptions received in advance on 31st March, 2007	8,000
Subscriptions received in advance on 31st March, 2008 Subscriptions of Rs. 1,500 are still in arrears for the year 2006-07.	9,000

1 PARTNERSHIP

Introduction

1. Meaning and definition of partnership

When two or more persons join together to form a business to share the profit or loss arising therefrom in an agreed ratio, the relationship among them is called partnership. The business may be carried on by all or any of them acting for all.

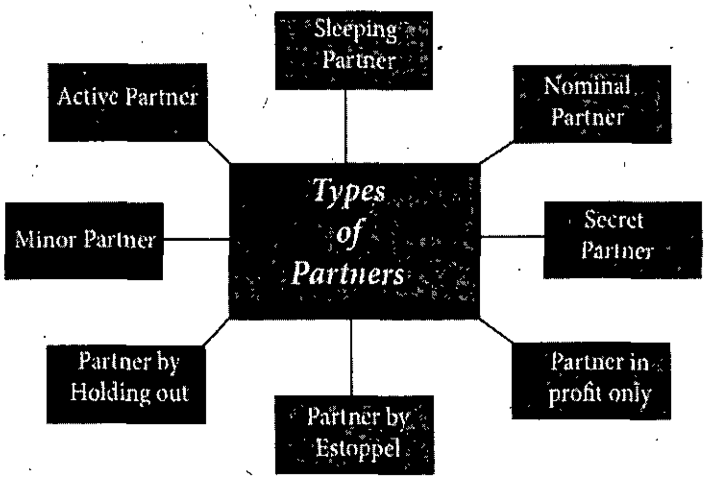
According to Section 4 of the Indian Partnership Act, 1932, partnership is defined as, "the relation between persons who have agreed to share the profits of a business carried on by all or any of them acting for all".

2. Features of partnership

Following are the essential features of partnership:

- Partnership is an association of two or more persons. The maximum number of partners is limited to 50.
- There should be an agreement among the persons to share the profit or loss of the business. The agreement may be oral or written or implied.
- The agreement must be to carry on a business and to share the profits of the business.
- The business may be carried on by all the partners or any of them acting for all.

Types of Partners



i. Active Partner

A partner who takes an active part in the conduct of the partnership business is known as an active partner. Though every partner is entitled to manage its affairs, all may not do so.

ii. Sleeping Partner or Dormant Partner

Such a partner contributes capital and shares in the profits or losses of the firm but does not take part in the management of the business. He may not be known as a partner to the outsiders; yet he is liable to third parties to an unlimited extent as any other partner.

iii. Nominal Partner

Such a partner neither contributes any capital nor is he entitled to manage the affairs of the business. He only lends his name to the firm because on the strength of his name and reputation, the firm may attract additional business and raise funds easily. A nominal partner, however, is liable for all the acts and debts of the firm as if he were a real partner, though he does not get any share in the firm's profit.

iv. Partner in Profits only

When a person joins a firm as a partner on the condition that he is entitled to a specified share of the firm's profit only, he is called a partner in profits only. It means that he will not be called upon to bear any portion of the losses sustained. He will, however, be liable to third parties for all the debts of the firm like any other partner. Such partners usually do not take part in the management of the business.

v. Partner by Estoppel

In case, a person represents himself/ herself by words or actions or has allowed him to be represented as a partner of the firm, even though he is not a partner, he is called partner by estoppels.

Such a partner cannot deny his liability, if outside party lends money to the firm supposing him to be a partner.

vi. Partner by Holding out

When a person is declared as a partner and he does not deny this even after becoming aware of it, he becomes liable to the third party, who lends money or credit to the firm on the basis of such a declaration.

vii. Secret Partner

A secret partner is one whose association is not known to the general public. Other than this distinct feature, he is like rest of the partners in all respects.

viii. Minor Partner

Under the Indian Majority Act, person who has not completed 18 years of age is a minor. However, he will continue to be a minor till he completes 21 years if a guardian has been appointed to the minor. He can be admitted to the benefits of partnership.

Partnership arises as a result of contract. But a minor has no contractual capacity. Though a partnership cannot be created with a minor as a partner, a minor can be admitted to the benefits of a partnership which is already in existence. The consent of all partners is a 'must' for such admission.

Registration of Partnership

The Indian Partnership Act does not make the registration of a partnership compulsory. Registration is optional. But the disabilities of non-registration virtually make it compulsory.

Partnership Deed and its Contents

Though a partnership agreement need not necessarily be in writing, it is important to have a written agreement in order to avoid misunderstandings; it is desirable to have a written agreement. A carefully drafted partnership deed helps in ironing out differences which may develop among partners and in ensuring smooth running of the partnership business. It should be properly stamped and registered.

Contents of Partnership Deed

i. **Name of the Firm**

ii. **Nature of the proposed business**

iii. **Duration of partnership**

Duration of the partnership business whether it is to be run for a fixed period of time or whether it is to be dissolved after completing a particular venture.

iv. **Capital contribution**

The capital is to be contributed by the partners. It must be remembered that capital contribution is not necessary to become a partner for one who contributes his organising power, business acumen, managerial skill etc., instead of capital.

v. **Withdrawal from the firm**

The amount that can be withdrawn from the firm by each partner.

vi. **Profit/loss sharing**

The ratio in which the profits or losses are to be shared. If the profit-sharing ratio is not specified in the deed, all the partners must share the profits and bear the losses equally.

vii. **Interest on capital**

Whether any interest is to be allowed on capital and if so, the rate of interest. If the deed is silent on interest on capital, the rules for interest on capital in partnership act will take effect.

viii. **Rate of interest on drawing**

Whether any interest is to be allowed on drawing, the rate of interest is to be specified

ix. Loan from partners

Whether loans can be accepted from the partners and if so the rate of interest payable thereon.

x. Account keeping

Maintenance of accounts and audit.

xi. Salary and Commission to Partners

Amount of salary or commission payable to partners for their services. (Unless this is specifically provided, no partner is entitled to any salary).

xii. Retirement

Matters relating to retirement of a partner. The arrangement to be made for paying out the amount due to a retired or deceased partner must also be stated.

xiii. Goodwill valuation

Method of valuing goodwill on the admission, death or retirement of a partner.

xiv. Distribution of responsibility

The work that is entrusted to each partner is better stated in the deed itself.

xv. Dissolution procedure

Procedure for dissolution of the firm and the mode of settlement of accounts thereafter.

xvi. Arbitration of dispute

Arbitration in case of disputes among partners. The deed should provide the method for settling disputes or difference of opinion. This clause will avoid costly litigations.

ADMISSION OF A PARTNER

Introduction

A person may join as a new partner in an existing partnership firm. This is called admission of a partner. The purpose of admission of a new partner may be to raise additional capital for expansion of business or managerial skill of the new partner or both. Generally, the new partner has to contribute capital to the firm and thereby he / she acquires the right to share the future profits and the assets of the firm.

On admission of a new partner, the firm is reconstituted with a new agreement and the existing agreement comes to an end.

According to Section 31(1) of the Indian Partnership Act, 1932, subject to contract between the partners no person shall be introduced as a partner into a firm without the consent of all the existing partners.

Adjustments required at the time of admission of a partner

On admission, the new partner may bring capital in cash or in kind or both. The following journal entry is passed to record the capital brought in.

Journal entry

Date	Particulars		L.F.	Debit ₹	Credit ₹
	Cash or Bank A/c	Dr.		xxx	
	Assets A/c	Dr.		xxx	
	To Partner's capital A/c				xxx

On the admission of a partner, generally there is a change in the mutual rights of the partners. The new partner becomes liable for all the acts which are carried out by the firm from the date of his / her admission into the firm. Hence, the accumulated profits, losses and reserves before admission are to be distributed to the existing partners. Similarly, assets and liabilities are to be revalued and the profit or loss on revaluation is to be distributed to the existing partners. The following adjustments are necessary at the time of admission of a partner:

1. Distribution of accumulated profits, reserves and losses
2. Revaluation of assets and liabilities
3. Determination of new profit-sharing ratio and sacrificing ratio
4. Adjustment for goodwill
5. Adjustment of capital on the basis of new profit-sharing ratio (if so agreed)

Distribution of accumulated profits, reserves and losses

Profits and losses of previous years which are not distributed to the partners are called accumulated profits and losses. Any reserve and accumulated profits and losses belong to the old partners and hence these should be distributed to the old partners in the old profit-sharing ratio. Reserves include general reserve, reserve fund, workmen compensation fund and investment fluctuation fund. Incase of workmen compensation fund, the excess amount after providing for anticipated claim is the accumulated profit to be transferred.

Following are the journal entries to be passed:

(a) For transferring accumulated profit and reserves

Journal entry

Date	Particulars		L.F.	Debit ₹	Credit ₹
	Profit and loss appropriation A/c	Dr.		xxx	
	General reserve A/c	Dr.		xxx	
	Reserve fund A/c	Dr.		xxx	
	Workmen compensation fund A/c	Dr.		xxx	
	Investment fluctuation fund A/c	Dr.		xxx	
	To Old partners' capital / current A/c (in the old ratio)				xxx

(b) For transferring accumulated loss

Journal entry

Date	Particulars	L.F.	Debit ₹	Credit ₹
	Old partner's capital / current A/c Dr.		xxx	
	ToProfit and loss A/c (in old ratio)			xxx

Illustration

Mala and Vimala were partners sharing profits and losses in the ratio of 3:2. On 31.3.2017, Varshini was admitted as a partner. On the date of admission, the book of the firm showed a reserve fund of □ 50,000. Pass the journal entry to distribute the reserve fund.

Solution

Journal entry

Date	Particulars	L.F.	Debit ₹	Credit ₹
2017	Reserve fund A/c Dr.		50,000	
March 31	To Mala's capital A/c (50,000 x 3/5)			30,000
	To Vimala's capital A/c (50,000 x 2/5)			20,000
	(Reserve fund transferred to old partners' capital account in the old profit sharing ratio)			

Revaluation of assets and liabilities

When a partner is admitted into the partnership, the assets and liabilities are revalued as the current value may differ from the book value. Determination of current values of assets and liabilities is called revaluation of assets and liabilities. The reasons for revaluation of assets and liabilities are as follows:

i. To give a true and fair view of the state of affairs of the firm and
ii. To share the gain arising from the revaluation of assets and liabilities as it is due to the old partners.

There are two ways in which the revaluation of assets and liabilities may be dealt with in the accounts.

a) Revised value of assets and liabilities are shown in the books
b) Revised value of assets and liabilities are not shown in the books

1. When revised value of assets and liabilities are shown in the books

Under this method, the assets and liabilities are shown at their revised values in the books and in the balance sheet which is prepared immediately after the admission of a partner. A Revaluation account is opened to record the increase or decrease in assets and liabilities. Revaluation account is also called Profit and loss adjustment account. It is a nominal account. Revaluation account is credited with increase in value of assets and decrease in the value of liabilities. It is debited with decrease in value of assets and increase in the value of liabilities. Unrecorded assets if any are credited and unrecorded liabilities if any are debited to the revaluation account. The profit or loss arising therefrom is transferred to the capital accounts of the old partners in the old profit-sharing ratio. If the total of the credit side of the revaluation account exceeds the total of the debit side, the difference is profit on revaluation. If the total of the debit side of the revaluation account exceeds the total of the credit side, the difference is loss on revaluation.

Following are the journal entries to be passed to record the revaluation of assets and liabilities:

Date	Particulars		L.F.	Debit ₹	Credit ₹
	1. For increase in the value of asset				
	Concerned asset A/c	Dr.		xxx	
	To Revaluation A/c				xxx
	2. For decrease in the value of asset				
	Revaluation A/c	Dr.		xxx	
	To Concerned asset A/c				xxx
	3. For increase in the amount of liabilities				
	Revaluation A/c	Dr.		xxx	
	To Concerned liability A/c				xxx
	4. For decrease in the amount of liability				
	Concerned liability A/c	Dr.		xxx	
	To Revaluation A/c				xxx
	5. For recording an unrecorded asset				
	Concerned asset A/c	Dr.		xxx	
	To Revaluation A/c				xxx
	6. For recording an unrecorded liability				
	Revaluation A/c	Dr.		xxx	
	To Concerned liability A/c				xxx
	7. For transferring the balance in revaluation A/c				
	(a) If there is profit on revaluation				
	Revaluation A/c	Dr.		xxx	
	To Old partners' capital A/c (individually in old ratio)				xxx
	(b) If there is loss on revaluation				
	Old partners' capital A/c (individually in old ratio)	Dr.		xxx	
	To Revaluation A/c				xxx

Format of Revaluation Account:

Dr. **Revaluation Account** **Cr.**

Particulars	₹	Particulars	₹
To Concerned asset A/c (net decrease)	xxx	By Concerned asset A/c (net increase)	xxx
To Concerned liability A/c (net increase)	xxx	By Concerned liability A/c (net decrease)	xxx
To Old partners' capital A/c (profit on revaluation shared in old ratio)*	xxx	By Old partners' capital A/c (loss on revaluation shared in old ratio)*	xxx
	xxx		xxx

*There will be either profit or loss on revaluation.

*There will be either profit or loss on revaluation.

2. When revised values of assets and liabilities are not shown in the books

Under this method, the assets and liabilities are shown at their original values and not at the revised values in the books and in the balance sheet which is prepared immediately after the admission of a partner. The net result of revaluation is adjusted through the capital accounts of the partners. A Memorandum revaluation account which is a temporary account is opened when the revised values are not to be shown in the books of accounts.

New profit-sharing ratio and sacrificing ratio

1. New profit-sharing ratio

It is necessary to determine the new profit-sharing ratio at the time of admission of a partner because the new partner is entitled to share the future profits of the firm. New profit-sharing ratio is the agreed proportion in which future profit will be distributed to all the partners including the new partner. If the new profit-sharing ratio is not agreed, the partners will share the profits and losses equally.

2. Sacrificing ratio

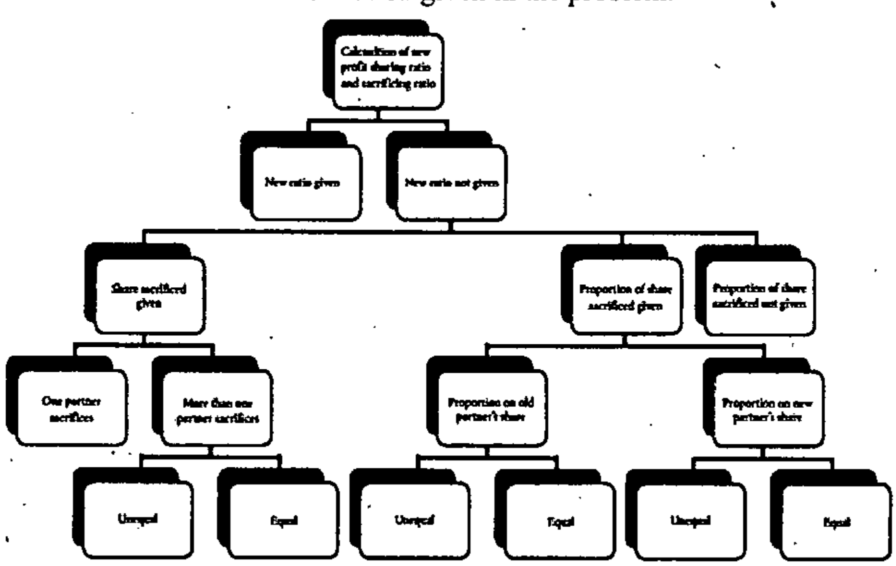
The old partners may sacrifice a portion of the share of profit to the new partner. The sacrifice may be made by all the partners or some of the partners. Sacrificing ratio is the proportion of the profit which is sacrificed or foregone by the old partners in favour of the new partner. The purpose of finding the sacrificing ratio is to share the goodwill brought in by the new partner. The share sacrificed is calculated by deducting the new share from the old share.

Share sacrificed = Old share - New share

Sacrificing ratio = Ratio of share sacrificed by the old partners

Share of the new partner is the sum of shares sacrificed by the old partners.

Tutorial note: When the new profit-sharing ratio is not given in the problem, it is to be calculated based on the information given in the problem.



Calculation of sacrificing ratio and new profit-sharing ratio under different situations

1. When new profit-sharing ratio is given

When new profit-sharing ratio is given, sacrificing ratio has to be calculated as follows:
Sacrificing ratio = Ratio of share sacrificed by the old partners
Share sacrificed = Old share - New share

Illustration 8

Anbu and Raju are partners, sharing profits in the ratio of 3:2. Akshai is admitted as a partner. The new profit-sharing ratio among Anbu, Raju and Akshai is 5:3:2. Find out the sacrificing ratio.

Solution

Old ratio of Anbu and Raju $= 3:2$ that is, $\frac{3}{5}:\frac{2}{5}$

New ratio of Anbu, Raju and Akshai $= 5:3:2$ that is, $\frac{5}{10}:\frac{3}{10}:\frac{2}{10}$

Share sacrificed = Old share - New share

Anbu $= \frac{3}{5} - \frac{5}{10} = \frac{6-5}{10} = \frac{1}{10}$

Raju $= \frac{2}{5} - \frac{3}{10} = \frac{4-3}{10} = \frac{1}{10}$

Sacrificing ratio of Anbu and Raju is $\frac{1}{10}:\frac{1}{10}$ that is 1:1

2. When new profit-sharing ratio is not given

(a) When share sacrificed is given

When new profit-sharing ratio is not given, but the share sacrificed by the old partner(s) is given, new profit-sharing ratio is calculated as follows:

New share of old partner	= Old share - Share sacrificed
Share of new partner	= Sum of shares sacrificed by old partners

Illustration 9

Hari and Saleem are partners sharing profits and losses in the ratio of 5:3. They admit Joel for 1/8 share, which he acquires entirely from Hari. Find out the new profit-sharing ratio and sacrificing ratio.

Solution

Computation of sacrificing ratio and new profit-sharing ratio

Share sacrificed by old partners

Hari $= \frac{1}{8}$

Saleem $= 0$

Sacrificing ratio $= 1:0$

Old ratio of Hari and Saleem is 5:3 that is $\frac{5}{8}:\frac{3}{8}$

New share of old partner = Old share - Share sacrificed

Hari $= \frac{5}{8} - \frac{1}{8} = \frac{5-1}{8} = \frac{4}{8}$

Saleem $= \frac{3}{8}$

Share of new partner

Joel $= \frac{1}{8}$

New profit sharing ratio of Hari, Saleem and Joel is $\frac{4}{8}:\frac{3}{8}:\frac{1}{8}$ that is, 4:3:1

Adjustment for goodwill

Reputation built up by a firm has an impact on the present profit and future profit to be earned by the firm. At the time of admission of a partner, the existing partners sacrifice part of their share of profit in favour of the new partner. Hence, to compensate the sacrifice made by the existing partners, goodwill of the firm has to be valued and adjusted. In addition to capital, the new partner may contribute towards goodwill. This goodwill is distributed in the sacrificing ratio to the old partners who sacrifice.

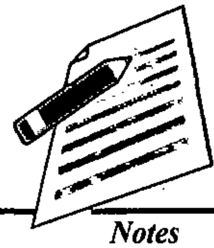
1. Accounting treatment for goodwill

Accounting treatment for goodwill on admission of a partner is discussed below:

1. When new partner brings cash towards goodwill
2. When the new partner does not bring goodwill in cash or in kind
3. When the new partner brings only a part of the goodwill in cash or in kind
4. Existing goodwill

1. When new partner brings cash towards goodwill

When the new partner brings cash towards goodwill in addition to the amount of capital, it is distributed to the existing partners in the sacrificing ratio. The following journal entries are to be made:



Notes

(i) For the goodwill brought in cash credited to old partners' capital account

Date	Particulars	L.F.	Debit ₹	Credit ₹
	Cash / Bank A/c Dr.		xxx	
	To Old partners' capital / current A/c (in sacrificing ratio)			xxx

(ii) For the goodwill brought in kind (in the form of assets) credited to old partners' capital account

Date	Particulars	L.F.	Debit ₹	Credit ₹
	Respective Asset A/c Dr.		xxx	
	To Old partners' capital / current A/c (in sacrificing ratio)			xxx

(iii) For withdrawal of cash received for goodwill by the old partners

Date	Particulars	L.F.	Debit ₹	Credit ₹
	Old partners' capital / current A/c Dr.		xxx	
	To Cash / Bank A/c			xxx

Illustration

Amudha and Bhuvana are partners who share profits and losses in the ratio of 5:3. Chithra joins the firm on 1st January, 2019 for 3/8 share of profits and brings in cash for her share of goodwill of □ 8,000. Pass necessary journal entry for adjusting goodwill on the assumption that the fluctuating capital method is followed and the partners withdraw the entire amount of their share of goodwill.

Solution

As the sacrifice made by the existing partners is not mentioned, it is assumed that they sacrifice in their old profit-sharing ratio 5:3. Therefore, sacrificing ratio is 5:3.

Journal Entry

Date	Particulars	L.F.	Debit ₹	Credit ₹
2019	Bank A/c Dr.		8,000	
January 1	To Amudha's capital A/c (5/8)			5,000
	To Bhuvana's capital A/c (3/8)			3,000
	(Cash brought for goodwill credited to Amudha and Bhuvana in sacrificing ratio)			
"	Amudha's capital A/c Dr.		5,000	
	Bhuvana's capital A/c Dr.		3,000	
	To Bank A/c			8,000
	(Amount withdrawn by the partners)			

2. When the new partner does not bring goodwill in cash or in kind

If the new partner does not bring goodwill in cash or in kind, his share of goodwill must be adjusted through the capital accounts of the partners. The following journal entry is passed.

Date	Particulars	L.F.	Debit ₹	Credit ₹
	New partners' capital A/c Dr.		xxx	
	To Old partners' capital / current A/c (in sacrificing ratio)			xxx

Illustration

Ashok and Mumtaj were partners in a firm sharing profits and losses in the ratio of 5:1. They have decided to admit Tharun into the firm for 2/9 share of profits. The goodwill of the firm on the date of admission was valued at □ 27,000. Tharun is not able to bring in cash for his share of goodwill. Pass necessary journal entries for goodwill on the assumption that the fluctuating capital system is followed.

Solution

As the sacrifice made by the existing partners is not mentioned, it is assumed that they sacrifice in their old profit-sharing ratio of 5:1. Therefore, sacrificing ratio is 5:1.

Tharun's share of goodwill = 27,000 x 2/9 = □ 6,000

Journal entry

Date	Particulars	L.F.	Debit ₹	Credit ₹
	Tharun's capital A/c Dr.		6,000	
	To Ashok's capital A/c (5/6)			5,000
	To Mumtaj's capital A/c (1/6)			1,000
	(Tharun's share of goodwill credited to the old partners' capital account in the sacrificing ratio)			

3. When the new partner brings only a part of the goodwill in cash or in kind

Sometimes the new partner may bring only a part of the goodwill in cash or assets. In such a case, for the cash or the assets brought, the respective account is debited and for the amount not brought in cash or kind, the new partner's capital account is debited. The following journal entry is passed.

Journal entry

Date	Particulars	L.F.	Debit ₹	Credit ₹
	Cash / Bank A/c Dr.		xxx	
	New partners' capital A/c Dr.		xxx	
	To Old partners' capital / current A/c (in sacrificing ratio)			xxx

Adjustment of capital on the basis of new profit-sharing ratio

Sometimes, it may be agreed by the partners that their capitals in the reconstituted firm be in the proportion of their new profit-sharing ratio. There can be two situations.

The new partner may be required to bring proportionate capital for his share of profit. New partner's capital is calculated on the basis of the capital of the reconstituted firm or on the basis of combined capitals of the old partners for their share of profit.

The old partners may be required to make their capital in proportion to their new profit-sharing ratio. Old partners' capital is calculated on the basis of the capital brought by the new partner for his share of profit. The deficiency or excess in the old partners' capital account may be adjusted through the current accounts or cash may be brought in or withdrawn by the partners.

Comprehensive problems

Illustration

Vetri and Ranjit are partners, sharing profits in the ratio of 3:2. Their balance sheet as on 31st December 2017 is as under:

Liabilities	₹	₹	Assets	₹
Capital accounts:			Furniture	25,000
Vetri	30,000		Stock	20,000
Ranjit	20,000	50,000	Debtors	10,000
Reserve fund		5,000	Cash in hand	35,000
Sundry creditors		45,000	Profit and loss A/c (loss)	10,000
		1,00,000		1,00,000

On 1.1.2018, they admit Suriya into their firm as a partner on the following arrangements.

(i) Suriya brings □ 10,000 as capital for 1/4 share of profit.

(ii) Stock to be depreciated by 10%

(iii) Debtors to be revalued at □ 7,500.

(iv) Furniture to be revalued at □ 40,000.

(v) There is an outstanding wage of □ 4,500 not yet recorded.

Prepare revaluation account, partners' capital account and the balance sheet of the firm after admission.

Solution

Dr **Revaluation Account** **Cr.**

Particulars	₹	₹	Particulars	₹
To Stock A/c		2,000	By Furniture A/c	15,000
To Debtors A/c		2,500		
To Outstanding wages A/c		4,500		
To Profit on revaluation transferred to capital A/c				
Vetri (3/5)	3,600			
Ranjit (2/5)	2,400	6,000		
		15,000		15,000

Dr. **Capital Account** **Cr.**

Particulars	Vetri ₹	Ranjit ₹	Suriya ₹	Particulars	Vetri ₹	Ranjit ₹	Suriya ₹
To Profit and loss A/c	6,000	4,000	-	By Balance b/d	30,000	20,000	-
To Balance c/d	30,600	20,400	10,000	By Reserve fund A/c	3,000	2,000	-
				By Revaluation A/c	3,600	2,400	-
				By Bank A/c	-	-	10,000
	36,600	24,400	10,000		36,600	24,400	10,000
				By Balance b/d	30,600	20,400	10,000

Balance Sheet as on 1st January 2018

Liabilities	₹	₹	Assets	₹	₹
Capital accounts:			Furniture	25,000	
Vetri	30,600		Add: Appreciation	15,000	40,000
Ranjit	20,400		Stock	20,000	
Suriya	10,000	61,000	Less: Depreciation	2,000	18,000
Sundry creditors		45,000	Debtors	10,000	
Outstanding wages		4,500	Less: Decrease	2,500	7,500
			Cash in hand	35,000	
			Add: Suriya's capital	10,000	45,000
		1,10,500			1,10,500

RETIREMENT AND DEATH OF A PARTNER

Introduction

When a partner leaves from a partnership firm, it is known as retirement. The reasons for the retirement of a partner may be illness, old age, better opportunity elsewhere, disagreement with other partners, etc. On retirement of a partner, existing agreement comes to an end. The firm is reconstituted and other partners continue the partnership firm with a new agreement. A partner who retires from the firm is called an outgoing partner or a retiring partner.

Section 32(1) of The Indian Partnership Act, 1932 states that a partner may retire from the firm

a) with the consent of all the other partners,

b) in accordance with an express agreement by the partners, or

c) where the partnership is at will, by giving notice in writing to all the other partners of his intention to retire.

The retiring partner is liable for all the acts of the firm up to the date of his retirement. It is necessary for the retiring partner to give a public notice of his retirement from the firm to get relieved from the liabilities to the third parties for the acts of the firm after the retirement. The remaining partners must settle the amount due to the retiring partner.

Adjustments required on retirement of a partner

On retirement of a partner, generally the mutual rights of the continuing partners change. The retiring partner is liable for all the acts which are carried out by the firm until the date of his retirement from the firm. Hence, the accumulated profits, losses and reserves up to the date of his retirement is to be distributed to all the partners. Assets and liabilities have to be revalued and the profit or loss on revaluation is to be distributed to all the partners. The following adjustments are necessary at the time of retirement of a partner:

a) Distribution of accumulated profits, reserves and losses

b) Revaluation of assets and liabilities

c) Determination of new profit-sharing ratio and gaining ratio

d) Adjustment for goodwill

e) Adjustment for current year's profit or loss up to the date of retirement

f) Settlement of the amount due to the retiring partner

Tutorial note: All these adjustments are similar to the adjustments to be done on admission of a partner except determination of profit-sharing ratio and settlement of the amount due to the retiring partner.

Distribution of accumulated profits, reserves and losses

Profits and losses of previous years which are not distributed to the partners are known as accumulated profits and losses. Reserve includes general reserve, reserve fund, workmen compensation fund and investment fluctuation fund. As the accumulated profits and losses belong to all the partners, these should be distributed to all the partners in the old profit-sharing ratio. Incase of workmen compensation fund, the excess amount after providing for anticipated claim is to be transferred. Following are the journal entries to be passed:

(a) For transferring accumulated profits and reserves

Date	Particulars	L.F.	Debit ₹	Credit ₹
	Profit and loss Appropriation A/c Dr.		xxx	
	General reserve A/c Dr.		xxx	
	Reserve fund A/c Dr.		xxx	
	Workmen compensation fund A/c Dr.		xxx	
	Investment fluctuation fund A/c Dr.		xxx	
	To All partners' capital / current A/c (in the old ratio)			xxx

(b) For transferring accumulated loss

Date	Particulars	L.F	Debit ₹	Credit ₹
	All partners' capital / current A/c Dr.		xxx	
	To Profit and loss A/c (in old ratio)			xxx

Illustration 1

Vivin, Hari and Joy are partners sharing profits and losses in the ratio of 3:2:1. On 31.3.2017, Hari retired. On the date of retirement, the books of the firm showed a general reserve of 60,000. Pass the journal entry to transfer the general reserve.

Solution.

Journal entry

Date	Particulars	L.F.	Debit ₹	Credit ₹
2017	General reserve A/c Dr.		60,000	
March 31	To Vivin's capital A/c (60,000 × 3/6)			30,000
	To Hari's capital A/c (60,000 × 2/6)			20,000
	To Joy's capital A/c (60,000 × 1/6)			10,000
	(General reserve transferred to all partners' capital account in the old profit sharing ratio)			

Illustration 2

Mary, Meena and Mariam are partners of a firm sharing profits and losses equally. Mary retired from the partnership on 1.1.2019. On that date, their balance sheet showed accumulated loss of □ 75,000 on the asset side of the balance sheet. Give the journal entry to distribute the accumulated loss.

Solution

Journal entry

Date	Particulars		L.F.	Debit ₹	Credit ₹
2019	Mary's capital A/c	Dr.		25,000	
January 1	Meena's capital A/c	Dr.		25,000	
	Mariam's capital A/c	Dr.		25,000	
	To Profit and loss a/c				75,000
	(Accumulated loss transferred to all partners' capital account in the old profit sharing ratio)				

Illustration

Prince, Dev and Sasireka are partners in a firm sharing profits and losses in the ratio of 2:4:1. Their balance sheet as on 31st March, 2019 is as follows:

Liabilities	₹	₹	Assets	₹
Capital accounts			Buildings	40,000
Prince	30,000		Plant	50,000
Dev	50,000		Furniture	10,000
Sasireka	20,000	1,00,000	Stock	15,000
Profit and loss appropriation A/c		10,000	Debtors	20,000
General reserve		15,000	Cash at bank	15,000
Workmen compensation fund		17,000		
Sundry creditors		8,000		
		1,50,000		1,50,000

Solution

Journal entry

Date	Particulars		L.F.	Debit ₹	Credit ₹
2019	Profit and loss appropriation A/c	Dr.		10,000	
March 31	General reserve A/c	Dr.		15,000	
	Workmen compensation fund A/c	Dr.		17,000	
	To Prince's capital A/c (42,000 × 2/7)				12,000
	To Dev's capital A/c (42,000 × 4/7)				24,000
	To Sasireka's capital A/c (42,000 × 1/7)				6,000
	(Accumulated profits and reserve transferred to all partners' capital account in the old profit sharing ratio)				

Revaluation of assets and liabilities

When a partner retires from the partnership firm, the assets and liabilities are revalued as the current value may differ from the book value. There are two ways in which the revaluation of assets and liabilities may be dealt with in the accounts.

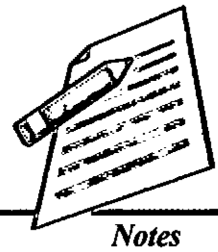
a) Revised value of assets and liabilities are shown in the books

b) Revised value of assets and liabilities are not shown in the books

(a) When revised value of assets and liabilities are shown in the books:

Under this method, the assets and liabilities are shown at their revised values in the books and in the balance sheet which is prepared immediately after the retirement of a partner. A revaluation account is opened to record the increase or decrease in the value of assets and liabilities. Revaluation account which is otherwise called profit and loss adjustment account is a nominal account. Revaluation account is credited with increase in value of assets and decrease in the value of liabilities. It is debited with decrease in value of assets and increase in the value of liabilities. Unrecorded assets if any are credited and unrecorded liabilities if any are debited to the revaluation account. The profit or loss arising therefrom is transferred to the capital accounts of all the partners in the old profit-sharing ratio.

Following are the journal entries to be passed to record the revaluation of assets and liabilities:



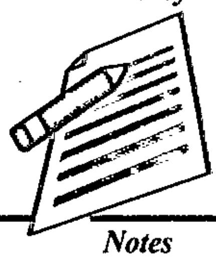
Date	Particulars		L.F.	Debit ₹	Credit ₹
	1. For increase in the value of asset				
	Concerned asset A/c	Dr.		xxx	
	To Revaluation A/c				xxx
	2. For decrease in the value of asset				
	Revaluation A/c	Dr.		xxx	
	To Concerned asset A/c				xxx
	3. For increase in the amount of liabilities				
	Revaluation A/c	Dr.		xxx	
	To Concerned liability A/c				xxx
	4. For decrease in the amount of liability				
	Concerned liability A/c	Dr.		xxx	
	To Revaluation A/c				xxx
	5. For recording an unrecorded asset				
	Concerned asset A/c	Dr.		xxx	
	To Revaluation A/c				xxx
	6. For recording an unrecorded liability				
	Revaluation A/c	Dr.		xxx	
	To Concerned liability A/c				xxx
	7. For transferring the balance in revaluation A/c				
	(a) For profit on revaluation				
	Revaluation A/c	Dr.		xxx	
	To All partners' capital A/c (individually in old profit sharing ratio)				xxx
	(b) For loss on revaluation				
	All partner's capital A/c (individually in old profit sharing ratio)	Dr.		xxx	
	To Revaluation A/c				xxx

Format of revaluation account is as follows:

Dr. **Revaluation Account** **Cr.**

Particulars	₹	Particulars	₹
To Concerned asset A/c (net decrease)	xxx	By Concerned asset A/c (net increase)	xxx
To Concerned liability A/c (net increase)	xxx	By Concerned liability A/c (net decrease)	xxx
To All partners' capital A/c (profit on revaluation shared in old ratio) *	xxx	By All partners' capital A/c (loss on revaluation shared in old ratio)*	xxx
	xxx		xxx

*There will be either profit or loss on revaluation.



Illustration

Ramya, Sara and Thara are partners sharing profits and losses in the ratio of 5:3:2. On 1st April 2018, Thara retires and on retirement, the following adjustments are agreed upon:

(i) Increase the value of premises by □ 40,000.

(ii) Depreciate stock by □ 3,000 and machinery by □ 6,500.

(iii)Provide an outstanding liability of □ 500

Pass journal entries and prepare revaluation account.

Solution

Journal Entries

Date	Particulars	L.F.	Debit ₹	Credit ₹
2018	Premises A/c Dr.		40,000	
April 1	To Revaluation A/c			40,000
	(Value of premises increased)			
"	Revaluation A/c Dr.		10,000	
	To Stock A/c			3,000
	To Machinery A/c			6,500
	To Outstanding liability A/c			500
	(Decrease in value of assets and outstanding liability recorded)			
"	Revaluation A/c Dr.		30,000	
	To Ramya's capital A/c			15,000
	To Sara's capital A/c			9,000
	To Thara's capital A/c			6,000
	(Profit on revaluation distributed)			

Dr. Revaluation account Cr.

Particulars	₹	₹	Particulars	₹
To Stock A/c		3,000	By Premises A/c	40,000
To Machinery A/c		6,500		
To Outstanding liability A/c		500		
To Profit on revaluation transferred to				
Ramya's capital A/c (5/10)	15,000			
Sara's capital A/c (3/10)	9,000			
Thara's capital A/c (2/10)	6,000	30,000		
		40,000		40,000

Illustration

Prabu, Ragu and Siva are partners sharing profits and losses in the ratio of 3:2:1. Prabu retires from partnership on 1st April 2017. The following adjustments are to be made:

(i) Increase the value of building by □ 12,000

(ii) Reduce the value of furniture by □ 8,500

(iii)A provision would also be made for outstanding salary for □ 6,500. Give journal entries and prepare revaluation account.

Journal entries

Date	Particulars		L.F.	Debit ₹	Credit ₹
2017	Building A/c	Dr.		12,000	
April 1	To Revaluation A/c				12,000
	(Increase in the value of building accounted)				
„	Revaluation A/c	Dr.		15,000	
	To Furniture A/c				8,500
	To Outstanding salary A/c				6,500
	(Reduction in the value of furniture and outstanding salary accounted)				
„	Prabu's capital A/c	Dr.		1,500	
	Ragu's capital A/c	Dr.		1,000	
	Siva's capital A/c	Dr.		500	
	To Revaluation A/c				3,000
	(Loss on revaluation transferred to capital accounts)				

Dr. **Revaluation Account** **Cr.**

Particulars	₹	Particulars		₹
To Furniture A/c	8,500	By Building A/c		12,000
To Outstanding salary A/c	6,500	By Loss on revaluation transferred to		
		Prabu's capital A/c (3/6)	1,500	
		Ragu's capital A/c (2/6)	1,000	
		Siva's capital A/c (1/6)	500	3,000
	15,000			15,000

Illustration

John, James and Raja are partners in a firm sharing profits and losses equally. Their balance sheet as on 31st March, 2019 is as follows:

Liabilities		₹	Assets		₹
Capital accounts:			Office equipment		70,000
John	80,000		Machinery		1,40,000
James	60,000		Sundry debtors	52,000	
Raja	1,00,000	2,40,000	Less: Provision for		
Sundry creditors		1,20,000	doubtful debts	2,000	50,000
			Stock		60,000
			Cash at bank		40,000
		3,60,000			3,60,000

Raja retired on 31st March, 2019 subject to the following conditions:

(i) Machinery is valued at □ 1,30,000

(ii) Value of office equipment is brought down by □ 2,000

(iii)Provision for doubtful debts should be increased to □ 3,000

(iv)Investment of □ 25,000 not recorded in the books is to be recorded now

Pass necessary journal entries and prepare revaluation account.

Solution

Journal entries

Date	Particulars	L.F.	Debit ₹	Credit ₹
2019	Revaluation A/c Dr.		13,000	
March 31	To Machinery A/c			10,000
	To Office equipment A/c			2,000
	To Provision for doubtful debts A/c			1,000
	(Depreciation on machinery and furniture and provision made for doubtful debts adjusted)			
"	Investments A/c Dr.		25,000	
	To Revaluation A/c			25,000
	(Unrecorded investments brought into accounts)			
"	Revaluation A/c Dr.		12,000	
	To John's capital A/c			4,000
	To James's capital A/c			4,000
	To Raja's capital A/c			4,000
	(Profit on revaluation transferred to capital accounts)			

Dr. Revaluation Account Cr.

Particulars	₹	₹	Particulars	₹
To Machinery A/c		10,000	By Investments A/c	25,000
To Office equipment A/c		2,000		
To Provision for doubtful debts		1,000		
To Profit on revaluation transferred to				
John's Capital A/c (1/3)	4,000			
James Capital A/c (1/3)	4,000			
Raja's Capital A/c (1/3)	4,000	12,000		
		25,000		25,000

(b) When revised values of assets and liabilities are not shown in the books:

Under this method, the assets and liabilities are shown at their original values and not at the revised values in the books and in the balance sheet which is prepared immediately after the retirement of a partner. The net result of revaluation is adjusted through the capital accounts of the partners. A Memorandum revaluation account which is a temporary account is opened when the revised values are not to be shown in the books of accounts.

Determination of new profit-sharing ratio and gaining ratio

1. New profit-sharing ratio

It is necessary to determine the new profit-sharing ratio at the time of retirement of a partner because the continuing partners acquire the retiring partner's share of profit. New profit-sharing ratio is the agreed proportion in which future profit will be distributed to the continuing partners. If the new profit-sharing ratio is not agreed, the continuing partners will share the profits and losses equally.

2. Gaining ratio

The continuing partners may gain a portion of the share of profit of the retiring partner. The gain may be shared by all the partners or some of the partners. Gaining ratio is the proportion of the profit which is gained by the continuing partners. The purpose of finding the gaining ratio is to bear the goodwill to be paid to the retiring partner. The share gained is calculated as follows:

Share gained = New share – Old share

Gaining ratio = Ratio of share gained by the continuing partners

Tutorial note: When the new profit-sharing ratio is not given in the problem, it is to be calculated based on the information given in the problem.

Calculation of gaining ratio and new profit-sharing ratio under different situations

1. When new profit-sharing ratio is given

When new profit-sharing ratio is given, only gaining ratio has to be calculated as follows:

Gaining ratio = Ratio of share gained by the continuing partners

Share gained = New share – Old share

Illustration

Kiran, Vinoth and Vimal are partners sharing profits in the ratio of 5:3:2. Kiran retires and the new profit-sharing ratio between Vinoth and Vimal is 2:1. Calculate the gaining ratio.

Solution

Share gained = New share – Old share

Vinoth $= \frac{2}{3} - \frac{3}{10} = \frac{20-9}{30} = \frac{11}{30}$

Vimal $= \frac{1}{3} - \frac{2}{10} = \frac{10-6}{30} = \frac{4}{30}$

Therefore, the gaining ratio of Vinoth and Vimal is $\frac{11}{30} : \frac{4}{30}$, that is, 11:4

2. When new profit-sharing ratio is not given

(a) Only one partner gains the retiring partner's share

When new profit-sharing ratio is not given and only one continuing partner gains the entire share of the retiring partner, new profit-sharing ratio is calculated as follows:
New share of continuing partner = Old share + Share gained

Illustration

Arya, Benin and Charles are partners sharing profits and losses in the ratio of 3:3:2. Charles retires and his share is taken up by Arya. Calculate the new profit-sharing ratio and gaining ratio of Arya and Benin.

Share gained by Arya $= \frac{2}{8}$

Gaining ratio $= \frac{2}{8} : 0$ that is, $\frac{1}{4} : 0$ or 1:0

New share of continuing partner = Old share + Share gained

Arya $= \frac{3}{8} + \frac{2}{8} = \frac{5}{8}$

Benin $= \frac{3}{8} + 0 = \frac{3}{8}$

Therefore, new profit sharing ratio of Arya and Benin is $\frac{5}{8} : \frac{3}{8}$ that is 5:3.

(b) More than one partner gains the retiring partner's share

(i) Proportion of share gained on retiring partner's share is given

When new profit-sharing ratio is not given, but the proportion of share gained on retiring partner's share is given, new profit-sharing ratio is calculated as follows:
New share of continuing partners = Old share + Share gained
Share gained = Retiring partner's share × Proportion of share gained

Illustration

Rahul, Ravi and Rohit are partners sharing profits and losses in the ratio of 5:3:2. Rohit retires and the share is taken by Rahul and Ravi in the ratio of 3:2. Find out the new profit-sharing ratio and gaining ratio.

Solution

Rohit's share $\frac{2}{10}$

Share gained = Retiring partner's share × Proportion of share gained

Rahul $= \frac{2}{10} \times \frac{3}{5} = \frac{6}{50}$

Ravi $= \frac{2}{10} \times \frac{2}{5} = \frac{4}{50}$

Gaining ratio $= \frac{6}{50} : \frac{4}{50}$ that is, 3:2

New share of continuing partners = Old share + Share gained

Rahul $= \frac{5}{10} + \frac{6}{50} = \frac{25+6}{50} = \frac{31}{50}$

Ravi $= \frac{3}{10} + \frac{4}{50} = \frac{15+4}{50} = \frac{19}{50}$

The new profit sharing ratio of Rahul and Ravi is $\frac{31}{50} : \frac{19}{50}$ that is 31:19.

Adjustment for goodwill

Reputation built up by a firm has an impact on the present and future profit to be earned by the firm. At the time of retirement of a partner, the continuing partners gain part of retiring partner's share of profit. Hence, the retiring partner's share of goodwill is to be valued and adjusted through the capital accounts of the gaining partners. The following journal entry is passed.

Date	Particulars	L.F.	Debit ₹	Credit ₹
	Continuing partners' capital / current A/c (in gaining ratio) Dr.		xxx	
	To Retiring partner's capital / current A/c			xxx

Illustration

Suresh, Senthamarai and Raj were partners in a firm sharing profits and losses in the ratio of 3:2:1. Suresh retired from partnership. The goodwill of the firm on the date of retirement was valued at □ 36,000. Pass necessary journal entries for goodwill on the assumption that the fluctuating capital system is followed.

Solution

As the new profit-sharing ratio and gain made by the continuing partners is not mentioned, it is assumed that they gain in their old profit-sharing ratio of 2:1. Therefore, gaining ratio is 2:1.

Suresh's share of goodwill = 36, 000 x 3/6 = □ 18,000

Journal Entries

Date	Particulars		L.F.	Debit ₹	Credit ₹
	Senthamari's capital A/c (18,000 x 2/3)	Dr.		12,000	
	Raj's capital A/c (18,000 x 1/3)	Dr.		6,000	
	To Suresh's capital A/c				18,000
	(Suresh's share of goodwill adjusted)				

Existing goodwill

If goodwill already appears in the balance sheet, at the time of retirement if the partners decide, it can be written off by transferring it to all the partners' capital account / current account in the old profit-sharing ratio. The following journal entry is to be passed:

Journal entry

Date	Particulars		L.F.	Debit ₹	Credit ₹
	All partners' capital / current A/c (in old ratio)	Dr.		xxx	
	To Goodwill A/c				xxx
	(Existing goodwill written off)				

Illustration

Naresh, Mani and Muthu are partners in a firm sharing profits and losses in the ratio of 2:2:1. On 31st March 2019, Muthu retires from the firm. On the date of Muthu's retirement, goodwill appeared in the books of the firm at □ 40,000. By assuming fluctuating capital method, pass the necessary journal entry if the partners decide to

a) write off the entire amount of existing goodwill

b) write off half of the amount of existing goodwill.

Solution

(a) Write off the entire amount of existing goodwill

Journal entry

Date	Particulars		L.F.	Debit ₹	Credit ₹
2019	Naresh's capital A/c (40,000 x 2/5)	Dr.		16,000	
March 31	Mani's capital A/c (40,000 x 2/5)	Dr.		16,000	
	Muthu's capital A/c (40,000 x 1/5)	Dr.		8,000	
	To Goodwill A/c				40,000
	(Existing goodwill written off)				

Notes

(b) Write off half of the amount of existing goodwill, that is ` 20,000

Journal entry

Date	Particulars		L.F.	Debit ₹	Credit ₹
2019	Naresh's capital A/c (20,000 x 2/5)	Dr.		8,000	
March 31	Mani's capital A/c (20,000 x 2/5)	Dr.		8,000	
	Muthu's capital A/c (20,000 x 1/5)	Dr.		4,000	
	To Goodwill A/c				20,000
	(Half of the existing goodwill written off)				

Adjustment for current year's profit or loss up to the date of retirement

When a partner retires in between in an accounting year, his share of the current year's profit or loss up to the date of retirement has to be distributed to him. It may be estimated based on the current year's turnover. Previous year's profit or the average of the past years' profit may also be taken as the base to estimate the current year's profit. The following journal entry is passed.

Date	Particulars		L.F.	Debit ₹	Credit ₹
	Profit and loss Suspense A/c	Dr.		xxx	
	To Retiring partner's capital / current A/c				xxx
	(Retiring partner's current year share of profit credited to his capital account)				

Note: If there is loss the reverse entry is passed.

Profit and loss suspense account is closed by transferring to the profit and loss account at the end the accounting period.

Illustration

Justina, Navi and Rithika are partners sharing profits and losses equally. On 31.3.2019, Rithika retired from the partnership firm. Profits of the preceding years is as follows: 2016: □ 5,000; 2017: □ 10,000 and 2018: □ 30,000

Find out the share of profit of Ritika for the year 2019 till the date of retirement if

a) Profit is to be distributed on the basis of the previous year's profit

b) Profit is to be distributed on the basis of the average profit of the past 3 years

Also pass necessary journal entries by assuming that partners' capitals are fluctuating.

Solution

(a) If profit is to be distributed on the basis of the previous year's profit:

Ritika's share of profit for 3 months = 30,000 × 3/12 × 1/3 = □ 2,500

Comprehensive problems

Illustration

Charles, Muthu and Sekar are partners, sharing profits in the ratio of 3:4:2. Their balance sheet as on 31st December, 2018 is as under:

Liabilities	₹	₹	Assets	₹
Capital accounts:			Furniture	20,000
Charles	30,000		Stock	40,000
Muthu	40,000		Debtors	30,000
Sekar	20,000	90,000	Cash at bank	42,000
Workmen compensation fund		27,000	Profit and loss A/c (loss)	18,000
Sundry creditors		33,000		
		1,50,000		1,50,000

On 1.1.2019, Charles retired from the partnership firm on the following arrangements.

(i) Stock to be appreciated by 10%

(ii) Furniture to be depreciated by 5%

(iii)To provide □ 1,000 for bad debts

(iv)There is an outstanding repair of □ 11,000 not yet recorded

(v) The final amount due to Charles was paid by cheque

Prepare revaluation account, partners' capital account and the balance sheet of the firm after retirement.

Solution

Dr. **Revaluation Account** **Cr.**

Particulars	₹	Particulars	₹	₹
To Furniture A/c	1,000	By Stock A/c		4,000
To Provision for bad debts A/c	1,000	By Loss on revaluation transferred to		
To Outstanding repairs	11,000	Charles capital A/c (3/9)	3,000	
		Muthu's capital A/c (4/9)	4,000	
		Sekar's capital A/c (2/9)	2,000	9,000
	13,000			13,000

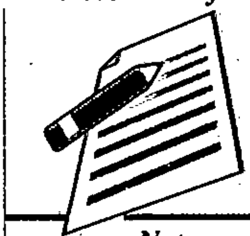
Notes

Dr. **Capital Account** Cr.

Particulars	Charles ₹	Muthu ₹	Sekar ₹	Particulars	Charles ₹	Muthu ₹	Sekar ₹
To Profit and loss A/c	6,000	8,000	4,000	By Balance b/d	30,000	40,000	20,000
To Revaluation A/c (loss)	3,000	4,000	2,000	By Workmen's compensation fund	9,000	12,000	6,000
To Bank	30,000	-	-				
To Balance c/d		40,000	20,000				
	39,000	52,000	26,000		39,000	52,000	26,000
				By Balance b/d	-	40,000	20,000

Balance Sheet as on 1st January 2019

Liabilities	₹	₹	Assets	₹	₹
Capital accounts:			Furniture	20,000	
Muthu	40,000		Less: Depreciation	1,000	19,000
Sekar	20,000	60,000	Stock	40,000	
Sundry creditors		33,000	Add: Appreciation	4,000	44,000
Outstanding repairs		11,000	Debtors	30,000	
			Less: Provision for bad debts	1,000	29,000
			Cash at bank	42,000	
			Less: Amount paid to Charles	30,000	12,000
		1,04,000			1,04,000



2 DISSOLUTION OF PARTNERSHIP FIRM

Dissolution of Partnership

Dissolution of Partnership is different from the dissolution of partnership firm. It is due to the fact that when the relation present between all partners, comes to an end, it is known as dissolution of firm. When any one of the partners become incapacitated, then the partnership comes to an end, but the firm may continue to operate, if new partnership is arranged among the other partners.

a. Dissolution of firm

Dissolution of firm means dissolution of partnership. On dissolution of firm, partnership business comes to an end. Its assets are realised and the creditors are paid off. The business cannot be continued after dissolution of partnership firm. For example, A, B and C are partners in a business. If all the three partners decide to dissolve, it is known as "dissolution of the firm".

b. Dissolution of partnership

Dissolution of partnership means the termination of the original partnership agreement. A partnership is dissolved by insolvency, retirement, expiry or completion of the term of partnership. The business will continue after dissolution of partnership. For example: A, B and C are partners in a business. If 'A' retires, 'B' and 'C' can continue the business which is known as dissolution of partnership.

The various circumstances leading to dissolution of partnership firm can be summarised by taking the first letters used in the term "Dissolution".

D - Death of partner

I - Incapacity of a partner

S - Stipulated period of partnership completed in the case of particular partnership

S - Serious misconduct of a partner

O - Object is completed (Particular partnership)

L - Lunacy of a partner

U - Unavoidable continuous loss

T - Transfer of interest of the firm

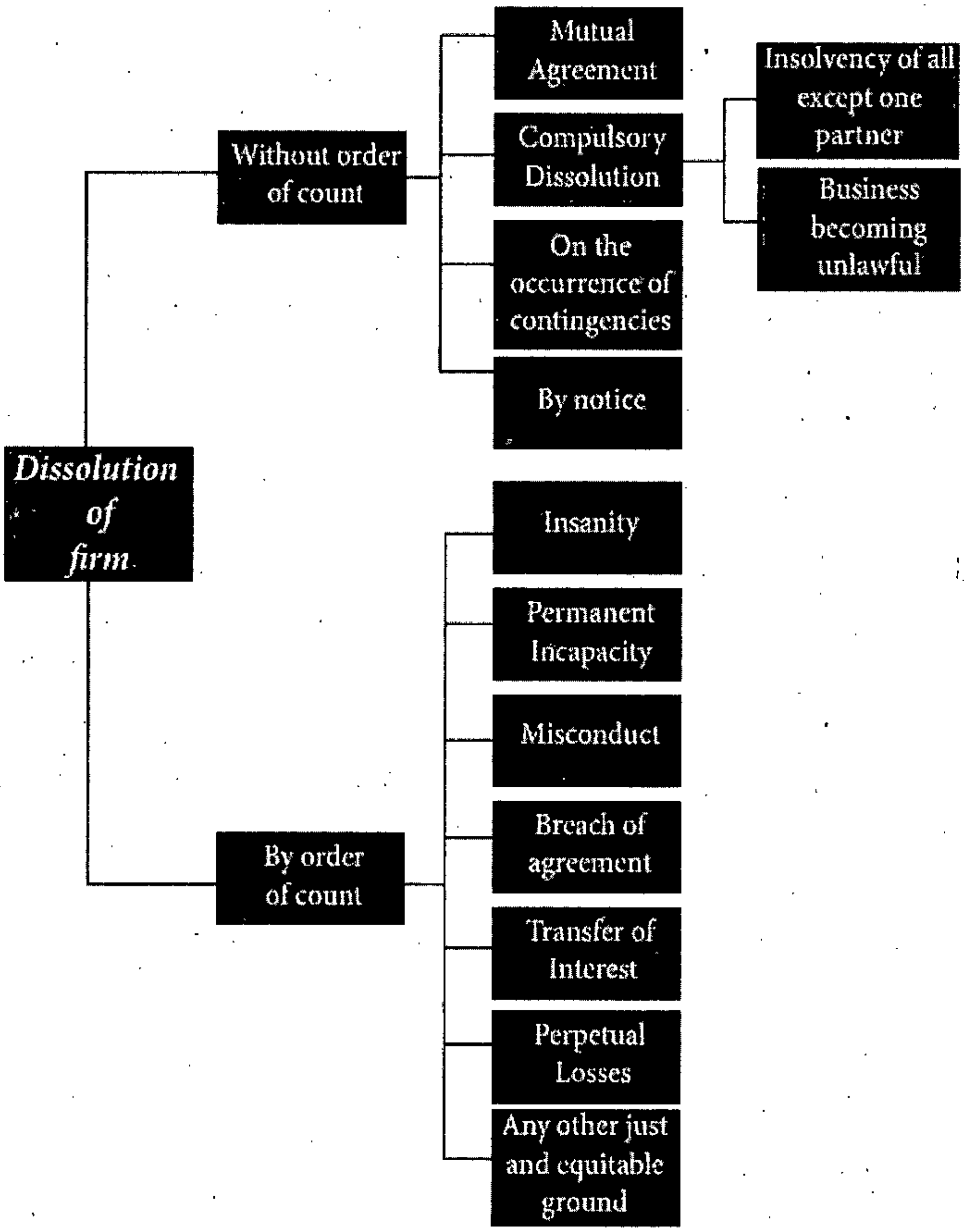
I - Insolvency of a partner

O - Objectionable unlawful objectives

N - Notice of dissolution by a partner.

Dissolution of Partnership can take the following forms

- Change in the existing profit-sharing ratio
- Admission of a Partner
- Retirement or Death of a Partner
- Insolvency of a partner.
- Expiry of the term of the partnership.
- Completion of the specified venture.
- Dissolution by agreement.



Dissolution of a partnership firm is taken place in two ways.

a. without the order of the court and

b. By order of the court.

a Without the order of the court

i. By agreement or mutual consent

A firm may be dissolved when all the partners agree to close the affairs of the firm. Just as a partnership is created by contract, it can also be terminated by contract.

ii. By insolvency of all the partners but one

If any of the partners adjudged an insolvent (or if all the partners become insolvent) it is necessary to dissolve the firm.

iii. When the objective becomes illegal

When the business carried on by the partnership becomes illegal, the partnership firm is automatically dissolved.

iv. By notice of dissolution

In the case of partnership at will when any partner gives in writing to all the other partners indicating his intention to dissolve the firm, the firm will be dissolved.

v. On certain contingencies:

Dissolution of partnership itself may involve the dissolution of the firm unless parties agree to continue it otherwise, it will take place.

a. On the expiry of a specified period in case of partnership for a fixed term.

b. On the completion of a particular adventure for which it has been formed

c. in case of particular partnership.

d. On the death of a partner.

e. On the retirement of a partner.

f. On the insolvency of a partner.

In all the above cases if the business is not continued by the remaining partners, dissolution of the firm takes place automatically.

b. Dissolution through court

The court may order dissolution of a firm at a suit of a partner in any of the following circumstances.

a. When a partner becomes insane

b. Permanent incapacity of any partner

c. Misconduct of any partner

d. Breach of agreement which makes the business impracticable

e. Transfer of interest to third person

f. Continued loss

g. When the court finds that it is just and equitable to dissolve the firm

1 COMPANY ACCOUNTS

Objective of the Module

> The basic objective of the unit is to through some light on the initial concepts of Meaning of Shares, Types of Shares and Methods of issue of shares. Debentures – Meaning and methods of issuing debentures and Redemption of Preference Shares have also been discussed in this unit.

COMPANY ACCOUNTS

Introduction

Human needs and wants are ever growing. In order to meet them production must be carried on, on a large scale. For this, large amount of capital, modern technology and managerial skills are needed for business units. Sole proprietorship and partnership firms may not be able to raise large amount of capital to equip themselves with these. To overcome this limitation, the concept of 'Company form of organisation' came into existence. The capital of companies is divided into small units called shares. Capital needed by the company could be raised by inviting the general public to buy shares and invest in the business. These investors are called shareholders or members of the company. The money raised by issuing shares is called share capital. Profits are distributed among the shareholders in the form of dividends.

It is not practical for all the members to take part in the management of the company. So, they appoint, at the annual general meeting, board of directors who take part in the management of the business. The liability of the shareholders is limited to the face value of shares. A limited company differs from other forms of business units. It has a separate legal entity.

Meaning and definition of a company

Company is a voluntary association of persons which has separate legal entity. It has perpetual succession and the liability of the members is limited.

According to Lord Justice Lindley, "A company is an association of many persons who contribute money or money's worth to a common stock and employ it in some trade or business and who share the profit and loss arising there from. The common stock so contributed is denoted in money and is the capital of the company. The persons who contributed in it or form it, or to whom it belongs, are members. The proportion of capital to which each member is entitled is his share".

Characteristics of a company

Following are the characteristics of a company:

Voluntary association: A company is a voluntary association of persons. No law can compel persons to form a company.

Separate legal entity: Company is an artificial person. It has a separate legal entity which is separate and distinct from its members.

Common seal: A company may have a common seal which can be affixed on the documents.

Perpetual succession: A company continues for ever. Its continuity is not affected by the changes in its members. It can be wound up only by law.

Limited liability: The liability of the shareholders of the company is limited to the extent of face value of the shares held by them.

Transferability of shares: The shares of a company are freely transferable except in case of a private company.

Meaning and types of shares

The capital of a company is divided into small units of fixed amount. These units are called shares. The shares which can be issued by a company are of two types (i) preference shares and (ii) equity shares.

(i) Preference shares

Preference shares are the shares which have the following two preferential rights over the equity shares:

a. Preference towards the payment of dividend at a fixed rate during the life time of the company and
b. Preference towards the repayment of capital on winding up of the company.

(ii) Equity shares

Equity shares are those shares which are not preference shares. These shares do not enjoy any preferential rights. Rate of dividend is not fixed on equity shares and it depends upon the profits earned by the company. In case of winding up of a company equity shareholder are paid after the payments are made to preference shareholders. Equity shares are also known as ordinary shares.

Divisions of share capital

The share capital of a company is divided into the following categories:

(i) Authorised capital

It means such capital as is authorised by the memorandum of association. It is the maximum amount which can be raised as capital. It is also known as registered capital or nominal capital.

(ii) Issued capital

This represents that part of authorised capital which is offered for subscription.

(iii)Subscribed capital

It refers to that part of issued capital which has been applied for and also allotted by the company.

(iv)Called up capital

It refers to that part of subscribed capital which has been called up by the company for payment.

(v) Paid up capital

It is that part of called up capital which has been actually paid by the shareholders.

(vi)Reserve capital

The company can reserve a part of its subscribed capital to be called up only at the time of winding up. It is called reserve capital.

Issue of equity shares

A public company may raise capital by issue of equity shares through the following ways:

1. Public issue
2. Private placement
3. Rights issue
4. Bonus issue

1. Public issue

Issue of equity shares to the public through prospectus by a public company is called public issue. It includes initial public offer and further public offer.

2. Private placement

Private placement means any offer of equity shares or invitation to subscribe equity shares to a select group of persons by a company (other than by way of public offer) through issue of a private placement offer letter and which satisfies the conditions specified in Section 42 of the Indian Companies Act, 2013.

3. Rights issue

Issue of equity shares to the existing shareholders of the company through a letter of offer is known as rights issue.

4. Bonus issue

Issue of equity shares to the existing shareholders of the company at free of cost out of accumulated profit is known as bonus issue.

Process of issue of equity shares

A company can issue shares as per the provisions of the Indian Companies Act and as per the guidelines issued by Securities and Exchange Board of India (SEBI).

Inviting subscription: A public company has to issue a prospectus and invite the general public to subscribe for its shares.

Receipt of application: On the basis of the prospectus, applications are deposited in a scheduled bank by the applicants along with application money within the time specified. Application money must be at least 5 per cent of the nominal value of the shares.

Allotment of shares: When the minimum subscription stated in the prospectus has been subscribed for by the public, a company can allot shares. For those to whom shares could not be allotted, their application money will be refunded. If the minimum subscription is not received, all the application money received has to be refunded to the applicants.

A company may issue equity shares either for cash or for consideration other than cash. When shares are issued for cash, the cash may be received (a) in instalments or (b) at one time (lumpsum).

Issue of shares for cash in instalments

The share capital may be received through instalments as below:

- First instalment called application money
- Second instalment called allotment money
- Third instalment called first call money
- The last instalment called final call money

(i) When shares are issued for cash at par:

Following are the journal entries to be passed:

Date	Particulars		L.F.	Debit ₹	Credit ₹
	1. On receipt of application money				
	Bank A/c	Dr.		xxx	
	To Equity share application A/c				xxx
	2. On allotment of shares to transfer share application money				
	Share application A/c	Dr.		xxx	
	To Equity share capital A/c				xxx
	3. On refund of application money for rejected applications				
	Equity share application A/c	Dr.		xxx	
	To Bank A/c				xxx
	4. For allotment money due				
	Equity share allotment A/c	Dr.		xxx	
	To Equity share capital A/c				xxx
	5. On receipt of allotment money				
	Bank A/c	Dr.		xxx	
	To Equity share allotment A/c				xxx
	6. On making call for the call money due				
	Equity share call A/c	Dr.		xxx	
	To Equity share capital A/c				xxx
	7. On receipt of call money				
	Bank A/c	Dr.		xxx	
	To Equity share call A/c				xxx

Illustration 1

Thai Ltd. issued 1,00,000 equity shares of □ 10 each, payable □ 5 on application, □ 2 on allotment, 2 on first call and □ 1 on final call. All the shares are subscribed and amount was duly received. Pass journal entries.

Solution

In the books of Thai Ltd.
Journal entries

Date	Particulars		L.F.	Debit ₹	Credit ₹
	Bank A/c	Dr.		5,00,000	
	To Equity share application A/c				5,00,000
	(Application money received)				
	Equity share application A/c	Dr.		5,00,000	
	To Equity share capital A/c				5,00,000
	(Transfer of share application money to share capital)				
	Equity share allotment A/c	Dr.		2,00,000	
	To Equity share capital A/c				2,00,000
	(Share allotment money due)				
	Bank A/c	Dr.		2,00,000	
	To Equity share allotment A/c				2,00,000
	(Allotment money received)				
	Equity share first call A/c	Dr.		2,00,000	
	To Equity share capital A/c				2,00,000
	(Share first call money due)				
	Bank A/c	Dr.		2,00,000	
	To Equity share first call A/c				2,00,000
	(Share first call money received)				
	Equity share second and final call A/c	Dr.		1,00,000	
	To Equity share capital A/c				1,00,000
	(Share second and final call money due)				
	Bank A/c	Dr.		1,00,000	
	To Equity share second and final call A/c				1,00,000
	(Share second and final call money received)				

1. Under subscription

All the shares offered to the public may not be subscribed in full. When the number of shares subscribed is less than the number of shares offered, it is known as under subscription. Under such circumstance, all those who have duly applied will obtain allotment provided minimum subscription as mentioned in the prospectus has been subscribed.

Illustration 2

Joy Company issued 10,000 equity shares at □ 10 per share payable □ 5 on application, □ 3 on allotment and □ 2 on first and final call. The public subscribed for 9,000 shares. The directors allotted all the 9,000 shares and duly received the money. Pass the necessary journal entries.

Solution

In the books of Joy Company

Journal entries

Date	Particulars		L.F.	Debit ₹	Credit ₹
	Bank A/c (9,000 × 5)	Dr.		45,000	
	To Equity share application A/c				45,000
	(Application money received)				
	Equity share application A/c	Dr.		45,000	
	To Equity share capital A/c				45,000
	(Transfer of application money to share capital A/c)				
	Equity share allotment A/c	Dr.		27,000	
	To Equity share capital A/c				27,000
	(Allotment money due)				
	Bank A/c	Dr.		27,000	
	To Equity share allotment A/c				27,000
	(Allotment money received)				
	Equity share first and final call A/c	Dr.		18,000	
	To Equity share capital A/c				40,000
	(Call money due)				
	Bank A/c	Dr.		18,000	
	To Equity share first and final call A/c				18,000
	(Call money received)				

2. Over subscription

When the number of shares applied for is more than the number of shares offered for subscription, it is said to be over subscription. This situation can be dealt with as per any of the following three alternatives:

a. Some applications are accepted in full and others are totally rejected. Application money is returned to the applicants for rejected applications.

b. All applications are allotted in proportion of shares applied for. This is called pro rata allotment. Excess application money may be returned or may be retained for adjustment towards allotment money and call money.

c. A combination of the above two may be applied.

Illustration 3

Bharath Ltd. issued 1,00,000 equity shares of □ 10 each to the public at par. The details of the amount payable on the shares are as follows:

On application □ 5 per share

On allotment □ 3 per share

On first and final call □ 2 per share

Application money was received for 1,20,000 shares. Excess application money was refunded immediately. Pass journal entries to record the above.

Solution

In the books of Bharath Ltd.
Journal entries

Date	Particulars	L.F.	Debit ₹	Credit ₹
	Bank A/c (1,20,000 × 5) Dr. To Equity share application A/c (Application money received)		6,00,000	6,00,000
	Equity share application A/c (1,00,000 × 5) Dr. To Equity share capital A/c (Transfer of share application money to share capital)		5,00,000	5,00,000
	Equity share application A/c (20,000 × 5) Dr. To Bank A/c (Excess share application money refunded)		1,00,000	1,00,000
	Equity share allotment A/c Dr. To Equity share capital A/c (Share allotment money due)		3,00,000	3,00,000
	Bank A/c Dr. To Equity share allotment A/c (Allotment money received)		3,00,000	3,00,000
	Equity share first and final call A/c Dr. To Equity share capital A/c (Share first and final call money due)		2,00,000	2,00,000
	Bank A/c Dr. To Equity share first and final call A/c (Share first and final call money received)		2,00,000	2,00,000

Illustration 4

Khan Ltd. issued 50,000 shares of □ 10 each to the public payable □ 4 on application, □ 4 on allotment and □ 2 on first and final call. Applications were received for 65,000 shares. The directors decided to allot 50,000 shares on pro rata basis and surplus application money was utilised for allotment. Pass journal entries assuming that the amounts due were received.

Solution

In the books of Khan Ltd.
Journal entries

Date	Particulars	L.F.	Debit ₹	Credit ₹
	Bank A/c (65,000 × 4) Dr. To Equity share application A/c (Application money received)		2,60,000	 2,60,000
	Equity share application A/c (50,000 × 4) Dr. To Equity share capital A/c (Transfer of share application money to share capital)		2,00,000	 2,00,000
	Equity share application A/c (15,000 × 4) Dr. To Equity share allotment A/c (Excess share application money utilised for allotment)		60,000	 60,000
	Equity share allotment A/c Dr. To Equity share capital A/c (Share allotment money due)		2,00,000	 2,00,000
	Bank A/c (2,00,000 – 60,000) Dr. To Equity share allotment A/c (Allotment money received)		1,40,000	 1,40,000
	Equity share first and final call A/c (50,000 × 2) Dr. To Equity share capital A/c (Share first and final call money due)		1,00,000	 1,00,000
	Bank A/c Dr. To Equity share first and final call A/c (Share first and final call money received)		1,00,000	 1,00,000

Illustration 5

Sudha Ltd. offered 1,00,000 shares of □ 10 each to the public payable □ 3 on application, □ 4 on share allotment and the balance when required. Applications for 1,40,000 shares were received on which the directors allotted as:

Applicants for 60,000 shares - Full

Applicants for 75,000 shares - 40,000 shares (excess money will be utilised for allotment)

Applicants for 5,000 shares - Nil

All the money due was received. Pass journal entries up to the receipt of allotment.

Solution

In the books of Khan Ltd.
Journal entries

Date	Particulars		L.F.	Debit ₹	Credit ₹
	Bank A/c (1,40,000 x 3) To Equity share application A/c (Application money received)	Dr.		4,20,000	 4,20,000
	Equity share application A/c (1,00,000 × 3) To Equity share capital A/c (Transfer of share application money to share capital)	Dr.		3,00,000	 3,00,000
	Equity share application A/c (5,000 x 3) To Bank A/c (Excess application money refunded)	Dr.		15,000	 15,000
	Equity share application A/c (35,000 x 3) To Share allotment A/c (Excess share application money utilised for allotment)	Dr.		1,05,000	 1,05,000
	Equity share allotment A/c (1,00,000 x 4) To Equity share capital A/c (Share allotment money due)	Dr.		4,00,000	 4,00,000
	Bank A/c To Equity share allotment A/c (Allotment money received)	Dr.		2,95,000	 2,95,000

Working note:

Shares applied for	Shares Allotted	Application money received	Application money	Appropriation towards Allotment money	Refunded
60,000	60,000	1,80,000	1,80,000	-	-
75,000	40,000	2,25,000	1,20,000	1,05,000	
5,000	-	15,000	-	-	15,000

3. Calls in advance

The excess amount paid over the called-up value of a share is known as calls in advance. It is the excess money paid on application or allotment or calls. Such excess amount can be returned or adjusted towards future payment. If the company decides to adjust such amount towards future payment, the excess amount may also be transferred to a separate account called calls in advance account.

Calls in advance does not form part of the company's share capital and no dividend is payable on such amount. In the balance sheet, it should be shown under current liabilities.

As per Section 50 of the Indian Companies Act, 2013, the company can accept calls in advance only if it is authorised by its Articles of Association. As per Table F of the Indian Companies Act, 2013, interest may be paid on calls in advance if Articles of Association so provide not exceeding 12% per annum.

Tutorial note

The excess application money on allotted shares after adjustment for allotment money should be transferred to calls in advance account.

Following are the journal entries to be passed:

Date	Particulars	L.F.	Debit ₹	Credit ₹
	(a) For money received in advance on allotment and call			
	Bank A/c Dr.		xxx	
	To Call in advance A/c			xxx
	(b) For adjusting towards call(s)			
	Calls in advance A/c Dr.		xxx	
	To Share call A/c			xxx

4. Calls in arrear

When a shareholder fails to pay the amount due on allotment or on calls, the amount remaining unpaid is known as calls in arrears. In other words, the amount called up but not paid is calls in arrears.

As per Table F of the Indian Companies Act, 2013, interest may be charged on calls in arrear if Articles of Association so provide not exceeding 10% per annum. There are two methods of accounting of calls in arrears.

(i) By not opening calls in arrear account

Under this method, amount unpaid by the shareholders remains in the respective call account until the amount is collected or the shares are forfeited.

(ii) By opening calls in arrear account

Under this method, amount unpaid by the shareholders is transferred by debiting it to a separate account called calls in arrear account. When calls in arrear is collected or when the share is forfeited, the calls in arrear account is credited.

Illustration 7

Jeyam Tyres issued 15,000 ordinary shares of □ 10 each payable as follows: □ 3 on application; □ 5 on allotment; □ 2 on first and final call. All money were duly received except one shareholder holding 100 shares failed to pay the call money. Pass the necessary journal entries for call (using calls in arrear account).

Solution

Journal entries

Date	Particulars		L.F.	Debit ₹	Credit ₹
	Equity share first and final call A/c (15,000 × 2)	Dr.		30,000	
	To Share capital A/c				30,000
	(Share first and final call money due)				
	Bank A/c (14,900 × 2)	Dr.		29,800	
	Calls in arrear A/c (100 × 2)	Dr.		200	
	To Equity share first and final call A/c				30,000
	(Amount received on calls and amount not received transferred to calls in arrear account)				

5. Forfeiture of shares

When a shareholder defaults in making payment of allotment and/or call money, the shares may be forfeited. On forfeiture, the share allotment is cancelled and to that extent, share capital is reduced. The person ceases to be a shareholder of the company after the shares are forfeited.

On forfeiture, the amount so far paid by the shareholder is forfeited which is a gain to the company and is credited to forfeited shares account. Forfeited shares account is shown under share capital as a separate head in the Note to Accounts to the balance sheet.

The following journal entry is to be passed in the books of the company:

Date	Particulars		L.F.	Debit ₹	Credit ₹
	Equity share capital A/c (called up amount)	Dr.		xxx	
	To Equity share allotment A/c (amount unpaid)				xxx
	To Equity share call A/c (amount unpaid)				xxx
	To Forfeited shares A/c (amount so far paid)				xxx
	(Forfeiture of shares for non payment of allotment and call)				

Illustration 8

Anitha was holding 500 equity shares of □ 10 each of Thanjavur Motors Ltd, issued at par. She paid 3 on application, □ 5 on allotment but could not pay the first and final call of □ 2. The directors forfeited the shares for non-payment of call money. Give Journal entry for forfeiture of shares.

Solution

Date	Particulars		L.F.	Debit ₹	Credit ₹
	Equity share capital A/c (500 × 10)	Dr.		5,000	
	To Equity share call A/c (500 × 2)				1,000
	To Forfeited shares A/c (500 × 8)				4,000
	(500 shares forfeited for non payment of call money)				

6. Re-issue of forfeited shares

Shares forfeited can be reissued by the company. The shares can be reissued at any price. But the reissue price cannot be less than the amount unpaid on forfeited shares.

Example: If a share of □ 10 on which □ 4 has already been paid as application money is forfeited and reissued as fully paid up, then a minimum of □ 6 must be fixed as the new price (10 – 4 = 6). When forfeited shares are reissued at a loss, such loss is to be debited to forfeited shares account. When forfeited shares are reissued at a premium, the amount of such premium will be credited to securities premium account. The following journal entries are passed on reissue:

Date	Particulars		L.F.	Debit ₹	Credit ₹
	(i) When reissue is made at par				
	Bank A/c	Dr.		xxx	
	To Equity share capital A/c				xxx
	(ii) When reissue is made at premium				
	Bank A/c	Dr.		xxx	
	To Equity share capital A/c				xxx
	To Securities premium A/c				xxx
	(iii) When reissue is made at loss				
	Bank A/c	Dr.		xxx	
	Forfeited shares A/c (loss on reissue)	Dr.		xxx	
	To Equity share capital A/c				xxx

If the reissue price is more than the amount unpaid on forfeited shares, it results in profit on reissue which is treated as capital profit and is transferred to capital reserve account. The following journal entry is passed:

Date	Particulars		L.F.	Debit ₹	Credit ₹
	Forfeited shares A/c	Dr.		xxx	
	To Capital reserve A/c				xxx

When only a part of the forfeited shares are reissued, the proportionate amount of profit on the shares reissued should be transferred to capital reserve account. Proportionate amount of profit is computed as follows:

$$\frac{\text{Total amount forfeited}}{\text{Total number of shares forfeited}} \times \text{Number of shares reissued}$$

The remaining amount in the forfeited shares account is shown under share capital as a separate head under share capital in the Note to Accounts to the balance sheet.

Illustration 10

Anu Company forfeited 200 equity shares of □ 10 each issued at par held by Thiyagu for non-payment of the final call of □ 3 per share. The shares were reissued to Laxman at □ 6 per share. Show the journal entries for forfeiture and reissue.

Solution

In the books of Anu Company
Journal entries

Date	Particulars	L.F.	Debit ₹	Credit ₹
	Equity share capital A/c (200 × 10) Dr.		2,000	
	To Equity share final call A/c (200 × 3)			600
	To Forfeited shares A/c (200 × 7)			1,400
	(100 shares forfeited)			
	Bank A/c (200 × 6) Dr.		1,200	
	Forfeited shares A/c (200 × 4) Dr.		800	
	To Share capital A/c (200 × 10)			2,000
	(Forfeited shares reissued)			
	Forfeited shares A/c (1,400-800) Dr.		600	
	To Capital reserve A/c			600
	(Gain on reissue of forfeited shares transferred to capital reserve account)			

7. Shares issued at premium

When a company issues shares at a price more than the face value (nominal value), the shares are said to be issued at premium. The excess is called as premium amount and is transferred to securities premium account. The amount of securities premium may be included in application money or allotment money or in a call. Securities premium account is shown under reserves and surplus as a separate head in the Note to Accounts to the balance sheet. Following are the journal entries for recording securities premium:

Date	Particulars		L.F.	Debit ₹	Credit ₹
	(i) If premium is collected with application money				
	(a) For receiving application money				
	(application money + premium)				
	Bank A/c	Dr.		xxx	
	To Equity share application A/c				xxx
	(b) For transfer of application money				
	Equity share application A/c	Dr.		xxx	
	To Equity share capital A/c				xxx
	To Securities premium A/c				xxx
	(ii) If premium is collected with allotment money/call money				
	(a) For allotment/ call money due				
	(allotment/call money + premium)				
	Equity share allotment/call A/c	Dr.		xxx	
	To Equity share capital A/c				xxx
	To Securities premium A/c				xxx
	(b) For receiving allotment/call money				
	Bank A/c	Dr.		xxx	
	To Equity share allotment/call A/c				xxx
	(iii) When shares are forfeited (for which premium is not received)				
	Equity share capital A/c	Dr.		xxx	
	Securities premium A/c	Dr.		xxx	
	To Equity share allotment A/c				xxx
	To Equity share call A/c				xxx
	To Forfeited shares A/c				xxx

Tutorial note While forfeiting shares for which premium had already been received, securities premium account should not be debited.

Illustration 15

Shero Health Care Ltd. invited applications for 3,00,000 equity shares of □ 10 each at a premium of □ 2 per share payable as follows:

□ 3 on application

□ 5 (including premium) on allotment

□ 4 on first and final call

There was over subscription and applications were received for 4,00,000 shares and the excess applications were rejected by the directors. All the money due were received. Pass the journal entries.

Solution

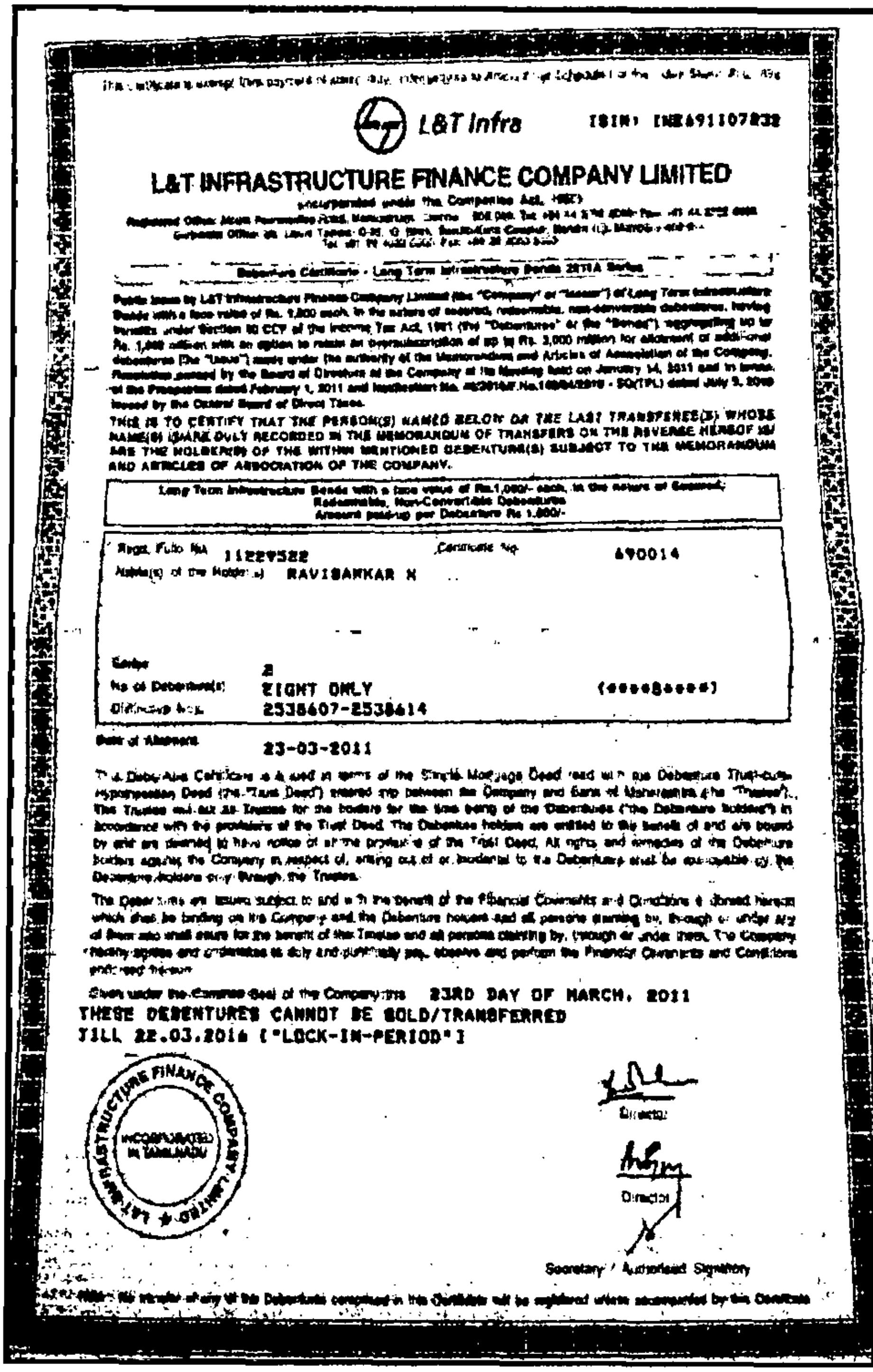
Note: Number of shares rejected = 4,00,000 - 3,00,000 = 1,00,000

In the books os Shero Health Care Ltd
Journal entries

Date	Particulars	L.F.	Debit ₹	Credit ₹
	Bank A/c (4,00,000 × 3) Dr.		12,00,000	
	To Equity share application A/c			12,00,000
	(Application money on 4,00,000 shares @ ₹ 3 per share received)			
	Equity share application A/c (3,00,000 × 3) Dr.		9,00,000	
	To Equity share capital A/c			9,00,000
	(Share application transferred to share capital)			
	Equity share application A/c (1,00,000 × 3)		3,00,000	
	To Bank A/c			3,00,000
	(Money refunded for rejected applications)			
	Equity share allotment A/c (3,00,000 × 5) Dr.		15,00,000	
	To Equity share capital A/c (3,00,000 × 3)			9,00,000
	To Securities premium A/c (3,00,000 × 2)			6,00,000
	(Share allotment money ₹ 5 per share including ₹ 2 premium receivable for 3,00,000 shares)			
	Bank A/c (3,00,000 × 5) Dr.		15,00,000	
	To Equity share allotment A/c			15,00,000
	(Allotment money received)			
	Equity share first and final call A/c Dr.		12,00,000	
	To Equity share capital A/c (3,00,000 × 4)			12,00,000
	(Call money receivable)			
	Bank A/c Dr.		12,00,000	
	To Equity share first and final call A/c			12,00,000
	(Call money received)			

Debentures – Meaning

Debenture means a document issued by a company to raise finance. It is an acknowledgement of a debt which is given under the common seal of the company.


L&T Infra ISIN: INE691I07832

L&T INFRASTRUCTURE FINANCE COMPANY LIMITED

Debenture Certificate - Long Term Infrastructure Bonds 2011A Series

THIS IS TO CERTIFY THAT THE PERSON(S) NAMED BELOW OR THE LAST TRANSFEREE(S) WHOSE NAME(S) IS/ARE DULY RECORDED IN THE MEMORANDUM OF TRANSFERS ON THE REVERSE HEREOF IS/ARE THE HOLDER(S) OF THE WITHIN MENTIONED DEBENTURE(S) SUBJECT TO THE MEMORANDUM AND ARTICLES OF ASSOCIATION OF THE COMPANY.

Long Term Infrastructure Bonds with a face value of Rs.1,000/- each, in the nature of Secured, Redeemable, Non-Convertible Debentures
Amount paid-up per Debenture Rs 1,000/-

Regd. Folio No. 11229522 Certificate No. 690014
Name(s) of the Holder(s) RAVISANKAR N

Series 2
No. of Debenture(s) EIGHT ONLY (*****8*****)
Distinctive Nos. 2538607-2538614

Date of Allotment 23-03-2011

Given under the Common Seal of the Company this 23RD DAY OF MARCH, 2011
THESE DEBENTURES CANNOT BE SOLD/TRANSFERRED
TILL 22.03.2016 ["LOCK-IN-PERIOD"]

L&T INFRASTRUCTURE FINANCE COMPANY LIMITED
INCORPORATED IN TAMILNADU

Director

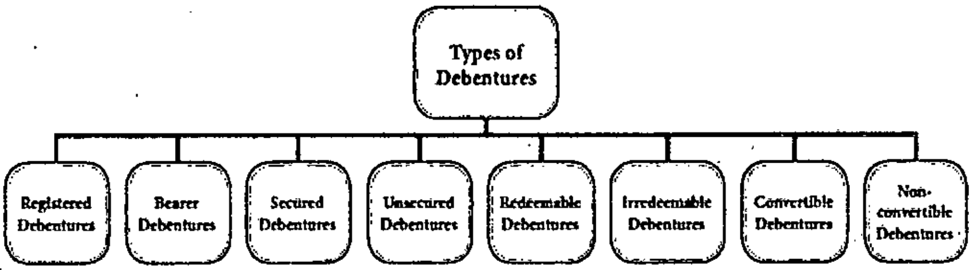
Director

Secretary / Authorised Signatory

Types of Debentures

1. **Registered Debentures:** Registered Debentures are those which are transferable only by transfer deed names, address and particulars of the debentures possessed by holders are entered in the register. Interest is paid to one whose name appears in the register.

2. **Bearer Debentures:** Bearer Debentures are those which are transferred by mere delivery and company does not keep any record of debenture holders name and address. Payment of interest is made on submission on coupons attached to the debentures.



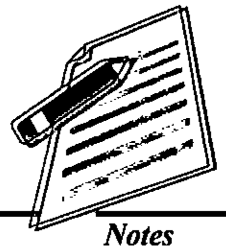
3. **Secured Debentures or Mortgage Debentures:** Mortgage debentures are those debentures that are secured either on a particular asset called fixed charge or on general assets of the company called floating charge. Mortgage debentures are also called collateral debentures. In this case, debentures may also be issued to banks and financial institutions as addition or subsidiary security along with certain principal security. Lending institutions can exercise their right as debenture-holders, if the company does not pay its loan and the principal security falls short.
4. **Un-secured or Naked Debentures:** Naked debentures are those which are not secured, companies of very good standing are able to issue Debentures of this type. They are not very common.
5. **Redeemable Debentures:** Redeemable Debentures are those debentures which are redeemed or the payment of which is made after a specified time.

   Debentures are redeemable in the following manner:

   (i) At the expiry of a specified period at par or at a premium.

   (ii) Through purchase in the open market any time, at the price prevailing in the market.

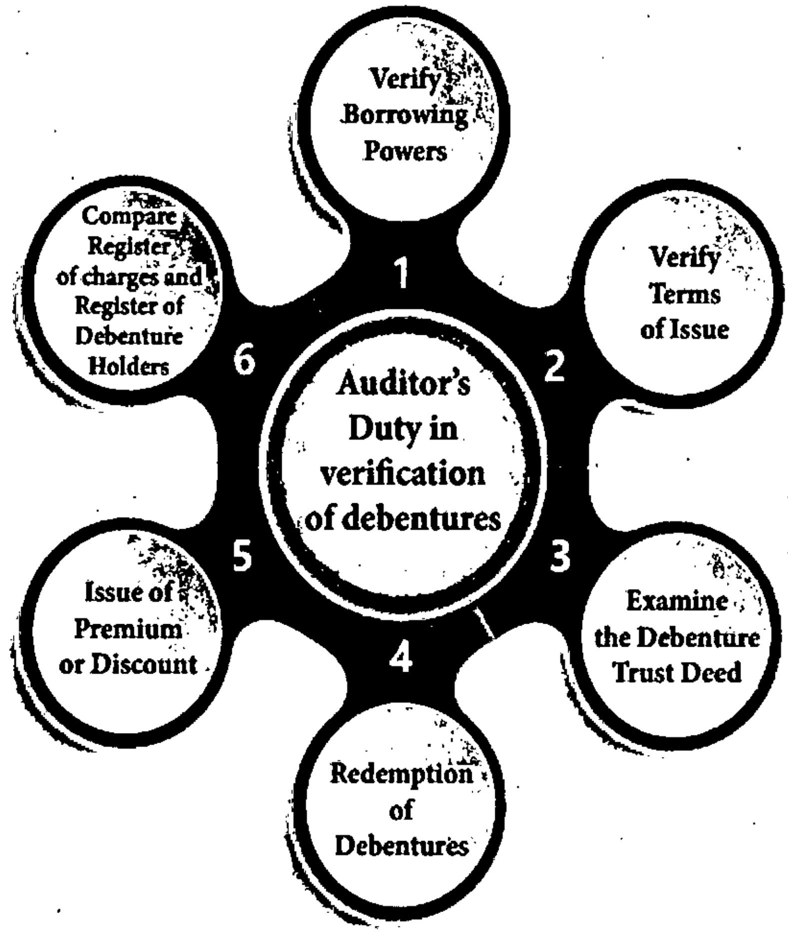
   (iii) By annual drawings.
6. **Irredeemable Debentures:** Irredeemable Debentures are those for which the issuing company does not fix any date by when they should be redeemed and the holders of such Debentures cannot demand payment from the company so long as it is going concern. Usually such Debentures are repayable after a long period of time or when the company is winding up.
7. **Convertible Debentures:** Convertible Debentures are those whose holders are given the option to convert the debentures fully or partly in to equity shares after a specified time. Those which are fully convertible are called fully Convertible Debentures and those which are partly Convertible are called partly convertible debentures.
8. **Non-convertible Debentures:** Non-convertible debentures are those whose holders have no right to convert them into equity shares.



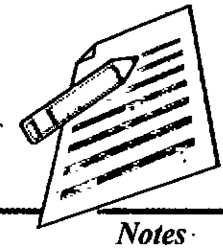
Notes

Auditor's Duty in Verification of Debentures

The auditor should note the following points while verifying debentures:



1. **Verify Borrowing Powers:** The auditor should verify the Memorandum and Articles of Association of the company and verify whether the company has got the power to issue debentures and ascertain the borrowing limits of the company.
2. **Verify Terms of Issue:** He should ensure that the terms of the issue have been complied with.
3. **Examine Debenture Trust Deed:** He should examine the Debentures Trust Deed to know the amount of debenture issued and securities offered and he should obtain a certificate from the debenture holder to confirm the debenture amount.
4. **Redemption of Debentures:** He should make an inquiry regarding Debenture redemption and verify the Articles of Association for the Debenture redemption fund.
5. **Issue at Premium or Discount:** He should examine whether premium or discount on issue of Debentures are properly disclosed in the Balance Sheet.
6. **Compare Register of Charges and Register of Debenture Holders:** He should compare the register of charges and register of debenture holders and check whether it is recorded correctly and verify that the assets mortgaged or charged are clearly indicated in the Balance Sheet.



SUMMARY

Stocks or shares are popular investment tools, issued by corporate entities through which they sell a portion of their proprietorship to general investors and raise funds through it. These are also known as scrips or owned capital. As an owner of stocks, you are holding a part of the company's financial capital. It entitles you to receive a portion of the company's profit in return.

Types of stocks are,

- – Equity shares
- – Preference shares

The price that you pay to buy shares is called share price. In return, you qualify to receive dividends as decided by the company. Profit is announced during the end of a financial year, which means, the longer you stay invested, higher will be your gain from the share.

Share prices depend on various factors, including market performance, macroeconomic parameters, sectoral performance, and individual company performance. As investment instruments, share are highly liquid and traded in the exchanges.

Debentures are debt tools; issued by companies to raise funds as loans from the public. It is an acknowledgement from a corporate entity that it has taken a loan from you. However, a debenture isn't a secured loan. It is backed solely by the creditworthiness of the issuing firm. But it carries some amount of assurance. It is why, in India, if a company declares bankruptcy, debenture holders have the first claim over the company's assets.

Like stocks, debentures also have different types, based on their intrinsic characters.

- **Perpetual Debentures:** Perpetual debentures don't have a maturity value and treated much like equities. These bonds create a lifelong stream of income for the investors, and they can trade those the market like equities.
- **Convertible Debentures:** Some corporate give the offer to receive maturity value on debenture or get it converted to equity. This allows investors to alleviate some of the uncertainties associated with investing in unsecured bonds.
- **Debentures: It** is a traditional type of bond that pays out the maturity and accrued interest at the end of the tenure without giving any opportunities to convert to equity.

Debentures can be either floating or fixed in nature. The pay out on floating rate debenture varies with the market movement. But, for fixed-rate debentures, final pay out remains assured.

Notes

EXERCISE

Multiple choice questions

1. Debenture holders are
   - A) Debtors of the Company
   - B) Creditors of the Company
   - C) External users
   - D) Owners of the Company

   Answer B

2. Debentures indicate the
   - A) Short-term Borrowings of a Company
   - B) Directors' shares in a company
   - C) The Investment of Equity-Shareholders
   - D) Long-term Borrowings of a Company

   Answer D

3. In debenture, interest payable is
   - A) Transferred to general reserve
   - B) Transferred to falling fund investment account
   - C) Charged against the firm's profits
   - D) Appropriation of the company's profits

   Answer C

4. The owner of the debenture is qualified for
   - A) Fixed-rate interest
   - B) Company's voting rights
   - C) Firm's Profits share
   - D) Fixed dividend

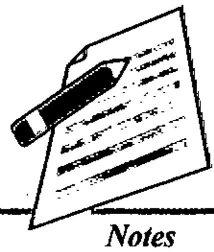
   Answer A

5. When a company is liquidated, the debenture holders have a prior right for :
   - A) principal amount
   - B) interest
   - C) both (a)and (b)
   - D) none of these

   Answer C

Review Questions

1. What do you understand by Issue of Shares
2. What are the various types of shares?
3. What is forfeited of shares and reissue of forfeited shares
4. Explain the process of Redemption of Preference Shares
5. What are the various methods of redemption of debentures
6. What are the types of debentures?



Notes

1 PREPARATION OF COMPARATIVE STATEMENTS

Objective

The basic objective of the unit is to through some light on the initial concepts of Comparative and common size financial statements. Trend analysis, Ratio analysis, Funds Flow and Cash Flow Statement have also been discussed in this unit.

Introduction

Preparation of comparative statements

A comparative statement has five columns. Following are the steps to be followed in preparation of the comparative statement:

i. Column 1: In this column, particulars of items of income statement or balance sheet are written.

ii. Column 2: Enter absolute amount of year 1.

iii. Column 3: Enter absolute amount of year 2.

iv. Column 4: Show the difference in amounts between year 1 and year 2. If there is an increase in year 2, put plus sign and if there is decrease put minus sign.

v. Column 5: Show percentage increase or decrease of the difference amount shown in column 4 by dividing the amount shown in column 4 (absolute amount of increase or decrease) by column 2 (year 1 amount). That is,

Percentage increase or decrease = [Absolute amount of increase or decrease / Year 1 amount] x 100

Format of comparative statement

Particulars	Year 1	Year 2	Absolute amount of increase (+) or decrease (-)	Percentage increase (+) or decrease (-)
	₹	₹	₹	
(1)	(2)	(3)	(4)	(5)

Illustration 1

From the following particulars, prepare comparative income statement of Tharun Co. Ltd.

Particulars	2016-17	2017-18
	₹	₹
Revenue from operations	2,00,000	2,50,000
Other income	50,000	40,000
Expenses	1,50,000	1,20,000

Solution

Comparative income statement of Tharun Co. Ltd for the years ended 31st March, 2017 and 31st March, 2018

Comparative income statement of Tharun Co. Ltd
for the years ended 31st March, 2017 and 31st March, 2018

Particulars	2016-17	2017-18	Absolute amount of increase (+) or decrease (–)	Percentage increase (+) or decrease (–)
	₹	₹	₹	
Revenue from operations	2,00,000	2,50,000	+50,000	+25
Add: Other income	50,000	40,000	–10,000	–20
Total revenue	2,50,000	2,90,000	+40,000	+16
Less: Expenses	1,50,000	1,20,000	–30,000	–20
Profit before tax	1,00,000	1,70,000	+70,000	+70

Tutorial note: Computation of percentage increase for revenue from operations

$$\frac{\text{Absolute amount of increase or decrease}}{\text{Year 1 amount}} \times 100 = \frac{50,000}{2,00,000} \times 100 = 25\%$$

Illustration 2

From the following particulars, prepare comparative income statement of Abdul Co. Ltd.

Particulars	2015-16	2016-17
	₹	₹
Revenue from operations	3,00,000	3,60,000
Other income	1,00,000	60,000
Expenses	2,00,000	1,80,000
Income tax	30%	30%

Solution

Comparative income statement of Abdul Co. Ltd for the years ended 31st March, 2016 and 31st March, 2017

Comparative income statement of Abdul Co. Ltd for the years ended 31st March, 2016 and 31st March, 2017

Particulars	2015-16	2016-17	Absolute amount of increase (+) or decrease (–)	Percentage increase (+) or decrease (–)
	₹	₹	₹	
Revenue from operations	3,00,000	3,60,000	+60,000	+20
Add: Other income	1,00,000	60,000	–40,000	–40
Total revenue	4,00,000	4,20,000	+20,000	+5
Less: Expenses	2,00,000	1,80,000	–20,000	–10
Profit before tax	2,00,000	2,40,000	+40,000	+20
Less: Tax (30%)	60,000	72,000	+12,000	+20
Profit after tax	1,40,000	1,68,000	+28,000	+20

Illustration 3

From the following particulars, prepare comparative income statement of Mary Co. Ltd.

Particulars	2015-16	2016-17
	₹	₹
Revenue from operations	4,00,000	5,00,000
Operating expenses	2,00,000	1,80,000
Income tax (% of the profit before tax)	20	50

Solution

Comparative income statement of Mary Co. Ltd for the years ended 31st March, 2016 and 31st March, 2017

Comparative income statement of Mary Co. Ltd for the years ended 31st March, 2016 and 31st March, 2017

Particulars	2015-16	2016-17	Absolute amount of increase (+) or decrease (–)	Percentage increase (+) or decrease (–)
	₹	₹	₹	
Revenue from operations	4,00,000	5,00,000	+1,00,000	+25
Less: Operating expenses	2,00,000	1,80,000	–20,000	–10
Profit before tax	2,00,000	3,20,000	+1,20,000	+60
Less: Income tax*	40,000	1,60,000	+1,20,000	+300
Profit after tax	1,60,000	1,60,000	-	-

* Note: Calculation of income tax:

For 2015-16: 2,00,000 x 20% = □ 40,000

For 2016-17: 3,20,000 x 50% = □ 1,60,000

Illustration 4

From the following balance sheet of Chandra Ltd, prepare comparative balance sheet as on 31st March 2016 and 31st March 2017.

Particulars	31st March 2016	31st March 2017
	₹	₹
I EQUITY AND LIABILITIES		
Shareholders' fund	1,00,000	2,60,000
Non-current liabilities	50,000	60,000
Current liabilities	25,000	30,000
Total	1,75,000	3,50,000
II ASSETS		
Non-current assets	1,00,000	2,00,000
Current assets	75,000	1,50,000
Total	1,75,000	3,50,000

Solution

Comparative balance sheet of Chandra Ltd as on 31st March 2016 and 31st March 2017

Particulars	2015-16	2016-17	Absolute amount of increase (+) or decrease (-)	Percentage increase (+) or decrease (-)
	₹	₹	₹	
I EQUITY AND LIABILITIES				
Shareholders' fund	1,00,000	2,60,000	+1,60,000	+160
Non-current liabilities	50,000	60,000	+10,000	+20
Current liabilities	25,000	30,000	+5,000	+20
Total	1,75,000	3,50,000	+1,75,000	+100
II ASSETS				
Non-current assets	1,00,000	2,00,000	+1,00,000	+100
Current assets	75,000	1,50,000	+75,000	+100
Total	1,75,000	3,50,000	+1,75,000	+100

Illustration 5

From the following particulars, prepare comparative balance sheet of Malar Ltd as on 31st March 2016 and 31st March 2017.

Particulars	31st March 2016	31st March 2017
	₹	₹
I EQUITY AND LIABILITIES		
1. Shareholders' fund		
a) Share capital	2,00,000	2,50,000
b) Reserves and surplus	50,000	50,000
2. Non-current liabilities		
Long-term borrowings	30,000	60,000
3. Current liabilities		
Trade payables	20,000	60,000
Total	3,00,000	4,20,000
II ASSETS		
1. Non-current assets		
a) Fixed assets	1,00,000	1,50,000
b) Non - current investments	50,000	75,000
2. Current assets		
Inventories	75,000	1,50,000
Cash and cash equivalents	75,000	45,000
Total	3,00,000	4,20,000

Solution

Comparative balance sheet of Malar Ltd as on 31st March 2016, and 31st March 2017

Particulars	2015-16	2016-17	Absolute amount of increase (+) or decrease (–)	Percentage increase (+) or decrease (–)
	₹	₹	₹	
I EQUITY AND LIABILITIES				
1. Shareholders' Fund				
a) Share capital	2,00,000	2,50,000	+50,000	+25
b) Reserves and surplus	50,000	50,000	-	-
2. Non-current liabilities				
Long-term borrowings	30,000	60,000	+30,000	+100
3. Current liabilities				
Trade payables	20,000	60,000	+40,000	+200
Total	3,00,000	4,20,000	+1,20,000	+40
II ASSETS				
1. Non-current assets				
a) Fixed assets	1,00,000	1,50,000	+50,000	+50
b) Non-current investments	50,000	75,000	+25,000	+50
2. Current assets				
Inventories	75,000	1,50,000	+75,000	+100
Cash and cash equivalents	75,000	45,000	–30,000	–40
Total	3,00,000	4,20,000	+1,20,000	+40

Preparation of common-size statements

Common-size statement can be prepared with three columns. Following are the steps to be followed in preparation of common-size statement:

(i) **Column 1:** In this column, particulars of items of income statement or balance sheet are written.

(ii) **Column 2:** Enter absolute amount.

(iii) **Column 3:** Choose a common base as 100. For example, revenue from operations can be taken as the base for income statement and total of balance sheet can be taken as the base for balance sheet. Work out the percentage for all the items of column 2 in terms of the common base and enter them in column 3.

Format of common-size statement

Particulars	Absolute amount	Percentage

Illustration 6

From the following particulars of Kumar Ltd, prepare a common-size income statement for the year ended 31st March, 2018.

Particulars	2017-18 ₹
Revenue from operations	5,00,000
Other income	20,000
Expenses	3,00,000

Solution

Common-size income statement of Kumar Ltd for the year ended 31st March, 2018

Particulars	Absolute amount ₹	Percentage of revenue from operations
Revenue from operations	5,00,000	100
Add: Other income	20,000	4
Total revenue	5,20,000	104
Less: Expenses	3,00,000	60
Profit before tax	2,20,000	44

Note: Computation of percentage for other income

[20,000/ 5,00,000] x 100 = 4%

Illustration 7

From the following particulars of Mani Ltd an Kani Ltd prepare a common-size income statement for the year ended 31st March, 2019.

Particulars	Mani Ltd	Kani Ltd
	₹	₹
Revenue from operations	2,00,000	2,50,000
Other income	30,000	25,000
Expenses	1,10,000	1,25,000

Solution

Common-size income statement for the year ended 31st March, 2019

Particulars	Mani Ltd		Kani Ltd	
	Absolute amount	Percentage of revenue from operations	Absolute amount	Percentage of revenue from operations
	₹		₹	
Revenue from operations	2,00,000	100	2,50,000	100
Add: Other income	30,000	15	25,000	10
Total revenue	2,30,000	115	2,75,000	110
Less: Expenses	1,10,000	55	1,25,000	50
Profit before tax	1,20,000	60	1,50,000	60

Illustration 8

From the following particulars of Siva Ltd, prepare common size income statement for the years ended 31st March, 2016 and 31st March, 2017.

Particulars	2015-16	2016-17
	₹	₹
Revenue from operations	2,00,000	3,00,000
Other income	25,000	75,000
Expenses	2,50,000	1,50,000
Income tax %	40	40

Solution

Common–size income statement of Siva Ltd for the year ended 31st March, 2016 and 31st March, 2017

Common-size income statement of Siva Ltd
for the year ended 31st March, 2016 and 31st March, 2017

Particulars	Absolute amount 2015-16	Percentage of revenue from operations for 2015-16	Absolute amount 2016-17	Percentage of revenue from operations for 2016-17
	₹		₹	
Revenue from operations	2,00,000	100.00	3,00,000	100
Add: Other income	25,000	12.50	75,000	25
Total revenue	2,25,000	112.50	3,75,000	125
Less: Expenses	2,50,000	125.00	1,50,000	50
Profit / loss before tax	-25,000	-12.50	2,25,000	75
Less: Income tax (40%)	-	-	90,000	30
Profit after tax	-25,000	-12.50	1,35,000	45

Illustration 9

Prepare common-size balance sheet of Maria Ltd. as on 31st March, 2018.

Particulars	31st March 2018
	₹
I EQUITY AND LIABILITIES	
Shareholders' funds	4,00,000
Non-current liabilities	3,20,000
Current liabilities	80,000
Total	8,00,000
II ASSETS	
Non-current assets	6,00,000
Current assets	2,00,000
Total	8,00,000

Solution

Particulars	Absolute amount	Percentage of total assets
	₹	
I EQUITY AND LIABILITIES		
Shareholders' funds	4,00,000	50
Non-current liabilities	3,20,000	40
Current liabilities	80,000	10
Total	8,00,000	100
II ASSETS		
Non-current assets	6,00,000	75
Current assets	2,00,000	25
Total	8,00,000	100

Illustration 10

Prepare common-size balance sheet of Sharmila Ltd. and Sangeetha Ltd. as on 31st March, 2019.

Particulars	Sharmila Ltd	Sangeetha Ltd
	₹	₹
I EQUITY AND LIABILITIES		
Shareholders' funds	5,00,000	11,00,000
Non-current liabilities	4,00,000	7,00,000
Current liabilities	1,00,000	2,00,000
Total	10,00,000	20,00,000
II ASSETS		
Non-current assets	6,50,000	18,00,000
Current assets	3,50,000	2,00,000
Total	10,00,000	20,00,000

Solution

Common-size balance sheet of Sharmila Ltd and Sangeetha Ltd as on 31st March, 2019

Particulars	Sharmila Ltd		Sangeetha Ltd	
	Absolute amount ₹	Percentage of total assets	Absolute amount ₹	Percentage of total assets
I EQUITY AND LIABILITIES				
Shareholders' funds	5,00,000	50	11,00,000	55
Non-current liabilities	4,00,000	40	7,00,000	35
Current liabilities	1,00,000	10	2,00,000	10
Total	10,00,000	100	20,00,000	100
II ASSETS				
Non-current assets	6,50,000	65	18,00,000	90
Current assets	3,50,000	35	2,00,000	10
Total	10,00,000	100	20,00,000	100

Cash Flow Statement

As prescribed by the Accounting standard -3, there are two methods which can be used to prepare cash flow statements:

A. Indirect method

B. Direct method

Whichever method be used, the end result under all three activities i.e., operating, investing and financing will be the same.

1. Preparation under Indirect method:

I. Operating Activities

The cash flow from operating activities are derived under two stages;

A. Calculating the operating profit before changes in working capital

B. The effect of changes in working capital

Stage 1: Operating profit before changes in working capital can be calculated as follows:

Net profit before Tax and extra ordinary Items	xxx	
Add: Non-cash and non-operating Items which have already been debited to profit and Loss Account like;		
Depreciation	xxx	
Amortisation of intangible assets	xxx	
Loss on the sale of Fixed assets	xxx	
Loss on the sale of Long-term Investments	xxx	
Provision for tax	xxx	
Dividend paid	xxx	xxx
Less: Non-cash and Non-operating Items which have already been credited to Profit and Loss Account like		
Profit on sale of fixed assets	xxx	
Profit on sale of Long-term investment	xxx	xxx
Operating profit before working Capital changes		xxx

Stage 2: Effect of changes in Working Capital is to be taken into as follows:

a. Current Assets

i. An increase in an item of current assets causes a decrease in cash inflow because cash is blocked in current assets

ii. A decrease in an item of current assets causes an increase in cash inflow because cash is released from the sale of current assets

b. Current Liabilities

i. An increase in an item of current liability causes a decrease in cash outflow because cash is saved

ii. A decrease in an item of current liability causes an increase in cash outflow because of payment of the liability

Thus, in a nutshell

Cash from operating activities = Operating profit before working capital changes + Net decrease in current assets + Net Increase in current liabilities – Net increase in current assets – Net decrease in current liabilities

II. Investing Activities

The cash flow from investing activities is derived by adding all the cash inflows from the sale or maturity of assets and subtracting all the cash outflows from the purchase or payment for new fixed assets or investments.

Cash flow arising from Investing activities typically are:

i. Cash payments to acquire Fixed Asset
ii. Cash receipts from disposal of fixed asset
iii. Cash payments to acquire shares or debenture investment
iv. Cash receipts from the repayment of advances and loans made to third parties

Furthermore,

Examples of Cash inflow from investing activities are:

i. Cash sale of plant and machinery, land and Building, furniture, goodwill etc.
ii. Cash sale of investments made in the shares and debentures of other companies
iii. Cash receipts from collecting the Principal amount of loans made to third parties

Examples of Cash outflow from investing activities are:

i. Purchase of fixed assets i.e., land, Building, furniture, machinery etc.
ii. Purchase of Intangible assets i.e., goodwill, trademark etc.
iii. Purchase of shares and debentures
iv. Purchase of Government Bonds
v. Loan made to third parties

III. Financing activities

Cash flows from financing activities are the cash paid and received from activities with non-current or long-term liabilities and shareholder's capital.

Cash flow arising from Financing activities typically are:

1. Cash proceeds from the issue of shares or other similar instruments
2. Cash proceeds from the issue of debentures, loans, notes, bonds, and other short-term borrowings
3. Cash repayment of the amount borrowed

Examples of cash inflow from financing activities are:

i. The issue of Equity and preference share capital for cash only
ii. The issue of Debentures, Bonds and long-term note for cash only

Examples of cash outflow from financing activities are:

i. Payment of dividends to shareholders
ii. Redemption or repayment of loans i.e., debentures and bonds
iii. Redemption of preference share capital
iv. Buyback of equity shares

Illustration of Indirect method:		
Net profit before Tax and extra ordinary Items	xxx	
Cash flow from Operating activities		
Add: Non-cash and non-operating Items which have already been debited to profit and Loss Account like;		
Depreciation	xxx	
Amortisation of intangible assets	xxx	
Loss on the sale of Fixed assets	xxx	
Loss on the sale of Long-term Investments	xxx	
Provision for tax	xxx	
Dividend paid	xxx	xxx
Less: Non-cash and Non-operating Items which have already been credited to Profit and Loss Account like		
Profit on sale of fixed assets	(xxx)	
Profit on sale of Long-term investment	(xxx)	(xxx)
Operating profit before working Capital changes (A)		xxx
Changes in working capital:		
Add: Increase in current liabilities	xxx	
Decrease in current assets	xxx	xxx
Less: Increase in current assets	(xxx)	

Illustration of Indirect method:		
Decrease in current liabilities	(xxx)	(xxx)
Net increase / decrease in working capital (B)		xxx
Cash generated from operations (C) = (A+B)		xxx
Less: Income tax paid (Net tax refund received) (D)		(xxx)
Cash flow from before extraordinary items (C-D) = (E)		xxx
Adjusted extraordinary items (+/–) (F)		xxx
Net cash flow from operating activities (E+F) = (G)		xxx
Cash flow from Investing activities		
Proceeds from sale of fixed assets	xxx	
Proceeds from sale of investments	xxx	
Purchase of shares/debentures/fixed assets	(xxx)	
Net cash from investing activities (H)		xxx
Cash flow from Financing activities		
Proceeds from issue of shares	xxx	
Proceeds from issue of debentures	xxx	
Payment of dividend	(xxx)	
Net cash flow from financing activities (I)		xxx
Net increase in cash and cash equivalents (G+H+I) = (J)		xxx
Cash and cash equivalents and the beginning of the period (K)		xxx
Cash and cash equivalents and the end of the period (J+K)		xxx

2. Preparation under the Direct method

The fundamentals of preparation of cash flow statement under Direct method is more or less same as in Indirect method with only a few exceptions in terms of its presentation.

Illustration of an Indirect method:

The Cash flow statement under Direct method is prepared as follows:

Cash flow from Operating activities		
Add: Operating cash receipts: (A)		
Cash sales	xxx	
Cash received from customers	xxx	
Trading commission received	xxx	
Royalties received	xxx	xxx
Less: Operating cash payments: (B)		
Cash purchase		
Cash paid to suppliers		
Cash paid for business expenses		
Cash generated from operations (A-B) = (C)		xxx
Less: Income tax paid (Net of tax refund received) (D)		
Cash flow before extraordinary items (C-D) = (E)		xxx
Adjusted extraordinary items (+/–) (F)		xxx
Net cash flow from operating activities (E-F) = (G)		xxx
Cash flow from investing activities (calculation same as under indirect method) (H)		xxx
Cash flow from financing activities (calculation same as under indirect method) (I)		xxx
Net increase in cash and cash equivalents (G+H+I) = (J)		xxx
Cash and cash equivalents and the beginning of the period (K)		xxx
Cash and cash equivalents and the end of the period (J+K)		xxx

Problem 1

The summary of cash transactions extracted from the books of Happy Ltd. are:

	(₹ '000)
Balance as on 1st April, 2015	140
Receipts from customers	11,132
Issue of shares	1,200
Sale of fixed assets	512
	12,984
Payment to suppliers	8,188
Payment for fixed assets	920
Payment for overheads	460
Wages and salaries	276
Taxation	972
Dividends	320
Repayment of bank loans	1,000
	12,136
Balance as on 31st March, 2016	848

You are required to prepare a cash flow statement of the company for the period ended 31st March, 2016 in accordance with the Indian Accounting Standard-3(Revised).

Solution:

Cash flow Statement for the period ending 31st March, 2016			(₹ '000)
(A) Cash flow from Operating Activities			
Receipts from customers		11,132	
Payment to suppliers		(8,188)	
Payment of wages and salaries		(276)	
Payment of overheads		(460)	
Payment of taxes		(972)	
Net cash from Operating Activities	(A)		1,236
(B) Cash flow from Investing Activities			
Proceeds on sale of fixed assets		512	
Acquisition of (payments) fixed assets		(920)	
Net cash used in Investing Activities	(B)		(408)
(C) Cash flow from Financing Activities			
Proceeds on issue of shares		1,200	
Payments of dividends		(320)	
Repayments of bank loans		(1,000)	
Net cash used in Financing Activities	(C)		(120)
Net increase in cash and cash equivalents	(A) + (B) + (C)		708
Cash and cash equivalents at the beginning of the period			140
Cash and cash equivalents at the end of the period			848

Problem 2:

Following information is available from the books of Standard Company Ltd.:

(₹)

Particulars	2015	2016
Profit made during the year		2,50,000
Income received in advance	500	600
Prepaid expenses	1,600	1,400
Debtors	80,000	95,000
Bills receivable	25,000	20,000
Creditors	45,000	40,000
Bills payable	13,000	15,000
Outstanding expenses	2,500	2,000
Accrued income	1,500	1,200

Calculate cash flow from operations.

Solution:

Statement Showing Cash flow from Operations		(₹)
Profit made during the year		2,50,000
Add: Decrease in Debtors	15,000	
Increase in Creditors	5,000	
Increase in Outstanding expenses	500	20,500
		2,70,500
Less: Decrease in Income received in advance	100	
Increase in Prepaid expenses	200	
Increase in Bills receivable	5,000	
Decrease in Bills payable	2,000	
Increase in Accrued income	300	7,600
Cash generated from Operations		2,62,900

Problem 3:

From the following calculate cash from operations:

Profit and Loss Account for the year ended 31st March, 2016

Particulars	₹ '000	Particulars	₹ '000
To Salaries	5,000	By Gross profit	25,000
To Rent	1,000	By Profit on sale of land	5,000
To Depreciation	2,000	By Income-tax refund	3,000
To Loss on sale of plant	1,000		
ToGoodwill written off	4,000		
To Proposed dividend	5,000		
To Provision for tax	5,000		
To Net profit	10,000		
	33,000		33,000

Solution:

Statement Showing Cash Generated From Operations		(₹ '000)
Net Profit		10,000
Add: Noncash Items:		
Depreciation	2,000	
Loss on sale of plant	1,000	
Goodwill written off	4,000	
Proposed dividend	5,000	
Provision for tax	5,000	17,000
		27,000
Less: Nonoperating income:		
Profit on sale of land	5,000	
Income-tax refund	3,000	8,000
Funds from Operations		19,000
Add: Decrease in current assets		Nil
Increase in current liabilities		
Less: Increase in current assets		Nil
Decrease in current liabilities		
Cash generated from Operations		19,000

Problem 4:

Swastik Oils Ltd. has furnished the following information for the year ended 31 st March, 2016:

	(₹ lakhs)
Net profit	37,500.00
Dividend (including interim dividend paid)	12,000.00
Provision for income-tax	7,500.00
Income-tax paid during the year	6,372.00
Loss on sale of assets (net)	60.00
Book value of assets sold	277.50
Depreciation charged to Profit &Loss Account	30,000.00
Profit on sale of investments	150.00
Value of investments sold	41,647.50
Interest income on investments	3,759.00
Interest expenses	15,000.00
Interest paid during the year	15,780.00
Increase in working capital (excluding cash and bank balance)	84,112.50
Purchase of fixed assets	21,840.00
Investments in joint venture	5,775.00
Expenditure on construction work-in-progress	69,480.00
Proceeds from long-term borrowings	38,970.00
Proceeds from short-term borrowings	30,862.50
Opening cash and bank balances	11,032.50
Closing cash and bank balances	2,569.50

You are required to prepare the cash flow statement in accordance with IAS-3 for the year ended 31st March, 2016. (Make assumption wherever necessary).

Solution:

Cash flow Statement of Swastik Oils Ltd. for the year ended 31st March, 2016 (₹ lakhs)

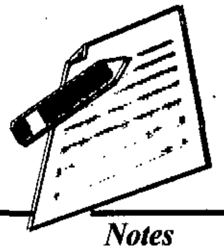
(A) Cash flows from Operating Activities		
Net profit before taxation (37,500 + 7,500)		45,000.00
Adjustment for:		
Depreciation charged to P&L A/c		30,000.00
Loss on sale of assets (net)		60.00
Profit on sale of investments		(150.00)
Interest income on investments		(3,759.00)
Interest expenses		15,000.00
Operating profit before working capital changes		86,151.00
Increase (change) in working capital (excluding cash and bank balance)		(84,112.50)
Cash generated from operations		2,038.50
Income tax paid		(6,372.00)
Net cash used in Operating Activities	(a)	(4,333.50)
(B) Cash flow from Investing Activities		
Sale of assets (277.50 - 60.00)		217.50
Sale of investments (41,647.50 + 150)		41,797.50
Interest income on investments (assumed)		3,759.00
Purchase of fixed assets		(21,840.00)
Investments in joint venture		(5,775.00)
Expenditure on construction work-in-progress		(69,480.00)
Net cash used in Investing Activities	(b)	(51,321.00)
(C) Cash flow from Financing Activities		
Proceeds from long-term borrowings		38,970.00
Proceeds from short-term borrowings		30,862.50
Interest paid		(15,780.00)
Dividends (including interim dividend paid)		(12,000.00)
Net cash from Financing Activities	(c)	42,052.50
Net increase in cash and cash equivalents	(a) + (b) + (c)	(13,602.00)
Cash and cash equivalents at the beginning of the year		11,032.50
Cash and cash equivalents at the end of the year		2,569.50

Problem 5:

The following data is available from the books of Jupiter Ltd.:

(₹)

Balance Sheet as on	31-3-2015	31-3-2016
Assets		
Land and buildings	8,00,000	8,55,000
Furniture, fixtures and fittings	90,000	76,500
Stock	5,32,500	5,96,300
Debtors	1,87,300	1,84,200
Cash in hand	18,200	13,400
Cash at bank	1,15,200	1,62,000
Bills receivable	30,000	50,000
Advance payment of Income-tax	2,55,000	2,70,000
Preliminary expenses	21,000	14,000
	20,49,200	22,21,400
Liabilities		
Equity share capital	10,00,000	11,00,000
Securities premium	-	30,000
General reserve	4,00,000	5,01,000
Bills payable	60,000	20,000
Creditors	2,07,200	1,57,400
Outstanding expenses	30,000	35,000
Provision for Income-tax	2,52,000	2,68,000
Proposed dividend	1,00,000	1,10,000
	20,49,200	22,21,400



Notes

Profit and Loss Account for the year ended 31st March, 2016	(₹)
Sales	46,37,200
Cost of goods sold	(37,21,200)
Gross profit	9,16,000
Sundry operating expenses	(3,17,500)
Depreciation on land and buildings	(45,000)
Depreciation on furniture, fixtures and fittings	(8,500)
Loss on disposal of furniture	(2,000)
Preliminary expenses amortised	(7,000)
Net profit before Income-tax	5,36,000
Provision for Income-tax	(2,68,000)
Net profit after Income-tax	2,68,000
Provision for Income-tax (2014-15)	(2,000)
Interim dividend	(55,000)
Proposed dividend	(1,10,000)
Transfer to general reserve	(1,01,000)
	Nil

Additional Information:

(i) Liability for income-tax for the accounting year 2014-15 was fixed at Rs.2,54,000 and hence, a refund of Rs.1,000 was received out of the advance tax paid for that year.

(ii) Book value of furniture sold during the year was Rs.5,000.

You are required to prepare a Cash flow statement for the year ended 31st March, 2016.

Solution:

(i) Cash Receipts from Customers:

		(₹)
Sales		46,37,200
Add: Debtors at the beginning	1,87,300	
Bills receivable at the beginning	30,000	2,17,300
		48,54,500
Less: Debtors at the end	1,84,200	
Bills receivable at the end	50,000	2,34,200
Cash receipts from Customers		46,20,300

(ii) Cash Paid to Suppliers and Employees:

		(₹)
Cost of Goods Sold		37,21,200
Add: Sundry operating expenses		3,17,500
		40,38,700
Add: Stock at the end	5,96,300	
Creditors at the beginning	2,07,200	
Bills payable at the beginning	60,000	
Outstanding expenses at the beginning	30,000	8,93,500
		49,32,200
Less: Stock at the beginning	5,32,500	
Creditors at the end	1,57,400	
Bills payable at the end	20,000	
Outstanding expenses at the end	35,000	7,44,900
Cash paid to Suppliers and Employees		41,87,300

Notes

(iii) Tax Paid:

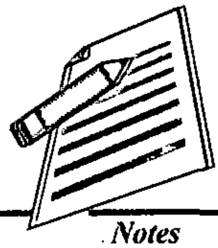
	(₹)
Advance tax paid during the year	2,70,000
Less: Refund of previous year	1,000
Total Income-tax paid	2,69,000

(iv) Purchase of Land and Building:

	(₹)
Balance on 31-3-2016	8,55,000
Add: Depreciation	45,000
	9,00,000
Less: Balance on 31-3-2015	8,00,000
Purchase of Land and Buildings	1,00,000

Cash flow Statement of Jupiter Ltd. for the year ended 31-3-2016 (Direct Method)		(₹)
Cash flows from Operating Activities		
Cash receipts from customers		46,20,300
Cash paid to suppliers and employees		(41,87,300)
Cash flow from operations		4,33,000
Advance income tax paid (net)		(2,69,000)
Net Cash Inflow from Operating Activities	(a)	1,64,000
Cash flows from Investing Activities		
Purchase of land and building		(1,00,000)
Sale of furniture		3,000
Net Cash Outflow in Investing Activities	(b)	(97,000)
Cash flows from Financing Activities		
Issue of equity shares at premium		1,30,000
Dividend paid (final)		(1,00,000)
Interim dividend paid		(55,000)
Net Cash Outflow in Financing Activities	(c)	(25,000)
Net Increase in Cash and Cash equivalents during the period	(a) - (b) - (c)	42,000
Cash and Cash equivalents at the beginning		1,33,400
Cash and Cash equivalents at the end		1,75,400

Cash flow Statement of Jupiter Ltd. for the year ended 31-3-2016 (Indirect Method)		(₹)
Cash flows from Operating Activities		
Net profit before tax and extraordinary items		5,36,000
Adjustments for:		
Depreciation on land and buildings		45,000
Depreciation on furniture, fixtures and fittings		8,500
Loss on disposal of furniture		2,000
Preliminary expenses amortised		7,000
Operating profit before working capital changes		5,98,500
Adjustments for:		
Increase in stock		(63,800)
Decrease in debtors		3,100
Increase in bills receivable		(20,000)
Decrease in bills payable		(40,000)
Decrease in creditors		(49,800)
Increase in outstanding expenses		5,000
Cash flow from operations		4,33,000
Advance Income-tax paid (net)		(2,69,000)
Net Cash Inflow from Operating Activities	(a)	1,64,000
Cash flows from Investing Activities		
Purchase of land and building		(1,00,000)
Sale of furniture		3,000
Net Cash Outflow in Investing Activities	(b)	(97,000)
Cash flows from Financing Activities		
Issue of equity shares at premium		1,30,000
Dividend paid (final)		(1,00,000)
Interim dividend paid		(55,000)
Net Cash Outflow in Financing Activities	(c)	(25,000)
Net Increase in Cash and Cash equivalents during the period	(a + b + c)	42,000
Cash and Cash equivalents at the beginning		1,33,400
Cash and Cash equivalents at the end		1,75,400



Classification of ratios

Ratios may be classified in the following two ways:

- Traditional classification
- Functional classification

1. Traditional classification

Traditional classification of ratios is done on the basis of the financial statements from which the ratios are calculated. Under the traditional classification, the ratios are classified as: (i) Balance sheet ratios, (ii) Income statement ratios and (iii) Inter-statement ratios.

Figure 9.1 shows some of the examples of ratios as per traditional classification:

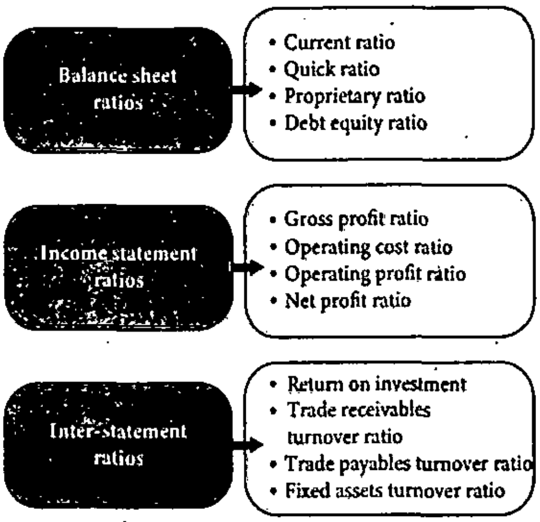


Figure 9.1 Traditional classification of ratios

(i) Balance sheet ratio

'If both items in a ratio are from balance sheet, it is classified as balance sheet ratio.

(ii) Income statement ratio

If the two items in a ratio are from income statement, it is classified as income statement ratio.

(iii) Inter-statement ratio

If a ratio is computed with one item from income statement and another item from balance sheet, it is called inter-statement ratio.

2. Functional classification

Functional classification of ratios is based on the purpose for which ratios are computed and it is the most commonly used classification. Under the functional classification, the ratios are classified as follows:

Notes

(i) Liquidity ratios
(ii) Long term solvency ratios
(iii)Turnover ratios
(iv)Profitability ratios

Figure 9.2 shows some of the examples of ratios as per functional classification:

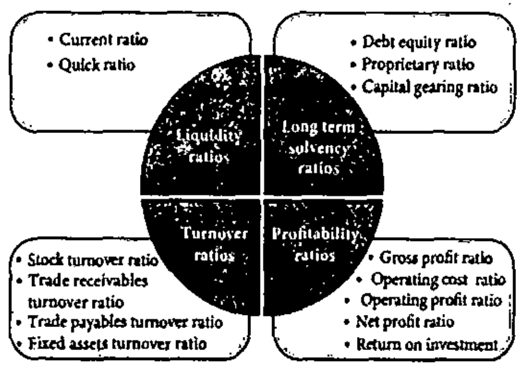


Figure 9.2 Functional classification of ratios

Liquidity ratios

Liquidity means capability of being converted into cash with ease. Liquidity ratios help to assess the ability of a business concern to meet its short-term financial obligations. Short term assets (current assets) are more liquid as compared to long term assets (fixed assets). Liquidity ratios are also called as short-term solvency ratios.

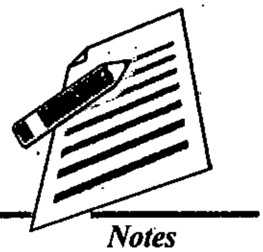
Liquidity ratios include: (i) Current ratio and (ii) Quick ratio.

(i) Current ratio

Current ratio gives the proportion of current assets to current liabilities of a business concern. It is computed by dividing current assets by current liabilities. Current ratio indicates the ability of an entity to meet its current liabilities as and when they are due for payment. It is calculated as follows:

$$\text{Current ratio} = \frac{\text{Current assets}}{\text{Current liabilities}}$$

Current assets	Current liabilities
Current assets are those assets that are either in the form of cash or cash equivalents or can be converted into cash or cash equivalents in a short time, that is, within a year or within the period of an operating cycle.	Current liabilities are those liabilities which are repayable in short time, that is, within a year or within the period of an operating cycle.
Current assets include (i) Current investments (ii) Inventories (stock) (iii) Trade receivables (Bills receivable and sundry debtors less provision for doubtful debts) (iv) Cash and cash equivalents (Cash in hand, cash at bank, etc.) (v) Short-term loans and advances given (vi) Other current assets (Prepaid expenses, accrued income, etc)	**Current liabilities include** (i) Short-term borrowings (ii) Trade payables (Bills payable and sundry creditors) (iii) Other current liabilities (Expenses payable, income received in advance, etc.) (iv) Short-term provisions



Notes

Higher the current ratio, the better is the liquidity position, as the firm will be in a better position to pay its current liabilities. However, a much higher ratio may indicate inefficient investment policies of the management.

Illustration 1

Calculate current ratio from the following information:

Particulars	₹	Particulars	₹
Current investments	80,000	Trade creditors	1,60,000
Inventories	1,60,000	Bills payable	1,00,000
Trade receivables	4,00,000	Expenses payable	1,40,000
Cash and cash equivalents	1,20,000		
Prepaid expenses	40,000		

Solution

$$\text{Current ratio} = \frac{\text{Current assets}}{\text{Current liabilities}} = \frac{8,00,000}{4,00,000} = 2:1$$

Current assets = Current investments + Inventories + Trade receivables + Cash and cash equivalents + Prepaid expenses

= 80,000 + 1,60,000 + 4,00,000 + 1,20,000 + 40,000 = □ 8,00,000

Current liabilities = Trade creditors +Bills payable + Expenses payable

= 1,60,000 + 1,00,000 + 1,40,000 = □ 4,00,000

(ii) Quick ratio

Quick ratio gives the proportion of quick assets to current liabilities. It indicates whether the business concern is in a position to pay its current liabilities as and when they become due, out of its quick assets. Quick assets are current assets excluding inventories and prepaid expenses. It is otherwise called liquid ratio or acid test ratio. It is calculated as follows:

Quick ratio = Quick assets / Current liabilities

$$\text{Quick ratio} = \frac{\text{Quick assets}}{\text{Current liabilities}}$$

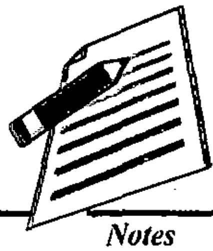
Quick assets = Current assets – Inventories – Prepaid expenses

Higher the quick ratio, better is the short-term financial position of an enterprise.

Illustration 2

Calculate quick ratio of Ananth Constructions Ltd from the information given below.

Particulars	₹
Total current liabilities	1,00,000
Total current assets	2,50,000
Inventories	50,000
Prepaid expenses	15,000



Notes

Solution

$$\text{Quick ratio} = \frac{\text{Quick assets}}{\text{Current liabilities}} = \frac{1,85,000}{1,00,000} = 1.85:1$$

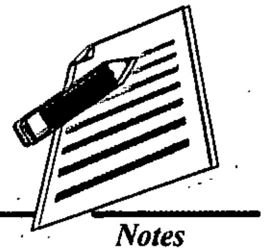
Quick assets = Current assets – Inventories – Prepaid expenses
= 2,50,000 – 50,000 – 15,000
= □ 1,85,000

Illustration 3

Following is the balance sheet of Magesh Ltd. as on 31st March, 2019:

Particulars	₹
I EQUITY AND LIABILITIES	
1. Shareholders' funds	
Equity share capital	2,00,000
2. Non-current liabilities	
Long term borrowings	50,000
3. Current liabilities	
(a) Short-term borrowings	17,000
(b) Trade payables	25,000
(c) Other current liabilities	
Expenses payable	3,000
(d) Short-term provisions	5,000
Total	**3,00,000**
II ASSETS	**₹**
1. Non-current assets	
Fixed assets	
(a) Tangible assets	1,50,000
2. Current assets	
(a) Inventories	45,000
(b) Trade receivables	70,000
(c) Cash and cash equivalents	30,000
(d) Other current assets	
Prepaid expenses	5,000
Total	**3,00,000**

Calculate: (i) Current ratio (ii) Quick ratio



Solution

(i) Current ratio = Current assets/Current liabilities = 1,50,000/50,000 = 3:1

Current assets = Inventories + Trade receivables + Cash and cash equivalents + Prepaid expenses

= 45,000 + 70,000 + 30,000 + 5,000 = □ 1,50,000

Current liabilities = Short term borrowings + Trade payables + Expenses payable + Short term provisions

= 17,000 + 25,000 + 3,000 + 5,000 = □ 50,000

(ii) Quick ratio = Quick assets / Current liabilities

= 1,00,000/50,000 = 2:1

Quick assets = Total current assets – Inventories – Prepaid expenses

= 1,50,000 – 45,000 – 5,000 = □ 1,00,000

Long term solvency ratios

Long term solvency means the firm's ability to meet its liabilities in the long run. Long term solvency ratios help to determine the ability of the business to repay its debts in the long run. The following ratios are normally computed for evaluating long term solvency of the business:

- Debt equity ratio
- Proprietary ratio
- Capital gearing ratio

(i) Debt equity ratio

Debt equity ratio is calculated to assess the long-term solvency position of a business concern.

Debt equity ratio expresses the relationship between long term debt and shareholders' funds.

It is computed as follows:

Debt equity ratio = Long term debt / Shareholders' funds

$$\text{Debt equity ratio} = \frac{\text{Long term debt}}{\text{Shareholders' funds}}$$

Long term debt	**Shareholders' funds**
Long term debt includes debentures, bonds, long term loans and other long term borrowings.	Shareholders' funds = Equity share capital + Preference share capital + Reserves and surplus

In general, lower the debt equity ratio, lower is the risk to the long-term lenders. A high ratio indicates high risk as it may be difficult for the business concern to meet the obligation to outsiders.

Notes

Illustration 4

From the following information, calculate debt equity ratio:

Balance sheet (Extract) as on 31.03.2018

Particulars	₹
I EQUITY AND LIABILITIES	
1. Shareholders' funds	
(a) Share capital	
Equity share capital	1,00,000
(b) Reserves and surplus	60,000
2. Non-current liabilities	
Long-term borrowings (Debentures)	80,000
3. Current liabilities	
(a) Trade payables	50,000
(b) Other current liabilities	
Outstanding expenses	30,000
Total	3,20,000

Solution

Debt equity ratio = Long term debt/Shareholders'funds = 80,000/1,60,000 = 0.5:1

Long term debt = Debentures = □ 80,000

Shareholders' funds = Equity share capital + Reserves and surplus

= 1,00,000 + 60,000 = □ 1,60,000

(ii) Proprietary ratio

Proprietary ratio gives the proportion of shareholders' funds to total assets. Proprietary ratio shows the extent to which the total assets have been financed by the shareholders' funds. It is calculated as follows:

$$\text{Proprietary ratio} = \frac{\text{Shareholders' funds}}{\text{Total assets}}$$

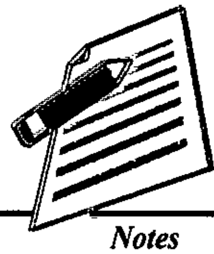
Higher the proprietary ratio, greater is the satisfaction for lenders and creditors, as the firm is less dependent on external sources of finance.

Illustration 5

From the following Balance Sheet of Pioneer Ltd. calculate proprietary ratio:

Balance sheet of Pioneer Ltd. as on 31.3.2019

Particulars	₹
I EQUITY AND LIABILITIES	
1. Shareholders' funds	
(a) Share capital	
(i) Equity share capital	1,00,000
(ii) Preference share capital	75,000
(b) Reserves and surplus	25,000
2. Non-current liabilities	
Long-term borrowings	
3. Current liabilities	
Trade payables	2,00,000
Total	4,00,000
II ASSETS	
1. Non-current assets	
(a) Fixed assets	2,75,000
(b) Non-current investments	50,000
2. Current assets	
Cash and Cash equivalents	75,000
Total	4,00,000



Notes

Solution

Proprietary ratio = Shareholders' funds / Total assets = 2,00,000 / 4,00,000 = 0.5:1

Shareholders' funds = Equity share capital + Preference share capital + Reserves and surplus

= 1,00,000 + 75,000 + 25,000

= □ 2,00,000

(iii) Capital gearing ratio

Capital gearing ratio is the proportion of fixed income bearing funds to equity shareholders' funds. Fixed income bearing funds include fixed interest and fixed dividend bearing funds. It is calculated as follows:

Capital gearing ratio = Equity shareholders' funds / Funds bearing Fixed interest or Fixed dividend

$$\text{Capital gearing ratio} = \frac{\text{Funds bearing fixed interest or fixed dividend}}{\text{Equity shareholders' funds}}$$

Funds bearing fixed interest or fixed dividend	Equity shareholders' funds
Preference share capital Debentures Bonds Long term borrowings carrying fixed interest	Equity shareholders' funds = Equity share capital + Reserves and surplus

Capital gearing ratio is a measure of long-term solvency as well as capital structure. When the capital gearing ratio is greater than one, the firm is said to be high geared.

Illustration 6

From the following information calculate capital gearing ratio:

Balance Sheet (Extract) as on 31.03.2018

Particulars	₹
I EQUITY AND LIABILITIES	
1. Shareholders' funds	
(a) Share capital	
Equity share capital	2,00,000
6% Preference share capital	1,00,000
(b) Reserves and surplus	
General reserve	1,25,000
Surplus	75,000
2. Non-current liabilities	
Long-term borrowings (8% Debentures)	2,00,000
3. Current liabilities	
Trade payables	1,50,000
Provision for tax	50,000
Total	**9,00,000**

$$\text{Capital gearing ratio} = \frac{\text{Funds bearing fixed interest and fixed dividend}}{\text{Equity shareholders' funds}}$$

$$= \frac{3,00,000}{4,00,000} = 0.75:1$$

Funds bearing fixed interest and dividend = 6% Preference share capital + 8% Debentures

= 1,00,000 + 2,00,000 = □ 3,00,000

Equity shareholder's funds = Equity share capital + General reserve + Surplus

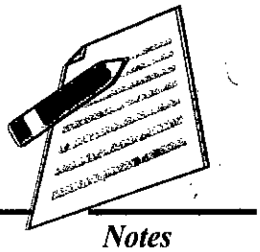
= 2,00,000 + 1,25,000 + 75,000 = □ 4,00,000

Illustration 7

From the following Balance Sheet of Arunan Ltd. as on 31.03.2019 calculate (i) Debt-equity ratio (ii) Proprietary ratio and (iii) Capital gearing ratio.

Balance Sheet of Arunan Ltd. as on 31.03.2019

Particulars	₹
I EQUITY AND LIABILITIES	
1. Shareholders' funds	
(a) Share capital	
Equity share capital	1,50,000
8% Preference share capital	2,00,000
(b) Reserves and surplus	1,50,000
2. Non current liabilities	
Long term borrowings (9% Debentures)	4,00,000
3. Current liabilities	
Short-term borrowings from banks	25,000
Trade payables	75,000
Total	10,00,000
II ASSETS	
1. Non-current assets	
Fixed assets	7,50,000
2. Current assets	
(a) Inventories	1,20,000
(b) Trade receivables	1,00,000
(c) Cash and cash equivalents	27,500
(d) Other current assets	
Expenses paid in advance	2,500
Total	**10,00,000**



Notes

Solution

(i) Debt equity ratio $= \dfrac{\text{Long term debt}}{\text{Shareholders' funds}} = \dfrac{4,00,000}{5,00,000} = 0.8:1$

Long term debt = 9% Debentures = ₹ 4,00,000

Shareholders' funds = Equity share capital + Preference share capital + Reserves and surplus

= 1,50,000 + 2,00,000 + 1,50,000 = ₹ 5,00,000

(ii) Proprietary ratio $= \dfrac{\text{Shareholders' funds}}{\text{Total assets}} = \dfrac{5,00,000}{10,00,000} = 0.5:1$

(iii) Capital gearing ratio $= \dfrac{\text{Funds bearing fixed interest and dividend}}{\text{Equity Shareholders' funds}} = \dfrac{6,00,000}{3,00,000} = 2:1$

Funds bearing fixed interest or dividend = 8% Preference share capital + 9% Debentures

= 2,00,000 + 4,00,000 = □ 6,00,000

Equity shareholders' funds = Equity share capital + Reserves and surplus

= 1,50,000 + 1,50,000 = □ 3,00,000

Turnover ratios

Turnover ratios show how efficiently assets or other items have been used to generate revenue from operations. They are also called as activity ratios or efficiency ratios. They show the speed of movement of various items. They are expressed as number of times in relation to the item compared.

The important turnover ratios are:

- Inventory turnover ratio
- Trade receivables turnover ratio
- Trade payables turnover ratio
- Fixed assets turnover ratio

(i) Inventory turnover ratio

It indicates the number of times inventory is turned over to make revenue from operations (sales) during a particular accounting period. It is a comparison of cost of revenue from operations (cost of goods sold) with average amount of inventory during a given period. It is calculated as under:

Inventory turnover ratio = Cost of revenue from operations / Average inventory

$$\text{Inventory turnover ratio} = \frac{\text{Cost of revenue from operations}}{\text{Average inventory}}$$

Cost of revenue from operations = Purchases of stock in trade + Changes in inventories of finished goods + Direct expenses

(or)

= Revenue from operations – Gross profit

Tutorial note

Revenue from operations is the net sales.

Changes in inventory = Opening inventory – Closing inventory

Direct expenses = Wages + Carriage inwards + Freight inwards + Dock charges + Octroi + Import duty + Coal, gas, fuel and power + Other direct expenses

Average inventory = [Opening inventory + Closing inventory] / 2

$$\text{Average inventory} = \frac{\text{Opening inventory} + \text{Closing inventory}}{2}$$

Cost of revenue from operations is taken because the inventory is always valued at cost except when net realisable value is lower than cost, it is valued at net realisable value. Greater the inventory turnover ratio, greater is the efficiency in the movement of stock. However, high inventory turnover ratio may also be due to insufficient inventory, buying in small quantities, etc. Similarly, a low inventory turnover ratio may be due to inclusion of obsolete items in inventory, etc. Hence, inventory turnover ratio must be analysed together with the related items.

Tutorial note

In the absence of opening inventory, closing inventory can be taken instead of average inventory.

Inventory conversion period

Inventory conversion period is the time taken to sell the inventory. A shorter inventory conversion period indicates more efficiency in the management of inventory. It is computed as follows:

$$\begin{array}{c}\text{Inventory conversion period} \\ \text{(in days)}\end{array} = \frac{\text{Number of days in a year}}{\text{Inventory turnover ratio}}$$

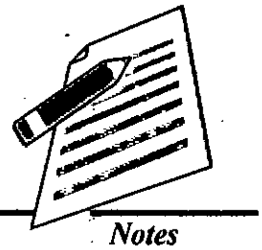
$$\begin{array}{c}\text{Inventory conversion period} \\ \text{(in months)}\end{array} = \frac{\text{Number of months in a year}}{\text{Inventory turnover ratio}}$$

Inventory conversion period (in days) = Number of days in a year / Inventory turnover ratio

Inventory conversion period (in months) = Number of months in a year / Inventory turnover ratio

Illustration 8

From the given information calculate the inventory turnover ratio and inventory conversion period (in months) of Sania Ltd.



Particulars	₹
Revenue from operations	1,90,000
Inventory at the beginning of the year	40,000
Inventory at the end of the year	20,000
Purchases made during the year	90,000
Carriage inwards	10,000

Solution

$$\text{Inventory turnover ratio} = \frac{\text{Cost of revenue from operations}}{\text{Average inventory}}$$

$$= \frac{1,20,000}{30,000} = 4 \text{ times}$$

Cost of revenue from operations

= Opening inventory + Net Purchases + Direct expenses (carriage inwards) – Closing inventory

= 40,000 + 90,000 + 10,000 – 20,000

= □ 1,20,000

$$\text{Average inventory} = \frac{\text{Opening inventory + Closing inventory}}{2}$$

$$= \frac{40,000 + 20,000}{2} = ₹\,30,000$$

$$\text{Inventory conversion period (in months)} = \frac{\text{Number of months in a year}}{\text{Inventory turnover ratio}}$$

$$= \frac{12}{4} = 3 \text{ months}$$

(ii) Trade receivables turnover ratio

Trade receivables turnover ratio is the comparison of credit revenue from operations with average trade receivables during an accounting period. It gives the velocity of collection of cash from trade receivables. It is calculated as follows:

$$\text{Trade receivables turnover ratio} = \frac{\text{Credit revenue from operations}}{\text{Average trade receivables}}$$

$$\text{Average trade receivables} = \frac{\text{Opening trade receivables + Closing trade receivables}}{2}$$

Trade receivables = Trade debtors + Bills receivable

Trade receivables turnover ratio = Credit revenue from operations / Average trade receivables

Average trade receivables = [Opening trade receivables + Closing trade receivables] / 2

Trade receivables = Trade debtors + Bills receivable

Credit revenue from operations (net credit sales) is taken for trade receivables turnover ratio as trade receivables arise only from credit sales. Greater the trade receivables turnover ratio, greater is the efficiency of management in collection of receivables.

Tutorial note

In the absence of opening trade receivables, closing trade receivables can be taken instead of average trade receivables to calculate the ratio.

Debt collection period

Debt collection period is the average time taken to collect the amount due from trade receivables. Lesser the debt collection period, greater is the efficiency of management in collection of cash from trade receivables. It is calculated as follows:

Debt collection period (in days) = Number of days in a year / Trade receivables turnover ratio

Debt collection period (in months) = Number of months in a year / Trade receivables turnover ratio

$$\text{Debt collection period (in days)} = \frac{\text{Number of days in a year}}{\text{Trade receivables turnover ratio}}$$

$$\text{Debt collection period (in months)} = \frac{\text{Number of months in a year}}{\text{Trade receivables turnover ratio}}$$

Illustration 9

The credit revenue from operations of Harini Ltd. amounted to □ 9,60,000. Its debtors and bills receivable at the end of the accounting period amounted to □ 1,00,000 and □ 60,000 respectively. Calculate trade receivable turnover ratio and also collection period in months

Solution

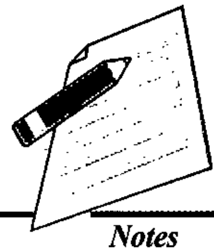
Trade receivables turnover ratio = Credit revenue from operations / Average trade receivables

= 9,60,000 / 1,60,000 = 6 times.

$$\text{Trade receivables turnover ratio} = \frac{\text{Credit revenue from operations}}{\text{Average trade receivables}}$$

$$= \frac{9{,}60{,}000}{1{,}60{,}000} = 6 \text{ times.}$$

Trade receivables = Debtors + Bills receivable = 1,00,000 + 60,000 = □ 1,60,000



Tutorial note

Closing trade receivables are taken instead of average trade receivables as the opening trade receivables are not given.

Debt collection period = Number of months in a year / Trade receivables turnover ratio

= 12/6 = 2 months

$$\text{Debt collection period} = \frac{\text{Number of months in a year}}{\text{Trade receivables turnover ratio}}$$

$$= \frac{12}{6} = 2 \text{ months}$$

(iii) Trade payables turnover ratio

Trade payables turnover ratio is the comparison of net credit purchases with average trade payables during an accounting period. It gives the velocity of payment of cash towards trade payables. It is calculated as follows:

Trade payables turnover ratio = Net credit purchases / Average trade payables

Net credit purchases = Total credit purchases – Purchases returns

Average trade payables = [Opening trade payables + Closing trade payables] / 2

Trade payables = Trade creditors + Bills payable

$$\text{Trade payables turnover ratio} = \frac{\text{Net credit purchases}}{\text{Average trade payables}}$$

$$\text{Net credit purchases} = \text{Total credit purchases} - \text{Purchases returns}$$

$$\text{Average trade payables} = \frac{\text{Opening trade payables} + \text{Closing trade payables}}{2}$$

$$\text{Trade payables} = \text{Trade creditors} + \text{Bills payable}$$

Greater the trade payable turnover ratio, better is the efficiency of the management in managing trade payable as it indicates that amount due to suppliers are settled quicker.

Tutorial note

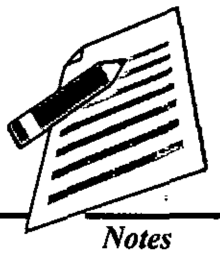
In the absence of opening trade payables, closing trade payables can be taken instead of average trade payables.

Credit payment period

It is the average time taken by the business for payment of accounts payable. Lesser the credit payment period, greater is the efficiency of the management in managing accounts payable as it indicates quicker settlement of trade payables. It is calculated as follows:

Credit payment period (in days) = Number of days in a year / Trade payables turnover ratio

Credit payment period (in months) = Number of months in a year / Trade payables turnover ratio



Notes

$$\underset{\text{(in days)}}{\text{Credit payment period}} = \frac{\text{Number of days in a year}}{\text{Trade payables turnover ratio}}$$

$$\underset{\text{(in months)}}{\text{Credit payment period}} = \frac{\text{Number of months in a year}}{\text{Trade payables turnover ratio}}$$

Illustration 10

From the following figures obtained from Kalpana Ltd, calculate the trade payables turnover ratio and credit payment period (in days).

Particulars	₹
Credit purchases during 2018 – 2019	1,00,000
Trade creditors as on 1.4.2018	20,000
Trade creditors as on 31.3.2019	10,000
Bills payable as on 1.4.2018	4,000
Bills payable as on 31.3.2019	6,000

Solution

$$\text{Trade payables turnover ratio} = \frac{\text{Net credit purchases}}{\text{Average trade payables}} = \frac{1,00,000}{20,000} = 5 \text{ times}$$

$$\text{Average trade payables} = \frac{\text{Opening trade payables + Closing trade payables}}{2}$$

$$= \frac{(20,000 + 4,000) + (10,000 + 6,000)}{2} = \frac{40,000}{2} = ₹\ 20,000$$

$$\underset{\text{(in days)}}{\text{payment period}} = \frac{\text{Number of days in a year}}{\text{Trade payables turnover ratio}} = \frac{365}{5} = 73 \text{ days.}$$

(iv) Fixed assets turnover ratio

Fixed assets turnover ratio gives the number of times the fixed assets are turned over during the year in relation to the revenue from operations. This ratio indicates the efficiency of utilisation of fixed assets.

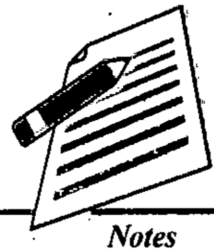
$$\text{Fixed assets turnover ratio} = \frac{\text{Revenue from operations}}{\text{Average fixed assets}}$$

$$\text{Average fixed assets} = \frac{\text{Opening fixed assets + Closing fixed assets}}{2}$$

Fixed assets turnover ratio = Revenue from operations / Average Fixed assets

Average fixed assets = [Opening fixed assets + Closing fixed assets] / 2

Greater the fixed assets turnover ratio better is the efficiency of management in utilisation of fixed assets.



Tutorial note

In the absence of opening fixed assets, closing fixed assets can be taken instead of average fixed assets.

Illustration 11

From the following information of Ashika Ltd., calculate fixed assets turnover ratio:

i. Revenue from operations during the year were □ 60,00,000.

ii. Fixed assets at the end of the year was □ 6,00,000.

Solution

Fixed assets turnover ratio = Revenue from operations / Average Fixed assets = 60,00,000 /6,00,000 = 10 times

$$\text{Fixed assets turnover ratio} = \frac{\text{Revenue from operations}}{\text{Average fixed assets}}$$

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

Tutorial note

As opening fixed assets are not given, fixed assets at the end are taken instead of average fixed assets.

Illustration 12

Calculate (i) Inventory turnover ratio (ii) Trade receivable turnover ratio (iii) Trade payable turnover ratio and (iv) Fixed assets turnover ratio from the following information obtained from Delphi Ltd.

Particulars	As on 31st March, 2018 ₹	As on 31st March, 2019 ₹
Inventory	1,40,000	1,00,000
Trade receivables	80,000	60,000
Trade payables	40,000	50,000
Fixed assets	5,50,000	5,00,000

Additional information:

(i) Revenue from operations for the year □ 10,50,000

(ii) Purchases for the year □ 4,50,000

(iii)Cost of revenue from operations □ 6,00,000.

Assume that sales and purchases are for credit.

Notes

Solution

(i) Inventory turnover ratio $= \dfrac{\text{Cost of revenue from operations}}{\text{Average inventory}} = \dfrac{6,00,000}{1,20,000} = 5$ times

$$\text{Average inventory} = \frac{\text{Opening inventory + Closing inventory}}{2}$$

$$= \frac{1,40,000 + 1,00,000}{2} = \frac{2,40,000}{2} = ₹\ 1,20,000$$

(ii) Trade receivables turnover ratio $= \dfrac{\text{Credit revenue from operations}}{\text{Average trade receivables}}$

$$= \frac{10,50,000}{70,000} = 15 \text{ times}$$

$$\text{Average trade receivables} = \frac{\text{Opening trade receivables + Closing trade receivables}}{2}$$

$$= \frac{80,000 + 60,000}{2} = \frac{1,40,000}{2} = ₹\ 70,000$$

(iii) Trade payables turnover ratio $= \dfrac{\text{Net credit purchases}}{\text{Average trade payables}} = \dfrac{4,50,000}{45,000} = 10$ times

$$\text{Average trade payables} = \frac{\text{Opening trade payables + Closing trade payables}}{2}$$

$$= \frac{40,000 + 50,000}{2} = \frac{90,000}{2} = ₹\ 45,000$$

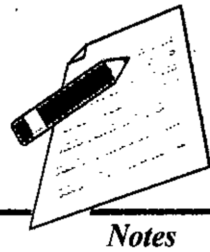
(iv) Fixed assets turnover ratio $= \dfrac{\text{Revenue from operations}}{\text{Average fixed assets}} = \dfrac{10,50,000}{5,25,000} = 2$ times.

$$\text{Average fixed assets} = \frac{\text{Opening fixed assets + Closing fixed assets}}{2}$$

$$= \frac{5,50,000 + 5,00,000}{2} = \frac{10,50,000}{2} = ₹\ 5,25,000$$

Profitability ratios

Profitability ratios help to assess the profitability of a business concern. These ratios also help to analyse the earning capacity of the business in terms of utilisation of resources employed in the business. Generally, these ratios are expressed as a percentage.



The profitability ratios commonly used are

(i) Gross profit ratio

(ii) Operating cost ratio

(iii)Operating profit ratio

(iv)Net profit ratio

(v) Return on investment

(i) Gross profit ratio

Gross profit ratio is the proportion of gross profit to net revenue from operations. Gross profit ratio shows the margin of profit available out of revenue from operations. It is computed as below:

$$\text{Gross profit ratio} = \frac{\text{Gross profit}}{\text{Revenue from operations}} \times 100$$

Gross profit ratio = [Gross profit / Revenue from operations] × 100

Gross profit = Revenue from operations – Cost of revenue from operations

A higher gross profit ratio indicates high profitability. It should be sufficiently high to provide for indirect expenses to be paid by a business.

Illustration 13

Calculate gross profit ratio from the following:

Revenue from operations □ 1,00,000, Cost of revenue from operations □ 80,000 and purchases 62,500.

Solution

$$\text{Gross profit ratio} = \frac{\text{Gross profit}}{\text{Revenue from operations}} \times 100$$

$$= \frac{20,000}{1,00,000} = \times 100 = 20\%$$

Gross profit = Revenue from operations – Cost of revenue from operations

= 1,00,000 – 80,000 = □ 20,000

(ii) Operating cost ratio

Operating cost ratio is the proportion of operating cost to revenue from operations. This ratio is a test of the operational efficiency of the business. It is calculated as under.

$$\text{Operating cost ratio} = \frac{\text{Operating cost}}{\text{Revenue from operations}} \times 100$$

Operating cost ratio = [Operating cost / Revenue from operations] × 100

Notes

Operating cost is the cost which is associated with the operating activities of the business.

Operating cost = Cost of revenue from operations + Operating expenses

Operating expenses = Employee benefit expenses + Depreciation + Other expenses related to office and administration, selling and distribution

A lower operating ratio indicates better profitability. Lesser the operating cost ratio, higher is the margin available for payment of non-operating expenses such as interest on loans, loss on sale of fixed assets, etc.

Illustration 14

Following is the statement of profit and loss of Maria Ltd. for the year ended 31st March, 2018.

Calculate the operating cost ratio.

Statement of Profit and Loss

Particulars	Note No.	Amount ₹
I. Revenue from operations		8,00,000
II. Other Income		20,000
III. Total revenue (I + II)		8,20,000
IV. Expenses:		
Purchases of stock-in-trade		4,50,000
Changes in inventories		-40,000
Employee benefits expenses	1	22,000
Other expenses	2	68,000
Total expenses		5,00,000
V. Profit before tax (III-IV)		3,20,000

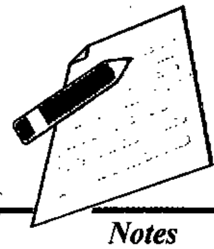
Notes to Accounts

Particulars	Amount ₹
1. Employee benefits expenses	
Wages (direct)	10,000
Salaries	12,000
Total	22,000
2. Other expenses	
Administrative expenses	20,000
Selling and distribution expenses	28,000
Loss on sale of fixed asset	20,000
Total	68,000

Solution

$$\text{Operating cost ratio} = \frac{\text{Operating cost}}{\text{Revenue from operations}} \times 100$$

$$= \frac{4,80,000}{8,00,000} = \times 100 = 60\%$$



Operating cost ratio = [Operating cost / Revenue from operations] × 100

= 4,80,000 /8,00,000 × 100 = 60%

Cost of revenue from operations = Purchases of stock-in-trade + Change in inventories of stock in trade + Direct expenses (wages) = 4,50,000 + (40,000) + 10,000 = □ 4,20,000

Operating expenses = Administrative expenses Selling and distribution expenses+ Employee benefits expenses (salaries) = 20,000 + 28,000 + 12,000 = □ 60,000

Operating cost = Cost of revenue from operations + Operating expenses

= 4,20,000 + 60,000= □ 4,80,000

Tutorial Note

Loss on sale of fixed assets is a non-operating item, hence it is ignored.

(iii) Operating profit ratio

Operating profit ratio gives the proportion of operating profit to revenue from operations. Operating profit ratio is an indicator of operational efficiency of an organisation. It may be computed as follows:

$$\text{Operating profit ratio} = \frac{\text{Operating profit}}{\text{Revenue from operations}} \times 100$$

Operating profit ratio = [Operating profit x Revenue from operations] × 100

Alternatively, it is calculated as under.

Operating profit ratio = 100 – Operating cost ratio

Operating profit = Revenue from operations – Operating cost

A higher ratio indicates better profitability. Greater the operating ratio, higher is the margin available for paying non-operating expenses.

Tutorial note

Operating cost ratio + Operating profit ratio = 100%

Illustration 15

Calculate operating profit ratio under the following cases.

Case 1: Revenue from operations □ 10,00,000, Operating profit □ 1,50,000.

Case 2: Revenue from operations □ 15,00,000, Operating cost □ 12,00,000.

Case 3: Revenue from operations □ 20,00,000, Gross profit 30% on revenue from operations, Operating expenses □ 4,00,000

Notes

Solution

Case 1: $\text{Operating profit ratio} = \dfrac{\text{Operating profit}}{\text{Revenue from operations}} \times 100$

$= \dfrac{1,50,000}{10,00,000} \times 100 = 15\%$

Case 2: $\text{Operating profit ratio} = \dfrac{\text{Operating profit}}{\text{Revenue from operations}} \times 100$

$= \dfrac{3,00,000}{15,00,000} \times 100 = 20\%$

Operating profit = Revenue from operations - Operating Cost
= 15,00,000 – 12,00,000 = ₹ 3,00,000

Case 3: $\text{Operating profit ratio} = \dfrac{\text{Operating profit}}{\text{Revenue from operations}} \times 100$

$= \dfrac{2,00,000}{20,00,000} \times 100 = 10\%$

Gross profit $= 20,00,000 \times \dfrac{30}{100} = ₹\ 6,00,000$

Operating profit = Gross profit - Operating expenses

Operating profit = 6,00,000 - 4,00,000 = ₹ 2,00,000

(iv) Net profit ratio

Net profit ratio is the percentage of net profit on revenue from operations. It is calculated as under:

$$\text{Net profit ratio} = \frac{\text{Net profit after tax}}{\text{Revenue from operations}} \times 100$$

Net profit ratio = [Net profit after tax / Revenue from operations] × 100

Net profit after tax = Gross profit + Indirect income – Indirect expenses – Tax (OR)

Net profit after tax = Revenue from operations – Cost of revenue from operations – Operating expenses –Non operating expenses + Non-operating income - Tax

Net profit ratio is an indicator of the overall profitability of the business. A higher net profit ratio indicates high profitability.

Illustration 16

From the following details of a business concern calculate net profit ratio.

Particulars	₹
Revenue from operations	3,50,000
Cost of revenue from operations	1,50,000
Administration expenses	50,000
Selling expenses	10,000

Solution

$$\text{Net profit ratio} = \frac{\text{Net profit after tax}}{\text{Revenue from operations}} \times 100$$

$$= \frac{1,40,000}{3,50,000} \times 100 = 40\%$$

Net profit = Revenue from operations – Cost of revenue from operations – Administration expenses – Selling expenses = 3,50,000 – 1,50,000 – 50,000 – 10,000 = □ 1,40,000

Tutorial note

It is assumed that there is no tax payable.

Illustration 17

From the following statement of profit and loss of Mukesh Ltd. Calculate
(i) Gross profit ratio (ii) Net profit ratio.

Statement of Profit and Loss

Particulars	Amount ₹
I. Revenue from operations	5,00,000
II. Other income:	
Income from investment	40,000
III. Total revenues (I+II)	**5,40,000**
IV. Expenses:	
Purchase of stock in trade	1,80,000
Changes in inventories	20,000
Employee benefits expense	30,000
Other expenses	1,10,000
Provision for tax	50,000
Total expenses	3,90,000
V. Profit for the year	**1,50,000**

Solution

(i) $\text{Gross profit ratio} = \frac{\text{Gross profit}}{\text{Revenue from operations}} \times 100 = \frac{3,00,000}{5,00,000} \times 100 = 60\%$

Gross profit = Revenue from operations – Cost of revenue from operations
= 5,00,000 – 2,00,000 = ₹ 3,00,000

Cost of revenue from operations = Purchase of stock in trade + Changes in inventories
= 1,80,000 + 20,000 = ₹ 2,00,000

(ii) $\text{Net profit ratio} = \frac{\text{Net profit after tax}}{\text{Revenue from operations}} \times 100 = \frac{1,50,000}{5,00,000} \times 100 = 30\%$

Illustration 18

From the following trading activities of Naveen Ltd. calculate

(i) Gross profit ratio (ii) Net profit ratio (iii) Operating cost ratio (iv) Operating profit ratio

Statement of Profit and loss

Particulars	₹
I. Revenue from operations	20,000
II. Other income:	
Income from investments	200
III. Total revenues (I+II)	**20,200**
IV. Expenses:	
Purchases of stock-in-trade	17,000
Changes in inventories	-1,000
Finance costs	300
Other expenses (administration and selling)	2,400
Total expenses	18,700
V. Profit before tax (III - IV)	**1,500**

Solution

$$\text{(i) Gross profit ratio} = \frac{\text{Gross profit}}{\text{Revenue from operations}} \times 100$$

$$= \frac{4,000}{20,000} \times 100 = 20\%$$

Cost of revenue from operations = Purchase of stock-in-trade + Changes in inventory + Direct expenses

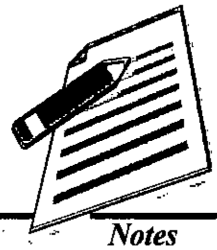
= 17,000 – 1,000 + 0 = □ 16,000

Gross profit = Revenue from operations – Cost of revenue from operations

= 20,000 – 16,000 = □ 4,000

$$\text{(ii) Net profit ratio} = \frac{\text{Net profit after tax}}{\text{Revenue from operations}} \times 100$$

$$= \frac{1,500}{20,000} \times 100 = 7.5\%$$



Tutorial note

It is assumed that there is no tax payable.

$$\text{(iii) Operating cost ratio} = \frac{\text{Operating cost}}{\text{Revenue from operations}} \times 100$$

$$= \frac{18{,}400}{20{,}000} \times 100 = 92\%$$

Operating cost = Cost of revenue from operations + Operating expenses

Operating expenses = Other expenses = □ 2,400

Operating cost = 16,000 + 2,400 = □ 18,400

$$\text{(iv) Operating profit ratio} = \frac{\text{Operating profit}}{\text{Revenue from operations}} \times 100$$

$$= \frac{1{,}600}{20{,}000} \times 100 = 8\%$$

Operating profit = Revenue from operations – Operating cost

= 20,000 – 18,400 = □ 1,600

(v) Return on Investment (ROI)

Return on investment shows the proportion of net profit before interest and tax to capital employed (shareholders' funds and long-term debts). This ratio measures how efficiently the capital employed is used in the business. It is an overall measure of profitability of a business concern. It is computed as below:

$$\text{Return on Investment (ROI)} = \frac{\text{Net profit before interest and tax}}{\text{Capital employed}} \times 100$$

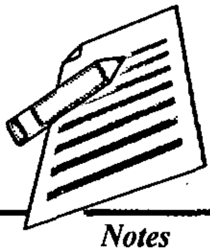
Return on Investment (ROI) = [Net profit before interest and tax / Capital employed] x 100

Capital employed = Shareholders' funds + Non-current liabilities

Greater the return on investment better is the profitability of a business and vice versa.

Illustration 19

Following is the extract of the balance sheet of Babu Ltd., as on 31st March, 2018:



Notes

Particulars	Amount ₹
I EQUITY AND LIABILITIES	
1. Shareholders' funds	
(a) Share capital	70,000
(b) Reserves and surplus	25,000
2. Non-current liabilities	
Long-term borrowings	30,000
3. Current liabilities	
(a) Trade payables	20,000
(b) Other current liabilities	15,000
(c) Short-term provisions	42,000
Total	**2,02,000**

Net profit before interest and tax for the year was □ 25,000. Calculate the return on capital employed for the year.

Solution

$$\text{Return on Investment} = \frac{\text{Net profit before interest and tax}}{\text{Capital employed}} \times 100$$

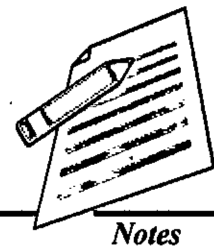
$$= \frac{25,000}{1,25,000} = \times 100 = 20\%$$

Capital employed = Share capital + Reserves and surplus + Long term borrowings
= 70,000 + 25,000 +30,000 = □ 1,25,000

SUMMARY

Comparative analysis

- It shows previous financial results side by side along with its change in amount/ percentage.
- It compares current year results with its base year.



- It's a horizontal analysis.
- The results are expressed in both percentages and pictorial form.
- Both inter and intra firm can be compared.
- It helps in internal decision making.
- It is useful to compare results with its previous financial years.
- Relative importance of individual figures can't be shown in statement with comparative analysis.

Common Size analysis

- It shows results regarding same year in the form of percentages.
- It compares figures of same year.
- It's a vertical analysis.
- The results are expressed in percentages only.
- Only inter firm are compared.
- It prepares as references to stakeholders.
- It is used to compare companies results with its competitors.
- Shows relative importance of individual figures in statement.

EXERCISE

Multiple Choice Questions

Select the best alternative and check your answer with the answers given at the end of the book.

1. Main objective of Common Size statement is:
   (A) To present the changes in various items
   (B) To provide for a common base for comparison
   (C) To establish relationship between various items
   (D) All of the Above
   Answer: D

2. Main objective of Common Size Balance Sheet is:
   (A) To establish relationship between revenue from operations and other items of statement of profit & loss
   (B) To present changes in assets and liabilities
   (C) To present changes in various items of income and expenses
   (D) All of the Above
   Answer: B

3. Common Size Statements are prepared
   (A) In the form of Ratios
   (B) In the form of Percentages
   (C) In both of the Above
   (D) None of the Above

   Answer: B

4. Which of the following is untrue:
   (A) Common size Balance Sheet
   (B) Common size Statement of Profit & Loss
   (C) Common size cash Flow Statement
   (D) None of the Above

   Answer: C

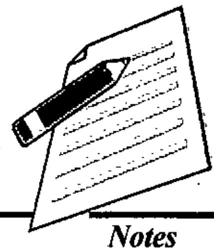
5. Main objective of Common Size Statement of Profit & Loss is :
   (A) To present changes in assets and liabilities
   (B) To judge the financial soundness
   (C) To establish relationship between revenue from operations and other items of statement of Profit & Loss
   (D) All of the Above

   Answer: C

Review Questions

Short Answer Questions

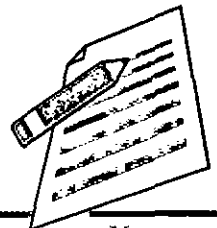
1. List the techniques of Financial Statement Analysis.
2. Distinguish between Vertical and Horizontal Analysis of financial data.
3. State the meaning of Analysis and Interpretation.
4. State the importance of Financial Analysis?
5. What are Comparative Financial Statements?
6. What do you mean by Common Size Statements?



Notes

Long Answer Questions

1. Describe the different techniques of financial analysis and explain the limitations of financial analysis.
2. Explain the usefulness of trend percentages in interpretation of financial performance of a company.
3. What is the importance of comparative statements? Illustrate your answer with particular reference to comparative income statement.
4. What do you understand by analysis and interpretation of financial statements? Discuss its importance.
5. Explain how common size statements are prepared giving an example.



1 APPLICATION OF COMPUTERS IN FINANCIAL ACCOUNTING

Spreadsheet – Meaning

Spreadsheet application is a computer program that allows to record, calculate and compare numerical or financial data. Using a spreadsheet program. We can store a lot of data in the worksheet and also arrange and analyse the data by using different functions and formulae for meaningful object.

It is used to establish relationship between two or more sets of data. Libre Office Calc, MS Office Excel, Open Office Spreadsheet etc. are examples of spreadsheet software.

Features of Spreadsheet

1. A spreadsheet is a configuration of rows and columns.
2. A spreadsheet is also known as worksheet.
3. Spreadsheet application allows to enter (i.e., add) and process data.
4. It makes quick and easy financial and numerical analysis of data.
5. The data stored in the spreadsheet can be converted into graphs, charts etc.
6. It can be used to store, arrange and filter data.

Introduction to Libre Office Calc

Libre Office Calc is one of the best spreadsheet applications, which can be used to calculate, analyse and manage data. It is a Free and Open-Source Software (FOSS). Libre Office Calc is available for a variety of platforms including Linux, OSX, Microsoft windows and Free BSD.

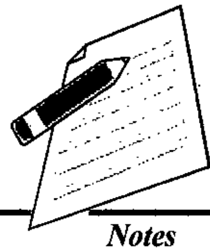
1. Features of Libre Office Calc:

- It is a spreadsheet application.
- It is both free software and open-source software.
- It can be used to calculate, analyse and manage data.
- The worksheet in Libre Office Calc contains Rows and Columns in a Table format.

Basic concept of Libre Office Calc Spread Sheet

(a) Workbook:

A file in spreadsheet is known as a workbook. A work book is a collection of a number of work sheets.



Notes

(b) Work sheets:

The work area which consists of rows and columns in a spreadsheet is called worksheet. By default, three worksheets – sheet-1, sheet-2, sheet-3 are available in work book.

(c) Active work sheet:

The worksheet which is available to the user for carrying out operations is called active work sheet. The name of the active worksheet will be shown in bold letters in the Sheet Tab at bottom of work sheet.

(d) Sheet Tab:

It shows the name of the work sheet at bottom left of the screen. Additional sheets can be added by clicking on the right-hand side of the sheet Tab.

(e) Rename:

The Sheet-1, Sheet-2, and Sheet-3 etc. can be renamed by right clicking the mouse over the worksheet and selecting "Rename" option.

(f) Rows:

Rows are the horizontal vectors in the worksheet. These are numbered numerically from Top to Bottom.

(g) Columns:

Columns are vertical vectors in the worksheet. These are referred by alpha characters from left to right such as A, B, C, …, AA, AB, AC …etc.

(h) Cell:

The intersection of a row and a column is called a cell. A cell is identified by a combination of an alpha – numeric character e.g.: A1, B6, C10, etc. This alpha numeric character is called cell address. Hence each cell has a unique address.

(i) Active cell:

When we start Libre Office Calc, the pointer (cursor) points the first cell i.e., A1, and this cell is called the active cell. The active cell is distinguished by a dark box called cell pointer. We can move the cell pointer by using the arrow keys UP, DOWN, LEFT and RIGHT.

(j) Cell Reference:

A cell reference identifies location of a cell or group of selected cells in spreadsheet.

(i) Types of Cell References:

1. Relative Cell references:

By default cell reference is relative; which means that as a formula or function is copied and pasted to other cells, the cell references in the formula or function change to reflect the new location.

2. Absolute Cell reference:

The absolute cell reference consist of the column letter and row number surrounded by dollar ($) signs. E.g. A5. An absolute cell reference is used when we want a cell reference to stay fixed on a specific cell.

3. Mixed cell reference:

It is a combination of relative and absolute cell references that holds either row or column constant when the formula or function is copied to another location.

(k) Inserting Rows and Columns:

We can add or delete Rows and Columns in a spreadsheet. To add column, click at the column header (right click on the mouse) there we get an option to add column.

Likewise, we can add rows. To delete the column, click the column header (right click on the mouse) there we get an option to delete column. Likewise, we can remove rows.

(l) Ranges:

Range is a group of adjacent cells that forms a rectangular area. A range is specified by giving the address for first cell in range and the last cell in the rage, e.g.: range starting from A10 to A20 is written asA10:A20 where colon (:) is the range operator.

(m)Spreadsheet navigation:

We can move around a worksheet through four arrow keys. i.e.;

- Left arrow key
- Right arrow key
- Up arrow key
- Down arrow key

Data Entry, Text Management, and Cell Formatting

In any computerised business application, the basic requirement is to input data, which may be either for processing or to update various data elements. In both the cases, data should be correct, accurate and should be in proper format.

Data Entry

LibreOffice Calc facilitates fast data entry. Some of the methods for data entry are mentioned below:

1. The data fill options:

   The 'fill' command can be used to fill data into worksheet cells. To fill quickly in several types of data series, we select cells and drag the fill handle (A fill handle is the small black square in the lower-right corner of the selection). When we point to the fill handle, the pointer changes to + symbol.

2. Import/Copy Data from other sources:

   This method will transfer data into required cells by copying or importing an external file to calc sheet.

3. Data validation:

   This is a feature to define restrictions on type of data entered into a cell. We can configure data validation rules for cells data that will not allow users to enter invalid data. There may be warning messages when users tries to type wrong data in the cell.

Notes

Data Formatting

Formatting of spread sheets makes easier to read and understand the important information. On the Ribbon there are several tools and shortcuts to format spreadsheets effectively. Some of them are explained below.

1. Number formatting:

   Number formatting includes adding percent symbols (%), commas (,), decimal places (.), and currency signs (?). date (dd/mm/yyyy), time (HH: mm), scientific values and as well as some special formats to a spreadsheet.

2. Currency:

   If we enter a financial value with the currency sign, calc assigns a currency format to the cell along with the entry.

3. Dates:

   If we enter the date, that follows one of the built-In Calc number formats, such as 01/06/2018 or 01 June 2018, the program assigns a Date format that follows the pattern of the date.

4. Changing cell colours:

   Select the range to format. From the Toolbar, select format and click on cells to display format cells dialog box and choose background tab. The back ground tab provide Background colourforthe cell. Select the desired colour from the colour pallets. Then click OK to make necessary changes.

5. Create a custom cell border:

   We can create a cell style that includes a custom border, and can apply to that cell style when we want to display the custom border around selected cells.

- Select the properties option on the side bar (Right)
- Click cell appearance
- We can modify cell border properties

6. Conditional formatting:

   We can apply conditional formatting to a cell range, a table, or a Pivot Table report. A conditional format changes the appearance of a cell range based on a condition or criteria. If the condition is true, the cell range is formatted based on that condition; if the condition is false, the cell range is not formatted based on that condition.

Notes

Use of Spread Sheet in Business Application

Business Applications

The following accounting applications are done with the help of a spreadsheet

- Payroll Accounting
- Asset Management
- Loan Repayment

Pay Roll Accounting

Payroll is a statement prepared to show the detailed salary calculation of employees. It contains Basic

Pay, Dearness Allowance, Travelling Allowance, Provident Fund Contribution, ESI Premium, etc. The computation of salary payment is based on the number of days an employee has worked, rate per grade, rate of allowances and deductions to be made therefrom.

1. Preparation of Salary Bill:

The preparation of salary bill should provide for the following:

- Maintaining payroll related data such as Employee No., Name, attendance, Basic Pay, DA, and other allowances, deductions to be made, etc.
- Periodic Payroll Computations: It includes the calculation of various earnings and deductions.
- Preparation of salary statement and employee's salary slip.
- Generation of advice to bank: It contains the net salary to be transferred to individual bank account of employees and other salary related statutory payments such as provident fund, tax, etc.

2. Pav Roll Components:

The following elements are important for salary computation and its payment.

Earnings:

- Basic Pay (BP): It is the pay in the pay scale
- Grade Pay (GP): It is the pay to be added to the basic pay according to the designation.
- Dearness Pay (DP): Portion of dearness allowance merged with Basic Pay
- Dearness allowance (DA): Compensation for erosion in the purchasing power of wage earner due to Price rise.
- House Rent Allowance (HRA): An amount paid as rent of residential accommodation.

- Transport Allowance (TA): It is an amount to facilitate commuting to the palace of work.

Deductions:

- Professional TAX: Statutory deduction levied by State Government.
- Provident Fund (PF): It is a statutory deduction under provident Fund Act. It is deducted from salary as a part of social security.
- Tax Deducted at Source (TDs)- Monthly deduction towards income Tax liability of an employee.
- Recovery of Loan instalment: An amount deducted on account of any loan taken up by employee.

3. Net Salary Calculation:

Step 1: Calculate Gross salary by using the given formula.

Step 2: Calculate Total Deduction by using the following formula:

Total Deduction = Professional Tax + Provident Fund + Tax deducted at source + Loan Recovery + Any other deductions.

Step 3: Calculate net salary by the given formula

Net Salary = Gross salary – Total Deduction.

Asset Accounting

Assets are resources of the organisation. Assets which are used in the business for more than one year, called Fixed assets. The value of Fixed assets may be reduced due to depreciation. The gradual and permanent diminution in the value of assets due to wear and tear is called depreciation.

Graphs and Charts for Business

Introduction

One of the very useful features of Libre Office Calc Spreadsheet is the capability to create charts and graphs of the data. They are visual representations of numerical data, which has at least a two-dimensional relationship. The graph has at least two axes-x and y. X axis is usually horizontal while Y-axis is vertical.

Types of Graphs and Charts

Libre Office Calc provides various types of chart to help us to display data in different ways as per the need of the viewers. The major types available are given below:

1. Column chart:

   It is the most commonly used chart type. It shows a bar chart or bar graph with vertical bars. The X axis shows the categories and Y axis shows the value for each category. Column chart are used to compare values across categories.

2. Bar chart:

   This type of chart shows a bar graph or column chart with horizontal bar. The Y axis shows categories and the X axis shows the value for each category. It is suitable for comparing multiple values.

3. Line chart:

   A line chart shows values in the Y axis and categories in X axis. The Y values of each data series is connected by a line. Line chart shows data changes for a certain period of time.

4. Pie chart:

   A pie chart displays the contribution of each value to a total. It represents multiple subgroups of a single variable. It contains only one data series. A pie chart shows values as circular sectors of the total circle. Pie chart may be

- Normal Pie chart
- Exploded Pie chart
- Doughnut chart or Donut chart
- Exploded Doughnut chart

5. Area chart:

   The chart shows values as points on the Y axis. The X axis shows categories. The Y values of each data series are connected by a line. The area between each two lines is filled with a colour.

6. Scatter chart:

   Scatter chart is also known as XY chart. In this type of chart, both axes display values. This chart is used to show the relationship among two variables.

7. Radar chart:

   It is also known as Net chart or Star chart. A radar chart has a separate axis for each category and the axes extend outward from the center of the chart. The value of each data point is plotted on the corresponding axis.

Basic steps for Graphs /Charts/Diagrams using Libre Office Calc

The steps involved in the chart preparation is given below:

- Step 1: Data entry (in spread sheet, in the form of a table)
- Step 2: Data selection (select data for plotting chart)
- Step 3: Plotting the chart (Standard tool bar → Insert → chart wizard)
- Step 4: Chart type (choose a chart type from the list)

Advantages in using Graph/Chart

1. It summarises a large data set in visual form.
2. Charts or graphs can clarify trends better than do tables.
3. It helps to estimate key values at a glance.

4. It shows each data category in a frequency distribution.
5. It permits a visual check of the accuracy and reasonableness of calculations.
6. The charts and graphs allow the investigator to draw a valid conclusion.

Data Base Management System for Accounting

Database/ Data source – Introduction

A database is a collection of related data. It is organised in such a way that its contents can easily be accessed, managed and updated. In LibreOffice, database is also called data source. Database consists of interrelated data tables that are structured in a manner that ensures-data consistency and integrity. LibreOffice base, MS Access, Oracle, SQL server, etc. are the commonly used software's for data base management.

Database Management System (DBMS)

DBMS is a collection of programs. It enables the users to create and maintain a data base. It is a general-purpose software system that facilitates the process of defining, constructing and manipulating database for various applications.

Advantage of database/data source

1. All of the information is together
2. The information is portable
3. Information can be accessed at any time
4. Many users can access the same database at the same time.
5. Reduced data entry, storage and retrieval cost.

Disadvantages of database/Data source

1. Designing of database is a complex and time-consuming process
2. Initial training is required for all the users
3. Installation cost is high

Basic concepts of LibreOffice Base

1. Entities: Anything in the real world is called entities. It may be person, place or things.

   Eg: Employee is an entity, Orange is an entry
2. Attributes: These. Define the characteristics of an entity.
3. Eg: Name, Age, Caste, Salary etc.
4. Identifiers: The unique attribute of an entity is called identifier. This is also called primary key.

Notes

5. Eg: Admission number of a student, Aadhar Number of a person etc.
6. Relationships: These are the logical links between two entities or tables.

Components /Elements of LibreOffice Base

1. Fields: Individual pieces of data in a database are called fields.
2. Table: rows and columns to present fields in a database is called table. When creating a table, the characteristics of each field to be defined.
3. Forms: Forms are used to enter or modify data (fields) in to tables. Forms allow the user to display the data in a Table or Query.
4. Query: Query is a question. Queries are used to view, change and analyse data in different ways. It creates a new table from the existing tables based upon the question/ request asked to the data base.
5. Reports: It is used to create and present information based on queries in an easily readable format.

Planning (or designing) a database/ Data source

The first step in creating a database is to list down the various fields which are necessary for creating a database. The listed fields are used to create tables of the database. While entering fields into Tables, a primary key or an identifier is to be set for each table.

The primary key field cannot be left blank. The relationships of entities or tables can be created with the support of primary key. The relationships may be

- One -to-One
- One -to-Many
- Many-to-Many

The database created on the basis of relationships between different data tables is called relational database. The database design can be used to describe the structure of different parts of the overall data base. Avoiding the duplication of attributes/ fields is key criteria of database design.

Creating a new database

To Create a new database, select File → New → Database from the menu bar, or click the arrow next to the New icon on the standard tool bar and select Database from the drop-down menu. Both methods open the Database wizard. On the first page of the Database wizard, Select create → a new database → click Next.

The second page has two questions

1. Yes, register the data base for me
2. Open the database for editing.

Choose any one from the above and click Finish. In LibreOffice Base, the entire database is encompassed in a file with extension. odb. This file format is actually a container of all elements of the database, including Fields, Tables, Forms, Queries and Reports.

Creating database Tables

In DBMS, data is organised in Tables. A Table is a collection of data about a specific topic. Tables organise data into columns and rows. Each table is given a name. This is used to refer the table. The name depicts the content of the table. A database must have at least one table and may have several.

To work with Table, clicks the Tables icon in the Database list or Press Alt+A. The three tasks that we can perform on a table are in the Task list given below.

- Using the wizard to create a Table
- Creating a table by copying an existing table
- Creating tables in Design view.

Using data sources in LibreOffice

Any data source registered in spreadsheet or text document can use in other LibreOffice components including writer and calc.

1. Viewing data sources:

   Open a document in writer or calc. To view the data sources available, Press F4 or select View → Data sources from the pull-down menu. This brings up a list of registered databases. To view each data base, click on the arrow to the left of the database's name.

2. Editing Data sources:

   Some data sources can be edited in the Data view window. A record can be edited, added or deleted. Editing the data requires only a click in the cell whose data should be changed. To delete the record, right click on the grey box to the left of row to highlight the entire row, and select Delete row to . remove the selected row.

3. Launching Base to work on data sources:

   We can launch LibreOffice Base at any time from the Data source window. Just right click on a database, or its tables or Queries icons and select Edit Database File. In Base, we can edit, add, and delete tables, queries, forms and reports.

Notes

4. Using Data sources in writer and Calc.:

Data can be placed into writer and Calc documents from the tables in the data source window. In writer, values from individual fields can be inserted. Or a complete table can be created in the writer document. One common way to use a data source is to perform a mail merge.

EXERCISE

MCQ

1. Which function will be used to calculate the interest portion of on instalment of loan:
   (a) PPMT
   (b) IPMT
   (c) FAPM
   (d) None of these

   Answer: (b)

2. Which formula to be used to get the sum total of cell A1, A2 and A3 :
   (a) SUM = (A1 + A2 + A3)
   (b) SUM = (A1, A2, A3)
   (c) = SUM (A1.: A3)
   (d) None of these

   Answer : (c)

3. Which of the following coordinates excel work book:
   (a) Workbook
   (b) Worksheet
   (c) Chart
   (d) Worksheet and chart

   Answer: (d)

4. For fixed the Raw and Column title in a worksheet, whereby they don't scroll, when spreadsheet is scrolled. What will be used in the following:
   (a) Freeze pens command
   (b) Unfreeze pens command
   (c) Hold title command
   (d) Marge command

   Answer: (a)

5. In windows at which place do we type values and formulae:
   (a) In title toolbar
   (b) Through smart screen menu command
   (c) In formula bar
   (d) In standard bar

   Answer: (c)

Review Questions

1. What is spreadsheet?
2. Write the syntax of PPMT function.
3. What is the process of saving the file in a spreadsheet?
4. What is called cell and row?
5 The cost of 10-year life machine is Rs 5,00,000. Explain the calculation process of depreciation by spreadsheet.

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