Chapter 1

Meaning and Objectives of Accounting

Meaning of Accounting

Definitions of Accounting:

1."Nearly every business enterprise has accounting system. It is a means of collecting, summarising, analysing and reporting in monetary terms, informations about business."

— R.N. Anthony

2. "Accounting is the art of recording, classifying and summarising in a significant manner and in terms of money, transactions and events, which are, in part at least, of a financial character, and interpreting the results thereof."

—American Institute of Certified Public Accountants

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

— Smith and Ashburne

Characteristics of Accounting

An analysis of the above definitions brings out the following as **characteristics or features or attributes of accounting:**

(1) Accounting is an Art as well as Science :— Art is the technique of attaining some pre-determined objectives. Accounting is an art of recording, classifying and summarising business transactions with a view to ascertain the net profit and financial position of the business enterprise.

Any organised body of knowledge which is based on certain specified principles is called science. In this respect accountancy is also a science since it is also an organised body of knowledge based on certain specified principles and accounting standards.

(2) Recording of Financial Transactions only :— Only those transactions and events are recorded in accounting which are of a financial character. There are so many transactions in the business which are very important for business but which cannot be measured and expressed in terms of money and hence such transactions will not be recorded. For example, the quarrel between the Production Manager and the Sales Manager, resignation by an able and experienced manager, strike by employees and starting of a new business by the other competitor etc. Though these events affect the earnings of the business adversely but as no one can measure the effect of such events in terms of money, these will not be recorded in the books of the business.

(3) Recording in terms of money :— Each transaction is recorded in the books in terms of money only. For example, if a businessman purchases 200 Chairs and 10 Tables, their value in terms of money will be recorded in the books. Similarly, if a business possesses Rs.50,000 in Cash; Land measuring 2,000 Metres; 5 Trucks; 5 Machines; 10 ton of raw materials; 200 Chairs; 10 Tables, and so on, then in the absence of money measurement concept these different types of assets cannot be added up and hence cannot give any useful information. But if they are expressed in terms of money, they will immediately provide useful information such as, Cash Rs.50,000; Land Rs.2 Crore; Trucks Rs.50,00,000; Machines Rs.20,00,000; Goods Rs.5,00,000; Chairs Rs.50,000 and Tables Rs.25,000.

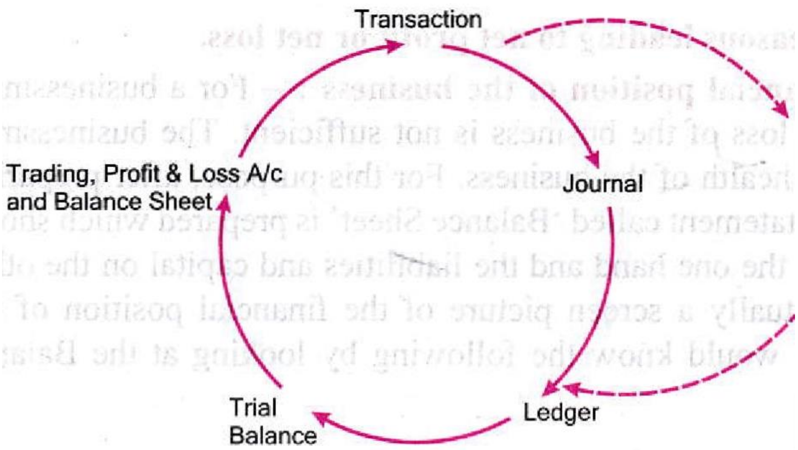
In a small business where the number of transactions is quite small, all transactions are first of all recorded in a book called "Journal". But in a big business where the number of transactions is quite large, the Journal is further sub-divided into various subsidiary books such as (I) 'Cash Book' for recording cash transactions; (II) 'Purchases Book' for recording credit purchases of goods; (III) 'Sales Book' for recording credit sales of goods; (IV) 'Purchases Return Book' for recording the return of credit purchases; (V) 'Sales Return Book' for recording the return of credit sales, (VI) Bills Receivable Book, (VII) Bills Payable Book, (VIII) Journal Proper etc. The number of subsidiary books to be maintained depends on the size and nature of the business.

(4) Classifying:— After recording the transactions in journal or subsidiary books, the transactions are classified. Classification is the process of grouping the transactions of one nature at one place, in a separate account. The book in which various accounts are opened is called "Ledger". Separate accounts are opened in the Ledger in the name of each person, whether customer or supplier. Likewise, separate accounts are opened for purchases, sales, assets etc. Similarly, all expenses and incomes, which are already recorded in Journal are again classified under separate heads in the Ledger, such as Wages Account, Salary Account, Advertisement Account, Commission Account etc.

(5) Summarising :— Summarising is the art of presenting the classified data in a manner which is understandable and useful to management and other users of such data. This involves the balancing of ledger accounts and the preparation of Trial Balance with the help of such balances. Final Accounts are prepared with the help of Trial Balance which include Trading and Profit & Loss Account and a Balance Sheet. Trading account is prepared for calculating gross profit or gross loss during the year. Profit and Loss Account is prepared to ascertain the net profit or net loss during the year. Balance Sheet is prepared to present the financial position of the business.

Recording, Classifying and Summarising are also termed as 'Process of Accounting' or 'Accounting Cycle' :—

Accounting Cycle



Books of Original Entry
1. Cash Book
2. Purchase Book
3. Sales Book
4. Purchase Return Book
5. Sales Return Book
6. Bills Receivable Book
7. Bills Payable Book
8. Journal Proper

The above diagram shows the accounting cycle. This accounting cycle starts with the recording of business transactions in the Journal or Subsidiary Books and after passing through the Ledger and Trial Balance it results in the preparation of Final Accounts (i.e., Trading and Profit & Loss Account and Balance Sheet). This accounting cycle is generally completed in an accounting year and is again repeated in each subsequent year.

(6) Interpretation of the results :— In Accounting, the results of the business are presented in such a manner (i.e., by preparing Trading and Profit & Loss Account and Balance Sheet) that the parties interested in the business such as proprietors, managers, banks, creditors, employees etc. can have full information about the profitability and the financial position of the business.

(7) Communicating :— Accounting attributes also include the communication of financial data to the users who analyse them as per their individual requirements.

Objectives of Accounting

The following are the main objectives or utility of accounting :—

(1) To keep systematic record of business transactions :— The main objective of accounting is to keep complete record of business transactions according to specified rules. Complete record of business transactions helps to avoid the possibility of omission and fraud. For this purpose, all the business transactions are first of all recorded in Journal or Subsidiary Books and then posted into Ledger.

(2) To calculate profit or loss :— The second main objective of accounting is to ascertain the net profit earned or loss suffered on account of business transactions during a particular period. For this purpose Trading and Profit & Loss Account of the business is prepared at the end of each accounting period. All the items relating to purchases, sales, expenses and revenues (incomes) of the business are recorded in Trading and Profit & Loss Account. If the amount of revenue exceeds the expenditure incurred in earning that revenue, there is said to be a profit. In case the expenditure exceeds the revenue, there is said to be a loss. In addition, a businessman is able to get the following informations by preparing a Trading and Profit & Loss Account:—

I. How much goods have been purchased during a particular period?

II. How much goods have been sold during a particular period?

III. How much goods have remained unsold and what is its value?

IV. How much amount has been spent on various heads of expenditure and how much amount has been earned by various heads of revenues?

By attaining these informations a businessman can keep effective control on expenditure.

(3) To know the exact reasons leading to net profit or net loss.

(4) To ascertain the financial position of the business :— For a businessman, merely ascertaining profit or loss of the business is not sufficient. The businessman must also know the financial health of the business. For this purpose, after preparing the Profit & Loss Account a statement called 'Balance Sheet' is prepared which shows the assets and their values on the one hand and the liabilities and capital on the other hand. A Balance Sheet is actually a screen picture of the financial position of the business. At one glance, one would know the following by looking at the Balance Sheet:—

I. How much the business has to recover from Debtors?

II. How much the business has to pay to Creditors?

III. How much the business has in the form of (a) Cash in hand, (b) Cash at Bank, (c) Closing Stock, and (d) Fixed Assets?

(5) To ascertain the progress of the business from year to year.

(6) To prevent and detect errors and frauds.

(7) To provide informations to various parties :— Another main objective of accounting is to communicate the accounting information to various interested parties like owners, investors, creditors, banks, employees and government authorities etc. The information helps them in taking sound and judicious decisions about the business entity.

Functions of Accounting :

Accounting performs the following major functions :

(1) Maintaining Complete and Systematic Records : Main function of accounting is to maintain complete and systematic records of business transactions, post them to ledger and to prepare the financial statements i.e., Statement of Profit & Loss and the Balance Sheet.

(2) Communicating the Financial Results to Various Parties : Another main function of accounting is to communicate the information regarding net profit (or loss), assets, liabilities etc. to the interested parties.

(3) Protecting the Assets of Business : Another function of accounting is to maintain proper records of various assets such as Cash in hand, bank balance, inventory, debtors etc. It enables the management to keep proper control over them.

(4) Providing Assistance to Management : By providing timely information, accounting assists the management in the task of planning, controlling and decision-making.

(5) Trusteeship : In case of Companies, the management is entrusted with the task of controlling the resources of the enterprise. The management is expected to act as trustee of the Company's funds and the accounting assists them to control the resources properly.

(6) Compliance of Legal Needs : Under the provisions of various laws such as Companies Act, Income Tax Act, Goods and Service Tax (GST) Act etc. a business firm has to submit various statements such as annual accounts, Income Tax and GST Returns etc. Accounting performs this function by supplying the information to the government agencies.

Goods & Service Tax (GST) : All indirect taxes like Excise Duty, Sales Tax, VAT, Service Tax etc. have been merged into a single tax known as GST. GST is paid at the time of purchase and GST is collected at the time of sale.

(7) Fixing Responsibility : Another function of accounting is to determine the profitability of each department of an enterprise. It facilitates the fixing of responsibility of each departmental head.

Book-keeping, Accounting and Accountancy

These three are sometimes considered as synonymous, i.e., having the same meaning. However, there is a fundamental difference amongst book-keeping, accounting and accountancy.

Book-keeping :— "Book Keeping is an art of recording business dealings in a set of books." **—J.R. Batliboi**

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

"Book keeping is an art of recording in books of accounts the monetary aspect of commercial or financial transactions." **— Northcott**

It is mainly concerned with record keeping or maintenance of books of accounts. The maintenance of books of accounts includes the following four activities:

(i) Identifying the transactions of financial nature from amongst the various transactions.

(ii) Measuring the identified transactions in terms of money.

(iii) Recording the identified transactions in the books of original entry.

(iv) Classifying them into ledger.

The book-keeping function is routine and clerical in nature and can be performed by persons having limited knowledge of accounting. At present this function is increasingly done by computers.

Accounting :— Accounting starts where book-keeping ends. It includes the following activities :

(i) Summarising the classified transactions in the form of Profit & Loss Account and Balance Sheet etc.

(ii) Analysing and interpreting the summarised results. In other words, drawing the meaningful information from Profit & Loss Account and Balance Sheet etc.

(iii) Communicating the information to the interested parties.

Thus an accountant's work goes beyond that of a book-keeper. However, in actual practice the accounting process includes the book-keeping function also because on the basis of book-keeping records, an accountant draws up periodically such financial statements as Profit & Loss Account and Balance Sheet etc. In a small concern, the accountant performs the work of a book-keeper also.

Accountancy :— It refers to a systematic knowledge of accounting concerned with the principles and techniques which are applied in accounting. It tells us how to prepare the books of accounts, how to summarize the accounting information and how to communicate it to the interested parties. According to Kohler, 'accountancy refers to the entire body of the theory and practice of accounting.'

Distinction between Book-keeping and Accounting

Book-keeping differs from accounting in the following respects :

Basis of Distinction	Book-keeping	Accounting
1. Scope	Book-keeping includes : (a) Identifying the transactions of financial nature; (b) Measuring the identified transactions in terms of money; (c) Recording the measured transactions; and (d) Classifying them into ledger.	Accounting in addition to Book-keeping includes: (a) Summarising the classified transactions; (b) Analysing and interpreting the summarised results; and (c) Communicating the results to parties interested in them.
2. Stage	Book-keeping is primary stage.	It is the secondary stage. Accounting starts where Bookkeeping ends.
3. Objective	The main objective of Book-keeping is to maintain systematic records of transactions of financial nature.	Its main objective is to ascertain the net results and financial position of the business and to communicate them to interested parties.
4. Nature of Job	The Book-keeping function is	The Accounting function is

	routine and clerical in nature.	analytical in nature.
5. **Who Performs**	The Book-keeping function is performed by junior staff.	The Accounting function is performed by senior staff.
6. Knowledge Level	It can be performed by persons having limited level of knowledge.	It is performed by persons having higher level of knowledge than that of Book-keeper.
7. Analytical Skill	The Book-keeper is not required to possess analytical skill.	The Accountant is required to possess analytical skill.

Distinction between Accounting and Accountancy

Basis of Distinction	**Accounting**	**Accountancy**
1. Meaning	It is concerned with recording, classifying and summarising of transactions.	It is a body of knowledge prescribing certain rules or principles to be observed while recording, classifying and summarising of transactions.
2. Scope	It is narrow in scope. Accounting starts where Book-keeping ends.	It is much wider in scope and includes Book-keeping as well as Accounting.
3. **Relation**	It depends on Book-keeping	It depends both on Book-keeping and Accounting.
4. **Function**	Its main function is to ascertain the net results and the financial position of the business and to communicate them to interested parties.	It includes the decision-making function also on the basis of information provided by bookkeeping and Accounting.

Types or Sub-fields of Accounting

Management now-a-days requires various types of informations to perform its functions more efficiently. To meet the increasing requirement of management, various specialised **branches of accounting** have come into existence such as Financial Accounting, Cost Accounting, Management Accounting, Tax Accounting, Social Responsibility Accounting etc. These branches are explained as under :

(1) Financial Accounting:— The main purpose of this branch of accounting is to record the business transactions in a systematic manner, to ascertain the profit or loss of the accounting period by preparing a Profit & Loss Account and to present the financial position of the business by preparing a Balance Sheet. This branch of accounting provides informations required by the management and various other interested parties.

(2) Cost Accounting :— The main purpose of cost accounting is to ascertain the total cost and per unit cost of goods produced and services rendered by a business. It also estimates the cost in advance and helps the management in exercising strict control over cost.

(3) Management Accounting :— The main purpose of management accounting is to present the accounting information in such a way as to assist the management in planning and controlling the operations of a business. The management accountant uses various techniques and concepts to make the accounting data more useful for managerial decision making. These techniques include ratio analysis, budgetary control, fund flow statement, cash flow statement etc.

(4) Tax Accounting :— The branch of accounting which is used for tax purposes is called Tax Accounting. Income tax and GST are computed on the basis of this accounting.

(5) Social Responsibility Accounting :— The society provides the infrastructure and the facilities without which business cannot operate at all. Hence the business also has a responsibility to the society. There is a growing demand for reports on activities which reflect the contribution of an enterprise to the society. Social responsibility accounting is the process of identifying, measuring and communicating the contribution of a business to the society. The contribution of a business to the society consist of providing employment to under-privileged, providing financial and manpower support for public programmes, environmental contribution, product safety, product durability, customer satisfaction etc. In social responsibility accounting techniques have been developed for measuring the cost of these contributions and the benefit to the society.

Accounting as a Source of Information

Accounting is often regarded as the language of business. Since the main aim of a language is to serve as a means of communication, accounting communicates the result of business activities to management, owners, investors, creditors, lenders, Government etc. Accounting as an information system is a process of identifying, measuring, recording, summarising and communicating the information about business to interested users of such information. Different groups of persons have vested interests in a business organisation. Accounting provides useful information to all these interested parties.

Users of Accounting Information and Their Needs

Or

Parties Interested in Accounting Information

Accounting information is used by various groups of people who have contact with the business enterprise. They use accounting information in order to satisfy some of their varied needs for information.

These users may be classified into two groups:

(1) Internal Users, and (2) External Users

(1) Internal Users :— Internal users are the persons who have a direct interest in the business enterprise such as owners and management:

(i) Owners :— Owners (or present investors) contribute capital in the business and as such want to know about the profitability and financial soundness of the business. They also want to know whether the profits are increasing or decreasing? What are the reasons for the increase or decrease in profits? What is the value of fixed assets and floating assets of the business? All such information is provided by accounting.

(ii) Management :— Management need accounting information for the efficient and smooth running of the business enterprise. Their needs are met by the accounting information provided by published reports of the business enterprise such as Profit & Loss Account, Balance Sheet and Cash Flow Statement. However, most of the needs of management are met by unpublished internal reports which are prepared most frequently to meet the specific requirements of management. Such unpublished or internal reports provide the information relating to the cost of a product, speed of increase in the cost of production, profitability of each product, reasons for increase or decrease in sales and profits, estimates of future sales and profits etc. Management has direct access to these unpublished (or confidential) reports which contain valuable information not available to external users.

(2) External Users :— Individuals or organisations who have present or future interest in the business enterprise but are not part of the management are called external users of accounting information. They have no access to the internal or unpublished reports of the enterprise and hence make use of external or published reports such as Profit & Loss Account, Balance Sheet and Cash Flow Statement. The external users are, potential (new) investors, creditors, lenders, employees, Government etc.

Some of the external users and their needs for information are given below:

(i)	Potential Investors (for example, those who want to invest)	Potential investors need information to judge how safe and rewarding the proposed investment will be.
(ii)	Short-term creditors (For example, suppliers of goods and services on credit)	They want information about the creditworthiness of the business enterprise. They want to know whether the amount owing to them will be repaid when due and whether they should extend, maintain or restrict the credit to the enterprise.
(iii)	Long-term creditors (Such as Financial Institutions)	They want to judge whether their principal and the interest thereof will be repaid when due and whether they should extend, maintain or restrict the long-term loans to the enterprise.
(iv)	Employees	Employees need information about the profits of a business to assess the ability of the business to pay higher wages and bonuses. They may also use the financial statements (i.e. accounting information) to ascertain whether various amounts due to them such as provident fund is being deposited regularly.
(v)	Tax Authorities	Tax authorities need information for the assessment

		of income tax, Goods and Service Tax (GST) etc.
(vi)	Government and their Agencies	Government and their agencies need information to form policies relating to taxation, allocation of resources and for providing subsidies etc.
(vii)	Social responsibility groups (such as environmental protection groups)	They need information on the impact on environment and the steps taken by the enterprise for the protection of environment.
(viii)	Public	An enterprise affects the public in a variety of ways such as a provider of employment, provider of amenities in the locality and being the customer to local suppliers. Hence, public at large is interested in knowing the future plans of the enterprise.
(ix)	Competitors	They want information on the relative strengths and weaknesses of the enterprise and for making comparisons.

As an information system, the accounting process provides information to all the users whether inside or outside the business-enterprise. Such information helps the users of the information in making various decisions. The information is communicated through various financial statements such as profit and loss account, balance sheet, fund flow statement, cash flow statement etc. The financial statements are normally prepared on yearly basis. However, the frequency of their preparation depends on the needs of their users. For example, the sales manager may require monthly or even weekly information of sales whereas the needs of investors, creditors etc. will be satisfied by annual financial statements. In order to make the information more understandable and meaningful, various items of financial statements are presented in the form of ratios, percentages, graphs, charts etc.

Advantages or Uses of Accounting

Accounting offers the following advantages :

(1) Helpful in Management of Business :— Management needs a lot of information for the efficient running of the business. All such information is provided by the accounting which helps the management in the following :–

(A) Helpful in Planning:— Management would like to know whether the sales are increasing or decreasing and also the speed of increase in the cost of production. All such information is provided by the accounting, which helps the management in estimating the future sales and expenses. It also helps them to estimate the cash receipts and cash disbursements during the next accounting period.

(B) Helpful in Decision Making :— At times, the Management has to take a number of decisions. For example, What should be the selling price of the product? How much discount should be offered to the customers? Accounting provides all the informations required for making such decisions.

(C) Helpful in Controlling :— Management would like to see that the cost incurred is reasonable and that no department is overspending. Accounting provides information to the management in this regard.

(2) Provides Complete and Systematic Record :— Business transactions have grown in size and complexity and it is not possible to remember each and every transaction. Accounting keeps a prompt and systematic record of all the transactions and summarizes them in order to provide a true picture of the activities of the business entity.

(3) Information Regarding Profit or Loss Accounting reports the net result of business activities of an accounting period. The Profit & Loss Account prepared at the end of each accounting period discloses the net profit earned or loss suffered during that period. The information regarding profit is of great use to the owners and various other interested parties.

(4) Information Regarding Financial Position ;— Accounting reports the financial position of the business by preparing a Balance Sheet at the end of each accounting period. Balance Sheet discloses the position of assets and their values on the one hand and liabilities and capital on the other hand.

(5) Enables Comparative Study :— By keeping a systematic record accounting helps the owners to compare one year's costs, expenses, sales and profit etc. with those of other years. Such a comparison provides the useful informations on the basis of which important decisions can be taken more judiciously.

(6) Helpful in Assessment of Tax Liability :—Properly maintained records will be of great help when the firm is assessed to Income Tax or GST. Such records when audited are trusted by the taxation authorities.

(7) Evidence in Legal Matters :— Properly maintained accounts, supported by authenticated documents are accepted by the courts as a firm evidence.

(8) Facilitates Sale of Business :— If a business entity is being sold, the accounting information can be utilised to determine the proper purchase price.

(9) Helpful in Raising Loans :— Accounting information is of great help while raising loans from banks or other financial institutions. Such institutions before sanctioning loan screen various financial statements of the firm such as final accounts, fund flow statement, cash flow statement etc.

(10) Helpful in Partnership Accounts :— Accounting records provide all the information needed at the time of admission of a partner, retirement or death of a partner and dissolution of the firm. Goodwill of the firm is also valued on the basis of accounting records.

(11) Helpful in Prevention and Detection of Errors and Frauds.

Limitations of Accounting

As discussed above, accounting provides information about the profitability and financial soundness of a concern to the owners and other interested parties. In addition, it provides various other valuable informations also. However, accounting has certain limitations which must be kept in mind while using such informations. These limitations are as follows :

(1) Influenced by Personal Judgements :— Accounting is as yet an exact science and accountant has to exercise his personal judgement in respect of various items. For example, it is extremely difficult to predict with any degree of accuracy the actual useful life of an asset which is needed for calculating depreciation. The same is true about method of valuation of stock and making provision for doubtful debts. Different persons are bound to have different opinions in respect of such things and hence it will result in ascertainment of different figure of profit or loss of a business by different persons. Hence the figure of profit cannot be taken as an exact figure.

(2) Based on Accounting Concepts and Conventions :— Accounts are prepared on the basis of a number of accounting concepts and conventions. Hence, the profitability and the financial position disclosed by it may not be realistic. For example, fixed assets are shown in the balance sheet according to the 'historical cost concept'. This means that the fixed assets are shown at their cost and not at their market value. The values realised on their sale may be more or less than the values stated in the balance sheet. Similarly, on account of convention of conservatism, the profit & loss account does not disclose the true profit of the business because future losses are provided whereas future incomes are ignored.

(3) Incomplete Information :— Accounting statements provide only the incomplete information because the actual profit or loss of a business can be known only when the business is closed down.

(4) Omission of Qualitative Informations :— Accounts contain only those informations which can be expressed in terms of money. Qualitative aspects of business units are completely omitted from the books as these cannot be expressed in monetary terms, Thus, changes in management, reputation of the business, cordial management-labour relations, firm's ability to develop new products, efficiency of management, satisfaction of firm's customers etc. which have a vital bearing on the profitability of the firm are all ignored and omitted from being recorded because all of these are qualitative in nature.

(5) Based on Historical Costs :— Accounts are prepared on the basis of historical costs (i.e., the original costs) and as such the figures given in financial statements do not show the effect of changes in price level. The assets remain undervalued in many cases particularly land and building. The outcome of this practice is that balance sheet values of assets are not helpful in estimating the true financial position of the business.

(6) Affected by **Window Dressing** :— Window dressing refers to the practice of manipulating accounts, so that the financial statements may disclose a more favourable position than the actual position. For example, the purchases made at the end of the year may not be recorded or the closing stock may be over-valued. Hence, correct decisions cannot be taken on the basis of such financial statements.

(7) Unsuitable for Forecasting :—Financial Accounts are only a record of past events. Continuous changes take place in the demand of the product, policies adopted by the firm, the position of competition etc. As such, the financial analysis based on past events may not be of much use for forecasting.

Qualitative Characteristics (Attributes) of Accounting Information

Accounting information should be prepared and presented in such a way that it is able to depict a clear and orderly view of the business enterprise. Following characteristics of accounting information make it more useful for its users :

(1) **Reliability** :—Accounting information must be reliable. Reliability implies that the information must be factual and verifiable. The accounting information is said to have verifiability if such information can be verified from source documents such as cash memos, purchase invoices, sales invoices, correspondence, agreements, property deed and other similar documents. Verifiability ensures the truthfulness of the recorded transactions which can be independently checked by anyone interested to ascertain the true position. But if the source documents are not available, the accounting information disclosed by profit and loss account and balance sheet will not be capable of being verified and it would imply that it cannot be relied on.

Some accounting records are most reliable while others are not. For example, recording of fixed assets at actual cost is most reliable since the same can be independently verified from property deed. But it is not true for some other transactions because accounting is not an exact science. For example, depreciation charged on fixed asset cannot be independently verified since it is based on estimated useful life of the asset which requires personal judgement. Personal judgement is also required while valuing stock and making provision for doubtful debts. In order to ensure reliability in such transactions the personal judgements must be free from bias.

(2) **Relevance** :—Accounting informations depicted by financial statements must be relevant to the objectives of the enterprise. Unnecessary and irrelevant informations should not be included in financial statements. To be relevant, information must be capable of making difference in decision, that is, it must help the management investors, creditors and other users of the accounting information in making decisions. For example, the information regarding the rate of dividend paid by a company in previous years is a relevant information for the investors since it provides a basis for forecasting future dividends. Similarly, while reporting debtors in the balance sheet, it is the total amount of debtors which is relevant and not the number of debtors.

An accountant is usually faced with the problem of choosing the relevant data from the mass of data because the needs of different users may be different. For example, the information required by bankers will not necessarily be the same as required by investors. Hence the accountant will have to study the needs of various users and find out which information is common and relevant to all the users. In addition, a difficulty arises in deciding as to whose needs should be given priority. For example, certain information regarding the profitability may be relevant to creditors but its disclosure may be harmful to the interests of shareholders as it may give vital clues to the competitors. While taking a decision in this matter the accountant will be guided by the concepts of truth, justice and fairness.

(3) **Understandability** :— Accounting informations should be presented in such a simple and logical manner that they are understood easily by their users such as investors, lenders, employees etc. A person who does not have any knowledge of accounting terminology should also be able to understand them without much difficulty. This can be done by giving relevant explanatory notes to explain the information given in financial statements. General topics which should be included in explanatory notes are method of depreciation, method of valuation of inventory, description of contingent liabilities, explanation of reserves, comment on extraordinary gains and losses, disclosure of events occurring after the balance sheet date etc. These explanatory notes make the financial statements more useful and understandable.

(4) Comparability :— Comparability is a very useful quality of the accounting information. The financial statements should contain the figures of previous year along with the figures of current year so that the current performance can be compared with past performance. Similarly, the financial statements should be prepared in such a way that the profitability and financial position of the concern may be compared with other concerns of the similar type. Comparison reveals the strong and weak points of the business entity. Comparability is possible when different firms in the same industry adopt the same accounting principles from year to year. For example, if diminishing balance method of charging depreciation is selected, it should not be changed from year to year. Similarly the method of valuation of stock should also be consistently the same from year to year. However, the consistency principle does not mean that a particular method once adopted should never be changed. When change in method is desirable for the purpose of better preparing and reporting the accounting information, it should be changed. In such a case, the nature and effect of change and the justification for change must be stated clearly by way of footnotes to enable the users of accounting information to be aware of such change.

(5) **Faithful Presentation** :— Financial statements are required to show a True and fair view of the profitability, financial position and cash flows of an enterprise. Application of appropriate accounting standards normally results in financial statements portraying true and fair view of information about an enterprise.

In addition to the above, accounting information should also have the characteristics of timeliness, neutrality and completeness.

Role of Accounting

Role of accounting has been changing with the changes in business environment and increasing social demands. Over the centuries, the role of accounting remained confined to the record keeping of financial transactions only. But, today's rapidly changing business environment has changed the role of accounting and at present the accounting plays the following different roles :

(1) **Role of a Language** :— Accounting is viewed as a language of business because it prepares reports and statements which communicate information -regarding the business enterprise.

(2) **Role of Historical Record** :— Accounting is viewed as chronological record of all financial transactions in the books of accounts according to specified rules.

(3) **Role of Determining the Net Profit** :— It is also regarded as a means of determining the true profit or loss of a business enterprise.

(4) **Role of Determining the Financial Position** :— It is also regarded as a means of showing the financial position of the business by the preparation of Balance Sheet.

(5) **Role of Information System** :— Accounting is now regarded as an information system because it is capable of providing the kind of information which managers and other interested parties require for taking appropriate decisions.

(6) **Role of Service Provider** :— Accounting is regarded as a service activity because it provides quantitative financial information which is helpful to the users in different ways.

Multiple Choice Questions (SET A)

Select the correct alternative:

1. In accounts recording is made of:
(A) Only Financial Transactions
(B) Only Non-financial transactions
(C) Financial as well as non-financial transactions
(D) Personal transactions of the Proprietor

2. Ghanshyam is a furniture dealer. Which one of the following will not be recorded in his books?
(A) Purchase of Timber for Rs.50,000
(B) Sofa set worth Rs.40,000 taken to his home
(C) Sale of household furniture for Rs.5.000
(D) Dining table of Rs.30,000 given to his friend as gift

3. Which of the following transactions is not of financial character?
(A) Purchase of asset on credit
(B) Purchase of asset for cash
(C) Withdrawing of money by
(D) Strike by Employees proprietor from business

4. Last step of accounting process is :
(A) Provide information to various parties who are interested in business enterprise.
(B) Record transactions in the books.
(C) To make summary in the form of financial statements.
(D) To classify the transactions under separate heads in the ledger.

5. Internal users of accounting information are :
(A) Potential Investors
(B) Creditors
(C) Management
(D) Employees

6. External users of accounting information are :

(A) Researchers

(B) Government

(C) Potential Investors

(D) All of the above

7. External users of accounting information are not:

(A) Lenders

(B) Officers

(C) Employees

(D) Public

8. Which of the following is not a limitation of accounting?

(A) Based on accounting conventions

(B) Evidence in Legal Matters

(C) Incomplete Information

(D) Omission of Qualitative Informations

9. Which one of the following is not an objective of accounting?

(A) To provide information about the assets, liabilities and capital of the enterprise.

(B) To provide information about the private assets and liabilities of the proprietor.

(C) To maintain records of the business

(D) To provide information regarding the profit and loss of the enterprise.

10. If accounting information is based on facts and it is verifiable by documents it has the quality of ……

(A) Relevance

(B) Reliability

(C) Understandability

(D) Comparability

11. Which of the following transactions is of a financial character and will be recorded in the business?

(A) Goods taken from the business by the proprietor for her personal use

(B) Interviewing the candidates for employment

(C) Sale of Household furniture Rs.5,000

(D) Received an order for sales of goods

12. Book-keeping is mainly concerned with :
(A) Recording of financial data
(B) Designing the systems of summarising the recorded data
(C) Interpreting the data for internal and external users
(D) Preparation of financial statements of the business enterprise

13. Which of the following is not a sub-field of accounting?
(A) Financial accounting
(B) Book Keeping
(C) Management accounting
(D) Cost Accounting

14. Which of the following is the most relevant accounting information for taxation authorities?
(A) Cash Balance of the firm
(B) Book Value of the Fixed Assets
(C) Credit Sales of the year
(D) Profit generated during the year

15. Which of the following limitations of accounting states that accounts may be manipulated to conceal vital facts :
(A) Accounting is not fully exact
(B) Accounting may lead to window dressing
(C) Accounting ignores price level changes
(D) Accounting ignores qualitative elements

Answers

Multiple Choice Questions (SET A)

Select the correct alternative:

1. (A)	**2. (C)**	**3. (D)**	**4. (A)**	**5. (C)**
6. (D)	**7. (B)**	**8. (B)**	**9. (B)**	**10. (B)**
11. (A)	**12. (A)**	**13. (B)**	**14. (D)**	**15. (B)**

Multiple Choice Questions (SET B)

Select the correct alternative:

(1) Book Keeping and Accounting

(a) means same and are used interchangeably.

(b) does not mean same and are not used interchangeably.

(e) means both (a) and (b).

(d) None of the above.

(2) Accounting

(a) includes Book Keeping.

(b) does not include Book Keeping.

(c) may or may not include Book Keeping.

(d) None of these.

(3) Which of the following will not be recorded in the books of account?

(a) Sales of goods

(b) Payment of salary

(c) Quality of staff

(d) Purchase of Goods

(4) Book Keeping is concerned with

(a) recording financial data relating to business operations.

(b) designing for systems recording, classifying and summarising recorded data.

(c) interpreting data for internal and external users.

(d) All of the above.

(5) Which is the last step of accounting as a process of information?

(a) Recording the transaction

(b) Preparation of financial statements

(c) Communication of information

(d) Analysis and interpretation of information

(6) Basic function of financial accounting is to

(a) record all business transactions.

(b) interpret financial data.

(c) assist the management.

(d) None of these.

(7) Transactions are posted into Ledger Account from

(a) Vouchers.

(b) Journal book,

(c) Bank Statement.

(d) None of these.

(8) Which of the following is not a business transaction?

(a) Purchase of goods for resale amounted to Rs. 50,000

(b) Paid salaries and wages amounted to Rs. 10,000

(c) Paid rent for office premises Rs. 5,000

(d) Purchased a LCD for personal use

(9) Which of the following transactions will not be recorded in the books of account?

(a) Purchased a LCD for personal use, paying the amount from personal bank account.

(b) Purchased machinery for manufacture.

(c) Purchased machinery for resale.

(d) Paid salaries and wages.

(10) Accounting does not show the realisable value of business. It is a/an

(a) limitation of Accounting.

(b) advantage of Accounting.

(c) Both (a) and (b).

(d) None of these.

(11) Which of the following is not an internal user of financial statements?

(a) Board of Directors

(b) Managers

(c) Employees

(d) Lenders

(12) Which of the following is not a characteristic of accounting?

(a) Recording non-monetary transactions

(b) Classifying

(c) Analysis

(d) Summarising

(13) Which of the following is a limitation of accounting?

(a) Assistance to Management

(b) Replaces Memory

(c) Unrealistic Information

(d) Evidence in Court

(14) Cost of Goods Manufactured is determined by

(a) Financial Accounting.

(b) Cost Accounting.

(c) Management Accounting.

(d) Human Resource Accounting.

(15) Qualitative characteristic of Accounting includes

(a) Reliability and Relevance.

(b) Understandability and Comparability.

(c) Both (a) and (b).

(d) None of the above.

(16) Which of the following is not a qualitative characteristic of accounting information?

(a) Reliability

(b) Understandability

(c) Comparability

(d) Materiality

(17) Which qualitative characteristic of accounting information is reflected when accounting information is clearly presented?

(a) Reliability

(b) Relevance

(c) Comparability

(d) Understandability

(18) Which external user of accounting information is most interested in knowing the long-term solvency position of the firm?

(a) Employees

(b) Management

(c) Bank and Financial Institutions

(D) Researchers

Answers

Multiple Choice Questions (SET B)

Select the correct alternative:

1. (b)	**2. (a)**	**3. (C)**	**4. (A)**	**5. (c)**
6. (A)	**7. (B)**	**8. (d)**	**9. (a)**	**10. (a)**
11. (d)	**12. (a)**	**13. (c)**	**14. (b)**	**15. (c)**
16. (d)	**17. (d)**	**18. (c)**		

Chapter 2

Basic Accounting Terms

There are certain basic accounting terms which are daily used in the business world. Before recording the transactions in the books, it is essential to understand these terms as these terms have their specific meaning in Accounting. These basic terms are called **accounting terminology**:

(1) Business Transaction: —A business transaction is an economic activity of the business that changes its financial position. Whenever any business transaction takes place, it results in a change in the values of some of the assets, liabilities or capital.

The chief features of a transaction are:

(i) It involves an economic activity. For example, when goods are purchased or sold for cash or on credit or when salaries are paid to employees or when interest is paid on money borrowed from the bank, a business transaction takes place. Social activities are not considered as transactions.

For example: if X purchases a gift for his friend, it will not be considered as a transaction because it is social engagement.

(ii) Transactions may be classified into two types — external and internal. External transactions are those which involve economic activities between two independent business entities such as purchase or sale of goods. Internal transactions are those economic activities that take place entirely within one business entity such as depreciation charged on fixed assets.

(iii) It results in a change in the financial position of the firm — a change in the values of some of the assets, liabilities or capital.

(iv) The change must be capable of being expressed in terms of money. Loss of goods by fire or the loss due to a customer's inability to pay are transactions because the losses can be measured in terms of money. However, when an efficient manager retires from the firm, the loss to the business may be quite large, but since it cannot be measured in terms of money, it will not be a business transaction.

(2) Event:— An event is the consequence or result of a transaction. For example:

Sachin starts a business with a Capital of Rs.5,00,000. He purchases goods for Rs.4,00,000 for Cash and sells 3/4th of these goods for Rs.3,80,000. He also pays Rs.20,000 as rent of the godown.

The following results can be drawn from the above:

1. Transactions are:

(a) Investment of Rs.5,00,000 in the business.

(b) Purchasing of goods for Rs.4,00,000.

(c) Making Cash Sales of Rs.3,80,000.

(d) Payment of godown rent Rs.20,000.

2. Events are:

(a) Profit of Rs.60,000 computed as under:

		Rs.
Sales		3,80,000
Cost of Purchases: 3/4 of Rs.4,00,000	3,00,000	
Add: Godown Rent	20,000	3,20,000
		60,000

(b) Closing Inventory of Rs. 1,00,000 computed as under:

	Rs.
1/4 of Rs.4,00,000	1,00,000

(c) Cash balance of Rs.4,60,000 computed as under:

		Rs.
Capital Contribution		5,00,000
Add: Cash Sales		3,80,000
		8,80,000
Less: Cash Purchases	4,00,000	
Godown Rent	20,000	4,20,000
		4,60,000

(d) Capital of Rs.5,60,000 computed as under :

	Rs.
Initial Capital Contribution	5,00,000
Add: Profit	60,000
	5,60,000

(3) Account: — In actual practice, the individual transactions of like nature are recorded, added and subtracted at one place. Such place is customarily termed as an 'Account'. Prior to understanding the meaning of debit and credit, it is essential to understand the meaning and form of an Account.

An account is a record of all business transactions relating to a particular person or item. In accounting we keep a separate record of each individual, asset, liability, expense or income. The place where such a record is maintained is termed as an 'Account'. Such as the Account of Ghanshyam, the Account of Ram, the Account of Machinery, the Account of Salary, the Account of rent and likewise. All transactions entered into with Ghanshyam will be recorded in the Account of Ghanshyam and similarly, all transactions relating to Ram will be recorded in the Account of Ram. According to Carter:

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

All accounts are divided into two sides. The left side of an account is arbitrarily or traditionally called Debit side and the right side of an account is called Credit side. In the abbreviated form, Debit is written as Dr. and Credit is written as Cr. For example, the transactions relating to cash are recorded in an account, entitled 'Cash Account' and its format will be as given below:—

Debit (Dr.) **CASH ACCOUNT** **Credit (Cr.)**

	Rs.		Rs.

The above account resembles English capital letter 'T'. As such, it is often called 'T' shape account. An Account is abbreviated as A/c.

(4) Capital: — It refers to the amount invested by the proprietor in a business enterprise. Amount may be in the form of cash, goods or assets. It is the amount with the help of which goods and assets are purchased in the business. As such, in order to calculate the amount of capital all current assets and fixed assets are added up and external liabilities are deducted out of it.

Capital = Assets - Liabilities

For example, suppose that the following balances appeared in the books of a firm: — Cash Rs.20,000; Machinery Rs.50,000; Stock Rs.1,00,000; Debtors Rs.40,000 and Creditors Rs.30,000. In this case the Capital will be: —

Capital = Cash Rs.20,000 + Machinery Rs.50,000 + Stock Rs.1,00,000 + Debtors Rs.40,000 - Creditors Rs.30,000 = Rs.1,80,000.

Capital is also known as Owner's Equity or Net Worth or Net Assets.

(5) Drawing: — Any cash or value of goods withdrawn by the owner for personal use or any private payments made out of business funds are called drawings.

(6) Liability: — It refers to the amount which the firm owes to outsiders (excepting the amount owed to proprietors). In the words of Finney and Miller, "Liabilities are debts, they are amounts owed to Creditors." This can be expressed as:

Liabilities = Assets - Capital

Thus, when a firm purchases goods on credit from A, the amount owing to A is a liability. Likewise, when a bank account is overdrawn, the amount owing to the bank (i.e., bank overdraft) is known as a liability. Likewise, the Bills Payable, Creditors, Unpaid Wages are also the examples of liabilities.

Liabilities may be divided into two parts:

(i) Internal Liabilities: — All amounts which a business entity has to pay to the proprietor or owners are internal liabilities such as capital and accumulated profits.

(if) **External Liabilities:** — All amounts which a business entity has to pay to outsiders are known as external liabilities such as creditors, bank overdraft, loans etc.

Liabilities may be further classified into two parts as under: —

(i) Non-Current Liabilities:—These refer to those liabilities which fall due for payment in a relatively long period (normally after more than one year). For example, Long Term Loans and Debentures etc.

(ii) **Current Liabilities:** —Current liabilities refer to those liabilities which are to be paid in near future (normally within one year). For example, Bank Overdraft, Bills Payable, Creditors, Outstanding Expenses and Short-Term Loans etc.

(7) Assets: — Anything which is in the possession or is the property of a business enterprise including the amounts due to it from others, is called an asset. In other words, anything which will enable a business enterprise to get cash or a benefit in future is an asset. Thus, Cash and Bank balances, Stock, Furniture, Machinery, Land and Building, Bills Receivable, Money owing by Debtors etc. are all assets.

"Assets are future economic benefits, the rights of which are owned or controlled by an organisation or individual." — **Finney & Miller**

"Assets are valuable resources owned by a business which are acquired at a measurable money cost." — **Prof. R.N. Anthony**

According to the above definitions there are three main characteristics of an asset:—

I. The resources must be valuable.

II. The resources must be owned by the business.

III. The resources must be acquired at a measurable money cost.

Assets may be classified into the following categories: —

(i) Non-Current Assets: — Non-Current Assets refer to those assets which are held for continued use in the business for the purpose of producing goods or services and are not meant for sale. Examples of non-current assets are long-term investments and fixed assets such as Land and Building, Plant and Machinery, Computer, Motor Vehicles, Furniture etc.

Fixed Assets are further classified into:

(a) Tangible Assets: — Tangible assets are those assets which can be seen and touched. In other words, which have a physical existence such as Land & Building, Plant & Machinery, Computer, Motor Vehicles, Furniture, Stock, Cash etc.

(b) Intangible Assets: — Intangible assets are those assets which do not have a physical existence and thus, cannot be seen or felt. Examples of such assets are Goodwill, Patents, Copyright, Trade Marks, Computer Software and Prepaid Expenses. Intangible assets are also valuable assets. For example, with the help of Patents (know-how) businessman is able to produce goods and his goodwill helps in attracting customers easily. Therefore, the intangible assets help the firm in earning profits as much as the tangible assets. Hence, both tangible and intangible are valuable assets. Value of intangible assets is based on the benefit and facility available to the business from such assets.

(ii) Current Assets: — Current assets are those assets which are meant for sale or which the management would want to convert into cash within one year. As such, these assets are also termed as 'Short-lived or active assets.

For example: 'Debtors' are expected to be converted into cash within a reasonable short period, Stock is continuously sold and Bills receivables are also converted into cash.

According to **The Institute of Certified Public Accountants, U.S.A.** "Current assets include cash and other assets or resources commonly identified as those which are reasonably expected to be realised in cash or sold or consumed during the normal operating cycle of the business."

Although 'Prepaid Expenses' will never be realised in Cash, these are also included in Current Assets, since service or benefit will be available against these without further payment.

Current assets are also known as floating assets or circulating assets as the amount and nature of such assets keeps changing continuously. For example, a businessman purchases goods for cash and these goods are sold to X on Credit, X becomes our Debtor and it means that the stock has been converted into 'Debtors'. Again, if a bill receivable is received from X, it means that the Debtors are converted into 'Bills Receivable' and after some time Bills Receivable will be converted into Cash. It shows that all Current assets are finally converted into Cash.

Current assets are usually shown in the balance sheet in the 'Liquidity Order'. Liquidity is the facility with which the asset may be converted into cash. Those assets which are most difficult to be converted into cash are written last. Following are the Current assets in order of liquidity: — Cash in Hand, Cash at Bank, Bills Receivable, Short Term Investments, Debtors, Stock and Prepaid Expenses.

Out of the above assets, Stock and Investments are shown in the balance sheet at **Cost or Realisable value whichever is less.** Bills Receivable and Debtors are shown at the estimated realisable values and the Cash in Hand and Cash at Bank are shown at the actual figure.

(iii) Fictitious or Nominal Assets: — These are the Assets which cannot be realised in Cash or no further benefit can be derived from these assets. Such assets include Debit balance of P & L A/c and the expenditure not yet written off such as Advertisement Expenses etc. These assets are not really assets but are shown on the Assets side only for the purpose of transferring them to the Profit & Loss Account gradually over a period of time.

(8) Capital Receipts and Revenue Receipts: — It is also necessary to make a proper distinction between capital receipts and revenue receipts because the revenue receipts are shown on the credit side of Trading and Profit & Loss Account whereas the capital receipts are shown in the Balance Sheet either as increase in liabilities or as reduction in the value of the assets.

Capital Receipts:

Examples of capital receipts are:

(i) Amount received from the sale of fixed assets or investments.

(ii) Capital contributed by proprietors, partners or money obtained from issue of shares and debentures in case of company.

(iii) Amount received by way of loans.

Revenue Receipts:

(i) Money obtained from sale of goods.

(ii) Commission and fees received for services rendered.

(iii) Interest and dividend received on investments.

(9) Expenditure:— Any disbursement of cash or transfer of property or incurring a liability for the purpose of acquiring assets, goods or services is called expenditure. It means that any type of payment for the receipt of a benefit is termed as expenditure. Expenditure may be classified into three categories:

(i) Capital expenditure,

(ii) Revenue expenditure and

(iii) Deferred revenue expenditure.

(i) Capital Expenditure:— Any expenditure which is incurred in acquiring or increasing the value of a fixed asset is termed as capital expenditure. As such, the amount spent on the purchase or erection of Building, Plant, Furniture etc. is capital expenditure. Such expenditure yields benefit over a long period and hence written in Assets.

(ii) Revenue Expenditure: — Any expenditure, the full benefit of which is received during one accounting period is termed as revenue expenditure such as cost of goods sold, salaries, rent, electricity charges etc. As such, all the revenue expenditures are debited to Trading and Profit & Loss Account. Such expenditure does not result in an increase in the earning capacity of the business but only helps in maintaining the existing earning capacity. It also does not bring into existence an asset of an enduring nature.

Distinction between Capital Expenditure and Revenue Expenditure

I. Capital expenditure is incurred for the acquisition or erection of a fixed asset, whereas revenue expenditure is incurred for the day to day running of the business.

II. Capital expenditure is incurred for the purpose of increasing the earning capacity of the business, whereas revenue expenditure is incurred for maintenance of earning capacity i.e., for keeping the assets in an efficient working order.

III. Capital expenditure yields benefit normally over a long period, whereas revenue expenditure yields benefit for a maximum period of one year.

IV. Capital expenditure is written in the balance sheet, whereas revenue expenditure is written in Trading or Profit & Loss Account.

(iii) Deferred Revenue Expenditure: — There are certain expenditures which are revenue in nature but the benefit of which is likely to be derived over a number of years. Such expenditures are termed as 'Deferred Revenue Expenditures'. The benefit of such an expenditure generally lasts between 3 to 7 years. As such, the whole of such expenditure is not debited to the Profit and Loss Account of the current year but spread over the years for which the benefit is likely to last. Thus, only a part of such expenditure is taken to Profit & Loss Account every year and the unwritten off portion is allowed to stand on the assets side of the Balance Sheet.

For example: a firm spent a huge amount of Rs.2,00,000 on advertising to introduce a new product in the market and it is estimated that its benefit will last for 4 years. In this case, Rs.50,000 will be charged to the P & L A/c of each year for four consecutive years.

Rs.50,000 will be debited to P & L A/c of each year and the balance will be treated as an asset and shown on the Assets side of the Balance Sheet. As such, the amounts shown on the Assets side will be Rs. 1,50,000 in the first year, Rs. 1,00,000 in the second year and Rs.50,000 in the third year.

(10) Expenses: — Expense is the cost incurred in producing and selling the goods and services. According to Finney and Miller, "Expense is the cost of use of things or services for the purpose of generating revenue".

Following are included in the term Expenses: —

I. Cost of goods sold.

II. Amount paid for Rent, Commission, Salary, Advertisement etc.

III. Decline in the value of an asset caused by the use of such asset for business purpose or depreciation is also an expense.

(11) Income: — 'Income' is different from 'revenue'. Amount received from sale of goods is called 'Revenue' and the cost of goods sold is called 'Expense'. Surplus of revenue over expenses is called 'Income.' For example, the goods costing Rs.4,00,000 are sold for Rs.5,00,000. The sale amounting to Rs.5,00,000 is the revenue, the cost amounting to Rs.4,00,000 is expense and the difference between the two i.e. Rs. 1,00,000 is the income. It can thus, be expressed as:

Income = Revenue - Expense

(12) Profit: — It is the excess of **total revenues** over **total expenses** of a business enterprise for an accounting period. Profit increases the investment of the owners.

(13) Gain: — It is a monetary benefit, profit or advantage resulting from events or transactions which are incidental to business such as sale of fixed assets, winning a court case or appreciation in the value of an asset. For example, if a building costing Rs.10,00,000 is sold for Rs. 12,00,000; Rs.2,00,000 will be the gain on sale of building.

(14) Loss: —The term conveys two different meanings. First, it conveys the result of the business for a period when total expenses exceed the total revenues. For example, if revenues are Rs.2,00,000 and expenses are Rs.2,40,000, the loss will be Rs.40,000. Second, it refers to some fact or activity against which firm receives no benefit. For example, loss due to fire, theft, accident etc. It may be noted that losses differ from expenses. Expenses are incurred to generate revenues whereas losses do not. For example, the theft of an asset is a loss but its depreciation is an expense.

(15) Purchases: — The term purchases is used only for the purchase of 'Goods' in which the business deals. In case of a manufacturing concern 'goods' means acquiring of raw material for the purpose of conversion into finished product and then sale. In case of trading concern 'goods' are those things which are purchased for resale. In both the cases the purpose is to make a profit by its resale. For example, if a cloth dealer purchases cloth for sale, the cloth so purchased will be called **goods**. However, if the same cloth dealer purchases furniture for seating the customers, such furniture will not be termed as goods, but it will be an 'Asset' and a separate account named 'Furniture Account' will be opened for it.

The term purchases includes both cash purchases and credit purchases of goods.

Purchase Returns :— When purchased goods are returned to the suppliers these are known as purchase returns. Such returns are also termed as 'returns outwards'.

(16) Sales: — Sales means transfer of ownership of goods or services to customers for a price. For example, If Tarun sells a Computer to Varun, the ownership of Computer will be transferred from Tarun to Varun and Tarun is entitled to receive the agreed price of Computer from Varun. The term 'sales' is used only for the sales of those goods which are purchased for resale purposes. It also includes revenues from services provided to customers. The term 'sales' is never used for the sale of assets. For example, if a cloth dealer sells cloth, it will be termed as sales, but if the same cloth dealer sells old furniture or a typewriter, it will not be termed as sales.

The term sales includes both Cash and Credit sales.

Sales Returns: — Some customers might return the goods sold to them. These are termed as sales returns or 'returns inwards.

(17) Stock or Stock-in-trade: —The term ‘stock’ includes the value of those goods which are purchased for reselling and which are lying unsold at the end of accounting period. The Stock may be of two types: —

(i) Opening Stock,

(ii) Closing Stock.

The term ‘Opening Stock’ means the value of goods lying unsold at the beginning of the accounting period whereas the term ‘Closing Stock’ means the value of goods lying unsold at the end of the accounting period.

(18) Inventory :— In case of a manufacturer, there can be opening and closing inventory of four types :—

(i) Inventory of Raw Material :— It includes inventory of raw materials purchased for using them in the products manufactured but still lying unused. For example, the value of cotton in case of cloth mills is the inventory of raw material.

(ii) Inventory of Work-in-progress :— It is also termed as inventory of partly finished goods. It means goods in semi-finished form. Such goods need further processing for converting into finished products. For the valuation of work in progress, the value of raw materials used in it, the cost of labour, power, fuel and other expenses on proportionate basis are included. In case of cloth mills the value of threads and the unfinished cloth will be the inventory of work in progress.

(iii) Inventory of Finished Goods :— It includes the inventory of those goods which have been completely processed and are ready for sale but are lying unsold at the end of the accounting period. In case of cloth mills the value of finished cloth will be the value of inventory of finished goods.

(iv) Inventory of stock-in-trade :— It includes the value of those goods which are purchased for reselling.

Calculation of Closing Inventory: — To ascertain the value of the closing inventory, a complete list of all the items in the godown together with their quantities is prepared. also, the separate lists should be prepared for raw materials, semi-finished goods, finished goods and stock-in-trade.

Care should be taken that the following goods are not included in the list of inventory:

I. Goods which have been sold but remain undelivered.

II. Goods purchased and received but which have not been recorded in the purchase book.

Following goods should be included in the list of inventories: —

I. Goods sent to the customers on sale or return basis.

II. Goods sent to the agents for sale but remain lying with them as unsold.

It should always be kept in mind that inventory is valued at cost price or realisable value, whichever is less.

Distinction between Stock and Inventory

Stock refers only to the value of those goods which are purchased for reselling and which are lying unsold at the end of the accounting period. Whereas the Inventory is a wide term which includes stock also. Thus, the Inventory includes the following:

(i) Inventory of Raw Material

(ii) Inventory of Semi-Finished Goods

(iii) Inventory of Finished Goods

(iv) Inventory of Stock

(19) Trade Receivables: — Trade receivables refer to the amount receivable on account of sale of goods or services rendered by the company in the normal course of business. Trade receivables include both Debtors and Bills Receivables.

Debtors: — The term 'Debtors' represents those persons or firms to whom goods have been sold or services rendered on credit and payment has not been received from them. They still owe some amount to the business. For example, if goods worth Rs.50,000 have been sold to Mohan on Credit, he will continue to remain the debtor of the business so long as, he does not make the full payment.

Bill Receivable: — A bill of exchange becomes bill receivable for the person who draws it (drawer) and gets it back, after its acceptance from the drawee. Thus, bill receivable is an accounting term for bills of exchange drawn on debtors or received by way of endorsement from them. The amount specified in such a bill is receivable at a future date.

(20) Trade Payables: — Trade payables is the amount payable on account of goods purchased or services taken in the normal course of business. Trade Payables includes both 'Creditors' and 'Bills Payables'.

Creditors: — The term 'Creditors' represents those persons or firms from whom goods have been purchased or services procured on credit and payment has not been made to them. Some money is still owing to them. For example, if goods worth Rs.50,000 are purchased from Govind on Credit, he will continue to remain the creditor of the firm so long as, the full payment is not made to him.

Bill Payable: — A bill of exchange becomes bill payable for the person who accepts it (drawee) and returns it to the drawer. Thus, bills payable is an accounting term for bills of exchange accepted in favor of creditors. The amount specified in such a bill is payable at a future date.

(21) Goods: — Goods include all those things which are purchased for resale or which are used for producing the finished products which are also meant to be sold. Thus, for a furniture dealer purchase of chairs and tables is termed as goods, while for others it is furniture and is termed as an asset. Similarly, for a stationery trader, stationery is goods, whereas for others it is expense.

(22) Cost: — Cost can be termed as the amount of resources given up in exchange for some goods or services. The resources given up are money or money's equivalent expressed in terms of money. The Chartered Institute of Management Accountants (CIMA), London has defined the term cost as follows "Cost is the amount of expenditure (actual or notional) incurred on, or attributable to a specified thing or activity." The specific thing or activity may be a product, service or any activity.

For example: cost of Machinery will include purchase price, freight and installation expenses etc. Further, the expenditure incurred may be actual or notional. The amount spent on the purchase of raw materials is the actual expenditure whereas notional expenditure is one which does not involve any cash outlay. Notional expenditure is conceptual and deemed to have been incurred, e.g. rent of owned factory, interest on owned capital etc.

(23) Voucher: — A voucher is a document which provides the authorisation to pay and on the basis of which the business transactions are, first of all, recorded in the books of accounts. A separate voucher is prepared for each transaction and it specifies the accounts to be debited or credited. The form of a voucher varies from firm to firm since vouchers are printed separately by different firms in their own names. Vouchers are prepared by accountant and each voucher is numbered and countersigned by an authorised person of the firm.

(24) Discount: — It is a rebate or an allowance given by the seller to the buyer. It is of two types:

(i) Trade Discount: — When discount is allowed by a seller to its customers at a fixed percentage on the list or catalogue price of the goods it is called trade discount. It is not recorded in the books of accounts as it is deducted in the invoice or cash memo itself from the gross value of goods.

(ii) Cash Discount: — When discount is allowed to the customers for making prompt payment it is called cash discount. For example, if a seller allows 2% discount for payment within a week it will be called cash discount. It is always recorded in the books of accounts.

(25) Goods & Service Tax (GST): All indirect taxes like Excise Duty, Sales Tax, VAT, Service Tax etc. have been merged into a single tax known as GST. GST is paid at the time of purchase and GST is collected at the time of sale.

Other Important Accounting Terms

(26) Entry: When a transaction or event is recorded in the books of accounts, it is called **'entry'**.

(27) Bad Debts: It is the amount that has become irrecoverable from a debtor. It is a business loss and is debited to Profit & Loss Account as an expense.

(28) Insolvent: A person or an enterprise which is not in a position to pay its debts is called insolvent.

(29) Solvent: A person or an enterprise which is in a position to pay its debts is called solvent.

(30) Stores: The term 'stores' is used to denote materials held by an enterprise for the purpose of consumption in the business and not for resale. Examples are lubricants, spare parts of machinery, packing materials etc.

(31) Revenue: Revenue in accounting means the income of a recurring (regular) nature from any source. It consists of the amount received from sale of goods and from service provided to customers. It also includes receipt of rent, commission, dividend, interest etc. Revenue is related with the day-to-day affairs of the business and should also be regular in nature. As such, the amount of capital introduced by the proprietor or borrowing loan is not revenue.

(32) Revenue from Operations: It is the revenue earned by an enterprise from its operating activities. It includes revenue from sale of goods and revenue from sale of services.

(33) Entity: An entity or business entity means an economic unit which is formed for earning income by providing service or selling goods (for example L.G. Electronics, Wipro, Maruti Suzuki etc.)

(34) Turnover: Turnover means total sales made in a particular period.

(35) Livestock: Domestic animals, such as cattle or horses are known as livestock.

(36) Investments: Investment refers to deployment of funds in the shares or debentures of Companies with the intention of earning a return.

Multiple Choice Questions (SET A)

Select the correct alternative:

1. Current Liabilities include:

(A) Bills Payable

(B) Creditors

(C) Outstanding Expenses

(D) All of the above

2. Which of the following is capital expenditure?

(A) Wages

(B) Wages paid for building construction

(C) Repair expenses of building

(D) Advertisement Expenses

3. A person who owes money to the firm is called ....

(A) Debtor

(B) Creditor

(C) Supplier

(D) None of these

4. Goods means:

(A) Commodity to be bought and sold

(B) Commodity to be bought but not to be sold

(C) Commodity to be used as an asset

(D) All of the above

5. Trade Discount is:

(A) Which is allowed at the time of receiving the payment

(B) Which is allowed at the time of sale of goods

(C) Which is allowed both at the time of receiving payment and sale of goods

(D) Allowed in all of the above

6. Cash Discount is:

(A) Which is received at the time of making the payment

(B) Which is allowed at the time of sale of goods

(C) Which is received at the time of purchase of goods

(D) Which is received both at the time of making payment and purchase of goods

7. Current assets do not include:

(A) Debtors

(B) Motor Car

(C) Bank Balance

(D) Prepaid Expenses

8. Tangible Assets do not include:

(A) Goodwill

(B) Furniture

(C) Stock

(D) Cash

9. Which of the following will be treated as drawings:

(A) Withdrawing money for payment of salary to employees

(B) Withdrawing money for payment to creditors

(C) Withdrawing money from business for private expenses

(D) Withdrawing money for purchase of asset

10. Main feature of business transaction is:

(A) It involves an economic activity

(B) It results in a change in the financial position of the firm

(C) Change must be capable of being expressed in terms of money

(D) All of the above

11. Current Liabilities do not include:

(A) Bills Payable

(B) Creditors

(C) Outstanding Exp.

(D) Debentures

12. Purchases refers to the buying of

(A) Stationery for office use

(B) Assets for the factory

(C) Goods of resale

(D) Investment

13. The term sales is used only for the sales of ...... and is never used for the sale of ....

(A) Assets, Investments

(B) Assets, Goods

(C) Intangible Assets, Goods

(D) Goods, Assets

14. Out of the following assets which one is NOT an intangible asset?

(A) Patents

(B) Investments

(C) Goodwill

(D) Trademark

15. At the end of financial year, during which sale of goods was worth Rs.5,00,000, the closing stock is valued at Rs.40,000. This is

(A) An event

(B) A transaction

(C) Both an event as well as transaction

(D) None of (A) and (B)

16. Which of the following is the Capital expenditure?

(A) Wages paid for repair of building

(B) Wages paid for white washing of building

(C) Wages paid for construction of building

(D) Wages paid for cleaning of building

17. Consider the following items:

1. Prepaid Salary

2. Accrued Interest (Receivable)

3. Loan (Short term)

4. Bank Overdraft

Current Liability would include:

(A) 1, 2, 3, 4

(B) 2,3,4

(C) 4, 3, 1

(D) 3, 4

Answers

Multiple Choice Questions (SET A)

Select the correct alternative:

1. (D)	**2. (B)**	**3. (A)**	**4. (A)**	**5.(B)**
6. (A)	**7. (B)**	**8. (A)**	**9. (C)**	**10. (D)**
11. (D)	**12. (C)**	**13. (D)**	**14. (B)**	**15. (C)**
16. (C)	**17. (D)**			

Multiple Choice Questions (SET B)

Select the correct alternative:

1. Select the correct alternative:

(i) Capital is

(a) internal liability.

(b) external liability.

(c) internal as well as external liability.

(d) None of these.

(2) Goods taken by the proprietor for personal use is

(a) Sale.

(b) Drawings.

(c) Purchase.

(d) None of these.

(3) Amount received or receivable against sale of goods is

(a) revenue receipt.

(b) capital receipt.

(c) sometimes revenue receipt and sometimes capital receipt.

(d) None of these.

(4) Amount paid or payable against purchase of goods is

(a) revenue expenditure.

(b) capital expenditure.

(c) Both (a) and (b).

(d) None of these.

(5) Goodwill is an

(a) Tangible Asset.

(b) Intangible Asset.

(c) Current Asset.

(d) Fictitious Asset.

(6) Expenditure of revenue nature that gives benefit for more than one accounting

period is categorised as

(a) Capital Expenditure.

(b) Revenue Expenditure.

(c) Deferred Revenue Expenditure.

(d) None of these.

(7) A person who owes money to a firm against goods sold is called a

(a) creditor.

(b) debtor.

(c) Both (a) and (b)

(d) None of these.

(8) A person to whom money is owed by a firm for purchase of goods is called a

(a) creditor.

(b) debtor.

(c) Both (a) and (b)

(d) None of these.

(9) Purchase refers to the purchase of

(a) goods for resale.

(b) stationery for office use.

(c) assets for the factory.

(d) None of the above.

(10) A liability arises because of

(a) cash transactions.

(b) credit transactions.

(c) cash as well as credit transactions.

(d) None of these.

(11) The amount invested by the proprietor in a business is called

(a) capital.

(b) cash.

(c) revenues.

(d) loan.

(12) Stock is valued at

(a) Cost or Net Realisable Value (Market Value), whichever is lower.

(b) Cost or Net Realisable Value (Market Value), whichever is higher.

(c) Cost.

(d) Net Realisable Value (Market Value).

(13) Bank overdraft is

(a) short-term liability.

(b) long-term liability.

(c) contingent liability.

(d) None of these.

(14) Which of the following is not a business transaction?

(a) Bought furniture of Rs. 25,000 for business.

(b) Paid for salaries of employees, Rs. 20.000.

(c) Cash withdrawn from personal bank account, Rs. 10,000 for domestic use.

(d) All of the above.

(15) Which of the following is not a fixed asset?

(a) Building

(b) Plant and Machinery

(c) Balance with bank

(d) Goodwill

(16) Which of the following is not a long-term liability?

(a) Creditors

(b) Term-loan

(c) Debentures

(d) Capital

(17) Which of the following are goods?

(a) Machines manufactured for sale.

(b) Furniture purchased for sale.

(c) Books and stationery purchased by a book seller.

(d) All of the above.

(18) Which of the following is an asset?

(a) Machinery

(b) Purchases

(c) Sales Return

(d) Interest Received

(19) Which of the following is a liability?

(a) Furniture

(b) Rent Payable

(c) Interest Received

(d) Stock

(20) Which of the following is revenue?

(a) Purchases

(b) Purchases Return

(c) Sales

(d) Salary Payable

(21) Which of the following is not an expense?

(a) Furniture

(b) Salary

(c) Rent

(d) Electricity Expenses

(22) Which of the following is a business transaction?

(a) Goods purchased on credit.

(b) An employee being dismissed.

(c) Proprietor purchasing a car for own use.

(d) Sale of personal asset by the proprietor.

(23) The nature of capital is

(a) an asset.

(b) a liability.

(c) an income.

(d) an expense.

(24) Sale is recognised as revenue

(a) when the contract for sale is entered into.

(b) at the point of sale or performance of service.

(c) after the expiry of credit period allowed to debtors.

(d) after the money collected from the customers.

(25) The nature of accrued income is

(a) revenue.

(b) liability.

(c) expenses.

(d) asset.

(26) Trade Discount allowed

(a) is shown separately in the books of account.

(b) is not shown separately in the books of account.

(c) can be shown either separately or deducted from purchase cost.

(d) None of the above.

(27) Which of the following transaction is not of financial character?

(a) Purchase of asset on credit

(b) Purchase of asset for cash

(c) Withdrawing of money by proprietor from business

(d) Strike by employees.

(28) Purchase refers to the buying of

(a) Stationery for office use.

(b) Assets for the factory.

(c) Goods for resale.

(d) Investment.

(29) Revenue from Operations refers to

(a) Revenue earned from Operating Activities.

(b) Revenue earned from activities that are not Operating Activities.

(c) Both (a) and (b).

(d) None of the above.

(30) Out of the following assets, which one is not an intangible asset?

(a) Machinery

(b) Patents

(c) Goodwill

(d) Trade Mark

Answers

Multiple Choice Questions (SET A)

Select the correct alternative:

1. (a)	2. (b)	3. (a)	4. (a)	5.(b)
6. (c)	7. (b)	8. (a)	9. (a)	10. (b)
11. (a)	12. (a)	13. (a)	14. (c)	15. (c)
16. (a)	17. (d)	18. (a)	19. (b)	20. (c)
21. (a)	22. (a)	23. (b)	24. (b)	25. (d)
26. (b)	27. (d)	28. (c)	29. (a)	30. (a)

Chapter 3

Accounting Principles

Theory base of accounting consists of principles, concepts, conventions, rules and guidelines developed over a period of time to bring uniformity and consistency to the process of accounting in order to enhance its utility to various users of accounting information. In addition, accounting standards issued by The Institute of Chartered Accountants of India (ICAI) also constitute the theory base of accounting.

Meaning of Accounting Principles

Unlike in the past when accounting statements were largely needed by the proprietor, these days the accounting statements are needed by various parties who have vested interest in the business, namely, proprietors, investors, creditors, government and many others. Accounting statements disclose the profitability and solvency of the business to various parties. It is, therefore, necessary that such statements should be prepared according to some standard language and set rules. These rules are usually called 'Generally accepted accounting principles' (GAAP). These principles have been generally accepted by accountants all over the world as general guidelines for preparing the accounting statements. These principles have developed over a course of period from usage, reason, common experiences, historical precedents, statements of individuals, professional bodies and regulation of Government agencies.

Nature or Characteristics (Features) of Accounting Principles:

(i) Accounting principles are Uniform set of Rules: Accounting principles are uniform set of rules or guidelines developed to ensure uniformity and easy understanding of the accounting information.

(ii) Accounting Principles are Man-Made: Accounting principles are man-made and are derived from experience and reason. They are not laboratory tested and hence they lack universal applicability like the principles of physics, chemistry and other natural sciences.

(iii) Accounting Principles are Flexible: Accounting principles are not rigid but flexible. They are bound to change with the passage of time in response to the changes in business practices, government policies and needs of the users of accounting information.

(iv) Accounting Principles are Generally Accepted : Accounting principles are bases and guidelines for accounting and are generally accepted. The general acceptance of an accounting principle depends upon how well it satisfies the following three criteria:

(a) Relevance: A principle is relevant if it results in information that is useful to the user of the accounting information.

(b) Objectivity: A principle is objective if it is free from personal bias or judgements of those who furnish the information. Objectivity also implies verifiability which means that there is some way of finding out the truthfulness or correctness of the information reported.

(c) Feasibility: A principle is feasible if it can be applied without undue complexity or cost.

Need of Accounting Principles:

In order to make the accounting information meaningful to its internal and external users, it is significant that such information is reliable as well as comparable. The comparability of information is required to see how a firm has performed as compared to the other firms and how it has performed as compared to the previous years. This becomes possible only if the information provided by the financial statements is based on some set rules known as policies, principles and conventions. These rules (usually called GAAP) bring uniformity and consistency to the process of accounting and enhance its utility to different users of accounting information.

Kinds of Accounting Principles: — Accounting principles are described by various terms such as assumptions, conventions, concepts, doctrines, postulates etc. These principles can be classified mainly into two categories: —

(I) Accounting Concepts or Assumptions

(II) Accounting Conventions

(I) Accounting Concepts or Assumptions: — In order to make the accounting language convey the same meaning to all people and to make it more meaningful, most of the accountants have agreed on a number of concepts which are usually followed for preparing the financial statements. These concepts provide a foundation for accounting process. No enterprise can prepare its financial statements without considering these basic concepts or assumptions. These concepts guide how transactions should be recorded and reported. Following may be treated as basic concepts or assumptions: —

As per Accounting Standard (AS-1), issued by the Institute of Chartered Accountants of India, there are three fundamental accounting concepts or assumptions:

(1) Going Concern Concept

(2) Consistency Concept

(3) Accrual Concept

Fundamental accounting concepts and assumptions are the assumptions which are presumed to have been followed in preparing the financial statements.

Other Accounting Concepts:

(4) Business Entity Concept

(5) Money Measurement Concept

(6) Accounting Period Concept

(7) Cost Concept or Historical Cost Concept

(8) Dual Aspect Concept

(9) Revenue Recognition Concept

(10) Matching Concept

(11) Objectivity Concept

(1) Going Concern Concept: — As per this concept it is assumed that the business will continue to exist for a long period in the future. The transactions are recorded in the books of the business on the assumption that it is a continuing enterprise. It is on this concept that we record fixed assets at their original cost and depreciation is charged on these assets without reference to their market value. For example, if a machinery is purchased which would last, say, for the next 10 years, the cost of this machinery will be spread over the next 10 years for calculating the net profit or loss of each year. Because of the concept of going concern the full cost of the machine would not be treated as an expense in the year of its purchase itself. The market value of the fixed assets is irrelevant and is not recorded in the balance sheet, as these assets are not going to be sold in the near future.

It is also because of the going concern concept that outside parties enter into long-term contracts with the enterprise, give loans and purchase the debentures and shares of the enterprise. Another example of this concept is that prepaid expenses, which have no realisable value are shown as assets in the balance sheet, because the benefit of such expenses will be received in future. Also without this concept, the classification of current and fixed assets and short and long term liabilities cannot be made and such classification would be difficult to justify.

(2) Consistency Concept: — This concept states that accounting principles and methods should remain consistent from one year to another. These should not be changed from year to year, in order to enable the management to compare the Profit & Loss Account and Balance Sheet of the different periods and draw important conclusions about the working of the enterprise. If a firm adopts different accounting principles in two accounting periods, the profits of current period will not be comparable with the profits of the preceding period. For example, a firm can choose any one of the several methods of depreciation, i.e., straight line method, written down value method or any other method. But it is expected that the method once chosen will be followed consistently year after year. Likewise, the method of stock valuation or making provision for likely bad debts should remain consistent with the previous years otherwise the decisions taken on the basis of accounts will be misleading.

But the consistency concept should not be taken to mean that it does not allow a firm to change the accounting methods according to the changed circumstances of the business. Otherwise, the accounting will become non-flexible and the improved techniques of accounting will not be used. As such, if the accountant feels that change in a particular method will lead to the better disclosure of the profits and the financial position of the business, the changed method may be adopted. However, the nature and effect of the change of method and justification for the change, must be stated clearly by way of footnotes to enable the users of the financial statements to be aware of the change.

(3) Accrual Concept: — In accounting, accrual basis is used for recording of transactions. It provides more appropriate information about the performance of business enterprise as compared to cash basis. Accrual concept applies equally to revenues and expenses. In accrual concept revenue is recorded when sales are made or services are rendered and it is immaterial whether cash is received or not.

Similary, according to this concept, expenses are recorded in the accounting period in which they assist in earning the revenues whether the cash is paid for them or not. Thus, to ascertain true profit or loss for an accounting period and to show the true financial position of the enterprise at the end of the accounting period all expenses and incomes relating to the accounting period are recorded whether actual cash has been paid or received or not. Accrual concept is often described as matching concept.

The significance of these fundamental assumptions is that they need not be specifically stated in the financial statements and the users of financial statements can take for granted that these assumptions have been followed while preparing financial statements.

However, if any of the above-mentioned fundamental accounting assumption is not followed, then this fact should be specifically disclosed.

Other Accounting Concepts:

(4) Business Entity Concept: —According to this concept, business is treated as a unit separate and distinct from its owners, creditors, managers and others. In other words, the owner of a business is always considered as distinct and separate from the business he owns. Business unit should have a completely separate set of books and we have to record business transactions from firm's point of view and not from the point of view of the proprietor. The proprietor is treated as a creditor of the business to the extent of capital invested by him in the business. The capital is treated as a liability of the firm because it is assumed that the firm has borrowed funds from its own proprietors instead of borrowing it from outside parties.

It is for this reason that we also allow interest on capital and treat it as an expense of the business. Interest on capital reduces the profits of the firm and at the same time it increases the capital of the proprietor. Similarly, the amount withdrawn by the proprietor from the business for his personal use is treated as his drawings. Likewise, goods used from the stock of the business for business purposes are treated as the expenditure of the business but similar goods used by the proprietor for his personal use are treated as his drawings.

Because of the concept of separate entity, the proprietor's house, his personal investment in securities, his personal car and personal income and expenditure are kept separate from the accounts of the business entity. Also, if the proprietor has some other business entity doing another business, the records of that business should also be kept separate. In the absence of the concept of separate entity, the net profits and financial position of a business entity cannot be known. The concept of separate entity is applicable to all forms of business organisations, i.e., sole proprietorship, partnership or a company.

(5) Money Measurement Concept:— Only those transactions and events are recorded in accounting which are capable of being expressed in terms of money. An event, even though it may be very important for the business, will not be recorded in the books of the business unless its effect can be measured in terms of money with a fair degree of accuracy. For example, accounting does not record a quarrel between the production manager and sales manager; it does not report that a strike is beginning and it does not reveal that a competitor has placed a better product in the market. These facts or happenings cannot be expressed in money terms and thus are not recorded in the books.

It should be remembered that money is the only measurement which enables various things of diverse nature to be added up together and dealt with. For example, a business, on a particular day has Rs.50,000 in cash, 5,000 kilograms of raw materials, 10,000 kilograms of finished goods, 5 Machines, 100 Chairs and 20 Fans. All these things cannot be added up unless expressed in terms of money. In order to make a record of these items, these will have to be expressed in monetary terms such as, cash Rs.50,000; raw materials Rs.2,50,000; finished goods Rs.5,00,000; Machines Rs.20,00,000; Chairs Rs.50,000 and Fans Rs.80,000. As such, to make accounting records relevant, simple, understandable and homogeneous, they are expressed in a common unit of measurement, i.e., money.

(1) "In one sense, capital itself may be regarded as liability — the amount due from the business to its proprietors." — **Rowland**

(6) Accounting Period Concept: — As the business is intended to continue indefinitely for a long period, the true results of the business operations can be ascertained only when the business is completely wound up. But ascertainment of profit after a very long period will be of little use to the proprietors, managers, investors and others because it will be too late to take corrective steps at that time. The users of the financial statements need to know the results of the business at frequent intervals. Thus, the entire life of the firm is divided into time-intervals for the measurement of the profits of the business. Twelve-month period is usually adopted for this purpose. According to the amended income tax law, a business has compulsorily to adopt financial year beginning on 1st April and ending on 31st March in the next calendar year, as its accounting period. Apart from this, companies whose shares are fisted on the stock exchange are required to publish quarterly results to depict the profitability and financial position at the end of three months period.

(7) Cost Concept or Historical Cost Concept: — According to this concept, an asset is ordinarily recorded in the books of accounts at the price at which it was acquired. This cost becomes the basis of all subsequent accounting for the asset. Since the acquisition cost relates to the past, it is referred to as historical cost. This cost is the basis of valuation of the assets in the financial statements. For example, if a business entity purchases a building for Rs.20,00,000, it would be recorded in the books at this figure. Subsequent increase or decrease in the market value of the building would not be recorded in the books of accounts. If two years later the market value of the building shoots up to Rs.60,00,000, the increased value will not be ordinarily* recorded in the books of accounts.

However, the cost concept or historical cost concept does not mean that assets will be continuously shown at their acquisition price for as long as the business entity owns them. Their cost is systematically reduced from year to year by charging depreciation and the assets are shown in the balance sheet at cost less depreciation.

The justification for the historical cost concept lies in the following arguments:

(i) This cost is objectively verifiable because the cost recorded in the books is derived from an actual transaction and is not arbitrarily determined.

(ii) It is justified by the going concern concept which assumes that the enterprise will continue its activities indefinitely and thus there is no need of using the current values or liquidation values.

(iii) Market values or current values of assets are difficult to be determined. The valuation by one expert will not be the same as that of another.

(iv) Market values of the assets may change from time to time and it will be extremely difficult to keep track of up and down of the market price.

The drawbacks of the historical cost concept are:

(i) Assets for which nothing is paid will not be recorded. Thus, a favourable location, brand name and reputation of the business, knowledge and technological skill built inside the enterprise will remain unrecorded though these are valuable assets.

*** The word ordinarily is used since there are certain situations in which the changed values are recorded in the books of accounts to reflect the market values, e.g., in case of inventories and investments.**

(ii) During periods of inflation, the figure of net profit disclosed by profit and loss account will be seriously distorted because depreciation based on historical costs will be charged against revenues at current prices.

(iii) Information based upon historical cost may not be useful to management, investors, creditors etc.

(8) Dual Aspect Concept: — According to this concept, every business transaction is recorded as having a dual aspect. In other words, every transaction affects at least two accounts. If one account is debited, any other account must be credited. The system of recording transactions based on this principle is called as 'Double Entry System. It is because of this concept that the two sides of the Balance Sheet are always equal and the following accounting equations will always hold good at any point of time

Assets = Liabilities + Capital

OR

Capital = Assets - Liabilities

Whenever a transaction is to be recorded, it has to be recorded in two or more accounts to balance the equation. If a transaction affects (increases or decreases) the one side of the equation, it will also affect (increase or decrease) the other side of the equation or increase one account and decrease another account on the same side of the equation. Equation remains balanced whenever a transaction takes place. For example, X commences business with Rs.20 Lakh in cash and takes a loan of Rs.5 Lakh from the bank, and these Rs.25 Lakh are used in buying some assets, say, plant and machinery. The equation will be as follows:

Assets = Liabilities + Capital

Rs.25 Lakh = Rs.5 Lakh + Rs.20 Lakh

(9) Revenue Recognition (Realisation) Concept:—Revenue means the amount which is added to the capital as a result of business operations. Revenue is earned by sale of goods or by providing a service. Concept of revenue recognition determines the time or the particular period in which the revenue is realised. Revenue is deemed to be realised when the title or the ownership of the goods has been transferred to the purchaser and when he has legally become liable to pay the amount. It should be remembered that revenue recognition is not related with the receipt of cash. For example, if a firm gets an order of goods on 1st January, supplies the goods on 20th

January and receives the cash on 1st April, the revenue will be deemed to have been earned on 20th January', as the ownership of goods was transferred on that day.

Revenues in case of incomes such as rent, interest, commission etc. is recognised on a time basis. For example, rent for the month of March 2020, even if received in April 2020 will be treated as revenue of the financial year ending March 31, 2020. Similarly, if commission for April 2020 is received in advance in March 2020, it will be treated as revenue of the financial year commencing April 2020.

There are few exceptions to this rule of revenue recognition:

(i) In case of sales on instalment basis, the amount collected in instalments is treated as realised.

(ii) In case of long-term construction projects, it is difficult to postpone the revenue till the completion of full contract. In such cases, that proportionate part of revenue which is equal to the part of contract completed by the end of the year is recognised as realised.

(iii) In case of mining, revenue is recognised in the accounting period when production is made even though a sale has not been made.

(10) Matching Concept: — This concept is very important for correct determination of net profit. According to this concept, in determining the net profit from business operations, all costs which are applicable to revenue of the period should be charged against that revenue. Accordingly, for matching costs with revenue, first revenues should be recognised and then costs incurred for generating that revenue should be recognised. Following points must be considered while matching costs with revenue:

1. When an item of revenue is included in the profit and loss account, all expenses incurred on it, whether paid or not, should be shown as expenses in the profit and loss account. On the basis of this principle, outstanding expenses, though not paid in cash are shown in the profit and loss account.

2. When some expense, say insurance premium is paid partly for the next year also, the part relating to next year will be shown as an expense only next year and not this year. This means that, that part of the insurance premium against which benefit will be derived or revenue will be earned in future should be shown in the balance sheet as an asset and the rest is treated as an expense during the current year.

3. Cost of the goods remaining unsold at the end of the year together with the expenses incurred on it must be carried forward to the next year, as these goods will be sold only during the next period. As such, the closing stock is carried over to the next period as opening stock.

4. Similarly, incomes receivable must be added in revenues and incomes received in advance must be deducted from revenues.

(11) Objectivity Concept :— This concept requires that accounting transaction should be recorded in an objective manner, free from the personal bias of either management or the accountant who prepares the accounts. It is possible only when each transaction is supported by verifiable documents and vouchers such as cash memos, invoices, sales bill, pay-in slip, correspondence, agreements etc. For example, when the goods are purchased for cash, the transaction must be supported by cash receipt for money paid and if the goods are purchased on credit, the transaction must be supported by a copy of invoice or delivery challan. The cash receipt or invoice become the documentary evidence of the transaction and provide an objective basis for verifying the transaction. Objectivity is one of the reasons for adopting the 'Historical Cost' as the basis of recording accounting transaction because cost actually paid for an asset (i.e. historical cost) can be verified from the documents. On the contrary, if assets are recorded on their market value, the objectivity cannot be adhered to because the market value may differ from person to person and from place to place.

(II) Accounting Conventions:— An accounting convention may be defined as a custom or generally accepted practice which is adopted either by general agreement or common consent among accountants. Accounting conventions differ from concepts in respect to the following:

Basis of Distinction	Accounting Concepts	Accounting Conventions
1. Legal Position	Accounting concepts have legal acceptance.	Accounting conventions are guidelines based upon custom, or usage or general agreement.
2. Recording of Financial Statements	Accounts concepts are the basic assumptions on the basis of which transactions are recorded and accounts are maintained.	Accounting conventions are followed in preparing the profit and loss account and balance sheet.
3. Significance	These are the uniform set of rules usually followed in recording the transactions.	These are not so important as accounting concepts.
4. Role of Personal	There is no role of personal judgment or individual bias in following the accounting concepts.	Personal judgment may play a crucial role in the adoption of accounting conventions.
5. Uniform adoption	There is uniform adoption of accounting concepts in different enterprises.	There is no uniformity in the adoption of accounting conventions in various enterprises.

Following are the main accounting conventions:

(1) Convention of Full Disclosure

(2) Convention of Materiality

(3) Convention of Conservatism (Prudence)

(1) Convention of full disclosure: — This Convention requires that all significant information relating to the economic affairs of the enterprise should be completely disclosed. In other words, there should be a sufficient disclosure of information which is of material interest to the users of the financial statements such as proprietors, present and potential creditors, investors and others. The principle is so important that the Companies Act makes ample provisions for the disclosure of essential information in the financial statements of a Company. The proforma and contents of Balance Sheet and Profit and Loss Account are prescribed by Companies Act. Various items or facts which do not find place in accounting statements are shown in the Balance Sheet by way of footnotes. Such as :—

(i) Contingent Liabilities :— For instance, a claim of a very big sum pending in a court of law against the enterprise should be brought to the notice of the users of the financial statements, otherwise the statements would be misleading.

(ii) If there is a change in the method of valuation of stock, or for providing depreciation or in making provision for doubtful debts, it should be disclosed in the Balance Sheet by way of a footnote.

(iii) Market value of investments should be given by way of a footnote.

Disclosing of material facts does not mean leaking out the secrets of the business but disclosing sufficient information which is of material interest to the users of the financial statements.

(2) Convention of Materiality: — This Convention is an exception to the convention of full disclosure. According to this convention, items having an insignificant effect or being irrelevant to the user need not be disclosed. These unimportant items are either left out or merged with other items, otherwise accounting statements will be unnecessarily overburdened. **American Accounting Association (AAA)** defines the term materiality as under:—

"An item should be regarded as material if there is reason to believe that knowledge of it would influence decision of informed investor."

According to **Kohler :—**"Materiality is the characteristics attaching to a statement, fact, or item whereby its disclosure or the method of giving its expression would be likely to influence the judgment of a reasonable person."

It should be noted that what is material for one concern may be immaterial for another. For instance, the cost of small tools may be material for a small repair workshop, but the same figure may be immaterial for Escorts Limited. Similarly, the nature of the transaction should also be taken into consideration. A difference of Rs.500 in the valuation of stock may be regarded as immaterial, but the difference of Rs.500 in cash could be termed material. Thus, the accountant should judge the importance of each transaction to determine its materiality.

(3) Convention of Conservatism or Prudence: — According to this convention, all anticipated losses should be recorded in the books of accounts, but all anticipated or unrealized gains should be ignored. In other words, conservatism is the policy of playing safe. Provision is made for all known liabilities and losses even though the amount cannot be determined with certainty. Likewise, when there are different alternatives for recording a transaction, the one having least favourable immediate effect on profits or capital should be adopted. Following are the examples of the application of the principle of conservatism: —

(i) Closing stock is valued at cost price or realisable value whichever is less.

(ii) Provision for doubtful debts is created in anticipation of actual bad-debts.

(iii) Joint life insurance policy is shown only at surrender value as against the amount paid.

(iv) Provision for a pending law suit against the firm, which may either be decided in its favour.

Effect of Convention of Conservatism: — The convention of conservatism should be used very cautiously, otherwise it will have two effects:

(i) Profit & Loss Account will disclose lower profits in comparison to the actual profits,

(ii) Balance Sheet will disclose understatement of assets and overstatement of liabilities in comparison to the actual values.

The above-mentioned effects will result in creation of secret reserves which is in direct conflict with the convention of full disclosure.

Need for Accounting Standards

Accounting is an information system and its main aim is to provide financial information to a number of parties such as investors, management, creditors, Governments etc. Such information is provided through a set of financial statements, namely, profit and loss account and balance sheet.

As per **Section 129** of the Companies Act 2013, the financial statements of an enterprise should depict a true and fair view of its operating results and financial position. However, what constitutes 'true and fair' view has not been defined either in the Companies Act, 2013 or in any other statute. Over a period of time a number of Generally Accepted Accounting Principles (GAAP) in the form of concepts and conventions have been developed and accepted to bring comparability and uniformity in the financial statements of various business entities. But the difficulty is that GAAP also allow a large number of alternative treatments for the same item. Different enterprises may adopt different accounting policies for the same transaction or an enterprise may follow different accounting policies for the same item over different accounting periods.

As a result, the financial statements become inconsistent and uncomparable. Hence there is an urgent need to harmonise and standardise these diverse accounting policies. Certain standards must be followed for preparing the financial statements, so that there is the minimum possible ambiguity and uncertainty about the figures contained in financial statements. The International Accounting Standards Committee (IASC) came into existence on 29th June, 1973 to develop accounting standards.

The Institute of Chartered Accountants of India and the Institute of Cost and Works Accountants of India are associate members of the IASC. The Institute of Chartered Accountants of India is also drawing up its own accounting standards which are basically patterned on the International Accounting Standards and are modified according to the conditions and practices prevailing in India.

Concept of Accounting Standards

Accounting standards may be defined as written statements, issued from time to time by institutions of accounting professionals, specifying uniform rules or practices for drawing the financial statements.

Kohler defines accounting standards as " code of conduct imposed on accountants by custom, law or professional body."

Nature of Accounting Standards

(i) Accounting standards lay down the norms of accounting policies and practices by way of codes to direct as to how the transactions and events should be dealt with in accounts and disclosed in the financial statements. For example, accounting standard may define the term cost and lay down a definite method for valuation of inventories with minor modifications under special circumstances.

(ii) In this way, they remove the effect of diverse accounting practices and policies so that financial statements of different business units become comparable.

(iii) They prescribe a preferred accounting treatment from the available set of methods for solving one or more accounting problems.

(iv) They provide information to the users of financial statements as to the basis on which such statements have been prepared.

(v) They limit the area within which accountant has to function and, in this respect, they are just like laws. However, accounting standards do not aim to introduce rigidity in accounting. They only attempt to limit the flexibility and provide the accountants realistic guidelines. If the specific circumstances of an enterprise do not justify the application of a certain accounting standard, the alternative practice, regarded as more suitable, may be adopted. However, in the event of any deviation from the standards, it will be the duty of the accountant to make adequate disclosure of this fact in the financial statements so that users of such statements may be aware of such deviations.

Objectives of Accounting Standards:

(i) To ensure uniformity in the preparation and presentation of financial statements.

(ii) To provide information to the users about the policies adopted in the preparation of financial statements.

(iii) To remove the effect of diverse accounting policies and practices.

(iv) To ensure consistency, transparency and comparability of financial statements.

(v) To improve the reliability and credibility of financial statements.

Utility or Benefits of Accounting Standards

Accounting standards have been evolved to curb the abuse of flexibility in the adoption of accounting policies by the business enterprises. Accounting Standards provide the accountants those accounting policies which are most suitable in a given situation. The utility of accounting standards may be stated as follows:

(i) Accounting Standards improve the reliability and credibility of Financial Statements: There are numerous parties which are interested in the accounting information of an enterprise. They include the investors, management, creditors, employees, Government Officials, researchers etc. It is therefore necessary that the financial statements present a true and fair view of the financial position and operating results- of an enterprise. Accounting standards generate confidence among the users of the accounting information by providing a definite structure of uniform guidelines which enhance the reliability and credibility of the accounting information.

(ii) Accounting Standards ensure the consistency and comparability of Financial Statements: Accounting standards make the financial statements of different enterprises or of the same enterprise for different accounting periods comparable. They bring the uniformity of assumptions, rules and policies adopted in the preparation of financial statements and thus they ensure the consistency and comparability of such statements which in turn ensures better comparison of profitability, financial position and future prospects of an enterprise. In the absence of accounting standards, comparison of different financial statements may lead to wrong conclusions because each enterprise would evolve its own rules or standards to suit its purpose.

(iii) Accounting Standards help in resolving conflict of financial interests among various groups: Sometimes, there is a conflict of financial interests among the various groups interested in financial statements. For example, shareholders and creditors may have opposite interests in assessing the profitability and net worth of an enterprise. Accounting standards are helpful in resolving such a conflict because financial statements drawn up on the basis of accounting standards will be accepted to all the groups.

(iv) Accounting Standards significantly reduce the chances of manipulations and frauds: Adoption of accounting standards in the preparation of financial statements has reduced the chances of manipulations, frauds, insufficient disclosures or the use of inappropriate accounting policies,

(v) Helpful to Auditors: It is the duty of the auditors to ensure that the accounting standards have been followed in the preparation of financial statements. In case of deviations, it is also their duty to make adequate disclosure in their reports so that the users of such statements may be aware of such deviations. As a result, the auditors will be free from court cases and various penal provisions under the company law in cases of inducted frauds, insufficient disclosures or due to adoption of inappropriate accounting policies.

Limitations of Accounting Standards:

In spite of many benefits derived from accounting standards, there are some limitations also. Some of these limitations are :

(i) **Restrict Initiative**: Since accounting standards are mandatory in nature they restrict initiative for better presentation and disclosure.

(ii) **Rigid in Nature**: Accounting standards are rigid in nature. They restrain the Accountants from using a more suitable alternative solution to a particular problem.

(iii) **Based on Historical Costs**: Accounting standards are based on historical cost concept. Assets are shown in the Balance Sheet at historical cost and as such depreciation is also charged on such historical cost. It is for this reason that IFRS (International Financial Reporting Standards) were introduced wherein the assets and liabilities are required to be shown at current or fair value as at the date of Balance Sheet.

(iv) **Obstruct the Judgement of Auditors** : Accounting Standards obstruct the judgement of the auditors as the standards are mandatory.

International Financial Reporting Standards (IFRS):

The term IFRS refers to the 'International Financial Reporting Standards' issued by International Accounting Standard Board (IASB). IFRS also cover a wide range of International Accounting Standards (IAS) issued by the International Accounting Standard Committee (IASC). International Accounting Standards (IAS) I require financial statements to comply with all requirements of IFRS.

Assumptions in IFRS:

(i) **Going Concern Assumption**: It is assumed that the life of the business is infinite, i.e., the entity will continue to exist for an indefinite period in the future.

(ii) **Accrual Assumption**: As per this assumption transactions are recorded on accrual basis, i.e., as and when they occur and the date of settlement is immaterial.

(iii) **Measuring Unit Assumption**: Measuring unit is the current purchasing power. It means that the assets are not shown in the Balance Sheet at historical cost but they are shown at current or fair value. In other words, assets are shown at the amount that would have been paid if the same asset has been acquired currently. Similarly, liabilities are shown at the amount that would be required to settle them.

(iv) **Constant Purchasing Power Assumption**: This assumption requires that the value of capital be adjusted to inflation at the end of the financial year.

Need for IFRS:

Each country has its own set of rules and regulations for accounting and financial reporting. Hence, when an enterprise decides to raise capital from abroad, the rules and regulations of that country will apply and there will be differences in the financial reporting in the foreign country as compared to its own country. Hence, a strong need was felt for adoption of IFRS as it would bring uniformity, comparability, transparency and adaptability in financial statements. The need for IFRS arises from the following reasons:

(i) Easy Access to Global Capital Markets: Capital markets have now become global and companies are now in a position to access the funds globally. But investors all over the world rely on financial statements prepared on the basis of IFRS. Hence, IFRS based financial statements are now a pre-requisite for the enterprises seeking to raise overseas funds.

(ii) Easy to Make Comparisons: International investors would like to compare financial statements based on internationally accepted set of accounting standards. It improves the ability of investors to compare their investments on a global basis and thus lowers their risk of errors of judgement. Financial statements based on IFRS will facilitate the investors to compare financial statements without making adjustments for national accounting differences.

(iii) Uniformity in Financial Reporting: The adoption of IFRS brings uniformity, comparability and transparency in financial statements. It improves the standard and quality of financial reporting.

(iv) Lower Cost of Capital Raised Abroad: At present, companies that operate in global environment have to prepare two sets of financial statements — One set based on home country's accounting standards and another set based on IFRS. In case of adoption of IFRS it will have to prepare only one set of financial statements and thus the cost of raising funds from abroad will be minimized.

(v) True and Fair Valuation of Assets : There is wide gap between existing Indian Accounting Standards and IFRS. As per Indian Accounting Standards, assets are valued on historical cost whereas as per IFRS assets are reported at fair value i.e., the estimated value at which the asset could be sold in the market. Adoption of IFRS would provide a uniform basis for the reporting of true and fair value of assets.

(vi) Difficult to Commit Fraud and Manipulate the Accounts : It is easy to manipulate the accounts and commit fraud in the traditional system of accounting. There are tough and rigid rules for the preparation and presentation of financial statements under IFRS and it is extremely difficult to manipulate the accounts.

Benefits of IFRS:

IFRS are very useful for business enterprises carrying on business worldwide. In addition to the enterprises operating globally, IFRS is helpful to investors, industry and accounting professionals in the following way:

(i) Helpful to Enterprises Operating Globally: Entities having business operations in different countries will face problems of consolidation of financial statements if they prepare their financial statements according to the standards prevailing in different countries. IFRS unify the accounting practices worldwide as a result of which the problem of consolidation is avoided.

(ii) Helpful to Investors: Investors require high quality, relevant, reliable, transparent and comparable information in financial statements in order to make economic decisions. The use of common set of high-quality accounting standards i.e., IFRS would be helpful to investors in comparison to financial statements prepared under different accounting standards adopted by different countries.

(iii) Helpful to Industry: Obtaining funds from outside the country becomes easier if the financial statements comply with Globally accepted accounting standards. Now a days most of the stock exchanges require information as per IFRS and Convergence to IFRS would enable Indian Companies to access international capital market easily.

(iv) Lower Cost of Raising Funds Abroad: Cost of raising funds abroad can be minimized under IFRS as there will be no need to prepare two sets of financial statements — one set on the basis of IFRS and another on the basis of Accounting Standards.

(v) Helpful to Accounting Professionals: Accounting professionals will be able to provide better services in countries adopting IFRS.

(vi) True and Fair View: In IFRS based financial statements assets are valued on the concept of true and fair value i. e., on the basis of their market value. Indian Accounting Standards ignore this concept.

Difference between IFRS and Indian GAAP or Accounting Standards:

(i) IFRS are based on Principles whereas Indian GAAP or Accounting Standards are based on Rules. For example, under the Indian laws, Balance Sheet and Statement of Profit & Loss are prepared according to Schedule III of the Companies Act 2013, whereas IFRS do not prescribe any format for these. IFRS prescribe that items should be shown in the Balance Sheet as per the principles associated with each item. For example, under Schedule III Redeemable Preference Shares are shown under the head 'Share Capital' but IFRS require it to be shown under the head 'Loans' since, in the real sense, Preference Share Capital is not a Capital but loan because it carries a fixed rate of dividend and also has to be redeemed as per the terms of issue but not later than 20 years from the date of their issue.

(ii) IFRS are based on 'Fair Value' concept whereas Indian GAAP or Accounting Standards are based on 'Historical Cost' concept. As per Indian GAAP or Accounting Standards assets are shown in the Balance Sheet at 'Historical Cost' and as such depreciation is also charged on such historical cost but IFRS require that the assets and liabilities should be shown at current or fair value as at the date of Balance sheet. Thus, under IFRS depreciation is not charged on the cost of the asset but the asset is valued on the date of Balance Sheet and the difference in the opening and closing value of the asset is debited or credited to Profit and Loss Account.

(iii) Under IFRS the useful life of the assets has to be reassessed again and again until the asset is fully depreciated whereas as per Indian GAAP the useful life is estimated only at the beginning.

(iv) Under IFRS depreciation is not calculated on the total cost of the asset but on the cost of significant components of the asset.

For example: in the case of a Truck, the depreciation may be calculated separately for its wheels and the main body of the Truck separately. However, as per Indian Accounting Standards, depreciation is calculated on the total value of the asset.

(v) IFRS provide a wide framework in which clear guidelines are given for financial reporting. Under the framework provided by IFRS, Assets, Liabilities and Equity are clearly defined. But no such framework exists under Accounting Standards.

Multiple Choice Questions (SET A)

Select the correct alternative:

1. As per Income Tax Act, accounting period is :

(a) From 1st January to 31st December

(b) From 1st April to 31st March

(c) From 1st July to 30th June

(d) From Diwali to Diwali

2. As per Dual Aspect Concept:

(a) Assets = Liabilities - Capital

(b) Assets = Capital – Liabilities

(c) Assets = Liabilities + Capital

(d) Capital = Assets + Liabilities

3. Concept of Consistency means:

(a) All the firms in the same industry should use identical accounting principles and procedures

(b) All principles and procedures of accounting are utilised

(c) Accounting principles and methods should remain consistent from one year to another

(d) All of the above

4. Convention of conservatism takes into account:

(a) All future profits and losses

(b) All future profits and not losses

(c) All future losses and not profits

(d) Neither profits nor losses of the future

5. According to Convention of Conservatism closing stock is valued at:

(a) At cost Price

(b) At Realisable value

(c) Cost price or realisable

(d) At Real value value whichever is less

6. According to Convention of Conservatism:

(a) Provision is made for bad and doubtful debts

(b) Depreciation is charged on assets

(c) Recording is made of outstanding expenses

(d) All of the above

7. According to which Concept even the proprietor of the business is treated as a creditor of the business;

(a) Going concern Concept

(b) Cost Concept

(c) Business Entity Concept

(d) Accounting Period Concept

8. Due to which Concept qualitative transactions are not recorded in the books :

(a) Business Entity Concept

(b) Money Measurement Concept

(c) Historical cost Concept

(d) Dual Aspect Concept

9. Accrual concept is based on :

(a) Matching Concept

(b) Dual Aspect Concept

(c) Cost Concept

(d) Going concern Concept

10. According to which Concept the same accounting methods should be used each year :

(a) Prudence

(b) Full Disclosure

(c) Materiality

(d) Consistency

11. Due to which of the following, contingent liabilities are shown in the Balance Sheet:

(a) Dual Aspect Concept

(b) Convention of Full Disclosure

(c) Convention of Materiality

(d) Going Concern Concept

12. The cost of a small calculator is accounted as an expense and not shown as an asset in a financial statements of a business entity due to …… .

(a) Materiality Convention

(b) Matching concept

(c) Periodicity concept

(d) Convention of full disclosure

13. According to the Cost Concept

(a) Assets are recorded at lower of cost and market value.

(b) Assets are recorded by estimating the market value at the time of purchase.

(c) Assets are recorded at the value paid for acquiring it.

(d) Assets are not recorded

14. Providing depreciation on fixed asset is in accordance with which of the following principles/concepts.

(i) Going concern (ii) Matching Concept (iii) Materiality

(a) (i) & (ii)

(b) (ii) & (iii)

(c) (i) & (iii)

(d) All the three

15. The owner of the firm records his medical expenses in the firms' income statement. Indicate the principle that is violated.

(a) Cost Concept

(b) Prudence

(c) Full disclosure

(d) Entity concept

16. M/s Future Ltd. has invested Rs. 10,000 in the shares of Relicam Industries Ltd. Current market value of these shares is Rs. 10,500. Accountant of Future Ltd. wants to show Rs. 10,500 as value of investment in the books of accounts, which accounting convention restricts him from doing so?

(a) Full disclosure

(b) Consistency

(c) Conservatism

(d) Materiality

17. Which of these is not a fundamental accounting assumption?

(a) Going concern

(b) Consistency

(c) Accrual

(d) Materiality

18. Omission of paise and showing the round figures in financial statements is based on ....

(a) Conservatism convention

(b) Consistency concept

(c) Materiality convention

(d) Money measurement concept

19. Income is measured on the basis of:

(a) Matching Concept

(b) Consistency Concept

(c) Cost Concept

(d) None of the above

Answers

Multiple Choice Questions (SET A)

Select the correct alternative:

1. (b)	2 .(c)	3.(c)	4. (c)	5 .(c)	6. (a)	7. (c)
8. (b)	9. (a)	10. (d)	11. (b)	12. (a)	13. (c)	14. (a)
15. (d)	16. (c)	17. (d)	18. (c)	19. (a)]		

Multiple Choice Questions (SET B)

Select the correct alternative:

1. Select the best alternative:

(i) According to the Business Entity Concept

(a) transactions between the business and its owners are not recorded.

(b) transactions between the business and its owners are recorded considering them to be one single entity.

(c) transactions between the business and its owners are recorded from the business point of view.

(d) None of the above.

(2) According to the Money Measurement Concept

(a) all transactions and events are recorded.

(b) all transactions and events which can be estimated in money terms are recorded in the books of account.

(c) all transactions and events which can be measured in money terms are recorded in the books of account.

(d) None of the above.

(3) According to the Cost Concept

(a) assets are recorded at the value paid for acquiring them.

(b) assets are recorded by estimating the market value at the time of purchase.

(c) assets are recorded at lower of cost or market value.

(d) None of the above.

(4) According to the Going Concern Concept

(a) assets are recorded at cost and are depreciated over their useful life.

(b) assets are valued at their market value at the year-end and are recorded in the books of account.

(c) assets are valued at their market value, recorded in the books and depreciation is charged on the market value.

(d) None of the above.

(5) According to the Accrual Concept

(a) transactions and events are recorded in the books at the time of their settlement in cash.

(b) transactions and events are recorded in the books at the time when they are entered into.

(c) transactions and events may be recorded either at the time of the settlement or when they are entered into.

(d) None of the above.

(6) According to the Convention of Consistency

(a) accounting policies and practices once adopted should be consistently followed.

(b) accounting policies and practices adopted may be changed as per the management's decision.

(c) accounting policies and practices once adopted cannot be changed under any circumstances.

(d) None of the above.

(7) According to Going Concern Concept, a business is viewed as having

(a) a limited life.

(b) a very long life.

(c) an indefinite life.

(d) None of these.

(8) According to which of the following accounting concepts, even the proprietor of a business is treated as creditor to the extent of his capital?

(a) Money Measurement Concept

(b) Dual Aspect Concept

(c) Cost Concept

(d) Business Entity Concept

(9) According to which of the following concepts, in determining the net income from business, all costs which are applicable to the revenue of the period should be charged against that revenue?

(a) Matching Concept

(b) Money Measurement Concept

(c) Cost Concept

(d) Dual Aspect Concept

(10) Valuation of stock at lower of cost or net realisable value is an example of

(a) Consistency Convention.

(b) Conservatism Convention.

(c) Realisation Concept.

(d) Matching Concept.

(11) During the life-time of an entity, accounting produces financial statements in accordance with which of the following accounting concept?

(a) Matching

(b) Conservatism

(c) Accounting period

(d) Cost

(12) X Ltd. follows the Written Down Value Method of depreciating machinery year after year due to

(a) comparability.

(b) convenience.

(c) consistency.

(d) All of these.

(13) The Convention of Conservatism takes into account

(a) all prospective profits and prospective losses.

(b) all prospective profits and leaves out prospective losses.

(c) all prospective losses but leaves out prospective profits.

(d) None of the above.

(14) IASB upon coming into existence has adopted

(a) all IAS and SIC.

(b) some IAS and SIC.

(e) none of the IAS and SIC.

(d) None of these.

(15) IFRS are

(a) rule based accounting standards.

(б) principle based accounting standards.

(c) partially rule based and partially principle based accounting standards.

(d) None of the above.

(16) IFRS are based on

(a) historical cost.

(b) fair value.

(c) both historical cost and fair value.

(d) None of these.

(17) Ind-AS are

(a) rule based accounting standards.

(b) principle-based accounting standards.

(c) partially rule based and partially principle-based accounting standards.

(d) None of the above.

(18) Assets (except Securities) may be valued under Ind-AS on.

(a) historical cost.

(b) fair value.

(c) both historical cost and fair value.

(d) None of these.

Answers

Multiple Choice Questions (SET A)

Select the correct alternative:

1. (c)	2. (c)	3. (a)	4. (a)	5.(b)
6. (a)	7. (c)	8. (d)	9. (a)	10. (b)
11. (c)	12. (c)	13. (c)	14. (a)	15. (b)
16. (b)	17. (b)	18. (a)		

Chapter 4

Process and Bases of Accounting

Process of Accounting

Accounting process begins with the origin and identification of business transaction and is followed by recording, classification and summarization of business transactions culminating in preparation of trial balance and financial statements, i.e., Profit & Loss Account and Balance Sheet. Following steps are followed in accounting process :

(i) Identification of Transactions → **(ii) Preparation of Vouchers** → **(iii) Recording in books of original entry** → **(iv) Posting to Ledger** → **(v) Preparation of Trial Balance and Financial Statements**

These steps are explained as below :

(i) **Identification of Transactions:** Accounting deals with business transactions which are monetary in nature. In other words, the transactions which cannot be measured and expressed in terms of money cannot be recorded in accounting. For recording business transactions, it is necessary that these transactions are evidenced by an appropriate document such as cash memo, purchase invoice, sales invoice, pay-in-slip, cheque book, pass book etc. A document which provides evidence of the transaction is called the **Source Document.**

(ii) **Preparation of Vouchers :** On the basis of source documents entries are, first of all, recorded on vouchers and then on the basis of vouchers recording is made in the Journal or books of original entry. Vouchers are printed separately by all the firms in their own names. A separate voucher is prepared for each transaction and it specifies the accounts to be debited and credited. Source document is generally attached to the voucher. Sometimes, voucher also serves as source document such as in the case of petty expenses. Vouchers, which are usually arranged in chronological order and serially numbered, are kept in a separate file.

(iii) **Recording in Books of Original Entry:** The books in which transactions are recorded for the first time from a voucher or a source document are called 'Books of Original Entry'. Journal is one of the books of original entry in which transactions are recorded in a chronological (day-to-day) order according to the principles of double entry system. When the size of the business is a small one, it may be possible to record all transactions in the journal but when the size of the business grows and the number of transactions is very large journal is sub-divided into a number of books called sub-journals or special journals. For example, all transactions relating to receipts and payments of cash are recorded in cash book, all transactions relating to credit purchase in purchase book, all transactions relating to credit sales in sales book and so on. Recording of transactions in special journals instead of journal only, is called practical system of book-keeping. These special journals are also called subsidiary books as these facilitate the preparation of ledger.

(iv) **Posting to Ledger:** The next step in the accounting process is to transfer all entries recorded in journal or subsidiary books to respective accounts in ledger. A ledger is the principal book of accounts in which all the transactions ultimately find their place under their respective accounts in a duly classified form. For recording in ledger, all transactions are classified and transactions of similar nature are recorded at one place in an account opened in their name which will provide a complete picture of all the transactions relating to them at a glance. Thus, in ledger separate accounts are opened in the name of each person, whether customer or supplier. Likewise, separate accounts are opened for assets, liabilities, purchases, sales etc. Similarly, all incomes and expenses, which are already recorded in Journal are again classified under separate heads in ledger, such as Salary Account, Rent Account, Discount Account etc.

(v) **Preparation of Trial Balance and Financial Statements:** Last step in the accounting process is the balancing of ledger accounts and the preparation of Trial Balance with the help of such balances. A Trial Balance is a statement, prepared with the debit and credit balances of ledger accounts to check the arithmetical accuracy of posting and balancing of ledger accounts. If a trial balance does not tally, it indicates that some errors in posting or balancing of accounts have occurred and steps are taken to locate and rectify such errors. As the trial balance contains the balances of all ledger accounts, it provides a basis for preparation of financial statements namely Trading and Profit & Loss Account and a Balance Sheet.

Bases of Accounting

One of the main objectives of accounting is to ascertain the profit or loss of a business enterprise at the end of an accounting period. There are two bases of ascertaining profit or loss, namely

(1) Cash Basis, and

(2) Accrual Basis.

(1) Cash Basis of Accounting: Under this basis, incomes are not recorded unless they are received in cash. Similarly, expenses are recorded only when they are paid in cash. In other words, credit transactions are not recorded at all and are ignored till cash is actually received or paid for them. Thus, profit is merely the excess of actual cash receipts in respect of sale of goods and other incomes over actual payments in respect of purchase of goods, expenses on wages, salary, rent etc. Income or profit is calculated with the help of a Receipts and Payments Account. This basis is useful for professional people like lawyers, doctors, chartered accountants etc.

Advantages:

(i) This basis is simple, realistic and satisfies the conservative instinct of many people.

(ii) It does not require the use of estimates and personal judgements.

(iii) It is suitable for those enterprises where most of the transactions are on cash basis.

Disadvantages:

(i) It does not give a true and fair view of profit or loss and financial position of the enterprise because it ignores outstanding expenses, prepaid expenses, accrued incomes and incomes received in advance.

(ii) It does not follow matching principle of accounting. For example, acquisition of goods will have to be treated as expenses of the period in which payment is made instead of the periods in which benefits are derived from them.

(iii) There is a great possibility of manipulation of profits in cash basis of accounting because payments may either be delayed or made early and similarly incomes may be postponed or collected early.

(iv) Companies Act, 2013 does not recognize it.

(2) Accrual Basis of Accounting: Under this basis, incomes are recorded when they are earned or accrued, irrespective of the fact whether cash is received or not, e.g., sales made on credit will be included in the total sales of the period. Similarly, expenses are recorded when they are incurred or become due and not when the cash is paid for them, e.g., rent due to the landlord but not paid will be treated as expense for the period when it is due and not in the period when it is paid. Hence, in accrual basis, profit or loss of a particular period is the result of matching of the revenues earned and expenses incurred during the period. This makes it necessary to consider outstanding expenses, prepaid expenses, accrued incomes, incomes received in advance etc. for the preparation of financial statements. Under the Companies Act, 2013, all companies are required to maintain their accounts according to accrual basis of accounting.

Advantages:

(i) It discloses true profit or loss for a particular period and also depicts true financial position of the business at the end of a particular period because it takes into account all transactions relating to a particular period and takes into account all adjustments like outstanding expenses, prepaid expenses, accrued income and income received in advance.

(ii) It follows the matching principle of accounting.

(iii) There is consistency in the computation of profits of different years in accrual

basis because it makes a distinction between capital and revenue expenditure,

(iv) It is recognised by Companies Act, 2013.

Disadvantages:

(i) It is not as simple as cash basis of accounting.

(ii) It requires the use of estimates and personal judgements.

Distinction between Cash Basis of Accounting and Accrual Basis of Accounting:

Basis of Distinction	Cash Basis of Accounting	Accrual Basis of Accounting
1. Recording of cash and credit transactions	This basis records only the cash transactions.	This basis makes a complete record of all cash as well as credit transactions.
2. Timing of Recording of incomes	As per this basis, only those incomes are recorded which have been received in cash.	As per this basis, all incomes are recorded whether cash is received for them or not.
3. Timing of Recording of expenses	As per this basis, only those expenses are recorded which have been paid in cash.	As per this basis, all expenses are recorded whether cash is paid for them or not.
4. Outstanding expenses, prepaid expenses, accrued incomes and incomes received in advance	This basis does not take into consideration outstanding expenses, prepaid expenses, accrued incomes and incomes received in advance.	This basis takes into consideration all such items.
5. Legal Position	This basis is not recognised under the Companies Act, 2013.	This basis is recognised under the Companies Act, 2013.
6. Ascertainment of correct profit or loss.	This basis does not ascertain correct profit or loss because it does not make a complete record of all cash and credit transactions.	This basis ascertains correct profit or loss because it makes a complete record of all cash and credit transactions.
7. Suitability	This basis is suitable for professional people like doctors, lawyers etc.	This basis is adopted by business enterprises with profit motive.

Hybrid or Mixed Basis of Accounting:

This basis of accounting is the mixture of cash basis and accrual basis. Under hybrid basis of accounting, revenues and assets are recorded on cash basis whereas expenses and liabilities are recorded on accrual basis. Usually professional people such as doctors, lawyers etc. adopt this method and prepare Receipts and Expenditure Account to ascertain their net income during a period. They ignore their outstanding income but take into consideration outstanding expenses. The idea is to claim deduction for outstanding expenses while computing taxable income. Hybrid system of accounting is an acceptable and approved system as per judgements of the courts.

Multiple Choice Questions (SET A)

Select the correct alternative:

(1) Under the Cash Basis of Accounting, expenses are recorded

(a) on payment.

(b) on being incurred.

(c) either (a) or (b).

(d) None of these.

(2) Under the Accrual Basis of Accounting, expenses are recorded

(a) on payment.

(b) on being incurred.

(c) either (a) or (b).

(d) None of these.

(3) Accrual Basis of Accounting

(a) does not give a true and fair view of profit and financial position.

(b) gives a true and fair view of profit and financial position.

(c) may or may not give a true and fair view of profit and financial position.

(d) None of the above.

(4) Accrual Basis of Accounting recognises

(a) Outstanding and Prepaid Expenses.

(b) Accrued Incomes and Incomes Received in Advance.

(c) Both (a) and (b).

(d) None of the above.

(5) Under Accrual Basis of Accounting

(a) both Cash and Credit transactions are recorded.

(b) only cash transactions are recorded.

(c) only credit transactions are recorded.

(d) None of the above.

Answers

Multiple Choice Questions (SET A)

Select the correct alternative:

1. (a)	**2. (b)**	**3. (b)**	**4. (c)**	**5.(a)**

Chapter 5

Accounting Equations

Accounting equation signifies that the assets of a business are always equal to the total of capital and liabilities. A business transaction will result in the change in either of the assets, liabilities or capital of the firm and even after the change the assets will be again equal to the total of capital and liabilities. If a business transaction results in the increase of assets, there will also be a corresponding increase in the amount of either capital or liabilities by the same amount.

Effect of Transactions on Accounting Equations

PROBLEM 1 Suppose Gopal starts a new business and the following successive transactions take place :—

Transaction 1 :—Gopal started business with Rs.75,000 as capital.

The effect of the transaction will be that the firm has received assets totaling Rs.75,000 in the form of cash and the claims against the firm are also Rs.75,000 in the form of capital. The transaction can be expressed in the form of an accounting equation as follows :—

	Assets =	**Liabilities**	**+**	**Capital**
	Cash =	Liabilities	+	Capital
Transaction	75,000 =	0	+	75,000

Transaction 2 :—Gopal purchased furniture for Cash Rs.5,000.

The effect of this transaction is that the cash is reduced by Rs.5,000, but a new asset of the same amount has been acquired. The transaction decreases one asset and at the same time increases the other asset with the same amount, leaving the total of the assets unchanged. The equation now will appear as follows :—

	Assets			**= Liabilities**	**+**	**Capital**
	Cash	+	Furniture	= Liabilities	+	Capital
Old Equation	75,000	+	0	= 0	+	75,000
Transaction	(-) 5,000	+	5,000	= 0	+	0
New Equation	70,000	+	5,000	= 0	+	75,000

Transaction 3 :—Gopal purchased goods for Cash Rs. 20,000.

As a result of this transaction, cash balance is reduced and another asset (goods) has come into existence, leaving the total of the assets unchanged. The equation will appear as follows

	Assets	**+**	**Furniture**	**+**	**Goods**	**= Liabilities**	**+**	**Capital**
	Cash					= Liabilities	+	Capital
Old Equation	70,000	+	5,000	+	0	= 0	+	75,000
Transaction	(-) 20,000	+	0	+	20,000	= 0	+	0
New Equation	50,000	+	5,000	+	20,000	= 0	+	75,000

Transaction 4:— Gopal purchased goods on credit for Rs. 16,000.

This transaction will increase goods on the assets side and will create a liability in the form of creditors. (The persons from whom goods have been purchased on credit are called creditors.) The equation will be as follows:—

	Assets					**= Liabilities**	**+**	**Capital**
	Cash	+	Furniture	+	Goods	= Creditors	+	Capital
Old Equation	50,000	+	5,000	+	20,000	= 0	+	75,000
Transaction	0	+	0	+	16,000	= 16,000	+	0
New Equation	50,000	+	5,000	+	36,000	= 16,000	+	75,000

Transaction 5 :— Goods costing Rs. 12,000 sold on credit for Rs. 15,000.

This transaction will give rise to a new asset in the form of Debtors to the extent of Rs. 15,000. (Debtors are those persons to whom goods have been sold on credit). But the goods will be reduced only by Rs. 12,000, the cost of goods sold. The net increase in assets Rs.3,000 is the amount of profit which will be added to the capital. The effect of the transaction has been explained in the following equation :—

	Assets							**=**	**Liabilities**	**+**	**Capital**
	Cash	+	Furniture	+	Goods	+	Debtors	=	Creditors	+	Capital
Old Equation	50,000	+	5,000	+	36,000	+	0	=	16,000	+	75,000
Transaction	0	+	0	-	12,000	+	15,000	=	0	+	3,000
New Equation	50,000	+	5,000	+	24,000	+	15,000	=	16,000	+	78,000

Transaction 6 :— Paid Rs. 1,000 for rent.

The effect of the transaction is that firstly, it reduces cash and secondly, as the rent is an expense, it results in a loss which decreases the capital. The revised equation will appear as follows :—

Assets								**=**	**Liabilities+**		**Capital**
	Cash	+	Furniture +	Goods	+	Debtors		=	Creditors +		Capital
Old Equation	50,000	+	5,000	+ 24,000	+	15,000		=	16,000	+	78,000
Transaction	(-) 1,000	+	0	+ 0	+	0		=	0	(-)	1,000
New Equation	49,000	+	5,000	+ 24,000	+	15,000		=	16,000	+	77,000

From the study of the above transactions it may be concluded that every transaction has a double effect and in each case Assets = Liabilities + Capital. In other words, it can be said that 'Accounting Equation is true in all cases'. The last equation appearing in the books of Gopal may also be presented in the form of a statement named as Balance Sheet. It will appear as shown below :—

BALANCE SHEET OF GOPAL

as at ……………………..

Liabilities + Capital	Rs.	Assets	Rs.
Creditors	16,000	Cash	49,000
Gopal's Capital	77,000	Furniture	5,000
		Goods	24,000
		Debtors	15,000
	93,000		**93,000**

Meaning of Debit and Credit

All accounts are divided into two sides. The left side of an account is arbitrarily or traditionally called Debit side and the right side of an account is called Credit side. In the abbreviated form, Debit is written as Dr. and Credit is written as Cr. For example, the transactions relating to cash are recorded in an account, entitled 'Cash Account' and its format wilt be as given below :—

Debit (Dr.) **CASH ACCOUNT** **Credit (Cr.)**

	Rs.		Rs.

The above account resembles English capital letter 'T'. As such, it is often called 'T' shape account. An Account is abbreviated as A/c.

Rules of Debit and Credit

In order to decide when to write on the debit side of an account and when to write on the credit side of an account. There are two approaches: —

(I) American approach or Modem approach, and

(II) English approach or Traditional approach.

(English approach is also called 'Double Entry System' which has been discussed in the next chapter).

American Approach: — The rules of debit and credit depend on the nature of an account. For this purpose, all the accounts are classified into the following five categories in the American approach: —

I. Assets Accounts

II. Liabilities Accounts

III. Capital Account or Owner's Equity Account

IV. Revenue or Income Accounts

V. Losses or Expenses Accounts

While discussing an accounting equation, we have studied that if there is an increase or decrease in one account, there will be equal decrease or increase in another account. Accordingly, following rules of debit or credit in respect of the various categories of accounts can be obtained: —

I. Assets Accounts: — When there is an increase in the amount of an asset, such an increase is recorded on the debit side of the asset account and if there is a reduction

in the amount of an asset, such reduction is recorded on the credit side of the asset account. For example, if a firm purchases furniture of Rs.5,000, it will be recorded on the debit side of the furniture account, since the furniture has increased by this amount. Again, if the firm sells furniture of Rs.2,000, the reduction will be recorded on the credit side of the furniture account.

Dr **ASSET ACCOUNT** **Cr.**

Increase in asset will be recorded on this side.	Rs.	Decrease in asset will be recorded on this side.	Rs.

II. Liabilities Accounts:— When there is an increase in the amount of a liability, such an increase will be recorded on the credit side of the liability account. On the contrary, if there is a reduction in the amount of a liability, it will be recorded on the debit side of the liability account. For example, if a firm borrows Rs. 10,000 from Govind, the account of Govind will be credited since Rs. 10,000 is now owing to him. When the loan is repaid, the account of Govind will be debited since the liability no longer exists.

Dr. LIABILITY ACCOUNT Cr.

Decrease in liability will be	**Rs.**	Increase in liability will be recorded recorded on this side. on this side.	**Rs.**

III. Capital Account: — An increase in the capital is recorded on the credit side and the decrease in the capital is recorded on the debit side. Suppose, the proprietor introduces the additional capital in the business, the capital account will be credited. Similarly, if the proprietor withdraws some money for his personal use, i.e., makes drawings, the capital account will be debited.

Dr. CAPITAL ACCOUNT Cr.

Decrease in capital will be recorded on this side.	Rs	Increase in capital will be recorded on this side.	Rs.

IV. Revenue or Income Accounts: — All increases in the gains and incomes are recorded on the credit side of the concerned income account as it leads to increase in the capital. On the contrary, if there is a reduction in any gain or income, the account concerned will be debited, as it leads to decrease in the capital.

Dr. REVENUE OR INCOME ACCOUNT Cr.

Decrease in gains and incomes will be recorded on this side.	Rs.	Increase in gains and incomes will be recorded on this side.	Rs.

V. Losses or Expenses Accounts:— All increases in the losses and expenses are recorded on the debit side of the concerned expenses account as it leads to decrease in the capital. On the contrary, the reduction in expenses is recorded on the credit side.

Dr. LOSSES OR EXPENSES ACCOUNT Cr.

Increase in losses and expenses will be recorded on this side.	Rs.	Decrease in losses and expenses will be recorded on this side.	Rs.

The rules given above may be summarised as below :—

1. Debit the increase in assets and Credit the decrease in assets.
2. Credit the increase in liabilities and Debit the decrease in liabilities.
3. Credit the increase in Capital and Debit the decrease in Capital.
4. Credit the increase in Incomes and Debit the decrease in Incomes.

5. Debit the increase in Expenses and Credit the decrease in Expenses.

On the basis of the above discussion it can be concluded that:—

The term debit should not be taken to mean favourable things. It may represent favourable or unfavourable, increase or decrease depending on the nature of an account. Similarly, the term credit may represent favourable or unfavourable, increase or decrease depending on the nature of the concerned account. In the case of assets and expenses, debit means increase and credit means decrease. In the case of liabilities, capital and incomes, debit represents decrease and credit represents increase.

Dr. **ASSETS OR EXPENSES ACCOUNT** **Cr.**

Record increase in these accounts on this side.	Rs.	Record decrease in these accounts on this side.	Rs.

Dr. **LIABILITY, CAPITAL OR INCOME ACCOUNT** **Cr.**

Record decrease in these accounts on this side.	Rs.	Record increase in these accounts on this side.	Rs.

Multiple Choice Questions (SET A)

Select the correct alternative:

(1) Which of the following equations is correct?

(a) Assets + Capital = Liabilities.

(b) Assets - Liabilities = Capital,

(c) Assets + Liabilities = Capital.

(d) None of these.

(2) Which of the following is correct?

	Assets	Liabilities	Capital
(a)	Rs. 7,85,000	Rs. 1,25,000	Rs. 6,60,000
(b)	Rs. 8,20,000	Rs. 2,80,000	Rs. 11,00,000
(c)	Rs. 9,55,000	Rs. 1,15,000	Rs. 8,20,000
(d)	Rs. 5,42,000	Rs. 6,54,000	Rs. 1,12,000

(3) Amount withdrawn by proprietor for personal use will ... Cash and Capital.

(a) Increase.

(b) Decrease.

(c) Not Change.

(d) None of these.

(4) Which accounting equation is incorrect out of the following?

(a) Liabilities = Assets - Capital.

(b) Assets = Liabilities - Capital.

(c) Capital = Assets - Liabilities.

(d) Assets = Liabilities + Capital.

(5) The liabilities of a firm are Rs. 3,000; the capital of the proprietor is Rs. 7,000. The total assets are:

(a) Rs. 7,000.

(b) Rs. 10,000.

(c) Rs. 4,000.

(d) None of these.

(6) X commenced business on 1st April, 2013 with a capital of Rs. 6,00,000. On 31st March,

2014 his assets were worth Rs. 8,00,000 and liabilities Rs. 50,000. Find out his closing capital.

(a) Rs. 7,50,000.

(b) Rs. 2,00,000.

(c) Rs. 5,50,000.

(d) None of these.

(7) An increase in one asset is accompanied by

(a) Decrease in another asset.

(b) increase in a liability.

(c) Increase in capital.

(d) All of these.

(8) Decrease in one liability may lead to

(a) Decrease in an asset.

(b) Increase in another liability.

(c) Either (a) or (b).

(d) None of these.

(9) Purchase of machine by cash means

(a) Decrease in asset and decrease in liability.

(b) Increase in asset and decrease in asset.

(c) Increase in asset and decrease in liability.

(d) Decrease in asset and increase in capital.

(10) Payment to a creditor means

(a) Increase in asset and decrease in liability.

(b) Decrease in asset and decrease in liability.

(c) Decrease in asset and increase in liability.

(d) Increase in asset and increase in liability.

(11) Purchase of furniture on credit means

(a) Decrease in asset and increase in liability.

(b) Increase in asset and increase in liability.

(c) Increase in asset and decrease in liability.

(d) Decrease in asset and decrease in liability.

[(i) (by, (it) (a); (iii) (by (iv) (6); (a) (b); (vi) (a); (vii) (d);

(viii) (c); (ix) (b); (x) (b); (xi) (b).]

Answers

Multiple Choice Questions (SET A)

Select the correct alternative:

1. (b)	**2. (a)**	**3. (b)**	**4. (b)**	**5.(a)**
6.(a)	**7.(a)**	**8.(a)**	**9.(a)**	**10.(a)**
11. (b)				

Chapter 6

Double Entry System

"Every transaction involving money or money's worth has a twofold aspect — the receiving of a value on the one hand and the giving of the same value on the other. This two-fold nature in all transactions must be recorded in the books, and this gives rise to the term Double Entry Book-Keeping". — **Munro and Palmer**

Double entry system is the most progressive, scientific and complete system of recording the financial transactions of a business. The rules of recording transactions under this system are so definite and clearly stated that the system is being used extensively in all countries. According to this system there are two accounts involved in every business transaction. One of them is debited and the other is credited. Under this system the accuracy of the accounts can be checked by preparing a trial balance with the help of balances of ledger accounts at any time and with the help of the trial balance a profit and loss account can be prepared in order to ascertain the profit earned or loss suffered during a particular period. Also, with the help of the trial balance a balance sheet can be prepared to ascertain the financial position of the firm.

A book on the double entry system was, first of all, written in 1494 by 'Luca Pacioli', a resident of the city of Venice in Italy. In this book he discussed the method of recording both the aspects of a transaction. The book became very popular in a very short period due to its characteristics. Afterwards, the book was translated into English by Huge Old Castle in 1544. Later on, many changes were incorporated in the system and finally a complete book named as 'English System of Book-Keeping' was written on this system by Edward Jones in 1785. It was in this book that the old system was completely revised and the use of purchase book, sales book and the preparation of a trial balance was discussed first of all. Due to its peculiarities this system has been adopted by all the progressive countries all over the world.

Meaning of Double Entry System

According to this system every business transaction affects at least two accounts in opposite directions. For example, if the furniture is purchased in the business, furniture is increased whereas the cash is decreased. There can be no transaction in the business which affects only one account or which has only one aspect. As such, both the aspects of every transaction are recorded under this system. It may, however, be noted that the double entry does not mean that a transaction is recorded twice. But it means that at least two accounts are affected by a transaction — one account receiving a benefit and the other account yielding a benefit. The person or the account receiving a benefit is debited and the person or the account who gives something to the business is credited. The amount of every transaction is written twice, once as a debit and again as a credit. For example, we received Rs.25,000 from Mohan. This transaction affects two accounts — Cash Account and the Mohan's Account. Cash account is receiving a benefit (as cash is coming in) and hence Cash account will be debited, whereas Mohan is yielding a benefit and hence his account will be credited.

Definitions :— Double entry system may be defined as follows :—

1. "The Double Entry System seeks to record every transaction in money or money's worth in its double aspect — The receipt of a benefit by one account and the surrender of a like benefit by another account, the former entry being to the debit of the account receiving and the latter to the credit of that account surrendering." — **William Pickles**

2. "Every business transaction has a two-fold effect and that it affects two accounts in opposite directions and if a complete record were to be made of each such transaction, it would be necessary to debit one account and credit another account. It is this recording of the two fold effect of every transaction that has given rise to the term Double Entry System." — **J.R. Batliboi**

Principles or Characteristics of Double Entry System

Double Entry System is based upon the principle that "Every debit has a credit and every credit has a debit". Following are the important features or essentials of the double entry system :—

(1) **Every business transaction affects two accounts :—** Every business transaction has a two-fold effect, i.e., it affects two accounts simultaneously. One of them is debited and the other is credited. Certain transactions may affect more than two accounts but the amount of the accounts to be debited and credited will always be equal.

(2) **Recording of both personal and impersonal aspects :—** Both personal and impersonal aspects of a transaction are recorded in Double Entry. It is possible that both the aspects of a transaction may be personal or both may be impersonal or one may be personal and the other may be impersonal.

(3) **Recording is made according to certain specified rules :—** In double entry one account is debited and the other is credited. It does not mean that any account may be debited and any account may be credited. There are certain rules for debiting and crediting and debits and credits are made on the basis of these rules.

(4) **Preparation of Trial Balance :—** Since one account is debited and the other is credited, total of all debits is always equal to the total of all credits. This helps in finding out the arithmetical accuracy of the accounting records. This is done by preparing a trial balance.

In order to keep a proper record of the two aspects of a transaction, accounts may be classified as shown below :—

Classification of Accounts

Personal Accounts

Impersonal Accounts

Real Accounts

Nominal Accounts

(1) Personal Accounts: — The accounts which relate to an individual, firm, company or an institution are called personal accounts. Account of Mohan, Account of Ram Chander Krishan Grander, Account of D.C.M. Limited, Account of Delhi University, Bank Account, Capital Account of the proprietor, Drawings Account of the proprietor etc. are examples of Personal Accounts.

Rule: — Rule for recording a transaction in personal accounts in simple words is 'Debit the receiver and credit the giver'. In other words, "Debit that person's account who receives something from the business and credit that person's account who gives something to the business".

Example 1: — Paid Rs.20,000 to Hari

In this case, two accounts affected are Hari's A/c and Cash A/c. According to the rule of "Debit the receiver", Hari's Account will be debited in the entry as he is the receiver of Cash. Simultaneously, the account of cash will be credited, as cash has gone out. The entry will be

Hari (Debit the receiver) Dr.	**20,000**	
To Cash A/c		**20,000**

Example 2: — Received Rs. 10,000 from Mohan

In this case, cash account will be debited as cash has been received, and Mohan's account will be credited according to the rule of "Credit the Giver". The entry will be

Cash A/c	**Dr. 10,000**	
To Mohan (Credit the Giver)		**10,000**

Objects: — Object of preparing a personal account is to ascertain as to how much amount a personal account owes to the business i.e., how much amount is due to be received from him and how much amount is owed to a personal account from the business, i.e., how much amount is payable to him.

Types or Classification of Personal Accounts

Personal accounts can be classified into the following three categories.

Personal Accounts

- Natural Personal Accounts
- Artificial Personal Accounts
- Representative Personal Accounts

(A) Natural Personal Accounts: — Accounts of 'Natural Persons' means the accounts of human beings. For example, Mohan's Account, Sohan's Account, Seema's Account, Nirmla's Account etc. Proprietor's Capital Account, Proprietor's Drawings Account, Debtors Accounts and Creditors Accounts are also included in this category.

(B) Artificial Personal Accounts: — These accounts do not have physical existence as human beings but they work as personal accounts. For example, any Firm's account, any limited company's account, any institution's account and any bank's account. These are treated as artificial persons for the recording of business transactions. These accounts also include the accounts of Clubs, Insurance Companies and the accounts of Government Departments which are recognised as 'persons' in the business dealings.

(C) Representative Personal Accounts: — When an account represents a particular person or group of persons, it is termed as a representative personal account. For example, if the salaries for the month of December are not paid to the employees, the amount payable to these employees will be added and put under one common title "Salaries Outstanding Account". This account represents the accounts of all the persons to whom salaries have to be paid. This is therefore termed as 'Representative Personal Account'. Other examples of the Representative Personal Accounts are, Prepaid Insurance Account, Accrued Interest Account and Unearned Commission Account etc.

(2) Real Accounts: — The accounts of all those things whose value can be measured in terms of money and which are the properties of the business are termed as Real Accounts. Such as, Cash Account, Furniture Account, Machinery Account, Building Account, Goodwill Account etc.

Rule: — Rule for recording a transaction in real account is 'Debit what comes in and credit what goes out'. According to this rule, whenever any property comes into the business, it is debited and when it goes outside the business, it is credited.

For example, if Furniture for Rs.10,000 has been purchased for cash, furniture account should be debited according to the rule of "Debit what comes in", while cash account should be credited according to the rule of "Credit what goes out". Entry will be

Furniture A/c (Debit what comes in) Dr. 10,000

To Cash A/c (Credit what goes out) 10,000

Objects: — These accounts represent the value of various properties owned by a business in terms of money and indicate the financial position of the business.

Types or Classification of Real Accounts

Real accounts can be classified in the following two categories:

Real Accounts

Tangible Real Accounts | **Intangible Real Accounts**

(A) Tangible Real Accounts: — Tangible real accounts are the accounts of those things which can be touched, felt, measured, purchased, sold etc. Examples of such accounts are Cash account, Stock account, Furniture account, Land account, Building account etc. It should be noted that Bank Account is not a real account but it is an Artificial Personal Account, since it represents the account of the Banking Company — an artificial person.

(B) Intangible Real Accounts: — These accounts represent such things which cannot be touched, but, of course, their value can be measured in terms of money. Examples are : Goodwill account, Patents account, Trade Marks account, Copyrights account etc.

(3) Nominal Accounts: — These accounts include the accounts of all expenses and incomes. The examples of nominal accounts relating to expenses are Salaries paid, Rent paid, Discount allowed, Bad Debts etc.

The examples of nominal accounts relating to incomes are Commission received, Interest received, Discount received etc.

Rule :— Rule for recording in nominal accounts is, "Debit the expenses and losses and Credit incomes and gains".

Example 1:— Paid Rs.20,000 for Salaries. In this case the two accounts being affected are Salaries A/c and Cash A/c. Salaries represent expenses and as such, Salaries Account will be debited according to the rule of ''Debit the expenses". On the other hand, Cash Account will be Credited according to the rule of "Credit what goes out". Entry will be

Salary A/c (Debit the Expenses)	**Dr.**	**20,000**	
To Cash A/c (Credit what goes out)			**20,000**

Example 2:— Received Rs.5,000 for Commission. In this case the two accounts being affected are Commission A/c and Cash A/c. Commission A/c is a nominal account and represents an income. As such, Commission A/c will be credited according to the rule of "Credit the incomes". Cash A/c is a real account and as Cash is coming in, therefore Cash A/c will be debited according to the rule of "Debit what comes in". Entry will be:

Cash A/c (Debit what comes in) Dr. 5,000

To Commission Ac (Credit the incomes) 5,000

Objects :— Nominal accounts are those accounts which are in name only and which do not really exist. These accounts are opened simply to explain the nature of head for which Cash has been paid. In the absence of nominal accounts, it will be very difficult for the management to know the amount paid separately on account of salary, rent, commission etc. As such, the nominal accounts provide information regarding the following :

(i) Amount spent on various heads in a particular period;

(ii) Income received on various heads in a particular period.

IMPORTANT NOTE
When any word (as a prefix or as a suffix) is added to a Nominal Account, it becomes a Personal Account.

Nominal Account	**Personal Account**
1. Rent A/c	Outstanding Rent A/c; Prepaid Rent A/c.
2. Salary A/c	Outstanding Salaries Ac; Salaries Prepaid A/c.
3. Commission A/c	Commission Outstanding A/c; Commission Received in Advance A/c.
4. Interest A/c	Interest Outstanding A/c; Interest Accrued A/c.

PROBLEM 1.

Classify the following Accounts into Personal, Real or Nominal Accounts:

1. Capital; 2. Drawings; 3. Cash paid; 4. Cash received; 5. Commission paid; 6. Commission received; 7. Purchases A/c; 8. Sales A/c; 9. Furniture; 10. Cash A/c; 11. Bank A/c; 12. Bank Overdraft A/c; 13. Debtors A/c; 14. Creditors A/c; 15. Travelling Expenses; 16. Goodwill; 17. Patents; 18. Salary A/c; 19. Salary Outstanding A/c; 20. Insurance A/c; 21. Insurance Prepaid A/c; 22. Bad Debts written off; 23. Bad Debts recovered.

SOLUTION:

Personal Accounts	**Real Accounts**	**Nominal Accounts**
1. Capital	3. Cash paid	5. Commission paid
2. Drawings	4. Cash received	6. Commission received
11. Bank A/c	9. Furniture A/c	7. Purchases A/c
12. Bank Overdraft A/c	10. Cash A/c	8. Sales A/c
13. Debtors A/c	16. Goodwill A/c	15. Travelling Expenses A/c
14. Creditors A/c	17. Patents A/c	18. Salary A/c
19. Salary Outstanding A/c*		20. Insurance A/c
21. Insurance Prepaid A/c*		22. Bad Debts written off
		23. Bad Debts Recovered

*** When a prefix or suffix is added to a Nominal A/c, it becomes a Personal A/c.**

Notes:

(i) Salary A/c is a nominal account whereas Salary Outstanding is a personal account because it is the account of some unnamed creditor.

(ii) Insurance A/c is a nominal account whereas Insurance Prepaid is a personal account because it is the account of some unnamed debtor.

(iii) Bank A/c is not a real account. It is a personal account since it is the account of some banking company or firm which is an artificial person.

(iv) Purchases A/c and Sales A/c are nominal accounts.

Stages or Parts of Double Entry System

Accounting process can be divided into three stages under the double entry system:

(1) Original Record: All the transactions are first recorded in a primary book called Journal. When the business is a big one and the number of transactions is large, Journal is divided into various books which are called 'Sub-division of Journal' or 'Subsidiary Books'. Thus, recording in Journal or in its subsidiary books is the first stage of double entry system. This stage is also known as original record stage.

(2) Classification: In this stage, all the transactions recorded in the Journal or its subsidiary books are transferred (posted) in a classified form to another book which is called 'Ledger'. This book contains, on different pages, individual account heads under which all financial transactions of similar nature are collected at one place, so that the combined effect of all the transactions relating to a particular account may be ascertained. Posting in ledger is also known as classification stage.

(3) Summary: In this stage, all the accounts in the ledger are balanced off and are put in a list, debit balances on one side and credit balances on the other side. The list so prepared is called a Trial Balance. The total of the debit side of Trial balance must be equal to that of its credit side. If the two sides of the trial balance are equal, the arithmetical accuracy of the accounts is proved. With the help of the trial balance a Trading and Profit & Loss account is prepared to ascertain the profit earned or loss suffered during a particular period and a Balance Sheet is prepared to show the financial position of the business.

Advantages of Double Entry System or Causes of its Popularity

(1) Scientific System: Under this system, the transactions are recorded according to certain specified rules and as such, the system is more scientific as compared to any other systems of Book-Keeping.

(2) Complete record of every transaction: In double entry all the accounts are divided in three parts i.e., personal accounts, real accounts and nominal accounts and both the debit and credit aspects of a transaction are recorded in these. Hence, the complete record of every transaction is maintained in this system, so that if the need arises full details of every transaction can be easily made available at any time in future.

(3) Preparation of Trial Balance: In double entry system, the amount recorded to the debit sides of various accounts will always be equal to the amounts recorded on the credit sides of various accounts. As such, a trial balance can be prepared to check the arithmetical accuracy of the accounts.

(4) Preparation of Trading and Profit & Loss Account: With the help of the trial balance, a Trader can prepare a Trading Account to find out the amount of gross profit or gross loss. Similarly, a profit and loss account can be prepared to find out the net profit earned or loss suffered during a particular period.

(5) Knowledge of financial position of the business: At the end of each accounting period every businessman wants to know the financial position of his business i.e., value of the assets, liabilities and capital of the business. In double entry system, separate accounts are opened for each and every asset and liability of the firm and as such, a Balance Sheet can be prepared which is a screen picture of the financial position of a business at a certain moment. A Balance Sheet reports the property values owned by the enterprise and the claims of the creditors and owners against these properties.

(6) Knowledge of various informations: In double entry system the accounts are maintained in such a way that the information regarding the following is readily available at any point of time:

(i) What is the amount of sales, purchase and closing stock?

(ii) What amount is due to be received from customers or in other words, the total number of debtors and the amount in each case?

(iii) What amount is due to be paid to suppliers or in other words, the total number of creditors and the amount in each case?

(iv) How much amount has been paid on account of each head of expenses separately?

(v) How much amount has been earned on account of each head of income separately?

(7) Lesser possibility of fraud: This system of book-keeping records each transaction in two accounts, as such there is hardly any scope of forgery and manipulation as compared to Other systems. If at all some manipulation takes place, it can be easily detected.

(8) Legal Approval: Complete record of each transaction is maintained under this system according to certain specified rules. As such, the system meets legal requirements and books of accounts maintained under this system are accepted as true and reliable by the Companies Act and various other Acts. It has been made compulsory for Joint Stock Companies, banks and insurance companies to maintain their accounts according to double entry system of accounts. Tax authorities also rely on the books maintained under this system and these are also accepted by the Court of Law as necessary documentary evidence.

(9) Comparative Study: Linder this system, separate recording is made for each item of expenditure and income. As such, the management can compare the expenditure of the current year with those of the previous years and can know on what head of expenditure the money spent is unreasonable and can take steps to check the unnecessary expenditure. Similarly, the profit and loss account and Balance Sheet of one year may be compared with those of the previous years and reasons for the change may be ascertained.

(10) Helps management in Decision Making: Under the system, the management can obtain all the requisite information quickly and also the information provided by the system is most reliable. Hence, the management can use the information for making decisions.

(11) Suitable for all Types of Businessmen: The system is so flexible that it can be conveniently introduced in small as well as big types of business.

Disadvantages of Double Entry System

(1) A number of books are to be kept under this system, as such, the system is quite expensive.

(2) It is quite difficult to apply the rules of debit and credit. Proper education, practical knowledge and training is required in order to have command over the rules of double entry system.

(3) Only the arithmetical accuracy of the accounts is checked by preparing a trial balance under the double entry system. Following types of errors are not disclosed under the system:

(i) Errors of Omission: If a transaction remains altogether unrecorded in the books of original entry.

(ii) Errors of Commission: If wrong amount is recorded in the books of original entry.

(iii) Errors of Principle: If the amount is recorded on the correct side though in a wrong account. For example, if purchase of machinery is debited to purchase account instead of machinery account.

(iv) Compensating Errors: If the effect of one error is cancelled by the effect of some other errors.

An analysis of the above disadvantages reveals that these arise due to the inefficiency and carelessness of the person responsible for making records in the books. The system of double entry cannot be held responsible for omitting to record a transaction altogether or for recording some transaction wrongly. The system has proved to be so systematic, scientific and flexible that it is being used extensively in all countries.

Multiple Choice Questions (SET A)

Select the correct alternative:

(1) Debit means

(a) an increase in asset.
(b) an increase in liability.
(c) an increase in the proprietor's equity.
(d) a decrease in asset.

(2) Credit means

(a) an increase in asset.
(b) an increase in liability.
(c) a decrease in liability.
(d) a decrease in proprietor's equity.

(3) Sale of goods to Ram for cash is debited to

(a) Ram.
(b) Cash A/c.
(c) Sales A/c.
(d) None of these.

(4) Withdrawal of cash from business by the proprietor is credited to

(a) Drawings A/c.
(b) Capital A/c,
(c) Cash A/c.
(d) Profit and Loss A/c.

(5) Bank account is a

(ci) Personal Account.
(b) Real Account,
(c) Nominal Account.
(d) None of these.

(6) Drawings Account is a

(a) Personal Account.
(b) Real Account.
(c) Nominal Account.
(d) None of these.

(7) Goodwill account is a

(a) Personal Account. (b) Real Account.

(c) Nominal Account. (d) None of these.

(8) Which of the following accounts has a credit balance?

(a) Carriage Inward (b) Discount Received

(c) Carriage Outward (d) Discount Allowed

(9) Balance of Capital Account is shown as

(a) Capital Account. (b) Liability Account.

(c) Revenue Account. (d) None of these.

(10) Sundry Creditors Account is a

(a) Revenue Account. (b) Capital Account.

(c) Liability Account. (d) None of these.

(11) Sales Account is a

(a) Revenue Account. (b) Liability Account.

(c) Capital Account. (d) None of these.

(12) Salaries Account is

(a) an Expense Account. (b) an Asset Account.

(c) a Liability Account. (d) None of these.

(13) Capital Account is a

(a) Natural Personal Account. (b) Artificial Personal Account.

(c) Representative Personal Account. (d) None of these.

(14) An increase in which of the following account will be recorded on the debit side?

(a) Building Account. (b) Capital Account.

(c) Bills Payable Account. (d) Rent Received Account.

(15) Outstanding salary is a

(a) Real Account. (b) Personal Account.

(c) Nominal Account. (d) None of these.

(16) Nominal Accounts are related to:

(a) Assets and Liabilities. (b) Expenses and Revenue.

(c) Debtors and Creditors. (d) None of these.

Answers

Multiple Choice Questions (SET A)

Select the correct alternative:

1. (a)	**2. (b)**	**3. (b)**	**4. (c)**	**5.(a)**
6.(a)	**7.(b)**	**8.(b)**	**9.(c)**	**10.(c)**
11. (a)	**12. (a)**	**13. (a)**	**14. (a)**	**15. (b)**
16. (b)				

Chapter 7

Origin of Transactions:

Source Documents of Accountancy

Origin of Transactions

Various transactions are made in a business every day such as purchase and sale of goods and services, receipt or payment of cash and so on. Each business transaction should be supported by documentary evidence such as cash memo, cash receipt, invoice or bill, debit and credit notes, pay-in-slip, cheque etc. These business documents are called source documents.

Source Documents of Accountancy

These documents are the first record about the details of a business transaction. Such documents report the date, the amount, parties involved and the nature of the transaction. Entries in the books are always made from the source documents. According to the verifiable objective principle of accounting, each transaction recorded in the books of accounts should have adequate proof to support it. These documents are the written and authentic proof of the correctness of the recorded transaction. These documents are required for audit and tax assessments. They also serve as the legal evidence in case of a dispute. The following are the most common source documents:

(1) Cash Memo: When a trader sells goods for cash, he gives a cash memo and when he purchases goods for cash, he receives a cash memo. Details regarding the item, quantity, rate and the total price is mentioned in the cash memo. Cash transactions are recorded in the books of accounts on the basis of these cash memos. Specimen of a cash memo is given on the next page:

CASH MEMO

GLOBAL WATCH CO.

No. A-115, Defence Colony, New Delhi-110015

To………………..   **Dated: 15-02-2020**

Qty.	Description	Rate Rs.	Amount Rs.
3	Titan Regalia D 06	2,300	6,900
2	Titan Raga 108	2,700	5,400
			12,300

	Less: Discount 10%		1,230
5	Total		11,070

Goods once sold are not taken back or exchanged. ....

Manager

For Global Watch Co.

(2) Invoice and Bill: When a trader sells goods on credit, he prepares a sale invoice which contains the name of the party to whom goods are sold, the rate, quantity and the total amount of sale. The original copy of the sale invoice is sent to the purchaser and its duplicate copy is kept for making records in our books of accounts. Similarly, when a trader purchases goods on credit, he receives a credit bill from the supplier of goods. We make an invoice on credit sale but receive a bill on credit purchase, though the two terms are used synonymously and mean the same thing. Specimen of an invoice or a bill is given below:

MALHOTRA ELECTRONICS

25, Palika Market, Connaught Place, New Delhi-110002

No.

Name of Customer: Ashoka Enterprises **Dated 10-01-2020**

Terms: 5% Cash discount if payment is made within 30 days.

Qty.	Description	Rate Rs.	Amount Rs.
2	I.F.B. Senator 6 kg. Washing Machine	23,300	46,600
1	I.F.B. Executive Plus 5 kg. Washing Machine	19,500	19,500
2	I.F.B. Senorita 4 kg. Washing Machine	14,500	29,000
			95,100
	Sales Tax @ 10%		9,510
			1,04,610
	Handling and Delivery Charges		400
5	**Total**		**1,05,010**

Rupees One Lac Five Thousand and Ten only

....

Partner

E.&O.E. **For Malhotra Electronics**

(3) Receipt: When a trader receives cash from a customer, he issues a receipt containing the date, amount and the name of the customer. The original copy of the receipt is given to the customer and its duplicate copy is kept for making records in the books of accounts. In the same way, whenever we make payment, we obtain a receipt from the party to whom we make payment.

(4) Debit Note: When we return goods to a supplier, we prepare a debit note and send it to the supplier with the returned goods. Debit note is a document which indicates that supplier's account is being debited. It is a source document which contains the date of transaction, the name of account which is debited, the amount and the reasons for debit.

A duplicate copy or the counterfoil of the 'debit note' is retained by us, on the basis of which, the supplier's account is debited in our books. A specimen of the debit note is given below:

DEBIT NOTE

PADMALAYA PRODUCTS LTD.

312, Annadurai Road
Chennai

No. ....

Date ....

To,

Name and Address (of the person to whom it is sent) ....

We are debiting your account as follows:

	Amount Rs.
15, Jeep Torches, your Invoice No. 350, are being returned, as the Torches are badly damaged.	6,000

For Padmalaya Products Ltd.

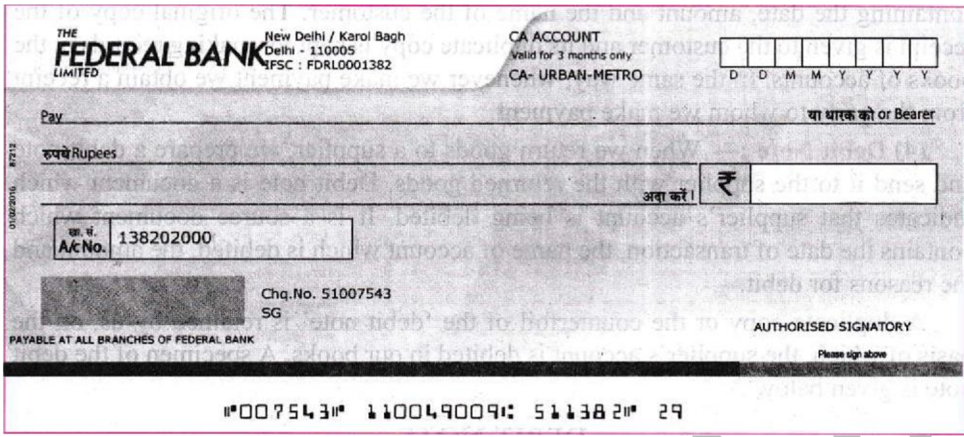
Manager

(5) Credit Note: When goods are received back from a customer a credit note is sent to him indicating that the customer's account has been credited in our books. A duplicate copy of the credit note is retained for record purpose.

(6) Pay-in-Slip: This is a form available from a bank and is used to deposit money in the bank. Each pay-in-slip has a counterfoil which is returned to the depositor duly stamped and signed by the cashier of the bank.

(7) Cheque: A cheque is an order in writing drawn upon a bank to pay a specified sum to the bearer or the person named in it. Each cheque book has a counterfoil in which the same details as entered in the cheque are filled. The counterfoil remains with the account holder for future reference. Specimen of a cheque is given on the next page:

SPECIMEN OF A CHEQUE



In addition to the above, bills receivable, bills payable, wages sheet, correspondence etc. also serve as the source documents. Source documents are also prepared for recording internal events such as depreciation and valuation of stock. Thus, there must be a source document for each transaction recorded in the books of accounts.

Vouchers

Meaning of Voucher

On the basis of source documents entries are, first of all, recorded on Vouchers and then on the basis of Vouchers recording is made in the Journal or books of original entry. Vouchers are printed separately by all the firms in their own names. A separate Voucher is prepared for each transaction and it specifies the accounts to be debited and credited. Vouchers are prepared by an accountant and each Voucher is countersigned by an authorised person of the firm.

A serial number is put on each Voucher and the relative source documents are attached with the Voucher. The Vouchers are properly filed according to their serial numbers so that the auditors may easily vouch them and these may also serve as documentary evidence in future.

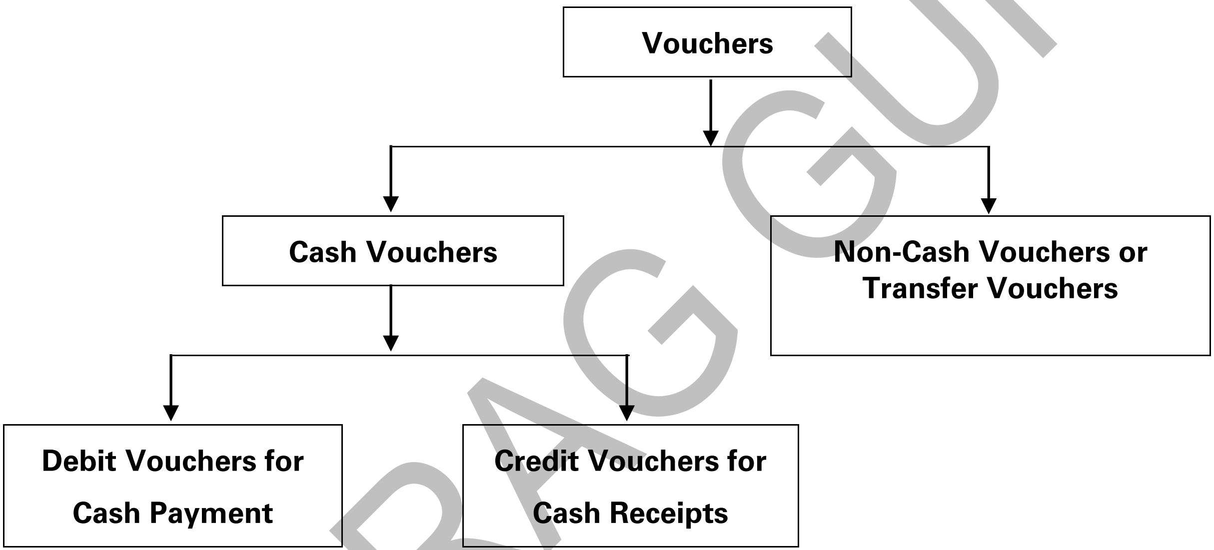
Distinction between source documents and vouchers

	Source Documents	**Vouchers**
I.	It is a support to the voucher.	Voucher is supported by source document.
2.	It is not prepared to record transactions.	It is prepared for the purpose of recording of transactions.

3.	It contains full details of a transaction.	It puts emphasis on which account is to be debited and which account is to be credited.
4.	It is evidence of the transaction.	It is document of correct recording of a transaction.

Types of Vouchers

Vouchers may be classified into two categories as follows:



(1) CASH VOUCHERS: Cash Vouchers are prepared for cash transactions i.e., cash receipts and cash payments. These are of two types viz., Debit Vouchers and Credit Vouchers.

DEBIT VOUCHERS

These are prepared for transactions involving cash payments such as:

- For Cash payment of expenses (say salaries, rent etc.)
- For Cash purchases of goods
- For Cash purchases of investments
- For Cash purchases of fixed assets
- For Cash payment to Creditors
- For Depositing Cash into the Bank

Contents: Usually the following information is contained in a Debit Voucher:

(i) Date of preparing Voucher

(ii) Serial number of Voucher

(iii) Name of Account Debited

(iv) Narration, i.e., a brief explanation of the transaction together with necessary details

(v) Net amount of transaction

(vi) Source document number (say cash memo number)

In case the source document is not available for a transaction, the receipt portion of the debit voucher is filled and is used as source document.

If the net amount of the debit voucher is Rs.5,000 or more, a revenue stamp of Rs. 1 is affixed and the signatures of the person receiving the payment are obtained across the revenue stamp.

Format:

Format of a debit Voucher may be as follows:

DEBIT VOUCHER

Received Rupees........................ / Affix Revenue Stamp	.M/S KOHINOOR ELECTRICAL CO. 34/3 Connaught Circus, New Delhi-2 Voucher No. 362 Date 15-01-2020	
	DEBIT **OFFICE EQUIPMENT A/C**	Amount
	....	
	(For Filing Cabinet purchased for Cash vide Cash Memo No. 521)	Rs. 30,000
	Total	30,000
	Signature .... Manager	Signature .... Accountant

Note: Since the source document (i.e., Cash Memo No. 521) is available, the receipt portion of the debit Voucher has not been filled.

CREDIT VOUCHERS

These are prepared for transactions involving Cash receipts such as :

- For Cash receipt of income (say Commission, Interest etc.)
- For Cash sales of goods
- For Cash sales of investments
- For Cash sales of fixed assets
- For Cash receipt from debtors
- For Withdrawing Cash from the Bank

Contents: Usually the following information is contained in a Credit Voucher:

(i) Date of preparing Voucher

(ii) Serial number of Voucher

(iii) Name of Account Credited

(iv) Narration i.e., a brief explanation of the transaction together with necessary details

(v) Net amount of transaction

(vi) Source document number (say Cash memo number)

Format: Format of a Credit Voucher may be as follows:

CREDIT VOUCHER

<table>
<tr><td colspan="3" align="center">M/S KOHINOOR ELECTRICAL CO.
34/3 Connaught Circus, New Delhi-110002
</td></tr>
<tr><td colspan="2">Voucher No. 430</td><td align="right">Date 05-02-2020</td></tr>
<tr><td>CREDIT</td><td align="center">SALES A/C
……………………………………………………
……………………………………………………</td><td align="right">Amount
Rs.
25,000</td></tr>
<tr><td colspan="2" align="center">(For goods sold for Cash
Vide Cash Memo No. 614)
Total</td><td align="right">25,000</td></tr>
<tr><td colspan="2">Signature
Manager</td><td align="right">Signature
Accountant</td></tr>
</table>

(2) NON-CASH VOUCHERS OR TRANSFER VOUCHERS: These Vouchers are prepared for non-cash transactions such as:

- For Credit Purchase or Credit Sale of goods

- For Credit Purchase or Credit Sale of investments
- For Credit Purchase or Credit Sale of fixed assets
- For Return of goods purchased or sold on credit
- For Providing depreciation
- For Writing off bad debts

Contents: Usually the following information is contained in a non-cash Voucher:

(i) Date of preparing Voucher

(ii) Serial number of Voucher

(iii) Name of Account Debited and Name of Account Credited

(iv) Narration, i.e., a brief explanation of the transaction together with necessary details

(v) Net amount of transaction

(vi) Source document number (say Sale Invoice No.)

For example, on 15th-February 2020, Kohinoor Electrical Co. purchases 100 Tube lights @ Rs.150 each and 5 Ceiling Fans @ Rs.8,000 each on credit from Triputi Electricals Ltd. Voucher for this transaction will be prepared as follows:

TRANSFER VOUCHER
M/S KOHINOOR ELECTRICAL CO.
34/3 Connaught Circus, New Delhi-110002

Voucher No. 463 | Date 15-2-2020

		Amount Rs.
DEBIT	**PURCHASES A/C**	
100 Tube lights @ Rs. 150 each		15,000
5 Ceiling Fans @ Rs.8,000 each		40,000
(Credit Bill No. 125)		
	Total Rs.	55,000
CREDIT	Triputi Electricals Ltd.	55,000
	Total Rs.	55,000

Signature **Signature**
Manager **Accountant**

Compound Voucher

A document showing a transaction that contains multiple debits and one credit or which contains multiple credits and one debit is called compound voucher. Thus a compound voucher may be of two types:

(i) Debit Voucher

(ii) Credit Voucher

(i) Debit Voucher:

A document showing a transaction that contains multiple debits and one credit is called Debit voucher.

(ii) Credit Voucher:

A document showing a transaction that contains multiple credits and one debit is called Credit voucher.

Multiple Choice Questions (SET A)

Select the correct alternative:

(1) Cash memo is prepared when goods are sold

(a) on credit.

(b) on cash.

(c) Both (a) and (b).

(d) None of these.

(2) Cash memo is a source voucher for purchaser of goods

(a) for cash purchases.

(b) for credit purchases,

(c) for credit sales.

(d) for cash sales.

(3) Invoice is a source voucher for seller of goods

(a) for cash sales.

(b) for credit purchases,

(c) for credit sales.

(d) for cash purchases.

(4) Invoice is a source voucher for purchaser of goods

(a) for cash purchases.

(b) for cash sales.

(c) for credit sales.

(d) for credit purchases.

(5) Accounting voucher is prepared from

(a) source voucher.

(b) Journal entry.

(c) Both (a) and (b).

(d) None of these.

(6) If purchaser of goods returns them, he will prepare

(a) Credit Note.

(b) Debit Note.

(e) Both (a) and (b).

(d) None of these.

(7) If seller receives back the goods sold, he will prepare

(a) Credit Note.

(b) Debit Note.

(c) Both (a) and (b).

(d) None of these.

(8) Voucher is prepared for

(a) Cash and Credit purchases.

(b) Cash and Credit sales,

(c) Cash received and paid.

(d) All of these.

(9) Cash Memo is

(a) a source voucher.

(b) an accounting voucher,

(c) neither (a) nor (b).

(d) both (a) and (b).

(10) Invoice is a source voucher for

(a) Cash purchases.

(b) Credit purchases.

(c) both (a) and (b).

(d) neither (a) nor (b).

(11) Books of Account are written on the basis of

(a) Source Document.

(b) Accounting Vouchers.

(c) Both (a) and (b).

(d) None of these.

(12) Credit Note is prepared

(a) when credit is given to the account.

(b) when debit is given to the account.

(c) both (a) and (b).

(d) None of the above.

(13) When goods are sold on credit the seller prepares

(a) Cash Memo.

(b) Invoice.

(c) Accounting Voucher.

(d) None of these.

(14) When goods are purchased against cash, the purchaser will get

(a) Cash Memo.

(b) Invoice.

(c) Accounting Voucher.

(d) None of these.

(15) Transfer vouchers are prepared to record

(a) cash transactions.

(b) non-cash transactions.

(c) (a) and (b).

(d) None of these.

(16) Credit purchase of furniture is recorded through

(a) Transfer voucher.

(b) Cash voucher,

(c) Debit voucher.

(d) Credit voucher.

Answers

Multiple Choice Questions (SET A)

Select the correct alternative:

1. (b)	**2. (a)**	**3. (c)**	**4. (d)**	**5.(a)**
6.(b)	**7.(a)**	**8.(d)**	**9.(a)**	**10.(b)**
11. (b)	**12. (a)**	**13. (b)**	**14. (a)**	**15. (b)**
16. (a)				

Chapter 8

Books of Original Entry — Journal

JOURNAL

Journal is a book of original entry in which the transactions are recorded first of all, as and when they take place.

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

Thus, the Journal provides a date-wise record of all the transactions with details of the accounts debited and credited, and the amount of each transaction. Prior to recording in Journal, the transactions may also be recorded in a rough book called 'Waste book' or 'Memorandum book'. Maintenance of waste book is not necessary but where the number of every day transactions is so large that it is not possible for a businessman to remember all of them, the use of waste book may prove helpful. Later on with the help of waste book recording is made in Journal.

Features or Characteristics of a Journal

The chief features of Journal may be stated as under :

(i) Journal is a book in which the transactions are recorded first of all, as and when they take place. For this reason it is called a book of original entry.

(ii) A journal is only a book of primary (original) entry. All the transactions recorded in the journal are subsequently transferred to ledger which is the principal book of accounts.

(iii) A journal is a daily accounting record, i.e., each day's transactions are recorded in the journal on the same day.

(iv) In journal, transactions are recorded in a chronological order, i.e., in a date-wise order.

(v) It maintains the identity of each transaction and provides a complete picture of the same in one entry.

(vi) A journal records both debit and credit aspects of a transaction according to the double entry system of book-keeping.

(vii) Each entry in the journal is followed by a brief explanation of the transaction which is called 'Narration'.

(viii) A single journal entry is capable of recording more than one transaction involving more than two accounts. Such an entry is called compound entry.

Functions of a Journal

(i) To keep a chronological (i.e., date-wise) record of all transactions.

(ii) To analyse each transaction into debit and credit aspects by using double entry system of book-keeping.

(iii) To provide a basis for posting into ledger.

(iv) To maintain the identity of each transaction by keeping a complete record of each transaction at one place on a permanent basis.

Advantages of a Journal

Although it is not necessary to maintain a journal and the transactions can be recorded directly in the ledger accounts, a journal, still is used for the following reasons:

(;') As transactions in journal are entered as and when they take place, the possibility of omission of a transaction in the books of accounts is minimised.

(ii) As transactions in journal are recorded in chronological order, it is very easy to locate a particular transaction when required.

(iii) By analysing each transaction into debit and credit aspects, the journal facilitates the posting into ledger.

(iv) Each entry in the journal carries narration which gives a brief explanation of the transaction. Hence, postings in the ledger can be made without explanation.

(v) Journal facilitates cross checking of ledger accounts in case a trial balance does not agree.

(vi) Since entire transaction is recorded at one place in the journal, the identity of each transaction is maintained on a permanent basis.

(vii) Once the transaction is recorded in journal, posting in the ledger can be made as and when convenient.

Limitations of Journal:

(i) When the number of transactions is large, it is not possible to record all the transactions in Journal. It will become bulky and voluminous. Hence, the usual practice is to have separate journals or books for different classes of transactions such as purchase book, sales book etc.

(ii) Many transactions are repetitive in nature and if all transactions are recorded in journal it will involve debiting and crediting the same accounts time and again. It will involve repetitive posting labour also.

(iii) In order to ascertain cash balance every day, cash transactions are usually recorded in a separate book called 'Cash book'. Thus, cash transactions need not be recorded in journal.

(iv) Journal does not provide the required information on prompt basis.

Format of Journal

JOURNAL

Date	Particulars	Ledger Folio	Amount Dr.	Amount Cr.
(1)	(2)	(3)	(4)	(5)

The columns have been numbered only to show how the Journal is written up, otherwise the columns are not numbered.

1. Date:— In the first column, the date of the transaction is entered. The year and the month is written only once, till they change. The sequence of the dates and months should be strictly maintained.

2. Particulars:— Each transaction affects two accounts out of which one account is debited and the other account is credited. The name of the account to be debited is written first and the word 'Dr.' is also written towards the end of the column. In the second line, the name of the account to be credited is written. The credit account starts with the word 'To', a few spaces away from the margin to make it distinct from the debit account (A practice is now developing to omit the writing of the words 'Dr.' and 'To' from Journal entries).

Narration:— After each entry, a brief explanation of the transaction together with necessary details is given. This explanation is called 'Narration'. The narration

helps to know in future the reason for the entry and also as to why a particular account was debited or credited. It is necessary to write the narration after each entry and should be short, complete and clear.

3. Ledger Folio or L.F.:— All entries from the Journal are later posted into the ledger accounts. The page number or folio number of the ledger account where the posting has been made from the Journal is recorded in the L.F. column of the Journal. For example, if we make a posting in Machinery A/c which is prepared at page 40 of the ledger, we shall write 40 in the L.F. column against Machinery A/c in the Journal. There are many advantages of writing the folio numbers:—

I. The L.F. column in journal shows whether an entry has been posted or not. If the page number of the ledger does not appear against an entry, it will indicate that the entry has not been posted to the ledger, so far.

II. Page number written in the L.F. column in the Journal is indicative of the page number of ledger where such posting has been made. It helps in understanding and checking the ledger posting at a glance in future.

III. If the trial balance does not agree, the posting of each and every entry has to be checked. Such checking will not be possible without the help of L.F. column.

4. Amount Dr. :— In the fourth column, the amount of the account being debited is written.

5. Amount Cr. :— In the fifth column, the amount of the account being credited is written.

Steps in Journalising

(1) Before recording a Journal entry, it is essential to analyse a transaction in order to determine the two accounts which are affected. Then, on the basis of rules of journalising, it must be decided as to which account is to be debited and which account is to be credited.

(2) It is not necessary to use the word 'Account' or A/c after the personal accounts.

(3) After every Journal entry, a line should be drawn in particulars column, so that each entry is separated from the preceding one.

(4) At the end of each page, both the Dr. and Cr. columns are totalled up just in front of each other. These totals must be equal because the amount debited in each entry equals the amount credited. These totals are carried forward to the next page progressively up to the end of accounting period. For this purpose, the words 'carried forward or C/F' are written in particulars column at the end of each page and the words 'Brought Forward or B/F' are written at the start of each page.

Rules of Journalising

On the basis of the rules discussed in the chapter on double entry system the accounts to be debited or credited will be determined. The same rules are again explained here in a simplified manner:—

(1) Personal Accounts: — According to the rule of 'Debit the receiver', the personal account of the person to whom we give some money or goods is debited. For example, if we gave Rs.20,000 to Gopal, the entry will be:—

Gopal	Dr.	20,000	
To Cash A/c			20,000
(Cash paid to Gopal)			

In the same way, according to the rule of 'Credit the giver', the personal account of the person from whom we receive some money or goods is credited. For example, if we received Rs.50,000 from Govind, the entry will be :—

Cash A/c	Dr.	50,000	
To Govind			50,000
(Cash received from Govind)			

(2) Real Accounts: — According to the rule of 'Debit what comes in and credit what goes out', the account of the cash or other property which is received by the business firm is debited and in the same way, the account of the Cash or other property which goes out of the business is credited. For example, if Machinery is bought for Rs.5,00,000 :—

Machinery A/c	Dr.	5,00,000	
To Cash A/c			5,00,000
(Machinery purchased for cash)			

(3) Nominal Accounts: — According to the rule of 'Debit all Expenses', the accounts of all expenses and losses are debited. For example, if Rs.20,000 are paid for salary, the entry will be :—

Salary A/c	Dr.	20,000	
To Cash A/c			20,000
(Salary paid)			

Similarly, according to the rule of 'Credit all Incomes', the accounts of all incomes and profits are credited. For example, if Rs.5,000 are received for commission. The entry will be:—

Cash A/c	Dr.	5,000	
To Commission A/c			5,000
(Commission received)			

Meaning of Goods

Goods are those things which are purchased for resale. In other words, goods are the commodities in which the business deals. For example, if a cloth merchant purchases cloth, the cloth will be termed as 'purchases'. But if the same cloth merchant purchases some furniture, say chairs and a sofa set for the seating of customers, the furniture so purchased will not be termed as purchases, but will be an asset of his business and in this case 'Furniture A/c' will be debited instead of 'Purchases A/c'. It means that the purchases of asset are not termed as purchases in accounting terminology because these assets are not meant for sale.

Goods Account is classified into five accounts for the purpose of passing the Journal entries:—

(I) Purchases A/c :— When goods are purchased, instead of debiting Goods A/c 'Purchase Ac' is debited. Purchase A/c is a nominal account and while passing a Journal entry 'Purchase A/c' should always be debited because of the rule of "Debit all Expenses and Losses."

(II) Sales A/c :— When goods are sold, instead of crediting Goods A/c 'Sales A/c' is credited. Sales A/c is a nominal account and while passing a Journal entry 'Sales A/c' should always be credited because of the rule of "Credit all Incomes and Gains".

(III) Purchases Return A/c :—This account is also named as 'Return Outward'. It is a nominal account and should always be credited because purchases i.e. expenses are reduced.

(IV) Sales Return A/c :— This account is also named as 'Return Inward'. It is a nominal account and should always be debited because incomes i.e. sales are reduced.

(V) Stock A/c

Important Considerations:

In the transactions relating to the purchase or sale of goods, it has to be decided whether a transaction is for cash or for credit, because the entry is passed accordingly. Following points should be considered for this:

1. If, in the transaction relating to purchase or sale of goods, the name of purchaser or seller is not given, it is considered as a cash transaction.

For example, Goods sold for Rs.50,000.

2. If, in the transaction relating to purchase or sale of goods, the name of purchaser or seller is given along with cash, it is considered as a cash transaction.

For example, 'Goods sold to Gopal for Cash'.

3. If, in the transaction relating to purchase or sale of goods, the name of purchaser or seller is given and it is not stated whether it is a cash or credit transaction, it is considered to be a credit transaction.

For example, 'Goods sold to Gopal'.

In Case of Expenses: Even if the name of party receiving or making payment is given, it is still considered as a cash transaction.

For example: Salary paid to Mukesh Rs. 10,000. The entry will be:

Salary A/c	Dr. 10,000	
To Cash A/c		10,000

Discount

Discount is of two types:

(1) Trade Discount, and

(2) Cash Discount

(1) Trade Discount: — This discount is allowed by wholesaler or manufacturer to the retailer at a fixed percentage on the listed price of goods. It is allowed when goods are purchased in bulk, i.e., large quantity. This discount is allowed both on credit as well as cash transactions since it is related to the purchases and not to the payment. No separate entry is passed for the Trade discount, as it is deducted from the cash memo or invoice of the goods. For example, if a trader sells goods of the list price of Rs. 1,00,000 at 20% trade discount for cash, the entry will be: —

Cash A/c	Dr. 80,000	
To Sales A/c		80,000

If the goods sold at trade discount are returned by the customer, the amount of trade discount is again deducted from the list price of the returned goods.

(2) Cash Discount: — This discount is allowed to the customers for making prompt or early payment. In other words, cash discount is allowed only if the customer makes the payment within a fixed period. Such discount motivates the customer to make the payment at the earliest. As the discount is allowed at the time of making payment, so the entry for cash discount is recorded along with the entry for payment. Discount is a nominal account and as such, it is debited when it is allowed to a customer and credited when it is received.

Distinction between Trade Discount and Cash Discount

Basis of Distinction	Trade Discount	Cash Discount
1. Meaning	Trade discount is allowed by wholesaler or manufacturer to the retailers at a fixed percentage on the printed price list.	Cash discount is allowed if the customer makes the payment immediately or within a fixed period.
2. When allowed?	It is allowed when goods are purchased in a **specified quantity.**	It is allowed when payment is made **on or before a specified date.**
3. Object	Generally, it is allowed to the retailers to enable them to make some profit even if they sell the goods at their catalogue price.	It is allowed to encourage quick or prompt payment.
4. Recording in the books of accounts	It is not recorded separately in the books of accounts.	It is recorded separately in the books of accounts.
5. Deduction from Invoice	It is deducted from the invoice.	It is not deducted from the invoice.

Sometimes, a customer is allowed both the discounts, i.e., trade discount as well as cash discount. In such a case, first trade discount is to be deducted from the price of the goods and then, cash discount is to be calculated on the balance of the amount.

For example, if a trader sells goods of the list price of Rs.20,000 at 10% trade discount and 2% cash discount, the net amount will be calculated as under:

		Rs.
List Price		20,000
Less: Trade Discount @ 10%		2,000
		18,000
Less: Cash Discount @ 2%	$18,000 \times \frac{2}{100}$	360
		17,640

It means that Rs. 17,640 will be paid if the payment is made in cash.

Advantages of Trade Discount:

To the Retailer:

1. It reduces the cost of purchase and thus, increases the margin of profit.
2. It enables the retailer to make some profit even if he sells the goods at their catalogue price.

To the Wholesaler or Manufacturer:

1. It increases sales by encouraging the retailers to make bulk purchases by offering higher rate of discount for orders of large quantities.
2. A change in the rate of trade discount may prove to be an effective weapon to face competition.
3. Different prices can be charged from regular customers and occasional customers simply by altering the rate of trade discount.
4. Change in rate of trade discount is an easy method to make changes in prices without reprinting of catalogues.

Advantages of Cash Discount:

To the Seller:

1. Seller receives the amount within a stipulated time because cash discount is allowed only if the customer makes the payment within the specified period.
2. Cash received in time improves the cash inflow of the business and the cash may be put to better use.
3. The possibility of bad debts is minimised.
4. Prompt payment reduces the clerical work of maintaining of debtor's accounts and of sending frequent reminders to debtors.

To the Buyer:

1. The earlier the buyer pays the higher he earns in cash discount.
2. A buyer who earns higher cash discount can sell the goods to his customers at lower rates.
3. Early payment enhances the reputation or goodwill of the buyer.

Compound Journal Entries

Sometimes, two or more transactions relating to one particular account take place on the same date. In such cases, instead of passing separate entries for all such transactions, only one entry is passed. Such a Journal entry is termed as Compound Journal Entry. For example, on 31st March Rs.50,000 are paid for salaries and Rs.20,000 are paid for rent, the entry will be:—

31st March	Salary A/c	Dr. 50,000	
	Rent A/c	Dr. 20,000	
	To Cash A/c		70,000
	(Expenses paid)		

Such entries can be passed in either of the following three ways: —

1. By debiting one account and crediting two or more accounts.

2. By crediting one account and debiting two or more accounts.

3. By debiting two or more accounts and crediting two or more accounts, such as the 'Opening Entry'.

Recording of Banking Transactions

S. No	Transaction	Entry
1.	When cash is deposited into the bank.	Bank A/c Dr. To Cash A/c
2.	When cash is withdrawn from the bank.	Cash A/c Dr. To Bank A/c
3.	When cheques, drafts etc. received from the customers are deposited into the bank on the same day.	Bank A/c Dr. To Customer's Personal A/c
4.	When cheques, drafts etc. received from the customers are not sent to bank on the same day.	Cheques in Hand A/c Dr. To Customer's Personal A/c
5.	On the date when above cheques, drafts etc. are sent to the bank.	Bank A/c Dr. To Cheques in Hand A/c
6.	When a customer directly deposits the amount in our bank account.	Bank A/c Dr. To Customer's Personal A/c
7.	When a cheque previously deposited into the bank is dishonoured.	Customer's Personal A/c Dr. To Bank A/c
8. A	When a cheque is received from a customer and	Bank A/c Dr.

	discount is allowed to him, and if the cheque is deposited into the bank on the same day.	Discount Allowed A/c Dr. To Customer's Personal A/c
8. B	In case the above cheque is dishonoured, the discount allowed to the customer will also be withdrawn.	Customer's Personal A/c Dr. To Bank A/c To Discount Allowed A/c
9.	When payment is made by issue of a cheque.	Personal A/c Dr. To Bank A/c
10.	When expenses are paid by the issue of a cheque.	Expenses A/c Dr. To Bank A/c
11.	When cash is withdrawn from the bank for the persona] use of the proprietor.	Drawings A/c Dr. To Bank A/c
12. A	When interest is charged by the bank.	Interest A/c Dr. To Bank A/c
12. B	When interest is allowed by the bank.	Bank A/c Dr. To Interest Received A/c
13.	When bank charges some amount for the services rendered by the bank.	Bank Charges A/c Dr. To Bank A/c

Opening Entry

Every firm starts its new books in the beginning of each year. Since the closing balances of last year have to be carried forward to the next year, the first entry in each year's Journal will be to record the previous year's closing balances of all the assets and liabilities. As it is the first entry, it is called the opening entry. In this entry the accounts of all assets are debited because assets always show debit balances and the accounts of liabilities and capital are credited because they always show credit balances. If the balance of the capital account is not given in the question, it will be found out by deducting the total of liabilities from the total of assets. On the contrary, if the total of liabilities exceeds the total of assets, the difference will be treated as the amount of Goodwill and the same will be debited in the opening entry.

For example, the following balances appeared in the books of Gopal on 1st April, 2020:

Assets: Cash Rs.8,000; Bank Balance Rs.20,000; Stock Rs.54,000; Debtors Rs.47,000 (Ashok Rs. 12,000, Pawan Rs.15,000, Vivek Rs.20,000); Machinery Rs.60,000.

Liabilities: Creditors Rs.20,000 (Chaman Lal Rs.7,000; Om Pal Rs. 13,000), Capital

Rs.2,00,000.

The Opening Entry will be:

Date	Particulars		L F.	Amount Dr.	Amount Cr.
2020				Rs.	Rs.
April 1	Cash A/c	Dr.		8,000	
	Bank. A/c	Dr.		20,000	
	Stock A/c	Dr.		54,000	
	Ashok	Dr.		12,000	
	Pawan	Dr.		15,000	
	Vivek	Dr.		20,000	
	Machinery A/c	Dr.		60,000	
	Goodwill A/c (Balancing Figure)	Dr.		31,000	
	(i.e., Total of Liabilities Rs.2,20,000				
	Less: Total of Assets Rs. 1,89,000)				
	To Chaman Lal				7,000
	To Om Pal				13,000
	To Capital A/c				2,00,000
	(Assets and liabilities brought forward*				

Bad Debts

When the goods are sold to a customer on credit, and if the amount becomes irrecoverable due to his insolvency or for some other reason, the amount not recovered is called bad debts. For recording it, bad debts account is debited and the customer's account is credited.

For example: Ravi who owed us Rs. 10,000 is declared insolvent and 30 Paise in a rupee is received from his estate. The journal entry will be:

Date	Particulars		L. F.	Amount Dr.	Amount Cr.
	Cash A/c	Dr.		3,000	
	Bad Debts Ale	Dr.		7,000	
	To Ravi				10,000
	(30 p. in the rupee received from Ravi on his insolvency)				

Some Special Entries

(1) Bad Debts Recovered: Sometimes, it so happens that the bad debts previously written off are subsequently recovered. In such cases, the following entry is passed: —

Cash A/c Dr.

To Bad Debts Recovered A/c

Care should be taken that the personal account of the debtor should not be credited because the Debtor's account must have been credited while passing the entry for bad debts.

(2) Outstanding Expenses: It is quite common for a business enterprise to be left with some expenses which are yet to be paid at the end of the accounting year due to one reason or the other. Such expenses are termed as outstanding expenses. These are the expenses which should have been paid during the current year but which have not been paid. For example, if an employee is paid salary @ Rs. 1,000 per month, and if during the year only 11 months' salary amounting to Rs. 11,000 has been paid to him, Rs. 1,000 for one month will be the outstanding salary. The entry will be :—

Salary A/c Dr. 1,000

To Outstanding Salary A/c 1,000

Outstanding Salary Account is a liability. It has been credited because it is a representative personal account, representing the employees to whom salaries are to be paid.

(3) Prepaid Expenses: There are certain expenses which are related to the next year but have been paid during the current year in advance. These are called prepaid expenses. The benefit of such expenses will be received during the next accounting year. For example, insurance premium amounting to Rs. 1,200 is paid on 1st July, 2019 for one year. Entry on 1st July, 2020 will be made as under:

Insurance Premium A/c Dr. 1,200

To Cash A/c 1,200

When the books will be closed on 31st March, 2020, insurance premium for 3 months, i.e., from 1st April, 2020 to 30th June 2020 will be treated as prepaid insurance and the following entry will be passed for it on 31st March, 2020

Prepaid Insurance A/c Dr. 300

To Insurance Premium A/c 300

Prepaid Insurance Account is an asset. It has been debited because it is a representative personal account and represents those persons to whom payment has been made in advance.

(4) Depreciation: It is the permanent and continuing decrease in the value of an asset on account of wear and tear and passage of time. It is a business expense though it is not paid in cash. Depreciation is a nominal account since it represents a loss and hence is debited. Asset account will be credited as its value is reduced due to depreciation. Journal Entry will be:

Depreciation A/c Dr.

To Asset A/c

(5) Interest on Capital: order to ascertain the true efficiency of the business it is a normal practice to charge business with interest on proprietor's capital. Profits left after charging the amount of such interest are the real profits earned by the business. Such interest is a loss from the point of view of the business and therefore according to the rule of nominal accounts Interest A/c is debited in the Journal entry. The amount of such interest is a gain from the point of view of the proprietor. His capital is increased by the amount of interest and therefore the capital account is credited in the Journal entry.

(6) Interest on Drawings: If the firm allows interest on capital it should also charge interest on drawings made by the proprietor. Such an interest is an expense for the proprietor and a gain to the business. Hence an entry is made by debiting the drawings account and crediting interest account.

Expenditure on the installation of Machinery and on the erection of Building

Machinery and Building are the assets of the business. As such, any expenditure incurred on the carriage and installation of machinery such as freight, transit expenses, installation expenses, wages paid for the installation etc. is treated as capital expenditure and is debited to the Machinery Account. Similarly, any expenditure incurred for the construction of a Building such as the purchase of materials and the payment of wages are also treated as capital expenditure and as such debited to the Building Account. However, repair charges incurred on an asset which is already appearing in the books are debited to repairs account.

Special transactions relating to goods

(1) Drawings in Goods: Sometimes the proprietor withdraws goods from the business for his personal use. The entry for recording this transaction will be:

Drawings A/c Dr.

To Purchases A/c

(Goods taken for personal use)

Purchase account is credited because as a result of the transaction the net amount of purchases of the business is reduced. Sales account should not be credited since the sale has not taken place. Also, when the goods go out of business at cost price, purchase account should be credited and not Sales account.

(2) Goods given away as charity: Charity is an expense of the business, as such charity account will be debited. Goods are going out of the business at cost price, hence purchases are reduced to that extent and as such, purchases account will be credited. The entry will be:

Charity A/c Dr.

To Purchases A/c

(Goods given away as charity)

(3) Goods distributed as free sample: Sometimes the goods are distributed as free samples to the potential buyers in order to promote sales. As such, free samples can legitimately be treated as expenses on advertisement. The entry will be :

Advertisement Expenses A/c Dr.

To Purchases A/c

(Goods distributed as free samples)

(4) Loss of goods by theft or loss by Fire:

The entry will be :—

Loss by Theft A/c Dr.

Loss by Fire A/c Dr.

To Purchases A/c

(Goods lost by theft and goods destroyed by fire)

In Case goods were insured:

Insurance Company or Insurance Claim A/c Dr.

To Loss by Theft or Loss by Fire

(Insurance Claim lodged with the Insurance Co.)

If the full amount of claim is received from the Insurance Company:

Bank A/c	Dr.	
To Insurance Company		

(Insurance claim received)

If the Insurance Company does not admit full claim:

Bank A/c	Dr.	(Amount received for claim admitted)
Profit and Loss A/c	Dr.	(Claim not admitted)
To Insurance Company A/c		

(Insurance claim partially admitted and received)

Multiple Choice Questions (SET A)

Select the correct alternative:

1. Purchase of goods from A' for Cash should be Credited to:

(a) Purchase

(b) Cash

(c) X

2. Main object of preparing a 'Journal' is:

(a) To ascertain the financial position of the business.

(b) To journalise the cash transactions

(c) To make posting in the ledger

(d) To record the business transactions first of all.

3. Personal accounts are related to :

(a) Assets and Liabilities

(b) Expenses, losses and incomes

(c) Debtors, Creditors etc.

4. Real accounts are related to

(a) Assets

(b) Expenses, losses and incomes

(c) Debtors, Creditors etc.

5. Nominal Accounts are related to :

(a) Assets and Liabilities

(b) Expenses, losses and incomes

(c) Debtors, Creditors etc.

6. Goods worth Rs.7,000 given away as charity would be credited to :

(a) Sales A/c

(b) Purchases A/c

(c) Charity A/c

(d) Trustee A/c

7. Payment of Rs.6,000 as wages to workmen for installation of a machine should be debited to :

(a) Wages A/c

(b) Repairs A/c

(c) Machinery A/c

8. What shall be the amount of Capital if Cash is Rs.5,000; Furniture Rs.12,000; Stock Rs.30,000 and Creditors Rs.6,000.

(a) Rs.53,000

(b) Rs.47,000

(c) Rs.41,000

9. Gopal is our debtor for Rs. 10,000. He became insolvent and only 60 paise in a Rs. is received from him. The balance of Rs.4,000 would be entered to the :

(a) Debit of Discount A/c

(b) Credit of Discount A/c

(c) Debit of Bad-Debts A/c

(d) Credit of Bad-Debts A/c

10. Rs.5,000 received from Mohan whose account was written off as bad in the previous year should be credited to :

(a) Mohan's A/c

(b) Bad-Debts A/c

(c) Bad-Debts Recovered A/c

(d) None of these

11. Cash received from Kajal Rs.36,000 after allowing her discount @10%. Amount debited to discount account will be :

(a) Rs. 3,600

(b) Rs. 4,000

(c) Rs. 4,400

(d) Rs.40,000

12. Loss of goods by fire should be credited to :

(a) Sales A/c

(b) Loss A/c

(c) Profit & Loss A/c

(d) Purchase A/c

13. Goods costing Rs.30,000 supplied to Mohan at a profit of 25% of sales price less Trade discount @5% will be credited to Sales A/c with :

(a) Rs.35,625

(b) Rs.38,000

(c) Rs.37,500

(d) Rs.34,200

14. Goods costing Rs.20,000 is sold at a profit of 20% on cost and trade discount is allowed @ 10% and cash discount of 10% is also allowed. Half the payment was received at the time of sale. What is the amount of cash received at the time of sale?

(a) Rs. 9,720

(b) Rs. 10,800

(c) Rs. 11,880

(d) Rs. 10,820

15. Paid to Rahul on behalf of Sanjay Rs.12,000 will be debited to

(a) Rahul's Personal Account

(b) Sanjay's Account

(c) Drawings Account

(d) Cash Account

16. Sold goods worth list price of Rs.8,000 at 10% trade discount and 2% cash discount. 25% received at the time of transaction only. The amount posted to discount account will be :

(a) Rs. 36 on Debit side

(b) Rs. 144 on Credit side

(c) Rs. 144 on Debit side

(d) Rs. 40 on Credit side

17. Journal records the transactions of a firm in a

(a) Periodical manner

(b) Chronological order

(c) Summarised manner

(d) Systematic order

18. Rent of proprietor's house paid from account on cash will

(a) Decrease the profit

(b) Increase the profit

(c) Reduce the capital of business

(d) Reduce the cash as well as capital of the business.

Answers

Multiple Choice Questions (SET A)

Select the correct alternative:

1. (b)	2. (d)	3. (c)	4. (a)	5.(b)
6.(b)	7.(c)	8.(c)	9.(c)	10.(c)
11. (b)	12. (d)	13. (b)	14. (a)	15. (b)
16. (a)	17. (b)	18. (d)		

Multiple Choice Questions (SET B)

Select the correct alternative:

(1) Journal is called

(a) a book of primary entry.

(b) a book of secondary entry.

(c) a book of final entry.

(d) both secondary entry and final entry.

(2) Business transactions are recorded

(a) in chronological order.

(b) weekly.

(c) at the end of the month.

(d) All of these.

(3) Recording of transaction in a Journal is called

(a) Posting.

(b) Journalising.

(c) Transfer.

(d) Ruling.

(4) Which of the following accounts will be credited on giving cash donation?

(a) Cash A/c.

(b) Donation Ale.

(c) Purchases A/c.

(d) Discount Received A/c.

(5) Sale of goods.to Ram for cash is debited to

(a) Ram.

(b) Cash A/c.

(c) Sales A/c.

(d) Stock A/c.

(6) Withdrawal of cash from business by the proprietor is credited to

(a) Drawings A/c.

(b) Capital A/c.

(c) Cash A/c.

(d) Bank A/c.

(7) Anil purchased 1,000 Add Gel Roller Pens @ Rs. 50 each less Trade Discount of 20%. Purchases Account will be debited by

(a) Rs. 50,000.

(b) Rs. 40,000.

(c) Rs. 45,000.

(d) Rs. 60,000.

(8) Anil purchased, 1,000 Add Gell Roller Pens @ Rs. 50 each less 20% Trade Discount and 3% Cash Discount if payment is made within 30 days. Anil paid Rs. 10,000 within 30 days and balance amount after 30 days period. Purchases Account will be debited and Discount Received Account will be credited respectively with

(a) Rs. 40,000, Nil.

(b) Rs. 40,000, Rs. 300.

(c) Rs. 40,000, Rs. 1,200.

(d) Rs. 40,000, Rs. 900.

(9) Which of the following is correct entry to record cash purchase of Rs. 3,000 from Amar?

(a) Dr. Purchases A/c and Cr. Amar by Rs. 3,000.

(b) Dr. Amar and Cr. Purchases A/c by Rs. 3,000.

(c) Dr. Cash A/c and Cr. Purchase A/c by Rs. 3,000.

(d) Dr. Purchases A/c and Cr. Cash A/c by Rs. 3,000.

(10) X sells goods on credit to Y. He receives 10% trade discount from X and a further 5% cash discount if paid within 15 days. K bought goods with a list price of Rs. 2,00,000 from X.

Which of the following Journal entry would correctly record the sale in the books of A?

(a) Dr. y and Cr. Sales A/c by Rs. 1,70,000.

(b) Dr. Y and Cr. Sales A/c by Rs. 1,80,000.

(c) Dr. X and Cr. Sales A/c by Rs. 1,90,000.

(d) Dr. X by Rs. 2,00,000; Cr. Sales A/c by Rs. 1,70,000 and Discount A/c by Rs. 30,000.

(11) Trade Discount received on purchases is recorded in the books of account as follows:

(a) Trade Discount is credited to Discount Received Account.

(b) Trade Discount is deducted from the List Price and recorded at net value.

(c) Trade Discount is debited to Discount Allowed Account.

(d) Any of (a) and (b).

(12) A sole trader took goods costing Rs.. 1,000 from stock from his own use. The normal selling price of the goods is Rs. 1,500.

Which of the following Journal entries would correctly record this?

(a) Dr. Drawings A/c and Cr. Purchases A/c by Rs. 1,000.

(b) Dr. Drawings A/c and Cr. Sales A/c by Rs. 1,500.

(c) Dr. Drawings A/c and Cr. Purchases A/c by Rs. 1,500.

(d) Dr. Sales A/c and Cr Drawings A/c by Rs. 1,000.

(13) Cash Discount received is recorded in the books of account as follows:

(a) Cash Discount is credited to Discount Received Account.

(б) Cash Discount is reduced from the Invoice Price.

(c) Cash Discount is debited to Discount Allowed Account.

(d) Any of (a) and (b).

(14) Bad Debts earlier written off and now received are credited to

(a) Bad Debts A/c.

(b) Bad Debts Recovered A/c.

(c) Miscellaneous Income A/c.

(d) Debtors A/c.

(15) Akhil, who owed Rs. 10,000 became insolvent. Rs. 0.75 in a rupee was received from his estate. Amount received and credited to Akhil's Account will be

(a) Rs. 7,500.

(b) Rs. 2,500.

(c) Rs. 10,000.

(d) Rs. 5,000.

(16) Lalit, who owed Rs. 20,000 became insolvent. 70 paise in a rupee was received from his estate. Bad Debts Account will be debited by

(a) Rs. 20,000.

(b) Rs. 10,000.

(c) Rs. 6,000.

(d) Rs. 14,000.

Answers

Multiple Choice Questions (SET B)

Select the correct alternative:

1. (a)	**2. (a)**	**3. (b)**	**4. (a)**	**5.(b)**
6.(c)	**7.(c)**	**8.(a)**	**9.(d)**	**10.(b)**
11. (b)	**12. (a)**	**13. (a)**	**14. (b)**	**15. (a)**
16. (c)				

Chapter 9

Accounting for Goods and Service Tax (GST)

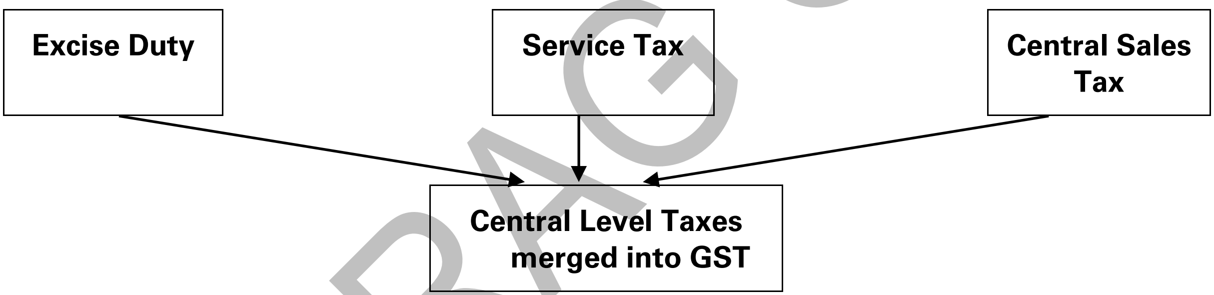
Meaning of GST

Goods and Service Tax (GST) is an indirect tax levied at prescribed rate on every supply of goods and services except on petroleum and alcohol for human comsumption. Supply of goods means sale of goods and supply of services means rendering of services. It is a nation-wide tax seeking to unify several indirect taxes and is based on the principle of 'One Nation one Tax'.

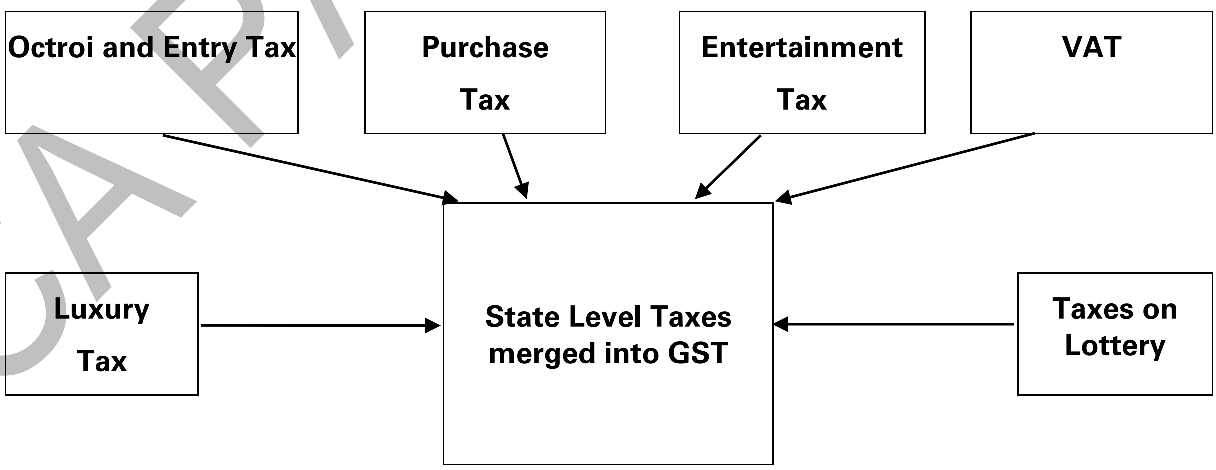
GST Act was passed in the Parliament on 24th March, 2020 and it came into effect from 1st July, 2020.

Taxes Merged into GST:

GST has replaced many indirect taxes levied by Centre and State Governments. Central level taxes that have merged into GST are as under:



State level taxes that have merged into GST are as under :



GST Rate Structure: Goods and Services are divided into five slabs for collection of GST:

Essential Items including food	0%
Common Use Items	5%
Standard Rate	12%
Maximum Goods and all services Standard Rate	18%
Luxury items and tobacco	28%

GST is paid on purchase of goods and services and it is collected from customers on sale of goods and services. GST Paid (termed as Input GST) is set off against GST Collected (termed as Output GST).

As such, GST Paid on Purchase (Input GST) is not a **Cost** for the purchaser but is an **Asset** since it can be set off against GST Collected on Sales (i.e., Output GST). Similarly, GST Collected on Sales (Output GST) is not an income of the seller but is a liability.

IMPORTANT NOTES

(1) Usually, GST Paid on purchase of goods and services (i.e,, Input GST) is not a Cost for the purchaser but is an Asset because it can be set off against GST Collected (i.e., Output GST)

(2) However, in certain cases GST Paid cannot be set off against GST collected. In such cases, GST Paid on purchase of goods and services is a Cost for the purchaser. Following are the cases where GST Paid on purchase of goods and services cannot be set off against GST collected:

(i) Food and Beverages Expenses (Restaurant Bills);

(ii) Payment for health insurance;

(iii) Payment of Membership Fee of a Club, health and Fitness Centre;

(iv) Repairs and Maintenance of Building;

(v) Purchase of Vehicles;

(vi) Free gift to Staff;

(vii) Payment for goods and services for personal use.

(3) GST Paid (i.e., Input GST) is Reversed (Credited) in the following cases:

(i) Purchase Returns;

(ii) Goods taken by the proprietor;

(iii) Goods lost or stolen;

(iv) Goods destroyed or become not saleable (written off);

(v) Goods distributed as free samples;

(vi) Goods given away as gift or charity.

Similarly, Output GST is Reversed (Debited) in case of Sales Returns.

(4) Following goods and services are exempt from levy of GST :

(i) Payment of Wages and Salaries;

(ii) Supply of Services to Government or to Embassies of other countries;

(iii) Electricity and water bills;

(iv) Educational Services;

(v) Health Services;

(vi) Travelling Expenses; and

(vii) Interest.

Characteristics of Goods and Service Tax (GST):

(i) GST is a Comprehensive Indirect Tax : GST is a comprehensive indirect tax which has replaced all indirect taxes levied by Centre and State Governments except Custom Duty, electricity, taxes on petroleum, taxes on alcoholic drinks and taxes levied by Local Bodies. All indirect taxes have been merged in a Single Tax i.e. GST.

(ii) Uniform GST Rates: There are uniform rates of GST across all States and Union Territories.

(iii) GST Paid is not a Cost: GST Paid on purchase of goods and services (termed as Input GST) is not a cost for the purchaser but is an Asset because it can be set off against GST Collected (termed as Output GST).

(iv) GST is a Value Added Tax: GST is a value added tax because GST Paid is set off against GST Collected. For example: A purchases goods for Rs. 1,00,000 and sells the same to B for Rs. 1,50,000 and GST rate is 12%, in such a case:

		Rs.
GST paid by A on purchase:	12% on Rs. 1,00,000	12,000
GST collected by A from B on sale:	12% on Rs. 1,50,000	18,000
GST now payable by A to Govt. :	12% on Rs. 5 0,000	6,000

Rs. 12,000 paid at the time of purchase is set off against Rs. 18,000 collected at the time of sale and balance Rs.6,000 is payable to the Government.

Further, suppose the above-mentioned goods are again sold by B to C for Rs. 1,60,000, the amount payable to the Govt. by B will be 12% on Rs. 10,000 (i.e. on Rs. 1,60,000-Rs. 1,50,000).

Objectives or Advantages of GST:

(1) Decrease in the Cost of Goods: The Cost of goods will decrease since tax on tax is eliminated in GST regime. In the pre-GST regime, there were many indirect taxes levied by both centre and state. For example, Centre charged excise duty on goods manufactured and States charged VAT on the same goods. This lead to a tax on tax also known as cascading effect of taxes. GST avoids this cascading effect as the tax is calculated only on the value added at each stage of transfer of ownership.

(2) Ease of Doing Business: In a pre-GST period, there were multiple types of indirect taxes such as Excise Duty, Sales Tax, Service Tax etc. and as a result, a business was required to register itself separately under each such Act. The introduction of GST has eased the doing of business because now it will be registered and administered only under one indirect tax i.e. GST.

(3) Developing Common National Market: GST is levied at the same rate on similar goods and services across all States and Union Territories. For example, electronic goods sold across India are levied at the rate of 18%. It has developed common national market.

(4) Reduction in Tax Evasion: GST is administered through computer system. Electronic return filing and assessment has reduced tax evasion and compliance cost.

(5) Goods Becoming Cheaper: In the pre-GST period, there were many indirect taxes and there was no set off of tax paid (e.g. Excise Duty) against taxes collected. In GST structure, GST Paid (Input GST) is set off against GST Collected (Output GST). As such it does not have cascading effect and goods and services shall become cheaper.

(6) Attracting Foreign Investment: Foreign investment in India was hindered because of multiple indirect taxes. GST has removed this obstruction with the introduction of one single tax. As such, it will help to increase the Foreign Direct Investment (FDI) in India.

(7) Tax system becomes more transparent, regular and predictable.

Type of Taxes under GST:

There are 3 taxes applicable under GST:

(i) Central GST (CGST)

(ii) State GST (SGST) or Union Territory GST (UTGST)

Both of these taxes are levied on intra-state sales, i.e. within the same state.

For example, a dealer of Rajasthan sells goods to a dealer (or consumer) in Rajasthan worth Rs.50,000. Suppose, the GST rate on the goods is 12%. This rate will comprise of CGST at 6% and SGST at 6%. The seller has to collect 12% of Rs.50,000 i.e. Rs.6,000 out of which Rs.3,000 will be CGST which will go to the Central Government and Rs.3,000 will be SGST which will go to the Rajasthan Government.

(iii) Integrated GST (IGST): It is levied on inter-state sales, i.e. sales of goods and services outside the state. It is also levied on import of goods and services into India and export of goods and services from India.

For example, a dealer of Rajasthan sells goods to a dealer in Madhya Pradesh worth Rs.50,000. Suppose, the IGST rate is 12%. In such a case, the seller will charge

Rs.6,000 as IGST and this entire amount will go to Central Government.

GST collected under IGST is divided between Central and State Governments as per the rates specified by the Government.

NOTE
If the GST rate is 12%, it will comprise of 6% COST + 6% SGST; in case of sales outside the State, it will be called 1GSI 12%. **Similarly, If the GST rate is 18%, it will comprise of 9% CGST + 9% SGST; in case of sales outside the State, it will be called IGST 18%. And so on.**

REVERSE CHARGE
Certain purchases of goods and services are placed under reverse charge. **Reverse charge means that GST is not charged by the seller but is paid by the purchaser to the Government and claim it as Input GST. Goods and services placed under Reverse charge are: Purchase of goods and services by Registered Dealer from Unregistered Person, Payment of fee to Lawyers, use of Copyright, Transport of goods, Insurance Commission etc.**

Accounting Procedure:

In case of Intra-state supply of goods and services (i.e., sales within the same state)

(i) For Purchase of goods:

Purchases A/c Dr.

Input CGST A/c Dr.

Input SGST A/c Dr.

To Bank/Creditors A/c

(Goods Purchased)

(ii) For Sale of goods:

Bank/Debtors A/c Dr.

To Sales A/c

To Output CGST A/c

To Output SGST A/c

(Goods Sold)

(iii) For Purchase Returns:

Creditors A/c Dr.

To Purchase Returns A/c

To Input CGST A/c

To Input SGST A/c

(Purchase Returns) ,

In case of purchase returns, Input CGST A/c and Input SGST A/cs are credited because at the time of purchase Input CGST A/c and Input SGST A/cs were debited.

(iv) For Sales Returns :

Sales Returns A/c Dr.

Output CGST A/c Dr.

Output SGST A/c Dr.

To Debtors A/c

(Sales Returns)

In case of sales returns, Output CGST A/c and Output SGST A/cs are debited because at the time of sale Output CGST A/c and Output SGST A/cs were credited.

(v) For Purchase of Fixed Assets:

Fixed Asset A/c Dr.

Input CGST A/c Dr.

Input SGST A/c Dr.

To Bank A/c

(Purchase of fixed assets)

(vi) For Expenses:

Expense A/c Dr.

Input CGST A/c Dr.

Input SGST A/c Dr.

To Bank A/c

(Expenses incurred)

(vii) For Income (for example commission received)

Bank A/c Dr.

To Commission Received A/c

To Output CGST A/c

To Output SGST A/c

(Income received)

(viii) For goods withdrawn by the Proprietor for personal use:

Drawings A/c Dr.

To Purchases A/c

To Input CGST A/c

To Input SGST A/c

(Goods taken for personal use)

(ix) For goods given as free samples, loss of goods by fire or goods stolen:

Advertisement A/c (Free Samples) Dr.

Loss by Fire A/c Dr.

Loss by Theft A/c Dr.

To Purchases A/c

To Input CGST A/c

To Input SGST A/c

(Goods distributed as free samples, goods stolen and goods destroyed by fire and Input CGST and Input SGST reversed)

(x) For Setting off Input CGST against Output CGST:

Output CGST A/c Dr.

To Input CGST A/c

(Input CGST set off against Output CGST)

(xi) For setting off Input SGST against Output SGST:

Output SGST A/c	Dr.
To Input SGST A/c	
(Input SGST set off against Output SGST)	

(xii) For payment of GST:

Output CGST A/c	Dr.
Output SGST A/c	Dr.
To Bank A/c	
(Balance amount of Output GST deposited with the Government)	

Note: Entry No. X, XI and XII may be combined.

GST NOT LEVIED:

GST is not levied in the following cases:

1. Amount introduced into the business by proprietor as Capital.
2. Amount withdrawn by the proprietor for personal use.
3. Amount deposited into Bank.
4. Amount withdrawn from Bank.
5. Amount paid to Creditors and discount received.
6. Amount received from Debtors and discount allowed.
7. Bad debts written off and bad debts recovered.
8. Payment of Wages and Salary.
9. Payment of Electricity and Water Bills.
10. Payment of Travelling Expenses.

ADJUSTMENT OF IGST, CGST AND SGST

With effect from 1st February 2020, there is a change in the adjustment of IGST: Before 1st February 2020, it was as follows:

First of all, Output IGST was adjusted against Input IGST Output CGST was adjusted against Input CGST Output SGST was adjusted against Input SGST Thereafter, excess of Input IGST or excess of Output IGST was adjusted against remaining amount of CGST and the balance, if any, was applied to set off SGST. However, now with effect from 1st February 2020, set off mechanism will be as follows:

First of all, Output IGST will be adjusted against Input IGST:

Output IGST A/c Dr.

To Input IGST A/c

After such adjustment there may be two situations:

(1) Input IGST may exceed Output IGST, OR

(2) Output IGST may exceed Input IGST

Case (1) : If Input IGST exceeds Output IGST :

In such a situation excess of Input IGST will be first adjusted against Output CGST and the balance, if any, will be applied to set off output SGST:

Output CGST A/c Dr.

Output SGST A/c Dr.

To Input IGST A/c

If, the full amount of Output CGST has not been adjusted against Input IGST, then the remaining amount of Output CGST will be adjusted against Input CGST and the balance will be paid off:

Output CGST A/c Dr.

To Input CGST A/c To Bank A/c

Similarly, remaining amount of Output SGST will be adjusted against Input SGST and the balance will be paid off:

Output SGST A/c Dr.

To Input SGST A/c

To Bank A/c

Case (2) If Output IGST exceeds Input IGST:

In such a situation:

(i) first of all, entry for adjusting IGST will be passed:

Entry will be:

Output IGST A/c Dr.

To Input IGST A/c

(ii) Thereafter, Input CGST will be adjusted against Output CGST Input SGST will be adjusted against Output SGST

Entry will be:

Output CGST A/c Dr.

Output SGST A/c Dr.

To Input CGST A/c

To Input SGST A/c

(iii) Thereafter, excess of Output IGST will be first adjusted against Input CGST and the balance, if any, will be applied to adjust Input SGST.

Entry will be:

Output IGST A/c Dr.

To Input CGST A/c

To Input SGST A/c To Bank A/c

Multiple Choice Questions (SET A)

Select the correct alternative:

(1) On intra-state (Le., within the state) purchase of goods, which of the following GST

is levied:

(a) CGST.

(b) SGST.

(c) CGST and SGST.

(d) SGST and IGST.

(2) On inter-state (i.e., outside the state) purchase of goods, which of the following GST is levied:

(a) IGST.

(b) IGST and CGST.

(c) CGST.

(d) SGST.

(3) On intra-state purchase of goods, which of the following accounts are debited:

(a) Input IGST Account.

(b) Input CGST Account and Input SGST Account.

(c) Input IGST Account and Input CGST Account.

(d) Input IGST Account and Input SGST Account.

(4) On inter-state sale of goods, which of the following account is credited:

(a) Output CGST A/c.

(b) Output IGST A/c.

(c) Input IGST A/c.

(d) Output SGST A/c.

Answers

Multiple Choice Questions (SET B)

Select the correct alternative:

1. (c) **2. (a)** **3. (b)** **4. (b)**

Chapter 10

Accounting Books of Original Entry

If the size of business is a small one, it may be possible to enter each and every transaction in one book only, i.e., Journal, which is generally known as the book of original entry. But when the size of the business grows and the number of transactions become very large, it is no longer possible to record all transactions in one Journal only. As such, the Journal is sub-divided into a number of Special Journals. These special journals are also known as 'clay books or special purpose books or Subsidiary Books' or the 'Books of Original Entry'. Each subsidiary book is meant for recording all the transactions of a similar nature. For example, all cash transactions may be recorded in one book, all credit purchase transactions in another book and all credit sales transactions in yet another book, and so on. Thus, the subsidiary books may be defined as books where the transactions are entered first and then ledger accounts are prepared on their basis. Following subsidiary books are most commonly used in a business:

(1) Cash Book: This book is used for recording all transactions relating to cash receipts and cash payments. All banking transactions relating to receipts and payments are also recorded in this book.

(2) Purchase Book: This book is used for recording the credit purchases of goods.

(3) Sales Book: This book is used for recording the credit sales of goods.

(4) Purchase Return Book or Return Outward Book: When the goods previously purchased on credit are returned to the suppliers, such returns are recorded in this book.

(5) Sales Return Book or Return Inward Book: When the goods previously sold on credit are returned by the customers, such returns are recorded in this book.

(6) Journal Proper: This book is used for recording the transactions which cannot be recorded in any of the above-mentioned books.

Thus, instead of recording the transactions in a single Journal, six journals are prepared as mentioned above.

Advantages of Special Purpose Subsidiary Books

or

Advantages of Sub-Division of Journal

The following are the uses or advantages of maintaining a number of special purpose subsidiary books instead of one general journal:

(1) Division of work according to ability: — Since there will be eight subsidiary books in place of one journal, the accounting work can be divided among different persons according to their ability. Also as the different persons will now do the accounting work on different books at the same time, the work will be completed in a very short time.

(2) Increase in Efficiency: — Because each person is entrusted the work of a particular book over a period of time, he becomes efficient in handling it. This will lead to the work being completed quickly and more accurately.

(3) Easiness in Posting :— Since all transactions of a particular nature are already collected at one place, it facilitates the posting into the ledger. For example, all credit purchases are collected in purchase book and only the total of purchase book is to be posted to the purchase account in the ledger,

(4) Easiness in Checking :— In case the trial balance does not agree, the existence of separate books helps **in** the detection of errors quickly.

(5) Protection from Frauds :— If only one book, i.e., Journal is maintained, only one person will be incharge of it. In such a case it is easier to commit a fraud. By the use of subsidiary books the work is divided among various persons, as such, the possibility of forgery and manipulation is greatly reduced. Internal check system can also be introduced in such a system.

(6) Full information at one place :— By the use of subsidiary books classified information in the form of cash receipts, cash payments, cash balance, credit purchases, credit sales etc. is readily available at one place. Such information helps the management in day-to-day decision making. No such information is available from Journal unless all the entries in Journal are classified and sorted out separately.

(7) Flexible :— It is not necessary for every business firm to use all the eight books. The number of books can be increased or decreased according to the needs of the particular business.

(8) Fixation of Responsibility :— Each employee is entrusted with a particular subsidiary book, and as such, he can be held responsible for the errors committed in that very book.

CASH BOOK

Meaning and Importance: — This book is used to record all transactions relating to cash receipts and cash payments. The number of cash transactions is quite large in every business and it is quite impracticable and inconvenient to record all cash transactions in the journal. It is, therefore, necessary to maintain a separate book for cash transactions. This book enables a businessman to know the balance of cash in hand and at bank at any point of time. It also gives information about the daily receipts, payments and the closing cash balance at the end of each day. Hence, this is a very popular book and is maintained by all the organisations — big or small.

Cash Book — A Subsidiary Book and a Principal Book

Cash book achieves a dual purpose. It is both a subsidiary book (book of original entry) and a principal book. When a cash book is maintained, transactions of cash are not recorded in the journal. As all the cash transactions are recorded for the first time in the cash book, it is therefore a book of original entry. But when a cash book is prepared, cash account in the ledger is not prepared. In this way, cash book represents the cash account and hence, becomes the principal book of accounts. As such, the cash book is a subsidiary book as well as principal book.

Distinction between Cash A/c and Cash Book

Infact, the Cash Book is a perfect substitute of Cash A/c. In both of these, Cash transactions are recorded date wise in order of occurrence. Both of these enable a businessman to know the Cash balance on any desired date. However, there are some differences between the two as follows :—

	Cash A/c	Cash Book
1.	It is an account in the Ledger.	It is a separate book maintained for recording Cash transactions.
2.	Cash account is opened in the ledger and posting is done in this account from journal.	It is a book of original entry because all cash transactions are first of all recorded in Cash book and then posted from Cash book to various accounts in the ledger.
3.	When transactions of Cash are recorded in journal, it is necessary to open a Cash A/c in ledger.	When transactions of Cash are recorded in Cash book, there is no necessity to open a Cash A/c in the ledger.
4.	It only records one aspect of a transaction, i.e., Cash.	It records both the aspects of a transaction.

Cash Book is a Journalised Ledger

Sometimes a question arises whether Cash book is a journal or ledger? It is a journal since the transactions are recorded in it for the first time from the source documents and from there these are posted to the respective accounts in the ledger. The Cash book is also a ledger in the sense that it serves the purpose of a Cash account also. When a Cash book is prepared, no separate Cash account is opened in the ledger. As such, the Cash book is a journal as well as a ledger and hence it may be called 'journalised ledger'.

Similarities of Cash Book with Journal

1. Just like a journal, transactions in the Cash book are recorded for the first time from source documents.

2. Just like a journal, transactions in the Cash book are recorded date wise, i.e., in a chronological order, as and when they take place.

3. Just like a journal, transactions from Cash book are also posted to the relevant accounts (except Cash account) in the ledger.

4. Just like a journal, a Cash book also contains a Ledger Folio Column.

Similarities of Cash Book with Ledger

1. Form of Cash book closely resembles to a ledger account. It has two equally divided sides having identical columns. The left side (receipts side) is the debit side and the right side (payment side) is the credit side.

2. Cash book itself serves as a Cash account also and as such when a Cash book is maintained, Cash account is not opened in the Ledger. The Cash book, hence, is a part of ledger also.

3. Just like a ledger account, the words 'To' and 'By' are used in a Cash Book also.

4. It is balanced just like a ledger account.

Advantages of Maintaining a Cash Book

1. Cash book is a journal as well as a ledger. When a Cash book is maintained, no separate 'Cash Account' is opened in the ledger. Hence, it prevents duplication of work in recording Cash transactions in the journal and then posting them into the ledger.

2. Since Cash Account is not opened in the ledger, it prevents the size of the ledger from becoming two voluminous.

3. Both Cash and Bank transactions can be entered in the Cash book.

4. It enables a businessman to know the balance of Cash in hand and at bank at any point of time without waiting for posting from the journal.

5. It gives information about daily receipts, payments and the closing cash and bank balance at the end of each day.

6. The Cash balance, as shown in Cash Book, must be equal to the actual (physical) Cash in hand. By a regular verification of actual Cash in hand with the balance shown by the Cash book the possibility of defalcation is reduced to the minimum.

Types of Cash Book

Cash book may be of four types:

(1) Single Column Cash Book or One Column Cash Book: for recording cash transactions only,

(2) Double Column Cash Book having

(i) Cash and Discount Columns; or

(ii) Bank and Discount Columns; or

(iii) Cash and Bank Columns.

(3) Triple Column Cash Book.

(4) Petty Cash Book.

Each business uses any one type of Cash book mentioned at serial no. (1), (2) or (3). It is called main Cash book. The type used by any business will depend upon the nature of business and its requirements. In addition to the main Cash book, firms also usually maintain a Petty Cash Book for recording petty expenses but it is maintained only on memorandum basis.

As per Syllabus, only Single Column, Double Column (having Cash and Bank

Columns) and Petty Cash Book will be discussed in this Chapter.

(1) Single Column Cash Book

Its format is similar to an account, with one amount column on each side. The left hand side known as 'Debit' records receipts of cash and the right hand side known as 'Credit' records payments. Its format is shown below :—

Form of Single Column Cash Book

Dr. **Cr.**

Date	Particulars	V. No.	L.F.	Amount Rs.	Date	Particulars (Payments)	V. No.	L.F.	Amount
(1)	(2) To	(3)	(4)	(5)	(1)	(2) By	(3)	(4)	(5)

It is clear from the above format that the columns on both sides of the cash book are similar to each other. These are as follows :—

(1) Date :— Day, month and the year of the transaction is recorded in this column.

(2) Particulars :— The name of the account in respect of which cash has been received or payment has been made is recorded in this column.

(3) Voucher Number :— The document supporting a transaction is called Voucher. The serial number of the voucher certifying the receipt or payment is written in this column.

(4) Ledger Folio or L.F. :— This column records the page number of the ledger where the posting of this amount has been made.

(5) Amount :— The amounts received are recorded on the Debit side and the amounts paid are recorded on the Credit side.

Following points should be remembered while preparing a cash book :—

(1) Cash book itself is a cash account also. As such, it is a real account and the rules of debit and credit are the same as that of a real account, i.e., "Debit What Comes In and Credit What Goes Out''.

Thus cash received is recorded on the debit side of the cash book and cash paid is recorded on the credit side.

(2) If opening balance of cash is given, it will be written on the debit side of the cash book as "To Balance b/d".

(3) Single Column Cash Book makes no record of

(a) Cheques received and given and

(b) Cash discount allowed and received.

Note:

Discount allowed, Discount received and cancellation of discount received or discount allowed (in case of dishonour of cheque) will be recorded through Journal Proper.

(4) When a Cash book is maintained, Cash Account is not opened in the Ledger.

(5) When an entry is recorded in Cash Book, a corresponding entry is recorded in ledger. For example, if Rs.2,000 are received from Gopal, the receipt (or debit) entry is passed in the Cash Book and Gopal's Account is credited in ledger.

Balancing of Cash Book and Carry Forward :— Cash book may be balanced daily, weekly or monthly depending on the need of the business. Normally, it is balanced daily in order to tally the balance shown by the cash book with that of the actual amount of cash in the cash box.

Following points should be taken into consideration while balancing the cash book :

(1) The receipts (Debit) column will always be bigger than the payments (Credit) column.

(2) The difference will be written on the credit side as "By Balance c/d". This will make the total of the two sides equal and the total will be written in the two columns opposite one another.

(3) The closing balance becomes opening balance of cash in hand at the beginning of the next period and is written on the debit side as "To Balance b/d".

Cash Book always shows a Debit Balance

It should be noted that the total of the debit side of the cash book always exceeds the credit side. It is because a businessman cannot pay more cash than what he has got. If the money is paid by borrowing from someone, it will first be recorded on the receipts side and only then it will be shown on the payment side. Hence, the cash book always shows a Debit Balance or at the most nil balance but can never show a credit balance.

IMPORTANT NOTES

1.	Transactions in which party name is not given, are treated as cash transactions. For example, goods purchased on 5th March and goods sold on 18th March in the above stated Problem will be treated as cash transactions and are recorded in the Cash Book.
2.	Transactions in which party name is given, are treated as credit transactions. For example, goods purchased from Ganesh on 10th March and goods sold to Saraswati on 20th March in the above stated Problem will be treated as credit transactions and are not recorded in the Cash Book.
3.	Transactions in which both party name and cash are given will be treated as cash transactions. For example, goods purchased from Luxmi in cash on 15th March

	and goods sold to Dev in cash on 25th March will be treated as cash transctions.

Cash discount allowed: — It is allowed to the customers if they make the payment either immediately or within a certain specified period. Suppose, goods for Rs. 10,000 are sold to X 1st of March 2020 on the terms "5% Cash discount" or "2% within a month". This means if he makes the payment immediately, he can clear his account by paying Rs. 10,000 less 5%, i.e., Rs.9,500. However, if he does not make the payment immediately, but pays it within a month, he can deduct 2% as Cash discount and can clear his account by paying Rs.9,800.

The net amount received from X is entered on the receipts side of the Cash Book as follows :—

Dr. **Cr.**

Date	**Particulars**	**V.No.**	**L.F.**	**Cash**	**Date**	**Particulars**	**V.No.**	**L.F.**	**Cash**
	To X			9,800					

Discount allowed to X is in the nature of expenses and is thus debited according to the rule of journalising — expenses and losses are debited and incomes and gains are credited. Following entry will be passed in Journal to record the discount allowed to X:

JOURNAL

Date	**Particulars**	**L.F.**	**Dr.(Rs.)**	**Cr. (Rs.)**
	Discount Allowed A/c Dr.		200	
	To A			200
	(2% discount on Rs. 10,000 allowed to X)			

Cash discount received :— When we make payment to a Creditor before the expiry' of fixed period certain discount is received from him.

For example, if goods valued Rs. 15,000 are purchased from Y on the terms of cash discount of 5% if payment is made within one week, we can clear our account by paying only Rs. 14,250 (i.e., Rs. 15,000 less 5%) within one week. The net amount paid to Y is entered on the payment side of the Cash Book as follows:—

Dr. **Cr.**

Date	**Particulars**	**V**	**L.F.**	**Cash**	**Date**	**Particulars**	**V. No.**	**L.F.**	**Cash**

	No.							
					By Y			14,250

Discount received from Y is in the nature of income and is thus credited according to the rule of journalising, Following entry will be passed in Journal to record the discount received from Y:

JOURNAL

Date	Particulars	L.F.	Dr. (Rs.)	Cr. (Rs.)
	Y Dr. To Discount Received A/c (5% discount on Rs. 15,000 received from		750	 750

2. Double Column Cash Book or Two-Column Cash Book (Cash Book with Cash and Bank Column)

It is a Cash Book with two column on each side; one column for recording cash transactions and the other column for recording bank transactions.

The advantage of maintaining such a type of Cash Book is that Cash Columns and Bank Columns represent Cash A/c and Bank A/c respectively. Hence, it is not necessary to open Cash A/c and Bank A/c in the Ledger.

Following rules are observed for preparing such a book :—

(1) A Bank Account is a Personal Account and as such the rule applicable to a personal account i.e. 'Debit the receiver and credit the giver' should be followed while recording transactions in the bank column of the Cash Book. Thus, for cash deposited into bank — the bank would be receiver and hence would be debited in the bank column of the Cash Book, Similarly, for cash withdrawn from the bank or for cheque issued — the bank would be giver and hence would be credited in the bank column of the Cash Book.

(2) Opening Balance :—As the cash column would always show a debit balance, it will be written as 'To Balance b/d' on the debit side. But the opening balance of bank column may be given as Debit or Credit. As such, if the debit balance of bank is given in the question, it will be written as 'To Balance b/d' on the debit side and on the contrary, if the credit balance of bank is given, it will be written as 'By Balance b/d' on the credit side. If overdraft balance is given, it will be treated as credit balance of bank.

(3) Contra Entries :— When cash is deposited into the bank or when cash is withdrawn from the bank for use in the office, each such transaction affects both 'Cash Column' as well as 'Bank Column' and the transaction is therefore, recorded on both sides of the cash book. Such entries, the double entry of which is complete in the Cash Book itself, are called "Contra entries" :—

(i) Cash deposited into Bank :— When cash is deposited into the bank, it increases the bank balance and reduces the cash balance. Hence, it affects the Cash Column as well as the Bank Column. As such the same amount is recorded on the debit side as well as on the credit side. On the Dr. side 'To Cash A/c' is written and the amount is recorded in the bank column. On the Cr. side 'By Bank A/c' is written and the amount is recorded in the Cash Column.

Debit Bank A/c (As bank is receiving the Cash, i.e., Debit the receiver)

Credit Cash A/c (As Cash is going out)

For example, if we deposit Rs.2,000 into the bank, it will be recorded in the cash book as follows :—

Dr. DOUBLE COLUMN CASH BOOK (with Cash and Bank Columns) Cr.

Date	Particulars	V. No.	L.F.	Cash	Bank	Date	Particulars	V. No.	L.F.	Cash	Bank
					Rs.					Rs.	Rs.
	To Cash A/c		C		2,000		By Bank A/c		C	2,000	

(ii) Cash withdrawn from Bank for office use:— In this case, the cash balance is increased and the bank balance is reduced. On the Dr. side 'To Bank A/c' is written and the amount is recorded in Cash Column. On the Cr. side 'By Cash A/c' is written and the amount is recorded in Bank Column.

Debit Cash A/c (As cash is coming in)

Credit Bank A/c (As bank is the giver, i.e., credit the giver)

For example, if we withdraw Rs.2,500 from the bank, it will be recorded in the cash book as follows :—

Dr. Cr.

Date	Particulars	V. No.	L.F.	Cash	Bank	Date	Particulars	V. No.	L.F.	Cash	Bank
				Rs.	Rs.					Rs.	Rs.
	To Bank A/c		C	2,500			By Cash A/c		C		2,500

Contra entries are not required to be posted to ledger as their double entry is complete in the Cash Book itself. Cash Book itself serves as the cash account and bank account. In order to indicate that these entries are not to be posted to the ledger, the word 'C', which stands for contra, is written on both the sides in 'L.F.' Column. The word Contra means 'opposite' or 'against'.

(4) Receipt of Cheque and Bank draft:—

(A) Cheques received from customers and deposited into bank the same day:— These are entered in Bank Column on the debit side.

(B) Cheques received from customers but not deposited into bank the same day :—

Cheques not deposited into the bank on the same day are first recorded in the books of accounts by means of a Journal entry as follows :

Cheques in Hand A/c Dr.

To Banerjee (say)

(Cheque received from Banerjee not yet deposited into bank)

When this cheque is deposited into the bank, it is recorded in the Cash Book by entering in the bank column on the Debit side as follows :

To Cheques in Hand A/c

Example: On 15th Feb., 2020, a Cheque is received from Gurpreet for Rs.25,000. This Cheque was deposited into the Bank on 20th Feb., 2020. On receipt of Cheque, the following Journal entry will be passed :

Date	Particulars	L.F.	Dr. (Rs.)	Cr. (Rs.)
2020			Rs.	Rs.
Feb. 15	Cheques in Hand A/c Dr.		25,000	
	To Gurpreet			25,000

On deposit of this Cheque into bank on 20th Feb., 2020, it will be recorded on the debit side of Cash Book as follows :

Dr. **CASH BOOK** **Cr.**

Date	Particulars	L.F	Cash	Bank	Date	Particulars	L.F.	Cash	Bank
2020 Feb. 20	To Cheques in Hand		Rs.	Rs. 25,000	2020			Rs.	Rs.

In the question, sometimes there is no information as to the deposit date of the cheque. In such a case, it will be assumed that the cheque has been deposited into the bank on the same day.

(5) Payment by Cheque :—As soon as we issue a cheque to someone, it will be immediately recorded on the credit side in Bank Column so that we may be acquainted of the True balance at the bank.

(6) Dishonour of a Cheque :— If a cheque, received from a customer and deposited into Bank for collection is dishonoured, an entry will be made on the credit side of the Cash Book by entering the amount of the dishonoured cheque in the bank column. **In** particulars column, the name of the customer will be entered. For example, a cheque for Rs.20,000 received from Ram Kumar is dishonoured, it will be recorded on the credit side as, "By Ram Kumar' ' and the amount will be entered in Bank Column.

(7) Cash Discount :— In a Cash Book having Cash and Bank Columns, the amount of discount is recorded in journal proper. For example, Rs.4,800 are received from Yuvraj Singh in full settlement of his account of Rs.5,000. In such a case Rs.4,800 will be recorded in Cash Book and the discount of Rs.200 will be recorded in Journal as follows :

Discount Allowed A/c	Dr. 200	
To Yuvraj Singh		200
(Discount allowed to Yuvraj Singh in full settlement)		

Similarly discount received by us is also recorded in Journal.

Balancing

(1) Debit side of cash column will always exceed the credit column and as such the balance will be shown on the credit side by writing the words, 'By Balance c/d'.

(2) Usually the bank columns are balanced just like the cash columns. However, the bank column may show either a debit balance or a credit balance. If it shows a credit balance, it is called overdraft. Overdraft is a situation when cash withdrawn from the bank exceeds the amount deposited into the bank. In such a case, the total of the credit side of bank column will be bigger than the total of the debit side. The difference will be written on the debit side as "To Balance c/d". At the beginning of the next month the balance will be shown as "By Balance b/d".

Some important transactions :—

(1) Amount withdrawn for personal use :— Amount withdrawn from bank for the personal use of the proprietor is not a contra transaction. It will affect only the bank column of the cash book. As it reduces the bank balance, it will be recorded on the credit side of cash book as 'By Drawings A/c' and the amount will be written in the bank column.

(2) Endorsement of a Cheque :— Sometimes, a cheque received from a customer is not deposited into bank, but it may be given to some other person, i. e., endorsed. The receipt as well as endorsement of Cheque is recorded through the Journal and not Cash Book because receipt and endorsement of Cheque neither affects Cash nor Bank account.

For example, a Cheque for Rs.20,000 is received from Arun on 2nd March, 2020 and it is endorsed to Vishal on 5th March, 2020. In this case we shall pass two Journal entries, one for receiving Cheque from Arun and another for endorsing Cheque to

Vishal. The Journal entries shall be as follows :

Date	Particulars		L. F.	Amount Dr.	Amount Cr.
2020				Rs.	Rs.
March 2	Cheques in Hand A/c	Dr.		20,000	
	To Arun				20,000
	(Cheque received from Arun not deposited into bank)				
March 5	Vishal	Dr.		20,000	
	To Cheques in Hand A/c				’ 20,000
	(Cheque received from Arun endorsed in favour of Vishal)				

(3) Bank Charges :— Bank usually charges some amount for the services rendered to its customers. Such charges will be recorded on the credit side as ‘By Bank Charges’ and the amount will be recorded in the bank column.

(4) Bank Charges on dishonoured cheques :— Expenses charged by the bank on dishonoured cheques will be added into the amount of dishonoured cheque itself.

(5) Amount directly deposited by a customer into our Bank A/c :— When the information of such a deposit is received by the trader, it will be recorded on the debit side of the cash book and the amount will be entered in the bank column.

(6) (I) Interest allowed by bank :— Interest allowed (credited) by the bank increases the balance at bank. The entry for such interest is, therefore, recorded on the debit side in bank column.

(II) Interest charged by bank :— When interest is charged (debited) by the bank on the amount of bank overdraft, the entry is recorded on the credit side in bank column.

(3) Petty Cash Book

In every business, of whatever size, a large number of small payments such as for postage, stationery, bus fare, taxi fare, cartage etc., have to be made. These payments are generally repetitive in nature. If all these payments are made by the cashier and are recorded in the main cash book, the cashier will be overburdened with the work and the cash book will also become very bulky. To avoid this, it is usual to appoint an employee as ‘Petty Cashier’. He is entrusted with the task of making small payments, say, below Rs. 1,000 and records them in a separate book, called Petty Cash Book.

Imprest System of Petty Cash Book :— Under this system, the petty cashier is given a definite sum, say Rs. 10,000, at the beginning of a certain period. This amount is called 'imprest amount'. The petty cashier goes on paying all petty expenses out of this imprest amount and records them in the petty cash book maintained by him. At the end of the given period, say after a month, the petty cashier submits the account to the main cashier who, after having examined the petty cash book, reimburses the amount actually spent by the petty cashier. Thus, on the first day of the next month, the petty cashier after including the balance already left with him, is found again with the same cash balance which he held on the first day of the preceding month. For instance, Rs. 10,000 are advanced to the petty cashier on 1st April. If petty cashier spends Rs.8,000 by the end of April, he will be again given Rs.8,000 so that after including Rs.2,000 which he has already got with him, he will again restart with the original amount of Rs. 10,000 on the first day of May. This system of petty cash book is called the Imprest System, because imprest means 'advance made to a certain person'.

A good imprest system should have the following essentials: —

(1) The petty cashier should obtain proper receipts for all the payments made by him. All these receipts should be arranged date wise and numbered so that these may be checked up easily by the main cashier when he takes reimbursement of the amount spent by him.

(2) The petty cashier should himself prepare proper vouchers for those expenses for which proper receipts cannot be obtained. He should get these vouchers sanctioned from a proper authority.

(3) There should be an upper limit of the amount of a single payment by the petty cashier. Payment above this limit should be made only by the main cashier.

(4) Petty cashier should get the reimbursement of the amount spent by him only from the main cashier.

(5) Petty Cashier should not be entitled to receive any cash coming from outside the business.

(6) Great care should be taken while fixing the amount of imprest. It should be sufficient to cover the petty expenses for the month.

Advantages of the Imprest System :

(1) Control over Misappropriation: Since the imprested sum is small, it does not provide a temptation either to the petty cashier or to other staff to misappropriate it.

(2) Control over Petty Expenses: Petty expenses are kept within the limits of imprest since the petty cashier can never spend more than the available petty cash with him.

(3) Control Exercised by Main Cashier : Main Cashier keeps a close watch on the amount refunded to the petty cashier from time to time. Hence, extravagance, if any, will be revealed.

(4) Lesser Chances of Misuse of Cash by Petty Cashier : At any time, the amount of Cash in hand plus the total value of vouchers which have not been reimbursed must equal the imprest amount. Existence of this simple check reduces the chances of misuse of cash by petty cashier.

(5) Advantageous to Petty Cashier : Imprest system is advantageous to petty cashier also because his liability to account for moneys spent can never exceed the imprest amount. Moreover, since his accounts are checked at regular intervals, say, weekly or monthly, he is not required to account for transactions which occurred in the far distant past.

Advantages of Petty Cash Book

(1) Saving of Time and Efforts of Chief Cashier:—As petty cashier handles the work of making all petty expenses and recording them as well, a lot of time and energy of the main cashier is saved. He is to record only the total of such expenses and that too only once, at the end of each month.

(2) Easiness in Posting :— Only the total of each head of expense is posted into the Ledger. As such, a lot of space is saved and the posting becomes very convenient.

(3) Easiness in preparing the Cash Book :— As the number of small payments in every business is quite large and as these are recorded in the petty cash book itself, the main cash book is not overburdened and can be more easily totalled.

(4) Control on Petty Expenses :— The main cashier keeps checking the petty cash book from time to time and a proper check is put on any unnecessary expenditure.

(5) Lesser chances of fraud :—Petty Cashier obtains a receipt of every payment made by him and keeps a proper record of them. The receipts are duly signed by the main cashier while reimbursing the amount to the petty cashier. As such, it minimises the chances of fraud.

(6) Simple Method :—The maintenance of petty cash book does not require any specialised knowledge of accounting.

Accounting Procedure

Petty cash book is prepared just like a simple cash book having the debit and credit sides. Amount received from the head cashier is recorded on the debit side, whereas the payments are recorded on the credit side.

On the payment (Credit) side, a separate column is provided for each class of most common expenses. Number of columns depends upon the nature and need of the particular business. A business of small size needs lesser number of columns whereas a business of large size will need more columns. Those expenses that are not entered in any separate column are entered in a column designated as 'Miscellaneous Expenses'. A specimen of a petty cash book is given below :

Form of Petty Cash Book

Dr.					Cr.		Analysis of Payments				
Amount Received	Cash Book Folio	Date	Particulars	Voucher No.	Total Payments	Postage & Courie	Wages	Conveyance	Cartage	Stationery	Miscellaneous Expen

						r					ses

Posting from the Petty Cash Book:

Petty cash book is not posted directly in the ledger. For posting the petty cash book, a petty cash account is opened in the ledger. It is debited with amount given to the petty cashier. Petty cash book is balanced weekly or monthly and a journal entry is first prepared on the basis of the petty cash book, debiting each expense account individually as per the total shown by respective analysis columns and crediting the petty cash account with the total expenditure incurred during the period.

Thereafter, posting is made to the debit of each expense account by writing 'To Petty Cash A/c' and the total expenditure is also posted to the credit of Petty Cash Account by writing 'By sundries as per petty cash book'.

In Problem 17, the journal entry and the posting will appear as follows :

Books of ....

JOURNAL

Date	Particulars		L.F.	Dr. Amount	Cr. Amount
				Rs.	Rs.
Jan. 1	Petty Cash A/c	Dr.		10,000	
	To Cash A/c				10,000
	(Cash paid to petty cashier)				
Jan. 31	Postage & Courier A/c	Dr.		1,450	
	Wages A/c	Dr.		1,600	
	Conveyance A/c	Dr.		950	
	Cartage A/c	Dr.		650	
	Stationery A/c	Dr.		700	
	Miscellaneous Expenses A/c	Dr.		2,900	
	To Petty Cash A/c			-	8,250
	(Petty expenses posted to petty cash account)				

Feb. 1	Petty Cash A/c	Dr.		8,250	
	To Cash A/c				8,250
	(Cash paid to petty cashier)				

Ledger Accounts

Dr. **Petty Cash Account** **Cr.**

Date	Particulars	J.F.	Amount	Date	Particulars	J.F.	Amount
			Rs.				Rs.
Jan. 1	To Cash A/c		10,000	Jan. 31	By Sundries as per petty cash book		8,250
				Jan. 31	By Balance c/d		1,750
			10,000				10,000
Feb. 1	To Balance b/d		1,750				
Feb. 1	To Cash		8,250-				

* Students are advised to undertake posting of petty cash book after studying the ledger posting in Chapter 13.

Dr. **POSTAGE & COURIER ACCOUNT** **Cr.**

Date	Particulars	J.F.	Amount	Date	Particulars	JF.	Amount
			Rs.				Rs.
Jan. 31	To Petty Cash A/c		1,450				

Dr. **WAGES ACCOUNT** **Cr.**

Date	Particulars	J.F.	Amount	Date	Particulars	J.F.	Amount
			Rs.				Rs.
Jan.. 31	To Petty Cash A/c		1,600				

Dr. **CONVEYANCE ACCOUNT** Cr.

Date	Particulars	J.F.	Amount	Date	Particulars	J.F.	Amount
			Rs.				Rs.
Jan. 31	To Petty Cash A/c		950				

Dr. **CARTAGE ACCOUNT** Cr.

Date	Particulars	J.F.	Amount	Date	Particulars	J.F.	Amount
			Rs.				Rs.
Jail. 31	To Petty Cash A/c		650				

Dr. **STATIONERY ACCOUNT** Cr.

Date	Particulars	JF	Amount	Date	Particulars	JF	Amount
			Rs.				Rs.
Jan. 31	To Petty Cash A7c		700				

Dr. **MISCELLANEOUS EXPENSES ACCOUNT** Cr.

Date	Particulars	J.F.	Amount	Date	Particulars	J.F.	Amount
			Rs.				Rs.
Jan. 31	To Petty Cash A/c		2,900	1			

Multiple Choice Questions (SET A)

Select the correct alternative:

1. When a firm maintains a cash book, it need not maintain

(a) Journal Proper

(b) Purchase Book

(c) Sales Book

(d) Cash and Bank Accounts in Ledger

2. The balance of bank column of cash book always shows a balance.

(a) Debit

(b) Credit

(c) Either Debit or Credit

(d) Neither Debit nor Credit

3. Which of the following will be recorded as Contra-entry :

(a) Cash directly deposited into bank by a customer

(b) Payment made to creditor by cheque

(c) Cash deposited into bank

(d) Cash sales

4. A cheque received and deposited into bank the same day will be recorded in cash book in

(a) Cash column on debit side

(b) Cash column on credit side

(c) Bank column on debit side

(d) Bank column on credit side

5. When a cheque deposited into bank is dishonoured by bank, it will be recorded in cash book in :

(a) Bank column on debit side

(b) Bank column on credit side

(c) Cash column on debit side

(d) Cash column on credit side

6. On 1st April 2020, balance of cash column of cash book was Rs. 10,000. After receiving Rs.2,000 from Anil, giving a cheque of Rs.3,200 to Sunil and making payment of wages Rs.500, balance of cash will be :

(a) Rs. 11,500

(b)Rs. 8,300

(c) Rs. 8,800

(d) Rs. 6,300

7. On 1st May 2020, cash book bank overdraft balance was Rs.2,000. On depositing Rs. 10,000 into bank and giving a cheque of Rs.7,200 for rent, the balance will be : (a) Rs.4,800 Dr. (b) Rs.4,800 Cr. (c)Rs.800 Dr. (d) Rs.800 Cr.

8. Which of the following is not recorded in cash book :

(a) Trade Discount

(b) Bad Debts

(c) Credit Purchases

(d) All of the above

9. Which is not contra entry in the cash book

(a) Cash deposited into bank

(b) Cash withdrawn from bank

(c) Cash withdrawn from bank for personal use

(d) None of these

10. If the debit as well as credit aspects of a transaction are recorded in the cash book, it is called ....

(a) Contra Entry

(b) Compound Entry

(c) Opening Entry

(d) Adjustment Entry

11 Cash book is a type of............ but can be treated as a... of account.

(a) Subsidiary Book, Principal Book

(b) Principal Book, Subsidiary Book

(c) Subsidiary Book, Subsidiary Book

(d) Principal Book, Principal Book

12. Which of the following may have both Dr. or Cr. Balance

(a) Only cash column of cash book

(b) Only bank column of cash book

(c) Both cash andbank column

(d) Neither bank nor cash column

13. Imprest amount Rs.5,000. What will be the amount of re-imbursement if following expenses were incurred by the petty cashier during the month — Wages = Rs. 1,450, Tiffin = Rs. 1,050, small Repairs = Rs.500, General expenses = Rs.400.

(a) Rs. 1,600

(b) Rs.3,400

(c) Rs.3,050

(d) Rs.3,000

14. Salary due for the month of March will appear in side of cash book

(a) Receipt

(b) Payment

(c) Contra

(d) None of the above

Answers

Multiple Choice Questions (SET A)

Select the correct alternative:

1 .(d)	2.(c)	3. (c)	4. (e)	5 .(b)	6. (a)
7.(c)	8 .(d)	9. (c)	10. (a)	11. (a)	12. (b)
13. (b)	14. (d)				

Multiple Choice Questions (SET B)

Select the correct alternative:

(1) Cash Book records all

(a) cash receipts and payments.

(b) cash and credit transactions.

(c) cash receipts.

(d) cash payments.

(2) If Ram has sold goods for cash to Param, the entry will be recorded in the

(a) Cash Book.

(b) Sales Book.

(c) Journal Proper.

(d) Petty Cash Book.

(3) Ravi has purchased goods for cash from Girish for Rs. 10,000. It will be recorded in

(a) Cash Book.

(b) Journal Book.

(c) both Cash Book and Journal Book.

(d) Petty Cash Book,

(4) Mohit paid Rs. 9,800 in settlement of his account of Rs. 10,000. Discount Allowed will be recorded in

(a) Cash Book.

(b) Journal Book.

(c) Both Cash Book and Journal.

(d) Petty Cash Book.

(5) Deposit of cash in bank is recorded in

(a) Debit of Bank Column and Credit of Cash Column.

(b) Debit of Cash Column and Credit of Bank Column.

(c) Debit of Cash Column and also Credit of Cash Column.

(d) Debit of Bank Column and also Credit of Bank Column.

(6) Withdrawal of Cash from Bank is recorded in

(a) Debit of Bank Column and Credit of Cash Column.

(b) Debit of Cash Column and Credit of Bank Column.

(c) Debit of Cash Column and also Credit of Cash Column.

(d) Debit of Bank Column and also Credit of Bank Column.

(7) Balance in the Petty Cash Book is

(a) an expense,

(b) a profit.

(c) an asset.

(d) income.

(8) When a firm maintains Two-column Cash Book, it does not maintain

(a) Purchases Book.

(b) Journal Proper.

(c) Sales Book.

(d) Bank and Cash Accounts in the Ledger.

(9) Which of the following is not recorded in the Cash Book?

(a) Credit Sales

(b) Cash Receipts

(c) Cash Payments

(d) Opening Cash Balance

(10) Contra entries on the debt side of the Cash Book are posted to

(a) Debit of Bank Account in the Ledger.

(b) Debit of Cash Account in the Ledger,

(c) Credit of Cash Account in the Ledger.

(d) Not posted in the Ledger.

(11) Which of the following is both a book of Journal and Ledger?

(a) Cash Book

(b) General Journal

(c) Purchases Journal

(d) Sales Journal

(12) Debit balance of Rs. 10,000 in the Cash Column of the Cash Book shows that

(a) Rs. 10,000 has been paid out.

(b) Rs. 10,000 is owing.

(c) the amount received exceeds the amount paid by Rs. 10,000.

(d) Rs. 10,000 has been credited into the Bank Account.

(13) Simple Petty Cash Book is like a

(a) Cash Book.

(b) Statement.

(e) Journal.

(d) None of these.

Answers

Multiple Choice Questions (SET B)

Select the correct alternative:

1 .(a)	**2.(a)**	**3. (a)**	**4. (b)**	**5 .(a)**	**6. (b)**
7.(c)	**8 .(d)**	**9. (a)**	**10. (d)**	**11. (a)**	**12. (c)**
13. (b)					

Chapter 11

BOOKS OF ORIGINAL ENTRY - SPECIAL PURPOSE

SUBSIDIARY BOOKS

As discussed, only the cash transactions are recorded in the cash book whereas non-cash transactions are recorded in other special purpose subsidiary books which are as follows:—

1. Purchase Book
2. Sales Book
3. Purchase Return Book
4. Sales Return Book
5. Bills Receivable Book
6. Bills Payable Book
7. Journal Proper

It is not necessary for every business to maintain all the above-mentioned special purpose subsidiary books but any of the above may be kept depending upon the need of the business. Bills Receivable Book and Bills Payable Book are not in the Syllabus.

Purchase Book or Purchase Journal

All credit purchases of goods are recorded in the purchase book. 'Goods' here mean only those things in which the firm is dealing. In other words, these are the articles which are purchased for resale. If, for example, a firm dealing in cloth purchases cloth, it will be treated as purchase of goods and will be-recorded in the Purchase Book. But if the same firm purchases furniture, it will be treated as purchase of an 'Asset' and will not be recorded in purchase book. Purchase book is also known as 'Invoice Book' or 'Purchase Day Book'.

Following transactions are not recorded in the purchase book :—

(1) Cash Purchases :— Cash purchases are not recorded in this book since these will be recorded in the cash book.

(2) Purchase of Asset:— Only credit purchase of goods are recorded in this book. Purchase of assets, such as Machinery, Furniture, Typewriters etc. are not recorded in the purchase book. Instead these are recorded in the Journal proper if purchased on credit or in the cash book if purchased for cash.

Recording of Transactions :— The source documents on the basis of which the transactions are recorded in the purchase book are invoices or bills received by the firm from the suppliers of the goods. An invoice contains the quantity of the goods, rate, amount, trade discount etc.

Trade Discount:— The amount of purchase to be recorded in the purchase book is always arrived at after deducting trade discount. If, for example, goods of the list price of Rs. 10,000 are purchased at 20% trade discount, only Rs. 8,000 will be recorded in the purchase book.

Format of Purchase Book

Date (1)	Particulars (Name of the Supplier) (Account to be Credited) (2)	Invoice No. (3)	L.F. (4)	Details (5)	Purchase (6)	Input CGST (7)	Input SGST (8)	Input IGST (9)	Total Amount (10)

Explanation of the columns of the purchase book :—

(1) Date :— The date of purchase of goods on credit is recorded in this column.

(2) Particulars :— The name of the person or firm from whom the goods are purchased is written in this column. Also it contains the description of the goods purchased, its quantity, rate, gross amount, trade discount etc.

(3) Invoice Number :— The number of the invoice or bill on the basis of which the transaction is being recorded in the purchase book is mentioned in this column.

(4) Ledger Folio or L.F. :— Page number of the ledger where the transaction is posted is recorded in this column.

(5) Details :— This column is used to write the individual amount of different items purchased from a particular supplier. This column is also used to deduct the amount of trade discount and for adding the amount of Input CGST, Input SGST and Input IGST.

(6) Purchase : Net amount of purchase i.e., purchase less trade discount is written in this column.

(7) Input Central GST (CGST) : This tax is paid on intra-state purchase of goods i.e., purchase of goods within the same state. It is charged by the seller from the purchaser on the net sale value i.e., sale price less trade discount. Total of this column is posted to the debit of Input CGST A/c in the Ledger.

(8) Input State GST (SGST) : This tax is also paid on purchase of goods within the same state. It is also calculated on the net sale value i.e., sale price less trade discount. Total of this column is posted to the debit of Input SGST A/c in the Ledger,

(9) Input Integrated GST (IGST) : This tax is paid on inter-state purchase of goods i.e., purchase of goods from outside the state. It is calculated on net sale value i.e., sale price less trade discount. Total of this column is posted to the debit of Input IGST A/c in the Ledger.

(10) Total Amount : Total amount of each transaction is shown in this column and the amount of each transaction is posted to the credit of the Supplier A/c in the Ledger.

Note : Either the CGST + SGST will be levied on a transaction or only IGST will be levied.

For example, suppose the rate of CGST is 6% and SGST is 6%, then if the goods have been purchased from within the state then CGST @ 6% + SGST @ 6% will be levied. If the goods have been purchased from outside the state, then only IGST @ 12% will be levied. ■

Freight or Cartage Charges

Freight or Cartage charges are incurred on purchase of goods. After the introduction of GST, it will not be appropriate to provide a separate column for freight in the purchase book. The reason is that GST is levied on purchase of goods at a different rate i.e., either of the five rates 0, 5%, 12%, 18% or 28%, whereas as per GST Act, GST on freight is charged at a fixed rate of 18%.

IMPORTANT NOTE

If COST is 6%, SGST will also be 6% and IGST will be 6% + 6% = 12%

Similarly, if COST is 9%, SGST will also be 9%, and IGST will be 9% + 9% = 18% and so on

Difference between Purchase Book and Purchase Account

(1) Purchase Book is a part of Journal, whereas Purchase Account is the part of Ledger.

(2) There is difference in the format of Purchase Book and Purchase Account. Purchase Book is not divided into debit and credit sides, whereas purchase account is divided into debit and credit sides.

(3) Purchase book records only credit purchases of goods, whereas credit as well as cash purchases of goods are posted in the purchase account.

Sales Book or Sales Journal

All credit sales of goods are recorded in the sale book. Cash sales will be recorded in the cash book and not in the sales book. Similarly, credit sales of things other than the goods in which the firm deals in, are not entered in the Sale Book, they are entered in the Journal. Sales Book is also called Sales Day Book. Following transactions are not recorded in the Sales Book :—

(1) Cash Sales :— It does not record cash sales of goods, as the cash sales are recorded in the cash book.

(2) Sale of Asset :— Only the credit sale of goods is recorded in this book. If, instead of goods, some asset such as Machinery, Furniture, Typewriter etc. is sold on Credit or for Cash, it will not be recorded in the Sale Book. Credit sale of an asset will be recorded in Journal proper, whereas cash sale of the asset will be recorded in cash book.

Recording of Transactions :— Entries in the sales book are recorded on the basis of the sales invoices issued by the firm to its customers at the time of sale. In fact, two or more than two copies of each sales invoice are prepared. One copy of the invoice is given to the customer and the other copies are numbered and kept in a file for making entries in the Sales Book. Sale invoice contains full information regarding the date, name of the customer, quantity, rate, gross amount, trade discount allowed to the customer, GST and the net amount of sales.

Format of Sales Book

Date (1)	Particulars (Name of the Customer) (Account to be Debited) (2)	Invoice No. (3)	L.F. (4)	Details (5)	Sale (6)	Output CGST (7)	Output SGST (8)	Output IGST (9)	Total Amount (10)

Explanation of the Columns of Sales Book :

(1) Date : The date of sale of goods on credit is recorded in this column.

(2) Particulars : In addition to the name of the customer, this column also contains the description of goods sold, its quantity, rate, gross amount, trade discount etc.

(3) Invoice Number.

(4) Ledger Folio or L.F.

(5) Details : This column is used to write the individual items sold less trade discount. It is also used to add the amount of Output CGST, Output SGST and Output IGST.

(6) Sale : Net amount of sale i.e. sale less trade discount is written in this column.

(7) Output Central GST (CGST) : A separate column is provided in the Sale Book to record Output CGST. This tax is collected by the seller from buyer on intra-state sale of goods i.e., sale of goods within the same state. It is computed on the net sale value i.e., sale price less trade discount. Total of this column is posted to the credit of Output CGST A/c in the Ledger.

(8) Output State GST (SGST) : A separate column is also provided in the Sale Book to record Output SGST. This tax is also collected by the seller on sale of goods within the same state. It is also calculated on net sale value i.e., sale price less trade discount. Total of this column is posted to the credit of Output SGST A/c in the Ledger.

(9) Output Integrated GST (IGST): A separate column is maintained to record Output IGST. This tax is collected by the seller on inter-state sale of goods i.e., sale of goods outside the state. It is calculated on net sale value. Total of this column is posted to the credit of Output IGST A/c in the Ledger.

(10) Total Amount [1] : Total amount of each transaction is shown in this column and the amount of each transaction is posted to the debit of the Customer's A/c in the Ledger.

Note:

(i) CGST + SGST will be collected on sales within the same state.

(ii) IGST will be collected on the sales outside the state.

Purchase Return Book or Purchase Return Journal

This book is used to record the return of such goods as were purchased on credit basis. The book is also known as Return Outward Book. There may be various reasons for returning the goods to the suppliers :—

(1) When the goods delivered are not according to the sample.

(2) When the goods are not according to the order or the quality of the goods supplied is inferior.

(3) When the goods are defective or they have been damaged in transit.

(4) When the price charged in the invoice is in excess of the agreed price.

(5) When the goods have not been delivered in time.

When the goods are returned, a debit note is prepared and is sent to the supplier with the returned goods, A debit note contains the name of the party to whom the goods have been returned, details of the goods returned and the reason for returning the goods. Each debit note is serially numbered, dated and is prepared in duplicate. Original copy is sent to the supplier, informing him the amount for which his account has been debited on account of return of goods. It is called a debit note because the party's account is debited with the amount written in this note. The party to whom the goods have been returned also prepares and sends a note which is called the credit note.

Duplicate copy of the debit note becomes a source document, on the basis of which the entries are recorded in the purchase return book.

A debit note is also sent when a sales invoice is under charged by mistake or a sales invoice is undercast or some particular goods are omitted to be recorded in the sales invoice.

Format of Purchase Return Book

The form of Purchase Return Book is given below :—

Date (1)	Particulars (Name of the Supplier) (Account to be Debited) (2)	Debit Note No. (3)	L.F. (4)	Details m (5)	Purch ase Return (6)	Input CGST (7)	Input SGST (8)	Input IGST (9)	Total Amo unt (10)
				Rs.	Rs.	Rs.	Rs.	Rs.	Rs.

Sales Return Book or Sales Return Journal

This book is used to record the return of such goods as were sold to the customers on credit basis. The book is also known as Return Inwards Book. When the goods are received back, a credit note is prepared in duplicate and the original copy of the same is sent to the party from whom goods were received. A credit note contains details relating to the name of the customer, details of the goods received back and the amount of return. Each credit note is serially numbered and dated.

This note is called a credit note because the party's account, from whom the goods are received back, is credited with the amount written in the note. The same note is called a debit note by the party who is returning the goods because that party will use this note for debiting the account of the party to whom it has returned the goods.

Duplicate copy of the credit note sent to the party becomes a source document, on the basis of which the entries are recorded in the sales return book.

A Credit note is also sent when a sales invoice is over charged by mistake or a sales invoice is overcast or some special discount is allowed to the customer because of defective goods.

CREDIT NOTE

Credit Note No........

525, Chandni Chowk

Delhi-110006

Dated 2nd July 2020

To,

New Furniture House

802, Patel Nagar, New Delhi

We are crediting your account with the value of undermentioned goods returned by you for the reason stated below :—

Reasons	Particulars	Details	Amount
		Rs.	Rs.
Overcharged in Invoice No. 105	Rs.50 per Chair on 20 Chairs		1,000

E. & O. E.

For Fashion Furniture House

Anil Sharma

Manager

Format of Sales Return Book

The format is given below :—

Date	Particulars (Name of the	Credit	L.F.		Sales	Output	Output	Output	Total

(1)	Customer) (Account to be Credited) (2)	Note No. (3)	(4)	Details (5)	Returns (6)	CGST (7)	SGST (8)	IGST (9)	Amount (10)
				Rs.	Rs.	Rs.	Rs.	Rs.	Rs.

Journal Proper or General Journal

After the sub-division of journal into various subsidiary books, journal remains only a residuary book in which only those transactions are recorded which cannot be recorded in any other subsidiary book. In such a case journal is called journal proper. For example, if machinery is purchased on credit, it can neither be recorded in cash book nor in purchase book. The reason is that cash book records only the cash transactions and the purchase book records only credit purchase of goods and not the purchase of an asset. The purchase of machinery which is an asset will thus be recorded in the journal proper. The following types of transactions are recorded in journal proper:

(1) Opening Entry : This entry is passed to bring the closing balances of various assets, liabilities and capital appearing in the Balance Sheet of previous accounting period, to the books of current accounting period.

(2) Closing Entries : At the end of the accounting period, a Trading and Profit and Loss Account has to be prepared to ascertain the net profit. For this purpose, the nominal accounts have to be closed by transferring their balances to this account. The entries passed for this purpose are called closing entries.

(3) Transfer Entries :— Transfer entries are passed for transferring an amount or the balance of one account to another such as transferring the balance of Drawings A/c to Capital A/c.

(4) Adjustment Entries: At the time of preparation of final accounts, entries are needed to record certain unrecorded items such as closing stock, outstanding expenses, prepaid expenses, depreciation on fixed assets, interest on capital etc. Entries for these are called adjustment entries.

(5) Rectifying Entries :— These entries are passed to rectify the errors while journalising, posting, totalling, balancing etc.

(6) Miscellaneous Entries: In addition to tire above, the following entries will also be passed in the journal proper :

(i) Purchase of an asset on credit;

(ii) Sale of an asset on credit;

(iii) Writing off bad debts;

(iv) Discount allowed and discount received;

(v) Bills Receivable received;

(vi) Bills Payable issued

(vii) Endorsement of Bill Receivable to a creditor; fviii) Dishonour of Bills Receivables (not discounted with the bank);

(ix) Cancellation of Bills Payable;

(x) Goods taken by the proprietor for personal use;

(xi) Goods given away as charity or free sample;

(xii) Abnormal loss of stock or other assets by fire, accident, theft etc.

Example. Mention the subsidiary books in which the following transactions are recorded along with reason thereof:

(i) Purchase of furniture on credit for use in shop.

(ii) Sale of goods on credit.

(iii) Goods returned by Debtors.

(iv) Purchase of stock on credit.

(v) Providing for interest on capital to proprietor.

(vi) Goods returned to creditors.

(vii) Bill accepted by proprietor from creditor.

(viii) Sale of goods for cash.

SOLUTION:

(i) Journal Proper : Because purchase of fixed assets on credit is recorded in Journal Proper.

(ii) Sales Book : Because sales book records only the sale of goods on credit.

(iii) Sales Return Book : Because goods returned by customers is recorded in Sales Return Book.

(iv) Purchase Book : Because purchase book records only the purchase of goods on credit.

(v) Journal Proper : Because Journal Proper records all those transactions which could not be recorded in any of other subsidiary books. Interest on capital is also one of those items which cannot be recorded in any other subsidiary books.

(vi) Purchase Return Book : Because Purchase Return Book records only goods returned by the firm to its suppliers.

(vii) Journal Proper : Because bill accepted by the proprietor on behalf of the firm is called 'Bill Payable' and it is recorded in this book.

(viii) Cash Book : Because Cash Book records all cash receipts and cash payments.

Multiple Choice Questions (SET A)

Select the correct alternative:

1. Purchase book is used to record :

(A) Purchases of goods

(B) Credit Purchases of goods

(C) Credit Purchases of asset

(D) All credit Purchases

2. Debit notes issued are used to prepare :

(A) Purchases Return Book

(B) Sales Return Book

(C) Purchases Book

(D) Sales Book

3 ....is not a subsidiary book

(A) Purchase Return Book

(B) Purchase Book

(C) Ledger

(D) Sales Book

4. Recording is made in purchases book :

(A) After deducting trade discount

(B) After adding trade discount

(C) After deducting cash discount

(D) After adding cash discount

5. Debit Note is the source of writing :

(A) A debit entry in an Account

(B) A sale to a person

(C) Sales Return Book

(D) Journal Proper

6. A separate column is made for 'Credit Note No.' in

(A) Purchases Book

(B) Sales Book

(C) Purchases Return Book

(D) Sales Return Book

7.Total of Purchase Return Column in the Purchases Return Book is posted to :

(A) Purchases Return A/c — Debit

(B) Purchases Return A/c — Credit

(C) Purchases A/c — Debit

(D) Purchases A/c — Credit

8. Total of Sales Return Column in the Sales Return Book is posted to :

(A) Sales A/c — Debit

(B) Sales A/c —Credit

(C) Sales Return A/c — Debit

(D) Sales Return A/c — Credit

9. In case lesser amount is recorded in sales invoice by mistake, then a is sent

(A) Debit Note

(B) Credit Note

(C) Cash Note

(D) Debit or Credit Note

10. A trader entered into following transactions. As a result, total of Purchase Column in the Purchase Book will be :

(i) Goods purchased from Gaurav Rs.8,000

(ii) Goods purchased from Sudhir for Cash Rs. 10,000

(iii) Goods purchased from Kamal on credit Rs.25,000

(iv) Machinery purchased from Dinesh on credit Rs.40,000

(A) Rs.83,000

(B) Rs.73,000

(C) Rs.33,000

(D) Rs.25,000

11. Goods taken away by the proprietor from business for his personal use will be recorded in :

(A) Purchases Book

(B) Sales Book

(C) Purchases Return Book

(D) Journal Proper

12. Recording is made in Journal Proper of:

(A) All transactions

(B) Those transactions which are not recorded in any subsidiary book.

(C) All cash transactions

(D) All credit Transactions

13. Recording is made in Journal Proper of:

(A) Opening Entries

(B) Closing Entries

(C) Adjustment Entries

(D) All of the above

14. The balance of sales column in the sales day book is Rs.30,000. Rs.5,000 were recovered from debtors. Then balance of sales column will be transferred by which amount?

(A) Rs.25,000

(B) Rs.30,000

(C) Rs.20,000

(D) Rs.35,000

15. A note sent by buyer on return of goods is

(A) Credit Note

(B) Return Note

(C) Debit Note

(D) None of these

16. Goods sold for Cash Rs.25,000 plus 12% IGST. Sales A/c will be credited by :

(A) Rs.22,000

(B) Rs.25,000

(C) Rs.28,000

(D) None of these

17. Purchase of furniture on credit should be recorded in

(A) Journal

(B) Purchase Book

(C) Cash Book

(D) Journal Proper

18. A .... is sent to a supplier when we return goods.

(A) Debit Note

(B) Credit Note

(C) Proforma Invoice

(D) None of these

Answers

Multiple Choice Questions (SET A)

Select the correct alternative:

1. (B)	**2. (A)**	**3.(C)**	**4. (A)**	**5. (A)**	**6. (D)**
7.(B)	**8.(C)**	**9. (A)**	**10. (C)**	**11. (D)**	**12. (B)**
13. (D)	**14. (B)**	**15. (C)**	**16. (B)**	**17. (D)**	**18. (A)**

Multiple Choice Questions (SET B)

Select the correct alternative:

(1) In the Purchases Book the record is in respect of

(a) cash purchases of goods dealt in.

(b) credit purchases of goods dealt in.

(c) all purchases of goods dealt in.

(d) purchase of anything.

(2) The Sales Return Book records

(a) the return of goods purchased.

(b) the return of goods sold on credit,

(c) the return of goods sold for cash.

(d) the return of anything sold.

(3) The Sales Book

(a) is a part of the Journal.

(b) is a part of the Ledger.

(c) is a part of the Balance Sheet.

(d) is a part of the Trial Balance.

(4) The total of the Sales Book is posted to

(a) debit of the Sales Account.

(b) credit of the Sales Account.

(c) debit of the Customers' Account.

(d) credit of Customers' Accounts.

(5) The periodic total of Sales Return Journal is posted to the

(a) Sales Account.

(b) Goods Account.

(c) Sales Return Account.

(d) Any of these.

(6) Goods purchased for cash are recorded in the

(a) Purchases Book.

(b) Cash Book.

(c) Purchases Return Book.

(d) Cash Book and Purchases Book.

(7) Total of these transactions is posted to Purchases Account

(a) Credit purchase of furniture.

(b) Purchases Return.

(c) Credit purchase of goods.

(d) Purchase of Stationery.

(8) Sale of business asset on credit is recorded in

(a) Sales Book.

(b) Journal Proper.

(c) Special Journal.

(d) Cash Book.

(9) Opening entry is recorded

(a) in the beginning of the accounting year.

(b) at the end of the accounting year.

(c) in the middle of the accounting year.

(d) anytime during the year.

(10) Closing entries are passed

(a) in the beginning of the accounting year.

(b) at the end of the accounting year.

(c) in the middle of the accounting year.

(d) anytime during the year,

(11) Which of the following transactions is entered into the Journal Proper?

(a) Cash Payment to an employee for expenses.

(b) Cash purchase of goods for resale.

(c) Correction of an error.

(d) Credit purchase of goods for resale.

(12) X received a cheque of Rs. 10,000 from Y in settlement of dues of Rs. 10,500. The cheque was dishonoured. The reversal of discount allowed by X will be recorded in

(a) Cash Book.

(b) Journal Proper.

(c) Ledger directly.

(d) None of the above.

Answers

Multiple Choice Questions (SET B)

Select the correct alternative:

1. (b)	**2. (b)**	**3.(a)**	**4. (b)**	**5. (c)**	**6. (b)**
7.(c)	**8.(b)**	**9. (a)**	**10. (b)**	**11. (c)**	**12. (b)**

Chapter 12

Ledger

Meaning and Definition

Business transactions are first entered in Journal or Special Purpose Subsidiary Books. The next step is to transfer the entries to respective accounts in Ledger. In other words, all entries recorded in Journal or Special Purpose Subsidiary Books are classified and in order to ascertain the position of a particular account, all transactions relating to that particular account are collected at one place in the Ledger. In short, a Ledger is a book which contains all accounts of the business enterprise whether Personal, Real or Nominal.

According to L.C. Cropper, "The book which contains a classified and permanent record of all the transactions of a business is called the Ledger."

According to J.R. Batliboi, "The Ledger is the chief book of accounts, and it is in this book that all the business transactions would ultimately find their place under their accounts in a duly classified form."

A Ledger may be kept in the form of a bound register, or cards or punched sheets in a loose leaf binder. Each account in the Ledger is opened preferably on a separate page or card.

Need and Importance

The basic objective of accounting is to ascertain as to (I) how much amount is due from each customer or how much amount the firm has to pay to each supplier; (II) how much is the amount of purchase and sale during a particular period; (III) how much amount has been spent on each head of expenditure and how much amount has been earned on account of each head of income. The Journal fails to provide us the above informations because it is only a chronological record of the daily transactions of a business.

Transactions of the same nature are not recorded at one place in the Journal. For example, if we want to know on a particular date the amount due from Surender Mohan & Company, the various transactions pertaining to them will have to be sorted out from Journal or Subsidiary Books and will have to be collected at one place. From sales book the amount of sales made to them on each date will have to be ascertained, from sales return book the amount of goods returned by them will have to be ascertained, from cash book the amount received from them on different dates will have to be ascertained and even then some information may be omitted to be collected from various books.

But in the Ledger all the transactions pertaining to Surender Mohan & Company will be posted at one place in an account opened in their name, which will provide a complete picture of all the transactions relating to them at a glance. As such, the Ledger is a very useful book and is of the utmost importance in any enterprise. Hence, the Ledger is called the 'Principal Book'. It is also called the book of final entry because the transactions which are first entered in Journal or Subsidiary Books are finally incorporated in the Ledger.

Advantages of Ledger

(1) All accounts are opened on separate pages in this book. Hence, all the transactions pertaining to an account are collected at one place in the Ledger. As such,

by looking at the balance of that account, one can understand the collective effect of all such transactions at any point of time.

(2) Any type of information relating to the business can be easily obtained from the Ledger, such as (I) how much amount each customer owes to the firm; (II) how much amount the firm owes to each creditor; (III) how much is the amount of purchase and sales during a particular period; (IV) how much amount has been paid or received on account of various items, and (V) what is the ultimate position of assets and capital.

(3) A trial balance can be prepared with the help of ledger balances which helps in ascertaining the arithmetical accuracy of the accounts.

(4) A trading and profit and loss account can only be prepared with the help of ledger balances.

(5) A balance sheet can also be prepared with the help of ledger balances which depicts the financial position of the business.

Distinction between 'Books of Original Entry' and 'Ledger'

The books in which the business transactions are recorded first of all are termed as 'books of original entry' or Special Purpose subsidiary books. The Transactions from these books are then transferred into the ledger accounts. As such, the Ledger is called the 'Principal Book' because all transactions ultimately find their way into Ledger.

So far as cash book is concerned, it is also a book of original entry and a principal book as well. Because all the cash transactions are recorded for the first time in the cash book, it is therefore a book of original entry and it is also a principal book because when a cash book is maintained, a cash account is not prepared in the Ledger.

	Journal or Books of Original Entry	**Ledger**
1.	As the name indicates, all the transactions are first of all recorded in these books, i.e.. journal or subsidiary books such as purchases book, sales book etc. As the transactions are entered for the first time in these books, they are also referred to as books of primary entry.	All the transactions entered in Journal or Subsidiary Books are later transferred to the Ledger. As such, the Ledger is also called a book of final entry.
2.	In these books, transactions are entered in a chronological order, as and when they take place. As such the position of an account at any point of time cannot be ascertained from these books.	In this book, transactions are recorded in analytical order, i.e., all the transactions pertaining to a particular account are contained at one place in the Ledger. Thus, position of an account can be easily ascertained at any point of time.
3.	Full details of a transaction (narrations) are recorded in these books.	Full details of a transaction are not recorded in the Ledger.

4.	Final Accounts (trading, profit and loss account and balance sheet) cannot be prepared with the help of books of original entry.	Final accounts can be prepared with the help of Ledger balances.
5.	These books are considered as more authentic and reliable in comparison to the ledger, since these are the books in which the entry is recorded first of all.	Ledger is considered as less authentic and reliable in comparison to books of original entry, since entries are recorded in the Ledger at a later stage.
6.	The process of recording entries in the books of original entry is called 'journalising'.	The process of recording entries in the Ledger is called 'posting'.
7.	Page number of the Ledger, i.e., Ledger Folio (L.F.) is written in these books.	Page number of the Journal or subsidiary books, i.e., Journal Folio (J.F.) is written in Ledger.
8.	Accuracy of these books cannot be tested.	Accuracy of the Ledger Accounts is tested by preparing a Trial Balance.

Proforma of Ledger

Each Ledger account is divided into two equal parts. The left-hand side is known as the debit side and the right-hand side as the credit side. As an account is in 'T' shape, therefore, sometimes it is called 'T' account. The format of an account is as shown below:—

Dr. **NAME OF ACCOUNT** **Cr.**

Date	Particulars	J.F.	Amount	Date	Particulars	J.F.	Amount
			Rs.				Rs.

As shown above, there are four columns on each side of an account:—

(1) Date :— The date of the transaction is recorded in this column.

(2) Particulars :— Each transaction affects two accounts. The name of the other account which is affected by the transaction is written in this column.

(3) Journal Folio or J.F. :— In this column, the page number of the Journal or Subsidiary Book from which that particular entry is transferred, is entered.

(4) Amount:— The amount pertaining to this account is entered in this column.

Rules of Posting

Posting is the process of transferring entries from Journal or Subsidiary Books to the Ledger. The following rules should be observed while posting entries in the Ledger:—

(1) All transactions relating to an account should be entered at one place. In other words, two separate accounts should not be opened for posting transactions relating to the same account. If there are two customers with similar names, their accounts should be distinguished by writing their address against their names, say the Account of Anil (of Karol Bagh) and the Account of Anil (of Chandni Chowk).

(2) The word 'To' is used before the accounts which appear on the debit side of an account. Similarly, the word 'By' is used before the accounts which appear on the credit side of an account.

(3) If an account has been debited in the Journal entry, the posting in the Ledger should also be made on the debit side of such account. In the Particulars column, the name of the other account which has been credited in the Journal entry should be written for reference.

(4) If an account has been credited in the Journal entry, the posting in the Ledger should also be made on the credit side of such account. In the particulars column, the name of the other account which has been debited in the Journal entry should be written for reference.

(5) Similar amount which has been posted on the debit side of an account should also be posted on the credit side of another account.

(6) It is not necessary to write the word 'A/c' after the personal accounts.

Example On 1st April 2020, sold goods for cash Rs.20,000. Pass Journal entry and post it into Ledger.

Solution :

Journal Entry :

2020	Cash A/c	Dr.	20,000	
April 1	To Sales A/c			20,000
	(Cash sales)			

The above entry will be posted into Ledger Accounts as follows :—

Dr. **CASH ACCOUNT** **Cr.**

Date	Particulars	J.F.	Amount	Date	Particulars	J.F.	Amount
2020			Rs.				Rs.
April 1	To Sales A/c		20,000				

Dr. **SALES ACCOUNT** **Cr.**

Date	Particulars	J.F.	Amount	Date	Particulars	J.F.	Amount
			Rs.	2020			Rs.

				April 1	By Cash A/c		20,000

Posting of Compound Journal Entries

When in a Journal entry, two or more accounts are debited and only one account is credited or vice versa, the entry is termed as compound journal entry. In case of posting of a compound journal entry, posting has to be made in all the accounts whether debited or credited in the entry. For example, if on 10th April 2020, cash received from Gopal & Co. is Rs. 14,800 and discount allowed to them is Rs.200, the compound entry and the Ledger Accounts will be as follows :—

2020				
April 10	Cash A/c	Dr.	14,800	
	Discount Allowed A/c	Dr.	200	
	To Gopal & Co.			15,000
	(Cash received and discount allowed)			

Dr. **CASH ACCOUNT** **Cr.**

Date	Particulars	J.F.	Amount	Date	Particulars	J.F.	Amount
2020			Rs.				Rs.
April 10	To Gopal & Co.		14,800				

Dr. **DISCOUNT ALLOWED ACCOUNT** **Cr.**

Date	Particulars	J.F.	Amount	Date	Particulars	J.F.	Amount
2020			Rs.				Rs.
April 10	To Gopal & Co.		200				

Dr. **GOPAL & CO** **Cr.**

Date	Particulars	J.F.	Amount	Date	Particulars	J.F.	Amount
			Rs.	2020			Rs.
				April 10	By Cash A/c		14,800
				April 10	By Discount Allowed A/c		200

Closing and Balancing of Accounts

At the end of the accounting period or whenever needed, a businessman will be interested in knowing the position of various accounts. For this purpose, the accounts are balanced. Balancing of an account means that the debit and credit sides are totalled and the difference between the two sides is inserted on the side which is shorter so as to make their totals equal. If the debit side exceeds the credit, the balance is called a debit balance and on the other hand, if the credit side exceeds the debit, the balance is called a credit balance.

As discussed earlier, all the accounts are classified into three categories according to their nature, i.e., (1) Personal Accounts, (2) Real Accounts and (3) Nominal Accounts, There are different methods for balancing of each of the three categories of accounts discussed as below :—

(1) Closing of Personal Accounts :— From the balancing of these accounts we can ascertain as to how much amount is owing from each individual customer and how much amount is owed to each individual creditor. If a personal account shows a debit balance, it indicates the amount owing from him. On the contrary, if a personal account shows a credit balance, it indicates the amount owing to him.

In case the total of the debit side is in excess of the credit side, the difference between the two is inserted on the credit side of the account in order to make their totals equal. The words 'By Balance c/d', i.e., balance carried down are written against the amount of the difference. In the next accounting period, the balance is brought down on the debit side by writing the words 'To Balance b/d'.

On the contrary, if the total of the credit side is in excess of the debit side, the difference between the two is inserted on the debit side of the account in order to make their totals equal. The words 'To Balance c/d' are written against the amount of the difference. In the next accounting period, the balance is brought down on the credit side by writing the words 'By Balance b/d'.

Closing of Real Accounts

Real accounts include the accounts of cash in hand and the accounts of all other assets such as Land, Building, Furniture, Investments etc. Method of closing the Cash A/c and the accounts of all other assets is the same as that of personal accounts. When balanced, these will always show debit balances.

Closing of Nominal Accounts

Nominal accounts include the accounts relating to the expenses and incomes of the firm. These accounts do not require balancing. As the main purpose of opening the nominal accounts is to ascertain the net profit or loss of the firm, all such accounts are transferred to the trading and profit and loss account of the firm at the end of the financial period. (For details refer to chapter on Financial Statements).

Accounts relating to 'Goods' such as Purchases A/c, Sales A/c, Purchases Return A/c, Sales Return A/c and Stock A/c are not balanced. These accounts are closed by transferring them to Trading Account at the end of the year. (For details refer to chapter on Financial Statements).

Trial Balance

When posting of all the transactions into the Ledger is completed and the accounts are balanced off, it becomes necessary to check the arithmetical accuracy of the accounting work. For this purpose, the balance of each and every account in the Ledger is put on a list. The list so prepared is called a trial balance.

Ledger account which shows a debit balance is put on the debit side of the trial balance and the account which shows a credit balance is put on the credit side of the trial balance. Account which shows no balance, i.e., whose debit and credit totals are equal, is not entered in the trial balance. If the total of the debit side of trial balance equals to that of its credit side, it is proved that books are atleast arithmetically correct and there are no errors in the posting and balancing the ledger accounts. (Trial Balance will be discussed in a subsequent chapter in detail.)

If a trial balance is prepared for Problem 1, with the help of the above prepared ledger accounts, it will appear as follows :—

TRIAL BALANCE OF SIYA RAM & SONS

as at 30th April 2020

Name of Accounts	L.F.	Dr. Balances	Cr. Balances
			Rs.
Capital A/c			2,00,000
Mohan Garments			8,000
Hero Limited		18,000	
Drawings A/c		14,000	
Pawan Brothers			24,000
Cash A/c		1,48,050	
Furniture A/c		20,000	
Purchases A/c		1,11,000	
Purchases Return A/c			5,000
Sales A/c			79,000
Discount Received A/c			1,200
Discount Allowed A/c		150	
Rent A/c		2,000	
Salaries A/c		4,000	
Total		3,17,200	3,17,200

Significance of Various Balances Relating to Accounts

(1) Debit balance of a Personal Account indicates the amount which is owing to the firm by a person. In other words, he is the debtor of the firm.

(2) Credit balance of a Personal Account indicates the amount which is owing to the person concerned. In other words, he is the creditor of the firm.

(3) Bank Account is a personal account and not a real account because bank account is the account of some banking company which is an artificial person. If the bank account shows a debit balance it would indicate the balance of Cash at bank. On the other hand, if it shows a credit balance, it would indicate an overdraft balance.

(4) Debit balance of a Real Account shows the value of an asset in the books of the firm.

(5) Usually real accounts do not show credit balances.

(6) Debit balance of a Nominal Account indicates loss or expense.

(7) Credit balance of a Nominal Account indicates gain or income.

In brief, it can be said that:

(I) A debit balance is either an asset or an expense.

(II) A credit balance shows liability, capital or the income earned.

Posting of Opening Entry

We have seen that the first entry in each year's Journal is to record the opening balances of various assets and liabilities at the beginning of the new year. It is termed as the 'Opening entry'.

As the accounts of all the assets will be debited in an opening entry, an account for each asset will be opened in the Ledger and the posting will be made on the debit side by writing the words 'To Balance b/d'.

Similarly, as the accounts of the liabilities will be credited in an opening entry, an account for each liability will be opened in the Ledger and the posting will be made on the credit side by writing the words 'By Balance b/d'.

Thus, by posting the opening entry completely, all the accounts pertaining to assets and liabilities in the beginning will be opened in the Ledger.

Ledger Posting of Single Column Cash Book

Following points should be considered while posting a cash book :—

(1) Cash book itself serves as a cash account also and as such when a cash book is maintained, cash account is not opened in the Ledger. The cash book, hence, is a Subsidiary Book and a part of the Ledger also.

(2) Opening and closing balances of cash book will not be entered in the Ledger

anywhere.

(3) Because the Cash Book serves the purpose of a Cash Account also, the recording of a Cash transaction in the Cash Book means that posting of one aspect of a Cash transaction has been completed in the Cash Book itself. Hence, only the second aspect is to be posted in the Ledger for which the following rules will apply :—

(i) Posting from the Debit Side of the Cash Book :— In order to complete the double entry of the entries appearing on the debit side of Cash Book these are posted to the credit side of the respective accounts in Ledger by writing the words 'By Cash A/c

Thus, if on the debit side of the cash book, an entry 'To Manohar Lal Rs.7,200' appears, it means that cash has been received from Manohar Lal. Therefore, in the Ledger, the posting will be made on the credit side of Manohar Lats account by writing 'By Cash A/c Rs.7,200'.

(ii) Posting from the Credit Side of the Cash Book :— In order to complete the double entry of the entries appearing on the credit side of Cash Book these are posted to the debit side of respective accounts in Ledger by writing the words 'To Cash A/c'.

Ledger Posting of Double Column Cash Book

All entries appearing on the debit side of the bank column are posted to the credit side of respective accounts in Ledger by writing the words 'By Bank A/c' and vice versa.

It may be noted that, when the bank column is maintained in the Cash Book, the bank account is not opened in the Ledger. The bank column itself serves the purpose of a bank account. All contra entries marked 'C' are ignored while posting from the Cash Book to the ledger. This is because the double aspect of such transactions is completed in the Cash Book itself.

Note It will not be proper to calculate the balances of the above prepared accounts, because so far only the entries relating to Cash Book and Journal Proper have been posted in the above accounts. Entries from other books such as Purchase Book, Sales Book etc. will also be posted in the above accounts later on and only then the above prepared accounts will be balanced off.

Ledger Posting of Purchase Book

Purchase Book is a part of the Journal and as such, just like Journal, posting from this book has also to be made into the Ledger accounts. Following rules will be applicable while posting a Purchase Book :—

(1) Posting to Personal Accounts :— Purchase Book shows the names of the persons or parties from whom goods have been purchased on credit. These parties are the giver of goods to us. As such, according to the rule of 'Credit the Giver', posting will be made on the credit side of the party's account by writing the words 'By Purchases A/c'. Posting to the accounts of parties is done daily from the Purchase Book because if at any time the need arises to settle the account of a particular person, his account may immediately disclose the up to date position,

(2) Posting to Purchases Account :— Purchase Book is totalled normally on a monthly basis and the monthly total of Purchase Column will be posted to the debit side of the purchases account by writing the words 'To Sundries as per purchase book'.

(3) Posting to Input CGST Account:

Posting to Input SGST Account:

Posting to Input IGST Account:

Posting to these accounts will be made by writing the name of the party on their debit side.

Ledger Posting of Sales Book

Following rules will be applicable while posting a Sales Book :—

(1) Posting to Personal Accounts :— Sales Book shows the names of the persons or parties to whom goods have been sold on credit. These parties are the receiver of goods from us. As such, according to the rule of 'Debit the Receiver', posting will be made on the debit side of the party's account by writing the words 'To Sales A/c'. Posting to the accounts of parties is done on a daily basis from Sales Book because if at any time the need arises to ascertain the up to date balance of a particular party's account, his account may disclose the exact position.

(2) Posting to Sales Account: Sales Book is totalled normally on a monthly basis and the monthly total of Sales Column will be posted to the credit side of the sales account by writing the words 'By Sundries as per Sales Book'.

(3)Posting to Output CGST Account:

Posting to Output SGST Account:

Posting to Output IGST Account:

Posting to these accounts will be made by writing the name of the party on their credit side.

Ledger Posting of Purchase Return Book

(1) Posting to Personal Accounts :— This book shows the names of those persons to whom goods have been returned by us. These persons are the receiver of goods, as such posting will be made on the debit side of their personal accounts by writing the words 'To Purchase Return A/c'.

(2) Posting to Purchases Return Account:— Monthly total of Purchase Return Column of this book will be posted to the credit side of the Purchase Return Account by writing the words 'By Sundries as per Purchase Return Book'.

Ledger Posting of Sales Return Book

(1) Posting to Personal Accounts :— This book shows the names of those persons who have returned goods to us. Those persons are the giver of goods, as such posting will be made on the credit side of their personal accounts by writing the words 'By Sales Return A/c'.

(2) Posting to Sales Return Account:— Monthly total of Sales Return Column of this book will be posted to the debit side of the Sales Return Account by writing the words 'To Sundries as per Sales Return Book'.

Multiple Choice Questions (SET A)

Select the correct alternative:

1. While posting in personal accounts from the purchases book, posting is done :

(a) On Debit side

(b) On Credit side

(c) On Debit or Credit side

(d) None of the above

2. Which of the following accounts always shows a debit balance :

(a) Capital Account

(b) Sales Account

(c) Purchases Return Account

(d) None of the above

3. Received Rs.4,900 from Garima in full settlement of Rs.5,000. Posting of Rs.100 will be made to the :

(a) Debit side of Garima's A/c

(b) Credit side of Garima's A/c

(c) Debit side of Discount A/c

(d) Credit side of Discount A/c

4. Paid to Jigyasa Rs.l 1,500 in full settlement of Rs. 12,000. Posting will be made in Jigyasa's A/c :

(a) Rs. 12,000 on Debit side

(b) Rs. 12,000 on Credit side

(c) Rs.l 1,500 on Debit side

(d) Rs.l 1,500 on Credit side

5. Proprietor of the business withdrew goods from business for private use. It will be posted to the :

(a) Credit of Drawings A/c

(b) Debit of Purchases A/c

(c) Credit of Purchases A/c

(d) None of the above

6. The total of Purchase Return Column of Purchases Return book will be posted to the :

(a) Debit of Purchases A/c

(b) Credit of Purchases A/c

(c) Debit side of Purchases Return A/c

(d) Credit side of Purchases Return A/c

7. Purchased goods from Manoj of Rs.20,000 at 20% trade discount. Posting will be made in Manoj A/c :

(a) Debit side Rs.20,000

(b) Credit side Rs.20,000

(c) Debit side Rs. 16,000

(d) Credit side Rs. 16,000

8. Dinesh who owed us Rs.8,000 became insolvent and paid us 60% in full settlement. Posting will be made to Dinesh A/c :

(a) Rs.8,000 on Debit side

(b) Rs.8,000 on Credit side

(c) Rs.4,800 on Debit side

(d) Rs.4,800 on Credit side

9. Total assets in a business are Rs.8,00,000 and total liabilities are Rs.5,00,000. The difference is called:

(a) Income

(b) Expenses

(c) Capital

(d) Goodwill

10. Sold goods for cash of the list price of Rs.8,000 at 10% trade discount and 3% cash discount. Posting will be made in Discount A/c :

(a) Rs.216 on Debit side

(b) Rs.216 on Credit side

(c) Rs.240 on Debit side

(d) Rs.240 on Credit side

11. Normally, the following accounts are balanced :

(a) Personal A/c & Nominal A/c

(b) Real A/c & Nominal A/c

(c) Only Nominal A/c

(d) Personal A/c & Real A/c

12. Which of these accounts has debit balance?

(a) Income received in advance

(b) Bank loan

(c) Prepaid insurance premium

(d) Creditors for goods

13. Which of the following is known as "Principal Book of Accounting"?

(a) Ledger

(b) Journal

(c) Trial balance

(d) Balance sheet

14. The credit balance of a personal account is

(a) Cash in hand

(b) Amount receivable

(c) Income earned

(d) Amount payable

Answers

Multiple Choice Questions (SET A)

Select the correct alternative:

1. (b)	**2 .(d)**	**3 .(c)**	**4 .(a)**
5 .(c)	**6.(d)**	**7.(d)**	**8.(b)**
9. (c)	**10. (a)**	**11 .(d)**	**12. (c)**
13. (a)	**14.(d)**		

Multiple Choice Questions (SET B)

Select the correct alternative:

(1) Posting of transaction means

(a) entering transactions in Journal.

(b) entering transactions in Ledger.

(a) entering transactions in Trial Balance.

(d) entering transactions in Financial Statements.

(2) Ledger Account is prepared from

(a) Vouchers.

(b) Trial Balance.

(c) Journal.

(d) Financial Statements.

(3) Trial Balance shows

(a) both debit and credit balances,

(b) only debit balance.

(c) only credit balance.

(d) either of debit or credit balance.

(4) Ledger is a book in which

(a) Real and Nominal Accounts are maintained.

(b) Real and Personal Accounts are maintained,

(c) Real, Personal and Nominal Accounts are maintained.

(d) Personal and Nominal Accounts are maintained.

(5) The process of transferring the transactions from the Journal to the ledger is called

(a) Journalising.

(b) Posting.

(c) Balancing.

(d) Costing.

(6) What type of Ledger Accounts are not carried forward to next year?

(a) Personal Accounts

(b) Real Accounts

(c) Nominal Accounts

(d) All of the above

(7) What type of following accounts will have debit balance only?

(a) Personal Accounts

(b) Real Accounts

(c) Nominal Accounts

(d) All of the above

(8) How many accounts are effected in a transaction?

(a) Only one

(b) Only Two

(c) At least two

(d) Two or Three

(9) When goods are lost by fire then Loss of Goods by Fire Account is debited with

(a) Cost of goods sold.

(b) Cost of goods sold plus Gross Profit.

(c) Cost of goods sold less Gross Profit.

(d) Cost of goods purchased.

(10) Which of the following expense is not a revenue expense?

(a) Salary

(b) Electricity

(c) Water

(d) Repair of second-hand machinery purchased

Answers

Multiple Choice Questions (SET A)

Select the correct alternative:

1. (b)	**2 . (c)**	**3 .(a)**	**4 .(c)**
5 .(b)	**6.(c)**	**7.(b)**	**8.(c)**
9. (d)	**10. (d)**		

Chapter 13

Trial Balance and Errors

"Trial balance is a statement, prepared with the debit and credit balances of Ledger accounts to test the arithmetical accuracy of the books". — **J.R. Batliboi**

Meaning of Trial Balance : All the businessmen after completion of postings from Journal or Subsidiary Books to the Ledger, want to verify accuracy of the posting. For this purpose a statement is prepared wherein the balances of all the accounts in the Ledger are incorporated. The statement so prepared is called 'Trial Balance'. Accounts showing debit balances are put on the debit side of the trial balance and the accounts showing credit balances are put on its credit side. If the total of the debit side of the trial balance is equal to that of its credit side, it is presumed that the posting to the ledger is accurate.

The reason for agreement of a trial balance is that under the double entry system, each transaction is recorded two times, once on the debit side of an account and again on the credit side of another account. Thus, the total of all the entries on the debit side of all the accounts must be equal to the total of all the entries on the credit side of all the accounts. If the totals of both the sides of a trial balance are equal, it is proved that the books are atleast arithmetically correct.

Definitions of Trial Balance

According to Carter, "Trial Balance is the list of debit and credit balances, taken out from ledger. It also includes the balances of cash and bank taken from cash book."

According to William Pickles, "The statement prepared with the help of ledger balances, at the end of financial year (or at any other date) to find out whether debit total agrees with credit total is called Trial Balance."

Features or Characteristics of a Trial Balance

1. It is a list of balances of all ledger accounts and the cash book.
2. It is just a statement, and not an account.
3. It is neither a part of double entry system, nor does it appear in the actual books of accounts. It is just a working paper.
4. It can be prepared at any time during the accounting period, say, at the end of every month, every quarter, every half year or every year. Usually it is prepared at the end of accounting year before preparing the final accounts.
5. It is always prepared on a particular date and not for a particular period.
6. It is prepared to check the arithmetical accuracy of the ledger accounts.
7. If the books are arithmetically accurate, the total of all debit balances of a trial balance will be equal to the total of all credit balances.
8. A tallied Trial Balance is not a conclusive proof of the accuracy of the books of accounts since certain type of errors remain even when the Trial Balance tallies.

Objectives or Need or Functions of Preparing Trial Balance

The following are the objects or functions of preparing a trial balance :—

(1) To ascertain the arithmetical accuracy of the ledger accounts.

(2) To help in locating errors.

(3) To obtain a summary of the ledger accounts.

(4) To help in the preparation of Final Accounts.

(1) To ascertain the arithmetical accuracy of the ledger accounts : The trial balance provides a useful check upon the ledger postings. If a trial balance tallies, it is proved that the posting to the ledger accounts is correct. In other words, it ensures that both the aspects of each transaction have been posted into the ledger i.e., debit aspects have been posted on the debit side and the corresponding credit aspects on the credit side.

(2) To help in the detection or location of errors : If a trial balance does not tally, it indicates that some errors have occurred and the accountant will then proceed to locate such errors. Even a small difference in the trial balance is to be given the same importance and attention as a large difference because it may be possible that there may be a number of errors which have offset the effect of one another, resulting in a small composite difference.

(3) To obtain a summary of the ledger accounts : A Trial Balance serves as a summary of all the ledger accounts. Scanning the Trial Balance enables one to know the assets, liabilities, expenses, incomes etc.

(4) For the preparation of Final Accounts : As the trial balance contains the list of all the Ledger accounts, it provides a basis for further processing of accounting data,

i.e., preparation of final accounts namely Trading and Profit & Loss Account and a Balance Sheet.

Preparation of a Trial Balance

A trial balance may be prepared at any time, say, at the end of every month, quarter, half-year or year. Usually it is prepared at the end of the accounting period, so as to verify the arithmetical accuracy of the ledger accounts before the preparation of final accounts. It may be noted it is always prepared on a particular date and not for a particular period.

In order to prepare a trial balance, all the accounts showing debit balances in the Ledger are put on the debit side of the Trial Balance and the accounts showing credit balances are put on its credit side. If, however, an account shows no balance, i.e., the debit and credit totals of an account are equal, the account is not included in the Trial Balance. After this, the debit and credit columns of the Trial Balance are totalled and if the total is equal, it is said that the Trial Balance has tallied. It may be noted that a trial balance can be prepared only when all the ledger accounts have been balanced.

Treatment of Closing Stock in Trial Balance :

Generally, closing stock does not appear in the Trial Balance because, in most cases, it is brought into accounts at the time of preparing the Trading Account. However, in the following cases, closing stock will appear in the Trial Balance :

(i) If, before preparing the Trial Balance, closing stock is brought into accounts by

adjusting it against purchases by the entry :

Closing Stock A/c Dr.

To Purchases A/c

(iii) In case a Trial Balance is prepared after preparing the Trading Accounts.

(iii) In case a Trial Balance is prepared after passing adjustment entries.

Steps to Locate or Detect the Errors :

If the Trial Balance does not tally, steps must be taken to locate the errors which are causing discrepancy. The following steps may be taken, one after another, to locate the errors :

Step I. Recheck the totals of both the debit and credit amount columns of the Trial Balance.

Step 2. The exact figure of difference in the Trial Balance should be ascertained. After this, the subsidiary books should be gone through to see if any item of that amount remains unposted. For example, if the difference is of Rs.3,200, all the entries of Rs.3,200 should be scanned to ensure that they have been duly posted.

Step 3. The difference should be halved to find out if some figure equal to half the difference has been posted on the wrong side of an account thereby making the difference double. For example, if the total of debit side of the Trial Balance exceeds by Rs.3,200, it is possible that a credit item of Rs.1,600 may have been posted to the debit side of a Ledger account.

Step 4. The difference in the Trial Balance should be divided by 9. If the difference is completely divisible, it can be a mistake of transposition of figures. For example, if the figure of 47 is written as 74, the difference is of Rs.27. This figure is completely divisible by 9. Likewise, if '0' is added against a figure, the difference will also be divisible by 9. For example, if the figure of 13 is written 130, the difference is Rs. 117 which is completely divisible by 9.

Step 5. In case, the difference is in a round figure, say Rs.l, Rs.10, Rs.lOO etc,, there will be a possibility of wrong totalling or wrong carry forwards of the totals of a subsidiary book or there will be an error in the balancing of an account. Hence, the totalling and balancing must be checked.

Step 6. Check with the help of the Ledger whether the balance of each and every account including the balances of Cash and Bank have been included in the Trial Balance on the correct side and with the correct amounts.

Step 7. Check whether all the closing balances from the previous year's Balance Sheet have been correctly carried forward and recorded in respective ledger accounts.

Step 8. Check the figures which are not clearly written.

Step 9. If the difference is of a very big amount, it is just possible that the balance of a certain Ledger account may not have been included in the Trial Balance. This can be detected by comparing the Trial Balance of the current year with that of the previous year. Also, if the figures of accounts under the same head show abnormal variation, the account should be rechecked to find out the cause of variation.

Step 10. If, in spite of all the above efforts, there is still a difference in the Trial Balance, a complete checking of the postings of all the entries will be necessary. A check mark (/) should be placed at the right of each amount to show that the item has been checked. It should also be checked that the totals of the subsidiary books have been posted to the relevant accounts in the Ledger.

Types of Errors :

All errors may be classified into the following two categories:

(1) Errors affecting Trial Balance (or errors disclosed by Trial Balance).

(2) Errors not affecting Trial Balance (or errors not disclosed by Trial Balance).

(1) Errors Affecting Trial Balance (or Errors Disclosed by Trial Balance): If the Trial Balance does not tally, it will indicate that certain errors have been committed which have affected the agreement of the Trial Balance. The accountant will then proceed to find out the errors and ultimately the errors will be located. Such errors are called 'Errors Disclosed by Trial Balance' or 'errors which affect the agreement of Trial Balance'. Until such errors are rectified, the Trial Balance will not agree. Some of the examples of such errors are as follows :—

(i) Wrong Casting : If the total of the Cash Book or some other Subsidiary Book is wrong, the Trial Balance will not tally. For example, the total of the Purchase Book has been added Rs. 1,000 in excess. When this total will be posted to the debit side of the purchase account, it will also show an excess debit of Rs. 1,000 and hence, the Trial Balance will not tally.

(ii) Posting to the Wrong Side : If instead of posting an amount on the debit side of an account, it is posted on the credit side, or vice versa, the Trial Balance will not tally. For example, goods for Rs.2,000 have been purchased from Gopal. If instead of posting the amount on the credit side of Gopal's account it is posted to his debit, the debit side of the Trial Balance will exceed the credit by Rs.4,000.

(iii) Posting of Wrong Amount: The Trial Balance will not tally if the posting in an account is made with an incorrect amount. For example, goods for Rs.600 have been purchased from Mahendra. If, it has been correctly entered in the Purchase Book but while posting to Mahendra's credit, the amount posted is Rs.60 instead of Rs.600, the Trial Balance will not tally.

(iv) Omission of Posting of One Side of an Entry : For example, if Rs.500 have been received from Ram and correctly entered in the Cash Book, but if it is omitted to be posted on the credit side of Ram's account, the Trial Balance will not tally.

(v) Double Posting in a Single Account : For example, if Rs.500 have been received from Shyam Lai and correctly entered in the Cash Book, but if it is posted twice on the credit side of Shyam Lai's account, the Trial Balance will not tally.

(vi) Errors of Totalling and Balancing of Accounts in the Ledger : Errors may occur in the totalling of debit or credit sides of accounts in the Ledger or in the balancing of accounts in the Ledger. Because the balances of accounts are transferred to the Trial Balance, it will not tally.

(2) Errors not Affecting Trial Balance (or Errors Not Disclosed by Trial Balance) : Main object of preparing a Trial Balance is to check the accuracy of the accounts. However, the equality of debits and credits of the Trial Balance does not mean that there are absolutely no errors in the books of accounts. There may be a number of errors which may remain undetected in spite of the agreement of a Trial Balance. As such, it is true to say that 'Trial Balance is not a conclusive proof of the accuracy of the books of accounts.' There are certain errors which do not affect the agreement of the Trial Balance. Such errors are also called limitations of Trial Balance. These may be discussed as below

(i) Errors of Omission: If a transaction remains altogether unrecorded either in the Journal or in Subsidiary Books, it will be termed as an error of omission. Such an error will not affect the agreement of a Trial Balance, as neither the transaction has been entered on the debit side of an account nor on the credit side of any other account. For example, suppose goods for Rs.2,000 have been sold to Ram on credit and the transaction was omitted to be recorded in the books. The omission will not affect the Trial Balance in any way, because neither has it been recorded on the debit side of Ram's account nor on the credit side of sales account.

(ii) Errors of Commission : If a wrong amount is entered either in the Journal or in the Subsidiary Books, the Trial Balance will tally because the same amount (though wrong) will be posted in both the accounts affected by the transaction. For example, sale of goods to Ram on credit for Rs.420 has been entered in the Journal as Rs.240. When the entry is posted to Ledger, Double Entry will be completed with Rs.240, Ram being debited with Rs.240, and sales account being credited with Rs.240. In spite of the inaccuracy in both the accounts, the Trial Balance will tally.

(iii) Compensating Errors : If the effect of one error is neutralised by the effect of some other error, such errors are called compensating errors. For example, while posting on the debit side of Anil's account, Rs.50 are posted instead of Rs.500 and while posting on the debit side of Sunil's account Rs.500 are posted instead of Rs.50. These two mistakes will nullify the effect of each other and in spite of the errors in both the accounts, the Trial Balance will still agree.

(iv) Errors of Principle : When some fundamental principle of Accountancy is violated while recording a transaction, the error is termed as error of principle. These errors are committed in those cases where a proper distinction between capital and revenue items is not made, i.e., a capital expenditure is treated as a revenue expenditure or **vice-versa**. These errors may be of two types :—

(a) When a capital expenditure is treated as revenue expenditure: For example, if the purchase of furniture is treated as an ordinary purchase and is thus debited to purchase account instead of furniture account, it will be an error of principle. Similarly, if amount spent on the extension of building is debited to repairs account instead of building account, it is also an error of principle.

(b) When a revenue expenditure is treated as capital expenditure: For example, if the amount spent on the repair of an old machinery is debited to machinery account instead of repairs account.

(v) Errors of Posting in Wrong Account : If, while posting from the books of original entry, posting is made to a wrong account but on the correct side, the error will not affect the agreement of Trial Balance. If, for example, goods are sold to Ram on credit but Shyam's account is debited in place of Ram's account in Ledger, the Trial Balance would tally in spite of errors in both the accounts.

Suspense Account

Sometimes, in spite of best efforts of an accountant, all the errors are not located and the Trial Balance does not tally. In such a situation, to avoid the delay in the preparation of final accounts, the difference in the Trial Balance is placed to a newly opened account known as "Suspense Account" and the Trial Balance tallies. If the debit side of the Trial Balance exceeds the credit side, the difference will be put on the credit side of the suspense account and if the credit side of the Trial Balance exceeds the debit side, suspense account will be debited. After including the balance of suspense account in the Trial Balance, it will appear to be tallied.

Later, when the errors are located, the rectification entries will be passed with the help of the suspense account. Therefore, when all the errors have been located and rectified, the suspense account will automatically stand closed. If suspense account still shows a balance, it will be taken to the Balance Sheet - on the assets side if it shows a debit balance or on the liabilities side if it shows a credit balance.

Multiple Choice Questions (SET A)

Select the correct alternative:

1. Which of the following errors is revealed by the Trial Balance :

(a) Wrong amount entered into the book of original entry

(b) Wrong amount posted in the ledger Account

(c) Complete omission of an entry from the books of original entry

(d) When accounting principle is violated while recording a transaction in the books of Account

2. Which item shows a debit balance in the Trial Balance?

(a) Purchase Return

(b) Salary outstanding

(c) Sales

(d) Prepaid Expense

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

(a) A sale of Rs.560 not recorded in Books at all.

(b) Rent paid to landlord was posted to Landlord's Account

(c) A purchase of Rs.840 was wrongly posted to sales Account.

(d) Instead of credited Shyam credited the other creditor Sham.

4. Which of the following errors will not affect the trial balance :

(a) Wrong balancing of an account

(b) Wrong totalling of an account

(c) Omission of an account from the trial balance

(d) Writing an amount in the wrong account but on the correct side

5. Rs. 10,000 received from Apoorva is credited in the account of Prachi. It is an error of

(a) Principle

(b) Omission

(c) Commission

(d) Compensatory

6. Which of the following is the error of principle?

(a) The purchase book was over casted by Rs.500

(b) Credit sale to Arun Rs.700 recorded as purchase from Arun

(c) Goods returned to Charu Rs.4,000, posted in Chinoo's A/c

(d) Wages paid for installation of machinery debited to Wages A/c

7. A machine is purchased for Rs. 10,000 which was wrongly recorded in purchase account. Due to this error……..

(a) Trial balance will show difference of Rs. 10,000

(b) Trial balance will not show any difference

(c) Trial balance will show the difference of Rs.20,000

(d) Trial balance will show a difference of Rs.5,000

Answers

Multiple Choice Questions (SET A)

Select the correct alternative:

1.(b)	**2. (d)**	**3. (a)**	**4.(d)**
5.(c)	**6.(d)**	**7 .(b)**	

Multiple Choice Questions (SET B)

Select the correct alternative:

(1) A Trial Balance is

(a) a statement.

(b) a summary,

(c) an account.

(d) None of these.

(2) An Asset Account shows a __________ balance.

(a) credit

(b) debit

(c) debit or credit

(d) None of these.

(3) Preparation of a Trial Balance is

(a) compulsory.

(b) optional.

(c) compulsory or optional.

(d) None of these.

(4) A Trial Balance shows

(a) only credit balance.

(b) only debit balance.

(c) both debit and credit balances.

(d) either debit or credit balance.

(5) Which item is shown as debit balance in the Trial Balance

(a) Cash in Hand.

(b) Rent Outstanding.

(c) Creditors.

(d) Bank Overdraft.

(6) Trial Balance is a list of the balance of

(a) All Accounts.

(b) Only Personal and Real Accounts.

(c) Only Real and Nominal Accounts.

(d) Only Personal Accounts.

(7) The preparation of Trial Balance helps in

(a) Judging the Financial Position.

(b) Locating Errors of All Types.

(c) Preparation of Final Accounts.

(d) None of these.

(8) Suspense Account is opened when:

(a) Balance Sheet does not match.

(b) Trial Balance does not match.

(c) Total of Sales Account does not agree.

(d) None of these.

Answers

Multiple Choice Questions (SET A)

Select the correct alternative:

1.(a)	**2. (b)**	**3. (b)**	**4.(c)**
5.(a)	**6.(a)**	**7 .(c)**	**8 .(b)**

Chapter 14

Bank Reconciliation Statement

Meaning of Bank Reconciliation Statement:

Usually, all the firms open a current account with a Bank and in order to record the transactions entered into with the bank, maintain a Bank Column in the Cash Book. Bank also opens a separate account for each firm in its ledger and enters all the transactions in it. Periodically, bank supplies a copy of the firm's account in its ledger to the firm for information. This copy of the firm's account supplied by the bank is called bank pass book or bank statement.

Since all the transactions entered with the bank are recorded in both the books, there should be no difference between the balance shown by the cash book and the pass book. The balance of the two books must tally with each other, because when the money is deposited into the bank, the firm enters it on the debit side of the bank column of the cash book and at the same time bank also enters it on the credit side of the firm's account maintained by the bank. On the other hand, when money is withdrawn from the bank, firm enters it on the credit side of the bank column of cash book and at the same time bank also enters it on the debit side of the firm's account in its books.

Hence, all the entries recorded on the debit side of the cash book must tally with the entries recorded on the credit side of the pass book and conversely, all the entries recorded on the credit side of the cash book must tally with the entries recorded on the debit side of the pass book. Therefore, at any time, the bank balance shown by the cash book must tally with the balance shown by the pass book. However, sometimes it so happens, that these two balances do not tally. This is, because on a certain date it is possible that there may be some entries which may have been recorded in the cash book but not in the pass book and vice versa. A statement is therefore prepared to identify the reasons for the difference and to reconcile the balances of the two books. Such a statement is called 'Bank Reconciliation Statement'.

Definition :— "Bank reconciliation statement is a statement prepared mainly to reconcile the difference between the 'Bank Balance' shown by the Cash Book and Bank Pass Book. " **— Patil**

Causes of Differences in the Cash Book and Pass Book Balance

The difference may arise on account of the following reasons :—

(a) Differences caused by Time gap in recording transactions.

(b) Differences caused by errors committed in recording transactions.

(a) Differences caused by Time Gap in recording transactions:

Quite often the difference between the Cash Book and Pass Book balance is caused by the time gap in recording the transactions. The reasons for time gap are as follows :

(1) Cheques issued but not yet presented for payment in the Bank: When a cheque is issued to a creditor by the firm, it is immediately recorded on the credit side of the bank column of the cash book. But the bank will debit the firm's account only when this cheque is actually presented to the bank for payment. Generally, there is a gap of some days between the issue of a cheque and its presentation to the bank. In the case of crossed cheques, the time lag is very high since such cheques can be presented for payment only through some bank. Thus, until the cheques are presented for payment, the cash book will show a reduced balance in comparison to the pass book.

(2) Cheques paid into the bank for collection but not yet credited by the bank : When a firm receives cheques, drafts etc. from its customers, they are immediately deposited into bank for collection and an entry is made on the debit side of the bank column of the cash book. But the bank will credit the firm's account only when it has actually collected the payment of these cheques from other banks. Again, there will be a gap of some days between the depositing of the cheques into the bank and credit given by the bank. In the case of outstation cheques, this gap will be very high. Thus, until the cheques are collected and credited by the bank, the cash book will show an increased balance in comparison to the pass book.

(3) Cheques paid into the bank for collection but dishonoured by the bank: When the cheques received from outside parties are deposited with the bank, these are immediately recorded on the debit side of the bank column of the cash book, but if the cheques are dishonoured, bank will not make any entry in the credit of customer's account. As a result, the cash book will show an increased balance in comparison to the pass book.

(4) Interest allowed by the bank : If a trader maintains a saving bank account, the bank allows a certain percentage of interest on the minimum balance of each month in such an account. Generally, the amount of such interest is credited by the bank at the end of six months. But the customer will come to know of the amount of interest only when he gets his pass book completed after a gap of time. In the intervening period, the balance of cash book will be comparatively less than the balance of pass book.

(5) Interest charged by the bank on Overdraft: When a bank gives a firm the facility of withdrawing in excess of its deposits, this excess withdrawal is called overdraft. The bank charges interest on this overdraft and debits the firm's account from such interest from time to time. But the entry for interest will be made in the cash book only when the customer receives a statement from the bank or when he receives the pass book duly completed. Until then, the balances of the two books will differ.

(6) Bank Charges and Commission charged by the bank : Bank renders many services to its clients and charges certain amount for these services. The notable charges levied by the bank are commission and collection charges on outstation cheques. The bank debits the customer's account with these charges but the customer will not make any entry in cash book until he receives a statement from the bank. In the intervening period, the two balances will differ.

(7) Direct deposit by customers into the bank : Some customers may directly deposit the amount in firm's bank account. The bank will immediately credit the firm's account on receipt of such a payment, but the firm will come to know of the deposit only when it receives the bank pass book duly completed after a gap of time. This also causes a difference.

(8) Interest and dividend collected by the bank : Sometimes bank collects interest and dividend on customer's investments. The bank credits the customer's account immediately on receipt of such payments, but the customer will make entries in the cash book only when he receives intimation from the bank pass book duly completed. Until such period, the two balances will differ.

(9) Direct payment made by the bank on behalf of customers : Sometimes an account holder gives a standing order to the bank to make certain payments such as insurance premium, rent etc. on his behalf. The bank makes these payments and debits the party's account, but the firm will be able to enter the same in its cash book only when the intimation is received from the bank. In the intervening period, the cash book will show an increased balance in comparison to the pass book.

(b) Differences caused by Errors Committed in Recording Transactions :

Sometimes the difference between the Cash Book and Pass Book balance may arise due to errors committed in recording transactions in the Cash Book or in the Pass Book. Hence, such errors may be of two types :

(1) Errors committed in recording transactions by the firm : Sometimes the firm may commit errors while recording entries in the Cash book. Such errors may be:

(i) Cheque issued to a creditor but omitted to be recorded in the Cash Book.

(ii) Cheques deposited into the bank but omitted to be recorded in the Cash Book.

(iii) Error in totalling or balancing the bank column of the Cash Book.

(2) Errors committed in recording transactions by the bank : Sometimes the bank commits an error and records a wrong entry in the customer's account which causes a difference between the bank balance shown by the cash book and the balance shown by the pass book.

Need and Importance of Bank Reconciliation Statement

It is essential to prepare a bank reconciliation statement due to the following reasons :—

(1) A bank reconciliation statement locates the errors or omissions that may have been committed either on the part of the customer or the bank. The errors so detected can be rectified accordingly.

(2) By preparing a bank reconciliation statement, the customer becomes sure of the correctness of the bank balance shown by the cash book. It helps him in making further transactions with the bank. For example, suppose the cash book shows a bank balance of Rs.20,000, whereas the balance shown by the pass book is Rs. 15,000. By reconciling the two, it is disclosed that cheques for Rs.5,000 were deposited into the bank but have not been collected so far (or some of these have been dishonoured). In such a case, further cheques will be issued by assuming the bank balance of Rs. 15,000 only.

(3) A reconciliation statement facilitates the preparation of a revised cash book. For example, the entries relating to bank charges, interest allowed or charged by the bank, direct payment by the bank on our behalf etc. will be recorded in the pass book but for which there is no entry in the cash book. Such entries will now be recorded in the cash book as well.

(4) Periodic preparation of this statement reduces the chances of embezzlement by the staff of the firm or even that of the bank. For example, if a cashier merely makes an entry in the cash book but does not deposit the cash and cheques into the bank, it will be disclosed by preparing a bank reconciliation statement.

(5) A reconciliation statement helps in revealing the unnecessary delay in the collection of cheques by the bank.

(6) It also helps in keeping a track of cheques which have been sent to the bank for collection.

Procedure of Preparing Bank Reconciliation Statement

A reconciliation statement is prepared when an account holder gets the duly completed pass book from the bank. Immediately on receiving the pass book, he tallies the bank balance shown by the cash book with the balance shown by the pass book and, in case of any difference, items appearing in the pass book are checked and ticked with the items appearing in the cash book. Unticked items in both the books will be the points of difference. These will be noted on a piece of paper and then, with the help of these causes of difference, a statement of reconciliation will be prepared.

A bank reconciliation statement can be prepared by taking the balance either as per cash book or as per pass book as a starting point. If the statement is started with the balance as per bank column of the cash book, the answer arrived at in the end will be the balance as per pass book. Alternatively, if the statement is started with the balance as per pass book, the answer arrived at in the end will be the balance as per cash book.

The balance as per cash book may be either debit or credit and similarly the balance as per pass book may also be either debit or credit:—

1. (a) Dr. Balance as per cash book indicates that the trader has so much balance of deposit at the bank.

(b) Cr. Balance as per cash book indicates the amount which has been withdrawn in excess of the deposits. Credit Balance as per cash book is also called 'Overdraft Balance as per Cash Book'.

2. (a) Cr. Balance as per pass book indicates that the trader has so much balance of deposit at the bank.

(b) Dr. Balance as per pass book indicates the amount which has been withdrawn in excess of the deposits. Debit Balance as per pass book is also called 'Overdraft as per Pass Book'.

Notes :

(1) If cash book balance is given in the question at the start, but it is not clearly stated that this balance is debit or credit, it will be treated as a debit balance.

(2) If pass book balance is given in the question at the start, but it is not clearly stated that this balance is debit or credit, it will be treated as a credit balance.

(3) Balance as per Ledger Account means the Balance as per Cash Book.

(4) 'Balance as per Bank Book' or 'Balance as per Bank Statement' means the Balance as per pass book.

A bank reconciliation statement can be started from any of the balances mentioned below

A. Dr. Balance (Favourable balance) as per Cash Book

B. Cr. Balance (Unfavourable or Overdraft balance) as per Cash Book

C. Dr. Balance (Unfavourable or Overdraft balance) as per Pass Book

D. Cr. Balance (Favourable balance) as per Pass Book

Method of preparing a bank reconciliation statement from each of the above balances is explained below :—

(A) Method of preparing Bank Reconciliation Statement by Debit Balance of Bank Column of Cash Book : Entries on account of which the debit balance of the cash book is lesser in comparison to the credit balance of the pass book will be added while preparing a bank reconciliation statement and vice versa.

Items to be added (Plus Items):

(1) Cheques issued but not yet presented for payment: When a businessman issues cheques to its creditors, he immediately enters them on the credit side of his cash book. It reduces the balance of his cash book but the pass book balance will remain the same because the cheques have not been presented for payment in the bank. As such, the cheques should be added to the balance of the cash book in order to make it equal to the pass book balance.

(2) Credit made by the Bank for Interest: When the bank allows interest to a customer, the bank credits the customer's account with the amount of such interest. It increases the pass book balance but the balance of the cash book will be the same, as there is no entry of interest in the cash book. Flence, it should be added to the cash book balance.

(3) Amount directly deposited by the customers in our bank account : Such deposits must have increased the balance of the pass book but the cash book will show' an unchanged balance. Therefore, this amount should be added to the cash balance.

(4) Interest and dividend collected by the bank : The bank must have credited these amounts to the customer's account. As such, the pass book balance must have increased whereas the cash book will show an unchanged balance. Therefore, this amount should be added to the cash balance.

(5) Cheques paid into the bank but omitted to be recorded in the cash book : Bank must have credited these cheques in the customer's account, but as there is no entry' in the cash book it shows a lesser balance. Hence, the amounts should be added to the cash book balance.

Items to be deducted (Minus Items):

(1) Cheques sent to the bank for collection but not yet credited by the bank : When the cheques were deposited into bank, entry must have been made on the debit side of the cash book. The balance as per cash book must have increased but the bank will not enter them unless they have been collected. As such, the cash book will show an increased balance in comparison to the pass book. Hence, the amount will be deducted while preparing a bank reconciliation statement.

(2) Cheques sent to the bank for collection but dishonoured by the bank: Such cheques must also have been entered on the debit side of the cash book but there will be no entry in the pass book, as the cheques have dishonoured. As a result, the cash book will show an increased balance in comparison to the pass book. Therefore, the cash book balance will be deducted in order to make it equal to the pass book balance.

(3) Direct payment made by the bank on behalf of customers : The bank makes payment for insurance premium, rent etc. and debits the customer's account. As such, the pass book balance is reduced whereas the cash book balance remains the same. Hence, this amount should be deducted from the balance of the cash book.

(4) Debits made by the bank for Commission, Bank Charges etc. : It also reduces the pass book balance whereas the cash book balance remains the same. Hence, the amount of bank commission and charges should be deducted from the balance of the cash book.

(5) Cheques issued but omitted to be recorded in the cash book : The bank, while making payment of these cheques, will debit the customer's account. Hence, the balance of the pass book will be reduced, whereas the cash book balance will remain unchanged, i.e., increased as compared to pass book. Hence, the amount of such cheques should be deducted from the cash book balance.

Format of Bank Reconciliation Statement when Dr. Balance as per Cash Book is taken as a starting point:

BANK RECONCILIATION STATEMENT

as on ....

Particulars	Plus Items	Minus Items
	Rs.	Rs.
Dr. Balance (favourable balance) as per Cash Book	xxx	
Add: 1. Cheques issued or drawn but not yet presented for payment.	xxx	
2. Interest allowed by bank not recorded in Cash Book.	xxx	
3. Amount directly deposited by the customers in our bank account.	xxx	
4. Interest and dividends collected by bank on trader's investments.	xxx	
5. Cheques paid into bank but omitted to be entered in the Cash Book.	xxx	
6. Any wrong credit given by bank in the Pass Book.	xxx	
Less: 1. Cheques paid into bank for collection but not yet credited by bank.		xxx
2. Cheques paid into bank for collection but dishonoured by the bank.		xxx
3. Direct payment made by the bank according to the standing		

instructions of customers.		xxx
4. Bank Charges and commission charged by bank.		xxx
5, Cheques issued but omitted to be recorded in the Cash Book.		xxx
6. Any wrong debit given by bank in the Pass Book.		xxx
	xxx	
Cr. Balance (favourable balance) as per Pass Book.	xxx	

Notes :

(1) In the above mentioned proforma, the bank reconciliation statement has been started from the debit balance of cash book. As such, the answer arrived, at will be the credit balance as per pass book.

(2) If the above statement is started from the credit balance (Overdraft) of the cash book, the starting balance will be written in minus items. All plus and minus items will be the same as mentioned in the above format. The answer arrived at will be the debit balance (Overdraft) as per pass book.

(3) If the above statement is started from the debit balance (Overdraft) of the pass book, the starting balance will be written in minus items and all items will be reversed, i.e. items shown in plus column in the above format will be written in minus column and items shown in minus column will be written in plus column. The answer arrived at will be credit balance (Overdraft) as per cash book.

(4) If the above statement is started from the credit balance, i.e. favourable balance of the pass book, the starting balance will be written in plus items and all items will be written as mentioned in point (3) above. The answer arrived at will be the debit balance as per cash book.

When Debit Balance (Favourable Balance) as per Cash Book is Given

(B) Method of preparing bank reconciliation statement by Credit Balance of Cash Book : If the cash book shows a credit balance (overdraft) at the start, the overdraft balance will be written in minus column and there will be no change in the column of all other items.

(B) When Credit Balance (Unfavourable or Overdraft Balance) as per Cash Book is Given

(C) Preparation of bank reconciliation statement by debit balance (overdraft) of Pass Book:

If bank reconciliation statement is started by Debit (i.e., unfavourable or overdraft) balance of Pass Book the starting balance will be written in minus items and all items will be reversed. In other words, items shown in plus column will now be written in minus column and items shown in minus column will be written in plus column.

(D) Preparation of Bank Reconciliation Statement from the Credit Balance of Pass Book :

If the bank reconciliation statement is started with favourable (or Credit Balance) of Pass Book, the starting balance will be written in Plus items and all items will be written in same columns as discussed earlier while starting with overdraft balance of pass book.

In brief: While starting a bank reconciliation statement as per the debit or credit balance of the cash book, the same treatment will be given to various items as given in the format but while starting the bank reconciliation statement with pass book Dr. or Cr. balance all items will be reversed, i.e. items shown in plus column will be written in minus column and minus items will be written in plus column.

Preparation of Amended Cash Book

Sometimes, in the examination, a student is required to complete the Cash Book first and then prepare a bank reconciliation statement on the basis of the balance of Amended Cash Book. This is another method for preparing bank reconciliation statement, the procedure for which is as follows :—

(1) First of all, a Cash Book will be prepared (with bank columns only). It will be started by writing down the balance of Cash Book given in the question.

(2) All errors that have been committed in the Cash Book will have to be rectified by passing adjusting entries in the cash book. Usual errors are :

(i) Overcasting or undercasting of debit or credit column of the Cash Book.

(ii) Cheques issued to creditors but omitted to be recorded in the Cash Book.

(iii) Cheques deposited into the bank but omitted to be recorded in the Cash Book.

(iv) Incorrect amount entered in the Cash Book.

(v) Entries on incorrect side or in wrong columns.

(vi) Any amount recorded twice in the Cash Book etc.

(3) Certain amounts for which bank has given credit in the Pass Book will be recorded on the debit side of Cash Book. Such items are :

(i) Interest allowed by bank,

(ii) Amount directly deposited by customers into the bank.

(iii) Interest and dividend collected by bank on our behalf.

(4) Certain amounts for which bank has debited our account will be recorded on

the credit side of Cash Book. Such items are :

(i) Interest charged by bank on overdraft.

(ii) Debits made by bank for bank charges, commission etc.

(iii) Direct payment made by bank on our behalf for insurance premium, rent etc.

(iv) Cheques sent for collection but dishonoured by the bank.

(5) Cash Book is then balanced and the new balance of Cash Book is taken as a starting point for preparing the bank reconciliation statement.

(6) It should be noted that the following items must not be recorded in the Amended Cash Book :

(i) Cheques deposited into bank but not credited by bank.

(ii) Cheques issued but not presented for payment in the bank.

(iii) Any wrong entry in Pass Book.

Multiple Choice Questions (SET A)

Select the correct alternative:

1. A bank reconciliation statement is :

(a) A part of Cash Book

(b) A part of Pass Book

(c) A statement prepared by the bank

(d) A statement prepared by a customer

2. A Pass Book is a copy of

(a) A customer's account in the bank's books

(b) Cash Book relating to bank column

(c) Cash Book relating to cash column

(d) Firm's receipts and payments

3. A bank reconciliation statement is prepared with the balance of

(a) Cash Book

(b) Pass Book

(c) Either Cash Book or Pass Book

(d) Neither Cash Book nor Pass Book

4. A bank reconciliation statement is prepared to ascertain the causes of differences between

(a) The balance as shown by the cash column of Cash Book with the balance of the Pass Book

(b) The balance as shown by the bank column of Cash Book with the balance of the Pass Book

(c) The balance as shown by the cash column of the Cash Book with that shown by its bank column

(d) The balance as shown by the Cheque Book and Pass Book.

5. Unfavourable bank balance means

(a) Credit balance in the Cash Book

(b) Credit balance in the Pass Book

(c) Debit balance in the Cash Book

(d) Favourable balance in the Cash Book

6. A bank reconciliation statement is prepared by

(a) Bank

(b) Customers of the bank

(c) Creditors

(d) Auditor

7. Which of the following will not be considered while preparing an Amended Cash Book?

(a) Cheques issued but not presented for payment

(b) Cheques deposited but not credited by bank

(c) Any wrong entry in the Pass Book

(d) All of the above

8. Which of the following transactions will result in higher balance in the bank column of Cash Book in comparison to Pass Book?

(a) Cheques issued but not presented for payment

(b) Interest allowed by bank

(c) Bank charges entered twice in Cash Book

(d) Cheques paid into bank for collection but not yet credited

9. Find out the Bank Balance as per Cash Book from the following particulars :

(i) Overdraft as per Pass Book = Rs. 5,000.

(ii) Cheques deposited into the bank but not credited = Rs.2,000

(a) Favourable Balance = Rs.3,000

(b) Overdraft = Rs.3,000

(c) Favourable = Rs.7,000

(d) Overdraft = Rs.7,000

10. Which of the following is not a part of Double Entry System?

(a) Cash Book

(b) Trial Balance

(c) Journal

(d) Bank Reconciliation Statement

11. Overdraft as per Cash Book is Rs. 10,000. Cheques deposited but not credited Rs.2,500. Cheques issued but not encashed Rs.3,500. What is the balance as per Pass Book?

(a) Balance Rs.9,000

(b) Overdraft Rs.9,000

(c) Overdraft Rs. 11,000

(d) Balance Rs. 11,000

12. The credit balance as per Cash Book is Rs. 1,500. Cheques for Rs.400 were deposited but were not collected. The cheques issued but not presented were Rs.100, Rs. 125 and Rs.50. Balance as per Pass Book will be :

(a) Rs.l,100 Debit

(b) Rs. 1,625 Debit

(c) Rs.2,175 Credit

(d) Rs. l,625 Credit

13. Bank charges Rs.5,000 debited twice in pass book. What should be done in BRS if overdraft as per cash book is starting point?

(a) Rs.5,000 must be deducted

(b) Rs.5,000 must be added

(c) Rs. 10,000 must be deducted

(d) Rs. 10,000 must be added

14. Payment done by the account holder through issuing a cheque is entered in

(a) the Pass Book at the time of issuing the cheque

(b) the Pass Book at the time of presenting the cheque to the bank for payment

(c) the Cash Book at the time of issuing the cheque

(d) Both (b) and (c)

Answers

Multiple Choice Questions (SET A)

Select the correct alternative:

1. (d);	**2. (a);**	**3. (c);**	**4. (b);**	**5. (a);**
6. (b);	**7. (d);**	**8. (d);**	**9. (b);**	**10. (d);**
11. (b);	**12. (b);**	**13. (b);**	**14. (d)**	

Multiple Choice Questions (SET B)

Select the correct alternative:

(1) Bank Reconciliation Statement is prepared so that the difference between the undermentioned balances can be reconciled:

(a) Difference in the balance in the bank and the cash balance.

(b) Difference in the balances in the Pass Book in the beginning and at the end.

(c) Difference in the Pass Book and Cash Book balances.

(d) None of the above.

(2) Pass Book of the account holder is a copy of

(a) the bank columns in the Cash Book of the account holder.

(b) the relevant account in the books of a bank.

(c) the cash columns in the Cash Book of a customer.

(d) None of the above.

(3) Bank Reconciliation Statement is prepared

(a) to know the payments made through cheques.

(b) to know the errors in the Pass Book.

(c) to compare the Cash Book with Pass Book and ascertain the differences.

(d) None of the above.

(4) Bank Reconciliation Statement is

(a) a part of Double Entry System.

(b) not a part of Double Entry System,

(c) part of Bank Statement.

(d) None of these.

(5) Balance shown in the Balance Sheet is of

(a) Cash Book.

(b) Pass Book.

(c) Adjusted Cash Book.

(d) None of these.

(6) Debit balance in the Cash Book is equivalent to

(a) Overdraft as per Pass Book.

(b) Credit balance as per Pass Book,

(c) Overdraft as per Cash Book.

(d) None of these.

(7) Bank Reconciliation Statement is prepared by matching

(a) entries in Pass Book with entries in bank columns of Cash Book.

(b) entries in Pass Book with entries in cash columns of Cash Book.

(c) entries in Pass Book with entries in bank columns and cash columns of Cash Book.

(d) None of the above.

(8) Bank Reconciliation Statement is prepared by

(a) Creditors.

(b) Debtors.

(c) Bank.

(d) Account holder.

(9) Which of the following will not require adjustment in the Cash Book balance?

(a) Cheque issued but not presented for payment.

(b) Cheque deposited but not cleared.

(c) Cheque wrongly credited by bank.

(d) All of the above.

(10) Bank Reconciliation Statement is prepared

(a) at the end of each week.

(b) at the end of each month.

(c) at the end of the accounting year.

(d) whenever a bank statement is received.

(11) A business receives its hank statement showing the closing balance as Rs. 8,500 overdrawn. It is found that there were unpresented cheques amounting to Rs. 2,000 and uncredited deposits amounted to Rs. 1,500. Overdraft as per Cash Book is

(a) Rs. 5,000.

(b) Rs. 8,000.

(c) Rs. 9,000.

(d) Rs. 12,000.

(12) Mohan's bank reconciliation statement shows cheques deposited but not credited by bank of Rs. 3,800 and cheques issued but not presented by suppliers of Rs. 3,500. His bank balance as per Cash Book is Rs. 25,000. Balance as per pass book statement is

(a) Rs. 25,000.

(b) Rs. 24,700.

(c) Rs. 25,300.

(d) Rs. 32,300.

(13) If balance in the bank statement shows Rs. 3,000 (Dr.) and there are deposits of Rs. 800 not yet credited and unpresented cheques totalling Rs. 500, the balance in the Cash Book should be

(a) Rs. 3,300 (Cr.).

(b) Rs. 2,700 (Cr.).

(c) Rs. 4,300 (Cr.).

(d) Rs. 1,700 (Dr.).

(14) Current account shows Rs. 1,000 as overdrawn. When bank statement is received, it was identified that one of debtors has deposited Rs. 400 into the account and bank charges of Rs. 20 had been debited to the account. Bank Statement balance is

(a) Rs. 1,420 (Dr.).

(b) Rs.620(Dr.).

(c) Rs. 4,300 (Cr.).

(d) Rs. 1,700 (Dr.).

(15) Cash book balance was Rs. 1,790 (Dr.). When compared with the bank statement, it was identified that unpresented cheques were Rs. 1,040 and deposits not credited were Rs. 820. Balance of the bank statement will

(a) Rs. 70 (Dr.).

(b) Rs. 1,570 (Cr.).

(c) Rs. 2,010 (Cr.).

(d) Rs. 3,650 (Cr.).

(16) Following details are related to a firm's banking transactions at 31st March, 2019. Balance as per bank statement Rs. 22,650; uncleared lodgements Rs. 3,110; unpresented cheques Rs. 6,290. Bank credit recorded twice by bank in error as Rs. 650.

Which balance for cash at bank should appear in the Balance Sheet as at 31st March, 2019?

(a) Rs. 18,820.

(b) Rs. 20,120.

(c) Rs. 25,180.

(d) Rs. 26,480.

Answers

Multiple Choice Questions (SET B)

Select the correct alternative:

1. (c);	**2. (b);**	**3. (c);**	**4. (b);**	**5. (c);**
6. (b);	**7. (d);**	**8. (d);**	**9. (c);**	**10. (d);**
11. (c);	**12. (b);**	**13. (b);**	**14. (b)**	**15. (c)**
16. (a)				

Chapter 15

Depreciation

Meaning: In every business there are certain assets of a fixed nature that are needed for the conduct of business operations. Some examples of such assets are Building, Plant and Machinery, Motor Vehicles, Furniture, Office equipment's etc. These assets have a definite span of life after the expiry of which the assets will lose their usefulness for the business operations. Fall in the value and utility of such assets due to their constant use and expiry of time is termed as depreciation. In other words, the process of allocation of the cost of a fixed asset over its useful life is known as depreciation.

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

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

Special features or Characteristics of Depreciation :

1. Depreciation is decline in the value of fixed assets (except land).
2. Such fall is of a permanent nature. Once the value of an asset is reduced due to depreciation, it cannot be restored to its original cost.
3. Depreciation is a gradual and continuing process because the value of the assets will decline either by their constant use or obsolescence due to expiry of time.
4. Depreciation is not the process of valuation of asset but process of allocation of the cost of an asset to its effective span of life.
5. It decreases only the book value of the asset, not the market value.
6. The term depreciation is used only in respect of tangible fixed assets. The term is not used for wasting assets such as mines, oil-wells etc.
7. It is a non-cash expense. It does not involve any cash outflow.

Causes of Depreciation :— Main causes of depreciation are as follows :—

(1) By Constant Use :— Due to the constant use of fixed assets in business operations wear and tear arise in them which results in the reduction of their values.

(2) By Expiry of Time :— The value of majority of assets decreases with the passage of time even if they are not being put to use in the business. Natural forces such as rain, winds, weather etc. contribute to the deterioration of their values.

(3) By Expiry of Legal Rights :— There are certain assets which have a definite span of life such as Lease. For example, if a lease has been obtained for 20 years for Rs.5,00,000, it will lose l/20th, i.e., Rs.25,000 of its value each year whether utilised or not, so that at the end of 20th year its value is reduced to zero.

(4) By Obsolescence :— Quite often, due to new inventions and improved techniques the old assets become obsolete and may have to be discarded even if they can be put to use physically.

(5) By Accident :— Sometimes a machine may be destroyed due to fire, earthquake, flood etc. or a vehicle may be damaged due to accident.

(6) By Depletion :—Depletion is the decrease in the value of wasting assets such as mines, oil-wells etc. due to their constant working.

(7) By Permanent fall in Market Price :— Though, the fluctuations in the market value of fixed assets are not recorded because such assets are not meant for resale but for use in the business, sometimes the fall in the value of certain fixed assets is treated as depreciation such as permanent fall in the value of investments.

Need, Importance or Objects of Providing Depreciation

(1) For ascertaining the true profit or loss :— The true profit of a business can be ascertained only when all costs incurred for the purpose of earning revenues have been debited to the Profit and Loss Account. As the Assets are used in earning revenues, the depreciation in the value of an asset is as much an expense as any other, such as wages, salary, rent etc.

(2) For showing the 'true and fair view' of the financial position :— If the depreciation is not charged, the assets will be shown in the Balance Sheet at an amount which is in excess of their true values. As such, the Balance Sheet will not present the 'true and fair view' of the financial position of a business.

(3) To ascertain the accurate cost of production :—As depreciation is also an item of expense, the correct cost of production cannot be calculated unless it is also taken into account. Sale price chargeable from customers is determined on the basis of cost of production and hence if the depreciation is not included in Cost of Production, the sale price will be fixed at lower rates and this in turn will lead to reduced profits.

(4) To provide funds for replacement of assets :—Depreciation though debited to Profit & Loss Account, is not paid in cash like other expenses. Hence, the amount of depreciation is retained in the business and is used for the replacement of fixed assets after the expiry of their estimated span of life.

(5) To prevent the distribution of profits out of capital:—If the depreciation is not charged, the profit shown by the Profit and Loss Account will be in excess of the actual profits. Such an excess profit may be wholly withdrawn by the proprietor or may be distributed among the shareholders as dividend. Hence, the amount of dividend distributed will also include the amount of depreciation which is actually a part of capital.

(6) For avoiding over payment of Income Tax :— Depreciation is a deductible expense for tax purposes. If depreciation is not debited to Profit and Loss Account, the net profit shown by it will be in excess of actual profits. Hence, we will also have to pay more income tax.

(7) Other Objectives :—If the depreciation is not charged, the net profit shown by Profit & Loss Account will exceed the actual profits and as a result:

(I) Employees may demand an increase in wages and bonus,

(II) It may also result in extravagance,

(III) It may lead to increase in competition in that type of business.

Factors determining the amount of Depreciation

It is impossible to calculate the actual and true amount of depreciation. It can only be estimated by keeping the following factors into consideration :—

(1) Total Cost of the Asset:—The cost of a fixed asset is determined after adding all expenses incurred for bringing the asset to usable condition, such as freight, transit insurance and installation costs etc.

(2) Estimated Useful Life of Asset:—Useful life of an asset is estimated in terms of number of years, it can be effectively used for business operations. For example, if a machine can work for 25 years but is likely to become obsolete in 15 years on account of availability of a better type of machine due to improved technology, its useful life will be considered as only 15 years.

(3) Estimated Scrap Value :— It is the estimated sale value of the asset at the end of its useful life. It is also known as residual value or break-up value. For example, a machine is purchased for Rs.60,000 and Rs.4,000 are spent on its freight and Rs. 1,000 for installation. It is estimated that its serviceable life will be 10 years at the end of which period it will have a scrap value of Rs.8,000. Depreciation in this case will be calculated on Rs.57,000 (i.e., Rs.60,000 + Rs.4,000 + Rs.1,000 - Rs.8,000).

Depreciation charged on this machine will be $\frac{57,000}{10}$ = Rs.5,700 every year.

Methods of Providing or Allocating Depreciation

Various methods have been devised for providing depreciation. Different methods are suitable for different assets depending upon the nature and type of the asset. These methods are enumerated as under

1. **Straight Line Method**
2. **Written Down Value Method**
3. **Annuity Method**
4. **Depreciation Fund Method**
5. **Insurance Policy Method**
6. **Revaluation Method**
7. **Depletion Method**
8. **Machine Hour Rate Method**

The first two methods are discussed below: —

(1) Straight Line Method:

This method is also termed as **'Original Cost Method'** because under this method depreciation is charged at a fixed percentage on the original cost of the asset. The amount of depreciation remains equal from year to year and as such the method is also known as **'Equal Instalment Method'** or **'Fixed Instalment Method'**. Under this method, the amount of depreciation is calculated by deducting the scrap value from the original cost of the asset and then by dividing the remaining balance by the number of years of its estimated life. The depreciation so calculated and charged annually will reduce the original cost of the asset to zero, or its scrap value, as the case may be, at the end of its estimated life. Under this method, the amount of depreciation is calculated by the following formula :—

$$\text{Yearly Depreciation} = \frac{\text{Original Cost of the Asset} - \text{Estimated Scrap Value}}{\text{Estimated Life of the Asset}}$$

For example, if the original cost of the asset is Rs. 1,00,000 and its scrap value is likely to be Rs. 15,000 after its estimated life of 10 years, the depreciation written off will be $\frac{1,00,000-15,000}{10}$ = Rs.8,500 every year.

Merits of Straight-Line Method

(1) Simplicity: —Calculation of depreciation under this method is very simple and as such the method is widely popular.

(2) Equality of Depreciation Burden: — Under this method, equal amount of depreciation is debited to the Profit and Loss Account of each year. Hence, the burden of depreciation on each year's net profit is equal.

(3) Assets can be completely written off: — Under this method, the book value of an asset can be reduced to net scrap value or zero value, which is not possible under some other methods.

(4) Knowledge of Original Cost and Up-to-date depreciation: — Under this method, the original cost of the asset is shown in the Balance Sheet and the up-to-date depreciation is shown as a direct deduction from it. As such, the information of Original Cost of the asset and its up-to-date depreciation is available at any time. Various assets also maintain their separate identity under this method.

Demerits:

(1) Difficulty in Computation: — When there are different machines having different life-spans, the computation of depreciation becomes complicated because the depreciation on each machine will have to be calculated separately.

(2) Unequal charge against income :— Repair charges go on increasing year by year as the asset becomes older but as the equal depreciation is charged under this method each year, the total burden charged to Profit and Loss Account in respect of depreciation and repairs put together will not be equal each year. The total burden will be lighter in earlier years and heavier during the later years.

(3) Undue pressure in later years :— It is a well-known fact that the efficiency and usefulness of a machine is more in the earlier years in comparison to later years. As such, more depreciation should be charged in earlier years in comparison to the later years, whereas, depreciation remains constant from year to year under this method.

(4) Omission of Interest Factor :— This method does not take into consideration the loss of interest on the amount invested in the asset. The amount would have earned interest, had it been invested outside the business.

(5) Unrealistic to Write off the Value of asset to Zero :— Sometimes, even after the value of an asset is reduced to zero in the books, it continues to be used in the business in actual practice.

(6) Difficulty in the determination of scrap value :— It is quite difficult to assess the true scrap value of the asset after a long period, say 15 or 20 years from the date of its installation.

Suitability: — This method is suitable for those assets whose useful life can be estimated accurately and which do not require much expenses on repairs and renewals.

Accounting Treatment

Following entries are passed in this method: —

1. **Entry for purchase of Asset: —**

Asset A/c Dr.

To Bank/Vendor A/c

2. **Entry for providing depreciation at the end of each year**

To Asset A/c

3. **Entry for the amount realised on sale of Asset: —**

Bank A/c Dr.

To Asset A/c

4. **Entry in case of loss on sale of Asset: —**

Profit & Loss A/c / Statement of Profit & Loss* Dr.

To Asset A/c

5. **Entry in case of profit on sale of Asset:—**

Asset A/c Dr.

To Profit & Loss A/c / Statement of Profit & Loss*

* In case of Companies, a 'Statement of Profit & Loss' is prepared in place of 'Profit & Loss A/c'

(2) Written Down Value Method

Under this method, as the value of asset goes on diminishing year after year, the amount of depreciation charged every year also goes on declining. For example, if a machine is purchased for Rs. 10,000 and depreciation is to be charged at 10% p.a. according to 'Written Down Value Method', the depreciation will be charged as under :—

		Rs.
1st Year on Rs. 10,000 @ 10%	=	1,000

2nd Year on Rs.9,000, i.e., 10,000 - 1,000 = 9,000 $\times\frac{10}{100}$	=	900
3rd Year on Rs. 8,100, i.e., 9,000- 900 = 8,100 $\times\frac{10}{100}$	=	810
4th Year on Rs. 7,290, i.e., 8,100- 810 = 7,290 $\times\frac{10}{100}$	=	729

and so on.

It will be observed from the above calculations that each year's depreciation is calculated on the book value of the asset at the beginning of that year, rather than on the original cost.

Book Value is the Written Down Value of the asset. In other words, it is that part of the original cost of the asset which has not been depreciated so far. Hence,

Book Value = Original Cost - Total Depreciation to date.

As the value of the asset and also the depreciation charged on it goes on reducing year after year, the method is also known as 'Reducing Instalment Method' or 'Diminishing Balance Method'.

Merits :

(1) Easy Calculation :— It is easy to calculate the depreciation under this method, even if some new assets are purchased year after year. Different assets are grouped for the purpose of providing depreciation.

(2) Equal charge against income :— In this method, the total burden on Profit & Loss Account in respect of depreciation and repairs put together remains almost equal year after year. This is so because in the initial years depreciation is more in comparison to repair charges whereas, in the later years, as the asset gets older, the amount of depreciation goes on decreasing while the expenses on repairs go on increasing, thus keeping the combined charge of depreciation and repairs almost uniform.

(3) No undue pressure in later years :— The efficiency and usefulness of a machine is more in the earlier years than in later years. Hence, the depreciation in first few years should be more in comparison to the later years. This is ensured by adopting the Diminishing Balance Method.

(4) Balance of asset is never written off to zero :— This method ensures that the asset is never reduced to zero so that some depreciation, however small, is debited to Profit & Loss Account so long as the asset remains in use.

(5) Approved method by Income Tax Authorities :— This method of providing depreciation is permissible under Income Tax regulations.

Demerits

(1) Asset cannot be completely written off :— Under this method, the value of an asset, even if it becomes obsolete and useless, cannot be reduced to zero and some balance, however small, would continue on Asset Account.

(2) Omission of Interest Factor :— As with the original cost method, this method also does not take into consideration the loss of interest on the amount invested in the asset.

(3) Difficulty in determining the rate of depreciation :— Under this method, the rate of providing depreciation cannot be easily decided. The rate is generally kept higher because it takes a very long time to write an asset down to its scrap value. If the rate of depredation is kept lower, the asset may become obsolete earlier.

(4) Knowledge of Original Cost and upto-date depreciation not possible :— Under this method, the original cost of various assets is not shown in the Balance Sheet. Sometimes, the assets are grouped in such a way that it becomes difficult to know their specific identity. The residue balance of some assets may continue in the Balance Sheet even after they have been actually scrapped.

Suitability :— This method is very suitable in case of assets having a comparatively long life and which require considerable repairs in the later years when they become older, such as building, plant etc.

Distinction between the two methods

Basis of Distinction	Straight Line or Original Cost Method	Written Down Value Method
1. **Amount of depreciation.**	Equal depreciation is charged every year.	Depreciation goes on decreasing year after year.
2. **Basis of calculation of depreciation.**	Depreciation is charged on the original cost of the asset.	Depreciation is charged on the reducing balance of the asset.
3. **Zero level.**	The book value of the asset can be reduced to zero.	The book value of the asset can never be reduced to zero.
4. **Combined effect of depreciation and repairs on P & L A/c.**	Combined burden on account of depreciation and repairs will be lighter in earlier years and heavier during the later years.	Combined burden on account of depreciation and repairs will be almost equal over different years.
5. **Rate of depreciation.**	Rate of depreciation is kept low in comparison to diminishing balance method.	Rate of depreciation is kept high in comparison to original cost method.
6. **Approval of Income Tax authorities.**	This method is not approved by Income Tax authorities.	This method is approved by Income Tax authorities.
7. **Suitability**	It is suitable for assets in which repair charges are	It is suitable for assets which require more repair

	less and the possibility of obsolescence is less such as land and buildings, patents, trade marks etc.	expenses with passage of time and where possibility of obsolescence is more due to technological changes such as plant and machinery, vehicles etc.

In practice, the Written Down Value Method is more widely used. This is so because the depreciation in this method goes on reducing according to the shrinking value of the asset.

Methods of Recording Depreciation

There are two methods of recording depreciation in the books :

(i) First Method : By Charging to Asset Account : In this case 'Provision for Depreciation Account is not maintained and the depreciation is directly credited to the 'Asset A/c'. Hence the Asset A/c appears in the Ledger at a written down value.

(ii)Second Method : By Creating Provision for Depreciation Account: In such a case, the depreciation is credited to 'Provision for Depreciation A/c' instead of 'Asset A/c' and hence the Asset A/c always appears in the Ledger at its original cost. The balance on the credit side of 'Provision for Depreciation A/c' shows the total amount of depreciation accumulated to date. However, when the asset is sold or discarded, the total accumulated depreciation for that asset is transferred to the credit side of the Asset A/c with the help of the following entry :

Provision for Depreciation A/c or Accumulated Depreciation A/c Dr.

To Asset A/c

After making the above entry, the balance in the provision for depreciation account will indicate the accumulated depreciation on the assets in service or unsold assets.

Asset Disposal Account

When part of the asset is sold or disposed off, it is appropriate to open a new account called 'Asset Disposal Account'. It provides a complete and clear view of all the transactions involved in the sale of an asset and shows the profit or loss on sale of asset. Method of recording the entries in Asset Disposal Account will depend on the fact whether a 'provision for depreciation account' is maintained or not. Entries in both these cases will be as follows :

When Provision for Depreciation Ale is not maintained	When Provision for Depreciation A/c is maintained
(i) For transferring the **book value** of the	(a) (i) For transferring the Original Cost of

asset sold to 'Asset Disposal Account' : Asset Disposal A/c Dr. To Asset A/c	the asset sold to 'Asset Disposal Account' : Asset Disposal A/c Dr. To Asset A/c (ii) For transferring the Accumulated Depreciation of the asset sold to Asset Disposal Account: Provision for Depreciation A/c Dr. To Asset Disposal A/c
(b) For recording sale proceeds of the asset: Bank A/c Dr. To Asset Disposal A/c	**(b)** For recording sale proceeds of the asset: Bank A/c Dr. To Asset Disposal A/c
(c) For profit on asset disposed off: Asset Disposal A/c Dr. To Statement of Profit & Loss In case of loss, the above entry will be reversed.	(c) For profit on asset disposed off: Asset Disposal A/c Dr. To Statement of Profit & Loss In case of loss, the above entry will be reversed.

Multiple Choice Questions (SET A)

Select the correct alternative:

1. What is the amount of difference between the closing balances of two machines after two years is both machines were purchased on the same date with the same amount i.e., for Rs. 1,00,000? Machine I is depreciated by 20% p.a. on Straight Line Method and Machine II is depreciated by 20% p.a. on Diminishing Balance Method:

(a) Value of Machine II is more by Rs.2,000

(b) Value of Machine I is more by Rs.4,000

(c) Value of Machine II is more by Rs.4,000

(d) Value of Machine II is less by Rs.2,000

2. Ambuja Cement Ltd. purchased a machine on 1-1-2020 for Rs.1,20,000. Installation expenses were Rs. 10,000. Its residual value after 10 year is Rs.5,000. On 1-03-2020 expenses on its repairs were incurred to the extent of Rs.2,000. Depreciation is provided under straight line method. Books are closed on 31st March every year. The amount of depreciation for the current year will be:

(a) Rs. 3,125

(b) Rs. 3,175

(c) Rs. 12,500

(d) Rs. 12,700

3. The balance of machine on 31st March 2020 is Rs.97,200. The machine was purchased on 1st April 2020. Depreciation is charged @10% p.a. by diminishing balance method. The cost price of the machine as on 1st April 2020 would be :

(a) Rs. 1,00,000

(b) Rs.1,20,000

(c) Rs. 1,08,000

(d) Rs. 1,32,000

4. Depreciation is provided on:

(a) Current Assets

(b) Intangible Assets

(c) Fixed Assets

(d) Fictitious Assets

5. Original cost of an asset is Rs. 1,26,000; Salvage value is Rs.6,000; Useful Life is 6 Years. The rate of depreciation under Straight Line Method will be:

(a) 15.87%

(b) 16.67%

(c) 15.80%

(d) 16.56%

6. In the books of D Ltd. the Machinery Account shows a debit balance of Rs.60,000 as on April 1, 2020 and Provision for Depreciation A/c at Rs.24,000. The machinery

was sold on September 30, 2020 for Rs.30,000. The company charges depreciation @20% p.a. on diminishing balance method. Profit / Loss on sale of the machinery is:

(a) Rs. 1,200 Profit

(b) Rs.2,400 Loss

(c) Rs.2,400 Profit

(d) Rs. 1,200 Loss

7. What will be the percentage of depreciation under SLM in the following case:

Original Cost of Machine	Rs. 1,50,000
Salvage value after 9 years	Rs. 15,000
Repair charges in 2nd year	Rs. 10,000

(a) 11.11%

(b) 10%

(c) 10.34%

(d) 9.37%

8. Which one of the following is not a feature of written down value method of depreciation?

(a) The book value of the asset becomes zero at any one point of time

(b) The depreciation is calculated on the book value of assets and not on the cost

(c) The amount of depreciation charged on a specific asset reduces every year.

(d) There is no need to estimate the residual value and estimated life at the time of deciding the amount of depreciation

9. Which of the following best describes the 'Depreciation' ?

(a) Valuation of fixed asset at the end of the year

(b) Verification of assets

(c) Allocation of cost of fixed assets over its useful life

(d) Decreasing the market value of asset

10. A machine was purchased on 1st April 2020 for Rs.5,00,000 and on 1st October, 2020 a new machine is added for Rs.2,00,000. Calculate the balance of machine account, if depreciation is charged at 20% p.a. on written down value method for the year ending March 31, 2020.

(a) Rs.6,00,000

(b) Rs.5,60,000

(c) Rs.6,60,000

(d) Rs.5,80,000

11. Amortisation refers to writing off............. ...

(a) Depleting Assets

(b) Wasting Assets

(c) Intangible Assets

(d) Fictitious Assets

12. Depreciation is calculated from the date of .

(a) Purchase of asset

(b) Receipt of asset at business premises

(c) Asset put to use

(d) Asset installed

13. A Ltd. purchased a machine on 1.1.2020 for Rs.1,20,000. Installation expenses were Rs.30,000. Residual value after 5 years Rs.5,000. On 1.7.2020, expenses for repair were incurred to the extent of Rs.2,000. Depreciation is provided @10% p.a. under written down value method. Total depreciation after 2nd year

(a) Rs.25,000

(b) Rs. 13,000

(c) Rs. 10,500

(d) Rs.28,500

14. The W.D.V. of an asset after three years of depreciation on reducing balance method @15% p.a. is Rs.49,130. What was its original value?

(a) Rs.40,000

(b) Rs.80,000

(c) Rs.45,000

(d) Rs.70,250

Answers

Multiple Choice Questions (SET A)

Select the correct alternative:

1. (c)	**2. (a)**	**3. (b)**	**4. (c)**
5. (a)	**6. (b)**	**7. (b)**	**8. (a)**
9.(c)	**10. (d)**	**11. (c)**	**12. (c)**
13. (d)	**14. (b)**		

Multiple Choice Questions (SET B)

Select the correct alternative:

(1) Depreciation arises because of

(a) wear and tear.

(b) inflation.

(c) fall in the value of the asset.

(d) None of these.

(2) The loss on sale of an asset is debited to

(a) reserves.

(b) depreciation fund.

(c) Profit and Loss Account.

(d) None of these.

(3) Diminishing Value Method means a method by which

(a) the rate of Depreciation falls year by year.

(b) the amount on which Depreciation is calculated falls year by year.

(c) the rate as well as the amount to which it is applied fall year by year.

(d) None of the above.

(4) Straight Line Method of Depreciation is that method under which

(a) Depreciation is charged at a fixed percentage on the book value of the asset.

(b) Depreciation is charged at a fixed percentage on the original cost of the asset.

(e) Depreciation is charged on original cost of asset but the depreciation rate changes.

(d) None of the above.

(5) The amount of Depreciation charged on machinery is debited to

(a) Depreciation Account.

(b) Machinery Account.

(c) Provision for Depreciation Account.

(d) None of these.

(6) Which of the following factors affect the amount of depreciation?

(a) Cost of the Asset.

(b) Expected Useful Life of the Asset.

(c) Expected residual value of the Asset.

(d) All of these.

(7) Depreciation on fixed assets is

(a) cash transaction.

(b) internal transaction.

(c) external transaction.

(d) No transaction at all.

(8) Which one is not the cause of depreciation?

(a) Efflux of time.

(b) Price fluctuation.

(c) Obsolescence.

(d) Natural wear and tear.

(9) Charging depreciation is

(a) compulsory.

(b) voluntary,

(c) dependent on the condition of assets.

(d) None of these.

(10) A machine is purchased on 1st April, 2018 for Rs. 80,000. Expenses incurred on its installation is Rs. 20,000. The residual value at the end of its expected useful life of 4 years is estimated at Rs. 10,000. The amount of depreciation under Straight Line Method, for the year ended on 31st March, 2019 will be:

(a) Rs. 22,500.

(b) Rs. 20,000.

(c) Rs. 17,500.

(d) Rs. 13,125.

(11) Depreciation is a

(a) Reserve.

(b) Provision.

(c) Both (a) and (b).

(d) None of these.

(12) Depreciation is

(a) Revenue Expenditure.

(b) Capital Expenditure.

(c) Deferred Revenue Expenditure.

(d) None of these.

(13) Depreciation is a process of

(a) valuation of asset.

(b) allocation of cost.

(c) both of valuation of asset and allocation of cost.

(d) None of the above.

(14) A machinery which costs Rs. 2,00,000 is depreciated at 25% per year using the Written Down Value Method. At the end of three years, it will have a net book value of

(a) Rs. 1,50,000.

(b) Rs. 84,375.

(c) Rs. 1,12,500.

(d) Rs. 1,00,000.

(15) Depreciation is charged on

(a) Current Assets.

(b) Fixed Assets.

(c) Total Assets.

(d) Fictitious Assets.

(16) The term amortisation is used to write off

(a) Fixed Assets.

(b) Intangible Assets.

(c) Tangible Assets.

(d) Wasting Assets.

(17) Amount of depreciation charged under diminishing balance method remains (a) Increasing.

(b) Decreasing.

(c) Fixed.

(d) Fluctuating.

(18) The term depreciation is used to write off

(a) Fixed Assets.

(b) Tangible Fixed Assets other than Land.

(c) Intangible Assets.

(d) Wasting Assets.

(19) Under diminishing balance method, depreciation is charged on

(a) Original Cost.

(b) Written Down Value.

(c) Cost of Production.

(d) Net Profits.

(20) Which of the following is not a cause of depreciation

(a) Wear and Tear.

(b) Passage of Time.

(c) Fall in the Market Value.

(d) Accident,

(21) An asset was purchased for Rs. 5,00,000 and as per reducing balance method, 20% deprecation is charged each year. What is the value of assets at the end of three years?

(a) Rs. 3,50,000.

(b) Rs. 2,56,000.

(c) Rs. 4,00,000.

(d) Rs. 3,20,000.

Answers

Multiple Choice Questions (SET B)

Select the correct alternative:

1. (a)	**2. (c)**	**3. (b)**	**4. (b)**
5. (a)	**6. (d)**	**7. (b)**	**8. (b)**
9.(a)	**10. (a)**	**11. (b)**	**12. (a)**
13. (b)	**14. (b)**	**15. (b)**	**16. (b)**
17. (b)	**18. (b)**	**19. (b)**	**20. (c)**
21. (b)			

Chapter 16

Provisions and Reserves

In order to strengthen the financial position of the business and with a view to meeting all eventualities -—both expected and unexpected, it is desirable that the entire profit should not be distributed among their owners. Some portion of the profit should be kept in the business for meeting the known as well as unknown liabilities in future. This is done, by making provisions and creating reserves out of current year's profits at the time of preparation of final accounts.

The terms 'provision' and 'reserve' are quite distinct from each other and cannot be used interchangeably. The law has defined the two terms clearly.

PROVISIONS

Meaning:

According to the Companies Act the term 'Provision' refers to any of the following amounts:—

(a) The amount written off or retained by way of providing for depreciation, renewals or diminution in value of assets; or

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

It should be clearly understood that if the amount of a known liability can be determined with reasonable accuracy, it must be classified as an outright liability and not a provision. Also if any excess provision is made knowingly or intentionally, the amount in excess of the actual need will be treated as 'reserve'.

Examples of Provisions :

Provisions are created for the fulfilment of various objectives :

1. Provision for Depreciation of Assets.
2. Provision for Taxation.
3. Provision for Bad and Doubtful Debts.
4. Provision for Discount on Debtors.
5. Provision for Repairs and Renewals of assets.

Characteristics or Features of Provisions

(1) Provision is made to meet a known liability.

(2) The liability is known but the amount of such liability cannot be determined with reasonable accuracy. For example, it is almost certain that some debts will prove irrecoverable but the exact amount of bad-debts cannot be predicted with certainty.

(3) Provision is a charge against profits and as such reduces the profits of the year in which it is created. The loss when actually occurs will be written off against such provision and thus the profit of the year in which such loss occurs will not be affected.

Purpose or Importance of Provisions:

(1) To ascertain the true net profit of the business: — In order to ascertain the true profit of a business it is necessary that all expenses pertaining to that year, whether paid or outstanding, must be debited to Profit and Loss account and a provision should also be made for expenses or liabilities the amount of which cannot be estimated with reasonable accuracy. For example, the provision should be made for doubtful debts, because the amount of such bad-debts cannot be estimated very accurately.

(2) To ascertain the true financial position of the business: — The Balance Sheet will depict the true and fair view of the financial position of the business only if adequate provision is made for all the anticipated losses and expenses.

(3) To provide for known losses in the future: —Funds will be required to meet the losses and liabilities that are likely to occur in the near future. As such, provisions are made to provide funds for meeting those losses such as provision for taxation, provision for repairs, provision Tor damages likely to arise from a pending suit and such others.

(4) For the equitable distribution of expenses: — For example, if a machine is estimated to run for 10 years and the total amount of repairs expected to be incurred during its entire life span is Rs. 10,000, a 'provision for repairs a/c' will be created by debiting Rs. 1,000 to each year's Profit & Loss Account. Actual expenses of repairs incurred each year will be debited to this account. Hence, it will put equal burden on the Profit & Loss Account of each year in respect of expenses of repairs which will be very light in the earlier years but definitely heavy in the later years.

RESERVES

Meaning:

Reserves mean amounts set aside out of profits and other surpluses to meet future uncertainties. In other words, a reserve is meant for meeting any unknown liability or loss in the future. According to William Pickles, "Reserves mean the amounts set aside out of profits and other surpluses, which are not earmarked in any way to meet any particular liability, known to exist on the date of the Balance Sheet".

Examples of reserves are:

(1) General Reserve,

(2) Capital Reserve,

(3) Dividend Equalisation Reserve,

(4) Investment Fluctuation Fund,

(5) Workmen Compensation Fund,

(6) Reserve for Redemption of Debentures.

It should be clearly understood that the amount of reserve does not represent any expense or loss and as such it is not debited to Profit & Loss Account. Creation of reserve does not reduce the net profits but only reduces the divisible profits. It is an appropriation of profits and hence after ascertaining the net profits it is debited to Profit & Loss Appropriation Account.

Characteristics or features of 'Reserves':

(1) It is created out of net profits or divisible profits. As such the reserves are also termed as 'Retained Earnings' or 'Undistributed Profits'.

(2) Creation of reserves is not a legal necessity. It is created voluntarily for strengthening the general financial position of the business and for meeting an unanticipated situation in the future.

(3) Normally, it is not created to meet any known liability or depreciation in the value of assets but for meeting an unknown liability or loss in the future.

(4) Reserves represent accumulated or undistributed profits and as such they belong to the proprietors just as capital does. They are available for distribution as dividends among shareholders and just as the capital is shown on the liabilities side of the Balance Sheet, they are also shown on the liabilities side.

(5) When the amount of reserve is invested in outside securities it is known as 'reserve fund'.

Purpose or Importance of Reserves:

(1) Helpful in meeting the unforeseen liability or loss: — If any unforeseen or abnormal loss arises in the future, reserves can be utilised to meet such eventualities.

(2) Helpful in strengthening the financial position of the business: — Reserves are undistributed or accumulated profits and technically known as 'ploughing back of profit'. It is a source of internal financing of the expansion of business. In case the reserves had not been maintained the profit would have been distributed as dividend among shareholders.

(3) Equalisation of dividends over the years: Goodwill of a Company depends upon maintaining a uniform rate of dividend from year to year and also to increase the dividend steadily. Reserves help the directors to achieve this objective because in the periods of inadequacy of profits, the amount can be withdrawn from reserves. Sometimes a reserve known as 'dividend equalisation reserve' is also created for the specific purpose of equalising the rate of dividend.

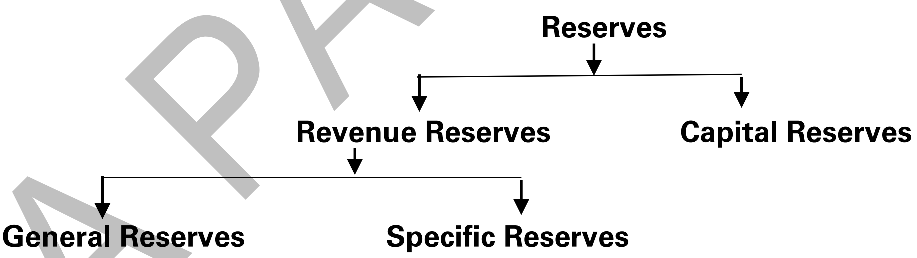
(4) To provide funds for meeting a specific liability :— Sometimes a reserve is created for a specific purpose such as 'Debenture Redemption Fund' for the payment of debentures. For example, if we need Rs.5 crore for the repayment of debentures after 10 years, a fund is created for this purpose by transferring a fixed amount from the divisible profits each year. The funds so accumulated may also be invested outside the business in such a way that after 10 years Rs.5 crore will become available for the payment of debentures. It will facilitate the payment of such a big sum in one go.

Difference between Provision and Reserve

Basis of Difference	Provision	Reserve
1. Meaning	It is created to meet a known liability.	It is created to meet an unknown liability.
2. Necessity (Charge or Appropriation)	Creation of provision is a legal necessity. Provisions have to be provided for even if there are no profits. Thus, provision is a charge against profits.	Creation of reserves is discretionary. It can be created only if adequate profits have been earned. Thus, reserve is an **Appropriation of Profit**

3. Object	The object is to provide for depreciation, doubtful debts and other specific liabilities.	The object of reserves is to strengthen the financial position of the business.
4. Mode of Creation	It is created by debiting to P & L A/c. Hence, net profit cannot be calculated unless all provisions have been debited to P & L A/c.	It is created not by debiting to P & L A/c but through P & L appropriation A/c. As such, it is created after the calculation of net profit.
5. Investment outside the business.	Provisions are never invested outside the business.	Reserves may be invested outside the business.
6. Presentation in Balance Sheet.	It is either shown on the assets side by way of deduction from the asset for which it is created or as a distinct item on the liabilities side.	It is shown on the liabilities side under the head 'Reserves and Surplus[1].
7. Utilisation for dividends.	It cannot be utilised for distribution as dividends among shareholders.	It can be utilised for distribution as dividends among shareholders.
8. Utilisation for other purposes.	It is created to provide for a specific loss and hence can only be used for meeting that loss.	It is not created to provide for a specific loss and hence can be used for any purpose.

Types of Reserves



Revenue Reserves :— These reserves come into existence out of profits which have been earned in the course of day-to-day business operations. Therefore, the revenue reserves represent undistributed profits and as such are available for the distribution of dividends.

Kohler has defined revenue reserves as, [1] 'that portion, or any detail thereof, of the net worth or total equity of an enterprise representing retained earnings available for withdrawal by proprietors."

Revenue reserves may be of the following two types :—

(A) General Reserve :— Usually, the businessmen do not withdraw the entire profits from the business but retain a part of it in the business to meet unforeseen future uncertainties. Profits so retained in the business for 'a rainy day' are known as 'General Reserve'. Similarly, Companies also do not distribute the entire profits as dividends but keep aside a part of it in the form of General Reserve. Such reserves are also termed as 'Contingency Reserves' or 'Free Reserves' because these are not created for any specific purpose and can be freely used for any purpose.

Objectives :— General Reserves may be created or utilised for any of the following purposes :

1. For meeting unforeseen losses.
2. For the strengthening of financial position of business.
3. For expansion of business through internal resources or ploughing back of profits.
4. For equalisation of dividends over years, in case of Companies.

It is not compulsory and binding upon the business enterprises to maintain general reserves. Such reserves may be created in the year in which the profits are sufficient and the management thinks it advisable to do so. General Reserves are shown on the liabilities side of the Balance Sheet under the head 'Owner's Equity'.

(B) Specific Reserve :— Such a reserve is created for a specific purpose and can be utilised only for that purpose. Examples of specific reserves are :—

(I) Dividend Equalisation Reserve: Such a reserve is created to maintain steady rate of dividend. In the years in which the profits are sufficient, a part of the profit is transferred to such reserve and it is utilised to keep the dividend up in the year in which the profits are insufficient.

(II) Reserve for Replacement of Asset:— Such a reserve is created to provide finances for the replacement of an asset at the end of its serviceable life. The amount of annual depreciation charged on assets is only capable of providing the original cost of the asset but the replacement of the asset will require a large sum of money due to the inflationary trend of prices. As such, a 'reserve for replacement of asset' is created to provide for the extra amount required for the purchase of the new asset. For example, if an asset was purchased 10 years ago at a cost of Rs.10 Lac and if the depreciation has been provided @ 10% on the original cost, it will provide only a sum of Rs.10 Lac. But, suppose, the current price of the asset is Rs.40 Lac, an additional sum of Rs.30 Lac will be required for purchasing a new asset. Therefore, the reserve is created for providing this additional sum.

'Reserve for Replacement of Asset' is created by annually transferring a certain amount from Surplus of Statement of Profit & Loss. Following entry is passed for this purpose :

Surplus of Statement of Profit & Loss Dr.

To Asset Replacement Reserve A/c

(Amount transferred out of divisible profits)

The amount of replacement reserve is either kept and utilised in the business itself or is invested in outside securities bearing interest at a pre-determined rate. When this reserve is invested in outside securities it is known as 'reserve fund'.

Such a reserve is created out of divisible profits. In other words, instead of declaring higher dividends the amount is transferred to replacement reserve. If such a reserve had not been created, the profit would have been distributed as dividend and the amount would have gone outside the business. The amount thus saved is accumulated from year to year and is utilised for the specific purpose of replacement of the asset. 'Reserve for Replacement of Asset A/c' is closed by transferring it to 'General Reserve A/c' at the end.

(III) Investment Fluctuation Fund : It is created to provide for decline in the value of investments due to market fluctuations.

(IV) Workmen Compensation Fund :— It is created to meet compensation payable to workers in case of unexpected or unknown event of an accident.

(V) Debenture Redemption Reserve :— It is created to provide funds for the redemption i.e., repayment of debentures.

Capital Reserves :— In addition to the normal profits, capital profits are also earned in the business from many sources. The reserves created out of such capital profits are known as Capital Reserves. Such reserves generally, are not available for distribution as cash dividend among the shareholders of a Company. Profits received from the following sources are termed as capital profits :—

1. Profits on the sale of fixed assets.
2. Profits on the revaluation of fixed assets and liabilities.
3. Premiums received on issue of Shares or Debentures.
4. Profit on the purchase of a running business.
5. Profit prior to the incorporation of a Company.
6. Profit from the reissue of forfeited shares.
7. Profit on redemption of debentures.

All the Capital profits mentioned above should be treated as Capital Reserves.

Capital reserves are used to write off Capital losses and for the issue of fully paid bonus shares. Usually, the capital reserves are not available for distribution as cash dividends. Some capital reserves can however be utilised to distribute dividends subject to fulfilment of the following conditions :—

1. Articles of the Company must not prohibit such dividend.
2. Capital profits must have been realised in cash.
3. Such profit remains after a fair revaluation of assets and liabilities.

All the same, it would be a prudent policy on the part of the management not to distribute such profits. They should be kept in the business to strengthen its financial position.

Distinction between Revenue Reserves and Capital Reserves

Basis of Distinction		Revenue Reserves	Capital Reserves
1.	**Source of Creation**	These reserves are created out of revenue profits which arise from the normal operating activities of the business and are otherwise available for distribution of dividends.	These reserves are created out of capital profits, which do not arise from the normal operating activities of the business and are not available for distribution of dividends.
2.	**Usage**	A specific reserve can be utilised only for the earmarked purpose while a general reserve can be utilised for any purpose including distribution of dividends to shareholders without any pre-conditions.	Normally, these reserves cannot be utilised for distribution of dividends to shareholders. However, some capital reserves can be utilised to distribute dividends subject to fulfilment of certain conditions laid down by Companies Act.
3.	**Purpose**	These reserves are created for meeting unforeseen losses and for strengthening the financial position of business.	These reserves are created to meet Capital losses or may be used for purposes laid down by Companies Act.

Secret Reserves : A secret reserve is one which is not disclosed by the Balance Sheet. These reserves are created by showing profit at figure much lower than actual and by showing the assets at a lower figure and liabilities at a higher figure. When secret reserves exist, the actual position of the firm is much better than what is disclosed by the Balance Sheet. Secret reserves may be created in the following ways :

(i) Writing off excessive depreciation;

(ii) Charging Capital expenditure (such as addition to assets) to Profit & Loss Account;

(iii) Treating a revenue receipt as a capital receipt (such as rent received credited to Building Account);

(iv) Undervaluation of assets (such as undervaluation of closing stock);

(v) Showing an actual asset as a contingent asset;

(vi) Showing a contingent liability as an actual liability;

(VI) Suppressing the sales;

(viii) Creating excessive or unnecessary provision for doubtful debts and other contingencies.

Advantages of Secret Reserves :

(i) Financial Stability : Creation of secret reserves strengthens the financial position of the enterprise without disclosing this fact to the shareholders or the public.

(ii) Helpful in Absorbing Unforeseen Losses : The presence of secret reserves enable such concerns to absorb any unexpected losses without any public discomfiture.

(iii) Regularity of Dividends : Such reserves help the enterprise in maintaining the rate of dividend during adverse trading conditions without disclosing this fact to shareholders or the public.

(iv) Avoidance of Competition : Because of concealment of actual profitability of the enterprise, the entry of the competing firms in the particular line of business is avoided.

Disadvantages of Secret Reserves :

(i) **Unfair Presentation of Financial Statements** : Statement of Profit & Loss fails to disclose true profit and the Balance Sheet fails to disclose a true and fair **view** of the financial position of the enterprise.

(ii) **Loss to Shareholders** : Shareholders who wish to sell their shares may not get actual price of their shares because of understatement of profits and financial position of the enterprise.

(iii) Misuse by Management : Fraudulent managements may take undue advantage by creating secret reserves. Profits may be suppressed to enable them to buy the shares of the Company at a lower price and then the profits may be enhanced by eliminating the secret reserves to enable them to sell the shares at a higher price.

(iv) Cover for Misdeeds of Management : Secret reserves may be utilised by management to cover their mistakes or misdeeds.

The creation of secret reserves is not allowed under the Companies Act, 2013 as it requires a full disclosure of all material facts and significant accounting policies followed in preparing financial statements.

Multiple Choice Questions (SET A)

Select the correct alternative:

1. If the amount of any known liability cannot be determined accurately.

(a) Provision should be created

(b) Definite liability should be created

(c) Reserve should be created

(d) Should be shown as a contingent liability

2. Which of the following is a correct difference between a provision and reserve?

(a) A provision is created out of a legal necessity whereas a reserve is created as a matter of prudence.

(b) A provision is invested whereas reserve is not invested

(c) A provision is an appropriation of profit whereas a reserve is a charge against profit

(d) A provision can be used for distribution of dividend whereas a reserve cannot be allowed to be used for distribution of dividend.

3. Which of the following is a correct distinction between a Revenue reserve and a Capital reserve?

(a) A revenue reserve is created out of capital profits whereas a capital reserve is created out of business profits.

(b) A revenue reserve can be used for distribution of dividend with certain preconditions whereas a capital reserve can be used for distribution of dividend without any preconditions

(c) A revenue reserve is created for strengthening the financial position whereas capital reserve is created for meeting capital losses or to be used for purposes specified by the Companies Act.

(d) There is no distinction between revenue reserve and capital reserve

4. Which of the following statements are correct about a “Provision”?

(i) Provisions are a charge against the profits of an enterprise

(ii) Provisions are created out of divisible profits

(iii) Creation of provisions are not necessary for a business

(iv) Provisions are created to meet a known liability

(a) (i), (U) and (iii)

(b) (ii) and (iv) only

(c) (i), (iii) and (iv)

(d) (i) and (iV) only

5. Which of the following statements is not appropriate in relation to “Provision”?

(a) Provision is a charge against profit

(b) Provision is created for known liability

(c) Provision is created for strengthening the financial position of the business.

(d) Creation of provision satisfies the principle of conservatism.

Answers

Multiple Choice Questions (SET A)

Select the correct alternative:

1. (a) **2. (a)** **3.(c)** **4.(d)** **5.(c)**

Multiple Choice Questions (SET B)

Select the correct alternative:

(1) Reserves arising from capital receipts are known as

(a) Capital Reserve.

(b) Reserve Fund,

(c) Any of (a) and (b).

(d) None of these.

(2) Provisions are

(a) external transactions.

(b) internal transactions,

(c) Can be (a) or (b).

(d) None of these.

(3) A Provision is

(a) an appropriation of profits.

(b) a charge against profit.

(c) Can be (a) or (b).

(d) None of these. –

(4) If the amount of any known liability cannot be determined with accuracy

(a) a liability should be provided.

(b) a provision should be made,

(c) a reserve should be set aside.

(d) None of these.

(5) If the amount of any known liability can be determined with accuracy

(a) a liability should be provided.

(b) a provision should be made,

(c) a reserve should be set aside.

(d) None of these.

(6) Provision is a

(a) Specific Reserve.

(b) General Reserve.

(c) Capital Reserve.

(d) None of these.

(7) Profit on sale of fixed asset is used to create

(a) Specific Reserve.

(b) General Reserve.

(c) Capital Reserve.

(d) None of these.

Answers

Multiple Choice Questions (SET B)

Select the correct alternative:

1. (a)	**2. (b)**	**3.(b)**	**4.(b)**	**5.(a)**
6.(d)	**7.(c)**			

Chapter 17

Bills of Exchange

In modem times a very large number of business transactions are made on credit basis. In case of credit sale of goods, the purchaser usually promises to make payment after a certain period. In such a case, the seller would like to get a written undertaking from the buyer to get the payment after a fixed period. As such, the seller prepares a document in which he puts in writing all the terms and conditions relating to sale of goods such as amount required to be paid; date of payment; place of payment; and the like. The buyer puts his signatures on the document and it is known as 'Bill of Exchange'.

As such, the bills of exchange are instruments of credit which facilitate the credit sale of goods. In India, these are known as 'Hundis' which are written in Indian languages and have been in use from the time immemorial. In western countries, the names used for such instruments are 'Bills of Exchange' and 'Promissory Notes'. The same names are now being increasingly used in India too. All such instruments are governed by Indian Negotiable Instruments Act, 1881.

Definition of Bill of Exchange

According to Indian Negotiable Instrument Act, 1881 :—

"A Bill of Exchange is an instrument in writing, an unconditional order signed by the maker directing to pay a certain sum of money only to or to the order of a certain person or to the bearer of the instrument."

Characteristics or Features of Bills of Exchange

On the basis of the above definition following are the main characteristics of bill of exchange :—

1. A bill of exchange must be in writing.
2. It must contain an order (and not a request) to make payment.
3. The order must be unconditional.
4. The amount of bill of exchange must be definite.
5. The date of payment must be a fixed one.
6. It must be signed by the maker (drawer) of the bill.
7. It must be signed by the acceptor (drawee).
8. The amount mentioned in the bill is payable either on demand or on the expiry of a fixed period.
9. The amount is payable either to the bearer of the bill or to a specified person or to his order.
10. It bears stamps according to its amount or is drafted on a stamped paper of the court.

Parties to a Bill of Exchange :— There are three parties to a bill of exchange :

(1) Drawer :— He is the seller or creditor entitled to receive money from someone. He writes or draws the bill and is known as drawer. The bill of exchange is signed by the drawer of the bill.

(2) Drawee or Acceptor :— He is the purchaser or the debtor on whom the bill is drawn and who is liable to pay the amount mentioned in the bill. He accepts to pay the amount by writing the word "Accepted" on the bill and then signs it. A bill is called a draft before it is accepted.

(3) Payee :— The person to whom the payment is to be made is called payee. The drawer himself or a third party may be the payee of the bill. The drawer will be the payee of the bill, if he retains the bill till the date of maturity and receives the payment.

The bank may also be the payee of the bill if the bill is discounted from the bank. In case the bill is endorsed by the drawer to a third party, the third party known as endorsee will be the payee of the bill. As such, the drawer himself or the bank or the endorsee may be the payee of the bill.

Advantages of Bills of Exchange :

(1) Helpful in the purchase and sale of goods on credit :— A bill of exchange serves as a written evidence of debt. It is a proof that the purchaser of goods (or the acceptor of the bill) owes the amount written in it. As such the goods can be sold on credit without difficulty.

(2) Legal Document :— It is a valid document in the eyes of law. If the drawee fails to make its payment, it would be easier to recover the amount legally in comparison to a verbal promise.

(3) Discounting Facility :— The holder of a bill need not wait till the due date of the bill to receive its payment as he can easily turn it into cash by discounting it from the bank before its due date.

(4) Endorsement Possible :— A bill of exchange can be easily transferred from one person to another in settlement of debts as it is a negotiable instrument.

(5) Relief from sending reminders :— The seller need not approach the purchaser time and again to demand the payment because the date of payment is fixed and written on the bill of exchange.

(6) Helpful in planning cash operations :— The seller knows the time when he would receive the money and, as such, he can plan his cash operations accordingly.

(7) Convenient means of making foreign payment:—Bills of Exchange enable the firms to receive and make payments in case of foreign trade also. It avoids the trouble and risk of transmitting the foreign currency from one place to another.

(8) Saving of money in circulation :—A bill of exchange performs the functions of money. By making payment through bills, the money in circulation will not be used and hence results in the saving of wear and tear in the currency in circulation.

(9) Convenience for the purchaser :— By accepting a bill, a purchaser gets time to make the payment. As such, he can purchase more goods and increase his business. Moreover, he cannot be called upon to make the payment at a date earlier than the one fixed in the bill.

Due to these advantages, bills of exchange have become extremely popular device for the grant of credit in business.

A bill of exchange closely resembles another document called the 'Promissory Note'.

Promissory Note :— Sometimes, the purchaser of the goods or debtor himself writes a note, signs it and gives it to the seller of the goods. It is called a 'Promissory Note'. According to Indian Negotiable Instrument Act, "A Promissory Note is an instrument in writing (not being a bank note or a currency note) containing an unconditional undertaking signed by the maker to pay a certain sum of money to, or to the order of, a certain person".

Features

(1) It must be in writing.

(2) There must be a promise to pay a certain sum of money in it. For example, " I owe you rupees ten thousand" is not a promissory note because it is merely an acknowledgement of debt and there is no promise to pay.

(3) The promise to make payment must be unconditional. For example, 'I promise to pay Rs. 10,000 as soon as possible" is not a promissory note because it is not unconditional.

(4) The amount to be paid must be specified (definite).

(5) It must be signed by the maker or promisor.

(6) The name of the payee must be mentioned in it.

(7) The promissory note cannot be made payable to bearer.

(8) It must be stamped according to its value.

Parties to a Promissory Note :

There are two parties to a promissory note :

(1) Maker :— He is the person who writes a promissory note and signs it. In the above specimen form of the Promissory Note, Prem Kishore is the maker.

(2) Payee :— He is the person who is entitled to get the payment. In the above case, Karima Sagar is the payee.

There is no acceptor in case of a promissory note because the maker himself is liable to pay the amount.

Distinction between a Bill of Exchange and a Promissory Note

	Basis of Distinction	Bill of Exchange	Promissory Note
1.	**Parties**	There may be three parties to it, viz., the drawer, the acceptor and the payee.	There are only two parties to it — the maker who draws the note and signs it and the payee to whom the amount is payable.
2.	**Drawer**	It is drawn by the creditor.	It is drawn by the debtor.
3.	**Order and Promise**	It is an order to make payment.	It is a promise to make payment.
4.	**Acceptance**	It needs acceptance by the drawee.	It does not need acceptance.
5.	**Liability**	The liability of the drawer is secondary. He will be liable	The liability of the drawer (maker) is primary.

		only if the acceptor does not pay.	
6.	**Payee**	Drawer can be the payee of the bill.	Maker cannot be the payee of it.
7.	**Noting**	It is better to get it noted in case of dishonour.	Noting is not necessary in case of a promissory note.
8.	**Copies**	In case of local bills only one copy is prepared but in case of foreign bills three copies are prepared.	Only one copy is prepared whether it is local or foreign.
9.	**Stamps**	There is no need of fixing the stamps on the bills payable 'on demand' but otherwise stamps would be necessary.	Stamps have to be fixed in any case.

Date of Maturity and Days of Grace :— The date on which the payment of the bill becomes due is called the 'due date' or 'date of maturity'. In other words, the date on which the duration of the bill comes to an end is called the due date.

While calculating the due date of the bill, it is compulsory to add three days to the period of the bill. These three days are called 'Days of Grace'. For example, if a bill is drawn on 1st July, 2020 and is payable 2 months after date, its maturity date will be 4th September, 2020.

The following points are very significant for calculating the date of maturity :—

(1) If a bill falls due in those months in which there is no corresponding day, i.e.,

29th, 30th or 31st dates, its maturity date will be the last date of such month. For example, if a bill was drawn on 30th January, 2020 for one month, it will become due on 28th February + 3 days of grace = 3rd March, 2020, because there is no 30th date in February.

(2) Bills drawn on 30th May or 31st May for one month will both become due on 3rd July.

Bill at Sight :— In a bill of exchange, the expressions, 'at sight' and 'on presentation' mean payable on demand. If no time for payment is mentioned in the bill, it is payable on demand. Bills payable on demand become due as soon as the bill is presented for payment. Such bills are not entitled to days of grace.

Bill after Date :— Where a bill is payable at a fixed period 'after date', the period begins to run from the date of drawing the bill. Three days of grace are allowed on such bills. For instance, a bill of exchange dated 1st January, 2020 is payable 2 months 'after date' and it is accepted on 15th January, 2020. The due date of the bill will be 4th March, 2020.

Bill after Sight:— The expression 'after sight' in a bill of exchange means after accepting. Thus, where a bill is payable at a fixed period 'after sight', the period begins to run from the date of acceptance. Three days of grace are allowed on such bills also. For instance, a bill of exchange dated 1st January, 2020 is payable 2 months 'after sight' and it is accepted on 15th January, 2020. The due date of the bill will be 18th March, 2020.

Accounting Treatment

For the purpose of accounting, bills are divided into two categories :

I. Bills Receivable or B/R.

II. Bills Payable or B/P.

The person who is entitled to receive money draws the bill and gets it accepted from the person who is liable to pay. As such, the same bill is a Bill Receivable (B/R) from the point of view of the drawer and a Bill Payable (B/P) from the point of view of the acceptor. In other words, the same bill is an asset (B/R) for drawer and a liability (B/P) for the acceptor.

Different Uses of Bills Receivable :—A party which holds a bill receivable can use it in either of the following ways :—

1. He may keep it till the date of maturity; or
2. He may discount it with the banker before the date of maturity; or
3. He may endorse it to some other party before the date of maturity; or
4. He may send it to his banker for collection.

(1) When the Bill is retained by the drawer in his own possession till the date of maturity

In such a case, the drawer will himself receive the payment of the bill on the date of maturity. The following entries are passed in the books of both the parties :—

	Transaction	**Journal Entries in Drawer (Suppose X)**	**the hooks of :— Drawee or Acceptor (Suppose F)**
1.	**When X sold goods to Y**	Y Dr. To Sales A/c (Goods sold on Credit)	Purchases A/c Dr. To X (Goods purchased on Credit)
2.	**When X received a bill duly accepted by Y**	Bills Receivable A/c Dr. To Y (Acceptance received)	X Dr. To Bills Payable A/c (Acceptance given)
3.	**When the bill is retained by X till the date of maturity and Y pays the**	Bank A/c Dr. To Bills Receivable A/c	Bills Payable A/c Dr. To Bank A/c

	amount of bill on maturity	(The amount of bill received on maturity)	(The amount of bill paid on maturity)

(2) When the bill is discounted from the bank :

If the holder of a B/R needs money before the date of maturity, he can discount the bill from the bank in order to obtain cash for it. Discounting means encashing the bill before the date of its maturity or borrowing from the bank on the security of the bill. Bank deducts a certain amount of discount from the face value of the bill and pays the balance to the person discounting the bill. The discount deducted by the bank is actually the amount of interest charged by the bank for lending the money. The amount of discount depends upon the rate of interest and the remaining period of the bill. Following entries are passed to record these transactions :—

	Transaction	**Journal Entries in the books of:—**	
		Drawer (Suppose X)	**Drawee or Acceptor (Suppose Y)**
1.	When A discounts the bill from the bank	Bank A/c Dr. Discounting Charges A/c Dr. To Bills Receivable A/c (Bill discounted)	NO ENTRY (No entry will be passed in the books of Y for the discounting of the bill, as he is not affected by the discounting of the bill)
2.	When Y pays the amount of the bill on the due date	NO ENTRY (Bank will receive the payment on the due date and as such no entry will be passed in the books of X because he has already received cash while discounting the bill.)	Bills Payable A/c Dr. To Bank A/c (The amount of the bill paid to bank)

Note 1. When a bill is discounted, it is more appropriate to debit bank account instead of cash because the banker does not make the payment in cash, rather the amount is credited in the party's account and as such the amount is deemed to be deposited with the banker.

(3) Negotiation of a Bill:

Negotiation means the transfer of bill of exchange to another person in such a manner that the transferee of the bill becomes its holder, who has the right to possess the bill in his own name and to recover the amount mentioned therein from concerned parties.

Modes of Negotiation :

A bill of exchange may be negotiated in the following two ways :

(i) Negotiation by delivery :— When a bill of exchange is payable to bearer, it may be negotiated by mere delivery. A bearer instrument does not require the signature of transferor.

(ii) Negotiation by endorsement and delivery :— When a bill of exchange is payable to a specified person or to his order, it can be negotiated only by endorsement and delivery. Endorsement is signing the bill for the purpose of negotiation.

Endorsement of a Bill

Endorsement means signing the bill of exchange for the purpose of transferring it to another. The holder of a bill receivable can endorse the bill to another person by putting his signature at the back of the bill. The person endorsing the bill is known as 'endorser' and the person to whom the bill is endorsed is called 'endorsee'. An endorsee may again endorse the bill over to some other person and the process may continue to any extent. The person holding the bill at the date of its maturity will be entitled to get its payment. Following entries are passed in case of endorsement:—-

Transaction		Journal of X	Journal of Y (Drawee)	Journal of Z,
1	If A endorsed a bill in favour of Z	Z Dr To B/R A/c (B/R endorsed to Z)	NO ENTRY	B/R A/c Dr. To A (B/R received)
2.	Y pays the amount of the bill on due date	NO ENTRY	B/P A/c Dr. To Bank A/c (The amount of the bill paid on due date)	Bank A/c Dr. To B/R A/c (The amount of the bill received)

(4) When the Bill is sent to the Bank for Collection

Sometimes, instead of discounting the bill, it is sent to the bank with the instructions to keep the bill till maturity and collect its amount from the acceptor on that date. In such a case, bank will not credit the Customers' A/c until the amount of the bill is actually realised by it.

Accounting Treatment :— When the bills are sent for collection, the sender of the bills opens a new account in its books named "Bills sent for Collection A/c." This is a personal account and is debited when the bills are sent for collection and is credited when the intimation of actual realisation is received from the bank. Following entries are passed :

(1) When bill is sent for collection :—

Bills sent for Collection A/c Dr.

To B/R A/c

(B/R sent to bank for collection)

(2) On the due date, when the intimation of actual realisation of the bill is received from the bank :—

Bank A/c Dr.

To Bills sent for Collection A/c

(Bill collected by bank)

Retiring a Bill under Rebate

When the drawee makes the payment of the bill before its due date, it is called retiring the bill. In such a case, the holder of the bill usually allows him discount, technically called 'rebate'. Such rebate is calculated at a specified rate per annum for the period the payment is being made too early. The rebate is a gain to the party making the payment and an expense to the party receiving the payment.

Transaction	Journal of X (Drawer)	Journal of Y (Drawee)
If Y retires his acceptance before the due date	Bank A/c Dr. Rebate on Bill A/c Dr. To B/R A/c (Amount received before due date and rebate allowed)	B/P A/c Dr. To Bank A/c To Rebate on Bill A/c (Amount paid before due date and rebate received)

Dishonour of a Bill

When the acceptor of the bill refuses to pay the amount of the bill on the date of maturity or becomes insolvent, it is called dishonour of the bill. In case of dishonour, the holder of the bill can recover the amount of the bill from any of the endorsers or the drawer. For this purpose, the holder of the bill must serve a notice of dishonour to the drawer and each prior endorser whom he seeks to make liable for payment. Such notice must be served immediately after dishonour or within a reasonable time. If this is not done, the holder of the bill loses his right to recover the amount from the party to whom such notice is not served.

Noting Charges :— To establish the fact that the bill was properly presented and dishonoured, the bill is usually handed over to a person called 'Notary Public', appointed by the court. The notary public again presents the dishonoured bill to the acceptor for payment and if the acceptor still refuses to make the payment, the Notary Public notes down the fact of dishonour on the bill itself. Such act of Notary Public is called 'Noting'. The notary public charges a small fee for the services rendered by him, which is called 'Noting Charges'. Such charges are paid to the Notary Public first by the holder of the bill, but are ultimately recovered from the acceptor, because he is the person responsible for the dishonour.

(1) Following entries are passed for the dishonour of the bill, in case the bill is held by the drawer himself till the date of maturity :—

	Transaction	Journal Entries in the hooks of: Drawer (Suppose X)	Drawee (Suppose YJ
1.	When 'P the acceptor of the bill dishonours the bill on the due date	Y Dr. To B/R A/c (Bill dishonoured or cancelled)	B/P A/c Dr. To A (Bill dishonoured or cancelled)
2.	When 'X' pays noting charges	Y Dr. To Cash A/c (Noting charges paid on Ps behalf)	Noting Charges A/c Dr. To A (Noting charges payable To X)
3.	Usually, a compound entry is passed for the two entries passed as above.	Y Dr. To B/R A/c To Cash A/c (Bill dishonoured and noting charges paid)	B/P A/c Dr. Noting Charges A/c Dr. To A (Bill dishonoured and noting charges paid by X)

Renewal of Bill

Sometimes, the acceptor of a bill finds himself unable to meet the bill on the due date. In such a case, he may request the holder of the bill to cancel the original bill and draw a new bill in place of the old one. If the holder agrees, a new bill will be drawn either for the lull amount of the old bill or for the balance amount in case of partial payment by the acceptor. In such a case, the drawer normally charges interest for the period of the new bill. The interest may be paid in cash or, as is more common, may be added in the amount of the new bill.

The entries to be made on the renewal of the bill are usually the same as in the case of dishonour. Because, first of all, an entry will have to be passed for the cancellation of the old bill.

Following entries are usually passed in case of renewal of bills :

	Transaction	Journal Entries in the books of :—	
		Drawer (Suppose X)	Drawee (Suppose Y)
1.	First of all, an entry is passed for the cancellation of the old bill.	Y Dr. To B/R A/c (Bill cancelled)	B/P A/c Dr. To X (Bill cancelled)
2.	When Y pays the amount of interest in cash.	Cash A/c Dr. To Interest A/c (The amount of interest received in Cash)	Interest A/c Dr. To Cash A/c (The amount of interest paid in Cash)
3.	When Y does not pay the amount of interest in cash.	Y Dr. To Interest A/c (Interest receivable from Y)	Interest A/c Dr. To X (Interest payable to X)
4.	When a new bill is received from Y.	B/R A/c Dr. To V (New acceptance received)	X Dr. To B/P A/c (New acceptance given)

(2) In case the bill discounted from the bank is dishonoured

In such a case, the noting charges will be paid by the bank. The bank will recover the noting charges from the person who discounted the bill from the bank and ultimately the noting charges will be borne by the acceptor. As such, the following entries will be passed in this case :—

Journal of X (Drawer)	Journal of Y (Drawee)
Y Dr. (Amount of bill - noting charges) To Bank A/c (Bill dishonoured and noting charges paid by bank)	B/P A/c Dr. Noting Charges A/c Dr. To A (Bill dishonoured and noting charges payable)

(3) When the bill endorsed to a third party is dishonoured

In such a case, the noting charges must have been paid by the endorsee. The endorsee will recover the noting charges from the endorser and ultimately these will have to be borne by the acceptor. The following entries will be passed in this case :—

Transaction	Journal of Drawer (Suppose X)	Journal of Drawee (Suppose Y)	Journal of Endorsee (Suppose Z)
Suppose, a bill which was received by X from Y, and was subsequently endorsed to Z, is dishonoured on the due date.	Y Dr. (Amount of bill + noting charges) To Z (Bill dishonoured and the amount of bill + noting charges receivable from Y and payable to Z)	B/P A/c Dr. Noting charges A/c Dr. To X (Bill dishonoured and noting charges payable toX)	X Dr. To B/R A/c To Cash A/c (Bill dishonoured and noting charges paid in cash)

Note :— (1) It may be noted that in case of dishonour of a bill, the drawer always debits the acceptor's account and credits the B/R A/c if he himself possesses the bill; or credits the bank's account if he discounted it with the bank; or credits the endorsee's account if he endorsed the bill.

(2) In case of dishonour of a bill, the acceptor always prepares the same entry whether the bill is presented for payment by the drawer himself or by the bank or by the third party. Whatever be the case, he will debit the B/P A/c and credit the Drawer's A/c.

When a bill is endorsed more than once and is dishonoured :

Accommodation Bills

Bills may be of two types

(i) Trade Bills, and (ii) Accommodation Bills

(i) Trade Bills :— When a bill is accepted to settle a trade debt it is known as 'trade bill'. Such bills are drawn for trade purposes and against proper consideration. For example, Xsells goods to Yand Y accepts a bill for the same, the bill will be called 'trade bill'.

(ii)Accommodation Bills :— Sometimes, in order to oblige a friend, a bill may be accepted without consideration. Such a bill is known as 'accommodation bill' or simply a 'kite' or a 'windmill'. Suppose A is temporarily in need of money. He approaches B to borrow Rs. 50,000 from him. B wants to help him but he is himself short of money. He may help A in another way i.e., by accepting a bill drawn on him by A. This bill will be discounted by A with his bank. The amount received from discounting of the bill will be utilised by A for the term of the bill and on the due date he will remit the amount of the bill to B, who in turn will meet the bill by making payment to the bank. Such a bill is known as an accommodation bill.

distinction between an ordinary bill (trade bill) and an accommodation bill

Basis for Distinction	Trade Bills	Accommodation Bills
1. Object	These bills are drawn against trade transactions of sale and purchase.	These bills are drawn for financial assistance.
2. Consideration	These bills are drawn against proper consideration.	These bills are drawn without consideration.
3. Proof of Debt	These bills are proof of debt. The drawee is a debtor.	These bills are not a proof of debt because the drawee is not a debtor.
4. Distribution of the proceeds	When these bills are discounted, the full proceeds remain with the drawer.	When these bills are discounted, the proceeds may be shared by drawer and drawee in pre-determined ratio.
5. Suit in the Court	In case of dishonour, the amount of trade bills may be recovered easily through the court.	Since the bills are drawn without consideration, the drawer cannot file a suit against drawee in case of dishonour. If, however, the bill is discounted or endorsed, any third party who gives value for the bill, can file suit against drawer, drawee or any prior endorser of the bill.

Multiple Choice Questions (SET A)

Select the correct alternative:

1. Aman draws a bill on Bimal for Rs.60,000. Aman wants to endorse it to Chirag in settlement of Rs.70,000 at 2% discount with the help of Bimal's acceptance and balance in cash. How much cash Aman will pay to Chirag?

(a) Rs. 8,200

(b) Rs. 8,000

(c) Rs.8,600

(d) Rs. 10,000

2. What account will be credited when discounted bill is dishonoured?

(a) Drawee's Account

(b) Drawer's Account

(b) Bank Account

(d) Endorsee's Account

3. Noting Charges are ultimately borne by :

(a) Drawer

(b) Drawee

(c) Payee

(d) Bank

4. Liability for a discounted bill is a

(a) Contingent Liability

(b) Fixed Liability

(c) Current Liability

(d) None of the above

5. If the due date of a bill falls on a public holiday then the bill is due on :

(a) One day after the due date

(b) Public Holiday

(c) One day before the due date .

(d) None of the above

6. Which account will be debited in the books of acceptor at the time of discharge of a bill?

(a) Bills Payable Account

(b) Cash Account

(c) Drawer's Account

(d) Endorsee's Account

7. X drew a bill on Y for Rs.20,000 for 3 months on 1-1-2020. The bill was discounted with banker at a charge of Rs. 100. At maturity the bill was returned dishonoured, the bank paid Rs. 100 as Noting charges. The bank account will be credited, in the books of X, for dishonour with :

(a) Rs. 19,900

(b) Rs.20,000

(c) Rs.20,100

(d) Rs. 19,800

8. A draws a bill on B for Rs.30,000. A endorses it to C in settlement of Rs.35,000 at 2% discount with the help of B's acceptance and the balance in cash. If the bill is dishonoured on the due date, by what amount will C debit A?

(a) Rs.30,000

(b) Rs.35,000

(c) Rs.34,300

(d) Rs.30,700

9. On 13-07-2020 Withdraws a bill on Y for Rs.25,000 for 30 days. The due date of the bill will be :

(a) 15th August, 2020

(b) 14th August, 2020

(c) 17th August, 2020

(d) 16th August, 2020

10. Under what circumstances the drawer and the payee is the same person, with reference to a bill of exchange?

(a) When the drawer discounts the bill with the banker

(b) When the drawer endorses the bill to a third party

(c) When the drawer holds the bill till the date of maturity

(d) When the drawee dishonour the bill

11. On 29th August, 2020, Mudit draws a bill on Paresh for one month, the due date will be ....

(a) 2nd October, 2020

(b) 29th September, 2020

(c) 3rd October, 2020

(d) 1st October, 2020

12. A endorsed a bill drawn on B for Rs.5,000 in favour of C. On the due date bill is honoured by B. Which account will be debited by B in his books?

(a) Bills Payable

(b) C's Account

(c) A's Account

(d) Bill Receivable

13. If a bill is accepted and the payment is made before the due date of maturity, the difference between the paid amount and the bill amount will be called as

(a) Interest

(b) Discount

(c) Rebate

(d) Commission

14. Satish draws a bill on Ashish for a sum of Rs. 10,000 payable after three months from the date of drawing of bill. Ashish gives his acceptance after adding a sentence "If my brother come back on due date". Satish claims that the bill has become invalid according to the Act.

(a) It should be signed by maker

(b) It should be unconditional

(c) It should be in writing

(d) It should contain a certain amount

15. On 1-6-2020 Anukriti draws a bill on Anurag for Rs.25,000. At maturity the bill is dishonoured and Rs. 100 is paid by Anukriti as noting charges. Anurag requests Anukriti to accept Rs.5,000 in cash and for the balance Anukriti draws a bill on

Anurag for 2 months with interest @12% p.a. What will be the amount of Interest?

(a) Rs.410

(b) Rs.420

(c) Rs.400

(d) Rs.402

16. Bill is drawn on 20th January, 2010 for 2 months. After sight date of acceptance is 29th January, 2010. The maturity date of bill will be :

(a) 1 April, 2010

(b) 23 March, 2010

(c) 20 March, 2010

(d) 29 March, 2010

17. Parul accepted a bill for 90 days of Rs.10,000 drawn by Rahul on 10th February, 2010. On 18th March, 2010, Parul wished to retire the bill, Rahul offered rebate @12% p.a. Considering the year of 360 days rebate amount will be

(a) Rs. 184

(b) Rs. 150

(c) Rs. 190

(d) None of these

18. Sohan draws a 40 days bill on Rohan on 20th January, 2010. The bill matures on

(a) March 4, 2010

(b) February 28, 2010

(c) March 1,2010

(d) None of these

19. Bill at sight has a grace period of

(a) 1 day

(b) 2 days

(c) 3 days

(d) None of these

Answers

Multiple Choice Questions (SET A)

Select the correct alternative:

1. (c)	**2. (c)**	**3. (b)**	**4. (a)**	**5. (c)**
6. (a)	**7.(c)**	**8. (d)**	**9. (b)**	**10. (c)**
11. (d)	**12. (a)**	**13. (c)**	**14. (b)**	**15. (d)**
16. (a)	**17. (c)**	**18. (a)**	**19. (d)**	

Multiple Choice Questions (SET B)

Select the correct alternative:

(1) A Bill of Exchange has .... parties.

(a) two

(b) three

(c) four.

(d) Seven.

(2) The party which is ordered to pay the amount is known as....

(a) drawer.

(b) payee.

(c) drawee.

(d) None of these.

(3) Three days are added for ascertaining the date of maturity. These are known as days of ....

(a) maturity.

(b) grace.

(c) payment.

(d) None of these.

(4) A Bill of Exchange cannot be...

(a) endorsed.

(b) crossed.

(c) accepted.

(d) None of these.

(5) A Bill of Exchange is renewed generally at the request of the ....

(a) drawer.

(b) bank.

(c) drawee.

(d) None of these.

(6) A Promissory Note is made by the...

(a) seller.

(b) purchaser.

(c) endorsee.

(d) None of these.

(7) If Ram's acceptance which was endorsed by us in favour of Saleem is dishonoured,

then the amount will be debited in our books to

(a) Saleem.

(b) Ram.

(c) Bills Receivable Account .

(d) None of these.

(8) A 4 months bill drawn on 1st January, 2019 will mature for payment on

(a) 3rd May, 2019.

(b) 4th May, 2019.

(c) 5th May, 2019.

(d) 10th May, 2019

(9) The Bills Receivable Book is part of

(a) the Journal.

(b) the Ledger.

(c) the profit.

(d) Balance Sheet.

(10) The Rebate on a Bill shows that

(a) it has been paid before the date of maturity.

(b) it has been paid after the date of maturity.

(c) it has been dishonoured,

(d) None of these.

(11) Noting Charges Account is debited by

(a) Drawer.

(b) Drawee.

(c) Payee.

(d) Endorser.

(12) If due date of a bill falls on a public holiday, then the maturity date is on

(a) one day after the maturity date.

(b) one day before the maturity date.

(c) Public holidays.

(d) None of these.

(13) In case of renewal of the bill, interest is charged for the period of

(a) Original Bill.

(b) Fresh Bill.

(c) One Month.

(d) None of these.

(14) Rebate is calculated for the period between date of

(a) Payment and Maturity Date.

(b) Drawing and Payment of Bill.

(c) Drawing and Maturity Date.

(d) None of these.

(15) A bill of Rs. 10,000 is renewed. The drawee pays Rs. 3,000 as part payment. The amount of interest charged is Rs. 200. What is the value of new bill?

(a) Rs. 700.

(b) Rs. 10,200.

(c) Rs. 9,000.

(d) Rs. 7,200.

Answers

Multiple Choice Questions (SET B)

Select the correct alternative:

1. (b) **2. (c)** **3. (b)** **4. (b)** **5. (c)**

6. (b)	7.(b)	8. (b)	9. (a)	10. (a)
11. (b)	12. (b)	13. (b)	14. (a)	15. (d)

Chapter 18

Rectification of Errors

"To error is human." Accountant, as a human being is likely to commit mistakes while recording the transactions in the books of original entry, posting them to Ledger accounts or in preparing a trial balance itself. It is essential to locate and rectify errors, otherwise profit and loss account will not disclose the true profit or loss of the business and the balance sheet will not present a true and fair view of the financial position of the business.

Errors should never be corrected by overwriting or erasing because it reduces the authenticity of accounting records and gives the impression that something is being concealed.

Method of rectification depends on the stage at which the errors are rectified. If an error is located in the books of original entry before its posting to the Ledger, it may be corrected by neatly crossing out the wrong figure by a single line and writing the correct figure above the crossed figure. Similarly, if a wrong figure has been posted to the correct Ledger account, it may also be corrected in the same manner.

If, however, an error is located after some time, it should be corrected by passing a suitable Journal entry, called rectifying entry.

From the rectification point of view, all errors can be classified into the following two categories :

(A) Errors which do not affect the Trial Balance or Two-sided Errors

(B) Errors which affect the Trial Balance or One-sided Errors

(A) Errors which do not affect the Trial Balance or Two-sided Errors :— Errors which affect two accounts simultaneously are called two-sided errors. Such errors may include the following types of errors :

(I) Omission to pass an entry in the books of original records,

(II) Wrong recording of a transaction in the books of original records,

(III) Posting to the wrong account, and

(IV) Errors of principle.

All these errors are rectified by passing a Journal entry, one account being debited and the other account being credited. Following rules should be observed while passing entries to rectify the two-sided errors

(I) The account showing an excess debit should be credited in the rectifying entry.

(II) The account showing a short debit should be debited in the rectifying entry.

(III) The account showing an excess credit should be debited in the rectifying entry.

(IV) The account showing a short credit should be credited in the rectifying entry.

These four rules as enumerated above can be explained by the examples given below:—

(I) When an account has wrongly been debited in place of another account.

Example : Machinery purchased for Rs.5,000 has been debited to Purchases A/c.

Solution :— This error affects the two accounts in the following manner :—

Dr. MACHINERY A/C	**Cr.**	**Dr. PURCHASES A/C**	**Cr.**
Short by Rs.5,000 (This account should		Excess by Rs.5,000 (This account was	

have been debited)		debited by mistake)	

While rectifying this mistake Machinery A/c will be debited because it was not debited earlier and the Purchases Ac will be credited because it was wrongly debited.

Rectifying entry :

Machinery A/c	Dr.	5,000	
To Purchases A/c			5,000

(For purchase of machinery wrongly debited to Purchases A/c)

Second Method

(i) Correct entry which should have been passed earlier :—

Machinery A/c	Dr.	5,000	
To Cash A/c			5,000

(ii) Wrong entry which has been actually passed :—

Purchases Ac	Dr.	5,000	
To Cash A/c			5,000

(iii) By comparing the correct entry and the wrong entry it will be ascertained that Machinery Ac should be debited and the Purchases Ac should be credited, as it has been wrongly debited earlier.

Rectifying entry which must be passed now.

Machinery A/c	Dr.	5,000	
To Purchases A/c			5,000

(II) When an account has wrongly been credited in place of another account.

Example :— Rs.3,000 being the sale proceeds of old furniture has been credited to Sales Ac.

Solution :— This error affects the two accounts in the following manner :—

Dr FURNITURE A/C Cr.		Dr. SALES A/C Cr.	
	Short by Rs.3,000 (This account should have been credited)		Excess by Rs.3,000 (This account was credited by mistake)

While rectifying this mistake Sales A/c will be debited because it has been credited by mistake and the Furniture A/c will be credited because it was not credited earlier.

Rectifying entry

Sales A/c Dr. 3,000

To Furniture A/c 3,000

(Sale of old furniture wrongly credited to Sales A/c)

Second Method

(i) Correct entry which should have been passed earlier :

Cash A/c Dr. 3,000

To Furniture A/c 3,000

(ii) Wrong entry which has been actually passed :

Cash A/c Dr. 3,000

To Sales A/c 3,000

(iii) By Comparing the correct entry and the wrong entry it will be ascertained that Sales A/c should be debited because it has been wrongly credited earlier and Furniture account should be credited.

Rectifying entry which must be passed now :—

Sales A/c Dr. 3,000

To Furniture A/c 3,000

(III) When there is a short debit in one account and a short credit in another account.

Example :— Goods purchased from Sanjay for Rs.2,000 was entered in Purchase Book as Rs.200 only.

Solution :— Effect of Error :

Dr. PURCHASES A/C Cr.		Dr. SANJAY A/C Cr.	
Short by Rs. 1,800			Short by Rs. 1,800

While rectifying this mistake Purchases A/c will be debited by Rs. 1,800 because there will be a short debit in Purchases A/c and Sanjay's A/c will be credited because it has been credited by a lesser amount.

Rectifying entry

Purchases A/c Dr. 1,800

To Sanjay 1,800

(Goods purchased from Sanjay for Rs.2,000 wrongly entered as Rs.200)

Second Method

(i) Correct entry which should have been passed earlier :—

Purchases A/c Dr. 2,000

To Sanjay 2,000

(ii) Entry which has been passed from the wrong amount:

Purchases A/c Dr. 200

To Sanjay 200

(in) Rectifying entry which must be passed now :—

Purchases A/c Dr. 1,800

To Sanjay 1,800

(IV) When there is an excess debit in one account and an excess credit in another account.

Example : Goods sold to Mohan for Rs.380 on credit was recorded in Sales Book as Rs.830.

Solution :— Effect of Error :

Dr. MOHAN **Cr.**		**Dr.** SALES A/C **Cr.**	
Excess by Rs.450 (Rs.830-Rs.380)			Excess by Rs.450 (Rs.830-Rs.380)

While rectifying this mistake Mohan will be credited by Rs.450 because it has been 'excess debited' by a similar amount and Sales A/c will be debited by Rs.450 because it has been 'excess credited' by a similar amount.

Rectifying entry

Sales A/c	Dr.	450	
To Mohan			450

(Sales to Mohan for Rs.380 wrongly entered as Rs.830)

Second Method

(i) Correct entry which should have been passed earlier :

Mohan	Dr.	380	
To Sales A/c			380

(ii) Entry which has been passed from the wrong amount:

Mohan	Dr.	830	
To Sales A/c			830

(iii) Rectifying entry which must be passed now :—

Sales A/c	Dr.	450	
To Mohan			450

Notes :—

(1) Students can adopt any of the two methods discussed as above, because rectifying entry in both the methods will be similar.

(2) In the examination the students should pass only the rectifying entries.

TWO SIDED ERRORS

(B) Errors which affect the Trial Balance or One Sided Errors :— These errors affect only one account. If, for example, a sum of Rs.2,500 given to Ajay is correctly recorded in the Cash Book but omitted to be posted to the Debit of Ajay, the error will be termed as one sided error because the error exists in the account of Ajay only.

Such type of errors occur in the following cases :—

(i) When a subsidiary book is undercast (totalled less) or Overcast (totalled in excess).

(ii) When the posting to an account is altogether omitted.

(iii) When the posting is made on the wrong side of an account.

(iv) When the posting of a wrong amount is done.

Rectification of such errors depends on the stage at which the errors are located :—

(A) When the errors are located and rectified before the closing of accounts (i.e., before preparing the Trial Balance and before opening of Suspense A/c).

(B) When the errors are located and rectified after the closing of accounts (i.e., after preparing the Trial Balance and after opening of Suspense A/c).

(A) When the errors are located and rectified before the closing of accounts (i.e., before preparing the Trial Balance and before opening of Suspense A/c) : Rectification of errors at this stage does not require rectification entries. Only the amount is written on the debit or credit side of the account which is affected by the error. For example, the total of the Purchase Book for the month of October is undercast (totalled less) by Rs. 1,000. To rectify this error, the amount of Rs. 1,000 will be put on the debit side of the purchase account by writing the words 'To undercasting of Purchase Book for the month of October'.

(C) When the errors are located and rectified after the closing of accounts (i.e., after preparing the Trial Balance and after opening of Suspense A/c) :—

When one sided errors are located after the preparation of trial balance, rectifications are carried out by passing journal entries. As only one account is to be debited or credited for the rectification of one sided errors, suspense account is used to complete the double entry.

SUSPENSE ACCOUNT

Meaning and utility:- When inspite of the best efforts, the Trial Balance does not tally, the difference is put to a newly opened account named 'Suspense Account' and the Trial Balance is thus made to tally. This is done to avoid the delay in the preparation of Final Accounts.

In case, the debit side of the Trial Balance exceeds the credit side, the difference is put on the credit side of the trial balance. In this case 'Suspense Account' will show a credit balance. Likewise, if the credit side of the Trial Balance exceeds the debit side, the difference is put on the debit side of the trial balance. In this case 'Suspense Account' will show a debit balance.

Disposal of Suspense Account :— Suspense Account is an imaginary account used as temporary measure only for the purpose of reconciling a Trial Balance. Later, as and when the errors affecting the suspense account are located, rectification entries are passed with the help of suspense account. Thus when all the errors are located and rectified, the suspense account will automatically stand closed, i.e., it will not show any balance. But if Suspense Account still shows a balance, it will indicate that certain errors are still to be discovered and rectified. In such cases, if the suspense account shows a debit balance, it is taken to the balance sheet on the assets side and on the contrary, if it shows a credit balance it is taken to the balance sheet on the liabilities side.

Following points should be noted while passing rectification entries with the help of suspense account:

(1) Suspense account is used to rectify only those errors which affect the Trial Balance.

(2) I. If the account which is to be rectified is debited in the rectifying entry,

suspense account will be credited to complete the double entry.

II. If the account which is to be rectified is credited in the rectifying entry, suspense account will be debited to complete the double entry.

Guiding Principles of Rectification of Errors

1. **If error relates to posting from the Cash Book :** The error will be related to the individual account in which posting was to be made not to Cash/Bank Account.
2. **If error relates to posting from other Subsidiary Books :** The error will be related to the Individual Personal Account only and not the Purchase A/c, Sales A/c etc. in which total of a particular subsidiary book is posted.

Example : Goods purchased from X for Rs.20,000 posted as Rs.2,000.

It means that A's A/c has been credited with Rs.2,000 and Purchase A/c was not affected.

3. **If error relates to omission of posting of a transaction recorded through Journal :** Assume that the transaction has not been posted to any of the Accounts.

Example : Machinery purchased on credit from A" for Rs.50,000 was not posted.

It means that the posting has not been done to any of the accounts i.e. Machinery A/c and A's A/c.

4. **If error is related to casting (totalling) of subsidiary books :** It will affect only that account where the total of the Subsidiary Book is posted and will not affect the individual Personal Account.

Example : Sales Book was overcast by Rs. 10,000.

It means that there is excess credit of Rs. 10,000 in Sales Account.

5. **If error is committed in the books of original entry, assume that all postings have been done accordingly.**

Example : Purchased goods on credit from .A for Rs.20,000 recorded as Rs.2,000.

It means that Purchases A/c has been debited and X's A/c has been credited with Rs.2,000.

6. **If error is at the posting stage, assume that recording in subsidiary book has been done correctly.**

Example : Purchased goods on credit from X for Rs.20,000 posted as Rs.2,000.

It means that credit purchase is correctly recorded in Purchase Book but while posting A's A/c has been credited with Rs.2,000.

7. **If error relates to posting to a wrong account (without mentioning side and amount of posting) then assume that posting has been done on correct side with correct amount.**
8. **If error relates to posting with wrong amount (without mentioning side of posting**

and account) then assume that posting has been done to a correct account and on correct side.

9. **If error relates to posting on wrong side (without mentioning amount and account) then assume that posting has been done to a correct account with correct amount.**

10. **Unless stated otherwise, it is presumed that errors are rectified before the preparation of financial statements.**

Multiple Choice Questions (SET A)

Select the correct alternative:

1. Wages paid to Mohan for erecting a machine should be debited to :

(ia) Wages A/c

(b) Machine A/c

(c) Mohan's A/c

(d) Cash A/c

2. Sale of typewriter that has been used in the office should be credited to :

(a) Sales A/c

(b) Cash A/c

(c) Capital A/c

(d) Typewriter A/c

3. Suspense Account in the trial balance will be entered in the :

(a) Manufacturing A/c

(b) Trading A/c

(c) Profit & Loss A/c

(d) Balance Sheet

4. Rs. 1,500 received from Bahadur whose account was previously written off as bad-debt should be credited to

(a) Bahadur's A/c

(b) Bad-debts Recovered A/c

(c) Suspense A/c

(d) Cash A/c

5. Rent paid to landlord amounting to Rs.500 was credited to Rent A/c with Rs.5,000. In the rectifying entry, Rent A/c will be debited with :

(a) 5,000

(b) 500

(c) 5,500

(d) 4,500

6. Purchased goods from Gopal for Rs.3,600 but was recorded in Gopal's A/c as Rs.6,300. In the rectifying entry, Gopal's A/c will be debited with :

(a) 9,900

(b) 2,700

(c) 3,600

(d) 6,300

7. Purchased goods from Gopal for Rs.3,600 but was recorded as Rs.6,300 to the debit of Gopal. In the rectifying entry, Gopal's A/c will be credited with :

(a) 9,900

(b) 2,700

(c) 3,600

(d) 6,300

8. Sohan returned goods to us amounting Rs.4,200 but was recorded as Rs.2,400 in his account. In the rectifying entry, Sohan's A/c will be credited with :

(a) 1,800

(b) 4,200

(c) 2,400

(d) 6,600

9. Goods sold to Sethi for Rs.640 was recorded in his account as Rs.460. In the rectifying entry, Sethi's A/c will be debited with :

(a) 180

(b) 460

(c) 640

(d) 1,100

10. A brief-case purchased for Rs.800 for the son of a partner was debited to General Exp. A/c with Rs.80. In the rectifying entry, Drawings A/c should be debited with:

(a) 880

(b) 720

(c) 800

(d) 80

11. Suspense Account is a

(a) Real Account

(b) Personal Account

(c) Nominal Account

(d) Any of these

12. It is easy to detect................ than to.........................

(a) frauds, errors

(b) mistakes, frauds

(c) errors, frauds

(d) errors, mistakes

13. Errors are

(a) Undetected mistakes

(b) Intentional Mistakes

(c) Frauds

(d) Unintentional Mistakes

Answers

Multiple Choice Questions (SET A)

Select the correct alternative:

1. (b) **2. (d)** **3. (d)** **4. (b)** **5. (c)** **6. (b)**

7. (a) **8. (a)** **9. (a)** **10. (c)** **11. (d)** **12. (c)**

13. (d)

Multiple Choice Questions (SET B)

Select the correct alternative:

(1) Rs. 2,000 paid as wages for installing a machine should be debited to

(a) Wages Account.

(b) Machinery Account.

(c) Capital Account.

(d) None of these.

(2) On purchase of old furniture, the amount of Rs. 1,000 spent on its repairs should be debited to

(a) Repairs Account.

(b) Furniture Account.

(c) Cash Account.

(d) None of these

(3) Goods of Rs. 500 given as charity should be credited to

(a) Charity Account.

(b) Sales Account.

(c) Purchases Account.

(d) None of these.

(4) Goods of Rs. 1,000 taken by the proprietor for personal use should be credited to

(a) Sales Account.

(b) Proprietor's Personal Expenses Account.

(c) Purchases Account.

(d) None of these.

(5) Errors of omission permit

(a) correct totalling of the Balance Sheet.

(b) correct totalling of the Trial Balance,

(c) the Trial Balance to match.

(d) None of these.

(6) Trial Balance is prepared to locate

(a) Errors of Principle.

(b) Errors of omission.

(c) Compensating Errors.

(d) None of these.

(7) Rs. 2,000 received from Smith whose account was previously written off as Bad

Debt should be credited to

(a) Bad Debts Recovered Account.

(b) Smith's Account.

(c) Cash Account.

(d) None of these.

(8) Purchase of office furniture for Rs. 1,200 was debited to the General Expenses Account. It is

(a) a clerical error.

(b) an error of principle,

(c) an error of omission.

(d) None of these.

(9) Goods destroyed by fire is credited to

(a) Trading Account.

(b) Goods lost by Fire Account. .

(c) Sales Account.

(d) None of these.

(10) Sale of office furniture is credited to

(a) Sales Account.

(b) Office Furniture Account.

(c) Cash Account.

(d) None of these.

(11) Suspense Account will give the

(a) Debit balance.

(b) Credit balance.

(c) Debit or credit balance, as the case may be.

(d) None of these.

(12) Error not shown by Trial Balance are:

(a) Errors of Principle.

(b) Compensating Errors.

(c) Errors of Complete Omission.

(d) All of the above.

(13) The accountant opens the following account when Trial Balance does not match

(a) Capital Account.

(b) Suspense Account.

(c) Drawings Account.

(d) Profit and Loss Account.

(14) Which of the following is not an error of principle?

(a) Purchase of machinery debited to Purchase Account.

(b) Sale of old furniture credited to Sales Account.

(c) Repairs on the overhauling of existing Machinery debited to Machinery Account.

(d) Cash received from Mohan posted to Sohan.

(15) An amount of Rs. 5,000 received from Ram is credited to Shyam. It is an error of

(a) Omission.

(b) Commission.

(c) Compensation.

(d) Principle.

Answers

Multiple Choice Questions (SET B)

Select the correct alternative:

1. (b)	2. (b)	3. (c)	4. (c)	5. (c)	6. (d)
7. (a)	8. (b)	9. (d)	10. (b)	11. (c)	12. (d)
13. (b)	14. (d)	15. (b)			

Chapter 19

Financial Statements

(A) Capital Expenditure and Revenue Expenditure :

Capital Expenditure :— Any expenditure which is incurred in acquiring or increasing the value of a fixed asset is termed as capital expenditure. As such, the amount spent on the purchase of Land and Building, Plant and Machinery, Furniture etc. is capital expenditure. Such expenditure yields benefit over a long period and hence is written in Assets. Following are the examples of capital expenditure :—

I. Expenditure which results in the acquisition of a fixed asset such as land, building, plant, motor vehicles, trade marks, etc. Such asset would be used in the business for a number of years.

II. Expenditure in connection with the purchase or erection of a fixed asset such as wages paid to workers for erecting machines, cartage paid on acquiring plant and machinery, over-hauling of second-hand machines etc.

III. Expenditure which results in the extension or improvement of fixed assets and which increases the earning capacity of such assets such as amount spent on increasing the seating capacity of a cinema hall.

IV. All amount spent upto the point an asset is put to use is treated as capital expenditure. Thus, legal fees and brokerage paid to acquire a property and interest paid on loans taken to acquire the asset for the period before the asset is put to use is capital expenditure and is added to the cost of such asset. But interest on loan for the period after the asset is put to use is treated as revenue expenditure.

V. Expenditure incurred for establishing the business, e.g., the cost of a patent, preliminary expenses, goodwill etc.

VI. Interest on capital upto the point production is ready to commence or during the period of formation of company.

VII. Expenditure incurred on the purchase of second-hand asset and on putting such asset into working condition.

Revenue Expenditure :— Any expenditure, the benefit of which is received during the current year itself is termed as revenue expenditure. As such, all the revenue expenditures are debited to Trading and Profit & Loss Account. Such expenditure does

not result in an increase in the earning capacity of the business but only helps in maintaining the existing earning capacity. Examples are :—

I. Expenses incurred for the purpose of day to day running of business such as manufacturing expenses, office expenses, selling expenses etc.

II. Expenses incurred on the ordinary repairs and maintenance of fixed assets, white-washing of building etc.

III. Payment for goods purchased for resale.

IV. Depreciation on fixed assets.

V. Purchase of raw materials for converting it into finished goods.

VI. Interest on loan and interest on capital for the period after the asset is put to use.

VII. Replacement of worn-out part of an existing machine.

VIII. Loss from sale of fixed assets.

Distinction between Capital Expenditure and Revenue Expenditure

Basis of Distinction	Capital Expenditure	Revenue Expenditure

1. Purpose	It is incurred for the acquisition or erection of a fixed asset for use in business.	It is incurred for the day-to-day running of the business.
2, Earning Capacity	It increases the earning capacity of the business.	It is incurred for maintaining the earning capacity.
3. Period	Its benefit extends to more than one year.	Its benefit is exhausted within a maximum period of one year.
4. Accounting Treatment	It is debited to related Asset Account.	It is debited to related Expenses Account.
5. Nature of Account	It is a real account.	It is a nominal account.
6. Presentation	It is shown in the Balance Sheet.	It is shown in the Trading or Profit and Loss Account.
7. Examples	Purchase of fixed assets like plant and machinery, land and building, furniture etc.	Rent, salaries, repairs, depreciation etc.

PROBLEM 1.

State whether the following transactions are capital expenditure or revenue expenditure. Give reasons :

(i) Rs.5,200 spent on repairs before using a second-hand car purchased recently.

(ii) During the year Rs.3,000 were spent on repairing of various machines.

(iii) Freight and cartage on the new machine Rs.1,200, erection charges Rs.600.

(iv) A sum of Rs.4,000 was spent on white-washing and painting the new factory.

(v) Cost of annual white-washing of building.

(vi) Fire insurance premium was paid on 1st July, 2020 for full one year Rs.2,400. Books are closed on 31st March every year.

(vii) Rs.20,000 spent towards additions to the machinery.

(viii) Rs.5,000 were spent in connection with the issue of capital and Rs.3,000 were incurred as legal expenses in raising a debenture loan.

SOLUTION:

(i) It is capital expenditure and will be debited to Car Account because the expenses have been incurred before the Car is put to use.

(ii) It is revenue expenditure because the expenses have been incurred on the repairs of existing machines. It is an expenditure of routine nature,

(iii) Rs. 1,800 is capital expenditure and will be debited to Machinery Account.

(iv) As the factory is white-washed and painted for the first time, it should be treated as capital expenditure and hence debited to factory account.

(v) It is revenue expenditure because it is normal and regular expenditure incurred with a view to maintain the building. Hence it will be debited to Profit & Loss Account.

(vi) Fire insurance premium amounting to Rs. 1,800 (i.e., from 1st July, 2020 to 31st March, 2020) is revenue expenditure and Rs.600 (i.e., from 1st April, 2020 to 30th June, 2020) is a prepaid expense and will be charged to next year's revenue.

(vii) It is capital expenditure, since it will result in an increase in the earning capacity of the business.

(viii) Rs.8,000 is capital expenditure since it is incurred on raising of capital for the business.

PROBLEM 2.

Classify the following into Capital, Revenue and Deferred Revenue expenditure, stating reasons in each case :

(1) Rs.50,000 paid for the installation of a new machine.

(2) Payment of annual taxes Rs.20,000 and annual insurance premium of Rs. 10,000.

(3) Wages paid to workers for converting raw material into finished goods.

(4) A sum of Rs.40,000 was spent in overhauling its entire plant which resulted in adding five years to its working life.

(5) Rs. 10 Lac spent on the construction of railway sidings.

SOLUTION :

(1) Cost of installing the machine is a Capital Expenditure because it is spent before the asset is ready to use.

(2) Annual taxes and insurance premium are Revenue Expenditure because their benefit will be exhausted within the year.

(3) It is Revenue Expenditure since it is incurred in the ordinary course of business.

(4) It is capital expenditure since it has resulted in increase of the working life of the asset.

(5) It is capital expenditure since an asset is created which will be used for a number of years.

PROBLEM 3.

State with reasons whether the following are Capital or Revenue expenditures :—

(a) An old plant costing Rs. 1,00,000 was purchased; Rs.2,000 were paid on its carriage; Rs.3,000 were spent on its repairs and Rs.4,000 were paid to an engineer who had supervised its installation.

(b) Rs.2,00,000 spent for repainting the factory building.

(c) Legal expenses incurred on purchase of Land.

(d) Rs. 10,000 were spent on lawyer's fees to defend a suit claiming that the firm's factory site belonged to the plaintiff.

(e) Expenditure on Advertisement Rs.25,000.

(f) Rs.25,000 paid to a discharged employee as compensation.

(g) Repairs for Rs.2,000 necessitated by negligence.

(h) Insurance claim of Rs.20,000 received from the insurance company for loss of goods by fire of Rs.25,000.

SOLUTION:

(a) Rs. 1,09,000 is capital expenditure because all expenditure has been made before the plant is put to use.

(b) It is revenue expenditure because it is normal and regular expenditure incurred to maintain an existing building.

(c) It is capital expenditure since it is incurred on purchase of an asset.

(d) It is a revenue expenditure since the fees is paid to maintain the title on an old asset and not to acquire any new asset.

(e) It is revenue expenditure since it is incurred in the ordinary course of business.

(f) It is revenue expenditure since it is incurred in the normal course of the business.

(g) It is revenue expenditure since it is not going to improve the asset in any way.

(h) Rs.5,000 is revenue expenditure.

(B) Capital Receipts and Revenue Receipts

It is also necessary to make a proper distinction between capital receipts and revenue receipts because the revenue receipts are shown on the credit side of Trading and Profit & Loss Account whereas the capital receipts are shown in the Balance Sheet either as increase in liabilities or as reduction in the value of the assets.

Capital Receipts :

Examples of capital receipts are :

(i) Amount received from the sale of fixed assets or investments.

(ii) Capital contributed by proprietors, partners or money obtained from issue of shares and debentures in case of company.

(iii) Amount received by way of loans.

Revenue Receipts :

(i) Money obtained from sale of goods.

(ii) Commission and fees received for services rendered.

(iii) Interest and dividend received on investments.

PROBLEM 4.

State, which of the following receipts would be treated as capital receipts and revenue receipts. Give reasons.

(i) Received Rs.5,00,000 from the issue of shares and the expenses of issue amounted to Rs. 10,000.

(ii) Received Rs. 1,00,000 as subsidy from State Government.

(iii) Compensation received from Improvement Trust for compulsory removal of business to another place.

(iv) Investments which were purchased in 2007 for Rs.10 Lac sold in 2020 for Rs.12 Lac.

(v) For the welfare of employees, a recreation centre was constructed at a cost of Rs.8 Lac; Rs.5 Lac was received from the State Govt, as grant,for its construction.

SOLUTION:

(i) Rs.5,00,000 is capital receipt and expenses of issue amounting to Rs. 10,000 is a capital expenditure since it is incurred in raising capital for the business.

(ii) It is a revenue receipt because it is received in the normal course of business and reduces the cost of production of the goods produced by the firm.

(iii) It is a revenue receipt since it will reduce the cost of removing the business to another place.

(iv) Rs. 12 Lac is capital receipt because it is the sale proceeds of a fixed asset. Rs.2 Lac is capital gain.

(v) Rs.8 Lac is capital expenditure since it is spent on the construction of building;

Grant of Rs.5 Lac is a capital receipt.

Deferred Revenue Expenditure: — There are certain expenditures which are revenue in nature but the benefit of which is likely to be derived over a number of years. Such expenditures are termed as 'Deferred Revenue Expenditures'. The benefit of such an expenditure generally lasts between 3 to 7 years. As such, the whole of such expenditure is not debited to the Profit and Loss Account of the current year but spread over the years for which the benefit is likely to last. Thus, only a part of such expenditure is taken to Profit & Loss Account every year and the unwritten off portion is allowed to stand on the assets side of the Balance Sheet. For example, a firm spent a huge amount of Rs.2,00,000 on advertising to introduce a new product in the market and it is estimated that its benefit will last for 4 years. In this case, Rs.50,000 will be charged to the P & L A/c of each year for four consecutive years. Entry will be :—

Profit & Loss A/c	Dr. 50,000	
To Advertisement A/c		50,000

($\frac{1}{4}$th of Advertisement expenses charged to P & L A/c)

Accounting Treatment:— Rs.50,000 will be debited to P & L A/c of each year and the balance will be treated as an asset and shown on the Assets side of the Balance Sheet. As such, the amounts shown on the Assets side will be Rs. 1,50,000 in the first year, Rs.1,00,000 in the second year and Rs.50,000 in the third year.

Meaning of Financial Statements

Financial Statements refer to such statements which report the profitability and the financial position of the business at the end of accounting period. The term financial statements includes at least two basic statements which are as under :

(i) Income Statement (or Trading and Profit and Loss Account) which shows results of business operations during an accounting period, and

(ii) Statement of Financial Position (or Balance Sheet) which shows financial position of an enterprise at a specified point of time.

In the words of **John N. Myer,** "The financial statements provide a summary of the accounts of a business enterprise, the balance sheet reflecting the assets, liabilities and capital as on a certain date and the income statement showing the results of operations during a certain period."

These two financial statements are termed as 'Final Accounts'.

In modern times, in addition to the aforesaid two basic financial statements, two other statements namely a Statement of Retained Earnings and a Cash Flow Statement are also generally included in financial statements.

Objectives of Preparing Financial Statements:

(i) To present a true and fair view of the financial performance (i.e. profit/loss) of the business;

(ii) To present a true and fair view of the financial position (i.e. Assets/Liabilities) of the business.

Users of Financial Statements : Information provided by financial statements is used by the management, investors, creditors, employees, government etc. The utility of financial statements to different parties is as follows :

(1) Management: The financial statements help the management in assessing the profitability of various activities and various departments. On their basis, the management can review the progress of the business and take decisions for controlling the non-profitable activities.

(2) Investors : They can assess the short-term and long-term financial soundness and earning capacity of the business with the help of financial statements. They can also study the trend of sales, trend of profits, shortcomings and the prospects of future growth of the enterprise.

(3) Short-term Creditors : On the basis of financial statements they assess whether the enterprise will be able to pay their debts when they fall due and may decide to extend, maintain or restrict the credit allowed to the enterprise.

(4) Long-term Creditors : On the basis of financial statements they may determine

(i) whether the enterprise will be able to pay the interest consistently, and

(ii) whether the company will be able to pay their debts when due.

On this basis they may also decide to extend, maintain or restrict the loans extended to the enterprise.

(5) Employees and Trade Unions : On the basis of financial statements they can judge as to how much bonus and increase in their wages is possible from the profits of the enterprise.

(6) Government : Government uses the financial statements to study the profit margins of various industries to announce or withdraw various concessions and to increase or decrease the excise duty.

(7) Taxation Authorities : They use the financial statements for the purpose of assessment of income tax, sales tax etc.

(8) Other Users : Such as trade associations, consumer organisations, researchers etc.

INCOME STATEMENT

It is divided into two parts :

(i) The first part is called 'Trading Account'. It shows the gross profit or gross loss,

(ii) The second part is called 'Profit & Loss Account'. It show's the net profit or net loss.

TRADING ACCOUNT

Trading account is prepared for calculating the gross profit or gross loss arising or incurred as a result of the trading activities of a business. In other words, it is prepared to show the result of manufacturing, buying and selling of goods. If the amount of sales exceeds the amount of purchases and the expenses directly connected with such purchases, the difference is termed as gross profit. On the contrary, if the purchases, and direct expenses exceed the sales, the difference is called gross loss. A Trading

Account records the amount of purchases of goods and also the expenses which are incurred in bringing that commodity to a saleable state. In other words, all expenses which relate to either purchase of raw material or manufacturing of goods are recorded in the Trading Account. All such expenses are called 'Direct Expenses'. 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."

Sometimes, a Trading Account is also called 'Goods A/c' because all the transactions relating to goods are recorded in it. Such as I. Opening Stock, II. Purchases, III. Purchases Returns, IV. Sales, V. Sales Returns, VI. Closing Stock, VII. Expenses incurred on manufacturing of goods, and VIII. Expenses incurred on purchasing and bringing the goods to the trading place. All such expenses are summarised and recorded in the Trading Account at the end of the year.

Need and Importance of Trading Account

Preparation of Trading Account serves the following objectives :—

(1) It provides information about Gross Profit and Gross Loss :— It informs of the gross profit or gross loss as a result of buying and selling the goods during the year. The percentage of Current Year's gross profit on the amount of sales can be calculated and compared with those of the previous years. Thus, it provides data for comparison, analysis and planning for a future period.

(2) It provides information about the direct expenses :— All the expenses incurred on the purchase and manufacturing of goods are recorded in the trading account in a summarised form. Percentage of such expenses on sales can be calculated and compared with those of the previous years. In this way it enables the management to control and rationalise the expenses.

(3) Comparison of closing stock with those of the previous years :— Closing stock has to be valued and recorded in a trading account. This stock can be compared with the closing stock of the previous years and if the stock shows an increasing trend, the reasons may be inquired into.

(4) It provides safety against possible losses :— If the ratio of gross profit has decreased in comparison to the preceding year, the businessman can take effective measures to safeguard himself against future losses. For example, he may increase the sale price of his goods or may proceed to analyse and control the direct expenses.

Preparation of Trading Account

Trading Account is a Nominal Account and all expenses which relate to either purchase or manufacturing of goods are written on the Dr. side of the Trading Account.

Items written on the Dr. side of the Trading Account

(1) Opening Stock or Inventory :— The stock of goods remaining unsold at the end of the previous year is termed as the opening stock of the current year. In other words, the closing stock of the last year becomes the opening stock of the current year. Opening Stock will include the following :—

I. Opening Stock of Raw Material,

II. Opening Stock of Semi-finished goods, and

III. Opening Stock of Finished goods.

(2) Purchases and Purchases Returns :— Goods which have been bought for resale are termed as Purchases and goods which are returned to suppliers are termed as purchase returns or returns outwards. Purchase Account will be given on the debit side of the trial balance and Purchase Return Account on the credit side of the trial balance. Purchase returns will be shown as a deduction from Purchases on the debit side of the trading account. Purchases include cash as well as credit purchases. '

(3) Direct Expenses :— All expenses incurred in purchasing the goods, bringing them to the godown and manufacture of goods are called direct expenses. Direct expenses include the following :—

(I) Wages :— Wages are paid to workers who are directly engaged in the loading, unloading and production of goods and as such are debited to the trading account. It should be noted that:—

(i) If the item 'Wages and Salaries' is given in the question it will be shown on the trading account. On the contrary, if 'Salaries and Wages' is given it will be shown on the Profit & Loss Account.

(ii) If wages are paid for bringing a new machine or for its installation it will be added to the cost of the machine and hence will not be shown in the trading account.

(II) Carriage or Carriage Inwards or Freight :— These expenses should be debited to trading account because these are generally paid for bringing the goods to the factory or place of the business. However, if any carriage or freight is paid on bringing an asset, the amount should be added to the asset account and must not be debited to trading account.

(III) Manufacturing Expenses :— All expenses incurred in the manufacture of goods are shown on the debit side of the trading account such as Coal, Gas, Fuel, Water, Power, Factory Rent, Factory Lighting etc.

(IV) Stores Consumed : These are incurred to keep the machines in perfect working condition and include engine oil, cotton waste, oil, grease etc.

(V) Dock Charges :—These are the charges levied on ships and their cargo while entering or leaving docks. If dock charges are paid on import of goods they are shown on the debit side of Trading Account. In the absence of specific instructions, these are debited to Trading Account.

(VI) Royalty :— This is the amount paid to the owner of a mine or patent for using his right or patent. Royalty is usually charged to Trading Account because it increases the cost of production. However, if it is specifically stated in the question that the Royalty is based on sales, it will be charged to Profit and Loss Account.

Items written on the Cr. side of the Trading Account

(1) Sales and Sales Returns :— Both Cash and Credit sales will be included in sales. The sales account will be a credit balance whereas, the sales return account or returns inwards account will be a debit balance. Sales return will be deducted out of Sales on the credit side of the trading account.

(2) Closing Stock or Inventory :— The goods remaining unsold at the end of the year is known as Closing Stock. It is valued at cost price or realisable value whichever is less. It includes the closing stock of raw material, Closing Stock of semi-finished goods and Closing Stock of finished goods.

Normally, the Closing Stock is given outside the Trial Balance. This is so because its valuation is made after the accounts have been dosed. It is incorporated in the books by means of the following entry :—

Closing Stock A/c Dr.

To Trading A/c

(Closing Stock transferred to Trading A/c)

When the above entry is passed, the Closing Stock Account is opened. On the one hand, it will be posted to the credit side of the trading account and on the other hand, will be shown on the Assets side of the Balance Sheet, in order to complete the double entry. **Sometimes, the Closing Stock is given inside the Trial Balance. This will mean that the entry to incorporate the closing stock in the books has already been passed. It would imply that the Closing Stock must have been deducted out of Purchases Account. Hence, in such a case, Closing Stock will not be shown in the Trading Account but will appear on the Assets side of the Balance Sheet only.**

Closing Entries Relating to Trading Account

The preparation of the Trading Account requires that the balances of all such accounts which are due to appear in the Trading Account are transferred to it. The entries required for such transfer are termed as Closing Entries. These will be as follows :—

(1) Purchases Returns Account is closed by transferring its balance to Purchases Account. Following entry is recorded for this purpose :

Purchases Return A/c Dr.

To Purchases A/c

(Transfer of purchases returns account to purchases account)

(2) Similarly, the Sales Returns Account is closed by transferring its balance to the Sales Account as :

Sales A/c Dr.

To Sales Return A/c

(Transfer of Sales Return Account to Sales Account)

(3) Closing Entry for those accounts which are to be transferred to the Dr. side of the Trading Account:

Trading A/c Dr.

To Opening Stock A/c

To Purchases A/c

To Wages A/c

To Direct Expenses A/c

To Carriage A/c

To Gas, Fuel & Power A/c

To Freight & Cartage A/c

To Manufacturing exp. A/c

To Factory Rent & Lighting A/c

To Royalty A/c

(The Transfer of above accounts to the Dr. side of the Trading A/c)

(4) Closing Entry for those accounts which are to be transferred to the Cr. side of the Trading Account:

Sales A/c Dr.

Closing Stock A/c Dr.

To Trading A/c

(The Transfer of above accounts to the Cr. side of the Trading A/c)

(5) Another Closing Entry is needed to close the Trading Account itself. If the credit side of the Trading Account exceeds the debit, the difference will be Gross Profit. The Gross Profit will be transferred to the credit of a newly opened account called Profit and Loss Account:—

Trading A/c Dr.

To Profit & Loss A/c

(The Transfer of Gross Profit to the Credit side of P & L A/c)

(6) If the debit side of the Trading Account exceeds the credit, the difference will be

Gross Loss. It will be transferred to the debit of P & L A/c by means of the following entry :—

Profit & Loss A/c Dr.

To Trading A/c

(The Transfer of Gross Loss to the Debit side of P & L A/c)

Format of a Trading Account

TRADING A/C

Dr. **for the year ending.** **Cr.**

Particulars	Amount	Particulars	Amount
To Opening Stock		By Sales	
To Purchases		Less : Sales Returns	
Less: Purchase Returns		or	
or		Returns inwards	
Returns outward		By Closing Stock	
To Wages		By Gross loss	
To Wages & Salaries		(if any) transferred to Profit	
To Direct Expenses		and Loss A/c	
To Carriage, or		(Balancing figure)	
To Carriage inwards, or			
To Carriage on Purchase			
To Gas, Fuel and Power			
To Freight and cartage			
To Manufacturing Expenses, or Productive Expenses			
To Factory Expenses, such as :			
Factory Lighting			
Factory Rent etc.			
To Dock charges and Clearing charges			
To Import Duty or Custom Duty			
To Royalty			
To Gross Profit			
Transferred to P & L Ale (Balancing Figure)			

Notes :

(1) In the heading of the Trading Account the words 'For the year ended ' are used. Because it discloses the position of the business for the full accounting year and not at a particular point of time.

(2) No separate column for date is prepared in the Final Accounts because the date will be already mentioned in the heading itself.

(3) No column for L.F. is prepared in Final Accounts because these are prepared from trial balance and not from ledger accounts directly.

PROFIT AND LOSS ACCOUNT

Trading account only discloses the gross profit earned as a result of buying and selling of goods. However, a businessman has to incur a number of expenses which are not taken to trading account. Hence, a businessman is more interested in knowing the net profit earned or net loss incurred during the year. As such, a Profit & Loss Account is prepared which contains all the items of losses and gains pertaining to the accounting period. According to Prof. Carter :—

"A Profit & Loss Account is an account into which all gains and losses are collected, in order to ascertain the excess of gains over the losses or vice-versa".

Need and Importance of Profit & Loss A/c

(1) To ascertain the Net Profit or Net Loss :— A Trading Account only discloses the Gross Profit earned as a result of trading activities, whereas the Profit & Loss Account discloses the net profit (or net loss) available to the proprietor and credited to his capital account.

(2) Comparison with previous years' profits :— The net profit of the current year can be compared with that of the previous years. It enables the businessman to know whether the business is being conducted efficiently or not.

(3) Control on Expenses :— Profit & Loss Account helps in comparing various expenses with the expenses of the previous year. Also the percentage of each individual expenses to net profit is calculated and compared with the similar ratio of previous years. Such comparison will be helpful in taking concrete steps for controlling the unnecessary expenses.

(4) Helpful in the preparation of Balance Sheet :— A Balance Sheet can only be prepared after ascertaining the Net Profit through the preparation of Profit and Loss Account.

Preparation of Profit and Loss Account

A Profit and Loss Account is started with the amount of gross profit or gross loss brought down from the Trading Account. As such, all those expenses and losses which have not been debited to the Trading Account are now debited to Profit & Loss Account. These expenses include administrative expenses, selling expenses, distribution expenses etc. These are called 'Indirect Expenses'. Profit and Loss Account is a Nominal Account and as such, all the expenses and losses are shown on its debit side and all the incomes and gains are shown on its credit side.

Items Written on the Dr. Side of Profit & Loss Account

(1) **Gross Loss** :— If trading account discloses Gross Loss, it is shown on the debit side first of all.

(2) Office **and Administrative Expenses** :— Such as salary of office employees, office rent, lighting, postage, printing, legal charges, audit fee etc.

(3) **Selling and Distribution Expenses** :— Such as advertisement charges, commission, carriage outwards, bad-debts, packing charges etc.

(4) **Miscellaneous Expenses** :— Such as interest on loan, interest on capital, repair charges, depreciation, charily etc.

Items written on the Cr. side of Profit & Loss Account

(1) **Gross Profit**:— The starting point of the Cr. side of Profit and Loss Account is the gross profit brought down from the Trading Account.

(2) Other Incomes and Gains :— All items of incomes and gains are shown on the credit side of the Profit & Loss Account, such as income from investments, rent received, discount received, commission earned, interest received, dividend received etc.

If the credit side of the profit and loss account exceeds that of debit side, the difference is termed as net profit. On the other hand, the excess of the debit side over the credit side is termed as net loss. Net profit is added to the capital whereas net loss is deducted from the capital.

Closing Entries relating to Profit and Loss Account

The preparation of Profit and Loss Account requires that the balances of all concerned items are transferred to it by passing the following closing entries :—

(1) Accounts of various items of expenses and losses are transferred to the debit side of Profit and Loss Account by means of the following entry :—

Profit and Loss A/c Dr.

To Salaries A/c

To Rent, Rates and Taxes A/c

To Printing and Stationery A/c

To Postage A/c

To General Expenses etc.

(The transfer of nominal accounts showing Dr. balances to the Debit of P & L A/c)

(2) Balances of all the accounts of incomes and gains will be transferred to the crdit side of Profit and Loss Account by means of the following entry :—

Interest Received A/c Dr.

Commission Received A/c Dr.

Rent Received A/c Dr.

To Profit and Loss A/c

(The transfer of nominal accounts showing Cr. balances to the Credit of P & L A/c)

(3) For the transfer of credit balance of Profit & Loss A/c, known as net profit:—

Profit and Loss A/c Dr.

To Capital A/c

(The transfer of net profit to Capital A/c)

(4) For the transfer of debit balance of Profit & Loss A/c, known as net loss :—

Capital A/c Dr.

To Profit and Loss A/c

(The transfer of net loss to Capital A/c)

Format of a Profit and Loss Account

PROFIT AND LOSS A/C

Dr. **for the year ending** **Cr.**

Particulars	Amount	Particulars	Amount
	Rs.		Rs.
To Gross Loss b/d		By Gross Profit b/d	
(Transferred from Trading A/c)		(Transferred from Trading A/c)	
Office expenses :—		By Rent from Tenant	
To Salaries		By Rent (Cr.)	
To Salaries & Wages		By Discount received	
To Rent, Rates & Taxes		Or Discount (Cr.)	
To Printing & Stationery		By Commission Received	
To Postage		By Interest on Investments	

To Lighting		By Dividend on Shares	
To Insurance Premium		By Bad-Debts Recovered	
To Telephone Charges		By Profit on sale of Assets	
To Legal Charges		By Income from other Sources	
To Audit Fees		By Miscellaneous Income	
To Travelling Expenses		By Net Loss (if any)	
To Establishment Expenses		Transferred to Capital A/c	
To Trade Expenses			
To Genera] Expenses			
Selling and Distribution Expenses:			
To Carriage Outwards, or			
Carriage on Sales			
To Advertisement			
To Commission			
To Brokerage			
To Bad-debts			
To Export duty			
To Packing charges			
To Delivery Van Expenses			
To Stable expenses			
Miscellaneous expenses :—			
To Discount Allowed			
To Repairs			
To Depreciation			
To Interest (Dr.)			
To Bank Charges			
To Entertainment Expenses			

To Conveyance Expenses To Donation and Charity To Loss on Sale of Assets To Net Profit— Transferred to Capital A/c			

Notes :—

(I) Those expenses which are not related to the business are not written in the Profit and Loss Account such as (I) Domestic and household expenses of the proprietor, (II) Income-Tax, and (III) Life Insurance Premium etc. These expenses are known as Drawings and deducted from Capital at the liabilities side of the Balance Sheet.

(2) Only those items of expenses and incomes are shown in the Profit & Loss Account which have not been shown in the Trading Account.

Operating Profit and Net Profit

Profit may be of two types :

(i) operating profit and

(ii) net profit.

Operating Profit is the profit earned through normal operating activities of the business. It is arrived at by deducting the operating expenses from gross profit. Expenses which are related to the main or normal activities of the business are called operating expenses. They include office and administrative expenses and selling and distribution expenses, discount, bad-debts etc. Operating Profit is also called 'Earning Before Interest & Tax or EBIT'.

Net Profit is arrived at by deducting operating as well as non-operating expenses from the gross profit. Expenses which are incidental or indirect to the main operations of the business are called non-operating expenses. They include interest on loan, charities and donations, loss on sale of fixed assets, extraordinary losses due to theft, loss by fire and so on. Similarly, non-operating incomes are added while calculating the net profit. Non-operating incomes include receipt of interest, rent and dividend, gain on sale of fixed assets etc.

BALANCE SHEET

After ascertaining the net profit or loss of the business enterprise, the businessman would also like to know the exact financial position of his business. For this purpose a statement is prepared which contains all the Assets and Liabilities of the business enterprise. The statement so prepared is called a Balance Sheet because it is a sheet of balances of ledger accounts which are still open after the transfer of all nominal acounts to the Trading and Profit & Loss Account. Balances of all the personal and real accounts are grouped as assets and liabilities. Liabilities are shown on the left hand side of the Balance Sheet and Assets on the right hand side.

Definitions : A Balance Sheet has been defined as follows :—

In the words of Karlson :—"A business form showing what is owed and what the proprietor is worth, is called a Balance Sheet."

According to A. Palmer :—"The Balance Sheet is a statement at a particular date showing on one side the trader's property and possessions and on the other hand the liabilities."

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."

Need and Importance of Preparing a Balance Sheet

The purposes of preparing a Balance Sheet are as follows :—

(1) The main purpose of preparing a Balance Sheet is to ascertain the true financial position of the business at a particular point of time.

(2) It helps in ascertaining the nature and cost of various assets of the business such as the amount of Closing Stock, amount owing from Debtors, amount of fictitious assets etc.

(3) It helps in determining the nature and amount of various liabilities of the business.

(4) It gives information about the exact amount of capital at the end of the year and the addition or deduction made into it in the current year.

(5) It helps in finding out whether the firm is solvent or not. The firm is solvent if the assets exceed the external liabilities. It would be insolvent if opposite is the case.

(6) It helps in preparing the Opening Entries at the beginning of the next year.

Drafting a Balance Sheet

Characteristics of Balance Sheet

(1) A Balance Sheet is a part of the Final Accounts. This is the reason that the Trading and Profit and Loss Account and the Balance Sheet are together called 'Final Accounts'. However, the Balance Sheet is a statement and not an account. It has no debit or credit side and as such the words 'To' and 'By' are not used before the names of the accounts written therein.

(2) A Balance Sheet is a summary of the Personal and Real Accounts, which are still open and have not been closed by transfer to the Trading and Profit & Loss Account. Debit balances of all Personal and Real Accounts are put on the right hand side known as Assets side, whereas the credit balances are put on the left hand side known as Liabilities side.

(3) The totals of the two sides of the Balance Sheet must be equal. If the totals are not equal, there will be an error somewhere.

(4) Balance Sheet is prepared on a particular date and not for a fixed period. As such, it discloses the financial position of a business on a particular date and not for a

period. It is True only for the date on which it is prepared because even a single transaction would cause a change in the assets and liabilities.

(5) It shows the financial position of the business according to the going concern concept.

Grouping and Marshalling of Assets and Liabilities in Balance Sheet

The Assets and Liabilities shown in the Balance Sheet are properly 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 owing from various customers will be shown under the heading 'Sundry Debtors'. Similary, under the heading 'Current Assets', the balance of cash, bank, debtors, stock etc. will be shown.

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

(1) In the Order of Liquidity :—According to this method, an asset which is most easily convertible into Cash such as Cash in hand is written first and then will follow those assets which are comparatively less easily convertible, so that the least liquid asset such as goodwill, is shown last.

In the same way, those liabilities which are to be paid at the earliest will be written first. In other words, current liabilities are written first of all, then non-current or long-term liabilities and lastly, the proprietor's capital.

Generally, sole proprietors and partnership firms prepare their Balance Sheet in the order of liquidity. Proforma of a Balance Sheet in the order of liquidity will be as follows :—

BALANCE SHEET as at ....

Liabilities	Amount	Assets	Amount
	Rs.		**Rs.**
Current Liabilities:—		**Current Assets :—**	
Bank Overdraft		Cash in Hand	
Bills Payable		Cash at Bank	
Sundry Creditors		Bills Receivable	
Outstanding expenses		Sho∩ Term Investments	
Unearned Income		Sundry Debtors /Book Debts	
Non-Current Liabilities :—		Closing Stock	
Long term loans		Prepaid Expenses!'!	
Reserves		Accrued Income	

Capital		**Long Term Investments**	
Add : Net Profit		**Non-Current Assets :—**	
Less: Drawings		Furniture	
Less: Income Tax		Loose Tools	
Less : Life Insurance Premium		Motor Vehicle	
		Plant and Machinery	
		Land and Buildings	
		Patents and Trade Marks	
	—	Goodwill	

Notes :

(1) The words 'As at' are used in the heading of the Balance Sheet, because it is true only for the date on which it is prepared.

(2) The total of both the sides of the Balance Sheet is always equal.

(3) Prepaid expenses are treated as current assets. Though Cash cannot be realised from prepaid expenses, the service will be available against these without further payment.

(2) In the Order of Permanence :— This method is exactly the reverse of the first method discussed above. Assets which are most difficult to be converted into cash such as Goodwill are written first and the assets which are most liquid such as Cash in hand are written last. Similarly, those liabilities which are to be paid last, will be written first. In other words, the proprietor's capital is written first of all, then non-current 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.

It is essential to understand the classification of various Assets and Liabilities before preparing a Balance Sheet.

Classification of Assets

According to the nature of assets, these may be classified into the following :—

(1) Non-Current Assets :— Non-Current Assets are those which are acquired for continuous use and last for many years such as Land and Building, Plant and Machinery, Motor Vehicles, Furniture etc. According to Finney and Miller :—

"Non-Current Assets are assets of a relatively permanent nature used in the operations of business and not intended for sale".

As the purpose of keeping such assets is not to sell but use them, changes in their market values are ignored and these are always shown in the Balance Sheet at cost less depreciation.

(2) Current Assets :— Current Assets are those which are either in the form of cash or can be easily converted into cash within one year of the date of Balance Sheet. In the words of Hovard & Upton

"The Current Assets are usually defined as those assets which are convertible into cash through the normal course of business within a short time ordinarily in a year."

Current Assets include Cash, Bills Receivable, Short Term Investments, Debtors, Prepaid Expenses, Accrued Income, Closing Stock etc. While valuing these assets, Closing Stock is valued at cost or realisable value whichever is less and a reasonable provision for doubtful debts is deducted out of Sundry Debtors.

(3) Liquid Assets :— Liquid Assets are those which are either in the form of Cash or can be quickly converted into cash, such as Cash, Bills Receivable, Short Term Investments, Debtors, Accrued Income etc. In other words, if Prepaid Expenses and Closing Stock are excluded from Current Assets, the balance will be Liquid Assets.

(4) Fictitious or Nominal Assets :— These are the Assets which cannot be realised in Cash or no further benefit can be derived from these assets. Such assets include Debit balance of P & L A/c and the expenditure not yet written off such as Advertisement Expenses etc. These assets are not really assets but are shown on the Assets side only for the purpose of transferring them to the Profit & Loss Account gradually over a period of time.

(5) Wasting Assets :— These are the Assets which are exhausted or consumed over a period of time such as mines and oil-wells. Their value reduces through being worked. These also include Patents and the properties taken on lease for a definite period of time.

(6) Tangible and Intangible Assets :— Tangible Assets are those which have a physical existence or which can be seen and felt like Plant and Machinery, Building, Furniture, Stock, Cash etc. Intangible Assets are those which do not have any physical existence or which cannot be seen or felt such as the Goodwill, Trade Marks, Patents etc. Intangible Assets are as much valuable as Tangible Assets because they also help the firm in earning profits. For example, Goodwill helps in attracting customers and patents are actually the know-how which help in producing the goods.

Distinction between Tangible Assets and Intangible Assets

S. No.	Basis of Distinction	Tangible Assets	Intangible Assets
1.	**Physical Existence**	These assets have physical existence. Examples of these assets are Plant and Machinery, Furniture etc.	These assets do not have physical existence. Examples of these assets are Goodwill, Patents, Trade Marks etc.
2.	**Non-Current V/s Current**	These assets can be non-current assets or current assets.	These assets usually fall in the category of non-current assets.
3.	**Depreciation or Amortisation**	Depreciation is charged on fixed tangible assets.	Intangible assets are amortised.

4.	**Acceptance as Security**	Lenders accept these assets as security for providing loan.	Lenders usually do not accept intangible assets as security for providing loan.
5.	**Risk of loss due to fire**	Tangible assets may be lost due to fire.	Intangible assets cannot be lost due to fire.

Classification of Liabilities

According to their nature, the liabilities may be classified as follows :—

(1) Non-Current or Long-term Liabilities :— Those liabilities which are to be repaid after one year or more are termed as non-current liabilities. These include Public Deposits, Long-term Loans, Debentures etc.

(2) Current or Short-term Liabilities :—Those liabilities which are expected to be paid within one year of the date of the Balance Sheet are termed as current or short-term liabilities. These include Bank Overdraft, Creditors, Bills Payable, Outstanding expenses etc.

(3) Contingent Liabilities :— These are the liabilities which will become payable only on the happening of some specific event, otherwise not. Such as :—

(I) Liabilities for bill discounted :— In case a bill discounted from the bank is dishonoured by the acceptor on the due date, the firm will become liable to the bank.

(II) Liability in respect of a suit pending in a court of law:— This would become an actual liability if the suit is decided against the firm.

(III) Liability in respect of a guarantee given for another person :— The firm would become liable to pay the amount if the person for whom guarantee is given fails to meet his obligation.

Contingent liabilities are not shown in the Balance Sheet. They are, however, shown as a footnote just below the Balance Sheet so that their existence may be revealed.

Distinction between Trial Balance and Balance Sheet

Basis of Difference		Trial Balance	Balance Sheet
1.	**Object**	It is prepared to check the arithmetical accuracy of the books of accounts.	It is prepared to know the true financial position of the firm.
2.	**Information about profit or loss.**	It is not possible to have information about net profit or net loss from a trial balance.	Since net profit or loss is recorded in the Capital shown in Balance Sheet, it is possible to have the information about net profit or net loss from a Balance Sheet.
3.	**Necessity**	Though desirable, its preparation is not necessary.	It is necessary to prepare a Balance Sheet.
4.	**Headings**	The headings of its two	The headings of its two sides

		columns are debit and credit.	are assets and liabilities.
5.	**Period**	It is normally prepared every month or whenever needed.	It is normally prepared half-yearly or yearly at the end of the accounting period.
6.	**Types of Accounts**	All types of accounts whether personal, real or nominal must be written in it.	Only personal and real accounts are included in it.
7.	**Closing Stock**	Normally, it does not contain the item of Closing Stock.	It contains the item of Closing Stock.
8.	**Adjustments**	It can be prepared without making adjustments for outstanding expenses, prepaid expenses, accrued incomes etc.	It cannot be prepared without making adjustments for outstanding expenses, prepaid expenses, accrued incomes etc.
9.	**Evidence**	It is not accepted by the court as documentary evidence.	It is accepted by the court as documentary evidence. It is also helpful while making payment of income-tax and Goods and Service Tax (GST).

Following points should be noted for preparing Final Accounts

(1) If a Trial Balance is not given in the question, it is better to prepare a Trial Balance first of all. If there is a difference in the Trial Balance, the difference is placed to a 'Suspense A/c' and shown in the Balance Sheet.

(2) It should be remembered that all items which appear in the Trial Balance should be shown only once whereas items which appear outside the Trial Balance, known as adjustments, have to be shown at two places.

(3) The items which appear on the debit side of the Trial Balance should be shown either on the debit side of the Trading or Profit and Loss A/c or on the Assets side of the Balance Sheet.

(4) The items which appear on the credit side of the Trial Balance should be shown either on the credit side of the Trading or Profit & Loss A/c or on the Liabilities side of the Balance Sheet.

(5) All accounts relating to Goods such as Purchases, Sales, Purchase Returns and Sales Returns are written in the Trading Account. In addition to these, the Trading Account will also be debited with all expenses which are directly related to either purchase or manufacturing of goods. All the remaining expenses or the balances of the Nominal Accounts are shown in the Profit & Loss Account.

(6) The balances of Personal and Real Accounts are always shown in the Balance Sheet.

(i) If the expenses in respect of 'Rent' and 'Lighting' are clearly stated as having been incurred in respect of factory, these will be shown in the Trading Account, otherwise these will be shown in Profit & Loss Account. For example, if 'Factory Rent' is given in the question, it will be shown in Trading Account. Instead, if 'Rent' is given, it will be shown in Profit & Loss Account.

(8) If a trial balance is not given in the question, and it is not clearly stated whether a particular item is expense or income, it will be treated as expense such as Discount, Commission, Brokerage or Rent etc.

(9) The total of both sides of the Balance Sheet will always be equal.

Multiple Choice Questions (SET A)

Select the correct alternative:

1. The purpose of preparing final accounts is to ascertain :

(A) Profit or loss

(B) Capital

(C) The value of assets

(D) Profit or loss and financial position

2. The Profit and Loss Account shows :

(A) Financial Position of the Concern

(B) Gross Profit

(C) Net Profit

(D) Net Profit and Financial Position

3. Balance Sheet shows :

(A) Profit or Loss

(B) Financial Position

(C) Errors of Accounts

(D) Total Debtors

4. Final Accounts are prepared :

(A) At the end of calendar year

(B) At the end of Assessment year

(C) On every Diwali

(D) At the end of Accounting year

5. Trading and Profit and Loss Account is prepared :

(A) For a particular period

(B) On a particular date

(C) For the whole year

(D) None of above

6. Balance Sheet is prepared :

(A) For a particular period

(B) On a particular date

(C) For the whole year

(D) None of the above

7. Excess of debit in Profit and Loss Account is called :

(A) Net Profit

(B) Net Loss

(C) Gross Profit

(D) Gross Loss

8. "Salaries and Wages" appearing in Trial Balance is shown :

(A) On the Debit Side of Trading A/c

(B) On the Debit Side of P & L A/c

(C) On the Asset Side of Balance Sheet

(D) On the Liabilities Side of Balance Sheet

9. Balance Sheet is prepared with the balances of which of the following :

(A) All balances in the Ledger

(B) Balances of Personal Accounts

(C) Balances of Real Accounts

(D) Balances of Personal and Real Accounts

10. Balance of Petty Cash is :

(A) Expenses

(B) Income

(C) Liability

(D) Asset

11. Fixed assets are kept:

(A) For earning revenue

(B) For conversion into cash as quickly as possible

(C) For resale

(D) For getting loan by mortgage

12. Goodwill is :

(A) Current Asset

(B) Tangible Asset

(C) Intangible Asset

(D) Fictitious Asset

13. Choose the Current Assets from the following :

(A) Cash

(B) Stock

(C) Debtors

(D) All of these

14. Schedule of balances prepared from ledger accounts is known as :

(A) Balance Sheet

(B) Trial Balance

(C) Statement of Accounts

(D) Statement of Affairs

15. Closing Stock appearing in the Trial Balance is shown :

(A) On the Dr. side of Trading A/c

(B) On the Cr. side of Trading A/c

(C) On the Assets side of Balance Sheet

(D) On the Cr. side of Trading A/c and on the Assets side of Balance Sheet

16. Calculate the gross profit if rate of gross profit is 25% on sales and cost of goods sold are Rs. 1,80,000

(A) Rs.60,000

(B) Rs.36,000

(C) Rs.45,000

(D) Rs.30,000

17.

Opening Stock	Rs.8,500
Purchases	Rs.30,700
Direct Wages	Rs.4,800
Interest on Loan	Rs.2,800
Closing Stock	Rs.9,000

Cost of goods sold will be ....

(A) Rs.30,000

(B) Rs.32,000

(C) Rs.35,000

(D) Rs.40,000

18. If sales are Rs.2,000 and the rate of gross profit on cost of goods sold is 25%, then the cost of goods sold will be :

(A) Rs. 1,600

(B) Rs. 1,500

(C) Rs. 1,700

(D) Rs. 1,800

19. Cost of Goods Sold Rs. 1,50,000; Closing Stock Rs.40,000; Opening Stock Rs.60,000; Amount of purchase will be

(A) Rs. 1,30,000

(B) Rs. 1,70,000

(C) Rs.50,000

(D) None of these

Answers

Multiple Choice Questions (SET A)

Select the correct alternative:

1. (D)	**2. (C)**	**3. (B)**	**4, (D)**
5. (A)	**6. (B)**	**7. (B)**	**8. (B)**
9. (D)	**10.(D)**	**11. (A)**	**12. (C)**
13. (D)	**14. (B)**	**15. (C)**	**16. (A)**
17. (C)	**18. (A)**	**19. (A)**	

Multiple Choice Questions (SET B)

Select the correct alternative:

(1) Current liabilities are such obligations which are to be satisfied

(a) within one year.

(b) within two years.

(c) within three years.

(d) within four years.

(2) Computers owned by a firm are classified as

(a) Tangible Assets.

(b) Current Assets.

(c) Liquid Assets.

(d) Intangible Assets.

(3) Loss on sale of an old car is debited to

(a) Profit and Loss A/c.

(b) Car A/c.

(c) Depreciation A/c.

(d) Trading Account.

(4) Sales are equal to

(a) Cost of Goods Sold + Gross Profit.

(b) Cost of Goods Sold — Gross Profit,

(c) Gross Profit — Cost of Goods Sold.

(d) Purchases + Gross Profit.

(5) Income tax paid by a sole trader is shown

(a) on the debit side of the Trading Account.

(b) on the debit side of the Profit and Loss Account.

(c) as deduction from capital in the Balance Sheet.

(d) as addition to capital in the Balance Sheet.

(6) Goodwill is a

(a) Fictitious Asset.

(b) Tangible Asset.

(c) Intangible Asset.

(d) Current Asset.

(7) Returns Inward in the Trial Balance is deducted from

(a) Purchases.

(b) Sales.

(c) Returns outward.

(d) Gross profit.

(8) Financial Statements includes

(a) Trial Balance.

(b) Trading and Profit and Loss Account.

(c) Balance Sheet.

(d) Trading and Profit and Loss Account and Balance Sheet.

(9) Which type of expenses are shown in Trading Account?

(a) Direct Expenses.

(b) Indirect Expenses.

(c) Opening Expenses.

(d) Direct and Indirect Expenses.

(10) Which statement shows financial position of the business?

(a) Trading Account.

(b) Profit and Loss Account.

(c) Balance Sheet.

(d) Trial Balance.

(11) Which of the following is correct?

(a) Operating Profit = Net Profit + Non-operating Expenses - Non-operating Income

(b) Operating Profit = Net Profit + Non-operating Expenses + Non-operating Income

(c) Operating Profit = Net Profit + Non-operating Expenses - Non-operating Income

(d) Operating Profit = Net Profit — Non-operating Expenses + Non-operating Income

(12) Carriage Outwards is shown in

(a) Trading Account.

(b) Profit and Loss Account.

(c) Balance Sheet.

(d) Either Trading Account or Profit and Loss Account.

(13) Expenditure incurred on a fixed asset which increases the earning capacity is accounted as

(a) Capital Expenditure.

(b) Revenue Expenditure.

(c) Deferred Revenue Expenditure.

(d) General Expenditure.

(14) Closing stock shown inside the Trial Balance is shown in

(a) Trading Account.

(b) Profit and Loss Account.

(c) Balance Sheet.

(d) None of these.

(16) Which of the following is not shown in Balance Sheet?

(a) Opening Stock

(b) Closing Stock

(c) Patents

(d) Debtors

(17) Capital Expenditure and Revenue Expenditure

(a) are distinguished.

(b) are not distinguished.

(c) may or may not be distinguished.

(d) must not be distinguished.

(17) Capital Receipts and Revenue Receipts

(a) are distinguished.

(b) are not distinguished.

(c) may or may not be distinguished.

(d) must not be distinguished.

(18) Revenue Expenditure is transferred to

(a) Profit and Loss Account.

(b) Trading and Profit and Loss Account.

(c) Balance Sheet.

(d) Purchases Account.

(19) Revenue Income is transferred to

(a) Profit and Loss Account.

(b) Trading and Profit and Loss Account.

(c) Balance Sheet.

(d) Miscellaneous Income.

(20) Capital Expenditure is included in

(a) Trading Account.

(b) Profit and Loss Account.

(c) Balance Sheet.

(d) Profit and Loss Appropriation Account.

(21) Capital Receipts are shown in

(a) Balance Sheet.

(b) Trading Account.

(c) Trading Account.

(d) Capital Account.

(22) Outstanding Salaries is shown as

(a) an asset in the Balance Sheet.

(b) a liability in the Balance Sheet.

(c) adjusted in Profit and Loss Account.

(d) both (b) and (c).

(23) Large advertisement expenditure to introduce a new product is

(a) Capital Expenditure.

(b) Revenue Expenditure.

(c) Deferred Revenue Expenditure.

(d) None of these.

(24) Purchase of machinery for production is

(a) Revenue Expenditure.

(b) Capital Expenditure.

(c) Deferred Revenue Expenditure.

(d) None of these.

(25) Computers purchased for re-sale is:

(a) Capital expenditure.

(b) Revenue Expenditure.

(c) Deferred Revenue Expenditure.

(d) None of these.

(26) Insurance premium paid to insure the machinery at the time of its purchase is

(a) Revenue Expenditure.

(b) Capital Expenditure.

(c) Deferred Revenue Expenditure.

(d) None of these.

(27) Expenses on overhauling a second-hand machine purchased is

(a) Revenue Expenditure.

(b) Capital Expenditure.

(e) Deferred Revenue Expenditure.

(d) None of these.

(28) Balance Sheet is a

(a) a list of all the accounts in the books of a business.

(b) an account showing trading activities of a business.

(c) an account showing the financial position of a business as on a certain date.

(d) a list of assets, liabilities and capital of a business at a certain date.

(29) Which of the following is not the part of Financial Statements?

(a) Trial Balance

(b) Trading Account

(c) Profit and Loss Account

(d) Balance Sheet

Answers

Multiple Choice Questions (SET B)

Select the correct alternative:

1. (a)	**2. (a)**	**3. (a)**	**4. (a)**
5. (c)	**6. (c)**	**7. (b)**	**8. (d)**
9. (a)	**10.(c)**	**11. (c)**	**12. (a)**
13. (a)	**14. (c)**	**15. (a)**	**16. (A)**
17. (a)	**18. (b)**	**19. (b)**	**20. (c)**
21. (a)	**22. (d)**	**23. (c)**	**24. (b)**
25. (b)	**26. (b)**	**27. (b)**	**28. (d)**
29. (a)			

Chapter 20

Financial Statements — With Adjustments

In order to ascertain the true profit or loss of the business for a particular year, it is necessary that all expenses and incomes relating to that year are taken into consideration. For example, if we want to ascertain the Net Profit for the year ended on 31st March and rent for the month of March has not yet been paid, it would be proper to include such rent along with the other expenses of the year. Similarly, it often happens that certain incomes, like interest, dividend, commission etc. are earned but not received during the year. Adjustment for such incomes must be made in the current year itself, so that the Profit and Loss Account may disclose the correct amount of Net

Profit or Loss and the Balance Sheet may present the true financial position of the business. Simply stated, while preparing Final Accounts it must be detected whether there is a transaction (I) Which has been omitted to be recorded in the books, or (II) Which has been wrongly recorded in the books, or (III) Of which only one aspect has been recorded in the books. Entries passed for such transactions are called 'adjustment entries'.

Objectives or Need of Adjustments

1. To ascertain the true Net Profit or loss of the business.

2. To ascertain the true financial position of the business.
3. To make a record of the transactions omitted from the books.
4. To rectify the errors committed in the books of accounts.
5. To make a record of such expenses which have accrued but have not been paid.
6. To make a record of such incomes which have accrued but have not been received.
7. To provide for depreciation and other provisions.

It must be remembered that while preparing Final Accounts the items which are given inside the Trial Balance are written only once either in Trading Account or in Profit and Loss Account or in the Balance Sheet. On the other hand, the items which are given outside the Trial Balance (known as adjustments) are to be written twice because the double entry in respect of all these adjustments is to be completed in the final accounts itself.

Explanation of important adjustments

1. Closing Stock :— The amount of goods unsold at the end of the year is called Closing Stock. It is valued at **Cost Price or Realisable Value, whichever is less.** For example, certain goods were purchased for Rs. 1,00,000 but at present its realisable value is Rs. 1,20,000. It will be valued at Rs. 1,00,000 and not at Rs. 1,20,000. But suppose, if the realisable value of the same goods is Rs.90,000, it will be valued only at Rs.90,000. The basic principle underlying the valuation of closing stock is that anticipated losses should be taken into account, but all unrealized gains should be ignored.

Closing stock is incorporated in the books by means of the following entry :—

Closing Stock A/c Dr.

To Trading A/c

(Closing Stock brought into books)

Treatment in Final Accounts :— Generally, the closing stock is given outside the Trial Balance. This is so because closing stock is valued at the end of the year after the accounts have been closed. As such, Closing Stock will be shown at two places, i.e., on the Credit side of the Trading A/c and on the Assets side of the Balance Sheet.

If the Closing Stock appears inside the Trial Balance, it will be shown only on the Assets side of the Balance Sheet. Because this means that the entry to incorporate the closing stock in the books has already been passed and it has already been deducted out of'Purchases Account' given in the Trial Balance.

2. Outstanding Expenses or Expenses Due but not Paid :— These are the expenses which have been incurred during the year but have been left unpaid on the date of preparation of final accounts. In other words, the benefit of such expenses has been derived during the year but the payment of which has not yet been made. For example, the firm pays Rent @ Rs. 1,000 per month. If during the accounting year ending on 31st March, only 11 months Rent amounting to Rs. 11,000 has been paid, Rent for one month Rs. 1,000 will remain outstanding at the end of the year.

Treatment in Final Accounts :—Outstanding Expenses on the one hand, will be added to the concerned expenses on the debit side of Trading or Profit and Loss Account and on the other hand, will also be shown on the Liabilities side of the Balance Sheet. Outstanding Expenses Account is a Personal Account because it represents those persons to whom the payment is to be made.

Example :—Extracts of Trial Balance as at 31st March, 2020

Name of Accounts	Dr. Balances	Cr. Balances
Wages paid	2,20,000	
Salary paid	55,000	

Adjustments :—Wages Rs.20,000 and Salary Rs.5,000 are outstanding.

SOLUTION

Adjustment Entries

(1) Wages A/c	Dr.	20,000	
To Outstanding wages A/c			20,000
(Wages due)			
(2) Salary A/c	Dr.	5,000	
To Outstanding Salary A/c			5,000
(Salary due)			

Effects on Final Accounts

Dr. **TRADING A/C** **Cr.**

Particulars	Rs.	Particulars	Rs.
Wages 2,20,000 Add: Outstanding wages 20,000	2,40,000		

Dr. **PROFIT & LOSS A/C** **Cr.**

Particulars	Rs.	Particulars	Rs.
To Salary 55,000 Add: Outstanding Salary 5,000	60,000		

BALANCE SHEET

Liabilities	Amount	Asset	Amount
	Rs.		Rs.
Outstanding Wages	20,000		
Outstanding Salary	5,000		

Note :—If outstanding expenses have been mentioned inside the Trial Balance, they wili be shown on the liabilities side only because it means that it has already been added to the concerned expenses. Outstanding Expenses Account is a Representative Personal Account and always shows a credit balance.

3. Prepaid Expenses or Unexpired Expenses or Expenses Paid in Advance :— These are the expenses which have been paid in advance for the next year during the current year itself. In other words, the benefit of such payments will be available in the next accounting year.

Treatment in Final Accounts :— Prepaid Expenses on the one hand, will be deducted from the concerned expenses on the debit side of Trading or Profit and Loss Account and on the other hand, will also be shown on the Assets side of the Balance Sheet. Prepaid Expenses is a Personal Account because it represents those persons to whom the payment has been made in advance.

Example

EXTRACTS OF TRIAL BALANCE

as at 31st March, 2020

	Dr. (Rs.)	Cr. (Rs.)
Insurance Account	20,000	

Adjustment:—Prepaid Insurance amounted to Rs.5,000

SOLUTION

Adjustment Entry

Prepaid Insurance A/c Dr. 5,000

To Insurance A/c 5,000

(Insurance paid in Advance)

Effects on Final Accounts

Dr. **PROFIT & LOSS A/C** **Cr.**

	Rs.		Rs.
To Insurance 20,000 Less : Prepaid Insurance 5,000	 15,000		

BALANCE SHEET

Liabilities	Amount	Assets	Amount
	Rs.	 Prepaid Insurance	Rs. 5,000

Note :— If Prepaid Expenses have been mentioned inside the Trial Balance, they will be shown on the Assets side only because it means that it has already been deducted out of the concerned expenses. Prepaid Expenses Account is a Representative Personal Account and always shows a debit balance.

4. **Depreciation :—** Depreciation is the loss or fall in the value of fixed assets due to their constant use and expiry of time.

Treatment in Final Accounts :— Depreciation on the one hand, will be shown on the debit side of the Profit and Loss Account because it is a loss or expense and on the other hand, will also be deducted from the value of the concerned asset on the Assets side of the Balance Sheet.

Example :—

EXTRACTS OF TRIAL BALANCE as at 31st March, 2020

	Dr. (Rs.)	Cr. (Rs.)
Machinery	5,00,000	
Furniture	80,000	

Adjustments:—Machinery is to be depreciated @10% p.a. and fiimiture @ 20% p.a.

SOLUTION

Adjustment Entry

Depreciation A/c	Dr. 66,000	
To Machinery A/c		50,000
To Furniture A/c		16,000
(Depreciation charged)		

Effects on Final Accounts :—

Dr. **PROFIT & LOSS A/C** **Cr.**

Particulars	Rs.	Particulars	Rs.
To Depreciation on : Machinery	50,000		
Furniture	16,000		

BALANCE SHEET

Liabilities	Amount	Assets		Amount
	Rs.			Rs.
		Machinery	5,00,000	
		Less : Dep.	50,000	4,50,000
		Furniture	80,000	
		Less : Dep.	16,000	64,000

5. Accrued Income or Income Receivable :— It is quite common that certain items of income such as interest on securities, commission, rent etc., are earned during the current year but have not been actually received by the end of the current year. Such incomes are known as 'Accrued Incomes' or 'Earned Incomes'.

Treatment in Final Accounts :— Such Incomes on the one hand, will be shown on the credit side of the Profit & Loss Account and on the other hand, will be shown on the Assets side of the Balance Sheet because the amount is yet to be received.

Example

EXTRACTS OF TRIAL BALANCE

as at 31st March, 2020

	Dr. (Rs.)	Cr. (Rs.)
Commission Received		15,000

Adjustment : Commission earned but not received Rs.3,000.

SOLUTION

Adjustment Entry

Accrued Commission A/c	Dr.	3,000	
To Commission Received A/c			3,000
(Commission receivable)			

Effects on Final Accounts

Dr. PROFIT & LOSS A/C Cr.

Particulars	Rs.	Particulars	Rs.
		By Commission 15,000 Add: Accrued Commission 3,000	18,000

BALANCE SHEET

Liabilities	Rs.	Assets	Rs.
		Accrued Commission	3,000

Note :—If Accrued Incomes have been mentioned inside the Trial Balance, they will be shown on the Assets side only because it means that it has already been included in the concerned account of income. Accrued Income Account is a Representative Personal Account and always shows a Debit Balance.

6.Unearned Income or Income Received in Advance :— It may also happen that a certain income is received in the current year but the whole amount of it does not belong to the current year. Such portion of this income which belongs to the next year is known as 'Unearned Income' or 'Income received but not earned'.

Treatment in Final Accounts :— Such incomes on the one hand, will be deducted from the concerned income on the Credit side of Profit & Loss Account and on the other hand, will also be shown on the Liabilities side of the Balance Sheet.

Example

EXTRACTS OF TRIAL BALANCE

as at 31st March, 2020

	Dr. (Rs.)	Cr. (Rs.)
Rent Received		39,000

Adjustment:—Rent received but not earned Rs.3,000.

SOLUTION :—

Adjustment Entry :—

Rent Received A/c Dr. 3,000

To Rent received in Advance A/c 3,000

(Adjustment entry for unearned rent)

Effects on Final Accounts

Dr. PROFIT & LOSS A/C Cr.

Particulars	Rs.	Particulars	Rs.
		By Rent 39,000 Less: Unearned Rent 3,000	36,000

BALANCE SHEET

Liabilities	Amount	Assets	Amount
	Rs.		Rs.
Unearned Rent	3,000		

Note :— If 'Unearned Incomes' have been stated inside the Trial Balance, they will be shown on the Liabilities Side only because it means that it has already been deducted out of the concerned income. Unearned Income Account is a Representative Personal Account and always shows a Credit Balance.

7. **Interest on Capital:—**Usually, in order to ascertain the true efficiency of the business, interest at a normal rate is charged on the capital invested by the proprietor in the business. Profits remaining after charging such interest may be considered as the real profits earned by the business enterprise. Capital invested by the proprietor is treated as a loan to the business earning interest at a fixed rate. If this amount had not been invested in the business, it would even then have earned some interest outside. As such, the proprietor wants interest for his capital and profit for the risk undertaken by him. For example, if 6% interest is to be allowed on the capital of Rs. 10,00,000, the adjusting entry for this will be as follows :—

Adjustment Entry

Interest on Capital A/c Dr. 60,000

To Capital A/c 60,000

(Interest allowed on Capital)

Treatment in Final Accounts: — Interest on capital is an expense for the business and hence it is shown on the debit side of Profit & Loss Account. At the same time, it is a gain to the proprietor and hence is added to his capital.

8. **Interest on Drawings :—** Occasionally, the proprietor draws cash or goods for his personal use. Such withdrawals are termed as Drawings. If the firm pays interest on capital, it is fully justified that it should also charge interest on the drawings.

Example

EXTRACTS OF TRIAL BALANCE

as at 31st March, 2020

	Dr. (Rs.)	Cr. (Rs.)

Capital Ac		5,00,000
Drawings A/c	80,000	

Adjustment:— Charge Rs.3,000 as interest on drawings.

SOLUTION :—

Adjustment Entry :—

Drawings A/c Dr 3,000

To Interest on Drawings A/c 3,000

(Interest charged on drawings)

Treatment in Final Accounts :— Interest on Drawings is a gain to the business and hence it is shown on the credit side of Profit & Loss Account. At the same time, it is an expense from the proprietor's view and hence will be deducted from the capital on the Liabilities side of the Balance Sheet.

Dr. **PROFIT & LOSS AC** **Cr.**

	Rs.		**Rs.**
		By Interest on Drawings	3,000

BALANCE SHEET

Liabilities		**Amount**	**Assets**	**Amount**
Capital	5,00,000	Rs.		Rs.
Less : Drawings	80,000			
	4,20,000			
Less : Interest on Drawings	3,000	4,17,000		

9. Interest on Loan :— Generally, item of 'Loan' appears on the credit side of the Trial Balance. It means that the amount has been borrowed from some person or from the bank etc. Loan is a Liability of the firm and the interest on such loan will be an expense. If up-to-date interest has not been paid on the Loan, the unpaid interest will have to be calculated and will be treated just like outstanding expenses.

On the contrary, if the item of 'Loan' appears on the debit side of Trial Balance, it will mean that the amount has been lent to outsiders. It will be an asset in this case and interest on such loan will be an income for the firm.

Treatment in Final Accounts :— Assuming that the Loan appears on the credit side of the Trial Balance, interest on it will be an expense and hence will be recorded on the debit side of Profit & Loss Account. Outstanding amount of such interest will also be added to Loan Account on the Liabilities side of the Balance Sheet.

Example

EXTRACTS OF TRIAL BALANCE

as at 31st March, 2020

	Dr. (Rs.)	Cr. (Rs.)
Loan from bank @ 12% p.a.		5,00,000

Adjustment:— Interest on Loan is due for the whole year.

SOLUTION :— Adjustment Entry

Interest on Loan A/c Dr. 60,000

To Outstanding Interest A/c 60,000

(Outstanding interest on Loan)

Effects on Final Accounts :—

Dr. **PROFIT & LOSS A/C** **Cr.**

	Rs.		
To Interest on Loan	60,000		

BALANCE SHEET

Liabilities	Amount	Assets	Amount
	Rs.		Rs.
Loan from Bank 5,00,000 Add: Outstanding Interest 60,000	5,60,000		

10. Bad Debts :— Persons to whom goods have been sold on credit are known as 'Debtors'. Sometimes due to the dishonesty, death or insolvency of a debtor, full amount is not recovered from him. When it becomes certain that a particular amount will not be recovered it is known as 'Bad-debts'. Bad-debt is undoubtedly a loss to the firm and is therefore written on the debit side of the Profit & Loss Account. If

Bad-debts are given in the adjustments, they will also be shown at one more place, deducted from debtors on the assets side of the Balance Sheet.

Example

EXTRACTS OF TRIAL BALANCE

as at 31st March, 2020

	Dr. (Rs.)	Cr. (Rs.)
Bad-Debts	8,000	
Sundry Debtors	2,00,000	

Adjustment:— Write off further Bad-debts Rs.10,000.

SOLUTION :—

Adjustment Entry :—

Bad-debts A/c	Dr.	10,000	
To Sundry Debtors A/c			10,000

(Further Bad-debts written off)

Treatment in Final Accounts :— Bad-Debts of Rs.10,000 given in adjustments will be added to the Bad-Debts of Rs. 8,000 on the debit side of the Profit & Loss Account and the amount of Rs. 10,000 will also be deducted from Debtors on the Assets side of the Balance Sheet.

Dr. **PROFIT & LOSS A/C** **Cr.**

Particulars		Rs.	Particulars	Rs.
To Bad-debts	8,000			
Add: Further Bad-debts	10,000	18,000		

BALANCE SHEET

as at 31st March, 2020

Liabilities	Amount	Assets		Amount
		Sundry Debtors	2,00,000	
		Less : Bad-debts	10,000	1,90,000

11. **Provision for Bad and Doubtful Debts :—** Even after deducting the amount of actual bad-debts from the debtors, the list of debtors at the end of the year may include some debts which are either bad or doubtful. As the amount of actual loss on account of current year bad-debts would be known only in the next year when the amount is realised from debtors, a provision is created to cover any possible loss on account of bad-debts likely to occur in future. Such a provision is created at a fixed percentage on debtors every year and is called 'Provision for Bad and Doubtful Debts'. The term 'Provision' should be used instead of 'Reserve' because the aim is not to strengthen the financial position of the business but to cover an expected future loss.

Treatment in Final Accounts :— The amount of Provision for Doubtful Debts on the one hand, is shown on the debit side of the Profit and Loss Account and on the other hand, is deducted from Sundry Debtors on the assets side of the Balance Sheet, so that the debtors may appear at their realisable value in the Balance Sheet.

Example

EXTRACTS OF TRIAL BALANCE

as at 31st March, 2020

	Dr. (Rs.)	Cr.(Rs.)
Debtors	60,000	

Adjustment:— Create a provision for Bad and Doubtful Debts @ 5% on Debtors.

SOLUTION

Adjustment Entry

Profit and Loss A/c Dr. 3,000

To Provision for Bad and Doubtful Debts A/c 3,000

(The creation of provision at 5% on Debtors)

Dr. **PROFIT & LOSS A/C** **Cr.**

Particulars	Rs.	Particulars	Rs.
To Provision for Bad and Doubtful Debts	3,000		

BALANCE SHEET

as at 31st March, 2020

Liabilities	Amount	Assets	Amount
		Debtors 60,000 Less : Provision for Bad and Doubtful Debts 3,000	57,000

In the above Problem, the provision of Rs.3,000 created in 2020 will be carried forward to the next year and will be shown on the credit side of the Trial Balance of the year 2020. This provision of Rs.3,000 is termed as 'New Provision' in the year 2020 and the same provision of Rs.3,000 will be termed as 'Old Provision' in the year 2020. In 2020 when the bad-debts actually occur, the bad-debts will be met from this Old Provision. At the end of 2020, a fresh provision (New Provision) is made again on the amount of

Debtors at a fixed percentage.

The amount of Bad-debts is added to the amount of New Provision on the debit side of Profit & Loss Account and the amount of Old Provision will be deducted from the total of the two. The amount of Old Provision will be given on the credit side of the Trial Balance or in other words, the amount of provision which is given on the credit side of the Trial Balance will be treated as Old Provision.

As the New Provision is given in adjustments, it will also be deducted from Debtors on the assets side of Balance Sheet in order to complete its double entry.

Example

EXTRACTS OF TRIAL BALANCE

as at 31st March, 2020

	Dr. (Rs.)	Cr. (Rs.)
Bad-Debts Account	800	
Provision for Doubtful Debts 1-4-2020		2,500
Debtors	80,000	

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

SOLUTION:

JOURNAL

Date	Particulars	L.F.	Dr. (Rs.)	Cr. Rs.
2020 March 31	Provision for Doubtful Debts Ac Dr.		800	
	To Bad-debts A/c			800
	(Bad-debts transferred to old provision)			
March 31	Profit & Loss A/c Dr.		2,300	
	To Provision for Doubtful Debts A/c			2,300
	(Net amount charged from P & L A/c)			

Note : (1) Net Amount chargeable from P & L A/c :— Rs.

Bad-Debts 800

Add: New Provision required at 5% on Rs.80,000	4,000
	4,800
Less : Old Provision	2,500
This amount is to be shown on the Debit of P & L A/c	2,300

Dr. BAD-DEBTS ACCOUNT Cr.

Date	Particulars	Amount	Date	Particulars	Amount
2020		Rs.	2020		Rs.
March 31	To Balance b/d (As per Trial Balance)	800	March 31	By Provision for Doubtful Debts A/c	800

Dr. PROVISION FOR DOUBTFUL DEBTS ACCOUNT Cr.

Date	Particulars	Amount	Date	Particulars	Amount
2020		Rs.	2020		Rs.
March 31	To Bad-Debts A/c	800	April 1	By Balance b/d (Old Provision)	2,500
			2020		
March 31	To Balance c/d (New Provision 5% on Rs.80,000)	4,000	March 31	By Profit & Loss A/c (Balancing figure)	2,300
		4,800			4,800
			2020		
			April 1	By Balance b/d	4,000

Dr. PROFIT & LOSS A/C Cr.

Particulars	Rs.	Particulars	Rs.
To Provision for Doubtful Debts A/c:			
Bad-debts 800			

Add: New Provision	4,000			
	4,800			
Less : Old Provision	2,500	2,300		

BALANCE SHEET

Liabilities	Amount	Assets		Amount
	Rs.			Rs.
		Debtors	80,000	
		Less: New Provision		
		(5% on Rs.80,000)	4,000	76,000

Following points should be noted in respect of Bad-Debts Provision :—

(1) If provision for doubtful debts is given in adjustments, it is called 'New Provision'. In this case, it will be recorded at two places. On the one hand, it will be added in Bad-debts on the debit side of the P & L A/c and on the other hand, will also be deducted from Debtors on the assets side of the Balance Sheet.

(2) If provision for doubtful debts is given inside the Trial Balance, it is called 'Old Provision'. In this case, it will be recorded only at one place, i.e., deducted from the total of Bad-debts and New Provision on the debit side of P & L A/c.

When Bad Debts are Given in Adjustments :— Sometimes, Bad-debts are given in adjustments. In such a case, on the one hand, these further Bad-debts will be written on the debit side of the P & L A/c and on the other hand, will also be deducted from debtors on the assets side. New Provision in this case, will be calculated on the amount of debtors which remain after deducting the amount of Bad-debts therefrom.

Example

The following balances appeared in the Trial Balance of M/s Kapil Traders as at 31st March 2020 :

	Rs.
Sundry Debtors	3,05,000
Bad Debts	5,000
Provision for Bad-debts	20,000

The partners of the firm agreed to record the following adjustments in the books of the firm. Further Bad-debts Rs.3,000; maintain provision for Bad-debts 10%. Show journal entries and the Bad-debts Account, Provision Account, Debtors Account, Profit and

Loss Account and Balance Sheet.

SOLUTION:

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Date	Particulars		L.F.	Dr. (Rs.)	Cr. (Rs.)
2020					
March 31	Bad-debts A/c	Dr		3,000	
	To Sundry Debtors A/c				3,000
	(Further Bad-debts)				
March 31	Provision for Doubtful Debts A/c	Dr		8,000	
	To Bad Debts A/c				8,000
	(Bad debts adjusted against the provision)				
March 31	Profit and Loss A/c$®	Dr		18,200	
	To Provision for Doubtful Debts A/c				18,200
	(Net amount charged from P & L A/c)				

Note:

(1) Net Amount chargeable from P & L A/c	Rs.
Bad-Debts (5,000 + 3,000)	8,000
Add: New Provision : 10% on (3,05,000 - 3,000)	30,200
	38,200
Less: Old Provision	20,000
	18,200

Dr. **BAD-DEBTS ACCOUNT** **Cr.**

Date	Particulars	Amount	Date	Particulars	Amount
2020		Rs.	2020		Rs.
March 31	To Balance b/d	5,000	March 31	By Provision for	
March 31	To Sundry Debtors A/c	3,000		Doubtfi.il Debts A/c	8,000
		8,000			8,000

Dr. PROVISION FOR DOUBTFUL DEBTS ACCOUNT Cr.

Date	Particulars	Amount	Date	Particulars	Amount
2020		Rs.	2020		Rs.
March 31	To Bad Debts A/c	8,000	April 1	By Balance b/d	
March 31	To Balance c/d			(Old Provision)	20,000
	(New Provision)	30,200	2020 March 31	By Profit & Loss A/c	
				(Balancing figure)	18,200
		38,200			38,200

Dr. PROFIT & LOSS ACCOUNT Cr.

for the year ended March 31, 2020

Particulars		Rs.	Particulars	Rs.
To Provision for Doubtful Debts A/c:				
Bad-debts	5,000			
Add: Further Bad-debts	3,000			
	8,000			
Add: New Provision	30,200			
	38,200			
Less: Old Provision	20,000	18,200		

BALANCE SHEET

as at March 31, 2020

Liabilities	Amount	Assets		Amount
	Rs.	Sundry Debtors	3,05,000	Rs.
		Less : Further Bad-debts	3,000	
			3,02,000	

		Less: New Provision (10% on 3,02,000)	30,200	2,71,800

When Old Provision Exceeds the Total of Bad-debts and New Provision :—If the old Provision is more than the total of Bad-debts and New Provision, the balance will be shown on the Credit side of the P & L AJc. New Provision, as usual, will also be deducted from Sundry Debtors on the assets side.

Example

Prepare Journal Entries and the Bad-debts Account, Provision Account, P & L Account and Balance Sheet from the following information as at 31st March, 2020 :

	Rs.
Debtors	80,000
Bad-debts	2,000
Provision for Bad-debts	5,000

Adjustments : Bad-debts Rs.500, provision on debtors 3%.

SOLUTION:

JOURNAL

Date	Particulars		L.F.	Dr. (Rs.)	Cr. (Rs.)
2020 March 31	Bad-debts A/c To Debtors A/c (Further bad debts)	Dr.		500	500
March 31	Provision for Doubtful Debts A/c To Bad-debts A/c (Bad debts adjusted against the provision)	Dr.		2,500	2,500
March 31	Provision for Doubtful Debts A/c To Profit and Loss Aid[1]) (Excess provision credited to P & L A/c)	Dr.		115	115

Rs.

Note : (1) Excess amount credited to P & L A/c :—

Bad-debts (2,000 + 500)	2,500
Add: New Provision : 3% on (80,000 - 500)	2,385
	4,885
Less: Old Provision	5,000
This amount is to be shown on the credit of P & L A/c	115

Since Old Provision exceeds the amount of Bad-debts and new provision the excess amount i.e. Rs. 115 will be credited to P & L A/c.

Dr. BAD-DEBTS ACCOUNT Cr.

Date	Particulars	Amount	Date	Particulars	Amount
2020		Rs.	2020		Rs.
March 31	To Balance b/d	2,000	March 31	By Provision for	
March 31	To Debtors A/c	500		Doubtful Debts A/c	2,500
		2,500			2,500

Dr. PROVISION FOR DOUBTFUL DEBTS ACCOUNT Cr.

Date	Particulars	Amount	Date	Particulars	Amount
2020		Rs.	2020		Rs.
March 31	To Bad Debts A/c	2,500	April 1	By Balance b/d	
March 31	To Profit & Loss A/c (Balancing figure)	115		(Old Provision)	5,000
March 31	To Balance c/d (New Provision)	2,385			
		5,000			5,000

PROFIT & LOSS ACCOUNT

Dr. for the year ended March 31, 2020 Cr.

Particulars	Rs.	Particulars	Rs.
		To Provision for Doubtful Debts Ale: Old Provision 5,000	

		Less : Bad Debts	
		(500 + 2,000) 2,500	
		2,500	
		Less : New Provision 2,385	115

BALANCE SHEET

as at March 31, 2020

Liabilities	Amount	Assets	Amount
	Rs.		Rs.
		Debtors 80,000	
		Less : Further Bad Debts 500	
		79,500	
		Less : New Provision (3% on 79,500) 2,385	77,115

12.Provision for Discount on Debtors :—It is a normal practice in the business to allow cash discount to those debtors from whom the payment is received promptly or within a fixed period. Discount thus allowed will be an expense of the business and is therefore debited to the Profit & Loss Account. Since there will be certain debtors who will make early payment in the next accounting year and will be allowed such discount, a provision for such discount is created in the current year itself. The process of creating a provision for discount is the same as for the provision for doubtful debts. The following entry will be passed for this purpose :—

Profit & Loss A/c Dr.

To Provision for Discount on Debtors A/c

(Provision for discount created on good Debtors)

Treatment in Final Accounts :— Such provision is shown on the debit side of the Profit & Loss Account and is also deducted from Sundry Debtors on the Assets side of the Balance Sheet.

Note :—It should be noted that discount will be allowed only to those debtors who will make prompt payment. As such, the provision for discount is calculated on good debtors left after deducting further bad-debts given in adjustments and the provision for doubtful debts required to be made at the end of year. In other words, first of all, further bad-debts given in adjustments will be deducted from Debtors and then provision for doubtft.il debts will be calculated on the balance of Debtors and lastly, provision for discount will be calculated on the remaining amount of Debtors.

Goods and Service Tax (GST):

All indirect taxes like Excise Duty, Sales Tax, VAT, Service Tax etc. have been merged into a single tax known as GST. GST is paid at the time of purchase and GST is collected from the customers at the time of sale.

(i) GST Paid : GST is paid at the time of purchase of goods, purchase of assets and on expenses incurred.

GST paid on purchase within the same state is bifurcated into two parts :

Input Central GST (or Input CGST)

Input State GST (or Input SGST)

(ii) GST Collected : GST is collected from customers at the time of sale of goods, sale of assets and on services provided to customers.

GST collected from customers on sales within the same state is also bifurcated into two parts :

Output Central GST (or Output CGST)

Output State GST (or Output SGST)

GST paid is adjusted against GST collected and the balance is shown in the Balance Sheet as follows :

Input CGST is adjusted against Output CGST, and

(i) If Input CGST is more than Output COST, the balance is shown on the Assets side just like a pre-payment.

(ii) If Output CGST is more than Input CGST, the balance is shown on the Liabilities side being the amount payable to the Government.

Similarly, Input SGST is adjusted against Output SGST, and (i) If Input SGST is more than Output SGST, the balance is shown on the Assets side just like a pre-payment.

(ii) If Output SGST is more than Input SGST, the balance is shown on the Liabilities side being the amount payable to the Government.

Case (I) **TRIAL BALANCE**

	Dr. Rs.	Cr. Rs.
Input CGST	40,000	
Input SGST	40,000	
Output CGST		30,000
Output SGST		30,000

SOLUTION:

Liabilities	Rs.	Assets		Rs.
		Input CGST	40,000	
		Less: Output CGST	30,000	10,000
		Input SGST	40,000	
		Less : Output SGST	30,000	10,000

Case (II)

TRIAL BALANCE

	Dr. Rs.	Cr. Rs.
Input CGST	60,000	
Input SGST	60,000	
Output CGST		75,000
Output SGST		75,000

SOLUTION :

Liabilities		Rs.	Assets	Rs.
Output CGST	75,000			
Less: Input CGST	60,000	15,000		
Output SGST	75,000			
Less : Output SGST	60,000	15,000		

GST on Adjustment Items

(1) GST Levied on Outstanding Expenses:

GST is also levied on Outstanding Expenses. For example, rent amounting to Rs. 10,000 is Outstanding and CGST and SGST @ 6% each are levied, the adjustment entry will be :

Rent A/c	Dr.	10,000
Input CGST A/c	Dr.	600
Input SGST A/c	Dr.	600

To Outstanding Rent A/c		11,200

Notes :

(i) If Outstanding expenses are shown inside the Trial Balance then GST will not be levied on such Outstanding expenses because it means that the adjusting entry has already been passed and GST is already included in the Outstanding expenses shown inside the Trial Balance.

(ii) Wages and Salaries are exempt from GST.

(2) GST in Case of Prepaid Expenses :

GST is not to be calculated on prepaid expenses. For example, Rent paid is Rs. 8,000 out of which Rs.3,000 is paid for the next year. Suppose COST and SGST are 6% each, the Journal Entry will be :

Rent A/c	Dr.	8,000	
Input CGST A/c	Dr.	480	
Input SGST A/c	Dr.	480	
To Bank A/c			8,960

At the time of passing adjustment entry for Prepaid Rent:

Prepaid Rent A/c	Dr.	3,000	
To Rent A/c			3,000

Thus, while preparing final accounts, there is no need to calculated GST on prepaid expenses.

(3) GST Levied on 'Income Earned but not Received' :

GST is also levied on 'Income Earned but not Received' or 'Accrued Income'. For example Commission earned but not received amounting to Rs.20,000 is given in adjustments and CGST and SGST @ 9% each are chargeable, then the adjustment entry will be :

Accrued/Eamed Commission A/c Dr.	23,600	
To Commission Received A/c		20,000
To Output CGST A/c		1,800
To Output SGST A/c		1,800

(4) Income Received in Advance :

If Income received in advance is given in adjustments then GST is not to be calculated on such income because GST has already been credited at the time of receipt of income.

Adjustments Relating to Goods

13.Abnormal Loss :— Sometimes losses occur due to some abnormal circumstances such as accident, fire, flood, earthquakes etc. Such losses are called Abnormal Losses. These may be divided into two categories :—

(A) Loss of Goods :— Following entries will be passed if the goods are destroyed :—

(I) Loss by Accident A/c Dr.

To Purchases A/c

To Input CGST A/c

To Input SGST A/c

OR

To Input IGST A/c

(Loss of goods in accident)

(II) Profit & Loss A/c Dr.

To Loss by Accident A/c

(Loss by accident transferred to P & L A/c)

Combined effect of the two entries mentioned above will be that on the one hand, the loss of goods will be deducted from purchases on the Dr. side of Trading Account because it reduces the goods purchased for resale and on the other hand, it will also be shown on the Dr. side of P & L A/c since it is a loss to the business.

In case, the goods are insured and the Insurance Company admits a claim, the Account of Insurance Claim or Insurance Company will be debited for the amount of claim admitted, in place of P & L A/c in the above-mentioned entry.

Insurance Claim or Insurance Company A/c Dr.

To Loss by Accident A/c

(Loss to be recovered from the Insurance Co.)

Example :— Goods worth Rs. 1,00,000 were burnt by fire and a claim of 70% has been accepted by the Insurance Company.

SOLUTION :—

Adjustment Entry :—

(I) Loss by Accident (Fire) A/c	Dr. 1,00,000	
To Purchases A/c		1,00,000
To Input CGST A/c		
To Input SGST A/c OR		
To Input IGST A/c		

(Goods burnt by fire)

(II) Insurance Claim or Insurance Company A/c Dr. 70,000

Profit & Loss A/c Dr. 30,000

To Loss by Accident A/c 1,00,000

(70% of the claim accepted by the Insurance Co.)

Treatment in Final Accounts :— Rs. 1,00,000 will be deducted from Purchases on the debit side of Trading A/c; Rs.30,000 will be shown on the debit side of Profit and Loss A/c and Rs.70,000 will be shown on the Assets side of the Balance Sheet.

As such, the full amount of loss of goods is deducted from purchases. Amount of claim admitted by the Insurance Company is shown on the Assets and the balance will be shown on the debit side of P & L A/c.

(B) Loss of Fixed Assets :— If some fixed asset of the firm is destroyed by some accident such as fire etc. the loss will be shown on the debit side of P & L A/c and also deducted from the value of Asset on the assets side of the Balance Sheet.

(14) Charity in the form of Goods :— Occasionally, certain amount of goods are given away as charity. The following entry will be passed for it:—

Charity A/c Dr.

To Purchases A/c

To Input CGST A/c

To Input SGST A/c

or

To Input IGST A/c

(Goods given away as charity)

Treatment in Final Accounts :— On the one hand, the amount will be deducted from Purchases because it reduces the goods purchased for resale and on the other hand, it will also be shown on the debit side of P & L A/c because it is business expense.

(15) Goods distributed as free samples :— Sometimes the goods which the business deals in are distributed as free samples for the purpose of advertising these goods. The following adjusting entry should be passed for it :—

Advertisement A/c Dr.

To Purchases A/c

To Input CGST A/c

To Input SGST A/c

or

To Input IGST A/c

(Goods distributed as free samples)

Treatment in Final Accounts :— It will be deducted from purchases in the Trading A/c and will also be shown on the Debit side of P & L A/c because it is an expense of business.

(16) Drawings in Goods :— If the proprietor of the business has taken some goods for his personal use from the business, the entry will be :—

Drawings A/c Dr.

To Purchases A/c

To Input CGST A/c

To Input SGST A/c

or

To Input IGST A/c

(Goods taken by proprietor for personal use)

Treatment in Final Accounts: It will be deducted from Purchases in the Trading Account and will also be deducted from the Capital on the liabilities side of the Balance Sheet as Drawings.

Example A manufacturer of cloth took cloth for personal use Rs.5,000; distributed as samples cloth worth Rs.30,000 and gave to his office staff cloth worth Rs.20,000 for their personal use. Give adjusting entry.

SOLUTION:

Drawings A/c	Dr.	5,000	
Advertisement A/c	Dr.	30,000	
Salary A/c	Dr.	20,000	
To Purchases A/c			55,000

(Goods taken away from business for different purposes)

Implied Interest:—Sometimes, Trial Balance includes 'Loan Account' carrying a specified rate of interest. In such a case, it is necessary to calculate the interest, even

if nothing is mentioned in the adjustments about the interest. If no amount of interest is shown in the Trial Balance, the hill amount of interest will be treated as outstanding. But if some amount of interest is shown in the Trial Balance, it should be compared with the full amount of interest and the difference, if any, will be treated as outstanding interest.

17. Deferred Revenue Expenditure: There are certain expenditures which are revenue in nature but the benefit of which is likely to be derived over a number of years. Such expenditures are termed as 'Deferred Revenue Expenditures'. The benefit of such an expenditure generally lasts between 3 to 7 years. As such, the whole of such expenditure is not debited to the Profit and Loss Account of the current year but spread over the years for which the benefit is likely to last. Thus, only a part of such expenditure is taken to Profit & Loss Account every year and the unwritten off portion is allowed to stand on the assets side of the Balance Sheet.

For example, a firm spent a huge amount of Rs.2,00,000 on advertising to introduce a new product in the market and it is estimated that its benefit will last for 4 years. In this case, Rs.50,000 will be charged to the P & L A/c of each year for four consecutive years.

Entry will be :—

Profit & Loss A/c	Dr.	50,000	
To Advertisement A/c			50,000

(1/4th of Advertisement expenses charged to P & L A/c)

Accounting Treatment:— Rs. 50,000 will be debited to P & L A/c of each year and the balance will be treated as an asset and shown on the Assets side of the Balance Sheet. As such, the amounts shown on the Assets side will be Rs. 1,50,000 in the first year, Rs. 1,00,000 in the second year and Rs.50,000 in the third year.

18. Manager's Commission on Net Profit :— Sometimes, in addition to his regular salary, the manager is entitled to a commission on net profit. This is done to induce him to take more interest in the business. Since the Commission is always calculated at the end of the accounting period, it is treated as outstanding expenses and the following adjusting entry is passed for it :

Commission A/c	Dr.
To Outstanding Commission A/c	

Treatment in Final Accounts :— On the one hand, it will be recorded on the debit side of P & L A/c because it is a business expense and on the other hand, shown on the Liabilities side as an outstanding expense.

Method of Calculating the Commission :—This Commission may be based :—

(a) On profits before charging such Commission.

(b) On profits after charging such Commission.

(a) On profits before charging such Commission :— Suppose, the profit earned by the firm before allowing the Manager's Commission is Rs.22,000 and the Manager is entitled to a Commission of 10% on Net Profit before charging his Commission, the Commission will be calculated as follows :—

Manager's Commission = 22,000 $\times \frac{10}{100}$ = Rs.2,200.

(b) On profits after charging such Commission :— Suppose, the profit earned by the firm before allowing the Manager's Commission is Rs.22,000 and the Manager is entitled to a Commission of 10% on Net Profit remaining finally after charging his Commission, the Commission will be calculated as follows :—

Manager's Commission = 22,000 $\times \frac{10}{110}$ = Rs.2,000.

In other words, it means that out of every Rs. 110 of profit, the Commission will be Rs.10.

19. Sometimes Capital Expenditure is wrongly treated as Revenue Expenditure. Examples are :—

(1) Wages include Rs.20,000 spent on the installation of New Machine :— In order to rectify the mistake, Rs.20,000 will be deducted from Wages and added in Machinery.

(2) Goods purchased for the Construction of Building were debited to Purchases AccountIn order to rectify the mistake, amount will be deducted from Purchases and added to Building.

(3) Rs.2,00,000 spent for the erection of a Cycle Shed were included in Repairs :— In order to rectify the mistake, Rs.2,00,000 will be deducted from Repairs and added to Building,

Note Depreciation on such assets should be calculated after rectifying the above mistakes. In other words, the depreciation will be calculated on the increased value of such assets.

20. Goods sold and despatched but omitted to be recorded :— Sometimes the goods are sold and despatched as well, but omitted to be recorded in the books of accounts. The following entry will be passed to make a record of such sales :—

Debtors A/c Dr.

To Sales A/c

(Goods sold on credit but omitted to be recorded)

Accounting Treatment :— On the one hand, it will be added to sales on the Credit side of Trading Account and on the other hand, it will also be added to the Debtors on the Assets side.

21. Goods purchased and included into stock but omitted to be recorded :— Sometimes the goods are purchased and included in stock as well, but these are omitted to be recorded in the books of accounts. The following entry will be passed to make a record of such purchases :

Purchases A/c Dr.

To Creditors A/c

(Goods purchased on credit but omitted to be recorded)

Accounting Treatment: — On the one hand, it will be added to purchases on the debit side of Trading Account and on the other hand, it will also be added to the Creditors on the Liabilities side.

Adjustment of IGST, CGST and SGST

Input IGST is first adjusted against Output IGST and the balance is adjusted against CGST and SGST as follows:

Case (i) If Input IGST exceeds Output IGST Case

(ii) If Output IGST exceeds Input IGST

Case (i) If Input IGST exceeds Output IGST: In such a case, excess Input IGST will be first applied to Output CGST and the balance of Input IGST, if any, will be applied to set off Output SGST.

Example:

TRIAL BALANCE

	Dr. (Rs.)	Cr. (Rs.)
Input IGST	70,000	
Input CGST	36,000	
Input SGST	36,000	
Output IGST		20,000
Output CGST		40,000
Output SGST		40,000

SOLUTION :

	Rs.
(I) Input IGST	70,000
Less : Output IGST	20,000
Excess of Input IGST	50,000

This excess of Rs.50,000 will be first used to set off Output CGST of Rs.40,000 and the balance of Rs. 10,000 will be used to set off Output SGST.

(2)	Rs.
Output CGST	40,000

Less : Adjusted against excess of Input IGST	40,000

Input CGST amounting to Rs.36,000 will be shown on the Assets Side of Balance Sheet.

(3)	Rs.
Output SGST	40,000
Less : Adjusted against balance of Input IGST	10,000
	30,000
Less : Input SGST	36,000
Balance of Input SGST to be shown on Assets Side	6,000

BALANCE SHEET

Liabilities	Amount	Assets	Amount
	Rs.		Rs.
		Input CGST (Note 2)	36,000
		Input SGST (Note 3)	6,000

22. Sale of Goods on Approval Basis :— Sometimes goods are sold to the customer on approval (or return) basis, i.e., if the goods are liked by him, he may keep them and if they are not liked by him, he may return them. Such goods cannot be regarded as sale unless consent is received during the accounting period. In case, the goods have been recorded as actual sale and no consent has been received up to the end of accounting period, the following entry will have to be passed to cancel the sale :—

Sales A/c Dr.

To Debtors (Customer's) AJc

(Goods sold on sale or return basis recorded as sale, now rectified)

Accounting Treatment:—

(i) Sales will be reduced on the credit side of Trading Account and Debtors will also be reduced on the Assets side of Balance Sheet.

(ii) Cost price of the Goods lying with the customer will be calculated and then treated just like the closing stock. As such, it will be added to the Closing Stock on the credit side of Trading Account and the stock thus increased will also be shown on the Assets side of Balance Sheet.

Treatment of Various Adjustments

	Adjustment	Adjustment Entry		Treatment in Trading A/c	Treatment in Profit & Loss A/c	Treatment in Balance Sheet
1.	Closing Stock	Closing Stock A/c To Trading A/c	Dr.	Shown on tire credit side		Shown on the assets side
2.	Outstanding Expenses	Expenses A/c To Outstanding Expenses A/c	Dr.	Added to tire respective expense on the debit side	Added to the respective expense on the debit side	Shown on the liabilities side
3.	Prepaid or unexpired expenses	Prepaid Expenses A/c To Expenses A/c	Dr.	Deducted from the respective expense on the debit side	Deducted from the respective expense on the debit side	Shown on the assets side
4,	Depreciation	Depreciation A/c To Asset A/c	Dr.		Shown on the debit side	Deducted from the concerned asset on the

						assets side
5.	Accrued Income (Income earned but not received)	Accrued Income A/c To Income A/c	Dr.		Added to the respective income on the credit side	Shown on the assets side
6.	Unearned Income (Income received in advance)	Income A/c To Unearned Income A/c	Dr.		Deducted from the respective income on the credit side	Shown on the liabilities side
7.	Interest on capital	Int. on Capital A/c To Capital A/c	Dr.		Shown on the debit side	Added to the capital on the liabilities side
8.	Interest on Drawings	Drawings A/c To Interest on Drawings A/c	Dr.		Shown on the credit side	Added to the drawings and then deducted from Capital
9.	Interest on Loan (taken from someone)	Interest on Loan A/c To Loan A/c	Dr.		Shown on the debit side	Added to the loan on the liabilities side
10.	Further Bad-debts	Bad-debts A/c To Sundry Debtors A/c	Dr.		Added to Bad-debts (given in Trial Balance) on the debit side.	Deducted from debtors on the assets side
11.	Provision for Doubtful debts	Profit & Loss A/c Dr. To Provision for Doubtful Debts A/c			Added to Bad-debts on the debit side	Deducted from Debtors on the assets side
12.	Provision for discount on Debtors	Profit & Loss A/c Dr. To Provision for Discount on Debtors A/c			Shown on the debit side as a separate item	Deducted from Debtors on the assets side
13.	Abnormal	Insurance Company	Dr.	Total	Amount not	Amount

	loss of stock	A/c Profit & Loss A/c To Purchases A/c	Dr.	amount of loss is deducted from purchases on the debit side	recovered from the insurance company is shown on the debit side	recovered from the insurance company is shown on the assets side.
14.	Charity in the form of goods	Charity A/c To Purchases A/c	Dr.	Deducted from purchases on the debit side	Shown on the debit side	
15.	Goods distributed as free samples	Free samples A/c To Purchases A/c	Dr.	-do-	Shown on the debit side	
J6.	Drawings in goods	Drawings A/c To Purchases A/c	Dr.	-do-		Deducted from capital on the liabilities side.
17.	Manager's Commission	Manager's Commission A/c To Outstanding Commission A/c	Dr.		Shown on the debit side	Shown on the liabilities side
18.	Goods sold but omitted to be recorded	Debtors A/c To Sales A/c	Dr.	Added to sales on the credit side		Added to Debtors on the assets side
19.	Goods purchased but omitted to be recorded	Purchases A/c To Creditors A/c	Dr.	Added to purchases on the debit side		Added to Creditors on the liabilities side
20.	Sale of goods on approval basis	(i) Sales A/c To Debtors A/c (Sale value of goods) (ii) Closing Stock A/c To Trading A/c (Cost price of goods)	Dr. Dr.	Deducted from sales on the credit side Added to closing stock on the credit side		Deducted from debtors on the assets side Added to closing stock on the assets side.

Multiple Choice Questions (SET A)

Select the correct alternative:

1. A new firm commenced business on 1st January, 2020 and purchased goods costing Rs.90,000 during the year. A sum of Rs.6,000 was spent on freight inward. At the end of the year the cost of goods still unsold was Rs. 15,000 (Realisable Value 12,000). Sales during the year was Rs. 1,20,000. What is the gross profit earned by the firm?

(a) Rs.42,000

(b) Rs.30,000

(c) Rs.36,000

(d) Rs.39,000

2. Income tax paid by a sole trader is reflected in his financial statements :

(a) On the debit side of the Trading Account

(b) On the debit side of the Profit and Loss Account

(c) As an asset in the Balance Sheet

(d) As way of deduction from capital in the Balance Sheet

3. Insurance paid Rs.4,000 (including premium of Rs.3,000 per annum paid up to 30th June, 2020). What will be the adjusting closing entry necessary as on 31st March, 2020:

(a) Insurance Prepaid A/c	Dr.	750	
To Insurance A/c			750
(b) Insurance A/c	Dr.	750	
To Insurance Prepaid A/c			750
(c) Insurance A/c	Dr.	4,000	
To Cash A/c			4,000
(.d) Insurance A/c	Dr.	3,000	
To Cash A/c			3,000

4. Which of the following statements is correct:

(a) King's International — P & L A/c as on 31st March, 2020

(b) King's International — P & L A/c for the year ended 31st March 2020

(c) King's International — P & L A/c for the year ended 31st March, 2020

(d) King's International — P & L A/c for the current year (2019-2020)

5. Rent paid on 1st October, 2020 for one year upto 30th September, 2020 was Rs.2,400. Rent paid on 1st October, 2020 for the year upto 30th September, 2020 was Rs.3,200. Rent shown in the Profit and Loss Account for the year ended on 31st December, 2020, would be :

(a) Rs.6,000

(b) Rs.3,200

(c) Rs.3,000

(d) Rs.2,600

6. Accrued income is :

(a) A Liability

(b) Revenue

(c) An Asset

(d) An Expense

7. If closing stock appears in Trial Balance then it will be appearing in ;

(d) Trading Account

(b) Balance Sheet

(c) Profit & Loss Account

(d) Trading A/c & Balance Sheet

8. Types of Account shown in Balance Sheet are

(d) Nominal and Personal

(b) Real and Nominal

(c) Real and Personal

(d) Real, Nominal and Personal

9. Following information is given in Trial Balance

Bad Debt	Rs. 3,000
Provision for Bad Debts	Rs. 3,500
Debtors	Rs.40,000

Additional information :

It is desired to make a provision for doubtful debts @ of 10% on debtors. The amount debited to P&L A/c is

(a) Rs.4,000

(b) Rs.5,000

(c) Rs.6,500

(d) Rs.3,500

10. Net Profit before the following adjustments Rs. 1,80,000

Outstanding salary	Rs. 10,000
Prepaid Insurance	Rs. 13,000

Calculate profit after adjustments

(a) Rs. 1,83,000

(b) Rs.1,77,000

(c) Rs.2,03,000

(d) Rs. 1,87,000

11. Net profit of a firm before charging manager's commission is Rs.21,000. If the manager is entitled to 5% commission after charging such commission, how much manager will get as commission?

(a) Rs. 1,050

(b) Rs. 1,000

(c) Rs.2,100

(d) Rs.2,000

12. Closing stock is shown in Financial Statements at:

(a) Cost price

(b) Reliasable Value

(c) Cost price or Reliasable Value whichever is greater

(d) Cost price or Reliasable Value whichever is less

13. General Manager gets 10% commission on net profit after charging such commission. Gross Profit Rs.70,000 and general expenses other than manager's commission are Rs. 12,000. Commission amount will be :

(a) Rs.5,273

(b) Rs.6,073

(c) Rs.5,373

(d) Rs.5,173

14. Heavy amount spent for the advertisement of new company product is

(a) Revenue Expenditure

(b) Deferred Revenue Expenditure

(c) Capital Expenditure

(d) Either (a) or (c)

15. Income tax in case of sole trader is treated as ,

(a) Personal expenses

(b) Debtors expenses

(c) Business expenses

(d) None of the above

16. Business paid to Mr. A Rs.50,000 as salary on 25th March, 2011. Mr. A went to bank to deposit cheque in his account on 3rd April, 2011. What is the entry to be passed in the Balance Sheet on the date of final accounts?

(a) No entry

(b) Bank A/c Dr.

To O/s Salary A/c

(c) Salary A/c Dr.

To O/s Salary A/c

(d) Salary A/c Dr.

To A

17. A machine was purchased in Bihar. During transit the machine was damaged and the cost of repairs incurred is Rs.20,000. This expense is treated as :

(a) Capital expense

(b) Revenue expense

(c) Deferred Revenue expense

(d) None of these

Answers

Multiple Choice Questions (SET A)

Select the correct alternative:

1.(c.)	**2. (d)**	**3. (a)**	**4. (c)**	**5. (d)**
6. (c)	**7. (b)**	**8.(c)**	**9 .(d)**	**10. (a)**
11. (b)	**12. (d)**	**13. (a)**	**14, (b)**	**15. (a)**
16. (a)	**17. (a)**			

Multiple Choice Questions (SET B)

Select the correct alternative:

(1) Adjustments given are recorded once in Trading and Profit and Loss Account and again in Balance Sheet. It is so because of

(a) Matching Principle. (b) Dual Aspect Principle.

(c) Accrual Concept. (d) Materiality Principle.

(ii) Expenses incurred but not yet paid are accounted because of

(a) Matching Principle. (ii) Dual Aspect Principle.

(c) Accrual Concept. (d) Materiality Principle.

(iii) Wages paid for installation of machine is added to the cost of machine because of

(a) Accrual Concept. (b) Matching Principle.

(c) Materiality Principle. (d) Cost Principle.

(iv) Prepaid Insurance existing in the Trial Balance is shown in the Balance Sheet in the assets side because of

(a) Accrual Concept. (b) Matching Principle.

(c) Materiality Principle. (d) Cost Principle.

(v) On 1st February, 2020, a loan of Rs. 1,00,000 was given to Parth @ 12% p.a. Interest was received for 3 months from February to April, 2020. In the financial statements for the year ended 31st March, 2020, amount of advance interest should be

(a) Rs. 1,200. (b) Rs. 1,000.

(c) Rs. 3,600. (d) Rs. 4,800.

(vi) Indirect Expenses are transferred to

(a) Trading Account. (6) Profit and Loss Account.

(c) Balance Sheet. (d) Trading Account and Balance Sheet.

(vii) Wages and Salaries Account is shown in

(a) Trading Account, (6) Profit and Loss Account.

(c) Balance Sheet. (d) Trading Account and Balance Sheet.

(viii) Salaries and Wages Account is shown in

(a) Trading Account. (b) Profit and Loss Account.

(c) Balance Sheet. (d) Trading Account and Balance Sheet.

(ix) Closing Stock is valued at

(a) Cost.

(b) Net Realisable Value (Market Value).

(c) Cost or Net Realisable Value (Market Value), whichever is more.

(d) Cost or Net Realisable Value, whichever is less.

(x) Closing Stock is valued at Cost or Net Realisable Value (Market Value), whichever is less because of

(a) Going Concern Concept. (b) Accrual Concept.

(c) Prudence Concept. (d) Consistency Concept.

(xi) Closing Stock, if given outside the Trial Balance, is shown in

(a) Trading Account and Balance Sheet.

(b) Profit and Loss Account.

(c) Profit and Loss Account and Balance Sheet.

(d) Balance Sheet.

(xii) Following information is extracted from the Trial Balance of a business:

Sales: Rs. 1,00,000; Purchase: Rs. 60,000; Wages Rs. 21,000.

Closing stock was Rs. 3,000 more than opening stock. One third of the wages was charged to cost of goods sold in the Trading Account. What was the Gross Profit?

(a) Rs. 30,000. (b) Rs. 33,000.

(c) Rs. 36,000. (d) Rs. 40,000.

(xiii) Prepaid Expenses, if given in the Trial Balance, is shown in

(a) Trading Account, as deduction from the respective expense.

(b) Profit and Loss Account, as deduction from the respective expense.

(c) Trading and Profit and Loss Account, as deduction from the respective expense and in the Balance Sheet, as an asset.

(d) Balance Sheet.

(xiv) In the Trial Balance, Sundry Debtors are shown at Rs. 2,25,000, Bad Debts Rs. 25,000 and Provision for Doubtful Debts Rs. 5,000. 5% Provision for Doubtful Debts is to be maintained and 2% Provision for Discount on debtors is to be made. The amount of Provision for Discount on Debtors would be (a) Rs. 4,293. (b) Rs. 4,500.

(c) Rs. 2,925. (d) Rs. 4,275.

(.xv) Gross Profit: Rs. 50,000; Salaries: Rs. 5,800; Rent paid: Rs. 6,000; Provision for Doubtful Debts: Rs. 2,000 (Old); Commission (Credit) Rs. 4,000. Net Profit of the firm will be (a) Rs. 42,200. (b) Rs. 40,000.

(c) Rs. 42,000. (d) Rs. 45,000.

(xvi) Income Received in advance, if given in the Trial Balance, is shown in

(a) Trading Account, as deduction from the respective income.

(b) Profit and Loss Account, as deduction from the respective income.

(c) Profit and Loss Account, as deduction from the respective income and in the liabilities side of the Balance Sheet.

(.d) Balance Sheet in the liabilities side.

(xvii) Income received in advance is deducted from the income because of (a) Revenue Recognition Concept. (b) Accrual Concept.

(c) Matching Concept. (d) Prudence Concept.

(xviii) Balance of Provision for Doubtful Debts (As on 1st April, 2019): Rs. 1,250; Bad Debts

during the year were: Rs. 300. Provision for Doubtful Debts is required @ 5% on debtors of Rs. 10,000. Provision for Doubtful Debts credited to Profit and Loss Account will be (a) Rs. 400. (b) Rs. 500.

(c) Rs. 600. (d) Rs. 450.

(xix) Accrued Income, if given outside the Trial Balance, is shown in

(a) Trading Account, as addition to the respective income.

(b) Profit and Loss Account, as addition to the respective income.

(c) Profit and Loss Account, as addition to the respective income and in the assets side of the Balance Sheet.

(d) Balance Sheet in the assets side.

(xx) Accrued Income, if given in the Trial Balance, is shown in

(a) Trading Account, as addition to the respective income.

(b) Profit and Loss Account, as addition to the respective income.

(c) Profit and Loss Account, as addition to the respective income and in the Balance Sheet, as an asset.

(d) Balance Sheet as an asset.

(xxi) On 1st April, 2019 M/s Omega Bros., had a Provision for Doubtful Debts of Rs. 6,500. During 2019-20, Rs. 4,200 proved irrecoverable and it was decided to maintain the Provision for Doubtful Debts @ 5% on debtors which stood at Rs. 1,96,500 before writing off bad debts. Amount of net provision debited to Profit and Loss Account will be (a) Rs. 9,500. (b) Rs. 8,200.

(c) Rs. 6,500. (d) Rs. 7,315.

(xxii) Balance sheet is prepared to know

(a) financial performance. (b) financial position.

(c) liabilities position. (d) assets position.

(xxiii) Trading Account is prepared to know

(a) Gross Profit. (6) Net Profit.

(c) Balance of Capital. (d) Financial Position.

(xxiv) Profit and Loss Account is prepared to know

(a) Gross Profit or Gross Loss. (6) Net Profit or Net Loss.

(c) Operating Profit or Operating Loss, (d) Financial Position.

(xxv) Goods destroyed by fire costing Rs. 50,000 and insurance company admitted 60% claim. The adjustment will be entered in

(a) Trading Account.

(b) Profit and Loss Account.

(c) Balance Sheet.

(d) Trading Account, Profit and Loss Account and Balance Sheet.

(xxvi) Depreciation for current year in the Trial Balance is shown in

(a) Debit side of Profit and Loss Account and it is deducted from that particular asset in the Balance Sheet.

(b) Assets side of Balance Sheet as a deduction from the concerned Asset.

(c) Debit side of Profit and Loss Account.

(d) Debit side of Trading Account.

(xxvii) Provision for Doubtful Debts is made on the debts that are

(a) Doubtful of recovery.

(б) Not doubtful of recovery.

(c) Total Debtors.

(d) Total Debtors less Provision for Doubtful Debts.

(xxviii) Provision for Doubtful Debts, in excess of the required provision, is credited to (a) Debtors Account. (b) Trading Account.

(c) Profit and Loss Account. (d) Capital Account.

(xxix) Debts that were earlier written off, if recovered, are transferred to the credit side of (a) Debtors Account. (b) Trading Account.

(c) Profit and Loss Account. (d) Provision for Doubtful Debts Account.

(xxx) What is the effect of overvaluing Closing Stock on the Current Year's Profit?

(a) Decreases the gross profit and net profit.

(b) Increases the gross profit but decreases the net profit.

(c) Decreases the gross profit and increases net profit.

(d) Increases the gross profit and net profit.

1(i) (b); (¿0 (c); (iii) (rf); (iv) (a); (v) (6); (vi) (6); (vii) (a); (viii) (b); (;ix) (d); (x) (c); (xi) (a); (xii) (c); (xiii) (d)\ (xiv) (ci); (xv) (a); (xvi) (d)\ (xvii) (c); (xviii) (d); (xix) (c); (xx) (d); (xxi) (d); (xxii) (b); (xxiii) (a); (xxiv) (b); (xxv) (d)\ (xxvi) (c);

(xxvii) (a); (xxviii) (c); (xxix) (c); (xxx) (d).]

Answers

Multiple Choice Questions (SET B)

Select the correct alternative:

1.(c.) **2. (d)** **3. (a)** **4. (c)** **5. (d)**

6. (c)	7. (b)	8.(c)	9 .(d)	10. (a)
11. (b)	12. (d)	13. (a)	14, (b)	15. (a)
16. (a)	17. (a)			

Chapter 21

Accounts from Incomplete Records

In all the chapters studied so far, accounting records have been prepared according to double entry principles. Accounting records which are not prepared in accordance with the principles of double entry are known as **'incomplete records'.** In other words, any accounting records which fall short of complete double entry are called 'incomplete records'. Sometimes, it is also termed as 'Single Entry System'.

But it is not proper to describe the system as 'single entry' because there is no such system of maintaining accounting records. 'Incomplete records' refer to maintaining of only those records which are essential. In other words, under the incomplete records some of the subsidiary books and some ledger accounts are not maintained which otherwise are essential under the double entry system.

According to Carter :– "Single Entry system is a method or a variety of methods, employed for the recording of transactions, which ignore the two-fold aspect and consequently fails to provide the businessman with the information necessary for him to be able to ascertain the position."

Kohler defines it as :–

"A system of book-keeping in which, as a rule, only records of cash and of personal accounts are maintained; it is always incomplete double entry system, varying with circumstances."

Salient Features

(1) Maintenance of Personal Accounts only : Usually under this system, only personal accounts are prepared in the books and the real and nominal accounts are ignored.

(2) Maintenance of Cash Book : A Cash Book is maintained under this system, which usually mixes up business as well as private transactions of the proprietor.

(3) Dependence on Original Vouchers : In order to collect the required information one has to depend on original vouchers. For example, the figure of purchase at the end of a particular period is ascertained by totalling the original invoices received from the suppliers. Similarly, the figure of sale is ascertained by making a total of the copies of invoices which have been issued to the customers during the year.

(4) Lack of Uniformity : The books maintained under the system may differ from firm to firm because the system is only an adjustment of double entry system according to the actual needs and conveniences of the business houses.

(5) Suitability : Books according to this system can be maintained only by a sole trader or partnership firm. Limited companies cannot keep their books on this system because of legal provisions.

(6) Preparation of Final Accounts : Since a record of all the nominal and real accounts is not maintained under this system, the final accounts cannot be prepared easily. Final accounts can be prepared only after converting the available information into double entry records and after ascertaining the missing figures. Even then the figures of assets and liabilities will be based merely on estimates. Because of this reason the statement of assets and liabilities prepared under this system is termed as 'Statement of Affairs' instead of 'Balance Sheet'.

Uses or Reasons for keeping Incomplete Records :

(1) Simple Method : It is an easy and simple method of recording business transactions because it does not require any special knowledge of the principles of double entry system.

(2) Less Expensive : Only the cash book and some of the ledger accounts are maintained under this system. As such, the staff required for maintaining the accounts is also less in comparison to double entry system.

(3) Suitable for small concerns : This method is most suitable to small business concerns which have mostly cash transactions and very few assets and liabilities.

(4) Easy to calculate profit or loss : It is easier to calculate profit or loss under this method. For this purpose, only the closing capital has to be compared with the opening capital along with some adjustments.

(5) Flexible Method : The system is more practical and rejects the strict rules of double entry system. It can be easily changed and adjusted according to the needs of a particular business.

Defects or Limitations of Keeping Incomplete Records

(1) Preparation of Trial Balance not possible : The method does not record both the aspects of a transaction. As such, a trial balance cannot be prepared to check the arithmetical accuracy of the books of accounts. This increases the possibility of frauds and misappropriations.

(2) Incomplete and Unscientific System : The system is incomplete and unscientific due to the fact that both the aspects, debit and credit of a transaction are not recorded. Also, no set rules are followed under this method.

(3) True Profit or Loss cannot be ascertained : Because nominal accounts are not maintained, a Trading and Profit and Loss Account cannot be prepared and hence, the profit earned or loss suffered during a particular period cannot be ascertained with reasonable accuracy.

(4) Difficulty in preparing Balance Sheet : Since real accounts are not maintained, Balance Sheet cannot be prepared to depict the true financial position of the business. Only a statement of affairs is prepared wherein the value of assets and liabilities is written on estimated basis.

(5) No Control on Assets : Since real accounts are not maintained, it is not possible to keep full control on the assets and as such, the chances of misappropriation of assets cannot be avoided.

(6) No recognition in the assessment of Income Tax and Sales Tax : The system fails to reveal the true profit and sales of a business. As such, the accounts maintained under the system are not accepted by tax authorities.

(7) Unsuitable for Planning and Control : The system fails to provide the adequate and reliable figures required for planning and sound decision-making.

(8) Difficulty in Comparative Study : Due to incomplete information, the profitability and the financial position of the current year cannot be compared with that of the previous year and as such, it becomes quite difficult to know the reasons of improving or deteriorating profitability and financial position of the business.

(9) Proper valuation of assets not possible at the time of sale of business : It becomes very difficult to fix the correct price of assets, specially goodwill, at the time of sale of the business.

(10) Internal Check not possible : Because of lack of double entry principles, internal checking is not possible and hence there are always the chances of errors and frauds. Also, it becomes very difficult to detect them.

Due to the above-mentioned defects the system is known as incomplete, unscientific and unreliable.

Difference between Double Entry System and Incomplete Records

Basis of Difference	Double Entry System	Incomplete Records
1. Recording of both	Both the aspects of every	Under this system, both the aspects of very few transactions

aspects	transaction are recorded in it.	are recorded. For some other transactions one aspect and yet for others no aspect at all is recorded.
2. Type of Accounts	All accounts — personal, real and nominal are maintained under it.	Only personal accounts and a cash book are maintained under it.
3. Trial Balance	Arithmetical accuracy of the books of accounts can be checked in it by preparing a trial balance.	Arithmetical accuracy cannot be checked in it because a trial balance cannot be prepared.
4. Net Profit or Loss	True profit or loss can be ascertained in it by preparing a Trading and Profit & Loss A/c.	True profit or loss cannot be ascertained in it because a Trading and Profit & Loss A/c cannot be prepared.
5. Financial Position	True financial position is ascertained by preparing a Balance Sheet.	True financial position cannot be ascertained because a Balance Sheet cannot be prepared. Only a statement of affairs is prepared based on incomplete accounts and estimates.
6. Adjustments	Under this system, adjustments are made while preparing final accounts.	No adjustments are made under this system because of incompleteness of accounts.
7. Proof	Books maintained under this system are accepted as evidence in the court of law.	Books maintained under this system are not accepted as evidence in the court of law.
8. Suitability	This method is suitable for all types of business, small or large.	This method is suitable only for small size business where the number of transactions is less and that too mostly of cash nature.
9. Reliability	Books maintained under this system are reliable because they are based on scientific principles.	Books maintained under this system are less reliable because they are based on estimates.

Ascertainment of Profit or Loss from Incomplete Records

Despite the records being incomplete, the businessman would like to know the trading results as also the financial position of his business at the end of a particular period. This is done by adopting one of the two methods mentioned below:

(1) Statement of Affairs Method or Capital Comparison Method or Net Worth Method.

(2) Conversion into Double Entry Method.

(1) Statement of Affairs Method

According to this method, the profits are ascertained by comparing the capital at the end and capital at the beginning of the accounting period. If the capital at the end of an accounting period is more than that at the beginning (with the necessary adjustments), the difference is treated as profit. If, on the other hand, the capital at the end is less than that of beginning, the difference is treated as a loss.

As such, in order to ascertain profit according to this method, it is necessary to calculate the capital at the beginning of the year and also at the end of the year.

Capital at the beginning is calculated by preparing an 'Opening Statement of Affairs' and similarly, capital at the end is calculated by preparing a 'Closing Statement of Affairs'. A Statement of Affairs is similar to, though not the same, as a Balance Sheet and prepared as follows :—

STATEMENT OF AFFAIRS

as at ....

Liabilities	**Amount**	**Assets**	**Amount**
	Rs.		Rs.
Bank Overdraft		Cash in Hand	
Bills Payable		Cash at Bank	
Sundry Creditors		Bills Receivable	
Outstanding Expenses		Sundry Debtors	
Incomes received in advance		Stock	
Capital (being, balancing figure)		Prepaid Expenses	
		Accrued Income	
		Furniture	
		Plant & Machinery etc.	
	....		....

If the total of liabilities is deducted from the total of assets side of the statement of affairs, the balance will be taken as capital. It is based on the accounting equation :

Capital = Assets - Liabilities

Although the assets and liabilities are recorded in a statement of affairs just like a Balance Sheet, it should not be described as a Balance Sheet because of the following differences :—

Basis of Difference	Balance Sheet	Statement of Affairs
1. Double Entry	It is prepared with the list of ledger balances drawn from the books of accounts kept on the basis of double entry.	It is not prepared with the list of ledger balances but with such information as is available from the accounting records kept on the basis of single entry.
2. Arithmetical Accuracy	The tallying of balance sheet proves arithmetical accuracy of accounting books because it is prepared on the basis of a trial balance.	A statement of affairs does not prove the arithmetical accuracy of accounting books because it is not prepared on the basis of a trial balance.
3. Value of Assets and Liabilities	The values of assets and liabilities shown in a Balance Sheet are the actual values based on ledger accounts.	The values of assets and liabilities shown in the statement of affairs are merely the estimates based on physical inspection.
4. Object	It is prepared for ascertaining the financial position of a business.	It is prepared for ascertaining the capital of a business.
5. Omission of an Asset or a Liability	If an asset or liability is omitted while preparing a Balance Sheet, it will be easily detected because the Balance Sheet will not tally.	If an asset or liability is omitted while preparing statement of affairs, it cannot be easily detected.
6. Reliability	A Balance Sheet is treated as more reliable because it is based on double entry principles.	It is treated as less reliable because it is based on incomplete records and estimates.

Calculation of Profit:— The steps for calculating the profit made during the year can be stated as under :—

Step 1. Prepare statement of affairs at the beginning for calculating the capital at the start of the year (known as opening capital).

Step 2. Prepare statement of affairs at the end for calculating the capital at the end (known as closing capital).

Step 3. Adjust the closing capital by adding into it the drawings made by the proprietor during the year and deductions therefrom the additional capital introduced during the year.

Drawings are added to the closing capital on the logic that if the drawings had not been made, closing capital would have been higher by this amount. Similarly, additional capital is deducted from the closing capital on the logic that if the additional capital had not been introduced, closing capital would have been lower by this amount.

Step 4. Now the opening capital is deducted from the adjusted closing capital to ascertain the profit or loss. If the adjusted closing capital exceeds the opening capital the difference is termed as profit. On the other hand, if the adjusted closing capital is less than the opening capital the difference is termed as loss.

The entire process discussed as above may be put in the form of a **Formula** as follows:

Profit = Closing Capital + Drawings - Additional Capital - Opening Capital.

(2) Conversion into Double Entry Method Or

Preparation of Trading and Profit & Loss A/c and Balance Sheet

If a businessman who keeps incomplete records, wants to ascertain the profit or loss by preparing Trading and Profit & Loss Account, it is essential for him to convert his incomplete records into Double Entry records. Following steps are necessary for such conversion:

(1) Opening Statement of Affairs :— First of all, a statement of affairs at the beginning should be prepared to calculate the capital at beginning of the year and the accounts for all items appearing in statement of affairs are opened in the ledger through "opening entries" in the Journal.

(2) Cash Book :— As a second step, a Cash Book should be prepared and all accounts whether Personal, Real or Nominal, appearing either on the debit side or on the credit side of the Cash Book are opened in the ledger and posting is made in these accounts.

(3) Subsidiary Books :— After this, the subsidiary books should be checked and their totals should be posted to their respective Accounts. Also, the necessary posting should be made in Personal Accounts with the help of subsidiary books,

(4) Other Accounts :— There may be certain other transactions too, of which no record is kept in the books. All such transactions must be journalised and posted.

(5) Final Accounts :—Lastly, a Trial Balance is prepared with the help of ledger balances and Trading and Profit & Loss A/c and Balance Sheet are prepared on the basis of it.

The conversion of single entry into double entry, in actual practice, will be done by following the above-mentioned process. It is lengthy and, therefore, not advisable from examination point of view. In the examination, final accounts are prepared directly with the help of whatever information is available instead of first preparing journal, ledger and trial balance.

Calculation of Missing Figure :— In practical questions, some items are usually missing which have to be found out by preparing various accounts. In the examination, a student should generally prepare the following accounts in order to trace the missing items :

(1) Preparation of Opening Statement of Affairs :— First of all, an Opening Statement of Affairs or Opening Balance Sheet should be prepared to ascertain opening balance of capital.

(2) Preparation of Cash Book:—As a second step, a summary of the Cash Book must be prepared by writing the receipts on the debit and the payments on the credit side. The purpose of preparing the summary of the Cash Book is to ascertain the

missing figure of cash or bank balance at the beginning or at the end of the year. If opening balance of cash is given in the question, the Cash Book will reveal the closing balance and vice versa.

(3) Preparation of Total Debtors Account:— Then, a 'Total Debtors Account' must be prepared in each question, usually to find out the missing figure of credit sales or closing Debtors and sometimes the missing figure of opening Debtors or cash received from debtors. Out of these four items, three items will be given in the question and as such the fourth item will be the balancing figure. Total Debtors Account is prepared in the following manner : .

Dr. **TOTAL DEBTORS ACCOUNT** **Cr.**

Particulars	**Rs.**	**Particulars**	**Rs.**
To Balance b/d (Opening balance of Debtors)		By Cash received from Debtors B> B/R received	
To B/R Dishonoured		By Sales Returns	
To Cash refunded to Debtors		By Discount Allowed	
To Credit Sales, if given (if not given, balancing figure is Credit Sales)		By Bad-Debts By Balance c/d (Closing balance of Debtors, either given or balancing figure)	

(4) Preparation of Total Creditors Account :—A 'Total Creditors Account' must also be prepared in each question, usually to find out the missing figure of credit purchase or closing creditors and sometimes the missing figure of opening creditors or cash paid to creditors. Out of these four items, three items will be given in the question and as such the fourth item will be the balancing figure. Total Creditors Account is prepared in the following manner :—

Dr. **TOTAL CREDITORS ACCOUNT** **Cr.**

Particulars	**Rs.**	**Particulars**	**Rs.**
To Cash paid to Creditors		By Balance b/d (Opening Balance of Creditors)	
To B/P accepted		By B/P dishonoured	
To B/R endorsed		By B/R endorsed dishonoured	
To Purchases Returns		By Credit Purchases, if given (if not given, balancing figure is Credit Purchases)	....
To Discount Received			
To Balance c/d (Closing Balance of Creditors, either given or balancing figure)			

(5) Preparation of Final Accounts :— Trading and Profit & Loss Account and Balance Sheet will be prepared last of all from the various informations given in the question and the missing figures arrived at as above.

In brief, a student should usually prepare the following statements in each question :—

(1) Opening Statement of Affairs	:	In order to find out 'Opening Capital'
(2) Cash Book	:	In order to find out the 'Opening' or 'Closing' balance of Cash or Bank.
(3) Total Debtors Account	:	Usually to find out Credit Sales or Closing Debtors and sometimes to find out opening Debtors or cash received from Debtors.
(4) Total Creditors Account	:	Usually to find out Credit Purchase or Closing Creditors and sometimes to find out opening Creditors or cash paid to Creditors.

Trading and Profit & Loss Account and closing Balance Sheet should be prepared after the preparation of above.

Multiple Choice Questions (SET A)

Select the correct alternative:

1. Generally accounts under single entry system are maintained by :

(A) Sole Trader

(B) Company

(C) Society

(D) Government

2. Single Entry System of book keeping is :

(A) Inaccurate

(B) Unsystematic

(C) Unscientific

(D) All of these

3. When closing capital is more than opening capital, it denotes:

(A) Profit

(B) Loss

(C) No Profit no loss

(D) Profit, if there is no introduction of fresh capital

4. When closing capital is less than opening capital, it denotes:

(A) Profit

(B) Loss

(C) Loss, if there is no drawing

(D) None of the above

5. If Capital at the end of the year is Rs.40,000; Capital introduced during the year Rs.30,000; drawings for the year Rs.20,000 and loss for the year is Rs.60,000, then Capital at the beginning of the year was :

(A) Rs.90,000

(B) Rs. 80,000

(C) Rs.70,000

(D) Rs. 10,000

Answers

Multiple Choice Questions (SET A)

Select the correct alternative:

1. (A)	**2. (D)**	**3. (D)**	**4. (C)**	**5. (A)**

Multiple Choice Questions (SET B)

Select the correct alternative:

(1) Capital in the beginning of the accounting year is ascertained by preparing

(a) Debtors' Account.

(b) Cash Account.

(c) Opening Statement of Affairs.

(d) None of these.

(2) Single Entry System can be adopted by

(a) Small firms.

(b) Joint Stock Companies.

(c) Co-operative Societies.

(d) None of these,

(3) In case of net worth method of Single Entry System, profit is ascertained by

(a) comparing the capital in the beginning of the accounting period and the capital at the end of the accounting period.

(b) Preparing a Profit and Loss Account.

(c) Preparing a Balance Sheet.

(d) None of these.

(4) Profit = Capital at the end +……….. - Capital introduced - Capital in the beginning.

(a) Sales.

(b) Drawings.

(c) Net Purchases.

(d) None of these.

(5) From incomplete records, it is possible to prepare

(a) Ledger Accounts.

(b) Trial Balance.

(c) Statement of Affairs.

(d) None of these.

(6) Given the opening and closing balances of debtors and the figure of credit sales, the balancing figure of Total Debtors Account will give

(a) Bills received during the year.

(b) Cash received from debtors.

(c) Closing balance of bill receivable.

(d) None of these.

(7) When closing capital is greater than opening capital it means

(a) Profit.

(b) Loss.

(c) Profit if fresh capital is not introduced.

(d) No profit, no Loss.

(8) When closing capital is less than opening capital, it means

(a) Profit.

(b) Loss.

(c) Loss if there is no drawing.

(d) None of these.

(9) If the rate of gross profit is 25% of sales and Cost of Goods sold is Rs. 1,00,000; the amount of gross profit will be

(a) Rs. 25,000.

(b) Rs. 33,333.

(c) Rs. 20,000.

(d) None of these.

(10) If the gross profit is 20% of cost of goods sold and sales are Rs. 1,00,000; the amount of gross profit will be

(a) Rs. 20,000.

(b) Rs. 25,000.

(c) Rs. 16,667.

(d) None of these.

(11) Closing balance of creditors is determined by preparing

(a) Total Debtors Account.

(b) Total Creditors Account.

(e) Bills Receivable Account.

(d) Bills Payable Account.

(12) Sales are calculated by adding

(a) Cash sales and cash received from debtors.

(b) Credit sales and cash received from debtors.

(c) Cash sales and credit sales.

(d) None of the above.

(13) Bills Receivable endorsed dishonoured are debited to

(a) Debtors Account.

(b) Bills Receivable Account.

(c) Creditors Account.

(d) Bank Account.

(14) Bills Payable honoured during the year will be debited to

(a) Cash Account.

(b) Bills Payable Account.

(c) Creditors Account.

(d) None of these.

Answers

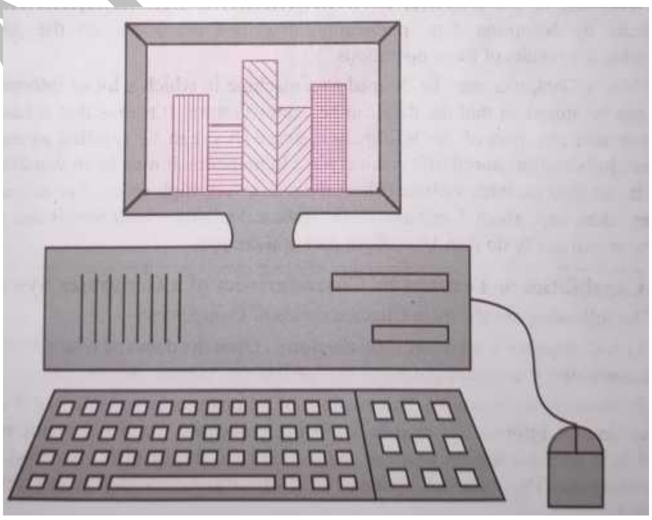
Multiple Choice Questions (SET B)

Select the correct alternative:

1.(c.)	**2. (a)**	**3. (a)**	**4. (b)**	**5. (c)**
6. (b)	**7. (c)**	**8.(c)**	**9 .(b)**	**10. (c)**
11. (b)	**12. (c)**	**13. (a)**	**14, (b)**	

Chapter 22

Introduction to Computers



Now a days, a box full of electrical circuits named as computer has brought complete revolution in every sphere of human activity. Today computers are in widespread use in almost every aspect of present day society. They are used to make reservation of seats on railway and air flights, to forecast the weather, to diagnose diseases, to prepare customer's invoices in business houses, to keep a record of customer's transactions in banks and even to keep a track of criminals on the run. In fact, computers have become indispensable in almost every field of science and research, technology, transport, communication, commerce and industry. Today the computers are used not only by mathematicians, scientists and engineers alone but even the type-setting of the newspaper we read early in the morning and the programmes we watch on T.V. late in the night are composed with the help of computers.

Computers are now a days being used on a large scale in business houses for a number of manual functions. They are now used for recording and posting business transactions, preparing wages and salary sheets, keeping effective stock control, preparing bills, maintaining purchases and sales ledger etc. Computer performs all the accounting operations at a phenomenal speed and with a high degree of accuracy.

Meaning and Definition of Computer

According to Webster's Dictionary, a Computer is "an automatic electronic machine for performing calculations". But it cannot be defined merely a calculating machine because it is capable of answering the questions based on the data stored inside it.

According to International Standard Organisation or I.S.O. : "A Computer is a data processor that can perform substantial computations, including numerous arithmetic and logic operations, Without intervention by a human operator during the run."

According to the U.S. Institute : "A Computer is a device capable of solving problems by accepting data, performing described operations on the datas and supplying the results of these operations."

Thus, a Computer may be defined as a machine in which a lot of information or data can be stored so that the data can be used in future. It means that it has a good memory and any part of the information stored in it can be recalled as and when needed. Information stored in it is not always in numbers. It may be in words or codes also. It can also perform various calculations at a very high speed. For example, if a person takes, say, about 5 minutes to do some calculations with pencil and paper, a computer can easily do it in 1/10,OOOth part of a second.

Capabilities or Features or Characteristics of a Computer System

The following are the main Characteristics of Computers :—

(1) A Computer is an automatic machine: Once the data and instructions are fed into a computer, it executes them one by one without human intervention.

(2) Memory or Storage : The memory of a Computer is so large that it can store any volume of information or data for being processed. Such informations can be stored in it on a permanent basis on magnetic discs, floppy discs, punched cards or microfilms etc. The information stored in it can also be recalled at any time when required.

(3) High Speed : Computers are known for their lightning speed of operations. The speed is so high that it is ordinarily expressed in microseconds (1 micro second = 1/10,00,000 of one second). In other words, they can perform millions of operations in one second. Moreover, the calculations will be error-free and the speed is rapidly increasing day-by-day.

(4) Accuracy : Computers are extremely accurate. Their operations are error-free and as such the information obtained from it is highly reliable. Of course, sometimes we hear funny stories about the mistakes committed by the Computers. But the real culprit is not the computer but the operator who feeds inaccurate data into it. As such, in computer terminology, there is a word GIGO (Garbage in, garbage out).

(5) Diligence : A man may feel mental and physical fatigue after long working hours but a computer never gets tired like a human being. It can work continuously for many days at a time and never says, "I am too tired to do any more work". Moreover, it does not suffer from lack of concentration and can perform the jobs of repetitive nature any number of times, in exactly the same way.

(6) Scientific Approach : A Computer operates scientifically and never gets emotional while solving the problems. It always acts in a neutral manner and is never affected by the feelings and opinions of someone.

(7) Versatile Machine : A Computer is capable of pierforming a Wide variety of jobs. It can switch over from one programme to another according to the instructions fed into it. The same computer can be used for accounting work, invoicing, stock control, sales analysis and even for playing Chess.

(8) Usage of Special Language : A Computer does not understand the ordinary language. A number of special languages have been developed in order to feed the informations and data into a Computer. The names of some of the special languages are : BASIC, COBOL, PASCAL, FORTRAN.

Each of the above languages is used for processing a specific type of data. Such as:–

(I) COBOL is a language used for processing the business informations.

(II) FORTRAN is a language most suited for processing the mathematical and statistical informations.

(III) BASIC is used by the persons who have just started to learn the programming.

(9) Detailed Instructions :— In order to solve a problem with the help of the computer, all informations relating to that problem are fed into the Computer in a logical sequence. A set of such logical instructions is. termed as 'Programme'. A Computer will operate according to the instructions contained in a particular programme and will solve a given problem accordingly. For example, if a programme containing the figures of wages of thousands of workers is fed into the Computer, it will immediately make various calculations and print a wage sheet in no time.

(10) Use of Binary System :— Computers do not use the decimal system but use a two-way system known as Binary System. Under this system the informations stored in the Computer are in two Digits only. These two digits are 0 and 1.

For example, if we want to convert the decimal number 43 into binary digits, the procedure for conversion will be as follows :

Operation	Quotient		Remainders
43 ÷ 2 =	21	With a remainder	1

214 ÷ 2 =	10	With a remainder	1
104 ÷ 2 =	5	With a remainder	0
54 ÷ 2 =	2	With a remainder	1
24 ÷ 2 =	1	With a remainder	0

In the above example, 43 is divided by 2 to give a quotient of 21 and a remainder of 1. Then the quotient of 21 is again divided by 2 and the remainder is 1. The process will be continued till the quotient becomes 1 or 0. Now, the last quotient will be written first and the remainders in the reverse order, i.e., from bottom to the top. Thus, for the decimal number 43, the binary number will be written as 101011.

11. A Computer is different from a Calculator A Computer contains much more than a Calculator: A Calculator can work only with numbers whereas a Computer can work with both numbers and words. Another difference is that a Calculator is not capable of storing the data, whereas a Computer can store large volume of data in its memory and reproduce any part of it, as and when needed.

Limitations of a Computer System

A computer system renders various useful services to its uses. It also suffers from the following limitations :

(i) Lack of Decision-making : Computers are only helpful in taking the decision while they cannot take decisions on their own. Decision-making is a complex process which requires a lot of understanding, information, intelligence and ability to decide. Computers need to be programmed beforehand in order to become able to take decisions.

(ii) Lack of Intelligence Quotient: Computers are mere machines with Zero IQ (Intelligence Quotient). Computers need to be programmed before hand in order to become able to handle the situation. They cannot think themselves and need to be directed each and every step. They are only as good as man makes and uses them.

(iii) Lack of Common-Sense : A computer system lacks in common-sense. A computer will keep on working as per its programming and fails to analyse the logical or illogical aspect of it.

(iv) Lack of Feelings : Computers are devoid of emotions. They have no feelings and no instincts because they are a machine. Although men have succeeded in building a memory for the computer, but no computer possesses the equivalent of a human heart and soul.

Components of Computer System

A Computer System is made up of a number of electronic components. These components are known as 'Hardware'. The names of the components are as follows:—

(I) Keyboard

(III) C.P.U.

(II) Monitor (IV) Magnetic Recorder

Keyboard and Monitor put together are known as Terminal.

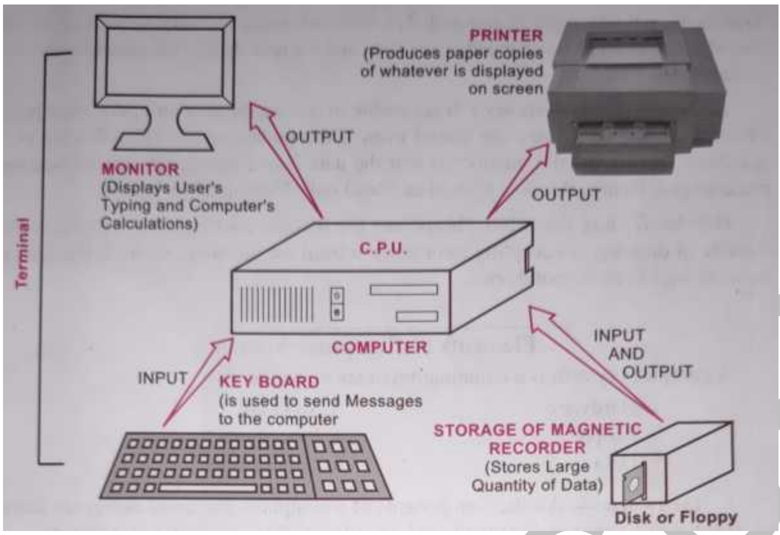


Diagram Components used in a Computer

(I) Keyboard :— The devices or components which are used to feed data and programmes into a Computer are called 'Input Devices'. Keyboard is one of such devices. The data which we want to feed into a Computer may be typed on the keyboard in binary language. The other input devices are Punched Cards, Paper Tapes, Magnetic Tapes, Magnetic Disc, Floppy Disc etc.

(II) Monitor :— A Computer displays the results, reports or answers on a screen known as monitor or 'output device'. Results are displayed on the screen in a language which can be easily read and understood by the users. Besides monitor there are other output devices also, such as Hard Copy Printer which prints the results shown on the screen.

(III) Central Processing Unit or C.P.U. :— This unit is the main and most important part of a Computer which consists of a group of complex electronic circuits. It is the brain or decision making part of the Computer which performs all the operations in accordance with the programme fed into the Computer. It can add, subtract, multiply or divide the different numbers and also performs all other arithmetic and logical operations. It keeps full control on the operations of all the other units of a Computer such as keyboard, monitor, magnetic recorder, printer etc.

(IV) Magnetic Recorder :— This unit permanently stores the data and informations fed into a Computer and is also known as memory unit. The memory of a Computer may be of two types :—-

(i) Volatile Memory :— It is only capable of storing the data temporarily. The data stored into it is automatically erased as soon as the power supply is cut off or fails. As such, a magnetic recorder which has a permanent record of all data is attached to each computer which again automatically feeds the data into the volatile memory as soon as the power supply is restored. The main advantage of volatile memory is that data stored into it can be changed at any time and the new data or informations can also be fed into it.

(ii) Non-Volatile Memory : It is capable of storing the data on a permanent basis. The data stored into it are not erased even if the power supply fails. But the main drawback of non-volatile memory is that the data stored into it can only be read and not changed. Hence, it is also termed as 'Read only Memories' or ROMs.

Besides feeding the informations into the memory, a magnetic recorder is also capable of drawing or accepting informations from the memory. As such, it is both an input as well as an output device.

Elements of Computer System

A computer system is a combination of six elements :—

1. Hardware	2. Software
3. People	4. Procedures
5. Data	6. Connectivity

1. Hardware :— All the Components of a computer discussed earlier are known as 'Hardware'. These include keyboard, monitor, C.P.U., magnetic recorder etc.

2. Software :— In order to solve a problem with the help of computer, a sequence of instructions written in a proper language will have to be fed into the Computer. A set of such instructions is known as a "Program" and the set of programs is called 'Software'. A Computer machine (hardware) can be used for various purposes only by a change of program (software). For example, a Computer by feeding a particular software can be used to prepare pay-roll, whereas by feeding a second software it can be used to prepare accounts, and similarly by feeding a third software it can be used for inventory control and also by feeding a fourth software it can be used for word processing. No change is to be effected in a Computer (hardware) for putting it to various uses.

A very large number of software packages recorded on the floppy discs are available in the market. Each floppy disc is accompanied by a 'Manual' wherein the details of the programmes recorded on the floppy disc and the method of its use is explained in detail.

There are six types of software, which are :

(1) Operating System : The operating system is an important program to start a computer and make them user interactive. An operating system performs basic tasks, such as recognising input from the keyboard, sending output to the display screen, keeping track of files and directories on the disk and controlling peripheral devices such as disk drives and printers.

(2) Utility Software : Utility programs or routines are pre-written programs to provide procedures commonly required by virtually all applications.

(3) Application Software : Any activity for which a computer is put to use is considered an application.

A user-oriented program which is designed for performing certain jobs, such as accounting, word processing, recreation etc. is known as application software. For example, if an enterprise desires to maintain its accounts, it shall have to install an accounting software such as Excel or Tally. Typing a letter is done with a word processing application. Playing computer games will need a recreational application. Creating a mailing list is accomplished with a database application, for which one shall install Oracle, SQL-server or My-SQL.

(4) System Software : System software are those programs that control the operation of the computer. These programs help in controlling the internal functions of a computer. Some of the system software are assemblers, compilers, interpreters, utility programs and operating system etc.

(5) Language Processors : This software checks for language syntax and finally translates the program language into machine language, i.e., into a language which machine understands.

A Computer cannot understand our language; it understands only the machine language.

(6) Connectivity Software : This software is helpful in creating and controlling a connection between a computer and a server. This helps the computer to communicate and share the resources of server and other connected computers.

3. People or Humanware : People are basically those individuals who use hardware and software to develop, maintain and use the information system residing in the computer memory. The main categories of people involved with the computer system are :

System Analysts : They design data processing system.

Operators : They operate the computers.

Programmers : They write programs to implement the data processing system design.

4. Procedures : The procedures are the various operations performed in a certain way in order to achieve some desired results.

There are basically three types of procedures which form a part of computer-system which are as follows :

(a) Software-oriented : They provide a set of instructions required for using the software of a computer system.

(b) Hardware-oriented : They provide information about the various components of a computer system and their various uses.

(c) Internal Procedure : The internal procedures help in sequencing the workings or operations of each sub-system of a computer system.

5. Data : Data can be anything like bio-data of various applicants when the computer is used for recruiting personnel, or the marks obtained by various students in various subjects when the computer is used to prepare results, or the details (like name, age, sex, etc.) of various passengers when the computer is employed for making airline or railway reservations, etc. A computer stores, processes and retrieves data as and when desired, in order to provide information which is required for taking decisions.

6. Connectivity : The element of connectivity refers to the way in which a computer system is connected to other electronic devices and link ups such as satellite link, telephone lines etc.

Distinction between Hardware and Software

Basis of Distinction	Hardware	Software
1. Meaning	Computer components that can be physically touched are known as computer hardware.	A set of programme which is used with hardware to perform computer applications is known as software.
2. Examples	Keyboard, monitor, C.P.U., magnetic recorder etc.	Operating system, utility software, application software, system software etc.

Commercial Softwares

Or

Softwares used in Business

Although a very large number of softwares used in business are available in the market, following are most commonly used :—

(A) Electronic Spread Sheets

(B) Word Processor

(C) Data Base Management

(A) Electronic Spread Sheets :— It is a type of programme on a large sheet of paper. There are various columns on the spread sheet and various figures are filled in these columns. Size and number of the columns can be increased or decreased according to the needs. The electronic spreadsheet is very useful in situations where some figures are related to each other and some figures are determined by other figures. A spread sheet offers replies to 'What if ' question. For example, in a payroll, if wages are proposed to be increased by 10%, we can quickly find out how much will be the additional cost. A spread sheet has the following utility in accounting:—

I. Pay-roll accounting: It is used for calculating the salary of each employee. In the spread-sheet one row is used for each employee and there are columns for basic pay, D.A., house rent allowance, other allowances, gross salary, deductions and the net amount payable. If the columns of names and basic pay are filled, the spread sheet will automatically calculate the values for other columns according to the given formulae.

II. Recalculation if some values are changed :— We can find out the answer of 'What if ' question quickly by a spread sheet by changing the formulae in it. For example, if the formula of D.A. is changed in the spread sheet, the new figures of D.A. and the total salary of each employee will be readily available.

III. Graphic representation :— Data in the spread sheet can be represented in the form of graphs, charts and diagrams. For example, the figures and trend of sales, profits or salary cost can be shown in the form of a graph. These graphs can be displayed on the screen and can also be printed on a sheet of paper.

IV. Depreciation Accounting :— The spread sheets can be used in selecting the

proper method of charging depreciation on fixed assets and also to determine the appropriate rate of depreciation.

V. Budgeting and financial forecasts :—- It can also be used for preparing budgets and for forecasting the future trend of sales, profits etc. relating to the business enterprise.

(B) Word Processor: A word processor may be called a jet-age typewriter which enables the user to draft the letters, reports and other text material on a video screen with a facility to make changes very conveniently and as many times as desired. More and more business enterprises are now replacing typewriters by word processors, because it offers the following advantages :,

I. Instead of typing the full matter again, any word, line or paragraph previously typed can be changed, erased or shifted to new location. New words or lines can also be inserted wherever needed.

II. Printing facilities are also available in a word processor. We can obtain the error free printed copies of the matter and also without any sign of the rectification of an error.

III. The matter once typed can be arranged in different formats, styles and also in a desired width of the page. If a new line or word is inserted or deleted, the space between the words is automatically adjusted in a fraction of a second.

IV. The word processor also helps in checking the spelling of words. It contains a dictionary and automatically identifies the words in the typed matter that are not found in the dictionary.

V. It also helps the user in word finding by suggesting and displaying the words that have a meaning similar to the word selected by the user for suggestion. The user will then select the suitable word and the computer will replace that word automatically.

VI. Text of letters, documents and contracts etc. can be stored in the memory of the computer and any part of it may be taken out without delay.

Some of the examples of the use of word-processor are mentioned below:—

I. Letters of Common Reply: A large number of letters pour in the office which have a common reply. The text of such reply can be stored in the word processor and replies can be sent only by a change of address.

II. Reminders to Debtors :— Reminders can be prepared and sent to a large number of debtors only by changing the figure of amount due.

III. In case of Contracts :— Usually the terms and conditions of the contract entered into by a big company with others are the same in all the contracts. These can be stored and used whenever a fresh contract is signed.

(C) Data Base Management:— It records all the useful and relevant information relating to a business at one centralised place. These datas are usually stored on floppy discs and the Data Base Management (or D.B.M.) converts the data into useful information. Data may relate to the various activities of the business such as daily purchase and sales of goods, debtors collection, expenditure and income relating to various heads, etc. The data fed into the Computer may be rearranged in a desired

order and different calculations can be performed. For example, we can obtain duly prepared and reconciled Trial Balance and Final Accounts any time when desired. Similarly, we may obtain the lists of customers city wise or sizewise. If we desire to enquire about the customers who owe us an amount exceeding Rs. 10,000, such queries are replied in no time. Hence, Data base management is useful in debt collection, inventory control, production planning and control, preparation of budgets, invoicing, preparing payrolls and in various other areas of decision making.

Role of Computer in Accounting

Or

Softwares used in Accounting

In addition to the above, there are a number of software packages readily available in the market which have been particularly designed to suit the accounting needs of a business. Some of these are as follows :—

(I) General Ledger

(II) Accounts Receivable

(III) Accounts Payable

(IV) Inventory Control

(V) Payroll Accounting

A business enterprise can choose one or any of the above programmes according to its requirements.

(I) General Ledger :— Once a transaction is recorded through a Computer, it is automatically posted to various accounts. As such, the Ledgers always contain upto-date informations. Computer prepares a bill or cheque and once it is prepared through the Computer, it is automatically recorded, classified and summarized.

(II) Accounts Receivable :—- This software is used to maintain the upto-date and accurate accounts of the debtors. This software is also helpful in printing periodical reminders to be sent to debtors.

(III) Accounts Payable :— It keeps a upto-date record of all the Creditors.

(IV) Inventory Control:— It keeps a complete record of receipts and issue of all the items in the stores. As such, the information regarding the stock in hand of each item is readily available.

(V) Payroll Accounting :— It prepares the wages and salary sheet of thousands of employees very accurately and in no time.

As a result, the Computers have increased the efficiency of accounting department in many ways. The work which was previously done by hundreds of clerks is done by the Computers very quickly and without a single error. Hence, the use of Computers in accounting work is increasing day-by-day and very soon, it ..will be difficult to locate an accounting department in a medium-sized business enterprise which is not using a Computer.

Multiple Choice Questions (SET A)

Select the correct alternative:

(1) Which of the following software is not an operating software:

(a) MS-DOS

(b) Windows XP

(c) MS Word?

(2) Which of the following is a limitation of a computer:

(a) Speed

(b) Accuracy

(c) Intelligence?

(3) Which of the following is not an input device:

(a) Scanner

(b) Keyboard

(c) Monitor?

Answers

Multiple Choice Questions (SET A)

Select the correct alternative:

1. **(c)** **2. (c)** **3. (c)**

Chapter 23

Introduction to Accounting Information System

Computer and Accounting: The Inter-relationship

The computer, an electronic device which calculates, compares, modifies, stores and retrieves facts and figures, is being widely used in the field of accounting. It has an inbuilt system of making arithmetical calculations, collecting & processing accounting data and presenting the results in the form of reports to the management for decision-making purposes. It is not only confined to pay roll only but it also performs the functions of recording, posting, classification, summarisation and also interpretation by the analysis of results.

Application of Computers in Accounting :

1. Recording of all business transactions : All the relevant business transactions are recorded accurately and regularly for making available upto-date accounting information to the management.

2. Preparation of various ledger accounts : It prepares various ledger accounts such as Cash, Bank, Sales, Purchases, Debtors and various nominal and real accounts.

3. Processing the payroll information : It processes the payroll information relating to wages and salaries paid or payable during the accounting period.

4. Preparation of Trial Balance : It prepares the trial balance to ensure the arithmetical

accuracy of accounting transactions so recorded, arranged and classified systematically.

5. Preparation of Final Accounts : It is helpful in preparing the final accounts such as Manufacturing Account, Trading Account, Profit and Loss Account, Profit & Loss Appropriation Account and the Balance Sheet at the end of the accounting period. It also provides for the automatic reconciliation of accounts.

Information and Decisions:

An organisation is a collection of various interdependent decision making units that strive to achieve the common organisational goals. Every organisation, as a system, performs the same functions of accepting the inputs and transforming them into outputs. Information is one of the most important resources in todays business environment and successful businesses are investing heavily in information systems. Every organisation irrespective of its size depends upon its information system for the purpose of decision-making.

An organisation has various types of information systems at various organisational levels as given in the following diagram.

(i) Executive Support System (ESS) : They help in making decisions at the strategic level through advanced graphics and communications.

(ii) Management Information System (MIS) : These are the information systems at the management level of an organisation that serve the functions of planning, controlling and decision making by providing routine summary and exception reports.

(iii) Decision Support Systems (DSS): They are the information systems at the organisations management level that combine data and analytical reports to support the decisions.

(iv) Transaction Processing Systems (TPS): They are the computerised systems that perform and record the daily routine transactions which are necessary to conduct the business. TPS serve the organisation at the operational level.

Processes of Transaction Processing System :

As the name suggests the Transaction Processing System (TPS) processes the

transactions affecting the activities of the organisation. TPS follows the six steps given below:

1. Data Collection: It gathers all data needed to complete one or more transactions either manually or using devices like scanners and point-of-sale equipment.

2. Data Editing: It is the process of checking the data for validity and completeness.

3. Data Validation: It is the process of validating the data for correctness and then correcting the same if errors are found.

4. Data Manipulation: It is the process of performing calculations.

5. Data Storage: It is the process of placing transaction data into one or more databases.

6. Output Generation: It is the process of creating reports and outputting records.

7. Query Support: It is the process of making available the mechanism that empowers the users of TPS to query upon the stored data and extract the required information in required format.

Applications of TPS

Some examples of application of TPS are:

1. Order Processing: Such applications collect and process orders from clients through mail or telephone or staff sales. Once orders are taken, invoicing, accounts receivable and inventory control processing applications are initiated.

2. Payroll Applications: They were used earlier to run on a computer system with punched cards using batch processing. Nowadays, payroll programs are being run using terminals and online processing.

3. Automatic Teller Machines (ATM's): Such machines use a number of specialised computer programs to handle bank transactions.

Introduction to Accounting Information System

An Accounting Information System is one of the oldest and most popular information systems. It is widely used in profit as well as non-profit organizations because the accounting information that it provides is used not only by the accounts department but also by other departments like sales department, production department, human resource department etc.

Meaning and Definition of Accounting Information System (AIS) :

An accounting information system gathers data describing the organisation's activities, maintains a detailed financial record of the organisations operations, transforms the data into information and makes the information available to users both inside and outside the organisation. An accounting information system contributes to problem solving by :

1. Producing standard management reports that summarise the firm's financial conditions and

2. Providing the database that is used by other information systems.

Definition : An Accounting Information System is a system of collecting, processing, summarising and reporting information about a business organisation in monetary terms.

Features or Characteristics of AIS :

An accounting information system is a 'transaction-based information system. It caters to the accounting applications of an organisation.

The main characteristics of AIS are as follows :

1. AIS helps in handling and manipulating accounting and financial transactions of an organisation.

2. AIS is responsible for meeting information needs by generating reports. These reports are of two types:

(a) Reports for the Outsiders: They include the reports generated for outsiders like for meeting Government requirements, for accounting standard authorities etc.

(b) The Internal Reports : They include the reports generated for the management.

3. AIS is helpful in producing futuristic data in the form of budget forecasts etc.

4. AIS is helpful in maintaining accounting information as per the guidelines of the law.

5. AIS is highly crucial for the organisation and thus can easily be harmfully manipulated. Thus, it is required to keep a highly safe and secure environment to ensure its safety.

AIS Sub-systems

There are four main sub-systems of an AIS namely:

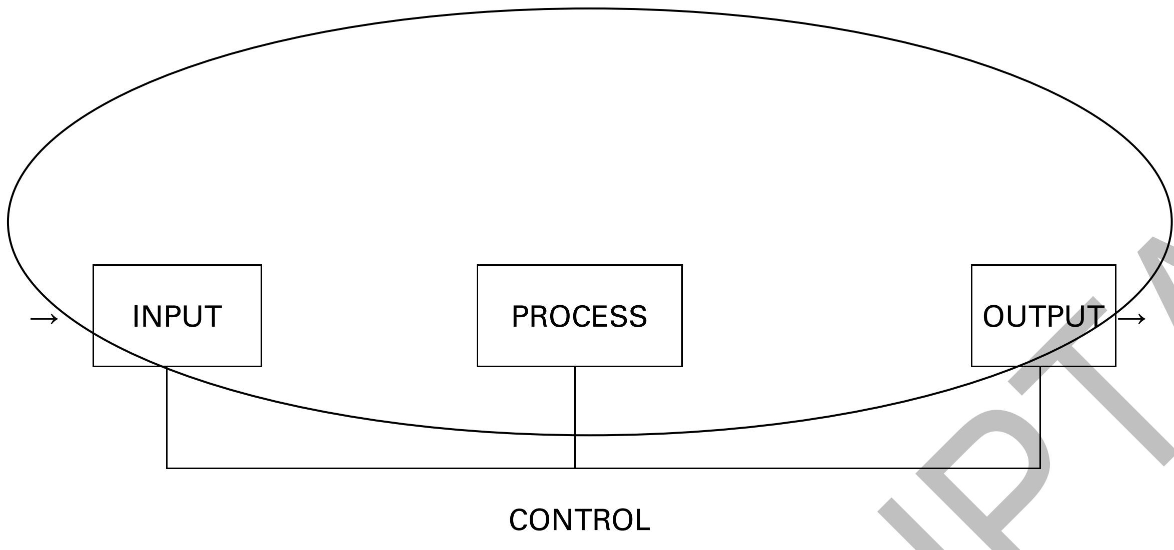
(i) Input

(ii) Process

(iii) Output

(iv) Control

Diagrammatically the four sub-systems of AIS can be represented as follows :



(i) Input: The input sub-system deals with the collection, arrangement and making available all types of, transactional, financial and accounting data to the system, required for its various functions.

(ii) Process: The processing sub-system deals with the processing of the information gathered by the input sub-system.

(iii) Output: The output sub-system is responsible for producing the processed data in user understandable format. It is also helpful in producing the data in the format as prescribed by the statutory bodies.

(iv) Control: The control sub-system is responsible for keeping control over AIS.

It helps to keep control over AIS by :

(a) following the internal laws and rules of the organisation.

(b) following the laws and rules as laid down by the Government and statutory bodies.

(c) ensuring quality of information by setting up performance standards.

(d) comparing actual performance against the standard performance.

(e) analysing the variances between the actual performance and the standard performance.

(f) taking the corrective action for the variances.

(g) ensuring safety and security of the information managed by AIS.

Purposes of Accounting Information Systems

Accounting Information systems serve six important purposes which are :

1. Sales order Processing

2. Inventory Control

3. Accounts Receivable

4. Accounts Payable

5. Payroll

6. General Ledger.

1. Sales Order Processing: It is an important transaction processing system which processes customer orders and produces invoices for customers and data required for sales analysis and inventory control.

2. Inventory Control : These systems keep a track of the various levels of inventory and the various changes occurring in them.

3. Accounts Receivable: These systems keep records of amounts owed by the customers with the help of the data generated by customer purchases and payments.

4. Accounts Payable': These systems keep records of the data related to the purchases from the suppliers and the payments made to them.

5. Payroll: The payroll systems record the data from the employee time cards. They are responsible for producing the pay checks and other documents like earning statements, payroll reports, labour analysis reports etc.

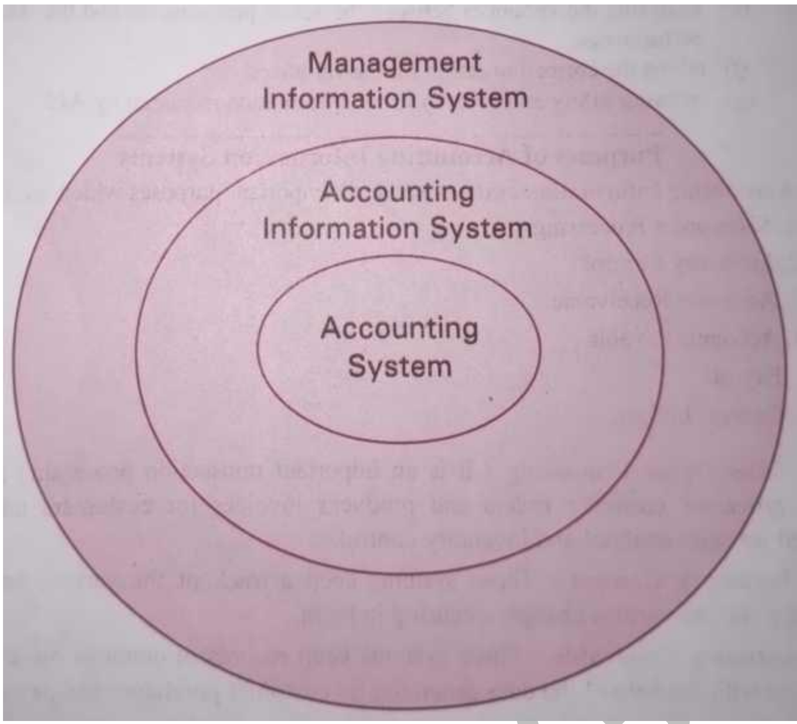
6. General Ledger: The general ledger systems consolidate the data received from accounts receivable, accounts payable, payroll and other accounting information systems.

Management Information System and Accounting Information System:

Managers have always had the responsibility for solving the larger problems of a company and making decisions among alternative solutions. In the past, they sought information from miscellaneous haphazard sources and processed the information on a personal basis. But now they have an information system which provides thorough details to base the decisions upon. A management information system is an information system that generates, accurate, timely and organised information to help managers make decisions, control process, solve problems, supervise activities and track progress.

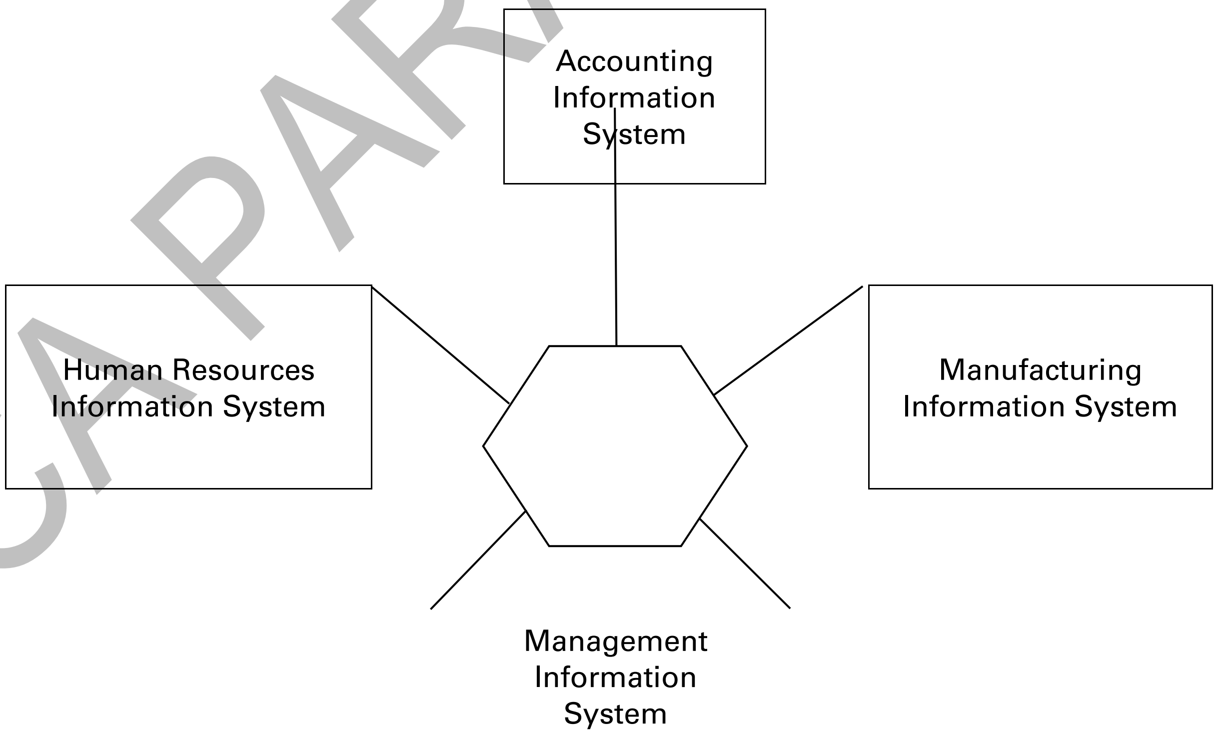
Accounting information system identifies, collects, processes and communicates economic information of an organisation to a wide variety of users.

Every accounting system is a part of the Accounting Information System which in turn is a part of the broader system i.e. the management information system.



Relationship between accounting system, accounting information system and management information system

Accounting Information System is one of the function information systems and management information system has a link with all the function information systems of an organisation.



Financial Information System

. Marketing Information System

Diagram showing link of Management Information system with other function information systems

Initially MIS was considered to be a financial accounting system and was a tool to maintain the financial record keeping activities. But gradually it developed into a broader concept and accounting system has now become one of its sub components.

An accounting information system on the other hand performs the accounting applications of an organisation. Accounting information systems contribute to problem solving by producing standard management reports that summarise the firm's financial conditions and by providing the data base that is used by other information systems.

Designing of Accounting Reports

Data from various sources is collected and manipulated in such a way as to provide certain information. Then the related information is comprised to render certain use, and such summarised information is known as a report. The level and extent of the report varies according to the level it is submitted and the type of decisions to be based on it. In order to be effective a report must be accurate, timely and relevant. In fact a report must have the following characteristics:

1. Relevance

2. Accuracy

3. Timeliness

4. Conciseness

5. Completeness

Steps in designing the accounting report:

1. Defining the Objectives: The objectives of the report must be defined clearly. The objectives must specify the type of users and the type of decisions to be based on the reports.

2. Content and format of the report: The report should be complete in itself and must be presented in a lucid style.

3. Manipulating the data base: The report must specify the various accounting information queries which are helpful in manipulating the database.

4. Finalising the report: The report must have a complete ending with proper analysis and suggestions of its study.

Types of Reports:

The reports are either routine reports or specific requirement reports.

For example, ledger is a routine report whereas a report generated to show the items supplied to a particular customer is a specific report. Different reports serve different purposes. Various types of reports most prominently used in MIS are as follows:

(1) Customer Reports: Reports generated as per the requirement of the management, depicting the top 10 customers, or top 10 defaulting customers or list of customers who have made no purchase at all in last six months or so, etc.

(2) Supplier Reports: Reports generated as per the requirements of the management, showing various aspects of the suppliers.

(3) Summary Reports: A summary report is a summarised report of all the activities of an organisation for example P & L Account.

(4) Demand Reports: Demand reports are prepared only on demand of the management for example: Inventory Valuation Report.

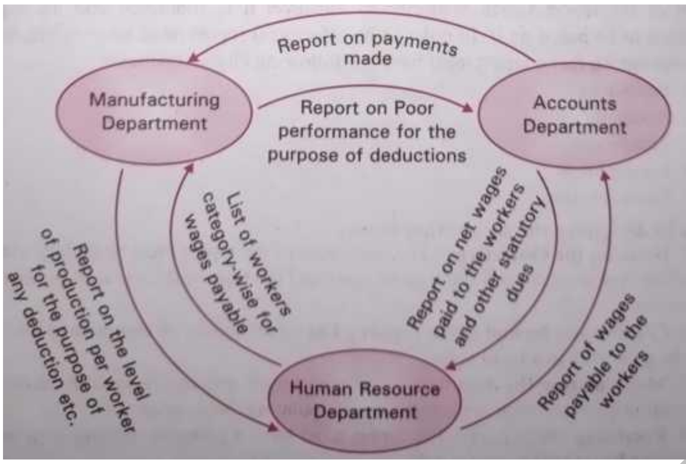
(5) Exception Reports: These reports are prepared for some specific conditions or exceptions. **For example,** Inquiry of inventory status regarding understocking, overstocking etc.

(6) Responsibility Reports: The responsibility reports are the various reports prepared by the managers responsible, for example report regarding different aspects of purchases to be submitted by the purchase manager.

Data exchange with other information systems:

The accounting information system (AIS) is an important component of the MIS structure of an organisation. It performs the function of receiving and disseminating such information to other functional MIS.

I. Relationship between Accounting Information System (AIS), Manufacturing Information System and Human Resource System



The above diagram depicts how the three functional departments are mutually related. The human resource department sends a list of number of workers, their category their level of skill etc. to the manufacturing department and to the accounts department. The manufacturing department on receiving such list sends a report of level of production achieved by each worker and other deductions to be made from their wages on various Accounts. This report is send by the manufacturing department to both Accounts department as well as the HR department. The accounts department on receiving such reports make its own calculations of the various statutory payments and dues of the workers and make the final payments and send the report of the same to both HR Department as well as the manufacturing department to monitor the performance of the workers.

II. Relationship between AIS and Manufacturing Information System:

The business process in the manufacturing department involve the following activities:

(a) Determination of plans and schedules

(6) Issue of material requisition forms

(c) Issue of stock procurement orders

(d) Issue of stock

(e) Handling supplier invoices

(i) Payment to suppliers

The accounting sub-system transaction cycle therefore includes :—

(a) Processing of purchase orders

(b) Advance to suppliers

(c) Stock updation reports

(d) Report of Accounts Payable

III. AIS and Marketing Information System

The business process in the marketing and sales department involve the following activities:

(a) Inquiry process

(b) Creating contacts and establishing personal relations

(c) Order taking

(d) Dispatching goods

(e) Bills generation

The accounting sub-system transaction cycle therefore includes:

(a) Processing sales order

(b) Authorising the credit limits

(c) Keeping custody of the goods

(d) Stock status

(e) Dispatch Details

(f) Accounts Receivables.

The system also keeps track of the customer status.

Multiple Choice Questions (SET A)

Select the correct alternative:

1. Book keeping is concerned with

(a) recording financial data relating to business transactions.

(b) designing for systems recording, classifying, and summarizing recorded data.

(c) interpreting data for internal and external users.

(d) All of the above.

2. The last step in accounting as a process of information is

(a) recording the transaction.

(b) preparation of financial statements,

(c) communication of Information.

(d) All of these.

3. Basic function of accounting is

(a) to record all business transactions.

(fa) to interpret financial data.

(c) to assist the management in performing functions effectively.

(d) None of the above.

4. Which of the following will not be recorded in the books of account?

(a) Purchased a LED TV for personal use, amount paid from personal account

(b) Purchased machinery of Rs. 1,00,000

(c) Purchased goods for Rs. 25,000

(d) Paid Salaries and Wages

5. Accounting is

(a) A process concerned with summarising of the recorded transactions.

(b) Not the language of business.

(c) An art of recording, classifying and summarising financial transactions in a significant manner.

(d) All of the above.

6. Which of the following is the objective of Accounting?

(a) Systematic Recording

(b) Comparison and Evaluation

(c) Solvency Position

(d) Forecasting

7. Which of the following is not the user of accounting information?

(a) Short-term creditors

(b) Debtors

(c) Government

(d) Owners

8. Which one is the advantage of accounting?

(a) Replacement of memory

(b) Shows the present value of the business

(c) Accounting does not record price level changes

(d) Accounting is not fully exact

9. Out of the following which is the branch of Accounting?

(a) Financial Accounting

(b) Cost Accounting

(c) Management Accounting

(d) All of these

10. Two primary qualitative characteristics of financial statements are

(a) Understandability and materiality.

(b) Relevance and reliability.

(c) Relevance and Materiality.

(d) All of these.

Answers

Multiple Choice Questions (SET B)

Select the correct alternative:

1.(a.)	**2. (c)**	**3. (a)**	**4. (a)**	**5. (c)**

6. (a) 7. (b) 8.(a) 9 .(d) 10. (b)

Chapter 24

Computerised Accounting System

What is Computerised Accounting System?

A Computerised Accounting System is that accounting information system that helps in processing the financial transactions and events as per the Generally Accepted Accounting Principles (GAAP) and leads to the generation Of reports as per the requirements of the users.

An accounting system whether manual or computerised has two parameters, namely,

1. It has to follow the well-defined concepts known as the accounting principles and

2. It has to maintain the user-defined structure for maintenance of records and generation of reports.

The framework of storage and processing of data in a computerised accounting system is known as the operating environment. It consists of the hardware and software in which the accounting system operates. The hardware and software components are dependent on each other and the type of hardware selected depends upon the secrecy level, the type of users, number of users and type and extent of functional activities in the organisation.

The complexity of the computerised accounting system depends upon the type of the organisation. For example, in a small company where the number of transactions are less and the number of customers and suppliers is relatively very few, there a simple computer system with a standard software may be sufficient. And in a large company whose work is scattered over large geographical areas, more sophisticated and specified software and other techniques may be required. Such complexed needs of large organisations are handled by multi-user operating systems such as UNIX, Linux etc.

The modem accounting systems make use of database to generate various information. Database is a set of computer softwares that manage and organise data effectively. Database helps in achieving an access to the stored data. The usage of computers in any database oriented application has four basic requirements as given below:

(1) Front-end interface: It is the link between the user and the database oriented software, through which the user communicates to the back-end database.

(2) Back-end Database: It stores data which can be retrieved by the user only to the extent he is authorised to access.

(3) Data Processing: It is the process of transforming the data into information useful for taking decisions.

(4) Reporting System: It is the system which helps in composing all the information in some integrated form known as a report.

Thus, the computerised accounting system is a system wherein the different data is collected, stored, classified, processed and interpreted using suitable software to render useful reports.

Features of Computerised Accounting System

The computerised accounting system is based on the concept of databases. It does not involve the process of creating and maintaining journals, ledgers etc. which are necessary in the manual accounting system. A computerised accounting system comprises of the following main features:

(1) It facilitates on-line input and storage of accounting data.

(2) It generates a print-out of purchase and sales invoices.

(3) It facilitates a system of codification of accounts and transactions.

(4) It facilitates grouping of the various accounts.

(5) It generates different reports quickly.

Comparison of Manual and Computerised Accounting System:

Accounting is the process of identifying, recording, classifying and summarising financial transactions for preparing financial statements. For making comparative study, we may discuss these processes under manual as well as computerised accounting.

Basis of Distinction	Manual Accounting	Computerised Accounting
1. Identifying Financial Transactions	In this system, identification of financial transactions is done manually by applying the principles of accounting.	In this system also identification of financial transactions is done manually by applying the principles of accounting.
2. Recording	In this system, the recording of transactions in the books of original entry and related calculations such as adding, subtraction and totalling are done manually.	In this system, the recording of transactions i.e., storing of data in database is done manually and all other calculations are done by computers.
3. Classification	In this system, classification i.e., posting to ledger accounts is done manually.	In this, the stored data are processed automatically by'the software to give us ledger accounts.
4. Summarising	In this system, summarising i.e., balancing of ledger accounts and the preparation of trial balance is done manually.	In this, transactions once recorded are stored in the database which will produce trial balance automatically.
5. Adjustment Entries	The identification, recording and posting of adjustment entries is done manually.	In this, identification and recording of adjustment entries is done manually and their posting etc. is done by software.
6. Financial Statements	In the manual process, preparation of trial balance is essential to produce the financial statements.	In this, financial statements are generated from the software itself and therefore there is no need to prepare a trial balance.
7. Close the Books	In this, closing of books of accounts and transferring of opening balance by recording opening entries are done manually.	In this, closing of books of accounts is done through the software' and opening balances are stored in the database.

Advantages of Computerised Accounting System

The computerised accounting system has various advantages over the manual system which are given below:

1. High Speed: The accounting speed of a computer is much faster than that of a human being.

2. High Reliability: The extent of reliability of the information generated by a computer is immense. The reliability remains the same despite the volume of the work whereas the reliability of a human work can be doubtful in case of voluminous work.

3. Accuracy: The accuracy of a computer cannot be doubted once a particular program is fed. All the results based on such program would be 100% accurate whereas the results produced by a human being can vary due to fatigue, carelessness, etc.

4. Updation of Information: All the related records in a computer get automatically updated once any information is punched in, whereas in case of manual accounts all the records will have to be altered one by one.

5. Efficiency: The computer-based accounting systems ensure better and efficient use of resources and time.

6. Legibility: The data displayed on a computer screen is clear and legible thus avoiding errors caused by untidy writing in a manual accounting system.

7. Lower Cost: The cost of maintaining accounts under the computerised system is much lower as compared to the manual system.

8. Timely Reporting: The computerised accounting system facilitates the generation of the Management Information System (MIS) reports at a very high speed which enables the management to take quick decisions, whereas the generation of the same reports manually is very time consuming and less accurate.

9. Flexible Reporting: In computerised system, the data can be processed further to obtain the desired report. For example, the list of debtors owing more than Rs. 10,000 or 20,000 or 50,0000 can be obtained very easily.

10. Storage and Retrieval: It enables the users to store data in a manner that does not require a large amount of physical space which is in the form of hard-disks, CD-ROM's, floppies that occupy a fraction of physical space as compared to books of accounts in the form of Ledger, Journal and other accounting registers.

11. Security of Data: Under computerised accounting, the accounting data is safer in comparison to manual system. Under computerised system secrecy of data can be maintained by using a password which means only authorised persons will have access to the data.

12. Queries: In computerised system, replies to various queries can be obtained very quickly. For example, if we want information about the debtors who have not paid in time, the list of such debtors can be taken out immediately.

Limitations of Computerised Accounting System

Despite many advantages offered by a computerised accounting system it is not free from limitations. Various limitations of a computerised accounting system are as follows:

(1) Staff Opposition: Introduction of computers lead to a lot of retrenchment as well as complication of activities which result in resistance of the staff.

(2) High Cost of Training: The sophisticated computerised accounting packages generally require specialised staff personnel, which leads to heavy amount of cost of training.

(3) Adverse effects on health: The excessive use of computers may lead to various health problems like eye strains, back aches, muscular pains etc.

(4) Security Problems: Fraud and embezzlements are usually committed on a computerised accounting system through alteration of data. People responsible for tampering of data cannot be located in a computerised set up whereas the same can be easily done in case of manual records.

(5) System failure: System failure due to hardware failures, attack by viruses, system down etc. are the usual problems faced by a computerised system.

(6) Wastage of time: A lot of significant time is wasted when an organisation switches over to the computerised accounting system due to the changes in the working environment and other adjustments.

(7) Lot of errors: The computer software is unable to detect unknown and unanticipated errors.

Sourcing of Accounting Software:

A variety of accounting software is available in the market. The most popular software used in India are Tally and Ex. An accounting software is an integral part of the computerised accounting system. But before acquiring any software it is very important to analyse the level of expertise of the people who would use it. Because eventually it is people and not the computer who are responsible for accounting. The need for the accounting software arises in two situation's namely :

(i) when the computerised system is replacing the manual system and (ii) when the computerised system already exists in the organisation and it is to be altered according to the recent changes.

Types of Accounting Packages or Softwares :

There are various types of accounting packages available in the market. However, the choice of the accounting software would depend upon the suitability to the organisation in terms of its accounting needs. The accounting packages are classified into the following categories:

(1) Ready to use Software

(2) Customised Software

(3) Tailor-made Software

(1) Ready to use Software:

A variety of readymade software's is available in the market. These software's are for users at large and are not developed according to the requirements of any specific user. Most popular readymade software's available in the market are Tally, Ex. Busy etc.

Advantages of Ready to Use Software are:

(i) These software are developed by a group of highly experienced group of professionals. Hence, they take care of the problems areas which may be overlooked if a particular software is developed for some specific user.

(ii) Since these software's are used by a large number of users, accounting personnel well versed with these software's are easily available.

(iii) They are easy to learn and their training is sometimes offered free by the vendor.

(iv) Because of their use by a large number of users, they have better after sales maintenance service.

(v) Because they are available off-the-shelf, time required in developing a tailor-made software is saved.

(vi) The cost of installation is low.

Disadvantages of Ready to Use Software's are :

(i) These software's use laser printers which are costly than the use of Dot Matrix Printers.

(ii) The level of secrecy in these software's is very low thus the software is highly prone to frauds.

(iii) These software offer very little scope of linking to other information systems. These software's are suitable to small organisations who have low volume of accounting.

(2) Customised Software :

The term 'Customised Software' means making changes in the ready to use software so as to suit the specific requirements of the user. Any readymade software can be changed according to the needs and specifications of the user. However, the cost of installation of customised software's are high because the cost of change is to be paid by the user.

Advantages of Customised Software:

(i) These softwares are designed to suit the specific requirements of the users. Hence, they are used by a large number of large and medium size business enterprises.

(ii) Level of secrecy for the data is higher.

(iii) Linkage to other information systems is available on the basis of need of the enterprise.

Disadvantages of Customised Software:

(i) Cost of installation and maintenance is higher in comparison to ready to use software.

(ii) Training requirement for using these packages is higher in comparison to ready to use software.

(3) Tailor-made Software:

The term 'tailor-made software means developing a software according to the needs and specifications of the user. These softwares are not available off-the-shelf.

The advantages of tailor-made software are :

(i) It being developed according to the specifications of the user, takes care of the specific needs of the enterprise.

(ii) The level of secrecy of data and authenticity checks are robust in such softwares.

(iii) They can be effectively linked to some other information systems.

Disadvantages of tailor-made software are :

(i) If the accounts are grouped in an incorrect manner, the results will be misleading.

(ii) The cost of development and maintenance of such software is much higher in comparison to readymade or customised software.

(iii) It is difficult to learn and require specialised training.

(iv) Training costs are high since they involve sophisticated applications.

(v) If someone leaves the job, it becomes very difficult for the new employee to be fully conversant with such software.

These softwares are suitable to large business enterprises.

Some considerations to be made before sourcing accounting systems:

The following factors are usually taken into consideration before sourcing an accounting software:

1. The cost of installation and maintenance: A simple cost benefit analysis is done before installing any software. The cost of its aquisition, installation and maintenance are the factors of deep consideration before sourcing any software.

2. Flexibility: It is one of the important considerations before sourcing an accounting software. The software should be easily upgradable and must have the feature of easy modifications.

3. Adaptability and Training needs: The accounting software should be easily understandable and adaptable. It must not require extensive training.

4. Size of the organisation: The size of the organisation and the volume of its accounting transactions determine the requirements of the type of accounting software.

5. The level of MIS reporting: The level of use and utility of MIS reporting in an organisation determine the acquisition of software to a lot of extent.

6. Level of Secrecy: The level of secrecy should be high. It should be impossible for any unauthorised user to access the data.

7. Vendors Reputation and Capability: Another very important consideration to be made before sourcing any software is the various information about the vendor — like since when the vendor is in the business of software development? whether there are other users of the same software or not? what is the after sale service the vendor is offering and how quick is his service? etc.

Chapter 25

Accounting Software Package: Tally

Information Technology has brought tremendous changes in business world. Usage of Computers and information technology enables a business to quickly, accurately and timely access the information that helps in decision making. Computerized Accounting System is the need of the day for enhancing the profitability of a business enterprise and for its existence. There are various accounting software like Tally 9 by Tally Solution Pvt. Ltd. and Ex. next Generation by Tata Consultancy Services available in market. In this chapter we will discuss about Tally ERP.9 and how can we use this software for generating different kind of reports.

SALIENT FEATURES OF TALLY:

Tally 9 is very popular Accounting software. A person who just knows basics of Accounts can operate Tally Software easily and can generate instant reports which help the management in taking quick decisions. Its latest version 9 makes it very unique as it has various features as follows:

1. In Tally, inventory management is possible. Once the available units are entered in it, updated stock summary after each transaction can be obtained.

2. There is no need of keeping record of salary and wages separately as Payroll feature facilitates the same.

3. Preparation of Tax reports and tax filing work becomes very easy in Tally as Balance Sheet, P & L statement, TDS returns, Excise forms, VAT forms, Service Tax returns etc. can be generated easily in Tally at any point of time.

4. To find out the cost of a particular job is very easy as Tally provides cost centre facility in it.

5. Syncronization of data is another main feature of Tally which facilitates to manage the data over different locations.

6. Various MIS reports can be generated easily and Budget can be maintained in Tally.

7. It also calculates interest on outstanding amount.

ADVANTAGES OF TALLY :

Following are the advantages of Tally software:

1. The reports generated by Tally software are accurate and reliable.

2. It is very simple to use. A person with basic knowledge of accounts can easily operate it.

3. It does not matter that business is big or small. It can be adopted by any kind of business organisation.

4. Various reports can be generated very easily at any point of time.

5. It can store huge volume of transactions. It can manage not only one company but is also able to manage accounts of multiple companies.

6. Its security feature keeps the data confidential. The data is generally password protected and it facilitates data vault and data audit feature to secure the data.

7. Installation cost of Tally software is very less. So Tally software is affordable by all kind of organisations.

8. If a business deals internationally, the multi currency and multi lingual option of tally facilitates it too.

Installation of Tally Software:

1, Insert CD in the System;

2, Double click on install.exe icon on the CD;

OR

Select Start>run>type>CD Drive>:\Install.exe

3, You will enter to Tally 9 setup wizard. This wizard guides you through the installation of Tally 9.

Fig. 27.1 : First step of installation wizard

4. After the above process the default directories of application, data and configuration opens in a window. If a user wants to change the default directories then he has to mention desired drive and file name. After following through the instructions displayed on windows installation process comes to an end. A wizard of successful installation will appear which indicates that installation process of Tally is over.

Fig. 27.2 : Final step of installation wizard

5. Now CD can be removed from CD Drive. Tally 9 icon will appear on the screen.

HOW TO START TALLY:

• Method 1

After installation Tally Icon appears on desktop. To work on Tally, double click on Tally Icon .

OR

• **Method 2**

We can also start Tally in following way :

Start>Program>Tally

Now Tally initial screen will appear that is called Gateway Screen of Tally. This screen includes various components of Tally. Now we will discuss various components of Tally Screen.

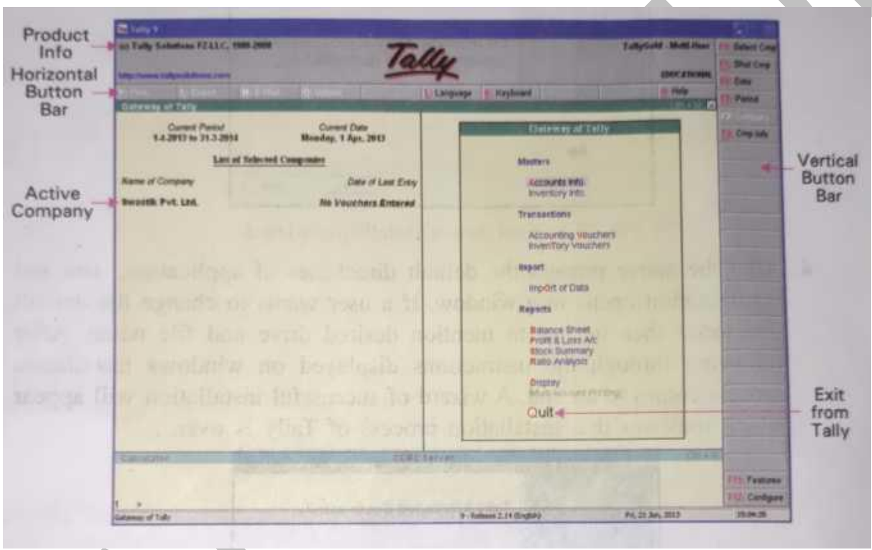


Fig. 27.3 : Gateway of Tally

GATEWAY OF TALLY :

Gateway of Tally is the main screen of Tally. We can call it the control centre of Tally. Following are the various components of Tally Gateway :

• **Product Info** : Software name 'Tally' with its version 9 and other info, is given on the top.

• **Horizontal Button Bar** : Under the Product Info, horizontal button bar with Hot Keys appears. Print, Export, e-mail, Language (to set up language) Keyboard and Help buttons are available in this bar.

■ Right part of screen shows following components:

• **Tally Menu:** At right part of Gateway screen we can see Tally menu with the list of options to initiate a task.

• **Vertical Button Bar** : Vertical button bar shows several buttons with various function keys/Hot keys which provide access to various functions.

■ Left part of the screen shows following components :

• **Current Period** : This option displays the starting date and ending date of financial year entered by user.

• **Current Date** : This date shows the date when the last data was entered.

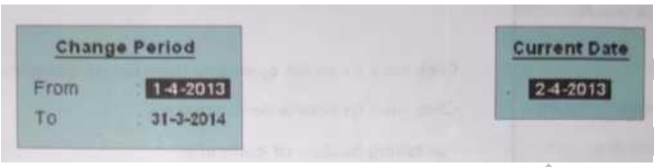


Fig. 27.4 : Financial year & date Entries

• **Active Company** : Under Current Period option Active Company appears. Active Company is the last selected company by the user.

• **Selected Companies** : Selected Companies displays the list of all selected companies along with the date of last voucher entered.

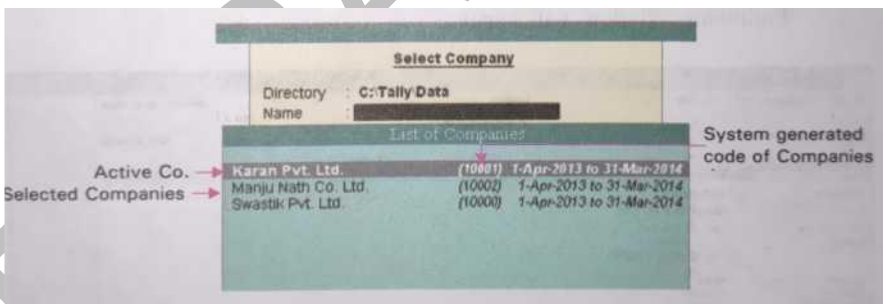


Fig. 27.5 : Active & Selected Companies

• **Tally Calculator/Command Line** : To do the calculations we can activate Calculator by Pressing Ctrl + N. For coming back on screen (main area) we need to press Ctrl + M.

HOW TO WORK ON TALLY :

In order to start the work on tally software, first step is to create Company. Tally software provides system generated code to each Company created by user. Following are the steps to create Company :

COMPANY CREATION :

In order to create a Company in Tally follow these steps :

• Press Alt + F3 Company Info, menu will appear as follows :

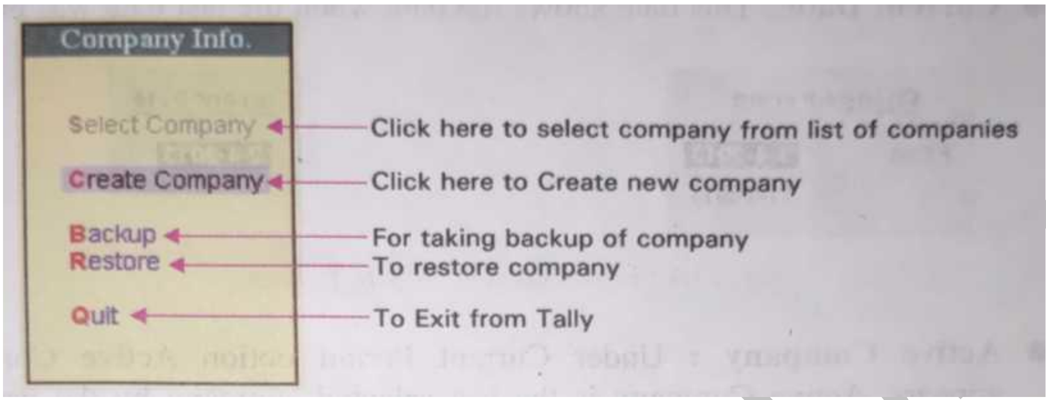


Fig. 27.6 : Company creation

• Use arrow keys for selection of "Create Company" & press enter key. Following Window will appear.

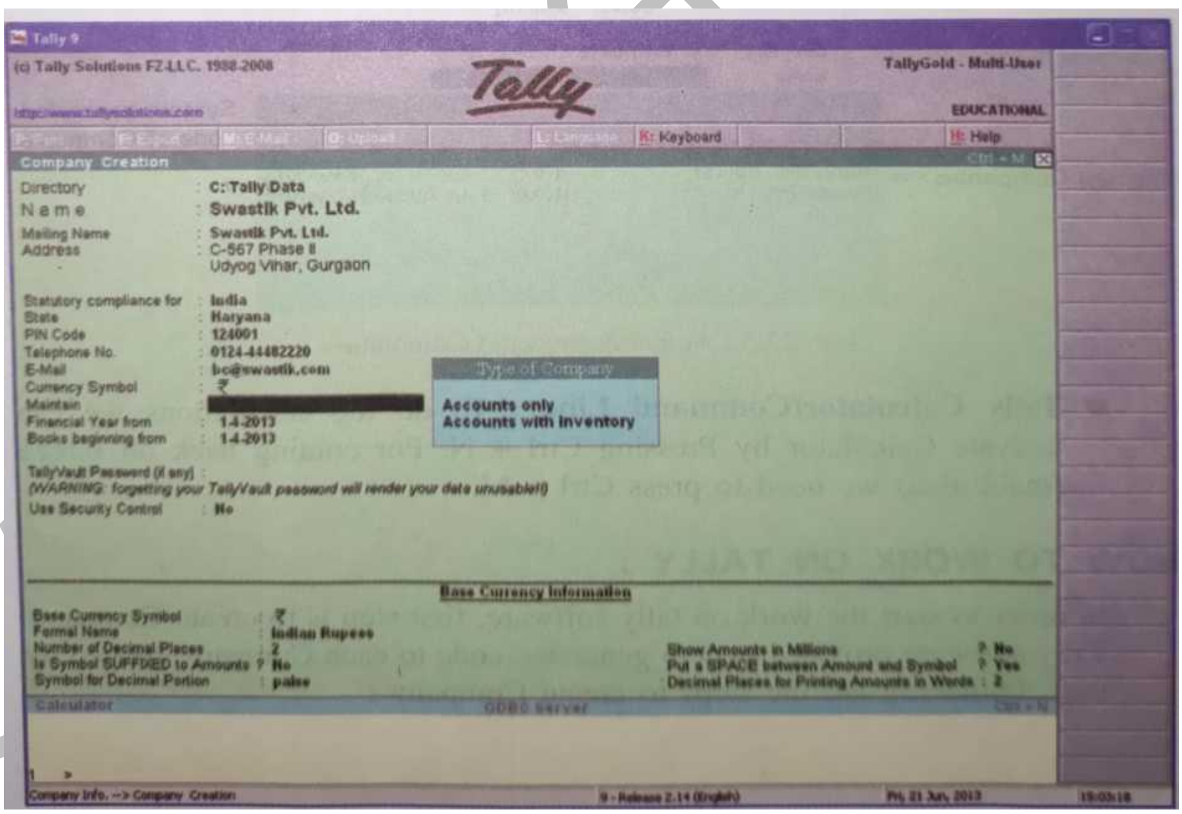


Fig. 27.7 : Company creation Window

Fill the necessary fields with the information taken from internal and external documents of the Company :

• **Company Name** : Enter the Name of the Company in this field.

• **Company's Mailing Address** : Mailing Address of the Company which is printed in all external documents.

• **IT Number** : Enter the Income Tax number allotted by Income Tax Deptt.

• **Accounting Module** : If user wants to maintain Financial Accounts only select Accounts only and if he wants to maintain accounts with inventory select other option.

• **Financial Year** : Specify financial year of the Company and enter beginning date of the financial year.

• **Other Details** : If the user wants to specify other information he can fill in these fields. For example, he can specify the currency symbol that will be used to maintain the books of accounts. The symbol Rs. already appears for India and SAARC Companies and the field is left blank for other nations currency.

• **Saving the Profile** : Finally when all Company details are filled save the Company Profile by accepting Yes.

CHART OF ACCOUNTS :

Chart of Accounts is a method of segmentation of liabilities and Assets of Balance Sheet and Income & Expenses of Profit and Loss Statement. In Tally such Chart of Accounts is further divided in Ledger Accounts and Accounts Groups :

I. Ledger Account : Ledger Accounts represent summarised and balanced transactions of similar nature. Without ledger we are unable to do voucher entry. Cash & P & L are predefined ledger in Tally.

II. Accounts Group : Collection of large number of ledger accounts is called Accounts group. All the Ledgers are organized into a tree structured hierarchical view for better interpretation and understanding in Tally. There are 28 pre defined groups in Tally in which 15 are primary groups and 13 are sub groups. These predefined groups cannot be altered. It is by default available in Tally :

• **Primary Group** : It is basic set of sub groups which is based on dividing major Accounts head according to their listing in balance sheet and P & L Statement.

• **Sub-Group** : Primary groups are divided in Subgroups. A subgroup is a collection of ledger A/cs of related transactions.

We can explain ledgers, sub groups and primary groups relationship in Tally with the following example : Assume Mohan, Kiranpal, Shikha are the sundry creditors of the Company and sundry creditors is a subgroup of Current Liabilities (Primary Group).

Ledgers < Sub Groups < Primary Groups

(i) Mohan's A/c
(ii) Kiranpal'sA/c
(iii) Shikha'sA/c
< Sundry Creditors < Current Liabilities

How accounts groups are divided into 15 Primary groups and 13 sub groups of Balance Sheet and P & L statement are mentioned below :

Accounts Groups of Balance Sheet :

• **Accounts groups of Liabilities**

1. Capital : Owner's Capital, Partner's Capital, Equity Share Capital, Preference Share Capital comes under it. It is a primary group.

• **Reserve & Surplus** : It is the sub group of Capital A/c. It includes General reserve, Capital Reserve etc.

2. Loans : It is used to keep the record of the Loans taken by the Company. It is a primary group which contains following sub groups :

• **Bank Overdraft**: Bank overdraft and cash credit facility taken from bank are placed under this group.

• **Secured Loans** : The Loans which are taken against a security like mortgage, pledge etc. are placed under it.

• **Unsecured Loans** : Apart from Secured Loans rest loans are unsecured which come under this subgroup.

3. Current Liabilities : It is a primary group which has three subgroups:

• **Duties & Taxes** : The accounts related to duties & taxes you collect or pay through sale and purchase come under it.

• **Provisions** : All the provisions which are made for the future e.g.. Provision for tax, proposed dividend, Bad debts.

• **Sundry Creditors** : All traders, suppliers which provide goods on credit basis to business.

• **Other Current Liabilities** : Place all other current liabilities in this group like

Outstanding Exp, Provident Fund, Tax Deducted at Source (TDS) etc.

• **Accounts groups of Assets**

4. Fixed Assets : Immovable properties like patents, Trade Rights, Plant, Goodwill, Building etc.

5. Investment : Investment Ledger account relates to Shares, Bonds, Govt. Securities and investment in other company.

6. Current Assets : Those assets which are consumed in operations and convertible in cash within a year are known as Current Assets, e.g., Stock on hand, Cash, bank, etc. It has six sub groups :

• **Stock on Hand** : Ledger Accounts related to stock of raw material, work in progress and finished goods.

• **Loans & Advances** : Loans & Advance of non-trading nature come under it e.g., Loan to employee, Advance against salary.

• **Sundry Debtors** : Customers to whom goods has been sold on credit.

• **Bank A/c** : Bank deposits in Current A/c, Saving A/c, fixed deposit, security deposits etc.

• **Cash in hand** : Cash in transit, Petty Cash and Cash in business.

7. Miscellaneous Expenditure : Expenses to the extent not written-off to statement of profit and loss are placed here.

8. Suspense : It holds the*' accounts which cannot be specified in any other account group and whose transaction is not yet known.

• **Accounts Groups of Profit & Loss Statement :**

9. Sales A/c : It holds different Sales Accounts of the Company e.g., center sale, state sales based on tax slab or type of sale.

10. Purchase A/c : This group holds all purchase of the company.

11. Direct Income : Direct Income earned by Company except from sale income comes under this group like servicing contract charges that follow after the sale of equipment.

12. Indirect Income : Indirect income of the Company is related to non sale income Accounts like commission received, Intt, received.

13. Direct Expenses : Expenses incurred at the time of manufacturing which determine Gross profit of the Company.

14. Indirect Expenses : Office, selling & administration related expenses come under this group.

15. Branch/Division : It holds the accounts of branches or divisions of the Company.

Accounts Master : The creation of groups & ledgers are done under Accounts Master

CREATION OF GROUP:

We already have discussed 28 predefined groups of Tally. If user has the requirement of creating a new group for business he can create the group by following these steps :

1. Select the Company

2. Gateway of Tally>Accounts Info.>Groups>Single Group>Create

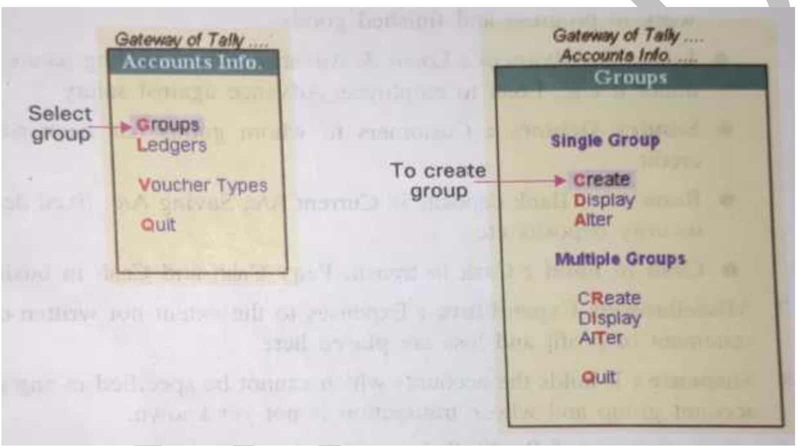


Fig. 27.8 : Group Creation

After selecting Create option Group creation box will appear. Fill the necessary field as shown in the following figure :

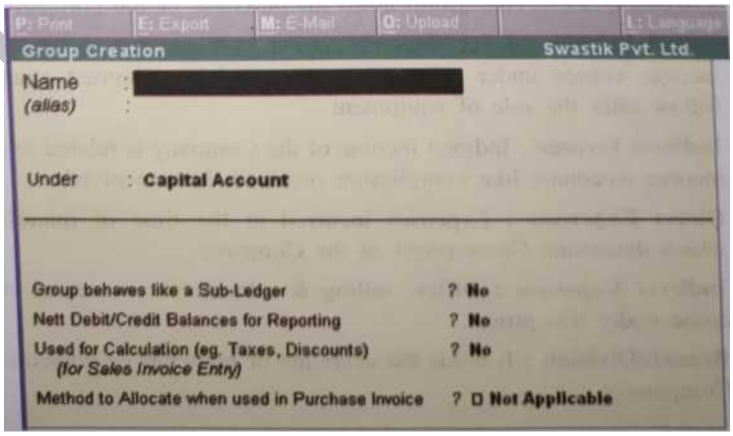


Fig. 27.9 : Group creation

- **Account Group Name :** Enter the unique Account group name in name field.

- **Parent Group Name :** In this field mention whether this group belongs to a primary group or a sub group. If it is sub group specify group from predefined list of groups.

- **Other Details :** If user want to set 'yes' in the sub options he will get Groups balances defining its sub ledger. Net Cr. or Dr. balance shows the balance which is higher. If user enable 'Used for Calculation' option, it will help the user to calculate Taxes and discount while making voucher entries.

CREATION OF LEDGERS

Tally automatically creates two ledgers one Cash and another P & L A/c. Automatic Voucher entries (recording of transactions) will only be possible if it is related to these two accounts. So you have to create all other ledger accounts for recording the transactions by following way :

Gateway of Tally>Acc.Info.>Ledgers>Single Ledger>Greate

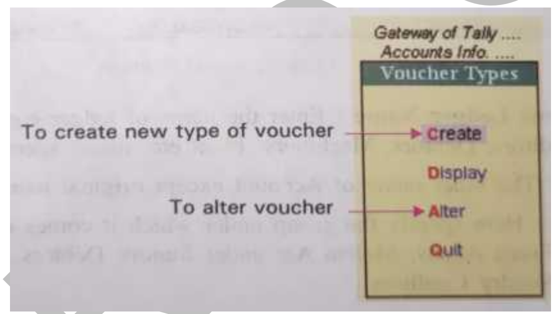


Fig. 27.10 : Creation of Ledger

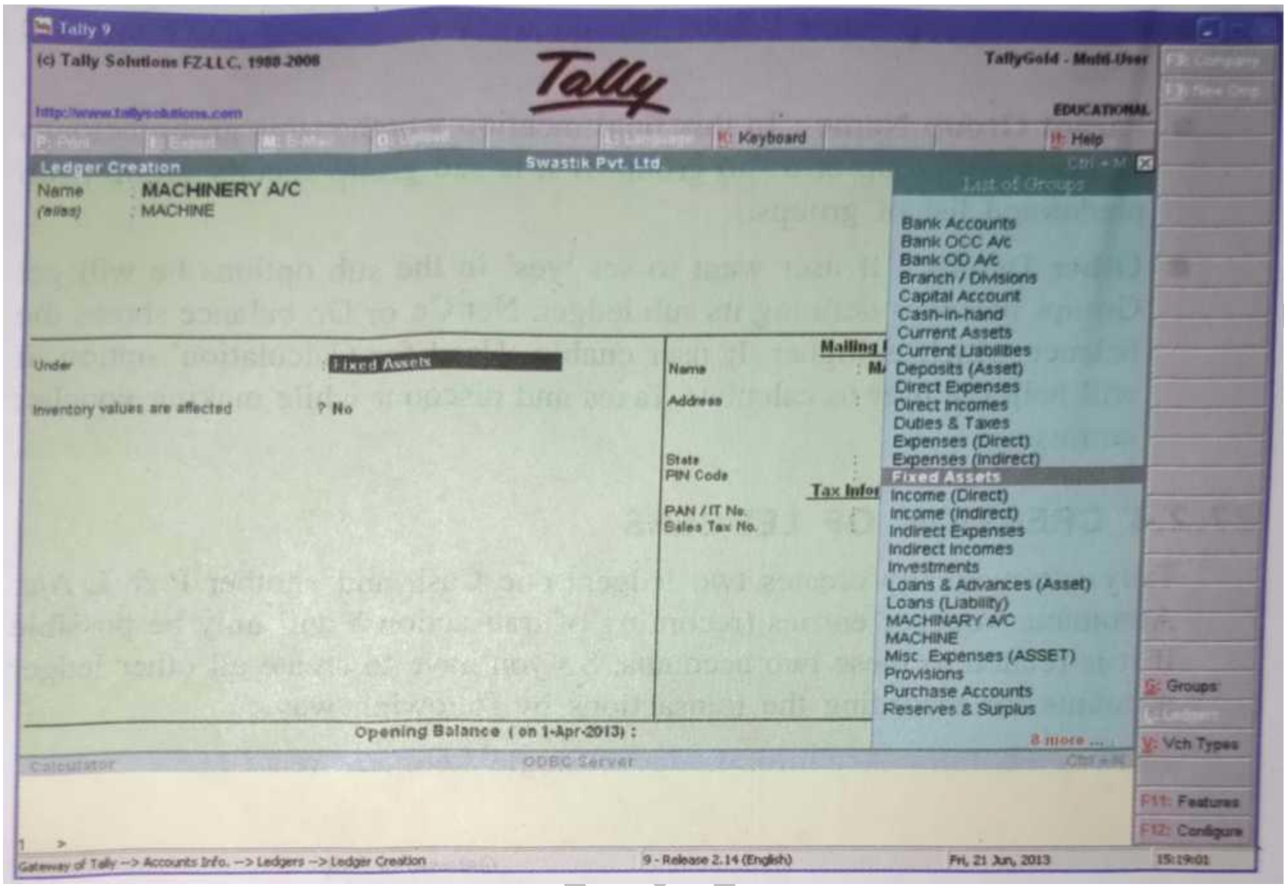


Fig. 27.11 : Ledger creation Window

- **Accounts Ledger Name** : Enter the name of ledger e.g., specify name of Creditors, Debtors, Machinery, Plant etc. under specified group.

- **Alias :** The other name of Account except original name.

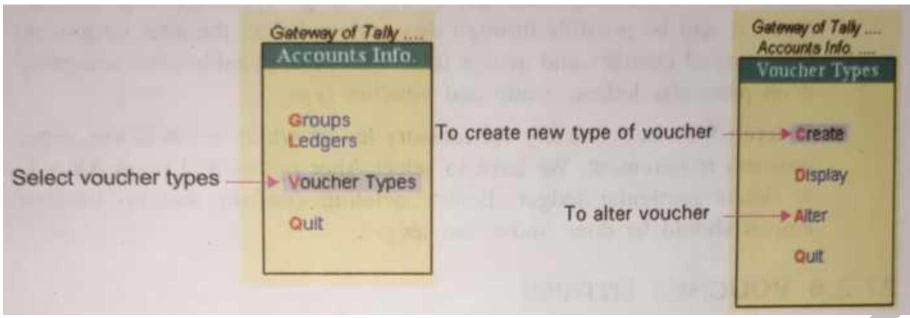
- **Under** : Here specify the group under which it comes e.g., Machinery under Fixed Assets, Mohan A/c under Sundry Debtors and Sohan A/c under Sundry Creditors.

- **Opening Balance** : If the Company is already an existing Company and it has already an opening balance then we will fill the amount in this field for showing opening balance of particular ledger Account. In case of no opening balance leave this field blank.

CREATION OF VOUCHERS :

In tally there are 23 predefined vouchers so rarely we feel need of creating new vouchers. If user has requirement to create a new voucher type he can create it by following way :

Gateway of Tally>Acc. Info.>Voucher Types>Create



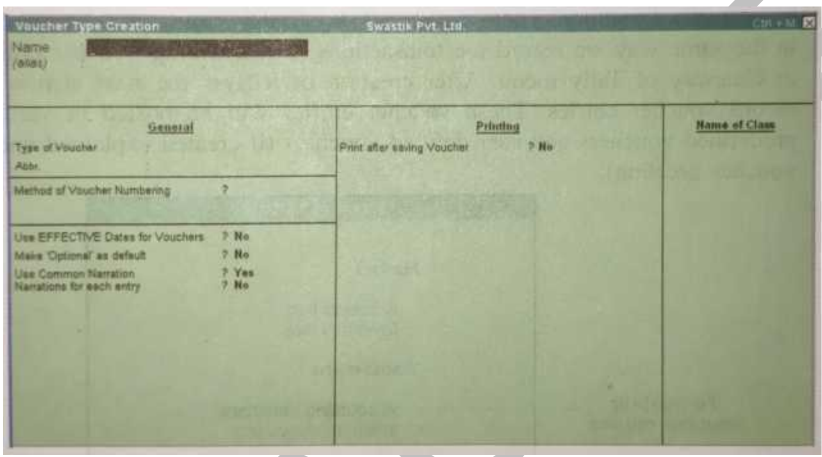


Fig. 27.12 : Steps of voucher creation.

Fill the necessary fields as per the requirement of business and by accepting 'yes' you will get a new type of voucher.

• **Method of Voucher Numbering :** As we can see in above figure a field of this name is Voucher Type creation. Two methods for voucher numbering are available :

(i) Manual: This method allow you to number voucher yourself. So in this method Tally software does not check the voucher number field. For preventing the duplicacy enable the next field 'prevent duplicates'.

(ii) Automatic : This is automatic method of numbering the voucher. It is of both kind : flexible and exhaustive. In this method no. of vouchers are incremented automatically.

• **Display** : We have seen Display option in Group ledger and voucher types. This option is used to view group, ledger and voucher types.

• **Alter** : If we want to make any changes in group, ledger and voucher types, it will be possible through this option. Select the alter option, do the required changes and accept it. It will be applicable after accepting it on particular ledger, group and voucher type.

• **Delete** : We can delete any unnecessary ledger which is not in use as per business requirement. We have to select Alter option and press Alt + D to delete particular ledger. Before deleting confirm that no voucher entries should be done under that ledger.

VOUCHER ENTRIES

In manual accounting system we record day to day transactions in journal. In the same way we record the transactions in Accounting voucher option in Gateway of Tally menu. After creation of ledgers the next step is to record voucher entries. These voucher entries will be posted in various predefined vouchers and user defined vouchers (if created explained under voucher creation).

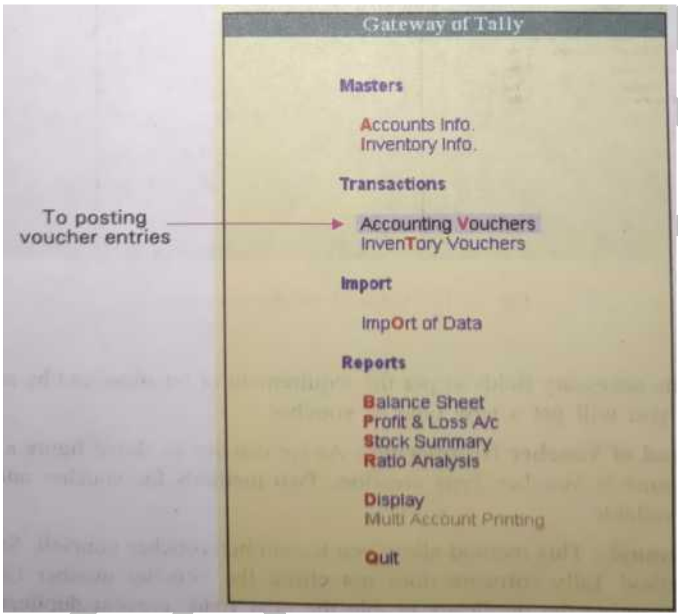


Fig. 27.13 : Voucher Entries

For recording the transactions first we have to select voucher type and then we can record the voucher entries. Follow the steps of Recording transactions in different type of vouchers.

Gateway of Tally>Transactions>Accounting Vouchers Receipt Voucher :

All inflow of money is recorded through receipt voucher. In other words the transactions in which Cash or Bank A/c are Debited come under this voucher. Cash received from debtors or capital A/c, loan and advance taken from another party are recorded in receipt voucher.

Gateway of Tally>Accounting Voucher>Press F6

Example : Ram introduced Rs. 5,00,000 in cash as Capital in business :

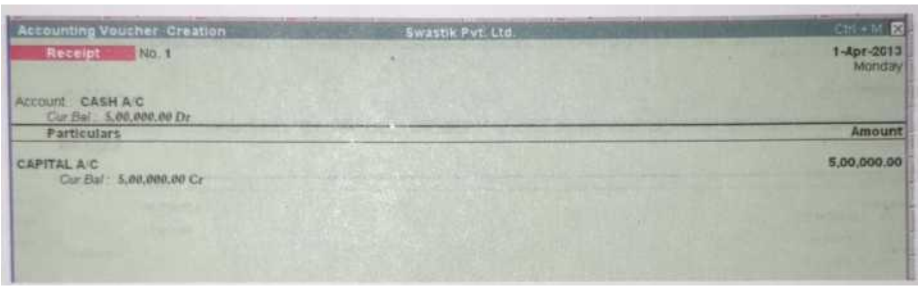


Fig. 27.14 : Receipt voucher

In above voucher single entry mode for Receipt/Payment/Contra is available. If you want double entry mode, Press F12 for configuration & Set no for single entry mode.

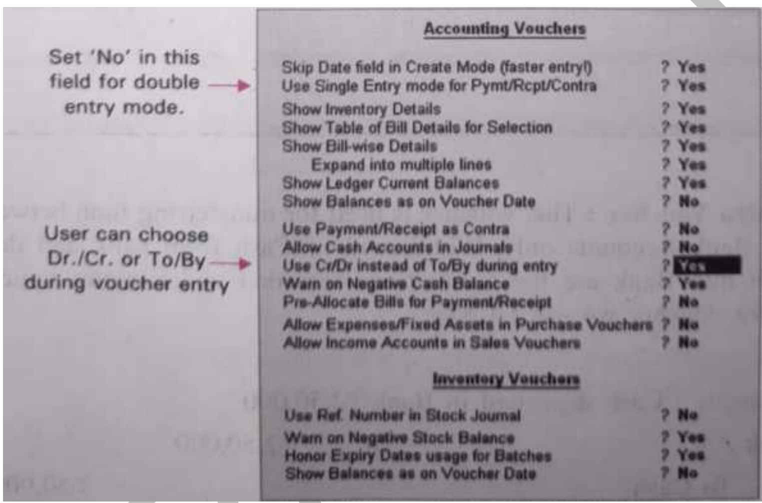


Fig. 27.15 : Voucher Configuration

Payment Voucher :

This voucher is used to record all outflow of money. Payment towards any expenses, creditors and advances are to be recorded in Payment Voucher. For payment voucher we use F5 key and press Fl 2 Key for any changes in configuration of Voucher.

Example :

Purchase of Building & Plant worth Rs.1,00,000 & Rs.50,000 by cheque. Gateway of Tally>Accounting Voucher>Press F5

Building A/c	Dr.	1,00,000	
Plant A/c	Dr.	50,000	
To Bank			1,50,000

(Being Plant & Machinery purchased)

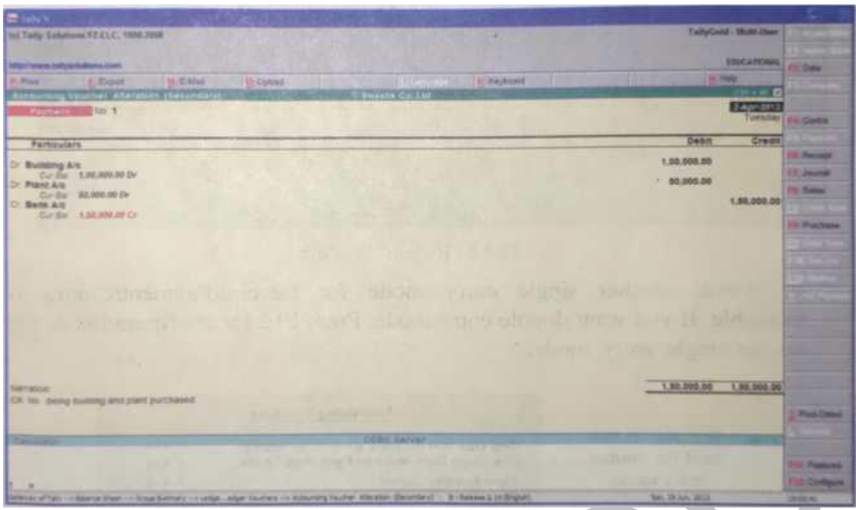


Fig. 27.16 : Payment Voucher

Contra Voucher : This voucher is used for transferring fund between Cash and Bank Accounts only. Withdrawal of Cash from bank and deposit of Cash into Bank are the transactions recorded under contra voucher. For contra voucher we use F4 Key.

Gateway of Tally≥Accounting Voucher≥Press F4

Example : Cash deposited in Bank Rs.2,50,000

Bank A/c	Dr.	2,50,000	
To Cash			2,50,000

(Being Cash deposited in Bank)

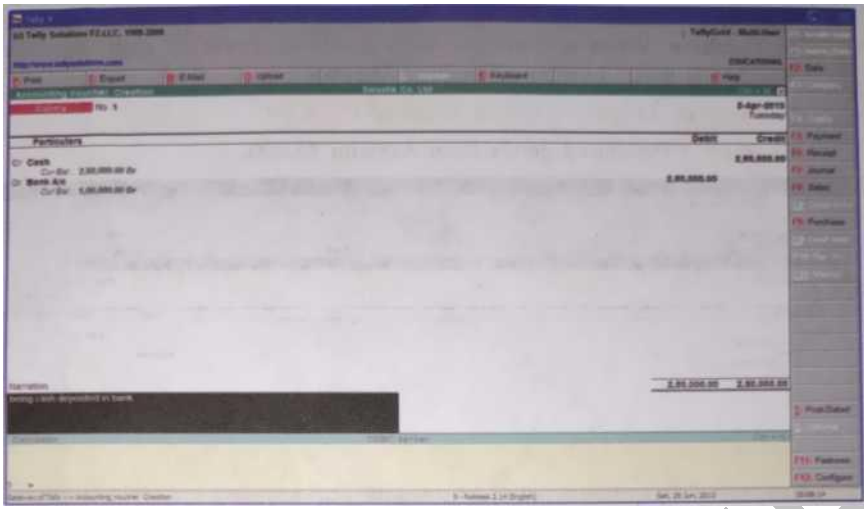


Fig. 27.17 : Contra Voucher

Journal Voucher : Journal Voucher is used to record Non-Cash transactions. It is an adjusting voucher. Adjustment between the ledgers are recorded under Journal Voucher.

Gateway of Tally>Accounting Voucher>Press F7 Example : Depreciation is charged on Machinery Rs.1,000

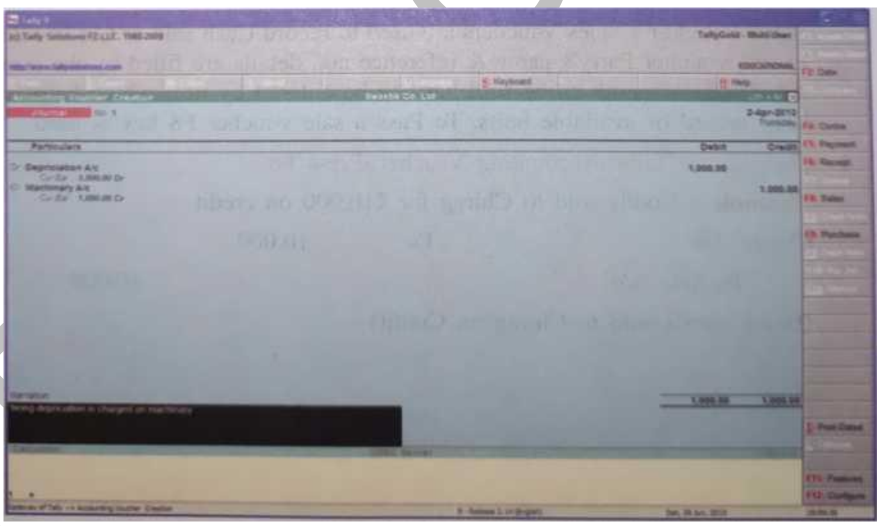


Fig. 27.18 : Journal Voucher

Purchase Voucher : In Purchase Voucher we record all transactions related to Purchase. When a Company buys goods on credit or cash, purchase voucher is used. To pass a Purchase Voucher :

Gateway of Tally≥Accounting Voucher≥Press F9

Example : Purchased goods from Ashwini Rs.5,000.

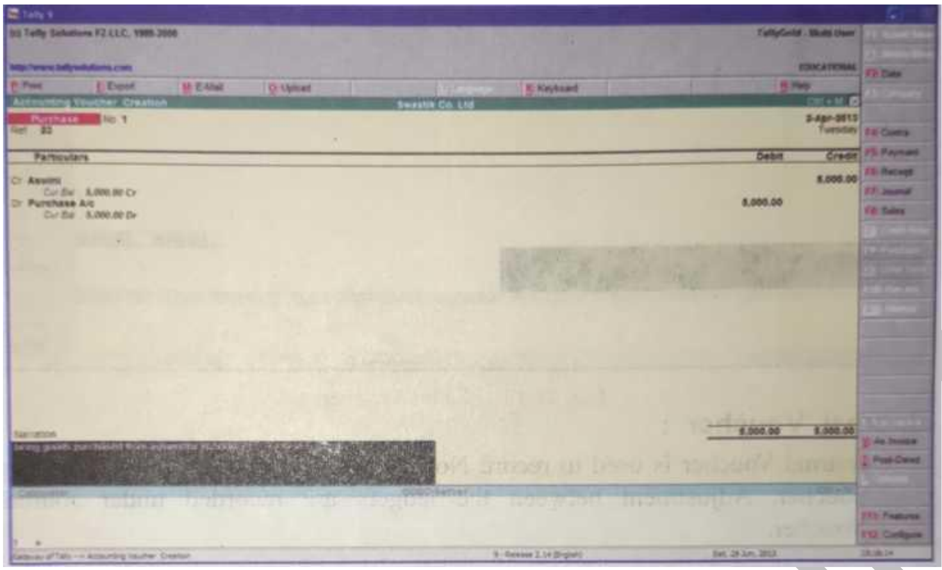


Fig. 27.19 : Purchase voucher. .

Sales Voucher : Sales Vouchers are used to record Cash sale or Credit sale. In this voucher Party's name & reference no., details are filled by the user. All details of goods to be sold have to be entered by user which helps to keep record of available units. To Pass a sale voucher F8 key is used. Gateway of Tally≥Accounting Voucher≥Press F8

Example : Goods sold to Chirag for Rs. 10,000 on credit.

Chirag A/c	Dr.	10,000	
To Sale A/c			10,000

(Being goods sold to Chirag on Credit)

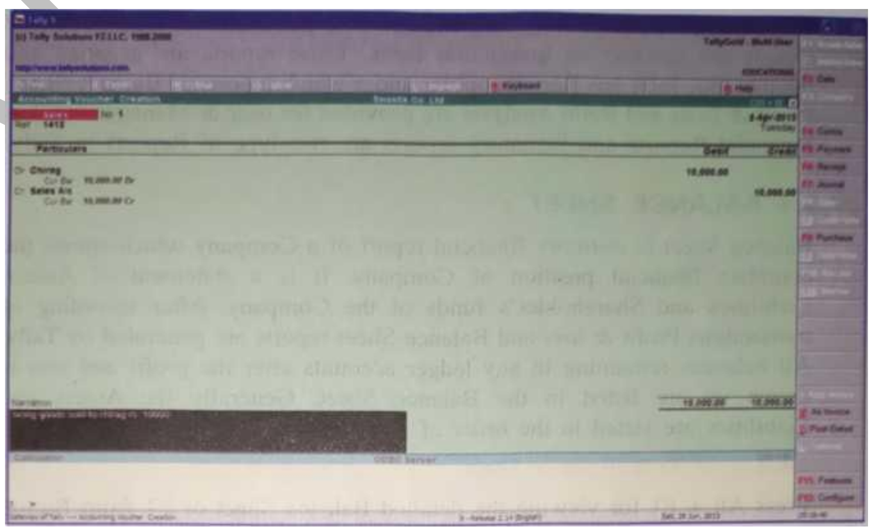


Fig. 27.20 : Sales voucher.

Memo Voucher : This is a non accounting voucher and the entries made under it will not affect the accounts. Tally does not post these entries to ledger but store them in a separate register. You can alter and convert a memo voucher in to a regular voucher when you decide to bring the entry in the book.

Post Dated Voucher : This is used to record for future transactions which are similar as memo voucher.

Memorandum : It is a type of memo voucher used for suspense payment and reminder service etc.

Rejection Out : It is used to record outward return of rejected goods. The rejected goods are sent back to supplier.

Sale Order : It is used for recording order for supply of goods and services. Sale Invoice : It is used to record sale invoice of customers.

Rejection In : This voucher is used to record return Inward of goods sold to customers.

REPORTS ;

Reports provide the information about actual Financial status of Company. In this competitive world reports get huge importance as various actions of management are inspired of it. Timely generation of reports help the management in devising an appropriate strategy for the business.

The strongest point of Tally software is timely generation of reports. All the reports are updated on transaction basis. These reports are accurate and reliable too. Tally has Reports option under which reports of Balance Sheet, Profit & Loss and Ratio Analysis are provided for user & Management use. Financial Reports and inventory reports are two type of Reports in Tally.

BALANCE SHEET :

Balance Sheet is statutory financial report of a Company which shows the complete financial position of Company. It is a statement of Assets, Liabilities and Shareholder's funds of the Company. After recording of transactions Profit & loss and Balance Sheet reports are generated by Tally. All balances remaining in any ledger accounts after the profit and loss is drawn up are listed in the Balance Sheet. Generally the Assets and Liabilities are stated in the order of permanence.

Gateway of Tally>Balance Sheet

Press Alt + Fl for viewing the detailed Balance Sheet or Fl from Button bar.

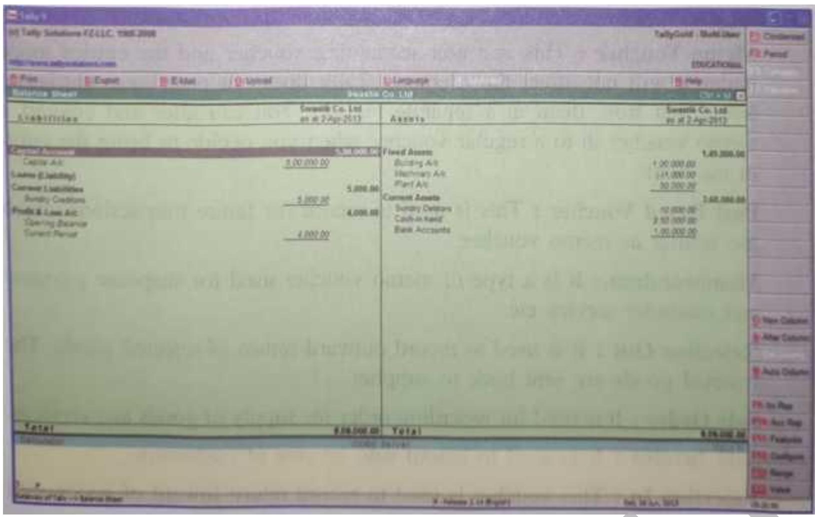


Fig. 27.21 : Balance Sheet

STATEMENT OF PROFIT & LOSS

Statement of Profit & Loss is a periodic statement of a Company which displays the net result in terms of Net Profit or Loss for a specified period. Profit & Loss is a statement of primary group. All the expenses incurred and income earned by the Company are shown on the Debit and Credit side of P & L A/c respectively. After recording of each transaction Profit & Loss A/c is updated so it states true profit or loss of business.

To Display Profit & Loss A/c :

Gateway of Tally>Profit & Loss A/c

For printing the Profit & Loss A/c Press Alt + P Key together or use Print Button.

RATIO ANALYSIS

Ratio Analysis is an arithmetic technique which helps the management to analyse solvency, profitability and liquidity of the business. In tally user need not to calculate ratios for the company. Once user pass the voucher entries, it automatically set the ratio on related accounts.

Gateway of Tally > Ratio Analysis

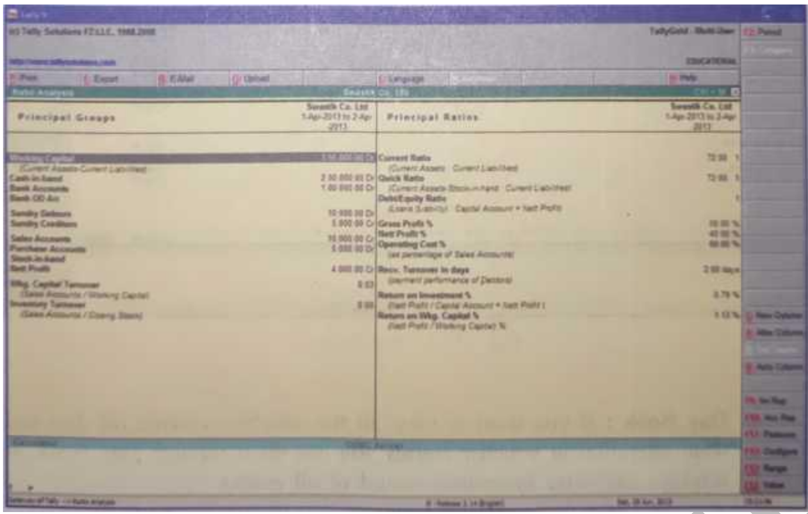


Fig. 27.22 : Ratio Analysis

DISPLAY MENU ;

Balance Sheet, Statement of Profit & Loss and Ratio Analysis can be generated from Gateway of Tally itself. But if user wants to view other

important reports of the business like Trial Balance, Day book, Accounts Books, Cash Flow and Fund Flow etc., he can find it in Display Menu.

- **Trial Balance** : After all voucher entries have been done Trial Balance report is available under display menu :

Gateway of Tally>Display>Trial Balance

Trial Balance shows the closing balance of accounts group ledger. Trial Balance is a Summary of closing balances of all ledgers which shows all entries posted are error free. The total of the Debit balances in a Trial Balance agree with the total of all Credit balances because as per double entry principles every amount on the debit side on an account must have a corresponding entry on the credit side of some other account. In manual accounting it is necessary to check all entries posted are correct. In Tally it is updated after posting of each transaction.

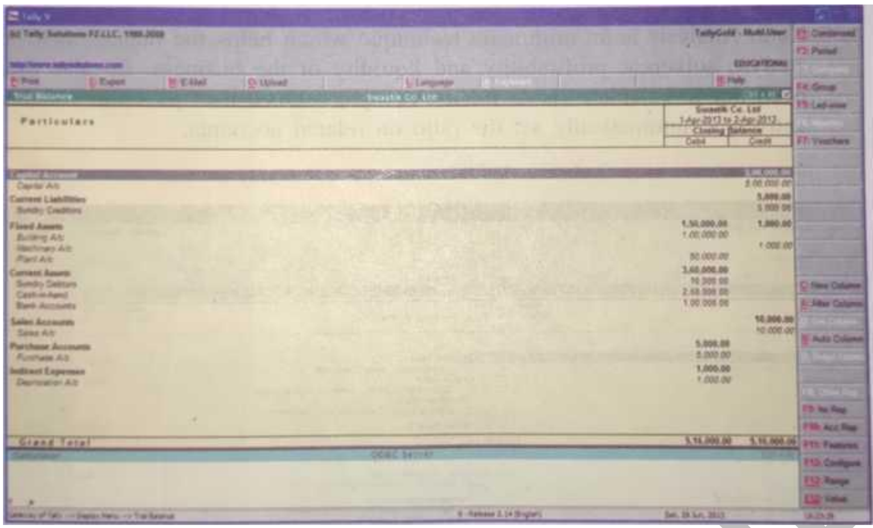


Fig. 27.23 : Trial Balance

• **Day Book** : If you want to view all the vouchers entered till date and want alteration in voucher entries you can do it through Day Book. It displays date-wise systematic record of all entries.

Gateway of Tally>Display>Day Book

You can obtain more information by selecting the entry by pressing <enter> key. It will show the details of particular ledger with graph and on again pressing <enter> key it will show voucher entry window. Here you can make required changes in voucher entry.

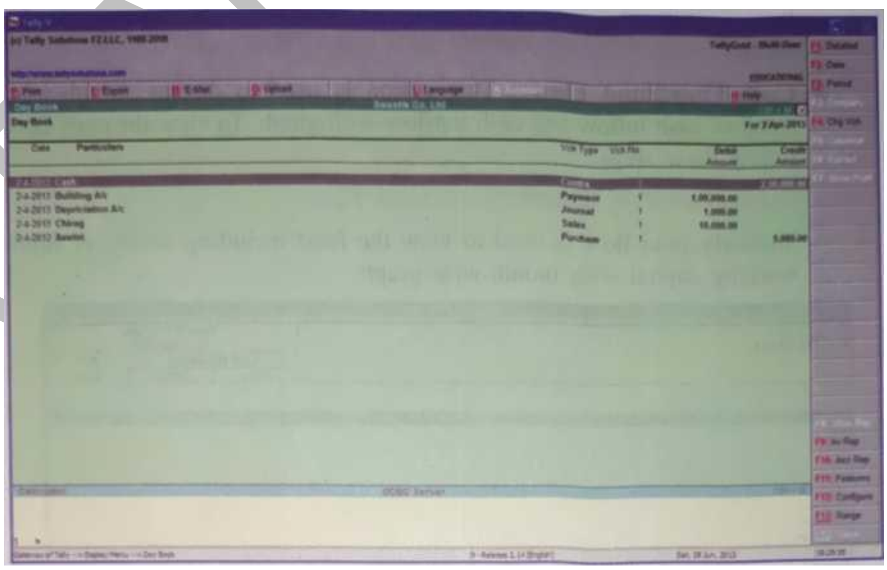
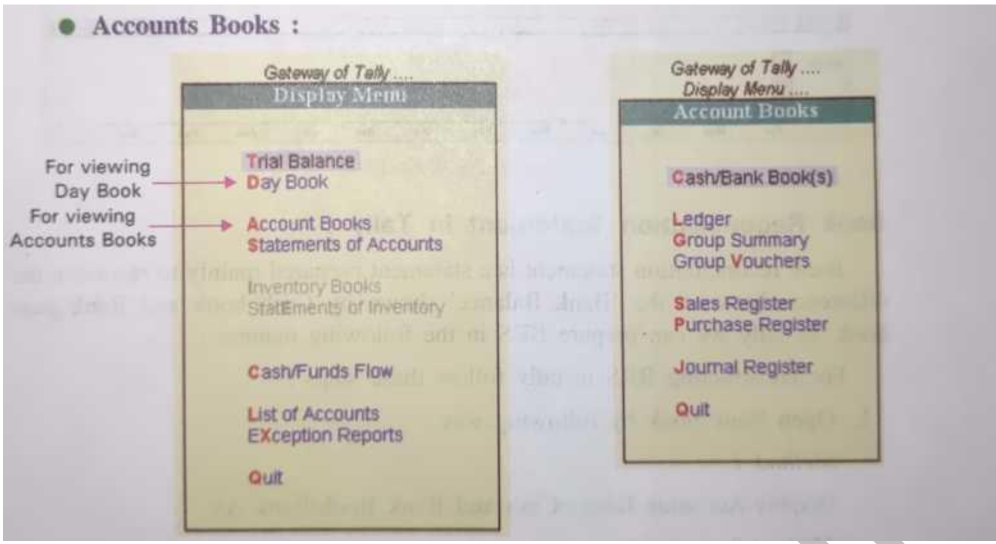


Fig. 27.24 : Day Book



Fig, 27.25 : Accounts books in Display Menu

In Display menu we can generate Cash/Bank Book, Ledger, Group Summary, Sale, Purchase and Journal register through Account Books submenu

Gateway of Tally>Display>Accounts Book>Sales Register Gateway of Tally>Display>Cash/Bank Book

Pressing Alt + P or selecting Print option from button bar for printing the reports.

• **Cash Flow/Fund Flow** : This option is used to display month-wise detail of cash inflow and cash outflow with graph. To view the cash flow follow these steps :

Gateway of Tally>Display>Cash/Fund Flow

Similarly fund flow is used to view the fund including source of fund, working capital with month-wise graph.

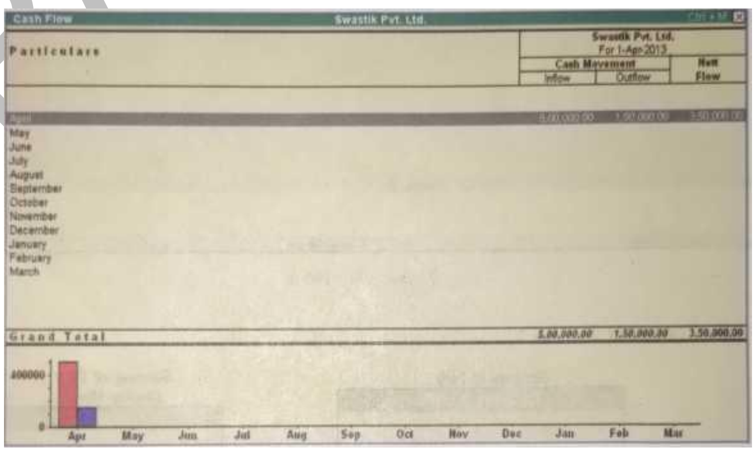


Fig. -27.26 : Cash Flow

Bank Reconciliation Statement in Tally

Bank reconciliation statement is a statement prepared mainly to reconcile the difference between the 'Bank Balance' shown by Cash book and Bank pass book. In tally we can-prepare BRS in the following manner :

For constructing BRS in tally follow these steps :

1. Open Bank book by following way :

Method 1

Display/Accounts Books/Cash and Bank Book/Bank A/c

Method 2

Balance Sheet or Trial Balance/Current Assets/Bank A/c

2. Bring the cursor to the first month (April) and press enter. This will show all the vouchers entered in the month of April.

3. Select F5 reconcile button from vertical botton bar for reconciliation mode.

4. On pressing this button a new column 'Bank date' will appear on screen.

In 'Bank Date' option you can mention the actual date of payment/Receipt from pass book.

At die bottom screen menu you can see following amounts :

(a) Balance as per company Book : It reflects the balance as per company books on last date, (in this example last date of month of April)

(b) Amounts not reflected in Bank : It shows the debit and credit sum of all those vouchers whose bank date in either blank or greater than April 30.

(c) Balance as per Bank : Net Balance of Bank.

For reconciliation statement you have to enter the date of clearing of the cheques from pass book as soon as you mark the date in 'bank date' option. It will start reflecting in [6]Amounts not reflected In bank' & 'balance as per bank'.

If you mark all the dates in bank date option the balance as per bank & company will get same. That mean there will be no difference left in bank & company books. If any cheque is uncleared then leave the date unmarked. Next time when you reconcile it you can mark the date. This is the process of preparing bank reconciliation statement in Tally.

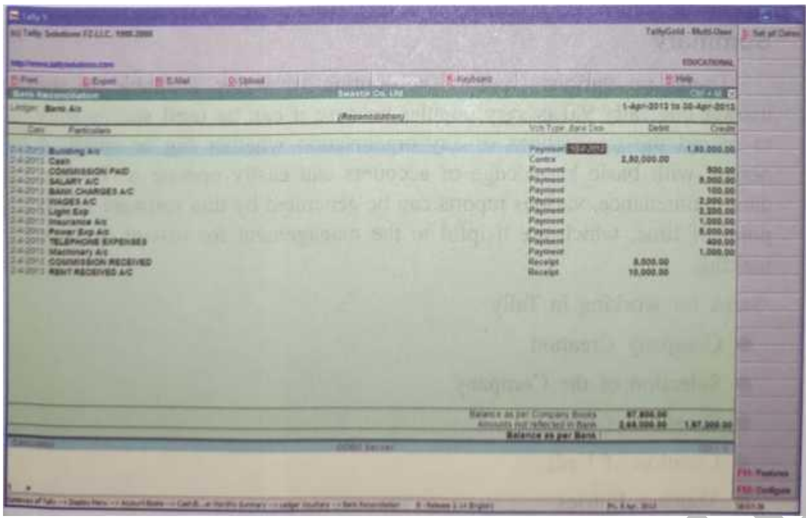


Fig. 27.27 : Bank Reconciliation Statement

OTHER FEATURES OF TALLY :

1. Back up & Restore : Tally Facilitates Back up and Restore option in Company info. menu. Back up is used to store the data of the Company from hard disk to some other destination whereas Restore option is used to store the data of another drive to hard disk. It is useful to move the data from one Computer to another Computer System.

2. Data Security in Tally : Tally software provides data security in following ways :

Password Security : Tally facilitates password security as only the authorized person can access the data. It uses a binary encoding format of storage and offers access to the database.

Data Audit: Audit feature of tally provides the user administrator rights in order to keep track of unauthorised access to the database. If any alteration in data is made by unauthorized user, it will show details with name, date and time to auditor.

Data Vault: Data vault ensures that original information is presented and is not tempered. It provides additional security in this way and password of data vault cannot be cracked.

Multiple Choice Questions (SET A)

Select the correct alternative:

1. For creating a company we use

(a) Alt + F1

(c) Alt + F2

(b) Alt + F3

(d) ESC key

2. For receipt voucher, we use .... Key.

(a) F6

(c) F4

(b) F5

(d) F7

3. This is a non-accounting voucher.

(a) Receipt Voucher

(c) Memo Voucher

(b) Payment Voucher

(d) Journal Voucher

4. Adjustment Entries/Non-Cash Entries are recorded in

(a) Payment Voucher

(c) Contra Voucher

(b) Journal Voucher

(d) Purchase Voucher

5. There are .... pre-defined groups in tally :

(a) 15

(b) 13

(c) 28

(d) 2

6. To change period in Tally we use .... Key.

(a) FI

(c) F5

(b) F3

(d) F2

7. For print option in Tally we use .... Short cut key.

(a) Ctrl + P

(c) Alt + P

(b) Shift + P

(d) Arrow Key

Answers

Multiple Choice Questions (SET A)

Select the correct alternative:

1. (b)	**2. (a)**	**3. (c)**	**4. (b)**
5. (c)	**6. (d)**	**7. (c)**	