

## FINANCIAL ACCOUNTING

UNIT – I: Definition of Account – Nature of Accounting – Accounting Concepts and Postulates – Double Entry Vs. single entry – Books of Accounts

UNIT – II: Journal – Ledger – Subsidiary Books – Trial Balance

UNIT – III: Bank Reconciliation Statement (BRS) – Final Accounts of Sole Trader – trading, Profit and Loss Account and Balance Sheet with simple adjustments.

UNIT – IV: Methods of Depreciation – Straight Line Method, Written Down Value Method and Annuity Method.

UNIT – V: Capital and Revenue – Accounts of Non-trading organizations – Income and Expenditure Account – Receipts and Payments Account.

(Marks – Theory 40% and Problems 60%)

TEXT BOOK RECOMMENDED: Advanced Accountancy – S.P.JAIN & K.L.NARANG, Kalyani Publishers.

**Account:** Financial records of an organization that register all financial transactions, and must be kept at its principal office or place of business. The purpose of these records is to enable anyone to appraise the organization's current financial position with reasonable accuracy.

**Accounting:** Practice and body of knowledge concerned primarily with

- Methods for recording transactions,
- Keeping financial records,
- Performing internal audits,
- Reporting and analysing financial information to the management, and
- Advising on taxation matters.

It is a systematic process of identifying, recording, measuring, classifying, verifying, summarizing, interpreting and communicating financial information. It reveals profit or loss for a given period, and the value and nature of a firm's assets, liabilities and owners' equity.

**Accounting:** It is the means of collecting, summarising and reporting in monetary terms, information about the business.

**Financial Accounting:** A field of accounting that treats money as a means of measuring economic performance instead of as a factor of production. It encompasses the entire system of monitoring and control of money as it flows in and out of an organization as assets and liabilities, and revenues and expenses.

*The American Institute of Certified Public Accountants* has defined the Financial Accounting as "the art of recording, classifying and summarising in as significant manner and in terms of money transactions and events which in part, at least of a financial character, and interpreting the results thereof". *American Accounting Association* defines accounting as "the process of identifying, measuring, and communicating economic information to permit informed judgements and decisions by users of the information.

*The following attributes of accounting*

- **Recording:** It is concerned with the recording of financial transactions in an orderly manner, soon after their occurrence in the proper books of accounts.
- **Classifying:** It is concerned with the systematic analysis of the recorded data so as to accumulate the transactions of similar type at one place. This function is performed by maintaining the ledger in which different accounts are opened to which related transactions are posted.
- **Summarising:** It is concerned with the preparation and presentation of the classified data in a manner useful to the users. This function involves the preparation of financial statements such as Income Statement, Balance Sheet, and Statement of Changes in Financial Position, Statement of Cash Flow, and Statement of Value Added.
- **Interpreting:** Nowadays, the aforesaid three functions are performed by electronic data processing devices and the accountant has to concentrate mainly on the interpretation aspects of accounting. The accountants should interpret the statements in a manner useful to action. The accountant should explain not only what has happened but also (a) why it happened, and (b) what is likely to happen under specified conditions.

**Financial accounting:** Financial accounting deals with the maintenance of books of accounts with a view to ascertain the profitability and the financial status of the business

**Transaction:** A transaction is a stimulus from one person and a related response from another.

**Book-keeping:** It is the art of recording in the books of accounts the monetary aspect of commercial or financial transactions.

### Distinction between accounting and accountancy

**Accounting:** To keep the record of each and every finance activity either in the ledger or journal form is called as accounting. It also depends on nature of business so accounting has the different meaning at a time. As it comprises distinct work. Here are the things that included in Accounting

- 1) Record of business finance in a standard format to analyse business cash inflow and outflow status.
- 2) Bookkeeping records to define the lifecycle of a financial system and its resources.
- 3) A process which upgrade business activities in time and within budget costs.

Accountancy: To summarize, classify and accordance of every financial activity into a system is known as accountancy. It includes:

1. It relates to reporting of accounting, bookkeeping, auditing etc.
2. Especially consider making reports on various distinct financial systems.

### Distinction between Bookkeeping and Accounting

Basis for Comparison	Bookkeeping	Accounting
Meaning	Bookkeeping is an activity of recording the financial transactions of the company in a systematic manner.	Accounting is an orderly recording and reporting of the financial affairs of an organization for a particular period.
What is it?	It is the subset of accounting.	It is regarded as the language of business.
Decision Making	On the basis of bookkeeping records, decisions cannot be taken.	Decisions can be taken on the basis of accounting records.
Preparation of Financial Statements	Not done in the bookkeeping process	Part of Accounting Process
Tools	Journal and Ledgers	Balance Sheet, Profit & Loss Account and Cash Flow Statement
Methods / Sub-fields	Single Entry System of Bookkeeping and Double Entry System of Bookkeeping	Financial Accounting, Cost Accounting, Management Accounting, Human Resource Accounting, Social Responsibility Accounting.
Determination of Financial Position	Bookkeeping does not reflect the financial position of an organization.	Accounting clearly shows the financial position of the entity.

### Functions of Accounting: (objectives)

- **Keeping Systematic Records:** As a language of business, accounting is to report the results of most business events. Hence, its main function is to keep a systematic record of these events. This function embraces recording transactions in journal and subsidiary books like cashbook, sales book etc., posting them to ledger accounts and ultimately preparing the financial statements [final accounts].
- **Communicating the Results:** The second main function of accounting is to communicate the financial facts of the enterprise to the various interested parties like owners, investors, creditors, employees, government, and research scholars, etc., The purpose of this function is to enable these parties to have better understanding of the business and take sound and realistic economic decisions.
- **Meeting the Legal Requirements:** Accounting aims at fulfilling the legal requirements, especially of the tax authorities and regulators of the business. It discharges this function in accordance with certain fundamental truths and uniform enforcement of generally accepted accounting principles.
- **Protecting the Properties of the Business:** Accounting helps protecting the property of the business.
- **Planning and Controlling the Business Activities:** Accounting also helps planning future activities of an enterprise and controlling its day-to-day operations. This function is done mainly to promote maximum operational efficiency.

### Branches of Accounting

- Financial Accounting:** The object of financial accounting is to ascertain the results (profit or loss) of business operations during the particular period and to state the financial position (balance sheet) as on a date at the end of the period.
- Cost Accounting:** The object of cost accounting is to find out the cost of goods produced or services rendered by a business. It also helps the business in controlling the costs by indicating avoidable losses and wastes.
- Management Accounting:** The object of management accounting is to supply relevant information at appropriate time to the management to enable it to take decisions and effect control.

### Nature of Accounting

- 1) **Accounting Is A Process:** A process refers to the method of performing any specific job step by step according to the objectives, or target. Accounting is identified as a process as it performs the specific task of collecting, processing and communicating financial information. In doing so, it follows some definite steps like collection of data recording, classification summarization, finalization and reporting.
- 2) **Accounting Is An Art:** Accounting is an art of recording, classifying, summarizing and finalizing the financial data. The word 'art' refers to the way of performing something. It is a behavioural knowledge involving certain creativity and skill that may help us to attain some specific objectives. Accounting is a systematic method consisting of definite techniques and its proper application requires applied skill and expertise. So, by nature accounting is an art.
- 3) **Accounting Is Means And Not An End:** Accounting finds out the financial results and position of an entity and the same time, it communicates this information to its users. The users then take their own decisions on the basis of such information. So, it can be said that mere keeping of accounts can be the primary objective of any person or entity. On the other hand, the main objective may be identified as taking decisions on the basis of financial information supplied by accounting. Thus, accounting itself is not an objective, it helps attaining a specific objective. So it is said the accounting is 'a means to an end' and it is not 'an end in itself.'
- 4) **Accounting Deals With Financial Information And Transactions:** Accounting records the financial transactions and date after classifying the same and finalizes their result for a definite period for conveying them to their users.

So, from starting to the end, at every stage, accounting deals with financial information. Only financial information is its subject matter. It does not deal with non-monetary information of non-financial aspect.

- 5) **Accounting Is An Information System:** Accounting is recognized and characterized as a storehouse of information. As a service function, it collects processes and communicates financial information of any entity. This discipline of knowledge has been evolved out to meet the need of financial information required by different interested groups.

### **Advantages and [Uses of Accounting Information]**

- i. Accounting helps to maintain the business records in a systematic manner.
- ii. It helps in the preparation of financial statements.
- iii. Accounting information is also used to compare the result of current year with the previous year to analyse the changes.
- iv. It helps the managers in the decision-making process.
- v. It provides information to other interested parties such as shareholders, creditors, investors, customers, government, employees, regulatory bodies etc.
- vi. It helps in taxation matter
- vii. Accounting information can be produced as evidence in the legal matter.
- viii. It helps in valuation of business.

### **Limitations of Accountings:**

- The items expressed in monetary terms are recorded in the accountings whereas the items which are nonmonetary nature not recorded.
- Sometimes accounting data are recorded on the basis of estimates and which could be inaccurate.
- Fixed assets are recorded as the original cost.
- Value of money does not remain stable so accounting value does not show true financial results.
- Accounting can be manipulated and biased.

### **Systems of accounting**

- 1) **Cash System:** Cash System. Under this system, actual cash receipts and actual cash payments are recorded. Credit transactions are not recorded at all until the cash is actually received or paid. The Receipts and Payments Account prepared in case of non-trading concerns such as a charitable institution, a club, a school, a college, etc. and professional men like a lawyer, a doctor, a chartered accountant etc. can be cited as the best example of cash system. This system does not make a complete record of financial transactions of a trading period as it does not record outstanding transactions like outstanding expenses and outstanding incomes. The system being based on a record of actual cash receipts and actual cash payments will not be able to disclose correct profit or loss for a particular period and will not exhibit true financial position of the business on a particular day.
- 2) **Mercantile (Accrual) system:** Under this system all transactions relating to a period are recorded in the books of account i.e., in addition to actual receipts and payments of cash income receivable and expenses payable are also recorded. This system gives a complete picture of the financial transactions of the business as it makes a record of all transactions relating to a period. The system being based on a complete record of the financial transactions discloses correct profit or loss for a particular period and also exhibits true financial position of the business on a particular day.

**Accounting Concepts:** It refers to assumptions and conditions on which accounting system is based.

- 1) **Business entity concept:** A business and its owner should be treated separately as far as their financial transactions are concerned.
- 2) **Money measurement concept:** Only business transactions that can be expressed in terms of money are recorded in accounting, though records of other types of transactions may be kept separately.
- 3) **Dual aspect concept:** For every credit, a corresponding debit is made. The recording of a transaction is complete only with this dual aspect.
- 4) **Going concern concept:** In accounting, a business is expected to continue for a fairly long time and carry out its commitments and obligations. This assumes that the business will not be forced to stop functioning and liquidate its assets at "fire-sale" prices.
- 5) **Cost concept:** The fixed assets of a business are recorded on the basis of their original cost in the first year of accounting. Subsequently, these assets are recorded minus depreciation. No rise or fall in market price is taken into account. The concept applies only to fixed assets.
- 6) **Accounting year concept:** Each business chooses a specific time period to complete a cycle of the accounting process—for example, monthly, quarterly, or annually—as per a fiscal or a calendar year.
- 7) **Matching concept:** This principle dictates that for every entry of revenue recorded in a given accounting period, an equal expense entry has to be recorded for correctly calculating profit or loss in a given period.
- 8) **Realisation concept:** According to this concept, profit is recognised only when it is earned. An advance or fee paid is not considered a profit until the goods or services have been delivered to the buyer.
- 9) **Accrual Concept:** The accrual concept in accounting means that expenses and revenues are recorded in the period they occur, whether or not cash is involved. Once a business receives or makes cash payments, it reverses the accrual accounting entries and records the cash transactions.

**Accounting convention:** Accounting convention refers to the customs and traditions followed by accountants as guidelines while preparing accounting statements.

- **Conservatism** is the convention by which, when two values of a transaction are available, the lower-value transaction is recorded. By this convention, profit should never be overestimated, and there should always be a provision for losses.

- *Consistency* prescribes the use of the same accounting principles from one period of an accounting cycle to the next, so that the same standards are applied to calculate profit and loss.
- *Materiality* means that all material facts should be recorded in accounting. Accountants should record important data and leave out insignificant information.
- *Full disclosure* entails the revelation of all information, both favourable and detrimental to a business enterprise, and which are of material value to creditors and debtors.

**Accounting Postulate:** An underlying assumption in accounting. An accounting postulate is not listed in any statement of accounting procedures because it is assumed that it is understood by everyone.

**Accounting process:**

- 1) Identification of Transaction.
- 2) Recording the transaction.
- 3) Classifying.
- 4) Summarising.
- 5) Analysis and Interpretation.
- 6) Presentation or reporting of financial information.

**Single Entry:** A single-entry bookkeeping system or single-entry accounting system is a method of bookkeeping relying on a one-sided accounting entry to maintain financial information.

*The single Entry System can be classified into following three categories:-*

- *Pure Single Entry System*:-Under this type of Single entry, the dual aspect of each transaction is ignored. Only personal account of debtors and creditors are kept but no record is kept for Real or Nominal Account.
- *Simple Single Entry System*:-Under this system, (i) Personal Account and (ii) Cash book are kept.
- *Quasi Single Entry System*:-Under this System, (i) Personal Account, (ii) Cash book and (iii) Some other subsidiary books are kept.

**Merits and Demerits Single Entry**

Merits	Demerits
<ul style="list-style-type: none"> <li>- It is an easy and simple method of maintaining books of accounts.</li> <li>- It is conventional and economical.</li> <li>- It is less time consuming.</li> </ul>	<ul style="list-style-type: none"> <li>- It is not a scientific method of accounting because it does not record the two-fold aspect of each transaction.</li> <li>- No trial balance can be prepared under Single Entry System.</li> <li>- The arithmetical accuracy of the books cannot be checked in the absence of trial balance.</li> <li>- In the absence of various checks, Fraud is more easily committed and it is very difficult to detect.</li> <li>- In the absence of Real and nominal accounts the true financial position of the business cannot be ascertained.</li> </ul>

**Double Entry:** Double-entry bookkeeping, in accounting, is a system of bookkeeping so named because every entry to an account requires a corresponding and opposite entry to a different account. Double entry system of accounts is a scientific system of accounts followed all over the world without any dispute. It is an old system of accounting. It was developed by '**Luco Pacioli**' of Italy in 1494. Under the double entry system of account, every entry has its dual aspects of debit and credit. It means, assets of the business always equal to liabilities of the business.

Assets = Liabilities

**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:

- Personal accounts
- Real accounts
  - Tangible accounts
  - Intangible accounts

**Personal Accounts:** Personal accounts may be further classified into three categories:

- 1) *Natural Personal Account:* An account related to any individual like David, George, Ram, or Shyam is called as a Natural Personal Account.
- 2) *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.
- 3) *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.

**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 type of assets is same.

**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.

### Rules of Debit and Credit under Double Entry System of Accounts

The following rules of debit and credit are called the golden rules of accounts:

Classification of accounts	Rules	Effect
<b>Personal Accounts</b>	Receiver is Debit Giver is Credit	Debit=Credit
<b>Real Accounts</b>	What Comes In Debit What Goes Out Credit	Debit=Credit
<b>Nominal Accounts</b>	Expenses & Loss are Debit Incomes & Gains are Credit	Debit=Credit

### Single entry vs Double entry accounting system:

Single Entry System	Double Entry System
- Under this system, both aspect of each transaction are not recorded.	- Under this system, both aspect of each transaction are record.
- In this system, only Personal accounts are kept, real and Nominal accounts are ignored.	- In this system, Personal, Real and Nominal accounts are kept fully.
- In this system, only debtors' ledger and creditors' ledger are kept. Cash book is also kept but personal transaction gets mixed up business transaction.	- In this system, Cash book, General ledger, Debtors' Ledger and creditors' ledger are maintained.
- Under this system, arithmetical accuracy cannot be checked because to Trial Balance can be prepared.	- Under this system, arithmetical accuracy can be checked by preparing Trial Balance at any moment of time.
- In this system, Trading, Profit and Loss Accounts and Balance sheet cannot be prepared.	- In this system, Trading, Profit and Loss Accounts and Balance sheet can be prepared.
- Vital ratios cannot be computed, if the accounts are maintained under this system.	- For interpretation of financial statement, we can compute different ratios, if the accounts are maintained under this system.
- This system is unscientific and does not follow any concrete rules.	- This system is scientific and follows certain rules.

### Basic Accounting Terms

**Accounting equation:** The accounting equation, the basis for the double-entry system (see below), is written as follows:

Assets = Sources of Finance (or) Liabilities + Stakeholders' equity (or) Liabilities + Capital (or) Liabilities + Owner's equity

This means that all the assets owned by a company have been financed from loans from creditors and from equity from investors. "Assets" here stands for cash, account receivables, inventory, etc., that a company possesses.

**Accounting methods (Accrual accounting or Cash accounting):** Companies choose between two methods—cash accounting or accrual accounting. Under cash basis accounting, preferred by small businesses, all revenues and expenditures at the time when payments are actually received or sent are recorded. Under accrual basis accounting, income is recorded when earned and expenses are recorded when incurred.

**Account receivable:** The sum of money owed by your customers after goods or services have been delivered and/or used.

**Account payable:** The amount of money you owe creditors, suppliers, etc., in return for goods and/or services they have delivered.

**Assets (fixed and current):** Current assets are assets that will be used within one year. For example, cash, inventory, and accounts receivable (see above). Fixed assets (non-current) may provide benefits to a company for more than one year—for example, land and machinery.

**Balance sheet:** A financial report that provides a gist of a company's assets and liabilities and owner's equity at a given time.

**Capital:** A financial asset and its value, such as cash and goods. Working capital is current assets minus current liabilities.

**Cash flow statement:** The cash flow statement of a business shows the balance between the amount of cash earned and the cash expenditure incurred.

**Credit and debit:** A credit is an accounting entry that either increases a liability or equity account, or decreases an asset or expense account. It is entered on the right in an accounting entry. A debit is an accounting entry that either increases an asset or expense account, or decreases a liability or equity account. It is entered on the left in an accounting entry.

**Double-entry bookkeeping:** Under double-entry bookkeeping, every transaction is recorded in at least two accounts—as a credit in one account and as a debit in another. For example, an automobile repair shop that collects ₹ 10,000 in cash from a customer enters this amount in the revenue credit side and also in the cash debit side. If the customer had been given credit, "account receivable" (see above) would have been used instead of "cash." (Also see "single-entry bookkeeping," below.)

**Financial statement:** A financial statement is a document that reveals the financial transactions of a business or a person. The three most important financial statements for businesses are the balance sheet, cash flow statement, and profit and loss statement (all three listed here alphabetically).

**General ledger:** A complete record of financial transactions over the life of a company.

**Journal entry:** An entry in the journal that records financial transactions in the chronological order.

**Profit and loss statement (income statement):** A financial statement that summarises a company's performance by reviewing revenues, costs and expenses during a specific period.

**Single-entry bookkeeping:** Under the single-entry bookkeeping, mainly used by small or businesses, incomes and expenses are recorded through daily and monthly summaries of cash receipts and disbursements. (Also see "double-entry bookkeeping," above.)

**Types of accounting:** Financial accounting reports information about a company's performance to investors and credits. Management accounting provides financial data to managers for business development.

**Books of Accounts:** The financial records, ledgers and journals that make up the accounts of a company. A company's books of account, or "books", represent the financial memory of the company, and are crucial for continuity, decision-making, analysis of company performance, and ensuring regulatory compliance.

### Journal Entry:

Journal is a historical record of business transactions or events. The word journal comes from the French word "Jour" meaning "day". It is a book of original or prime entry written up from the various source documents. Journal is a primary book for recording the day to day transactions in a chronological order i.e. in the order in which they occur. The journal is a form of diary for business transactions. This is also called the book of first entry since every transaction is recorded firstly in the journal.

There are three types of Accounts in Accounting which are

Date	Particulars	LF	Debit		Credit	
			₹	P	₹	P
	<b>Personal Account</b>					
	Receiver a/c Dr		xxxx			
	To giver				xxxx	
	(Narration : Being )					
	<b>Real Account</b>					
	What comes in a/c Dr		xxxx			
	To what Goes out				xxxx	
	(Narration: Being )					
	<b>Nominal Account</b>					
	All expenses and loss a/c Dr		xxxx			
	To Incomes and gains				xxxx	
	(Narration: Being )					

LF: Ledger Folio

*Journal has the following characteristics:*

- Journal is the first successful step of the Double Entry system. A transaction is recorded first of all in the Journal. So, Journal is called the book of Original Entry.
- A transaction is recorded on the same day it takes place. So, Journal is also called a Day Book.
- Transactions are recorded chronologically. So, Journal is called Chronological Book.
- For each transaction the names of the two concerned accounts indicating which is debited and which is credited, are clearly written in two consecutive lines. This makes ledger-posting easy. That is why Journal is called "Assistant to Ledger".
- Narration is written below each entry.
- The amount is written in the last two columns, debit amount in Debit column and credit amount in Credit column.

*Advantages of Journal:*

- Each transaction is recorded as soon as it takes place. So there is no possibility of any transaction being omitted from the books of account.
- Since the transactions are kept recorded in Journal chronologically with narration. It can be easily ascertained when and why a transaction has taken place.

- iii. For each and every transaction which of the two concerned accounts will be debited and which account credited, are clearly written in Journal. So, there is no possibility of committing any mistake in writing the Ledger.
- iv. Since all the details of transactions are recorded in Journal, it is not necessary to repeat them in Ledger. As a result Ledger is kept tidy and brief.
- v. Journal shows the complete story of transaction in one entry.
- vi. Any mistake in ledger can be easily detected with the help of Journal.

**Compound Journal Entries:** When more than two accounts are involved in a transaction and the transaction is recorded by means of a single journal entry instead of passing several journal entries, such single journal entry is termed as 'Compound Journal Entry'.

### Same Entry's:

**Opening Entry:** A journal entry by means of which the balances of various assets, liabilities and capital appearing in the balance sheet of previous accounting period are brought forward in the books of the current accounting period, is known as 'Opening Entry'. While passing an opening entry, all assets accounts (individually) are debited and all liabilities accounts (individually) are credited and the Net worth (i.e. excess of assets over liabilities) is credited to Proprietor's Capital Account (in case of a proprietary concern) or Partners' Capital Accounts (in case of a partnership concern).

**Goods Account:** In accounting the meaning of goods is restricted to only those articles which are purchased by a businessman with an intention to sell it. For example, if a businessman purchased typewriter, it will be good for him if he deals in typewriter but if he deals in other business say clothes then typewriter will be asset for him and clothes will be goods.

### Sub-Division of Goods Accounts

The goods account is not opened in accounting books. In place of goods account the following accounts are opened in the books of accounts:

- **Purchases Account:** This is opened for goods purchased on cash and credit.
- **Sales Account:** This account is opened for the goods sold on cash and credit.
- **Purchase Returns Account or Return Outward Account:** This account is opened for the goods returned to suppliers.
- **Sales Returns Account or Return Inward Account:** This account is opened for the goods returned by customers.

**Trade Discount:** Trade discount is usually allowed on the list price of the goods. It may be allowed by producer to wholesaler and by wholesaler to retailer for purchase of goods in large quantity. It is not recorded in the books of account and entry is made only with the net amount paid or received. For example purchased goods of list price ₹ 8,000 at 15% trade discount from X. In this case the following entry will be passed:

Purchase a/c	Dr	6800	
To x a/c			6800
(Being goods purchased at 15% trade discount less list price)			

**Cash Discount:** Cash discount is a concession allowed by seller to buyer to encourage him to make early cash payment. It is a Nominal Account. The person who allows discount, treat it as an expense and debits in his books and it is called discount allowed and the person who receives discount, treat it as an income and it is called discount received and credited in his books of account as "Discount Received Account." For example, X owes ₹ 6,000 to Y. He pays ₹ 5,950 in full settlement against the amount due.

In the books of X, the journal entry will be:

Y A/c	Dr	6000	
To Cash A/c			5950
To Discount Received A/c			50
(Being Cash paid and discount received)			

In the books of Y

Cash A/c	Dr	5950	
Discount Allowed A/c	Dr	50	
To X a/c			6000
((Being cash received and discount allowed)			

**Goods distributed as free samples:** Sometimes business distribute goods as free samples for the purpose of advertisement. In this case, Advertisement Account is debited and Purchases Account is credited. For example, goods costing ₹ 8000 were distributed as free sample. To record this transaction following entry will be passed:

Advertisement a/c	Dr	8000	
To Purchases a/c			8000

**Interest on capital:** Interest paid on capital is an expense. Therefore interest account should be debited. On the other hand the capital of the business increases. So the capital account should be credited.

Interest on Capital a/c	Dr	xxxx	
To Capital a/c			xxxx

**Interest charged on Drawings:** If the interest is charged on drawings then it will be an increase in the income of business, so interest on drawings will be credited. On the other hand there will be increase in drawings or decrease in Capital. So Drawings Account will be debited.

Drawing Account/Capital a/c Dr xxxx  
To Interest on Drawing a/c xxxx

**Depreciation charged on Fixed Assets:** Depreciation is the gradual, permanent decrease in the value of an asset due to wear and tear and many other causes.

Depreciation a/c Dr xxxx  
To Asset a/c xxxx

**Bad Debts:** Sometimes a debtor of business fails to pay the amount due from him. Reasons may be many e.g. he may become insolvent or he may die. Such irrecoverable amount is a loss to the business.

Bad Debts a/c Dr xxxx  
To Debtor's a/c xxxx

**Bad Debts Recovered:** When any amount becomes irrecoverable from any customer or debtor his account is closed in the books. If in future any amount is recovered from him then his personal account will not be credited because that does not exist in the books.

Cash a/c Dr xxxx  
To Bad Debts Recovered a/c xxxx

**Purchase and Sale of investment:** When business has some surplus money it may invest this amount in shares, debentures or other types of securities. When these securities are purchased, these are recorded at the purchase price paid. At the time of sale of investment the sale price of an investment is recorded in the books of accounts. The following entry is passed to record the purchase of investment:

Investment a/c Dr xxxx  
To Cash a/c xxxx

In case of sale of these securities the entry will be:

Cash a/c Dr xxxx  
To Investment a/c xxxx

**Loss of Goods by Fire/Accident/theft:** A business may suffer loss of goods on account of fire, theft or accident. It is a business loss and a nominal account. It also reduces the goods at cost price, and increases the loss/expenses of the business.

Loss by fire/Accident/theft a/c (loss) Dr xxxx  
Insurance Company a/c (for insurance claim admitted) Dr xxxx  
To Purchases a/c xxxx

**Income Tax Paid:** Income Tax paid should be debited to Capital Account or Drawings Account and credited to Cash Account in case of sole proprietorship and partnership firms. The reason behind this is that income tax is a personal expense for the sole trader and partners because it is paid on income of proprietor.

Capital Account/Drawings a/c Dr xxxx  
To Cash a/c xxxx

**Bank Charges:** Bank provides various services to their customers. Bank deducts some charges by debiting the account of customers. It is an expense for the business. To record this, Bank charges account is debited and bank account is credited in the books of customer.

**LEDGER:** Collection of an entire group of similar accounts in double-entry bookkeeping. Also called book of final entry, a ledger records classified and summarized financial information from journals (the 'books of first entry') as debits and credits, and shows their current balances. In manual accounting systems, a ledger is usually a loose leaf binder with a separate page for each ledger account. In computerized systems, it consists of interlinked digital files, but follows the same accounting principles as the manual system.

The books of RAJ Journal

Date		Particulars	LF	Debit		Credit	
				₹	p	₹	p
2010 Jan	1	Cash a/c Dr. To Raj's Capital a/c (Being Raj started Business)		10000	-	10000	-

Ledger

Cash Account

Dr.				Cr.			
Date	Particulars	J.F	Amount	Date	Particulars	J.F	Amount
2010 Jan	To Raj's Capital a/c		10000	2010 Jan	By Balance c/d		10000
			10000				10000
2010 Feb	To Balance b/d		10000				

Journal folio; c/d = Carried Down; b/d = Brought down



### Raj's Capital Account

Dr.					Cr.				
Date		Particulars	J.F	Amount	Date		Particulars	J.F	Amount
2010	31	To Balance c/d		10000	2010	1	By Cash C/d		10000
Jan				-	Jan				-
				10000					10000
				-					-
					2010	1			
					Feb		by Balance b/d		10000

**Drawings Account:** It is a personal account of the proprietor. When the businessman withdraws cash or goods from the business for his personal/domestic use it is called as 'drawings'. Drawings reduce the capital as well as goods/cash balance of the business.

Drawing a/c	Dr    xxxx
To Cash a/c	xxxx
To Purchases a/c	xxxx

**Personal expenses of the proprietor:** When the private expenses such as life insurance premium, income tax, home telephone bill, tuition fees of the son of the proprietor etc. are paid out of the cash or bank account of business it should be debited to the Drawings Account of the proprietor.

**Sale of Asset/Property:** When the asset of a business is sold, there may occur a profit or loss on its sale. Its journal entry is:

In case there is a profit on sale of Property/Assets

Cash/Bank a/c	Dr    xxxx
To Asset/Property a/c	xxxx
To Profit on sale of Asset a/c	xxxx

In case of a loss on sale of asset

Cash/Bank a/c	Dr    xxxx
Loss on sale of Asset a/c	Dr    xxxx
To Asset a/c	xxxx

**Paid wages/installation charges for erection of machinery:** Wages and installation charges are the expenses of nominal nature. But for erection of machinery no separate account should be opened for such expenses because these expenses are of capital nature and it will be merged/debited to the cost of assets i.e. machinery.

Machinery a/c	Dr    xxxx
To Cash/Bank a/c	xxxx
(Being wages/installation charges paid for the erection of machinery)	

### Important Characteristics of Ledger:

- 1) Books of Secondary Entry: Ledger is also known as books of secondary entry, because second step of processing of financial transaction is performed in ledger.
- 2) Ledger Keep the Accounts: Ledger keeps the account of all heads. Therefore ledger is also described as ledger accounts. Thus we can say that ledger is a book which contains the accounts.
- 3) Types of Ledger: Ledger can be broadly classified in to general ledger and subsidiary ledger. General ledger keep all the account and used by the small scale organization, while subsidiary ledger is kept in addition to general ledger by large scale organization, which is a memorandum record. Examples of subsidiary ledger are subsidiary ledger for customer and subsidiary ledger for supplier.
- 4) Classification of Transaction: Ledger is used to classify the financial transactions. Thus we can say that ledger is used to process the raw financial information gathered in Journal. Journal is used to gather information, where ledger is used to process the information.
- 5) Related & Relevant information: Ledger account gathers all related information on a subject matter in one place. Thus ledger provides the detailed activity in a particular head of account. Accountant used ledger account to analyse the detailed activity in particular account.
- 6) Closing balance information: Ledger provides closing balance information. This information is not only used for payment and receipt, but trial balance is also prepared from the closing balances of general ledger accounts.
- 7) Facilitates Reporting: Ledger facilitates reporting. It is technically impossible to prepared financial reports directly from the journal. Thus ledger is an important book for preparing the financial statements.
- 8) List of Characteristics of ledger: Some important characteristics of ledger are listed below
  - a. Ledger is used to classify information.
  - b. Ledger keeps all related information at one place.
  - c. Ledger facilitates reporting.
  - d. Ledger facilitates timely payment & receipt.

### Difference between Journal and Ledger

Journal	Ledger
- Journal is a book of accounting where daily records of business transactions are first recorded in a chronological order. I.e. in the order of dates.	- A ledger is an accounting book in which all similar transactions related to a particular person or thing are maintained in a summarized form.
- It is known as the primary book of accounting or the book of original/first entry.	- It is known as the principal book of accounting or the book of final entry.

- It is prepared out of transaction proofs such as vouchers, receipts, bills, etc.,	- It is prepared with the help of a journal itself, therefore, it is the immediate step after recording a journal.
- A journal is not balanced.	- Except normal accounts all ledger accounts are balanced to find the net result.
- Procedure of recording in a journal is known as journalizing, which perform in the form of a journal entry.	- Procedure of recording in a ledger is known as posting.
- It may be subdivided into a cash book, a sales day book, sales return day book, purchases day book, purchases return day book, B/R book, B/P book, Petty Cash Book.	- It may be sub-divided into General ledger, debtors/sales ledger, and creditors/purchases ledger.

### Subsidiary Book

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

Name	Specific transactions to be recorded
<b>1) Cash Books</b>	<b>Used to record all the cash receipts and payments.</b>
• Single column cash book	Cash transactions.
• Double column cash book	Cash and discount transactions.
• Triple column cash book	Cash, bank and discount transactions.
• Petty cash book	Petty cash transactions
<b>2) Goods Books</b>	
• Purchase book	Credit purchase of goods.
• Sales book	Credit sales of goods.
• Sales returns book/Return Inwards book.	Goods returned by those customers to whom goods were sold on credit.
• Purchase returns book/Return outwards book.	Goods returned to those suppliers from whom goods were purchased on credit.
<b>3) Bill Books</b>	
• Bills receivable book	Bills receivable drawn
• Bills payable book	Bills payable accepted
<b>4) Journal proper</b>	<b>Transactions not covered elsewhere.</b>

Advantages of Subsidiary Books:

- Facilitates: The accounting work can be divided among many persons.
- Permits the installation of internal check system: The accounting work can be divided in such a manner that another person automatically checks the work of one person. With the use of internal check, the possibility of occurrence of error/fraud may be avoided.
- Permits the use of specialized skill: The accounting work requiring specialized skill may be assigned to a person possessing the required skills. With the use of a specialized skill, prompt, economical and more accurate supply of accounting information may be obtained.
- Time and labour saving in journalizing and posting: For instance, when a Sales Book is kept, the name of the sales account will not be required to be written down in the Journal as many times as the sales transactions occur and at the same time, sales account will not be required to be posted again and again since, only a periodic total of sales book is posted to the sales account.

**Cash Book:** A cash book is a special journal, which is used for recording all cash receipts and cash payments.

**Single-Column Cash Book:** This cash book has one amount column on each side. All cash receipts are recorded on the receipt side and all cash payments on the payment side. In fact, this book is nothing but a Cash Account.

Performa

Dr. (receipts)					CASH BOOK (Single Column)					(payments)Cr.			
Date	Particulars	R.N.	L.F.	Amount	Date	Particulars	V.N.	L.F.	Amount				

R.N – Receipt Number

V.N – Voucher Number

**Double Column Cash Book:** Here, we have an additional Discount column on each side of the cash book. The debit side column of discount represents the discount to debtors of the company and the credit side of discount column means the discount received from our suppliers or creditors while making payments. The total of discount column of debit side of cash book is posted in the ledger account of 'Discount Allowed to Customers' account as 'To Total as per Cash Book'. Similarly, credit column of cash book is posted in ledger account of 'Discount Received' as 'By total of cash book'.

Dr. (receipts)						CASH BOOK (with Discount Column)						(payments)Cr.			
Date	Particulars	R.N.	L.F.	Discount	Amount	Date	Particulars	V.N.	L.F.	Discount	Amount				

**Triple Column Cash Book:** When one more column of Bank is added in both sides of the double column cash book to post all banking transactions, it is called triple column cash book. All banking transactions are routed through this cash book and there is no need to open a separate bank account in ledger.

**Dr. (receipts)****CASH BOOK (Three Column)****(payments)Cr.**

Date	Particulars	R.N.	L.F.	Discount	Amount	bank	Date	Particulars	V.N.	L.F.	Discount	Amount	bank

**Contra entry:** An accounting transaction involves two accounts and there may be a transaction where both cash account and bank account are involved. Since in the ledger there is no separate cash account and bank account, therefore, no posting will be done from the cash book to the ledger in case of such a transaction. The transaction will be recorded on both the side of the cash book. Such an accounting entry, which is recorded on the both the sides of the cash book, is known as contra entry. In order to give hint for the purpose the word 'C' is written in the ledger folio.

**Petty Cash Book:**

In any organization, there may be many petty transactions incurring for which payments have to be done. Therefore, cash is kept with an employee, who deals with it and makes regular payments out of it. To make it simple and secure, mostly a constant balance is kept with that employee. Suppose cashier pays ₹ 5,000 to Mr A, who will pay day-to-day organization expenses out of it. Suppose Mr A spend ₹ 4,200 out of it in a day, the main cashier pays ₹ 4,200, so his balance of petty cash book will be again ₹ 5,000. It is very useful system of accounting, as it saves the time of the main cashier and provides better control.

We will soon discuss about '**Analytical or Columnar Petty Cash Book**' which is most commonly used in most of the organizations.

**PETTY CASH BOOK**

Amount Received	C.B.F	Date	Particulars	Amount Paid	Stationery & Printing	Cartage	Loading	Postage	L.F.

**Purchases Book (Purchases Day Book):** Purchase book for recording credit purchase of goods only. Cash purchase or assets purchased on credit are not entered in this book.

**PURCHASE BOOK**

Date	Particulars	Inward Invoice No.	L.F.	Amount

**Purchases Returns Book:** Purchases Returns Book for recording the goods returned to the suppliers when purchased on credit.

**PURCHASE RETURN BOOK**

Date	Particulars	Credit Note No.	L.F.	Amount

**Sales book:** Sales book (Sales Day Book) for recording credit sales of goods only, Assets sold or cash sales are not recorded in this book.

**SALE BOOK**

Date	Particulars	Outward Invoice No.	L.F.	Amount

**Sales Returns Books:** Sales Returns Books for recording goods returned by the customers when sold on credit.

**SALE RETURN BOOK**

Date	Particulars	Debit Note No.	L.F.	Amount

**Bills Receivable Book:** Bills Receivable Book for recording the bills received [Bills Receivables] from customers for credit sales.

**BILLS RECEIVABLE BOOK**

Date	Received From	Term	Due Date	L.F.	Amount

**Bills Payables Book:** Bills Payables Book for recording the acceptances [Bills Payables] given to the suppliers for credit purchases.

**BILLS PAYABLE BOOK**

Date	To Whom Given	Term	Due Date	L.F.	Amount

**Trial Balance:**

Trial balance may be defined as an informal accounting schedule or statement that lists the ledger account balances at a point in time compares the total of debit balance with the total of credit balance.

The fundamental principle of double entry system is that at any stage, the total of debits must be equal to the total of credits. If entries are recorded and posted correctly, the ledger will reflect equal debits and credits, and the total credit balance will then be equal to the total debit balances.

Every business concern prepares final accounts at the end of the year to ascertain the result of the activities of the whole year. To ensure correct result, the concern must be free from doubt that the books of accounts have been correctly recorded throughout the year. Trial balance is prepared to test the arithmetical accuracy of the books of accounts. As we know that under double entry system for each and every transaction one account is debited and other account is credited with an equal amount. If all the transactions are correctly recorded strictly according to this rule, the total amount of debit side of all the ledger accounts must be equal to that of credit side of all the ledger accounts. This verification is done through trial balance.

If the trial balance agrees we may reasonably assume that the books are correct. On the other hand, if it does not agree, it indicates that the books are not correct - there are mistakes somewhere. The mistakes are to be detected and corrected otherwise correct result cannot be ascertained. There are however, a few types of errors which the trial balance cannot detect. In other words, the trial balance will agree in spite of the existence of those errors.

The trial balance is not an absolute or solid proof of the accuracy of books of accounts. Thus if trial balance agrees, there may be errors or may not be errors. But if it does not agree, certainly there are errors.

#### Purposes of Trial Balance:

The trial balance serves two main purposes. These are as under:

- To check the equality of debits and credits - an arithmetical or mathematical test of accuracy.
- To provide information for use in preparing final accounts.

#### Method of trial Balance:

1. **Balance Method:** Under balance method, only the balances of all the ledger accounts are taken up to prepare the trial balance.
2. **Total Method:** Under total method, trial balance is prepared by taking up the total of debits and credit of all ledger accounts.
3. **Total and Balance Method:** Compound method is the combination of both the methods, total method and balance method. Thus, compound method is also known as total cum balance method.

#### Reasons of Preparing Trial Balance

1. Helpful to Find Transposition Error.
2. Helpful to Find Miscalculation Error.
3. Helpful to Find Duplication Error.
4. Helpful to Find Omission Error.
5. Helpful to Find Wrong Side Error.

#### Importance of Trial Balance:

1. It ensures that the transactions recorded in the books of accounts have identical debit and credit amount.
2. It shows that the balance of each ledger account has been computed correctly.
3. It shows that the balances of each and every ledger account have been transferred accurately and on the correct side of the sheet on which trial balance has been prepared.
4. It shows that the debit and the credit columns of trial balance have been added up correctly.
5. It makes the preparation of final accounts possible. Thus, figures in the final accounts are picked from the trial balance.
6. Agreed trial balance is a prima facie evidence of the arithmetical accuracy of the accounting books maintained

#### Model Trial Balance

TRIAL BALANCE				
S.No.	Ledger Accounts	L.F.	Debit(₹)	Credit(₹)
1	Advance From Customers			XX
2	Advance To Stiff		XX	
3	Audit Fees		XX	
4	Balance At Bank		XX	
5	Bank Borrowings			XX
6	Bank Interest Paid			XX
7	Capital			XX
8	Cash In Hand		XX	
9	Commission On Sale		XX	
10	Electricity Expenses		XX	
11	Fixed Assets		XX	
12	Freight Outward		XX	
13	Interest Received			XX
14	Inward Freight Charges		XX	
15	Office Expenses		XX	
16	Outstanding Rent			XX
17	Prepaid Insurance		XX	
18	Purchases		XX	
19	Rent		XX	
20	Repair And Renewal's		XX	
21	Salary		XX	
22	Salary Payable			XX
23	Sale			XX
24	Staff Welfare Expenses		XX	
25	Stock		XX	
26	Sundry Creditor's			XX
27	Sundry Debtors'		XX	
	<b>TOTAL</b>		<b>XXXXX</b>	<b>XXXXX</b>

#### Limitations of Trial Balance:

- A trial balance only checks the sum of debits against the sum of credits. That is why it does not guarantee that there are no errors. The following are the main classes of errors that are not detected by the trial balance.
- An error of original entry is when both sides of a transaction include the wrong amount.
- An error of omission is when a transaction is completely omitted from the accounting records. As the debits and credits for the transaction would balance, omitting it would still leave the totals balanced. A variation of this error

is omitting one of the ledger account totals from the trial balance (but in this case the trial balance will not balance).

- An error of reversal is when entries are made to the correct amount, but with debits instead of credits, and vice versa.
- An error of commission is when the entries are made at the correct amount, and the appropriate side (debit or credit), but one or more entries are made to the wrong account of the correct type.
- An error of principle is when the entries are made to the correct amount, and the appropriate side (debit or credit), as with an error of commission, but the wrong type of account is used.
- Compensating errors are multiple unrelated errors that would individually lead to an imbalance, but together cancel each other out.

### Trial Balance Vs Balance Sheet

Define	Trial balance	Balance sheet
1.Object	It is prepared for knowing mathematical accuracy of accounts and the total amount of account balances with debit balances is equal to the total of amount of account balances with credit balances.	Objective of preparing balance sheet is to know the financial position of business.
2. Accounts	All accounts balances are included.	Only real and personal accounts balances are included.
3. Heading	It has two sides, one is debit side and other is credit side.	It has also two sides but we show assets in one side and liabilities in other side.
4. Stock	In many cases, we only include opening stock in trial balance.	We only include closing stock in balance sheet.
5. Stages of Preparation	It is prepared before making trading and profit and loss account.	It is prepared after making trading and profit and loss account.
6. Adjustment Entry	It is prepared before adjustment entries.	It is prepared after adjustment entries.
7. Time of Preparation	It is made in the end of every month.	It is prepared at the end of a year and checked by CA.
8. Proof	It cannot be used as evidence in court.	It can be used as the proof in court.

#### Meaning of Adjusted Trial Balance:

Adjusted trial balance is that list which shows the balances of all accounts including all adjustments. For example, if you see outstanding salary account in trial balance, it will be adjusted trial balance because we pass the closing entries of outstanding salary and same account has been mentioned in adjusted trial balance before preparing financial statement. If we have done all the adjustments and mention in adjusting trial balance, we need not to do more adjustments in final account.

For example, if adjusted trial balance is showing ₹ 20000 as outstanding salary account, it means it has been adjusted with salary account and there is no need to add outstanding salary in salary expenses in profit and loss account. We only show salary account in profit and loss account and then we show outstanding salary as current liability in balance sheet.

#### Importance of Adjusted Trial Balance

Every good account should keep eye on every unadjusted financial item. If he passes the journal entry of every adjustment and shows its effect on adjusted trial balance, it is good for fair practical view of financial statements.

### Bank Reconciliation Statement (BRS)

Bank Reconciliation Statement is a statement prepared to reconcile the difference between the balances as per the bank column of the cash book and pass book on any given date.

**Need of preparing Bank Reconciliation Statement:** It is neither compulsory to prepare Bank Reconciliation Statement nor a date is fixed on which it is to be prepared. It is prepared from time to time to check that all transactions relating to bank are properly recorded by the businessman in the bank column of the cash book and by the bank in its ledger account. Thus, it is prepared to reconcile the bank balances shown by the cash book and by the bank statement. It helps in detecting, if there is any error in recording the transactions and ascertaining the correct bank balance on a particular date.

#### Bank Pass Book:

Bank pass book is merely a copy of the customers' account in the book of a bank. The bank either sends periodical statement of accounts or gives as pass book to its customer in which all deposits and withdrawals made by the customer during the particular period is recorded.

#### Importance of Bank Reconciliation Statement

- Internal control of cash flows tool.
- The reconciliation will bring out any errors that may have been committed either in the cash book or in the pass book.
- Any undue delay in the clearance of cheques will be shown up by the reconciliation.
- A regular reconciliation discourage the accountant of the bank from embezzlement. There have been many cases when the cashiers merely made entries in the cash book but never deposited the cash in the bank, they were able to get away with it only because of lack of reconciliation.
- It helps in finding out the actual position of the bank balance.

#### Preparation of Bank Reconciliation Statement:

To reconcile the bank balance as shown in the pass book with the balance shown by the cash book, Bank Reconciliation Statement is prepared. After identifying the reasons of difference, the Bank Reconciliation statement is prepared

without making change in the cash book balance. We may have the following different situations with regard to balances while preparing the Bank Reconciliation statement. These are:

1. Favourable balances.
  - a. Debit balance as per cash book is given and the balance as per pass book is to be ascertained.
  - b. Credit balance as per pass book is given and the balance as per cash book is to be ascertained.
2. Unfavourable balance/overdraft balance.
  - a. Credit balance as per cash book (i.e. overdraft) is given and the balance as per pass book is to be ascertained.
  - b. Debit balance as per pass book (i.e. overdraft) is given and the balance as per cash book is to be ascertained.

The following steps are taken to prepare the bank reconciliation statement:

- i. Favourable balances : When debit balance as per cash book or credit balance as per pass book is given :
  - a. Take balance as a starting point say Balance as per Cash Book.
  - b. Add all transactions that have resulted in increasing the balance of the pass book.
  - c. Deduct all transactions that have resulted in decreasing the balance of pass book.
  - d. Extract the net balance shown by the statement which should be the same as shown in the pass book.

### BRS – Adjustment

Causes of Differences	Favourable balance (Dr.) as per cash book	Unfavourable balance (Cr.) as per cash book	Favourable balance (Cr.) as per pass book	Unfavourable balance (Dr.) as per Pass book
Cheque deposited but not cleared	Subtract	Add	Add	Subtract
Cheque issued but not presented to bank	Add	Subtract	Subtract	Add
Cheque directed deposited in bank by a customer	Add	Subtract	Subtract	Add
Income (e.g., interest from UTI) directly received by bank	Add	Subtract	Subtract	Add
Expenses (e.g., telephone bills) directly paid by bank on standing instructions	Subtract	Add	Add	Subtract
Bank charges levied (collected) by bank	Subtract	Add	Add	Subtract
Locker rent levied by bank	Subtract	Add	Add	Subtract
Wrong debit in the cash book	Subtract	Add	Add	Subtract
Wrong credit in the cash book	Add	Subtract	Subtract	Add
Wrong debit in the pass book	Subtract	Add	Add	Subtract
Under-casting of Dr. side of bank account in the cash book	Add	Subtract	Subtract	Add
Overcasting of Dr. side of bank account in the cash book	Subtract	Add	Add	Subtract
Under-casting of Cr. Side of bank account in cash book	Subtract	Add	Add	Subtract
Overcasting of Cr. Side of bank account in cash book	Add	Subtract	Subtract	Add
Bill receivable collected directly by bank	Add	Subtract	Subtract	Add
Interest on bank overdraft charged	Subtract	Add	Add	Subtract
<b>Final balance</b>	If answer is positive then favourable balance (Cr.) as per pass book and if negative then unfavourable balance (Dr.) as per pass book	If answer is positive then unfavourable balance (Dr.) as per pass book and if negative then favourable balance (Cr.) as per pass book	If answer is positive then favourable balance (Dr.) as per cash book and if negative then unfavourable balance (Cr.) as per cash book	If answer is positive then unfavourable balance (Cr.) as per cash book and if negative then favourable balance (Dr.) as per cash book

### Reasons for difference (Cash book and Bank Pass book)

When a businessman compares the Bank balance of its cash book with the balance shown by the bank pass book, there is often a difference. As the time period of posting the transactions in the bank column of cash book does not

correspond with the time period of posting in the bank pass book of the firm, the difference arises. The reasons for difference in balance of the cash book and pass book are as under:

- i. *Cheques issued by the firm but not yet presented for payment:* When cheques are issued by the firm, these are immediately entered on the credit side of the bank column of the cash book. Sometimes, receiving person may present these cheques to the bank for payment on some later date. The bank will debit the firm's account when these cheques are presented for payment. There is a time period between the issue of cheque and being presented in the bank for payment. This may cause difference to the balance of cash book and pass book.
- ii. *Cheques deposited into bank but not yet collected:* When cheques are deposited into bank, the firm immediately enters it on the debit side of the bank column of cash book. It increases the bank balance as per the cash book. But, the bank credits the firm's account after these cheques are actually realised. A few days are taken in clearing of local cheques and in case of outstation cheques few more days are taken. This may cause the difference between cash book and pass book balance.
- iii. *Amount directly deposited in the bank account:* Sometimes, the debtors or the customers deposit the money directly into firm's bank account, but the firm gets the information only when it receives the bank statement. In this case, the bank credits the firm's account with the amount received but the same amount is not recorded in the cash book. As a result the balance in the cash book will be less than the balance shown in the Pass book.
- iv. *Bank Charges:* The bank charge in the form of fees or commission is charged from time to time for various services provided from the customers' account without the intimation to the firm. The firm records these charges after receiving the bank intimation or statement. Example of such deductions is: Interest on overdraft balance, credit cards' fees, outstation cheques, collection charges, etc. As a result, the balance of the cash book will be more than the balance of the pass book.
- v. *Interest and dividend received by the bank:* Sometimes, the interest on debentures or dividends on shares held by the account holder is directly deposited by the company through Electronic Clearing System (ECS). But the firm does not get the information till it receives the bank statement. As a consequence, the firm enters it in its cash book on a date later than the date it is recorded by the bank. As a result, the balance as per cash book and pass book will differ.
- vi. *Direct payments made by the bank on behalf of the customers:* Sometimes, bank makes certain payments on behalf of the customer as per standing instructions. Telephone bills, rent, insurance premium, taxes, etc. are some of the expenses. These expenses are directly paid by the bank and debited to the firm's account immediately after their payment. But the firm will record the same on receiving information from the bank in the form of Pass Book or bank statement. As a result, the balance of the pass book is less than that of the balance shown in the bank column of the cash book.
- vii. *Dishonour of Cheques/Bill discounted:* If a cheque deposited by the firm or bill receivable discounted with the bank is dishonoured, the same is debited to firm's account by the bank. But the firm records the same when it receives the information from the bank. As a result, the balance as per cash book and that of pass book will differ.
- viii. *Errors committed in recording transactions by the firm:* There may be certain errors from firm's side, e.g., omission or wrong recording of transactions relating to cheques deposited, cheques issued and wrong balancing etc. In this case, there would be a difference between the balances as per Cash Book and as per Pass Book.
- ix. *Errors committed in recording transactions by the Bank:* Sometimes, bank may also commit errors, e.g., omission or wrong recording of transactions relating to cheques deposited etc. As a result, the balance of the bank pass book and cash book will not agree.

## Final Accounts

The final accounts are primarily prepared for ascertaining the operational result and the financial position of the business. These are prepared with the help of Trial Balance.

The preparation of the final accounts is not the first stage of an accounting cycle but they are the final products of the accounting cycle that is why, they are called final accounts. These accounts summaries all the accounting information recorded in the original books of entry and the ledger consisted of hundreds of thousands of pages.

*The final accounts or financial statements consists of:*

1. Trading and profit and loss account or income statement, which is prepared to know the profit earned or loss suffered by the business during a specific period.
2. Balance sheet, which is prepared to know the financial position of the business on a particular date.

## Trade Account:

The account which is prepared to determine the gross profit or gross loss of a business concern is called trading account.

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.

Dr			Performa Trading Account Trading Account for the year ending _____			Cr		
Particulars		₹	₹	Particulars		₹	₹	
To Opening Stock			xxxx	By Sales		xxxx		
To Purchases		xxxx		Less: Returns		xxxx	xxxx	
Less returns		xxxx	xxxx	By Closing Stock			xxxx	
To Direct Expenses								
<ul style="list-style-type: none"><li>• Carriage Inwards.</li><li>• Wages.</li><li>• Cleaning charges.</li><li>• Packing charges.</li><li>• Salary of the foremen.</li><li>• Fuel and power.</li><li>• Manufacturing expenses.</li><li>• Coal, water and gas.</li><li>• Motive power.</li><li>• Import duty.</li><li>• Custom duty.</li><li>• Consumable stores.</li><li>• Work manager's</li><li>• Royalty on manufacture goods.</li><li>• Freight.</li></ul>								
To Gross profit c/d (Transferred to P & L a/c)			xxxx	By Gross Loss c/d (Transferred to P & L a/c)			xxxx	
Total			xxxx	Total			xxxx	

**Purpose of Preparing Trading Account:** The profit or loss determined by a trading account is the gross result of the business but not the net result. If so, then a question arises - what is the use of preparing a trading account? This account is necessary because of the following advantages.

- Gross profit of a business is very important data, since all business expenses are met out of it. So the amount of gross profit should be adequate to meet the indirect expenses of a business concern.
- The amount of net sales can be determined through this account. Gross sales can be ascertained from sales account in the ledger, but net sales cannot be so obtained. The true sales of a business is net sales - not gross sales. Net sales are determined by deducting sales returns from gross sales in trading account.
- The success or failure of a business can be ascertained by comparing net sales of the current year with that of the last year. It should be noted that an increase in the amount of net sales of the current year over the last year may not be regarded as a sign of success, since sales may increase because of rise in price level.
- Percentage of gross profit on net sales (gross profit ratio) can be easily determined from trading account. This percentage is very important yardstick for measuring the success or failure of a business. Compared to last year, if the rate increases, it indicates success; on the other hand if the rate decreases, it is an indication of failure.
- Percentage of different items of buying expenses (direct expenses) on gross profit can be easily determined and by comparing the percentage of the current year with that of the previous year the variations can be ascertained. An analysis of variances will disclose their cause which will help in controlling the amount of expenses.

Inventory or stock turnover ratio can be determined from trading account. The success or failure of a business can be measured by this rate. Higher rate indicates a favourable sign i.e. goods are sold soon after their purchase. On the other hand, low rate signifies deterioration, i.e. goods are sold long after their purchase.

**Profit and Loss Account:** The account through which annual net profit or loss of a business is ascertained, is called profit and loss account. Gross profit or loss of a business is ascertained through trading account and net profit is determined by deducting all indirect expenses (business operating expenses) from the gross profit through profit and loss account. Thus profit and loss account starts with the result provided by trading account.

*Features of Profit and Loss Account:*

- This account is prepared on the last day of an account year in order to determine the net result of the business.
- It is second stage of the final accounts.
- Only indirect expenses and indirect revenues are shown in this account.
- It starts with the closing balance of the trading account i.e. gross profit or gross loss.
- All items of revenue concerning current year - whether received in cash or not - and all items of expenses. Whether paid in cash or not - are considered in this account. But no item relating to past or next year is included in it.

A Profit and Loss account can briefly summarized under

- The ascertain Net Profit.
- Comparison with the Previous Year's profit.
- Control over expenses

Dr			Profit and Loss Account for the year ended _____			Cr		
Particulars		₹	₹	Particulars		₹	₹	
To Gross Loss b/d			xxxx	By Gross profit b/d			xxxx	
To Selling and distribution expenses.			xxxx	By Interest received			xxxx	
<ul style="list-style-type: none"><li>• Advertisement.</li><li>• Traveller's salary, expenses, commission.</li><li>• Bad debts.</li></ul>				By Discount received.			xxxx	
				By Commission received.			xxxx	



<ul style="list-style-type: none"> <li>• Godown rent.</li> <li>• Carriage outwards.</li> <li>• Agent's commission.</li> <li>• Upkeep of motor vans.</li> <li>• Export expenses.</li> <li>• others</li> </ul>			By Rent and tenants.		xxxx
			By Income From Investments		xxxx
			By Apprenticeship Premium		xxxx
			By Interest On Debentures		xxxx
			By Income From Any Other Sources		xxxx
			By Miscellaneous Revenue Receipts		xxxx
To Management Expenses <ul style="list-style-type: none"> <li>• Office salaries.</li> <li>• Rent, rates &amp; taxes.</li> <li>• Printing &amp; stationary.</li> <li>• Postage &amp; telegrams.</li> <li>• Telephone charges.</li> <li>• Audit fees.</li> <li>• Insurance.</li> <li>• General expenses.</li> <li>• Legal charges.</li> <li>• Heating and lighting, etc.,</li> </ul>		xxxx			
To Depreciation And Maintenance <ul style="list-style-type: none"> <li>• Depreciation.</li> <li>• Repairs and maintenance.</li> </ul>		xxxx			
To Financial Expenses <ul style="list-style-type: none"> <li>• Interest on capital.</li> <li>• Interest on loan.</li> <li>• Discount allowed.</li> <li>• Discount bills, etc.,</li> </ul>		xxxx			
To Extraordinary Expenses Loss By Fire (not covered by insurance cash defalcations) (Others)		xxxx			
To Net profit (Transferred to Capital a/c)		xxxx	To Net Loss (Transferred to Capital a/c)		xxxx
Total		<b>XXXX</b>	Total		<b>XXXX</b>

#### Differentiate between trading account and profit and loss account

Trading Account	Profit and Loss Account
It is the first stage of final accounts.	It is the second stage of the final accounts.
It shows the gross result (gross profit or gross loss) of the business.	It shows the net results (net profit or net loss) of the business.
All direct expenses (expenses connected with purchase or production of goods) are considered in it.	All expenses connected with sales and administration (indirect expenses) of business are considered.
It does not start with the balance of any account.	It always starts with the balance of a trading account (gross profit or gross loss).
Its balance (G.P or G.L) is transferred to profit and loss account.	Its balance (N.P or N.L) is transferred to capital account in balance sheet.

#### Difference between gross profit and net profit:

Gross Profit	Net Profit
It is the excess of net sales over cost of purchase or manufacture (all expense relating to purchase or manufacture of goods) of goods.	It is the excess of gross profit over all indirect expenses.
It is not true profit of the business	It is true profit of the business.
It shows credit balance of the trading account	It shows credit balance of the profit and loss account.
The progress of the business can be judged by the comparison of gross profit with net sales	The profitability of the business can be measured by the comparison of net profit with net sales.

**Direct Expenses:** Expenses connected with purchases of goods are known as direct expenses. For example, freight, insurance, of goods in transit, carriage, wages, custom duty, import duty, octroy duty etc. Without incurring

these expenses, it is not possible to bring the goods from the purchase point to the godown of the business. Such expenses are collectively known as direct expenses.

**Indirect Expenses:** All expenses other than direct expenses are assumed as indirect expenses. Such expenses have no relationship with purchase of goods. Examples of indirect expenses include rent of building, salaries to employees, legal charges, insurance of building, depreciation, printing charges etc.

### Balance sheet

Balance sheet is a list of the accounts having debit balance or credit balance in the ledger. On one side it shows the accounts that have a debit balance and on the other side the accounts that have a credit balance. The purpose of a balance sheet is to show a true and fair financial position of a business at a particular date. Every business prepares a balance sheet at the end of the account year. A balance sheet may be defined as:

- "It is a statement of assets, liabilities and owner's equity (capital) on a particular date".
- "It is a statement of what a business concern owns and what it owes on a particular date". What is owns are called assets and what it owes are called liabilities.
- "It is a statement which discloses total assets, total liabilities and total capital (owner's equity) of a concern on a particular date".
- "It is a statement where all the ledger account balances which remain open after the preparation of trading and profit and loss account, find place".

Balance sheet is so called because it is prepared with the closing balance of ledger accounts at the end of the year. It has two sides - assets side or left hand side and liabilities side or right hand side. The accounts have a debit balance are shown on the asset side and those have a credit balance are shown on the liabilities side and the total of the two sides will agree.

Assets means all the things and properties under the ownership of the business i.e. building, plant, furniture, machinery, stock, cash etc. Assets also include anything against which money or service will be received i.e. creditors accrued income, prepaid expenses etc.

Liabilities means our dues to others or anything against which we are to pay money or render service, i.e. creditors, outstanding expenses, amount payable to the owner of the business (capital) etc.

Asset side of the balance sheet indicates the different types of assets owned by a concern, while liabilities side discloses the various sources through which funds have been obtained in order to acquire those assets. Balance sheet reveals the financial position of the firm on a particular date at a point of time, so it is also called "position statement". It is prepared on the last day of the accounting year and discloses concern for the whole year cannot be determined through the balance sheet because financial position is ever changing.

### Features of Balance Sheet:

- i. It is the last stage of final accounts
- ii. It is prepared on the last day of an accounting year.
- iii. It is not an account under the double entry system - it is a statement only.
- iv. It has two sides - left hand side known as asset side and right hand side known as liabilities side.
- v. The total of both sides are always equal.
- vi. The balances of all asset accounts and liability accounts are shown in it. No expense accounts and revenue accounts are shown here.
- vii. It discloses the financial position and solvency of the business.
- viii. It is prepared after the preparation of trading and profit and loss account because the net profit or net loss of a concern is included in it through capital account.

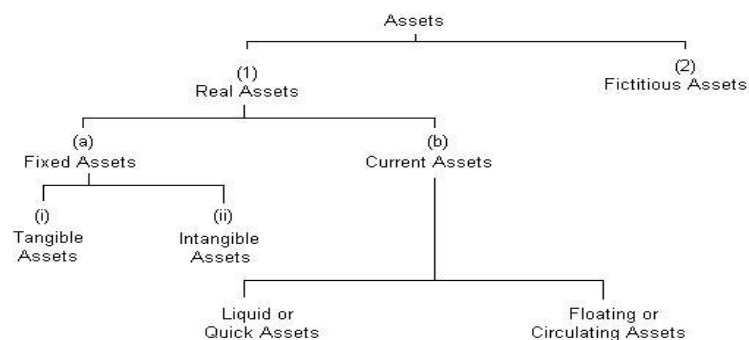
Performa Balance sheet \_\_\_\_\_ as on \_\_\_\_\_

Liability	₹	₹	Assets	₹	₹
<b>Fixed Liabilities</b>			<b>Fixed &amp; Intangible Assets</b>		
Capital	xxxx		<ul style="list-style-type: none"> <li>• Good will</li> <li>• Land &amp; Buildings</li> <li>• Loose tool</li> <li>• Furniture's &amp; fixtures.</li> <li>• Vehicles.</li> <li>• Patents and Copyrights.</li> <li>• Trade Marks.</li> <li>• Long term loans(advances)</li> <li>• Business Premises.</li> <li>(Less: Depreciation)</li> </ul>	xxx	xxxx
Add					
<ul style="list-style-type: none"> <li>• Net profit</li> <li>• Interest on capital</li> </ul>	xxx				
	xxx				
	xxxx				

Less					
<ul style="list-style-type: none"> <li>• Drawings.</li> <li>• Interest on Drawings</li> <li>• Net loss or loss(any)</li> <li>• Income tax</li> </ul>	xxx				
	xxx				
	xxx				
	xxx	xxxx			
<b>Long Term Liabilities</b>					
<ul style="list-style-type: none"> <li>• Loan on mortgage.</li> <li>• Bank Loan.</li> </ul>	xxx	xxxx			
<b>Current Liabilities</b>					
<ul style="list-style-type: none"> <li>• Sundry Creditors.</li> <li>• Bills Payable.</li> <li>• Bank Overdraft.</li> <li>• Creditors at outstanding expenses.</li> <li>• Income received in Advance.</li> </ul>	xxx	xxxx			
<b>Total</b>		xxxx		<b>Total</b>	xxxx

### Classification of Assets:

Assets may be classified as follows:



**Real Assets:** Assets which have some market value are called real assets, e.g. building, machinery, stock, debtors, cash, goodwill, etc. Real assets are further divided into two types according to their permanence:

**Fixed Assets:** Assets which have long life and which are bought for use for a long period of time are called "fixed assets". These are not bought for selling purposes, e.g. land, building, plant, machinery, furniture etc. Fixed assets are again sub-divided into two:

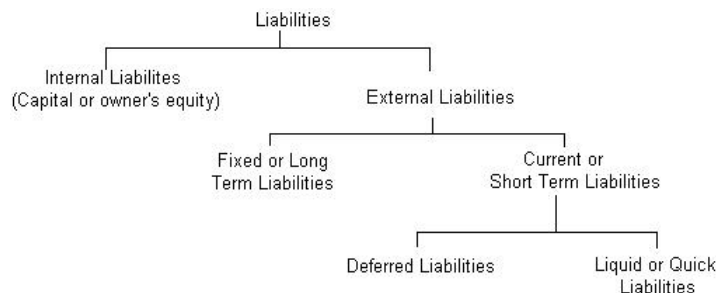
- *Tangible Assets:* Assets which have physical existence and which can be seen, touched and felt are called "tangible assets", e.g. building, plant, machinery, furniture etc.
- *Intangible Assets:* Assets which have no physical existence and which cannot be seen, touched or felt are called "intangible assets", e.g. goodwill, patent right, trade mark etc.

**Current Assets:** Assets which are short-lived and which can be converted into cash quickly to meet short term liabilities are called "current assets", e.g. stock debtors, cash etc. Such assets change their form repeatedly and so, they are also known as circulating or floating assets. For example, on purchase of goods cash is converted into stock and on

sale of goods, stock is converted into debtors, on collection from debtors, debtors take the form of cash etc. Out of current assets those which can be converted into cash very quickly or which are already in the form of cash are called liquid or quick assets e.g. debtors, cash in hand, cash at bank etc.

**Fictitious Assets:** Assets which have no market value are called fictitious assets. Examples of fictitious assets include preliminary expenses, loss on issue of shares etc. They are also known as nominal assets. Besides these, there is another type of assets whose value gradually reduce on account of use and finally exhaust completely. This type of assets is called wasting assets e.g. mine, forest etc.

### Classification of Liabilities:



**Internal Liabilities:** The total amount of debts payable by a business to its owner is called internal liability e.g. Owner's equity (capital), reserve etc. From practical view point internal liabilities should not be regarded as liabilities, since there is no question of meeting such liabilities along as the business continues.

**External Liabilities:** All debts payable by a business to the outsiders (other than the owner) are called external liabilities e.g. creditors, debentures, bills payable, bank overdraft, etc. External liabilities are further divided into two.

**Fixed or Long-term Liabilities:** The liabilities which are payable after a long period of time are called fixed or long term liabilities e.g. debentures, loan on mortgage etc.

**Current or Short Term Liabilities:** The debts which are repayable within a short period of time are called current or short-term liabilities e.g. creditors, bills payable, bank overdraft etc. Current liabilities may again be divided into two:

- Deferred Liabilities: Debts which are repayable in the course of less than one year but more than one month are called deferred liabilities e.g. Short term loan etc.
- Liquid or Quick Liabilities: Debts are repayable in the course of a month are called liquid or quick liabilities e.g. bank overdraft, outstanding expenses, creditors etc.

Besides the above, there is another type of liability which is known as contingent liability. It is one which is not a liability at present, but which may or may not become a liability in future. It depends upon certain future event. For example, suppose, the buyer of goods filed a suit in the court against the seller claiming damage of \$10,000 for breach of contract. This will be regarded as a contingent liability to the seller until the receipt of the court's order. To the buyer, this is a contingent asset. Both contingent liability and contingent asset are not recorded in the balance sheet. They are generally mentioned in the balance sheet as a note.

### Depreciation

Depreciation expense is the cost allocated to a fixed asset during a period. Many people think this is a way to "expense" assets over time, but that's not really true. It is recorded as an expense on the income statement, but it isn't an expense of the asset. Instead, it is allocating the cost of the asset over its useful life.

### Features of Depreciation

1. Depreciation is decline in the book value of fixed assets.
2. Depreciation includes loss of value of assets due to passage of time, usage or obsolescence.
3. Depreciation is a continuing process till the end of the useful life of assets.
4. Depreciation is an expired cost and hence must be deducted before calculating taxable profits.
5. Depreciation is a non-cash expense. It does not involve any cash flow.
6. Depreciation is the process of writing-off the capital expenditure already incurred.

The major causes of depreciation are as follows:

- a) **Wear And Tear:** wear and tear refer to a decline in the efficiency of asset due to its constant use. When an asset loses its efficiency, its value goes down and depreciation arises. This is true in case of tangible assets like plant and machinery, building, furniture, tools and equipment used in the factory.
- b) **Effusion of Time:** The value of asset may decrease due to the passage of time even if it is not in use. There are some intangible fixed assets like copyright, patent right, and lease hold premises which decrease its value as time elapse.
- c) **Exhaustion:** An asset may lose its value because of exhaustion too. This is the case with wasting assets such as mines, quarries, oil-wells and forest-land. On account of continuous extraction, a stage will come where mines and oil-wells get completely exhausted.

- d) **Obsolescence:** Changes in fashion are external factors which are responsible for throwing out of assets even if those are in good condition. For example black and white televisions have become obsolete with the introduction of colour TVs, the users have discarded black and white TVs although they are in good condition. Such as loss on account of new invention or changed fashions is termed as obsolescence.
- e) **Other Causes:** Market value and accident of an asset are other causes of depreciation which decrease in the value of assets.

#### *Factors Affecting the Amount of Depreciation*

- 1) **Cost Of Assets:** The cost of asset include the purchase price, less any trade discount plus all the costs essential to bring the asset to a usable condition. In other word, the total cost of asset includes from purchase price to the installation.
- 2) **Estimated Scrap Value:** Scrap value refers to the value estimated to be realized after the expiry of the useful working life of the asset. This is also known as residual value or salvage value. Depreciation should be determined after deducting the estimated scrap value from the cost of asset.
- 3) **Estimated Useful Life:** An asset cannot work forever. Every asset has a certain working and useful life. The longer the working life, the amount of depreciation will be lower and vice versa. Therefore, the useful life of an asset is generally to be taken in terms of asset's expected use. This estimated useful life of asset determines the rate or the amount of depreciation.
- 4) **Legal Provisions:** The amount of depreciation also depends upon the statutory and legal provisions prescribing the admissible rate of depreciation on fixed assets.

#### **Advantages of Providing Depreciation (Objectives)**

- **Ascertainment of True Profits:** When an asset is purchased, it is nothing more than a payment in advance for the use of asset. Depreciation is the cost of using a fixed asset. To determine true and correct amount of profit or loss, depreciation must be treated as revenue expenses and debited to profit and loss account.
- **Reporting Of True And Fair Financial Position Of A Business:** The value of assets decrease over a period of time on account of various factors. In order to present a true state of affairs of the business, the assets should be shown in the balance sheet, at their true and fair values. If the depreciation is not provided then the asset will appear in the balance sheet at the original value. So, in order to show the true financial position of a business, depreciation is required to be charged on the assets.
- **Replacement Of Assets:** Assets used in the business need to be replaced after the expiry of their useful life. Depreciation can be taken as a source of fund for replacing worn out asset by a new asset. Thus, depreciation charges help in accumulating funds for the replacement of an asset.
- **Saving In Taxes:** The profit and loss account will show more profits if depreciation is not charged on asset. So, the business needs to pay more income tax to the government. Depreciation charges on assets save the amount of tax equivalent to tax rate. Since it is shown as expense in the profit and loss account, it reduces the amount of the profit.

#### *Methods of Providing Depreciation (Depreciation Methods)*

- 1) Fixed Instalment Method Of Providing Depreciation.
- 2) Diminishing Balance Method of Providing Depreciation.
- 3) Annuity Method of Providing Depreciation.
- 4) Depreciation Fund Method.
- 5) Insurance Policy Method.
- 6) Revaluation Method.
- 7) Machine Hour Rate Method of Providing Depreciation.
- 8) Sum Of The Year's Digits Method Of Providing Depreciation

#### **Fixed Instalment method or Fixed percentage on Original Cost method or Straight line Method**

According to this method, an equal amount is written off every year during the working life of an asset so as to reduce the cost of the asset to nil or its residual value at the end of its useful life. The advantage of this method is that it is simple to apply and gives accurate results especially in case of leases, patents and copy rights, and also in case of plant and machinery. Calculation of depreciation for additions to plant and machinery may be a complicated affair unless different classes of machines are classified separately in a plant register based on year of additions. This method is also known as Fixed Instalment Method.

$$\text{Straight Line Depreciation} = \frac{\text{Cost Price of Asst} - \text{Scrap Value}}{\text{Estimated Life of Asset}}$$

$$\text{Straight Line Depreciation Rate} = \frac{\text{Straight Line Depreciation}}{\text{Cost of Asset}} \times 100$$

#### **Advantages of straight line method**

- a) **Simplicity.** This is the simplest method of providing depreciation. This can be easily understood even by ordinary person. Calculation of depreciation according to this method is also very simple.
- b) **Assets can be completely written off.** According to this method, assets can be written off to zero. The depreciation is calculated on the original cost of the asset at the specified rate, so the value of asset is fully split over the useful life of asset.
- c) **Knowledge of total depreciation charged.** The amount of total depreciation charged can be easily known by multiplying the yearly amount of depreciation with number of years, the asset has been used.
- d) **Suitable for small firms.** Straight line method is the most suitable method for small firms. These firms use this method, because it is easy, simple and suitable to the size of the firms.

- e) Suitable for firms having large number of old and new machines. The weaknesses of this method are removed, if the firm has both old and new machines. More maintenance charges on old machines and lesser on the new machines balance each other.
- f) Useful for assets having lesser value. This method is the most suitable for charging depreciation on assets of lesser value such as furniture, fixture and patents etc.

#### Disadvantages or limitations of straight line method

- a) Undue pressure on final years. The final years of the life of the asset have to bear more repairs and maintenance charges and also the same amount of depreciation. Whereas initial years have to suffer lesser repair charges.
- b) No provision for replacement. The amount charged as depreciation is retained in the business and used in the routine affairs. The firm has to bother for making arrangement of funds for the replacement of assets although depreciation has been charged every year.
- c) Loss of interest. The amount of depreciation charged every year is not invested outside the firm, so no interest is received. In certain methods of depreciation the amount of depreciation is invested outside the business in securities and interest is received.
- d) Illogical method. It seems illogical to charge depreciation on the original cost of the asset every year when the balance of the asset is declining year after year.
- e) Unsuitable for assets having long life and more value. This method is not suitable for those assets which are subject to additions and extension from time to time, such as land and building and plant and machinery. It is not suitable for assets having more value also.

#### **Diminishing Balance Method or Reducing Instalment Method or Written Down Value Method.**

Under reducing balance method, the depreciation is charged at a fixed rate like straight line method (also known as fixed instalment method). But the rate percent is not calculated on cost of asset as is done under fixed instalment method - it is calculated on the book value of asset. The book value of an asset is obtained by deducting depreciation from its cost. The book value of asset gradually reduces on account of charging depreciation. Since the depreciation rate per cent is applied on reducing balance of asset, this method is called reducing balance method or diminishing balance method.

Depreciation Per year =  $(1/N)$  Previous year's value, Where N= No. of years

Depreciation = Book value x Depreciation rate

Book value = Cost - Accumulated depreciation

#### Advantages:

- Amount charged to the profit & loss account towards depreciation and repairs will remain more or less uniform year after year.
- Any addition of fixed asset, there is no need to have fresh calculation unless the purchase is made in the middle of the year.
- Simple to use.

#### Disadvantages:

- Interest lost due to the capital investment in the asset is not taken into account.
- Book value of the asset cannot be brought down to zero.
- Though this method charges uniformly to the profit & loss account year on year, in many cases, this may not happen either due to low rate of depreciation or due to excessively repair charges in later stages.

#### *Difference between Straight line Method and Reduce Balance Method*

<b>Straight Line Method</b>	<b>Reducing Balance Method</b>
The rate and amount of depreciation remain the same each year.	The rate remains the same, but the amount of depreciation diminishes gradually.
Depreciation rate per cent is calculated on cost of assets each year	Depreciation rate per cent is calculated on book value of asset.
At the end of its life the value of asset is reduced to zero or scrap value.	The value of asset is never reduced to zero at the end of its life.
The older the asset the larger the cost of its repair. But the amount of depreciation remain the same each year. Hence, the total of depreciation and repairs increases every year. This reduces annual profit gradually.	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 or no change in annual profit/loss.
Computation of depreciation under straight line method is comparatively easy and simple.	Depreciation can be computed without any difficulty, but it is not easy and simple.

## Annuity method

Under annuity method of depreciation the cost of asset is regarded as investment and interest at fixed rate is calculated thereon. Had the proprietor invested outside the business, an amount equal to the cost of asset, he would have earned some interest. So as a result of buying the asset the proprietor loses not only cost of asset by using it, but also the above mentioned interest. Hence depreciation is calculated in such a way as will cover both the above mentioned losses. The amount of annual depreciation is determined from annuity table.

Annuity method is particularly applicable to those assets whose cost is heavy and life is long and fixed, e.g. leasehold property, land and building etc.

n	<u>1%</u>	<u>2%</u>	<u>3%</u>	<u>4%</u>	<u>5%</u>	<u>6%</u>	<u>8%</u>	<u>10%</u>	<u>12%</u>
1	0.9901	0.9804	0.9709	0.9615	0.9524	0.9434	0.9259	0.9091	0.8929
2	1.9704	1.9416	1.9135	1.8861	1.8594	1.8334	1.7833	1.7355	1.6906
3	2.9410	2.8839	2.8286	2.7751	2.7233	2.6730	2.5771	2.4869	2.4018
4	3.9020	3.8077	3.7171	3.6299	3.5460	3.4651	3.3121	3.1699	3.0374
5	4.8534	4.7135	4.5797	4.4518	4.3295	4.2124	3.9927	3.7908	3.6048
6	5.7955	5.6014	5.4172	5.2421	5.0757	4.9173	4.6229	4.3553	4.1114
7	6.7282	6.4720	6.2303	6.0021	5.7864	5.5824	5.2064	4.8684	4.5638
8	7.6517	7.3255	7.0197	6.7327	6.4632	6.2098	5.7466	5.3349	4.9676
9	8.5660	8.1622	7.7861	7.4353	7.1078	6.8017	6.2469	5.7590	5.3283
10	9.4713	8.9826	8.5302	8.1109	7.7217	7.3601	6.7101	6.1446	5.6502

### Advantages of Annuity Method

- Annuity method takes interest on capital invested in the asset into account.
- Annuity method is regarded as most exact and precise from the point of view of calculations. So it is a scientific method.

### Disadvantages of Annuity Method of Depreciation

- The annuity method is difficult to understand.
- The burden on profit and loss account goes on increasing with the passage of time whereas the amount of depreciation charged each year remains constant. The amount of interest credited goes on diminishing as years pass by, the ultimate consequence being that the net burden on profit and loss account grows heavier each year.
- When the asset requires frequent addition and extensions, the calculation have to be changed frequently, which is very inconvenient.

### Relevant Journal entries are:

a) For charging interest on asset account	Asset Account Dr	xxxx	
	To Interest Account		xxxx
b) For charging depreciation on asset	Depreciation Account Dr	xxxx	
	To Asset Account		xxxx
c) For transferring depreciation to Profit and Loss Account	Profit and Loss Account Dr	xxxx	
	To Depreciation Account		xxxx

d) For transferring interest to Profit and Loss Account	Interest Account	Dr	xxxx	
	To Profit and Loss Account			xxxx

### Capital and Revenue Accounts

The main objective of accounting is to ascertain the true profit or loss and to reveal the financial position of a business at the end of financial year.

To achieve the objectives, the business must take a clear distinction between its capital and revenue items. The distinction between capital and revenue items is essential for their correct treatment in the final accounts. Any incorrect treatment of those two items in the final accounts adversely affects the operating results and financial position of the business.

Capital is the wealth invested by an investor for producing additional wealth. The original figure of wealth is known as capital. Making of additional wealth with the investment of original capital is known as revenue. Thus, capital is the source of the basis of revenue. In other words, capital is invested in the business to earn revenue.

*Capital items concerned* with the payment for assets and receipt from the owners and outsiders. It is the item of the balance sheet. It is of long-term nature and its benefit is long-lasting. In fact, capital items are assets, liabilities and capital that determine the financial strength of the business.

*Revenue item is concerned* with the payment for producing or buying goods and receipt from sale of goods and services. Those revenue incomes and expenditures are the items of trading account and profit and loss account. It is of short-term nature. Its benefit expires within the year. In fact, revenue items are incomes and expenses, which determine the operating result (profit or loss) of the business.

The following capital and revenue concepts are relevant for accounting purpose

- Capital and revenue expenditures.
- Capital and revenue receipts.
- Capital and revenue losses.
- Capital and revenue profits.
- Capital and revenue reserves.

**Capital Expenditures:** The expenditures which generates revenue or income is called capital expenditure. Capital expenditure incurred either for buying permanent assets or for improving their exiting working capacity. Capital expenditure helps in increasing production volume or decreasing cost of production. Such expenditures are shown on the asset side of balance sheet.

Items relating to capital expenditure

- Expenditure incurred in buying transporting and installing a permanent asset.
- Expenditure incurred in overhauling and installing an old asset to put it in production process.
- Cost of registration and legal charges incurred in buying or constructing a permanent assets.
- Expenditure incurred in improving or extending the working capacity of an existing asset.
- Expenditure incurred in getting benefits over a number of years.
- Expenditure incurred in raising capital like brokerage and commission for underwriting shares and debentures.

**Revenue Expenditures:** Any expenditure incurred in connection with the operation and administration of daily activities of the business is called revenue expenditure. Revenue expenditure is incurred for maintaining earning capacity and working efficiency of the fixed assets. Revenue expenditure is incurred for acquiring merchandise for resale either in its original or improved form. Its benefit expires within a year. Revenue expenditure is shown on debit side of the trading and profit and loss accounts.

Items relating to revenue expenditure

- Expenditure incurred in acquiring raw materials for manufacturing process or finished goods for resale.
- Wages and all other items of manufacturing expenses
- All items of office, administration, selling and distribution expenses
- Repair, maintenance, and depreciation of all the fixed assets.
- Interest on loan and other financial expenses.

Comparison between Capital Expenditure vs Revenue expenditure

Basis	Capital Expenditure	Revenue Expenditure
Meaning	The expenditure incurred in acquiring a capital asset or improving the capacity of an existing one, resulting in the extension in its life years.	Expenses incurred in regulating day to day activities of the business.
Term	Long term	Short term



Capitalization	Yes	No
Outlay	Non recurring	Recurring
Benefit	More than one year	Only in current accounting year
Earning capacity	Seeks to improve earning capacity	Maintain earning capacity
Matching concept	Not matched with capital receipts	Matched with revenue receipts

### Concept and Meaning of Capital Receipts and Revenue Receipts and Their Related Items

**Capital Receipts:** An amount received in the form of capital from the owner and as loan from outsiders is known as capital receipts. Besides, cash received by selling shares, debentures and permanent assets is also capital receipt. It is of non-recurring type of receipt. It is treated as obligation of the business and shown on liabilities side of the balance sheet.

Items relating to capital receipts

- Amount received from the owner as capital.
- Amount received through the sale of shares and debentures.
- Amount of loan received
- Amount received from the sale of old assets.
- Other receipts of non-recurring nature.

**Revenue Receipts:** Revenue receipt is an amount which is received from the regular transaction of a business. It is the amount received from the sale of goods and services. It is the main source of income. It is a regular type of income. It is shown on the credit side of the trading account and profit and loss account.

Items relating to revenue receipts

- Amount received from the sale of goods and services.
- Amount received by way of discount, commission, rent, interest and dividend.
- Amount received from the sale of waste paper and packing cases.

Comparison between Capital receipts vs Revenue receipts

Basis	Capital receipts	Revenue receipts
Meaning	Capital receipts are the income generated from investment and financing activities of the business.	Revenue receipts are the income generated from the operating activities of the business.
Nature	Non-recurring.	Recurring.
Term	Long term	Short term.
Shown in	Balance sheet.	Income statement.
Received in exchange of	Source of income	Income
Value of asset or liabilities	Decrease the value of asset or increases the value of liability.	Increase or decreases the value of asset or liabilities.

### Accounts of Non-trading organizations (Concept of Non-Trading Concern and Its Accounting System)

The organizations, which are established for the purpose of rendering social services to its members and to the society is known as non-trading concern. Such organizations include clubs, schools, colleges, Hospitals, libraries, trusts, professional associations and unions. These organizations render their service to the members and to the general public, such as a club provides sports and other recreational services to the members. Schools and colleges provide education services, hospital provides treatment and services to the patients.

The sole object of non-trading concern is to provide necessary services to its members and the society at large through welfare activities. The aim of such organization is not to make profit. They should prepare systematic books of account to provide necessary information about receipts and payments. It also helps to know, whether the current income is sufficient to meet the current expenditures or needs. The balance sheet is prepared to know the financial position, besides providing information about the proper utilization of grants, donations, and so on.

Proper accounting is essential for non-trading concern to provide the required information. Such institutions prepare receipts and payment account to show the receipts and payments of cash. Income and expenditure account is pre-

pared to know the surplus or deficit for the period. Balance sheet is prepared to know the financial status of the concern. The detailed and transparent financial information of non-trading concern can be obtained by preparing receipts and payment account, income and expenditure account as well as balance sheet.

The Final Accounts of non-trading concerns consists of:

- a. Receipts and Payments Account
- b. Income and Expenditure Account, and
- c. Balance Sheet.

**Receipts and Payments Account:** It is a Real Account. It is a consolidated summary of Cash Book. It is prepared at the end of the accounting period. All cash receipts are recorded on the debit side and all cash payments are recorded on the credit side.

Cash Book consisting of entries of receipts and payments in a chronological order while the Receipts and payments is a summary of total cash receipts and cash payments. It starts with opening balance of Cash and Bank and ends with closing balance of Cash and Bank. It does not take into account outstanding amounts of receipts and payments. Receipts and Payments may be of Capital or Revenue nature; they may relate to the current or previous year or subsequent year; so long as they are actually received or paid, they must appear in this account.

**Features of Receipts and Payment Account, In Brief:**

- 1) It starts with opening balance and ends with closing balance.
- 2) It is the summary of cash and bank transactions.
- 3) Actual cash transactions are entered.
- 4) It includes capital as well as revenue items.
- 5) It follows cash system of accounting.
- 6) It shows cash position and excludes all non-cash items.
- 7) It is a real account.
- 8) It does not take any income/expense outstanding at the beginning or at the end.

**Income and Expenditure Account:** It is a Nominal Account. It is in the form of Profit and Loss Account. It is concerned with only revenue items—expenses and incomes. It records all losses and expenses on its debit side and all incomes and gains on its credit side. Of the incomes and expenses of revenue nature, only the portion pertaining to the current year is shown in the Income and Expenditure Account i.e. amount relating to the previous year or future year are excluded. Again, the incomes and expenses of current year, whether received or not, must be shown. In other words, incomes and expenses have to be adjusted for both out-standing and pre-payments. All non-cash items, Depreciation, Bad Debts, Provision for Doubtful Debts etc. are taken into account.

The difference between the debit side and the credit side is either surplus or deficit for the year concerned and the difference will be transferred to the Capital Fund (also called General Fund or Accumulated Fund) appearing in Balance Sheet.

**Features of Income and Expenditure Account, In Brief:**

1. It is prepared in lieu of Profit and Loss Account.
2. It is a nominal account.
3. It is based on mercantile system of accounting.
4. There is no opening balance.
5. It ends with Surplus or Deficit.
6. It excludes all capital income and capital expenses.
7. It includes only revenue items.
8. It records all expenses whether paid or not, and all incomes whether received or not.

Difference between receipt and payment accounts Vs Income and Expenditure accounts

Receipt and payment account	Income and expenditure account
<ul style="list-style-type: none"> <li>It is a real account.</li> <li>It is cash account of non-trading organizations.</li> <li>All receipts are shown in debit side of this account.</li> <li>All payment are shown in credit side of this account.</li> <li>Opening balance of cash is shown in beginning of this account.</li> <li>Balance at the end represents as closing balance of cash.</li> <li>All revenue and capital receipts are recorded in this account.</li> <li>It shows all receipts and payment whether they relate to other financial year.</li> <li>Depreciation, bad debts etc. are not recorded in this account.</li> <li>As it is a cash account, it will always show debit balance.</li> </ul>	<ul style="list-style-type: none"> <li>It is a nominal account</li> <li>It is like profit and loss account</li> <li>All expenses and losses are shown in debit side of this account.</li> <li>All incomes are shown in credit side of this account</li> <li>No such balance is shown in beginning of this account</li> <li>Balance at the end represents excess of income over the expenditure or vice versa.</li> <li>It records only revenue receipts.</li> <li>It show income and expenditures of current year only.</li> <li>Depreciation, bad debts are recorded in this account since these are the losses to the organization.</li> <li>This account may show debit or credit balance according to loss or profit.</li> </ul>

**Balance Sheet:** Balance Sheet in case of non-trading concern is prepared in the usual manner and consists of all liabilities and assets on the date on which it is prepared. The excess of assets over liabilities is termed Capital Fund or General Fund. Again, The Capital Fund are accumulated with Capital Receipts, Receipts that are capitalized

and further increased by surplus or decreased by deficit, during the year. At the inception of a non-trading concern, there will be no formal Capital Fund and in such case, the Surplus, if any, earned during the year constitute the Capital Fund at the end of the year.

**Treatment of Special Items:** Subscriptions from members are collected periodically. These are regular revenue incomes and credited to Income and Expenditure Account. These are the major source of income for the non-trading concern. However, special subscriptions, if collected are kept separately from the General Fund for the specific purpose.

*There are certain items which are peculiar to non-trading concerns and they need special treatment and are:*

- 1) **Donations:** Charitable institution may receive donations from time to time. If the amount is small and if such collections are frequent, then they may be treated as an income. Donations may also be of two types—General Donations and Specific Donations. Any donations received, not for a specific purpose, are treated as General Donations. The General Donations of comparatively small amount may be taken to Income and Expenditure Account. General Donations of comparatively huge amount, which are of non-recurring nature, may be added to the Capital Fund. The nature and size of the organisation decide about the amount of donation being small or big. In case of donations received for any specific purpose then it is termed Specific Donations. Such amount cannot be used for any other purpose, except the purpose of donor. Therefore, such amount may be shown in Balance Sheet (liability side). All the Donations debited to Receipts and Payments Account and these amounts may be credited to Income and Expenditure Account or Liability side of the Balance Sheet, if it is for a specific purpose.
- 2) **Legacy:** It is like donation. It is the amount given to a non-trading concern as per the will of deceased person. It is taken to the Receipts and Payments Account as Capital Receipts. These are not income but may appear in Balance Sheet. These types of receipts are of non-recurring nature.
- 3) **Life Members Fee:** Non-trading concerns usually collect subscriptions every month from their ordinary members. There are another category of members called "Life Members", from whom the subscriptions are collected as a lump sum. Such subscriptions are called life subscription and are capital receipts. This can also be kept in a separate account and an amount equal to annual subscription can be transferred to subscription account. The balance in such account, on the death of the member must be transferred to Capital Fund.
- 4) **Entrance Fee (Admission Fee):** These are the fees collected from every member at the time of his admission into membership. It is paid only once by the new entrants on becoming a member of a society or a club. Generally, there may be bye-laws as regards the accounting treatment of such amount. In the absence of any bye-laws, it is taken as an item for income. Against treating it as an income, there are arguments favouring it as a capital receipt as the members pay such fees only once and therefore treat it as a capital receipt. In the absence of any instruction, it may be treated as an income and is credited to Income and Expenditure Account.
- 5) **Sale of Old Sports Materials and Old Newspapers:** The amount received on account of sale of old sports materials and old newspapers are recurring incomes to a concern and therefore, treated them as revenue incomes. The purchases of balls, nets, etc. are revenue expenditure.
- 6) **Purchase of Equipment:** The price paid for acquiring any equipment is a Capital Expenditure.
- 7) **Honorarium Paid:** It is a payment of remuneration to a person who is not an employee of the organisation. Such as any special performance is done, by an outsider, at the organisation, then the payment is honorarium and is taken to Income and Expenditure Account as it is a revenue expenditure.
- 8) **Subscription:** It is a primary source of income of a non-profit organisation. It is usually collected every month from all the ordinary members. Subscription is the amount paid by the members to keep their membership alive. The subscription amounts are treated as revenue receipts. Subscription received from members is credited to Income and Expenditure Account on accrual basis i.e. total amount receivable from all the members as subscription should be considered as income for the year.
- 9) **Special Fund:** If there is any specific fund, such as Prize Distribution Fund, the expenses or incomes relating to the fund may be adjusted to the fund itself (on the liability side of the Balance Sheet). Such expenses or incomes may not be taken to Income and Expenditure Account.
- 10) **Sale of Old Assets:** If any asset is sold, the amount is debited to Receipts and Payments Accounts. It is not taken to Income and Expenditure Account. The profit or loss made on sale of old asset is recorded in Income and Expenditure Account.

*Some Important Adjustments:*

(A) **Subscription:** Subscription received from members is treated as revenue income. In income and Expenditure Account, subscription for current year will be shown. If total subscription received as per Receipts and Payments Account during the year is given, adjustments will be made for outstanding subscription in the beginning and at the end of the year; and advance subscription in the beginning and at the end of the year.

(B) **Expenses:** Total expenses paid during the year are shown in Receipts and Payments Account. These expenses may include outstanding of previous year and advance for next year. Similarly, some account may still be outstanding. Therefore, to calculate correct figure of expenses to be shown in Income and Expenditure Account, adjustments will have to be made.

(C) **Consumable Items:** If institution consumes certain items such as medicines by hospital or sports items by clubs, relevant figures for Receipts and Payments Account and Income and Expenditure Account will be calculated. The value of goods consumed is shown in Income and Expenditure Account and the amount paid to creditors is shown in Receipts and Payments Account.