Block-I

Foundations of Accounting and Finance

Fundamentals of Financial Accounting

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Block

I

FUNDAMENTALS OF FINANCIAL ACCOUNTING

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COURSE INTRODUCTION

Managers at all levels are required to take day-to-day decisions on various aspects of business. Their information needs to include both financial information and non-financial information. A vital source of financial information are the Financial Statements. Financial Statements form the basis to understand the financial health of companies, to assess their past and estimate future performance. In addition to the financial statements which are external documents, managers need information provided by the Cost Accounting Systems. The information derived from these statements is important for rational, systematic and effective decision making. This course provides the inputs essential for Accounting and Finance in the organizational context. It helps to understand the accounting concepts, preparation of financial statements, financial statement analysis, and fundamentals of finance and the use of cost information for decision making.

The course is organized into four blocks of 14 units:

- ***Block – I: Fundamentals of Financial Accounting*** gives an introduction to financial statements and discusses in detail the double entry system of accounting, Generally Accepted Accounting Principles that govern the preparation of financial statements, qualitative characteristics required of Financial Statements and the users of financial statements. The block also covers the cconceptual framework in accounting that deals with the accounting cycle, the rules of debit and credit, and the various books that facilitate the accounting process.
- ***Block – II: Financial Statements and Analysis*** deals with the essential components of Financial Statements i.e., the Income Statement, the Balance Sheet and the Cash Flow Statement. It lays special emphasis on the preparation and presentation of Financial Statements of Companies as governed by Companies Act, 2013. The important tools and techniques used for Financial Statement Analysis such as Cross-Sectional Analysis, Time Series Analysis, Ratio Analysis and Cash Flow Analysis are also discussed.
- ***Block – III: Management Accounting*** equips managers with the fundamentals of Cost Accounting and the tools and techniques to make better and optimum decisions and improve their company’s competitiveness.
- ***Block – IV: Financial Management*** covers the fundamentals of Financial Management such as time value of money, objectives of financial management, financial management process, financial system etc. It gives a sound and thorough knowledge on the application of finance concepts such as time value of money, sources of long term and short term funds and the basic components of international trade and finance.

BLOCK I: FUNDAMENTALS OF FINANCIAL ACCOUNTING

This is an introductory block for Financial Accounting. It briefly reviews the basic aspects of accounting. It covers the principles of accounting, accounting process of recording business transactions, classification of transactions, the books required for journalizing and their posting to ledger accounts. This block consists of three units.

Unit 1 Introduction to Financial Statements outlines the nature, definition and scope of accounting, the basic principles, concepts and conventions that govern the recording of transactions and events and explains the double entry system of accounting.

Unit 2 Conceptual Framework of Financial Accounting deals with identifying the events and transactions, journalizing the transactions, and posting them into ledgers. It also deals with preparing of subsidiary books and recording for cash and bank transactions in different types of cash books.

Unit 3 Elements of Financial Statements deals with the concept of Capital and Revenue, the components of Financial Statements, that is, Manufacturing and Trading Account, Profit & Loss Account, the Balance Sheet and the Cash Flow Statement.

The financial statements are introduced and the contents of the statements explained with illustrations from the latest financial statements of a software services company Infosys Limited and a manufacturing entity, Tata Steel Limited. To enhance the learning, exhibits that showcase the applications of a concept and that capture the latest trends in the applications of the concept are also presented. The learner can self-check his/her level of understanding with the check your progress exercises and activities given within the block.

Unit 1

Introduction to Financial Statements

Structure

1.1 Introduction

You may have often come across your parents or people around you scanning through financial data related to companies. The purpose behind such an activity is to make investment decisions regarding their savings. The economic reforms have opened the doors for numerous avenues for investments and thus we find a shift from the traditional form of savings to newer forms. However, careful analysis should back any investment decision. Investors today explore the financial information contained in financial statements to take prudent decisions.

Financial statements thus form the basis for understanding the financial position of businesses and for assessing historical and prospective financial performance. A basic understanding of the accounting process, of Generally Accepted Accounting Principles (GAAP) and the traditional accounting assumptions is required to understand better the financial statements and to recognize their limitations.

Accounting is required to account for resources involved in business or non-business activities which require money. In other words, wherever money is involved, it must be accounted for. Accounting in simple words means ‘reckoning’ or ‘recounting’ the past events. It requires systematic record keeping on a daily basis and analyses of this information. Accounting has universal applicability, yet its growth is closely related and associated with the growth in the business world. In this unit, we shall learn the fundamental concepts and conventions on which accounting as a discipline is based upon, the importance, form, content and uses of financial statements. Additionally, we also familiarize ourselves with the qualitative characteristics that make financial statements more meaningful and useful.

1.2 Objectives

After reading through the unit, the student should be able to:

- Define the term Accounting and state the objectives of Accounting
- Explain and evaluate the importance of Double Entry System of Accounting
- State the Generally Accepted Accounting Principles (GAAP) and demonstrate their applicability
- List the contents of Financial Statements and sketch their format
- Discuss the importance of Financial Statements
- State the various qualitative characteristics that make Financial Statements more useful

1.3 Definition of Accounting

In general, Accounting can be rightly called as the ‘Language of the Business’. Learning accounting is like learning a new language. Some words and terms we use in our everyday life are used in accounting too but convey a different sense. Accounting is the means through which all the business information or events are communicated to the users of financial information. It explains the business events in a systematic and meaningful way. It enables the decision makers to make the right decisions.

In 1941, The American Institute of Certified Public Accountants (AICPA) defined financial accounting as “the art of recording, classifying and summarizing in a significant manner and in terms of money, transactions and events, which are in part at least, of a financial character and interpreting the results thereof.”

With the development of economic and technological environment, the scope of accounting became broader. So, in 1966, the American Accounting Association (AAA) gave a broader definition to accounting. It defined accounting as, “the process of identifying, measuring and communicating economic information to permit informed judgments and decisions by users of the information”.

The above definitions bring out the following attributes of accounting:

i. It is an art of recording and classifying business transactions. All accounting transactions are analyzed in such a way that it becomes possible to prepare financial statements.

ii. Events and transactions of a financial nature are recorded while events of non-financial nature are not.

iii. It is an art of summarizing, analyzing and interpreting the business transactions. The summarized information is analyzed and interpreted by calculating ratios and percentages to evaluate the past and present performance. This analysis helps to prepare good financial plans.

iv. The basic aim of accounting is to present information in a form which is beneficial to the users. Summaries of the transactions and events are reported through Financial Statements. All the information should be provided in time to the users so that they can understand and analyze it.

Based on the various definitions given, Financial Accounting can be said to involve creation of information and the consequent use of such information.

Creation consists of three steps – recording, classifying and summarization, which are described below:

Recording: Accounting commences on the occurrence of a business transaction, which can be quantified. A systematic record of these transactions is kept in the order in which they occur (chronological order) in the Journal Book. What is to be recorded? When is it to be recorded? How is it to be recorded? At what value should it be recorded? These questions need to be answered.

What to record? All the events and transactions which affect the results of a business are to be recorded. However, as money is a common unit of measurement, only those events which can be expressed in monetary terms are recorded. On the contrary, events and transactions howsoever important, but which cannot be translated into monetary terms will not be recorded. For instance, In September, 2021, Gaurav Gupta, the co-founder of Zomato announced that he is quitting the company. This decision was a non-financial event, so it was not recorded in financial records whereas there could be widespread financial implications of the event. Distinction must be maintained between the owner's transactions and that of the business transactions. Transactions which affect the business shall be recorded whereas the personal transactions of the owner are ignored.

When to record? Accounting is historical in nature; hence recording is effected only after the occurrence of the subject transaction. For example, sale of goods cannot be recorded in the books of accounts when the goods are merely intended to be sold but it should be recorded only after such sale is complete and the property in the goods has been transferred to the buyer.

How to record? The double entry system is the practical base of accountancy. All the transactions are recorded systematically based on this system. This technique will be explained in depth in the subsequent part of this unit.

At what value to record? All the ingredients of the financial statements are to be assigned appropriate values. Money is the scale of measurement in accounting and we can measure only those transactions which can be translated into monetary terms. Value refers to the benefit derived from objects and different valuation bases such as historical cost, current cost, realizable value and present value are used in accounting. The most commonly used base in financial accounting is historical cost, which refers to the amount paid/payable to acquire the asset or a benefit.

Classifying: Refers to the rational segregation of the recorded information into related groups to make the record useful. For example, all the receipts forming inflows and all the payments forming outflows are grouped to ascertain the net cash position of the firm. The arrangement in this case is better known as the cashbook.

Summarizing: After recording and classification phases are completed, they are summarized for reporting. These summaries are reported through the financial statements.

The accounting information thus created may be used for multiple uses by various users. This aspect is dealt with greater detail under users of financial information sub-topic later in the unit.

1.4 Objectives of Accounting

Accounting is a versatile discipline. It reacts with the changes in the field of mathematics and science and technology. The whole concept of accounting has changed with the revolution in information technology. Accounting has changed to serve many goals of present business and industrial environment simultaneously. The accounting information needed by decision makers is different from the accounting information needed by the shareholders, investors and creditors. Different principles are required to meet the different objectives of accounting. As per the American Accounting Association (AAA), the basic objective of accounting is to provide information for the following purposes:

a. Making crucial decisions with the limited resources.

b. Directing and controlling the organization’s physical and manual resources.

c. Maintaining systematic records and reporting on the protection of resources.

d. Helping for special functions and control.

From the above, we can summarize the primary objectives of accounting as follows:

Maintenance of Records for Business Transactions/Events: The golden rule for every accountant is that "first record, then pay". Even an intelligent executive cannot remember all things accurately. Moreover, he need not remember all things if proper records are maintained. Different executives use accounting records for different purposes. Thus, the basic objective of accounting is proper maintenance of records to help the executives to make business decisions.

Ascertaining whether the Business Operations have been Profitable or Not: Every businessman wants to know whether the business is earning profits or not. Profit is the difference between incomes and expenses. Accounting helps to know the profit or loss made by a firm in an accounting period. All incomes and expenses that are earned and incurred in a particular accounting period are collected and are presented in a statement, which is called as profit and loss account or income statement. The difference between the incomes and expenses is the profit or loss made by the business in that accounting period.

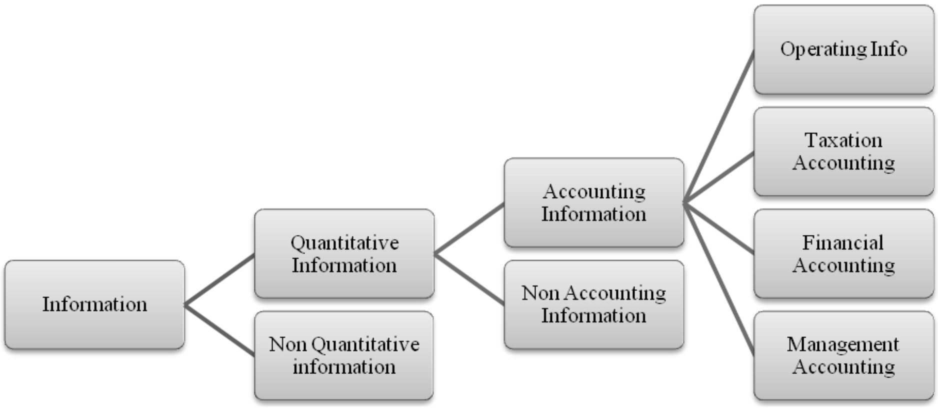
Depicting the Financial Position of the Business: Every businessman wants to know the value of the total assets in his business, the solvency of the business and the total amount of liabilities in his business. Accounting can give information of the above aspects in the form of a statement, which is called as position statement or balance sheet. All the assets and liabilities of the business are placed in this statement. Excess of assets over liabilities denotes the capital of the business and it is also an indicator of the financial soundness of the business.

Providing Information to the Users of Financial Information: As per the American Accounting Association (AAA) accounting includes the process of communicating the accounting information to the users of the information to make judgments and decisions. Mere generation of information is not useful to anyone. It is useful only when it is communicated to different persons and groups. So, now-a-days communication of accounting information is also the function of accounting. Generally, accounting information is communicated in the form of reports, statements, graphs and charts to the internal and external users.

1.5 Accounting Information

We are all living in an age of information explosion. Daily, we take a number of decisions, small and big in our personal life. Before taking such decisions, we collect the relevant data pertaining to the decision, the various alternatives and their consequences before zeroing in on the final decision. Take for instance a decision to purchase a car. We collect all the relevant information about types of cars, manufacturers, mileage and other relevant data. Then we decide which car is suitable and best for us. It consumes resources in terms of money, time and mental work. Now, think of the person/persons, who are managing crores of rupees through businesses. If the information provided to them is not accurate and timely, the decision taken by them based on that information may be wrong and results in wastage of resources. In an organization different people need different information, collected from different sources for making different decisions. For example, investors and creditors use information to assess the future risk and return of their potential investments. Thus, depending on the information needs, information may be quantitative or non-quantitative.

Figure 1.1: Quantitative and Non-Quantitative Information



Source : ICFAI Research Center

From the above Figure 1.1, we understood that information consists of quantitative or non- quantitative information. In quantitative information, also there is some non-accounting information. Accounting information can be divided into operating information, financial accounting information, management accounting information and tax accounting information.

Operating information gives the information about the day-to-day operations of the business. When this information is specifically prepared to help management, it is called Management Accounting Information.

Financial accounting gives information relating to the financial performance and financial position. Financial Accounting Information is concerned with providing relevant financial information to various external users.

Operating information and management accounting information is generated only for people internal to the organization, but financial accounting information is useful both for internal users and external users. For example, investors, suppliers, customers, financial institutions and government take their decisions relating to company based on the financial information.

Tax accounting information helps in filing tax returns. In some countries, like USA, they must keep tax accounting records separately for tax purpose because their tax accounting rules are different from financial accounting rules.

Exhibit 1.1 below illustrates the classification of information into quantitative and non-quantitative information, with the help of a news item about ICICI Prudential Life Insurance Company Ltd:

Exhibit 1.1: Classification of Information by ICICI Prudential Life Insurance Company Limited

ICICI Prudential Life Insurance Company Limited, completed 20 years in December 2020. In FY2021, the company topped the industry with a 13th month persistency ratio of 87.1% up from 72.7% in FY2010. ICICI Pru also had one of the lowest grievance ratios of 46 in FY 2021 as against 361 per 10,000 new retail policies sold in FY2011.

The Indian life insurance industry is ranked as the 10th largest in the world. It is also the 5th largest in Asia. The life insurance industry in India has a total premium basis of Rs. 5.7 trillion in Financial Year 2020. The Retail Weighted Received Premiums under new business (RWRP) improved by 3.0% from Rs. 734.88 billion in financial year 2020 to Rs.756.58 billion in financial year 2021.

ICICI Prudential's new business received premium grew by 5.5% from Rs. 123.48 billion in FY2020 to Rs. 130.32 billion in FY2021. The Company continued its focus on the protection business, resulting in a new business sum assured growth of 8.0% to Rs. 6.17 trillion in FY2021.

The company reached its customers through 517 company branches spread throughout India. It has 1,87,500 agents operating in the country.

Now, let us analyze this news item.

The first statement above which contains information about ICICI Prudential Life Insurance Company's completion of 20 years, its grievance ratios and persistency ratios are quantitative information, but non-accounting information.

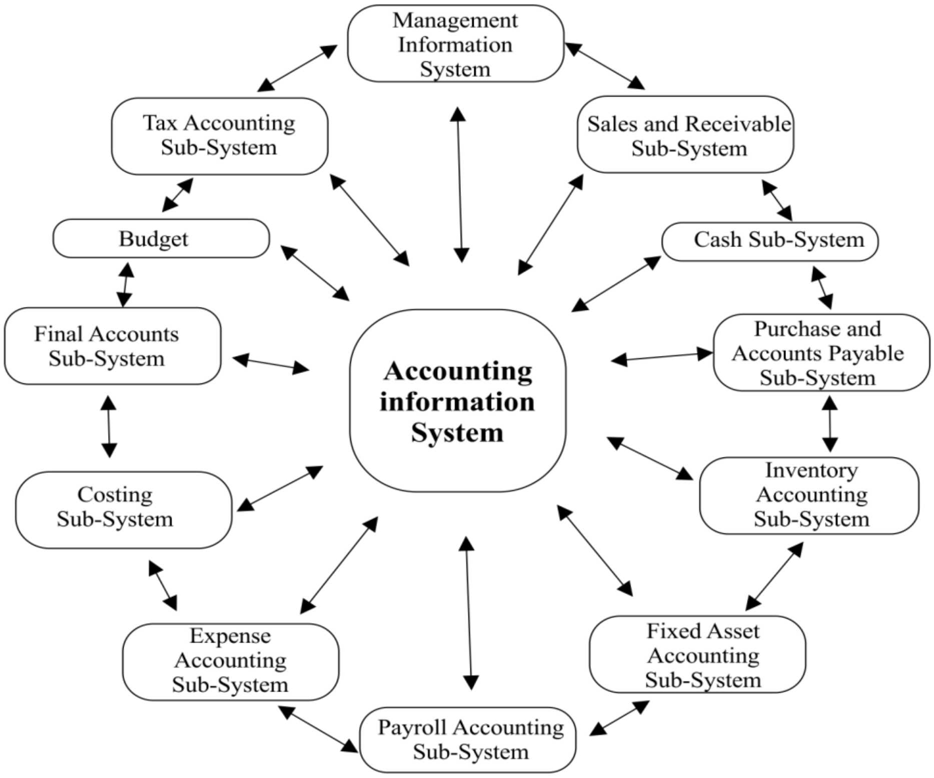
The details of the life insurance sector has accounting information such as total premium and RWRP amounts. The details of ICICI Pru's new business premium and growth of new business assurance is also accounting information.

The company reached its customers through 517 company branches and 1,87,500 agents in quantitative information but non-accounting in nature.

Source: https://www.iciciprulife.com/content/dam/icicipru/about-us/FinancialInformation/ Annual Reports/FY2021-AnnualReport.pdf

Over the years, accounting has undergone a sea change; so, has the role of the accountant. Earlier, accounting was a process of recording business transactions. Today, accounting is considered as a tool of the management. The emphasis is on using the accounting information in the process of decision-making. Hence, it is now an information system and not merely a recording system. Today, accounting can be defined as an information system that provides information about the economic activities and conditions of the business. The components of an Accounting Information System is presented in Figure 1.2

Figure 1.2: Accounting Information System



Source: Adapted from Jain, S.P., and Narang, K.L. Financial Accounting, 2020

In big organizations, accounting system is divided into several subsystems for generating accounting information. Various ERP packages like SAP, PeopleSoft, Oracle are proving helpful for generating accounting information comprehensively and by a subsystem separately.

1.6 Sources of Accounting Information

Financial information provides the information about the financial state of the company. Accounting information is however, available only to the internal people of the organization. External users also require financial information. The following sources of financial information are available to the external users:

- Financial Statements
- Auditor's Reports
- Director's Reports
- Supplementary Schedules
- Other Sources

1.6.1 Financial Statements

Financial statements consist of Balance Sheet, Profit and Loss Account, Cash flow statement and other notes to the financial statements. Balance sheet gives information about major classes and amounts of assets, liabilities and stockholders' equity. Profit and Loss account provides information about the net operating result of the business. Cash flow statement provides information about cash flows resulting from investment activities, financing activities and operating activities. Notes to the financial statements provide data like off-balance sheet items (These shall be dealt with in detail at the relevant places in the coming paragraphs).

1.6.2 Auditor's Reports

An independent audit of the financial statements is important as it attests the conformity of the financial statements to Generally Accepted Accounting Principles (GAAP). The auditor's report contains the estimates, and other disclosures.

1.6.3 Directors' Report

The directors' report discusses in detail the financial performance of the company and its subsidiaries, research and development activities, technology absorption and innovation, foreign exchange earnings etc.

Exhibit 1.2 shows the information about the foreign exchange earned and used by Infosys Limited for the year ending 31st March, 2021 contained in their directors' report:

Exhibit 1.2: Extract of Director's Report of Infosys Technologies Limited 2020-21

(₹ Crore)

Earnings	2021	84,252
	2020	77,974
Expenditure	2021	46,433
	2020	44,254
Net Foreign Exchange Earnings (NFE)	2021	37,819
	2020	33,720
NFE/Earnings (%)	2021	44.90
	2020	43.20

Source: https://www.infosys.com/investors/reports-filings/annual-report/annual/documents/infosys-ar-21.pdf

1.6.4 Supplementary Schedules

Most of the companies include some supplementary schedules which are frequently used in the financial statement analysis. For example, Infosys operates in several lines of business and provides a breakdown of key financial figures by the operating segment. This segment disclosure is valuable to the financial analyst in identifying areas of strength and weakness within the company, proportionate contribution of revenue and expenses, etc. Exhibit 1.3 presents the cash and cash equivalents schedule of Infosys Limited as on March 31, 2021 and March 31, 2020.

Exhibit 1.3: Schedule of Cash and Cash Equivalents

(₹ crore)

Particulars	**As at March 31,**	
	2021	**2020**
Balances with Banks		
In Current and Deposit Accounts	13,792	8,048
Cash on Hand	-	-
Others		
Deposits with Financial Institutions	3,820	5,514
Total Cash and Cash Equivalents	17,612	13,562

Source: https://www.infosys.com/investors/reports-filings/annual-report/annual/documents/infosys-ar-21.pdf

1.6.5 Other Sources

In addition to the above, some other sources too provide data about the company. Sometimes, articles published in magazines and newspapers perform this function. Reports by research companies, government companies and reports submitted to stock exchanges and associations also provide information. Some Internet websites like www.finance.yahoo.com, www.reuters.com, provide the past and present data of various companies. Most of academic libraries and public libraries may provide information through computerized search systems and computerized databases for financial analysis.

1.7 Double Entry System of Financial Accounting

The Double entry system – the base of financial accounting is not a modern system. The history and sequence of events resulting in the evolution of double entry system date back to 3000 BC. The Babylonians, Assyrians, Chaldeans and Sumerians showed signs of book-keeping. Between 1122 and 256 BC, accounting played a key role in China. The Chinese used systematic records for government transactions. Many other parts of the world had their own way of keeping records before the 14th century. The Lombards (rulers of Italy) introduced the method of double entry called as Italian Book-Keeping. In 1494, *Luca Pacioli,* an Italian Merchant wrote a book, *Summa de Arithmetica Geometria Proportioni et Proportionalita*. It had a chapter, *De Computis et Scripturis* which explained the double entry system of book-keeping. According to him, the purpose of book-keeping was to give the information to the businessman about his assets and liabilities. He described two aspects, Debit and Credit used for double entry book-keeping. Since then, many changes have taken place in the system of book-keeping but the basic idea i.e., two aspects of a transaction remains unchanged and continues to be the base for accounting.

According to the double entry system of accounting, every business transaction has two aspects, i.e., when we receive something, we also give something in return. For example, when we sell goods, we receive cash. Thus, for every debit there is always an equal and corresponding credit and vice versa. According to double entry system, the total of all debits must always be equal to the total of all credits.

Book-keeping is both an art and science of recording business transactions in a systematic manner by using double entry system of accounting. The information is recorded in such a way that it is quickly available to the users at any time. The book-keeper is responsible for maintaining all accounting records. His job is clerical in nature and routine. These days however, most of book-keeping is mechanized and electronic.

Accounting starts where book-keeping ends. Accounting mainly deals with the designing of the system of keeping records, preparation of various reports and interpretation of these reports. The accountant must review the work of the book-keeper. He must possess a high level of accounting knowledge, conceptual understanding and analytical skill than a book-keeper. To some extent, the job of accountants can be mechanized like generating various reports but analysis and interpretation cannot be mechanized, because these two functions are non-routine and require personal skills.

Check Your Progress – 1

1. As per the double entry concept_________________.
   a. Assets + Liabilities = Capital
   b. Capital = Assets – Liabilities
   c. Capital – Liabilities = Assets
   d. Capital + Assets = Liabilities
   e. Capital = Assets.
2. Which of the following is not a basic objective of Accounting?
   a. Maintenance of records for business transactions
   b. Depicting the financial position of the business
   c. Providing financial information to the users
   d. Ascertaining the profitability of business operations
   e. Procuring funds for business operations.
3. Accounting starts where book keeping ends. Which of the following aspects is **correct** to the double entry system of book keeping?
   a. All debits may not always equal all credits
   b. Lays emphasize on single aspect of accounting

c. Depicts unfair view of financial soundness of business
d. Every debit has an equal and corresponding credit
e. All assets unequal total liabilities and capital

4. Accounting is termed as the "Language of the Business". Identify the attribute that is **not true** to the description of Financial Accounting.
   a. Rational segregation of recording information
   b. Systematic way of recording transactions
   c. Creation of information only for shareholders
   d. Presenting information in a summarized manner
   e. Records maintained in chronological order.

5. Which process lays more emphasis on usage of accounting information system that provides information on economic activities and conditions of the business?
   a. Recording business transactions
   b. Decision making
   c. Segregation of information in chronological order
   d. Creation of sub-systems
   e. Accounts summarization.

1.8 Generally Accepted Accounting Principles

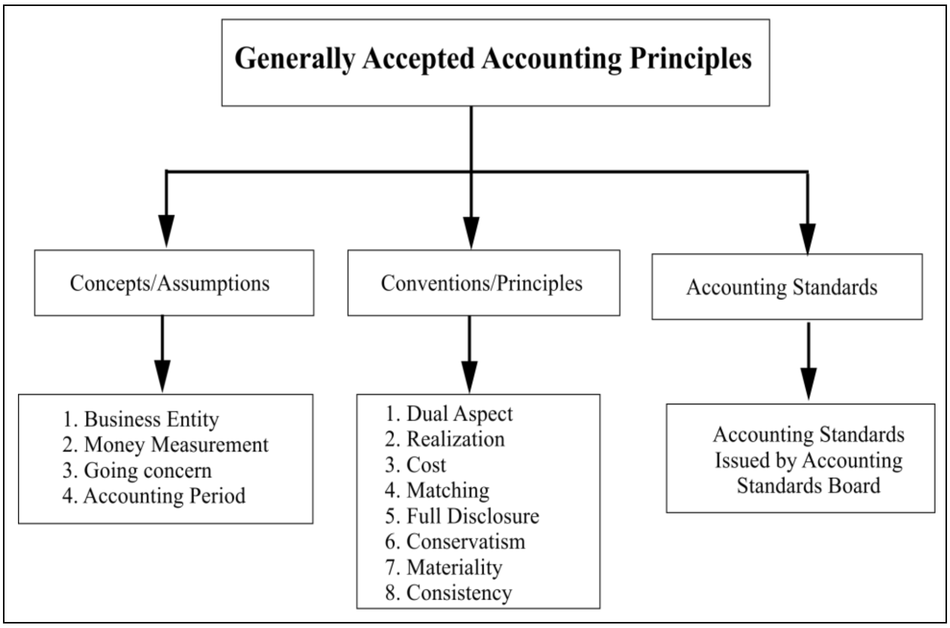
The primary objective of financial accounting is to communicate and provide information to the investors and creditors on the economic activities of the enterprise that will help them in their investment decisions. The financial statements of different entities must be prepared on a uniform basis, and an enterprise must maintain consistency in the preparation of these statements. Therefore, the language of accounting needs to adhere to a framework of principles, known as Generally Accepted Accounting Principles (GAAP). Accounting principles may be defined as rules of action and conduct that are adopted by accountants while recording the accounting transactions. Unlike the principles of Physics, Chemistry and other Natural sciences (that can be verified by observation), accounting principles have been evolved and established by humans. These principles enable to certain extent standardization in recording and reporting of information.

Statement No. 4 of the Accounting Principles Board (USA) on 'Basic concepts and Accounting principles Underlying Financial Statements of Business Enterprises' describes accounting principles as follows:

"Generally Accepted Accounting Principles incorporate the consensus at a time as to which economic resources and obligations should be recorded as assets and liabilities by financial accounting, which changes in assets and liabilities should be recorded, when these changes are to be recorded, how the assets and liabilities and changes in them should be measured, what information should be disclosed and which financial statements should be prepared."

Accounting principles are the rules, bases, conventions and procedures adopted by management in preparing accounting records and presenting financial statements. These principles, assumptions or rules have been developed over several years. These principles can be categorized into three viz., (i) Accounting Concepts/Assumptions, (ii) Accounting Conventions and (iii) Accounting Standards (refer to Figure 1.3). Accounting concepts are based on logical considerations and help in recording the business transactions. Accounting conventions are based on what is practicable and include those customs and traditions, which guide the accountant in the preparation of financial statements. Accounting Standards are the guidelines issued by Accounting Standards Board (ASB) of a country for financial reporting. Generally, these standards are issued to bring uniformity in financial reporting in a country. For multinational operating countries, there are International Accounting Standards for financial reporting.

Figure 1.3: GAAP Concepts



Source: ICFAI Research Center

Generally Accepted Accounting Principles are the building blocks of the accounting edifice. The following are the Generally Accepted Accounting Principles followed in several countries including India.

Business Entity Concept

In accounting, business is considered to have a separate existence from that of its proprietors or owners. It implies that a distinction between the economic activities of the enterprise and that of the owners is to be maintained. All the transactions and the events are analyzed and recorded in the books from the point of view of the business enterprise. This concept ensures that accounting records only reflect the economic activities of business and not that of its owners. This concept is applied to all forms of business enterprises such as sole proprietorship concerns, partnership concerns and joint stock companies. However, in India a separate entity is recognized under Law only in the case of corporate entities. This concept has its genesis in the fact that a business entity is considered as a separate entity with its own identity, separate from its members.

This concept helps the business to maintain its affairs strictly free from the private affairs of its proprietors. Thus, when owners invest capital into the business say ₹ 1,00,000, the business considers the money it received from the owners as money lent by the owners. Therefore, as money is due to the owners it is shown as a ‘liability’ in the books of the business. When the proprietor withdraws some amount (say ₹ 10,000) from the business it is treated as money lent by the business to the owner. Therefore, it is charged to him and deduction in the form of drawings is made and only the net amount due i.e., ₹ 90,000 (₹ 1,00,000 less ₹ 10,000) by the business is shown as ‘liability’.

Owing to the fuzzy relation between the legal entity of a sole proprietary concern and its sole proprietor, the proprietor usually may not pay himself a salary, even when he works for his business. However, since the business is an accounting entity, his position as the owner must not come in the way of drawing a salary (even though not actually paid) from the business for the services rendered by him. This is because as far as the business is concerned, it is immaterial whether the service is rendered by the owner or an outsider. Both being workers, the services rendered cannot be therefore regarded as cost free. The reward of ownership is manifested only in the form of profit, which must be arrived at after charging ‘all costs’.

Money Measurement Concept

Numerous transactions constitute business. The identification, recording, classification and summarization of these transactions require a common unit of measurement. Money serves as the common denominator in measuring these transactions. In financial accounting, a record is made only of information that can be expressed in monetary terms. If events cannot be quantified in monetary terms, then they do not facilitate accounting. The activities and their attributes will be based on the yardstick – whether they are amenable to be translated in currency terms. Money is the standard of exchange and the changes in purchasing power caused by inflation are ignored for accounting because of the assumption about stability of money, for ensuring a smooth accounting process. Hence, all the transactions are recorded through a common denominator, namely the monetary unit. Thus, if a certain event, no matter how significant for the health or even the existence of the business, cannot be measured in monetary terms, such event is not recorded in the books of accounts. For example, the death or retirement of the Chairman of a company, even if it has far reaching consequences for the business is not accounted for, since no monetary measurement of the event is feasible. Also, to assess the financial health of the business, the assets and liabilities of the business need to be expressed in monetary terms. If the different assets and liabilities of the business are expressed in different units of measurement, it becomes difficult to compile and discern the financial health of the business.

The money measurement concept gives rise to the following limitations:

i. Non-monetary events and transactions however important, which cannot be expressed in terms of money are to be excluded from accounting. Hence, the users of the financial statements need to keep in mind this aspect and cannot expect to get a complete picture of the business from accounting records.

ii. Money as a unit of measurement has its own limitations. It serves as a common denominator only if there are no significant changes in its purchasing power. In reality, fluctuations in the prices result in fluctuations in the purchasing power of money. Thus, the financial statements fail to represent the fair and true picture of the affairs of the business.

Going Concern Concept

In the absence of information to the contrary, a business entity is assumed to carry on its operations indefinitely. This concept assumes that the enterprise neither has the intention nor the necessity to liquidate or curtail materially the scale of operations of its business venture soon. Seemingly inconsequential, this concept is critical to many broad and specific accounting principles.

Going concern concept implies that the resources of the concern would continue to be used for the purposes they are meant to be used. For instance, a manufacturing concern like Tata Steel, requires land, buildings, machinery, etc., primarily for carrying out the production and selling of iron and steel products. Going concern concept implies that these land, buildings, machinery, etc., would continue to be used for this purpose. In fact, it is because these assets are expected to be with the concern for a long period for production and selling of end products hence these assets are termed as ‘Fixed assets’.

This concept does not imply that the business shall run permanently. Generally, when a business is set-up, it begins with a hope of long life, to achieve the goal. This justifies the basis of measuring many assets of the business on historical cost basis. Where it is anticipated that the business is going to cease operations in future, the assets and liabilities of the enterprise will not be measured at historical cost but at their liquidation values.

Accounting Period Concept

Since the going concern concept assumes that the entity continues its operations indefinitely, the income of the business can be accurately measured by comparing the assets of the company at the time of commencement of business with the assets at the time of liquidation. But the information made available after liquidation will render the information useless for decision-making and too late to take a corrective action. In order to confront this limitation and to provide useful and timely information to the users of the financial statements, the business period is split up into a convenient shorter period called the accounting period.

The accounting period for the preparation of financial statements generally comprises a period of twelve months. Very often the accounting period chosen is a calendar year (January 1 to December 31) or a fiscal year (April 1 to March 31). It is also common to synchronize one’s accounting period with one’s operating period. In some businesses, such as trading, the operating period may be relatively short, say a month or even less; while in other cases it may stretch well beyond a year. Depending on one’s nature of business, one may adopt a Hindu year, or the period beginning with Diwali or any other period as one’s accounting period. Under the Companies Act, 2013, a company is required to prepare it financial statements on March 31 every year. Now-a-days because of the needs of the management, or to comply with listing requirements final accounts are prepared for shorter intervals on a half-yearly or quarterly basis. These accounts are known as interim accounts. More often such accounts are used for internal management and decision purposes.

Dual Aspect Concept

The foundation of accounting is transactions and events. Modern financial accounting recognizes and records two aspects for every transaction or event. This is known as dual aspect or duality of a transaction. The system of maintenance of books based on duality is known as double entry system.

For example, when capital is invested in the business by the proprietor, in recognition of the concept of separate entity, the business treats the same as a liability. The result of such transaction is the increase in liability of the entity on one hand, and the increase in the cash of the business on other hand. Thus, the introduction of capital has a two-fold effect. Similarly, when loan is raised from outside sources, the two aspects of the event are the increase in the outside liability and the increase in the cash (assets) of the business.

In accounting terminology, the resources of the business are termed as ‘assets’, the obligations of the business to outsiders is termed as ‘liabilities’ and the obligation of the business towards the owners is termed as ‘capital’ or ‘Equity’. The result of the duality concept, at any point of time, is that the sum of the assets of the business equals the sum of the liabilities and capital of the business.

Thus, the duality or accounting equivalence concept implies that:

Owners' Equity + Outside Liability = Assets

This equation is also known as the 'Fundamental Accounting equation'. We shall see that the entire mechanics of Financial Accounting revolves around this equation.

Realization Concept (Revenue Recognition)

Revenue is the gross inflow of cash, receivables or other consideration arising from the sale of goods, from rendering services and from holding assets. When to recognize this revenue (the stage or time) becomes critical for the determination of the income of an entity. For example, sale of goods involves many stages such as acceptance of order, the stage of commencement of the work for the specified order, delivery of goods after completion of the work, invoicing, actual receipt of the money. At which time, would one say that revenue is recognized? The realization concept removes the ambiguity on this front. Revenue is to be recognized when the sale actually takes place i.e., the title to the goods is transferred and accepted by the buyer and there exists a reasonable certainty of receiving a return consideration in the future. Revenue for service transactions is generally recognized on performance of service.

However, there are certain exceptions:

Revenue recognition at work-in-progress stage: In the case of long-term construction contracts, for instance, the contractor may elect to follow the percentage of completion method or the completed contract method. Under the percentage of completion method, revenue is recognized as the contract activity progresses based on the stage of completion reached. In case of completed contract method, revenue is recognized only when the contract is completed or substantially completed.

Revenue recognition on production: Similarly, when a firm manufactures a product which has an assured market, there is a reasonable certainty that the product would take off as soon as it is produced. Thus, the revenue may be recognized on production.

Revenue recognition on cash basis: Where there is doubt or risk of collection of the amount, revenue recognition is postponed to the stage of its actual realization. For example, the revenue is recognized by doctors, lawyers, and other professionals in their books of accounts when the amount is actually collected.

Cost Concept (Historical Cost)

Cost concept implies that all the assets are to be recorded in the books of accounts at the price paid to acquire it and this cost forms the basis for subsequent accounting for the asset. For example, if a piece of land is acquired for ₹ 1 lakh, it would continue to be shown in the Balance Sheet at ₹ 1 lakh even when the market value of the land rises to ₹2 lakh. Why should this be so? This is because cost concept is closely related to going concern concept. If the land is acquired for the operation of the business and its continuous usage is expected in future, there is no reason why the cost at which it was originally recorded cannot be the basis of future accounting since it is not going to be sold anyway. Hence, the value of the assets as reported in the accounts corresponds to the market value of the asset only at the time of acquisition and at no other time.

Cost concept is used because of the intricacies involved in the accurate determination of the market value. The market value is volatile and prone to frequent changes and fluctuations because of the continual operation of market forces in an ever-changing economy. Further, the market value can either be the net realizable value (price at which it can be sold) or the current replacement value (price at which it can be bought) whose choice again is not without subjective bias. Secondly, cost concept also provides important cash flow information as it represents cash or cash equivalent paid for an asset. Thirdly, cost concept has the added advantage of being objective and is verifiable. As Anthony and Reece rightly said, "adherence to cost concept indicates a willingness on the part of accounting profession to sacrifice some degree of relevance in exchange for greater objectivity and feasibility."

However, on certain occasions the departure from the cost concept is warranted. For example, non-monetary current assets are normally valued at lower of cost or market price. Similarly, the accounts receivable is recorded at their original transaction cost. Later, when bad debts are anticipated, they are valued at net realizable value after providing for bad debts anticipated. A departure from cost concept provides for more objective information to aid the users of financial statements in decision-making.

Matching Concept

This concept emphasizes that the whole of the revenue earned by an enterprise is not income. To earn the revenue, resources are consumed and the cost of the resources consumed should be set off to obtain income. This concept states that the expenses are to be recognized in the period of their related revenue. This requires that the expenses must relate to the goods and services sold during that period to arrive at the net profits of the enterprise. Hence, matching concept requires the recognition of revenue and expenses on a comparable basis.

To determine the profits and losses accrued during an accounting period, the expenses must relate to the goods or services sold during the period. For example, as the fixed assets are used to generate income, the cost of these assets (in the form of depreciation) is allocated over the effective life of the asset. Likewise, the credit sales of a period may result in bad debts in subsequent period. The matching concept implies the matching of such bad debts against the credit sale revenue of that period. Generally, the advertisement expenditure incurred by an enterprise is heavy and the benefit of the expenditure lasts for more than a year. In such a case, it is inappropriate to charge whole of the expenditure in one period. A part of the expenditure is carried forward and written off over subsequent periods, against the revenue of the subsequent periods.

The cash system of accounting does not adhere to this principle of matching and hence the Companies Act, 2013 does not recognize cash system of accounting. The Companies Act, 2013 requires the pursuance of accrual system of accounting for adhering to the matching concept. Under the accrual systems revenues and expenses are recognized in the period in which they are earned or incurred; instead of the period in which they are received or paid for.

Concept of Full Disclosure

The purpose of financial accounting is to provide information to the users for decision-making. The full disclosure concept implies that all material information that could affect the decision of the user must be disclosed. Businesses today are managed by managers and not the owners of the company. Hence, the Companies Act makes adequate provisions for disclosure of essential and adequate information in the company accounts. The format of balance sheet and the profit and loss account prescribed under the Companies Act itself justifies the concept of full disclosure. Entries such as contingent liabilities and market value of investments appearing in as notes, further reiterate the principle of full disclosure. It ensures complete, fair, and adequate disclosure of business transactions in financial reports. Because of wide recognition of this principle, Accounting Standards have been evolved, which deal with the disclosure requirements on significant accounting policies. AS-1 of the Institute of Chartered Accountants of India deals with the disclosure of Accounting Policies.

Conservatism Concept

Today, the business world faces uncertainty and risks which are inherent. The solution to such a business situation is a prudent reaction. Conservatism concept can be viewed as a practical justification for certain accounting treatments. This requires the business enterprise to record an event in such a way as to 'play safe' at the time of uncertainty. The practice of reporting the closing inventory at lower of the cost or market value appears to justify this principle of conservatism.

The concept often works on the principle – 'Recognize all possible losses, anticipate no gains'. This concept requires the accountants to underplay favorable prospects until they are realized. The idea behind this principle is that recognition of revenue requires better evidence than recognition of expenses. Thus, revenues are to be recognized only when they are reasonably certain, and expenses as soon as they are reasonably possible. For example, a sales manager might have finalized a deal with his client for say, 100 units of the product. But unless these units are produced and delivered to the client there is no reasonable certainty about receiving payment. It is only when the payment is received that he can record the sales amount for these 100 units that the deal would be complete. On the other hand, if he comes to know that a customer has lost all his assets and is likely to default payment, then he should immediately provide for such loss.

It is more often argued that conservatism may lead to understating of revenue and income and overstating of liabilities and expenses. It must be remembered that this principle cannot justify deliberate overstatement or understatement, undermining the usefulness of financial statements. It must be applied prudently so as not to result in secret profits and reserves which contravenes the convention of full disclosure discussed above.

Materiality Concept

The concept of materiality places a constraint on what should be recorded and reported. It emphasizes that Generally Accepted Accounting Principles need not be applied to immaterial facts. Kohler defines materiality as, 'The characteristic attaching to a statement, fact, or item whereby its disclosure or the method of giving it expression would be likely to influence the judgment of a reasonable person.' This concept assumes significant importance in reporting financial statements. In the area of reporting, information is said to be material if it affects or is likely to affect the decision made by a user of the financial statements. For example, an error of ₹ 1,000 in finished goods inventory whose total is valued at a few crores of rupees is meagre to warrant special attention (the error is immaterial), while the same needs attention in case the total stock amounts to a few thousands. Thus, the concept of materiality is relative in the sense that what is material or immaterial depends on the circumstances, nature of the item, the nature of the business and various other factors.

A few established and accepted general rules in support of this concept are:

i. Prior year adjustments should be preferably reported distinctly and below the line. A common instance is the payment of income tax dues wherein the sum ultimately remitted to the revenue after assessment significantly varies from the provision made earlier. Such differences ought to be debited /credited and reported below the line as a part of appropriation.

ii. The magnitude of net profit and the size of the group to which the item belongs to needs to be considered in ascertaining the materiality of the said item. Similarly, for the constituents of the balance sheet, the total assets and liabilities as well as the group/sub-group concerned ought to be examined.

iii. As per the materiality concept, any significant changes in the accounting policies and their impact on the profit or loss of the enterprise for the relevant accounting year should be reported. Financial transparency requires that a significant change as described above should be given effect to only when it is required by law or for compliance with well-established standards and if such a change leads to a better presentation of financial statements.

Consistency Concept

The concept of consistency requires a business enterprise to follow consistent accounting procedures and practices from time to time. Steady application of practices and procedures enables a comparative study of the performance of the business over a period and an objective comparison of various enterprises within the industry. The comparison of a business performance over a period is called trend analysis and the comparison of different enterprises belonging to the same industry is called cross sectional analysis. Consistency in application of the procedures and methods eliminates personal bias and subjective judgment.

There are alternative accounting methods for a given item or event. The consistency concept requires that once an entity has decided on one method, it will treat all the subsequent events of the same character in the same fashion unless it has a sound reason to change the method of treatment of that event. For example, if a concern is valuing its inventory by a particular method in one year, it is expected to value its inventory in the subsequent years also in the same method unless there are strong reasons to change the same. Similarly, if an enterprise charges depreciation by the Written Down method, it is expected to follow the same method in the subsequent years also. However, where the change in the method of accounting is required by law or for better presentation of financial statements, a change of procedure may be justified. However, adequate disclosure of the fact of change, reason and affect of the change shall be made in the financial statements so that the users can perceive its impact.

Accounting as a ‘language of the business’, aims to communicate financial information about a business enterprise to the management and the external users. Therefore, it is necessary and imperative that the financial statements and the data, which form the basis for the preparation of financial statements, must be in honest conformity with the Generally Accepted Accounting Principles (GAAP).

1.9 Financial Statements

As discussed earlier, accounting is the art of summarizing, analyzing and interpreting the business transactions. All the accounting transactions are summarized in such a way that they facilitate the preparation of “Financial Statements”. Financial statements are the statements, which present the information relating to a company’s current financial position, operating results and other information that are used by the stakeholders to assess the company’s performance.

Generally, financial statements are prepared in a certain format by following certain rules. It facilitates the users to compare different companies and their financial performance. These financial statements are prepared by following the legal system of the country i.e., by following GAAP of that country. If the company is a multinational company, it should prepare its financial statements separately by following GAAP of different nations. It is difficult for the companies to follow different GAAP for the same set of accounting records. The International Accounting Standards Board (IASB) is trying to standardize accounting rules. It has developed International Financial Reporting Standards (IFRS) for uniform reporting. Australia and the European Union have already adopted these standards. USA made a commitment to converge the US GAAP to IFRS over time.

In India, according to Section 129 of the Companies Act, 2013, at every annual general meeting, the board of directors is required to submit an annual report to the shareholders. As per Section 134 of the said Act, they should be issued, published, and circulated to the relevant parties.

1.9.1 Objectives of Financial Statements

The preparation of Financial Statements is mandatory as well as necessary. As per International Accounting Standards Committee (IASC), the objective of financial statements is, "to provide information about the financial position, performance and changes in financial position of an enterprise that is useful to a wide range of users in making economic decisions".

As per the Institute of Chartered Accountants of India (ICAI), financial statements have the following objectives:

- To provide information about the financial position, performance and cash flows of an enterprise that is useful to a wide range of users in making economic decisions.
- To meet the common needs of most users. However, financial statements do not provide all the information that users may need to make economic decisions since (a) they largely portray the financial effects of past events and (b) they do not necessarily provide non-financial information.
- Financial statements also show the results of the stewardship of management, or the accountability of management for the resources entrusted to it. Those users who wish to assess the stewardship or accountability of the management may do so to make economic decisions; these decisions may include, for example, whether to hold or sell their investment in the enterprise or whether to reappoint or replace the management.

1.9.2 Components of Financial Statements

All commercial companies produce financial statements annually. In many countries, these must be filed with the government and sent to shareholders. So, the statements filed with the government are available to the public i.e., to competitors, customers, suppliers and financial analysts and consultancies. Generally, large companies publish their statements on their websites and in newspapers. These companies understand this will create more confidence in those with whom the company wishes to do business.

The financial statements consist of the following reports:

Profit and Loss Account

It is also called as 'Income Statement' or 'Statement of Profit and Loss'. It indicates the amount of net income or loss obtained by the company during a period. Net income is the excess of revenues over its expenses, and the net loss is the excess of expenses over its revenues. It gives the summarized operating information about the sales, costs, incomes, profits, and losses of the company during a particular period. It is the best measure to assess the profitability and performance of the company.

Balance Sheet

It is also called as 'Statement of Financial Position'. It depicts the financial position of a company on a date. It gives the information of how the company has been financed and how that money has been invested in various productive resources. A company can obtain finance from owners and outsiders. Thus, the balance sheet has three major sections viz., assets (i.e., the resources of the company), liabilities (i.e., the debts of the company) and shareholder's equity (i.e. the amount invested by owners). At any time, the total number of assets must be equal to the amount invested by owners and creditors. The balance sheet is based upon the fundamental accounting equation of

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

Cash Flow Statement

It is also called as 'Statement of Cash flows'. It reports the amount of cash collected and paid out of a company on operating, investing and financing activities. The type of activities that come in each of these categories will be explained in chapter "Cash Flow Statement". Preparation of this statement is obligatory in most of the countries. In India, preparation of cash flow statement is mandatory for all companies whose debts and securities are listed in recognized stock exchanges and for all other commercial, industrial and business reporting enterprises, whose turnover for the accounting period exceeds ₹ 50 crores.

Foot Notes (Notes to Accounts)

The notes to the financial statements provide detailed information on some of the figures in the balance sheet or profit and loss account. They may also contain a statement on different accounting policies followed by the company, information about the contingent liabilities (i.e., liability may or may not arise in the future), commitments to honor future contracts. They are the best means to convey the non-accounting information.

Activity 1.1

a. Ramesh, a businessman, purchases 100 Dairies for ₹ 100 each for the year 20xx, and sells 50 of them at ₹ 200 each during the same year. What is the amount of Profit that can be attributed to his activity for 20xx? State and examine the underlying concept that governs your answer.

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b. Mr. Ganesh owns a business godown whose current market value is ₹ 20 crores (including land value). He purchased the land for ₹ 50,000 in 2020 and subsequently built the godown for business purposes in 2021 for ₹ 10,00,000. What is the figure at which he should disclose the Godown (an asset) in his balance sheet? Justify.

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1.10 Form and Contents of Financial Statements

Generally, financial statements are prepared in a certain format. But the format is not the same for all the types of business. Generally, public companies other than banking, insurance and electricity companies, must prepare their financial statements based on the provisions in Schedule III of the Companies Act, 2013. Following is the brief explanation about the form and contents of financial statements. You will learn these statements in detail in later units.

1.10.1 Profit and Loss Account

Profit and Loss Account or the Statement of Profit and Loss summarizes the operating activities of an enterprise during a certain period. It enables the users to understand the changes in the equity or the owners' capital that occurred during the period because of the operating activities of the business.

A generally accepted format of Income Statement or statement of profit and loss is given in Exhibit 1.4:

Exhibit 1.4: Infosys Ltd.'s Statement of Profit and Loss for the Year ended 31st March, 2021

In ₹ Crore except equity share and per equity share data

Particulars	Note no.	Year ended March 31,	
		2021	**2020**
Revenue from Operations	2.17	85,912	79,047
Other Income, Net	2.18	2,467	2,700
Total Income		88,379	81,747
Expenses			
Employee Benefit Expenses	2.19	45,179	42,434
Cost of Technical Sub-contractors		9,528	8,447
Travel Expenses		484	2,241
Cost of Software Packages and Others	2.19	2,058	1,656
Communication Expenses		464	381
Consultancy and Professional Charges		999	1,066
Depreciation and Amortization Expense	2.1&2.2.2&2.3	2,321	2,144
Finance Cost	2.3	126	114
Other Expenses	2.19	2,743	2,787
Total Expenses		63,902	61,270
Profit before Tax		24,477	20,477
Tax Expense			
Current Tax	2.16	6,013	5,235
Deferred Tax	2.16	416	(301)
Profit for the Year		18,048	15,543
Other Comprehensive Income			
Items that will not be reclassified subsequently to Profit or Loss			
Re-measurement of the Net Defined Benefit Liability/Asset, Net	2.16&2.20	148	(184)
Equity Instruments through Other Comprehensive Income, Net	2.4&2.16	120	(31)
Items that will be reclassified subsequently to Profit or Loss			
Fair Value Changes on Derivatives Designated as Cash Flow Hedge, Net	2.10&2.16	25	(36)
Fair Value Changes on Investments, Net	2.4&2.16	(102)	17
Total Other Comprehensive Income/(Loss), Net of Tax		191	(234)
Total Comprehensive Income for the Year		18,239	15,309

Earnings per Equity Share			
Equity Shares of Par Value ₹ 5 each			
Basic (₹)		42.37	36.34
Diluted (₹)		42.33	36.32
Weighted Average Equity Shares used in Computing Earnings per Equity Share			
Basic	2.21	425,94,38,950	427,70,30,249
Diluted	2.21	426,30,92,514	427,98,08,826

Source: https://www.infosys.com/investors/reports-filings/annual-report/annual/documents/infosys-ar-21.pdf

Contents of the Income Statement

The Companies Act does not require the preparation of any manufacturing account or trading account. Accordingly, it is sufficient to include all expenses under the heading "operating expenses". Though the Companies Act does not specify any format, clause 2 of Part II of Schedule III requires that the various items be arranged under the most convenient heads. Nowadays almost all listed companies prepare the statement of profit and loss in the Vertical format under the following convenient heads:

- *Revenue from Operations* appearing in the income statement is the sum of the invoice price of goods and services rendered during the period and other operating revenues, reduced by the amount of excise duty. Sales inwards represent the invoice value of goods returned by the customers. Excise duty refers to the amount paid to the government. The net income received from the sales is termed as net operating income or income from operations.
- *Other Income* appears in the statement of profit and loss as an addition to the revenue from operations and includes interest income, dividend income, net gain/loss on sale of investments and other non-operating income.
- *Operating expenses* consist of all direct and indirect operating expenses including wages, carriage inwards, general administrative expenses, selling and distribution expenses and depreciation.
- *Operating profits* is the difference between gross profit and operating expenses. As a measure of profits, it reflects the operating performance and is not affected by non-operating gains/losses, financial leverage and tax factor.
- *Non-operating surplus* represents gains arising from sources other than normal operations of the business. Its major components are income from investments and gains from disposal of assets. Likewise, non-operating deficit represents losses from activities unrelated to the normal operations of the firm. Generally, these are shown under the head, 'other incomes' or 'other expenses'.

- *Profits Before Interest and Taxes (PBIT*) is the sum of operating profits and non-operating surplus/deficit. Referred to as earnings before interest and tax, it represents a measure of profit, which is not influenced by financial leverage and the tax factor. Hence, it is pre-eminently suitable for inter-firm comparison.
- *Interest* is the expense incurred for borrowed funds, such as term loans, debentures, public deposits, and working capital advances.
- *Profits before tax* are obtained by deducting interest from profits before interest and taxes.
- *Tax* represents the income tax payable on the taxable profits for the year.
- *Profits after tax* is the difference between the profits before tax and the tax for the year.
- *Dividends* represent the amount earmarked for distribution to shareholders.
- *Retained earnings* is the difference between the profits after tax and dividends.

Most entities generally follow the above format of the income statement. However, the income statement can also be presented in a horizontal format as follows:

Trading and Profit and Loss Account of Y Ltd. for the Period Ended 20xx (Horizontal Form)

Dr. *Cr.*

Particulars	Amount (₹)	Particulars	Amount (₹)
To Opening stock	xxx	By Sales	Xxx
To Purchases	xxx		
To Manufacturing expenses	xxx	By Closing stock	Xxx
To Gross Profit c/d	xxx		
	xxx		xxx
To Administrative expenses	xxx	By Gross Profit	xxx
To Marketing expenses	xxx		
To Depreciation	xxx		
To Interest	xxx		
To Provision for tax	xxx		
To Net Profit	xxx		
	xxx		xxx
To Appropriations	xxx	By Balance b/f	xxx
To Dividends transferred	xxx	By Net profit for the	xxx

Particulars	Amount (₹)	Particulars	Amount (₹)
		year	
To Reserve	xxx		
To Balance c/f to Balance sheet	xxx		
	xxx		xxx

Contents of the Trading and Profit and Loss Account

In the above format, income statement is divided into trading account and profit and loss account. Trading account shows the net trading results of the company. Profit and loss account shows the overall profitability of the company.

Cost of goods sold is the sum of costs incurred for manufacturing goods sold during the accounting period. It consists of the direct material cost, direct labor cost, and factory overheads. It should be distinguished from the cost of production which represents the goods produced during the accounting period, not the cost of goods sold during the year.

Cost of Goods Sold = Opening Stock + Purchases + Manufacturing Cost – Closing Stock

Gross Profit is the difference between the net sales and cost of goods sold.

All other expenses like administration, selling and distribution and all other incomes like interest received, dividends received and any other income are shown in the profit and loss account. In this format, we cannot get the operating profit directly. We can get the operating profit by the following equation:

Operating Profit = Gross Profit + Other operating income – Other Operating Expenses or

= Net Profit + Non-operating Expenses – Non-operating Incomes

Net Profit is the difference between the Gross Profit and all other expenses and loss.

1.10.2 Balance Sheet

The balance sheet is prepared based on the accounting equation

Assets = Liabilities + Equity.

Assets: Broadly speaking, assets represent resources which are of some value to the firm. Assets can be divided into Fixed Assets and Current Assets. Fixed assets are acquired for use over relatively long periods and for carrying the operations of the firm. They are not ordinarily meant for sale. Fixed assets include: land, buildings, and equipment. Such assets are recorded at historical cost. Current assets can be quickly and easily converted into cash.

They include: cash, accounts receivable, marketable securities, bills receivable, inventory and prepaid expenses for example, prepaid rent etc.

Liabilities: Liabilities represent what the business entity owes to others. They can be broadly classified as long-term liabilities and short-term liabilities (current liabilities). Current liabilities are debts that are expected to be satisfied within the next twelve months. All liabilities that do not satisfy the above definition of current liabilities are classified as long-term liabilities.

Equity: Equity means the amount invested by owners. It comprises shareholders' capital and retained earnings. Thus, it is a part of the assets (residual, after the liabilities are paid-off) belonging to the owners of the business.

As per the Companies Act, 2013 a company's balance sheet should be in vertical format. The vertical form is presented in Part I, Schedule III of the Act which is shown in Exhibit 1.5 below:

Exhibit 1.5: Part I - Balance Sheet

Name of the Company……………… Balance Sheet as at …………………			
			(Rupees in…………)
Particulars	Note No.	Figures as at the end of current reporting period	Figures as at the end of the previous reporting period
1	2	3	4
I. EQUITY AND LIABILITIES			
(1) **Shareholders' funds**			
(*a*) Share capital			
(*b*) Reserves and surplus			
(*c*) Money received against share warrants			
(2) **Share application money pending allotment**			
(3) **Non-current liabilities**			
(*a*) Long-term borrowings			
(*b*) Deferred tax liabilities (Net)			
(*c*) Other Long term liabilities			
(*d*) Long-term provisions			
(4) **Current liabilities**			
(*a*) Short-term borrowings			
(*b*) Trade payables			
(*c*) Other current liabilities			
(*d*) Short-term provisions			
TOTAL			

II. ASSETS			
(1) **Non-current assets**			
(*a*) Fixed assets			
(*i*) Tangible assets			
(*ii*) Intangible assets			
(*iii*) Capital work-in-progress			
(*iv*) Intangible assets under development			
(*b*) Non-current investments			
(*c*) Deferred tax assets (net)			
(*d*) Long-term loans and advances			
(*e*) Other non-current assets			
(2) **Current Assets**			
(*a*) Current investments			
(*b*) Inventories			
(*c*) Trade receivables			
(*d*) Cash and cash equivalents			
(*e*) Short-term loans and advances			
(*f*) Other current assets			
TOTAL			

Source: Companies Act, 2013

The balance sheet for organizations other than the joint stock companies can also be presented in a horizontal format as follows:

Table 1.1: Format of Horizontal form of Balance Sheet

Balance Sheet of Y Ltd. as on March 31, 20xx *(₹ in crore)*

Liabilities	Amount	Assets	Amount
Share capital	xxx	Fixed assets	xxx
Reserves and Surplus	xxx	Investments	xxx
Secured loans	xxx	Current Assets, Loans and Advances	xxx
Unsecured loans	xxx	Current assets	xxx
Current liabilities and Provisions	xxx	Loans	xxx
Current liabilities	xxx	Misc. Expenditure	xxx
Provisions	xxx		
	xxxx		xxxx

Source: ICFAI Research Center

Contents of Balance Sheet

Assets

In a horizontal format, assets are classified as follows:

i. Fixed assets

ii. Investments

iii. Current assets, loans and advances

iv. Miscellaneous expenditure and losses

Fixed Assets

These assets have two characteristics: they are acquired for use over relatively long periods for carrying on the operations of the firm and they are ordinarily not meant for resale. Accounting Standard-10 (AS-10) defines a fixed asset as an asset held with the intention of being used for producing or providing goods and services and is not held for sale in the normal course of business. Examples of fixed assets are land, buildings, plant, machinery, patents, and copyrights.

Investments

These are financial securities owned by the firm. Investments are defined as assets held by an enterprise for earning income by way of dividends, interest and rentals, for capital appreciation, or for other benefits to the investing enterprise. Some investments represent long-term commitment of funds. (Usually, these are the shares of other firms held for income and control purposes). Other investments by their very nature are readily realizable and are intended to be held for not more than one year and are called short-term investments.

Current Assets, Loans, and Advances

Cash and other resources which get converted into cash during the operating cycle of the firm are defined as current assets. These are held for a short period as against fixed assets which are held for relatively longer periods. The major components of current assets are cash, debtors, inventories, loans and advances, and pre-paid expenses. Cash denotes funds readily disbursable by the firm. The bulk of it is usually in the form of bank balance, the rest comprises currency held by the firm. Debtors (also called accounts receivable) represent the amounts owed to the firm by its customers who have bought goods, services on credit. Debtors are shown in the balance sheet at the amount owed, less an allowance for the bad debts. Inventories consist of stocks of raw materials, work-in-progress, finished goods, stores and spares. They are usually reported at the lower of cost or market value. Loans and advances are the amounts to employees, advance given to suppliers and contractors and deposits made to governmental and other agencies. They are shown at the actual amount. Prepaid expenses are expenditures incurred for services to be rendered in the future. These are shown at the cost of unexpired reserve.

Miscellaneous Expenditure and Losses

This category consists of two items: (i) miscellaneous expenditure, and (ii) losses. Miscellaneous expenditure represents certain outlays such as preliminary expenses and pre-operative expenses which have not been written-off. From the accounting point of view, a loss represents a decrease in owner's equity. Hence, when a loss occurs, the owner's equity should be reduced by that amount. However, as per company law requirements, the share capital cannot be reduced when a loss incurs. So, the share capital is kept intact on the liabilities side of the balance sheet and the loss is shown on the right hand side (the assets side).

Liabilities

Liabilities represent what the business entity owes to others. The liabilities can be classified as follows:

i. Share capital

ii. Reserves and surplus

iii. Secured loans

iv. Unsecured loans

v. Current liabilities and provisions.

Share Capital

This is divided into two types: Equity capital, and preference capital. The first represents contribution of the equity shareholders who are considered the real owners of the firm. Equity capital is riskier and carries no fixed rate of dividend. Preference capital represents the contribution of preference shareholders for whom the dividend rate payable is fixed.

Reserves and Surplus

Reserves and surplus are profits which have been retained in the firm. Revenue reserves represent accumulated retained earnings created out of profits from normal business operations. These take several forms such as General Reserve, Investment allowance reserve, capital redemption reserve, dividend equalization reserve, etc. Capital reserves arise out of gains which are not related to the normal business operations. Examples of such gains are the premium on issue of shares or gains on revaluation of assets.

Surplus is the balance in the profit and loss account which has not been appropriated to any particular reserve account. It may be noted that reserves and surplus along with equity capital represents owner's equity.

Secured Loans

These denote borrowings of the firm against which specific securities have been provided. The important components of secured loans are – debentures, loans from financial institutions and loans from commercial banks.

Unsecured Loans

These are borrowings of the firm against which no specific security has been provided. The major components of unsecured loans are – fixed deposits, loans and advances from promoters, inter corporate borrowings and unsecured loans from bank.

Current Liabilities and Provisions

Current liabilities and provisions, as per the classification under the Companies Act, consist of the following – amounts due to the suppliers of the goods and services bought on credit, advance payments received, accrued expenses, unclaimed dividends, provision for taxes, dividends, gratuity, pensions etc.

Current liabilities (as distinct from their definition in the Companies Act) are obligations which are expected to mature in the next twelve months. They include the following: (i) loans which are payable within one year from date of the balance sheet, (ii) accounts payable (creditors) because goods and services purchased on credit for which payments are to be made within one year, (iii) provision for taxation (iv) accruals for salaries, wages and other expenses and (v) advance payments received for goods and services to be supplied in the future.

1.10.3 Cash Flow Statement

This statement depicts the event that caused a change in the cash during the accounting period. It must be emphasized that the nature of accrual accounting is such that a company may be profitable but nonetheless experience a shortfall in cash. The statement of cash flows is useful in evaluating a company's ability to meet its current liabilities as and when the need arises. For a given period, the cash flow statement provides information regarding the Sources of cash, Uses of cash and Change in cash balance.

The cash flow statement represents transactions that affect cash into the following categories:

i. Operating activities
ii. Investing activities
iii. Financing activities

This statement is mandatory in the case of Companies whose shares are listed on the stock exchange. Ind AS-7 of the ICAI deals with the requirements of Cash Flow statement.

The following Exhibit 1.6 is a specimen of the Cash flow statement:

Exhibit 1.6: Cash Flow Statement of Infosys Ltd., for Year Ended March 31st, 2021

In ₹ crore

Particulars	Note no.	Year ended March 31,	
		2021	**2020**
Cash Flow from Operating Activities			
Profit for the Year		18,048	15,543
Adjustments to Reconcile Net Profit to Net Cash Provided by Operating Activities			
Depreciation, Amortization and Provision for Impairments	2.1&2.2&2.3&2.24	2,604	2,144
Income Tax Expense	2.16	6,429	4,934
Impairment Loss Recognized/(reversed) under Expected Credit Loss Model		152	127
Finance Cost		126	114
Interest and Dividend Income		(1,795)	(1,502)
Stock Compensation Expense		297	226
Other Adjustments		(47)	(248)
Exchange Differences on Translation of Assets and Liabilities, Net		(32)	17
Changes in Assets and Liabilities			
Trade Receivables and Unbilled Revenue		(1,414)	(3,621)
Loans, Other Financial Assets and Other Assets		(684)	319
Trade Payables	2.12	(5)	(75)
Other Financial Liabilities, Other Liabilities and Provisions		2,284	1,475
Cash Generated from Operations		25,963	19,453
Income Taxes Paid		(6,061)	(3,881)
Net Cash Generated by Operating Activities		19,902	15,572
Cash Flow from Investing Activities			
Expenditure on Property, Plant and Equipment and Intangibles		(1,720)	(3,063)
Deposits Placed with Corporations		(183)	(112)
Loans to employees		-	(2)
Loan given to Subsidiaries		(76)	(1,210)
Loan repaid by Subsidiaries		328	444
Proceeds from Redemption of Debentures		623	286
Investment in Subsidiaries		(1,530)	(1,338)
Payment Towards Business Transfer		(237)	-
Proceeds from Liquidation of a Subsidiary		173	-
Payment of Contingent Consideration Pertaining to Acquisition		(125)	(6)

Redemption of Escrow Pertaining to Buyback		-	257
Other Receipts		49	46
Payments to Acquire Investments			
Preference, Equity Securities and Others		-	(41)
Liquid Mutual Fund Units and Fixed Maturity Plan Securities		(31,814)	(30,500)
Tax-free Bonds and Government Bonds		(318)	(11)
Certificates of Deposit		-	(876)
Non-convertible Debentures		(3,398)	(733)
Government Securities		(7,346)	(1,561)
Others		(13)	(2)
Proceeds on Sale of Investments			
Preference and Equity Securities		73	-
Liquid Mutual Fund Units and Fixed Maturity Plan Securities		32,996	30,332
Tax-free Bonds and Government Bonds		-	12
Non-convertible Debentures		944	1,788
Certificates of Deposit		900	2,175
Commercial Paper		-	500
Government Securities		2,704	1,673
Others		-	9
Interest Received		1,340	1,817
Dividend Received from Subsidiary		321	-
Net Cash (used in) / from Investing Activities		(6,309)	(116)
Cash Flow from Financing Activities			
Payment of Lease Liabilities	2.2	(420)	(364)
Buyback of Equity Shares Including Transaction Cost		-	(7,478)
Shares Issued on Exercise of Employee Stock Options		9	2
Payment of Dividends (including dividend distribution tax)		(9,155)	(9,551)
Net Cash used in Financing Activities		(9,566)	(17,391)
Effect of Exchange Differences on Translation of Foreign Currency Cash and Cash Equivalents		23	(54)
Net Increase / (Decrease) in Cash and Cash Equivalents		4,027	(1,935)
Cash and Cash Equivalents at the beginning of the Period	2.7	13,562	15,551
Cash and Cash Equivalents at the End of the Period		17,612	13,562

Source: https://www.infosys.com/investors/reports-filings/annual-report/annual/documents/infosys-ar-21.pdf

1.11 Understanding Financial Statements

An understanding of financial statements is necessary for the people connected with the organization. It is very important for the successful administration of the organization. These statements are like windows to know the health of the company. Owners can assess the strengths and weaknesses of their organization. They can accordingly plan.

Financial statements consist of Balance Sheet, Profit and Loss Account and Cash Flow Statement. Additional notes and materials are provided along with the financial statements to the readers, to give a clear picture about the organization. Sometimes these statements are referred by different names, but the basic elements and other similar reports are same for any organization. All financial statements will not appear the same i.e., the way of presentation may be different for different types of business.

Generally, a balance sheet consists of assets, liabilities, and equity. Assets can be broadly classified into fixed assets and current assets. Fixed assets indicate the long-term financial strength of the organization. They are amortized over a period. It is not easy to liquidate fixed assets i.e., they cannot be converted into cash easily. On the other hand, current assets can be liquidated quickly. By analyzing the current assets, we can assess the liquidity position and short-term solvency position of the organization.

Liabilities also can be classified into long-term debt and current liabilities. Long-term debt includes debentures and loans taken from financial institutions. Generally, they have a charge on assets. Thus, long-term liabilities are the indicators of long-term solvency position of the company. Current liabilities include, bills/notes and accounts payable. If there is insufficient cash within the company, current liabilities can drag the company down. Equity is the amount of capital invested by the owners. If we look deeper into these items, we can understand that both these items are obligations for the company i.e., they need to be paid. Long-term liabilities and long-term assets indicate long-term solvency and current liabilities, and current assets indicate the short-term solvency of the organization.

Profit and loss account indicates the profit or loss made by the company during a period. It also provides information about the earnings per share and various appropriations made during the year. This is the main indicator of the profitability of the business. We can assess the performance or growth of the company by comparing the current year’s profit with the previous year’s profit.

Cash flow statement gives the information about the flow of cash in the organization. It indicates the liquidity strength of the organization.

Thus, an understanding of the financial statements is necessary for the users to assess the profitability, liquidity and solvency position of the organization. This can be done through analysis and interpretation of the financial statements. Various tools are used for analysis and interpretation.

1.12 Qualitative Characteristics of Financial Statements

Information to be useful to the users should possess certain characteristics. These characteristics help to evaluate the strengths and weaknesses of accounting and its relevance to effective analysis and decision-making. Four qualitative characteristics identified by IASB's (International Accounting Standards Board) conceptual framework are:

Understandability

Information provided in the financial statements must be readily understandable. This implies that the users must understand the information within the context of the decision being made. Because users differ in their ability to comprehend any set of information, this is to be a user-specific quality. For this purpose, it is deemed that the users have reasonable knowledge of the business, economic activities, and accounting. However, this does not mean that complex information that is needed for users is to be excluded because it is too difficult to be understood.

Relevance

Information should be relevant to the decision-making needs of the user. Information is said to be relevant when it influences the economic decision of the users. Relevance of information is said to be affected by its nature and materiality.

In some cases, the nature of information alone is sufficient to determine its relevance. For example, the reporting of a new segment may affect the assessment of risks and opportunities that face the entity.

Information is said to be material if its omission or misstatement could influence the economic decision of users.

Reliability

Information must be reliable. Reliability means the extent to which information is representationally faithful, and neutral. Representational faithfulness means that the information must represent faithfully the transactions and events it purports to represent. The quality of neutrality implies being free from bias and material errors. To be reliable, information must be free from material error, bias, and be representatively faithful.

To be reliable, transactions and events must be accounted for and presented in accordance with their substance and economic reality and not merely legal form.

Information must not be presented to achieve a predetermined result or outcome.

Often accountants face uncertainties while preparing the balance sheet. In such a situation, for the financials to be reliable, prudence should be exercised. Prudence is the exercise of caution in uncertain conditions.

To be reliable, the information in financial statements must be complete, within the limits of materiality and cost.

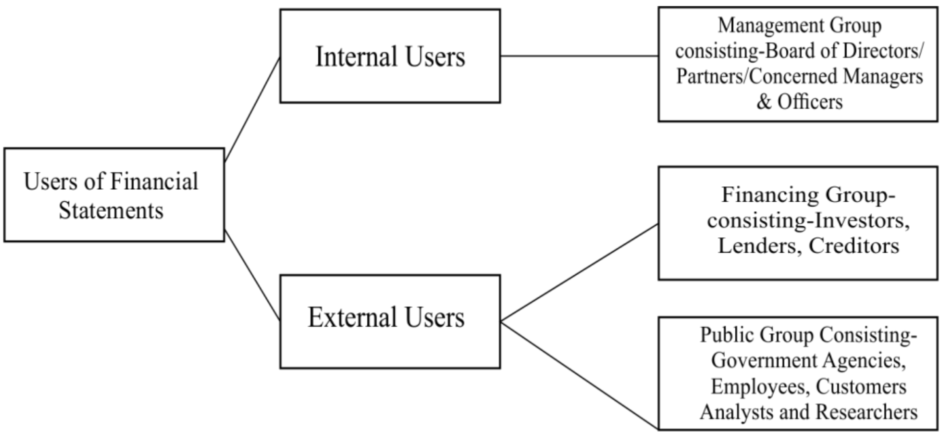
Comparability

It is the ability to help users see similarities and differences among events and conditions. It enhances the ability of investors and creditors to compare information across companies to make their resource allocation decisions. The financial statement users must be able to compare the statements of an entity through time to identify trends in financial position and compare the financial statements of different entities to evaluate their relative financial position and performance. This requires that the users be informed of accounting policies employed in the preparation of financial statements. Closely related to comparability is the notion that consistency of accounting practices over time permits valid comparisons between different periods. Lack of consistency threatens the comparability of the financial statements.

1.13 Users of Financial Statements

As stated earlier, financial statements are the windows to the health of the company. This information is useful not only to the internal people of the organization but also to the people external to the organization. The following Figure 1.4 gives you a clear idea about the users of Financial Statements.

Figure 1.4: Users of Financial Statements



Source: ICFAI Research Center

Internal Users

Management Group – Board of Directors/Partners/Managing Officers

In a company form of organization, the owners or the shareholders elect a group of people to manage the day-to-day affairs of the company. Such a group is referred to as Board of Directors headed by Chairman or Managing Director or Chief Executive Officer (CEO) and other members known as Directors. They are assisted by the functional level managers and other officers. Since these people are ultimately responsible for the financial performance, they periodically compile and interpret the financial statements. An analysis of the financial figures is essential for the smooth and efficient functioning of the enterprise.

External Users

Financing Group

Shareholder/Investors/Owners

The suppliers of the risk capital are called as owners in case of a sole proprietorship, partners in the case of a partnership concern and shareholders in case of joint stock companies. The shareholders are the investors who provide capital or resources to an enterprise in exchange for a share in ownership of the enterprise. Because of the separation of the ownership from management in case of Joint Stock Companies, the financial statements are the means by which the shareholders become aware of how their funds are being used. The information provided in the financial statements helps them to arrive at various investment decisions such as, whether to invest further, or withdraw the existing investments, etc. Similarly, potential investors use the financial statements to arrive at investment decisions.

Lenders

Banks, financial institutions and other lenders provide funds to the business entity. They would be willing to part their money only if they are assured a periodical return in the form of interest and ultimate return of their principal. The financial statements reflect the profitability and long-term solvency of the business and provide the assurance which the lenders look out for.

Suppliers/Creditors

Suppliers of raw materials etc., to the company are interested in the short-term liquidity of the company. The inability of the business to pay-off short-term liabilities affects its credibility and credit rating. Commercial bankruptcy may lead to sickness or dissolution in extreme cases. The suppliers look for short-term liquidity and solvency of the business for judging the credibility of the firm through the analysis of the statements. The financial statements help the creditors to ascertain the capacity of the organization to pay on time for the goods and services supplied.

Public Group

Government and other Regulatory Agencies

The correct assessment of income tax, excise duty, etc., requires a scrutiny of the financial statements of an organization specially to detect tax evasion, if any. Government plans and policies in respect of taxation, subsidies and incentives are guided by the requirements of the industries and their past performance. Government as an overall guardian of public interest keeps a close watch on the various firms to detect profiteering and the creation of monopolies. A lot of information in this regard can be gathered by scrutinizing the financial statements of business enterprises.

National income accounting used in macroeconomic analysis derives its fundamental inputs from financial statements. The tax payable by the enterprises as well as the compilation of countrywide statistics is discerned using the financial statements.

Employees

Employees have vested interest in the continued and profitable operations of the organization in which they work. Financial statements can be used as important sources for obtaining information regarding the current and future profitability and solvency. Most of the incentive plans of large number of enterprise are directly related to the profitability of the business. This further magnifies the interest of the employees in the company’s future profitability and health. Financial statements are used as important sources for obtaining information in this direction.

Customers

They comprise groups such as producers, wholesalers and retailers and final consumers. Legal obligations associated with guarantees, warranties and after sales service contracts tend to establish long-term relationship between the business and its customers. Customers may use the financial statements to draw inferences about the long-term viability of the firm.

Research

Scholars undertaking research into management science covering diverse facets of business practices consider the financial statements for the information eventually used for analysis. Such statements are of great value to persons searching for company specific information.

Others

Diverse persons such as academicians, researchers and analysts may approach business firms for information regarding the financial performance. To draw proper conclusions, they would have to study the financial statements in depth. The public in general also examine the financial statements for employment opportunities, health of the concern and economy.

Each interested party as listed above may have a different focus. For instance, a owner may be largely interested in the profitability of his firm so that he may be able to assess his own share in the assets. The managers may be primarily interested in various cost and control information pertaining to different departments and functions. The banks may be interested in assessing the working capital needs of the firm. Thus, no one set of accounts can ever meet the requirements of all the users. However, the balance sheet, profit and loss statement, cash flow statements briefly discussed above, are general purpose financial statements which are by and large of interest to everybody.

Check Your Progress – 2

6. Which of the following is **not** a step in accounting process?
   a. Recording
   b. Classifying
   c. Verification
   d. Summarizing
   e. Communication
7. Business is considered as a separate entity and the capital invested by the owners is shown as a "liability" in the books of the business. Which accounting principle implies that there is a distinction between the economic activities of the enterprise and owners of the business?
   a. Double entry
   b. Going concern
   c. Separate entity
   d. Materiality
   e. Consistency
8. Most of the concerns have a practice of reporting the closing inventories at the lower of the cost or market value, undermining the concern's revenue and incomes as well. Based on which accounting concept or principle is this justified?
   a. Historical cost concept
   b. Consistency concept
   c. Conservatism concept
   d. Full disclosure concept
   e. Matching concept
9. Alpha Limited Co., an expert in manufacturing engine motors, had an accumulated profit of ₹ 10, 00,000 at the end of the fiscal year 20x0-x1 that was reinvested in its core business activities, for the next financial year and was recorded in the balance sheet. What is the term used to refer to these accumulated profits in the balance sheet?
   a. Retained Earnings
   b. Investments
   c. Operating Profits
   d. Capital
   e. Deferred Revenue

10. Significant changes made in the accounting policies of a company during the financial year, is referred under which of the given statements?
    a. Statement of Financial Position
    b. Income Statement
    c. Cash Flow Statement
    d. Footnotes
    e. Statement of Shareholder's equity

Activity 1.2

a. Financial statements are generally prepared in a certain format by following certain rules. Explain the components of Balance Sheet and Income Statement and how it differs from each other.

____

____

____

b. What is the need for preparing a cash flow statement? How is it different from the other financial statements?

____

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____

1.14 Summary

- Accounting is the art of recording, classifying and summarizing the business transactions and events. Double Entry System is the base for recording business transactions. According to this system, every business transaction has two aspects i.e., we receive something and give something else in return. So, for every debit there is always a corresponding credit and vice versa.
- To standardize accounting information, every organization would have to establish certain accounting policies based on GAAP. Accounting policies encompass the principles, bases, conventions, rules and procedures adopted by managements in preparing and presenting financial statements.
- While the conventions are based on what is practicable, there are certain accounting concepts, which are based on logical considerations. Accounting concepts are ideas and assumptions that are fundamental to accounting practice. Some of the important concepts are money measurement concept, business entity concept, going concern concept, duality concept, cost concept, matching concept, realization concept and accrual concept.

- The primary function of financial accounting is to provide relevant financial information to users for making decisions and taking actions. The primary means of providing financial information to investors, creditors and other external users is through financial statements.
- The primary financial statements include the profit and loss account, balance sheet and cash flow statement. Understanding financial statements is necessary for decision-making to the internal and external stakeholders of the organization.

1.15 Glossary

Accounting is the art of recording, classifying and summarizing in a significant manner and in terms of money, transactions and events which are, in part at least, of a financial character, and interpreting the results thereof.

Accounting policies are the specific principles, bases, conventions, rules, and practices applied by an entity in preparing and presenting financial statements.

Asset is a resource controlled by the entity because of past events and from which future economic benefits are expected to flow to the entity.

Audit report is a written report by an auditor, in which he expresses his opinion as to the accuracy, fairness, consistency, and acceptability of the financial statements.

Balance sheet is a statement showing an entity's financial position at a certain date. It forms part of the financial statement.

Double Entry is the system wherein both the debit and credit aspects of a transaction are recorded.

Financial Statements generally mean and include balance sheet, statement of profit and loss, cash flow statement and other statements, schedules, and notes attached or annexed to them which form an integral part of financial statements.

Liability is the present obligation of the entity arising from past events, the settlement of which is expected to result in an outflow from the entity of the resources embodying economic benefits.

Net income is the result of Gross income from all sources less all administrative and operating expenditures, depreciation, taxes, and interest and other charges on debt.

1.16 Self-Assessment Test

1. Define and explain the term accounting.
2. State the various qualitative characteristics of Financial Statements.
3. What are the various components of Balance Sheet and Profit & Loss accounts? Briefly explain each of them.

4. Why is there a need for Generally Accepted Accounting Principles?
5. “Anticipate no profits, but provide for all possible losses.” Identify and explain the underlying principle
6. Discuss the superiority of the vertical format over the horizontal format for presentation of financial statements.

1.17 Suggested Readings/Reference Material

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1.18 Answers to Check Your Progress Questions

1. (b) Capital = Assets – Liabilities

As per the accounting equation Assets = Liabilities + Capital or Capital = Assets – Liabilities

2. (e) Procuring funds for business operations.

The objectives of financial accounting are: maintenance of records for business transactions/events; ascertaining whether the business operations have been profitable or not; depicting the financial position of the business and providing information to the users of financial information.

3. (d) Every debit has an equal and corresponding credit

According to the double entry system of accounting every business transaction has two aspects, i.e., when we receive something, we also give something in return. Thus, for every debit there is always an equal and corresponding credit and vice versa.

4. (c) Creation of information only for shareholders

The basic aim of accounting is to create information in a form which is useful to both the internal and external users. Summaries of the transactions and events are reported through Financial Statements. All the information should be provided in time to the users so that they are able to understand and analyze it.

5. (b) Decision making

Earlier, accounting was a process of recording business transactions. Today, accounting is considered as a tool of the management. The emphasis is on using the accounting information in the process of decision-making. Hence, it is now an information system and not merely a recording system.

6. (c) Verification

Verification is the work of auditor and not accountant.

7. (c) Separate entity

In accounting, business is considered to have a separate existence from that of its proprietors or owners. It implies that a distinction between the economic activities of the enterprise and that of the owners is to be maintained. All the transactions and the events are analyzed and recorded in the books from the point of view of the business enterprise.

8. (c) Conservatism

The concept often works on the principle – 'Recognize all losses, anticipate no gains'. The idea behind this principle is that recognition of revenue requires better evidence than recognition of expenses. Thus, revenues are to be recognized only when they are reasonably certain and expenses as soon as they are reasonably possible.

9. (a) Retained Earnings

Retained earnings are the difference between the profits after tax and dividends. It refers to the profits or cumulated earnings of the company that are not distributed to stockholders (shareholders) as dividends.

10. (d) Footnotes

The notes to the financial statements provide detailed information on some of the figures in the balance sheet or profit and loss account. They contain a statement on different accounting policies followed by the company, information about the contingent liabilities (i.e., liability may or may not arise in the future) and commitments to honour future contracts.

Unit 2

Conceptual Framework of Financial Accounting

Structure

2.1 Introduction

In the previous unit, we have learnt that financial accounting is concerned with providing relevant information to various external users. Generally Accepted Accounting Principles (GAAP) comprises a dynamic set of guidelines for measuring and reporting the information in the financial statements.

In this unit, we shall learn the basic mechanics of accounting i.e., the process of accounting, the various books used and how to prepare Trial Balance before and after passing adjustment entries.

2.2 Objectives

After reading through the unit, the student should be able to:

- Identify and state the importance of the various steps in the Accounting Cycle
- Discuss the importance of Fundamental Accounting Equation
- Explain the rules of Debit and Credit pertaining to different types of Accounts

- Demonstrate how entries are made in the Journal, Ledger and various Subsidiary books and state the need to maintain subsidiary books
- Construct a Trial Balance from the various account balances provided
- Summarize the year-end adjustments in the books of accounts before financial statements are made

2.3 Conceptual Framework of Financial Accounting

Accounting is the process of identifying, recording, classifying and summarizing transactions and events, which lead to preparation of financial statements. All this is done in a systematic way in various stages. The stage from identification of transactions to preparation of adjusted trial balance is called 'Accounting Cycle'. The steps in the accounting cycle are:

i. Identification of Transactions

ii. Preparation of Business Documents

iii. Recording of Transactions in the Journal

iv. Posting to Ledger

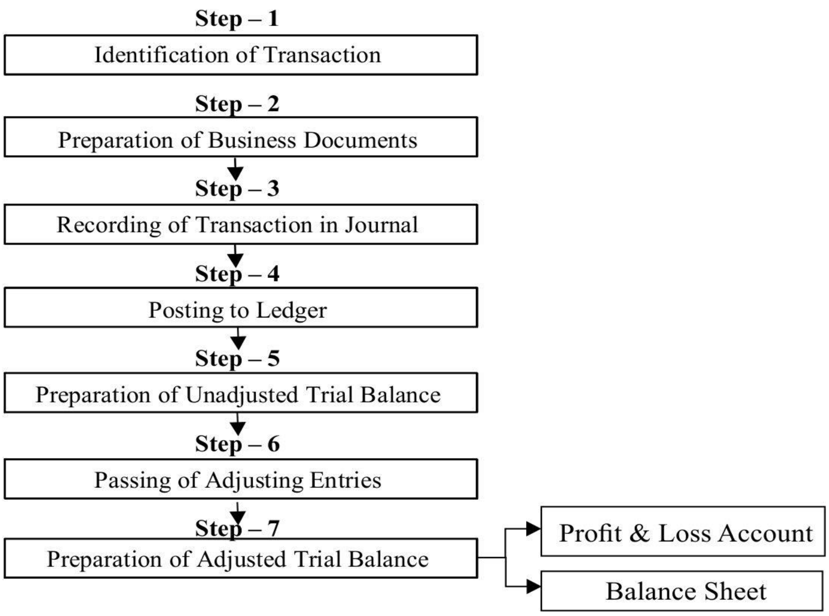
v. Preparation of Unadjusted Trial Balance

vi. Passing of Adjusting Entries

vii. Preparation of Adjusted Trial Balance

Figure 2.1 depicts the accounting process:

Figure 2.1: The Accounting Process



Source: ICFAI Research Center

The first step in the accounting process is to identify the external transactions and events affecting the accounting equation.

The second step involves the documentation of the events and transactions identified in the first step. Documentation is the mechanism used to capture essential information regarding each transaction. The source documents such as sales invoices, bills from suppliers, cash memos are generated which provide complete evidence of the transactions and events affecting the business.

The third step is to record the transaction in the Journal. Journal provides a chronological record of all economic events affecting a firm. This is dealt with in detail in the subsequent part of this unit.

The fourth step in the process involves the transfer of debits and credits recorded in the Journal entries to specific accounts or individual accounts in the Ledger. This process is called posting.

The fifth step in the accounting process entails the preparation of Unadjusted Trial Balance. This is simply a list of individual accounts appearing in the Ledgers and their balances on a particular day. Its purpose is to check for completeness and to prove that the sum of the accounts with debit balances equals the sum of the accounts with credit balances, that is, the accounting equation is in balance.

The sixth step involves the passing of adjustment entries. This step takes into consideration the effect of internal events, which have not been captured in Step 1 and 2 and which affect the Accounting Equation. These adjusting entries are required to implement accrual system of accounting by which revenues earned in a period are recognized in that period, regardless of when cash is paid and to recognize all expenses incurred during a period, regardless of when cash payment is made. Adjusting entries are also required to update certain accounts.

Along with adjusting entries, the sixth step may also involve passing of rectification entries to rectify any accounting errors that may have been committed during the previous stages. Such rectification entries, in case of one-sided errors can be passed using a temporary account called “Suspense account”.

The seventh step in the accounting process involves the preparation of Adjusted Trial Balance. This step is undertaken after the adjusting entries and the rectification entries have been posted to the accounts involved.

The above seven steps in the accounting process facilitate the preparation of financial statements. The financial statements are the output of the accounting process and are the means of communicating financial information to external users.

Let us now understand each of these steps in further detail:

2.4 Fundamental Accounting Equation

All the business transactions have two-fold effect. Recording of both aspects of a transaction is called double entry system of book-keeping. For example, if a loan is raised from outside sources, the two aspects of the event are the increase in the outside liability and the increase in cash of the business. Thus, in accounting, generally the resources of the business are termed as assets and the obligations of the business to outsiders are termed as liabilities and the obligations towards owners are termed as capital or equity.

As a result of duality concept, at any point of time the sum of the sources of the funds equals the sum of the uses of funds. In other words, at any point of time, the sum of the assets of the business equals the sum of the liabilities and capital of the business. This may be expressed in the form of an equation.

Sources of Funds = Uses of Funds, or

Owner’s Funds + Outsiders Funds = Assets, or

Capital + Liabilities = Assets

This is known as Fundamental Accounting Equation. This is the base for recording all the business transactions under double entry system of bookkeeping.

The fundamental accounting equation has two important implications:

Firstly, it portrays that at any point of time the total economic resources of an entity is equal to the total economic obligations or claims to those resources.

Secondly, this equation also implies that each event or transaction must have a dual effect, since the total assets should always be equal to the total liabilities.

For instance, consider the following example:

A business is started with a capital of ₹ 1,00,000 brought in cash. The above event gives rise to a cash balance of ₹ 1,00,000, which, being an increase in an asset (namely, cash), is a use.

At the same time, the business now owes ₹ 1,00,000 to the owner who invests the capital in it, so that the owners’ equity in the business is ₹ 1,00,000. This being a liability of the business towards the owner, constitutes a source.

Thus, the above event would look as follows:

Liabilities (Sources)	Assets (Uses)
Owners’ Equity ₹ 1,00,000	Cash ₹ 1,00,000

In terms of the accounting equation the effect is

Capital + Liabilities = Assets

Capital (₹ 1,00,000) + 0 = Cash (₹ 1,00,000)

Now assume that in the above business, land and buildings worth ₹ 60,000 are bought for cash.

The above event would look as follows:

Liabilities (Sources)	₹	Assets (Uses)	₹
Owners' Equity	1,00,000	Land & Buildings	60,000
		Cash	40,000
	1,00,000		1,00,000

It is clear from the above that the purchase of land and building is the use (being an increase in an asset), whereas the decrease in the cash balance is a source (being a decrease in an asset).

In terms of the Fundamental Accounting equation the effect is

Capital + Liabilities = Assets

Capital (Rs. 1,00,000) + 0 = Cash (₹ 40,000) + Land & Building (₹ 60,000)

A vehicle is purchased for ₹ 40,000 by taking a loan for the purpose. Now the sources and uses of funds look as follows:

Liabilities (Sources)	₹	Assets (Uses)	₹
Owners' Equity	1,00,000	Land & Building	60,000
Loan	40,000	Vehicle	40,000
		Cash	40,000
	1,40,000		1,40,000

Here, the asset creation (namely, the vehicle) is the use and the liability created (namely, the loan) is the source.

In terms of the Fundamental Accounting equation the effect is

Capital + Liabilities = Assets

Capital (₹ 1,00,000) + Loan (₹ 40,000) = Cash (₹ 40,000) + Land &Building (₹ 60,000) + Vehicle (₹ 40,000)

Now suppose that goods worth ₹ 15,000 are purchased for cash.

The balance sheet gets modified to:

Liabilities (Sources)	₹	Assets (Uses)	₹
Owners' Equity	1,00,000	Land & Building	60,000
Loan	40,000	Vehicle	40,000
		Goods (Inventory)	15,000
		Cash	25,000
	1,40,000		1,40,000

In this case, the inventory build-up is the use, whereas the cash depletion is the source.

In terms of the Fundamental Accounting equation the effect is

Capital + Liabilities = Assets

Capital (₹ 1,00,000) + Loan (₹ 40,000)

= Cash (₹ 25,000) + Land & Building (₹ 60,000) + Vehicle (₹ 40,000) + Goods (₹ 15,000)

Now assume that ₹ 10,000 worth of goods from the inventory are sold for ₹ 12,000 in cash. This means, a profit of ₹ 2,000 is obtained on sale of inventory.

On account of the sale made, cash worth ₹ 12,000 is realized. ₹ 10,000 worth of inventory is reduced. The business owes the profit it earns to the owners. Thus, profit may be regarded as increase in the owners' equity.

Now, on account of the above event of sale, the sources and uses would stand modified as shown below:

Liabilities (Sources)	₹	Assets (Uses)	₹
Owners' Equity	1,00,000	Land & Building	60,000
Add: Profit	2,000	Vehicle	40,000
	1,02,000	Goods (Inventory)	5,000
Loan	40,000	Cash	37,000
	1,42,000		1,42,000

In terms of the Fundamental Accounting equation the effect is

Capital + Liabilities = Assets

Capital (₹ 1,02,000) + Loan (₹ 40,000)

= Cash (₹ 37,000)+ Land &Building (₹ 60,000) + Vehicle (₹ 40,000) + Goods (₹ 5,000)

Thus, it can be seen that the fundamental accounting equation holds good for every business transaction.

2.5 Symbols for Sources and Uses

In business, money is collected from different 'sources' and has 'uses' for different purposes. The words, sources and uses are longer words, so accountants use other symbols to denote them. The accepted symbol for sources is 'Cr.' short form for 'Credit'. The accepted symbol for uses is 'Dr', short form for 'Debit'.

The following are the sources of funds:

– Additional capital (increases owner's equity)

– Additional loans (increases outside liability)

– Earning revenue (increases owner's equity)

– Making profits (increases owner's equity)

– Disposing or reducing some of the assets (reduces assets).

Thus, all increases in liabilities (including owner's equity) and reduction in assets represent sources of funds.

Similarly, increases in use of funds are called Debit items. The following are the uses of funds:

– Purchase of assets (increases assets)

– Incurring operational expenses (decreases owner's equity)

– Discharging earlier liabilities (decreases liabilities)

– Keeping idle funds so that the cash balance increases (increases assets)

– Suffering losses (decreases owner's equity).

Thus all increases in assets and decreases in liabilities (including owner's equity) are uses of funds.

This can be expressed as follows:

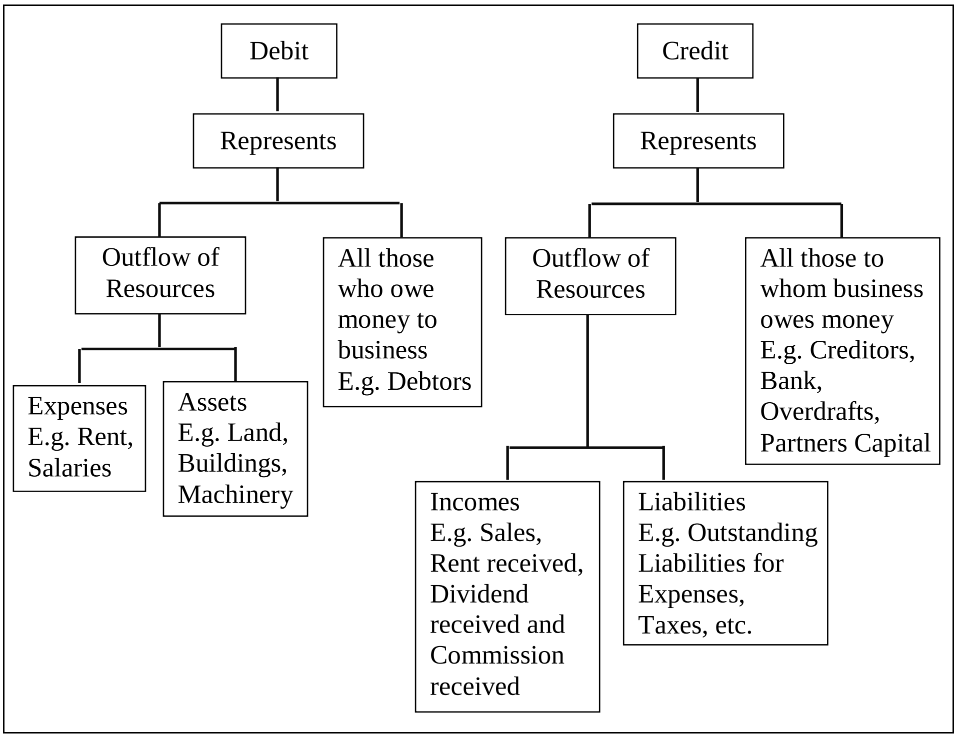
Liabilities			Capital			Assets	
		+			=		
Debit –	Credit +		Debit –	Credit +		Debit +	Credit –

The above can be summarized as:

Particulars	Increase	Decrease
Liabilities, Revenue and Profit	CR = Source	DR = Use
Assets, Expenses and Loss	DR = Use	CR = Source

From the above, we understand that the words debit and credit represent two different concepts. You can understand the nature of debit and credit more clearly from the following Figure 2.2:

Figure 2.2: Nature of Debit and Credit



Source: ICFAI Research Center

2.6 Types of Accounts

We know cash, vehicles, land and buildings and inventory are the uses of funds. We know that these are also called assets. We can record all the transactions relating to assets in one place. But it does not give you the individual information about cash, vehicles or inventory. If you want information separately, you need to record each one as a separate element. All these elements are termed as "Accounts" in accounting terminology. For example, cash is an element and all the information relating to cash is available in 'cash account'. In the similar way, inventory is an element; all the information relating to inventory is available in 'Inventory Account'. The number of elements or accounts maintained by a business depends on the type of business, nature of business and the information requirement of the owners.

Traditionally, all the elements/accounts of a business organization can be broadly classified into three types:

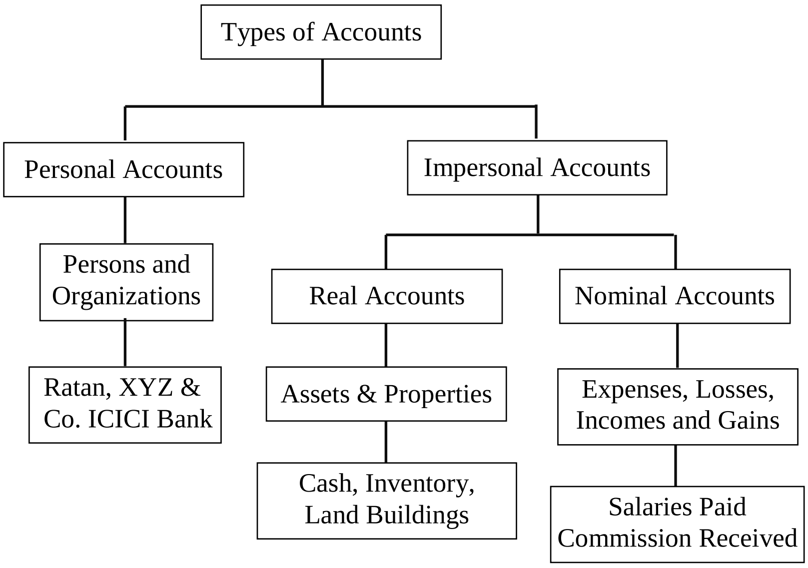
i. Personal Accounts

ii. Real Accounts

iii. Nominal Accounts

Figure 2.3 shows the above categories of accounts and their sub-classification

Figure 2.3: Types of Accounts



Source: ICFAI Research Center

2.6.1 Personal Accounts

These are accounts that are used to record transactions with a person or group of persons. It constitutes the accounts of individuals like creditors, debtors, bank, etc. It depicts the balance due to individuals and organizations or due from them on a particular date. As per the separate entity concept, proprietor is also creditor to the business. But two accounts are maintained for him, one is for amount invested by him i.e., capital account and second is for amount withdrawn by him i.e., drawings account. The Personal Accounts are of the following types:

- **Natural Person's Accounts** are accounts of persons such as proprietor's account, supplier's account, receiver's account, etc.
- **Artificial Person's Accounts** are accounts of legal persons (entities regarded as persons under law) such as Limited company's accounts, Insurance company's accounts, Banking company's accounts, any institution's accounts, etc.
- **Representative Personal Accounts**: This type of account needs a little more elaboration. These accounts represent certain person or groups of persons. For example, if the business is unable to pay salaries to the workers for the past six months, the workers can be conveniently treated as creditors to the business. The total amount due to them can be collectively put under the heading of 'Salaries Outstanding Account'. Other examples of representative personal accounts are rent outstanding account, interest outstanding account, prepaid interest account, prepaid rent account, etc.

2.6.2 Real Accounts

These accounts are used to record transactions relating to properties and assets. Assets may be tangible or intangible. Thus, real accounts take the form of:

i. **Tangible Real Accounts:** These are assets, which can be seen or touched in physical sense and have monetary value. *Example:* Land account, Buildings account, Furniture account, Stock account, etc.

ii. **Intangible Real Accounts:** These are assets, which cannot be seen or touched in physical sense but have monetary value. *Example:* goodwill, trademarks, copyrights, patent rights, etc.

2.6.3 Nominal Accounts

These are accounts, which are related to expenses, losses, incomes and gains. These accounts show the amount of income earned or expense incurred during a particular period. Examples of nominal accounts are – salaries account, commission account, carriage, interest account, etc.

Now-a-days many accountants prefer to classify accounts as:

i. **Assets Account:** These accounts relate to tangible and intangible assets. *Example:* land account, buildings account, goodwill account.

ii. **Liabilities Account:** These accounts relate to obligation of the enterprise towards outsiders. *Example:* long-term loans, trade creditors, bank overdraft, etc.

iii. **Capital Account:** These accounts relate to obligation to the owners of the enterprise. *Example:* Capital account and Drawings account, etc.

iv. **Revenue Account:** These accounts relate to amount charged for goods sold or services rendered or permitting others to use enterprise resources yielding interest, royalty or dividend. *Example:* Sales account, Discount received account, Royalties received account, etc.

v. **Expenses Accounts:** These accounts relate to amounts expended or lost in the process of earning revenue. *Example:* Purchases account, Discount paid account, Royalties paid account, etc.

The above classification is in accordance with the fundamental accounting equation.

2.7 Rules of Debit and Credit

Every business transaction has two aspects – receiving aspect (or source of fund) and giving aspect (or use of fund). But the problem is identification of these aspects. There are certain rules for determining which aspect has to be debited and which aspect has to be credited. For centuries, accountants have used the system of debit and credit to increase or decrease an account. Debit merely means the left side of the account and credit merely means the right side of the account.

Figure 2.4: Rules of Debit and Credit

Rules of Debit and Credit

	Personal Accounts	**Real Accounts**	**Nominal Accounts**
Debit:	The benefit receiver	What comes in	All expenses and losses
Credit:	The benefit giver	What goes out	All incomes and gains

Source: ICFAI Research Center

Rule in case of Personal Accounts

Debit the receiver

Credit the giver

It implies the account of the person who receives something is to be debited and the account of the person who gives something is to be credited. For example, if Raman receives goods from the business or receives cash from business, Raman's account is debited. Similarly, if Narain gives any cash to the business, Narain's account is credited.

Rule in case of Real Accounts

Debit what comes in

Credit what goes out

It implies the accounts of the assets and property are debited when additions are made or when they are coming into business. And the accounts of the assets and property are credited when any deletions are made or when they go out of business. For example, when the enterprise purchases land, land account is debited, at the same time if cash is paid for land, cash is credited since cash is a real account (apply 'credit what goes out').

Rule in case of Nominal Accounts

Debit all expenses and losses

Credit all incomes and gains

It implies the accounts of the expenses such as wages and salaries are debited and the accounts of incomes and gains such as interest received, dividend received, etc., are credited. For example, when the enterprise pays wages or salaries to workers, wages account or salaries account is debited, and since cash is paid in respect of the wages, cash being a real account, cash account is credited (apply 'credit what goes out').

Remember the following rules of Debit and Credit in case of classification of accounts based on the Fundamental Accounting equation:

Asset Account	Debit the increase, Credit the decrease
Liabilities Account	Debit the decrease, Credit the increase
Capital Accounts	Debit the decrease, Credit the increase
Revenue Accounts	Debit the decrease, Credit the increase
Expenses Accounts	Debit the increase, Credit the decrease

Activity 2.1

a. What type of account is bank account? Justify and recall the rules of debit and credit pertaining to the account.

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b. The assets of a business are in the form of land ₹ 5,00,000 and buildings ₹ 4,00,000, and the liabilities of the business is ₹ 6,00,000. How much is the owners' capital in the business?

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c. Now, you are familiar with Debit and Credit and the different types of accounts. You must have noticed Dr. and Cr. in your Bank Pass Book. Explain these entries.

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2.8 Recording of Transactions in Journal

The word journal is derived from the French word 'Jour' which means a day. Thus, the book in which daily business transactions are recorded is called a Journal. The journal is called the book of original entry, subsidiary book or book of prime entry. All the transactions are first entered in the journal in the order of their occurrence. Recording a transaction in the journal is known as journalizing. The form in which a transaction is recorded is called journal entry.

Format of a Journal

Date	Particulars	LF	Debit	Credit
			Amount (₹)	Amount (₹)

The journal has a column for recording the date of the transaction, the account titles which are entered in the 'Particulars' column, a column for debit amount entry and a column for credit amount entry. A brief explanation is also given in the 'Particulars' column, which is called 'Narration'. The Journal entry is recorded in terms of equal debit and credit to accounts affected by transactions being recorded. The 'LF' otherwise known as Ledger Folio column is meant for writing the number of the page in the ledger on which the particular transaction is posted.

Steps in Journalizing

1. Analyze the transactions and identify the two accounts that are being affected by the transaction.
2. Ascertain the nature of the accounts involved as real, personal or nominal.
3. Determine which rule of debit and credit is applicable for each of the accounts involved.
4. Ascertain the account to be debited and the account to be credited.
5. Write the name of the account to be debited along with the abbreviation "Dr" and on the same line against the name of the account in particulars column, the amount to be debited in the debit amount column is to be mentioned.
6. Write the name of the account to be credited in the next line preceded by the word "To" at a few spaces towards the right in the particulars column and the amount to be credited in the credit amount column against the name of the account.
7. Write a brief narration (a brief description of the transaction in the particulars column; narration usually begins with the prefix "Being").

Example

TMR Ltd., received ₹ 1,00,000 from Amit & Co., on 6-6-20xx

Journalize the above transaction in the books of TMR Ltd.

Step 1: The accounts involved in the above transaction are: (i) Cash account – money being received and (ii) Amit & Co., – the person paying the amount.

Step 2: The nature of the accounts: (i) Cash account is Real account, and (ii) Amit & Co., is Personal account.

Step 3 & 4: The rule to be applied in the case of Real account is 'debit what comes in and credit what goes out'. In the given transaction, Cash is coming in so Cash account should be debited.

The rule for personal account is 'debit the receiver, credit the giver'. In the above transaction, Amit & Co. is the giver, therefore credit Amit & Co.

Step 5, 6 & 7: The journal entry is recorded in the following way:

Journal of TMR Ltd.

Date	Particulars	LF	Debit (₹)	Credit (₹)
6.06.20xx	Cash a/c Dr. To Amit & Co. a/c (Being cash received from Amit & Co.)		1,00,000	 1,00,000

Illustration 2.1

Journalize the following transactions of January 20xx in the books of Dixit Enterprises:

Date (20xx)	Particulars
Jan. 1	Started business with a capital of ₹ 7, 50,000.
Jan. 2	Opened a bank account with State Bank of India for ₹ 2,00,000.
Jan. 3	Purchased goods from Tandon & Co. for cash ₹ 1,00,000.
Jan. 6	Purchased goods from Burman for ₹ 2,00,000.
Jan. 8	Goods returned to Mr. Burman ₹ 50,000.
Jan. 10	Paid ₹ 1,40,000 to Mr. Burman in full settlement of his dues.
Jan. 11	Paid Mr. Dharam, the landlord ₹ 50,000 towards rent by cheque.
Jan. 12	Withdrew cash for household expenses ₹ 60,000.
Jan. 14	Sold goods to Mr. Karan for cash ₹ 2,50,000.
Jan. 15	Sold goods to Mr. Dev on credit ₹ 1,00,000.
Jan. 17	Goods returned by Mr. Dev for ₹ 25,000.
Jan. 19	Received cash from Mr. Dev ₹ 70,000 in full settlement.
Jan. 21	Paid cartage on goods purchased ₹ 35,000.
Jan. 22	Paid for purchase of computer for office use ₹ 80,000.
Jan. 24	Purchased furniture for office purpose ₹ 1,00,000.
Jan. 26	Purchased furniture for re-sale ₹ 1,00,000.
Jan. 27	Sold furniture out of those meant for resale ₹ 1,50,000.
Jan. 29	Paid rent out of personal cash ₹ 40,000.
Jan. 30	Received commission from Johar ₹ 25,000 by cheque.
Jan. 31	Paid for Salaries ₹ 50,000

Solution

In the Books of Dixit Enterprises
Journal Entries

Date 20xx	Particulars		L.F	Debit ₹	Credit ₹
Jan. 1	Cash A/c	Dr.		7,50,000	
	To Capital A/c				7,50,000
	(Being cash invested in the business)				
Jan. 2	Bank A/c	Dr.		2,00,000	
	To Cash A/c				2,00,000
	(Being cash deposited in the Bank)				
Jan. 3	Purchases A/c	Dr.		1,00,000	
	To Cash A/c				1,00,000
	(Being goods purchased from Tandon & Co. for cash)				
Jan. 6	Purchases A/c	Dr.		2,00,000	
	To Burman A/c				2,00,000
	(Being goods purchased from Burman on credit)				
Jan. 8	Burman A/c	Dr.		50,000	
	To Returns outward A/c				50,000
	(Being goods returned to Burman)				
Jan. 10	Burman A/c	Dr.		1,50,000	
	To Cash A/c				1,40,000
	To Discount Received A/c				10,000
	(Being cash paid to Mr. Burman and received discount)				
Jan. 11	Rent A/c	Dr.		50,000	
	To Bank A/c				50,000
	(Being rent paid by cheque)				
Jan. 12	Drawings A/c	Dr.		60,000	
	To Cash				60,000
	(Being cash withdrawn for household expenses)				
Jan. 14	Cash A/c	Dr.		2,50,000	
	To Sales A/c				2,50,000
	(Being goods sold for cash)				
Jan. 15	Dev A/c	Dr.		1,00,000	
	To Sales A/c				1,00,000
	(Being goods sold to Dev on credit)				
Jan. 17	Returns Inward A/c	Dr.		25,000	
	To Dev A/c				25,000
	(Being goods returned by Dev)				
Jan. 19	Cash A/c	Dr.		70,000	
	Discount Allowed A/c	Dr.		5,000	
	To Dev A/c				75,000
	(Being cash received from Dev and discount allowed to him)				

Contd…

Date 20xx	Particulars		L.F	Debit ₹	Credit ₹
Jan. 21	Cartage Inward A/c	Dr.		35,000	
	To Cash A/c				35,000
	(Being cartage paid on goods purchased)				
Jan. 22	Computer A/c	Dr.		80,000	
	To Cash A/c				80,000
	(Being cash paid for purchase of computer)				
Jan. 24	Furniture A/c	Dr.		1,00,000	
	To Cash A/c				1,00,000
	(Being furniture purchased on cash for office)				
Jan. 26	Purchases A/c	Dr.		1,00,000	
	To Cash A/c				1,00,000
	(Being furniture purchased on cash for re-sale)				
Jan. 27	Cash A/c	Dr.		1,50,000	
	To Sales A/c				1,50,000
	(Being furniture meant for resale sold for cash)				
Jan. 29	Rent A/c	Dr.		40,000	
	To Capital A/c				40,000
	(Being rent paid out of personal cash)				
Jan. 30	Bank A/c	Dr.		25,000	
	To Commission A/c				25,000
	(Being commission received from Johar by cheque)				
Jan. 31	Salaries A/c	Dr.		50,000	
	To Cash A/c				50,000
	(Being the amount of salaries paid)				

Illustration 2.2

Special Transactions

Journalize the following transactions in the Books of Rakesh for the month of January 20xx

Date	Transactions
2.1.20xx	Withdrawn cash for personal use ₹ 2,500.
8.1.20xx	Withdrawn goods for personal use (Sale price ₹ 1,500, Cost ₹ 1,250).
9.1.20xx	Goods distributed to children in an orphanage (Sale price ₹ 2,000, Cost ₹ 1,700).
10.1.20xx	Goods distributed as free samples (Sale price ₹ 1,200, Cost ₹ 1,000).
11.1.20xx	Goods stolen (Sale price ₹ 1,000, Cost ₹ 800).
12.1.20xx	Goods destroyed by fire (Sale price ₹ 1,500, Cost ₹ 1,250).
12.1.20xx	Goods used in furnishing the office (Sale prices ₹ 2,000, Cost price ₹ 1,750).
25.1.20xx	₹ 250 payable by Rakesh was written-off as bad.
28.1.20xx	Recovered from Pramod half the amount, which was written-off as bad. ₹ 300 was written-off as bad earlier.

Solution

In the Books of Rakesh Journal Entries

Date	Particulars	L.F.	Debit ₹	Credit ₹
2.1.20xx	Drawings a/c Dr.		2,500	
	To Cash a/c			2,500
	(Being cash withdrawn for personal use)			
8.1.20xx	Drawings a/c Dr.		1,250	
	To Purchases a/c			1,250
	(Being goods withdrawn for personal use)			
9.1.20xx	Donation a/c Dr.		1,700	
	To Purchases a/c			1,700
	(Being goods distributed to the children in an orphanage)			
10.1.20xx	Sales Promotion a/c Dr.		1,000	
	To Purchases a/c			1,000
	(Being goods distributed as free samples)			
11.1.20xx	Loss by Theft a/c Dr.		800	
	To Purchases a/c			800
	(Being goods stolen)			
12.1.20xx	Loss by fire a/c Dr.		1,250	
	To Purchases a/c			1,250
	(Being goods destroyed by fire)			
12.1.20xx	Office furniture a/c Dr.		1,750	
	To Purchases a/c			1,750
	(Being goods used in furnishing the office)			
25.1.20xx	Bad Debts a/c Dr.		250	
	To Rakesh a/c			250
	(Being amount due from Rakesh written-off as bad)			
28.1.20xx	Cash a/c Dr.		150	
	To Bad Debts Recovered a/c			150
	(Being cash recovered out of an amount which was written-off as bad earlier)			

Compound Entry

Sometimes when recording a transaction, we realize that there may be more than two accounts affected on the same date for a particular transaction. Such transactions can be recorded by a single entry instead of two or more entries. Also when a number of transactions, which are of a similar or same nature with a particular party on the same date, are entered, a compound entry may be passed in the journal instead of several journal entries. This takes the following forms:

i. A single debit entry (a particular account) with several credit entries involving several accounts.

ii. Several debit entries involving several accounts and a single credit entry involving one account.

iii. Several debit entries involving several accounts and several credit entries involving several accounts.

In all these cases, total of debits is always equal to total of credits and the fundamental equation is balanced.

Illustration 2.3

Journalize the following transactions:

Date	Transaction
2.1.20xx	Purchased goods from Arora at the list price of ₹ 8,000. A trade discount of 10% was allowed.
8.1.20xx	Sold goods to Flora at a list price of ₹ 4,000. A trade discount of 5% was allowed.
15.1.20xx	Received a cheque from Flora for ₹ 3,600 in full settlement.
20.1.20xx	Paid Arora ₹ 7,000 by cheque in full settlement.
25.1.20xx	Shyam is declared insolvent and received from his official receiver, a first and final dividend of 60 paise in a rupee against a debt of ₹ 2,500.

Solution

Journal Entries

Date	Particulars		L.F.	Debit ₹	Credit ₹
2.1.20xx	Purchases a/c	Dr.		7,200	
	To Arora a/c				7,200
	(Being goods purchased from Arora for ₹ 8,000 at a trade discount of 10%)				
8.1.20xx	Flora a/c	Dr.		3,800	
	To Sales a/c				3,800
	(Being goods sold to Flora for ₹ 4,000 at a trade discount of 5%)				
15.1.20xx	Bank a/c	Dr.		3,600	
	Discount Allowed a/c	Dr.		200	
	To Flora a/c				3,800
	(Being cheque received from Flora in full settlement)				
20.1.20xx	Arora a/c	Dr.		7,200	
	To Bank a/c				7,000
	To Discount received a/c				200
	(Being cheque paid to Arora in full settlement)				
25.1.20xx	Cash a/c	Dr.		1,500	
	Bad Debts a/c	Dr.		1,000	
	To Shyam a/c				2,500
	(Being 60 paise in a rupee received from Shyam in full settlement of dues)				

2.9 Ledger – Process of Posting and Balancing

Journal is a chronological record of business transactions. It fails to give details of similar transactions together at one place. Thus, to have the consolidated information at one place separate accounts are prepared in the ledger. Thus, ledger is a collection of various accounts of the enterprise. Each account contains a summary of all transactions recorded in the journal. It can be viewed as a summary of all events and transactions in that particular account. The ledger is often called the book of final entry and more often the principal book as the final information pertaining to the financial position of the business emerges only from the ledger accounts.

The transactions recorded in the books of original entry are transferred to the ledger. The process of transferring entries from the journal to the ledger is called ledger posting. Posting involves transferring of debits and credits made in journal entries of individual accounts.

Format of Ledger

Dr. Cr.

Date	Particulars	JF	Amount	Date	Particulars	JF	Amount

The date column records the date, month and year of transaction. The particulars column records the title of the other account in the transaction effected. The title of the accounts used in posting is exactly the same as used in the journal. It is customary to use the words 'To' and 'By' when posting transactions in the ledger. The word 'To' precedes the title of the account on the debit side and the word 'By' precedes the title of the account on the credit side. The JF column is used to quote the folio number of the journal from where the posting to the ledger took place. This facilitates a cross reference between the journal and the ledger.

Steps in Ledger Posting

The posting to be done on the debit side is as follows:

- Enter the date of the transaction on the debit side of the relevant account.
- Record the title of the account credited in the Journal in the particulars column with the word 'To' preceding it.
- Record the page number of the journal (being the source) in the JF column of the ledger (where it is posted) and the page number of the ledger in the LF column in the Journal.
- Record the debit side amount column with the amount mentioned in the journal against the title of the account under consideration.

The posting to be done on the credit side of the relevant ledger account is the same as above except that in particulars column, the title of the account is preceded by the word 'By'.

Let us see how a particular transaction entered in the Journal is posted to the Ledger.

On 1.4.20xx received ₹ 10,000 from Ghosh, a customer.

Journal

Date 20xx	Particulars	LF	Debit (₹)	Credit (₹)
April 1	Cash A/c Dr. To Mr. Ghosh A/c (Being cash received from Mr. Ghosh on account)		10,000	10,000

Ledger Accounts

Dr. **Cash Account** Cr.

Date 20xx	Particulars	JF	Amount (₹)	Date	Particulars	JF	Amount (₹)
April 1	To Ghosh A/c		10,000				

Dr. **Ghosh's Account** Cr.

Date	Particulars	JF	Amount (₹)	Date 20xx	Particulars	JF	Amount (₹)
				April 1	By Cash A/c		10,000

Balancing of Ledger

After the posting has been completed accounts are balanced periodically. Balancing of an account means to make the total of amounts column appearing on the debit and the credit side equal to each other. If the debit side is bigger than the credit side the difference between the two is known as debit balance, likewise if the credit side is more than the debit side the difference is known as credit balance.

- In the case of Debit balance, the difference is placed on the credit side with 'By Balance c/d' implying the balance is being carried down to the next period.
- In case of a Credit balance, the difference is placed on the Debit side with 'To Balance c/d' implying the balance is being carried down to the next accounting period. [Both carried down (c/d) or carried forward (c/f) can be used].
- The next step is to total both the debit side and the credit side and enclose the total between two lines.

In the next accounting period, the closing balance of the earlier accounting period becomes the opening balance. The closing debit balance is posted as credit balance on the credit side as 'By Balance b/f' as opening in the current period.

The Closing Credit Balance is carried forward on the Debit side of the Account as 'To Balance b/f'.

The differences between journal and ledger are shown in Exhibit 2.1 below:

Exhibit 2.1: Table showing differences between Journal and Ledger

BASIS FOR COMPARISON	JOURNAL	LEDGER
Meaning	It is the book in which the transactions are recorded as and when they arise	This book is used to classify and transfer the transactions to separate accounts.
What is it?	It is a subsidiary book	It is a principal book.
Status	Book of initial entry.	Book of final entry.
Process	The process of recording transactions into Journal is known as Journalizing.	The process of transferring entries from the journal to the ledger is known as Posting.
How transactions are recorded?	Chronologically	Account-wise
Debit and Credit	Columns	Sides
Narration	Is usually given	Not necessary.
Balancing	Balancing of Journal is not required	Balancing of individual accounts is a must as it leads to preparation of trial balance.

Source: http://keydifferences.com/difference-between-journal-and-ledger.html#ixzz4VQkGx5im

Now let us take up the transactions of a business during a month and study how they will be recorded in the journal and posted into the General Ledger.

Illustration 2.4

During January 20xx, Narayan transacted the following business:

Date 20xx	Particulars	₹
Jan. 1	Commenced business with cash	40,000
Jan. 2	Cash deposited into bank	15,000
Jan. 3	Purchased goods on credit from Shyam	30,000
Jan. 5	Purchased goods for cash	5,000
Jan. 6	Bought goods from Gopalan	20,000
Jan. 7	Sold goods to Murthy	25,000
Jan. 9	Purchased furniture for office use from Tumbo & Co., on credit	10,000
Jan. 10	Bought machinery for cash	15,000
Jan. 11	Received commission (in cash)	6,000
Jan. 13	Goods returned to Shyam	2,000
Jan. 14	Paid to Shyam by cheque ₹ 5,000; discount received ₹ 100	
Jan. 15	Goods sold to Kamal	10,000
Jan. 17	Withdrew from Bank for office use	2,000
Jan. 19	Goods returned by Kamal	1,000

Contd…

Date 20xx	Particulars	₹
Jan. 20	Cheque received from Kamal after allowing a discount of ₹ 200	5,000
Jan. 21	Cash withdrawn from bank for personal use	2,000
Jan. 22	Goods sold for cash	5,000
Jan. 24	Bought goods for cash and paid by cheque	1,000
Jan. 25	Paid salaries	2,000
Jan. 28	Paid rent by cheque	3,000
Jan. 31	Drew cash for personal use	1,000

Solution

Journal Entries

Date 20xx	Particulars		Debit ₹	Credit ₹
Jan. 1	Cash Account	Dr.	40,000	
	To Capital Account			40,000
	(Being the cash brought into business as capital)			
	(Logic: Cash is a real account. Debit what comes in. Proprietor's capital is a personal account. Credit the giver.)			
Jan. 2	Bank Account	Dr.	15,000	
	To Cash Account			15,000
	(Being cash deposited into the bank)			
	(Logic: Bank is a personal account. Debit the benefit receiver. Cash is a real account. Credit what goes out.)			
Jan. 3	Purchases Account	Dr.	30,000	
	To Shyam Account			30,000
	(Being the goods purchased on credit)			
	(Logic: A purchase of goods is an expense. Nominal account rule is debit all expenses. Shyam is a personal account. Credit the giver.)			
Jan. 5	Purchases Account	Dr.	5,000	
	To Cash Account			5,000
	(Being the goods purchased for cash)			
	(Logic: A purchase of goods is an expense. Nominal account rule is Debit all expenses. Cash is a real account. Credit what goes out.)			
Jan. 6	Purchases Account	Dr.	20,000	
	To Gopalan Account			20,000
	(Being the goods bought from Gopalan on credit)			
	(Logic: Purchases is a nominal account. Debit all expenses and losses. Gopalan is a personal account. Credit the giver.)			
Jan. 7	Murthy Account	Dr.	25,000	
	To Sales Account			25,000
	(Being the goods sold to Murthy)			
	(Logic: Murthy is a personal account. Debit the receiver. Sales is a nominal account. Credit all incomes and gains.)			

Contd…

Date 20xx	Particulars	Debit ₹	Credit ₹
Jan. 9	Furniture Account Dr. To Tumbo & Co Account (Being the furniture purchased for office use on credit) (Logic: Furniture is a real account. Debit what comes in. Tumbo & Co is a personal account. Credit the giver.)	10,000	 10,000
Jan. 10	Machinery Account Dr. To Cash Account (Being the cash paid for purchase of machinery) (Logic: Machinery is a real account. Debit what comes in. Cash is a real account. Credit what goes out.)	15,000	 15,000
Jan. 11	Cash Account Dr. To Commission Received a/c (Being the commission received) (Logic: Cash is a real account. Debit what comes in. Commission (received) is a nominal account. Credit all incomes.)	6,000	 6,000
Jan. 13	Shyam Account Dr. To Purchases Returns Account (Being goods returned to Shyam) (Logic: Shyam is a personal account. Debit the receiver. Purchase Returns is a nominal account. Credit all incomes and gains.)	2,000	 2,000
Jan. 14	Shyam Account Dr. To Bank Account To Discount (Received) Account (Being the amount paid to Shyam by cheque) (Logic: Shyam is a personal account. Debit the receiver. Bank is a personal account Credit the giver; Discount is a nominal account. Credit all incomes and gains.)	5,100	 5,000 100
Jan. 15	Kamal Account Dr. To Sales Account (Being goods sold to Kamal on credit) (Logic: Kamal is a personal account. Debit the receiver. Sales account is a nominal account. Credit all incomes and gains.)	10,000	 10,000
Jan. 17	Cash Account Dr. To Bank Account (Being cash withdrawn from bank) (Logic: Cash is a real account. Debit what come in. Bank account is a personal account. Credit the giver.)	2,000	 2,000
Jan. 19	Sales Returns Account Dr. To Kamal Account (Being the goods returned by Kamal) (Logic: Sales return is a nominal account. Debit all expenses. Kamal is a personal account. Credit the giver.)	1,000	 1,000

Contd…

Date 20xx	Particulars		Debit ₹	Credit ₹
Jan. 20	Bank Account	Dr.	5,000	
	Discount (Allowed) Account	Dr.	200	
	To Kamal Account			5,200
	(Being the amount cheque received from Kamal)			
	(Logic: Bank is a personal account. Debit the receiver. Discount is a nominal account. Debit all expenses and losses. Kamal is a personal account. Credit the giver.)			
Jan. 21	Drawings Account	Dr.	2,000	
	To Bank Account			2,000
	(Being cash withdrawn from bank for personal use)			
	(Logic: Drawings is a personal account. Debit the receiver. Bank is a personal account. Credit the giver.)			
Jan. 22	Cash Account	Dr.	5,000	
	To Sales Account			5,000
	(Being the goods sold for cash)			
	(Logic: Cash is a real account. Debit what comes in. Sales is a nominal account. Credit all incomes.)			
Jan. 24	Purchases Account	Dr.	1,000	
	To Bank Account			1,000
	(Being the goods purchased and paid by cheque)			
	(Logic: Purchases is a nominal account. Debit all expenses. Bank is a personal account. Credit the giver.)			
Jan. 25	Salaries Account	Dr.	2,000	
	To Cash Account			2,000
	(Being the amount paid as salaries)			
	(Logic: Salaries is a nominal account. Debit all expenses. Cash is a real account. Credit what goes out.)			
Jan. 28	Rent Account	Dr.	3,000	
	To Bank Account			3,000
	(Being the rent paid)			
	(Logic: Rent is a nominal account. Debit all expenses. Bank is a personal account. Credit the giver.)			
Jan. 31	Drawings Account	Dr.	1,000	
	To Cash Account			1,000
	(Being the cash drawn for personal use)			
	(Logic: Drawings is a personal account. Debit the receiver. Cash is a real account. Credit what goes out.)			

General Ledger

Dr. **Cash Account** Cr.

Date 20xx	Receipts	JF	Amount ₹	Date 20xx	Payments	J F	Amount ₹
Jan. 1	To Capital a/c		40,000	Jan. 2	By Bank a/c		15,000
Jan. 11	To Commission a/c		6,000	Jan. 5	By Purchases a/c		5,000
Jan. 17	To Bank a/c		2,000	Jan. 10	By Machinery a/c		15,000
Jan. 22	To Sales a/c		5,000	Jan. 25	By Salaries a/c		2,000
				Jan.31	By Drawings a/c		1,000
				Jan.31	By Balance c/d		15,000
			53,000				53,000
Feb. 1	To Balance b/d		15,000				

Dr. **Bank Account** Cr.

Date 20xx	Particulars	JF No.	Amount ₹	Date 20xx	Particulars	JF No.	Amount ₹
Jan. 2	To Cash a/c		15,000	Jan.14	By Shyam a/c		5,000
Jan. 20	To Kamal a/c		5,000	Jan.17	By Cash a/c		2,000
				Jan.21	By Drawings a/c		2,000
				Jan.24	By Purchases a/c		1,000
				Jan.28	By Rent a/c		3,000
				Jan.31	By Balance c/d		7,000
			20,000				20,000
Feb. 1	To Balance b/d		7,000				

Dr. **Capital Account** Cr.

Date 20xx	Particulars	JF No.	Amount ₹	Date 20xx	Particulars	JF No.	Amount ₹
Jan.31	To Balance c/d		40,000	Jan.1	By Cash a/c		40,000
			40,000				40,000
				Feb.1	By Balance b/d		40,000

Dr. **Purchases Account** Cr.

Date 20xx	Particulars	JF No.	Amount ₹	Date 20xx	Particulars	JF No.	Amount ₹
Jan. 3	To Shyam a/c		30,000	Jan.31	By Balance c/d		56,000
Jan. 5	To Cash a/c		5,000				
Jan.6	To Gopalan a/c		20,000				
Jan.24	To Bank a/c		1,000				
			56,000				56,000
Feb. 1	To Balance b/d		56,000				56,000

Contd…

Dr. **Shyam Account** Cr.

Date 20xx	Particulars	JF No.	Amount ₹	Date 20xx	Particulars	JF No.	Amount ₹
Jan. 13	To Purchases returns a/c		2,000	Jan.3	By Purchases a/c		30,000
Jan.14	To Bank a/c		5,000				
	To D/R a/c		100				
Jan. 31	To Balance c/d		22,900				
			30,000				30,000
				Feb.1	By Balance b/d		22,900

Dr. **Sales Account** Cr.

Date 20xx	Particulars	JF No.	Amount ₹	Date 20xx	Particulars	JF No.	Amount ₹
Jan. 31	To Balance c/d		40,000	Jan. 7	By Murthy a/c		25,000
				Jan. 15	By Kamal		10,000
				Jan. 22	By Cash		5,000
			40,000				40,000
				Feb. 1	By Balance b/d		40,000

Dr. **Gopalan Account** Cr.

Date 20xx	Particulars	JF No.	Amount ₹	Date 20xx	Particulars	JF No.	Amount ₹
Jan. 31	To Balance c/d		20,000	Jan. 6	By Purchases a/c		20,000
			20,000				20,000
				Feb. 1	By Balance b/d		20,000

Dr. **Murthy Account** Cr.

Date 20xx	Particulars	JF No.	Amount ₹	Date 20xx	Particulars	JF No.	Amount ₹
Jan. 7	To Sales a/c		25,000	Jan.31	By Balance c/d		25,000
			25,000				25,000
Feb. 1	To Balance b/d		25,000				

Dr. **Furniture Account** Cr.

Date 20xx	Particulars	JF No.	Amount ₹	Date 20xx	Particulars	JF No.	Amount ₹
Jan. 9	To Tumbo & Co. a/c		10,000	Jan.31	By Balance c/d		10,000
			10,000				10,000
Feb. 1	To Balance b/d		10,000				

Dr. **Tumbo & Co. Account** Cr.

Date 20xx	Particulars	JF No.	Amount ₹	Date 20xx	Particulars	JF No.	Amount ₹
Jan. 31	To Balance c/d		10,000	Jan. 9	By Furniture a/c		10,000
			10,000				10,000
				Feb. 1	By Balance b/d		10,000

Dr. **Machinery Account** Cr.

Date 20xx	Particulars	JF No.	Amount ₹	Date 20xx	Particulars	JF No.	Amount ₹
Jan. 10	To Cash a/c		15,000	Jan.31	By Balance c/d		15,000
			15,000				15,000
Feb. 1	To Balance b/d		15,000				

Dr. **Commission Account** Cr.

Date 20xx	Particulars	JF No.	Amount ₹	Date 20xx	Particulars	JF No.	Amount ₹
Jan. 31	To Balance c/d		6,000	Jan. 11	By Cash a/c		6,000
			6,000				6,000
				Feb. 1	By Balance b/d		6,000

Dr. **Purchase Returns Account** Cr.

Date 20xx	Particulars	JF No.	Amount ₹	Date 20xx	Particulars	JF No.	Amount ₹
Jan. 31	To Balance c/d		2,000	Jan. 11	By Shyam a/c		2,000
			2,000				2,000
				Feb. 1	By Balance b/d		2,000

Dr. **Kamal Account** Cr.

Date 20xx	Particulars	JF No.	Amount ₹	Date 20xx	Particulars	JF No.	Amount ₹
Jan. 15	To Sales a/c		10,000	Jan.19	By Sales Returns a/c		1,000
				Jan.20	By Bank		5,000
					By D/A a/c		200
				Jan.31	By Balance c/d		3,800
			10,000				10,000
Feb. 1	To Balance b/d		3,800				

Dr. **Sales Returns Account** Cr.

Date 20xx	Particulars	JF No.	Amount ₹	Date 20xx	Particulars	JF No.	Amount ₹
Jan. 19	To Kamal a/c		1,000	Jan.31	By Balance c/d		1,000
			1,000				1,000
Feb. 1	To Balance b/d		1,000				

Dr. **Drawings Account** Cr.

Date 20xx	Particulars	JF No.	Amount ₹	Date 20xx	Particulars	JF No.	Amount ₹
Jan. 21	To Bank a/c		2,000	Jan.31	By Balance c/d		3,000
Jan.31	To Cash a/c		1,000				
			3,000				3,000
Feb. 1	To Balance b/d		3,000				

Dr. **Salaries Account** Cr.

Date 20xx	Particulars	JF No.	Amount ₹	Date 20xx	Particulars	JF No.	Amount ₹
Jan. 25	To Cash a/c		2,000	Jan.31	By Balance c/d		2,000
			2,000				2,000
Feb. 1	To Balance b/d		2,000				

Dr. **Rent Account** Cr.

Date 20xx	Particulars	JF No.	Amount ₹	Date 20xx	Particulars	JF No.	Amount ₹
Jan. 28	To Bank a/c		3,000	Jan.31	By Balance c/d		3,000
			3,000				3,000
Feb. 1	To Balance b/d		3,000				

Dr. **Discount Allowed Account** Cr.

Date 20xx	Particulars	JF No.	Amount ₹	Date 20xx	Particulars	JF No.	Amount ₹
Jan. 20	To Kamal a/c		200	Jan.31	By Balance c/d		200
			200				200
Feb. 1	To Balance b/d		200				

Contd.

Dr. **Discount Received Account** Cr.

Date 20xx	Particulars	JF No.	Amount ₹	Date 20xx	Particulars	JF No.	Amount ₹
Jan. 31	To Balance c/d		100	Jan. 14	By Shyam a/c		100
			100				100
				Feb. 1	By Balance b/d		100

Note: Some traders, instead of maintaining two accounts, maintain one discount account. In that case, discount allowed is debited and discount received is credited to discount account.

Check Your Progress - 1

1. Journal is a
   a. Book of original entry
   b. Classified summary of specific transactions
   c. Temporary record
   d. Book of secondary entry
   e. Book of final entry
2. The process of transferring the corresponding debit and credit items recorded in journal to its corresponding individual accounts is known by which term?
   a. Journalizing
   b. Posting
   c. Accounting
   d. Finalizing
   e. Adjusting
3. While observing a company's balance sheet it was found that certain additions were made to the block of assets. How will it affect the flow of funds in the Balance sheet of the company?
   a. Increase in Owner's Equity
   b. Decrease in Outsider's Liability
   c. Increase in Outsider's Liability
   d. Increase in Assets
   e. Decrease in Owner's Liability
4. Payment of salary is recorded by
   a. Debiting salary a/c, crediting cash a/c
   b. Debiting cash a/c, crediting salary a/c
   c. Debiting employee a/c, crediting cash a/c
   d. Debiting cash a/c, crediting employee a/c
   e. Debiting employee a/c, crediting salary a/c

5. Goods returned by customers is entered by
   a. Debiting purchases account and crediting customer's account
   b. Debiting customer's account and crediting sales account
   c. Debiting sales returns account and crediting customer's account
   d. Debiting customer's account and crediting goods account
   e. Debiting purchases account and crediting sales account

2.10 Sub-Journals or Subsidiary Books or Special Journals

The growth in business and the consequent increase in the number of transactions led to complexity in recording all transactions in the journal. Therefore, to facilitate recording of similar transactions, large concerns maintain special journals also known as subsidiary books. For cash transactions, a cashbook is maintained. For credit transactions, purchases book, sales book, purchases returns book, sales returns book are maintained. Now the journal, known as Journal Proper is restricted to recording special entries like opening, closing, transfer and rectification entries, which do not find a place in other subsidiary books.

2.10.1 Sales Journal

The sales journal is also called the Sales Day book. Where goods are sold for cash, the entry is recorded in the Cash Book. However, when goods are sold on credit, the transaction is recorded in the Sales Journal. Hence, the Sales Journal is restricted to recording the sale of goods on credit basis only. The Sales Journal, also, does not record sale of any asset other than the sale of merchandise. The entries in the Sales Day book are made with reference to the invoices raised against the customers for the sale of goods. The details as to the amount of trade discount or quantity discount are also filled in the Sales Journal. Periodically, this book is totaled and the total amount is posted on the credit side of the Sales a/c in the general ledger. However, in the personal ledger, postings are made on the date of transaction.

Format of the Sales Journal

Date	Outward Invoice Number	Name of the Customer	LF	Details ₹	Amount ₹

2.10.2 Purchase Journal

The Purchase Journal is also called the Bought Book or Purchases Day Book. Where the goods are purchased for cash the entry is recorded in the Cash Book.

However, when goods are purchased on credit, the transaction is recorded in the Purchase Journal. Hence, the Purchase Journal is restricted to recording purchase of goods on credit basis only. The Purchase Journal, also, does not record purchase of any asset other than the purchase of merchandise the enterprise deals in. The entries in the Purchase Day Book are made with reference to the purchase invoice also known as inward invoice. The details as to the amount of trade discount, or quantity discount granted by the supplier are also filled in the Purchase Journal. Periodically, this book is totalled and the total amount is posted on the debit side of the Purchases a/c in the general ledger. But in the personal ledger, postings are made on the date of transaction.

Format of the Purchase Journal

Date	Inward Invoice Number	Name of the Supplier	LF	Details ₹	Amount ₹

2.10.3 Sales Returns Journal

Sales Returns Journal is also called Return Inwards Book. When goods are sold on credit the initial entry is made in the Sales Journal. On the return of such goods (sold on credit) it is recorded in the Sales Returns Journal. The Sales Return Journal, does not record sales return of any asset other than the sales return of merchandise. The entries in the Sales Return Journal are made with reference to the credit notes issued to the customers. Periodically, this book is totalled and the total amount is posted on the debit side of the Sales Returns a/c in the general ledger. But in the personal ledger, postings are made as on the date of transaction.

Credit Note: In case of sales returns, a credit note is prepared by the seller and sent to the buyer/customer informing him that his account has been credited with the amount of the value of goods returned. It is also referred to as credit memo.

Format of Sales Return Journal

Date	Credit Note No.	Name of the Customer	LF	Details ₹	Amount ₹

2.10.4 Purchase Returns Journal

Purchase Returns Journal is also called the Return Outwards Book. When goods are purchased on credit the initial entry is made in the Purchase Journal. On the return of such goods (purchased on credit), it is recorded in the Purchase Returns Journal. The Return outwards book does not record the purchase return of any asset other than the purchase return of merchandise. The entries on the Purchase Returns Journal are made with reference to the debit notes issued to the supplier. Periodically, this book is totalled and the total amount is posted on the credit side of the Purchase Returns a/c in the general ledger. But in the personal ledger, postings are made as on the date of transaction.

Debit Note: In case of purchase returns transaction, the buyer prepares a debit note and sends it to the seller indicating the fact that the seller's account has been debited with the amount of goods returned to the seller.

Format of Purchase Return Journal

Date	Debit Note No.	Name of the Supplier	LF	Details ₹	Amount ₹

Many of the enterprises also maintain the Bills Receivable Journal and Bills Payable Journal.

2.10.5 Bills Receivable Journal

The 'Bills Receivable' of an enterprise is used to record all promissory notes given or Bills of Exchange accepted by customers in respect of amounts due from them. According to Section 5 of the **Negotiable Instruments Act**,1881, a "**bill of exchange**" is an instrument in writing containing an unconditional order, signed by the maker, directing a certain person to pay a certain sum of money only to, or to the order of, a certain person or to the bearer of the instrument. A bill of exchange is an asset to the seller and is known as 'Bills Receivable'.

Format of Bills Receivable Book

S. No.	Date	From whom received	Acceptor	Date of Bill	Term	Date of Maturity	Amount ₹	How Disposed

2.10.6 Bills Payable Journal

A bill of exchange represents a liability to the drawee and hence is referred to as "Bills Payable". The Bills Payable journal is used to record all promissory notes given or Bills of Exchange accepted by the business in respect of amounts owed to its suppliers.

Format of Bills Payable Book

S. No.	Date	Name of the Drawer	Payee	Date of the Bill	Term	Date of Maturity	Where Payable	Amount ₹	Remarks

2.10.7 Cash Journal

Cash book is a Special Journal in which all cash transactions are recorded directly. The cash book is of a special nature. It serves the purpose of a subsidiary book as well as a ledger. The cash book qualifies as a subsidiary book – it is the book of original entry where the transactions are directly recorded from the source documents. It also qualifies as a ledger in the sense that the account is balanced at the end of the accounting period facilitating the preparation of trial balance. It resembles a ledger with a debit and credit side, and the balance represents cash on hand at the end of the accounting period. Since the cash book serves the purpose as a ledger too, no separate cash account is opened.

Types of Cash Book

The cash book can be classified into four types depending on the necessity of the user. The different types of cash book are:

- Simple Cash book
- Double Column Cash book
- Three Column Cash book
- Petty Cash book

Simple Cash Book

As already mentioned a cash book, like a ledger, has two sides – the debit side and the credit side. All the cash receipts are entered on the debit side and the cash payments are entered on the credit side. The simple cash book is also called a single column cash book as there is only one 'Amount' column on each side.

Format of Simple Cash Book

Simple Cash Book

Dr. Cr.

Date	Particulars	LF	Amount (₹)	Date	Particulars	LF	Amount (₹)

Double Column Cash Book

This cash book is an extension of simple cash book. It is also called a two column cash book. It has two amount columns – one to record the amount of cash and the other to record the amount of discount. The discount column is also maintained to record the discount involved in the settlement of debtors and creditors.

Trade Discount and Cash Discount

Here it is important to make a distinction between trade discount and cash discount.

A trade discount is granted by a supplier from the list price as a trade practice or to promote sale, at the time of the purchase or sale itself. Hence, it is shown as a reduction in the invoice itself and does not require to be posted. Hence, no ledger account is opened in the case of trade discount. A cash discount is granted by a supplier from the invoice price in consideration of immediate payment or payment within stipulated period. Hence such deduction is not shown in the invoice. The discount amount is recorded in the discount column of the cash book where a double column cash book is prevalent.

When cash is received from debtor in final settlement, it is recorded in the cash column and cash discount allowed is accounted for as an expense in the discount column (both on the debit side). When cash is paid to a creditor in final settlement, cash paid is recorded in the cash column and cash discount received or earned is accounted for as an income in the discount column (both on the credit side).

At the end of the period only the cash column is balanced. The discount is not balanced but merely totalled. The total discount on the credit side of the double column cash book, being discount received, is credited to the discount account. The total amount of discount on the debit side of the cash book, being discount allowed, is debited to the discount account. Sometimes, firms also maintain double column cash book with cash and bank columns instead of cash and discount columns.

Format of the Double Column Cash Book (with cash and discount columns)

Dr. Cr.

Date	Particulars	LF	Discount Allowed (₹)	Cash Amount (₹)	Date	Particulars	LF	Discount Received (₹)	Cash Amount (₹)

Format of the Double Column Cash Book (with cash and bank columns)

Dr. Cr.

Date	Particulars	L F	Cash (₹)	Bank (₹)	Date	Particulars	LF	Cash (₹)	Bank (₹)

Illustration 2.5

Compile cash book with discount column from the following transactions for the month of March, 20xx:

Date	Particulars
1.3.20xx	Mr. Ganesh commenced business with cash ₹ 65,000
3.3.20xx	Bought goods for cash ₹ 6,850
4.3.20xx	Paid Mr. Mohan cash ₹ 950; discount was allowed thereon ₹ 50
6.3.20xx	Deposited in bank ₹ 40,000
6.3.20xx	Paid for office furniture by cash ₹ 4,650
9.3.20xx	Sold goods for cash ₹ 30,000
12.3.20xx	Paid wages by cash ₹ 1,200
13.3.20xx	Paid for stationery ₹ 400
15.3.20xx	Sold goods for cash ₹ 25,000
17.3.20xx	Paid for miscellaneous expenses ₹ 450
19.3.20xx	Received cash from Mr. Tilak 4,850; Allowed him discount ₹ 150
21.3.20xx	Purchased a radio set for ₹ 2,500 for personal use
22.3.20xx	Paid salary ₹ 4,000
25.3.20xx	Paid rent ₹ 900
28.3.20xx	Paid electricity bill ₹ 350
29.3.20xx	Paid advertising expenses ₹ 400
31.3.20xx	Paid into bank ₹ 25,000

Solution

Dr. **Cash Book** Cr.

Date	Particulars	LF	Discount ₹	Cash ₹	Date	Particulars	L.F	Discount ₹	Cash ₹
1.3.20xx	To Capital a/c			65,000	3.3.20xx	By Purchases a/c			6,850
9.3.20xx	To Sales a/c			30,000	4.3.20xx	By Mohan a/c		50	950

Date	Particulars	LF	Discount ₹	Cash ₹	Date	Particulars	L.F	Discount ₹	Cash ₹
15.3.20xx	To Sales a/c			25,000	6.3.20xx	By Bank a/c			40,000
19.3.20xx	To Tilak a/c		150	4,850	6.3.20xx	By Office furniture a/c			4,650
					12.3.20xx	By Wages a/c			1,200
					13.3.20xx	By Stationery a/c			400
					17.3.20xx	By Miscellaneous expenses a/c			450
					21.3.20xx	By Drawings a/c			2,500
					22.3.20xx	By Salary a/c			4,000
					25.3.20xx	By Rent a/c			900
					28.3.20xx	By Electricity a/c			350
					29.3.20xx	By Advertising a/c			400
					31.3.20xx	By Bank a/c			25,000
					31.3.20xx	By Balance c/d			37,200
			150	1,24,850				50	1,24,850
1.4.20xx	To balance b/d			37,200					

Three Column Cash Book

With the development of banking sector, bank instruments are used for receipt and payment, transfer or other purposes. This necessitated an additional column for bank transactions and hence the three-column cash book came into existence. This cash book has three amount columns - one for the cash, one for bank and one for discount. All transactions involving cash receipts, deposits into bank and discount allowed is recorded on the debit side of the book and the cash payments, withdrawals from bank and discount received is recorded on the credit side of the book.

Three-column cash book performs the function of a journal and ledger with regard to the cash and bank transactions.

Format of three-column cash book

Dr. Cr.

Date	Particulars	LF	Discount (₹)	Cash (₹)	Bank (₹)	Date	Particulars	LF	Discount (₹)	Cash (₹)	Bank (₹)

A three column cash book requires the recording of ‘contra entries’.

Contra Entries

An entry, which is to be made on both sides of the cash book, is called a contra entry. In a three-column cash book, cash and bank columns are maintained simultaneously. If a transaction affects cash account and bank account simultaneously, entry for recording the transaction is called a contra entry. For contra entries no posting is required because the double entry is completed in the cash book itself. For example, cash deposited in bank and cash withdrawn from bank affects cash and bank account only. Both aspects of these transactions are recorded in cash column and bank column on the debit and credit side of the cash book. No ledger posting is required, because both aspects of the transaction are recorded in the cash book itself. This fact is indicated in the cash book by writing ‘C’ in ledger folio column.

Illustration 2.6

Prepare a Triple Column Cash book from the following transactions of Madona Enterprises for the month of March, 20xx and bring down the balance at the end of the month:

Date	Particulars	₹
01.3.20xx	Cash-in-hand	2,500
	Cash at bank	10,000
02.3.20xx	Paid into bank	1,000
05.3.20xx	Bought furniture and issued cheque	2,000
08.3.20xx	Purchased goods for cash	500
12.3.20xx	Received cash from Mohinder	980
	Discount allowed to him	20
14.3.20xx	Cash Sales	4,000
16.3.20xx	Paid to Amaranth by cheque	1,450
	Discount received	50
19.3.20xx	Paid into Bank	400
23.3.20xx	Withdrawn from Bank for private expenses	600
24.3.20xx	Received cheque from Patel	1,430
	allowed him discount	20
28.3.20xx	Withdrawn cash from bank for office use	2,000
30.3.20xx	Paid rent by cheque	800

Solution

Dr. **Cash Book** Cr.

Date	Particulars	LF	Discount Allowed (₹)	Cash (₹)	Bank (₹)	Date	Particulars	LF	Discount Received (₹)	Cash (₹)	Bank (₹)
1.3.20xx	To Balance b/f			2,500	10,000	2.3.20xx	By Bank a/c	C	–	1,000	–
2.3.20xx	To Cash a/c	C			1,000	5.3.20xx	By Furniture a/c		–	–	2,000
12.3.20xx	To Mohinder a/c		20	980	–	8.3.20xx	By Purchases a/c		–	500	–
14.3.20xx	To Sales a/c			4,000	–	16.3.20xx	By Amaranth a/c		50	–	1,450
19.3.20xx	To Cash	C			400	19.3.20xx	By Bank a/c	C	–	400	–
24.3.20xx	To Patel a/c		20		1,430	23.3.20xx	By Drawings a/c		–	–	600
28.3.20xx	To Bank	C		2,000		28.3.20xx	By Cash a/c	C	–	–	2,000
						30.3.20xx	By Rent a/c		–	–	800
						30.3.20xx	By Balance c/d		–	7,580	5,980
			40	9,480	12,830				50	9,480	12,830
1.4.20xx	To Balance b/d			7,580	5,980						

Petty Cash Book

Many enterprises establish a petty cash fund to meet small day-to-day transactions of money. The responsibility of operating this system is entrusted to a person who is designated as the petty cashier. He generally maintains a petty cash book to record the petty cash transactions.

In the Petty Cash system, petty expenses will be recorded in the petty cash book. This avoids recording of too many transactions in the main cash book. There are two systems of maintaining the petty cash book. One is the imprest system, under which at the end of the period the head cashier reimburses the amount expended by the petty cashier from the funds. Under the Non-imprest system, the head cashier may give the petty cashier more or less than the amount spent.

The petty cash book can be maintained like a cash book. This method of maintaining the cash book is called simple cash book. Another method of maintaining the cash book is called the analytical petty cash book. In analytical petty cash book, separate columns are used to record commonly occurring expenses such as postage, travelling, stationery, carriage expenses, etc. At the end of the period, all the heads of expenses are totalled and the total is posted to their respective ledger accounts.

When petty cash is given to the petty cashier for disbursements, entry is made on the credit side of the main cash book as ‘By Petty Cash a/c’ and the same is recorded on the debit side of the petty cash book.

Format of Petty Cash Book

A specimen petty cash book is given below:

Analytical Petty Cash book of X Ltd.

(Amount in ₹)

Amount Received	Date	Particulars	Total Amount Paid	Postage & Telegram	Printing & Stationery	Carriage	Travelling Expenses	Sundry Expenses
300	20xx April,1	To Bank a/c (check encashed)						
	2	By Postal stamps	80	80				
	4	By Stationery	32		32			
	5	By Carriage	16			16		
	7	By Auto fare to salesman	20				20	
	8	By Telegrams	5	5				
	15	By Tea to customers	15					15
		By Stationery	36		36			
	17	**Total**	**204**	**85**	**68**	**16**	**20**	**15**
	30	By Balance c/d	96					
300			300					
96	20xx May 1	To Balance b/d						
204		To Bank a/c (cheque encashed)						

2.10.8 Journal Proper

Journal Proper is a residual book which is used to record all transactions which cannot be included in the cash book or any of the other subsidiary books discussed so far. The transactions that will be recorded in Journal Proper are purchase or sale of fixed assets on credit, investments on credit, opening entries, closing entries, transfer entries, adjusting entries, rectification entries, etc. The format is the same as the general Journal discussed earlier:

a. **Opening Entries:** When accounts are started for the new accounting period, the opening balance of assets and liabilities are journalized.

b. **Closing Entries:** At the end of the accounting period, the nominal accounts are closed by transferring to the Trading and Profit and Loss account. This is done through journal entries.

c. **Transfer Entries:** Where an amount in one account is required to be transferred to another account, the transfer is done through journalizing.

d. **Adjusting Entries:** At the end of the period, an adjustment may be required in the case of certain income and expenditure accounts. For example: adjustment for outstanding expenses, prepaid expenses, depreciation, advance incomes etc. All these adjustments are made through Journal entries.

e. **Rectification Entries:** At the time of preparation it is often found that the debit total does not tally with credit total in the trial balance (a statement prepared to ascertain the completeness of accounts). This necessitates the detection of errors. Rectification entries are passed through the Journal to rectify the errors detected.

f. **Miscellaneous Entries:** Various other entries are made through the Journal such as credit purchase of asset, effects of loss of property by fire, dishonor of bills receivable, cancellation of bills payable, writing of bad debts, withdrawal of goods for personal use by owner, partnership transactions, consignment transactions, branch transactions etc.

Now let us take up the transactions of a business during a month and study how they will be recorded in the sub-journal and posted in the General Ledger.

Illustration 2.7

Consider the problem given in Illustration 2.4. The same transactions are recorded in the sub-journals in the following way.

Cash Book

Dr. Cr.

Date 20xx	Receipts	L F	Discount Allowed	Cash ₹	Bank ₹	Date 20xx	Payments	L F	Discount Received	Cash ₹	Bank ₹
Jan. 1	To Capital a/c			40,000		Jan. 2	By Bank a/c	C		15,000	
Jan. 2	To Cash a/c	C			15,000	Jan. 5	By Purchases a/c			5,000	
Jan. 11	To Commission a/c			6,000		Jan. 10	By Machinery a/c			15,000	
Jan. 17	To Bank a/c	C		2,000		Jan. 14	By Shyam a/c		100		5,000
Jan. 20	To Kamal a/c		200		5000	Jan. 17	By Cash a/c	C			2,000
Jan. 22	To Sales a/c			5,000		Jan. 21	By Drawings & a/c				2,000
						Jan. 24	By Purchases a/c				1,000
						Jan. 25	By Salaries a/c			2,000	
						Jan. 28	By Rent a/c				3,000
						Jan. 31	By Drawings a/c			1,000	
						Jan. 31	By Balance c/d			15,000	7,000
			200	53,000	20,000				100	53,000	20,000
Feb. 1	To Balance b/d			15,000	7,000						

Purchases Book

Date 20xx	Name of Supplier	Ledger Folio	Inward Invoice No.	Amount ₹
Jan. 3	Shyam			30,000
Jan. 6	Gopalan			20,000
			Total	50,000

Dr. **Purchase Returns Book** Cr.

Date 20xx	Name of Supplier	Ledger Folio	Debit Note No.	Amount ₹
Jan. 13	Shyam			2,000
			Total	2,000

Dr. **Sales Book** Cr.

Date 20xx	Name of Customer	Ledger Folio	Outward Invoice No.	Amount ₹
Jan. 7	Murthy			25,000
Jan. 15	Kamal			10,000
			Total	35,000

Dr. **Sales Returns Book** Cr.

Date 20xx	Name of Customer	Ledger Folio	Credit Note No.	Amount ₹
Jan. 19	Kamal			1,000
			Total	1,000

Dr. **Journal Proper** Cr.

Date 20xx	Particulars	Debit ₹	Credit ₹
Jan. 9	Furniture Account Dr.	10,000	
	To Tumbo & Co Account		10,000
	(Being the furniture purchased for office use on credit)		
	(Logic: Furniture is a real account. Debit what comes in. Tumbo & Co is a personal account. Credit the giver.)		

Dr. **Capital Account** Cr.

Date 20xx	Particulars	JF No.	Amount ₹	Date 20xx	Particulars	JF No.	Amount ₹
Jan.31	To Balance c/d		40,000	Jan.1	By Cash a/c		40,000
			40,000				40,000
				Feb.1	By Balance b/d		40,000

Dr. **Purchases Account** Cr.

Date 20xx	Particulars	JF No.	Amount ₹	Date 20xx	Particulars	JF No.	Amount ₹
Jan. 5	To Cash a/c		5,000	Jan.31	By Balance c/d		56,000
Jan.24	To Bank a/c		1,000				
Jan. 31	To Sundry Creditors a/c		50,000				
			56,000				56,000
Feb. 1	To Balance b/d		56,000				

Dr. **Shyam Account** Cr.

Date 20xx	Particulars	JF No.	Amount ₹	Date 20xx	Particulars	JF No.	Amount ₹
Jan. 13	To Purchases returns a/c		2,000	Jan.3	By Purchases a/c		30,000
Jan.14	To Bank a/c		5,000				
	To D/R a/c		100				
Jan. 31	To Balance c/d		22,900				
			30,000				30,000
				Feb.1	By Balance b/d		22,900

Dr. **Sales Account** Cr.

Date 20xx	Particulars	JF No.	Amount ₹	Date 20xx	Particulars	JF No.	Amount ₹
Jan. 31	To Balance c/d		40,000	Jan. 22	By Cash		5,000
				Jan. 31	By Sundry Debtors a/c		35,000
			40,000				40,000
				Feb. 1	By Balance b/d		40,000

Dr. **Gopalan Account** Cr.

Date 20xx	Particulars	JF No.	Amount ₹	Date 20xx	Particulars	JF No.	Amount ₹
Jan. 31	To Balance c/d		20,000	Jan. 6	By Purchases a/c		20,000
			20,000				20,000
				Feb. 1	By Balance b/d		20,000

Dr. **Murthy Account** Cr.

Date 20xx	Particulars	JF No.	Amount ₹	Date 20xx	Particulars	JF No.	Amount ₹
Jan. 7	To Sales a/c		25,000	Jan.31	By Balance c/d		25,000
			25,000				25,000
Feb. 1	To Balance b/d		25,000				

Dr. **Furniture Account** Cr.

Date 20xx	Particulars	JF No.	Amount ₹	Date 20xx	Particulars	JF No.	Amount ₹
Jan. 9	To Tumbo & Co. a/c		10,000	Jan.31	By Balance c/d		10,000
			10,000				10,000
Feb. 1	To Balance b/d		10,000				

Dr. **Tumbo & Co. Account** Cr.

Date 20xx	Particulars	JF No.	Amount ₹	Date 20xx	Particulars	JF No.	Amount ₹
Jan. 31	To Balance c/d		10,000	Jan. 9	By Furniture a/c		10,000
			10,000				10,000
				Feb. 1	By Balance b/d		10,000

Dr. **Machinery Account** Cr.

Date 20xx	Particulars	JF No.	Amount ₹	Date 20xx	Particulars	JF No.	Amount ₹
Jan. 10	To Cash a/c		15,000	Jan.31	By Balance c/d		15,000
			15,000				15,000
Feb. 1	To Balance b/d		15,000				

Dr. **Commission Account** Cr.

Date 20xx	Particulars	JF No.	Amount ₹	Date 20xx	Particulars	JF No.	Amount ₹
Jan. 31	To Balance c/d		6,000	Jan. 11	By Cash a/c		6,000
			6,000				6,000
				Feb. 1	By Balance b/d		6,000

Dr. **Purchase Returns Account** Cr.

Date 20xx	Particulars	JF No.	Amount ₹	Date 20xx	Particulars	JF No.	Amount ₹
Jan. 31	To Balance c/d		2,000	Jan. 11	By Sundry Creditors a/c		2,000
			2,000				2,000
				Feb. 1	By Balance b/d		2,000

Dr. **Kamal Account** Cr.

Date 20xx	Particulars	JF No.	Amount ₹	Date 20xx	Particulars	JF No.	Amount ₹
Jan. 15	To Sales a/c		10,000	Jan.19	By Sales Returns a/c		1,000
				Jan.20	By Bank		5,000
					By D/A a/c		200
				Jan.31	By Balance c/d		3,800
			10,000				10,000
Feb. 1	To Balance b/d		3,800				

Dr. **Sales Returns Account** Cr.

Date 20xx	Particulars	JF No.	Amount ₹	Date 20xx	Particulars	JF No.	Amount ₹
Jan. 19	To Sundry Debtors a/c		1,000	Jan.31	By Balance c/d		1,000
			1,000				1,000
Feb. 1	To Balance b/d		1,000				

Dr. **Drawings Account** Cr.

Date 20xx	Particulars	JF No.	Amount ₹	Date 20xx	Particulars	JF No.	Amount ₹
Jan. 21	To Bank a/c		2,000	Jan.31	By Balance c/d		3,000
Jan.31	To Cash a/c		1,000				
			3,000				3,000
Feb. 1	To Balance b/d		3,000				

Dr. **Salaries Account** Cr.

Date 20xx	Particulars	JF No.	Amount ₹	Date 20xx	Particulars	JF No.	Amount ₹
Jan. 25	To Cash a/c		2,000	Jan.31	By Balance c/d		2,000
			2,000				2,000
Feb. 1	To Balance b/d		2,000				

Dr. **Rent Account** Cr.

Date 20xx	Particulars	JF No.	Amount ₹	Date 20xx	Particulars	JF No.	Amount ₹
Jan. 28	To Bank a/c		3,000	Jan.31	By Balance c/d		3,000
			3,000				3,000
Feb. 1	To Balance b/d		3,000				

Dr. **Discount Account** Cr.

Date 20xx	Particulars	JF No.	Amount ₹	Date 20xx	Particulars	JF No.	Amount ₹
Jan. 20	To Sundry Debtors a/c		200	Jan.14	By Sundry Creditors a/c		100
				Jan.31	By Balance c/d		100
			200				200
Feb. 1	To Balance b/d		100				

Activity 2.2

a. Madhu & Co., maintains subsidiary books of accounts. If the business purchases fixed assets on credit, which is the appropriate subsidiary book in which the original entry is to be made?

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b. A business maintains a double column cash book with Cash and Discount columns because the business often gives discount to its customers. Examine the need for contra entry in this case.

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c. Pass Journal entries for the following transactions in the books of the Ram & Co.:

Discount allowed to customer

Bills Receivable drawn on Beta Ltd.

Electricity bill paid by business for the residence of owner.

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2.11 Preparation of Trial Balance

We know that, as per double entry system of accounting, every debit must have a corresponding credit. Thus, at any time the sum of debit amounts should be equal to the sum of credit amounts. But, if the ledger accounts are balanced, then the total of all debit balances ledger accounts must be equal to the total of credit balances ledger accounts. At the end of an accounting period or any other time, the balances of all the ledger accounts are extracted and are written up in a statement called 'Trial Balance' to check the arithmetical accuracy of accounting records. Thus, Trial Balance is a summary of all General Ledger Balances outstanding as on a particular date. Preparation of Trial Balance is a process of summarization of information, which has been earlier recorded and classified.

An agreement of the debit side and the credit side establishes reasonable accuracy of the accounting process. However, if debit side and the credit side are equal, it does not imply that the accounts are accurate. The Trial Balance could contain certain offsetting errors. Trial balance is, thus, not a conclusive proof of accuracy of accounts.

Objectives of Preparation of Trial Balance

The following are the objectives of preparing a Trial balance:

a. **To ensure the arithmetical accuracy*:*** A tallied trial balance ensures the arithmetical accuracy of the books of accounts. Since the transactions are recorded on the basis of double entry system, a tallied trial balance to some extent establishes the accuracy in posting and balancing of the ledger accounts. However, as said earlier it is not a conclusive proof as the trial balance sometimes fails to disclose certain errors which affect both sides (debit and credit amounts) of the account.

b. **Facilitates the detection of errors:** When the trial balance does not tally, it indicates the existence of errors in some of the ledger accounts. It paves the way for detection of errors before preparation of financial statements.

c. **Concise summary:** A trial balance provides a summary of the accounts of the business hence, details within an account can be avoided.

d. **Facilitates the preparation of the financial statements*:*** The chief requirement of a tallied Trial balance is to prepare the financial statements. A tallied trial balance facilitates the preparation of the financial statements and conversely an untallied trial balance makes the process of preparation of financial statements cumbersome.

Construction and Format of Trial Balance

There are principally two methods of preparation of Trial Balance: (i) Totals Method, and (ii) Balances Method. Under totals method, the debit and credit totals of each account are shown in the debit and credit columns of the trial balance. Under balances method, the difference of debit and credit totals (referred to as balance amount) for each account is taken. If the account shows debit balance, the amount is put in the debit column of the Trial Balance. If the account shows credit balance, the amount is put in the credit column of the Trial Balance.

The most widely used method of preparation of Trial balance is balances method. The first step under this method is to balance the accounts.

- Arrive at the balances of all ledger accounts including cash book balance.
- Prepare a trial balance with five columns one each for (i) Serial number; (ii) Name of the account; (iii) Ledger folio; (iv) Debit amount; and (v) Credit amount.
- Post the debit balances in the accounts to the debit column in the trial balance, and the credit balance in the accounts to the credit column in the trial balance with all other columns duly filled with details.
- Add debit column total and the credit column total to see whether they agree.

Format of Trial Balance

Trial balance of – as at—

S. No.	Name of the Account	LF	Debit Balance (₹)	Credit Balance (₹)

The trial balance can also be shown in the ledger account format, i.e., in 'T' format.

Illustration 2.8

Consider the Problem and Solution given in Illustration 2.4.

We know that in the process of accounting, all the transactions are first recorded in journal, and then posted into the ledger. After that a trial balance is prepared. In illustration 2.4 we prepared a journal and a ledger. Now we shall prepare a trial balance.

Trial Balance of M/s __________ as on 31.1. 20xx

Sl. No.	Name of the Account	LF	Debit Balance (₹)	Credit Balance (₹)
01.	Cash a/c		15,000	
02.	Bank a/c		7,000	
03.	Capital a/c			40,000
04.	Purchases a/c		56,000	
05.	Shyam a/c			22,900
06.	Sales a/c			40,000

Contd….

Sl. No.	Name of the Account	LF	Debit Balance (₹)	Credit Balance (₹)
07.	Gopalan a/c			20,000
08.	Murthy a/c		25,000	
09.	Furniture a/c		10,000	
10.	Tumbo & Co. a/c			10,000
11.	Machinery a/c		15,000	
12.	Commission a/c			6,000
13.	Purchase Returns a/c			2,000
13.	Kamal a/c		3,800	
14.	Sales Returns a/c		1,000	
15.	Drawings a/c		3,000	
16.	Salaries a/c		2,000	
17.	Rent a/c		3,000	
18.	Discount Allowed a/c		200	
19	Discount Received a/c			100
	Total		1,41,000	1,41,000

This above trial balance can be presented in the following format also.

Trial Balance of M/s __________ as on 31.1. 20xx

Name of the Account	LF	Debit Balance (₹)	Name of the Account	LF	Credit Balance (₹)
Cash a/c		15,000	Capital a/c		40,000
Bank a/c		7,000	Shyam a/c		22,900
Purchases a/c		56,000	Sales a/c		40,000
Murthy a/c		25,000	Gopalan a/c		20,000
Furniture a/c		10,000	Tumbo & Co. a/c		10,000
Machinery a/c		15,000	Commission a/c		6,000
Kamal a/c		3,800	Purchase Returns a/c		2,000
Sales Returns a/c		1,000	Discount a/c		100
Drawings a/c		3,000			
Salaries a/c		2,000			
Rent a/c		3,000			
Discount a/c		200			
		1,41,000			1,41,000

If you observe carefully, you will find the following:

a. All the asset accounts and expenses accounts are on the debit side.

b. All the liabilities accounts, income accounts and capital account are on the credit side.

We can thus infer that all assets and expenses accounts always show debit balance and all incomes, liabilities and capital accounts show credit balance. If you remember this, you can directly prepare a trial balance from the ledger account balances if you can identify the element (i.e., as an asset or an expense, or an income or a liability).

Computerized Accounting Systems

Most organizations are now doing accounting work on computers rather than using manual methods as explained so far. Nevertheless, an accountant should learn manual methods of accounting even though computerized accounting systems are available. This is because, in the manual system, the records and forms are visible whereas they are not on the computer. If any problem arises in the process of accounting, it is easy to solve through the manual system of accounting.

Computerized accounting system performs the following functions of accounting:

a. Records and Stores data

b. Performs arithmetic operations

c. Sorts and summarizes the data

d. Generates reports

Thus, the computerized accounting system conducts the whole accounting process i.e., journalizing entries, posting in ledger accounts, preparation of trial balance and financial statements. However, the first step in the accounting process, i.e., analysis of a transaction is not done by the computer system itself. In the same way, after preparation of trial balance accountants analyze the trial balance and induce proper adjusting and rectification entries, if required.

There are several new technologies that have emerged for use by accountants. Some such technologies include Artificial Intelligence (AI), Big Data, Cloud Computing, Block chain technology etc. Exhibit 2.2 captures the role of one such technology tool, Artificial Intelligence in Accounting.

Exhibit 2.2: Role of Artificial Intelligence in Accounting

There are several new AI based technologies that are aiding organizations in improving efficiency, deriving insights into competitive customer and talent strategies. Some such technologies include –Computer vision, Natural Language Processing (NLP), speech recognition and machine learning.

Contd….

As per an article in EY titled "How to harness AI in Accounting", these AI technologies also contribute to accounting in a strategic way. One direct perceived benefit of AI technologies to accountants is that it helps manage enormous amount of data, both financial and non-financial. Using AI, accountants can store, sort, summarize and present financial data in more effective way. Added to this, it ensures that the financial reporting is timely, accurate and consistent. This is more of a necessity in the scenario of complex reporting challenges that emerge due to regulatory requirements, especially for companies operating in multiple jurisdictions.

Automation through AI and Robotics has also provided the time for accountants to perform more high valued, high tasks as the more routine tasks can be automated. Such automation considerably reduced the room for human errors, thereby improving the quality of financial reporting. AI can mimic human interventions, can provide real time data, process documents with NLP and computer vision. All these culminate into timely insights that better the decision making process.

Source: Ronald Wong. How to harness Artificial Intelligence in Accounting. May, 2020 https://www.ey.com/en_sg/ai/how-to-harness-artificial-intelligence-in-accounting

Rectification of Errors

A tallied trial balance is an indicator of the correctness of the entries made in books of accounts. However, it is possible that certain errors may occur even after the trial balance tallies. For instance, omission to record a transaction altogether may result in the trial balance tallying though with a wrong total. Thus location of errors and their timely correction is vital to enhance the true and fair view of accounting information.

For the purpose of understanding, accounting errors can be classified into four categories:

1. Errors of Omission – where a transaction is completely or partially omitted
2. Errors of Commission – Errors committed due to wrong posting of transactions, wrong totaling, incorrect balancing of ledger accounts and other clerical errors.
3. Errors of Principle – Errors committed due to wrong application of accounting principles.

Accounting errors can be rectified by passing rectification entries. In case of one-sided errors (errors affecting only one side - either debit or credit) the rectification entry is passed using suspense account. Suspense account is a temporary account that is opened to transfer the difference in trial balance and facilitate preparation of financial statements. Later, after the financial statements are prepared, the errors are identified and the suspense account is closed.

2.12 Passing Adjustment Entries

Even though the events affecting the enterprise may have been properly journalized and posted properly in appropriate ledger accounts, there are certain account balances which need to be updated before an accountant can proceed to prepare the Financial Statements from the Trial Balance. Such entries are called the Adjusting Entries. Thus, adjustment entries are nothing but the entries, which are not yet recorded in the books of account. Adjusting entries are required to implement the accrual concept and more specifically the realization concept and the matching concept. Adjusting entries help to ensure that all revenues earned in the period are recognized in the period regardless of when the exchange of cash took place. Similarly, in the case of expenses, the adjusting entries ensure that the enterprise recognizes all the expenses incurred in the period regardless of when the payment for the expenses is made. This results in the income statement reflecting a more complete measurement of the enterprise's operating performance and the Balance Sheet reflecting a more complete measurement of the financial position of the enterprise.

Adjusting entries can be recorded before or after the preparation of Trial Balance. More often they are recorded after the preparation of the Trial Balance. These entries are recorded in journal proper.

Adjustment Entries are required in case of:

i. Accrued income
ii. Income received in advance
iii. Outstanding expenses
iv. Prepaid expenses
v. Stock at the end of the period
vi. Depreciation
vii. Bad debts
viii. Bad debts provision
ix. Provision for discount on debtors and creditors
x. Interest on capital
xi. Interest on drawings
xii. Other Adjustments

Accrued Income

Accrued income involves the recognition of revenue earned before it is actually received. It implies that if a portion of an income has been earned but it has not yet been received as the due date of payment falls in the next accounting period, then the income must be brought into account. Few examples of accrued or accruing incomes in respect of which adjustment entries may have to be made are interest on government loans, discounts on bill, interest on investments, rents and premium on leases, etc.

The following entry is made to bring into book the amount of accrued income:

Accrued income account Dr.

To Appropriate income account

Effect:

a. Accrued income will be shown on the credit side of profit and loss account by way of addition to the appropriate income.

b. Accrued income will be shown on the assets side of the balance sheet as accrued income under the head current assets.

Illustration 2.9

ABC Trading Company holds 14% debentures of the face value of ₹ 5,000 in Bright Ltd. as investments The interest is payable on the 30th June and 31st December every year. If accounting period ends on 31st March 20x1, what is the, accrued interest on debentures? Also write adjusting Journal entry for the same.

Solution

Current Accounting Period is 1-4-20x0 to 31-3-20x1

Amount of interest received for half year ending on 30-06-20x0 = 5,000 x 14% x 6/12 = ₹ 350. Of this, only three month's interest is current year's interest i.e. ₹ 175 is pertaining to current year's income.

Amount of interest received for half year ending on December 31, 20x0
= 5,000 x 14% x 6/12 = ₹ 350.

Next amount of interest is due on 30-06-20x1. But the accounting period ends on 31-03-20x1. Thus, interest is accrued for three month's from 1-1-20x1 to 31-3-20x1. This will be received on 30-6-20x1. But this interest is earned in the current period. Thus it should be shown in the current year's financial statements by passing the following adjustment entry.

Accrued interest on investment A/c	Dr.	₹ 175
To Interest on investment A/c		₹ 175

Effect: Interest on investment is shown at an amount of ₹ 700 (175 + 350 + 175) in the profit and loss account and accrued interest on investment ₹ 175 is recorded on the assets side of the Balance Sheet.

(Students may note that when an amount has been earned as income and due date falls in the next accounting period, the term 'Accrued' is used. However, where the due date falls within the same accounting period, the term 'Outstanding' is used.

In the subsequent accounting period, the amount in the Outstanding or Accrued Interest A/c will be transferred to the Interest on Investment A/c and the actual receipt of interest will offset the former transfer entry.)

Income Received in Advance

Income received in advance results when the enterprise receives cash from customers in one accounting period for goods or services to be provided in the next accounting period. While preparing the financial statements adjustment entries are required for this item. Rent received in advance, subscriptions received in advance in the case of clubs, etc., are a few examples where income may be received in advance. Such entries need adjustment.

The following entry is to be made to bring to book the income received in advance.

Appropriate Income A/c Dr.

To Income received in Advance A/c

Effect:

a. Income received in advance will be shown on the credit side of profit and loss account by way of deduction from the appropriate income.

b. Income received in advance a/c will be shown on the liabilities side of the balance sheet under the head current liabilities and provisions.

Illustration 2.10

Law publications has received subscriptions amounting to ₹ 30,000 in respect of twelve months, ending May 31, 20xx. Assume accounting period ends on 31.03.20xx. Are there advanced subscriptions? If so, write adjustment entry.

Solution

The amount of subscriptions received included advanced subscriptions. Only 10 months' subscription relates to the financial year ending 31st March, 20xx. The balance of two months' subscription received is treated as advance subscriptions and relates to the next financial year. The adjustment entry to be made is

Subscription A/c	Dr.	5,000
To Subscription received in Advance A/c		5,000

Effect: Subscription account is shown at an amount of ₹ 25,000 (₹ 30,000 Less ₹ 5,000 received in advance) in the Statement of Profit and Loss. The subscription received in advance represents the amount received in respect of services to be provided in the next accounting year and is recorded as a liability in the balance sheet.

Outstanding Expenses

Outstanding expenses refer to expenses incurred but not yet paid. Before the preparation of the financial statements it must be ensured that all the expenses which have fallen due to be paid but which have not been paid during the accounting period are brought to account. Rent outstanding, interest outstanding and wages outstanding are examples of expenses outstanding. The relevant adjustment entry is

Appropriate Expense Account	Dr.
To Outstanding Expenses Account	

Effect:

a. Outstanding expenses will be shown on the debit side of trading/profit and loss account by way of addition to the appropriate expense.

b. Outstanding expenses a/c will be shown on the liabilities side of the balance sheet under the head current liabilities.

Illustration 2.11

ABC Trading Company has the practice of paying the salaries of the employees on the 4th of the subsequent month. During the financial year ending 31st March, 20xx, the salaries account shows a debit balance of ₹ 55,000. The salaries of ₹ 6,000 pertaining to March, 20xx were to be paid on 4th April, 20xx. Write adjustment entry for salaries pertaining to March, 20xx.

Solution

While preparing the financial statements for the year ending 31st March, 20xx the salaries of ₹ 6,000 of March must be included as they are related to the current financial year. This is done with the following journal entry:

Salaries A/c	Dr.	₹ 6,000	
To Outstanding Salaries A/c			₹ 6,000

Effect: The above journal entry increases the salaries to the correct amount of ₹ 61,000 (₹ 55,000 + ₹ 6,000) and this amount is shown on the debit side of the profit and loss account. Again the outstanding salaries of ₹ 6,000 will be shown as a liability in the Balance Sheet.

In the subsequent accounting period, the outstanding expense liability will be transferred to the expense account and will be offset by the actual payment made in respect of the same.

Prepaid or Unexpired Expenses

Prepaid expenses result when the cash outflow precedes the actual expense. In other words, these are amounts paid in the accounting period for services to be received in the subsequent accounting period. It is important to identify that portion of the expenditure for which the payment has been made but the benefit is yet to be received and make an adjusting entry. Rent paid in advance, Insurance prepaid, etc., are a few examples where an adjusting entry is required as follows:

Expenses Prepaid Account	Dr.
To Appropriate Expense Account	

Effect:

a. Prepaid expense will be shown on the debit side of trading/profit and loss account by way of deduction from the appropriate expense.

b. Prepaid expense a/c will be shown on the assets side of the balance sheet under the head current assets.

Illustration 2.12

ABC Trading company took an insurance cover for all assets against fire on 1st October, 20xx and paid the premium of ₹ 2,400 on the same day. Is there any prepaid expense? If so, write adjustment entry. Assume accounting period ends on 31st March 20x1.

Solution

The benefit of the entire expenditure will expire on 30th September 20x1. But the accounting period ends on March 31st, 20x1. Thus, the expenditure from April 1st to 30th September (i.e. 6 months) is related to the next accounting period.

Thus, the amount of expense prepaid on 31st March, 20x1 is

= 2,400 x 6/12 = ₹ 1,200

The adjusting entry to record the prepaid insurance is

Prepaid Insurance A/c	Dr.	₹ 1,200	
To Insurance A/c			₹ 1,200

Effect: This entry ensures that the insurance expense is reported at the correct figure of ₹ 1,200 in the Statement of Profit and Loss and the prepaid amount is shown as an asset in the Balance Sheet.

In the subsequent accounting period, the balance in the prepaid expense account will be transferred back to the expense account.

Following Exhibit 2.3 shows the current liabilities schedule of Infosys. Accrued salaries, provision for expenses (i.e., outstanding expenses), advances from clients (i.e., income received in advance), unearned income (i.e., income received in advance) and unclaimed dividends (i.e. outstanding expenses) are shown under current liabilities.

Exhibit 2.3: Current Liabilities Schedule of Infosys Limited

(₹ in crore)

Particulars	March 31, 2021	March31, 2020
Financial Liabilities:	-	-
Trade payables	-	-
Total outstanding dues of micro enterprises and small enterprises	-	-
Total outstanding dues of creditors other than micro enterprises and small enterprises	1,562	1,529
Lease Liabilities	487	390
Other Financial Liabilities:		
Unpaid dividends	33	30
Accrued compensation to employees	2,915	2,264
Accrued expenses	2,944	2,646
Retention monies	13	30
Payable for acquisition of business – contingent consideration	5	151
Capital creditors	340	254
Compensated advances	1,640	1,497
Other payables	460	603
Foreign currency forward and option contracts	9	461
Other Current Liabilities	4,816	3,557
Provisions	661	506
Income tax liabilities (net)	1,737	1,302
Total	**17,622**	**15,220**

Source: https://www.infosys.com/investors/reports-filings/annual report/annual/documents/ infosys-ar-21.pdf

Closing Stock

Amount of unsold stock lying at the end of accounting period is called “Closing stock”. The closing inventory of every item is arrived at by physically counting the inventory available and is valued as per Ind AS-2. Thus, closing stock should be valued at cost price or net realizable value, whichever is lower. Here, cost price means purchase price, and net realizable value means the estimated selling price in the ordinary course of business less the estimated cost of completion, and the estimated cost necessary to make the sale.

The value of the closing inventory will be brought into the books of accounts through the following journal entry:

Inventory (or Stock) A/c   Dr.

To Trading A/c /Purchases A/c

Effect:

a. Closing stock will be shown on the credit side of trading account or it can be deducted from the purchases on the debit side of the trading account.

b. Closing stock a/c will be shown on the assets side of the balance sheet under the head current assets.

At the beginning of the next accounting period, closing stock will become opening stock. It is brought into the books by writing the following entry (or by reversing the above entry).

Trading Account A/c	Dr.
To Inventory (or Stock) A/c	

Depreciation

Most of the fixed assets like plant, machinery and office equipment have limited useful life. The acquisition cost is written off over the useful life of the asset as an expense. Thus the process of accounting, where the unexpired cost of an asset is converted into an expense and charged against the profits of the enterprise over the useful life of the asset is called Depreciation. Thus, depreciation is the reduction in the value of fixed asset.

Depreciation is a measure of the wear and tear of assets caused by usage, passage of time, technological obsolescence, and market changes. The purpose of charging depreciation is to spread the cost of the long-lived assets over the economic life of the asset as an expense and match it with the revenue earned by using the asset. Depreciation does not involve any payment of money or outflow of cash; nevertheless it is a very important accounting entry in the books.

Charging depreciation on fixed assets is necessary for determining income, to measure the service potential of the assets and to know the real financial position of the organization. Exhibit 2.4 gives an example of the depreciation policy adopted by companies.

Exhibit 2.4: Depreciation Accounting in Infosys Limited

Depreciation on Fixed assets is provided on straight-line method over the useful life of the assets estimated by Management. Management estimates the useful lives of property, plant and equipment as follows:

Buildings	22 - 25 years
Plant and Machinery	5 years
Office equipment	5 years
Computer equipment	3-5 years
Furniture and Fixtures	5 years
Vehicles	5 years

Leasehold improvements lower of useful life of the asset or lease term

Depreciation Methods, useful lives and residual values are valued at each Reporting date.

Source: Infosys Annual Report 2020 -21

There are two ways of recording depreciation:

Method I: Under the first method, the asset account is directly credited for depreciation. Thus, the asset account readily reflects the unexpired cost or helps ascertain the written down value of the asset. The Journal entry to record depreciation under this method is as follows:

Depreciation Account Dr.

To Asset Account

(Being the depreciation provided for the accounting period)

At the end of the accounting period, the depreciation account is closed by transferring to the profit and loss account. The following is the closing journal entry

Profit and Loss Account Dr.

To Depreciation Account

Effect:

a. Depreciation will be shown on the debit side of profit and loss account.

b. Depreciation a/c will be shown on the assets side of the balance sheet by way of deduction from the appropriate asset.

Method II: Under the second method, the depreciation charged to date is credited to the depreciation provision account and not directly to the asset account. Under this method, the asset account shows the original cost. In the balance sheet on the assets side, the written down value of the asset is shown as a deduction of the depreciation provision account from the original cost of the asset. The journal entry under this method is

Depreciation Account Dr.

To Depreciation Provision Account

(Being the depreciation provided for the accounting period)

At the end of the accounting period, the depreciation account is closed by transferring to the profit and loss account. The following is the closing journal entry

Profit and Loss Account Dr.

To Depreciation Account

Effect:

a. Depreciation will be shown on the debit side of profit and loss account.

b. Provision for depreciation account will be shown on the assets side of the balance sheet by way of deduction from the appropriate asset.

Alternatively, some prefer to show the asset account at its original cost on the assets side and the depreciation provision a/c on the liabilities side. (The students are advised to show the provision as a deduction from the original cost of the asset on the assets side.)

How is the amount of depreciation determined?

There are various methods available for determining depreciation. For example, Straight Line Method, Diminishing Balance Method, Annuity Method, Sinking Fund Method, Sum-of-digits Method, Units of Production, Revaluation Method etc. Of all these methods, the Straight line method and Diminishing Value Method are most popular.

Straight – Line Method

It is also known as fixed installment method or original cost method. In this method, it is assumed that the usage of the assets remains uniform during its effective life and hence the quantum of depreciation remains fixed every year. It is calculated by the formula:

$$\text{Depreciation} = \frac{\text{Original Cost of the Asset} - \text{Scrap Value}}{\text{Estimated useful life of the asset}}$$

This method is simple to calculate but is based on the incorrect assumption of uniform usage of the asset as the asset is used more in initial years and its usage reduced with time.

Diminishing Balance Method

In the diminishing value method, depreciation is charged as a percentage on the written down value of the asset i.e., on the book value of the asset. Thus, since the book value of the asset reduces after charging depreciation year after year, the quantum of depreciation reduces year after year. This method is based on a more realistic assumption and hence is popularly followed.

To bring about uniformity in diversified practices in selection of depreciation methods, the Institute of Chartered Accountants of India (ICAI) has issued a revised Accounting Standard (AS)-6, on Depreciation Accounting.

Bad Debts

The sales revenue recorded in the books of the accounts of an organization represents the amount realized/to be realized from the sale of goods. When goods are sold on credit it may sometimes happen that owing to certain circumstances, customers may not fulfill their obligations. For instance, if a customer, subsequent to the date of the credit sales, is adjudged as insolvent and his estate cannot pay anything towards satisfaction of the amount due from him, then logically, the entry passed at the time of the sale should be reversed, as it amounts to sale not taking place at all. However, in practice, instead of reversing the previous entry, the amount which cannot be recovered is considered as 'bad debts' and a separate account is opened called the Bad debts account.

Thus, bad debt is an amount due from a debtor, but not expected to be received. It is a loss to the business. The accounts receivable are reported in the financial statements at net realizable value that is equal to the gross amount of receivables less an estimated allowance for uncollectible accounts.

The adjustment entry for bad debts is

Bad Debts Account Dr.

To Customer's Account

The bad debts account is closed by transferring the same to the Profit and Loss Account. The entry in this respect is

Profit and Loss Account Dr.

To Bad debts Account

Effect:

a. Bad debts will be shown on the debit side of profit and loss account.

b. Bad debts a/c will be shown on the assets side of the balance sheet by way of deduction from the debtors/accounts receivables.

Students should note that where the bad debts appear in the trial balance, it means the adjustment entry is already passed and no further adjustment entry is needed. It only needs to be debited in the profit and loss Account.

Bad Debts Provision

In addition to the bad debts, an organization may find that some of the debts may or may not be collectible i.e. doubtful. Based on the conservatism concept the organization may create a provision for this anticipated loss i.e. for doubtful debts. The amount of doubtful debts may be calculated on the basis of careful examination of accounts receivable or it may be estimated on the basis of some percentage of debtors. An enterprise may base its estimate of uncollectible receivables on its prior experience, the experience of other enterprises in the industry, the debtor's ability to pay, or an appraisal of economic conditions. There are two reasons for creating this provision:

i. Loss caused by likely bad debts must be shown in the profit and loss account for which credit sales have been made to determine the true profits. (Based on Matching Concept)

ii. To show the true amount realizable from debtors in the balance sheet.

The adjustment entry for creating a provision on debtor for bad debts is as follows:

Profit and Loss Account Dr.

To Provision for Bad Debts Account

Effect:

a. Provision for bad debts will be shown on the debit side of profit and loss account.

b. Provision for bad debts a/c will be shown on the assets side of the balance sheet by way of deduction from the debtors/accounts receivables.

Students may note that where an adjustment in respect of the bad debts, and also adjustment in respect of provision for doubtful debts needs to be made, then the bad debts will be deducted from debtors first and then a fixed percentage is applied to the remaining (debtors) provision for bad debts.

There may be balance in this provision, which is carried forward in the balance sheet to the next accounting period. This naturally appears in the trial balance. The balance appearing in the provision account represents the opening balance. In addition, when the financial statements for the next accounting period are prepared, an adjustment entry needs to be made for this opening balance of provision for bad and doubtful debts. The following is the procedure to be followed.

First, compare the opening balance of provision appearing in the trial balance with the new provision amount that should be maintained (to be created at the end of the period).

If the amount of provision to be maintained at the end of the accounting period is more than the opening balance of the provision, it implies an additional amount of provision is to be created. The following entry is to be made.

Profit and Loss Account Dr.

To Provision for Bad and Doubtful Debts Account

(With the difference between new and old provision)

Effect:

a. The additional amount of provision for bad debts will be shown on the debit side of profit and loss account.

b. New provision for bad debts will be shown on the assets side of the balance sheet by way of deduction from the debtors/accounts receivables.

If the new provision amount that should be maintained (to be created at the end of the period) is less than the opening balance of provision, it implies excess provision to be written-off. The following entry is to be made.

Provision for Bad and Doubtful Debts Account Dr.

To Profit and Loss Account

Effect:

a. The additional amount of provision for bad debts to be written-off will be shown on the credit side of profit and loss account.

b. New provision for bad debts will be shown on the assets side of the balance sheet by way of deduction from the debtors/accounts receivables.

(Students may note that where an adjustment in respect of the bad debts, and also adjustment in respect of provision for doubtful debts needs to be made, the bad debts to be written-off should be first debited to the opening balance of provision and the resultant balance should be compared with the New Provision).

Provision for Discount on Debtors

The organization, which allows the facility of making payments before the due date and enable their debtors to avail of cash discounts, must take into account the possible amount of discounts that may be allowed on closing debtors in the forthcoming year. This is necessary to show the closing sundry debtors at their realizable value. This provision is also created on the basis of matching concept and conservatism concept.

The principles for creation and maintenance of the provision for discounts for debtors are the same as those for the provision for bad debts. The only point to be noted is that discounts will be estimated on debts considered good i.e., closing debtors less provision for bad debts. The accounting entry is –

Profit and Loss A/c Dr.

To Provision for Discount on Debtors A/c

Effect:

a. Provision for discount on debtors will be shown on the debit side of profit and loss account.

b. Provision for discount on debtors a/c will be shown on the assets side of the balance sheet by way of deduction from the debtors/accounts receivables.

Illustration 2.13

An extract of the trial balance of Rajesh Traders as on March 31, 20xx is as follows:

Sl. No	Account	Debit (₹)	Credit (₹)
1.	Sundry Debtors	64,000	

Additional Information:

1. Bad debts not recorded amounted to ₹ 4,000

2. Provision for bad debts is to be maintained @ 10% on debtors. Pass necessary journal entries

Solution

Date	Particulars	Debit (₹)	Credit (₹)
31.3.20xx	Bad debts a/c………..Dr.	4,000	
	To Sundry Debtors a/c		4,000
31.3.20xx	Profit and Loss a/c…..Dr.	4,000	
	To Bad debts a/c		4,000
31.3.20xx	Profit and Loss a/c……Dr.	6,000	
	To Provision for Bad debts		6,000

Balance of Sundry Debtors as on March 31, 20xx	- ₹ 64,000
Less: Bad debts	- ₹ 4,000
Net Amount of debtors	- ₹ 60,000
Provision for bad debts @ 10% (₹ 60,000 x 10/100)	- ₹ 6,000
Debtors to be shown in Balance Sheet	- ₹ 54,000

Recovery of Bad Debts Written off

Sometimes, an amount written off as bad debts may be subsequently recovered. Any such recovery must be treated as a windfall and transferred to the Profit and Loss account as gain.

The journal entries will be

At the time of receipt of the amount

Cash A/c	Dr.
To Bad Debts recovered A/c	

At the end of the financial year

Bad debts recovered A/c	Dr.
To Profit and Loss A/c	

Effect:

a. Bad debts recovered will be shown on the credit side of profit and loss account.

b. Bad debts recovered a/c will be shown on the assets side of the balance sheet by way of addition to the cash account if it is given in adjustment. If it is given in the trial balance no adjustment is required for cash.

Provision for Discount on Creditors

Organizations may like to show the sundry creditors in the balance sheet at the net payable value by estimating in advance the amount of cash discounts that may be received at the time of settlement of amounts due. This is usually done by creating a reserve for discount on creditors and then transferring the discounts received to such reserve. Even though this reserve is against the concept of conservatism, it is necessary to create it as per the matching concept.

Since, income in respect of discounts receivable is recognized in advance, the journal entry for the creation of the reserve will be

Provision for Discount on Creditors A/c Dr.

To Profit and Loss A/c

Effect:

a. Provision for discount on creditors will be shown on the credit side of profit and loss account.

b. Provision for discount on creditors' a/c will be shown on the liabilities side of the balance sheet by way of deduction from the creditors/accounts payables.

Interest on Capital

In the case of proprietary concerns or partnerships, a provision in respect of interest on the capital contributed by the proprietor or the partners of the firm needs to be provided for determining the correct amount of profit. This provision is considered as an appropriation of profit and not a charge against the profit. Hence it does not appear in the profit and loss account, but appears in the appropriation account. The entries to be passed are:

a. Interest on Capital Account Dr.

To Capital/Current Account

b. Profit and Loss Appropriation Account Dr.

To Interest on Capital Account

Effect:

a. Interest on capital will be shown on the debit side of profit and loss account (in case of sole trading concerns) or profit and loss appropriation account.
(In case of partnership firms).

b. It will be credited to the capital/current account of the proprietors.

Interest on Drawings

We know that drawings are the amount used by owners for their personal use. If interest on capital is allowed, then it is natural that interest on drawings should be charged from the owners. This results in income to the enterprise. The entries in this respect are:

a. Capital/Current Account Dr.
To Interest on Drawings Account

b. Interest on Drawings Account Dr.
To Profit and Loss Appropriation Account

Effect:

a. Interest on drawings will be shown on the credit side of profit and loss account (in case of sole trading concerns), or profit and loss appropriation account
(in case of partnership firms).

b. It will be debited to the capital/current account of the proprietors. Alternatively, it may be debited to the drawings, which is ultimately deducted from the capital account.

Illustration 2.14

Take the trial balance given in Illustration 2.8. Give the necessary adjustment entries for the following items as on 31st January, 20xx. Also prepare the Trial Balance after adjustments.

i. Closing Stock as on 31st January, 20xx – ₹ 10,000

ii. Salary due but not paid – ₹ 1,000

iii. Unexpired Rent – ₹ 2,000

iv. Commission received in advance – ₹ 1,500

v. Interest due but not received – ₹ 2,000

vi. Depreciation on Machinery @10%

vii. Kamal became insolvent. Nothing was recovered from his estate.

viii. Allow interest on capital @10% and charge interest on drawings @ 12%.

Solution

Journal

Sl.No	Particulars	Dr. (₹)	Cr. (₹)
i.	Closing Stock a/c Dr.	10,000	
	To Trading a/c/Purchases a/c		10,000
	(Being closing stock brought into account.)		

Sl.No	Particulars		Dr. (₹)	Cr. (₹)
ii.	Salaries a/c	Dr.	1,000	
	To Outstanding salary a/c			1,000
	(Being the outstanding expenses brought into account.)			
iii.	Prepaid Rent a/c	Dr.	2,000	
	To Rent a/c			2,000
	(Being prepaid expenses brought into account.)			
iv.	Commission a/c	Dr.	1,500	
	To Commission received in advance a/c			1,500
	(Being rent received in advance brought into account.)			
v.	Accrued Interest	Dr.	2,000	
	To Interest a/c			2,000
	(Being interest due but not received brought into account.)			
vi.	Depreciation a/c	Dr.	1,500	
	To Machinery a/c			1,500
	(Being depreciation charged.)			
vii.	Bad debts a/c	Dr.	3,800	
	To Kamal a/c			3,800
	(Being bad debts provided for.)			
viii.	Interest on capital a/c	Dr.	4,000	
	To Capital a/c			4,000
	(Being interest on capital allowed @10%.)			
	Capital a/c/Drawings a/c	Dr.	360	
	To Interest on drawings a/c			360
	(Being interest on drawing charged @ 12%.)			

S.No.	Name of the Account	LF	Trial balance		Adjustments		Adjusted Trial Balance	
			Dr. ₹	Cr. ₹	Dr. ₹	Cr. ₹	Dr. ₹	Cr. ₹
01.	Cash a/c		15,000				15,000	
02.	Bank a/c		7,000				7,000	
03.	Capital a/c			40,000		4,000		44,000
04.	Purchases a/c		56,000			10,000	46,000	
05.	Shyam a/c			22,900				22,900
06.	Sales a/c			40,000				40,000
07.	Gopalan a/c			20,000				20,000
08.	Murthy a/c		25,000	–	–	–	25,000	–

S.No.	Name of the Account	LF	Trial balance		Adjustments		Adjusted Trial Balance	
			Dr. ₹	Cr. ₹	Dr. ₹	Cr. ₹	Dr. ₹	Cr. ₹
09.	Furniture a/c		10,000	–	–	–	10,000	–
10.	Tumbo & Co. a/c		–	10,000	–	–		10,000
11.	Machinery a/c		15,000	–	–	1,500	13,500	–
12.	Commission a/c		–	6,000	1,500	–	–	4,500
13.	Purchase Returns a/c		–	2,000	–	–	–	2,000
14.	Kamal a/c		3,800	–	–	3,800	–	–
15.	Sales Returns a/c		1,000	–	–		1,000	–
16.	Drawings a/c		3,000		360		3,360	–
17.	Salaries a/c		2,000		1,000		3,000	–
18.	Rent a/c		3,000	–	–	2,000	1,000	–
19.	Discount Allowed a/c		200	–	–	–	200	–
20.	Discount Received a/c		–	100	–	–	–	100
21.	Closing Stock		–	–	10,000		10,000	–
22.	Outstanding Salaries		–	–	–	1,000	–	1,000
23.	Prepaid Rent		–	–	2,000	–	2,000	–
24.	Commission Received in advance		–	–	–	1,500	–	1,500
25.	Accrued Interest		–	–	2,000		2,000	–
26.	Interest		–	–		2,000	–	2,000
27.	Depreciation		–	–	1,500	–	1,500	–
28.	Bad debts		–	–	3,800	–	3,800	–
29.	Interest on Capital		–	–	4,000	–	4,000	–
30.	Interest on Drawings		–	–	–	360	–	360
	Total		1,41,000	1,41,000			1,48,360	1,48,360

Other Adjustments

The following are other adjustments, which are generally made at the time of preparation of financial statements:

Goods Sent on Sale or Approval Basis

Sometimes goods are sold on approval basis. While sending the goods a journal entry for sale of goods is passed. If the goods are approved, they are treated as sales and no adjustment entry is needed. If they are not approved till the last day of accounting period, they are treated as stock lying with customers and the following adjustment entries should be passed.

a. Sales Account Dr. (at sale price)
 To Debtors Account

b. (Closing) Stock Account Dr. (at cost price)
 To Trading Account

Effect:

a. The value of goods sent on approval basis will be shown on the credit side of trading account by deducting from sales account at sale price and by adding to stock account at cost price.

b. Goods sent on approval will be shown on the assets side of the balance sheet by deducting from debtors at sale price and by adding to stock at cost price.

Abnormal Loss (Goods Lost by Fire or Theft)

In the business, sometimes there may be loss of stock due to fire or theft. The stock may or may not be insured. Sometimes part of the stock is insured. The adjustment entries for loss of stock by fire are as follows:

i. ***If stock is fully insured***, no loss to the organization. Whole amount will be collected from the insurance company. Thus, the journal entry is

 Insurance Co. Account Dr.

 To Trading /Purchases Account

 Effect:

 a. The amount of stock lost will be shown on the credit side of trading account or it may be shown on the debit side of trading account by way of deduction from purchases account.

 b. The amount due from insurance company will be shown on the assets side of the balance sheet as the amount due from insurance company.

ii. ***If stock is not insured***, the whole amount is lost to the organization. Thus, the journal entry is

 Profit and Loss Account Dr.

 To Trading/Purchases Account

 Effect:

 a. The amount of stock lost will be shown on the credit side of trading account or it may be shown on the debit side of trading account by way of deduction from purchases account.

 b. The amount of stock lost will be shown on the debit side of the profit and loss account as abnormal loss.

iii. ***If part of the stock is insured***, or sometimes the insurance company accepts only part of the claim to be given, then the part of the stock which is not insured or recovered is loss to the organization.

Thus, the journal entry is

Insurance Co. Account Dr. (Claim recovered/accepted)
Profit and Loss Account Dr. (Claim not recovered/accepted)
To Trading / Purchases Account

Effect:

a. The total amount of loss will be shown on the credit side of trading account or it may be shown on the debit side of trading account by way of deduction from purchases account. The net amount of loss will be shown on the debit side of profit and loss account.

b. Amount of stock insured or amount of claim agreed by Insurance Co. will be shown on the assets side of the balance sheet as the amount due from Insurance co.

Manager's Commission

Sometimes, some percentage of commission based on profits is to be given to the managers to encourage them. This commission may be calculated on profits before charging commission or after charging commission.

The formula for calculating manager's commission on profits, before charging commission is

Commission payable =

$$\text{Net Profit before charging commission} \ \ x \ \frac{\text{Rate of Commission}}{100}$$

The formula for calculating manager's commission on profits, after charging commission is

Commission payable =

$$\text{Net Profit before charing commission } x \ \frac{\text{Rate of Commission}}{100 + \text{Rate of Commission}}$$

The journal entry for commission payable is

Profit and Loss Account Dr.
To Commission payable Account

Effect:

a. Manager's Commission payable appears on the debit side of the profit and loss account.

b. Manager's Commission payable a/c will be shown on the liabilities side of the balance sheet under the head current liabilities.

Reserves

Sometimes, certain amount of profits is kept aside for future contingencies or for future expansion of the business. That amount is called 'Reserve'. Reserve is not a charge on profits. It is an appropriation of profits. The journal entry for creating reserve is

Profit and Loss Account Dr. (in case of sole trading concern) (or) Profit and Loss Appropriation Account Dr. (in case of other concerns)

To Reserve Account

Effect:

a. The amount in respect of reserves will be shown on the debit side of the profit and loss account.

b. It will be shown on the liabilities side of the balance sheet under the head reserves and surplus.

Check Your Progress – 2

6. Which of the following statement is/are true?
   i. Cash book records all cash receipts and cash payments.
   ii. Cash book records all sale and purchase transactions of goods both in cash and on credit.
   iii. Cash book records discount on cash payments
   a. Only (i) above
   b. Only (ii) above
   c. Only (iii) above
   d. Both (i) and (iii) above
   e. All of (i), (ii) and (iii) above
7. The balance sheet of a company showed an inventory value of ₹ 7083 crore for the year ended March 20xx. In which of the following entries is it recorded in journal proper in the next accounting period?
   a. Opening Entries
   b. Closing Entries
   c. Rectifying Entries
   d. Adjusting Entries
   e. Transfer Entries
8. When the total of debit balances equals the total of credit balances, it is said that the accounts are summarized reasonably with accuracy in accounting process. Identify the statement that is contrary to the objective of preparation of Trial Balance.

a. Ensures arithmetical accuracy of accounts
b. Facilitates detection of errors
c. Concise summary
d. Facilitates the preparation of financial statements
e. Is a conclusive proof of accuracy of accounts.

9. Which of the given functions of accounting, when done manually are not performed by the computerized accounting system?
   a. Records & stores data
   b. Analysis of transactions
   c. Performs arithmetic operations
   d. Sorts & summarizes data
   e. Generation of reports

10. Goods purchased on credit and paid on a later date is recorded at the net payable value, at the time of settlement. Certain organizations provide provisions for discount that is expected to earn at the time of the payment or on the given maturity date. From the following, recognize the term dealt with such provision.
   a. Reserve for Bad debts
   b. Reserve for doubtful debts recovered
   c. Reserve for discount on creditors
   d. Reserve for discount on debtors
   e. Special Reserve / Contingent reserves

11. PQR Ltd., had sold goods worth ₹ 2,500 to XYZ Ltd., on credit. PQR Ltd., subsequently found that XYZ Ltd., has become insolvent and the prospects of recovering its dues are low. Hence PQR Ltd., writes off its receivables from its books. However, the administrator of XYZ Ltd., instructs the company to pay off ₹ 1,000 to PQR Ltd., as full settlement of dues, at the time of liquidation. How does such recovery of bad debts effect in company's financial statements?
   a. Credit Bad Debts Recovered to P& L A/c and Add to Cash account in the asset side of balance sheet
   b. Debit Bad Debts Recovered to P& L A/c and Add to Cash account in the asset side of balance sheet
   c. Subtract bad debts recovered from new bad debts created in P& L A/c
   d. Credit bad debts recovered to P & L A/c and deducted from debtors in the assets side of balance sheet
   e. Shown as a Liability in the Balance Sheet

Activity 2.3

Give journal entries for each of the following adjusting entries:

1. Closing Stock ₹ 5,000
2. Depreciation to be charged on Machinery @ 5% (machinery value ₹ 20,000)
3. Interest on Capital to be provided @ 2% on capital of ₹ 1,00,000
4. Goods worth ₹ 3,000 destroyed by fire, insurance company admitted a claim of ₹ 1,000

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2.13 Summary

- Accounting is a systematic process, which starts from identification of a transaction and ends with the preparation of trial balance. Based on the trial balance an accountant can prepare financial statements. Double entry system of accounting is the base for recording business transactions in the accounting books.
- All the elements/accounts in the organization can be broadly classified into three types viz., personal accounts, real accounts and nominal accounts. Based on this classification, all the business transactions are analyzed.
- After its analysis, a transaction is first entered in the journal and then posted in the ledger. Thus, journal is a book of prime entry and ledger is a book of final entry. Instead of preparing one journal, accountants of big organizations use various journals for different purposes.
- At the end of an accounting period or any other time, the balances of all the ledger accounts are extracted and are written up in a statement called 'Trial Balance' to check the arithmetical accuracy of accounting records. Thus, Trial Balance is a summary of all General Ledger Balances outstanding as on a particular date.
- Even though the trial balance may tally, some errors might remain in the accounting records. Thus, trial balance is not a conclusive proof of accuracy of accounts. Sometimes, some adjustments are needed to prepare the financial statements from the trial balance. These entries are also recorded on the basis of double entry system of accounting.

2.14 Glossary

Accounting is the art of recording, classifying and summarizing in a significant manner and in terms of money, transactions and events which are, in part at least, of a financial character, and interpreting the results thereof.

Closing Stock is the amount of unsold stock lying at the end of accounting period. The closing inventory of every item is arrived at by physically counting the inventory available and is valued as per Ind AS-2.

Contra Entry is an entry, which is to be made on both sides of the three column cash book.

Double Entry is the system wherein both the debit and credit aspects of a transaction are recorded.

Fundamental Accounting Equation is the base for recording all the business transactions under double entry system of bookkeeping. It is expressed as:

Capital + Liabilities = Assets

Impress System of petty cash involves maintaining petty cash at a fixed amount by periodically reimbursing the petty cash expenses incurred during the period from the main cash book.

Journal is the book in which daily business transactions are recorded. The journal is also called the book of original entry, subsidiary book or book of prime entry.

Journal Proper is a residual book which is used to record all transactions which cannot be included in the cash book or any of the other subsidiary books. The transactions that will be recorded in Journal Proper are purchase or sale of fixed assets on credit, investments on credit, opening entries, closing entries, transfer entries, adjusting entries, rectification entries, etc.

Ledger is a collection of various accounts of the enterprise. It can be viewed as a summary of all events and transactions in that particular account. The ledger is often called the book of final entry and more often the principal book.

Nominal Account deals with different types of expenses or incomes or loss or profit. It shows the amount of income earned or expenses incurred for a particular period under a particular head.

Personal Account deals with accounts of individuals like creditors, debtors, bank, etc. It shows the balance due to these individuals or due from them on a particular date.

Real Account represents assets other than personal accounts.

Sub-Journal or Subsidiary Books or Special Journals are maintained to facilitate recording of similar transactions by large concerns.

Trial Balance is a summary of all General Ledger Balances outstanding as on a particular date. Preparation of trial balance is a process of summarization of information

2.15 Self-Assessment Test

1. Describe the classification of accounts with relevant examples.
2. Enumerate the differences between Journal and Ledger.
3. Why are subsidiary books maintained? What is the significance of these books?
4. Journalize the following transactions.

   1st July - started business by bringing in cash ₹ 1,00,000; land ₹ 5,00,000 bank balance ₹ 3,00,000.

   5th July - purchased plant ₹ 1,00,000 from Capital Limited on credit.

   6th July - purchased furniture ₹ 50,000 by issuing cheque.

   7th July - paid to Viswakarma as advance on contract for construction of building ₹ 20,000 cash.

   5th August - building construction completed. Viswakarma raises bill for ₹ 2,25,000. Bill verified and passed.

   10th August - ₹ 50,000 cheque issued to Viswakarma.

   15th August - ₹ 25,000 cheque issued to Capital Limited.

   16th August - ₹ 10,000 cash paid for installation of plant.

   17th August - Raw materials purchased from Raw Limited ₹ 25,000 on credit.

   18th August - Raw materials purchased from Extra Limited ₹ 10,000 on credit.

   25th August - Weekly wages paid ₹ 12,000.

   26th August - Sold goods to Raju for cash ₹ 28,000.

   27th August - Sold goods to Ramu on credit ₹ 35,000.

   29th August - Amount received from Ramu ₹ 10,000 by cheque.

   30th August - Cash paid to Raw Limited ₹ 25,000.

   31st August - Cheque issued to Viswakarma ₹ 25,000, Extra Limited ₹ 5,000 and Capital Limited ₹ 25,000.

3. During May 20xx, M/s Blackbox transacted the following business:

Date	Transaction	₹
May 1	Commenced business with cash	4,00,000
May 1	Opened current account with SBI	3,50,000
May 1	Purchased goods on cash	20,000
May 2	Purchased goods on credit from Ram	1,30,000
May 3	Purchased goods for cash	1,000
May 3	Sold goods to TVK Ltd.	80,000
May 4	Purchased goods from Ashok	26,000
May 4	Paid Andhra Traders an advance for goods ordered	21,000
May 5	Goods returned by TVK Ltd.	5,000
May 5	Sold goods to Ross	30,000
May 5	Deposited cheque received from Murthy as advance for goods ordered by him	31,000
May 6	Purchased furniture for office use by cheque payment	22,000
May 6	Goods returned by Ross	1,000
May 7	Paid wages by cash	5,000
May 7	Drawings for personal use	10,000
May 8	Received goods from Andhra Traders	15,000
May 8	Purchased goods from Xing Ltd.	45,000
May 9	Goods returned to Xing Ltd.	500
May 10	Goods sold to Quamal	11,000
May 10	Goods dispatched to Murthy	21,000
May 11	Paid for postage and telegrams	2,000
May 13	Goods returned by Quamal	5,000
May 15	Paid for stationery	2,000
May 18	Paid into bank	500
May 19	Paid to Andhra Traders by cheque	9,000
May 20	Goods sold for cash	11,750
May 22	Bought goods for cash	1,500
May 22	Received cheque from Quamal and deposited	9,000
May 22	Discount allowed to Quamal for prompt payment	500
May 25	Paid salaries	7,000
May 26	Sold goods to Raghu	50,000
May 26	Goods returned by Raghu	300
May 28	Paid rent	5,000
May 28	Cheque issued to Ram	1,00,000
May 29	Cash received from TVK Ltd.	30,000
May 29	Discount allowed to TVK Ltd. for prompt payment	1,000
May 30	Purchased goods – payment by cheque	5,000
May 31	Drew cash for personal use	1,000
May 31	Paid to Ram by cash	10,000
May 31	Discount received from ram for prompt payment	5,000
May 31	Received Cheque from Raghu and deposited	15,000
May 31	Discount allowed to Raghu for prompt payment	250

Prepare triple column cash book, other required subsidiary books, post all the transactions to respective ledgers.

2.16 Suggested Readings/Reference Material

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Additional References:

1. Accounting Standards Quick Referencer, April 2019, Published by ICAI. (Pdf downloaded), https://resource.cdn.icai.org/55939asb45327.pdf
2. KPMG Spark. How to read a cash flow statement. 2020, https://www.kpmgspark.com/blog/how-to-read-a-cash-flow-statement

2.17 Answers to Check Your Progress Questions

1. (a) Book of original entry

The journal is called the book of original entry, subsidiary book or book of prime entry. All the transactions are first entered in the journal in the order of their occurrence.

2. (b) Posting

The transactions recorded in the books of original entry are transferred to the ledger. The process of transferring entries from the journal to the ledger is called ledger posting.

3. (d) Increase in assets

An addition to the assets will result in increase in assets

4. (a) **Debiting salary a/c, crediting cash a/c**

   Salary being an expense is debited and cash, a real account is credited as cash is going out

5. (c) **Debiting sales returns account and crediting customer's account**

   Sales returns account is debited and customer being the giver, his account is credited.

6. (d) **Both (i) and (iii) above**

   A double column cash book has both cash and discount columns.

7. (a) **Opening Entries**

   Closing inventory of the year becomes the opening inventory for the next year.

8. (e) **Is a conclusive proof of accuracy of accounts**

   The preparation of trial balance is not a conclusive proof of accuracy of accounts as there still can be errors

9. (b) **Analysis of transactions**

   Analysis of transactions should be done manually only

10. (c) **Reserve for discount on creditors**

    Organizations may like to show the sundry creditors in the balance sheet at the net payable value by estimating in advance the amount of cash discounts that may be received at the time of settlement of amounts due. This is usually done by creating a reserve for discount on creditors.

11. (a) **Credit bad debts recovered to P& L a/c and Add to cash account in the asset side of balance sheet.**

    Any bad debts recovered is credited to bad debts recovered account and debited to cash account as cash is received. The bad debts recovered account is then transferred to Profit and Loss ccount credit side being income.

Unit 3

Elements of Financial Statements

Structure

3.1 Introduction

In the previous unit "Conceptual Framework of Financial Accounting" we defined accounting and detailed the classification of accounts into personal accounts, real accounts, and nominal accounts. The details about the double-entry system in recording business transactions in journals and ledgers were discussed in the previous unit. The unit also discussed the preparation of trial balance and adjustment entries.

This unit introduces some basic concepts for preparation of financial statements. Financial statements are the primary means of communicating financial information to external users or more specifically, decision-makers.

Every businessman is interested in knowing two facts about his business – whether he has earned a profit or suffered a loss during a particular period and what is his financial position on a particular date. For this purpose, financial statements are prepared at the end of the accounting period. These statements are also called Final Accounts. The financial statements reflect the financial operations of the enterprise during the period under consideration and the financial position at the end of the period.

Before learning to prepare Financial Statements, it is essential to understand the distinction between Revenue and Capital Expenditure and some concepts relating to the preparation of financial statements.

3.2 Objectives

After reading through the unit, the student should be able to:

- Distinguish between Capital and Revenue items
- Describe various elements of financial statements
- Prepare manufacturing and trading account
- Solve problems on Profit and Loss Account and Balance Sheet
- Explain the meaning and importance of Cash Flow Statement

3.3 Distinction between Capital and Revenue Items

The concept of capital and revenue is of fundamental importance to correctly determine the accounting profits of a business and recognize the assets of an enterprise.

3.3.1 Capital and Revenue Expenditure

Expenses can be classified into capital or revenue expenditure based on their utility to the entity. Capital expenditure relates to such expenses, which generate benefits and assist the entity in earning revenue over a period of time. Revenue expenditure relate to those expenses which are incurred in earning the revenues and the benefit of which gets exhausted within the accounting period. The below given Table 3.1 gives the points of difference between capital and revenue expenditure.

Table 3.1: Distinction between Capital Expenditure and Revenue Expenditure

Capital Expenditure	Revenue Expenditure
• Results from outflow of cash needed to bring into existence an asset of an enduring nature.	• Results from outflow of cash relating to routine operations of the business during the accounting period.
• Increases the profit earning capacity by either reducing the cost or increasing the output.	• Generates revenue during the period.
• Is incurred for more than one accounting period.	• Is incurred for a particular accounting period.
• Is non-recurring in nature.	• Is generally recurring in nature.
• Does not match with capital receipts.	• Matches with revenue receipts and is charged to profits during the period.
• May be incurred before or after the commencement of the business.	• Generally incurred after the commencement of the business.
• If any asset which is not meant for resale is bought by an enterprise, it becomes a capital expenditure for the enterprise.	• If an asset is purchased by an enterprise for resale, it becomes revenue expenditure for the enterprise.

Source: ICFAI Research Center

3.3.2 Deferred Revenue Expenditure

Expenditure that is basically of revenue nature for which payment has been made or liability incurred but the benefits are presumed to result in subsequent periods can be treated as deferred revenue expenditure. The guidance note issued by the ICAI (Institute of Chartered Accountants of India) defines deferred revenue expenditure as, 'expenditure for which the payment has been made or a liability incurred but which is carried forward on the presumption that it will be of benefit over a subsequent period or periods'.

Features of Deferred Revenue Expenditure

i. The expenditure must be of revenue nature.

ii. The exact amount and the period of time for which the benefit will be available cannot be precisely determined.

iii. The expenditure does not result in acquisition of any tangible or intangible asset.

iv. The expenditure is written off over a period of time during which benefits are assumed to result.

Example: Heavy advertisement expenditure incurred to launch a new product.

3.3.3 Capital Receipts and Revenue Receipts

The receipts, which do not affect the profits earned or losses incurred during the course of the year, but which are non-recurring in nature, are called capital receipts, which take the following forms:

i. Contributions made by the proprietor towards the capital of the business in the case of sole proprietorship. In the case of companies, the receipts from the issue of shares are considered as capital receipts.

ii. Receipts from the sale of fixed assets, previously not intended for resale.

Receipts from sale of goods to customers or from rendering of services in the ordinary course of business are termed as revenue receipts. These directly add to the profits of the business or decrease the losses of the business. The net revenues or profits remaining after deducting the revenue expenses are available for distribution to the shareholders.

3.4 Elements of Financial Statements

The purpose of the accounting process is the preparation of the financial statements. It is the final step in the accounting process. The basic financial statements are:

i. The Income Statement

ii. The Balance Sheet

iii. The Cash Flow Statement

The preparation of these financial statements is a product of the items appearing in the trial balance and the adjustment entries which are required to be made to show a true and fair view of the financial statements. In accounting terminology, closing entries are required to be passed resulting in the preparation of financial statements. These closing entries are dealt with in the later sections.

Income Statement/Statement of Profit and Loss

The purpose of the income statement is the determination of the profits of the business. The statement discloses the profit that has accrued to a concern during the reporting period. It is also helpful in predicting the future profitability of the concern and the future cash generating ability of the enterprise. The statement reports the change in the owner's capital or the shareholder's equity as a result of operations of the enterprise.

Concepts Relating to Profit Determination

Determination of profit or net income is important in financial accounting. Accountants need to measure the business income or net income or profit. There are some concepts, which guide the accountant while determining the income. A brief explanation of these concepts is given in this section:

Accounting Period Concept

Determination of a definite period is very essential to measure net income or profit. Users of financial statements periodically would like to know the net income generated on the resources invested by them. Thus, they want regular reports about net result and the financial position. Accountants may prepare reports for a particular period or after the completion of a particular project depending on the type of business. If the interval between the reports is one year, it will be helpful to the businessman and the users.

Realization Concept

The timing of revenue recognition is critical in profit determination. It ensures that proper cut-off is made to each reporting period. If this criterion is followed, it results in avoidance of overstatement or understatement of revenues. Revenue should be recognized in the period in which it is earned, not necessarily when cash is received.

Matching Concept

This concept helps in matching the revenues with the expenses. Determination of profit involves recognition of revenue and allocation of costs. As per this concept, the expenses are to be recognized in the period of their related revenue. Thus, matching concept requires the recognition of revenue and expenses on a comparable basis.

Conservatism Concept

According to this concept, the accountants require to underplay favourable prospects until they are actually realized. They should "anticipate no profits, but provide for all possible losses". Thus, revenues are to be recognized only when they are reasonably certain and expenses as soon as they are reasonably possible. This concept must be applied prudently so as not to result in secret profits and reserve which contravenes the convention of full disclosure.

No specific format exists for the presentation of the Income Statement. Hence, companies take considerable leeway while presenting this statement resulting in a variety of presentations. However, two distinct types can be identified in these modern days. One is the multiple step format that reports the results in a series of subtotals such as Gross Profit, Operating Profit Before Interest and Depreciation, Operating Profit Before Tax and Exceptional items, Net Profit Before Tax and exceptional items. For example, the income statement of Infosys Limited is a multiple step income statement. The second format is a single step format that groups all revenues and deducts expenses in a single step, doing away with specific sub-totals. For example, the income statement of Tata Steel Limited is a single step presentation.

Traditionally, the income statement (referred to as Trading and Profit and Loss Account) was presented in the form of a Ledger Account (also known as T form or horizontal form) with expenses and losses being shown on the debit side and the incomes and gains on the credit side of the account. The Account was usually sub-divided into Manufacturing Account, Trading Account and Profit and Loss Account.

Activity 3.1

Classify the following items into capital or revenue expenditure:

- Expenses incurred on a foreign tour for purchasing new machinery
- Freight and insurance expenses incurred on import of new machinery
- Wages paid in connection with the erection of new machinery
- Repairs expense on a second hand machine before it is put to use
- Amount spent on an advertisement, the benefit of which is likely to accrue for next five years
- Amount spent on repainting the factory premises
- Compensation paid to employees who were retrenched
- Amount paid to a lawyer for defending a suit in the court of law

3.5 Manufacturing and Trading Account

Manufacturing concerns prepare a manufacturing account to determine the cost of goods manufactured. The balance in this account (i.e., cost of goods manufactured) is transferred to the trading account. Thus, the financial statements of a manufacturing concern would comprise a manufacturing account, a trading account, profit and loss account and a balance sheet.

Format of Manufacturing Account

The format of a Manufacturing Account is as follows:

Dr. **Manufacturing Account for the Year Ended ……** Cr.

Particulars	Amount (₹)	Particulars	Amount (₹)
To Raw Materials consumed	xxx	By Cost of Goods	xxx
To Direct labour	xxx	manufactured transferred to	
To Direct Expenses	xxx	trading account	
Prime Cost	xxx		
To Factory overheads	xxx		
To Work-in-progress			
Opening xxx Less: Closing xxx Sale of scrap xxx	xxx		
	xxx		**xxx**

Note: *Raw Material Consumed*

= Opening stock of raw materials + Purchases – Closing stock of raw materials.

Trading account is prepared to know the net trading results of the concern. It shows the profit or loss earned by the firm during a particular period of trading activity i.e., from buying to selling. In manufacturing concerns where a Manufacturing Account is opened to account for the cost of goods manufactured, the trading account takes into account only the opening stock and closing stock of finished goods with the amount transferred from manufacturing account and net sale of finished goods. Where no separate manufacturing account is opened, all the direct expenses and manufacturing expenses are shown on the debit side and all direct incomes are shown on the credit side of the Trading Account. The balance in this account denotes gross profit or loss earned by the organization during a particular period and is transferred to profit and loss account. Thus, gross profit is the difference between sales and cost of goods sold.

Trading Account of XYZ Co., for the Year Ending 31st March, 20xx

Dr. Cr.

Date	Particulars	Amount ₹	Date	Particulars	Amount ₹
	To Opening stock a/c	xxx		By Sales a/c	xxx
	To Purchases a/c	xxx		Less: Sales Returns	xxx
	Less: Returns	xxx			xxx
	To Wages a/c	xxx		By Closing stock a/c	xxx
	To Carriage inward a/c	xxx			
	To Motive power and coal	xxx			
	To Gas, water and fuel	xxx			
	To Packaging charges	xxx			
	To Octroi	xxx			
	To Manufacturing and factory expenses	xxx			
	To Gross Profit c/d	xxx			
		xxx			xxx

Elements of Trading Account

Opening Stock: The amount of unsold stock in hand at the beginning of the year is termed as opening stock. In case where a manufacturing account is separately opened, opening stock comprising opening stock of raw material, opening work-in-progress and opening stock of finished goods is shown separately and distinctly. However, where no manufacturing account is separately opened, the value of opening stock comprising opening raw material stock, opening work in progress and opening stock of finished goods is shown on an aggregate basis. The amount corresponding to the opening stock is available on the debit side of the trial balance and the Trading Account.

Purchases: The purchases amount in the trial balance comprises both cash purchases and credit purchases of goods. As purchases always show debit balance, it appears on the debit side of the trial balance and the trading account.

Purchase Returns: Purchase returns account shows the amount of goods returned to the suppliers. Also known as returns outward account it has a credit balance and appears on the credit side of the trial balance. It will be shown as deduction from purchases on the debit side of the trading account.

Wages: Wages may be direct wages or indirect wages. Only the direct wages are considered in Trading Account. Since wages are an expense, they reflect a debit balance and appear on the debit side of the trial balance.

Carriage Inwards: This is also a direct expense incurred in respect of purchases. It shows a debit balance and hence appears on the debit side of the Trial Balance and Trading Account.

Motive Power, Coal, Gas, Fuel and Power Expenses: These expenses are direct expenses incurred to run the machines and are directly related to the production of goods. They show debit balance and hence appear on the debit side of the Trial Balance and the trading account.

Octroi: When goods are purchased within local limits, octroi duty has to be paid.
This is a kind of direct tax, which shows debit balance and appears on the debit side of trial balance and the trading account.

Packaging Charges: Certain goods need to be primarily packaged before they are sold. For example, fruit pulp needs to be packaged in some plastic wrapper or bottles before it can be sold. However, this expense does not include charges on safe dispatch, advertisement, fancy packaging or safe transportation, etc., which are of secondary expenses. Thus, packing expenses, which are treated as direct expense, are shown on the debit side of the trading account.

All Manufacturing Expenses: Expenses such as rent and insurance of factory premises, depreciation on factory machinery, factory lighting and all other factory expenses that go to determine the cost of goods sold are debited to trading account.

Sales: Sales, as per accounting terminology, include both cash and credit sales. Sales are a direct income, and show credit balance and appear on the credit side of trial balance and the trading account.

Sales Returns: Sales returns account shows the amount of goods returned from the customers. Also termed as returns inward account it has a debit balance and appears on the debit side of the trial balance. It will be shown as deduction from sales on the credit side of the trading account.

Closing Stock: The amount of unsold stock in hand at the end of the year is termed as closing stock. In case where a manufacturing account is separately opened, closing stock comprising raw material stock, work-in-progress and stock of finished goods is shown separately and distinctly. However, where no manufacturing account is separately opened, the value of stock comprising raw material stock in hand at the end of the period, work-in-progress at the end of period and stock of finished goods is shown on an aggregate basis. Generally closing stock is mentioned outside the trial balance and an adjustment entry has to be passed by debiting closing stock and crediting trading account (dealt with in our earlier chapter). If it is given in the trial balance, it means the adjustment entry is passed and it will be shown on the assets side of the balance sheet only.

Closing Entries for Trading Account

The preparation of a Trading Account and Profit and Loss Account requires the passing of closing journal entries in the Journal Proper. The revenue and expenses accounts appearing in the trial balance incorporating the adjustment entries are to be passed in the Journal Proper. Once the closing entries are passed the balances in these accounts no longer exist.

i. For transferring expenses to Trading account

   Trading a/c Dr.

   To Opening stock A/c

   To Purchase A/c

   To Sales returns A/c

   To Wages A/c

   To Carriage inwards A/c

   To Factory expenses A/c

   To Gas, water and electricity A/c

ii. For transferring incomes to Trading account

   Sales A/c Dr.

   Purchase returns A/c Dr.

   To Trading a/c

iii. For recording closing stock

   Closing stock A/c Dr.

   To Trading A/civ.

iv. For transferring Gross Profit from Trading Account to Profit & Loss Account

   Trading A/c Dr.

   To Profit and loss A/c

v. For transferring Gross Loss from Trading Account to Profit & Loss Account

   Profit and loss A/c Dr.

   To Trading A/c

A Simple Example: Trading Account

The following is a simple example of a Trading Account:

Dr. **Trading Account for the Period Ending March 31, 20xx** Cr.

Particulars	₹	₹	Particulars	₹	₹
To Opening Inventory a/c			By Sales a/c	7,90,000	
Raw materials	90,000		Less: Sales returns a/c	10,000	
Work-in-progress	70,000				7,80,000
Finished goods	2,40,000		By Closing inventory a/c		
		4,00,000	Raw materials	40,000	
To Purchases a/c	5,00,000		Work-in-progress	80,000	
Less: Purchase Returns a/c	15,000		Finished goods	3,00,000	
		4,85,000			4,20,000
To Carriage inwards a/c		10,000			
To Wages a/c		40,000			
To Factory expenses a/c		20,000			
To Fuel and Power a/c		5,000			
To Trading expenses a/c		15,000			
To Gross Profit transferred to P&L a/c		2,25,000			
		12,00,000			12,00,000

3.6 Profit and Loss Account

The trading account only shows the gross profit or loss made on trading activity. There may be some expenses and incomes, which are not related to trading activity. These are termed as indirect expenses and indirect incomes. In order to know the exact profit or loss made during a particular period, all these expenses and incomes should be taken into account. The account, which is prepared for this purpose is called Profit and Loss account. The profit here is termed as Net profit. It is transferred to the capital account (in the Balance Sheet).

The matching concept and the realization concept are very essential to the preparation of Profit and Loss account. The profit or loss measured is the result of matching the revenues and expenses according to accounting principles. The accounts debited or credited in the profit and loss account reflect the expenses incurred and incomes accrued irrespective of whether the amounts are received in cash or not.

Format of Profit and Loss Account

Date 20xx	Particulars	Amount (₹)	Date 20xx	Particulars	Amount (₹)
	To Gross Loss b/d			By Gross profit b/d	
	To Office salaries and wages a/c				
	To Office rent, rates and taxes a/c			By Cash discounts received a/c	
	To Office lighting and insurance a/c			By Bad debts recovered a/c	
	To Printing and stationery a/c			By Income from investments a/c	
	To Postage, telegrams and telephone a/c			By Commission received a/c	
	To Legal expenses a/c			By Interest on deposits a/c	
	To Trade expenses a/c			By Gain on sale of fixed assets a/c	
	To Audit fees a/c				
	To General expenses a/c				
	To Cash discounts allowed a/c				
	To Interest on capital a/c				
	To Interest on loans a/c				
	To Bad debts a/c				
	To Storage expenses a/c				
	To Carriage, freight, cartage outwards a/c				
	To Cost of samples, catalogue expenses a/c				
	To Salesmen's salaries, expenses and commission a/c				
	To Advertising expenses a/c				
	To Depreciation on fixed assets a/c				
	To Net profit (transferred to capital account)				

Elements in Profit and Loss Account

Salaries: Salaries shown in the profit and loss account include the salaries paid to office and sales staff. If salaries are paid after deducting income tax and provident fund, then these should be added back to the salaries in order to show the gross amount of salaries. As salaries constitute expense, they should be debited to profit and loss account. Facilities given to employees like free meals, refreshments are also regarded as salaries.

Rent, Rates and Taxes, Lighting and Insurance: Expenses relating to maintenance of administrative buildings and sales office buildings are treated as indirect expenses. Maintenance includes rent, rates, taxes, lighting, insurance etc. These are expenses and should be debited to profit and loss account. If rent is received from tenants or from sub-letting it should be shown on the credit side of the profit and loss account.

Printing, Stationery, Postage and Telegrams: Expenses like printing and stationery, postage and telegrams are indirect expenses. These expenses are incurred for smooth maintenance of clerical work and are shown on the debit side of the profit and loss account.

Legal Fees and Audit Fees: Any fees like audit fees paid for consultation and advisory in nature is treated as indirect expenditure and is shown on the debit side of the profit and loss account.

Discount: The amount of cash discount given to customers is termed as discount allowed. It is a loss and should be debited to profit and loss account. The amount of cash discount received from creditors is an income and is shown on the credit side of the profit and loss account.

Other General Expenses: Any other expenditure, which can be treated as indirect, is shown on the debit side of the profit and loss account. For example, trade expenses, miscellaneous expenses, and general expenses.

Bad Debts and Bad Debts Recovered: The amount, which cannot be recovered from customers, is termed as bad debt. It is a loss and should be debited to profit and loss account. If the amount which was previously written off as bad debt, is received, it is treated as income and is shown on the credit side of the profit and loss account.

Interest: Interest paid on loans, overdrafts and to creditors is an expense and is shown on the debit side of the profit and loss account. Any amount received in the form of interest should be shown on the credit side of the profit and loss account. For example: interest received on investment, interest received on deposits, etc. Interest paid on capital should be shown separately on the debit side of the profit and loss account and interest received on drawings should be shown on the credit side of the profit and loss account in the case of sole proprietor and partnership firm.

Selling Expenses: All the selling expenses like salesmen commission, travelling expenses etc., are indirect expenses. These expenses are shown on the debit side of the profit and loss account.

Distribution Expenses: All distribution expenses like advertisement, samples given to customers, storage expenses are shown on the debit side of the profit and loss account.

Depreciation: Depreciation is a loss, which arises due to wear and tear of assets used in the business. It should be charged to profit and loss account.

Abnormal Losses: Loss, which arises on account of abnormal reasons, is termed as abnormal loss. For example: loss by theft, fire, and accident. These losses, to the extent not covered by insurance claim, are debited to the profit and loss account.

Profit or Loss on Sale of Assets: Loss on sale of assets is shown on the debit side of the profit and loss account. Gain or profit arises on sale of fixed assets and is shown on the credit side of the profit and loss account.

Expenses Not Shown in the Profit and Loss Account

Proprietor's personal expenses should not be shown in the profit and loss account. Thus, income tax paid by the sole trader is also treated as personal expenditure of sole trader. Any life insurance premium paid on the life policy of proprietor is also treated as personal expenditure. These personal expenses are recorded in the books of accounts as drawings.

Closing Entries for Profit and Loss Account

Like trading account, there are closing entries for profit and loss account. These entries are also recorded in the Journal Proper.

i. For the transfer of expenses to P&L a/c

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

Note: A separate credit should be given for every individual expense

ii. For the transfer of incomes to P&L a/c

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

Note: A separate debit should be given for every individual income

iii. For the transfer of Net Profit to Capital Account

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

iv. For the transfer of Net loss to Capital Account

Capital A/c Dr.

To Profit and Loss A/c

Check Your Progress - 1

1. Frozen Delight, a prominent bakers and confectionary store, spent an amount of ₹ 3,01,000 in July, 20xx, on local advertisements and printing of brochures & catalogues as a part of its promotional activity for that fiscal year. Which head is this amount classified in the books of account?
   a. Capital Expenditure
   b. Revenue Expenditure
   c. Capital Receipts
   d. Revenue Receipts
   e. Deferred Revenue Expenditure
2. A manufacturing company has paid a duty fee of ₹ 750 to its suppliers for the goods purchased. The supplier company was situated within the same limits of the manufacturer concern. Under what term is the above item mentioned in Manufacturing A/c.
   a. Excise Duty
   b. Custom duty
   c. Octroi Charges
   d. Freight Inwards
   e. Carriage Outwards
3. Depreciation appearing in the trial balance should be
   a. Debited to P&L a/c
   b. Shown as liability in balance sheet
   c. Reduced from related asset in balance sheet
   d. Debited to P&L a/c and shown as liability in balance sheet
   e. Debited to P&L a/c and reduced from related asset in balance sheet
4. An amount due from the debtor which is not collectible is referred to as
   a. Sundry debtors
   b. Doubtful debts
   c. Good debts
   d. Bad debts
   e. Bad and doubtful debts

5. Which of the following does not form a part of manufacturing account?
   a. Raw material consumed
   b. Net sales
   c. Direct labour
   d. Direct expenses
   e. Factory overheads

Preparation of Profit and Loss Account without Adjustments

Profit and loss account is a nominal account. In general, all expenses and losses which are on the debit side of the trial balance are debited to profit and loss account and all incomes and gains which are on the credit side of the trial balance are credited. Following is an illustration of profit and loss account without adjustments.

Illustration 3.1

Given below is the Trial balance of Srinivas as on 31st March, 20xx

Particulars	Amount (₹)	Particulars	Amount (₹)
Land	5,300	Sales	41,400
Purchases	21,200	Return outwards	420
Salaries	2,200	Interest	240
Rent	600	Accounts payable	4,980
Postage	300	Loan	3,000
Stationery	240	Capital	12,000
Wages	5,200		
Freight on purchases	560		
Misc. Expenses	500		
Carriage on sales	800		
Repairs	900		
Bad debts	120		
Opening inventory	3,100		
Buildings	11,700		
Furniture	1,000		
Accounts receivable	6,000		
Cash in hand	1,300		
Return inwards	1,020		
	62,040		62,040

The value of inventory on 31st March 20xx is estimated at ₹ 2,980. You are required to prepare the trading and profit and loss account for the year ended March 31, 20xx.

Solution

Trading & Profit & Loss a/c of Mr. Srinivas for the year ended March 31, 20xx

Dr. Cr.

Particulars	Amount (₹)	Amount (₹)	Particulars	Amount (₹)	Amount (₹)
To Opening stock		3,100	By Sales	41,400	
To Purchases	21,200		Less: Returns	1,020	40,380
Less: Returns	420	20,780			
To Wages		5,200	By Closing stock		2,980
To Freight on purchases		560			
To Gross profit c/d		13,720			
		43,360			43,360
To Salaries		2,200	By Gross profit b/d		13,720
To Rent		600	By Interest		240
To Postage		300			
To Stationery		240			
To Miscellaneous expenses		500			
To Carriage on sales		800			
To Repairs		900			
To Bad debts		120			
To Net profit c/d		8,300			
		13,960			13,960

Preparation of Profit and Loss Account with Adjustments

The following is an example of profit and loss account with adjustments:

Illustration 3.2

From the following balances extracted from the books of Mr. Karan and the additional information given, prepare the profit and loss account for the year ended 31st March, 20x1.

Particulars	Amount (₹)	Amount (₹)
Inventory on April 1, 20x0	60,500	
Purchases and sales	90,300	1,37,200
Returns	2,200	1,300
Share capital		30,000
Drawings	4,500	
Land and buildings	30,000	
Furniture and fittings	8,000	
Accounts receivable and payables	25,000	45,000
Cash in hand	3,500	
Investments	10,000	
Interest		500
Commission		3,000
Total direct expenditure	7,500	
Postage, stationery and phones	2,500	
Fire insurance premium	2,000	
Salaries	11,000	
Bank overdraft		40,000
	2,57,000	2,57,000

Additional Information:

a. Closing inventory on 31st March, 20x1 was valued at ₹ 65,000

b. Interest on investments ₹ 500 is yet to be received while ₹ 1,000 of the commission received is yet to be earned in 20x0-20x1

c. ₹ 500 of the fire insurance premium paid is in respect of the quarter ending
30th June, 20x1

d. Salaries ₹ 1,000 for March 20x1 and bank overdraft interest estimated at ₹ 2,000 have to be recorded as outstanding charges.

e. Depreciation is to be provided on Land & Buildings @ 5% and on furniture and fittings @ 10%.

f. Provide provision for doubtful debts @ 5% of sundry debtors.

g. Goods worth ₹ 500 are taken away by the proprietor for personal use.

h. Provide interest on capital at 5% and interest on drawings at 2%.

Solution

Trading & Profit & Loss a/c of Karan for the year ending 31.3.20x1

Dr. Cr.

Particulars	Amount (₹)	Amount (₹)	Particulars	Amount (₹)	Amount (₹)
To Opening stock		60,500	By Sales	1,37,200	
To Purchases	90,300		Less: Returns	2,200	1,35,000
Less: Returns	1,300		By Closing stock		65,000
	89,000				
Less: Drawings	500	88,500			
To Direct expenditure		7,500			
To Gross profit c/d		43,500			
		2,00,000			2,00,000
To Postage, Stationery & Phones		2,500	By Gross profit b/d		43,500
To Fire insurance premium	2,000		By Interest	500	
Less: Prepaid	500		Add: Receivable	500	
		1,500			1,000
To Salaries	11,000		By Commission	3,000	
Add: Outstanding	1,000	12,000	Less: Pre-received	1,000	2,000
To Interest on bank overdraft		2,000	By Interest on drawings	$4,500 \times \frac{2}{100}$	90

Contd….

Dr. Cr.

Particulars	Amount (₹)	Amount (₹)	Particulars	Amount (₹)	Amount (₹)
To Depreciation on Land & Buildings $\left(30,000 \times \frac{5}{1,000}\right)$		1,500			
To Furniture & Fittness $\left(8,000 \times \frac{10}{100}\right)$		800			
To Provision for Bad debts $\left(25,000 \times \frac{5}{100}\right)$		1,250			
To Interest on capital $\left(30,000 \times \frac{5}{100}\right)$		1,500			
To Net profit		23,540			
		46,590			46,590

3.7 Balance Sheet

After ascertaining the profit by preparing trading account and profit and loss account, a business man would like to know the financial position of his business. All the nominal accounts are closed by transferring them to trading account or profit and loss account. But real accounts which are related to assets and personal accounts which are related to persons and organizations, are not closed. All these are presented in the form of a statement and the statement is called Position Statement or Balance Sheet. Balance sheet is not an account but only a statement containing assets, liabilities and capital.

For better understanding of the meaning of balance sheet, some definitions given below by prominent writers:

"The Balance Sheet is a statement at a given date showing on one side the trader's property and possessions and on the other side his liabilities"

– *Palmer*

"A Balance Sheet is an itemized list of the assets, liabilities and proprietorship of the business of an individual at a certain date"

– *Freeman*

"A list of balances in the asset and liability accounts. This list depicts the position of assets and liabilities of a specific business at a specific point of time"

– *American Institute of CPA*

Thus, balance sheet lists out the assets and liabilities and capital of the business at a certain date.

Format of Balance Sheet

There is no specific form of balance sheet for non-corporate entities like sole proprietorship firms and partnership firms. But, the assets and liabilities may be shown in the order of

a. Liquidity, or

b. Permanency

a. **Liquidity Order:** The assets, which are easily convertible into cash (called as liquid assets) come first and those, which cannot be readily converted, come next and so on. Similarly, liabilities are also arranged in this manner. The liabilities which are payable on a priority basis come first and those payable later come next and so on.

The pro forma of the balance sheet in the order of liquidity is as follows:

Balance Sheet of ____________ as on _________________

Liabilities	Amount	Assets	Amount
Income received in advance		Cash	
Outstanding Expenses		Bank	
Bank overdraft		Short term Investments	
Bills payable		Prepaid Expenses	
Sundry Creditors		Income Receivable	
Long-term Loans		Bills Receivable	
Reserves		Debtors	
Capital		Closing Stock	
		Long-term Investments	
		Furniture	
		Buildings	
		Machinery	
		Freehold Premises	
		Goodwill	

b. **Permanency Order:** In the order of permanency, permanent assets are shown first and those of less permanent are shown next and so on. In other words, fixed assets are shown first, followed by liquid assets. On the liabilities side permanent liabilities are shown first and less permanent ones are shown next and so on. In other words, capital is shown first followed by long-term liabilities, short-term liabilities and current liabilities. In this method, arrangement of assets and liabilities will be reversed when compared to order of liquidity method.

Balance Sheet of ____________as on _________

Liabilities	Amount	Assets	Amount
Capital		Goodwill	
Reserves		Freehold Premises	
Long-term Loans		Machinery	
Sundry Creditors		Buildings	
Bills Payable		Furniture	
		Long-term investments	
Bank Overdraft		Closing stock	
Outstanding Expenses		Debtors	
Income received in advance		Bills receivable	
		Income receivable	
		Prepaid expenses	
		Short-term investments	
		Bank	
		Cash	

Elements of Balance Sheet

There are three basic elements in balance sheet i.e; equity or capital, liabilities and assets. Detailed explanation of each element is given below:

Liabilities

Capital: We know that the amount contributed by owners is termed as capital. As per business entity concept, capital is a liability. Hence, it is shown on the credit side of the trial balance. The capital given in the trial balance is called opening capital. In the balance sheet, capital is shown on the liability side after adjusting profits, drawings, interest on capital and interest on drawings and this amount is called closing capital. Thus,

Closing Capital = Opening Capital + Net Profit + Additional Capital + Interest on Capital – Drawings – Interest on Drawings
– Net Loss (if there is loss).

Reserves: A part of the amount kept aside from profits for contingencies is termed as reserve. Thus, Reserve is an appropriation of profit. It is created to strengthen the financial position of the business. It shows credit balance and is shown on the credit side of the trial balance. It is shown on the liability side of the balance sheet after adding the current year appropriation, if any.

Long-term Liabilities: The liabilities which are not payable within the next financial year but will be payable within next five to ten years are termed as long-term liabilities. They will show credit balance and appear on the liabilities side of the balance sheet.

Short-term/current Liabilities: The liabilities which are payable within the next financial year are termed as short-term liabilities. These liabilities include creditors, bills payable, bank overdraft, outstanding expenses and incomes received in advance. They will show credit balance and appear on the liabilities side of the balance sheet.

Contingent Liabilities: The liabilities, which may or may not arise in the future, are termed as contingent liabilities. These are shown as a footnote to balance sheet. Liability of bills discounted, liability of a case pending in the court are the some of the examples of contingent liabilities.

Assets

Assets are the properties of the business. Based on their nature, assets can be classified in the following ways:

Fixed Assets: These assets are acquired for permanent use in the business. These are used for making profits in the business. Examples include buildings, land, furniture, goodwill, etc.

Current Assets: Assets, which can be realized within the next accounting period, are called current assets. These can be liquidated easily. Example – cash, debtors, investments, bank, bills receivable etc.

Intangible Assets: Assets, which cannot be seen or touched, are known as intangible assets. Goodwill, patents, licence fees, etc., are the examples of intangible assets.

Fictitious Assets: Actually these are not assets. These may be past losses or expenses, incurred once in the life time of a business. Profit and loss account debit balance, heavy advertisement expenditure are the examples of this type of assets.

Wasting Assets: The assets, which lose their value along with use, are termed as wasting assets. For example, timber forests are exhausted by cutting wood and quarries by extracting minerals.

Concepts Relating to Balance Sheet

Generally, all accounting statements are prepared based on some concepts and conventions. Balance sheet is also an accounting statement. There are no specific rules for preparing a balance sheet. It is prepared based on certain concepts and conventions. The following are the concepts and conventions, which help prepare a balance sheet:

Going Concern Concept

All accounts are prepared based on this assumption only. Going concern concept implies that a business entity is assumed to carry on its operations indefinitely. This concept helps in categorizing assets into ‘fixed’ and ‘current’. Going concern concept implies that the resources of the concern would continue to be used for the purpose for which they are meant to be used. If the organization is not a going concern, then the fixed assets are recorded at their realizable values.

Cost Concept

As per this concept, the assets should be recorded in the books of accounts at a price which forms the basis for its subsequent accounting. Assets are recorded at the cost price at the time of purchase and subsequently their value is reduced by charging depreciation. Thus, according to this concept assets shown in the balance sheet are either at their cost price or at their written down value. This concept actually flows from the going concern concept.

Consistency Concept

This concept requires a business enterprise to follow consistent accounting procedures and practices from time-to-time. This is required to enable a comparative study of the performance of the business over a period of time and also make objective comparison within the industry.

Concept of Full Disclosure

The purpose of financial accounting is to provide information to the users for decision-making. This concept implies that all material information that could affect the decision of the user must be disclosed. Full disclosure ensures complete, fair and adequate disclosure of business transactions in financial reports.

Illustration 3.3

From the following Trial Balance of Moon Shine and Company, prepare Trading, Profit and Loss account and Balance Sheet.

Trial Balance as on 31.3.20xx

Particulars	Debit (₹)	Credit (₹)
Capital a/c		50,000
Loans a/c		10,000
Sales a/c		70,000
Accounts Payable a/c		8,000
Bills Payable a/c		10,000
Purchase Returns a/c		,000
Dividends Received a/c		6,000
Plant & Machinery a/c	26,000	
Buildings a/c	34,000	
Receivables a/c	19,300	
Purchases a/c	36,000	
Discount Allowed a/c	2,400	
Wages a/c	14,000	

Contd….

Particulars	Debit (₹)	Credit (₹)
Salaries a/c	6,000	
Travelling Expenses a/c	1,500	
Freight Outwards a/c	400	
Insurance a/c	600	
Commission paid a/c	200	
Cash on hand a/c	200	
Cash at Bank a/c	3,200	
Repairs a/c	1,000	
Interest on Loans a/c	1,200	
Opening Inventory a/c	12,000	
Total	1,58,000	1,58,000

Additional Data:

1. Closing inventory is ₹ 16,000.
2. Depreciation on Plant & Machinery at 15% and 10% on buildings is to be charged.
3. Provision for doubtful receivables is to be created for ₹ 1,000.
4. Insurance prepaid is ₹ 100
5. Outstanding rent is ₹ 200.

Solution

Moon Shine and Company

Trading and Profit and Loss Account for the year ending 31.3.20xx

Dr. Cr.

Particulars	₹	₹	Particulars	₹
To Opening inventory a/c		12,000	By Sales a/c	70,000
To Purchases a/c	36,000		By Closing inventory a/c	16,000
Less: Returns a/c	4,000			
		32,000		
To Wages a/c		14,000		
To Gross Profit c/d		28,000		
		86,000		86,000
To Discount allowed a/c		2,400	By Gross Profit b/d	28,000
To Salaries a/c		6,000	By Dividends received a/c	6,000
To Travelling expenses a/c		1,500		
To Freight outwards a/c		400		
To Insurance a/c	600			
Less: Prepaid a/c	100	500		

Contd….

Dr. Cr.

Particulars	₹	₹	Particulars	₹
To Commission paid a/c		200		
To Repairs a/c		1,000		
To Interest on loan a/c		1,200		
To Rent outstanding a/c		200		
To Provision for doubtful receivables a/c		1,000		
To Depreciation a/c				
Plant & Machinery		3,900		
Buildings		3,400		
To Net profit c/d		12,300		
		34,000		34,000

Moon Shine and Company
Balance Sheet as on 31.3.20xx

Liabilities	₹	₹	Assets	₹	₹
Capital a/c	50,000		Fixed Assets:		
Add: Net profit a/c	12,300	62,300	Plant & Machinery a/c	26,000	
Loan		10,000	Less: Depreciation	3,900	22,100
Current Liabilities:					
Accounts Payable a/c		8,000	Buildings a/c	34,000	
Bills payable a/c		10,000	Less: Depreciation	3,400	30,600
Outstanding rent a/c		200	Current Assets:		
			Cash on hand a/c		200
			Cash at Bank a/c		3,200
			Accounts receivable a/c	19,300	
			Less: Provisions for doubtful debts	1,000	18,300
			Closing inventory a/c		16,000
			Insurance a/c		100
		90,500			90,500

<u>Check Your Progress – 2</u>

6. Which of the following is a liability of a firm?

   a. Debit balance of analytical petty cash book.

   b. Credit balance of bank pass book.

   c. Debit balance of bank column of cash book.

   d. Debit balance of cash column of cash book.

   e. Credit balance of bank column of cash book.

7. Which of the following is an asset which does not have a physical existence, and is held through acquisition, production process or for use in supply of goods and services?
   a. Fixed asset
   b. Intangible assets
   c. Current assets
   d. Fictitious assets
   e. Wasting assets
8. Which of the following accounting concepts is not applicable to the preparation of balance sheet?
   a. Matching concept
   b. Cost concept
   c. Going concern concept
   d. Concept of full disclosure
   e. Consistency concept
9. What is the term used to denote assets, which lose their value along with use?
   a. Fixed assets
   b. Intangible assets
   c. Wasting assets
   d. Fictitious assets
   e. Tangible assets
10. The goodwill acquired by the company is accounted for deduction of an expense year on year, based on its expected life until it reaches its estimated residual value. What is the term that is used to define such systematic allocation of an expense?
   a. Depreciation
   b. Amortization
   c. Fair value
   d. Market value
   e. Impairment loss

Presentation of Financial Statements - (Horizontal and Vertical)

Financial statements may be presented in two ways: horizontal or vertical. Traditionally financial statements were presented in the horizontal form. The statements discussed so far are the horizontal form of financial statements. Now-a-days many organizations prepare their financial statements in a vertical form. The data, of course, remains the same. It is only the presentation, which changes. Vertical form of presentation is more useful to financial analysts and other users of financial statements as it gives some additional information.

The formats of vertical form of statement of profit and loss is given below in Exhibit 3.1.

Exhibit 3.1: Format of Statement of Profit and Loss

Name of the Company……………………

Profit and loss statement for the year ended ………………………

(₹in…………)

	Particulars	Note No.	Figures as at the end of current reporting period	Figures as at the end of the previous reporting period
	1	2	3	4
I.	Revenue from operations		xxx	xxx
II.	Other income		xxx	xxx
III.	Total Revenue (I + II)			
IV.	Expenses:			
	Cost of materials consumed			
	Purchases of Stock-in-Trade			
	Changes in inventories of finished goods			
			xxx	xxx
	work-in-progress and		xxx	xxx
	Stock-in-Trade		xxx	xxx
	Employee benefits expense		xxx	xxx
	Finance costs			
	Depreciation and amortisation expense			
	Other expenses			
	Total expenses		xxx	xxx
V.	Profit before exceptional and extraordinary items and tax (III - IV)		xxx	xxx
VI.	Exceptional items		xxx	xxx
VII.	Profit before extraordinary items and tax (V - VI)		xxx	xxx
VIII.	Extraordinary items		xxx	xxx
IX.	Profit before tax (VII- VIII)		xxx	xxx
X.	Tax expense:			
	(1) Current tax		xxx	xxx
	(2) Deferred tax		xxx	xxx

Contd.…

XI.	Profit (Loss) for the period from continuing operations (VII-VIII)	xxx	xxx
XII.	Profit/(loss) from discontinuing operations	xxx	xxx
XIII.	Tax expense of discontinuing operations	xxx	xxx
XIV.	Profit/(loss) from Discontinuing operations (after tax) (XII-XIII)	xxx	xxx
XV.	Profit (Loss) for the period (XI + XIV)	xxx	xxx
XVI.	Earnings per equity share:		
	(1) Basic	xxx	xxx
	(2) Diluted	xxx	xxx

The vertical format of a Balance Sheet is given in Exhibit 3.2 below:

Exhibit 3.2: Format of Balance Sheet

Name of the Company……………………..

Balance Sheet as at ………………………

(₹ in………..)

Particulars	Note No.	Figures as at the end of current	Figures as at the end of the previous
1	2	3	4
I. Equity and Liabilities			
(1) **Shareholders' funds**			
(*a*) Share capital			
(*b*) Reserves and surplus			
(*c*) Money received against share warrants			
(2) **Share application money pending allotment**			
(3) **Non-current liabilities**			
(*a*) Long-term borrowings			
(*b*) Deferred tax liabilities (Net)			
(*c*) Other Long-term liabilities			
(*d*) Long-term provisions			
(4) **Current liabilities**			
(*a*) Short-term borrowings			
(*b*) Trade payables			
(*c*) Other current liabilities			
(*d*) Short-term provisions			
Total			

Contd. ...

II. Assets

(1) **Non-current assets**

(*a*) Fixed assets

(*i*) Tangible assets

(*ii*) Intangible assets

(*iii*) Capital work-in-progress

(*iv*) Intangible assets under development

(*b*) Non-current investments

(*c*) Deferred tax assets (net)

(*d*) Long-term loans and advances

(*e*) Other non-current assets

(2) **Current assets**

(*a*) Current investments

(*b*) Inventories

(*c*) Trade receivables

(*d*) Cash and cash equivalents

(*e*) Short-term loans and advances

(*f*) Other current assets

This type of presentation is used generally by corporate entities. Non-corporate entities like sole traders and partnership firms generally prefer the horizontal form of presentation. Exhibit 3.3 depicts the Balance Sheet of Tata Steel, a corporate entity, presented in a vertical format.

Exhibit 3.3: Vertical Format of Balance Sheet of Tata Steel as on March 31, 2021

(₹ Crore)

		Note	Page	As at March 31, 2021	As at March 31, 2020
Assets					
I	**Non-current Assets**				
	(a) Property, plant and equipment	3	268	64,032.32	66,392.35
	(b) Capital work in progress			10,057.18	8,070.41
	(c) Right-of-use assets	4	271	3,905.97	4,113.31
	(d) Intangible assets	5	273	839.33	727.72
	(e) Intangible assets under development			408.79	176.64
	(f) Investments in subsidiaries, associates and joint ventures	6	274	28,444.61	26,578.41
	(g) Financial assets				
	(i) Investments	7	279	22,621.66	20,282.50
	(ii) Loans	8	283	7,509.33	199.26
	(iii) Derivative assets			42.52	162.46
	(iv) Other financial assets	9	285	91.66	60.42
	(h) Non-current tax assets (net)			1,645.10	1,557.82
	(i) Other assets	11	288	1,681.22	2,062.07
	Total non-current assets			**1,41,279.69**	**1,30,383.37**
II	**Current Assets**				

	(a) Inventories	12	289	8,603.79	10,716.66
	(b) Financial assets				
	(i) Investments	7	279	6,404.46	3,235.16
	(ii) Trade receivables	13	289	3,863.31	1,016.73
	(iii) Cash and cash equivalents	14	291	1,501.71	993.64
	(iv) Other balances with banks	15	291	170.00	233.23
	(v) Loans	8	283	1,555.95	1,607.32
	(vi) Derivative assets			66.93	209.96
	(vii) Other financial assets	9	285	351.54	230.41
	(c) Other assets	11	288	854.99	1,715.92
	Total Current Assets			**23,372.68**	**19,959.03**
III	**Assets held for sale**			**383.62**	**50.16**
Total Assets				**1,65,035.99**	**1,50,392.56**
Equity and Liabilities					
IV	**Equity**				
	(a) Equity share capital	16	292	1,198.78	1,146.13
	(b) Hybrid perpetual securities	17	295	775.00	2,275.00
	(c) Other equity	18	295	89,293.33	73,416.99
	Total equity			**91,267.11**	**76,838.12**
V	**Non-Current Liabilities**				
	(a) Financial liabilities				
	(i) Borrowings	19	299	27,313.80	31,381.96
	(ii) Derivative liabilities			71.20	122.55
	(iii) Other financial liabilities	20	302	413.66	293.59
	(b) Provisions	21	302	2,543.94	2,113.56
	(c) Retirement benefit obligations	22	303	2,087.86	2,224.44
	(d) Deferred tax liabilities (net)	10	286	6,111.70	5,862.28
	(e) Other liabilities	24	304	5,913.40	684.76
	Total Non-Current Liabilities			**44,455.56**	**42,683.14**
VI	**Current Liabilities**				
	(a) Financial liabilities				
	(i) Borrowings	19	299	-	7,857.27
	(ii) Trade payables	25	304		
	(a) Total outstanding dues of micro and small enterprises			160.66	118.62
	(b) Total outstanding dues of creditors other than micro and small enterprises			10,477.93	10,482.34
	(iii) Derivative liabilities			69.39	81.69
	(iv) Other financial liabilities	20	302	5,274.11	5,401.55
	(b) Provisions	21	302	1,074.43	663.86
	(c) Retirement benefit obligations	22	303	116.10	106.61
	(d) Deferred income	23	304	34.44	6.15
	(e) Current tax liabilities (net)			4,093.26	277.26
	(f) Other liabilities	24	304	8,013.00	5,875.95
	Total Current Liabilities			**29,313.32**	**30,871.30**
Total Equity and Liabilities				**1,65,035.99**	**1,50,392.56**
Notes forming part of the financial statements		1- 46			

Source: https://www.tatasteel.com/media/13915/tsl_ir21_final.pdf

Exhibit 3.4 below shows the vertical format of Statement of Profit and Loss of Tata Steel for the Year ended March 31, 2021

Exhibit 3.4: Vertical Format of Statement of Profit and Loss of Tata Steel for the Year Ended March 31, 2021

(₹ Crore)

		Note	Page	Year Ended March 31, 2021	Year Ended March 31, 2020
I	Revenue from operations	26	305	64,869.00	60,435.97
II	Other income	27	306	637.89	404.12
III	**Total income**			**65,506.89**	**60,840.09**
IV	**Expenses:**				
	(a) Cost of materials consumed			13,868.60	17,407.03
	(b) Purchases of stock-in-trade			1,146.05	1,563.10
	(c) Changes in inventories of finished and semi-finished goods, stock-in-trade and work-in-progress	28	307	1,464.12	(564.40)
	(d) Employee benefits expense	29	307	5,198.82	5,036.62
	(e) Finance costs	30	308	3,393.84	3,031.01
	(f) Depreciation and amortisation expense	31	308	3,987.32	3,920.12
	(g) Other expenses	32	308	22,747.30	23,803.18
				51,806.05	**54,196.66**
	Less: Expenditure (other than interest) transferred to capital and other accounts			1,321.24	1,671.13
	Total expenses			**50,484.81**	**52,525.53**
V	**Profit before exceptional items and tax (III-IV)**			**15,022.08**	**8,314.56**
VI	**Exceptional items:**	33	310		
	(a) Profit/(loss) on sale of non-current investments			1,084.85	-
	(b) Provision for impairment of investments/doubtful advances			149.74	(1,149.80)
	(c) Provision for demands and claims			-	(196.41)
	(d) Employee separation compensation			(443.55)	(107.37)
	(e) Gain/(loss) on non-current investments classified as fair value through profit and loss (net)			1,982.01	(250.00)
	Total exceptional items			**2,773.05**	**(1,703.58)**
VII	**Profit before tax (V+VI)**			**17,795.13**	**6,610.98**
VIII	**Tax expense:**				
	(a) Current tax			3,949.05	1,787.95
	(b) Deferred tax			239.46	(1,920.77)
	Total tax expense			**4,188.51**	**(132.82)**
IX	**Profit for the year (VII-VIII)**			**13,606.62**	**6,743.80**

X	**Other comprehensive income/(loss)**				
	A (i) Items that will not be reclassified subsequently to profit and loss				
	(a) Remeasurement gain/(loss) on post-employment defined benefit plans			81.97	(461.27)
	(b) Fair value changes of investments in equity shares			333.55	(244.30)
	(ii) Income tax on items that will not be reclassified subsequently to profit and less			(27.40)	116.65
	B (i) Items that will be reclassified subsequently to profit and loss				
	(a) Fair value changes of cash flow hedges			27.56	(79.76)
	(ii) Income tax on items that will be reclassified subsequently to profit and loss			(6.94)	19.81
	Total other comprehensive income/(loss) for the year			**408.74**	**(648.87)**
XI	**Total comprehensive income/(loss) for the year (IX+X)**			**14,015.36**	**6,094.93**
XII	**Earning per share**	34	310		
	Basic (₹)			117.04	57.11
	Diluted (₹)			117.03	57.11
XIII	**Notes forming part of the financial statements**	1-46			

Source: https://www.tatasteel.com/media/13915/tsl_ir21_final.pdf

Activity 3.2

1. An accountant of a manufacturing concern wants to ascertain the cost of goods sold incurred for the year from the available details :

   Inventory at the beginning- ₹ 20,000; Raw materials Purchases – ₹ 1,00,000. Closing inventory – ₹ 40,000; Manufacturing cost – ₹ 20,000 and sales made during the year is at ₹ 3,60,000.

   Calculate the cost of goods sold for the manufacturing concern.

   ____

   ____

   ____

2. Elucidate the items that appear in Manufacturing A/c and Trading A/c of a company.

   ____

   ____

   ____

3.8 Cash Flow Statement

The cash flow statement is prepared to give information on cash inflows and outflows during a period of time. It provides information about the cash receipts and cash disbursements of an enterprise. Similar to income statement, a cash flow statement is a change statement disclosing the events that cause the cash to change during the period. A cash flow statement is prepared as per the provisions of Ind AS–7.

Exhibit 3.5: Cash Flow Statement of Tata Steel for the Year ended March 31, 2021

(₹ Crore)

			Year ended March 31, 2021		**Year ended March 31, 2020**
A	**Cash Flows from Operating Activities:**				
	Profit before Tax		17,795.13		6,610.98
	Adjustments for:				
	Depreciation and amortisation expense	3,987.32		3,920.12	
	Dividend income	(68.13)		(89.73)	
	(Gain)/loss on sale of property, plant and equipment including intangible assets (net of loss on assets scrapped/written off)	(23.50)		1.20	
	Exceptional (Income)/expenses	(2,773.05)		1,703.58	
	(Gain)/Loss on cancellation of forwards, swaps and options	2.72		1.26	
	Interest income and income from current investments and guarantees	(451.60)		(171.58)	
	Finance costs	3,393.84		3,031.01	
	Foreign exchange (gain)/loss	(20.33)		(85.86)	
	Other non-cash items	(10.84)		(1,152.70)	
			4,036,43		7,157.30
	Operating profit before changes in non-current/current assets and liabilities		**21,831.56**		**13,768.28**
	Adjustments for:				
	Non-current/current financial and other assets	(2,058.17)		1,441.64	
	Inventories	2,105.79		533.21	
	Non-current/current financial and other liabilities/provisions	7,850.16		(470.69)	
			7,897.38		1,504.16
	Cash generated from operations		**29,729.34**		**15,272.44**
	Income taxes paid (net of refund)		(360.78)		**(1,818.78)**
	Net cash from/(used in) operating activities		**29,368.56**		**13,453.66**

B	**Cash Flows from Investing Activities:**				
	Purchase of capital assets	(2,122.26)		(4,749.28)	
	Sale of capital assets	34.32		173.07	
	Purchase of investments in subsidiaries	(935.82)		(8,945.16)	
	Purchase of other non-current investments	(64.41)		(61.20)	
	Sale of investments in subsidiaries	21.06		-	
	(Purchase)/sale of current investments (net)	(2,973.61)		(2.661.50)	
	Loans given	(8,114.74)		(1,527.02)	
	Repayment of loans given	788.94		7.36	
	Principal receipts under sublease	2.80		1.83	
	Fixed/restricted deposits with banks (placed)/realized	67.85		(80.23)	
	Interest and guarantee commission received	219.28		117.34	
	Dividend received from subsidiaries	25.22		35.38	
	Dividend received from associates and joint ventures	23.43		34.20	
	Dividend received from others	19.48		20.15	
	Net cash from/(used in) investing activities		**(13,008.46)**		**(17,634.66)**
C	**Cash Flows from Financing Activities:**				
	Proceeds from issue of equity shares (net of issue expenses)	3,240.91		0.04	
	Proceeds from long term borrowings (net of issue expenses)	9,777.19		5,052.88	
	Repayment of long-term borrowings	(14,775.68)		(2,866.18)	
	Proceeds/(repayments) of short-term borrowings (net)	(7,854.16)		7,846.07	
	Payment of lease obligations	(376.68)		(260.66)	
	Amount received/(paid) on utilization/cancellation of derivatives	31.35		(5.19)	
	Repayment of hybrid perpetual securities	(1,500.00)		-	
	Distribution on hybrid perpetual securities	(266.25)		(265.76)	
	Interest paid	(2,982.78)		(3,084.03)	
	Dividend paid	(1,145.93)		(1,489.67)	
	Tax on dividend paid			(297.71)	
	Net cash from/(used in) financing activities		(15,852.03)		4,629.79

	Net increase/(decrease) in cash and cash equivalents		508.07		448.79
	Opening cash and cash equivalents		993.64		544.85
	Closing cash and cash equivalents		**1,501.71**		**993.64**

Source: https://www.tatasteel.com/media/13915/tsl_ir21_final.pdf

3.9 Summary

- The concepts of capital expenditure and revenue expenditure are very relevant for preparation of financial statements. Capital expenditure relates to such expenses which generate benefits and assist the entity in earning revenue over a period of time. Revenue expenditure on the other hand relates to those expenses which are incurred in earning the revenues and the benefit of which gets exhausted within the accounting period.
- Preparation of financial statements includes, preparation of trading account, profit and loss account and balance sheet. In manufacturing concerns, a manufacturing account is also prepared in addition to the above statements.
- Trading account and profit and loss account are prepared to determine the profit/loss from the operation of the business during a particular period. All expenses and incomes are shown in either trading account or profit and loss account. The balance shown in the trading account is termed as gross profit or loss and the balance in the profit and loss account is termed as net profit or loss.
- Balance sheet is known as position statement because it is prepared to understand the financial position at the end of a particular period. Assets are shown on the assets side and capital and liabilities are shown on the liabilities side of the balance sheet.
- Financial statements can be prepared in vertical form or in horizontal form. Generally, all non-corporate entities present their financial statements in horizontal form. Nowadays, all corporate entities are presenting their statements in vertical form.

3.10 Glossary

Balance Sheet is not an account but only a statement containing assets, liabilities and capital. It shows the financial position of an enterprise on a particular date.

Capital Expenditure relates to such expenses, which generate benefits and assist the entity in earning revenue over a period of time.

Capital Receipts are the receipts, which do not affect the profits earned or losses incurred during the course of the year, and which are non-recurring in nature.

Cash Flow Statement is prepared to give information on cash inflows and outflows during a period of time. It provides information about the cash receipts and cash disbursements of an enterprise.

Contingent Liabilities are the liabilities, which may or may not arise in the future. These are shown as a footnote to the balance sheet.

Deferred Revenue Expenditure is the expenditure that is basically of revenue nature for which payment has been made or liability incurred but the benefits are presumed to result in subsequent periods can be treated as.

Manufacturing Account is prepared by manufacturing concerns to determine the cost of goods manufactured. The balance in this account (i.e., cost of goods manufactured) is transferred to the trading account.

Profit and Loss account is prepared in order to know the exact profit or loss made during a particular period. All the expenses and incomes of a specified period should be taken into account to ascertain the profit or loss for the period.

Revenue Expenditure relates to those expenses which are incurred in earning the revenues and the benefit of which gets exhausted within the accounting period.

Revenue Receipts are receipts from sale of goods to customers or from rendering of services in the ordinary course of business.

Trading Account is prepared to know the net trading results of the concern. It shows the profit or loss earned by the firm during a particular period of trading activity i.e., from buying to selling.

3.11 Self-Assessment Test

1. Distinguish between Capital and Revenue Expenditure.
2. What is deferred revenue expenditure?
3. What are direct expenses? Give examples.
4. Explain the classification of assets.
5. Describe the meaning of contingent assets and contingent liabilities.

Numerical Questions:

1. The following balances were extracted from the books of accounts of M/s. Silver Gold as on March 31, 20x1.

Particulars	₹
Capital account	2,68,800
Preliminary expenses	21,100
Sundry creditors	1,19,260
15% Loan	40,000

Cash in hand	6,060
Cash at bank	37,940
Sundry debtors	1,24,000
Bills receivable	19,000
Provision for doubtful debts	5,000
Fittings and Fixtures	17,940
Plant and Machinery	57,600
Opening inventory as on April 1, 20xx	1,09,360
Purchases	5,13,180
Manufacturing wages	81,940
Sales	7,12,860
Return inwards	5,560
Salaries	1,22,000
Rent and Taxes	11,240
Interest and Discount (Debit)	11,740
Travelling expenses	3,760
Repairs and renewals	6,740
Insurance premium	800
Bad debts	7,240
Commission received	11,280

Other Information:

1. Inventory on March 31, 20x1 was valued at ₹ 2,57,920.
2. Manufacturing wages include ₹ 2,400 for erection of machinery purchased last year.
3. Provide depreciation on Plant and Machinery at 15% and on fixtures and fittings at 10% p.a.
4. Create a provision for doubtful debts at 5% on sundry debtors.
5. Commission earned but not received by the company amounts to ₹ 1,200.
6. Interest on loan for the last two months was not paid.
7. Insurance premium includes ₹ 300 paid up to September 30, 20x1.
8. Sundry debtors include ₹ 650 due from a customer who has become insolvent.

9. Goods of the value of ₹ 1,000 have been destroyed by fire and the insurance company has admitted a claim of ₹ 700.
10. Bills receivable includes a dishonored promissory note for ₹ 650.

You are required to prepare the trading and profit and loss account for the year ending March 31, 20x1 and the balance sheet as on March 31, 20x1 after giving effect to the above adjustments.

2. The following is the trial balance of Anil as on March 31, 20x1:

Trial Balance as on March 31, 20x1

Particulars	Dr. (₹)	Cr. (₹)
Capital		6,00,000
Stock as on April 1, 20xx	40,000	
Sales and Sale returns	80,000	9,60,000
Purchases and purchase returns	6,64,000	84,000
Carriage inward	27,800	
Rent & taxes	12,000	
Sundry creditors		1,16,000
Sundry debtors	2,40,000	
Bank loan (interest at the rate of 12% per annum)		40,000
Interest on bank loan	4,000	
Advertisement expenses	24,000	
Bad debts	2,000	
Income from investments		4,000
Cash at bank	21,000	
Discount (allowed and received)	4,050	2,800
Investments	40,000	
Furniture & Fittings	45,000	
Audit fees	5,400	
Insurance premium	2,400	
Travelling expenses	2,200	
Cash in hand	5,400	
Salaries	1,37,550	
Wages	50,000	
Building	2,50,000	
Plant & Machinery	1,50,000	
	18,06,800	18,06,800

Additional Information:

a. Closing Stock as on March 31, 20x1 was ₹ 42,500.

b. The effect of advertisement being not yet expired, 1/4 of the amount of advertisement expenses is to be carried forward to the next year.

c. Depreciation is to be provided as follows:

Furniture & fittings	–	10%
Plant & machinery	–	20%
Building	–	10%

d. Salaries outstanding as on March 31, 20x1 were ₹ 12,450.

e. Provide 2% for discount on debtors and create a provision for bad and doubtful debts at 5% on debtors.

f. Sundry debtors include an amount of ₹ 5,000 due from Mr. Aman and Sundry creditors include ₹ 3,000 due to Mr. Aman.

After making the necessary adjustments, you are required to prepare,

a. Trading and profit & loss account of Mr. Anil for the year ended March 31, 20x1

b. Balance sheet of Mr. Anil as at March 31, 20x1

3.12 Suggested Readings/Reference Material

1. Jain, S.P., and Narang, K.L. Financial Accounting. New Delhi: Kalyani Publishers, 2020.
2. Mukherjee Amitabha, and Mohammed Hanif. Modern Accountancy. Vol. 1&2. 3rd ed. New Delhi: Tata McGraw Hill Publishing, 2018.
3. T.S. Grewal et.al, Double Entry System of Book Keeping, Sultan Chand, 2021.
4. R. Narayanaswamy. Financial Accounting: A Managerial Perspective. 6th edition. PHI Publishing, 2017.
5. S.N. Maheshwari, Suneel K Maheshwari et.al. Financial Accounting. 6th edition. Vikas Publishing House. 2018.
6. David Spiceland et.al. Financial Accounting. 5th edition. McGraw Hill. 2019.
7. N. Ramachandran and Ram Kumar Kakani. How to Analyze Financial Statements. 2nd edition. McGraw Hill Education India. 2019.
8. Robert N. Anthony et.al. Accounting: Text and Cases. 13th edition. McGraw Hill. 2019.

9. Thomas R. Ittelson. Financial Statements: A Step-by-Step Guide to Understanding and Creating Financial Reports. Pan Macmillan India. 2017.

10. Aswath Damodaran. Narrative and Numbers: The Value of stories in Business. 2017.

Additional References:

1. Accounting Standards Quick Referencer, April 2019, Published by ICAI. (Pdf downloaded), https://resource.cdn.icai.org/55939asb45327.pdf

2. KPMG Spark. How to read a cash flow statement. 2020, https://www.kpmgspark.com/blog/how-to-read-a-cash-flow-statement

3.13 Answers to Check Your Progress Questions

1. (b) Revenue Expenditure

Revenue expenditure relates to those expenses which are incurred in earning the revenues and the benefit of which gets exhausted within the accounting period. Since the benefit of the advertisement expenditure is for the current fiscal year only, it is classified as revenue expenditure.

2. (c) Octroi Charges

When goods are purchased within local limits, octroi duty has to be paid This is a kind of direct tax, which shows debit balance and appears on the debit side of trial balance and the trading account.

3. (a) Debited to Profit and Loss Account

Depreciation is a loss and hence is debited to profit and loss account.

4. (d) Bad Debts

The amount, which cannot be recovered from customers, is termed as bad debt. It is a loss and should be debited to profit and loss account.

5. (b) Net Sales

Net sales is shown in trading account and not manufacturing account.

5. (b) Deduct prepaid expenses from respective expense account and show it as an asset.

6. (e) Credit Balance of Bank Column of Cash Book

The credit balance of bank column of cash book represents overdraft balance

7. (b) Intangible Assets

Assets, which cannot be seen or touched, are known as intangible assets. Goodwill, patents, licence fees, etc., are the examples of intangible assets.

8. (a) Matching Concept

Matching concept is used in preparing profit and loss account.

9. (c) Wasting Assets

The assets, which lose their value along with use, are termed as wasting assets. For example, timber forests are exhausted by cutting wood and quarries by extracting minerals.

10. (b) Amortization

Amortization is the term used for any reduction in the value of intangible assets such as goodwill.

Foundations of Accounting & Finance

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IV	**Financial Management**
9.	Introduction to Financial Management
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11.	Financial System – Indian and International Scenario
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14.	Basics of International Trade and Finance