BBA - II Year (III Semester)

FINANCIAL ACCOUNTING

Subject Code : 18UAD4 – Lecturer : Dr.M.P, B Section

Unit –I

Introduction to accounts : Definition of account – The Nature, Object and utility of accounting in industrial and business enterprise – Books of accounts – Accounting concepts and conventions.

Definition of account: The main purpose of accounting is to ascertain profit or loss during a specified period, to show financial condition of the business on a particular date and to have control over the firm's property. Such accounting records are required to be maintained to measure the income of the business and communicate the information so that it may be used by managers, owners and other interested parties. Accounting is a discipline which records, classifies, summarises and interprets financial information about the activities of a concern so that intelligent decisions can be made about the concern. *The American Institute of Certified Public Accountants* has defined the Financial Accounting as "the art of recording, classifying and summarising in as significant manner and in terms of money transactions and events which in part, at least of a financial character, and interpreting the results thereof". *American Accounting Association* defines accounting as "the process of identifying, measuring, and communicating economic information to permit informed judgements and decisions by users of the information.

From the above the following attributes of accounting emerge :

(i) **Recording :** It is concerned with the recording of financial transactions in an orderly manner, soon after their occurrence In the proper books of accounts.

(ii) **Classifying :** It Is concerned with the systematic analysis of the recorded data so as to accumulate the transactions of similar type at one place. This function is performed by maintaining the ledger in which different accounts are opened to which related transactions are posted.

(iii) **Summarising :** It is concerned with the preparation and presentation of the classified data in a manner useful to the users. This function involves the preparation of financial statements such as Income Statement, Balance Sheet, Statement of Changes in Financial Position, Statement of Cash Flow, Statement of Value Added.

(iv) **Interpreting :** Nowadays, the aforesaid three functions are performed by electronic data processing devices and the accountant has to concentrate mainly on the interpretation aspects of accounting. The accountants should interpret the statements in a manner useful to action. The accountant should explain not only what has happened but also (a) why it happened, and (b) what is likely to happen under specified conditions.

DISTINCTION BETWEEN BOOK-KEEPING ANDACCOUNTING

Book-keeping is a part of accounting and is concerned with the recording of transactions which is often routine and clerical in nature, whereas accounting performs other functions as well, viz., measurement and communication, besides recording. An accountant is required to have a much higher level of knowledge, conceptual understanding and analytical skill than is required of the book-keeper.

An accountant designs the accounting system, supervises and checks the work of the book-keeper, prepares the reports based on the recorded data and interprets the reports. Nowadays, he is required to take part in matters of management, control and planning of economic resources.

DISTINCTION BETWEEN ACCOUNTINGAND ACCOUNTANCY

Although in practice Accountancy and Accounting are used interchangeably yet there is a thin line of demarcation between them. The word Accountancy is used for the profession of accountants - who do the work of accounting and are knowledgeable persons. Accounting is concerned with recording all business transactions systematically and then arranging in the form of various accounts and financial statements. And it is a distinct discipline like economics, physics, astronomy etc. The word accounting tries to explain the nature of the work of the accountants (professionals) and the word Accountancy refers to the profession these people adopt.

NATURE OFACCOUNTING

The various definitions and explanations of accounting has been propounded by different accounting experts from time to time and the following aspects comprise the nature of accounting :

i) Accounting as a service activity

Accounting is a service activity. Its function is to provide quantitative information, primarily financial in nature, about economic entities that is intended to be useful in making economic decisions, in making reasoned choices among alternative courses of action. It means that accounting collects financial information for the various users for taking decisions and tackling business issues. Accounting in itself cannot create wealth though, if it produces information which is useful to others, it may assist in wealth creation and maintenance.

(ii) Accounting as a profession

Accounting is very much a profession. A profession is a career that involve the acquiring of a specialised formal education before rendering any service. Accounting is a systematized body of knowledge developed with the development of trade and business over the past century. The accounting education is being imparted to the examinees by national and international recognised the bodies like The Institute of Chartered Accountants of India (ICAI), New Delhi in India and American Institute of Certified Public Accountants (AICPA) in USA etc. The candidate must pass a vigorous examination in Accounting Theory, Accounting Practice, Auditing and Business Law. The members of the professional bodies usually have their own associations or organisations, where in they are required to be enrolled compulsorily as Associate member of the Institute of Chartered Accountants (A.C.A.) and fellow of the Institute of Chartered Accountants (F.C.A.). In a way, accountancy as a profession has attained the stature comparable with that of lawyer, medicine or architecture.

(iii) Accounting as a social force

In early days, accounting was only to serve the interest of the owners. Under the changing business environment the discipline of accounting and the accountant both have to watch and protect the interests of other people who are directly or indirectly linked with the operation of modern business. The society is composed of people as customer, shareholders, creditors and investors. The accounting information/data is to be used to solve the problems of the public at large such as determination and controlling of prices. Therefore, safeguarding of public interest can better be facilitated with the help of proper, adequate and reliable accounting information and as a result of it the society at large is benefited.

(iv) Accounting as a language

Accounting is rightly referred the "language of business". It is one means of reporting and communicating information about a business. As one has to learn a new language to converse and communicate, so also accounting is to be learned and practised to communicate business events.

A language and accounting have common features as regards rules and symbols. Both are based and propounded on fundamental rules and symbols. In language these are known as grammatical rules and in accounting, these are termed as accounting rules. The expression, exhibition and presentation of accounting data such as a numerals and words and debits and credit are accepted as symbols which are unique to the discipline of accounting.

(v) Accounting as science or art

Science is a systematised body of knowledge. It establishes a relationship of cause and effect in the various related phenomenon. It is also based on some fundamental principles. Accounting has its own principles e.g. the double entry system, which explains that every transaction has two fold aspect i.e. debit and credit. It also lays down rules of journalising. So we can say that accounting is a science.

Art requires a perfect knowledge, interest and experience to do a work efficiently. Art also teaches us how to do a work in the best possible way by making the best use of the available resources. Accounting is an art as it also requires knowledge, interest and experience to maintain the books of accounts in a systematic manner. Everybody cannot become a good accountant. It can be concluded from the above discussion that accounting is an art as well as a science.

(vi) Accounting as an information system

Accounting discipline will be the most useful one in the acquisition of all the business knowledge in the near future. You will realise that people will be constantly exposed to accounting information in their everyday life. Accounting information serves both profit-seeking business and non-profit organisations. The accounting system of a profit-seeking organisation is an information system designed to provide relevant financial information on the resources of a business and the effect of their use. Information is relevant and valuable if the decision makers can use it to evaluate the financial consequences of various alternatives.

Accounting generally does not generate the basic information (raw financial data), rather the raw financial data result from the day to day transactions of the business.

As an information system, accounting links an information source or transmitter (generally the accountant), a channel of communication (generally the financial statements) and a set of receivers (external users).

OBJECTIVES OF ACCOUNTING

The following are the main objectives of accounting :

1. **To keep systematic records :** Accounting is done to keep a systematic record of financial transactions. In the absence of accounting there would have been terrific burden on human memory which in most cases would have been impossible to bear.

2. **To protect business properties :** Accounting provides protection to business properties from unjustified and unwarranted use. This is possible on account of accounting supplying the following information to the manager or the proprietor:

   (i) The amount of the proprietor's funds invested in the business.

   (ii) How much the business have to pay to others?

   (iii) How much the business has to recover from others?

   (iv) How much the business has in the form of (a) fixed assets, (b) cash in hand, (c) cash at bank, (d) stock of raw materials, work-in-progress and finished goods?

Information about the above matters helps the proprietor in assuring that the funds of the business are not necessarily kept idle or underutilised.

3. **To ascertain the operational profit or loss :** Accounting helps in ascertaining the net profit earned or loss suffered on account of carrying the business. This is done by keeping a proper record of revenues and expense of a particular period. The Profit and Loss Account is prepared at the end of a period and if the amount of revenue for the period is more than 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.

Profit and Loss Account will help the management, investors, creditors, etc. in knowing whether the business has proved to be remunerative or not. In case it has not proved to be remunerative or profitable, the cause of such a state of affairs will be investigated and necessary remedial steps will be taken.

4. **To ascertain the financial position of the business :** The Profit and Loss Account gives the amount of profit or loss made by the business during a particular period. However, it is not enough. The businessman must know about his financial position i.e. where he stands ?, what he owes and what he owns? This objective is served by the Balance Sheet or Position Statement. The Balance Sheet is a statement of assets and liabilities of the business on a particular date. It serves as barometer for ascertaining the financial health of the business.

5. **To facilitate rational decision making :** Accounting these days has taken upon itself the task of collection, analysis and reporting of information at the required points of time to the required levels of authority in order to facilitate rational decision-making. The American Accounting Association has also stressed this point while defining the term accounting when it says that accounting is the process of identifying, measuring and communicating economic information to permit informed judgements and decisions by users of the information. Of course, this is by no means an easy task. However, the accounting bodies all over the

world and particularly the International Accounting Standards Committee, have been trying to grapple with this problem and have achieved success in laying down some basic postulates on the basis of which the accounting statements have to be prepared.

6. **Information System :** Accounting functions as an information system for collecting and communicating economic information about the business enterprise. This information helps the management in taking appropriate decisions. This function, as stated, is gaining tremendous importance these days.

USERS OF ACCOUNTING INFORMATION

The basic objective of accounting is to provide information which is useful for persons inside the organisation and for persons or groups outside the organisation. Accounting is the discipline that provides information on which external and internal users of the information may base decisions that result in the allocation of economic resources in society.

I. **External Users of Accounting Information :** External users are those groups or persons who are outside the organisation for whom accounting function is performed. Following can be the various external users of accounting information:

1. *Investors,* Those who are interested in investing money in an organisation are interested in knowing the financial health of the organisation of know how safe the investment already made is and how safe their proposed investment will be. To know the financial health, they need accounting information which will help them in evaluating the past performance and future prospects of the organisation. Thus, investors for their investment decisions are dependent upon accounting information included in the financial statements. They can know the profitability and the financial position of the organisation in which they are

interested to make that investment by making a study of the accounting information given in the financial statements of the organisation.

2. *Creditors.* Creditors (i.e. supplier of goods and services on credit, bankers and other lenders of money) want to know the financial position of a concern before giving loans or granting credit. They want to be sure that the concern will not experience difficulty in making their payment in time i.e. liquid position of the concern is satisfactory. To know the liquid position, they need accounting information relating to current assets, quick assets and current liabilities which is available in the financial statements.

3. *Members of Non- profit Organisations.* Members of non- profit organisations such as schools, colleges, hospitals, clubs, charitable institutions etc. need accounting information to know how their contributed funds are being utilised and to ascertain if the organisation deserves continued support or support should be withdrawn keeping in view the bad performance depicted by the accounting information and diverted to another organisation. In knowing the performance of such organisations, criterion will not be the profit made but the main criterion will be the service provided to the society.

4. *Government.* Central and State Governments are interested in the accounting information because they want to know earnings or sales for a particular period for purposes of taxation. Income tax returns are examples of financial reports which are prepared with information taken directly from accounting records. Governments also needs accounting information for compiling statistics concerning business which, in turn helps in compiling national accounts.

5. *Consumers.* Consumers need accounting information for establishing good accounting control so that cost of production may be reduced with the resultant

reduction of the prices of goods they buy. Sometimes, prices for some goods are fixed by the Government, so it needs accounting information to fix reasonable prices so that consumers and manufacturers are not exploited. Prices are fixed keeping in view fair return to manufacturers on their investments shown in the accounting records.

6. *Research Scholars.* Accounting information, being a mirror of the financial performance of a business organisation, is of immense value to the research scholars who wants to make a study to the financial operations of a particular firm. To make a study into the financial operations of a particular firm, the research scholar needs detailed accounting information relating to purchases, sales, expenses, cost of materials used, current assets, current liabilities, fixed assets, long term liabilities and shareholders' funds which is available in the accounting records maintained by the firm.

II **Internal Users of Accounting Information.** Internal users of accounting information are those persons or groups which are within the organisation. Following are such internal users :

1. *Owners.* The owners provide funds for the operations of a business and they want to know whether their funds are being properly used or not. They need accounting information to know the profitability and the financial position of the concern in which they have invested their funds. The financial statements prepared from time to time from accounting records depicts them the profitability and the financial position.

2. *Management.* Management is the art of getting work done through others, the management should ensure that the subordinates are doing work properly. Accounting information is an aid in this respect because it helps a manager in appraising the performance of the subordinates. Actual performance of the

employees can be compared with the budgeted performance they were expected to achieve and remedial action can be taken if the actual performance is not upto the mark. Thus, accounting information provides "the eyes and ears to management".

The most important functions of management are planning and controlling. Preparation of various budgets, such as sales budget, production budget, cash budget, capital expenditure budget etc., is an important part of planning function and the starting point for the preparation of the budgets is the accounting information for the previous year. Controlling is the function of seeing that programmes laid down in various budgets are being actually achieved i.e. actual performance ascertained from accounting is compared with the budgeted performance, enabling the manager to exercise controlling case of weak performance. Accounting information is also helpful to the management in fixing reasonable selling prices. In a competitive economy, a price should be based on cost plus a reasonable rate of return. If a firm quotes a price which exceeds cost plus a reasonable rate of return, it probably will not get the order. On the other hand, if the firm quotes a price which is less than its cost, it will be given the order but will incur a loss on account of price being lower than the cost. So, selling prices should always be fixed on the basis of accounting data to get the reasonable margin of profit on sales.

3. *Employees*. Employees are interested in the financial position of a concern they serve particularly when payment of bonus depends upon the size of the profits earned. They seek accounting information to know that the bonus being paid to them is correct.

Utility of accounting in Industrial and Business organisation.

1. Permanent recording of transactions

In a business organization, a huge number of transactions occur. It is not possible for anybody to keep it in mind for long. The permanent keeping of accounts is possible since transactions are recorded systematically.

A businessman at any time can easily collect information from these accounts.

2. Ascertainment of profit and loss of business

At the end of a particular accounting period, profit and loss of a business concern can be ascertained by preparing an income statement.

3. Exhibition of total financial position

The total financial position of a business concern i.e. total capital, total payable, total receivable, total assets, and cash in hand and a bank can be known by preparing a balance sheet at a particular date.

3. Cost control

Head wise amount of income and expenditure can be known if accounts are maintained systematically and properly. As a result, excess expenditure or misuse can be controlled and expenditures are controlled keeping consistency with the income.

4. Helping management of business

Planning regarding income and expenditure becomes easier through proper and accurate accounts keeping.

Appropriate steps can be adopted identifying profitable and non-profitable items of income and expenditure. Besides, sales price and income tax are determined through accounts.

5. Prevention of errors; fraud and forgery

Prevention and detection of fraud and forgery are possible by keeping accounts systematically. Arithmetical accuracy of accounts is also tested by preparing trial balance. And timely steps are possible, if necessary, like rectifying the errors in accounts.

6. Comparative analysis

Current year's profit-loss and property-liabilities can' be compared with previous year's matters of similar nature if accounts are kept systematically and accurately. This helps the businessman in formulating rules and taking decisions.

7. Helping settlement of the dispute

The misunderstanding may arise among the interested parties in a business concern i.e. debtors, creditors, investors, owners, employees etc. Systematic and accurate accounts' keeping minimizes the possibility of such unwanted developments.

8. Helping determination of tax

The systematic keeping of accounts in accepted principles helps to present reliable income tax statements based on which income tax is determined.

9. Keeping accounts regarding VAT

Accounting records all transactions of VAT systematically and helps to determine VAT.

10. Knowing cash position

In cash book, all cash receipts and cash payment are recorded. Day-to-day cash receipts, payments and cash in hand and cash at bank can be known from cash book. Information regarding cash in hand is very essential in running business.

11. Control over assets and liabilities

A businessman is to acquire various types of property and assets to run the business profitably and thereby he is to face a lot of liabilities.

The exact position of the assets and liabilities can be ascertained by maintaining accounts properly. As a result, a businessman can take necessary steps to control decrease of assets and an increase of liabilities.

12. Authentic and presentable documents before the court

In settlement of disputes among interested parties of business, cases are filed in the court. Accounts kept properly can be presented before the court as documentary evidence.

13 Helping in the valuation of assets and liabilities at the time of winding up the business and in case of insolvency of the owner

In both cases of winding up and insolvency, authorities concerned can determine the value of various assets and liabilities properly from the books of accounts maintained systematically and accurately. Under this situation, accurate valuation of assets and liabilities is very essential.

14. Helping in fixation of the sale price of a business

For any reason, the question of selling the whole business or a. part may arise in course of time. In this situation, an accurate selling price can be determined on the basis of properly kept accounts.

15. Testing arithmetical accuracy of accounts

Under double entry system of accounting errors and frauds in accounts, if any, can be detected easily by preparing a trial balance and appropriate measures can be taken in time for rectification.

16. Matching of income and expenditure

Overall development of a business is possible through matching income and expenditure if accounts are kept properly.

17. Advantages in taking a loan

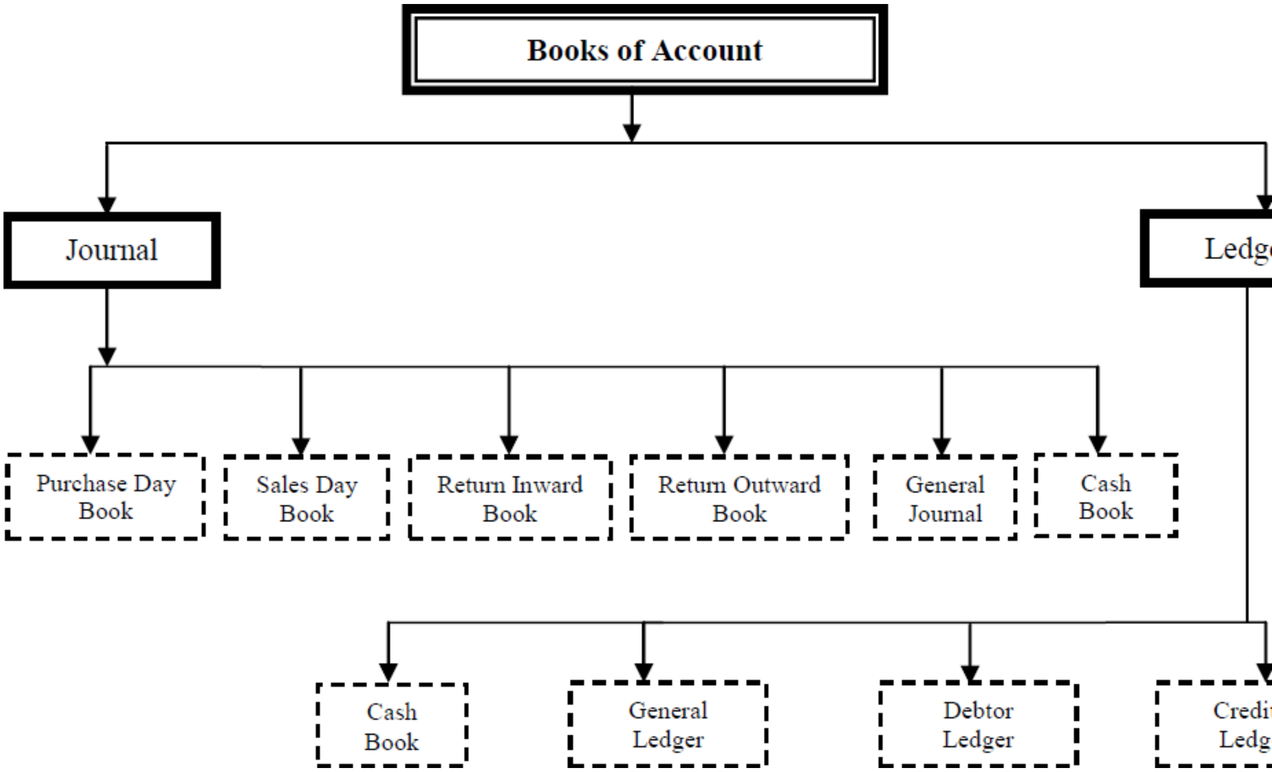
Taking loan becomes easier if accounts are kept properly. The loan giver sanctions loan on the basis of accounting information.

18. Settlement of outstanding debts receivable

Properly kept accounts help in preparing the statement of outstanding debts and receivable and thereby measures can be adopted for timely payment of debts and collection of receivables.

Books of Accounts

There are two main books of accounts, **Journal** and **Ledger**. Journal used to record the economic transaction chronologically. Ledger used to classifying economic activities according to nature.



Types of Journals

Special Journals are used in large business organizations, where it is found inconvenient to journalize every transaction in one journal. Therefore, the journal is sub-divided into different journals known as the subsidiary books. The journal is divided in such a way that a separate book is used for each class of transactions The important books of accounts used in modern business world are the following:

- Purchase Day Book
- Sales Day Book
- Return Inward Book

- Return Outward Book
- General Journal

>> **Practical Multiple Choice Questions Books of Accounts MCQs.**

Purchases Day Book

Purchases book or purchases day book is a book of original entry maintained to record credit purchases. You must note that cash purchases will not be entered in purchases day book because entries in respect of cash purchases must have been entered in the **Cash Book**. At the end of each month, the purchases book is totaled. The total shows the total amount of goods purchased on credit. Purchases book is written up daily from the invoices received. The invoices are consecutively numbered. The invoice of each number is noted in the purchases book.

Sales Day Book

A sales book is also known as sales day book in which are recorded the details of credit sales made by a businessman. Total of sales book shows the total credit sales of goods during the period concerned. Usually the sales book is totaled every month. The sales day book is written up daily from the copies of invoices sent out.

Return Inward Book

Sales returns book is also called returns inwards book. It is used for recording goods returned to us by our customers. Customers who return goods should be sent a credit note. It is a statement sent by a business to customer showing the amount credited to the account.

Return Outward Book

Purchases returns book is a book in which the goods returned to suppliers are recorded. It is also called returns outward book or purchases returns day book. Goods may be returned because they are of the wrong kind or not up to sample or because they are damaged etc.When the goods are returned to the suppliers, intimation is sent to them through what is known as a debit note. These debit notes serve as vouchers for these entries. A debit note is a statement sent by a businessman to vendor, showing the amount debited to the account.

Proper General or General Journal

Journal proper is book of original entry (simple journal) in which miscellaneous credit transactions which do not fit in any other books. It is also called miscellaneous journal or General Journal. For example purchase assets on credit, **Correcting Entries**, **Adjusting Entries** and **Closing Entries** etc.

Accounting Concepts

Four important accounting concepts underpin the preparation of any set of accounts:

Going Concern

Accountants assume, unless there is evidence to the contrary, that a company is not going broke. This has important implications for the valuation of assets and liabilities.

Consistency

Transactions and valuation methods are treated the same way from year to year, or period to period. Users of accounts can, therefore, make more meaningful comparisons of financial performance from year to year. Where accounting policies are changed, companies are required to disclose this fact and explain the impact of any change.

Prudence

Profits are not recognised until a sale has been completed. In addition, a cautious view is taken for future problems and costs of the business (the are "provided for" in the accounts" as soon as their is a reasonable chance that such costs will be incurred in the future.

Matching (or "Accruals")

Income should be properly "matched" with the expenses of a given accounting period.

Key Characteristics of Accounting Information

There is general agreement that, before it can be regarded as useful in satisfying the needs of various user groups, accounting information should satisfy the following criteria:

Understandability

This implies the expression, with clarity, of accounting information in such a way that it will be understandable to users - who are generally assumed to have a reasonable knowledge of business and economic activities

Relevance

This implies that, to be useful, accounting information must assist a user to form, confirm or maybe revise a view - usually in the context of making a decision (e.g. should I invest, should I lend money to this business? Should I work for this business?)

Consistency

This implies consistent treatment of similar items and application of accounting policies

This implies the ability for users to be able to compare similar companies in the same industry group and to make comparisons of performance over time. Much of the work that goes into setting accounting standards is based around the need for comparability.

Reliability

This implies that the accounting information that is presented is truthful, accurate, complete (nothing significant missed out) and capable of being verified (e.g. by a potential investor).

Objectivity

This implies that accounting information is prepared and reported in a "neutral" way. In other words, it is not biased towards a particular user group or vested interest

Accounting Conventions

The most mmonly encountered convention is the "historical cost convention". This requires transactions to be recorded at the price ruling at the time, and for assets to be valued at their original cost.

Under the "historical cost convention", therefore, no account is taken of changing prices in the economy.

The other conventions you will encounter in a set of accounts can be summarised as follows:

Monetary measurement

Accountants do not account for items unless they can be quantified in monetary terms. Items that are not accounted for (unless someone is prepared to pay something for them) include things like workforce skill, morale, market leadership, brand recognition, quality of management etc.

Separate Entity

This convention seeks to ensure that private transactions and matters relating to the owners of a business are segregated from transactions that relate to the business.

Realisation

With this convention, accounts recognise transactions (and any profits arising from them) at the point of sale or transfer of legal ownership - rather than just when cash actually changes hands.

For example, a company that makes a sale to a customer can recognise that sale when the transaction is legal - at the point of contract. The actual payment due from the customer may not arise until several weeks (or months) later - if the customer has been granted some credit terms.

Materiality

An important convention. As we can see from the application of accounting standards and accounting policies, the preparation of accounts involves a high degree of judgement. Where decisions are required about the appropriateness of a particular accounting judgement, the "materiality" convention suggests that this should only be an issue if the judgement is "significant" or "material" to a user of the accounts. The concept of "materiality" is an important issue for auditors of financial accounts.

Unit – II

Book –keeping : The theory of double entry – Book keeping – Journal – Subsidiary books – Ledger trail balance.

What is Double-Entry System?

The most scientific and reliable method of accounting is the Double Entry System. One must have a clear conception of the nature of the transaction to understand the double-entry system.

Every transaction involves two parties or accounts – one account gives the benefit, and the other receives it.

It is called a dual entity of transaction.

In every transaction, the account receiving a benefit is debited, and the account giving benefit is credited.

The process of keeping account accepting this dual entity i.e., debiting one account for a definite amount of money and crediting the other account for the same amount, is called a double-entry system.

Every **transaction affects the accounting equation of a business**. Dual change may take place between two assets.

For example, machinery purchase in cash.

Here machinery account receives the benefit, and the cash account gives the benefit, or the amount of decrease in cash will give an increase of machinery for the same amount.

Again this change may take place between two liabilities.

For example, to meet up the claim of a creditor taking a long-term loan.

Here long-term liability is credited abolishing the short term liability of creditor. Besides, this change may take place between assets and liabilities.

For example, furniture purchased on credit.

Here asset is debited for a particular amount, and at the same time, an equal amount of liability is also credited.

Since every transaction brings changes in assets for an equal sum of money or asset and liability or liabilities, the transactions are to be recorded according to a double-entry system to know the accurate position of assets and liabilities of a business concern.

If accounts are maintained under a double-entry system, two accounts are affected.

One is debited, and another is credited. This is the main principle of the double-entry system.

To make the matter clear some examples are given below;

Mr. Angel invested cash $20,000 in his business as capital. This transaction involves two accounts – Cash Account and Capital Account – Angel. For this transaction, asset-cash increases for $20,000 on one side, and the other side, liability increases for $20,000 as capital, which is the claim of the owner.

This transaction is to be recorded debiting cash and crediting capital accounts. If the transactions are not recorded in two accounts, proper results are not reflected.

Furniture purchased for $2,000. This transaction involves two accounts – a furniture account and a cash account.

For this transaction, cash decreases for $2,000, and furniture increases by $2,000. Here, the furniture account is debited, and the cash account is credited for $2,000 cash.

In another way, the transaction changes only. An element of accounting equation i.e., A = L + P.

It is clear from the above discussion that every transaction is to be recorded in two accounts – one is debited, and the other is credited.

The main principle of the double-entry system is that for every debit there is a corresponding credit for an equal amount of money and for every credit there is a corresponding debit for an equal amount of money; i.e., for every transaction one account is debited for the amount of transaction and the other account is credited for the equal amount of money.

Therefore, it can be said that the system under which every transaction is accounted in two accounts for the equal amount of money debiting one and crediting the other ignoring no account is called a double-entry system.

Every debit must have a corresponding credit and Vice – Versa. Double-entry Book-Keeping is a system by which every debit entry is balanced by an equal credit entry.

Characteristics or Fundamental Principles of Double Entry System

The double-entry system is a scientific, self-sufficient, and reliable system of accounting. Following some widely accepted characteristics or principles, the account is kept under this system.

As a result, on one side, the arithmetical accuracy of the transaction is ensured, and on the other side, ascertainment of the financial position of the business is easily possible.

Characteristics of the double-entry system are stated below;

- **Two parties:** Every transaction involves two parties – debit and credit. According to the main principles of this system, every debit of some amount creates corresponding credit, or every credit creates the corresponding debit for the same amount.
- **Giver and receiver:** Every transaction must have one giver and one receiver.
- **Exchange of equal amount:** The amount of money of a transaction the party gives is equal to the amount the party receives.
- **Separate entity:** Under this system, business is treated as a separate entity from the owner. Here the business is considered as a separate entity.
- **Dual aspects:** Every transaction is divided into two aspects. The left side of the transaction debit and the right side is credit.
- **Results:** Under double entry system totality of debit is equal to the totality of credit. In its ascertainment of the result is easy.
- **Complete accounting system:** Double entry system is a scientific and complete accounting system.

Through this system, the account is kept completely, and no party is ignored. In fine, it can be said that every transaction must possess these characteristics.

If there is an exception to this, complete information will not be available in the books of accounting. As a result, the main objective of accounting will be frustrated.

The process of keeping accounts under the double-entry system;

1. **Journal:** At first, transactions are recorded in the **primary book of accounting called a journal**.
2. **Ledger:** In the **second phase, transactions are classified and recorded permanently in the ledger in brief**.

3. **Trial balance:** In the third phase, the **arithmetical accuracy of the account is verified through the preparation of the trial balance**.
4. **Financial statements:** In the fourth or final stage through **financial statements, the results of all the financial activities of a year are determined**.

Advantages of Double Entry System

The double-entry system is the most scientific method of keeping accounts. In the modem age, this system is accepted as the best one.

In every organization, whether big or small accounts are kept under the double-entry system.

The advantages of the double-entry system are stated in brief;

Complete accounts of transactions

The double-entry system can keep complete accounts of transactions as it is based on dual aspects of each transaction, i.e., debit and credit, are recorded simultaneously.

For this reason, this system maintains accounts of all parties relating to transactions.

Verification of arithmetical accuracy

Arithmetical accuracy of accounting can be verified through the preparation of trial balance if the accounts are maintained under the double-entry system.

Under this system, every debit for a certain amount of money will have corresponding credit for an equal amount.

For this reason, the total amount of debt will be equal to the total amount of credit. It can be detected through trial balance whether two sides of accounts are equal or not, and thereby the arithmetical accuracy of the account is verified.

Determining profit or loss

Under the double-entry system, profit or loss of the company for a particular accounting period can be known by preparing an income statement.

Since all accounts relating to income and expenditure are maintained properly in the ledger under the double-entry system, it becomes convenient to **draw income statement at the end of a particular accounting period**.

Determining the financial position

Under the double-entry system, the total assets and liabilities of a business concern are recorded properly.

As a result, on the closing day of the **accounting period balance sheet is prepared with the help of all assets and liabilities**. Through this balance sheet financial position of the business concerned can be ascertained.

Knowing assets and liabilities

The total amount of assets and liabilities can be ascertained if the account is kept under a double-entry system, and it becomes easier to settle liability and assets.

Fixation of the price of commodities

It becomes easier to fix-up the price of commodities as the accounts are maintained systematically under the double-entry system.

Submission of income and VAT statements

The double-entry system being the reliable system of keeping accounts the submission of reliable income and VAT statement under it is possible based on which income tax and VAT are fixed and paid.

Comparative analysis

Under this system of accounting, the future course of action can be formulated by comparing income -expenditure, asset, and liability of the current year with that of the previous year.

Increase in profit

Under this system of accounting, the picture of all incomes or profits is reflected.

It can be identified which item is more profitable for a business comparing the items relating to a profit of the current year with that of the previous year.

In this way, attempts can be made to make more profit.

Expenditure control

Through comparative analysis, expenditure may be controlled by curtailing expensive expenditure.

Detection and prevention of forgery

Under this system of accounts, errors, or forgery of accounts can easily be detected. As a result, the moral qualities of an accountant and other employees are upheld.

Supply of information

This system helps run the business properly, supplying necessary information and statistics to the management.

Future reference

Under this system, as every transaction is permanently recorded properly and completely, any necessary information can be detected easily in the future.

Easy application

It is easier to record the transactions properly in the books of accounts following the scientific method of the double-entry system.

Generally accepted method

The double-entry system is a scientific method, is a generally accepted system. The accounts under the double-entry system become reliable and acceptable to all concerned, like income tax authority, creditors, etc.

Efficiency evaluation of business concern

Capacity for earning a profit and repaying liabilities can be evaluated with the help of various ratios relating to accounts from financial statements.

For example, creditors or loan givers evaluate the loan repaying capacity of a business concern with the help of the current ratio. If the ratio is 2:1, then it is assumed that the loan repaying capacity of the business concern is sound enough.

Timely step for correcting accounting errors

Accounting errors can properly be detected, and taking necessary measures for correction is possible under a double-entry system of accounting; i.e., before going to the next stage, the errors of accounting can be corrected.

Utility

The utility and application of this system in the accounts of all business concerns, whether big, medium or small, are accepted by all.

Disadvantages or Limitations of Double Entry System

The double entry system is a generally accepted scientific method. Despite its many important advantages, some limitations of it exist which are stated below:

Increased size of books of accounts

Under the double-entry system, every transaction is recorded on two sides of two accounts and in two steps (Journal & ledger) of books of accounts.

Complexity in the accounting process

Complexity arises in following rules, principles, techniques, and methods, etc. for keeping accounts under the double-entry system.

Expensive, time and labor-consuming

Since the accounting process under the double-entry system is extensive, a good number of books are to be kept, and a large number of employees are employed for accounting work.

As a result, it requires enough labor, time, and money. Therefore, it becomes impossible to follow this system by small business concerns.

Persons of specialized knowledge required.

The accountant should possess both theoretical and practical knowledge of accounting for the proper keeping of accounts under the double-entry system.

An inexperienced person in **accounting fails and faces problems in maintaining accounts** under this double-entry system.

Possibility of mistake

As the accounting process under the double-entry system is complex and complicated, the possibility of errors and mistakes cannot be avoided completely.

The limited scope of application

In a small business organization, daily shopping, a cultural ceremony, the application of a single entry system of accounting is more popular and advantageous than the double-entry system.

A problem in maintaining the secrecy

A lot of people are engaged in maintaining accounts under the double-entry system since the accounting process is very wide and extensive.

As a result, a problem arises in maintaining the secrecy of the accounts or business.

Though there arise some problems in maintaining accounts under double entry systems, its advantages and acceptability are so wide and comprehensive that at present age in almost all field accounts is kept under this system.

What are Subsidiary Books

What are Subsidiary Books? Subsidiary Books are books of Original Entry. They are also known as Day Book or special journals. We record transactions of similar nature are in Subsidiary Books. They are helpful in overcoming the limitations of journal book or journal entries. In this article, we will see different types of Subsidiary Books.

Different Types of Subsidiary Books

We can divide the subsidiary books into the following types:

1. Cash book
2. Purchases book

3. Sales book
4. Purchases return or return outwards book
5. Sales return or return inwards book
6. Bills receivable book
7. Bills payable book
8. Journal proper

Cash Book

It records all the cash and bank receipts and payments. It is a book of original entry as we record transactions in it for the first time from the source documents such as vouchers, invoices, etc.

A cash book has a debit and a credit side both. Thus, it is similar to a ledger account. Hence, it acts as a subsidiary book as well as a ledger account.

Purchases book

A firm records all its credit purchases of goods in Purchase Book or Purchase Day Book. While it records all the cash purchases of goods in the Cash Book.

Sales Book

A firm records all credit sales of goods in the Sales Book or Sales Day Book. It records cash sales of goods in the Cash Book. We do not record the sale of assets in the Sales Book.

Sales Return or Return Inwards Book

We record the return of goods sold in the Sales Return Book. A Credit Note is prepared for every return of goods in duplicate.

The Credit Note contains the name of the customer, details of goods returned and reason thereof. It also needs to be dated and serially numbered.

Bills Receivable Book

We record all the acceptance of the bills in our favor in the Bills receivable book. We need to post the total of bills receivable book to the Bills receivable A/c. Also, we need to post the individual accounts of the customers.

Bills Payable Book

We record all the acceptance of the bills that we issue in favor of others in the Bills payable book. We need to post the total of bills payable book to the Bills payable A/c. Also, we need to post the individual accounts of the suppliers.

Journal Proper

It includes transactions relating to credit purchase and sale of assets, depreciation, outstanding and pre-paid expenses, accrued and unearned income, opening and closing entries, adjustment entries and rectification entries.

LEDGER

Journal is a daily record of all business transactions. In the journal all transactions relating to persons, expenses, assets, liabilities and incomes are recorded. Journal does not give a complete picture of the fundamental elements of book keeping i.e. properties, liabilities, proprietorship accounts and expenses and incomes at a glance and at one place. Business transactions being recurring in nature, a number of entries are made for a particular type of transactions such as sales, purchases, receipts and payments of cash, expenses etc., through out the accounting year. The entries are therefore scattered over in the Journal. In fact, the whole Journal will have to be gone through to find out the combined effect of various transactions on a particular account. In case, at any time, a businessman wants to now :

i) How much he has to pay to the suppliers/creditors of goods ?

ii) How much he has to receive from the customers ?

iii) What is the total amount of purchases and sales made during a particular period?

iv) How much cash has been spent/incurred on various items of expenses such as salaries, rent, carriage, stationery etc.

v) What is the amount of profit or loss made during a particular period ?

vi) What is the financial position of the unit on a particular date ?

The above mentioned information cannot be easily gathered from the journal itself because the details of such information is scattered all over the journal. It is thus of dire need to get a summarised/grouped record of all the transactions relating to a particular person, or a thing or an expenditure to take managerial decisions. The mechanics of collecting, assembling and summarising all transactions of similar nature at one place can better be served by a book known as 'ledger' i.e. a classified head of accounts.

Ledger is a principal book of accounts of the enterprise. It is rightly called as the 'King of Books'. Ledger is a set of accounts. Ledger contains the various personal, real and nominal accounts in which all business transactions of the entity are recorded. The main function of the ledger is to classify and summarise all the items appearing in Journal and other books of original entry under appropriate head/set of accounts so that at the end of the accounting period, each account contains the complete information of all transaction relating to it. A ledger therefore is a collection of accounts and may be defined as a summary statement of all the transactions relating to a person, asset, expense or income which have taken place during a given period of time and shows their net effect.

Relationship between Journal and Ledger

Journal and Ledger are the most useful books kept by a business entity. The points of distinction between the two are given below :

1. The journal is a book of original entry where as the ledger is the main book of account.
2. In the journal business transactions are recorded as and when they occur i.e. date-wise. However posting from the journal is done periodically, may be weekly, fortnightly as per the convenience of the business.
3. The journal does not disclose the complete position of an account. On the other hand, the ledger indicates the position of each account debit wise or credit wise, as the case may be. In this way, the net position of each account is known immediately.

4. The record of transactions in the journal is in the form of journal entries whereas the record in the ledger is in the form of an account.

Utility of a Ledger

The main utilities of a ledger are summarised as under :

(a) It provides complete information about all accounts in one book.

(b) It enables the ascertainment of the main items of revenues and expenses

(c) It enables the ascertainment of the value of assets and liabilities.

(d) It facilitates the preparation of Final Accounts.

A Trial Balance is a two-column schedule listing the titles and balances of all the accounts in the order in which they appear in the ledger. The debit balances are listed in the left-hand column and the credit balances in the right-hand column. In the case of the General Ledger, the totals of the two columns should agree.

We, now, know the fundamental principle of double entry system of accounting where for every debit, there must be a corresponding credit. Therefore, for every debit or a series of debits given to one or several accounts, there is a corresponding credit or a series of credits of an equal amount given to some other account or accounts and vice-versa. Hence, according to this principle, the sum total of debit amounts must equal the credit amounts of the ledger at any date. If the various accounts in the ledger are balanced, then the total of all debit balances must be equal to the total of all credit balances. If the same is not true then the books of accounts are arithmetically inaccurate.

It is, therefore, at the end of the financial year or at any other time, the balances of all the ledger accounts are extracted and are recorded in a statement known as Trial Balance and finally totalled up to see whether the total of debit balances is equal to the total of credit balances. A Trial Balance may thus be defined as a statement of debit and credit totals or balances extracted from the various accounts in the ledger books with a view to test the arithmetical accuracy of the books.

The agreement of the Trial Balance reveals that both the aspects of each transaction have been recorded and that the books are arithmetically accurate. If both the sides of Trial Balance do not agree to each other, it shows that there are some errors, which must be detected and rectified if the correct final accounts are to be prepared. Thus, Trial Balance forms a connecting link between the ledger accounts and the final accounts.

OBJECTIVES OF PREPARING TRIALBALANCE

The following are the main objectives of preparing the trial balance:

(i) **To check the arithmetical accuracy of books of accounts**: According to the principle of double entry system of book-keeping, every business transaction has two aspects, debit and credit. So, the agreement of the trial balance is a proof of the arithmetical accuracy of the books of accounts. However, it is not a conclusive evidence of their accuracy as their may be certain errors, which the Trial Balance may not be able to disclose.

(ii) **Helpful in preparing final accounts**: The trial balance records the balances of all the ledger accounts at one place which helps in the preparation of final accounts, i.e. Trading and Profit and Loss Account and Balance Sheet. But, unless the trial balance agrees, the final accounts cannot be prepared. So, if the trial balance does not agree, errors are located and necessary corrections are made at the earliest, so that there may not be unnecessary delay in the preparation of the final accounts.

(iii) **To serve as an aid to the management:** By comparing the trial balances of different years changes in figures of certain important items such as purchases, sales, debtors etc. are ascertained and their analysis is made for taking managerial decisions. So, it serves as an aid to the management.

LIMITATIONS OF TRIAL BALANCE

The following are the main limitations of the Trial Balance:

(i) Trial Balance can be prepared only in those concerns where double entry system of accounting is adopted.

(ii) Though trial balance gives arithmetic accuracy of the books of accounts but there are certain errors, which are not disclosed by the trial balance. That is why it is said that trial balance is not a conclusive proof of the accuracy of the books of accounts.

(iii) If trial balance is not prepared correctly then the final accounts prepared will not reflect the true and fair view of the state of affairs of the business. Whatever conclusions and decisions are made by the various groups of persons will not be correct and will mislead such persons.

Unit – III

Statement of account : Statement of accounts – Manufacturing account – Trading account – Profit and Loss account and Balance sheet.

TRADING ACCOUNT

After the preparation of trial balance, the next step is to prepare Trading Account. Trading Account is one of the financial statements which shows the result of buying and selling of goods and/or services during an accounting period. The main objective of preparing the Trading Account is to ascertain gross profit or gross loss during the accounting period. Gross Profit is said to have been made when the sale proceeds exceed the cost of goods sold. Conversely, when sale proceeds are less than the cost of goods sold, gross loss is incurred. For the purpose of calculating cost of goods sold, we have to take into consideration opening stock, purchases, direct expenses on purchasing or manufacturing the goods and closing stock. The balance of this account i.e. gross profit or gross loss is transferred to the Profit and Loss Account.

Format of Trading Account

A Trading Account is prepared in "T" form just like every other account. Though it is an account, yet it is not exactly an ordinary ledger account. It is one of the accounts which are prepared only once in an accounting period to ascertain the gross profit or gross loss of the business. As it is prepared once in a year, columns for date and journal folio are not provided. While preparing a Trading Account, an important point thatmust be kept in mind is that a closing journal entry is to be recorded in the journal proper. At the end of every accounting period, items of revenue and direct expenses are closed by transferring their respective balances to the Trading Account.

The format of a Trading Account and the usually appearing entries therein are shown below :

TRADING ACCOUNT

For the year ended 31st March, 2006

Particulars	**Amount Rs.**	**Particulars**	**Amount Rs.**
To Opening Stock		By Sales	
To Purchases		*Less* Sales Returns	
Less Purchases Returns		By Closing Stock	
To Direct Expenses:		By Gross Loss transferred to P & L A/c	
Carriage Inward			
Freight and			
Insurance Wages			
Fuel, Power and Lighting expenses			
Manufacturing Expenses			
Coal, Water and Gas			
Motive Power			
Octroi			
Import Duty			
Custom Duty			
Consumable Stores			
Royalty on manufactured Goods			
Packing charges			
To Gross Profit transferred to P & L A/c			

Balancing of Trading Account

After recording the relevant items of various accounts in the respective sides of the Trading Account, the balance is calculated to ascertain Gross Profit or Gross Loss. If the total of the credit side is more than that of the debit side, the excess represents Gross Profit. Conversely, if the total the debit side is more than that of the credit side, the excess represents Gross Loss. Gross Profit is transferred to the credit side of the Profit and Loss Account and Gross loss to the debit side of the Profit and Loss Account.

Closing Entries for Trading Account

The journal entries necessary to transfer opening stock, purchases, sales and returns to the Trading Account are called closing entries, as they serve to close these accounts. These are as follows:

1. For transfer of opening stock, purchases and direct expenses to Trading A/c

Trading A/c Dr.

To Stock (Opening) A/c

To Purchases A/c

To Direct Expenses A/c

(Being opening stock, purchases and direct expenses transferred to Trading Account)

2. For transfer of sales and closing stock to Trading A/c

Sales A/c Dr.

Stock (Closing) A/c Dr.

To Trading A/c

(Being sales, closing stock transferred to Trading Account)

3.(a) For Gross Profit

Trading A/c Dr.

To Profit & Loss A/c

(Being gross profit transferred to Profit and Loss Account)

(b) For Gross Loss

Profit & Loss A/c Dr.

To Trading A/c

(Being gross loss transferred to Profit and Loss Account)

Important Points Regarding Trading Account

1. Stock

The term 'stock' includes goods lying unsold on a particular date. The stock may be of two types:

(a) Opening stock

(b) Closing stock

Opening stock refers to the closing stock of unsold goods at the end of previous accounting period which has been brought forward in the current accounting period. This is shown on the debit side of the Trading Account.

Closing stock refers to the stock of unsold goods at the end of the current accounting period. Closing stock is valued either at cost price or at market price whichever is less. Such valuation of stock is based on the principle of conservatism which lays down that the expected profit should not be taken into account but all possible losses should be duly provided for.

Closing stock is an item which is not generally available in the trial balance. If it is given in Trial Balance, it is not to be shown on the credit side of Trading Account but appears only in the Balance Sheet as an asset. But if it is given outside the trial balance, it is to be shown on the credit side of the Trading Account as well as on the asset side of the Balance Sheet.

2. Purchases

Purchases refer to those goods which have been bought for resale. It includes both cash and credit purchases of goods. The following items are shown by way of deduction from the amount of purchases:

(a) Purchases Returns or Return Outwards.

(b) Goods withdrawn by proprietor for his personal use.

(c) Goods received on consignment basis or on approval basis or on hire purchase.

(d) Goods distributed by way of free samples.

(e) Goods given as charity.

3. Direct Expenses

Direct expenses are those expenses which are directly attributable to the purchase of goods or to bring the goods in saleable condition. Some example of direct expenses are as under:

(a) Carriage Inward

Carriage paid for bringing the goods to the godown is treated as carriage inward and it is debited to Trading Account.

(b) Freight and insurance

Freight and insurance paid for acquiring goods or making them saleable is debited to Trading Account. If it is paid for the sale of goods, then it is to be charged (debited) to Profit and Loss Account.

(c) Wages

Wages incurred in a business are direct expenses, when they are incurred on manufacturing or merchandise or on making it saleable. Other wages are indirect wages. Only direct wages are debited to the Trading Account. Other wages are debited to the Profit and Loss Account. If it is not mentioned whether wages are direct or indirect, it should be assumed as direct and should appear in the Trading Account.

(d) Fuel, Power and Lighting Expenses

Fuel and power expenses are incurred for running the machines. Being directly related to production, these are considered as direct expenses and debited to Trading Account. Lighting expenses of factory are also charged to Trading Account, but lighting expenses of administrative office or sales office are charged to Profit and Loss Account.

(e) Octroi

When goods are purchased within municipality limits, generally octroi duty has to be paid on it. It is debited to Trading Account.

(f) Packing Charges

There are certain types of goods which cannot be sold without a container or proper packing. These form a part of the finished product. One example is ink, which cannot be sold without a bottle. These type of packing charges are debited to Trading Account. But if the goods are packed for their safe despatch to customers, i.e. packing meant for transportation or fancy packing meant for advertisement, will appear in the Profit and Loss Account.

(g) Manufacturing Expenses

All expenses incurred in manufacturing the goods in the factory such as factory rent, factory insurance etc. are debited to Trading Account.

(h) Royalties

These are the payments made to a patentee, author or landlord for the right to use his patent, copyright or land. If royalty is paid on the basis of production, it is debited to Trading Account and if it is paid on the basis of sales, it is debited to Profit and Loss Account.

4. Sales

Sales include both cash and credit sales of those goods which were purchased for resale purposes. Some customers might return the goods sold to them (called sales return) which are deducted from the sales in the inner column and net amount is shown in the outer column. While ascertaining the amount of sales, the following points need attention:

(a) If a fixed asset such as furniture, machinery etc. is sold, it should not be included in sales.

(b) Goods sold on consignment or on hire purchase or on sale or return basis should be recorded separately.

(c) If goods have been sold but not yet despatched, these should not be shown under sales but are to be included in closing stock.

(d) Sales of goods on behalf of others and forward sales should also be excluded from sales.

Illustration 1: From the following information, prepare the Trading Account for the year ending on 31March 2002 :

Opening Stock Rs. 1,50,000, Cash Sales Rs. 60,000, Credit Sales Rs. 12,00,000, Returns Outwards Rs. 10,000, Wages Rs. 4,000, Carriage Inward Rs. 1,000, Freight Inward Rs. 3,000, Octroi Rs. 2,000, Cash Purchases Rs. 50,000, Credit Purchases Rs. 10,00,000, Returns Inward Rs. 20,000, Closing Stock as on 31.3.2002 Rs. 84,000.

Solution :

Trading Account

Dr. for the year ending on 31March, 2002 Cr.

Particulars		Rs.	Particulars		Rs.
To Opening Stock		1,50,000	By Sales		
To Purchases			Cash Sales	60,000	
Cash Purchases	50,000		Credit Sales	12,00,000	
Credit Purchases	10,00,000		Total Sales	12,60,000	
Total Purchase	10,50,000		*Less* : Return		
Less : Return			Inward	20,000	12,40,000
Outwards	10,000	10,40,000	By Closing Stock		84,000
To Freight Inwards		3,000			
To Octroi		2,000			
To Carriage Inwards		1,000			
To Gross Profit tfd. to P&L A/c		4,000			
					13,24,000

MANUFACTURING ACCOUNT

Manufacturing Account is prepared by an enterprise engaged in manufacturing activities. It is prepared to ascertain the cost of goods manufactured during an accounting period. This account is closed by transferring its balance to the debit of the Trading Account. A general format of a Manufacturing Account is shown below :

Dr. **Manufacturing Account of ...... for the period ending on........** **Cr.**

Particulars	Rs.	Particulars	Rs.
To Opening Work-in-progress		By Sale of Scrap	
To Raw material consumed		By Closing Work-in-progress	
Opening Stock		By Trading Account	
Add : Purchases		(Cost of goods produced transferred)	
Add : Cartage Inwards			
Add : Freight Inwards			
Less : Return Outwards			
Less : Closing Stock			
To Wages			
To Salary of Works Manager			
To Power, Electricity & Water			
To Fuel			
To Postage & Telephone			
To Depreciation on :			
Plant & Machinery			
Factory Land & Buildings			
To Repairs to :			
Plant & Machinery			
Factory Land & Building			
To Insurance			
Plant & Machinery			
Factory Land & Building			
To Rent and Taxes			
To General Expenses			
To Royalty based on production			

DIFFERENCE BETWEEN TRADING ACCOUNT AND MANUFACTURING ACCOUNT

Trading Account	Manufacturing Account
1. Trading Account is prepared to find out the Gross Profit/Gross Loss.	Manufacturing account is prepared to find out the cost of goods produced.
2. The balance of the Trading account is transferred to the Profit and Loss Account.	The balance of the Manufacturing Account is transferred to the Trading Account.
3. Sale of scrap is not shown in the Trading Account.	Sale of crap is shown in the Manufacturing Account.
4. Stocks of finished goods are shown in the Trading Account.	Stocks of raw materials and work-in-progress are shown in the Manufacturing Account.
5. Trading Account is a part of the Profit and Loss Account.	Manufacturing Account is a part of the Trading Account.

Illustration 2 : From the following information, prepare a Manufacturing Account for the year ending on 31 March 2002 :

	Rs.		Rs.
Work-in-progress (1.4.2001)	4,000	Wages	20,000
Raw Material (31.3.2002)	90,000	Salary of Works Manager	8,000
Carriage Inwards	3,000	Power, Electricity & Water	6,000
Freight Inwards	2,000	Fuel	4,000
Return Outwards	2,700	Depreciation :	
Sales of Scrap	1,000	Plant & Machinery	8,000
Work-in-progress (31.3.2002)	5,000	Factory Building	4,000
Raw Materials (1.4.2001)	74,000	Repairs & Insurance :	
Raw Material Purchased	45,000	Plant & Machinery	6,000
General Expenses	2,000	Factory Building	2,000
		Factory Rent & Taxes	10,000

Solution :

Manufacturing Account

Dr. for the year endingon 31 March 2002 Cr.

Particulars		Rs.	Particulars	Rs.
To Opening WIP		4,000	By Sale of Scrap	1,000
To Raw Materials consumed			By Closing WIP	5,000
Opening Stock	74,000		By Trading A/c (Cost of goods	
Add : Purchases	45,000		manufactured transferred)	99,800
Add :Carriage Inwards	3,000			
Add :Freight Inwards	2,000			
Less : Returns Outwards	2,200			
Less :Closing Stock	90,000	31,800		
To Wages		20,000		
To Salary of Works Managers		8,000		
To Power, Electricity & Water		6,000		
To Fuel		4,000		
To Depreciation				
Plant & Machinery		8,000		
Factory Building		4,000		
To Repairs & Insurance				
Plant & Machinery		6,000		
Factory Building		2,000		
To Factory Rent & Taxes		10,000		
To General Expenses		2,000		
		1,05,800		1,05,800

4 PROFIT AND LOSS ACCOUNT

Trading Account results in the gross profit/loss made by a businessman on purchasing and selling of goods. It does not take into consideration the other operating expenses incurred by him during the course of running the business. Besides this, a businessman may have other sources of income. In order to ascertain the true profit or loss which the business has made during a particular period, it is necessary that all such expenses and incomes should be considered. Profit and Loss Account considers all such expenses and incomes and gives the net profit made or net loss suffered by a business during a particular period. All the indirect revenue expenses and losses are shown on the debit side of the Profit and Loss Account, where as all indirect revenue incomes are shown on the credit side of the Profit and Loss Account.

Profit and Loss Account measures net income by matching revenues and expenses according to the accounting principles. Net income is the difference between total revenues and total expenses. In this connection, we must remember that all the expenses, for the period are to be debited to this account - whether paid or not. If it is paid in advance or outstanding, proper adjustments are to be made (Discussed later). Likewise all revenues, whether received or not are to be credited. Revenue if received in advance or accrued but not received, proper adjustment is required.

A proforma of the Profit and Loss Account showing probable items therein is as follows :

PROFIT AND LOSS ACCOUNT

For the year ended ....

Particulars	Rs.	Particulars	Rs.
To Gross Loss b/d		By Gross Profit b/d	
To Management Expenses:		*By Other Income :*	
Rent, Rates and Taxes		Discount received	
Heating and Lighting		Commission received	
Office Salaries		*By Non-trading Interest :*	
Printing & Stationary		Bank Interest	
Postage & Telegrams		Rent of property let-out	
Telephone Charges		Dividend from shares	
Legal Charges		*By Abnormal Gains :*	
Audit Fees		Profit on sale of machinery	
Insurance		Profit on sale of investment	
General Expenses		By Net Loss transferred to	
To Selling and Distribution		Capital Account	
Expenses :			
Advertisement			
Tavellers' Salaries			
Expenses & Commission			
Godown Rent			
Export Expenses			
Carriage Outwards			
Bank Charges			
Agent's Commission			
Upkeep of Motor Lorries			
To Depreciation and			
Maintenance :			
Depreciation			
Repairs & Maintenance			
To Financial Expenses :			
Discount Allowed			
Interest on Loans			
Discount on Bills			
To Abnormal Losses:			
Loss by fire (not			
covered by Insurance)			
Loss on Sale of Fixed			
Assets			
Loss on Sale of Investments			
To Net profit transferred to			
Capital A/c			

Important Points in Profit and Loss Account

(i) Salaries. These include salaries paid to office, godowns and warehouse staff and should be shown in Profit and Loss Account being indirect expenses. Salaries to partners must be debited separately.

If salaries are paid after deduction of Income tax or Provident Fund then these should be added back to the salaries in order to have gross figure of salaries to be shown in Profit and Loss Account. If salaries are paid in kind by providing certain facilities to the employees such as house free of rent, meals or cloth or washing facility free of charge, then the value of such facilities should be regarded as salaries.

(ii) *Rent, Rates and Taxes.* These include offices and warehouse rent, municipal rates and taxes. Factory rent, rates and taxes should be debited to Trading Account and others to Profit and Loss Account. If any rent is received on subletting of the building, the same should be shown separately on the credit side of the Profit and Loss Account. If rent is paid after deduction of some taxes then these should be added back to know the correct amount of rent payable.

(iii) *Interest.* Interest paid on loans, overdrafts and bills overdue is an expense and is taken to the debit side of Profit and Loss Account. Interest received on loans advanced by the firm, on deposits and on securities is a gain and is shown on the credit side of Profit and Loss Account. Interest on capital should be shown separately on the debit side and interest on drawing on the credit side of Profit and Loss Account.

(iv) *Commission.* Commission received for doing the work of other firms may be credited to Profit and Loss Account as a gain and commission payable to the agents employed to sell the firm's goods is debited to Profit and Loss Account as an expense.

(v) *Repairs.* Repairs and small renewals or replacements relating to the plant and machinery, fixtures, fittings and utensils etc. are generally included under this heading and such expenditure, being as expense, is debited to Profit and Loss Account.

(vi) *Depreciation.* It is an expense due to wear and tear, lapse of time and exhaustion of assets used in business. This is loss sustained by fixed assets and should be charged to Profit and Loss Account.

(vii) *Advertising* . All sums spent on advertising should be charged to Profit and Loss Account. If a large amount is paid under a contract covering two or three years, proportionate part should be charged to Profit and Loss Account and the balance appears as an asset in the Balance Sheet.

Expenses not to be shown in Profit and Loss Account

(i) *Domestic and Household Expenses*. These expenses are not shown in Profit and Loss Account, as these are personal expenses of the proprietor and should be treated asdrawings.

(ii) *Income tax*. It should be treated as a personal expense of the proprietor and added to drawing. It should not be shown as an expense in Profit and Loss Account.

(iii) *Life Insurance Premium.* Premium paid on the life police of the proprietor should be charged to the Drawings Account.

Closing Entries for Profit and Loss Account

(i) For transfer of various expenses to Profit & Loss A/c

Profit and Loss A/c Dr.

To Various Expenses A/c

(Being various indirect expenses transferred to Profit and Loss Account)

(ii) For transfer of various incomes and gains to Profit & Loss A/c

Various Incomes & Gains A/c Dr.

To Profit & Loss A/c

(Being various incomes & gains transferred to Profit and Loss Account) (iii)(a) For Net Profit

Profit & Loss A/c Dr.

To Capital A/c

(Being Net Profit transferred to capital

(b) For Net Loss

Capital A/c Dr.

To Profit & Loss A/c

(Being Net Loss transferred to Capital Account)

DISTINCTION BETWEEN TRADING ACCOUNT AND PROFIT AND LOSS ACCOUNT

Trading Account	Profit and Loss Account
1. Trading Account is prepared as a part or section of the Profit and Loss Account.	Profit and Loss Account is prepared as a main account.
2. Direct Expenses are taken in Trading Account.	Indirect expenses are taken in Profit and Loss Account.
3. Gross Profit or Gross Loss is ascertained from Trading Account.	Net Profit or Net Loss is ascertained from the Profit and Loss Account.
4. The Balance of the Trading Account i.e. Gross Profit or Gross Loss is transferred to the Profit and Loss Account.	The balance of the Profit and Loss Account i.e. Net Profit or Net Loss is transferred to proprietor's Capital Account.
5. Items of account written in the Trading Account are few as compared the Profit and Loss Account.	Items of accounts written in the Profit and Loss Account are much more as compared to the Trading Account.

5 BALANCE SHEET

A Balance Sheet is a statement of financial position of a business concern at a given date. It is called a Balance Sheet because it is a sheet of balances of those ledger accounts which have not been closed till the preparation of Trading and Profit and Loss Account. After the preparation of Trading and Profit and Loss Account the balances left in the trial balance represent either personal or real accounts. In other words, they either represent assets or liabilities existing on a particular date. Excess of assets over liabilities represent the capital and is indicative of the financial soundness of a company.

A Balance Sheet is also described as a "Statement showing the Sources and Applications of Capital". It is a statement and not an account and prepared from real and personal accounts. The left hand side of the Balance Sheet may be viewed as description of the sources from which the business has obtained the capital with which it currently operates and the right hand side as a description of the form in which that capital is invested on a specified date.

Characteristics

The characteristics of a Balance Sheet are summarised as under:

(a) A Balance Sheet is only a statement and not an account. It has no debit side or credit side. The headings of the two sides are 'Assets' and 'Liabilities'.

(b) A Balance Sheet is prepared at a particular point of time and not for a particular period. The information contained in the Balance Sheet is true only at that particular point of time at which it is prepared.

(c) A Balance Sheet is a summary of balances of those ledger accounts which have not been closed by transfer to Trading and Profit and Loss Account.

(d) A Balance Sheet shows the nature and value of assets and the nature and the amount of liabilities at a given date.

Classification of Assets and Liabilities

Assets

Assets are the properties possessed by a business and the amount due to it from others. The various types of assets are :

(a) Fixed Assets

All assets which are acquired for the purpose of using them in the conduct of business operations and not for reselling to earn profit are called fixed assets. These assets are not readily convertible into cash in thenormal course of business operations. Examples are land and building, furniture, machinery, etc.

(b) Current Assets

All assets which are acquired for reselling during the course of business are to be treated as current assets. Examples are cash and bank balances, inventory, accounts receivables, etc.

(c) Tangible Assets

These are definite assets which can be seen, touched and have volume such as machinery, cash, stock, etc.

(d) Intangible Assets

Those assets which cannot be seen, touched and have no volume but have value are called intangible assets. Goodwill, patents and trade marks are examples of such assets.

(e) Fictitious Assets

Fictitious assets are not assets at all since they are not represented by any tangible possession. They appear on the asset side simply because of a debit balance in a particular account not yet written off e.g. provision for discount on creditors, discount on issue of shares etc.

(f) Wasting Assets

Such assets as mines, quarries etc. that become exhausted or reduce in value by their working are called wasting assets.

Liabilities

A liability is an amount which a business is legally bound to pay. It is a claim by an outsider on the assets of a business. The liabilities of a business concern may be classified as :

(a) Fixed Liabilities

These are those liabilities which are payable only on the termination of the business such as capital contributed by the owner.

(b) Long Term Liabilities

The liabilities or obligations of a business which are not payable within the next accounting period but will be payable within next five to ten years are known as long term liabilities. Public deposits, debentures, bank loan are the examples of long term liabilities.

(c) Current Liabilities

All short term obligations generally due and payable within one year are current liabilities. This includes trade creditors, bills payable etc.

(d) Contingent Liabilities

A contingent liability is one which is not an actual liability but which may become an actual one on the happening of some event which is uncertain. Thus such liabilities have two characteristics : (a) uncertainty as to whether the amount will be payable at all, and (b) uncertainty about the amount involved. Examples of such liabilities are :

(a) Claims against the companies not acknowledged asdebts.

(b) Uncalled liability on partly paid up shares.

(c) Arrears of fixed cumulativedividend.

(d) Estimated amount of contracts remaining to be executed on capital account and not providedfor.

(e) Liability of a case pending in the court.

(f) Bills of exchange, guarantees given against a particular firm or person.

Grouping and Marshalling of Assets and Liabilities

The arrangement of assets and liabilities in certain groups and in a particular order is called Grouping and Marshalling of the Balance Sheet of a business. Assets and liabilities can be arranged in the Balance Sheet into two ways :

(i) In order of liquidity.

(ii) In order of permanence.

(i) *In order of liquidity.* When assets and liabilities are arranged according to their reliability and payment preferences, such an order is called liquidity order. Such arrangement is given in the Balance Sheet (I).

Balance Sheet (I)

Liabilities	Rs.	Assets	Rs.
Current Liabilities :		*Liquid Assets :*	
Bills Payable		Cash in Hand	
Sundry Creditors		Cash at Bank	
Bank Overdraft		*Floating Assets :*	
Long Term Liabilities :		Sundry Debtors	
Loan from Bank		Investments	
Debentures		Bill Receivable	
Fixed Liabilities :		Stock in Trade	
Capital		Prepaid Expenses	
		Fixed Assets :	
		Machinery	
		Building	
		Furniture & Fixtures	
		Motor Car	
		Fictitious Assets :	
		Advertisement	
		Misc. Expenses	
		Profit & Loss A/c	
		Intangible Assets	
		Goodwill	
		Patents	
		Copyright	

(ii) *In order of permanence.* When the order is reversed from that what is followed in case of liquidity, it is called order of permanence. This order is followed in case of joint stock companies compulsorily but can be followed in other forms of business organisations also. Fixed assets and liabilities are shown first on the assumption that these will be sold or paid only on the insolvency of a business. This order of Balance Sheet is given below in Balance Sheet (II).

Balance Sheet (II)

Liabilities	Rs.	*Assets*	Rs.
Fixed Liabilities		Intangible Assets	
Long TermLiabilities		Fictitious Assets	
Current Liabilities		Fixed Assets	
		Floating Assets	
		Liquid Assets	

Illustration 3: The following balances are extracted from the books of Nikhil & Co. on 31st March, 2002. You are required to make the necessary closing entries and to prepare the Trading and Profit and Loss Account and a Balance Sheet as on that date :

	Rs.		Rs.
Opening Stock	500	Commission (Cr.)	200
B/R	2,250	Returns Outwards	250
Purchases	19,500	Trade Expenses	100
Wages	1,400	Office Fixtures	500
Insurance	550	Cash in Hand	250
Sundry Debtors	15,000	Cash at Bank	2,375
Carriage Inwards	400	Rent & Taxes	550
Commission (Dr.)	400	Carriage Outwards	725
Interest on Capital	350	Sales	25,000
Stationary	225	Bills Payable	1,500
Returns Inwards	650	Creditors	9,825
		Capital	8,950

The Closing Stock was valued at Rs. 12,500.

Solution :

Closing Entries

Date	Particulars		Dr.	Cr.
			Amount	Amount
2002			Rs.	Rs.
March 31	Trading Account	Dr.	22,450	
	To Stock A/c			500
	To Purchases A/c			19,500
	To Wages A/c			1,400
	To Returns Inwards A/c			650
	To Carriage Inwards A/c			400
	(Being balance transferred)			
"	Sales A/c	Dr.	25,000	
	Returns Outwards A/c	Dr.	250	
	To Trading Account			25,250
	(Being balances transferred)			
	Closing Stock A/c	Dr.	12,500	
	To Trading A/c			12,500
	(Being value of closing stock)			
"	Trading Account	Dr.	15,300	
	To Profit and Loss A/c			15,300
	(Being gross profit transferred)			
"	Profit and Loss Account	Dr.	2,900	
	To Insurance A/c			550
	To Commission A/c			400
	To Interest on Capital A/c			350
	To Stationary A/c			225
	To Trade Expenses A/c			100
	To Rent and Taxes A/c			550
	To Carriage Outwards A/c			725
	(Being balances transferred)			
"	Commission A/c	Dr.	200	
	To Profit & Loss A/c			200
	(Being balance transferred)			
"	Profit and Loss A/c	Dr.	12,600	
	To Capital A/c			12,600
	(Being net profit transferred)			

Trading & Profit and Loss A/c of Messers Nikhil & Co.

for the year ended 31st March, 2002

Particulars		Rs.	Particulars		Rs.
To Opening Stock		500	By Sales	25,000	
	19,500		*Less* : Returns Inwards	650	24,350
Less: Returns Outwards	250	19,25 0			
To Wages		1,400			
To Carriage Inwards		400			
		36,850			36,85 0
To Insurance		550	By Gross Profit b/d		15,30
To Commission		400	By Commission		
To Interest on Capital		350			
To Stationary		225			
To Trade Expenses		100			
To Rent and Taxes		550			
		725			
		15,500			15,500

Balance Sheet of Messers Nikhil & Co.

as on 31st March, 2002

Liabilities		Rs.	Assets	Rs.
Creditors		9,825	Cash in Hand	250
Bills Payable		1,500	Cash at Bank	2,375
Capital			Bill Receivable	2,250
March 31, 2002				
	8,950		Stock	12,500
Add : Net Profit	12,600	21,550	Sundry Debtors	15,000
			Office Fixtures	500
		32,875		32,875

6 ADJUSTMENT ENTRIES

While preparing Trading and Profit and Loss Account one point that must be kept in mind is that expenses and incomes for the full trading period are to be taken into consideration. For example if an expense has been incurred but not paid during that period, liability for the unpaid amount should be created before the accounts can be said to show the profit or loss. All expenses and incomes should properly be adjusted through entries. These entries which are passed at the end of the accounting period are called adjusting entries . Some important adjustments which are to be made at the end of the accounting year are discussed in the following pages.

1. Closing Stock

This is the stock which remained unsold at the end of the accounting period. Unless it is considered while preparing the Trading Account, the gross profit shall not be correct. Adjusting entry for closing stock is as under :

Closing Stock Account Dr.

To Trading Account

(Being closing stock brought in to books)

Treatment in final accounts

(i) Closing stock is shown on the credit side of Trading Account.

(ii) At same value it will be shown as an asset in the Balance Sheet.

2. Outstanding Expenses

Expenses which have become due and have not been paid by the end of financial year, are called outstanding expenses.

For example, when Profit and Loss Account is being prepared on 31st March 31, 2002, it may be found that salaries for the month of March have become due on March 31, 2002 but have not been paid till that date. This must be shown on the debit side of Profit and Loss Account being prepared on March 31, 2002. The entry will be as under :

Salary account Dr.

To Outstanding salary account

(Being salary due but not paid)

Treatment in final accounts :

(i) The amount of outstanding salary shall be added to particular expenses on the debit side of Profit and Loss Account.

(ii) In balance sheet the same amount will be shown as a liability.

3. Unexpired or Prepaid Expenses

Those expenses which have been paid in advance, i.e., whose benefit will be available in future are called unexpired or prepaid expenses. For example, if a fire insurance policy is taken for a year paying Rs. 1,000 as insurance premium on Ist July, 2000 and will expire on 30th June, 2001, the position on 31st March 2001, when accounts are closed, will be that Rs. 750, i.e., premium from Ist July, 2000 to 31st March, 2001 will be an expense but Rs. 250 i.e., premium from Ist April, 2001 to 30th June, 2001 will be unexpired expense. In order to bring this into account on 31st March, 2001, the following entry will be passed :

Prepaid Insurance Premium A/c	Dr.	Rs. 250	
To Insurance Premium A/c			Rs. 250

The two-fold effect of prepaid expenses will be:

(i) Prepaid expenses will be shown in the Profit and Loss Account by way of deduction from the expensesand

(ii) These will be shown on the assets side of the Balance Sheet as prepaid expenses. In the beginning of the next year, a reverse entry will be passed to nullify the effect of adjusting entry.

4. Accrued Income

That income which has been earned but not received during the accounting year is called accrued income. For example, if the business has invested Rs. 10,000 in 5% gilt edged securities on Ist April, 2001 but during the year Rs. 350 has been received as interest on securities. Then Rs. 150 interest on securities earned and due for payment on 31st March, 2002 but not received, will be accrued interest for the year 2001-2002. In order to bring accrued interest into books of account, the following adjusting entry will be passed :

Accrued Interest A/c	Dr.	Rs. 150	
To Interest A/c			Rs. 150

The two-fold effect of accrued income will be :

(i) It will be shown on the credit side of Profit and Loss Account by way of addition to the income, and

(ii) It will be shown on the assets side of the Balance Sheet as Accrued Income.

Next year, in the beginning, a reverse entry will be passed in order to eliminate the effect of adjusting entry and to bring the same to the correct position.

5. Income Received in Advance

Income received but not earned during the accounting year is called as income received in advance. For example, if building has been given to a tenant on Rs. 2,400 per annum but during the year Rs. 3,000 has been received, then Rs. 600 will be income received in advance. In order to bring this into books of account, the following adjusting entry will be made at the end of the accounting year :

Rent A/c	Dr.	Rs. 600	
To Rent Received in Advance Account			Rs. 600

The two-fold effect of this adjustment will be:

(i) It is shown on the credit side of Profit and Loss Account by way of deduction from the income, and

(ii) It is shown on the liabilities side of the Balance sheet as income received in advance.

A reverse entry will be passed at the beginning of the next year to nullify the effect of adjusting entry.

6. Depreciation

Depreciation is the reduction in the value of fixed asset due to its use, wear and tear or obsolescence. When an asset is used for earning purposes, it is necessary that reduction due to its use, must be charged to the Profit and Loss Account of that year in order to show correct profit or loss and to show the asset at its correct value in the Balance Sheet. There are various methods of charging depreciation on fixed assets. Suppose machinery for Rs.10,000 is purchased on 1.1.2001, 20% p.a. is the rate of depreciation. Then Rs.2,000 will be depreciation for the year 2001 and will be brought into account by passing the following adjusting entry :

Depreciation A/c	Dr.	Rs.2,000	
To Machinery A/c			Rs.2,000

The two-fold effect of depreciation will be :

(i) Depreciation is shown on the debit side of Profit and Loss Account, and

(ii) It is shown on the asset side of the Balance Sheet by way of deduction from the value of concerned asset.

7. Interest on Capital

The amount of capital invested by the trader in his business is just like a loan by the firm. Charging interest on capital is based on the argument that if the same amount of capital were invested in some securities elsewhere, the businessman would have received interest thereon. Such interest on capital is not actually paid to the businessman. Interest on capital is a gain to the businessman because it increases its capital, but it is a loss to the business concern.

Interest is calculated on the opening balance of the capital at the given rate for the full accounting period. If some additional amount of capital has been brought in the business during the course of accounting period, interest on such additional amount of capital is calculated from the date of introduction to the end of the accounting period. The following adjustment entry is passed for allowing interest on capital :

Interest on Capital Account Dr.

To Capital Account

Treatment in final accounts

(i) Interest allowed on capital is an expense for the business and is debited to Profit and Loss Account, i.e. it is shown on the debit side of the Profit and Loss Account.

(ii) Such interest is not actually paid in cash to the businessman but added to his capital account. Hence, it is shown as an addition to capital on the liabilities side of the Balance Sheet.

8. Interest of Drawings

It interest on capital is allowed, it is but natural that interest on drawings should be charged from the proprietor, as drawings reduce capital. Suppose during an accounting year, drawings are Rs.10,000 and interest on drawings is Rs.500. In order to bring this into account, the following entry will be passed :

Drawings A/c		Dr. Rs.500	
	To Interest on Drawings A/c		Rs.500

The two-fold effect of interest on drawings will be :

(i) Interest on drawings will be shown on the credit side of Profit and Loss Account, and

(ii) Shown on the liabilities side of the Balance Sheet by way of addition to the drawings which are ultimately deducted from the capital.

9. Bad Debts

Debts which cannot be recovered or become irrecoverable are called bad debts. It is a loss for the business. Such a loss is recorded in the books by making following adjustment entry :

Bad Debts A/c		Dr.
	To Sundry Debtors A/c	

The two-fold effect of bad debts will be that bad debts will be :

(i) Shown on the debit side of Profit and Loss Account, and

(ii) Shown on the assets side of the Balance Sheet by way of deduction from sundry debtors.

10. Provisions for Doubtful Debts

In addition to the actual bad debts, a business unit may find on the last day of the accounting period that certain debts are doubtful, i.e., the amount to be received from debtors may or may not be received. The amount of doubtful debts is calculated either by carefully examining the position of each debtor individually and summing up the amount of doubtful debts from various debtors or it may be computed (as is usually done) on the basis of some percentage (say 5%) of debtors at the end of the accounting period. The percentage to be adopted is usually based upon the past experience of the business. The reasons for making provision for doubtful debts are two as discussed below :

(a) Loss caused by likely bad debts must be charged to the Profit and Loss Account of the period for which credit sales have been made to ascertain correct profit of the period.

(b) For showing the true position of realisable amount of debtors in the Balance Sheet, i.e., provision for doubtful debts will be deducted from the amount of debtors to be shown in the Balance Sheet.

For example, sundry debtors on 31.03.2002 are Rs.55,200. Further bad debts are Rs.200. Provision for doubtful debts @ 5% is to be made on debtors. In order to bring the provision for doubtful debts of Rs.2,750, i.e., 5% on Rs.55,000 (55,200-200), the following entry will be made :

Profit and Loss A/c	Dr. Rs.2,750	
To Provision for Doubtful Debts A/c		Rs.2,750

It may be carefully noted that further bad debts (if any) will be first deducted from debtors and then a fixed percentage will be applied on the remaining debtors left after deducting further debts. It is so because percentage is for likely bad debts and not for bad debts which have been decided to be written off.

Treatment in final accounts

(i) The amount of provision for doubtful debts is a provision against a possible loss so it should be debited to Profit and Loss Account.

(ii) The amount of provision for doubtful debts is deducted from sundry debtors on the assets side of the Balance Sheet.

11. Provision for Discount on Debtors

It is a normal practice in business to allow discount to customers for prompt payment and it constitutes a substantial sum. Sometimes the goods are sold on credit to customers in one accounting period whereas the payment of the same is received in the next accounting period and discount is to be allowed. It is a prudent policy to charge this expenditure (discount allowed) to the period in which sales have been made, so a provision is created in the same manner, as in case of provision for doubtful debts i.e.

Profit and Loss Account Dr.

To Provision for Discount on Debtors Account

Treatment in final accounts

(i) Provision for discount on debtors is a probable loss, so it should be shown on the debit side of Profit and Loss Account.

(ii) Amount of provision for discount on debtors is deducted from sundry debtors on the assets side of the Balance Sheet.

Note : Such provision is made on debtors after deduction of further bad debts and provision for doubtful debts because discount is allowable to debtors who intend to make the payment.

12. Reserve for Discount on Creditors

Prompt payments to creditors enables a businessman to earn discount from them. When a businessman receives cash discount regularly, he can make a provision for such discount since he is likely to receive the discount from his creditors in the following years also. The discount received being a profit, the provision for discount on creditors amounts to an addition to the profit.

Accounting treatment of Reserve for Discount on Creditors is just reverse of that in the case of Provision for Discount on Debtors. The adjustment entries for Reserve for Discount on Creditors is as follows :

Reserve for Discount on Creditors Account	Dr.	
To Profit and Loss Account		

Treatment in final accounts

i) Reserve for discount on creditors is shown on the credit side of Profit and Loss Account.

ii) In the liabilities side of the Balance Sheet, the reserve for discount on creditors is shown by way of deductions from Sundry Creditors.

13. Deferred Revenue Expenditure

The expenditure done in the initial stage but the benefit of which will also be available in subsequent years is called deferred revenue expenditure. Part of such expenditure will be written off in each year and the rest will be capitalised. The entry for this expenditure (say advertisement Rs. 2,000 which will be spread over 5 years) will be :

Profit and Loss A/c	Dr.	Rs. 400	
To Advertisement A/c			Rs. 400

The two-fold effect of such expenditure will be :

(i) It is shown on the debit side of Profit and Loss Account, and

(ii) It is shown on the assets side by way of deduction from capitalised expense.

14. Loss of Stock by Fire

In business, the loss of stock may occur due to fire. The position of the business may be :

(a) All the stock is fully insured.

(b) The stock is partlyinsured.

(c) The stock is not insured atall.

If the stock is fully insured, the whole loss (say Rs. 15,000) will be claimed from the insurance company. The following entry will be passed :

Insurance Co. A/c	Dr.	Rs. 15,000	
To Trading A/c			Rs. 15,000

The double effect on this entry will be :

(i) It will be shown on the credit side of the Trading Account, and

(ii) It is shown on the assets side of the Balance Sheet.

If the stock is not fully insured, the loss of stock covered by insurance policy (say Rs. 10,000) will be claimed from the insurance company and the rest of the amount (say Rs. 5,000) will be loss for the business. The following entry will be passed:

Insurance Co. A/c	Dr.	Rs. 10,000	
Profit & Loss A/c	Dr.	Rs. 5,000	
To Trading A/c			Rs. 15,000

The two-fold effect of this entry will be :

(i) It will be shown on the credit side of the Trading Account with the value of stock and shown on the debit side of the Profit and Loss Account for that part of the stock which is not insured, and

(ii) It is shown on the assets side of the Balance Sheet with the amount which is to be realised from the Insurance Co., i.e., that part of the loss which is insured.

If the stock is not insured at all, whole of the loss (say Rs. 15,000) will be borne by the firm. The entry for this will be :

Profit and Loss A/c	Dr.	Rs. 15,000	
To Trading A/c			Rs. 15,000

The double effect of this entry will be :

(i) It is shown on the credit side of the Trading Account, and

(ii) It is shown on the debit side of the Profit and Loss Account.

16. Goods Distributed as Free Samples

Sometimes in order to promote the sale of goods, some of the produced goods are distributed as free samples. For example, if goods worth Rs. 2,000 are distributed as free samples then it will be an advertisement for the concern and on other hand stock will be less by such goods. In order to bring this into books of account, the following entry is passed :

Advertisement A/c	Dr.	Rs. 2,000	
To Trading or Purchases A/c			Rs. 2,000

The two-fold effect of this entry will be :

(i) It is shown on the credit side of the Trading Account, or deducted from the purchases, and

(ii) It is also shown on the credit side of the Profit and Loss Account as advertisement expenses.

Illustration 4 : From the following Trial Balance of Mr. Nitin, prepare Trading and Profit and Loss Account for the year ending 31st March, 2002 and Balance Sheet on that date :

Debit Balance	Rs.	Credit Balance	Rs.
Drawings	14,200	Capital	85,000
Plant and Machinery	19,000	Sales	2,38,120
Stock on Ist April, 2001	29,200	Discount Received	1,200
Purchases	2,07,240	Provision for Doubtful Debts	2,100
Bills Receivable	4,800	Returns outward	5,820
Returns Inwards	4,200	Apprenticeship premiums	2,400
Cash in hand	960	Bank Overdraft	4,000
Sundry Debtors	64,000	Sundry Creditors	20,000
Bad debts	3,440	Bills Payable	3,600
Sundry Expenses	8,800		
Rent	2,400		
Rates and Taxes	4,000		
	3,62,240		3,62,240

Adjustments :

(i) Interest is charged on capital @ 5% per annum.

(ii) Provide for Doubtful Debts at 5% on sundry debtors.

(iii) Depreciation is charged on Plant and Machinery @ 10% p.a.

(iv) Outstanding Rent was Rs.800

(v) There were prepaid taxes for Rs. 1,600.

(vi) Apprenticeship Premium Rs. 400 was to be carried forward.

(vii) The value of stock on 31st March 2001 was Rs. 34,000.

Solution :

Trading and Profit and Loss Account

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

Particulars		Rs.	Particulars		Rs.
To Opening Stock		29,200	By Sales	2,38,120	
To Purchases	2,07,240		*Less* Returns Inwards	4,200	2,33,920
Less Returns Outwards	5,820	2,01,420	By Closing Stock		34,000
To Gross Profit c/d		37,300			
		2,67,920			2,67,920
To Sundry Expenses		8,800	By Gross Profit b/d		37,300
To Rent	2,400				
Add O/S rent	800	3,200	By Apprenticeship Premium	2,400	
			Less Carried forward	400	2,000
To Rates and Taxes	4,000				
Less P/P rates and insurance	1,600	2,400	By Discount Received		1,200
To Depreciation on Plant & Machinery		1,900			
To Provision for Bad debts :					
Bad debts	3,440				
Add New Provision required	3,200				
	6,640	4,540			
Less Old Provision To		4,250			
Interest on Capital					
		15,410			
		40,500			40,500

Balance Sheet

as on 31st March, 2002

Liabilities		Rs.	Assets		Rs.
Capital	85,000		Plant and Machinery	19,000	
Add Interest on Capital	4,250		*Less* Depreciation @ 10%	1,900	17,100
Add Net Profit	15,410				
	1,04,660		Closing Stock		34,000
Less drawings	14,200	90,460	Sundry Debtors	64,000	
Bank overdraft		4,000	*Less* New Provision for		
Sundry Creditors		20,000	Doubtful debt @ 5%	3,200	60,800
Bills Payable		3,600	Bills Receivable		4,800
Outstanding Rent		800			
Apprenticeship Premium		400	Cash in hand		960
received in advance			Prepaid rates and insurance		1,600
		1,19,260			1,19,260

Unit – IV

Capital and revenue : Capital and revenue – Income and expenditure account – Receipts and payments depreciation – Reserves and Provisions.

Capital and Revenue

NEED FOR DISTINCTION BETWEEN CAPITAL AND REVENUE

We know that the purpose of maintaining a detailed and systematic record of business transactions is two-fold i.e., i) to ascertain the net result of the trading activity for an accounting year, and ii) to ascertain the financial position of the business as at the end of the accounting year. Hence, we prepare an income statement called Profit and Loss Account for ascertaining the net result, and a position statement called Balance Sheet for determining the financial position. The Profit and Loss Account and Balance Sheet together are called Final Accounts. You also'know that before preparing the final accounts, we prepare another statement called Trial Balance in order to check the arithmetical accuracy of the books of account. The Trial Balance also forms the basis for the preparation of the Final Accounts. All items appearing in the Trial Balance are transferred either to the Profit and Loss Account or to the Balance Sheet.

As per rules, items of revenue nature are shown in the Profit and Loss Account and items of capital nature in the Balance Sheet. In other words, whether an item will appear in Profit and Loss Account or in the Balance Sheet depends upon the revenue and capital nature of the item. If any item is wrongly classified i.e., if any item of revenue nature is treated as a capital item or vice versa, the ascertainment of profit will be incorrect. For example, the revenues earned during an accounting year are Rs. 1,00,000 and the costs shown are Rs. 80,000. The profit will work out as Rs. 20,000. On rechecking you found that a revenue item of Rs. 5,000 (an expenditure on repairs of machinery) had been treated as a capital item (added to cost of machinery) and hence not included. It means the actual costs are Rs. 85,000 and not 80,000. So the correct profit is Rs. 15,000. In other words, the profit worked out earlier was overstated. Thus, it can also be stated that if any capital expenditure is wrongly classified as revenue expenditure, it would result in an understatement of profits. Let us also illustrate this. Assume that a purchase of furniture worth Rs. 10,000 was wrongly passed through the

Purchases Book treating it as purchases of goods on credit. This would result in the boosting of costs by Rs. 10,000 leading to an understatement of profits by Rs. 10,000 and also to an understatement of assets. As such the final accounts will not reflect the try and fair view of the affairs of the business. Thus you learn that wrong classification of items would lead to the wrong ascertainment of profit and also the financial position. Hence, it is necessary to determine correctly whether , an item is of a capital or of a revenue nature. This distinction is also important from taxation point of view because capital profits are taxed differently from revenue profits.

CAPITAL AND REVENUE EXPENDITURES Weincur expenditure on various items every day. You buy food items, stationery, cosmetics, utensils, furniture, etc. Some of them are consumables and some are durables. The benefit of expenditure on consumables like stationery, cosmetics, etc. is derived over a short period. But in case of durables like furniture, utensils, etc., the benefit spreads over a number of years. Same thing is true of business also. In business you incur expenditure on two types of items: (i) routine items like stationery, postage, repairs, salaries, etc., where the benefit is available for a short period, and (ii) fixed assets like machinery, building, furniture, etc., whose benefit is available over a number of years. In accounting terminology the first category of expenditure is called revenue expenditure and the second one is called capital expenditure.

Capital Expenditure

As stated above, when the benefit of an expenditure is not exhausted in the year in which it is incurred but is available over a number of years it is considered as capital expenditure. The following expenditures are usually treated as capital expenditures.

1 Any expenditure which results in the acquisition of fixed assets such as land, buildings, plant and machinery, furniture and fixtures, office equipment, copyright, etc. We should note that such capital expenditure includes not only the purchase price of the fixed asset but also various other expenses incurred in connection with their acquisition. So brokerage or commission paid in connection with the acquisition of an asset, freight and cartage paid for transportation of machinery, expenses incurred on its installation, legal fees and registration charges incurred in connection with purchase of land and buildings are also treated as capital expenditure.

2 Any expenditure incurred on a fixed asset which results in (a) its expansion, (b) substantial increase in its life, and (c) improvement in its revenue earning capacity. Improvement in the revenue earning capacity can be in the form of (i) increased production capacity, or (ii) reduced cost of production, or (iii) increased sales r~f the firm. Thus, cost of making additions to buildings and the amount spent on renovation of the old machinery are also regarded as capita1 expenditures. Sometimes, you buy a second hand machinery and incur heavy expenditure on reconditioning it. Such expenditure is also to be capitalised. Similarly, expenditure on stnlctural improvements or alterations to existing fixed assets whereby their revenue earning capacity is increased, is also treated as capital expenditure.

3.Expenditure incurred, during the early years, on development of mines and land for plantations till they become operational.

4 Cost of experiments which ultimately result in the acquisition of a patent. However, the cost of experiments which are not successful is treated as a deferred revenue expenditure which is written off within two to three years.

5 Legal charges incurred in connection with acquiring or defending suits for protecting fixed assets, rights, etc.

6.Legal charges incurred during the regular course of business such as legal expenses incurred on collection from debtors, legal charges incurred on defending a suit for damages. etc.

Deferred Revenue Expenditure

Sometimes, certain expenditure which is normally treated as revenue may be unusually heavy. Its benefit is likely to be available in more than one year. It is considered appropriate to spread the cost of such expenditure over a number of accounting years. Hence, it is capitalised and only a portion of the total amount spent is charged to the Profit and Loss Account for the current year. The balance is shown as an asset which will be written off during the subsequent accounting years. Such expenditure is called a Deferred Revenue Expenditure because the charge to Profit and Loss Account is deferred to future years. Some examples of such expenditure are:

1 Expenditure incurred on advertising campaign to introduce a new product in the market.

Expenditure incurred on formation of a new company (preliminary expenses).

2 Brokerage charges, underwriting commission paid and other expenses incurred in connection with the issue of shares and debentures.

3 Cost of shifting the plant and machinery to a new site which may involve dismantling,

4 removing and re-erection of the plant and machinery. Let us take the case of expenditure on advertising campaign. It is not a routine advertisement and the amount involved is unusually heavy. Its benefit will not completely exhaust in one accounting year but will continue over two-three years. Hence, it is not proper to charge such expenditure to the Profit and Loss Account of one year. It is better-to distribute it carefully over three years. So, in the first year we can charge one-third of the amount spent to the Profit and Loss Account and show the balance in the Balance Sheet as an asset. In the second year again we can charge a similar amount to the Profit and Loss Account and show the balance as an asset. In the third year, we may charge this balance to the Profit and Loss Account. Every expenditure which is regarded as deferred revenue is treated in this way in the final accounts.

CAPITAL AND REVENUE RECEIPTS

Receipts refer to amounts received by a business i.e., cash inflows. Receipts may be classified as Capital Receipts and Revenue Receipts. It is necessary to note this distinction clearly because only the revenue receipts are taken to the Profit and Loss Account and not the capital receipts.

CAPITAL RECEIPTS

Capital receipts are the amounts received in the form of (a) additional capital introduced in the business, (b) loans received, and (c) sale proceeds of fixed assets. You are aware that a loan taken by the business is repayable sooner or later. Similarly, additional capital received represents an increase in the proprietor's claim over the business assets. Thus these two items represent increase in liabilities of the business and obviously are not incomes or , revenues. These are capital receipts and should be treated as such. The sale proceeds of a fixed asset are also treated as a capital receipt because the amount received is not revenue ,,earned in the normal course of business. The capital receipts increase the liabilities or reduce he assets. They do not affect the profit or loss.

REVENUE RECEIPTS

Revenue receipts are the amounts received in the normal and regular course of business. They take the form of (a) sale proceeds of goods, and (b) incomes such as interest earned, commission earned, rent received, etc. These receipts are on account of goods sold or some services rendered by the business and as such they are not repayable. All revenue receipts are treated as incomes and shown on the credit side of the Profit and Loss Account

CAPITAL AND REVENUE PROFITS

Revenue profits are those profits that are earned in the normal and ordinary course of business i.e., through regular sales of goods or by way of income from investments. Capital profits, on the other hand, are those profits which are not earned in the course of regular trading. Such profits arise as a result of (i) selling some fixed assets at a profit or (ii) shares issued at a premium. The revenue profits are credited to Profit and Loss Actount whereas the capital profits are transferred to capital reserve and shown in the Balance Sheet.

CAPITAL AND REVENUE LOSSES

Revenue losses are those losses that arise during the normal course of business. The capital losses are losses which arise on account of ttie sale of some fixed assets or on issue of shares at a discount. Capital losses are not shown in the Profit and Loss Account. They are I generally set off against capital profits. However, if the amount of capital loss is heavy and capital profits are not available for writing it off, the same is spread over a number of years. It will be written off in instalments.

Income and Expenditure Account

The income and expenditure account is prepared by the non-trading entities to determine surplus or deficit of income over expenditures for a particular time frame. The accumulated or accrual concept of accounting is rigidly pursued while preparing income and expenditure a/c of non-trading concerns. It is prepared as a portion of final accounts of non-trading entities and is equal to the profit and loss account outlined by for-profit business entities.

INCOME AND EXPENDITURE ACCOUNT

for the year ended ....

Dr. Cr.

Expenditure	₹	Income	₹
To Consumable Materials	xxx	By Subscriptions	xxx
To Honorarium	xxx	By Grants Received	xxx
To Salary and Wages	xxx	*(for General Purposes)*	
To Repairs	xxx	By Entrance Fees	xxx
To Expenses Paid on Specific Show	xxx	*(To the extent not capitalized)*	
(Any cultural events)	xxx	By General Donations	xxx
To Entertainment Expenses	xxx	By Interest on deposits	xxx
To Printing and Stationery	xxx	By Dividends	xxx
To News Papers and Periodicals	xxx	By Collection for Specific Show	xxx
To Postage	xxx	*(Any Cultural events)*	
To Upkeep of Lawns	xxx	By Profit on Sale of Fixed Assets	xxx
To Rent	xxx	By Locker's Rent	xxx
To Municipal Taxes	xxx	By Cloak Room Rent Received	xxx
To Insurance	xxx	By Hall Rent Received	xxx
To Loss on sale of Fixed Asset	xxx	By Receipts from Sale of	xxx
To Depreciation on Fixed Assets	xxx	Newspapers and Magazines	
To Audit Fees	xxx	By Miscellaneous Incomes	xxx
To Miscellaneous Expenses	xxx	By Deficit*	xxx
To Surplus *	xxx	*(Excess of Expenditure over*	xxx
(Excess of Income over Expenditure)	xxx	*Income)*	
	xxx		xxx

Features of Income and Expenditure Account

Below mentioned are the characteristic features of Income and Expenditure Account :

- Income and expenditure account presented by non-trading entities are much like the profit and loss a/c presented by trading entities.
- It is prepared by stringently following the fundamentals of the double-entry system of bookkeeping or accounting.
- It is always prepared during the end of the period which normally comprises of 1 year.
- It decides the surplus or deficit of income over expends of the non-trading entities for the particular year.
- The surplus or deficit from the income and expenditure account is moved to the capital fund a/c.
- The Income and expenditure account of only revenue nature are incorporated in this account. Any income and expenditure of capital nature are not comprehended.
- It is prepared by accountants chosen by the enterprise's management and is audited by an independent auditor.

- It does not begin with the opening balance, and it follows back the incomes received and expenditures incurred by the non-trading entities during the financial year.
- The accumulated or accrual concept of accounting is rigidly pursued when it is prepared.

Receipt and Payment Account

Receipt and payment account functions as a summary of cash payments and receipts of an organisation during an accounting period. It provides a picture of the cash position of a Not-for-Profit organisation. It does not differentiate between the receipts and payments, whether they are of capital or revenue in nature and records all cash and bank transactions of both capital and revenue nature.

Receipt and payment account does not include any non-cash transactions such as depreciation. The Receipt and payment account is prepared at the end of an accounting period.

Receipt and Payment Account format

Receipt and Payment Account format is presented below:

Receipts and Payments Account
for the period ending on

Dr. *Cr.*

Receipts		*Rs.*	*Payments*		*Rs.*
To Balance b/d :			By Balance b/d (Bank overdraft)		xxx
Cash	xxx		By Annual Sports Expenses		xxx
Bank	xxx	xxx	By Salaries & Wages		xxx
To Subscription :			By Rent, Rates & Taxes		xxx
for previous year	xxx		By Insurance		xxx
for current year	xxx		By Furniture		xxx
for next year	xxx	xxx	By Sports Equipments		xxx
To Entrance Fees		xxx	By Books & Periodicals		xxx
To Donation for Building		xxx	By Audit Fees		xxx
To General Donations		xxx	By Printing & Stationery		xxx
TO Life Membership Fees		xxx	By Honorarium		xxx
To Legacy		xxx	By Bank Charges		xxx
To Grant from Govt.		xxx	By Postage & Telegrams		xxx
To Contribution for		xxx	By Water & Electricity		xxx
Annual Dinner			By Conveyance & Travelling		xxx
To Rent		xxx	By Sundry Expenses		xxx
To Receipt on Annual Sports		xxx	By Annual Dinner Expenses		xxx
To Sale of Old Sports Materials		xxx	By 19% Investments		xxx
To Sale of Old Magazines		xxx	By Balance c/d:		xxx
To Sundry Receipts		xxx	Cash	xxx	
To Balance c/d (Bank overdraft)		xxx	Bank	xxx	xxx
		xxx			xxx

Features of Receipt and Payment Account

Below mentioned are some of the features of Receipt and Payment Account :

1.It does not include any transactions that are not cash or bank items.

2.It shows all cash payments and receipts without making any difference between capital and revenue

3. Receipt and Payment Account starts with the opening balance of cash and bank and ends with ending balance of cash and bank

4. It is prepared on the last day of the accounting period of the business organisation.

5. All cash and cheque receipts are recorded in the debit side while all cash and cheque payments are recorded on the credit side.

Depreciation Concept:

Fixed assets are held on a long term basis and used to generate periodic revenue. That portion of assets, which is believed to have been consumed or expired to earn the revenue, needs to be charged as cost. Such an appropriate proportion of the cost of fixed assets is called Depreciation.

Business enterprises require fixed assets for their business operations such as furniture and fixtures, office equipment's plant and machinery, motor vehicles, land and building etc. In the process of converting **Raw material into finished products, the fixed assets depreciate in value over a period of time, i.e. its useful life**.

Need or objectives of providing Depreciation

1. Ascertaining true profit or loss:

(i) The true profit of an enterprise can be ascertained when all costs incurred for the purpose of earning revenues have been debited to the profit and loss account.

(ii) Fall in the value of assets used in business operations is a part of the cost and should be shown in the profit and loss account of concerned accounting period.

(iii) Keeping this in view, depreciation must be debited to profit & loss account, since loss in value of fixed assets is also an expenses like other expenses.

Presentation of True and Fair value of assets: If depreciation is not pro- vided, the value of assets shown in Balance sheet will not present the true and fair value of assets because assets are shown at the cost price but actual value is less than cost price of the assets.

3. To ascertain the accurate cost of the Production: Depreciation is an item of expense, the correct cost of production cannot be calculated unless it is also taken consideration. Hence, depreciation must be provided to ascertain the corn- recto cost of production.

4. Computation of correct income tax:

(i) Income tax of an enterprise is determined after charging all the costs of production.

(ii) If depreciation is not charged, the profits will be higher and the income tax will also be higher.

(iii) If depreciation is charged, Tax liability is reduced.

2. **Presentation of True and Fair value of assets:** If depreciation is not pro- vided, the value of assets shown in Balance sheet will not present the true and fair value of assets because assets are shown at the cost price but actual value is less than cost price of the assets.

3. **To ascertain the accurate cost of the Production:** Depreciation is an item of expense, the correct cost of production cannot be calculated unless it is also taken consideration. Hence, depreciation must be provided to ascertain the corn- recto cost of production.

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(i) Income tax of an enterprise is determined after charging all the costs of production.

(ii) If depreciation is not charged, the profits will be higher and the income tax will also be higher.

(iii) If depreciation is charged, Tax liability is reduced.

5. **Provision of funds and replacement of assets:** Depreciation is a non-cash expense. So that amount of depreciation charged to profit and loss accounts is retained in business every year. These funds are available for replacement of the assets when its useful life is over.

Methods of providing depreciation

1. Straight line method

(i) This method is also known as ‘original cost method’

(ii) Under this method, depreciation is charged at fixed percentage on the original cost of the asset, throughout its estimated life.

(iii) Under this method of the amount of depreciation is uniform from year to year. That is why this method is also known as (iv)‘Fixed Installment Method’ or Equal installment method’.

(iv) The annual amount of depreciation can be easily calculated by the following formula:

Annual Depreciation = Original Cost – Estimated scrap value/Estimated life in Years

Provisions

· Provision is to be made is respect of a liability, which is certain to be incurred, but its accurate amount is not known.

· It is charged in the Profit and loss Account on estimate basis. It Should be clearly understood that if the amount of a known liability can be determined with reasonable accuracy, it can not a provision.

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

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

Reserves

· Reserves are the amount set aside out of profits. It is an appropriation of profits and not a charge on the profits.

The amount of profit retained is used in the business when difficult time comes. Since reserves are neither expenses nor losses, so these are not charged to profit & loss Account rather these are debited to Profit & Loss Appropriation Account which is prepared after Profit and Loss Account.

· Reserves are also known as 'Plough Back of Profits'.

· Reserves are created to strengthening the financial positions of the business enterprise.

· Examples are General Reserves, Dividend Equalization Reserve etc.

· If the amount of reserve is invested outside the business then, it is called 'Reserve Fund'.

· Creation of reserve does not reduce the not profit but only reduced the divisible profits.

DIFFERENCE BETWEEN PROVISIONS AND RESERVE

Basis		**Provision**	**Reserve**
1.	**Meaning**	It is created to meet a known liability	It is created to strengthen the financial position of business enterprise
2.	**Charge or Appropriation**	Provisions are charge against profits	Reserve is an appropriation of profit.

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

Types of Reserve

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

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

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

1. Not of recurring nature.

2. Not readily available for distribution as dividend among the shareholders.

3. These reserve can be utilized for writing off capital losses.

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

Unit – V

Average Due Date and Account Current : Average Due Date - Account Current – Fire Claims.

Average due date:

In the present scenario in business enterprises, there are numbers of receipts and payments involved related to a single party. These may occur at different points of time. To simplify the calculation of interest involved in such transactions, we use the concept of the average due date. In this concept, a person pays all his dues on a particular date, in a manner so that neither the debtor nor the creditor suffers loss or gain by way of interest. This date is the Average due date (ADD).

Meaning, Calculation Of Average Due Date

The concept of Average due date (ADD) is generally used in the following situations:

- Calculating interest on drawings of partners;
- For settling accounts between principle and agent;
- For settling contra accounts e.g. where parties sell goods to each other;
- Making lump sum payment against various bills drawn on different dates with different due datesAverage due date=Base date±Total of the productsTotal of the amountsAverage due date=Base date±Total of the productsTotal of the amounts

Important Points about ADD

1. Base date/ zero date may be taken as the due date of the first transaction or the due date of the last transaction or any other due date between the first and the last but preferably an earlier due date may be taken.
2. While calculating the number of days always ignore the first day and include the last day.
3. If the due date is in the fraction, round it off.
4. If the amount is paid before the due date, a rebate is given. While, where the amount is paid after the due date, then interest will be charged.
5. Whenever there is a sale of goods by two persons to each other on different dates, the formula for calculating average due date is Average due date=Base date±Total of

the productsTotal of the amountsAverage due date=Base date±Total of the productsTotal of the amounts

6. Due date: Due date means the date on which the amount becomes payable.
7. Maturity date: Always calculate the Maturity date after taking into consideration three days of Grace. Calculation of Due Date when there is a Holiday on maturity day, due date is the next preceding working or business day.

Examples:

- A bill dated 1st April is made payable three months after date. Thus, it falls due on the 3rd of July.
- Due Date=30 June
- Maturity date= 30 June +3 =3 July

Fire claims:

A fire at a business place destroys assets such as building, Machinery, furniture, stock, etc. It destroys records also. Not only does it destroy the assets but also creates dislocation in the usual working of a business concern. Hence, a prudent businessman prefers to take out an insurance policy to cover the risk of loss due to fire. In case of happening of an event, the businessman gets compensation equal to the amount of loss sustained. For this purpose he has to lodge a claim for loss of stock with the Insurance company. It is easy to claim for loss of assets except stock. In case of stock, the insured has to decide the stock on date of fire [SOFD]. It becomes difficult to decide the claim when there is no proper record of inventory is left due to loss of documents due to fire.

Procedure of claim for loss of stock: - If records are not destroyed by fire:- In such a case calculation of claim will be:-

Calculate the amount of stock lost by fire:

SOFD xx (-) Salvage

Stock lost by fire

Calculation for amount of claim:

If there no average clause then stock lost by fire = Amount of claim –

If there is average clause then amount of claim = Policy Amount/SOFD × Stock lost by fire - If records are also destroyed by fire.

Calculate Percentage of Gross Profit:

Determine the Gross Profit to sales. In absence of any information. It is necessary to take the figure of pervious year for deciding the percentage. In case of information about sale and gross profit is available. It is necessary to take average of these figures.

Prepare a Trading Account in the usual manner. Following are some of the items connected with preparation of Trading Account:

(a) Stock: Stock includes stock on Raw materials, Work in progress, Finished goods, etc. In absence of clear information, stock is considered as stock of finished goods only. Valuation of such stock should be at cost. If any other basis is given, convert it to cost.

(b) Purchases less returns.

(c) Wages. (d) Manufacturing expenses.

(e) Sales less returns.

(g) Gross profit.

The rate of Gross profit is important for deciding the stock on the date of fire. Therefore, there should be consistency in the gross profit ratio..