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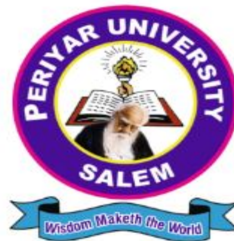

FINANCIAL ACCOUNTING - I

(Candidates admitted from 2024 onwards)

Prepared by:

Dr.M.K.SENTHIL KUMAR
Assistant Professor,
Department of B.Com (CA)
Sri Ramakrishna College of Arts & Science,
Coimbatore – 641006.

FIRST YEAR – SEMESTER – I

CORE–I

FINANCIALACCOUNTING - I

Unit	Contents	No. of Hours
I	**Fundamentals of Financial Accounting** Financial Accounting – Meaning, Definition, Objectives, Basic Accounting Concepts and Conventions - Journal, Ledger Accounts – Subsidiary Books — Trial Balance - Classification of Errors – Rectification of Errors – Preparation of Suspense Account – Bank Reconciliation Statement - Need and Preparation	**15**
II	**Final Accounts** Final Accounts of Sole Trading Concern - Capital and Revenue Expenditure and Receipts – Preparation of Trading, Profit and Loss Account and Balance Sheet with Adjustments.	**15**
III	**Depreciation and Bills of Exchange** Depreciation - Meaning – Objectives – Accounting Treatments - Types - Straight Line Method – Diminishing Balance method – Conversion method. Units of Production Method–Cost Model vs Revaluation **Bills of Exchange** – Definition – Specimens – Discounting of Bills – Endorsement of Bill – Collection – Noting – Renewal – Retirement of Bill under rebate	**15**
IV	**Accounting from Incomplete Records – Single Entry System** Incomplete Records – Meaning and Features – Limitations – Difference between Incomplete Records and Double Entry System -Methods of Calculation of Profit – Statement of Affairs Method –Preparation of final statements by Conversion method.	**15**
V	**Royalty and Insurance Claims** Meaning – Minimum Rent – Short Working – Recoupment of Short Working – Lessor and Lessee – Sublease – Accounting Treatment. **Insurance Claims** – Calculation of Claim Amount – Average clause (Loss of Stock only)	**15**
TOTAL		**75**

THEORY 20% & PROBLEM 80%	
CO	**Course Outcomes**
CO1	Remember the concept of rectification of errors and Bank reconciliation Statements
CO2	Apply the knowledge in preparing detailed accounts of sole trading concerns
CO3	Analyse the various methods of providing depreciation
CO4	Evaluate the methods of calculation of profit
CO5	Determine the royalty accounting treatment and claims from insurance Companies in case of loss of stock.
	Textbooks
1.	S.P.Jainand K.L.Narang FinancialAccounting-I, Kalyani Publishers, New Delhi.
2.	S.N.Maheshwari, FinancialAccounting, Vikas Publications, Noida.
3.	Shukla Grewal and Gupta, Advanced Accounts‖,volume1, S.Chand and Sons, New Delhi.
4.	Radhaswamy and R.L.Gupta: Advanced Accounting, Sultan Chand, New Delhi.
5.	R.L. Guptaand V.K.Gupta, Financial Accounting‖, Sultan Chand, NewDelhi.
	ReferenceBooks
1.	Dr.Arulanandan and Raman: Advanced Accountancy, Himalaya Publications, Mumbai.
2.	Tulsian, Advanced Accounting, Tata McGraw Hills, Noida.
3.	Charumathi and Vinayagam, Financial Accounting, S.Chand and Sons, New Delhi.
4.	Goyal and Tiwari, Financial Accounting, Taxmann Publications, New Delhi.
5.	Robert N Anthony, David Hawkins, Kenneth A. Merchant, Accounting: Text and Cases. McGraw – Hill Education, Noida.
NOTE: Latest Edition of Text books Maybe Used	
	Web Resources
1.	https://www.slideshare.net/mcsharma1/accounting-for-depreciation-1
2.	https://www.slideshare.net/ramusakha/basics-of-financial-accounting
3.	https://www.accountingtools.com/articles/what-is-a-single-entry-system.html

FINANCIAL ACCOUNTING – I

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II	Final Accounts	70-112
III	Depreciation and Bills of Exchange	113-141
IV	Accounting from Incomplete Records – Single Entry System	142-172
V	Royalty and Insurance Claims	173-198

FINANCIAL ACCOUNTING

UNIT OBJECTIVES

After reading the first units, students can understand how accounting are maintaining a complete and systematic record of all transactions and analyzing the financial position of a business. Every individual or a business concern is interested to know the results of financial transactions and their result are ascertained through the accounting process.

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1.3	1.3.1 Bases of Accounting 1.3.2 Accounting Concepts and Convention 1.3.3 Basic Accounting Concepts 1.3.4 Accounting Conventions
1.4	1.4.1 Journal 1.4.2 Ledger 1.4.3 Subsidiary Books 1.4.4 Trial Balance
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1.1.1: FINANCIAL ACCOUNTING - AN INTRODUCTION

A businessman invests capital with the objective of making profit and thereby increasing his resources. He incurs various expenses like salaries, rent and stationery to operate his business. He receives income from different sources like commission, interest and discount. He deals with several persons in the course of buying and selling of goods, purchasing and selling of assets and borrowing money for financing the business. He acquires various properties and assets like building, machinery, furniture to generate revenue. Effective management of business requires control over expenses to reduce the cost of operation and to make the business profitable. Assets must be properly maintained to increase their productivity. Liabilities of a business have to be repaid in due time. Dealings with customers and suppliers must be managed properly to keep them satisfied.

In order to maintain property in good condition. to repay debts in time, to reduce the expenses and to increase sales, the businessman requires complete information about all his business transactions. In practice, it is impossible for any businessman to memorise and recollect all his business dealings. Moreover, he will be interested in knowing at the end of each year (i) What he owns? (ii) What he owes? (iii) How much profit he has earned? (iv) What his financial position is? To relieve businessmen from the burden of memorizing all the business dealings and for providing necessary information, Accounting was developed. Businessmen also require accounting records to submit in courts to prove their claims or to defend in courts against claims made by outsiders. They are required to produce business records to tax authorities whenever demanded. Similarly, financiers requires accounting records of businessmen to decide about sanctioning of loans. Thus, transactions relating to business have come so important that their recording has become a necessity.

1.1.2 : Meaning and Definition of Accounting

Meaning: Financial accounting is a branch of accounting that focuses on the systematic recording, summarizing, and reporting of a business's financial transactions to external entities. It involves preparing financial statements available for public use and ensuring compliance with generally accepted accounting principles (GAAP).

Definition of Accounting : the American Institute of Certified Public Accountants (AICPA) "Accounting is the art of recording, classifying and summarizing in a significant manner and

in terms of money transactions and events which are of a financial character and interpreting the results thereof". This comprehensive definition highlights in a logical sequence the different steps in the accounting process and some important attributes of accounting. The following detailed explanation makes each of them clear.

1.1.3 : Objectives of Accounting

Objectives of Accounting may differ from business to business depending upon their specific requirements. However, the following are the general objectives of accounting.

1. Maintenance of Accounting Records: Accounting records are the basis for the accounting work. The records have to be maintained systematically. While maintaining the concepts have to be followed. In the years, maintenance of books and records is relegated to the lower level employees. Still, required guidance has to be provided to them as and when necessary.

2. Ascertainment of Profit or Loss : Accounting is expected to ascertain and reveal the net results of the operations of a business. Various interested parties like owners, management, investors and creditors should be supplied with the results of operations as per their specific requirements. While finalizing the accounts, objective approach is essential, combined with consistency and conservatism.

3. Depiction of financial position: A true and fair view of the financial position should be presented. The properties and assets possessed by the business should be shown at appropriate values as per the prevailing practices. The stake of creditors and owners in the business should be clearly presented. All the material information must be clearly presented. All the material information must be clearly disclosed.

4. Providing Information: In the recent years, providing information has become the most important objective of accounting. The American Accounting Association (AAA) has listed out the following purposes for which accounting should provide information.

(a) Making decisions concerning the use of limited resources including identification of crucial decision areas and determination of objectives and goals.

(b) Effectively directing the controlling of an organisation's human and material resources.

(c) Maintaining and reporting on the custodianship of resources.

(d) Facilitating social functions and control.

1.1.4 : Booking – Keeping Vs. Accounting

The terms book-keeping and accounting are used interchangeably by laymen. In practice, they are differentin their nature and scope.

Book-keeping is concerned with the recording of business transactions in a systematic manner. This work is mechanical and repetitive in nature. It does not need specialised skill and knowledge. It is usually entrusted to the junior level employees of the accounts department who are known as Book-keepers.

Book-keeping is responsible for recording business transactions of financial nature in the books of original entry. Each transaction is recorded with as many details as possible. The data of the transactions, quantities and prices involved, the accounts to be debited and credited respectively, the ledger folio number are all shown systematically. Each entry is made on the basis of supporting, verifiable documentary evidence.

Book-keeping is also responsible for posting every transaction to the ledger. The debit and credit aspects are posted separately to the respective accounts with the correct amount. In the ledges, the date of the transaction, the journal folio number and the amount are clearly shown whenever a posting is made into an account.

Balancing of all the ledger accounts and subsidiary books at the end of the accounting year, is another major work for book-keeping. Each account in the ledger has to be balanced by totaling both sides of the account and the balance may be debit balance or credit balance depending on which side of the account shows larger total amount. Balances have to be carried forward to the subsequent accounting period.

Extracting, Trial Balance is also a task for book-keeping. The Trial Balance ensures arithmetical accuracy of the accounts maintained. When there is any difference between the debits and credits, verifying the ledger accounts, posting and balancing is essentialto identify mistakes and adjust the trial balance.

Book-keeping prepares the ground for the important steps of finalisation and interpretation which are usually performed by “accounting”

Accounting includes the designing of suitable accounting system, preparation of financial statements cost studies, income tax work etc. It is also responsible for analysing and interpreting the accounting information for internal as well as external end users. Accounting work requires some skill, imagination and experience. The person in charge of this work is called the Accountant.

Accounting has to devise a suitable system of maintaining accounts after studying the requirements and characteristics of the organisation. The various books of accounts have to be organised as per the needs of the system developed Different forms, books, sheets etc.,have to be designed and printed.

When accounts are finalised, accounting is responsible for making various adjustments essential for ascertaining profit or loss for the period, and showing the financial position of the business. Examples are depreciation of fixed assets outstanding and prepaid expenses, accrued incomes, provisions etc. Trading and profit & Loss account is to be prepared in a systematic manner on the basic of generally accepted accounting practices. Similarly, Balance sheet has to be prepared, portiaying true and fair picture of the financial position of the business.

The financial statements are to be analysed and interpreted to extract additional and useful information as per the requirements of the management, owners creditors etc.

In a broad sense, accounting includes book-keeping also. But in practice, book-keeping and accounting differ in their scope and nature of their functions. In small businesses, both the functions may by performed by a single accountant. bigger firms, the accounts department may be divided into book keeping and accounting sections.

Summary:

Financial accounting helps organizations with accurate recordkeeping, which is key to creating financial statements that meet accounting standards and legal guidelines. Organizations following accounting best practices evaluate and optimize their performance more efficiently. As a result, they remain in a better position to weather any financial hardship.

Multiple Choice Questions

1. A systematic way to maintain the books of accounts is called__________

    a. Accountancy b. Economics c. Book Keeping d. Auditing

2. The basic function of accounting is to

    a. Classifying and recording business transactions

    b. Provide the informal basis of action c. Record economic data. d. None of these

3. Accounting provides data or information on

    a. Income and cost for the managers b. Financial conditions of the institutions

    c. Company's tax liability for a particular year d. All the above

4. Accounting is an art of recording, _________ and ______ in terms of money, transactions and events of a financial character and interpreting the result thereof.

    a. Tabulating, Classifying b. Classifying, Summarizing

    c. Highlighting, Formulating d. Formulating, Tabulating

5. GAAP stands for:

    a. Generally Accepted Accounting Provisions

    b. Generally Accepted Accounting Policies

    c. Generally Accepted Accounting Principles

    d. None of these

Answer: 1.C, 2.a, 3.d, 4.b, 5.c

Short Answer questions (5 Marks)

1. Define Accounting
2. State the main objectives of accounting
3. What are the different bases of accounting?
4. What do you understand by "Accounting"?
5. What is GAAP?

Long Answer questions (10 Marks)

1. Explain the Benefits of Accounting standards?
2. State the differences between the book-keeping and accounting.
3. List out the objectives of Accounting.
4. Explain reasons why users need accounting information.
5. What are the different roles of accounting?

1.2.1 : Methods of Accounting

Basically all methods of accounting are classified under two headings:

1. Single entry system
2. Double entry system

Single entry system: The term single entry is vaguely used to define the method of maintaining accounts which do not conform to strict principles of double entry. It is wrong to define it as system. The term 'single entry' does not mean that there is only one entry for each transaction. It simply signifies that principles of double entry bookkeeping have not been observed in all cases. Under this system, only the personal accounts of the debtors and creditors and cash book of the trader are maintained. Impersonal accounts such as sales accounts, purchase accounts etc., as well as the assets accounts are ignored. The absence of the two fold effect of each transaction makes it impossible to prepare a trial balance and to check the arithmetical accuracy of the books of accounts, engendering a spirit of laxity and inviting fraud and misappropriations. Owing to the absence of purchases and sales accounts, the preparation of trading account is not possible. Again Profit & Loss account and Balance Sheet cannot be prepared due to the absence of nominal accounts and real accounts. Hence, Single entry is not only incomplete but the final results are also not reliable.

Practically this system is followed by those firms whose transactions are limited and the time, who maintain only the essential records. There is no hard and fast rule for maintaining records under this system. i.e., it depends on the circumstances and the needs of the firm.

Double entry system: This system was invented by an Italian named Iuco Pacioli in 1494 A. D. and it has spread all over the worldd, becoming as popular as Arabic numerals. According to this system, every transaction has two aspects. One is benefil receiving aspect or incoming aspect and the other one is benefit giving aspect or outgoing aspect. The benefit receiving aspect is said to be a 'debit' and the benefit giving aspect is said to be a 'credit'. For every transaction, one account is to be debited and another account is to be credited in order to have a complete record of the transaction. Therefore, every transaction affects two accounts in opposite direction.

For example, ‘if furniture is purchased for cash’, it is a monetary transaction. Furniture is benefit receiving aspect, it is debited. Cash is benefit giving aspect, itis credited. Therefore, the basic principle, under this system is that for every debit, there must be a corresponding and equal credit and for every credit there must be a corresponding and equal debit.

1.2.2 : Meaning of debit and credit:

The word Debit is derived from the Latin word Debitum which means Due for that. In short, the benefit receiving aspect of a transaction is known as debit.

The word Credit is derived from the Latin word Creder which means Due to that. The benefit giving aspect of a transaction is known as credit.

The abbreviations ‘Dr’ for debit and ‘Cr’ for credit are usually used. By convention, the left hand side of an account is termed as debit side and right hand side of an account is termed as credit side.

Advantages of Double Entry System

(i) Complete record: Double entry system enables businessmen to keep a complete, systematic and accurate record of all business transactions. Details ofo any transactions or events can be verified at any time.

(ii) Ascertainment of profit or loss: The systematic record maintained under double entry system enables a business to ascertain the result of business operations for any given period. The owners can know the profitability of business operations periodically.

(iii) Knowledge of financial position: With the help of Real and Personal accounts, the financial position of the business can be ascertained with accuracy. This is done by preparing balance sheet.

(iv) A check on the accuracy of accounts: Under the double entry system ‘Every debit has a corresponding credit’. The arithmetical accuracy of the books can be tested by preparing a statement called ‘Trial Balance’.

(v) No scope for fraud: The firm is saved from frauds and misappropriations since full information about all assets and liabilities will be available.

(vi)Tax authorities: The businessmen can satisfy the tax authorities if he maintains his accounts books properly under the double entry system.

(vii) Amount due from customers: The account books will reveal the amount due by customers, reminders can be sent to the customers who do not settle their accounts promptly.

(viii) Amount due to suppliers: The trader can ascertain from the books of accounts the sums he owes his creditors and make proper arrangements to pay them promptly.

(ix) Comparative study: Results of one year may be compared with those of previous years and reasons for the change may be ascertained.

1.2.3: Types of Accounts:

The object of book keeping is to keep a complete record of all the transactions that take place in the business. Practically every business.

(i) deals with other persons, firms and companies.

(ii)possesses assets like cash, stock, buildings, furniture etc., and receives incomes such as commission, interest etc. It is necessary to maintain the following to record all the above dealings.

(1) An account of each person, firm, or company with which the business deals. The accounts under this class are known as Personal Accounts e.g., if Mr. X, a cloth dealer, has dealings with four wholesalers and has twenty customers to whom he sells on credit, he must operate an account for each one of them separately.

(2) An account of each type of asset which a business owns. It comes under the class of Real Accounts.

(3) An account for each expense and gain. The accounts under this class are known as Nominal or Fictitious Accounts.

An account is a statement in the ledger which records the transactions relevant to the person, asset, expense or profit named in the heading. Accounts can be divided into:

(a) Personal Accounts

(b)Impersonal Accounts Impersonal accounts can be further divided into real and nominal accounts. Thus, there are three kinds of accounts maintained by a business.

(1)Personal Accounts

(2)Real Accounts

(3)Nominal Accounts

1. Personal Accounts: Accounts of Persons with whom the business has dealings are known as personal accounts. It takes the following forms:

(a) Natural Persons: The name of an individual – customers or suppliers. (e.g.) Sudhir's account, Sharma's account, Anusha's account, Priya's account. Both males and females are included in it.

(b) Artificial persons or legal bodies: Firms' accounts, limited companies' accounts, educational institutions' accounts, bank account, co-operative society account etc., are known as artificial persons' accounts.

(c) Representative personal accounts: All accounts representing outstanding expenses and accrued or prepaid incomes are personal accounts. (e.g.) prepaid insurance, outstanding wages, salary, rent etc. When a person starts a business, he is called proprietor. This proprietor is represented by capital account for all that he invests in business and by drawings account for all that which he withdraws from business. So, capital account and drawings account are also personal accounts.

2. Real Accounts: Accounts in which the business records the real things owned by it. i.e., assets of the business are known as real accounts. Real accounts are of two types i.e., tangible real accounts and intangible real accounts. Building, furniture, cash and machinery etc., are examples of tangible real accounts, because these can be touched and felt and they have a physical shape. There are some intangible real accounts, which cannot be touched because they have no physical shape, such as trademark, good will, patents and copyright etc.

3. Nominal Accounts: It relates to the items which exist in name only. Expenses, incomes etc., are there in business activities. Accounts which record expenses, losses, incomes and gains of the business are known as nominal accounts. e.g., rent A/c, salaries A/c, telephone charge A/c, postage A/c, advertising A/c, commission received A/c, interest received A/c.

1.2.4 : Accounting Rules

The double entry system of book-keeping is a scientific and complete system. Hence, the transactions should be recorded according to the following rules. As we have already discussed, each transaction must have two aspects. The benefit receiving aspect and benefit giving aspect. A transaction should be divided into two aspects.

(1) Debit aspect

(2) Credit aspect

The rules for making entries under double entry system can be summarised as follows:

1. Personal accounts: Debit the receiver
   Credit the giver
2. Real accounts : Debit what comes in
   Credit what goes out
3. Nominal accounts: Debit all expenses and losses
   Credit all incomes and gains.

Summary

Overall, the double-entry system is crucial for maintaining financial integrity, providing reliable financial information for decision-making and ensuring compliance with accounting standards and regulations. Accounting rules play a critical role in ensuring consistency, transparency, and reliability in financial reporting. It provided a structured framework that supports effective financial management and facilitates global business operations.

Multiple Choice Questions

1. The modern system of accounting is based on

   a. Double account system b. Single entry system

   c. Double entry system d. None of these

2. In Double entry system of book-keeping, every business transaction affects:

   a. Two accounts b. Two sides of the same account

   c. The same account on two different dates. d. None of these

3. Which concept states that "for every debit, there is a credit"?

   a. Money Measurement Concept b. Accounting Period Concept

   c. Separate Entity Concept d. Dual Aspect Concept

4. Drawings account is related to
   - a. Personal account
   - b. nominal account
   - c. Real account
   - d. profit and loss account
5. Goodwill account is related to
   - a. Nominal account
   - b. personal account
   - c. Capital account
   - d. real account

Answer: 1.C, 2.A,3. D, 4.A,5.D.

Short Answer questions (5 Marks)

1. What is Methods of accounting?
2. Define a single-entry system of accounting
3. Define Double entry system
4. Give the accounting rules for debit and credit
5. What do you mean by Personal account.

Long Answer questions (10 Marks)

1. Explain the concepts of double entry system.
2. Explain the advantages of double entry system.
3. State the differences between the Single entry and double entry system.
4. Explain the golden roles with examples
5. Discuss “Why double entry system is need compare to single entry system”.

1.3.1 : Bases of Accounting

There are three bases of accounting in common usage. Any one of the following bases may be used to finalise accounts.

(1) Cash basis

(2) Accrual of Mercantile basis

(3) Mixed or Hybrid basis

1. Accounting on ‘Cash basis’ Under cash basis of accounting, all incomes are considered to beearned only when they are actually received in cash. Expenses are considered to be incurred only when they are actually paid. The difference between total income and expenses represents profit. No adjustments are needed for outstanding and prepaid expenses. Similarly, accrued incomes and incomes received in advance are also not adjusted.

Thus, income is recognised only when cash is received. Expense is recognised only when cash is paid.

Government system of accounting is mostly on cash basis. Professionals like doctors. lawyers, brokers also prefer to follow this method, since it is simple to understand and easy to practice.

2. Accrual Basis of Accounting or Mercantile system: It is a system in which accounting entries are made on the basis of amounts having become due for payment or receipt. Incomes are credited to the period in which they are earned, whether cash is received or not. Similarly, expenses and losses are debited to the period in which they are incurred, whether cash is paid or not.

The profit or loss of any accounting period is the difference between incomes earned and expenses incurred, irrespective of cash payment or receipt.

All outstanding expenses and prepaid expenses, accrued incomes and incomes received in advance are adjusted while finalising the accounts.

This method is followed by all the merchants, trade and industry. That is why it is known as Mercantile system.

3. Mixed or Hybrid Basis of Accounting: This is a system of accounting in which some items of income are taken on cash basis while most of the expenses are shown on accrual basis. It is a hybrid system because it combines both 'cash basis' and 'accrual basis'

In practice, the profit or loss shown will not be realistic. Conservative people who prefer recognising income when received, but cautious to provide for all expenses, whether paid or not prefer this system. It is not widely practised due to its inconsistency.

1.3.2 : Accounting Concepts and Convention:

Meaning and Classifications:

The Generally Accepted Accounting Principles (GAAP) are all termed Concepts by some experts. Some others call all of them Conventions. However, an overwhelming majority of authors on accounting distinguish between concepts and conventions.

Accounting concepts, are the assumptions or postulates or ideas which are essentialto the practice of Accounting and preparation of financial statements. The following is agenerally accepted list of basic Accounting Concepts:

(1) The entity concept

(2) The money measurement concept

(3) Going concern concept

(4) Dual aspect concept

(5) Accounting period concept

(6) Cost concept

(7) Revenue Recognition concept or Realisation concept

(8) Matching concept

(9) Accrual concept

(10) Objective evidence concept Accounting conventions are the established traditions, customs, methods and practices which usually act as guidelines for preparation and presentation of accounts. Accounting community has accepted their utility and importance in making the financial statements more realistic, reliable and useful to the end users. The following are the generally accepted accounting conventions:

(1) Convention of full disclosure

(2) Convention of consistency

(3) Convention of materiality

(4) Convention of conservatism

Accounting concepts are subdivided into fundamental concepts and non-fundamental concepts, based on their importance.

1. Fundamental Concepts There are two fundamental concepts – The entity concept and the money measurement concept. The entity concept states that financial accounting information relates to the activities of a business entity only and not to the activities of owners of the business. The money measurement concept limits recognition of activities to those which can be expressed in terms of money. The alteration of either of these concepts will change the entire nature of financial accounts.

2. Non fundamental Concepts These concepts are important for recording and finalising accounts. But any alterations in them do not affect the basic nature of financial accounting.

They include all other concepts except the entity and money measurement concepts. Accounting concepts are also classified on the basis of the aspects of accounting for which they are useful.

(a) Concepts related to income measurement and preparation of financial statements.

(i) Going concern concept

(ii) Accounting period concept

(iii)Matching concept

(b) concepts relating to identification, measurement and recording of financial transactions.

(i) Entity concept

(ii) Dual aspect concept

(iii) Money measurement concept

(iv) Cost concept

(v) Objective evidence concept

(vi) Realisation concept

(vii) Accrual concept

Classification of the accounting concepts reveals their relative importance and their practicaluse in the accounting process.

The various accounting concepts and conventions are explained below in detail.

1.3.3 : BASIC ACCOUNTING CONCEPTS

(1) Business Entity Concept

A business entity is an organisation of persons to accomplish an economic goal. According to the entity concept, the entity that represents the association of persons is considered distinct and separate from the owners, managers and employees of the enterprise. The accounting entity may be the business unit itself (sole proprietorship, partnership firm, joint stock company, co-operative societies or a government enterprise) or a defined part of business (i.e., a department), or an amalgamation of related businesses (i.e., a holding company), depending on the user’s needs. It can be a non-business group like a club, religious body which engages in economic activities.

The entity concept de-limits the area to be covered by accounting records and reports. It determines what is to be recorded and what is to be excluded from the books of accounts. A separate set of books is to be maintained for the accounting entity. The personal transactions of the owners and managers which are not connected to the

business unit are excluded from the books of accounts. All business transactions of financial nature, including transactions with the owners are recorded in the books of the business. For example, if a sole trader withdraws money from the business for personal use, it is recorded as drawings by the owner. If he buys a car with the money withdrawn, it is ignored in the books of the business. All the financial transactions are recorded from the point of view of the entity itself and not from the point of view of the other parties such as customers, suppliers, partners, owners etc. For example, when a firm sells goods to a customer it is recorded as 'sale' by the firm and not as 'purchases' by the customer.

Similarly, when dividend is paid to the shareholders of the company, it is dividend paid by the company and not dividend received by the shareholders.

The entity concept underlines the accounting concept of profit in which a sharp distinction is made between the operating expenses of the business and payment to owners. All payments to owners are recorded as repayment of capital or drawings or loan or distribution of profits. They are not treated as expenses of the business. The owners are entitled for the capital invested by them and also for the profits earned by the business entity.

From legal point of view, a joint stock company is recognised as separate legal entity from the shareholders. Partnership firms and sole trading businesses do nothave legal entity, but they have business entity for accounting purposes.

The business entity concept implies that accounting has to maintain financial records of the business, record incomes and expenses of the business, ascertain profit or loss made by the business entity and show its financial position periodically. The owners of the business entity have to be treated like financiers but eligible for profits and responsible for losses.

(2) Going Concern Concept

According to International Accounting Standard-1 (IAS-1) "The enterprise is normally viewed as a going concern, that is, as continuing in operation for the foreseeable future. It is assumed that the enterprise has neither the intention nor the necessity of liquidation". This concept assumes that a business entity has continuity of life. It will continue for an indefinite period of time. It has no need or intention to close down. This concept is

important for valuation of assets and liabilities. It recognises the value of assets and liabilities of the business enterprise on the basis of their productivity and not on the basis of their current realisable value. Many assets derive their value from employment in the firm. If the firm ceases to operate, their realisable values may be a fraction of their book values or their value to the firm in generation of income. For example, approach roads laid to connect a factory with a highway will be worthless when the factory is closed down. So, realisable values of assets are ignored. They are valued at cost less depreciation for the purpose of balance sheet. Historical cost of the fixed assets is recovered throughout their useful life by way of charging depreciation. This is based on the assumption that the business continues for the foreseeable future. The depreciation is an allocation of future cot and is not based on valuation of asset. Going concern is the basis for several business transactions. Outsiders enter into contracts and dealings with a firm. Financial institutions lend money to a business unit. Creditors supply goods on credit and customers buy goods on credit. All such transactions are based on the treatment of a business units as a going concern. Similarly, prepaid expense and accrued incomes are treated as assets on the presumption of continuation of business.

(3) Money Measurement Concept

All business transactions are measured, expressed and recorded in items of money. ‘Money’ provides a common denominator or unit of measurement by means of which heterogeneous facts about a business can be expressed in items of quantities which can be added or subtracted and summarised. Money, as a common denominator helps to quantify a diverse range of data to enable cetermination of profit or loss and financial position. The ‘Rupee’ is the common unit of measurement for economic events and transactions in India since it is the legal tender used a the medium of exchange.

The money measurement concept excludes all business transactions and events which cannot be measured in terms ofmoney. Thu, quality of the products, value ofkilled labour force, working conditions, production policies, disputes etc., cannot be recorded in accounts in spite of their importance to the business. The concept is invaluable in summarising business operations, assets and liabilities. Buildings in square feet, land in square meter, furniture in numbers, stock of liquids in liters and bank balance in Rupees cannot be added up for balance sheet purpose unless they are all expressed in terms of the common measure of money. Managerial planning and control must also take shape in monetary terms. The main objective of a business unit is to make profit and planning is

directed towards this end. Optimum production and sales policies, investment decisions become meaningful and can be better understood with the usage of monetary denomination.

Accounting records provide evidence of the financial dimensions of the rights and obligations resulting from legal contracts. They have to be kept in the form of legal currency of the country. The accounting records also are used as a basis for providing financial information for shareholder, employees, tax authorities etc. These user of accounts data can comprehend the information which is expressed in monetary terms alone. The money measurement concept ilnposescert a in limitations on a business unit. Important event, specific strengths and weaknesses of a firm which cannot be measured in terms of money are not recorded in accounting. This restricts the availability of data for managerial decision making. All assets and liabilities are recorded whenever they are acquired or contracted at the value assigned to them on that date. Any chages in their market prices or the impact of inflation on their values are not recognised. This renders the value shown unrealistic.

In spite of its limitations, money measurement concept is indispensable because it is the common denominator for recording diverse transactions in the books of accounts.

(4) Dual Aspect Concept Every business transaction recorded in the books of accounts of a business has two aspects – receiving of benefit and giving of benefit. Both the aspect of each transaction must be recorded in appropriate accounts of the business.

For example, when a building i acquired by a firm (receiving of benefit), it has to pay cash (giving of benefit) or create an obligation for payment in future (benefit to be given). Recording of the transaction takes place through debiting the building account and crediting cash account or the personal account of the seller, thus showing both the benefit receiving and giving aspects.

Dual aspect concept is the basis for double entry system of book-keeping which is universally used. the governing principle of double entry system is that 'for every debit there is an equal and corresponding credit'. Dual aspect concept is also the basis for 'accounting equation' developed by American accountants. The equation is Assets= Equities.

'Assets' represents all properties acquired by a business for generating income in the short run (current assets) or long run (fixed assets). 'Equities' represent the claim of different claimants, including the owners, against the assets. The equities are usually subdivided into capital and liabilities to distinguish between the claim of owners from the outsiders. Thus, the equation can be restructured as follows:

Capital + liabilities = Assets or

Capital = Assets – Liabilities.

Capital denotes the funds provided by the owners of the business and liabilities represents the funds provided by the outsiders. In the equation, asset and liabilitiesare the independent variables and capital isthe dependent variable, since it is the difference between assets and liabilities. Every business transaction of financial nature affects the accounting equation through its dual aspect. Increase in an asset may result in increase of liabilities or capital or decrease of some other asset. Decrease in a liability may result in decrease of an asset, increase in capital or another liability. The accounting equation provides an insight into the impact of each transaction on the assets, liabilities and capital. Dual aspect concept is the edifice on which modern accountancy is built and developed.

(5) Accounting period Concept of Periodicity Concept

A business unit may continue for an indefinite period. It is possible to ascertain overall profit or loss of the business when it is liquidated. But practically it is not possible to wait for an indefinite period. The interested parties like owners or shareholders, creditors, tax authorities need periodical reports about the business performance. So, it is necessary to sub-divide the indefinite life span of firm into smaller time units for measurement of performance and understanding the financial position. Such smaller and usable time frame is called an accounting period. The period should not be too short which result in the burden of preparing financial statements frequently. It should not be too long which renders the information useless. The usual accounting period is one year as it help to absorb seasonal fluctuations in business, to assess and pay income tax undertake any remedial measures to rectify poor performance. Now-a-days the length of the accounting period is determined by statute.

Accounting period concept is the basis for segregation of capital expenditure from revenue expenditure. All expenses whose benefit is derived within the accounting period are revenue expenses. All incomes pertaining to the period are revenue incomes. All expenses whose benefit is derived over several accounting periods is capital expenditure.

Accounting period helps to measure the income generated during the specific accounting period which makes it possible to distribute it to the owners. It makes comparison of the results of one accounting period with those of another possible. Leading to comparative performance evaluation. Mercantile system or accrual system of accounting is needed to show all incomes and expense pertaining to the accounting period at the time of finalising the accounts.

(6) Cost Concept Accounting is a historical record of the transactions of a business entity. According to cost concept, asset are recorded at the price paid to acquire them. This cost is the basis for all subsequent accounting for the assets. The assets are gradually depreciated on the basis of cot and the effective life of the asset. The market values of assets are not considered either for valuation or depreciation of such assets. This practice is also supported by the going concern concept. Market values cannot be accurately ascertained. They are also subject to frequent fluctuations. Subjective estimates of the accountants can distort market values. Cost concept provides the reliable objective evidence for recording and depreciating the assets.

Recently the historical cost concept ha been criticised for three reasons. firstly, the historical cost does not reflect true value of the asset. Secondly, aet shown on cost basis do not provide a true and fair view of the financial position of a business unit. Thirdly, the cost concept ignores inflation which erodes the value of money and the true worth of assets. The traditional accounting system has undergone a lot of change over the years. Now it is not exclusively based on historical cost. Different measurement bases like present value of future cash flows of assets', 'current cost', 'replacement cost' are also used according to suitability to depict true and fair view of the financial position of a business unit. Cost concept is still the predominantly used basis for valuation and depreciation of business assets.

(7) Realisation Concept or Revenue Recognition Concept

"Revenue is the gross inflow of cash, receivables or other consideration arising in the course of an enterprise from the sale of goods, services and from holding of assets". According to the realisation concept, revenue is considered as earned on the date when it is realised. The term 'realisation' implies the legal liability to pay by the buyer or user or customer. The revenue should be recognised only when it is legally due and realisable. When goods are sold, the date of placing the order, the date of receiving cash are

irrelevant for recognition of sales income. The date of passing of title to the goods is relevant for income recognition. Income payable. Advance payment of cash by customers for goods should be ignored for the purpose of income recognition. In hire purchase transactions, the down payments and instalments received or due can be taken as income though title to the goods is passed only when last instalment is paid. Till such time, the amounts paid or payable are treated as hire charges.

(8) Matching Concept Primary objective of commercial enterprises is profit making. The accountants are responsible to match the revenues earned during an accounting period with the cost associated with the period to ascertain the profit earned. Matching of revenues and costs relevant to a specific period is called the matching concept. It is the basis for finding reliable profit for a period which can be safely distributed to the owners. All the revenue expense and incomes associated with the accounting period have to be identified. Outstanding and prepaid expenses and income have to be properly adjusted. Depreciation and necessary provisions have to be made.

Matching of the costs with revenue has to be done in two stages. Direct costs are matched with sale revenue to ascertain gross profit. Indirect costs are matched with gross profit and other incomes to ascertain net profit from operations. Non-operating losses like loss on sale of fixed assets. abnormal losses due to theft, fire, etc., capital expenses to be written off like preliminary expense, underwriting commission should also be matched with the operating profit to find disposable net profit. Mercantile system of accounting facilitates matching of costs with revenues in order to ascertain profit or lo of an accounting period. Periodical matching of cost and revenue provides a reliable measure of the progress of an enterprise.

(9) Accrual Concept This concept make a distinction between receipt of cash and the right to receive cash and the legal obligation to pay cash in relation to revenues and expenses respectively. Revenues and cost are accrued i.e., recognized as they are earned or incurred and not as money is received or paid. The accrual concept is the basis ignore the accrual aspect and use paying and receiving of cash as the criteria for recording expenses and incomes. While finalising accounts, all expenses and losses pertaining to the accounting period must be listed out. Any outstanding expense and prepaid expenses must be recorded. Similarly, all incomes associated with the period should be included. Any accrued incomes and incomes received in advance must be appropriately recorded.

The accrual concept ensures that the profit or loss shown is on the basis of full facts relating to all expenses and incomes.

(10) Objective Evidence concept

All accounting entries must be based on objective evidence. 'Objective' refers to verifiability, reliability and absence of bias. No transaction must be recorded in the books of accounts without verifiable documentary evidence. Examples are cash receipts for payment made, bank paying-in counterfoils of bank statements for deposits in bank, invoice copies for purchases etc. The confidence of users of financial statements can be achieved through systematic adherence to this concept.

Objective evidence concept facilitates auditing of accounts and eliminates unauthorised entries in the books of accounts improving their reliability. Management decisions based on such accounts are likely to be more successful. Accounting achieves authenticity. Accuracy and reliability by following the concept of objective evidence.

1.3.4 : Accounting Conventions

(1) Convention of Full Disclosure

According to this convention, all accounting statements should be prepared honestly. This should be evident through the transparency of the statements. The statement should disclose fully all the significant information. Fact, figures and the details which are of material interest to the owners, investors, creditors etc., must be clearly presented in the financial statements. This type of disclosure needs proper classification, summariation, aggregation and explanation of the numerous business transactions.

The convention of disclosure is gaining importance due to the shift in the growth of business organiations. Modern business world is completely separated from the management. The Companies Act 1956, has made several provisions for the disclosure of essential information by companies. Detailed form and schedules are prescribed by the Act. The basis for valuation of investments and inventories has to be specifically stated. Contingent liabilities have to be listed out. The scope for concealment of information by joint stock companies is very limited. The footnote, comments, descriptive captions, supplementary schedules etc, in the accounting reports are an invaluable aid for full disclosure, For example, market value of investments may be given a foot note. Revaluation reserve included in the reserves and surpluses may be indicated through a

separate caption. The full disclosure does not imply providing any information required by anybody or revealing trade secret and strategies. But the legitimate demands for information of the interested parties like shareholders and creditor should be fully satisfied.

(2) Convention of Consistency The basic aim of the doctrine of consistency is to preserve the comparability and reliability of financial statements. According to this convention, the rules, practices and concepts used in accounting should be continuously observed and applied year after year. Comparisons of results among different accounting periods can be significant and meaningful only when consistent practices were followed in ascertaining them. Valuation of stock can be done in different acceptable ways like average price method or cot price method. It can also be on the basis of cost or market price whichever is lesser. Similarly, depreciation can be provided under different methods; investments can be valued in several way. Whichever method or practice is followed, it should be followed regularly. If any change is implemented it must be clearly indicated with reasons for the change.

According to E.L. Kohler, consistency can be at three levels – vertical, horizontal and dimensional.

Vertical consistency refer to consistency in the various aspect of financial statements in the same year in a firm.

Horizontal consistency refer to consistency of practices between different years in a firm. Dimensional consistency refer to consistent accounting practices in the financial statements of different firms in the same industry.

Consistency serves the purpose of eliminating personal bias, whims and fancies of the accountants. They will have to follow consistent rules, practices and methods. The convention of consistency makes the financial statements more reliable and comparable for the needs of the end users.

(3) Convention of Materiality

Materiality means 'relative importance'. All important item and facts should be disclosed in accounting statements. Unimportant and immaterial details need not be separately given. Otherwise, the accountant becomes over burdened with unnecessary

detail. For example, a plastic container for drinking water can be clubbed with general expenses instead of separately being disclosed as an asset.

According to the American Accounting Association (AAA)"An item should be regarded as material if there is reason to believe that knowledge of it would influence the decision of informed investor". The test of materiality can be applied to three aspects. (i) information (ii) amounts (iii) procedures.

(i) Loans to directors and employees can be material information and should be separately disclosed, as per Banking Companies Regulation Act.

(ii) Adjusting amounts to the nearest Rupee is based on materiality of amounts.

(iii) Disclosing procedural changes in valuation of inventories is based on materiality of procedures.

The term 'Material' is subjective, amenable for interpretation of individual accountants. Similarly, what is material in one firm may be immaterial for another firm. What is material in one accounting year may not be o in the subsequent years. In spite of thee limitations, maximum possible material details should be provided in the financial statements.

(4) Convention of conservatism Conservatism is a policy of caution or 'playing safe'. It demands taking a 'gloomy' view of situation. Conservatism is the defensive accounting mechanism against 'uncertainty'. According to Kohler, "Conservatism is a guideline which choose between acceptable accounting alternatives for recording event and transactions so that the least favourable immediate effect on assets, income and owner's equity is reported".

Uncertainty is unavoidable in the estimation of useful life of assets, contingent liabilities, realisation of receivables etc. The convention of conservatim demands that the least favourable situation to the firm will materialise and precautions should be taken on that basis.

When stock are valued, the usual principle followed is 'cost or market price whichever is lower'. if market price is more than cost, tock is shown at cot only. All provisions like provision for doubtful debts, provision for discount on debtors. Provision for contingencies are based on he convention of conservatism. Conservatism may result in understatement of assets income and overstatement of provisions and liabilities. This may result in secret reserves. Over emphasis on conservatism, within limits, serves a useful

purpose. It should not be taken to extreme where it can distort the operating results and financial position of a business unit.

Multiple Choice Questions

1. Which accounting principle states that companies and owners should be treated as separate entities.

   a. Monetary Unit Assumption b. Business Entity Concept

   c. Periodicity Assumption d. Going Concern Concept

2. Due to which concept, accounting does not record non-financial transactions?

   a. Going concern concept b. Money measurement concept

   c. Accrual concept d. Cost concept

3. The correct form of Accounting equation is

   a. Assets – Receivable = Equity b. Assets + Receivable = Equity

   c. Assets – Liabilities = Equity d. Assets + Liabilities = Equity

4. The concept of conservatism result in

   a. Understatement of assets b. Understatement of liabilities

   c. Overstatement of capital d. overstatement of assets

5. The Accounting Equation is connected with

   a. Assets, Liabilities and Capital b. Assets only

   c. Liabilities only d. capital only

Answer: 1.b, 2.b,3. c, 4.b,5.a.

Short Answer questions (5 Marks)

1. Define the concept of Accounting on ‘Cash basis’
2. What is mean by Accounting Concepts and Convention?
3. What are accounting concepts and why are they important?
4. Define the Business Entity Concept and Going Concern Concept
5. What do you understand by accounting period concept?

Long Answer questions (10 Marks)

1. Explain the accounting concepts.
2. Explain some of prominent “accounting conventions”.
3. Discuss in details about the basic accounting concepts.
4. Why is the concept of consistency important in financial reporting?
5. How does the concept of conservatism impact the valuation of assets and liabilities?

1.4.1 : JOURNAL

The French word 'Jour' means 'day'. Journal, therefore means a daily record of business transactions.

Journal is a book of 'primary entry' or original entry'. All transaction are initially recorded in the Journal. The ruling of the journal is such that any business transaction can be analysed under the heads of debit and credit. A thorough understanding of the principle of debit and credit which are the basis for Journal is essential for every student of accountancy to get a thorough grasp of the subject.

Journal

Date	Particulars	L.F	Debit Amount (Rs.)	Credit Amount (Rs.)

Transactions are recorded in the Journal in chronological order, according to dates. 'Particular column' specifies the account to be debited and credited. 'L.F' represents 'Ledger Folio' which means the page number in Ledger into which the journal entry is posted. Debit amount and credit amount represent the amount to be debited and credited to the respective account mentioned in the entry. Every journal entry is accompanied by a 'narration' which explains the detail of transaction for which the entry is written.

Transaction Analysis for Journal entries

Any business transaction should be analysed through the following three step to write correct journal entry.

1. The accounts affected by the transaction have to be identified.
2. The identified account should be classified as to personal or real or nominal.
3. The accounts to be debited and credited should be decided on the basis of 'Rules' governing debiting and crediting.

1.4.2 : LEDGER

'Ledger' is the second important stage in the accounting cycle or process. In this stage of accounting cycle, all recorded business transaction or entries are grouped on a predetermined basis. Such classification or grouping takes the form of 'Accounts' in a

separate book known as ‘Ledger’. The ‘accounts’ in the ledger provide identifiable ‘grouping’ to the numerous business transactions.

‘Ledger’ is the main book of accounts in a business. Subsidiary books, though books of original entry, are of secondary importance only. ‘Ledger and the accounts it contains’ are the core of accounting process.

The ledger contains various accounts – account relating to persons, properties and asset, expenses and incomes. A ledger account may be described 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 how their net effect”.

In subsidiary books, there is no scope to ‘summarise’ Goods sold to a customer on credit are entered in sale book; cash received from him is recorded in cash book; goods returned by him are shown in sale returns book, etc. They are all grouped in one place in the ledger in his personal account. “Each ledger account provides the complete picture of the dealings in relation to a particular person or property or expense or income”.

Account

An account is usually in the ‘T’ format and contains two sides – the left hand side called ‘debit’ and the right hand side called ‘credit side’. The heading mentions the name of the account. On both side of the account, date column is maintained.

When an entry is written on the left hand side of an account, it is called ‘Debiting’. When an entry is made on the right hand side of an account. It is known a ‘Crediting’.
All the accounts must be ‘debited’ and credited for relevant transactions as per the rules for debiting and crediting.

Posting of Journal to Ledger

‘Ledger being the second stage in the accounting cycle, it is dependent or ‘journal accounts. Thus, one can claim, ‘ledger’ is the ground floor of a building standing on the ‘foundation’ of journal.

When journal is in the form of entries, each entry specifies the account to be debited and the account to be credited. A per the 'instruction' in the journal entry, one account is to be 'debited' i.e., on the left hand side of the account entry is to be made; and another account is to be 'credited' i.e., on the right hand side of the account entry is to be made. For example,

Journal entry

Date	Particulars	Debit Rs.	Credit Rs.
1.8.99	Raman' A/c Dr	5,000	
	To Sale A/c		5,000
	[Being credit sales made]		

Raman's Account

Date	Particulars	Rs.	Date	Particulars	Rs.
1.8.99	To Sales A/c	5,000			

Sales Account

Date	Particulars	Rs.	Date	Particulars	Rs.
			1.8.99	By Raman' A/c	5,000

In the subsidiary book system, one positing to the ledger is made on the day the transaction is entered in subsidiary book like purchases book, sales book, return books, cash book, B.R. book and B.P book. However, at the end of the month, the purchases book, sales book, etc., are totalled and the total is posted to the respective accounts in the ledger. Thus, one posting is avoided for each individual transaction resulting in saving of time and effort.

Throughout the accounting year, posting of journal of subsidiary books into ledger take place in a systematic manner. By the end of the accounting year, ledger reflects the sum result of all the business transactions of the firm.

1.4.3 : SUBSIDIARY BOOKS

Maintaining a single 'journal book' in which journal entries are written for each transaction and posting them to ledger is practicable in small businesses

where a single accountant can maintain accounts or the owner himself can do the accounts work. In bigger businesses, transactions are o numerous and varied that a single journal book is absolutely inadequate and cumbersome. Several account assistants may have to do accounts work as a team and share the burden. It may be necessary to group similar transactions even at journal stage in the shape of **'special journals'** to minimise and facilitate ledger work. Thus, the system of **Subsidiary Books** as an alternative for ingle journal was developed.
Subsidiary book comprise of the following:

1. Purchases book to record credit purchase of goods
2. Sale book to record credit sales of goods;
3. Purchase returns book to record return from customers
4. Sales returns book to record returns from cutomers.
5. Cash book to record all cash receipts and payments.
6. Bills receivable book to record bills received.
7. Bills payable book to record bills received.

General journal or journal proper to record any other transactions which cannot be entered in the above specialised subsidiary books.

Benefits of Subsidiary Book system

Subsidiary books result in the following benefits:

Reduction in work: Overall work reduce in this system compared to a single journal because one posting alone is made on the date of the transactions. Consolidated monthly posting is made for the second aspect.

Permits group work: Single can be written by one person alone. Work on subsidiary book can be carried on by many accountants.

Accuracy: Accounts will be more accurate because of specialised work and monthly summarised postings.

Better information: A lot of useful data like total credit sale, credit purchase, returns, etc., is made available which is not possible in journal system.

Cash book: Cash book itself takes the place of journal as well as ledger account. Thus, separate cash account is not needed. In case of three column cash book, even bank A/c is not needed in the ledger.

Basic documents for Subsidiary Books

Inward invoice: This is the document sent by the suppliers of goods giving detail of goods sent, price, value, discount etc. It is basis for entries in purchases book.

Outward Invoice: This is a document sent by the firm to the customers, showing the details of goods supplied, their price and value, discounts, etc. It is the basis for writing sales book.

Debit note: When good purchased from supplier are returned, a debit note is sent to them showing the goods returned and their value. It is the basis for purchase return book.

Credit Note: When customers return goods, a credit note is prepared by the firm and sent to them mentioning the amount credited to them based on the goods received as returns. This note is the basis to write sales returns book.

Cash Receipt and Vouchers: These are the vouchers and receipt for cash received and paid. Entries in cash book are made on the strength of the vouchers and receipts. They are also useful for auditing purpose.

ILLUSTRATIONS

Journal Illustration 1

Journalise the following transactions:

1. Purchased goods for cash Rs.10,000
2. Purchased stationery for cash Rs.500
3. Purchased furniture for cash Rs.3,000
4. Sold goods for cash Rs.8,000
5. Sold goods to Jane for cash Rs.3,000
6. Sold goods to James Rs.2,000
7. Paid Rent to Krishnan, the landlord Rs.800
8. Paid salary of Rs.8,000
9. Paid Lokesh, the manage his salary of Rs.3,000
10. Paid freight on goods purchased Rs.300
11. Paid freight on machine purchased Rs.400
12. Paid wages Rs.500
13. Paid wages to erect a machine Rs.1,000
14. Received Rs.800 from Kamal
15. Received Rs.600 from Kamal as interest
16. Received Rs.7,000 from Kamal as loan at 5% interest

Solution:

Journal Entries

Date	Particulars	L.F	Debit Rs.	Credit Rs.
1.	Purchases A/c Dr To Cash A/c [Being cash purchase of goods]		10,000	 10,000
2.	Stationary A/c Dr To Cash A/c		500	 500

	[Being purchase of stationary]			
3.	Furniture A/c Dr To Cash A/c [Being cash purchase c Furniture]		3,000	 3,000
4.	Cash A/c To Sales A/c Dr [Being cash sales made]		8,000	 8,000
5.	Cash A/c Dr To Sales A/c [Being cash sales to Jane]		3,000	 3,000
6.	James A/c Dr To Cash A/c [Being good sod on credit]		2,000	 2,000
7.	Rent A/c Dr To Cash A/c [Being rend paid to Krishnan, the landlord]		800	 800
8.	Salary A/c Dr To Cash A/c [Being freight paid for goods]		8,000	 8,000
9.	Salary A/c Dr To Cash A/c [Being Manager's salary paid in cash]		3,000	 3,000
10.	Freight A/c Dr To Cash A/c [Being freight paid for goods]		300	 300
11.	Machinery A/c Dr To Cash A/c [Being payment of Freight on machinery]		400	 400
12.	Wages A/c Dr To Cash A/c		500	 500

	[Being payment of wages]			
13.	Machinery A/c Dr To Cash A/c [Being wages paid to erect machine]		1,000	1,000
14.	Cash A/c To Kamal's A/c [Being amount received from Kamal on account]		800	800
15.	Cash A/c Dr To Interest A/c [Being interest received from Kamal]		600	600
16.	Cash A/c Dr To 5% Loan A/c [Being loan from Kamal for interest]		7,000	7,000

Illustration 2

Journalise the following transaction of M/s. Radha & Sons.

M/s. Radha & Sons

2000		**Rs.**
Jan 1	Business started with Rs.2,50,000 and cash deposited with Bank	1,50,00
3	Purchased machinery on credit from Rangan	50,000
6	Bought furniture from Ramesh for cash	25,000
12	Goods sold to Yeodha	22,500
13	Goods Returned by Yeodha	2,500
15	Goods sold for cash	50,000
17	Bought goods for cash	25,000,

20	Cash received from Yeodha	10,000
21	Cash paid to Ramola	20,000
25	Cash withdrawn from bank	50,000
29	Paid advertisement expenses	12,500
30	Bought office stationery for cash	5,000
31	Cash withdrawn from bank for personal use of the proprietor	6,250
31	Paid salaries	15,000
31	Paid rent	2,500

Books of M/s. Radha & Sons, Journal

Date	Particulars	L.F	Debit Rs.	Credit Rs.
2000 Jan 1	Cash A/c Dr To Capital A/c [Being cash brought in as capital]		2,50,000	2,50,000
1	Bank A/c Dr To Cash A/c [Being cash deposited into bank]		1,50,000	1,50,000
3	Machinery A/c Dr To Rangan's A/c [Being machinery bought on credit from Rangan]		50,000	50,000
6	Furniture A/c Dr To Cash A/c [Being furniture purchased for cash from Ramesh]		25,000	25,000
12	Yeodha's A/c Dr To Sales A/c [Being goods sold to Yesodha on credit]		22,500	22,500
13	Sale A/c Dr To Yesodha's A/c [Being goods returned by Yesodha]		2,500	2,500

15	Cash A/c Dr To Sales A/c [Being goods sold for cash]		50,000	 50,000
17	Purchase A/c Dr To Cash A/c [Being goods purchased for cash]		25,000	 25,000
20	Cash A/c Dr To Yeodha's A/c [Being cash received from Yesodha]		10,000	 10,000
21	Ramola A/c To Cash A/c Dr [Being cash paid to Ramola]		20,000	 20,000
25	Cash A/c Dr To Bank A/c [Being cash withdrawn from bank]		50,000	 50,000
29	Advertisement Expenses A/c Dr To Cash A/c [Being advertisement expenses paid]		12,500	 12,500
30	Office stationary A/c To CashDr A/c [Being stationery purchased for cash]		5,000	 5,000
31	Drawings A/c Dr To Bank A/c [Being cash withdrawn from bank for personal use]		6,250	 6,250
31	Salaries A/c Rent A/c Dr To Cash A/c [Being salaries and rend paid]		15,000 2,500	 17,500

LEDGER

Illustration 3

Record the following transactions in the personal account of Kapil:

2000		Rs
Apr. 1	Sold good to Kapil	6,000
5	Cash received from Kapil	5,800
	and allowed him discount	200
18	Kapil purchased goods	8,000
30	Received Cash form Kapil on account	4,500
May1	Balance from last month b/d	3,500
12	Sold good to kapil	12,000
22	Received Cash from kapil	4,850
	and allowed him discount	150
31	Received Cash in full settlement of	
	Kapil's A/c	10,250

Solution:

Kapil's A/c

Date	Particulars	Rs.	Date	Particulars	Rs.
2000			2000		
Apr.1	To Sales	6,000	Apr.5	By Cash	5,800
18	To Sales	8,000		By Discount allowed	200
			30	By Cash	4,500
			30	By Balance C/d	3,500
			14,000		14,000
May 1	To Balance b/d	3,500	May 22	By Cash	4,850
12	To Sales	12,000		By Discount allowed	150
			31	By Cash	10,250
				By Discount allowed (Bal.fig.)	250
			15,500		15,500

Illustration 4

Enter the following transaction in the Journal & ledger of Hari prasad of Hyderabad

2000		Rs.
Jan 1	Commenced business with cash	1,80,000
3	Deposited into Bank	55,000
4	Purchases goods for cash	22,000
5	Bought good of Swaminathan	72,000
8	Cash Sales	16,200
11	Cash deposited into Bank	23,000
14	Purchased furniture for cash	4,000
16	Sold goods to Vivek	12,700
17	Received cash from Vivek	12,446
	Allowed him discount	254
18	Paid Swaminathan Cash	12,000
	Discount allowed by him	240
20	Paid Wage	1,800
21	Sold good to jagadeesan	35,000
22	Paid cash for trade expenses	150
24	Sold good to Rajan	23,280
25	Received from Jagadeesan	21,000
	Allowed him discount	525
26	Paid Swaminathan cash on account	24,000
28	Sold goods for cash	9,000
29	Paid cash for stationery	180
30	Paid cash for miscellaneous expenses	150
31	Bought good from Sridhar	17,870
31	Withdrew Cash for private expenses	1,480

BOOKS HARI PRAAD OF HYDERABAD

JOURNAL ENTRIES

Date	Particulars	L.F	Debit Rs.	Credit Rs.
2000				
July 1	Cash A/c Dr		1,80,000	
	To Capital A/c			1,80,000
	[Being Cash brought in a capital]			
3	Bank A/c Dr		55,000	
	To Cash A/c			55,000
	[Being the amount deposited into Bank]			
4	Purchase A/cDr		22,000	
	To Cash A/c			22,000
	[Being goods bought for cash]			
5	Purchases A/c Dr		72,000	
	To Swaminathan A/c			72,000
	[Being good bought on credit]			
8	Cash A/c Dr		16,200	
	To Sales A/c			16,200
	[Being goods sold for cash]			
11	Bank A/c Dr		23,000	
	To Cash A/c			23,000
	[Being the amount deposited into Bank]			
14	Furniture A/c Dr		4,000	
	To Cash A/c			4,000
	[Being furniture bought for cash]			
16	Vivek A/c Dr		12,700	
	To Sales A/c			12,700
	[Being good sold on credit]			

17	Cash A/c Dr	12,446	
	Discount allowed A/c Dr.	254	
	To Vivek A/c		12,700
	[Being amount received from Vivek and discount allowed to him]		
18	Swaminathan A/c Dr	12,240	
	To Cash A/c		12,000
	To Discount received A/c		240
20	Wage A/c Dr	1,800	
	To Cash A/c		1,800
	[Being Cash paid for wages]		
21	Jagadeesan A/c Dr	3,500	
	To sales A/c		3,500
	[Being goods sold on credit]		
22	Trade expenses A/c Dr	150	
	To Cash A/c		150
	[Being Cash paid for trade expenses]		
24	Ranjan A/c Dr	23,280	
	To Sales A/c		23,280
	[Being goods old on credit]		
25	Cash A/c Dr	21,000	
	Discount allowed A/c Dr	525	
	To Jagadeesan A/c		21,525
	[Being Part payment received from Jagadeesan & discount allowed to him]		
26	Swaminathan A/c Dr	24,000	
	To Cash A/c		24,000
	[Being Part payment made to Swaminathan]		

Date	Particulars	L.F.	Debit	Credit
28	Cash A/c Dr		9,000	
	To Sales A/c			9,000
	[Being Cash paid for Stationery]			
29	Stationary A/c Dr		180	
	To Cash A/c			180
	[Being cash paid for stationery]			
30	Miscellaneous expenses A/c Dr		150	
	To Cash A/c			150
	[Being cash paid for Miscellaneous]			
31	Purchases A/c Dr		17,870	
	To Sridhar A/c			17,870
	[Being goods bought on credit]			
	Drawing A/c Dr		1,480	
	To Cash A/c			1,480
	[Being cash withdrawn for private expenses]			

LEDGER

Cash A/c

		Rs.			Rs.
1.7.2000	To Capital A/c	1,80,000	3.7.2000	By Bank A/c	55,000
6.7.2000	To Sales A/c	16,200	4.7.2000	By Purchase A/c	22,000
17.7.2000	To Vivek A/c	12,446	11.7.2000	By Bank A/c	23,000
25.7.2000	To Jagadesan A/c	21,000	14.7.2000	By Furniture A/c	4,000
28.7.2000	To Sales A/c	9,000	18.7.2000	By Swaminathan A/c	12,000
			20.7.2000	By Wages A/c	1,800
			22.7.2000	By Trade expenses A/c	150
			26.7.2000	By Swaminatham	24,000
			29.7.2000	By Stationery A/c	180
			30.7.2000	By Misellancou	150
			31.7.2000	By Drawings A/c	1,480
			31.7.2000	By Balance C/d	94,886
			2,38,646		2,38,646
1.8.2000	To Balance b/d	94,886			

Capital A/c

		Rs.			Rs.
31.7.2000	To Balance C/d	1,80,000	1.7.2000	By Cash A/c	1,80,000
		1,80,000			1,80,000
			1.8.2000	By Balance b/d	1,80,000

Bank A/c

		Rs.			Rs.
3.7.2000	To Cash A/c	55,000			
11.7.2000	To Cash A/c	23.000	31.7.2000	By Balance C/d	78,000
		78,000			78,000
1.8.2000	To Balance b/d	78,000			

Purchase A/c

		Rs.			Rs.
4.7.2000	To Cash A/c	22,000			
5.7.2000	To Swaminathan A/c	72,000			
31.7.2000	To Sridhar A/c	17,870	31.7.2000	By Balance c/d	1,11,870
		1,11,870			1,11,870
1.8.2000	To Balance b/d	1,11,870			

Swaminathan A/c

		Rs.			Rs.
18.7.2000	To Cash A/c	12,000	5.7.2000	By Purchases A/c	72,000
18.7.2000	To Discount received A/c	240			
26.7.2000	To Cash A/c	24,000			
31.7.2000	To Balance C/d	35,760			
		72,000	1.8.2000	By Balance b/d	35,700

Sales A/c

		Rs.			Rs.
			6.7.2000	By Cash A/c	16,200
			16.7.2000	By Vivek A/c	12,700
			21.7.2000	By Jagadeesan A/c	35,000
				By Ranjan A/c	23,280
			24.7.2000	By Cash A/c	9,000
31.7.2000	ToBalance C/d	96,180	28.7.2000		
		96,180			96,180
			1.8.2000	By Balance b/d	96,180

Furniture A/c

		Rs.			Rs.
14.7.2000	To Cash A/c	4,000	31.4.2000	By Balance c/d	4,000
		4,000			4,000
1.8.2000	To Bal. b/d	4,000			

Vivek A/c

		Rs.			Rs.
16.7.2000	To Sale A/c	12,700	17.7.2000	By Cash A/c	2,446
				By Discount allowed	254
		12,700			12,700

Discount Allowed A/c

		Rs.			Rs.
17.7.2000	To Vivek A/c	254			
25.7.2000	To Jagadeesan	525	31.7.2000	By Balance c/d	779
		779			779
1.8.2000	To Balance b/d	779			

Discount Received A/c

		Rs.			Rs.
31.7.2000	To Balance C/d	240	18.7.2000	By Swaminathan A/c	240
		240	1.8.2000	By Balance b/d	240

Wages A/c

		Rs.			Rs.
20.7.2000	To Cash A/c	1,800	31.7.2000	By Balance C/d	1,800
		1,800			1,800
1.8.2000	To Balance b/d	1,800			

Jagadeesan A/c

		Rs.			Rs.
21.7.2000	To Sales A/c	35,000	25.7.2000	By Cash A/c	21,000
			25.7.2000	By Discount allowed A/c	525
			31.7.2000	By Balance C/d	13,475
		35,000			35,000
1.8.2000	To Balance b/d	13,475			

Traded Expenses A/c

		Rs.			Rs.
22.7.2000	To Cash A/c	150	31.7.2000	By Balance C/d	150
		150			150
1.8.2000	To Balance b/d	150			

Ranjan A/c

		Rs.			Rs.
24.7.2000	To Sales A/c	23,280	31.7.2000	By Balance C/d	23,280
		23,280			23,280
1.8.2000	To Balance b/d	23,280			

Stationery A/c

		Rs.			Rs.
29.7.2000	To Cash A/c	180	31.7.2000	By Balance C/d	180
		180			180
1.8.2000	To Balance b/d	180			

Miscellaneous Expenses

		Rs.			Rs.
30.7.2000	To Cash A/c	150	31.7.2000	By Balance C/d	150
		150			150
1.8.2000	To Balance b/d	150			

Sridhar A/c

		Rs.			Rs.
31.7.2000	To Balance c/d	17,870	31.7.2000	By Purchases A/c	17,870
		17,870			17,870
			1.8.2000	By Balance b/d	

Drawings A/c

		Rs.			Rs.
31.7.2000	To Cash A/c	1,480	31.7.2000	By Balance C/d	1,480
		1,480			1,480
1.8.2000	To Balance b/d	1,480			

SUBSIDIARY BOOKS

Illustration 5

Record the following transaction for the month of January 1999 in the purchases book of M/s. Narain electronics:

Jan. 4 Purchased from M/s Brown Electronics:

20 Balck & White T.Vs @ Rs. 5,200 per piece. 10 Colour T.Vs @ Rs.12,000 per piece.

Jan 10 Purchased from M/s Mani Electronics: 12 Veideo tapes @ Rs.600 per piece.

8 Philips tape recorders @ R. 2,500 per piece.

Jan 19 Purchased from M/s Sehgal electonics: 10LG Stereos @ Rs.3,500 per piece

8 LG Colour T.Vs @ Rs.25,000 per piece. Trade discount @ 15%

Jan 24 Purchased from M/s Gupta Electronics: 200 Audio Casettes @ Rs.25 Per piece 30 Equity toassters @ Rs.500 per piece.

Also show posting of the above transactions into ledger accounts from purchase book.

Books of M/s. NARAIN

ELECTRONICS PURCHAESES BOOK

Date	Name of the Supplier	L.F	Inward Invoice No	Details Rs.	Amount Rs.
4.1.99	M/s Brown Electronics: 20B/W T.Vs @ Rs.5,200 per piece. 10 Colour T.Vs at Rs.12,000 per piece. Less: Trade discount @ 12%		1,20,000	1,04,000 2,24,000 26,880	1,97,120
10.1.99	M/s Mani Electronics: 12 video tapes @ Rs. 600 per piece. 8 Philip tape Recorders @ Rs. 2,500 per piece.			7,200 20,000	27,200
19.1.99	M/s Sehgal Electronics: 10 LG Stereos @ Rs. 3,500 per piece. 8 LG Colour T.Vs @ 25,000 per piece.			35,000 2,00,000	

				2,35,000	
	Les: Trade discount @ 15%			35,250	1,99,750
24.1.99	M/s Gupta Electronics:				
	200 Audio Cassettes @ Rs.25 per piece			5,000	
	30 Equity toasters @ Rs. 500 per piece.			15,000	20,000
	Total				**4,44,070**

Note: Total of purchases book is posted to the debit of Purchases Account in the ledger at the end of every month. But posting to personal A/c are made on the same day of a transaction.

LEDGER ACCOUNTS

Purchases A/c

31.1.99	To Sundries (as per purchases book)	4,44,070			

M/s. Brown Electronics A/c

			4.1.99	By Purchases A/c	1,97,120

M/s. Mani Electronics A/c

			10.1.99	By Purchases A/c	27,200

M/s Sehgal Electronics A/c

			19.1.99	By Purchases A/c	1,99,750

M/s. Gupta Electronics A/c

			24.1.99	By Purchase A/c	20,000

Illustration 6

Enter the following transactions in the Sales Book of M/. Saran Raj & Sons and post them into ledger:

1999

May 2 Sold to M/s Ragul Bros:

200 Pieces long cloth at Rs.90 per piece 300 pieces shirting @ Rs.110 per piece

May 5 Sold to M/s Gupta & Verma:

20 Pieces Coating @ Rs.250 per piece May 16 Sold to M/s Mathur & Jain:

250 blankets @ Rs.50 each 120 blankets @ Rs.75 each

May 20 Sold 20 Shirt to cheap stores @ Rs.30 each for cash.

May 25 Sold old furniture to M/s. Santhosh & Co. on credit Rs.800.

It is the practice followed by M/s Saran Raj & Sons to allow 10% trade discount on all sales.

Books of M/s. SARAN RAJ & SONSALES BOOK

ate	Name of the Supplier	L.F	Inward Invoice No.	Details Rs.	Amount Rs.
2.5.99	M/s Ragul Bros:				
	200 Piece long cloth @ Rs.90			18,000	
	300 Pieces shirting @ Rs.110			33,000	
	Less: Trade discount @ 10%			51,100	45,900
	M/s Gupta & Verma:			5,100	
5.5.99	20 pieces coating @ Rs.250			5000	4,500
	Less: Trade discount @ 10%			500	
16.5.	M/s Mathur & Jain:			12,500	
	250 blankets @ Rs.50			9,000	
	120 blankets @ Rs.75				
				21,500	
	Less: Trade discount				
	@ 10%			2,150	19,350
	Total				69,750

Note: (1)

Cash sale and sale of furniture are not entered in sale book. Only credit sales of goods are recorded in Sales Book.

LEDGER ACCOUNTS

Sales A/c

			31.5.99	By Sundries (as per Sales Book)	Rs. 69,750

M/s Ragul & Sons A/c

2.5.99	To Sales A/c	Rs. 45,900			

M/s Mathur & Jain A/c

16.5.99	To Sales A/c	Rs. 19,350			

1.4.4: TRIAL BALANCE

Meaning

All business transactions are initially recorded in Journal or Subsidiary books. Then they are transferred to ledger by posting to relevant accounts. After balancing the ledger accounts of a business enterprise, a statement is prepared to show separately the debit and credit balances. Such a statement is known as 'Trial balance'. It is not an account. It is not an account. It is not an account. It is a statement in which debit and credit balance of all the accounts in the ledger are shown to test the arithmetical accuracy of the book-keeping is that every debit has a corresponding credit and Vice versa. Therefore the total of the debit balance must be equal in aggregate to the total of the credit balances when the account are balanced. Thus, to find out the arithmetical correctness of the book-keeping work, we prepare a summary of balances a they appear in the ledger at some particular date. This summary of balances is known as a 'Trial balance'. Or to put in other words, we take a 'trial' of ledger balances, like a tailor taking a trial of a suit, for the purpose of proving doubt it is a useful device and it helps in preparation of final accounts since it contains all the Personal, Real and nominal accounts. As it is prepared by taking up the balances of ledger accounts, both debit and credit sides of a trial balance must always be equal.

ILLUSTRATIONS

Illustration 7

The following balances were extracted from the ledger of Ramakrishna Engineering Works on 31st March 1997. You are required to prepare a trial balance as on that date in proper form.

	Rs.		Rs.
Drawings	6,000	Salaries	9,500
Capital	24,000	Sales Returns	1,000
Sundry creditors	43,000	Purchase Returns	1,100
Bills payable	4,000	Travelling expenses	4,600
Sundry debtors	50,000	Commission paid	100
Bills receivable	5,200	Trading expenses	2,500
Loan from Karthik	10,000	Discount earned	4,000
Furniture & fixtures	4,500	Rent	2,000
Opening stock	47,000	Bank overdraft	6,000
Cash in hand	900	Purchases	70,800
Cash at bank	12,500		
Tax	3,500		
Sales	1,28,000		

Solution:

Trial balance of Ramakrishna Engineering Works as on 31.03.1997

S. No.	Name of Account	L.F.	Debit balance Rs.	Credit balance Rs.
1.	Drawings		6,000	-
2.	Capital		-	24,000
3.	Sundry creditors		-	43,000
4.	Bills payable		-	4,000
5.	Sundry debtors		50,000	-
6.	Bills receivable		5,200	-
7.	Loan from Karthik		-	10,000

8.	Furniture & Fittings		4,500	-
9.	Opening stock		47,000	-
10.	Cash in hand		900	-
11.	Cash at bank		12,500	-
12.	Tax		3,500	-
13.	Sales		-	1,28,000
14.	Salaries		9,500	-
15.	Sales returns		1,000	-
16.	Purchase returns		-	1,100
17.	Travelling expenses		4,600	-
18.	Commission paid		100	-
20.	Discount earned		-	4,000
21.	Rent		2,000	-
22.	Bank overdraft		-	6,000
23.	Purchases		70,800	-
			2,20,100	2,20,100

Illustration 8

Messers. Rajkumar & Bros. started their business on 1st April 1995 with Rs.50,000 as their capital. Following were the transactions for one month:

		Rs.
1995 April 1	Paid into bank	20,000
" 2	Purchased furniture from Modern furniture Ltd., on credit	3,000
" 5	Purchased goods from Mohan	8,800
" 6	Sold goods on credit to Sivakumar	3,500
" 8	Paid to Modern furniture Ltd., cash	2,000
" 15	Paid wages in cash	200
" 16	Issued cheque to Mohan	7,000
" 20	Received from Sivakumar	1,500
" 21	Paid into bank	1,500

” 23	Cash sales	3,500
” 25	Cash purchases	1,800
” 27	Goods withdrawn for personal use	500
” 28	Cash withdrawn for personal use	750
” 29	Paid for stationery	100
” 30	Paid salaries by cheque	1,000

Give journal entries and prepare ledger accounts and trial balance as on 30.04.1995.

Solution:

In the books of Messers. Rajkumar & Bros.

Journal Entries

Date	Particulars	L.F.	Debit Rs.	Credit Rs.
1-4-95	Cash A/c Dr.		50,000	
	To Rajkumar & Bros. capital A/c			50,000
	[Being cash brought in for capital]			
1-4-95	Bank A/c Dr.		20,000	
	To Cash A/c			20,000
2-4-95	[Being amount deposited into bank]			
	Furniture A/c Dr.		3,000	
	To Modern Furniture Ltd. A/c			3,000
	[Being furniture bought on credit]			
5-4-95	Purchases A/c Dr.		8,800	
	To Mohan A/c			8,800
6-4-95	[Being goods purchased on credit]			
	Sivakumar A/c Dr.		3,500	
	To Sales A/c			3,500
8-4-95	[Being goods sold on credit]			
	Modern Furniture A/c Dr.		2,000	
	To Cash A/c			2,000
	[Being part payment made to			
15-4-95	Modern Furniture Ltd.]			
	Wages A/c Dr.		200	

Date	Particulars	L.F.	Debit	Credit
	To Cash A/c [Being wages paid]			200
16-4-95	Mohan A/c Dr.		7,000	
	To Bank A/c			7,000
20-4-95	[Being payment made to Mohan by			
	cheque] Cash A/c Dr.		1,500	
	To Sivakumar A/c			1,500
21-4-95	[Being cash received]			
	Bank A/c Dr.		1,500	
	To Cash A/c			1,500
23-4-95	[Being amount deposited]			
	Cash A/c Dr.		3,500	
	To Sales A/c			3,500
25-4-95	[Being goods sold for cash]			
	Purchases A/c Dr.		1,800	
	To Cash A/c			1,800
27-4-95	[Being goods purchased for cash]			
	Drawings A/c Dr.		500	
	To Purchases A/c			500
28-4-95	[Being goods taken away for			
	personal use]		750	
	Drawings A/c Dr.			750
29-4-95	To Cash A/c			
	[Being cash taken away for personal			
	use]			
	Stationery A/c Dr.		100	
	To Cash A/c			100
30-4-95	[Being stationery purchased for			
	cash]			
	Salary A/c Dr.		1,000	
	To Bank A/c			1,000
	[Being salary paid by cheque]			

Ledger Accounts

Cash A/c

		Rs.			Rs.
1-4-95	To Rajkumar & Bros.	50,000	1-4-95	By Bank A/c	20,000
	capital			ByModern Furniture	2,000
20-4-95	To Sivakumar A/c	1,500	8-4-95	Ltd.	
				By Wages A/c	200
23-4-95	To Sales A/c	3,500	15-4-95	By Bank A/c	1,500
		55,000	21-4-95	By Purchases A/c	1,800
			25-4-95	By Drawings A/c	750
			28-4-95	By Stationery A/c	100
			29-4-95	By Balance c/d	28,650
			30-4-95		55,000
1-5-95	To Balance b/d	28,650			

Messers. Rajkumar & Bros. Capital A/c

		Rs.			Rs.
30-4-95	To Balance c/d	50,000	1-4-95	By Cash A/c	50,000
					50,000
		50,000			
			1-5-95	By Balance b/d	50,000

Bank A/c

		Rs.			Rs.
1-4-95	To Cash A/c	20,000	16-4-95	By Mohan A/c	7,000
21-4-95	To Cash A/c	1,500	30-4-95	By Salary A/c	1,000
		21,500	30-4-95	By Balance c/d	13,500
1-5-95	To Balance b/d	13,500			21,500

Furniture A/c

		Rs.			Rs.
2-4-95	To Modern Furniture A/c	3,000	30-4-95	By Balance c/d	3,000
		3,000			3,000
1-5-95	To Balance b/d	3,000			

Modern Furniture Ltd. A/c

		Rs.			Rs.
8-4-95	To Cash A/c	2,000	2-4-95	By Furniture A/c	3,000
30-4-95	To Balance c/d	1,000			
		3,000			3,000
			1-5-95	By Balance b/d	1,000

Mohan A/c

		Rs.			Rs.
16-4-95	To Bank A/c	7,000	5-4-95	By Purchase A/c	8,800
30-4-95	To Balance c/d	1,800			
		8,800			8,800
			1-5-95	By Balance b/d	1,800

Sivakumar A/c

		Rs.			Rs.
6-4-95	To Sales A/c	3,500	20-4-95	By Cash A/c	1,500
		3,500	30-4-95	By Balance c/d	2,000
1-5-95	To Balance b/d	2,000			3,500

Sales A/c

		Rs.			Rs.
30-4-95	To Balance c/d	7,000	6-4-95	By Sivakumar A/c	3,500
		7,000	23-4-95	By Cash A/c	3,500
					7,000
			1-5-95	By Balance b/d	7,000

Purchases A/c

		Rs.			Rs.
5-4-95	To Mohan A/c	8,800	27-4-95	By Drawings A/c	500
25-4-95	To Cash A/c	1,800	30-4-95	By Balance c/d	
		10,600			10,100
1-5-95	To Balance b/d	10,100			10,600

Wages A/c

		Rs.			Rs.
15-4-95	To Cash A/c	200	30-4-95	By Balance c/d	200
		200			200
1-5-95	To Balance b/d	200			

Drawings A/c

		Rs.			Rs.
27-4-95	To Purchases A/c	500	30-4-95	By Balance c/d	1,250
28-4-95	To Cash A/c	750			
		1,250			1,250
1-5-95	To Balance b/d	1,250			

Stationery A/c

		Rs.			Rs.
29-4-95	To Cash A/c	100	30-4-95	By Balance c/d	100
		100			100
1-5-95	To Balance b/d	100			

Salary A/c

		Rs.			Rs.
30-4-95	To Bank A/c	1,000	30-4-95	By Balance c/d	1,000
		1,000			1,000
1-5-95	To Balance b/d	1,000			

Schedules of Debtors	
	Rs.
Sivakumar	2,000
Sundry Debtors	2,000
Schedule of Creditors	
	Rs.
Modern Furniture Ltd.	1,000
Mohan	1,800
Sundry Creditors	2,800

Trial balance of Messers. Rajkumar & Bros. as on 30-4-95

Name of Account	L.F.	Debit balance Rs.	Credit balance Rs.
Cash A/c		28,650	-
Messers. Rajkumar & Bros. Capital A/c		-	50,000
Bank A/c		13,500	-
Furniture A/c		3,000	-
Sundry Creditors		-	2,800
Sundry Debtors		2,000	-
Sales A/c		-	7,000
Purchases A/c		10,100	-
Wages A/c		200	-
Drawings A/c		1,250	-
Stationery A/c		100	-
Salary A/c		1,000	-
		59,800	59,800

Summary:

The journal, ledger, subsidiary books, and trial balance are essential components of the accounting cycle. Each plays a critical role in ensuring that financial transactions are accurately recorded, categorized, and summarized, ultimately leading to the preparation of accurate financial statements. The journal provides the initial record, the ledger categorizes these records, subsidiary books streamline the recording of frequent transactions, and the trial balance ensures accuracy and completeness.

Multiple Choice Questions

1. Which of the following is recorded first in the accounting cycle?

    a. Ledger b. Trial Balance c. Journal d. Financial Statements

2. What is the purpose of the narration in a journal entry?

    a. To provide a detailed description of the transaction

    b. To indicate the date of the transaction

    c. To specify the accounts affected

d. To calculate the balance of the account

3. What is the main purpose of a ledger?

a. To record all business transactions in chronological order

b. To provide a summary of financial accounts

c. To prepare the trial balance

d. To calculate net income

4. The primary purpose of a trial balance is to:

a. Prepare financial statements   b. Record all business transactions

c. Ensure that debits equal credits   d. Determine the net income

5. A trial balance is typically prepared:

a. At the end of the fiscal year   b. At the beginning of the fiscal year

c. At the end of each accounting period   d.Whenever a new transaction occurs

Answer: 1.C, 2.A,3. b, 4.c,5.c.

Short Answer questions (5 Marks)

1. What is a journal in accounting?
2. Distinguish between Journal and Ledger.
3. What is a trial balance? Explain its objectives.
4. What are the key components of a trial balance?
5. What is meant by “Subsidiary books”? What are they?

Long Answer questions (10 Marks)

1. How do journal entries help in tracking the financial performance of a company?
2. How does a trial balance contribute to the preparation of financial statements?
3. Explain the impact of the double-entry accounting system on the trial balance.
4. Explain the relationship between a journal, a ledger, and a trial balance?
5. What steps are involved in preparing a trial balance after posting journal entries to the ledger?

1.5 : BANK RECONCILIATION STATEMENT

Meaning:

Bank reconciliation statement is a list in which are indicated the various items that cause a difference between the bank balances as per cash book and pass book on any given date. This statement bridges the gap between

the balance shown by the cash book and the pass book.

Causes for differences

The bank balance as per cash book may differ from the bank balance as per bank statement as on a particular date due to a variety of reasons as under:

I. Transactions entered in cash book but not in pass book as on the date of bank reconciliation statement:

(a) Cheques are issued but are not presented to bank for payment [cash book credited but pass book not debited].

(b) Cheques and bills are deposited in bank but not collected and credited in pass book [cash book debited but pass book not credited].

(c) Cheques or cash are debited in cash book but actually not sent to bank [cash book debited but pass book not credited].

(d) Cheques are deposited but returned dishonoured by bank, but they are not adjusted in cash book yet [cash book debited but pass book not credited]. Similarly, cheques are issued but the bank returns them dishonoured [cash book credited but pass book not debited].

(e) Cash book is credited for issue of cheques but they are actually not issued or money not drawn [cash book credited but pass book not debited].

(f) Dividend, interest, deposits etc. debited in cash book more than once in error. [Excess debit in cash book but not credited in pass book]. Similarly, bank charges or withdrawals etc. are credited in cash book more than once, in error [excess credit in cash book but not debited in pass book].

II. Transactions entered in pass book but not in cash book as on the date of bank reconciliation statement

(a) Cash or cheque is directly deposited in bank by debtors or others and credited by bank but the depositor has no intimation of the same [pass book credited but cash book not debited].

(b) Bank has credited the pass book for interest on investments, for dividends on shares etc. collected by it but the depositor has no intimation of the same [pass book credited but cash book not debited].

(c) Bank has debited the pass book for direct payments [under standing instructions] on insurance premiums, interest on loans from others, electricity bills etc., but the depositor has no intimation of the same [pass book debited but cash book not credited).

(d) Bank debits the pass book for interest on overdraft or bank loan, for bank charges, commission, service charges, collection charges etc. [pass book debited but cash book not credited].

Similarly, bank credits pass book for interest in bank balance on fixed deposits etc. [pass book credited but cash book not debited].

(e) Cheques or bills discounted previously are dishonoured and or debited in pass book [pass book debited but cash book not credited].

(f) Bank has credited pass book for cheques deposited and collected; and pass book has debits for payment of cheques issued; but both have remained unrecorded in cash book [for deposits: pass book credited but cash book not debited; and for issues: pass book debited but cash book not credited].

(g) There may be erroneous debits in pass book for bank charges, interest and for cheques drawn by others [pass book debited but cash book not credited]. Similarly, there may be erroneous credits in pass book for interest on deposits etc., and for cheques etc., deposited by others [pass book credited but cash book not debited].

The various causes mentioned above necessitate the preparation of bank reconciliation statement which explains the specific reasons for the difference between the balances shown by the pass book and the cash book.

Proforma of a bank reconciliation statement

The following statements indicate the effect of each 'difference' on cash book balance or pass book balance.

I. If we take cash book balance or overdraft as per pass book as the starting point: Bank Reconciliation Statement as on ....

		Rs.	Rs.
	Balance as per cash book or overdraft as per pass book		xxx
Add:	(i) Cheques issued / drawn but not	xxx	

	presented	xxx	
	(ii) Direct deposit made by customers into bank not recorded in cash book		
	(iii) Dividend or other incomes collected by the bank not recorded in cash book	xxx	
	(iv) Interest credited by the bank but not debited in cash book	xxx	xxx
			xxx
Less:	(i) Cheques paid / deposited into bank but not credited	xxx xxx	
	(ii) Payments by the bank as per standing instruction, not entered in cash book	xxx	
	(iii) Bank charges debited in pass book but not recorded in cash book	xxx	
	(iv) Cheques deposited but dishonoured, not recorded in cash book	xxx	
	(v) Cheques issued and recorded in cash book as deposited into bank but the same was not deposited into bank	xxx	xxx
	(vi) Cheques issued but not recorded in cash book	xxx	xxx
	(vii) Interest on bank deposits recorded in cash book but not credited by the bank		
	Balance as per pass book or overdraft as per cash book		

II. **If we take pass book balance or overdraft as per cash book as starting point: Bank Reconciliation Statement as on ………**

		Rs.	Rs.
	Balance as per pass book or		xxx
Add	overdraft as per cash book	xxx	
:	(i) Cheques paid / deposited into	xxx	
	bank but not credited		
	(ii) Payment made by the bank as	xxx	
	per standing instruction, not	xxx	
	entered in cash book	xxx	
	(iii) Bank charges debited in pass		
	book but not recorded in cash	xxx	
	book	xxx	
	(iv) Cheques deposited but		xxx
	dishonoured not recorded in		xxx
	cash book		
	(v) Cheques issued and		
	recorded in cash book as		
	deposited into the bank but		
	the same was not		
	deposited into the bank		
	(vi) Cheques issued but not recorded		
	in cash book		
	(vii) Interest on bank deposits		
	recorded in cash book but not		
	credited, by the bank		
Les	(i) Cheques issued / drawn but not	xxx	
s:	presented	xxx	
	(ii) Direct deposit made by		
	customers into bank, not	xxx	xxx
	recorded in cash book	xxx	xxx

	(iii) Dividends or other income collected by the bank but not recorded in cash book (iv) Interest credited by the bank but not debited in cash book Balance as per cash book or overdraft as per pass book		

I.Reconciliation from favorable cash book balance

Illustration 9

From the under-mentioned particulars of Mr. M. Mohan prepare a Bank Reconciliation Statement as on 31st July 1994.

(i) Cheques paid into Bank on the 28th July 1994 but credited to Mohan's account in the first week of August 1994.

(ii) The following cheques were issued by Mohan on 30th July 1994 but presented to bank for payment after the close of the year. D. David Rs.1,200; H. Hari Rs.1,000; L. Lal Rs.800.

(iii) A cheque for Rs.300 was credited direct to the account and was not passed through the cash book.

(iv) The bank balance as per cash book on 31st July 1994 amounted to Rs.30,000.

Solution:

Bank Reconciliation Statement of M. Mohan as on 31st July 1994

		Rs.	**Rs.**
	Bank Balance as per cash book		30,000
Add:	(i) Cheques issued but not presented for payment D. David Rs.1,200 H. Hari Rs.1,000 L. Lal Rs.800	3,000	
	(ii) Cheque credited direct to the account but not passed through the cash book	300	3,300
			33,300
Less:		3,000	3,000

	Particulars		Rs.
	Cheques paid into bank but not credited in the pass book K. Kalyan Rs.1,000 J. Joy Rs.800 R. Raghul Rs.1,200 Bank balance as per pass book		30,300

II. Reconciliation from favourable pass book balance

Illustration 10

From the following particulars, prepare a bank reconciliation statement as at 31st December 1992 to find out the balance as per cash book of Ms. Akila.

(i) The following cheques were paid into bank in December 1992 but were credited by the bank in January 1993.
Maninder – Rs.1,400; Kalyani – Rs.1,600; Rajesh – Rs.1,200.

(ii) The following cheques were issued in December 1992 but were presented for payment in January 1993.
Shalini – Rs.1,000; Bhagat - Rs.900

(iii) The following charges were made by the bank which were not recorded in the cash book.
Incidental charges for the half year ended 31-12-1992 Rs.40 collection charges for outstanding cheques Rs.30.

(iv) The following payments made by the bank direct as per standing instructions were not entered in the cash book.
Insurance premium – Rs.700; Subscription for commerce – Rs.150

(v) A cheque for Rs.1,000 which was received from a customer was entered in the bank column of cash book in December 1992 but was omitted to be banked in December 1992.

(vi) A bill for Rs.2,000 was retired by the bank under rebate of Rs.40 but the full amount of the bill was credited in bank column of the cash book.

The bank balance as per pass book was Rs.31,600 on 31st December 1992.

Books of Ms. Akila
Bank Reconciliation Statement as on 31-12-1992

		Rs.	Rs.
	Balance as per pass book		31,600
Add:	(i) Cheques paid into bank but not yet cleared and credited:		
	Maninder 1,400		
	Kalyani 1,600		
	Rajesh 1,200	4,200	
	(ii) Charges recorded in the pass book but not in the cash book:		
	Incidental charges 40		
	Collection charges 30	70	
	(iii)Payment made by the bank directly as per standing instructions, not recorded in the cash book:		
	Insurance Premium700		
	Subscription for commerce 150	850	
	(iv)Cheques entered in the cash book but omitted to be banked	1,000	6,120
			37,720
Less:	Cheques issued but not yet presented for payment		
	Shalini 1,000		
	Bhagat 900	1,900	
	Rebate allowed for the bill retired but not entered in the cash book	40	1,940
	Balance as per cash book		35,780

III. Reconciliation from Overdrawn cash book balance

Illustration 11

The bank overdraft of Rajinin on 31-12-93 as per cash book is Rs.9,000. From the following particulars, prepare bank reconciliation statement:

		Rs.
(i)	Unpresented cheque	3,000
(ii)	Uncleared cheque	1,700
(iii)	Bank interest debited in the pass book only	500
(iv)	Bill collected and credited in the pass book only	800
(v)	Cheque of Renu dishonoured	500
(vi)	Cheques issued to Sekar entered in the Cash column of cash book	300

Solution:

Bank Reconciliation Statement as on 31-12-93

		Rs.	Rs.
	Bank Overdraft as per cash book		9,000
Add:	(i) Uncleared cheques	1,700	
	(ii) Interest debited	500	
	(iii)Dishonoured cheques	500	
	(iv)Cheques omitted from the Bank column	300	3,000
			12,000
Less:	(i) Unpresented cheques	3,000	
	(ii) Bill collected	800	3,800
	Bank overdraft as per pass book		8,200

Summary:

A bank reconciliation statement serves as a critical tool for businesses to maintain accurate financial records and ensure transparency in financial reporting. By reconciling the company's cash book balance with the bank statement balance and making necessary adjustments, businesses can mitigate risks, improve financial controls, and facilitate informed decision-making. Regular reconciliation is essential to maintain financial integrity and compliance with accounting standards.

Multiple Choice Questions

1. A deposit recorded in the company's books in June but recorded by the bank in July is an example of:

    a. An outstanding check b. A deposit in transit

    c. A bank error d. A book error

2. An outstanding check is:

    a. A check that has been cashed by the bank

    b. A check that has not yet been presented for payment

    c. A check that has been voided by the company

    d. A check that has been lost in transit

3. Which of the following would cause the bank statement balance to be higher than the company's cash book balance?

    a. Outstanding checks b. Deposits in transit

    c. Bank fees not yet recorded in the cash book

    d.NSF (Non-Sufficient Funds) checks

4. What should be done if a bank error is discovered during the bank reconciliation process?

    a. Adjust the company's cash book to match the bank statement

    b. Contact the bank to correct the error

    c. Record the error as a miscellaneous expense

    d. Ignore the error, as it will be resolved in the next period

5. Bank service charges are:

    a. Added to the bank statement balance

    b. Added to the company's cash book balance

c. Subtracted from the bank statement balance

d. Subtracted from the company's cash book balance

Answer: 1.b, 2.b, 3.b, 4.b, 5.d

Short Answer questions (5 Marks)

1. What is a bank reconciliation statement?
2. What is the primary purpose of a bank reconciliation statement?
3. Why is it important to prepare a bank reconciliation statement?
4. What are the main components of a bank reconciliation statement?
5. What is the difference between the bank statement balance and the company's cash book balance?

Long Answer questions (10 Marks)

1. Explain the steps involved in preparing a bank reconciliation statement
2. What are common errors that can be detected through a bank reconciliation statement?
3. Why might a bank reconciliation statement be important for internal controls?
4. Explain the role of technology in simplifying the bank reconciliation process.
5. What are the challenges faced in reconciling accounts with multiple bank transactions daily?

Overall Summary:

Accounting serves as the foundation for financial transparency and accountability in organizations. It plays a critical role in providing accurate financial information for decision-making, regulatory compliance, and strategic planning. Understanding the principles and practices of accounting is essential for effective management, governance, and sustainable growth in businesses of all sizes.

Accounting principles and tools—such as journals, ledgers, subsidiary books, trial balance, and the bank reconciliation statement—form a comprehensive framework for recording, summarizing, and reporting financial transactions. They play a crucial role in ensuring the accuracy, reliability, and transparency of financial information, supporting effective business management and regulatory compliance. Understanding and applying these fundamentals are essential for maintaining financial health, making informed decisions, and fostering sustainable growth in organizations.

Practical sums:

1. Journalise the following transactions during the month of January, 2018.

Jan.		Rs.
1	Commenced business with cash	80,000
2	Deposited cash with bank	40,000
3	Purchased goods by paying cash	5,000
4	Purchased goods from Lipton & Co. on credit	10,000
5	Sold goods to Joy and received cash	11,000
6	Paid salaries by cash	5,000
7	Paid Lipton & Co. by cheque for the purchases made on 4th Jan.	
8	Bought furniture by cash	4,000
9	Paid electricity charges by cash	1,000
10	Bank paid insurance premium on furniture	300

2. Prepare a Trial Balance with the following information:

Name of Account	(₹)
(i) Capital	2,00,000
(ii) Stock	70,000
(iii) Cash	1,80,000
(iv) Debtors	3,00,000
(v) Creditors	1,00,000
(vi) Bank Loan	1,50,000
(vii) Sales	3,00,000
(viii) Purchases	2,00,000

Answer: 7,50,000

FINAL ACCOUNTS

After learning the second unit, the students can understand the organisation's financial accounts for a specific period and ensure the accuracy of the balances shown by the pass book and cash book.

Contents

2.1 Introduction
2.2 Objectives of Final Accounts
2.3 Trading Account
2.4 Preparation of Trading Account
2.5 Features of Trading Account
2.6 Contents of a Trading Account
2.7 Profit & Loss Account
2.8 Preparation of profit and loss account
2.9 The specimen proforma of a profit and loss account is given below:
2.10 Components of a balance sheet
2.11 The features of a balance sheet:
2.12 The importance of a balance sheet
2.13 The difference between trial balance and balance sheet
2.14 Financial Statement with Adjustments
2.15 Illustration sums
2.16 Summary
2.17 Multiple Choice Questions
2.18 Short Answer questions (5 Marks)
2.19 Long Answer questions (10 Marks)
2.20 Practical sums

2.1 Introduction

The primary function of accounting is to accumulate accounting data in a manner that the amount of profit made or loss suffered during a period can be determined. The manner in which the amount of profit or loss has been arrived at is disclosed in the statement of accounts, prepared at the end of the accounting period are detailed out therein, grouped under significant heads. It is also accompanied by a balance sheet, exhibiting assets and liabilities of the business as at the close of the period. In addition, for

showing the nature of economic activity to which the account pertains, the revenue account as well as different sections in which it is set up are invariably headed as manufacturing trading and profit and loss account or simply as profit and loss account. These two statements i.e., trading and profit and loss account and balance sheet are prepared to give the final results of the business. That is why both are collectively called final accounts.

Thus, preparation of final accounts is the last step in the accounting cycle. In fact, final accounts include a number of accounts such as (i) Trading accounts (ii) Profit and loss account and (iii) balance sheet. Though balance sheet is a statement, for all practical purposes, it is treated as one of the final accounts.

Once the “trial balance” is extracted and ‘errors’ rectified, a trader prepares the “final accounts” so as to known the final results (i.e., net profit or loss) and financial position (i.e., assets and liabilities) of his business. Trading account and profit and loss account are prepared by transferring from the trial balance, all nominal accounts and accounts concerning goods by passing entries known as “closing entries”. All remaining accounts viz., real and personal accounts pertaining to property, assets, debtors and creditors are just shown in a statement called balance sheet.

2.2 Objectives of Financial Accounts

The objective of financial accounts, often referred to as financial statements, is to provide a structured and accurate representation of an organization's financial performance, position, and cash flows over a specific period. These accounts are designed to fulfill several key purposes:

Decision-Making: Financial accounts provide vital information to various stakeholders, including investors, creditors, management, and regulatory agencies, to aid in making informed decisions.

Performance Evaluation: They help in assessing the financial performance of an organization by detailing revenue, expenses, profits, and losses, allowing stakeholders to evaluate the company's operational efficiency and profitability.

Financial Position Assessment: Financial statements offer a snapshot of an organization's financial position at a given point in time, showing assets, liabilities, and equity. This helps stakeholders understand the company's solvency and liquidity.

Cash Flow Analysis: These accounts detail cash inflows and outflows, providing insight into the company's cash management and its ability to generate cash to meet obligations, invest in growth, and distribute dividends.

Compliance and Legal Requirements: Financial accounts ensure that organizations comply with legal and regulatory requirements, providing a formal record of financial activities and ensuring transparency and accountability.

Investor Confidence: Accurate and reliable financial statements build trust and confidence among investors and potential investors, facilitating capital raising and investment activities.

Internal Control and Planning: For management, financial accounts are crucial for internal control, planning, budgeting, and strategizing. They help in setting financial goals, monitoring progress, and making necessary adjustments.

2.3 Trading Account

At the end of the financial year or at the end of the financial accounting period, an entity prepares the financial accounting statements to know the profit and loss and also the financial position of the business. These statements help users of financial accounting, information in decision making. In this article, we will see the steps of preparation of trading account.

2.4 Preparation of Trading Account

Trading account is the first step in the process of preparing final accounts. It helps in finding out the gross profit or gross loss during an accounting year, which is an important indicator of business efficiency.

It is normally prepared by a merchandising concern which purchases and sells the goods during a particular period.

The trading account shows the gross profit or gross loss during the accounting period. Trading account is based on matching the selling price of goods and services with the cost of goods sold and services rendered.

The trading account shows the gross profit or gross loss during the accounting period. Trading account is based on matching the selling price of goods and services with the cost of goods sold and services rendered.

Trading Account

(For the year ended…)

Dr. Cr.

Particulars		Amount	Particulars		Amount
To Opening stock		Xxx	By Sales	xxx	
To Purchases	xxx		Less: Return Inwards	(xxx)	Xxx
Less: Return Outwards	(xxx)	Xxx	By Closing stock		Xxx
To Wages		Xxx	By Gross Loss		Xxx
To Carriage Inwards		Xxx			
To Freight Inwards/cartage		Xxx			
To Gross Profit c/d		Xxx			
		xxx			xxx

2.5 Features of Trading Account

- It is the first stage in the preparation of financial accounting statement of a trading concern.
- It records only the net sales and direct cost of goods sold.
- The balance of this account discloses the gross profit and gross loss.
- We transfer the balance of the trading account to the profit and loss account.

2.6 Contents of a Trading Account

Trading Account Statement include

- Opening Stock
- Purchases
- Direct expenses

- Gross profit

Opening Stock

In the case of trading concern, the opening stock means the finished goods only. We take the amount of opening stock from Trial Balance.

Purchases

The amount of purchases during the year includes cash as well as credit purchases. The deductions from purchases are purchase return, drawings of goods by the proprietor, distribution of goods as free samples, etc.

Direct expenses

It means all those expenses which are incurred from the time of purchases to making the goods in suitable condition. This expense includes freight inward, wages etc.

Gross profit

If the credit side of Trading A/c is greater than the debit side of Trading A/c gross profit will arise.

The following are the items appearing in the credit side of Trading Account

- Sales Revenue
- Closing Stock
- Gross Loss
- Sales Revenue

Sales Revenue

The income earned from the main business activity or activities. When goods or services are sold to customers then the income is earned.

If there is any return, it should be deducted from the sales value. As per the accrual concept, income should be recognized as soon as it is accrued and not necessarily only when the cash is paid for.

The Accounting standard 7 (in case of contracting business) and Accounting standard 9 (in other cases) define the guidelines for revenue recognition.

The essence of the provisions of both standards is that revenue should be recognized only when significant risks and rewards (vaguely referred to as ownership in goods) are transferred to the customer.

Example, if an invoice is made for the sale of goods and the term of sale is door delivery, and then recognition of sale can be done only on getting proof of delivery of goods at the door of the customer.

And if such proof is pending at the end of the accounting period, then we can not treat this transaction as sales but will have to treat it as unearned income.

Closing Stock

In the case of trading business, there will be closing stocks of finished goods only. According to the convention of conservatism, the stock is valued at cost or net realizable value whichever is lower.

Gross Loss

When the debit side of Trading A/c is greater than the credit side of Trading A/c, the gross loss will appear.

2.7 Profit & Loss Account

According to Prof. Carter, "Profit and Loss account is an account into which all gains and losses are collected in order to ascertain the excess of gains over the losses or vice versa". Profit and loss account is prepared in order to calculated the net profit or net loss of the business. This account starts with the credit from the trading account in respect of gross profit (or debit if there is gross loss). From gross profit, operating and non-operating expenses are deducted and operating and non-operating income is added in order to calculated the net profit. When total of all the expenses is more than gross profit and other income, there remains a deficit and this is called net loss. The net profit or net loss is ultimately transferred to capital account of the proprietor or to partners' capital accounts in case of partnership firm.

2.8 Preparation of profit and loss account

As in the case of a trading account the profit and loss account is an account and hence, its form and construction conform to the rules of ledger account and principles of double entry system.

Since the profit and loss account is prepared to shown the net profit earned or set loss incurred during a particular period, it should be headed as under:

Profit and Loss A/c of for the year ended"

2.9 The specimen proforma of a profit and loss account, Balance Sheet is given below

ABC Company
Profit and Loss Account
For the Year Ended 31st Dec.

	$		$
Gross Loss (Transferred from Trading A/c)	xxxx	Gross Profit (Transferred from Trading A/c)	xxxx
Office and Administration Expenses		Commission Received	xxxx
Salaries	xxxx	Rent Received	xxxx
Rent, Rates, and Taxes	xxxx	Interest Received	xxxx
Postage and Telegram	xxxx	Discount Received	xxxx
Telephone Charges	xxxx	Discount from Creditors	xxxx
Printing and Stationery	xxxx	Discount on Purchases	xxxx
Office Electricity	xxxx	Dividend Received	xxxx
Insurance	xxxx	Interest on Drawings	xxxx
Legal Charges	xxxx	Reserve for Discount on Creditors	xxxx
Marketing and Selling Expenses		Interest on Renewal of Bills	xxxx
Carriage outwards	xxxx	Bad Debts Recovered	xxxx
Freight Outwards	xxxx	Provision for Bad Debts (Cr.)	xxxx
Sales Salaries	xxxx	Royalty Received	xxxx
Advertisement	xxxx	Apprentice Premium	xxxx
Godown Rent	xxxx	Miscellaneous Income	xxxx
Commissions	xxxx	Sundry Income	xxxx
Discount Allowed	xxxx		
Bad Debts	xxxx		
Financial and Other Expenses			
Bank Charges	xxxx		
Interest	xxxx		
Depreciation	xxxx		
Repairs and Maintenance	xxxx		
Audit Fees	xxxx		
Loss by Theft, Accident, and Fire	xxxx		
Miscellaneous and Sundry Expenses	xxxx		
Net Profit Transferred to Capital	xxxx	Net Loss (Transferred to Capital)	xxxx

Proforma of balance sheet in the order of permanency Balance sheet of.... as on....

Balance Sheet of...
(as at ..)

Liabilities			Amount (₹)	Assets	Amount (₹)
Capital		XXX		Goodwill	XXX
Add: Net Profit	xxx			Patents and Trade Marks, etc.	XXX
Interest on Capital	xxx	XXX		Business Premises	XXX
Less: Drawings	xxx			Freehold/Leasehold Land	XXX
Income Tax	xxx			Land and Building	XXX
Interest on Drawings	xxx			Plant and Machinery	XXX
Net Loss	xxx	(XXX)	XXX	Furniture and Fixtures	XXX
Reserves and Surplus			XXX	Investments	XXX
Mortgage			XXX	Loose Tools	XXX
Loan (Credit)			XXX	Closing Stocks	XXX
Employment Provident Fund			XXX	Loan (Debit)	XXX
Bank Overdraft			XXX	Sundry Debtors	XXX
Bills Payable			XXX	Bills Receivable	XXX
Sundry or Trade Creditors			XXX	Cash at Bank	XXX
				Cash in Hand	XXX
Total			**XXXX**	**Total**	**XXXX**

2.10 Components of a balance sheet

There are main components of a balance sheet. They are:

Liabilities

This section of the balance sheet shows the money that a company owes to others, like loan expenses, recurring expenses, other forms of debt, etc. Now, liabilities can be further subdivided into two categories:

Current liabilities

Under current liabilities fall notes payable due within a year, current maturities of long-term, debt and accounts payable.

Non-current liabilities

Non-current liabilities include deferred tax liabilities, bonds payable, long-term debt and notes payable in the long term.

Assets

In the assets section of the balance sheet, you will find items of value that can be converted into cash. These items will be listed in order of liquidity, that is, how easily they can be converted to cash.

Assets can be further subdivided into the following:

Current assets

The assets that can be converted easily into cash within a year or less are called current assets. They have the following divisions:

Assets	Particulars
Prepaid expenses	Items of value for which the company has already made a payment, like business insurance, office rent, etc.
Inventory	Raw materials, finished products, etc.
Accounts receivable	Money that a company's clients owe for services rendered that is payable in the short term.
Marketable securities	Investments that a business can sell off within a year.
Cash and cash equivalents	Money saved in a firm's checking and savings accounts, currency and checks.

Long-term assets

Those assets that cannot be converted into cash within a year are called long-term assets. You can further subdivide them into the following:

Assets	Particulars
Fixed assets	Machinery, buildings, property, etc.
Intangible assets	Patents, copyrights, franchise agreements and more.
Long-term securities	Investments that a company cannot sell within a year.

2.11 The features of a balance sheet

A balance sheet consists of all the liabilities and assets of a company. It shows their value and nature enabling you to know the position of the capital on a specific date. However, it does not show any revenues or expenses.

Balance sheets follow the equation “Asset = Liability + Capital”, and both of its sides are always equal.

It takes into account the credit as well as debit balances of a company’s current and personal accounts. The credit balance comes under the personal account and is called the liabilities of a business. In comparison, the debit balance comes under the real account and is known as the assets of a business.

A company’s accountants generally prepare the balance sheet on the last day of an accounting year. This is so as it is the ultimate step of final accounts and needs an assessment of the company’s trading as well as profit and loss account for its preparation.

2.12 The importance of a balance sheet

A balance sheet is an essential component that assists in the smooth running of a business. Here are some of the reasons that explain the importance of a company’s balance sheet:

Assist banks in evaluating a firm’s net worth

When a business wants to expand its operations and make future investments, it seeks loans from banks. Under such circumstances, the banks will look at the firm’s balance sheet to evaluate whether or not it has the financial position to pay back the loan amount.

Helps investors take decisions

While choosing a firm for the purpose of investment, a majority of investors look at the company's balance sheet to determine its financial position. Moreover, they combine it with various other factors to assess the firm's future growth potential.

Serves as a determiner for risk and returns

If you are a business owner, maintaining a balance sheet will enable you to determine the ease at which you can meet your short-term obligations. Furthermore, you can also put a check on the liabilities of your business if they are rapidly growing and avoid the chances of bankruptcy.

Enables financial analysis

Having a proper balance sheet will let you get a clear idea of the liquidity conditions of your company. Thus, you can view the cash flow of your firm, working capital funding, trade receivable status and also how much daily transactions your business can afford.

2.13 The difference between trial balance and balance sheet

Trial Balance	Balance Sheet
Trial balance is not a financial statement and does not form a part of a company's final account	The balance sheet is a financial statement that is an important component of a company's final account
It is made for use within the company	It is made for the company's external affairs
All its accounts are divided into debit and credit balances	All its accounts are divided into equity, liabilities and assets
It records the closing balances of all the general ledgers of accounts	It records a company's equity, liabilities and assets

Its purpose is to verify that the total debits and credits of all the ledgers are in balance	Its purpose is to determine whether the business's assets are equal to the sum of its liabilities and equity
For trial balances, there is no specific arrangement rule	For balance sheets, there is a specific arrangement format
Auditor's signature is not mandatory	Auditor's signature is mandatory
Recorded at the end of every year, half-year and quarter	Recorded at the end of every financial year

2.14 Financial Statement with Adjustments

Effect of Adjustment

Before we start seeing all the adjustments one by one, some matters must be considered at the time of adjustment:

Accounting for items mentioned in the trial balance will be carried out only once i.e. in one account only whether in the Trading A/c, Profit and Loss A/c, or Balance Sheet. Accounting for items given outside the trial balance in adjustments will be carried out twice or at two places or two accounts.

Now we will see all the adjustments one by one:

1. Closing Stock:

The number of goods that remain unsold at the end of the financial year is called closing stock. It is valued at cost price or market price whichever is less.

Journal Entry:

Date	Particulars	LF	Amount(Dr.)	Amount(Cr.)
	Closing Stock A/c Dr. To Trading A/c			

Adjustment:

If Closing Stock is given outside the trial balance: Usually closing stock is given outside the trial balance. In such case, two entries are passed-

- In the Cr. side of the Trading A/c.
- In the Assets side of the Balance Sheet.

If Closing Stock is given inside the trial balance: If Closing Stock is given in the trial balance then it will be recorded only once in the Assets side of the Balance Sheet.

2. Outstanding Expenses:

Outstanding expenses are those expenses that are related to the same accounting period of which accounts are being made but are not yet paid.

Journal Entry:

Date	Particulars	LF	Amount(Dr.)	Amount(Cr.)
	Expenses A/c Dr. To Outstanding Expenses A/c			

Adjustment:

If Outstanding Expense is given outside the trial balance: In such case, two entries will be passed-

- Will be added in the concerned item (expense) at the Dr. side of Trading A/c or Profit & Loss A/c.
- Will be shown in the liabilities side of the balance sheet.

If Outstanding Expense is given inside the trial balance: It will be only shown on the liabilities side of the Balance Sheet. (Because it is a Representative Personal A/c which has a Cr. balance)

3. Prepaid Expenses:

Such expenses which are concerned with the next financial year but have been paid in the current year are called prepaid expenses.

Journal Entry:

Date	Particulars	LF	Amount(Dr.)	Amount(Cr.)
	Prepaid Expenses A/c Dr. To Expenses A/c			

Adjustment:

If Prepaid Expenses is given outside the trial balance: In such, case two entries will be passed-

- Will be deducted from the related Expenses A/c in the Dr. side of the Trading A/c or Profit & Loss A/c
- Will be shown in the Assets side of the Balance Sheet (Because it is a Representative Personal A/c the benefit of which will be received in the next year)

If Prepaid Expenses is given inside the trial balance: It will only be shown in the Assets side of the Balance Sheet. (Because it is a Representative Personal A/c and has a Dr. balance)

4. Accrued Income:

Such an income that has been earned but not yet received in the current financial year is called Accrued Income.

Journal Entry:

Date	Particulars	LF	Amount(Dr.)	Amount(Cr.)
	Accrued Income A/c Dr. To Income A/c			

Adjustment:

If Accrued Income is given outside the trial balance: In such case, two entries will be passed-

- Will be added to the related Income A/c in the Cr. side of Profit & Loss A/c.
- Will be shown in the Assets side of the Balance Sheet or added to the concerned source in the Assets side of the Balance Sheet.

If Accrued Income is given inside the trial balance: It will only be shown on the Assets side of the Balance Sheet.

5. Unearned Income:

Such an income that has not been earned as yet but has been received in advance is called Unearned Income.

Journal Entry:

Date	Particulars	LF	Amount(Dr.)	Amount(Cr.)
	Income A/c Dr. To Unearned Income A/c			

Adjustment:

If Unearned Income is given outside the trial balance: In such cases, two entries will be passed-

- Will be deducted from the related Income A/c in the Cr. side of the Profit & Loss A/c
- Will be shown in the Liabilities side of the Balance Sheet.

If Unearned Income is given inside the trial balance: It will only be shown in the Liabilities side of the Balance Sheet.

6. Interest on Capital:

Sometimes there is a provision of interest being given on the capital brought in by the proprietor or partners. Interest on Capital is a loss to the business while profit for the proprietor.

Journal Entry:

Date	Particulars	LF	Amount(Dr.)	Amount(Cr.)
	Interest on Capital A/c Dr. To Capital A/c			

Adjustment:

If Interest on Capital is given outside the trial balance: In such case, two entries will be passed-

- It is shown in the Dr. side of the Profit & Loss A/c.
- Amount of Interest on Capital is added to the Capital A/c in the Liabilities side of the Balance Sheet.

If Interest on Capital is given inside the trial balance: It will only be shown in the Dr. side of the Profit & Loss A/c.

7. Interest on Drawings:

Money or Goods withdrawn by the proprietor from the business for personal use is called drawings. Drawings are a sort of loan taken by the proprietor from the business. Sometimes proprietor has to pay interest on his drawings which is called Interest on Drawings.

Journal Entry:

Date	Particulars	LF	Amount(Dr.)	Amount(Cr.)
	Drawings A/c Dr. To Interest on Drawings A/c			

Adjustment:

If Interest on Drawings is given outside the trial balance: In such case, two entries will be passed-

- It is shown in the Cr. side of the Profit & Loss A/c. (It is a kind of income for the business)
- Amount of Interest on Drawings is added to the Drawings A/c and deducted from the Capital A/c in the Liabilities side of the Balance Sheet.

If Interest on Drawings is given Inside the trial balance: It will only be shown in the Cr. side of the Profit & Loss A/c.

8. Interest on Deposits:

The interest received on the amount deposited in the Bank is called Interest on Deposits. It is an income for the firm.

Journal Entry:

Date	Particulars	LF	Amount(Dr.)	Amount(Cr.)
	Bank Deposits A/c Dr. To Interest on Deposits A/c			

Adjustment:

If Interest on Deposits is given outside the trial balance: In such case, two entries will be passed-

- It is shown in the Cr. side of the Profit & Loss A/c. (It is income for the business)
- Amount of Interest on Deposits is added to the Bank Deposits in the Assets side of the Balance Sheet.

If Interest on Deposits is given Inside the trial balance: It will only be shown in the Cr. side of the Profit & Loss A/c.

9. Interest on Loan:

If money is invested in the business by taking a loan then interest has to be paid on that loan. If Interest has not been paid in the same financial year then this is called Outstanding Interest. So, the entries will be the same as Outstanding Expenses (Point No. 2 of Adjustments of this Article)

Journal Entry:

Date	Particulars	LF	Amount(Dr.)	Amount(Cr.)
	Interest on Loan A/c Dr. To Outstanding Interest A/c			

Adjustment:

If Interest on Loan is given outside the trial balance: In such case, two entries will be passed-

- It is shown in the Dr. side of the Profit & Loss A/c.
- Amount of Interest on Loan is added to the Loan A/c in the Liabilities side of the Balance Sheet.

If Interest on Loan is given Inside the trial balance: It will only be shown in the Dr. side of the Profit & Loss A/c.

10. Proprietor's Salary:

If the proprietor work in the firm, the firm has to a pay salary to the proprietor. The proprietor's salary is an expense to the firm.

Journal Entry:

Date	Particulars	LF	Amount(Dr.)	Amount(Cr.)
	Proprietor's salary A/c Dr. To Capital A/c			

Adjustment:

If Proprietor's Salary is given outside the trial balance: In such case, two entries will be passed-

- It is shown in the Dr. side of the Profit & Loss A/c.
- Amount of Proprietor's Salary is added to the Capital A/c in the Liabilities side of the Balance Sheet.

If Proprietor's Salary is given Inside the trial balance: It will only be shown in the Dr. side of the Profit & Loss A/c.

11. Depreciation:

Reduction in the value of fixed assets due to wear and tear caused by continuous use or any other reason is called Depreciation. It is a loss to the business.

Journal Entry:

Date	Particulars	LF	Amount(Dr.)	Amount(Cr.)
	Depreciation A/c Dr. To Fixed Assets A/c			

Adjustment:

If Depreciation is given outside the trial balance: In such case, two entries will be passed-

- It is shown in the Dr. side of the Profit & Loss A/c.
- Amount of Depreciation is deducted from the concerned Fixed Assets in the Assets side of the Balance Sheet.

If Depreciation is given Inside the trial balance: It will only be shown in the Dr. side of the Profit & Loss A/c.

12. Appreciation:

Sometimes the value of Fixed Assets increases due to a change in the price level, such an increase is called Appreciation. It is a type of income for the business.

Journal Entry:

Date	Particulars	LF	Amount(Dr.)	Amount(Cr.)
	Fixed Assets A/c Dr. To Appreciation A/c			

Adjustment:

If Appreciation is given outside the trial balance: In such case, two entries will be passed-

- It is shown in the Cr. side of the Profit & Loss A/c.

- Amount of Appreciation is added to the concerned Fixed Assets in the Assets side of the Balance Sheet.

If Appreciation is given Inside the trial balance: It will only be shown in the Cr. side of the Profit & Loss A/c.

13. Bad Debts:

A businessman sells his goods on cash as well as on credit. The buyers to whom the goods are sold on credit are called Debtors. These are also known as Book Debts. When a debtor is unable to pay off his debts due to any reason then such debts are called irrecoverable or Bad Debts. It is a loss to the business.

Journal Entry:

Date	Particulars	LF	Amount(Dr.)	Amount(Cr.)
	Bad Debts A/c Dr.			
	To Debtors A/c			

Adjustment:

If Bad Debts is given outside the trial balance: In such case, two entries will be passed-

- It is shown in the Dr. side of the Profit & Loss A/c.
- Amount of Bad Debts is deducted from the Debtors in the Assets side of the Balance Sheet.

If Bad Debts is given Inside the trial balance: It will only be shown in the Dr. side of the Profit & Loss A/c.

14. Provision for Bad & Doubtful Debts:

Even after deducting the bad debts from the debtors, all the remaining debtors cannot be considered as Good Debtors. We may have doubts about some of the debtors that whether they will be able to pay their debts or not, for such doubtful debtors a provision for a certain amount from the current year's profit is made so that next year the amount which remains unrecovered can be adjusted from the provision.

Journal Entry:

Date	Particulars	LF	Amount(Dr.)	Amount(Cr.)
	Profit & Loss A/c Dr.			
	To Provision for Bad & Doubtful Debts A/c			

Adjustment:

If Provision for Bad & Doubtful Debts is given outside the trial balance: In such case, two entries will be passed-

- It is shown in the Dr. side of the Profit & Loss A/c.
- Amount of Provision for Bad & Doubtful Debts is deducted from the Debtors in the Assets side of the Balance Sheet.

If Provision for Bad & Doubtful Debts is given inside the trial balance: It will only be shown in the Dr. side of the Profit & Loss A/c.

15. Bad Debts Recovered:

Sometimes the amount earlier written as Bad Debts is now recovered, it is considered as a gain to the business.

Journal Entry:

Date	Particulars	LF	Amount(Dr.)	Amount(Cr.)
	Cash A/c Dr.			
	To Bad Debts Recovered A/c			

Adjustment:

If Bad Debts Recovered is given outside the trial balance: In such case, two entries will be passed-

- It is shown in the Cr. side of the Profit & Loss A/c or case of Bad Debts already given then it is deducted from Bad Debts in the Dr. side of the Profit & Loss A/c.
- Amount of Bad Debts Recovered is added to Cash A/c in the Assets side of the Balance Sheet.

If Bad Debts Recovered is given inside the trial balance: It will only be shown in the Cr. side of the Profit & Loss A/c or in e of Bad Debts already given then it is deducted from Bad Debts in the Dr. side of the Profit & Loss A/c.

16. Provision for Discount on Debtors:

Almost all businessmen provide discounts to their debtors to encourage them to make prompt payments. Provision for Discount on Debtors is created in the same way as the provision for bad & doubtful debts because at the end of the year there will undoubtedly be some debtors who will be provided da iscount to receive prompt payments next year.

Journal Entry:

Date	Particulars	LF	Amount(Dr.)	Amount(Cr.)
	Profit & Loss A/c Dr. To Provision for Discount on Debtors A/c			

Adjustment:

If Provision for Discount on Debtors is given outside the trial balance: In such case, two entries will be passed-

- It is shown in the Dr. side of the Profit & Loss A/c.
- Amount of Provision for Discount on Debtors is deducted from the Debtors in the Assets side of the Balance Sheet.

If Provision for Discount on Debtors is given inside the trial balance: It will only be shown in the Dr. side of the Profit & Loss A/c.

17. Provision for Discount on Creditors:

Like the way we provide discounts to our debtors, in the same way, our creditors provide a discount to us for receiving prompt payments. Discount received is a gain for the business.

Journal Entry:

Date	Particulars	LF	Amount(Dr.)	Amount(Cr.)
	Provision for Discount on Creditors A/c Dr. To Profit & Loss A/c			

Adjustment:

If Provision for Discount on Creditors is given outside the trial balance: In such case, two entries will be passed-

- It is shown in the Cr. side of the Profit & Loss A/c.
- Amount of Provision for Discount on Creditors is deducted from the Creditors A/c in the Liabilities side of the Balance Sheet.

If Provision for Discount on Creditors is given inside the trial balance: It will only be shown in the Cr. side of the Profit & Loss A/c.

18. Loss of Insured Goods and Assets:

Sometimes businessman faces the loss of Goods or Assets due to fire, flood, earthquake, etc. This type of loss is called abnormal loss. Mostly all the goods and assets are insured.

(I) Accounting treatment of loss of Insured Goods: Such losses are classified into three categories:

A} Insurance Company doesn't accept the claim-

Journal Entry:

Date	Particulars	LF	Amount(Dr.)	Amount(Cr.)
(i)	Loss by Accident/Fire/Theft A/c Dr. To Purchases A/c			
(ii)	Profit & Loss A/c Dr. To Loss by Accident/Fire/Theft A/c			

Adjustment:

If Loss by Accident/Fire/Theft is given outside the trial balance: In such case, two entries will be passed-

- Will be shown in the Cr. side of the Trading A/c. [By Goods Lost] [At the total amount of loss]
- Will be shown in Dr. side of Profit & Loss A/c. the [At the actual amount of Loss]

If Loss by Accident/Fire/Theft is given inside the trial balance: It will only be shown in the Dr. side of the Profit & Loss A/c.

B} Insurance company partially accepted the claim-

Journal Entry:

Date	Particulars	LF	Amount(Dr.)	Amount(Cr.)
(i)	Loss by Accident/Fire/Theft A/c Dr. Insurance Company A/c Dr. To Purchases A/c		[Actual Amount of Loss] [Value of Claim Accepted]	[Total Amount of Loss]
(ii)	Profit & Loss A/c Dr. To Loss by Accident/Fire/Theft A/c			

Adjustment:

If Loss by Accident/Fire/Theft is given outside the trial balance: In such case, three entries will be passed-

- Will be shown in the Cr. side of the Trading A/c. [By Goods Lost] [At the total amount of loss]
- Will be shown in Dr. side of Profit & Loss A/c. [At the actual amount of Loss]
- Will be shown in the Assets side of the Balance Sheet. [By Insurance Claim] [Value of Claim Accepted]

If Loss by Accident/Fire/Theft is given inside the trial balance: It will only be shown in the Dr. side of the Profit & Loss A/c.

C} Insurance Company fully accept the claim-

Journal Entry:

Date	Particulars	LF	Amount(Dr.)	Amount(Cr.)
	Insurance Company A/c Dr. To Purchases A/c		[Value of Claim Accepted]	[Total Amount of Loss]

Adjustment:

If Loss by Accident/Fire/Theft is given outside the trial balance: In such case, two entries will be passed-

- Will be shown in the Cr. side of the Trading A/c. [By Goods Lost] [At the total amount of loss]

- Will be shown in the Assets side of the Balance Sheet. [By Insurance Claim] [Value of Claim Accepted]

If Loss by Accident/Fire/Theft is given inside the trial balance: It will only be shown in the Dr. side of the Profit & Loss A/c.

(II) Accounting treatment of loss of Insured Assets: Such losses are classified into three categories:

A} Insurance Company doesn't accept the claim-

Journal Entry:

Date	Particulars	LF	Amount(Dr.)	Amount(Cr.)
(i)	Loss by Accident/Fire/Theft A/c Dr. To Particular Assets A/c			
(ii)	Profit & Loss A/c Dr. To Loss by Accident/Fire/Theft A/c			

Adjustment:

If Loss by Accident/Fire/Theft is given outside the trial balance: In such case, two entries will be passed-

- Will be shown in Dr. side of Profit & Loss A/c. [At the actual amount of Loss]
- Will be deducted from the Particular Asset in the Assets side of the Balance Sheet. [At the full amount of loss]

If Loss by Accident/Fire/Theft is given inside the trial balance: It will only be shown in the Dr. side of the Profit & Loss A/c.

B} Insurance company partially accepted the claim-

Journal Entry:

Date	Particulars	LF	Amount(Dr.)	Amount(Cr.)
(i)	Loss by Accident/Fire/Theft A/c Dr. Insurance Company A/c Dr. To Particular Assets A/c		[Actual Amount of Loss] [Value of Claim Accepted]	[Total Amount of Loss]
(ii)	Profit & Loss A/c Dr. To Loss by Accident/Fire/Theft A/c			

Adjustment:

If Loss by Accident/Fire/Theft is given outside the trial balance: In such case, three entries will be passed-

- Will be shown in Dr. side of Profit & Loss A/c. [At the actual amount of Loss]
- Will be deducted from the Particular Asset in the Assets side of the Balance Sheet. [At the full amount of loss]
- Will be shown in Assets side of the Balance Sheet. [By Insurance Claim] [Value of Claim Accepted]

If Loss by Accident/Fire/Theft is given inside the trial balance: It will only be shown in the Dr. side of the Profit & Loss A/c.

C} Insurance Company fully accept the claim-

Journal Entry:

Date	Particulars	LF	Amount(Dr.)	Amount(Cr.)
	Insurance Company A/c Dr. To Particular Assets A/c		[Value of Claim Accepted]	[Total Amount of Loss]

Adjustment:

If Loss by Accident/Fire/Theft is given outside the trial balance: In such case, two entries will be passed-

- Will be shown in Assets side of the Balance Sheet. [By Insurance Claim] [Value of Claim Accepted]

- Will be deducted from the Particular Asset in the Assets side of the Balance Sheet. [At the full amount of loss]

If Loss by Accident/Fire/Theft is given inside the trial balance: It will only be shown in the Dr. side of the Profit & Loss A/c.

19. Goods are given away as Charity or Free Sample:

Sometimes Goods are given as charity or free sample. In accounting terms, it is considered as loss.

Journal Entry:

Date	Particulars	LF	Amount(Dr.)	Amount(Cr.)
	Charity/Free Sample A/c Dr.			
	To Purchases A/c			

Adjustment:

If Charity/Free Sample is given outside the trial balance: In such case, two entries will be passed-

- Will be shown in the Dr. side of the Profit & Loss A/c
- Amount of Goods given as Charity/Free Sample will be deducted from Purchases A/c in the Trading A/c

If Charity/Free Sample is given inside the trial balance: It will only be shown in the Dr. side of the Profit & Loss A/c.

20. Goods used for Personal Purpose:

Sometimes proprietors withdraw goods from the business for personal use. Business treat those goods as Drawings.

Journal Entry:

Date	Particulars	LF	Amount(Dr.)	Amount(Cr.)
	Drawings A/c Dr.			
	To Purchases A/c			

Adjustment:

If Goods used for Personal Purpose is given outside the trial balance: In such case, two entries will be passed-

- Amount of Goods used for Personal Purpose (Drawings) will be deducted from Purchases A/c in the Trading A/c
- Amount of Goods used for Personal Purpose (Drawings) will be added to Drawings then deducted from Capital A/c in the Liabilities side of Balance Sheet.

21. Use of Goods in Business:

When a trader uses a portion of goods purchased for the business then that portion of goods becomes Assets for the business.

Journal Entry:

Date	Particulars	LF	Amount(Dr.)	Amount(Cr.)
	Assets A/c (Name) Dr.			
	To Purchases A/c			

Adjustment:

If Use of Goods in Business is given outside the trial balance: In such case, two entries will be passed-

- Amount of Goods used in Business will be deducted from Purchases A/c in the Trading A/c
- Amount of Goods used in Business will be shown as an Asset in the Assets side of the Balance Sheet.

22. Manager's Commission on Profit:

Sometimes the Manager in the firm asks for a commission on the Gross Profit or Net Profit. It is an expense to the business.

Journal Entry:

Date	Particulars	LF	Amount(Dr.)	Amount(Cr.)
	Profit & Loss A/c Dr. To Manager's Commission A/c			

Adjustment:

If Manager's Commission is given outside the trial balance: In such case, two entries will be passed-

- Will be shown in the Dr. side of the Profit & Loss A/c
- Amount of Manager's Commission is shown as an Outstanding Liability in the Liabilities side of the Balance Sheet.

23. Deferred Revenue Expenditure:

Sometimes there are certain expenses the benefit of which is received for some years but the payment is made in the current financial year itself. If the total burden of such expenses is put on the current financial year then it would be wrong as the profits will be reduced while the benefit out of such expense will be received for some years. Thus, such expenses are divided equally for an estimated period of receiving benefits.

Journal Entry:

Date	Particulars	LF	Amount(Dr.)	Amount(Cr.)
	Profit & Loss A/c Dr. To Deferred Revenue Expenditure A/c		[Amt belonging to this year]	

Adjustment:

If Deferred Revenue Expenditure is given outside the trial balance:

- Will be shown in the Dr. side of the Profit & Loss A/c
- The remaining amount of the Deferred Revenue Expenditure [For future years] is shown as an asset in the Assets side of the Balance Sheet.

24. Contingent Liabilities:

Contingent Liability is such a liability that is not a liability on the date of preparing the Balance Sheet but in the future due to some specific turn of events become a liability.

Accounting Treatment: No record is kept in the books of accounts for the contingent liability, it should be mentioned as a NOTE below the Balance Sheet.

25. Sale of Goods on Sale or Return Basis:

When Goods are sold as Sale or Return Basis then this should not be treated as an actual sale till the customer gives his approval. If such a sale has been already entered in the sales book then an adjustment entry should be made to rectify the error made.

Journal Entry:

SALE

Date	Particulars	LF	Amount(Dr.)	Amount(Cr.)
(i)	Sales A/c Dr. To Debtors A/c		[At Selling Price]	
(ii)	Closing Stock A/c Dr. To Trading A/c		[At Cost Price]	

Adjustment:

If Sale of Goods on Sale or Return Basis is given outside the trial balance: In such case, four entries will be passed-

- The amount will be deducted from Sales A/c in the Cr. Side of the Trading A/c.[At Selling Price]
- The amount will be deducted from Debtors on the Assets side of the Balance Sheet.[At Selling Price]
- The amount will be added to Closing Stock in the Cr. side of the Trading A/c.[At Cost Price]
- The amount will be added back to Closing Stock in the Assets side of the Balance Sheet.[At Cost Price]

26. Goods in Transit:

Sometimes ordered goods are dispatched by the supplier but not received till the date of preparing the Balance Sheet. We have to make an adjustment entry in such a case.

Journal Entry:

Date	Particulars	LF	Amount(Dr.)	Amount(Cr.)
	Goods in Transit A/c Dr.			
	To Creditors A/c			

Adjustment:

If Goods in Transit is given outside the trial balance: In such case, two entries will be passed-

- Will be shown in the Assets side of the Balance Sheet.
- Added to the Creditors A/c in the Liabilities side of the Balance Sheet.

If Goods in Transit is given inside the trial balance: It will only be shown in the Assets side of the Balance Sheet.

2.15 Illustration sums

Illustration 1

Prepare Trading Account of Archana for the year ending 31-12-96 from the following information:

	Rs.
Opening Stock	80,000
Purchases	8,60,000
Freight Inward	52,000
Wages	24,000
Sales	14,40,000
Purchase Returns	10,000

Trading Account of Archana for the year ending 31-12-1996

		Rs.			Rs.
To opening Stock		80,000	By Sales	14,40,000	
To Purchases	8,60,000		Less: Sales returns	3,16,000	11,24,000
Less: Purchase returns	10,000	8,50,000	By closing Stock		1,00,000
To Freight Inward		52,000			
To Wages		24,000			
To Import duty		30,000			
To Gross Profit c/d		1,88,000			
		12,24,000			**12,24,000**

Illustration 2

From the following balances extracted at the close of the year ended 31st Dec. 1996, prepare Profit and loss account of Mr. Raj as at that date:

	Rs.		Rs.
Gross profit	55,000	Repairs	500
Carriage on sales	500	Telephone expenses	520
Office Rent	500	Interest (Dr.)	480
General expenses	900	Fire Insurance premium	900
Discount to customers	360	Bad debts	2,100
Interest from Bank	200	Apprentice Premium (Cr.)	1,500
Travelling expenses	700	Printing & Stationery	2,500
Salaries	900	Trade expenses	300
Commission	300		

Solution:

Profit & Loss Account of Mr. Raj for the year ending 31-12-1996

	Rs.		Rs.
To Carriage on Sales	500	By Gross profit b/d	55,000
To office Rent	500	By Bank Interest	200
To General expenses	900	ByApprentice Premium	1,500
To Discount to customers	360		
To Travelling expenses	700		
To Salaries	900		
To Commission	300		
To Repairs	500		
To Telephone expenses	520		
To Interest paid	480		
To Fire Insurance Premium	900		
To Bad debts	2,100		
To Printing & Stationery	2,500		
To Trade expenses	300		
To Net Profit transferred to Capital A/c	45,240		
	56,700		56,700

Illustration 3

The following are the balances in the Ledger of Mr. Sherif for the year ended 31st March 1996.

	Rs.
Opening Stock:	
Raw materials	20,000
Work-in-progress	3,000
Finished goods	10,800
Purchase of raw materials	50,000
Sales	2,40,000
Fuel and coal	1000
Wages	32,000
Factory expenses	40,000

Office expenses	30,000
Depreciation on Plant & Machinery	3,000
Closing Stock:	
Raw materials	20,000
Work-in-progress	4,000
Finished goods	8,000

Prepare manufacturing and Trading Account for the year ended 31st March 1996.

Solution:

Manufacturing and Trading Account of Mr. Sherif for the year ending 31.3.96

Particulars		Rs.	Particulars	Rs.
To opening work-in-progress		3,000	By Closing work-in-progress	4,000
To Cost of Materials consumed:			By Cost of goods	
Opening Stock	20,000		Manufactured transferred to Trading A/c	1,25,000
Add: Purchases	50,000			
	70,000			
Less: Closing Stock	20,000	50,000		
To wages		32,000		
To Fuel & Coal		1,000		
To Factory expenses		40,000		
To Depreciation on Plant & Machinery		3,000		
		1,29,000		1,29,000
To Opening Stock of finished goods		10,800	By Sales	2,40,000
To Cost of goods manufactured		1,25,000	By Closing Stock of finished goods	8,000
To Gross Profit c/d		1,12,200		
		2,48,000		2,48,000

Illustration 5

The following is the Trial Balance of Dhandapani of Madras as on 31st December 1996.

Debit Balances	Rs.		Rs.
Opening Stock	6,200	Carriage on Sales	1,600
Buildings	34,000	Repairs	1,800
Furniture	2,000	Sundry Debtors	12,000
Purchases	42,400	Bad debts	240
Salaries	4,400	Cash in hand	2,600
Rent	1,200	Return inwards	2,040
Miscellaneous Expenses	1,000		
		Total	**1,24,080**
		Credit Balances	
Postage	560	Sales	82,920
Stationery	520	Capital	24,000
Wages	10,400	Bank Loan	6,000
Freight on purchases	1,120	Sundry Creditors	9,840
		Return outwards	840
		Interest	260
		Dividend	220
		Total	**1,24,080**

The Value of stock on 31-12-1996 was estimated at Rs.5,960. You are required to make the necessary closing entries and prepare Trading and Profit & Loss Account and a Balance Sheet as on 31st December 1996.

Closing Entries

Date	Particulars	Dr. Rs.	Cr. Rs.
1996	Trading A/c Dr.	62,160	
Dec. 31	To Opening Stock A/c To		6,200
	Purchases A/C		42,400
	To Wages A/c		10,400
	To Return Inwards A/c		2,040
	To Freight on Purchase A/c		1,120
Dec.31	[Being transfer] Dr.	82,920	
	Sales A/c Dr.	840	
	Return outwards A/c		83,760
	To Trading A/c [Being Transfer]		

Dec. 31	Closing Stock A/c	Dr.	5,960	
	To Trading A/c			5,960
	[Being incorporation of closing stock in Trading A/c]			
Dec. 31	Trading A/c	Dr.	27,560	
	To Profit & Loss A/c			27,500
	[Being Gross Profit transferred]			
Dec.31	Profit & Loss A/c	Dr.	11,320	
	To Salaries A/c			4,400
	To Rent A/c			1,200
	To Miscellaneous Expenses A/c			1,000
	To postage A/c			560
	To Stationery A/c			520
	To Carriage on Sales A/c			1,600
	To Repairs A/c			1,800
	To Bad debts A/c			240
Dec. 31	Interest A/c	Dr.	260	
	Dividend A/c	Dr.	220	
	To Profit & Loss A/c			480
	[Being interest & dividend transferred]			
Dec.31	Profit & Loss A/c	Dr.	16,720	
	To Capital A/c			16,720
	[Being net profit transferred]			

Trading and P& L A/c of Dhandapani for the year ending 31-12-96

Particulars		Rs.	Particulars		Rs.
To opening Stock		6,200	By Sales	82,920	
To Purchases	42,400		Less: Return inward	2,040	80,880
To Returns outward	840	41,560	By Closing Stock		5,960
To wages		10,400			
To Freight on purchase		1,120			
To Gross Profit c/d		27,560			
		86,840			**86,840**
To Salaries		4,400	By Gross Profit b/d		27,560
To Rent		1,200	By Interest		260
To Miscellaneous expenses		1,000	By Dividend		220
To postage		560			
To Stationery		520			
To Carriage on Sales		1,600			
To Repairs		1,800			
To Bad Debts		240			
To Net Profit Transferred to		16,720			
Capital A/c		**28,040**			**28,040**

Balance Sheet of Dhandapani as on 31-12-96

Liabilities		Rs.	Assets	Rs.
Sundry Creditors		9,840	Cash in hand	2,600
Bank Loan Capital A/c		6,000	Sundry Debtors Stock	12,000
Balance	24,000		Furniture Buildings	5,960
Add: Net Profit	16,720		Furniture	2,000
		40,720	Buildings	34,000
		56,560		**56,560**

2.16 Summary:

Final accounts, also known as financial statements, are crucial summaries of a company's financial activities and position. These documents provide a comprehensive

overview of a business's financial performance during a specific period, usually a fiscal year. Final accounts serve as essential tools for assessing the company's profitability, liquidity, and overall financial health.

Trading account : A trading account records the factory or direct expense/ incomes. It shows the results of the buying and selling of goods. This sheet is prepared to demonstrate the difference between the selling price and the cost price. The trading account is prepared to show the trading results of the business such as gross profit earned or gross loss sustained by the business.

Profit and loss account: This account is prepared to ascertain the net profit/loss and expenses of a business during an accounting year. It records the indirect expenses of a business firm, like rent, salaries, and advertising expenses. Profit and loss a/c includes expenses and losses as well as income and gains, which have occurred in business other than the production of goods and services.

Balance sheet: The balance statement demonstrates the financial position of a business on a specific date, usually at the end of a year. The financial position of a business is found by tabulating its assets and liabilities on a particular date. The excess of assets over liabilities represents the capital sunk into the business and reflects the financial soundness of a company.

2.17 Multiple Choice Questions

1. The trading account is primarily used to calculate:
   A) Net Profit B) Gross Profit C) Operating Expenses D) Net Loss
2. Which of the following is not included in the trading account?
   A) Sales Revenue B) Cost of Goods Sold C) Operating Expenses
   D) Closing Stock
3. The formula for calculating gross profit is:
   A) Sales Revenue - Operating Expenses B) Sales Revenue - Cost of Goods Sold
   C) Total Revenue - Total Expenses D) Sales Revenue - Closing Stock
4. Net profit is calculated in the:
   A) Trading Account B) Balance Sheet
   C) Profit and Loss Account D) Cash Flow Statement

5. Which of the following items would be found on a profit and loss account?

A) Sales Revenue B) Purchases C) Rent Expense D) All of the above

6. In the trading account, the cost of goods sold is calculated as:

A) Opening Stock + Purchases + Closing Stock

B) Opening Stock - Purchases + Closing Stock

C) Opening Stock + Purchases - Closing Stock

D) Purchases + Closing Stock - Opening Stock

7. Depreciation is typically recorded in the:

A) Trading Account B) Balance Sheet

C) Profit and Loss Account D) Cash Flow Statement

8. The primary purpose of the balance sheet is to:

A) Show the company's profitability over a period

B) Detail cash inflows and outflows

C) Provide a snapshot of the company's financial position at a specific point in time

D) Record all transactions in the accounting period

9. Final accounts are prepared at the end of:

A) Every month B) Every week C) Each accounting period D) Every day

10. Final accounts are important for compliance because:

A) They show daily transactions

B) They ensure adherence to legal and regulatory requirements

C) They detail monthly sales

D) They record inventory levels

Answer: 1.b, 2.c, 3.b, 4.c, 5.d, 6.c, 7.c, 8.c, 9.c, 10.b.

2.18 Short Answer Questions

1. Define Final Accounts.
2. What are the main components of Final Accounts?
3. Explain the purpose of the Income Statement.
4. What information does the Balance Sheet provide?
5. Why are Notes to the Financial Statements important?
6. Differentiate between Gross Profit and Net Profit.
7. What is the role of the Profit and Loss Accounts?
8. What is mean by Direct expenses and Indirect expenses?
9. Describe the format of a Trading Account.
10. Why is depreciation included in the Final Accounts?

2.19 Long Answer Questions

1. Explain the structure and purpose of a Trading Account.
2. Discuss the significance of the Trading Account in the preparation of final accounts.
3. Describe the steps involved in preparing a Trading Account with examples.
4. Explain the important of the Profit and Loss Account
5. What are the adjustments are affect the Profit and Loss Account? Provide a detailed explanation with examples.
6. Analyze the relationship between the Trading, Profit and Loss Account.
7. Discuss the objectives and importance of Final Accounts.
8. Explain the steps involved to preparation of Final Accounts.
9. Provide a detailed explanation of the items typically found in a Balance Sheet and their significance.
10. Describe the importance of Final Accounts for different stakeholders such as investors, creditors, and management.

2.20 Practical sums

1. N.B. The figures of net profit given as answer are after interest on capital, if any.

Prepare Trading and Profit and Loss Account for the year ended 31st March, 1990 and Balance Sheet as at that date from the following Trial Balance of K. Rama Rao.

Dr. Balances	Rs.	Cr. Balances	Rs.
Drawings	45,000	Capital	1,60,000
Goodwill	80,000	Bills Payable	33,800
Land & Buildings	60,000	Creditors	70,000
Plant & Machinery	40,000	Purchase Returns	2,650
Loose Tools	3,000	Sales	4,18,000
Bills Receivable	3,000		
Stock, 1st April, 1989	40,000		
Purchases	2,51,000		
Wages	20,000		
Carriage Outwards	500		

Carriage Inwards	1,000		
Coal	5,800		
Salaries	35,000		
Rent, Rates, & Taxes	2,800		
Discount	1,500		
Cash at Bank	25,000		
Cash in hand	400		
Sunday Debtors	45,000		
Repairs	1,800		
Printing & Stationery	500		
Bad Debts	1,200		
Advertisements	3,500		
Sales & Returns	2,000		
Furniture	11,200		
General Expenses	5,250		

Adjustments:

Closing Stock on 31st March, 1990 was Rs. 35,000

Depreciate Plant & Machinery, Tools and Furniture by 10% and Land & Buildings by 5%

Provide Rs. 1,500 for wages

Advertisements prepaid are Rs. 500

Provide 5% Debtors against bad debts and 2% against discount.

(Gross Profit, Rs. 1,34,350; Net Profit, Rs. 71,275 Total of Balance Sheet, Rs. 2,91,575.)

2. Prepare Trading and profit and Loss Account and Balance Sheet as on 31st March, 1990 from the following balances:

	Rs.
M. Mirza's Capital Account	1,19,400
M. Mirza's Drawings Account	10,550
Sundry Creditors	59,630
15% Loan Account (Credit)	20,000
Cash in hand	3,030
Cash at Bank	18,970
Sundry Debtors (including Badri Das for dishonoured	62,000

bill of Rs. 1,000)	
Bill Receivable	9,500
Provision for Doubtful Debts	2,500
Fixtures and Fittings	8,970
Plant and Machinery	28,800
Stock, 1st April, 1989	89,680
Purchases	2,56,590
Manufacturing Wages	40,970
Sales	3,56,430
Returns Inwards	2,780
Salaries	11,000
Rent and Taxes	5,620
Interest and Discount (Debit)	5,870
Travelling Expenses	1,880
Insurance (including Premium of Rs. 300 per annum paid up to 30th September, 1990)	400
Bad Debts	3,620
Commission Received	5,640

Stock in hand on 31st March, 1990 was Rs. 1,28,960. Write off half of Badri Das's dishonoured bill. Create a provision of 5% on Sundry Debtors. Charge 10% interest on Capital. Manufacturing wages include Rs. 1,200 for erection of new machinery purchased last year. Depreciate Plant and Machinery by 15% and Fixtures and Fittings by 10% per annum. Commission earned but not received amounts to Rs. 600. Interest on loan for the last two months is not paid.

(Gross Profit, Rs. 96,570; Net Profit, Rs. 52,313; B/S Totals, Rs. 2,53,233)

3. On 31st March, 1990, the following Trial Balance was extracted from the books of Chatterji:

	Dr. Rs.	Cr. Rs.
Capital A/c		90,000
Plant and Machinery	80,000	
Sales		4,07,000
Purchase	2,60,000	

Returns	6,000	5,750
Opening Stock	30,000	
Discount	350	
Bank Charges	75	
Sundry Creditors	45,000	
Sundry Creditors		25,000
Salaries	26,800	
Manufacturing Wages	40,000	
Carriage In	750	
Carriage Out	1,200	
Bad Debts Provision		525
Rent, Rates and Taxes	10,000	
Advertisements	2,000	
Cash in hand	900	
Cash in Bank	6,000	
Furniture & Fittings	20,000	
	5,29,075	5,29,075

You are asked to prepare the final accounts for the year ended 31st March, 1990 and the Balance Sheet as on that date. The following adjustments are required:

1. Closing Stock Rs. 35,000
2. Depreciation on Plant and Machinery @ 15% p.a. and on Furniture & Fittings @ 10% p.a. to be provided.
3. Bad Debts provision to be adjusted to Rs. 500.
4. Interest on capital to be allowed at 10% per annum.
5. 15% of the profits remaining after providing interest on capital is to be carried to General Reserve.

(Gross Profit, Rs. 1,11,000, Net Profit, Rs. 41,140; Balance Sheet Totals, Rs. 1,72,000).

4. On 31st March, 1990 the following Trial Balance was prepared from the books of Brown:

		Dr. Rs.	Cr. Rs
Sundry Debtors	..	30,600	
Sundry Creditors	..		10,000
Bills Receivable	..	5,000	

Plant and Machinery	..	75,000	
Purchases	..	1,90,000	
Capital Account	..		70,000
Freehold Premises	..	50,000	
Salaries	..	21,000	
Wages	..	24,400	
Postage and Stationery	..	1,750	
Carriage In	..	1,750	
Carriage out	..	1,000	
Bad Debts	..	950	
Bad Debts Provision	..		350
Office General Chages	..	1,500	
Cash at Bank	..	5,300	
Cash in hand	..	800	
Bills payable	..		7,000
Reserve	..		20,000
Sales	..		3,31,700
Closing Stock	..	30,000	
		4,39,050	4,39,050

The following adjustments are required:

1. Brown gets a salary of Rs. 12,000 per annum.
2. Allow 10% interest on Capital
3. Bad Debts Provision to be adjusted to 2½% on sundry Debtors.
4. 10% of the net profit is to be credited to the Reserve
5. It was discovered in April, 1989 that stock sheets as on 31st March, 1989 were overcast by Rs. 1,000. However, no entry was passed in April, 1989.
6. Depreciate Plant and Machinery @ 10% p.a. and Freehold Premises @ 2% p.a. You are asked to prepare the Trading and Profit and Loss Account of the firm for the year ended 31st March, 1990 and a Balance Sheet as at that date.

(Gross Profit, Rs. 1,16,550; Net Profit, Rs. 55, 291; Balance Sheet, Rs. 1,87,435.)

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UNIT– III

DEPRECIATION ACCOUNTING

Content	
3.1	3.1.1 Introduction 3.1.2 Definition 3.1.3 Causes of Depreciation 3.1.4 Basic features of depreciation 3.1.5 Depreciation Accounting 3.1.6 Objectives of providing Depreciation 3.1.7 Factors Affecting the Account of Depreciation 3.1.8 Methods of Providing Depreciation 3.1.9 Depreciation of Different Assets 3.1.10 IAS4 (International Accounting Standard)
3.2	3.2.1 Meaning of Bill of Exchange 3.2.2 Features of Bill of Exchange 3.2.3 Types of Bill of Exchange 3.2.4 Advantages of Bill of Exchange 3.2.5 Parties of Bill of Exchange 3.2.6 Promissory Note 3.2.7 Important Terms 3.2.8 Problem and Solution

3.1.1 Introduction

The concept of depreciation is closely linked to the concept of business income. In their venue generating process, the use of long term assets tends to consume their economic potential. At some point of time the assets become useless and are disposed of and possibly replaced. The economic potential so consumed represents the expired cost of these assets and must be recovered from the revenue of the business in order to determine the income earned by the business. Depreciation may, therefore, be defined as

that portion of the cost of the assets that is deducted from revenue for assets services' used in the operation of a business.

3.1.2 Definition

In order to have a clear understanding about the concept of depreciation, it will be useful to quote definitions given by some prominent writers.

According to Pickles, "Depreciation is the permanent and continuing diminution in the quality, quantity or value of an asset".

The Institute of Chartered Accountants of England and Wales defines depreciation as"that part of the cost of a fixed asset to its owner which is not recoverable when the asset isfinally put out of use by him. Provision against this loss of capital is an integral cost of conducting the business during the effective commercial life of the asset and is not dependent upon the amount of profit earned."

According to Spicer and Pegler, "depreciation may be defined as the measure of the exhaustion of the effective life of an asset from any cause during a given period."

From the above definitions, it can be concluded that depreciation is a gradual decrease in the value of an asset from any cause.

3.1.3 CAUSES OF DEPRECIATION

The causes of depreciation are as follows:

Wear and tear: Assets get worn or torn out on account of constant use as is the case with plant and machinery, furniture, and fixtures used in a factory.

Exhaustion: An asset may get exhausted through working. This is the case with mineral mines, oil wells, etc. On account of continuous extraction of minerals or oil, a stage comes when the mine or well gets completely exhausted and nothing is left.

Obsolescence: Some assets are discarded before they are worn out because of changed conditions. For example, an old machine which is still workable may have to be replaced by an machine because of the latter being more efficient an economical. Such a loss on account of new inventions or changed fashions is termed as loss on account of obsolescence.

Efflux of time: Certain assets get decreased in their value with the passage of time. This is true in the case of assets like lease hold properties, patents or copyrights.

Accidents: An asset may meet with an accident and, therefore, it may get depreciation in its value.

On the basis of the above causes, it can be said that depreciation, is the decrease or depletion in the value of an asset due to wear and tear, lapse of time, obsolescence, exhaustion and accidents,

3.1.4 Basic features of depreciation

1. The term depreciation is used only in respect of fixed assets. Of course, the current assets may also lose their value. Loss on account off all in their value is taken care of by valuing them for Balance Sheet purpose at cost or market price whichever is less.

2. Depreciation is a charge against profits. This means that true profit of the business cannot be ascertained without charging depreciation.

3. Depreciation is different from maintenance. Maintenance expenses are incurred for keeping the machine in a state of efficiency. However, any degree of maintenance cannot assure that the asset will never reach a state of scrap. Of course, good maintenance delays this stage but it cannot absolutely prevent it.

4. All fixed assets, with certain possible exceptions e.g. land, and antiques, etc., suffer depreciation although the process may be invisible or gradual.

3.1.5 DEPRECIATION ACCOUNTING

Depreciation Accounting is mainly concerned with a rational and systematic distribution of cost over the estimated useful life of the asset. According to the American Institute of Certified Public Accountants, Depreciation Accounting is "a system of accounting which aims to distribute the cost for other basic values of tangible capital as sets less salvage (if any) over the estimated useful life of the unit (which may be a group of assets) in a systematic and rational manner. It is the process of allocation and not of valuation."

The objective of Depreciation Accounting is to absorb the cost of using the assets in different accounting periods in away so as to give the true figures of profit or loss made by the business.

3.1.6 Objectives of providing Depreciation

The following are the objectives of providing depreciation:

Ascertainment of true profits: When an asset is purchased, it is nothing more than a payment in advance for an expense. For example, if a building is purchased for Rs.10,000 for business purposes, the effect of such a purchase will be saving in the cost of rent in the future. But, after a certain number of years, the building will become useless. The cost of the building is, therefore, nothing except paying rent in advance for a period of years. If the rent had been paid, it would have been charged as an expense for determination of the true profits, made by the business during a particular period. The amount paid for the purchase of building should, therefore, be charged over a period of time for which the asset would be serviceable.

Presentation of true financial position: The assets get depreciated in their value over a period of time on account of various factors as explained before. In order to present a true state of affairs of the business, the assets should be shown in the Balance Sheet, at their proper values.

Replacement of assets: Assets used in the business need replacement after the expiry oftheir service life. By providing depreciation a part of the profits of the business is kept in the business which can be used for purchase of new assets on the old fixed assets becoming useless.

3.1.7 Factors Affecting the Account of Depreciation

Following are the three important factors which should be considered for determining the amount of depreciation to be charged to the Profit and Loss Account in respect of a particular asset.

Cost of the asset: The cost of the asset includes the invoice price of the asset less any trade discount plus all costs essential to bring the asset to a usable condition. It should be noted that financial charges, such as interest on money borrowed for the purchase of the asset, should not be included in the cost of the asset.

Estimated scrap value: The terms crap value means there si dual or the salvage value which is estimated to be realised on account of the sale of the asset at the end of its useful

life. Indetermining the scrap value, the cost to be incurred in the disposal or removing of the assets should be deducted out of the total realisable value.

Estimated useful life: This is also termed as economic life of the asset. This may becalculated in terms of years, months, hours, units of output or other operating measures such as kilometers in case of a taxi or a truck.

3.1.8 METHODS OF PROVIDING DEPRECIATION

The following are the various methods of providing depreciation:

i) Fixed installment or Straight Line Method

ii) Diminishing Balance or Written Down Value Method

iii) Sum of the years [orDigits] Method

iv) Annuity Method

v) Sinking Fund or Depreciation Fund Method

vi) Insurance Policy Method

vii) Revaluation Method

viii) Depletion Method

ix) Machine Hour Rate Method

We will now discuss in detail each of the above Methods.

1. Fixed Installment or Straight Line Method:

In this method, a suitable percentage of original cost is written off the asset every year throughout the effective life of the asset. Thus if an asset costs Rs. 50,000 and 10 percent depreciation is thought proper (over its useful life of 10 years),Rs.5000 would be written off every year. In this method, the amount of depreciation is arrived at as under:

$$\text{ValueDepreciation} = \frac{\text{Cost} - \text{Scrap}}{\text{Estimated LifeinYears}}$$

Merits:

- This method is very simple to understand and easy to apply.
- The value of the asset can be reduced to zero or to its scrap value under this method.

- This method is very suitable particularly in case of those assets which get depreciated more on account of expiry of period e.g., Lease-hold properties, patent Rights, etc.

Demerits:

- This method does not take into account the effective utilization of the asset. The amount of depreciation charged in this method is same every year irrespective of the use of the asset.
- This method tends to report an increasing rate of return on investment in the asset on account of the fact that net balance of the asset account is taken. This is not justifiable.

Illustration1

ABC Ltd. purchases a machinery for a sum of Rs.48,000 on 1st January 1990. Installation charges are Rs.3,000. The machinery is estimated to have a scrap value of Rs.1,000 at the end of its useful life of five years. You are required to prepare the Machinery account for five years charging depreciation according to Straight Line Method.

Solution

Annual Depreciation to be charged = $\frac{C - S}{N} = \frac{51,000 - 1,000}{5}$

Dr. Machinery Account Cr.

Date	Particulars	Rs.	Date	Particulars	Rs.
1990 Jan 1	To Bank To Bank (installation charges)	48,000 3,000	1990 Dec.31	ByDepreciation "Balance c/d	10,000 41,000
		51,000			**51,000**
1991 Jan 1	To Balance b/d	41,000	1991 Dec.31	By Depreciation "Balance c/d	10,000 31,000
		41,000			**41,000**
1992 Jan. 1	To Balance b/d	31,000	1991 Dec.31	By Depreciation "Balance c/d	10,000 21,000
		31,000			31,000
1993 Jan. 1	To Balance b/d	21,000	1993 Dec.31	By Depreciation "Balance c/d	10,000 11,000

		21,000			21,000
1994 Jan. 1	To Balance b/d	11,000	1994 Dec.31	By Depreciation "Balance c/d(Scrap value)	10,000 1,000
		11,000			11,000

2. Diminishing Balance or Written Down Value Method

In this method, the rate or percentage of depreciation is fixed and depreciation is charged on the book value of the asset standing at the beginning of each year. Thus, the amount of depreciation goes on decreasing every year. For example, if the cost of an asset is Rs. 10,000 and the rate of depreciation is 10%, then the amount of depreciation to be charged in the firstyear will be Rs.1000 [10% on Rs.10,000]. In the second year, depreciation will be charged at 10% on the book value of theasset i.e., on Rs.9000 [i.e., 10000-1000] and so on.

Merits:

- This method is simple to understand and easy to follow.
- This method puts an equal burden for the use of the asset on each subsequent year.The amount of depreciation goes on decreasing for each subsequent year while the charge for repairs goes on increasing for each subsequent year. Thus, the increasein the cost of repairs for each subsequent year is compensated by decrease in the amount of depreciation for each subsequent year.

Demerits:

- The value of the asset cannot be brought down to zero under this method.
- The determination of a suitable rate of depreciation is also difficult under this method as compared to the Fixed Installment Method.

Illustration2

Cosmos Enterprises Ltd. acquired a machine on 1st January 1992 at a cost of Rs. 18,000 and spent Rs.2,000 on its installation. The firm writes off depreciation at 10% of the original cost every year. Show the Machinery Account for three years.

Solution

Machinery Account

Date	Particulars	Rs.	Date	Particulars	Rs.
1992 Jan 1	To Bank To Bank (installation charges)	18,000 2,000	1992 Dec. 31	By Depreciation (10%onRs.20,000) "Balancec/d	2,000 18,000
		20,000			**20,000**
1993 Jan 1	To Balance b/d	18,000	1993 Dec. 31	By Depreciation (10% on Rs.18,000) "Balance c/d	1,800 16,200
		18,000			**18,000**
1994 Jan.1	To Balance b/d	16,200	1991 Dec. 31	By Depreciation(10% on Rs.16,200) "Balance c/d	1,620 14,580
		16,200			**16,200**
1995	To Balance b/d	14,580			

3. Sum of the Years (or Digits) Method:

This method is on the pattern of Diminishing Balance method. Under this method, the amount of depreciation to be charged to Profit and Loss Account goes on decreasing every year. The depreciation is calculated according to the following formula:

Remaining Life of the Asset (including the current year) x Original cost

Sum of all the digits of the life of the asset in years

For example, if the cost of an asset is Rs.10000 and it has an effective life of 5 years, the amount of depreciation to be written off each year will be computed as follows:

1st Year - 5 / (1+2+3+4+5) x 1000 = 5/15 x10000 = Rs. 3333

2nd Year = 4/15 x 10000 = Rs. 2666

3rd Year = 3/15 x 10000 = Rs. 2000

4th Year = 2/15 x 10000 = Rs.1333

5th Year = 1/15 x10000 = Rs. 667

4. Annuity Method:

The three methods discussed above ignore interest factor. The Annuity Method takes care of this factor. Under this method, the depreciation is charged on the basis that besides losing the original cost of the asset, the business also loses interest on the amount used for buying the asset. The 'interest' here means the interest which the business could have earned otherwise if the money used in purchasing the asset would have been invested in some other form of investment. Thus, according to this method, such an amount is charged by way of depreciation which takes into account not only the cost of the asset but also interest there on at an accepted rate. The amount of interest is calculated on the book value of the asset in the beginning of the year. The amount of depreciation is uniform and is determined on the basis of the Annuity Table. An extract of the Annuity Table is shown in the Appendix. The following journal entries are passed incase depreciation is charged according to this method.

a. On purchase of an asset : Asset A/C Dr.
To Bank

b. For Charging interest AssetA/C Dr.
ToInterest A/C

c. For charging Depreciation: Depreciation A/C Dr.
ToAsset A/C

Illustration3

A lease is purchased on 1st January 1990 for four years at a cost of Rs. 20,000. It is proposed to depreciate the lease by the annuity method charging 5% interest. Show the Lease Account for four years and also the relevant entries in the P & LA/C.

Solution:

Annuity Table shows that to depreciate Re.1 by annuity method over 4 years, charging 5% interest, one must write off a sum of Re.0.282012. To write off Rs.20,000 one requires to write off every year Rs.5.640.24 [i.e.. 0.282012 x20,000].

Dr. Lease Account Cr.

Date	Particulars	Rs.	Date	Particulars	Rs.
1990	To Bank	20,000	1990	By Depreciation	5,640.24
Jan. 1	" Interest	1,000	Dec.31	" Balance c/d	15,359.76

Dec.31	(5%on 20,000)				
		21,000			**21,000**
1991 Jan. 1 Dec.31	To Balanceb/d " Interest (5% on 15359.76)	15,359.76 767.99	1991 Dec.31	By Depreciation " Balancec/d	5,640.24 10,487.51
		16,127.75			**16,127.75**
1992 Jan. 1 Dec.31	To Balance b/d " Interest (5%on10487.51)	10,487.51 524.38	1992 Dec.31	By Depreciation "Balance c/d	5,640.24 5,371.65
		11,011.89			**11,011.89**
1993 Jan. 1 Dec.31	To Balance b/d " Interest (5%on5371.65)	5,371.65 268.59	1993 Dec.31	By Depreciation	5,640.24
		5,640.24			**5,640.24**

ProfitandLoss Account

Date	**Particulars**	**Rs.**	**Date**	**Particulars**	**Rs.**
1990Dec.31	To Depreciation a/c	5640.24	1990Dec.31	By Interest a/c	1,000.00
1991Dec.31	To Depreciation a/c	5640.24	1991Dec.31	By Interest a/c	769.99
1992Dec.31	To Depreciation a/c	5640.24	1992Dec.31	By Interest a/c	524.00
1993Dec.31	To Depreciation a/c	5640.24	1993Dec.31	By Interest a/c	268.59

Sinking Fund or Depreciation Fund Method:

One of the objectives of providing for depreciation is to provide for replacement of the asset at the end of its useful life. In case of the four methods discussed earlier, the amount of depreciation charged from the Profit and loss Account continues to remain in the business.However, this amount may get invested in all sorts of assets in course of running the business thus making it difficult to buy a new asset in place of the old one. Depreciation Fund method takes care of such a contingency. According to this method, the amount charged by way of depreciation is invested in readily saleable securities carrying a certain rate of interest. The amount received on account of interest from these securities is also invested from time to time together with the annual amount charged, by way of depreciation. At the end of the useful life of the asset, when replacement is required, the

securities are sold away and the money realized on account of the sale of the securities is used for purchase of a new asset. How much amount is to be invested every year so that a given sum is available at the end of a given period depends on the rate of interest. The Sinking Fund table shows how much is to be invested every yeartogetherwith theinterestearned so thatat the endoftheperiod onegets Re. 1.

Merits

- Periodic depreciation together with realized interest is invested outside the business in liquid securities which readily provides ready money for replacing the old asset.
- Over all as also periodic depreciation is smaller than the asset's actual depreciable cost due to deduction of interest.

Demerits

- Sinking fund method assumes a constant rate of return on every period ic investment in identical securities. This is hardly true in this dynamic world where rates do vary now and then. This upsets the earlier periodic allocation for depreciation.
- This method puts an increasing burden on the profit and loss of each year on Account of a fixed charge for depreciation but increasing charging for repairs. The journal entries are as follows:

A] At the end of First Year:

i) On setting aside the amount of depreciation:

Depreciation A/c (or P&La/c) Dr.
(With the periodic depreciation)
To Depreciation Fund A/c
(Calculated from the SFTable)

ii) For investing the money charged by way ofDepreciation:

Depreciation Fund Investment A/c Dr.
To Bank A/c

B] At the end of each subsequent accounting year:

i) For receipt of interest:

BankA/c Dr. (With the interest received)

To Depreciation FundA/c (transferred to the credit of Depreciation Fund A/c)

iv) For setting aside the amount of depreciation:

Depreciation (or P&L A/c) A/c Dr. With the annual installment of
To Depreciation Fund A/c depreciation

v)For investing the money:

Depreciation Fund Investment A/c Dr. With the annual installment plus interest earned
To Bank A/c

C] At the end of the last year:

vi) For receipt of interest:

Bank A/c Dr. With the amount of interest received
To Depreciation Fund A/c transferred to D.F. A/c

vii) For setting aside the amount of depreciation:

Depreciation A/c (or P&L A/c)Dr. With the annual installment
To Depreciation Fund A/c of Depreciation

No investment will be made in the last year, since the asset is due for replacement.

viii) For sale of investment:

Bank A/c Dr. With the net sale proceeds of Dep. Fund Investments
To Depreciation Fund Investment A/c

ix) The profit or Loss on sale of Depreciation Fund Investments will be transferred to the depreciation Fund Account:

a) In case of Profit:

Depreciation Fund Investments A/c Dr. With the amount of profit on sale of investments
To Depreciation Fund A/c

b) In case of Loss:

Depreciation Fund A/c Dr. With amount of loss on sale of investments

To Depreciation Fund Investment A/c

x)For sale of old Asset:

BankA/c Dr. With the sale proceeds of old asset

To old Asset A/c

xi) The balance in the Depreciation Fund Account represents accumulated depreciation and it will be transferred to old asset account. Theentry will be:

Depreciation Fund A/c Dr. with the amount of

To old Asset A/c accumulated depreciation

xii) The balance in old Asset Account represents profit or loss which will be transferred to P&L A/C.

xiii) When new asset is bought:

New Asset A/c Dr. with the sale proceeds of investments

To Bank A/c and old asset

Illustration4

A firm purchased a machinery or 1st January 1990 for Rs.20,000 whose estimated life is four years. It is decided to provide for the replacement of the asset at the end of four years by setting up a Depreciation Fund. It is expected that investments will yield interest at 4%p.a.Sinking Fund Table shows that to provide the requisite sum at 4% at the end of four years, an investment of Rs.4709.80 [i.e., 0.235490 X 20,000] is required. Investments are made to the nearest rupee.

On 31st December 1993, the investments were sold for Rs.15,000. On 1st January 1994, new machinery was purchased for Rs.24000.

Pass journal entries and prepare the necessary ledger accounts.

Journal

1990 Jan 1	Machinery A/c Dr. To Bank A/c	20,000	 20,000

	(Purchase of Machinery for 4years)		
Dec.31	Depreciation A/c Dr. To Depreciation Fund A/c (Annual Depreciation to be provided)	4,709.80	4,709.80
	Depreciation Fund Investments A/c Dr. To Bank A/c (Annual installment invested)	4,710.00	4,710.00
1991 Dec.31	Bank A/c Dr. To Depreciation Fund A/c (Interest on investments transferred to fund)	188.40	188.40
	DepreciationA/c Dr. To Depreciation Fund A/c (Annual Depreciation set aside)	4,709.80	4,709.80
	Depreciation Fund Investment A/c Dr. To Bank A/c (Annual installment with interest invested)	4,989.00	4,898.00
1992 Dec.31	Bank A/c Dr. To Depreciation Fund A/c (Interest on Investments transferred to Fund)	384.32	384.32
	Depreciation A/c Dr.	4,709.80	

	To Depreciation Fund A/c (Annual depreciation set aside)		4,709.80
	Depreciation Fund Investment A/c Dr. To Bank A/c (Annual installment with interest invested)	5,094.00	5,094.00
1993 Dec.31	Bank A/c Dr. To Depreciation Fund A/c (Interest on investments transferred to Fund)	588.08	588.08
	Depreciation A/c Dr. To Depreciation Fund A/c (Annual Depreciation set aside) Bank A/c Dr. To Depreciation Fund Investment A/c (Sale of DFinvestment for Rs.15,000)	4,709.80 15,000.0	4,709.80 15,000.0
	Depreciation Fund Investment A/c Dr. To Depreciation Fund A/c (Profit on DF Investments transferred)	298.00	298.00
	Depreciation Fund A/c Dr. To Machinery A/c (Transfer of Machinery A/c to DF A/c upon its expiry)	20,000	20,000
	Depreciation Fund A/c Dr. To P & LA/c (Balance left in the DF A/c transferred to P&L A/c)	298.00	298.00
1994 Jan. 1	New Machinery A/c Dr. To Bank (New machinery purchased)	24,000.00	24,000.00

Depreciation Fund Account

Date	Particulars	Rs.	Date	Particulars	Rs.
1990 Dec.31	To Balance c/d	4,709.00	1990 Dec.31	By Depreciation A/c	4,709.00
		4,709.00			**4,709.00**
1991 Dec.31	To Balance c/d	9,608.00	1991 Jan.1	By Balance b/d	4,709.80
				"Intereston DF Investments A/c	188.40
			Dec.31	"Depreciation A/c	4,709.80
		9,608.00			**9,608.00**
1992 Dec.31	To Balance c/d	14,702.12	1992 Jan.1	By Balance b/d	9,608.00
				"Interest on DF Investments A/c	384.32
				"Depreciation A/c	4,709.12
		14,702.12			**14,702.12**
1993 Dec.31	To Machinery A/c (transfer)	20,000.00	1993 Jan.1	ByBalanceb/d	14,702.12
Dec.31	To P & L A/c (Balance transferred)	298.00		"Interest on DF Investments A/c	588.08
				" Depreciation A/c	4.709.80
				" DF Investments A/c (profit)	298.00
		20,298.00			**20,298.00**

MachineryAccount

Date	Particulars	Rs.	Date	Particulars	Rs.
1990Jan.1	To Bank A/c	20,000	1991Dec.31	By Balance c/d	20,000
1991Jan.1	To Balance b/d	20,000	1991Dec.31	By Balance c/d	20,000
1992Jan.1	To Balance b/d	20,000	1992Dec.31	By Balance c/d	20,000
1993Jan.1	To Balance b/d	20,000	1993Dec.31	By Depreciation Fund A/c transfer	20,000

Depreciation Fund Investment Account

Date	Particulars	Rs.	Date	Particulars	Rs.
1990 Dec.31	To Bank a/c	4,710.00	1990 Dec.31	By Balance c/d	4,710.00
		4,710.00			**4,710.00**
1991 Jan.1	To Balance b/d To Bank A/c (Rs4710+188.40)	4,710.00 4,898.00	1991 Dec.31	By Balance c/d	9,6,08.00
		9,608.00			**9,608.00**
1992 Jan. 1	To Balance b/d To Bank A/c	9,608.00 5,094.00	1992 Dec.31	By Balance c/d	14,702.00
		14,702.00			**14,702.00**
1993 Jan 1 Dec.31	To Balance b/d To Dep.fund A/c (profit transferred)	 14,702.00 298.00	1993 Dec.31	By Bank	15,000.00
		15,000.00			**15,000.00**

Interest on Depreciation Fund Investment A/c

Date	Particulars	Rs.	Date	Particulars	Rs.
1991 Dec.31	To Depreciation Fund A/c transfer	188.40	1991 Dec.31	By Bank A/c	188.40
1992 Dec.31	To Depreciation Fund A/c transfer	384.32	1992 Dec.31	By Bank A/c	384.40
1993 Dec.31	To Depreciation Fund A/c transfer	588.08	1993 Dec.31	By Bank A/c	588.08

New Machinery Account

Date	Particulars	Rs.	Date	Particulars	Rs.
1994Jan.1	To Bank	24.000			

5. InsurancePolicyMethod

This method is similar to the Depreciation Fund method. Instead of making investment, arrangements are made with the insurance company which will receive premium annually and pay at the end of the fixed period, the required amount with which the old asset can be replaced premium have to be paid at the beginning of each year. The annual premium is treated as the annual depreciation.

The following entries are passed:

A. First and subsequent years:

On payment of insurance premium at the beginning of each year

(i) Depreciation Insurance Policy A/C Dr.

To Bank

At the end of the year for providing depreciation:

(ii) Profit and Loss A/C Dr.

To Depreciation Fund A/C

B. At the end of the last year:

On realization of money from the Insurance Co.,

(i) Bank A/C Dr.

To Depreciation Insurance Policy A/C

(ii) For transfer of profit on insurance policy

Depreciation Insurance Policy A/C Dr.

To Depreciation Fund A/C

(iii) For transfer of accumulated depreciation to the Asset A/C

Depreciation Fund A/C Dr.

To Asset A/c

Illustration5

Alfa Co. Ltd., purchased a machine on 1st January 1992 for Rs.11.000. It decided to provide for its replacement by Insurance policy method. The company took an insurance policy for 3years for Rs.10,000 in consideration of the yearly premium of Rs.3150.

Show the Insurance Policy A/c, Depreciation Fund A/C and the Machinery A/c assuming that the retired machine realizes Rs.900 as scrap.

Solution

Dr. **InsurancePolicy Account** Cr.

Date	Particulars	Rs.	Date	Particulars	Rs.
1992 Jan. 1	To Bank (Premium)	3,150	1992 Dec.31	By Balance c/d	3,150
		3,150			**3,150**
1993 Jan 1	To Balance b/d To Bank (Premium)	3,150 3,150	1993 Dec.31	By Balance c/d	6,300
		6,300			**6,300**
1994 Jan 1	To Balance b/d To Bank (Premium) To Depreciation A/c (Profit Transferred)	6,300 3,150 550	1994 Dec.31	By Bank	10,000
		10,000			**10,000**

Depreciation Fund Account

Date	Particulars	Rs.	Date	Particulars	Rs.
1992 Dec.31	To Balance c/d	3,150	1992 Dec.31	By P&L A/c	3,150
		3,150			**3,150**
1993 Jan 1	To Balance c/d To Bank (Premium)	6,300 3,150	1993 Jan 1	By Balance b/d By P&L A/c	3,150 3,150
		6,300			**6,300**
1994 Dec.31	To Machinery A/c Transfer	10,000	1994 Dec.31	By Balance b/d By P& L A/c By Insurance PolicyA/c	6,300 3,150 550

		10,000			**10,000**

Machinery Account

Date	Particulars	Rs.	Date	Particulars	Rs.
1992 Jan. 1	To Bank	11,000	1992 Dec.31	By Balance c/d	11,000
1993 Jan 1	To Balance b/d	11,000	1993 Dec.31	By Balance c/d	11,000
1994 Dec.31	To Balance b/d	11,000	1994 Dec.31	By Depreciation Fund A/c By Bank By P & L A/c Loss(transferred)	10,000 900 100
		11,000			**11,000**

7. **Revaluation Method:**

This method is used in case of loose tools, live stock, etc. At the end of every year, the loose tools in hand are valued properly and enough depreciation is written off to bring the value of the assets to its proper figure. Suppose, a firm had in the beginning of the year loose tools worth Rs.5000. During the year it purchased new tools costing Rs.2000 thus making a total of Rs.7000. At the end of the year the loose tools are found to be worth Rs. 5500. Then the depreciation to be written off is Rs. 1500 (ie Rs. 7000 -5500).

8. **Depletion Method:** This method is most suitable for mines quarries, etc. from which acertain quantity of output is expected to be extracted. The value of mines depends only on the quantity of minerals that can be extracted. When the whole quantity is taken out, the mine loses its value. Hence one can say that the mine depreciates according to the quantity mined. The rate of depreciation is worked out as so much per tonne. It is obtained by simply dividing the cost of the mine by the total quantity of mineral expected to be extracted. Thus, if a mine is acquire data cost of Rs.10,00,000 and if it is expected that a total of 8,00,000 tonnes of minerals will be extracted, then the depreciation rate will be Rs. 1.25 per ton, (i.e), Rs.10,00,000 / 8,00,000. The total depreciation to be written off will depend upon the quantity mined. If, in the above example, in the first year 30,000 tonnes are taken out, the depreciation will be 30,000 x Rs.1.25 or Rs 37,500. If, in the next year, the output is 40,000 tonnes, the depreciation will be 40,000 x Rs.1.25 or Rs. 50,000 and so on.

9. Machine Hour Rate Method:

This method is useful in case of machines. The life of the machine is fixed in terms of hours. Hourly rate of depreciation is worked out by the total number of hours for which the machineis expected to be used. Suppose, a machine costing Rs. 62,000 and having an estimated scrap value of Rs.2,000 is expected to be used for 30,000 hours in all. The hourly rate of depreciation is then Rs. 60,000 / 30,000 or Rs 2.00. Depreciation to be written off in a year will be ascertained by multiplying the hourly rate of depreciation by the number of hours that the machine actually works in the year. To continue the example, suppose the machine works for 1,000 hours in the first year and 1,500 hours in the next. The depreciation for the first year will be Rs.2,000 (ieRs.2.00X1,000) and Rs.3,000 in the next. The students can observe that the is method is similar to the first method-fixed installment method.

Depreciation on an asset purchased in the course of a year:

There are two alternatives available regarding charging of depreciation on an asset which has been purchased during the course of an accounting year.

(a) Depreciation may be charged for the full year irrespective of the date of purchase at the given rate. This is also accepted by the Income Tax authorities.

(b) Depreciation may be charged only for the part of the year for which the asset could have been made available for use on account of it's being purchased, during the course of the year. For example, if the asset has been purchased on 1st July, 1980 and the accounting year ends on 31st December, depreciation may be charged only for a period of six months.

Note: The students are advised to give the assumption made by them in the absence of any instructions in the question. However, if the rate of depreciation has been given as a certain percentage per annum and the date of the purchase of the asset has been given, it would be advisable to charge depreciation only for the part of the accounting year for which the asset has been made available for use.

Sale of an asset during the year: In case an asset is sold during the course of the year, the amount realized should be credited to the Asset Account. Depreciation for the period for which the asset has been used (i.e., up to the date of sale) should be written off in the usual manner.Any balance in the Asset Account representing profit or loss on sale of the asset should be transferred to the Profit and Loss Account.

Change in the Method of Depreciation: Sometimes a change in the method of depreciation may be required. For example, a firm may change the method of depreciation from Fixed installment Method to Reducing Balance Method or vice versa. In such a case, there can be two different situations:

(1) Change in the method of depreciation may be desired from the current year onwards. In such a case, depreciation will be charged according to the new method from the current year.

(2) Change in the method of depreciation may be desired from aback date (with retrospective effect). In such a case, adjustments will have to be made in the current year for any additional or shortage of depreciation charged in earlier years. In such acase, the best course would be to compute the amount of depreciation which has already been charged according to the old method and the amount of depreciation that is to becharged according to the new method separately. The difference, if any, should be credited (or debited) to the Asset Account in the current year and should be shown as a separate charge (or income) in the Profit and Loss Account of the current year of thefirm.

3.1.9 DEPRECIATION OF DIFFERENT ASSETS

The following observations can be made regarding charging of depreciation on different assets:

Goodwill: Depreciation does not arise in the value of the goodwill of the business unless the profits of the firm are declining. Since, goodwill is an intangible asset; it will be advisable to **write off** the value of the good will over are as on able period. The amount written off should be shown separately in the Profit and Loss Account.

Free – hold land: No depreciation need be charged in case of such properties.

Free- hold buildings, plants, ship, etc: Fixed Installment Method or Diminishing

Balance Method may be used for charging depreciation on these assets. The end year our should Be to write off the asset during its effective life. In case of **Plant and Machinery, the Machine Hour Rate method** can also be profit ably used.

Lease-hold land and buildings: The Fixed Installment Method should generally be used for writing off depreciation in respect of such assets. **However,** Depreciation Fund Method or Insurance Policy Method can also be used profit ably for assets coming in the 3rd and 4th category discussed above.

Loose tools, jigs, livestock, etc: Revaluation Method is the most appropriate method for charging depreciation on these assets.

Patents, trademarks, etc: These assets have a maximum legal life. However, their commercial life may be much shorter. Such assets should, therefore, be depreciated according to the **Fixed Installment Method** in a way so that they are written off within their legal or commercial life, whichever is shorter.

Mines, oil wells, quarries, etc: Depreciation should be charged according to the **Depletion Method** in case of these assets.

It should be noted that the method of charging depreciation in respect of assets should be consistent year after year. In case, the method of depreciation is changed, such fact together with the effect on profit, on account of the change in the method of depreciation has to be disclosed by way of a note in the final accounts of the business. Similarly, if it has not been possible to charge depreciation on assets on account of in adequacy of profits in any year, such fact should also be disclosed in the Final Accounts of the business for that particular year.

DEPRECIATION POLICY: The management has to adopt a suitable depreciation policy keeping in view the following objectives: (i) Recovery of the original investment i.e. the acquisition cost of the asset before the expiry of the economic life of the asset. (ii) Ensuring auniform rate of return on investments. (iii) Generating sufficient funds for the replacement of the assets after the expiry of its economic life. (iv) Deriving maximum tax benefit. (v) Ascertainment of correct profit or loss. The above objectives can be considerably achieved if the management takes care of the following aspects in framing its depreciation policy.

(i) **Selection of an appropriate method:** The management should select an

appropriate method keeping in view the nature of the asset and the prime objective of the management.

(ii) Periodic review of provision: The choice of the method determines the amount of the depreciation and the mode of its recording. However, the management must review periodically whether the provision for depreciation which is being made is proper or not .Any under or over provision in the context of changed circumstances should properly be adjusted in the books of accounts.

(iii) Evaluation and disclosure of depreciation policy: The depreciation policy being followed by the business should be evaluated in the context of tax incidence, price level changes, Government regulation, etc. The effect of any change in the depreciation policy in an accounting period should be quantified and disclosed in the financial statements of the business.

3.1.10 IAS 4 (INTERNATIONAL ACCOUNTING STANDARD)

Depreciation Accounting

The standard was issued in October, 1976. The main recommendations are as summarized below:

(1) The depreciable amount of a depreciable asset should be allocated on a systematic basis to each accounting period during the useful life of the asset;

(2) The depreciation method selected should be applied consistently from period toperiod unless altered circumstances justify a change. In an accounting period in which the method is changed, the effect should be quantified and disclosed and the reason for the change should be stated.

(3) The useful life of a depreciable asset should be estimated after considering the following factors:

(a) expected physical wear and tear taking into consideration the number of shifts for which the asset is to be used and repairs and maintenance;

(b) Obsolescence;

(c) Legal or other limits on the use of the asset, expiry dates of related leases.

(4) The useful life of major depreciable assets or classes of depreciable assets should be reviewed periodically and depreciation rates adjusted for the current and future periods if expectations are significantly different from the previous estimates. The effect of change should be disclosed in the accounting period in which the change takes place.

(5) The valuation bases used for determining the amount at which depreciable assets are stated should be included with the disclosure of other accounting policies as described in IASI (Disclosure of Accounting policies).

(6) The following should be disclosed for each major class of depreciable assets:

(a) The depreciation methods used.

(b) The useful life or the depreciation rates used.

(c) Total depreciation allocated for the period.

(d) The gross amount of depreciable assets and the related accumulated depreciation.

These provisions will be applicable to financial statements covering periods beginning on or after 1st January, 1977.

Depreciation is to be charged in each accounting period even though the value of an asset has increased and irrespective of the level of profitability of the enterprise and of taxation considerations. Land should not usually be regarded as depreciable asset, except when it has a limited useful life. Land and buildings are to be considered separately, not in aggregate.

Summary:

Depreciation is a key concept in accounting, representing the allocation of the cost of tangible fixed assets over their useful lives. This process is essential for accurate financial reporting, tax calculation, and informed decision-making.

Purpose of Depreciation

Cost Allocation: Distributes the cost of an asset over its useful life.

Matching Principle: Ensures expenses are recorded in the same period as the revenues they help generate.

Asset Valuation: Reflects the decline in value due to usage, wear and tear, or obsolescence.

Financial Planning: Helps in budgeting for future capital expenditures and maintenance.

Depreciation is a critical accounting process that ensures financial statements accurately reflect the usage and value of fixed assets over time. By understanding the different methods and their impacts on financial statements, businesses can make informed decisions regarding asset management, tax planning, and overall financial strategy.

Multiple Choice Questions

1. Which of the following methods of depreciation calculates the depreciation expense using a constant percentage of the book value at the beginning of each period?

A. Straight-line method B. Units of production method

C. Double declining balance method D. Sum-of-the-years'-digits method

2. In the context of depreciation, what is the "salvage value"?

A. The amount of depreciation expense for the first year

B. The total accumulated depreciation at the end of the asset's useful life

C. The estimated residual value of an asset at the end of its useful life

D. The cost to repair the asset after it becomes fully depreciated

3. Which of the following methods of depreciation is most suitable for an asset that depreciates more in its early years?

A. Straight-line method B. Sum-of-the-years'-digits method

C. Units of production method D. All of the above

4. If an asset is purchased for Rs.10,000, has a salvage value of Rs 2,000, and a useful life of 5 years, what is the annual depreciation expense using the straight-line method?

A. Rs.1,600 B. Rs.2,000 C. Rs.2,500 D. Rs.3,200

5. An asset has a cost of Rs.15,000, a salvage value of Rs.3,000, and a useful life of 4 years. Using the double declining balance method, what is the depreciation expense for the first year?

A. Rs.3,000 B. Rs.6,000 C. Rs.7,500 D. Rs.9,000

6. Which of the following is not a factor in calculating depreciation?

A. Cost of the asset B. Salvage value

C. Useful life D. Market value

7. What is the journal entry to record depreciation expense at the end of an accounting period?

A. Debit Accumulated Depreciation, Credit Depreciation Expense

B. Debit Depreciation Expense, Credit Accumulated Depreciation

C. Debit Depreciation Expense, Credit Cash

D. Debit Accumulated Depreciation, Credit Cash

8. The method of depreciation where the depreciation expense is higher in the earlier years and lower in the later years of the asset's useful life is known as:

A. Straight-line method B. Double declining balance method

C. Units of production method D. Component depreciation method

9. Under which method is the depreciation expense determined by the number of units produced or hours used during the period?

A. Straight-line method B. Units of production method

C. Double declining balance method D. Sum-of-the-years'-digits method

10. If a company revises the estimated useful life of an asset, how should this change be accounted for?

A. Retrospectively, adjusting prior period financial statements

B. Prospectively, applying the change in the current and future periods

C. As an error correction in the financial statements

D. It does not require any adjustments

Answer: 1.c, 2.c, 3.b, 4.b, 5.b, 6.d, 7.b, 8.b, 9.b, 10.b.

Short Answer questions (5 Marks)

1. Define the term of Depreciation
2. State the main objectives of depreciation accounting
3. What is sinking fund method?
4. List out the Merits of Diminishing Balance Method:
5. How the depreciation is charged on current assets?

Long Answer questions (10 Marks)

1. State the advantages and limitations of written down value method.
2. Explain the need for providing depreciation arises on account.
3. what are factors affecting depreciation?
4. Explain the various methods of calculating deprecation.

5. Explain the different between the Straight Line Method and the Written Down Value Method

3.2.1Meaning of Bill of Exchange

According to the Negotiable Instruments Act 1881, a bill of exchange is defined as "an instrument in writing containing an unconditional order, signed by the maker, directing a certain person to pay a certain sum of money only to, or to the order of a certain person or to the bearer of the instrument".

3.2.2 Features of Bill of Exchange

- It is important to have a bill of exchange in writing
- It must contain a confirm order to make a payment and not just the request
- The order should not have any condition
- The bill of exchange amount should be definite
- Fixed date for the amount to be paid
- The bill must be signed by both the drawee and the drawer
- The amount stated on the bill should be paid on-demand or on the expiry of a fixed time
- The amount is paid to the beneficiary of the bill, specific person, or against a definite order

3.2.3 Types of Bill of Exchange

- **Documentary Bill-** In this, the bill of exchange is supported by the relevant documents that confirm the genuineness of sale or transaction that took place between the seller and buyer.
- **Demand Bill-** This bill is payable when it demanded. The bill does not have a fixed date of payment, therefore, the bill has to be cleared whenever presented.
- **Usance Bill-** It is a time-bound bill which means the payment has to be made within the given time period and time.
- **Inland Bill-** An Inland bill is payable only in one country and not in any other foreign country. This bill is opposite to the foreign bill.

- **Clean Bill-** This bill does not have any proof of a document, so the interest is comparatively higher than the other bills.
- **Foreign Bill-** A bill that can be paid outside India is termed as a foreign bill. Two examples of a foreign bill are an export bill and import bill.
- **Accommodation Bill-** A bill that is sponsored, drawn, accepted without any condition is known as an accommodation bill.
- **Trade Bill-** This kind of bill is specially related only to trade.
- **Supply Bill-** The bill that is withdrawn by the supplier or contractor from the government department is known as the supply bill.

3.2.4 Advantages of Bill of Exchange

- **Legal Document-** It is a legal document, and if the drawee fails to make the payment, it will be easier for the drawer to recover the amount legally.
- **Discounting Facility-** In cases where the drawer is in immediate need of money, the bill can be converted into cash by discounting it from a bank by paying some nominal charges.
- **Endorsement Possible-** This bill of exchange can be exchanged from one individual to another for the adjustment of the debt.

Bill of Exchange Format

Bangalore
1st June, 2018

₹4,00,000

Two months after date, pay to me or my order, the sum of
Rupees Four lakh only, for value received

STAMP

Accepted
(Signed)
Raj Kiran
14, Bangalore

(Signed)
Kunal Singh
Lal Bagh, Bangalore

In the above-mentioned bill of exchange format, Kunal Singh is the drawer as well as the payee of the bill.

3.2.5 Parties of Bill of Exchange

A bill of exchange has three parties:

(1) **Drawer:**

- The drawer is the maker of a bill of exchange.
- The bill is signed by Drawer.
- A creditor who is entitled to receive payment from the debtor can draw a bill of exchange.

(2) **Drawee:**

- Drawee is the person upon whom the bill of exchange is drawn.
- Drawee is the debtor who has to pay the money to the drawer.
- He is also known as ‘Acceptor’.

(3) **Payee:**

- The payee is the person to whom payment has to be made.
- The payee may be the drawer himself or a third party.

3.2.6 Promissory Note

The promissory note is defined as an instrument in writing (not being a banknote or a currency note), containing an unconditional undertaking signed by the maker, to pay a certain sum of money only to or to the order of a certain person, or to the bearer of the instrument.

Importance of Promissory note in Bill of Exchange

According to the Negotiable Instruments Act 1881, the meaning of promissory note is ‘an instrument in writing (not being a banknote or a currency note), containing an

unconditional undertaking signed by the maker, to pay a certain sum of money only to or to the order of a certain person, or to the bearer of the instrument. However, according to the Reserve Bank of India Act, a promissory note payable to bearer is illegal. Therefore, a promissory note cannot be made payable to the bearer.'

Parties to a Promissory Note

There Are Two Parties to a Promissory Note:

(1) **Maker:** Maker or drawer is an individual or entity who makes or draws the promissory note with a promise to pay a certain sum as is specified in the promissory note. Maker is also known as promsior.

(2) **Payee:** The payee is the person in whose favour the promissory note is drawn.

The above mentioned is the concept, that is elucidated in detail about 'Bill of Exchange' for the Commerce students.

3.2.7 Important Terms

Term of Bill or Period of Bill : It is the time period between the date on which a bill is drawn and the date on which it is payable.

Due Date: It is the date on which the payment of the bill is due.

Days of Grace: These are the three extra days added to the period of bill.

Date of Maturity: The date which comes after adding three days of grace to the period of bill.

Discounting of Bill

- It means encashment of bill before the date of its maturity.
- The bank deducts its charges from the bill.

Endorsement of Bill;

- Endorsement means the transfer of bill or promissory note to another person.
- It is transferred on account of the settlement of debts and dues.

Bill Sent for Collection.

- When a bill is sent to the bank for collection with instruction, that it will be retained till the maturity date.
- Bill will be realised on its due date. It is known as 'Bill sent for collection'.

Dishonour of Bill;

- When payment is not made by the acceptor of the bill on its due date. It is known as 'Dishonor of Bill'.
- Non-payment may be due to insufficient balance or insolvency.

Noting of a Bill

- On dishonour of a bill, when this fact is brought to the notice of a Notary Public, it is termed as 'Noting of a bill'.
- Notary public charges to record or take a noting of dishonour.

Nothing Charges.

- It is the fee paid to the Notary Public for noting of dishonour of a bill.

Retiring of a Bill

- When the Drawee pays the bill before its due date, It is termed as the retirement of a bill.
- It happens with the mutual understanding between the Drawer and the Drawee.
- To encourage Retiring of the bill, the holder allows some discount called Rebate on the bill amount from the date of retiring the bill to the maturity.

Renewal of a Bill

- When the holder of a bill is not in a position to meet the bill on its due date, Drawee approaches the Drawer with a request of extension of time for payment.
- If Drawer agrees, the old bill is cancelled, and a fresh bill with the new terms of payment is drawn and duly accepted and delivered. This is called Renewal of the Bill.

Important Points Regarding Due Date or Date of Maturity

When the Period of Bill is Given in Months

- In this case, the maturity date is calculated according to calendar months.
- Ignoring the number of days in a month.
- 3 days of the Grace period are added.

For example: – if a bill dated 4th May, 2017 is payable 3 months after date:-

= Then the maturity date will be 4th August 2017 + 3 Days of Grace = 7th August 2017.

When the Period of Bill is Given in Days

- The maturity date will be calculated in days,
- This excludes the date of transaction but includes the date of payment.
- 3 days of the Grace period are added in this case also.
- For example: -if a bill dated 5th June 2017 is payable after 65 days, then the maturity date will be:-

=25 Days of June + 31 Days of July + 9 Days of August + 3 Days of Grace=12th August 2017

When Maturity Date Falls on a Public Holiday

- If the due date of the bill is on the national holiday
- Then the maturity day of the bill shall be the preceding business day.
- Example:-If due date of the bill falls on 26th January (Republic Day), then its due date will be 25th January.

If the due date is 15th August (Independence Day), then the due date will be 14th August.

When the Maturity Date Has Been Declared as Emergency Holiday

- If the due date of the bill is declared as an emergency holiday,
- Then the due date of the bill shall be after 1 day from the date of maturity.

Example:- if the due date of a bill is 25th July and it is declared as an emergency holiday, then the due date will be 26th July.

The Following some of the important Terms

Maturity Date in Case of ‘bill at Sight’ or ‘instrument Payable on Demand’.

- The bill at sight becomes due for payment, as soon as it is presented for payment.
- In case of ‘Instrument payable on demand’, No time for payment is mentioned.
- Such Bills are not entitled to the Days of Grace.

Maturity Date in Case of ‘bill After Date’.

- In the case of ‘Bill after date,’ the time for payment is mentioned.
- Three Days of Grace is allowed on such a bill.

Maturity Date in Case of ‘bill After Sight’.

- In case of ‘Bill after Sight, payable at a fixed period ‘after sight’.
- The period begins from the date of accepting the bill.
- Three Days of Grace is allowed on such a bill.

Renewal of Bill

- When the acceptor is not in his capacity to pay his bill on the due date.
- He may request the drawer of the bill to cancel the original bill and draw a new Bill in place of the old Bill.
- If drawer agrees and a new bill is drawn, it is known as Renewal of a Bill.

Dishonour of a Bill

- A bill is said to be dishonoured when the drawee fails to make the payment on the date of maturity.
- The bill may get dishonoured when the drawee does not have sufficient funds to pay the bill or he becomes insolvent.
- In this situation, the liability of the acceptor is restored.

Accommodation Bill

- Accommodation bill is drawn and accepted for the purpose of mutual help.

- It is accepted by the drawee to accommodate the drawer.
- Hence, the drawee is called the 'Accommodating Party' and the drawer is called the 'Accommodation Party'.
- Accounting entries are made for accommodation bills in the same manner as for other bills.

Distinguish Between an Accommodation Bill and a Trade Bill.

Parameters	**Trade Bills**	**Accommodation Bills**
Objectives	These bills are drawn to facilitate the trade transactions of sale and purchases of goods.	These bills are drawn to help someone in need of financial assistance.
Consideration	There is a definite consideration for which the bill is accepted.	These bills are drawn without consideration.
Extension of Credit	Trade bills are a form of credit extension.	These bills are not a form of credit extension.
Proceeds	When trade bills are discounted, the proceeds remain with the holder.	When these bills are discounted, the proceeds may be shared by two parties in an agreed ratio.
Recovery	If trade bills are dishonoured, the amount may be recovered easily through the court.	In case of dishonour of these bills, the drawer cannot file a suit against the drawee.

3.2.8 Problem and Solution

Illustration1

A receives three promissory notes from B, dated 1st January, 2012 for 3 months. One bill is for Rs 3,000, the second is for Rs 4,000 and the third is for Rs 5,000. The second bill is immediately endorsed in favour of C and on 4th January, 2012 the third bill is discounted with the bank for Rs 4,700. Pass the entries in A's journal assuming (i) the bills are met on maturity and (ii) they are dishonoured.

Solution:

Journal

Date	Particulars		L.F.	Dr. ₹	Dr. ₹
2012 Jan. 1	Bill Receivable Account ...	Dr.		12,000	
	To B				12,000
	There promissory notes for ₹ 3,000, ₹ 4,000 and ₹ 5,000 received from B.				
Jan. 1	C. ...	Dr.		4,000	
	To Bills Receivable Account				4,000
	The bill for ₹ 4,000 received from B, now endorsed in favour of C.				
Jan. 4	Bank ...	Dr.		4,700	
	Discount Account ...	Dr.		300	
	To Bills Receivable Account				5,000
	The bill for ₹ 5,000 discounted with the bank for ₹ 4,700 *i.e.*, at a discount of ₹ 300.				
(*i*) April 4	On maturity, supposing the bills are met:				
	Cash Account/Bank ...	Dr.		3,000	
	To Bills Receivable Account				3,000
	Cash/cheque received in respect of the bill for ₹ 3,000 held till maturity.				
(*ii*) April 4	On maturity, supposing the bills are dishonoured:				
	B ...	Dr.		3,000	
	To Bills Receivable Account				3,000
	The bill for ₹ 3,000 dishonoured by B				
April 4	B				
	To C ...	Dr.		4,000	
	Dishonour of B's promissory note for ₹ 4,000 which was endorsed in favour of C				4,000
April 4	B ...	Dr.		5,000	
	To Bank				5,000
	Dishonour of B's promissory note for ₹ 5,000 which was discounted with bank.				

Illustration2

B owes C a sum of Rs 6,000. On 1st April, 2011 he gives a promissory note for the amount for 3 months to C who gets it discounted with his bankers for Rs 5,760. On the due date the bill is dishonoured, the bank paying Rs 15 as noting charges. B then pays Rs 2,000 in cash and accepts a bill of exchange drawn on him for the balance together with Rs 100 as interest. This bill of exchange is for 2 months and on the due date the bill is again dishonoured, C paying Rs 15 for noting charges draft the journal entries to be passed in C's books.

Solution:

Journal

Date		Particulars		L.F.	Dr. ₹	Cr. ₹
2011 April	1	To Bills Receivable Account	... Dr.		6,000	
		To *B*				6,000
		B' promissory note received in settlement of his account.				
April	1	Bank	... Dr.		5,760	
		Discount Account	... Dr.		240	
		To Bills Receivable Account				6,000
		B's promissory note discounted for ₹ 5,760.				
July	4	*B*	... Dr.		6,015	
		To Bank				6,015
		The promissory note dishonoured by *B;* the amount of the bill and the noting charges recoverable from *B* and payable to Bank.				
July	4	Cash Account	... Dr.		2,000	
		To *B*				2,000
		The amount received from *B*.				
July	4	*B*	... Dr.		100	
		To Interest Account				
		Interest due from *B* for the second bill.				100
July	4	Bills Receivable Account	... Dr.		4,115	
		To *B*				4,115
		B's acceptance for 2 months in settlement of amount due.				
Sept.	7	*B*	... Dr.		4,115	
		To Bills Receivable Account				4,115
		The dishonour by *B* of his acceptance.				
Sept.	7	*B*	... Dr.		15	
		To Cash Account				15
		Payment of noting charges, recoverable from *B*.				

Illustration3

X draws on Y a bill of exchange for Rs 15,000 on 1st April, 2011 for 3 months. Y accepts the bill and sends it to X who gets it discounted for Rs 14,400. X immediately remits Rs 4,800 to Y. On the due date, X, being unable to remit the amount due, accepts a bill for Rs 21,000 for three months which is discounted by Y for Rs 20,055. Y sends Rs 3,370 to X. Before the maturity of the bill X becomes bankrupt, his estate paying fifty paise in the rupee. Give the journal entries in the books of X and Y. Also show X's account in T's books.

Solution:

BOOKS OF *X*
Journal

Date		Particulars		L.F.	Dr. ₹	Cr. ₹
2011 April	1	Bills Receivable Account ...	Dr.		15,000	
		To *Y*				15,000
		Acceptance received from *Y*.				
"	"	Bank ...	Dr.		14,400	
		Discount Account ...	Dr.		600	
		To Bills Receivable Account				15,000
		The amount received—and discount—on the discounting of *Y*'s acceptance.				
"	"	*Y* ...	Dr.		5,000	
		To Bank				4,800
		To Discount Account				200
		The amount remitted to *Y* and the proportionate share of discount debited to him.				
July	4	*Y* ...	Dr.		21,000	
		To Bills Payable Account				21,000
		The acceptance sent to *Y*.				
"	"	Bank ...	Dr.		3,370	
		Discount Account ...	Dr.		630*	
		To *Y*				4,000
		The amount received from *Y* on his discounting our acceptance and the discount debitable to us.				
	?	Bills Payable Account ...	Dr.		21,000	
		To *Y*				21.000
		The bill due having had to be dishonoured due to bankruptcy.				
	?	*Y* ...	Dr.		14,000	
		To Bank				7,000
		To Deficiency Account				7,000
		The amount due to *Y* discharged by payment of fifty paise in the rupee.				

* The discount to be borne by *X* is arrived at as follows:

₹	10,000	due by him but not remitted to *Y*, plus
₹	3,370	received by him from *Y*.
₹	13,370	Total.
₹	13,370	is 2/3 of ₹ 20,055 and hence *X* should bear 2/3 of the discount.

BOOKS OF Y
Journal

Date		Particulars		L.F.	Dr. ₹	Cr. ₹
2011 April	1	*X* ...	Dr.		15,000	
		To Bills Payable Account				15,000
		The acceptance sent to *X*.				

Date		Particulars		L.F.	₹	₹
April	1	Bank ...	Dr.		4,800	
		Discount Account ...	Dr.		200	
		To X				5,000
		The amount received from X on the discounting of the acceptance and the discount due.				
July	4	Bills Receivable Account ...	Dr.		21,000	
		To X				21,000
		The acceptance received from X.				
"	"	Bank ...	Dr.		20,055	
		Discount Account ...	Dr.		945	
		To Bills Receivable Account				21,000
		X's acceptance discounted for ₹ 20,055				
"	"	Bills Payable Account ...	Dr.		15,000	
		To Bank				15,000
		Our acceptance due this day met.				
"	"	X ...	Dr.		4,000	
		To Bank				3,370
		To Discount Account				630
		The amount received and the discount debited to X.				
?	?	X ...	Dr.		21,000	
		To Bank				21,000
		X's acceptance which was discounted dishonoured due to X's bankruptcy.				
?	?	Bank ...	Dr.		7,000	
		Bad Debts Account ...	Dr.		7,000	
		To X				14,000
		The amount received from X and the balance being written off as debt.				

Ledger

Dr. **X** *Cr.*

2011			₹	2011			₹
April	1	To Bills Payable Account	15,000	April	1	By Bank	4,800
July	4	To Bank	3,370	"	1	By Discount Account	200
"	"	To Discount Account	630	July	4	By Bills Receivable A/c	21,000
?	?	To Bank (Dishonour of bill)	21,000	?	?	By Bank	7,000
				?	?	By Bad Debts Account	7,000
			40,000				40,000

Illustration4

On 1st January, 2011, X drew and Y accepted a bill of exchange at three months for Rs 16,000. On 4th January, 2011, X got the bill discounted at 12% per annum and remitted half of the proceeds to Y. On 1st February, 2011, Y drew and X accepted a bill at four months for Rs 12,000. On 4th February, 2011, Y got the bill discounted at 12% per annum and remitted half of the proceeds to X. They both agreed to share the discount equally.

On maturity, X met his acceptance but Y dishonoured his acceptance and X had to pay for it. X drew and Y accepted a new bill at three months for the original bill plus interest at

16% per annum for three months. On 1st July, 2011, Y became insolvent. On 21st September, 2011, a final dividend of 50 paise in a rupee was received from Y's estate.

Solution :

Bills Receivable Account

Dr.		₹	Cr.		₹
2011			2011		
Jan. 1	To Y	16,000	Jan. 4	By Bank	15,520
Apr. 4	To Y	16,640	" "	By Discount	480
			July 1	By Y	16,640
		32,640			32,640

Y

Dr.		₹	Cr.		₹
2011			2011		
Jan. 4	To Bank	7,760	Jan. 1	By Bills Receivable Account	16,000
,, ,,	To Discount Account	240	Feb. 4	By Bank	5,760
Feb. 1	To Bills Payable Account	12,000	,, ,,	By Discount Account	240
April 4	To Bank	16,000	Apr. 4	By Bills Receivable Account	16,640
,, ,,	To Interest Account	640	Sept. 21	By Bank	7,320
July 1	To Bills Receivable Account	16,640	,, ,,	By Bad Debts Account	7,320
		53,280			53,280

Illustration5

In the books of Ram Lall, there was a balance of Rs 6,500 due by K. Sampat on 31st, March, 2011 which was written off as a bad debt in closing of the books on that date. On 10th May, 2011, K. Sampat paid cash Rs 6,000 in full and final settlement of his dues. Further transaction took place between Ram Lall and K. Sampat as follows:

2011

June, 3 Ram Lall sold goods to K. Sampat invoiced at ₹ 12,500 which were paid by cheque for ₹ 2,000 and a bill of exchange for ₹ 10,500 at one month, Ram Lall discounted the Bill of Exchange at the Bank for ₹ 10,340.

July, 6 K. Sampat 's Bill was dishonoured and Ram Lall was called upon to take it up. This he did, paying noting charges, ₹ 10.

" 7 K. Sampat met his obligation for ₹ 10,500 with a bill at two months for the same amount, paid cash for noting charges on the old bill and interest of ₹ 315 on the new bill.

Sept., 10 K. Sampat met his bill by paying cash ₹ 5,500 and accepted a fresh bill at 3 months for ₹ 5,250 including interest.

Dec, 10 K. Sampat, having become insolvent, paid a compensation of 50 paise in the rupee.

Show important ledger accounts in Ram Lall's books.

Solution:

RAM LALL'S LEDGER

K. Sampat

Dr.		₹	Cr.		₹
2011			2011		
Mar. 31	To Balance b/d	6,500	Mar. 31	By Bad Debts A/c	6,500
2011			2011		
June 3	To Sales A/c	12,500	June 3	By Bank	2,000
July 6	To Bank	10,510	,, ,,	By Bills Receivable A/c	10,500
,, 7	To Interest A/c	315	July 7	By Bank	325
Sept. 10	To Bills Receivable A/c	10,500	,, ,,	By Bills Receivable A/c	10,500
,, ,,	To Interest A/c		Sept. 10	By Bank	5,500
Dec. 10	To Bills Receivable A/c	250	Sept. 10	By Bills Receivable A/c	5,250
		5,250	Dec. ,,	By Bank	2,625
			Dec. ,,	By Bad Debts A/c	2,625
		39,325			39,325

Bills Receivable Account

2011			₹	2011			₹
June 3	To K. Sampat		10,500	June 3	By Bank		10,340
July 7	To K. Sampat		10,500	,, ,,	By Discount Account		160
Sept. 10	To K. Sampat		5,250	Sept. 10	By K. Sampat		10,500
				Dec. 10	By K. Sampat		5,250
			26,250				26,250

Bad Debts Account

2011			₹	2011			₹
Mar. 31	To K. Sampat		6,500	Mar. 31	By Profit & Loss A/c		6,500
2011				2012			
Dec. 10	To K. Sampat		2,625	Mar. 31	By Profit & Loss A/c		2,625

Bad Debts Recovered A/c

2012			₹	2011			₹
Mar. 31	To Profit & Loss A/c		6,000	May 10	By Cash/Bank		6,000

Summary:

A Bill of Exchange is a financial instrument used in trade and commerce to ensure the payment of a specified amount of money at a future date or on demand. It is an vital financial instrument in business, facilitating secure and efficient payment processes. Understanding its features, parties involved, and legal aspects is crucial for businesses engaged in domestic and international trade. Proper usage of bills of exchange can enhance financial stability and foster trust between trading partners.

Explanation of Key Concepts

- **Bill of Exchange:** A written order binding one party (the drawee) to pay a fixed sum of money to another party (the payee) on demand or at a predetermined future date.
- **Drawer:** The person who creates or writes the bill of exchange.
- **Drawee:** The person on whom the bill is drawn and who is ordered to pay the amount.
- **Payee:** The person in whose favor the bill is drawn and who is entitled to receive the payment.
- **Acceptance:** The drawee's agreement to pay the bill as specified, typically signified by signing the bill.
- **Endorsement:** The act of signing the back of a bill of exchange, allowing the

transfer of rights to another party.

Multiple Choice Questions

1. What is a Bill of Exchange?

A) A formal agreement between two parties to exchange goods.

B) A written, unconditional order directing one party to pay a fixed sum of money to another party on demand or at a specified future date.

C) An agreement to provide services at a future date.

D) A contract for buying and selling foreign currencies.

2. Who is the Drawer in a Bill of Exchange?

A) The person who accepts the bill.

B) The person to whom the bill is payable.

C) The person who draws or makes the bill.

D) The person who guarantees payment.

3. Who is the Drawee in a Bill of Exchange?

A) The person who accepts the bill.

B) The person who draws the bill.

C) The person who guarantees payment.

D) The person to whom the bill is payable.

4. Who is the Payee in a Bill of Exchange?

A) The person who draws the bill.

B) The person who accepts the bill.

C) The person to whom the bill is payable.

D) The person who guarantees payment.

5. Which of the following is NOT a feature of a Bill of Exchange?

A) It must be in writing.

B) It must be signed by the drawer.

C) It must contain a promise to pay.

D) It must specify the amount to be paid.

6. What happens if a Bill of Exchange is dishonored?

A) The bill is paid in full.

B) The drawer is released from liability.

C) The payee may take legal action to recover the amount.

D) The bill is automatically renewed.

7. What term describes the period between the date of a Bill of Exchange and its maturity

date?

A) Tenure B) Duration C) Term D) Validity period

8. In a Bill of Exchange, what is an Acceptance?

A) An agreement to deliver goods.

B) A promise to pay money.

C) The drawee's signed agreement to pay the bill as presented.

D) The payee's receipt of payment.

9. What is a Promissory Note?

A) Similar to a Bill of Exchange but includes a promise to pay rather than an order.

B) A receipt for payment received.

C) A demand for payment.

D) A guarantee of payment by a third party.

10. Which of the following parties can endorse a Bill of Exchange?

A) Drawer only

B) Drawee only

C) Payee only

D) Any holder of the bill

Answer: 1.b,2.c, 3.a, 4.c, 5.c, 6.c, 7.c, 8.c, 9.a, 10.d.

Short Answer questions (5 Marks)

1. Define the term of Bill of Exchange.
2. What Do You Mean by Dishonour of Bill?
3. Why is a bill of exchange unconditional?
4. What is the difference between Bill of Exchange and Cheque?
5. What is average due date? How it is calculated?

Long Answer questions (10 Marks)

1. Explain the importance of bills of exchange.
2. Distinguish between promissory note and bill of exchange.
3. Distinguish Between an Accommodation Bill and a Trade Bill.
4. Explain the characteristics of a bill of exchange.
5. Explain the Retiring of a Bill, Accommodation Bill and Renewal of a Bill.

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Accounts from Incomplete Records

Contents

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4.1 Single Entry System - Introduction

The single-entry system, also known as the incomplete record system, is an accounting method that is simpler than the double-entry system. In this system, only one account is used to record a transaction, unlike the double-entry system, where two accounts are used. The single-entry system is often used by small businesses and individuals who do not require detailed financial statements.

The single-entry system works on the principle of cash-basis accounting, which means that transactions are recorded only when cash changes hands. This system does not use a formal set of accounts, such as the chart of accounts in the double-entry system, and instead records transactions in a simple format, such as a cash book or a ledger.

4.2 Meaning and Definition

Meaning of Incomplete Records Accounting records:

which are not strictly kept according to double entry system are known as incomplete records. Many authors describe it as single entry system. However, single entry system is a misnomer because there is no such system of maintaining accounting records. It is also not a 'short cut' method as an alternative to double entry system. It is rather a mechanism of maintaining records whereby some transactions are recorded with proper debits and credits while in case of others, either one sided or no entry is made. Normally, under this system records of cash and personal accounts of debtors and creditors are properly maintained, while the information relating to assets, liabilities, expenses and revenues is partially recorded. Hence, these are usually referred as incomplete records.

Definition:

Kohler defines Single Entry System as, "A system of book keeping in which as a rule only records of cash and of personal accounts are maintained, it is always incomplete double entry varying with the circumstances." Sometimes, the term Single Entry System is mistakenly understood that under this system only one aspect of a transaction is recorded in the books. This is not true. The fact remains that under this system, while for certain transactions both the aspects are recorded, for others only one aspect is recorded and some trasactions are even ignored.

4.3 Feature of Incomplete Records

Incomplete records, often encountered in accounting, refer to situations where a business does not maintain a comprehensive and systematic set of financial records. This can occur due to various reasons such as lack of knowledge, small scale of operations, or intentional oversight. The features of incomplete records typically include:

Absence of Double-Entry System:

The most prominent feature is the lack of a double-entry bookkeeping system, where each transaction is recorded twice (debit and credit). Instead, transactions are recorded in a single entry or not recorded at all.

Insufficient Documentation:

There is often a lack of proper documentation and vouchers supporting the transactions. This makes it difficult to verify the accuracy and authenticity of the recorded data.

No Trial Balance:

Without a double-entry system, it is not possible to prepare a trial balance. A trial balance is crucial for checking the arithmetic accuracy of accounts, and its absence indicates potential discrepancies.

Unreliable Financial Statements:

Financial statements prepared from incomplete records are often unreliable. They might not give a true and fair view of the business's financial position due to missing or inaccurate data.

Difficulty in Ascertaining Profit or Loss:

Calculating the accurate profit or loss of a business becomes challenging. Alternative methods, such as the Statement of Affairs method, are used to estimate the profit or loss, but these are not as precise as those derived from complete records.

Challenges in Legal Compliance:

Incomplete records can lead to non-compliance with legal and statutory requirements. Businesses might find it difficult to file accurate tax returns, comply with auditing standards, and meet regulatory requirements.

Dependence on Owner's Memory:

There is often a heavy reliance on the owner's or manager's memory for recalling transactions, which can lead to errors and omissions.

Limited Analysis and Decision-Making:

Incomplete records hinder the ability to perform detailed financial analysis, which is crucial for informed decision-making. Management may not have access to

critical data needed for strategic planning and operational improvements.

Potential for Fraud and Mismanagement:

The lack of systematic records increases the risk of fraud and mismanagement. It becomes easier for discrepancies and unauthorized transactions to go unnoticed.

Inconsistency in Recording:

There is often inconsistency in the recording of transactions, with some entries recorded in detail while others are missing or summarized, leading to an imbalanced and incomplete financial picture.

4.4 Advantages and Disadvantages

Advantages of Incomplete Records

Simplicity and Ease of Maintenance: Maintaining incomplete records can be simpler and less time-consuming than a full double-entry system. It requires less specialized knowledge and fewer resources.

Cost-Effective: For small businesses, the cost of maintaining a comprehensive accounting system, including hiring professional accountants, can be prohibitive. Incomplete records can be a cost-saving measure.

Focus on Core Activities: Small business owners can focus more on their core business activities rather than spending excessive time on detailed record-keeping.

Flexibility: Without the rigidity of a double-entry system, businesses may find it easier to adapt their record-keeping practices to suit their specific needs and circumstances.

Reduced Administrative Burden: There is less paperwork and fewer administrative tasks associated with maintaining incomplete records.

Disadvantages of Incomplete Records

Inaccuracy and Unreliability: Financial data from incomplete records are often inaccurate and unreliable, leading to a distorted view of the business's financial health.

Difficulty in Financial Analysis: Incomplete records hinder detailed financial analysis, making it hard to track profitability, manage expenses, and plan for future growth.

Challenges in Legal Compliance: Businesses with incomplete records may struggle to meet legal and regulatory requirements, including tax filings and audits, which can lead to penalties and legal issues.

Risk of Fraud and Errors: The lack of a systematic approach increases the risk of errors and fraudulent activities, as discrepancies are less likely to be detected.

Limited Decision-Making Ability: Incomplete records provide insufficient data for informed decision-making, which can negatively impact business strategy and operations.

4.5 Difference between Single Entry System and Double Entry System

S.No	Single Entry System	Double Entry System
1	Based on the cash book	Based on the principles of debit and credit
2	Simple and easy to maintain	More complex and requires proper knowledge
3	Records only cash and personal accounts	Records all types of accounts and transactions
4	Provides limited financial information	Provides comprehensive financial information
5	Suitable for small businesses	Suitable for large businesses and organizations

6	No trial balance or balance sheet is prepared	Trial balance and balance sheet are prepared
7	Lacks internal control measures	Offers better internal control measures
8	Does not conform to accounting principles	Conforms to accounting principles
9	Does not require specialized software	Often requires specialized accounting software
10	Difficult to detect errors and frauds	Errors and frauds can be detected more easily

4.6 Ascertainment of Profit or Loss

Every business firm wishes to ascertain the results of its operations to assess its efficiency and success and failures. This gives rise to the need for preparing the financial statements to disclose:

(a) the profit made or loss sustained by the firm during a given period; and

(b) the amount of assets and liabilities as at the closing date of the accounting period. Therefore, the problem faced in this situation is how to use the available information in the incomplete records to ascertain the profit or loss for the particular accounting year and to determine the financial position of a entity as at the end of the year.

This can be done in two ways :

1. Preparing the **Statement of Affairs** as at the beginning and as at the end of the accounting period, called statement of affairs or net worth method.

2. Preparing Trading and Profit and Loss Account and the Balance Sheet by putting the accounting records in proper order, called **conversion method.**

4.7 Statement of Affairs Method

This method is similar to preparing a balance sheet and involves estimating the capital at the beginning and end of the period to determine profit or loss.

Steps:

i. **Prepare Opening Statement of Affairs:** This is essentially a balance sheet prepared at the beginning of the period. It lists the assets and liabilities to find the opening capital.

ii. **Prepare Closing Statement of Affairs:** Similarly, prepare a balance sheet at the end of the period to determine the closing capital.

iii. **Adjust for Additional Capital Introduced and Drawings:** Adjust the closing capital for any additional capital introduced during the period and any drawings made by the owner.

iv. **Calculate Profit or Loss:** The difference between the adjusted closing capital and the opening capital represents the profit or loss for the period.

A specimen format of statement of affairs is given below:

Statement of Affairs as on

	Rs.		Rs.
S.Creditors	---	Cashonhand	---
Billspayable	---	CashatBank	---
Capital(Balancefig)	---	Sundrydebtors	---
		Billspayable	---
		Stock	---
		Fixedassets	---
		(-)Depreciation	---

After ascertaining opening and closing balances of capital by preparing the statement of affairs, one at the beginning and another at the end, a 'statement of profit' is prepared to know the profit for the accounting period.

A specimen format of statement of profit is given below:

Statement of Profit for the year ended………………

	Rs.	Rs.
Closingbalanceof capital	---	---
(-)Openingbalanceof capital	---	---
(-)Interestoncapital	---	---
(+)Drawings		---

(+)Interestondrawings		---
(-)Additionalcapitalintroduced Profitduringtheyear		---

4.8 Problem and Solution

Example1

Mr.X keeps his books under single entry system. Ascertain profit from the following data, by preparing a statement of profit.

Capital balance as on1-1-90 Rs. 80,000

Capital balance as on31-12-90 Rs.1,20,000

Drawings made during the year1990 Rs.12,000

Additional capital introduced during the year 1990 Rs.10,000

Solution

Statement of Profit for the year 1990

	Rs.	Rs.
Capital balance as on31-12-90	1,20,000	
(-)Capital balance as on01-01-90	80,000	
		40,000
(+)Drawings made during the year		12,000
		52,000
(-)Additional capital introduced during the year Profit for the year 1990		10,000
		42,000

Example2

Mr. Y keeps his books under single entry system. His position as on 31-12-90 was asfollows: Cash on hand Rs.8000; Cash at Bank Rs.15000; Sundry creditors Rs.10,000; Sundry debtorsRs.45,000; Stock Rs.35,000; Furniture Rs.25,000.

Prepare a statement of affairs and ascertain capital balance as on 31-12-1990.

Solution

Statement of Affairs as on 31-12-90

	Rs.		Rs.
S.Creditors	10,000	Cash on hand	8,000
Capital	1,18,000	Cash at Bank	15,000
(Balancing figure)		S.Debtors	45,000
		Stock	35,000
		Furniture	25,000
	1,28,000		1,28,000

Example3

Mr.Z keeps incomplete records relating to his business. His financial position as on 01-01-94 and 31-12-95 is given below. You are required to ascertain profit.

	1-1-94 Rs.	31.12.95 Rs.
Cash	5,000	6,000
Stock	8,000	5,000
Debtors	10,000	20,000
Creditors	8,000	9,000
Machinery	30,000	30,000

AdditionalInformation:

(1) During the year Mr.Z withdrew Rs.4000 from the business.

(2) Mr. Z has decided to depreciate Machinery @ 10 percent and create a Reserve for Doubtful Debts @ 5percent.

Solution

Statement of Affairs as on 1-1-94

	Rs.		**Rs.**
S.Creditors	8,000	Cash	5,000
Capital	45,000	Stock	8,000
(Balancing figure)		Debtors	10,000
		Machinery	30,000
	53,000		53,000

Statement of Affairs as on 31-12-94

	Rs.		Rs.
Creditors	9,000	Cash	6,000
Capital	48,500	Stock	5,000
(Balancing figure)		Debtors 10,000	
		(-) Provision for doubtful debts5% 500	9,500
	57,500	Machinery 30,000	
		(-)Depreciation 10%3,000	27,000
	57,500		57,500

StatementofProfitfortheyear1994

	Rs.	Rs.
Capital balance as on 31-12-94	48500	
(-)Capital balance as on 01-12-94	45000	3500
(+)Drawings made during the year		4000
Profit for the year 1994		7500

Example4

Mr.Pand Mr.Qare in partnership and share profits and losses in the ratio of 3:2. On 31.12.93 their statement of affairs showed the following position.

Liabilities		Assets	
Capital		Machinery	20000
Mr.P.	20000	Stock	15000
Mr.Q.	20000	Debtors	6000
Creditors	5000	Cash	4000
	45000		45000

On 31.12.93 their assets and liabilities were: Machinery Rs.20000; Stock Rs.25000; Debtors Rs.80000; Cash Rs.2000; Creditors Rs.8000. You are required to ascertain profit after charging depreciation on machinery @ 10 percent and interest on capital @ 10 percent. ShowtheBalanceSheet on 31-12-94.

Solution

Statement of Affairs as on 31-12-94

Liabilities	Rs.	Assets		Rs.
Creditors	8,000	Machinery	20,000	
Capital of Mr.P & Mr. Q	45,000	(-)Dep.	2,000	18,000
(Balancing figure)		Stock		25,000
		Debtors		8,000
		Cash		2,000
	53,000			53,000

StatementofProfitfortheyear1994	**Rs.**
CapitalbalanceofMr. P &Mr. Qas on31.12.94	45000
(-)Capital balanceof Mr. P &Mr.Qas on 31.12.93	40000
	5000
(-)Interestoncapital(40000@10%)	4000
Profitfortheyear1994	1000

Statement of Capital Balance as on 31.12.94

		P(Rs.)	Q(Rs.)
	Opening balance of capital	20000	20000
Add	Interest on capital	2000	2000
	Profit Rs.1000		
	(Appropriated in the ratio of 3:2)	600	400
		22600	22400

Balance Sheet as on 31-12-94

Liabilities		Assets		
Capital		Machinery	20,000	
Mr.P	22,600	(-)Dep.	2,000	18,000
Mr.Q	22,400	Stock		25,000
Creditors	8,000	Debtors		8,000
		Cash		2,000
	53,000			53,000

Example 5

On 1.4.94, Mohan started a business with the following assets.

Cash	Rs.10000
Stockofgoods	Rs.10000
Furniture	Rs.20000
On 31.3.95 his assets and liabilities were as follows: Cash	Rs.8000
Stock of goods	Rs.14000
Debtors	Rs.20000
Furniture	Rs.20000
Bills Receivable	Rs.6000
Loans	Rs.4000
Creditors	Rs.8000

Of the Debtors, Rs.1000 was bad. Provision for doubtful debts were to be created at 5% on Debtors. Reserve for discount on Debtors and on Creditors at 5%. Write off 2% on Bills Receivable. The proprietor had withdrawn Rs.2400 during the year. Charge interest at 5% on capital as well as on drawings. Depreciate furniture@ 10%p.a.

Solution

Statement of affairs as on 1.4.94

Liabilities	Rs.	Assets	Rs.
Capital	40,000	Cash	10,000
(Balancing figure)		Stock	10,000
		Furniture	20,000
	40,000		40,000

Statement of Affairs as on 31.3.95

Loans		4,000	Cash		8,000
Creditors	8,000		Stock		14,000
(-)Reservefor			Debtors	20,000	
Discount on Crs.	160	7,840	(-)Baddebts	1000	
Capital		51,729		19,000	

(Balancing figure)			(-)Provision for D/D 5%	950	
				18,050	
			(-)Reserve for Dis.on Debtors2%	361	17,689
			Furniture	20,000	
			(-)Dep.	2000	18,000
			Bills receivable	6000	
			(-)Unrecoverable	120	5,880
		63,569			63,569

Statement of Profit for the year ended 31.3.95

	Closing balance of capital (as on31.3.95)	51,729	
Less	Opening balance of capital (as on1.4.94)	40,000	11,729
Add	Drawings		2,400
			14,129
Add	Interest on drawings (5/100)x 2400		120
Less	Interest on Capital (5/100)x40000		14,249
			2,000
	Profit for the year ended 31.03.95		12,249

4.9 Conversion Method

This method involves converting single-entry records into double-entry records and then preparing the necessary financial statements.

Steps:

i. **Identify All Available Information:** Collect all available cash receipts, payments, bank statements, and any other relevant documents.

ii. **Prepare Cash and Bank Accounts:** Reconstruct the cash and bank accounts from the available information to find the opening and closing balances.

iii. **Determine Missing Figures:** Use the information to estimate missing figures such as sales, purchases, expenses, and income. This may involve making reasonable assumptions based on trends or historical data.

iv. **Prepare Ledger Accounts:** Reconstruct key ledger accounts (e.g., sales,

purchases, expenses) using the identified and estimated figures.

v. **Prepare Trial Balance:** Using the reconstructed ledger accounts, prepare a trial balance to check for accuracy.

vi. **Prepare Financial Statements:** From the trial balance, prepare the income statement (Profit and Loss account) and the balance sheet.

Under conversion method there are two variations

(1)Full Conversion and

(2) Abbridged Conversion.

In Full Conversion single entry system is converted into double entry system. All possible accounts are opened and postings from existing records. (viz.,cashbook, personal accounts and previous year's statement of affairs) are made. Such a process enables a trader, who keeps his accounts under single entry, to prepare trial balance and thereafter he can finalize his account stok now the profit. It is a lengthy process and also amounts to duplication of work.

In Abbridged conversion, all accounts are not opened, but necessary information is obtained by preparing consolidated (Total) accounts. This process will enable the trader to prepare Trading and Profit and Loss account and Balance Sheet. Also it will save the trader from the lengthy process of full conversion.

Following are the consolidated (Total) accounts which are prepared to obtain necessary information.

S.No	Name of the account	Information Disclosed
1.	Summary cash (account) book	Total receipts and payments under each head of account.
2.	Total Debtors account	Credit sales or opening/closing balance of debtors
3.	Total Creditors account	Credit purchases or opening/ closing balance of creditors.
4.	Total Bills Receivable account	Bills Received during the year or opening/closing Balance of B/R

5.	Total bills payable account	Bills payable accepted or opening / closing balance of B/P

In some problems, the rate of gross profit on cost of goods sold or sales may be given, without giving the opening or closing stock. In such cases a Memorandum Trading Account is prepared to ascertain the opening or closing stock. Apart from preparing these accounts statement of affairs in prepared to ascertain the opening balance of capital. In this lesson only abridged conversion is dealt with, as full conversion is not in vogue. Format of the following consolidated (Total) accounts are given below:

Total Debtors Account

Opening Balance	----	Cash / Cheque received	----
Credit Sales	----	Discount allowed	----
Bills Receivable	----	Bad debts	----
(Dishonoured)		Sales returns	----
		Bills receivable	----
		Closing balance	----

Total Creditors Accounts

Cash paid	----	Opening Balance	----
Cheques issued	----		
Bills payable			
accepted	----		
Discount received	----		
Purchase returns	----		
Closing Balance	----		

Bills Receivable Account

Opening Balance	----	Cash/Cheques received	----
Sundry debtors	----	Bills Discounted	----
(Bills received)		Sundry debtors	
	----	(Bills dishonoured)	----
	----	Closing balance	----

Bills Payable Account

Cash paid	----	Opening balance	----
Cheques issued	----	Sundry creditors	----
Sundry creditors		(bills accepted)	
(Forbillsnot			----
Honoured)	----		**----**
Closing Balance	----		

4.10 Problem and Solution

Example1

The following information is available from the incomplete records maintained by Mr.X for his business. You are required to prepare trading and profit and loss account for the year ended 31-12-1990 and the balance sheet as on that date.

Fresh capital introduced	5,000
Salary paid	8,000
Wages paid	5,000
Discount allowed	3,000
Discount received	2,000
Business expenses	10,000
Other information:	
Closing creditors	15,000
Closing stock	50,000
Total assets	70,000
Cash sales	10,000
Cash purchases	15,000
Cash paid to creditors	35,000
Cash received from debtors	60,000

Assets – Liability position of Mr.X as on 01-01-1990 Building Rs.20000. Machinery Rs.60,000; Furniture Rs.10,000; Debtors Rs.20,000; Creditors Rs.10,000; Stock Rs.20,000; Cash 5000. For bad and doubtful debts. Depreciate Machinery @ 10% p.a Transactions during the year.

Solution

Given below is the list of information which are needed to do the problem and the means of getting the information.

Statement of Affairs as on 01.01.1990

Creditors	10,000	Building	
Capital	1,25,000	Machinery	10,000
(Balancing figure)		Furniture	10,000
		Debtors	20,000
		Stock	40,000
		Cash	5,000
	1,35,000		1,35,000

Create5%pro

Total Debtors Account

Creditors	10,000	Building	
Capital	1,25,000	Machinery	10,000
(Balancing figure)		Furniture	10,000
		Debtors	20,000
		Stock	40,000
		Cash	5,000
	1,35,000		1,35,000

Total Creditors Account

Cash paid to creditors	35,000	Opening Balance	10,000
Discount received	2,000	Credit purchases	42,000
		(Balancing figure)	
Closing creditors	15,000		
	52,000		52,000

Summary Cash Book

Opening balance of cash	5,000	Cash paid to creditors	35,000
Cash sales	10,000	Cash purchases	15,000
Cash received from		Salary paid	8,000
Debtors	60,000	Wages paid	5,000
Fresh Capital introduced	5,000	Business expenses	10,000
		Closing balance of cash	7,000
		(Balancing figure)	
	80,000		80,000

After obtaining the above information the problem is worked as below:

Trading and Profit and Loss Account for the year ended 31.12.1990.

Dr.	Rs.		Rs.Cr.
To Stock	20,000	By Sales	70,000
To Purchases		By Closing stock	50,000
(42,000+15,000)	57,000		
To Wages	5,000		
To Gross profit	38,000		
	1,20,000		1,20,000
To Business expenses	10,000	By Gross Profit	38,000
To Salary	8,000	By Discount	2,000
To Discount	3,000		
To Provision for bad & Doubtful debts	850		
To Depreciation	6,000		
To Net Profit	12,150		
	40,000		40,000

Balance Sheet as on 31-12-90

Capital & Liabilities			Assets		
Capital	1,25,000		Building		20,000
Add:Fresh			Machinery	60,000	
Capital introduced	5,000		(-)Depreciation	6000	54,000
	1,30,000		Furniture		10,000
Add Net profit	12,150	1,42,150	Stock(closing)		50,000
Creditors		15,000	Debtors	17,000	
			(-)Provisionfor		
			Doubtful debts	850	16,150
					7000
		1,57,150			1,57,150

Example2

Suman a keeps her books under single entry system. Her capital as at 01.01.1982 was Rs.60,000. An abstract of her cash transactions for the year ended31.12.1982 was as follows:

	Rs.		Rs.
To Balance b/d	10,000	By Cash purchases	15,000
Cash Sales	40,000	Wages	20,000
Collection from Debtors	60,000	Payment to creditors	28,000
Capital further introduced	10,000	B/P Paid	14,000
B/R Collected	20,000	Salaries	8,000
		General Expenses	4,000
		Drawings	15,000
		Plant Purchased	10,000
		Balance c/d	26,000
	1,40,000		1,40,000

Other particulars of her assets and liabilities as on 01-01-1982 and 31-12-1982 were asfollows:

	01-01-1982 Rs.	**31-12-1982 Rs.**
Plant	20,000	30,000
Furniture	2,000	2,000
Billspayable	8,000	10,000
Billsreceivable	9,000	13,000
Sundrydebtors	22,000	25,000
Sundrycreditors	15,000	16,000
Stock-in-trade	20,000	15,000

You are required to draft a Trading and Profit and Loss Account for the year ended 31-12-1982 and a Balance Sheet as on date after providing for 5% interest on capital and 2 ½% of further introduction, 5% reserve for doubtful debts, 2 ½ reserve on bills receivable, 10% depreciation on plant and 6% depreciation on furniture.

Solution

Following information are needed to solve the problem and the means of finding them is listed below.

Information needed	How to obtain it
1.Billsreceivedduringthe year	Prepare total bills receivable account
2.Creditsales	Prepare total debtors account
3.Billsaccepteddduringthe year	Prepare total bills payable account
4.Creditpurchase	Prepare total creditors account

Total Bills Receivable Account

	Rs.		**Rs.**
To Balance b/d	9,000	Cash	20,000
To Total Debtors a/c	24,000		
(Bills received)		By Balance c/d	13,000
(Balancing figure)	33,000		33,000

Total Debtors Account

	Rs.		Rs.
To Balance b/d	27,000	By Bills receivable	24,000
		By Cash	60,000
To Credit sales	82,000	By Balance c/d	25,000
(Balancing figure)	1,09,000		1,09,000

Total Bills Payable Account

	Rs.		Rs.
To Cash	14,000	By Balance b/d	8,000
To Balance c/d	10,000	By Total creditors a/c	16,000
		(Balancing figure)	
		(Bills accepted)	
	24,000		24,000

Total Creditors Account

	Rs.		Rs.
To Bills payable	16,000	By Balance b/d	15,000
To Cash	28,000	By Credit purchase	45,000
To Balance c/d	16,000	(Balancing figure)	
	60,000		60,000

Trading and Profit and Loss Account for the year ended 31-12-1982

	Rs.		Rs.
To Opening stock	20,000	BySales	
To Purchases		Cash40,000	
Cash15,000		Credit87,000	1,27,000
Credit45,000	60,000		
To Wages	20,000	ByClosingstock	15,000
To Gross Profit	42,000		
	1,42,000		1,42,000
To Salaries	8,000	ByGross Profit	42,000

To General Expenses	4,000		
To Interest on Capital	3,250		
To Reserve for bad debts	1,250		
To Reserve on B/R	325		
Depreciation as on			
Plant 2500			
Furniture 120	2,620		
To Capital a/c(NP transferred	22,555		
	42,000		42,000

Balance Sheet as on 31-12-1982 (inRupees)

Liabilities			Assets		
Capital	60,000		Plant	30,000	
+Capital	10,000		-Depreciation	2,500	27,500
- NetProfit	22,555		Furniture	2000	
+Interest on Capital	3,250		-Depreciation	120	1880
	95,805		Bills receivable	13,000	
- Drawings	15,000	80,805	-Reserve	325	12,675
Bills payable		10,000	Sundry debtors	25,000	
Sundry Creditors		16,000	-Reserve for		
			Baddebts	1250	23,750
			Stock in trade		15,000
			Cash		26,000
		1,06,805			1,06,805

Example3

A merchant has not kept any book except cash book and personal ledger. Prepare his final accounts with the help of the following details. Also find out his opening capital (on 01-01-86). Summary of Cash book - received from debtors Rs.45650; Drawings Rs.3000; Paid to creditors Rs.33600; Salaries Rs.2500; Rent Rs.1600; Advertisement expenses Rs.400. His other assets and liabilities were:

	31-12-1985 Rs.	31-12-1986 Rs.
Debtors	5,250	6,450
Creditors	3,700	5,100
Prepaid rent	20	---
Unpaid rent	---	25
Cash	5,000	8,000

On 31-12-1986 the stock was valued at Rs.5000 and the value of stock on 31-12-1985 (i.e. opening) was not known. The merchant however states that he has sold goods at cost + 25°

Solution

The algorithm of solving the problem is listed below.

Step1: Finding closing balance of cash	-by preparing summary cash book
Step2 :Finding credit sales	-by preparing total debtors account
Step3:Finding credit purchases	-by preparing total creditors account

Step4 : Finding opening stock	-by preparing a memorandum trading Account
Step5:Finding opening balance of capital	-by preparing a statement of affairs as on 01-01-85
Step6:Finalization of Accounts	

SummaryCashBook

	Rs.		Rs.
To Balance b/d	5,000	By Drawings	3,000
Debtors	45,650	By Creditors	33,600
		By Salaries	2,500
		By Rent	1,600
		By Advertisement	400
		By Balancec/d	9,550
	50,650		50,650

Total Debtors Account

	Rs.		Rs.
To Balance b/d	5,250	By Cash	45,650
To Credit sales	46,850	By Balancec/d	6,450
(Balancing figure)	52,110		52,110

Total Creditors Account

	Rs.		Rs.
To Cash	33,600	By Balance b/d	3,700
		By Credit purchase	35,000
To Balance c/d	5,100	(Balancing figure)	
	38,700		38,700

Memorandum Trading Account

	Rs.		Rs.
To Opening Stock	7,480	By Sales	46,850
(Balancing figure)		By Closing Stock	5,000
To Purchases	35,000		
To Gross Profit	9,370		
	51,850		51,850

Note:

Let the cost be Rs. 100 If 125 is sales, profit is 25.Profit Rs.25 If 46850 is sales, profit is Sales Rs.12525 x 46850/125 = Rs. 9,370

Statement of Affairs as on 01-01-86 (Fig.in rupees)

	Rs.		Rs.
Creditors	3,700	Creditors	5,000
Capital	14,050	Debtors	5,250
(Balancing figure)		Stock	7,480
		Prepaid rent	20
	17,750		17,750

Trading and Profit and Loss Account

	Rs.		Rs.
To Opening stock	7,480	By Sales	46,850
To Purchases	35,000	By Closing Stock	5,000
To Gross profit	9,370		
	51,850		51,850
		By Gross Profit	9,370
To Salaries	2,500		
To Rent 1600			
+Prepaid less 20			
+Outstanding year 25	1,645		
To Advertisement	400		
To Net profit	4,825		
	9,370		9,370

Balance Sheet as on 31-12-86

	Rs.			Rs.
Capital	14,050		Cash	9,550
+NP	4,825		Debtors	6,450
	18,875		Stock	5,000
(-)Drawings	3,000	15,875		
Creditors		5,100		
Unpaid rent		25		
		21,000		21,000

Summary :

Accounts from incomplete records, also known as single-entry systems, refer to a method of bookkeeping where only a partial recording of transactions is maintained. This contrasts with the double-entry system, where every transaction affects at least two accounts. Incomplete records are often used by small businesses or individuals due to their simplicity and cost-effectiveness. However, they come with significant limitations, particularly in accuracy and reliability.

While incomplete records may offer simplicity and cost savings for small

businesses, they pose significant risks and challenges. Accurate financial analysis, legal compliance, and effective management decisions are often compromised. As businesses grow, adopting a more comprehensive double-entry accounting system becomes essential to ensure financial integrity and transparency.

4.11 Multiple Choice Questions

1. What is the primary characteristic of accounting from incomplete records?

   a) Double-entry bookkeeping b) Single-entry bookkeeping

   c) Comprehensive financial statements d) Detailed trial balance

2. Which method is commonly used to ascertain profit or loss from incomplete records?

   a) Double-entry system b) Bank reconciliation

   c) Statement of Affairs method d) Accrual accounting

3. In the Statement of Affairs method, what is the formula to calculate the closing capital?

   a) Total Assets - Total Liabilities b) Total Liabilities - Total Assets

   c) Total Assets + Total Liabilities

   d) Opening Capital + Drawings - Additional Capital Introduced

4. Which of the following is a disadvantage of accounting from incomplete records?

   a) Simplicity b) Cost-effectiveness

   c) Limited financial analysis d) Flexibility

5. What does the absence of a trial balance in incomplete records imply?

   a) Accurate financial data b) Systematic recording of transactions

   c) Potential for undetected errors d) Complete financial statements

6. How can the reliability of financial statements from incomplete records be described?

   a) Highly reliable b) Partially reliable

   c) Completely reliable d) Unreliable

7. What is the main reason small businesses might use incomplete records?

   a) Legal requirements b) Complexity

   c) Cost and simplicity d) Accuracy

8. Which of the following adjustments is necessary when calculating profit or loss using the Statement of Affairs method?

   a) Depreciation b) Additional capital introduced

c) Inventory valuation d) Cash flow analysis

9. When reconstructing accounts from incomplete records, which document is typically used to gather information on cash transactions?

a) Income statement b) Cash receipts and payments

c) Balance sheet d) Trial balance

10. What risk is increased due to the lack of systematic record-keeping in incomplete records?

a) Transparency b) Fraud and mismanagement

c) Efficient tax filing d) Accurate budgeting

Answer: 1.b, 2.c, 3.a, 4.c, 5.c, 6.d, 7.c, 8.b. 9.b, 10.b.

4.12 Short Answer Questions

1. What is single entry system?
2. What is the primary characteristic of accounting from incomplete records?
3. what is net worth method?
4. What is an Opening Statement of Affairs?
5. what is conversion method in single entry?

Long Answer Questions

1. What is single entry and its salient features?
2. Distinguish between Statement of Affairs and Balance Sheet.
3. How profit is arrived under Single Entry System?
4. Explain the advantage and disadvantage of using incomplete records.
5. Explain the methods used to ascertain profit or loss in incomplete records.

4.13 Problems - Statement of Affairs Method

1. From the particulars given below, find out the profit or loss for the period ending 31-12-1985;

	Position as on01-01-85 Rs.		Position as on 31-12-85 Rs.
Cash	800	Cash	1,400
Bank	4,700	Bank	2,300

Stock	8,200	Stock	5,900
Debtors	5,100	Debtors	5,900
Furniture	6,000	Furniture	8,000
Goodwill	12,000	Goodwill	12,000
Creditors	2,000	Creditors	4,000
Liability for expenses	3,200	Bills receivables	8,000
Bills receivables	5,000	Bills payable	5,000
Bills payable	4,000	Prepaid expenses	2,000

During the year, the proprietor had withdrawn Rs.4500 for personal expenses.

2. Sri Kaushik, a trader keeps his books by the Single Entry Method. His financial position as on 01-01-87 and 31-12-87 were as follows:

	Position as on 01-01-87. Rs.	Position as on 31-12-87. Rs.
Cash on hand	1,500	1,600
Bank balance Dr:01-01-87 Cr:31-12-87	1,200	1,800
Stock-in-trade	4,000	4,650
Sundry debtors	3,400	3,800
Sundry creditors	2,400	3,600
Plant and machinery	6,000	8,000
Furniture	1,200	1,600

During the year, Sri Kaushik had withdrawn Rs.75 per month for his personal use. From the above information ascertain his profit or loss for the year and also give his statement of affairs as on 31-12-87, after taking into account the following further information:

(a) Depreciate Plant and Machinery by 15% and Furniture by 12 1/2% p.a. (assume the addition is on 30-06-87).

(b) Of the debtors Rs.100 are bad and to be written off.

(c) Create a Reserve for Discount on Debtors at 2% and a reserve for Doubtful Debts at5%

(d) Allow interest on capital at 5% and charge interest on drawings at 6% p.a.

3. Kelo and Dhelo are partners in a firm sharing profits or losses at Kelo 60% and Dhelo 40%. Their Statement of Affairs as at 31-03-1982, is given below:

Liabilities	Rupees	Assets	Rupees
Sundry creditors	40,000	Plant	40,000
Capital Accounts		Furniture	15,000
Kelo 50,000		Stock	25,000
Dhelo 30,000	80,000	Debtors	30,000
		Cash	10,000
	1,20,000		1,20,000

The partners keep their books by single entry system. On 31-03-83, the position of the business was as follows:

Plant Rs.50000; Furniture Rs.20000; Stock Rs.40000; Debtors Rs.45000; Cash Rs.11000 and Sundry creditors Rs.30000.

On 30-09-82, Kelo and Dhelo withdraw from the business Rs.6000 and Rs.4000 respectively. Plant and furniture are to be depreciated at 10% and 20% respectively. A Bad Debt Reserve at 21/2% is to be raised against Sundry Debtors and interest on capital is to be allowed at 5% p.a. and interest on drawings to be charged at 12% p.a.

4.14 Problems - Conversion Method

1. M. Mohan carries on grocery business and does not keep his books on double entry basis. The following particulars have been extracted from his books.

	1stJuly,1975 Rs.	30th June,1976 Rs.
Plant and Machinery	25,000	25,000
Stock in trade	22,000	19,500
Sundry debtors	8,000	22,500
Sundry creditors	12,500	10,000
Cash in hand	400	800
Bank balance	6,250	7,000

The following cash transactions took place during the year ending 30th June,1976.

Received from debtors	1,60,000	Payments for purchases	28,850
Received from cash sales	31,250	Payments to creditors	1,32,000
		General expenses	21,450
		Wages	15,000
		Drawings	6,800
	1,91,250		2,04,100

During the year Mohan had taken goods from the business for his own consumption which accounted to Rs.1900 for the whole year and had not paid any amount into the business for them. You are required to prepare the Final Accounts after writing off 10% depreciation on Plant and Machinery.

2. The following information is obtained from Gopal's incomplete accounts. Prepare Trading and Profit and Loss Account for the year and the Balance sheet as on 31-12-1971.

	01-01-71 Rs.	31-12-71 Rs.
Creditors	15,770	12,400
Outstanding general expenses	600	330

Sundry Assets	11,610	12,040
Stock	8,040	11,120
Cash on hand and at Bank	6,960	8,080
Debtors	?	17,870
Other Detailsare:		Rs.
Cash and discounts credited to debtors		64,000
Return from debtors		1,450
Bad debts		420
Sales-cash and credit		71,810
Discount allowed by creditors		700
Returns to creditors		400
Capital introduced into bank		8,500
Cash purchases		1,030
Receipts from debtors paid into bank		62,500
Expenses paid by cash		9,570
Purchase of Machinery by cheque		430
Withdrawn from bank into cash		9,240
Drawings by cheque		3,180
Cash payments into bank		5,000
Cash on hand at end		1,200
Payments to creditors by cheque		60,270

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Royalty

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5.1.1 Royalty - Introduction

The owner of an asset (e.g. mines, quarries, patent, copyright, etc), as a business arrangement, may allow other party (lessee, licencee, publisher, etc) the right to use that asset against some consideration. Such consideration is calculated with reference to the quantity produced or sold. This payment to the owner by the user of the asset is termed as Royalty.

We can therefore say that the royalty is the amount of consideration paid by a party to the owner of the asset in return for the right to use that asset.

For example, when a publisher publishes a book, he makes a payment to the author which is based on the number of copies sold known as royalty.

Royalty can be defined as a proper and periodic payment that is made by one person to another in order to use the right to some resources. There are two different sides to royalty. The person who is responsible for providing the right for

using the resource is known as the lessor. The person who is responsible for the use of the resource by making the payment is known as the lessee.

5.1.2 Meaning and Definition

Meaning of Royalty:

Royalty is a payment made by one party (the licensee or lessee) to another (the licensor or lessor) for the right to use the latter's asset, typically intellectual property such as patents, trademarks, copyrights, or natural resources. This payment is often a percentage of the revenue generated from the use of the asset or a fixed amount per unit sold.

Definition of Royalty:

Royalty is a periodic payment made by the licensee to the licensor for the ongoing use of an asset or intellectual property. The amount of royalty is usually determined based on the terms specified in a licensing agreement and is often calculated as a percentage of the sales revenue or a fixed fee per unit produced or sold.

5.1.3 Feature of Royalty

1. Periodic Payments

Royalty payments are usually made on a regular basis, such as monthly, quarterly, or annually. This ensures continuous compensation to the licensor based on the ongoing use of the asset.

2. Usage-Based Calculation

Royalties are often calculated based on the usage or revenue generated from the asset. Common methods include:

Percentage of Revenue: A set percentage of the revenue generated from sales or usage.

Fixed Fee per Unit: A predetermined amount for each unit sold or produced.

Combination: A mix of a fixed fee and a percentage of revenue.

3. Defined by Contract

The specifics of royalty payments are governed by a licensing agreement or contract. This document outlines the royalty rate, payment schedule, duration, and other critical terms and conditions.

4. Audit and Reporting Requirements

To ensure accuracy, licensors often have the right to audit the licensee's records. The licensee is typically required to provide regular reports detailing sales and revenue, which form the basis for calculating royalty payments.

5. Transfer of Rights

Royalties involve the transfer of usage rights from the licensor to the licensee. The licensor retains ownership of the asset, while the licensee gains the right to use it under specified conditions.

6. Incentive for Innovation and Creativity

Royalties provide financial incentives for creators, inventors, and property owners. This encourages the development of new products, technologies, and creative works.

7. Application Across Various Industries

Royalties are applicable in numerous industries, including:

Entertainment: Music, film, and book publishing.

Technology: Software licensing and patents.

Natural Resources: Mining, oil, and gas extraction.

Franchising: Use of brand names and business models.

8. Negotiable Terms

The terms of a royalty agreement are typically negotiable, allowing both parties to agree on rates and conditions that reflect the asset's value and market conditions.

9. Protection of Intellectual Property

Royalty agreements help protect intellectual property rights by legally defining how and where an asset can be used, ensuring that unauthorized use can be challenged.

10. Revenue Stream for Licensors

For licensors, royalties provide a steady revenue stream without the need to commercialize the asset themselves. This can be particularly beneficial for creators who may lack the resources to market their products directly.

5.1.4 Advantages and Disadvantages

Advantages of Royalty

1. Steady Income Stream

For Licensors: Provides a continuous revenue stream without the need for direct commercialization or operational involvement.

Example: An author receives regular payments based on book sales, ensuring ongoing income.

2. Incentive for Innovation and Creativity

For Creators and Inventors: Royalties offer financial rewards for creating and innovating, encouraging further development of new products, technologies, and creative works.

Example: A musician earns royalties from their songs, motivating them to produce more music.

3. Risk Mitigation

For Licensors: Reduces the financial risk associated with producing and marketing a product, as the licensee assumes these responsibilities.

Example: A patent holder licenses the patent to a manufacturer, who then bears the costs of production and marketing.

4. Access to Expertise and Resources

For Both Parties: Licensees can benefit from the expertise and resources of licensors, while licensors can leverage the licensee's market presence and distribution channels.

Example: A small tech startup licenses its software to a larger company with a vast distribution network.

5. Market Expansion

For Both Parties: Facilitates market expansion by allowing licensors to reach new markets through the licensee's existing channels.

Example: A foreign publisher licenses a book to a local publisher, enabling access to new readers.

6. Flexibility

For Both Parties: Royalty agreements can be tailored to fit the specific needs and goals of both parties, offering flexibility in terms and conditions.

Example: A film production company negotiates a tiered royalty rate based on box office performance.

Disadvantages of Royalty

1. Complexity in Calculation and Monitoring

For Both Parties: Calculating and monitoring royalties can be complex, requiring detailed tracking of sales and usage, which can be time-consuming and costly.

Example: A software company must implement robust tracking systems to monitor licensee sales accurately.

2. Potential for Disputes

For Both Parties: Disagreements can arise over the interpretation of contract terms, calculation of royalties, or audit rights, leading to potential legal disputes.

Example: A dispute occurs over whether certain revenue streams should be included in the royalty base.

3. Dependency on Licensee Performance

For Licensors: The licensor's income is dependent on the licensee's ability to market and sell the product effectively.

Example: If a licensee fails to effectively market a patented product, the licensor's royalty income will be low.

4. Upfront Costs and Delays

For Licensees: Initial costs for acquiring rights and potential delays in generating revenue can be significant, especially if the product requires further development or marketing.

Example: A pharmaceutical company pays substantial upfront royalties for a drug that is still in the trial phase.

5. Limited Control

For Licensors: Once an asset is licensed, the licensor has limited control over how it is used and marketed, which could affect the asset’s reputation and value.

Example: A fashion brand licenses its name to a manufacturer who produces subpar products, potentially damaging the brand's reputation.

6. Audit and Compliance Costs

For Both Parties: Regular audits and compliance checks to ensure accurate royalty payments can be expensive and resource-intensive.

Example: A music label incurs significant costs to audit streaming services and ensure accurate royalty reporting.

5.1.5 Common terms used in Royalty:

Minimum Rent / Dead Rent

A contract is entered into between the landlord and the lessee for payment of royalty, usually calculated upon the quantum of production or sale at a certain stipulated rate. So, if there is little or no production or sale, the landlord would receive little or no royalty at all, thus affects the monetary interest of the landlord as well as the lessee. It is normally not acceptable to the owner, since sale or production mostly depends on the capacity of the person to whom the rights have been given. To avoid such a situation, the landlord and the lessee agreed upon a minimum periodical amount that the landlord will receive from the lessee, even if the actual royalty as calculated on the basis of actual production or sale is less than such minimum amount.

This assured and mutually agreed periodical minimum amount is known as “Minimum Rent”.

Short workings/Redeemable Dead Rent

Short workings is the amount by which the minimum rent exceeds the actual royalty. It is the difference between Actual Rent and Minimum Rent.

Ground Rent/Surface Rent

It refers to the fixed yearly or half-yearly rent payable by the lessee to the landlord in addition to the minimum rent.

Recoupment of Short workings

Generally the royalty agreement contains a provision for carrying forward of short workings with a view to adjust it in the future. In the subsequent years, such short working is adjusted against the surplus royalty. This process of adjustment is called recoupment of short workings. The right of recoupment of short workings enables the lessee to recover the excess payment, made in the earlier years to meet the condition of payment of minimum rent. A time is usually agreed upon the number of years for which such short workings can be recouped. This time limit for recoupment of short workings may be fixed or fluctuating. If the short workings cannot be recouped within the specified time, they lapse and are charged to Profit and Loss Account in the year when that specified time limit for recoupment ends.

Fixed right :

When the lessee can recoup short workings within a certain period from the date of the lease it is known as fixed right. For example, short workings can be recouped within three years from the date of the lease. So, after three years from the date of the lease the short workings cannot be recouped.

Fluctuating right :

In this type of agreement, lessee can recoup short workings of any year during the next following year(s). For example, shortworkings can be recouped in the year subsequent to the year of short workings.

Strike and Lockout, etc :

If agreement so provides, the minimum rent may be proportionately reduced in the event of strike and/ or lockout. So special entry is required for the same except the adjustment of minimum rent for that particular year.

5.1.6 Accounting Entries

When there is no royalty in the year	(a) Minimum Rent A/c Dr To Landlord A/c (b) Shortworking A/c Dr To Minimum Rent A/c
Where Royalties are less than minimum rent and shortworkings are recoverable in next years.	(c) Minimum Rent A/c Dr To Landlord A/c (d) Royalties A/c Dr Shortworkings A/c Dr To Minimum Rent A/c (e) Landlord A/c Dr To Bank A/c (f) Profit & Loss A/c Dr To Royalty A/c
When Short workings are recouped	(g) Royalties A/c Dr To short workings A/c To Landlord A/c (h) Landlord A/cDr To Bank A/c
Transfer of irrecoverable Short workings	(i) Profit & Loss A/c Dr To Short workings A/c

5.1.7 Problem and Solution

1. S.K. Collieries Co. Ltd. took from M/s Bihari Bros, a lease of a coal field for a period of 25 years from 1st April, 2007 on a royalty of Rs 25 per tonne of coal extracted with a Dead Rent of Rs 2,20,000 a year with power to recoup short-

workings during the first five years of the lease. The company closes its books of account on 31st March every year.

The output in the first five years of the lease was as follows:

Year ended 31st March, 2008	...	2,000	tonnes
Year ended 31st March, 2009	...	3,600	"
Year ended 31st March, 2010	...	9,000	"
Year ended 31st March, 2011	...	15,000	"
Year ended 31st March, 2012	...	20,000	"

(a) Pass journal entries for all the transactions relating to royalties for the five years in the books of S.K. Collieries C. Ltd.

(b) Suppose, output for the year ended 31st March, 2012 was 14,000 tonnes only. What would be the journal entries for the year 2011-2012 then?

Solution:

Before proceeding to pass journal entries, preparation of the following chart minimises the chances of mistakes in the amounts of the journal entries:

Date	Output (in tonnes)	Royalty @ ₹25 per tonne ₹	Minimum Rent ₹	Shortworkings Arising ₹	Shortworkings Being Recouped ₹	Shortworkings Becoming Irrecoverable ₹	Amount Payable to Landlord ₹
31-3-2008	2,000	50,000	2,20,000	1,70,000	—	—	2,20,000
31-3-2009	3,600	90,000	2,20,000	1,30,000	—	—	2,20,000
31-3-2010	9,000	2,25,000	2,20,000	—	5,000	—	2,20,000
31-3-2011	15,000	3,75,000	2,20,000	—	1,55,000	—	2,20,000
31-3-2012	20,000	5,00,000	2,20,000	—	1,40,000	—	3,60,000
(b) 31-3-2012	14,000	3,50,000	2,20,000	—	1,30,000	10,000	2,20,000

Journal

Date		Particulars		L.F.	₹	₹
2008 Mar.	31	Royalties Account ...	Dr.		50,000	
		Shortworkings Account ...	Dr.		1,70,000	
		To M/s Bihari Bros.				2,20,000
		Royalties @ ₹ 25 per tonne on 2,000 tonnes subject to a minimum of ₹ 2,20,000.				
"	"	M/s Bihari Bros. ...	Dr.		2,20,000	
		To Bank				2,20,000
		Payment of the sum due to Bihari Bros; the landlord.				
"	"	Profit and Loss Account ...	Dr.		50,000	
		To Royalties Account				50,000
		Transfer of Royalties Account to Profit and Loss Account.				

Date		Particulars			₹	₹
2009 Mar.	31	Royalties Account	...	Dr.	90,000	
		Shortworkings Account	...	Dr.	1,30,000	
		To M/s. Bihari Bros.				2,20,000
		Royalties @ ₹ 25 per tonne on 3,600 tonnes *plus* ₹ 1,30,000 needed to make it up to ₹ 2,20,000 payable to M/s Bihari Bros, the landlord.				
Mar.	31	M/s. Bihari Bros.	...	Dr.	2,20,000	
		To Bank				2,20,000
		Payment of the sum due to Bihari Bros., the landlord.				
"	"	Profit and Loss Account	...	Dr.	90,000	
		To Royalties Account				90,000
		Transfer of Royalties Account to Profit and Loss Account.				
2010 Mar.	31	Royalties Account	...	Dr.	2,25,000	
		To M/s. Bihari Bros.				2,20,000
		To Shortworkings Account				5,000
		Royalties @ ₹ 25 per tonne on 9,000 tonnes *less* ₹ 5,000 recovered against shortworkings payable to landlord.				
"	"	M/s. Bihari Bros.	...	Dr.	2,20,000	
		To Bank				2,20,000
		Payment of the sum due to landlord.				
"	"	Profit and Loss Account	...	Dr.	2,25,000	
		To Royalties Account				2.25,000
		Transfer of Royalties Account to Profit & Loss Account.				
2011 Mar.	31	Royalties Account	...	Dr.	3,75,000	
		To M/s. Bihari Bros.				2,20,000
		To Shortworkings Account				1,55,000
		Royalties @ ₹ 25 per tonne on 15,000 tonnes *less* ₹ 1,55,000 recovered against shortworking payable to landlord.				
"	"	M/s. Bihari Bros.	...	Dr.	2,20,000	
		To Bank				2,20,000
		Payment of the sum due to landlord.				
"	"	Profit and Loss Account	...	Dr.	3,75,000	
		To Royalties Account				3,75,000
		Transfer of Royalties Account to Profit & Loss Account.				
2012 Mar.	31	Royalties Account	...	Dr.	5,00,000	
		To Shortworkings Account				1,40,000
		To M/s. Bihari Bros.				3,60,000
		Royalties @ ₹ 25 per tonne on 20,000 tonnes *less* ₹ 1,44,000, the balance in Shortworkings Account, recouped payable to M/s Bihari Bros., the landlord				

Date		Particulars		L.F.	₹	₹
2012 Mar.	31	M/s. Bihari Bros. ...	Dr.		3,60,000	
		To Bank				3,60,000
		Payment of the sum due to landlord.				
"	"	Profit and Loss Account ...	Dr.		5,00,000	
		To Royalties Account				5,00,000
		Transfer of Royalties Account to Profit and Loss Account.				

(*b*) Output for the year ended 31st March, 2012 being 14,000 tonnes only :—

Date		Particulars		L.F.	₹	₹
2012 Mar.	31	Royalties Account ...	Dr.		3,50,000	
		To Shortworkings Account				1,30,000
		To M/s. Bihari Bros.				2,20,000
		Royalties @ ₹ 25 per tonne on 14,000 tonnes *less* ₹ 1,30,000 recovered against shortworkings payable to landlord.				
"	"	M/s. Bihari Bros. ...	Dr.		2,20,000	
		To Bank				2,20,000
		Payment of the sum due to landlord.				
"	"	Profit and Loss Account ...	Dr.		3,60,000	
		To Royalties Account				3,50,000
		To Shortworkings Account				10,000
		Transfer of royalties for the year and the balance in the Shortworking Account which is now irrecoverable to Profit & Loss Account.				

2. A colliery worked coal under a lease which provided for the payment of royalties at Rs 5 per tonne with a minimum rent of Rs 1,70,000 per annum. Each year's excess of minimum rent over the actual royalties was recoverable during the subsequent three years. The lease, however, stipulated that if in any year the normal rent was not attained due to strike or accident, the minimum rent was to be regarded as having been reduced proportionately having regard to the length of the stoppage.

The output was as follows:

For the year ended 31st March,	2007	4,000 tonnes
For the year ended 31st March,	2008	28,000 "
For the year ended 31st March,	2009	30,000 "
For the year ended 31st March,	2010	46,000 "
For the year ended 31st March,	2011	30,000 "
For the year ended 31st March,	2012	50,000 "

During the year 2010-11 there was a stoppage due to strike lasting three months. Give the necessary ledger accounts in the books of the colliery for each of the above years.

Solution :

Minimum Rent Account

Date		Particulars	₹	Date		Particulars	₹
2007 Mar.	31	To Landlord	1,70,000	2007 Mar.	31	By Royalties Account on 4,000 tonnes @ ₹ 5 per tonne	20,000
				,,	,,	By Shortworkings A/c	1,50,000
			1,70,000				1,70,000

Dr. **Shortworkings Account** Cr.

Date		Particulars	₹	Date		Particulars	₹
2007 Mar.	31	To Minimum Rent A/c	1,50,000	2007 Mar.	31	By Balance c/d	1,50,000
2007 Apr.	1	To Balance b/d	1,50,000	2008 Mar.	31	By Balance c/d	1,80,000
2008 Mar.	31	To Minimum Rent A/c	30,000				
			1,80,000				1,80,000
2008 Apr.	1	To Balance b/d	1,80,000	2009 Mar.	31	By Balance c/d	2,00,000
2009 Mar.	31	To Minimum Rent A/c	20,000				
			2,00,000				2,00,000
2009 Apr.	1	To Balance b/d	2,00,000	2010 Mar.	31	By Landlord	60,000
				,,	,,	By Profit & Loss A/c— Balance of shortworking for 2006-2007 being irrecoverable now	90,000
				,,	,,	By Balance c/d	50,000
			2,00,000				2,00,000
2010 Apr.	1	To balance b/d	50,000	2011 Mar.	31	By Landlord	22,500
				,,	,,	By Profit and Loss A/c— balance of shortworking for 2007-2008	7,500
				,,	,,	By Balance c/d	20,000
			50,000				50,000
2011 Apr.	1	To Balance b/d	20,000	2012 Mar.	31	By Landlord	20,000

Dr. **Production Account** Cr.

Date		Particulars	₹	Date		Particulars	₹
2007 Mar.	31	To Royalties A/c	20,000				
2008 Mar.	31	To Royalties A/c	1,40,000				
2009 Mar.	31	To Royalties A/c	1,50,000				
2010 Mar.	31	To Royalties A/c	2,30,000				
2011 Mar.	31	To Royalties A/c	1,50,000				
2012 Mar.	31	To Royalties A/c	2,50,000				

Profit and Loss Account

Date		Particulars	₹			
2011 Mar.	31	To Shortworkings A/c	90,000			
2012 Mar.	31	To Shortworkings A/c	7,500			

3. **Exe Ltd. of Mumbai obtained on 1st April, 2008 the use of a patent from Zed Ltd. of New York on the terms mentioned below:**

(i) A royalty of 1% on sales subject to a minimum of $ 300 per annum will be payable in U.S. dollars; all payments to be free of the Indian income-tax.

(ii) The royalty will be payable on 15th April following the year to which it related.

(iii) Exe Ltd. will have the right of recouping any short-workings in the first three years of the agreement.

Sales affected by Exe Ltd. were as follows:

For the year ended 31st March, 2009	₹	8,40,000
For the year ended 31st March, 2010	₹	12,00,000
For the year ended 31st March, 2011	₹	16,80,000
For the year ended 31st March, 2012	₹	22,50,000

The income-tax rate concerned is 25%. The value of one U.S. dollar was Rs 32 till September 5, 2009 and Rs 50 thereafter. Prepare accounts in the ledger of Exe Ltd. for the first four years of the contract.

Zed Ltd.

Date		Particulars	₹	Date		Particulars	₹
2009				2009			
Mar.	31	To Balance *c/d*	9,600	Mar.	31	By Royalties Account	8,400
				"	"	By Shortworkings Account*	1,200
			9,600				9,600
2009				2009			
Apr.	15	To Bank	9,600	Apr.	1	By Balance *b/d*	9,600
2010				2010			
Mar.	31	To Balance *c/d*	15,000	Mar.	31	By Royalties Account**	12,000
				"	"	By Shortworkings Account**	3,000
			24,600				24,600
2010				2010			
Apr.	15	To Bank	15,000	Apr.	1	By Balance *b/d*	15,000
2011				2011			
Mar.	31	To Shortworkings Account	1,800	Mar.	31	By Royalties Account	16,800
"	"	To Balance *c/d*	15,000				
			31,800				31,800
2011				2011			
Apr.	15	To Bank	15,000	Apr.	1	By Balance *b/d*	15,000
2012				2012			
Mar.	31	To Balance *c/d*	22,500	Mar.	31	By Royalties Account	22,500
			37,500				37,500
				2012			
				Apr.	1	By balance *b/d*	22,500

Shortworkings Account

Date		Particulars	₹	Date		Particulars	₹
2009				2009			
Mar.	31	To Zed Ltd.	1,200	Mar.	31	By Balance *c/d*	1,600
"	"	To Income-tax Payable	400				
			1,600				1,600
2009				2010			
Apr.	1	To Balance *b/d*	1,600	Mar.	31	Balance *c/d*	5,600
2010							
Mar.	31	To Zed Ltd.	3,000				
"	"	To Income-tax Payable A/c	1,000				
			5,600				5,600
2010				2011			
Apr.	1	To Balance *b/d*	5,600	Mar.	31	By Zed Ltd	1,800
				"	"	By Income-tax Payable A/c	600
				"	"	By Profit & Loss Account—irrecoverable amount	3,200
			5,600				5,600

Income-tax Payable Account

Date		Particulars	₹	Date		Particulars	₹
2009				2009			
Mar.	31	To Balance c/d	3,200	Mar.	31	By Royalties Account	2,800
				"	"	By Shortworkings A/c	400
			3,200				3,200
2009				2009			
Apr.	15	To Bank	3,200	Apr.	1	By Balance b/d	3,200
2010				2010			
Mar.	31	To Balance c/d	5,000	Mar.	31	By Royalties Account	4,000
				"	"	By Shortworkings A/c	1,000
			8,200				8,200
2010				2010			
Apr.	15	To Bank	5,000	Apr.	1	By Balance b/d	5,000
2011				2011			
Mar.	31	To Shortworkings A/c*	600	Mar.	31	By Royalties Account	5,600
"	"	To Balance c/d	5,000				
			10,600				10,600
2011				2011			
Apr.	15	To Bank	5,000	Apr.	1	By Balance b/d.	5,000
2012				2012			
Mar.	31	To Balance c/d	7,500	Mar.	31	By Royalties Account	7,500
			12,500				12,500
				2012			
				Apr.	1	By Balance b/d	7,500

5.1.8 Multiple Choice Questions

1. What is a royalty payment typically based on?

   a) Fixed monthly salary b) Percentage of revenue or usage

   c) Annual subscription fee d) One-time lump sum

2. Which of the following is a primary benefit for a licensor in a royalty agreement?

   a) Unlimited control over the asset b) Continuous revenue stream

   c) No need to monitor sales d) Full responsibility for marketing

3. In a royalty agreement, who is the licensee?

   a) The owner of the asset

   b) The party that pays for the right to use the asset

   c) The auditor of the financial transactions

   d) The person who created the licensing agreement

4. Which of the following industries commonly uses royalty agreements?

   a) Healthcare b) Hospitality

   c) Natural resources d) Retail banking

5. What is one disadvantage for the licensee in a royalty agreement?

   a) Continuous revenue stream b) Reduced risk of marketing

c) Complexity in calculation and monitoring

d) Access to additional resources

6. Which term refers to the agreement detailing the terms and conditions of royalty payments?

a) Sales contract b) Licensing agreement

c) Purchase order d) Employment contract

7. How often are royalty payments typically made?

a) Only once at the beginning

b) Periodically (e.g., monthly, quarterly, annually)

c) On an as-needed basis

d) Irregularly, without a set schedule

8. What can licensors include in the royalty agreement to ensure accurate payments?

a) Sales targets b) Audit rights

c) Customer satisfaction surveys d) Marketing strategies

9. Why might a small business prefer a royalty agreement over selling their intellectual property outright?

a) To gain unlimited control over the intellectual property

b) To receive an immediate large sum of money

c) To benefit from a continuous revenue stream

d) To avoid any future involvement with the intellectual property

10. What risk does a licensor face in a royalty agreement?

a) Full responsibility for product development

b) Dependency on the licensee's performance

c) Immediate large expenditure

d) Complete loss of control over the asset

Answer: 1.b, 2.b, 3.b, 4.c, 5.c, 6.b, 7.b, 8.b, 9.c, 10.b

5.1.9 Short Answer Questions

1. What is a royalty?
2. What are the main components of a royalty agreement?
3. What is a fixed fee royalty, and when might it be used?
4. List out advantage of royalty account.
5. How do audit rights benefit licensors in royalty agreements?

Long Answer Questions

.1. Explain the features of Royalty Accounts.

2. Explain the advantages and disadvantages in Royalty Accounts.

3. What is the accounting treatment used for Royalty Accounts.

4. Explain the various types of royalties and the contexts in which each type might be used.

5. What are the journal entries used in royalty Accounts.

5.1.10 Problems

1. The Visu coal co LTD took a lease of mine from M/s C.V.K. Co for a period of 25 years from 1st Jan. 2002 upon the terms of a royalty of 50 praise per tonne of coal raised with the minimum rent of Rs 20,000 and short workings if any, can be recouped within the subsequent three years. The following was the production of coal in the first five years.

Year	Production in tonnes
2002	6,000
2003	36,000
2004	48,000
2005	60,000
2006	64,000

2. P.K. Rao took a lease of a mine from P.N Rao for a period of 20 years from 1.1.2000 upon the terms of royalty of Re1 per each tone of output with a minimum rent of Rs.40,000 P.K. Rao had the right of recouping short working during the first Four years. The following were the production.

Year	Output in tonnes
2000	5,000
2001	24,000
2002	40,000
2003	60,000
2004	75,000

Give necessary journal entries in the books of P.KRao.

5.2.1 Introduction – Fire Insurance Claims

Business enterprises get insured against the loss of stock on the happening of certain events such as fire, flood, theft, earthquake etc. Insurance being a contract of indemnity, the claim for loss is restricted to the actual loss of assets. Sometimes an enterprise also gets itself insured against consequential loss of profit due to decreased turnover, increased expenses etc. If loss consequential to the loss of stock is also insured, the policy is known as loss of profit or consequential loss policy. Insurance claim can be studied under two parts as under:-

- Claim for loss of stock
- Claim for loss of profit

5.2.2 Meaning of Fire

For purposes of insurance, fire means:

1. Fire (whether resulting from explosion or otherwise) not occasioned or happening through:

(a) Its own spontaneous fomentation or heating or its undergoing any process involving the application of heat;

(b) Earthquake, subterraneous fire, riot, civil commotion, war, invasion act of foreign enemy, hostilities (whether war be declared or not), civil war, rebellion, revolution, insurrection, military or usurped power.

2. Lightning.

3. Explosion, not occasioned or happening through any of the perils specified in 1 (a) above.

(i) of boilers used for domestic purposes only;

(ii) of any other boilers or economisers on the premises;

(iii) in a building not being any part of any gas works or gas for domestic purposes or used for lighting or heating the building.

The policy of insurance can be made to cover any of the excepted perils by agreement and payment of extra premium, if any. Damage may also be covered if caused by storm or tempest, flood, escape of water, impact and breakdown of machinery, etc., again by agreement with the insurer.

Usually, fire policies covering stock or other assets do not cover explosion of boilers used for domestic purposes or other boilers or economizers in the premises

but policies in respect of profit cover such explosions.

5.2.3 Claim for loss of stock

Fire insurance being a contract of indemnity, a claim can be lodged only for the actual amount of the loss, not exceeding the insured value. In dealing with problems requiring determination of the claim the following point must be noted:

(a) Total Loss: If the goods are totally destroyed, the amount of claim is equal to the actual loss, provided the goods are fully insured. However, in case of under insurance(i.e. insurable value of stock insured is more than the sum insured),the amount of claim is restricted to the policy amount.

(b) Partial Loss: If the goods are partially destroyed, the amount of claim is equal to the actual loss provided the goods are fully insured. However in case of under insurance, the amount of claim will depend upon the nature of insurance policy as follows:

(i) Without Average clause: Claim is equal to the lower of actual loss or the sum insured.

(ii) With Average Clause: Amount of claim for loss of stock is proportionately reduced, considering the ratio of policy amount (i.e. insured amount) to the value of stock as on the date of fire (i.e insurable amount) as shown below:

Amount of claim = Loss of stock × sum insured / Insurable amount (Total Cost)

Loss of Stock

Amount of loss of stock is calculated as under:

Value of stock on the date of fire	xxx
Less: Value of Salvaged stock	xxx
Amount of loss of stock	**xxx**

Being transferred to the Profit & Loss Account.

Particulars	**Amount**
Value of salvaged stock	xxx
Add: Expenses on re-conditioning	xxx
Less: Sales	xxx

Profit/ (loss) xxx

5.2.4 Problem and Solution

1. From the following information, ascertain the value of stock as on 31st March, 2022:

	Rs.
Stock as on 01-04-2021	28,500
Purchases	1,52,500
Manufacturing Expenses	30,000
Selling Expenses	12,100
Administration Expenses	6,000
Financial Expenses	4,300
Sales	2,49,000

At the time of valuing stock as on 31st March, 2021, a sum of Rs.3,500 was written off on a particular item, which was originally purchased for Rs.10,000 and was sold during the year for Rs.9,000. Barring the transaction relating to this item, the gross profit earned during the year was 20% on sales.

Statement showing valuation of stock as on 31.3.2022

Stock as on 01.04.20X1	28,500	
Less: Book value of abnormal stock (10,000 – 3,500)	6,500	22,000
Add: Purchases		1,52,500
Manufacturing expenses		30,000
		2,04,500
Less: Cost of Sales:		
Sales	2,49,000	
Less: Sale of abnormal stock	(9,000)	
	2,40,000	
Less: Gross profit @ 20%	.(48,000)	(1,92,000)
Value of Stock as on 31st March, 20X2		12,500

2. Mr. A prepares accounts on 30th September each year, but on 31st December, 2021 fire destroyed the greater part of his stock. Following information was collected from his book:

	`
Stock as on 1.10.2021	29,700

Purchases from 1.10.2021 to 31.12.2021	75,000
Wages from 1.10.2021 to 31.12.2021	33,000
Sales from 1.10.2021 to 31.12.2021	1,40,000

The rate of gross profit is 33.33% on cost. Stock to the value of ` 3,000 was salvaged. Insurance policy was for ` 25,000 and claim was subject to average clause.

Additional information:

- Stock at the beginning was calculated at 10% less than cost.
- A plant was installed by firm's own worker. He was paid 500, which was included in wages.
- Purchases include the purchase of the plant for 5,000

You are required to calculate the claim for the loss of stock.

Solution

Computation of claim for loss of stock:

	`
Stock on the date of fire i.e. 31.12.2021(Refer working note)	30,500
Less: Salvaged stock	(3,000)
Loss of stock	27,500

Amount of claim

$$= \frac{\text{Insured value}}{\text{Total cost of stock on the date of fire}} \times \text{loss of stock}$$

$$= \frac{25,000}{30,500} \times 27,500 = 22,541$$

Memorandum Trading Account

for period from 1.10.2021 to 31.12.2021

	`	`		`
To Opening stock (29,700 x 100/90)		33,000	By Sales	1,40,000
			By Closing stock (bal. fig.)	30,500
To Purchases	75,000			
Less: Cost of plant	(5,000)	70,000		
To Wages	33,000			
Less: Wages paid for plant	(500)	32,500		
To Gross profit (33.33% on cost or 25% on sales)		35,000		
		1,70,500		1,70,500

3. On 20th October, 20X1, the godown and business premises of Aman Ltd. were affected by fire. From the salvaged accounting records, the following information is available:

	`
Stock of goods @ 10% lower than cost as on 31st March, 2021	2,16,000
Purchases less returns (1.4.2021 to 20.10.2021)	2,80,000
Sales less returns (1.4.2021 to 20.10.2021)	6,20,000

Additional information:

- Sales upto 20th October, 2021 includes 80,000 for which goods had not been dispatched.
- Purchases upto 20th October, 2021 did not include 40,000 for which purchase invoices had not been received from suppliers, though goods have been received in Godown.
- Past records show the gross profit rate of 25%.
- The value of goods salvaged from fire ` 31,000.
- Aman Ltd. has insured their stock for ` 1,00,000.

Compute the amount of claim to be lodged to the insurance company.

Memorandum Trading A/c
(1.4.2021 to 20.10.2021)

Particulars	(`)	*Particulars*	(`)
To Opening stock (Refer W.N.)	2,40,000	By Sales (6,20,000 – 80,000)	5,40,000

To Purchases (2,80,000 + 40,000)	3,20,000	By Closing stock (bal. fig.)	1,55,000
To Gross profit (5,40,000 x 25%*)	1,35,000		
	6,95,000		6,95,000

* It is assumed that gross profit is provided as a percentage of sales

	`
Stock on the date of fire (i.e. on 20.10.2021)	1,55,000
Less: Stock salvaged	(31,000)
Stock destroyed by fire	1,24,000

$$= \frac{\text{Insured value}}{\text{Total cost of stock on the date of fire}} \times \text{loss of stock}$$

$$= \frac{1{,}24{,}000 \times 1{,}00{,}000}{1{,}55{,}000} = 80{,}000$$

Working Note:

Stock as on 1st April, 2021 was valued at 10% lower than cost. Hence, original cost of the stock as on 1st April, 2021 would be

2,16,000 / 90 x 100 = 2,40,000

Summary:

In summary, when stock is lost due to an insured event, you first record the loss of stock, then recognize the insurance claim receivable, and finally record the receipt of the insurance proceeds. Any difference between the actual loss and the insurance proceeds is recorded as a loss in the profit and loss account. This process ensures that the financial statements accurately reflect the financial impact of the loss and the subsequent insurance recovery.

5.2.5 Multiple Choice Questions

1. When a company suffers a loss of inventory due to fire, the initial journal entry should include:

a) Debit Inventory and Credit Cash

b) Debit Loss by Fire and Credit Inventory

c) Debit Cash and Credit Inventory

d) Debit Insurance Claim Receivable and Credit Loss by Fire

2. What account is credited when an insurance claim receivable is recorded?

a) Cash b) Inventory c) Loss by Fire d) Insurance Claim Receivable

3. In the case of an uninsured portion of a loss, how is this amount reflected in the financial statements?

a) As a decrease in inventory

b) As an expense in the Profit & Loss account

c) As an increase in assets

d) As a liability

4. Which of the following accounts is affected when the insurance claim is finally settled and the cash is received?

a) Sales Revenue b) Insurance Claim Receivable

c) Accounts Payable d) Deferred Revenue

5. What entry is made if the insurance proceeds received are less than the amount of the loss?

a) The difference is written off as an expense.

b) The entire amount is recorded as insurance income.

c) The difference is recorded as a liability.

d) The difference is ignored.

Answer: 1.b, 2.c, 3.b, 4.b, 5.a.

5.2.6 Short Answer Questions

1. What do you mean by under insurance?
2. What do you mean by Gross Profit Ratio?
3. Why is an average clause included in fire insurance policy?
4. How do you ascertain the amount of claim under a fire insurance claim?
5. What is a consequential loss policy?

Long Answer Questions

1. How loss due to short sales is calculated in connection with loss of profits policy?
2. How will you ascertain the claim for loss of profit as a result of fire?

5.2.7 Sums

1. On 12th June, 2022 fire occurred in the premises of N.R. Patel, a paper merchant. Most of the stocks were destroyed, cost of stock salvaged being ` 11,200. In addition, some stock was salvaged in a damaged condition and its value in that condition was agreed at 10,500. From the books of account,

   The following particulars were available.

   - His stock at the close of account on December 31,2021 was valued at 83,500.
   - His purchases from 1-1-2022 to 12-6-2022 amounted to 1,12,000 and his sales during that period amounted to 1,54,000.

On the basis of his accounts for the past three years it appears that he earns on an average a gross profit of 30% of sales. Patel has insured his stock for 60,000. Compute the amount of the claim.

*****