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DIPLOMA IN MANAGEMENT

DIM-5

**Finance and Accounting for
Management**

Block

3

Unit – 1

Financial Accounting and its Principles

Unit – 2

Preparation of Financial Statements

Unit – 3

Depreciation Methods and Techniques

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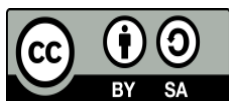
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UNIT-1

FINANCIAL ACCOUNTING AND ITS APPLICATIONS

Learning Objectives

After reading this chapter, you should be able to understand:

- Meaning of Accounting cycle
- Classification of Accounts
- Meaning of Journal and writing up journal
- Meaning of Ledger and format of ledger
- Journal and Ledger-Relationship and Differences
- Meaning and characteristics of Trial Balance
- Preparation of Trial Balance

Structure

- 1.1 Accounting Cycle
- 1.2 Classification of Accounts
- 1.3 Rules of Debit and Credit
- 1.4 Meaning and Format of Journal
- 1.5 Method of Writing up Journal
- 1.6 Limitations of Journal
- 1.7 Meaning and Utility of Ledger
- 1.8 Relationship between Journal and Ledger
- 1.9 Differences between Journal and Ledger
- 1.10 Format of a Ledger Account
- 1.11 Procedure of Posting
- 1.12 Balancing of an Account
- 1.13 Meaning and Characteristics of Trial Balance
- 1.14 Importance of Trial Balance
- 1.15 Methods of Preparation of Trial balance
- 1.16 Errors Not Disclosed by Trial Balance
- 1.17 Errors Disclosed by a Trial Balance
- 1.18 Subsidiary Books
- 1.19 Let's sum-up

- 1.20 Key terms
- 1.21 Self-Assessment Questions
- 1.22 Further Readings
- 1.23 Model Questions

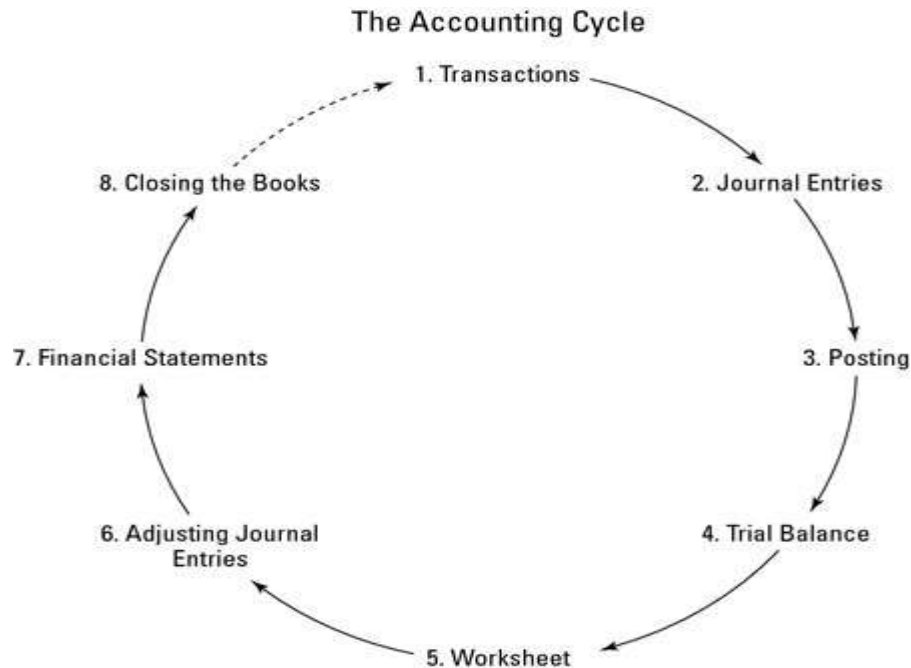




1.1 Accounting Cycle

The accounting cycle is the name given to the collective process of recording and processing the accounting events of a company. The series of steps begin when a transaction occurs and end with its inclusion in the financial statements. An organization begins its accounting cycle with the recording of transactions using journal entries. The entries are based on the receipt of an invoice, recognition of a sale or completion of other economic events. After the company posts journal entries to individual general ledger accounts, an unadjusted trail balance is prepared. The trial balance ensures the total debits equals the total credits in the financial records. At the end of the period, adjusting entries are made. These are the result of corrections that need to be made as well as results from the passage of time. For example, an adjusting entry may accrue interest revenue that has been earned based on the passage of time. Upon the posting of adjusting entries, a company prepares an adjusted trail balance followed by the financial statements.

It's called a cycle because the accounting workflow is circular: entering transactions, manipulating the transactions through the accounting cycle, closing the books at the end of the accounting period, and then starting the entire cycle again for the next accounting period. The accounting cycle has eight basic steps, which you can see in the following illustration. These steps are described in the list below.



1. Transactions

Financial transactions start the process. Transactions can include the sale or return of a product, the purchase of supplies for business activities, or any other financial activity that involves the exchange of the company's assets, the establishment or payoff of a debt, or the deposit from or payout of money to the company's owners.

2. Journal entries

The transaction is listed in the appropriate journal, maintaining the journal's chronological order of transactions. The journal is also known as the "book of original entry" and is the first place a transaction is listed.

3. Posting

The transactions are posted to the account that it impacts. These accounts are part of the General Ledger, where you can find a summary of all the business's accounts.

4. Trial balance

At the end of the accounting period (which may be a month, quarter, or year depending on a business's practices), you calculate a trial balance.



5. *Worksheet*

Unfortunately, many times your first calculation of the trial balance shows that the books aren't in balance. If that's the case, you look for errors and make corrections called *adjustments*, which are tracked on a worksheet.

Adjustments are also made to account for the depreciation of assets and to adjust for one-time payments (such as insurance) that should be allocated on a monthly basis to more accurately match monthly expenses with monthly revenues. After you make and record adjustments, you take another trial balance to be sure the accounts are in balance.

6. *Adjusting journal entries*

You post any corrections needed to the affected accounts once your trial balance shows the accounts will be balanced once the adjustments needed are made to the accounts. You don't need to make adjusting entries until the trial balance process is completed and all needed corrections and adjustments have been identified.

7. *Financial statements*

You prepare the balance sheet and income statement using the corrected account balances.

8. *Closing the books*

You close the books for the revenue and expense accounts and begin the entire cycle again with zero balances in those accounts.

1.2 **Classification of Accounts**

It is necessary to know the classification of accounts and their treatment in double entry system of accounts. Broadly, the accounts are classified into three categories (i) Personal accounts (ii) Real accounts (iii) Nominal Account

Let us go through them each of them one by one.



(a) *Personal Accounts*

Personal accounts may be further classified into three categories:

(i) Natural Personal Account: An account related to any individual like David, George, Ram, or Shyam is called as a *Natural Personal Account*.

(ii) Artificial Personal Account: An account related to any artificial person like M/s ABC Ltd, M/s General Trading, M/s Reliance Industries, etc., is called as an *Artificial Personal Account*.

(iii) Representative Personal Account: Representative personal account represents a group of account. If there are a number of accounts of similar nature, it is better to group them like salary payable account, rent payable account, insurance prepaid account, interest receivable account, capital account and drawing account, etc.

(b) *Real Accounts*

Every Business has some assets and every asset has an account. Thus, asset account is called a real account. There are two type of assets:

- ***Tangible*** assets are touchable assets such as plant, machinery, furniture, stock, cash, etc.
- ***Intangible*** assets are non-touchable assets such as goodwill, patent, copyrights, etc.

Accounting treatment for both types of assets is same.

(c) *Nominal Accounts*

Since this account does not represent any tangible asset, it is called nominal or fictitious account. All kinds of expense account, loss account, gain account or income accounts come under the category of nominal account. For example, rent account, salary account, electricity expenses account, interest income account, etc.



1.3 Rules of Debit and Credit

All accounts are divided into five categories for the purposes of recording the transactions: (a) Asset (b) Liability (c) Capital (d) Expenses/Losses, and (e) Revenues/Gains. Two fundamental rules are followed to record the changes in these accounts:

(1) For recording changes in Assets/Expenses (Losses):

- (i) “Increase in asset is debited, and decrease in asset is credited.”
- (ii) “Increase in expenses/losses is debited, and decrease in expenses/losses is credited.”

(2) For recording changes in Liabilities and Capital/Revenues (Gains):

- (i) “Increase in liabilities is credited and decrease in liabilities is debited.”
- (ii) “Increase in capital is credited and decrease in capital is debited.”
- (iii) “Increase in revenue/gain is credited and decrease in revenue/gain is debited.”

The rules applicable to the different kinds of accounts have been summarized in the following chart:

The Golden Rules of Accounting

1. Debit The Receiver, Credit The Giver

This principle is used in the case of personal accounts. When a person gives something to the organization, it becomes an inflow and therefore the person must be credit in the books of accounts. The converse of this is also true, which is why the receiver needs to be debited.

2. Debit What Comes In, Credit What Goes Out

This principle is applied in case of real accounts. Real accounts involve machinery, land and building etc. They have a debit balance by default. Thus when you debit what comes in, you are adding to the existing account balance. This is exactly what needs to be done. Similarly when you credit what goes out, you are reducing the account balance when a tangible asset goes out of the organization.



3. Debit All Expenses And Losses, Credit All Incomes And Gains

This rule is applied when the account in question is a nominal account. The capital of the company is a liability. Therefore it has a default credit balance. When you credit all incomes and gains, you increase the capital and by debiting expenses and losses, you decrease the capital. This is exactly what needs to be done for the system to stay in balance.

The golden rules of accounting allow anyone to be a bookkeeper. They only need to understand the types of accounts and then diligently apply the rules.

1.4 Meaning and Format of Journal

When the business transactions take place, the first step is to record the same in the books of original entry or subsidiary books or books of prime or journal. Thus journal is a simple book of accounts in which all the business transactions are originally recorded in chronological order and from which they are posted to the ledger accounts at any convenient time. Journalising refers to the act of recording each transaction in the journal and the form in which it is recorded, is known as a journal entry. In accounting and bookkeeping, a journal is a record of financial transactions in order by date. A journal is often defined as the book of original entry.

Format of Journal

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

The journal has five columns, viz. (1) Date; (2) Particulars; (3) Ledger Folio; (4) Amount (Debit); and (5) Amount (Credit) and a brief explanation of the transaction by way of narration is given after passing the journal entry.

(1) **Date:** In each page of the journal at the top of the date column, the year is written and in the next line, month and date of the first entry are written. The year



and month need not be repeated until a new page is begun or the month or the year changes. Thus, in this column, the date on which the transaction takes place is alone written.

(2) **Particulars:** In this column, the details regarding account titles and description are recorded. The name of the account to be debited is entered first at the extreme left of the particulars column next to the date and the abbreviation 'Dr.' is written at the right extreme of the same column in the same line. The name of the account to be credited is entered in the next line preceded by the word "To" leaving a few spaces away from the extreme left of the particulars column. In the next line immediately to the account credited, a short about the transaction is given which is known as "Narration". "Narration" may include particulars required to identify and understand the transaction and should be adequate enough to explain the transaction. It usually starts with the word "Being" which means what it is and is written within parentheses. The use of the word "Being" is completely dispense with, in modern parlance. To indicate the completion of the entry for a transaction, a line is usually drawn all through the particulars column.

(3) **Ledger Folio:** This column is meant to record the reference of the main book, i.e., ledger and is not filled in when the transactions are recorded in the journal. The page number of the ledger in which the accounts are appearing is indicated in this column, while the debits and credits are posted o the ledger accounts.

(4) **Amount (Debit):** The amount to be debited along with its unit of measurement at the top of this column on each page is written against the account debited.

(5) **Amount (Credit):** The amount to be credited along with its unit of measurement at the top of this column on each page is written against the account credited.

The following are the inherent advantages of using journal, though the transactions can also be directly recorded in the respective ledger accounts;

1. As all the transactions are entered in the journal chronologically, a date wise record can easily be maintained;



2. All the necessary information and the required explanations regarding all transactions can be obtained from the journal; and
3. Errors can be easily located and prevented by the use of journal or book of prime entry. The specimen journal is as follows:

1.5 Method of Writing up Journal

Opening Entry:-

Opening entry is passed in the new books for bringing in all assets and liabilities as appearing in the books on the last day of the previous year.

Rule for passing opening entry is to debit each asset account; Credit each liability account; excess of debits over credits represents capital balance.

Students can understand with the help of the following examples:

Samir had the following assets and liabilities as on 1st January, 2008;

Cash Rs. 25,000; Bank Rs. 5,000; Stock Rs. 5,000; Furniture Rs.10, 000; Plant and Machinery Rs. 20,000; Land and Building Rs. 1, 25,000; Sundry Debtors Rs.20, 000; Sundry Creditors Rs. 35,000; Bills Payable Rs. 15,000; Loan A/c Rs. 50,000. Pass the necessary opening entry .

Solutions:-

Date	Particulars	L.F.	Debit Amt.(Rs.)	Credit Amt.(Rs.)
2008 Jan 1	Cash A/c Dr. Bank A/c Dr. Stock A/c Dr. Furniture A/c Dr. Plant and Machinery A/c Dr. Land and Building A/c Dr. Sundry Debtors A/c Dr. To Sundry Creditors A/c To Bills Payable A/c To Loan A/c To Samir's Capital A/c (Being the opening entry is passed and balance transferred to capital A/c)		25,000 5,000 5,000 10,000 20,000 1,25,000 20,000	35,000 15,000 50,000 1,10,000



1. Journalize the following transactions in the journal of Mr. Vikrant.

2007

April 1. Started business with cash Rs.2, 50,000, Goods Rs. 1,00,000 , Furniture RS.1,00,000.

April 2. Deposited into bank Rs. 1, 00,000.

3. Placed an order with Shahrukh for the supply of goods of the list price of Rs.1, 00,000.

4. Shahrukh supplied goods of the list price of Rs.1, 00,000 less 10% trade discount.

5. Purchased goods from Salman of the list price of Rs.1,00,000 less 10% trade discount. Cheque paid to him under a cash discount of 5%.

6. Goods sold to Shyam of the list price of Rs.1,00,000 less 10% trade discount . He paid half of the amount due from him.

7. Goods costing Rs.80, 000 sold to Mr. Y for cash at a profit of 25% on cost price less 20% trade discount and 5% cash discount.

8. Goods taken away by the proprietor for the personal use (Cost price Rs.5,000; Sale price Rs. 10,000).

9. Shyam became insolvent and paid only 80 paisa in rupee in full and final settlement.

10. Paid Sharrukh 98% of the amount due to him in full and final settlement of account.

12. Goods (cost Rs.5, 000, sale price Rs.6, 000)stolen.

13. Paid life insurance premium Rs. 2,000.

14. Cash embezzled by an employee Rs.3, 000.



Date	Particulars	L.F	Debit Amt. (Rs.)	Credit Amt. (Rs.)
2007 April 1	Cash A/c Dr. Stock A/c Dr. Furniture A/c Dr. To Capital A/c (Being the cash , goods and furniture b in as capital)		2,50,000 1,00,000 1,00,000	4,50,000
2	Bank A/c Dr. To Cash A/c (Being the amount deposited into bank)		1,00,000	1,00,000
4	Purchases A/c Dr. To Shahrukh A/c (Being the goods purchased on credit)		90,000	90,000
	Rs. List Price 1,00,000 Less: Trade Discount @10% <u>(10,000)</u> Invoice Price 90,000			
5	Purchase A/c Dr. To Bank A/c To Discount A/c (Being the goods purchased for cash)		90,000	85,500 4,500
	Rs. List price 1,00,000 Less: Trade Discount @ 10% <u>(10,000)</u> Invoice Price 90,000 Less: Cash Discount @ 5% <u>(4,500)</u> Cash received <u>85,500</u>			



6	<p>Cash A/c Dr.</p> <p>Shyam A/c Dr.</p> <p style="padding-left: 40px;">To Sales A/c</p> <p>(Being the goods sold to Shyam , half amount is received)</p> <p style="text-align: right;">Rs.</p> <p>List Price 1,00,000</p> <p>Less : Trade Discount</p> <p>@ 10 % <u>10,000</u></p> <p>Invoice Price <u>90,000</u></p>	45,000	45,000	90,000
7	<p>Cash A/c Dr.</p> <p>Discount a/c Dr.</p> <p style="padding-left: 40px;">Top sales Account</p> <p>(Being the goods sold to Mr. Y for cash)</p> <p style="text-align: right;">Rs.</p> <p>Cost price 80,000</p> <p>Add: Profit @ 25%</p> <p>on cost <u>20,000</u></p> <p>List price 1,00,000</p> <p>Less : Trade Discount</p> <p>@20% <u>(20,000)</u></p> <p>Invoice price 80,000</p> <p>Less : Cash Discount</p> <p>@ 5% <u>(4,000)</u></p> <p>Cash Received 76,000</p>	76,000	4,000	80,000
8	<p>Drawings Account Dr.</p> <p>To Purchase Account</p> <p>(Being the goods withdrawn by proprietor for personal use)</p> <p>Cash Account Dr.</p>		5,000	5,000



9	Bad Debts Account Dr. To shyam Account (Being 80 paise in rupee received from in full and final settlement)		36,000 9,000	45,000
10	Shahrukh Account Dr. To Discount A/c To Cash A/c (Being the 98% of amount due to sh paid to him in full and final settleme account)		90,000	1,800 88,200
11	Loss by Theft Account Dr. To purchase A/c (Being the goods stolen)		5,000	
12	Drawings Account Dr. To Cash A/c (Being life insurance premium paid)			5,000 2,000
13	Loss by Embezzlement A/c Dr. To cash A/c (Being cash embezzled by an employe			2,000 3,000
	Total		<u>10,50,000</u>	<u>3,000</u> <u>10,50,000</u>



1.6 Limitations of Journal

There are various limitations of journal and these are:

(i) Bulky and voluminous:

Journal is a main book of original entry which records all business transactions. Sometimes, it becomes so bulky and voluminous that it cannot be handled easily.

(ii) Information in scattered form:

In this book, all information is recorded on daily basis and scattered form; hence it is very difficult to locate a particular transaction unless one remembers the date of occurrence of that transaction.

(iii) Time consuming:

Unlike posting from subsidiary books, posting the transactions from journal to ledger accounts take too much time because every time one has to post the transactions in different ledger accounts.

(iv) Lack of internal control:

Unlike other books of original entries like subsidiary books and cash book, journal does not facilitate the internal control, because in journal only transactions are recorded in chronological order. However, subsidiary books and cash book gives a clear picture of special type of transactions recorded therein.

1.7 Meaning and Utility of Ledger

Ledger is a main book of account in which various accounts of personal, real and nominal nature, are opened and maintained. In journal, as all the business transactions are recorded chronologically, it is very difficult to obtain all the transactions pertaining to one head of account together at one place. But, the preparation of different ledger accounts helps to get a consolidated picture of the transactions pertaining to one ledger account at a time. Thus, a ledger account may be defined as a summary statement of all the transactions relating to a person, asset, expense, or income or gain or loss which have taken place during a specified period and shows their net effect ultimately. From the above definition,



it is clear that when transactions take place, they are first entered in the journal and subsequently posted to the concerned accounts in the ledger. Posting refers to the process of entering in the ledger the information given in the journal. In the past, the ledgers were kept in bound books. But with the passage of time, they became loose-leaf ones and the advantages of the same lie in the removal of completed accounts, insertion of new accounts and arrangement of accounts in any required manner.

1.8 Relationship between Journal and Ledger

According to principles of double entry accounting, business transactions are first recorded in the journal and thereafter these are transferred to ledger under respective heads of accounts. But transactions can directly be posted to the ledger without making their entries in the journal and total results of accounts can be determined at the end of accounting period. However, It is never wise to maintain ledger by ignoring the journal, because:

1. Detail particulars of transactions are available in the journal but not in the ledger.
2. Numerous transactions take place every day in a big business organization. As a result, it becomes almost impossible to post these transactions in ledger same day directly. Therefore transactions are recorded primarily in the journal and thereafter it becomes convenient to transfer them in the ledger.
3. There remains a possibility of errors in transferring the transactions directly to the ledger.
4. Journal is the primary book of account. So, in recording transactions in the journal, if any mistake or error is detected, it can be rectified at the time of transferring them to the ledger.

1.9 Differences between Journal and Ledger

The key differences between journal and ledger are:

- (i) Journal is a book of prime entry, whereas ledger is a book of final entry.



(ii) Transactions are recorded daily in the journal, whereas posting in the ledger is made periodically.

(iii) In the journal, information about a particular account is not found at one place, whereas in the ledger information about a particular account is found at one place only.

(iv) Recording of transactions in the journal is called journalizing and recording of transactions in the ledger is called posting.

(v) A journal entry shows both the aspects debit as well as credit but each entry in the ledger shows only one aspect.

(vi) Narration is written after each entry in the journal but no narration is given in the ledger.

(vii) Vouchers, receipts, debit notes, credit notes etc., from the basic documents form journal entry, whereas journal constitutes basic record for ledger entries.

1.10 Format of a Ledger Account

To understand clearly as to how to write the accounts in ledger, the standard form of an account is given below with two separate transactions:

Dr.

Cr.

Date	Particulars	J.R	Amount	Date	Particulars	J.R	Amount
2005 Dec. 17	Cash A/C		1,200	2005 Dec. 17	Purchases A/C		2,000

It appears that each account in the ledger has two similar sides - left hand side is called debit side (briefly Dr.) and right hand side (briefly Cr.) side.

1.11 Procedure of Posting

Transferring information i.e. entries from journal to ledger accounts is called posting. The procedure of posting from journal to ledger is as follows:

1. Locate the ledger account from the first debit in the journal entry.
2. Record the date in the date column on the debit side of the account. The date is the date of transaction rather than the date of the posting.



3. Record the name of the opposite account (account credited in entry) in the particular (also known as reference column, description column etc) column.
4. Record the page number of the journal in the journal reference (J.R) column from where the entry is being posted.
5. Record the amount of the debit in the "amount column"
6. Locate the ledger account for the first credit in the journal and follow the same procedure.

1.12 Balancing of an Account

The difference between the two sides of an account is its balance. The balance is written on the lesser side to make the two sides equal. The process of equalizing the two sides of an account is known as *balancing*.

The *rules for balancing an account* are stated as below:

1. Add up the amount columns of both the sides of an account and write the totals in a separate slip of paper.
2. Find out the difference of the two totals.
3. Write down the difference on the lesser side of the account.
4. Now total up both the sides and write the totals and draw double lines under them.
5. Again write the difference on the opposite side below the double line.

If the debit side of an account is heavier, its balance is known as debit balance. And if the credit side of an account is heavier its balance is known as credit balance. If the two sides are equal, that account will show zero balance. The rules for determining the balance is as follows:

Total debit	= More than total credit	= Debit balance
Total credit	= More than total debit	= Credit balance
Total debit	= Total credit	= Nil balance

It may be noted that at the time of balancing an account debit balance is placed on the credit side and credit balance on debit site. This balance is known as closing



balance. What is closing balance in this year, is the opening balance of the next year.

Illustration.1 Prepare Ledger Accounts from the following transaction in the books of Imran:

1996		Rs.
June 1	started business with cash	45,000
June 1	paid into bank	25,000
June 2	Goods purchased for cash	15,000
June 3	Purchase of furniture and payment by cheque	5,000
June 5	Sold goods for cash	8,500
June 8	Sold goods to Arvind Walia	4,000
June 10	Goods purchased from Amrit Lal	7,000
June 12	Goods returned to Amrit Lal	1,000
June 15	Returned from Arvind Walia	200
June 18	Cash received from Arvind Walia and discount allowed to him	3,760 40
June 21	Withdrew from bank for private use Withdrew from bank for use in the business	1,000 5,000
June 25	Paid telephone rent for one year	400
June 28	Cash paid to Amrit Lal in full settlement of his account	5,940
June 30	Paid for : Stationery Rent Salaries to staff	200 1,000 2,500



Solution

Cash Account

Dr			Cr		
1996		Rs	1996		Rs
June 1	To Capital A/c	45,000	June 1	By bank A/c	25,000
June 5	To Sales A/c	8,500	June 2	By purchases a/c	15,000
June 18	To Arvind Walia	3,760	June 25	By telep. Rent A/c	400
June 21	To Bank A/c	5,000	June 28	By amrit Lal	5,940
			June 30	By Stationery A/c	200
			June 30	By Rent A/c	1,000
			June 30	By Salaries A/c	2,500
			June 30	By Balance C/d	12,200
		62,000			62,200
July 1	To Balance b/d	12,200			

Capital Account

Dr.			Cr.		
1996		Rs.	1996		Rs.
June 30	To balance c/d	45,000	June 1	By Cash Account	45,000
		45,000	July 1	By Balance b/d	45,000

Bank Account

Dr.			Cr.		
1996		Rs.	1996		Rs.
June 1	To Cash A/c	25,000	June 3	By Furniture A/c	5,000
			June 21	By Drawings A/c	1,000
			June 21	By Cash A/c	5,000
			June 30	By Balance C/d	14,000
		25,000			25,000
July 1	To Balance b/d	14,000			=====

Purchases Account

Dr.			Cr.		
1996		Rs	1996		Rs.
June 2	To cash account	15,000	June 30	By balance c/d	22,000
June 10	To amrit Lal	7,000			22,000
		22,000			=====
July 1	To balance b/d	22,000			

Furniture Account

Dr.			Cr.		
1996		Rs	1996		Rs.
June 3	To bank A/c	5,000	June 30	By balance c/d	5,000



July 1	To balance b/d	5,000			
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Sales Account

Dr.			Cr.		
1996		Rs.	1996		Rs.
June 30	To balance c/d	12,500	June 5	By cash A/c	8,500
			June 8	By Arvind Walia	4,000
		<u>12,500</u>			<u>12,500</u>
			July 1	By Balance c/d	12,500

Arvind Walia

Dr.			Cr.		
1996		Rs.	1996		Rs.
June 8	To sales A/c	4,000	June 15	By returns inwards	200
			June 18	By cash account	3,760
			June 18	By Discount A/c	40
		<u>4,000</u>			<u>4,000</u>

Amrit Lal

Dr.			Cr.		
1996		Rs.	1996		Rs.
June 12	To returns Outwards	1,000	June 10	By purchase A/c	7,000
	To cash accounts	5,940			
June 28	To Discount A/c	60			
June 28		<u>7,000</u>			<u>7,000</u>

Returns Inwards Account

Dr.			Cr.		
1996		Rs.	1996		Rs.
June 15	To Arvind Walia	200	June 30	By balance c/d	200
July 1	To Balance b/d	200			

Returns Outwards Account

Dr.			Cr.		
1996		Rs.	1996		Rs.
June 30	To balance c/d	1,000	June 12	By Amrit Lal	1,000
			July 1	By Balance b/d	1000

Discount Account

Dr.			Cr.		
1996		Rs.	1996		Rs.
June 18	To Arvind Walia	40	June 28	By Amrit Lal	60
June 30	To Balance c/d	20			
		<u>60</u>			<u>60</u>



			=====	July 1	By balance b/d		=====
							20

Drawings Account

Dr.

Cr.

1996 June 21	To Bank Account		Rs. 1,000	1996 June 30	By Balance c/d		Rs. 1000
			=====				=====
July 1	To Balance b/d		1,000				

Telephone Rent Account

Dr.

Cr.

1996 June 21	To cash Account		Rs. 400	1996 June 30	By Balance c/d		Rs. 400
			=====				=====
July 1	To Balance b/d		400				

Stationery Account

Dr.

Cr.

1996 June 30	To Cash Account		Rs. 200	1996 June 30	By Balance c/d		Rs. 200
			=====				=====
July 1	To Balance b/d		200				

Rent Account

Dr.

Cr.

1996 June 30	To Cash A/c		Rs. 1,000	1996 June 30	By Balance c/d		Rs. 1,000
			=====				=====
July 1	To Balance b/d		1,000				

Salaries Account

Dr.

Cr.

1996 June 30	To Cash A/c		Rs. 2,500	1996 June 30	By Balance c/d		Rs. 2,500
			=====				=====
July 1	To Balance b/d		2,500				

1.13 Meaning and Characteristics of Trial Balance

When the transactions are recorded under double entry system there is a credit for every debit. When one account is debited, another account is credited with equal



amount. Therefore, it is quite evident that the total of debit balances of the ledger accounts of given transactions will be equal to the total of the credit balances.

If a statement is prepared with debit balances in one side/column and credit balances on the other side/column, the totals of the two sides/columns will be equal. Such a statement is called as 'Trial Balance'. Or simply a trial balance may be defined as "a list of balances standing on the ledger accounts and cashbook of a concern".

Characteristics of Trial Balance

The following are its main features:

1. It is a tabular statement having separate sides/columns for debit balances and credit balances.
2. Closing balances of the various ledger accounts are brought to this statement.
3. It can be prepared at any date on which accounts are closed and balanced. But it is usually prepared at the end of the accounting year.
4. Trial balance is not an account. It is only a statement.

1.14 Importance of Trial Balance

The trial balance is important due to the following reasons:

- (i) Trial balance summarizes all the financial transactions of the business.
- (ii) Trial balance provides a check on the arithmetical accuracy of recordings of all the financial transactions of the business.
- (iii) Trial balance helps in locating errors by providing a starting point for the location of errors committed if any.
- (iv) Trial balance provides a basis for the preparation of final accounts.

1.15 Methods of Preparation of Trial balance

The following are the methods of preparing a trial balance



1. Total Method

Under total method, trial balance is prepared by taking up the total of debits and credit of all ledger accounts.

2. Balance Method

Under balance method, only the balances of all the ledger accounts are taken up to prepare the trial balance.

Accounts showing debit balance

In accounting, a debit balance is the ending amount found on the left side of a general ledger account or subsidiary ledger account.

A debit balance is normal and expected for the following accounts:

- **Asset accounts** such as Cash, Accounts Receivable, Inventory, Prepaid Expenses, Buildings, Equipment, etc. For example, a debit balance in the Cash account indicates a positive amount of cash. (Therefore, a credit balance in Cash indicates a negative amount likely caused by writing checks for more than the amount of money currently on hand.)
- **Expense accounts and loss accounts** including Cost of Goods Sold, Wages Expense, Rent Expense, Interest Expense, Loss on Disposal of Equipment, Loss from Lawsuit, etc. (The debit balances in these accounts will be transferred to Retained Earnings or to the proprietor's capital account at the end of each accounting year.)
- **Contra-revenue accounts** including Sales Discounts, Sales Returns, etc. (The debit balances in these accounts allow for the reporting of both the gross and net amounts of sales. These balances will also be transferred to an equity account at the end of each accounting year.)
- **Contra-liability accounts** such as Discount on Bonds Payable. (This debit balance allows for the presentation of both the maturity value and the book or carrying value of the bonds.)
- **Contra-equity accounts** such as the owner's drawing account and Treasury Stock. (The debit balance in the drawing account will be closed to the owner's



capital account thereby reducing its balance at the end of each year. The debit balance in Treasury Stock serves as a reduction to the total amount of Stockholders' Equity.)

Accounts showing credit balance

In accounting, a credit balance is the ending amount found on the right side of a general ledger account or subsidiary ledger account.

A credit balance is normal and expected for the following general ledger and subsidiary ledger accounts:

- **Liability accounts.** These include Accounts Payable, Notes Payable, Wages Payable, Interest Payable, Income Taxes Payable, Customer Deposits, Deferred Income Taxes, and so on. For instance, a credit balance in Accounts Payable indicates the amount owed to vendors. (Therefore, a debit balance in a liability account indicates that the company has paid more than the amount owed, has made an incorrect entry, etc.) Since liability accounts are permanent accounts, their balances are *not* closed at the end of the accounting year.
- **Equity accounts.** Four examples of equity accounts are Common Stock, Paid-in Capital in Excess of Par Value, Retained Earnings, and M. Smith, Capital. These are also permanent accounts and their balances are *not* closed at the end of the accounting year.
- **Revenue accounts and gain accounts.** Examples include Sales Revenues, Service Revenues, Interest Revenues, Gain on Disposal of Equipment, Gain from Lawsuit, etc. Since these accounts are temporary accounts, their balances will be transferred to Retained Earnings or to the proprietor's capital account at the end of each accounting year.
- **Contra-asset accounts.** Two examples are Allowance for Doubtful Accounts and Accumulated Depreciation. The credit balances in these accounts will allow for the reporting of both the gross and net amounts for accounts receivable and for property, plant and equipment. These are



permanent accounts and therefore their balances will *not* be closed at the end of the accounting year.

- **Contra-expense accounts.** These include Purchases Discounts, Purchases Returns and Allowances, and Expenses Reimbursed by Employees, etc. The credit balances in these accounts allow the company to report both the gross and net amounts. The credit balances in these temporary accounts will be transferred to Retained Earnings or to the proprietor's capital account at the end of the accounting year.

1.16 Errors Not Disclosed by Trial Balance

The Trial Balance is not absolute proof of the accuracy of ledger accounts. It is a proof only of the arithmetical accuracy of the postings. The total of debits may be equal to the total of credits yet still there may be errors.

Such errors are not disclosed by a trial balance and they are:

1. Errors of Principle:

An error of principle is an error which violates the fundamentals of book-keeping. For instance, purchase of furniture is debited to Purchase Account, instead of Furniture Account; Wages paid for the erection of plant is debited to Wages Account, instead of Plant Account; the amount spent on extension of building is debited to Repairs Account instead of Building Account etc. These types of errors do not affect the total debits and total credits but affect the principle of book-keeping.

2. Errors of Omission:

If a transaction is completely omitted, there will be no effect on the Trial Balance. When a transaction goes completely unrecorded in both aspects or a transaction after being recorded in the books of primary entry is not at all posted in the ledger, the error is an error of omission. For instance, if a credit purchase is omitted to be recorded in the Purchase Day Book, then it will be omitted to be posted both in



the Purchase Account and the Supplier's Account. This error will not, however, result in the disagreement of Trial Balance.

3. Posting to Wrong Account:

Posting an item to wrong account, but on the correct side. For instance, if a purchase of Rs 200 from Ramu has been credited to Raman, instead of Ramu and this error will not affect the agreement of Trial Balance. Thus, Trial Balance will not detect such an error.

4. Error of Amounts in Original Book:

If an invoice for Rs 632 is entered in Sales Book as Rs 623, the Trial Balance will come out correctly, since the debit and credit have been recorded as Rs 623. The arithmetical accuracy is there, but in fact there is an error.

5. Compensating Errors:

If one account in the ledger is debited with Rs 500 less and another account in the ledger is credited Rs 500 less, these errors cancel themselves. That is, one error is neutralized by similar error on the opposite side.

1.17 Errors Disclosed by a Trial Balance

If the Trial Balance does not agree, there must have been some error or errors somewhere in our working. The following are some of the errors, which cause the Trial Balance to disagree, in brief:

1. Wrong Totaling of Subsidiary Books:

If the total of any subsidiary book is wrongly cast, it would cause a disagreement in the Trial Balance. For instance, Sales book has been under cast by Rs 100. From the Sales book, all the personal accounts have been debited correctly but mistake occurred only in Sales Account, to the extent of Rs 100 (Less). Thus, the



Trial Balance disagrees to the extent of Rs 100; credit side falls short of the amount.

2. Posting of the Wrong Amount:

If a wrong amount is posted in one of the two accounts, the Trial Balance disagrees. For instance sales made to Ram for Rs 570, wrongly debited to Ram's Account with Rs 750, instead of Rs 570. Ram's account has been over debited by Rs 180. Thus, the debit side of the Trial Balance will exceed by Rs 180. i.e., $750 - 570 = 180$.

3. Posting an Amount on the Wrong side of the Account:

For instance, a credit sales made to a customer for Rs 500 has been credited to the customer account, instead of debit. As a result of this error, the credit side of the Trial Balance will exceed by Rs 1,000 (double the amount of the error) because there are two credits one in Sales Account and another in Personal Account and no debit for the transaction.

4. Posting Twice to a Ledger:

For instance, salary of Rs 500 paid has been debited to Salary Account twice by mistake. This will cause disagreement of Trial Balance in debit side by excess of Rs 500.

Apart from the above, the following are some of the common errors, by which Trial balance totals disagree:

5. Omission of an account from the Trial Balance (Cash, Bank etc.):

6. Wrong additions or balancing of ledger accounts.

7. Balance of account written to the wrong side of the Trial Balance.

8. Errors made in preparing the list of Debtors and Creditors.

9. Errors made in carrying forward the total from one page to another page.

10. There may be some items to which double entry is incomplete.

11. Wrong totals of the Trial Balance.



Example on Trial Balance

1. From the following balances taken from the ledger of Shir Krishna, prepare a trial balance as on 31st march, 2007 :

Cash	10,000
Trade debtors	15,000
Rent	5,000
Salaries	8,000
Trade Creditors	20,000
Insurance	5,000
Depreciation	1,000
Cost of Goods Sold	20,000
Sales	2,00,000
Purchases	1,00,000
Capital	3,39,000
Drawings	5,000
Motor Vehicle	50,000
Machinery	1,00,000
Building	2,00,000
Stock	50,000
Bank Overdraft	10,000



Solutions:

Trial Balance Of Krishna as on 31st march , 2007

Particulars	Debit Balance Amount(Rs.)	Credit Balance Amount(Rs.)
Cash	10,000	
Trade debtors	15,000	
Rent	5,000	
Salaries	8,000	20,000
Trade Creditors		
Insurance	5,000	
Depreciation	1,000	
Cost of Goods Sold	20,000	2,00,000
Sales		
Purchases	1,00,000	
Capital		3,39,000
Drawings	5,000	
Motor Vehicle	50,000	
Machinery	1,00,000	
Building	2,00,000	
Stock	50,000	
Bank Overdraft		10,000
	<u>5,69,000</u>	<u>5,69,000</u>

2. An accountant provides you with the following trial balance. In case you find it to be incorrect redraft it.



Debit:Heads of Account	Amount (Rs)	Credit: Heads of Accounts	Amount (Rs)
Opening stock	5,000	Furniture	10,000
Machinery	1,000	Capital	11,550
Creditors	5,000	Debtors	10,000
Bank overdraft	3,000	Purchases	5,000
Discount allowed	50	Salaries	1,000
Sales	10,000	Int. on investment	200
Loan from Z	1,000	Advertisements	500
Carriage Inwards	500	Drawings	500
Investment	2,000	Insurance premium	150
Returns inwards	50	Int. on loan	100
Return outwards	100		

Solutions:-

S.No	Heads of Accounts	Dr. Amount(Rs)	Cr. Amounts(Rs)
1.	Opening Stock	5,000	
2.	Machinery	1,000	
3.	Creditors		5,000
4.	Bank Overdraft		3,000
5.	Purchases	5,000	
6.	Discount allowed	50	
7.	Sales		10,000
8.	Loan from Z		1,000
9.	Carriage Inwards	500	
10.	Investments	2,000	
11.	Returns Inwards	50	
12.	Returns Outwards		100
13.	Insurance Premium	150	
14.	Interest on loan	100	
15.	Capital		11,550
16.	Furniture	10,000	
17.	Debtors	5,000	
18.	Salaries	1,000	
19.	Interest on Investments		200
20.	Advertisements	500	
21.	Drawings	500	
		30,850	30,850



1.18 Subsidiary Books

Subsidiary book is the sub division of Journal. These are known as books of prime entry or books of original entry as all the transactions are recorded in their original form. In these books the details of the transactions are recorded as they take place from day to day in a classified manner. The important subsidiary books used are as following:-

- (i) Cash Book : Used to record all the cash receipts and payments.
- (ii) Purchase Book : Used to record all the credit purchases.
- (iii) Sales Book : Used to record all the credit sales.
- (iv) Purchase Return Book : Used to record all goods returned by business to the supplier.
- (v) Sales Return Book : Used to record all good returned by the customer to the business.
- (vi) Bills Receivable Book : Used to record all accepted bills received by business.
- (vii) Bills Payable Book : Used to record all bill accepted by us to our creditors.
- (viii) Journal Proper : Used to record those transactions for which there is no separate book.

These subsidiary books are maintained because it may be impossible to record each transaction into the ledger as it occurs. And these books record the details of the transactions and therefore help the ledger to become brief. Future reference and any desired analysis becomes easy as transactions of similar nature are recorded together.



1.19 Let's sum-up

Business transactions are first entered in the records in the form of journal. As per the double entry system of accounting we have to classify the accounts and apply the double accounting rule accordingly. A journal entry is a formal accounting entry used to identify a business transaction. The entry itemizes accounts that are debited and credited, and should include some description of the reason for the entry, as well as the date. If properly documented, journal entries provide an excellent audit trail for anyone investigating the accounting records of an entity. Then in order to summaries the accounts, posting should be done through ledger. Then subsequently Trial Balance is prepared which becomes the input for preparation of final accounts.

1.20 Key terms

- (i) Journal
- (ii) Ledger
- (iii) Trial Balance
- (iv) Subsidiary Books

1.21 Self-Assessment Questions

- (i) What do you mean by journal? Why journal is treated as book of original entry?



(ii) What are the different types of accounts? State the golden rules as per the accounts.

(iii) What do you mean by ledger? Narrate the differences between journal and ledger.



(iv) What do you mean by Trial Balance? Enumerate the importance of Trial Balance.

1.22 Further Readings

- (i) Vasudeva S., Accounting for Business managers, Himalaya Publishing House, Mumbai, 1st Edition, 2009
- (ii) Vijayakumar T., Accounting for Management, Tata McGraw Hill Education Pvt. Ltd., New Delhi.
- (iii) Narayanaswamy R., Financial Accounting: A Managerial Perspective, PHI, New Delhi, 2nd Edition, 2005



- (iv) Babu P.P and Mohan M.M., Financial Accounting and Analysis, Himalaya Publishing House, Mumbai, 1st Edition, 2008.
- (v) Jain S.P. and Narang K.L., Financial Accounting, Kalyani Publishers, Ludhiana, 10th Edition, 2008
- (vi) Lal J., Advance Management Accounting: Text and Cases, S.Chand & Company Limited, 1st Edition, 2003

1.23 Model Questions

(a) Journalise the following transactions in the books of Shankar & Co.

2016		Rs.
June 1	Started business with a capital of	60,000
June 2	Paid into bank	30,000
June 4	Purchased goods from Kamal on credit	10,000
June 6	Paid to Shiram	4,920
June 6	Discount allowed by him	80
June 8	Cash Sales	20,000
June 12	Sold to Hameed	5,000
June 15	Purchased goods from Bharat on credit	7,500
June 18	Paid Salaries	4,000
June 20	Received from Prem	2,480
June 20	Allowed him discount	20
June 25	Withdrew from bank for office use	5,000
June 28	Withdraw for personal use	1,000
June 30	Paid Hanif by cheque	3,000

(b) Explain the different rules for journalizing the transaction with appropriate illustrations.

(c) Explain the meaning of the term 'Real Accounts'.

(d) Explain the term Accounting Cycle.

(e) What is an opening entry?



(f) Briefly explain the difference between:

- (i) Personal and Impersonal Accounts.
- (ii) Real Accounts and Nominal Accounts.

(g) Surendra commenced business on 1st January, 1999. His transactions for the month are given below. Journalise them.

2000	Rs
Jan. 1 Commenced business with a cash capital	20,000
Jan. 2 Paid into Bank	10,000
Jan. 3 Bought goods from Ramesh & Co.	5,000
Jan. 3 Sold goods to Rajesh	4,000
Jan. 7 Bought goods of Ram Chand	6,000
Jan. 8 Paid wages in cash	200
Sold goods to Mahesh Chand	5,000
Jan. 10 Received cheque from Rajesh (discount allowed Rs 200)	3,800
Jan. 10 Paid into bank	4,000
Jan. 11 Paid to Ramesh & Co. (discount received Rs 200)	4,000
Jan. 12 Paid rent for three months to March	400
Jan. 13 Bought goods from C. Khare	7,400
Jan. 15 Wages paid in cash	80
Jan. 15 Paid office expenses in cash	70
Jan. 16 Sold goods to Jagdish	3,200
Jan. 17 Sold goods to Rajesh	1,600
Jan. 21 Sold goods to Mahesh Chand	2,500
Jan. 21 Payment received by cheque from Jagdish	3,200
Jan. 22 Paid wages in cash	80
Jan. 22 Paid office expenses in cash	50
Jan. 25 Paid Ram Chand by cheque (discount Rs 200)	5,800
Jan. 26 Received cheque from Mahesh Chand (discount Rs 200)	4,800
Jan. 27 Mahesh Chand returned goods not up to the sample	200
Jan. 29 Paid wages in cash	80



Jan. 31	Paid office expenses in cash	40
Jan. 31	Paid salaries for the month	300
Jan. 31	Cash used at home	400

(h) Soraj Mart furnishes the following information :

Transactions during the month of April, 2014 are as under :

<i>Date</i>	<i>Details</i>
01.4.2014	Business started with cash Rs. 1,50,000.
01.4.2014	Goods purchased form Manisha Rs. 36,000.
01.4.2014	Stationery purchased for cash Rs. 2,200.
02.4.2014	Open a bank account with SBI for Rs. 35,000.
02.4.2014	Goods sold to Priya for Rs. 16,000.
03.4.2014	Received a cheque of Rs. 16,000 from Priya.
05.4.2014	Sold goods to Nidhi Rs. 14,000.
08.4.2014	Nidhi pays Rs. 14,000 cash.
10.4.2014	Purchased goods for Rs. 20,000 on credit from Ritu.
14.4.2014	Insurance paid by cheque Rs. 6,000.
18.4.2014	Paid rent Rs. 2,000.
20.4.2014	Goods costing Rs. 1,500 given as charity.
24.4.2014	Purchased office furniture for Rs. 11,200.
29.4.2014	Cash withdrawn for household purposes Rs. 5000.
30.4.2014	Interest received cash Rs.1,200.
30.4.2014	Cash sales Rs.2,300.
30.4.2014	Commission paid Rs. 3,000 by cheque.
30.4.2014	Telephone bill paid by cheque Rs. 2,000.
30.4.2014	Payment of salaries in cash Rs. 12,000.

Journalise the transactions and prepare ledgers.



UNIT-2

PREPARATION OF FINANCIAL STATEMENTS

Learning Objectives

After reading this chapter, students should be able to understand:

- Meaning and Preparations of Final Accounts
- Manufacturing Account
- Trading Account
- Profit and Loss Account
- Balance Sheet
- Adjustment Entries in Final Accounts

Structure

- 1.24 Meaning of Final Accounts
- 1.25 Manufacturing Account
- 1.26 Trading Account
- 1.27 Profit and Loss Account
- 1.28 Balance Sheet
- 1.29 Adjustment Entries
- 1.30 Let's sum-up
- 1.31 Key terms
- 1.32 Self-Assessment Questions
- 1.33 Further Readings
- 1.34 Model Questions



1.1 Meaning of Final Accounts

Preparation of final account is the last stage of the accounting cycle. The basic objective of every concern maintaining the book of accounts is to find out the profit or loss in their business at the end of the year. Every businessman wishes to ascertain the financial position of his business firm as a whole during the particular period. In order to achieve the objectives for the firm, it is essential to prepare final accounts which include Manufacturing and Trading, Profit and Loss Account and Balance Sheet. The determination of profit or loss is done by preparing a Trading, Profit and Loss Account. The purpose of preparing the Balance Sheet is to know the financial soundness of a concern as a whole during the particular period.

1.2 Manufacturing Account

Manufacturing Account is the important part which is required to preparing Trading, Profit and Loss Account. Accordingly, in order to calculate the Gross Profit or Gross Loss, it is essential to determine the Cost of Goods Manufactured or Cost of Goods Sold. The main purpose of preparing Manufacturing Account is to ascertain the cost of goods manufactured or cost of goods sold, which is transferred to the Trading Account. This account is debited with opening stock and all items of costs including purchases related to production and credited with closing balance of work in progress and cost of goods produced transferred to Trading Account. The term "Cost of Goods Sold" refers to cost of raw materials consumed plus direct related expenses.

Components of Manufacturing Account

The following are the important components to be considered for preparation of Manufacturing Accounts:

- (1) Opening Stock of Raw Materials.
- (2) Purchase of Raw Materials.



- (3) Purchase Returns.
- (4) Closing Stock of Raw Materials.
- (5) Work in Progress (semi-finished goods).
- (6) Factory Expenses.
- (7) Opening Stock of Finished Goods.
- (8) Closing Stock of Finished Goods.

(1) **Opening Stock:** The term Opening Stock refers to stock on hand at the beginning of the year which includes raw materials, work-in-progress and finished goods.

(2) **Purchases:** Purchases include both cash and credit purchase of goods. If any purchase is returned, the same will be deducted from gross purchases.

(3) **Direct Expenses:** Direct expenses are chargeable expenses or productive expenses which include factory rent, wages, freight on purchases, manufacturing expenses, factory lighting, heating, fuel, customs duty, dock duty and packing expenses. In short, all those expenses incurred in bringing the raw materials to the factory and converting them into finished goods will constitute the direct expenses that are to be shown on the debit side of the trading account.

Calculation of Cost of Goods Sold

Cost of Goods Sold can be calculated as under:

$$\text{Cost of Goods Sold} = \text{Value of Opening Stock} + \text{Cost of Purchases} + \text{Direct Expenses} - \text{Value of Closing Stock}$$

THE FORMAT OF A MANUFACTURING ACCOUNT

Manufacturing account for the year ended

Opening stock of raw materials	xxxx	
Add purchase of raw materials	xxxxxx	
Add carriage inwards (if any)	<u>Xxxx</u>	
	Xxxxxx	
Less Returns outwards (of raw materials)	<u>xxxx</u>	



	Xxxxx	
Less Goods drawings (if any)	<u>xxxx</u>	
	xxxxx	
Less Closing stock of raw materials	<u>xxxx</u>	
Cost of Direct Materials		xxxxxxx
Add Direct labor		xxxxxxx
Add Direct expenses (E.g.: royalties)		<u>xxxxxxx</u>
Prime Cost		xxxxxxx
<u>Add Factory overhead expenses</u>		
Factory lighting	xxxxxxx	
Factory heating	xxxxxxx	
Factory insurance	xxxxxxx	
Factory rent	xxxxxxx	
Factory maintenance	xxxxxxx	
Factory indirect wages	xxxxxxx	
Factory supervisor's wages	xxxxxxx	(+)
Depreciation on plant & machinery	xxxxxxx	
Depreciation on factory building	xxxxxxx	
Depreciation on factory furniture	xxxxxxx	
Depreciation on factory motor van	xxxxxxx	
Depreciation on other factory fixed asset	<u>xxxxxxx</u>	<u>xxxxxxx</u>
		xxxxxxx
Add Opening stock of work in progress		xxxxxxx
		xxxxxxx
Less Closing stock of work in progress		xxxxxxx
Cost of production		xxxxxxx



1.3 Trading Account

Trading Account and Profit and Loss Account are the two important parts of income statements. Trading Account is the first stage in the final account which is prepared to know the trading results of gross profit or loss during a particular period. In other words, it is a summary of the purchases, and sale of a business or production cost of goods sold and the value of sales. The difference between the elements establishes the gross profit or loss which is then carried forward to the profit or loss account for calculation of net profit or net loss. Accordingly, if the sales revenue is higher than the cost of goods sold the difference is known as 'Gross Profit,' Similarly, if the sales revenue is less than the cost of goods sold the difference is known as 'Gross Loss.'

It should be noted that the result of the business determined through trading account is not true result. The true result is the net profit or the net loss which is determined through profit and loss account. The trading accounting has the following features:

1. It is the first stage of final accounts of a trading concern.
2. It is prepared on the last day of an accounting period.
3. Only direct revenue and direct expenses are considered in it.
4. Direct expenses are recorded on its debit side and direct revenue on its credit side.
5. All items of direct expenses and direct revenue concerning current year are taken into account but no item relating to past or next year is considered in it.
6. If its credit side exceeds it represents gross profit and if debit side exceeds it shows gross loss.



Specimen of trading Account

Format of Trading Account

<i>Debit/Payments/Expenses</i>		<i>Credit/Receipts/Incomes</i>	
Particulars	Amount	Particulars	Amount
<u>DIRECT EXPENSES:</u>		<u>DIRECT INCOMES:</u>	
To Opening Stock	xxx	By Sales A/c	xxx
To Purchase A/c	xxx	Less: Sales Return A/c (If a	xxx
Less: Purchase Returns A	xxx	By Closing Stock A/c	xxx
any)		By Gross Loss c/d (bal	xxx
To Wages A/c	xxx	fig.)	
To Power, fuel & water A/c	xxx		
To Carriage inward A/c			
To Import duty A/c	xxx		
To Excise duty A/c	xxx		
To Octroi A/c	xxx		
To Gross Profit c/d(balancin	xxx		
	<u>xxx</u>		
To Gross Loss b/d	<u>xxx</u>		<u>xxx</u>
	xxx	By Gross Profit b/d	
			xxx

Elements of Trading Account (Debit Side)

- (1) Opening Stock.
- (2) Purchases and Purchase Returns.
- (3) Direct Expenses.
- (4) Gross Profit is the excess value of sales over the cost of Sales.

Elements of Trading Account (Credit Side)

- (1) Sales: The term sales refers to the total of sales of goods which include both cash sales and credit sales during the particular period.
- (2) Sales Return: If any goods returned from the customers will be deducted from the total sales.



(3) Closing Stock: Closing Stock refers to the goods remaining unsold at the end of the particular period. The closing stock may be raw materials, work-in-progress and finished goods. Generally closing stock does not appear in the Trial Balance. Therefore, the closing stock is not brought into the books of accounts but it is credited to Trading Account and also recorded in the assets side of the Balance Sheet.

1.4 Profit and Loss Account

The trading account shows the result of trading (i.e., buying and selling of goods) called gross profit or gross loss. Trading account does not consider the administration, selling and financial expenses incurred in running the business. The profit and loss account shows the net profit or net loss (i.e., ultimate profit or loss) of a business for a particular trading period. It considers all the income and expenses incurred in running the business. The determination of Gross Profit or Gross Loss is done by preparation of Trading Account. But it does not reveal the Net Profit or Net Loss of a concern during the particular period. This is the second part of the income statement and is called as Profit and Loss Account.

The purpose of preparing the profit and loss account to calculate the Net Profit or Net Loss of a concern. Net profit refers to the surplus which remains after deducting related trading expenses from the Gross Profit. The trading expenses refer to inclusive of office and administrative expenses, selling and distribution expenses. In other words, all operating expenses such as office and administrative expenses, selling and distribution expenses and non-operating expenses are shown on the debit side and all operating and non operating gains and incomes are shown on the credit side of the Profit and Loss Account. The difference of two sides is either Net Profit or Net Loss. Accordingly, when total of all operating and non-operating expenses is more than the Gross Profit and other non-operating incomes, the difference is the Net Profit and in the reverse case it is known as Net



Loss. This Net Profit or Net Loss is transferred to the Capital Account of Balance Sheet.

Format of Profit and Loss Account

<i>Debit/Payments/Expenses</i>		<i>Credit/Receipts/Incomes</i>	
Particulars	Amount	Particulars	Amount
To Gross Loss b/d		By Gross Profit b/d	xxx
<u>INDIRECT EXPENSES:</u>	xxx	<u>INDIRECT INCOMES:</u>	
<i><u>Office Expenses:</u></i>		By Rent Received A/c	
To Salaries A/c		By Interest Received A/c	xxx
To Rent A/c		By Dividend Received A/c	xxx
To Printing and stationery A/c	xxx	By Commission Received A/c	
To Postage and telegram A/c	xxx	By Bad debts recovered A/c	xxx
To Office insurance A/c	xxx	By Discount Received A/c	
To Lighting and heating A/c	xxx	By Profit on sale of property	xxx
To Audit fees A/c	xxx	By Profit on sale of investment	
To Legal Charges A/c	xxx	a/c	xxx
<i><u>Maintains Expenses:</u></i>	xxx	By Interest on Drawing A/c	
To Repairs A/c	xxx	By Net Loss (balancing figure)	xxx
To Depreciation A/c	xxx		
<i><u>Selling and distribution expenses:</u></i>			xxx
To Rent of warehouse A/c	xxx		
To Packing charges A/c			xxx
To Advertisement A/c	xxx		
To Carriage outwards A/c	xxx		xxx
To Bad debts A/c			
To Commission paid A/c	xxx		(xxx)
To Travelling expenses A/c	xxx		
<i><u>Financial Expenses:</u></i>			
To Interest on loan A/c,	xxx		
To Discount allowed A/c,	xxx		
To Loss on sale of property	xxx		
To Loss on sale of investment			
To Net Profit c/d (balancing figure)	xxx		
	xxx		
	xxx		



	XXX		
	XXX		
	XXX		
	XXX		
	<u>XXX</u>		
	<u>XXX</u>		
			<u>XXX</u>

Components appearing on Debit Side of the P & L A/c

Those expenses incurred during the manufacturing process of conversion of raw materials into finished goods will be treated as direct expenses which are recorded in the debit side of Trading Account. Any expenditure incurred subsequent to that will be known as indirect expenses to be shown in the debit side of the Profit and Loss Account. The indirect expenses may be classified into: (1) Operating Expenses and (2) Non-Operating Expenses.

(1) Operating Expenses: It refers to those expenses as the day-to-day expenses of operating a business include office & administrative expenses, selling and distribution expenses.

(2) Non-Operating Expenses: Those expenses incurred other than operating expenses. Non-Operating expenses which are related to a financial nature. For example, interest payment on loans and overdrafts, loss on sale of fixed assets, writing off fictitious assets such as preliminary expenses, under writing commission etc.

Components appearing on Credit Side of P&L A/c

The following are the components as shown on the Credit Side:

(1) Gross Profit brought down from Trading Account

(2) Operating Income: It refers to income earned from the operation of the business excluding Gross Profit and Non-Operating incomes.



(3) Non-Operating Income: Non-Operating incomes refer to other than operating income. For example, interest on investment of outside business, profit on sale of fixed assets and dividend received etc.

1.5 Balance Sheet

A balance sheet, also referred to as Statement of Financial Position, is a statement that exhibits the assets and liabilities of a business enterprise prepared at a particular date.

According to AICPC (The American Institute of Certified Public Accountants) defines Balance Sheet as a tabular Statement of Summary of Balances (Debit and Credits) carried forward after an actual and constructive closing of books of accounts and kept according to principles of accounting. The purpose of preparing balance sheet is to know the true and fair view of the status of the business as a going concern during a particular period. The balance sheet is one of the important statements which is used by owners or investors to measure the financial soundness of the concern as a whole. A statement is prepared to show the list of liabilities and capital or credit balances of the business on the left hand side and list of assets and other debit balances are recorded on the right hand side is known as "Balance Sheet."

The Balance Sheet is also described as a statement showing the sources of funds and application of capital or funds. In other words, liability side shows the sources from where the funds for the business were obtained and the assets side shows how the funds or capital were utilized in the business. Accordingly, it describes that all the assets owned by the concern and all the liabilities and claims it owes to owners and outsiders. A balance sheet comprises of three parts viz., Assets, Liabilities & Capital.



Proforma of Balance Sheet

LIABILITIES	Amount	ASSETS	Amount
Capital:	xxx	Fixed Assets	
		Depreciation):	
Reserves and Surplus	xxx	Land & Building A/c	xxx
		Plant & Machinery A/c	xxx
Current Liabilities		Furniture & Fixture A/c	xxx
Sundry Creditors A/c	xxx	Typewriter & Computers A/c	xxx
Bills Payable A/c	xxx	Vehicles A/c	
Bank overdraft(BoD) A/c	xxx	Goodwill A/c	xxx
Outstanding Expenses A/c		Patents A/c	xxx
Income Received Advance	xxx	Trade Marks A/c	xxx
Long term Liabilities:		Copy Rights A/c	xxx
Long term Loans	xxx	Long term Investments:	xxx
Debentures		Investment in shares, debentures etc	xxx
	xxx	Current Assets:	
	xxx	Cash A/c	
		Bank A/c	
		Short term investment A/c	xxx
		Sundry Debtors less Bad Debts A/c	xxx
		Bills Receivable A/c	xxx
		Stock A/c	xxx
		Prepaid Expenses A/c	xxx
		Outstanding Incomes A/c	xxx
			xxx
			xxx
	<u>xxx</u>		<u>xxx</u>

1.6 Adjustment Entries

The preparation of income statements, i.e., Trading, Profit and Loss Account and Balance Sheet is the last stage of accounting process. According to the principles of double entry system of accounting all the expenses and incomes relating to a particular period whether incurred or not should be taken into account. In order to give the true and fair view of the state of affairs of the business concern, it is



essential to consider various adjustments while preparing Trading, Profit and Loss Account and Balance Sheet. The following are the various adjustments usually related to:

- (1) Closing Stock
- (2) Outstanding Expenses
- (3) Prepaid Expenses
- (4) Accrued Income
- (5) Income Received in Advance
- (6) Depreciation
- (7) Interest on Capital
- (8) Interest on Drawings
- (9) Bad Debts
- (10) Provision for Doubtful Debts
- (11) Provision for Discount on Debtors
- (12) Provision for Discount on Creditors

(1) Closing Stock: The term Closing Stock refers to stock of raw materials, work in progress and finished goods at the end of the year valued at cost price or market price whichever is less. The following adjustment entry is:

Closing Stock Account	Dr.	* * *
To Trading Account		* * *

The stock at the end appears in the balance sheet and the balance in the stock is carried forward to the next year as opening stock. The opening stock account balance will appear in the Trial Balance and would be closed and transferred to the debit of the Trading Account.

(2) Outstanding Expenses: Outstanding expenses refer to those expenses incurred and remain unpaid during the accounting period. For example, salary, rent, interest etc. are expenses which are incurred but remain unpaid during the accounting period. In order to ascertain the correct profit and loss made during the year, it is essential that such related expenses are treated as Salary Outstanding,



Interest Outstanding and Rent Outstanding etc. The following necessary adjustment entry is:

Expenses (Salaries) Account	Dr.	* * *
To Outstanding Expenses (Salaries) A/c		* * *

As per the rules, respective expenses are nominal account therefore it be charged to profit and loss account and also shown in the balance sheet on the liability side.

(3) Prepaid Expenses: Prepaid expenses are also known as unexpired expenses. Those expenses which are incurred and paid in advance. Such expenses are actually related to a future period. In order to ascertain the correct picture of the profit and loss accounts the following adjustment entry is required for adjusting such prepaid expenses.

Prepaid Expenses Account	Dr	* * *
To Expenses Account		* * *

The amount paid in advance will be deducted from the actual amount paid because it is related to the future accounting period. And the net amount will be debited to profit and loss account and the balance in the prepaid expenses account is shown the advance payment indicates as an amount due to the business concern.

(4) Accrued Income: Accrued Income otherwise known as Outstanding Income. Such incomes are accrued during the accounting period but not actually received in cash during that period. The adjustment entry will be as follows:

Accrued Income Account	Dr.	* * *
To Concerned Income Account		* * *

The accrued income is added to the respective income account. And the total accrued amount will be credit to profit and loss account and is shown on the asset side of the balance sheet.

(5) Income Received in Advance: Any income received in advance which is not earned during the accounting period. Therefore, if any income received in



advance, it should be treated as income for the subsequent year. The adjustment entry will be:

Income Account	Dr.	***	
To Income Received in Advance Account			***

The Income Received in Advance is treated as a liability because an amount due to the party. Therefore, it is shown on the liability side of the balance sheet. The income actually earned alone will appear on the credit side of Profit and Loss Account.

(6) Depreciation: The term depreciation refers to loss on account of reduced value of assets due to wear and tear, obsolescence, effluxion of time or accident. Depreciation is treated as the cost or loss arised when the asset is used in the normal course of time. In order to ascertain the correct value of the assets in the balance sheet, it is essential to make to following adjustment entry as:

Depreciation Account	Dr.	***	
To Fixed Assets Account			***

The amount of depreciation is charged to debit side of the profit and loss account and is deducted from the respected assets shown on the asset side of the balance sheet.

(7) Interest on Capital: In order to ascertain true profitability of the business concern, it is essential that profit is determined after deducting interest on the capital provided by proprietor. Interest on capital is included in the capital expenditure and thus the adjustment entry will be :

Interest on Capital Account	Dr.	***	
To Capital Account			***

Interest on Capital is an expenditure charged to debit side of profit and loss account and it is added to capital shown on the liability side of the balance sheet.

(8) Interest on Drawings: It is like a interest on capital provided by the proprietor. Any amount charged as interest on drawings made by the proprietors



for his personal use during the particular period is treated as interest on drawings. Interest on drawings should be taken as an income for ascertaining the true profit for a period. The adjustment entry will be:

Capital Account	Dr.	* * *	
To Interest on Drawings Account			* * *

Interest on drawings is charged on the credit side of the profit and loss account and it is deducted from the capital account shown on the liability side of the Balance Sheet.

(9) Bad Debts: The term bad debts refer to any amount which are definitely irrecoverable are termed as Bad Debts. It may be treated as actual loss of the business. Any amount irrecoverable due to inability of the debtors, it should be written off from the accounts of debtors. The necessary adjustment entry will be:

Bad Debts Account	Dr.	* * *	
To Debtor's Personal Account			* * *

Being bad debts are treated as expenses is charged to debit side of profit and loss account. And the amount deducted from debtors account shown on the assets side of the balance sheet.

(10) Provision for Doubtful Debts: It is like a bad debt but recovery is doubtful. Thus doubtful debts should not be written off from the books of accounts. Doubtful debts are treated as anticipated loss therefore making suitable provisions required to be made in the books of accounts. In order to ascertain the correct picture of the debtor's balance, it is essential to make an adjustment entry:

Profit and Loss Account	Dr.	* * *	
To Provision for Doubtful Account			* * *

The provision for doubtful debts is an anticipated expenses charged to the debit side of the profit and loss account and it is deducted from the debtor's account shown on the asset side of the balance sheet.

(11) Provision for Discount on Debtor: Discount allowed to debtor is treated as expenses of a business concern. Such discounts are allowed to encourage for



prompt payment made by the debtors on credit sales. When discount allowed, an adjustment entry is:

Discount Allowed Account	Dr.	***
To Debtor's Personal Account		* * *

The provision for discount is charged to debit side of profit and loss account and it is deducted from the debtor's account shown on the assets side of balance sheet.

(12) Provision for Discount on Creditors: It is like a discount on debtors, such discounts are allowed to make prompt payment due to its creditors. The firm receives such discounts when the payment made to its creditors in time. It is an anticipated income or profit which is required to create a suitable provision's in order to ascertain the correct picture of the creditor's balance, to make an adjustment entry will be:

(a) For Receipt of Discount:

Sundry Creditor's Account	Dr.	***
To Discount Received Account		* * *

(b) For Provision for Discount on Creditors:

Provision for Discount on Creditor's Account	Dr.	* * *
To Profit and Loss Account		* * *

Example on Trading, Profit & Loss Account and Balance Sheet

Illustration-1

From the following balances extracted from the books of X & Co., **prepare a trading and profit and loss account and balance sheet** on 31st December, 2015.

	Rs.		Rs.
Stock on 1st January	11,000	Returns outwards	500
Bills receivables	4,500	Trade expenses	200
Purchases	39,000	Office fixtures	1,000
Wages	2,800	Cash in hand	500
Insurance	700	Cash at bank	4,750
Sundry debtors	30,000	Tent and taxes	1,100
Carriage inwards	800	Carriage outwards	1,450



Commission (Dr.)	800	Sales	60,000
Interest on capital	700	Bills payable	3,000
Stationary	450	Creditors	19,650
Returns inwards	1,300	Capital	17,900

The stock on 31st December, 2015 was valued at Rs.25,000.

Solution:

X Trading and Profit and Loss Co. Account
For the year ended 31st December, 2015

Particulars	Amount	Particulars	Amount
To Opening stock	11,000	By Sales	60,000
To Purchases	39,000	Less returns	1,300
Less returns o/w	<u>500</u>		
	38,500		58,700
To Carriage inwards	800	By Closing	25,000
To Wages	2,800		
To Gross profit c/d	30,600		
	<u>83,700</u>		<u>83,700</u>
To Stationary	450	By Gross pr	30,600
To Rent and rates	1,100		
To Carriage outwards	1,450		
To Insurance	700		
To Trade expenses	200		
To Commission	800		
To Interest on capital	700		
To Net profit transferred to capital a/c	25,200		
	<u>30,600</u>		<u>30,600</u>

X Balance Sheet Co. Sheet
As at 31st December, 2015

Liabilities	Rs.	Assets	Rs.
Creditors	19,650	Cash in hand	500
Bills payable	3,000	Cash at bank	4,750
Capital	17,900	Sundry debtors	30,000
Add Net profit	25,200	Bill receivable	4,500
	<u>43,100</u>	Stock	25,000
		Office equipment	1,000



65,750

65,750

Illustration-2:

The following trial balance has been taken out from the books of XYZ as on 31st December, 2015.

	Dr.	Cr.
	Rs.	Rs.
Plant and Machinery	100,000	
Opening stock	60,000	
Purchases	160,000	
Building	170,000	
Carriage inward	3,400	
Carriage outward	5,000	
Wages	32,000	
Sundry debtors	100,000	
Salaries	24,000	
Furniture	36,000	
Trade expense	12,000	
Discount on sales	1,900	
Advertisement	5,000	
Bad debts	1,800	
Drawings	10,000	
Bills receivable	50,000	
Insurance	4,400	
Bank balances	20,000	
Sales		480,000
Interest received		2,000
Sundry creditors		40,000
Bank loan		100,000
Discount on purchases		2,000
Capital		171,500
	<hr/> 795,500	<hr/> 795,500
	<hr/>	<hr/>

Closing stock is valued at Rs.90,000



Required: Prepare the trading and profit and loss account of the business for the year ended 31.12.2015 and a balance sheet as at that date.

XYZ

**Trading and Profit and Loss Account
For the year ended 31st, December 2015**

Particulars	Amount	Particulars	Amount
Opening stock	60,000	Sales	480,000
Purchases	160,000	Less discount	<u>1,900</u> 478,100
Less discount	<u>2,000</u> 158,000	Closing stock	90,000
Carriage inward	3,400		
Wages	32,000		
Gross profit (transferred to P&L)	314,700		
	<u>568,100</u>		<u>568,000</u>
Carriage outward	5,000	Gross profit (transferred to I)	314,700
Salaries	24,000	Interest receive	2,000
Trade expenses	12,000		
Advertisement	5,000		
Bad debts	1,800		
Insurance	4,400		
Net profit (transferred to capital)	264,500		
	<u>316,700</u>		<u>316,700</u>

Note: Discount on purchases and discount on sales are deducted from purchases and sales respectively. They may be shown on the credit and debit side of profit and loss account respectively and it will not affect the net profit of the business. The gross profit will be affected if discount is treated so.

**XYZ
Balance
For the year ended 31st, December 2015**

Sheet



Assets	Rs	Liabilities	Rs
Current Assets:		Current Liabilities:	
Bank balance	20,000	Sundry creditors	40,000
Bills receivable	50,000	Bank loan	100,000
Sundry debtors	100,000	Fixed and Long Ter:	
Closing stock	90,000	Capital	171,500
Fixed Assets:		+Net profit	264,500
Furniture	36,000		—
Plant and Machinery	100,000	-Drawings	10,000
Building	170,000		426,000
	<u>566,000</u>		<u>566,000</u>

Comparison between Balance Sheet and Profit & Loss Account

Basis Comparison	Balance Sheet	Profit And Loss Account
Meaning	A statement that shows com assets, liabilities and equity specific date.	Account that shows company's revenue and ex over a period of time.
Represents	Financial position of the busin a particular date.	Profit earned or loss suffer business for the accounting]
Information Disclosed	Assets, liabilities, and capit shareholders.	Income, expenses, gains losses.
Sequence	It is prepared after the preparat Profit & Loss Account.	It is prepared before preparation of Balance Shee

1.7 Let's sum-up



Financial Statements are prepared to know profit or loss and financial position of the business. These statements are presented to users of accounting information for decision-making. A complete set of financial statements include Manufacturing Account, Trading and P & L Account and Balance sheet. Final account is the last step involved in accounting cycle. It is maintained with a view to knowing the over result of a business operation. The final account depicts the results from operations of a business organization and also reflects the financial condition of the business organization during a certain period in other words; it is prepared to achieve overall objectives of accounting. The operation result is shown by profit and loss account thus indication profit or loss made during a period. Similarly, the financial position is depicted by balance sheet showing assets and liabilities of the business organization in a certain date.

1.8 Key terms

- (i) Manufacturing Account
- (ii) Trading Account
- (iii) Profit and Loss Account
- (iv) Balance Sheet
- (v) Positional statement

1.9 Self-Assessment Questions

- (i) What do you mean by Trading Account? How is it different from Manufacturing Account?



(ii) What is Balance sheet? Why is it known as positional statement?

1.10 Further Readings

- (vii) Vasudeva S., Accounting for Business managers, Himalaya Publishing House, Mumbai, 1st Edition, 2009
- (viii) Vijayakumar T., Accounting for Management, Tata McGraw Hill Education Pvt. Ltd., New Delhi.
- (ix) Narayanaswamy R., Financial Accounting: A Managerial Perspective, PHI, New Delhi, 2nd Edition, 2005
- (x) Babu P.P and Mohan M.M., Financial Accounting and Analysis, Himalaya Publishing House, Mumbai, 1st Edition, 2008.



- (xi) Jain S.P. and Narang K.L., Financial Accounting, Kalyani Publishers, Ludhiana, 10th Edition, 2008
- (xii) Lal J., Advance Management Accounting: Text and Cases, S.Chand & Company Limited, 1st Edition, 2003

1.11 Model Questions

(i) **From the following balances of the ledger of Sh. Gurdeep Singh, prepare Trading and Profit and Loss Account and Balance Sheet :-**

Dr. Balances	Rs.	Rs.
Stock on 30-6-2007	30,000	
Stock on 30-6-2008	46,200	
Purchases and Sales	2,30,000	3,45,800
Returns	12,500	15,200
Commission on Purchases	1,200	
Freight, octroi and carriage	26,000	
Wages and Salary	10,800	
Fire Insurance Premium	820	
Business premises	40,000	
Sundry Debtors	26,100	
Sundry Creditors		26,700
Goodwill	8,000	
Patents	8,400	
Coal, Gas and Power	7,600	
Printing and Stationery	2,100	
Postage and Telegram	710	
Travelling expenses	4,250	



Drawings	7,200	
Depreciation	1,000	
General Expenses	8,350	
Capital		89,760
Investments	8,000	
Interest on Investments		800
Custom Duty on imported goods	4,500	
Cash in hand	2,570	
Banker's Account		5,200
Commission	4,600	4,400
Loan on Mortgage		30,000
Interest on Loan	3,000	
B/P		2,280
B/R	4,540	
Income Tax	3,000	
Horses and Carts	20,300	
Discount on Purchases		1,600
TOTAL	<u>5,21,740</u>	<u>5,21,740</u>

Ans. Gross Profit Rs. 38,400, Net Profit Rs. 20,370, Balance Sheet Rs. 1,64,110

(ii) **3 From the following balances of Sehajta Ltd. prepare Final Accounts as on 31st March, 2016 :—**

	Rs.		Rs.
Stock on 01-4-2007	23,500	Freight In	1,100
Purchases	46,800	Freight Out	3,000
Sales	1,30,000	Rent (Factory 1/3, Office 2/3)	7,500
Productive Expenses	27,000	Legal Expenses	800
Unproductive Expenses	5,800	Miscellaneous Receipts	500
Trade Expenses	1,200	Sundry Debtors	30,000



Returns In	6,600	Sundry Creditors	12,200
Returns Out	2,800	Donation	600
Loose Tools	7,200	Bad-Debts	4,750
Trade Marks	5,000	Bad-Debts Recovered	4,000
Discount Cr.	2,100	Sales Tax Collected	3,900
Salaries	9,600	Bank Charges	2,800
Fixed Deposit with P.N.B.	10,000	Loan on Mortgage	20,000
Cash in Hand	1,300	Interest on Loan	2,400
Motor Vehicles	50,000		
Leasehold Land	60,000		
Capital	1,37,450		
Life Insurance Premium	6,000		

Value of Closing Stock was Rs. 36,500 on 31st March 2016.



UNIT-3

DEPRECIATION METHODS AND TECHNIQUES

Learning Objectives

After reading this chapter, students should be able to understand:

- Meaning of Depreciation
- Characteristics of Depreciation
- Methods of Depreciation

Structure

- 1.1 Meaning of Depreciation
- 1.2 Characteristics of Depreciation
- 1.3 Causes of Depreciation
- 1.4 Depreciation, Depletion and Amortization
- 1.5 Need of Depreciation Accounting
- 1.6 Important Factors in the Measurement of Depreciation
- 1.7 Methods and Techniques of Depreciation
- 1.8 Let's sum-up
- 1.9 Key terms
- 1.10 Self-Assessment Questions
- 1.11 Further Readings
- 1.12 Model Questions



1.1 Meaning of Depreciation

The term depreciation refers to fall in the value or utility of fixed assets which are used in operations over the definite period of years. In other words, depreciation is the process of spreading the cost of fixed assets over the number of years during which benefit of the asset is received. The fall in value or utility of fixed assets due to so many causes like wear and tear, decay, efflux ion of time or obsolescence, replacement, breakdown, fall in market value etc.

They are used to generate income over its economic life. Hence, their cost should be properly allocated as expense to the accounting periods in which these assets are used. Except land, all other physical assets have a limited period of useful life.

The accounting process for this gradual conversion of the cost of fixed assets into expense is called as ‘depreciation’. Depreciation is defined as “a permanent, continuing and gradual shrinkage in the book value of a fixed asset due to use, wear and tear, obsolescence or efflux ion of time.”

As the asset is used for business purposes the annual decrease in the value of an asset is like any other expenses and should be deducted from the revenue of the business in order to determine the income earned by the business. Depreciation is a measure of the wearing out, consumption or other loss of value of a depreciable asset arising from use, efflux ion of time or obsolescence through technology and market changes. Depreciation is allocated so as to charge a fair proportion of the depreciable amount in each accounting period during the expected useful life of the asset. Depreciation includes amortization of assets whose useful life is predetermined. It also has been defined as ‘the diminution in the utility or value of an asset, due to natural wear and tear, exhaustion of the subject matter, effluxion of time accident, obsolescence or similar cause. The word “accident”, “obsolescence” and the phrase “efflux ion of time” included in the definition, signify that when an asset held by a business cannot be employed for even one of



the purposes for which it was acquired due to some damages suffered, the assets having become out of date or due to no occasion having arisen for it to be used, the loss caused to the business will be depreciation. Depreciation caused by any one of the last mentioned factors often is described as external depreciation, to distinguish it from the natural wear and tear of assets which is known as internal depreciation. Depreciation has a significant effect in determining and presenting the financial position and results of operations of an enterprise. Depreciation is charged in each accounting period by reference to the extent of the depreciable amount, irrespective of an increase in the market value of the assets.

According to the Institute of Chartered Accountant of India, "Depreciation is the 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.

1.2 Characteristics of Depreciation

- (a) Depreciation refers to fall or shrinkage rather than an increase in the value of an asset.
- (b) It refers to a fall in book value of the asset. This value may or may not be equal to the market value or the cost price of the asset.
- (c) The fall in book value is a slow and gradual process rather than a sudden event. It is always continuing and a permanent shrinkage.
- (d) Depreciation is restricted to the fall in the value of fixed assets. Once a fixed asset is put to use, depreciation begins to occur and it stays there forever.

1.3 Causes of Depreciation

The causes of depreciation are as follows:

- (i) **physical wear and tear** :- Tangible fixed asset like building machinery are worn or torn out on account of constant use of an asset, strain, weathering out, lack of adequate maintenance, improper handling etc. All fixed asset are bound to lose value on account of wear and tear.



(ii) **Efflux ion of time:-** There are certain assets which decreases in the value with the passage of time. It is especially true in case of certain intangible assets like leasehold properties, copyrights, patents, etc. The term amortization is respect of fall in the value of such asset.

(iii) **Obsolescence:-** Certain fixed assets lose value on account of obsolescence which is caused by new invention, technological improvements, loss of demand due to change in fashion, tastes or habits of consumers. It reduces the existing economic life of an asset.

(iv) **Depletion:-** Depletion is the decrease in the value of wasting assets such as mines, queries, oil wells, etc. Such assets get exhausted on account of continuous extraction.

(v) **Accidents:-** The assts losses its value if it meets with an accident. An accident means breakdown of an assets which decreases the value of an assets.

1.4 Depreciation, Depletion and Amortization

In accounting the terms depreciation, depletion and amortization often involve the movement of costs from the balance sheet to the income statement in a systematic and logical manner.

For example, the systematic expensing of the cost of assets such as buildings, equipment, furnishings and vehicles is known as depreciation. The systematic expensing of the cost of natural resources is referred to as depletion. The systematic expensing of other long-term costs such as bond issue costs and organization costs is referred to as amortization.

Depreciation, depletion and amortization are also described as noncash expenses, since there is no cash outlay in the years that the expense is reported on the income statement. As a result, these expenses are added back to the net income reported in the operating activities section of the statement of cash flows when it is prepared under the indirect method.



Amortization quite literally means to ‘bring to death, and is the gradual extinction of an intangible asset or liability by periodic amounts. In this case there is no physical substance to the asset or liability, there is nothing to wear and tear over time, so the term depreciation is not applicable. The term amortization is also used to indicate the systematic reduction in a loan balance resulting from a predetermined schedule of interest and principal payments.

1.5 Need of Depreciation Accounting

(a) To ascertain true profits:

Depreciation is a charge for capital assets used in earning profits and therefore, it should be viewed as business expenditure. Unless proper charge for this expense is made in accounts, the correct profit cannot be ascertained.

(b) To show the assets at their proper values:

Depreciation must be accounted for in order to show the assets at their proper values and thereby present a true and fair view of the financial position of the business. Unless depreciation is provided, the value of the assets will be overstated in the Balance Sheet and it will not reflect the true and fair view of the business.

(c) To create funds for replacement of assets:

Depreciation is non-cash expenditure. Hence, the amount of depreciation charged to Profit and Loss account remains in the business and the amount thus accumulated during the working life of the asset provides funds for its replacement at the end of the working life of the asset.

(d) To keep the capital in tact:

If depreciation is not charged, the amount of profit will be inflated. If such profits are distributed among the owners, then it will amount to the distribution of fixed capital from the business. In the long run it will affect the financial health of the business.



(e) Statutory Need: Provision of depreciation is a statutory need:

Section 205 of the Indian companies Act has made compulsory for a joint stock company to provide for depreciation before distributing the profits as dividends.

1.6 Important Factors in the Measurement of Depreciation

Assessment of depreciation and the amount to be charged in respect thereof in an accounting period are usually based on the following three factors

- (a) Historical cost or other amount substituted for the historical cost of the depreciable asset when the asset has been revalue.
- (b) Expected useful life of the depreciable asset; and
- (c) Estimated residual value of the depreciable asset.

(a) Depreciable Asset:

Depreciable assets are assets which

- (i) are expected to be used during more than one accounting period; and
- (ii) have a limited useful life; and
- (iii) are held by an enterprise for use in the production or supply of goods and services, for rental to others, or for administrative purposes and not for the purpose of sale in the ordinary course of business.

(b) Useful Life

Useful life is either (i) the period over which a depreciable asset is expected to be used by the enterprise; or (ii) the number of production or similar units expected to be obtained from the use of the asset by the enterprise.

(c) Depreciable amount

Depreciable amount of a depreciable asset is its historical cost, or other amount substituted for historical cost¹ in the financial statements, less the estimated residual value.

1.7 Methods and Techniques of Depreciation

There are numerous methods of computing depreciation of fixed tangible assets. The method selected will depend on circumstances and kind of asset it must be



remember that once the method is selected, it should be applied consistently from one accounting period to another so as to give a true and fair view of the financial standing of the concern. Two methods which are most commonly employed in the sphere of commerce and industry are discussed as follows:-

(a) The Straight-line or Fixed Installment Method

Under this method, an installment or fixed proportion of the original capital outlay is provided equally in each accounting period so that the value of asset is reduced to its residual value at the end of its estimated economic useful life. The fixed amount is then charged to the revenue account. The following formula for calculating the periodic depreciation charge is :

$$\text{Depreciation} = \frac{\text{Original cost of asset} - \text{scarp value}}{\text{Estimated life of asset}}$$
$$\text{Depreciation} = \frac{C - S}{N}$$

Where,

D = Depreciation Rate

C = Original Cost Of Asset

S = Salvage or Scarp Value

N = Estimated Useful Life

Example:-

From the following information required to calculate the amount of depreciation :

(i)	Cost of the machine	Rs. 30,000
(ii)	Erection Charges	Rs. 3,000
(iii)	Estimated useful life	10 years
(iv)	Estimated scarp value	Rs. 3,000

Solution :

Calculation of amount of depreciation for every year:



$$\begin{aligned}
 \text{Depreciation} &= \frac{\text{Original Cost of Asset} - \text{Scarp Value}}{\text{Estimated Life of an asset}} \\
 &= \frac{\text{Rs. } 33,000 - \text{Rs. } 3,000}{10} \\
 &= \frac{\text{Rs. } 30,000}{10} = \text{Rs. } 3,000
 \end{aligned}$$

Thus, the amount of depreciation would be Rs. 3,000 for every year.

ILLUSTRATION: - A company charges depreciation on plant and machinery under constant charge method @ 25% per annum. On 1st January, 2012 Machinery was purchased for Rs. 1, 00,000.

From the above information, you are required to prepare a Machinery account for three years.

Solution:

Machinery account

Dr.

Cr.

Date	Particulars	Amount	Date	Particulars	Amount
Jan.1 2012	To Bank A/c	1,00,000	Dec. 31, 2012	By Depreciation	25,000
		_____		By Balance c/d	<u>75,000</u>
Jan.1 2013		<u>1,00,000</u>	Dec. 31, 2013		<u>1,00,000</u>
	To Balance b/d	75,000		By Depreciation	25,000
Jan.1 2014		_____	Dec. 31, 2013	By Balance c/d	<u>50,000</u>
		<u>75,000</u>			<u>75,000</u>
	To Balance b/d	50,000		By Depreciation	25,000
		_____		By Balance c/d	<u>25,000</u>
		<u>50,000</u>			<u>50,000</u>



(2) *The Reducing Balance Method*

This method is also known as ‘Diminishing Balance Method’. The computation of this method is entirely based on a fixed percentage of the book value of the asset as reduced by previous provision. This method tends to give a fairly even charge against income every year. The amount of depreciation charged in each period is not fixed but goes on decreasing gradually every year. On the one hand, the depreciation of fixed asset is heavier in the early periods while the repairs and maintenance are lightest. On the other hand the lighter burden by way of depreciation falls in the closing stages of the useful life, when repairs and maintenance are heaviest.

Reducing balance method charges depreciation at a higher rate in the earlier years of an asset. The amount of depreciation reduces as the life of the asset progresses. Under fixed installment method the amount of annual depreciation remains the same but under reducing balance method the amount of annual depreciation gradually reduces. This method is especially suitable to assets with long life, e.g., plant and machinery, furniture, motor car etc.

Example:

Suppose the cost of asset is Rs. 1,000 and rate of depreciation 10% p.a.

Cost of asset	1,000	
<i><u>Depreciation:</u></i>		
1st year: 10% of 1,000	100	

Book value	900	
2nd year: 10% of 900	90	

Book value	810	
3rd year: 10% of 810	81	

Book value	729	
and so on.....		



Under this method the real cost of using an asset is the depreciation and repair expenses so this method gives better results because in early years when repair expenses are less the depreciation is more. As the asset gets older repair charges on it increases and the amount of depreciation decreases. So the combined effect of both these costs remain almost constant on the profit and loss of each year.

The great weakness of this method is that it takes very long time to write off an asset to approximately nil, unless a very high rate is used, in which case the burden on earlier years shall be excessive. This method is used by income tax authorities for granting depreciation allowance to assesses.

Difference between Straight Line Method and Reducing Balance Method:

Following are the main points of difference between straight line method and reducing balance method of depreciation:

Straight Line Method

Reducing Balance Method

- | | |
|--|--|
| 1. The rate and amount of depreciation remain the same each year. | 1. The rate remains the same, but amount of depreciation decreases gradually. |
| 2. Depreciation rate per cent is calculated on cost of assets each year. | 2. Depreciation rate per cent is calculated on book value of asset. |
| 3. At the end of its life the value of asset is reduced to zero or nil value. | 3. The value of asset is never reduced to zero at the end of its life. |
| 4. The older the asset the larger amount of its repair. But the amount of depreciation remain the same each year. Hence, the total of depreciation and repairs increases every year. | 4. The amount of depreciation decreases gradually, while the cost of repairs increases. So the total of depreciation and repairs remain more or less the same each year. Hence, it causes little |



reduces annual profit gradually; change in annual profit/loss.

5. Computation of depreciation 5. Depreciation can be computed
straight line method is compared any difficulty, but it is not easy and simple. easy and simple.

1.8 Let's sum-up

The purpose of depreciation is to match the cost of a productive asset (that has a useful life of more than a year) to the revenues earned from using the asset. Since it is hard to see a direct link to revenues, the asset's cost is usually allocated to (assigned to, spread over) the years in which the asset is used. Depreciation systematically allocates or moves the asset's cost from the balance sheet to expense on the income statement over the asset's useful life. In other words, depreciation is an allocation process in order to achieve the matching principle; it is not a technique for determining the fair market value of the asset. Many different depreciation methods are available for use in accounting. Basic elements for these items include historical cost, salvage value and useful life. Companies will often subtract the salvage value --- the money gained when selling the asset -- - from the historical cost. Using the straight-line depreciation method, accountants divide this figure by the asset's useful life. This represents the annual expense for using the asset. Companies use depreciation to report asset use to stakeholders. Depreciation also reduces the historical value of assets. Stakeholders can review this information and know when to expect replacement assets purchased by a company.

1.9 Key terms

- (i) Depreciation
- (ii) Depletion
- (iii) Amortization
- (iv) Straight-down method



1.10 Self-Assessment Questions

- (i) What do you mean by depreciation? Narrate the needs of charging depreciation.

- (ii) Elaborate the straight-line method of depreciation with a suitable example.



1.11 Further Readings

- (xiii) Vasudeva S., Accounting for Business managers, Himalaya Publishing House, Mumbai, 1st Edition, 2009
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- (xv) Narayanaswamy R., Financial Accounting: A Managerial Perspective, PHI, New Delhi, 2nd Edition, 2005
- (xvi) Babu P.P and Mohan M.M., Financial Accounting and Analysis, Himalaya Publishing House, Mumbai, 1st Edition, 2008.
- (xvii) Jain S.P. and Narang K.L., Financial Accounting, Kalyani Publishers, Ludhiana, 10th Edition, 2008
- (xviii) Lal J., Advance Management Accounting: Text and Cases, S.Chand & Company Limited, 1st Edition, 2003

1.12 Model Questions

- (i) Distinguish between depreciation, depletion and amortization.
- (ii) What are the factors to be considered while computing depreciation? Identify and explain the nature of each.
- (iii) What are the managerial significance of depreciations accounting?
- (iv) What are the methods of depreciation?
- (v) What is 'depreciation'? State briefly the different causes of depreciation.
- (vi) A machine was purchased on 1st April, 2012 for Rs. 5,00,000 by Samir Auto Ltd. The installation cost for the machine is Rs.1,00,000. Depreciation is to be calculated at 20% p.a on straight line method. Show the machinery account for the year 2013, 2014 and 2015. The accounting year is from 1st April to 31st March.