# UNIT 1 PREPARATION AND ANALYSIS OF FINAL ACCOUNTS

Stru	cture	Page Nos.
1.0	Introduction	5
1.1	Objectives	5
1.2	Trading Account	6
	1.2.1 Opening/Closing Stock	-
	1.2.2 Net Purchases	
	1.2.3 Direct Expenses	
	1.2.4 Net Sales	
	Profit and Loss Account	8
1.4	Difference between Trading and Profit & Loss Account	11
1.5	Balance Sheet	11
1.6	Constructing a Balance Sheet	13
1.7	Classification of Balance Sheet's Items	15
1.8	Adjustment Entries	21
	1.8.1 Closing Stock	
	1.8.2 Depreciation	
	1.8.3 Bad Debts	
	1.8.4 Provision for Bad and Doubtful Debts	
	1.8.5 Outstanding Expenses (Assets)	
	1.8.6 Prepaid Expenses (Assets) 1.8.7 Accrued Income	
	1.8.8 Income Received in Advance (Liability)	
1.9	Summary	26
	Key Words	26
1.10	•	27
1.12	Further Readings	29

#### 1.0 INTRODUCTION

The primary function of accounting is to accumulate accounting data in order to calculate the profit and loss made by the business firm during and also to understand the financial position of the business on a given date. A business can ascertain this by preparing the Final Accounts. Preparation of final accounts from a trial balance is the final phase of the accounting process. Final accounts include the preparation of Trading and Profit and Loss Account and the Balance Sheet, although the Balance Sheet is not an account but only a statement. Trading and Profit and Loss Account is simply one account which is usually divided into two sections. The first section is called the Trading Account and the second section the Profit and Loss Account. In case of manufacturing concerns, Final Accounts also include the Manufacturing Account.

#### 1.1 OBJECTIVES

After going through this unit, you should be able to:

- define Final Account;
- understand their objectives and preparation of Trading and Profit and Loss Account;
- conclude the difference between Trading Account and Profit and Loss Account, Gross Profit and Net Profit;
- understand and explain the terms used in a balance sheet;

- apply simple principles of valuation of assets;
- role of depreciation in valuation and determining the proper profit of a firm;
- understand Adjustment entries; and
- the importance of adjustment entries to ascertain the financial position of a business firm.

#### 1.2 TRADING ACCOUNT

Trading account is prepared to ascertain the Gross Profit and Loss of a firm, where Gross Profit is the excess of net revenue over cost of goods sold (the credit side of the trading account exceeds the debit side). Similarly, Gross Loss is the excess of cost of goods sold over net revenue (the debit side of the trading account exceeds the credit side).

Gross Profit = Net Sales Revenue – Cost of Goods Sold Gross Loss = - (Net Sales Revenue – Cost of Goods Sold)

Where:

Net Sales Revenue = Cash Sales + Credit Sales - Sales Returns

Cost of Goods Sold = Opening Stock + Net Purchases + Direct Expenses - Closing Stock

Net Purchase = Cash Purchases + Credit Purchases - Purchases Returns.

Trading Account is generally prepared in 'T' form. In this case, opening stock, purchases and direct expenses are shown on the debit side and sales and closing stock on the credit side of the trading account. The format of the Trading Account is explained along with the format of Profit and Loss Account.

#### 1.2.1 Opening/Closing Stock

The Opening Stock of goods is the stock of goods in hand at the beginning of an accounting year. This may include stock of raw material, work-in-progress and fininshed goods. This appears in the debit column of the trial balance. In the Trading Account this is the first entry on the debit side. The valuation is usually done at cost or market price which ever is lower. The Stock of goods in hand at the end of accounting year is called Closing Stock. Similarly, closing stock may include stock of raw material, work-in-progress and finished goods. The closing stock is shown on the credit side of the Trading Account. Closing stock is usually not given in the trial balance but is given by way of additional information.

#### 1.2.2 Net Purchases

These include goods purchased only for production and selling purposes. Goods used as assets and not- for- sale are not included in this head. Net purchase is the difference between purchases and the purchase return, where purchase is the sum of cash and credit purchase. Note that sometimes, purchased return is known as Return Outward.

#### 1.2.3 Direct Expenses

Direct expenses include all those expenses incurred in bringing the goods to the place of business or trade or in-production process until the goods are placed in a saleable position. The following expenses may be considered as direct expenses:

- 1. **Wages paid** to workers engaged in production are debited to the trading account provided the manufacturing account is not prepared separately.
- 2. Carriage/freight inwards are transportation expenses incurred to bring the goods or raw material to the place of the business or to the firm's godown/factory. Such expenses, whether paid or outstanding, are debited to trading account.
- 3. **Octroi** is paid when goods enter municipal limits. Octroi paid on goods purchased is a direct expense and is debited to trading account.
- 4. **Custom duty** paid on importing goods for selling purposes is debited to trading account. If the duty is paid on sales export, it amounts to selling expenses and is shown in the profit and loss account.
- 5. Factory rent, insurance, lighting & power and heating are the expenses incurred to convert raw material into finished goods. Such expenses are debited to trading account.

#### 1.2.4 Net Sales

It includes both cash and credit sales of goods. From this figure of total sales, sales return (also called Returns Inward), if any, is deducted in the inner column and the net sales amount is shown in the outer column on the credit side of the Trading Account. Sales of assets are not credited to the Trading Account. It should be noted, if goods have been sold but not yet dispatched, these should not be shown under sales but are included in closing stock if the property/ownership in the goods has not passed to the customer. But if the property/ownership in the goods has passed to the customer goods sold but not yet dispatched it will not be included in closing stock but will be treated as sales.

Following is the proforma of the Trading Account:

Trading Account
For the Year Ended

Debit		our Endou	Credi
Particular	Rs.	Particulars	Rs.
Opening Stock:		Net sales:	
Raw Material		Sales	
Work-in-Progress		Less: Sales Return	
Finished Goods			
		Closing Stock:	
Net Purchase:		Raw Material	
Purchase		Work-in-Progress	
Less: Purchase Returns		Finished Goods	
Direct Expenses			
Direct Material		Transfer to Profit & Loss	
Direct Labour		Account	
Profit & Loss Account		(If Gross Loss)	
(If Gross Profit)		·	

#### **Illustration 1**

Prepare the Trading Account from the following details:

Opening stock Rs.25,000; Purchases Rs. 80,100; Carriage Inward Rs. 12,000; Stock at the end Rs. 15,000; Carriage Outward Rs. 2,000; Office Rent Rs. 5,000; Sales Rs. 1,40,000; Sales Return Rs. 2,000; Purchases Return Rs. 100.

#### Solution

## Trading Account For the year ending

Particulars	Rs.	Particulars	Rs.
Opening Stock:  Raw Material  Work-in-Progress Finished Goods	25,000	Net sales:         1,40,000           Sales         2,000	1,38,000
Net Purchase: Purchase 80,100 Less: Purchase Returns 100	80,000 48,000	Raw Material Work-in-Progress Finished Goods	15,000
Profit & loss Account (Transferred to)	1,53,000		1,53,000

#### Check Your Progress 1

1) Prepare the Trading Account from the following figures:

Opening Stock	40,000	Power	6,000
Purchases	1,80,000	Octroi	11,000
Carriage Inward	4,000	Freight	8,000
Wages	42,000	Sales	3,20,000
Return Outwards	7,000	Sales Return	10,000

Closing Stock Rs. 60,000.

- 2) How is Purchases different from Net Purchases?
- 3) How are Net Sales different from Sales?

#### 1.3 PROFIT AND LOSS ACCOUNT

Profit and Loss Account is prepared in order to discern whether the firm has made net profit or suffered net loss for a given accounting period. This account deals with indirect expenses such as administrative, selling and distribution expenses and the like. Profit and Loss Account starts where trading account ends; in other words it starts with gross profit on the credit side brought forward from the trading account. In case of gross loss brought forward from the trading account, profit and loss account begins with gross loss as the first item on the debit side.

All the indirect/running expenses, incurred on selling and distribution of the goods and the general administration of the business, are listed on the debit side while all the items of income and gain are listed on the credit side. When the credit side (revenue) exceeds the debit (expenses) side, the difference is net profit. But, if the debit side exceeds the credit side, the difference is net loss. Profit and loss account is balanced by transferring net profit to the capital account(s) in the balance sheet and net profit thus increases the capital; the net loss is deducted from the capital account(s) in the balance sheet and thus decreases the capital.

The following items are debited in the profit and loss account:

1. Administrative Expenses including Office Salaries, Office Rent, Office Lighting, Printing, Director's Fees, Telephone Rent, Postage, Insurance, etc.

- 2. Sales and Distribution Expenses including Salesmens salary, Commission, Travelling expenses, Advertising, Packing expenses, Royalty, etc.
- 3. Financial Expenses including Interest on loan/Capital, Cash Discount Allowed, Bad Debts, Bank Charges, etc.
- 4. Depreciation of Assets and various provisions.
- 5. Other Expenses and Losses including Loss on Sales of Fixed Assets, Loss by Fire, by Theft, by Accident, etc.
- 6. Taxes including Sales Taxes, Income Taxes etc.

The following items are credited in the Profit and Loss Account:

- 1. Cash Discount Received
- 2. Interest Received
- 3. Rent Received
- 4. Gain on Sale of Fixed Assets
- 5. Apprentice Premium
- 6. Dividend Received.

**Note:** The household and personal expenses of the proprietor paid by the firm do not appear in the profit and loss account. Rather these are treated as personal drawings of the proprietor and are deducted from the capital in the balance sheet.

The Following is the proforma of Trading and Profit & Loss Account:

## PROFIT AND LOSS ACCOUNT For the year ended...

Debit Cr			
Particulars	Rs.	Particulars	Rs.
Trading Account (For Gross Loss)		Trading Account (For Gross Profit)	
Indirect / office Running Expenses Rent Lighting Salaries Insurance Sundry /General Expenses Printing and Stationery Repair Advertising Commission Paid Cash Discount Allowed Motor Expenses Warehouse Rent/ Insurance Packing Expenses Depreciation Provision for Doubtful Debts Interest on Loan Loss on Sale etc.		Income and Gain Cash Discount Received Interest Received Rent Received Gain on Sale Bonus Received Income on Investment etc.  Capital Account (Transfer of Net Loss)	
Capital Account (Transfer of Net Profit) Total		Total	

*Note:* 1. Either gross profit or gross loss as opening balance will be reflected.

2. Similarly, the ending balance will also reflect either net profit or net loss.

#### **Illustration 2:**

The Following figures from trial balance has been extracted from the books of M/s. Naina Prepare the Trading and Profit & Loss Account for the year ended 31 March 2004.

	Debit (Rs.)	Credit (Rs.)
Drawings	35,000	· · · · · · · · · · · · · · · · · · ·
Building	60,000	
Debtors and Creditors	50,000	80,000
Returns	3,500	2,900
Purchases and Sales	3,00,000	4,65,000
Discount	7,100	5,100
Life Insurance	3,000	
Cash	30,000	
Stock (Opening)	12,000	
Bad Debts	5,000	
Reserves for Bad Debts	-	17,000
Carriage Inwards	6,200	
Wages	27,700	
Machinery	8,00,000	
Furniture	60,000	
Salaries	35,000	
Bank Commission	2,000	
Bills Receivable/Payable	60,000	40,000
Trade Expenses/Capital	13,500	9,00,000

Adjustment: Stock on 31st March 2004 was valued at Rs. 50,000.

#### **Solution**

M/s. Naina Trading and Profit & Loss Account For the Year Ending on 31st March, 2004

Debit		,	Credit
Particulars	Rs.	Particulars	Rs.
To Opening Stock To Purchases 3,00,000 Less: Return 2,900  To Wages To Carriage Inward To Gross Profit	12,000 2,97,100 27,700 6,200 1,68,500	By Sales 4,65,000 Less: Return 3,500  By Closing Stock	4,61,500 50,000
To Discount Paid To Life Insurance To Salaries To Bank Commission To Trade Expenses To Bad Debts To Net Profit	5,11,500  7,100 3,000 35,000 2,000 13,500 5,000 1,25,000 1,90,600	By Gross Profit By Discount Received By Reserve for Bad Debts	5,11,500 1,68,500 5,100 17,000 1,90,600

Note: Balance Sheet of this Illustration is given on under topic "Balance Sheet"

# 1.4 DIFFERENCE BETWEEN TRADING AND PROFIT AND LOSS ACCOUNT

- 1. Trading account is prepared in order to calculate gross profit/loss, while the function of the profit and loss account is to disclose net profit/loss.
- 2. Trading account deals with the sales and cost of goods sold which includes direct expenses. But the profit and loss account deals with indirect expenses such as administrative and financial expenses and the same is charged against gross profit and other revenues.
- 3. The result of the trading account in the form of gross profit/loss is transferred to profit and loss account while the result of profit and loss account in the net profit/loss is transferred to capital account.

#### **Check Your Progress 2**

- 1) List all the items debited or credited in the Profit and Loss account.
- 2) Explain the difference between Trading Account and Profit & Loss Account.
- 3) Explain the difference between Gross Profit and Net Profit.
- 4) Prepare Trading and Profit and Loss Account for the year ended 2005.

Particulars	Dr. (Rs.)	Cr. (Rs.)
Capital		1,00,000
Building	15,000	
Drawing	18,000	
Furniture	7,500	
Motor Car	25,000	
Interest Paid for Loan	900	
Loan from Ashok @ 12%		15,000
Purchases and Sales	75,000	1,00,000
Opening Stock	25,000	
Establishment Ex.	15,000	
Wages	2,000	
Insurance	1,000	
Commission		7,500
Debtors and Creditors	28,100	10,000
Bank Balance	20,000	

Closing Stock Rs. 32,000.

#### 1.5 BALANCE SHEET

Balance sheet is concerned with reporting the financial position of an entity at a particular point in time. This position is conveyed in terms of listing all the things of value owned by the entity as also the claims against these things of value i.e. Liabilities. The position as represented by i.e., Assets. The balance sheet is valid only until another transaction is carried out by the entity.

The above statement can be elaborated by an example:

I want to purchase a car costing Rs. 8,00,000. To do so, I have to borrow capital/money. A bank agrees to finance me if I can invests. 3,00,000 on my own.

Now let us follow the sequence of events when I approach the bank with the proposal. Granting my ability to repay the loan, the banker will ask two specific questions:

- 1. What are the things of value you own?
- 2. How much do you owe, and to whom?

In other words, the banker would like to know what I am worth in material terms. My replies to the questions could be tabulated as follows:

Claims against things of value		Things of value owned by me	
	Rs.		Rs.
Personal loan from friend	1,00,000	Balance with bank	3,50,000
		Fixed deposits	1,50,000
		Other personal belongings	5,00,000
-	1,00,000	-	10,00,000

This implies I own Rs. 10,00,000 worth things of value, Rs. 3,50,000 of this could be withdrawn at any time in cash. We say I have Rs. 3,50,000 in liquid form. Another Rs. 1,50,000 is in monetary investment and the remaining Rs. 5,00,000 is in non-monetary property. Further, I owe Rs. 1,00,000 to friend of mine. In other words, he has got a claim against the things of value owned by me to the extent of Rs. 1,00,000. In brief, we can say I am worth Rs. 10,00,000, claim against my worth is Rs. 1,00,000 and hence my **net worth** is Rs. 9,00,000. This implies Rs. 9,00,000 is my own claims against the things of value owned by me or my net worth.

Now I can present my financial position in the following form:

#### **Financial Position Statement 1**

Amount owned by me		Things of value owned by me	
	Rs.		Rs.
Personal loan from friend	1,00,000	Balance with bank	3,50,000
Own claim or net worth	9,00,000	Fixed deposits	1,50,000
		Other personal belongings	5,00,000
	10,00,000	· -	10,00,000

Now that the bank grants me the loan of Rs. 5,00,000 and I buy the car for Rs.8,00,000. After purchase of the car my financial position statement will change as follows:

#### **Financial Position Statement 2**

Claims against things of value		
Rs.		Rs.
1,00,000	Balance with bank	50,000
5,00,000	Fixed deposit	1,50,000
9,00,000	Car	8,00,000
	Other personal belongings	5,00,000
15,00,000	-	15,00,000
,	<b>Rs.</b> 1,00,000 5,00,000 9,00,000	Rs. 1,00,000 Balance with bank 5,00,000 Fixed deposit 9,00,000 Car Other personal belongings

Now, as a result of this transaction my worth has increased from Rs. 10,00,000 to Rs.15,00,000. However, since there is also an equal increase in claims against my worth in the form of mortgage loan from the bank, my net worth remains the same.

Things of monetary value possessed by an entity are referred to as assets. Accountants use the term assets to describe things of value measurable in monetary terms.

The amount owed by an entity or individual which represent claims against it or his assets by outsiders are liabilities. It is the claims of outsiders which are legally enforceable claims against an individual or entity that are referred to as liabilities.

The assets owned by the entity, less liabilities or outsider's claims, is the net worth. Since the net worth represents the claims of owner(s) in case of an **entity**, it is referred to as owner's equity.

Now we can understand that the financial position statement is a summary of the assets, liabilities and net worth of a firm at a specific point in time.

#### 1.6 CONSTRUCTING A BALANCE SHEET

Having examined the conceptual basis of the balance sheet we will now try to study the balance sheet itself. We have seen that every transaction affects the financial position. Since it is not feasible to draw up a balance sheet after every transaction, it is prepared at the end of a specified period, usually, a year. This period is referred to as **accounting period** or **fiscal year** or **financial year**. This period as a convention has become one calendar year, though, there is no accounting justification for it.

Balance sheet preparation is the arrangement of the assets and liabilities of a firm in a proper or in a systematic way. The balance sheet as prepared at the end of the accounting period shows the year-end status of each of the assets of the firm and the various claims on these assets. We could also say that the balance sheet shows the **year-end balance** in the asset, liability and capital accounts. It may be clarified that there are two conventions of preparing the Balance sheet. The American and the English. According to the American convention, assets are shown on the left hand side and the liabilities and the owner's equity on the right hand side. The **English convention** is just the opposite. i.e., assets are shown on the right hand side of the Balance Sheet and the liabilities and the owner's equity on the left hand side. In India, generally the English conventions are followed. The format given below is the format of the balance sheet in the order of **liquidity**, i.e., ease of conversion of the assets into cash. The more liquid assets is shown first and then the less liquid one appear on the pro-forma. Similarly, on the liabilities side, current liabilities in order of payment are shown first, then fixed or long-term and lastly, the capital of the proprietor.

#### **Balance Sheet as on**

Liabilities	Rs.	Assets	Rs.
<b>Current Liabilities</b>		Current Assets	
Creditors		Cash in Hand	
Bills Payable		Cash at Bank	
Bank Overdraft		Stock-in-Trade	
Outstanding Expenses		Debtors	
Income Received in Advance		Bills Receivable	
		Prepaid Expenses	
Fixed Liabilities		Fixed Assets	
Loan		Furniture and Fixtures	
Mortgage		Plant Machinery	
Capital		Land	
•		Goodwill	

The assets of a business can also be shown in the balance sheet in order of **permanence**, i.e., in order of the desire to keep them in use.

Balance	Shoot	ac an
Baiance	Sneet	as on

Capital Mortgage Bank Overdraft Outstanding Expenses Income Received in Advance Creditors  Goodwill Patents and Trade Marks Furniture and Fittings Plant and Machinery Unexpired Expenses Stock-in-Trade	Liabilities	Rs.	Assets	Rs.
Bills Payable Loan Sundry Debtors Investments Bills Receivable Cash in Bank Cash in Hand	Mortgage Bank Overdraft Outstanding Expenses Income Received in Advance Creditors Bills Payable		Patents and Trade Marks Furniture and Fittings Plant and Machinery Unexpired Expenses Stock-in-Trade Sundry Debtors Investments Bills Receivable Cash in Bank	

Now, let us examine how the ideas what we have learnt so far could be used in a business situation. Please recall that based on the entity principle we shall be dealing with the 'business' as distinct and separate from the owners. We shall demonstrate this by means of an illustration. Following is the Balance sheet of the above mentioned profit and loss account:

M/s. Naina Balance Sheet as on 31<sup>st</sup> March, 2004

+ Net profit 1,25,000	Liabilities	Rs.	Assets	Rs.
Cash Bills Receivable  60,000	+ Net profit 1,25,000 - Drawings 35,000	40,000 80,000	Machinery Furniture Debtors Stock Cash	60,000 8,00,000 60,000 50,000 50,000 30,000 60,000

The following Accounting Concepts would enable us to evaluate the balance sheet:

- The dual aspect principle has particular relevance to balance sheet. As per this principal, every transaction is related as one which has dual effects and hence, it is recorded on debit side as well as credit side. Due to this, we ensure the equality of assets to liabilities and owner's equity.
- All the figures are expressed in monetary units irrespective of its nature. In our example we had cash, merchandise inventory and shop premises all expressed in monetary quantities.
- All the transactions we reflected were in respect of only the **business entity**, and as such, the balance sheet represents the financial position of the business entity and not that of the owners.
- All the valuations were based on the assumption of a **going concern**, and not based on liquidated value. As a consequence, the total value of the assets is written off over a period through a mechanism known as depreciation.
- All the assets were based on **historical cost** as the basis of valuation.

#### Check Your Progress 3

Complete the following blanks:

o)			
<i>-</i>			
	pared at the end of an ye Accounts		
e)			
Assets on a balanc	ce sheet are usually grou	ped together as:	
	assets		equipme
E)	assets.		
Claims against the	assets on the balance sl	neet are summarise	ed as:

# 1.7 CLASSIFICATION OF BALANCE SHEET'S ITEMS

The balance sheet lists assets, liabilities and capital separately. It is an accepted convention that the assets and liabilities are shown into sub-groups and listed in the order of their **liquidity/Permanence**.

The balance sheet in our example/format is presented in the T account form. That is the assets are listed on one side and liabilities and owners' equity on the other.

Another commonly used way of presentation is the **report form** where liabilities and capital are listed above the assets. However, the presentation matters very little since the balance sheet represents the equality between assets, liabilities and capital.

#### **Current Assets**

Current assets are assets, which will normally be converted into cash within a year or within the **operating cycle**. The operating cycle is the duration in time taken by a unit to convert raw material into finished goods, plus time to sell it and finally, plus time to get cash from debtors to whom goods are sold. For example, in a simple trading operation, we use cash to buy merchandise and sell it to recover cash. The operating cycle in such a situation will consist of the period for which, merchandise inventory, and receivables are held. The cycle starts with cash and ends with the collection of cash. Current Assets are liquid and current liabilities can be met from the realisation of them.

#### Cash

Cash is usually taken to include currency (legal tender), cheques or any other document that circulates as cash. Cash is usually classified as a current asset when it is available for a firm's day-to-day operations. It includes cash kept in the cash chest as also deposits on call on current accounts with banks. If cash is specifically earmarked for any purpose and not available for transactions it is better classified as **other assets**.

#### **Accounts Receivable**

Accounts receivable are amounts owed to the company by **debtors**. This is the reason why we also use the term **sundry debtors** to denote the amounts owed to the firm. This represents amounts usually arising out of normal commercial transactions. In other words, 'accounts receivable' or sundry debtors represent unpaid customer accounts. In the balance sheet illustration these represent amounts owed to the firm by customers on the balance sheet date. These are also known as trade receivables, since they arise out of normal trading transactions. Trade receivables arise directly from credit sales and as such provide important information for management and outsiders. In most situations these accounts are unsecured and have only the personal security of the customer.

It is normal that some of these accounts default and become uncollectable. These collection losses are called **bad debts**. It is not possible for the management to know exactly which accounts and what amount will not be collected. However, based on past experience, it is possible for the management to estimate the loss on the receivable or sundry debtors as a whole. Such estimates reduce the gross value of accounts receivable to their estimated realisable value. For instance:

Accounts Receivable	7,50,000
Less: Estimated collection loss at 10%	75,000
Net realisable value of accounts receivable	6,75,000

The estimated collection loss is variously referred to as provision for doubtful debts, provision for bad debts or provision for collection losses.

It is a usual practice for debts to be evidenced by formal written promises to pay or acceptance of an order to pay. These formal documentary debts represent **Promissory Notes, Receivable** or **Bills Receivable**. These instruments used in trade are negotiable instruments and hence enable the trader to assign any of his/her receivables to another party or a bank for realising immediate liquidity.

It is also usual for accounts receivables to be pledged or assigned mostly to banks against short-term credits in the form of **cash credits** or **overdrafts**.

#### **Inventory**

In a trading firm, inventory is merchandise held for sale to customers in the ordinary course of business. In case of manufacturing firms, inventory would mainly consist of materials required to manufacture the products, namely, raw materials, materials remaining with the factory at various stages of completion i.e., work in process and goods ready for sale or finished goods. Apart from these there may be inventory of stores and supplies. Thus we have raw material inventory, work in process inventory, finished goods inventory and stores and supplies inventory.

It is common to refer to inventory as stock-in-trade and thus we could come across stock of raw materials, stock of work in process and stock of finished goods. Inventory is usually valued on the basis of "lower of cost or market price". Market price is taken to mean the cost of replacement either by purchase or by reproduction of the material in question. As a general principle, inventory cost includes all normal costs incurred to make the goods available at the place where it can be sold or used are, treated as costs of inventory.

In trading firms, inventory costs include freight-in, transit insurance costs, import or entry levies as also the invoice cost. Warehouse costs, handling costs, insurance costs in storage and interest costs are not included as costs. They are treated as expenses of a period of the firm.

In case of manufacturing units, the valuation of inventory costs is more complex and involved. As a general rule all costs of materials, labour and plant facilities used for manufacturing the goods are included in the valuation of inventory.

In valuing inventory at lower of cost or market price, care should be taken to see that the valuation does not exceed the realisable value or selling price in the ordinary course of business.

#### **Prepaid Expenses**

In many situations, as a custom, some of the item of expenses are usually paid in advance such as rent, taxes, subscriptions and insurance. The rationale of including these prepayments as current assets is that if these prepayments were not made they would require use of cash during the period.

#### **Fixed Assets**

Fixed assets are tangible, relatively long-lived items owned by the business. The benefit of these assets are available not only in the accounting period in which the cost is incurred but over several accounting periods. Current assets provide benefits to the organisation by their exchange into cash. In the case of fixed assets, value addition arises by facilitating the process of production or trade. In other words, benefits from fixed assets are indirect rather than direct.

All man made things have limited life. In accounting we are concerned with the useful life of the assets. Useful life is the period for which a fixed asset could be economically used. This implies that the benefits from the fixed assets will flow to the organisation throughout its useful life. Another aspect of this is that the cost incurred in the period of purchase of the asset will be providing benefits over the useful life of the asset.

Valuation of the fixed assets is usually made on the basis of original cost. However, since assets have limited life the cost will be expiring with the expiration of the life. Thus, valuation of the asset is reduced by an amount proportionate to the expired life of the asset. Such expired cost is referred to as depreciation in accounting.

Fixed assets normally include assets such as land, building, plant, machinery and motor vehicles. All these items, with the exception of land, are depreciated. Land is not subject to depreciation and hence shown separately from other fixed assets.

#### **Intangible and Other Assets**

Intangible assets are assets or things of value without physical dimensions. They cannot be touched, they are incorporeal, representing intrinsic value without material being. One of the most common of these assets is **goodwill**. Goodwill reflects the ability of a firm to earn profits in excess of normal return. Almost all firms may have some goodwill. However, they appear in the books and balance sheet only when it has been purchased. Usually, when a going concern is purchased, the purchase price paid in excess of the fair value of the assets is considered goodwill. The amount is classified as another asset 'goodwill' on the balance sheet. Like fixed assets, the value of intangible assets should also be expired over a period of time. Such an expiration cost is called amortisation, similar to depreciation.

#### **Current Liabilities**

We have studied that **liabilities** are claims of outsiders against the business. In other words, these are amounts owed by the business to people who have lent money or

provided goods or services on credit. If these liabilities are due within an accounting period or the operating cycle of the business, they are classified as current liabilities. Most of such liabilities are incurred in the acquisition of materials or services forming part of the current assets. As was the case with current assets, current liabilities are also listed in the order of their relative liquidity.

#### **Accounts Payable**

Accounts Payable or sundry creditors are usually unsecured debts owed by the firm. These are also referred to as payables on open accounts. They may not be evidenced by any formal written acceptance or promise to pay. They represent credit purchase of goods or services for which payment has not been made as on the date of the balance sheet.

#### **Accrued Liabilities**

Accrued liabilities represent expenses or obligations incurred in the previous accounting period but the payment for the same will be made in the next period. In many cases where payments are made periodically, such as wages, rent and similar items, the last month's payment may appear as accrued liabilities (especially if the practice is to pay the same on the first working day of a month). This obligation shown on the balance sheet indicates that the firm owed the said amount on the balance sheet date.

#### **Provisions or Estimated Liabilities**

Where the liabilities are known but the amounts cannot be precisely determined, we estimate the liability and provide for it as a liability. A common example is **income tax payable**. Unless the tax liability is determined the amount payable cannot be accurately determined. There could be other examples too, such as product warranty expenses to be met and so on. The common practice is to estimate these liabilities based on past experience and make a provision for the same which is shown as a part of liabilities

#### **Contingent Liabilities**

Contingent liabilities should be distinguished from estimated liabilities. Estimated liabilities are known liabilities where the amount is uncertain. Contingent liabilities on the other hand are not liabilities at the current moment. They may become liabilities only on the happening of a certain event. In other words, both the amount and the liability (or obligation) are uncertain till the specified event occurs in future. These may include items like a claim against the company **contested** in a court. Only if the court gives an unfavourable verdict, it becomes a liability. They are not listed as liabilities in the body of the balance sheet. However, if the firm wishes, it may make same provision for the same.

#### **Long-Term Liabilities**

Long-term liabilities are usually for more than one year. They cover almost all the outsider's liabilities not included in the **current liabilities** and **provisions**. These liabilities may be unsecured or secured. Security for long-term loans, are usually the fixed assets owned by the firm assigned to the lender by a pledge or mortgage. All details such as interest rate, repayment commitment and nature of security are disclosed in the balance sheet. Usually, such long-term liabilities include debentures and bonds, borrowings from financial institutions and banks.

#### Capital

We have seen earlier in this unit that the fundamental accounting equality states: **assets = liabilities + owners equity**. From the example of balance sheet we can easily establish this. See Ms. Naina's balance sheet:

Total assets Rs. 1,00,00,000
Total liabilities Rs. 60,00,000
Owner's equity Rs. 40,00,000

We also know that the owner's equity consists of the contributed capital and the retained earnings of the firm. Therefore, capital is that part of owner's equity which is contributed by the owners. If Ms. Naina were an individual proprietorship business, the owner's equity will be reflected directly as:

Capital Rs 40,00,000

If 'M/s. Naina' were a partnership firm with four partners W, X, Y and Z all sharing equally, the capital would be represented as:

Capital Partner W	Rs. 10,00,000
Partner X	Rs. 10,00,000
Partner Y	Rs. 10,00,000
Partner Z	Rs. 10,00,000
Total	Rs. 40,00,000

#### **Reserves and Surplus**

Reserves and surplus or **retained earnings** normally arise out of profitable operations. It is a surplus not distributed by the firm as dividends. In other words, these are profits that are to be retained within the business. When a firm starts its operations it has no retained earnings. If in the first year it earns say Rs. 10,000 profit and decides to distribute Rs. 5,000 as dividends, the reserves and surplus at the end of the year will be Rs. 5,000. During its second year of operation if the firm makes a loss of Rs. 3,000 then the retained earnings at the end of the year will be Rs. 2,000. Retained earnings (or reserves and surplus) are in the nature of **earned capital** for the firm. We have seen earlier that the dividends are limited to retained earnings. This implies that at no point in time the original capital of the firm can be distributed as dividend. In other words, the capital originally contributed is to be maintained intact.

It is possible to allocate profits earned and accumulated as reserves or retained earnings to be earmarked for specific purposes. The earmarked reserves are not distributed. Only non-earmarked or **free reserves** are available for distribution as dividends.

### Check Your Progress 4

Fill in the blanks:

1)	As a convention, items appearing on the balance sheet are listed in the order of their relative
2)	Balance sheet could be presented either in a) from, or
	b)

3)	Operating cycle is the duration
4)	Inventories are valued in the balance sheet by applying the principle of
5)	Accounts receivable are also referred to as
6)	Expired cost with respect to a fixed asset is referred to as expense.
7)	Expiration of cost of intangible assets is referred to as
8)	Sundry creditors are also referred to as,
9)	We judge an item as a current asset if it is converted into cash during an
10)	Liquidity refers to nearness of an item to
11)	Items classified as current assets are usually listed in the order of their relative
12)	The basis of valuation as applied to temporary investment is
13)	Asset losses expected out of non-collection of receivables are called
14)	Formal written/documented debts refer to
15)	Items commonly referred to as inventory include (i), (ii) and (iii)
16)	Fixed Assets are valued on the basis of
17)	Balance sheet is a statement of
18)	represents the owners' claim against assets of a business.
19)	are claims of outsiders against the business.
20)	increase owners' equity.
21)	Amounts owed by a business on account of purchase of inventory are usually called or
22)	Amounts receivable by a firm against credit sales are usually called
23)	As a general rule all assets are valued at their to the business.
24)	Owner's equity could be understood as comprising two parts: and
25)	The dual aspect principle ensures an important equality reflected by balance sheet
26)	All valuations specially those of fixed assets in a balance sheet are based on an important assumption about the entity as a

#### 1.8 ADJUSTMENT ENTRIES

Accounts are prepared as per accounting concepts, conventions and principles. Since final accounts are prepared on accrual basis, it becomes necessary to subtract all those expenses, which are basically paid during the current financial year although applicable to other accounting period(s). And to add all those expenses, which benefit the current accounting period either the payment was made or not. Similarly in case of earnings subtract all those revenue items, received in the current accounting period but applicable to other accounting period (s). Add all those revenue items, which have been earned currently but not yet been received. The above stated corrections in the final account are called Adjustments, which are made with the help of adjusting entries. Adjustments ensure a proper matching of costs and revenue for obtaining correct profit or loss for the given accounting period.

Let us see the treatment and impact of some adjustments on final account.

#### 1.8.1 Closing Stock

The value of unsold stock. The stock is valued at cost or market price whichever is lower. Generally, the closing stock is not given in the trial balance but is given in adjustments. Closing stock will appear on the credit side of the trading account and will also appear on the assets side of the balance sheet.

#### 1.8.2 Depreciation

It is the amount charged because of the usage and passage of time. Fixed assets are used for earning revenue. Therefore, a decrease in their value is considered to be the operational expenses of business. In order to ascertain true profits and to show the true value of the assets in the balance sheet, depreciation has to be charged. Depreciation account is debited while individual asset account is credited and then the profit and loss account is debited and the while depreciation accounts is credited.

#### 1.8.3 Bad Debts

Bad debts are losses on account of uncollectable debts. When the amount due from debtors is irrecoverable, it is called bad debts. Bad debts, being loss are closed by transferring them to the debit side of the profit and loss account. The amount of bad debts is also deducted from debtors in the balance sheet. If the same appears in the trial balance, no adjustment entry is needed. In this case, debtors appear at their adjusted figure.

#### 1.8.4 Provision for Bad and Doubtful Debts

A provision should be made in advance for those debts whose recovery is doubtful and to writing off bad debts. All enterprises, based on their past experience, create a provision for doubtful debts to meet such a loss when it happens. This is done for the purpose of reflecting the debtors in the balance sheet at their true value. Provisions for bad and doubtful debts appear on the debit side of the profit and loss account and at the credit side of the provision for bad debts account.

#### 1.8.5 Outstanding Expenses (Liabilities)

Expenses are generally recorded only when they are paid. The failure to record an unpaid expenses in the accounts results in an understatement of that expense and also an understatement of a liability. In order to avoid understatement of these expenses and liabilitie, an adjustment entry is passed by debiting the expense account and, crediting the personal account of the party to whom such amount is to be paid. If outstanding expenses appear on the credit side of the trial balance, then they will be taken to the liability side of the balance sheet.

#### 1.8.6 Prepaid Expenses (Assets)

Expenses paid in advance of their use or consumption are known as prepaid expenses. At the end of the year, a part of the payment remains unconsumed and is treated as an asset, because its benefit is to be availed of in future. For prepaid expense, the adjustment entry is made by debiting prepaid expense account and crediting expense account. If this item appears on the debit side of the trial balance, it will be shown only on the assets side of the balance sheet. It will not appear in Profit &Loss Account at all.

#### 1.8.7 Accrued Income (Assets)

Accrued income is an amount earned but not actually received during the accounting period or till the date of preparation of final accounts for the period concerned. The first effect of accrued income is to credit the profit and loss account and to show the same in the assets side of the balance sheet.

#### 1.8.8 Income Received in Advance (Liability)

It is the income received but not earned during the accounting period. In other words, it is the income for which services are to be rendered in future. This income is deducted from the concerned income in the credit side of profit and loss account and is also shown as a liability in the balance sheet.

To see the impact of adjustment entries' on the final account (financial condition of the business firm) let's take the same illustration of Ms. Naina again only including the some common adjustments in it. And let us check its impact practically by comparing the transactions of both the illustrations (with or without adjustment entries).

#### **Revised Illustration 2:**

The following figures from the trial balance has been extracted from the books of M/s. Naina Prepare the Trading and Profit & Loss Account for the year ended 31 March 2004.

	Debit (Rs.)	Credit (Rs.)
Drawings	35,000	
Building	60,000	
Debtors and Creditors	50,000	80,000
Returns	3,500	2,900
Purchases and Sales	3,00,000	4,65,000
Discount	7,100	5,100
Life Insurance	3,000	
Cash	30,000	
Stock (Opening)	12,000	
Bad Debts	5,000	
Reserves for Bad Debts	-	17,000
Carriage Inwards	6,200	
Wages	27,700	
Machinery	8,00,000	
Furniture	60,000	
Salaries	35,000	
Bank Commission	2,000	
Bills Receivable/Payable	60,000	40,000
Trade Expenses/Capital	13,500	9,00,000

#### Adjustment:

- 1. Stock on 31st March 2004 was valued at Rs. 50,000.
- 2. Depreciation of building 5%; furniture and machinery is 10% p.a.
- 3. Trade expenses Rs. 2,500 and wages Rs. 3,500 have not been paid as yet.

- 4. Allow interest on capital at 5% p.a.
- 5. Make provision for doubtful debts at 5%.
- 6. Machinery includes Rs. 2,00,000 of a machinery purchased on 31st December 2003. Wages include Rs. 5,700 spent on the installation of machine.

#### **Solution**

			1
T. O	Rs.	D G 1	Rs.
To Opening Stock To Purchases 3.00.000	12,000	By Sales 4,65,000	4 (1 500
	2.07.100	Less: Return 3,500	4,61,500
Less: Return 2,900	2,97,100		
To Wages 27,700			
Less: Installation Charges 5,700		By Closing Stock	
Add: Outstanding 3,500	25,500		50,000
To Carriage Inward ———	6,200		
To Gross Profit c/d	1,70,700		
	5,11,500		5,11,500
	3,11,300	D C D C(1/1	3,11,300
		By Gross Profit b/d	
	7 100	By Discount Received	1,70,700
To Discount	7,100	By Reserve for Bad and Doubtful	5,100
To Life Insurance	3,000	Debts	17,000
To Salaries	35,000	Deois	
To Bank Commission	2,000		
To Trade Expenses 13,500			
Add: Outstanding 2,500	16,000		
T. D. 1D.14	5,000		
To Bad Debts	45,000		
To Interest on Capital To Provision for Doubtful Debts	2,500		
	3,000		
To Depreciation on: Building	65,143		
Machine	6,000		
Furniture	3,057		
To Net Profit	1,92,800		1,92,800

Ms. Naina
Balance Sheet as on 31<sup>st</sup> March, 2002

Liabilities	Rs.	Assets	Rs.
Capital 9,00,000		Building 60,000	
+ Net profit 3,057		– Dep. @ 5% 3,000	57,000
+ int. on Capital 45,000			
– Drawings 35,000	9,13,057	Machinery 8,00,000	
		+ Wages 5,700	
Creditors	80,000	– Dep. 65,143	7,40,557
Outstanding Wages	3,500		_
Bills Payable	40,000	Furniture 60,000	
Outstanding Trade Exp.	2,500	– Dep. 6,000	_   54,000
		Debtors 50,000	
		- Provision <u>2,500</u>	_ 47,500
		a. 1	<b>7</b> 0.000
		Stock	50,000
		Cash	30,000
		Bills Receivable	60,000
	10,39,057		10,39,057

#### Analyses of the above two Examples

Particular	Illustration 2	<b>Revised Illustration 2</b>
Wages	27,700	25,500
Gross Profit	1,68,500	1,70,700
Trade Expenses	13,500	16,000
Depreciation	Nil	74,570
Net Profit	1,11,000	2,630
Building	60,000	57,000
Machinery	8,00,000	7,40,557
Furniture	60,000	54,000
Debtors	50,000	47,500
Capital	9,90,000	9,12,630

The above table is self-explanatory. It shows clearly the importance of adjustment entries for a business firm and for all concerned parties of the same to ascertain the correct financial position of the enterprise.

### Check Your Progress 5

- 1) What is Trading Account? Distinguish between Trial Balance and Profit and Loss Account
- 2) Write short note on Final Accounts and Adjustments Entries.
- 3) What are Adjustments? What is the need of making adjustments while preparing Final Account?
- 4) Show the treatment of the following adjustments:
  - a. Outstanding Expenses
  - b. Depreciation
  - c. Bad Debts
- 5) Prepare the trading account from the following figures of Mr. Deep on 31<sup>st</sup> March 2004.

Opening Stock	34,200
Purchases	1,02,000
Wages	34,500
Returns Outwards	1,740
Power	1,280
Factory Lighting	950
Manufacturing Ex.	9,500
Freight on Purchases	1,860
Sales	2,50,850
Sales Return	3,100

#### 5) The following is the trial balance of Mr. Virat as at 31.03.2005

	Debit (Rs.)	Credit (Rs.)
Fixed Assets	3,00,000	
Debtors	75,000	
Opening Stock	2,05,000	
Bills Receivables		
	10,000	
12% Investments (1.7.1998)	50,000	
Cash in Hand	5,000	
Cash in Bank	10,000	
Drawings	10,000	
Purchases	5,25,000	
Sales Return	10,000	
Carriage Inwards	5,000	
Carriage Outwards	2,000	
Rent	3,000	
Insurance	3,600	
Office Expenses	13,200	
Discount Allowed	2,000	
Bad Debts	5,000	
Interest	2,500	
Selling Expenses	15,800	
Creditors		1,00,000
Bills Payable		5,600
Loan from Bank		4,000
Sales		6,30,000
Purchase Return		5,000
Discount		1,000

#### Adjustment:

- 1. Stock on 31st March 2005 was valued at Rs. 42,000.
- 2. Rent is payable at the rate of Rs. 300 p.m.
- 3. Insurance premium was paid for the year ending 30<sup>th</sup> June, 2005.
- 4. Interest on investment is payable half yearly on 30<sup>th</sup> June and 31<sup>st</sup> December.
- 5. Write off further bad debts Rs. 5000. Also create a provision for doubtful debts @ 10% on debtors and provision for discount on debtors @ 2%.
- 6. Create a reserve for discount on creditors @ 2%.
- 7. Provide for depreciation on fixed assets @ 10%.

Prepare the Trading and Profit and Loss Account for the year ended and Balance Sheet as on 31<sup>st</sup> March 2005.

- 6) On 31<sup>st</sup> March 2004 the following trial balance of Sanjeev Tomar was taken out. Prepare final account for the year after making the following adjustments.
  - 1. Depreciation: 5% of plant and machinery and 10% of fixtures and fittings.
  - 2. Reserve for bad debts 2.5% on Sundry Debtors
  - 3. Insurance unexpired on 31st March 2004 Rs. 70
  - 4. Outstanding wages Rs. 800 and Salaries Rs. 350.

#### **Trial Balance**

Plant and Machinery	55,000
Fixtures and Fittings	1,720
Factory Fuel and Power	542
Office Salaries	3,745
Lighting (Factory)	392
Travelling Expenses	925
Carriage on Sales	960
Cash in Bank	2,245
Sundry Debtors	47,800
Purchases (Adjusted)	66,710
Wages	9,915
Rent and Taxes	1,915
Office Expenses	2,778
Carriage on Purchase	897
Discount	422
Drawings	6820
Stock 1 April 2003	21,725
Manufacturing Expenses	2,680
Sales Return	7,422
Insurance	570
Closing Stock	16,580
Rent Outstancing	150
Sanjeev's Capital	93,230
Sales	1,26,177
Sundry Creditors	22,680
Purchase Return	3,172
Bills Payable	6,422

#### 1.9 SUMMARY

Both the parts, Trading Account and Profit and Loss Account, of Final Account are interdependent on each other. Gross Profit/loss plays a very special role in the calculation of net Profit and loss figure. Trading and profit and loss account gives the true picture of an organisation by showing its revenues and expenses. This account is normally prepared at the end of the accounting period. Balance Sheet as we have seen is one of the most important financial statements. It is a periodic summary of the financial position of the business. It is the statement of assets, liabilities and owners' capital at a particular point in time. This statement in itself does not reveal anything about the details of the operations of the business. However, a comparison of two balance sheets could reveal the changes in business position. A realistic understanding of the operations of the business would require two other statements — Cash Flow Statement and Funds Flow Statement. We shall take them up in subsequent units.

#### 1.10 KEY WORDS

**Asset:** Anything, tangible or intangible, of monetary value to a business entity; something which a business entity owns.

**Current Assets:** All the assets held by a firm with the objective of conversion to cash within the operating cycle or within one year whichever is longer. Current Assets include items such as cash, receivables, inventory and prepayments.

**Current Liabilities:** All those claims against the assets of the firm to be met out of cash or other current assets within one year or within the operating cycle, whichever is longer. Usually include items such as accounts payable, tax or other claims payable, and accrued expenses.

**Contingent Liability:** A liability which has not been recognised as such by the entity. It becomes a liability only on the happening of a certain future event. An example could be the liability which may arise out of a pending lawsuit.

**Fixed Asset:** Tangible long-lived asset. Usually having a life of more than one year. Includes items such as land, building, plant, machinery, motor vehicles, furniture and fixtures.

**Intangible Assets:** Any long-term assets useful to the business and having no physical characteristics. Include items such as goodwill, patents, franchises, formation expenses and copyrights.

**Liability:** Any amount owed by one person (the debtor) to another (the creditor). In a balance sheet all those claims against the assets of the entity, other than those of the owners.

**Owner's Equity:** It is the owner's claim against the assets of a business entity. It could be expressed as total assets of an entity less claims of outsiders or liabilities, including both contributed capital and retained earnings.

#### 1.11 SOLUTIONS / ANSWERS

#### **Check Your Progress 1**

- 1) Gross Profit Rs. 86,000
- 2) Net purchase is the difference between purchases and the purchase return
- 3) Net sales is the difference between sales and the sales return

#### **Check Your Progress 2**

4) Gross Profit Rs. 30,000 and Net Profit Rs. 10,600

#### **Check Your Progress 3**

- 1) (a) accounting period (b) fiscal year (c) financial year
- 2) (a) asset (b) liability (c) capital
- 3) (a) current (b) property, plant (c) other
- 4) (a) current (b) long-term (c) shareholders.

#### **Check Your Progress 4**

- 1) Liquidity
- 2) (a) T account form (b) Report form
- 3) Is time taken by a unit to convert goods into sales and to collect money from debtors?
- 4) Lower of cost or market price
- 5) Sundry debtors

- 6) Depreciation
- 7) Amortisation
- 8) Accounts payable
- 9) Operating cycle or accounting year
- 10) Cash
- 11) Liquidity
- 12) 'Lower of cost or market price'.
- 13) Bad debts.
- 14) Promissory Notes receivable or bills receivable.
- 15) Raw material (ii) Work-in-Process (iii) Finished goods.
- 16) Historical cost, less Depreciation.
- 17) Assets, Liabilities and capital
- 18) Owners' equity
- 19) Liabilities
- 20) Profits
- 21) Accounts payable or sundry creditors
- 22) Accounts receivable or sundry debtor
- 23) Original cost
- 24) Contributed capital and retained earnings
- 25) Assets = Liabilities + Owner's Equity
- 26) Going concern.

#### **Check Your Progress 5**

- 4) a. Expense Account Dr. (It will go to trading or profit & loss A/c) To Outstanding Expenses Account
  - b. Depreciation Account Dr.

To individual Asset Account

Profit and Loss Account Dr.

To Depreciation Account

- c. Bad Debts Account Dr.
  To Debtors Account
- 5) Gross Profit Rs. 62,000 and Net Loss Rs. 32,400
- 6) Gross Profit Rs. 62,000 and Net Loss Rs. 32,400
- 7) Balance Sheet total Rs. 1,19,366. Net Profit Rs. 2,554, Gross Profit Rs. 18,266.

### 1.12 FURTHER READINGS

- 1. Financial Accounting, Dr. R.K. Sharma and Dr. R.S. Popli, Kitab Mahal, 2005.
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- 3. *Financial Accounting*, Horngren C.T. and Harrison, *01/23/2003*, Prentice Hall: New Delhi (Chapter 1).
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