

BBA-202

FINANCIAL ACCOUNTING



DIRECTORATE OF DISTANCE EDUCATION

SWAMI VIVEKANAND

SUBHARTI UNIVERSITY

Meerut (National Capital Region Delhi)

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SYLLABUS

BBA 1st Year Semester 2nd

FINANCIAL ACCOUNTING

Course Code: BBA 202		
Course Credit: 5	Lecture: 04	Tutorial: 1
Course Type:	Core Course	
Lectures delivered:	40 L + 10 T	

End Semester Examination System

Maximum Marks Allotted	Minimum Pass Marks	Time Allowed
70	28	3 Hours

Continuous Comprehensive Assessment (CCA) Pattern

Tests	Assignment/ Tutorial/ Presentation/class test	Attendance	Total
15	5	10	30

Course Objective: The objective of this subject is to acquaint students with the accounting concepts, tools and techniques influencing business organizations.

UNIT	Content	Hours
1	Financial Accounting-Definition, scope, objectives of financial accounting, Accounting Vs Bookkeeping, Advantages and Limitations of Financial Accounting, Concepts and conventions, Principles of Accounting.	12
2	Types of accounts, rules of debit and credit, Subsidiary books, Cash Book, Accounting Process- Journals, Ledger, Preparation of Final accounts.	12
3	Depreciation Meaning, need and importance of depreciation, Methods of charging depreciation.	12
4	SHARE CAPITAL AND DEBENTURES: Features of Equity share capital, Preference share Capital, Share Vs Debentures, Entries relating to issue, forfeiture and reissue.	12
5	Analysis and interpretation of financial statements through ratio analysis.	12

Course Outcomes:

Upon successful completion of the course, students will be able to:

1. Understand the conceptual of Financial Accounting and their application in real world.
2. Describe the Generally Accepted Accounting Principles and its contribution in preparation of Final Accounts of a company.
3. Understand Indian Accounting System.
4. Get an insight to the concepts and principles for their routine monetary transaction.

Text Books:

1. Financial Accounting For Management: By Dr. S. N. Maheshwari, Vikas Publishing House. 2017
2. Financial Accounting For Management: By Amrish Gupta, Pearson Education, 2017

Reference Books:

1. Accounting Made Easy By Rajesh Agarwal & R Srinivasan, Tata McGraw –Hill, 2015
2. Fundamentals of Accounting & Financial Analysis: By Anil Chowdhry, Pearson Education, 2017

Weblinks:

1. <https://www.zeroinfy.com/mod/resource/view.php?id=4542>
2. <https://targetstudy.com/courses/bcom-financial-accounting.html>
3. <https://sol.du.ac.in/course/view.php?id=149>
4. <https://www.youtube.com/watch?v=80QWVZCxbaA>
5. <https://www.studocu.com> › ... › Introduction to Financial Accounting

CHAPTER 1 MEANING AND SCOPE OF ACCOUNTING

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★ STRUCTURE ★

- ☆ Book-keeping
- ☆ Accounting
- ☆ Development of Accounting
- ☆ Objectives of Accounting
- ☆ Need of Accounting
- ☆ Types or Sub-Fields/Branches of Accounting Information
- ☆ Persons/Parties Interested in Accounting
- ☆ Basic Accounting Terminology

BOOK-KEEPING

Meaning

Book-keeping is the proper and systematic keeping or maintenance of the books of accounts. Book-keeping starts from the identification of business transactions. These transactions must be supported by the documents and they must be financial in nature. For example, selling goods for cash is an accounting transaction, because cash is received and goods are going outside the business. The transaction will increase cash and reduce goods.

It will affect the finances of the business. There will also be documentary proof of the transaction because cash memo must have been issued for sale. The book-keeper after identification of the accounting transaction will record it in the proper books of accounts.

Definition

Book-keeping may be defined as the science and art of identifying and recording accounting transactions systematically in the proper books of accounts.

According to North Cott, "Book-keeping is the art of recording in the books of accounts the monetary aspect of commercial or financial transactions."

Prof. R.N. Carter defines, "Book-keeping as the science and art of correctly recording in the books of accounts all those business transactions that result in the transfer of money or money's worth."

Book-keeping is concerned with the proper maintenance of the books of accounts i.e., journal, ledger, cash book and other subsidiary books. It is not concerned with disclosing or interpreting the results of the business. Book-keeping involves the following process :

Process of Book-keeping

1. **Identifying accounting transactions.** All business transactions which are financial in nature and have documentary proof are accounting transactions. Non-economic

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activities concerning emotions of love, patriotism and respect do not find place in Book-keeping.

2. **Initial record of accounting transactions.** The identified accounting transactions are passed through subsidiary books, such as purchases book, sales book, returns inward book, returns outward book, bills receivable book, bills payable book, cash book and journal proper.
3. **Preparation of ledger accounts.** All the transactions relating to a particular person, party or item are put together at one place under one head, which is known as its ledger account. For example, information regarding sales to Ram, amount received from Ram, discount allowed to Ram and so further sales and receipt of the amount should be written in Ram's Ledger Account. This will enable us in understanding the actual position of Ram's dealings at a glance. With the help of subsidiary books and journal proper all ledger accounts are prepared.
4. **Balancing ledger accounts.** Ledger accounts are balanced *i.e.*, the difference between the debit and credit side of the ledger accounts are ascertained. Personal accounts show the amount payable to or receivable from them. Assets accounts show the value of assets on a particular date. Ledger accounts, thus, reveal the balances of expenses, revenue, liability, capital and assets.
5. **Preparation of trial balance.** Trial balance is prepared with the balances shown by the ledger accounts. While passing journal entries and preparing subsidiary books we take into consideration the dual aspect of every transaction, so the debit and credit balance of the trial balance must tally. Trial balance is prepared to check arithmetical accuracy. If the totals of the debit and credit side of the trial balance is not equal, there must be certain errors. These errors are located and rectified.

ACCOUNTING

Every business has profit motive. It has transactions of financial nature, such as, purchasing goods, selling goods, incurring expenses, receiving income etc. These transactions are financial in nature and affect the profit of the business. Accounting transactions are both money transactions and money worth transactions. Credit transactions are known as money worth transactions. It means that accounting transactions may not be necessarily cash transactions.

Transactions are classified as assets, liabilities, capital, revenues and expenses. Income statements are prepared to ascertain profit or loss of the business. The position statement is prepared to assess the value of assets and liabilities of the business. Various statements are prepared and ratios are calculated to measure the actual performance of the business. Comparison of the actual performance is compared with previous performance or desired performance and effective plans for future is made. In this way, *accounting is an art of identifying, classifying, recording, summarising and interpreting business transactions of financial nature.* The process of maintaining accountancy records contains the following steps :

All financial transactions which have documentary evidence are identified as accounting transactions. The elements of the transactions are classified as assets, liabilities, capital, revenues and expenses. These transactions are recorded in the appropriate books of accounts. Income statements are prepared to ascertain profit or loss of the business during accounting period. Position statements are prepared to ascertain assets and liabilities of the business. Finally, result of the business transactions are communicated.

Definition of Accounting

In the words of **Smith and Ashburne**, "Accounting is a means of measuring and reporting the results of economic activities."

In the opinion of **Bierman and Derbin**, "Accounting may be defined as the identifying, measuring, recording and communicating of financial information."

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Difference between Book-keeping and Accounting

Points of difference	Book-keeping	Accounting
1. Objective	The objective of book-keeping is to prepare original books of accounts. It is restricted to journal, subsidiary books and ledger accounts only.	The objective of accounting is to record, analyse and interpret the business transactions.
2. Scope	It has limited scope and is concerned with the recording of business transactions.	It has wider scope as compared to book-keeping.
3. Level of work	It is restricted to low level of work. Clerical work is involved in it.	It is concerned with low level, medium level and even top level management. Low level clerks prepare the accounts, medium level report it and top level interpret it.
4. Mutual dependence	Book-keeping is only the art of recording transactions, so it has to depend upon accounting which makes it more meaningful and purposeful.	Accounting is based upon book-keeping which is its initial and vital part. It depends upon book-keeping.
5. Result of the business	It does not show the net result of the financial position of business.	Accounting shows the net result of the business. It tells us about the profit earned and also about the assets and liabilities of the business.
6. Principles of Accounting	In book-keeping, accounting concepts and conventions are followed.	The methods of reporting and interpretation in accounting may vary from firm to firm.

DEVELOPMENT OF ACCOUNTING

The role of accounting has changed from that of a mere record keeping during the 1st decade of 20th century to the present stage, when it is accepted as **information system and decision making activity**.

The term accounting is becoming gradually broader. It is evident from **definitions of accounting** arranged in historical order :

(i) **1941**. The American Institute of Certified Public Accountants (AICPA) defined accounting as :

The art of recording, classifying and summarising in a significant manner and in terms of money transactions and events, which are in part, at least, of a financial character and interpreting the result thereof.

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(ii) 1966. The American Accounting Association (AAA) defined accounting as :
The process of identifying, measuring and communicating economic information to permit informed judgements and decisions by uses of the information.

(iii) 1970. Accounting Principles Board (APB) and AICPA states :
The function of Accounting is to provide quantitative information primarily financial in nature, about economic entities, that is intended to be useful in making economic decisions.

The above statements about Accounting show that the role of Accounting is gradually widening.

The role of accounting at present is assumed :

- (i) To provide information for judging management ability to utilise resources effectively in achieving goals.
- (ii) To provide factual and interpretative information by disclosing underlying assumptions on matters, subject to interpretation, evaluation, prediction or estimation and
- (iii) To provide information or activities affecting society.

Accounting in this way, identifies business transactions, records them in proper subsidiary books and journal proper and prepares ledger accounts. Trial balance is prepared with the balance of ledger accounts and finally financial statements are prepared, reported and communicated to parties concerned.

OBJECTIVES OF ACCOUNTING

Followings are the objectives of accounting :

1. **Maintaining proper record of business transaction.** The main purpose of accounting is to identify business transactions of financial nature and enter them into appropriate books of accounts. Business transactions are classified as, assets, liabilities, capital, revenues, expenses and accordingly passed through books. The accounting records should be made properly and systematically, so that requisite information may be obtained at a glance from the books of accounts.
2. **Calculation of profit or loss.** One of the main object of accounting is to calculate the profit or loss of the business. Income statements are prepared with the help of trial balance (prepared with the balances of ledger accounts). At the end of accounting period, we prepare Trading Account and ascertain gross profit or gross loss. Afterwards Profit and Loss Account is prepared to calculate net profit or net loss. Accounting in this way, is the source to evaluate the performance of the business in terms of profit.
3. **Depiction of the financial position.** At the end of accounting period, we prepare position statement. The value of assets and liabilities are depicted in the balance sheet, also known as position statement.

The assets side of the balance sheet shows the position of various assets such as cash in hand, cash at bank, sundry debtors, closing stock, building, machinery, furniture, etc. The liabilities side shows creditors' claim as creditors' for goods, bills payable, loans, outstanding expenses and proprietor's claim as capital, net profit and reserves. Balance Sheet is said to be a mirror, reflecting the true position of assets and liabilities on a particular date.
4. **Providing effective control over the business.** Accounting reveals the actual performance of the business in terms of production, sales, profit, loss, cost of production and the book value of sundry assets. The actual performance can be

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compared with the planned or desired performance of the business. It can also be compared with the previous performance. Comparison reveals deviation in terms of weaknesses and plus points. Causes responsible for the poor performance are identified and efforts are made to remove them. Causes responsible for better performance are reinforced. Accounting, in this way, enables the management to adopt effective control over the business.

5. **Making information available to various groups.** Business, these days is a social institution. In addition to the owners of the business various groups, such as, creditors, lenders, investors, researchers, government and even workers and consumers have an interest in the performance of business. Accounting makes information available to all these interested parties. Proprietors have interest in the profit or dividend, debenture holders, lenders and investors are concerned with the safety of money advanced by them to the business and interest thereon. Financial soundness of the business makes their loans secured. Employees have an interest in their increased wages and bonus. The object of the accounting is to provide meaningful information to all these interested groups.

NEED OF ACCOUNTING

1. **Replacing memory.** Business transactions are innumerable, varied and complex, as such it is quite impossible to memorise each and every transaction. Accounting records these transactions in writing and thus it is not necessary that the businessman should memorise all the transactions.
2. **Assisting the performance of the business.** Accounting keeps proper and systematic record of all business transactions. Income statements are prepared with these records and we are able to know the profit earned and the loss suffered by the business. Trading Account is prepared to find out gross profit or loss of the enterprise. Net profit or net loss can be known by preparing Profit and Loss Account.
3. **Assessing the financial status of the business.** Financial position of the business is displayed through position statement *i.e.*, Balance Sheet of the business. The statement is prepared at the end of the accounting year and reflects the true position of assets and liabilities of the business on a particular date.
4. **Documentary evidence.** Accounting records can also be used as an evidence in the court to substantiate the claim of the business. These records are based on documentary proof. Every entry is supported by authentic vouchers. That is why, the court accepts these records as evidence.
5. **Assisting in realisation of debts.** In 'Accounts' we prepare personal ledger accounts of all the parties. The personal account shows the exact amount due from the debtors. We can send the debtors their statement of accounts and thus enable them to verify entries and also to make early payment of the amount due. The account can also be used to prove the claim of the business against the debtors in the court.
6. **Facilitating the sale of the business.** The position statement of the business shows the value of assets and liabilities of the business. We can calculate the 'Net Worth' of the business on the basis of these statements. Accounting facilitates in the calculation of the consideration for which the business should be sold.
7. **Preventing and detecting frauds.** The proper accounting system and effective arrangement of internal check prevents leakage of goods and cash. In case,

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cheating takes place, theft or embezzlement is made and fraud is committed, accounting helps in detection of these losses and also fixes responsibility for it. Proper accounting prevents employees from committing fraud.

8. **Helpful to management.** Accounting is useful to the management in various ways. It enables the management to assess the achievements of its performance. Actual performance can be compared with the desired performance or with the performance of previous years. The weaknesses of the business can be identified and corrective measures can be applied to remove them. Various profitability, sales and liquidity ratios can be calculated, the actual performance can be evaluated and effective line of action can be decided for the future. Funds flow statement can also be prepared to understand the additional funds earned during the year and their application.

Full Disclosure. The concept is also known as convention of full disclosure. **Accounting must disclose all material information.** It should be honestly prepared, free from any bias, favour or prejudice. Figures should not be manipulated. It should be the sincere effort of the accountant to present facts, keeping in view the various accounting assumptions. No material information should be concealed. Material information means the information capable of changing the results of the business. Enterprises have their existence separate from their proprietors. In case of companies, there is a divorce between ownership and management. In this context it becomes binding upon the management to disclose all material information in accounts to its owners and other interested parties.

Disclosure of material facts does not mean leaking out the business secrecy, but disclosing all information of proprietors' and investors' interest. Accounting to this principle, certain unimportant items are left and some of them are merged with other items. The intention is not to over burden Accounting with information but present facts without any malafide intention.

TYPES OR SUB-FIELDS/BRANCHES OF ACCOUNTING INFORMATION

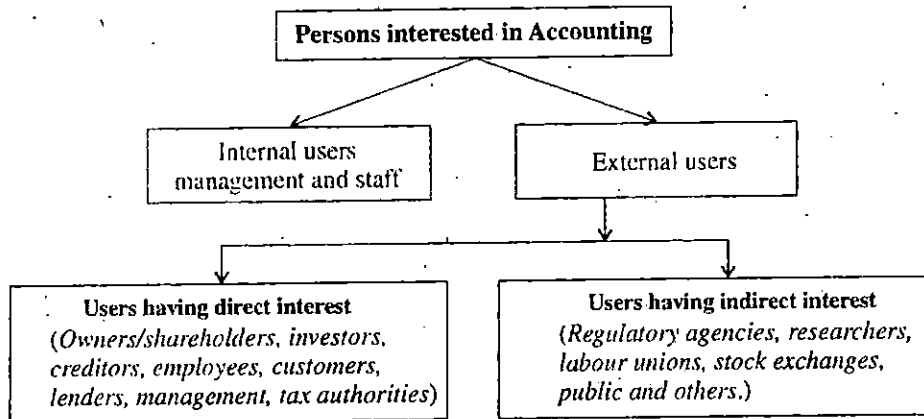
Accounting has at present three sub-fields or branches, mentioned as under :

1. **Financial accounting.** Accounting is a wider and comprehensive concept. It is an art of identifying, classifying, recording, summarising and interpreting business transactions of financial nature. Accounting work involves low, medium and even top level employees. Accounting as such is Book-keeping plus preparation of financial statements, reporting the results of the business and interpreting the accounting information in the forms of ratios, funds and cash flow statements, schedules, charts and diagrams.
2. **Cost accounting:** It is that branch of accounting, which deals with cost of production and its various constituents. It is concerned with the classification, allocation, recording, summarising and reporting current and prospective costs. Cost accounting, like financial accounting serves the needs of proprietors, managers and interested outsiders. Cost accounting is the systematic process of determining unit cost at different levels of production.
3. **Management accounting.** Management in the business is concerned with decision making for the efficient working of the enterprise, so management accounting is a system to assemble and furnish the useful material and summarised accounting

information to the management. Management accounting as such is the effective blending of financial and cost accounting together with financial management. The ultimate end of management is to maximise profit at the minimum cost and sacrifice. The management accounting serves as an effective tool for determining right line of action in future.

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PERSONS/PARTIES INTERESTED IN ACCOUNTING



1. **Internal users.** Top, middle and bottom level of management executives are the internal users of accounting information. They need it for making their decisions. These users are interested in the profitability, operational efficiency and financial soundness of the business. The top level management is concerned with accounting information relating to planning, the middle level is interested in planning and controlling and the lower level with operational affairs.

2. **External users.** External users may have direct interest or indirect interest.

(i) *External users having direct financial interest.* The existing and the prospective creditors and investors have direct interest in the accounting information. The sources of information for external users are financial statements and reports of directors and auditors. Investors assess the financial worth of the business so that they may decide about buying, selling or holding investment in the business. Creditors, such as banks, lenders, debenture holders and financial institutions assess the risk involved in granting loans to the business.

(ii) *External users having indirect interest.* These users, such as Department of Company Affairs, Registrar of Joint Stock Companies, sales tax and income tax authorities, labour unions, customers, stock exchanges, trade associations and others are also interested in the affairs of the business. They have to make their own decision on the basis of the financial reports of the business.

BASIC ACCOUNTING TERMINOLOGY

Every subject has got its own terminology. Accounting, as a subject has got its own terms. These terms have their specific meaning in Accounting and used to express financial nature of the business.

1. Business Transactions

The economic event that relates to a business entity is called business transaction.

Every business activity is not an Accounting activity. That is why, every activity is not recorded in the books of accounting. We record only business transactions in Financial Accounting. The first step in the accounting process is the identification of business transaction. *Every activity of financial nature having documentary evidence, capable of being presented in numerical, monetary term causing effect on assets, liabilities, capital, revenue and expenses is termed as business transactions.*

Special features of business transactions are as under :

- (i) Business transactions must be financial in nature.
- (ii) Business transactions must be supported by documentary evidence.
- (iii) Business transactions must be presented in numerical monetary terms.
- (iv) Business transactions must cause an effect on assets, liabilities, capital, revenue and expenses.

Business transactions as such refer to business activities involving transfer of money or goods or services between two parties or two accounts. Purchase and sale of goods, receipts of income, etc, are business transactions. Business transactions may be both cash or credit.

2. Assets

The valuable things owned by the business are known as assets. These are the properties owned by the business. Assets are the economic resources of an enterprise which can be expressed in monetary terms. In the words of **Prof. R.N. Anthony**, "*Assets are valuable resources owned by a business which were acquired at a measurable money cost.*" The most important assets are :

(a) Fixed assets

These assets are acquired for long term use in the business. They are not meant for sale. These assets increase the profit earning capacity of the business. Expenditure on these assets is not regular in nature. Land and building, plant and machinery, vehicles and furniture, etc. are some of the examples of fixed assets.

(b) Current assets

These assets, also known as circulating, fluctuating or floating assets. They change their values constantly. In the words of **Institute of Certified Public Accountants, USA**, "*Current assets include cash and other assets or resources, commonly identified as those which are reasonably expected to be realised in cash or sold or consumed during the normal operating circle of the business.*"

It should be noted that certain assets, which are popularly known as fixed may prove to be current by virtue of their specific use such as :

- (i) **Land** will be current assets in the hands of land developers and property dealers.
- (ii) **Building** with the builders and property dealers.
- (iii) **Plant and Machinery** with the manufacturers and dealers of plant and machinery.
- (iv) **Furniture** with the furniture dealers and furnishers.
- (v) **Shares and Debentures** with the dealers in securities.

It should be taken care of that assets meant for regular purchase and sale are always current assets.

(c) **Fictitious assets**

Fictitious assets are those assets, which do not have physical form. They do not have any real value. Actually, they are not the real assets but they are called assets on legal and technical ground. These assets are the revenue expenditure of capital nature which are also termed as deferred revenue expenditure. The example of these assets are loss on issue of shares, advertising suspense and preliminary expenses, etc. Fictitious assets do not have real value, so they are written off in the future.

(d) **Tangible assets**

Traditional View : Assets having physical existence which can be seen and touched are known as tangible assets. These assets are land, building, plant, equipment, furniture, stock etc.

Alternative View : In a court testimony in USA, it was argued that tangible assets should not be allowed to mean assets having physical construction only because there are certain assets, such as cash, cash equivalent and receivables which do not have physical construction but even then treated as tangible assets. It finally emerged that all assets where revenue generation is certain should be treated as tangible assets. The examples of these assets are building, plant, equipment, furniture, stock, receivable cash, cash equivalents such as treasury bills, commercial papers and money market funds.

On the other hand, in the case of assets like goodwill, patent or copyright the revenue generation is assumed to be uncertain. That is why they are put in the category of intangible assets.

(e) **Intangible assets**

These are the assets which are not normally purchased and sold in the open market such as goodwill and patents. It does not mean that these assets are never purchased and sold. They may be purchased and sold in special circumstances. Payment for patents can be made to reputed manufacturers of the country and abroad. Payments for patents is mostly made in case of medicines. While purchasing the business of other firms payment for goodwill is made. Goodwill may also be raised in case of admission or retirement of partner. It is also preferable to write off goodwill and patents accounts and not to show in the balance sheet.

(f) **Wasting assets**

Assets, whose value goes on declining with the passage of time are known as wasting assets. Mines, patents and assets taken on lease are its examples.

(g) **Liquid assets**

Liquidity refers to convertibility in cash. Liquid assets, therefore are those assets, which can be converted into cash at short notice. The examples of liquid assets are cash in hand, cash at bank, debtors, bills receivable, etc. In other words, liquid assets are current assets less stock *i.e.*,

$$\text{Liquid Assets} = \text{Current Assets} - (\text{Stock} + \text{prepaid expenses})$$

3. Capital

It is that part of wealth which is used for further production and thus capital consists of all current assets and fixed assets. Cash in hand, cash at bank, building, plant and furniture, etc. are the capital of the business. Capital need not necessarily be in cash. It may be in kind also. Capital may be classified as follows.

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(a) Fixed capital

The amount invested in acquiring fixed assets is called fixed capital. The money is blocked in fixed assets and not available to meet the current liabilities. The amount spent on purchase or extension or addition to the fixed assets is fixed capital. Plant and machinery, vehicle, furniture and building, etc. are some of the examples of fixed capital.

(b) Floating capital

Assets purchased with the intention of sales, such as stock and investments are termed as floating capital.

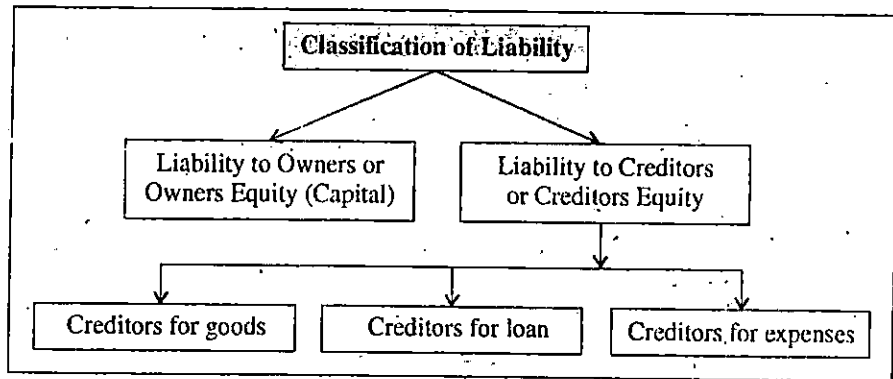
(c) Working capital

The part of capital available with the firm for day-to-day working of the business is known as working capital. Sufficient funds are required for purchasing goods and incurring direct and indirect expenses. Operational expenses are met with working capital. Current assets and current liabilities constitute working capital. Current assets consist of cash in hand, cash at bank, bills receivable, debtors, stock in hand, etc. and creditors, bills payable, short term loan, income received in advance and outstanding expenses are the current liabilities. Working capital can also be expressed as under :

$$\text{Working Capital} = \text{Current Assets} - \text{Current Liabilities}$$

4. Equity or Liability

Liabilities are the obligations or debts payable by the enterprise in future in the form of money or goods. It is the proprietors' and creditors' claim against the assets of the business. Creditors may be classified as creditors for goods and creditors for expenses. The business should have sufficient current assets to meet its current liabilities and reasonable amount of fixed assets to meet its fixed liability. Liabilities can be classified as under :



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

(a) Liability to owners. It is the owner's claim against the assets of the business, generally known as capital. It is technically known as internal equity or shareholder's funds. It may also be expressed as under :

$$\begin{aligned} \text{Owner's equity or Internal equity} &= \text{Capital} + \text{Profit earned} + \text{Retained earning} \\ \text{(Shareholders' funds)} &+ \text{Undistributed profit} + \text{Interest on Capital} \\ &- \text{Drawings} - \text{Expenses.} \end{aligned}$$

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(b) **Creditors' equity.** It is creditors' claim against the assets of the business. These creditors may be creditors for goods and creditors for expenses :

(i) *Creditors for goods.* Business has to purchase goods on credit, so the suppliers of goods to the business on credit are known as creditors for goods. They may be called as creditors and bills payable.

(ii) *Creditors for loan.* These creditors are the parties, banks and other financial institutions. The liability is named as Bank loan, Bank overdraft, Loan from Industrial Finance Corporation, Industrial Development Bank of India and World Bank.

(iii) *Creditors for expenses.* Certain expenses may concern the accounting period but may remain unpaid. These expenses may be outstanding salaries, rent due and wages unpaid. It is the current liability of the business.

Liabilities can also be classified as fixed, current and contingent liabilities.

(a) *Fixed liability.* These liabilities are paid after a long period. Capital, loans, debentures, mortgage, etc. are its examples. These are not current liabilities.

(b) *Current liabilities.* Liabilities payable within a year are termed as current liabilities. The value of these liabilities goes on changing. Creditors, bills payable and outstanding expenses, etc. are current liabilities.

(c) *Contingent liabilities.* These are not the real liabilities. Future events can only decide whether it is really a liability or not. Due to their uncertainty, these liabilities are termed as contingent (doubtful) liabilities. Important examples of contingent liabilities are as under :

(i) Value of bills discounted.

(ii) Cases pending in the court of law.

(iii) Guarantees undertaken.

The value of contingent liabilities is not shown in the amount column at the liabilities side of balance sheet. It is clearly mentioned as a note inside/outside the balance sheet.

Liabilities are also classified as long term liabilities and short term liabilities :

(a) *Long term liabilities.* Liabilities payable after a period of one year such as term loans and debentures are long term liabilities.

(b) *Short term liabilities.* Obligations payable within a period of one year, such as creditors, bills payable and overdraft, etc., are short term liabilities.

Financial Statements/Final Accounts

Statements prepared by an enterprise at the end of accounting year to assess the status of income and assets is termed as Financial Statement/Final Accounts. It is categorised as Income Statement and Position Statement traditionally known as Profit and Loss Account and Balance Sheet.

Accounting Equation

Accounting rotates around three basic terms. These terms are Assets, Liabilities and Capital. The true inter-relationship between these terms is represented as Accounting equations i.e.,

$$\text{Assets} = \text{Liabilities} + \text{Capital}$$

Goods

Articles purchased for sale at profit or processing by the business or for use in the manufacture of certain other goods as raw material are known as goods. In other

words, goods are the commodities, in which the business deals. Furniture will be good for the firm dealing in furniture but it will be an asset for the firm dealing in stationery. *Americans use the term 'merchandise' for goods.*

8. Cost

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

9. Purchases

In its routine business, the firm has to either purchase finished goods for sale or purchase of raw material for the manufacture of the article, being sold by the firm. The acquisition of these articles are purchases. The purchase of 10,000 metres of silk by Naro, a cloth merchant is termed as purchases in the business. In the same way the purchases of ten fans by Kevi, a dealer in electrical appliances for use in the cooler being assembled in his factory will also be the purchases. It is immaterial whether goods have been purchased for cash or on credit. They may be purchased within the country or imported from abroad. *Purchases of assets, are not the purchases in accounting terminology as these assets are not meant for sale.*

Proper, complete and systematic record of the purchases is essential as the cost price of goods is based upon it. Purchases must be made at competitive rates.

10. Sales

The ultimate end of the goods purchased or manufactured by the business is their sales. It includes both cash and credit sales. In accounting terminology, sale means the sale of goods, never the sale of assets, sales should have a regular feature. The sales of ten sofa sets by Amenla, a furniture is sales but sale of old furniture by Akho, a stationery dealer will not be a sale. Sales may be effected within the country or exported abroad.

The maintenance of proper and complete record of sales is necessary, because the profit or loss is associated with the amount of sales. It should be the sincere effort of every business to purchase goods at competitive rates and make sales at reasonably higher rates to earn more profit.

11. Purchases return or Returns outward

It is that part of the purchases of goods, which is returned to the seller. This return may be due to unnecessary, excessive and defective supply of goods. It may also result, if the supplier violates the terms and conditions of the order and agreement. In order to calculate net purchases, purchases return is deducted from purchases. Purchase returns are also known as returns outward, because it is the return of goods outside the business.

12. Sales return or Returns inward

It is that part of sales of goods which is actually returned to us by purchasers. This return may also be due to excessive, unnecessary and defective supply of goods or violation of terms of agreement. Sales return, also known as returns inward is deducted from sales, in order to calculate net sales.

13. Stock

The goods available with the business for sale on a particular date is termed as stock. It varies *i.e.*, increases or decreases and goes on changing. In accounting, we use the term stock widely as opening and closing stock. In case of business which is

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being carried on for the last so many years, the value of goods on the opening day of the accounting year is known as opening stock. In the same way, the value of goods on the closing day of the accounting year will be closing stock. For example, Avi and Sons started their business on Jan. 1, 2006 and decided to close their books on 31st December every year. The firm will not have any opening stock on Jan. 1, 2006, because the business did not exist before Jan. 1, 2006. If the firm has goods worth Rs. 50,000 on 31st December, 2006, it will be the closing stock on this date. On January 1, 2007, the closing stock of December 31, 2006 will be the opening stock of the year 2007. It should always be kept in mind that stock is valued at cost price or market price, whichever is lower.

In case of manufacturing enterprises stock is classified as under :

- (i) **Stock of raw material.** Raw material required for manufacturing of the product in which the business deals is known as stock of raw material. Cotton in case of cotton mill is its example.
- (ii) **Work in progress.** It is the stock of partly finished or partly manufactured goods just as price of thread and unfinished cloth in case of cotton mill.
- (iii) **Stock of finished goods.** Manufactured and finished goods ready for sale are known as stock of finished goods. Finished cloth is its example.

14. Expenses

Expenses are cost incurred by the business in the process of earning revenues. Generating income is the foremost objective of every business. The firm has to use certain goods and services to produce articles, sold by it. Payment for these goods and services are called expenses. Cost of raw material for the manufacture of goods or the cost of goods purchased for sale, expenses incurred in manufacturing or acquiring goods, such as wages, carriage, freight and amount spent for selling and distributing goods such as salaries, rent, advertising and insurance, etc. are known as expenses in accounting terminology. According to **Finney and Miller**, "*Expense is the cost of use of things or services for the purpose of generating revenue. Expenses are voluntarily incurred to generate income*".

15. Losses

Losses are unwanted burden which the business is forced to bear. Loss of goods due to theft or fire, or flood or storm or accidents are termed as losses in accounting. Losses are different from expenses in the sense that expenses are voluntarily incurred to generate income where losses are forced to bear.

Losses may be classified as normal and abnormal. Normal loss is due to the inherent weakness in the commodities *i.e.*, coal, cement, oil, ghee, ice, petrol. There will be shortage in their weight due to leakage, meltage, evaporation, spoilage and wastage during the journey. Abnormal loss on the other hand, is an extra ordinary loss due to earthquake, fire, flood, storm, theft and accidents.

Losses adversely affect the profit of the business, so it should be the sincere effort of every firm to adopt preventive measures to minimise losses.

16. Profit

Excess of revenue over expense is termed as profit. In other words excess of sale proceeds over cost of goods sold is income. Here, sales means net sales *i.e.*, sales less sales return. Cost of goods sold, also known as cost of sales is opening stock plus net purchases plus direct expenses less closing stock. Income must be regular in

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nature. It must concern routine activities of the business. It is always the part of revenue receipt. It must relate to the business of the current year. It is shown at the credit side of profit and loss A/c. Profit is generated through business activities.

17. Income

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Increase in the net worth of the enterprise either from business activities or other activities is termed as income. Income is a wider term, which includes profit also. From accounting point of view, *income is the positive change in the wealth of the enterprise over a period of time.*

18. Debtors

The term 'debtors' represents the persons or parties who have purchased goods on credit from us and have not paid for the goods sold to them. They still owe to the business. For example, if goods worth Rs. 20,000 have been sold to Adi, he will continue to remain the debtor of the business so far as he does not make the full payment. In case, he makes a payment of Rs. 16,000, he will remain to be debtor for Rs. 20,000 - Rs. 16,000 = Rs. 4,000.

In case, the firm is a service institution and the payment for service still remains to be realised, beneficiaries of the service will also be known as 'debtors'.

19. Creditors

In addition, to cash purchases the firm has to make credit purchases also. The sellers of goods on credit to the firm are known as its creditors for goods. Creditors are the liability of the business. They will continue to remain the creditors of the firm so far the full payment is not made to them. Liability to creditors will reduce with the payment made to them.

Creditors may also be known as creditors for expenses. In case, certain expenses such as salaries, rent, repairs, etc. remain unpaid during the accounting period, it will be termed as outstanding expenses. Parties rendering these services will be our creditors. Creditors are current liability so the firm should have sufficient current assets to make their timely payment.

20. Receivables

Receivable means, what business has to receive from outside parties on revenue account. When we sell goods on credit, purchasers are known as debtors. Certain debtors accept bills drawn by us and become part of bills receivable. The total of Debtors and Bills Receivable is known as Receivables. These are current assets and realised within a year. Receivables are shown at the assets side of the Balance Sheet.

21. Payables

Payable means, what the business has to pay to outside parties. When we purchase goods on credit, sellers are known as creditors. We accept bills drawn by certain creditors, which becomes a part of Bills Payable. The total of Creditors and Bills Payable is termed as Payables. It is shown at the liabilities side of the Balance Sheet.

22. Proprietor

An individual or group of persons who undertake the risk of the business are known as proprietor. They invest their funds into the business as capital. Proprietors are adventurous persons who make arrangement of land, labour, capital and organisation. They pay wages to labour, rent to land, interest to capital and salary to organisation.

After meeting all the expenses of business, if there remains any surplus, it is known as profit. The proprietor is rewarded with profit for the risk undertaken by him. If expenses exceed revenue the deficit is a loss to be borne by the proprietor.

In case of profit, proprietor's capital increases and in case of loss the capital decreases. Proprietor is an individual in case of sole trade, partners in case of partnership firms and shareholders in case of company.

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23. Drawings

Amount or goods withdrawn by the proprietor for his private or personal use is termed as drawing. The cost of using business assets for private or domestic use is also drawing. Use of business car for domestic use or use of business premises for residential purpose is also drawing. Acquiring personal assets with business funds is also drawing. Certain examples of drawings are as under :

- (a) Amount withdrawn by proprietor for personal use.
- (b) Goods taken by the proprietor for domestic use.
- (c) Purchasing pocket transistor for proprietor's son.
- (d) Using business vehicles for domestic use.
- (e) Using business premises for residential purpose.

24. Accounting Year

Books of accounts are closed annually. From the balances of different ledger accounts we prepare income statement and position statement. Income statement shows gross and net income of the business. Position statement, traditionally known as Balance Sheet is a mirror, which reflects the true value of assets and liabilities on a particular date. There is no legal restriction about the accounting year of sole proprietorship and partnership firm. They may adopt the accounting year of their choice. It may be between January 1st to December 31st of the same year or July 1st of the year to June 30th of the next year or between two Diwalis or even financial year, i.e., April 1st to March 31st of the next year. The only restriction is that the accounting period must consist of 12 months.

Companies must adopt financial year as their accounting year.

25. Entry

An entry is the systematic record of business transactions in the books of accounts. While passing entries, the principle 'every debit has got its corresponding credit' is adopted. Different accounts are debited and credited in the entry with the same amount.

26. Vouchers

Accounting transactions must be supported by documents. These documentary proofs in support of the transactions are termed as vouchers. It may be a receipt, cash memo, invoice, wages bill, salaries bill, deeds or any document as an evidence of transaction having taken place. The contents of vouchers are date, amount paid, purpose of the payment, payment passed by competent authority, payment made and cancelled. Vouchers are the basis of accounting records. They facilitate accounting. Vouchers are also used for verification and auditing of business records. Vouchers may also be used for detecting embezzlement and frauds.

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27. Insolvent

All business firms who have been suffering losses for the last many years and are not even capable of meeting their liabilities out of their assets are financially unsound. Only the court can declare the business firm as insolvent if it is satisfied that the continuation of the firm will be against the interest of the public or creditors. No firm can declare itself as insolvent. In case of solvency, the assets of the business are sold and liabilities paid with the funds realised from the sale of assets. If the funds realised fall short of the liabilities creditors are paid proportionately.

28. Solvent

Solvent are those persons and firms who are capable of meeting their liabilities out of their own resources. Solvent firms have sufficient funds and assets to meet proprietors' and creditors' claim. Solvency shows the financial soundness of the business.

29. Gain

Change in the net worth (equity) due to change in the form and place of goods and holding of assets for a long period, whether realised or unrealised is termed as gain. It may either be of capital nature or revenue nature or both.

30. Expenditure

Expenditure is the amount of resources consumed. It is long term in nature. It is the benefit to be derived in future. It is the amount spent for the purchase of assets. Expenditures can be made through cash, or exchanged for other assets or commodities or a promise to make the payment is made. Expenditures increase the profit earning capacity of the business and profit is expected from them in future. Expenditures are incurred to acquire assets of the business.

REVIEW QUESTIONS

A. Very Short Answer Type Questions :

1. Define accountancy.
2. What is the accounting year of the company ?
3. Mention two advantages of accounting.
4. Name the document, which is used as a source document for recording business transactions.
5. State the meaning of Book-keeping.

B. Short Answer Type Questions :

1. Define Book-keeping.
2. Mention the objectives of Accounting in about 50 words.
3. Describe the steps in Book-keeping process.

C. Long Answer Type Questions :

1. What is accounting ? Explain its objectives.
2. What is meant by Book-keeping ? In what respects book-keeping is different from accounting ?
3. Explain whether accounting is science or art or both.
4. Explain briefly the advantages of accountancy.

CHAPTER 2 ACCOUNTING PRINCIPLES

★ STRUCTURE ★

- ☆ Introduction
- ☆ Meaning of GAAP
- ☆ Basic Accounting Concepts

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INTRODUCTION

The business today is large in size and complex in nature. There are various groups who are interested in the performance of the business such as shareholders, debenture holders, investors, employees and consumers, etc. Accounting, in this way, is required to report and present the facts of the business in such a way, which can meet the varied requirements of different groups. It is, therefore, necessary that the language and terminology of accounting may be standardised so that there may be uniformity in the presentation of accounts. The idea requires scientific study, analysis and presentation of Accounts.

MEANING OF GAAP

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

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

Accounting is the systematised body of knowledge having cause and effect relationship. The subject has certain established concepts, conventions, standard language and terminology to enable the interested parties in the subject to understand it in the same sense as the accountant wants to communicate. These rules are usually called *Generally Accepted Accounting Principles* (GAAP). Accounting assumptions, rule of recording and reporting business transactions are also known by terms like *concepts, principles, conventions, doctrines, tenets, axioms postulates, assumptions and modifying principles*.

The Principles of Accounting are not static in nature. These are constantly influenced by changes in legal, social and economic environment as well as the needs of the users. The various terms for principles are inter-changeably used by different authors. Generally the term 'Basic Accounting Concepts' is used to refer all these terms.

BASIC ACCOUNTING CONCEPTS

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The fundamental ideas or basic concepts underlying the theory and practice of financial accounting and broad working rules for all accounting activities; developed by professionals are listed and discussed below :

BASIC ACCOUNTING CONCEPTS

1. Business Entity Concept.
2. Money Measurement Concept.
3. Going Concern Concept.
4. Accounting Period Concept.
5. Dual Aspect (or Duality) Concept.

These concepts are the foundation of systematic and proper accounting. Every business enterprise must adopt these concepts, popularly known as pillars upon which the sound structure of accounting stands. Let us discuss these basic concepts :

1. Business Entity Concept

In accounts, we distinguish between the business and its proprietors. Business is assumed to have distinct entity *i.e.*, existence other than the existence of its proprietors and other business units. As an accountant, we are concerned with the business not the businessman. We have to record business transactions from firm's point of view and never from the viewpoint of proprietors. We record transactions in the books of shop, establishment, factory, firm, company and enterprise and never in the books of proprietor, partners and shareholders. While making decisions regarding asset, liability, capital, revenue and expense, business viewpoint is taken into consideration.

The capital introduced by the proprietor in its own business is considered liability from business point of view. It will not be a liability if proprietor's viewpoint is taken. The logic behind treatment of capital as liability is that the firm has borrowed funds from its own proprietors instead of borrowing it from outside parties. It would have been a liability if the funds would have been borrowed from outside agency, then why not, if it is being invested by the proprietor himself. We also allow interest on capital to the proprietors because capital is supposed to be a liability. Interest on capital is an expense of the business, therefore, it will reduce the profit of the firm. It is at the same time proprietor's claim against the business, so it will increase his capital. Amount withdrawn by the proprietor for personal use, known as drawings is assumed to be the assets of the business and at the same time a liability to the proprietor.

The business as a distinct entity records all business transactions into the books of Accounts and reports the result to the proprietor in case of sole trade; partners in case of partnership firms and shareholders in case of company. There is a legal divorce between the ownership and management of a company. The company is owned by shareholders but managed by the elected representatives of the shareholders *i.e.*, directors. Accounts are prepared by the management and a copy of the financial statements is supplied to the shareholders, the owners of the company for information.

Every accountant whether he is concerned with a petty shop or a firm or a company or a big business house will have to compulsorily adopt the concept of business entity in his accounting operations.

Legally, a sole proprietor or the partner of a partnership firm are not separate from their business units but in Accounting the business units are assumed to have distinct entity. Accounting entity is different from business entity. Accounting entity is wider term including business, clubs, institutions, public enterprises, local bodies and government, etc.

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2. Money Measurement Concept

In accounting, we identify and record only those business transactions which are financial in nature. Accounting transactions must have their monetary value. The worth of the transaction must be measured in terms of money. In all the accounting records, we have amount column showing rupees and paise. There is never any accounting record in metres, litres, kilograms and quintals. We evaluate the value of the commodities in terms of money and accordingly record them in the books of accounts. Recording transactions in monetary terms makes the information more meaningful. For example, statement that the business was started with Rs. 50,000 cash and 20,000 metres of silk is meaningless and fails to tell us the capital of the business. If the value of 20,000 metres of silk is estimated to be Rs. 5,00,000, we can safely say that the business was started with Rs. $50,000 + 5,00,000 = 5,50,000$, which will be meaningful. The concept of money measurement is not free from problems when we integrate the financial statements of an entity having operations in more than one nation.

3. Going Concern Concept

While recording business transactions in the books of accounts, we assume that the **business will be carried on indefinitely**. That is why, the business purchases fixed assets like land and building, plant and machinery, vehicles, furniture, etc. If the concept of going concern is not there, we would have hired these assets and not purchased. These assets have been acquired for use and not for sale, so we maintain individual assets account and charge necessary depreciation on it.

According to **International Accounting Standard** "*The enterprise is normally viewed as a going concern, that is as continuing in operation for the foreseeable future*". It is viewed that the enterprise has an intention to be carried on for longer period. The concept of assets, liabilities, capital, revenue and expenses used in the accounting operation prove that the firm has to last long. Planning, organising and personnel policies substantiate the fact that the business has been assumed to be going entity. It is binding upon every accountant to treat business activity as a continuing process and record transaction accordingly.

4. Accounting Period Concept

Strictly speaking, the result of the business can be estimated at the end of its life. If a firm was started with a capital of Rs. 50,000 and at the end of its life the capital was Rs. 5,00,000 we can say that the firm earned a profit of Rs. 4,50,000 *i.e.*, $5,00,000 - 50,000$ during its life. In this way, business as a going entity will continue *indefinitely* and we will have to wait for a very long period to estimate the financial

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result of the business. It will be too late to wait for the results, so the life span of accounting should be split into shorter and convenient period. At present, accounting periods are regarded as twelve months. According to the Companies Act and Banking Regulation Act, accounting period should consist of twelve months. The period of twelve months is regarded as ideal and convenient period for accounting.

5. Dual Aspect (or Duality) Concept

Every business transaction has double effect. There are two sides of every transaction. This is evident when we study the accounting term *i.e.*, assets, capital and liabilities.

(i) **Assets.** These are the valuable articles owned by the business. Expenditure incurred in acquiring valuable things for the firm is assets. Special features of assets are that they are meant for use in the business and will increase the profit earning capacity of the business. Cash in hand, cash at bank, land and buildings, furniture, vehicles, etc. are the assets of the firm. It has been an established fact that no business can be carried on without assets. Business as a separate entity and going concern must possess certain assets.

(ii) **Capital.** Capital is that part of wealth which is used for further production. In the context of dual aspect concept capital supplies necessary funds to the business to purchase certain assets. In the absence of capital, there will be no funds with the enterprise and thus the question of acquiring assets does not arise. If we take it from business point of view, proprietor's capital is the liability of the business. Capital received in cash represents two accounts, capital and cash. Capital is the proprietor's claim against the assets of the business and the cash is the asset of the business itself. As the amount of the two accounts are the same, we can safely conclude that :

$$\text{Capital} = \text{Assets.}$$

(iii) **Liabilities.** If the capital invested by the proprietor falls short the business has to borrow funds. Thus the loan on the one side is the liability of the firm and on the other side it will be in the form of cash or other assets. The amount represented by both loan and assets are equal. This transaction enables us to think about the two aspects so it is called dual aspect concept or double entry system. All the assets of the business are acquired by the funds contributed by the proprietors and creditors, so it is always correct to conclude as under :

$$\text{Capital} + \text{Liabilities} = \text{Assets.}$$

The relationship between assets, liabilities and capital is at present known as *Accounting Equation* which can also be expressed as under :

$$\text{Assets} = \text{Capital} + \text{Liabilities}$$

Or

$$\text{Capital} = \text{Assets} - \text{Liabilities}$$

Or

$$\text{Liabilities} = \text{Assets} - \text{Capital}$$

We record all the business transactions on the basis of dual aspect and call the system as *double entry system*.

REVIEW QUESTIONS

A. Very Short Answer Type Questions :

1. Give an example of a transaction which may be an expense for business and income for the businessman.
2. Name the concept responsible for the origin of 'Double Entry System'.
3. 'Business units last indefinitely'. Mention the concept on which the statement is based.

C. Short Answer Type Questions :

1. Explain Business Entity concepts.
2. Explain the concepts of money measurement.
3. Explain briefly the principle of Double Entry System.

D. Long Answer Type Questions :

1. Explain the following :
(a) Money measurement concept, (b) Accounting period concept, (c) Going concern concept,
(d) Dual aspect.
2. Explain the following with examples :
(a) Money measurement concept, (b) Dual aspect, (c) Accounting period.

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CHAPTER 3 SOURCE DOCUMENTS AND ACCOUNTING CYCLE

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★ STRUCTURE ★

- ★ Introduction
- ★ Source Documents
- ★ Vouchers
- ★ Contents of Accounting Vouchers
- ★ Accounting Equation/Cycle
- ★ Computation—Classification of Transactions

INTRODUCTION

Origin of Transaction

We know that Accountancy is based upon verifiable objectives. The assumption explains that accounting deals with facts. There is no place for imaginations, expectations and possibilities in accounting.

We record financial transactions in the books of accounts, when they actually happen and that too supported by documents. There must be certain written and authentic proof of the transaction, which has taken place. The written document is known as 'voucher', the source document upon which we base our accounting records.

Source Documents/Vouchers

A document which becomes the basis for recording a transaction in the books of account is called source document. These documents show the nature and amount of the transaction and named vouchers.

Vouchers are the receipts, bills, cash memos, invoices, salaries bills, wages bills, travelling allowance bills, counterfoils of cheques, registration deeds, and any other form of written proof that the transaction has actually taken place and can be verified from the documents. Whenever we sell goods, we prepare invoice for sending goods out of station, bills for credit sales, and cash memos for cash sales. The original copy is handed over or sent to the purchaser but the duplicate copy is kept as record in the business. These duplicate copies are the source documents for making record in our books of accounts. In the same way, while making purchase we receive original copy of invoices or bills or cash memos. *These copies also work as source documents for recording purchase.* Whenever we make payment we obtain receipt from the party receiving payment. While making payment of rent to landlord, a receipt for the rent is received. Workers and employees affix their signature on wages and salaries bills on receiving their wages and salaries. Insurance Company, Delhi Electric Supply Undertaking (DESU), Water Works issue receipts for having received the payment.

Buses, railways and airlines issue tickets on receiving payments. We receive receipts even for petty and insignificant payment. These receipts are the source documents for accounting records. The first step in accounting is to identify the origin of the transaction which is undoubtedly based upon documentary evidence known as source documents.

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SOURCE DOCUMENTS

Meaning

As we know Accounting deals in facts, which actually happen and can be verified by documentary evidence known as source documents.

It shows that source documents are real, visible, legible and meaningful records certifying the actual happening of the transactions of financial nature. In Accountancy, every journal entry must be supported by source documents popularly known as vouchers. Some important documents are discussed herewith :

1. **Cash Memo.** It is a document indicating the amount, date and details of cash purchases and cash sales. We receive cash memo on cash purchases and issue cash memo on sales. On the basis of these cash memos, cash purchases, cash sales and cash payments are recorded in the books.
2. **Invoices and Bills.** These documents *i.e.*, invoices and bills are used for credit purchases and credit sales. In case of credit sale of goods we issue invoices/bills, which indicate the date, amount and details of sale. We prepare three copies of invoice. The first copy is sent to the purchaser through post office or bank, the second copy is kept in the bundles, packets or cases of the goods, the third copy is retained with us. The third copy is used as source document for recording credit sale. In case of credit purchases of goods, we receive invoice or bills and record credit purchases on its basis.
3. **Receipt.** In case of receiving amount, we issue a receipt indicating the date and amount of payment, details of the payer and the purpose of payment. The counterfoil or the carbon copy of the receipt issued is used as source document for the receipt of the amount. In the same way, when we make the payment, we are issued receipts and record the payment in the books of Accounts.
4. **Pay-in-Slip.** In case of depositing cash and cheques in the Bank, we have to fill up Pay-in-Slip (Deposit slip). The main body of the Pay-in-Slip is retained by the bank and the counterfoil duly signed and stamped is returned to the customer. The counterfoil is used as the source document for recording the deposits.
5. **Cheques.** We issue cheques against different payments. The counterfoil of the cheque or notes on the cheque book containing details of the payment is used for recording the payment or withdrawal for self. Cheques received are deposited into the bank through Pay-in-Slip, which is used as source document.
6. **Debit Note.** In case of the return of goods purchased on credit we issue Debit Note to the seller, meaning that the Sellers' Account has been debited with the amount of purchases return. This debit note is used as source document for recording purchase return. A format of Debit Note is given as under :

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Name of the Firm Issuing the Note		Address of the Firm
No.		Date of Issue
DEBIT NOTE		
Against : Supplier's Name		
Goods returned as per Delivery		Amount (Rs.)
Challan No.		
(Details of goods returned)		
(Rupees Only)		
Signature of the Manager with date		

7. **Credit Note.** In case of sales return by our customers we issue Credit Note to them, meaning that the Customers Account is credited with the amount of sales return. The Credit Note is used as source document. A format of Credit Note is given as under :

Name of the Firm Issuing the Note		Address of the Firm
No.		Date of Issue
CREDIT NOTE		
Against : Customer's Name		
Goods returned by the customer		Amount (Rs.)
Challan No.		
(Details of goods received)		
(Rupees Only)		
Signature of the Manager with date		

8. **Miscellaneous.** Correspondence, registration deeds, wages, salaries, water, electricity, telephone bills, tickets, conveyance bills, counterfoils and receipts, etc. are also used as source documents.

VOUCHERS

Meaning

A voucher may be defined as a written document to be used in support of entry made in the books of accounts.

In the words of **J.R. Batliboi**, "A voucher may be defined as documentary evidence in support of an entry appearing in the books of accounts".

According to **Ronald A. Irish**, "A voucher may be a receipt, an invoice, an agreement, written requisition slip or in short any suitable written evidence, which confirms a written transaction."

Transaction Voucher		
Name of Firm		
Voucher No	:	Date :
Debit account	:	
Credit account	:	
Amount (Rs)	:	
Narration	:	
Authorised By	:	Prepared By :

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Special Features of Vouchers

- (i) Vouchers are documentary evidence.
- (ii) Vouchers are written document.
- (iii) Vouchers support the entry appearing in the books of accounts.
- (iv) Vouchers present full description of the transaction.
- (v) Vouchers substantiate the accuracy of entries in the books of accounts.

Examples of Vouchers

- (i) **Cash Receipts.** Various vouchers of cash receipts are counterfoils, carbon copies of receipts issued, carbon copies of contracts made, correspondence etc.
- (ii) **Cash Payment.** Various vouchers of cash payments are cash memos, wage sheets, salary register, copies of contracts, correspondence etc.
- (iii) **Purchases.** Vouchers regarding purchases are invoices, copies of order sent, goods inward books, correspondence, etc.
- (iv) **Sales.** Copies of orders received, records of goods supplied, goods outward book, correspondence, etc.
- (v) **Purchases Return.** Goods outward book, letter of credit, correspondence, etc.

Preparation of Vouchers :

Format of Accounting Vouchers

Laxmi Publications Private Limited

113, GOLDEN HOUSE, DARYAGANJ, NEW DELHI-
110002

Voucher No. Dated 20...

	Rs.	P.
DEBIT _____		

TOTAL Rs.		
CREDIT _____		

TOTAL Rs.		

Accountant/Manager

M.D.

RECEIVED from M/s LAXMI PUBLICATIONS PRIVATE LIMITED
 the sum of Rupees _____
 on account of _____
 By Cash/Cheque No. _____ Dated _____
 Rs. _____
 Receiver's Signature

CONTENTS OF ACCOUNTING VOUCHERS

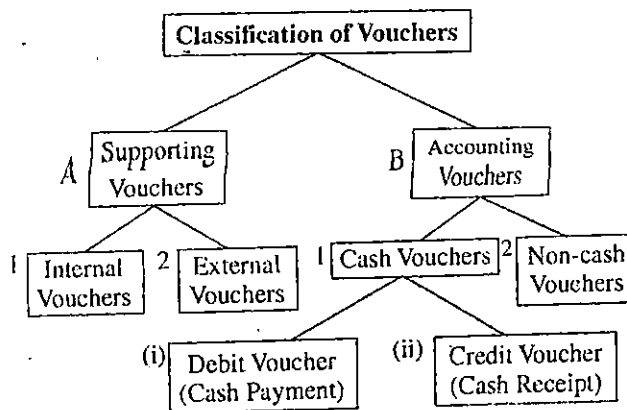
NOTES

Voucher is a documentary evidence of the transaction, so it must be prepared carefully and cautiously. The voucher must be preferably printed. It should contain the following information about the transactions.

1. **Name and address of the firm.** Every voucher should bear the name and address of the firm at its top. It is generally printed at the top of the voucher.
2. **Voucher number.** Every voucher must bear its serial number, so that it can be easily identified, differentiated with other vouchers and referred in the books of accounts. Vouchers are serially numbered and their number is mentioned against the posting in the ledger, cash book and subsidiary books.
3. **Date.** The date of preparing the voucher must be written. It must bear the date, the month and the year of the transaction.
4. **Details of party to be debited.** It contains the name and address of the party, whom payment has been made. The purpose and the details of the payment is also recorded therein. In modern big business enterprises, voucher is prepared for every transaction. As such, in these enterprises the debit side may contain the name of the party to whom payment has been made. It may also contain the head of account against which the payment has been made. It may be Purchases Account, Assets Account and Expenses Account.
5. **Details of party to be credited.** The payment is made either through Cash or Cheque/Bank Draft, so we record Cash Account or Bank Account, with the number and date of issue of the cheque and bank draft. We may also use the account to be credited at the credit column.
6. **Proof of receiving the amount.** In case the payment is made through cash to someone, his signature is obtained with full details of the amount, the purpose and the date of payment received by him.
In case payment is made through crossed Account Payee cheque, receivers signature is not necessary.
7. **Revenue Stamp.** Revenue stamp must be affixed on every payment of Rs. 500/- and more as per law, so that the document may be legalised. The signature of the receiver must touch certain part of the revenue stamp.
8. **Signature of the accountant and officer of the firm.** Voucher must be signed by the responsible person of the firm. He may be an accountant or manager. After verification and authentication it must be signed by the proprietor of the firm or any authorised officer of the enterprise.

Types of Vouchers

Vouchers may be classified as under :



NOTES

A. Supporting Vouchers

These vouchers are prepared as documentary evidence in support of transaction having taken place. These vouchers are classified as internal and external vouchers.

1. **Internal Supporting Vouchers.** These vouchers are prepared by the organisation itself but authenticated and validated by third parties, such as counter foils of pay-in-slip and challan, etc.
2. **External Supporting Vouchers.** These vouchers are prepared by third parties and sent to us such as bills, cash memo and invoice received from supplier of goods. It may also be rent receipt received from land lord, debit note and credit note, etc.

B. Accounting Vouchers

The subsidiary or secondary vouchers prepared on the basis of supporting vouchers issued by third parties is called accounting vouchers. It is prepared by the Accountant and must be signed by the authorised signatory of the enterprise. Accounting vouchers are classified as cash vouchers and non-cash vouchers.

1. **Cash Vouchers.** The documentary evidence of cash payments and cash receipts is known as cash voucher. Cash vouchers are classified as debit (payments) voucher and credit (receipts) voucher.

(i) **Debit (Payment) Voucher.** The documentary evidence of cash payment is known as debit voucher such as cash payment of salaries, cash purchases of goods and assets, payment to creditors, employees and bank, etc. The debit voucher may be based on supporting voucher. In case supporting voucher is not available, the Receipt portion of the voucher is filled in and used as supporting voucher.

It should be noted that if the payment is worth Rs. 500 or more, revenue stamp of Re. 1 must be affixed.

(ii) **Credit (Receipt) Voucher.** The documentary evidence of cash receipt is known as credit voucher, such as cash receipt of interest, rent or any other income, cash sales of goods, assets and investments, amount withdrawn from bank, loans borrowed, collection from debtors, etc.

ACCOUNTING EQUATION/CYCLE

Meaning

NOTES

There has been a revolution in every field of knowledge. Scientific approach towards every subject has emerged as a basic consideration to decide its utility. Scientific studies were also made in accounting and result was the discovery of 'Accounting Equation'. The study revealed that accounting rotates round the three terms *i.e.*, assets, liabilities and capital. The entire accounting structure is based upon these three terms. These terms are inter-related and inter-woven. Before explaining accounting equation let us discuss these terms :

Analysis of Transactions

Assets, liabilities and capital are constituents of business transactions. Let us discuss these elements :

(a) **Assets.** The acceptable meaning of assets is the valuable things owned by the firm. Expenditure for acquiring these valuable articles for use in the business is also termed as assets. The assets are acquired for constant future use. They are not meant for sale. These assets increase the profit earning capacity of the business. Some of the assets are listed as under :

- | | |
|------------------------------------|---------------------------------|
| (i) Cash in hand | (viii) Plant and machinery |
| (ii) Cash at bank | (ix) Equipments and tools |
| (iii) Sundry debtors or Book debts | (x) Furniture and fittings |
| (iv) Bills receivables | (xi) Patents, trade marks, etc. |
| (v) Investments | (xii) Goodwill |
| (vi) Closing stock | (xiii) Prepaid expenses |
| (vii) Land and building | (xiv) Accrued income |

(b) **Liabilities.** Creditors' and proprietors' claim against the assets of business is termed as its liability. Proprietor's claim is termed as capital, which we shall be discussing later on. Liabilities are also known as equities or claims. The term liability means the claim of outsiders against the business such as creditors for goods and expenses. Liability is the account for which the firm is indebted to outside parties. Certain external liabilities are mentioned as under :

- (i) Creditors for goods—sundry creditors and bills payable
- (ii) Creditors for expenses :
 - (a) Outstanding salaries
 - (b) Unpaid wages
 - (c) Rent due but not paid.
- (iii) Other liabilities :
 - (a) Bank loan or overdraft
 - (b) Partner's loan
 - (c) Loan from Financial Institution, *i.e.*, IFC, IDBI, etc.
 - (d) Debentures
 - (e) Employees Provident Fund
 - (f) Workmen's Compensation Fund, etc.

Liabilities also go on changing. Their value either increases or decreases. In case of increase the business will have to pay more and in case of decrease the business will have to pay lesser.

(c) **Capital.** It is the proprietor's claim against the assets of the business. In case of one man business the capital is contributed by the proprietor himself. In case of partnership, capital is contributed by partners and in case of companies, shareholders contribute for capital. Owners of the business are the contributors of the capital. *Owners are the entrepreneurs of the business.* They get profit of the business for the risk taken by them. If certain amount of profit remains undistributed or retained as reserve and funds, it is also known as proprietor's claim. Proprietor's claim can be enumerated as under :

NOTES

- (i) Capital
- (ii) Reserve, general reserve or reserve fund
- (iii) Profit or retained earning
- (iv) Interest on capital.

Explanation of Accounting Equation. Business transactions are financial in nature and so every transaction affects the financial position of the business. These transactions increase or decrease the assets, liabilities or capital. Every business has certain assets. These assets are purchased with the funds supplied to the business by its proprietors or creditors. Proprietors' and creditors' funds, in whatever form they are, create assets. For example, if the business receives Rs. 1,00,000 as capital from the proprietor and retains that in the firm, it will create an asset *i.e.*, cash in hand. If Rs. 80,000 are deposited into the bank, the total capital will be represented by two assets *i.e.*, cash Rs. 20,000 (due to deposit into the bank of Rs. 80,000 out of a cash balance of Rs. 1,00,000) and cash at bank Rs. 80,000. If furniture, worth Rs. 20,000 are purchased and payment is made out of bank deposit, the assets will now consist of cash in hand Rs. 20,000, cash at bank Rs. 60,000 (due to purchase of furniture, bank balance has reduced by Rs. 20,000) and furniture Rs. 20,000. **As such accounting equation is a statement of equality between debits and credits.** These above facts can also be presented in this way :

<i>Capital</i>	<i>Assets</i>
(i) Rs. 1,00,000 =	Cash (Rs. 1,00,000)
(ii) Rs. 1,00,000 =	Cash (Rs. 20,000) + Bank balance (Rs. 80,000)
(iii) Rs. 1,00,000 =	Cash (20,000) + Bank (60,000) + Furniture (20,000)

The above facts are technically known as Accounting Equations in simple form and reveal that capital which is always equal to assets.

Increase in capital will generally result in the corresponding increase in the assets and in the same way, decrease in capital will result in the decrease of assets. If the proprietor introduces Rs. 40,000 as additional capital there will be corresponding increase in cash balance. As both capital and assets are increasing simultaneously with Rs. 40,000, the capital will remain equal to assets. Amount withdrawn by the proprietor for personal use will decrease capital and there will be decrease in the cash, an asset at the same time. If drawings are worth Rs. 10,000 both the capital and assets will decrease simultaneously with Rs. 10,000.

Introduction of Creditors' Liability in Accounting Equations

It has been accepted fact that business does not possess anything of its own. The business receives funds from proprietors and creditors and retains all of them in the form of various assets. This shows that capital + liabilities are always equal to assets. The fact can be presented in terms of accounting equation as under :

NOTES

Equation.	Capital + Liabilities = Assets	or	C + L = A
or	Assets = Liabilities + Capital	or	A = L + C
or	Liabilities = Assets - Capital	or	L = A - C
or	Capital = Assets - Liabilities	or	C = A - L
or	Assets - Liabilities - Capital = Zero	or	A - L - C = Zero.

COMPUTATION—CLASSIFICATION OF TRANSACTIONS

Assets, liabilities and capital are the three basic elements of every business transaction. The relationship between these terms, as mentioned above in the form of Accounting Equation remains unchanged. It has been a mathematical truth. No business transaction can upset the relationship between these items. The inter-relationship of assets, liabilities and capital results into nine transactions. These transactions show that change in one element results in corresponding change in the same item or in other element. These nine basic transactions are as under :

- (i) Increase in assets with corresponding increase in capital.
 - (ii) Increase in assets with corresponding increase in liabilities.
 - (iii) Increase and decrease in assets.
 - (iv) Decrease in assets with corresponding decrease in liabilities.
 - (v) Decrease in assets with corresponding decrease in capital.
 - (vi) Increase and decrease in liabilities.
 - (vii) Increase and decrease in capital.
 - (viii) Increase in liabilities and decrease in capital.
 - (ix) Increase in capital and decrease in liabilities.
- (i) **Increase in assets with corresponding increase in capital.** Commencement of business with Rs. 20,000 increases both the assets and capital of the firm. At the same time, it will affect the financial position of the business as under :

Financial Position (Balance Sheet)

Liabilities	Amount Rs.	Assets	Amount Rs.
Capital	20,000	Cash	20,000
Creditors	—		
	20,000		20,000

- (ii) **Increase in assets with corresponding increase in liabilities.** Purchase of goods on credit for Rs. 7,000 will increase stock of goods with Rs. 7,000 and also increase creditors' liabilities. The transaction will affect the financial position as under :

Financial Position (Balance Sheet)

Liabilities	Amount Rs.	Assets	Amount Rs.
Capital	20,000	Cash	20,000
Creditors	7,000	Stock in trade	7,000
	27,000		27,000

The position can be presented alternatively as under :

$$\begin{aligned} \text{Assets} &= \text{Liabilities} + \text{Capital} \\ 27,000 &= 7,000 + 20,000 \end{aligned}$$

- (iii) **Increase and decrease in assets.** Purchase of furniture worth Rs. 3,000 involves furniture and cash, the two assets. The transaction will increase furniture as an asset and decrease cash, also an asset. Increase and decrease in the assets with the same amount will not upset the equation. The transaction can be expressed as follows :

$$\begin{array}{rcl} \text{Cash} & + & \text{Stock} & + & \text{Furniture} & = & \text{Creditors} & + & \text{Capital} \\ 17,000 & + & 7,000 & + & 3,000 & = & 7,000 & + & 20,000 \end{array}$$

- (iv) **Decrease in assets with corresponding decrease in liabilities.** Payment of Rs. 2,000 to creditors will decrease creditors, the liabilities of the business and at the same time cash an asset will decrease. The decrease in assets and liabilities simultaneously with the same amount will hold the Accounting Equation true. The transaction will effect the Accounting Equation as follows :

$$\begin{array}{rcl} \text{Cash} & + & \text{Stock} & + & \text{Furniture} & = & \text{Creditors} & + & \text{Capital} \\ 17,000 & + & 7,000 & + & 3,000 & = & 7,000 & + & 20,000 \\ -2,000 & + & 0 & + & 0 & = & (-) 2,000 & + & 0 \\ \hline 15,000 & + & 7,000 & + & 3,000 & = & 5,000 & + & 20,000 \end{array}$$

- (v) **Decrease in assets with corresponding decrease in capital.** Rs. 4,000 withdrawn by the proprietor for personal use will reduce capital and also cash, an asset simultaneously with Rs. 4,000. The transaction still proves the validity of Accounting Equation as under :

NOTES

	<i>Assets</i>			=	<i>Liabilities</i>		+	<i>Capital</i>
Cash	+	Stock	+	Furniture	=	Creditors	+	Capital
15,000	+	7,000	+	3,000	=	5,000	+	20,000
-4,000	+	0	+	0	=	0	(-)	4,000
11,000	+	7,000	+	3,000	=	5,000	+	16,000

The financial position of the business upto 5th transaction will be as under :

Financial Position (Balance Sheet)

<i>Liabilities</i>	<i>Amount</i> Rs.	<i>Assets</i>	<i>Amount</i> Rs.
Capital	16,000	Furniture	3,000
Creditors	5,000	Stock	7,000
		Cash	11,000
	21,000		21,000

(vi) **Increase and decrease in liabilities.** Creditors for goods sometimes draw a bill of exchange on us as per the arrangement of the payment. After acceptance of the bill, the payment becomes due for payment after the expiry of certain specified period. Acceptance of the bill reduces creditor's liability and creates another liability, known as bills payable, the bill whose payment has to be made. If we accept a bill for Rs. 1,500 creditors will be reduced to Rs. 5,000 - 1,500 = 3,500 and fresh liability known as Bills Payable will come into our records. The transaction will affect the financial position of the business as under :

Financial Position (Balance Sheet)

<i>Liabilities</i>	<i>Amount</i> Rs.	<i>Assets</i>	<i>Amount</i> Rs.
Capital	16,000	Cash	11,000
Creditors	3,500	Stock in trade	7,000
Bills payable	1,500	Furniture	3,000
	21,000		21,000

The above position can alternatively be presented as under :

<i>Assets</i>			=	<i>Liabilities</i>		+	<i>Capital</i>
Cash	+	Stock + Furniture	=	Creditors	+	Bills payable	+ Capital
11,000	+	7,000 + 3,000	=	3,500	+	1,500	+ 16,000.

(vii) **Increase and decrease in capital.** Certain transactions involve capital only, such as transfer of share of the company from one shareholder to another shareholder. In this case, the capital of the company will increase and decrease with the same amount and this will remain unchanged. There will be change in the name of shareholder which will be recorded in the transfer register of the company. Interest on capital is another item affecting capital only. Proprietors

capital will increase with the amount of interest allowed to him. Interest on capital is the expense of the business, so it will have to be borne by the proprietor and thus charged out of capital account. The net result will be an increase and decrease in capital simultaneously with the same figure and accounting equation will still prove to be true. Financial position of the business will remain unchanged.

NOTES

- (viii) **Increase in liabilities and decrease in capital.** In certain cases, capital may be converted into loan, as a liability. Such transactions may happen, when a partner retires from the firm and the capital refundable to him is transferred to his loan account. In this case, the firm will be showing partner's loan as a liability instead of partner's capital. In case of death of a partner amount payable to the legal inheritor of the deceased partner is transferred to partner's executor's loan account. This transaction will also decrease capital and increase liability. If Rs. 5,000 are transferred from capital account to loan account the financial position will be as under :

Financial Position (Balance Sheet)

<i>Liabilities</i>	<i>Amount Rs.</i>	<i>Assets</i>	<i>Amount Rs.</i>
Capital —	11,000	Cash	11,000
Creditors	3,500	Stock in trade	7,000
Bills Payable	1,500	Furniture	3,000
Loan	5,000		
	21,000		21,000

The above position can also be presented as under :

<i>Assets</i>	=	<i>Liabilities</i>	+	<i>Capital</i>
Cash + Stock + Furniture	=	Creditors + Bills payable + Loan + Capital		
11,000 + 7,000 + 3,000	=	3,500 + 1,500 + 5,000 + 11,000		

- (ix) **Increase in capital and decrease in liabilities.** Conversion of loan into capital reduces the liability of the business on one hand and increases capital on the other hand. Conversion of debentures into share capital is an example of such transaction. Creditors may also be converted into share capital. If creditors for Rs. 1,000 are allotted shares against their loan, the financial position will be affected as under :

Financial Position (Balance Sheet)

<i>Liabilities</i>	<i>Amount Rs.</i>	<i>Assets</i>	<i>Amount Rs.</i>
Capital	12,000	Cash	11,000
Creditors	2,500	Stock in trade	7,000
Bills Payable	1,500	Furniture	3,000
Loan	5,000		
	21,000		21,000

The financial position shows that capital has increased by Rs. 1,000 and is now Rs. 11,000 + 1,000 = 12,000 and at the same time creditors have been reduced to Rs. 3,500 - 1,000 = 2,500.

The fact can alternatively be presented as under :

NOTES

<i>Assets</i>	=	<i>Liabilities</i>	+	<i>Capital</i>
Cash + Stock + Furniture	=	Creditors + Bills payable	+	Loan + Capital
11,000 + 7,000 + 3,000	=	2,500 + 1,500	+	5,000 + 12,000

The basic nine transactions discussed above are summarised through the following illustrations.

Illustration 1. Develop accounting equation from the following transactions :

	Rs.
(i) <i>Adi commenced business with cash</i>	50,000
(ii) <i>Purchased goods for cash</i>	30,000
(iii) <i>Purchased goods on credit</i>	20,000
(iv) <i>Sold goods (cost Rs. 10,000) for</i>	12,000
(v) <i>Bought furniture on credit</i>	2,000
(vi) <i>Paid cash to a creditor</i>	15,000

Solution.

Accounting Equation

Transactions	<i>Assets</i>			=	<i>Liabilities</i> + <i>Capital</i>	
	<i>Cash</i>	+ <i>Stock</i>	+ <i>Furniture</i>	=	<i>Creditors</i>	+ <i>Capital</i>
(i) <i>Adi commenced business with cash</i> Rs. 50,000	50,000 +	0 +	0 =	0 +	50,000	
(ii) <i>Purchased goods for cash</i> Rs. 30,000	(-)30,000 +	30,000 +	0 =	0 +	0	
New Equation	20,000 +	30,000 +	0 =	0 +	50,000	
(iii) <i>Purchased goods on credit</i> Rs. 20,000	+ 20,000 +	0 +	0 =	20,000 +	0	
New Equation	20,000 +	50,000 +	0 =	20,000 +	50,000	
(iv) <i>Sold goods (cost Rs. 10,000) for</i> Rs. 12,000	+ 12,000(-)	10,000 +	0 =	0 +	2,000	
New Equation	32,000 +	40,000 +	0 =	20,000 +	52,000	
(v) <i>Bought furniture on credit</i> Rs. 2,000	0 +	0 +	2,000 +	2,000 +	0	
New Equation	32,000 +	40,000 +	2,000 =	22,000 +	52,000	
(vi) <i>Paid cash to a creditor</i> Rs. 15,000	(-)15,000 +	0 +	0 =	(-)15,000 +	0	
New Equation	17,000 +	40,000 +	2,000 =	7,000 +	52,000	

Treatment of Revenue Payments and Receipts

(a) Revenue Payments

NOTES

- (i) **Treatment of expenses paid.** The business had to pay certain expenses in its day-to-day operations, such as payment of salaries, rent, insurance premium, office expenses, wages, repairs, etc. These expenses are paid regularly. These business expenses are paid in cash, so cash will reduce and thus payment of expenses are reduced from cash balance. These expenses will also reduce net income of the business. As the income is the reward paid to proprietor for the risk undertaken by him so expenses will reduce proprietor's reward. Proprietor is represented by Capital Account so the payment of expenses will decrease capital.
- (ii) **Treatment of outstanding expenses.** If expenses relate to accounting period and remain unpaid, they are termed as outstanding expenses. Outstanding salaries, rent unpaid, wages due, repairs due but not paid are its certain examples. As these expenses relate to the accounting period, so they will reduce capital of the proprietor. Both the cases of expenses paid and expenses due are treated at par as regards decrease in the capital of the proprietor. They are different in the sense that expenses paid reduce cash balance but expenses outstanding do not reduce cash balance. As these expenses are still payable, it is a liability of the business and thus increase liability.
- (iii) **Treatment of prepaid or unexpired expenses.** There may be certain cases where expense may have been paid in advance. In certain cases, expenses relating to the next accounting period may be paid during the current year. These expenses are prepaid or unexpired *i.e.*, insurance and rent paid in advance for the next following year. Prepaid expenses increase and decrease assets simultaneously. The payment has been made in cash, so cash will be reduced. As the expenses have been paid during the current year for the next year, it will be an asset for the current year because the amount has to be realised by the current year from the following year :

Illustration 2. Show the effect of following transactions on accounting equation and also prepare a Balance Sheet :

	Rs.
(i) Started business with cash amounting to Rs. 35,000 and goods	15,000
(ii) Salaries paid	2,000
(iii) Wages outstanding	200
(iv) Prepaid insurance	700
(v) Interest due but not paid	100
(vi) Rent paid in advance	150

Solution.

Accounting Equation

NOTES

Transactions	Assets			=	Liabilities + Capital	
	Cash	Stock	Prepaid expenses	=	Outstanding expenses	Capital
(i) Started business with cash Rs. 35,000 .Goods Rs. 15,000	35,000 +	15,000 +	0 =		0 +	50,000
(ii) Salaries paid Rs. 2,000 New Equation	(-) 2,000 +	0 +	0 =		0 (-)	2,000
(iii) Wages outstanding Rs. 200 New Equation	33,000 +	15,000 +	0 =		0 +	48,000
(iv) Prepaid Insurance Rs. 700 New Equation	0 +	0 +	0 =		200 (-)	200
(v) Interest due but not paid Rs. 100 New Equation	33,000 +	15,000 +	0 =		200 +	47,800
(vi) Rent paid in advance Rs. 150 New Equation	(-) 700 +	0 +	700 =		0 +	
	32,300 +	15,000 +	700 =		200 +	47,800
	0 +	0 +	0 =		100 (-)	100
	32,300 +	15,000 +	700 =		300 +	47,700
	(-) 150 +	0 +	150 =		0 +	0
	32,150 +	15,000 +	850 =		300 +	47,700

The accounting facts presented by the above accounting equation can also be verified by the following Balance Sheet :

Balance Sheet

Liabilities	Amount Rs.	Assets	Amount Rs.
Outstanding wages	200	Cash	32,150
Outstanding interest	100	Stock in trade	15,000
Capital	47,700	Prepaid insurance	700
		Rent paid in advance	150
	48,000		48,000

(b) Revenue Receipts

- (i) **Income received.** The business receives certain income during its day-to-day operations. The income is received regularly. Rent received, commission earned and discount received, etc. are its examples. As the income is received in cash it increases cash balance on the one hand and also increases proprietor's capital. Proprietor's claim against the assets of business increases with every income; so the income earned is added to capital.
- (ii) **Income due but not received or accrued income.** The income has been earned during the year, so proprietors capital will increase but as income is accrued or still to be received it will be treated as assets. The income relates to the current year, so it will increase current year's income. The income has become due from other parties so the concerned party will be the debtor of the firm. Debtor's being assets, accrued income will also be an asset.

(iii) **Unearned income or income received in advance.** It is just possible that we may have received certain income in advance. The income has been received during the current year, although it relates to the next year. As the income has been received in cash, it will increase cash balance. The income actually belongs to the next year but has been received by the current year, as such it will be a liability of the current year towards next year.

NOTES

Illustration 3. Show the effect of the following transactions on assets, liabilities and capital using accounting equation. Also prepare Balance Sheet.

	Rs.
(i) Started business with cash	60,000
(ii) Rent received	2,000
(iii) Accrued interest	500
(iv) Commission received in advance	1,000

Solution.

Accounting Equation

Transactions	Assets		=	Liabilities		-	Capital	
	Cash	+ Accrued interest	=	Commission received in advance	+	Capital		
(i) Started business with cash Rs. 60,000	60,000 +		0 =		0 +	60,000		
(ii) Rent received Rs. 2,000	+ 2,000 +		0 =		0 +	2,000		
New Equation	62,000 +		0 =		0 +	62,000		
(iii) Accrued interest Rs. 500	0 +		500 =		0 +	500		
New Equation	62,000 +		500 =		0 +	62,500		
(iv) Commission received in advance Rs. 1,000	+ 1,000 +		0 =		1,000 +	0		
New Equation	63,000 +		500 =		1,000 +	62,500		

Accounting facts presented by the above accounting equation is also presented in the form of Balance Sheet.

Balance Sheet

Liabilities	Amount Rs.	Assets.	Amount Rs.
Commission received in advance	1,000	Cash	63,000
Capital	62,500	Accrued interest	500
	63,500		63,500

Treatment of Purchases and Sales

(a) Purchases

(i) **Cash purchases.** Purchases of goods for cash affects assets only. It increases stock of goods with the business and at the same time decreases cash, because the payment for goods has been made in cash.

NOTES

- (ii) **Credit purchases.** The transaction increases stock of goods, an asset but also creates a liability. Payments to creditors have not been made so far, as such liability to creditors is still there. Credit purchases, therefore increase both assets and liabilities at the same time.

Payment to creditors in cash will reduce cash, an asset and also creditors, a liability. If creditors draw a bill of exchange, the firm will accept the bill and thus a liability, as Bills Payable will be created in place of creditors. In this way, the transaction will decrease creditors and also create a liability as Bills Payable. In certain cases, if the payment to creditors is made immediately and creditors allow us discount, the transaction will reduce cash with actual amount paid, increase capital with the amount of discount received and decrease creditors with the amount of actual payment plus discount. For example, if we purchase goods worth Rs. 1,000 from Anshu on credit and make a payment of Rs. 990 in full settlement. The payment will reduce creditors by Rs. 1,000, cash by Rs. 990 and also increase capital by Rs. 10.

(b) Sales

- (i) **Cash sales.** It is the sincere effort of every business to sell goods at a price more than its cost price. Excess of sales price over the cost price is profit and will increase capital. For example, if goods costing Rs. 1,740 are sold for Rs. 2,000, it will increase cash by Rs. 2,000, reduce stock of goods by Rs. 1,740 and the resultant profit *i.e.*, $\text{Rs. } 2,000 - 1,740 = 260$ will be added to capital.
- (ii) **Credit sales.** In case goods costing Rs. 2,700 are sold for Rs. 3,000 on credit, it will increase debtors, the assets of the firm by Rs. 3,000, reduce stock of goods by Rs. 2,700 and also increase capital with Rs. $3,000 - 2,700 = \text{Rs. } 300$. In this case, if full payment is received from debtors, it will increase cash and decrease debtors. Cash and debtors are both assets, so the effect of the transaction will be restricted to assets only. In the above case, if we receive Rs. 2,900 from debtors and allow them Rs. 100 as discount, the transaction will increase cash by Rs. 2,900, reduce capital with the amount of discount allowed *i.e.*, Rs. 100 and at the same time decrease debtors, by Rs. 3,000.

Treatment of Miscellaneous Transactions

- (a) **Amount withdrawn by the proprietor.** If the proprietor withdraws Rs. 2,000 for personal use, the transaction will reduce cash by Rs. 2,000 and at the same time reduce proprietor's capital. In case the proprietor takes certain goods for domestic use, it will decrease his capital and the stock of goods.
- (b) **Depreciation on assets.** Depreciation is the wear and tear or loss in the value of assets due to its use, so it will reduce assets and capital at the same time. For example, if there is a depreciation of Rs. 2,000 on plant, the transaction will reduce plant by Rs. 2,000. As depreciation is a loss it will also reduce capital.
- (c) **Interest on capital.** Capital is the liability of the business. Interest on a liability is an expense and thus capital will be reduced. Interest on capital is credited to capital account, so capital will be increased. The transaction will increase and also decrease the capital.
- (d) **Interest on drawings.** Drawing is the amount withdrawn by the proprietor from the business. In other words, it is the amount advanced by the firm to the proprietor and thus interest on drawings will be received by the firm and capital

will be increased. Interest on drawings will be charged on proprietor's capital, so the capital will be reduced. This transaction will also result in the increase and decrease of capital.

Source Documents and Accounting Cycle

Illustration 4. Show the accounting equation on the basis of the following transactions :

	Rs.
(i) Ankita started business with cash	50,000
(ii) Purchased goods on credit	4,000
(iii) Purchased goods for cash	1,000
(iv) Purchased furniture	500
(v) Paid rent	200
(vi) Withdrew for private use	700
(vii) Received interest	100
(viii) Sold goods on credit (cost Rs. 500) for	700
(ix) Paid to creditors	400
(x) Paid salaries	200

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Solution.

Accounting Equation

Transactions	Assets				=	Liabilities + Capital	
	Cash	Stock of goods	Debtors		Furniture	= Creditors	Capital
(i) Ankita started business with Rs. 50,000	50,000 +	0 +	0 +		0 =	0 +	50,000
(ii) Purchased goods on credit Rs. 4,000	0 +	4,000 +	0 +		0 =	4,000 +	0
New Equation	50,000 +	4,000 +	0 +		0 =	4,000 +	50,000
(iii) Purchased goods for cash Rs. 1,000	(-) 1,000 +	1,000 +	0 +		0 =	0 +	0
New Equation	49,000 +	5,000 +	0 +		0 =	4,000 +	50,000
(iv) Purchased furniture Rs. 500	(-) 500 +	0 +	0 +		500 =	0 +	0
New Equation	48,500 +	5,000 +	0 +		500 =	4,000 +	50,000
(v) Paid rent Rs. 200	(-) 200 +	0 +	0 +		0 =	0 (-)	200
New Equation	48,300 +	5,000 +	0 +		500 =	4,000 +	49,800
(vi) Withdrew for private use Rs. 700	(-) 700 +	0 +	0 +		0 =	0 (-)	700
New Equation	47,600 +	5,000 +	0 +		500 =	4,000 +	49,100
(vii) Received interest Rs. 100	+ 100 +	0 +	0 +		0 =	0 +	100
New Equation	47,700 +	5,000 +	0 +		500 =	4,000 +	49,200
(viii) Sold goods on credit costing Rs. 500 for Rs. 700	0 (-)	500 +	700 +		0 =	0 +	200
New Equation	47,700 +	4,500 +	700 +		500 =	4,000 +	49,400
(ix) Paid to creditors Rs. 400	(-) 400 +	0 +	0 +		0 =	(-) 400 +	0

	New Equation	47,300 +	4,500 +	700 +	500 =	3,600 +	49,400
(x) Paid salaries Rs. 200		(-) 200 +	0 +	0 +	0 =	0 (-)	200
	New Equation	47,100 +	4,500 +	700 +	500 =	3,600 +	49,200

The above fact can be presented by a Balance Sheet as under :

Balance Sheet

Liabilities	Amount Rs.	Assets	Amount Rs.
Creditors	3,600	Cash	47,100
Capital	49,200	Debtors	700
		Stock of goods	4,500
		Furniture	500
	52,800		52,800

Illustration 5. Show the effect of the following business transactions on assets, liabilities and capital through accounting equation :

	Rs.
(i) Commenced business with cash	20,000
(ii) Goods purchased on credit	7,000
(iii) Furniture purchased	3,000
(iv) Paid to creditors	2,000
(v) Amount withdrawn by the proprietor	4,000
(vi) Creditors accepted a bill for	1,500
(vii) Interest on capital	1,000
(viii) Transfer from capital to loan	5,000
(ix) Allotted shares to creditors	1,000

Solution. The inter-relationship of nine transactions may be summarised as under :

Transactions	Assets			=	Liabilities			+	Capital
	Cash	Stock	Furniture	=	Creditors	B/P	Loan	+	Capital
(i) Commenced business with cash Rs. 20,000	20,000 +	0 +	0 =	0 +	0 +	0 +	0 +	20,000	
(ii) Goods purchased on credit Rs. 7,000	0 +	7,000 +	0 =	7,000 +	0 +	0 +	0 +	0	
New Equation	20,000 +	7,000 +	0 =	7,000 +	0 +	0 +	0 +	20,000	
(iii) Furniture purchased Rs. 3,000	(-)3,000 +	0 +	3,000 =	0 +	0 +	0 +	0 +	0	
New Equation	17,000 +	7,000 +	3,000 =	7,000 +	0 +	0 +	0 +	20,000	
(iv) Paid to creditors Rs. 2,000	(-)2,000 +	0 +	0 =	(-)2,000 +	0 +	0 +	0 +	0	

	New Equation	15,000 +	7,000 +	3,000 =	5,000 +	0 +	0 +	20,000
(v) Amount withdrawn by the proprietor	Rs. 4,000	(-)4,000 +	0 +	0 =	0 +	0 +	0 +	(-)4,000
	New Equation	11,000 +	7,000 +	3,000 =	5,000 +	0 +	0 +	16,000
(vi) Creditors accepted a bill for	Rs. 1,500	0 +	0 +	0 =	(-)1,500 +	1,500 +	0 +	0
	New Equation	11,000 +	7,000 +	3,000 =	3,500 +	1,500 +	0 +	16,000
(vii) Interest on capital	Rs. 1,000	0 +	0 +	0 =	0 +	0 +	0 +	(-) 1,000
	New Equation	11,000 +	7,000 +	3,000 =	3,500 +	1,500 +	0 +	16,000
(viii) Transfer from capital to loan	Rs. 5,000	0 +	0 +	0 =	0 +	0 +	5,000 +	(-)5,000
	New Equation	11,000 +	7,000 +	3,000 =	3,500 +	1,500 +	5,000 +	11,000
(ix) Allotted shares to creditors	Rs. 1,000	0 +	0 +	0 =	(-)1,000 +	0 +	0 +	1,000
	New Equation	11,000 +	7,000 +	3,000 =	2,500 +	1,500 +	5,000 +	12,000

The above accounting equation proves that whatever the transaction, assets are always equal to capital and liabilities. The fact can also be verified by the Previous Financial Position (Balance Sheet).

Illustration 6. Prove that the accounting equation is satisfied in all the following transactions. Verify the result with Balance Sheet of the last new equation :

	Rs.
(i) Rajesh started business with :	
Cash	20,000
Goods	12,000
Machine	8,000
(ii) He purchased goods	5,000
(iii) Sold goods (Costing Rs. 2,000) for Rs.	2,500
(iv) Purchased goods on credit	7,000
(v) Payment made to creditors in full settlement	6,900
(vi) Sold goods on credit (Costing Rs. 5,400)	6,000
(vii) Payment received from debtors	5,800
Discount allowed	200
(viii) Salaries paid	4,000
(ix) Wages outstanding	400
(x) Prepaid insurance	100
(xi) Rent received	300

(xii) Amount withdrawn	3,000
(xiii) Interest on drawing	200
(xiv) Depreciation on machinery	800
(xv) Purchased goods on credit	17,000

Solution.**Accounting Equation**

Transactions	Assets					=	Liabilities		+	Capital
	Cash	Stock of goods	Machine	Debtors	Prepaid expenses	=	Creditors	Outstanding expenses	+	Capital
(i) Started business with :										
Cash Rs. 20,000										
Goods Rs. 12,000										
Machine Rs. 8,000										
(ii) Purchased goods Rs. 5,000	(-) 5,000 +	5,000 +	0 +	0 +	0 =	0 +	0 +	0 +		0
New Equation	15,000 +	17,000 +	8,000 +	0 +	0 =	0 +	0 +	0 +		40,000
(iii) Sold goods (Costing Rs. 2,000) for Rs. 2,500	+ 2,500 +	(-)2,000 +	0 +	0 +	0 =	0 +	0 +	0 +		500
New Equation	17,500 +	15,000 +	8,000 +	0 +	0 =	0 +	0 +	0 +		40,500
(iv) Purchased goods on credit Rs. 7,000	0 +	7,000 +	0 +	0 +	0 =	7,000 +	0 +	0 +		0
New Equation	17,500 +	22,000 +	8,000 +	0 +	0 =	7,000 +	0 +	0 +		40,500
(v) Payment made to creditors in full settlement Rs. 6,900	(-) 6,900 +	0 +	0 +	0 +	0 =	(-)7,000 +	0 +	0 +		100
New Equation	10,600 +	22,000 +	8,000 +	0 +	0 =	0 +	0 +	0 +		40,600
(vi) Sold goods on credit (Costing Rs. 5,400) for Rs. 6,000	0 +	- 5,400 +	0 +	6,000 +	0 =	0 +	0 +	0 +		600
New Equation	10,600 +	16,600 +	8,000 +	6,000 +	0 =	0 +	0 +	0 +		41,200
(vii) Payment received from Debtors Rs. 5,800 Discount allowed Rs. 200	+ 5,800 +	0 +	0 +	- 6,000 +	0 =	0 +	0 +	0 +		- 200
New Equation	16,400 +	16,600 +	8,000 +	0 +	0 =	0 +	0 +	0 +		41,000
(viii) Salaries paid Rs. 4,000	(-) 4,000 +	0 +	0 +	0 +	0 =	0 +	0 +	0 +		(-) 4,000
New Equation	12,400 +	16,600 +	8,000 +	0 +	0 =	0 +	0 +	0 +		37,000
(ix) Wages outstanding Rs. 400	0 +	0 +	0 +	0 +	0 =	0 +	400 +	(-) 400		
New Equation	12,400 +	16,600 +	8,000 +	0 +	0 =	0 +	400 +			36,600
(x) Prepaid Insurance Rs. 100	(-) 100 +	0 +	0 +	0 +	100 =	0 +	0 +	0 +		0
New Equation	12,300 +	16,600 +	8,000 +	0 +	100 =	0 +	400 +			36,600
(xi) Rent received Rs. 300	+ 300 +	0 +	0 +	0 +	0 =	0 +	0 +	0 +		300
New Equation	12,600 +	16,600 +	8,000 +	0 +	100 =	0 +	400 +			36,900

(xii) Amount withdrawn Rs. 3,000	(-) 3,000 +	0 +	0 +	0 +	0 =	0 +	0 +	- 3,000
New Equation	9,600 +	16,600 +	8,000 +	0 +	100 =	0 +	400 +	33,900
(xiii) Interest on drawings Rs. 200	0 +	0 +	0 +	0 +	0 =	0 +	0 +	± 200
New Equation	9,600 +	16,600 +	8,000 +	0 +	100 =	0 +	400 +	33,900
(xiv) Depreciation on machinery Rs. 800	0 +	0 +	- 800 +	0 +	0 =	0 +	0 +	- 800
New Equation	9,600 +	16,600 +	7,200 +	0 +	100 =	0 +	400 +	33,100
(xv) Purchased goods on credit Rs. 17,000	0 +	17,000 +	0 +	0 +	0 =	17,000 +	0 +	0
New Equation	9,600 +	33,600 +	7,200 +	0 +	100 =	17,000 +	400 +	33,100

Balance Sheet

<i>Liabilities</i>	<i>Amount Rs.</i>	<i>Assets</i>	<i>Amount Rs.</i>
Creditors	17,000	Cash	9,600
Outstanding expenses	400	Stock in trade	33,600
Capital	33,100	Machine	7,200
		Prepaid expenses	100
	50,500		50,500

REVIEW QUESTIONS

A. Very Short Answer Type Questions :

1. If we receive Rs. 490 from our debtors in full settlement of a debt Rs. 500. What will be the accounting effect of Rs. 10 on assets, liabilities and capital ?
2. If creditors worth Rs. 1000 are paid Rs. 980 in full settlement, what will be the accounting effect of Rs. 20 ?
3. How is income received in advance (unearned income) shown in the accounting equation ?
4. If goods costing Rs. 9,500 are sold for Rs. 10,000, show how the capital will be affected ?
5. Point out one transaction which will affect capital only.

B. Short Answer Type Questions :

1. Explain accounting equation in about 50 words.
2. What is meant by creditors for goods and creditors for expenses ? How will these transactions affect assets, liabilities and capital ?
3. Calculate total assets of the business if :

Jacob starts business with Rs. 1,00,000. He earned a profit of Rs. 20,000. He has to pay his creditors for goods Rs. 7000 and outstanding salary amounts to Rs. 1000.

4. Explain the meaning of source documents with example.
5. Describe two basic purpose of source documents.

C. Long Answer Type Questions :

1. Describe the fundamental accounting equation. How are the revenue and expenses account related to it ?
2. Discuss any seven basic transactions resulting from the relationship of assets, liabilities and capital.
3. Name the items affecting capital and explain them briefly.
4. How are the following items in accounting equation dealt with ?
(a) Outstanding expenses (b) Prepaid expenses (c) Accrued income (d) Unearned income.
5. Accounting equation remains intact under all circumstances. Justify the statement with the help of an example.

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★ STRUCTURE ★

- ☆ Introduction
- ☆ Definition of Debit and Credit (*Modern American Approach*)
- ☆ Books of Original Entry
- ☆ Rules for Debit and Credit (*Accounting Equation Approach*)
[*Modern American Approach*]
- ☆ Summary of Rules of Debit and Credit (*Modern Approach*)
- ☆ Traditional Rules (*English Approach*) of Debit and Credit
- ☆ Meaning of Journal
- ☆ Summarised Presentation of Journal Entries

INTRODUCTION

Every accounting transaction has got two sides, 'debit' and 'credit'. These are the two signs used in accounting to present and report the financial effect of every transaction. All the business transactions must have debit and its corresponding credit of the same amount. The term 'debit' and 'credit' is used in every walk of accounting. We use the term in our journal entries, ledger accounts, trial balance, Trading and Profit and Loss Account. The debit and credit can be said to be the only media to report the financial position of the business. We have been using the term as a convention and age old tradition. We simply know that 'left hand side is debit' and the 'right hand side is credit'. Keeping debit at the left hand side and credit at the right hand side may be a convention but not the meaning of the two words.

DEFINITION OF DEBIT AND CREDIT

(Modern American Approach)

Debit means decrease in proprietor's equity and credit means increase in proprietor's equity. Business is the creation of the businessman. In other words, business is the representative of the proprietors of the business. Whatever the business earns, has to be paid to its proprietors. It will increase proprietor's claim against the business or proprietor's equity or capital and thus it has to be credited. In this way, we can say that income increases proprietor's equity, therefore it is to be credited. The word 'credit' refers to the word 'creditor', whose short form is known as 'Cr'. Creditors are those persons and parties whom payment has to be made. In case of income proprietor is the creditor of the business because the income earned by business, the representative of the proprietor belongs to the

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owner of the business. *It increases proprietor's capital as such is to be credited.* All the expenses are incurred by the business on behalf of the proprietors, therefore, proprietors are liable to bear these expenses. *It will decrease their equity and thus debited in the books of accounts.* The word 'debit' refers to the word 'Debtor', whose short form is 'Dr'. The proprietor is the debtor for all expenses, and thus he is rightly debited.

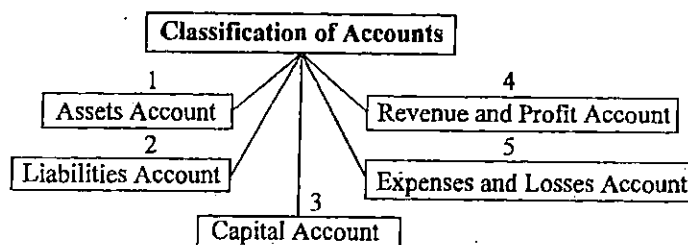
Conventional approach towards 'Debit' and 'Credit'

In addition to accounting concepts and assumptions, there are certain accounting conventions which we have to follow to make accounting uniform, comparable and meaningful. We follow certain conventions regarding 'Debit and Credit' which are as under :

- (i) The left hand side of every account is debit and the right hand side of the account is credit.
- (ii) In case of Journal and Trial Balance the amount column is divided in two parts. The left part of the amount column is Debit and the right part is Credit.
- (iii) While passing journal entries, we use the term 'Dr', the short form of 'Debit', 'Debtor' against the accounts debited but do not use the word credit against accounts credited.
- (iv) All receipts are debited and all payments are credited.
- (v) All expenses and losses are debited but income and gains are credited.
- (vi) Increase in the assets is debited, whereas increase in liability is credited.
- (vii) The assets side of the Balance Sheet represents debit, whereas the liabilities side shows credit.

BOOKS OF ORIGINAL ENTRY

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

RULES OF DEBIT AND CREDIT (Accounting Equation Approach) [Modern American Approach]

1. Assets

Every business owns and possesses assets. The various assets and their value will differ on the basis of size and nature of business. Generally firms own cash in hand, cash at bank, stock of goods, building, plant, machinery, furniture, vehicles and debtors, etc. The business makes use of these assets for earning income. There are certain dealings in these assets and the result is either increase in the value of assets or decrease in their value. The increase or decrease in the assets must be recorded systematically and scientifically, so that true financial position of the business may be assessed.

Business is the representative of the proprietors of the business. Whatever the business spends, the proprietors have to reimburse and repay it back. In other words, proprietors become liable for expenditure on acquiring assets and their capital will be reduced. In this way, increase in assets will be debited because it will reduce proprietor's equity and debit means decrease in the proprietor's share in the business. In the same way, decrease in the assets will increase proprietors' equity and thus credited. The fact can be presented as under :

Assets	
Debit	Credit
Increase (+)	Decrease (-)

While recording business transactions, we have to identify whether the transaction relates to assets, liabilities, capital, expenses or losses and revenues or profits. If the transaction relates to assets, we have to ascertain that the transaction increases assets or decreases it. If it increases, the increase is debited and if it decreases, the decrease is credited. It can be summarised as under :

Debit increase in the assets
Credit decrease in the assets

It has been an accepted fact that assets either increase or decrease. The increase in the assets are debited and the decrease in the assets are credited. In case of commencement of the business cash will increase, so cash account will be debited. While purchasing furniture for business use, furniture will increase and thus furniture account will be debited. At the same time as the payment for furniture has been made in cash, therefore, it will decrease cash and thus cash account will be credited. In the same way, if a part of machinery is sold, cash will increase because the payment has been received in cash and thus debited. The balance of machinery will decrease as such machinery account will be credited. In case of depreciation on fixed assets, the balance of assets will reduce and thus credited. While recording, we have to identify assets account in the transaction and then satisfy ourselves whether, there has been an increase in the assets or decrease in it. The assets, whose value has increased will be debited with the amount of increase and the assets decreasing in the value will be debited with the amount of decrease.

2. Liability

The liability of the business, like its assets either increases or decreases. An increase in the liability will increase proprietor's claim against the business because the amount borrowed has been received on behalf of the proprietor and will definitely increase proprietor's equity as such, increase in the liability is to be credited and decrease in it will be

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debited. The fact regarding rules of 'Debit' and 'Credit' in case of liabilities can also be presented as under :

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Liabilities

Debit	Credit
Decrease (-)	Increase (+)

In case of borrowing Rs. 7,000 from Mhabemo, firm's liability will increase, therefore Mhabemo's account will be credited. If the payment is made to Mhabemo, liability of the business towards him will reduce and thus his account will be debited. The rule can be summarised as under :

Debit decrease in the liability
Credit increase in the liability

3. Capital

Capital represents proprietor's account. Amount introduced by the proprietor as capital will increase his claim against the business and thus capital account representing increase in proprietor's equity will be credited. In the same way, amount withdrawn by the proprietor will reduce capital and thus debited. The rule regarding capital can be presented as under :

Capital

Debit	Credit
Decrease (-)	Increase (+)

In case of commencement of the business the proprietor introduces capital. He may also bring additional amount of capital in the business. He may also be allowed interest on capital. His capital balance will increase with the initial investment, additional funds and even with the interest on capital so capital account will be credited in these cases. If there is any loss or drawings made by the proprietor the capital will reduce and thus capital account will be debited. The rule can also be summarised as under :

Debit decrease in capital
Credit increase in capital

4. Revenue and Profit

Proprietor's equity increases due to increase of revenue, so revenue account is credited with the increase. Decrease in the revenue will decrease proprietors' claim against business, so revenue account will be debited with the decrease. Receiving interest is a revenue gain. It will increase proprietor's capital, so interest account will be credited. At the end of an accounting period, interest account will be closed by transfer to profit and loss account and thus in this case interest account will be debited. Decrease in the revenue or increase in the expenses are synonymous. In both cases proprietors equity decreases so increase in expenses and decrease in revenue are debited. This rule of debit and credit can also be displayed as under :

Revenue and Profit

Debit	Credit
Decrease (–)	Increase (+)

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Revenue received and profit earned is the liability of the business. The amount of profit is to be credited to proprietor's account, because profit is the reward for the risk taken by the proprietor, so profit will be credited. The rule can be summarised as under :

Debit decrease in revenue and profit
Credit increase in revenue and profit

5. Expenses and Losses

Expenses and losses reduce proprietors' claim against business so these accounts are debited when they increase. Reduction in expenses or losses will increase proprietors' equity, as such it has to be credited. The rule regarding debit and credit concerning expenses and losses can also be presented as under :

Expenses and Losses

Debit	Credit
Increase (+)	Decrease (–)

In case of payment of salaries to employees, salaries, as an expense will increase and thus debited. The salaries amount will be closed by transfer to Profit and Loss Account. The transfer will reduce or close salaries account and thus it will be credited. It can be summarised as under :

Debit increase in expenses and losses
Credit decrease in expenses and losses

All business transactions can be classified as assets, liability, revenue, expense and capital. All the business transactions either increase or decrease them. The increase and decrease is either debited or credited on the basis of rules explained for different items. The above rules can be put together as under :

SUMMARY OF RULES OF DEBIT AND CREDIT
(Modern Approach)

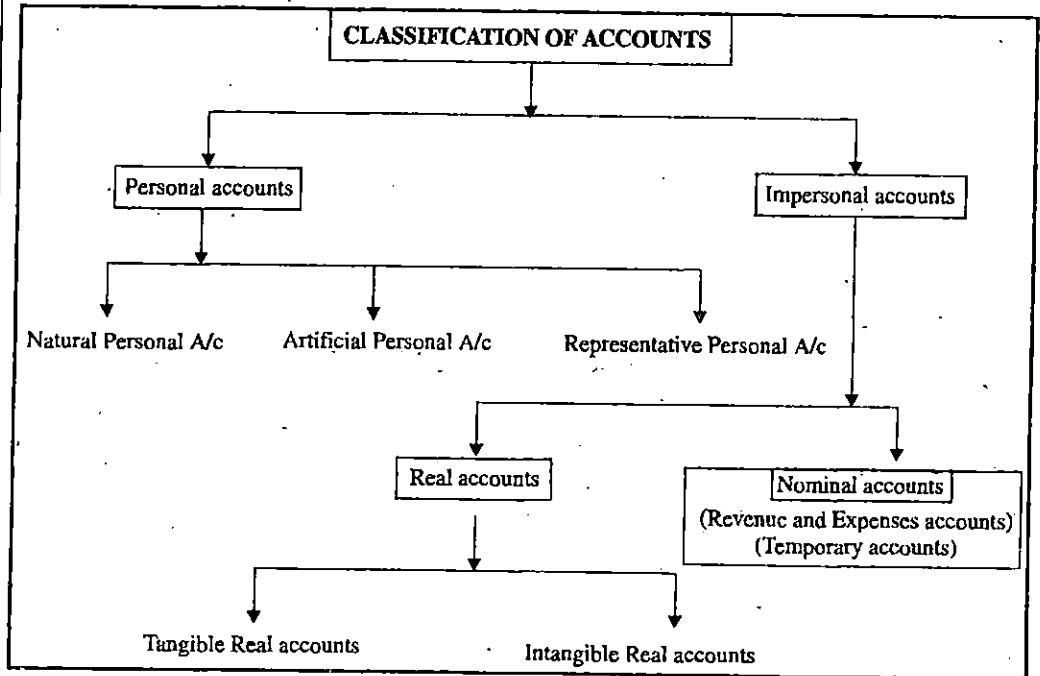
<i>Debit</i>	<i>Credit</i>
Increase in assets	Decrease in assets
Increase in expense or loss	Decrease in expense or loss
Decrease in liability	Increase in liability
Decrease in capital	Increase in capital
Decrease in revenue and profit	Increase in revenue or profit

The above approach towards debit and credit is termed as *American approach* or *modern scientific approach*. The rules have been developed after scientific study and analysis. They have been tested and verified in the real situations of accounting and, therefore prove to be true for accounting record of all business transactions. The earlier conventional or traditional approach towards recording business transactions and its rules for debit and credit were different. The traditional approach of recording transactions are discussed as under :

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TRADITIONAL RULES (*English Approach*) OF DEBIT AND CREDIT

In the conventional approach, accounts were classified as personal, real and nominal and different rules of debit and credit for different accounts were developed. The classification of accounts and rules of debit and credit are discussed as under :



Meaning of Account

An account is the systematic presentation of all material information regarding a particular heading at one place, under one head. Transactions recorded in the account also show the nature and direction of the information.

Personal Accounts

There are two types of persons *i.e.*, natural and artificial. Accounts is related to both these types of persons. Natural persons mean human beings, such as John, Jack, David and James. Artificial persons do not have physical construction as human beings but they work as personal accounts. These accounts are related to firms, companies, institutions, factories and establishments, such as Gupta & Sons Account, Michael & Bros Account, Bank of India Account, Congress Party's Account, Bata Shoe Company's Account and Nagaland Sporting Club's Account, Debtor's Account, Creditor's Account, Capital Account and Drawings Account.

Representative Personal Accounts represent a particular person and group of persons, such as outstanding wages A/c. Here, instead of using the names of workers whose wages is outstanding, we shall be crediting outstanding wages A/c which represents workers, whose wages are payable. In this way, Outstanding salaries, Prepaid expenses, Accrued and un-earned income are Representative Personal Accounts.

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Rules of Debit and Credit

Personal accounts either receive something or give something in the business. When goods are sold to them or amount paid to them, they are the receiver. In the same way, personal accounts are giver, when goods are purchased from them or amount is received from them. According to this nature of personal account, the rule of 'debit and credit' in the personal account are as under :

Debit the receiver
Credit the giver

Illustration. Goods sold to Kunal. Here, in this transaction, Kunal is a personal account as being the name of human beings. He is receiving goods because it has been sold to him. He will be debited in the entry as receiver. In the same way, in case of goods purchased from Kishore, the giver of goods *i.e.*, Kishore will be credited. Bank A/c will be debited in case of deposits into the Bank, because Bank will be the receiver of the deposit. If the amount is withdrawn from Bank, the amount will be given by the Bank. The Bank will be the giver, as such credited in the book. It shows that we have to identify the personal account, which will be in the name of persons, firms, companies and institutions. After that, it should be verified, whether the account is a receiver or giver in the transaction. If it is a receiver, it should be debited and in case of giver, it should be credited.

Examples :

Transactions

(i) Goods sold to Kunal for Rs. 10,000

Kunal A/c	Dr.	10,000	
To Sales A/c			10,000
(Being goods sold to Kunal)			

Note. Here Kunal's A/c has been debited as per rule of personal A/c. (Debit the Receiver)

(ii) Goods purchased from Kishore for Rs. 8,000

Purchases A/c	Dr.	8,000	
To Kishore A/c			8,000
(Being goods purchased from Kishore)			

Note. Here Kishore's A/c has been credited as per rule of personal A/c. (Credit the Giver)

(iii) Amount deposited into the Bank Rs. 20,000

Bank A/c	Dr.	20,000	
To Cash A/c			20,000
(Being amount deposited into the bank)			

Note. Here Bank A/c has been debited as per rule of personal A/c. (Debit the Receiver)

(iv) Amount withdrawn from the Bank Rs. 4,000

Cash A/c	Dr.	4,000	
To Bank A/c			4,000

(Being amount withdrawn from the bank)

NOTES

Note. Here Bank A/c has been credited as per rule of personal A/c. (Credit the Giver)

We should also take into consideration the following rule in case of Personal Accounts.

Debit the debtor
Credit the creditor

The traditional rule of debiting and crediting personal accounts may sometimes prove to be incorrect. It is, therefore, advised that learners should develop an attitude for applying the modern American Accounting equation approach for journalising transactions.

In order to debit or credit representative personal accounts, the rule of Debiting the Debtor and Crediting the Creditor is applied. For example, in case of outstanding salaries, salaries will be payable to those employees, whose salaries for the current year is due. They are our creditors, so outstanding salaries A/c, representative of such employees will be credited. In the same way, prepaid expenses, representing those parties who have been paid expenses in advance will be debited, because they are our debtors. As prepaid expenses represent the debtors, so prepaid expenses A/c will be debited. According to American approach prepaid expenses are assets, so it will be debited, because it is increasing (Debit the increase in assets).

Examples :

Transactions

(i) Goods sold to Vijay for cash Rs. 10,000

Cash A/c	Dr.	10,000	
To Sales A/c			10,000

(Being goods sold to Vijay for cash)

Note. Here Vijay's A/c has not been debited because we have sold goods to him for cash and Vijay is not our debtor, though he is the receiver of the goods.

(ii) Goods purchased from Fernandes for cash Rs. 8,000

Purchases A/c	Dr.	8,000	
To Cash A/c			8,000

(Being goods purchased from Fernandes for cash)

Note. Here Fernandes's A/c has not been credited because he has made cash purchases and is not our creditor, though he is the giver of the goods.

It should be noted that if any prefix or suffix i.e., outstanding, due, unpaid, owing, prepaid, unexpired, accrued, unearned etc. is added to nominal account, it becomes personal A/c as commission accrued A/c, unearned rent A/c, unexpired insurance and wages owing A/c.

Impersonal Accounts

All those accounts, which are not personal accounts are termed as impersonal accounts. These accounts may be related to assets, losses, expenses, incomes and gains. In other words, impersonal account may be classified as Real and Nominal Accounts.

NOTES

Real Accounts. It is classified as (a) Tangible and (b) Intangible.

(a) *Tangible Real Accounts.* This account is related to property. In other words tangible real accounts are generally those accounts which are concerned with the things which really exist. All those things which can be seen, touched and have physical construction, shape, form and size are Real Accounts. In this way, Cash A/c, Building A/c, Plant A/c, Furniture A/c, Goods A/c, Machinery A/c etc. are real accounts.

(b) *Intangible Real Accounts.* These real accounts are intangible i.e., they do not have any physical construction, form, size, shape. They can neither be seen nor touched. The value of these accounts are measured in pecuniary terms. Goodwill, trade marks and patent rights are its example.

Rules of Debit and Credit

Real accounts are related to lifeless properties which cannot do anything at their will. They are either purchased or sold. They either come into the business or go outside the business. On the basis of this nature of real account, the following rules have been ascertained :

Debit what comes in
Credit what goes out

According to this rule, whenever any property comes into the business i.e., owned by the business, it is debited and property account is credited, when it goes outside the business. In case of purchasing furniture for cash, furniture will be coming under the ownership of the firm, therefore, furniture account will be debited but cash account will be credited because cash is going outside the business against the payment for furniture.

Examples :

Transactions

(i) Furniture purchased for cash Rs. 15,000

Furniture A/c	Dr.	15,000	
To Cash A/c			15,000

(Being furniture purchased for cash)

Note. Here furniture A/c has been debited and cash A/c has been credited as per rule of Real Account.

(ii) Machinery sold for Rs. 5,000

Cash A/c	Dr.	5,000	
To Machinery A/c			5,000

(Being amount received from the sale of machinery)

Note. Here cash A/c has been debited and machinery A/c credited as per rule of Real Account.

Nominal Account

This account is just reverse to the Real account. Real accounts generally have existence, but Nominal accounts do not have any existence. These accounts do not have any form, shape and physical construction. In other words, these accounts are related to Income and Expenditure or Gains and Losses. Wages A/c, Salaries A/c, Rent A/c, Interest A/c, Discount A/c and Advertisement A/c are some of its examples.

Nominal Accounts are also known as *Revenue and Expenses Accounts*, because they deal with revenue and expenses. These accounts are also known as *Temporary Accounts*,

specially in America because these accounts are closed at the end of every accounting year by transfer to Trading or Profit and Loss A/c. These accounts do not have any opening or closing balance.

Rules of Debit and Credit

NOTES

Nominal accounts are expenses or losses and incomes or gains. According to this nature of Nominal accounts, the following rules for their debit and credit have been determined :

Debit all expenses or losses

Credit all incomes or gains

According to the above rule, wages A/c, salaries A/c, insurance A/c and interest A/c etc. are debited when these expenses are met. Discount A/c, commission A/c, interest A/c, etc. are credited, whenever they are received. In case of payment of salaries to workers, salaries are an expense, so salaries account will be debited. While receiving rent from the tenant, rent will be gain and thus credited in the books of accounts.

Examples :

Transactions

(i) Salaries paid Rs. 25,000

Salaries A/c	Dr.	25,000	
To Cash A/c			25,000
(Being salaries paid)			

Note. Here salaries A/c has been debited as per rule of Nominal Account. (Expenses are debited)

(ii) Rent received Rs. 5,000

Cash A/c	Dr.	5,000	
To Rent A/c			5,000
(Being rent received)			

Note. Here rent A/c has been credited as per rule of Nominal Account. (Income is credited).

MEANING OF JOURNAL

The word 'Journal' has been derived from the French word 'JOUR' meaning daily records. *Journal is a book of prime record* for small firms. Big concerns prepare Cash Book, Purchases Book, Sales Book and other subsidiary books in addition to Journal proper. Small firms record their business transactions in Journal and post them to the concerned ledger accounts. Big concerns record their business transactions in subsidiary books and Journal and post them from these prime books to respective ledger accounts.

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

Business transactions of financial nature are studied and classified as assets, liabilities, capital, revenues and expenses and accordingly debited or credited in the Journal. Accounts are debited or credited according to rules of debit and credit applicable to the specific account. Journal entries are passed on the following format :

Format of Journal

Date	Particulars	L.F.	Amounts	
			Debit Rs.	Credit Rs.
(1)	(2)	(3)	(4)	(5)

NOTES

The journal is sub-divided into five columns. These columns as per above format are Date, Particulars, Ledger Folio, Amount (Debit), Amount (Credit) and narration. These columns show the following informations :

I. Date

This is the first column of the Journal. It records the date of the transaction with its month and year. We need not repeat the year against every entry because the year is almost the same. In the same way, months should also not be repeated but the date should change because the dates of transactions ordinarily differ. The sequence of the dates and months should be strictly maintained *i.e.*, transaction taking place on January 1, 2005 will be recorded in Journal first and afterward the transaction taking place on January 2, 2005. In the same way, transaction for the month of January, 2005 will be recorded before the transactions of February, 2005. Date should be recorded in the Journal as under :

<i>Date</i>	
2005	
Jan.	1
" "	20
Feb.	1

2. Particulars

This column is used for recording the details of the business transaction. As we know every transaction has got double effect and there are always two or more accounts to be debited and credited. We write the name of account to be debited and also write 'Dr' against the account. Account to be credited is written below the account to be debited. The credit account starts after leaving certain space and we do not write 'Cr' against this account. After the Journal Entry 'Narration' is written, just to explain the journal entry. If furniture is purchased, furniture account will be debited, because the transaction will increase the value of furniture and cash account will be credited because cash will decrease due to the payment for furniture. This transaction will be recorded in the Particulars column of the journal as under :

<i>Particulars</i>	
Furniture A/c	Dr.
To Cash A/c	
(Being furniture purchased)	

The important feature of the above Journal entry are using 'Dr' against Furniture A/c, *leaving space while writing Cash A/c and not using 'Cr' against Cash A/c.* Narration is preceded by the words 'Being', 'For' can also be used instead of 'Being'. Presenting Jour-

nal entry as above is the convention of Accounting. It should be honoured to establish norms of the subject and to bring uniformity in the presentation.

3. Ledger Folio (L.F.)

Journal is the original record of the business transactions. On the basis of journal entries posting in the ledger accounts are made. It shows that journal and ledger are inter-related and the ledger posting is based upon Journal. It is, therefore, necessary that there should be certain reference as regards the page number of ledger, where the account in the journal is being posted. This will facilitate in understanding and checking the ledger posting at a glance. In the above journal, if we write '7' in the L.F. column against furniture, it will mean that the Furniture A/c is prepared at page '7' of the ledger. We can turn page '7' of the ledger and check the posting in the ledger account. The posting can be verified from the Journal and if necessary from the source document, wherefrom the Journal is recorded.

4. Amount (Debit) and (Credit)

Every transaction has got debit and its corresponding credit of the same amount. It is therefore, necessary that the amount column should be divided into debit and credit columns. The amount of the account debited is written against the debit column of the amount and the amount of the account credited is written at the credit column of the amount.

5. Narration

After passing journal entry, we have to explain briefly the transaction for which the entry has been passed. It enables everyone going through the journal entry to have an idea about the transaction. It is customary to start the statement with the word 'Being' or 'For' denoting the reason for which entries have been passed. This statement is known as 'narration' meaning description, because it narrates briefly the transaction for which the entry has been passed. It is also customary to write the narration within small brackets. After the narration, horizontal line is drawn in the particulars column only just to separate the journal entry from the other entry.

Compound or Composite Journal Entries

Sometimes a particular transaction involves more than two accounts. Many transactions are related to specific account on a particular date. There may be certain transactions of the same nature on a certain date. In these cases, we prefer to pass only one entry instead of passing two or more entries. Such entries can be passed in either of the following three ways :

- (a) By debiting one account and crediting two or more accounts.
- (b) By crediting one account and debiting two or more accounts.
- (c) By debiting two or more accounts and crediting two or more accounts.

Illustration 1. Pass necessary Journal entries in the following cases :

(i) Amount received from James	Rs. 1,980	
Discount allowed		Rs. 20
(ii) Amount paid to John	Rs. 2,920	
Discount received		Rs. 80

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

Journal Entries :

(i) Cash A/c	Dr.	1,980	
Discount A/c	Dr.	20	
To James A/c			2,000
(Being amount received from James and discount allowed)			

NOTES

(ii) Adi A/c	Dr.	3,000	
To Cash A/c			2,920
To Discount received A/c			80
(Being amount paid to Adi and discount received from him)			

(iii) Salaries A/c	Dr.	3,000	
Wages A/c	Dr.	5,000	
To Cash A/c			8,000
(Being payment of salaries and wages)			

NOTES

Opening Journal Entry

Business, according to going concern concept is supposed to be carried on indefinitely. At the end of the accounting year different accounts are closed but the business has to be carried on, so previous year's assets and liabilities are to be brought into account of the current year. Passing journal entry in the beginning of the current year with the balances of assets and liabilities of the previous year is opening journal entry. In this entry assets accounts are debited because assets always show debit balance. Liabilities and capital accounts are credited because they show credit balance.

Illustration 2. The firm of M/s Garg and Gupta has the following balances in their different ledger accounts on January 1, 2006.

Cash	Rs. 20,000
Closing Stock	Rs. 20,000
Building	Rs. 60,000
Debtors	Rs. 20,000
Creditors	Rs. 16,000
Capital	Rs. 1,08,000

Pass the opening Journal Entry.

Solution.

Journal Entry

Date	Particulars	L.F.	Amount	
			Debit Rs.	Credit Rs.
2006 Jan. 1	Cash A/c Dr.		20,000	
	Goodwill A/c (difference) Dr.		4,000	
	Stock A/c Dr.		20,000	
	Building A/c Dr.		60,000	
	Debtors A/c Dr.		20,000	
	To Creditors A/c			16,000
	To Capital A/c			1,08,000
	(Being previous year's balance brought into books)			

Note. Excess of credit over debit has been assumed to be Goodwill.

Illustration 3. Journalise the following transactions :

2002

Jan. 1 Started business with cash Rs. 10,000 and goods Rs. 5,000.

Jan. 3 Paid into Current Account Rs. 4,000.

Jan. 5 Sold goods to Neeraj Rs. 2,000.

Jan. 9 Goods returned by Neeraj Rs. 200.

Jan. 12 Goods purchased from Kapoor Rs. 3,000.

Jan. 15 Goods returned to Kapoor Rs. 150.

Jan. 18 Purchased goods from John for Rs. 10,000.

He allowed 10% Trade discount.

Jan. 21 Received a V.P.P. from Prem for Rs. 1,000.

Sent a worker to collect it who paid Rs. 7 as cartage.

Jan. 22 Paid interest on loan Rs. 30.

NOTES**Solution.****Journal Entries**

Date	Particulars	L.F.	Amount	
			Debit Rs.	Credit Rs.
2002				
Jan. 1	Cash A/c Dr. Goods A/c Dr. To Capital A/c (Being started business with cash Rs. 10,000 and goods Rs. 5,000)		10,000 5,000	15,000
Jan. 3	Bank A/c Dr. To Cash A/c (Being amount deposited into bank)		4,000	4,000
Jan. 5	Neeraj A/c Dr. To Sales A/c (Being goods sold to Neeraj)		2,000	2,000
Jan. 9	Sales Return A/c Dr. To Neeraj A/c (Being goods returned by Neeraj)		200	200
Jan. 12	Purchases A/c Dr. To Kapoor A/c (Being goods purchased from Kapoor)		3,000	3,000
Jan. 15	Kapoor A/c Dr. To Purchases Return A/c (Being goods returned to Kapoor)		150	150
Jan. 18	Purchases A/c Dr. To John A/c (Being goods purchased from John Rs. 10,000. He allowed 10% trade discount)		9,000	9,000

Jan. 21	Purchases A/c	Dr.	1,000	
	Cartage A/c	Dr.	7	
	To Cash A/c			1,007
	(Being V.P.P. received and cartage paid)			
Jan. 22	Interest on Loan A/c	Dr.	30	
	To Cash A/c			30
	(Being payment of interest on loan)			
	Total		34,387	34,387

NOTES

Illustration 4. Record the following transactions in journal :

- (i) Goods worth Rs. 500 given as charity.
- (ii) Received Rs. 975 from Mahesh in full settlement of his account for Rs. 1,000.
- (iii) Received a first and final dividend of 60 paise in a rupee from the Official Receiver of Mr. Mahesh, who owed us Rs. 1,000.

Solution.

Journal Entries

Date	Particulars	L.F.	Amount	
			Debit Rs.	Credit Rs.
(i)	Charity A/c	Dr.	500	
	To Purchases A/c			500
	(Being goods given as charity)			
(ii)	Cash A/c	Dr.	975	
	Discount A/c	Dr.	25	
	To Akato A/c			1,000
	(Being amount received from Mahesh and discount allowed)			
(iii)	Cash A/c	Dr.	600	
	Bad Debts A/c	Dr.	400	
	To David A/c			1,000
	(Being 60% received from David in full settlement of account)			

Notes. (i) Goods given as charity must have been charged at cost price, so they will reduce purchases. This is why, Purchases Account has been credited instead of Sales Account.

(ii) Rs. 25, received lesser from Mahesh is discount allowed. It is an expense, so debited.

Illustration 5. Pass necessary journal entries for the following transactions :

- (i) Rs. 1000 was stolen from the safe of the firm.
- (ii) Received an order from Miss Ape for the supply of goods worth Rs. 40,000. In this connection we received Rs. 20,000 as advance.
- (iii) Goods sold for cash Rs. 10,000. Also received 7% sales tax.

NOTES

(iv) Given as charity : Cash Rs. 1000, Goods Rs. 3,000 and a Sofa-set worth Rs. 4,000.

(v) Goods worth Rs. 700 stolen by an employee.

(vi) Purchased two horses worth Rs. 20,000 for the business.

(vii) Goods given to proprietor's daughter Rs. 300.

(viii) Goods worth Rs. 1,000 destroyed by fire.

(ix) Goods worth Rs. 2,000 distributed as sample.

(x) Bricks worth Rs. 1,00,000 purchased for the construction of building.

(xi) Received cash from Kiwalo against bad debts written off last year, Rs. 3,300.

Solution.**Journal Entries**

Date	Particulars	L.F.	Amount	
			Debit Rs.	Credit Rs.
(i)	Loss by theft A/c Dr. To Cash A/c (Being cash stolen from the safe of the firm)		1,000	1,000
(ii)	Cash A/c Dr. To Advances from Miss Ape A/c (Being amount received from Miss Ape in advance)		20,000	20,000
(iii)	Cash A/c Dr. To Sales A/c To Sales Tax A/c (Being goods sold for cash and sales tax received)		10,700	10,000 700
(iv)	Charity A/c Dr. To Cash A/c To Purchases A/c To Furniture A/c (Being charity given as cash, goods and furniture)		8,000	1,000 3,000 4,000
(v)	Loss by theft A/c Dr. To Purchases A/c (Being loss of goods by theft)		700	700
(vi)	Livestock A/c Dr. To Bank A/c (Being purchases of two horses)		20,000	20,000

(vii)	Drawings A/c To Purchases A/c (Being goods given to proprietors daughter)	Dr.	300	300
(viii)	Loss by fire A/c To Purchases A/c (Being goods lost by fire)	Dr.	1,000	1,000
(ix)	Free samples A/c To Purchases A/c (Being goods distributed as sample)	Dr.	2,000	2,000
(x)	Building A/c To Bank A/c (Being purchase of bricks for the construction of building)	Dr.	1,00,000	1,00,000
(xi)	Cash A/c To Bad Debts Recovered A/c (Being amount received from Kiwalo against bad debts previously written off)	Dr.	3,300	3,300

NOTES

Illustration 6. Journalise the following transactions :

- (i) Sold furniture to M/s Satish & Sons at the list price of Rs. 20,000 and allowed them 5% trade discount. We deal in furniture.
- (ii) M/s Satish & Sons cleared the account and we allowed them 3% cash discount.
- (iii) Furniture costing Rs. 2,000 was used in furnishing the office of the firms, we deal in furniture.
- (iv) Sold goods to Sony at the list price of Rs. 12,000, allowed trade discount @ 10% and cash discount at the rate of 5%. Sony cleared the account.
- (v) Supplied goods costing Rs. 4,000 to Jimmy at 20% above the cost price and allowed 10% trade discount.
- (vi) Paid sweeper's salary Rs. 3,000.
- (vii) Received interest on loan Rs. 250 from Anshu, the debtor.
- (viii) Goods used personally by the proprietor Rs. 350.
- (ix) Purchased postcards Rs. 100 and envelopes Rs. 200.
- (x) Paid cash to Mrs. Andrews on behalf of Mr. Andrews Rs. 1,050.
- (xi) Received an order from Ramesh for supply of goods for Rs. 50,000 and received Rs. 15,000 as an advance.
- (xii) Purchased bullocks of Rs. 4,000 for the business.

NOTES

Date	Particulars	L.F.	Amount	
			Debit Rs.	Credit Rs.
(i)	M/s Satish & Sons A/c Dr. To Sales A/c (Being furniture sold to M/s Satish & Sons)		19,000	19,000
(ii)	Cash A/c Dr. Discount allowed A/c Dr. To M/s Satish & Sons A/c (Being amount received and allowed discount)		18,430 570	19,000
(iii)	Furniture and Fittings A/c Dr. To Purchases A/c (Being furniture used in furnishing the office of the firm)		2,000	2,000
(iv)	(a) Sony A/c Dr. To Sales A/c (Being goods sold to Sony)		10,800	10,800
	(b) Cash A/c Dr. Discount allowed A/c Dr. To Sony A/c (Being amount received from Sony and discount allowed)		10,260 540	10,800
(v)	Jimmy A/c Dr. To Sales A/c (Being goods sold to Jimmy)		4,320	4,320
(vi)	Salaries A/c Dr. To Cash A/c (Being salaries paid to sweeper)		3,000	3,000
(vii)	Cash A/c Dr. To Interest on Loan A/c (Being interest on loan received)		250	250
(viii)	Drawings A/c Dr. To Purchases A/c (Being goods used by the proprietor personally)		350	350
(ix)	Postage A/c Dr. To Cash A/c (Being purchases of postcards and envelopes)		300	300

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(x)	Mr. Andrews A/c To Cash A/c (Being amount paid to Mrs. Andrews on behalf of Mr. Andrews)	Dr.	1,050	1,050
(xi)	Cash A/c To Ramesh A/c (Being amount received from Ramesh as an advance against the order for the supply of goods worth Rs. 50,000)	Dr.	15,000	15,000
(xii)	Livestock A/c To Bank A/c (Being purchased bullocks for the business)	Dr.	4,000	4,000

Closing Journal Entries

At the end of the accounting period, all ledger accounts pertaining to goods *i.e.*, purchases, sales, purchases return, sales return, stock and other accounts concerning expenses, losses, incomes and gains are closed by transferring to Trading and Profit and Loss Accounts. These transferred entries are termed as closing entries. In other words, the closing entries concern all the items of the debit and credit side of Trading and Profit and Loss A/c *i.e.*, Nominal Accounts.

It should be noted that closing entries are made for Nominal Accounts only.

SUMMARISED PRESENTATION OF JOURNAL ENTRIES

Transactions	Journal Entry	Rule Applicable
1. Commenced business	Cash A/c Dr. To Capital A/c	Increase in assets is debited. Increase in capital is credited.
2. Cash purchases or Goods purchased for cash	Purchases A/c Dr. To Cash A/c	Increase in expense or assets is debited. Decrease in assets is credited.
3. Purchased goods on credit or Credit purchases	Purchases A/c Dr. To Supplier's A/c	Increase in expenses or assets is debited. Increase in liability is credited.
4. Cash sales	Cash A/c Dr. To Sales A/c	Increase in assets is debited. Decrease in revenue or assets is credited.
5. Credit sales	Debtors A/c Dr. To Sales A/c	Increase in assets is debited. Decrease in or assets is credited.
6. Purchases return	Supplier's A/c Dr. To Purchases return A/c or Returns outward A/c	Decrease in liability is debited. Decrease in assets is credited.

NOTES

7. <i>Sales return</i>	Sales return A/c or Returns inward A/c To Debtors A/c	Dr. Dr.	Decrease in revenue is debited. Decrease in assets is credited.
8. <i>Purchase of assets</i>	Assets A/c To Cash A/c	Dr.	Increase in assets is debited. Decrease in assets is credited.
9. <i>Sale of assets</i>	Cash A/c To Assets A/c	Dr.	Increase in assets is debited. Decrease in assets is credited.
10. <i>Payment of expenses</i>	Expenses A/c To Cash A/c	Dr.	Increase in expenses is debited. Decrease in assets is credited.
11. <i>Receipt of income</i>	Cash A/c To Income A/c	Dr.	Increase in assets is debited. Increase in revenue is credited.
12. <i>Collection from debtors (Discount allowed)</i>	Cash A/c Discount A/c To Debtors A/c	Dr. Dr.	Increase in assets is debited. Increase in expense is debited. Decrease in assets is credited.
13. <i>Payment to creditors (Discount Received)</i>	Suppliers A/c To Cash A/c To Discount A/c	Dr.	Decrease in liability is debited. Decrease in assets is credited. Increase in revenue is credited.
14. <i>Depreciation on assets</i>	Depreciation A/c To Assets A/c	Dr.	Increase in expenses is debited. Decrease in assets is credited.
15. <i>Interest on capital</i>	Interest on capital A/c To Capital A/c	Dr.	Increase in expenses is debited. Increase in capital is credited.
16. <i>Outstanding expenses</i>	Expenses A/c To Outstanding expenses A/c	Dr.	Increase in expenses is debited. Increase in liability is credited.
17. <i>Prepaid expenses</i>	Prepaid expenses A/c To Expenses A/c	Dr.	Increase in assets is debited. Decrease in expenses is credited.
18. <i>Withdrawal of cash for personal use</i>	Drawings A/c To Cash A/c	Dr.	Decrease in capital is debited. Decrease in assets is credited.
19. <i>Withdrawal of goods for personal use</i>	Drawings A/c To Purchases A/c	Dr.	Decrease in capital is debited. Decrease in expense or assets is credited.
20. <i>Goods given as charity</i>	Charity A/c To Purchases A/c	Dr.	Increase in expenses is debited. Decrease in expenses or assets is credited.
21. <i>Insolvency of debtors</i>	Cash A/c Bad Debts A/c To Debtors A/c	Dr. Dr.	Increase in assets is debited. Increase in expenses is debited. Decrease in assets is credited.
22. <i>Bad Debts recovered</i>	Cash A/c To Bad Debts recovered A/c	Dr.	Increase in assets is debited. Increase in revenue is credited.
23. <i>Distribution of goods as free samples</i>	Free Samples or Advertising A/c To Purchases A/c	Dr.	Increase in expense is debited. Decrease in expense or assets is credited.

NOTES

24. <i>Loss of goods by theft/fire</i>	Loss by theft A/c or Loss by fire A/c To Purchases A/c	Dr. Dr.	Increase in expenses is debited. Increase in expense is debited. Decrease in expense or assets is credited.
25. <i>Loss of cash by theft/fire</i>	Loss by theft A/c or Loss by fire A/c To Cash A/c	Dr. Dr.	Increase in expense is debited. Increase in expense is debited. Decrease in assets is credited.
26. <i>Income Tax paid</i>	Capital A/c To Bank/Cash A/c	Dr.	Decrease in capital is debited. Decrease in assets is credited.
27. <i>Refund of Income Tax</i>	Cash A/c To Capital A/c	Dr.	Increase in assets is debited. Increase in capital is credited.
28. <i>Interest received on (Income Tax surplus)</i>	Cash A/c To Capital A/c	Dr.	Increase in assets is debited. Increase in capital is credited.
29. <i>Bills drawn</i>	Bills Receivable A/c To Drawee's A/c	Dr.	Increase in assets is debited. Decrease in assets (Debtors) is credited.
30. <i>Bills accepted</i>	Drawer's A/c To Bills Payable A/c	Dr.	Decrease in liability is debited. Increase in liability is credited.
31. <i>Payment of the bill received</i>	Cash A/c To Bills receivable A/c	Dr.	Increase in assets (cash) is debited. Decrease in assets (B/R) is credited.
32. <i>Payment of the bill made</i>	Bills Payable A/c To Cash A/c	Dr.	Decrease in liability (B/P) is debited. Decrease in assets (cash) is credited.
33. <i>Bills Receivable dishonoured</i>	Drawee's A/c To Bills receivable A/c or Bank A/c or Endorsee's A/c	Dr.	Increase in assets is debited. Decrease in assets is credited. Decrease in assets is credited Increase in liability is credited.
34. <i>Bills Payable dishonoured</i>	Bills payable A/c To Drawer's A/c	Dr.	Decrease in liability is debited. Increase in liability is credited.
35. <i>Sale of Assets for more than the book value</i>	Cash A/c To Assets A/c To Profit on Sale of Assets A/c	Dr.	Increase in assets (cash) is debited. Decrease in assets is credited. Increase in revenue is credited.
36. <i>Sale of Assets for lesser than the book value</i>	Cash A/c Profit & Loss A/c To Assets A/c	Dr. Dr.	Increase in assets is debited. Increase in expenses is debited. Decrease in assets is credited.
37. <i>Amount deposited into Bank/opened a Bank Account</i>	Bank A/c To Cash A/c	Dr.	Increase in assets is debited. Decrease in assets is credited.

NOTES

38. Amount withdrawn from Bank	Cash A/c To Bank A/c	Dr.	Increase in assets is debited. Decrease in assets is credited.
39. Cheque received and retained	Cash A/c To Debtors A/c	Dr.	Increase in assets is debited. Decrease in assets is credited.
40. Cheque received previously deposited into Bank	Bank A/c To Cash A/c	Dr.	Increase in assets is debited. Decrease in assets is credited.
41. Cheque received previously and endorsed	Endorsee's A/c To Cash A/c	Dr.	Decrease in liability is debited. Decrease in assets is credited.
42. Cheque received and deposited into Bank	Bank A/c To Debtors A/c	Dr.	Increase in assets is debited. Decrease in assets is credited.
43. Cheque issued	Creditors A/c To Bank A/c	Dr.	Decrease in liability is debited. Decrease in assets is credited.
44. Interest allowed or Credited by bank	Bank A/c To Interest A/c	Dr.	Increase in assets is debited. Increase in revenue is credited.
45. Interest charged or Debited by bank	Interest A/c To Bank A/c	Dr.	Increase in expenses is debited. Decrease in assets is credited.
46. Bank charges or collection charges	Bank Charges A/c To Bank A/c	Dr.	Increase in expenses is debited. Decrease in assets is credited.
47. Dishonour of cheques, Discounted earlier	Drawee's A/c To Bank A/c	Dr.	Increase in assets is debited. Decrease in assets is credited.
48. Sale of wastes or scrap	Cash A/c To Miscellaneous Receipts A/c	Dr.	Increase in assets is debited. Increase in revenue is credited.
49. Subscribing newspaper	Miscellaneous Expenses A/c To Cash A/c	Dr.	Increase in expenses is debited. Decrease in assets is credited.
50. Treatment of Sales Tax	(a) Cash A/c To Sales A/c To Sales Tax A/c (b) Sales Tax A/c To Cash A/c	Dr. Dr.	Increase in assets is debited. Decrease in assets, revenue is credited. Increase in liability is credited. Decrease in liability is debited. Decrease in cash as assets is credited.
51. Receipt of VPP (value payable post)	Purchases A/c To Cash A/c	Dr.	Increase in assets or expenses is debited. Decrease in assets is credited.

Illustration 7. Classify the following under three different types of accounts :

- | | | |
|-------------------------------------|--------------|------------------|
| (i) Stock | (ii) Loan | (iii) Fixture |
| (iv) Cash | (v) Drawings | (vi) Salaries |
| (vii) Current Accounts of a partner | | (viii) Insurance |
| (ix) Banks. | | |

Solution.

Personal Account :

- (i) Loan
- (ii) Drawings
- (iii) Bank A/c
- (iv) Current A/c of a Partner.

Real Account

- (i) Stock A/c
- (ii) Fixture A/c
- (iii) Cash A/c

Nominal Account :

- (i) Salaries A/c
- (ii) Insurance A/c.

NOTES

Illustration 8. On 1st January, 2006 the following were the balances of Garg & Co. :
Cash in hand Rs. 900 ; Cash at bank Rs. 21,000 ; Gopi (Cr.) Rs. 3,000 Anu (Dr.)
Rs. 2,400 ; Stock Rs. 12,000 ; Dharmendra (Cr.) Rs. 6,000 ; Keshav (Dr.) Rs. 4,500 ; Kunal
(Cr.) Rs. 2,700.

Transactions during the month were—

		Rs.
2001		
Jan. 2	Bought goods from Dharmendra	2,700
Jan. 3	Sold to Keshav	3,000
Jan. 5	Sold to Kunal goods for cash	3,600
Jan. 7	Took goods for personal use	200
Jan. 13	Received from Anu in full settlement	2,350
Jan. 17	Paid to Gopi in full settlement	2,920
Jan. 22	Paid cash for stationery	50
Jan. 29	Paid to Dharmendra by cheque	2,650
	Discount allowed	50
Jan. 30	Provide interest on capital	100
	Rent due to landlord	200

Journalise the above transactions.

Solution.

Journal Entries

Date	Particulars	L.F.	Amount	
			Debit Rs.	Credit Rs.
2006				
Jan. 1	Cash A/c Dr.		900	
	Bank A/c Dr.		21,000	
	Anu A/c Dr.		2,400	
	Keshav A/c Dr.		4,500	
	Stock A/c Dr.		12,000	
	To Gopi A/c			3,000
	To Dharmendra A/c			6,000
	To Kunal A/c			2,700
	To Capital A/c			29,100*
	(Being the various assets and liabilities are brought to new books)			
Jan. 2	Purchases A/c Dr.		2,700	
	To Dharmendra A/c			2,700
	(Being goods purchased from Dharmendra)			

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Jan. 3	Keshav A/c To Sales A/c (Being goods sold to Keshav)	Dr.	3,000	3,000
Jan. 5	Cash A/c To Sales A/c (Being goods sold to Kunal for cash)	Dr.	3,600	3,600
Jan. 7	Drawings A/c To Purchases A/c (Being goods taken for personal use)	Dr.	200	200
Jan. 13	Cash A/c Discount allowed A/c To Anu A/c (Being cash received from Anu in full settlement of the account)	Dr. Dr.	2,350 50	2,400
Jan. 17	Gopi A/c To Cash A/c To Discount received A/c (Being cash paid to Gopi in full settlement of the account)	Dr.	3,000	2,920 80
Jan. 22	Stationery A/c To Cash A/c (Being stationery purchased)	Dr.	50	50
Jan. 29	Dharmendra A/c To Bank A/c To Discount received A/c (Being amount paid to Naro by cheque and she allowed discount)	Dr.	2,700	2,650 50
Jan. 30	Interest on Capital A/c To Capital A/c (Being interest on capital is provided)	Dr.	100	100
Jan. 30	Rent A/c To Rent Outstanding A/c (Being rent due to landlord)	Dr.	200	200

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

Alternate of Illustration No. 8

Analysis of Transactions

S.No.	Transactions	Related Account	According to Accounting Equation (American Approach)		According to Traditional Classification (English Approach)		Account to be debited	Account to be credited
			Nature of Account	How Effected	Kind of Accounts	Effect of Rule		
1.	Commenced business with cash	Cash Capital	Asset Capital	Increased Increased	Real Personal	Cash comes in Proprietor is giver	Cash —	— Capital
2.	Goods purchased on credit from Avi	Goods Avi	Asset Liability	Increased Increased	Real Personal	Goods comes in Avi is giver	Goods (Purchase)	— Avi
3.	Received Interest	Cash Interest	Asset Income	Increased Increased	Real Nominal	Cash comes in Interest is income	Cash —	— Interest
4.	Purchased machinery for cash	Machinery	Asset	Increased	Real	Machine comes in	Machinery	—
5.	Rent Paid	Cash Rent	Asset Expense	Decreased Increased	Real Nominal	Cash goes out Rent expense	— Rent	— Cash
6.	Rent Received	Cash Rent	Asset Revenue	Increased Increased	Real Nominal	Cash comes in Income	Cash —	— Interest
7.	Sold goods to Kevi	Kevi Goods	Asset Asset	Increased Decreased	Personal Real	Receiver Goods goes out	Kevi —	— Goods (Sales)
8.	Depreciation on Machinery	Depreciation Machinery	Expense Asset	Increased Decreased	Nominal Real	Expenses Goes outside (Decreasing in value)	Deprecia- ation —	— Machinery

Note. Analysis of transactions and their Accounting treatment to the modern American approach and Traditional English approach as per above statement shows the same Accounting treatment. Learners of the subject should base their understanding on Accounting Equation Approach in order to develop scientific outlook towards Accounting. It may also be noted that purchases A/c can also be treated as an expense and sales A/c can be treated as revenue. According to this approach, rule of debit and credit regarding expense and revenue will apply in case of purchases and sales but lead to the same entry as discussed above.

Illustration 9. Record the following transactions in the Journal of NOIDA Furniture Mart :

2006

Jan. 1 Started business with cash Rs. 10,000.

Jan. 2 Deposited into bank Rs. 9,000.

Jan. 3 Purchased machinery for Rs. 5,000 from Miss Jolly and gave her a cheque for the amount.

Jan. 15 Paid installation charges of machinery Rs. 100.

Jan. 20 Purchased timber from Romi of the list price of Rs. 2,000. He allowed 10% Trade Discount.

Jan. 23 Furniture costing Rs. 500 was used in furnishing the office.

Jan. 25 Sold furniture to Ramesh of the list price of Rs. 1,000 and allowed him 5% Trade Discount.

Jan. 31 Paid wages Rs. 350 and rent Rs. 200.

Solution.**Journal Entries**

Date	Particulars	L.F.	Amount	
			Debit Rs.	Credit Rs.
2006 Jan. 1	Cash A/c Dr. To Capital A/c (Being business started with cash)		10,000	10,000
Jan. 2	Bank A/c Dr. To Cash A/c (Being amount deposited into Bank)		9,000	9,000
Jan. 3	Machinery A/c Dr. To Bank A/c (Being machinery purchased and paid by cheque)		5,000	5,000
Jan. 15	Machinery A/c Dr. To Cash A/c (Being installation charges of machinery)		100	100
Jan. 20	Purchases A/c Dr. To Romi A/c (Being timber purchased from Romi Rs. 2,000 at a trade discount of 10%)		1,800	1,800
Jan. 23	Office Furniture A/c Dr. To Purchase A/c (Being furniture costing Rs. 500 used in furnishing the office)		500	500

NOTES

Jan. 25	Ramesh A/c To Sales A/c (Being furniture sold to Ramesh for Rs. 1,000 and allowed him 5% trade discount)	Dr.	950	950
Jan. 31	Wages A/c Rent A/c To Cash A/c (Being amount paid for wages and rent)	Dr. Dr.	350 200	550
	Grand Total		30,650	30,650

NOTES

Notes. (i) Installation charges on machinery is capital expenditure. It will increase the value of machinery, so it will be debited to machinery account not charges account.

(ii) Timber will be treated as goods, because West Point Furniture Mart, the firm concerned has been dealing in furniture.

(iii) No entry regarding Trade Discount is passed.

Advantages/need of Journal

Journal has got the following advantages :

1. Reducing the chances of error. The double effect of every transaction is recorded in the same journal entry at the same place. It becomes easier to check and compare it. In case, direct posting is made, there is possibility of omission, posting at the wrong side and writing wrong amount in the two accounts.

2. Permanent Record. *The Journal has permanent record.* It has date-wise record of every transaction and can be used for auditing, whenever required.

3. Narration. Journal entries bear narration, which provides complete information about the transaction. It enables us to understand the entry.

4. Convenient distribution of work. Division of Journal into subsidiary books helps the administration in the distribution of work among employees.

5. Location of errors. Errors can be easily located through journal.

Limitations of Journal

Journal inspite of its above advantages suffers from the following limitations :

1. Huge and bulky size. A single journal for the entire business will be bulky and difficult to operate and handle.

2. Balance of accounts at a glance not available. The actual position of ledger balances as purchases, sales, returns, bills etc. is not known on a particular date from journal.

3. Difficulty in reconciling cash balance. In case all transactions including cash transactions are recorded in the journal and no cash book is maintained, it will be very difficult to reconcile daily cash balance.

In order to overcome the limitations of Journal, business units sub-divide the journal into convenient parts and prepare subsidiary books *i.e.*, Purchases book, Sales book, Returns Inward and Outward book, Bills receivable and Payable book. Other transactions which do not find a place in the subsidiary books are recorded in journal.

REVIEW QUESTIONS

NOTES

A. Very Short Answer Type Questions :

1. Name the types of Personal Accounts.
2. What is the classification of Impersonal Account ?
3. Every transaction has two aspects debit and credit. How is it true in case of Nominal Accounts ?
4. Write short notes on any two of the following (a) Compound entries, (b) Opening entries, (c) Trade discount.
5. State to which class of account does each of the following belong ?
(i) Trade mark (ii) Commission received in advance (iii) Accrued commission (iv) Commission received.

B. Short Answer Type Questions :

1. Name basic accounting terms which are debited for increase.
2. Mention basic accounting terms which are debited for decrease.
3. Name and state three types of accounts.
4. Explain the meaning and purpose of the ledger folio (L.F.).
5. Why are the rules of debit and credit same for both liability and capital ?

C. Long Answer Type Questions :

1. What are the different types of accounts ? Explain with examples their rules of debit and credit.
2. Explain the term :
(a) Opening journal entry (b) Compound journal entry
(c) Narration (d) Ledger folio.
3. 'Every debit must have its corresponding credit.' Discuss this statement.
4. Explain the procedure of recording the journal entries in a journal. Give specimen of a journal with five transactions recorded in it.
5. Explain the double entry mechanism with an illustrative example.

CHAPTER 5 SUB-DIVISION OF JOURNAL

NOTES

★ STRUCTURE ★

- ☆ Subsidiary Books
- ☆ Special Journal
- ☆ Purchases Book
- ☆ Sales Book
- ☆ Purchases Return Book
- ☆ Sales Return Book
- ☆ Journal Proper
- ☆ Debit Note and Credit Note

SUBSIDIARY BOOKS

We know that all cash transactions are recorded in the cash book. In addition to these cash transactions, there are innumerable credit transactions. These credit transactions are classified as credit purchases of goods, credit sales of goods, purchases returns of goods and sales returns of goods. Instead of over-burdening journal with all the credit transactions of goods, we prepare subsidiary books separately. These subsidiary books are Purchases Book, Sales Book, Purchases Return Book, Sales Return Book.

Business, these days have been greater in size. They have got innumerable transactions. It is quite impossible to record all the transactions in journal or ledger direct, because this approach will not allow division and sub-division of work and speedy working. The easy, convenient, speedy and appropriate maintenance of accounts requires that journal should be sub-divided in convenient and requisite parts. Separate books should be used for each type of transaction. **These books are known as special journal or books of primary record or books of primary entry or subsidiary books.**

These subsidiary books having non-cash transactions may be enumerated as under :

1. Purchases book or Purchases Journal
2. Sales book or Sales Journal
3. Purchases return or returns outward book
4. Sales return or returns inward book

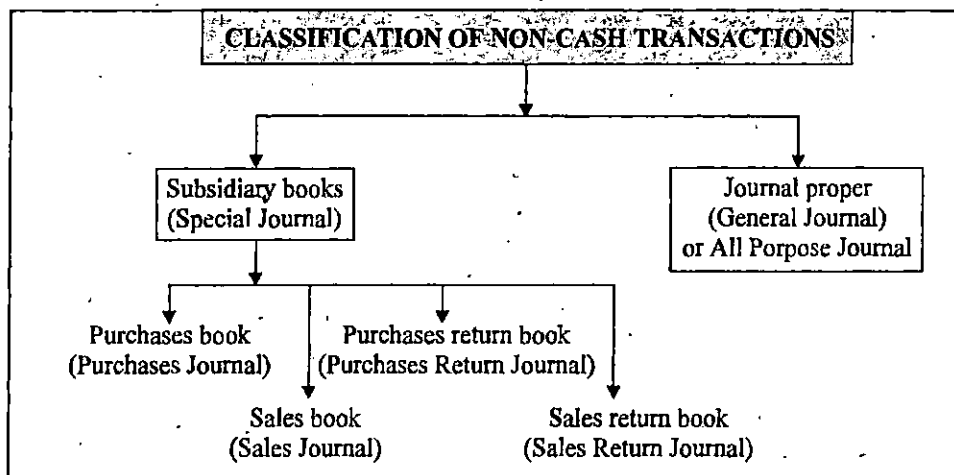
Advantages of Subsidiary Books or Sub-division of Journal :

The uses, importance and advantages of the subsidiary books or sub-division of journal are discussed herewith :

1. **Proper and systematic record of the business transactions.** All the business transactions are studied and classified as cash and non-cash transactions, which are further classified as purchases, sales and returns. The individual transactions are *properly and systematically recorded* in the specific concerned book.

NOTES

2. **Convenient posting.** All the transactions of a particular-type are recorded at one place *i.e.*, in one of the subsidiary books. For example, all credit purchases of goods are recorded in the purchases book and credit sales of goods are recorded in sales book. It facilitates posting to purchases account, sales account and concerned personal accounts.
3. **Division of work.** In case of entering all the transactions into journal, division of work could not be possible. As there is only one journal, only one person can work on it. If journal is sub-divided, or subsidiary books are prepared, the work will be sub-divided and different persons can work on different books at the same time and the work can be speedily completed.
4. **Availability of detailed information.** Subsidiary books provide detailed information about the transactions more than what is available from the narration of journal entry. It is due to the fact that different type of transactions are dealt in different subsidiary books.
5. **Helpful in decision making.** Subsidiary books provide complete details about every type of transaction separately, so the management can use these information as a basis for deciding its future line of action. For example, information regarding sales return will enable the management to analyse the causes for return of these goods. The management can adopt effective measures to remove weaknesses responsible for the poor performance.
6. **Availability of requisite information at a glance.** In case all the transactions are recorded in the journal, it would have been very difficult and result in unnecessary delay in obtaining requisite information regarding sales, purchases and returns. The maintenance of subsidiary books helps in obtaining the necessary information at a glance.



All non-cash transactions are recorded in subsidiary books or journal proper. If the transaction does not find a place in subsidiary books, it is recorded in the journal proper.

SPECIAL JOURNAL (*Subsidiary Books*)

Special Journal, also known as Subsidiary Books or Day Books consists of Cash Book, Purchase Book, Sales Book, Returns Inward and Returns Outward Book. These are subsidiary books having their own unique and specific features. All transactions concerning these books are recorded therein. In general, there are lot of transactions concerning these books so, these books are separately prepared in our financial accounting and special treatment is accorded to them.

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

PURCHASES BOOK (Or Purchase Journal)

NOTES

It is one of the most important book, which records credit purchases of goods. As we know, all cash purchases are recorded in the cash book. Credit purchases cannot be recorded in the cash book. The business wants to know the information about the credit purchases of goods at a glance. The information can be made available, when purchases of goods on credit are separately recorded. Purchases book does not keep record of the purchases of assets even though it is on credit. **Purchases of goods on credit only is recorded in the purchases book.** Goods, here means the articles in which the firm is dealing. In other words, it is the item, which is purchased for regular sales. For example, furniture will be treated as goods in case of the firm dealing in furniture. For other firms, which are not dealing in furniture, it will be an asset for them. Plant and machinery are generally assets but if there is a firm which has been dealing in plant and machinery, it will be goods for the firm. While recording transactions in the purchases book, we must ascertain that the credit purchases is related to the articles in which the firm is dealing. Purchases book is prepared on the following format :

Specimen format of Purchases Book/Purchases Journal					
Date	Invoice No.	Name of Suppliers (Account to be credited)	L.F.	Amount	
				Details	Total
				Rs.	Rs.
(1)	(2)	(3)	(4)	(5)	(6)

Explanation of Columns

- (1) **Date.** The date column records the dates of the purchases of goods on credit.
- (2) **Invoice.** Invoice is the statement prepared by the seller of goods. It contains details about the goods, its price and other expenses incurred. Instead of writing complete details about the goods purchased, only invoice number is mentioned. The requisite information, if any, may be obtained from the invoice.
- (3) **Particulars.** This column bears the name of the supplier from whom goods have been purchased. The details of goods purchased is also written in this column. It contains the name, quantity, number and rate of the goods purchased. Any other specification and specialities of the goods is also written in this column.
- (4) **Ledger Folder.** Ledger folio means the page number of the ledger. We have to post the purchases of goods in the ledger accounts of suppliers. Purchase book contains the page number of supplier's account in the ledger. It facilitates in the posting and also in checking the records.

NOTES

- (5) **Amount (Details).** This column is divided in two parts *i.e.*, *details* and *total*. The details column is used to write the individual total of the items purchased from a particular supplier. This column is used when we purchase more than one item from a particular supplier. This will also be used when we purchase only one item and trade discount is allowed to us. The column is used for additions and subtractions.
- (6) **Amount (Total).** The total column shows the net amount payable to the supplier of goods. The purchases book can also be prepared in column form. The column purchases book is prepared as under :

Illustration 1. Record the following transactions in the Purchases Book :
2006

Mar. 1 Purchased from Garg Furnishers, Kirti Nagar (Invoice No. 516)
20 chairs @ Rs. 150 each

2 tables @ Rs. 400 each

Less : Trade Discount @ 10%

Mar. 7 Bought of M/s Roy & Co., Kirti Nagar (Invoice No. 700)

2 stools @ Rs. 125 each

10 Collapsible chairs @ Rs. 20 each

Delivery and cartage Rs. 15

Mar. 21 Purchased from Patel, Lajpat Nagar (Invoice No. 909)

10 chairs @ Rs. 150 each

15 steel cabinets @ Rs. 150 each

Packing and delivery charges Rs. 25

Less : Trade Discount @ 10%

Mar. 25 Purchased from Adi & Sons, Kirti Nagar (Invoice No. 1000)

2 Typewriters @ Rs. 7750 for Office use.

Solution.

Purchases Book/Purchases Journal

Date	Invoice No.	Supplier's Name (Account to be credited)	L.F.	Amount	
				Details Rs.	Total Rs.
2006					
Mar. 1	516	Garg Furnishers, Kirti Nagar 20 chairs @ Rs. 150 2 tables @ Rs. 400		3,000 800	3,420
		Less : Trade Discount @ 10%		3,800 380	
Mar. 7	700	M/s Roy & Co., Kirti Nagar 2 stools @ Rs. 125 10 Collapsible chairs @ Rs. 20		250 200	465
		Add : Delivery and cartage		450 15	

Mar. 21	909	Patel, Lajpat Nagar			
		10 chairs @ Rs. 150		1,500	
		15 steel cabinets @ Rs. 150		2,250	
				3,750	
		<i>Less : Trade Discount @ 10%</i>		375	
				3,375	
		<i>Add : Packing and delivery charges</i>		25	3,400
		Purchases A/c	Dr.		7,285

NOTES

Notes.

1. Purchases of typewriter will not be recorded in the purchases book, because typewriter is an asset for a firm dealing in furniture.
2. Trade discount is allowed on the purchase price of goods excluding delivery charges and cartage.
3. Delivery charges and cartage is direct expense, chargeable from purchaser, so added to amount payable.

SALES BOOK (Or Sales Journal)

Sales book records credit sale of goods only. It does not record cash sales of goods. Cash sales is recorded in the cash book. All the credit sales are not recorded in it. Credit sales of assets are also not recorded in the sales book. We can summarise that :

1. Cash sales is not recorded in sales book.
2. All sales are not recorded in it.
3. Credit sales of assets are not recorded.
4. *Only credit sales of goods is recorded.*

Goods means the articles in which the firm has been dealing. Goods are purchased for regular sales. Raw materials used for manufacture of the articles, sold by the firm is also goods. Articles produced, assembled, manufactured or purchased for sales are all goods.

The date column of the sales book shows the date of credit sales. Particulars column contains the name of party purchasing goods or the party whom goods have been sold. It also shows the details of goods as regards its quantity, specifications and also the rate of trade discount allowed. L.F. column shows the page number of debtors' account in the ledger. The details column is used for additions and subtractions, if any. The total column bears the net amount payable by individual customers. The format of the sales book is as under :

Sales Book/Sales Journal

NOTES

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

Explanation of Columns :

- (1) **Date.** It is the first column of the sales book. It records the date of actual credit sale.
- (2) **Invoice No.** Invoice is the statement sent by us to the customer containing details of goods sold and dispatched. Its number is mentioned in the sales book, so that necessary information regarding sales may be obtained whenever required.
- (3) **Particulars.** It records the names and addresses of persons or parties from whom goods have been purchased. Names, types, size, number, quantities and other specific features of the goods are also recorded.
- (4) **Ledger Folio (L.F.).** The column records the ledger page number of the persons/ parties mentioned in the sales book, so that posting in the concerned Purchases A/c can be made.
- (5) **Amount (Details).** This column records the amount of different items purchased from single party and the total is transferred to the total column. This column will also record the amount of sales, even if only one item has been sold and trade discount is allowed. This column is used for additions and subtractions.
- (6) **Amount (Total).** This column records the net total of amount of sale to every party.

Illustration 2. Enter the following transactions in the Sales Book of M/s David & Co., NOIDA :

2006

May 4 Sold to M/s Sharma Bros., NOIDA (Invoice No. 175)

10 dozens pencils @ Rs. 20 per dozen

14 gross rubbers Rs. 5 per dozen

May 14 Sold to M/s Verma & Co., Kirti Nagar (Invoice No. 200)

5 dozens gum bottles @ Rs. 5 per bottle

70 dozens rulers @ Rs. 15 per dozen

Less : 10% Trade Discount

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

May 21 Sold to M/s Sumit & Co., Moti Nagar (Invoice No. 255)

10 reams of paper @ Rs. 60 per ream

Less : Trade Discount @ 10%

May 25 Sold to M/s Gupta & Co., Kirti Nagar for cash (Invoice No. 285)

10 dozens pens @ Rs. 120 per dozen for cash

May 30 Sold to M/s Cheap Stores, New Delhi (Invoice No. 299)

10 dozens pencils @ Rs. 18 per dozen

Less : Trade Discount @ 10%

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

Solution.

NOTES

Sales Book/Sales Journal

Date	Invoice No.	Name of the Customers (Account to be debited)	L.F.	Amount	
				Details Rs.	Total Rs.
2006					
May 4	175	M/s Sharma Bros, NOIDA 10 dozens pencils @ Rs. 20 per dozen 14 gross rubbers @ Rs. 5 per dozen		200 840	1040
May 14	200	M/s Verma & Company Kirti Nagar 5 dozens gum bottles @ Rs. 5 per bottle 70 dozens rulers @ Rs. 15 per dozen		300 1050	
		Less : Trade Discount @ 10%		1350 135	1215
May 21	255	M/s Sumit & Company, Moti Nagar 10 reams paper @ Rs. 60 per ream Less : Trade discount @ 10%		600 60	540
May 30	299	M/s Cheap Stores, New Delhi 10 dozens pencils @ Rs. 18 per dozen Less : Trade discount @ 10%		180 18	162
		Sales A/c Cr.			2,957

Notes.

- (i) Sale of newspaper will not be recorded in the sales book, because it is cash sales and the firm has been dealing in stationery not newspaper. Sale of furniture also will not be recorded.
- (ii) Cash sales is recorded in cash book, not sales book.

PURCHASES RETURN BOOK (Or Purchases Return Journal)

Goods purchased on credit may be returned to the seller in case of certain defect or violation of certain conditions. They may be returned, if they are not according to sample and specification or if goods have been supplied more than what they have been ordered.

Purchases return book is made in the same fashion as purchases book is prepared. In the details column, it contains the names of those parties, whom goods have been returned. It also contains the details of goods returned. If the supplier had allowed trade discount at the time of purchases, it will also be shown at the time of returning goods. Purchases return

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is also known as returns outward because goods brought inside the business at the time of purchases are being sent outside the business to supplier. This is the return of goods outside the business, so it is also known as returns outward. In case of goods returned to supplier, the business sends a Debit Note to the supplier indicating that the Supplier's A/c has been debited with the price of goods returned. While preparing Purchases Return Book the Debit Note Number is mentioned. It has got a separate column for Debit Note Numbers. Preparation of purchases return book is explained by the following illustration.

Illustration 3. Prepare Purchases Returns Book/Journal from the following transactions :

2006

March 4 Returned to M/s Garg & Co., Chandigarh : (Debit Note No. 225)

2 Collapsible chairs @ Rs. 200 each

March 8 Returned to M/s Aggarwal Furniture, Chandigarh : (Debit Note No. 245)

4 Chairs @ Rs. 150 each

Less : 10% Trade Discount

March 15 Returned to M/s Jain Ltd., Chandigarh (Debit Note No. 315)

1 Steel Almirah of Rs. 4,000.

Solution.

Purchases Returns Journal>Returns Outward Book

Date	Debit Note No.	Name of the Suppliers (Account to be credited)	L.F.	Amount			
				Details		Total	
				Rs.	P.	Rs.	P.
2006							
Mar. 4	225	M/s Garg & Co. Chandigarh 2 Collapsible chairs @ Rs. 200				400	—
Mar. 8	245	M/s Aggarwal Furniture, Chandigarh 4 chairs @ Rs. 150 Less : Trade Discount 10%		600	—	540	—
				60	—		
Mar. 15	315	M/s Jain Ltd., Chandigarh 1 Steel Almirah				4,000	—
		Purchases Returns A/c Cr.				4,940	—

SALES RETURN BOOK (Or Sales Return Journal)

Goods sold on credit to customers may be returned to us in the following cases :

1. Due to the defect in the goods.
2. Due to delay in the dispatch of goods.
3. Due to over-supply of goods.
4. Due to goods not being in accordance with the sample and specifications.
5. Due to violation of the terms of the contract.

Goods returned by the customers to us may also be known as 'Returns Inward' because goods once sent outward with the sales have been returned back and coming inside the business.

Sales return book has got almost the same columns as sales book. This book records the return of goods sold on credit only. This is not concerned with the return of assets or return of goods sold for cash. After accepting the goods returned by customer. We issue a Credit Note to him indicating that the customer's A/c has been credited for the goods returned by him. While Preparing Sales Return Book Credit Note No. is also referred, therein. The preparation of sales return book has been explained with the help of following illustration.

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Illustration 4. Enter the following transactions in the Sales Returns Book :

2006

Jan. 9 Returned by M/s Gope & Co. (Credit Note No. 308)
20 bags Coffee @ Rs. 300 per bag
10 chests Tea @ Rs. 400 per chest

Jan. 17 Returned by M/s Ankita & Sisters (Credit Note.No. 412)
15 tins Ghee @ Rs. 500 per tin
Less : Trade discount 10%.

Solution.

Sales Return Book/Journal

Date	Credit Note No.	Name of the Customer (Account to be credited)	L.F.	Amount			
				Details		Total	
				Rs.	P.	Rs.	P.
2006							
Jan. 9	308	M/s Gope & Co. 20 bags Coffee @ Rs. 300 per bag 10 chests Tea @ Rs. 400 per chest		6,000 4,000	— —	10,000	—
Jan. 17	412	M/s Ankita & Sisters 15 tins Ghee @ Rs. 500 per tin Less : Trade Discount @ 10%		7,500 750	— —	6,750	—
		Sales returns A/c Dr.				16,750	—

Illustration 5. Enter the following transactions in proper Subsidiary Books of Ram :

	Rs.
Jan. 1 Sold goods to John	525
Jan. 1 Bought of David	780
Jan. 2 John returned goods	75
Jan. 2 Sold to Ankit	550
Jan. 2 Purchased goods from Imtiyaz	700
Jan. 4 Returned goods to Imtiyaz	100
Jan. 4 Bought of Naresh	325
Jan. 4 Sold to Ashok	350

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Jan. 5	Ashok returned goods	45
Jan. 6	Sold to Abhay	500
Jan. 6	Sold to Anil	300
Jan. 7	Abhay returned goods	50
Jan. 7	Bought of Naresh	700
Jan. 8	Returned goods to Naresh	75
Jan. 9	Purchased goods from Anshu subject to a trade discount of 10%	1,000
Jan. 10	Sold to James goods subject to trade discount of 5%	500

Solution.

Purchases Book

Date	Supplier's Name (Account to be credited)	L.F.	Amount	
			Rs.	P.
2006				
Jan. 1	David		780	00
Jan. 2	Imtiyaz		700	00
Jan. 4	Naresh		325	00
Jan. 7	Naresh		700	00
Jan. 9	Anshu	1,000		
	Less : Trade Discount @ 10%	100	900	00
	Purchases A/c	Dr.	3,405	00

Sales Book/Sales Journal

Date	Name of Customers (Account to be debited)	L.F.	Amount	
			Rs.	P.
2006				
Jan. 1	John		525	00
Jan. 2	Ankit		550	00
Jan. 4	Ashok		350	00
Jan. 6	Abhay		500	00
Jan. 6	Anil		300	00
Jan. 10	James	500		
	Less : Trade Discount @ 5%	25	475	00
	Sales A/c	Cr.	2,700	00

Purchases Return Book/Journal

Sub-division of Journal

Date	Particulars	L.F.	Amount	
			Rs.	P
2006				
Jan. 4	Imtiyaz		100	00
Jan. 8	Naresh		75	00
	Purchases Return A/c	Cr.	175	00

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Sales Return Book/Journal

Date	Particulars	L.F.	Amount	
			Rs.	P
2006				
Jan. 2	John		75	00
Jan. 5	Ashok		45	00
Jan. 7	Abhay		50	00
	Sales Return A/c	Dr.	170	00

JOURNAL PROPER (Or General Journal)

Business firms of smaller size may record all their transactions in the journal, but in practice most of the firms record their transactions in subsidiary books including cash book. If the transaction does not find a place in the subsidiary books, it is recorded in the journal proper. There are certain transactions, which cannot be recorded in either of the subsidiary books, such as purchases of furniture on credit. If it would have been cash purchases of furniture, it would have been recorded in the cash book. As purchases book records credit purchases of goods only, so the purchases of furniture, an asset will not be shown in the purchases book. The purchases of furniture will thus be recorded in the journal proper. The following transactions are recorded in the journal proper :

1. Opening entries
2. Closing entries
3. Adjusting entries
4. Rectifying entries
5. Transfer entries
6. *Special items, which do not find a place in any subsidiary book :*
 - (a) Purchases of assets on credit
 - (b) Sales of assets on credit
 - (c) Interest on capital
 - (d) Goods taken by the proprietor for personal use
 - (e) Goods given as charity or free sample

(f) Loss of goods

(g) Endorsement and dishonour of bills.

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1. Opening Journal Entry

Business according to going concern concept is supposed to be carried on indefinitely. At the end of the accounting year different accounts are closed but the business has to be carried on, so previous years assets and liabilities are to be brought into account of the current year. Passing journal entry in the beginning of the current year with the balance of assets and liabilities of the previous year is opening journal entry. In this entry assets accounts are debited because assets always shows debit balance. Liabilities and capital accounts are credited because they show credit balance.

Illustration 7. The firm of M/s Pandey and Goyal has the following balances in their different ledger accounts on January 1, 2006.

Cash	Rs. 40,000
Closing Stock	Rs. 40,000
Building	Rs. 1,20,000
Debtors	Rs. 40,000
Creditors	Rs. 32,000
Capital	Rs. 2,16,000

Pass the opening journal entry.

Solution.**Journal Entry**

Date	Particulars	L.F.	Amount	
			Debit Rs.	Credit Rs.
2006				
Jan. 1	Cash A/c Dr.		40,000	
	Goodwill A/c Dr.		8,000	
	Stock A/c Dr.		40,000	
	Building A/c Dr.		1,20,000	
	Debtors A/c Dr.		40,000	
	To Creditors A/c			32,000
	To Capital A/c			2,16,000
	(Being previous year's balance brought into books)			

*Note. Excess of credit over debit has been assumed to be goodwill.

2. Closing Journal Entry

At the end of accounting period, all ledger accounts pertaining to goods *i.e.*, purchases, sales, purchases return, sales return, stock and other accounts concerning expenses, losses, income and gain are closed by transfer to trading and profit and loss accounts. These transfer entries are termed as closing entries. In other words, the closing entries concern all the items of the debit and credit side of Trading, Profit and Loss A/c *i.e.*, Nominal Accounts.

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

- (i) For closing items appearing at the debit side of Trading A/c
- | | |
|---|-----|
| Trading A/c | Dr. |
| To Opening stock A/c | |
| To Purchases A/c | |
| To Sales return A/c | |
| To Direct expenses A/c (individually by name) | |
- (ii) For closing items appearing at the credit side of Trading A/c
- | | |
|----------------------|-----|
| Sales A/c | Dr. |
| Purchases Return A/c | Dr. |
| Closing stock A/c | Dr. |
| To Trading A/c | |
- (iii) For Transfer of Gross Profit to Profit and Loss A/c
- | | |
|------------------------|-----|
| Trading A/c | Dr. |
| To Profit and loss A/c | |
- (iv) For Transfer of Gross Loss to Profit and Loss A/c
- | | |
|-------------------|-----|
| Profit & Loss A/c | Dr. |
| To Trading A/c | |
- (v) For closing items (indirect expenses and losses) appearing at the debit side of Profit and Loss A/c
- | | |
|--|-----|
| Profit & Loss A/c | Dr. |
| To Indirect expenses and losses A/c
(Individual expenses A/c by name) | |
- (vi) For transfer of Income and Gains A/c
- | | |
|---------------------------------|-----|
| Individual Income and Gains A/c | Dr. |
| To Profit and Loss A/c | |
- (vii) For transfer of Net profit
- | | |
|--|-----|
| Profit and Loss A/c | Dr. |
| To Capital A/c (In case of proprietorship and partnership) | |
| OR | |
| Profit & Loss Appropriation A/c (In case of Company) | |
- (viii) For transfer of Net Loss
- | | |
|---------------------------------|-----|
| Capital A/c or | Dr. |
| Profit & Loss Appropriation A/c | Dr. |
| To Profit and Loss A/c | |

It should be noted that closing entries are made for nominal accounts only.

3. Adjusting Entries

Business is going concern. It has to be carried on indefinitely. We cannot wait indefinitely for the assessment of the performance of the business, so we distribute the life of the business in equal and uniform periods, generally a year. At the end of every accounting year, we prepare trading and profit and loss account and measure the performance of the business in terms of Gross profit and Net profit. We also prepare a Balance Sheet at the end of the year to assess the value of assets and liabilities.

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While preparing Final Accounts at the end of every accounting period, we come across certain problems. The expenses of the current year are still payable or the expenses of the next year have been paid during the current year. Sometimes, income of the current year remain still receivable and the income of the next year has been received during the current year. Depreciation on assets, interest on capital and provision for bad and doubtful debts of the current year has not been recorded in the books as yet. We are required to adjust these amounts in the final accounts of the current year, so that the correct profit or loss of the business may be ascertained. We will have to pass adjusting journal entries for all these items, errors and omissions, not yet recorded in the books. These items do not appear in the Trial Balance. They are adjusted at two places in the final accounts.

4. Rectifying Entries

“To err is human”. This old statement is also true for accounting. We, as a human being are likely to commit mistake of omission, commission and principles in maintaining books of accounts. We may omit the entire transaction from being recorded wholly or partially. We may commit mistake in calculation, *i.e.*, addition, subtraction, division and multiplication. Mistakes may also be committed in carrying forward total from one page to other page, posting from subsidiary books to ledger accounts. Sometimes capital expenditure may be recorded as revenue expenditure or revenue expenditure may be recorded as capital expenditure. These mistakes are likely to be omitted in the books of accounts.

Mistakes committed in the books of accounts must be rectified at the earliest. It should be noted that errors in accounts are not rectified by removing mistakes by ink remover or rubbing it off or by over-writing or cutting or even by tearing off the page. Once errors are committed, we boldly accept it and rectify the mistake by passing a rectifying entry. The rectified entry will neutralise the effect of wrong entry and also bring the correct effect of the transaction. Rectification of errors should be made at the earliest. While passing rectifying entry we will have to take into consideration the nature and type of errors.

5. Transfer Entries

At the end of accounting period, all ledger accounts pertaining to goods, *i.e.*, purchases, sales, purchases return, sales return, stock and other accounts concerning expenses, losses, income and gain are closed by transfer to Trading and Profit and Loss Account. These journal entries are termed as transfer entries.

For transfer of gross profit to Profit and Loss Account

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

For Transfer of Net Profit

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

6. Special items, which do not find a place in any subsidiary book

- (a) **Purchases of assets on credit.** We know that credit purchases of goods are recorded in the purchases book. Cash purchases of goods are recorded in the cash book. Goods here, means the articles in which the firm deals. Stationery will be goods for stationery dealer and furniture will be goods for furnishers. In case assets are purchased on credit they can neither be recorded in the purchases book nor in the cash book. We have to pass a separate journal entry for this transaction. It is recorded in the journal proper.

- (b) **Sales of assets on credit.** This item also does not belong to any of the subsidiary book. It can neither be shown in the cash book nor in the sales book, because it is neither cash transaction nor credit sale of the goods. It is therefore, recorded in the journal proper or general journal and a separate journal entry is passed for it.
- (c) **Interest on capital.** It is an item which does not find a place in any of the subsidiary book. It is credited to proprietors' capital accounts at the end of the accounting period. It is recorded in the journal proper.
- (d) **Goods taken by the proprietor for personal use.** If goods are taken by the proprietor for personal use, it is neither a purchases nor the sales of the firm. As such it cannot be recorded in the purchases or sales book. That is why, we have to pass a separate journal entry in the journal proper.
- (e) **Goods given as charity or free sample.** If goods are distributed as free sample or given as charity, it cannot be treated as purchases or sales. That is why, it is also recorded in the journal proper as a separate journal entry.
- (f) **Loss of goods.** If goods are lost by theft, fire, storm or by any natural disaster or accident, it cannot be treated as purchases or sales. It must be recorded as a separate journal entry in journal proper.
- (g) **Endorsement and dishonour of bills.** These items do not concern with any of the subsidiary book. So, they do not find a place in the subsidiary books. A separate journal entry is also required for these items in the journal proper.

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DEBIT NOTE AND CREDIT NOTE

In case of purchases return and sales return, adjustment is required in the amount payable or receivable. These adjustments are made through notes, known as debit note and credit note.

Debit Note. In case of purchases return, the purchases will reduce the amount payable to seller. When goods are purchased, the purchaser credits the seller's account. If certain part of goods are returned to the seller, the value of goods returned will not be paid to the seller or will be deducted from the amount payable to seller or technically seller's account will be debited with the value of goods returned to him. In this case the purchaser will send a 'Debit Note' to the seller meaning that the seller's account is being debited for the value of goods returned to him. The seller after receiving the goods returned to him and the enclosed debit note will send a credit note to the purchaser, which will mean that the seller has credited purchaser's account with the value of goods returned to him. Debit note can be sent by the seller to the purchaser also, if the total of the invoice is **cast short** or the price of certain goods is not included by mistake or price calculated at lesser rates. In all these cases, the seller will charge amount over and above the invoice value from the purchaser, so he will send a debit note to the purchaser, who will send a credit note to the seller in return.

We have got a separate column for Debit Note Numbers in our Purchases Return Book indicating the details of goods returned to supplier.

Credit Note. In case of sales return, goods are received back, so allowance is to be given to the purchaser for the value of goods returned by him. At the time of sales, pur-

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chaser A/c is debited for the value of invoice sent to him. As certain part of goods is being returned by the purchaser, so the value of goods returned by him should be deducted from the invoice value of goods or technically credited to the purchaser's A/c. The seller in this case will send a credit note, so to adjust the amount debited in excess at the time of recording sales. The purchaser will send debit note against the credit note sent by the seller. The seller will also send credit note to the purchaser to rectify mistakes in the following cases :

1. If the total of the invoice has been wrongly added more.
2. If the price of certain goods has been charged, which was not sent.
3. If goods have been charged at more than their price.
4. If certain part of goods prove to be defective.

The purchaser will send debit note on receiving credit note from the seller. The debit and credit notes are exchanged between purchaser and seller for adjustments of amount payable or receivable. If one party sends debit note, the other party sends credit note and *vice versa*.

We have got a separate column for Credit Note Number in our Sales Return Book indicating the details of goods returned by customer.

A specimen of debit and credit note is given below :

Name of the Firm Issuing the Note	Address of the Firm
	Date of Issue
No.	
DEBIT NOTE	
Against : Supplier's Name	
Goods returned as per Delivery	Amount (Rs.)
Challan No.	
(Details of goods returned)	
(Rupees Only)	
Signature of the Manager with date	

Name of the Firm Issuing the Note	Address of the Firm
	Date of Issue
No.	
CREDIT NOTE	
Against : Customer's Name	
Goods returned by the customer	Amount (Rs.)
Challan No.	
(Details of goods received)	
(Rupees Only)	
Signature of the Manager with date	

CHAPTER 6 LEDGER ACCOUNTS

NOTES

★ STRUCTURE ★

- ☆ Meaning of Ledger Accounts
- ☆ Classification of Ledger Accounts
- ☆ Importance/Advantages of Ledger Accounts
- ☆ Relationship Between Journal and Ledger
- ☆ Ledger Posting from Journal Entries
- ☆ Balancing of Ledger Accounts

MEANING OF LEDGER ACCOUNTS

We have discussed that business transactions of financial nature are recorded in the books of original records. These books are cash book, purchases book, sales book, purchases return book, sales return book, bills receivable book, bills payable book and journal. Business transactions are first recorded in these books. The proprietor of the business expects from accounting to let him know the position of individual debtors and creditors account. He would also like to know the value of individual assets and other material information. The answers to these questions cannot be given unless, we prepare individual party's and assets accounts separately. **Collection of requisite information concerning a particular account and presenting them under one head is known as ledger posting.** In the words of **Carier**, "*An Account is a ledger record in a summarised form of all the transactions that have taken place with the particular person or things specified.*"

Ledger accounts are prepared on the following format.

CLASSIFICATION OF LEDGER ACCOUNTS

Ledger Accounts are classified into five categories: These categories are (a) Assets Accounts, (b) Liabilities Accounts (c) Capital Accounts (d) Revenue Accounts and (e) Expenses Accounts. These ledger accounts may be grouped as : (i) Permanent Ledger Accounts and (ii) Temporary Ledger Accounts. Permanent Ledger Accounts have their opening balances except in case of newly started business. These accounts show a closing balances at the end of accounting year and are also carried forward to the next accounting year. Temporary Ledger Accounts do not have any opening and closing balance. These accounts are closed at the end of the accounting year by transfer to Trading or Profit and Loss Accounts. Purchases, Sales and Direct Expenses Accounts are closed by transfer to Trading A/c. Selling, Distribution, Indirect Expenses and Losses Accounts are transferred to the debit side of income and gains accounts at the credit side of Profit and Loss A/c.

Format of Ledger Account

Name of Account (Title)

Page No.

Dr.

Cr.

Date	Particulars	Folio	Amount Rs.	Date	Particulars	Folio	Amount Rs.
(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
	To A/c				By A/c		

NOTES

This format of Ledger Account resembles English Capital letter 'T', so it is sometimes called 'T' shape account. As teachers generally use this type of Ledger Account while taking classes, so this account is also known as 'Classroom Account'. Practically 'T' shape Ledger Accounts are not used in business houses.

Ledger Accounts are divided in two parts. The left hand side is debit side and the right hand side is the credit side. All business transactions are classified as assets, liabilities, revenue, expense and capital. While preparing these ledger accounts, we have to apply the rules of debit and credit applicable to the particular category of account.

IMPORTANCE/ADVANTAGES OF LEDGER ACCOUNTS

Ledger Accounts are the most important record of business accounting. Every business transaction whether it is recorded in journal or cash book or subsidiary books must be posted into Ledger Accounts. Its importance are summarised herewith :

1. Separate accounts. There are separate ledger accounts for different parties and heads, so the information regarding every account is collected at one place. For example, if we prepare Ram's A/c, information regarding Ram's purchases, sales, payments and bills drawn and accepted etc. will be brought to Ram's A/c from purchases book, sales book, cash book, bills payable book and bills receivable book etc.

2. Requisite information at a glance. The correct position and status of every account can be ascertained at a glance by going through it. In case of personal accounts, we know what we have to receive or pay to the particular party. Information regarding purchases, sales and returns are easily available from their ledger accounts.

3. Preparation of trial balance. Ledger accounts facilitate the preparation of trial balance, which is the test of examining arithmetical accuracy in the books of accounts. Trial balance is prepared with the balances of ledger accounts.

4. Facilitating the preparation of financial statements. Ledger Accounts supply information for the preparation of Trading, Profit & Loss A/c and Balance Sheet. They also help in identifying adjustments, which are incorporated in Final Accounts.

RELATIONSHIP BETWEEN JOURNAL AND LEDGER

NOTES

Accounting transactions need to be recorded in the books of accounts. The first step is to record journal entry of the transaction which is also known as original entry for the transaction. Once journal entry is prepared, it is posted in the ledger account.

In double entry book keeping, every transaction will have debit and credit effect. Ledger accounts are prepared for both debit and credit accounts. For example, goods purchased from Ram for Rs. 3,000. The journal entry for this transaction is as follows :

Purchases A/c	Dr.	xxx
To Ram		xxx

From the above journal entry two ledger accounts will be prepared namely purchases A/c and Ram's A/c. This indicates that there is back to back relationship between journal entry and ledger accounts where in ledger accounts are prepared after the journal entry is made for the transaction. Journal entry is transaction specific and ledger account is based on individual account.

LEDGER POSTING FROM JOURNAL ENTRIES

Journal is the book of original record. In case of small firms, all business transactions are recorded in the journal. Big firms record their transactions in subsidiary books and those transactions which do not find a place in subsidiary books are recorded in the journal. We cannot ascertain the position of different accounts at a glance through journal. It is, therefore, necessary that we should prepare ledger accounts with the help of journal entries. Let us take an example to explain ledger posting from journal entries.

Illustration 1. Pass the following journal entries and post them in the ledger accounts:

2005		Rs.
Jan. 1	Started business with cash	20,000
Jan. 3	Purchased goods from Vivek	5,000
Jan. 6	Paid to Vivek	4,900
	Discount allowed	100
Jan. 9	Purchased furniture	2,000
Jan. 12	Paid salaries	1,000
Jan. 15	Rent received	500
Jan. 18	Sold goods to Vineet	4,000

Solution.

Journal Entries

Date	Particulars	L.F.	Amount	
			Debit Rs.	Credit Rs.
2005 Jan. 1	Cash A/c To Capital A/c (Being commencement of business)	Dr.	20,000	20,000

Jan. 3	Purchases A/c To Vivek A/c (Being goods purchased from Vivek)	Dr.	5,000	5,000
Jan. 6	Vivek's A/c To Cash A/c To Discount received A/c (Being amount paid to Vivek who allowed discount)	Dr.	5,000	4,900 100
Jan. 9	Furniture A/c To Cash A/c (Being furniture purchased)	Dr.	2,000	2,000
Jan. 12	Salaries A/c To Cash A/c (Being payment of salaries)	Dr.	1,000	1,000
Jan. 15	Cash A/c To Rent A/c (Being rent received)	Dr.	500	500
Jan. 18	Vineet's A/c To Sales A/c (Being goods sold to Vineet)	Dr.	4,000	4,000

NOTES

Ledger Posting

Cash Account

Dr.				Cr.			
Date	Particulars	J.F.	Amount Rs.	Date	Particulars	J.F.	Amount Rs.
2005				2005			
Jan. 1	To Capital A/c		20,000	Jan. 6	By Vivek A/c		4,900
Jan. 15	To Rent A/c		500	Jan. 9	By Furniture A/c		2,000
				Jan. 12	By Salaries A/c		1,000
				Jan. 31	By Balance c/d		12,600
			20,500				20,500
Feb. 1	To Balance b/d		12,600				

Capital Account

Dr.				Cr.			
Date	Particulars	J.F.	Amount Rs.	Date	Particulars	J.F.	Amount Rs.
2005				2005			
Jan. 31	To Balance c/d		20,000	Jan. 1	By Cash A/c		20,000
			20,000				20,000
				Feb. 1	By Balance b/d		20,000

Purchases Account

Dr. Cr.

Date	Particulars	J.F.	Amount Rs.	Date	Particulars	J.F.	Amount Rs.
2005 Jan. 3	To Vivek's A/c		5,000	2005 Jan. 31	By Balance c/d		5,000
			5,000				5,000
Feb. 1	To Balance b/d		5,000				

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Vivek's Account

Dr. Cr.

Date	Particulars	J.F.	Amount Rs.	Date	Particulars	J.F.	Amount Rs.
2005 Jan. 6	To Cash A/c To Discount received		4,900 100	2005 Jan. 3	By Purchases A/c		5,000
			5,000				5,000

Discount Received Account

Dr. Cr.

2005 Jan. 31	To Balance c/d		100	2005 Jan. 6	By Vivek's A/c		100
			100				100
				Feb. 1	By Balance b/d		100

Furniture Account.

Dr. Cr.

Date	Particulars	J.F.	Amount Rs.	Date	Particulars	J.F.	Amount Rs.
2005 Jan. 9	To Cash A/c		2,000	2005 Jan. 31	By Balance c/d		2,000
			2,000				2,000
Feb. 1	To Balance b/d		2,000				

Salaries Account

Dr. Cr.

2005 Jan. 12	To Cash A/c		1,000	2005 Jan. 31	By Balance c/d		1,000
			1,000				1,000
Feb. 1	To Balance b/d		1,000				

Rent Account

Cr.

Dr.

2005 Jan. 31	To Balance c/d	500	2005 Jan. 15	By Cash A/c	500
		500			500
			Feb. 1	By Balance b/d	500

NOTES

Vineet's Account

Cr.

Dr.

2005 Jan. 18	To Sales A/c	4,000	2005 Jan. 31	By Balance c/d	4,000
		4,000			4,000
Feb. 1	To Balance b/d	4,000			

Sales Account

Cr.

Dr.

2005 Jan. 31	To Balance c/d (Transfer)	4,000	2005 Jan. 18	By Vineet A/c	4,000
		4,000			4,000
			Feb. 1	By Balance c/d	4,000

Explanation

We have been making cash, an asset's account, which is debited for increase and credited for decrease. All the transactions resulting in the increase of cash will be posted at the debit side of the cash book and those resulting in decrease will be posted at the credit side of the cash book. *Alternatively following rules of posting should be noted :*

1. We never use the name of the same account which we have been preparing either at the debit or credit side of the account. It should be verified from the previous cash account that we have not written 'To Cash A/c' or 'By Cash A/c' in it anywhere.

2. It should be seen that the account being prepared has been debited or credited. If the account has been debited, posting will be made at the debit side of the account and if the account being prepared is credited in the journal entry the posting will be made at the credit side of the account.

3. We write the name of reverse account at the debit or credit side of the account, as we do not use name of the same account. This is why, while making posting of the first journal entry in the cash account, we shall write capital account, which is opposite to the cash account being prepared. It means that we write the name of account to be credited for the debit of the account being prepared. While preparing an account being debited in the journal entry the name of the account credited in the entry will be written. In the same way, while preparing an account being credited, in the journal entry the name of the account being debited in the entry will be written. This fact can be verified from the previous cash account.

4. In case of compound entries the amount written against the account being prepared will be written. With reference to journal entry on Jan. 6, we have written Rs. 4,900 in cash account and while preparing discount we shall write Rs. 100, the amount written against discount account.

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BALANCING OF LEDGER ACCOUNTS

Ledger Posting of Opening Journal Entry

Opening Journal entry as we know is passed to bring the previous year's closing balances of assets and liabilities to the current year. While making ledger accounts of assets and liabilities appearing in the opening journal entry opening balances as represented in the journal entry must be shown in the beginning of the ledger account as 'To Balance b/d' on the debit side for assets and 'By Balance b/d' at the credit side of liabilities. Remaining posting in the concerned A/c will be made as usual.

Ledger accounts are categorised as assets, liabilities, capital, revenue and expenses according to modern American approach. The first three of them *i.e.*, assets, liabilities and capital account have certain closing balance at the end of accounting period, so their values are to be carried forward to the next accounting period. This is why, they are closed as 'By Balance c/d' or 'To Balance c/d'. In the previous ledger accounts, cash account, capital account, furniture and Ram's account have been closed in this way. The balances of these accounts are carried forward to the next accounting period, because the firm has to carry on its business with these assets, liabilities and capital in hand. While closing these accounts we write the word 'Balance c/d' to show the closing balance of the account. We can write *c/d* both at the debit or credit side, while closing personal and real accounts, *c/d* here means carried down to the next period. We can also use the word *c/f* which means carried forward or *c/o* which means carried over. All these words *c/d* or *c/f* or *c/o* are synonymous and carry the same meaning. It should be noted once more that the word *c/d* is not restricted to the debit or credit side. It can be used on both the debit and credit side.

The closing balance of the previous period *i.e.*, balance *c/d* is brought forward to the next accounting period as balance *b/d*, which means brought down from the previous period. We can also use the word *b/f*, meaning brought forward or *b/o* which means brought over. These words *i.e.*, *b/d* or *b/f* or *b/o* can be used both at the debit or credit side of personal and real accounts to show the opening balance of the account.

While closing nominal accounts or those accounts which are either an expense or revenue, we do not use the word balance *c/d* because the balance of these accounts need not be carried forward to the next period. Whatever has been paid on account of expenses has been paid once and forever. This is the expense of the business, so it should be directly posted to the debit side of the profit and loss account or trading account. In the same way, accounts relating to income or gain or revenues are also closed by transfer to profit and loss account. Receipts *i.e.*, rent, interest and discount are revenue of the business, so while closing these accounts their balance will be transferred to profit and loss account. That is why, rent, discount and salaries accounts in the example have been closed by transfer to profit and loss account.

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

Ledger Posting from Cash Book

Cash book is the book of original record. All cash receipts and cash payments are recorded in the cash book. Cash account need not be prepared when cash book is maintained but all the other accounts from whom payment has been received or those accounts whom payment has been made will be prepared with the help of cash book. Posting in all the accounts appearing in the cash book is made through cash book. The procedure of posting is explained with the following illustration.

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Illustration 2. Prepare a cash book from the following transactions and post them into concerned ledger accounts. Also explain the rule and procedure of preparing ledger accounts with the help of cash book.

2006		Rs.
Nov. 1	Cash in hand	10,000
Nov. 3	Cash purchases	5,000
Nov. 6	Cash sales	4,000
Nov. 9	Payment of wages	2,000
Nov. 15	Rent received	700
Nov. 20	Furniture purchased	1,000
Nov. 25	Goods sold to David	800
Nov. 28	Payment received from David	800
Nov. 29	Goods purchased from John	3,000
Nov. 30	Payment made to John	3,000

Solution.

Cash Book

Dr.				Cr.			
Date	Particulars	J.F.	Amount Rs.	Date	Particulars	J.F.	Amount Rs.
2006				2006			
Nov. 1	To Balance b/d		10,000	Nov. 3	By Purchases A/c		5,000
Nov. 6	To Sales A/c		4,000	Nov. 9	By Wages A/c		2,000
Nov. 15	To Rent A/c		700	Nov. 20	By Furniture A/c		1,000
Nov. 28	To David's A/c		800	Nov. 30	By John's A/c		3,000
				Nov. 30	By Balance c/d		4,500
			15,500				15,500
Dec. 1	To Balance b/d		4,500				

Notes

- (i) Sales of goods to David has not been shown in the cash book, because it is credit sales and credit transactions are not recorded in the cash book.
- (ii) Purchases of goods from John is a credit purchases, so it will also not be shown in the cash book. It should be once more noted that cash book records only cash transactions.

1. Ledger Posting from the Debit Side of the Cash Book

The debit side of the cash book records all cash receipts. The posting will be made in all the ledger accounts appearing at the debit side of the cash book. Cash has been received through these accounts, therefore cash account must have been debited. The debit side

NOTES

cash book shows that cash account has been debited for all these receipts, so the accounts appearing at the debit side of the cash book must have been credited at the time of receiving cash. It is, therefore, suggested that posting in the accounts appearing at the debit side will be made at the credit side of the accounts as 'By Cash A/c'. This is due to the fact that we cannot use the name of the same account in its own ledger account. In the previous cash book sales account, rent account and David's account have been posted at the debit side of the cash book, so we shall be preparing these accounts through cash book and the posting will be made as under :

Sales Account

Dr.				Cr.			
Date	Particulars	J.F.	Amount Rs.	Date	Particulars	J.F.	Amount Rs.
2006 Dec. 31	To Balance c/d		4,000	2006 Nov. 1	By Cash A/c		4,000
			4,000				4,000
				2007 Jan. 1	By Balance b/d		4,000

Rent Account

Dr.				Cr.			
Date	Particulars	J.F.	Amount Rs.	Date	Particulars	J.F.	Amount Rs.
2006 Dec. 31	To Balance c/d		700	2006 Nov. 15	By Cash A/c		700
			700				700
				2007 Jan. 1	By Balance b/d		700

David's Account

Dr.				Cr.			
Date	Particulars	J.F.	Amount Rs.	Date	Particulars	J.F.	Amount Rs.
2006 Dec. 31	To Balance c/d		800	2006 Nov. 28	By Cash A/c		800
			800				800
				2007 Jan. 1	By Balance b/d		800

2. Ledger Posting from the Credit Side of the Cash Book

All accounts appearing at the credit side of cash book will be separately prepared. Posting will be made to the debit side of these accounts to complete double entry record. Credit side of the cash book shows cash payment to the accounts appearing at the credit side of the cash book. Purchases account, wages account, furniture account and John's account must have been debited when payment would have been made to them, so the posting will be made at the debit side of these accounts. While making posting from cash book, it should be seen, whether the particular account has been posted at the debit side or the credit side of cash book. If it is posted at the debit side of the cash book, posting will be made at credit side of the account appearing there and *vice versa*.

Purchases Account

Dr.				Cr.			
Date	Particulars	J.F.	Amount Rs.	Date	Particulars	J.F.	Amount Rs.
2006 Nov. 3	To Cash A/c		5,000	2006 Dec. 31	By Balance c/d		5,000
			5,000				5,000
2007 Jan. 1	To Balance b/d		5,000				

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Wages Account

Dr.				Cr.			
2006 Nov. 3	To Cash A/c		2,000	2006 Dec. 31	By Balance c/d		2,000
			2,000				2,000
2007 Jan. 1	By Balance b/d		2,000				

Furniture Account

Dr.				Cr.			
2006 Nov. 20	To Cash A/c		1,000	2006 Dec. 31	By Balance c/d		1,000
			1,000				1,000
2007 Jan. 1	By Balance b/d		1,000				

John's Account

Dr.				Cr.			
2006 Nov. 31	To Cash A/c		3,000	2006 Dec. 31	By Balance c/d		3,000
			3,000				3,000
2007 Jan. 1	By Balance b/d		3,000				

Ledger Posting from Purchases Book

Purchases book records only credit purchases of goods. Cash purchases are recorded in the cash book. It is, therefore, necessary that purchases account showing the position of total purchases both cash and credit should be prepared. Posting to purchases account will be made through purchases book. It contains the names of those persons and parties from whom goods have been purchased on credit, so the posting will also be made in these personal accounts. The procedure of posting is explained with the help of following illustration.

Illustration 3. Prepare a purchases book from the following details and also prepare concerned ledger accounts :

2006

Dec. 1 Purchased from Laxmi Publications, New Delhi :
 100 Golden Accountancy for Class XII @ Rs. 80 each
 50 Golden Commerce for Class XII @ Rs. 40 each
 100 Golden Economics for Class XII @ Rs. 50 each
 Trade Discount allowed @ 20%

Dec. 15 Purchased from Laxmi Kitab Ghar, Sonapat :
 100 English Guide for Class X @ Rs. 25 each
 200 Hindi Guide for Class X @ Rs. 20 each

Dec. 20 Cash purchases of books from Ankita & Sisters Rs. 300.

Solution.

Purchases Book/Purchases Journal

Date	Particulars	L.F.	Amount	
			Debit Rs.	Credit Rs.
2006				
Dec. 1	Laxmi Publications, New Delhi : 100 Golden Accountancy for Class XII @ Rs. 80 each 50 Golden Commerce for Class XII @ Rs. 40 each 100 Golden Economics for Class XII @ Rs. 50 each Less : Trade Discount @ 20%		8,000 2,000 5,000 15,000 3,000	12,000
Dec. 15	Laxmi Kitab Ghar, Sonapat : 100 English Guide for Class X @ Rs. 25 each 200 Hindi Guide for Class X @ Rs. 20 each		2,500 4,000	6,500
	Purchases A/c	Dr.		18,500

Purchases Account

Dr.				Cr.			
Date	Particulars	J.F.	Amount Rs.	Date	Particulars	J.F.	Amount Rs.
2006				2006			
Dec. 31	To Total Amount as per Purchases Book		18,500	Dec. 31	By Balance c/d		18,500
			18,500				18,500
2007							
Jan. 1	To Balance b/d		18,000				

Explanation. The total of the purchases book is posted to the purchases account. The total of the purchases book represents the total of all credit purchases of goods. We need

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not show every credit purchases individually in the purchases account. The total will be posted at the debit side as 'To Total Amount as per Purchases Book'. Cash purchases are also posted at the debit side of purchases account. The balance of this account will be transferred to the debit side of Trading account.

Laxmi Publications Account

NOTES

<i>Dr.</i>				<i>Cr.</i>			
2006			2006				
Dec. 31	To Balance c/d		Dec. 1	By Purchases A/c			
		12,000				12,000	
		12,000				12,000	
			2007				
			Jan. 1	By Balance b/d			12,000

Explanation. Laxmi Publications Account appears in the purchases book. As the purchases book has a debit balance, so the posting will be made at the credit side of parties accounts appearing in the purchases book. The name of the supplier of goods on credit is recorded in the purchases book, so all the accounts appearing therein are suppliers. Sellers of goods on credit or suppliers are always credited for supplying goods, so posting is made at the credit side of Laxmi Publications Account as 'By Purchases Account'. The closing balance of the account will be carried forward to next period.

Laxmi Kitab Ghar's Account

<i>Dr.</i>				<i>Cr.</i>			
2006			2006				
Dec. 31	To Balance c/d		Dec. 15	By Purchases A/c			
		6,500				6,500	
		6,500				6,500	
			2007				
			Jan. 1	By Balance b/d			6,500

Explanation. The account of Laxmi Kitab Ghar appears in the purchases book which shows a debit balance, so the posting will be made at the credit side of firm's account. Posting will be made at the credit side of all the accounts appearing in the purchases book. Laxmi Kitab Ghar is the supplier of goods on credit. The firm is our creditor, so the posting will be made at the credit side and we shall be writing 'By Purchases A/c'. The firm's account will show a credit balance so its closing balance will be transferred to the next accounting period as 'By Balance b/d' and treated as opening balance of the next period.

Ledger Posting from Sales Book

Sales book records credit sales of goods only. Cash sales are recorded in the cash book. It is, therefore, necessary that sales account should be prepared to show the overall picture of sales. It should include cash and credit sales. Sales has always a credit balance, so posting in case of sales will be made at the credit side. The persons and parties, whom goods have been sold must have been debited, so posting will be made at their debit side. Sales account will be closed by transfer to trading account but personal accounts will show a balance and closed as 'By Balance c/d'. The procedure of posting to personal accounts through sales book is explained as under :

Illustration 4. Prepare a sales book from the following information and post them into concerned accounts :

2000

- Dec. 1 Sold goods on credit to Novelty Book Depot, Chandigarh
200 Copies of Golden Accountancy for Class XII @ Rs. 80 each
- Dec. 5 Sold to Standard Book Depot books worth Rs. 2,000 for cash
- Dec. 25 Sold to Adi Book Depot, Chandigarh
200 Copies of Golden Economics for Class XII @ Rs. 50 each
300 Copies of Golden Accountancy for Class XII @ Rs. 80 each
Trade discount allowed @ 20%.

NOTES

Solution.

Sales Book/Sales Journal

Date	Particulars	L.F.	Amount	
			Debit Rs.	Credit Rs.
2005				
Dec. 1	Novelty Book Depot, Chandigarh : 200 Copies of Golden Accountancy for Class XII @ Rs. 80 each			16,000
Dec. 25	Adi Book Depot, Chandigarh : 200 Copies of Golden Economics for Class XII @ Rs. 50 each 300 Copies of Golden Accountancy for Class XII @ Rs. 80 each		10,000	
			24,000	
			34,000	
	Less : Trade Discount @ 20%		6,800	
				27,200
	Sales A/c	Cr.		43,200

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

Sales Account

Dr.				Cr.			
Date	Particulars	J.F.	Amount Rs.	Date	Particulars	J.F.	Amount Rs.
2005				2005			
Dec. 31	By Balance c/d		43,200	Dec. 31	By Total amount as per Sales Book		43,200
			43,200				43,200
				2006			
				Jan. 1	By Balance b/d		43,000

Explanation. The total of sales book is transferred to the credit of sales account. Sales book always shows a credit balance, so its posting will be made at the credit side of sales

account. Sales book records all credit sales of goods. Cash sales are recorded in the cash book. Both credit sales as per sales book and cash sales as per cash book are posted at the credit side of sales account, which shows total sales of the period. The balance of sales account is transferred to the credit side of trading account.

Novelty Book Depot Account

NOTES

Dr.				Cr.			
2005				2005			
Dec. 1	To Sales A/c		16,000	Dec. 31	By Balance c/d		16,000
			16,000				16,000
2006							
Jan. 1	By Balance b/d		16,000				

Explanation. The account of Novelty Book Depot appears in the sales book which shows a credit balance, so the posting will be made at the debit side of Novelty Book Depot's Account. Posting in all the accounts appearing in the sales book will be made at the debit side. Parties appearing in sales book are the debtors of the firm, as credit sales was made to them. Debtors as assets have debit balance so the posting will be made at the debit side as 'To Sales A/c'.

Adi Book Depot Account

Dr.				Cr.			
2005				2005			
Dec. 25	To Sales A/c		27,200	Dec. 31	By Balance c/d		27,200
			27,200				27,200
2006							
Jan. 1	To Balance b/d		27,200				

Explanation. Posting will be made at the debit side of Adi Book Depot's Account because it appears in the sales book as the rule goes. 'Posting will be made at the debit side, of every account appearing in the sales book'. Adi Book Depot is the debtor of the firm, so the posting will be made at the debit side of Adi Book Depot. The account will show a debit balance and its balance will be transferred to the next period as opening balance and shown as 'To Balance b/d'.

Summary of Rules of Posting from Subsidiary Books

- 1. Posting from the debit side of the cash book.** Posting in all the accounts appearing at the debit side of the cash book is made at the credit side of the account. No cash account is prepared, if cash book is maintained by the firm.
- 2. Posting from the credit side of the cash book.** Posting in all accounts appearing at the credit side of the cash book will be made at the debit side as 'To Cash A/c'. Cash account is not prepared, if cash book is maintained by the firm.
- 3. Posting from purchases book.** Posting from purchases book is made in the purchases account and supplier's account from whom goods have been purchased. Posting in the suppliers account is made at the credit side as 'By Purchases A/c' and in purchases account posting is made at the debit side as total amount as per Purchase Book.
- 4. Posting from sales book.** Posting is made at the debit side of debtors' account, whom goods have been sold on credit and which appear in the sales book. The posting in the sales account is made at the credit side as By Total Amount as Per Sales Book.

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5. **Posting from purchases return book.** Posting is made at the debit side of suppliers' accounts which appear in the purchases return book. Posting is also made at the credit side of the purchases return account.
6. **Posting from sales return book.** Posting is made at the credit side of the debtors accounts whose account appear in the sales return book. Posting in the sales return account is made at the debit side.

Distinction between Journal and Ledger

All business transactions are recorded in the subsidiary books. If the transaction does not find a place in subsidiary books, it is recorded in the journal proper. With the help of subsidiary books and Journal, Ledger Accounts are prepared. **Ledger Accounts are known as Principal books.** Ledger Accounts are maintained with the help of Journal, which is of the initial record of business transactions. This is why, **Journal is known as the initial book of original record.** Though Journal and Ledger both keep the record of business transactions but, even then they are different from each other in the following respects :

Difference between Journal and Ledger

<i>Points of Difference</i>	<i>Journal</i>	<i>Ledger</i>
1. <i>Primary record</i>	Journal is the primary record of business transactions.	It is the principal book of business transactions, not primary record.
2. <i>Information</i>	Information regarding different Accounts are shown at one place.	Information regarding particular Account is shown at one place.
3. <i>Basis</i>	Ledger Accounts are prepared taking Journal entries and subsidiary books as basis.	Ledger Accounts are used as a basis for preparing Trial Balance.

REVIEW QUESTIONS**A. Very Short Answer Type Questions :**

1. Mention the balance of Sales A/c and Purchases A/c. How are these accounts closed ?
2. What is meant by 'Net Purchases' ?
3. What is the balance of Sales A/c and where its balance is transferred ?

B. Short Answer Type Questions :

1. Prepare the format of an account.
2. Is the balance of Nominal Accounts calculated, if not ? How is it closed ?
3. "Ledger is the principal book of business ?" Explain.
4. What is the meaning of an account ?
5. What is the purpose of a ledger ?

C. Long Answer Type Questions :

1. What is meant by Ledger Posting ? Explain its importance in Accounting.
2. Explain the procedure for preparing Ledger Accounts through Journal entry.
3. How are Ledger Accounts of items appearing at the credit side of Cash Book prepared ?
4. Why is it necessary to prepare Ledger Accounts, when there are Subsidiary Books and Journal ?
5. Which accounts can be prepared on the basis of Purchases book and Sales book ? Explain the process of preparing these accounts.

CHAPTER 7 TRIAL BALANCE

NOTES

★ STRUCTURE ★

- ☆ Meaning of Trial Balance
- ☆ Purpose and Functions of Trial Balance
- ☆ Limitations of Trial Balance
- ☆ Preparation of Trial Balance
- ☆ Methods of Preparing Trial Balance

All the transactions of financial nature are recorded in the books of accounts. Journal proper and subsidiary books record all business transactions originally. With the help of subsidiary books and journal, we prepare ledger accounts. These ledger accounts have the debit and credit sides. The ledger accounts are balanced. If the credit side exceeds the debit side, the excess is known as credit balance. In the same way, excess of debit side of an account over its credit side shows debit balance. After balancing ledger accounts, we would like to check the arithmetical accuracy of our accounts and for this purpose trial balance is prepared.

MEANING OF TRIAL BALANCE

Trial balance is a statement, prepared with the debit and credit balances of ledger accounts to test the arithmetical accuracy of the books. It may also be prepared with debit and credit totals of ledger accounts and also with the balances and totals of ledger accounts. Books of accounts are maintained according to the '**Double Entry System**', where every debit has its corresponding credit, so the total of the debit and credit columns of the amount column must tally. If the total of debit and credit amount column is equal, we assume our books of accounts to be arithmetically correct, but it should not be taken as the conclusive proof of arithmetical accuracy.

Special Features of Trial Balance

Trial balance has the following special features :

1. The trial balance is prepared on a specific date. That is why, we use the word 'as on.....' with its heading.
2. Trial balance contains the list of all ledger accounts including cash account.
3. Trial balance may be prepared with the balances or totals or balances and totals of ledger accounts.
4. The total of the debit and credit column of the amount must be equal.
5. In case the debit and credit side of the trial balance are equal, we assume that the principles of 'Double Entry System' and the assumptions of accounting equation have been observed.
6. The difference between the debit and credit side of the trial balance points out that certain mistakes have been committed somewhere.

7. If both the debit and credit sides have the same total, it does not mean that there is no mistake in accounting.

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PURPOSE AND FUNCTIONS OF TRIAL BALANCE

The Trial balance is prepared with the following purpose :

1. **Test of arithmetical accuracy.** Trial balance is the test of accuracy of arithmetical calculations. If correct posting has been made from subsidiary books and ledger accounts and correct figures have been recorded and copied, the debit and credit total of the trial balance must tally.
2. **Summarised information of ledger accounts.** Trial balance contains a list of all ledger accounts. It presents the names of ledger accounts and the amount of their debit or credit balance. The summarised position of ledger accounts can be obtained at a glance from the trial balance. It would have been very difficult to assess the position of different ledger accounts from subsidiary books and ledger accounts.
3. **Basis for preparing final accounts.** The ultimate end of maintaining books of accounts is to ascertain the result of the business in term of profit and the value of different assets and liabilities. For this purpose, we prepare a profit and loss account and balance sheet on the basis of information supplied by the trial balance. It is, in this way, a source statement for preparing final accounts.
4. **Helpful for making adjustments.** While making final accounts certain adjustments regarding closing stock, outstanding and prepaid expenses, accrued and unearned income are to be made. While identifying items for adjustments, we will have to study the information furnished by the trial balance.

LIMITATIONS OF TRIAL BALANCE (*Errors not Affecting or Undetected by Trial Balance*)

Trial balance is taken as test of arithmetical accuracy. If both the debit and credit columns of trial balance are equal to each other, we assume that there is no mistake in the posting of journal and subsidiary books to ledger accounts, in carrying forward balances of ledger accounts to trial balance and even in the balancing of ledger accounts. This assumption is correct but should never be taken as conclusive proof of accuracy. It means that there are certain errors which remain undetected by trial balance. Both the debit and credit columns of the trial balance may be equal inspite of certain mistakes of omissions and principles. These errors may be mentioned as under :

1. Errors of omission in the books of original record
2. Errors of principle
3. Compensating errors
4. Incorrect account in the original books
5. Posting to wrong account.

1. Errors of omission in the books of original record

The entire transaction is not recorded in the books of accounts, we omit to record the transaction. For example, goods returned by Mohan were taken into stock but the return

was not entered in the books. The mistake cannot be discovered by trial balance, because equal amount could not be written at both the debit and credit sides of the trial balance as the entire transaction was not passed through due to omission. The error will affect the result of the business, so it should be rectified at the earliest.

If the omission is made in posting only one part of journal entry or omission is made in posting the total of the subsidiary books to ledger accounts or the total of ledger accounts to trial balance itself, the mistake will be detected. The trial balance will fail to discover the error, if the entire transaction has not been passed through journal or subsidiary book or a particular journal entry has not been posted in the ledger accounts completely.

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2. Errors of principle

We maintain books of accounts according to **double entry system**. According to this system, every debit has got its corresponding credit. The accounts will be arithmetically correct, if the same amount is written at the debit and also at the credit side. Errors of principles may be committed, if we debit or credit a wrong account due to our ignorance. The accountant does not have the understanding of the accounting concepts and commits errors. For example, purchases of building is capital expenditure and building account should be debited but if the accountant debits purchases account instead of building account, errors of principle will be there in the accounts. The trial balance will tally. Double entry record will be complete but the mistake will continue to remain in its accounts. Errors of principles in this way are not detected by the trial balance. In the same way, if salary is paid to the Managing Director but instead of debiting salaries account, Managing Director's personal account is debited, the errors of principle will be committed. The error will not at all be detected by the trial balance. Accountants and auditors should never take it as granted that there are no mistake after the agreement of trial balance, *i.e.*, trial balance should not be taken as final proof of accuracy.

3. Compensating errors

It is just possible that the effect of certain error is neutralised by the effect of another error. The combined effect of the two errors will equalise the debit and credit side of trial balance inspite of errors. It can be explained with the help of the following example.

Example. Sale of goods to Mohan for Rs. 100 was debited to Mohan's account with Rs. 10 only.

Rs. 100 received from Sohan was credited to Sohan's account with Rs. 10 only.

In the first error, Mohan's account was debited with Rs. 10 only, whereas it should have been debited with Rs. 100. It means that Rs. 90 was debited short. The effect of the error in the trial balance will be that the total of the debit side will be Rs. 90 lesser.

In the second error, Sohan's account has been credited with Rs. 10, whereas it should have been credited with Rs. 100. It shows that Rs. 90 have been written lesser at the credit side of Sohan's account. As per the effect of this error, the total of the credit column of trial balance will be lesser by Rs. 90.

The combined effect of the two errors on the trial balance is that the first error has reduced the total of the debit side by Rs. 90 and the second error has reduced the total of the credit side of the trial balance by the same amount *i.e.*, Rs. 90. Reduction of Rs. 90 from both sides will not affect trial balance. Both sides of trial balance will tally inspite of the two errors.

NOTES

4. Incorrect account in the original book

If the name of wrong account are used in the journal of subsidiary books, trial balance will not be able to detect it. For example, goods sold to Ramdhari for Rs. 300 was wrongly debited to Namdhari with Rs. 300. The mistake will not affect trial balance, because posting at the debit side of the trial balance has been made against Namdhari's account though instead of Ramdhari's account. In the same way, debiting or crediting wrong personal accounts cannot be detected by trial balance.

5. Posting to wrong account

If the posting from the debit side or credit side of cash book or from purchases book or sales book or returns book is made to wrong account but at the correct side and also with the correct amount, both the debit and credit side of trial balance will be equal inspite of these errors.

Following ledger accounts have debit balance :

1. All assets account, *i.e.*, cash, building and furniture etc.
2. All expenses and losses account, *i.e.*, wages, salaries and bad debts etc.
3. Purchases account
4. Sales return or returns inward account
5. Drawings account
6. Debtors account

Following ledger accounts have credit balance :

1. Capital account
2. Liabilities accounts
3. Reserve and funds accounts
4. Revenue and income account
5. Sales account
6. Purchases return or returns outward account
7. Creditors account
8. Interest on drawing account.

PREPARATION OF TRIAL BALANCE

The preparation of trial balance is the third step of recording business transactions in the books of accounts. The first step is to record the business transactions in subsidiary books and journal proper. The second step is to prepare ledger accounts on the basis of subsidiary books and journal. Trial balance is prepared on the following format :

Format of Trial Balance

Trial Balance

Name of the Accounts	L.F.	Amount	
		Debit Rs.	Credit Rs.
(1)	(2)	(3)	(4)

NOTES

Explanation of Columns

- (1) **Name of the account.** This column contains list of all ledger accounts. Names of accounts are written in this column. Accounts should not be omitted. Omission of any account will throw trial balance out.
- (2) **L.F. (Ledger Folio).** This column contains the page number of the different ledger accounts in the ledger. If salaries account is prepared at page 17 of the ledger, 17 will be written in the folio column against salaries account.
Amount column. All accounts in the ledger must be enlisted in the trial balance and their total or balance or both should be written in the amount column against them.
- (3) **Debit column.** The amount column is divided as debit and credit. If the trial balance is prepared by total method, the debit total of every account or debit balance of ledger accounts (in case the trial balance is prepared according to balance method) is written in the amount column. Debit balance means excess of debit side of an account over its credit side.
- (4) **Credit column.** If the ledger account shows a credit balance *i.e.*, credit side exceeds the debit side, the amount will be shown in the credit column (In case trial balance is prepared according to balance method). We will have to write the total of the credit side of the account if the trial balance is being prepared according to total method.

METHODS OF PREPARING TRIAL BALANCE

There are three methods of preparing trial balance. The total of both the debit and credit columns of the trial balance must be equal in all the methods. The following methods can be used for preparing trial balance :

1. Balance method
2. Total method
3. Total and Balance method

1. Balance Method

Trial balance, as its name itself points out is prepared with the balance of ledger accounts. Every ledger account has got the debit and credit side. At the end of a certain period, ledger accounts are balanced. Excess of the total of the debit side of an account over

its credit side is known as debit balance and written in the debit column of the trial balance. In the same way, excess of credit side of an account over its debit side shows credit balance and will be written at the credit side of the trial balance. The total of both the debit and credit side must be equal.

NOTES

2. Total Method

According to this method, the total of the debit and credit side of every account is separately written in the debit and credit column of the trial balance. The total of both the debit and credit must be equal. If it is not equal, there are definitely certain errors which should be located and rectified.

3. Total and Balance Method

This method presents both the balance and total method in the same trial balance. The amount column is divided between total and balance methods. Each method has further two columns of debit and credit. The total of the debit and credit under each method must be equal. There will be different totals according to the different methods but the total of debit and credit of each method will be equal.

Illustration 1. Pass journal entries with the following information. Also prepare ledger accounts and trial balance.

2005		Rs.
Jan. 1	Michael started business with cash	20,000
Jan. 3	He opened a current account in the bank	5,000
Jan. 7	Purchased goods on credit from Nancy	4,000
Jan. 10	Paid to Nancy in full settlement	3,900
Jan. 13	Machinery purchased	2,000
Jan. 16	Goods sold to Rana	3,000
Jan. 18	Amount received from Rana	1,000
Jan. 20	Salaries paid	700
Jan. 23	Rent received	300
Jan. 28	Goods purchased from Rohit	4,000
Jan. 31	Interest on capital @ 10% for the month	
Jan. 31	Depreciation on machinery	100

Solution.

Journal Entries

Date	Particulars	L.F.	Amount	
			Debit Rs.	Credit Rs.
2006				
Jan. 1	Cash A/c Dr. To Capital A/c (Being Michael started business with cash)		20,000	20,000
Jan. 3	Bank A/c Dr. To Cash A/c (Being amount paid into Bank)		5,000	5,000

Jan. 7	Purchases A/c To Nancy A/c (Being goods purchased from Nancy)	Dr.	4,000	4,000
Jan. 10	Nancy A/c To Cash A/c To Discount Received A/c (Being amount paid to Nancy who allowed discount)	Dr.	4,000	3,900 100
Jan. 13	Machinery A/c To Cash A/c (Being purchase of machinery)	Dr.	2,000	2,000
Jan. 16	Rana A/c To Sales A/c (Being sale of goods to Rana)	Dr.	3,000	3,000
Jan. 18	Cash A/c To Rana A/c (Being amount received from Rana)	Dr.	1,000	1,000
Jan. 20	Salaries A/c To Cash A/c (Being payment of salaries)	Dr.	700	700
Jan. 23	Cash A/c To Rent A/c (Being rent received)	Dr.	300	300
Jan. 28	Purchases A/c To Rohit A/c (Being goods purchased from Rohit)	Dr.	4,000	4,000
Jan. 31	Interest on Capital A/c To Capital A/c (Being Interest on Capital allowed)	Dr.	167	167
Jan. 31	Depreciation A/c To Machinery A/c (Being depreciation on machinery)	Dr.	100	100

NOTES

Ledger Accounts

Cash Account

NOTES

Dr.

Cr.

Date	Particulars	J.F.	Amount Rs.	Date	Particulars	J.F.	Amount Rs.
2005				2005			
Jan. 1	To Capital A/c		20,000	Jan. 3	By Bank A/c		5,000
Jan. 18	To Rana's A/c		1,000	Jan. 10	By Nancy's A/c		3,900
Jan. 23	To Rent A/c		300	Jan. 13	By Machinery A/c		2,000
				Jan. 20	By Salaries A/c		700
				Jan. 31	By Balance c/d		9,700
			21,300				21,300
Feb. 1	To Balance b/d		9,700				

Bank A/c

Dr.

Cr.

2005				2005			
Jan. 3	To Cash A/c		5,000	Jan. 31	By Balance c/d		5,000
			5,000				5,000
Feb. 1	To Balance b/d		5,000				

Purchases A/c

Dr.

Cr.

2005				2005			
Jan. 7	To Akali A/c		4,000	Jan. 31	By Balance c/d		8,000
Jan. 28	To Abeni A/c		4,000				8,000
			8,000				
Feb. 1	To Balance b/d		8,000				

Nancy's A/c

Dr.

Cr.

2005				2005			
Jan. 10	To Cash A/c		3,900	Jan. 7	By Purchases A/c		4,000
	To Discount A/c		100				4,000
			4,000				

Discount Received A/c

Trial Balance

<i>Dr.</i>			<i>Cr.</i>		
2005 Jan. 31	To Balance c/d	100	2005 Jan. 10	By Nancy A/c	100
		100			100
			Feb. 1	By Balance b/d	100

NOTES

Capital A/c

<i>Dr.</i>			<i>Cr.</i>		
2005 Jan. 31	To Balance c/d	20,167	2005 Jan. 1	By Cash A/c	20,000
			Jan. 31	By Interest on Capital A/c	167
		20,167			20,167
			Feb. 1	By Balance b/d	20,167

Machinery A/c

<i>Dr.</i>			<i>Cr.</i>		
2005 Jan. 13	To Cash A/c	2,000	2005 Jan. 31	By Depreciation A/c	100
			Jan. 31	By Balance c/d	1,900
		2,000			2,000
Feb. 1	To Balance b/d	1,900			

Rana's A/c

<i>Dr.</i>			<i>Cr.</i>		
2005 Jan. 16	To Sales A/c	3,000	2005 Jan. 18	By Cash A/c	1,000
			Jan. 31	By Balance c/d	2,000
		3,000			3,000
Feb. 1	To Balance b/d	2,000			

Salaries A/c

<i>Dr.</i>			<i>Cr.</i>		
2006 Jan. 20	To Cash A/c	700	2006 Jan. 31	By Balance c/d	700
		700			700
Feb. 1	To Balance b/d	700			

Sales A/c

<i>Dr.</i>		<i>Cr.</i>	
2005		2005	
Jan. 31	To Balance c/d	Jan. 16	By Rana A/c
		Feb. 1	To Balance b/d

NOTES

Rent A/c

<i>Dr.</i>		<i>Cr.</i>	
2005		2005	
Jan. 31	To Balance c/d	Jan. 23	By Cash A/c
		Feb. 1	To Balance b/d

Rohit's A/c

<i>Dr.</i>		<i>Cr.</i>	
2005		2005	
Jan. 31	To Balance c/d	Jan. 28	By Purchases A/c
		Feb. 1	To Balance b/d

Interest on Capital A/c

<i>Dr.</i>		<i>Cr.</i>	
2005		2005	
Jan. 31	To Capital A/c	Jan. 31	By Balance c/d
Feb. 1	To Balance b/d		

Depreciation A/c

<i>Dr.</i>		<i>Cr.</i>	
2005		2005	
Jan. 31	To Machinery A/c	Jan. 31	By Balance c/d
Feb. 1	To Balance b/d		

I. Balance Method

Trial Balance
as on January 31, 2005

NOTES

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

Explanation :

- (i) The trial balance, prepared as above contains the list of all ledger accounts except Nancy's account which is closed and does not show any balance (the total of the debit and credit of Nancy's account are equal).
- (ii) Cash account, bank account, purchases account, machinery account, Rama's account, salaries account, depreciation account and interest on capital account show debit balance (excess of debit over credit) so the balance has been shown in the debit column. In the same way, capital account, discount account, sales account, rent account and Rohit's account show credit balance, so the amount has been written in the credit column.
- (iii) The total of the debit and credit side each is Rs. 27,567 and is equal.

2. Total Method

Trial Balance
as on January 31, 2005

Name of the accounts	L.F.	Amount	
		Debit Rs.	Credit Rs.
Cash A/c.....		21,300	11,600
Capital A/c.....		—	20,167
Bank A/c.....		5,000	—
Purchases A/c.....		8,000	—
Nancy's A/c.....		4,000	4,000

NOTES

Discount A/c.....	—	100
Machinery A/c.....	2,000	100
Rana's A/c.....	3,000	1,000
Salaries A/c.....	700	—
Sales A/c.....	—	3,000
Rent A/c.....	—	300
Depreciation A/c.....	100	—
Rohit's A/c.....	—	4,000
Interest on Capital A/c.....	167	—
	44,267	44,267

Explanation :

- (i) Trial balance has the list of all the ledger accounts including Nancy's account which was dropped from the balance method. Cash account, Nancy's account, machinery account and Rana's account have posting at the debit and also at credit side, so the total of their debit side is written in the debit column and the total of the credit side is written in the credit column. Bank account, purchases account, salaries account, depreciation account and interest on capital account have posting only at their debit side so their totals have been written only at the debit side. In the same way, capital account, discount account, sales account, rent account and Rohit's account have posting only at the credit side; so the amount has been written in the credit column.
- (ii) The total of debit and credit columns according to this method is also equal.
- (iii) **Total and Balance Method**

Trial Balance
as on January 31, 2005

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

Explanation. The amount column is divided between total and balance methods. Each method has got its own debit and credit column. Names of all ledger accounts are enlisted. The debit and credit total of every account is posted in the total method. The balance of accounts have been written in the balance method. The total of the total method is Rs. 44,267 as per both the debit and credit side. The total of the debit and credit columns under balance method is Rs. 27,567 and are also equal.

NOTES

Illustration 2. The following trial balance was drawn from the books of Rana Traders on 31-12-2006 :

Trial Balance			
Debit	Rs.	Credit	Rs.
Building	60,000	Capital	73,600
Machinery	17,000	Fixtures	5,600
Returns outward	2,600	Sales	1,04,000
Bad debts	2,800	Debtors	60,000
Cash	400	Interest received	2,600
Discount received	3,000		
Bank overdraft	10,000		
Creditors	50,000		
Purchases	1,00,000		
	<u>2,45,800</u>		<u>2,45,800</u>

Even though the debit and credit sides agree, the trial balance contains certain mistakes. Redraft the Trial Balance.

Solution.**Redrafted Trial Balance**

as on 31-12-2006

Name of the accounts	L.F.	Amount	
		Debit Rs.	Credit Rs.
Building A/c.....		60,000	
Machinery A/c.....		17,000	
Returns outward A/c.....			2,600
Bad debts A/c.....		2,800	
Cash A/c.....		400	
Discount received A/c.....			3,000
Bank overdraft A/c.....			10,000
Creditors A/c.....			50,000
Purchases A/c.....		1,00,000	
Capital A/c.....			73,600
Fixtures A/c.....		5,600	
Sales A/c.....			1,04,000
Debtors A/c.....		60,000	
Interest received A/c.....			2,600
		<u>2,45,800</u>	<u>2,45,800</u>

LIST OF IMPORTANT ACCOUNTS AND THEIR BALANCES

NOTES

Account Code	Name of the Account	Debit (Rs.)	Credit (Rs.)
	Capital Account	—	✓
	Fixed Assets Accounts :		
	* Land and Buildings.....	✓	—
	* Plant and Machinery.....	✓	—
	* Equipment and Tools.....	✓	—
	* Furniture, Fixtures and Fitting.....	✓	—
	* Goodwill	✓	—
	Current Assets Accounts :		
	* Cash in hand.....	✓	—
	* Cash at Bank(Generally)	✓	—
	* Sundry Debtors.....	✓	—
	* Bills Receivable.....	✓	—
	* Stock of Raw Materials.....	✓	—
	* Work-in-progress.....	✓	—
	* Stock of finished goods.....	✓	—
	Miscellaneous Accounts :		
	* Purchases	✓	—
	* Carriage inwards.....	✓	—
	* Carriage outwards.....	✓	—
	* Sales.....	—	✓
	* Sales Returns.....	✓	—
	* Purchase Returns.....	—	✓
	* Interest due/outstanding	—	✓
	* Commission/Discount paid.....	✓	—
	* Interest on drawings.....	—	✓
	* Long term Loan.....	—	✓
	* Bills Payable.....	—	✓
	* Outstanding Salaries.....	—	✓
	* Prepaid Insurance	✓	—
	* Loans advanced	—	✓
	* Advances from Customers.....	—	✓
	* Drawings.....	✓	—
	* Reserves and Surplus.....	—	✓
	* Provision for bad and doubtful debts.....	—	✓
	* Wages owing.....	—	✓

REVIEW QUESTIONS

NOTES

A. Very Short Answer Type Questions :

1. Give four functions of trial balance.
2. Is it compulsory that the debit and credit side of trial balance must tally ?
3. How is the preparation of trial balance useful ?

B. Short Answer Type Questions :

1. How will an error be located if the posting is made at the wrong side of an account ?
2. Explain compensating error with a suitable example.
3. State the meaning of trial balance.
4. What is the purpose of preparing trial balance ?
5. Write two objectives of preparing trial balance.

C. Long Answer Type Questions :

1. Bring out clearly the purpose and limitations of trial balance.
2. "Is trial balance a conclusive proof of the accuracy of the books of accounts" ? Give examples in support of the answer.
3. "Is trial balance a conclusive proof of the accuracy of the books of accounts." If not, what are the errors which remain undetected inspite of its agreement.
4. If a trial balance tallies, can it be concluded that there is no error ?
5. Explain the meaning and objective of trial balance.

(2) Revenue Income

This refers to regular business income by sale of goods and services in the market. For example, if a television manufacturing company sells T.V. sets then income realised on that sale will be known as revenue income.

Final Accounts
(Without Adjustments)

NOTES

CAPITAL AND REVENUE EXPENDITURE

Classification of Expenditure

Expenditure incurred in the business are classified as :

- (a) Capital expenditure
- (b) Revenue expenditure
- (c) Deferred revenue expenditure.

(a) **Capital expenditure.** Expenses incurred in acquiring and increasing the value of fixed assets are termed as capital expenditure. Amount spent on the purchase of land and building, plant and machinery, vehicles, furniture etc., is capital expenditure. The expenses incurred for addition and extension of fixed assets are also capital expenditure. Special features of capital expenditure is as under :

Special Features :

- (i) Capital expenditure is made for acquiring fixed assets.
- (ii) This expenditure increases the value of assets.
- (iii) These expenditures increase the profit earning capacity of business.
- (iv) These expenditures are casually incurred.
- (v) The assets acquired through these expenditures are not meant for sales.
- (vi) These expenditures are shown at the assets side of the Balance Sheet.

Certain examples of capital expenditure :

- (i) Purchasing fixed assets.
- (ii) Purchase of material for construction of building.
- (iii) Payment of wages for construction or extension of building.
- (iv) Payment of wages for addition of rooms or erection of sheds in the building.
- (v) Carriage, cartage and freight paid on acquiring assets such as plant and machinery, furniture etc.
- (vi) Installation charges of plant and machine.
- (vii) Repairs of assets, purchased second hand.
- (viii) Payment for goodwill.

Accounting Treatment of Capital Expenditure. On acquiring or increasing, the value of fixed assets through capital expenditure assets account is debited because these expenses increase the value of assets. (Assets are always debited for increase). These assets are shown at the assets side of the balance sheet. These expenses are not shown at the debit side of profit and loss account. The distinction between capital and revenue expenditure is important because revenue expenditures are debited to profit and loss account and capital expenditures are assets recorded in the Balance sheet.

(b) **Revenue expenditure.** These expenses are incurred as routine business expense. They are concerned with our day-to-day transactions. These expenses are incurred usually

NOTES

in the ordinary life of business. They maintain the assets but do not increase their value. Special features of these expenditure is as follows :

Special Features :

- (i) These are routine expenses.
- (ii) These expenses are usually incurred.
- (iii) These expenses do not add to the value of assets but maintain it, *i.e.*, white-washing and repairs.
- (iv) Revenue expenditure does not increase the profit earning capacity of the firm but simply maintains it.
- (v) Current assets acquired through these expenditures are meant for sale.
- (vi) Revenue expenses are shown at the debit side of the trading and profit and loss A/c.

Certain examples of revenue expenditure :

- (i) Purchase of goods.
- (ii) Payment of expenses in acquiring or manufacturing goods, *i.e.*, carriage and wages etc.
- (iii) Payment of selling and distribution expenses.
- (iv) Repairs and maintenance of plant, machines, furniture, equipments etc.
- (v) White-washing of building.

It must be understood that expenditure is a wider term and includes expenses as well as assets. There is a difference between expenditure and expense. Expenditure is any outlay made or incurred by the firm. The part of expenditure, which is perceived to have been used or consumed in the current year, is termed as Expense of the current year.

Accounting Treatment of revenue expenditure. Expenses accounts are debited for these expenditures. These accounts are shown at the debit side of Trading account or Profit and loss account. For example, purchases account is debited for purchasing goods and shown at the debit side of Trading account. Other accounts concerning direct expenses, *i.e.*, Carriage, cartage, freight, manufacturing expenses are recorded at the debit side of Trading account salaries, rent insurance, printing, stationery and other selling, administrative and financial expenses are shown at the debit side of profit and loss account. Revenue expenditures vitally affect our Gross Profit and Net profit, so they should be distinguished from capital expenditure.

Distinction between Capital Expenditures and Revenue Expenditures

<i>Points of Distinction</i>	<i>Capital Expenditures</i>	<i>Revenue Expenditures</i>
1. <i>Meaning</i>	Expenses incurred in acquiring and increasing the value of fixed assets are termed as capital expenditure.	Expenses incurred as routine business expenses are known as Revenue Expenditure.
2. <i>Purpose</i>	These are incurred in purchasing of fixed assets.	These are incurred for conducting of business affairs.
3. <i>Where are they shown ?</i>	These are shown at the assets side of the Balance Sheet.	These are shown at the debit side of trading profit and loss account.
4. <i>Capacity</i>	It increases the earning capacity of the business.	These are incurred for earning profit.
5. <i>Period</i>	Its benefits extend to more than one year.	Its benefits are restricted to only one year.

(c) **Deferred revenue expenditure.** *The expenditures which are incurred likely to give benefit for more than one accounting period are termed as deferred revenue expenditure.* These are revenue expenditures of capital nature. Expenses are very huge, so instead of charging the whole amount of expenditure in the year of the actual expense, the expenditure is split and written off over certain period. Preliminary expenses and advertising suspense are its examples.

Special Features :

- (i) Expenditures for developments, improvement and alterations are revenue expenditure but treated as capital expenditure.
- (ii) These expenditures are not immediately written off in the year of actual expenditure but split over a period of certain years as per the decisions and policies of the management.
- (iii) These expenditures are treated as assets and shown at the assets side of Balance sheet.

Certain examples of deferred revenue expenditures :

- (i) Advertising suspense—Huge expenditure on advertising, benefits of which will be availed of during certain following years.
- (ii) Preliminary expenses.
- (iii) Underwriting commission.
- (iv) Discount on issue of shares or debentures.
- (v) Loss on issue of shares or debentures.
- (vi) Cost of issue of shares and debentures.

Accounting treatment of Deferred revenue expenditure. These expenditures are capitalised, so they are treated as assets in the Balance sheet like other assets. As these assets are not tangible, therefore, they will have to be written off over a certain period. Whenever a part of these expenditures will be charged out of profit and loss account, we shall debit profit and loss account and credit specific assets account. The amount written off will also be deducted from the book value of assets. The treatment will be made just as we treat depreciation on assets.

Classification of Receipts

Receipts are also classified as :

- (a) Capital receipts
 - (b) Revenue receipts
- (a) **Capital receipts.** *Amount received from sale of fixed assets is capital receipts.* Amount received through capital, long-term loans or by issue of shares and debentures is capital receipts. Capital receipts are not current liabilities. These receipts show a credit balance, they are capitalised and shown at the liabilities side.
- (b) **Revenue receipts.** These are the routine receipts of the business just as receipt from sale of goods. Routine receipt of rent discount, interest, commission is also revenue receipts. **These receipts are shown either at the credit side of Trading account or profit and loss account.**

Distinction between Capital Receipts and Revenue Receipts

NOTES

Point of distinction	Capital Receipts	Revenue Receipts
1. Meaning	The amount received in form of capital introduced, loans taken and sale proceeds of the fixed assets is known as Capital Receipts.	The amount received mainly by selling of goods and services is known as Revenue Receipts.
2. Nature	These receipts are capital in nature.	These receipts are Revenue (<i>i.e.</i> , day to day activities) in nature.
3. Where are these shown?	These receipts are shown in the Liabilities side of Balance Sheet only.	These receipts are shown at the credit of either trading account or Profit and Loss account.
4. Examples	Sale of fixed assets, capital contribution and loans taken etc.	Profit on sale of assets, sale of goods, interest received on loans (advanced), royalty etc.

Illustration 1. Point out whether the following transactions are capital expenditure or revenue expenditure and also explain the treatment of these transactions in the final accounts :

- (i) Purchase of new material for the construction of factory building Rs. 2,00,000.
- (ii) Payment of wages amounting to Rs. 2,50,000 for construction of building.
- (iii) Cost of furnishing the newly constructed building Rs. 20,000.
- (iv) Cost of electrical installation in the new building Rs. 30,000.
- (v) Expenses in connection with obtaining the licence for the factory Rs. 10,000.
- (vi) Cost of acquiring machines Rs. 1,00,000.
- (vii) Payment of fire insurance premium Rs. 1,260.
- (viii) Renewal fee of licence Rs. 200.
- (ix) Distribution of free goods costing Rs. 40,000 to introduce the goods in the market.
- (x) Cost of purchasing old machinery for Rs. 12,000 and cost of its repair Rs. 10,000. The machinery was installed in the factory at a cost of Rs. 3,000.
- (xi) Cost of white-washing building and maintenance of machinery Rs. 12,000.

Solution.

- (i) **Cost of material for construction of building Rs. 2,00,000.** Cost of material will form part of the value of building, so it is a capital expenditure and will be shown at the assets side of the Balance sheet.
- (ii) **Payment of wages for construction of building.** Wages are the part of the value of building so it is a capital expenditure and thus added to the value of building and treated as an asset.
- (iii) **Cost of furnishing new building.** The value of building will increase with cost of the furniture so it will be capital expenditure and treated as an asset.
- (iv) **Cost of electrical installation in the new building.** Electrical installation will add to the value of new building, so it is a capital expenditure and will be shown at assets side.

- (v) **Expenses for obtaining licence of the factory.** It is capital expenditure, because benefits of this expenditure are not restricted to the current year only. The expense was necessary for the formation of factory. It will be treated as an asset.
- (vi) **Cost of acquiring machines.** It is capital expenditure and shown at assets side.
- (vii) **Payment of fire insurance premium** is revenue expenditure, because the expense will be paid regularly every year. It will be shown at the debit side of P/L A/c.
- (viii) **Renewal fee of the licence.** It is revenue expenditure and posted at the debit side of profit and loss account. Renewal fee is regularly paid whenever due.
- (ix) **Cost of distribution of free goods.** Cost of distribution of free goods with a view to introduce the item in the market is a type of advertising, Rs. 40,000 the cost of goods should be capitalised, treated as assets and written off within next 3 to 5 years.
- (x) **Cost of purchasing repairing and installing of old machinery.** It is capital expenditure and treated as an asset. Amount spent in the repairs and erection of old machinery will add to its value. It should be noted here that normal repairs and maintenance are revenue expenditure.
- (xi) **Cost of white-washing of Building and maintenance of machinery.** It is revenue expenditure, so it will be debited to profit and loss account. It is normal, regular and usual expenditure incurred with a view to maintain building and machinery.

Illustration 2. Identify whether following receipts are capital or revenue. How will they be treated in final accounts :

- (i) Sale proceeds of goods Rs. 20,000.
- (ii) Commencement of business with Rs. 60,000.
- (iii) Rent received from premises sublet Rs. 4,000.
- (iv) Profit on sale of land and building Rs. 5,000.
- (v) Amount received from sale of assets Rs. 80,000.
- (vi) Amount received from sale of scraps, i.e., newspapers, boxes, grass, bottles etc. Rs. 300.

Solution.

- (i) **Sale proceeds of goods.** It is revenue receipt and credited to Trading account. Sales of goods is normal and regular feature.
- (ii) **Commencement of business with Rs. 60,000.** It is capital receipt and shown at the liabilities side of the Balance sheet.
- (iii) **Rent received from premises sublet.** It is revenue receipt, because it is a regular income. It will be posted at the credit side of profit and loss account.
- (iv) **Profit on sale of land and building.** It is revenue receipts and posted at the credit side of profit and loss account. It should not be treated as operating income
- (v) **Sale proceeds of assets.** Amount received from the sale of an asset is capital receipt. Excess of amount received over the book value of asset is revenue receipt. Loss on sale of asset is treated as revenue loss.
- (vi) **Sale proceeds from scraps.** It is revenue receipts and posted at the credit side of profit and loss account because its amount, is very nominal and it is routine affair.

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Limitations of Final Accounts/Financial Statements

In spite of being very useful to the business financial statements suffer from the following limitation :

NOTES

1. **Ignores qualitative aspect.** The notable weakness of financial statements is to present quantitative facts of the business in terms of money. Qualitative aspect however important are completely ignored. Administrative efficiency of the management and harmonious relations between management and labour are very significant factors in the success of the business but do not find a place in financial statements.
2. **Based upon convention and practices.** Financial statements are prepared according to the practices adopted by individual firms. Different identical firms may adopt different methods of charging depreciation. Different methods of depreciation will depict different performance in the identical situations. Methods of valuating stock may also differ. Accounting is criticised for its convention of conservatism *i.e.*, showing expected losses but ignoring expected income. **Stock is valued at cost price or market price whichever is lower.** In the same way, we do not show appreciation in the assets generally but we do not miss to show depreciation.
3. **Ignores human resource.** Human element is essential, active and sensitive factor of production. Physical factors, *i.e.*, land, material, money, machines and equipments are meaningless without human factor. Financial statements do not accord any weightage to human resources.
4. **Ignores price level changes.** Change in the price affects cost of production, sales and value of assets. Changes in the price are quite obvious under inflation but financial statements ignore it. Changes are not incorporated in financial statements.
5. **Ignores interest of all concerned parties.** Financial statements are prepared taking into considerations proprietors interest. The Interest of other interested parties such as workers, investors, debenture holders, creditors, stock exchanges, economists and taxation authorities is ignored.

Preparation of Final Accounts (Financial Statements)

There are three following stages of preparing final accounts of a trading concern :

1. Trading account
2. Profit & Loss Account and
3. Balance Sheet.

TRADING ACCOUNT**Meaning**

An Income statement prepared with cost of raw material, purchases and direct expenses (expenses on acquiring and manufacturing goods) with a view to ascertain gross Profit or Loss is known as Trading Account.

Direct Expenses**(i) Expenses on acquiring goods**

Carriage and cartage (inward)

Freight inward

Octroi and local taxes

Excise duty

Import duty, landing and clearing charges.

(ii) Expenses on manufacturing goods

Coal, gas, water and fuel
Wages (Productive)
Fuel, power and motive power
Consumable stores
Manufacturing expenses
Factory expenses.

NOTES

Direct expenses form part of the cost of goods purchased or manufactured. It does not include selling and distribution expenses.

Need/Importance and Purpose of Trading Account

The purpose and importance of preparing trading account is summarised as under :

- 1. Ascertaining gross profit/gross loss.** The main purpose of preparing Trading account is to ascertain gross profit or gross loss. Excess of credit side over the debit side of Trading account is gross profit and the excess of debit side over the credit side is gross loss. The gross profit ratio between 20% to 30% is treated as standard. Gross profit should be sufficient to cover selling and distribution expenses. The adequacy of gross profit is measured with reference to sales.
- 2. Ascertaining ratio of direct expenses to gross profit.** Trading account shows the details of direct expenses incurred in acquiring and manufacturing goods. Cost of production increases with the increase in direct expenses. The margin and the amount of profit is vitally affected by direct expenses. The ratio of direct expenses to gross profit is calculated and compared with the desired and previous performance and efficiency is measured.
- 3. Ascertaining ratio between purchases and direct expenses.** Relationship between purchases and direct expenses is ascertained through Trading account. The amount of purchases and direct expenses are available from Trading account. Direct expenses add to the cost of purchases.

The relationship between purchases and direct expenses indicates how far direct expenses are reasonable and adequate.

- 4. Calculation of cost of goods sold.** Gross profit or loss is based upon cost of goods sold. It is based upon the information available from Trading account. Cost of goods sold is ascertained by adding opening stock, purchases and direct expenses, and deducting closing stock from it. It can also be calculated by deducting gross profit from sales. Cost of goods sold helps us in calculating profit of the firm.
- 5. Calculation of gross profit ratio.** The firm calculates gross profit ratio and measures the efficiency of its performance. Gross profit ratio is calculated by comparing gross profit to net sales. Gross profit ratio should be sufficient to cover expenses. The ratio is compared with the desired ratio or with the ratio of previous year and performance evaluated.

Trading Account

(for the period ending December 31, 2006)

Dr.

NOTES

<i>Expenses/Losses</i>	<i>Amount Rs.</i>	<i>Revenue/Gain</i>	<i>Amount Rs.</i>
To Opening Stock <i>Or</i> Stock (1-1-2003 or opening date of accounting period) <i>or</i> Stock in the beginning <i>or</i>		By Sales <i>Less</i> : Sales return <i>Or</i> Returns inward	
To Stock :		By Closing stock <i>Or</i> Stock on 31-12-2003 <i>Or</i> Stock at the end of the year <i>Or</i>	
Raw material.....		By Stock :	
Work in progress <i>or</i>		Raw material	
Semi finished goods <i>or</i>		Work in progress	
Partly manufactured goods		- Finished goods	
Finished Goods		By Gross loss—transferred to P/L A/c <i>(If debit side exceeds the credit side)</i>	
To Purchases			
<i>Less</i> : Purchases return <i>Or</i> Returns outward			
<i>Less</i> : Goods taken by proprietor <i>(if in adjustment)</i>			
<i>Less</i> : Goods given as charity <i>(if in adjustment)</i>			
<i>Less</i> : Goods given as free sample. <i>(if in adjustment)</i>			
To Carriage or cartage <i>or</i> Carriage inward <i>or</i> Carriage on purchases <i>or</i> Carriage and freight			
To Octroi or local taxes			
To Import duty, customs, Landing charges, clearing charges			
To Wages or productive Wages or manufacturing Wages or direct wages or wages and salaries			
To Coal gas and water			
To Fuel			
To Heating and Lighting			
To Power or motive power			
To Manufacturing expenses			
To Consumable stores			
To Packing charges			

NOTES

To Assembling expenses			
To Direct expenses			
To Factory Expenses			
To Productive expenses			
To Royalty			
To Gross Profit transferred to P/L A/c.			
(If credit side exceeds the debit side)			

Illustration 3. Prepare trading account only from the following Trial balance of Chinese Corner Hotel as on 31st March, 2003 :

	Dr. Rs.	Cr. Rs.
Purchases.....	15,750	
Sales.....		21,000
Returns inward.....	600	
Opening stock.....	13,000	
Freight outward.....	65	
Carriage inward.....	50	
Salaries and wages.....	572	
Rent and taxes.....	226	
Travelling expenses.....	187	
Discount.....	115	
Commission.....	108	
Bank A/c.....	6,647	
Trade Creditors.....		2,700
Sundry debtors.....	4,380	
Capital A/c.....		20,000
Drawings A/c.....	2,000	
	43,700	43,700

Closing Stock was estimated at Rs. 12,000.

Solution.

Trading Account of Chinese Corner Hotel
for the year ended 31st March, 2003

Dr.		Cr.	
Expenses/Losses	Amount Rs.	Revenue/Gain	Amount Rs.
To Opening Stock	13,000	By Sales	21,000
To Purchases	15,750	Less : Returns	600
To Carriage Inward	50		20,400
To Gross Profit transferred to P/L A/c	3,600	By Closing Stock	12,000
	32,400		32,400

NOTES

Explanation. Information contained in the Trial balance refer to assets, liabilities and indirect expenses, so these accounts have been omitted and not transferred to Trading account. Freight outward, salaries and wages, rent and taxes, travelling expenses and commission are indirect expenses. They are concerned with selling of goods. These expenses will be transferred to the debit side of profit and loss account.

Bank and debtors are assets and these accounts will be posted at the assets side of Balance sheet. Drawings will be shown as deducted from capital at the liabilities side.

Creditors and capital represent liabilities so they will also be entered at the liabilities side.

PROFIT AND LOSS ACCOUNT

Meaning

The income statement prepared with the items of expenses, losses, income and gain with a view to ascertain the amount of Net Profit or Loss in the business is known as Profit and Loss Account.

Need/Purpose and Importance of Profit and Loss Account

The purpose and the importance of preparing profit and loss account is as under:

1. **Knowledge of net profit or net loss.** The purpose of preparing profit and loss account is to ascertain the amount of net profit or loss. This is the actual profit available to the proprietor and credited to his capital account. In case of net loss proprietor's capital account will be debited. The net profit is calculated after charging all indirect expenses.
2. **Ascertaining ratio between net profit and net sales.** We get net profit from profit and loss account. This net profit is matched with the net sales to calculate net profit ratio. This ratio is compared with the desired net profit ratio and if there is any short coming, that will be removed. This ratio can also be compared with the ratio of previous years and effective future line of action can be taken.
3. **Calculation of expenses ratio to sales.** Expenses ratio to sales is calculated. We can calculate individual expenses to sales ratio and compare it with desired expenses ratio and with the ratio of previous years. It will always be in the interest of the firm that the expenses ratio should be the minimum.
4. **Comparison of actual performance with desired performance.** The actual performance of the business is available with the profit and loss account as regards net profit, individual expenses and individual income. We compare our actual performance with our planned and desired performance, identify weaknesses and try to remove them.
5. **Maintaining provision and reserves.** We have to maintain certain reserves and provision to meet our future uncertainties. The amount of provisions, reserves and funds to be maintained depends upon net profit earned by the firm. It is necessary to prepare profit and loss account to determine the net profit, so that effective provision for uncertain future could be maintained.

Proforma
Profit and Loss Account
for the year ending.....

Final Accounts
(Without Adjustments)

Dr.

Cr.

NOTES

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

NOTES

To Bad debts or Bad debts written off	A/c (If debit side exceeds credit side)
To Reserve or provision for bad and doubtful debts (New reserve—in adjustment)	—Balancing Figure
To Depreciation	
To Interest on Capital	
To Discounting charges	
To Bank charges or Collection charges	
To Export charges	
To Trade expenses	
To Administrative expenses	
To Financial expenses	
To Commission paid	
To Advertisement	
To Charity and Donation	
To Sample expenses	
To Licence fee	
To Delivery charges	
To Brokerage	
To Sales tax paid	
To Loss on sale of assets	
To Loss by fire/theft/accident	
To Upkeep or Maintenance of assets	
To Commission	
To Net Profit—Transferred to Capital A/c (If credit side exceeds debit side)	
—Balancing Figure	

Illustration 4. Prepare Profit and Loss A/c from the following information :

	Rs.		Rs.
Carriage on Purchase	2,000	Salaries-factory's manager	2200
Carriage on Sales	1,000	Office manager	1,500
Duty on Exports	2020	Gross Profit	15,200
Lighting	1050	Rent received	1500
Wafer and electricity	2120	Rent paid	500
Advertisement	100	Commission (Cr.)	1200

Solution.

Profit & Loss A/c

*Final Accounts
(Without Adjustments)*

Dr.

Cr.

<i>Expenses/Losses</i>	<i>Amount</i>	<i>Revenue/Gain</i>	<i>Amount</i>
To Carriage on sales	1,000	By Gross Profit	15,200
To Duty on Exports	2,020	By Rent received	1,500
To Lighting	1,050	By Commission	1,200
To Water and electricity	2,120		
To Advertisement	100		
To Salaries—Office	1,500		
To Rent paid	500		
To Net profit transferred to capital A/c	9,610		
	17,900		17,900

NOTES

Illustration 5. From the following Trial balance of Sri Ram & Sons, prepare the Trading and profit and loss account for the year ended 31st March, 2002.

Trial Balance

as on 31st March, 2002

<i>Name of Account</i>	<i>Debit Rs.</i>	<i>Credit Rs.</i>
Ram's Capital		29,000
Ram's Drawings	760	
Purchases and Sales	8,900	15,000
Sales and Purchases Return	280	450
Stock (1-4-2001)	1,200	
Wages	800	
Building	22,000	
Freight and Carriage	2,000	
Trade Expenses	200	
Advertisement	240	
Interest		350
Taxes and Insurance	130	
Debtors and Creditors	6,500	1,200
Bills Receivable and Bills Payable	1,500	700
Cash at bank	1,200	
Cash in hand	190	
Salaries	800	
	46,700	46,700

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

Solution.

Trading and Profit and Loss Account of Sri Ram & Sons

Dr.

for the year ended 31st March, 2002

Cr.

NOTES

Expenses/Losses		Amount Rs.	Revenue/Gain		Amount Rs.
To Stock (1-4-2001)		1,200	By Sales	15,000	
To Purchases	8,900		Less : Returns	280	14,720
Less : Returns	450	8,450	By Closing Stock		1,500
To Wages		800			
To Freight & Carriage		2,000			
To Gross Profit c/d		3,770			
		16,220			16,220
To Trade Expenses		200	By Gross Profit b/d		3,770
To Advertisement		240	By Interest		350
To Taxes and Insurance		130			
To Salaries		800			
To Net Profit transferred to Capital A/c		2,750			
		4,120			4,120

Explanation. Purchases and sales have been given under one head purchases have debit balance, so Rs. 8,900 placed at the debit side of Trial balance is purchases and Rs. 15,000 will be the amount of sales, because it is given at the credit side of Trial balance (sales have credit balance) sales and purchases return have also been given under one head. Purchases return shows credit balance and sales return shows debit balance. This is why, Rs. 280 represents sales return and Rs. 450 is purchases return.

BALANCE SHEET

Meaning

Balance sheet is a mirror which reflects the true position of assets and liabilities on a particular date. Trading and profit and loss account shows gross profit or gross loss and net profit or net loss respectively. These accounts deal with expenses, income and receipts, i.e., revenue receipts and payment. The firm also makes certain capital expenditure and gets capital receipts. It owns certain assets and also certain liabilities. These assets and liabilities show that the financial position of the firm. This is why, Balance sheet is also known as position statement. We adopt double entry system of accounting, where every debit has got its corresponding credit. According to our accounting equation also :

$$\text{Assets} = \text{Liabilities} + \text{Capital.}$$

It means that the total of the assets side of Balance sheet must be equal to the total of liabilities. Liabilities consists of creditors equity (liability) and proprietor's equity. In other words, creditors and proprietor's claim againsts the firm must be equal to its assets. If assets and liabilities of Balance sheet do not tally, there is definitely certain mistake. According to Freeman "A Balance sheet is an itemwise list of assets, liabilities and proprietorship of a business at a certain date".

Features/Characteristics of Balance Sheet

Balance sheet is the position statement which shows the position of assets and liabilities. It has got the following special features :

- 1. Balance sheet is a statement.** Though Balance sheet is an integral part of double entry system, but it is not an account. It has got the balance of certain ledger accounts. The balance of all ledger accounts are not shown in it.
- 2. Prepared on a specified date.** Balance Sheet is prepared on a specific date, *i.e.*, at the end of accounting period. It is common practice and also legal requirement to prepare Balance sheet together with Trading and profit and loss account at the end of the accounting year. It may be prepared after every six months if the proprietors so desire. Accounting year may consist of calender year or assessment year or its own accounting year. Companies are required to adopt assessment year (April 1 to 31st March) as per legal requirement. Sole proprietorship and partnership can adopt accounting year which suits them, *i.e.*, Diwali to Diwali or Dussehra to Dussehra or assessment or calender year.
- 3. It is a statement of assets and liabilities.** Though the Balance sheet has debit and credit balance but its sides are named as assets and liabilities. The left hand side is a liability representing credit balance. Right hand side is assets representing debit balances.
- 4. Knowledge about the nature of assets and liabilities.** Balance sheet categorise assets as liquid assets, current assets, fixed assets and fictitious assets. Knowledge of liabilities as current liabilities, fixed liabilities and reserve and funds can be gained from Balance sheet.
- 5. Knowledge of financial position.** Balance sheet depicts true financial position of the business. The position can be ascertained by study of the Balance sheet. We can calculate short-term and long-term financial ratios, proprietary and other ratios to have the knowledge of the financial soundness of the business.
- 6. Assets and liabilities tally each other.** The total of assets must be equal to liabilities. According to accounting equation, assets are always equal to creditors, and proprietor's equity. If the total of assets and liabilities are not equal, there is likely to be certain mistake.

Need and Purpose of Balance Sheet

Balance sheet is a vital part of final account. It has to be compulsorily prepared as per legal provisions. Objects of the Balance sheet have been summarised as under :

Main objectives of Balance Sheet

The main object of Balance sheet is to assess the financial position of the firm. It is the list of assets and liabilities of the firm on a specific date. The short-term and long-term financial position of the firm can be obtained from the analysis of the Balance sheet.

Balance sheet is rightly said to be a mirror reflecting the true value of assets and liabilities on a particular date.

Difference between Profit and loss accounts (Income Statement) and Balance sheet (Position Statement)

Income statement (Trading and profit and loss account) and position statements (Balance sheet) can be differentiated as under :

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NOTES

<i>Points of Difference</i>	<i>Profit and Loss Account</i>	<i>Balance Sheet</i>
1. <i>Types of account</i>	Only nominal accounts are entered in profit and loss account.	It records personal and real accounts.
2. <i>Objective</i>	The objective of preparing profit and loss account is to ascertain the net profit or loss of the business.	The purpose of preparing balance sheet is to understand the financial position of the firm.
3. <i>Sides</i>	The left hand side of the profit and loss account is the debit and the right hand side is credit.	It has liabilities at its left hand side and assets at right hand side.
4. <i>Nature</i>	Profit and loss account is an account. We use the word 'To' before accounts at the debit side and 'By' at the credit side.	Balance sheet is not an account, it is a statement. We do not use 'To' or 'By' in it.
5. <i>Balancing figure</i>	The balancing figure of the profit and loss account is either net profit or net loss. Excess of credit side is net profit and the excess of debit side is net loss.	It does not show any balancing figure. The total of assets and liabilities are always equal.
6. <i>Specific date/ period</i>	Profit and loss account shows the position of the accounting period, generally a year.	Balance sheet shows the position of assets and liabilities on a particular date.
7. <i>Types of expenditure</i>	Revenue expenditures are recorded in the profit and loss account.	Capital expenditures are entered at the assets side of the Balance Sheet.

**Proforma
Balance Sheet**
as on

<i>Liabilities</i>	<i>Amount Rs.</i>	<i>Assets</i>	<i>Amount Rs.</i>
Current Liabilities Creditors Bills payable Bank overdraft Outstanding expenses Income received in advance Short-term loans Fixed Liabilities Loan Mortgage Loan from financial institutions Debentures		Current Assets Cash in hand Cash at bank Debtors or sundry Debtors or book debts Stock or inventory Goods sent on consignment Bills or Notes Receivable Short-term or Trade investment Prepaid expenses Accrued income Sales Tax Collected	

Capital

Add : Net Profit
 Add : Interest on capital
 (if in adjustment)
 Add : Remuneration, i.e., salaries,
 commission, fee payable to
 proprietors
 (if in adjustment)
 Less : Drawings
 Less : Interest on drawings
 Less : Net loss
 Less : Income tax

Reserves and Funds

General reserve
 Reserve funds
 Contingency reserve
 Provident fund
 Employees compensation fund
 Provision for taxation

Investments

Details of investment :
 Long-term investment
 Loans granted

Fixed Assets

Land and building
Or
 Freehold premises
 Machinery
Or
 Plant and Machinery
 Equipments
Or
 Tools and Equipments or
 loose tools
 Furniture or Fixtures
Or
 Furniture and fittings
Or
 Fixtures and fittings
 Vehicles—truck, car, vans,
 tempo, scooter, cycle etc.
 Horses and carts
 Live-stock (animals)
 Goodwill
 Patents and Trade Mark

Miscellaneous Expenses
 Advertising suspense
 Discount on issue of shares
 Discount on issue of
 debentures

NOTES

POINTS TO BE CONSIDERED WHILE PREPARING FINAL ACCOUNTS

- 1. Preparation of Trial balance.** Trial balance should be prepared before preparing Balance sheet. If the debit and credit sides of trial balance do not tally the difference should be provisionally transferred to suspense account and the suspense account should be shown in the Balance sheet.
- 2. Showing items from Trial balance at one place.** All the items appearing in the trial balance are shown at one place only whether at the debit side of trading account or profit and loss account or assets or at the credit side of trading account or profit and loss account or liabilities.
- 3. Posting from Trial balance.** Accounts appearing at the debit side of Trial balance are shown: at the debit side of Trading account or profit and loss or at the assets side of

NOTES

the Balance sheet. In the same way, accounts appearing at the credit side of trial balance are shown at the credit side of Trading or profit and loss account or at the liabilities side.

4. **Posting of expenses.** All direct expenses, *i.e.*, expenses for manufacturing and acquiring goods are written in Trading account. Indirect expenses and losses regarding selling and distribution of goods are written in profit and loss account.
5. **Personal and Real accounts.** All the personal and real accounts are recorded in the Balance sheet.
6. **Factory and office expenses.** All factory expenses are direct expenses. They are written at the debit side of Trading account. Office expenses are indirect expenses and they are written at the debit side of Profit and loss account.
7. **Treatment of rent, discount, interest and commission.** Rent, discount, interest and commission may be an income or an expense. If these expenses are paid they are our expenses. If they are received it will be an income and posted at the credit side of Profit and loss account. If there is no Trial balance or no specific word as allowed or received these items should be treated as expense and posted to be debit of profit and loss account.

Illustration 6. From the following Trial Balance extracted from the books of Mahinder Singh, prepare Trading and Profit & Loss A/c for the year ending March 31st, 2004 and the Balance sheet as on that date.

Name of Account	Debit Balances	Credit Balances
Drawing and Capital	20,000	1,99,000
Plant & Machinery	80,000	
Debtors & creditors	70,000	50,000
Purchases and sales	1,10,000	2,20,000
Returns	10,000	7,000
Wages	40,000	
Cash in hand	5,000	
Cash at Bank	10,000	
Salaries	30,000	
Repairs	8,000	
Stock	45,000	
Rent	10,000	
Manufacturing Expenses	7,000	
Bill receivable	12,000	
Bill Payable		20,000
Bad debts	5,000	
Carriage	9,000	
Furniture	15,000	
Income tax	10,000	
	4,96,000	4,96,000

Closing stock was valued at Rs. 50,000.

Solution.

*Final Accounts
(Without Adjustments)*

Dr. Trading and Profit and Loss Account Cr.

<i>Expenses/Losses</i>	<i>Amount Rs.</i>	<i>Revenue/Gain</i>	<i>Amount Rs.</i>
To Opening Stock	45,000	By Sales	2,20,000
To Purchases	1,10,000	Less : Returns	10,000
Less : Returns	7,000	By Closing stock	50,000
To Manufacturing Expenses	7,000		
To Carriage	9,000		
To Wages	40,000		
To Gross Profit c/d	56,000		
	<u>2,60,000</u>		<u>2,60,000</u>
To Salaries	30,000	By Gross Profit b/d	56,000
To Repairs	8,000		
To Rent	10,000		
To Bad debts	5,000		
To Net Profit transferred to Capital A/c	3,000		
	<u>56,000</u>		<u>56,000</u>

NOTES

Balance Sheet

<i>Liabilities</i>	<i>Amount Rs.</i>	<i>Assets</i>	<i>Amount Rs.</i>
Capital	1,99,000	Plant & Machinery	80,000
Add : Net Profit	3,000	Furniture	15,000
	<u>2,02,000</u>	Bills receivable	12,000
Less : Drawings	20,000	Sundry Debtors	70,000
	<u>1,82,000</u>	Closing stock	50,000
Less : Income tax	10,000	Cash at bank	10,000
Sundry creditors	50,000	Cash in hand	5,000
Bills payable	20,000		
	<u>2,42,000</u>		<u>2,42,000</u>

Notes. It should be noted that Drawings, debtors and returns inward have debit balance, so the amount of these items should be picked from the debit side of Trial balance. In the same way Capital, creditors and returns outward have credit balance, so picked up from the credit side of Trial balance.

REVIEW QUESTIONS

NOTES

A. Very Short Answer Type Questions :

1. How will you show the following items :
(i) Drawing ; (ii) Returns Inward (Bills returned) ; (iii) Returns outward.
2. Mention the stages of Final Accounts.
3. How will you treat expenses on acquiring goods ?
4. Where will you show goods in transit A/c ?
5. Give any two difference between Profit & Loss A/c and a Balance Sheet.

B. Short Answer Type Questions :

1. Point out any three points of difference between Profit and Loss Account and Balance Sheet.
2. Mention the two formulae (except the preparation of trading Account) for the calculation of Gross Profit.
3. Explain briefly the object of Trading Account.
4. Describe briefly three objectives of preparing Profit and Loss A/c.
5. Explain briefly the two characteristics of position statement.

C. Long Answer Type Questions :

1. What do you mean by Final accounts ? What are its constituents ? Name them and briefly explain the purpose of each of them.
2. Explain the importance and purpose of final accounts.
3. Explain : (a) Current assets ; (b) Current liabilities ; and (c) Working capital.
4. Explain the following statements :
(a) Balance sheet is not an account but it is the list of assets and liabilities.
(b) Balance sheet and profit and loss account are inter-dependent.

CHAPTER 9 FINAL ACCOUNTS (WITH SIMPLE ADJUSTMENTS)

NOTES

★ STRUCTURE ★

- ☆ Adjustments/Additional Information in preparation of Final Accounts
- ☆ Depreciation in the Value of Assets
- ☆ Appreciation in the Value of Assets
- ☆ Outstanding Expenses
- ☆ Prepaid Expenses
- ☆ Accrued or Outstanding Income
- ☆ Unearned Income
- ☆ Interest on Capital
- ☆ Interest on Drawings
- ☆ Interest and Dividend on Investment
- ☆ Interest on Loan
- ☆ Bad Debts (Not in Adjustment)
- ☆ Provision for Bad and Doubtful Debts (Adjustment)
- ☆ Further Bad Debts (Adjustment)
- ☆ Provision for Bad and Doubtful Debts (Given in the Trial Balance)
- ☆ Provision for Discount on Debtors
- ☆ Closing Stock
- ☆ Summarised Presentation of Adjustments

ADJUSTMENTS/ADDITIONAL INFORMATION IN PREPARATION ON FINAL ACCOUNTS

Business is going concern. It has to be carried on indefinitely. We cannot wait indefinitely for the assessment of the performance of the business, so we distribute the life of the business in equal and uniform periods, generally a year. At the end of every accounting year, we prepare Trading and profit and loss account and measure the performance of business in terms of Gross profit and Net profit. We also prepare a Balance sheet at the end of the year to assess the value of assets and liabilities.

While preparing Final accounts at the end of every accounting period, we come across certain problems. The expenses of the current year are still payable or the expenses of the next year have been paid during the current year. Sometimes, income of the current year remains still receivable and the income of the next year has been received during the current year. Depreciation on assets, interest on capital and provision for bad and doubtful debts of the current year has not been recorded in the books as yet. We are required to adjust these amounts in the final accounts of the current year so that the correct profit or loss of the business may be ascertained. We will have to pass adjusting journal entries for all these items, errors and omissions, not yet recorded in the books. These items do not appear in the Trial balance. They are adjusted at two places in the final accounts.

NOTES

DEPRECIATION IN THE VALUE OF ASSETS

The assets acquired in the business are continuously used. They will naturally be losing their utility, value and usefulness. In other words, there will be wear and tear. *Loss in the value of assets due to its constant use is termed as depreciation.* It is necessary that loss due to depreciation must be accounted for. Certain provisions should be made, so that the assets may be replaced without much financial problems.

Treatment in Final Accounts

- (i) **If depreciation account appears in Trial balance.** It will be posted to the debit side of profit and loss account only, as it is an item from Trial balance. (Items from Trial balance are posted only at one place).
- (ii) **If depreciation is an item of adjustments.** We shall first of all calculate the amount of depreciation on the specific assets at the given rate. An adjusting entry (mentioned as above) will be passed. Depreciation account will be transferred to the debit side of Profit and Loss account. It will also reduce the value of the concerned asset, so the value of asset will be shown at reduced price in the Balance sheet. Depreciation on furniture (mentioned in the above example) will be shown as under in the profit and loss account and Balance sheet.

Profit and Loss Account

Balance Sheet

Dr.	Cr.	Liabilities	Assets
To Depreciation on Furniture	1,000		Furniture 10,000 Less : Depreciation <u>1,000</u> 9,000

APPRECIATION IN THE VALUE OF ASSETS

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

Treatment in Final Accounts

- (i) **If appreciation appears in Trial balance.** It will be shown at the credit side of profit and loss account only, because it is gain.
- (ii) **If appreciation appears in adjustment.** All the items appearing in adjustments are shown at two places in the final accounts. Appreciation is a gain so it will be shown at the credit side of profit and loss account on the one hand, and on the other hand, it will be added to the value of concerned assets in the Balance sheet. If land and building worth Rs. 1,00,000 appreciated @ 15% the following entry will be passed.

It will be shown in the Profit and loss account and Balance sheet as under :

Profit and Loss Account

Balance Sheet

Dr.	Cr.	Liabilities	Assets
	By Increase in the value of land and building	15,000	Land and building 1,00,000 Add : Appreciation <u>15,000</u> 1,15,000

Note. As a convention of conservatism firms generally do not show the increase in the value of their assets, as such appreciation is casual item, whereas depreciation is an usual item.

NOTES

OUTSTANDING EXPENSES OR ACCRUED EXPENSES OR EXPENSES OWING OR UNPAID OR DUE

These expenses are related to the current year but remain unpaid. As they are the expenses of the current year, so they must be debited and charged from the profit and loss account of the current year. The expenses remained unpaid so far during the current year, so they are the liability of the firm. For example, the firm pays Rs. 5,000 wages per month to its workers. Wages are paid on the 1st day of every month, *i.e.*, wages for the month of March, 2003 will be paid on April 1, 2003, the wages for October, 2003 will be paid on November 1, 2003 so the wages of December, 2003 will be paid on January 1, 2004. The accounting period ends on 31st December, 2003 but only Rs. 55,000 have been actually paid on account of wages. Wages for the month of December, 2003 is still to be paid. It is outstanding. It is a liability. It has to be paid.

Treatment in final accounts. Outstanding expenses account may be available at two places. It may be given in the Trial balance or it may be mentioned outside the Trial balance, *i.e.*, adjustments. If outstanding salaries or wages owing account have been mentioned in the trial balance, they will be shown at the liabilities side only (accounts appearing in the trial balance are shown only at one place in the final accounts).

In case, outstanding expenses are in the adjustment, they will be shown at two places (all items appearing in the adjustments are shown at two places). Outstanding expenses will be added to the concerned expense at the debit side of trading or profit and loss account such as outstanding wages will be added to wages account at the debit side of trading account and outstanding salaries will be added to salaries account at the debit side of profit and loss account. Outstanding expenses will also be shown at the liabilities side of the balance sheet.

PREPAID EXPENSES OR EXPENSES PAID IN ADVANCE OR EXPENSES RELATING TO THE NEXT OR FOLLOWING YEAR OR UNEXPIRED EXPENSES

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

Treatment in the Final Accounts

- (i) **If prepaid expenses appear in adjustments.** Prepaid insurance show a debit balance, so it will be shown at the assets side of Balance sheet. The amount of prepaid insurance will be deducted from insurance at the debit side of profit and loss account.

NOTES

Prepaid expenses are also known as unexpired expenses, because the part of expenses relating to the current year have expired (benefit from the expenditure has been availed of). The part of expenditure relating to next year is still unexpired, i.e., the benefit of the expenditure is to be availed of. Let us take an example. Rent for the whole year amounting to Rs. 12,000 has been paid on 1st May, 2004. The rent for the first eight months (May 1—Dec. 31) relates to the current year 2004, and the rest rent for the next four months, i.e., (from Jan. 1 to April 30, 2005) are concerned with the next year. Rs. 4,000, the rent for four months is unexpired or the benefits of this rent are to be availed of, so it is an asset. The current year should bear only Rs. 8,000 for rent, i.e., Rs. 4,000 will be deducted from the rent, i.e., Rs. 12,000 at the debit side of profit and loss account. It will be shown in the profit and loss account and Balance sheet as under :

Profit and Loss Account		Balance Sheet		
Dr.	Cr.	Liabilities	Assets	
To Rent A/c	12,000		Prepaid Rent A/c	4,000
Less : Prepaid Rent	4,000		Prepaid Insurance	600
	8,000			
To Insurance	2,400			
Less : Prepaid Insurance	600			
	1,800			

- (ii) **If prepaid expenses appear in Trial balance.** Sometimes items like unexpired rent or prepaid insurance may be given in the Trial balance. In such case, unexpired rent and prepaid expenses will be shown at the assets side only.

ACCRUED OR OUTSTANDING INCOME OR INCOME DUE BUT NOT RECEIVED

Sometimes income of the current year may be due but not received just as expenses due but not paid. For example, the firm advanced a loan of Rs. 20,000 at 12% interest on January 1, 2004. Interest on this loan for the month of November and December are accrued

i.e., still to be received. In this case Rs. 400, i.e., $20,000 \times \frac{12}{100} \times \frac{2}{12}$ will be accrued

interest. In the same way, if a portion of the building has been sublet on a monthly rent of Rs. 700. One quarter's rent (three months', rent) has not been received so far. $Rs. 700 \times 3 = Rs. 2,100$ will be accrued income as rent.

Treatment in the Final Accounts

- (i) **If accrued income is in adjustment.** Accrued income is the income of the current year. The income has not been received so far, but it will be treated as income according to our accrual concept. It will be added to the concerned income at the credit side of profit and loss account and also shown at the assets side, because the amount is to be received by the current year. Journal entry for accrued interest and rent as mentioned in the example will be passed as under :

The treatment of accrued income will be made in the profit and loss account and balance sheet as under :

Profit and Loss Account		Balance Sheet		
Dr.	Cr.	Liabilities	Assets	
By Interest	2,000		Accrued Interest	400
Add : Accrued Interest	400		Accrued Rent	2,100
		2,400		
By Rent	6,300			
Add : Accrued Rent	2,100			
		8,400		

NOTES

(ii) **If accrued income appears in Trial Balance.** Accrued income will be shown at the assets side only because current year's income is still receivable (whatever is receivable is an asset). As items from Trial balance are shown at one place only, so it is enough to show it at the assets side.

UNEARNED INCOME OR INCOME RECEIVED IN ADVANCE

It is just possible that we may receive the income of the next year during the current year. Such income is also known as unearned, because the income has not been earned by the current year. It relates to the next year, though received during the current year. It will be deducted from concerned income at the credit side of profit and loss account and also shown as a liability.

Treatment in Final Accounts

(i) **If unearned income appears in the adjustment.** All the items appearing in the adjustments are shown at two places, so unearned income will also be shown at two places. Unearned rent amounting to Rs. 15,000 referred to in the above example will be deducted from the rent at the credit side of profit and loss account and also shown at the liabilities side. The treatment of this rent received in advance will be made in the profit and loss account and the Balance sheet as under :

Profit and Loss Account		Balance Sheet		
Dr.	Cr.	Liabilities	Amount Rs.	Assets
By Rent	36,000	Rent received in advance	15,000	
Less : Rent received in advance	15,000	(Unearned Rent)		
		21,000		
		21,000		

Rent received account is debited, so it will reduce the amount of rent received at the credit side of profit and loss account. Unearned rent account shows a credit balance so it will be shown at the liabilities side (liabilities have credit balance).

NOTES

- (ii) **If unearned income appears in Trial balance.** Appearing in the Trial balance means that it has been routed through double entry record (journal entries have already been passed for it) so it will be shown only at one place. That only place for it will be the liabilities side, simply because it shows a credit balance and the amount received in advance has to be paid by the current year to the next year.

INTEREST ON CAPITAL

Capital is the liability of the business. It is proprietor's claim against the firm. The business assumes capital as amount borrowed from the proprietors of the firm. Interest payable on this liability will be an expense of the business. It will, therefore, be debited to profit and loss account. Interest on capital at the same time will increase the balance of proprietor's capital, so it should also be added to capital account at the liabilities side. For example, the firm started its business on January 1, 2004 with Rs. 2,00,000. It was decided to charge interest on capital at the rate of 12%. The total interest on capital due to proprietors

will be Rs. 24,000, i.e., $2,00,000 \times \frac{12}{100}$.

Interest on capital has been debited as an expense, so it will be posted at the debit side of profit and loss account. Capital account has been credited in the journal entry, so capital will also increase with the amount of interest on capital at the liabilities side of the Balance Sheet.

If interest on capital account appears in the Trial balance, it will be posted to the debit side of profit and loss account only.

INTEREST ON DRAWINGS

The owners of business may sometimes draw cash or goods for their private or personal or domestic use. Drawings, in this way, is the amount advanced by the firm to its proprietors. If the firm pays interest on capital, the funds invested by the proprietor, it is fully justified that it should also charge interest on the amount withdrawn by the proprietors from business. Interest on drawing will be received by the business, so it is an income. It should, therefore, be credited. The capital will reduce with the interest on drawing, so capital account should be debited. In case of drawing and interest on drawing it will be preferable to debit. Drawings account instead of capital account.

Interest on drawings will be posted at the credit side of profit and loss account, because it is an income of the business. It will also be deducted from the capital at the liabilities side of the Balance sheet. This treatment will be made if it is an item in the adjustment.

If the item of interest on drawings is given in the Trial balance, it will mean that the balance of capital account has already been adjusted. Now, interest on drawings account will be shown as income at the credit side of profit and loss account only.

INTEREST AND DIVIDEND ON INVESTMENT

Investment is an asset of the firm. Funds of the firm may be invested outside in shares, debentures and securities of other companies. The firm will receive dividends on shares

and interest on debentures, loan and other securities. Interest/Dividend received is undoubtedly an income, so it will be posted at the credit side of profit and loss account. If the interest/dividend has been received during the year in cash, the item will appear at the credit of Trial balance and will be posted at the credit side of profit and loss account only.

If interest on investment is due for certain months, it will be treated as accrued income. The item will appear in the adjustment and will be shown at two places in the final accounts. Outstanding interest on investment is the revenue of the current year so it will be credited. The value of investment will also increase with the amount of accrued interest, so investment account will be debited.

Interest on investment, if it is an item of adjustment will be shown at two places. These places will be credit side of profit and loss account and the assets side of the Balance sheet, where it will be added to the value of investment, appearing in the Trial balance.

Interest on investment will be shown at the credit side of profit and loss account only, if it is an item from Trial balance.

NOTES

INTEREST ON LOAN

Loan is an ambiguous item. It may be borrowed or it may also be lent. **If loan appears at the debit side of Trial balance, it will mean that the funds have been advanced to outsiders. It is an asset.** The interest received on it will be gain and thus credited to profit and loss account. If this item appears in the trial balance, it will be shown at the credit side of profit and loss account only. In case the item belongs to adjustment it will be shown at two places. It will be shown at the credit side of profit and loss account and also added to loan at the assets side of the Balance sheet.

Interest on loan borrowed, will be shown at the debit side of the profit and loss account only, if it is an item from Trial balance.

Interest on loan account will be shown at the credit side of profit and loss account and will also be added to loan account at the assets side of Balance sheet.

BAD DEBTS (NOT IN ADJUSTMENT)

It is just possible that debts may not be fully recovered from debtors. Certain amounts may prove to be bad. The irrecoverable amount is termed as bad debts. It is undoubtedly a loss, so posted at the debit side of profit and loss account. *If bad debts is declared during the year* the following journal entry will be passed :

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

The above journal entry reveals that the amount of sundry debtors has been reduced by amount of bad debts, so debtors in the balance sheet will be shown at their value mentioned in the Trial balance. Bad debts account will appear in the trial balance. It will show debit balance and be posted at the debit side of profit and loss account only.

PROVISION FOR BAD AND DOUBTFUL DEBTS (ADJUSTMENT)

It has been the experience of businessmen that certain amount out of the entire amount of debtors will definitely prove to be bad. Amount may remain irrecoverable due to the dishonesty

NOTES

or unsound financial position of the debtors. In such circumstance, it is advisable to firms that they should make certain provisions out of the profit and loss account of the current year, so that the next year may not suffer the loss of bad debts relating to the current year. It is possible that current year's debtors may prove to be bad in the next year. Decision regarding maintenance for provisions of bad and doubtful debts is taken at the end of year, so it is an item from adjustment. For making provision for probable bad and doubtful debts and following journal entry will be passed :

Profit and Loss A/c	Dr.
To Provision for bad and doubtful debts	
(Being maintenance of provision for bad and doubtful debts)	

Provision for bad and doubtful debts account will be shown at the liabilities side, as it shows a credit balance. It may also be deducted from sundry debtors at the assets side of Balance sheet. It will also be shown at the debit side of profit and loss account.

FURTHER BAD DEBTS (ADJUSTMENT)

It may be ascertained at the end of accounting period that certain amount have been declared as bad. The following adjusting entry will be passed :

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

The above journal entry reveals that bad debts account has been debited and it will be closed by transferring to profit and loss account. In other words, it will be posted at the debit side of profit and loss account. The item belongs to adjustment, so it will also be shown at one more place, i.e., deducted from debtors at the assets side of the Balance sheet. If there is already an item of bad debts in the trial balance, further bad debts will be added to it at the debit side of profit and loss account.

PROVISION FOR BAD AND DOUBTFUL DEBTS (GIVEN IN THE TRIAL BALANCE)

We maintain provision for bad and doubtful debts every year. Provision maintained is the amount likely to prove bad. It is not the actual bad debts. If bad debts is lesser than the amount of provision for bad and doubtful debts, there will remain a credit balance in the provision for bad and doubtful debts account. The amount will appear in the trial balance, so it will be shown at one place only. It will be either shown at the credit side of profit and loss account or it will be deducted from the total of bad debts, further bad debts and new provision at the debit side of profit and loss account. It may also be shown at the liability side. Only one of the three treatments will be made.

Calculation of Provision for Bad and Doubtful Debts

Provision for bad and doubtful debts is calculated on sundry debtors at given rate. In certain cases, there are further bad debts in the adjustments and the provision is also to be calculated at certain rate. In these cases, provision for bad and doubtful debts will be calculated on debtors after deducting the amount of bad debts or further bad debts (given in the adjustment). Calculation is explained as under.

Illustration 1. Calculate provision for bad debts in the following cases :

(a) Create or maintain or make provision for bad and doubtful debts @ 7%.

(b) (i) There was a further bad debts of Rs. 350.

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

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

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

(b) Rs. 350 have proved to be bad debts, so the amount due from debtors will reduce by Rs. 350 and it is actually $50,000 - 350 = \text{Rs. } 49,650.$ Now, the provision will be made on Rs. 49,650 not on Rs. 50,000.

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

NOTES

PROVISION FOR DISCOUNT ON DEBTORS

It is common practice of the business to allow its debtors, cash discount, so that they may be encouraged to make early and immediate payment. Discount is allowed to debtors. We shall be receiving lesser amount from debtors after allowing them discount. It is, therefore, a loss and debited to profit and loss account. If discount allowed appears in the Trial balance, it will be shown at debit side of Profit and loss account only. *It may be noted that provision for discount on debtors is made only on good debtors.*

We may be asked to make a provision for discount on debtors in the adjustment. In this case, discount on debtors will be calculated at the given rate on debtors. It will be shown at the debit side of profit and loss account and also deducted from debtors at the assets side of Balance sheet.

Calculation of discount on debtors. Discount on debtors is allowed to only those debtors, who are going to make us payment. It means that it will exclude those debtors, who have become bad and also those who are doubtful. Suppose we have been given further bad debts, and asked to create a provision for bad and doubtful debts in addition to discount on debtors. We shall deduct the amount of further bad debts from debtors to calculate provision for bad and doubtful debts. Discount on debtors will be calculated after deducting further bad debts and provision for doubtful debts both from debtors.

If we are asked to create a provision for bad and doubtful debts and also discount on debtors, we shall calculate provision for doubtful debts first, deduct its amount from debtors and calculate discount on debtors on deducted amount of debtors. Calculation and treatment of discount on debtors is illustrated herewith.

Relationship between Bad Debts and Provision for Bad Debts

Bad debts and bad debts provision are inter-related and interdependent. Bad debts provision is maintained to meet the loss due to bad debts. This is why, bad debts account is closed by transfer to profit and loss account. Provision for bad debts account shows the amount to be charged out of profit and loss account. The balancing figure of this account is transferred to profit and loss account. Maintenance of these accounts has been illustrated as under :

CLOSING STOCK

It is also an item of adjustment. Closing stock does not appear in the Trial balance. Following adjusting entry is passed for closing stock.

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Closing Stock A/c To Trading A/c	Dr.
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It will be clear from the above journal entry that closing stock will be posted at the credit side of Trading account. Closing stock account, if prepared will show debit balance (every asset has a debit balance) and as such it will also be written at the assets side of the balance sheet.

Closing stock may be in Trial balance, if it so, the closing stock will be written only at one place i.e., Assets side of the Balance sheet.

Illustration 2. The following balances were extracted from the books of Shri Brijesh Chandra on 30th June, 2003

	Rs.		Rs.
Capital	24,500	Bad debts	550
Drawings	2,000	Loan	7,880
General expenses	2,500	Sales	65,360
Buildings	11,000	Purchases	47,000
Machinery	9,340	Scooter	2,000
Stock	16,200	Bad debts, provision	900
Power	2,240	Commission (Cr.)	1,320
Taxes and Insurance	1,315	Scooter Expenses	1,800
Wages	7,200	Bills payable	3,850
Debtors	6,280	Cash	80
Creditors	2,500	Bank Overdraft	3,300
Charity	105		

Prepare final accounts for the year ended 30th June, 2003 after giving effect to the following adjustments :

- (a) Stock on 30th June, 2003 was valued at Rs. 23,500.
- (b) Write off a further of Rs. 160 as bad debts and maintain the provision for bad debts at 5% on debtors.
- (c) Depreciate machinery at 10% and scooter 12%.
- (d) Provide Rs. 750 for outstanding interest on overdraft.

Solution.

**Trading and Profit and Loss Account of Sh. Brijesh Chandra
for the year ended 30th June, 2003**

Dr.			Cr.
Expenses/Losses	Amount Rs.	Revenue/Gain	Amount Rs.
To Opening Stock	16,200	By Sales	65,360
To Purchases	47,000	By Closing Stock	23,500
To Power	2,240		
To Wages	7,200		

To Gross Profit transferred to Profit and Loss A/c	16,220		
	88,860		88,860
To General expenses	2,500	By Gross Profit transferred from Trading A/c	16,220
To Taxes and Insurance	1,315	By Commission A/c	1,320
To Charity	105		
To Scooter expenses	1,800		
To Bad debts	500		
Add : Further Bad Debts	160		
Add : Provision for bad debts	306		
	<u>1,016</u>		
Less : Old reserve	900	116	
To Depreciation on :			
Machinery	934		
Scooter	240	1,174	
To Interest Outstanding		750	
To Net Profit transferred to Capital account		9,780	
	17,540		17,540

Final Accounts (With Simple Adjustments)

NOTES

Balance Sheet of Sh. Brijesh Chandra
as on 30th June, 2003

Liabilities		Amount	Assets		Amount
		Rs.			Rs.
Creditors		2,500	Cash		80
Bills Payable		3,850	Debtors	6,280	
Loan		7,880	Less : Written off	160	
Bank overdraft	3,300			6,120	
Add : Interest Outstanding	750		Less : Provision for B/D	306	
		4,050			5,814
Capital	24,500		Closing Stock		23,500
Add : Net Profit	9,780		Buildings		11,000
			Machinery	9,340	
			Less : Depreciation	934	
	34,280				8,406
Less : Drawings	2,000		Scooter	2,000	
		32,280	Less : Depreciation	240	
					1,760
		50,560			50,560

Note. Provision for bad debts has been calculated on Rs. 6,120, i.e., 6,280 – 160.

Illustration 3. The following is the trial balance of Mr. S. Kapur on 31st March, 2003.

Name of Accounts	Debit	Credit
	Rs.	Rs.
Cash in hand	1,080	
Cash in bank	5,260	
Purchases	81,350	
Sales account		1,97,560
Returns inward	1,360	
Return outwards		1,000
Wages.....	20,960	
Fuel and power.....	9,460	
Carriage on sales.....	6,400	
Carriage on purchases.....	4,080	
Stock (1-4-2002).....	11,520	
Buildings.....	60,000	
Freehold land.....	20,000	
Machinery.....	40,000	
Salaries.....	30,000	
Patents.....	15,000	
General expenses.....	6,000	
Insurance.....	1,200	
Capital.....		1,42,000
Drawings.....	10,490	
Sundry debtors.....	29,000	
Sundry creditors.....		12,600
	Rs. 3,53,160	3,53,160

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Taking into account the following adjustments, prepare Trading and Profit and loss account and the Balance sheet :

- (a) Stock in hand on 31st March, 2003 is Rs. 13,600.
- (b) Machinery is to be depreciated at the rate of 10% and patents at the rate of 20%.
- (c) Salaries for the month of March, 2003 amount to Rs. 3,000 were unpaid.
- (d) Insurance includes a premium of Rs. 170 for the next year.
- (e) Wages include a sum of Rs. 4,000, spent on the erection of cycle-shed for employees and customers.
- (f) A provision for bad and doubtful debts is to be created to the extent of 5% on sundry debtors.

Solution.

Final Accounts (With Simple Adjustments)

Trading and Profit and Loss Account of Mr. S. Kapur
for the year ended 31st March, 2003

Dr.

Cr.

<i>Expenses/Losses</i>	<i>Amount Rs.</i>	<i>Revenue/Gain</i>	<i>Amount</i>
To Opening Stock	11,520	By Sales	1,97,560
To Purchases	81,350	Less : Return	(-) 1,360
Less : Return	(-) 1,000		
To Carriage on Purchases	4,080	By Closing Stock	13,600
To Wages	20,960		
Less : Erection of a cycle shed	(-) 4,000		
To Fuel and Powers	9,460		
To Gross Profit transferred to P/L A/c	87,430		
	<u>2,09,800</u>		<u>2,09,800</u>
To Carriage Outward	6,400	By Gross Profit transferred from trading A/c	87,430
To Salaries	30,000		
Add : Outstanding	3,000		
To General expenses	6,000		
To Insurance	1,200		
Less : Pre-paid Insurance	170		
To Depreciation on : Machinery	4,000		
Patents	3,000		
To Provision for bad and doubtful debts	1,450		
To Net Profit transferred to Capital A/c	32,550		
	<u>87,430</u>		<u>87,430</u>

NOTES

Balance Sheet of Mr. S. Kapur
as on 31st March, 2003

<i>Liabilities</i>	<i>Amount Rs.</i>	<i>Assets</i>	<i>Amount Rs.</i>
Creditors	12,600	Cash in hand	1,080
Outstanding Salaries	3,000	Cash at Bank	5,260
Capital	1,42,000	Debtors	29,000
Add : Net Profit	32,550	Less : Provision	1,450
	<u>1,74,550</u>		<u>27,550</u>
Less : Drawings	10,490	Insurance Prepaid	170
	<u>1,64,060</u>	Closing Stock	13,600
		Building	60,000
		Add : Cost of erection of a cycle shed	4,000
			<u>64,000</u>

NOTES

	Land		20,000
	Machinery	40,000	
	Less : Depreciation	4,000	
			36,000
	Patents	15,000	
	Less : Depreciation	3,000	
			12,000
			1,79,660
	1,79,660		1,79,660

Note. Wages paid for erection of a cycle shed is capital expenditure. Cycle shed is a part of building. It will increase the value of building, so wages paid for construction of shed should be added to the value of building. As it has been wrongly included in the wages, so it should be subtracted from wages at the debit side of Trading account.

Illustration 4. From the following Trial Balance of M/s Shradha & Sons as on 31st December, 2003, prepare Trading and Profit & Loss Account and Balance Sheet :

Name of Accounts	Dr. (Rs.)	Cr. (Rs.)
Drawing and Capital	18,000	80,000
Purchases and Sales	82,600	1,55,000
Stock (1.1.2003)	42,000	
Return outward		1,600
Carriage Inward	1,200	
Wages	4,000	
Power	6,000	
Machinery	50,000	
Furniture	14,000	
Rent	22,000	
Salary	15,000	
Insurance	3,600	
8% Bank Loan		25,000
Debtors	20,600	
Creditors		18,900
Cash in hand	1,500	
	<u>2,80,500</u>	<u>2,80,500</u>

Adjustments :

- Closing stock Rs. 64,000.
- Wages Outstanding Rs. 2,400.
- Bad debts Rs. 600 and make Provision for bad and doubtful debts to be 5%.
- Rent is paid for 11 months.
- Loan from the bank was taken on 1st July, 2003.
- Provide depreciation on machine @ 10% & on furniture @ 5%.

Solution.

Final Accounts (With Simple Adjustments)

Trading and Profit and Loss Account

for the year ended 31st December, 2003

Dr.

Cr.

NOTES

Particulars		Amount Rs.	Particulars		Amount Rs.
To Opening Stock		42,000	By Sales		1,55,000
To Purchases	82,600		By Closing Stock		64,000
Less : Returns	<u>- 1,600</u>	81,000			
To Power		6,000			
To Wages	4,000				
Add : Outstanding	<u>2,400</u>	6,400			
To Carriage Inward		1,200			
To Gross Profit c/d		82,400			
		<u>2,19,000</u>			<u>2,19,000</u>
To Rent	22,000		By Gross Profit b/d		82,400
Add : Outstanding	<u>2,000</u>	24,000			
To Salary		15,000			
To Insurance	3600				
Less : Prepaid	<u>(600)</u>	3,000			
To Depreciation on :					
Furniture	700				
Machinery	<u>5,000</u>	5,700			
To Interest on Bank Loan		1,000			
Outstanding					
To Bad debts		600			
To Provision for bad debts		1,000			
To Net Profit transferred to Capital A/c		32,100			
		<u>82,400</u>			<u>82,400</u>

Balance Sheet of M/s Shradha & Sons

as on 31st December, 2003

Liabilities		Amount Rs.	Assets		Amount Rs.
Creditors		18,900	Cash in hand		1,500
Outstanding Expenses			Debtors	20,600	
Rent	2,000		Less : Bad debts	<u>600</u>	
Wages	<u>2,400</u>	4,400		20,000	
			Less : Provision for	<u>(1000)</u>	19,000
			B/D		
8% Bank Loan	25,000		Closing Stock		64,000
Add : Unpaid Interest	<u>1,000</u>	26,000	Prepaid Insurance		600

Capital	80,000		Machinery	50,000	
Less : Drawings	18,000		Less : Depreciation	5,000	45,000
	62,000		Furniture	14,000	
Add : Net Profit	32,100	94,100	Less : Depreciation	700	13,300
		1,43,400			1,43,400

Notes. (i) Rent has been paid amounting to Rs. 22,000 for eleven months. It means that the rent for one month amounting to Rs. $22,000 \div 11 = \text{Rs. } 2,000$ is still outstanding. This is why, it has been added to Rent at the debit side of P/L A/c and also shown as liability in the Balance sheet.

(ii) The Trial Balance does not contain any amount of interest on Bank Loan, which is undoubtedly due for six months *i.e.*, July 1, 2003 to Dec. 31, 2003 @ 8%. It amounts to

$$25,000 \times \frac{8}{100} \times \frac{6}{12} = \text{Rs. } 1,000 \text{ and treated as outstanding interest on loan.}$$

(iii) Provision for Bad debts will be calculated on $20,600 - 600 = \text{Rs. } 20,000 @ 5\%$. It will amount to Rs. 1,000. This is based upon the logic that, why should provision be made on the amount which has been declared as bad.

SUMMARISED PRESENTATION OF ADJUSTMENT

Adjustments at a Glance

Adjustments	Journal Entry	Adjustment in Trading and P/L A/c	Adjustment in Balance Sheet
1. Closing Stock	Closing Stock A/c Dr. To Trading A/c	Posted at the credit side of Trading A/c	Shown at the assets side
2. Depreciation	Depreciation A/c Dr. To Asset A/c	Posted at the debit side of P/L A/c	Shown as deducted from concerned assets
3. Appreciation	Asset A/c Dr. To Appreciation A/c	Posted at the credit side of P/L A/c	Shown as added to concerned asset
4. Outstanding expenses	Expenses A/c Dr. To Outstanding Expenses A/c	Added to the concerned expense at the debit side of P/L or Trading A/c	Shown at the liabilities side
5. Prepaid expense	Prepaid Expenses A/c Dr. To Expense A/c	Deducted from the concerned expense at the debit side of P/L A/c.	Shown at the assets side
6. Accrued income	Accrued Income A/c Dr. To Income A/c	Added to the concerned income at the credit side of P/L A/c	Shown at the assets side
7. Unearned income	Income A/c Dr. To Unearned Income A/c	Deducted from concerned income at the credit side	Shown at the liabilities side
8. Interest on capital	Interest on Capital A/c Dr. To Capital A/c	Posted at the debit side of P/L A/c	Added to capital at the liabilities side

9. Interest on drawings	Drawings A/c To Interest on Drawings	Dr.	Posted at the credit side of P/L A/c	Deducted from capital at the liabilities side
10. Interest on investment	Investment A/c To interest on Investment	Dr.	Posted at the credit side of P/L A/c	Added to investment at the assets side
11. Interest on loans (borrowed)	Interest on loans A/c To Loan A/c	Dr.	Posted at the debit side of P/L A/c	Added to loan at the liabilities side
12. Interest on loans (advanced)	Loans A/c To Interest on Loans A/c	Dr.	Posted at the credit side of P/L A/c	Added to loan at the assets side
13. Bad debts	Bad Debts A/c To Debtors A/c	Dr.	Posted at the debit side of P/L A/c	Deducted from debtors at the assets side
14. Provision for bad debts	P/L A/c To Provision for Bad debts A/c	Dr.	Posted at the debit side of P/L A/c	Deducted from debtors at the assets side
15. Provision for discount on debtors	P/L A/c To Provision for discount on debtors	Dr.	Posted at the debit side of P/L A/c	Deducted from debtors at the assets side
16. Provision for discount on creditors	Provision for Discount on creditors A/c To P/L A/c	Dr.	Posted at the credit side of P/L A/c	Deducted from creditors at the liabilities side
17. Accidental loss of stock	Loss of Stock A/c To Trading A/c or To Purchases A/c	Dr.	Deducted from Purchases or Posted at the credit side of Trading A/c and also at the debit side of P/L A/c	No Effect
18. Accidental loss of goods (If Insured) (Partial admission of claim)	Insurance Co. A/c Loss of Stock A/c To Trading A/c	Dr. Dr.	Insurance Co. A/c will be shown with the amount of claim admitted by Co., loss of stock will be shown with the amount of the claim not admitted at the credit side of Trading A/c. Loss of the stock will also be shown at the debit side of P/L A/c	Insurance Co. A/c will be shown at the Assets side with the amount of claim admitted as debtor
19. Loss of Assets by fire (If not insured)	Loss by fire A/c To Asset A/c	Dr.	Loss by fire A/c will be shown at the debit side of P/L A/c	Loss will be deducted from the concerned asset at the assets side
20. Accidental loss of Assets (if insured) (Partial admission of claim)	Insurance Co. A/c Loss by fire A/c To Assets A/c	Dr. Dr.	Loss by fire A/c will be shown at the debit side of P/L A/c	Insurance Co. A/c will be shown at the assets side. Loss by fire A/c will be deducted from the Assets

21. Outstanding Manager's commission	P/L A/c To Outstanding manager's commission	Dr.	Manager's commission A/c will be shown at debit side of P/L A/c	Shown at the liabilities side of Balance sheet
22. Goods sent on sale or return basis treated as sales (cost of goods Rs. 6000 included in sales Rs. 8000)	Sales A/c Dr. 8000 To Debtors A/c 8000 and Stock A/c Dr. 6000 To Trading A/c 6,000		Rs. 8000 will be deducted from sales and Rs. 6000 will be added to closing stock at the credit side of Trading A/c	Rs. 8,000 deducted from debtors and Rs. 6,000 added to stock at the assets side
23. Goods taken by the proprietor for personal use	Drawing A/c To Purchases A/c	Dr.	Amount of goods taken by the proprietor will be deducted from purchases in Trading A/c	Amount of goods taken by the proprietor will be deducted from capital at the liabilities side.
24. Goods given as charity	Charity A/c To Purchases A/c	Dr.	Deducted from purchase at the debit side of trading A/c	Deducted from capital at the liabilities side
25. Goods distributed as free samples	Advertising A/c or Free Samples A/c To Purchases A/c	Dr. Dr.	Posted at the debit side of P/L A/c Also deducted from purchases A/c	No effect
26. Wages paid for construction of building was debited to wages A/c	Building A/c To Wages A/c	Dr.	The amount will be deducted from wages at the debit side of Trading A/c	The amount will be added to building at the assets side
27. Goods in transit (Goods were not received although titles to goods were received)	Goods in Transit A/c. To Supplier's A/c	Dr.	No effect	Goods in transit A/c will be shown at the assets side. Supplier's A/c will be shown at liabilities side
28. Remuneration paid to employee was debited to his personal A/c	Salaries A/c To Employee's Personal A/c	Dr.	Added to salaries at the debit side of P/L A/c	Deducted from debtors at the assets side
29. Deferred Revenue expenditure paid for future benefits (e.g., Advertisement expenditure)	(i) Advertising A/c To Bank (with total amount) (ii) P/L A/c To Advertising (with instalment amortised or written off)	Dr. Dr.	Debited to P/L A/c (with the amortised value)	Shown at the assets side with unamortised amount.

REVIEW QUESTIONS

Final Accounts (With Simple Adjustments)

A. Very Short Answer Type Questions :

1. Where will you show unearned income in the financial statements, if it appear in the Trial Balance ?
2. How will you treat wages owing in Final Accounts if it appears in the Trial Balance ?
3. Name the account and its side, where from we may pick up the item of Net Loss. Also mention its treatment in the Balance Sheet.
4. What adjusting entry will be passed for the prepaid rent ?
5. What journal entry will you pass for the recovery of bad debts previously written off ?

B. Short Answer Type Questions :

1. Name any three current assets and four fixed assets.
2. Mention items to be added to and deducted from capital at the liabilities side.
3. Mention situation in which purchases A/c is credited.

C. Long Answer Type Questions :

1. What do you mean by adjusting entries ? Why is it necessary to pass adjusting entries at the time of preparing final accounts ?
2. Why is it necessary to create provision for bad and doubtful debts ? How is it treated in final accounts ?
3. Explain the treatment of accidental loss of goods in the final accounts, if
(a) Goods are not insured (b) Goods are insured and full claim is admitted by the Insurance Company.
4. Write short notes on the following :
(a) Expenses owing (b) Unearned income (c) Discount on creditors (d) Interest on drawings (e) Unexpired insurance (f) Increase in the value of assets.
5. Explain the rationale of making adjustments at the time of preparing the final accounts ? Mention any three important adjustments that are made for the preparation of the profit and Loss Account.

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☆ STRUCTURE ☆

- ☆ Introduction
- ☆ Methods of Calculating Depreciation

INTRODUCTION

Meaning and Definition

Business is established for indefinite period. This is why, it acquires fixed assets for its use. These assets increase the profit earning capacity. Fixed assets are constantly used in the business. The assets lose their value gradually due to their constant use. *Loss in the value and utility of assets due to their constant use and expiry of time is termed as depreciation.* It has been our own experience that the furniture purchased for our own use in 2004 will lose a part of its value and lustre in 2005, Its value will further decrease in 2006 and so its effectiveness and value will go on decreasing with the passage of time, This 'wear and tear' is known as 'Depreciation' in accounting :

According to **R.N. Carter**, "*Depreciation is gradual and permanent decrease in the value of an asset from any cause*".

W. Pickles views, "*Depreciation may be defined as permanent and continuing diminution in the quality, quantity or the value of an asset*".

In the opinion of **Spicer and Peglar**, "*Depreciation is the measure of exhaustion of the effective life of an asset from any cause during a given period*".

According to **Accounting Standard**, "*Depreciation is a measure of the wearing out, consumption or other loss of value of a depreciable asset arising from use, effluxion of time or obsolescence through technology and market changes*".

According to **Institute of Cost and Management Accounting London (ICMA) terminology**, "*The depreciation is the diminution in intrinsic value of the asset due to use and/or lapse of time*".

According to Accounting Standard-6 issued by the Institute of Chartered Accountants of India (in November 1987) every company is liable to make provision for depreciation on its fixed assets.

Special Features of Depreciation

1. Depreciation is loss in the value of assets.
2. Loss should be gradual and constant.
3. Depreciation is the exhaustion of the effective life of business.
4. Depreciation is the normal feature.

5. Maintenance of assets is not depreciation.
6. It is continuing decrease in the value of assets.
7. It is the allocation of cost of assets to the period of its life.

Accountants have developed certain specific words to denote the loss in the value of particular assets, other than depreciation. These words are as under:

NOTES

1. Obsolescence/Dilapidation

Sometimes new inventions throw away the existing machines and equipments as obsolete (useless) although the old machines and equipments are not completely useless. The firm will have to replace the old machine and equipment with the latest, up-to-date and newly invented machine and equipment. Loss due to the obsolescence of the old machine and equipment is known as 'obsolescence'.

2. Depletion

The firm may possess certain mineral wealth such as coal, oil, iron ore *etc.* The more we extract mineral wealth from these mines the more mines are depleted. Decrease in mineral wealth of the mines is termed as depletion.

3. Amortisation

The word 'amortisation' is used to show loss in the value of intangible assets. These assets are goodwill, patents and preliminary expenses *etc.* These assets are written off over certain period.

4. Fluctuation

Increase and decrease in the market value of assets is known as fluctuation. As we record the value of these assets on historical basis, we do not pass any entry for the fluctuations in the market value of assets. In case of permanent fall in the value of investments fluctuation may be recorded.

Causes for Depreciation

1. **By constant use.** The loss in the value, efficiency and utility of fixed assets due to its constant use is termed as depreciation.
2. **By expiry of time.** The effective life of assets goes on decreasing with the passage of time. If certain lease has been obtained for 20 years for ₹ 1,00,000, it will lose its $\frac{1}{20}$ th, i.e., $\left(\frac{1}{20} \times 1,00,000\right) = ₹ 5,000$ value at the end of the first year and so on. At the end of 20th year it will become valueless.
3. **By obsolescence.** The old assets will become obsolete due to new inventions, improved techniques and technological advancements.
4. **By depletion.** Loss of mineral wealth due to constant working of mines is also depreciation, but specifically known as 'depletion'. Suppose a particular mine has got 1,00,000 tons of coal during 1st year, coal worth 5,000 tons have been extracted. The loss of 5,000 tons of coal from mines is loss due to depletion. This is why, we charge depreciation on these mineral wealth according to depletion method.
5. **Permanent fall in price.** Though fluctuations in the market value of fixed assets is not recorded in the books. Sometimes we have to account for this loss such as permanent fall in the value of investments.

6. **By Abnormal factors.** Depreciation may also be due to the loss in the value of assets by accidents and damage.

Depreciation in the value of assets in all the above cases is accounted for in the books of accounts.

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Objectives of Charging Depreciation

Recording depreciation in the books of accounts is essential due to the following reasons:

1. **For determination of net profit or net loss.** Loss in the value of assets is undoubtedly a business expense. It must be recorded and shown at the debit side of the profit and loss account for the correct calculation of net profit or net loss. The ultimate objective of accounting is to determine the correct net income. This objective will not be achieved, unless we account for depreciation in the books of accounts.
2. **For showing assets at fair and true value in the Balance Sheet.** If depreciation is not charged, the assets will be shown at value more than its actual value. The purpose of recording assets is to show them at their true value. Provision for depreciation reduces the value of assets with the amount of depreciation and assets are shown at their true and fair value.
3. **Provision of funds for replacement of assets.** The assets acquired and used in the business will become useless after expiry of its estimated life or even before that, we will have to replace the obsolete assets with another fresh asset. The replacement will require funds. Proper method of depreciation will make the funds available for the purchase of fresh assets.
4. **Ascertaining accurate cost of production.** Depreciation on factory plant and machinery is factory overhead. It will increase the cost of production and the price of the commodity will be fixed at higher rates. In the absence of provision for depreciation, the sales price of the commodity will be fixed at lower rates, because cost of production will also be lower due to ignorance of depreciation. Profit will thus be reduced.
5. **Distribution of dividend out of profit only.** Depreciation is charged out of Profit and loss account, so the profit after charging depreciation will be lesser. Shareholders will get dividend out of this profit. If depreciation is not charged, the profit will be more and the excess dividend will be paid out of capital, which should have been paid out of profit.
6. **Avoiding over payment of income tax.** If depreciation is not charged, profit and loss account will show more profit. We will have to pay more income tax on this profit. In this way, the payment of tax will be definitely more than what it should have actually been. The profit will reduce with the amount of depreciation, so lesser or the actual income tax due will be paid. Provision for depreciation in this way, avoids over payment of income tax.

Factory Affecting the Amount of Depreciation

It is quite impossible to calculate the actual and accurate amount of depreciation. It can always be estimated, though we try our best to be more accurate and correct. Following factors have to be considered before estimation of the amount of depreciation.

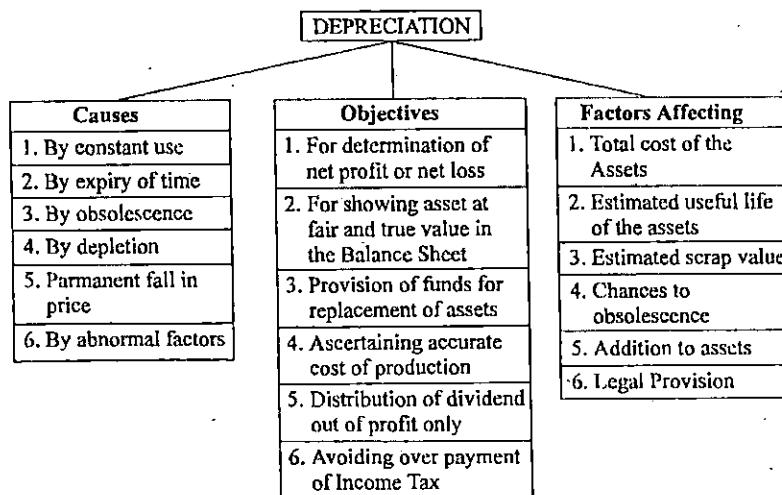
1. **Total cost of the assets.** Value of assets is determined after adding all expenses of acquiring, installing and constructing the assets. We should take into consideration the total cost of assets for determining the rate and the amount of depreciation.

2. **Estimated useful life of assets.** The estimated working life of the assets may be measured in terms of years, months, hours, output (units) or kilometres (for trucks). In case of depreciation the value of assets is allocated over the estimated useful life of the asset. If expected life is more, the rate of depreciation will be lesser and *vice versa*.

Useful life of asset depends upon the following factors

- (i) Predetermined by legal or contractual limits e.g., in case of leasehold asset, the useful life is the period of lease.
 - (ii) The number of shifts for which asset is to be used,
 - (iii) Repair and maintenance policy of the business organisation.
 - (iv) Technological obsolescence,
 - (v) Innovation/improvement in production method.
 - (vi) Legal or other restrictions.
3. **Estimated scrap value.** It is the residual value, which is expected to be realised even if the asset becomes obsolete. We shall have to make provision of the amount which is the value of assets less its scrap value. Suppose we purchase a machine for ₹ 10,000, whose expected life is ten years. If the scrap value is ₹ 1,000, we will have to arrange ₹ 9,000, i.e., $10,000 - 1,000$ in ten years. Every year will bear a depreciation of ₹ 900, i.e., $9,000/10$. If the scrap value in the above case is ₹ 2,000 depreciation to be charged will be ₹ 800 only.
4. **Chances to obsolescence.** If the asset acquired is expected to be obsolete within 5 years, we will have to split its value over 5 years. If it will be obsolete within four years the value will be split over four years. It shows that the amount of depreciation charged every year will decrease with comparatively remote chances of obsolescence.
5. **Addition to assets.** Depreciation should be charged on the additions to the assets also. If book value of furniture on Jan. 1, 2006 is ₹ 10,000 and additions worth ₹ 5,000 are made on July 1, 2006, Depreciation is to be charged @ 10%, We shall be calculating depreciation on ₹ 10,000 for the whole year and on 5,000 for six months.
6. **Legal provisions.** The rate and method of depreciation being used must be subject to legal provisions. Companies have to honour the legal provision with regard to depreciation.

NOTES



METHODS OF CALCULATING DEPRECIATION

1. Fixed or Equal Instalment or Straight Line Method or Depreciation on Original Cost

NOTES

It is the simplest method of charging depreciation. The original cost of the asset is divided by the estimated life period of the asset. For example, if the value of asset is ₹ 20,000 and its useful life is estimated to be 10 years, the amount of depreciation to be charged every year will be ₹ 2,000 *i.e.*, 20,000/10. Depreciation to be charged every year will be ₹ 2,000 or in other words, it will be fixed at ₹ 2,000 for every year. If we draw a graph of depreciation of 10 years, we shall find it to be a straight line because depreciation every year is the same *i.e.*, ₹ 2,000.

In certain cases, we are also given the scrap or residual value of the assets. The term residual or scrap value means the amount realised from the sale of obsolete asset.

In these cases, we use the following formula for the calculation of depreciation :

Annual depreciation

$$= \frac{\text{Cost of asset} - \text{Scrap value or Residual value or Breakup or salvage value}}{\text{Expected or estimated life of asset}}$$

Under straight line method, depreciation may also be determined by applying a fixed rate to the original cost of the asset.

Explanation of formula

Cost of the assets. Cost of the assets means the original cost or the historical cost of the asset. The cost includes the purchase price and the expenses incurred in acquiring (carriage, cartage, freight on newly purchased asset), installation charge (in case of fixtures, plant and machinery) construction charges (in case of building).

Scrap or residual or breakup or salvage value. The asset being used will definitely become obsolete sooner or later. The asset can be disposed off, even if it is obsolete (useless) as a scrap. The amount fetched by scrapped asset is known as its residual value.

Estimated life of the asset. Whenever asset is acquired, the manufacturer generally mentions the estimated working life of the asset. It may be in years, months, days or hours (in case of machines and equipments) in tons (in case of coal mines) in kilometres (in case of truck) so on. If the estimated life is not mentioned by the manufacturer we can assume it on the basis of our past experience or any scientific method.

Advantages of Straight Line Method

Straight line method of providing depreciation has got the following advantages :

1. **Simplicity.** This is the simplest method of providing depreciation. This can be easily understood even by ordinary person. Calculation of depreciation according to this method is also very simple.
2. **Assets can be completely written off.** According to this method, assets can be written off to zero. The depreciation is calculated on the original cost of the asset at the specified rate, so the value of asset is fully split over the useful life of asset.
3. **Knowledge of total depreciation charged.** The amount of total depreciation charged can be easily known by multiplying the yearly amount of depreciation with number of years, the asset has been used.

NOTES

4. For loss on sale of assets

P/L A/c Dr.
To Assets A/c

The third and fourth entry regarding sale of asset or loss can be combined together:

Bank or Cash A/c Dr.
Loss on Sale of Assets A/c Dr.
To Assets A/c

Loss on sale of assets account will be closed by transfer to profit and loss account;

5. For profit on sale of assets

Assets A/c Dr.
To P/L A/c

Illustration 1. (Straight Line Method: When rate is given). The purchase of furniture amounted to ₹ 4,000 and it is decided to write off 5 per cent on the original cost as depreciation at the end of each year. Show the ledger account as it will appear during the first four years. Pass journal entries also.

Solution.

Journal Entries

Date	Particulars	L.F.	Amount	
			Debit ₹	Credit ₹
Ist year Jan. 1	Furniture A/c Dr, To Bank A/c (Being purchase of furniture)		4,000	4,000
Dec. 31	Depreciation A/c Dr. To Furniture A/c (Being depreciation on furniture @ 5% on ₹ 4,000)		200	200
2nd year Dec. 31	Depreciation A/c Dr. To Furniture A/c (Being depreciation charged on furniture @ 5% on ₹ 4,000)		200	200
3rd year Dec. 31	Depreciation A/c Dr. To Furniture A/c (Being depreciation charged on furniture @ 5% on ₹ 4,000)		200	200
4th year Dec. 31	Depreciation A/c Dr. To Furniture A/c (Being depreciation charged on furniture @ 5% on ₹ 4,000)		200	200

Explanation. As per the instructions of question, depreciation on furniture has to be charged @ 5% on original cost. The original cost of the furniture is ₹ 4,000, so depreciation on furniture will be charged every year on its original value, i.e., ₹ 4,000. This is why, every year ₹ 200 has been charged as depreciation.

Depreciation

**Fixed Instalment Method
Furniture Account**

NOTES

Dr.				Cr.			
Date	Particulars	J.F.	Amount ₹	Date	Particulars	J.F.	Amount ₹
1st year Jan. 1	To Bank A/c		4,000	1st year Dec. 31	By Depreciation A/c		200
					By Balance c/d		3,800
			4,000				4,000
2nd year Jan. 1	To Balance b/d		3,800	2nd year Dec. 31	By Depreciation A/c		200
					By Balance c/d		3,600
			3,800				3,800
3rd year Jan. 1	To Balance b/d		3,600	3rd year Dec. 31	By Depreciation A/c		200
					By Balance c/d		3,400
			3,600				3,600
4th year Jan. 1	To Balance b/d		3,400	4th year Dec. 31	By Depreciation A/c		200
					By Balance c/d		3,200
			3,400				3,400
5th year Jan. 1	To Balance b/d		3,200				

Illustration 2. (Straight Line Method: Original cost, expected life and scrap value).
On January 1, 2003 M/s Ram & Sons purchased a Machinery for ₹ 2,00,000. They spent ₹ 12,000 on its freight and ₹ 8,000 for its installation. The expected life of the machine is 10 years. It is expected that the machine will be sold for ₹ 20,000 after its useful life. Prepare machinery account and depreciation account for 3 years, Books of Accounts are closed on December 31, every year.

Solution.

Machine Account

Dr.				Cr.			
Date	Particulars	J.F.	Amount ₹	Date	Particulars	J.F.	Amount ₹
2003 Jan. 1	To Bank A/c		2,20,000	2003 Dec. 31	By Depreciation A/c		20,000
				Dec. 31	By Balance c/d		2,00,000
			2,20,000				2,20,000

NOTES

2004				2004			
Jan. 1	To Balance b/d		2,00,000	Dec. 31	By Depreciation A/c		20,000
				Dec. 31	By Balance c/d		1,80,000
			<u>2,00,000</u>				<u>2,00,000</u>
2005				2005			
Jan. 1	To Balance b/d		1,80,000	Dec. 31	By Depreciation A/c		20,000
				Dec. 31	By Balance c/d		1,60,000
			<u>1,80,000</u>				<u>1,80,000</u>
2006				2006			
Jan. 1	To Balance b/d		1,60,000				

Depreciation Account

Dr.

Cr.

Date	Particulars	J.F.	Amount ₹	Date	Particulars	J.F.	Amount ₹
2003				2003			
Dec. 31	To Machine A/c		20,000	Dec. 31	By P/L A/c		20,000
2004				2004			
Dec. 31	To Machine A/c		20,000	Dec. 31	By P/L A/c		20,000
2005				2005			
Dec. 31	To Machine A/c		20,000	Dec. 31	By P/L A/c		20,000

Working Note :

Calculation of Depreciation :

$$= \frac{\text{Cost of machine} - \text{Scrap value}}{\text{Expected life of machinery}} = \frac{2,20,000 - 20,000}{10} = ₹ 20,000$$

Illustration 3, (Straight Line Method; Additions to assets). On 1st January, 2001 a Company bought Plant and Machinery costing ₹ 35,000. It is estimated that its working life is 10 years, at the end of which it will fetch ₹ 5,000. Additions are made on 1st January, 2002 to the value of ₹ 20,000 (Residual value ₹ 2,000). More additions are made on July 1, 2003 to the value of ₹ 10,000. (Breakup value ₹ 1,000). The working life of both the additional Plants and Machinery is 20 years.

Show the Plant and Machinery account for the first four years, if depreciation is written off according to Straight Line Method. The accounts are closed on 31st December every year.

Solution.

Depreciation

Plant and Machinery Account

Dr.

Cr.

Date	Particulars	J.F.	Amount ₹	Date	Particulars	J.F.	Amount ₹
2001 Jan, 1	To Bank A/c		35,000	2001 Dec. 31	By Depreciation A/c		3,000
				Dec. 31	By Balance c/d		32,000
			<u>35,000</u>				<u>35,000</u>
2001 Jan, 1	To Balance b/d		32,000	2002 Dec. 31	By Depreciation A/c		
Jan, 1	To Bank A/c		20,000	(i) ₹ 3,000			
				(ii) ₹ 900			3,900
				Dec. 31	By Balance c/d		
				(i) ₹ 29,000			
				(ii) ₹ 19,100			43,100
			<u>52,000</u>				<u>52,000</u>
2003 Jan, 1	To Balance b/d			2003 Dec. 31	By Depreciation A/c		
	(i) ₹ 29,000			(i) ₹ 3,000			
	(ii) ₹ 19,100		48,100	(ii) ₹ 900			
				(iii) ₹ 225			
July, 1	To Bank A/c		10,000	(for 6 months)			4,125
				Dec. 31	By Balance c/d		
				(i) ₹ 26,000			
				(ii) ₹ 18,200			53,978
				(iii) ₹ 9,775			58,100
			<u>58,100</u>				
2004 Jan, 1	To Balance b/d			2004 Dec. 31	By Depreciation A/c		
	(i) ₹ 26,000			(i) ₹ 3,000			
	(ii) ₹ 18,200		53,975	(ii) ₹ 900			
	(iii) ₹ 9,775			(iii) ₹ 450			4,350
				July, 1	By Balance c/d		
				(i) ₹ 23,000			
				(ii) ₹ 17,300			
				(iii) ₹ 9,325			49,625
			<u>53,975</u>				<u>53,975</u>
2005 Jan, 1	To Balance b/d						
	(i) ₹ 23,000			(i) ₹ 3,000			
	(ii) ₹ 17,300			(ii) ₹ 900			
	(iii) ₹ 9,325		<u>49,625</u>				

NOTES

NOTES

Notes 1. Calculation of Depreciation = $\frac{\text{Cost of plant and Machinery} - \text{Residual value}}{\text{Working life}}$

(1) = $\frac{₹ 35,000 - ₹ 5,000}{10 \text{ years}} = \frac{30,000}{10} = ₹ 3,000 \text{ per year.}$

(2) = $\frac{₹ 20,000 - ₹ 2,000}{20 \text{ years}} = \frac{18,000}{20} = ₹ 900 \text{ per year.}$

(3) = $\frac{₹ 10,000 - ₹ 1,000}{20 \text{ years}} = \frac{9,000}{20} = ₹ 450 \text{ per year.}$

2. The amount of depreciation on all the three machines will be ascertained separately as above.

Illustration 4. (Straight Line Method: Sale of assets). On 1st July 2003 Raj & Co., purchased machinery worth ₹ 40,000. On 1st July, 2005 it buys additional machinery worth ₹ 10,000, On 30th June, 2006 half of the machinery purchased on 1st July, 2003 is sold for ₹ 9,500, The company writes off 10% on the original cost. The accounts are closed every year on 31st December.

Show the machinery account for four years. Accounts are closed on December 31, every year.

Solution.

Machinery Account

Dr.

Cr.

Date	Particulars	J.F.	Amount ₹	Date	Particulars	J.F.	Amount ₹
2003 Jan, 1	To Bank A/c		40,000	2003 Dec. 31	By Depreciation (On 40,000 for six months)		2,000
				Dec. 31	By Balance c/d		38,000
			40,000				40,000
2004 Jan, 1	To Balance c/d		38,000	2004 Dec. 31	By Depreciation (On 40,000 for one year)		4,000
				Dec. 31	By Balance c/d		34,000
			38,000				38,000
2005 Jan, 1	To Balance c/d		40,000	2005 Dec. 31	By Depreciation (On 40,000 for one year and on 10,000 for six months)		4,500
July 1	To Bank A/c		10,000	Dec. 31	By Balance c/d		39,500
			44,000				44,000

Depreciation

2006			2006		
Jan. 1	To Balance b/d	39,500	June 30	By Bank A/c	9,500
				By Depreciation (On 20,000 for six months)	1,000
			Dec. 31	By profit and Loss	4,500
				By Depreciation (On 20,000 for one year + on 10,000 for one year)	3,000
			Dec. 31	By Balance c/d	21,500
		39,500			39,500
2007					
Jan. 1	To Balance b/d	21,500			

NOTES

Notes. (i) Calculation of loss on sale of Machinery :

Book value of full machine (on July 1, 2003) = 40,000

Book value of half machinery (on July 1, 2003) = $40,000 \times \frac{1}{2} = 20,000$

Less: Depreciation on half machinery @ 10% on straight line method :

2003 (July 1—Dec. 31)	1,000	
2004 (for full year)	2,000	
2005 (for full year)	2,000	
2006 (Jan. 1—June 30)	<u>1,000</u>	<u>6,000</u>

Book value as on June 30, 2006 14,000

Less : Amount received from sale 9,500

Loss on sale of machinery 4,500

(ii) Journal entry for sale of machinery:

2006

June 30,	Bank A/c	Dr.	9,500
	Profit and Loss A/c	Dr.	4,500
	Depreciation A/c	Dr.	1,000
	To Machinery A/c		15,000

Calculation of Depreciation on Additions to Asset

Business is a continuing activity, so we may purchase additional assets or we may add to the existing assets. Addition to the fixed assets, such as land and building, plant and machinery, vehicles and furniture etc., are capital expenditure. It will increase the value of assets, so depreciation will also be charged on these additions. Depreciation on additions will be charged since the date of additions at the specified rate.

For example, if addition to machinery worth ₹ 20,000 on July 1, 2005, will be depreciated at the rate of 10% (specified) for six months together with the depreciation on the book value of old machinery, depreciation on the additions during the first year will be the same under straight line or written down value method.

The firm may sell asset, if it is obsolete. It may also be sold when it is not in perfect order. The disposal of asset will take place, when purchase of fresh, up-to-date asset is made and the old asset becomes unwanted. In any case, the sale of asset has to be accounted for.

NOTES

The treatment of asset in case of sale will be made as under:

Treatment of Sale of Asset**(i) If asset is sold at the book value**

Bank A/c	Dr.
To Asset A/c	

(ii) If the asset is sold at lesser than book value (loss)

Bank A/c	Dr.
Profit and Loss A/c	Dr.
To Asset A/c	

(iii) If the asset is sold for more than the book value

Bank A/c	Dr.
To Asset A/c	
To Profit and Loss A/c	

2. Diminishing or Written Down Balance Method

This method has been developed to remove the short comings of straight line method. Equal amount of depreciation is charged every year under straight line method. The method is criticised for showing disfavour to final years of the life of the assets. During final years repairs and maintenance charges are more but the depreciation is the same. It shows that the final years are over burdened with charges. Diminishing balance method was developed to remedy the weakness of straight line method.

Under the diminishing balance method, the value of asset upon which depreciation is to be calculated goes on diminishing, so the amount of depreciation to be charged every year also goes on declining. For example, if a machine has been acquired for ₹ 1,00,000 and depreciation is charged @ 10% according to written down value method the depreciation to be charged will be made as under:

$$\text{1st year on ₹ 1,00,000 @ 10\%} = \frac{10}{100} \times 1,00,000 = ₹ 10,000$$

$$\text{2nd year on ₹ 90,000, i.e., ₹ 1,00,000 - 10,000} = 90,000 \times \frac{10}{100} = ₹ 9,000$$

$$\text{3rd year on ₹ 81,000, i.e., ₹ 90,000 - 9,000} = 81,000 \times \frac{10}{100} = ₹ 8,100$$

$$\text{4th year on ₹ 72,900, i.e., ₹ 81,000 - 8,100} = 72,900 \times \frac{10}{100} = ₹ 7,290.$$

and so on.

It will be observed from the above calculation that the balance of machine upon which depreciation is being calculated goes on diminishing or reducing or it is being written down. It should also be noted that the amount of depreciation goes on declining year after year. In the first year it was ₹ 10,000, in the second year, it came down to ₹ 9,000. It reduced further to ₹ 8,100 in the third year. In the 4th year, it remained only ₹ 7,290. In this way, depreciation will go on declining year after year.

NOTES

Advantages of Diminishing Balance/Written Down Value Method

Diminishing balance method has got the following advantages :

1. **Easy calculation.** Calculation of depreciation is easier as compared to other methods of calculating depreciation except straight line method. Depreciation is calculated every year on the opening balance of asset. Depreciation on additions is separately calculated.
2. **Balanced effect on the profit and loss account of different years.** In the initial years depreciation is more and the maintenance charges are lesser. In the final years, depreciation is lesser but repairs and maintenance charges are more, so every year bears the charges almost the same as regards depreciation and maintenance.
3. **Approved method by income tax authorities.** The method is approved by income tax authorities.
4. **Logical method.** It seems logical even to layman that the value of asset goes on diminishing year after year, so the depreciation should also be charged on the reducing balances.
5. **Suitable for assets having long-life.** This method is suitable for those assets which have long-life, It is also suitable for those assets, where additions and extensions are common feature, such as land, building and plant and machinery.

Disadvantages or limitation of the Diminishing Balance Method

Diminishing balance method of providing depreciation suffers from following weaknesses:

1. **The value of asset cannot be reduced to zero.** It is very difficult to determine the rate by which the value of asset could be written down to zero,
2. **No funds for replacement** Though depreciation is charged every year but the amount charged is retained in the business and used in routine business operations. At the time of replacing assets, firm has to bother for making arrangement of funds, although it has charged depreciation every year.
3. **Loss of interest.** The amount charged as depreciation is not invested outside the business, so no interest is received. In certain methods, the amount is invested outside the business in securities and interest is received.
4. **Higher rate of depreciation.** The rate of depreciation in this method is higher, because it will require longer period to write off the asset, if the rate is lower and the assets may become useless earlier.
5. **Inequal burden on profit and loss account.** The amount of depreciation goes on declining year after year, whereas the asset is used equally by every year.

Uses of Diminishing Balance Method

Diminishing balance is the method for assets having long-life. It is also suitable for those assets which are subject to additions and extensions from time to time, such as land and building, plant and machinery etc.

Difference between Straight Line and Diminishing Balance Method

Difference between straight line and diminishing balance method can be made as under:

NOTES

Points of Difference	Straight Line Method	Diminishing Balance Method
1. Amount of Depreciation	Equal amount of depreciation is charged every year.	The amount of depreciation goes on reducing year after year.
2. Calculation of Depreciation	Depreciation is calculated on the original cost of the assets.	Depreciation is calculated on the reducing balance of the assets.
3. Zero level	The value of assets can be written down to zero.	The value of assets cannot be written down to zero.
4. Effect on profit and loss account	The initial years of the life of the asset bear lesser amount as depreciation and repairs but final years bear the same amount of depreciation but more repairs and maintenance charges.	Every year bears almost the same charges. Depreciation goes on declining, whereas repairs and maintenance charges go on increasing.
5. Suitability	This method is useful for assets of lesser value such as patents, furniture and fixtures etc.	The method is suitable for assets having longer life and more value such as land and building, plant and machinery etc.
6. Recognition by Income tax law	Straight line method is not recognised by Income tax law.	Written down value method is recognised by Income tax law.

Illustration 5. (Diminishing Balance Method): Sale of assets), Kaushal Traders purchased a second hand machinery on 1st January, 2002 for ₹ 23,000 and spent ₹ 2,000 on its repairs, It was decided to depreciate the machinery at 20% every year, according to diminishing balance method. Prepare the machinery account from 2002 to 2004 and show profit or loss as it was sold on 31st December, 2004 for ₹ 10,800. The accounts are closed on December 31 every year.

Solution.

Diminishing Balance Method**Machinery Account**

Dr:

Cr:

Date	Particulars	J.F.	Amount ₹	Date	Particulars	J.F.	Amount ₹
2002				2002			
Jan. 1	To Bank A/c		23,000	Dec. 31	By Depreciation A/c		5,000
	To Bank A/c (Repairs)		2,000	Dec. 31	By Balance c/d		20,000
			<u>25,000</u>				<u>25,000</u>

2003			2003		
Jan. 1	To Balance b/d	20,000	Dec. 31	By Depreciation A/c	4,000
				By Balance c/d	16,000
		20,000			20,000
2004			2004		
Jan. 1	To Balance b/d	16,000	Dec. 31	By Depreciation A/c	3,200
			Dec. 31	By Bank A/c	10,800
			Dec. 31	By Profit & Loss (Loss on sale)	2,000
		16,000			16,000

NOTES

Note. The amount of depreciation has been calculated @ 20% on diminishing (reducing) balances of machinery. In 2002, depreciation has been calculated on 25,000. Amount spent on repairs to second hand machinery is capital expenditure. It was necessary to bring the old machinery in working order. It is the part of the cost of machinery, so it has been added to its cost. The balance of machinery reduced to ₹ 20,000 in 2003 and further reduced to ₹ 16,000 in 2004, so depreciation for 2003 has been calculated on 20,000 and for 2004 on ₹ 16,000.

Loss on sale of machinery has been calculated as under;

Book value of machinery as on January 1, 2002 ₹ 25,000

Less: Depreciation:

2002 (for full year) 5,000

2003 (for full year) 4,000

2004 (for full year) 3,200

12,200

Book value of machinery as on December 31, 2004 12,800

Less: Amount received from sale of machinery 10,800

Loss on sale of machinery 2,000

Illustration 6. (Diminishing Balance: Assets sold partly). A company whose accounting year is the calendar year purchased on 1st April, 2001 machinery costing ₹ 30,000.

It further purchased machinery, on 1st October, 2001 costing ₹ 20,000 and on 1st July, 2002 costing ₹ 10,000.

On 1st January, 2003 one-third of the machinery which was installed on 1st April, 2001 became obsolete and was sold for ₹ 3,000.

Show how the machinery account would appear in the books of company. The depreciation is charged at 10% p.a. on Written Down Value Method.

Machinery Account

Dr.

Cr.

NOTES

Date	Particulars	J.F.	Amount ₹	Date	Particulars	J.F.	Amount ₹
2001				2001			
April 1	To Bank A/c		30,000	Dec. 31	By Depreciation A/c		2,750
Oct. 1	To Bank A/c		20,000	Dec. 31	By Balance c/d		47,250
			<u>50,000</u>				<u>50,000</u>
2002				2002			
Jan. 1	To Bank b/d		47,250	Dec. 31	By Depreciation A/c		5,225
July 1	To Bank A/c		10,000		By Balance c/d		52,025
			<u>57,250</u>				<u>57,250</u>
2003				2003			
Jan. 1	To Balance b/d		52,025	Jan. 1	By Bank A/c		3,000
				Jan. 1	By P&L A/c (Loss)		5,325
				Dec. 31	By Depreciation A/c		4,370
				Dec. 31	By Balance c/d		39,330
			<u>52,025</u>				<u>52,025</u>
2004							
Jan. 1	To Balance b/d		39,330				

Working Notes:**(i) Calculation of depreciation for year 2003:**

Total Written Down Value as on January 1, 2003	₹ 52,025
Less: Written Down Value of 1/3rd of plant sold (10,000 - 750 - 925)	- 8,325
Written down value of remaining machine	<u>43,700</u>
Depreciation at 10% on Written Down Value $\left(43,700 \times \frac{10}{100}\right)$	<u>4,370</u>

(ii) Calculation of loss on sale of machinery :

Book value of 1/3rd machinery purchased on April 1, 2001 as on January 1, 2003 (10,000 - 750 - 925)	8,325
Less : Amount received from sale	(-) 3,000
Loss on sale of machinery	<u>5,325</u>

Illustration 7. (Diminishing Balance: Sale of assets). A manufacturing concern, whose books are closed on 3rd December, purchased machinery for ₹ 50,000 on 1-1-2000. Additional machinery was acquired for ₹ 10,000 on 1-7-2001 and for ₹ 16,061 on 1-1-2004. Certain machinery purchased for ₹ 10,000 on 1-1-2000 was sold for ₹ 5,000 on 30-6-2003.

* Give the machinery account for 5 years. Depreciation is written off at 10% per annum on written down value method.

Solution.

Written Down Value Method
Machinery Account

Depreciation

Dr.

Cr.

Date	Particulars	J.F.	Amount ₹	Date	Particulars	J.F.	Amount ₹
2000				2000			
Jan. 1	To Bank A/c		50,000	Dec. 31	By Depreciation A/c		5,000
				Dec. 31	By Balance c/d		45,000
			50,000				50,000
2001				2001			
Jan. 1	To Balance b/d		45,000	Dec. 31	By Depreciation A/c		5,000
July 1	To Bank A/c		10,000	Dec. 31	By Balance c/d		50,000
			55,000				55,000
2002				2002			
Jan. 1	To Balance b/d		50,000	Dec. 31	By Depreciation A/c		5,000
				Dec. 31	By Balance b/d		45,000
			50,000				50,000
2003				2003			
Jan. 1	To Bank b/d		45,000	June 30	By Bank A/c		5,000
				June 30	By Profit & Loss A/c		1,925
				Dec. 31	By Depreciation A/c		4,136
				Dec. 31	By Balance b/d		33,939
			45,000				45,000
2004				2004			
Jan. 1	To Balance b/d		33,939	Dec. 31	By Depreciation A/c		5,000
Jan. 1	To Bank A/c		16,061	Dec. 31	By Balance c/d		45,000
			50,000				50,000
2005							
Jan. 1	To Balance b/d		45,000				

NOTES

Working Notes:**(i) Calculation of loss on sale of machinery :**

Book value of machinery as on January 1, 2000	₹ 10,000
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Less: Depreciation according to diminishing balance method:

2000 (for full year)	1,000
2001 (for full year)	900
2002 (for full year)	810
2003 (for six months)	<u>365</u>

	3,075
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Book value of Machine sold as on June 30, 2003	6,925
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Less: Amount received from sale	(-) 5,000
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Loss on sale of machine	<u>1,925</u>
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NOTES

(ii) Calculation of depreciation for the year 2003 :

Book value of all machineries as on January 1, 2003	45,000
Less: Book value of machinery to be sold as on January 1, 2003	(-) 7,290
	<u>37,710</u>
Depreciation on 37,710 @ 10% for full year	3,771
Add: Depreciation on 7,290 @ 10% for six months	365
Total depreciation for 2003	<u>4,136</u>

Replacement Cost Method

Under this method an asset is depreciated over a period of time and a fund is maintained for the replacement of that asset by the amount of decreasing its value. For example, if there is an asset purchased on 1st Jan. 2008 for ₹ 10,00,000 and straight line method is applied at 10% then at the end of the year 2008 the depreciation will be ₹ 1,00,000. The company will maintain a fund for the replacement of the asset with ₹ 1,00,000 as balance at the end of the year 2008. This means that the amount depreciated is set aside in the form of a fund for future replacement of the asset.

REVIEW QUESTIONS**A. Very Short Answer Type Questions:**

1. Mention any three important features of depreciation.
2. Mention names of three factors affecting the amount of depreciation.
3. Mention the formula for calculating depreciation under straight line method.
4. What is depreciation ?
5. A pharmaceutical manufacturer has just developed and registered a patent for a rare medicine. Which term will appear in its profit and loss account regarding the cost of patent written off.

B. Short Answer Type Questions:

1. Explain the following terms:

(a) Obsolescence	(b) Depletion
(c) Fluctuation	(d) Amortisation.
2. What are the different causes of depreciation ? Explain them briefly.
3. You are looking at the profit and loss account of three business enterprises. You find the term depreciation in first, depletion in case of second and amortisation in case of third enterprise. State the type of business each of the enterprise is into.
4. There are two dentists Dr. Aggarwal and Dr. Mehta in your locality who are competitors. Both of them have recently bought machine for patients. Dr. Aggarwai has decided to write off an equal amount of depreciation every year while Dr. Mehta wants to write off a larger amount in earlier years. They do not know anything about the methods of depreciation. Can you inform them more about the methods of depreciation they are applying even without knowing anything about accounting in formal. Who is more wise in your opinion ? Give reasons in support of your answer.

C. Long Answer Type Questions:

1. Explain the meaning of depreciation. Enumerate different methods of depreciation. Explain straight line method.
2. Why is it necessary to provide for depreciation ? Explain the effect of depreciation on Profit and loss account and Balance Sheet.
3. Differentiate between straight line method and written down value method of providing depreciation.
4. Discuss the advantages and disadvantages of fixed instalment method and diminishing balance method.
5. Explain the following:
(a) Obsolescence, (b) Amortisation, (c) Depletion, (d) Fluctuation.

NOTES

CHAPTER 11 · ISSUE OF SHARES

NOTES

☆ STRUCTURE ☆

- ☆ Shares
- ☆ Share Capital
- ☆ Public Subscription
- ☆ Accounting of Equity Share Capital
- ☆ Accounting of Preference Share Capital
- ☆ Preparation of Cash Book
- ☆ Over-subscription of Shares
- ☆ Under Subscription of Shares
- ☆ Issue of Shares at Par
- ☆ Issue of Shares at Premium
- ☆ Calls in Advance
- ☆ Calls in Arrear
- ☆ Issue of Shares for Consideration Other than Cash

MEANING OF COMPANY

According to Chief Justice Marshal, "A company is a person, artificial, invisible, intangible and existing only in the eyes of law. Being a mere creation of law, it possesses only those properties which the charter of its creation confers upon it, either expressly or as incidental to its very existence."

SHARES

Meaning

The capital of a company is divided into units, called shares. In other words, **shares are the denomination of share capital**. In the words of Farwel, "A share is the interest of a shareholder in the company measured by a sum of money." According to the Indian Companies Act, 2013 a company can issue only two types of shares, namely :

1. Equity shares
2. Preference shares

Types of Shares

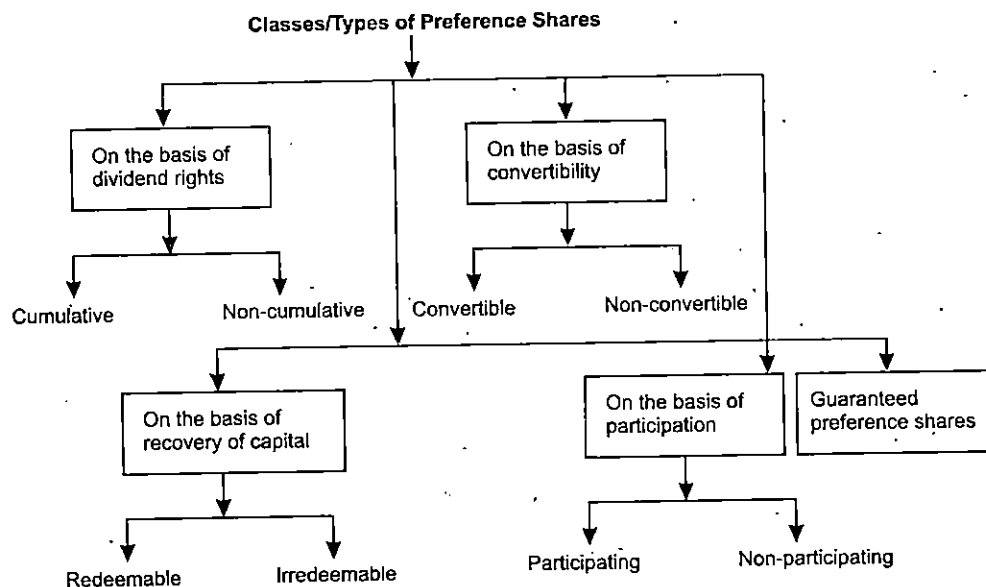
1. Equity or ordinary shares

A share which is not a preference share is an equity share. It means that if the shareholder is not entitled to a fixed dividend in preference to others or if there is not prior right for the capital to be repaid, the share capital will be treated as equity share capital. In other words, equity shares participate in profits of a company, after all preferential rights have been satisfied. Equity shareholders are the virtual owners of the company. They get dividend after payment of all expenses and dividend to preference shareholders.

2. Preference shares

(According to section 43 of the companies act 2013. Person holding preference share is called preference share holder). Preference shares are those shares which are entitled to a priority in the payment of dividends at a fixed rate and sometimes also in the return of capital in the event of the winding up of the company. Preference shares can be divided into following classes if the Articles of Association of the Company permit:

NOTES



(i) *Cumulative preference shares.* The holders of this class of shares are entitled to all arrears before dividend is paid on equity shares. Suppose, a company has issued 1,500 preference shares of ₹ 10 each carrying dividend at the rate of 10% and suppose dividend was not paid for 2017 and 2018. In 2019 company earns a good amount of profit. In that case dividend for the two years 2017 and 2018 will be payable.

(ii) *Non-cumulative preference shares.* In this case, arrears are not payable. In the above example in 2019 only the dividend for 2019 will be paid and not for 2017 or 2018.

(iii) *Redeemable preference shares.* If preference shares are redeemable out of the profits by the creation of a "capital redemption reserve fund" or by new issue of shares or out of the sale proceeds of the property of the company, they are called redeemable preference shares.

(iv) *Irredeemable preference shares.* Preference shares, which do not carry any provision for redemption of shares are known as irredeemable preference shares.

(v) *Convertible preference shares.* The holders of these shares have the option to convert their preference shares into equity shares as per terms and conditions of their issue.

(vi) *Non-convertible preference shares.* The holders of these shares do not have any right of converting their shares into equity shares, as such it is known as non-convertible preference shares. These are non-convertible unless otherwise stated.

(vii) *Participating preference shares.* When preference shares participate like equity shares in profits of a company in addition to their fixed dividend, they are known as participating preference shares.

(viii) *Non-participating preference shares.* These shares are not entitled to participate in surplus Profit. Dividend at fixed rate is given to them.

NOTES

(ix) *Guaranteed preference shares.* Guaranteed preference shares are the shares at which a fixed dividend is guaranteed by the vendors or some other party, if the profits in a particular year are insufficient to pay the dividend, the guarantors will pay the amount. The company itself cannot give guarantee. The guarantee can be given by the vendor or promotor.

SHARE CAPITAL

What is Share Capital?

"Funds generated through issue of shares is known as share capital."

The capital of the company is divided into shares. This is why, it is known as share capital. Company is large sized business structure, so it requires very large amount of capital. As it cannot be supplied by sole proprietor or limited number of persons, so the entire share capital is divided into shares.

Nature/Features of Share Capital

Following are the special features of share capital:

(i) **Widely held capital:** Unlike sole proprietorship and partnership, share capital is generally widely distributed. In case of private companies, there are maximum 200 subscribers. On the other hand, there can be unlimited subscribers for public company. Each subscriber is termed as the member of the company.

(ii) **Legally regulated capital:** As a large number of investors are involved with share capital. It is regulated by specific regulations like SEBI regulation, Companies Act 2013, Cooperative Societies Act etc. Legal complications are relatively less in sole proprietorship and partnership.

(iii) **Associated with heavy investment projects:** Share Capital oriented concerns are generally heavy investment projects. Hence, it has a heavy risk Capital.

PUBLIC SUBSCRIPTION

The company intending to issue shares makes an offer or invitation to the general public to subscribe for its shares through a Prospectus. The Prospectus specifies the number of shares offered to the Public, the face value of shares and the amount to be paid on application, allotment and calls. The intending subscribers to the shares are required to send their application forms together with the application money by the specified date.

Subscription of shares is generally made in instalments termed as **application, allotment and calls**. When an investor applies for shares, he deposits application money. The company allots these shares and receives allotment money and the rest of the amount is received in calls. **For example**, for a ₹ 10 share, Company may have application of ₹ 3, Allotment ₹ 4 and First and Final Call of ₹ 3.

ACCOUNTING OF EQUITY SHARE CAPITAL

Legal provision pertaining to Allotment of shares:

Sec. 39 of Companies Act 2013 deals with Allotment of Securities by Company. The main features of the provision are as below:

1. **Restriction on allotment:** The condition is that no allotment of any securities of a company offered to the public for subscription shall be made unless the amount stated in the prospectus as the minimum amount has been subscribed and the sums payable on application for the amount so stated have been paid to and received by the company by cheque or other instrument.
2. **Restriction on amount payable on application:** The amount payable on application on every security shall not be less than five per cent of the nominal amount of the security or such other percentage or amount, as may be specified by the securities and exchange board by making regulations in this behalf.
3. **Consequences of non-compliance of points 1 and 2 stated above:** If the stated minimum amount has not been subscribed and the sum payable on application is not received within a period of thirty days from the date of issue of the prospectus, or such other period as may be specified by the securities and exchange board, the amount received under sub-section (1) shall be returned within such time and manner as may be prescribed.

NOTES

Steps for Accounting Treatment for the Issue of Shares

- Step 1:** Application money received.
- Step 2:** Share application money to be transferred to share capital.
- Step 3:** Share application money returned on unallotted shares.
- Step 4:** Share allotment money to be made due.
- Step 5:** Share allotment money received.
- Step 6:** Share call money to be made due.
- Step 7:** Share call money to be received.

Step 1: Application money received by the company is deposited into a Scheduled Bank and retained until certificate to commence business is obtained by the new company and minimum subscription is received by the existing company. This provision does not apply to private companies.

On receipt of the application money the following journal entry will be made:

Bank A/c	Dr.
To Share Application A/c	
(No. of shares applied × Rate of application)	

Step 2: Share application money is simply a part of the Share Capital of the company, so it is transferred to Share Capital Account. For transferring share application money to Share Capital the following journal entry is passed:

Share Application A/c	Dr.
<u>To Share Capital A/c</u>	

Step 3: Sometimes, the application money received by the company is rejected or returned to some applicant when Board of Directors do not allot any shares to them. On the return of application money the following journal entry will be made:

Share Application A/c	Dr.
<u>To Bank A/c</u>	
(No. of share which is Rejected × Rate of application)	

NOTES

Step 4: Share Allotment is made due on actual number of shares issued in case of full subscription or over-subscription. *For example*, the company issues 10,000 shares and application is received for 12,000 shares or 10,000 shares. In both the cases allotment will be made due on 10,000 shares. If applications were received for 8,000 shares, share allotment will be made due on 8,000 shares. The journal entry for making allotment due will be made as under:

Share Allotment A/c	Dr.
<u>To Share Capital A/c</u>	

Step 5: On Receiving Share Allotment:

Bank A/c	Dr.
<u>To Share Allotment A/c</u>	

(With the actual amount received on allotment)

Combined Share Application and Allotment Account. In certain cases, the company maintains combined account for share application and allotment. In such case separate journal entries for share application and share allotment are not made. A combined account known as "Share Application and Allotment A/c" is opened. The following journal entries are passed:

For receiving share application and allotment money

Bank A/c	Dr.
<u>To Share Application and allotment A/c</u>	

For transfer to share capital

Share Application and Allotment A/c	Dr.
<u>To Share Capital A/c</u>	

Step 6: After receiving allotment, the company makes the call due. The company can call the money on first call, second call, and third call. No call shall exceed one-fourth of the Nominal value of share. At least 14 days' notice must be given to shareholders for payment of the call. Journal entry for making the call due will be made as under:

Share Call A/c	Dr.
<u>To Share Capital A/c</u>	

Step 7: Share call is made due on actual number of shares allotted irrespective of share call money received or not received.

Bank A/c	Dr.
<u>To Share Call A/c</u>	

This journal entry is made with the actual amount of call received.

Points to be Considered While Issuing Shares to the Public

The following points should be kept in mind while issuing the share capital for public subscription:

1. The application money should be at least 5% of the face value of the share.
2. Calls are to be made as per the provisions of the articles of association.
3. Where there is no articles of association of its own, the following provisions of Table F of Companies Act 2013 will apply:

- (a) A period of one month must elapse between two calls;
- (b) The amount of call should not exceed 25% of the face value of the share;

- (c) A minimum of 14 days notice is given to the shareholders to pay the amount; and
 (d) Calls must be made on a uniform basis on all shares within the same class.

Illustration 1 (Full Subscription of Shares). The Guardians Ltd. issued 30,000 shares of ₹ 10 each, payable ₹ 2 on application, ₹ 3 on allotment, ₹ 3 on First call and the balance ₹ 2 on Second and Final call. The shares were fully subscribed and all the amount due was received.

Pass necessary Journal Entries.

NOTES

Solution.		Journal		
Date	Particulars	L.F.	Debit (₹)	Credit (₹)
	Bank A/c To Share Application A/c <i>(Being application money on 30,000 shares @ ₹ 2 per share received)</i>	Dr.	60,000	60,000
	Share Application A/c To Share Capital A/c <i>(Being application money on 30,000 shares @ ₹ 2 per share transferred to Share Capital A/c)</i>	Dr.	60,000	60,000
	Share Allotment A/c To Share Capital A/c <i>(Being allotment money on 30,000 shares @ ₹ 3 per share made due)</i>	Dr.	90,000	90,000
	Bank A/c To Share Allotment A/c <i>(Being allotment money on 30,000 shares @ ₹ 3 per share received)</i>	Dr.	90,000	90,000
	Share First Call A/c To Share Capital A/c <i>(Being first call money on 30,000 shares @ ₹ 3 per share made due)</i>	Dr.	90,000	90,000
	Bank A/c To Share First Call A/c <i>(Being share first call money on 30,000 shares @ ₹ 3 per share received)</i>	Dr.	90,000	90,000
	Share Second and Final Call A/c To Share Capital A/c <i>(Being final call money on 30,000 shares @ ₹ 2 per share made due)</i>	Dr.	60,000	60,000
	Bank A/c To Share Second and Final Call A/c <i>(Being final call money on 30,000 shares @ ₹ 2 per share received)</i>	Dr.	60,000	60,000

Combined Call of Share Application and Allotment

In certain cases application and allotment money can be called together. Such call is known as combined call. Its treatment in the books of accounts will be made as under:

NOTES

Illustration 2 *The Deceney Ltd. issued 10,000 shares of ₹ 10 each, payable ₹ 5 on application and allotment, ₹ 3 on first call and ₹ 2 on final call. All the shares were applied and fully subscribed. Pass necessary Journal Entries.*

Solution. In the Books of Deceney Limited
Journal

Date	Particulars	L.F.	Debit (₹)	Credit (₹)
	Bank A/c Dr. To Share Application and Allotment A/c (Being application and allotment money on 10,000 shares @ ₹ 5 per share received)		50,000	50,000
	Share Application and Allotment A/c Dr. To Share Capital A/c (Being application and allotment money on 10,000 shares @ ₹ 5 per share transferred to Share Capital A/c)		50,000	50,000
	Share First Call A/c Dr. To Share Capital A/c (Being first call money on 10,000 shares @ ₹ 3 per share made due)		30,000	30,000
	Bank A/c Dr. To Share First Call A/c (Being first call money on 10,000 shares @ ₹ 3 per share received)		30,000	30,000
	Share Second and Final Call A/c Dr. To Share Capital A/c (Being final call money on 10,000 shares @ ₹ 2 per share made due)		20,000	20,000
	Bank A/c Dr. To Share Final Call A/c (Being final call money on 10,000 shares @ ₹ 2 per share received)		20,000	20,000

ACCOUNTING OF PREFERENCE SHARE CAPITAL

According to Indian Companies Act 2013, a company can issue two classes of shares— (i) Equity or ordinary shares and; (ii) Preference shares. In order to take benefit of the psychology of those investors, who want regular source of income, the Company issues preference shares, where dividend at fixed rate is received. Priority regarding the payment of dividend at fixed rate and refund of capital is provided to preference shareholders. This is why, these shareholders are called Preference Shareholders.

Accounting Treatment. Preference shares are issued by the same procedure and in the same manner, in which equity shares are issued. The entire face value of share is called up

in certain instalments, known as preference share application, preference share allotment and preference share calls.

This can further be explained with the help of following illustration:

Combined Call of Preference Share Application and Allotment

There may be combined call of preference share application and allotment also. In this case following accounting treatment will be made:

Illustration 3 (Combined Call of Preference Shares application and allotment). Efficiency Limited issued 40,000 preference shares of ₹ 10 each, payable ₹ 6 on application and allotment and the balance on first and final call. Shares were fully subscribed and all amounts received. Pass necessary Journal Entries.

Solution.		Journal		
Date	Particulars	L.F.	Debit (₹)	Credit (₹)
	Bank A/c Dr. To Preference Share Application and Allotment A/c (Being application and allotment money on 40,000 shares @ ₹ 6 per share received)		2,40,000	2,40,000
	Preference Share Application and Allotment A/c Dr. To Preference Share Capital A/c (Being transfer of preference share application and allotment money to preference share capital)		2,40,000	2,40,000
	Preference Share First and Final Call A/c Dr. To Preference Share Capital A/c (Being first and final call on 40,000 shares @ ₹ 4 per share made due)		1,60,000	1,60,000
	Bank A/c Dr. To Preference Share First and Final Call A/c (Being final call money on 40,000 preference shares @ 4 per share received)		1,60,000	1,60,000

PREPARATION OF CASH BOOK

Why Cash Book is Prepared?

Cash book is prepared to record cash transactions of the company. In case of a company, most of the payments are made through bank and receipts are also banked. The company has got its account in the scheduled bank and the shareholders are asked to deposit their application, allotment and calls money direct to the bank. As such cash book bears bank column only.

What is the Significance of Cash Book?

The significance of cash book is to disclose the balance of bank at a glance at any moment. The preparation of cash book is also useful in the sense that it reduces the burden of Journal entries as all transactions relating to cash i.e., receiving application, allotment, calls money and refunding application money are posted direct into the cash book.

NOTES

Rules Regarding Cash Book.

The debit side of cash book as usual records receipts, as bank being a personal account is debited for receipts. Bank account belongs to assets and assets are debited for increase. In the same way, when excess money received on application is refunded, it is shown at the credit side of the cash book.

NOTES

Steps for Preparation of Cash Book

Step 1: Prepare format of cash book.

Step 2: Write the opening balance of cash at the debit side as 'To Balance b/d'.

Step 3: Post all receipts of Share application, Share allotment, Calls etc. at the debit side with respective date.

Step 4: Any refund of application money on account of over-subscription of shares will be credited.

Step 5: Find out the closing balance.

Specimen of Cash Book

Dr.

(Bank Column only)

Cr.

Date	Particulars	Amount (₹)	Date	Particulars	Amount (₹)
	To Balance b/d (if any)	—		By Share Application	
	To Share Application A/c (— shares @ ₹—)	—		(If excess on application is refunded)	—
	To Share Allotment A/c (— shares @ ₹—)	—		By Balance c/d (closing balance)	—
	To Calls paid in Advance A/c (if any)	—			
	To Share first call (— shares @ ₹—)	—			
	To Share final call A/c (— shares @ ₹—)	—			
	To Share Capital A/c (in case of reissue of forfeited shares)	—			
		—			—

OVER-SUBSCRIPTION OF SHARES

Meaning

"Over-subscription is a situation when applications received are for more shares than the number of shares offered to the public for subscription through prospectus by a company." For example, if a company offers 50,000 shares of ₹ 10 each for public subscription and the application is received for more than 50,000 shares i.e., 60,000, this will be a case of over-subscription.

NOTES

Share Allotment A/c To Share Capital A/c <i>(Being allotment money on 20,000 shares @ ₹ 4 per share made due)</i>	Dr.	80,000	80,000
Bank A/c To Share Allotment A/c <i>(Being allotment money on 20,000 shares @ ₹ 4 per share after adjusting ₹ 16,000 received in advance for allotment, received)</i>	Dr.	64,000	64,000

Note.	No. of Shares applied	No. of Shares allotted	Share Application (₹)	Credited to Share capital (₹)	Credited to Share Allotment (₹)	Credited to Bank (₹)
	6,000	—	24,000	—	—	24,000
	8,000	4,000	32,000	16,000	16,000	—
	16,000	16,000	64,000	64,000	—	—
	<u>30,000</u>	<u>20,000</u>	<u>1,20,000</u>	<u>80,000</u>	<u>16,000</u>	<u>24,000</u>

Illustration 5 (Over-subscription, Calls paid in Advance and Calls in Arrears). The Wye Ltd. was registered with a capital of ₹ 5,00,000 divided into 20,000 shares as ₹ 25 each, payable as follows : ₹ 2.50 per share on application, ₹ 7.50 per share on allotment and the balance in two calls of ₹ 7.50 per share each. The company offered to the public for subscription 10,000 shares but applications were received for 10,500 shares. A applied for 400 shares, paid ₹ 1,000 on application, but was allotted only 200 shares. B applied for 800 shares, paid the full amount, ₹ 20,000 of his share money on application, was allotted only 500 shares and the surplus money was returned to him. C applied for 1,000 shares paid his application and allotment money in order, paid ₹ 2,000 on first call and did not pay for the second call at all. Make Journal Entries to record the above transactions.

Solution. In the Books of Wye Limited
Journal

Date	Particulars	L.F.	Debit (₹)	Credit (₹)
	Bank A/c To Share Application A/c <i>(Being application money on 9,700 shares @ ₹ 2.50 and on 800 shares @ ₹ 25 per share received)</i>	Dr.	44,250	44,250
	Share Application A/c To Share Capital A/c To Share Allotment A/c To Share First Call A/c To Share Final Call A/c To Bank A/c <i>(Being application money on 10,000 shares @ ₹ 2.50 per share transferred to Share Capital A/c, on 300 shares refunded and on 500 shares transferred to share allotment, first call and final call @ ₹ 7.50 per share)</i>	Dr.	44,250	25,000 4,250 3,750 3,750 7,500
	Share Allotment A/c To Share Capital A/c <i>(Being allotment money on 10,000 shares @ ₹ 7.50 per share made due)</i>	Dr.	75,000	75,000

Bank A/c To Share Allotment A/c <i>(Being allotment money on 10,000 shares @ ₹ 7.50 per share received after adjusting ₹ 4,250 received in advance)</i>	Dr.	70,750	70,750
Share First Call A/c To Share Capital A/c <i>(Being first call money on 10,000 shares @ ₹ 7.50 per share made due)</i>	Dr.	75,000	75,000
Bank A/c To Share First Call A/c <i>(Being first call money on 10,000 shares @ ₹ 7.50 per share after adjusting call in arrears of ₹ 5,500 and ₹ 3,750 as calls paid in advance received)</i>	Dr.	65,750	65,750
Share Final Call A/c To Share Final Call A/c <i>(Being first call money on 10,000 shares @ ₹ 7.50 per share made due)</i>	Dr.	75,000	75,000
Bank A/c To Share Final Call A/c <i>(Being first call money on 9,000 shares @ ₹ 7.50 per share after adjusting calls in arrears and ₹ 3,750 as calls paid in advance received)</i>	Dr.	63,750	63,750

NOTES

Working Notes

(i) Calculation of application money received:	₹
On 10,500-800 = 9,700 shares @ ₹ 2.50	= 24,250
per share = 9,700 × 2.50	= 20,000
+ on 800 shares @ ₹ 25 = 800 × 25	<u>44,250</u>
(ii) Adjustment of over-subscription:	
Total money paid on application 800 × 25	= 20,000
Less: money refunded on unallotted shares (i.e., 300 × 25)	<u>(-) 7,500</u>
	12,500
Less: amount utilised for application i.e., 500 × 2.50	<u>(-) 1,250</u>
	11,250
Less: amount retained for allotment on allotted shares i.e., 500 × 7.50	<u>(-) 3,750</u>
Surplus amount after allotment	7,500
Less: amount retained for first call on allotted shares, i.e., 500 × 7.50	<u>(-) 3,750</u>
Surplus amount after first call	3,750
Less: amount retained for final call on allotted shares, i.e., 500 × 7.50	<u>(-) 3,750</u>
	<u>Nil</u>

NOTES

(iii) Total money transferred to Allotment:	
On 200 shares applied by A @ ₹ 2.50 =	.500
On 500 shares applied by B @ ₹ 7.50 =	3,750
	<u>4,250</u>
(iv) Amount received on First Call:	
Total amount due on 10,000 shares @ ₹ 7.50 =	75,000
Less: amount received in advance =	(3,750)
Less: calls in arrears from C (7,500 – 2,000) =	(5,500)
	<u>65,750</u>
Amount received on Final Call (75,000 – 3,750 – 7,500)	<u>= 63,750</u>

UNDER SUBSCRIPTION OF SHARES

Under subscription of shares indicates lesser shares subscribed by the public than what was offered to them. For example, if 10,000 shares of ₹ 10 each are offered for public subscription and actually share applications are received for 9,500 shares, the issue is said to be under subscribed to the extent of 500 shares.

ISSUE OF SHARES AT PAR

Issue of shares at the face value is known as issue of shares at par. For example, if a share of ₹ 10 is issued for ₹ 10 or a share of ₹ 100 for ₹ 100 that means the shares have been issued at par. The face value of shares may be called in full or in certain instalments as per the decision and requirement of the company.

ISSUE OF SHARES AT PREMIUM

A company can issue its shares at more than its face value. Excess of issue price of share over its face value is termed as securities premium. If a share of ₹ 10 is issued at ₹ 12 per share, the excess of ₹ 2 i.e., 12 – 10 will be termed as securities premium.

Note. According to section 53 of the Companies Act 2013, A company cannot issue share at a discount.

Securities Premium is a gain to the company, because the Company is receiving more than the par value (face value) of share. While passing journal entry Securities Premium A/c is credited. Securities Premium Account should be treated on share allotment, unless otherwise mentioned. Securities Premium Account may be credited at the time of making allotment due or receiving allotment. Both the treatments are correct.

➤ **Accounting Treatment 1 (Due Method or Due Basis)**

(i) Share Allotment A/c	Dr.
To Share Capital	
To Securities Premium	
(ii) Bank A/c	Dr.
To Share Allotment	

➤ **Accounting Treatment 2 (Receipt Method/Receipt Basis)**

(i) Share Allotment A/c	Dr. [Excluding Premium]
To Share Capital	
(ii) Bank A/c	Dr.
To Share Allotment	
To Securities Premium	

Illustration 6 (Issue of Shares at Premium, Partially called up). A company issued 20,000 shares of ₹ 10 each at ₹ 12 per share. The amount was payable at ₹ 3 on application, ₹ 5 (including premium of ₹ 2) on allotment and the balance on First and Final call. The company did not make the final call. All the shares were subscribed and amount duly received. Pass necessary Journal Entries regarding allotment under Due Method and Receipt Method.

Solution.**Journal (Traditional Method)**

Date	Particulars	L.F.	Debit (₹)	Credit (₹)
	Under Due Method (Also known as Due basis)			
	Share Allotment A/c	Dr.	1,00,000	
	To Share Capital A/c			60,000
	To Securities Premium A/c			40,000
	<i>(Being allotment money on 20,000 shares @ ₹ 5 including a premium of ₹ 2 per share made due)</i>			
	Bank A/c	Dr.	1,00,000	
	To Share Allotment A/c			1,00,000
	<i>(Being share allotment money on 20,000 shares @ ₹ 5 including ₹ 2 per share as premium received)</i>			

Journal (Alternative (Recent) Method)

Date	Particulars	L.F.	Debit (₹)	Credit (₹)
	Under Receipt Method (Also known as Receipt basis)			
	Share Allotment A/c	Dr.	60,000	
	To Share Capital A/c			60,000
	<i>(Being allotment money on 20,000 shares @ ₹ 3 per share made due)</i>			
	Bank A/c	Dr.	1,00,000	
	To Share Allotment A/c			60,000
	To Securities Premium A/c			40,000
	<i>(Being allotment money on 20,000 shares @ ₹ 3 per share and premium money @ ₹ 2 per share received)</i>			

- Notes.** (i) In view of the restrictions placed on the utilisations of securities premium money under Section 52(2), of Indian Companies Act, 2013 alternative method should be preferred.
- (ii) Traditional method being commonly used by most of the authors as yet, the same method has also been followed in this book.
- (iii) The balance of Securities Premium A/c is shown at the Reserves and Surplus part of schedule III Balance Sheet.

Illustration 7 (Issue of Shares at Premium). Good Luck Limited issued 25,000 shares of ₹ 10 each, at a premium of ₹ 2 per share and asked the shareholders to pay the entire amount with the application. 15,000 shares were applied and fully paid. Pass the necessary Journal Entry.

NOTES

Solution.

Journal

Date	Particulars	L.F.	Debit (₹)	Credit (₹)
	Bank A/c Dr.		1,80,000	
	To Share Capital A/c			1,50,000
	To Securities Premium A/c			30,000
	<i>(Being amount of Share Capital on 15,000 shares @ ₹ 10 per share and amount of securities premium @ ₹ 2 per share received)</i>			

Illustration 8 (Over-subscription and Securities Premium). X-company issued ₹ 10,00,000 new capital, divided into 100 shares at a premium of ₹ 20 per share payable, thus:

₹ 10 per share on application;

₹ 40 per share and ₹ 10 premium on allotment; and

₹ 50 per share and ₹ 10 premium on final payment.

Over-payments on application were to be applied towards sums due on allotment and over-payments on application exceeding sums due on allotment were to be returned. Where no allotment was made, money was to be returned in full. The issue was over subscribed to the extent of 13,000 shares. Applicants for 12,000 shares were allotted only 1,000 shares and applicants for 2,000 shares were sent letters of regret and application deposit were returned to them. All the money due on allotment and final call was duly received.

Make the necessary Journal Entries in the Company's books to record the above transactions.

Solution.

In the Books of X Company

Journal

Date	Particulars	L.F.	Debit (₹)	Credit (₹)
	Bank A/c Dr.		2,30,000	
	To Share Application A/c			2,30,000
	<i>(Being application money on 23,000 shares @ ₹ 10 per share received)</i>			
	Share Application A/c Dr.		2,30,000	
	To Share Capital A/c			1,00,000
	To Share Allotment A/c			50,000
	To Bank A/c			80,000
	<i>(Being application money on 10,000 shares transferred to share capital and the balance transferred to Share Allotment A/c and refunded)</i>			
	Share Allotment A/c Dr.		5,00,000	
	To Share Capital A/c			4,00,000
	To Securities Premium A/c			1,00,000
	<i>(Being allotment money on 10,000 shares @ ₹ 50 per share including a premium of ₹ 10 per share made due)</i>			
	Bank A/c Dr.		4,50,000	
	To Share Allotment A/c			4,50,000
	<i>(Being allotment money on 10,000 shares @ ₹ 50 including premium was received except allotment received in advance)</i>			

Share First and Final Call A/c	Dr.	6,00,000	
To Share Capital A/c			5,00,000
To Securities Premium A/c			1,00,000
<i>(Being final call on 10,000 shares @ ₹ 60 per share including premium of ₹ 10 made due)</i>			
Bank A/c	Dr.	6,00,000	
To Share Final Call A/c			6,00,000
<i>(Being final call money on 10,000 shares @ ₹ 60 including ₹ 10 as premium per share received)</i>			

NOTES

Working Note**Adjustment of over-subscription (allottee of 12,000 shares):**

Application money received on ₹ 12,000 shares @ ₹ 10 = 1,20,000

Less: amount utilised as application money on 1,000

allotted shares i.e., 1,000 × 10

(-) 10,000

1,10,000

Less: money retained for allotment on 1,000

shares @ ₹ 50

(-) 50,000

Excess money to be refunded as per terms of issue

60,000

Those applicants, who applied for 2,000 shares were not allotted any share, so their application money i.e., 2,000 × 10 = 20,000 will be refunded.

Total money to be refunded 60,000 + 20,000 = ₹ 80,000.

CALLS IN ADVANCE

The company may receive calls in advance, if the Articles permit. It is the amount paid by the shareholder of a company even before the particular call is made due. Table 'F' of the Companies Act permits to receive calls in advance.

Disclosure in the Balance Sheet:

Calls in Advance is shown in Notes to Accounts of sub-head "Other Current Liabilities" of main head Current Liabilities.

The articles should specify the rate at which interest is to be paid. Table F of Companies Act 2013 leaves the matter of rate of interest to the Board of Directors subject to maximum of 12 per cent per annum.

For example, a company issues 10,000 shares of ₹ 10 each payable ₹ 3 on Application, ₹ 3 on Allotment and the balance of ₹ 4 on First and Final call. The company made its allotment due but A, the holder of 100 shares paid the entire amount of shares together with allotment. In this case the payments of ₹ 400 i.e., 100 × 4 on allotment for First and Final Call is calls paid in advance.

The journal entry in the above example will be made as under:

NOTES

Date	Particulars	L.F.	Debit (₹)	Credit (₹)
(i)	For making allotment due Share Allotment A/c Dr. To Share Capital A/c <i>(Being allotment money on 10,000 shares @ ₹ 3 per share made due)</i>		30,000	30,000
(ii)	For receiving Share allotment Bank A/c Dr. To Share Allotment A/c To Calls in Advance A/c <i>(Being allotment on 10,000 shares @ ₹ 3 and call money on 100 shares @ ₹ 4 received)</i>		30,400	30,000 400
(iii)	For making Share First and Final Call due Share First and Final Call A/c Dr. To Share Capital A/c <i>(Being final call money on 10,000 shares @ ₹ 4 per share made due)</i>		40,000	40,000
(iv)	For receiving Share First and Final Call Bank A/c Dr. Calls in advance A/c Dr. To Share First and Final Call A/c <i>(Being First call money on 9,900 shares @ ₹ 4 per share received after adjusting calls paid in advance on 100 shares)</i>		39,600 400	40,000

Calls in Advance account is closed when the particular call on which advance money is received made due alongwith the amount received on that call, which can be seen in the entry (iv).

The company may receive calls paid in advance, if the Articles of Association of the Company permits. Table 'F' of the Companies Act, 2013 permits the shareholder to pay calls in advance. Articles should specify the rate at which interest on calls paid in advance has to be paid. Table 'F' specifies 12% per annum as maximum rate of interest. Interest is calculated for the period between receiving the call in advance and the date on which the call is due for payment.

CALLS IN ARREAR

This is the amount called by the company, but remains unpaid. When a person applies for the shares of company, he makes an offer. If the company accepts the application and allots the shares to the person, it becomes a valid contract. The shareholder, thus becomes liable to pay the entire amount of shares. In case, he fails to pay the allotment and calls on shares held by him, the unpaid amount is known as calls in arrears. For example, A was allotted 100 shares. He paid application money @ ₹ 3 per share and allotment @ ₹ 3 per share but did not pay first call of ₹ 2 and final call of ₹ 2 per share. In this case, calls in arrears will amount to ₹ 400 i.e., 100 (2 + 2).

Interest on Calls in Arrear

A member is generally liable to pay interest on calls made but not paid. Table F of Companies Act 2013 provides a rate of interest of 10% per annum or such lower rate as the Board of Directors may determine. However, the Board of Directors is at liberty to waive payment of any such interest wholly or partly.

Treatment of Calls in Arrear in the books of Accounts. While receiving the particular call on which a certain amount remains unpaid calls in arrears account is debited or the entry is passed with the actual amount received. Calls in arrears account may not be opened or may be opened. This can be explained with the following illustration:

Illustration 9 (Calls in Arrears). A company issued 10,000 shares of ₹ 10 each, payable ₹ 3 on application, ₹ 3 on allotment and the balance of ₹ 4 on first and final call. Final call was not received on 1000 shares. Pass necessary journal entries regarding Final Call.

Solution.

Journal

Date	Particulars	L.F.	Debit (₹)	Credit (₹)
(i) Without opening calls in Arrears Account				
	Share First and Final Call A/c To Share Capital A/c <i>(Being Final Call on 10,000 shares @ ₹ 4 per share made due)</i>	Dr.	40,000	40,000
	Bank A/c To Share First and Final Call A/c <i>(Being Final Call money on 9,000 shares @ ₹ 4 per share received)</i>	Dr.	36,000	36,000
(ii) Alternatively. By opening Calls in Arrears Account. Entry for receiving Share Final Call will be:				
	Bank A/c Calls in Arrears A/c To Share First and Final Call A/c <i>(Being Final call money on 10,000 shares @ ₹ 4 per share except on 1,000 shares received)</i>	Dr. Dr.	36,000 4,000	40,000

Difference between Call in Arrears and Calls Paid in Advance

Bases of Difference	Calls in Arrears	Calls Paid in Advance
1. Meaning	Calls remaining unpaid by the specified date is known as calls in arrear.	Calls paid by the shareholders before it is made due is known as calls paid in advance.
2. Interest	Interest on calls in arrear is charged.	Interest on calls paid in advance is paid.
3. Rate of Interest	The maximum rate of interest as per table 'F' is 10% p.a.	The maximum rate of interest as per table 'F' is 12% p.a.
4. Disclosure in the Balance Sheet	It is shown as deducted from capital.	It is shown as a separate item under the head current liabilities.

Disclosure in the Balance Sheet

Calls in Arrears is shown as deduction in Notes to Accounts of Share Capital from the Subscribed but not fully paid up Capital under Subscribed Capital.

NOTES

Note 1: Share Capital

NOTES

<i>Particulars</i>	<i>Amount (₹) Current Year</i>	<i>Amount (₹) Previous Year</i>
Authorised Capital ... Shares of ₹ ... each	...	
Issued Capital ... Shares of ₹ ... each	
Subscribed Capital Subscribed and fully paid up ... Shares of ₹ ... each	xxx	
Subscribed but not fully paid up ... Shares of ₹ ... each ... Called up	xxx	
Less-calls in-Arrear	(xxx)	
Total	xxx	

ISSUE OF SHARES FOR CONSIDERATION OTHER THAN CASH

The company purchases certain assets from vendors (sellers or suppliers) on credit. Instead of making payment to vendors in cash, the company issues them certain agreed number of shares at an agreed rate as a consideration (payment in exchange) of assets purchased. Shares may be issued to vendors at par or at premium. The requisite journal entry to be passed is as under:

1. On purchasing the asset

Particular Asset A/c Dr.

or

Sundry Assets A/c Dr.

To Vendor A/c

[Purchase Consideration]

2. On purchasing the business of a going concern

Sundry Assets A/c Dr.

[Agreed value]

Goodwill A/c Dr.

To Sundry Liabilities

[Agreed value]

To Vendor A/c

[Purchase Consideration]

To Capital Reserve

Notes:

- (i) If the name of assets and liabilities are given individually, it is advisable to write their name individually alongwith there agreed value.
- (ii) Purchase consideration means the amount paid or payable for purchase of assets or business as the case may be.
- (iii) Net Worth means the value of the business.
Net Worth = Total Assets – External Liabilities
- (iv) Either Goodwill A/c or Capital Reserve will appear in (2) journal entry depending upon the below conditions:
 - (a) In case Net Worth is less than the purchase consideration, then the difference is debited to Goodwill A/c.
 - (b) In case Net Worth is more than the purchase consideration, then the difference is credited to Capital Reserve A/c.
 - (c) In case Net Worth is equal to purchase consideration then neither Goodwill A/c nor Capital Reserve A/c will appear.

3. On part payment to Vendor

Vendor A/c	Dr.	[Amount Paid]
	To Bank/Cash A/c	

4. On issue of shares**(i) Issue at part**

Vendor A/c	Dr.	[Amount payable]
	To Share Capital A/c	[Nominal value of shares issued]

(ii) Issue at premium

Vendor A/c	Dr.	[Amount payable]
	To Share Capital A/c	[Nominal value of shares issued]
	To Securities Premium	[Premium on issue of shares]

Notes:

(a) Amount Payable = Purchase Consideration – Amount Paid

(b) Number of shares issued will be calculated as follows:

$$\text{No. of Shares Issued} = \frac{\text{Amount payable}}{\text{Issue Price of a Share}}$$

Disclosure in the Balance Sheet

Shares issued for consideration other than cash is shown in Notes to Accounts of sub head "Share Capital" under the sub-head of "Subscribed Share Capital".

Illustration 10 ITC Ltd., whose subscribed shares capital is of ₹ 1,00,00,000 equity shares of ₹ 10 each, purchase Plant and Machinery from Sunil Ltd. and issued 20,000 fully paid equity shares of ₹ 10 each to Sunil Ltd. Show the following:

- (a) Share Capital in the Balance Sheet of ITC Ltd. as per Schedule III Part I of the Companies Act, 2013.
 (b) Also prepare 'Notes to Accounts' for the same.

Solution.**Extract of Balance Sheet of ITC Ltd.**

As at.....

Particulars	Note No.	Amount (₹) Current Year	Amount (₹) Previous Year
I. EQUITY & LIABILITIES			
1. Shareholder's funds:			
(a) Share Capital	1	1,02,00,000	

Notes to Accounts**Note 1: Share Capital**

Particulars	Amount (₹) Current Year	Amount (₹) Previous Year
Authorised Capital		
... Shares of ₹ ... each	...	
Issued Capital		
... Shares of ₹ ... each	...	
Subscribed Capital		
Subscribed and fully paid up		
10,20,000 Equity Shares of ₹ 10 each	1,02,00,000	
(out of the above 20,000 shares, have been issued for consideration other than cash)		
Total	1,02,00,000	

NOTES

NOTES

Illustration 11 Pass necessary journal entries for the following transactions in the books of Rajan Ltd.:

Rajan Ltd. purchased a running business from Vikas Ltd. for a sum of ₹ 2,50,000 payable as ₹ 2,20,000 in fully paid equity shares of ₹ 10 each and balance by a bank draft. The assets and liabilities consisted of the following:

Plant & Machinery ₹ 90,000; Building ₹ 90,000; Sundry Debtors ₹ 30,000; Stock ₹ 50,000; Cash ₹ 20,000; Sundry Creditors ₹ 20,000.

Solution.

Rajan Ltd.

Journal

Date	Particulars	L.F.	Debit (₹)	Credit (₹)
	Plant & Machinery A/c	Dr.	90,000	
	Building A/c	Dr.	90,000	
	Sundry Debtors A/c	Dr.	30,000	
	Stock A/c	Dr.	50,000	
	Cash A/c	Dr.	20,000	
	To Sundry Creditors A/c			20,000
	To Vikas Ltd.			2,50,000
	To Capital Reserve A/c (Balancing Fig.)			10,000
	(Business purchased from Vikas Ltd.)			
	Vikas Ltd.	Dr.	2,50,000	
	To Equity Shares Capital A/c			2,20,000
	To Bank A/c			30,000
	(Shares issued and draft given to Vikas Ltd.)			

SUMMARY

- **Joint Stock Company.** It is an artificial person, created by law, with a fixed capital, divisible into transferable shares, with perpetual succession and common seal.
- **Types of Shares:**
 1. **Equity/Ordinary Share.** A share, which is not a preference share is called equity share (Section 43 of Companies Act).
 2. **Preference Shares.** Share entitled to priority in the payment of dividend at a fixed rate and also in return of a capital in the event of winding up are known as preference shares.
- **Types of Preference Shares.**
 - **Preference Shares:** Cumulative and Non-cumulative, Redeemable and Irredeemable, Participating and Non-participating, Convertible and Non-convertible and Guaranteed preference shares.
- **Status of Preference Shareholders, if Articles of Association is silent**

Preference Shares will be presumed to be (i) Cumulative (ii) Non-Participating (iii) Irredeemable and (iv) Non-convertible.
- **Bases of Difference between Equity Shares and Preference Shares**
 1. Priority of dividend
 2. Predetermined rate of dividend
 3. Refund of share capital
 4. Right to vote
 5. Right to participate in the management.

- **Preparation of Cash Book.** All money transactions of the company are made through Bank. As such, we should always use Bank Account for money transactions and avoid using cash account. While preparing cash book all the receipts are shown at the debit side of cash book (having bank column only).

- **Share Capital.** Capital consisting of denominations/parts of capital are known as share capital.

- **Types of Share Capital.**

1. Authorised, 2. Issued and unissued, 3. Subscribed and unsubscribed, 4. Called up and uncalled up, 5. Paid up and calls in arrears and 6. Unreserved and reserve capital.

Capital in the balance sheet is disclosed under three headings (i) Authorised (ii) Issued and (iii) Subscribed capital. Calls in arrears is deducted from subscribed capital and forfeited shares is added. Capital Reserve and Securities Premium, etc., are shown under the heading of 'Reserve and Surplus' in the Balance Sheet calls paid in advance is shown as current liability.

- **Private Placement of Shares.** Issue and allotment of shares to a selected group of persons is known as Private Placement of Shares.

- **Under-subscription/Over-subscription of Share.** Short subscription of shares is known as under-subscription. Excess Subscription (Receiving applications more than issued number of shares is known as over-subscription.

- **Bases of difference between Over-subscription and Under-subscription**

(i) Number of shares subscribed (ii) Refund or Adjustment (iii) Investors mindset (iv) Retaining over subscribed capital (v) Issued capital.

- **Issue of Shares at Par and Premium**

(i) Shares may be issued at their face value (at par) or more than the face value (at premium).

(ii) If shares are issued at premium we shall be crediting Securities Premium Account with the amount of premium. Securities Premium Account may be credited while making the instalment due or receiving the call. Securities Premium Account should be shown in Schedule III under the heading 'Reserve and Surplus.'

NOTES

REVIEW QUESTIONS

A. Very Short Answer Type Questions:

1. Name the different kinds of the share capital of Company.
2. Point out the main point of difference between called up and paid up capital.
3. What do you mean by Reserve Capital?
4. Mention the side of cash book where you will record refund of application money.
5. How will you deal with over-subscription?
6. Is there any legal restriction on issue of shares at premium?
7. Give the meaning of 'called-up capital'.
8. What are preliminary expenses?

NOTES

B. Short Answer Type Questions:

1. Exhibit different kinds of capital in balance sheet of a company with imaginary figures.
2. Explain briefly the accounting treatment of the following items:
 - (a) Issue of shares for consideration other than cash.
 - (b) Issue of shares to promoters.
3. Write notes on:
 - (a) Over-subscription
 - (b) Calls in Arrears
 - (c) Issue of shares at premium
 - (d) Calls paid in advance.
4. Discuss the treatment of securities premium in the books of accounts.
5. Are there any restrictions on the issue of shares at premium?
6. State the purposes for which Securities Premium can be utilised.
7. What do you mean by calls in advance?
8. Distinguish between over-subscription and under-subscription of shares issued by company.

C. Long Answer Type Questions:

1. What are the different kinds of shares issued by a company? Explain in brief the classification of preference shares.
2. What is authorised capital? What is its significance? How does it differ from issued capital?
3. Discuss the legal provisions regarding issue of shares at discount. How is it recorded in the books of accounts?

Practical Questions

1. A company was formed with an authorised capital of ₹ 18,00,000 divided into 18,000 shares of ₹ 100 each. It issued to the public 15,000 shares, payable as ₹ 30 on application, ₹ 30 on allotment and the balance on first and final call. Applications were received for ₹ 12,000 shares. The amount of allotment was duly received except from Mahesh, who held 1,000 shares did not pay allotment. The company did not make call.

How will you show share capital in the Balance Sheet?

2. A company issued 40,000 shares of ₹ 10 each, payable ₹ 4 on application, ₹ 4 on allotment and the balance of final call. Applications were received for 60,000 shares. The board of directors rejected applications for 12,000 shares and allotted 50% to the applicants of 16,000 shares. The company did not make the final call.

Pass the necessary Journal Entries.

3. Efficiency Co. Ltd., issued 20,000 shares of ₹ 10 each, at a premium of ₹ 4 per share, payable ₹ 1 per share on application, ₹ 6 per share on allotment (including premium), ₹ 3, on first call and ₹ 4 on final call. The shares were all subscribed and money was duly received except the first call money on 4,000 shares and the final call money on 6,000 shares.

Give the Journal and Cash Book entries to record the above transactions.

[Ans. Total of Cash Book ₹ 2,44,000]

NOTES

4. Competency Limited Company offered for subscription 3,90,000 shares of ₹ 25 each, payable ₹ 5 per share on application, ₹ 10 per share on allotment (including ₹ 5 per share as premium), ₹ 5 per share as first call on the shares and the balance in two equal amounts at intervals of three months. All the shares were applied for and allotted. All the money were received excepting the 2nd call and the final call money on 7,800 and 15,600 shares respectively.

You are asked to show the entries in the Company's Journal, Cash Book and the Ledger. Show also the Company's Balance Sheet on completion of the above transactions.

[Ans. Total of Cash Book, ₹ 1,15,83,000, Total of Balance Sheet ₹ 1,15,83,000]

5. X, Y, Z Co. Ltd., issued 90,000 Equity shares of ₹ 10 each at a premium of ₹ 2 per share and 9,000, 10% Preference Shares of ₹ 100 each payable as follows:

	<i>Equity Shares</i>	<i>Preference Shares</i>
	₹	₹
On Application	2	20
On Allotment	5 (including premium)	35
On First Call	3	25
On Final Call	2	20

All the shares offered were subscribed for by the public and cash duly received. *Pass necessary Journal Entries to record the above issue of shares.*

6. J.P. Ltd., purchased building costing ₹ 70,00,000 from M/s Construction Ltd. The company paid ₹ 20,50,000 by cheque and for the balance issued equity shares of ₹ 100 each in favour of M/s Construction Ltd. *Pass necessary journal entries in the books of J.P. Ltd. for the purchase of building and making payment if shares were issued at a premium of 25%.*

CHAPTER 12 FORFEITURE AND REISSUE OF SHARES

NOTES

☆ STRUCTURE ☆

- ☆ Forfeiture and Reissue of Shares
- ☆ Accounting Treatment of Forfeiture of Shares
- ☆ Forfeiture and Reissue of Shares, Earlier Issued at Premium

FORFEITURE AND REISSUE OF SHARES

Meaning

Forfeiture of shares means cancellation of shares. The shareholder, who applies for the shares of the company makes an offer on the one hand, and on the other hand company by accepting shares or allotting shares accords acceptance. In this way offer and acceptance with the lawful consideration make a valid contract between the shareholder and the company. The contract makes it binding upon the shareholders (allottees) to pay the instalment of allotment and calls, whenever due.

Effect of Non-Payment of Instalments

If the shareholder fails to pay allotment or calls money or both, the company sends reminders to the shareholder to make the payment of calls in arrears. In case the reminders do not produce the desired result, the company, if permitted by its Articles of Association, serves a clear 14 days' notice to the shareholder concerned to pay the amount due with interest, if any, by a certain specified date, failing which shares are forfeited.

Effect on Amount Already Paid

Forfeiture means the seizure of shares, as such whatever amount has already been received on shares, being forfeited is seized. While passing journal entry regarding forfeiture, Share Capital Account is debited with the called up amount on shares. The logic behind debiting Share Capital A/c is to cancel the share capital on forfeited shares. Forfeited shares A/c is credited with the amount received on forfeited shares, because whatever the amount has been received will be seized, as such it is a gain to the company and thus credited (being Nominal Account, where rule goes 'Debit all losses and credit all gains'). Calls in Arrears A/c or Specific Call A/c is credited to close these accounts.

Reissue of Shares

The shares forfeited can also be reissued. The reissue of shares involves a decision to be taken by the board of directors of the company. It should be noted the shares can be reissued only when they are forfeited and they cannot be reissued only on the basis of unpaid calls.

ACCOUNTING TREATMENT OF FORFEITURE OF SHARES

In the context of accounting treatment of forfeiture of shares there are following cases:

- (a) If shares are forfeited but not Reissued.
- (b) If shares are forfeited and Reissued.

NOTES

A. Shares are Forfeited but Not Reissued

When shares are forfeited, following journal entry is passed:

Share Capital A/c	Dr.
To Forfeited Shares A/c	
To Unpaid Calls or Calls in Arrears A/c	

(Being forfeiture of shares for non-payment of allotment or calls)

Explanation of the Journal Entry

- **Share Capital A/c.** It is debited, because the amount of share capital will decrease on forfeited shares. As forfeiture means cancellation of shares, so the capital structure built upon the cancelled shares cannot stand. It will have to fall. For demolishing the structure *i.e.*, reduction in Capital, Share Capital A/c will be debited (Rule-Decrease in the capital is debited).

In order to calculate the amount to be written against Share Capital A/c the following hint will be very useful:

Share Capital = Number of forfeited shares × Amount per share called

- (i) *Number of forfeited shares* means only those shares which have been declared forfeited by the company. It is just possible that the number of defaulting shareholders (those shareholders, who have not paid share allotment and calls) may be more, but lesser number of shares may be forfeited.

We are concerned with the number of shares declared forfeited not the defaulters. There may be different categories of defaulters, such as first category may not have paid since allotment, other may not have paid since first call and another since final call. In these cases shareholders, who have not paid their final call may be provided an opportunity to make payment and their shares may not be forfeited. Shares owned by those shareholders, who have not been paid since allotment and their first call may be forfeited.

- (ii) *Amount per share called* means amount which has been asked to be paid by the shareholder to the company.

Suppose the company has issued shares of the face value of ₹ 10, and the amount payable is ₹ 3 on application, ₹ 3 on allotment and the balance on final call. If the company has asked the shareholder to pay all the application, allotment and call money (i.e., ₹ 3 + 3 + 4), the called up amount will be treated to be ₹ 10. In case, the final call has not been made the called up amount will be ₹ 6, i.e., ₹ 3 for application and ₹ 3 for allotment.

- **Forfeited Shares A/c.** Holders of forfeited shares have not paid the amount due, so their contract stands repudiated (cancelled). This is why, the amount paid by them on the shares, being forfeited is seized by the company. The forfeited amount is a gain for the company so it has to be credited (Credit all income or increase in revenue is to be credited). In order to calculate the amount to be written against forfeited shares A/c, the following hint will prove to be very useful:

NOTES

Forfeited Shares = Number of forfeited shares × Amount per share received from them
 Amount per share received means the amount per share paid by the defaulters on the forfeited shares.

Suppose in the above case, if the shareholder has paid application money of ₹ 3 per share only, amount per share received will be ₹ 3 only. If he has paid upto allotment, i.e., ₹ 3 for application and ₹ 3 for allotment, amount per share received will be ₹ 6, i.e., ₹ 3 + 3.

- **Unpaid Calls or Calls in Arrears.** It is the amount which has been called up but still remains unpaid or it is still in arrears. **It should be specifically noted that Calls in Arrears A/c should be credited in the journal entry if this account has already been debited while receiving the instalment remaining unpaid.** Call in Arrears A/c may be credited, if the name of the instalment remaining unpaid is not specified, whether it is on allotment or calls.

Accounting Treatment

In place of Calls in Arrears A/c, we will credit share allotment or share call A/c (remaining unpaid) if we have passed entry while receiving the call with the actual amount received. The amount of calls in arrears or the unpaid calls can be easily ascertained by the following under mentioned hint:

Calls in arrears = Number of forfeited shares × unpaid amount per share.

Journal entry regarding forfeiture is further explained with the following illustration:

Illustration 1 (Forfeiture of Shares). A company forfeited 100 shares of ₹ 10 each for non-payment of allotment of ₹ 3 and final call of ₹ 4 per share.

Pass journal entry regarding forfeiture.

Solution. **In the Books of Company**
Journal

Date	Particulars	L.F.	Debit (₹)	Credit (₹)
	Share Capital A/c Dr.		1,00	
	To Forfeited Shares A/c			300
	To Share Allotment A/c			300
	To Share Final Call A/c			400
	<i>(Being forfeiture of 100 shares for non-payment of allotment and call)</i>			

Note. As the company has called upto final call (i.e., ₹ 3 on application, ₹ 3 on allotment and ₹ 4 on final call) share capital account has been debited with the full value of shares, i.e., 100 × 10 = 1,000. We have received ₹ 3 on application only, so the company can forfeit ₹ 300, the amount received by it. Share allotment and final call A/c have been credited with the unpaid amount on these instalments.

Alternatively, we can credit Calls in Arrears A/c with ₹ 700 instead of crediting share allotment and Share Final Call A/c.

Illustration 2 (Forfeiture of Shares). B Company Ltd. forfeited 500 shares of ₹ 10 each, ₹ 8 per share called up, on which ₹ 3 on application, and ₹ 3 on allotment was received, ₹ 2 on first call remained unpaid.

Pass journal entry regarding forfeiture

Solution. In the Books of B Company
Journal

Date	Particulars	L.F.	Debit (₹)	Credit (₹)
	Share Capital A/c	Dr.	4,000	
	To Forfeited Share A/c			3,000
	To Share First Call A/c or Calls in Arrears A/c			1,000
	<i>(Being forfeiture of 500 shares, ₹ 8 called up for non-payment of first call of ₹ 2 per share)</i>			

NOTES

Effect on the Balance Sheet. Forfeited shares account will be shown as part of Share Capital (under note to Balance Sheet) in Schedule III with '300 in Illustration 1 and ₹ 3,000 in Illustration 2 (If shares are forfeited but not reissued, shares forfeited account is shown in the balance sheet).

B. Shares are Forfeited and Reissued

(i) *Reissue of Forfeited Shares.* Shares, after being forfeited, become quite fresh to be resold or reissued to the same or other shareholders. The amount received from reissue is debited to Bank account. Share capital account is credited with paid up value of reissued shares and forfeited shares account is debited with the difference between the paid up value of shares and the amount received on their reissue.

The Journal Entry will be as follows:

Bank A/c	Dr. (with amount received)
Forfeited Share A/c	Dr. (with amount not received)
To Share Capital	(Total paid up amount)

(Being Reissue of shares as fully paid up)

(ii) *Transfer to Capital Reserve.* After reissue of shares, the balance of 'Forfeited Shares A/c' on reissued shares is transferred to Capital Reserve A/c.

Capital reserve is the profit of capital nature. It is not a revenue of routine nature, earned by the company in its day-to-day affairs. In case of companies, such gain arises, when forfeited shares are reissued for more than the unpaid amount on these shares.

The Journal Entry will be as follows:

Forfeited Shares A/c	Dr.
To Capital Reserve	

(Being remaining balance of forfeited shares account transferred to Capital Reserve A/c)

For example, if the company forfeits a share of ₹ 10 for non-payment of ₹ 4 and reissues it @ ₹ 7. The capital reserve will be the difference between the amount received from the reissue, i.e., ₹ 7 less unpaid amount on forfeited shares, i.e., ₹ 4, as such Capital Reserve will be 7 - 4 = 3. In other words, it may be difference between the amount gained on forfeiture, i.e., ₹ 6 and lost on reissue i.e., ₹ 3. This will also be the same, i.e., ₹ 6 - 3 = 3.

If all the forfeited shares are reissued, capital reserve will be the balancing figure of forfeited shares account. In this example, forfeited shares account would have been credited with ₹ 6, the amount already received from forfeited shares and debited with ₹ 3, so the forfeited shares account will show a credit balance of ₹ 3, which will be transferred to capital reserve.

NOTES

Please Remember

If forfeited shares are not reissued, there will be no capital reserve, and the money will be retained in forfeited shares account. In case a part of the forfeited shares are reissued capital reserve will be formed only on reissued shares.

Capital Reserve Account is shown in the notes to Account under "Reserve and Surplus" in Schedule III Balance Sheet.

The amount of the capital reserve is utilised to meet capital losses.

Journal entries regarding forfeiture and reissue of shares and transfer to capital reserve are explained with the help of the following illustrations:

Illustration 3 (Forfeiture and Reissue of Forfeited Shares). The company forfeited 1,000 shares of ₹ 10 each for non-payment of final call of ₹ 2. All the forfeited shares were issued at ₹ 6 per share, fully paid.

Pass journal entries regarding forfeiture and reissue of shares.

Solution.

In the Books of ...
Journal

Date	Particular	Debit (₹)	Credit (₹)
	Forfeiture of Shares		
	Share Capital A/c Dr.	10,000	
	To Forfeited Shares A/c		8,000
	To Share Final Call A/c or Calls in Arrears A/c		2,000
	<i>(Being forfeiture of 1,000 shares of ₹ 10 each for non-payment of final call of ₹ 2 per share)</i>		
	Reissue of forfeited Shares		
	Bank A/c Dr.	6,000	
	Forfeited Shares A/c Dr.	4,000	
	To Share Capital A/c		10,000
	<i>(Being reissue of 1,000 forfeited shares @ ₹ 6 per share)</i>		
	Transfer of Forfeited Shares A/c to Capital Reserve A/c		
	Forfeited Shares A/c Dr.	4,000	
	To Capital Reserve A/c		4,000
	<i>(Being transfer of balance in the forfeited shares account to capital reserve account)</i>		

Notes. (i) The balance of the forfeited shares account is transferred to capital reserve account, in case all the forfeited shares are reissued. Capital reserve is formed on the reissued forfeited shares.

(ii) While reissuing shares, forfeited shares account is debited with amount of loss on reissued shares. As the profit on forfeiture of shares account was credited to forfeited shares account, it will be proper to debit the same account in case of loss on reissue of the same shares.

Illustration 4 (Forfeiture and Reissue of Forfeited Shares at Different paid up Values). Democracy Ltd. forfeited its 200 shares of ₹ 10 each on which ₹ 5 per share was received. Pass entry regarding reissue of all the shares if:

- (i) Shares are reissued at ₹ 8 per share, fully paid up.
- (ii) Shares are reissued at ₹ 7, ₹ 8 called up.
- (iii) Shares are reissued at ₹ 4.50, ₹ 7 called up.

Solution.

Journal in the Books of Democracy Ltd.

Date	Particulars	L.F.	Debit (₹)	Credit (₹)
	Share Capital A/c Dr.		2,000	
	To Forfeited Shares A/c			1,000
	To Calls in Arrears A/c			1,000
	<i>(Being forfeiture of 200 shares for non-payment of ₹.5 per share)</i>			
(i)	Bank A/c Dr.		1,600	
	Forfeited Shares A/c Dr.		400	
	To Share Capital A/c			2,000
	<i>(Being reissue of 200 forfeited shares @ ₹ 8 fully paid)</i>			
	Forfeited Shares A/c Dr.		600	
	To Capital Reserve A/c			600
	<i>(Being transfer of forfeited shares account to Capital Reserve A/c)</i>			
(ii)	Bank A/c Dr.		1,400	
	Forfeited Shares A/c Dr.		200	
	To Share Capital A/c			1,600
	<i>(Being reissue of 200 shares @ ₹ 7 per share, ₹ 8 called up)</i>			
	Forfeited Shares A/c Dr.		800	
	To Capital Reserve A/c			800
	<i>(Being transfer of forfeited shares account to Capital Reserve A/c)</i>			
(iii)	Bank A/c Dr.		900	
	Forfeited Shares A/c Dr.		500	
	To Share Capital A/c			1,400
	<i>(Being reissue of 200 forfeited shares @ ₹ 4.50 ₹ 7 called up)</i>			
	Forfeited Shares A/c Dr.		500	
	To Capital Reserve A/c			500
	<i>(Being transfer of forfeited shares A/c to Capital Reserve A/c)</i>			

NOTES

Notes. (i) In case of reissue, Share Capital Account is credited with the called up or paid up value of shares.

(ii) If all the forfeited shares are reissued the balancing figure of forfeited shares A/c is transferred to Capital Reserve A/c. Balancing figure means excess of the credit side of forfeited shares A/c over its debit side.

Illustration 5 (Forfeiture and reissue of shares). M limited forfeited 2,000 equity shares of ₹ 10 each, issued at a premium of ₹ 5 per share, held by Ram for non-payment of the Final call of ₹ 3 per share. Of these, 100 shares were reissued to Vishu at a discount of ₹ 4 per share.

Pass Journal Entries.

Solution.

Journal Entries in the Books of M Limited

(i)	Equity Share Capital A/c Dr.	20,000	
	To Forfeited Shares A/c		14,000
	To Equity Share Final Call A/c		6,000
	<i>(Being forfeiture of 2,000 equity shares of ₹10 each for non-payment of final call)</i>		

NOTES

Bank A/c	Dr.	600	
Forfeited Shares A/c	Dr.	400	
To Equity Share Capital A/c			1,000
<i>(Being reissue of 100 forfeited shares at a discount of ₹ 4 per share)</i>			
Forfeited Shares A/c	Dr.	300	
To Capital Reserve A/c			300
<i>(Being transfer of forfeited shares A/c to Capital Reserve A/c)</i>			

Working Note

Gain on forfeiture of 100 shares	$\left(\frac{14,000}{2,000} \times 100 \right) = 700$
Less loss on reissue of 100 shares (100 × 4)	= (400)
Net gain (Capital Reserve) on 100 shares	= 300

Illustration 6 (Forfeiture and reissue of shares). A company forfeited 100 shares of ₹ 10 each, on which B, the shareholder failed to pay allotment of ₹ 5 per share including a premium of ₹ 2 per share and final call of ₹ 3 per share. These shares were reissued at ₹ 8 per share.

Pass Journal Entries regarding forfeiture and reissue of shares.

Solution. If convention of conservatism is applied and Securities Premium A/c is not reinstated as originally intended entries will be passed as under:

Journal

Date	Particulars	L.F.	Debit (₹)	Credit (₹)
(i)	Share Capital A/c	Dr.	1,000	
	Securities Premium A/c	Dr.	200	
	To Forfeited Shares A/c			400
	To Share Allotment A/c			500
	To Share Final Call A/c			300
	<i>(Being forfeiture of 100 shares for non-payment of share allotment and final call)</i>			
(ii)	Bank A/c	Dr.	800	
	Forfeited Shares A/c	Dr.	200	
	To Share Capital A/c			1,000
	<i>(Being reissue of 100 shares @ ₹ 8 per share)</i>			
(iii)	Forfeited Shares A/c	Dr.	200	
	To Capital Reserve A/c			200
	<i>(Being transfer of forfeited shares to Capital Reserve)</i>			

Alternative Treatment

Date	Particulars	L.F.	Debit (₹)	Credit (₹)
(i)	Bank A/c	Dr.	800	
	Forfeited Shares A/c	Dr.	400	
	To Share Capital A/c			1,000
	To Securities Premium A/c			200
	<i>(Being reissue of 100 shares @ ₹ 8 per share)</i>			

NOTES

Illustration 7 (Forfeiture and Reissue of Forfeited Shares). Ahmed Trading Co. Ltd. had issued share capital of ₹1,40,000 in Equity Shares of ₹ 10 each, on which ₹ 7.50 per share was called and paid. When the final call of ₹ 2.50 per share was made, all the shareholders paid their money in full excepting two shareholders, one holding 200 shares and the other 100 shares. The shares were forfeited in due course and were reissued to a new shareholder who paid ₹ 5 per share.

You are to pass the Journal Entries recording the above transactions in the books of the company.

Solution. Journal in the Books of Ahmed Trading Co.

Date	Particulars	L.F.	Debit (₹)	Credit (₹)
	Bank A/c Dr. To Equity Share Application and Allotment A/c (Being application and allotment money on 14,000 equity shares @ ₹ 7.50 per share received)		1,05,000	1,05,000
	Equity Share Application and Allotment A/c Dr. To Equity Share Capital A/c (Being equity share application and allotment money on 14,000 shares @ ₹ 7.50 per share transferred to share capital account)		1,05,000	1,05,000
	Equity Share Final Call A/c Dr. To Equity Share Capital A/c (Being equity share final call money on 14,000 shares @ ₹ 2.50 per share made due)		35,000	35,000
	Bank A/c Dr. To Equity Share Final Call A/c (Being equity share final call money on 13,700 shares @ ₹ 2.50 per share received)		34,250	34,250
	Equity Share Capital A/c Dr. To Forfeited Equity Shares A/c To Equity Share Final Call A/c (Being forfeiture of 300 shares for non-payment of final call)		3,000	2,250 750
	Bank A/c Dr. Forfeited Equity Shares A/c Dr. To Share Capital A/c (Being reissue of 300 forfeited equity shares @ ₹ 5 per share)		1,500 1,500	3,000
	Forfeited Shares A/c Dr. To Capital Reserve A/c (Being transfer of forfeited shares account to capital reserve A/c)		750	750

Working Notes

(i) As the defaulting shareholders failed to pay Equity Share Final Call of ₹ 2.50 each, it has been assumed that ₹ 7.50 per share are for the Share Application and Allotment.

(ii) Calculation of Capital Reserve:

Amount received from Forfeited shares

(per share) = 7.50

NOTES

Less: Amount of loss on reissued Forfeited shares

(per share) = $\frac{5.00}{}$

Still gain (per share) = $\frac{2.50}{}$

Total gain on reissued shares or Capital Reserve = $300 \times 2.50 = ₹ 750.$

FORFEITURE AND REISSUE OF SHARES, EARLIER ISSUED AT PREMIUM

Meaning

Premium is the excess of issue price over the face value of shares. Premium once received cannot be cancelled as per the provisions of Section 52 of the Companies Act, 2013. *It means that if securities premium has already been received on shares being forfeited, Securities Premium A/c will neither be debited nor credited in the entry regarding forfeiture or reissue of forfeited shares.*

Forfeiture of Shares, Originally Issued at Premium (Premium Not Received)

In case the defaulting shares have not paid the instalment containing premium, the entry regarding forfeiting these shares will be:

Share Capital A/c Dr.

Securities Premium A/c Dr.

-To Forfeited Shares A/c

To Unpaid Calls or Calls in Arrear A/c

(Being forfeiture of shares issued at premium)

The logic for debiting Securities Premium account is that securities premium should be cancelled to the extent it has not been received, so that Securities Premium A/c should show the actual amount received. When the instalment containing securities premium is made due, Securities Premium Account is credited on all shares, whether received or not. While receiving the same instalment defaulting share did not pay the instalment containing securities premium, so it is proper to debit Securities Premium A/c, while forfeiting these shares to bring the balance of Securities Premium A/c to the actual amount received.

Reissue of Forfeited Shares, Originally Issued at Premium (Premium Received)

In case of Reissue of the forfeited shares from whom Securities premium was not received, Securities Premium A/c on reissued forfeited shares is not credited or credited to the extent it was debited in the forfeiture on reissued shares if **extra amount is available**. The journal entry regarding reissue is passed as under:

Bank A/c Dr.

Forfeited Shares A/c Dr.

To Share Capital A/c

While reissuing forfeited shares, originally issued at premium, Securities Premium A/c is not credited (reinstated) in accordance with the convention of conservatism. According to this convention, *Gains are not anticipated. They are recorded in the books of accounts only when they have been actually realised.* On the other hand, all possible losses are recognised and is recorded

in the books of accounts. The business adopts the policy of playing safe under the protection of this convention. The convention of conservatism is criticised because it fails to disclose the correct picture and deliberately understates the income.

NOTES

Illustration 8 (Forfeiture of Shares Issued at Premium and their Reissue at Par).

A company forfeited 100 shares of ₹ 10 each, on which B, the shareholder failed to pay allotment of ₹ 5 per share including a premium of ₹ 2 per share and final call of ₹ 3 per share. These shares were reissued at ₹ 8 per share.

Pass journal entry regarding forfeiture and reissue of shares.

Solution. If convention of conservatism is applied and Security Premium A/c is not reinstated as originally intended:

Journal

Date	Particulars	L.F.	Debit (₹)	Credit (₹)
(i)	Share Capital A/c	Dr.	1,000	
	Securities Premium A/c	Dr.	200	
	To Forfeited Shares A/c			400
	To Share Allotment A/c			500
	To Share Final Call A/c			300
	<i>(Being forfeiture of 100 shares for non-payment of share allotment and final call)</i>			
(ii)	Bank A/c	Dr.	800	
	Forfeited Shares A/c	Dr.	200	
	To Share Capital A/c			1,000
	<i>(Being reissue of 100 shares @ ₹ 8 per share)</i>			
(iii)	Forfeited Shares A/c	Dr.	200	
	To Capital Reserve A/c			200
	<i>(Being transfer of forfeited shares to Capital Reserve)</i>			

Working Notes

- (i) Entry regarding capital reserve account will not be made as forfeited shares account is closed, because it was both debited and credited with the same amount i.e., ₹ 400.
- (ii) Securities Premium A/c will be debited in the entry regarding forfeiture in both treatments, even if alternative treatment is applied. Students are advised to prefer the first treatment as most of the authors have been using it.

Illustration 9 (Issue of Shares at Premium, their Forfeiture and Reissue). X Y Z Limited has an authorised capital of ₹ 4,00,000 divided into shares of ₹ 20 each, the whole of which is issued and subscribed at a premium of ₹ 2 per share. The amount was payable as follows:

On application and allotment: ₹ 10 per share;

On 1st Call ₹ 4 per share (including premium);

The balance as and when required.

The company made both the calls. The application and allotment money was duly received, but a shareholder holding 2,000 shares failed to pay both the calls and his shares were forfeited. They were later on reissued at ₹ 14 per share as fully paid.

Give Journal Entries regarding the above.

Solution.

Journal in the Books of X Y Z Ltd.

NOTES

Date	Particulars	L.F.	Debit (₹)	Credit (₹)
	Bank A/c To Share Application and Allotment A/c <i>(Being application and allotment money on 20,000 shares @ ₹ 10 per share received)</i>	Dr.	2,00,000	2,00,000
	Share Application and Allotment A/c To Share Capital A/c <i>(Being application and allotment money on 20,000 shares @ ₹ 10 per share transferred to Share Capital A/c)</i>	Dr.	2,00,000	2,00,000
	Share First Call A/c To Share Capital A/c To Securities Premium A/c <i>(Being share first call money on 20,000 shares @ ₹ 4 including a premium of ₹ 2 made due)</i>	Dr.	80,000	40,000 40,000
	Bank A/c To Share First Call A/c <i>(Being share first call money on 18,000 shares @ ₹ 4 per share received)</i>	Dr.	72,000	72,000
	Share Final Call A/c To Share Capital A/c <i>(Being share final call money on 20,000 shares @ ₹ 8 per share made due)</i>	Dr.	1,60,000	1,60,000
	Bank A/c To Share Final Call A/c <i>(Being share final call money on 18,000 shares @ ₹ 8 per share received)</i>	Dr.	1,44,000	1,44,000
	Share Capital A/c Securities Premium A/c To Forfeited Shares A/c To Share First Call A/c To Share Final Call A/c <i>(Being forfeiture of 2,000 shares for non-payment of share first and final call)</i>	Dr. Dr.	40,000 4,000	20,000 8,000 16,000
	Bank A/c Forfeited Shares A/c To Share Capital A/c <i>(Being reissue of forfeited shares for ₹ 28,000)</i>	Dr. Dr.	28,000 12,000	40,000
	Forfeited Shares A/c To Capital Reserve A/c <i>(Being transfer of forfeited shares A/c to Capital Reserve A/c)</i>	Dr.	8,000	8,000

Notes. (i) *Treatment of Securities Premium. Securities Premium has not been received on 2,000 shares together with first call money so Securities Premium A/c has been debited in the forfeiture to cancel the excess amount for which it was credited.*

(ii) *Balancing figure of forfeited shares account has been treated as capital reserve, because all the forfeited shares have been reissued.*

Illustration 10 (Over Subscription of Shares issued at Premium, partially called up with different classes of Defaulters). Rajendra & Co. issued 10,000 shares of ₹ 10 each at a premium of ₹ 2 per share payable as to ₹ 3 per share with application; ₹ 5 per share on allotment (including premium) and ₹ 2 per share on each of the two calls. Applications for 12,000 shares were received, of which applications for 1,000 shares were declined altogether and those for 2,000 shares were allotted 50 per cent of their demand, while those for the remaining 9,000 shares were allotted in full. The calls were duly made and the payments for them were received as follows:

7,000 shares ₹ 12 per share; 1,000 shares ₹ 10 per share; 1,500 shares ₹ 8 per share and 500 shares ₹ 3 per share.

The Directors, there, upon forfeited those shares on which less than ₹ 10 per share was paid. They reissued them as fully paid up to Shri Kailash Chand at ₹ 18,000.

Show the Journal and Cash Book entries in the Books of the Company.

Solution.

Rajendra & Co.

Cash Book

(Bank Column only)

Dr.			Cr.		
Date	Particulars	Amount (₹)	Date	Particulars	Amount (₹)
	To Share Application A/c	36,000		By Share Application A/c	3,000
	" Share Allotment A/c	44,500		" Balance c/d	1,25,500
	" Share First Call A/c	16,000			
	" Share Final Call A/c	14,000			
	" Share Capital A/c	18,000			
		1,28,500			1,28,500

Journal in the Books of Rajendra & Co.

Date	Particulars	L.F.	Debit (₹)	Credit (₹)
	Share Application A/c Dr.		33,000	
	To Share Capital A/c			30,000
	To Share Allotment A/c			3,000
	<i>(Being application money on 10,000 shares @ ₹ 3 per share transferred to share capital account and on 1,000 shares @ ₹ 3 per share transferred to share allotment account)</i>			
	Share Allotment Dr.		50,000	
	To Share Capital A/c			30,000
	To Securities Premium A/c			20,000
	<i>(Being allotment money on 10,000 shares @ ₹ 5 per share including a premium of ₹ 2 per share made due)</i>			
	Share First Call A/c Dr.		20,000	
	To Share Capital A/c			20,000
	<i>(Being first call money on 10,000 shares @ ₹ 2 per share made due)</i>			
	Share Final Call A/c Dr.		20,000	
	To Share Capital A/c			20,000
	<i>(Being share final call on 10,000 shares @ ₹ 2 per share made due)</i>			

• **Reissue of Forfeited Shares**

Bank A/c	Dr.	—	
Forfeited Shares A/c	Dr.	—	
To Share Capital A/c		—	

NOTES

Note. Bank account is debited with the amount actually received, forfeited shares account is debited with the amount remaining unpaid on reissue and share capital account is credited with the total amount of capital on these shares (called up value).

• **Capital Reserve**

It is the excess of amount received on forfeiture of shares over the amount unpaid on reissue of forfeited shares. It shows that, we gain by the forfeiture of shares and we lose by the reissue of forfeited shares. *Excess of gain over loss on forfeited and reissued shares is capital reserve.*

• **Bases of Difference between Capital Reserve and Reserve Capital**

(1) Meaning (2) Accounting records (3) Utilisation (4) Amount received

• **Forfeiture and Reissue of Shares, earlier Issued at Premium**

If the forfeited shares have been issued Earlier at premium, we will have to ascertain whether Premium on forfeited shares has been received or not received. If the premium has been received, we shall neither debit nor credit Securities Premium account while passing entry regarding forfeiture. If Securities Premium has not been received on these shares, we shall be debiting Securities Premium Account while passing entry regarding forfeiture because the amount of Securities Premium has not been actually received. While reissuing forfeited shares, Securities Premium account may not be credited (if convention of conservatism is followed). Securities premium account may be credited to the extent it has been received, **if we ignore the convention. As most of the authors have not been crediting Securities Premium account on reissue of forfeited shares, students are advised to follow the majority.**

REVIEW QUESTIONS

A. Very Short Answer Type Questions:

1. What do you mean by forfeiture of shares?
2. Can we show forfeited Shares A/c and Capital Reserve A/c on the same shares simultaneously if not why?
3. What is meant by Capital Reserve?
4. Can forfeited shares be reissued at discount? If yes, to what extent.
5. While passing entry regarding forfeiture of shares, with what amount Share Capital Account is debited?

B. Short Answer Type Questions:

1. Explain the procedure for forfeiting shares.
2. Differentiate between Reserve Capital and Capital Reserve.
3. What are the uses of Securities Premium?
4. Explain the relationship between calls in arrears, forfeited shares A/c and Capital Reserve.

C. Long Answer Type Questions:

1. What do you mean by forfeiture of shares? Explain procedure for forfeiture of shares.
2. Explain the treatment of forfeiture of shares if shares were issued earlier at premium.
3. Explain procedure with accounting treatment, if shares issued at par were forfeited for non-payment of calls.

Practical Questions

1. A company forfeited 150 shares of ₹ 10 each for non-payment of allotment of ₹ 3 and final call of ₹ 4 per share. *Pass journal entry regarding forfeiture.*
2. A company forfeited 1,050 shares upon which ₹ 7.50 per share were called up, and ₹ 5 per share were paid for application and allotment. The first call of ₹ 2.50 per share was not paid. *Calculate capital reserve in the following cases:*
 - (i) If all the forfeited shares were reissued at ₹ 5 per share, ₹ 7.50 per share paid up.
 - (ii) If only 700 shares were reissued @ ₹ 5 per share, ₹ 7.50 per share paid up.
 - (iii) If 350 shares were reissued @ ₹ 4 per share, ₹ 7.50 called up.
 - (iv) If 525 shares were reissued @ ₹ 6 per share fully paid up.

[Ans. Capital Reserve (i) 2,625, (ii) ₹ 1,750, (iii) ₹ 525, (iv) 525]

3. A company issues 5,000 shares of the face value of ₹ 10 each, payable ₹ 3 on application, ₹ 3 on allotment, ₹ 2 on first call and ₹ 2 on final call. All the shares are subscribed and duly allotted and both the calls are made. All cash is duly received, except the final call on 100 shares. These are subsequently forfeited by the directors and are resold as fully paid for ₹ 250. *Give entries necessary to record these transactions in the company's journal.*

[Ans. Capital Reserve ₹ 50]

4. A company forfeited 490 shares of ₹ 10 each, on which B, the shareholder failed to pay allotment of ₹ 5 per share including a premium of ₹ 2 per share and final call of ₹ 3 per share. These shares were reissued at ₹ 8 per share. *Pass journal entry regarding forfeiture and reissue of shares.*

[Ans. Capital Reserve ₹ 980]

5. A holds 290 shares of ₹ 10 each on which he has paid ₹ 1 per share on application.
B holds 580 shares of ₹ 10 each on which he has paid ₹ 1 and ₹ 2 per share on application and allotment respectively.

C holds 870 shares of ₹ 10 each and has paid ₹ 1 on application ₹ 2 on allotment and ₹ 3 on first call.

They all fail to pay their arrears and the second call of ₹ 2 per share. Shares are forfeited and subsequently reissued at ₹ 11 per share as fully paid. *Journalise the above.*

[Ans. Capital Reserve ₹ 7,250]

CHAPTER 13 ISSUE OF DEBENTURES

★ STRUCTURE ★

- ☆ Meaning of Debentures
- ☆ Bond
- ☆ Types/Kinds of Debentures
- ☆ Utility/Advantages of Debentures
- ☆ Accounting for Issue of Debentures for Cash
- ☆ Calls in Arrears
- ☆ Calls Paid in Advance
- ☆ Over-Subscription of Debentures
- ☆ Issue of Debentures at Par
- ☆ Issue of Debentures at Premium
- ☆ Debenture Interest

NOTES

MEANING OF DEBENTURES

The word 'debenture' has been derived from a Latin word 'debre' which means to borrow.

Debenture is an instrument issued by the company acknowledging its debts to the holder under its seal. Debentures carry interest at certain per cent. As it is a loan taken by the company, it is repaid after certain specified period or at the option of the company as per the terms of their issue. There are *no legal restrictions* on the price for which debentures are issued. Debentures may be issued at par, at discount or at premium like shares.

According to section 2(30) of Companies Act, 2013, *debenture includes "debenture stock, bonds and any other securities of a company whether constituting a charge on assets of the company or not"*. In this way, important features of debenture may be summarised as under:

- Debentures are certificates acknowledging debt of a specified amount to the person named in it.
- Periodic payment of interest at specified rate.
- Mentioning the period after which it will be redeemed.
- Mentioning details of security, if any.

Status of Debenture-holders

Debenture-holders are the creditors of the company. They are paid interest on their debentures regularly at fixed rate. It is usual practice to prefix the rate before debentures i.e., 12% debentures. **Debenture-holders have priority as to their interest and refund of their loan in case of winding up of the company over shareholders.** Debenture-holders are not concerned with the management of the company. They are not involved in the administration and control of the company.

A debenture is a loan certificate issued by the company to its holders. The company instead of borrowing entire funds from an individual, divides the funds into certain small denominations or parts. These parts are known as debentures. Suppose the Company wants to borrow ₹ 10,00,000

NOTES

as loan by issuing debentures, it may issue debentures of ₹ 100 each and thus 10,000 debentures will be issued. In case of ₹ 1,000 debentures only 1,000 debentures will be required for the loan of ₹ 10,00,000.

BOND

Bond. A bond is negotiable certificate evidencing indebtedness. It is normally unsecured. A debt security is generally issued by a company, municipality or government agency. A bond investor lends money to the issuer and in exchange, the issuer promises to repay the loan amount on a specified maturity date. The issuer usually pays the bondholder periodic interest payments over the life of the loan.

TYPES/KINDS OF DEBENTURES

Debentures may be classified as under:

- **From payment/tenure point of view:**
 - (i) **Redeemable debentures.** The amount of the debentures which are to be repaid within certain specified period as per the terms of their issue.
 - (ii) **Irredeemable or perpetual debentures.** These are perpetual debentures. The company has no right to make the payment of the principal of these debentures during its life time. These debentures are repaid in case of winding up of the company.
- **From transferability point of view**
 - (i) **Bearer debentures.** These debentures are transferable by mere delivery. The name of the holder is not registered with the company.
 - (ii) **Registered debentures.** These debentures are not transferable by mere delivery. The names of the debenture-holders are registered with the company.
- **From safety/security point of view**
 - (i) **Simple or naked debentures.** These debentures are not mortgaged and they are issued without any charge on company's assets. The issue of these debentures is not popular with the company. These are unsecured debentures.
 - (ii) **Secured or mortgaged debentures.** These debentures are secured by a charge on company's assets. This charge may be fixed or floating.
 - (a) **Fixed Charge:** Charge created against specific assets held by enterprise is called fixed charge. These assets are not meant for sale. On the basis of rank of order of payment, charge may be classified as First charge/Second charge/Floating charge. It means that the amount received from the sale of specific asset will be utilised for making payment to first charge holder and if there remains surplus it will be used for making payment to second charge holders. Finally, if there is any surplus left it will be used in making payment to floating charge holders.
 - (b) **Floating Charge:** The charge for which no specific assets are given is known as floating charge. All assets except those given for specific charge to secured creditors are under charge of such creditors. The claims of floating charge holders will be settled first before making payment to unsecured creditors. Amount unpaid to second charge holders will be added to unsecured creditors.

• From redemption point of view

Convertible and non-convertible debentures. In certain cases the company provides an option to its debenture-holders to convert their holdings of debentures into shares after certain specified period. As such, the debenture-holder becomes the shareholder *i.e.*, the lender becomes the owner of company. Debentures may be fully convertible partially convertible and non-convertible.

• From coupon point of view

The term coupon rate means a specified rate of interest on debentures. Debentures can be classified into two categories from the point of view of coupon rate:

- (i) Zero coupon rate debentures.
 - (ii) Deep discount debentures.
- (i) **Zero coupon rate debenture.** These are the debentures which do not carry a specified rate of interest. In order to compensate the debenture-holder for the fall in the value of money due to price rise debentures are issued at discount and redeemable at par. *For example*, if the price level index is 80 in 2011 and increases to 100 in 2013 then ₹ 20 will be the fall in value of rupee. In similar situation, if a debenture is issued at ₹ 80 in 2011 redeemable at ₹ 100 in 2013, the investor will be compensated for the fall in the value of money. However, the rate of interest remains nil because ₹ 20 discount only compensate investor for the fall in value of money but not the interest earned on debentures. Hence, it is called zero coupon rate debenture. The formula will be

$$\text{Issue Price} = \frac{\text{Redeemable Price}}{(1 + i)^n}$$

As per the above example, issue price will be ₹ 80, redeemable price will be ₹ 100, 'i' will indicate the discounting rate for fall in value of money and n will indicate number of years debenture is redeemable

$$80 = \frac{100}{(1 + i)^2}$$

By solving the above equation, discount rate can be found out.

- (ii) **Deep discount debenture.** This concept is similar to the concept of zero coupon rate debenture with the only difference that additional discount is offered on the issue price of the debenture to benefit the investor over and above compensation for the fall in value of money due to price rise. *For example*, price level index in the year 2011 is 80 and the price level index in the year 2013 is 100. If a debenture is issued at ₹ 70 in 2011 redeemable at ₹ 100 in 2013, there will be a discount of ₹ 30. This discount will have two elements, ₹ 20 as compensation for the fall in the value of money and ₹ 10 as additional discount offered over and above the fall in value of money. Hence, it will be called deep discount debenture.

• Collateral debentures

Debentures may also be issued to banks and financial institutions as an additional or subsidiary security in addition to certain principal security. Lending institutions can exercise their right as debenture-holders, if the company does not pay loan and the principal security falls short.

UTILITY/ADVANTAGES OF DEBENTURES

Advantages to the Company

- **Availability of necessary funds.** If the company is not able to obtain the necessary funds by issue of shares, it obtains the required amount by issue of debentures.

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- **Non-interference in the management.** Debenture-holders do not have voting rights, so they cannot participate in the election of directors who manage the company. As such the management of company is not disturbed by the presence of debenture-holders.
- **Fixed rate of interest.** Interest is paid at prescribed fixed rate to debenture-holders, so the company can arrange the amount of interest in a planned way.
- **More dividend to shareholders.** A good company after payment of interest at prescribed fixed rate to debenture-holders declares dividend at higher rates to shareholders.
- **Facility to return funds.** Debentures can be redeemed and the company can reduce the burden of loan, if the company becomes financially sound.

Difference between Shareholders and Debenture-holder

<i>Bases of Difference</i>	<i>Shareholders</i>	<i>Debenture-holders</i>
1. <i>Meaning</i>	The subscribers to the shares are shareholders. Shares are the parts of share capital.	The subscribers to debentures are debenture-holder. Debentures are parts of loan.
2. <i>Status</i>	They are the owners of the company.	They are the creditors of the company.
3. <i>Return</i>	Shareholders are paid dividend on their holdings.	Debenture-holders are paid interest on debentures held by them.
4. <i>Regularity of return</i>	Dividends are paid, when there is sufficient profits. The rate of dividend is not fixed. Dividends are not the regular source of income.	Interest on debentures is paid at fixed-rate regularly.
5. <i>Security</i>	Shares are not secured.	Debentures are ordinarily secured.
6. <i>Right to attend meetings</i>	Shareholders are invited to attend the annual general meeting of the company.	Debenture-holders are not invited, unless any decision affecting their interest is taken.
7. <i>Repayment</i>	Share Capital is not returned except in case of redeemable preference shares.	Debentures being loan is repaid by the company.
8. <i>Priority of refund</i>	In case of winding up of the company, shareholders funds are refunded after every claim is settled.	Debenture-holders have a priority of the refund of their loan prior to shareholders.
9. <i>Restriction on Issue</i>	There are certain restrictions on issue of shares at discount.	There are no restrictions as to issue of debentures at discount.
10. <i>Control</i>	Shareholders control the affairs of the company. It is managed by the Board of Directors, the elected representatives of the shareholders.	They are not involved in the management and control of the company.

Accounting for Issue of Debentures

Whenever debentures are issued, accounting entry needs to be made so that it is recorded in the books of account. Debentures can be issued either in cash or consideration other than cash or as a collateral security. In this section, we will study:

(a) Accounting for Issue of Debentures

- Calls in Arrears
- Calls Paid in Advance
- Over Subscription of Debentures
- Issue of Debentures at Par
- Issue of Debentures at Premium
- Debenture Interest

(b) Issue of Debentures for consideration other than cash.

(c) Issue of Debenture as Collateral Security.

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ACCOUNTING FOR ISSUE OF DEBENTURES FOR CASH

Issue of debentures is ordinarily the same as the issue of shares. The entire money can be received in lump sum with the application or it can be received in certain instalments known as debenture application, debenture allotment and debenture calls. The following journal entries are made regarding issue of debentures for cash:

Issue of Debentures for Cash**Case A: If the entire amount is received in lump sum with the debenture application:**

Bank A/c	Dr.
To Debentures Application and Allotment A/c	
<i>(Being debenture money received)</i>	

Debenture Application and Allotment A/c	Dr.
To % Debenture A/c	
<i>(Being transferred to debenture A/c)</i>	

Case B: If the value of debenture is received in certain instalments:**Step 1: On receiving debenture application**

Bank A/c	Dr.
To Debenture Application A/c	
<i>(Being application money on—debentures @ ₹—per debenture received)</i>	

Step 2: On transferring debenture application to debentures account

Debenture Application A/c	Dr.
To % Debentures A/c	
<i>(Being application money on—debentures @ ₹—per debenture transferred to debentures A/c)</i>	

Step 3: For making debenture allotment due

Debenture Allotment A/c	Dr.
To % Debentures A/c	
<i>(Being allotment money on—debentures @ ₹—per debenture made due)</i>	

Step 4: On receiving debenture allotment

Bank A/c	Dr.
To Debenture Allotment A/c	
<i>(Being allotment money on—debentures @ ₹—per debenture received)</i>	

Step 5: For making debenture call due

Debenture Call A/c	Dr.
To % Debentures A/c	
<i>(Being call money on—debentures @ ₹—per debenture made due)</i>	

Step 6: For Receiving Debenture Call

Bank A/c	Dr.
To Debentures Call A/c	
<i>(Being call money on—debentures @ ₹—per debenture received)</i>	

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Illustration 1 (Issue of Debentures Payable in instalments). A company issued 10,000, 12% debentures of ₹ 100 each, payable ₹ 10 on application, ₹ 40 on allotment, ₹ 25 on first call and the balance ₹ 25 on final call. All the money was received when due. Pass necessary Journal Entries.

Solution.

Date	Particulars	L. F.	Debit (₹)	Credit (₹)
	Bank A/c To 12% Debenture Application A/c (Being application money on 10,000 debentures @ ₹ 10 per debenture received)	Dr.	1,00,000	1,00,000
	Debenture Application A/c To 12% Debentures A/c (Being application money on 10,000 debentures @ ₹ 10 per debenture transferred to debentures A/c)	Dr.	1,00,000	1,00,000
	Debenture Allotment A/c To 12% Debentures A/c (Being allotment money on 10,000 debentures @ ₹ 40 per debenture made due)	Dr.	4,00,000	4,00,000
	Bank A/c To Debenture Allotment A/c (Being allotment money on 10,000 debentures ₹ 40 per debenture received)	Dr.	4,00,000	4,00,000
	Debenture First Call A/c To 12% Debentures A/c (Being first call on 10,000 debentures @ ₹ 25 per debenture made due)	Dr.	2,50,000	2,50,000
	Bank A/c To Debenture First Call A/c (Being first call on 10,000 debentures @ ₹ 25 per debenture received)	Dr.	2,50,000	2,50,000
	Debenture Final Call A/c To 12% Debentures A/c (Being final call on 10,000 debentures @ ₹ 25 per debenture made due)	Dr.	2,50,000	2,50,000
	Bank A/c To Debenture Final Call A/c (Being final call on 10,000 debentures @ ₹ 25 per debenture received)	Dr.	2,50,000	2,50,000

CALLS IN ARREARS

Debenture-holders may be asked to make the payment of the issue price of debentures in certain instalments i.e., Debenture application, allotment and calls. In certain cases, allotment and calls remain unpaid on certain debentures. These unpaid calls are termed as calls in arrears. The journal entry for making calls due and receiving it is the same as in the case of shares. Interest on calls in arrears may be charged as per the terms of the prospectus or on the basis of agreement between the company and debenture-holders.

Illustration 2 (Calls in Arrears on Debentures). Proficiency Limited issued 5,000 debentures of ₹ 100 each. The amount was payable as ₹ 20 on application, ₹ 30 on allotment and ₹ 50 on first and final call. All the debentures were applied for and money duly received except final call on 200 debentures.

Pass necessary Journal Entries.

Solution. In the Books of Proficiency Limited
Journal

Date	Particulars	L.F.	Debit (₹)	Credit (₹)
	Bank A/c To Debenture Application A/c (Being application money on 5,000 debentures @ ₹ 20 per debenture received)	Dr.	1,00,000	1,00,000
	Debenture Application A/c To Debentures A/c (Being application money on 5,000 debentures @ ₹ 20 per debenture transferred to debentures A/c)	Dr.	1,00,000	1,00,000
	Debenture Allotment A/c To Debentures A/c (Being allotment money on 5,000 debentures @ ₹ 30 per debenture made due)	Dr.	1,50,000	1,50,000
	Bank A/c To Debenture Allotment A/c (Being allotment money on 5,000 debentures @ ₹ 30 per debenture received)	Dr.	1,50,000	-1,50,000
	Debenture First and Final Call A/c To Debentures A/c (Being final call money on 5,000 debentures @ ₹ 50 per debenture made due)	Dr.	2,50,000	2,50,000
	Bank A/c To Debenture First and Final Call A/c (Being final call money on 4,800 debentures @ ₹ 50 per debenture received)	Dr.	2,40,000	2,40,000

Working Notes

Treatment of Calls in Arrears. Debenture first and final call has been made due on 5,000 debentures @ ₹ 50 per debenture but it was received only on 4,800 debentures, so the entry regarding receipt of debenture final call has been made with the actual amount received i.e., $4,800 \times 50 = 2,40,000$.

CALLS PAID IN ADVANCE

Calls paid in Advance on debentures may be received on certain debentures before the call is actually made due. Entries will be made in a fashion similar to the calls paid in advance on shares. The interest payable on such calls in advance will depend upon the terms of issue of debentures or on agreement between the company and the debenture-holders. Interest will be calculated for the period, the advance has been received. Journal entries regarding calls in advance on debentures is explained with the following illustration.

Illustration 3 (Calls paid in Advance and Calls in Arrears on Debentures). Efficiency Limited issued 15,000 debentures of ₹ 100 each, payable ₹ 15 on application,

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₹ 25 on allotment and ₹ 60 on final call. All the debentures were applied. A, the applicant of 100 debentures paid the entire amount on his holding on allotment and B, the holder of 200 debentures failed to pay the allotment and final call.

Pass necessary Journal Entries.

Solution. In the Books of Efficiency Limited
Journal

Date	Particulars	L.F.	Debit (₹)	Credit (₹)
	Bank A/c To Debenture Application A/c <i>(Being application money on 15,000 debentures @ ₹ 15 per debenture received)</i>	Dr.	2,25,000	2,25,000
	Debenture Application A/c To Debentures A/c <i>(Being application money on 15,000 debentures @ ₹ 15 per debenture transferred to debentures account)</i>	Dr.	2,25,000	2,25,000
	Debenture Allotment A/c To Debentures A/c <i>(Being allotment money on 15,000 debentures @ ₹ 25 per debenture made due)</i>	Dr.	3,75,000	3,75,000
	Bank A/c Calls in Arrear A/c To Debenture Allotment A/c To Calls paid in Advance on Debentures A/c <i>(Being allotment money on 14,800 debentures @ ₹ 25 per debenture received. Calls money on 100 debentures @ ₹ 60 per debenture received in advance)</i>	Dr. Dr.	3,76,000 5,000	3,75,000 6,000
	Debenture First and Final Call A/c To Debentures A/c <i>(Being final call money on 15,000 debentures @ ₹ 60 per debenture made due)</i>	Dr.	9,00,000	9,00,000
	Bank A/c Calls Paid in Advance on Debenture A/c To Debenture Final Call A/c <i>(Being final call money on 14,800 debentures @ ₹ 60 per debenture after adjusting calls paid in advance received)</i>	Dr. Dr.	8,82,000 6,000	8,88,000

Working Note

Calls paid in advance account will be credited when the allotment is received. It will remain as calls paid in advance and shown at other Current Liabilities of Revised Schedule IV of Balance Sheet, so far the call is not made due. Calls paid in advance account will be written off or closed by debiting, when the call is received.

Illustration 4 G Ltd., issued 75,00,000, 6% Debenture of ₹ 50 each at par payable ₹ 15 on application and ₹ 35 on allotment, redeemable at par after 7 years from the date of issue of debenture. Record necessary entries in the books of Company.

Solution. Books of G. Ltd.

Journal

Date	Particulars	L.F.	Debit (₹)	Credit (₹)
	Bank A/c To 6% Debenture Application A/c <i>(Application money @ ₹ 15 each received for 75,00,000 debentures)</i>	Dr.	11,25,00,000	11,25,00,000

6% Debenture Application A/c To 6% Debenture A/c (Application money of 75,00,000 debentures transferred to 6% Debentures Account)	Dr.	11,25,00,000	11,25,00,000
6% Debenture Allotment A/c To 6% Debentures A/c (Allotment money @ ₹ 35 each due for 75,00,000 debentures)	Dr.	26,25,00,000	26,25,00,000
Bank A/c To 6% Debenture Allotment A/c (Allotment money received @ ₹ 35 each on 75,00,000 debentures)	Dr.	26,25,00,000	26,25,00,000

NOTES

OVER-SUBSCRIPTION OF DEBENTURES

Meaning

In case, applications are received for more debentures than issued, it is known as *over-subscription*. Application money received on over applied debentures is returned, if the company rejects application for certain number of debentures or adjusted towards allotment and calls as per the decision of the company.

Accounting Treatment

In case of refunding application money the following entry is passed:

Debenture Application A/c	Dr.
To Bank A/c	
<i>(Being refund of debenture application money on debentures @ ₹ per debenture)</i>	

In case, certain applicant is allotted lesser number of debentures, his application money on unallotted debentures is transferred to debenture allotment and calls. Requisite journal entry is made as under:

Debenture Application A/c	Dr.
To Debenture Allotment A/c	
To Debenture Call A/c	
<i>(Being transfer of application money on debentures @ ₹ per debenture to allotment and calls)</i>	

This can be further explained by the following illustration:

Illustration 5 (Over-subscription on Debentures). A Company Limited issued 20,000 debentures of ₹ 100 each, payable ₹ 10 on application, ₹ 30 on allotment and balance on first and final call.

Applications were received for 24,000 debentures. Ram, the applicant of 1,000 debentures was refused allotment and Mohan, the applicant of 8,000 debentures was allotted 5,000 debentures. Excess application money was adjusted towards allotment.

Pass necessary Journal Entries.

NOTES

Solution. In the Books of A Company Limited
Journal

Date	Particulars	L.F.	Debit (₹)	Credit (₹)
	Bank A/c Dr. To Debenture Application A/c <i>(Being application money on 24,000 debentures @ ₹ 10 per debenture received)</i>		2,40,000	2,40,000
	Debenture Application A/c Dr. To Debentures A/c To Debenture Allotment A/c To Bank A/c <i>(Being application money on 20,000 debentures @ ₹ 10 each transferred to debentures A/c, on 1,000 debentures @ ₹ 10 returned and the balance transferred to allotment)</i>		2,40,000	2,00,000 30,000 10,000
	Debenture Allotment A/c Dr. To Debentures A/c <i>(Being allotment money on 20,000 debentures @ ₹ 30 per debenture made due)</i>		6,00,000	6,00,000
	Bank A/c Dr. To Debenture Allotment A/c <i>(Being allotment money on 20,000 debentures @ ₹ 30 per debenture, except allotment received in advance, received)</i>		5,70,000	5,70,000
	Debenture First and Final Call A/c Dr. To Debentures A/c <i>(Being final call money on 20,000 debentures @ ₹ 60 per debenture made due)</i>		12,00,000	12,00,000
	Bank A/c Dr. To Debenture First and Final Call A/c <i>(Being final call on 20,000 debentures @ ₹ 60 per debenture received)</i>		12,00,000	12,00,000

Working Note

Over-subscription on application has been returned on 1,000 debentures as they were refused allotment. Mohan, the applicant for 8,000 debentures was allotted only 5,000 debentures. His excess application money on unallotted debentures i.e., $3,000 \times 10 = 30,000$ transferred to allotment. While receiving allotment, advance for allotment has been deducted:

ISSUE OF DEBENTURES AT PAR

Debentures can be issued at par which indicates the face value or registered price of a debenture. This is a normal case of issuing a ₹ 100/- debenture at the same price without charging any premium or discount on the face value of ₹ 100/-. Generally, new companies or companies having limited presence in Capital market go for this option of debenture issue.

ISSUE OF DEBENTURES AT PREMIUM**Meaning**

Debentures can be issued at a price, more than their face value. The excess of issue price over the face value of debentures is the premium. The premium is the gain for the company, so it is

DEBENTURE INTEREST

NOTES

Meaning

Debenture interest is an obligation of issuer company to pay 'fixed rate' of interest to the debentureholders. The interest is paid till the repayment of debenture. The interest is calculated on the face value of the debenture.

For example, if a company issues ₹ 100 face value of debentures at an interest of 10%, then interest ₹ 10 (i.e., $100 \times \frac{10}{100}$) is payable per debenture every year till the maturity of debenture term.

Treatment of Debenture Interest

1. Debenture interest is a charge against the profit of the company. It is debited to profit and loss account.
2. The company must deduct income tax at a prescribed rate from interest payable on debentures if it exceeds the prescribed limit. According to Income Tax Act 1961, it is called Tax Deducted at Source (TDS).

Accounting Treatment

The following journal entries are recorded in the books of a company in connection with the interest on debentures:

1. When interest is due

Debenture Interest A/c	Dr.
To TDS Payable A/c	
To Debentureholders A/c	

(Being amount of interest due on debenture and TDS deducted at source)

2. For amount of interest to debentureholders

Debentureholders A/c	Dr.
To Bank A/c	

(Being amount of interest paid to debentureholders)

3. On transfer of debenture interest account to statement of profit and loss

Statement of Profit and Loss	Dr.
To Debenture Interest A/c	

(Being debenture interest transferred to statement of profit and loss)

4. On payment of tax deducted at source to government

TDS Payable A/c	Dr.
To Bank A/c	

(Being payment of TDS deducted at source on interest on debentures)

Illustration 7 W Ltd., issued 5,000, 10% debentures of ₹ 100 each on January 1, 2018 at a discount of 10% redeemable at a premium of 10%. Give journal entries relating to the issue of debentures and debenture interest for the period ending December 31, 2018 assuming that interest was paid half yearly on June 30, and December 31, and tax deducted at source is 10%. W Ltd., follows calendar year as its accounting year.

Solution.

In Books of W Ltd.
Journal

Date	Particulars	L.F.	Debit (₹)	Credit (₹)
1.1.18	Bank A/c To Debenture Application & Allotment A/c <i>(Being application received on 5,000, 10% debentures)</i>	Dr.	4,50,000	4,50,000
	Debentures Application & Allotment A/c Loss on Issue of Debenture A/c To 10% Debentures A/c To Premium on Redemption of Debenture A/c <i>(Being allotment of debentures at a discount of 10% and redeemable at a premium of 10%)</i>	Dr. Dr.	4,50,000 1,00,000	5,00,000 50,000
30.6.18	Debentures Interest A/c To Debentureholders A/c To TDS Payable A/c <i>(Being interest due for 6 months and tax deducted at source)</i>	Dr.	25,000	22,500 2,500
	Debentureholders A/c To Bank A/c <i>(Being payment made for interest)</i>	Dr.	22,500	22,500
31.12.18	Debenture Interest A/c To Debentureholders A/c To TDS Payable A/c <i>(Being interest transferred to debentureholder account and tax payable)</i>	Dr.	25,000	22,500 2,500
31.12.18	Debentureholders A/c To Bank A/c <i>(Being payment made for interest)</i>	Dr.	22,500	22,500
31.12.18	TDS Payable A/c To Bank A/c <i>(Being payment made for tax deducted at source to the government)</i>	Dr.	5,000	5,000
31.12.18	Statement of Profit and Loss To Debenture Interest A/c <i>(Being debenture interest transferred to Statement of Profit and Loss)</i>	Dr.	50,000	50,000

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Illustration 8 BG Ltd. issued 2,000, 12% debentures of ₹ 100 each on 1st April, 2012. The issue was fully subscribed. According to the terms of issue, interest on the debentures is payable half-yearly on 30th September and 31st March and the tax deducted at source is 10%. Pass necessary journal entries related to the debenture interest for the half-yearly ending 31st March, 2013 and transfer of interest on debentures of the year to the Statement of Profit and Loss.

- **Bases of Difference between Share (Equity) and Debentures.**

1. Meaning 2. Return 3. Assured return 4. Security 5. Repayment 6. Status.

- **Bases of Difference between Share-holders and Debenture-holders**

(1) Meaning (2) Status (3) Return (4) Regularity of return (5) Security (6) Right to attend meetings (7) Repayment (8) Priority of refund (9) Restriction on issue (10) Control.

- **Accounting for Issue of Debentures for Cash.**

Debentures can be issued at par, at premium and at discount like shares. These debentures may also be payable in certain instalments known as debenture application, debenture allotment and debenture calls. In these cases the journal entry is the same as we have been passing in case of issue of shares. The simple difference is that the word share is substituted by debentures *i.e.*, share application is known as debenture application and so on. Share Capital is replaced by the word debentures. It is customary that the rate of interest on debentures is used as prefix before the word debenture just as 12% Debentures.

If debentures are issued at premium and at discount and the amount is payable in certain instalments we repeat the procedures followed in case of issue of shares with the simple difference as explained above.

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REVIEW QUESTIONS

A. Very Short Answer Type Questions:

1. What is meant by debenture?
2. Define redeemable debentures.
3. What is meant by convertible debenture?
4. Define a bond.
5. In what respect a debenture is different from bond?
6. What do you mean by charge?
7. What is a bearer debenture?
8. Mention one point of difference between share and debenture.
9. What is zero coupon rate?
10. What is coupon rate debenture?
11. What is meant by 'Convertible Debentures'?

B. Short Answer Type Questions:

1. Explain different types of debentures on the basis of tenure and security.
2. Differentiate between shareholder and debenture-holder.
3. Explain briefly the advantages to the company by issue of debentures.
4. Differentiate between debenture calls in arrears and debenture calls in advance.
5. How will you deal with over subscription on debenture?
6. What journal entry will you pass, if ₹ 40,000 12% debentures were issued at a discount of 5% and repayable at a premium of 5%?
7. What is meant by debentures? Name any four types of debentures.

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C. Long Answer Type Questions:

1. What do you mean by debenture? Describe briefly various types of debentures.
2. Discuss the accounting treatment of issue of debentures to vendors against assets at par, premium and discount.

Practical Questions

1. A company issued 15,000, 12% debentures of ₹ 100 each, payable ₹ 10 on application, ₹ 40 on allotment, ₹ 25 on first call and the balance ₹ 25 on final call. All the money was received when due. *Pass necessary Journal Entries.*
2. X Y Z Company Ltd., issued 18,000, 10% debentures of ₹ 100 each at a premium of ₹ 5, payable as follows:

On Application	₹ 40 (including Premium)
On Allotment	₹ 65

All the debentures were subscribed for and the money was duly received.

Pass necessary Journal Entries to record the above issue of debentures.

3. Raj limited purchases furniture costing ₹ 6,60,000. It was agreed that the purchase consideration be paid by issue of 15% debentures of ₹ 100 each. *Assume debentures have been issued (i) at par (ii) at a premium of 10%.*

[Ans. Number of debentures to be issued (i) 6,600 (ii) 6,000]

4. A company borrows ₹ 5,00,000 from the bank and deposits debentures worth ₹ 5,50,000 as collateral security (in addition to certain other principal security). *Make its accounting treatment.*
5. Swastik Ltd., issued 16,000, 8% Debentures of ₹ 100 each. Assuming that all the debentures issued are taken up and paid for, *pass the Journal Entries in the books of the company in each of the following cases:*
 - (i) The Debentures are issued at ₹ 90 each.
 - (ii) The Debentures are issued at a premium of 10%.
 - (iii) The Debentures are issued to a supplier of furniture amounting to ₹ 17,00,000.

CHAPTER 14 ACCOUNTING RATIOS

☆ STRUCTURE ☆

- ☆ Introduction
- ☆ Ratio and Accounting Ratio
- ☆ Classification of Accounting Ratio
- ☆ Profitability Ratios
- ☆ Turnover or Performance or Activity Ratios
- ☆ Financial Ratios
- ☆ Solvency Ratios

NOTES

INTRODUCTION

Accounting ratio is one of the methods of analysing financial statements. It has been our experience that financial statements in their original form are collection of monotonous figures. The statements are detailed and do not present the required information at a glance. Accountants have to toil very hard in digging out the needed information. Accounting ratios are therefore, an attempt to present the information of the financial statements in simplified, systematised and summarised form. Accountants introduced ratio analysis to meet this end.

Ratio analysis measures the profitability, efficiency and financial soundness of the business. The relationship between two facts *i.e.*, gross profit and sales or current assets and current liabilities is studied and the result is presented in the form of simple ratios.

RATIO AND ACCOUNTING RATIO

Meaning of Ratio and Accounting Ratio

The dictionary meaning of ratio is "*a figure showing the number of times one quantity contains another. It is used to show the relationship between two amounts.*" A ratio is an arithmetical expression of relationship between two items. When ratios are calculated on the basis of accounting information, they are called "**Accounting Ratios**".

Meaning of Ratio Analysis

Ratio analysis refers to a technique of analysing the financial statements by computing various types of ratios. In simple words, it is a process of determining and interpreting relationship between the items of financial statements to provide a meaningful result of the performance and financial position of a business. According to Myeres, "*Ratio analysis is a study of relationship among various financial factors in a business.*"

CLASSIFICATION OF ACCOUNTING RATIOS

NOTES

Classification of ratios depends upon the objectives for which they are calculated. It may also depend upon the availability of data. Analysis of financial statement is made with a view to ascertain the efficiency and financial soundness of the company, as such ratios can be classified on the basis of profitability, turnover and financial capability.

PROFITABILITY RATIOS

Profitability refers to the ability of the business to earn profit. It shows the efficiency of the business. These ratios measure the profit earning capacity of the company. Profitability has direct link with sales. This is why, we calculate these ratios on the basis of sales. Return on investments and capital is calculated on the basis of capital employed. The profitability of the business can be measured with the following ratios.

1. Gross Profit Ratio

It shows the relationship between the **Gross Profit and Revenue from Operations (Net Sales)**. This ratio shows the **margin of gross profit on revenue**. In order to calculate this ratio we require gross profit and revenue. Gross profit, if not given, can be calculated on the basis of the following formula:

$$\text{Gross Profit Ratio} = \frac{\text{Gross Profit}}{\text{Revenue from Operations}} \times 100$$

$$\begin{aligned} \text{Gross Profit} &= \text{Revenue from Operations} - \text{Cost of Revenue from Operations} \\ \text{Cost of Revenue from Operations} &= \text{Cost of materials consumed} + \text{purchase of stock-in-trade} + \\ &\text{change in Inventories (Finished Goods; Work-in-progress and} \\ &\text{Stock-in-trade)} + \text{Direct Expenses.} \end{aligned}$$

or

$$\begin{aligned} \text{Cost of Goods Sold} &= \text{Opening Inventories} + \text{Net Purchases} + \text{Direct Expenses} - \\ &\text{Closing Inventories.} \end{aligned}$$

Or

$$\text{Revenue from Operations} - \text{Gross Profit.}$$

Gross Profit can be ascertained by preparing Trading Account also. *The term revenue from operations means sales less sales return. If sales return is not given, sales will be assumed to be net sales.* The formula for its calculation is as under:

$$\text{Gross profit ratio} = \frac{\text{Gross Profit}}{\text{Revenue from Operations}} \times 100$$

Note: If, direct Expenses are not given, it is assumed that there are no direct expenses.

Illustration 1 Calculate gross profit ratio if:

$$\begin{aligned} \text{Gross profit} &= 40,000 \\ \text{Sales} &= 2,20,000 \\ \text{Sales return} &= 20,000 \end{aligned}$$

$$\text{Solution. Gross profit ratio} = \frac{\text{Gross Profit}}{\text{Revenue from Operations}} \times 100 = \frac{40,000}{2,00,000} \times 100 = 20\%.$$

Note. Revenue from operations = Sales - Sales Return = 2,20,000 - 20,000 = ₹ 2,00,000.

Purpose of Gross Profit Ratio

The purpose is to measure the gross profit in terms of total sales of the company.

Illustration 2 Calculate gross profit ratio from the following:

S. No.	Items	Amount (₹)
1.	Opening Inventories	50,000
2.	Purchases	1,50,000
3.	Returns outwards	20,000
4.	Wages	10,000
5.	Revenue from Operations	2,50,000
6.	Closing Inventories	40,000

NOTES

Solution.

$$\text{Gross Profit Ratio} = \frac{\text{Gross Profit}}{\text{Revenue from Operations}} \times 100$$

$$\text{Gross Profit} = \text{Revenue from Operations} - \text{Cost of Revenue from Operations}$$

$$\text{Cost of Revenue from Operations} = \text{Opening Inventories} + \text{Purchases} - \text{Returns outwards} + \text{Wages} - \text{Closing Inventories}$$

$$= ₹ 50,000 + ₹ 1,50,000 - ₹ 20,000 + ₹ 10,000 - ₹ 40,000$$

$$= ₹ 1,50,000$$

$$\text{Gross Profit} = ₹ 2,50,000 - ₹ 1,50,000$$

$$= ₹ 1,00,000$$

$$\therefore \text{Gross Profit Ratio} = \frac{\text{Gross Profit}}{\text{Revenue from Operations}} \times 100$$

$$= \frac{1,00,000}{2,50,000} \times 100 = 40\%$$

2. Net Profit Ratios

This ratio establishes relationship between net profit and net sales. Net profit or net income is the gross profit less selling, distribution and financial expenses. Net profit, for calculating this ratio is picked up from the statement of Profit and Loss. It should be noted that the net profit is ascertained after adding operation and non-operating income to Gross Profit and deducting both operating and non-operating expenses therefrom. We can understand Net profit better in this way.

Net Profit = Gross Profit + Operating and Non-operating income (-) Operating and Non-operating expenses.

Operating Income. Income earned in the ordinary life of the business from trading activities such as Gross Profit, Discount on creditors, Interest on drawings and Sale of scraps etc.

Non-operating Income. It includes income from non-trading operations, such as, refund of tax, interest and dividend received. Gain on sale of assets, compensation received etc.

Operating Expenses. It includes selling, administrative and distribution expenses incurred in the day-to-day affairs of the business.

Non-operating Expenses. These expenses include all financial expenses such as interest on debentures dividend, depreciation, loss on sale of assets, abnormal loss such as loss by fire, discount or loss on issue of shares and debentures, goodwill and preliminary expenses written off, reserves, dividend and interest paid etc.

Net profit ratio can be calculated on the basis of the following formula:

$$\text{Net Profit Ratio} = \frac{\text{Net Profit}}{\text{Revenue from Operations}} \times 100$$

NOTES

Illustration 3 Net Profit = ₹ 24,000

Revenue from Operations = ₹ 2,00,000, Calculate Net Profit Ratio.

Solution. Net Profit Ratio = $\frac{\text{Net Profit}}{\text{Revenue from Operations}} \times 100 = \frac{24,000}{2,00,000} \times 100 = 12\%$.

Purpose of Net Profit Ratio

The purpose of this ratio is to measure the net profit in relation to the net sales of the business.

Illustration 4 Calculate (a) Operating Profit ratio and (b) Net profit ratio in the following cases:

(i) Net Profit	₹ 15,000
Revenue from Operations	₹ 80,000
(ii) Net Profit before interest	₹ 20,000
Net Profit after interest	₹ 17,000
Revenue from Operations	₹ 2,00,000

Solution. (i) (a) Operating Profit Ratio = $\frac{\text{Net Profit}}{\text{Revenue from Operations}} \times 100$
 $= \frac{15,000}{80,000} \times 100 = 18.75\%$.

(b) Net Profit ratio will also be the same, because operating expenses and operating income are not given separately.

(ii) (a) Operating Profit Ratio = $\frac{\text{Net Profit before Interest}}{\text{Revenue from Operations}} \times 100$
 $= \frac{20,000}{2,00,000} \times 100 = 10\%$.

Note. Interest excluded because it is non-operating expenses.

(b) Net Profit Ratio = $\frac{\text{Net Profit after Interest}}{\text{Revenue from Operations}} \times 100 = \frac{17,000}{2,00,000} \times 100 = 8.5\%$

Concept of Income Tax

Income Tax is an direct tax which is paid by the firms and also borne by them. It is calculated on the net profit. This is why, Net profit is classified as Profit before tax (PBT) and Profit after tax (PAT). We can calculate, net profit ratio before tax and after tax, so its formula may be:

Net Profit Ratio:

(i) Net profit before tax ratio = $\frac{\text{PBT}}{\text{Revenue from Operations}} \times 100$

(ii) Net profit after tax ratio = $\frac{\text{PAT}}{\text{Revenue from Operations}} \times 100$

Here Revenue from Operations (Net Sales) = Revenue from Operations (Gross Sales) – Sales Tax and Sales Returns.

Illustration 5 From the following data, calculate Net Profit Ratio.

Gross sales ₹ 20,00,000

Sales Tax 7% on Gross Sales

Income Tax 40%

Profit before tax 4,00,000

Solution. Revenue from Operations = Gross Sales – Sales Tax

$$= \left(\frac{7}{100} \times 20,00,000 \right) = ₹ 18,60,000$$

Profit before tax (PBT) = 4,00,000

$$\text{Income tax} = \frac{40}{100} \times 4,00,000 = ₹ 1,60,000$$

Profit after tax = 4,00,000 – 1,60,000 = ₹ 2,40,000

Net Profit Ratio:

$$(i) \text{ Net Profit before tax ratio: } \frac{\text{PBT}}{\text{Revenue from Operations}} \times 100 = \frac{4,00,000}{18,60,000} \times 100 = 21.5\%$$

$$(ii) \text{ Net Profit after tax ratio: } \frac{\text{PAT}}{\text{Revenue from Operations}} \times 100 = \frac{2,40,000}{18,60,000} \times 100 = 12.9\%$$

Note. PBT means net profit before tax and PAT means net profit after tax.

3. Operating Ratio

Operating ratio indicates the ratio of operational cost to the sales. Operating cost consists of cost of goods sold and other operating expenses. Operational efficiency of the business will be more in case of lesser operating ratio and *vice versa*. The ratio can be calculated on the basis of the following formula:

$$\text{Operating Ratio} = \frac{\text{Operating Cost}}{\text{Revenue from Operation}} \times 100$$

$$\text{Operating Cost} = \text{Cost of Revenue from Operations} + \text{Operating Expenses}$$

$$\text{Cost of Revenue from Operations} = \text{Cost of materials consumed} + \text{purchase of stock-in-trade} + \text{change in Inventory (Finished Goods; Work in Progress \& Stock-in-trade)} + \text{Direct Expenses}$$

Or

$$\text{Opening Inventories} + \text{Net Purchases} + \text{Direct Expenses} - \text{Closing Inventories}$$

Or

$$\text{Revenue from Operations} - \text{Gross Profit}$$

$$\text{Operating Expenses} = \text{Employees Benefit expenses} + \text{Depreciation} + \text{Other expenses}$$

$$\text{Other Expenses} = \text{Office, Administrative, Selling and Distribution Expenses etc.}$$

Operating expenses do not include loss on sale of assets, depreciation, reserve maintained and goodwill written off etc. These expenses mean only those expenses which are concerned with the day-to-day affairs of the business.

Operating ratio is also related to net profit ratio. As such it can also be calculated by the following formula:

$$\text{Operating ratio} = 100\% - \text{Net profit ratio.}$$

In other words:

$$\text{Operating Ratio} + \text{Operating profit ratio} = 100\%$$

NOTES

The true efficiency of the business is increasing net profit ratio and decreasing operating ratio. An increase in the operating ratio means increased operating cost, which is against the interest of the company.

NOTES

Purpose of Operating Ratio

The purpose is to calculate operating expenses in relation to total sales of the company.

Illustration 6

From the following Calculate operating Ratio

S. No.	Items	Amount (₹)
1.	Cost of Revenue from Operations	50,000
2.	Revenue from Operation	1,50,000
3.	Other Operating Expenses	20,000

Solution.

$$\begin{aligned} \text{Operating Ratio} &= \frac{\text{Operating Cost}}{\text{Revenue from Operation}} \times 100 \\ &= \frac{50,000 + 20,000}{1,50,000} \times 100 = 46.67\% \end{aligned}$$

Operating Profit Ratio

The ratio establishes relationship between operating net profit and net sales. Operating profit is ascertained as under:

Operating Profit = Net Profit as per Profit and Loss + Non-operating expenses – Non-operating income

Alternatively. Gross Profit + Operating income – Operating expenses

$$\text{Operating Profit Ratio} = \frac{\text{Operating Profit}}{\text{Revenue from Operations}} \times 100$$

$$\text{Operating Profit} = \text{Net Profit (After Tax)} + \text{Non-Operating Expenses/Losses} - \text{Non-Operating Incomes}$$

Or

$$\text{Gross Profit} + \text{Other Operating Incomes} - \text{Other Operating Expenses}$$

$$\text{Non-Operating Expenses} = \text{Finance cost} + \text{Other Non-Operating Expenses}$$

$$\text{Finance cost} = \text{Interest on Long-Term Borrowings etc.}$$

$$\text{Other Non-Operating Expenses} = \text{Loss on sale of Non-Current Assets etc.}$$

$$\text{Non-Operating Incomes} = \text{Other Incomes}$$

$$\text{Other Income} = \text{Interest received on investments} + \text{Profit of sale of Non-Current Assets etc.}$$

Illustration 6 From the following calculate:

(a) Net Profit Ratio

(b) Operating Profit Ratio

S. No.	Items	Amount (₹)
1.	Revenue from Operations	2,00,000
2.	Gross Profit	75,000
3.	Office Expenses	15,000
4.	Selling Expenses	26,000
5.	Interest on Debentures	5,000
6.	Accidental losses	12,000
7.	Income from Rent	2,500
8.	Commission received	2,000

NOTES

Solution.

(a) Net Profit Ratio = $\frac{\text{Net Profit}}{\text{Revenue from Operations}} \times 100$

Net Profit = Gross Profit – Indirect expenses and losses
+ Other incomes

Indirect expenses and losses = Office expenses + Selling expenses + Interest on debentures + Accidental losses

= ₹ 15,000 + ₹ 26,000 + ₹ 5,000 + ₹ 12,000

= ₹ 58,000

Other incomes = Commission received + Income from rent

= ₹ 2,000 + ₹ 2,500

= ₹ 4,500

Net profit = ₹ 75,000 – ₹ 58,000 + ₹ 4,500

= ₹ 21,500

Revenue from Operations = ₹ 2,00,000

∴ Net Profit Ratio = $\frac{21,500}{2,00,000} \times 100 = 10.75\%$

(b) Operating Profit Ratio = $\frac{\text{Operating Profit}}{\text{Revenue from Operations}} \times 100$

Operating Profit = Gross Profit + Other Operating Income – Other Operating Expenses

= ₹ 75,000 + ₹ 2,000 – ₹ 15,000 – ₹ 26,000

= ₹ 36,000

Revenue from Operations = ₹ 2,00,000

∴ Operating Profit Ratio = $\frac{36,000}{2,00,000} \times 100 = 18\%$

4. Return on Investment or Return on Capital Employed or Yield on Capital

This is one of the most important ratios for the measure of overall profitability. It indicates the **relationship of net profit with capital employed in the business**. Here, return for calculating return on investment will mean the **net profit before interest, tax and preference dividend**. Net profit means net profit of the year **excluding** undivided profit and reserves. Investment, here means capital employed meaning **long term funds which consists of the following:**

Return on Investment of Return on Capital Employed

$$= \frac{\text{Net Profit before Interest and Tax}}{\text{Capital Employed}} \times 100$$

NOTES.

Capital Employed may be calculated by any of the following two Methods.

(1) Liabilities Side Approach	(2) Assets Side Approach
Shareholders Funds (Share Capital + Reserves and surplus) + Non-Current liabilities (Long-term borrowings + Long-term Provisions)	Non-Current Assets + Working Capital Non-Current Assets = Tangible Assets + Intangible Assets + Non-Current investments + Long-term Loans & Advances Working Capital = Current Assets - Current Liabilities
<i>Note: It is assumed that all Investments are Trade Investments.</i>	

Illustration 8

From the following calculate Return on Investment (or Return on Capital Employed)

S. No.	Items	Amount (₹)
1.	Share Capital	50,000
2.	Reserves and Surplus	25,000
3.	Net Fixed Assets	2,25,000
4.	Non Current Trade Investments	25,000
5.	Current Assets	1,10,000
6.	12% Long-term borrowings	2,00,000
7.	Current Liabilities	85,000

Net Profit before tax ₹ 60,000.

Solution.

Return on Investment or Return on Capital Employed

$$= \frac{\text{Net Profit before Interest and Tax}}{\text{Capital Employed}} \times 100$$

Net Profit before interest and tax = ₹ 60,000 + ₹ 24,000
= ₹ 84,000

Capital Employed = Share Capital + Reserves and Surpluses + 12% long term borrowings
= ₹ 50,000 + ₹ 25,000 + ₹ 2,00,000
= ₹ 2,75,000

∴ Return on Investment or Return on Capital Employed
= $\frac{84,000}{2,75,000} \times 100 = 30.54\%$

Uses of Return on Investment

- (i) Return on Investment is a very significant ratio for measuring operation efficiency of the management.
- (ii) It measures overall profitability of the business.
- (iii) It is used for comparing the performance of the different departments and sections of the enterprise.
- (iv) It can also be used to compare the profitability of the firm with other firms of the industry.

(v) Return on Investment helps in making investment decisions.

(vi) It also assists in planning capital structure of the company. It enables the enterprise in deciding the ratio of various long term sources in the capital structure of the company.

(vii) Return on Investment helps in determining the price of the product.

NOTES

TURNOVER OR PERFORMANCE OR ACTIVITY RATIOS

Turnover means 'sales', so turnover ratios are related to sales. It is an accepted fact that sales has direct relationship with the performance of the business. Higher sales means better performance, which really means better efficiency and productivity of the business. Higher sales also means more production, which is undoubtedly the result of the best possible utilisation of physical resources *i.e.*, material, machine, and active participation of human resource. In this way, words turnover, performance and activity are synonymous. These three words carry the same sense. In other words, more sales means the business is more active and has better performance.

Lesser sale shows inactivity of the business, poor performance and lesser productivity. All business activities revolve round the sales. It is the sales budget, which is prepared first of all. Production budget is made to produce the desired quantity of goods, required for sale. Production concerns raw material workers, machines, tools, equipments and management. Every company should try to multiply its sales, because it is an indicator of all round development of the business.

Kinds of Turnover Ratios

Turnover ratios consist of the following important ratios:

- (i) Stock or Inventory turnover ratio
- (ii) Working capital turnover ratio
- (iii) Trade Receivables turnover ratio
- (iv) Payable turnover ratio
- (v) Fixed assets turnover ratio
- (vi) Current assets turnover ratio

1. Stock or Inventory Turnover Ratio

This ratio establishes relationship between cost of goods sold and average Inventory and reflects the speed of turning over the stock into sales.

This ratio is calculated as under:

$$(a) \text{ Inventory Turnover Ratio} = \frac{\text{Cost of Revenue from Operations}}{\text{Average Inventory}} = \text{Items}$$

$$\text{Cost of Revenue from Operations} = \text{Cost of materials consumed} + \text{purchase of stock-in-trade} + \text{change in inventory (Finished Goods; Work in Progress and Stock-in-trade)} + \text{Direct Expenses}$$

Or

$$\text{Opening Inventory} + \text{Net Purchases} + \text{Direct Expenses} - \text{Closing Inventories}$$

Or

$$\text{Revenue from Operations} - \text{Gross Profit}$$

$$\text{Average Inventory} = \frac{\text{Opening Inventory} + \text{Closing Inventory}}{2}$$

Purpose of Inventory Ratio

The purpose of this ratio is to calculate the number of times inventory is covered by the cost of goods sold or sales.

NOTES

Illustration 9 Calculate Inventory turnover ratio in the following cases:

(i)	Cost of revenue from operation	₹ 2,00,000
	Average Inventory	₹ 40,000
(ii)	Revenue From Operations (Gross)	₹ 2,20,000
	Average Inventory	₹ 40,000
	Sales return	₹ 20,000
	Gross Profit	20% on sales.
(iii)	Opening Inventory	₹ 21,000
	Closing Inventory	₹ 29,000
	Purchases	₹ 1,00,000
	Wages	₹ 10,000

Solution. (i) $\text{Inventory turnover ratio} = \frac{\text{Cost of revenue from operations}}{\text{Average Inventory}}$
 $= \frac{2,00,000}{40,000} = 5 \text{ times.}$

(ii) $\text{Revenue from Operations (Net sales)} = \text{Revenue from operations (Gross)} - \text{Sales return}$
 $= 2,20,000 - 20,000 = ₹ 2,00,000$

Gross profit = 20% on sales
 $= 2,00,000 \times \frac{20}{100} = ₹ 40,000$

Cost of Revenue from Operations = Revenue from Operation (Net Sales)
 - Gross Profit = 2,00,000 - 40,000
 $= ₹ 1,60,000$

$\text{Inventory turnover ratio} = \frac{\text{Cost of good sold}}{\text{Average Inventory}} = \frac{1,60,000}{40,000} = 4 \text{ times.}$

(iii) **Cost of revenue from operations** = Opening Inventory + Purchases + Wages
 - Closing Inventory
 $= 21,000 + 1,00,000 + 10,000 - 29,000 = ₹ 1,02,000$

Average Inventory = $\frac{\text{Opening Inventory} + \text{Closing Inventory}}{2}$
 $= \frac{21,000 + 29,000}{2} = 25,000$

$\text{Inventory turnover ratio} = \frac{\text{Cost of goods sold}}{\text{Average Inventory}} = \frac{1,02,000}{25,000}$
 $= \frac{102}{25} = 4.08 \text{ times.}$

Illustration 10 Inventory turnover ratio is 2.5 times. Average Inventory is ₹ 20,000. Calculate cost of revenue from operations and also Revenue from Operations, if profit earned is 25% of cost.

Solution. $\text{Inventory turnover ratio} = \frac{\text{Cost of Revenue from Operations}}{\text{Average Inventory}} = 2.5 \text{ times (given)}$

It shows that cost of revenue from operations is 2.5 times of average inventory, i.e.,

$$\text{Cost of Revenue from Operations} = 20,000 \times 2.5 = ₹ 50,000$$

$$\text{Profit} = 25\% \text{ of cost}$$

$$= 50,000 \times \frac{25}{100} = ₹ 12,500$$

$$\text{Revenue from Operations (i.e., Net Sales)} = \text{Cost of Revenue from Operations} + \text{Profit}$$

$$= 50,000 + 12,500 = ₹ 62,500$$

NOTES

2. Working Capital Turnover Ratio

This ratio measures the relationship between working capital and sales. The ratio shows the number of times the working capital results, in sales. Working capital as usual is the excess of *current assets over the current liabilities*. The following formula is used to measure this ratio.

$$\text{Working Capital turnover Ratio} = \frac{\text{Revenue from Operations}}{\text{Working Capital}} = \text{Times}$$

$$\text{Working Capital} = \text{Current Assets} - \text{Current Liabilities}$$

$$\text{Current Assets} = \text{Current Investments} + \text{Inventories} + \text{Trade Receivables} + \text{Cash and Cash Equivalents} + \text{Short Term Loans and Advances} + \text{Other Current Assets}$$

$$\text{Current Liabilities} = \text{Short-Term Borrowings} + \text{Trade Payables} + \text{Other Current Liabilities} + \text{Short-term Provisions}$$

Purpose of Working Capital Turnover

The purpose of this ratio is to measure the working capital performance of the business in terms of total sales.

Illustration 11 Calculate working Capital Turnover Ratio from the following:

S. No.	Items	Amount (₹)
1.	Current Asset	9,00,000
2.	Revenue from Operations	24,00,000
3.	Current Liabilities	1,00,000

$$\text{Solution. Working Capital Turnover Ratio} = \frac{\text{Revenue from Operations}}{\text{Working Capital}}$$

$$\text{Revenue from Operations} = ₹ 24,00,000$$

$$\text{Working Capital} = \text{Current Asset} - \text{Current Liabilities}$$

$$= ₹ 9,00,000 - ₹ 1,00,000$$

$$= ₹ 8,00,000$$

$$\text{Working Capital Turnover Ratio} = \frac{24,00,000}{8,00,000} = 3 \text{ Times}$$

3. Trade Receivables Turnover Ratio

It is also known as receivable turnover ratio. It establishes relationship between credit revenue from operation and average trade receivables. This ratio is calculated on the basis of the following formula:

$$\text{Trade Receivables turnover ratio} = \frac{\text{Net credit Revenue from Operations}}{\text{Average trade receivables}}$$

NOTES

Net credit revenue from operations = Revenue from Operations – Cash Revenue from Operations

Credit sales is separately given or it may be the difference between total sales and cash sales. Credit sales may also be calculated by preparing Account Receivable Account. In other words, excess of the total of cash received from Account Receivable, Sales Return, Bad Debts and bills drawn over the opening balance of Account Receivable is credit sales.

$$\text{Average Trade Receivables} = \frac{\text{Opening Trade Receivable} + \text{Closing Trade Receivable}}{2}$$

In case of receivable turnover ratio Account Receivable and B/R are added together to determine the receivable.

Purpose of Receivable Turnover Ratio

The purpose is to measure the Account Receivable coverage through total credit sales of the business.

Illustration 12 Calculate Trade Receivables turnover ratio, if total sales are ₹ 2,50,000, cash sales ₹ 70,000. Account Receivable in the beginning are ₹ 16,000 and at the end is ₹ 8,000 more.

$$\begin{aligned} \text{Solution. Credit sales} &= \text{Total revenue from operations} - \text{Cash revenue from operations} \\ &= 2,50,000 - 70,000 = 1,80,000 \end{aligned}$$

$$\text{Receivables in the beginning} = 16,000$$

$$\text{Receivables at the end} = 16,000 + 8,000 = 24,000$$

$$\begin{aligned} \text{Average Receivable} &= \frac{\text{Opening Trade Receivables} + \text{Closing Trade Receivables}}{2} \\ &= \frac{16,000 + 24,000}{2} = ₹ 20,000 \end{aligned}$$

$$\text{Receivable Turnover Ratio} = \frac{\text{Credit Revenue from Operations}}{\text{Average Trade Receivables}} = \frac{1,80,000}{20,000} = 9 \text{ times.}$$

4. Trade Payables or Creditor's Turnover Ratio

The ratio explains the velocity with which Account Payables are paid and establishes relationship between Account Payables and amount paid to them. Accounts payable includes Account Payables and bills payable. The following formula is used to calculate it:

$$\text{Payable turnover ratio} = \frac{\text{Net Credit Purchases}}{\text{Accounts Payable}}$$

Purpose of Payable Turnover

The purpose is to calculate the account payable coverage through credit purchases of the business.

Illustration 13 Calculate payable turnover ratio from the following information:

Credit Purchases	₹ 4,50,000
Trade Payable	₹ 1,00,000
Bills Payable	₹ 50,000.

$$\text{Solution. Trade Payable Turnover Ratio} = \frac{\text{Credit Purchases}}{\text{Trade Payables}} = \frac{4,50,000}{1,50,000} = 3 \text{ times.}$$

FINANCIAL RATIOS

Liquidity Ratios

Liquidity ratios are calculated to measure the short term financial soundness of the business. The ratio assesses the capacity of the company to repay its short term liability. Banks and other moneylenders for short period are interested in the current assets of the company *i.e.*, short-term financial position of the business. This ratio is also an effective source to ascertain, whether the working capital has been effectively utilised. Liquidity in the ratio means ability to repay loans.

Following ratios are calculated to determine the liquidity or short term solvency of the company:

(i) Current ratio or Working capital ratio (ii) Liquid ratio.

1. Current Ratio or Working Capital Ratio

The ratio indicates the short term financial soundness of the company. It judges whether current assets are sufficient to meet the current liabilities or not. The company must be able to meet its current obligations out of the current assets. It should not depend upon its long term sources to pay its short term liabilities. The ratio is calculated on the basis of the following formula:

$$(a) \text{ Current ratio} = \frac{\text{Current Assets}}{\text{Current Liabilities}}$$

Current Assets = Current Investments + Inventories + Trade Receivables + Cash and Cash Equivalents + Short Term Loans and Advances + Other Current Assets (prepaid expenses + accrued incomes + advance tax)

Current Liabilities = Short-term Borrowings + Trade Payables + Other Current Liabilities + Short-term Provisions

Purpose of Current Ratio

The purpose of current ratio is to measure the liquidity position of the company in terms of its short term working capital requirement. This is a widely used ratio to analyse the short-term solvency of the business.

2. Liquid Ratio

This ratio is also known as **Acid test ratio** or **Quick assets ratio**. The ratio shows liquidity of the business in real sense. According to **Soloman, J. Flink**, "*Liquidity is the ability of the firm to meet its current obligations as they fall due.*" **Liquid assets are current assets less stock and prepaid expenses.** These assets are called liquid assets, because they can be converted into cash promptly or very shortly. The following formula is used to calculate this ratio:

$$(b) \text{ Liquid ratio} = \frac{\text{Liquid Assets}}{\text{Current Liabilities}}$$

Liquid Assets = Current Assets – Inventories – Other current assets

Current Liabilities = Short-term Borrowings + Trade Payables + Other Current Liabilities + Short-term Provisions

The standard liquid ratio is thought to be 1 : 1 *i.e.*, liquid assets should be equal to current liabilities. If the ratio is higher *i.e.*, current assets are more than the current liabilities, the short-term financial position is supposed to be very sound.

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Alternative Calculation of Current Assets and Current Liabilities:

Current Assets may also be calculated by adding working capital and Current Liabilities. Current Liabilities are excess of Current Assets over working capital. Current Liabilities may also be calculated by deducting long term-debts from Total debts. It can be summarised as under:

$$\text{Current Liabilities} = \text{Total Debts} - \text{Long-term Debts}$$

$$\text{Current Liabilities} = \text{Current Assets} - \text{Working Capital}$$

$$\text{Current Assets} = \text{Working Capital} + \text{Current Liabilities}$$

Purpose of Liquid Ratio

The purpose of liquid ratio is to calculate the very short term (i.e., 6 months) availability of cash to meet day-to-day requirement.

**Illustration 14 Calculate current and liquid ratio from the following information:
Statement of Profit and Loss**

Particular	As at Current Year
I. EQUITY AND LIABILITIES	
1. Shareholder's Funds	
(a) Share Capital	
Equity Share Capital	1,00,000.00
2. Non-current Liabilities	
(a) Long-term Borrowings Debentures	1,15,000.00
3. Current Liabilities	
	65,000.00
Total	2,80,000.00
II. ASSETS	
1. Non-current Assets	
(a) Fixed Assets	1,50,000.00
2. Current Assets	
(a) Inventory	10,000.00
(b) Trade Receivables	1,20,000.00
Total	2,80,000.00

Solution. (i) $\text{Current Ratio} = \frac{\text{Current Assets}}{\text{Current Liabilities}} = \frac{1,30,000}{65,000} = 2 \text{ times.}$

$$\text{Current Assets} = \text{Trade Receivables} + \text{Inventory} = 1,20,000 + 10,000 = ₹ 1,30,000$$

(ii) $\text{Liquid Ratio} = \frac{\text{Liquid Assets}}{\text{Current Liabilities}} = \frac{1,20,000}{65,000} = 1.84 \text{ times}$

Illustration 15 Calculate current assets:

- (i) If current ratio is 2.5 times and current liabilities are 20,000.
- (ii) Calculate current liabilities, if current assets are 1,20,000 and current ratio is three times.
- (iii) If current liabilities are 30,000, current ratio 2.25 times and liquid ratio 1.25 times. Calculate current assets, liquid assets and stock in trade.

Solution. (i) $\text{Current Ratio} = \frac{\text{Current Assets}}{\text{Current Liabilities}} = 2.5 \text{ times (given)}$

It shows that current assets are 2.5 times of the current liabilities, i.e., 20,000
 $\times 2.5 = ₹ 50,000.$

(ii) $\text{Current Assets} = ₹ 1,20,000 \text{ (given)}$

$$\text{Current Ratio} = \frac{\text{Current Assets}}{\text{Current Liabilities}} = 3 \text{ times}$$

The ratio shows that current liabilities will be 1/3rd of the current assets, i.e.,

$$1,20,000 \times 1/3 = ₹ 40,000.$$

(iii) $\text{Current Liabilities} = ₹ 30,000$

$$\text{Current Ratio} = \frac{\text{Current Assets}}{\text{Current Liabilities}} = 2.25 \text{ times}$$

The ratio shows that current assets are 2.25 times of current liabilities, i.e.,

$$30,000 \times 2.25 = ₹ 67,500 = \text{Current Assets}$$

$$\text{Liquid Ratio} = \frac{\text{Liquid Assets}}{\text{Current Liabilities}} = 1.25 \text{ times}$$

Hence, $\text{Liquid Assets} = 30,000 \times 1.25 = ₹ 37,500$

$$\begin{aligned} \text{Inventory} &= \text{Current assets} - \text{Liquid assets} \\ &= 67,500 - 37,500 = ₹ 30,000. \end{aligned}$$

Illustration 16 *Smrita Limited has current ratio of 3 : 1. If its Inventory is ₹ 40,000 and total current liabilities are ₹ 75,000. Find out its quick ratio and comment upon the short term financial position of the company.*

Solution. $\text{Current Ratio} = \frac{\text{Current Assets}}{\text{Current Liabilities}} = \frac{\text{Current Assets}}{75,000} = 3$
 $= \text{Current Assets} = 75,000 \times 3 = ₹ 2,25,000$

$\text{Liquid (Quick) Assets} = \text{Current assets} - \text{Inventory} = 2,25,000 - 40,000 = ₹ 1,85,000$

$$\text{Quick Ratio} = \frac{\text{Quick Assets}}{\text{Current Liabilities}} = \frac{1,85,000}{75,000} = 37 : 15 = 2.47 \text{ times.}$$

Comment

Short-term financial position of the Smrita limited is sound because its quick ratio is 2.47 times, whereas ideal standard quick ratio is 1 : 1.

Illustration 17 *Calculate the current ratio from the following information:*

Total Assets ₹ 3,00,000

Non-current Liabilities ₹ 80,000

Shareholders' Funds ₹ 2,00,000

Non-current Assets:

Fixed Assets ₹ 1,60,000

Non-current Investments ₹ 1,00,000

Solution. $\text{Total Assets} = \text{Non-current Assets} + \text{Current Assets}$
 $₹ 3,00,000 = ₹ 2,60,000 + \text{Current Assets}$
 $\text{Current Assets} = ₹ 3,00,000 - ₹ 2,60,000 = ₹ 40,000$

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$$\begin{aligned}
 \text{Total Assets} &= \text{Equity and Liabilities} \\
 &= \text{Shareholders' Funds} + \text{Non-current Liabilities} + \text{Current Liabilities} \\
 ₹ 3,00,000 &= ₹ 2,00,000 + ₹ 80,000 + \text{Current Liabilities} \\
 \text{Current Liabilities} &= ₹ 3,00,000 - ₹ 2,80,000 \\
 &= ₹ 20,000 \\
 \text{Current Ratio} &= \frac{\text{Current Assets}}{\text{Current Liabilities}} = \frac{₹ 40,000}{₹ 20,000} = 2 : 1
 \end{aligned}$$

SOLVENCY RATIOS

'Solvency' means the ability of the business to repay its outside liabilities. These liabilities may be categorised as short term liabilities and long term liabilities. Ratios concerning the short term solvency (financial soundness) of the business have been discussed under liquidity ratios. Here, the term solvency ratios has been used to mean long term financial position of the business. It is an accepted financial truth that the company must have sufficient long term funds to meet its long term liabilities. Long term funds include long term loans and shareholders' funds. Solvency ratios also measure the relationship between external equities and internal equities.

Objectives of Solvency Ratios

Solvency refers to the financial capability of the enterprise in honouring their long term commitments (obligation). These ratios serve our following purpose:

1. Ascertaining capability to honour long term obligations, such as repayment of loan and interest thereon.
2. Ensuring long term financial stability of the business.
3. Measuring relationship between internal and external equity.

Long-term requirements must be met out of long term funds, such as funds for purchase of fixed assets *i.e.*, Land and Building, Plant and Machinery must be provided out of share capital or long term loans. These ratios indicating long term financial position are as under:

1. Debt to Equity Ratio
2. Total Assets to Debt Ratio
3. Proprietary Ratio
4. Interest Coverage Ratio.

1. Debt to Equity Ratio

$$\begin{aligned}
 \text{Debt Equity Ratio} &= \frac{\text{Debt}}{\text{Equity Shareholders Fund}} \\
 \text{Debt} &= \text{Long-term Borrowings} + \text{Long-term Provisions} \\
 \text{Equity/Shareholders' Funds} &= \text{Share Capital} + \text{Reserves and Surplus} \\
 \text{Share Capital} &= \text{Equity Share Capital} + \text{Preference Share capital}
 \end{aligned}$$

Or

$$\begin{aligned}
 \text{Equity/Shareholders' Funds} &= \text{Non-current Assets} + \text{Working Capital} - \text{Non-current Liabilities} \\
 \text{Non-current Assets} &= \text{Tangible Assets} + \text{Intangible Assets} + \text{Non-current Investments} + \text{Long-term Loans and Advances} \\
 \text{Working Capital} &= \text{Current Assets} - \text{Current Liabilities} \\
 \text{Non-current Liabilities} &= \text{Long-term Borrowings} + \text{Long-term Provisions}
 \end{aligned}$$

This ratio is calculated to judge the long-term financial policy of the business. The ratio establishes relationship between long term loans and owners' funds.

The ideal debt equity ratio in India is accepted as 2 : 1, meaning that the long-term liabilities of the business should be two times of shareholders' funds. In other words, shareholders' funds should be 0.5 times of long-term loans. Higher debt equity ratio shows lesser margin for long-term lenders. This ratio indicates to what extent the firm depends on outsiders' funds for existence. It also shows the cushion or cover of owners' funds available to creditors.

Purpose of Debt Equity Ratio

The purpose of debt equity ratio is to measure the long-term solvency of the business. A higher debt to equity ratio is not considered good for the business.

Illustration 18 From the following balance sheet of a company, calculate Debt-Equity Ratio:

Balance Sheet

Particular	Note No.	Amount in (₹)	
		Amount as on current year (₹)	Amount as on previous year (₹)
I. EQUITY AND LIABILITIES			
1. Shareholder's Funds			
(a) Share capital		10,00,000	
(b) Reserves and surplus	1	1,00,000	
2. Non-current Liabilities			
(a) Long-term borrowings		1,50,000	
3. Current Liabilities			
		1,50,000	
Total		14,00,000	
II. ASSETS			
1. Non-current Assets			
(a) Fixed assets			
(i) Tangible assets	2	11,00,000	
2. Current Assets			
(a) Inventories		1,00,000	
(b) Trade receivables		90,000	
(c) Cash and cash equivalents		1,10,000	
Total		14,00,000	

Notes to Accounts

Note 1

Share Capital

Particulars	Amount as on current year (₹)	Amount as on previous year (₹)
Equity Share Capital	8,00,000	
Preference Share Capital	2,00,000	
	10,00,000	

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Tangible Assets

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Particulars	Amount as on current year (₹)	Amount as on previous year (₹)
Plant and Machinery	5,00,000	
Land and Building	4,00,000	
Motor Car	1,50,000	
Furniture	50,000	
	11,00,000	

$$\text{Solution. Debt-Equity Ratio} = \frac{\text{Long-term Debts}}{\text{Equity (Shareholders Funds)}}$$

$$\begin{aligned} \text{Long-term Debts} &= \text{Long-term Borrowings} \\ &= ₹ 1,50,000 \end{aligned}$$

$$\begin{aligned} \text{Equity} &= \text{Share capital + Reserves and surplus} \\ &= ₹ 10,00,000 + ₹ 1,00,000 = ₹ 11,00,000 \end{aligned}$$

$$\text{Debt-Equity Ratio} = \frac{1,50,000}{11,00,000} = 136 : 1$$

Illustration 19 (a) From the following information, compute 'Debt-Equity Ratio':

	₹
Long-term Borrowings	2,00,000
Long-term Provisions	1,00,000
Current Liabilities	50,000
Non-current Assets	3,60,000
Current Assets	90,000

(b) The current ratio of X Ltd., is 2 : 1. State with reason which of the following transactions would (i) increase; (ii) decrease; or (iii) not change the ratio:

- (i) Included in the trade payables was a bills payable of ₹ 9,000 which was met on maturity.
- (ii) Company issued 1,00,000 equity shares of ₹ 10 each to the Vendors of machinery purchased.

$$\text{Solution. (a) Debt - Equity Ratio} = \frac{\text{Debts}}{\text{Equity}}$$

$$\begin{aligned} \text{Debt} &= \text{Long-term borrowings + Long-term Provisions} \\ &= ₹ 2,00,000 + ₹ 1,00,000 \\ &= ₹ 3,00,000 \end{aligned}$$

$$\begin{aligned} \text{Equity} &= \text{Current Assets + Non-current Assets - Debt - Current Liabilities} \\ &= 90,000 + 3,60,000 - 3,00,000 - 50,000 \\ &= ₹ 1,00,000 \end{aligned}$$

$$\text{Debt - Equity Ratio} = \frac{₹ 3,00,000}{₹ 1,00,000} = 3 : 1.$$

(b) Change Reason

- (i) Increase : Both Current Assets and Current Liabilities are decreasing with same amount.
- (ii) No change: Neither Current Assets nor Current Liabilities are changing.

2. Total Assets to Debt Ratio

This ratio represents the relationship between Total Assets and Debt. Total Assets include all those assets which have been purchased from long term resources. **These assets do not include Fictitious Assets**, like, Preliminary Expenses, Underwriting Commission and Discount or loss on issue of shares and Debentures etc.

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$$\text{Total Assets to Debt Ratio} = \frac{\text{Total Assets}}{\text{Debt}}$$

Total Assets = **Non-current Assets** (Tangible Assets + Intangible Assets + Non-current Investments + Long-term Loans and advances)

Current Assets (Current Investments + Inventories + Trade Receivables + Cash and Cash Equivalents + Short-term Loans and Advances + Other Current Assets).

Debt = Long-term Borrowings + Long-term Provisions

Significance

The ratio is significant, because it informs the Account Payables that how far loans advanced by them are safe. It also provides knowledge regarding the protection provided by assets of the company to their debts. This ratio facilitates the lenders and investors to take a decision regarding grant of loans in future.

Note. The Standard Total Assets to Debt Ratio is 2 : 1.

Purpose of Total Assets to Debt

The purpose is to analyse the coverage of total assets on the total debt of the company.

3. Proprietary Ratio

This ratio indicates the relationship between proprietors funds and total assets. The proprietor's funds include equity share capital, preference share capital, revenue, capital reserves and accumulated surplus. Total assets include fixed, current and fictitious assets.

This ratio is very important for the Account Payables, because they know the share of proprietors funds in the total assets and satisfy how far their loan is secured. The higher the ratio, the more safety will be to the creditors. The ratio also shows the general financial position of the company also. 50% is supposed to be the satisfactory proprietary ratio for the Account Payables. Lesser than 50% is the sign of risk for Account Payables. The following formula is used to calculate proprietary ratio:

$$\text{Proprietary Ratio} = \frac{\text{Proprietary Fund or Shareholder's Fund}}{\text{Total Assets}}$$

Proprietor's Fund = Share Capital + Reserves and Surplus

Share capital = Equity Share Capital + Preference Share Capital

Or

Proprietor's Fund = Non-current Assets + Working Capital Non-current Liabilities

Non-current Assets = Tangible Assets + Intangible Assets + Non-current Investments + Long-term Loans and Advances

Working Capital = Current Assets – Current Liabilities

Non-current liabilities = Long-term Borrowings + Long-term Provisions

Total Assets = **Non-current Assets** (Tangible Assets + Intangible Assets + Non-current Investments + Long-term Loans and advances + Other Non-current Assets).
Current Assets (Current Investments + Inventories + Trade Receivables + Cash and Cash Equivalent + Short-term Loans and Advances + Other Current Assets).

Purpose of Proprietary Ratio

The purpose of this ratio is to calculate the consistency of proprietor's fund in the overall business profits. This is used to indicate the control of proprietors of the business.

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4. Interest Coverage Ratio

$$\text{Interest Coverage Ratio} = \frac{\text{Profit before Interest and Tax}}{\text{Interest on Long-term Debt}}$$

Profit before interest and tax = Profit after interest and tax + Interest on long term debt + tax

This ratio calculates the cover or cushion available for fixed interest payment on loans availed by the company. Higher ratio indicates business stability while lower ratio indicates business risk.

Illustration 20 From the following compute:

- (a) Debt to Equity Ratio
- (b) Total Assets to Debt Ratio
- (c) Proprietary Ratio

S. No.	Items	Amount (₹)
1.	Long-term Borrowings	1,00,000
2.	Long-term Provisions	50,000
3.	Current Liabilities	25,000
4.	Non-current Assets	1,80,000
5.	Current Assets	45,000

Solution.

(a) Debt to Equity Ratio = $\frac{\text{Debt}}{\text{Equity/Shareholders' Funds}}$

Debt = Long-term Borrowing + Long-term Provisions
 = ₹ 1,00,000 + ₹ 50,000
 = ₹ 1,50,000

Equity/Shareholders' Funds = Non-current Assets + Working Capital - Non-current Liabilities
 = Non-current Assets + Current Assets - Current Liabilities - Long-term Borrowings - Long-term Provisions
 = ₹ 1,80,000 + ₹ 45,000 - ₹ 25,000 - ₹ 1,00,000 - ₹ 50,000
 = ₹ 50,000

∴ Debt-Equity Ratio = $\frac{1,50,000}{50,000} = 3 : 1$

(b) Total Assets to Debt Ratio = $\frac{\text{Total Assets}}{\text{Debt}}$

Total Assets = Non-current Assets + Current Assets
 = ₹ 1,80,000 + ₹ 45,000
 = ₹ 2,25,000

Debt = Long-term Borrowings + Long-term Provisions
 = ₹ 1,00,000 + ₹ 50,000
 = ₹ 1,50,000

∴ Total Assets to Debt Ratio = $\frac{2,25,000}{1,50,000} = 1.5 : 1$

$$(c) \text{ Proprietary Ratio} = \frac{\text{Shareholder's Fund}}{\text{Total Assets}}$$

$$\text{Shareholders' Funds} = ₹ 50,000$$

$$\text{Total Assets} = ₹ 2,25,000$$

$$\therefore \text{ Proprietary Ratio} = \frac{₹ 50,000}{2,25,000} = 0.22 : 1$$

Illustration 21 *Akshara Ltd., has 8% Debentures of ₹ 5,00,000. Its profit before interest and tax is ₹ 2,00,000. Calculate Interest Coverage Ratio.*

Solution.

$$\text{Interest Coverage Ratio} = \frac{\text{Profit before Interest and Tax}}{\text{Interest on Debentures}}$$

$$\text{Profit before Interest and Tax} = ₹ 2,00,000$$

$$\text{Interest on Debenture} = ₹ 5,00,000 \times \frac{8}{100} = ₹ 40,000$$

$$\therefore \text{ Interest Coverage Ratio} = \frac{2,00,000}{40,000} = 5 \text{ Times}$$

Illustration 22 *Calculate Current Ratio of a company from the following information: Inventory Turnover Ratio: 4 times; Inventory in the end was ₹ 20,000 more than stock in the beginning; Sales ₹ 3,00,000. Gross Profit Ratio 25%. Current Liabilities ₹ 40,000, Quick Ratio 0.75 : 1.*

Solution.

$$\text{Gross profit Ratio} = \text{Gross profit/Sales} \times 100$$

$$25 = \text{Gross Profit/} ₹ 3,00,000 \times 100$$

$$\Rightarrow \text{Gross profit} = ₹ 75,000$$

We know that, $\text{Cost of Goods sold} + \text{Gross Profit} = \text{Net Sales}$

$$\text{Cost of Goods sold} \Rightarrow ₹ 3,00,000 - ₹ 75,000 = ₹ 2,25,000$$

$$\text{Stock turnover Ratio} = \text{Cost of goods sold/average inventory}$$

$$4 = ₹ 2,25,000/\text{average inventory,}$$

$$\text{Average inventory} = ₹ 56,250$$

$$\text{Average Inventory} = (\text{opening inventory} + \text{closing inventory})/2$$

Let Opening inventory be x then Closing Inventory = $x + ₹ 20,000$

$$₹ 56,250 = (x + x + ₹ 20,000)/2$$

$$₹ 56,250 \times 2 = 2x + ₹ 20,000 \Rightarrow x = ₹ 46,250$$

Hence, Opening inventory = ₹ 46,250 and closing inventory = ₹ 66,250

$$\text{Liquid Ratio} = \text{Liquid Assets/Current Liabilities}$$

$$0.75 = \text{Liquid Assets/} ₹ 40,000$$

$$\Rightarrow \text{Liquid Assets} = ₹ 30,000$$

$$\text{Liquid Assets} = \text{Current Assets-inventory} - \text{Prepaid Expenses}$$

$$₹ 30,000 = \text{Current Assets} - ₹ 66,250 - 0$$

$$\text{Current Assets} = ₹ 96,250$$

$$\text{Current Ratio} = \text{Current Assets/Current Liabilities}$$

$$= ₹ 96,250/₹ 40,000 \Rightarrow 2.41$$

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Illustration 23 From the following, Calculate any two ratios (i) Current Ratio, (ii) Debt equity ratio (iii) Inventory Turnover Ratio

Net Sales ₹ 5,00,000, Opening Inventory ₹ 7,000; Closing Inventory ₹ 4,000 more than the Opening Inventory, Net Purchases ₹ 1,00,000 less than Net sales, Operating Expenses ₹ 30,000; Liquid assets ₹ 75,000; Prepaid expenses ₹ 2,000; Current Liabilities ₹ 60,000, 9% Debentures ₹ 3,00,000; Long-term loan ₹ 11,00,000, Equity Shares Capital ₹ 10,00,000; 8% Pref. Share Capital ₹ 2,00,000.

- Solution.** (i) **Liquid Assets** = Current Assets – (Inventory + Prepaid Expenses)
 ₹ 75,000 = Current Assets – (₹ 7,000 + ₹ 4,000 + ₹ 2,000)
 Current Assets = ₹ 88,000
 Current Liabilities = Bills payable + Account Payable + Expenses Payable
 = ₹ 60,000
 Current Ratio = Current Assets/Current Liabilities
 = ₹ 88,000/₹ 60,000 = 1.467 : 1
- (ii) **Debts** = Debentures, Mortgage, public deposit, etc.
 = ₹ 3,00,000 + ₹ 11,00,000 = ₹ 14,00,000
 Shareholders' funds = Paid up Equity Share + Pref. Share + Reserves and Surplus
 = ₹ 10,00,000 + ₹ 2,00,000 = ₹ 12,00,000
 Debt-Equity Ratio = Debts/Equity
 = ₹ 14,00,000/₹ 12,00,000 = 1.167 : 1
- (iii) **Average Inventory** = (Opening Inventory + Closing Inventory)/2
 = (₹ 7,000 + ₹ 11,000)/2 ⇒ ₹ 9,000
 Cost of goods sold = Opening Inventory + Purchases + Direct expenses
 – Closing Inventory
 = ₹ 7,000 + ₹ 4,00,000 + ₹ 30,000 – ₹ 11,000
 ⇒ ₹ 4,26,000
- (iv) **Inventory Turnover Ratio** = Cost of Goods Sold/Average Inventory
 = ₹ 4,26,000/₹ 9,000 = 47.33 Time

Illustration 24 (a) Net profit after Interest but before tax: ₹ 140,000; 15% long-term debts ₹ 4,00,000; Shareholders funds ₹ 2,40,000; Tax rate 50%. Calculate Return on Capital Employed.

(b) Opening Inventory ₹ 60,000; Closing Inventory ₹ 1,00,000; Inventory Turnover Ratio 8 times Selling price 25% above cost. Calculate the Gross Profit Ratio.

Solution. (a) Net Profit after interest but before tax = ₹ 1,40,000

Interest – 15% of 400,000 = ₹ 60,000

No profit before interest and tax = ₹ 1,40,000 + ₹ 60,000 = ₹ 2,00,000

Capital Employed = Long-term debts + Shareholders funds
 = ₹ 4,00,000 + ₹ 2,40,000 ⇒ ₹ 6,40,000

Return on capitals employed = Net profit before interest and tax/capital employed
 = ₹ 2,00,000/₹ 6,40,000 × 100 ⇒ 31.25%

- (b) Average Inventory = (Opening inventory + Closing inventory)/2
 = ₹ 1,60,000/2 ⇒ ₹ 80,000
- Inventory Turnover Ratio = Cost of revenue from operations/Average inventory
 8 = Cost of revenue from operations/ ₹ 80,000
- Cost of Revenue from Operation = ₹ 6,40,000
- Selling price = 25% above cost
 = ₹ 6,40,000 × 1/4 + ₹ 6,40,000 = ₹ 8,00,000
- Gross profit ratio = Gross Profit/Sales × 100
 = (₹ 1,60,000/₹ 8,00,000) × 100 ⇒ 20%

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SUMMARY**(a) Profitability Ratios:**

1. **Gross Profit Ratio** = $\frac{\text{Gross Profit}}{\text{Revenue from Operations}} \times 100$
Gross Profit = Revenue from Operations (*Net Sales*) – Cost of Revenue from Operations
2. **Net Profit Ratio** = $\frac{\text{Net Profit}}{\text{Revenue from Operations}} \times 100$
Net Profit = (Gross Profit + operating and non-operating income – Operating and non-operating expenses)
3. **Operating net profit ratio** = $\frac{\text{Operating Net Profit}}{\text{Revenue from Operations}} \times 100$
Operating Net Profit = (Net Profit as Statement Profit and Loss + Non-operating Expenses – Non-operating Income)
4. **Operating Ratio** = $\frac{(\text{Cost of Revenue from Operations} + \text{Operating expenses})}{\text{Revenue from Operations}} \times 100$
5. **Return on Investment (ROI)** = $\frac{\text{Net profit before interest, tax and dividend}}{\text{Capital employed}} \times 100$
Capital Employed = Shareholders' fund (Share Capital + Reserves and Surplus) + Non-Current Liabilities (Long-Term Borrowings + Long-Term Provisions)
 Or
 = Non-Current Assets + Working Capital
Working Capital = Current Assets – Current Liabilities.
Non-Current Assets = Tangible Assets + Intangible Assets + Non-Current Investments + Long-term Loans and Advances

(b) Turnover or Activity or Performance Ratios:

1. **Working Capital Turnover Ratio** = $\frac{\text{Revenue from Operations}}{\text{Working Capital}}$
Working Capital = Current Assets – Current Liabilities

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$$2. \quad \text{Stock or Inventory Turnover Ratio} = \frac{\text{Cost of Revenue from Operations}}{\text{Average Inventory}}$$

Cost of Revenue from Operations = Revenue from Operations – Gross Profit

or

$$\frac{\text{Opening Inventory} + \text{Net Purchases} + \text{Direct Expenses}}{\text{Less: Closing Inventory}}$$

$$\text{Average Inventory} = \frac{\text{Opening Inventory} + \text{Closing Inventory}}{2}$$

$$3. \quad \text{Debtors Turnover Ratio} = \frac{\text{Net Credit Revenue from Operations}}{\text{Average Receivable}}$$

Average Debtors

$$= \frac{\text{Receivable in the beginning} + \text{Receivable at the end}}{2}$$

Receivables = Trade Receivable + Bills Receivable.

$$4. \quad \text{Trade Payable Turnover Ratio} = \frac{\text{Net Credit Purchases}}{\text{Trade Payable}}$$

(c) Liquidity Ratios:

$$1. \quad \text{Current Ratio} = \frac{\text{Current Assets}}{\text{Current Liabilities}}$$

$$2. \quad \text{Liquid or Quick or Acid Test Ratio} = \frac{\text{Liquid Assets}}{\text{Current Liabilities}}$$

or

$$= \frac{\text{Current Assets} - (\text{Inventory} + \text{Prepaid expenses})}{\text{Current Liabilities}}$$

(d) Solvency (long-term) Ratios:

$$1. \quad \text{Debt to Equity Ratio} = \frac{\text{Debt}}{\text{Equity Shareholders' Funds}}$$

Debt = Long-Term Borrowing + Long-Term Provision.

Shareholders' Funds = Equity and Preference share capital + Reserves and Surplus

$$2. \quad \text{Total Assets to Debt Ratio} = \frac{\text{Total Assets}}{\text{Debt}}$$

Total Assets = Non-Current Assets + Current Assets.

$$3. \quad \text{Proprietary Ratio} = \frac{\text{Proprietors' Funds or Shareholders' Funds}}{\text{Total Assets}}$$

Proprietors' Funds = Share Capital + Reserves and Surplus or Non-Current Assets + Intangible Assets than Current Investments than Current Loans and Advances.

Total Assets = Non-Current Assets + Current Assets

$$4. \quad \text{Interest Coverage Ratio} = \frac{\text{Profit before Interest and Tax}}{\text{Interest on Long-term Debt}}$$

REVIEW QUESTIONS

A. Very Short Answer Type Questions:

1. Name two ratios measuring profitability.
2. What is the ideal proprietary ratio?
3. Name the items required for calculating liquid ratio.
4. What do you mean by Accounting ratios?
5. Assuming that the Current Ratio is 2 : 1, state giving reason whether the ratio will improve, decline or will have no change in case a Bill Receivable is dishonoured.

B. Short Answer Type Questions:

1. Name the classification of ratios on the basis of the purpose.
2. What are the different names of activity ratios? Name two activity ratios.
3. Describe three ratios based upon sales.
4. Explain the uses of profitability ratios.
5. What do you mean by ratio analysis?
6. Write any two advantages of ratio analysis.
7. Write any two objectives of solvency ratio.
8. What do you mean by Accounting ratios? Give any three limitations of ratio analysis.
9. What do you mean by Ratio Analysis? What are the objectives of solvency ratio?
10. What is meant by Accounting ratios? How are they useful?

C. Long Answer Type Questions:

1. What do you mean by ratio analysis? Explain briefly the different methods of ratio analysis with suitable examples.
2. Explain the various objectives or uses of ratio analysis.
3. Explain the importance of ratio analysis.
4. What do you mean by profitability ratios? Explain the calculation of Gross Profit ratio. What can be the possible causes for the decline of gross profit ratios?
5. Explain the meaning and calculation of Net profit and operating net profit ratio.
6. What do you mean by Accounting ratios? Discuss its four uses.
7. Explain the concepts of following ratios and also point out their significance:

(i) Current ratio	(ii) Fixed assets turnover ratio
(iii) Operating ratio	(iv) Debt to equity ratio
(v) Receivable turnover ratio	(vi) Net working capital turnover ratio
(vii) Stock or Inventory turnover ratio	(viii) Gross profit ratio
(ix) Quick ratio/Acid test or liquidity ratio	(x) Net profit ratio
(xi) Return on investment	(xii) Proprietary ratio

NOTES

Practical Questions

NOTES

1. Calculate gross profit ratio in the following cases:

(i) Gross Profit	₹ 60,000
Revenue from Operations	₹ 4,00,000
(ii) Gross Profit	₹ 3,00,000
Revenue from Operations	₹ 15,08,000
Sales Return	₹ 8,000
(iii) Revenue from Operations	₹ 1,20,000
Gross Profit is 25% on cost	
(iv) Revenue from Operations	₹ 4,00,000
Gross Profit is 20% on sales	
(v) Revenue from Operations	₹ 4,00,000
Cost of Revenue from Operations	₹ 3,60,000

[Ans. (i) 15%, (ii) 20%, (iii) 20%, (iv) 20%, (v) 10%]

2. Calculate stock turnover ratio in the following cases:

- (i) Cost of goods sold ₹ 6,00,000 average inventory ₹ 1,20,000
- (ii) Gross Sales ₹ 2,05,000; Sales return ₹ 5,000; Gross Profit 20% on Revenue from Operations and average stock ₹ 40,000
- (iii)

Opening Inventory	82,000	Closing Inventory	59,000
Purchases	2,04,000	Purchase return	4,000
Wages	20,000	Salaries	15,720

[Ans. (i) 5 times (ii) 4 times (iii) 3.45 times]

3. Calculate inventory turnover ratio from the data given below:

Inventory at the beginning of the year	₹ 20,000	Carriage inwards	₹ 5,000
Inventory at the end of the year.	₹ 10,000	Sales	₹ 1,00,000
Purchases	₹ 50,000		

[Ans. 4.33 times or 4.33 : 1]

4. Calculate Receivables turnover ratio from the following information:

Credit sales for the year	₹ 22,50,000
Account Receivables	₹ 2,25,000
Bills receivable	₹ 1,50,000

[Ans. Receivables Turnover Ratio = 6 times]

5. Calculate payable turnover ratio from the following information:

Credit purchases	₹ 4,59,000
Account payable	₹ 1,20,000
Bills payable	₹ 33,000

[Ans. 3 times]

NOTES

6. (i) If current ratio is 2 times and current liabilities are ₹ 20,000. Calculate current assets.
 (ii) Calculate current liabilities, if current assets are ₹ 4,20,000 and current ratio is 2.5 times.
 (iii) If current liabilities are 30,000, current ratio 2.20 times and liquid ratio 1.20 times, calculate current assets, liquid assets and inventory in trade.

[Ans. (i) Current assets = ₹ 40,000 (ii) Current liabilities = ₹ 1,68,000 (iii) Current assets = ₹ 66,000, Liquid assets = ₹ 36,000, Inventory = ₹ 30,000]

7. (i) Current Liabilities of a company are ₹ 6,00,000. Its current ratio is 3 : 1 and liquid ratio is 1 : 1. Calculate value of Inventory-in-trade.
 (ii) A Company's Inventory turnover is 5 times; Inventory at the end is ₹ 10,000 more than that of the beginning; Sales (all credit) are ₹ 4,00,000; Rate of gross profit on cost 1/4; Current Liabilities ₹ 1,20,000 acid test ratio 0.75 times. Calculate Current Assets.

[Ans. (i) 12,00,000 (ii) 1,59,000]

8. Calculate Return on Investment, Inventory turnover ratio from the figures given below:

Particulars	Amount (₹)	Particulars	Amount (₹)
Opening Inventory	30,000	Closing Inventory	40,000
Carriage Inward	10,000	Purchases	1,00,000
Current Assets,	50,000	Current Liabilities	20,000
Fixed Assets	80,000	Indirect expenses	15,000
Sales	2,00,000		

[Ans. Return on Investment = 77.27%; Inventory turnover ratio = 2.86 times]

9. Calculate the amount of opening receivable and closing receivable from the following figures:
 - Account Receivable Turnover ratio 4 times
 Cost of goods sold ₹ 6,40,000
 Gross Profit ratio 20%
 Closing Account Receivable were ₹ 20,000 more than at the beginning. Cash sales being 33.33% of credit sales.
 [Ans. Opening Account Receivable ₹ 1,40,000 and closing account receivable ₹ 1,60,000]
10. Assuming that the Debt-Equity ratio is 2. State giving reasons whether this ratio would increase, decrease or remain unchanged in the following cases:
 (a) Purchase of fixed asset on a credit of 2 months.
 (b) Purchase of fixed asset on a long term deferred payment basis.
 (c) Issue of New shares for each.
 (d) Issue of Bonus shares.
 (e) Sales of fixed asset at a loss of ₹ 3,000.

[Ans. (a) No Change; (b) Increase; (c) Decrease; (d) No Change; (e) Increase]

BBA-202

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