UPSC EPFO APFC/AO/EO Exam 2023

Accounting

By **CA Rahul Kumar** (3 UPSC Interviews)
(Commerce, Accountancy & Economy Faculty)

HIGHLIGHTS

- 100% EPFO Oriented
- Factual Focus
- As Per PYQ Pattern
- Concepts Clarity

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ACCOUNTING

& General Accounting Principles

(APFC/EPFO)

STUDY MATERIAL & MCQs

By CA Rahul Kumar
(Faculty, Commerce & Economy, 3 UPSC Interviews)

Accounting – Study Material

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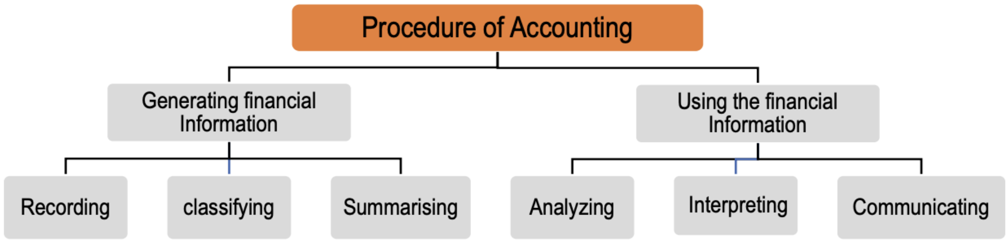
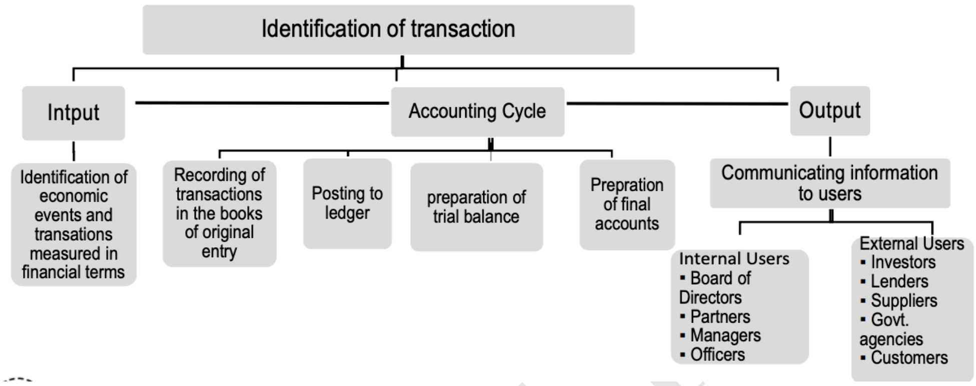
CHAPTER 1 : THE BASIC ACCOUNTING





1. Accounting – An Introduction

Every individual performs some kind of economic activity. A salaried person gets a salary and spends to buy provisions and clothing, for children's education, construction of house, etc. A sports club formed by a group of individuals, a business run by an individual or a group of individuals, a local authority like Calcutta Municipal Corporation, Delhi Development Authority, Governments, either Central or State, all are carrying out some kind of economic activities. Not necessarily all the economic activities are run for any individual benefit; such economic activities may create social benefit i.e., benefit for the public, at large. Anyway, such economic activities are performed through 'transactions and events'. Transaction is used to mean a business, performance of an act, an agreement' while event is used to mean 'a happening, as a consequence of transaction(s), a result.'

Accounting has universal application for recording transactions and events and presenting suitable information to aid decision-making regarding any type of economic activity ranging from a family function to functions of the national government. But hereinafter we shall concentrate only on business activities and their accounting because the objective of this study material is to provide a basic understanding on accounting for business activities. Nevertheless, it will give adequate knowledge to think coherently of accounting as a field of study for universal application.

The growth of accounting discipline is closely associated with the development of the business world. Thus, to understand accounting as a field of study for universal application, it is best identified with recording of business transactions and communication of financial information about business enterprise to facilitate decision-making. The aim of accounting is to meet the information needs of the rational and sound decision- makers, and thus, called the language of business.

2. Accounting Concepts

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

As per this definition, accounting is simply an art of record keeping. The process of accounting starts by first identifying the events and transactions which are of financial character and then be recorded in the books of account. This recording is done in Journal or subsidiary books, also known as primary books. Every good record keeping system includes suitable classification of transactions and events as well as their summarisation for ready reference.

After the transactions and events are recorded, they are transferred to secondary books i.e. Ledger. In ledger, transactions and events are classified in terms of income, expense, assets and liabilities according to their characteristics and summarised in profit and loss account and balance sheet. Essentially the transactions and events are to be measured in terms of money. Measurement in terms of money means measuring at the ruling currency of a country.

A. Procedural aspects of accounting:

On the basis of the above definitions, procedure of accounting can be basically divided into two parts:

- Generating financial information and
- Using the financial information.

- **Generating Financial Information**

  a) Recording - All business transactions of a financial character, as evidenced by some documents such as sales bill, pass book, salary slip etc. are recorded in the books of account. Recording is done in a book called "Journal."

  b) Classifying - Classification is concerned with the systematic analysis of the recorded data, with a view to group transactions or entries of one nature at one place. The book containing classified information is called "Ledger". For example, there may be separate account heads for Salaries, Rent, Printing and Stationeries, Advertisement etc.

c) **Summarising** - It is concerned with the preparation and presentation of the classified data in a manner useful to the internal as well as the external users of financial statements.

d) **Analysing** - The term 'Analysis' means methodical classification of the data given in the financial statements. It is concerned with the establishment of relationship between the items of the Profit and Loss Account and Balance Sheet i.e. it provides the basis for interpretation.

e) **Interpreting** - This is the final function of accounting. It is concerned with explaining the meaning and significance of the relationship as established by the analysis of accounting data. The recorded financial data is analysed and interpreted in a manner that will enable the end-users to make a meaningful judgement about the financial condition and profitability of the business operations.

f) **Communicating** - It is concerned with the transmission of summarised, analysed and interpreted information to the end-users to enable them to make rational decisions. This is done through preparation and distribution of accounting reports, which include besides the usual profit and loss account and the balance sheet, additional information in the form of accounting ratios, graphs, diagrams, fund flow statements etc.

- **Using the Financial Information**

Accounting provides the art of presenting information systematically to the users of accounts. Accounting data is more useful if it stresses economic substance rather than technical form. Information is useless and meaningless unless it is relevant and material to a user's decision. The information should also be free of any biases. The users should understand not only the financial results depicted by the accounting figures, but also should be able to assess its reliability and compare it with information about alternative opportunities and the past experience.

A. Book Keeping

Book-keeping is an activity concerned with the recording of financial data relating to business operations in a significant and orderly manner. It covers procedural aspects of accounting work and embraces record keeping function. Obviously, book-keeping procedures are governed by the end product, the financial statements. The term 'financial statements' means Profit and Loss Account, Balance Sheet and cash flow statements including Schedules and Notes forming part of Accounts.

Book-keeping also requires suitable classification of transactions and events. This is also determined with reference to the requirement of financial statements. A book-keeper may be responsible for keeping all the records of a business or only of a minor segment, such as position of the customers' accounts in a departmental store. Accounting is based on a careful and efficient book-keeping system.

B. Book keeping vs Accounting

S. No.	**Book keeping**	**Accounting**
1	It is a process concerned with recording of transactions.	It is a process concerned with summarising of the recorded transactions.
2	It constitutes as a base for accounting.	It is considered as a language of the business.
3	Financial statements do not form part of this process.	Financial statements are prepared in this process on the basis of book-keeping records.
4	Managerial decisions cannot be taken with the help of these records.	Management takes decisions on the basis of these records.
5	There is no sub-field of book-keeping.	It has several sub-fields like financial accounting, management accounting etc.
6	Financial position of the business cannot be ascertained through book-keeping records.	Financial position of the business is ascertained on the basis of the accounting reports.

C. Sub-fields of Accounting

The various sub-fields of accounting are:

- **Financial Accounting** - It covers the preparation and interpretation of financial statements and communication to the users of accounts. It is historical in nature as it records transactions which had already been occurred. The final step of financial accounting is the preparation of Profit and Loss Account and the Balance Sheet. It primarily helps in determination of the net result for an accounting period and the financial position as on the given date.

- **Management Accounting** - It is concerned with internal reporting to the managers of a business unit. To discharge the functions of stewardship, planning, control and decision- making, the management needs variety of information. The different ways of grouping information and preparing reports as desired by managers for discharging their functions are referred to as management accounting. A very important component of the management accounting is cost accounting which deals with cost ascertainment and cost control. Management Accounting will be dealt with at higher levels of the Chartered Accountancy Course.

- **Cost Accounting** - The terminology of Cost Accounting published by the Institute of Cost and Management Accountants of England defines cost accounting as: "the process of accounting for cost which begins with the recording of income and expenditure or the bases on which they are calculated and ends with the preparation of periodical statements and reports for ascertaining and controlling costs.

- **Social Responsibility Accounting** - The demand for social responsibility accounting stems from increasing social awareness about the undesirable by-products of economic activities. As already discussed earlier, social responsibility accounting is concerned with accounting for social costs incurred by the enterprise and social benefits created.

- **Human Resource Accounting** - Human resource accounting is an attempt to identify, quantify and report investments made in human resources of an organisation that are not presently accounted for under conventional accounting practice.

D. Users of accounting information

- Investors
- Employees
- Leaders
- Supplier and Creditor
- Customers
- Government and their agencies
- Public
- Management

E. Role of Accountancy in society

Areas of Service

- Maintenance of Books of Accounts
- Statutory Audit
- Internal Audit
- Taxation
- Management Accounting and Consultancy Services
- Financial Advice
- Other Services
    - Secretarial Work

- Share Registration Work
- Company Formation
- Receiverships, Liquidations, etc
- Arbitrations
- As regards the Cost Accounts
- Accountant and Information Services

3. Accounting Conventions and Standards

A. Accounting Conventions

Accounting conventions emerge out of accounting practices, commonly known as accounting principles, adopted by various organizations over a period of time. These conventions are derived by usage and practice. The accountancy bodies of the world may change any of the convention to improve the quality of accounting information. Accounting conventions need not have universal application.

In the study material, the terms 'accounting concepts", 'accounting principles' and 'accounting conventions' have been used interchangeably to mean those basic points of agreement on which financial accounting theory and practice are founded.

B. Concepts, principles and Conventions

- Entity concept: Accountants treat a business as distinct from the persons who own it; then it becomes possible to record transactions of the business with the proprietor also.

- Money Measurement Concepts: Accounting records only those transactions which are being expressed in monetary terms though quantitative records are also kept.

- Cost Concept: Transactions are entered in the books of account at the amounts actually involved. Suppose a firm purchases a piece of land for Rs. 1,50,000 but considers it as worth of Rs. 3,00,000. The purchase of land will be recorded at for Rs. 1,50,000 and not anymore. This is one of the most important concepts–it prevents arbitrary values being put on transactions, chiefly those resulting in acquisition of assets.

- Going Concern Concept: It is assumed that the business will exist for the foreseeable future and transactions are recorded from this point of view.

- Dual–Aspect Concept: Each transaction has two aspects: if a business has acquired an asset, it must have resulted in one of the following:

(a) some other asset has been given up;

(b) the obligation to pay for it has arisen;

(c) there has been a profit, leading to an increase in the amount that the business owes to the proprietor; or

(d) the proprietor has contributed money for the acquisition of the asset.

Assets = Liabilities + Capital
or
Capital = Assets – Liabilities

- Realization Concept: Accounting is a historical record of transactions; it records what has happened. It does not anticipate events, though anticipated adverse effects of events that have already occurred are usually recorded.

- Accrual Concept: When an event takes place or a transaction is entered into, its consequences are bound to follow. For example, if one borrows `1,00,000 @ 15% p.a., at the end of the year `15,000 will become due as interest.

- Consistency Concept: Various accounting practices should remain the same from one year to another–for instance it would not be proper to value stock in trade according to one method one year and according to another method next year.

- Disclosure Concept: Apart from legal requirements, good accounting practice also demands that all significant information should be disclosed.

- Conservatism Concept: Financial statements are usually drawn up on rather a conservative basis. Window–dressing, i.e. showing a position better than what it is, is not permitted.

- Matching Concept: In keeping with the assumption that accounting is concerned with the business entity as a continuing enterprise is the concept of a periodic determination of income.

- Periodicity Concept: A period, usually a period of twelve months is selected to find out profit or loss of the business and ascertain financial position of the business.

C. Accounting equation

According to the double entry principle, each transaction has two aspects, the debit and credit or attracts two accounts. Simultaneously, it is entered in two separate accounts. Thus every debit has a corresponding credit to it and vice versa. Every business has some resources which are supplied by the proprietor in the form of capital and has some Owings. Since business has a separate entity, all transactions are considered accordingly. Increase in one asset is accompanied by a decrease in another asset or increase in the liability with equivalent amount. At any point of time, it can be proved that total assets are equal to total liabilities. Liabilities to outsiders are known as 'liabilities' but liabilities to owners in the accounting parlance is referred to as 'capital'. This relationship that exists among assets, liabilities and capital is known as accounting equations. Thus

Assets = Liabilities (Outsides and Owners Equity)

or Assets = Liabilities + Capital

or Assets − Liabilities = Capital

D. Concepts of Accounting Standards

Financial statements summaries the economic consequences of business activities of an enterprise during an accounting period. Accounting Standards provide a guideline how to present information in financial statements. Accounting Standards are in the nature of a structural framework within which credible financial statements can be prepared. These are formulated with a view to harmonies different accounting policies and practices. It ensures comparability of financial statements of different enterprises and provides meaningful information to various users of financial statements. Accounting Standards cover various aspects of recognition, measurement, treatment, presentation and disclosure of accounting transactions in the financial statement.

Compliance of Accounting Standards (As per Companies Act, 2013)

(a) By Auditor: The Auditors should report compliance of Accounting Standards.

(b) Constitution of National Financial Reporting Authority to advise Central Government on the formulation of Accounting Standards.

(c) Every Profit and Loss account and Balance Sheet (Financial Statement) shall comply with the Accounting Standards.

(d) Where Profit and Loss Account and Balance Sheet of the Company do not comply with the Accounting Standards, such companies shall disclose in its profit and loss account and balance sheet, the following:
   (i) The deviation from accounting standards.
   (ii) The reasons for such deviation.
   (iii) The financial effect, if any, arising due to such deviation.

(e) Central Government has power to prescribe, in consultation with National Authority the Accounting Standards as recommended by ICAI.

(f) Directors Report to include a statement that applicable accounting standards have been followed along with explanation relating to material departures.

A. Objectives of Accounting Standards–Salient Features of First Time Adoption of AS

(i) **For bringing uniformity in accounting methods**: Accounting standards are required to bring uniformity in accounting methods by proposing standard treatments to the accounting issue. For example, AS 6(Revised) states the methods for depreciation accounting.

(ii) **For improving the reliability of the financial statements**: Accounting is a language of business. There are many users of the information provided by accountants who take various decisions relating to their field just on the basis of information contained in financial statements. In this connection, it is necessary that the financial statements should show true and fair view of the business concern.

(iii) **Simplify the accounting information**: Accounting standards prevent the users from reaching any misleading conclusions and make the financial data simpler for everyone. For example, AS 3 (Revised) clearly classifies the flows of cash in terms of 'operating activities', 'investing activities' and 'financing activities.

(iv) **Prevents frauds and manipulations**: Accounting standards prevent manipulation of data by the management and others. By codifying the accounting methods, frauds and manipulations can be minimized.

B. Accounting policies and their disclosures

Accounting policy means specific method or principle of accounting adopted by an enterprise for a particular transaction or event in the preparation and presentation of financial statements. The accounting policies followed vary from enterprise to enterprise.

The Institute of Chartered Accountants of India issued Accounting Standard-1(AS 1). '**Disclosure of Accounting Policies'** effective from 1.4.1999. The standard is mandatory and applicable for Joint Stock Companies as well as:

(a) Sole proprietary concerns/individuals
(b) Partnership firms
(c) Societies registered under the Societies Registration Act
(d) Trusts
(e) Hindu Undivided Families
(f) Association of persons

C. Consideration in selection of accounting policies

- Prudence
- Substance over form
- Materiality

Change in Accounting policies

- Due to change in Law, or
- Due to change in Accounting Standard, or
- In order to present the financial statements in a manner so as to present a true and fair view of the state of affairs of the enterprise.

D. Accounting Standards Issued by the Institute of Chartered Accountants of India

Sl. no.	**Number of the Accounting Standards (AS)**	**Title of the Accounting Standard**
	AS 1	Disclosure of Accounting Policies
	AS 2 (Revised)	Valuation of Inventories
	AS 3 (Revised)	Cash Flow Statement
	AS 4 (Revised)	Contingencies and Events Occurring after the Balance Sheet Date
	AS 5 (Revised)	Net Profit of Loss for the Period, Prior period items and changes in Accounting Policies Deleted and Merged with
	AS 6 (Revised)	AS 10
	AS 7	Accounting for Construction Contracts
	AS 8	Deleted and replaced by As 26
	AS 9	Revenue Recognition
	AS 10 (Revised)	Accounting for Property, Plant and Equipment Accounting for the Effects of Changes in Foreign Exchange Rates

	AS 11 (Revised)	Accounting for Government Grants
	AS 12	Accounting for Investments
	AS 13	Accounting for Amalgamations
	AS 14	Accounting for Retirement Benefits in the Financial
	AS 15	Statements of Employers
	AS 16	Borrowing Costs
	AS 17	Segment Reporting
	AS 18	Related Party Disclosures
	AS 19	Leases
	AS 20	Earnings Per Share
	AS 21	Consolidated Financial Statements
	AS 22	Accounting for Taxes on Income
	AS 23	Accounting for Investments in Associates in
		Consolidated Financial Statements
	AS 24	Discontinuing Operation
	AS 25	Interim Financial Reporting
	AS 26	Intangible Assets
	AS 27	Financial Reporting of Interest in Joint Venture
	AS 28	Impairment of Assets
	AS 29	Provision, Contingent Liabilities and Contingent Assets
	AS 30	Financial Instruments Recognition and Measurements.
	AS 31	Financial Instruments Presentation
	AS 32	Financial Instruments Disclosures

E. WHAT IS INTERNATIONAL FINANCIAL REPORTING STANDARDS (IFRS)?

International Financial Reporting Standards (IFRS) is a set of high quality and globally acceptable financial reporting standards developed by the International Accounting Standard Board (IASB). The IASB is the independent Standard-setting body of the IFRS Foundation, its head-quarter is in London.

Difference between AS and IAS (IFRS)

Normally AS are in conformity with international Accounting standard. While formulating the Accounting Standards the ASB gives due consideration to International Accounting Standards or international financial reporting standards (IFRS) issued by international Accounting Standard Boards. ASB also tries to integrate the two, to the extent possible in the light of conditions and practices prevailing in India. It may be said the ICAI adapts the IFRS and makes changed in IAS/IFRS to suit Indian conditions. However the AS may and, in fact, actually differ from IFRS. The main reasons of difference are on following points.

1. There is need to maintain consistency with the legal and regulatory requirement of the country.
2. Difference in economic environment of the country. IFRS are meant for developed countries.
3. In India, the level of preparedness of industry is different
4. At times there are conceptual differences in Indian Standards and IFRS

As issued by the council of Institute of Chartered Accountants and Corresponding Accounting Standards issued as IFRS are as follows:

Accounting Standard (AS)	**Title**	**IAS/FRS**	**Title**
AS 1	Disclosure of Accounting	1	Presentation of Financial
AS 2	Policies	2	Statements
AS 3	Valuation of Inventories	7	Inventories
AS 4	Cash Flow Statements	10	Cash Flow Statements
	Contingencies and Events		Events Occurring after the
AS 5	Occurring after the	8	Balance Sheet Date
	balance sheet date		Net profit or loss for the period,
AS 6	Net Profit or Loss for the		Fundamental errors, and
	period, prior period items		changes in accounting policies
	and changes in accounting	11	Corresponding IAS has been
	policies		withdrawn since the matter is
AS 7	Depreciation Accounting	18	now covered IAS 38
AS 8	Construction contracts	16	Construction contracts
AS 9	Withdrawn by ICAI	21	Revenue
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	in Consolidated Financial	36	Interim Financial Reporting
AS 23	Statements	37	Intangible Assets
	Discontinuing Operations		Interests in Joint Ventures
	Further, AS 10 deals with	39	
AS 24	accounting for fixed assets		Impairment of Assets
	retired from active use.	32	Provisions, Contingent Liabilities
AS 25	Interim Financial		and Contingent Assets
AS 26	Reporting		Financial Instruments:
	Intangible Assets		Recognition and Measurement
	Financial Reporting of		Financial Instruments:
AS 27	Interests in		Presentation
	Joint Ventures		
	Impairment of Assets		

AS 28 AS 29 AS 30 AS 31	Provisions, Contingent Liabilities and Contingent Assets Financial Instruments: Recognition and Measurement Financial Instruments: Presentation		

4. Accounting for Business Transactions

5. Journal

A. DOUBLE ENTRY SYSTEM

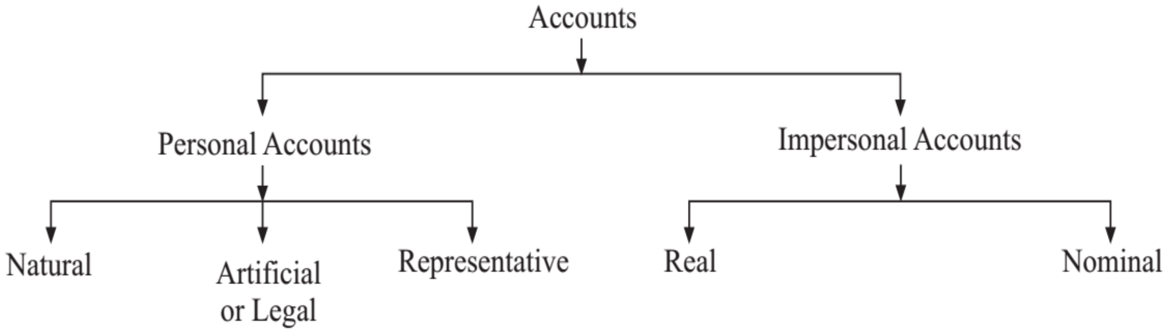
Every business transaction has two aspects – Debit and Credit. Double Entry System is based on this dual aspect of transactions. These two aspects are identified with the name of some account. One account is debited and the other account is credited.

B. KINDS OF ACCOUNTS

To carry on business activity, a businessman must have an office, certain items of furniture like office tables, chairs, cupboard, goods and cash. During the course of business, he deals with a number of persons, customers and suppliers. He spends money on office staff salary, printing, telephone charges, office rent and such other expenses. He receives his income from certain sources such as sales, interest, commission, discount, etc. Thus, from the above, we will observe that business activity revolves mainly on the three categories of accounts:

- 1. Personal Accounts
- 2. Real Accounts
- 3. Nominal Accounts

The accounts can also be classified as personal and impersonal. The following chart will show the various types of accounts.



Personal Accounts

These are the accounts of individuals, firms, companies, local authorities, associations with whom the business deals. A separate account is maintained for every person, firm or company. Personal Accounts may be of the following types:

- Natural Persons: They are individual human beings, such as Ram, Rahim, Jacob.
- Artificial or Legal Persons: Examples: Joint Stock Companies, Societies, Club, Firms, Bank.
- Representative Persons: Examples: Capital Accounts, Drawings Accounts, Sundry Debtors, Sundry Creditors, Outstanding Expenses, Prepaid Expenses.

Impersonal Accounts

These are classified into two categories:

(A) Real Accounts: These are related to assets of the business enterprise such as Building, Machinery, Furniture, Cash, Goodwill, Patents. However, these will not include Debtors.

(B) Nominal Accounts: These accounts represent Expenses, Losses, Income of the business. Examples: Rent, Salary, Interest paid and received, Loss by Fire, Commission, etc.

C. RULES OF DEBIT AND CREDIT

Double entry book-keeping is a scientific method of recording the business transactions. Every transaction has two aspects, i.e. two-fold effect. In each transaction, two accounts are involved. One account gives benefit and the other account receives benefit. The account that gets benefit is debited and the account that gives benefit is credited. Both these aspects are recorded in the books simultaneously.

- **Personal Account:** The personal account which receives the benefit is debited while the personal account which gives the benefit is credited. In other words, the fundamental rule of debit and credit regarding the personal account is Personal account of the proprietor/ partner/owner is called Capital Account. Customers to

whom goods have been sold are collectively called debtors, supplier of goods are called creditors. It proprietor withdraws cash from the business, his personal account is called Drawings Account. The golden rule of Personal Account is:
'DEBIT THE RECEIVER AND CREDIT THE GIVER'

- **Real Account:** Real account deals with property or real assets like building, machinery, furniture, goods cash, etc. For the real accounts, the golden rule of debit and credit is: '**DEBIT WHAT COMES IN, CREDIT WHAT GOES OUT'**

- When an asset is purchased that asset comes in and benefits received. Hence, the asset account is debited. When an asset is sold out that asset goes out and the benefit is given therefore that asset account is credited.

- **Nominal Accounts**: When an expense is incurred or loss suffered, the account representing the expense or loss is debited because the business receives the benefit thereof. When any income is earned or gain made, the account representing the income or the gain is credited. This is because the business gives some benefit.

The golden rules or Debit and Credit can be summarised in a tabular form as under.

Accounts	**Debit**	**Credit**
Personal	The receiver	The giver
Real	What comes in	What goes out
Nominal	Expenses or losses	Income or gains

D. JOURNAL

All business transactions are recorded in the journal in the order in which they take place. The process of recording transactions in the journal is called journalising. After recording the transactions in the journal, these are posted in the Ledger in their respective accounts. The journal is, therefore, called a book of original entry.

Column (1) Date - This column shows the date of the transactions while.

Column (2) Particulars–In this column, the name of the account to be debited is written first starting with the line marked as (A) in the above form. On the next line, after leaving certain space, the account to be credited is written preceded by the word 'To'. A short description of the transaction is given in the third line which is called 'Narration' shown above as (.......).

Column (3) L.F.–L.F. means Ledger Folio, i.e. page number of the ledger where the respective account is opened. After posting the entry in the ledger, the ledger page number is recorded in 'L.F.' column.

Column Nos. (4) and (5) –Debit and Credit–The amount to be debited is entered in 'Debit' column while the amount to be credited is entered in 'Credit' column.

MP Gupta | BM Agarwal. Grewal's Accountancy [CA Foundation] (p. 5.4). Kindle Edition.

Points to be Noted While Passing Journal Entries

1. First read the transaction carefully and find out two accounts involved in it.
2. Then find out to which category these accounts belong viz., real, nominal or personal.
3. Apply the golden rules of Debit and Credit and find out which account is to be debited and which is to be credited. Enter debit and credit accounts in particulars column.
4. Enter the date of the transaction in the 'Date' column. Give short description of the transaction (narration) in the 'Particulars' column within bracket.
5. Enter the amount in figure in 'Debit' and 'Credit' columns.
6. When it is not clearly stated in the problem whether the transactions is on a cash basis or on a credit basis and when the name of the party is not given, it should be considered on cash basis.
7. When the word 'Received' or 'Paid' appears in the transaction, it means cash is received or paid.
8. The term 'Purchase Account' should be used when goods are purchased and the term 'Sales Account' should be used when the goods are sold.
9. When goods are returned by the customers, the term 'Sales Return' or 'Return Inward' should be used. Similarly, when goods are returned to the supplier, the term 'Purchase Return' or 'Return Outward' should be used.

Example:
Journal Entries:

Date	**Transactions**	**Two Aspects**	**Name of Accounts**	**Debit/ Credit**
2018 June 1	Business started	Cash Capital	Real Account Personal Account	Dr. Cr.
June 2	Goods purchased for cash	Purchase (Goods) Cash	Real Account Real Account	Dr. Cr.
June 4	Goods purchased on credit from Subodh	Purchase (Goods) Subhod	Real Account Personal Account	Dr. Cr.
June 5	Furniture purchased for cash	Furniture Cash	Real Account Real Account	Dr. Cr.

June 7	Goods sold for cash	Cash Sales (Goods)	Real Account Real Account	Dr. Cr.
June 9	Goods sold on credit to Mahendra	Mahendra Sales	Personal Account Real Account	Dr. Cr.
June 10	Paid cash to Subodh	Subhod Cash	Personal Account Real Account	Dr. Cr.
June 12	Received cash from Mahendra	Cash Mahendra	Real Account Personal Account	Dr. Cr
June 16	Purchased goods for cash	Purchases Cash	Real Account Real Account	Dr. Cr
June 17	Purchased goods from Ravindra on credit	Purchases Ravindra	Real Account Personal Account	Dr. Cr
June 18	Sold goods for cash	Cash Sales	Real Account Real Account	Dr. Cr
June 19	Goods sold to Surendra on credit	Surendra Sales	Personal Account Real Account	Dr. Cr
June 20	Machinery purchased for cash	Machinery Cash	Real Account Real Account	Dr. Cr
June 24	Withdraw cash for personal use	Drawings Cash	Personal Account Real Account	Dr. Cr
June 27	Rent paid	Rent Cash	Nominal Account Real Account	Dr. Cr
June 27	Wages paid	Wages Cash	Nominal Account Real Account	Dr. Cr
June 27	Salary paid	Salary Cash	Nominal Account Real Account	Dr. Cr
June 27	Commission received	Cash Commission	Real Account Nominal Account	Dr. Cr

Sales Return and Purchase Return
For goods returned inward or Sales Return and for goods returned outward or Purchase Return, separate accounts are opened. These are real accounts (related to goods).

Discount Allowed and Discount Received
Discount is of two types:
1. Trade Discount, and
2. Cash Discount

Compound Entry
When there are two or more similar type of transactions and account debited or credited is common, a combined entry may be passed. For example, in above example two entries on April 10 may be combined.

Cash A/c	Dr.	2,940
Discount A/c	Dr.	60
To M/s Lalwani & Co.		3,000

Concept of Implied Giver and Implied Receiver

While applying rule of double entry to personal account, in some cases rule – Debit the Receiver and Credit the Giver may not appear to be applicable. For example, when cash discount is allowed to a customer on payment within stipulated time, accounting entry is:

Discount allowed A/c (Nominal Account). Dr.
To Customer (Personal Account)

As per rule of Double Entry, Personal account is credited when he is a giver. In this case he is paying less amount and amount not paid is treated as Discount Allowed. It becomes difficult to understand how customer is receiver.

Outstanding Expenses/Prepaid Expenses /Accrued Income/Advance Income

(a) **Outstanding Expenses:** When liability for an expenses has arisen but it is not yet paid, the relevant expenses account will be debited and relevant outstanding expenses account will be credited. Suppose at the end of the period rent amounting to `500 has become due but it is not paid (i.e. outstanding) the entry will be
Rent A/c Dr. 500
To Outstanding Rent A/c 500
In the next period, unpaid rent will be paid. Outstanding Rent A/c is a personal account.

(b) **Prepaid Expenses:** When an expense has been paid in advance, which was not due at the time of payment, it is called prepaid expense, Normally in case of insurance premium, the amount is paid in advance the entry will be
Prepaid Exps. (like, Insurance Premium) A/c Dr.
To Cash Prepaid Exps. A/c is a Personal account.
Next year it will be adjusted as under. Insurance Premium A/c Dr. To Prepaid Exps. A/c

(c) **Accrued Income:** If an income has been earned but it is not yet received, it is called accrued income As per accounting rules, at the end of the year such income should be recorded.
Accrued Income A/c Dr.
To Income A/c
Accrued Income A/c is personal account. Later on it will be received.

(d) **Income Received in Advance:** If an income which has not earned or become receivable and it is received in advance, it will be recorded.
Cash A/c Dr.
To Income Received in Advance A/c
Income Received in Advance is personal account. Next year when it will be earned, it will be credited to Income A/c.

Income Received in Advance A/c Dr.
To Income A/c

S. NO.	TRANSACTIONS	JOURNAL
1	Goods taken by proprietor for personal use.	Drawings Alc Dr. To Purchases A/c
2	Goods are given as charity	Charity A/c Dr. To Purchases A/c
3	Goods used as stationery in a business of Stationery goods	Stationery A/c Dr. To Purchases A/c
4	Goods used as furniture in a business of Furniture Goods.	Furniture A/c Dr. To Purchases A/c
5	Goods lost in transit	Loss in Transit A/c Dr. To Purchases A/c
6	Cash paid to A on behalf of B	B Dr. To Cash A/c
7	Cheque dishonoured (Cheque was received earlier from Mr. Ramesh)	Ramesh To Bank A/c
8	Amount receivable from Rakesh became irrecoverable	Bad Debts Alc Dr. To Rakesh
9	Dinesh became insolvent and 50% of the amount received from his estate	Cash A/c (50%) Dr. Bad Debts A/c (50%) Dr. To Dinesh
10	A part of the bad debts earlier written off is recovered	Cash A/c Dr. To Bad Debts Recovered A/c
11	Paid Rent to landlord but half of the premises is occupied for own residential purpose	(a) Rent A/c Dr. To Cash A/c (With full amount) (b) Drawings A/c Dr. To Rent A/c (With half amount)
12	Received Bank Interest	Bank A/c Dr. To Interest Received A/c
13	Purchased machinery and paid wages on its installation	Machinery A/c Dr. To Cash/Bank A/c
14	Charge depreciation on machine	Depreciation A/c Dr. To Machine A/c
15	Provide interest on capital	Interest on Capital A/c Dr. To Capital A/c
16	Bought horse for carriage of goods	Live Stock (Horses) Dr. To Cash A/c
17	Sold personal Jewellery and paid money into business	Cash A/c Dr. To Capital A/c

18	Sold old news papers	Cash A/c Dr. To Miscellaneous Income A/c
19	Paid Income Tax by a Proprietorship Enterprise	Drawings A/c Dr. To Cash A/c
20	Paid Sales Tax	Sales Tax A/c Dr. To Cash A/c

- There are three types of accounts:
  - (a) Personal Accounts,
  - (b) Real Accounts and
  - (c) Nominal Accounts.
- Personal Accounts are classified into:
  - (a) Natural Persons
  - (b) Artificial Persons and
  - (c) Representative Persons
- Journal entries are made by following the dual aspect concept. This is known as Double Entry System.
- Every transaction and event has two aspects: Debit and Credit
- The rules of double entry system are:
  - (a) For Personal Accounts−Debit the receiver and credit the giver.
  - (b) For Real Accounts−Debit what comes in and credit what goes out.
  - (c) For Nominal Accounts−Debit expenses and losses and credit income and gains.
- Journal is the initial record (original entry) of transactions and events.
- Goods refer to the commodities which are purchased for resale or for use in the production.
- Goods Account is classified into Purchase, Sales, Purchase Return and Sales Return.
- Goods taken out of the business for personal use of the proprietor, given as charity and used as samples are credited to Purchases Account.
- Personal Accounts:
  - (a) Accounts of individuals, firm, company, society, club or other association of persons
  - (b) Capital Account, Drawing Account, Current Account
  - (c) Bank Account, Loan Account, Advance Account, Bank Overdraft
  - (d) Outstanding Expenses, Prepaid Expenses, Accrued Income and Advance Income
  - (e) Bills Payable Account, Bills Receivable Account, Sundry Debtors Account and Sundry Creditors Account
- Personal Accounts are classified as:
  - (a) Natural personal Accounts−Human beings: Ram, Mohan, Rita.
  - (b) Artificial (Legal) Personal Accounts−Joint Stock company, Partnership firm, Cooperative society, Club, Central Govt., State Government, Municipal Corporation.

(c) Representative Personal Accounts– Capital Account, Drawings Account, Outstanding Expenses, Prepaid Expenses, Accrued Income, Advance Income.

- Real Accounts:
  (a) Tangible Fixed Assets
  (b) Intangible Fixed Assets
  (c) Cash, Goods (Purchases, Sales, Purchase Return and Sales Return)
- Nominal Accounts
  (a) Expenses: of Revenue Nature, Depreciation
  (b) Losses: Bad Debts, Loss by theft
  (c) Gains: Income, Profits.
- The source documents on the basis of which transactions are recorded in the account books are known as 'Source Documents'.
- Debit balance of a Personal Account shows amount receivable and credit balance as amount payable.
- Debit balance of Nominal Account is expenses or loss and credit balance is income.
- Cash Discount is allowed/received for prompt payment.
- Trade discount is allowed to promote sales. It is allowed to a customer on a sale in excess of a certain quantity. It is deducted from selling price or purchase price.
- Payment of personal expenses of the proprietor is debited to Drawing Account.
- The source document related to sale return is credit note.
- The source document related to purchase return is debit note.
- Increases in assets are debits and decreases in assets are debits.
- Increases in liability are credits and decreases in Liability are debits.
- Increases in owners capital are credits and decreases are debits.
- Increases in expenses are debits and decreases are credits.
- Increases in revenue/income are credits and decreases are debits.
- Assets = Equity (capital) + Liability
- Assets − Liabilities = Capital
- Fixed Assets may be tangible or intangible.
- Tangible fixed assets: Land, Building, Machinery, Furniture, Fixtures, Vehicles, Office equipment, Computer hardware.
- Intangible fixed assets: Goodwill, Trademarks, Patents, Copy rights, Brands, Computer software.
- Current Assets: (Recoverable within 12 months) Cash, Bank, Sundry Debtors, Bills Receivable, Prepaid expenses, Accrued income, Short term investments.
- Current Liabilities: (Payable within 12 months) Sundry creditors, Bills Payable, Outstanding expenses, Bank overdraft, Cash credit.
- Long Term Liabilities: Term loans, Debentures.
- Impersonal Account: Real Account and Nominal Account.
- Net Assets: Net worth, Capital, Proprietors Fund, Share Holders Funds.
- Current Assets – Current Liabilities = Working Capital.

(c) Ledger

A. Meaning of Ledger

Ledger is a book of Secondary Entry. It is one of the principal books. In Journal, transactions are recorded date wise, where one account is debited and another is credited. Consequently different accounts are created in the ledger. The purpose of ledger is to know the consolidated position of each account separately. Therefore, head-wise classification of different accounts is made. Each account is separately opened in the ledger and posting is made from the Journal in the relevant account. The statement which contains transactions relating to a particular subject for a particular period and in which the transactions are properly arranged into Debits and Credits is known as an account.

In the middle of the account, name of the account, say, Salary A/c, Furniture A/c, Capital A/c and so on is written. On the left hand side corner 'Dr.' is written and on the right hand corner 'Cr.' is written. 'Dr.' stands for debit and 'Cr.' stands for credit.

B. Difference Between Journal and Ledger

1. Journal is a book of prime entry, whereas ledger is a book of secondary entry.
2. Transactions are recorded daily in the journal whereas posting in the ledger is made periodically.
3. In the journal, information about a particular account is not found at one place, whereas in the ledger information about a particular account is found at one place.
4. Recording of transactions in the journal is called journalising and recording of transactions in the ledger is called posting.
5. A journal entry shows both the aspects debit as well as credit but each entry in the ledger shows only one aspect.
6. Narration is written after each entry in the journal but no narration is given in the ledger.
7. Vouchers, receipts, debit notes, credit notes, etc. form the basic (source) documents for a journal entry, whereas journal constitutes basic record for ledger entries.

C. Ledger posting

Each business transaction is first recorded in the journal. We have learned that each entry has two effects, one debit and the other credit. Thus, each journal entry involves two accounts, one is debited and the other is credited. Now ledger is a book wherein all accounts are opened. The journal entries are then transferred to the respective accounts in the ledger. Such transfer of an entry from journal to ledger is called posting.

D. Points to be Noted While Posting the Transactions

1. All the transactions relating to a particular account should be recorded in the account already opened. No new account for the same should be opened in the ledger.
2. Posting will be made on the debit side of the account which has been debited in the journal and the credit side of the account which has been credited in the journal.
3. Every entry on the debit side of the account begins with the word ‘To’ in the ‘Particulars’ column and that on the credit side of the account begins with the word ‘By’.
4. While posting the entry on the debit side of an account, the account credited in journal is written on the debit side after the word ‘To’. Similarly, while posting the entry on credit side of an account, the account debited in the journal is written after the word ‘By’.
5. In the folio column, enter the journal folio (page) number where the entry is recorded in the journal. At the same time, page number of the ledger account will be entered in L.F. column in the journal.
6. Journal entries should be posted in the ledger in order of dates.
7. Every ledger account should be balanced periodically.

E. Opening Entry

In above illustrations, the business is started. But after the first year of its working, a firm will start new books of account. The balances of last year are carried to the current year. The entry to start the new books is known as opening entry. In this entry debit the respective accounts with the opening balances (being closing balances of last year) of various assets and to credit the relevant accounts with the opening amounts due to creditors and to credit Capital Accounts. If the amount of capital in the beginning is not known, it will be excess of debit accounts (assets) over credit accounts is worth remembering that capital is assets minus liabilities.

F. Balancing of account

After making posting in the various accounts, each account is balanced. In some accounts total of debit and credit sides will be equal i.e. balance is ‘Nil’. In other accounts there will be either Debit Balance or Credit Balance. If total of the Debit side of an account is more than total of the Credit side, the difference is put on the credit side as “By Balance c/d”. However, this will be known as Debit Balance. Similarly, if the total of credit side of an account is more than total of the Debit Side, the difference will be put on the Debit Side as “To Balance c/d”.

G. Significance of balances

Accounts are balanced regularly and these balances are drawn on a separate sheet called Trial Balance. Trial balance shows arithmetical accuracy of the transactions entered during a particular period, say, a month, quarter, etc. We are going to learn more about this aspect in chapter 7. Let us now try to understand the significance of balances of various accounts drawn from the ledger.

- *Personal Accounts*: Debit balance in personal account means amount receivable and credit balance means amount payable. Personal accounts are accounts of customers and suppliers. It is very important for a businessman to know how much money he has to recover from his customers and how much is payable to his suppliers on a particular day. He will make efforts to recover his dues from the customers with the time of credit allowed to them. Thus he will enable him to make payments to his suppliers within the credit period allowed by them. If his cash balance permits, he may settle the accounts of his suppliers before the credit period and earn a cash discount.
- *Real Accounts:* Real accounts are assets account. Assets Account have debit balance. These are normally balanced at the end of the accounting year for the purpose of preparing final accounts. Cash account is, however, balanced daily to know the cash balance.
- *Nominal Accounts*: Nominal accounts are accounts of expenses/ losses and incomes/ gains. These are closed every year by transferring the balances to Profit & Loss Account. However, for the purpose of preparing a Trial Balance, these accounts will be balanced. The accounts relating to expenses or losses will always show debit balance whereas accounts relating to incomes or gains will always show credit balance.

GLOSSARY (REVISION) OF LEDGER

- Posting of various accounts is made in the ledger.
- Posting is the classification of various accounts according to their head of accounts.
- A separate account is opened for each account in the ledger.
- Ledger is one of the principal books of accounts but a book of secondary entry.
- Every account in the ledger has two sides: one debit and the other credit.
- An account shows collective effect of all transactions related to that account.
  While posting from Journal, account which has been debited in Journal will also be debited in that account in the ledger. But name of the other account credited in that entry is written. Similarly account which has been credited in Journal will be credited in that account in the ledger.
- Posting in the debit side is prefixed by 'To' and posting in the credit side is pre-fixed by 'By'.
- Every side has columns for–Date, Particulars, Journal Folio and Amount. i.e. four columns in the debit side and four columns in the credit side.
- An account may have either Debit or credit balance. If amount posted in the debit side and credit side are equal, that account will have nil balance.
- If debit side of an account exceeds credit side, balance will be written in the credit side as 'By Balance c/d or c/f'. This will be known as debit balance of that account.
- If credit side of an account exceeds debit side, balance will be written on the debit side as 'To Balance c/d or c/f'. This will be known as credit balance of that account.
- Abbreviation 'c/d' is written for closing balance and 'b/d' for opening balance.
- Balances of nominal accounts will be closed at the end of accounting period by transfer to Trading and Profit and Loss Account.

- Balance of personal accounts and real accounts at the end of the year, will be taken as opening balances of next year.
- Debit balance of a personal account means amount receivable from him.
- Credit balance of a personal account means amount payable to him.
- Debit balance of a real account means an Asset.
- Cash Account will never show a credit balance.
- Bank Account may show either Debit or Credit balance. Credit balance of Bank A/c indicates overdraft.
- Debit balance of a nominal account shows expense or loss.
- Credit balance of a nominal account shows income.

(d) Cash Book

A. Meaning of cash book

The number of transactions relating to cash are usually large because most of the business dealings ultimately resolve themselves into cash transactions, so it is necessary to keep a separate book for cash transactions. If every cash transaction is recorded in the Journal, a tremendous amount of work will be involved in debiting or crediting Cash Account for every item cash is received or paid. If the cash book is maintained, botheration of posting every item of receipt or payment of cash individually to Cash Account in the ledger is avoided.

A daybook-cum-ledger kept for making entry of cash transactions as well as posting to the cash and bank accounts is called Cash Book. It is a unique book of account that combines journal and ledger. Cash Book is a journal for making primary entry of all cash transactions. It is also ledger wherein cash and bank accounts are maintained.

B. TYPES OF CASH BOOK

The different types of Cash Book in use are:

1. Simple or single column cash book
2. Two or double column cash book: -
   (i) Cash and Discount Column.
   (ii) Cash and Bank Column.
3. Three or triple column cash book

C. Simple or Single Column Cash Book

This book contains only cash column. It has two sides, i.e. receipts side and payments side. All receipts in cash are recorded on Receipts side (Debit side) and all payments of cash of Payments side or credit side. Cash account is a real account. So according to the golden rule of debit and credit, all cash receipts are debited (debit whatever comes in) and all cash payments are credited (credit whatever goes out).

There are five columns each on both the sides of Cash Book.

1. **Date**: The date on which cash is received or paid is entered in this column.
2. **Particulars**: In this column, the name of the account in respect of which the amount is received or paid is shown.

3. **L.F.:** means ledger folio. This column shows page number of the ledger where the entry has been posted.
4. **The serial number** of the Receipt is entered on receipts side. On the payments side Vr. No. i.e. voucher number is entered. For all payments made by the business, voucher number is recorded on the payments side.
5. **Amount**: This column shows amount of cash received or paid in the account. For recording any receipt (on the receipts side) 'To' is written first in 'Particulars' column and then the account head which is to be credited for any payment 'By', is written in Particulars column before the head which is to be debited.

D. Posting of the Simple Cash Book

In order to complete the double entry of each and every transaction that has been recorded in the cash book, posting of such transactions is to be made to the respective ledger accounts. Cash book itself is a ledger account of cash and hence, we need not open cash account again in the ledger.

For all transactions entered on the receipts (debit) side of the cash book, credit the concerned accounts in the ledger by writing 'By Cash A/c' in the 'Particulars' column. For all transactions, entered on the payments (credit) side of the cash book, debit the concerned accounts in the ledger by writing 'To Cash A/c' in the 'Particulars' column. Cash account is a real account and the relative golden rule viz., debit whatever comes in and credit whatever goes out applies to all cash transactions.

E. Double Column Cash Book with Cash and Discount Columns

In this type of cash book, there is an extra column for recording cash discount on either side. Thus, there will be two columns for showing amount on both sides—Cash and Discount. When cash is received from a customer before due date, some cash discount may be allowed to him. Similarly, when an earlier payment is made to a creditor, he may allow us a cash discount.

Balancing of Two Column Cash Book

At the time of balancing of such two column (double column) cash book, only cash column is to be balanced. The total of discount column on the debit side which represents discount allowed by the business is directly posted to the debit of Discount Allowed Account in the ledger. Similarly, the total of discount column on the credit side which represents discount received by the business is directly posted to the credit side of Discount Received Account in the ledger.

F. Double Column Cash Book (Cash and Bank Column)

Such Cash Book will have Cash and Bank Columns. Cash receipts and payments are recorded in cash column and receipt and payment through cheques are recorded in Bank Column.

G. Some Important Transactions

- **Contra Entries**: Contra means opposite side. When debit and credit of a transaction are entered in the same account in different columns, each entry in the debit or, credit side is considered as the Contra entry of the other, e.g.

Cash deposited into the Bank `600. The entry will be:
Bank A/c Dr. Rs. 600
To Cash A/c Rs.600

It means debit aspect is entered on the debit side Bank Column of the Double Column Cash Book and credit aspect is entered on the credit side Cash Column of the Double Column Cash Book.

Cash Withdrawn from the Bank for office use Rs. 600: The entry will be:
Cash A/c Dr. Rs. 600
To Bank A/c Rs. 600

It is also a contra entry where debit side cash column is debited and credit side Bank Column is credited.

- **Cheque received and deposited into the bank**: If the date of deposit of the cheque is not given, it may be assumed that the cheque has been deposited on the same date.
  The entry will be:
  Bank A/c Dr.
  To Customer's/Party's/Debtors A/c
  When the cheque is deposited into the bank at a later date, entries will be:

  (a) When the cheque is received:
  Cheque in hand A/c. Dr.
  To Customer's/Party's/Debtors A/c
  (Note: No entry in Cash Book)
  (b) When the cheque is deposited into the bank at a later date:
  Bank A/c. Dr.
  To Cheque in hand A/c

  (c) When above cheque is dishonoured by bank:
  Debtor's/Customer's/Party's A/c. Dr.
  To Bank A/c

- **Cheque received and endorsed:**
  (a) On the same day
  The entry will be:
  Creditor a/c Dr. (In Journal Proper)
  To Debtor's/Customer's/Party's A/c

  (b) Endorsed at later date:
  (i) On Receipt of Cheque
  Cheque in hand A/c Dr. (In Journal Proper)
  To Debtors
  (ii) On Endorsement of Cheque
  Creditor a/c Dr. (In Journal Proper)

To Cheque in hand A/c
(Note: No Entry in Cash Book)

(c) When the endorsed cheque is returned dishonoured:
Debtor's/Customer's A/c. Dr. (In Journal Proper)
To Creditor's Alc
(The cash book will remain unaffected)

- **Bearer cheque received from a customer:**
    1. Cheque is encashed same day:
       Cash A/c Dr.
       To Debtors
    2. When the cheque is received but not yet encashed or deposited into the bank same day:
       Cheque in hand A/c. Dr. (In Journal Proper)
       To Debtor's/Customer's A/c
       (Note: No entry in Cash Book)

    - On encashment of the above cheque:
      Cash A/c. Dr.
      To Cheque in hand
    - If above bearer cheque is deposited into Bank:
      Bank A/c Dr.
      To Cheque in hand A/c
    - If above bearer cheque is dishonoured after deposit in Bank:
      Debtor's/Customer's/Party's A/c Dr.
      To Bank A/c
    - If above bearer cheque is endorsed to a creditor:
      Creditor's A/c Dr. (In Journal Proper)
      To Cheque in hand A/c
    - When the above bearer cheque is dishonoured after endorsement:
      Debtor's/Customer's/Party's A/c Dr. (In Journal Proper)
      To Creditors A/c

- When a cheque is issued to a creditor:
  The entries will be:
    - Creditors/Party's A/c Dr.
      To Bank A/c
    - When the above cheque is dishonoured:
      Bank A/c Dr.
      To Creditor's/Party's A/c
    - If "Stop Payment" order is given to the bank after issuing the cheque due to pickpocket, or some other reason, the entry will be:
      Bank A/c Dr.
      To Creditor's/Party's A/c

Important: Whenever cash or Bank A/c is debited or Credited in above entries, these will be recorded in Cash Book others will be recorded in Journal Proper only.

H. Triple Column Cash Book

This cash book contains three columns for amount on both the sides which are Cash, Bank and Discount. In modern times, a bank plays a very important role in providing finance to industry, trade and commerce. The businessman will always keep a small cash balance and deposit the rest in his bank account. It is very safe to keep money in bank. The bank collects the proceeds of the cheque deposited by its constituents or customer. Similarly, bank makes payment on behalf of his customer by honouring the cheques drawn on it, subject to availability of fund in the account. A businessman can also enjoy an overdraft facility from the bank.

I. Posting from the Triple Column Cash Book

1. **Discount Column**: Total amount of discount column is posted to the Discount Account in the ledger. Total of discount column of the debit side (receipt side) is debited to Discount Allowed Account and total of discount column of the credit side (payment side) is credited to Discount Received Account. The posting is done as under:

2. **Cash and Bank Column**: Cash Book serves the purpose of Journal as well as Ledger. Therefore, Cash Account and Bank Account are not opened in the ledger. However, amount shown in the payment side (Credit Side) of Cash Book are debited to respective accounts in the ledger. Similarly, amount shown in the receipt side (debit side) of the Cash Book are credited to respect accounts. For example, salary paid in Cash will be debited to Salary Account as “To Cash A/c” and if paid through cheque, it will be debited as “To Bank A/c” and if amount has been received through cheque, it will be credited as “By Bank A/c” in the respective account in ledger.

J. PETTY CASH BOOK

In business, there are a number of petty (small) payments to be made every day. If all these payments are recorded in the main cash book, it will become bulky and unwieldy. Therefore, many firms appoint a person as petty cashier to make all such petty payments. A petty cash book is one of the subsidiary books in which all small payments or petty expenses such as conveyance, cartage, etc., are recorded. The word ‘petty’ means small, i.e. small in amounts.

The person maintaining the petty cash book is known as petty cashier.

Types of Petty Cash Book:

Following are the two types of petty cash book:

- Simple Petty Cash Book; and
- Columnar Petty Cash Book

Simple Petty Cash Book: It is similar to a simple (Single Column) cash book. It has two sides viz., debit and credit. On the debit side, the amount received from main cashier is recorded and on the credit side all payments made in cash are recorded.

Columnar Petty Cash Book: Under the simple petty cash book, each payment is posted in the ledger separately. There are certain payments which are made practically every day; for example, conveyance, tea expenses, etc. Thus, there will be many credits in the particular's column. To avoid this, additional columns are opened on the payments side of the petty cash book for usual expenses head and posting to the Ledger accounts is made with the total at the end of period. Each payment is, thus, analysed and shown in the particular expense column. This type of petty cash book is, therefore, called Columnar or Analytical Petty Cash Book.

K. Imprest System of Petty Cash Book

This is the most popular system of petty cash book. Under this system, the Chief Cashier pays a certain sum of money to the Petty Cashier for particular period, say, a fortnight or a month. At the end of that period, Petty Cashier submits the statement of expenditure along with the supporting vouchers to the Chief Cashier. The Chief Cashier verifies the statement and after being satisfied, makes good the total amount actually incurred by the Petty Cashier so that he is left with the same amount at the beginning of the next period. This system (of advance) is called the imprest system of petty cash and the amount given to Petty Cashier as advance is known as 'Imprest Amount'. For example, on 1st January, `200 is given as advance to the Petty Cashier and during the week, he spent `198 on various petty expenses. Now, in the next week, the Chief Cashier will give him `198 only. So at the beginning of the next period (here it is next week), the Petty Cashier will have `200 with him again. The Imprest System of petty cash has the following advantages:

1. The Chief Cashier is relieved of maintaining records of petty cash payments and he can devote his time for more important matters like cash management, etc.
2. Under this system, the Petty Cashier is not allowed to drew cash from the Chief Cashier as and when he desires. He has to estimate his requirements for a particular period and accordingly cash is advanced to him. Since there is no unnecessary accumulation of cash in hand, chances of defalcation of cash are minimised.
3. As the Petty Cashier has to submit his account to the Chief Cashier before his further drawings, accounts are always kept up to date. This ensures strict supervision and control over his activities.

L. Sale through Debit Card, Credit Card, Mobile Banking, Online Banking, etc.

If a customer purchases goods through above modes, cost of goods purchased is debited to Bank Account of purchaser and credited to Bank Account of seller. After demonetisation, volume of such cashless transactions has increased. Accounting of these transactions is made as under in the books of seller:

- When sale amount is credited to Bank Account
  Bank A/c Dr.
  To Sales A/c

- Bank normally charge some commission as a percentage of sale. Such commission is debited to seller's Account. Entry for such commission will be
  Commission A/c Dr.
  To Bank A/c

GLOSSARY(REVISION) OF CASHBOOK

- Cash Book is one of the subsidiary books.
- Cash Book contains all cash receipts and payments.
- When any receipt or payment is entered in cash book, journal entry is not made for that receipt and payment.
- Cash Book may be: (a) Simple Cash Book: This book contains only cash transactions. This is also known as single column cash book. In this case bank transactions are recorded through Journal or a separate Bank Book is maintained. (b) Double Column Cash Book: This book contains two columns for amount, one for cash and the other for discount or one column for cash and the other for bank. (c) Three Column Cash Book: This book contains three columns: Cash, Bank and Discount.
- Cash and Bank columns are balanced, but discount column is totalled.
- Cash column will always show debit balance.
- Bank column may show debit or credit balance.
- Debit balance of Bank column will represent deposit balance and credit balance will represent overdraft.
- Total of discount column in the receipt side will show discount allowed and total of discount column in the payment side will show discount received.
- Cash deposited to Bank and Cash withdrawn from Bank will be shown in both sides of cash book. These are known as 'Contra items.
- When cheque is received and not sent to Bank same day, receipt of such cheque will be shown in the Cash Column. When such cheque is deposited in Bank, this will be shown as Contra item.
- When a bearer cheque is received and encashed from bank the amount will be shown in the cash column.
- When received cheque is endorsed to a creditor, such cheque may be shown in both sides of cash column with suitable explanation, or a separate entry is passed in the Journal proper.
- When cash book is maintained Cash Account and Bank Account are not maintained. However, Discount Allowed and Discount Received Account will be maintained.
- Cash Book serves the purpose of Journal as well as Ledger.

- Accounts shown in the receipt and payment side of the Cash Book will be posted in the Ledger.
- All accounts shown in the payment side of the cash book will be debited in Ledger.
- All accounts shown in the receipt side of the cash book will be credited in Ledger.
- Total of discount column of the receipt side will be debited to 'Discount Allowed Account'.
- Total of discount column of the payment side will be credited to 'Discount Received Account'.
- Balance of cash column of the cash book represents cash in hand (Asset).
- Petty cash book is maintained for small day to day expenses.
- Petty cash book is normally maintained according to Imprest System and in columnar form.
- Under imprest system specific amount is advanced by the main cashier to the Petty cashier. Amount of actual expenses is reimbursed by the main cashier to the petty cashier periodically.

(e) Special Purpose Books

Meaning of Special Purpose Books

Special purpose books are those books which are used for quick, efficient and accurate recording of the business transactions such as cash book, purchase book, sales book, sales return book, purchase return book and journal proper.

Business transactions are large in number and difficult to record. A Journal is sub-divided for quick, efficient and accurate recording of the business transactions into a number of subsidiary books or special purpose books like, sales book, purchases book, cashbook, purchase return, sales return, etc. which are maintained for those transactions that are routine and repetitive in nature. Recording through these books is economical and enables division of work among accountants as per the nature of transactions.

A. SUBSIDIARY BOOKS

Subsidiary books are substitute of Journal. In addition to Cash Book following are the common subsidiary books, which are normally maintained by a business enterprise.

	Subsidiary Books	**Nature of Transaction**
1	Sales Book, Sales Journal/Sales Day Book	Credit sale of goods
2	Purchase Book Purchase Journal/Purchase Day Book	Credit purchase of goods
3	Sales Return Book/Return Inward Book	Goods returned by customers

4	Purchase Return Book/Return Outward Book	Goods returned to suppliers
5	Bills Receivable Book	Bills of exchange drawn on debtors
6	Bills Payable Book	Bills accepted by business enterprise

Above are the common transactions in a firm. Most of the transactions will be covered by above subsidiary books and cash book. Those transactions, which are not covered by these books are recorded through Journal Entry, in the 'Journal Proper'. Common transactions recorded through Journal Entry are: Credit purchase/sale of assets, bad debts written off, depreciation, outstanding and prepaid expenses and other adjustment and rectification entries. Opening entry and closing entries are also recorded in the 'Journal Proper'.

B. SALES BOOK

Sales Book records credit sales of goods or merchandise in which firm deals in. Credit sale of non-goods items e.g. credit sale of an asset, scrap etc. will be recorded through journal entry in the Journal Proper. Further, cash sales will be recorded in Cash Book. Sales book is totalled periodically.

Posting From Sales Book
Periodical total of Sales Book is posted to credit side of the Sales Account as "By Sundries as per Sales Book". Personal accounts of customers are debited individually with respective number of sales as "To Sales A/c".

C. PURCHASE BOOK

Purchase Book records credit purchases of goods or merchandise in which firm deals in. Credit purchase of other items such as assets, stationary, books, etc. will be recorded through journal entry in the Journal Proper. Further cash purchases are recorded in Cash Book. Purchase Book is totalled periodically.

Posting from Purchase Book
Periodical total of Purchase Book is posted to debit side of Purchase Account as "To Sundries as per Purchase Book". Personal account of customers are credited individually with respective amount of purchase as "By Purchase A/c".

D. SALES RETURN BOOK OR RETURN INWARD BOOK

Goods returned by the customers are recorded in this book. The format of Sales Returned Book is as under:

Date	*Particulars*	*Credit Note No.*	*L.F.*	*Amount (₹)*

When goods are returned by customers, a credit note is issued showing the details of goods returned. On the basis of copy of credit note, details are recorded in Sales Returned Book. This book is also prepared periodically. In case goods sold on cash basis are returned and money is refunded to the customer, such sales returned will be recorded in Cash Book.

Posting from Sales Return Book: Periodical total of Sales Returned Book is debited in Sales Returned Account as "To Sundries as per Sales Returned Book". Personal account of customers are credited individually as "By Sales Returned Book". At the end of the period balance of Sales Return Account is transferred to Sales Account.

E. PURCHASE RETURN BOOK OR RETURN OUTWARD BOOK

This book records goods returned to suppliers of goods or merchandise. The format of Purchase Return Book is similar to Sales Returned Book. If goods have been purchased in Cash and on return of goods to supplier cash has been received, such purchase returned will be credited in Cash Book.

Posting from Purchase Return Book

Periodically total of the book will be credited in Purchase Return Account as "By Sundries". Personal account of suppliers will be debited individually as "To Purchase Return A/c".

Note: Bill Receivable Book and Bills Payable Book will be discussed in the chapter 'Bills of Exchange'.

F. Journal Proper

Transactions relating to cash, bank, sale of goods, purchase of goods or materials, returns inwards and returns outwards are not entered in the journal because for each class of such transactions a separate book is maintained. But a journal will be still maintained. The purpose of the journal in such a case will be only to record such transactions as do not find a place in the special or subsidiary books maintained. Following are examples of transactions that will be recorded in the journal proper:

(a) Opening entry-the entry to record the opening balances of assets and liabilities.

(b) Credit sales and purchases of:
- fixed assets.

- investments, and
- anything else that is not usually falling in the category of 'Goods'.

(c) Special discounts or allowances given to customers or received from suppliers.
(d) Writing off of bad debts.
(e) Depreciation.
(f) Accrued Income and Expenses due.
(g) Losses such as due to fire, earthquake, etc.
(h) Closing Entries and Transfer Entries.
(i) Rectification Entries and Adjustment Entries.

GLOSSARY (REVISION) OF SPECIAL PURPOSE BOOKS

- In addition to Cash Book other subsidiary books are: Sale Book, Purchase Book, Sales Return Book, Purchase Return Book, Bills Receivable Book and Bills Payable Book.
- Credit sale of goods (Items in which business enterprise is dealing in) is recorded in sales book or sale day book. This is also known as Sales Journal.
- Credit sale of other items (e.g. sale of machinery, furniture) will be recorded in Journal which is known as Journal proper.
- Credit Purchase of goods is recorded in Purchase Book or Purchase Day Book. This is also known as Purchase Journal.
- Sales Return is recorded in Sales Return Book or Return Inward Book.
- Purchase Return is recorded in Purchase Return Book or Return onward Book.
- These subsidiary books are substitute of journal.
- Posting is made from these subsidiary books in the ledger.
- Periodical total of Sales Book, Purchase Book Sales Return Book and Purchase Return Book are posted to their respective accounts (i.e. Sales A/c Purchase A/c, Sales Return A/c and Purchase Return A/c) at the end of the period.
- Personal Accounts are individually posted from these subsidiary books.
- Source document to record sales return is credit note.
- Source document to record purchase return is debit note.
- Source document to record credit sales in sales book is copy of invoice/bill sent to customer.
- Source document to record credit purchase in purchase book is invoice/bill received.
- Transactions which are not covered by these subsidiary books are recorded through Journal Proper.

(f) Understanding accounts process in accounting

The accounting process can be broken down into several steps. The steps may vary depending on the specific company and the type of accounting system used, but the basic steps are as follows:

A. Collecting and recording financial transactions: The first step in the accounting process is to collect and record all financial transactions that occur during a period. These transactions may include sales, purchases, payments, and receipts. They are recorded in the company's accounting system, which may be a manual system or an electronic system like an accounting software.

B. Classifying transactions: After recording the transactions, they are classified into different accounts based on their nature. For example, all sales transactions may be classified under the "Sales" account, while all purchases may be classified under the "Purchases" account. This step helps to organize the financial information and makes it easier to analyze later.

C. Posting transactions to the general ledger: Once transactions are classified, they are posted to the appropriate accounts in the general ledger. The general ledger is a record of all accounts used in the company's accounting system. It provides a complete picture of the company's financial transactions and their impact on different accounts.

D. Preparing a trial balance: A trial balance is a list of all the accounts in the general ledger and their balances. It is used to ensure that the debits and credits in the accounting system are equal, and there are no errors in the recorded transactions. If the debits and credits are not equal, it indicates that there is an error that needs to be corrected.

E. Making adjusting entries: Adjusting entries are made to ensure that the accounts reflect the correct balances at the end of an accounting period. These entries may include accruals for expenses or revenues that have not yet been recorded, depreciation expenses, or adjustments for prepaid expenses.

F. Preparing financial statements: After making the necessary adjustments, financial statements are prepared. These statements include the income statement, balance sheet, and cash flow statement. The income statement shows the company's revenues, expenses, and net income, while the balance sheet shows the company's assets, liabilities, and equity. The cash flow statement shows the inflows and outflows of cash during the period.

G. Closing the books: The final step in the accounting process is to close the books for the period. This involves transferring the balances from the temporary accounts, such as revenue and expense accounts, to the retained earnings account. The retained earnings account is a permanent account that shows the company's accumulated profits and losses over time.

(g) Objectives of accounting

Here are 12 objectives of most accounting processes:

1. **Accurate transaction record:** The first objective of accounting is to maintain an accurate record of all transactions. A transaction includes any exchange of

money for goods or services, whether purchased or sold by the company. This can include materials, building costs and equipment.

2. **Asset and liability tracking:** Assets and liabilities are types of financial items that a company can own. Assets are any item that has value, while liabilities refer to the debt the company has. Another objective of accounting is to maintain a consistent record of the assets and liabilities a company maintains.

3. **Business decision guidance:** Business professionals can use accounting resources to guide their business decisions. Because accounting professionals keep an accurate record of all transactions and the financial status of the company, a leader can use the information to better understand which decisions may result in success. For example, if one department within the company consistently requires more money than it generates, the leader may decide to downsize or eliminate it.

4. **Compliance with legal regulations:** Accounting can be a legal requirement for many companies. Legal compliance is another accounting objective because companies can often supply their accounting records to show compliance with rules and regulations. For example, if a region requires a certain wage for staff or fees for operation, accounting records can show that the company paid them properly.

5. **Control over fraud and risk:** An important objective of accounting is controlling instances of fraud. Fraud can occur when information isn't accurate within the records. Detailed and meticulous accounting can protect the company from financial errors, theft and fraud. Accounting creates a system of accountability that requires all team members and departments to communicate their financial transactions.

6. **Economic data recording:** Accounting creates a detailed history of financial actions within a company from when it starts. This generates a store of data relating to the business's financial history. A company can use accounting information to create a database containing economic and financial data.

7. **Financial budgeting and planning:** Budgeting and financial planning are aspects of accounting that help companies prepare for the future. Creating a budget is an important accounting objective because it allows accounting professionals to prepare a plan for what the company intends to spend in the upcoming month or quarter. Financial planning can help companies keep costs low and profits high.

8. **Information for financing:** Financing is a process that entails a company applying for a loan to fund a business expense. When companies apply for business loans, they often present their financial information to show lenders

they're capable of paying the money back. This makes collecting information for financing applications an important function of accounting.

9. **Management of cash flow:** The term cash flow refers to the number of liquid assets a company maintains. Management of cash flow is an important accounting objective because it helps accountants ensure there's enough cash for company processes. For example, a company ensures it has the proper amount of funds to pay all team members every two weeks.

10. **Measure of performance:** The process of accounting produces financial records that business professionals can use to measure performance. This may include accounting performance, in which professionals assess the level of accuracy and adherence to budgets. It can also include team or departmental performance.

11. **Tax preparation and filing:** Filing and paying taxes are vital actions for a company's financial health. One objective of accounting is tracking all expenses so when it's time to file and pay taxes, the company can be sure it pays the correct amount. Businesses want to avoid overpaying on taxes, and accounting can help them identify opportunities for tax credits and ensure they pay the correct amount.

12. **Understanding of financial health:** The accounting process monitors all aspects of a company's financial profile. This allows business professionals to access accounting information and receive a general overview of the company's financial health. They may review assets and liabilities, cash flow, future financial planning and budgets, tax estimates, how departments perform financially and wages.

PRACTICE MCQs

MCQ_1:

Which of the following is an example of a liability in accounting?

A) Accounts Receivable

B) Inventory

C) Accounts Payable

D) Prepaid Expenses

Answer: C) Accounts Payable

Explanation: Liabilities are obligations that a business owes to others, and accounts payable are one of the most common types of liabilities. Accounts payable represents the money a business owes to suppliers, vendors, or creditors for goods or services received but not yet paid for. Accounts receivable, inventory, and prepaid expenses are assets in accounting.

MCQ 2:

Which of the following financial statements provides a summary of a company's financial position at a specific point in time?

A) Income Statement

B) Balance Sheet

C) Statement of Cash Flows

D) Statement of Retained Earnings

Answer: B) Balance Sheet

Explanation: A balance sheet is a financial statement that provides a summary of a company's financial position at a specific point in time, usually

MCQ 3:

Which of the following accounting principles requires that expenses should be recognized in the period in which they are incurred, regardless of when payment is made?

A) Matching principle

B) Revenue recognition principle

C) Conservatism principle

D) Accrual accounting principle

Answer: D) Accrual accounting principle

Explanation: The accrual accounting principle requires that expenses should be recognized in the period in which they are incurred, regardless of when payment is made. This means that expenses are recorded when they are used, not when they are paid. The matching principle requires that expenses should be matched with the revenues they help generate. The revenue recognition principle requires that revenue should be recognized when it is earned, not when it is received. The conservatism principle requires that when there are uncertainties in accounting, companies should choose the option that is least likely to overstate assets or income.

MCQ 4:

Which of the following accounting concepts assumes that the business will continue to operate for the foreseeable future?

A) Cost concept

B) Matching concept

C) Going concern concept

D) Consistency concept

Answer: C) Going concern concept

Explanation: The going concern concept is a fundamental accounting concept that assumes that the business will continue to operate for the foreseeable future. This means that the financial statements are prepared on the assumption that the business will continue to operate and generate revenue. The cost concept states that assets are recorded at their original cost, the matching concept states that expenses should be matched with the revenue they generate, and the consistency concept states that accounting methods should be consistent over time.

MCQ 5:

Which financial statement shows the financial position of a business at a specific point in time?

A) Income statement

B) Statement of changes in equity

C) Cash flow statement

D) Balance sheet

Answer: D) Balance Sheet

Explanation: The balance sheet is the financial statement that shows the financial position of a business at a specific point in time. It provides information on the assets, liabilities, and equity of the business, and is also referred to as a statement of financial position. The income statement shows the revenue, expenses, and net income of a business over a period of time, the statement of changes in equity shows the changes in the equity of a business over a period of time, and the cash flow statement shows the inflows and outflows of cash over a period of time.

Chapter 2 - TRIAL BALANCE

1. MEANING OF A TRIAL BALANCE

In the earlier chapters we have learnt how business transactions are recorded in the journal and Subsidiary Books. Then these entries are posted to various accounts in the ledger. The books of account are written on the basis of Double Entry System of Book-Keeping. It means every debit has a corresponding credit. Thus, when from ledger accounts a summary of these debits and credits is prepared, it must tally. Such a list of balances is known as Trial Balance.

The Directory for Accountants written by Eric L. Kohler defines Trial Balance as a list or abstract of balances or of total debits and total credits of the accounts in a ledger, the purpose being to determine the equality of posted debits and credits and to establish a basic summary for financial statements.

2. FEATURES AND PURPOSES OF A TRIAL BALANCE

1. It is a list of debit and credit balances drawn from ledger.
2. It includes cash and bank balances.
3. Its main purpose is to establish arithmetical accuracy of transactions recorded in the books of account.
4. It is usually prepared at the end of the year but it can also be prepared any time as and when required, e.g. monthly, quarterly or half yearly.
5. It enables the trader to know amounts receivable from customers and amounts payable to suppliers.
6. It facilitates preparation of final accounts.

Balances of Ledger Accounts

1. Normally asset accounts like Building, Cash, Debtors, etc. show debit balance and liabilities like Loan, Bank overdraft, Creditors, etc. have credit balance.
2. Capital Account has credit balance and Drawing Account has debit balance.
3. Accounts of expenses and losses (like rent, salary, depreciation, bad debts, etc.) have debit balance.
4. Accounts of income and gains have credit balance.

3. TYPES OF TRIAL BALANCE AND PREPARATION OF TRIAL BALANCE

There are two types of trial balance:

A. Gross Trial Balance
B. Net Trial Balance

A. Gross Trial Balance:

It is prepared in the following stages:

- Take totals of debit and credit columns of each ledger account.
- Take totals of receipts and payments of Cash Book showing separately cash, bank and discount columns.
- Write names of all accounts as per the ledger and cash, bank, and discount accounts as per cash book into a statement.
- Enter the debit and credit totals against each item.
- Finally take total of debit and credit columns. All these steps should be taken as on a particulars date.

B. Net Trial Balance:

When balance of each account is taken and these balances are arranged in a table (showing two column of amount for debit and credit balances) it is called Net Trial Balance. Following is a specimen of trial balance.

	Gross T/B		**Net T/B**	
	Debit Total	**Credit Total**	**Debit Balance**	**Credit Balance**
Cash Account	✓	✓	✓	-
Bank Account	✓	✓	✓	-
Capital Account	✓	✓	-	✓
Debtors Accounts	✓	✓	✓	-
Creditors Accounts	✓	✓	-	✓
Drawings Account	✓	-	✓	-
Furniture Account	✓	✓	✓	-
Purchases Account	✓	-	✓	-
Sales Account	-	✓	-	✓
Expenses Accounts	✓	-	✓	-
Income Accounts	-	✓	-	✓
Total				

4. DISTINCTION BETWEEN TRIAL BALANCE AND BALANCE SHEET BASIS TRIAL BALANCE

Basis	**Trial Balance**	**Balance Sheet**
Timing of preparation	This is prepared before Balance Sheet.	This is prepared after preparing Trial Balance.
Names of account	Balances of all the accounts are shown in Trial Balance.	Balances of only assets and liabilities are shown in Balance Sheet.
Purpose	Trial Balance shows arithmetical accuracy of the accounts books.	Balance Sheet shows financial position of the business.

Effect of errors	Difference in trial balance indicates existence of errors.	Balance Sheet is prepared after correction of errors.
Two sides	Trial Balance has debit and credit sides in the statement.	Balance Sheet has assets and liabilities side in the statement.

5. DISAGREEMENT OF TRIAL BALANCE

We have learnt in the earlier paragraphs that a trial balance is prepared to verify arithmetical accuracy of the transactions recorded in the books. Under the double entry system of book keeping, if all the transactions are correctly recorded through various books of prime entry, correctly posted therefrom to the ledger and if totalling is correct, then only the trial balance should tally. However, it is possible that a few mistakes may be committed by the persons entrusted with the work of journalising and posting. In that event, the trial balance will not tally. At the same time, there are certain errors which are not disclosed even though the trial balance agrees.

6. CLASSIFICATION OF ERRORS

Errors can be broadly divided into two types:

(a) Clerical Errors
(b) Errors of Principle

(a) Clerical Errors:

Clerical errors can be further divided into:

(a) Errors of omission,
(b) Errors of commission, and
(c) Compensating Errors.

(a) Errors of Omission:

When a transaction is completely or partially omitted to be recorded in books of account, it is called an 'Error of omission'. Goods are purchased on credit from Mr. A. This transaction is not recorded in the Purchased Journal. This is called error of 'Complete omission'. If the above entry is recorded in Purchases Journal but remains to be posted to the supplier, Mr A's account, then it will be called 'Partial omission'. The error of complete omission does not affect the trial balance, but the partial omission will result in disagreement of trial balance.

(b) Errors of Commission:

When an error is committed in recording a transaction with wrong amount or posting to wrong side of the account, it is called an 'Error of Commission'.

Following are some of the examples:

- Posting of correct amount but on the wrong side
- Posting of a wrong amount but on the correct side
- Posting of a wrong amount on wrong side of an account
- Totalling error in subsidiary book i.e. Purchase Journal, Sales Journal, Returns Journal or totalling error in any ledger account
- A mistake committed in balancing of ledger account
  E.g.: A credit sale of goods to Mr A for Rs. 920 recorded correctly in the Sales Journal but while posting to A's account, it is posted as Rs. 290
  An amount received from a customer Rs. 2,000 recorded correctly in the Cash Book but posted to the debit side of Customer Account in the ledger. These errors will result in disagreement of trial balance.

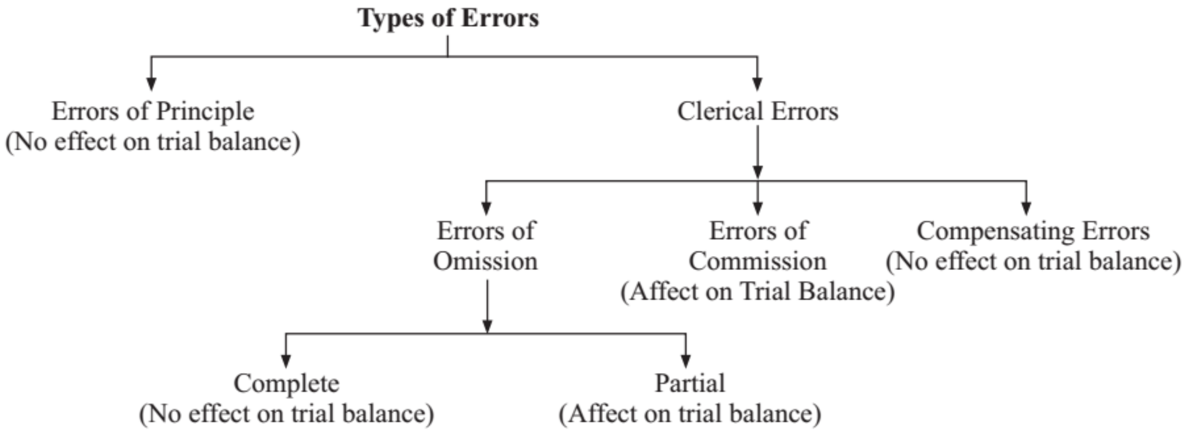
(c) Compensating Errors:

When one mistake nullifies the wrong effect of another, it is called a compensating error. These errors are two or more in number and balance each other. These are generally arithmetical errors. Let us suppose that total of Rent Account is undercast by Rs. 2,000 and the total of Printing and Stationery Account is overcast by Rs. 2,000; both the errors will compensate each other and there will be no effect on the agreement of the Trial Balance.

(b) Errors of Principle:

These are errors arising from not observing the accounting principles correctly, e.g. wages paid for installation of machinery debited to wages account, purchase of fixed asset on credit recorded in purchase journal when revenue item is treated as capital and vice-versa or when personal account is treated as nominal account and vice-versa. These errors will not affect agreement of trial balance.

Following chart will show the various types of error:



Distinction between Errors of Principle and Errors of Omission

Basis	Error of Principle	Error of Omission
Effect on Trial Balance	This error does not affect Trial Balance.	This error may affect Trial Balance.

Causes of Error	This error is due to wrong classification of Capital and Revenue expenditure or personal and nominal account.	This error is due to complete omission of transaction or partial omission.
Nature of Error	This is not a clerical error.	This is a clerical error.
Effect on Profit	This error affects profit of the business.	This error may or may not affect profit of the business.
Effect on Balance Sheet	This error will affect value of asset or liability	This error may or may not affect value of asset or liability.

7. LOCATION OF ERRORS

We have learnt different types of errors which are usually committed in the process of accounting. If the trial balance shows some difference, then we must first ascertain the exact amount of difference and try to locate it. Following steps can be taken to locate the difference:

1. Check the totals of debit and credit sides of trial balance.
2. Verify whether cash and bank balances are correctly shown in the trial balance.
3. When exact amount of difference is ascertained, say Debit side is excess by Rs. 1,600.
   (a) Check whether debit of Rs.1,600 appears twice in the trial balance.
   (b) Take half the amount of difference–Rs. 800 in our case-find out if there is any item appearing in the trial balance on debit side-and if this item is wrongly shown on debit instead of credit side then after correcting the item trial balance will tally.
   (c) See whether there is any credit item of Rs. 1,600 omitted from trial balance.

8. RECTIFICATION OF ERRORS

One-side Errors Located Before Trial Balance:

One-sided errors, when located before preparing a trial balance, can be rectified by simply correcting the posting. No entry is required to be passed as it affects only one account.

Two-sided Errors:

In case of two-sided errors two or more accounts are affected and in most of the cases the debit and credit are equally affected. While rectifying these errors first pass the correct entry, then show wrong entry which is already passed in the books and by comparing wrong entry with the correct one, rectification entry can by passed.

9. SUSPENSE ACCOUNT AND RECTIFICATION

After preparation of a trial balance, if there is a difference, it may be temporarily transferred to a new account called 'Suspense Account'. During the course of checking or audit, some one-sided errors may be found out. Now to rectify these one-sided errors, second account can be Suspense Account, as the difference is transferred to Suspense Account.

If the trial balance debit total is more, then the difference will be put to Suspense Account on credit side. On the other hand, if credit total is more, difference will go to Suspense Account on debit side. At the time of preparation of final accounts if any balance remains in 'Suspense A/c' then it will be shown in the Balance Sheet of the Asset side (if balance is debit) or on the Liability side (if balance is credit).

10. RECTIFICATION OF ERRORS WHEN BOOKS HAVE BEEN CLOSED (RECTIFICATION IN THE NEXT YEAR)

When the errors detected before preparation of final accounts, necessary rectification entries are passed in the books and the accounts rectified will then show correct balances. With these corrected balances, final accounts will be prepared and correct profit or loss can be arrived at. When difference in trial balance remains even after applying various checks, it is carried forward to the Balance Sheet on the appropriate side, in the suspense account (or even transferring to capital account) as preparation of final accounts cannot be delayed indefinitely. Personal accounts balances, i.e. those of customers and suppliers are carried forward to the next year. But nominal accounts (expenses and incomes accounts) are always closed by transferring these to Trading and Profit and Loss Account. Any difference located in nominal accounts, in the next year cannot be adjusted to the nominal accounts, as this will affect current year's profit or loss. Therefore, a new account 'Profit and Loss Adjustment Account' will be opened to rectify the errors in nominal account. The balance of this account is then directly transferred to capital account.

Example:

The following errors were committed by the accountant of a firm.

1. Cash Rs. 350 received from T.C. posted as Rs. 530 to their account.
2. Rs. 260 paid for purchase of new office furniture charged to office expenses (ignore depreciation).
3. Purchase of stationery worth Rs. 150 remained unposted from the Cash Book.
4. Credit sale of Rs. 400 to TR was posted to the credit of their account.
5. Purchase of Rs. 420 from MC passed through Sales Day Book as Rs. 240.

How would you rectify the errors assuming that:

(a) they were detected before preparation of Trial Balance.
(b) they were detected after preparation of Trail Balance but before preparing Final Accounts, the difference was taken to Suspense account.
(c) they were detected after preparing final accounts.
(Narration to journal entries not required)

Solution:

We have already learnt that: (1) for one-sided errors, no entries will be passed when these are detected before preparing trial balance. Mistake is directly corrected in the account (2) after preparation of trial balance entries will be passed taking Suspense Account as the other account and (3) no nominal accounts will be shown when entries are rectified after preparation of final accounts. For nominal account, P & L Adj. A/c is debited or credited.

1. This is a one sided error. TC account is credited in excess.

Before Trial Balance	**After Trial Balance**	**After Final Account**
No Entry Debit TC with Rs. 180	TC Dr. 180 To Suspense A/c. 180	TC Dr. 180 To Suspense A/c. 180

2. In this case entry affects two accounts viz. office furniture and office expenses.

Before Trial Balance	**After Trial Balance**	**After Final Account**
Office Furniture A/c Dr. 260 To Office Expense A/c 260	Office Furniture A/c Dr. 260 To Office Expense A/c 260	Office Furniture A/c Dr. 260 To Profit & Loss Adjustment A/c. 260

3. This is a one-sided error. Stationery account is not posted.

Before Trial Balance	**After Trial Balance**	**After Final Account**
No Entry Debit Stationary A/c Rs. 150	Stationary A/c 150 To Suspense A/c. 150	P & L Adj A/c Dr. 150 To Suspense A/c. 150

4. This is one-sided error. Account is credited instead of debit.
Amount posted to the wrong side and therefore while rectifying the account, double the amount (i.e. Rs. 800) will have to be taken.

Before Trial Balance	**After Trial Balance**	**After Final Account**
No Entry Debit TR with Rs. 800	TR Dr. 800 To Suspense A/c. 800	TR Dr. 800 To Suspense A/c. 800

5. Purchase of Rs. 420 is wrongly recorded through sales day book as Rs. 240.

Before Trial Balance	**After Trial Balance**	**After Final Account**
Correct entry Purchase A/c Dr. 420 To MC 420 Sales A/c Dr. 240 Purchase Alc Dr. 420	*Wrong entry* MC Dr. 240 To Sales A/c 240 Sales A/c. Dr. 240 Purchases A/c Dr.420	Profit & Loss Adj. A/c Dr. 660 To MC 660

To MC	660	To MC	660	

Note: At the end balance of P & L Adj. a/c is transferred to Capital Account, where rectification entries are passed after final account i.e. in the next year.

11. Computerized accounting system

A computerized accounting system is a software application designed to manage and process accounting transactions in a digital format. This system automates accounting tasks, such as recording financial transactions, generating financial reports, and maintaining financial records.

A computerized accounting system typically includes the following modules:

1. General Ledger: This module is the central repository for all financial transactions, including accounts payable, accounts receivable, payroll, and other financial transactions.
2. Accounts Payable: This module is used to manage vendor payments, including recording and tracking invoices, creating checks, and reconciling bank statements.
3. Accounts Receivable: This module is used to manage customer payments, including recording and tracking invoices, creating receipts, and reconciling bank statements.
4. Inventory: This module is used to manage inventory levels, including recording stock movements, managing stock levels, and generating reports on inventory levels.
5. Payroll: This module is used to manage employee pay, including recording employee hours, calculating taxes and deductions, and generating pay checks.
6. Financial Reporting: This module is used to generate financial statements and reports, including balance sheets, income statements, and cash flow statements.

By using a computerized accounting system, businesses can streamline their financial processes, reduce errors, and improve their financial reporting capabilities. Additionally, these systems can provide real-time insights into a business's financial performance, enabling better decision-making.

GLOSSARY(REVISION) OF TRIAL BALANCE

- Trial Balance is prepared after preparing ledger accounts and balancing of accounts.
- Trial Balance checks arithmetical accuracy of the accounts.
- Agreed Trial Balance is not the conclusive proof of the accuracy of accounts.
- If Trial Balance has agreed, it does not mean that there is no misappropriation of fraud.
- Closing stock normally appears outside the Trial Balance.
- If closing stock has been adjusted against purchases, closing stock will appear in Trial Balance.

- Any difference in Trial Balance is shown as Suspense Account and shown in Balance Sheet.
- Excess credit or short debt in trial balance will result in debit balance of suspense account.
- Excess debit or short credit in Trial Balance will result in credit balance of suspense account.
- After rectification of all errors suspense account will show nil balance.
- If there is some balance in suspense account, even after correcting entries, it will indicate that there are still some errors.
- If balance of suspense account has become nil it is not a conclusive proof that there are no errors.
- Error may be classified as: (i) Errors of Principle (ii) Clerical Errors: (a) Errors of omission (b) Errors of Commission (c) Compensating errors
- Errors of Principle: (a) Revenue item treated as capital and vice versa. (b) Personal account treated as nominal and vice versa.

MCQs

MCQ 1: What is a trial balance?
A. A list of all accounts with their balances at the end of the accounting period.
B. A list of all transactions during the accounting period.
C. A summary of all financial statements.
D. None of the above.

Answer: A
Explanation: A trial balance is a list of all accounts with their balances at the end of the accounting period. It is prepared to ensure that the total debit balances are equal to the total credit balances in the ledger accounts.

MCQ 2: What is the purpose of a trial balance?
A. To identify errors in the accounting records.
B. To summarize the financial statements.
C. To provide a list of all transactions during the accounting period.
D. None of the above.

Answer: A
Explanation: The purpose of a trial balance is to identify errors in the accounting records. It is a tool that helps ensure the accuracy of the ledger accounts and provides an opportunity to correct any errors before the financial statements are prepared.

MCQ 3: Which of the following errors will not be detected by a trial balance?

A. A transaction was recorded twice.

B. A transaction was omitted from the accounting records.
C. An incorrect amount was posted to an account.
D. None of the above.

Answer: B
Explanation: A trial balance will not detect an omitted transaction. This is because an omitted transaction will not be recorded in the accounting records and will not affect the account balances.

MCQ 4: What is the difference between a balanced and an unbalanced trial balance?

A. A balanced trial balance means that the total debit balances are equal to the total credit balances, while an unbalanced trial balance means that they are not equal.
B. A balanced trial balance means that all accounts have zero balances, while an unbalanced trial balance means that they have non-zero balances.
C. A balanced trial balance means that all transactions have been recorded, while an unbalanced trial balance means that some transactions have been omitted.
D. None of the above.

Answer: A
Explanation: A balanced trial balance means that the total debit balances are equal to the total credit balances, while an unbalanced trial balance means that they are not equal. An unbalanced trial balance may indicate errors in the accounting records.

MCQ 5: When should a trial balance be prepared?
A. At the beginning of the accounting period.
B. At the end of the accounting period.
C. Both at the beginning and end of the accounting period.
D. None of the above.

Answer: B
Explanation: A trial balance should be prepared at the end of the accounting period, after all transactions have been recorded in the accounting records. It is a tool that helps ensure the accuracy of the ledger accounts and provides an opportunity to correct any errors before the financial statements are prepared.

CHAPTER 3 - FINANCIAL STATEMENTS

1. AN INTRODUCTION

When a student has studied for a year, he/she wants to know how much he/she has learnt during that period. Similarly, every business enterprise wants to know the result of activities of a particular period which is generally one year and what is its financial position on a particular date which is at the end of this period. For this, it prepares various statements which are called the financial statements.

2. OBJECTIVES OF FINANCIAL STATEMENTS

Financial statements are prepared to ascertain the profits earned or losses incurred by a business concern during a specified period and also to ascertain its financial position at the end of that specified period. Financial statements are generally of two types (a) Income statement which comprises of Trading Account and Profit & Loss Account, and (b) Position Statement i.e., the Balance Sheet.

Following are the objectives of preparing financial statements

A. Ascertaining the results of business operations
Every businessman wants to know the results of the business operations of his enterprise during a particular period in terms of profits earned or losses incurred. Income statement serves this purpose.

B. Ascertaining the financial position
Financial statements show the financial position of the business concern on a particular date which is generally the last date of the accounting period. Position statement i.e. Balance Sheet is prepared for this purpose.

C. Source of information
Financial statements constitute an important source of information regarding finance of a business unit which helps the finance manager to plan the financial activities of the business and making proper utilisation of the funds.

D. Helps in managerial decision making
The Manager can make comparative study of the profitability of the concern by comparing the results of the current year with the results of the previous years and make his/her managerial decisions accordingly.

E. An index of solvency of the concern
Financial statements also show the short term as well as long term solvency of the concern. This helps the business enterprise in borrowing money from bank and other financial institutions and/or buying goods on credit.

3. CAPITAL EXPENDITURE AND REVENUE EXPENDITURE, CAPITAL RECEIPTS AND REVENUE RECEIPT

The preparation of Trading Account and Profit and Loss Account requires the knowledge of revenue expenditure, revenue receipts and capital expenditure and capital receipts. The knowledge shall facilitate the classification of revenue items and put them in the Trading account and Profit and Loss Account on one hand and prepare Balance Sheet based on capital items (expenditure as well as receipts) on the other hand.

Capital Expenditure refers to the expenditure incurred for acquiring fixed assets or assets which increase the earning capacity of the business. The benefits of capital expenditure to the firm extend to number of years. Examples of capital expenditure are expenditure incurred for acquiring a fixed asset such as building, plant and machinery etc.

Revenue expenditure, on the other hand, is an expenditure incurred in the course of normal business transactions of a concern and its benefits are availed of during the same accounting year. Salaries, carriage etc. are examples of revenue expenditure.

There is another category of expenditure called deferred revenue expenditure. These are the expenses incurred during one accounting year but are applicable wholly or in part in future periods. These expenditures are otherwise of a revenue nature. Example of deferred revenue expenditure are heavy expenditure on advertisement say for introducing a new product in the market, expenditure incurred on research and development, etc.

4. CAPITAL AND REVENUE RECEIPTS

Capital receipts are receipts which do not arise out of normal course of business. Examples of such receipts are sale of fixed assets, and raising of loans etc. Such receipts are not treated as income of the enterprise.

Revenue receipts are receipts which arise during the normal course of business, Sale of goods, rent from tenants, dividend received, etc. are some of the examples of revenue receipts. They are the items of incomes of the business entity.

Basis of Difference	**Capital Expenditure**	**Revenue Expenditure**
Purpose	It is incurred for acquiring of fixed assets	It is incurred for the maintenance of fixed assets.
Earning capacity	It increases the earning capacity of the business.	It helps in maintaining the earning capacity of the business intact.
Periodicity of benefit	Its benefits are spread over a number of years.	Its benefits accrue only in one accounting year.

Placement in financial statements	It is an item of Balance Sheet and is shown as an item of asset.	It is an item of Trading and Profit and Loss Account and is shown on the debit side of either of the two.
Occurrence of expenditure	It is non-recurring in nature.	It is usually a recurring expenditure.
Source	Receipts that do not arise during the normal course of business.	Receipts that arise during the normal course of business.
Nature	These are of capital nature and hence are not treated as items of income of the business.	These are of revenue nature and hence are treated as items of income of the business.
Occurrence	These are of non-recurring in nature.	These are recurring in nature.

5. TRADING ACCOUNT

Income statement consists of Trading and Profit and Loss Account. Let us first study the Trading Account. A business firm either purchases goods from others and sells them or manufactures and sells them to earn profit. This is known as trading activities. A statement is prepared to know the results in terms of profit or loss of these activities. This statement is called Trading Account.

Trading Account is prepared to ascertain the results of the trading activities of the business enterprise. It shows whether the selling of goods purchased or manufactured has earned profit or incurred loss for the business unit. Cost of goods sold is subtracted from the net sales of the business of that accounting year. In case the total sales value exceeds the cost of goods sold, the difference is called Gross Profit. On the other hand, if the cost of goods sold exceeds the total net sales, the difference is Gross Loss.

All accounts related to cost of goods sold such as opening stock, net purchases i.e. purchase less returns outward, direct expenses such as wages, carriage inward etc. and closing stock with net sales (i.e. Sales minus Sales returns) are taken to the Trading Account. Then this account is balanced. Credit balance shows the gross Profit and debit balance shows the gross loss. It is necessary to understand the meaning of cost of goods sold before preparing Trading Account.

- **Cost of goods sold and gross profit**

A business enterprise either purchases goods or manufactures goods to selling the market. Cost of goods sold is computed to know the profit earned (Gross Profit) or loss incurred (Gross Loss) from the trading activities of a business unit for a particular period.

Cost of goods sold = the amount of goods purchased + expenses incurred in bringing the goods to the place of sale or expenses incurred on manufacturing the goods (called direct expenses).

In case there is a stock of goods to be sold in the beginning of the year or at the end of the year, the cost of goods is calculated as follows:

Cost of goods sold = Opening stock + Net purchases + All direct
expenses - Closing stock
Gross Profit = Net sales - Cost of goods sold

- **Need of Trading Account**

Trading Account serves the following purposes:

1. **Knowledge of Gross Profit**
   Trading Account gives information about Gross Profit. It is the profit earned by a business enterprise from its trading activities. The percentage of gross profit on sales reflects the degree of success of business.

2. **Knowledge of All Direct expenses**
   All direct expenses are taken to trading Account. Direct expenses are the expenses that can be directly attributed to purchase or manufacturing of goods for sale. Percentage of Direct expenses on sales of current year when compared with the same of previous years, helps the manager to exercise control over direct expenses.

3. **Precaution against future losses**
   Trading Account, if shows gross loss, reasons for this loss can be found out and necessary corrective steps can be taken

6. FORMAT OF TRADING ACCOUNT

Trading Account

Particulars	Amt	Particulars	Amt
To Opening Stock	**XX**	By sales	**XX**
To Purchases	**XX**	By Less: Sales Returns	**XX**
To Less: Purchase Rectums	**XX**	By Closing stock	**XX**
To Direct Expenses:	**XX**	By Gross loss transferred to	
To Carriage Inward	**XX**	Profit & Loss Account	
To Freight	**XX**		**XX**
To Wages	**XX**		
To Fuel & Power	**XX**		

To Excise Duty To Factory Rent To Heating & Lighting To Factory Rent & Insurance To Work Managers Salary To Gross Profit transferred To Profit & Loss Account	**XX** **XX** **XX** **XX** **XX** **XX** **XX**		

- **Important items of Trading account**

Important items of Trading account are:

a. Stock

Stock refers to the goods lying unsold on a particular date. It can be of two types:

(a) Opening stock and
(b) Closing stock

(a) *Opening stock* - Opening stock refers to the value of goods lying unsold at the beginning of the accounting year. It is shown on the debit side of the Trading Account. In the first year of business there is no opening stock.

(b) *Closing Stock* - It is the value of goods lying unsold at the end of the accounting year. It is valued at the cost price or market price whichever is less. It is shown on the credit side of the Trading Account.

b. Purchases

Purchases mean total items purchased for resale during the year. It can be both in cash and on credit. Purchases are shown on the debit side of the Trading account. These are always shown as net purchases i.e. amount of purchases returned (Purchase returns or return outwards) is deducted from the total amount of purchases made. Goods received on consignment basis are never treated as purchases. Similarly, goods received on 'sale or return' basis are never treated as purchases.

c. Sales

Sales refer to the total revenue from sale of goods of the business enterprise for which the Trading account is being prepared. It includes both cash sales and credit sales. These are recorded on the credit side of the Trading Account. Sales are shown at their net value i.e. sales return or returns inward is deducted from the total sales. Cash sales plus credit sales minus sales returns constitute net sales. Goods sent on 'sale or approval' are not part of sales until approval is received.

d. Direct Expenses

Direct expenses are the expenses that can be attributed directly to the purchase of goods or goods manufactured. These are shown on the debit side of the Trading Account. These are shown at the amount as shown in the Trial balance. For example, wages are recorded on the debit side of Trading Account at the amount shown in the Trial balance.

Important items of direct expenses

- **A.** Wages i.e. wages relate to production. If amount under this head includes wages paid for construction of building or manufacturing of furniture for office it will be subtracted from the amount of wages.
- **B.** Carriage Cartage Freight i.e. amount paid for carriage of goods purchased for sale or raw material purchased for manufacturing.
- **C.** Other such direct expenses are customs and import duty, packing materials, gas, electricity water, fuel, oil, gas grease, heating and lighting, factory rent and insurance and many more such items.

e. Gross Profit/Gross Loss

It is the excess of net sales revenue over cost of goods sold. Gross Profit is equal to net sales minus cost of goods sold. If total of the credit side exceeds the total of debit side, the excess amount is termed as 'gross profit' and is show on the debit side of Trading Account. On the other hand if debit side is more than the credit side, the difference in amount is called gross loss and is shown on the credit side of the Trading Account.

Gross profit = Net sales - Cost of goods sold
Gross loss = Cost of goods sold - Net sales

7. PROFIT & LOSS ACCOUNT

As stated earlier, income statement consists of two accounts :Trading Account and Profit & Loss Account. You have seen that Trading account is prepared to ascertain the Gross profit or Gross loss of the trading activities of the business. But these are not the final results of business operations of an enterprise. Apart from direct expenses, there are indirect expenses also. These may be conveniently divided into office and administrative expenses, selling and distribution expenses, financial expenses, depreciation and maintenance charges etc.

Similarly, there can be income from sources other than sales revenue. These may be interest on investments, discount received from creditors, commission received, etc. Another account is prepared in which all indirect expense sand revenues from sources other than sales are written. This account when balanced shows profit (or loss). This account is termed as Profit and Loss Account. The profit shown by this account is called 'net profit' and if it shows loss it is known as 'net loss'.

Profit & Loss Account

Particulars	Amt	Particulars	Amt
To Gross loss b/d	**XX**	By Gross Profit b/d	**XX**
To Salaries	**XX**	By Discount Received	**XX**
To Rent, Rates & taxes	**XX**	By Commission Received	**XX**
To Insurance Premium	**XX**	By Dividend Received	**XX**
To Advertising	**XX**	By Interest on Investment	**XX**
To Commission paid	**XX**	By Rent Received	**XX**
To Discount Allowed	**XX**	By Net Loss transferred to capital account	**XX**
To Repairs & Renewals	**XX**		
To Bad Debts	**XX**		
To Establishment charges	**XX**		
To Travelling Expenses	**XX**		
To Bank Charges	**XX**		
To Sales Tax/Value added Tax	**XX**		
To Depreciation on fixed assets	**XX**		
To Net Profit transferred to	**XX**		
To Capital Account	**XX**		

8. SOME IMPORTANT ITEMS OF PROFIT AND LOSS ACCOUNT

As stated earlier Indirect expense are written on the debit side of Profit and Loss A/c. These can be classified under the following heads:

Debit items

- **Selling and distribution expenses** - To materialise sales, the expenses incurred are called selling and distribution expenses. Examples are: Carriage on sales/carriage outwards, advertisement, selling expenses, travelling expenses and salesman commission, depreciation of delivery van, salary of driver of the delivery van, etc.
- **Office and administration expenses** - These are the expenses incurred on establishment and maintenance of office. Some of the expenses that may be under this head are: rent, rates and taxes, postage, printing and stationery, insurance, legal charges, audit fees, office salaries, etc.
- **Financial expenses -** Finances are to be arranged for business. Expenses that are incurred in this connection are called financial expenses. Some of the financial expenses are: interest on loan, interest on capital, discount on bills, etc.
- **Depreciation and maintenance charges** - The total value of a fixed asset like machinery, building, furniture, etc.is not charged to profit and loss account in the year in which it is purchased. Such assets help running business for a number of years to come. Therefore, only a part of the value of such assets is treated as an

expense and is charged to Profit and Loss A/c as depreciation. Depreciation means decline in the value of fixed asset due to wear and tear, lapse of time, obsolescence, etc. Expense incurred on repairs and renewals and maintenance of assets are expenses other than depreciation under this category.

- **Other expenses** - These are the expenses which are not included under the abovementioned heads of expenses for example, losses and expenses due to fire, theft etc.

<u>Credit items</u>

On the credit side of Profit and Loss Account, items of revenue and incomes are written. The first item on this side of Profit and Loss Account is the gross profit transferred from trading account. Other items of the credit side are :(i) Interest on investment, fixed deposits etc. Rent Received, Commission Received, Discount Received, Dividend on shares.

Need of preparing Profit and Loss Account

Need of preparing profit and loss account by a business concern may be stated as follows:

(i) Knowledge of the net profit or net loss of a business for an accounting year.

(ii) Net profit of one year can be compared with net profits of previous year or years. It helps in ascertaining whether the business is being conducted efficiently or not.

(iii) Different expenses which are taken to Profit & Loss A/c in one year can be compared with the amounts incurred in previous year or years. This helps in ascertaining the need of applying control over such expenses

9. TRANSFER ENTRIES OF PROFIT AND LOSS ACCOUNT

Before preparing Profit and Loss Account as per the format given in the previous section, closing entries are made in the journal proper of the enterprise. Following journal entries are made:

(i) *<u>For transferring the indirect expense accounts:</u>*

Profit & Loss A/c Dr.

To Salaries A/c

To Insurance Premium A/c

To Bad Debts A/c

To Discount Allowed A/c

(Transfer of indirect expenses)

(ii) *For transfer of items of incomes and gain:*
Interest on investment A/c Dr.
Rent Received A/c Dr.
Discount Received A/c Dr.
To Profit & Loss A/c
(Transfer of items of income)

(iii) *For transferring Net Profit:*
Profit & Loss A/c Dr.
To Capital A/c
(Transfer of Net Profit to Capital A/c)

(iv) *For transferring Net Loss:*
Capital A/c Dr.
To Profit & Loss A/c
(Transfer of Net Loss to Capital Account)

10. POSITION STATEMENT/BALANCE SHEET

Position Statement or Balance Sheet is another basis of financial statement. Balance Sheet is a statement prepared on a particular date, generally at the end of accounting year to ascertain the financial position of the entity. It consists of assets on the one hand and liabilities on the other.
In the words of Francis R Steal, “Balance Sheet is a screen picture of the financial position of a going business at a certain moment.” In the words of Freeman, “A Balance Sheet is an item wise list of assets, liabilities and proprietorship of a business at a certain date.”
Financial position of a business is the list of assets owned by the business and the claims of various parties against these assets. The statement prepared to show the financial position is termed as Balance Sheet. In the next lesson we shall discuss Balance Sheet in detail.

Glossary (Points to Remember)

- Financial statements are of two types:
  - (a) Income Statement i.e. Trading Account and Profit and Loss Account.
  - (b) Position Statement i.e. Balance Sheet. Trading Account is prepared to ascertain the results of the trading activities of the business.

- Trading Account may show profit (i.e. the excess of sales to cost of goods sold or excess of credit side over debit side), which is termed as Gross Profit.
  Trading Account may show loss (i.e. Cost of goods sold exceeds sales or total of debit side exceeds total of credit side). This is called Gross Loss.
- Profit and Loss Account is prepared to find out Net Profit/Net Loss.Net Profit = Gross Profit + other incomes – Indirect expenses.
  It may also show a net loss.
  All indirect expenses are shown on the debit side of Profit & Loss Account.
  All incomes and gains are shown on the credit side of Profit & Loss Account.
- Balance Sheet is prepared to ascertain the financial position of a firm on a particular date.

I. FINANCIAL STATEMENT – I

1. PREPARATION OF TRADING ACCOUNT AND PROFIT AND LOSS ACCOUNT

You have already learnt the meaning and format of Trading Account and Profit and Loss Account. You have also learnt how to make journal entries to transfer relevant ledger balances to Trading Account and Profit and Loss Account. Now you will learn the various steps to be followed in preparing these statements.

Steps to be followed while preparing Trading Account

A. Debit side

(i) We write the amount of opening stock (In case of a new firm there will not be any opening stock).

(ii) We write the amount of purchases Out of this purchases returns or returns outward is deducted. Purchases may be cash or credit or both.

(iii) Then we write the direct expenses such as carriage inward, wages, power, etc.

B. Credit side

(i) We write sales. Sales return or returns inward is deducted from the sales to get the net sales figure. Sales may be cash or credit or both.
Closing stock is the next item.

C. Ascertaining Gross Profit/Gross Loss

Finally Trading Account is closed by calculating the difference of the two sides. If credit side exceeds the debit side, the difference is written as Gross Profit on the debit side of the Trading A/c. In case debit side is more than the credit side, the difference amount is termed as 'Gross Loss' and is written on the credit side of the Trading A/c.

Total of Debit column > Total of credit column
Gross profit
Total of credit column > Total of debit column
Gross loss

Steps to be followed while preparing Profit and Loss Account

A. Debit side

(i) Gross Loss, if any, transferred from Trading A/c is written as the first item.

(ii) Next all items of revenue expenses and losses are written. These items may be salaries, rent paid, depreciation, etc.

B. Credit side

- Gross Profit transferred from Trading A/c is the first item.
- Next all items of revenue incomes and gains are written. These may be interest on investments, discount received, commission received, etc.

C. Ascertaining Net Profit/Net Loss

The next step is to get the balance. If credit side is more than the debit side the difference in amount is written as Net Profit. If debit side exceeds the credit side, the difference is Net Loss. This amount is transferred to Capital Account.

Total of Debit side >Total of credit side
⇒Net profit Total of credit side >Total of debit side
⇒Net loss

2. BALANCE SHEET

Apart from Trading Account and Profit and Loss Account, Balance Sheet is another financial statement that is prepared by every business firm. Balance sheet is a statement which shows the financial position of a business organisation on a particular date which is generally the last date of the accounting period. Financial position of a business unit is the amount of claims against the resources of business. These resources are cash, stock of goods, furniture, machinery, etc. The claims include the claims of the owner capital and the claims of outsiders such as creditors, bankers, etc. Therefore, it can be stated that Balance Sheet is the statement which shows assets owned by the business and liabilities owed by it on a particular date. Balance Sheet is not an account. It has two sides. (i) Assets side and (ii)the Liabilities side. The Asset side has a list of fixed as well current assets. The liabilities side has a list of items of capital, long term as well as short term liabilities.

Need

- Balance Sheet is prepared to measure the true financial position of a business entity at a particular point of time.
- It is a systematic presentation of what a business unit owns and what it owes.
- Balance Sheet shows the financial position of the concern at a glance.
- Creditors, financiers are particularly interested in the Balance Sheet of a concern so that they can decide whether to deal with the concern or not.

Marshalling of Assets and Liabilities

As stated above Balance sheet has two sides i.e. Assets side, which has various items of assets of the concern and liabilities side which has the liability or claim of the owner as well as of the outside parties.

Assets refer to the financial resources of the business and can broadly be divided into Current Assets and Fixed Assets, Liabilities denote claims against the assets of the business. Liabilities can be of two types owners liability or capital and outsiders liabilities such as creditors, bills payable, Bank Loan etc. There is no prescribed form of a Balance Sheet in which it should be prepared by a sole proprietary business or a partnership firm. However, an order is generally maintained in which assets and liabilities are written. This is to maintain uniformity/consistency which facilitates comparative analysis for decision making. Balance sheet may be prepared in any of the following orders:

(a) Liquidity order
(b) Permanency order.

(a) Liquidity order

Liquidity means convertibility of assets into cash. Every asset cannot be converted into cash at the same degree of ease and convenience. Assets are written in the order of their liquidity, Assets of highest liquidity is written first and next highest follows and so on. Similarly, liabilities are also written in this very order. Short term liabilities are written first and then long-term liabilities and lastly the capital.

A specimen of the balance sheet prepared on the basis of liquidity order is given below:

Balance sheet

Particulars	**Amt**	**Particulars**	**Amt**
Bank overdraft	XX	Cash in hand	XX
Outstanding Expenses	XX	Cash at bank	XX
Bill payables	XX	Prepaid expenses	XX
Sundry creditors	XX	Investments (short term)	XX
Loans	XX	Bill Receivables	XX

Capital Add Net Profit Less drawings	XX XX (XX)	Sundry Debtors Closing stock Investments Furniture Plant & Machinery Land & Building Goodwill	XX XX XX XX XX XX XX

(b) Permanency order

While following the order of permanency, assets, which are to be used permanently i.e. for a long time and not meant for resale are written first. For example, Land and Building, Plant and Machinery, furniture etc. are written first. Assets which are most liquid such as cash in hand is written in the last. Order of liabilities is similarly changed. Capital is written first, then the long term liabilities and lastly the short term liabilities and provisions and Specimen of a Balance Sheet that can be prepared in the order of permanency is as follows:

Balance sheet

Particulars	**Amt**	**Particulars**	**Amt**
Capital Add: Net profit Less: Drawings Loans Sundry creditors Bills payable Outstanding expenses Bank overdraft	**XX** **XX** **(XX)** **XX** **XX** **XX** **XX** **XX**	Goodwill Land & Building Plant & Machinery Furniture Investments Closing stock Sundry Debtors Bills Receivables Investments (short term) Prepaid expenses Cash at bank Cash in hand	**XX** **XX** **XX** **XX** **XX** **XX** **XX** **XX** **XX** **XX** **XX** **XX**

3. CLASSIFICATION OF ASSETS AND LIABILITIES

Assets and Liabilities are of various types. These can be classified as under:

(a) Fixed Assets

These are the assets that are purchased for permanent i.e. long term use and these help the business to earn revenue. Examples of such assets are Building, Machinery, Motor Vehicle, etc. These assets are not for sale in ordinary course of business but can be disposed off, if no more needed for business use.

(b) Current Assets

These are the assets which are acquired by the business either for resale or for converting them into cash. These are normally realised within a period of one year. Examples of such assets are : cash in hand, cash at bank, bill receivable, debtors, stock etc.

(c) Tangible Assets

These are the assets that can be seen, touched and have certain volume. Building, Machinery, goods etc. are tangible assets.

(d) Intangible Assets

Assets which can neither be seen nor touched and have no volume are called intangible assets. Patents, trademark, goodwill etc are the examples of such assets.

(e) Liquid Assets

These are the assets which are either in cash or can be easily converted into cash. For example cash, stock, marketable securities etc.

(f) Wasting Assets

These are the assets which exhaust or reduce in value by their use. Mines, quarries etc come under this category.

(g) Fictitious Assets

These are not the real assets. These are the items of such expenses and losses which have not been written off in full. For example, preliminary expenses, under writing commission, etc.

LIABILITIES

Liabilities can be classified as follows:

(a) Long term Liabilities

These are the liabilities which are not payable during the current accounting year. Generally, the funds raised through such means are used for purchase of fixed assets. Examples of such liabilities are loan on mortgage, loan from financial institutions.

(b) Current Liabilities

These are the liabilities which are payable during the current year. These include Bank overdraft, trade creditors, bill payable etc.

(c) Owners' funds

The amount owing to the proprietor or proprietors is called owners' funds. As per business entity concept this is a liability of the business. Apart from capital it also includes undistributed profits and reserves. Amount of drawings by the proprietor is deducted from it.

4. PREPARATION OF BALANCE SHEET

Balance sheet has two sides: Assets and Liabilities. On the assets side we write all types of assets such as Cash, Bills Receivable, Stock, Building etc. On the liabilities side all liabilities, are written both long term liabilities and current liabilities, such as Bills Payable, trade creditors, bank loan etc. Next we write owners' capital. Net profit is added to it. If there is net loss it is deducted from the capital. Amount of drawings is also deducted from the capital. Finally the two sides are totalled and the totals should agree.

Glossary (Points to Remember)

- To prepare Trading Account on the debit side we write opening stock, net purchases and direct expenses on the credit we write net sales and closing stock. The difference of the two sides is calculated which maybe Gross Profit or Gross Loss. The same is transferred to Profit & Loss Account.
- All items of revenue expenditure and losses are written on the debit of Profit and Loss Account and the on the credit we write items of revenue receipts and gains. The difference of the two sides is calculated which may be either Net Profit or Net Loss.
- Balance sheet is a statement showing the financial position of a business unit on the last date of the accounting year.
- Balance sheet is a systematic presentation of what a business unit own sand what it owes.
- Balance sheet has two sides Assets and Liabilities.
- Assets and Liabilities may be written in (i) Liquidity order or (ii)Permanency order.
- Assets may be classified as: fixed assets, current assets, tangible assets, intangible assets, liquid assets, wasting assets and fictitious assets.
- Liabilities can be long term liabilities, current liabilities and owners funds

FINANCE STATEMENT – II

1. NEED FOR ACCOUNTING ADJUSTMENTS

Every business entity prepares Trading and Profit & Loss Account and Balance Sheet, the two financial statements, at the end of an accounting period which is generally one year. It needs to be ensured that such items of income and expenditure which do not pertain to the said accounting period, should not be included. If some of these items have been included in the financial statements these must be excluded by making necessary adjusting entry. Similarly, there can be items which are left out and are needed to be accounted for. Adjustment entry will also be made for them. This is necessary in order to calculate the correct profit or loss and to show true and fair financial position of the business.

For example, a firm closes its books on March 31, every year, Suppose it has not paid rent of the shop for the month of March. This will not be reflected in Trial Balance and hence it needs to be accounted for as it relates to the year for which accounts are being prepared. Similarly, suppose annual insurance premium has been paid up to June, 30. It means premium for three months has been paid in advance.

2. ADJUSTMENTS AND THEIR INCORPORATION

The number and nature of adjustments differ from organisation to organisation. It depends upon the volume and nature of activities in the organisation, However, certain adjustments are common in all types of organisations. Moreover, while making adjustments you will have to follow the general principle of double entry i.e. the amount is to be debited to one account and credited to another account. Thus in the financial statements the item to be adjusted should appear at two places one representing the debit and the other representing the credit.

Let us now discuss some of the items of adjustment and its accounting treatment in financial statements.

These are as under:

a. **Closing Stock –** Closing Stock is the stock of goods remaining unsold at the end of the accounting year. Ordinarily this does not appear in the Trial Balance. Hence, this needs to be incorporated in financial statements. This appears on the credit side of the Trading Account as well as Assets side of the Balance Sheet.
   The adjustment entry will be:
   Closing Stock A/c Dr
   To Trading A/c
   (Closing stock transferred to trading A/c)

b. **Outstanding Expenses** – Expense which is related to the current accounting period but not yet paid is known as Outstanding Expense. Suppose the accounts are closed on 31stDecember every year. Salary for the month of December is due but not paid. It is an example of salary outstanding. Similarly, there are some other items like Rent outstanding, Wages outstanding etc. In case of Salaries Outstanding following the adjustment entry will be made:
   Salary A/c Dr.
   To Salary Outstanding A/c
   (Salary outstanding for the month of December)

c. **Prepaid Expenses –** Sometimes a part of a certain expense paid may relate to the next accounting period. Such expenses is called prepaid expense or expenses paid in advance. For example, insurance premium paid in the current year may before the year ending, the date of which falls in the next year. The part of insurance premium which relates to next accounting year is the insurance

premium paid in advance is deducted from the amount paid and is shown as an item of asset. Similarly, such items may be rent prepaid, tax prepaid etc.
Adjustment entry for prepaid Insurance Premium
Prepaid Insurance Premium A/c Dr
To Insurance Premium A/c
(Insurance premium paid in advance)

d. **Accrued Income –** Accrued income means income earned but not received till the end of the accounting year. For example, interest on securities or dividends on shares, which has become due but may be received on a date falling in the next year. Such income does not appear in the trial balance but should be duly accounted for in the year, because such income has accrued.
Adjustment entry for the transaction: suppose Rent receivable as it has become due but is not yet received
Rent Receivable (accrued) A/c Dr
To Rent Received A/c
(Amount of rent due but not received)

e. **Income received in advance –** Sometimes income is received before it becomes actually due. Such income is called "unearned income" or "income received in advance". Since this income does not relate to the accounting year, it should be deducted from the relevant head of income in the Profit & Loss A/c. It is a liability and hence is shown in the liability side of the Balance Sheet. Example of such income is rent that has been received for the months of January and February of the coming accounting year.
Adjustment entry for the same is
Rent Received A/c Dr
To Rent Received in Advance A/c
(Rent received in advance)

f. **Interest on Capital –** s per business entity concept capital of the proprietor is a liability for the business. Like other loans interest can be paid on capital also. In case I decided to allow interest on capital, adjustment entry will be as follows
Interest on Capital A/c Dr
To Capital A/c
(Interest allowed on capital)

g. **Interests on Drawings** – Interest may also be charged on money withdrawn by the proprietor for household use. Following journal entry is made.
Capital A/c Dr
To Interest on Drawings A/c
(Interest on Drawings charged)

h. **Depreciation –** The value of fixed assets such as Plant and Machinery, Furniture and Fixtures, Land & Building, Motor Vehicles etc. goes on reducing year after year due to wear and tear, obsolescence or for any other reason. As the fixed

assets are used for earning revenue the amount by which the value of a fixed asset decreases is an item of expense, similar to other expenses. This is called depreciation. It should be charged to the Profit and loss Account. The value of such assets should also be shown in the Balance Sheet at the reduced value by the amount of depreciation:
The adjustment entry for depreciation will be
Depreciation A/c Dr
To Asset (by name)Account

i. **Further Bad Debts –** When the goods are sold on credit basis some of the debtors partly pay the due amount or do not pay at all. If this amount cannot be recovered it is called bad debts and is a loss to the firm. This is entered on the debit side of the Profit & loss A/c. But then there may be amount of bad debt which was not recorded in the books of accounts and hence did not appear in the Trial Balance. But the same was discovered before preparing the financial statements. It is called further bad-debts. Following adjustment entry is made for the same:
Bad Debts A/c Dr
To Debtors A/c
(Further bad debts recorded)

j. **Provision for Bad and Doubtful Debts** - Some Debts of a particular year may become bad debts in the next year. It means the loss due to bad debts will be written off in the year it takes place instead of the year it belongs to. It will be a sound accounting practice that a suitable amount is kept aside in the current year to meet the possible loss of bad debts in the next year. Decision regarding maintenance for provision for Bad Doubtful Debts is taken at the end of the year so it is an item of adjustment. It is called a provision for Bad and Doubtful Debt.
The adjustment entry will be as under:
Profit & loss A/c Dr
To Provision for Doubtful Debts A/c
(Provision for doubtful debts created)

3. SUMMARISED VIEW OF ADJUSTMENT ENTRIES

Adjustments	**Adjustment Entry**	**Treatment of Trading and P & L a/c**	**Treatment in B/S**
Closing Stock	Closing stock Alc Dr. To Trading A/c	Shown on the credit side of Profit & Loss Alc	Shown on the Assets side
Outstanding expenses	Expenses A/c Dr. To Outstanding expenses A/c	Added to respective expenses on the debit side.	Shown on the liabilities side
Prepaid expenses	Prepaid expenses A/c Dr To Expenses A/c	Deducted from the respective expenses on the debit side Shown on the debit side	Shown on the Assets side

Accrued income	Accrued income A/c Dr To Income Alc	Added to the respective income on the credit side	Shown on the Assets side
Income received in advance	Income Alc Dr To income received in advance Alc	Deducted from the respective income on the credit side	Shown on the liabilities side
Interest on capital	Interest on capital A/c Dr To capital A/c	Shown on the debit side	Shown as addition to capital on liabilities side
Interest on drawings	Capital A/c Dr. To interest on drawing A/c	Shown on the credit side	Shown as deduction to capital on liabilities side
Depreciation	Depreciation A/c Dr. To Assets Alc	Shown on the debit side	Deducted from the value of Assets
Further bad debts	Bad Debts Alc. Dr. To Debtors A/c	Shown on the debit side	Deducted from debtors, shown on Assets side
Provision for bad and doubtful debts	Profit & Loss Alc. Dr To Provision for bad and doubtful debts	Shown on the debit side	Shown as deduction from debtors on Asset side.

Glossary (Points to Remember)

- Adjustments are needed to be accounted for so that Income Statement and Position Statement show the correct profit or loss and financial position.
- There can be items of income and expenditure which do not pertain to the accounting year for which financial statements are being prepared. These are to be excluded. These are called prepaid items.
- There can be items of expenses and income which are left out and are to be accounted for which are called outstanding expenses or accrued incomes.
- Other important adjustments to be carried out are Closing Stock, Depreciation on fixed assets, interest on capital and interest on Drawings.
- There may be additional bad debts and provision for bad and doubtful debts need to be made on debtors.
- Additional bad debts are irrecoverable debts in addition to what has been shown in the Trial Balance as bad debts
- Provision for bad and doubtful debts is created for future payments due from debtors but seems to be irrecoverable. It is created on the basis of past experiences

II. NOT FOR PROFIT ORGANISATION – AN INTRODUCTION

A. Not-for-profit organisations – meaning and characteristics.

one must have come across organisations which are not engaged in business activities. Their objective is not to make profits but to serve. Examples such organisations are: schools, hospitals, charitable institutions, welfare societies, clubs, public libraries, resident welfare association, sports club etc. These are called Not-for-Profit Organisations (NPOs). These organisations provide services to their members and to the public in general. Their main source of income is membership fees, subscription, donation, grant-in-aid, etc. As the money is Involved In the activities of these organisations, they also maintain accounts. These organisations prepare certain statements to ascertain the results in financial terms of their activities for a particular period say, one year.

B. Characteristics of NPO

Following are the main characteristics or the salient features of Not for Profit organisations (NPOs):'

- The objective of such organisations is not to make profit but to provides service to its members and to the society in general.
- The main source of income of these organisations is not the profit earned from purchase and sale of goods and services but is admissions fees, subscriptions, donations, grant-in-aid, etc.
- These organisations are managed by a group of persons elected by the members from among themselves. This group is called managing committee.
- They also prepare their accounts following the same accounting principle sand systems that are followed by business for profit organisations that are run with an objective to earn profits:

The type of financial statements that are generally prepared by Not-for-Profit Organisations (NPOs) are:

- Receipts and Payments Account
- Income and Expenditure Account
- Balance Sheet

C. Receipts and payments account–meaning and need

like any other organisations Not-for-Profit Organizations (NPOs) also maintain cash book to record cash transactions on day to day basis. But at the end of the year they prepare a summary of cash transactions based on the cash-book. This summary is prepared in the form of an account. It is called Receipts and Payments account. All cash receipts and payments are recorded in this account whether these belong to current year or next year or previous year. All receipts and payments are recorded in this account whether these are of revenue nature or capital nature. As it is an accounts o it has the debit side and the credit side. All receipts are recorded on its debit side while all payments are shown on the credit side. This account begins with opening cash or/and bank balance. Closing balance of this account is cash in hand and or cash at bank/overdraft. Items in this account are recorded under suitable heads

Following are the main features of Receipts and Payments Account :

- It is prepared at the end of the year taking items from the cash book.
- It is the summary of all cash transactions of a year put under various heads.
- It records all cash transactions which occurred during the year concerned irrespective of the period they relate to i.e. previous/current/next year.
- It records cash transactions both of revenue nature and capital nature
- Like any other account it begins with opening balance and ends with closing balance.

Need for preparing Receipts and Payments Accounts

As most of the transactions of Not-for-Profit Organisations are for cash, the Receipts and Payments Account shows most of the items at one place. As it is in a summary form, it gives an idea of large number of transactions at a glance. It contains accounting information under various heads. So it gives information item wise for the accounting year. It shows the closing cash or/and bank balance, this cash/Bank balance is taken to the Balance Sheet. The Receipts and Payments Account serves the purpose of trial balance and becomes the basis of preparing financial statements i.e. Income and Expenditure Account and Balance sheet for the organisation. Very small Not-for-Profit Organisations (NPOs) prepare only Receipts and Payments Account.

As the name itself suggests, Receipts and Payments Account is an account which has two sides, the debit side and the credit side. All receipts are written on the debit side and payments on the credit side.

Receipts and Payment Account

Particular	Amt (Rs.)	Particulars	Amt (Rs.)
To Balance b/d:	XX	By Purchase of Assets	XX
Cash	XX	By Printing and stationery	XX
Bank	XX	By Repairs and Renewal	XX
To Donations	XX	By Newspapers/Magazines	XX
To Legacies	XX	By Rent and taxes	XX
To Membership fees	XX	By Postage	XX
To Entrance fees	XX	By Investments	XX
To Subscriptions	XX	By Conveyance	XX
To Donations	XX	By Honorarium	XX
To Lockers Rent	XX	By Charity	XX
To Sale of fixed assets	XX	By Insurance Premium	XX
To Interest on investments	XX	By Upkeep of Ground	XX
To Miscellaneous Receipts	XX	By Telephone Charges	XX
To Sale of old periodicals	XX	By Balance c/d:	XX
		Cash	XX
		Bank	XX

D. Specific items of receipts and payments account

- **Subscription** It is a regular payment made by the members to the organisation. It is generally contributed annually. It is one of the main sources of income. It appears on the debit side i.e. Receipts side of the Receipts and Payments Account. Apart from amount for current year, it may include amount pertaining to previous year or advance payment for next years.

- **Entrance fees or Admission fees -** Whenever a person is admitted as a member of the organisation certain amount is charged from him/her to give him/her admission. This is called entrance fee or admission fee. It is an item of income and is shown on the debit side of the Receipts and Payments Account.

- **Life membership fees** Membership, if granted to a person for the whole life, special fee is charged from him/her, this is called life membership fees. It is charged once in the life time of a member. It is a capital receipt for the organisation.

- **Endowment fund** It is a fund which provides permanent means of support for the organisation. Any contribution towards this fund is an item of capital receipt.

- **Donation** Donation is the amount received from some person, firm, company or any other body by way of gift. It is also an important item of receipt. It can be of two types:

  (a) *Specific donation*: It is a donation received for a specific purpose. Examples of such donations are: donation for library, donation for building, etc.

  (b) *General donation*: It is a donation which is received not for some specific purpose. It can be of two types:

  (i) General donation of big amount

  (ii) General donation of small amount

- **Legacy** It is the amount which is received by organisations as per the will of a deceased person. It is treated as a capital receipt.

- **Sale of old newspapers/periodicals and sports material** Old newspapers used/condemned sport material is sold and fetches some money. It is a source of revenue. It is taken to the debit of Receipts and Payments account.

- **Purchase of fixed assets** Assets such as building, machinery, furniture, books etc. are purchased for the organisation. These are items of capital expenditure. These

are shown on the credit side i.e. the payment side of Receipts and Payments Account.

- **Payment of honorarium** This is another item of payment. This is an amount paid to persons who are not the employees of the organisation but take part in the management of the organisation. Remuneration paid to them is called honorarium. For example, payment made to the secretary of the club as honorarium. This is a payment of revenue nature.

- **Purchase of consumable items** Items such as stationery, sports material, drugs and medicines etc. are called consumable items. Payments are regularly made by Not-for-Profit Organisation (NPO). These are shown on the payment side. Payments are made for rent, salary, insurance, office expenses etc. which are payments made as revenue expenditure by both business for profit and not for Profit Organisations (NPOs).

E. Preparation of Receipts and Payments Account

Following are the steps followed to prepare Receipts and Payments A/c:

- At first the cash and bank balance carried forward from the last year is written on its debit side. In case there is bank overdraft at the beginning of the year, enter the same on the credit side of this account.
- The amounts are written under relevant heads such as subscription, donations etc. on the receipts side and salary, rent, purchase of sports equipment, books etc. on the Payment side.
- The amounts comprise of only cash and all cash received or paid during the period for which Receipts and Payments Account is prepared. No distinction is made between the items of revenue nature or capital nature and whether these belong to current year, previous year or the coming year.

Finally, this account is balanced by deducting the total of the credit side i.e. the total payments from the total of the debit side i.e. total receipts and is put on the credit side as 'balance cld'.

F. RECEIPTS AND PAYMENTS ACCOUNT AND CASH BOOK

You have learnt about Cash Book and Receipts and Payments Account. You have also learnt that Receipts and Payments Account is prepared with the items taken from the cash Book. There is a distinction between the two which is given as below

Receipts & Payments Accounts	Cash Book
▪ It is prepared at the end the accounting year. ▪ Every item appears only once. ▪ It serves the purpose of Trial Balance to prepare the financial statements. ▪ It reflects the activities of the organisation. ▪ It is prepared only by Not-for-Profit Organisations (NPOs).	▪ It is prepared on day-to-day basis. ▪ Items appear number of times on different dates depending upon their occurrence. ▪ It is a means of maintaining record of cash transactions. ▪ It is only a systematic record of day-to-day cash transactions. ▪ It is also prepared by business organisations meant to earn profit.

GLOSSARY (POINTS TO REMEMBER)

- Not for Profit Organisations are sports clubs, charitable institutions, schools, welfare societies, health clubs, blood banks, etc.
- Their objective is to serve its members and public in general.
- Summary of Cash Book entries for the year when presented in the form of an Account is called Receipts and Payments A/c.
- All cash transactions are recorded in Receipts and Payments Account irrespective of the transaction being of capital nature or revenue and whether belong to current year or preceding or succeeding year.
- Receipts and Payments Account is the Cash Book in summary form and becomes the basis of preparing Income and Expenditure A/c and balance Sheet of a Not for Profit organisation.
- Specific items of receipts are subscription, entrance fees, Life membership fees, Endowment fund, Donations, Legacy, sale of old newspapers, government grant, etc. Specific items of payments are purchase of fixed assets, consumable stores, honorarium, etc

II. FINANCIAL STATEMENTS (FOR NPOs)

1. Meaning

It is the summary of incomes and expenditures of the organisation of a particular year and is prepared at the end of the year. This account is similar to the Profit and Loss Account of the Business Organisations. In this account revenue expenditure and revenue income of the year for which Income and Expenditure A/c is prepared are taken. That means any amount of these items pertaining to either previous year or next year are not considered. The balance amount of this account is either surplus or deficit. If the income side of this account exceeds the expenditure side, the difference is ‘surplus’. In case the expenditure side exceeds the income side, the difference is ‘deficit’.

2. Need of preparing Income and Expenditure Account

Even the Not for Profit Organisations would like to know the net result of their activities of a particular period which generally is one year. Though such organisations do not engage in trading activities and their objective is not earning profits, yet they would like to know whether income exceeds expenditure or vice a versa. The amount of the such difference is not termed as Net Profit or Net Loss as it is so termed in case of business organisations. In case of Not for Profit organisations the net result is termed as ‘surplus’ or ‘deficit’ as the case may be. Moreover of a preparation of Income and Expenditure Account is a legal requirement. It helps the organisations to control their expenditure.

Income And Expenditure a/c

particulars	**amt**	**particulars**	**amt**
Rent	XX	Subscriptions received during the year	XX
Less paid for last year’s outstanding	(XX)	**Less** received on account of last year	(XX)
Less paid for next year	(XX)	**Less** received on account of next year	(XX)
Add current year outstanding	XX	**Add** subscription outstanding for current year	XX
Add received last year	XX	**Add** subscription received last year on account of current year	XX
On account of current car	XX		
Salaries	XX		
Newspaper expenses	XX		
Loss on sale of furniture	XX	Donations	XX
Depreciation	XX	Grant in aid	XX
Any other item of revenue expenses	XX	Sale of Grass	XX
		Interest on Investment	XX
Expenses on consumable material say stationery	XX	Miscellaneous Receipts	XX
		Sale of old newspapers	XX
Surplus-excess of income or expenditure	XX	Revenue incomes	XX
		Deficit: excess of expenditure over income	**XXX**

3. Relevant Items of income and Expenditure

Following are the relevant items of income of a Not for Profit Organisations (NPOs).

- **Subscription**. It is a periodic contribution by members of the organization

- **Entrance fees/Admission fees**. It is received from members at the time of their admission to the organisation.
- **Donations**. Donation is the amount received from person, firm, company etc. by way of gift. But only general donation that too of smaller amount and of recurring nature is treated an item of revenue income.
- **Sale of old newspapers, sports material, etc**. Sale of old newspapers or condemned books, sports material etc. is treated as an item of revenue income.
- **Interest receipt**. The surplus funds may be kept in a fixed deposit account in a bank or invested elsewhere. Interest received thereon is an item of revenue income.
- **Grant-in-Aid**. Local, state and central government and some government agencies give money as grant-in-aid to Not-for-Profit Organisations (NPOs).

Apart from these, there are numerous other items like rent of hall, sale of grass, income from entertainment, etc.

Items of revenue expenses

Some important items are as follows

- Salaries, wages, rent, stationery, postage, telephone charges, electricity charges are some items of revenue expenses which are common to all Not for Profit Organisations (NPOs).
- Honorarium. It is the amount paid to the person who looks after the functioning of the organisation but is not the employee of the company.
- Depreciation. Depreciation is provided on the fixed assets such as furniture, building and books, etc.
- Expenses on tournament, fair, etc.
- Other items

There are numerous other items depending upon the nature of organisation. For example, upkeep of ground if it is a sports club, medicines, laundry if it is a hospital and so on.

4. Preparation of income and expenditure account

This account is prepared from Receipts and Payments account and additional information if any. While preparing an Income and Expenditure account, the following important points have to be kept in min

A. Steps for Expenditure side

The payment column of Receipts and Payments Account contains both revenue items as well as capital items. Revenue items such as rent paid salary, telephone charges etc. will be entered on the expenditure side of Income and Expenditure Account. If necessary, adjustments will be made in these items for expenses that are outstanding at the end of the current year and/or were outstanding at the end of the previous year. Adjustment will also be made for prepaid expenses at the end of previous year as well as those at the end of current year.

B. Steps for Income side

The receipt column contains items of revenue receipts as well as capital receipts. Revenue receipts are entered in the income column of the Income and Expenditure Account. Example of such items are subscription, interest on investment, entrance fees etc. These items need to be adjusted for the amount received for the previous year or for the next year. Similarly, adjustment should be made for outstanding income both at the current year and at the end of the previous year. There may be other adjustments such as bad debts, depreciation, etc. will also be entered in the expenditure column

C. Surplus or Deficit

Finally, this account is balanced i.e. difference of the totals of two amount columns is worked out. If credit side is more than the debit side the difference amount is written on its debit side as surplus and if debit side exceeds the credit side, the difference is deficit is written on the credit side of the account.

5. Adjustment of items in income and expenditure account

Income and Expenditure A/c is prepared on the basis of Receipts and Payments A/c but there may be certain items which are not included in Receipts and Payments A/c. However these need to be incorporated in Income and Expenditure A/c. Following are some of the most common adjustments to be carried out:

- **Subscription Received** It is an item of income and is of recurring nature. It appears on the Receipts side of the Receipts and Payments account. It may include arrears of previous years which is received in the current year and may also include amount received for next year in advance. There may be an amount outstanding for the current year. Some members might have paid current year’s subscription during the previous year. For the purpose of preparing Income and Expenditure Account, subscription for the current year only is to be taken into account. Hence, there is a need for adjustment to be made for the above reasons. Various adjustments relating to subscription are made in the following manner:

- **Subscription outstanding for current year**
  Journal entry
  Subscriptions outstanding A/c Dr
  To Subscriptions A/c
  (Subscription for current year due but not received)
  Adjustment in Income and Expenditure A/c

- **Subscription due in the previous year but received during the current year.**
  Journal entry
  Subscription A/c Dr
  To Subscription Outstanding A/c
  (Adjustment of subscription due in last year but received in the current year).

- **Rent Paid**

Rent paid is an item of expenditure. It may also require some adjustments in rent. The adjustments required to made to the amount of rent paid during the year may be as follows:

(i) Rent outstanding for the current year
(ii) Rent paid in the current year as advance for the next year
(iii) Rent paid in the current year on account of the outstanding amount in the previous year
(iv) Rent paid in the previous year on account of current year.

Journal entries in the books will be made as follows :

(i) Rent A/c Dr.
To Rent outstanding A/c
(Rent due but not paid)

(ii) Rent paid in advance A/c Dr.
To Bank A/c
(Rent paid in advance for the year)

(iii) Rent outstanding A/c Dr.
To Bank A/c

(Amount paid for outstanding rent of the previous year)

(iv) Rent A/c Dr.
To Rent paid in Advance
(Rent paid in advance last year being transferred to Rent A/c)

Calculation of Rent Amount to be shown for current year in the Income and Expenditure Account

Rent paid in the current year
Add : Rent paid in advance in the previous year for current year
Add : Rent due in current year but not paid
Less : Outstanding Rent paid for previous year in current year
Less : Advance rent paid for next year in current year

Amount of rent to be debited to Income and Expenditure A/c

6. Difference between Receipts and Payments A/c and Income and Expenditure A/c

Basis of Difference	**Receipts & Payment A/c**	**Income & Expenditure a/c**
Nature	It is a summary of the Cash Book.	It is the summary of Revenue Income and Revenue Expenditure.
Side	Debit side of this account shows receipts and credit side shows payments.	Debit side of this account shows expenses and losses and credit side shows incomes and gains.
Opening Balance	It starts with the opening balance of Cash in hand or cash at bank.	There is no balance in the beginning.
Closing Balance	Closing balance of this account shows Cash in hand or cash at Bank.	Closing balance of this account shows Surplus or deficit.
Capital and Revenue Items	In Receipts and payments Ale, both capital and revenue nature items are recorded.	In Income and expenditure A/c, only revenue nature items are recorded.
Adjustment	Adjustments are not considered while preparing it.	It is necessary to consider adjustments while preparing it.
Transfer of closing balance	Closing balance of this account is transferred to the Receipts and Payments Alc for the next period.	Closing balance of this account is transferred to the capital fund general fund in the Balance Sheet.

7. Preparation of balance sheet

Not for Profit Organisations (NPOs) also prepare Balance Sheet at the end of the year. The Balance Sheet prepared by a Not for Profit Organisation (NPOs)is not different from that which is prepared by Profit Organisation. It has two sides (a) Assets side and (b) liabilities side. It has only capital items i.e. Assets, liabilities and Capital fund.

The objective of preparing a balance sheet by a Non for Profit Organisation is to show the financial stability, strength and soundness on the last date of the accounting year.

The format of the balance Sheet is given below:

Balance Sheet
As at 31st Dec…….

Liabilities	**Amt**	**Assets**	**Amt**
Rent outstanding	XX	Cash in hand	XX
Salary outstanding	XX	Cash at Bank	XX
Subscription Received in advance	XX	Fixed Deposits	XX
		Subscription outstanding	XX
Building fund	XX	Sports material	XX
Capital fund/General fund	XX	Books	XX
Add : Life membership fee	XX	Furniture	XX
Add : Surplus or Less deficit	XX	Building	XX

Income and Expenditure A/c and the Balance Sheet of NPOs is prepared from the Receipts and Payments Account and the additional information. While preparing Balance Sheet of a Not for Profit organisations (NPOs) certain points are to be kept in mind which are as follows :

1. Assets appearing in the preceding years balance sheet need to be adjusted for any sale or purchase of the asset made during the year and the depreciation provided on the particular asset. Only the adjusted amount will appear in the Balance Sheet of the current year.

2. If any new asset has been purchased during the year it will appear on the payment side of Receipts & Payments A/c, therefrom it is taken to the Balance Sheet.

3. If any loan has been raised it will appear on the receipt side of Receipts and Payments A/c and repayment on its payment side. Net amount will be shown on the liability side of the balance sheet. In the same manner if any advance has been made or some repayment has been made by a person, it will be shown on the Asset side of the Balance sheet as the net amount.

4. Any adjustments made regarding expenses and/or regarding incomes such as outstanding or prepaid will be shown in the Balance Sheet

5. Any item of liability appearing in the previous year's Balance Sheet will be shown at its net value i.e. after deducting from it the amount paid against them.

6. Special receipts like donations for Building etc. will not be treated as income. It will be shown as a fund meant for a special purpose on the liability side of the Balance Sheet.

7. Capital General fund taken from the last balance sheet will be shown after adjusting for the current years 'surplus' or 'deficit'

One important point regarding preparing balance sheet is that before preparing Income and Expenditure Account and Balance sheet of a Not for Profit organisation (NPOs) for the current year. Capital General fund carried forward from the last year should be considered. Besides this, other items of liabilities and assets carried from last year are also need to be adjusted. For this Balance Sheet of the previous year will be drawn with the help of given information. This is termed as opening Balance Sheet.

GLOSSARY (POINTS TO REMEMBER)

- Income and Expenditure Account is similar to Profit and Loss Account Income and Expenditure Account is the summary of Incomes and Expenditures of a Not for Profit Organization (NPO) of a particular year.
- Income and Expenditure Account is prepared to know the net result of the financial activities of Not for Profit organisations (NPOs) which may be either surplus or Deficit.
- Important items of expenditure are revenue expenses such as salary, postage, stationery, honorarium, depreciation etc. Main items of incomes are subscription, entrance fees etc.
- All adjustments such as outstanding, prepaid etc. are incorporated before arriving at the surplus or deficit.
- Receipts and Payments Account and Income and Expenditure Account can be differentiated on the basis of nature, side, opening balance, closing balance, capital and Revenue items adjustments and transfer of closing balance.
- Every Not for Profit organization (NPO) prepares Balance Sheet at the end of the year. It also has the asset side and the liability side. Opening balance sheet is required to prepare Balance sheet for the current yea

MCQs (Financial Statement of Profit Organisation)

1. Which financial statement of a profit organization shows the financial performance over a specific period of time?
a) Balance Sheet
b) Income Statement

c) Cash Flow Statement
d) Statement of Retained Earnings

Answer: b) Income Statement
Explanation: The income statement shows the financial performance of a profit organization over a specific period of time, typically a month, quarter, or year. It summarizes the revenue, expenses, and net income or loss for the period.

2. Which financial statement shows the financial position of a profit organization at a specific point in time?
a) Balance Sheet
b) Income Statement
c) Cash Flow Statement
d) Statement of Retained Earnings

Answer: a) Balance Sheet
Explanation: The balance sheet shows the financial position of a profit organization at a specific point in time, typically the end of a month, quarter, or year. It summarizes the assets, liabilities, and equity of the organization.

3. Which financial statement shows the sources and uses of cash during a specific period of time?
a) Balance Sheet
b) Income Statement
c) Cash Flow Statement
d) Statement of Retained Earnings

Answer: c) Cash Flow Statement
Explanation: The cash flow statement shows the sources and uses of cash during a specific period of time, typically a month, quarter, or year. It summarizes the cash inflows and outflows from operating, investing, and financing activities

4. Which financial statement shows the changes in retained earnings during a specific period of time?
a) Balance Sheet
b) Income Statement
c) Cash Flow Statement
d) Statement of Retained Earnings

Answer: d) Statement of Retained Earnings
Explanation: The statement of retained earnings shows the changes in retained earnings during a specific period of time, typically a month, quarter, or year. It summarizes the beginning balance of retained earnings, net income or loss for the period, dividends paid, and other adjustments.

5. Which financial statement is used to calculate the return on investment for a profit organization?
a) Balance Sheet
b) Income Statement
c) Cash Flow Statement
d) Statement of Retained Earnings

Answer: b) Income Statement
<u>Explanation:</u> The income statement is used to calculate the return on investment for a profit organization. The return on investment is calculated as the net income divided by the total investment, which includes both equity and debt.

CHAPTER 4 - ACCOUNTING FOR SHARE CAPITAL

1.1 MEANING, CHARACTERISTICS AND NATURE OF A COMPANY

- **Meaning**

  A company is an incorporated association which is an artificial person created by law, having a corporate and legal personality distinct and separate from its members, perpetual succession and a common seal.

- **Characteristics**

  The essential characteristics of a company are as follows:

  (a) It is an incorporated (registered) association

  (b) It is an artificial person created by law.

  (c) It has a separate legal entity.

  (d) It has a perpetual succession, (i.e., Continued Existence) (it can be created and wound up by law only).

  (e) It has a common seal, i.e., official signature

- **Nature**

  Unlike a proprietary concern or partnership concern which has no existence apart from its members, a company is a corporate and legal personality distinct and separate from its members.

1.2 Meaning and Categories of Share Capital

- **Meaning**

  Share Capital means the capital raised by the issue of shares. The amounts invested by the shareholders towards the face value of shares are collectively known as 'Share Capital' which is quite distinct from the capital put in by individual shareholders.

- **Categories of Share Capital**

  The share capital is divided under the following three heads:

  1. **Authorized Capital** — An Authorized Capital refers to that amount which is stated in the 'Capital Clause' of the Memorandum of Association as the

share capital of the company. This is the maximum limit of the company which it is authorized to raise and beyond which the company cannot raise unless the capital clause in the Memorandum is altered in accordance with the provisions of Sec. 94 of the Companies Act, 1956**.**

2. **Issued Capital** — An Issued Capital refers to the nominal value of that part of authorized capital, which has been

    (i) subscribed for by the signatories to the Memorandum of Association,
    (ii) allotted for cash or for consideration other than cash and
    (iii) allotted as Bonus shares.
    (iv) shares allotted to the existing shareholders by way of rights offer, known as rights shares
    (v) shares for which offers have been invited for subscription.

    Note: Issued capital can never exceed the authorised capital or at the most equal to authorised capital.

3. **Subscribed capital-** Subscribed capital means such part of capital which is for the time being subscribed by the members of the company [Section 2(86)]. It includes bonus shares.It is also called allotted shares. It is immaterial whether the shares are fully paid or partly paid. Where the shares issued for subscription are wholly subscribed for, the terms issued and subscribed capital are the same.

4. **Called up capital-** Called up capital means such part of the capital which has been called for payment [Section 2(15)]. It is that part of the subscribed share capital which the company actually demands from the members.

    For example- where ` 8 has been called upon each of 1,00,000 shares of the face value of ` 10, the called up capital shall be ` 8,00,000. Paid up share capital or share capital paid up means such aggregate amount of money credited as paid up as is equivalent to the amount received as paid up in respect of shares issued and also includes any amount credited as paid

1.3 Types of Share Capital

The share capital of a company limited by shares shall be of two kinds, namely:

(a) Equity share capital:
    (i) with voting rights; or

(ii) with differential rights as to dividend, voting or otherwise in accordance with such rules may be prescribed; and

(b) Preference share capital.

Explanation:

(i) Equity share capital means all share capital which is not preference share capital

(ii) Preference share capital means that part of issued capital which would carry a preference right with references to

(a) payment of dividend and

(b) repayment of paid up capital in case of winding up.

1.4 Disclosure of Share Capital-

SCHEDULE III OF THE COMPANIES ACT 2013

According to Schedule III of Companies Act 2013, Share Capital should be disclosed on the face of the Balance sheet as given below-

Balance Sheet of .... Ltd.
as on 31st March 20XX

Particulars	Note No.	Amount (₹)
I) Equity and Liabilities		
1. Shareholder's Fund:		
(A) Share Capital	1.	XXXX
Total		**XXXX**

1.5 Issue Of Shares For Cash

- To issue shares, private companies depend upon 'Private Placement' of shares. Public companies issue a 'Prospectus' and invite general public to subscribe for shares. To discuss accounting treatment, we shall concentrate on public companies who invite general public to subscribe for equity shares. Similar accounting treatment is applicable in other cases.
- However, for journal entries in case of issue of preference shares, the word 'Equity' is replaced with the word 'Preference'.

- First installment paid along with application is called 'Application Money'. As per Section 39 of the Companies Act, 2013. Application money **must be at least 5% of the nominal value of shares**.

- After the closing date of the issue (the last date for filing applications), company decides about allotment of shares in consultation with the SEBI and stock exchange concerned. According to the Companies Act, 2013, a company cannot proceed to allot shares unless **minimum subscription** is received by the company.

- **Minimum Subscription**: A public limited company cannot make any allotment of shares unless the amount of minimum subscription stated in the prospectus has been subscribed and the sum payable as application money for such shares has been paid to and received by the company.

- The amount of minimum subscription to be disclosed in prospectus by the Board of Directors taking into account the following:

  (a) Preliminary expenses of the company,
  (b) Commission payable on issue of shares,
  (c) Cost of fixed assets purchased or to be purchased,
  (d) Working capital requirements of the company, and
  (e) Any other expenditure for the day to day operation of the business.

- The company reserves the right to reject or accept an application fully or partially. Successful applicants become shareholders of the company and are required to pay the second instalment which is known as **'Allotment Money'** and unsuccessful applicants get back their money. However, in case of delay in refunding the money, the Company becomes liable to pay interest on the amount of refund. Subsequent instalments, if any, to be called by the company are known as **'Calls'**.

- The issue price of shares is generally received by the company in instalments and these instalments are known as under:

  First instalment …………. Application Money
  Second Instalment …………. Allotment Money
  Third Instalment …………. First Call Money
  Fourth Instalment …………. Second Call Money and so on.
  Last Instalment ……………. Final Call Money

1.6 OVER-SUBSCRIPTION

Meaning of Over-subscription

Shares are said to be over-subscribed when the numbers of shares applied is more than the
number of shares offered.

For example, in case a company has offered 5,000 shares to public but the public applied for 6,000 only, it is called a case of over-subscription.

Note: An oversubscription to the extent of 10% of the net offer to public is permissible for the purpose of rounding off to the nearer multiple of 100 while finalising the allotment.

- **Alternatives Available in Case of Over-subscription**

Following three alternatives are available to deal with the situation of oversubscription:

Alternative	**Course Of Action**
1. To reject the excess applications and to allot in full to other applicants	Letters of Regret alongwith the refund of application money are sent to the applicants of rejected applications and letters of allotment are sent to applicants of accepted applications.
2. To make pro-rata allotment to all the applicants received [No of shares applied by an applicant × Total no of shares to be allotted/Total no. of shares applied for]	Letters of allotment are sent to all the applicants. Excess application money is adjusted towards the amount due on allotment of shares allotted. If the whole issue price is required to be paid along with to be the application, the excess money over and above 10% of the offered securities shall be refunded.
3. Any combination of the above two alternatives such as: — (a) To reject some of the applications and make pro-rata allotment to remaining applicants. (b) To allot in full to some of the application and make pro-rata allotment to remaining applicants (c) To reject some of the applications, allot in full to some of the applications and make pro-rata allotment to remaining applicants	(a) Letters of regret are sent to rejected ones. Letters of allotment are sent to accepted over. (b) Letters of allotment are sent to all the applicants (c) Letters of regret are sent to rejected ones.

1.7 Accounting Treatment- Issue of Shares for cash

The accounting entries for the issues of shares are related to the format of the issue price namely:

(i) Issue of shares at par

(ii) Issue of shares at premium

Then shares may be issued for cash or for consideration other than cash in all the foregoing cases.

1.7.1 ISSUE OF SHARES AT PAR FOR CASH (PAYMENT IN INSTALLMENTS)

When a share is issued at its nominal or face value, it is an issue of shares at par e.g., a share of the nominal value of ` 100 issued at ` 100. Thus, **the par value of a share is its face or nominal value**. In case the nominal or par value is payable in installments, the investors (purchasers of shares) have to pay application money, allotment money and call money.

Accounting entries take care of payments made in installments-

(i) Receipt of application money:

As noted above the investors would fill up the application forms and deposit the same with the company itself or company' bankers along with the required amount. This is called application money. It is calculated by multiplying the number of shares applied with the application money per share.

The journal entry is:
Bank Account Dr. [With the total amount of application money actually received]
To Share Application Account
[Being the application money received on...shares @... per share]

POINTS TO REMEMBER 💡-

(a) The share application account is a personal account since it represents those investors who have applied for shares.
(b) When share capital of a company consists of both equity and preference shares, the company will have to open separate Equity Share Application Account and Preference Share Application Account respectively.

(ii) Transfer of application money to share capital account:

The application money is not directly credited to share capital account. It is treated as deposit money. The reason is that an application for shares is only an offer to buy shares and until this offer is accepted by allotment of shares, the applicants are simply creditors of the company.

Thus, the application money does not belong to the company since it has to be refunded if the shares are not allotted to the individual applicants. But as soon as shares are allotted, the situation changes. The company has accepted the offers of the applicants (made through application money) and contracts come into being making the applicants the shareholders of the company. The application money which stood to the credit of the applicants as deposit is no longer owed to them. Instead, it becomes immediately a part of share capital.

Hence, application money on allotted shares only becomes immediately (on allotment) a part of the share capital.

(iii) Transfer of excess application money towards allotment money:

In some cases the applicants may be allotted a smaller number of shares than applied for—technically called partial allotment.

In such a case, the excess amount of application money (also called the surplus or overpaid amount) is not refunded but retained and treated as a payment towards allotment money on the shares allotted.

(iv) **Refund of application money:**

In case there is still some balance in the share application account on account of partial allotment to some applicants, their surplus money may be refunded

(v) Calls-in-advance:

As a rule excess application money over and above that due on allotment should be refunded to the allottees. However, the company may transfer the surplus to a newly opened account, namely, Calls-in-Advance Account when following two conditions are satisfied:

(i) The articles of the company provide for the acceptance of calls-in-advance.
(ii) The consent of the applicant(s) has been taken either by a separate letter or by inserting a clause in company' prospectus or application form.

(vi) Allotment money becoming due:

On allotment of shares, the applicants become shareholders and get letters of allotment. And the money which the applicants agreed to pay on allotment becomes payable. Thus, their status is changed from that of creditors to debtors and the amount payable on allotment immediately becomes part of the share capital.

POINTS TO REMEMBER 💡-
The Share Allotment Account is a personal account of the applicants who have now become shareholders.

(vii) Receipt of allotment money:

(viii) Calls on shares:

In case the company does not collect the full issue price in the form of application money and allotment money, the balance amount is collected by making one or more calls on the shareholders.

The different calls are distinguished from each other by their serial numbers such as First call, Second call, Third call and so on. The last call is also called final call e.g., First and Final call or Second and Final call etc.,as the case may be. When the call is made on the shareholders, they become liable to pay the call because they are debtors of the company.

1.7.2 ISSUE OF SHARES AT A PREMIUM-

Meaning

(a) Shares are said to be issued at a premium when they are issued at a price higher than the face value.
(b) The excess of issue price over the face value is called as the amount of 'Securities Premium', e.g., if a share of Rs 10 is issued at Rs 15, it is said that the share has been issued at a premium of Rs 5.
(c) The premium on issue of shares (whether received in cash or in kind) is a capital receipt and not a revenue receipt.
(d) The premium must be credited to a separate account called '**Securities Premium Account**.'

(e) Since the company has inherent power to issue shares at a premium, it can issue shares at a premium in the absence of any express authority in its articles.

PURPOSE OF SECURITIES PREMIUM ACCOUNT-
According to Sec. 78 of the Companies Act 1956, the securities premium may be applied only for the following purposes:

(i) To issue fully paid bonus shares to the members.
(ii) To write off preliminary expenses of the company.
(iii) To write off the expenses of or the commission paid or discount allowed on any issue of shares or debentures of the company.

(iv) To provide for the premium payable on the redemption of any redeemable preference shares or of any debentures of the company.

Important to Note: According to Sec. 77A, a company may buy back its own shares or other specified securities out of the securities premium account. The use of Securities Premium for purposes other than those mentioned above requires the compliance of the provisions of the Act relating to reduction of share capital.

Methods of Recording

There are two methods of recording the securities premium:

1. **Under Due Method**
   (i) an entry is passed for securities premium, when it becomes due and
   (ii) on receipt of securities premium, the Share Allotment Account is credited with the amount received (including securities premium) on allotment.

2. **Under Receipt Method**
   (i) no entry is passed for securities premium when it becomes due, and
   (ii) on receipt of securities premium, the 'Securities Premium Account' is credited with the amount of securities premium received.

The advantage of this method is that the 'Securities Premium Account' will not be required to be debited in the event of the forfeiture of those shares on which the securities premium money has not been received.

POINTS TO REMEMBER 💡-

(i) The amount of securities premium may be demanded along with the application money/allotment money/call money.
(ii) The amount of securities premium may be demanded either in lumpsum or in instalments e.g., partly with application money and balance with allotment money.
(iii) A company may issue securities at premium for cash or consideration other than cash.
(iv) Securities Premium is in the nature of capital receipt and not a revenue receipt.
(v) Securities Premium cannot be treated as free reserves except for the purpose of buy-back of shares.

Disclosure

The balance of Securities Premium Account appears under the head 'Reserves and Surplus' on the liabilities of the Balance Sheet.

1.7.3 ISSUE OF SHARES AT A DISCOUNT [SEC. 79]

Meaning

(a) Shares are said to be issued at a discount when they are issued at a price lower than the face value.
(b) The excess of the face value over the issue price is called as the amount of discount, e.g., if a share of Rs 10 is issued at Rs 9, it is said that the share has been issued at a discount of Re. 1.
(c) The discount on issue of shares must be treated as a loss of capital nature and not of revenue nature.
(d) The discount must be debited to a separate account called 'Discount on Issue of Shares Account'.

FIVE CONDITIONS-
According to Sec. 79 of the Companies Act 1956, a company may issue the shares at a discount only if the following conditions are fulfilled:

(i) The shares must belong to a class already issued;
(ii) The issue must be authorised by an ordinary resolution of the company;
(iii) The sanction of the *Central Government must be obtained;
(iv) The resolution must specify the maximum rate of discount at which the shares are to be issued. No resolution shall be sanctioned by the Company Law Board if the maximum rate of discount specified in the resolution exceeds 10% unless it is of opinion that a higher percentage of discount may be allowed in the special circumstances of the case;
(v) At least one year must have elapsed since the date on which the company was entitled to commence business;
(vi) The issue must be made within two months from the date of receiving the sanction of the *Central Government or within such extended time as the *Central Government may allow.

* After the Companies (Amendment) Act 2002.

Disclosure- The unwritten off amount of Discount on Issue of Shares appears under the head **'Miscellaneous Expenditure'** on the assets side of the Balance Sheet.

1.8 Sweat Equity Shares [SEC. 79A]

Meaning
Sweat equity shares means equity shares issued by the company to employees or directors at a discount or for consideration other than cash for providing know-how or making available right in the nature of intellectual property rights or value additions, by whatever name called. (Explanation II to section 79A)

FIVE CONDITIONS-
According to section 79A (1), a company may issue sweat equity shares if the Conditions

following conditions are fulfilled, namely:

(a) the shares must belong to a class of shares already issued;
(b) the issue must be authorised by a special resolution passed by the company in the general meeting.
(c) the resolution must specify the number of shares, current market price, consideration, if any, and the class or classes of directors or employees to whom such equity shares are to be issued.
(d) at least 1 year must have elapsed since the date on which the company was entitled to commence business;
(e) the sweat equity shares of a company whose equity shares are listed on a recognised stock exchange must be issued in accordance with the regulations made by the Securities and Exchange Board of India in this behalf:

Provided that in the case of a company whose equity shares are not listed on any recognised stock exchange, the sweat equity shares are issued in accordance with the guidelines as may be prescribed.

1.9 Call-in Arrears

When some allottees fail to pay the allotment money or call money or both, there will be debit balance in the share allotment account or share call account or both. The unpaid amount is technically called calls-in-arrears and is debited to calls-in-arrears account and credited to relevant unpaid installment account

The calls-in-arrears account is closed only when the arrears are received by the company or when the shares on which the installments remain unpaid are forfeited.

Interest on Calls-in-Arrears Articles of Association generally specify the rate of interest, payable on calls-in arrears. In the absence of specific rates. Table F of Schedule I of Companies Act 2013 applies which authorizes the directors to **charge interest not exceeding 10% p.a.**

Disclosure
Interest due and accrued on calls in arrears is shown as under:

Current Assets
Other Current assets: Interest on calls in arrears.

1.10 Call-in Adavance

- Sometimes, a shareholder may pay a part or the whole of the unpaid amount in advance in anticipation of the calls that are likely to be made subsequent to the allotment of shares.
- Section 50 of the Companies Act 2013 provides that if a company is authorised by its articles, it can accept advance payment from any shareholder in respect of

the shares held by him although no call has been made on them as yet. This is called calls-in-advance and a separate account bearing this title is opened.

(i) Calls-in-advance arise after adjustment of surplus application money towards allotment money.
(ii) The advance payment of calls does not entitle a shareholder for additional dividends and voting rights.
(iii) **Disclosure** in the Balance Sheet: The amount of calls-in-advance is shown in the Balance Sheet as under:
Current Liabilities
Other-current Liabilities: calls-in-Advances
(iv) It is not added to the paid-up capital.

Interest on Calls-in-Advance

The shareholder who has paid the calls-in-advance becomes a creditor of the company for the amount of interest which may accrue to him from the date of advance payment to the date when the appropriate call is actually due for payment. Such interest is a charge against profit and can be paid out of capital also if there are no profits.

The articles of the company usually provide for the rate at which interest is payable on calls-in-advance. But in case the articles are silent on the rate of interest, Table F of Schedule I of Companies Act 2013 is applicable which leaves the matter to the Board subject to a maximum rate of 12% p.a.

1.11 ISSUE OF SHARES TO VENDORS FOR CONSIDERATION OTHER THAN CASH

A company may take over either the whole of a running business, that is, its assets and liabilities or it may purchase only assets such as land, building, machinery etc. The sellers of the business (assets and liabilities) or only assets are known as Vendors.

The company may issue shares for purchase consideration (or purchase price) instead of cash to the Vendors who sold their whole business or some assets to company. When shares are so issued, there is no receipt of cash and hence it is termed as issue of shares for consideration other than cash.

Purchase consideration is the amount paid by the purchasing company to the vendors in consideration of the whole business or some assets as the case may be.

Purchase consideration for taking over the entire business is calculated as under:

Agreed value of the assets Minus Agreed value of the liabilities.
On the other hand, if only some assets are taken over, the purchase consideration is simply equal to the agreed value of the assets taken over.

Furthermore, the difference between Purchase Consideration and Net Assets taken over is debited to either Goodwill Account or credited to Capital Reserve Account as shown below:

Goodwill = Excess of Purchase price (Consideration) over Net Assets taken over
Capital Reserve = Excess of Net Assets over the Purchase Price (Consideration)

NOTE

Assets — Liabilities = Net Assets

NOTES

(i) Assets and liabilities are recorded at their respective agreed values.
(ii) Vendor's Account will be recorded at the actual purchase consideration.
(iii) The difference between the amounts of debit and credit entries will result in either debit to Goodwill Account or Credit to Capital Reserve Account and not to both. Unless Goodwill is also purchased as a separate asset.

Disclosures

(i) Shares: Under the heading: Share Capital
(ii) Goodwill: Under the heading: Fixed Assets: Intangible Assets
(iii) Capital Reserves: Under the heading Reserves and Surplus

1.12 ISSUE OF SHARES TO PROMOTERS AS REMUNERATION

A company may also issue fully paid shares for consideration other than cash to the promoters or other persons in recognition of their services rendered to the company by way of furnishing technical information, engineering services, plant layout, managerial know-how etc. As these services are likely to be used by the company for a long time, such expenditure should be treated as capital expenditure and debited to Goodwill Account:

Goodwill Account Dr.
To Share Capital Account

1.13 FORFEITURE OF SHARES

(a) Forfeiture of shares means the cancellation of allotment to defaulting shareholders and to treat the amount already received on such shares as forfeited to the company.
(b) When a shareholder fails to pay one or more instalments (viz., allotment money and/or call money) due on the shares held by him, the company has the authority

to forfeit such shares by following the procedure specified in its Articles of Association.

(c) According to SEBI Guidelines, the subscription money must be received within twelve months from the date of allotment. If the investor fails to pay the call money within twelve months, the subscription money already paid may be forfeited.

Surrender of shares

(a) Surrender of shares is a voluntary return of shares for the purposes of cancellation.

(b) The directors can accept the surrender of shares only when the Articles authorise them to do so.

(c) Surrender is lawful only in two cases viz.

  a) where it is done as a short cut to forfeiture to avoid the formalities for a valid forfeiture

  b) Where shares are surrendered in exchange for new shares of the same nominal value (but with different rights).

(d) A surrender will be void if it amounts to purchase of the shares by the company or if it is accepted for the purpose of relieving a member from his liabilities.

Thus, surrender of shares is at the instance of shareholder whereas forfeiture of shares is at the instance of company.

Note: So far as accounting treatment is concerned, the surrender of shares is considered similar to the forfeiture of shares. Surrendered shares may be reissued in the same way as forfeited shares.

Accounting Treatment

Accounting Generally speaking, accounting treatment on forfeiture is to reverse all the entries (except those relating to premium) already passed till the stage of forfeiture and to treat the amount already received as forfeited to the company.

The accounting treatment to record the forfeiture of shares in various cases are summarised as follows:

Disclosure-
The balance of the Forfeited Shares Account is shown as an addition to the total paid up capital of the company under the heading 'Share Capital' on the liabilities side of the Balance Sheet till the forfeited shares are reissued.

1.14 RE-ISSUE OF SHARES

Meaning

A company can <u>re-issue the forfeited shares in accordance with the provisions</u> contained in the Articles of the company.

Re-issue at a Discount
<u>The forfeited shares can be re-issued at a discount</u>.

Maximum Discount
The maximum amount of discount which may be allowed on re-issue is explained as follows:

Cases

(a) **When the shares were originally issued at par or at a premium.**

The amount credited to Forfeited Share Account

Maximum Permissible Discount On Re-issue

(b) When the shares were originally issued at a discount

Share Account plus the amount of original discount

A/c to be Dr.

1. Debit 'Bank Account' with the amount received on shares re-issued. Amount = No. of shares re-issued × re-issue price per share

2. Debit 'Discount on Issue of Shares Account' with the amount of discount originally allowed on such shares In case shares were originally issued at a discount.

A/c to be Cr.

1. Debit Forfeited Shares Account with the excess of re-issue discount over original discount (if any) allowed on shares re-issued. Such amount is calculated as under: = No. of Shares re-issued × [Paid-up value per share – Re-issue price per share – Original Discount per share (if any)

2. Credit Share Capital Account with the paid-up value of shares re-issued. Amount = No. of shares re-issued × Paid-up value per share

Note: *In case the forfeited shares are re-issued at a price higher than the paid-up value, the excess of re-issue price over paid-up value should be credited to 'Securities Premium Account'.*

1.16 RIGHT SHARES [SEC. 81]

Meaning

Sec. 81 gives pre-emptive right to existing equity shareholders in case of further issue of shares. Pre-emptive rights mean that further shares must be offered to the existing shareholders in proportion as nearly as the circumstances admit to the capital paid up on those shares at that date. Such shares are called 'Rights Shares.'

When Available

Pre-emptive right is available when it is proposed to increase the subscribed capital of the company by allotment of further shares at any time after the expiry of 2 years from the formation of a company or after the expiry of one year from the first allotment of shares, whichever is earlier.

Offer to Outsiders

to In the following circumstances new shares can be offered to the outsiders before offering them to the existing shareholders.

1. Where the special resolution to that effect is passed by the company in general meeting.
2. Where the ordinary resolution to that effect is passed by the company in general meeting and the Central Government is satisfied on an application made by the Board of Directors in this behalf that the proposal is most beneficial to the company.
3. Where the existing shareholder to whom the offer is made or the person(s) in whose favour the renunciation if any, is made, does not accept the offer within the specified time.
4. Where allotment of further shares is made at any time before the expiry of 2 years from the formation of a company or before the expiry of one year from the first allotment of shares, whichever is earlier.

Value of Right-
The computation of value of right consists of the following two steps:
Step 1 Calculate Average Price of a share -

$$\frac{\text{Market price of the existing shares + Issue price of proportionate right shares}}{\text{No. of Existing shares + No. of Rights shares}}$$

Step 2 Calculate Value of Right

Value of Right= Market price of a share — Average price of a share

Accounting Treatment-
Accounting treatment of right issue of shares is similar to the treatment discussed under application and allotment.

1.17 Bonus Shares

When a company has large accumulated reserves which cannot be distributed as dividends in cash either because of legal restrictions or accounting principle of prudence (or conservatism), it converts this surplus into capital (by process of capitalising the surplus) and divides the capital among the existing shareholders in proportion to the (share) capital held by them by issuing fully paid bonus shares. The shareholders to whom these shares are allotted have to pay nothing i.e. Bonus issue is made to the existing members free of charge.

The basic characteristics of bonus shares are:
(i) Bonus shares are issued to the existing members;
(ii) Bonus shares are always fully paid and
(iii) Right to renunciation is not available in respect of bonus shares.

SOURCES OF CAPITALISATION-
According to Section 63(1) of Companies Act 2013, a company may issue fully paid bonus shares to its members out of:
(i) Its free reserves;
(ii) the securities premium account;
(iii) the capital redemption reserve Account.

However, issue of bonus shares shall not be made by capitalising reserves created by revaluation of assets. As the capitalisation of surplus is done either by making partly paid shares as fully paid or by issuing fully paid bonus shares, the sources are indicated separately for both the types:
(i) Sources for making partly paid shares as fully paid: The following accounts may be utilised for this purpose:
  (a) Surplus or profit (unappropriated part).
  (b) Any type of revenue reserve e.g., general reserves
  (c) Development Rebate Reserve
  (d) Investment Allowance Reserve
  (e) Debenture Redemption Reserve.

(ii) Sources for issuing fully paid bonus shares: The following accounts may be utilised for this purpose:
  (a) Securities Premium Account
  (b) Capital Redemption Reserve
  (c) Surplus or profit (unappropriated part)

(d) Any type of Revenue Reserve e.g., General Reserve
(e) Development Rebate Reserve
(f) Investment Allowance Reserve
(g) Debenture Redemption Reserve and so on.

(A) Securities Premium Account and Capital Redemption Reserve Account can not be utilised for making partly paid shares as fully paid.
(B) Capital Reserve is not available for any type of bonus issue as per SEBI guidelines.

CONDITIONS FOR ISSUE OF BONUS SHARES [SECTION 63)]

Conditions for bonus issue or capitalising reserves under Section 63(2) as given below:

(a) It is authorised by its articles.
(b) It has, on the recommendation of the Board, been authorised in the general meeting of the company;
(c) It has not defaulted in the payment of interest or principal in respect of fixed deposits or debt securities issue by it;
(d) It has not defaulted in respect of the payments of statutory dues of the employees such as, contribution to provident fund, gratuity and bonus.
(e) The partly paid-up shares, if any, outstanding at the date of allotment must be made fully paid-up.
(f) It complies with such other conditions as may be prescribed.
The bonus shares shall not be issued in lieu of dividend [Section 63(3)]

Rules 14 of the Companies (Share Capital and Debentures) Rules 2014 provides that once a company announces the decisions of the Board recommending bonus issue, it cannot withdraw such decision subsequently.

Stock Split

A stock split is a corporate action in which a company issues additional shares to present shareholders to increase the number of outstanding shares. A stock split results in an increase in the number of total shares and a proportionate decrease in the share price, while the market capitalization and value of the company remain constant. The face value of shares also decreases proportionately.

1.20 BUY-BACK OF SHARES

1.20.1 Meaning

The term buy-back of shares implies <u>the act of purchasing its own shares by a company.</u>

1.20.2 THREE SOURCES OF FUNDS FOR BUY-BACK [SEC. 77A(1)]

A company <u>may purchase its own shares or other specified securities out of</u> —

(i) its <u>Free Reserves</u>; or
(ii) the <u>Securities Premium Account</u>; or

(iii) the proceeds of any shares or other specified securities;

1.20.3 CONDITIONS FOR BUY-BACK

Procedural Conditions

1. **Authorised by Articles**—The buy-back must be authorized by the Article

2. **Special Resolution/Board's Resolution**—The special resolution must be passed in the General Meeting of shareholders.

OR

The Board must pass a resolution at its meeting where the buy-back does not exceed 10% of the total equity paid up capital and free reserves of the company.

Note: Minimum Time Interval between Two buy-back made in pursuance of Board's Resolution—No offer of such buy back must be made within a period of 365 days from the date of preceding offer of buy-back.

1. **Fully Paid Shares**—All the shares for buy-back must be fully paid-up.

2. **Solvency Declaration**—The company must file solvency declaration with the Registrar and SEBI in the form of an affidavit signed by at least two directors of the company. The affidavit must state that the Board has made full inquiry into the affairs of the company as a result of which they have formed an option that the company is capable of meeting its liabilities and will not render insolvent within a period of one year from the date of declaration adopted by the Board [77A(6)].

3. **As per SEBI Guidelines**—Buy-back must be as per SEBI Guidelines

4. **Time Limit**—The buy-back must be completed within 12 months from the date of passing the Special Resolution/Board's Resolution.

5. **Transfer of Certain Sums to Capital Redemption Reserve Account**—Where a company purchases its own shares out of free reserves, than a sum equal to the nominal value of the shares so purchased shall be transferred to the Capital Redemption Reserve Account referred to in Clause (d) of the proviso to Sub-section (1) of Section 80 and details of such transfer shall be disclosed in the balance sheet.

Three Tests Conditions

1. **Maximum Debt-Equity Ratio**—The debt-equity ratio must not be more than 2:1 after such buy-back. Here Debt = Secured + Unsecured Debt and Equity = Capital + Free Reserves Free Reserves = Free Reserves as per Sec 372A which includes Securities Premium as per Sec 78 also.

2. **Maximum Limit of Amount of Shares to be bought back**—The buy-back of the shares must not exceed 25% of total paid-up capital and free reserves.

3. **Maximum Limit of Number of Shares to be bought back in any Financial Year**—The buy-back of equity shares in any financial year must not exceed 25% of its total paid up equity capital

CHAPTER 5 - RATIO ANALYSIS

3.1. Ratio Analysis (Meaning)

- The ratio analysis is based on the fact that a single accounting figure by itself may not communicate any meaningful information but when expressed as a relative to some other figure, it may definitely provide some significant information.
- It can be used to compare the risk and return relationships of firms of different sizes.
- It is defined as the systematic use of ratios to interpret the financial statements so that the strengths and weaknesses of a firm as well as its historical performance and current financial condition can be determined.
- The term ratio refers to the numerical or quantitative relationship between two items/ variables. This relationship can be expressed as (i) percentage (ii) fraction, and (iii) proportion of numbers.

3.2 Sources of Financial Data for Analysis The sources of information for financial statement analysis are:

1. Annual Reports
2. Interim financial statements
3. Notes to Accounts
4. Statement of cash flows
5. Business periodicals.
6. Credit and investment advisory services

3.4 Importance of Ratio Analysis

- The importance of ratio analysis lies in the fact that it presents facts on a comparative basis and enables the drawing of inferences regarding the performance of a firm.

- Ratio analysis is relevant in assessing the performance of a firm in respect of the following aspects:

1. **Liquidity Position** The ability to meet the short-term liabilities is reflected in the liquidity ratios of a firm.

2. **Long-term Solvency**: This aspect of the financial position of a borrower is of concern to the long-term creditors, security analysts and the present and potential owners of a business.

3. **Operating Efficiency**: It is relevant from the viewpoint of management, because it throws light on the degree of efficiency in the management and utilisation of its assets.

4. **Overall Profitability**: Unlike the outside parties which are interested in one aspect of the financial position of a firm, the management is constantly concerned about the overall profitability of the enterprise.

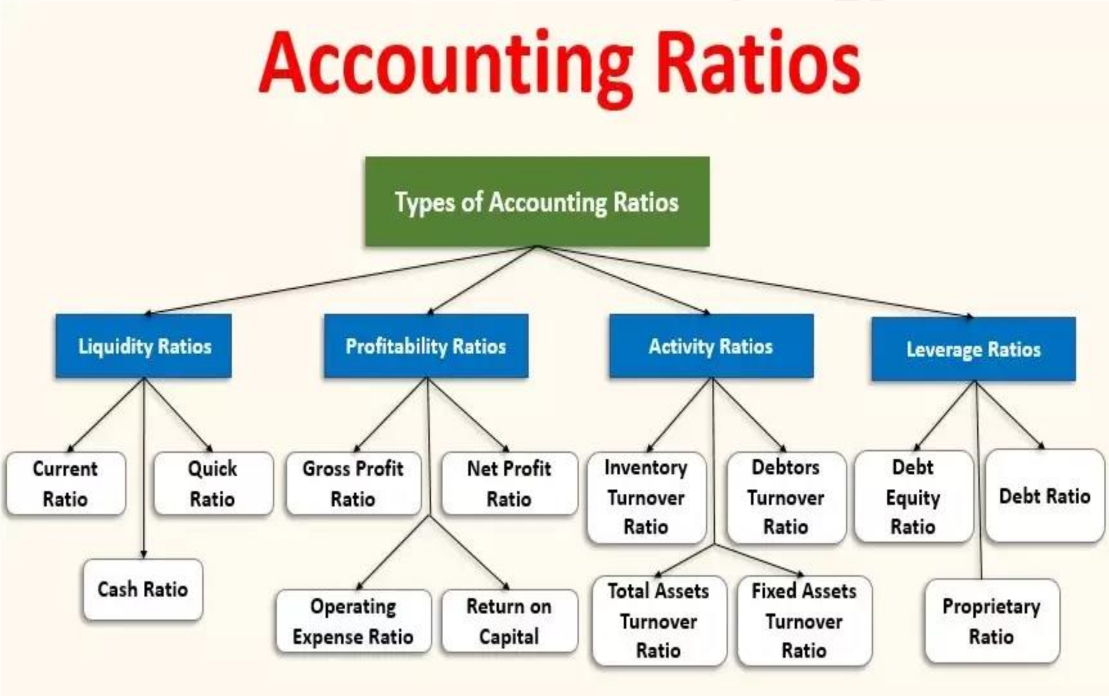
5. **Inter-firm Comparison**

6. **Trend Analysis**: Whether the financial position of a firm is improving or deteriorating over the years. This is made possible by the use of trend analysis.

3.7 Types of Ratios

In the view of financial management various ratios have been classified as-

1. Liquidity Ratios
2. Long-term Solvency and Leverage Ratios
3. Activity Ratios
4. Profitability Ratios



3.7.1 Liquidity Ratios

Liquidity or short-term solvency means ability of the business to pay its short-term liabilities.

.Current Ratio

i. Liquid Ratio
ii. Cash Ratio
iii. Interval Ratio

3.7.2 Long-term Solvency and Leverage Ratios (UPSC 1979)

A solvency ratio measures how well a company's cash flow can cover its long-term debt. The leverage ratios may be defined as those financial ratios which measure the **long-term stability and capital structure** of the firm.
Ratios includes:

Debt to capital Ratio

i. Debt Equity Ratio
ii. Debt to Total Assets Ratio
iii. Capital Gearing Ratio
iv. Proprietary Rati
v. Debt-Service Coverage Ratio (DSCR)
vi. Interest Coverage Ratio
vii. Preference Dividend Coverage Ratio
viii. Fixed Charges Coverage Ratio

3.7.3 Activity Ratios

These ratios are employed to **evaluate the efficiency with which the firm manages and utilises its assets**. For this reason, they are often called as 'Asset management ratios.

Total Assets Turnover Ratio

i. Fixed Assets Turnover Ratio
ii. Capital Turnover Ratio/ Net Assets Turnover Ratio
iii. Current Assets Turnover Ratio
iv. Working Capital Turnover Ratio
v. Inventory/ Stock Turnover Ratio
vi. Receivables (Debtors) Turnover Ratio
vii. Payables (Creditors) Turnover Ratio

3.7.4 Profitability Ratios

- The profitability ratios measure the **profitability or the operational efficiency** of the firm. These ratios reflect the final results of business operations.
- Therefore, the profitability ratios are broadly classified in four categories:

i. **Profitability Ratios based on Sales**
   (a) Gross Profit Ratio
   (b) Net Profit Ratio
   (c) Operating Profit Ratio
   (d) Expenses Ratio

ii. **Profitability Ratios related to Overall Return on Assets/ Investments**
   (a) Return on Investments (ROI)
   (b) Return on Assets (ROA)

(c) Return of Capital Employed (ROCE)
(d) Return on Equity (ROE)

iii. Profitability Ratios required for Analysis from Owner's Point of View

(a) Earnings per Share (EPS)
(b) Dividend per Share (DPS)
(c) Dividend Pay-out Ratio (DP)

iv. Profitability Ratios related to Market/ Valuation/ Investors

(a) Price Earnings (P/E) Ratio
(b) Dividend and Earning Yield
(c) Market Value/ Book Value per Share (MV/BV)
(d) Q Ratio

3.8 Current Ratio

- The current ratio of a firm measures its short-term solvency, that is, its ability to meet short-term obligations.
- As a measure of short-term/ current financial liquidity, it indicates the rupees of current assets (cash balance and its potential source of cash) available for each rupee of current liability/ obligation payable.
- The higher the current ratio, the larger is the amount of rupees available per rupee of current liability, the more is the firm's ability to meet current obligations and the greater is the safety of funds of short-term creditors.
- Thus, the current ratio, in a way, is a measure of margin of safety to the creditors.

Current Ratio = Current Assets Current Liabilities

Components	
Current Assets	**Current Liabilities**
Cash in hand, Cash at bank, Marketable Securities, Prepaid Expenses, Inventories, Sundry Debtors, Bill Receivables, Short term investments, Work-in-progress.	Sundry Creditors, Short-term Loans, Bank Overdraft, Outstanding Expenses/accrued expenses, Provision for Taxation, Proposed Dividend, Unclaimed Dividend.

Satisfactory Ratio	**High Ratio**	**Low Ratio**
2:1	It indicates the liquidity of a firm and ability to pay its current obligation.	It represents the bad liquidity position of a firm, and the firm shall not be able to pay its current liabilities in time.

3.9 Acid Test Ratio

- Acid-test ratio (quick ratio) is a measure of liquidity calculated by dividing current assets minus inventory and prepaid expenses by the current liabilities. It is also known as the Quick or Liquid Ratio.
- The term quick assets refer to current assets which can be converted into cash immediately or at a short notice without diminution of value. Included in this category of current assets are (i) cash and bank balances; (ii) short-term marketable securities and (iii) debtors/ receivables.
- Thus, the current assets which are excluded are: prepaid expenses and inventory. The exclusion of inventory is based on the reasoning that it is not easily and readily convertible into cash.
- Prepaid expenses by their very nature are not available to pay off current debts. They merely reduce the amount of cash required in one period because of payment in a prior period.

Quick Ratio = Quick Assets - Quick Liabilities

Components	
Quick Assets	**Current Liabilities**
Cash in hand, Cash at bank, Bill Receivables, Sundry Debtors, Marketable Securities, Short term Investments.	Sundry Creditors, Short-term Loans, Bank Overdraft, Outstanding Expenses/accrued expenses, Income tax payable, Proposed Dividend, Unclaimed Dividend.

Interpretation

Satisfactory Ratio	**High Ratio**	**Low Ratio**
1:1	It indicates that the firm is liquid and can meet its current or liquid liabilities in time.	It represents that the firm's liquidity position is not good.

3.10 Cash Ratio

- The cash ratio is calculated by dividing the super-quick assets by the current liabilities of a firm.
- The super-quick current assets are cash and marketable securities. This ratio is the most rigorous and conservative test of a firm's liquidity position

Cash Ratio = Absolute liquid assets Current Liabilities

3.11 Defensive Interval Ratio

- The defensive-interval ratio provides a measure of liquidity. It is a ratio between the quick/ liquid assets and the projected daily cash requirements. It is also known as Interval Measure

Defensive Interval Ratio = Liquid Assets Projected daily cash requirement Projected Daily cash requirement = Projected daily operating expenditure No. of days in a year

Components	
Quick Assets	**Average Daily Cash Operating Expenses**
Cash in hand, Cash at bank, Bill Receivables, Sundry Debtors, Marketable Securities, Short term Investments.	[(COGS + Adm. & Office expenses + Sell. & Dis. Expenses) – (Dep. And other non-cash expense)] / No. of days in a year.

Satisfactory Ratio	**High Ratio**	**Low Ratio**
1:1	It helps to determine the number of days for which the company can cover its cash expenses without the aid of additional financing.	It represents that the firm's liquidity position is not good.

3.12 Debt Equity Ratio

- Debt-Equity Ratio measures the relationship between long-term debt and equity. If the debt component of the total long-term funds employed is small, outsiders feel more secure.
- From a security point of view, a capital structure with less debt and more equity is considered favourable as it reduces the chances of bankruptcy.

Formula Debt-ratio= Long - term Debts Shareholders Fund

Satisfactory Ratio	**High Ratio**	**Low Ratio**
2:1	A high debt to equity ratio here means less protection for creditors.	It indicates a wider safety cushion (i.e., creditors feel the owner's funds can help absorb possible losses of income and capital).

3.13 Equity Ratio

- The shareholder's equity is Equity share capital and Reserves & Surplus (excluding fictitious assets etc).

- Net Assets or Capital employed includes Net Fixed Assets and Net Current Assets (Current Assets – Current Liabilities).
- This ratio indicates the proportion of the owner's fund to the total fund invested in the business. Traditionally, it is believed that the higher the proportion of the owner's fund, the lower the degree of risk for potential lenders.

  Formula Equity Ratio = Shareholder’s Equity Net Assets

Components	
Shareholder's equity	**Net Assets or Capital employed**
Equity share capital and Reserves & Surplus (excluding fictitious assets etc).	Net Fixed Assets and Net Current Assets (Current Assets – Current Liabilities).

3.14 Capital Gearing Ratio

- In addition to debt-equity ratio, sometimes capital gearing ratio is also calculated to show the proportion of fixed interest (dividend) bearing capital to funds belonging to equity shareholders i.e. equity funds or net worth.

Capital Gearing Ratio = Long term Debt + Preference Sh. Equity + Reserve and surplus

Satisfactory Ratio	High Ratio	Low Ratio
<0.50	It means the company has a larger proportion of debt versus equity.	It means the company has a small proportion of debt versus equity.

3.15 Proprietary Ratio

- Proprietary ratio expresses the relationship of the proprietor’s (shareholders) funds to net assets. The proprietary fund includes Equity Share Capital, Preference Share Capital and Reserve & Surplus. Total assets exclude fictitious assets and losses.

Proprietary Ratio = Shareholder’s Funds/Capital employed (or net assets)

Significance

- Higher proportion of shareholders’ funds in financing the assets is a positive feature as it provides security to creditors.
- This ratio can also be computed in relation to total assets instead of net assets (capital employed).
- It may be noted that the total of debt to capital employed ratio and proprietary ratio is equal to 1.

Satisfactory Ratio	High Ratio	Low Ratio
0.50:1	It indicates that a business is in a strong position and provides security to creditors.	It shows the dependence of the company on the debt financing in order to run its business.

3.16 Debt Ratio

- The term debt ratio refers to a financial ratio that measures the extent of a company's leverage.
- Total debt or total outside liabilities includes short and long term borrowings from financial institutions, debentures/bonds, deferred payment arrangements for buying capital equipment, bank borrowings, public deposits and any other interest bearing loan.
- A ratio greater than 1 would mean greater portion of company assets are funded by debt and could be a risky scenario.

Debt Ratio = Total debt Total assets

Satisfactory Ratio	High Ratio	Low Ratio
<0.50	It means the company has more debt than assets.	It means the company has lower risk.

3.17 Debt Service Coverage Ratio (DSCR)

- Debt-Service Coverage Ratio (DSCR) is considered a more comprehensive and apt measure to compute debt service capacity of a business firm.
- It provides the value in terms of the number of times the total debt service obligations consisting of interest and repayment of principal in installments are covered by the total operating funds available after the payment of taxes: Earnings after taxes, EAT + Interest + Depreciation + Other non-cash expenditures like amortization

Formula

Debt Service Coverage Ratio = Earnings available for Debt services Interest + Installment

Components	
Earnings available for debt service	**Interest & Installments**
Net profit (Earning after taxes) + Non-cash operating expenses like depreciation and other amortizations + Interest + other adjustments like loss on sale of Fixed Asset etc.	Interest + Installments

Satisfactory Ratio	High Ratio	Low Ratio
1.5 - 2	The higher the ratio, the better it is.	It indicates that the firm does not generate enough cash internally to service debt.

3.18 Interest Coverage Ratio

- It indicates the firm's ability to meet interest (and other fixed charges) obligations. It is also known as the times interest earned ratio.

Interest Coverage Ratio = EBIT (Earnings available to equity shareholders) Interest

Satisfactory Ratio	High Ratio	Low Ratio
At least 2 or 3	It means that an enterprise can easily meet its interest obligations even if earnings before interest and taxes suffer a considerable decline.	It indicates excessive use of debt or inefficient operations.

3.19 Preference Dividend Coverage Ratio

- This ratio measures the ability of a firm to pay dividend on preference shares which carry a stated rate of return.
- A higher ratio is desirable from preference shareholders point of view

Preference Dividend Coverage Ratio = Net profit /Preference dividend

3.20 Fixed Charges Coverage Ratio

- This ratio shows how many times the cash flow before interest and taxes covers all fixed financing charges.
- This ratio of more than 1 is considered safe

Fixed Charges Coverage Ratio = (EBIT + Dep.) (Interest + Repayment of loan)

3.21 Net Assets or Capital Employed Turnover Ratio

- It reflects the relationship between revenue from operations and net assets (capital employed) in the business. Higher turnover means better activity and profitability.

Net Asset Turnover Ratio = Revenue from Operation/ Capital Employed

3.22 Fixed Assets Turnover Ratio

- Fixed Assets Turnover Ratio measures the efficiency with which the firm uses its fixed assets.

- A high fixed assets turnover ratio indicates efficient utilisation of fixed assets in generating sales.

Fixed Assets Turnover Ratio = Net Revenue from Operation/ Net Fixed Assets

3.23 Inventory Turnover Ratio

- It determines the number of times inventory is converted into revenue from operations during the accounting period under consideration.
- It expresses the relationship between the cost of revenue from operations and average inventory. It is also known as the Stock turnover ratio

Inventory Turnover Ratio = (Sales or COGS) Average Inventory Average Inventory = (Opening Stock + Closing Stock) 2

Satisfactory Ratio	High Ratio	Low Ratio
>5	A high ratio is good from the view point of liquidity and vice versa.	It indicates that inventory is not used/ sold/ lost and stays in a shelf or in the warehouse for a long time.

3.24 Debtors Turnover Ratio

- It is determined by dividing the net credit sales by average debtors outstanding during the year.
- Net credit sales consist of gross credit sales minus returns, if any, from customers.
- Average debtors is the simple average of debtors (including bills receivable) at the beginning and at the end of year.
- The analysis of the debtor's turnover ratio supplements the information regarding the liquidity of one item of current assets of the firm.
- The ratio measures how rapidly receivables are collected.

Debtors Turnover Ratio = Net Credit sales/ Average Debtors

Satisfactory Ratio	High Ratio	Low Ratio
>4	A high ratio is indicative of shorter time-lag between credit sales and cash collection.	A low ratio shows that debts are not being collected rapidly.

3.25 Average Collection Period

Average collection period is the average amount of time needed to collect accounts receivable.

Average Collection Period = Average Accounts Receivables / Average Daily Credit Sales OR =Months days in a year X Debtors turnover ratio

3.26 Creditors Turnover Ratio

- It measures how fast a company makes payment to its creditors and shows the velocity of payables payment by the firm. It is also known as Payables turnover ratio.
- A low creditor's turnover ratio reflects liberal credit terms granted by suppliers, while a high ratio shows that accounts are settled rapidly.

Creditors Turnover Ratio = Net Credit Annual Purchases Average Trade Creditors

Satisfactory Ratio	High Ratio	Low Ratio
	A high ratio shows that accounts are settled rapidly	A low creditor's turnover ratio reflects liberal credit terms granted by suppliers.

3.27 Average Payment Period

- It represents the average number of days taken by the firm to pay its creditors.
- A higher ratio may imply that greater credit period enjoyed by the firm.
- The lower the ratio the better the liquidity position of the firm.

Average payment period = Average Accounts Payable Average Daily Credit Purchases OR = 12months /52weeks /360daysCreditors/ Payables turnover ratio

3.28 Working Capital Turnover Ratio

- It measures how effective a company is at generating sales for every rupee of working capital put to use.
- It indicates the no. of times the working capital is turned over in a year.

Formula

Working Capital Turnover Ratio = Sales Average Working Capital Average Working Capital = (Opening + Closing) 2

Satisfactory Ratio	High Ratio	Low Ratio
1.5-2	The more efficient is the utilisation of working capital in generating sales.	It indicates that a company is investing too much on account receivables and inventory to support sales.

3.29 Gross Profit Ratio

- Gross profit ratio as a percentage of revenue from operations is computed to have an idea about gross margin.

Gross Profit Ratio = Gross Profit / Net Revenue of Operations × 100

Satisfactory Ratio	High Ratio	Low Ratio
50%	It is a favorable sign of good management.	It indicates the high cost of goods sold due to unfavorable purchasing policies, lesser sales, high competition, etc.

3.30 Net Profit Ratio

- Net profit margin measures the percentage of each sales rupee remaining after all costs and expenses including interest and taxes have been deducted.
- The net profit margin is indicative of management's ability to operate the business with sufficient success not only to recover from revenues of the period, the cost of merchandise or services, the expenses of operating the business (including depreciation) and the cost of the borrowed funds, but also to leave a margin of reasonable compensation to the owners for providing their capital at risk.
- The ratio of net profit (after interest and taxes) to sales essentially expresses the cost price effectiveness of the operation.

Net Profit Ratio = Net profit/Revenue from Operation× 100

Satisfactory Ratio	High Ratio	Low Ratio
Depends	It would ensure adequate return to the owners as well as enable a firm to withstand adverse economic conditions when selling price is declining, cost of production is rising and demand for the product is falling.	It has the opposite implications.

3.31 Operating Profit Ratio

- Operating profit ratio is also calculated to evaluate operating performance of business.
- It measures the percentage of each sale in rupees that remains after the payment of all costs and expenses except for interest and taxes.

Operating Profit Ratio = Operating Profit/ Revenue from Operations × 100

3.32 Expense Ratio

- It is computed by dividing expenses by sales. The term 'expenses' includes (i) cost of goods sold, (ii) administrative expenses, (iii) selling and distribution expenses, (iv) financial expenses but excludes taxes, dividends and extraordinary losses due to theft of goods, good destroyed by fire and so on.

Formula

Cost of Goods Sold (COGS) Ratio = COGS Sales × 100 Operating Expenses Ratio = Administrative exp.+ Selling & Distribution OH Sales × 100 Operating Ratio = COGS + Operating expenses Sales × 100 Financial Expenses Ratio = Financial expenses Sales × 100

*It excludes taxes, loss due to theft, goods destroyed by fire etc.

3.33 Return on Investment

- Return on Investment estimates the loss and gain generated on the amount of money invested.
- ROI (Return on Investment) is generally expressed in the percentage to analyse an organisation's profit or the earnings of different investments.
- In simple words, Return on Investments estimates what you receive back as compared to what you invest.
- Return on Investment can be used in different ways to calculate the profitability of the business. It can be used by a company to estimate inventory investments, pricing policy, capital equipment investments, etc.,

Return on Investment = Return /Profit /Earnings Investment ×100

3.34 Return on Assets

- The profitability ratio is measured in terms of relationship between net profits and assets employed to earn that profit. This ratio measures the profitability of the firm in terms of assets employed in the firm.

ROA = Net Profit after taxes Average Total Assets or Average Tangible Assets or Average Fixed Assets

Here, net profit is exclusive of interest. As Assets are also financed by lenders, hence ROA can be calculated as:

= Net Profit after taxes +Interest Average Total Assets/Average Tangible Assets/Average Fixed Assets Or, = EBIT (1- t) Average Total Assets {also known as Return on Total Assets (ROTA)}

Satisfactory Ratio	High Ratio	Low Ratio
>5%	It indicates a more efficient use of company resources.	It indicates that the company is not able to make maximum use of its assets for getting more profits.

3.36 Return on Capital Employed

- It explains the overall utilisation of funds by a business enterprise. Capital employed means the long-term funds employed in the business and includes shareholders' funds, debentures and long-term loans.
- Alternatively, capital employed may be taken as the total of non-current assets and working capital. Profit refers to the Profit Before Interest and Tax (PBIT) for computation of this ratio.

ROCE (Pre-tax) = Earnings before interest and taxes (EBIT) Capital Employed × 100 ROCE (Post-tax) = EBIT(1-t) Capital Employed × 100

Sometimes, it is also calculated as:

= {[Net Profit after taxes (PAT /EAT) + Interest]/ Capital Employed} ×100
Where, Capital Employed = Total Assets – Current Liabilities Or
= Fixed Assets + Working Capital Or

= Equity + Long Term Debt

3.37 Return on Equity (ROE)

- Return on Equity (ROE) measures the profitability of equity funds invested in the firm. This ratio reveals how profitably of the owners' funds have been utilised by the firm.
- It also measures the percentage return generated to equity shareholders.
- Return on equity is one of the most important indicators of a firm's profitability and potential growth. Higher the ratio better it is.

Formula Return on Equity= Net Profit after taxes - Preference dividend (if any)Net Worth/ Equity Shareholders' Funds x 100

3.40 Equity Multiplier It is possible for a company with terrible sales and margins to take on excessive debt and artificially increase its return on equity. The equity multiplier, a measure of financial leverage, allows the investor to see what portion of the return on equity is the result of debt.

Equity Multiplier = Total Assets Total Equity Shareholders

3.41 Earnings per Share

- EPS measures the profit available to the equity shareholders on a per share basis, that is, the amount that they can get on every share held.
- It is calculated by dividing the profits available to the equity shareholders by the number of the outstanding shares.
- The profits available to the ordinary shareholders are represented by net profits after taxes and preference dividend.
- This ratio is very important from equity shareholders point of view and also for the share price in the stock market.

EPS = Earnings available to equity shareholder's Number of equity shares outstanding

3.42 Dividend per Share

- Dividend Per Share (DPS) is the dividends paid to the equity shareholders on a per share basis. In other words, DPS is the net distributed profit belonging to the ordinary shareholders divided by the number of ordinary shares outstanding.

DPS = Total dividend paid to Equity Shareholder Total no. of outstanding shares

3.43 Dividend Pay-out Ratio

- Dividend Pay-out (D/ P) Ratio is also known as pay-out ratio. It measures the relationship between the earnings belonging to the ordinary shareholders and the dividend paid to them.
- In other words, the D/ P ratio shows what percentage share of the net profits aftertaxes and preference dividend is paid out as dividend to the equity-holders.

Dividend Pay-out Ratio = Dividend per share Earnings per share

3.44 Price- Earnings Ratio

- Price/ Earnings (P/ E) ratio measures the amount, investors are willing to pay for each rupee of earnings; the higher the ratio, the larger the investors' confidence in the firm's future.

Price- Earnings Ratio = Market price per share EPS

CHAPTER 6 - CASH FLOW STATEMENT

2.20 Meaning of Cash flow statement

- Statement that indicates sources of cash inflows and transactions of cash outflows of a firm during an accounting period. The activities/ transactions which generate cash inflows are known as sources of cash and activities which cause cash outflows are known as uses of cash.
- Provides information about the historical changes in cash and cash equivalents of an enterprise by classifying cash flows into operating, investing, and financing activities.
- The economic decisions that are taken by users require an evaluation of the ability of an enterprise to generate cash and cash equivalents and the timing and certainty of their generation.
- This statement provides relevant information in assessing a company's liquidity, quality of earnings, and solvency.

2.25 Elements of Cash

As per Accounting Standard-3, **'Cash' include:**

a) Cash in hand,
b) Demand deposits with banks, and

Cash equivalents include:

a) Components
- Short term highly liquid investments that are readily convertible into known amounts of cash and which are subject to an insignificant risk of changes in value
- Securities with a short maturity period of, say, three months or less from the date of acquisition

b) Objective
- Deploy, for a short period, idle cash required to meet short-term cash commitments.

Examples: Acquisition of preference shares, shortly before their specified redemption date, bank deposits with a short maturity period, etc. **Conclusion** Thus, the cash flow statement deals with the flow of cash funds but does not consider the movements among cash, bank balance payable on demand, and investment of excess cash in cash equivalents. Examples are cash withdrawn from the current account, cash deposited in a bank for 60 days, etc.

2.26 Classification of Activities for the Preparation of Cash Flow Statement

These activities are to be classified into three categories:

1. Operating Activities
2. Investing Activities
3. Financing Activities

2.27 Cash from Operating Activities

- Operating activities are the activities that constitute the primary or main activities of an enterprise.
- These are the principal revenue-generating activities (or the main activities) of the enterprise and these activities are not investing or financing activities.
- **For example**, for a company manufacturing garments, operating activities are procurement of raw materials, the incurrence of manufacturing expenses, sale of garments, etc.

Cash Inflows (Receipts)	**Cash Outflows** (Payments)
Cash Sales	Cash Purchases
Debtors	Payment to creditors, employees
Commission and Royalty	Payment of wages

2.28 Cash from Investing Activities

- As per AS-3, Investing activities are the acquisition and disposal of long-term assets and other investments not included in cash equivalents.
- Investing activities relate to the purchase and sale of long-term assets or fixed assets such as machinery, furniture, land, and building, etc.
- Transactions related to long-term investment are also investing activities.

Cash Inflows	**Cash Outflows**
Proceeds from the sale of Fixed Assets and Investments	Purchase of long-term fixed assets such as Land & Building, Plant & Machinery, Investments, etc.
Interest and dividends received	Purchase of shares, warrants or debt instruments of other enterprises

2.29 Cash from Financing Activities

- As per AS-3, Financing activities are activities that result in changes in the size and composition of the owners' capital(including preference share capital in case of a company) and borrowings of the enterprise.
- Financing activities relate to long-term funds or capital of an enterprise, e.g., cash proceeds from issue of equity shares, debentures, raising long-term bank loans, etc.

Cash Inflows	**Cash Outflows**

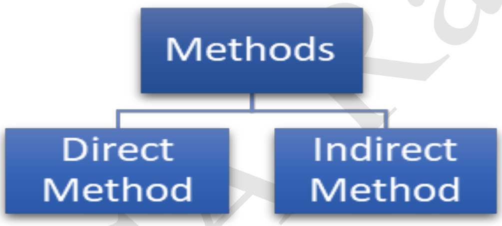
Proceeds from Issue of Shares and Debentures for Cash	Repayment of Loans
Proceeds from Long-term Borrowings such as Bonds, Loans, etc.	Redemption of Preference Shares and Debentures
	Buy-back of Equity Shares
	Payment of Dividend and Interest, etc.

2.31 Ascertaining Cash Flow from Operating Activities

- Operating activities are the main source of revenue and expenditure in an enterprise. Therefore, the ascertainment of cash flows from operating activities need special attention.
- As per AS-3, an enterprise should report cash flows from operating activities either by using:
    i. Direct method whereby major classes of gross cash receipts and gross cash payments are disclosed; or
    ii. Indirect method whereby net profit or loss is duly adjusted for the effects of:
        (1) transactions of a non-cash nature,
        (2) any deferrals or accruals of past/future operating cash receipts, and
        (3) items of income or expenses associated with investing or financing cash flows.

2.32 Calculation of Cash Flows from Operating Activities

An enterprise can determine cash flows from operating activities using either:



(a) **Direct Method**: The direct method, whereby major classes of gross cash receipts and gross cash payments are considered; or
(b) **Indirect Method**: The indirect method, whereby net profit or loss is adjusted for the effects of transactions of a non-cash nature, deferrals or accruals of past or future operating cash receipts or payments, and items of income or expense associated with investing or financing activities.

2.32.1 Direct Method

1. Information Required
    (a) Gross receipts and gross cash payments may be obtained from the accounting records to ascertain cash flows from operating activities.

For example, information about cash received from trade receivables, payment to trade payables, cash expenses etc., which may be obtained by an analysis of cash book.

(b) In actual practice, the relevant information is obtained by adjusting sales, cost of sales and other items in the profit and loss accounts for:

(i) Changes during the period in inventories and operating receivables and payables;

(ii) Other non-cash items such as depreciation on fixed assets, goodwill written off, preliminary expenses written off, loss or gain on sale of fixed assets etc.; and

(iii) Other items for which the cash effects are investing or financing cash flows. Examples are interest received and paid, dividend received and paid etc

2. The direct method provides information which may be useful in estimating future cash flows and which is not available under the indirect method and is, therefore, considered more appropriate than the indirect method.

Format For Computation of Cash from Operations under Direct Method

Cash Flow Statement for the year ended …….

Particulars	**Rs.**	**Rs.**
(I) Cash Flow from operating Activities		
A. Operating Cash Receipts, e.g.,		
– Cash Sales	XXX	
– Cash received from Customers	XXX	
– Trading commission received	XXX	
– Royalties received	XXX	XXX
B. Operating Cash Payments, e.g.,		
– Cash purchases	(XXX)	
– Cash paid to Suppliers	(XXX)	
– Cash paid for Business expenses like Office Expenses, Manufacturing Expenses, Selling and Distribution Expenses etc.	(XXX)	(XXX)

C. Cash generated from Operations (A-B)		XXX
D. Income Tax paid (Net Tax Refund received)		(XXX)
E. Cash Flow from Extraordinary Item		XXX
F. Extraordinary Items (Receipt / Payment)		(+/-) XXX
G. Net Cash from (or used in) Operating Activities		XXX
(II) Cash Flow from Investing Activities (same as indirect method)		XXX
(III) Cash Flow from Financing Activities (same as indirect method)		XXX
(IV) Net Increase/Decrease in Cash and Cash Equivalents		XXX
(Same as under Indirect method- I+II+III)		
(V) Add Cash and Cash Equivalents in the beginning of the year		XXX
(Same as indirect method)		
(VI) Cash and Cash Equivalents in the end of the year		XXX

2.32.2 Indirect Method

Under the indirect method, profit and loss account is adjusted for

(i) the effects of transactions of non-cash items such as depreciation, amortisation, deferred taxes, loss on sale of fixed assets and unrealised foreign exchange gains and losses,
(ii) changes during the period in inventories and operating receivables and payables, and
(iii) for all other items for which the cash effects are shown either in financing or investing activities.

Conclusion

1. It is worth noting that both direct and indirect methods adjust current assets and current liabilities related to operating activities to determine cash from operating activities.

2. But the direct method adjusts individual items of the profit and loss account and the indirect method adjusts overall net profit (or loss) to determine cash from operation.

3. Therefore, the indirect method fails to provide break-up of cash from operations

Some Special Items: In addition to the general classification of three types of cash flows, AS-3 has also dealt with and clarified the treatment of cash flow on account of certain items such as:

1. **Interest and Dividends** In the case of Financial Enterprise, Cash flows arising from interest paid and interest &dividends received should be classified as cash flow from operating activities.

- In the case of other enterprises –

  a) Cash flows arising from **interest paid** should be classified as cash flows from financing activities while **interest and dividends received** should be classified as cash flows from investing activities,
  b) **Dividend paid** is always classified as a financing activity. It is a cash outflow on account of financing activity irrespective of whether the company is a financial or non-financial company.

2. **Proposed Dividend** The proposed dividend of the current year becomes due and is also paid in the next year. It is an outflow of cash and cash equivalents in the next year.

   - The proposed dividend of the previous year becomes due and is also paid in the current year. It is an outflow of cash and cash equivalent in the current year.

   - The accounting treatment of the Proposed Dividend as per AS 3 shall be as follows:

     a) Proposed Dividend (**Current Year**): Add back to the current year's profits to find out cash from Operating Activities
     b) Proposed Dividend (**Previous year**): Cash used in Financing Activities.

3. **Interim Dividend** The Accounting treatment shall be as follows:

   a) Add back to the current year's profits to find out cash from Operating Activities.

   b) Show as cash used in Financing Activities in the cash flow statement.

4. **Tax on Income:** should be separately disclosed and be classified as cash flows from operating activities unless they can be specifically identified with financing and investing activities.

5. **Extraordinary Items** such as bad debts recovered, claims on insurance companies, winning of a lawsuit, lottery, etc., are shown separately as arising from operating, financing and investing activities in the cash flow statement.

6. **Non-cash Transaction** Examples of Non-Cash transactions are:

   The acquisition of assets by the issue of debentures.
   The acquisition of an enterprise by means of issue of shares and debentures.
   Conversion of debentures into shares
   - These transactions are shown separately as a footnote to the cash flow statement.

CHAPTER 7 - PARTNERSHIP ACCOUNTS

1. DEFINITION: "Partnership is the relation between persons who have agreed to share the profit of a business carried on by all or any of them acting for all."

FEATURES OF PARTNERSHIP

(i) Partnership is the result of an agreement:	It means that the relation of partnership arises from contract and not from status. For example, a joint family carrying on a family business or husband and wife carrying on business as such are not partners is such business. The reason is that such relations do not arise by agreement but are the results of status, operation of law, succession or inheritance. It may be added that a formal or written agreement is not necessary to create a partnership.
(ii) Business:	A partnership can exist only in business. Thus it is not the agreement alone which creates a partnership. A partnership comes into existence only when partners begin to carry on business in accordance with their agreement. Section 2 (6) only states that business includes every trade, occupation and profession. However broadly speaking, 'business' means any activity which if successful would result in profit. But whether temporary or permanent, the business must be in existence because an agreement to carry on business at a future time does not result in present partnership.
(iii) Sharing of profit	The persons concerned must agree to share the profits of the business. Because no person is a partner unless he or she has the right to share the profits of the business. Section 4 does not insist upon sharing of losses. Thus a provision for sharing of loss is not necessary.
(iv) Mutual agency:	It means that the business is to be carried on by all or any of them acting for all. Thus, if the person carrying on the business acts not only for himself but for others also so that they stand in the positions of principals and agents, they are partners.

2. NATURE OF PARTNERSHIP SUMMARISED

In short, Section 4 of the Partnership Act portrays the following four features of a partnership:

(i) A partnership is the result of an agreement.
(ii) A partnership is created to carry on a business and business alone.
(iii) Persons concerned agree to share the profits of the business. An agreement to share losses alone does not create a partnership.
(iv) The business is to be carried on by all or any of them acting for all.

MINIMUM AND MAXIMUM NUMBERS OF PARTNERS

Minimum Partners	**2 persons** must be required to form a partnership.
Maximum Partners	As per Indian Companies Act, 2013 a Partnership firm can have **maximum 100 Partners**. Though, it might sound strange but

	upper limit on number of partners are fixed under Companies Act and not in Partnership Act.

3. PARTNERSHIP DEED

A partnership deed is an agreement between the partners of a firm that outlines the terms and conditions of partnership among the partners. A **partnership firm** is one of the popular types of organisations for starting a new business.

- The smooth and successful running of a partnership firm requires a clear understanding among its partners regarding the various policies governing their partnership.
- The partnership deed serves this purpose. The partnership deed contains various terms such as profit/loss sharing, salary, interest on capital, drawings, admission of a new partner, etc. in order to bring clarity to the partners.
- A deed of partnership also known as a partnership agreement is a legal document signed by two or more partners who come together and decide to run a business for profit
- The partnership deed helps to resolve any disagreement or conflict which arises between the partners regarding the partnership norms.
- The purpose of a partnership deed is to give a clear understanding of the roles of all partners, ensuring the smooth running of the operations of the partnership firm.

3.1 Importance of Partnership Deed

A partnership deed defines the position of the partners of the firm. Below is the importance of a partnership deed:

- It regulates the liabilities, rights and duties of all partners.
- It helps to avoid misunderstandings between the partners since all of the terms and conditions of the partnership are specified in the deed.
- In the case of a dispute amongst the partners, it will be settled as per the terms of the partnership deed.
- There will be no confusion between the partners regarding the profit and loss sharing ratio amongst them.
- It mentions the role of each individual partner.

- It contains the remuneration that is to be paid to partners, thereby avoiding any dispute or confusion.

3.2 Contents of Partnership Deed

The partnership deed contains the following details:

Capital contribution	The amount of capital to be contributed by each partner. And also, whether the capital accounts are to be fixed or fluctuating amounts.
Drawings	The amount and period of drawings.
Interest on capital	Whether the interest on capital is to be allowed? If yes, at what rate?
Interest on drawings	Whether interest on drawings is to be charged? If yes, at what rate?
Interest on loan	The rate of interest on loan by a partner to the firm.
Profit-sharing ratio	The ratio in which profits or losses are to be shared by the partners.
Salary and commission	The amount of salary and commission to any partner and basis of their calculation.
Valuation of assets	The procedure for the valuation of assets in the event of reconstruction of the firm resulting from admission, retirement or death of a partner.
Valuation of goodwill	The method of valuation of goodwill on the reconstruction of the firm.
Accounting period	Whether the firm would adopt calendar year or financial year or any other period of 365 days for finalisation of accounts.
Settlement of accounts	The method of ascertaining or calculating the amount of a partner' share in the event of his retirement or death.
Settlement of accounts in the event of insolvency of a partner	The applicability of Garner vs. Murry rule or any other method.
Joint life policies	The treatment of premium on joint life insurance policies.

4.PROVISIONS OF PARTNERSHIP ACT AFFECTING ACCOUNTING TREATMENT
In the absence of a Partnership Deed (i.e. written agreement) the following provisions the Partnership Act having bearing on the accounting treatment shall apply

Profit-sharing ratio	The partners shall share profits and losses of the firm equally irrespective of amount of their capital contribution.
Interest on capital	No partner is allowed (or entitled to) interest on capital.
Interest on drawings	No interest is to be charged on drawings made by the partners in cash or kind.
Salary to partner(s)	A partner is not entitled to any salary or other remuneration (e.g. commission) for taking part in the conduct of the business.

Interest on partner' loan to the firm	If any partner makes a loan to the business in addition to his capital contribution, if any, he/she is entitled to receive interest @ 6% per annum.

5.CAPITAL ACCOUNTS

In a partnership firm, there is more than one capital account and the total number of capital accounts would depend on the number of partners. Whenever a partner introduces cash or property—stock, building, machine, patent etc. or both as his capital contribution, the following journal entry is made in the books of accounts**:**

Cash/Property Account Dr.

To Partner's Capital Account

5.1 FIXED CAPITAL ACCOUNT

- Partnership Deed that the amount of capital introduced by each partner shall remain fixed or unaltered at the original figure during the life of the Partnership.
- Capital accounts of partners are not debited or credited with any other transaction under fixed capital method
- Fixed capital method only credits capital contributions and debits specific withdrawals of capital
- Current Account or Drawings Account is opened for transactions such as drawings, interest on capital, interest on drawings salaries, share of profits or losses.
- Each partner has their own current Account or Drawings Account, such as A's Current Account or B's Current Account.

Debited with:	**Credited with**
(i) his/her drawings (in cash or kind	i) interest on his/her capital account, if any
(ii) interest on such drawings, if any;	ii) salary or commission payable to him/her
(iii) his/her share in the loss of business	(iii) his/her share in the profit of the business.

Current Account is a personal account and is shown as a separate account in the balance sheet.
The current account may sometimes have a debit balance indicating that the partner has withdrawn in excess of his share of profit and interest due to him or there is loss in the business. It will then appear in the assets side of the balance sheet without disturbing the capital account.

5.2 FLUCTUATING CAPITAL ACCOUNT

- Fluctuating means one that is not stable or one that is changing frequently. The same can be said about the fluctuating capital account. Under the fluctuating capital account, the capital of the partners keeps on fluctuating.

- The partners of the firm will have separate capital accounts and the capital accounts of each partner will be credited with the initial capital investment that is made individually by them and any additional capital investment done by them during the accounting period.
- The different kinds of adjustments that result in decrease of the capital will be debited to the partners capital account. The examples of such adjustments include drawings by each partner, loss share of the partner or interest on drawings.
- Similarly, the activities or adjustments that lead to increase in capital is credited to the partners capital account. Examples of such adjustments are salary of partners, interest received on capital and share of profit from the business for each partner.
- The capital account balance of each partner is shown on the balance sheet with debit balance being reflected in the asset side and credit balance on the liabilities side.

5.3 DISTINCTION BETWEEN FIXED AND FLUCTUATING CAPITAL ACCOUNTS

Points of Difference	**Fixed Capital Method**	**Fluctuating Capital Method**
1. Number of Accounts	Two accounts have to be maintained, namely: Capital Account and Current Account for each partner.	Only capital account is maintained for each partner .
2. Balance	Normally the balance in the capital account remains same except when capital in introduced or capital is withdrawn	The balance in the capital account changes every year because of profits/ losses, drawings, interest on capital, interest on drawings etc.
3. Adjustments for drawings, interest on drawings, interest on capital etc.	All adjustments in respect of profit/loss, drawings, interest on capital, interest on drawings, salary etc. are all made in the current account only	The adjustments for profit/loss, drawings, interest on capital, interest on drawings, salary etc. are all made in the capital account
4. Negative Balance	The capital account will always have a credit (or positive) balance while the current account may have debit or negative balance	Fluctuating capital may have sometime a debit or negative balance.

6 PROFIT AND LOSS APPROPRIATION ACCOUNT

- In a partnership, profit has to be divided between the partners in a certain profit-sharing ratio after making necessary adjustments stated in the partnership deed such as interest on capitals, drawings and loans; salaries or/and commission to partners etc.

- Accordingly, an additional account is prepared and net profit is transferred from the debit side of the profit and loss account to the credit side of this new account which is called **Profit and Loss Appropriation Account** and before the profit is divided between partners, it is necessary to record the above stated adjustments in this account.

NOTE:

(i) Under Fluctuating Capital Method, the entries in the **Profit and Loss Appropriation Account** would be made in the respective **Capital Accounts of the partners.**

(ii) Under Fixed Capital Method, entries would be made in the Profit and Loss Appropriation Account through respective Current **Accounts of the Partners.**

7 INTEREST ON CAPITAL

- Interest on capital is the interest allowed on capital allocated by the partners. Generally, if the partner's capital is unequal to the profit-sharing ratio, then the partners may agree to allow interest on capital.
- It will compensate the partners who have invested a high amount towards the capital. The rate of interest on capital is generally agreed upon by the partners of the business firm and is always mentioned in **the partnership deed**.
- It is permitted only when the business earns a profit, and it is provided before the division of profits among the partners.
- **No interest** is permitted on the capitals of partners if it is **not specifically mentioned** in the partnership deed
- When the business firm faces loss, the interest on capital will not be provided.
- If there is **insufficient profit**, that is, the net profit is less than the amount of interest on capital, interest on capital will **not be given**, but the profit among the partners of the business firm will be distributed in their capital ratio.

(i) For interest on capital

Profit and Loss Appropriation Account Dr.
To (Individual) Capital (or Current) Accounts of Partners

8 INTEREST ON DRAWINGS

Only when agreed upon

Interest on Drawing is to be charged to partners only if it is specifically agreed upon. If there is no mention in the partnership agreement regarding this, **no interest** need to be charged

@6% If rate is not mentioned

Where the partnership deed provide for charging interest on drawings and it does not mention the rate of interest to be charged it is convention to charge interest **6% p.a.**

For interest on drawings (Individual)

Capital (or Current) Accounts of Partners Dr.
To Profit and Loss Appropriation Account

9 PARTNERS' SALARY

- When there is an agreement for salaries to be paid to one or more partners, the salaries so paid are debited to profit and loss appropriation account and credited to the capital or current account(s) of the partner(s) concerned.
- The payment of salaries is regarded as a distribution of part of the profits of the firm. Thus, the amount of profits is reduced before it is divided in the agreed profit-sharing ratio. The accounting treatment is same when a partner is paid some bonus or commission.
- **Partners' salaries can be charged against profits while assessing the income for Income Tax purposes provided the firm has a Partnership Deed or instrument of partnership registered under Income Tax Act.**

For salary or bonus payable to a partner
Profit and Loss Appropriation Account Dr.
To (Individual) Capital (or Current) Accounts of the Partners

10. PARTNERS' LOAN ACCOUNTS

- Where a partner makes a loan to the firm in addition to his capital, he is a creditor of the firm for the amount of the loan and hence, a separate loan account is opened for him. The interest on loan shall be credited to his current or loan account.
- **The rate of interest on loan would depend on the agreement between the partners. But if there is no agreement the interest is to be paid at 6% p.a. as per the Partnership Act.**

11. CAPITAL RATIO

- Partners may agree to share profits and losses in the capital ratio. When capitals are fixed, profits will be shared in the ratio of given capitals.
- But if capitals are fluctuating and partners introduce or withdraw capitals during the year, the capitals for the purpose of ratio would be determined with reference to time on the basis of weighted average method.

12. ADMISSION OF NEW PARTNER

Section 31(1) of the Indian Partnership Act, 1932 provides that a person can be admitted as a new partner onlywith the consent of all the existing partners, unless otherwise agreed upon.

This is a form of reconstruction of partnership, as because whenever a new partner is admitted to a firm, the partnership between/among the existing partners comes to an end which begins a new partnership.

Usually the following accounting adjustments are required at

the time of such admission: 1. Computation of New Profit-Sharing Ratio 2. Revaluation of Assets and Liabilities 3. Distribution of Reserves, Accumulated Profits and Losses 4. Adjustment for Goodwill 5. Adjustments regarding Capital Contribution of new partner and the Capitals of the existing partners 6. Adjustment for Life Policy

12.1 Computation of New Profit-Sharing Ratio

- In the event of admission of a partner, the existing partners usually <u>sacrifice a share of their future profit</u>, which the new partner becomes entitled to.
- The ratio in which each of the existing partners <u>sacrifice their share of profit on the event of admission of a new partner</u> is referred to as **Sacrificing Ratio** [which is basically, **(Old Ratio – New Ratio)].**
- The new profit-sharing ratio may be agreed upon by the partners, or the mutual profit-sharing ratio among the existing partners may remain unchanged after giving away the share of the new partner.

12.2 Revaluation of Assets and Liabilities:

➢ In order to unveil any 'secret profit' or 'secret loss' existing in the books of accounts, the revaluation of Assets and Liabilities are done at the time of Admission (or any other form of Reconstruction), so that they reflect their fair values ➢ A firm earns profit as a result of increase in the value of assets and/or decrease in the value of liabilities. ➢ Similarly loss suffered by an entity when there is decrease in assets and/or increase in liabilities.

The effect of such revaluations are given by opening a Revaluation Account through the following journals:

Particular		**Journal Entry**
Assets	Upward revaluation	Asset A/c Dr. To Revaluation A/c
	Downward revaluation:	Revaluation A/c Dr. To Asset A/c
	Recording of unrecorded asset	Asset A/c Dr To Revaluation A/c
Liabilities	Upward revaluation:	Revaluation A/c Dr. To Liability A/c
	Downward revaluation:	Liability A/c Dr.

		To Revaluation A/c
	Recording of unrecorded liability	Revaluation A/c Dr To Liability A/c
Revaluation Expenses	Paid by the firm	Revaluation A/c Dr To Bank A/c
	Paid by the partner	Revaluation A/c Dr To Partner’s Capital A/c

A firm may decide to give the effect of such revaluations without incorporating the changes in the Balance Sheet values of those assets and liabilities. In that case, they **<u>have to</u>** open one **Memorandum Revaluation Account**. The preparation of Memorandum Revaluation Account involves the following:

(i) Record increase/decrease in the value of assets and liabilities as discussed.

(ii) Share the profit or loss on Revaluation amongst the old partners in their <u>old profit sharing Ratio.</u>

(iii) Reverse the increase/decrease in the value of assets and liabilities.

(iv) After reversal, calculate profit or loss.

(v) Share the profit/loss, after reversal amongst all the partners (including the new partner) in their new profit sharing ratio.

MEMORANDUM REVALUATION ACCOUNT

PARTICULAR	AMOUNT	PARTICULAR	AOMUNT
To Assets (Decrease)	xx	By Assets (Increase)	xx
To, Liabilities A/c (Increase)	xx	By, Liabilities A/c (Decrease)	xx
To, Partners Capital A/c (Share of Revaluation Profit) [Old Partners in old Profit sharing Ratio]	xx	By, Partners Capital A/c (Share of Revaluation loss) [Old Partners in their Oldprofit sharing ratio]	xx
To, Reversal of Items b/d	xx	By, Reversal of Items b/d	xx
To, Partners’ Capital A/c (Revaluation Profit amount all partners in new profit sharing Ratio)	xx	By, Partner(Revaluation loss amount all partners in their new Profit sharing (Ratio s’ Capital A/c)	xx

12.3 Distribution of Reserves, Accumulated Profits and Losses:

Reserves and accumulated profits or losses refer to the profits/losses that had been earned in preceding accounting periods but not yet distributed to the existing partners

For reserves and accumulated profits, partners’ capital accounts are credited and for accumulated losses partners’ capital accounts are debited in the old profit sharing ratio. The accounting entries are as follows:

In case of Reserves/ Accumulated Profits	
Under Fluctuating Capital Method	**Under Fixed Capital Method**
Reserves A/c Dr. Profit and Loss A/c Dr. To Partners' Capital A/c (Among old partners in old p.s.r.)	Reserves A/c Dr. Profit and Loss A/c Dr. To Partners' Current A/c (Among old partners in old p.s.r.)

In case of Accumulated Loss	
Partners' Capital A/c Dr. To Profit and Loss A/c (Among old partners in old p.s.r.)	Partners' Current A/c Dr. To Profit and Loss A/c (Among old partners in old p.s.r.)

12.4 ADJUSTMENT FOR GOODWILL:

- Due to the existence of goodwill (generated by the old partners), a firm may have the capacity to earn super- normal profit, the share of which will be enjoyed by the new partner from the moment of admission to the firm
- For this reason, an incoming partner is supposed to bring in, some extra amount in addition to the capital contribution.This extra amount is called Premium for Goodwill.
- **When the incoming partners brings in his share of Premium for goodwill then it is to be shared among the existing partners in the Sacrificing Ratio.**

Bank A/c Dr.

To, Sacrificing Partners' Capital A/c

- In case the incoming partner fails to bring in the Premium for Goodwill, it is to be checked whether thefailure on the part of the incoming partner is a 'temporary failure' or a 'permanent failure'

Temporary Failure: In such a case, accounting is done involving 'New Partner's Loan A/c', as follows:

New Partner's Loan A/c Dr.

To, Sacrificing Partners' Capital A/c

Permanent Failure: This adjustment can be given effect to in two alternative ways:

- Involving Goodwill Account; or
- Without involving Goodwill Account/ Capital Adjustment.

Involving Goodwill Account

In this case, the Goodwill account is first raised to its full value by giving due credit to the old partners, andsubsequently written-off among all the partners (including the new partner) as follows: 1. **Raising of Goodwill** Goodwill A/c Dr. To, Existing/ Old Partners' Capital A/c [in the old p.s.r.] 2. **Writing-off the Raised Goodwill** All Partners' Capital A/c Dr. To, Goodwill A/c [in new p.s.r.] **Without involving Goodwill Account/ Capital Adjustment** In this case, the accounting entries to be passed will involve the Partners' Capital Accounts, as follows: New Partner's Capital A/c Dr. To, Sacrificing Partners' Capital A/c

When the incoming partner fails to bring in his share of Premium for goodwill, it is adjusted through the Partners' Capital Accounts.

There are different methods of valuation of goodwill. They are discussed as under:

Valuation of Inherent or Non- Purchased Goodwill

Name of method	**Description of the Method**	**Other Consideration**
Average Profits Methods	Under this method - **Value of Goodwill = Agreed Number of Years (Purchase) × Average Maintainable Profits** Average Maintainable/Profit Average Annual Profits 00 [Simple average or may be weighted average considering the trend of profits] Less: "Exceptional/Casual Income 00 Add: Abnormal Loss 00 00 Add: Capital Expenditure wrongly charged against	i. If profits are fluctuating, simple average is taken. If profits show an increasing trend, weights may be used. If profits constantly decrease, the lowest of the profits after

	profits 00 00 Less: Provision for Taxation (As may be required) 00 Adjusted Maintainable Profits 000 ("Adjustments for undercharged or overcharged Depreciation or under or over valuation of stocks to be made, if required)	adjustments may be considered. ii. Exceptional Income or Expense of any particular year should better be adjusted against the profit of that year. iii. More weightage is usually given to later years.
Super Profits Methods	Super Profit = Future maintainable profits – NormalReturn on Capital Employed Goodwill = Super Profit × No. of years Steps to be followed Steps (a) Calculation of Capital employed OR Average Capital Employed	i. Calculation of Average capital Employed cannot be made if current years' profits are not separately given. ii. Trading Profits exclude any non trading income like Interest on Non- trading investments. iii. Adjustments against profits including provision for managerial remuneration, should be made. iv. If there is any change in the value of any

		fixed asset on revaluation, that does not affect Annual Trading Profit
		But adjustment for over charged or undercharged depreciation may be required to adjust the profits. v. If there is any decrease in the value of any Current Asset like bad debts or reduction of stock and that has not been adjusted, the adjustment should bemade for finding out correct Trading Profit of the current year. vi. For calculating capital employed, proposed dividend need not be deducted

	Sundry Assets 00 **Excluding:** i. Goodwill But including Goodwill at Cost Paid for ii. Non-trading assets and iii. Fictitious Assets Less: (i) Current Liabilities & Provisions -00 (ii) Contingent & Probable Liabilities -00 (Trading) **Capital Employed** 00 Less: ½ of Current years trading profits after taxation (ifthe profits remain undistributed) -00 **Average Capital Employed** 000	
	Step (b) Average Annual Adjusted Profits (Maintainable) 00 Step (c) Calculate Normal Return on Capital Employed or Average Capital Employed [Say at 10% or 12%, etc. — as may be given or assumed] **Step(d) Deduct Normal Return (c) from Average Maintainable Profits (b).** The difference is called **Annual Super Profit** **Step (e) Goodwill = Annual Super Profit × No. of Years for which the Super Profit can be maintained.** [Usually expressed as...years purchase of super profit]	
Capitalization of Profits Methods **(A) Profits**	Under the method follow these steps – a. Calculate Annual Maintainable Profit as shown above. b. Calculate normal Capital Employed capitalizing theabove profit by applying the normal rate of return. $\text{Normal Capital Employed} = \frac{\text{Maintainable Profit}}{\text{Normal Rate of Return}} \times 100$ c. Calculate actual Capital Employed d. Goodwill = Normal Capital Employed – Actual	Here also the profits should be adjusted considering necessary adjustments for managerial remunerations, change of depreciation, etc.

	capital Employed	
(B)Capi-talization of Super Profits	a. Calculate Super profit as said under Method 2. b. $\text{Goodwill} = \dfrac{\text{Super profit}}{\text{Normal Rate of Return}} \times 100$	
Annuity Method	It is a derivative of super profit concept. If super profit is expected to be earned uniformly over a number of years, Goodwill is computed with the help of Annuity Table. Calculate Super Profit as discussed before **Goodwill = Annual Super ProfitxPresent Value of** **Annuity of `1.**	Here also similar principles as said before should be followed for calculating — Capital Employed or Average Capital Employed, Annual Average Profits and Annual Super Profits

12.5 Adjustments regarding capital contribution of new partner and the capitals of the existing partners

- At the time of admission the incoming partner is required to bring capital into the firm, the amount of whichis mutually agreed upon by the partners.
- The capital introduced by the new partner may be either in cash or inthe form of any other assets.
- Necessary adjustments regarding revaluation profit/loss, distribution of reserves, adjustment for goodwill etc. are effected in the books of the firm and thus, the adjusted capital account balances arefound out which are shown in the Balance Sheet after admission of the new partner.
- The partners may decide to maintain the closing balances of their capital accounts in a pre-determined ratio.

12.6 ADJUSTMENT FOR LIFE POLICY:

- Joint Life Insurance Policy is a common Life insurance policy which covers the lives of all the partners of the firm and the premium of which is borne by the firm.
- The Surrender Value of the Joint Life Policy as on the date of admission is to be considered for the accounting purpose. The Maturity Value is irrelevant in these cases.

12 RETIREMENT /DEATH OF A PARTNER

Normally the retirement takes place by consent of all the partners and/or by other mode of communication by the intended partner to all other partners.

As per Section 32 of the Indian Partnership Act, 1932 a partner may retire:

- With the consent of all the existing partners; or
- In accordance with an express agreement by the partners; or
- By giving a written notice to all other partners of his intention to retire in case of
- 'Partnership at Will'.

After retirement of a partner, the other partners may continue the business. For paying off the retiring partner(s), some specific adjustments are required to be done in the books of the firm. These are discussed as follows:

- Calculation of new profit sharing ratio and gaining ratio,
- Distribution of reserves and accumulated profits and losses,
- Revaluation of assets and liabilities,
- Adjustment for goodwill,
- Adjustment for Joint Life Policy (JLP),
- Settlement of final balance of the retiring partner,
- Adjustment of existing partners' capital accounts

13.1 CALCULATION OF NEW PROFIT SHARING RATIO AND GAINING RATIO

- As a consequence of retirement, the share of profit of the retiring partner gets distributed to the continuing partners which results in again in the share of the continuing partners
- The ratio in which the continuing partners will share future profits and losses is known as the New Profit Sharing Ratio.
- The ratio in which the continuing partners acquire the share of profit forgone by the retiring partner is referred to as Gaining Ratio
- It is calculated by taking the difference between the old profit sharing ratio and the new profitsharing ratio.

13.2 DISTRIBUTION OF RESERVES AND ACCUMULATED PROFITS AND LOSSES

The balance of reserves or profit and loss account are distributed among all the partners (including the retiringpartner), in their **Old Profit Sharing Ratio** in the event of Retirement.

13.3 REVALUATION OF ASSETS AND LIABILITIES

The logic for revaluation of Assets and liabilities at the time of retirement of a partner is same as that at thetime of admission of a new partner.

In case of retirement, the revaluation profit or loss is distributed among all the partners in the **Old Profit Sharing Ratio.**

13.4 ADJUSTMENT FOR GOODWILL

- The goodwill of the existing partnership firm had been created and developed by all the existing partners (including the retiring partner). That is why the continuing partners are required to compensate the retiring partnerin their Gaining Ratio and the necessary adjustments for Goodwill is required to be made

- Gaining ratio is the ratio ofthe gain or increase in the profit share that is made by the continuing partners on the retirement of an outgoing partner.

- It is calculated by taking the difference between the old profit sharing ratio and new profit sharing ratio. The accounting treatment of goodwill in the event of retirement of a partner is as under:

Writing-off the value of Goodwill A/c (if any) appearing in the pre-retirement Balance Sheet of the firm:

All Partners' Capital A/c Dr. (in old p. s. r.)
To, Goodwill A/c (existing book value)

The Capital Accounts of the partners are required to be adjusted:

Gaining Partners' Capital A/c Dr. (in Gaining Ratio)
To, Outgoing Partner's A/c (with his share of goodwill)

13.5 ADJUSTMENT FOR JOINT LIFE POLICY (JLP)

- JOINT LIFE INSURANCE POLICY IS A COMMON LIFE INSURANCE POLICY WHICH COVERS THE LIVES OF ALL THE PARTNERS OF THE FIRM AND THE PREMIUM OF WHICH IS BORNE BY THE FIRM.
- THE SURRENDER VALUE OF THE JOINT LIFE POLICY AS ON THE DATE OF RECONSTITUTION (I.E. ADMISSION, RETIREMENT, CHANGE IN PROFIT SHARING RATIO) IS TO BE CONSIDERED FOR THE ACCOUNTING PURPOSE. THE MATURITY VALUE IS IRRELEVANT IN THESE CASES

13.6 SETTLEMENT OF FINAL BALANCE OF THE RETIRING PARTNER:

- The amount due to the retiring partner is ascertained and to be settled in a mode as decided by the firm according to the terms of the partnership deed; or in the absence of such deed it is to be mutually decided by the partners.
- THE AMOUNT DUE TO THE RETIRING PARTNER CAN EITHER BE DISCHARGED IMMEDIATELY AFTER HIS RETIREMENT BY PAYING OFF THEWHOLE AMOUNT USING THE BUSINESS FUNDS (I.E. CASH OR BANK), OR, IF THE FIRM IS HAVING PAUCITY OF LIQUID FUNDS, THEN THERETIRING PARTNER IS PAID IN A CERTAIN NUMBER OF INSTALMENTS. IN SUCH CASE, THE FIRM OPENS A LOAN ACCOUNT IN THE NAMEOF THE RETIRING PARTNER.

Right of retiring partner under Section 37 of the Indian Partnership Act,1932: The retiring partner has the option of claiming higher of the following amounts:

1. **Share in Profits:** The retiring partner's profit share is determined since the date of retirement which is to be calculated in the ratio of the present adjusted capitals or
2. **Interest @ 6% per annum:** Such interest is calculated on the amount due to the retiring partner from the firm for the period starting from the date of retirement up to the date of settlement.

13 DEATH OF PARTNER

In the event of death of a partner, the other partners may decide to continue the business which requires certain adjustments to be made in the books of accounts of the existing partnership firm which are as follows

- Calculation of new profit sharing ratio and gaining ratio,
- Distribution of reserves and accumulated profits and losses,
- Revaluation of assets and liabilities,
- Adjustment for goodwill,
- Adjustment for Joint Life Policy (JLP),
- Adjustment for interim period's profit/loss,
- Settlement of final balance of the deceased partner to his Executor.

14.1 CALCULATION OF NEW PROFIT SHARING RATIO AND GAINING RATIO:

- THE SHARE OF PROFIT OF THE DECEASED PARTNER GETS DISTRIBUTED TO THE CONTINUING PARTNERSWHICH RESULTS IN AGAIN IN THE SHARE OF THE CONTINUING PARTNERS.
- THE RATIO IN WHICH THE CONTINUING PARTNERS WILL SHAREFUTURE PROFITS AND LOSSES IS KNOWN AS THE NEW PROFIT SHARING RATIO.
- THE RATIO IN WHICH THE CONTINUING PARTNERS ACQUIRE THE SHARE OF PROFIT FORGONE BY THE DECEASED PARTNER IS REFERRED TO AS GAINING RATIO.
- It is calculated by takingthe difference between the old profit sharing ratio and the new profit sharing ratio.

14.2 DISTRIBUTION OF RESERVES AND ACCUMULATED PROFITS AND LOSSES:

The balance of reserves or undistributed profit (as represented by balance of Profit & Loss Account) are distributed among all the partners (including the Executor of deceased partner) in their old profit sharing ratio in the event ofdeath of a partner.

14.3 REVALUATION OF ASSETS AND LIABILITIES:

- The logic for revaluation of Assets and liabilities at the time of death of a partner is same as that at the time of admission of a new partner.
- In case of death, the revaluation profit or loss is distributed among all the partners (including the Executor of the deceased partner) in the Old Profit Sharing Ratio.

14.4 ADJUSTMENT FOR GOODWILL:

- The goodwill of the existing partnership firm had been created and developed by all the existing partners (including the deceased partner).
- So, the continuing partners are required to compensate the deceased partner in their Gaining Ratio and the necessary adjustment for Goodwill is required to be made.

14.5 ADJUSTMENT FOR JOINT LIFE POLICY (JLP):

- The mode of accounting for Joint life policy depends upon the accounting policy of the firm. Either JLP is treatedas an asset or as an expense in the books of the firm.
- Unlike Admission and Retirement, the Surrender Value has no role to play, only the maturity value of the Joint Life Policy is to be taken into consideration in the case of deathof a partner.

14.6 ADJUSTMENT FOR INTERIM PERIOD'S PROFIT/LOSS:

The amount of profit or loss, starting from the opening date of the accounting period ending up to the date of death, is to be determined (which is called as the interim period's profit or loss) and the share of the deceased partner in such Profit/Loss is to be duly accounted for. For thispurpose, generally a temporary account is opened in the books of the firm **called P/L Suspense A/**c.

Normally two approaches are there to estimate the profit or loss for the interim period:

- ❖ **On Time Basis:** Here the average profit of last periods is considered, which is apportioned between thepre-death period and the post-death period.

- **On Sales Basis:** Under this approach, the rate of profit on sales earned in the last year is computed and is applied to the interim period's sales.

14.7 SETTLEMENT OF FINAL BALANCE OF THE DECEASED PARTNER TO HIS EXECUTOR:
The amount payable to the representative of the deceased partner (commonly known as Executor) can be made either immediately or as deferred settlement.

The accounting procedure involved is similar to that followed in caseof retirement of a partner. The mode of payment depends on the agreement between the partners. It may be:

(i) **Lump Sum Payment:** If the firm has sufficient funds, the total amount payable on account of the deceased partner is transferred to his Representative's Account (or Executor). Such Representative's Account is debited and Bank Account is credited on payment of the dues.

(ii) **Instalment Payment/Loan Payment:** The firm may not have enough funds to make prompt payment. In such a case, the total amount payable is transferred to a loan account in the name of the legal representative or executor. The loan is paid off gradually by installments after considering interest on unpaid balance. The word "Loan" may or may not be appended with the Account. But its gradual payment will definitely resemble the payment of loan.

15 ADJUSTMENT OF JOINT LIFE POLICY

The treatment of joint life policy on the admission of a partner would depend on the fact whether the premium paid has been treated in the books of account as a revenue expenditure or capital expenditure. The accounting treatment would take into consideration this aspect.

A firm may decide to terminate i.e. surrender an insurance policy before its date of maturity. In that case, the insurance company pays an amount to the insured and this amount is referred to as 'Surrender Value'. This surrender value does not remain constant over the years. It gradually increases with time. It is considered to be its 'fair value' for the purpose of accounting

There are two broad methods of JLP accounting:

Method A: JLP is not treated as an asset in the books of the firm

Method B: JLP is treated as an asset the books of the firm

METHOD A: JLP IS NOT TREATED AS AN ASSET IN THE BOOKS OF THE FIRM

Under this method, the insurance premium paid on the joint life policy is treated as an 'expense' of the firm andnot as an asset. The insurance premium is debited to the Profit & Loss A/c and JLP A/c does not appear in the Balance Sheet. The surrender value of the JLP does not get reflected in the books.

On payment of insurance premium on joint life policy the following entries are passed as under:

Joint Life Policy Premium A/c Dr.
To, Bank A/c

P/L A/c Dr.
To, Joint Life Policy Premium A/c

ON CHANGE IN CONSTITUTION OF FIRM (I.E. ADMISSION, RETIREMENT, CHANGE IN PROFIT SHARING RATIO ETC.)

The surrender value of the JLP is accounted for in any one of the following two ways:

- By raising and writing-off JLP Account; or
- By adjusting the capital accounts of the partners

Raising and writing-off JLP Account

Raising of JLP A/c

JLP A/c Dr.
To, Existing Partners' Capital A/c (in old p.s.r.)

Writing-off JLP A/c

Continuing Partners' Capital A/c Dr.
TO, JLP A/C (IN NEW P.S.R.)

Adjusting the capital accounts of thepartners

Gaining Partners' Capital A/c Dr.
To, Sacrificing Partners' Capital A/c

ON THE EVENT OF DEATH OF A PARTNER

The JLP taken by the firm matures, and the policy value is received by the firm and it gets distributed among allthe existing partners in their old profit sharing ratio. It is accounted for as under:

On maturity of the JLP	JLP Receivable A/c To, Existing Partners' Capital A/c (in old p.s.r.)	Dr.
On receipt of maturity value	Bank A/c To, JLP Receivable A/c	Dr.

METHOD B: JLP IS TREATED AS AN ASSET IN THE BOOKS OF THE FIRM

- UNDER THIS METHOD, THE INSURANCE PREMIUM PAID ON THE JOINT LIFE POLICY IS TREATED AS 'INVESTMENT IN AN ASSET' OF THE FIRM. IT IS REFLECTED IN THE BALANCE SHEET AT ITS SURRENDER VALUE.
- THE SURRENDER VALUE OF THE JLP ON ANY DATE HAPPENS TO BE LOWER THAN THE AMOUNT OF THE TOTAL AMOUNT OF INSURANCE PREMIUM PAID ON THE JLP OVER THE YEARS.
- SO, TO MAINTAIN THE JLP A/C AT ITS SURRENDER VALUE, THE DIFFERENCE BETWEEN THE AMOUNT OF PREMIUM PAID AND THE SURRENDER VALUE AS ON THE DATE OF PREPARATION OF THE BALANCE SHEET IS WRITTEN- OFF.
- FOR THE PURPOSE OF ENSURING THAT THE JLP A/C IS REFLECTED AT ITS SURRENDER VALUE, THERE ARE TWO RECOGNISED METHODS OF ACCOUNTING. THEY ARE DISCUSSED AS UNDER:

APPROACH 1: SURRENDER VALUE METHOD

In this case one ledger account – Joint Life Policy Account (JLP A/c) is maintained. The insurance premium paid on the joint life policy is recorded in the **JLP A/c as under:**

JLP A/c Dr.
To, Bank A/c

Thereafter for ensuring that this JLP A/c is maintained at its 'surrender value', the excess of premium paid over the increase in surrender value is debited to the Profit & Loss A/c by passing the following entry:

P/L A/c Dr.

To, JLP A/c

This ensures that JLP A/c appears in the Balance Sheet of the firm at its 'Surrender value'.

APPROACH 2: JOINT LIFE POLICY RESERVE METHOD

Under this method, two ledger accounts are maintained – Joint Life Policy Account (JLP A/c) and Joint LifePolicy Reserve Account (JLP Reserve A/c).

In this case, the insurance premium paid on the joint life policy is treated as an investment in joint life policy. Itis debited to the JLP A/c as under:

JLP A/c Dr.

To, Bank A/c

Moreover, the insurance premium paid on the joint life policy is considered as an 'appropriation of profit' and so it is provided through JLP Reserve A/c. In this case, an amount equal to the insurance premium is debited to the Profit & Loss Appropriation A/c, as follows:

P/L Appropriation A/c Dr.

To, JLP Reserve A/c

Both the JLP A/c and JLP Reserve A/c appear in the Balance Sheet of the firm in the Asset-side and Liabilities-side respectively.

Further, for ensuring that JLP A/c and JLP Reserve A/c are maintained at its 'surrender value', the excess of premium paid over the increase in surrender value is adjusted between JLP A/c and JLP Reserve A/c by passing the following entry:

JLP Reserve A/c Dr.

To, JLP A/c

The above entry ensures that both JLP A/c and JLP Reserve A/c appear in the Balance Sheet of the firm at the '**Surrender value'.**

ON CHANGE IN CONSTITUTION OF FIRM (I.E. ADMISSION, RETIREMENT, CHANGE IN PROFIT SHARING RATIO)

Under the 'Surrender Value Method': JLP is considered as an asset and it already appears in the books of the firm at the surrender value. As such no further accounting treatment is required.

Under the 'JLP Reserve Method': both the JLP A/c and JLP Reserve A/c appear in the books of the firm at surrender value.

CASE	TREATMENT
If the partners decide not to maintain the JLP Reserve A/c	JLP Reserve A/c is written-back and distributed among the existing partners' inold P.S.R.: **JLP Reserve A/c Dr.** **To, Existing Partners' Capital A/c (in old P.S.R.)**
If the partners decide to keep on maintaining the JLP Reserve A/c	Adjustment is required to be made through Partners' Capital A/c: **Gaining Partners' Capital A/c Dr.** **To, Sacrificing Partners' Capital A/c**

ON THE EVENT OF DEATH OF A PARTNER

The JLP matures, and the maturity value of the policy is received by the firm. Thereafter it gets distributed among all the existing partners in their old p.s.r.

Transaction	Surrender Value Method	JLP Reserve Method
On death of partner i.e. maturity ofthe JLP	JLP Receivable A/c Dr. To, JLP A/c (with Maturity Value)	JLP Receivable A/c Dr. To, JLP A/c (with Maturity Value)
On receipt of maturity value	Bank A/c Dr. To, JLP Receivable A/c	Bank A/c Dr. To, JLP Receivable A/c
Closing of JLP Reserve A/c by transfer to JLP A/c	N.A.	JLP Reserve A/c Dr. To, JLP A/c (with 'last recorded Surrender Value')
Closing of JLP A/c	JLP A/c Dr. To, All Partners' Capital A/c (with the difference between 'last recorded surrender value' and 'maturity value' in old P.S.R.)	JLP A/c Dr. To, All Partners' Capital A/c (with the difference between 'current year premium paid, if any' and

		‘maturity value’ in old P.S.R.)

16 DISSOLUTION OF FIRM

- Whenever a reconstitution takes place within a Partnership in the form of admission, retirement or death of a Partner, the existing partnership is dissolved. The Partnership firm, may however, continue, if the remaining partners desire so.
- But if the partnership firm is discontinued for any reason, that is called Dissolution of the firm. Dissolution of Firm – when does it take place [in accordance with the Indian Partnership Act of 1932]

1. By Mutual consent of all the partners or in accordance with a contract made by them [Section 40]
2. By Notice – given in writing, by any partner to all other partners if the Partnership is at will [Section 43].
3. On the happening of any one of the following events: [Section 42] :
   (i) expiry of the term, where the Partnership was constituted for a fixed term;
   (ii) completion of the adventure for which the firm was constituted;
   (iii) Death of a partner,
   (iv) Adjudication of a Partner as insolvent.
4. Compulsory Dissolution [Section 41]
   (i) Where all the partners or all but one are adjudged insolvent.
   (ii) If any event occurs making it unlawful for the business of the firm to be carried on.
5. Dissolution by Court: According to Section 44 of the Indian Partnership Act the court, at the suit of a partner,
   may dissolve a firm on any one of the grounds namely –
   (i) insanity of a partner;
   (ii) permanent incapability of a partner to do his duties;
   (iii) if a partner is guilty of misconduct that might affect prejudicially the carrying on of the business;
   (iv) If a partner willfully or persistently commits breach of agreement;
   (v) If a partner transfers all his shares to a third party or has allowed his share to be charged under the
   Provisions of Rule 49 of order XXI of the First Schedule to the Code of Civil Procedure, 1908;
   (vi) If the court considers that the business cannot be carried on except at loss;
   (vii) On any other ground on which the court considers the dissolution as just and equitable.

16.1 SETTLEMENT OF ACCOUNTS ON DISSOLUTION

According to Section 48 of the Indian Partnership Act the following rules should be observed for settlement of Accounts after dissolution, subject to agreement by partners :

Regarding Losses : "Losses, including deficiencies of capital, shall be paid first out of profits, next out of capital, and lastly if necessary, by the partners individually in the proportions in which they are entitled to share profits". [Section 48(1)]

Regarding Assets : "The assets of the firm, including any sums contributed by the partners to make updeficiencies of capital, shall be applied in the following manner and order :

(i) in paying the debts of the firm to third parties;

(ii) In paying each partner rateably what is due to him from the firm for advances as distinguished from capital;

(iii) In paying to each partner rateably what is due to him as capital; and

(iv) The residue, if any, shall be divided among the partners in the proportions in which they are entitled to share profits." [Section 48(2)]

ACCOUNTING ENTRIES REGARDING DISSOLUTION

The two separate aspects of Dissolution for which accounting entries have to be made are:

[A] Realization of Assets and Payment of liabilities and [B] Settlement of the dues of the Partners,

[A] REALIZATION OF ASSETS AND PAYMENT OF LIABILITIES

(i) Prepare Realisation Account

(ii) Transfer all assets (except cash, bank & fictitious assets) and liabilities at book values to Realisation Account.

JOURNAL ENTRIES

ITEM	ENTRY	SPECIAL POINTS TO BE NOTED
1. Transfer of book values of assets as recorded in the Balance Sheet	Realization A/c Dr. To, Sundry Assets [Book value] (including goodwill if any, shownin the Balance Sheet) Realization A/c Dr. To, Debtors A/c Provision for Bad Debts	(a) Cash or Bank A/c are not to be credited unless the firm, asa whole, is sold out as a going concern. (b) Debit balance of any Cap. A/c etc. or Debit balance of P/L A/c not to be transferred to Realization A/c. (c) If there is any Provision for badDebts, debit Realization

	A/c Dr. To, Realization A/c	A/c and credit Debtors A/c with gross figure. Then debit Provision A/c and credit Realization A/c.Same treatment for Provision for Depreciation.
2.Realization/Sale of above Assets	Cash/Bank A/c (amt. realized) Dr. Or Partners Cap. A/c Dr. (agreed value at which a partnertakes over an asset/assets) To, Realization A/c.	
3. Shares etc. received as purchaseconsideration	In exchange of the firm's assets.Shares A/c Dr. To, Realization A/c. (agreed value)	
4. Closing the External liabilities	External Liabilities A/c Dr. (such as creditors, outstandingexpenses, Bank Loan etc.) To, Realization A/c. (book value)	(a) Alternatively – this entry may be passed (combining 4,5 & 6)Liability A/c................Dr. To, Bank A/c (actual amt. paid) OR,
5. External liabilities taken over by any partner	Realization A/c. Dr. To, Particular Partner's Cap. A/c (agreed value)	To, Partners Cap. A/c (agreed value) To, Realization A/c (Discount, if any received on payment/discharge) Where assets and liabilities are taken over by another business on making some lump sum payment, separate entries for realization of assets and / payment of liabilities need not be made.
7. Unrecorded asset sold or takenover by any partner	Cash/Bank A/c Dr. Partners Capital A/c Dr. To, Realisation A/c	
8. If any unrecorded	Realization A/c Dr.	

liability is paid.	To, Cash/Bank A/c(actual amt.)	
9. If shares etc. received and shown in (3) above are sold out or transferred to partners	Cash/Bank A/c Dr. Or, Partners Cap. A/c Dr.[excluding insolvent partner] To, shares A/c	For sale, there may be profit or loss on sale which is transferred toRealization A/c.
10. Payment of Expenses of Realization.	Realization A/c Dr. To, Cash/Bank A/c (if paid by the firm) Or, To, Partners Cap. A/c (if paid by any partner)	If a partner bears such expenses personally in pursuance of a separate agreement – NO ENTRY is required.
11. Balance of Realization Account representing Profit or Loss on Realization.	Realization A/c. Dr. To, Partners Cap. A/c (Profit shared in Profit SharingRatio) Or, Partner's Cap. A/c Dr. To, Realization A/c. (Loss shared in Profit SharingRatio)	

[B] Settlement of Partners Dues – through Capital Accounts

ITEM	ENTRY	SPECIAL POINTS TO BE NOTED
1. Prepare Capital Accounts with balance as per Balance Sheet before the dissolution.	By Balance b/d (Cr. balance) To, Balance b/d (Dr. balance)	
2. Transfer of Current A/c, if any.	Partner's Current A/c Dr.To, Partner's Cap. A/c. (Credit Balance) Or Partner's Capital A/c …Dr. To, Partner's Current A/c (Debit balance)	
3. Undistributed Profit, Reserve,Joint Life Policy Reserve, Investment Fluctuation Fund,	Profit & Loss (Cr.) A/c…Dr. Or, Any Reserve A/c Dr.	

Contingency Reserve etc. transfer	To, Partner's Capital A/cs [Profit sharing ratio]	
4. Undistributed Loss, Fictitious/ Unrealizable Assets etc. transfer.	Partners Capital A/c… Dr. To, Profit & Loss (Dr.) A/c Or, To, Fictitious Assets A/c (Profit Sharing Ratio)	Example of unrealizable Asset- Advertisement Suspense A/c
SSS5. Any loan taken from anypartner	Partner's Loan A/c …. Dr. To, Cash/Bank A/c	u/s 48 Repayment of loan should enjoy priority over repayment of capital.
6. Any loan given to any partner	Cash/Bank A/c….. Dr.To, Partner's Loan A/c Or Partner's Capital A/c Dr. To Partner's Loan A/c	If such amount is realized. Adjustment of loan against Capital
7. If any Partner's Capital A/c shows a debit balance (after balancing)	Cash/Bank A/c….. Dr.To, Particulars Partner's Capital A/c [Cash brought in to make up theshortfall]	If the deficient partner is insolvent, treatment will be different- Vide – Insolvency of Partner
8. Payment of credit balance **(after final balancing)**	Particulars Partner's Cap. A/c Dr. To, Cash/Bank A/c	Same as above

<u>**Practice MCQs**</u>

1. If partnership deed is silent or has not been formulated, then partners are entitled to
   (a) Salary (b) Commission
   (c) Interest on Capital (d) Profit share in capital ratio

2. In partnership business, partner's liability is:-
   (a) In proportion to profit/loss
   (b) In proportion to capital
   (c) Limited
   (d) Unlimited

3. In partnership, interest on partner's capital is:-
   (a) Debited to profit and loss appropriation account

(b) Credited to profit and loss account
(c) Debited to profit and loss account
(d) Credited to profit and loss account

4. The partnership is an association of __ or more person
   (a) **Two** (b) Seven
   (c)Ten (d) Twenty

5. The relationship between person who have agreed to share profit of a business carried on by all or any of of them acting for all is known as
   (a) **Partnership** (b) Joint Venture
   (c)Association of Person (d) Body of Individual

CHAPTER 8 - NATURE AND SCOPE OF COST ACCOUNTING

INTRODUCTION TO COST ACCOUNTING

IMPORTANT DEFINITIONS

1. **Cost:** The term 'cost' has to be studied in relation to its purpose and conditions. As per the definition by the Chartered Institute of Management Accountants (C.I.M.A.), 'cost' is the amount of *actual expenditure incurred* on or attributed to a given thing.

2. **Costing:** The C.I.M.A., has defined costing as the *ascertainment of costs*. "It refers to the techniques and processes of ascertaining costs and studies the principles and rules concerning the *determination of cost* of products and services".

3. **Cost Accounting:**
   - It is the method of *accounting for cost*.
   - The process of recording and accounting for all the elements of cost is called cost accounting. I.C.M.A. has defined cost accounting as follows: "The process of accounting for cost from the point at which expenditure is incurred or committed to the establishment of its *ultimate relationship with cost centers and cost units*.
   - In its widest usage it embraces the preparation of statistical data, the application of cost control methods and the ascertainment of the profitability of activities carried out or planned".

4. **Cost Accountancy:**
   - The term 'Cost Accountancy' includes Costing and Cost accounting.
   - Its purposes are *Cost-control and Profitability – ascertainment*.
   - It serves as an essential tool of the management for decision-making.
   - I.C.M.A., has defined cost accountancy as follows: "*The application of costing and cost accounting principles, methods and techniques to the science, art and practice of cost control and the*

ascertainment of profitability. It includes the presentation of information derived there from for the purpose of managerial decision making".

5. **Cost Units:** It is a unit of product, service or time (or combination of these) in relation to which costs may be ascertained or expressed. (e.g., Nos., Kg, liter, pieces, etc)

6. **Cost Driver:** A Cost driver is a factor or variable which effect level of cost. Generally, it is an activity which is responsible for cost incurrence. Level of activity or volume of production is the example of a cost driver. An activity may be an event, task, or unit of work etc.

7. **Cost Center:** A cost center is a location, person, or item of equipment (or a group of these) for which *costs may be ascertained* and used for the purposes of cost control. (Mileage – liter per km, Hospital – patient per bed, etc)

Function or Objectives of Cost Accounting

According to **Blocker and Weltemer,** "Cost Accounting is to serve management in the execution of polices and in comparison, of actual and estimated results in order that the value of each policy may be appraised and changed to meet the future conditions".

The main functions of cost accounting are:

- To serve as a guide to *price fixing* of products.
- To disclose *sources of wastage* in process of production.
- To reveal *sources of economy* in production process.
- To provide for an *effective system of stores, materials etc.*
- To exercise *effective control* on factors of production.
- To ascertain the *profitability* of each product.
- To suggest management of *future expansion* policies.
- To present and *interpret data* for management decisions.
- To organize *cost reduction* programs.
- To facilitate *planning and control* of business activity.
- To supply *timely information* for various decisions.
- To organize the *internal audit systems* etc. To measure the *degree of efficiency* of the various departments or units of production.

- To provide suitable *means* and *information* to the top management to control and guide the operations of the business organization.
- To exercise *effective control* on the costs, time and efforts of labor, machines and other factors of production.
- To *compare actual costs* with the *standard costs* and analyze the causes of variation.
- To provide necessary information to develop cost standards and to introduce the system of *budgetary control*.
- It enables the management to know where to *economize on costs*, how to fix prices, how to maximize profit and so on.

Scope of Cost Accounting

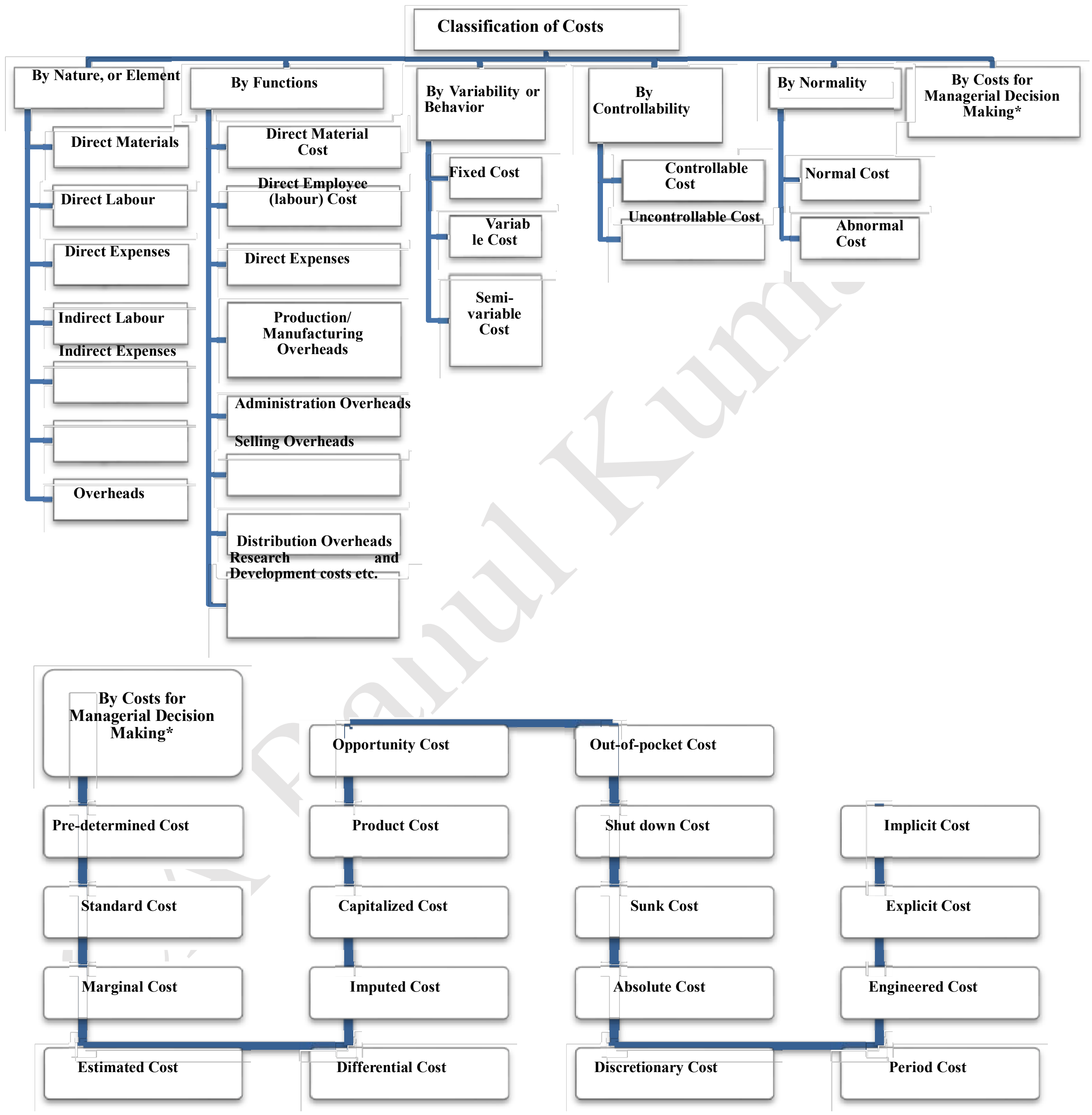
1. ***Cost Determination:*** This is the first step in the cost accounting system. It refers to determining the cost for a specific product or activity. This is a critical activity since the other three activities, explained below, depend on it.

2. ***Cost Recording:*** It is concerned with recording of costs in the cost journal and their subsequent posting to the ledger. Cost recording may be done according to integral or non-integral system a separate set of books is maintained for costing and financial transactions.

3. ***Cost Analyzing:*** It is concerned with critical evaluation of cost information to assist the management in planning and controlling the business activates. Meaningful cost analysis depends largely upon the clear understanding of the cost finding methods used in cost accounting.

4. ***Cost Reporting:*** It is concerned with reporting cost data both for internal and external reporting purpose. In order to use cost information intelligently it is necessary for the managers to have good understanding of different cost accounting concepts.

Classification of Cost



By Nature, or Element

(i) **Direct Materials**: Materials which are present in the finished product (cost object) or can be economically identified in the product are termed as direct materials. For example, cloth in dress making; materials purchased for a specific job etc. However, in some cases a material may be direct but it is treated as indirect, because it is used in small quantities, it is not economically feasible to identify that quantity. Those materials which are used for purposes ancillary to the business are also treated as Indirect Materials.

(ii) **Direct Labour**: Labour which can be economically identified or attributed wholly to a cost object is termed as direct labour. For example, employee engaged on the actual production of the product or in carrying out the necessary operations for converting the raw materials into finished product.

(iii) **Direct Expenses**: All expenses other than direct material or direct labour which are specially incurred for a particular cost object and can be identified in an economically feasible way are termed as Direct Expenses. For example, hire charges for some special machinery, cost of defective work etc.

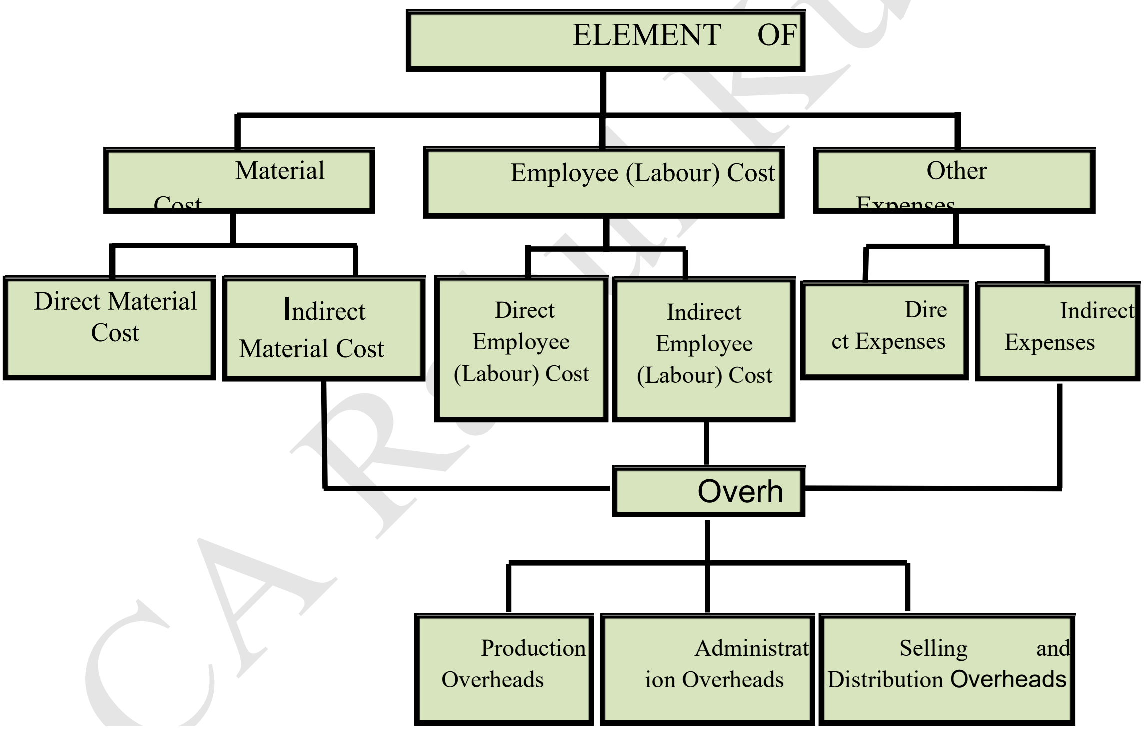
(iv) **Indirect Materials**: Materials which do not normally form part of the finished product (cost object) are known as indirect materials. These are —
- Stores used for maintaining machines and buildings (lubricants, cotton waste, bricks etc.)
- Stores used by service departments like power house, boiler house, canteen etc.

(v) **Indirect Labour**: Labour cost which cannot be allocated but can be apportioned to or absorbed by cost units or cost centers is known as indirect labour. Examples of indirect labour includes salary paid to foreman and supervisors; maintenance workers; etc.

(vi) **Indirect Expenses**: Expenses other than direct expenses are known as indirect expenses. These cannot be directly, conveniently and wholly allocated to cost centers. Factory rent and rates, insurance of plant and machinery for the running of the factory. E.g.: rent, power etc.

(vii) **Overheads**: The aggregate of indirect material costs, indirect labour costs and indirect expenses is termed as Overheads. The main groups into which overheads may be subdivided are as follows:

- **Production or Works Overheads**: Indirect expenses which are incurred in the factory and for the running of the factory. E.g.: rent, power et
- **Administration Overheads**: Indirect expenses related to management and administration of business. E.g.: office rent, lighting, telephone etc.
- **Selling Overheads**: Indirect expenses incurred for marketing of a commodity. E.g.: Advertisement expenses, commission to sales persons etc.
- **Distribution Overheads**: Indirect expenses incurred for dispatch of the goods E.g.: warehouse charges, packing(secondary) and loading charges.



By Functions

Under this classification, costs are divided according to the function for which they have been incurred. It includes the following:

(i) Direct Material Cost

(ii) Direct Employee (labour) Cost

(iii) Direct Expenses
(iv) Production/ Manufacturing Overheads
(v) Administration Overheads
(vi) Selling Overheads
(vii) Distribution Overheads
(viii) Research and Development costs etc.

Direct Materials		**Prime Cost**
Direct Employees (Labours)		
Direct Expenses		
	Factory Overheads	
Indirect Material		**Factory Cost or Works Cost**
Indirect Labour	Administration Overheads	
Indirect Expenses		**Cost of Goods Sold**
	Selling and Distribution Overheads	
		Cost of Sales

By Variability or Behavior

Based on this classification, costs are classified into three groups viz., fixed, variable and semi-variable.

(a) **Fixed costs–** These are the costs which are incurred for a period, and which, within certain output and turnover limits, tend to be unaffected by fluctuations in the levels of activity (output or turnover). They do not tend to increase or decrease with the changes in output. For example, rent, insurance of factory building etc., remain the same for different levels of production.

(b) **Variable Costs**– These costs tend to vary with the volume of activity. Any increase in the activity results in an increase in the variable cost and vice-versa. For example, cost of direct material, cost of direct labour, etc

(c) **Semi-variable costs**– These costs contain **both fixed and variable components** and are thus partly affected by fluctuations in the level of activity. Examples of semi variable costs are telephone bills, gas and electricity etc. Such costs are depicted graphically.

By Controllability

Costs here may be classified into controllable and uncontrollable costs.

(a) **Controllable Costs:** - Cost that **can be controlled**, typically by a cost, profit or investment center manager is called controllable cost. Controllable costs incurred in a particular responsibility center can be influenced by the action of the manager heading that responsibility center. For example, direct costs comprising direct labour, direct material, direct expenses and some of the overheads are generally controllable by the shop floor supervisor or the factory manager.

(b) **Uncontrollable Costs** - Costs which **cannot be influenced** by the action of a specified member of an undertaking are known as uncontrollable costs. For example, expenditure incurred by, say, the tool room is controllable by the foreman in-charge of that section but the share of the tool-room expenditure which is apportioned to a machine shop is not controlled by the machine shop foreman.

Distinction between **Controllable Cost and Uncontrollable Cost:** The distinction between controllable and uncontrollable costs is not very prominent and is sometimes left to individual judgement. In fact, no cost is uncontrollable; it is only in relation to a particular individual that we may specify a particular cost to be either controllable or uncontrollable.

By Normality

According to this basis, cost may be categorized as follows:

(a) **Normal Cost** - It is the cost which is normally incurred at a given level of output under the conditions in which that level of output is normally attained.

(b) **Abnormal Cost** - It is the cost which is not normally incurred at a given level of output in the conditions in which that level of output is normally attained. It is charged to Costing Profit and loss Account

By Costs used in Managerial Decision Making *(2018)*

According to this basis, cost may be categorized as follows:

a. **Pre-determined Cost-** A cost which is computed in advance before production or operations start, on the basis of specification of all the factors affecting cost, is known as a **pre-determined cost.**

b. **Standard Cost** - A pre-determined cost, which is calculated from managements 'expected standard of efficient operation' and the relevant necessary expenditure.
   - It may be used as a basis for price fixation and for cost control through variance analysis.

c. **Marginal Cost** - The amount at any given volume of output by which aggregate costs increases if the volume of output is increased or decreased by one unit.

d. **Estimated Cost- Kohler** defines estimated cost as "the expected cost of manufacture, or acquisition, often in terms of a unit of product computed on the basis of information available in advance of actual production or purchase".
   - Estimated costs are prospective costs since they refer to prediction of costs.

e. **Differential Cost** - (Incremental and decremental costs). It represents the change (increase or decrease) in total cost (variable as well as fixed) due to change in activity level, technology, process or method of production, etc.
   - For example, if any change is proposed in the existing level or in the existing method of production, the increase or decrease in total cost or in specific elements of cost as a result of this decision will be known as incremental cost or decremental cost.

f. Imputed Costs
   - These costs are notional costs which do not involve any cash outlay.
   - Interest on capital, the payment for which is not actually made, is an example of imputed cost.
   - These costs are similar to opportunity costs.

g. Capitalized Costs
   - These are costs which are initially recorded as assets and subsequently treated as expenses.
   - Example, installation expenses on the erection of a machine are added to the cost of a machine.

h. Product Costs
   - These are the costs which are associated with the **purchase and sale of goods** (in the case of merchandise inventory).

- In the production scenario, such costs are associated with the acquisition and conversion of materials and all other manufacturing inputs into finished product for sale.
- Hence, under marginal costing, variable manufacturing costs and under absorption costing, total manufacturing costs (variable and fixed) constitute inventoriable or product costs.

i. Opportunity Cost

- This cost refers to the **value of sacrifice** made or benefit of **opportunity foregone in accepting** an alternative course of action.
- This is concerned with the cost of the next best alternative opportunity
- It is the cost of the missed opportunity and involves a comparison between the policy that was chosen and the policy that was rejected.
- For example, a firm financing its expansion plan by withdrawing money from its bank deposits. In such a case the loss of interest on the bank deposit is the opportunity cost for carrying out the expansion plan.

j. Out-of-pocket Cost

- It is that portion of total cost, which involves cash outflow.
- This cost concept is a short-run concept and is <u>used in decisions relating to fixation of selling price in recession,</u> make or buy, etc.
- Out–of–pocket costs can be avoided or saved if a particular proposal under consideration is not accepted.

k. Shut down Costs

- Those costs, which continue to be, incurred even when a plant is temporarily shut-down e.g., rent, rates, depreciation, etc.
- These **costs cannot be eliminated** with the closure of the plant. In other words, all fixed costs, which cannot be avoided during the temporary closure of a plant, will be known as shut down costs.

l. Sunk Costs

- **Historical costs** incurred in **the past** are known as sunk costs.
- Sunk costs refer to those costs which are already incurred once and for all and cannot be recovered.
- They are based on past commitments and cannot be revised or reversed if the firm wishes to do so.
- Sunk costs act as an important barrier to entry of firms into business.
- They play **no role in decision making i**n the current period.

- For example, in the case of a decision relating to the replacement of a machine, the written down value of the existing machine is a sunk cost and therefore, not considered.

m. Absolute Cost

- These costs refer to the cost of any product, process or unit in its totality.
- When costs are presented in a statement form, various cost components may be shown in absolute amount or as a percentage of total cost or as per unit cost or all together.
- Here the costs depicted in absolute amount may be called absolute costs and are base costs on which further analysis and decisions are made.

n. Discretionary Costs

- Such costs are not tied to a clear cause and effect relationship between inputs and outputs.
- They usually arise from periodic decisions regarding the maximum outlay to be incurred.
- Examples include advertising, public relations, executive training etc.

o. Period Costs

- These are the costs, which are not assigned to the products but are charged as expenses against the revenue of the period in which they are incurred.
- All non-manufacturing costs such as general & administrative expenses, selling and distribution expenses are recognized as period costs.

p. Engineered Costs

- These are costs that result specifically from a clear cause and effect relationship between inputs and outputs.
- The relationship is usually personally observable. Examples of inputs are direct material costs, direct labour costs etc. Examples of output are cars, computers etc.

q. Explicit Costs

- These costs are also known as **out-of-pocket** costs and refer to costs involving immediate payment of cash.
- Salaries, wages, postage and telegram, printing and stationery, interest on loan etc. are some examples of explicit costs involving immediate cash payment.

r. Implicit Costs

– These costs do not involve any **immediate cash payment.** They are not recorded in the books of account. They are also known as **economic costs**.

Sunk cost VS Shut down Cost

Sunk Cost	Shut Down Cost
1. Sunk costs include expenses like investment in land and machinery, buildings etc.	1. Shut down costs include fixed costs and such as rent, insurance, depreciation etc.
2. Sunk costs are historical costs which have already been incurred.	2. Shut down costs are those costs which have to be incurred even if production or operation of an undertaking are discontinued temporarily due to strike or other reasons.

Financial Accounting

- Financial accounting is a specific branch of accounting involving a process of recording, summarizing, and reporting the myriad of transactions resulting from business operations over a period of time.
- Financial Accounting is the branch of accounting, which keeps the complete record of all monetary transactions of the entity and reports them at the end of the financial period in proper formats that increases readability of the financial statements among its users i.e., from internal management to outside parties.

2. INTRODUCTION TO COST SHEET

One of the objectives of cost accounting system is **ascertainment of cost** for a cost object. The cost objects may be a **product, service or any cost centre.** Ascertainment of cost includes element wise collection of costs, accumulation of the costs so collected for a certain volume or period and then arrange all these accumulated costs into a sheet to calculate total cost for the cost object. In this chapter, a product or a service will be the cost object for cost calculation and cost ascertainment.

A Cost Sheet or Cost Statement is "a document which provides a detailed cost information. In a typical cost sheet, cost information are presented on the basis of functional classification. However, other classification may also be adopted as per the requirements of users of the information.

FUNCTIONAL CLASSIFICATION OF ELEMENTS OF COST (2010)

Under this classification, costs are divided according to the function for which they have been incurred. The following are the **classification of costs based on functions:**

- Direct Material Cost
- Direct Employee (labour) Cost
- Direct Expenses
- Production/ Manufacturing Overheads
- Administration Overheads
- Selling Overheads
- Distribution Overheads Research and Development costs etc.

COST HEADS IN A COST SHEET

The costs as classified on the basis of functions are grouped into the following cost heads in a cost sheet:

- Prime Cost
- Cost of Production
- Cost of Goods Sold
- Cost of Sales

Prime Cost

Prime cost represents the total of direct materials costs, direct employee (labour) costs and direct expenses. The total of cost for each element has to be calculated separately.

Direct Material Cost	xx
Direct Employees (labour)	x
Cost Direct Expenses	xx
Prime Cost:	x
	xx
	xxx

(i) **Direct Material Cost:** It is the cost of direct material consumed. The cost of direct material consumed is calculated as follows:

Opening Stock of Material	xxx
Add: Additions/ Purchases	xxx
Less: Closing stock of Material	(xxx)

Direct materials consumed	xxx x

The valuation of materials purchased and issued for production shall be done as per methods discussed in the 'Chapter- 2 Material Cost'. Few examples are:

(a) Cost of material;

(b) Freight inwards;

(c) Insurance and other expenditure directly attributable to procurement;

(d) Trade discounts or rebates (to be deducted);

(e) Duties & Taxes (if input tax credit is not available/ availed) etc.

(ii) **Direct Employee (labour) Cost**: It is the total of payment made to the employees who are engaged in the production of goods and provision of services. Employee cost is also known as labour cost; it includes the following:

- Wages and salary;
- Allowances and incentives;
- Payment for overtimes;
- Bonus/ ex-gratia;
- Employer's contribution to welfare funds such as Provident fund and other similar funds;
- Other benefits (medical, leave with pay, free or subsidised food, leave travel concession and provisions for retirement benefits) etc.

(iii) **Direct Expenses**: Expenses other than **direct material cost and direct employee cost,** which are incurred to manufacture a product or for provision of service and can be directly traced in an economically feasible manner to a cost object. The following costs are examples for direct expenses:

(a) Cost of utilities such as power & fuel, steam etc.;

(b) Royalty paid/ payable for production or provision of service;

(c) Hire charges paid for hiring specific equipment;

(d) Fee for technical assistance and know-how;

(e) Amortised cost of moulds, patterns, patents etc.;

(f) Cost for product/ service specific design or drawing;

(g) Cost of product/ service specific software;

(h) Other expenses which are directly related with the production of goods or provision of service.

Cost of Production

In a conventional cost sheet, this item of cost can be seen. It is the total of prime cost and factory related costs and overheads.

Prime Cost	xxx
Add : Factory Overheads	xxx
Gross Works Costs	xxxx
Add: Opening stock of Work-in-process	xxx
Less: Closing stock of Work-in-process	(xxx)
Factory or Works Costs	xxxx
Add: Quality Control Cost	xxx
Add: Research & Development cost (Process related)	xxx
Add: Administrative Overheads related with production	xxx
Less: Credit for recoveries (miscellaneous income)	(xxx)
Add: Packing Cost (Primary packing)	xxx
Cost of Production	**xxxx**

(i) **Factory Overheads**: It is also known as works/ production/ manufacturing overheads. It includes the following indirect costs:

(a) Consumable stores and spares;

(b) Depreciation of plant and machinery, factory building etc.

(c) Lease rent of production assets;

(d) Repair and maintenance of plant and machinery, factory building etc.

(e) Indirect employees cost related with production activities;

(f) Drawing and Designing department cost;

(g) Insurance of plant and machinery, factory building, stock of raw material & WIP etc.

(h) Amortized cost of jigs, fixtures, tooling etc.

(i) Service department cost such as Tool Room, Engineering & Maintenance, Pollution Control etc.

(ii) **Stock of Work-in-process**: The cost of opening and closing stock of work-in-process (WIP) is adjusted to arrive at factory/ works cost. The WIP stock is valued on the basis of percentage of completion in respect of each element of cost. Students may refer the 'Chapter- Process & Operation Costing' to know the WIP valuation methods.

(iii) **Quality Control Cost**: This is the cost of resources consumed towards quality control procedures.

(iv) **Research & Development cost**: It includes only those research and development related cost which is incurred for the improvement of process, system, product or services.

(v) **Administrative Overheads**: It includes only those administration overheads which are related to production. The general administration overhead is not included in production cost.

(vi) **Credit for recoveries**: The realised or realisable value of scrap or waste is deducted as it reduces the cost of production.

(vii) **Joint products and By-products**: Joint costs are allocated between/among the products on a rational and consistent basis. In case of by- products, the net realisable value of by-products is deducted from the cost of production.

(viii) **Packing Cost (primary)**: Packing material which is essential to hold and preserve the product for its use by the customer.

Cost of Goods Sold

It is the cost of production for goods sold. It is calculated after adjusting the values of opening and closing stocks of finished goods. It can be calculated as below:

Cost of Production	xxx

Add: Cost of Opening stock of finished goods	xxx
Less: Cost of Closing stock of finished goods	(xxx)
Cost of Goods Sold	**xxxx**

Cost of Sales

It is the total cost of a product incurred to make the product available to the customer or consumer. It includes **Cost of goods sold, administration and marketing expenses**. It is calculated as below:

Cost of Goods Sold	xxx
Add: Administrative Overheads (General)	xxx
Add: Selling Overheads	xxx
Add: Packing Cost (secondary)	xxx
Add: Distribution Overheads	xxx
Cost of Sales	**xxxx**

(i) **Administrative Overheads**: It is the cost related with **general administration of the entity**. It includes the followings:

- Depreciation and maintenance of, building, furniture etc. of corporate or general management.
- Salary of administrative employees, accountants, directors, secretaries etc.
- Rent, rates & taxes, insurance, lighting, office expenses etc.
- Indirect materials- printing and stationery, office supplies etc.
- Legal charges, audit fees, corporate office expenses like directors' sitting fees, remuneration and commission, meeting expenses etc.

(ii) **Selling Overheads**: It is the cost related with **sale of products or services.** It includes the following costs:

<u>Salary and wages related </u>with sales department and employees directly related with selling of goods.

Rent, depreciation, maintenance and other cost related with sales department.

Cost of advertisement, maintenance of website for online sales, market research etc.

(iii) **Packing cost (secondary)**: Packing material that enables to store, transport, inform the customer, promote and otherwise make the product marketable.

(iv) **Distribution Overheads**: It includes the cost related with making the goods available to the customers. The costs are

- Salary and wages of employees engaged in **distribution of goods.**
- Transportation and insurance costs related with distribution.
- Depreciation, hire charges, maintenance and other operating costs related with distribution vehicles etc.

COST SHEET/STATEMENT

Presentation of cost information

The cost items in the cost statement shall be presented on 'basis of relevant classification.

Specimen Format of Cost Sheet for a Manufacturing entity

	Particulars	**Total Cost (Rs)**	**Cost per unit (Rs)**
1.	Direct materials consumed:		
	Opening Stock of Raw Material	xxx	
	Add: Additions/ Purchases	xxx	
	Less: Closing stock of Raw Material	xxx	
		xxx	
2.	Direct employee (labour) cost	xxx	
3.	Direct expenses	xxx	
4.	**Prime Cost (1+2+3)**	**xxx**	
5.	Add: Works/ Factory Overheads	xxx	
6.	Gross Works Cost (4+5)	xxx	
7.	Add: Opening Work in Process	xxx	
8.	Less: Closing Work in Process	(xxx)	
9.	**Works/ Factory Cost (6+7-8)**	**xxx**	

10.	Add: Quality Control Cost	xxx	
11.	Add: Research and Development Cost	xxx	
12.	Add: Administrative Overheads (relating to production activity)	xxx	
13.	Less: Credit for Recoveries/Scrap/By-Products/ misc. income	(xxx)	
14.	Add: Packing cost (primary)	xxx	
15.	**Cost of Production (9+10+11+12-13+14)**	**xxx**	
16.	Add: Opening stock of finished goods	xxx	
17.	Less: Closing stock of finished goods	(xxx)	
18.	**Cost of Goods Sold (15+16-17)**	**xxx**	
19.	Add: Administrative Overheads (General)	xxx	
20.	Add: Marketing Overheads:		
	Selling Overheads	xxx	
	Distribution Overheads	xxx	
21.	**Cost of Sales (18+19+20)**	xxx	

Treatment of various items of cost in Cost sheet/statement

1. **Abnormal costs**- Any abnormal cost, where it is **material and quantifiable**, shall not form part of cost of production or acquisition or supply of goods or provision of service. Examples of abnormal costs are:

   (a) Cost pertaining to or arising out of a pandemic e.g. COVID-19
   (b) Cost associated with employees due to sudden lockdown.

2. **Subsidy/ Grant/ Incentives**- Any such type of payment received/ receivable are reduced from the cost objects to which such amount pertains.

3. **Penalty, fine, damages, and demurrage** - These types of expenses are not form part of cost.

4. **Interest and other finance costs**- Interest, including any payment in the nature of interest for use of non- equity funds and incidental cost that an entity incurs in arranging those funds. Interest and finance charges are not included in cost of production.

Advantages of Cost sheet or Cost Statements

The main advantages of a Cost Sheet are as follows:

- It provides the total cost figure as well as cost per unit of production.
- It helps in cost comparison.
- It facilitates the preparation of cost estimates required for submitting tenders.
- It provides sufficient help in arriving at the figure of selling price.
- It facilitates cost control by disclosing operational efficiency.

PRACTICE MCQs

1. In process, conversion cost means

(A) Cost of direct materials, direct labour, direct expenses

(B) **Direct labour, direct expenses, indirect material, indirect labour, indirect expenses**

(C) Prime cost plus factory overheads

(D) All costs up to the product reaching the consumer, less direct material costs

2. Which of the following items is not included in preparation of cost sheet?

(a) Carriage inward (b) Purchase returns
(c) Sales Commission **(d) Interest pa**

3. Direct Expenses ———— includes imputed cost.

(a) Shall **(b) Shall not**
(c) None of these

4. Directors remuneration and expenses form a part of

(a) Production overhead **(b) Administration overhead**
(c) Selling overhead (d) Distribution overhead

5. What is prime cost?

(a) Total direct costs only (b) Total indirect costs only
(c) Total non-production costs (d) Total production costs

CHAPTER 9 - INSURANCE CLAIM FOR LOSS OF STOCK AND LOSS OF PRO

1. LOSS OF STOCK

Of the different forms of accidental losses, loss by fire is the most common one. A fire insurance policy is usually taken to cover two types of losses: 1. Loss of Stock and 2. Loss of Profits.

As stocks constitute a considerable portion of the working capital of any business and specially for trading concerns, any loss of stock directly affects the solvency of the business. A business has to cover this risk adequately.

1.2 DETERMINATION OF AMOUNT OF INSURANCE CLAIM

The amount of insurance claim to be made by the organization which suffered the loss depends on the following factors:

1. **Value of stock present at the time of accident:**
   - If stock records and stock are destroyed, it becomes difficultto ascertain the amount of stock lost
   - When the loss suddenly occurs, up-to-date value of stock does not become available. In that case, the value of stock present can be ascertained using relevant information, andby drafting a Memorandum Trading Account
   - A **Memorandum Trading Account** is actually a statement (notan account) which is prepared following the proforma of a Trading Account. It has to be prepared starting from the first date of the accounting period in which the accident has taken place and ending on the date of accident.
   - It is to be noted that in Memorandum Trading Account, the Gross Profit is estimated by multiplying '**Sales'** for this period with the **rate of Gross Profit** (GP). The GP rate may be known to the entity or it has to be ascertained.
   - The GP rate is usually estimated on the basis of the details of the last accounting period. The organization determines the GP rate by preparing the Trading Account for the accounting period immediatelypreceding the period in which the accident has occurred.

Memorandum Trading Account

Particulars	Amount	Particulars	Amount
To opening Stock	***	By sale	***
To Purchase	***	By Closing Stock	***
To Gross Profit	***		

2. **Value of stock salvaged:** It is the quantity of stock that could be saved from the accident. The value of thissalvaged stock is to be deducted from the 'value of stock present at the time of accident' for ascertaining the 'value of stock lost by the accident' which represents the 'Gross Claim' to be lodged 3. **Contents of the insurance policy:** The insurance policy includes details like policy value, average clause etc. Policy Value is the maximum amount that can be realized by the insured from the insurance company on the occurrence of the accident. It influences the amount of net claim that can be lodged by the insured. **Average Clause** simply states that in the absence of adequate insurance coverage, the insurance company will not shoulder the entire risk. This clause implies that in case of under-insurance, the insured will also have to share a portion of the loss along with the insurance company. It is to be noted that Average Clause will not be applicable if thepolicy value is greater than or equal to the amount of loss suffered. In case of under-insurance, the net claimfrom the insurance company will be lower than the Gross Claim. On application of Average Clause, Net Claim will be computed as under: $\text{Net Claim} \times \dfrac{\text{Policy Value}}{\text{Value of Stock lost on date of accident}}$

Certain special situations

1. **Goods-in-Transit or Goods sent to branches/ consignee:**	The cost of Goods-in-transit is to be deducted from 'Purchases' figure in Trading A/c or Memorandum Trading A/c, as the case may be. Alternatively, the cost of such goods may also be credited to the Trading A/c or Memorandum Trading A/c.
2. **Goods sold but not yet to be delivered:**	Sale value of such goods is to be deducted from 'Sales' figure in Trading A/c or Memorandum Trading A/c.
3. **Goods sent on approval basis**	Cost of such goods is to be deducted from 'Purchases' figure in Trading A/c or Memorandum Trading A/c, as the case may be. Further, deduct the sale value of such goods from 'Sales' figure inTrading A/c or Memorandum Trading A/c.

4. CHANGE IN PRICE LEVEL	For applying the GP rate determined sale of the period in which loss has occurred in the Memorandum Trading A/c, the effect of such price changes have to be nullified from the different items of Memorandum Trading A/c. For this purpose the method of stock pricing (i.e**. FIFO, LIFO etc.) is to be considered**
5. UNDER-VALUED OR OVER-VALUED STOCK	When the stock is valued at a figure higher or lower than the cost, it affects the normal GP rate. When stock is under-valued, amount of under-valuation is added back to the respective stock to arrive at the cost; while in case ofover-valuation, the over-valued amount is to be deducted to arrive at the cost of such stock
6. ABNORMAL/ DEFECTIVE/ USUAL SELLING LINE ITEMS	➢ Goods which cannot fetch the usual rate of gross profit are considered as referred to as unusual or abnormal items. ➢ For preparing the Memorandum Trading Account, the portion of the value of such goods which has not yet been written off, should be deducted from the Opening Stock. ➢ If any such goods have been purchased in the current period, the Cost Price of such goods should be deducted frompurchases. ➢ If any portion of such goods have been sold in the current period, **the Selling Price should be deductedfrom current sales.**
	➢ Lastly if any portion of such, goods remains **unsold on the date of fire**, the agreed value of such portion should be **added** with the **estimated value of normal stock** to arrive at the estimated value of (total) stock onthat date. Similar adjustments may be required while preparing the Trading Account of the last financial year/s, if abnormal items existed then.

2. LOSS OF PROFIT

FOR DETERMINATION OF THE AMOUNT OF CLAIM FOR 'LOSS OF PROFIT POLICY', THE ORGANIZATION NEEDS TO ASCERTAIN THE AMOUNT OF PROFIT WHICH THE ORGANIZATION COULD HAVE EARNED. IN RELATION TO DETERMINATION OF SUCH LOSS OF PROFIT, THE FOLLOWING TERMS ARE SIGNIFICANT:

• **Indemnity period:**	The period for which normal activities of the business is interrupted is known asindemnity period.
• **Standard turnover**	The turnover of the previous year corresponding to the period of indemnity afteradjustment of trend in turnover.
• **Adjusted annual turnover**	Turnover during 12 months immediately preceding the date of damage (takingtrend into consideration).
• **Standing charges**	Unavoidable fixed expenses which have to be paid even if there is reduction in sale.

2.1 CALCULATION OF THE NET CLAIM UNDER LOSS OF PROFIT POLICY

STEP 1	Ascertainment of Gross Profit (GP) for previous accounting period: 1. **In case of existence of Net profit** GP = Net Profit for Previous Accounting Period + Insured Standing Charges. 2. **In case of existence of Net loss** $GP = \text{Insured standing charges} - \text{Net Loss} \times \frac{\text{Insured Standing Charges}}{\text{All Standing Charges}}$
STEP 2	Determination of GP rate $\text{GP rate} = \frac{\text{GP}}{\text{Sales}} \times 100$
STEP 3	Calculate Short Sales Short Sales = Standard Turnover – Actual Turnover for Indemnity Period.
STEP 4	Calculate GP Lost on Short Sales: GP Lost = Short Sale × GP rate
STEP 5	Determine admissible additional expenses for insurance claim: Least of the following: i. Actual additional expenses ii. Sales due to additional expenses × GP rate iii. $\text{Actual additional expenses} \times \frac{\text{Net Profit} + \text{Insured Standing Charges}}{\text{Net Profit} + \text{All Standing Charges}}$
STEP 6	Calculation of Gross Claim Gross claim = GP lost + Admissible Expenses for Insurance Claim – Saving in Standing Charges.
STEP 7	Insurable value = Adjusted Annual Turnover × GP rate
STEP 8	Claim to be lodged: **Situation 1: When average clause is applicable(insurable value < policy**

	value) Net Claim = $\frac{\text{Policy value}}{\text{Insurable value}}$ x Gross Claim **Situation 2: When average clause is Not applicable (insurable value is >policy value)** Net Claim = Gross Claim

Some of the important points relating to the variables are as under:

- If additional Sales due to additional expenses is not given, assume that entire sale has been attained due to additional expenses.
- All standing charges = insured standing charges + uninsured standing charges.
- In absence of specific information assume that all standing charges are insured.
- If sales for past years is given we need to determine the trend of sales