



ALAGAPPA UNIVERSITY

[Accredited with 'A+' Grade by NAAC (CGPA:3.64) in the Third Cycle
and Graded as Category-1 University by MHRD-UGC]

(A State University Established by the Government of Tamil Nadu)

KARAIKUDI – 630 003



Directorate of Distance Education

B.C.A.

V - Semester

101 51

ACCOUNTING FUNDAMENTALS

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E-28, Sector-8, Noida - 201301 (UP)

Phone: 0120-4078900 • Fax: 0120-4078999

Regd. Office: A-27, 2nd Floor, Mohan Co-operative Industrial Estate, New Delhi 1100 44

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Work Order No. AU/DDE/DE12-27/Preparation and Printing of Course Materials/2020 dated 12.08.2020, Copies 500

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INTRODUCTION

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Accounting is the language of business. It is the art of recording, classifying and summarizing financial transactions and interpreting the results thereof. It communicates the result of business operations to various parties who have some stake in the business, viz., proprietors, creditors, investors, government and other agencies. Every businessman is interested in two facts: (i) has his business earned a profit or suffered a loss during the period covered by the Trial Balance, and (ii) where does the business stand now? In other words, what is the financial position of the business? The determination of profit or loss is done by preparing a trading account and a profit and loss account or 'Income Statement'. The financial position is judged by preparing a balance sheet of the business.

The role of the accountant has undergone revolutionary change with the passage of time. Traditionally, accounting was considered solely a historical description of financial activities. This view is no longer acceptable. Accounting is now considered a service activity and an important tool of management for decision-making. Keeping this in mind, this book, will deal with the basics of accounting, double-entry system of book-keeping, accounting from incomplete records, and ratio analysis.

This book, *Accounting Fundamentals*, has been designed keeping in mind the self-instruction mode (SIM) format and follows a simple pattern, wherein each unit of the book begins with the Introduction followed by the Objectives for the topic. The content is then presented in a simple and easy-to-understand manner and is interspersed with Check Your Progress questions to reinforce the student's understanding of the topic. A list of Self-Assessment Questions and Exercises is also provided at the end of each unit. The Summary and Key Words further act as useful tools for students and are meant for effective recapitulation of the text.

BLOCK I
ACCOUNTING FUNDAMENTALS

*Introduction to
Accounting*

**UNIT 1 INTRODUCTION TO
ACCOUNTING**

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Structure

- 1.0 Introduction
- 1.1 Objectives
- 1.2 Accounting: Definition
 - 1.2.1 Accounting for Historical Function and Managerial Function
 - 1.2.2 Various Uses of Accounting Information
- 1.3 Answers to Check Your Progress Questions
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1.0 INTRODUCTION

Accounting has rightly been termed as the language of the business. The basic function of a language is to serve as a means of communication. Accounting also serves this function. It communicates the result of business operations to various parties who have some stake in the business, *viz.*, the proprietor, creditors, investors, Government and other agencies. Though accounting is generally associated with business but it is not only business which makes use of accounting. Persons like housewives, Government and other individuals also make use of accounting. For example, a housewife has to keep a record of the money received and spent by her during a particular period. She can record here receipts of money on one page of her “household diary”, while payments for different items such as milk, food, clothing, house, education, etc., on some other page or pages of her diary in a chronological order. Such a record will help her in knowing about:

- (i) The sources from which she received cash and the purposes for which it was utilised.
- (ii) Whether her receipts are more than her payments or *vice versa*?
- (iii) The balance of cash in hand or deficit, if any, at the end of a period.

In case the housewife records her transactions regularly, she can collect valuable information about the nature of her receipts and payments. For example, she can find out the total amount spent by her during a period (say, a year) on different items, say milk, food, education, entertainment, etc. Similarly, she can find the sources of her receipts such as salary of her husband, rent from property, cash gifts from her near relations, etc. Thus, at the end of a period (say, a year) she

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can see for herself about her financial position, i.e., what she owns and what she owes. This will help her in planning her future income and expenses (or making out a budget) to a great extent.

The need for accounting is all the more greater for a person who is running a business. He knows: (i) What he owns? (ii) What he owes? (iii) Whether he has earned a profit or suffered a loss on account of running a business? (iv) What is his financial position, i.e., whether he will be in a position to meet all his commitments in the near future or he is in the process of becoming a bankrupt.

1.1 OBJECTIVES

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

- Discuss the meaning and definition of accounting
- Explain the historical and managerial functions of accounting
- Describe the various uses of accounting information

1.2 ACCOUNTING

Some people take book-keeping and accounting as synonymous terms, but they are different from each other. Book-keeping is mainly concerned with recording of financial data relating to the business operations in a significant and orderly manner. A book-keeper may be responsible for keeping all the records of a business or only of a minor segment, such as a position of the Customers' accounts in a departmental store. A substantial portion of the book-keeper's work is of a clerical nature and is increasingly being accomplished through the use of mechanical and electronical devices.

Accounting is primarily concerned with designing the systems for recording, classifying and summarizing the recorded data and interpreting them for internal and external end-users. Accountants often direct and review the work of the book-keepers. The larger the firm, the greater is the responsibility of the accountant. The work of an accountant in the beginning may include some book-keeping. An accountant is required to have a much higher level of knowledge, conceptual understanding and analytical skill than what is required for a book-keeper.

Difference between Book-keeping and Accounting

The difference between book-keeping and accounting can be well understood with the help of the following example:

If *A* sells goods to *B* on credit, the only fundamental principle involved is of "dual aspect" and to give a true picture of the transaction, both the aspects must be considered. On the one hand, *A* has lost one asset, i.e., good and on the other hand, he has obtained another asset, i.e., a "debt due from *B*". The book-keeper should debit *B*'s account

in *A*'s books and credit the sales account. However, if at the end of a year, *A* has got some stock of goods with him, they should be properly valued in order to ascertain the true profit of the business. The principle to be followed in valuing the stock and many adjustment that will have to be made before the books of account can be closed and true profit or loss can be ascertained, are all matters of accounting. Thus, book-keeping is more of a routine work and a book-keeper, if instructed properly, can record the routine transactions quite efficiently even if he does not know much of accounting principles.

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Is Accounting a 'Science' or an 'Art'?

Any organized knowledge based on certain basic principles is a 'science'. Accounting is also a science. It is a organized knowledge based on scientific principles which have been developed as result of study and experience. Of course, accounting cannot be termed as a "perfect science" like Physics or Chemistry where experiments can be carried and perfect conclusions can be drawn. It is a social science depending much on human behaviour and other social and economic factors. Thus, perfect conclusions cannot be drawn. Some people, therefore, though not very correctly, do not take accounting as a science.

Art is the technique which helps us in achieving our desired objective. Accounting is definitely an art. The American Institute of Certified Public Accountants also defines accounting as "the art of recording, classifying and summarizing the financial transactions". Accounting helps in achieving our desired objective of maintaining proper accounts, *i.e.*, to know the profitability and the financial position of the business, by maintaining proper accounts.

Accounting and Accountancy

Honestly speaking, in today's world, there is not much difference between accounting and accountancy. The terms have become pretty much interchangeable. Accounting is traditionally one of the three principles of accountancy (the others were bookkeeping and auditing), which was the application of reading and maintaining the financial records of said company. Traditionally, accountancy is the parent term for the entire field and accounting was a specific duty of an accountant. Accountancy is referred to as the actual process of communicating information about the financial state of a company to its shareholders, usually in the form of financial statements, which show the assets and resources under the company's control in monetary terms.

1.2.1 Definitions, Scope and Functions of Accounting

From the above discussion it is clear that over a period of time the concept of accounting and the role of accountant has undergone a revolutionary change. The change is particularly noticeable during the last fifty years.

Earlier, accounting was considered simply as a process of recording business transactions and the role of accountant as that of record-keeper. However,

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accounting is now considered to be a tool of management providing vital information concerning the organisation's future. Accounting today is thus more of an information system rather than a mere recording system.

It will be useful here to give in a chronological order the definitions given by some of the well established accounting bodies which show how the concept of accounting has undergone a change over a period of time.

In 1941, the American Institute of Certified Public Accountants (AICPA) defined accounting as follows:

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

In 1966, the American Accounting Association (AAA) defined accounting as follows:

“Accounting is the process of identifying, measuring and communicating economic information to permit informed judgements and decisions by users of the information”.

Scope of Accounting

Accounting has a wide scope and it extends to business, trade, government, financial institutions, individuals and families. The accounting principle is used in every step. This is wrong to assume that the accounting scope is only limited to financial transactions of a business concern. Accounting is essential for all types of business organizations, even for individuals and families.

Functions of Accounting

In 1970, the Accounting Principles Board (APB) of the American Institute of Certified Public Accountants (AICPA) enumerated the functions of accounting as follows:

“The function of accounting is to provide quantitative information, primarily of financial nature, about economic entities, that is needed to be useful in making economic decisions”.

Thus, accounting may be defined as the process of recording, classifying, summarizing, analysing and interpreting the financial transactions and communicating the results thereof to the persons interested in such information.

An analysis of the definition brings out the following functions of accounting:

1. **Recording:** This is the basic function of accounting. It is essentially concerned with not only ensuring that all business transactions of financial character are, in fact, recorded but also that they are recorded in an orderly manner. Recording is done in the book “Journal”. This book may be further sub-divided into various subsidiary books such as Cash Journal (for recording cash transactions), Purchases Journal

(for recording credit purchase of goods), Sales Journal (for recording credit sales of goods), etc. The number of subsidiary books to be maintained will be according to the nature and size of the business.

2. **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 work of classification is done in the book termed as “Ledger”. This book contains on different pages individual account heads under which all financial transactions of similar nature are collected. For example, there may be separate account heads for Travelling Expenses, Printing and Stationery, Advertising etc. All expenses under these heads after being recorded in the Journal will be classified under separate heads in the Ledger. This will help in finding out the total expenditure incurred under each of the above heads.
3. **Summarizing:** This involves presenting the classified data in a manner which is understandable and useful to the internal as well as external end-users of accounting statements. This process leads to the preparation of the following statements:
(i) Trial Balance (ii) Income Statement (iii) Balance Sheet.
4. **Dealing with Financial Transactions:** Accounting records only those transactions and events in terms of money which are of a financial character. Transactions which are not of a financial character are not recorded in the books of account. For example, if a company has got a team of dedicated and trusted employees, it is of great use to the business but since it is not of a financial character and capable of being expressed in terms of money, it will not be recorded in the books of the business.
5. **Analysing and Interpreting:** The recorded financial data is analysed and interpreted in a manner that the end-users can make a meaningful judgement about the financial condition and profitability of the business operations. The data is also used for preparing the future plan and framing of policies for executing such plans.

A distinction here can be made between the two terms—‘Analysis’ and ‘Interpretation’. The term ‘Analysis’ means methodical classification of the data given in the financial statements. The figures given in the financial statements will not help one unless they are put in a simplified form. For example, all items relating to ‘Current Assets’ are put at one place while all items relating to ‘Current Liabilities’ are put at another place. The term ‘Interpretation’ means explaining the meaning and significance of the data so simplified.

However, both ‘Analysis’ and ‘Interpretation’ are complementary to each other. Interpretation requires Analysis, while Analysis is useless without Interpretation.

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6. **Communicating:** The accounting information after being meaningfully analysed and interpreted has to be communicated in a proper form and manner to the proper person. This is done through preparation and distribution of accounting reports, which include besides the usual income statement and the balance sheet, additional information in the form of accounting ratios, graphs, diagrams, funds flow statements, cash flow statements etc. The initiative, imagination and innovative ability of the accountant are put to test in this process.

1.2.1 Accounting for Historical Function and Managerial Function

Historical functioning of accounting involves keeping the accurate records of all the past transactions made in the business. This type of functioning of accounting includes:

- Recording the financial transactions and maintain a journal to keep them all.
- It is important to classify and separate the records and the ledger.
- Preparation of brief summary takes place for the quick reviews.
- This type of accounting gives the net result other than just keeping the records.
- Preparation of balance sheet takes place to determine the financial position of the business.
- The analyzed data and records are then used for the other purposes.
- The last step is to communicate the obtained financial information to the interested sectors, for instance, owners, suppliers, government, researchers etc.

Managerial Functions

In an organization, the management committee looks for all kind of the decision making. To ensure that the decisions are smooth and beneficial for everyone, they do an evaluation of the past records provided by accounting. These are managerial functions. The five managerial functions of accounting are:

- Formation of plans in addition to controlling the financial policies.
- Besides that, a budget is prepared to estimate the total expenditure for the future activities.
- Also, cost control is made possible by comparing the cost with the efficiency of the work.
- The accounting also provides the necessary information during the evaluation of employee's performance.
- To check for frauds and errors is what the workability of the whole procedure depends.

1.2.2 Various Uses of Accounting Information

Accounting is of primary importance to the proprietors and the managers. However, other persons such as creditors, prospective investors, employees, etc., are also interested in the accounting information.

1. **Proprietors:** A business is done with the objective of making profit. Its profitability and financial soundness are, therefore, matters of prime importance to the proprietors who have invested their money in the business.
2. **Managers:** In a sole proprietary business, usually the proprietor is the manager. In case of a partnership business either some or all the partners participate in the management of the business. They, therefore, act both as managers as well as owners. In case of joint stock companies, the relationship between ownership and management becomes all the more remote. In most cases the shareholders act merely as rentiers of capital and the management of the company passes into the hands of professional managers. The accounting disclosures greatly help them in knowing about what has happened and what should be done to improve the profitability and financial position of the enterprise in the period to come.
3. **Creditors:** Creditors are the persons who have extended credit to the company. They are also interested in the financial statements because these will help them in ascertaining whether the enterprise will be in a position to meet its commitment towards them both regarding payment of interest and principal.
4. **Prospective Investors:** A person who is contemplating an investment in a business will like to know about its profitability and financial position. A study of the financial statements will help him in this respect.
5. **Government:** The Government is interested in the financial statements of business enterprise on account of taxation, labour and corporate laws. If necessary, the Government may ask its officials to examine the accounting records of a business.
6. **Employees:** The employees are interested in the financial statements on account of various profit sharing and bonus schemes. Their interest may further increase in case they purchase shares of the companies in which they are employed.
7. **Citizen:** An ordinary citizen may be interested in the accounting records of the institutions with which he comes in contact in his daily life, *e.g.*, bank, temple, public utilities such as gas, transport and electricity companies. In a broader sense, he is also interested in the accounts of a government company, a public utility concern etc., as a voter and a tax-payer.

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Check Your Progress

1. What is book-keeping mainly concerned with?
2. Mention an example of non-financial transaction not included in the accounting records.
3. State the difference between analysis and interpretation.
4. What does the workability of the whole managerial function of accounting depends on?

1.3 ANSWERS TO CHECK YOUR PROGRESS QUESTIONS

1. Book-keeping is mainly concerned with recording of financial data relating to the business operations in a significant and orderly manner.
2. An example of non-financial transaction not included in the accounting records is that if a company has got a team of dedicated and trusted employees, it is of great use to the business but since it is not of a financial character and capable of being expressed in terms of money, it will not be recorded in the books of the business.
3. The term 'Analysis' means methodical classification of the data given in the financial statements. The term 'Interpretation' means explaining the meaning and significance of the data so simplified.
4. To check for frauds and errors is what the workability of the whole procedure of managerial accounting depends on.

1.4 SUMMARY

- Accounting is primarily concerned with designing the systems for recording, classifying and summarizing the recorded data and interpreting them for internal and external end-users.
- Accountants often direct and review the work of the book-keepers.
- Accounting is a science as it is an organized knowledge based on scientific principles which have been developed as a result of the study and experience.
- Art is the technique which helps us in achieving our desired objective. Accounting is definitely an art.
- In today's world, there is not much difference between accounting and accountancy. The terms have become pretty much interchangeable. Accounting is traditionally one of the three principles of accountancy.
- Over a period of the time, the concept of accounting and the role of accountant has undergone a revolutionary change.

- Accounting has a wide scope and it extends to business, trade, government, financial institutions, individuals and families.
- The definition of accounting brings out the following functions of accounting: recording, classifying, summarizing, dealing with financial transactions, analysis and interpreting and communicating.
- Historical functioning of accounting involves keeping the accurate records of all the past transactions made in the business.
- In an organization, the management committee looks for all kind of the decision making. To ensure, that the decisions are smooth and beneficial for everyone, they do an evaluation of the past records provided by accounting. There are five managerial functions of accounting.
- Accounting is of primary importance to the proprietors and the managers. However, other persons such as creditors, prospective investors, employees, etc., are also interested in the accounting information.

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1.5 KEY WORDS

- **Accountancy:** It refers to the actual process of communicating information about the financial state of a company to its shareholders, usually in the form of financial statements, which show the assets and resources under the company's control.
- **Accounting:** It may be defined as the process of recording, classifying, summarizing, analysing and interpreting the financial transactions and community the results thereof to the persons interested in such information.
- **Historical functioning of accounting:** It involves keeping the accurate records of all the past transactions made in the business.

1.6 SELF ASSESSMENT QUESTIONS AND EXERCISES

Short Answer Questions

1. Write a short note on the difference between accounting and book-keeping.
2. 'Is accounting a science or an art?' Comment.
3. What is the scope of accounting?
4. Briefly explain the historical and managerial functions of accounting.

Long Answer Questions

1. Explain the functions of accounting.
2. Discuss the various uses of accounting information.

1.7 FURTHER READINGS

NOTES

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UNIT 2 SCOPE OF ACCOUNTING

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2.0 INTRODUCTION

Accounting can broadly be classified into two categories: (i) financial accounting, and (ii) management accounting. Accounting, which is designed to serve parties external to the operating responsibility of the firm, *e.g.*, creditors, investors and employees, is termed as 'financial accounting'. Accounting, designed for use in the operational needs of the business, *i.e.*, to provide information relating to the conduct of the various aspects of the business, like costs, funds, profits, etc., is termed as 'management accounting'. In this unit, you will learn about the scope and branches of accounting including financial, cost and management accounting. You will also learn about the relationship between accounting and other disciplines as well as role and services of accountants.

2.1 OBJECTIVES

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

- Discuss accounting and other disciplines
- Describe the role of accountants
- Explain the scope of accounting with relation to financial, cost and management accounting

2.2 ACCOUNTING AND OTHER DISCIPLINES

Accounting is closely related with other disciplines. It is, therefore, necessary for the accountant to have a working knowledge of these disciplines for effective

performance of his job. The relationship between accounting and some of the other disciplines is being discussed in the following pages:

Accounting and Economics

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Economics is concerned with rational decision making regarding efficient use of scarce resources for satisfying human wants. The efficient utilisation of resources, particularly when they are scarce, is important both from the viewpoint of a business firm and of the country as a whole.

Accounting is considered to be a system which provides appropriate information to the Management for taking rational decisions. Of course, some non-accounting information is also useful for decision making. However, accounting provides a major and dependable data base for decision making. The basic objective of management of a business organisation is to maximise the wealth of its owners. This is also the objective of economics. Efficient use of scarce resources results in maximising the wealth of a nation. Thus, accounting and economics both have a similarity in the sense that both seek the optimum utilisation of resources of the firm or the nation, as the case may be. Moreover, the accountants have got the ideas such as value of assets, income, capital maintenance etc., from the economists. Of course, the accountants have suitably adapted these ideas keeping in view their own requirements and limitations. For instance, according to the economists, the value of an asset is the present value of all future earnings that can be derived from the asset. However, it is a real difficult or almost impossible task for one to estimate correctly the future earnings particularly when an asset has a very long life—say, 50 years or more. The accountants have, therefore, adopted a realistic basis for valuation of asset—the cost or the price paid for the acquisition of the asset. Similarly, the accountants' concept of marginal cost is different from the economists' concept of marginal cost. According to the accountants, the marginal cost represents the variable cost, *i.e.*, the cost which varies in direct proportion of output. Such cost remains fixed per unit of output. However, according to the economists the marginal cost refers to the cost of the producing one additional unit. Such cost per unit may increase or decrease depending upon the law of returns. For example, in case of law of increasing returns, the cost per unit would decrease while in case of law of decreasing returns, the cost per unit would increase.

Accounting and Statistics

Statistics is the science of numbers. It is concerned with numerical data as well as various statistical techniques which are used for collection, classification, analysis and interpretation of such data. The statistical techniques are now increasingly used for managerial decision making.

Accounting is an important information tool. It provides significant information about the working of a business firm to the outsiders, *viz.*, shareholders, creditors, financial institutions, etc., and the insiders, *i.e.*, the management.

Accounting has a close relationship with statistics. A number of statistical techniques are used in collection, analysis and interpretation of the accounting data. For instance, computation of accounting ratios is based on statistical method, particularly averaging. Similarly, the technique of regression is being increasingly used for forecasting, budgeting and cost control. The techniques of standard deviation, co-efficient of variation are used for capital budgeting decisions. The technique of index numbers is used for computation of present value of an asset in case of accounting for price level changes.

Accounting and Mathematics

Accounting bears a close relationship with mathematics too. As a matter of fact the dual aspect concept which is the basic concept of accounting is expressed in the form of a mathematical equation. It is popularly termed as “accounting equation”. The knowledge of mathematics is now considered to be a prerequisite for accounting computations and measurements. For example, computation of depreciation, ascertaining the cash price in case of hire-purchase and instalment systems, determination of the loan instalment, settling of lease rentals—all require use of mathematical techniques.

The introduction of computer in accounting has further increased the importance of mathematics for the accountants. The accountants are now increasingly making the use of statistics and econometric models for decision making. The use of the technique of operation research has made accounting all the more mathematical. In view of these developments, it would not be incorrect to say that a good accountant has to be a good mathematician too.

Accounting and Law

A business entity operates within a legal framework. An accountant records, classifies, summarises and presents the various transactions. Naturally, these transactions have to be in accordance with the rules and regulations applicable to such business entity. There are laws which are applicable in general to all business transactions, *e.g.*, the Indian Contract Act, the Sale of Goods Act, the Negotiable Instruments Act, etc. There are laws governing specific business entities, *e.g.*, the Companies Act is applicable to joint stock companies, the Banking Regulation Act is applicable to banking companies, the Insurance Act is applicable to insurance companies etc. While preparing the accounts of different business entities, the accountant has to keep in mind the specific provisions given by the specific Acts applicable to the specific business entities. Similarly, there are a number of industrial laws such as the Factories Act, the Payment of Wages Act, the Minimum Wages Act, the Employees Provident Fund and Miscellaneous Provisions Act, etc., governing payment of wages, salaries or other benefits to employees. The accountant has to abide by the provisions of these Acts and prepare and maintain appropriate records keeping in mind their provisions.

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2.2.1 Role of Accountants

The Accountants are the persons who practice the art of accounting. The Accounting System and the Accountants who maintain it, provide useful services to the Society.

The Accountants can broadly be classified into two categories.

1. Accountants in Public Practice
2. Accountants in Employment.

Accountants in Public Practice

The accountants in public practice offer their services for conducting financial audit, cost audit, designing of accounting system and rendering other professional services for a fee. Such accountants are usually members of professional bodies. In our country there are two recognised professional bodies for this purpose. They are (i) the Institute of Chartered Accountants of India and (ii) the Institute of Cost and Works Accountants of India.

The accountants in public practice are also known as professional accountants. Such accountants are the members of the professional accounting bodies. These accounting bodies usually require from their members the following:

- (i) Getting themselves trained in the prescribed manner over a prescribed period.
- (ii) Pass the examination conducted by the professional bodies.
- (iii) Undertake to observe the generally accepted accounting principles enunciated by the professional bodies concerned.
- (iv) Observe the Code of Ethics laid down by the concerned accounting body.
- (v) Subject themselves to disciplinary proceedings whenever it is alleged that the member has violated the Code of Ethics laid down by the concerned body.

Accountants in Employment

These are the accountants who are employed in non-business entities or business entities. Non-business entities are a diverse set of organisations including Educational Institutions, Government, Churches, Museums, Hospitals, etc. Their object is not to earn profit. The accountants employed by business entities are frequently called 'Management Accountants' since they report to, and are the part of the entity's management. These accountants provide information for the tax returns, budgeting, routine operating of the business decisions, investment decisions, performance evaluation and external financial reporting of the business. Most of these accountants are also members of a professional accounting body. Of course, it is not necessary.

Accountants' Services

The services rendered by the accountants to the society can be summarised as follows:

1. **Maintenance of Books of Accounts** An accountant keeps a systematic record of the transactions entered by a business firm or an institution in the normal course of its operation. This helps the organisation in ascertaining the profit or loss made for a particular period and also the financial position of the organisation as on a particular date.

The advantages derived through maintenance of a systematic record of all transactions can be summarised as follows:

- (a) *Help to Management* Accounting is an important managerial tool since it provides the management adequate information for its effective functioning. The basic functions of the management are planning, controlling, co-ordinating, motivating and communicating.

Accounting helps the management in planning by making available the relevant data after pruning and analysing suitably for effective planning and decision making.

Controlling involves evaluation of performance keeping in view that the actual performance coincides with the planned one and remedial measures are taken in the event of variation between the two. The techniques of budgeting control, standard costing and departmental operating statements greatly help in performing these functions.

Coordinating involves interlinking different divisions of the business enterprise in a way so as to achieve the objectives of the organisation as a whole. Thus, perfect coordination is required among production, purchase, finance, personnel and sales departments. Effective coordination is achieved through departmental budgets and reports which form the nucleus of Management Accounting.

Motivating involves maintenance of high degree of morale in the organisation. Conditions should be such that each person gives his best to realise the goals of the enterprise. The superior should be in a position to find out whom to promote or demote or to reward or penalise. Periodical departmental profit and loss accounts, budgets and reports go a long way in achieving these objectives.

Communicating involves transmission of data results etc., both to the insiders as well as the outsiders. Accounting provides information both to the insiders, *i.e.*, management, and the outsiders, *i.e.*, the creditors, prospective investors, shareholders, etc.

- (b) *Replacement of Memory* A person cannot remember everything about his business transactions since human memory has its own limitations. It is, therefore, necessary that the transactions are recorded in the books of account at the earliest. This considerably relieves strain

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of one's memory.

(c) *Comparative Study* A system of recording the business transactions will help a business entity to make a comparative study and evaluation of its performance.

(d) *Acceptance by Tax Authorities* Properly maintained accounting records are accepted by Income Tax or Sales Tax authorities.

(e) *Evidence in Court.* Properly maintained accounting records are often taken as good evidence by the court of law.

(f) *Sale of Business* Properly maintained accounting records will help a business entity to fetch a proper price in the event of sale of the business.

2. **Auditing of Accounts** The function of auditing is also performed by the accountants. Auditing is concerned with verification of accounting data for determining the accuracy and reliability of accounting statements and reports. It may be classified into two categories:

(i) Statutory Audit

(ii) Internal Audit.

Statutory Audit Statutory Audit is required to be done because of the provisions of law. For example, under the Companies Act every company has to get its accounts audited by a qualified Chartered Accountant. The Statutory Auditor has to report whether in his opinion the profit and loss account shows the true profit or loss for the year and the balance sheet shows a true and fair view of the state of affairs of the business on the balance sheet date.

Internal Audit Internal audit is a review of various operations of the company and its records by the staff specially appointed for this purpose. Many large organisations have a system of internal audit within the organisation as an integral part of internal control. They have a separate internal audit department for this purpose. Generally, the internal audit department is also headed by a professionally qualified accountant.

3. **Taxation** An Accountant also handles taxation matters of a person or a business organisation. Since an accountant has a comprehensive knowledge about the different accounting matters, he is in a position to present the case of his client before the Tax Authorities in the proper perspective. He also assists his client/organisation in reducing tax burden and making proper tax planning.

4. **Financial Services** An accountant being well familiar with legal, accounting and taxation matters, can properly advise individual firms with regard to managing their financial affairs. For instance, he can assist his clients in selecting the most appropriate investment or insurance policy. Professional accountants have also these days started management consultancy services.

Such services include designing of Management Information System, Corporate Planning, Conducting of Feasibility Studies, Executive Selection Services, etc.

In conclusion, it can be said that an accountant is almost a caretaker of the society's resources. He sees that not only proper accounting is kept of the society's resources, but they are also used in the optimum manner. As a matter of fact, accountants will be presented with many opportunities for innovative actions in the global economic environment. In addition to their role of recording business transactions, providing accurate, timely and relevant information, they will also be accepted to participate as business consultants and partners with management in the strategic planning process. Thus, there are tremendous possibilities for the accountants to shine as a professional group in the years to come. To fit in this role it is necessary that the accountants develop effective communication abilities, adopt a structured approach, a flexible accommodation and keep themselves aware with the latest evolving technologies in the profession.

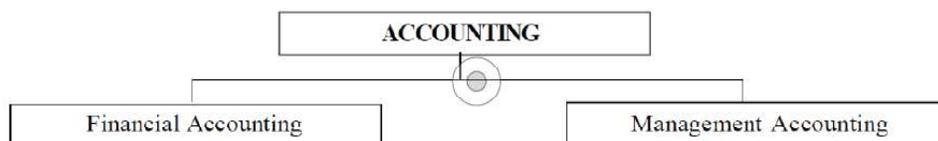
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Check Your Progress

1. How is accounting related with statistics?
2. Mention the type of information management accountants provide.

2.2 SCOPE OR BRANCHES OF ACCOUNTING

In order to satisfy the needs of different people interested in the accounting information, different branches of accounting have developed. They can broadly be classified into two categories:



- (i) **Financial Accounting:** It is the original form of accounting. It is mainly confined to the preparation of financial statements for the use of outsiders like shareholders, debenture holders, creditors, banks and financial institutions. The financial statements, *i.e.*, the Profit and Loss Account and the Balance Sheet, show them the manner in which operations of the business have been conducted during a specified period.
- (ii) **Management Accounting:** It is accounting for the management, *i.e.*, accounting which provides necessary information to the management for discharging its functions. According to the Chartered Institute of Management Accountants, London, "Management accounting is the application of professional information in such a way as to assist the management in the

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formation of policies and in the planning and control of the operations of the undertaking.” It covers all arrangements and combinations or adjustments of the orthodox information to provide the Chief Executive with the information from which he can control the business, *e.g.*, information about funds, costs, profits, etc.

Management accounting covers various areas such as cost accounting, budgetary control, inventory control, statistical methods, internal auditing etc.

Let’s learn about the major areas of accounting

2.3.1 Cost and Financial Accounting

As explained earlier, accounting can broadly be classified into two categories: (i) Financial or general accounting, and (ii) Management accounting. Management accounting embraces within its fold, several subjects and cost accounting is one of them. Though financial accounting and cost accounting each rests on the same principles of debits and credits and uses the same records, but each deals with matters special to itself. Financial accounting reveals the profit or loss of the business as a whole, during a particular period, while cost accounting shows, by analysis and localization, the unit costs and profits and losses of different product lines. Take, for instance, a factory manufacturing four products *A, B, C* and *D*. Financial accounts will tell about the overall profit or loss made by the factory on these products. They cannot explain whether product *A* is more profitable than *B*, or the production of product *C* should be stopped because the enterprise is suffering a loss on its production. If proper cost accounts are maintained the management can come to know not only about the profitability or non-profitability of a product, but also about the profitability or non-profitability of each process involved in the production of the product. Such detailed information facilitates better control over the business which ultimately helps in achieving maximum efficiency at every point.

Financial accounting well answered the needs of business in the initial stages when the business was not so complex. The growth and complexities of modern business brought out the following limitations of financial accounting:

1. **Provides only limited information:** There are now no set patterns of business on account of radical changes in business activities. An expenditure may not bring an immediate advantage to the business but it may have to be incurred because it may bring advantage to the business in the long run or may be necessary simply to sell the name of the business. The management needs a lot of varied information to decide whether on the whole it will be justifiable to incur a particular expenditure or not. Financial accounting fails to provide such information.
2. **Treats figures as single, simple and silent items:** Financial accounting fails to make the people realize that accounting figures are not mere isolated phenomena but they represent a chain of purposeful

and pertinent events. The role of accountant these days is not only of a book-keeper and auditor, but also that of a financial adviser. Recording of transactions is now the secondary function of the accountant. His primary function now is to analyse and interpret the results.

3. **Provides only a post-mortem record of business transactions:** Financial accounting provides only a post-mortem record of business transactions since it records transactions only on historical basis. These days business decisions are made on the basis of estimates and projections rather than historical facts. Of course, past records are helpful in making future projections but they alone are not sufficient. Thus, needs of modern management demand a break-up from the principles and practice of traditional accounting.
4. **Considers only quantifiable information:** Financial accounting considers only those factors which are capable of being quantitatively expressed. In modern times, the concept of welfare state has resulted in increased government interference in all sectors of the national economy. The management has, therefore, to take into account government decisions over and above purely commercial considerations. Some of these factors are not capable of being quantitatively expressed and hence their impact is not reflected in financial statements.
5. **Fails to provide informational needs of different levels of management:** The shareholders are only rentiers of capital. The business is run in reality by different executives, each an expert in his area. These executives have powers based on the level of management to which they belong. There are usually three levels of management—top management, middle management and lower management. The type of information required by each level of management is different. The top management is mainly concerned with the policy decisions. They, therefore, are interested in knowing about the soundness of the plans, proper structuring of the organization, proper delegation of authority and its effectiveness. The middle management executives function as coordinators. They must know: (i) What happened? (ii) Where it happened? and (iii) Who is responsible? The lower management people function as operating supervisors. They should get information regarding effectiveness of their operations. The reports submitted to them should give details about the planned performance, actual performance and the deviations with their reasons. Financial accounting does not have a built-in system to provide all such information.

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Cost Accounting

In the initial stages, cost accounting was merely considered to be a technique for ascertainment of costs of products or services on the basis of historical data. In the course of time, due to competitive nature of the market, it was realized that ascertainment of cost is not so important as controlling costs. Hence, cost accounting started to be considered more as a technique for cost control as compared to cost ascertainment. Due to technological developments in all fields, now cost reduction has also come within the ambit of cost accounting. Cost accounting is thus concerned with recording, classifying and summarising, costs, for determination of costs of products or services; planning, controlling and reducing such costs and furnishing of information to management for decision making.

According to Charles T Horngren, cost accounting is ‘a quantitative method that accumulates, classifies, summarizes, and interprets information for three major purposes: (i) operational planning and control, (ii) special decisions, and (iii) product decisions.’

According to the Chartered Institute of Management Accountants (CIMA), London, cost accounting is ‘the process of accounting for costs from the point at which the expenditure is incurred or committed to the establishment of its ultimate relationship with cost units. In its widest sense, it embraces the preparation of statistical data, the application of cost control methods and the ascertainment of the profitability of the activities carried out or planned.’

According to Morse, ‘Cost accounting is the processing and evaluation of monetary and non-monetary data to provide information for external reporting, internal planning and control of business operations and special analysis and decisions.’

Cost Accounting Activities

Cost accounting, as explained above, refers to the process of determining the cost of a particular product or activity. It provides useful data both for internal and external reporting. Internal report presents details of cost information regarding cost of specific products or services while external reports contain cost data in a summarized and aggregate form. For instance, in case of a company manufacturing electrical goods, the cost of each product, for example a lamp, a tubelight and a bulb is separately calculated with all details for internal reporting purposes. While for external reporting, the total cost of goods sold appears as a single item in income statement.

In order that cost accounting satisfies the requirements of both internal and external reporting, the following are the different activities which are undertaken under cost accounting system:

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 nons-integral systems. In case of a non-integral system, a separate set of books is maintained for costing and financial transactions, while in case of an integral system, both costing and financial transactions are recorded in the same set of books.
3. *Cost Analysing* It is concerned with critical evaluation of cost information to assist the management in planning and controlling the business activities. 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 purposes. In order to use cost information intelligently and effectively, it is necessary for the managers to have good understanding of the different cost accounting concepts.

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Cost Accounting and Cost Accountancy

The meaning of the term ‘cost accounting’ is different from ‘cost accountancy.’ The term cost accountancy has a wider meaning as compared to the term cost accounting. According to the Chartered Institute of Management Accountants (CIMA), London, cost accountancy means ‘the application of costing and cost accounting principles, methods and techniques to the science, art and practice of cost control. It includes the presentation of information derived therefrom for the purpose of managerial decision making.’ Cost accountancy is thus the science, art and practice of a cost accountant. It is a science because it consists of organized or systematic knowledge, which a cost accountant must possess for proper discharge of his functions. As a matter of fact, the cost accountant’s knowledge should not remain restricted only to such subjects which cost accountancy embraces but it should also extend to such subjects like production control, operations research, linear programming which will help him in application of his cost accountancy knowledge to the problems of the business.

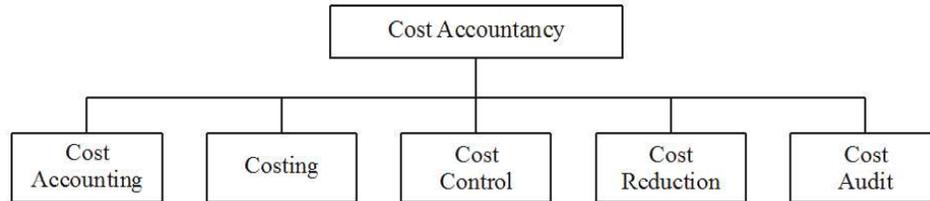
Cost accountancy is also an art because it involves costing techniques and methods, such as those of differential or marginal costing, standard costing, etc. The application of these techniques helps the cost accountant in deciding how to control costs, whether to go for replacement of the existing plant by a new one or not, etc.

Cost accountancy is also the practice of a cost accountant because he has

to make constant efforts in the field of cost accountancy. He has to endeavour constantly for reducing costs, present cost information in a condensed but informative way to the management so that the management may take proper action at the opportune time.

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Cost accountancy includes several subjects. They are as follows:



Cost Accounting

Cost accounting is the process of accounting for costs. It embraces the accounting procedures relating to the recording of all income and expenditure and the preparation of periodical statements and reports with the object of ascertaining and controlling costs. It is thus the formal mechanism by means of which costs of products or services are ascertained and controlled.

Costing

Costing is ‘the technique and process of ascertaining cost.’ Cost accounting is different from costing in the sense that the former provides only the basis and information for ascertainment of cost. Once the information is made available, the costing can be carried out arithmetically, by means of memorandum statements or by method of integral accounts.

However, the two terms—costing and cost accounting—are often used interchangeably. No such distinction has also been observed for the purpose of this book.

Wheldon has given an exhaustive definition of costing after expanding the ideas contained in the definitions of the terms ‘costing’ and ‘cost accounting’. According to him, costing is ‘the classifying recording and appropriate allocation of expenditure for the determination of the costs of products or services; the relation of these costs to sales values; and the ascertainment of profitability.’⁵

Wilmot has summarized the nature of cost accounting as ‘the analysing, recording, standardising, forecasting, comparing, reporting and recommending,’ and the role of a cost accountant as that of ‘a historian, news agent and prophet.’ As a historian he must be meticulously accurate and sedulously impartial. As a news agent he must be up-to-date, selective and pithy. As a prophet he must combine knowledge and experience with foresight and courage.’⁶

Cost Control

Nowadays a cost accountant is not only concerned with the ascertainment of costs and fixing selling prices of the products but also with furnishing such information as to enable the management to control the costs of operating the business. As a matter of fact, the latter function has become the prime function of the cost accountant these days. Cost control is exercised by a variety of techniques such as those of standard costing, budgetary control and quality control, etc. Submission of periodical reports by him also helps management in exercising better control over costs. For example, a statement of value of stocks on hand (raw materials, finished goods and work-in-progress) together with relevant ratios will show whether there is any tendency of over or under-stocking.

Cost Reduction

This is a new dimension to the functions of a cost accountant. Cost reduction is concerned with real and permanent reduction in the unit cost of goods manufactured or services rendered. In this era of liberalization and competition only the best would survive. Hence, the cost accountant has to make continuous efforts to reduce per unit cost. The techniques used for this purpose are value analysis, design analysis, technological forecasting, simplification and standardization, etc.

Cost Audit

Cost audit is the verification of cost accounts and a check on the adherence to the cost accounting plan.⁷ Thus cost audit involves checking up the arithmetical accuracy of cost accounts and verifying whether the principles laid down have been followed or not. It becomes essential in case of a business where cost accounting is carried out on a large scale.

2.3.2 Management Accounting

The term management accounting refers to accounting for the management, *i.e.*, accounting which provides necessary information to the management for discharging its functions. The functions of the management are planning, organizing, directing and controlling. Thus, management accounting provides information to the management so that planning, organizing, directing and controlling of business operations can be done in an orderly and effective manner.

However, the above is a very general definition of management accounting. More specific definitions have been given by different authorities. Some of the important definitions are:

The definition given by the American Accounting Association is as follows:

‘Management accounting is the application of appropriate techniques and concepts in processing historical and projected economic data of an entity to assist management in establishing plans for reasonable economic objectives and in the making of rational decisions with a view towards achieving these objectives.’

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The definition given by the Management Accounting Team of the Anglo-American Council of Productivity seems to be more precise. It reads, 'Management accounting is the presentation of accounting information in such a way as to assist management in the creation of policy and in the day-to-day operations of an undertaking.'

The above definitions clearly indicate that management accounting is concerned with accounting information, which is useful to the management. Efficiency of the various phases of management is, as a matter of fact, the common thread which underlies all these definitions. However, it should be clearly understood that it does not supplant financial accounting but rather it supplements it in order to serve the diverse requirements of modern management.

Management accounting rearranges for management control to a great extent the accounting information provided by the financial accounting. It, therefore, lies between the following two activities:

- (i) Completing the accounting results on the one hand, and
- (ii) Controlling the business by the management on the other.

Management accounting, therefore, covers all rearrangement, combination or adjustment of orthodox accounting figures which may be required to provide the Chief Executive with the information from which he can control the business.

Functions of Management Accounting

The basic function of management accounting is to assist the management in performing its functions effectively. The functions of the management are planning, organizing, directing and controlling. Management accounting helps in the performance of each of these functions in the following ways:

- (i) *Provides data:* Management accounting serves as a vital source of data for management planning. The accounts and documents are a repository of a vast quantity of data about the past progress of the enterprise which are a must for making forecasts for the future.
- (ii) *Modifies data:* The accounting data required for managerial decisions is properly compiled and classified. For example, purchases figures for different months may be classified to know total purchases made during each period productwise, supplierwise and territorywise.
- (iii) *Analyses and interprets data:* The accounting data is analysed meaningfully for effective planning and decision making. For this purpose, the data is presented in a comparative form. Ratios are calculated and likely trends are projected.
- (iv) *Serves as a means of communicating:* Management accounting provides a means of communicating the management plans, upward, downward and outward through the organization. Initially, it means identifying the feasibility and consistency of the various segments of the plan. At later stages it keeps

all parties informed about the plans that have been agreed upon and their roles in these plans.

- (v) *Facilitates control*: Management accounting helps in translating given objectives and strategies into specified goals for attainment by a specified time and secures effective accomplishment of these goals in an efficient manner. All this is made possible through budgetary control and standard costing, which are an integral part of management accounting.
- (vi) *Uses also qualitative information*: Management accounting does not restrict itself to financial data for helping the management in decision making but also uses such information which may not be capable of being measured in monetary terms. Such information may be collected from special surveys, statistical compilations, engineering records, etc.

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Scope of Management Accounting

Management accounting is concerned with presentation of accounting information in the most useful way for the management. Its scope is, therefore, quite vast and includes within its fold, almost all aspects of business operations. However, the following areas can rightly be identified as falling within the ambit of management accounting:

- (i) *Financial accounting*: Management accounting is mainly concerned with the rearrangement of the information provided by financial accounting; hence management cannot obtain full control and coordination of operations without a properly designed financial accounting system.
- (ii) *Cost accounting*: Standard costing, marginal costing, opportunity cost analysis, differential costing and other cost techniques, play a useful role in operation and control of the business undertaking.
- (iii) *Revaluation accounting*: This is concerned with ensuring that capital is maintained intact in real terms and profit is calculated with this fact in mind.
- (iv) *Budgetary control*: This includes framing of budgets comparison of actual performance with the budgeted performance, computation of variances, finding of their causes, etc.
- (v) *Inventory control*: It includes control over inventory from the time it is acquired till its final disposal.
- (vi) *Statistical methods*: Graphs, charts, pictorial presentation, index numbers and other statistical methods make the information more impressive and intelligible.
- (vii) *Interim reporting*: This includes preparation of monthly, quarterly, half-yearly income statements and other related reports, cash flow and funds flow statements, scrap reports, etc.
- (viii) *Taxation*: This includes computation of income in accordance with the tax laws, filing of returns and making tax payments.

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(ix) *Office services:* This includes maintenance of proper data processing and other office management services, reporting on best use of mechanical and electronic devices.

(x) *Internal audit:* Development of a suitable internal audit system for internal control.

Check Your Progress

3. List the type of information the top management is mainly interested in.
4. Mention some of the techniques used for cost reduction.
5. What are the two activities between which management accounting lies?

2.4 ANSWERS TO CHECK YOUR PROGRESS QUESTIONS

1. A number of statistical techniques are used in collection, analysis and interpretation of the accounting data. For instance, computation of accounting ratios is based on statistical method, particularly averaging. Similarly, the technique of regression is being increasingly used for forecasting, budgeting and cost control. The techniques of standard deviation, co-efficient of variation are used for capital budgeting decisions. The technique of index numbers is used for computation of present value of an asset in case of accounting for price level changes.
2. Management Accountants' since they report to, and are the part of the entity's management. These accountants provide information for the tax returns, budgeting, routine operating of the business decisions, investment decisions, performance evaluation and external financial reporting of the business.
3. The top management is mainly interested in knowing about the soundness of the plans, proper structuring of the organization, proper delegation of authority and its effectiveness.
4. The techniques used for cost reduction include value analysis, design analysis, technological forecasting, simplification and standardization, etc.
5. Management accounting lies between the following two activities:
 - (i) Completing the accounting results on the one hand, and
 - (ii) Controlling the business by the management on the other.

2.5 SUMMARY

- Accounting is closely related with other disciplines. It is, therefore, necessary for the accountant to have a working knowledge of these disciplines for effective performance of his job.

- The subject of accounting is related to many disciplines including economics, statistics, mathematics, and law.
- The Accountants can broadly be classified into two categories.
 1. Accountants in Public Practice
 2. Accountants in Employment.
- The services rendered by the accountants to the society can be summarised as follows: Maintenance of Books of Accounts, auditing, taxation services and financial services.
- In order to satisfy the needs of different people interest in the accounting information, different branches of accounting have developed. They can be classified into two categories: financial accounting and management accounting.
- Management accounting covers various areas such as cost accounting, budgetary control, inventory control, statistical methods, internal auditing, etc.
- Though financial accounting and cost accounting each rests on the same principles of debits and credits and uses the same records, but each deals with matters special to itself. Financial accounting reveals the profit or loss of the business as a whole, during a particular period, while cost accounting shows, by analysis and localization, the unit costs and profits and losses of different product lines.
- The differences between cost accounting and financial accounting may be understood from the perspective of objectives, mode of presentation, recording, analysing, periodicity of reporting and degree of accuracy.
- Cost accounting is concerned with recording, classifying, and summarizing costs for determination of costs of products and services; planning, controlling and reducing such costs and furnishing of information to the management for decision making.
- The term cost accountancy has a wider meaning as compared to the term cost accounting. It is considered as the science, art and practice of a cost accountant.
- Cost accounting includes several subjects like cost accounting, costing, cost control, cost reduction, cost audit, etc.
- Management accounting provides information to the management so that planning, organising, directing and controlling of business operations can be done in an orderly and effective manner.

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2.6 KEY WORDS

- **Financial accounting:** It is the original form of accounting mainly confined to the preparation of financial statements for the use of outsiders.

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- **Management accounting:** It is accounting which provides necessary information to the management for discharging its functions.
- **Cost accounting:** It concerned with recording, classifying, and summarizing costs for determination of costs of products and services; planning, controlling and reducing such costs and furnishing of information to the management for decision making

2.7 SELF ASSESSMENT QUESTIONS AND EXERCISES

Short-Answer Questions

1. Write a short note on the field of accounting and other disciplines.
2. What is cost accountancy?
3. What are the different subjects included under cost accountancy?

Long-Answer Questions

1. What is the role of accountants and accounting services?
2. Discuss the limitations of financial accounting.
3. Describe the functions and scope of management accounting.

2.8 FURTHER READINGS

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UNIT 3 MANAGERIAL USES AND DIFFERENCES

*Managerial Uses
and Differences*

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Structure

- 3.0 Introduction
- 3.1 Objectives
- 3.2 Managerial Uses
- 3.3 Differences
- 3.4 Answers to Check Your Progress Questions
- 3.5 Summary
- 3.6 Key Words
- 3.7 Self Assessment Questions and Exercises
- 3.8 Further Readings

3.0 INTRODUCTION

In the previous unit, you were introduced to the scope or branches of accounting: management accounting, financial accounting and cost accounting. In this unit, you will study the managerial uses and the differences between these branches of accounting.

3.1 OBJECTIVES

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

- Explain the managerial uses of management, financial and cost accounting
- Discuss the differences between financial, cost and management accounting

3.2 MANAGERIAL USES

As mentioned in Unit-2, the branches of accounting were developed to satisfy the different needs of users of accounting information. In this section, let's learn about the managerial uses of management, financial and cost accounting.

Utility of Management Accounting

Management accounting provides invaluable services to management in all of its functions. The basic functions of management are: (i) Planning, (ii) Controlling, (iii) Coordinating, (iv) Organizing, (v) Motivating, and (vi) Communicating. Management accounting helps in performance of each of these functions effectively as explained below:

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- (i) *Planning*: It involves formulation of policies, setting up of goals and initiating necessary programmes for achievement of the goals. Management accounting makes an important contribution in performance of this function. It makes available the relevant data after pruning and analysing them suitably for effective planning and decision making.
- (ii) *Controlling*: It involves evaluation of performance, keeping in view that the actual performance coincides with the planned one, and remedial measures are taken in the event of variation between the two. The techniques of budgetary control, standard costing and departmental operating statements greatly help in performing this function. As a matter of fact the entire system of control is designed and operated by the management accountant designated as Controller.
- (iii) *Coordinating*: It involves interlinking of different divisions of the business enterprise in a way so as to achieve the objectives of the organization as a whole. Thus, perfect coordination is required among production, purchase, financial, personnel, sales, etc., departments. Effective coordination is achieved through departmental budgets and reports, which form the nucleus of management accounting.
- (iv) *Organizing*: It involves grouping of operative action in a way as to identify the authority and responsibility within the organization. Management accounting here also plays a prominent role. The whole organization is divided into suitable profit or cost centres. A sound system of internal control and internal audit for each of the cost or profit centres helps in organising and establishing a sound business structure.
- (v) *Motivating*: It involves maintenance of a high degree of morale in the organization. Conditions should be such that each person gives his best to realise the goals of the enterprise. The superiors should be in a position to find out whom to demote or promote or to reward or penalize. Periodical departmental profit and loss accounts, budgets and reports go a long way in achieving this objective.
- (vi) *Communicating*: It involves transmission of data, results, etc., both to the insiders as well as the outsiders. The orders of the superiors should be communicated to the subordinates while the results achieved by the subordinates should be reported to the superiors. Moreover, the management owes a duty to the creditors, prospective investors, shareholders, etc., to communicate to them about the progress, financial position, etc., of the enterprise. Management accounting helps the management in performance of this function by developing a suitable system of reporting which emphasizes and highlights the relevant facts.

Uses or Objectives of Financial Accounting

- To identify financial events and transactions that occur in an organization;
- To measure the value of these occurrences in terms of money;

- To organize the accumulated financial data into meaningful information; and
- To analyse, interpret, and communicate that information to a broad range of persons and groups, both within and outside the organization.

Cost Accounting

Compared with financial accounting, cost accounting is a relatively recent development. Modern cost accounting developed only during the nineteenth century. In fact, cost accounting started as a branch of financial accounting, but it is now regarded as an accounting system in its own right. The vital importance that cost accounting has acquired in the modern age is because of the increasing complexity of the modern industry.

Financial information, supplied by financial accounting in the form of financial statements stated above, relates to past activity. Cost accounting, on the other hand, is not restricted to just the past. It is concerned with the ascertainment of past, present and expected future costs of products manufactured or services supplied. Cost accounting is a system of determining the costs of products or services.

Cost accounting has primarily developed to help managers understand the costs of running a business. Profit and loss account and balance sheet are presented to the management by the financial accountant. But modern management needs much more detailed information than those supplied by these financial statements. Cost accounting provides detailed cost information to various levels of management for efficient performance of their functions. The information supplied by cost accounting acts as a management tool for decision making, to optimize the utilization of scarce resources and ultimately add to the profitability of business by controlling expenditure under various heads.

Cost accounting provides invaluable aid to management. It is so closely allied to management that it is difficult to indicate where the work of the cost accountant ends and managerial control begins. Adequate costing data helps management in reaching certain important decisions such as, whether hand labour should be replaced by the machinery or not; whether a particular product line should be discontinued or not, etc.

Costing checks recklessness and avoids occurrence of mistake. Costs can be reduced by proper organization of the plant and executive personnel. As an aid to management, it also provides invaluable information to enable management, to maintain effective control over stores and inventory, to increase efficiency of the business, and to check wastage and losses. It facilitates delegation of responsibility for important tasks and rating of employees. However, for all this, it is necessary for the management to be capable of using in a proper way the information provided by the cost accounts. The various advantages derived by management on account of a good costing system are as follows:

1. *Aids in price fixing* Though economic law of supply and demand and activities of the competitors to a great extent, determine the price

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of the article, the cost to the producer does play an important part. The producer can take necessary guidance from his costing records.

2. *Helps in estimates* Adequate costing records provide a reliable basis, upon which tenders and estimates may be prepared. The chances of losing a contract on account of over-rating or suffering loss in the execution of a contract due to under-rating can be minimized. Thus, 'ascertained costs provide a measure for estimates, a guide to policy and a control over current production.'
3. *Wastages are eliminated* As it is possible to know the cost of the article at every stage, it becomes possible to check various forms of waste, such as of time, expense etc., or in the use of machinery, equipment and tools.
4. *Costing makes comparison possible* If the costing records are regularly kept, comparative costs data for different periods and various volumes of production will be available. It will help the management in forming future lines of action.
5. *Provides data for periodical profit and loss accounts* Adequate costing records supply to the management such data as may be necessary for preparation of profit and loss accounts and balance sheets, at such intervals as may be desired by the management.

It also explains in details the sources of profit or loss revealed by the financial accounts; thus, helps in presentation of better information before the management.

6. *Aids in determining and enhancing efficiency* Losses due to wastage of materials, idle time of workers, poor supervision, etc., will be disclosed if the various operations involved in manufacturing a product are studied by a cost accountant. The efficiency can be measured and costs controlled and through it various devices can be formed to increase the efficiency.
7. *Helps in inventory control* Costing furnishes control which management requires in respect of stock of materials, work-in-progress and finished goods.
8. *Helps in determining break-even point* The term break-even point means 'point of no profit no loss.' In other words, it is that level of activity where the concern neither makes a profit nor suffers a loss. Every industrial concern is interested in determining this point, since it starts making profit only after reaching the break-even level. Sooner the break-even level is attained, the better it is for the organization.

Example:

Selling Price per unit	₹10
Variable Cost per unit	₹6

(i.e., cost which varies with production)

Fixed Cost	₹2,000
Capacity of the firm	1,000 units

Managerial Uses
and Differences

The above data indicate that on every unit, the concern earns a sum of ₹4 over and above its variable cost. This earning is termed as 'contribution.' In order to recover the total fixed cost of ₹2,000 the concern must produce and sell 500 units (*i.e.*, 2,000/4). The formula for computation of the break-even point can be put as follows:

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$$\text{Break-even Point} = \frac{\text{Fixed Cost}}{\text{Contribution per unit}} = ₹2,000/4 = 500 \text{ units}$$

In case the concern manufactures more than 500 units, the entire contribution of ₹4 per unit will be its profit. Thus, if it manufactures and sells 700 units, the amount of profit would be ₹800 (*i.e.*, 200 units × ₹4).

9. *Helps in determining the level of output for a desired profit* A firm must earn sufficient profits to pay dividends to its shareholders or provide sufficient return to its proprietors. Cost accounting helps in determining this level. For instance, if in the example given above, the desired profit is a sum of ₹500, the level of output for this profit can be determined as follows:

$$\begin{aligned} \text{Level of output for Desired Profit} &= \frac{\text{Fixed Cost}}{\text{Contribution per unit}} \\ &= \frac{2,000 + 500}{4} = 625 \text{ units} \end{aligned}$$

10. *Helps in periods of trade depression and competition* In periods of trade depression and trade competition, a firm may have to sell its products even below the total cost. It has to choose between closing of the production and continuing of production. This can be understood with the help of the following example:

Selling Price per unit	₹10
Variable Cost per unit	₹6
Fixed Cost	₹2,000
Capacity in units	1,000 units

Total cost of article per unit comes to ₹8 (*i.e.*, variable cost ₹6 + fixed cost ₹2). In case the demand for the product falls and presuming that the people are prepared to buy the product only for a sum of ₹7 and the situation is going to continue for at least 3 months, a cost accountant has to advise the management whether to shut-down the production or sell the units at ₹7 per unit. In the present case, apparently there seems to be a loss of ₹1 per unit (*i.e.*, total cost of ₹8 less selling price of ₹7), but it will be advisable to continue

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the production and sell the product even below the total cost of ₹8. This is because in any case during this period the fixed cost will have to be incurred. The selling of the article at ₹7 will provide a contribution of ₹1,000 towards meeting of the fixed cost. This will reduce the amount of loss from ₹2,000 (if the factory is closed down) to ₹1,000. It would not be incorrect to say that even if the product is sold in the market for ₹6 per unit on account of some temporary difficulties, the firm should continue to sell because in any case the variable costs are fully recovered. The question of stopping the production should attract the attention of the management only when the market price falls below ₹6 per unit. Even in such a case, the management, before closing down the production, must look to other factors, such as, payment of compensation to the retrenched workers, probability of development of a substitute product and losing of goodwill.

11. *Channelizing production in right lines* Cost accounting makes possible for the management to distinguish between profitable and non-profitable activities. Profits can be maximized by concentrating on profitable operations and eliminating non-profitable ones.

Example:

A company is manufacturing three products *A*, *B* and *C*. The data regarding output, costs and sales are as follows:

	<i>A</i>	<i>B</i>	<i>C</i>
Output and Sales (Units)	1,000	1,000	1,000
Selling price per unit (₹)	10	10	10
Cost per unit (₹)	8	6	12

In case detailed cost accounts are not maintained, the financial accounts will show a profit of ₹4,000 calculated as follows:

Product <i>A</i>	₹2,000
Product <i>B</i>	₹4,000
Product <i>C</i>	₹2,000 (loss)

The trading and profit and loss account of the firm will show an overall profit of ₹4,000. It will not disclose that a loss of ₹2,000 is being suffered by the firm on product *C*. In case detailed cost accounts are maintained, the firm can know which product is profitable and which product is not profitable. In this case the firm can immediately stop the production of product *C* and thus increase its profit from ₹4,000 to ₹6,000 (*i.e.*, a 50 per cent increase). It can further increase its profit by utilizing those resources which were used for product *C* for manufacturing and selling of product *A* or *B*.

Check Your Progress

1. Mention some of the management accounting techniques used for controlling function.
2. Which type of accounting is related to past activity only?

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3.3 DIFFERENCES

In this section, you will learn about the differences between financial, cost and management accounting. Financial accounting and management accounting are closely interrelated since management accounting is to a large extent rearrangement of the data provided by financial accounting. Moreover, all accounting is financial in the sense that all accounting systems are in monetary terms and management is responsible for the contents of the financial accounting statements. In spite of such a close relationship between the two, there are certain fundamental differences. These differences can be laid down as follows:

1. **Objectives:** Financial accounting is designed to supply information in the form of Profit and Loss Account and Balance Sheet to external parties like shareholders, creditors, banks, investors and Government. Information is supplied periodically and usually such in which management is not much interested. Management accounting is designed principally for internal use by the management.
2. **Analysing performance:** Financial accounting portrays the position of business as a whole. The financial statements like income statement and balance sheet report on overall performance or status of the business. On the other hand, management accounting directs its attention to the various divisions, departments of the business and reports about the profitability, performance etc., of each of them. Financial accounting deals with the aggregates and, therefore, cannot reveal what part of the management action is going wrong and why. Management accounting provides detailed analytical data for these purposes.
3. **Data used:** Financial accounting is concerned with the monetary record of past events. It is a post-mortem analysis of past activity and, therefore, out of date for management action. Management accounting is an accounting for future and, therefore, it supplies data both for present and future duly analysed and in detail in the “management language” so that it becomes the basis for management action.
4. **Monetary measurement:** In financial accounting only such economic events find a place which can be described in money. However, the management is equally interested in non-monetary economic events, viz., technical

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innovations, personnel in the organisation, changes in the value of money etc. These events affect the management's decision and, therefore, management accounting cannot afford to ignore them. For example, change in the value of money may not find a place in financial accounting on account of "going concern concept", but while effecting an insurance policy on an asset or providing for replacement of an asset, the management will have to take into account this factor.

5. **Periodicity of reporting:** The period of reporting is much longer in financial accounting as compared to management accounting. The Income Statement and the Balance Sheet are usually prepared yearly or in some cases half-yearly. The management requires information at frequent intervals, and, therefore, financial accounting fails to cater to the needs of the management. In management accounting, there is more emphasis on furnishing information quickly and at comparatively short intervals as per the requirements of the management.
6. **Precision:** There is less emphasis on precision in case of management accounting as compared to financial accounting since the information is meant for internal consumption.
7. **Nature:** Financial accounting is more objective while management accounting is more subjective. This is because management accounting is fundamentally based on judgement rather than on measurement.
8. **Legal compulsion:** Financial accounting has more or less become compulsory for every business on account of the legal provisions of one or the other Act. However, a business is free to install or not to install a system of management accounting.

The above points of difference between financial accounting and management accounting prove that management accounting has a flexible approach as compared to rigid approach in the case of financial accounting. In brief, financial accounting simply shows how the business has moved in the past while management accounting shows how the business has to move in the future.

Cost accounting is the process of accounting for costs. It embraces the accounting procedures relating to recording of all incomes and expenditures and the preparation of periodical statements and reports with the object of ascertaining and controlling costs. It is, thus, the formal mechanism by means of which the costs of products or services are ascertained and controlled. On the other hand, management accounting involves collecting, analysing, interpreting and presenting all accounting information which is useful to the management. It is closely associated with management control which comprises planning, executing, measuring and evaluating the performance of an organization. Thus, management accounting draws heavily on cost data and other information derived from cost accounting. Today cost accounting is generally indistinguishable from the so-called management accounting or internal accounting because it serves multiple purposes.

However, management accounting can be distinguished from cost accounting is one important respect. Management accounting has a wider scope as compared to cost accounting. Cost accounting deals primarily with cost data while management accounting involves the considerations of both cost and revenue. Management accounting is an all-inclusive accounting information system, which covers financial accounting, cost accounting and all aspects of financial management. But it is not a substitute for other accounting functions. It involves a continuous process of reporting cost, financial and other relevant data in an analytical and informative way to management. We should not be very much concerned with the boundaries of cost accounting and management accounting since they are complementary in nature. In the absence of suitable system of cost accounting, management will not be in a position to have detailed cost information and their function is bound to lose significance. On the other hand, the management cannot effectively use the cost data unless it has been reported to them in a meaningful and informative form.

The differences between cost accounting and financial accounting may be summarized as follows:

1. *Objectives* Financial accounting aims at safeguarding the interest of the business and its proprietors and others connected with it. This is done by providing suitable information to various parties such as shareholders or partners, present and prospective creditors. Cost accounting, on the other hand, renders information for the guidance of the management for proper planning, operational control and decision making. For example, if the materials have been purchased, financial accounts will only tell whether they have been correctly accounted and paid for, while cost accounts will reveal whether the quantity purchased was reasonable, whether the purchase was at all necessary, and whether the quantity of material utilized was reasonable. Similar considerations also apply to the utilization of labour and capital resources.
2. *Mode of presentation* Financial accounts are prepared according to some accepted accounting concepts and conventions. They are kept in a manner so as to comply with the requirements of the Companies Act, Income Tax Law, Excise and other statutes. Maintenance of cost records is purely voluntary and therefore there are no statutory forms regarding their presentation. However, the Central Government has the power to require by notification any company engaged in production, manufacturing or mining activities to maintain proper cost records.
3. *Recording* In case of financial accounts, the emphasis is on the ascertainment and exhibition of profits earned or losses incurred in the business. On account of this reason, in financial accounts the transactions are recorded, classified and analysed in a subjective

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manner, *i.e.*, according to the nature of expenditure. In cost accounts the emphasis is more on aspects of planning and control and, therefore, transactions are recorded in an objective manner, *i.e.*, according to the purpose for which costs are incurred. For example, if ₹5,000, ₹8,000 and ₹7,000 have been paid as wages for products *A*, *B* and *C*, financial accounts will record the total wages paid, while cost accounts will record wages separately for each product. Besides that in cost accounts a difference will also be made between direct and indirect wages, etc.

4. *Analysing profit* Financial accounting reveals the profit of the business as a whole, while cost accounting shows the profit made on each product, job or process. This enables the management to eliminate the less profitable product lines and maximize the profits by concentrating on more profitable ones.
5. *Periodicity of reporting* Financial accounting is largely concerned with the transactions between the undertaking and the third parties and therefore it has to observe the accounting period convention which is usually a year. The income statement and the balance sheet are, therefore, prepared and presented before the members, usually once at the end of the accounting period, while cost accounting is mainly concerned with the people in the organization and, therefore, it is not subject to the domination of this convention. The cost reports are frequently submitted to the management and in some cases they are submitted every week.
6. *Degree of accuracy* Since financial accounting provides information useful to the outsiders, the information has to be absolutely accurate. Cost accounting provides information to the insiders, *i.e.*, the management, and hence the information may be fairly accurate. Thus, degree of accuracy is more in financial accounting as compared to cost accounting.

It may be noted that in spite of these differences, cost accounting does not totally discard the basic principles and procedures used in financial accounting. As a matter of fact, cost accounting is concerned with a more adequate and detailed recording, measurement and analysis of cost elements as they originate and flow through the productive processes.

Check Your Progress

3. What is the difference between financial and management accounting with respect to periodicity of reporting?
4. Which type of accounting involves consideration of both cost and revenue data?
5. In comparison, which type of accounting has a higher degree of accuracy?

3.4 ANSWERS TO CHECK YOUR PROGRESS QUESTIONS

1. The techniques of budgetary control, standard costing and departmental operating statements greatly help in performing controlling function.
2. Financial information, supplied by financial accounting in the form of financial statements, relates to past activity.
3. The period of reporting is much longer in financial accounting as compared to management accounting. The Income statement and the Balance Sheet are usually prepared yearly or in some cases half-yearly. The management requires information at frequent intervals.
4. Management accounting involves the considerations of both cost and revenue.
5. Since financial accounting provides information useful to the outsiders, the information has to be absolutely accurate. Cost accounting provides information to the insiders, i.e., the management, and hence the information may be fairly accurate.

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3.5 SUMMARY

- Management accounting provides invaluable services to management in all of its functions. The basic functions of management are: (i) Planning, (ii) Controlling, (iii) Coordinating, (iv) Organizing, (v) Motivating, and (vi) Communication.
- Financial accounting helps the management in identifying financial events/ transactions, measuring value of occurrences in terms of money, organizing data into meaningful information, and analysing, interpreting and communicating that information.
- Cost accounting has primarily developed to help managers understand the costs of running a business.
- The various advantages derived by management on account of a good costing system are as follows: aids in price fixing, helps in estimates, wastages are eliminated, makes comparison possible, provides data for periodical profit and loss accounts, aids in determining and enhancing efficiency, helps in inventory control, etc.
- Financial accounting and management accounting are closely interrelated since management accounting is to a large extent rearrangement of the data provided by financial accounting.
- In brief, financial accounting simply shows how the business has moved in the past while management accounting shows the business how to move in the future.

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3.6 KEY WORDS

- **Controlling:** It is a management function involving the evaluation of performance, keeping in view that the actual performance coincides with the planned one, and remedial measures are taken in the event of variation between the two.
- **Break-even point:** It is that level of activity where the concern neither makes a profit nor suffers a loss.
- **Going concern concept:** According to this concept, it is assumed that the business will continue for a fairly long time to come.

3.7 SELF ASSESSMENT QUESTIONS AND EXERCISES

Short Answer Questions

1. State the objectives of financial accounting.
2. What are the differences between cost and management accounting?

Long Answer Questions

1. Discuss the utility of management accounting.
2. Explain the various advantages by management on account of a good costing system.
3. Examine the differences how management accounting is different from financial accounting.
4. Describe the differences between cost and financial accounting.

3.8 FURTHER READINGS

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BLOCK II
FINANCIAL ACCOUNTING

UNIT 4 ACCOUNTING CONCEPTS

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Structure

- 4.0 Introduction
- 4.1 Objectives
- 4.2 Meaning and Types of Accounting Concepts
- 4.3 Conventions
- 4.4 Principles
- 4.5 Answers to Check Your Progress Questions
- 4.6 Summary
- 4.7 Key Words
- 4.8 Self Assessment Questions and Exercises
- 4.9 Further Readings

4.0 INTRODUCTION

It has already been stated in Unit 1 that accounting is the language of business through which normally a business house communicates with the outside world. In order to make this language intelligible and commonly understood by all, it is necessary that it should be based on certain uniform scientifically laid down standards. These standards are termed as accounting principles.

Accounting principles may be defined as those rules of action adopted by the accountants universally while recording accounting transaction. ‘They are a body of doctrines commonly associated with the theory and procedures of accounting, serving as an explanation of current practices and as a guide for selection of conventions or procedures where alternatives exist’. These principles can be classified into two categories: (i) Accounting Concepts and (ii) Accounting Conventions.

4.1 OBJECTIVES

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

- Explain the meaning and types of accounting concepts
- Describe the major accounting conventions
- Discuss the accounting principles

4.2 MEANING AND TYPES OF ACCOUNTING CONCEPTS

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The term 'concepts' includes those basic assumptions or conditions upon which the science of accounting is based. The following are the important accounting concepts:

1. **Separate Entity Concept:** In accounting business is considered to be a separate entity from the proprietor(s). It may appear to be ludicrous that one person can sell goods to himself but this concept is extremely helpful in keeping business affairs strictly free from the effect of private affairs of the proprietor(s). Thus, when one person invests ₹10,000 into business, it will be deemed that the proprietor has given that much of money to the business which will be shown as a 'liability' in the books of the business. In case the proprietor withdraws ₹2,000 from the business, it will be charged to him and the net amount payable by the business will be shown only as ₹8,000.

The concept of separate entity is applicable to all forms of business organisations. For example, in case of a partnership business or sole proprietorship business, though the partners or sole proprietor are not considered as separate entities in the eyes of law, but for accounting purposes they will be considered as separate entities.

2. **Going Concern Concept:** According to this concept it is assumed that the business will continue for a fairly long time to come. There is neither the intention nor the necessity to liquidate the particular business venture in the foreseeable future. On account of this concept, the accountant while valuing the assets does not take into account forced sale value of assets. Moreover, he charges depreciation on fixed assets on the basis of their expected lives rather than on their market value.

It should be noted that the 'going concern concept' does not imply permanent continuance of the enterprise. It rather presumes that the enterprise will continue in operation long enough to charge against income, the cost of fixed assets over their useful lives, to amortise over appropriate period other costs which have been deferred under the actual or matching concept, to pay liabilities when they become due and to meet the contractual commitments. Moreover, the concept applies to the business as a whole. When an enterprise liquidates a branch or one segment of its operations, the ability of the enterprise to continue as a going concern is normally not impaired.

The enterprise will not be considered as a going concern when it has gone into liquidation or it has become insolvent. Of course, the receiver or the liquidator may endeavour to carry on business operations for some period pending arrangement with the creditors or the final buyer for the sale of the business as a going concern, the going concern status of the concern will

stand terminated from the date of his appointment or will be at least regarded as suspended, pending the results of his efforts.

3. **Money Measurement Concept:** Accounting records only monetary transactions. Events or transactions which cannot be expressed in money do not find place in the books of accounts though they may be very useful for the business. For example, if a business has got a team of dedicated and trusted employees, it is definitely an asset to the business but since their monetary measurement is not possible, they are not shown in the books of the business.

Measurement of business event in money helps in understanding the state of affairs of the business in a much better way. For example, if a business owns ₹10,000 of cash, 600 kg of raw materials, two trucks, 1,000 square feet of building space etc., these amounts cannot be added together to produce a meaningful total of what the business owns. However, if these items are expressed in monetary terms such as ₹10,000 of cash, ₹12,000 of raw materials, ₹2,00,000 of trucks and ₹50,000 of building, all such items can be added and much more intelligible and precise estimate about the assets of the business will be available.

4. **Cost Concept:** The concept is closely related to going concern concept. According to this concept:
- (a) an asset is ordinarily entered in the accounting records at the price paid to acquire it, and
 - (b) this cost is the basis for all subsequent accounting for the assets.

If a business buys a plot of land for ₹50,000, the asset would be recorded in the books at ₹50,000 even if its market value at that time happens to be ₹60,000. In case a year later the market value of this assets comes down to ₹40,000, it will ordinarily continue to be shown at ₹50,000 and not at ₹40,000.

The cost concept does not mean that the asset will always be shown at cost. It has also been stated above that cost becomes the basis for all future accounting for the asset. It means that asset is recorded at cost at the time of its purchase, but it may systematically be reduced in its value by charging depreciation.

Cost concept has the advantage of bringing objectivity in the preparation and presentation of financial statements. In the absence of this concept the figures shown in the accounting records would have depended on the subjective views of a person. However, on account of continued inflationary tendencies the preparation of financial statements on the basis of historical costs, has become largely irrelevant for judging the financial position of the business. This is the reason for the growing importance of inflation accounting.

5. **Dual Aspect Concept:** This is the basic concept of accounting. According to this concept every business transaction has a dual effect. For example, if A starts a business with a capital of ₹10,000, there are two aspects of the

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transaction. On the one hand, the business has asset of ₹10,000 while on the other hand the business has to pay to the proprietor a sum of ₹10,000 which is taken as proprietor's capital. This expression can be shown in the form of following equation:

$$\begin{aligned}\text{Capital (Equities)} &= \text{Cash (Assets)} \\ 10,000 &= 10,000\end{aligned}$$

The term 'assets' denotes the resources owned by a business while the term "Equities" denotes the claims of various parties against the assets. Equities are of two types. They are: owners' equity and outsiders' equity. Owners' equity (or capital) is the claim of owners against the assets of the business while outsiders' equity (for liabilities) is the claim of outside parties, such as creditors, debenture-holders etc., against the assets of the business. Since all assets of the business are claimed by some one (either owners or outsiders), the total of assets will be equal to total of liabilities, Thus:

$$\begin{aligned}\text{Equities} &= \text{Assets} \\ \text{or} \quad \text{Liabilities} + \text{Capital} &= \text{Assets}\end{aligned}$$

In the example given above, if the business purchases furniture worth ₹5,000 out of the money provided by A, the situation will be as follows:

$$\begin{aligned}\text{Equities} &= \text{Assets} \\ \text{Capital ₹10,000} &= \text{Cash ₹5,000} + \text{Furniture ₹5,000}\end{aligned}$$

Subsequently, if the business borrows ₹30,000 from a bank, the new position would be as follows:

$$\begin{aligned}\text{Equities} &= \text{Assets} \\ \text{Capital ₹10,000} + \text{Bank Loan ₹30,000} &= \text{Cash ₹35,000} + \text{Furniture ₹5,000}\end{aligned}$$

The term 'accounting equation' is also used to denote the relationship of equities to assets. The equation can be technically stated as "for each debit, there is an equivalent credit". As a matter of fact the entire system of double entry book-keeping is based on this concept.

6. **Accounting Period Concept:** According to this concept, the life of the business is divided into appropriate segments for studying the results shown by the business after each segment. This is because though the life of the business is considered to be indefinite (according to going concern concept), the measurement of income and studying the financial position of the business after a very long period would not be helpful in taking proper corrective steps at the appropriate time. It is, therefore, absolutely necessary that after each segment or time interval the businessman must 'stop' and 'see back', how things are going. In accounting such a segment or time interval is called 'accounting period'. It is usually of a year.

At the end of each accounting period an Income Statement and a Balance Sheet are prepared. The Income Statement discloses the profit or loss made by the business during the accounting period while the Balance Sheet depicts

the financial position of the business as on the last day of the accounting period. While preparing these statements a proper distinction has to be made between capital and revenue expenditure.

7. **Periodic Matching of Costs and Revenue Concept:** This is based on the accounting period concept. The paramount objective of running a business is to earn profit. In order to ascertain the profit made by the business during a period, it is necessary that 'revenues' of the period should be matched with the costs (expenses) of the period. The term matching, means appropriate association of related revenues and expenses. In other words, income made by the business during a period can be measured only when the revenue earned during a period is compared with the expenditure incurred for earning that revenue. The question when the payment was received or made is 'irrelevant'. For example, if a salesman is paid commission in January, 2011, for sales made by him in December, 2010, the commission paid to the salesman in January, 2011 should be taken as the cost for sales made by him in December, 2010. This means that revenues of December, 2010 (*i.e.*, sales) should be matched with the costs incurred for earning that revenue (*i.e.*, salesman's commission) in December, 2010 (though paid in January, 2011). On account of this concept, adjustments are made for all outstanding expenses, accrued incomes, prepaid expenses and unearned incomes, etc., while preparing the final accounts at the end of the accounting period.

8. **Realisation Concept:** According to this concept revenue is recognised when a sale is made. Sale is considered to be made at the point when the property in goods passes to the buyer and he becomes legally liable to pay. This can be well understood with the help of the following example:

A places an order with *B* for supply of certain goods yet to be manufactured. On receipt of order, *B* purchases raw materials, employs workers, produces the goods and delivers them to *A*. *A* makes payment on receipt of goods. In this case the sale will be presumed to have been made not at the time of receipt of the order for the goods but at the time when goods are delivered to *A*.

However, there are certain exceptions to this concept:

- (i) In case of hire purchase the ownership of the goods passes to the buyer only when the last instalment is paid, but sales are presumed to have been made to the extent of instalments received and instalments outstanding (*i.e.* instalments due but not received).
- (ii) In case of contracts accounts, though the contractor is liable to pay only when the whole contract is completed as per terms of the contract, the profit is calculated on the basis of work certified year after year as per certain accepted accounting norms.

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Check Your Progress

1. What does the going concern concept presume?
2. What is the meaning of the term 'matching' in the periodic matching of costs and revenue concepts?

4.3 CONVENTIONS

The term 'conventions' includes those customs or traditions which guide the accountant while preparing the accounting statements. The following are the important accounting conventions.

1. **Conservatism:** In the initial stages of accounting, certain anticipated profits which were recorded, did not materialise. This resulted in less acceptability of accounting figures by the end-users. On account of this reason, the accountants follow the rule 'anticipate no profit but provide for all possible losses' while recording business transactions. In other words, the accountant follows the policy of "playing safe". On account of this convention, the inventory is valued 'at cost or market price whichever is less'. Similarly, a provision is made for possible bad and doubtful debts out of current year's profits. This concept affects principally the category of current assets.

The convention of conservatism has become the target of serious criticism these days especially on the ground that it goes against the convention of full disclosure. It encourages the accountant to create secret reserves (*e.g.*, by creating excess provision for bad and doubtful debts, depreciation etc.), and the financial statements do not depict a true and fair view of the state of affairs of the business. The Income Statement shows a lower net income, the Balance Sheet understates assets and overstates liabilities.

The research studies conducted by the American Institute of Certified Public Accountants have indicated that conservatism concept needs to be applied with much more caution and care if the results reported are not to be distorted.

2. **Full disclosure:** According to this convention accounting reports should disclose fully and fairly the information they purport to represent. They should be honestly prepared and sufficiently disclose information which is of material interest to proprietors, present and potential creditors and investors. The convention is gaining more importance because most of big businesses are run by joint stock companies where ownership is divorced from management. The Companies Act, 2013 not only requires that Income Statement and Balance Sheet of a company must give a true and fair view of the state of affairs of the company but it also gives the prescribed forms in which these statements are to be prepared. The practice of appending notes to the

accounting statements (such as about contingent liabilities or market value of investments) is in pursuance to the convention of full disclosure.

3. **Consistency:** According to this convention, accounting practices should remain unchanged from one period to another. For example, if stock is valued at “cost or market price whichever is less”, this principle should be followed year after year. Similarly, if depreciation is charged on fixed assets according to diminishing balance method, it should be done year after year. This is necessary for the purposes of comparison. However, consistency does not mean inflexibility. It does not forbid introduction of improved accounting techniques. However, if adoption of such a technique results in inflating or deflating the figures of profit as compared to the previous period, a note to that effect should be given in the financial statements.
4. **Materiality:** According to this convention the accountant should attach importance to material details and ignore insignificant details. This is because otherwise accounting will be unnecessarily overburdened with minute details. The question what constitutes a material detail, is left to the discretion of the accountant. Moreover, an item may be material for one purpose while immaterial for another. For example, while sending each debtor “a statement of his account”, complete details upto paise have to be given. However, when a statement of outstanding debtors is prepared for sending to top management, figures may be rounded to the nearest ten or hundred. The Companies Act also permits ignoring of ‘paise’ while preparing financial statements. Similarly, for tax purposes, the income has to be rounded to nearest ten.

Thus, the term ‘materiality’ is a subjective term. The accountant should regard an item as material if there is reason to believe that knowledge of it would influence the decision of the informed investor. According to Kohler, “materiality means the characteristic attaching to a statement, fact or item whereby its disclosure or method of giving it expression would be likely to influence the judgement of a reasonable person.”

It should be noted that accounting is a man-made art designed to help man in achieving certain objectives. “The accounting principles, therefore, cannot be derived from or proven by laws of nature. They are rather in the category of conventions or rules developed by man from experience to fulfil the essential and useful needs and proposes in establishing reliable financial and operating information control for business entities. In this respect, they are similar to the principles of commercial and other social disciplines.”

4.4 PRINCIPLES

Accounting practices follow certain guidelines. The rules that govern how accountants measure progress and communicate financial information fall under

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the heading “Generally Accepted Accounting Principles” (GAAP). GAAP comprises of conventions, rules and procedures that constitute accepted accounting practices at any given time. They are like the law or rules for conducting behaviour in a way acceptable to majority of the people. They may readily be defined as rules of action or conduct which are adopted by the accountants universally while recording accounting transactions. They are a body of doctrines commonly associated with the theory and procedures of accounting, serving as an explanation of current practices and as a guide for selection of conventions or procedures where alternatives exist.

It should be noted that GAAP differ from country to country because of the legislative requirements of each country, local accounting practices, customs, usage and business environment peculiar to each country. Each country has set up its own professional accounting body/regulatory authority to frame, implement and regulate the application of the GAAPs in the country. For example, in USA the Financial Accounting Standard Board (FASB) set up in 1973 makes major pronouncements called Statements of Financial Accounting Standards (SFAS) from time to time. Similarly, in UK the Accounting Standard Board set up in 1990 issues financial reporting standards. The Board has replaced the Accounting Standards Committee which was responsible for issuing Statements of Standard Account Practices (SSAPs) earlier from time to time. In India, the Accounting Standard Board set up by the Institute of Chartered Accountants of India issues the accounting standards to be observed by all business entities. However, the Ministry of Corporate Affairs (MCA) has also notified presently 40 Indian Accounting Standards (Ind AS), as a step towards convergence of International Financial Reporting Standards (IFRS) in India. It may be noted that Ind AS would be applicable to various classes of entities as may be prescribed by the relevant authorities such as Ministry of Corporate Affairs for the companies governed under the Companies Act, 2013 from the notified date(s). The existing Accounting Standards (AS) would continue to apply to entities other than those to which Ind AS would apply. In case of differences between the two standards i.e. AS issued by the Institute of Chartered Accountants of India and Ind AS notified by the Ministry of Corporate Affairs, Government of India, the Institute of Chartered Accountants of India would harmonise their differences. This, in some cases, has already been done e.g. withdrawal of AS 6: Depreciation Accounting and replacement of AS 10: Fixed Assets by AS 10: Property, Plant and *Equipment*.

Check Your Progress

3. How does convention of conservatism go against the convention of full disclosure?
4. Who harmonises the difference in accounting standards between AS issued by ICAI and Ind AS as notified by MCA?

4.5 ANSWERS TO CHECK YOUR PROGRESS QUESTIONS

1. The going concern concept does not imply permanent continuance of the enterprise. It rather presumes that enterprise will continue in operation long enough to charge against income, the cost of fixed assets over their useful lives, to amortise over appropriate period other costs which have been deferred under the actual or matching concept, to pay liabilities when they become due and to meet the contractual commitments.
2. The term 'matching' means appropriate association of related revenues and expenses. In other words, income made by the business during a period can be measured only when the revenue earned during a period is compared with the expenditure incurred for earning that revenue, The question when the payment was received or made is 'irrelevant'.
3. The convention of conservatism goes against the convention of full disclosure since it encourages the accountant to create secret reserves and the financial statements do not depict a true and fair view of the state of affairs of the business.
4. In case of differences between the AS issued by the Institute of Chartered Accountants of India and Ind AS notified by the Ministry of Corporate Affairs, Government of India, the Institute of Chartered Accountants of India would harmonise their differences.

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4.6 SUMMARY

- Concepts refers to the basic assumptions forming the basis of accounting.
- The important accounting concepts include separate entity concept, going concern concept, money measurement concept, cost concept, dual aspect concept, accounting period concept, periodic matching of costs and revenue concept, and realisation concept.
- Conventions includes customs which guide the accounting in the preparation of the accounting statements.
- The following are the important accounting concepts: conservatism, full disclosure, consistency, materiality, etc.
- Accounting practices follow certain guidelines. The rules that govern how accountants measure progress and communicate financial information fall under the heading, "Generally Accepted Accounting Principles."
- It should be noted that GAAP differ from country to country because of the legislative requirements of each country.

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4.7 KEY WORDS

- **Concepts:** It includes those basic assumptions or conditions upon which the science of accounting is based.
- **Equities:** It denotes the claims of various parties against the assets.
- **Accounting equation:** It is used to denote the relationship of equities to assets.
- **Conventions:** It includes those customs or traditions which guide the accountant while preparing the accounting statements.
- **GAAP:** It stands for Generally Accepted Accounting Principles which comprises of conventions, rules and procedures that constitute accepted accounting practices at any given time.

4.8 SELF ASSESSMENT QUESTIONS AND EXERCISES

Short Answer Questions

1. Mention the advantage and criticism against cost concept of accounting.
2. List the exceptions to the realisation concept.
3. What is materiality?
4. What is the meaning of accounting convention of consistency?
5. Write a short note on accounting principles followed in India.

Long Answer Questions

1. Discuss the major accounting concepts.
2. Explain the important accounting conventions.

4.9 FURTHER READINGS

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UNIT 5 ACCOUNTING STANDARDS

Structure

- 5.0 Introduction
- 5.1 Objectives
- 5.2 International Accounting Standards
- 5.3 Answers to Check Your Progress Questions
- 5.4 Summary
- 5.5 Key Words
- 5.6 Self Assessment Questions and Exercises
- 5.7 Further Readings

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5.0 INTRODUCTION

In the previous unit, you learnt about the accounting concepts and conventions. You also learnt that accounting principles are rules that govern current accounting practices and are used as references that determine the application of appropriate treatment of complex transactions. In order to ensure that the application of these rules/principles is uniform in different enterprises, and the financial statements are comparable, the accounting regulatory bodies in different countries have codified these principles/rules in the form of accounting standards. Thus, accounting standards are basically accounting principles which have been codified and formalised by concerned regulatory bodies. In this unit, you will learn about the international accounting standards.

5.1 OBJECTIVES

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

- Explain the meaning and objectives of accounting standards
- Discuss the history and structure of IASC and IAS/IFRS

5.2 INTERNATIONAL ACCOUNTING STANDARDS

Accounting standards are rules according to which accounting statements have to be prepared. They can be termed as statements of code of practice of the regulatory accounting bodies that are to be observed in the preparation and presentation of financial statements. Accounting Standards may vary from country to country or industry to industry depending upon specific requirements. According to Institute of Chartered Accountants of India “Accounting Standards act as pillars of financial reporting structure of the country as they lay down sound principles for recognition,

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measurement, presentation and disclosures of information in the financial statements, which substantially improve the quality of financial statements.”

Objectives of Accounting Standards: Financial statements provide useful financial information about an enterprise to various stakeholders to base their economic and financial decisions. The comparison of the financial statements of various reporting enterprises poses some difficulties because of the divergence in the methods and principles adopted by these enterprises in preparing their financial statements. Accounting Standards have been evolved to bring uniformity to the extent possible in the accounting methods and principles adopted by the various enterprises.

Thus, accounting standards rationally harmonize the diverse accounting policies followed in the preparation and presentation of financial statements by different reporting enterprises so as to facilitate intra-firm and inter-firm comparison by the stakeholders to take informed economic decisions.

International Accounting Standards Committee and IAS/IFRS

History and Structure: International Accounting Standards Committee (IASC) came into existence on 29th June, 1973 when 16 accounting bodies from nine nations (called founder-members) signed the agreement and constitution for its formation. The Committee has its headquarters at London. Its interpretative arm was known as Standard Interpretation Committee (SIC).

The objective of the committee was “to formulate and publish in the public interest standards to be observed in the presentation of audited financial statements and to promote their world-wide acceptance and observance.” The formulation of such standards will bring uniformity in terminology, approach and presentation of results. This will not only help in a correct understanding and exchange of economic and financial information but also in facilitating a smooth flow of international investment.

Between 1973 and 2000, the *IASC* issued several Accounting Standards, known as International Accounting Standards (IASs). Since 2001, the *IASC* was renamed as the International Accounting Standard Board (IASB). The *IASB* has now taken over the work of *IASC*. Its members (currently 15 full time members) are responsible for the development and publication of *IFRSs* and approving interpretations as developed by *IFRIC*.

The *IASB* has issued a new series of pronouncements known as International Financial Reporting Standards (IFRSs) on topics on which there was no previous *IAS*. Besides this, the *IASB* has replaced some *IASs* with new *IFRSs*. Thus, now the *IASs* issued by the *IASC* and *IFRSs* issued by the *IASB* all come within the purview of *IASB*. An International Financial Reporting Interpretation Committee (IFRIC) has also been formed to provide interpretations of the standards similar to previous SIC.

The *IASB* works closely with stakeholders around the world, including investors, analysts, regulators, business leaders, accounting standard-setters and the accountancy profession.

Objectives of IASB: The broad objectives of *IASB* as per the IFRS Foundation, (not for profit private sector organisation) can be summarised as under.

- (a) To develop, in the public interest, a single set of high quality, understandable, enforceable and globally accepted financial reporting standards based upon clearly articulated principles. These standards should require high quality, transparent and comparable information in financial statements and other financial reporting to help investors, other participants in the world's capital markets and other users of financial information to make economic decisions;
- (b) To promote the use and rigorous application of those standards;
- (c) To pay attention to the needs of medium and small scale enterprises and emerging economies in tune with (a) and (b) objectives stated above; and
- (d) To promote and facilitate adoption of IFRSs, being the standards and interpretations issued by the IASB, through the convergence of national accounting standards and IFRSs.

Meaning of IFRS: It is a set of international accounting standards developed by the International Accounting Standards Board (IASB) providing the mode of reporting particular type of transactions and events in the financial statements. They include standards and interpretations issued by the International Accounting Standards Board (IASB) and its predecessor body, viz., International Accounting Standards Committee (IASC). They comprise:

- (a) International Financial Reporting Standards;
- (b) International Accounting Standards, and
- (c) Interpretations developed by the International Financial Reporting Interpretations Committee (IFRIC) or the former Standing Interpretations Committee (SIC).

Objective of IFRS: The basic objective of IFRSs is to make international comparison of financial statements of business enterprises as easy as possible. At present it is difficult since each country has its own set of rules. IFRSs have been designed as a common global language for business affairs to synchronize accounting standards across the globe. They are progressively replacing the many different national accounting standards. They require the accountants to maintain books of account in a manner that the financial statements based on them are comparable, understandable, reliable and relevant as per the requirements of users—both internal and external.

Scope of IFRS: The scope of IFRS is as under.

- (i) IFRS apply to the general purpose financial statements and other financial reporting by profit-oriented entities— those engaged in commercial, industrial, financial, and similar activities, regardless of their legal form.

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Explanations:

- (a) General purpose financial statements are intended to meet the common needs of shareholders, creditors, employees, and the public at large for information about an entity's financial position, performance, and cash flows.
- (b) Other financial reporting includes information provided outside financial statements that assists in the interpretation of a complete set of financial statements or improves users' ability to make efficient economic decisions.
- (ii) Entities other than profit-oriented business entities may also find IFRSs appropriate.
- (iii) IFRSs apply to individual company and consolidated financial statements.

IFRS Assumptions: There are four underlying assumptions in IFRS as detailed below.

1. **Accrual basis:** The assumption that the financial effect of transactions and events are recognised as they occur, not when cash is received or paid.
2. **Going concern:** The assumption that a business entity will be in operation for the foreseeable future.
3. **Measuring unit:** Measuring unit for valuation of capital is the current purchasing power. In other words assets should be reflected in the financial statements at their fair value.
4. **Unit of constant purchasing power:** The value of capital should be adjusted at end of the financial year to inflation prevailing in the economy.

IFRS Around the World

IFRS is a globally accepted financial reporting framework. It is used over 110 countries but in both the US and the UK, the Generally Accepted Accounting Principles (GAAP) is the more widely used set of guidelines for accountants.

Currently the Financial Accounting Standards Board (FASB) of USA and the IASB are working on numerous joint projects designed to improve the GAAP and the IFRS with the goal to ultimately make the standards fully compatible.

In India also we are following GAAP *i.e.*, accounting standards as prescribed by Institute of Chartered Accountants of India. Of course steps are being taken for converging the Indian Accounting Standards with IFRS.

IFRS Main Financial Statements

Types: The IFRS financial statements include the following.

- A Statement of Financial Position. It comprises Assets, Liabilities and Equity

- A Statement of Comprehensive Income. It includes two separate statements (i) an Income Statement and (ii) a Statement of Comprehensive Income. The Statement of Comprehensive Income reconciles the Profit or Loss as per Income Statement to total comprehensive income
- A Statement of Changes in Equity
- A Cash Flow Statement or Statement of Cash Flows
- Notes, comprising a summary of the significant accounting policies

Objective: A financial statement should present true and fair picture of the business affairs of an organisation. Since these statements are used by different constituents of the regulators/society, they are required to present the true view of financial position of the organisation.

Qualitative characteristics: As per IFRS, the main characteristics required in its main financial statement include:

- Understandability
- Relevance
- Reliability
- Comparability

Current Status of IAS/IFRS and Interpretations: The current status of International Accounting Standards (IAS), International Financial Reporting Standards (IFRS), and Interpretations issued by Standing Interpretation Committee (SIC), International Financial Reporting Interpretation Committee (IFRIC) is as under.

International Accounting Standards (IASs): All 41 IASs have been issued out of which 16 have been withdrawn. Thus, at present 25 IAS are in operation. They are as under.

IAS 1. Presentation of Financial Statements.

IAS 2. Inventories.

IAS 7. Cash Flow Statements.

IAS 8.

Accounting Policies, Changes in Accounting Estimates and Errors.

IAS 10. Events after the Reporting Period.

IAS 12. Income Taxes.

IAS 16. Property, Plant and Equipment.

IAS 17. Leases.

IAS 19. Employee Benefits.

IAS 20.

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Accounting for Government Grants and Disclosure of Government Assistance.

IAS 21. The Effects of Changes in Foreign Exchange Rates.

IAS 23. Borrowing Costs

IAS 24. Related Party Disclosures.

IAS 27. Consolidated and Separate Financial Statements.

IAS 28. Investments in Associates.

IAS 29. Financial Reporting in Hyperinflationary Economies.

IAS 31. Interests in Joint Ventures.

IAS 32. Financial Instruments: Presentation

IAS 33. Earnings per share.

IAS 34. Interim Financial Reporting.

IAS 36. Impairment of Assets.

IAS 38. Intangible Assets.

IAS 39. Financial Instruments: Recognition and Measurement.

IAS 40. Investment Property.

IAS 41. Agriculture.

International Financial Reporting Standards (IFRSs): In all 17 IFRSs have been issued. The list is as under.

No.	Title	Originally issued	Effective
IFRS 1	First-time Adoption of International Financial Reporting Standard	2003	Jan. 1, 2004
IFRS 2	Share-based Payment	2004	Jan. 1, 2005
IFRS 3	Business Combinations	2004	Apr. 1, 2004
IFRS 4	Insurance Contracts	2004	Jan. 1, 2005
IFRS 5	Non-current Assets held for Sale and Discontinued Operations	2004	Jan. 1, 2005
IFRS 6	Exploration for and Evaluation of Mineral Resources	2004	Jan. 1, 2006
IFRS 7	Financial instrument: Disclosures	2005	Jan. 1, 2007
IFRS 8	Operating Segments	2006	Jan. 1, 2009
IFRS 9	Financial instruments	2009 (updated 2014)	Jan. 1, 2013
IFRS 10	Consolidated Financial Statements	2011	Jan. 1, 2013
IFRS 11	Joint Arrangements	2011	Jan. 1, 2013
IFRS 12	Disclosure of Interests in Other Entities	2011	Jan. 1, 2013
IFRS 13	For Value Measurement	2011	Jan. 1, 2013
IFRS 14	Regulatory Deferral Accounts	2014	Jan. 1, 2016
IFRS 15	Revenue from Contracts with Customers	2014	Jan. 1, 2017
IFRS 16	Leases	2016	Jan. 1, 2019
IFRS 17	Insurance Contracts	2017	Jan. 1, 2021

Interpretations Issued by SIC/IFRIC: In all 25 interpretations have been issued as given under.

SIC 7 Introduction of the Euro

SIC 10 Government Assistance - No Specific Relation to Operating Activities

- SIC 12** Consolidation - Special-Purpose Entities
- SIC 13 Jointly Controlled Entities - Non-monetary Contributions by Ventures
- SIC 15** Operating Leases - Incentives
- SIC 21 Income Taxes - Recovery of Revalued Non-Depreciable Assets
- SIC 25 Income Taxes - Changes in the Tax Status of an Enterprise or its Shareholders.
- SIC 27 Evaluating the Substance of Transactions Involving the Legal Form of a Lease
- SIC 29** Service Concession Arrangements: Disclosures
- SIC 31 Revenue - Barter Transactions Involving Advertising Services
- SIC 32** Intangible Assets - Web Site Costs
- SIRC 33** Consolidation and Equity Method: Potential Voting Rights and Allocation of Ownership Interests
- IFRIC 1** Changes in Existing Decommissioning, Restoration and Similar Liabilities
- IFRIC 2** Members' Shares in Co-operative Entities and Similar Liabilities
- IFRIC 4** Determining Whether an Arrangement contains a Lease
- IFRIC 5** Rights to Interests arising from Decommissioning, Restoration and Environmental Rehabilitation Funds.
- IFRIC 6** Liabilities arising from Participating in a Specific Market - Waste Electrical and Electronic Equipment
- IFRIC 7** Applying the Restatement Approach under IAS 29, Financial Reporting in Hyperinflationary Economies
- IFRIC 9** Reassessment of Embedded Derivatives
- IFRIC 10** Interim Financial Reporting and Impairment
- IFRIC 12** Service Concession Arrangements
- IFRIC 14** IAS 19 - The Limit on a Defined Benefit Asset, Minimum Funding Requirements, and their Interaction
- IFRIC 16** Hedges of a Net Investment in a Foreign Operation
- IFRIC 17** Distribution of Non-Cash Assets to Owners
- IFRIC 19** Extinguishing Financial Liabilities with Equity Instruments
- IFRIC 20** Stripping Costs in the Production Phase of a Surface Mine
- IFRIC 21** Levies
- IFRIC 22** Foreign Currency Transactions and Advance Consideration
- IFRIC 23** Uncertainty over Income Tax Treatment

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Check Your Progress

1. When did the International Accounting Standards Committee came into existence?
2. What are the pronouncements by the IASB known as?
3. What does the IFRSs comprise of?
4. Mention the main characteristics required in its financial statements as per IFRS.

5.3 ANSWERS TO CHECK YOUR PROGRESS QUESTIONS

1. International Accounting Standards Committee (IASC) came into existence on 29 June 1973 when 16 accounting bodies from nine nations signed the agreement and constitutes for its formation.
2. The IASB has issued a new series of pronouncements known as International Financial Reporting Standards (IFRSs) on topics on which there was no previous IAS.
3. The IFRS comprises of:
 - (a) International Financial Reporting Standards,
 - (b) International Accounting Standards, and
4. As per IFRS, the main characteristics required in its main financial statement include understandability, relevance, reliability and comparability.

5.4 SUMMARY

- Accounting standards are rules according to which accounting statements have to be prepared.
- Accounting Standards may vary from country to country or industry to industry depending upon specific requirements.
- Accounting standards rationally harmonize the diverse accounting policies followed in the preparation and presentation of financial statements by different reporting enterprises so as to facilitate intra-firm and inter-firm comparison by the stakeholders to take informed economic decisions.
- The International Accounting Standards Committee (IASC) came into existence on 29 June 1973 when 16 accounting bodies form nine nations signed the agreement and constitution for its formations. Its interpretative arm was known as Standard Interpretation Committee (SIC).

- Since 2001, the IASC was renamed as the International Accounting Standard Board (IASB). Its members are responsible for the development and publication of IFRSs and approving interpretations as developed by IFRIC.
- IFRS includes standards and interpretations issued by the International Accounting Standards Board (IASB), and its predecessor body, viz., International Accounting Standards Committee (IASC) along with its own IFRSs.
- IFRS is a globally accepted financial reporting framework which is used over 110 countries. In India, we are following GAAP as issued by ICAI, but steps are being taken for converging Indian Accounting Standards with IFRS.
- At present, 25 IAS, 17 IFRS and 25 interpretations by SIC/IFRIC are in operation.

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5.5 KEY WORDS

- **Accounting standards:** It can be termed as statements of code of practice of the regulatory accounting bodies that are to be observed in the preparation and presentation of financial statements.
- **IFRS:** It refers to the International Financial Reporting Standards developed by the International Accounting Standards Board providing the mode of reporting particular type of transactions and events in the financial statements.

5.6 SELF ASSESSMENT QUESTIONS AND EXERCISES

Short Answer Questions

1. State the objectives of accounting standards.
2. Write a short note on the history and structure of IASC and IAS/IFRS.
3. List the broad objectives of IASB as per the IFRS foundation.

Long Answer Questions

1. Discuss the meaning, objectives, scope and assumptions of IFRS.
2. What are the different types of IFRS financial statements, their objectives, current status and interpretations?

5.7 FURTHER READINGS

Maheshwari, S.N., Suneel K. and Sharad K. 2017. *Advanced Accountancy*, Vol I. New Delhi: Vikas Publishing House.

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Ahmed, N. 2008. *Financial Accounting*. New Delhi: Atlantic Publishers and Distributors Pvt. Ltd.

BLOCK III
DOUBLE ENTRY SYSTEM OF ACCOUNTING

*Introduction To Double
Entry System of
Accounting-I*

**UNIT 6 INTRODUCTION TO
DOUBLE ENTRY SYSTEM
OF ACCOUNTING-I**

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Structure

- 6.0 Introduction
- 6.1 Objectives
- 6.2 Preparation of Journal
- 6.3 Preparation of Ledger
- 6.4 Answers to Check Your Progress Questions
- 6.5 Summary
- 6.6 Key Words
- 6.7 Self Assessment Questions and Exercises
- 6.8 Further Readings

6.0 INTRODUCTION

Book-keeping, as explained earlier, is the art of recording pecuniary or business transactions in a regular and systematic manner. This recording of transactions may be done according to any of the following two systems:

An incomplete double entry system can be termed as a single-entry system. According to Kohler, "It is a system of book-keeping in which as a rule only records of cash and personal accounts are maintained, it is always incomplete double entry, varying with circumstances". This system has been developed by some business houses, who for their convenience, keep only some essential records. Since all records are not kept, the system is not reliable and can be used only by small firms. The working of this system has been discussed in detail later in Units 9-11.

The system of 'double entry' book-keeping which is believed to have originated with the Venetian merchants of the fifteenth century, is the only system of recording the two-fold aspect of the transaction. This has been, to some extent, explained while discussing the 'dual aspect concept'. The system recognises that every transaction has a two-fold effect. If someone receives something then either some other person must have given it, or the first mentioned person must have lost something, or some service etc., must have been rendered by him.

In this block you will learn about double entry system of book-keeping beginning with the preparation of journal and ledger.

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6.1 OBJECTIVES

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

- Discuss the double entry system of accounting and accounting books
- Explain the preparation of journal
- Describe the preparation of ledgers

6.2 DOUBLE ENTRY SYSTEM OF BOOK-KEEPING AND ACCOUNTING BOOKS

The double entry system of book-keeping can very well be explained by the “accounting equation” given below:

$$\text{Assets} = \text{Equities}$$

The properties owned by business are called ‘assets’. The rights to the properties are called ‘Equities’. Equities may be sub-divided into two principal types: the rights of the creditors and the rights of the owners. The equity of creditors representing debts of the business and are called “liabilities”. The equity of owners is called “capital”, or proprietorship or owner’s equity. Thus:

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

or

$$\text{Capital} = \text{Assets} - \text{Liabilities}$$

The accounting equation can be understood with the help of the following transactions:

Transaction 1. *A* starts business with a capital of ₹10,000

There are two aspects of the transaction. The business has received cash of ₹10,000. It is its asset but on the other hand it has to pay a sum of ₹10,000 to *A*, the Proprietor.

Thus:

<i>Capital and Liabilities</i>	₹	<i>Assets</i>	₹
Capital	10,000	Cash	10,000

Transaction 2. *A* purchases furniture for cash worth ₹2,000. The position of his business will be as follows:

<i>Capital and Liabilities</i>	₹	<i>Assets</i>	₹
Capital	10,000	Cash	10,000
Furniture	2,000		
	10,000		10,000

Transaction 3. *A* purchases cotton bales from *B* for ₹5,000 on credit. He sells for cash cotton bales costing ₹3,000 for ₹4,000 and ₹1,000 for ₹1,500 on credit to *P*.

As a result of these transactions the business makes a profit of ₹1,500 (*i.e.* ₹5,500 – ₹4,000) this will increase *A*'s Capital from ₹10,000 to ₹11,500. The business will have a liability of ₹5,000 to *B* and two more assets in the form of a debtor *P* for ₹1,500 and stock of cotton bales of ₹1,000. The position of his business will now be as follows:

<i>Capital and Liabilities</i>	₹	<i>Assets</i>	₹
Creditor (<i>B</i>)	5,000	Cash ('8,000 + ₹4,000)	12,000
Capital	11,500	Stock of Cotton Bales	1,000
		Debtor (<i>P</i>)	1,500
		Furniture	2,000
	16,500		16,500

Transaction 4. *A* withdraws cash of ₹1,000 and cotton bales of ₹200 for his personal use. The amount and the goods withdrawn will decrease relevant assets and *A*'s capital. The position will be now as follows:

<i>Capital and Liabilities</i>	₹	<i>Assets</i>	₹
Creditor (<i>B</i>)	5,000	Cash ('12,000 – ₹1,000)	11,000
Capital ('11,500 – ₹1,200)	10,300	Stock of Cotton Bales	800
		Debtor (<i>P</i>)	1,500
		Furniture	2,000
	15,300		15,300

The above type of statement showing the financial position of a business on a certain date is termed as balance sheet.

The result of applying the system of double entry system may be summarised in the form of following rule:

“For every debit there must be equivalent credit and *vice versa*.”

You have already learnt what double entry system of book-keeping is. It is different from single entry system on account of the following points:

- Recording of transactions** In case of double entry system, the dual aspect concept is completely followed while recording business transactions. In case of single entry system, the dual aspect concept is not followed for all transactions. In case of some transactions both the aspects are recorded, while for some only one aspect is recorded, while in case of some other transactions no recording is at all done.
- Maintenance of books** In case of double entry system, various subsidiary books *viz.*, sales book, purchases book, returns book, cash book etc., are maintained. While in case of single entry system, no subsidiary books except cash book is maintained.
- Maintenance of books of account** In case of double entry system, all major accounts real, nominal and personal are maintained. However, in case of single entry system, only personal accounts are maintained.
- Preparation of trial balance** In case of double entry system, trial balance is prepared to check arithmetical accuracy of the books of account. While in case of single entry system trial balance cannot be

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prepared. Hence, it is not possible to check the accuracy of books of account.

(e) *Accuracy of profits and financial position* In case of double entry system, Trading and Profit and Loss Account gives the true profit of the business while Balance Sheet shows the true and fair financial position of the business. While in case of single entry system only a rough estimate of profit or loss can be made. The Statement of Affairs prepared in single entry system also does not show the true financial position of the business.

(f) *Utility* Single entry system is used only by very small business units. It has no utility for large business units. As a matter of fact, they have to compulsorily adopt double entry system.

Accounting Books

Accounting books refers to the books of accounts maintained in the double entry system. The Journal is the book of original entry for recording of transactions. For convenient and effective maintenance of records, the journal is sub-divided into specified books known as subsidiary books. The Ledger is the books where the recorded transactions are classified. The trail balance is the account where the arithmetical accuracy is check. Then, the statements of financial positions are drawn. In this unit, you will learn about journals and ledgers.

6.3 PREPARATION OF JOURNAL

The Journal records all daily transactions of a business into the order in which they occur. A Journal may, therefore, be defined as a book containing a chronological record of transactions. It is the book in which the transactions are recorded first of all under the double entry system. Thus, Journal is the book of original record. A Journal does not replace but precedes the Ledger. The process of recording transaction in a Journal, is termed as Journalising. A proforma of journal is given as:

JOURNAL				
Date	Particulars	L.F.	Debit ₹	Credit ₹
(1)	(2)	(3)	(4)	(5)

1. **Date:** The date on which the transaction was entered is recorded here.
2. **Particulars:** The two aspects of transaction are recorded in this column, *i.e.*, the details regarding accounts which have to be debited and credited.
3. **L.F.:** It means Ledger Folio. The transactions entered in the Journal are later on posted to the ledger. The relevant ledger folio is entered here. Procedure regarding posting the transactions in the Ledger has been explained in the next unit.
4. **Debit:** In this column, the amount to be debited is entered.
5. **Credit:** In this column, the amount to be credited is shown.

Rules of Debit and Credit

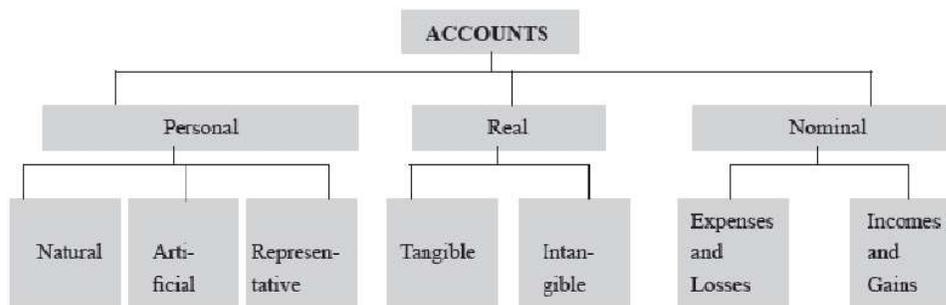
The transactions in the Journal are recorded on the basis of the rules of debit and credit. For this purpose business transactions have been classified into three categories:

- (i) Transactions relating to persons.
- (ii) Transactions relating to properties and assets.
- (iii) Transactions relating to incomes and expenses.

On this basis, it becomes necessary for the business to keep an account of:

- (i) Each person with whom it deals.
- (ii) Each property or asset which the business owns.
- (iii) Each item of income or expense.

The accounts falling under the first heading are called as 'Personal Accounts'. The accounts falling under the second heading are termed as 'Real Accounts'. The accounts falling under the third heading are termed as 'Nominal Accounts'. The classification of the accounts, as explained above, can be put in the form of the following chart:



Each of the above categories of accounts and the relevant rule for 'debit and credit' have been explained in detail in the following pages:

Personal accounts: Personal accounts include the accounts of persons with whom the business deals. These accounts can be classified into the three categories.

1. *Natural Personal Accounts:* The term 'Natural Persons' means persons who are creation of God. For example, Mohan's Account, Sohan's Account, Abha's Account etc.
2. *Artificial Personal Accounts:* These accounts include accounts of corporate bodies or institutions which are recognised as persons in business dealings. For example, the account of a Limited Company, the account of a Co-operative Society, the account of a Club, the account of Government, the account of an Insurance Company etc.
3. *Representative Personal Accounts:* These are accounts which represent a certain person or group of persons. For example, if the rent is due to the landlord, an outstanding rent account will be opened in the books. Similarly, for salaries due to the employees (not paid), an outstanding salaries account

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will be opened. The outstanding rent account represents the account of the landlord to whom the rent is to be paid while the outstanding salaries account represents the accounts of the persons to whom the salaries have to be paid. All such accounts are, therefore, termed as 'Representative Personal Accounts'.

The rule is:

- Debit the Receiver
- Credit the Giver

For example, if cash has been paid to Ram, the account of Ram will have to be debited. Similarly, if cash has been received from Keshav, the account of Keshav will have to be credited.

Real accounts: Real accounts may be of the following types:

1. *Tangible real accounts:* Tangible Real Accounts are those which relate to such things which can be touched, felt, measured etc. Examples of such accounts are cash account, building account, furniture account, stock account, etc. It should be noted that bank account is a personal account; since it represents the account of the banking company—an artificial person.
2. *Intangible real accounts:* These accounts represent such things which cannot be touched. Of course, they can be measured in terms of money. For example, patents account, goodwill account, etc.

The rule is:

- Debit What Comes In
- Credit What Goes Out

For example, if building has been purchased for cash, building account should be debited (since it is coming into the business) while cash account should be credited (since cash is going out of the business). Similarly when furniture is purchased for cash, furniture account should be debited while the cash account should be credited.

Nominal accounts: These accounts are opened in the books to simply explain the nature of the transactions. They do not really exist. For example, in a business, salary is paid to the manager, rent is paid to the landlord, commission is paid to the salesman—cash goes out of the business and it is something real; while salary, rent or commission as such do not exist. The accounts of these items are opened simply to explain how the cash has been spent. In the absence of such information, it may be difficult for the person concerned to explain how the cash at his disposal was utilised.

Nominal Accounts include accounts of all expenses, losses, incomes and gains. The examples of such accounts are rent, rates lighting, insurance, dividends, loss by fire, etc.

The rule is:

- Debit All Expenses and Losses
- Credit All Gains and Incomes

Tutorial Note. Both Real Accounts and Nominal Accounts come in the category of Impersonal Accounts. The student should note that when some prefix or suffix is added to a Nominal Account, it becomes a Personal Account. A table is being given to explain the above rule:

<i>Nominal Account</i>	<i>Personal Account</i>
1. Rent account	Rent prepaid account, Outstanding rent account.
2. Interest account	Outstanding interest account, Interest received in advance account, Prepaid interest account.
3. Salary account	Outstanding salaries account, Prepaid salaries account.
4. Insurance account	Outstanding insurance account, Prepaid insurance account.
5. Commission account	Outstanding commission account, Prepaid commission account.

Illustration 6.1. From the following transactions find out the nature of account and also state which account should be debited and which account should be credited.

- | | |
|-----------------------------------|---|
| (a) Rent paid. | (b) Salaries paid. |
| (c) Interest received. | (d) Dividends received. |
| (e) Furniture purchased for cash. | (f) Machinery sold. |
| (g) Outstanding for salaries. | (h) Telephone charges paid. |
| (i) Paid to Suresh. | (j) Received from Mohan (the proprietor). |
| (k) Lighting. | |

Solution:

<i>Transaction</i>	<i>Accounts involved</i>	<i>Nature of Accounts</i>	<i>Debit/Credit</i>
(a) Rent paid Cash A/c	Rent A/c Real A/c	Nominal A/c Credit	Debit
(b) Salaries paid Cash A/c	Salaries A/c Real A/c	Nominal A/c Credit	Debit
(c) Interest received Interest A/c	Cash A/c Nominal A/c	Real A/c Credit	Debit
(d) Dividends received Interest A/c	Cash A/c Nominal A/c	Real A/c Credit	Debit
(e) Furniture purchased Cash A/c	Furniture A/c Real A/c	Real A/c Credit	Debit
(f) Machinery sold Interest A/c	Cash A/c Real A/c	Real A/c Credit	Debit
(g) Outstanding for salaries Outstanding Salaries A/c	Salaries A/c Personal A/c	Nominal A/c Credit	Debit
(h) Telephone charges paid Cash A/c	Telephone Charges A/c Real A/c	Nominal A/c Credit	Debit
(i) Paid to Suresh Cash A/c	Suresh Real A/c	Personal A/c Credit	Debit

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(j)	Received from Mohan (the proprietor) Capital A/c	Cash A/c Personal A/c	Real A/c Credit	Debit
(k)	Lighting Cash A/c	Lighting A/c Real A/c	Nominal A/c Credit	Debit

The journalising of the various transactions is explained now with the help of the following illustration:

Illustration 6.2. Ram starts a business with capital of ₹20,000 on January 1, 2011. In this case there are two accounts involved. They are:

(i) The account of Ram (ii) Cash Account

Solution: 1. Ram is natural person and, therefore, his account is a Personal Account. Cash Account is a tangible asset and, therefore, it is a Real Account. As per the rules of Debit and Credit, applicable to Personal Accounts, Ram is the giver and, therefore, his account, *i.e.*, Capital Account should be credited. Cash is coming in the business and, therefore, as per the rules applicable to Real Accounts, it should be debited. The transaction will now be entered in the Journal as follows:

JOURNAL

Date	Particulars	L.F.	Debit ₹	Credit ₹
2011 Jan. 1	Cash Account Dr. To Capital Account (Being commencement of business)		20,000	20,000

The words put within brackets “Being commencement of business” constitute the narration for the entry passed, since, they narrate the transaction.

2. He purchased furniture for cash for ₹5,000 on January 5, 2011.

The two accounts involved in this transaction are the Furniture Account and the Cash Account. Both are Real Accounts. Furniture is coming in and, therefore, it should be debited while cash is going out and, therefore, it should be credited. The Journal entry will, therefore, be as follows:

JOURNAL

Date	Particulars	L.F.	₹	₹
2011 Jan. 5	Furniture Account Dr. To Cash Account (Being purchase of furniture)		5,000	5,000

3. He paid rent for business premises ₹2,000 on January 10, 2011.

In this transaction, two accounts involved are the Rent Account and the Cash Account. Rent Account is Nominal Account. It is an expense and, therefore, it should be debited. Cash Account is a Real Account. It is going out of the business and, therefore, it should be credited. The journal entry will, therefore, be as follows:

JOURNAL

Date	Particulars	L.F.	₹	₹
2011 Jan. 10	Rent Account To Cash Account (Being payment of rent)	Dr.	2,000	2,000

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4. He purchased goods on credit of ₹2,000 from Suresh on January 20, 2011.

The two accounts involved in the transaction are those of Suresh and Goods. The account of Suresh is a Personal Account while that of Goods is a Real Account. Suresh is the giver of goods and, therefore, his account should be credited while Goods are coming in the business and, therefore, Goods Account should be debited.

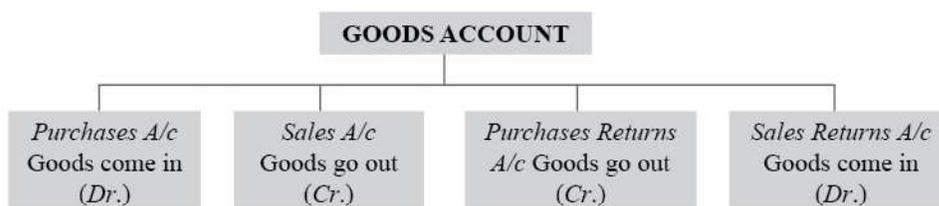
JOURNAL

Date	Particulars	L.F.	₹	₹
2011 Jan. 20	Goods Account To Suresh (Being purchase of goods on credit)	Dr.	2,000	2,000

Classification of Goods Account: The term goods include articles purchased by the business for resale. Goods purchased by the business may be returned back to the supplier. Similarly, goods sold by the business to its customers can also be returned by the customers back to the business due to certain reasons. In business, it is desired that a separate record be kept of all sale, purchase and return of goods. Hence, Goods Accounts can be classified into the following categories:

- (i) *Purchases Account:* The account is meant for recording all purchases of goods. Goods “come in” on purchasing of goods and, therefore, the Purchases Account is debited on purchase of goods.
- (ii) *Sales Account:* The account is meant for recording of selling of goods. The goods “go out” on selling of goods, and therefore, on sale of goods, the Sales Account is credited.
- (iii) *Purchases Returns Account:* The account is meant for recording return of goods purchased. The goods “go out” on returning of goods to the suppliers and, therefore, the account should be credited on returning goods purchased.
- (iv) *Sales Returns Account:* The account is meant for recording return of goods sold, by the customers. The goods “come in” and, therefore, the Sales Returns Account should be debited on return of goods.

The above classification of Goods Account can be shown in the form of the following chart:



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Compound Journal Entry

Sometimes there are a number of transactions on the same date relating to one particular account or of one particular nature. Such transactions may be recorded by means of a single journal entry instead of passing several journal entries. Such entry regarding recording a number of transactions is termed as a “Compound Journal Entry”. It may be recorded in any of the following three ways:

- (i) One particular account may be debited while several other accounts may be credited.
- (ii) One particular account may be credited while several other accounts may be debited.
- (iii) Several accounts may be debited and several other accounts may also be credited.

This has been explained in the following illustration:

Illustration 6.3. Pass a compound journal entry in each of the following cases:

1. Payment made to Ram ₹1,000. He allowed a cash discount of ₹50.
2. Cash received from Suresh ₹800 and allowed him ₹50 as discount.
3. A running business was purchased by Mohan with the following assets and liabilities:

Cash ₹2,000; Land ₹4,000; Furniture ₹1,000; Stock ₹2,000; Creditors ₹1,000; Bank Overdraft ₹2,000.

Solution:

JOURNAL

Sl. No.	Particulars	L.F.	Debit ₹	Credit ₹
1.	Ram Dr. To Cash A/c To Discount A/c (Being payment made to Ram ₹1,000, and he allowed ₹50 as discount)		1,050	1,000 50
2.	Cash A/c Dr. Discount A/c Dr. To Suresh (Being cash received from Suresh ₹800 and discount allowed ₹50)		800 50	850
3.	Cash A/c Dr. Land A/c Dr. Furniture A/c Dr. Stock A/c Dr. To Creditors To Bank Overdraft To Capital A/c (Being commencement of business by Mohan by taking over a running business)		2,000 4,000 1,000 2,000	1,000 2,000 6,000

Notes:

1. The total of payment due to Ram was ₹1,050. A payment of ₹1,000 has been made to him and he allowed a discount of ₹50. This means by paying ₹1,000, a full credit for ₹1,050 has been obtained. The account of Ram is a Personal Account, and therefore, it has been debited as he is the receiver. The cash has gone out of the business and, therefore, Cash Account being a Real Account, has been credited. Discount Account is a Nominal Account; getting discount is a gain to the business and, therefore, it has been credited.
2. Suresh was to pay sum of ₹850. He paid ₹800 and he was allowed a discount of ₹50. It means by paying ₹800 only, Suresh could get a full credit of ₹850. The Cash Account is a Real Account and, therefore, it has been debited since cash is coming in. Discount Account is a Nominal Account; it has been debited since it is a loss to the business. Suresh is the giver. His account being a Personal Account, it has been credited by ₹850.
3. It is not necessary that a person should start business only with cash. He may bring the assets into the business or he may purchase a running business. Mohan in the present case has purchased the assets of some other business. The net assets (*i.e.* assets–liabilities taken over) will be the capital of Mohan. The business is getting various assets and, therefore, the assets accounts have been debited. The business creates certain liabilities in the form of creditors, bank overdraft, and, therefore, these accounts have been credited. Mohan's Account, *i.e.*, his Capital Account has been credited by the balance since it represents the capital brought in by him.

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Opening Entry

In case of a running business, the assets and liabilities appearing in the previous year's balance sheet will have to be brought forward to the current year. This is done by means of a journal entry which is termed as "Opening Entry". All Assets Accounts are debited while all Liabilities Accounts are credited. The excess of assets over liabilities is the proprietor's capital and is credited to his Capital Account. This will be clear with the help of the following illustration:

Illustration 6.4. Pass the Opening Entry on January 1, 2016 on the basis of the following information taken from the business of Mr. Sunil:

(i)	Cash in Hand	2,000
(ii)	Sundry Debtors	6,000
(iii)	Stock of Goods	4,000
(iv)	Plant	5,000
(v)	Land and Buildings	10,000
(vi)	Sundry Creditors	10,000

Solution:

JOURNAL

Date	Particulars	L.F.	₹	₹
2016	Cash A/c	Dr.	2,000	
Jan.1	Sundry Debtors A/c	Dr.	6,000	
	Stock A/c	Dr.	4,000	
	Plant A/c	Dr.	5,000	
	Land & Buildings A/c	Dr.	10,000	
	To Sundry Creditors			10,000
	To Capital A/c (balancing figure)			17,000
	(Being balances brought forward from the last year)			
			<u>27,000</u>	<u>27,000</u>

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Debit Balances on Jan. 1, 2016:

1.	Jan.	01	Cash in hand ₹8,000
			Cash at Bank ₹25,000
			Stock of Goods ₹20,000
			Furniture ₹2,000
			Building ₹10,000
			Sundry Debtors:
			Vijay ₹2,000
			Anil ₹1,000
			Madhu ₹2,000

Credit Balances on Jan. 1, 2016:

			Sundry Creditors
			Anand ₹5,000
			Loan from Bablu ₹10,000

Following were further transactions in the month of January, 2016:

2.	Jan.	01	Purchased goods worth ₹5,000 for cash <i>less</i> 20% trade discount and 5% cash discount.
3.	Jan.	04	Received ₹1,980 from Vijay and allowed him ₹20 as discount.
4.	Jan.	06	Purchased goods from Bharat ₹5,000.
5.	Jan.	08	Purchased plant from Mukesh for ₹5,000 and paid ₹100 as cartage for bringing the plant to the factory and another ₹200 as installation charges.
6.	Jan.	12	Sold goods to Rahim on credit ₹600.
7.	Jan.	15	Rahim became an insolvent and could pay only 50 paise in a rupee.
8.	Jan.	18	Sold goods to Ram for cash ₹1,000.
9.	Jan.	20	Paid salary to Ratan ₹2,000.
10.	Jan.	21	Paid Anand ₹4,800 in full settlement.
11.	Jan.	26	Interest received from Madhu ₹200.
12.	Jan.	28	Paid to Bablu interest on loan ₹500.
13.	Jan.	31	Sold Goods for cash ₹500.
14.	Jan.	31	Withdrew goods from business for personal use ₹200.

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8.	Jan. 18	Cash A/c To Sales A/c (Being cash sales)	Dr.	1,000	1,000
9.	Jan. 20	Salary A/c To Cash (Being salary paid)	Dr.	2,000	2,000
10.	Jan. 21	Anand To Cash To Discount (Being cash paid to Anand and he allowed ₹200 as discount)	Dr.	5,000	4,800 200
11.	Jan. 26	Cash A/c To Interest (Being receipt of interest)	Dr.	200	200
12.	Jan. 28	Interest on Loan To Cash (Being payment of interest on loan)	Dr.	500	500
13.	Jan. 31	Cash A/c To Sales A/c (Being goods sold for cash)	Dr.	500	500
14.	Jan. 31	Drawings A/c To Purchases A/c (Being goods withdrawn for personal use)	Dr.	200	200
		Total		<u>96,900</u>	<u>96,900</u>

Check Your Progress

1. What are the principle types of equities?
2. Define artificial personal accounts.
3. Give examples of accounts that come under nominal accounts.
4. How is the excess of assets over liabilities treated in opening journal entry?

6.4 PREPARATION OF LEDGER

Recording is done in the Journal. This has already been explained in the preceding section. Classifying of the recorded transactions is done in the Ledger. This is being explained in the present section.

Ledger is a book which contains various accounts. In other words, Ledger is a set of accounts. It contains all accounts of the business enterprise whether Real, Nominal or Personal. It may be kept in any of the following two forms:

- (i) Bound Ledger (ii) Loose-leaf Ledger

It is common to keep the Ledger in the form of loose-leaf cards these days. This helps in posting transactions particularly when mechanised system of accounting is used.

Posting

The term “Posting” means transferring the debit and credit items from the Journal to their respective accounts in the Ledger. It should be noted that the exact names of accounts used in the Journal should be carried to the Ledger. For example, if in the Journal, Expenses Account has been debited, it would not be correct to debit the Office Expenses Account in the Ledger. Though, in the Journal, it might have been indicated clearly in the narration that it is an item of office expenses the correct course would have been to record the amount to the Office Expenses Account in the Journal as well as in the Ledger.

Posting may be done at any time. However, it should be completed before the financial statements are prepared. It is advisable to keep the more active accounts posted to date. The examples of such accounts are the cash account, personal accounts of various parties etc.

The posting may be done by the book-keeper from the Journal to the Ledger by any of the following methods:

- (i) He may take a particular side first. For example, he may take the debits first and make the complete postings of all debits from the Journal to the Ledger.
- (ii) He may take a particular account and post all debits and credits relating to that account appearing on one particular page of the Journal. He may then take some other accounts and follow the same procedure.
- (iii) He may complete postings of each journal entry before proceeding to the next journal entry.

It is advisable to follow the last method. One should post each debit and credit item as it appears in the Journal.

The Ledger Folio (L.F.) column in the Journal is used at the time when debits and credits are posted to the Ledger. The page number of the Ledger on which the posting has been done is mentioned in the L.F. column of the Journal. Similarly, a folio column in the Ledger can also be kept where the page from which posting has been done from the Journal may be mentioned. Thus, there are cross references in both the Journal and the Ledger.

A proper index should be maintained in the Ledger giving the names of the accounts and the page numbers.

NOTES

NOTES

Relationship between Journal and Ledger

Both Journal and Ledger are the most important books used under Double Entry System of book-keeping. Their relationship can be expressed as follows:

- (i) The transactions are recorded first of all in the Journal and then they are posted to the Ledger. Thus, the Journal is the book of first or original entry, while the Ledger is the book of second entry.
- (ii) Journal records transactions in a chronological order, while the Ledger records transactions in an analytical order.
- (iii) Journal is more reliable as compared to the Ledger since it is the book in which the entry is passed first of all.
- (iv) The process of recording transactions is termed as “Journalising” while the process of recording transactions in the Ledger is called as “Posting”.

Rules Regarding Posting

The following rules should be observed while posting transactions in the Ledger from the Journal:

- (i) Separate accounts should be opened in the Ledger for posting transactions relating to different accounts recorded in the Journal. For example, separate accounts may be opened for sales, purchases, sales returns, purchases returns, salaries, rent, cash, etc.
- (ii) The concerned account which has been debited in the Journal should also be debited in the Ledger. However, a reference should be made of the other account which has been credited in the Journal. For example, for salaries paid, the salaries account should be debited in the Ledger, but reference should be given of the Cash Account which was has been credited in the Journal.
- (iii) The concerned account, which has been credited in the Journal should also be credited in the Ledger, but reference should be given of the account, which has been debited in the Journal. For example, for salaries paid, Cash Account has been credited in the Journal. It will be credited in the Ledger also, but reference will be given of the Salaries Account in the Ledger.

Thus, it may be concluded that while making posting in the Ledger, the concerned account which has been debited or credited in the Journal should also be debited or credited in the Ledger, but reference has to be given of the other account which has been credited or debited in the Journal, as the case may be. This will be clear with the following example.

Suppose, salaries of ₹10,000 have been paid in cash; the following entry will be passed in the Journal:

Salaries Account	(i)	Dr.	10,000
To Cash Account	(ii)		10,000

In the Ledger two accounts will be opened, (i) Salaries Account, and

(ii) Cash Account. Since Salaries Account has been debited in the Journal, it will also be debited in the Ledger. Similarly, Cash Account has been credited in the Journal and, therefore, it will also be credited in the Ledger, but reference will be given of the other account involved. Thus, the accounts will appear as follows in the Ledger:

<i>Dr.</i>	SALARIES ACCOUNT	<i>Cr.</i>
	₹	<i>Particulars</i>
Cash A/c (ii)	10,000	

<i>Dr.</i>	CASH ACCOUNT	<i>Cr.</i>
<i>Particulars</i>	₹	<i>Particulars</i> ₹
		Salaries A/c (i) 10,000

NOTES

Use of the words “To” and “By”

It is customary to use words ‘To’ and ‘By’ while making posting in the Ledger. The word ‘To’ is used with the accounts which appear on the debit side of a Ledger Account. For example, in the Salaries Account, instead of writing only “Cash” as shown above, the words “To Cash” will appear on the debit side of the account. Similarly, the word “By” is used with accounts which appear on the credit side of a Ledger Account. For example, in the above case, the words “By Salaries A/c” will appear on the credit side of the Cash Account instead of only “Salaries A/c”. The words ‘To’ and ‘By’ do not have any specific meanings. Modern accountants are, therefore, ignoring the use of these words.

The procedure of posting from the Journal to the Ledger will be clear with the help of the illustrations given in the following pages.

Illustration 6.5. Journalize the following transactions and post them into the Ledger:

1. Ram started business with a capital of ₹10,000.
2. He purchased furniture for cash ₹4,000.
3. He purchased goods from Mohan on credit ₹2,000.
4. He paid cash to Mohan ₹1,000.

Solution:

JOURNAL

NOTES

Date	Particulars	L.F.	Dr: ₹	Cr: ₹
1	Cash Account To Capital Account	Dr.	10,000	10,000 ← 5
2	Furniture Account To Cash Account	Dr.	4,000	4,000 ← 6
3	Purchases Account To Mohan	Dr.	2,000	2,000 ← 7
4	Mohan To Cash Account	Dr.	1,000	1,000 ← 8

Ledger

CASH ACCOUNT	
1	To Capital A/c 10,000
	By Furniture A/c 4,000
	By Mohan 1,000
	10,000 ← 5
CAPITAL ACCOUNT	
	By Cash A/c 10,000 ← 5
FURNITURE ACCOUNT	
2	To Cash A/c 4,000
PURCHASES ACCOUNT	
3	To Mohan 2,000
MOHAN	
4	To Cash A/c 1,000
	By Purchases A/c 2,000 ← 7

Balancing of an Account

In business, there may be several transactions relating to one particular account. In Journal, these transactions appear on different pages in a chronological order while they appear in a classified form under that particular account in the Ledger. At the end of a period (say, a month, a quarter or a year), the businessman will be interested in knowing the position of a particular account. This means, he should total the debits and credits of the account separately and find out the net balance. This technique of finding out the net balance of an account, after considering the totals of both debits and credits appearing in the account is known as 'Balancing the Account'. The balance is put on the side of the account which is smaller and a reference is given that it has been carried forward or carried down (*c/f* or *c/d*) to the next period. On the other hand, in the next period, a reference is given that the

opening has been brought forward or brought down (*b/f* or *b/d*) from the previous period. This will be clear with the help of the following illustration.

Illustration 6.6. Journalize the following transactions, post them in the Ledger and balance the accounts on 31st January.

1. Ram started business with a capital of ₹10,000.
2. He purchased goods from Mohan on credit ₹2,000.
3. He Paid cash to Mohan ₹1,000.
4. He sold goods to Suresh ₹2,000.
5. He received cash from Suresh ₹3,000.
6. He further purchased goods from Mohan ₹2,000.
7. He paid cash to Mohan ₹1,000.
8. He further sold goods to Suresh ₹2,000.
9. He received cash from Suresh ₹1,000.

NOTES

Solution:

JOURNAL

<i>Particulars</i>	<i>L.F.</i>	<i>Debit (₹)</i>	<i>Credit (₹)</i>
Cash Account To Capital Account (Being commencement of business)	Dr.	10,000	10,000
Purchases Account To Mohan (Being purchase of goods on credit)	Dr.	2,000	2,000
Mohan To Cash (Being payment of cash to Mohan)	Dr.	1,000	1,000
Suresh To Sales (Being goods sold to Suresh)	Dr.	2,000	2,000
Cash Account To Mohan (Being cash received from Suresh)	Dr.	3,000	3,000
Purchases Account To Mohan (Being purchase of goods from Mohan)	Dr.	2,000	2,000
Mohan To Cash Account (Being payment of cash to Mohan)	Dr.	1,000	1,000
Suresh To Sales Account (Being goods sold to Suresh)	Dr.	2,000	2,000
Cash Account To Suresh (Being cash received from Suresh)	Dr.	1,000	1,000
Total		<u>24,000</u>	<u>24,000</u>

NOTES

Ledger

CASH ACCOUNT					
Dr.			Cr.		
Date	Particulars	₹	Date	Particulars	₹
	To Capital A/c	10,000		By Mohan	1,000
	To Suresh	3,000		By Mohan	1,000
	To Suresh	1,000	Jan. 31	By Balance c/d	12,000
		<u>14,000</u>			<u>14,000</u>
Feb. 1	To Balance b/d	<u>12,000</u>			

CAPITAL ACCOUNT					
Dr.			Cr.		
Date	Particulars	₹	Date	Particulars	₹
Jan. 31	To Balance c/d	<u>10,000</u>		By Cash A/c	10,000
		<u>10,000</u>			<u>10,000</u>
			Feb. 1	By Balance b/d	<u>10,000</u>

PURCHASES ACCOUNT					
Date	Particulars	₹	Date	Particulars	₹
	To Mohan	2,000	Jan. 31	By Balance c/d	4,000
	To Mohan	2,000			
		<u>4,000</u>			<u>4,000</u>
Feb. 1	To Balance b/d	<u>4,000</u>			

MOHAN					
Date	Particulars	₹	Date	Particulars	₹
	To Cash	1,000		By Purchases	2,000
	To Cash	1,000		By Purchases	2,000
	To Balance c/d	<u>2,000</u>			<u>4,000</u>
		<u>4,000</u>			<u>4,000</u>
			Feb. 1	By Balance b/d	<u>2,000</u>

SURESH					
Date	Particulars	₹	Date	Particulars	₹
	To Sales	2,000		By Cash A/c	3,000
	To Sales	2,000		By Cash A/c	1,000
		<u>4,000</u>			<u>4,000</u>

SALES ACCOUNT					
Date	Particulars	₹	Date	Particulars	₹
Jan. 31	To Balance c/d	4,000		By Suresh	2,000
	By Suresh				<u>2,000</u>
		<u>4,000</u>			<u>4,000</u>
			Feb. 1	By Balance b/d	<u>4,000</u>

It is to be noted that the balance of an account is always known by the side which is greater. For example, in the above illustration, the debit side of the Cash Account is greater than the credit side by ₹12,000. It will be, therefore, said that Cash Account is showing a debit balance of ₹12,000. Similarly, the credit side of the Capital Account is greater than debit side by ₹10,000. It will be, therefore, said that the Capital Account is showing a credit balance of ₹10,000.

Check Your Progress

5. When can posting be done?
6. Which out of journal and ledger records transactions in analytical order?
7. How is the balance of a ledger account always known by?

NOTES

6.5 ANSWERS TO CHECK YOUR PROGRESS QUESTIONS

1. Equities may be sub-divided into two principal types: the rights of the creditors and the rights of the owners.
2. Artificial personal accounts include accounts of corporate bodies or institutions which are recognised as persons in business dealings.
3. Nominal accounts include accounts of all expenses, losses, incomes and gains. The examples of such accounts are rent, lighting, insurance, dividends, loss by fire, etc.
4. The excess of assets over liabilities is the proprietor's capital and is credited to his Capital Account.
5. Posting may be done at any time. However, it should be completed before the financial statements are prepared. It is advisable to keep the more active accounts posted to date.
6. The Ledger records transactions in analytical order
7. The balance of an account is always known by the side which is greater, be it debit or credit.

6.6 SUMMARY

- The double entry system of book-keeping can very well be explained by the following "accounting equation": $Assets = Equities$
- The properties owned by business are called 'assets'. The rights to the properties are called 'Equities'. Equities may be sub-divided into two principal types: the rights of the creditors and the rights of the owners. The equity of creditors representing debts of the business and are called "liabilities". The equity of owners is called "capital", or proprietorship or owner's equity.
- The Journal records all daily transactions of a business into the order in which they occur. A Journal may, therefore, be defined as a book containing a chronological record of transactions. It is the book in which the transactions are recorded first of all under the double entry system. Thus, Journal is the book of original record.

NOTES

- The transactions in the Journal are recorded on the basis of the rules of debit and credit. For this, personal, nominal and real accounts are maintained.
- Ledger is a book which contains various accounts. In other words, Ledger is a set of accounts. It contains all accounts of the business enterprise whether Real, Nominal or Personal.
- The transferring of the debit and credit items from the Journal to their respective accounts in the Ledger is known as posting.
- While making posting in the Ledger, the concerned account which has been debited or credited in the Journal should also be debited or credited in the Ledger, but reference has to be given of the other account which has been credited or debited in the Journal.
- At the end of a period, the businessman will be interested in knowing the position of a particular account. The technique of finding out the net balance of an account, after considering the totals of both debits and credits appearing in the account is known as ‘balancing the account.’

6.7 KEY WORDS

- **Journal:** It may be defined as a book containing a chronological record of transactions.
- **Compound journal entry:** It refers to the single journal entry made for recording a number of transactions on the same date relating to one particular account or of one particular nature.
- **Ledger:** It is a book which contains various accounts.
- **Posting:** It means transferring the debit and credit items from the Journal to their respective accounts in the Ledger.

6.8 SELF ASSESSMENT QUESTIONS AND EXERCISES

Short Answer Questions

1. Draw a proforma of journal and describe the columns in it.
2. What are the ways in which compound journal entry can be recorded?
3. Mention the ways in which posting from Journal to the Ledger can be done by a book-keeper.
4. What is the relationship between journal and a ledger?

Long Answer Questions

1. Describe the rules of debit and credit as followed on account of personal, nominal and real accounts.

NOTES

6.9 FURTHER READINGS

Maheshwari, S.N., Suneel K. and Sharad K. 2017. *Advanced Accountancy*, Vol I. New Delhi: Vikas Publishing House.

Maheshwari, S.N., Suneel K. and Sharad K. 2018. *An Introduction to Accountancy*, 12th edition. New Delhi: Vikas Publishing House.

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UNIT 7 INTRODUCTION TO DOUBLE ENTRY SYSTEM OF ACCOUNTING-II

NOTES

Structure

- 7.0 Introduction
- 7.1 Objectives
- 7.2 Subsidiary Books
- 7.3 Errors and Rectification
- 7.4 Answers to Check Your Progress Questions
- 7.5 Summary
- 7.6 Key Words
- 7.7 Self Assessment Questions and Exercises
- 7.8 Further Readings

7.0 INTRODUCTION

In this unit, you will learn about subsidiary books. Subsidiary books are the sub-division of the journal. These books made the entire process of recording the transactions organized and efficient. This is especially useful for large businesses. While recording business transactions, there are chances of committing an error due to a variety of reasons, but this does not mean that these errors cannot be corrected. In this unit, you will also learn about the types of error, their location and rectification.

7.1 OBJECTIVES

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

- Explain the preparation of subsidiary books
- Discuss the concept of location of errors
- Describe the rectifying accounting entries

7.2 SUBSIDIARY BOOKS

It has already been explained in an earlier chapter that Journal is the book of prime entry. It means all business transactions are to be first recorded in the Journal. However, in a big business recording of all transactions in one Journal will not only be inconvenient but also cause delay in collecting information required. The Journal is, therefore, sub-divided into many subsidiary books.

Sub-division of Journals

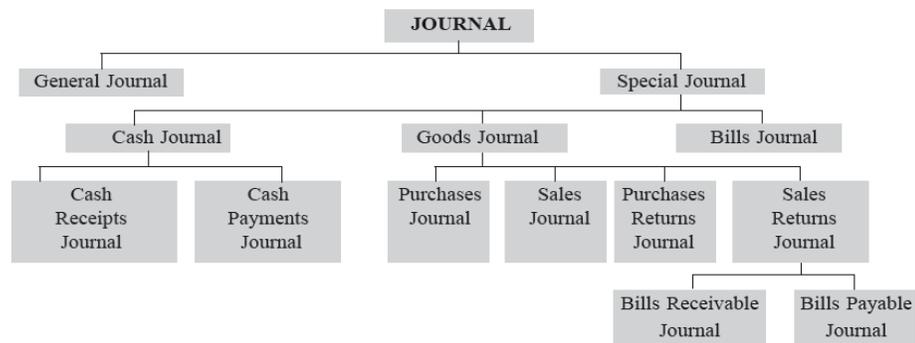
This sub-division results in the following advantages:

NOTES

- (i) **Convenience:** As stated above maintenance of one Journal only will make it quite bulky or difficult to handle. Sub-division of Journal only will result in reducing the size of Journal and making it convenient to handle.
- (ii) **Division of labour:** Sub-division of Journal helps in division of labour since different persons can write different Journals.
- (iii) **Classified information:** Each Journal provides information relating to a particular aspect of the business. For example, a Purchases Journal gives information about the total credit purchases made by the business. Similarly, a Sales Journal gives information about the total credit sales made by the business. Thus, the businessman gets the information relating to different aspects of the business in a classified form in the shortest possible time.

SUB-DIVISION OF JOURNAL

The sub-division of Journal can be explained with the help of the following chart:



1. General Journal

It is also known as Journal Proper. It is meant for recording all such transactions for which no special journal has been kept by the business. As a matter of fact, it is meant for recording such transactions which do not occur frequently in the business and, therefore, do not warrant setting up of special journals. Examples of such transactions are as follows:

- (i) **Opening entries:** When a new set of books is started, the old accounts have to be brought forward in the beginning of the year from last year's books. The opening entry is meant for recording these transactions. The entries are made from the balance sheet of the last year.
- (ii) **Closing entries:** At the end of accounting year, the nominal accounts are closed by transferring them to trading account or profit and loss account. The entries passed for this purpose are termed as 'Closing Entries'.

- (iii) **Adjustment entries:** At the end of the accounting year, adjustment entries are to be passed for outstanding/prepaid expenses, accrued/outstanding income etc. Entries for all these adjustment are passed in the General Journal.
- (iv) **Transfer entries:** Transfer entries are required for transferring one account to the other. Entries for such transfer are passed in the General Journal.
- (v) **Rectification entries:** Rectification entries are passed for rectifying the errors which might have been committed in the books of account. For example, the account of Mohan might have been debited in place of the account of Sohan. The necessary rectifying entry will be passed in the General Journal.
- (vi) **Purchases of fixed assets:** The entries for purchases of fixed assets such as plant, machinery, furniture, etc., on credit are also passed in this Journal.

NOTES

2. Special Journal

The term 'Special Journal' means a Journal which is meant for a special purpose. The following are the various types of Special Journals.

- (i) **Cash Journal:** Cash Journal is meant for recording all cash transactions. It may be further classified into Cash Receipts Journal and Cash Payments Journal. Cash Receipts Journal records all cash receipts while Cash Payments Journal records all cash payments.
- (ii) **Goods Journal:** The Journal is meant for recording all transactions relating to goods. It may, further, be classified into the following categories:
 - (a) *Purchases Journal:* The Journal is meant for recording all credit purchases of goods. Cash purchases are to be recorded in the Cash Journal. Moreover, only purchases of goods is to be recorded in this Journal. The term "goods" means articles purchased for resale.
 - (b) *Sales Journal:* The Journal is meant for recording all credit sales of goods. Cash sales of the goods are to be recorded in the Cash Journal.
 - (c) *Purchases Returns Journal:* It is meant for recording all returns of goods purchased on credit. It is also known as *Returns Outward Journal*.
 - (d) *Sales Returns Journal:* It is meant for recording all return of goods sold on credit. It is also known as *Returns Inward Journal*.
- (iii) **Bills Journal:** The Journal is meant for recording all bills of exchange or promissory notes received or issued by the business. It can be classified into two categories:

NOTES

(a) *Bills Receivable Journal*: It is meant for recording all bills of exchange or promissory notes received by the business from its debtors.

(b) *Bills Payable Journal*: It is meant for recording all bills of exchange or promissory notes issued by the business in favour of its creditors.

In the following pages, we are explaining the method of recording business transactions in each Journal and their posting into the ledger.

Cash Journal or Book

Cash Journal or Cash book is meant for recording all cash transactions. It is a very important Journal of business on account of the following reasons:

- (i) The number of cash transactions is quite large in every business. The business has to pay for salaries, rent, lighting, insurance, purchase of goods and it has to receive cash for sales of goods and capital assets.
- (ii) The chances of fraud being committed regarding cash are higher as compared to other assets. A strict control is, therefore, required. A properly maintained cash book helps in achieving this objective.
- (iii) Cash is the nerve centre of the business. Timely payments to its creditors increases the reputation of the business. Similarly timely payments from its debtors improves the financial position of the business.

The cash book can be of any of the following types:

- (i) Simple Cash Book
- (ii) Two-Columnar Cash Book
- (iii) Three-Columnar Cash Book
- (iv) Multi-Columnar Cash Book
- (v) Cash Receipts Book
- (vi) Cash Payments Book

(i) Simple (Single)-Columnar Cash Book

Simple Cash Book is like an ordinary cash account. Its proforma is given below:

Dr.				SIMPLE CASH BOOK				Cr.			
Date	Particulars	L.F.	Amount	Date	Particulars	L.F.	Amount				

The recording of the transactions in the Simple Cash Book and their posting in the Ledger can be understood with the help of the following illustration:

Illustration 7.1. Record the following transactions in the Cash Book and post them in the ledger:

Jan.	01	Opening Cash balance ₹5,000.
Jan.	04	Rent paid ₹2,000
Jan.	06	Interest received ₹3,000.
Jan.	15	Cash purchases ₹4,000.
Jan.	25	Cash sales ₹8,000.
Jan.	31	Salaries paid ₹2,000.

NOTES

Solution:

Dr.				CASH BOOK				Cr.			
Date	Particulars	L.F.	Amount (₹)	Date	Particulars	L.F.	Amount (₹)				
Jan. 1	To Balance b/d		5,000	Jan. 4	By Rent		2,000 ←				
Jan. 2	To Interest	4	3,000	Jan. 15	By Purchases A/c		4,000 ←				
Jan. 25	To Sales	5	8,000	Jan. 31	By Salaries A/c		2,000 ←				
			16,000	Jan. 31	By Balance c/d		8,000				
	To Balance b/d		8,000				<u>16,000</u>				

Ledger			
Dr.		Cr.	
INTEREST ACCOUNT			
		4	By Cash A/c
			3,000
SALES ACCOUNT			
		5	By Cash A/c
			8,000
RENT ACCOUNT			
To Cash A/c	2,000	1	←
PURCHASES ACCOUNT			
To Cash A/c	4,000	2	←
SALARIES ACCOUNT			
To Cash A/c	2,000	3	←

It should be noted that in the ledger no separate cash account will be opened. The Cash Book functions both as a book as well as an account as shown in the illustration above.

(ii) Two (Double)-Columnar Cash Book

Such a Cash Book has two columns: (i) Cash Column, and (ii) Discount Column. Cash column is meant for recording cash receipts and payments while discount column is meant for recording discount received and the discount allowed. The discount column on the debit side represents the discount allowed while discount column on the credit side represents the discount received.

NOTES

It should be noted that while the cash column of the cash book serves both the functions of a book as well as an account but discount column does not serve the function of a discount account. A separate discount account has to be opened in the ledger in which total debits and credits from the Cash Book are posted. Sometimes, two separate discount accounts are kept in the ledger—one for discount allowed and the other for discount received.

Trade Discount and Cash Discount: The following are the points of distinction between trade discount and cash discount:

- (i) Trade discount is a deduction granted by a supplier from the list price of the goods due to large quantity of sales or business tradition. While cash discount is allowed by the creditor to the debtor for either buying in cash or for making payment before the stipulated period.
- (ii) Trade discount is allowed on sale of goods while cash discount is allowed on payment of money.
- (iii) Trade discount is not recorded in the books of account. The goods are recorded on the net price. While cash discount is shown in the books of account.
- (iv) Trade discount may vary with the quantity of goods purchased while cash discount may vary with the time period.

The recording of transactions in a two columnar cash book will be clear with the help of the following illustration:

Illustration 7.2. Record the following transactions in the Cash Book and post them in the ledger:

1. Jan. 01 Cash balance ₹5,000.
2. Jan. 06 Sold goods to Mahesh ₹4,000.
3. Jan. 08 Purchased goods from Mukesh ₹3,000.
4. Jan. 15 Cash received from Mukesh ₹3,900 in full satisfaction.
5. Jan. 20 Paid to Mukesh ₹2,830 in full satisfaction.
6. Jan. 25 Sold goods to Suresh ₹3,000.
7. Jan. 31 Received cash from Suresh ₹2,900 in full satisfaction.

Solution:

Dr.					CASH BOOK					Cr.				
Date	Particulars	L.F.	Dis- count (₹)	Cash ₹	Date	Particulars	L.F.	Dis- count (₹)	Cash (₹)					
Jan. 1	To Balance b/d			5,000	Jan. 20	By Mukesh		150	2,850					
Jan. 25	To Mahesh		100	3,900	Jan. 31	By Balance c/d			8,950					
Jan. 31	To Suresh		100	2,900										
			200	11,800				150	11,800					

Ledger

MAHESH

Date	Particulars	₹	Date	Particulars	₹
Jan. 6	To Sales A/c	4,000	Jan. 15	By Cash A/c	3,900
		_____	Jan. 15	By Discount A/c	<u>100</u>

SURESH

Date	Particulars	₹	Date	Particulars	₹
Jan. 25	To Sales A/c	3,000	Jan. 31	By Cash	2,900
		_____	Jan. 31	By Discount	<u>100</u>

MUKESH

Date	Particulars	₹	Date	Particulars	₹
Jan. 20	To Cash	2,850	Jan. 8	By Purchases A/c	3,000
Jan. 20	To Discount	<u>150</u>			_____

DISCOUNT ALLOWED ACCOUNT

Date	Particulars	₹	Date	Particulars	₹
Jan. 31	To Sundries	<u>200</u>			

DISCOUNT RECEIVED ACCOUNT

Date	Particulars	₹	Date	Particulars	₹
			Jan. 31	By Sundries	<u>150</u>

NOTES

Notes:

1. Transactions 2 and 6 relate to credit sales of goods and, therefore, they have not been recorded in the cash book. They will be recorded in the Sales Book and the posting will be done in the personal account of Mahesh and Suresh from there as shown in the Ledger.
2. Transaction 3 relates to credit purchase of goods. It has, therefore, not been recorded in the Cash Book. It will be recorded in the Purchases Book from where posting will be done in the personal account of Mukesh as shown in the Ledger.
3. The total of the debit side of the discount column has been taken to the 'Discount Allowed Account' in the ledger. The word 'sundries' has been put in the 'particulars' column. Any person who is interested in knowing the person to whom the discount has been allowed can find it out from the Cash Book.
4. The total of the discount column appearing on the credit side of the cash book has been taken to 'Discount Received Account' in the ledger. The word 'Sundries' has been put in the 'Particulars' column. Any person who is interested in knowing the names of the persons from whom the discount has been received can find it out from the cash book.

(iii) Three-Columnar Cash Book

This type of cash book contains the following three columns on each side:

- (i) Cash column for cash received and cash paid.
- (ii) Discount column for discount received and discount allowed.
- (iii) Bank column for money deposited and money withdrawn from the bank.

SURESH

			Jan. 10	By Bank A/c By Discount A/c	2,000 100
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RENT ACCOUNT

Jan. 4	To Bank A/c		2,000		
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MEHTA BROS

Date	Particulars	Amount (₹)	Date	Particulars	Amount (₹)
Jan. 8	To Bank A/c	2,000			
Jan. 8	To Discount A/c	100			

PURCHASES ACCOUNT

Date	Particulars	Amount (₹)	Date	Particulars	Amount (₹)
Jan. 20	To Cash A/c	15,000			

SALARIES ACCOUNT

Date	Particulars	Amount (₹)	Date	Particulars	Amount (₹)
Jan. 31	To Cash A/c	5,000			

DISCOUNT ALLOWED ACCOUNT

Date	Particulars	Amount (₹)	Date	Particulars	Amount (₹)
Jan. 31	To Sundries A/c	100			

DISCOUNT RECEIVED ACCOUNT

Date	Particulars	Amount (₹)	Date	Particulars	Amount (₹)
			Jan. 31	By Sundries	200

NOTES

Contra entry: As explained above, a three columnar cash book contains columns both for cash and bank transactions. An accounting transaction involves two accounts and there may be a transaction where both Cash Account and Bank Account are involved. Since in the ledger, there are no separate Cash Account and Bank Account, therefore, no posting will be done from the Cash Book to the Ledger in case of such a transaction. The transaction will be recorded on both sides of the Cash Book. For example, if cash is withdrawn from the bank, the two accounts involved are the Cash Account and the Bank, Account. In the Cash Book, on the debit side, the amount will be put in cash column against the words “To Bank” while on the credit side of the Cash Book, the amount will be written in the bank column against the words “By Cash”. Such an accounting entry which is recorded on both the debit and credit sides of the cash book is known as a Contra Entry. In order to give a hint to the ledger-keeper, that no posting is required for such an entry, the word ‘C’ is put in the ledger folio column on both the sides of the Cash Book.

NOTES

Special points regarding cheques: A business may receive cheques from its customers or it can issue cheques in favour of its customers or other creditors. Following are some special points which should be kept in view while making accounting entries in the Cash Book regarding such cheques received or issued.

1. *Receipt of cheques:* There can be two situations:

(A) A cheque may be received by the business and sent to the Bank the same day for collection. In such a case, it will be better to put the cheque received in the debit side of the bank column as soon as it is received. For example, if on January 10, a cheque is received from *A* for ₹10,000 and is sent to the Bank for collection on the same day, the entry for receipt of the cheque will appear in the Cash Book as follows:

CASH BOOK (RECEIPTS SIDE)

Date	Particulars	Date	Cash (₹)	Bank (₹)
Jan. 10	To <i>A</i>			10,000

(B) In case a cheque received from a party is sent to the Bank at a later date, it will be better to take the cheque as receipt of cash when it is received and deposit of cash in the bank when the cheque is sent for collection to the Bank. For example, if on January 10, a cheque is received from *A* for ₹10,000 and is sent to the Bank for collection on January 14, the entries in the Cash Book will appear as follows:

Dr. CASH BOOK (CASH AND BANK COLUMNS) Cr.

Date	Particulars	L.F.	Cash (₹)	Bank (₹)	Date	Particulars	L.F.	Cash (₹)	Bank (₹)
Jan. 10	To <i>A</i>		10,000		Jan. 14	By Bank	C	10,000	
Jan. 14	To Cash	C		10,000					

Tutorial Note. In the absence of any specific instructions in the question, the students should presume that the cheque received from a party was sent to the Bank the same day for collection.

2. *Endorsement of cheques received:* A cheque received by the business may not be sent by it to the Bank for collection, but may be endorsed by the business in favour of a creditor of the business. In such a case, the cheque received will be taken as a receipt of cash. Similarly, the cheque endorsed, will be taken as payment of cash. For example, if on January 10, cheque was received from *A* for ₹10,000 and it was endorsed on January 14 in favour of *B*, a creditor of the business, the entries in the Cash Book will appear as follows:

CASH BOOK (CASH COLUMN ONLY)

Date	Particulars	L.F.	Amount	Date	Particulars	L.F.	Amount
Jan. 10	To <i>A</i>		10,000	Jan. 14	By <i>B</i>		10,000

(b) On dishonour of the cheque issued by the Bank

Bank

Dr.

To Creditor

NOTES

Thus, when the cheque is issued in favour of a creditor, the creditor is debited and the Bank Account is credited. The entry will appear in the Cash Book on the credit side in the Bank column. On return of the cheque by the creditor on account of its non-payment, the Creditor's Account, which was previously debited, would now be credited while the Bank Account, which was previously credited, would now be debited. The entry for dishonour will, therefore, appear in the debit side of the Cash Book in the Bank column.

The recording of transactions in a three-columnar cash book and from there posting into the ledger will be clear with the help of the following illustration.

Illustration 7.4. Enter the following transactions in the appropriate type of the cash books, and post the same to the relevant ledger accounts:

2016

July	01	Started business with an investment of ₹9,000.
July	02	Deposited in Bank of India, ₹7,000.
July	04	Acquired a building by issuing a cheque of ₹5,000.
July	10	Paid the bill of the furniture by cheque ₹1,000.
July	15	Purchased ₹800 of merchandise by cheque.
July	18	Withdrew ₹100 from the bank.
July	20	Sold merchandise for ₹1,200.
July	22	Deposited ₹2,000 into the bank.
July	25	Bought ₹1,000 merchandise.
July	26	Sold ₹1,500 merchandise by crossed cheque.
July	27	Paid ₹100 by cheque as the premium for insuring building against fire.
July	28	Paid freight ₹50.
July	30	Withdrew from bank for personal use ₹500.
July	31	Cleared electricity bill ₹90.
July	31	Paid to Mahesh ₹1,080 in full satisfaction by cheque. We owed to Mahesh ₹1,100 for goods purchased.
July	31	Received from Suresh a cheque for ₹1,480, in full satisfaction of the debt of ₹1,510.

Solution:

Dr: CASH BOOK Cr:

Dt.	Particulars	L.F	Dis. (₹)	Bank (₹)	Cash (₹)	Dt.	Particulars	L.F.	Dis. (₹)	Bank (₹)	Cash (₹)
2016						2016					
Jul. 1	To Capital				9,000	Jul. 2	By Bank	C			7,000
Jul. 2	To Cash	C		7,000		Jul. 4	By Building			5,000	
Jul. 18	To Bank	C			100	Jul. 10	By Furniture			1,000	
Jul. 20	To Sales				1,200	Jul. 15	By Purchases			800	
Jul. 22	To Cash	C		2,000		Jul. 18	By Cash	C		100	
Jul. 26	To Sales			1,500		Jul. 22	By Bank	C			2,000
Jul. 31	To Suresh		30	1,480		Jul. 25	By Purchases				1,000
						Jul. 27	By Insurance Premium			100	
						Jul. 28	By Freight				50
						Jul. 30	By Drawings			500	
						Jul. 31	By Electricity				90
						Jul. 31	By Mahesh		20	1,080	
						Jul. 31	By Bal. c/d			3,400	160
			<u>30</u>	<u>11,980</u>	<u>10,300</u>				<u>20</u>	<u>11,980</u>	<u>10,300</u>
Aug. 1	To Bal. b/d			3,400	160						

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Ledger

Dr: CAPITAL ACCOUNT Cr:

Date	Particulars	Amount (₹)	Date	Particulars	Amount (₹)
			July 1	By Cash	<u>9,000</u>

BUILDING ACCOUNT

July 4	To Bank	<u>5,000</u>			
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PURCHASES ACCOUNT

July 15	To Bank	800			
July 25	To Cash	<u>1,000</u>			

FREIGHT ACCOUNT

July 28	To Cash	<u>50</u>			
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ELECTRICITY ACCOUNT

July 31	To Cash	<u>90</u>			
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SALES ACCOUNT

			July 20	By Cash	1,200
			July 26	By Bank	1,500

FURNITURE ACCOUNT

July 10	To Bank	<u>1,000</u>			
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INSURANCE PREMIUM ACCOUNT

July 27	To Bank	<u>100</u>			
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DRAWINGS ACCOUNT

July 30	To Bank	<u>500</u>			
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DISCOUNT ACCOUNT

July 31	To Sundries	<u>35</u>	July 31	By Sundries	<u>20</u>
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NOTES

Notes:

- (i) Cash and Bank columns in the cash book serve the purpose of prime as well as final entries. Hence, in the ledger no Cash and Bank Accounts have been opened.
- (ii) Cash Account never shows a credit balance, since a person cannot spend more than what he has. While, the Bank Account may show a credit balance, since a bank may permit a customer to overdraw his account (*i.e.*, withdraw more money than what he has in his account). In such a case, it will be said that the customer has an overdraft with the Bank.
- (iii) Postings to the Discount Account is done at the end of the period with Total Discount Received and Total Discount Allowed.

Cash Receipts and Payments Journal

It is common practice these days to keep separate Cash books for receipts and payments. Thus, the business maintains two Cash Journals: (i) Cash Receipts Journal, and (ii) Cash Payments Journal.

- (i) **Cash Receipts Journal:** The Journal is meant for recording all cash receipts. The posting is done daily from the Cash Receipts Book to the Journal. The concerned accounts are all credited with amount mentioned in the Cash Receipts Journal. The total cash received as shown by the Cash Receipts Journal is debited to the Cash Account at the end of a period usually at the end of a week.
- (ii) **Cash Payments Journal:** The book is meant for recording all cash payments. The posting is done daily from this book to the ledger and the concerned accounts are debited. At the end of a period (usually at the end of the week), cash account is credited with the total cash paid during the period.

Petty Cash Book

Petty Cash Book is maintained by the business to record petty cash expenses of the business, such as postage, cartage, stationery, cleaning charges etc. In every business, there are many payments like the above which are of small amounts. In case all these transactions are recorded in the Main Cash

Book, their recording will not only be inconvenient but also consume a lot of valuable time of the cashier and the Posting Clerk. A Petty Cashier is appointed by the business to make payments of all such petty expenses. He works under the supervision of the Chief Cashier, who advances money in the beginning of every month/quarter to meet petty expenses. At the end of the month/quarter, the Petty Cashier submits a statement of account of the expenses incurred by him during the month/quarter and gets a fresh advance.

The Petty Cash Book is usually maintained on the basis of Imprest System. According to this system, a fixed amount is advanced to the Petty Cashier at the beginning of the period by the Chief Cashier. He submits his accounts at the end of the period and the Chief Cashier after examining his accounts gives him a fresh advance equivalent to the amount spent by him during the period. Thus, in the beginning of the each period (month or quarter as the case may be), the Petty Cashier has a fixed balance. The amount so advanced to him is termed as “Imprest” or “Float”.

The recording of transactions in a Petty Cash Book will be clear with the help of the following Illustration.

Illustration 7.5. Enter the following transactions in the Petty Cash Book (maintained on Imprest system) for the month of January, 2015.

Jan. 01	Cash received from the Chief Cashier ₹200
Jan. 03	Typing paper ₹8, Postage ₹4
Jan. 06	Office cleaning ₹4
Jan. 08	Postage ₹2
Jan. 10	Cartage ₹2
Jan. 15	Postage ₹6
Jan. 18	Ink ₹3, Typing paper ₹10
Jan. 20	Typewriter ribbon ₹10
Jan. 22	Telephone charges ₹7
Jan. 24	Office cleaning ₹2
Jan. 25	Nailpolish ₹27
Jan. 27	Telegrams ₹25
Jan. 29	Typing paper ₹30

NOTES

Postings from the Petty Cash Book: Postings in the Ledger from the Petty Cash Book is done at the end of the period, *i.e.*, month or quarter as the case may be. There are two alternative ways of making postings from the Petty Cash Book.

1. *Petty Cash Book maintained as a Memorandum Book only:* In such a case, the total of the various expenses from the Petty Cash Book is debited, to the concerned accounts at the end of the period and credit is given to the Cash Account with the actual expenditure incurred. The amount advanced by the Chief Cashier to the Petty Cashier is recorded by him as a memorandum by way of a note in the Cash Book itself. This method is usually not followed.

2. *Where Petty Cash Book is taken as a part of the Double Entry System:* This method is quite popular. The recording is done regarding the petty cash transactions on the basis of the following entries:

- (i) When money is advanced to the Petty Cashier:
- | | |
|--------------------|-----|
| Petty Cash Account | Dr. |
| To Cash Account | |

(The Petty Cash Account is debited with the actual amount of money advanced)

- (ii) On submission of accounts by the Petty Cashier:
- | | |
|-----------------------|-----|
| Expenses Accounts | Dr. |
| To Petty Cash Account | |

(Each expense is to be debited separately with the expenditure incurred during the period as shown by the Petty Cash Book.)

Thus, in the Ledger, there is a Petty Cash Account as well as separate Expenses Accounts for each of the expenses.

Taking the figures as given in the preceding illustration, the various ledger accounts, according to the second method, will appear as follows:

Dr.			PETTY CASH ACCOUNT			Cr.		
Date	Particulars	Amount (₹)	Date	Particulars	Amount (₹)			
Jan. 1	To Cash	200	Jan. 3	By Stationery	61			
				By Postal Charges	44			
				By Cartage	2			
				By Cleaning	8			
				By Miscellaneous	27			
				By Balance c/d	58			
		200			200			
Feb. 1	To Balance b/d	58						

STATIONERY ACCOUNT					
July 31	To Petty Cash A/c	61			

NOTES

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POSTAL CHARGES ACCOUNT

July 31	To Petty Cash A/c	<u>71</u>		
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CARTAGE ACCOUNT

July 31	To Petty Cash A/c	<u>2</u>		
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CLEANING ACCOUNT

July 31	To Petty Cash A/c	<u>8</u>		
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MISCELLANEOUS expenses ACCOUNT

July 31	To Petty Cash A/c	<u>27</u>		
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Purchases Journal

The Purchases Journal is meant for recording credit purchases of goods. It is also known as the Purchases or Bought Day Book. It has columns for date of purchase, invoice number, name of the party, ledger folio and the amount of purchases. It should be noted that the book records only purchase of goods on credit. Purchases of items other than goods on credit is recorded in the General Journal. Similarly, cash purchases are recorded in the Cash Book.

Posting: The posting is done in the Personal Accounts daily from the Purchases Book. At the end of a week/month, the total of the Purchases Book is debited to the Purchases Account in the ledger.

The following illustration will make clear the recording of transactions in the Purchases Journal and their subsequent posting in the ledger.

Illustration 7.6. Record the following transactions in the Purchases Journal and post them in the Ledger.

2016

Jan.	01	Purchased from Ram & Co. on credit:	
		30 Heater rods	@ ₹10
		20 Philips Bulbs	@ ₹20
Jan.	04	Purchased from Shyam & Co. on credit:	
		40 Heater rods	@ ₹10
		20 E.C.E. Bulbs	@ ₹15
Jan.	08	Purchased from Bajaj & Co. on credit:	
		20 Electric Elements	@ ₹40
		3 Electric Mixers	@ ₹100
Jan.	24	Purchased from K.C. & Co. on credit:	
		30 Electric Plugs	@ ₹20
		40 Table Fans	@ ₹200

Solution:

PURCHASES JOURNAL

Sl. No.	Invoice No.	Particulars	L.F.	Amount (₹)	Amount (₹)
2016 Jan. 1	50	Ram & Co.: 30 Heater rods @ ₹10 20 Philips Bulbs @ ₹20	4	300 400	700
Jan. 4	55	Shyam & Co.: 40 Heater rods @ ₹10 20 E.C.E. Bulbs @ ₹15	8	400 300	700
Jan. 8	62	Bajaj & Co.: 20 Electric Elements @ ₹40 3 Electric Mixers @ ₹100	12	800 300	1,100
Jan. 24	65	K.C. & Co.: 30 Electric Plugs @ ₹20 40 Table Fans @ ₹200	13	600 8,000	8,600
Jan. 31		Purchases Account Dr.	14		11,100

NOTES**Ledger**

RAM & CO. (Folio 4)

Date	Particulars	Amount (₹)	Date	Particulars	Amount (₹)
			Jan. 1	By Purchases	700

SHYAM & CO. (Folio 8)

			Jan. 4	By Purchases	700
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BAJAJ & CO. (Folio 12)

			Jan. 8	By Purchases	1,100
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K.C. & CO. (Folio 13)

			Jan. 24	By Purchases	8,600
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PURCHASES ACCOUNT (Folio 14)

Jan. 31	To Sundries	11,100			
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Notes:

- (i) Folio Nos. are all imaginary.
- (ii) Purchases Account has been debited with the total purchases made during the month. This has been done at the end of the month. A firm may make the posting in the Purchases Account weekly also.
- (iii) Posting is done in the Personal Accounts daily.

Sales Journal

The Journal is meant for recording all sales of goods on credit. This is also known as Sales or Sold Day Book. It should be noted that Cash Sales are recorded in the Cash Book while sales of articles other than goods on credit is to be recorded in the General Journal.

NOTES

Posting is done in the Personal Accounts daily from the Sales Book. They are debited with individual amounts. The Sales Account is credited with the total sales made during the period (*i.e.*, a week or month) at the end of the period.

The recording of the transactions in the Sales Book and their posting in the Ledger will be clear with the help of the following illustration.

Illustration 7.7. Record the following transactions in the Sales Day Book and post them into the ledger.

2015

- Jan. 01 Sold to Mukesh & Co.:
- 10 Heater Rods @ ₹ 20
 - 10 Lamp Shades @ ₹ 30
- Jan. 10 Sold to Suresh & Brothers:
- 10 Table Fans @ ₹ 250
 - 20 Philips Tubelights @ ₹ 30
- Jan. 25 Sold to Ramesh & Co.:
- 10 Electric Switches @ ₹ 50
 - 20 E.C.E. Tubelights @ ₹ 30

Solution:

SALES JOURNAL

Sl. No.	Invoice No.	Particulars	L.F.	Amount (₹)	Amount (₹)
Jan. 1	101	Mukesh & Co.:	4		
		10 Heater Rods @ ₹20		200	
		10 Lamp Shades @ ₹30		<u>300</u>	500
Jan. 10	102	Suresh & Brothers:	6		
		10 Table Fans @ ₹250		2,500	
		20 Philips Tubelights @ ₹30		<u>600</u>	3,100
Jan. 25	103	Ramesh & Co.:	8		
		10 Electric Switches @ ₹50		500	
		20 E.C.E. Tubelights @ ₹30		<u>600</u>	<u>1,100</u>
		Sales A/c Cr.	10		4,700

Ledger

MUKESH & CO.

(Folio 4)

Date	Particulars	Amount (₹)	Date	Particulars	Amount (₹)
Jan. 1	To Sales	<u>500</u>			

SURESH & BROTHERS						(Folio 6)
Jan. 10	To Sales	3,100				
RAMESH & CO.						(Folio 8)
Jan. 25	To Sales	1,100				
SALES ACCOUNT						(Folio 10)
			Jan. 31	By Sundries	4,700	

NOTES

Notes:

- (i) Folio Nos., Invoice Nos. are all imaginary.
- (ii) Posting is done in the Personal Accounts daily. The total sales are posted at the end of the month (or week) on the credit side of the Sales Account, against the word 'Sundries'. Any person interested in finding out the names of the parties to whom the sales have been made can do so by looking to the Sales Book.

Sales Returns Journal

The Journal is meant for recording return of goods sold on credit. The goods which are sold for cash, if returned, are either exchanged for new goods or the parties are paid in respect of them depending upon the circumstances. In case the goods returned are not immediately exchanged for the other goods or not paid for in cash, they are recorded in a memorandum book only. Thus, goods sold for cash and returned do not find a place in the Sales Returns Journal. They are recorded in the Cash Book in case cash is paid for them or no entry will be passed in case they have been recorded in a memorandum book only. A proforma of Sales Returns Journal is as under:

SALES RETURNS JOURNAL					
Date	Credit Note No.	Particulars	L.F.	Amount (₹)	Amount (₹)
Jan. 10	202	Ram & Co.:			
		5 Electric Plugs @ ₹20		100	
		3 Philips Tubelights @ ₹30		<u>90</u>	<u>190</u>
		Sales Returns A/c Dr.			190

The posting from the Sales Returns Journal will be done daily in the personal accounts. For example, in the above case, the account of Ram & Co. will be credited with a sum of ₹190 on Jan. 10. The total of the Sales Returns Journal will be posted to the debit of Sales Returns Account at the end of the period, say, a week or a month.

Credit Note: The customer who returns the goods, gets credit for the value of the goods returned. A Credit Note is sent to him intimating that his account has been credited with the value of the goods returned. The Note is prepared in duplicate. Its Proforma is as under:

NOTES

MAHESHWARI BROTHERS		3, Strand Road, Kolkata		Date Jan. 10, 2016
No. 202				
To				
Ram & Co.,				
21, Shri Ram Road, Delhi.				
Dear Sir,				
We have credited your account in respect of the following goods returned by you:				
		₹	₹	
(i)	5 Electric Plugs @ ₹20	100		
(ii)	3 Philips Tubelights @ ₹30	90	190	
			For Maheshwari Brothers Sunil Manager	

Purchases Returns Journal

The book is meant for recording return of goods purchased on credit. The goods purchased for cash and returned are not recorded in this book. They are recorded in a memorandum book only. On receipt of cash in respect of the goods returned, the entry will be passed through cash book. In case, the goods are exchanged for other goods of the same value, no entry will be required. The entry in the memorandum book will be cancelled on getting cash or goods for goods returned. A proforma of the Purchases Returns Journal is given below:

PURCHASES RETURNS JOURNAL

Date	Credit Note No.	Particulars	L.F.	Amount ₹	Amount ₹
Jan. 12	301	Shyam & Co. 3 Electric Rods @ ₹40			120
Jan. 21	302	Bajaj & Co. 3 Electric Mixers @ ₹300			900
		Purchases Returns A/c	Cr.		1,020

Note: The entries in the Personal Accounts are done daily from the Purchases Returns Book. They are debited with the respective amounts. The total of the Purchases Returns Book is posted to the credit of Purchases Returns Account at the end of the period, say, a week or a month, as the case may be.

Debit Note: When the goods are returned to the supplier, a debit note is sent to him indicating that this account has been debited with the amount mentioned in the Debit Note. Its proforma is given as under:

MAHESHWARI BROTHERS		3, Strand Road Kolkata		Date Jan. 12, 2014
No. 301				
To				
Shyam & Co.				
3, Clive Road, Kolkata.				
Dear Sir,				
We have debited your account for the goods returned by us as under:				
		₹120		
	4 Electric Rods @ ₹30			
			For Maheshwari Brothers Sunil Manager	

Thus, in case of purchases returns or sales returns of goods, the flow of *Debit Note* or *Credit Note* can be put as follows:

- (i) The Debit Note is sent by the Purchaser of goods to the Seller of goods on return of goods by the Purchaser to the Seller.
- (ii) The Credit Note is sent by the Seller of goods to the Purchaser of goods on return of goods to the Seller by the Purchaser.

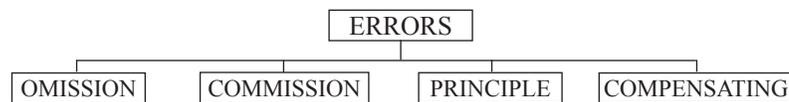
Check Your Progress

1. What are the adjustment entries?
2. How is the dishonour of cheque received by a business and sent to bank for collection recorded in the cash book?
3. What is the fixed balance advanced to the Petty cashier at the beginning of each period known as?
4. Where is the total of sales returns journal posted at the end of the period?

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7.3 ERRORS AND RECTIFICATION

Errors can broadly be classified as clerical and those of principle.



Clerical errors may be of three kinds. These are explained here below.

I. Clerical Errors

These include the following errors:

- 1. Errors of omission:** These errors are incurred in those cases when a transaction is completely omitted from the books of account. It happens when a transaction is not recorded in the books of the original entry (i.e., various journals). For example, if a purchase of goods on credit from Shri Ram Lal has not at all been recorded in the books of account, such an error will be termed as an error of omission. Since, there has been neither a debit entry nor a credit entry, therefore, the two sides of the Trial Balance will not be at all affected on account of this error. Such errors, therefore, cannot be located out very easily. They come to the notice of the businessman when statement of accounts are received from or sent to creditors or debtors, as the case may be.
- 2. Errors of commission:** Such errors include errors on account of wrong balancing of an account, wrong posting, wrong carry forwards, wrong totalling, etc. For example, if a sum of ₹ 50 received from Mukesh is credited to his account as ₹ 500, this is an error of commission. Similarly, if the total of debit side of an account is carried forward from one page to another and the mistake is committed in such carry forward (e.g., total of ₹ 996 is carried forward as ₹ 699) such an error

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is an error of commission. Errors of commission affect the agreement of the Trial Balance and, therefore, their location is easier.

3. Errors of principle: Errors of principle are committed, where a proper distinction between revenue and capital items is not made, i.e., a capital expenditure is taken as a revenue expenditure or vice versa, or a capital receipt may have been taken as a revenue receipt or vice versa. For example, a sale of old furniture of ₹ 500 should be credited to the Furniture Account, but if it is credited to the Sales Account, it will be termed as an error of principle. Sale of old furniture is a capital receipt. If it is credited to Sales Account, it has been taken as a revenue receipt. Such errors by themselves do not affect the agreement of the Trial Balance. Therefore, they are also difficult to be located.

4. Compensating errors: As the name indicates, compensating errors are those errors which compensate each other. For example, if a sale of ₹ 500 to Ram is debited as only of ₹ 50 to his account, while a sale of ₹ 50 to Shyam is debited as of ₹ 500 to his account, it is a compensating error. These errors also do not affect the agreement of the Trial Balance and, therefore, their location is also difficult.

Thus, errors of omission, errors of principle and compensating errors by themselves alone do not affect the agreement of the Trial Balance. In case these errors get combined with errors of commission, they may affect the agreement of the Trial Balance. For example, if a sale of old furniture of ₹ 500 is credited to the Sales Account only as of ₹ 50, the error combines in itself both an error of principle as well as error of commission. Thus, such an error will affect the agreement of the Trial Balance.

Location of Errors

Location of errors of principle, errors of compensating nature and errors of omission is slightly difficult because of the fact that such errors do not affect the agreement of the Trial Balance and, therefore, their location may be considerably delayed. However, location of errors of commission is comparatively easier because they affect the agreement of the Trial Balance. Thus, the errors can be classified into two categories from the point of view of locating them:

- (i) Errors which do not affect the agreement of the Trial Balance.
- (ii) Errors which affect the agreement of the Trial Balance.

Errors which do not affect the agreement of the trial balance: As stated before, errors of omission, errors of commission and errors of compensating nature by themselves do not affect the agreement of the Trial Balance. Their location is, therefore, a difficult process. They are usually found out when statement of accounts are received by the business or sent to the customers or during the course of internal or external audit and sometimes by chance. For example, if a credit purchase of ₹ 500 from Ram has not been recorded in the books of accounts, the error will not affect the agreement of the Trial Balance and, therefore, at the time of finalising the accounts it may not be

traced out. However, this will be found out when a statement of account is sent to Ram showing the money due to him or when a statement of account is received from Ram showing the money recoverable by him.

Errors which affect the agreement of the trial balance: Such errors are easy to be located since they are caught at an early stage. As soon as the Trial Balance does not tally, the accountant can proceed to find out these errors. The procedure to be followed for location of such errors can be put as follows:

- (i) The difference of the two sides of the Trial Balance should be found out. The amount should then be divided by two. The two sides of the Trial Balance should then be checked to find out if there is an amount equal to that figure. It is possible that the amount was placed on a wrong side resulting in a difference in the totals of the Trial Balance. For example, if the total of the debit side of the Trial Balance is ₹ 450 more than the credit side of the Trial Balance, ₹ 450 should be divided by 2, thus giving a figure of 225. The debit side should then be checked to find out if there is an amount of ₹ 225 appearing on that side. If it is so, it should be seen whether the amount has been correctly put to that side or it should have gone to the credit side.
- (ii) If the mistake is not found out by taking step number (i), the difference should be divided by 9. If the difference is completely divisible, it can be error of transposition of figures. For example, if the figure of 698 is written as 986, the difference is of ₹ 198. This figure is completely divisible by 9. Thus it can be concluded that in such cases where the difference is divisible by 9, there can be a probability of this type of error.
- (iii) In case the difference is still not traceable, the following further possibilities should be checked:
 - (a) If the difference is in a round figure, there is a possibility of wrong casting or wrong carry forwards of the totals of a subsidiary books or there is an error in balancing the accounts.
 - (b) In case the difference is not in a round figure, there is a possibility of error being committed in posting the transactions from the Journal to the Ledger.
 - (c) If the difference is of a substantial amount, it will be appropriate to compare the Trial Balance of the current year with the Trial Balance of the preceding year and see whether there is any abnormal difference between the balances of important accounts of the two Trial Balances.
- (iv) Since, cash and bank account are not maintained usually in the Ledger, it will be also advisable to check whether the balances of the cash and bank accounts have been taken in the Trial Balance or not.
- (v) The schedules of sundry debtors and sundry creditors should be checked to find out whether all balances of debtors and creditors have been included in these schedules or not.

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- (vi) The totals of the subsidiary books such as the Sales Book, Purchases Book should be checked and it should be seen whether posting has been done from these two books correctly to the Sales, Purchases or other accounts as the case might be.
- (vii) If the error is still not traceable, check thoroughly the books of original entry and their posting into the Ledger and finally the balancing of different accounts.
- (viii) A business may keep ledgers on sectional self-balancing system. In such a case, there are three ledgers: (a) Sales Ledger containing personal accounts of all trade debtors, (b) Purchases Ledger containing personal accounts of all trade creditors, and (c) General Ledger containing all other real, nominal and personal accounts except those of trade debtors and trade creditors. However, there will be two total accounts in this ledger. (i) Total Debtors Accounts, and (ii) Total Creditors Account. The balance of the Total Debtors Account should tally with the total of the Schedule of Debtors as prepared from the Sales Ledger. Similarly, the balance of the Total Creditors Account should tally with the total of the Schedule of Creditors as prepared from the Purchases Ledger. In case the balance of Total Debtors Account does not tally with the total of the Schedule of Debtors, the personal accounts in the Sales Ledger should be checked and the other Ledger may not be touched. Same is true of the Total Creditors Account and the Schedule of Total Creditors.

Suspense Account

The accountant should take the above-mentioned steps one after the other to locate the difference in the totals of the Trial Balance. In case he is not in position to locate the difference and he is in hurry to close the books of accounts, he may transfer the difference to an account known as “Suspense Account”. Thus, Suspense Account is an account to which the difference in the Trial Balance has been put temporarily. On locating the errors in the beginning or during the course of the next year, suitable accounting entries are passed (as explained later) and the Suspense Account is closed. However, it should be noted that Suspense Account should be opened by the accountant only when he has failed to locate the errors in spite of his best efforts. It should not be by way of normal practice, because the very existence of the Suspense Account creates doubt about the authenticity of the books of accounts. The result shown by the books of accounts may not be trusted by the proprietors, tax officials and other government authorities in such a case. This may create complications for the business.

Rectifying Accounting Entries

The errors committed in the books of accounts when located out, have to be corrected. However, corrections in the books of accounts should be done by

passing proper rectifying entries and not by cutting or erasing figures. Such entries, as explained earlier, are passed in the General Journal or Journal Proper. The passing of proper rectifying entries is being explained below with suitable examples.

Example 1: The Sales Book overcast by ₹ 50.

Overcasting of Sales Book will result in over-credit to Sales Account by ₹ 50 since the total of the Sales Book is posted to the credit of the Sales Account at the end of a period. There can be two situations in such a case:

- (i) The error might have been located out by the accountant before transferring the difference to the Suspense Account. In such a case, there is mistake only in one account, i.e., the Sales Account. It has been credited more by ₹ 50. The error can be rectified if the Sales Account is debited by ₹ 50. Thus, the following will be the rectifying entry in the Journal Proper:

<i>Particulars</i>	<i>Dr. ₹</i>	<i>Cr. ₹</i>
Sales Account <i>(Being excess credit to sales account, now rectified)</i>	<i>Dr.</i> 50	

No account is to be credited since the error affects only one account.

- (ii) The error might have been located out by the accountant after transferring the difference in the Trial Balance to a Suspense Account. In such a case two accounts are involved: (a) Sales Account, and (b) Suspense Account. Since Sales Account had been credited more by ₹ 50 the credit side of the Trial Balance must have been more than debit side of the Trial Balance. The Suspense Account should, therefore, have been put on the debit side of the Trial Balance in order to balance the two sides as shown below:

Trial Balance

<i>Particulars</i>	<i>Dr. ₹</i>	<i>Cr. ₹</i>
Excess Credit to Sales Account		50
Suspense Account	50	
	50	50

The Sales Account has been credited more by ₹ 50. In order to rectify the error, the Sales Account should, therefore, be debited by ₹ 50. Suspense Account has been debited because of this mistake which has now been found out. It should therefore, be closed by giving credit to it. The rectifying accounting entry should, therefore, be passed as follows:

<i>Particulars</i>	<i>Dr. ₹</i>	<i>Cr. ₹</i>
Sales Account To Suspense Account	<i>Dr.</i> 50	50

Example 2: A credit sale of ₹ 100 to Ramesh has been entered in the Sales Book as a sale of ₹ 1,000.

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In order to pass a rectifying entry, it will be appropriate to find out the accounts involved. In this case, the error involves two accounts: (i) Sales Account, and (ii) The account of Ramesh. This is because the posting is done in the individual accounts from the Sales Book and, therefore, if a transaction is wrongly recorded in the Sales Book (which is the book of original entry) not only the total of the Sales Book will be wrong, but also the entry in the personal account will be wrong as shown below:

Sales Book

<i>Particulars</i>	₹
Sales to Ramesh (wrongly recorded in place of ₹ 100)	1,000
Sales Account <i>Cr.</i>	1,000

Ledger

Dr. **Ramesh** *Cr.*

<i>Particulars</i>	₹	<i>Particulars</i>	₹
To Sales A/c	1,000		

Dr. **Sales Account** *Cr.*

<i>Particulars</i>	₹	<i>Particulars</i>	₹
		By Sundries (including sales to Ramesh)	1,000

The recording of the transactions as shown above shows that the Sales Account has been credited by ₹ 1,000 in place of ₹ 100. Similarly, the account of Ramesh has been debited by ₹ 1,000 in place of ₹ 100. Thus, Sales Account has been over-credited by ₹ 900, while the account of Ramesh has been over-debited by ₹ 900. In order to set the matters right, Sales Account should now be debited by ₹ 900 and the account of Ramesh should be credited by ₹ 900. The error should not have affected the agreement of the Trial Balance because of the same amount being put to the debit as well as the credit sides. The Suspense Account is, therefore, not at all involved.

The rectifying accounting entry will, therefore, be as follows:

<i>Particulars</i>	<i>Dr.</i> ₹	<i>Cr.</i> ₹
Sales Account <i>Dr.</i>	900	
To Ramesh		900

Example 3: A sale of ₹ 50 to Suresh was posted to his account as a sale of ₹ 5.

In this case, the account of Suresh has been debited by only ₹ 5, in place of ₹ 50. His account has, therefore, been under-debited by ₹ 45. It means the credit side of the Trial Balance must have been more by ₹ 45 on account of this error. In case, the Suspense Account has been opened, it should have been debited by ₹ 45. The rectifying entry should, therefore, give debit of ₹ 45 to Suresh and give credit of ₹ 45 to Suspense Account. The entry will thus be as follows:

<i>Particulars</i>	<i>Dr. ₹</i>	<i>Cr. ₹</i>
Sales Account To Ramesh	<i>Dr.</i> 45	45

The Suspense Account which was showing the debit balance of ₹ 45 would now be closed on account of passing of this rectifying entry.

Example 4: A sale of ₹ 50 to Kamlesh was entered in the Sales Book as of ₹ 500, from where he was debited by ₹ 5,000.

This is a multiple type of error. It affects more than two accounts. The accounts involved are (i) Kamlesh, (ii) Sales Account, and (iii) Suspense Account.

The total of the Sales Book is posted to the Sales Account. The sale has been recorded as of ₹ 500 in the Sales book from where the posting must have been done to the Sales Account. Thus, the Sales Account has been credited by ₹ 500 instead of ₹ 50. It has been credited more by ₹ 450. In order to rectify the error, it should, therefore, be debited by ₹ 450. The account of Kamlesh should have been debited by ₹ 50 only but it has been debited by ₹ 5,000. It has, therefore, been debited more by ₹ 4,950. In order to rectify the matters, it should be credited by ₹ 4,950. These two errors must have created difference in the Trial Balance which should have gone to the Suspense Account. Sales Account comes on the credit side of the Trial Balance. It has been credited by ₹ 450 more and, therefore, the credit side of the Trial Balance will be more by this amount on account of this error. On the other hand, Kamlesh is a debtor, his account has been excess debited by ₹ 4,950. The debit side of the Trial Balance should, therefore, be more by this amount. The net effect is that the debit side of the Trial Balance must have been more by ₹ 4,500 which must have been put to the Suspense Account by giving credit to it. The rectifying entry will, therefore, be as follows:

<i>Particulars</i>	<i>Dr. ₹</i>	<i>Cr. ₹</i>
Suspense A/c	<i>Dr.</i> 4,500	
Sales A/c <i>Dr.</i> To Kamlesh	450	4,950

Thus, on the basis of the above examples, the following rules can be framed out:

- (i) Find out the accounts affected by the error.
- (ii) Find out what should have been and what has been done.
- (iii) Credit or Debit the respective account in order to set the matters right.
- (iv) Put the difference to Suspense Account.

The above rules will be further clear by the following example.

Example 5: A sales of ₹ 1,000 to Suresh was entered in the Purchases Book from where the account of Suresh was debited by ₹ 100.

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The above error affects the following accounts: (i) Sales Account, (ii) Purchases Account, and (iii) Account of Suresh.

Sales Account should have been credited by a sum of ₹ 1,000. It has not been done since it has been recorded in the Purchases Book. Thus, Sales Account should be credited (i.e., what should have been done).

Purchases Account has been debited since the transaction has been entered in the Purchases Book from where it must have been posted to the Purchases Account. It has been debited by a sum of ₹ 1,000 unnecessarily. It should, therefore, be credited to rectify what has been done wrongly.

Account of Suresh should have been debited by ₹ 1,000. In the normal course, since the transaction has been recorded in the Purchases Book, his account should have been credited. However, the accountant has debited his account by ₹ 100 instead of ₹ 1,000. His account should, therefore, be debited by ₹ 900 more in order to give full debit to his account.

The difference, if any, should be transferred to the Suspense Account as given in rule (iv) explained above.

The rectifying journal entry will, therefore, be as follows:

<i>Particulars</i>		<i>Dr. ₹</i>	<i>Cr. ₹</i>
Suspense A/c	<i>Dr.</i>	1,100	
Sales A/c Dr.		900	
To Purchases A/c			1,000
To Sales A/c			1,000

Check Your Progress

5. Which types of errors affect the agreement of the Trial Balance?
6. When should a suspense account be opened by an accountant?

7.4 ANSWERS TO CHECK YOUR PROGRESS QUESTIONS

1. Adjustment entries are entries passed at the end of the accounting year for outstanding/prepaid expenses, accrued/outstanding income etc. Entries for all these adjustments are passed in General Journal.
2. In the case a cheque received by a business and sent to the Bank for collection may be dishonoured on presentation for payment, the party from whom the cheque was received should be debited while the account of the Bank should be credited.
3. In the beginning of each period, the Petty Cashier has a fixed balance. The amount so advanced to him is termed as 'Imprest' or 'Float'.
4. The total of the Sales Returns Journal will be posted to the debit of Sales Return Account at the end of the period, say, a week or a month.

5. Errors of commission affect the agreement of the Trial Balance and, therefore, their location is easier.
6. Suspense account should be opened by the accountant only when he has failed to locate the errors in spite of his best efforts. It should not be by way of normal practice, because the very existence of the Suspense Account creates doubt about the authenticity of the books of accounts.

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7.5 SUMMARY

- The sub-division of journal has the following advantages: convenience, division of labour, and classified information.
- The journals are sub-divided into two categories of subsidiary books: general journal and special journal.
- General journal is meant for recording all such transactions for which no special journal has been kept by the business.
- Special journal means a journal which is meant for a special purpose. It has many types including cash, goods and bills journals.
- Cash journal or cash book is meant for recording all cash transactions. It may be simple, two-columnar, three-columnar, multi-columnar, cash receipts or cash payments book.
- Petty cash book is maintained by the business to record petty cash expenses like postage, cartage, stationery, cleaning charges, etc.
- Errors can be broadly classified as clerical and those of principle. Clerical errors are divided into errors of omission, errors of commission and compensating errors.
- Errors can be classified into two categories from the point of view of locating them: errors which do not affect the agreement of the Trial Balance and Errors which affect the agreement of the Trial Balance.
- Suspense Account is an account to which the difference in the Trial Balance has been put temporarily.
- The errors committed in the books of accounts when located out, have to be corrected. However, corrections in the books of accounts should be done by passing proper rectifying entries and not by cutting or erasing figures.

7.6 KEY WORDS

- **Subsidiary books:** These are sub-divisions of the journal.
- **Special Journal:** It refers to journal meant for recording transactions of a specific type.

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- **Contra Entry:** It refers to an accounting entry which is recorded on both the debit and credit sides of the Cash Book.
- **Suspense Account:** It is an account to which the difference in the Trial balance has been put temporarily.

7.7 SELF ASSESSMENT QUESTIONS AND EXERCISES

Short Answer Questions

1. What are the advantages of sub-division of journals?
2. List examples of transactions recorded in general journal.
3. Write a short note on special journals.
4. Briefly explain the concept of contra entry.
5. What are the different types of errors which can happen in journalising?
6. What is a suspense account?

Long Answer Questions

1. Discuss the importance and types of cash journal.
2. Explain the special points regarding recording of cheques in cash journal.
3. Describe the maintenance of Petty cash book.
4. Write short notes on purchases, purchase returns, sales and sales returns journals.
5. Examine the concept of location of errors.

7.8 FURTHER READINGS

Maheshwari, S.N., Suneel K. and Sharad K. 2017. *Advanced Accountancy*, Vol I. New Delhi: Vikas Publishing House.

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UNIT 8 INTRODUCTION TO DOUBLE ENTRY SYSTEM OF ACCOUNTING-III

NOTES

Structure

- 8.0 Introduction
- 8.1 Objectives
- 8.2 Preparation of a Trial balance
- 8.3 Preparation of Final Accounts
 - 8.3.1 Trading Account
 - 8.3.2 Profit and Loss Account
 - 8.3.3 Preparation of Manufacturing Account
 - 8.3.4 Balance Sheet
- 8.4 Answers to Check Your Progress Questions
- 8.5 Summary
- 8.6 Key Words
- 8.7 Self Assessment Questions and Exercises
- 8.8 Further Readings

8.0 INTRODUCTION

Up till, now we have learnt about the recording and posting of entries in Journal and Ledger. But merely recoding and posting does not ensure mathematical accuracy. This is why it is important to verify the entries at the end of reporting periods. A Trial Balance is prepared periodically just for this purpose. On the basis of this preparation, errors are identified, and rectifications done. This then leads to the last stage of the accounting cycle which is the preparation of final accounts. It determines the financial position of the business. Under this it is compulsory to make trading account, the profit and loss account and balance sheet. The term 'final accounts' includes the trading account, the profit and loss account, and the balance sheet.

The Trading and Profit and Loss Account is a final summary of such accounts which affect the profit or loss position of the business. In other words, the account contains the items of Incomes and Expenses relating to a particular period. The account is prepared in two parts: (i) Trading Account, and (ii) Profit and Loss Account. The Balance Sheet shows the position of various accounts during the accounting period.

8.1 OBJECTIVES

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

- Describe the preparation of the Trial balance

- Explain the preparation of Trading and Profit and Loss Account
- Discuss the construction of the Balance Sheet

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8.2 PREPARATION OF A TRIAL BALANCE

In case the various debit balances and the credit balances of the different accounts are taken down in a statement, the statement so prepared is termed as a Trial Balance. In other words, Trial Balance is a statement containing the various ledger balances on a particular date.

Objects of Preparing a Trial Balance

1. *Checking of the arithmetical accuracy of the accounting entries:*
As indicated above, Trial Balance helps in knowing the arithmetical accuracy of the accounting entries. This is because according to the dual aspect concept for every debit, there must be an equivalent credit. Trial Balance represents a summary of all ledger balances and, therefore, if the two sides of the Trial Balance tally, it is an indication of this fact that the books of account are arithmetically accurate. Of course, there may be certain errors in the books of account in spite of an agreed Trial Balance. For example, if a transaction has been completely omitted from the books of account, the two sides of the Trial Balance will tally, in spite of the books of account being wrong. This has been discussed in detail later in a separate unit.
2. *Basis for financial statements:* Trial Balance forms the basis for preparing financial statements such as the Income Statement and the Balance Sheet. The Trial Balance represents all transactions relating to different accounts in a summarised form for a particular period. In case the Trial Balance is not prepared, it will be almost impossible to prepare the financial statements as stated above to know the profit or loss made by the business during a particular period or its financial position on a particular date.
3. *Summarised ledger:* It has already been stated that a Trial Balance contains the ledger balances on a particular date. Thus, the entire ledger is summarised in the form of a Trial Balance. The position of a particular account can be judged simply by looking at the Trial Balance. The Ledger may be seen only when details regarding the accounts are required.

Methods of Preparation of a Trial Balance

A Trial Balance may be prepared according to any of the two methods:

1. **Total Method:** In case of this method after totaling each side of the ledger account, the respective debit and credit totals of the ledger

accounts are transferred to the respective sides of the trial balance. Thus, in case of this method, the trial balance can be prepared soon after totaling various accounts and the time taken in balancing the account is saved to that extent. This method is not generally followed since it does not help in preparation of financial statements.

2. **Balance Method:** According to this method, every ledger account is balanced and only the balance of the ledger account is carried forward to the trial balance. This method is generally used since the preparation of the financial statements where only balances are to be taken.
3. **Total and Balance Method:** This method combines the first two methods explained above. In case of this method, the trial balance contains both the totals of both sides of the respective accounts as well as their final balances. This method has the advantage that it helps in immediate location of a mistake incurred, if any in the balancing the account. However, it has disadvantage of increasing the workload of the staff.

Illustration 8.1. Prepare (a) ledger accounts and (b) the trial balance according to (i) Total method (ii) Balance method and (iii) Total and balance method on the basis of transactions.

Solution:

(a) **Preparation of Ledger Accounts**

Dr. CASH ACCOUNT Cr.

Date	Particulars	L.F.	₹	Date	Particulars	L.F.	₹
2016				2016			
Jan. 1	To Balance b/d		8,000	Jan. 1	By Purchases A/c		3,800
Jan. 4	To Vijay		1,980	Jan. 8	By Plant A/c		300
Jan. 15	To Rahim		300	Jan. 20	By Salary A/c		2,000
Jan. 18	To Sales A/c		1,000	Jan. 21	By Anand		4,800
Jan. 26	To Interest A/c		200	Jan. 28	By Interest on Loan A/c		500
Jan. 31	To Sales A/c		500	Jan. 31	By Balance c/d		580
			11,980				11,980
Feb. 1	To Balance b/d		580				

INTEREST ACCOUNT

Date	Particulars	₹	Date	Particulars	₹
Jan. 31	To Balance c/d	200	Jan. 26	By Cash A/c	200
		200	Feb. 1	By Balance b/d	200

BANK ACCOUNT

Date	Particulars	₹	Date	Particulars	₹
Jan. 1	To Balance b/d	25,000	Jan. 31	By Balance c/d	25,000
		25,000			25,000
Feb. 1	To Balance b/d	25,000			

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STOCK ACCOUNT

Date	Particulars	₹	Date	Particulars	₹
Jan. 1	To Balance b/d	<u>20,000</u>	Jan. 31	By Balance c/d	<u>20,000</u>
		<u>20,000</u>			<u>20,000</u>
Feb. 1	To Balance b/d	20,000			

Dr. FURNITURE ACCOUNT Cr.

Date	Particulars	₹	Date	Particulars	₹
Jan. 1	To Balance b/d	<u>2,000</u>	Jan. 31	By Balance c/d	<u>2,000</u>
		<u>2,000</u>			<u>2,000</u>
Feb. 1	To Balance b/d	2,000			

BUILDING ACCOUNT

Date	Particulars	₹	Date	Particulars	₹
Jan. 1	To Balance b/d	<u>10,000</u>	Jan. 31	By Balance c/d	<u>10,000</u>
		<u>10,000</u>			<u>10,000</u>
Feb. 1	To Balance b/d	10,000			

VIJAY

Date	Particulars	₹	Date	Particulars	₹
Jan. 1	To Balance b/d	2,000	Jan. 4	By Cash A/c	1,980
		<u>2,000</u>		By Discount A/c	<u>20</u>
					<u>2,000</u>

ANIL

Date	Particulars	₹	Date	Particulars	₹
Jan. 1	To Balance b/d	<u>1,000</u>	Jan. 31	By Balance c/d	<u>1,000</u>
		<u>1,000</u>			<u>1,000</u>
Feb. 1	To Balance b/d	1,000			

MADHU

Date	Particulars	₹	Date	Particulars	₹
Jan. 1	To Balance b/d	<u>2,000</u>	Jan. 31	By Balance c/d	<u>2,000</u>
		<u>2,000</u>			<u>2,000</u>
Feb. 1	To Balance b/d	2,000			

ANAND

Date	Particulars	₹	Date	Particulars	₹
Jan. 21	To Cash A/c	4,800	Jan. 1	By Balance b/d	5,000
Jan. 21	To Discount A/c	<u>200</u>			<u>5,000</u>
		<u>5,000</u>			<u>5,000</u>

CAPITAL ACCOUNT

Date	Particulars	₹	Date	Particulars	₹
Jan. 31	To Balance c/d	<u>55,000</u>	Jan. 1	By Balance b/d	<u>55,000</u>
		<u>55,000</u>			<u>55,000</u>
			Feb. 1	By Balance b/d	<u>55,000</u>

Dr:

BABU'S LOAN ACCOUNT

Cr:

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Date	Particulars	₹	Date	Particulars	₹
Jan. 31	To Balance c/d	10,000	Jan. 1	By Balance b/d	10,000
		<u>10,000</u>	Feb. 1	By Balance b/d	<u>10,000</u>

PURCHASES ACCOUNT

Date	Particulars	₹	Date	Particulars	₹
Jan. 1	To Cash A/c	3,800	Jan. 31	By Drawings A/c	200
Jan. 1	To Discount A/c	200	Jan. 31	By Balance c/d	8,800
Jan. 6	To Bharat	5,000			
		<u>9,000</u>			<u>9,000</u>
Feb. 1	To Balance b/d	8,800			

DISCOUNT ACCOUNT

Date	Particulars	₹	Date	Particulars	₹
Jan. 4	To Vijay	20	Jan. 1	By Purchases A/c	200
Jan. 31	To Balance c/d	380	Jan. 21	By Anand	200
		<u>400</u>	Feb. 1	By Balance b/d	<u>380</u>

BHARAT

Date	Particulars	₹	Date	Particulars	₹
Jan. 31	To Balance c/d	5,000	Jan. 6	By Purchases A/c	5,000
		<u>5,000</u>	Feb. 1	By Balance b/d	<u>5,000</u>

PLANT ACCOUNT

Date	Particulars	₹	Date	Particulars	₹
Jan. 8	To Mukesh	5,000	Jan. 31	By Balance c/d	5,300
Jan. 8	To Cash A/c	300			
		<u>5,300</u>			<u>5,300</u>
Feb. 1	To Balance b/d	5,300			

INTEREST ON LOAN ACCOUNT

Date	Particulars	₹	Date	Particulars	₹
28	To Cash A/c	500	Jan. 31	By Balance c/d	500
		<u>500</u>			<u>500</u>
Feb. 1	To Balance b/d	500			

Dr:

MUKESH

Cr:

Date	Particulars	₹	Date	Particulars	₹
Jan. 31	To Balance c/d	5,000	Jan. 8	By Plant A/c	5,000
		<u>5,000</u>	Feb. 1	By Balance b/d	<u>5,000</u>

SALES ACCOUNT

Date	Particulars	₹	Date	Particulars	₹
Jan. 31	To Balance c/d	2,100	Jan. 21	By Rahim	600
			Jan. 18	By Cash A/c	1,000
		<u>2,100</u>	Jan. 31	By Cash A/c	500
			Feb. 1	By Balance b/d	<u>2,100</u>

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Dr. RAHIM Cr.

Date	Particulars	₹	Date	Particulars	₹
Jan. 12	To Sales A/c	600	Jan. 15	By Cash A/c	300
		<u>600</u>	Jan. 15	By Bad Debts A/c	<u>300</u>
					<u>600</u>

BAD DEBTS ACCOUNT

Date	Particulars	₹	Date	Particulars	₹
Jan. 15	To Rahim	<u>300</u>	Jan. 31	By Balance c/d	<u>300</u>
Feb. 1	To Balance b/d	<u>300</u>			<u>300</u>

SALARY ACCOUNT

Date	Particulars	₹	Date	Particulars	₹
Jan. 20	To Cash A/c	<u>2,000</u>	Jan. 31	By Balance c/d	<u>2,000</u>
Feb. 1	To Balance b/d	<u>2,000</u>			<u>2,000</u>

DRAWINGS ACCOUNT

Date	Particulars	₹	Date	Particulars	₹
Jan. 31	To Purchases A/c	<u>200</u>	Jan. 31	By Balance c/d	<u>200</u>
Feb. 1	To Balance b/d	<u>200</u>			<u>200</u>

(b) (i) Total Method

TRIAL BALANCE

(as on 31st January, 2016)

Particulars	Debit (₹)	Credit (₹)
Cash Account	11,980	11,400
Interest Account		200
Bank Account	25,000	
Stock Account	20,000	
Furniture Account	2,000	
Building Account	10,000	
Vijay	2,000	2,000
Anil	1,000	
Madhu	2,000	
Anand	5,000	5,000
Capital Account		55,000
Babu's Loan Account		10,000
Purchases Account	9,000	200
Discount Account	20	400
Bharat		5,000
Plant Account	5,300	
Interest on Loan Account	500	
Mukesh		5,000
Sales Account		2,100
Rahim	600	600
Bad Debts Account	300	

Particulars	Debit (₹)	Credit (₹)
Salary Account	2,000	
Drawings Account	200	
Total	<u>96,900</u>	<u>96,900</u>

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(ii) Balance Method

TRIAL BALANCE
(as on 31st January, 2016)

Particulars	Debit (₹)	Credit (₹)
Cash Account	580	
Interest		200
Bank Account	25,000	
Stock Account	20,000	
Furniture Account	2,000	
Building Account	10,000	
Anil	1,000	
Madhu	2,000	
Capital Account		55,000
Babu's Loan Account		10,000
Purchases Account	8,800	
Discount Account		380
Bharat		5,000
Plant Account	5,300	
Interest on Loan Account	500	
Mukesh		5,000
Sales Account		2,100
Bad Debts Account	300	
Salary Account	2,000	
Drawings Account	200	
	<u>77,680</u>	<u>77,680</u>

(iii) Total and Balance Method

TRIAL BALANCE
(as on 31st January, 2016)

Particulars	Total Method		Balance Method	
	Debit (₹)	Credit (₹)	Debit (₹)	Credit (₹)
Cash Account	11,980	11,400	580	
Interest Account		200		200
Bank Account	25,000		25,000	
Stock Account	20,000		20,000	
Furniture Account	2,000		2,000	
Building Account	10,000		10,000	
Vijay	2,000	2,000		
Anil	1,000		1,000	
Madhu	2,000		2,000	
Anand	5,000	5,000		
Capital Account		55,000		55,000
Babu's Loan Account		10,000		10,000
Purchases Account	9,000	200	8,800	

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Discount Account	20	400		380
Bharat		5,000		5,000
Plant Account	5,300		5,300	
Interest on Loan Account	500		500	
Mukesh		5,000		5,000
Sales Account		2,100		2,100
Rahim	600	600		
Bad Debts Account	300		300	
Salary Account	2,000		2,000	
Drawings Account	200		200	
Total	<u>96,900</u>	<u>96,900</u>	<u>77,680</u>	<u>77,680</u>

Check Your Progress

1. Name the accounting book whose summarized form is known as the Trial Balance.
2. Which method of preparation of Trial Balance is used for the preparation of the financial statements?

8.3 PREPARATION OF FINAL ACCOUNTS

It has already been explained that the accuracy of the books of accounts is determined by means of preparing a Trial Balance. Having determined the accuracy of the books of accounts every businessman is interested in knowing about two more facts. They are: (i) Whether he has earned a profit or suffered a loss during the period covered by the Trial Balance, (ii) Where does he stand now? In other words, what is his financial position?

The determination of the Profit or Loss is done by preparing a Trading and Profit and Loss Account (or an Income Statement). While the financial position is judged by means of preparing a Balance Sheet of the business. The two statements together, i.e., Income Statement and the Balance Sheet, are termed as Final Accounts. As the term indicates, Final Accounts means accounts which are prepared at the final stage to give the financial position of the business.

Characteristics of Final Accounts

- It is the final process of accounting.
- It is prepared to show the final result of the company in a specific period.
- It is the account, which is prepared at the end of the given year or period, to see the profit and loss position as well as the financial position of a going concern for the period given.
- It is also known as financial statement.

- It consists of trading account, profit and loss account and balance sheet.
- The trading account shows the gross profit or gross loss, net profit or net loss is calculated from profit and loss account and balance sheet is prepared to know the position of assets and liabilities.
- Profit and loss account shows the profitability achieved during the accounting period and balance sheet reflects the composition of various assets, liabilities, and shareholder's equity on the accounting period.

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Objectives of Final Accounts

The following are the main objectives of final accounts:

- To determine gross profit and net profit of the business during the year.
- To present the true financial position of the business on a given date.
- To make effective control on financial activities of the business.
- To make a summary presentation of all the financial transactions.
- To communicate the operating results and financial position of the users.
- To help in making a different financial decision to the users of accounting information.

8.3.1 Trading Account

Trading Account gives the overall result of trading, *i.e.*, purchasing and selling of goods. In other words, it explains whether purchasing of goods and selling them has proved to be profitable for the business or not. It takes into account on the one hand the cost of goods sold and on the other the value for which they have been sold away. In case the sales value is higher than the cost of goods sold, there will be a profit, while in a reverse case, there will be a loss. The profit disclosed by the Trading Account is termed as Gross Profit, similarly the loss disclosed by the Trading Account is termed as Gross Loss.

This will be clear with the help of the following illustration:

Illustration 8.2. The following figures have been taken from the Trial Balance of a trader:

	₹
Purchases	30,000
Purchases Returns	5,000
Sales	40,000
Sales Returns	5,000

Calculate the amount of profit or loss made by the trader.

Solution:

The profit or loss made by the trader can be found out by comparing the cost of goods sold with sales value. This has been done as follows:

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<i>Particulars</i>	<i>Amount ₹</i>	<i>Amount ₹</i>
Sales	40,000	
Less Sales Returns	<u>5,000</u>	35,000
Purchases	30,000	
Less Purchases Returns	<u>5,000</u>	<u>25,000</u>
Gross Profit		<u><u>10,000</u></u>

Opening and Closing Stocks

In Illustration 8.2, we have presumed that all goods purchased have been sold away by the trader. However, it does not normally happen. At the end of the accounting year, a trader may be left with certain unsold goods. Such stock of goods with a trader unsold at the end of the accounting period is termed as Closing Stock. Such a stock will become the opening stock for the next period. For example, if a trader has with himself goods amounting to ₹5,000 unsold at the end of the year 2017, this stock of ₹5,000 will be termed as his Closing Stock. For the year 2017, this stock of ₹5,000 will be termed as his Opening Stock. While calculating the amount of profit or loss on account of trading, a trader will have to take such Opening and Closing Stocks into consideration. This will be clear with the help of the following illustration.

Illustration 8.3. From the following data calculate the profit made by a trader in 2017.

	₹
Stock of goods on 1.1.2017	10,000
Purchases during the year	40,000
Purchases Returns during the year	3,000
Sales during the year	60,000
Sales returns during the year	10,000
Stock of goods on 31.12.2017	15,000

Solution:

<i>Particulars</i>	<i>Amount ₹</i>	<i>Amount ₹</i>
Sales	60,000	
Less: Sales Returns	<u>10,000</u>	50,000
Cost of goods sold:		
Opening Stock	10,000	
Add: Net Purchases (₹40,000 – 5,000)	<u>35,000</u>	
	45,000	
Less: Closing Stock	<u>15,000</u>	<u>30,000</u>
Gross Profit		<u><u>20,000</u></u>

Expenses on Purchases etc.

In the Illustrations given above, we have presumed that the trader has not incurred any expenses for purchase of goods and bringing them to his shop for sale. However, a trader has to incur various types of expenses for purchasing of goods as well as for bringing them to his shop for sale. Such expenses may include brokerage or commission paid to agents for purchase

of goods, cartage or carriage charges for bringing the goods to the trader's shop, wages paid to coolies for transportation of goods etc. All such expenses increase the cost of the goods sold and hence they have also to be included in the cost of purchasing the goods. In other words, cost of goods sold will be calculated as follows:

$$\text{COST OF GOODS SOLD} = \text{OPENING STOCK} + \text{NET PURCHASES} + \text{EXPENSES ON PURCHASING OF GOODS} - \text{CLOSING STOCK}$$

Cost of goods sold calculated as above will then be compared with the net sales to find out the amount of profit or loss made by the business. This will be clear with the following Illustrations.

The term 'merchandise' is also used for the term 'goods'.

Thus:

$$\begin{aligned} \text{COST OF GOODS} &= \text{COST OF MERCHANDISE} \\ \text{COST OF GOODS PURCHASED} &= \text{COST OF MERCHANDISE PURCHASED} \\ \text{COST OF GOODS SOLD} &= \text{COST OF MERCHANDISE SOLD} \end{aligned}$$

Illustration 8.4. Find out the cost of merchandise purchased, cost of merchandise sold, cost of merchandise unsold and Gross Profit from the following transactions:

	₹
Purchases (3,000 articles)	25,000
Freight	1,000
Local Taxes	1,000
Salaries	2,500
Shop Rent	500
Godown Rent	500
Electrical Charges	600
Municipal Taxes	200
Stationery	250
Furniture (estimated life 5 years)	12,000
Sales (2,700 articles)	32,000

Solution:

<i>Particulars</i>	<i>Amount ₹</i>
Cost of Merchandise purchased	
This consists of:	
Purchases	25,000
Freight	1,000
Local Taxes	1,000
	<u>27,000</u>
Cost of Merchandise sold	
Cost of 3,000 units of merchandise purchased	27,000
Cost of one unit of merchandise	9
Cost of 2,700 units of merchandise sold	24,300

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Gross Profit		
Sales of 2,700 units of merchandise		32,000
Less: Cost of merchandise sold		<u>24,300</u>
		<u>7,700</u>
Cost of Merchandise unsold		
300 units @ ₹9 per unit		<u><u>2,700</u></u>

All other expenses including annual depreciation of furniture (amounting in all to ₹6,950) will be considered for computing the Net Profit of the business. The concept of Net Profit has been explained later in the chapter.

Equation for Preparing Trading Account

On the basis of the Illustrations given in the preceding pages, the following equation can be derived for preparing Trading Account:

	Gross Profit	=	Sales – Cost of Goods Sold
	Cost of Goods Sold	=	Opening Stock + Purchases + Direct Expenses – Closing Stock
Therefore,	Gross Profit	=	Sales – (Opening Stock + Purchases + Direct Expenses – Closing Stock)
Or	Gross Profit	=	(Sales + Closing Stock) – (Opening Stock + Purchases + Direct Expenses)

The term “Direct Expenses” include those expenses which have been incurred in purchasing the goods, bringing them to the business premises and making them fit for sale. Examples of such expenses are carriage charges, octroi, import duty, expenses for seasoning the goods, etc.

The Trading Account can be prepared in the following form on the basis of equation given above.

TRADING ACCOUNT				
Dr.		for the period ending ...		Cr.
Particulars	Amount ₹	Particulars	Amount ₹	
To Opening Stock	By Sales	.....
To Purchases	Less: Returns	.....	.....
Less: Returns	By Closing Stock	.....
To Direct Expenses	By Gross Loss*	.....
To Gross Profit*	
	

*Only one figure will be there.

Illustration 8.5. Prepare the Trading Account of Mr. Ramesh for the year ending 31st December, 2017 from the data as follows:

	₹		₹
Purchases	10,000	Wages	4,000
Purchases Returns	2,000	Carriage Charges	2,000
Sales	20,000	Stock on 1.1.2017	4,000
Sales Returns	5,000	Stock on 31.12.2017	6,000

$$\begin{aligned}\text{Closing Stock} &= \text{Opening stock} + \text{Cost of purchases} - \text{Cost of Goods Sold} \\ &= 4,000 + 14,000 - 12,000 = ₹6,000\end{aligned}$$

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Valuation of Closing Stock: The closing stock is valued on the basis of “cost or market price whichever is less” principle. It is, therefore, very necessary that the cost of the goods lying unsold should be carefully determined. The market value of such goods will also be found out on the Balance Sheet date. The closing stock will be valued at the lower of the two values. For example, if the goods lying unsold at the end of the accounting period amount to ₹11,000, while their market price on the Balance Sheet date amounts to ₹10,000, the closing stock will be valued at ₹10,000. This valuation is done because of the accounting convention of conservatism, according to which expected losses are to be taken into account but not expected profits.

2. Purchases: The term “Purchases” includes both cash and credit purchases of goods. The term “goods”, means items purchased for resale. Assets purchased for permanent use in the business such as purchase of plant, furniture, etc., are not included in the purchase of goods. Similarly, purchase of articles such as stationery meant for using in the business will also not be included in the item of purchases. In case a proprietor has himself used certain goods for his personal purposes, the value of such goods at cost will be deducted from the purchases and included in the drawings of the proprietor. The journal entry in such a case would be as follows:

Drawings Account	Dr.
To Purchases Account	

Similarly, in case certain goods are given by way of free samples, etc., the value of such goods should be charged to advertisement account and deducted from purchases. The journal entry in such a case would be as follows:

Advertisement Account	Dr.
To Purchases Account	

The amount of purchases will be the net purchases made by the proprietor. The term ‘net purchases’ means total purchases of goods made by the businessman less the goods that he has returned back to the suppliers. In other words, purchases will be taken to the Trading Account after deducting purchases returns from the gross purchases made during the accounting period.

3. Sales: The term ‘Sales’ includes both cash and credit sales. Gross sales will be shown in the inner column of the Trading Account out of which “sales returns” will be deducted. The net sales will then be shown in the outer column of the Trading Account. Proper care should be taken in recording sale of those goods which have been sold at the end of the financial year but have

not yet been delivered. The sales value of such goods should be included in the sales, but care should be taken that they are not included in the closing stock at the end of the accounting period.

Sales have to be recorded at net realisable value excluding sales tax, i.e., Sales excluding Sales Tax – Cost incurred necessarily to make the sale. For example, an item can be sold for ₹50 plus sales tax at 10% after getting it repaired at a cost of ₹5. The sales should be recorded at net realisable value, i.e., ₹45.

Sales of assets like plant and machinery, land and building or such other assets which were purchased for using in the business, and not for sale, should not be included in the figure of 'sales' to be taken to the Trading Account.

4. Wages: The amount of wages is taken as a direct expense and, therefore, is debited to the Trading Account. Difficulty arises in those cases when the Trial Balance includes a single amount for "wages and salaries". In such a case, the amount is taken to the Trading Account. However, if the Trial Balance shows "salaries and wages" the amount is taken to the Profit and Loss Account. In actual practice such difficulties do not arise because the businessman knows for which purpose he has incurred the expenditure by way of wages or salaries. However, in an examination problem, it will be useful for the students to follow the principle given above, i.e., "wages and salaries" to be charged to Trading Account while "wages and salaries" to be charged to the Profit and Loss Account. Wages paid for purchase of an asset for long-term use in the business, i.e., wages paid for plant and machinery or wages paid for construction of a building should not be charged to the Wages Account. They should be charged to the concerned Asset Account.

5. Customs and Import Duty: In case the goods have been imported from outside the country, customs and import duty may have to be paid. The amount of such duty should be charged to the Trading Account.

6. Freight, Carriage and Cartage: Freight, Carriage and Cartage are taken as direct expenses incurred on purchasing of the goods. They are, therefore, taken to the debit side of the Trading Account. The terms "Freight In", "Cartage In" and "Carriage In" have also the same meaning. However, "Cartage Out", "Freight Out" and "Carriage Out" are taken to be the expenses incurred on selling the goods. They are, therefore, charged to the Profit and Loss Account. The term "Inward" is also used for the term "IN". Similarly, the term "Outward" is also used for the term "Out". In other words, "Carriage" or "Carriage Inward" or "Carriage In" are used as synonymous terms. Similarly, "Carriage Out" or "Carriage Outward" are also synonymous terms. The same is true for other expenses like Freight or Cartage.

7. Royalty: Royalty is the amount paid to the owner for using his rights. For example, the royalty is paid by a "Lessee" of a coalmine to its owner for taking out the coal from the coalmine. Similarly, royalty is paid to the owner of a patent for using his right. It is generally taken as a direct expense

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and, therefore, is charged to the Trading Account. However, where royalty is based on sales, for example, in case of the book publishing trade, it may be charged to the Profit and Loss Account.

8. Gas, Electricity, Water, Fuel, etc. All these expenses are direct expenses and, therefore, they are charged to the Trading Account.

9. Packing Materials: Packing Materials used for packing the goods purchased for bringing them to the shop or convert them into a saleable state are direct expenses and, therefore, they are charged to the Trading Account. However, packing expenses incurred for making the product look attractive or packing expenses incurred after the product has been sold away are charged to the Profit and Loss Account.

Closing Entries

Closing Entries are entries passed at the end of the accounting year to close different accounts. These entries are passed to close the accounts relating to incomes, expenses, gains and losses. In other words, these entries are passed to close the different accounts which pertain to Trading and Profit and Loss Account. The accounts relating to assets and liabilities are not closed but they are carried forward to the next year. Hence, no closing entries are to be passed regarding those accounts which relate to the Balance Sheet.

The principle of passing closing entry is very simple. In case an account shows a debit balance, it has to be credited in order to close it. For example, if the Purchases Account is to be closed, the Purchases Account will have to be credited so that it may be closed because it has a debit balance. The Trading Account will have to be debited.

The closing entries are passed in the Journal Proper. The different closing entries to be passed by the accountant for preparing a Trading Account are being explained below:

(i)	Trading Account	Dr.
	To Stock Account (Opening)	
	To Purchases Account	
	To Sales Returns Account	
	To Carriage Account	
	To Customs Duty Account	
(ii)	Sales Account	Dr.
	Purchases Returns Account	Dr.
	Stock Account (Closing)	Dr.
	To Trading Account	

In case the total of the credit side of the Trading Account is greater than the total of the debit side of the Trading Account, the difference is known as

Gross Profit. In a reverse case it will be a Gross Loss. Gross Profit or Gross Loss disclosed by the Trading Account is transferred to the Profit and Loss Account.

Importance of the Trading Account

Trading Account provides the following information to a businessman regarding his business:

1. Gross Profit disclosed by the Trading Account tells him the upper limit within which he should keep the operating expenses of the business besides saving something for himself. The cost of purchasing and the price at which he can sell the goods are governed largely by market factors over which he has no control. He can control only his operating expenses. For example, if the cost of purchasing an article is ₹10 and it can be sold in the market at ₹15 per unit, the gross margin available on each article is ₹5. In case a businessman proposes to sell 1,000 units of that article in a year, his gross profit or gross margin will be ₹5,000. His other expenses should therefore be less than ₹5,000 so that he can also save something for himself.
2. He can calculate his Gross Profit Ratio¹ and compare his performance year after year. A fall in the Gross Profit Ratio means increase in the cost of purchasing the goods or decrease in the selling price of the goods or both. In order to maintain at least same figure of gross profit in absolute terms, he will have to push up the sales or make all out efforts to obtain goods at cheaper prices. Thus, he can prevent at least fall in the figure of his gross profit if he cannot bring any increase in it.
3. Comparison of stock figures of one period from another will help him in preventing unnecessary lock-up of funds in inventories.
4. In case of new products, the businessman can easily fix up the selling price of the products by adding to the cost of purchases, the percentage gross profit that he would like to maintain. For example, if the trader has been so far maintaining a rate of gross profit of 20% on sales and he introduces a new product in the market having a cost of ₹100, he should fix the selling price at ₹125 in order to maintain the same rate of gross profit (i.e., 20% on sales).

8.3.2 Profit and Loss Account

The Trading Account simply tells about the gross profit or loss made by a businessman on purchasing and selling of goods. It does not take into account the other operating expenses incurred by him during the course of running the business. For example, he has to maintain an office for getting orders and executing them, taking policy decisions and implementing them.

1. $\text{Gross Profit} \div \text{Sales} \times 100$

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All such expenses are charged to the Profit and Loss Account. Besides this, a businessman may have other sources of income. For example, he may receive rent from some of his business properties. He may have invested surplus funds of the business in some securities. He might be getting interest or dividends from such investments. In order to ascertain the true profit or loss which the business has made during a particular period, it is necessary that all such expenses and incomes should be considered. Profit and Loss Account considers all such expenses and incomes and gives the net profit made or loss suffered by a business during a particular period. It is generally prepared in the following form:

PROFIT AND LOSS ACCOUNT			
<i>Dr.</i>	<i>for the year ending.....</i>		<i>Cr.</i>
<i>Particulars</i>	₹	<i>Particulars</i>	₹
To Gross Loss b/d*	By Gross Profit b/d*	.....
To Salaries	By Discount received	.....
To Rent	By Net Loss transferred	.....
To Commission	to Capital A/c*	.....
To Advertisements		
To Bad Debts		
To Discount		
To Net Profit Transferred to Capital Account*		
	=====		=====

* Only one figure of profit or loss will appear.

Important Points Regarding Profit and Loss Account

1. **Gross Profit or Gross Loss:** The figure of gross profit or gross loss is brought down from the Trading Account. Of course, there will be only one figure, *i.e.*, either of gross profit or gross loss.
2. **Salaries:** Salaries payable to the employees for the services rendered by them in running the business being of indirect nature are charged to the Profit and Loss Account. In case of a partnership firm, salaries may be allowed to the partners. Such salaries will also be charged to the Profit and Loss Account.
3. **Salaries less Tax:** In case of employees earning salaries beyond a certain limit, the employer has to deduct at source income tax from the salaries of such employees. In such a case, the amount of gross salaries should be charged to the Profit and Loss Account, while the tax deducted by the employer will be shown as a liability in the Balance Sheet of the business till it is deposited with the Tax Authorities. For example, if salaries paid are ₹2,400 after deducting income tax of ₹600, the amount of salaries to be charged to the Profit and Loss Account will be a sum of ₹3,000. The amount of tax-deducted at source by the employer, *i.e.*, ₹600 will be shown as a liability in the Balance Sheet.

4. **Salaries after deducting Provident Fund Contribution etc.:** In order to provide for old age of the employees, employers contribute a certain percentage of salaries of the employees to the Provident Fund. The employee is also required generally to contribute an equivalent amount. The share of the employee's contribution to Provident Fund is deducted from the salary due to him and the net amount is paid to him. The amount of salaries to be charged to the Profit and Loss Account will be the gross salary payable to the employee, *i.e.*, including the employee's contribution to the Provident Fund. The contribution by the employer will also be charged as an expense to the Profit and Loss Account. Both employer's and employee's contributions to the Provident Fund will also be shown as liability in the Balance Sheet under the heading "Employees Provident Fund".
5. **Interest:** Interest on loans whether short-term or long-term is an expense of an indirect nature and, therefore, is charged to the Profit and Loss Account. However, interest on loans advanced by a firm to third-parties is an item of income and, therefore, will be credited to the Profit and Loss Account.
6. **Commission:** Commission may be both an item of income as well as an item of expense. Commission on business brought by agents is an item of expense while commission earned by the business for giving business to others is an item of income. Commission to agents is, therefore, debited to the Profit and Loss Account while commission received is credited to the Profit and Loss Account.
7. **Trade Expenses:** Trade expenses are expenses of a miscellaneous nature. They are of small amount and varied in nature and, therefore, it is not considered worthwhile to open separate accounts for each of such types of expenses. The terms "Sundry Expenses", "Miscellaneous Expenses" or "Petty Expenses" have also the same meaning. They are charged to the Profit and Loss Account.
8. **Printing and Stationery:** This item of expense includes expenses on printing of bills, invoices, registers, files, letter heads, ink, pencil, paper and other items of stationery, etc. It is of an indirect nature and, therefore, charged to the Profit and Loss Account.
9. **Advertisements:** Advertisement expenses are incurred for attracting the customers to the shop and, therefore, they are taken as selling expenses. They are debited to the Profit and Loss Account. However, advertisement expenses incurred for purchasing of goods should be charged to the Trading Account, while an advertisement expense incurred for purchase of a capital asset (*e.g.*, cost of insertion in a newspaper for purchase of car) should be taken as a capital expenditure and debited to the concerned asset account. Similarly, advertisement

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expenditure incurred for sale of a capital asset should be deducted out of the sale proceeds of the asset concerned.

10. **Bad Debts:** Bad Debts denotes, the amount lost from debtors to whom the goods were sold on credit. It is a loss and, therefore, should be debited to the Profit and Loss Account.
11. **Depreciation:** Depreciation denotes decrease in the value of an asset due to wear and tear, lapse of time, obsolescence, exhaustion and accident. For example, a motor car purchased gets depreciated on account of its constant use. A property purchased on lease for ₹12,000 for a period of 12 years will depreciate at the rate of ₹1,000 per year. On account of new inventions, old assets become obsolete and they have to be replaced. Mines etc. get exhausted after the minerals are completely taken out of them. An asset may meet an accident and may lose its value. It is necessary that depreciation on account of all these factors is charged to the Profit and Loss Account to ascertain the true profit or loss made by the business.
12. **Discount:** It is a reduction from a list price, quoted price or invoice price. Discount may be of three types:
 - (a) *Trade Discount:* It is a reduction from the list price. It is a reduction granted by a supplier from the list price of goods or services.
 - (b) *Quantity Discount:* It is similar to trade discount with the difference that it is given in case of purchasing of goods in bulk quantity.
 - (c) *Cash Discount:* It is a reduction granted by a supplier from the invoice price in consideration of immediate payment or payment within a stipulated period.

Thus, quantity discount is similar to trade discount. However, cash discount is different from trade discount.

Distinction between trade discount and cash discount can be put as follows:

- (a) *Meaning:* A trade discount is a reduction granted by the supplier from the list price on total amount of sales, while a cash discount is a reduction for prompt payment or payment within a stipulated time period.
- (b) *Objective:* The objective of trade discount is to promote sales, while the objective of cash discount is quick collection of payment.
- (c) *Time:* Trade discount is allowed at the time of purchasing of goods, while cash discount is allowed at the time of making payment.
- (d) *Disclosure:* Trade discount is shown as reduction in the invoice itself, while cash discount is not shown in the invoice. Moreover,

trade discount account is not opened in the ledger, while cash discount account is opened in the ledger.

- (e) *Variation*: Trade discount may vary with the quantity of goods purchased, while cash discount may vary with time period within which payment is received.

13. **Manager's Commissions**: The manager of a firm may be given a certain percentage of net profit. This percentage of commission may be before or after charging of such commission. The computation of commission can be understood with the following example.

Example:

Net Profit before charging commission: ₹10,000.

Manager's Commission 10% of Net Profit before charging his commission.

The Manager's Commission can be computed as under:

$$= ₹10,000 \times \frac{10}{100} ₹1,000$$

However, if the manager's commission is 10% of Net profit after charging his commission, the amount of commission will be computed as follows:

$$= ₹10,000 \times \frac{10}{100} ₹909$$

This can be verified as under:

Net Profit before charging commission	=	₹10,000
Less: Manager's Commission	=	₹909
Net Profit after charging commission	=	<u>9,091</u>

Thus, manager's commission of ₹909 is 10% of firm's net profits after charging commission.

Accounting (Closing) Entries for Preparing Profit and Loss Account

The following journal entries will be passed in the Journal Proper for preparing the Profit and Loss Account.

- (i) For transfer of items of expenses, losses, etc., appearing on the debit side of the Trial Balance

Profit and Loss Account	Dr.
To Salaries	
To Rent	
To Commission	
To Advertisements	
To Bad Debts	
To Discount	
To Printing and Stationery	

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(ii) For transfer of items of incomes, gains, etc., appearing on the credit side of the Trial Balance

Interest Account	Dr.
Dividends Account	Dr.
Discount Account	Dr.
To Profit and Loss Account	

(iii) For transfer of net profit or net loss:

In case the total of the credit side of the Profit and Loss Account is greater than the debit side of the Profit and Loss Account, the difference is termed as Net Profit. In a reverse case, it will be termed as Net Loss. The amount of Net Profit or Net Loss shown by the Profit and Loss Account will be transferred to Capital Account in case of sole proprietary firm. In case of a partnership firm, the amount of net profit or net loss will be transferred to the Partners' Capital Accounts in the agreed ratio. In the absence of any agreement, the partners will share profits and losses equally.

For transfer of Profit

Profit and Loss Account	Dr.
To Capital Account(s)	

For transfer of Net Loss

Capital Account(s)	Dr.
To Profit and Loss Account	

Illustration 8.6. From the following balances, taken from the Trial Balance of Shri Suresh, prepare a Trading and Profit and Loss Account for the year ending 31st Dec., 2017:

Particulars	Dr. ₹	Cr. ₹
Stock on 1.1.2017	2,000	
Purchases and Sales	20,000	30,000
Returns	2,000	1,000
Carriage	1,000	
Cartage	1,000	
Rent	1,000	
Interest Received		2,000
Salaries	2,000	
General Expenses	1,000	
Discount		500
Insurance	500	

The Closing Stock on 31st December, 2017 is ₹5,000.

Solution:

TRADING AND PROFIT AND LOSS ACCOUNT

Dr: Cr:
for the year ending 31st December, 2017

Particulars	₹	Particulars	₹
To Opening Stock	2,000	By Sales	30,000
To Purchases	20,000	Less: Returns	<u>2,000</u>
Less: Returns	<u>1,000</u>	By Closing Stock	5,000
To Carriage	1,000		
To Cartage	1,000		
To Gross Profit c/d	10,000		

	<u>33,000</u>		<u>33,000</u>
To Rent	1,000	By Gross Profit b/d	10,000
To Salaries	2,000	By Interest	2,000
To General Expenses	1,000	By Discount	500
To Discount	1,000		
To Insurance	500		
To Net Profit taken to Capital Account	8,000		
	<u>12,500</u>		<u>12,500</u>

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Importance of Profit and Loss Account

The Profit and Loss Account provides information regarding the following matters:

- (i) **Ascertainment of net profit (or loss):** It provides information about the net profit or net loss earned or suffered by the business during a particular period. Thus, it is an index of the profitability or otherwise of the business.
- (ii) **Comparative study:** The Profit figure disclosed by the Profit and Loss Account for a particular period can be compared with that of the other period. Thus, it helps in ascertaining whether the business is being run efficiently or not.
- (iii) **Controlling expenses:** An analysis of the various expenses included in the Profit and Loss Account and their comparison with the expenses of the previous period or periods helps in taking steps for effective control of the various expenses.
- (iv) **Providing for contingencies:** Allocation of profit among the different periods or setting aside a part of the profit for future contingencies can be done.
- (v) **Prospective planning:** On the basis for profit figures of the current and the previous period estimates about the profit in the year to come can be made. These projections will help the business in planning the future course of action.

8.3.3 Preparation of Manufacturing Account

In the preceding pages, we have explained the preparation of the Trading and Profit and Loss Account from the point of view of a trade, *i.e.*, a person who purchases and sells goods. However, a person may manufacture goods by himself for selling them at a profit. In case of such a person, *i.e.*, a manufacturer, it will be necessary to ascertain the cost of manufacturing the goods. In his case, therefore, the profit or loss made by him will be ascertained by preparing the following three accounts:

- (i) **Manufacturing account:** This account gives the cost of the goods manufactured by a manufacturer during a particular period.

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(ii) **Trading account:** This account gives information about the gross profit or loss made by a manufacturer in selling the manufactured goods. In case a manufacturer also functions as a trader, *i.e.*, besides manufacturing and selling goods of his own, he also purchases and sells goods of others, he will be a manufacturer-cum-trader. In such a case, his Trading Account will disclose not only the profit made by him on selling his manufactured goods, but also the profit made by him in selling the goods purchased by him from others.

(iii) **Profit and Loss account:** This account gives the overall profit or loss made or suffered by the manufacturer or manufacturer-cum-trader during a particular period. The proforma of a Manufacturing Account is given below:

MANUFACTURING ACCOUNT

Dr.		<i>for the year ending.....</i>		Cr.
<i>Particulars</i>	₹	<i>Particulars</i>	₹	
To Work-in-process (Opening)	.....	By Work-in-process (Closing)	.....
To Raw Materials consumed:		By Sale of Scrap	.....
Opening Stock	.....	By Cost of Production of		
<i>Add:</i> Purchases of Raw		Finished Goods during the		
Materials	.....	Period transferred to the	.....
<i>Less:</i> Closing Stock of	.....	Trading Account		
Raw Materials	.....		
To Direct or Productive wages	.....		
To Factory Overheads:				
Power and Fuel	.....		
Repairs of Plant	.....		
Depreciation on Plant	.....		
Factory Rent	.....		

The Trading Account in case of a manufacturer will appear as follows:

TRADING ACCOUNT

Dr.		<i>for the year ending.....</i>		Cr.
<i>Particulars</i>	₹	<i>Particulars</i>	₹	
To Opening Stock of Finished Goods	.....	By Sales <i>less</i> Returns	.....
To Cost of Production of Finished Goods Transferred from Manufacturing Account	.....	By Closing Stock of Finished Goods	.....
To Purchases of Finished Goods <i>less</i> Returns	.....	By Gross Loss c/d*	.....
To Carriage Charges on Goods Purchased	.....		
To Gross Profit c/d*	.....		

* Only one figure of profit or loss will appear.

The Gross Profit or Loss shown by the Trading Account will be taken to the Profit and Loss Account which will be prepared in the usual way as explained in the preceding pages.

Important Points Regarding Manufacturing Account

1. **Stock:** In case of a manufacturer, there can be stocks of three types:
 - (i) **Stock of Raw Materials:** It includes stock of raw materials or finished components which might have been purchased by the manufacturer for using them in the products manufactured by him but still lying unsold.
 - (ii) **Stock of Work-in-process:** This is also termed as stock of work-in-progress. It includes goods in semi-finished form.
 - (iii) **Stock of Finished Goods:** It includes stock of those goods which have been completely processed and are lying unsold at the end of a period with the manufacturer. It also includes stock of those finished goods which might have been purchased by a manufacturer-cum-trader from outside parties, but still lying unsold with him at the end of the accounting period.
2. **Raw Materials Consumed:** It is customary to show in the Manufacturing Account, the value of raw materials consumed for manufacturing goods during a particular period. This is computed as follows:

Opening Stock of Raw Materials	.....
<i>Add:</i> Purchase of Raw Materials	.....

<i>Less:</i> Closing Stock of Raw Materials	.....
Raw Materials Consumed	.....

For example, if the opening stock of raw materials is ₹5,000, purchases of raw materials is ₹20,000 and closing stock of raw materials is ₹8,000, the value of raw materials consumed will be calculated as follows:

	₹	₹
Opening Stock of Raw Materials	<u>5,000</u>	
<i>Add:</i> Purchase of Raw Materials	20,000	25,000
<i>Less:</i> Closing Stock of Raw Materials		<u>8,000</u>
Raw Materials Consumed		<u>17,000</u>

3. **Carriage Inwards, etc.:** The expenses incurred for bringing the raw materials to the factory or the octroi or customs duty paid by the manufacturer on the raw materials purchased or imported by him will also be charged to Manufacturing Account.
4. **Factory Overheads:** The term “Overheads” includes indirect material, indirect labour and indirect expenses. The term “Factory Overheads”, therefore, stands for all factory indirect material, indirect labour, and indirect expenses. For example, in case of a manufacturer of chairs, the cost of timber purchased will be taken as raw materials. However, the polishing material used by him will be taken as indirect material and will be taken as an item of factory overheads. Similarly, the wages paid to the carpenters who have been employed for making chairs will come

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as cost of direct labour since they are actively engaged in manufacturing the chairs. However, the salaries of the supervisor or the wages of the gatekeeper will be taken as indirect labour cost and come in the definition of factory overheads. Similarly, the carriage charges paid for bringing the raw materials to the factory are considered to be direct charges since they can directly be charged to the raw materials purchased. However, the rent for the factory, depreciation of the factory machines, insurance of the factory are all taken as indirect factory expenses and, therefore, covered under the category of factory overheads.

5. **Cost of Production:** The Manufacturing Account gives the cost of manufacturing the goods during a particular period. This is computed by deducting from the total of the debit side of the Manufacturing Account, the total of the various items appearing on the credit side of the Manufacturing Account as shown in the proforma of the Manufacturing Account given earlier in the chapter.
6. **Sale of Scrap:** In manufacturing operations, certain scrap is unavoidable. It may or may not have any sales value. In order to calculate the true cost of manufacturing the goods, it is necessary that the money realised on account of sale of scrap (or realisable value of the scrap in case it had not been sold) should be considered. The amount of scrap is, therefore, credited to the Manufacturing Account.

Illustration 3.7. From the following details, prepare a Manufacturing and a Trading Account for the year ending 31st December, 2017.

	₹
Stock on 1.1.2017:	
Raw Materials	10,000
Work-in-Process	5,000
Finished Goods	20,000
Stock on 31.12.2017:	
Raw Materials	5,000
Work-in-Process	15,000
Finished Goods	30,000
Purchase of Raw Materials	50,000
Direct Wages	10,000
Carriage Charges on purchase of raw materials	5,000
Factory Power	5,000
Depreciation on Factory Machines	5,000
Purchase of Finished Goods	30,000
Cartage paid on Finished Goods purchased	2,000
Sales of Finished Goods	1,00,000

Solution:

MANUFACTURING ACCOUNT for the year ending 31.12.2017

Particulars	₹	Particulars	₹
To Work-in-process on 1.1.2017	5,000	By Work-in-process on 31.12.2017	15,000
To Raw Materials consumed		By Cost of Production transferred to Trading Account	70,000

Particulars	₹	Particulars	₹
Stock on 1.1.2017	10,000		
Add : Purchases	<u>50,000</u>		
	60,000		
Less: Closing Stock	<u>5,000</u>		
	55,000		
To Direct Wages	10,000		
To Carriage Charges	5,000		
To Factory Power	5,000		
To Depreciation on Factory Machines	<u>5,000</u>		
	<u>85,000</u>		<u>85,000</u>

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TRADING ACCOUNT for the year ending 31.12.2017

Particulars	₹	Particulars	₹
To Stock of Finished Goods on 1.1.2017	20,000	By Stock of Finished Goods on 31.12.2017	30,000
To Cost of Production of Finished Goods Transferred from Manufacturing Account	70,000	By Sale of Finished Goods	1,00,000
To Purchases of Finished Goods	30,000		
To Cartage on Finished Goods Purchased	2,000		
To Gross Profit Transferred to Profit and Loss A/c	<u>8,000</u>		
	<u>1,30,000</u>		<u>1,30,000</u>

Tutorial Note. The following points may further be noted by students:

- (i) It is customary to give a separate heading to the Manufacturing Account as shown above. However, the Trading Account and Profit and Loss Account are not given separate headings. There will be a common heading for both these accounts as shown below:

TRADING AND PROFIT & LOSS ACCOUNT

for the year ending.....

- (ii) In case in an examination question, a Manufacturing Account is not separately asked, the examinees may show all items relating to the Manufacturing Account in the Trading Account itself. However, it will be advisable in such a case to prepare a Manufacturing Account, if possible.
- (iii) In case of joint stock companies, the heading given is only, "Profit and Loss Account for the year ending....." and not Trading and Profit and Loss Account. However, the amount of Gross Profit and Net Profit may be calculated separately.

8.3.4 Balance Sheet

Having prepared the Trading and Profit and Loss Account, a businessman will like to know the financial position of his business. For this purpose, he prepares a statement of his assets and liabilities as on a particular date. Such a statement is termed as "Balance Sheet". Thus, Balance Sheet is not an account but only a statement containing the assets and liabilities of a business on a particular date. It is, as a matter of fact, a classified summary of the various remaining accounts after accounts relating to Incomes and Expenses have been closed by transfer to Manufacturing, Trading and Profit and Loss Account.

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Balance Sheet has two sides. On the left hand side, the “liabilities” of the business are shown while on the right hand side the assets of the business appear. These two terms have been explained later in the unit.

It will be useful here to quote definitions of the Balance Sheet given by some prominent writers. According to Palmer, “The Balance Sheet is a statement at a given date showing on one side the trader’s property and possessions and on the other side his liabilities.” According to Freeman, “A Balance Sheet is an itemised list of the assets, liabilities and proprietorship of the business of an individual at a certain date.” The definition given by the American Institute of Certified Public Accountants makes the meaning of Balance Sheet more clear. According to it, Balance Sheet is “a list of balances of the asset and liability accounts. This list depicts the position of assets and liabilities of a specific business at a specific point of time.”

Proforma of Balance Sheet and Principle of Marshalling

Marshalling: There is no prescribed form of Balance Sheet for a sole proprietary and partnership firm.² However, the principle of marshalling is applied while arranging the assets and liabilities in the balance sheet of a firm. Marshalling refers to arrangement of assets and liabilities in the balance sheet in any of the following order:

1. Liquidity Order

2. Permanency Order

1. Liquidity Order: In case a concern adopts liquidity order, the assets which are more readily convertible into cash come first and those which cannot be so readily converted come next and so on. Similarly, those liabilities which are payable first come first, and those payable later, come next and so on. A proforma of Balance Sheet according to liquidity order is given below:

BALANCE SHEET

as on

<i>Liabilities</i>	₹	<i>Assets</i>	₹
Bank Overdraft	.....	Cash in Hand	.....
Outstanding Expenses	.....	Cash at Bank	.....
Bills Payable	.....	Prepaid Expenses	.....
Sundry Creditors	.....	Bills Receivable	.....
Long-term Loans	.....	Sundry Debtors	.....
Capital	.....	Closing Stock:	
		Raw Materials	.....
		Work-in-Progress	.....
		Finished Goods	.....
		Plant and Machinery	.....
		Furniture	.....
		Building	.....
		Land	.....
		Goodwill	.....
	_____	

2. In case of Joint Stock Companies the proforma of balance sheet has been prescribed by Schedule III (Part-I) of the Companies Act, 2013.

2. **Permanency Order:** In case of permanency order, assets which are more permanent come first, less permanent come next and so on. Similarly, liabilities which are more permanent come first, less permanent come next and so on. In other words, an asset which will be sold in the last or a liability which will be paid in the last come first and that order is followed both for all assets and liabilities. In case a balance sheet is to be prepared according to permanency order, arrangement of assets and liabilities will be reversed than what has been shown above in case of liquidity order.

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Distinction between Profit & Loss Account and Balance Sheet

The points of distinction between Profit & Loss Account and Balance Sheet are as under:

- (i) A profit and loss account shows the profit or loss made by the business during a particular period. While a balance sheet shows the financial position of the business on a particular date.
- (ii) A profit and loss account incorporates those items which are of a revenue nature while a balance sheet incorporates those items which are of a capital nature.
- (iii) Of course, both profit and loss account and the balance sheet are prepared from the Trial Balance. However, the accounts transferred to the profit and loss account are finally closed while the accounts transferred to the balance sheet represent those accounts whose balances are to be carried forward to the next year.

Difference between Trial Balance and Balance Sheet

The difference between trial balance and balance sheet can be put as under:

- (a) **Meaning:** A trial balance is a statement containing various ledger balances on a particular date while a balance sheet is a statement of various assets and liabilities of the business on a particular date.
- (b) **Objective:** The objective of preparation of a trial balance is to check the arithmetical accuracy of the books of account of the business, while the objective of preparation of a balance sheet is to ascertain the financial position of the business.
- (c) **Items covered:** A trial balance contains all items relating to incomes, expenses, assets and liabilities while a balance sheet incorporates only assets and liabilities.
- (d) **Preparation:** A trial balance is prepared before preparation of a balance sheet. In other words, the preparation of a trial balance is independent of the preparation of a balance sheet. While a balance sheet is prepared not only on the basis of trial balance but also of any additional information which may not have been incorporated in the trial balance.

(e) **Use:** A trial balance is meant only for internal use while a balance is prepared both for internal as well as external use.

Important Points Regarding Balance Sheet

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1. **Liabilities:** The term “Liabilities” denotes claims against the assets of a firm, whether those of owners of the business or of the creditors. As a matter of fact, the term “Equity” is more appropriate than the term “Liabilities”. This is supported by the definition given by American Accounting Association. According to this Association, Liabilities are “claims of the creditors against the enterprise arising out of past activities that are to be satisfied by the disbursement or utilisation of corporate resources”. While the term “Equity” stands both for owners equity (owners claims) as well as the outsiders equity (outsiders claims). However, for the sake of convenience, we are using the term “Liabilities” for the purposes of this book.

Liabilities can be classified into two categories:

(i) Current Liabilities (ii) Long-Term or Fixed Liabilities

Current liabilities: The term “Current Liabilities” is used for such liabilities which are payable within a year from the date of the Balance Sheet either out of existing current assets or by creation of new current liabilities. The broad categories of current liabilities are as follows:

- (a) Accounts Payable, *i.e.*, bills payable and trade creditors.
- (b) Outstanding Expenses, *i.e.*, expenses for which services have been received by the business but for which payments have not been made.
- (c) Bank Overdraft.
- (d) Short-term Loans, *i.e.*, loans from Bank which are payable within one year from the date of the Balance Sheet.
- (e) Advance payments received by the business for the services to be rendered or goods to be supplied in future.

Fixed liabilities: All liabilities other than Current Liabilities come within this category. In other words, these are the liabilities which do not become due for payment in one year and which do not require current assets for their payment.

2. **Assets:** The term “Assets” denotes the resources acquired by the business from the funds made available either by the owners of the business or others. It thus includes all rights or properties which a business owns. Cash, investments, bills receivable, debtors, stock of raw materials, work-in-progress and finished goods, land, buildings, machinery, trademarks, patent rights, etc., are some examples of assets.

Assets may be classified into the following categories:

- (a) **Current assets:** Current Assets are those assets which are acquired with the intention of converting them into cash during the normal business

operations of the enterprise. According to Grady, “the term Current Assets is used to designate cash and other assets or resources commonly identified as those which are reasonably expected to be realised in cash or sold during the normal operating cycle of the business.” Thus, the term “Current Assets” includes cash and bank balances, stocks of raw materials, work-in-progress and finished goods, debtors, bills receivable, short-term investments, prepaid expenses, etc.

- (b) **Liquid assets:** Liquid Assets are those assets which are immediately convertible into cash without much loss. Liquid Assets are a part of current asset. In computing liquid assets, stock of raw materials, work-in-progress and finished goods and prepaid expenses are excluded while all other current assets are taken.
- (c) **Fixed assets:** Fixed assets are those assets which are acquired for relatively long periods for carrying on the business of the enterprise. They are not meant for resale. Land and building, machinery, furniture are some of the examples of Fixed Assets. Sometimes, the term “Block Capital” is also used for them.
- (d) **Intangible assets:** Intangible Assets are those assets which cannot be seen and touched. Goodwill, patents, trademarks, etc., are some examples of Intangible Assets.
- (e) **Fictitious assets:** There are assets not represented by tangible possession or property. Examples of such assets are formation expenses incurred for establishing a business such as registration charge paid to the Registrar of joint stock companies for getting a company incorporated, discount on issue of shares, debit balance in the Profit and Loss Account when shown on the assets side in case of a joint stock company etc.

Valuation of Assets: The following requirements of various accounting standards (ASs) should be kept in mind while valuing assets.

- (i) The cost of a fixed asset should comprise its purchase price and any attributable costs of bringing the asset to its working condition for its intended use. (AS 10)
- (ii) Goodwill should be recorded in the books only when some consideration in money or money’s worth has been paid for it. (AS 10)
- (iii) The direct costs incurred in developing the patents should be capitalised, and written off over their legal term of validity or over their working life, whichever is shorter. (AS 10)
- (iv) Amount paid for knowhow for the plants, lay-out and designs of building and/or design of the machinery should be capitalised under

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the relevant asset heads, such as buildings, plants and machinery, etc., (AS 10)

- (v) If the recoverable amount of an asset is less than its carrying amount, *i.e.*, it has become an impaired asset, the carrying amount of the asset should be reduced to its recoverable amount. That reduction is an impairment loss. Impairment loss should be recognised as an expense in the statement of profit and loss immediately, unless the asset is carried at revalued amount in accordance with another Accounting Standard (see Accounting Standard (AS) 10, Accounting for Fixed Assets), in which case any impairment loss of a revalued asset should be treated as a revaluation decrease under that Accounting Standard. (AS 28)
- (vi) The current assets are meant for converting into cash during the normal operating cycle of business, hence, they are valued on the principle of “cost or market price whichever is less”.
- (vii) Assets and liabilities should be adjusted for events occurring after the balance sheet date that provide additional evidence to assist the estimation of amounts relating to conditions existing at the balance sheet date or that indicates that the fundamental accounting assumption of going concern (*i.e.*, the continuance of existence or substratum of the enterprise) is not appropriate. (AS 4)

Illustration 8.8. From the following balance extracted from the books of M/s Rajendra Kumar Gupta & Co., pass the necessary closing entries, prepare a Trading and Profit and Loss Account and a Balance Sheet.

Particulars	₹	Particulars	₹
Opening Stock	1,250	Plant and Machinery	6,230
Sales	11,800	Returns Outwards	1,380
Depreciation	667	Cash in hand	895
Commission (Cr.)	211	Salaries	750
Insurance	380	Debtors	1,905
Carriage Inwards	300	Discount (Dr.)	328
Furniture	670	Bills Receivable	2,730
Printing Charges	481	Wages	1,589
Carriage Outwards	200	Returns Inwards	1,659
Capital	9,228	Bank Overdraft	4,000
Creditors	1,780	Purchases	8,679
Bills Payable	541	Petty Cash in hand	47
		Bad Debts	180

The value of stock on 31st December, 2017 was ₹3,700.

Solution:

JOURNAL

Date	Particulars	Dr. Amt ₹	Cr. Amt ₹
	Trading A/c	Dr. 13,477	
	To Opening Stock A/c		1,250
	To Purchases A/c		8,679
	To Wages A/c		1,589
	To Returns Inward A/c		1,659
	To Carriage Inward A/c		300
	(For closing all accounts to be debited to Trading A/c)		

Date	Particulars	Dr. Amt ₹	Cr. Amt ₹
	Sales A/c Dr.	11,800	
	Returns Outward A/c Dr.	1,380	
	To Trading A/c		13,180
	(For closing all accounts to be credited to the Trading A/c)		
	Trading A/c Dr.	3,403	
	To Profit and Loss A/c		3,403
	(For transfer of Gross Profit)		
	Profit and Loss A/c Dr.	2,986	
	To Depreciation A/c		667
	To Insurance A/c		380
	To Printing Charges A/c		481
	To Carriage Outward A/c		200
	To Salaries A/c		750
	To Discount A/c		328
	To Bad Debts A/c		180
	(For closing all indirect and selling expenses accounts)		
	Commission A/c Dr.	211	
	To Profit and Loss A/c		211
	(For closing commission account)		
	Profit and Loss A/c Dr.	628	
	To Capital A/c		628
	(For transferring Net Profit to Capital Account)		

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TRADING AND PROFIT & LOSS ACCOUNT for the year ending 31st December, 2017

Particulars	₹	Particulars	₹
To Opening Stock	1,250	By Sales	11,800
To Purchases	8,679	Less: Returns	
Less: Returns Outward	<u>1,380</u>	Inwards	<u>1,659</u>
To Wages	1,589	Closing Stock	3,700
To Carriage Inward	300		
To Gross Profit c/d	<u>3,403</u>		
	<u>13,841</u>		<u>13,841</u>
To Depreciation	<u>667</u>	By Gross Profit b/d	<u>3,403</u>
To Insurance	380	By Commission	211
To Printing Charges	481		
To Carriage Outwards	200		
To Salaries	750		
To Discount	328		
To Bad Debts	180		
To Net Profit	<u>628</u>		
	<u>3,614</u>		<u>3,614</u>

BALANCE SHEET as on 31st December, 2017

Liabilities	₹	Assets	₹
Bills Payable	541	Cash	895
Creditors	1,780	Petty Cash	47
Bank Overdraft	4,000	Bills Receivable	2,730
Capital	9,228	Debtors	1,905
Add: Net Profit	<u>628</u>	Closing Stock	3,700
		Plant and Machinery	6,230
		Furniture	670
	<u>16,177</u>		<u>16,177</u>

Illustration 8.9. From the following Trial Balance prepare the Manufacturing Account, Trading and Profit and Loss Account for the year ending 31st March, 2017 and the Balance Sheet as on that date:

NOTES

Particulars	Debit ₹	Credit ₹
Shri Banker's Capital Account	41,000	
Shri Banker's Drawing Account	6,100	
Mrs Banker's Loan Account		4,000
Sundry Creditors		45,000
Cash in Hand	250	
Cash at Bank	4,000	
Sundry Debtors	40,500	
Patents	2,000	
Plant and Machinery	20,000	
Land and Buildings	26,000	
Purchases of Raw Materials	35,000	
Raw Material as on 1.4.2016	3,500	
Work-in-process as on 1.4.2016	2,000	
Finished Stock as on 1.4.2016	18,000	
Carriage Inwards	1,100	
Wages	27,000	
Salary of Works Manager	5,600	
Factory Expenses	3,400	
Factory Rent and Taxes	2,500	
Royalties (paid on sales)	1,200	
Sales (<i>less</i> Returns)		1,23,400
Advertising	3,000	
Office Rent and Insurance	4,800	
Printing and Stationery	1,000	
Office Expenses	5,800	
Carriage Outwards	600	
Discounts	1,400	2,100
Bad Debts	750	
	<u>2,15,500</u>	<u>2,15,500</u>

The Stock on 31st March, 2017 was as follows:

₹4,000 Raw Materials, ₹4,500 Work-in-progress and ₹28,000 Finished Goods.

Solution:

MANUFACTURING ACCOUNT
for the year ending March 31, 2017

Particulars	₹	Particulars	₹
To Opening Work-in-process	2,000	By Transfer to Trading Account (cost of finished goods produced)	71,600
To Raw Materials used:		By Closing Work-in-process	4,500
Opening Stock	3,500		
Add: Purchases	<u>35,000</u>		
	38,500		
Less: Closing Stock	<u>4,000</u>		
	34,500		
To Carriage Inwards	1,100		
To Wages	27,000		
To Salary of Works Manager	5,600		
To Factory Expenses	3,400		
To Factory Rent and Taxes	<u>2,500</u>		
	<u>76,100</u>		<u>76,100</u>

TRADING AND PROFIT & LOSS ACCOUNT
for the year ending March 31, 2017

*Introduction to Double
Entry System of
Accounting-III*

Particulars	₹	Particulars	₹
To Opening Stock of Finished Goods	18,000	By Sales	1,23,400
To Manufacturing A/c (Cost of goods produced)	71,600	By Closing Stock of Finished Goods	28,000
To Gross Profit c/d	<u>61,800</u>		
	<u>1,51,400</u>		<u>1,51,400</u>
To Royalties	1,200	By Gross Profit b/d	61,800
To Advertising	3,000	By Discount received	2,100
To Office Rent and Insurance	4,800		
To Printing and Stationery	1,000		
To Office Expenses	5,800		
To Carriage Outwards	600		
To Bad Debts	750		
To Discount Allowed	1,400		
To Net Profit carried to Capital Account	<u>45,350</u>		
	<u>63,900</u>		<u>63,900</u>

NOTES

BALANCE SHEET
as on 31st March, 2017

Particulars	₹	Particulars	₹
Sundry Creditors	45,000	Current Assets:	
Mrs. Banker's Loan	4,000	Cash in hand	250
Capital Account		Cash at Bank	4,000
Balance on		Sundry Debtors	40,500
1.4.2016	41,000	Closing Stock:	
Profit	<u>45,350</u>	Raw Materials	4,000
	86,350	Work-in-process	4,500
Less: Drawings	<u>6,100</u>	Finished goods	36,500
	80,250	<u>28,000</u>	
		Fixed Assets:	
		Patents	2,000
		Plant and Machinery	20,000
		Land and Buildings	26,000
	<u>1,29,250</u>		<u>1,29,250</u>

Accounting from Incomplete Records

Up till now, we have seen the preparation of Final Accounts in the double-entry system. Accounting from incomplete records comprising of statements of affairs methods will be discussed in detail in the next unit.

Check Your Progress

3. What is the term given to profit disclosed by the Trading Account?
4. State the principle on which the valuation of closing stock is done.
5. State the entry for Salaries less Tax in the Profit and Loss Account.
6. What is the difference between cash discount and trade discount on account of disclosure?

8.4 ANSWERS TO CHECK YOUR PROGRESS QUESTIONS

NOTES

1. Ledger is the accounting book whose summarized form is known as the Trial Balance.
2. The Balance method of the preparation of Trial Balance is used for the preparation of the financial statements.
3. The profit disclosed by the Trading Account is termed as Gross Profit.
4. The closing stock is valued on the basis of 'cost or market price which is less' principle.
5. In the case for Salaries less Tax entry in the Profit and Loss Account, the amount of gross salaries should be charged to the Profit and Loss Account, while the tax deducted by the employer will be shown as a liability in the Balance Sheet of the business till its is deposited with the Tax Authorities.
6. On account of disclosure, the trade discount is shown as reduction in the invoice itself, while cash discount is not shown in the invoice. Moreover, trade discount account is not opened in the ledger, while cash discount account is opened in the ledger.

8.5 SUMMARY

- The accuracy of the books of accounts is determined by means of preparing a Trial Balance. Having determined the accuracy of the books of accounts every businessman is interested in knowing about two more facts. They are: (i) Whether he has earned a profit or suffered a loss during the period covered by the Trial Balance, (ii) Where does he stand now? In other words, what is his financial position?
- The determination of the Profit or Loss is done by preparing a Trading and Profit and Loss Account (or an Income Statement). While the financial position is judged by means of preparing a Balance Sheet of the business. The two statements together, i.e., Income Statement and the Balance Sheet, are termed as Final Accounts. As the term indicates, Final Accounts means accounts which are prepared at the final stage to give the financial position of the business.
- Trading Account gives the overall result of trading, i.e., purchasing and selling of goods. In other words, it explains whether purchasing of goods and selling them has proved to be profitable for the business or not. It takes into account on the one hand the cost of goods sold and on the other the value for which they have been sold away.

- The Trading Account simply tells about the gross profit or loss made by a businessman on purchasing and selling of goods. It does not take into account the other operating expenses incurred by him during the course of running the business. All such expenses are charged to the Profit and Loss Account.
- Having prepared the Manufacturing, Trading and Profit and Loss Account, a businessman will like to know the financial position of his business. For this purpose, he prepares a statement of his assets and liabilities as on a particular date. Such a statement is termed as “Balance Sheet”. It is a classified summary of the various remaining accounts after accounts relating to Incomes and Expenses have been closed by transfer to Manufacturing, Trading and Profit and Loss Account.

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8.6 KEY WORDS

- **Profit & Loss Account:** It is an account presenting the revenues and expenses of an enterprise for an accounting period and shows the excess of revenues over expenses and vice-versa. It is also known as Income Statement.
- **Trading Account:** It is an account giving the overall result of trading, i.e., purchasing and selling of goods.
- **Balance Sheet:** It refers to a statement of financial position of an enterprise as at a given period.

8.7 SELF ASSESSMENT QUESTIONS AND EXERCISES

Short Answer Questions

1. Write a short note on the objects of preparing a Trial Balance.
2. Briefly discuss the characteristics of final accounts.
3. Explain the importance of Trading Account.
4. What are the important information provided by the Profit and Loss Account?
5. Write a short note on Manufacturing Account.
6. Distinguish between Profit and Loss Account and Balance Sheet.

Long Answer Questions

1. Describe the different methods of preparation of a Trial Balance.
2. Discuss the important points regarding Trading Account.

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3. Examine the important points to be kept in mind while preparing a Profit and Loss Account.
4. Illustrate the different forms of Marshalling.
5. Discuss the differences between Trial Balance and Balance Sheet.
6. What are the important points regarding the preparation of Balance Sheet?

8.8 FURTHER READINGS

Maheshwari, S.N., Suneel K. and Sharad K. 2017. *Advanced Accountancy*, Vol I. New Delhi: Vikas Publishing House.

Maheshwari, S.N., Suneel K. and Sharad K. 2018. *An Introduction to Accountancy*, 12th edition. New Delhi: Vikas Publishing House.

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BLOCK-IV
ACCOUNTING FROM INCOMPLETE RECORDS

**UNIT 9 INTRODUCTION TO
ACCOUNTING FROM
INCOMPLETE RECORDS-I**

NOTES

Structure

- 9.0 Introduction
- 9.1 Objectives
- 9.2 Accounting from incomplete records
 - 9.2.1 Statement of Affairs Methods
 - 9.2.2 Conversion Method
- 9.3 Answers to Check Your Progress Questions
- 9.4 Summary
- 9.5 Key Words
- 9.6 Self Assessment Questions and Exercises
- 9.7 Further Readings

9.0 INTRODUCTION

In Unit 6, we have explained that there are two systems of recording transactions in the books of a business (i) Single Entry System, and (ii) Double Entry System. The system of double entry has already been explained in the preceding units. As a matter of fact, the system has been followed by us so far throughout the book.

Single Entry System may be defined as any system which is not exactly the Double Entry System. In other words, Single Entry System may consist of: (i) Double entry in respect of certain transactions such as cash received from debtors, cash paid to creditors etc.; (ii) Single Entry in respect of certain transactions such as cash purchases, cash sales, expenses in current, fixed assets purchased etc.; (iii) No Entry in respect of certain transactions such as depreciation, bad debts etc. Thus, a business is said to be using Single Entry System if it is not following completely the principles of Double Entry System of Book-keeping. This is also why single entry system is often referred to as accounting from incomplete records.

Kohler defines Single Entry System as, “A system of book-keeping in which as a rule only records of cash and of personal accounts are maintained, it is always incomplete double entry varying with the circumstances”. In this unit, you will learn about the features and disadvantages of single entry system along with the methods of computation of profit.

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9.1 OBJECTIVES

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

- Explain the features and disadvantages of accounting from incomplete records
- Describe the net worth method of calculation of profit
- Discuss the conversion method of computation of profit

9.2 ACCOUNTING FROM INCOMPLETE RECORDS

The salient features of the Single Entry System can be put as follows:

- Maintenance of personal accounts:** Usually under this system personal accounts are maintained while real and nominal accounts are avoided. On account of this reason some accountants define it as a system where only personal accounts are maintained.
- Maintenance of cash book:** A Cash Book is maintained, which usually mixes up both the personal transactions and the business transactions.
- Dependence on original vouchers:** In order to collect the necessary information one has to depend on original voucher. For example, the figure of credit purchases may not be readily available, it may have to be found out on the basis of original invoices received from the suppliers. Similarly, the total figure of sales at the end of a particular period may have to be found out on the basis of the invoices which have been issued by the business from time to time.
- No uniformity:** The system may differ from firm to firm as per their individual requirements and conveniences.
- Suitability:** The system is suitable in case of small, proprietary or partnership concerns. Limited companies can not adopt this system on account of legal requirements.

Disadvantages

The system suffers from several disadvantages:

- Arithmetical accuracy cannot be checked:** In case of Double Entry System of Book-keeping Trial Balance is prepared to check the arithmetical accuracy of the books of accounts. This is possible because every transaction is recorded at two places. In case of Single Entry System, this is not done. Hence, Trial Balance cannot be prepared and the arithmetical accuracy of the books of accounts cannot be checked.

This increases the possibility of more frauds and misappropriations as compared to the Double Entry System of Book-keeping.

- (ii) **True profits cannot be known:** In the absence of complete information for sales, purchases and other expenses, it is not possible to draw the Profit and Loss Account. Hence, the true profit or loss made or suffered by the business cannot be known.
- (iii) **Financial position of the business cannot be judged:** In the absence of true figure of profit and correct information about the assets and liabilities of the business, the Balance Sheet cannot be drawn up to give a correct picture of the financial position of the business on a particular date.
- (iv) **Make planning and decision-making difficult:** The system does not provide accurate figures about the performance of the business and its financial position. For example, separate figures of gross profit, net profit and sales are not available. Thus, the ratio of gross profit to sales or net profit to sales cannot be found out. Similarly in the absence of any information about the cost of goods sold, the proportion of different elements of cost of sales cannot be found out. In the absence of such information, it becomes difficult for the proprietor of the business to know the reasons of his improving or deteriorating profitability and financial position. Thus, he is not in a position to compare, plan and take sound decision for the prosperity of the business. Moreover, it may be difficult for him to find the real value of his business in the event of his deciding to sell the business.

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Computation of Profit

The profit (or loss) in case of a business maintaining accounts according to Single Entry System can be computed by two methods:

- (i) Net Worth Method. (Statement of Affairs Method)
- (ii) Conversion Method. (Conversion of Single entry into Double Entry System)

9.2.1 Statement of Affairs Methods

Net worth method is also called the statement of affairs method or capital comparison method. According to this method, profit or loss of the business is determined by making a comparison between the capitals of two dates of a period. If there are other capital related items such as drawing, additional capital, interest on capital etc. are to be adjusted to ascertain the amount of profit or loss.

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According to this method, the profit or loss made by the business is computed by comparing the net worth (or capital) of the business on two different dates. For example, if the capital of the business on 1.1.2010 was ₹80,000 and it is ₹90,000 on 31st December, 2010, it can be said that the business has made profit of ₹10,000 during the period.

Adjustments. Following adjustments are required for determination of the profit in case of this method.

- (i) **Adjustment for drawings:** The proprietor may withdraw money from the business for his personal use. In the absence of any such withdrawal, the capital at the end of accounting period would have been more by the amount of money withdrawn by him. Thus, the amount of drawings should be added back to the capital at the end of the accounting period to find out his true capital on that date.
- (ii) **Adjustment for capital introduced:** The proprietor may introduce further capital in the business during the course of the accounting year. This will increase the capital of the proprietor at the end of the accounting year. It is, therefore, necessary to reduce the amount of capital by the amount of capital introduced by the proprietor during the year in order to ascertain the real increase in the capital of the proprietor on account of profit earned by him during the course of the accounting year.

Illustration 9.1. From the following information, prepare a Statement of Profit showing the amount of profit earned by 'A' during the year 2017.

<i>Particulars</i>	₹
Capital as on 31.12.2017	90,000
Capital as on 1.1.2017	80,000
A's Drawings	5,000
Further capital introduced by A	3,000

Solution:

STATEMENT OF PROFIT for the year 2017

<i>Particulars</i>	₹
Capital as on 31.12.2017	90,000
Add: Drawings	5,000
	<u>95,000</u>
Less: Further capital introduced by A	3,000
	<u>92,000</u>
Less: Capital as on 1.1.2017	80,000
Profit made during the year	<u><u>12,000</u></u>

Computation of net worth or capital: On the basis of whatever has been stated in the preceding pages, it is clear that in order to determine profit or loss made during a period on the basis of net worth method, it is necessary to know the net worth or capital both in the beginning as well as at the end of the accounting period. This is done by preparing a Statement of Affairs.

Statement of Affairs is a statement giving the assets and liabilities of the business on a particular date. It is virtually the Balance Sheet of the business. However, the term Balance Sheet is used for the Statement of Assets and Liabilities in the Double Entry System of Book-keeping where balances are taken from the ledger. In case of Single Entry System, all the assets and liabilities which appear in the Statement of Affairs are not necessarily taken from the ledger accounts on account of incomplete recording of the transactions. Moreover, the term Balance Sheet is used for statement which shows the correct financial position of the business. In case of Single Entry System, it may not be possible to prepare a statement which shows the correct financial position of the business since the information is collected from different sources which may include not only the books of accounts but also other sources which may not be hundred per cent reliable. For example, estimate about drawings may have to be made on the basis of the estimated living expenses of the proprietor of the business and also other estimated payments which might have been made on his behalf.

Steps for preparing Statement of Affairs

The following steps may be taken for preparing the Statement of Affairs.

- (i) In most cases in single entry system, a cash book is maintained. In case this has been done, the cash and the bank balances can be taken from the cash book. In the absence of a proper cash book, cash balance may have to be found out by preparing a receipts and payments account on the basis of information collected from the proprietor of the business and the statement of accounts which might have been received or sent by the proprietor from/to his debtors and creditors. Information regarding other business expenses can be collected from the salaries register of his employees, petty cash book, if any, maintained by him, etc., and the actual cash balance available with the business. The balance at the bank can be verified from the bank pass book or Statement of Account from the Bank.
- (ii) A list of sundry debtors and creditors should be prepared. This may not be difficult because in most cases, a record of personal accounts is maintained under the single entry system.

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- (iii) The value of the fixed assets like building, plant, furniture, etc., should be ascertained from vouchers or other documents available with the business. A reasonable charge for depreciation should also be made and the assets should be shown in the Statement of Affairs after charging depreciation.
- (iv) A physical verification of the stock should be taken and the value of the stock in hand should be ascertained on the basis of the different invoices received from suppliers from time to time in respect of the goods purchased.
- (v) The amount of outstanding expenses and the accrued income should also be determined. Last year's figures about these items may be of considerable help in this respect.
- (vi) The excess of assets over liabilities should be found out and this will denote the net worth or the capital of the business on the date on which the Statement of Affairs has been prepared.

Difference between Balance Sheet and Statement of Affairs

Both balance sheet and statement of affairs show the financial position of a business on a particular date. However, they differ from each other in several ways:

- (i) A balance sheet is prepared from the Trial Balance extracted on the basis of ledger accounts. While a statement of affairs is prepared from ledger accounts and several additional informations available from other sources.
- (ii) Balance sheet is assumed to show the true financial position of the business while it may not be the case in case of statement of affairs.
- (iii) The omissions of assets and liabilities cannot be easily traced in a statement of affairs while such omissions can be traced in a balance sheet.
- (iv) A balance sheet is basically prepared to show the financial position of a business on a particular date. While a statement of affairs helps in ascertaining not only the financial position but also the profit made by the business during a particular period.
- (v) The capital account balance shown in the balance sheet is taken from the ledger. While the capital account balance in case of a statement of affairs is the excess of assets over liabilities on a particular date.

Sole-proprietary Firms

Illustration 9.2. A keeps his books by single entry system. His position on January 1, 2017 was as follows:

Cash at Bank ₹5,000; Cash in hand ₹1,000; Stock ₹7,000; Sundry Debtors ₹8,400; Machinery and Plant ₹6,500; Bills Receivable ₹2,600; Creditors ₹2,500; Bills Payable ₹4,000.

On December 31, 2017, his position was as follows:

Cash at Bank ₹4,300; Cash in hand ₹1,700; Stock ₹9,000; Sundry Debtors ₹6,000; Machinery and Plant ₹6,500; Bills Payable ₹3,200; Bill Receivable ₹3,200; Creditors ₹1,600. During the year A introduced further capital of ₹2,000 and his drawings were ₹800 per month.

Depreciate Machinery and Plant by 5% and create a Reserve for Bad and Doubtful Debts @ 5%.

From the above information, prepare a statement showing the profit or loss made by him for the year ended December 31, 2017.

Solution:

A's STATEMENT OF AFFAIRS
as on 1.1.2017

Liabilities	₹	Assets	₹
Creditors	2,500	Cash at Bank	5,000
Bills Payable	4,000	Cash in hand	1,000
Capital (balancing figure)	24,000	Stock	7,000
		Debtors	8,400
		Machinery and Plant	6,500
		Bills Receivable	2,600
	<u>30,500</u>		<u>30,500</u>

A's STATEMENT OF AFFAIRS
as on 31.12.2017

Liabilities	₹	Assets	₹
Bills Payable	3,200	Cash at Bank	4,300
Creditors	1,600	Cash in hand	1,700
Capital (balancing figure)	25,275	Stock	9,000
		Debtors	6,000
		Less: Provision @ 5%	300
		Machinery and Plant	6,500
		Less: Dep. @ 5%	325
		Bills Receivable	3,200
	<u>30,075</u>		<u>30,075</u>

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STATEMENT OF PROFIT
for the year ending 31.12.2017

NOTES

Particulars	₹
Capital as on 31.12.2017	25,275
Add: Drawings made during 2017 (₹800×12)	<u>9,600</u>
	34,875
Less: Fresh capital introduced	<u>2,000</u>
	32,875
Less: Capital as on 1.1.2017	<u>24,000</u>
Profit made during 2017	<u>8,875</u>

Illustration 9.3. Mahesh, who keeps his books by Single Entry, has submitted returns to the Income Tax Authorities showing his income to be as follows:

	₹
Year ending December 31, 2011	7,350
Year ending December 31, 2012	7,400
Year ending December 31, 2013	7,870
Year ending December 31, 2014	13,750
Year ending December 31, 2015	12,140
Year ending December 31, 2016	9,26

The Income Tax Officer is not satisfied as to the accuracy of the accounts submitted. You are instructed to assist in establishing their correctness, and for that purpose you are supplied with the following information:

- Business liabilities and assets as 31st December, 2010 were: Debtors ₹1,450; Cash at Bank and in hand, ₹9,470; Stock, ₹5,420 (at selling price which is 25% above cost); Creditors, ₹7,320.
- Mahesh owed his brother, ₹4,000 on 31st December, 2010. On 15th February, 2013 he repaid this amount and on 1st January, 2016, he lent his brother ₹3,000.
- Mahesh owns a house which he purchased in 2016 for ₹20,000 and a car purchased in 2012 for ₹7,500. In 2015, he bought 10,000 shares in X Ltd. for ₹7,500.
- In 2016 ₹3,000 was stolen from his house.
- Mahesh estimates that living expenses have been: 2011, ₹3,000; 2012, ₹4,000; 2013, ₹6,000; 2014, 2015 and 2016, ₹7,000 per annum exclusive of the amount stolen.
- On 31st December, 2017, the business Liabilities and Assets were: Creditors ₹8,400, Debtors, ₹5,920; Cash in hand and at bank, ₹19,450 and Stock ₹6,740 (at selling price which shows a gross profit of 25%).

From the information submitted, prepare a statement showing whether or not the income declared by Mahesh is correct.

Solution:

STATEMENT OF AFFAIRS

as on 31.12.2016

Liabilities	₹	Assets	₹
Creditors	8,400	Cash in hand and at Bank	19,450
Capital (balancing figure)	22,025	Debtors	5,920
		Stock	6,740
		Less: Profit	1,685*
	<u>30,425</u>		<u>30,425</u>

*The percentage of gross profit to sales is 25%. The amount of profit involved in the stock of ₹6,740 (at selling price) has been computed as follows:

$$\frac{6,704 \times 25}{100} = 1,685$$

STATEMENT OF AFFAIRS

as on 31.12.2010

Liabilities	₹	Assets	₹
Creditors	7,320	Cash at Bank and in hand	9,470
Capital (balancing figure)	7,936	Debtors	1,450
		Stock	5,420**
		Less: Profit 20%	1,084
	<u>15,256</u>		<u>15,256</u>

**The stock is appearing at selling price which includes a profit of 25% on cost. In other words, if cost is ₹100, the selling price is ₹125. The amount of profit involved in the stock or ₹5,420 has been computed as follows:

$$\frac{5,420 \times 25}{125} = 1,084 \text{ ₹1,084}$$

STATEMENT OF PROFIT

for the period from 1.1.2011 to 31.12.2016

Particulars		₹
Capital as on 31.12.2016 as per Statement of Affairs		22,025
Add: Living expenses during this period:		
20011	3,000	
20012	4,000	
20013	6,000	
20014 to 2016	<u>21,000</u>	34,000
		<u>56,025</u>
Less: Capital as on 31.12.2010 as per Statement of Affairs		7,936
Profit as per Books during the period:		<u>48,089</u>
Add: Undisclosed incomes:*		
(a) Repayment of Brother's loan	4,000	
(b) Money lent to Brother	3,000	
(c) Purchase of car	7,500	
(d) Purchase of shares	7,500	
(e) Amount stolen from the house	<u>3,000</u>	25,000
		<u>73,089</u>
Actual Income during the period		

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Particulars			₹
Less:	Declared Income		
	2011	7,350	
	2012	7,400	
	2013	7,870	
	2014	13,750	
	2015	12,140	
	2016	<u>9,260</u>	<u>57,770</u>
	Excess of Actual Income over Declared Income		<u>15,319</u>

*Any purchase of property or lending of money or repayment of loan etc. during the period 1.1.2011 to 31.12.2016 will be taken as additional income of Mahesh, since only the living expenses have been so far added to the capital at the end of 2016. The house was purchased by Mahesh in 2006. It does not fall within the period from 1.1.2011 to 31.12.2016 and, therefore, it has been excluded. However, repayment of the brother's loan, lending money to his brother, purchase of shares, purchase of car and theft of money from his house have all been added in order to find out his real income.

Partnership Firms

In case of a partnership firm, the balances in the capital accounts of all the partners will have to be considered for ascertainment of the profit made by the business. However, where partners have a fixed capital system (*i.e.*, where current accounts are maintained), the balances in the current accounts should be considered while preparing Statement of Profit. Capital Accounts of the partners should be adjusted for any fresh capital introduced or withdrawn by the partners before ascertaining the combined closing balance of the current accounts.

Illustration 9.4. *A, B and C* were in partnership, and towards the end of 2017 most of their books and records were destroyed in a fire. The Balance Sheet as on 31st December, 2016 was as under:

Liabilities		₹	Assets		₹
Creditors		5,500	Cash		2,400
Capitals:			Debtors		3,600
<i>A</i>	4,500		Stock		6,500
<i>B</i>	3,000		Machinery		1,440
<i>C</i>	<u>1,500</u>	9,000	Fixture and Fittings		600
Current Accounts:			Advance Payments		35
<i>A</i>	145		Current Account:		
<i>B</i>	<u>100</u>	245	<i>C</i>		<u>170</u>
		<u>14,745</u>			<u>14,745</u>

The partners' drawings during 2017 have been proved at *A*: ₹1,400; *B*: ₹1,000 and *C*: ₹650. *A* introduced ₹1,500 as additional capital on July 1, 2017. On 31st December, 2017 the cash was ₹3,200, Debtors ₹4,025, Stock ₹5,900, Advanced Payments ₹25 and Creditors ₹4,540. Machinery is to be depreciated

by 10% per annum and Fixtures and Fittings as 7½%. 5% interest is to be allowed on capitals. No interest is to be charged on drawings. The partners share profits in the proportions of 3 : 2 : 1.

You are required to prepare a statement, showing the net trading profit for the year 2017 and the division of the same between the partners, together with the Balance Sheet as on 31st December, 2017.

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Solution:

A, B and C
STATEMENT OF AFFAIRS
as on 31st December, 2017

<i>Liabilities</i>	₹	<i>Assets</i>	₹
Sundry Creditors	4,540	Cash	3,200
Capital Accounts: (Fixed)		Sundry Debtors	4,025
A	6,000	Stock	5,900
B	3,000	Advance Payments	25
C	<u>1,500</u>	Machinery	1,440
	10,500	Less: Depreciation	<u>144</u>
		Fixtures & Fittings	600
		Less: Depreciation	<u>45</u>
		Combined Current Accounts	555
		(balancing figure)	<u>39</u>
	<u>15,040</u>		<u>15,040</u>

STATEMENT OF PROFIT & LOSS

<i>Particulars</i>	₹	₹
Combined Current Accounts as on 31.12.2017		(Dr.) 39
Add: Drawings: A	1,400	
B	1,000	
C	<u>650</u>	3,050
		<u>3,011</u>
Less: Combined Current Accounts as on 31.12.2016:		
A	145	
B	100	
C	(Dr.) <u>170</u>	75
Profit subject to interest on capitals		<u>2,936</u>
Interest on Capital:		
A (225 + 38)	263	
B	150	
C	<u>75</u>	488
Profit		<u>2,448</u>
Division of Profit		
A		1,224
B		816
C		408

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CURRENT ACCOUNTS

Particulars	A ₹	B ₹	C ₹	Particulars	A ₹	B ₹	C ₹
To Balance b/d			170	By Balance b/d	145	100	
To Drawing	1,400	1,000	650	By Interest on Capitals	263	150	75
To Balance c/d	232	66		By Profit	1,224	816	408
				By Balance c/d			337
	<u>1,632</u>	<u>1,066</u>	<u>820</u>		<u>1,632</u>	<u>1,066</u>	<u>820</u>

A, B, and C

BALANCE SHEET

as on 31st December, 2017

Liabilities	₹	Assets	₹
Sundry Creditors	4,540	Cash	3,200
Capital Accounts (Fixed)		Sundry Debtors	4,025
<i>A</i>	6,000	Stock	5,900
<i>B</i>	3,000	Advance Payments	25
<i>C</i>	<u>1,500</u>	Machinery:	1,440
Current Accounts		<i>Less: Depreciation</i>	<u>144</u>
<i>A</i>	232	Fixtures & Fittings	600
<i>B</i>	<u>66</u>	<i>Less: Depreciation</i>	<u>45</u>
		<i>C's Current Account</i>	337
	<u>15,328</u>		<u>15,238</u>

9.2.2 Conversion Method

The Net Worth Method explained in the preceding pages does not provide a clear picture of the operational results of a business. It does not give information about sales, purchases, gross profit, operating expenses etc. of the business. As a result, a meaningful analysis of the financial statements cannot be done nor effective steps can be taken to improve the financial position of business. It will, therefore, be better to collect all such information from the books of accounts, and other sources which are necessary for preparing Trial Balance of the business. This is done by preparing a Total Debtors Account, a Total Creditors Account, a Bills Receivable Account, a Bills Payable Account and Receipts and Payments Account etc., on the basis of double entry. Account relating to different expenses, incomes, fixed assets and fixed liabilities and outstanding are also prepared with the help of Receipts & Payments Account and additional information available. Thus, the closing balances of different accounts are found out and a Trial Balance prepared. Final accounts can then be prepared in the usual way. Such a method of collecting information as per the requirements of the double entry system of book-keeping, is termed as Conversion Method.

In practice usually Abridged Conversion Method is followed. Under this method, normal accounts are not opened in the ledger, nor a trial balance is prepared. Only such information is collected which is required for preparing the Trading and Profit & Loss Account, and Balance Sheet of the business.

The following steps will be taken for preparing final accounts according to this method:

- Ascertainment of sales
- Ascertainment of purchases
- Ascertainment of stocks
- Ascertainment of cash and bank balances
- Ascertainment of total debtor's balances
- Ascertainment of total creditor's balances
- Ascertainment of bills receivable balances
- Ascertainment of bills payable balance
- Ascertainment of opening capital
- Ascertainment of other balances

You will learn about the preparation of final accounts from incomplete records through conversion method in the next two units.

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Check Your Progress

1. What are some of the other names used for the Net Worth method?
2. Why is it said that the Net Worth method does not provide a clear picture of the operational results of a business?
3. What is the abridged conversion method of preparation of accounts from incomplete records?

9.3 ANSWERS TO CHECK YOUR PROGRESS QUESTIONS

1. Net Worth method is also called the Statement of Affairs method or capital comparison method.
2. The Net Worth Method explained does not provide a clear picture of the operational results of a business. It does not give information about sales, purchases, gross profit, operating expenses etc., of the business.
3. In the Abridged Conversion Method, normal accounts are not opened in the ledger, nor a trial balance is prepared. Only such information is collected which is required for preparing the Trading and Profit and Loss Account, and Balance Sheet of the business.

9.4 SUMMARY

- Kohler defines Single Entry System as, "A system of book-keeping in which as a rule only records of cash and of personal accounts are

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maintained, it is always incomplete double entry varying with the circumstances”.

- The salient features of single entry system includes: maintenance of personal accounts, maintenance of cash book, dependence on original vouchers, no uniformity and suitability.
- The single entry system of accounting suffers from several disadvantages: arithmetical accuracy cannot be checked, true profits cannot be known, financial position of the business cannot be judged and it makes planning and decision-making difficult.
- The profit (or loss) in case of a business maintaining accounts according to Single Entry System can be computed by two methods: Net Worth Method and Conversion Method.
- According to the Statement of Affairs or Net Worth, the profit or loss made by the business is computed by comparing the net worth (or capital) of the business on two different dates. This requires the preparation of Statement of Affairs.
- In the conversion method, the Trial balance is prepared with the preparation of accounts on the basis of double entry and then the final accounts is prepared in the usual way.

9.5 KEY WORDS

- **Single entry system:** It refers to an accounting system in which does not follow completely the principles of Double Entry System of Book-keeping.
- **Net Worth:** It is the same as net assets. It refers to the excess of the book value of assets (other than fictitious assets) of an enterprise over its liabilities.
- **Statement of affairs:** It is a statement giving the assets and liabilities of the business on a particular date.

9.6 SELF ASSESSMENT QUESTIONS AND EXERCISES

Short Answer Questions

1. Write a short note on the salient features of single entry or accounting from incomplete records.
2. What are the disadvantages of single entry system?
3. Briefly describe how conversion method is used for accounting from incomplete records.

Long Answer Questions

1. Discuss the steps for preparing the Statement of Affairs. Also differentiate between Balance Sheet and Statement of Affairs.
2. Mr. Din Dayal did not believe in spending too much time on maintaining the accounts of his business on strictly double entry system, but relied on his Auditors to prepare his Statement at the end of the year in the best manner possible. The following Statement of Affairs had been prepared as on 31st March, 2017.

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STATEMENT OF AFFAIRS

<i>Particulars</i>	₹	<i>Particulars</i>	₹
Capital Account	28,000	Leasehold Land	2,075
Sundry Creditors	3,170	Plant & Machinery	4,940
Bills Payable	2,150	Stock in Trade	9,673
		Book Debts	15,550
		Cash in hand	1,082
	<u>33,320</u>		<u>33,320</u>

On 31st March, 2018, it was learnt that he had introduced further capital of ₹1,000 on 1.7.2017 and he had drawn ₹1,580 on various dates during the year. It was also ascertained that the proprietor had taken ₹75 worth of goods for his own use.

Statements prepared on the same date disclosed that book debts were ₹14,610, Creditors were ₹2,039 and Bills Payable were ₹1,775. The stock was valued at ₹11,417 and the cash in hand amounted to ₹917 on the same date.

You are required to prepare (a) Statement of Profit for the year 2017-2018, and (b) a Statement of Affairs of Din Dayal as on 31.3.2018 taking into consideration the following:

5% reserve to be created on Book Debts.

7½% Depreciation to be written off on Plant & Machinery.

₹125 to be written off the lease.

Interest at 5% on the Capital to be provided.

[Ans. Capital at end ₹28,948; Net Profit after interest ₹166]

3. A and B are carrying on business in partnership sharing profits and losses equally. They were unable to maintain full and complete records. From the available following information compute the profits of the firm and prepare a balance Sheet:

	<i>At the beginning of the year</i>	<i>At the end of the year</i>
	₹	₹
Land and Building (Cost)	50,000	50,000
Machinery (Cost)	60,000	75,000

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Furniture (Cost)	20,000	25,000
Stock	12,000	30,000
Debtors	17,000	22,000
Bank	4,900	5,000
Cash	1,100	5,000
Insurance Policy Premium Paid	5,000	—
Bills Receivables	—	8,000
Creditors	60,000	50,000
Bills Payable	10,000	—

At the beginning of the year the capital of the partners were equal. During the year *A* brought in ₹15,000 and *B* has withdrawn ₹5,000. Insurance policy matured, during the year, for ₹10,000. A sum of ₹4,000 had become bad out of debtors. Provision has to be made for depreciation @10% on Land and Building, Machinery and Furniture.

[Ans. Net Profit ₹36,000; Total Balance Sheet ₹2,01,000]

9.7 FURTHER READINGS

Maheshwari, S.N., Suneel K. and Sharad K. 2017. *Advanced Accountancy*, Vol I. New Delhi: Vikas Publishing House.

Maheshwari, S.N., Suneel K. and Sharad K. 2018. *An Introduction to Accountancy*, 12th edition. New Delhi: Vikas Publishing House.

Jain, S.P. and Narang, K.L. 2001. *Advanced Accountancy*. New Delhi: Kalyani Publishers.

Ahmed, N. 2008. *Financial Accounting*. New Delhi: Atlantic Publishers and Distributors Pvt. Ltd.

UNIT 10 INTRODUCTION TO ACCOUNTING FROM INCOMPLETE RECORDS-II

NOTES

Structure

- 10.0 Introduction
- 10.1 Objectives
- 10.2 Preparation of Trading, Profit and Loss Account from Incomplete Records
- 10.3 Answers to Check Your Progress Questions
- 10.4 Summary
- 10.5 Key Words
- 10.6 Self Assessment Questions and Exercises
- 10.7 Further Readings

10.0 INTRODUCTION

You have learnt in the previous unit that the single entry system of book keeping is called the system of accounting from incomplete records. This is so because the principles of double entry book keeping is not followed completely for each step in the recording and maintenance of accounting records. You also learnt about the Statement of Affairs method with some examples. In the unit, the conversion method was briefly introduced. Conversion method of accounting from incomplete records involves the method of actually collecting information as per the requirements of the double entry system of book-keeping. In this unit, you will learn about steps involved in the preparation of final accounts through this method with the help of illustrations.

10.1 OBJECTIVES

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

- Discuss the figures needed for the preparation of Trading and Profit and Loss Account
- Explain the steps involved in the preparation of final accounts from incomplete records

10.2 PREPARATION OF TRADING, PROFIT AND LOSS ACCOUNT FROM INCOMPLETE RECORDS

Final accounts can be prepared by collecting information as per the requirements of the double entry system of book-keeping. It is called the conversion method.

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As mentioned in the previous unit, in practice usually Abridged Conversion Method is followed. Under this method, normal accounts are not opened in the ledger, nor a trial balance is prepared. Only such information is collected which is required for preparing the Trading and Profit & Loss Account, and Balance Sheet of the business.

It has been mentioned that in accounting from incomplete records, certain figures are missing that are important for the preparation of the Trading and Profit and Loss Account.

The following are generally the figures needed for the preparation of Trading Account are: Opening Stock, Purchases, Direct Expenses, Manufacturing Expenses, Sales and Closing Stock.

For the Profit and Loss A/c the following figures are need: Indirect expenses and losses, Depreciation, Gross Profit and Gains and Incomes, etc.

Lets have a look at the manner in which these information are to be ascertained.

Tutorial Note. It will be advisable for the students to prepare Trading and Profit and Loss Account and Balance Sheet simultaneously. This will help them in finding out the missing information. They should put whatever information has been given in the question in the Final Accounts and then trace the rest of the information required by them for preparing Final Accounts. For example, if Cash Sales have been given, the students should put the amount on the credit side of the Trading Account in the inner column. Since information regarding Total Sales will be needed for Trading Account, the students should prepare Total Debtor Account. The Working Notes should invariably be given.

The following steps will be taken for preparing final accounts according to this method:

1. **Ascertainment of sales:** Sales may be of two types (i) Credit Sales, and (ii) Cash Sales. Credit Sales should be found out by preparing a Total Debtors Account while cash sales should be found out from the Cash Book.

Illustration 10.4. From the following information, find out the Credit Sales:

	₹		₹
Balance of Debtors on 1.1.2017	12,000	Bills Receivable from customers	17,000
Returns Inward	5,000	Bad Debts	1,500
Cash received from customers	45,000	Bills Receivable Dishonoured	3,500
Discount allowed to them	3,000	Debtors on 31.12.2017	10,000

Solution:TOTAL DEBTORS ACCOUNT
(or Sundry Debtors Account)

<i>Particulars</i>	₹	<i>Particulars</i>	₹
To Balance b/d	12,000	By Returns Inward	5,000
To Bill Receivable dishonoured	3,500	By Cash	45,000
To Credit Sales		By Discount	3,000
(balancing figure)	66,000	By Bills Receivable	17,000
		By Bad Debts	1,500
		By Balance c/d	10,000
	<u>81,500</u>		<u>81,500</u>

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The amount of Cash Sales may be given in the Cash Book. However, its amount may have to be ascertained by preparing a Receipts and Payments Account in case complete Cash Book has not been given.

Illustration 10.2. From the following cash transactions ascertain the amount of Cash Sales:

	₹		₹
Cash Balance as on 1.1.2017	5,000	Payment made to Creditors	10,000
Bank Balance as on 1.1.2017	10,000	Cash Purchases	20,000
Cash collected from Debtors	20,000	Cash Balance as on 31.12.2017	10,000
Other Income	5,000	Bank Balance as on 31.12.2017	15,000

Solution:RECEIPTS AND PAYMENTS ACCOUNT
for the year ending 31st December, 2017

<i>Particulars</i>	₹	<i>Particulars</i>	₹
To Balance:		By Creditors	10,000
Cash in Hand	5,000	By Purchases	20,000
To Cash at Bank	10,000	By Balance:	
To Debtors	20,000	Cash in Hand	10,000
To Other Incomes	5,000	Balance at Bank	15,000
To Cash Sales (balancing figure)	<u>15,000</u>		
	<u>55,000</u>		<u>55,000</u>

In the above illustration, cash receipts (including opening cash and bank balances) without taking into account the amount of cash sales amounts to ₹40,000, while cash payments (including closing cash and bank balances) amount to ₹55,000. This means ₹15,000 must have been received from somewhere. There can be three important sources: (i) Cash Sales, (ii) Collections from debtors, and (iii) Introduction of further capital by the proprietor. Since the amount of cash collected from debtors has already been

given the choice falls between introduction of further capital by the proprietor and the sales. In the absence of any other information, it will be proper to presume that cash ₹15,000 is on account of cash sales.

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On the same basis, the amount of cash collected from debtors can be found out. For example, if in the above illustration, the cash sales are given as ₹20,000, and other figures remain the same, the amount of cash collected from debtors can be taken as ₹15,000.

2. Ascertainment of purchases: The purchases may be of two types (i) Credit purchases, and (ii) Cash purchases. The amount of credit purchases can be ascertained by preparing a Total Creditors Account.

Illustration 10.3. From the following information, find out the Credit Purchases for the year 2010.

	₹		₹
Balance of Creditors on 1.1.2017	7,600	Returns Outward	2,400
Cash paid to Creditors	20,000	Bills accepted	4,600
Discount allowed by them	500	Creditors on 31.12.2017	9,500

Solution:

TOTAL CREDITORS ACCOUNT

<i>Particulars</i>	₹	<i>Particulars</i>	₹
To Cash	20,000	By Balance b/d	7,600
To Discount	500	By Credit Purchases	
To Returns Outward	2,400	(balancing figure)	29,400
To Bills Payable A/c	4,600		
To Balance c/d	<u>9,500</u>		
	<u>37,000</u>		<u>37,000</u>

The amount of cash purchases can be ascertained from the Cash Book. In case complete Cash Book has not been given, the amount of cash purchases can be ascertained by preparing a Receipts and Payments Account.

Illustration 10.4. From the following cash transactions, ascertain the amount of cash purchases.

<i>Particulars</i>	₹	<i>Particulars</i>	₹
Balance as on 1.1.2017	10,000	Cash paid to Creditors	40,000
Cash	20,000	Balances as on 31.12.2017	
Bank	30,000	Cash	10,000
Cash receipts from debtors	10,000	Bank	10,000
Cash sales	10,000		

Solution:RECEIPTS AND PAYMENTS ACCOUNT
for the year ending 31st December, 2017

Particulars	₹	Particulars	₹
To Balance b/d:		By Creditors	40,000
To Cash in Hand	10,000	By Cash Purchases	
To Cash at Bank	20,000	(balancing figure)	10,000
To Debtors	30,000	By Balance c/d:	
To Cash Sales	10,000	Cash in Hand	10,000
		Cash at Bank	10,000
	<u>70,000</u>		<u>70,000</u>

NOTES

In the above illustration, total cash receipts including opening balances amount to ₹70,000 while total cash payments including closing balances amount to ₹60,000. It means ₹10,000 must have been paid for some item. There can be three possible alternatives.

(i) Payments to Creditors, (ii) Drawing by the proprietor, and (iii) Cash Purchases. The amount paid to creditors is already given in the question. The choice is now between the drawings made by the proprietor and the cash purchases. In the absence of any other information, it will be better to presume this as the amount of cash purchases.

In case, in the above illustration, the amount of cash purchases had been given as ₹40,000, the balancing figure could have been taken as the amount paid to the creditors as ₹10,000.

3. Ascertainment of stocks: Stocks may be classified into two categories: (i) Opening Stock, and (ii) Closing Stock. The amount of Opening Stock or Closing Stock can be ascertained by preparing a Memorandum Trading Account.

Illustration 10.5. From the following particulars, find out the amount of Opening Stock.

	₹		₹
Purchases	20,000	Rates of Gross Profit on Sales	25%
Sales	30,000	Closing Stock	10,000

Solution:

MEMORANDUM TRADING ACCOUNT

Particulars	₹	Particulars	₹
To Opening Stock (balancing figure)	14,000	By Sales	30,000
To Purchases	20,000	By Closing Stock	10,000
To Gross Profit (20% of Sales)	6,000		
	<u>40,000</u>		<u>40,000</u>

$$\begin{aligned} \text{Alternatively: Opening Stock} &= \text{Cost of Sales} + \text{Closing Stock} - \text{Purchases} \\ &= 24,000 + 10,000 - 20,000 = ₹14,000 \end{aligned}$$

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4. Ascertainment of cash and bank balances: The amount of Cash in Hand or Cash at Bank can be ascertained by preparing a Receipts and Payments Account in case Cash Book completed in all respects has not been given.

Illustration 10.6. From the following figures, ascertain the amount of cash in hand as on 31.12.2011:

	₹		₹
Cash in hand as on 1.1.2017	5,000	Total Cash Payments	35,000
Cash at Bank on 1.1.2017	10,000	Cash at bank 31.12.2017	5,000
Total Cash Receipts	30,000		

Solution:

RECEIPTS AND PAYMENTS ACCOUNT

Particulars	₹	Particulars	₹
To Balance on 1.1.2017		By Cash Payments	35,000
Cash in Hand	5,000	By Balance:	
Cash at Bank	<u>10,000</u>	Cash in Hand	
To Cash Receipts	30,000	(balancing figure)	5,000
	<u>45,000</u>	Cash at Bank	<u>5,000</u>
			<u>45,000</u>

5. Ascertainment of total debtor's balances: The balance in the Debtors Account in the beginning of accounting year or at the end of the accounting year can be ascertained by preparing a Total Debtors Account.

Illustration 10.7. From the following data, ascertain the amount of Debtors as on 1.1.2017

	₹		₹
Sales during 2017 (including cash sales of ₹10,000)	40,000	Bad Debts	3,000
Bills of Exchange received from the customers during 2017	10,000	Returns Inward	5,000
Cash received from debtors	30,000	Bad Debts previously written off, now recovered	2,000
Discount allowed to debtors	5,000	Bills Receivable dishonoured	5,000
		Balance of Debtors on 31.12.2017	15,000

Solution:

TOTAL DEBTORS ACCOUNT

Particulars	₹	Particulars	₹
To Balance b/d (balancing figure)	33,000	By Bills Receivable	10,000
To Credit Sales	30,000	By Cash	30,000
To Bills Receivable dishonoured	5,000	By Discount	5,000
		By Bad Debts	3,000
		By Returns Inward	5,000
	<u>68,000</u>	By Balance c/d	15,000
			<u>68,000</u>

On the same basis the Closing Balance in the Debtors Account can be ascertained in case other information have been given.

6. Ascertainment of total creditors' balances: The balance in the Total Creditors Account in the beginning or at the end of the accounting year can be ascertained by preparing a Total Creditors Account.

Illustration 10.8. From the following date, ascertain the amount of creditors as on 31.12.2017.

	₹		₹
Creditors as on 1.1.2017	10,000	Bills Payable issued to creditors	5,000
Cash paid to creditors	20,000	Returns Outward	5,000
Purchases (including credit purchases of ₹25,000)	35,000	Discount allowed by creditors	1,000

Solution:

TOTAL CREDITORS ACCOUNT

Particulars	₹	Particulars	₹
To Cash	20,000	By Balance b/d	10,000
To Bills Payable	5,000	By Credit Purchases	25,000
To Returns Outward	5,000		
To Discount	1,000		
To Balance c/d (balancing figure)	4,000		
	35,000		35,000

On the same basis the Opening Balance in the Creditors Account can be ascertained.

7. Ascertainment of bills receivable balance: The balance of bills receivable at the beginning or at the end of the accounting year can be ascertained by preparing a Bills Receivable Account.

Illustration 10.9. From the following data, calculate the amount of Bills Receivable as on 31.12.2017.

	₹		₹
Bills Receivable as on 1.1.2017	10,000	Cash received on account of bills receivable	5,000
Bills Receivable received during the year	30,000	Bills Receivable dishonoured	5,000
Bills Receivable discounted from the bankers	10,000	Bills Receivable endorsed in favour of creditors	5,000

Solution:

BILLS RECEIVABLE ACCOUNT

Particulars	₹	Particulars	₹
To Balance b/d	10,000	By Bank and Discount (Bills discounted)	10,000
To Sundry Debtors (Bills receivable received)	30,000	By Cash	5,000
		By Sundry Debtors	5,000
		By Creditors	5,000
		By Balance c/d (balancing figure)	15,000
	40,000		40,000

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On the same basis, the balance in the beginning of the accounting year in the Bills Receivable Account can be ascertained if other details are given.

8. Ascertainment of bills payable balance: The balance of the Bills Payable Account at the beginning or at the end of the accounting year can be ascertained by preparing a Bills Payable Account.

Illustration 10.10. Ascertain the amount of bills payable as on 1.1.2017.

	₹		₹
Bills payable issued in favour of creditors during 2017	30,000	Bills payable dishonoured during the year	5,000
Bills payable paid during the year	20,000	Bills payable on 31.12.2017	10,000

Solution:

BILLS PAYABLE ACCOUNT

Particulars	₹	Particulars	₹
To Cash	20,000	By Balance b/d (balancing figure)	5,000
To Sundry Creditors (Bills payable dishonoured)	5,000	By Sundry Creditors (Bills payable issued)	30,000
To Balance c/d	<u>10,000</u>		
	<u>35,000</u>		<u>35,000</u>

9. Ascertainment of opening capital: The amount of capital in beginning of the accounting year can be ascertained by preparing a Statement of Affairs which may be called the Balance Sheet of the business in case of Conversion Method.

Illustration 10.11. From the following details ascertain A's Capital as on 1.1.2017.

	₹		₹
Cash in Hand	5,000	Plant	20,000
Cash at Bank	10,000	Building	30,000
Sundry Debtors	20,000	Sundry Creditors	15,000
Stock	10,000	Bills Payable	5,000

Solution:

BALANCE SHEET

as on 1.1.2017

Liabilities	Amt. (₹)	Assets	Amt. (₹)
Bills Payable	5,000	Cash in Hand	5,000
Sundry Creditors	15,000	Cash at Bank	10,000
Capital (balancing figure)	75,000	Sundry Debtors	20,000
		Stock	10,000
		Plant	20,000
		Building	30,000
	<u>95,000</u>		<u>95,000</u>

10. Ascertainment of other balances: The balances of some other assets such as Land, Building, Plant and Machinery, Furniture, etc., can be ascertained by taking into account the following:

- (i) Balance in the beginning of the accounting year as shown by last year's Balance Sheet.
- (ii) Any purchase or sale of the asset as shown by the Cash Book.
- (iii) Depreciation on the basis of additional information given.

Illustration 10.12. Ascertain the Balance in the Plant Account as on 31.12.2017 on the basis of the following information:

	₹		₹
Plant as on 1.1.2017 (at original cost)	10,000	Provision Depreciation on Plant on 1.1.2017	2,000
Purchase of Plant during 2017	20,000	Book Value of the Plant sold	4,000
Sale of Plant during 2017 (original cost ₹5,000)	2,000		

Solution:

PLANT ACCOUNT

Particulars	₹	Particulars	₹
To Balance	10,000	By Plant Disposal A/c	5,000
To Bank (purchase of plant)	<u>20,000</u>	By Balance c/d	<u>25,000</u>
	<u>30,000</u>		<u>30,000</u>

PROVISION FOR DEPRECIATION ON PLANT

Particulars	₹	Particulars	₹
To Plant Disposal Account (depreciation on plant sold)	1,000	By Balance b/d	2,000
To Balance c/d	3,500	By P & L Account (depreciation for the year on ₹25,000 at the rate of 10%)	<u>2,500</u>
	<u>4,500</u>		<u>4,500</u>

PLANT DISPOSAL ACCOUNT

Particulars	₹	Particulars	₹
To Plant Account	5,000	By Provision for Depreciation on Plant Account	1,000
		By Bank (sale proceeds)	2,000
		By P & L Account (loss on sale of plant)	<u>2,000</u>
	<u>5,000</u>		<u>5,000</u>

NOTES

NOTES

Illustration 10.13. Suneel commenced business as a cloth merchant on 1.1.2017, with a capital of ₹10,000. On the same day, he purchased furniture and fittings for cash ₹3,000. From the following particulars obtained from his books kept by single entry, you are asked to prepare a Trading and Profit and Loss Account for the year ending 31st December, 2017 and a Balance Sheet as on the date.

Sales (inclusive of cash ₹7,000)	₹17,000
Purchases (inclusive of cash ₹4,000)	15,000
Suneel's drawings	1,200
Salaries to staff	2,000
Bad Debts written off	500
Business expenses	700

Suneel took cloth worth ₹500 from the shop for private use and paid ₹200 to his son, but omitted to record these transactions in his books. On 31st December, 2017, his sundry debtors were ₹5,200 and sundry creditors ₹3,600. Stock in hand on 31st December, 2017, was ₹6,500.

Solution:

SUNEEL'S TRADING AND PROFIT & LOSS ACCOUNT
for the year ending 31st December, 2017

Particulars	₹		Particulars	₹
To Purchases	15,000		By Sales	17,000
Less: Drawings	<u>500</u>	14,500	By Closing Stock	6,500
To Gross Profit c/d		<u>9,000</u>		
		<u>23,500</u>		<u>23,500</u>
To Salaries		2,000	By Gross Profit b/d	9,000
To Bad Debts		500		
To Business Expenses		700		
To Net Profit		<u>5,800</u>		
		<u>9,000</u>		<u>9,000</u>

SUNEEL'S BALANCE SHEET
as on 31.12.2017

Particulars	₹		Particulars	₹
Sundry Creditors		3,600	Cash Balance	2,800
Capital	10,000		Sundry Debtors	5,200
Less: Drawings	<u>1,900</u>		Closing Stock	6,500
	8,100		Furniture & Fittings	3,000
Add: Net Profit	<u>5,800</u>	<u>13,900</u>		
		<u>17,500</u>		<u>17,500</u>

Working Notes:

1.

RECEIPTS AND PAYMENTS ACCOUNT

for the year ending 31.12.2017

Introduction to Accounting
from Incomplete Records-II

Particulars	₹	Particulars	₹
To Capital A/c	10,000	By Furniture	3,000
To Cash Sales	7,000	By Cash Purchases	4,000
To Sundry Debtors (Note 2)	4,300	By Drawing (1,200+200)	1,400
		By Salaries	2,000
		By Business Expenses	700
		By Sundry Creditors (Note 3)	7,400
		By Balance c/d	2,800
	<u>21,300</u>		<u>21,300</u>

NOTES

2.

SUNDRY DEBTORS ACCOUNT

Particulars	₹	Particulars	₹
To Credit Sales	10,000	By Cash (balancing figure)	4,300
		By Bad Debts	500
		By Balance c/d	5,200
	<u>10,000</u>		<u>10,000</u>

3.

SUNDRY CREDITORS ACCOUNT

Particulars	₹	Particulars	₹
To Cash (balancing figure)	7,400	By Credit Purchases	11,000
To Balance c/d	3,600		
	<u>11,000</u>		<u>11,000</u>

4. The Money given by Suneel to his son and cloth taken by him from the business have been taken as his drawings. The value of cloth taken has been deducted from purchases.

Illustration 10.14. Mr. Pranlal is a dealer in fertilizers. He purchases some chemicals and mixes them to manufacture the fertilizers. He has prepared the following statements. He requires you to examine them and prepare a Trading Account a Profit & Loss Account and a Balance Sheet, after taking into account the additional information furnished:

TRADING AND PROFIT & LOSS ACCOUNT

as on 31.3.2014

Particulars	₹	Particulars	₹
To Stock as on 31-3-14	8,00,000	By Sales	5,00,000
To Purchases	8,00,000	By Creditors	10,00,000
To Expenses	7,00,000	By Stock as on 1-4-13	2,00,000
		By Other Income	1,00,000
		By Net Loss	5,00,000
	<u>23,00,000</u>		<u>23,00,000</u>

BALANCE SHEET
as on 31.3.2014

NOTES

Liabilities		₹	Assets		₹
Capital as on 1-4 2013	3,00,000		Debtors		2,50,000
Add:		8,00,000	Cash		20,000
Loss	5,00,000		Bank		80,000
Loans taken on 1-4-2013 at 12%		1,00,000	Closing stock		10,00,000
Surpluses (Difference)		4,50,000			
		13,50,000			13,50,000

On enquiry, the following additional information was obtained:

(1) He is entitled to a rebate of 10 per cent on the listed price of a chemical. The purchase during the year ended 31st March 2014 of the said chemicals at the listed price amounted to ₹ 4,00,000.

(2) The details of the expenses are as under:

	₹
Mixing wages	2,00,000
Administration and selling expenses	2,00,000
Mixing equipments purchased	1,00,000
Construction of factory sheds	1,00,000
Advance for materials	1,00,000
	<u>7,00,000</u>

(3) A certain raw material was received on 2nd April 2014, the invoice for the material amounting to ₹ 1,00,000 was included in the purchase.

(4) A customer who has purchased the goods for ₹ 1,00,000 had taken delivery. The value of the stock was inadvertently included in the closing stock as on 31st March 2014.

(5) He had entered into a joint venture with Mr. Babu Ram. The sales made on account of the joint venture was included in the sales for 2,00,000. He had paid ₹ 1,00,000 for the purchases of raw materials. It had been included in the expenses. His share of profit in the venture was determined at ₹ 50,000. The amount paid for setting the account was wrongly debited to the Debtors Account.

(6) Sum received for cash sales for ₹ 5,00,000 was included in the creditors.

(7) An invoice for ₹ 50,000 for the goods received on 25th March, 2014 and included in the stock, was received only on 1st April, 2014.

(8) Other outstanding as on 31st March, 2014 were:

(a) for the erection of factory sheds ₹ 50,000

(b) other expenses ₹ 25,000

(9) Provide depreciation at 5% on the factory sheds and at 10% on the equipments on the closing balances.

(10) The bank balance of ₹ 80,000 includes the encashment of his personal deposit of ₹ 50,000 with the bank He had forgotten to credit his Capital Account with this amount.

Solution

Introduction to Accounting
from Incomplete Records-II

Mr. Pranalal
Trading and Profit & Loss Account
for the year ended 31-3-2014

Particulars	₹	Particulars	₹
To Opening Stock	2,00,000	By Sales	8,00,000
To Purchases	8,10,000	By Closing Stock:	
To Mixing Wages	2,00,000	In Hand	7,00,000
To Gross Profit c/d	3,90,000	In Transit	1,00,000
	16,00,000		16,00,000
To Administrative & Selling Expenses	2,25,000	By Gross Profit b/d	3,90,000
To Depreciation:		By Other Income	1,00,000
Equipment	10,000	By Income from Joint Venture	50,000
Factory Shed	7,500		
To Interest on Loans	12,000		
To Net Profit	2,85,500		
	5,40,000		5,40,000

NOTES

Mr. Pranalal
Balance Sheet
as on 31st March 2014

Liabilities	₹	Assets	₹
Capital : Opening balance	3,00,000	Fixed Assets	1,50,000
Add: Capital introduced	50,000	Factory Shed	7,500
Add: Profit for the year	2,85,500	Mixing Equipment	1,00,000
	6,35,500	Less: Depreciation	10,000
Loan	1,00,000	Current Assets:	
Interest payable	12,000	Stock in trade	8,00,000
Creditors—Trade	5,50,000	Sundry Debtors	2,00,000
—Expenses	25,000	Rebate Receivable	40,000
Capital Expenses	50,000	Cash in hand	20,000
	13,72,500	Cash at Bank	80,000
			13,72,500

Working Notes:

(i) Sale as shown in Trading Account	₹ 5,00,000
Add: Credited to Sundry Creditors	5,00,000
	10,00,000
Less: Joint Venture Sales	2,00,000
	8,00,000
(ii) Stock as shown on 31.3.2014	8,00,000
Add: Goods purchased but in transit	1,00,000
Less: Goods sold but not delivered	1,00,000
	8,00,000

NOTES

(iii) Profit on Joint Venture: JV Sales	2,00,000
Cost of Sales	1,00,000
Profit	<u>1,00,000</u>
Share of Pranlal	<u>50,000</u>
(iv) Purchases: As given	8,00,000
Add: Outstanding	<u>50,000</u>
	8,50,000
Less: Rebate Receivable	<u>40,000</u>
	<u>8,10,000</u>

Check Your Progress

1. Where is the amount of cash purchases ascertained from in case complete Cash book is not given?
2. How is the amount of capital in the beginning of the accounting year ascertained in conversion method?

10.4 ANSWERS TO CHECK YOUR PROGRESS QUESTIONS

1. In case complete cash book has not given, the amount of cash purchases can be ascertained by preparing a Receipts and Payments Account.
2. The amount of capital in the beginning of the accounting year can be ascertained by preparing a Statement of Affairs which may be called the Balance Sheet in case of Conversion Method.

10.5 SUMMARY

- In accounting from incomplete records, certain figures are missing that are important for the preparation of the Trading and Profit and Loss Account.
- The following are generally the figures needed for the preparation of Trading Account are: Opening Stock, Purchases, Direct Expenses, Manufacturing Expenses, Sales and Closing Stock.
- For the Profit and Loss A/c the following figures are need: Indirect expenses and losses, Depreciation, Gross Profit and Gains and Incomes, etc.
- The missing figures can be found out by preparing Total Debtors Account, Total Creditors Account, Bills Receivable Account, Bills Payable Account, Receipts and Payments account, etc.

- It is generally advised to prepare Trading and Profit and Loss Account and Balance Sheet simultaneously. This will come in help while finding out the missing information. One can put whatever information has been given in the question in the Final Accounts and then trace the rest of the information required by them for preparing Final Accounts.

NOTES

10.6 KEY WORDS

- **Conversion method:** In accounting from incomplete records, it refers to the method of preparation of final accounts by collection of information as per the requirements of the double entry system of book-keeping.
- **Receipt and Payment Account:** It refers to the summary of all the actual cash payments and receipts (capital and revenue) taken from the cash book for an accounting period.
- **Bill receivable:** It refers to the bills of exchange that a company will receive payment for in the future, and the part of the company's accounts that shows these bills.
- **Bills payable:** It refers to the bills of exchange that a company will have to pay in the future.

10.7 SELF ASSESSMENT QUESTIONS AND EXERCISES

Short Answer Questions

1. What are the types of information needed to prepare a Trading account?
2. Mention three important sources of cash.
3. How are balances of assets like land, building, plant, etc., ascertained in conversion method?

Long Answer Questions

1. The books of Moneymaker showed the following figures:

<i>Particulars</i>	31.3.2014 ₹	31.3.2015 ₹
Cash at Bank	3,500	8,500
Cash in Hand	410	850
Stock in Trade	22,500	25,500
Sundry Debtors	18,000	?
Sundry Creditors	8,000	7,300
Bills payable	20,000	18,000
Furniture and Fittings	5,000	?
Outstanding Salary	200	?

The cash book analysis showed the following figures amongst others:

NOTES

	₹		₹
Receipts from customers	1,05,000	Drawings	6,000
Discount allowed to customers	1,300	Payment to creditors	19,000
Salary up to 31.12.2015	2,600	Discount received from creditors	2,600
Rent	3,600	Payment for bills payable	80,000
Sundry Trade Expenses	8,500		
Furniture purchased on 1.7.2015	1,000		

Depreciation is provided on furniture and fittings @10% per annum. No figures are available for total sales. However, Moneymaker informs you that he maintains a steady gross profit rate of 25% on sales.

Prepare Moneymaker's trading and profit and loss account for the year ended 31st December, 2015 and the balance sheet as at date.

[Ans. Cash Sales ₹ 21,140; Opening Capital ₹ 21,210;
Net Profit ₹ 18,217; B/S Total ₹ 58,727]

2. ANSHU keeps his books under single entry system. On 31st March, 2014 his Balance Sheet was as follows:

<i>Liabilities</i>	₹	<i>Assets</i>	₹
Capital	4,50,000	Fixed Assets	2,25,000
Creditors	8,70,000	Stock	9,15,000
Bills Payable	1,87,500	Debtors	2,22,000
Expenses Outstanding	67,500	Bills Receivable	90,000
		Prepaid Insurance	3,000
		Cash/Bank Balance	1,20,000
	15,75,000		15,75,000

(i) Following is the summary of cash and bank transaction for the year ended 31st March, 2015:

Cash Sales ₹ 1,10,70,000; Collection from Debtors ₹ 22,65,000; Payments to Creditors ₹ 1,12,60,500; Paid for Bills Payable ₹ 12,22,500; Sundry Expenses Paid ₹ 9,31,050; Drawings for Domestic expenses by Mr. Anshu ₹ 3,60,000; Cash and Bank Balance as on 31-03-2015 ₹ 1,90,950.

(ii) Following further details are furnished:

Gross Profit on Sales @ 10%; Bills Receivable from Debtors during the year ₹ 6,52,500; Discount Allowed to Debtors ₹ 54,000; Discount Received from Creditors ₹ 42,000; Bills Receivable Endorsed to Creditors ₹ 22,500; Annual Fire Insurance Premium paid (This is paid on 1st August every year) ₹ 9,000; Depreciation on Fixed Assets @ 10%.

(iii) Balance as on on 31-03-2015 are given below:

Stock in hand ₹ 9,75,000; Debtors ₹ 2,28,000; Bills Receivable ₹ 2,10,000; Outstanding Expenses ₹ 7,500; Bills payable ₹ 2,10,000.

you are required to prepare:

- (1) Trading and Profit and Loss Account for the year ended March 31,2015: and
- (2) Balance Sheet as on 31.03.2015.

(CMA, Intermediate, June, 2015)

(Ans. Gross Profit ₹ 14,04,750, Net Profit ₹ 4,99,200,
Balance Sheet Total ₹ 18,09,450)

3. Mr. PQ has a small trading business for which the following procedures are followed:

- (1) All collections are deposited with the bank each day.
- (2) All payments except petty expenses are made by cheque.
- (3) To meet petty expenses a cheque of ₹ 500 is withdrawn from the bank on the 1st day of each month.
- (4) Mr. PQ makes personal drawings from the bank.

The following figures are available from Mr. PQ's records:

	₹
Cash in hand as on 1.1.2015	320
Cash in hand as on 31.12.2015	200
Balance in Bank as on 1.1.2015	2,500
Balance in Bank as on 31.12.2015	5,000 (Overdraft)
Debtors as on 1.1.2015	20,000
Debtors as on 31.12.2015	30,000
Creditors as on 1.1.2015	20,000
Creditors as on 31.12.2015	30,000
Stock of goods on 1.1.2015	10,000
Stock of goods on 31.12.2015	30,000
Payments made to creditors during the year	20,000
Sales made during the year	30,000

Mr. PQ spent during the year ₹ 200 from the office cash for his personal expenses.

Prepare Profit and Loss A/c for the year ended on 31st December, 2015 and Balance Sheet as on that date from the above information.

[Ans. Gross Profit ₹ 20,000; Net Profit ₹ 14,080;
Total of Balance Sheet ₹ 60,200]

[Hint. Opening Capital ₹ 12,820; Drawings from the Bank ₹ 1,500; Collections from Debtors ₹ 20,000]

NOTES

10.8 FURTHER READINGS

NOTES

Maheshwari, S.N., Suneel K. and Sharad K. 2017. *Advanced Accountancy*, Vol I. New Delhi: Vikas Publishing House.

Maheshwari, S.N., Suneel K. and Sharad K. 2018. *An Introduction to Accountancy*, 12th edition. New Delhi: Vikas Publishing House.

Jain, S.P. and Narang, K.L. 2001. *Advanced Accountancy*. New Delhi: Kalyani Publishers.

Ahmed, N. 2008. *Financial Accounting*. New Delhi: Atlantic Publishers and Distributors Pvt. Ltd.

UNIT 11 INTRODUCTION TO ACCOUNTING FROM INCOMPLETE RECORDS-III

NOTES

Structure

- 11.0 Introduction
- 11.1 Objectives
- 11.2 Balance Sheet from Incomplete Records
- 11.3 Practical Problems
- 11.4 Answers to Check Your Progress Questions
- 11.5 Summary
- 11.6 Key Words
- 11.7 Self Assessment Questions and Exercises
- 11.8 Further Readings

11.0 INTRODUCTION

In the previous unit, you were have learnt about the information needed for the preparation of Trading and Profit and Loss Account and some of the major steps involved in the conversion method of preparing final accounts from incomplete records. The preparation of Balance was also illustrated in the previous unit. We will continue this unit with a brief look at the information required for Balance Sheet and its sources followed by illustrations to explain the preparation of final accounts.

11.1 OBJECTIVES

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

- Discuss the information need for the preparation of Balance Sheet from incomplete records
- Explain the preparation of final accounts from incomplete records

11.2 BALANCE SHEET FROM INCOMPLETE RECORDS

The following information are needed for the preparation of the Balance Sheet through conversion method under accounting for incomplete records: Cash in hand and Bank, Sundry Debtors/Bills Receivable, Fixed Assets, Closing Stock, Sundry Creditors/Bills Payable, Capitals, Net Profit/Loss, Drawings, etc. These have been already explained in the previous unit. For recapitulation, the following table can be looked at:

NOTES

Information Required	Source
Cash/Bank Balance	Opening Statement of Affairs or Receipt and Payments Account
Sundry Debtors/Bills Receivable	Bills Receivable Account on the basis of other details given
Fixed Assets	By considering the balance at the beginning of the accounting year through last year balance sheet; purchase or sales as mentioned in the cash book and whether there is any information on depreciation
Closing Stock	Memorandum Trading Account
Sundry Creditors/Bills Payable	Bills Receivable Account on the basis of other details given
Opening Capital	Statement of Affairs
Net Profit/Loss	Profit and Loss Account prepared from the information given

Now let's study some more illustrations to understand the preparation of balance sheet and final accounts.

The comprehensive illustration given in the following pages will make clear the preparation of Final Accounts under Single Entry System in case Conversion Method is followed by the business.

Illustration 11.1. The following balances were disclosed by the books of Anil.

Particulars	31.12.2014	31.12.2015
	₹	₹
Cash at Bank	3,000	19,100
Cash in Hand	400	850
Stock-in-trade	22,000	25,000
Sundry Debtors	—	35,000
Sundry Creditors	23,400	18,500
Fixtures and Fittings	2,000	—
Office Car	1,000	—

The Cash Book analysis showed the following figures amongst others:

Particulars	₹	Particulars	₹
Receipts from Customers	1,35,000	Motor Upkeep	1,350
Discounts allowed to them	1,400	Printing & Stationery	800
Further capital introduced on 1.7.2015	2,000	Drawings	6,000
Salaries up to 31.11.2015	11,000	Payments to Trade Creditors	1,12,000
Office rent to 30.11.2015	2,200	Discounts allowed by them	1,200
Advertising	900	Travelling Expenses	1,000
General Expenses	600		

No ready figures are available for total sales but Anil maintains a steady gross profit rate of 25% on sales.

There were bills outstanding for petrol ₹ 25, Advertising ₹ 75, and Printing ₹ 45. Provide 5% on debtors for doubtful debts and 2½% on creditors for discounts. The motor car fixtures are to be depreciated by 20% and 5% respectively. 5% interest is to be allowed on capital.

Prepare Anil's Trading and Profit and Loss Account for 2015 and his Balance Sheet on 31.12.2015.

*Introduction to Accounting
from Incomplete
Records-III*

Solution

**Mr. Anil
Trading and Profit and Loss Account
for the year ending 31.12.2015**

<i>Receipts</i>	₹	₹	<i>Payments</i>	₹
To Stock		22,000	By Sales: Cash and	16,000
To Purchases		1,08,300	Credit	1,24,400
To Gross Profit c/d		35,100	By Stock	25,000
		1,65,400		1,65,400
To Discount		1,400	By Gross Profit b/d	35,100
To Salaries	11,000		By Discount	1,200
<i>Add: Outstanding</i>	1,000	12,000	By Reserve for discount on	
To Office Rent	2,200		sundry creditors	462
<i>Add: Outstanding</i>	200	2,400		
To Advertising	900			
<i>Add: Outstanding</i>	75	975		
To General Expenses		600		
To Motor Upkeep (including outstanding petrol bill)		1,375		
To Printing and Stationery	800			
<i>Add: Outstanding</i>	45	845		
To Travelling Expenses		1,000		
To Provision for bad and doubtful debts		1,750		
To Depreciation:				
Motor Car	200			
Fixtures	100	300		
To Interest on Capital		2,650		
To Net Profit transferred to Capital Account		11,467		
		36,762		36,762

NOTES

**Mr. Anil
Balance Sheet
as on 31.12.2015**

<i>Liabilities</i>	₹	<i>Assets</i>	₹
Capital	52,000	Cash at Bank	19,100
<i>Add: Addition</i>	2,000	Cash in Hand	850
Interest on Capital	2,650	Sundry Debtors	35,000
Net Profit for the year	11,467	<i>Less: Provision</i>	1,750
	68,117	Stock	25,000

NOTES

<i>Liabilities</i>		₹	<i>Assets</i>		₹
Less: Drawings	6,600	61,517	Fixtures and Fittings	2,000	
Petrol Outstanding		25	Less: Depreciation	100	1,900
Advertising Outstanding		75	Office Car	1,000	
Printing Outstanding		45	Less: Depreciation	200	800
Salaries Outstanding		1,000			
Rent Outstanding		200			
Sundry Creditors	18,500				
Less: Reserve for discount	462	18,038			
		80,900			80,900

Working Notes:

Mr. Anil

1. Receipts and Payments Account

<i>Receipts</i>		₹	<i>Payments</i>		₹
To Balance b/d			By Salaries		11,000
Bank	3,000		By Rent		2,200
Cash	400	3,400	By Advertising		900
To Sundry Debtors		1,35,000	By General Expenses		600
To Anil—Capital Introduced		2,000	By Motor Upkeep		1,350
To Cash Sales			By Printing and Stationery		800
(balancing figure)		16,000	By Drawings		6,600
			By Trade Creditors		1,12,000
			By Travelling Expenses		1,000
			By Balance c/d		
			Bank	19,100	
			Cash	850	19,950
		1,56,400			1,56,400

Mr. Anil

**2. Balance Sheet
as on 31.12.2015**

<i>Liabilities</i>		₹	<i>Assets</i>		₹
Sundry Creditors		23,400	Cash at Bank		3,000
Capital (balancing figure)		52,000	Cash in Hand		400
			Stock-in-trade		22,000
			Sundry Debtors		47,000
			Fixtures and Fittings		2,000
			Office Car		1,000
		75,400			75,400

3. Sundry Debtors Account

<i>Particulars</i>		₹	<i>Particulars</i>		₹
To Balance b/d			By Cash		1,35,000
(balancing figure)		47,000	By Discount		1,400
To Credit Sales			By Balance c/d		35,000
(Total sales less Cash sales)		1,24,400			
		1,71,400			1,71,400

Sundry Creditors Account

Particulars	₹	Particulars	₹
To Cash	1,12,000	By Balance b/d	23,400
To Discount	1,200	(By Purchases (balancing figure	1,08,300
To Balance c/d	18,500		
	1,31,700		1,31,700

4. Sales

Particulars	₹
Opening Stock	22,000
Purchases	1,08,300
	1,30,300
<i>Less:</i> Closing Stock	25,000
Cost of goods sold	1,05,300
<i>Add:</i> Profit (1/3 of cost)	35,100
Total Sales	1,14,400

Illustration 11.2. Prepare a Trading A/c, Profit and Loss A/c for the year ended 31st December, 2015 and Balance Sheet as at that date from the following information available from the books of a Trader.

	31.12.2014	31.12.2015
	₹	₹
1. Liabilities and Assets:		
Bank Balance	20,000	9,400
Cash in hand	3,000	2,000
Prepaid Expenses	5,000	7,000
Stock	70,000	60,000
Debtors for sales	2,30,000	?
Bills Receivable	—	?
Furniture at written down value	70,000	82,000
Creditors for purchases	2,20,000	2,60,000
Outstanding Liabilities	30,000	15,000
2. Receipts and Payments during 2015		
Collection from debtors (after allowing 2½% discount)		5,85,000
Proprietor's Drawings		50,000
Capital introduced by proprietor		95,150
Purchase of Furniture at the middle of the year		20,000
4% Govt. Securities purchased at 96% on 1.7.2015		96,000
Expenses		2,00,000
Sale of Scrap		5,000
Payment to Creditors (after receiving 2% discount)		3,92,000
Proceeds of Bills Receivable discounted at 2%		61,250
3. Sales are made so as to realise 331/3% profit on sale proceeds.		
4. Goods worth ₹ 5,000 were taken by the proprietor.		

NOTES

5. During the year Bills Receivable worth ₹ 1,50,000 were drawn on Debtors. Of these, bills amounting to ₹ 30,000 were endorsed in favour of the creditors. Out of this later amount, a bill for ₹ 5,000 was dishonoured by the debtor.
6. Sales and Purchases are made on credit.

NOTES

Solution

Trading and Profit and Loss Account for the year ending 31st December, 2015

1.

<i>Particulars</i>		₹	<i>Particulars</i>		₹
To Opening Stock		70,000	By Sales		7,05,000
To Purchases	4,65,000		By Closing Stock		60,000
<i>Less: Drawings by</i>		4,60,000			
Proprietor	5,000				
To Gross Profit		2,35,000			
		7,65,000			7,65,000
To Expenses		1,83,000	By Gross Profit		2,35,000
To Depreciation		8,000	By Interest on Securities		2,000
To Discount on Debtors		15,000	By Discount		8,000
To Discount on Bills Receivable		1,250	By Sale of Scrap		5,000
To Net Profit		42,750			
		2,50,000			2,50,000

Balance Sheet as on 31st December, 2015

<i>Liabilities</i>		₹	<i>Assets</i>		₹
Capital:			Fixed Assets:		
Opening	1,48,000		Furniture	90,000	
<i>Add: Introduced during</i>			<i>Less: Depreciation</i>	8,000	82,000
the year	95,150				
Profit for the year	42,750		Investment		
	2,85,900		4% Govt. Securities		
<i>Less: Drawings</i>	55,000		(Nominal Value ₹ 1,00,000)		96,000
	2,30,900		Current Assets, Loans and		
Sundry Creditors		2,60,000	Advances:		
Outstanding Expenses		15,000	Stock in Trade		60,000
			Sundry Debtors		1,90,000
			Bills Receivable		57,500
			Interest Accrued		2,000
			Prepaid Expenses		7,000
			Cash in Hand		2,000
			Cash at Bank		9,400
		5,05,900			5,05,900

Working Notes:

**(i) Balance sheet
as on 31st Dec., 2014**

<i>Liabilities</i>	₹	<i>Assets</i>	₹
Sundry Creditors	2,20,000	Furniture	70,000
Outstanding Expenses	30,000	Stock in trade	70,000
Capital (balancing figure)	1,48,000	Sundry Debtors	2,30,000
		Prepaid Expenses	5,000
		Cash at Bank	20,000
		Cash in Hand	3,000
	3,98,000		3,98,000

NOTES

(ii) Total Creditors Account

<i>Particulars</i>	₹	<i>Particulars</i>	₹
To Cash/Bank	3,92,000	By Balance b/d	2,20,000
To Discount	8,000	By Sundry Debtors (bills dishonoured)	5,000
To Bills Receivable	30,000	By Purchases (balancing figure)	4,65,000
To Balance c/d	2,60,000		
	6,90,000		6,90,000

(iii) Sales during the year: ₹

Stock on 1st Jan. 2015	70,000
Purchases	4,65,000
	5,35,000
<i>Less:</i> Closing stock plus Goods withdrawn	65,000
Cost of Goods sold	4,70,000
<i>Add:</i> Profit margin: 50% on cost or 33 1/3% on selling price	2,35,000
	7,05,000

(iv) Total Debtors Account

<i>Particulars</i>	₹	<i>Particulars</i>	₹
To Balance b/d	2,30,000	By Cash/Bank	5,85,000
To Sales	7,05,000	By Discount	15,000
To Sundry Creditors (bills endorsed dishonoured)	5,000	By Bills Receivable	1,50,000
		By Balance c/d (balancing figure)	1,90,000
	9,40,000		9,40,000

(v) Bills Receivable Account

<i>Particulars</i>	₹	<i>Particulars</i>	₹
To Sundry Debtors	1,50,000	By Sundry Creditors	30,000
		By Cash/Bank	61,250
		By Discount	1,250
		By Balance c/d	57,500
	1,50,000		1,50,000

NOTES

(vi) Furniture Account

<i>Particulars</i>	₹	<i>Particulars</i>	₹
To Balance b/d	70,000	By Depreciation (balancing figure)	8,000
To Cash/Bank	20,000	By Balance c/d	82,000
	90,000		90,000

(vii) Cash/Bank Account

<i>Particulars</i>	₹	<i>Particulars</i>	₹
To Balance b/d	23,000	By Sundry Creditors	3,92,000
To Sundry Debtors	5,85,000	By Furniture	20,000
To Bills Receivable	61,250	By 4% Govt. Securities	96,000
To Sale of Scrap	5,000	By Expenses	2,00,000
To Capital A/c (Capital introduced)	95,150	By Drawings	50,000
		By Balance c/d	11,400
	7,69,400		7,69,400

(viii) Expenses to be charged to P & L Account

<i>Particulars</i>	₹
Expenses Paid	2,00,000
<i>Add:</i> Outstanding Expenses as on 31.12.2015	15,000
	2,15,000
<i>Less:</i> Outstanding Expenses as on 31.12.2014	30,000
	1,85,000
<i>Add:</i> Prepaid Expenses as on 31st Dec. 2014	5,000
	1,90,000
<i>Less:</i> Prepaid Expenses as on 31st Dec. 2015	7,000
	1,83,000

Illustration 11.3. The following is the Balance Sheet of Shri Raman as on 30th June, 2014

<i>Particulars</i>	₹	<i>Particulars</i>	₹
Capital	96,000	Building	65,000
Loan	30,000	Furniture	10,000
Creditors	62,000	Motor-Car	18,000
		Stock	40,000
		Debtors	34,000
		Cash in Hand	4,000
		Cash at Bank	17,000
	1,88,000		1,88,000

A riot occurred on the night of 30th June 2015 in which all the books and records were lost. The cashier had absconded with the available cash. Shri Raman gives you the following information:

- (a) His sales for the year ended 30th June, 2015 was 20% higher than the previous year's sales. He always sells his goods at cost plus 25%; 20% of the total sales for the year ended 30th June 2015, were for cash. There were no cash purchases.

- (b) On 1st July, 2014, the stock level was raised to ₹ 60,000 and stock was maintained at the new level throughout the whole year.
- (c) Collections from debtors amounted to ₹ 2,80,000 of which ₹ 70,000 was received in cash. Business expenses amounted to ₹ 40,000 of which ₹ 10,000 was outstanding as on 30th June, 2015 and ₹ 12,000 was paid by cheques.
- (d) Analysis of the pass book revealed the following:

Particulars	₹
Payment to Creditors	2,75,000
Personal Drawings	15,000
Cash deposited in Bank	1,43,000
Cash withdrawn from Bank	24,000

- (e) Gross profit as per last year's audited accounts was ₹ 60,000.
- (f) Provide depreciation Building and Furniture at 5% and Motor-Car at 20%.
- (g) The amount defalcated by the cashier may be treated as recoverable from him. Prepare the Trading and Profit & Loss Account for the year ended 30th June, 2015 and the Balance Sheet as on the date.

NOTES

Solution

Shri Raman Trading and Profit & Loss Account for the year ended 30th June, 2015

Liabilities	₹	Assets	₹
To Opening Stock	40,000	By Sales	3,60,000
To Purchases (balancing figure)	3,08,000	By Closing Stock	60,000
To Gross Profit c/d (20% on sales)	72,000		
	<u>4,20,000</u>		<u>4,20,000</u>
To Sundry Expenses	40,000	By Gross Profit b/d	72,000
To Depreciation:			
Building	3,250		
Furniture	500		
Motor-Car	3,600		
	7,350		
To Net Profit transferred to capital account	24,650		
	<u>72,000</u>		<u>72,000</u>

Shri Raman Balance Sheet as on 30th June, 2015

Liabilities	₹	Assets	₹
Capital Account:		Building	65,000
Opening Capital	96,000	Less: Depreciation	3,250
Add: Net Profit	24,650	Furniture	10,000
	1,20,650	Less: Depreciation	500
Less: Drawings	15,000	Motor-Car	18,000
	1,05,650	Less: Depreciation	3,600
Loan	30,000	Current Assets:	
Sundry Creditors	95,000	Stock-in-trade	60,000
Outstanding Expenses	10,000		

NOTES

	Sundry Debtors	42,000
	Cash at Bank	44,000
	Sundry Advances (Amount recoverable from Cashier)	9,000
		2,40,650
		2,40,650

Working Notes:

(i) Total Debtors Account

Particulars	₹	Particulars	₹
To Balance b/d	34,000	By Bank	2,10,000
To Sales (80% of 3,60,000)	2,88,000	By Cash	70,000
		By Balance c/d	42,000
	3,22,000		3,22,000

(ii) Total Creditors Account

Particulars	₹	Particulars	₹
To Bank	2,75,000	By Balance b/d	62,000
To Balance	95,000	By Purchases	3,08,000
	3,70,000		3,70,000

(iii) Cash Book

Particulars	Cash ₹	Bank ₹	Particulars	Cash ₹	Bank ₹
To Balance b/d	4,000	17,000	By Sundry Expenses	18,000	12,000
To Sales	72,000	—	By Drawings	—	15,000
To Sundry Debtors	70,000	2,10,000	By Sundry Creditors	—	2,75,000
To Cash (contra)	—	1,43,000	By Bank (contra)	1,43,000	—
To Bank (contra)	24,000	—	By Cash (contra)	—	24,000
			By Balance c/d	*9,000	44,000
	1,70,000	3,70,000		1,70,000	3,70,000

The cash defalcated by the cashier is recoverable from him

(iv) Total Sales:

The gross profit was ₹ 60,000 @ 20% on sales. Last year's sales were, therefore, ₹ 3,00,000. Current year's sales are 20% higher than the previous year's. It, therefore, comes to ₹ 3,60,000. The gross profit on this sale would be @ 20%, i.e., ₹ 72,000.

(v) The amount of purchases has been ascertained at the balancing figure in the Trading Account. This could have been alternatively calculated as follows:

	₹	
Cost of Sales: $\frac{4}{5}$ of 3,60,000	2,88,000	
Add: Increase in Stock	20,000	
	3,08,000	

Illustration 11.4. Bhavnagarwala is a small trader in electrical goods who commenced his business on 1st January 2012, with an initial capital of ₹ 1 lakh. He had acquired, in that month, premises on lease for ten years on a monthly rental of ₹ 750 payable at the end of each month and a security deposit of ₹ 12,000 free of interest which he was entitled to adjust against the rent for each month proportionately during the lease period. He also acquired, at the same time, the following assets for use in his business:

	₹
Delivery Van	40,000
Motor-Cycle	5,000
Cycles	600
Furniture Fittings and Office Equipment	10,000

Since then, he has neither brought in any fresh capital of his own nor withdrawn any amount from the business on account of either capital or profits. However, he has been drawing, every month, ₹ 1,500 as his salary, which he treats as business expense.

Bhavnagarwala's business consisted of an agency for the distribution of certain electrical goods manufactured by a reputed company, in the area allotted to him. Supplies are invoiced to him at authorised retail prices less 20% discount, drawn through Bills of Exchange, at 30 days sight, all bank charges on this account being born by the manufacturer. Under the terms of the agency, he can sell these goods either directly to consumers at authorised retail prices or to other retail outlets at a discount of 15 per cent. All direct sales to consumers are made only at the business premises of Bhavnagarwala, while supplies to retail shops are made through the delivery van at the latter's shop.

No regular books of account are maintained. He operates two Bank Accounts, designated as No. I Account and No. II Account. A serially numbered sale bill book is in use. For each sale, a set of three copies is made out. When a customer pays on the delivery of goods the original and duplicate are given to him with receipt on the original. If the sale is on credit, the signature of the customer is obtained on the original, which is retained till payment is received, while the duplicate alone is given to the customer. All operating expenses of the delivery van and the incidental expenses enroute are met out of the sale proceeds collected from retail shops in each trip and the net proceeds are deposited periodically in Bank Account No. I Bills payable for goods supplied by the manufacturer, are paid only through this Bank Account.

All sale proceeds collected on direct sales to consumers, are remitted to Bank Account No. II. All expenses other than for purchases are met out of No. II. Account only.

NOTES

The following information was compiled:

NOTES

<i>Particulars</i>	<i>As on 31.12.2014 ₹</i>	<i>As on 31.12.2015 ₹</i>	<i>For the year 2015 ₹</i>
Stock (at retail prices)	1,85,335	2,06,605	
Value of original sale bills on hand:			
Consumers	12,271	16,254	
Retail shops	56,271	71,623	
Bills payable (Acceptances)	71,850	92,265	
Bank Account No. I (Overdrawn)	48,063	56,337	
Bank Account No. II (Overdrawn)	7,045	3,296	
Sundry Creditors	8,272	9,348	
Transfer of Funds from No. II to No. I A/c			2,60,000
Deposit during the year:			
No. I Account			8,19,631
No. II Account			3,08,925
Running expenses of delivery van and other incidental expenses met out of the collections			36,573

A special bonus of 5% due from the manufacturer of the excess over ₹ 10 lakhs of the net value of goods invoiced to Bhavnagarwala, was yet to be received. Depreciation is to be provided at 20% on van, motor-cycle and cycles and at 10% on furniture, etc., on the diminishing balance method (correct to the nearest rupee).

You are required to prepare a Balance Sheet as on 31st December, 2015, and a Profit and Loss Account for the year ended on that date and also to advise Bhavnagarwala, if there have any stock losses.

Solution

**Mr. Bhavanagarwala
Profit & Loss Account
for the year ending 31st Dec., 2015**

<i>Particulars</i>	<i>₹</i>	<i>Particulars</i>	<i>₹</i>
To Opening Stock	1,48,268	By Sales	
To Purchases	11,08,320	Customers	3,12,755
To Running expenses of Delivery Van	36,573	Retail Outlet	8,71,556
To Other expenses	20,452	By Closing Stock	1,65,284
To Rent	9,000	By Bonus on purchases	5,416
To Depreciation	5,398		
To Proprietor's Salary	18,000		
To Net Profit	9,000		
	<u>13,55,011</u>		<u>13,55,011</u>

**Balance Sheet of Mr. Bhavnagarwala
as on 31st Dec., 2015**

*Introduction to Accounting
from Incomplete
Records-III*

<i>Liabilities</i>	₹	<i>Assets</i>	₹
Capital	1,00,000	Delivery Van (<i>Less: Depreciation</i>)	16,384
Proprietor's Current Account		Motor-Cycle (<i>Less: Depreciation</i>)	2,048
Opening Balance	20,770	Cycles (<i>Less: Depreciation</i>)	246
Surplus Profit after salary	9,000	Furniture, Fittings & Office Equipment	
	29,770	(<i>Less: Depreciation</i>)	6,561
Bank Overdraft		Stock at cost	1,65,284
I	56,337	Sundry Debtors:	
II	3,296	Consumers	16,254
Sundry Creditors:		Retail shops	71,623
Acceptances	92,265	Security Deposit	7,200
Expenses	9,348	Commission Receivable	5,416
	2,91,016		2,91,016

NOTES

<i>Particulars</i>	₹
Loss of Stock:	
Opening Stock, at cost	1,48,268
Add: Purchases	11,08,320
	12,56,588
Less: Cost of goods sold:	
Sale to consumers:	3,12,755
Less: 20% margin of profit	62,551
Sale to Retail Shops:	8,71,556
Less: 5/85 mark up	8,20,288
Stock expected	51,268
Actual closing stock at cost	1,65,284
Loss of stock during the period	20,812

Working Notes:

**(i) Balance Sheet of Mr. Bhavnagarwala
as on 31st Dec. 2014**

<i>Liabilities</i>	₹	<i>Assets</i>	₹
Capital	1,00,000	Fixed Assets, at cost (<i>less: Depreciation</i>):	
Surplus (Balancing figure)	20,770	Delivery Van	20,480
Bank Overdraft		Motor-Cycle	2,560
I	48,063	Cycles	307
II	7,045	Furniture & Fittings	7,290
Sundry Creditors (Trade)		Stock at cost	1,48,268
Acceptances	71,850	Sundry Debtors	
Sundry Creditors (Ex- penses)	8,272	Consumers	12,424
		Retail Shop	56,271

Liabilities	₹	Assets	₹
		Security Deposit	8,400
	2,56,000		2,56,000

NOTES

(ii) Depreciation and Written Down Value of Fixed Assets

Particulars	Delivery Van	Motor Cycle	Cycles	Furniture, Fittings & Office Equipment
	₹	₹	₹	₹
Cost as on 1.1.12	40,000	5,000	600	10,000
Depreciation for 12	8,00	1,000	120	1,000
w.d.v as on 1.1.13	32,000	4,000	480	9,000
Depreciation for 13	6,400	800	96	900
w.d.v as on 1.1.14	25,600	3,200	384	8,100
Depreciation for 14	5,120	640	77	810
w.d.v as on 1.1.15	20,480	2,560	307	7,290
Depreciation for 15	4,096	512	61	729
w.d.v on 31.12.15	16,384	2,048	246	6,561

(iii)

Particulars	2004	2005
Stock at Retail Price	1,85,335	2,06,605
Less: Mark up 20%	37,067	41,321
	1,48,268	1,65,284

(iv) Bank Account I

Date	Particulars	₹	Date	Particulars	₹
2015	To Debtors: Retail Outlet	8,19,631	2015	By Balance b/d	48,063
	To Bank Account II (transfer)	2,60,000	Jan. 1	By Bills Payable	10,87,905
Dec. 31	To Balance c/d	56,337		(balancing figure)	
		11,35,968			11,35,968

(v) Bank Account II

Date	Particulars	₹	Date	Particulars	₹
2015			2015		
Dec.	To Debtors-Consumers	3,08,925	Jan. 1	By Balance b/d	7,045
	To Balance c/d	3,296		By Bank No. I A/c	2,60,000
				By Proprietor's Salary	18,000
				By Rent	7,800
				By Sundry Expenses	
				(balancing figure)	19,376
		3,12,221			3,12,221

(vi) **Bills Payable Account**

Date	Particulars	₹	Date	Particulars	₹
2015 Dec.	To Bank To Balance	10,87,905 92,265	2015 Jan. 1	By Balance b/d By Purchases (balancing figure)	71,850 11,08,320
		11,80,170			11,80,170

NOTES

(vii) **Sundry Debtors (Consumers) Account**

Date	Particulars	₹	Date	Particulars	₹
2015 Jan. 1	To Balance b/d To Sales (balancing figure)	12,424 3,12,755	2015 Dec. 31	By Bank A/c II By Balance c/d	3,08,925 16,254
		3,25,179			3,25,179

(viii) **Sundry Debtors (Retail Shop) Account**

Date	Particulars	₹	Date	Particulars	₹
2015 Jan. 1	To Balance b/d To Sales (balancing figure)	56,271 8,71,556	2015 Dec. 31	By Bank I A/c By Van Expenses By Balance c/d	8,19,631 36,576 71,623
		9,27,827			9,27,827

(ix) **Sundry Creditors (Expenses) Account**

Date	Particulars	₹	Date	Particulars	₹
2015 Dec. 31	To Bank A/c II To Balance c/d	19,376 9,348	2015 Jan. 1	By Balance b/d By Profit & Loss A/c (balancing figure)	8,272 20,452
		28,724			28,724

Check Your Progress

1. What is the source of information for calculating the Closing Stock under accounting from incomplete records?
2. If the rate of gross profit is 25% of sales and the cost of goods sold is ₹1,00,000, what will the amount of gross profit be?
3. If the rate of gross profit is 20% on cost of goods sold and the sales are ₹1,00,000, the amount of gross profit will be?

11.4 ANSWERS TO CHECK YOUR PROGRESS QUESTIONS

NOTES

1. Memorandum Trading Account is used for calculating the Closing Stock under accounting from incomplete records.
2. If the rate of gross profit is 25% of sales and the cost of goods sold is ₹1,00,000, the amount of gross profit ₹33,333.
3. If the rate of gross profit is 20% on cost of goods sold and the sales are ₹1,00,000, the amount of gross profit will be ₹16,667.

11.5 SUMMARY

- The following information are needed for the preparation of the Balance Sheet through conversion method under accounting for incomplete records: Cash in hand and Bank, Sundry Debtors/Bills Receivable, Fixed Assets, Closing Stock, Sundry Creditors/Bills Payable, Capitals, Net Profit/Loss, Drawings, etc.
- Cash/Bank Balance can be ascertained from the opening Statement of Affairs or Receipt and Payments Account.
- Sundry Debtors/Bills Receivable can be found out Bills Receivable Account on the basis of other details given.
- The Memorandum Trading account helps in given the closing stock.
- The amount for Sundry creditors can be computed through the Bills Receivable Account.
- The Statement of Affairs gives the opening capital.
- The fixed assets can be ascertained by considering the balance at the beginning of the accounting year through last year balance sheet; purchase or sales as mentioned in the cash book and whether there is any information on depreciation.

11.6 KEY WORDS

- **Fixed assets:** These are assets which are acquired for relatively long period for carrying on the business of the enterprise.
- **Drawings:** It refers to the withdrawal of goods or cash from the business by the owner for personal use.
- **Net Profit/Income:** It is the profit left after deducting all business expenses from the Gross Profit made by the business.

11.7 SELF ASSESSMENT QUESTIONS AND EXERCISES

Short Answer Questions

1. From the following details ascertain A's Capital as on 1.1.2017.

Cash in Hand	₹6500	Plant	₹20,000
Cash at Bank	₹11500	Building	₹25,000
Sundry Debtors	₹25000	Sundry Creditors	₹15,000
Stock	₹15,000	Bills Payable	₹7,500

2. From the following particulars, find out the amount of Opening Stock.

Purchase	₹25,000	Rates of Gross Profit on Sales	25%
Sales	₹ 35,000	Closing Stock	15,000

3. Ascertain the amounts of Sundry Creditors payable as on 1.1.2020.

Bills payable issued in favour of creditors during 2020	₹40,000
Bills payable paid during the year	₹30,000
Bills payable dishonoured during the year	₹10,000
Bills payable as on 31.12.2020	₹20,000

Long Answer Questions

1. You are instructed by a trader to prepare for him a Profit & Loss A/c for the year ended 31st March, 2014 and a Balance Sheet as on that date. The following information is furnished to you:
(1) Assets and Liabilities as on 31st March, 2013.

	₹
Bills Receivable	50,000
Sundry Debtors	?
Stock-in-trade	1,56,600
Plant & Machinery	94,000
Land and Building	1,40,000
Sundry Creditors	72,000
Bills Payable	32,000

(2) Summarised Cash transactions for the year ended 31st March, 2014.

Particulars	₹	Particulars	₹
To Cash balance as on 1.4.2013	1,400	By Bank overdraft as on 1.4.2013	10,000
To Receipts from Debtors	5,80,000	By Salaries	24,000
To Bills Receivable	2,00,000	By Bills Payable	2,86,000
		By Wages	31,600
		By Payments to Creditors	2,94,000
		By Office Expenses	16,000
		By Drawings	96,000
		By Balance as on 31.3.2014	
		4,800 In hand	
		25,000 At Bank	29,800
	7,81,400		7,81,400

NOTES

NOTES

(3) Other Information:

Particulars	₹
Sales	8,14,000
Discount to customers	4,000
Purchases	6,00,000
Discount allowed by suppliers	2,000
Bills Receivable, recd. during the year	2,18,000
Billi Payable, issued during the year	3,00,000
Stock-in-trade as on 31.3.2014	1,06,000
Sundry Debtors as on 31.3.2014	9,0000

Provide depreciation at 15% on Plant and Machinery, and at 5% on Land & Buildings.

[Ans. Gross Profit: ₹ 1,37,800; Net Profit: ₹ 74,700; Total of Balance Sheet: ₹ 5,06,700

2. On 31st December, 2015, J. Sen's books & records were destroyed by fire. The following information was available. (i) The Balance Sheet of J. Sen as on 31st Dec. 2014, was as follows:

Balance Sheet

Capital & Liabilities	₹	₹	Property & Assets	₹
Capital		42,000	Fixtures	10,000
Creditors:			Stock	15,000
Goods	9,400		Debtors	12,000
Electricity	200		Rates in Advance	450
Accountancy Charges	500	10,100	Cash in Hand	1,500
			Cash at Bank	13,150
		52,100		52,100

- (ii) The Insurance Company agreed to pay ₹ 9,500 for fixtures and ₹ 10,500 for stock without the production of accounts; the stock, however, was worth ₹ 11,500.

- (iii) From the Bank statements and the cheque books which were in his house, the following information on payments was available:

Particulars	₹	Particulars	₹
Personal Expenses	8,000	Rates	1,350
Sundry expenses	650	Rent	5,170
Accountancy charges	800	Goods for resale	2,15,800
Electricity	750	Fixtures	2,000

- (iv) Total Banking for the year amounted to ₹ 2,45,020.
- (v) All the cash received were banked with the exception of the following payments during the year:
- (a) An assistant's salary ₹ 1,800 per annum,
 - (b) Goods for resale averaging ₹ 1,050 per month,
 - (c) Drawing varied between ₹ 2,000 to ₹ 3,000 per month,
- (vi) ₹ 250 per month for 9 month was received as rent, in cash, for letting a portion of the shop. This amount was not banked.
- (vii) During the year, sale proceeds for waste paper amounting to ₹ 3,050 was paid into the bank.
- (viii) On 31-12-2015
- (a) debtors were ₹ 20,500,
 - (b) creditors for goods were ₹ 9,000, for electricity ₹ 80, for accounting charges ₹ 75 and for rent ₹ 470.
 - (c) rates in advance ₹ 650,

- (d) cash in hand ₹ 1,700,
(e) during the year a bad debt of ₹ 600 was incurred,
(f) the rate of gross profit as a percentage of sale should be taken as 20%.

You are required to prepare a Trading and Profit & Loss A/c for the year ended 31st December, 2015, and a Balance Sheet as on that date.

[Hint. Collections from Debtors: ₹ 2,80,275, Cash Drawings: ₹ 25,955, Closing Bank Balance: ₹ 23,650].

[Ans. Gross Profit ₹: 57,875; Net Profit: ₹ 48,830 and Balance Sheet Total: ₹ 66,500].

3. Sree Ram Dass, a trader supplies you with the following information and requests you to draw a Trading and Profit & Loss Account for the year ended 31st December, 2015, and a Balance Sheet as on that date:

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Particulars	Balance as on 31-12-2014 ₹	Balance as on 31-12-2015 ₹
(i) Sundry creditors for goods	80,000	?
Sundry creditors for expenses	4,000	5,000
Bills Receivable	14,000	12,000
Sundry Debtors	90,000	?
Bills Payable	12,000	8,000
Stock	?	30,000
Motor-car (after depreciation)	60,000	60,000
Furniture (up to 31-12-2014)	40,000	?
Building	1,20,000	1,40,000
Cash and Bank Balances	90,000	50,000
Profit and Loss Account (Credit)	30,000	?

- (ii) The cash transactions (excluding payments for furniture), not otherwise indicated, are shown below:

Particulars	₹	Particulars	₹
Sales of scrap	15,000	Cash purchases	30,000
Various expenses	47,000	Payment to creditors	90,000
Collections from debtors	1,20,000	Cash sales	50,000

- (iii) Other information:

- (a) Some items of furniture, whose written down value as on 31-12-14, was ₹ 8,000 were sold on 30-6-15 for ₹ 6,000. Depreciation (on the Diminishing Balance Method) is to be provided on building and furniture @ 10% p.a. and on motor car @ 20% p.a. Additions to furniture and building were made at the beginning of the year.
(b) Bills receivable drawn during the year were ₹ 8,000 and bills payable accepted ₹ 6,000.
(c) Of the debtors, a sum of ₹ 6,000 should be written off as bad debts, and 2% provision is to be made for doubtful debts.
(d) Sree Ram Das maintains a steady gross profit at the rate of 30%.
(e) 20% of the total sales and purchases made are to be treated as for cash.

[Ans. Gross Profit: ₹ 75,000; Net Loss: ₹ 2,720; Balance Sheet Total: 4,87,280; Furniture purchased: 44,000].

NOTES

11.8 FURTHER READINGS

Maheshwari, S.N., Suneel K. and Sharad K. 2017. *Advanced Accountancy*, Vol I. New Delhi: Vikas Publishing House.

Maheshwari, S.N., Suneel K. and Sharad K. 2018. *An Introduction to Accountancy*, 12th edition. New Delhi: Vikas Publishing House.

Jain, S.P. and Narang, K.L. 2001. *Advanced Accountancy*. New Delhi: Kalyani Publishers.

Ahmed, N. 2008. *Financial Accounting*. New Delhi: Atlantic Publishers and Distributors Pvt. Ltd.

BLOCK V
RATIO ANALYSIS

*Introduction to Ratio
Analysis-I*

**UNIT 12 INTRODUCTION TO RATIO
ANALYSIS-I**

NOTES

Structure

- 12.0 Introduction
- 12.1 Objectives
- 12.2 Types of Ratios
- 12.3 Profitability and Market Earnings Ratios
- 12.4 Turnover Ratios
- 12.5 Financial or Accounting Ratios
 - 12.5.1 Fixed Assets Ratio
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- 12.8 Key Words
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- 12.10 Further Readings

12.0 INTRODUCTION

In this unit, you will learn about ratio analysis, which is a quantitative analysis of information contained in a company's financial statements. Ratio analysis is used to evaluate various aspects of a company's operating and financial performance, such as its efficiency, liquidity, profitability and solvency. It involves evaluating the performance and financial health of a company by using data from the current and historical financial statements. Ratios are categorized into three main groups, namely profitability ratios, turnover ratios and financial or accounting ratios.

12.1 OBJECTIVES

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

- Describe the categories of classification of ratios
- Explain the concept and computation of profitability and market earnings ratios
- Discuss the turnover ratios
- Examine the liquidity, proprietary and other accounting ratios

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12.2 TYPES OF RATIOS

Ratios can be classified into different categories depending upon the basis of classification.

Traditional Classification: This classification has been on the basis of the financial statements to which the determinants of a ratio belong. On this basis, the ratios could be classified as:

1. Profit and loss account ratios, *i.e.*, ratios calculated on the basis of the items of the profit and loss account only, *e.g.*, gross profit ratio and stock turnover ratio.
2. Balance sheet ratios, *i.e.*, ratios calculated on the basis of the figures of balance sheet only, *e.g.*, current ratio and debt-equity ratio.
3. Composite ratios or inter-statement ratios, *i.e.*, ratios based on figures of profit and loss account as well as the balance sheet, *e.g.*, fixed assets turnover ratio and overall profitability ratio.

Functional Classification: The traditional classification has been found to be too crude and unsuitable because the analysis of balance sheet and income statement cannot be done in isolation. They have to be studied together in order to determine the profitability and solvency of the business. In order that ratios serve as a tool for financial analysis, they are classified according to their functions as follows:

1. Profitability Ratios
2. Turnover Ratios
3. Financial Ratios

In the following pages we are explaining the ratios covered by each of the above categories in detail.

12.3 PROFITABILITY AND MARKET EARNINGS RATIOS

Profitability is an indication of the efficiency with which the operations of the business are carried on. Poor operational performance may indicate poor sales and hence poor profits. A lower profitability may arise due to the lack of control over the expenses. Bankers, financial institutions and other creditors look at the profitability ratios as an indicator whether or not the firm earns substantially more than it pays interest for the use of borrowed funds and whether the ultimate repayment of their debt appears reasonably certain. Owners are interested to know the profitability as it indicates the return which they can get on their investments. The following are the important profitability ratios

Overall Profitability Ratio

It is also called as 'return on investment' (ROI). It indicates the percentage of return on the total capital employed in the business. It is calculated on the basis of the following formula:

$$\frac{\text{Operating Profit}}{\text{Capital Employed}} \times 100$$

The term capital employed has been given different meanings by different accountants. Some of the popular meanings are as follows:

- (i) Sum-total of all assets whether fixed or current
- (ii) Sum-total of fixed assets
- (iii) Sum-total of long-term funds employed in the business, *i.e.*:

$$\text{Share Capital} + \text{Reserves and Surplus} + \text{Long-term Loans} - \left(\text{Non-business Assets} + \text{Fictitious Assets} \right)$$

In management accounting, the term capital employed is generally used in the meanings given in the third point above.

The term 'operating profit' means 'profit before interest and tax'. The term 'interest' means 'interest on long-term borrowings'. Interest on short-term borrowings will be deducted for computing operating profit. Non-trading incomes such as interest on government securities or non-trading losses or expenses such as loss on account of fire, etc., will also be excluded.

The computation of ROI can be understood with the help of the following illustration:

Illustration 12.1. From the following figures extracted from the income statement and the balance sheet of Anu Pvt. Ltd, calculate the return on total capital employed (ROI):

Particulars	₹	Particulars	₹
Fixed Assets	4,50,000	Reserves	1,00,000
Current Assets	1,50,000	Debentures	1,00,000
Investment in Government Securities	1,00,000	Income from Investments	10,000
Sales	5,00,000	Interest on Debentures at 10 per cent	
Cost of Goods sold	3,00,000	Provision for Tax at 50 per cent	
Share Capital:		of Net Profits	
10 per cent Preference	1,00,000		
Equity	2,00,000		

Solution: It will be appropriate to prepare the profit and loss account and the balance sheet of the company before computation of the return on capital employed.

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Anu Sales Pvt. Limited
Profit and Loss Account

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<i>Particulars</i>	₹	<i>Particulars</i>	₹
To Cost of goods sold	3,00,000	By Sales	5,00,000
To Interest on Debentures	10,000	By Income from Investments	10,000
To Provision for Taxation	1,00,000		
To Net Profit after Tax	<u>1,00,000</u>		
	<u>5,10,000</u>		<u>5,10,000</u>

Balance Sheet

as on.....

<i>Liabilities</i>	₹	<i>Assets</i>	₹
Share Capital:		Fixed Assets	4,50,000
10% Preference	1,00,000	Current Assets	1,50,000
Equity	2,00,000	Investment in Government Securities	1,00,000
Reserves	1,00,000		
10% Debentures	1,00,000		
Profit and Loss A/c	1,00,000		
Provision for Taxation	<u>1,00,000</u>		
	<u>7,00,000</u>		<u>7,00,000</u>

$$\begin{aligned} \text{Return on total capital employed} &= \frac{\text{Net Operating Profit before Interest and Tax}}{\text{Total Capital employed}} \times 100 \\ &= \frac{20,00,000}{5,00,000} \times 100 = 40 \text{ per cent} \end{aligned}$$

$$\begin{aligned} \text{Net Operating Profit} &= \text{Net Profit} + \text{Provision for Tax} - \text{Income from Investments} \\ &\quad + \text{Interest on Debentures} \\ &= 1,00,000 + 1,00,000 - 10,000 + 10,000 = ₹2,00,000 \end{aligned}$$

$$\begin{aligned} \text{Capital employed} &= \text{Fixed Assets} + \text{Current Assets} - \text{Provision for Tax} \\ &= 4,50,000 + 1,50,000 - 1,00,000 = ₹5,00,000 \\ &\quad \text{Share Capital} + \text{Reserves} + \text{Debentures} + \text{Profit and} \\ &\quad \text{Loss A/c Balance} - \text{Investments in Government Securities} \\ &= 3,00,000 + 1,00,000 + 1,00,000 + 1,00,000 - 1,00,000 \\ &= ₹5,00,000 \end{aligned}$$

Return on Investment (ROI) can be computed for calculating the return for different purposes. Some of the ratios that are calculated are as follows:

- (i) *Return of Shareholders' Funds*: In case it is desired to work out the profitability of the company from the shareholders' point of view, it should be computed as follows:

$$\frac{\text{Net Profit after Interest and Tax}}{\text{Shareholders' Funds}} \times 100$$

The term net profit here means 'net income after interest and tax'. It is different from the 'net operating profit', which is used for computing the 'return on total capital employed' in the business. This is because the shareholders are interested in total income after tax including net-non-operating income (*i.e.*, non-operating income – non-operating expenses).

Taking the figures from Illustration 12.1, the Return on Shareholders' Funds will be computed as follows:

$$\frac{\text{₹}1,00,000}{\text{₹}5,00,000} \times 100 = 20 \text{ per cent}$$

- (ii) *Return on Equity Shareholders' Funds*: The profitability from the point of view of the equity shareholders will be judged after taking into account the amount of dividend payable to the preference shareholders. The return on equity shareholders' funds will, therefore, be computed on the following basis:

$$\frac{\text{Net Profit after Interest, Tax and Preference Dividend}}{\text{Equity Shareholders Funds}} \times 100$$

Taking the figure from the Illustration 12.1, the return on equity shareholders' funds will be computed as follows:

$$= \frac{\text{₹}90,000}{\text{₹}3,90,000} \times 100 = 23 \text{ per cent}$$

- (iii) *Return on Total Assets*: This ratio is computed to know the 'productivity of the total assets.' There are three methods for computing it:

(a)
$$\frac{\text{Net Profit after Tax}}{\text{Total Assets}} \times 100$$

On the basis of the figures in the Illustration 6.1, the ratio will be:

$$= \frac{1,00,000}{7,00,000} \times 100$$

(b)

$$\frac{\text{Net Profit after Tax + Interest}}{\text{Total Assets}} \times 100 = 14.29 \text{ per cent}$$

On the basis of the figures given in the Illustration 6.1, the ratio will be:

$$= \frac{1,00,000 + 10,000}{7,00,000} \times 100 = 15.71 \text{ per cent}$$

The inclusion of interest is conceptually sound because total assets have been financed from the 'pool' of funds supplied by the creditors and the owners. The objective of computing the 'return on total assets' is to find out how effectively the funds pooled together have been used. Hence, it will be proper to include the interest in computing the return on total assets.

A further modification of this formula has been suggested by many accountants. It excludes 'intangible assets' from the 'total assets'. However, it will be proper to exclude only fictitious assets and not all intangible assets. The term 'fictitious assets' includes assets such as preliminary expenses, debit balance in the profit and loss account, etc. The return on assets, according to this method, may, therefore, be calculated as follows:

(c)
$$\frac{\text{Net Profit after Tax + Interest}}{\text{Total Assets excluding Fictitious Assets}} \times 100$$

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- (iv) **Return on Gross Capital employed:** The term gross capital employed means the total of fixed assets and the current assets employed in the business. The formula for its computation can be put as follows:

$$\frac{\text{Net Profit before Interest (on long as well as short-term borrowings) and Tax}}{\text{Gross Capital employed (i.e., Net Fixed Assets + Current Assets employed in the business)}} \times 100$$

On the basis of the figures given in the Illustration 12.1, the Return on Gross Capital employed can be computed as follows:

$$\frac{2,00,000}{6,00,000} \times 100 = 33.3\%$$

Tutorial Note: The students are advised to give their assumptions regarding computation of 'net profits' as well as 'capital employed' while calculating the return on investment (ROI).

Average Capital employed: Some people prefer to use '*average capital employed*' (or average total assets, as the case may be) in place of only 'capital employed' (or total assets). Average capital employed is the average of the capital employed at the beginning and at the end of the accounting period. For example, if in Illustration 12.1 given earlier, the capital employed at the beginning of the accounting period was ₹4,50,000 the ROI will be calculated as follows:

$$\begin{aligned} \text{ROI} &= \frac{\text{Net Profit before Interest and Tax}}{\text{Average Capital employed}} \times 100 \\ &= \frac{2,00,000}{1/2(5,00,000 + 4,50,000)} \times 100 \\ &= \frac{2,00,000}{4,75,000} \times 100 = 42.11\% \end{aligned}$$

It should be noted that while computing 'return on investment' according to any of the above methods 'abnormal gains or losses' should always be excluded from net profit.

Significance of ROI: The return on capital invested is a concept that measures the profit which a firm earns on investing a unit of capital. 'Yield on capital' is another term employed to express the idea. It is desirable to ascertain this periodically. The profit being the net result of all operations, the return on capital expresses all efficiencies or inefficiencies of a business collectively and, thus, is a dependable measure for judging its overall efficiency or inefficiency. On this basis, there can be comparison of the efficiency of one department with that of another, of one plant with that of another, one company with that of another and one industry with that of another. For this purpose, the amount of profits considered is that before making deductions on account of interest, income tax and dividends and capital is the aggregate of all the capital at the disposal of the company, viz., equity capital, preference capital, reserves, debentures, etc.

The return on capital, when calculated in this manner, would also show whether the company's borrowing policy was wise economically and whether the

capital had been employed fruitfully. Suppose funds have been borrowed at 8 per cent and the return on capital is 7½ per cent, it would have been better not to borrow (unless borrowing was vital for survival). It would also show that the firm had not been employing the funds efficiently.

Return on capital, as explained, may also be calculated on equity shareholders' capital. In that case, the profit after deductions for interest, income tax and preference dividend will have to be compared with equity shareholders' funds. It would not indicate operational efficiency or inefficiency but merely the maximum rate of dividend that might be declared.

The business can survive only when the return on capital employed is more than the cost of capital employed in the business.

Earning Per Share (EPS)

In order to avoid confusion on account of the varied meanings of the term 'capital employed', the overall profitability can also be judged by calculating earning per share with the help of the following formula:

$$\text{Earning per Equity Share} = \frac{\text{Net Profit after Tax and Preference Dividend}}{\text{Number of Equity Shares}}$$

Illustration 12.2. Calculate the earning per share from the following data:

Net Profit before Tax	₹1,00,000
Taxation at 50% of Net Profit	
10% Preference Share Capital (₹10 each)	₹1,00,000
Equity Share Capital (₹10 shares)	₹1,00,000

Solution:

$$\begin{aligned} \text{Earning per Share} &= \frac{\text{Net Profit after Tax and Preference Dividend}}{\text{Number of Equity Shares}} \\ &= \frac{₹40,000}{10,000} = ₹4 \text{ per share} \end{aligned}$$

Significance: The earning per share helps in determining the market price of the equity share of the company. A comparison of earning per share of the company with another will also help in deciding whether the equity share capital is being effectively used or not. It also helps in estimating the company's capacity to pay dividend to its equity shareholders.

Earnings Per Share (EPS – AS 20)

The Institute of Chartered Accountants of India (ICAI) has issued AS 20 – Earnings per Share, which has become mandatory *w.e.f.* 1.4.2001, in respect of enterprises whose equity shares or potential equity shares are listed on a recognized stock exchange in India.

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The Standard makes a distinction between basic and diluted earning per share. The enterprise has to give both types of earnings as per the standard.

(i) Basic Earnings Per Share (BEPS): The basic earnings per share is computed as follows:

$$\frac{\text{Net Profit (or Loss) for the Period Attributable to Equity Shareholders}}{\text{Weighted Average Number of Equity Shares Outstanding during the year}}$$

The net profit for the above purpose means profit after deducting preference dividend and tax, excluding dividend tax on equity shares. The weighted average number of equity shares are the equity shares outstanding at the beginning of the period adjusted by the number of equity shares bought back or issued in the period, multiplied by the time weighting factor.

Illustration 12.3. From the following details, compute the basic earnings per share:

Net profit for the year ending 31-12-2019 after tax and preference dividend	₹21,000
Equity as on 1-1-2019	1,800
Issued Equity Shares for Cash on 31-5-2019	600
Bought back Equity Shares on 1-11-2019	300

Solution:

Weighted Average Number of

Equity Shares Outstanding = $(1,800 \times 12/12 + 600 \times 7/12 - 300 \times 2/12) = 2,100$ shares

Basic Earnings Per Share =

$$\frac{\text{Net Profit for the Period Attributable to Equity Shareholders}}{\text{Weighted Average No. of Equity Shares Outstanding during the Year}}$$

$$= \frac{21,000}{2,100} = ₹10 \text{ per share}$$

(ii) Diluted Earnings Per Share (DEPS): Diluted earnings per share are calculated when there are potential equity shares in the capital structures of the enterprise. A potential equity share is a financial instrument or other contract (e.g., convertible debentures, convertible preference shares, option warrants, etc.) that entitles or may entitle its holder to equity shares. The diluted earnings per share are calculated as follows:

$$\frac{\text{Adjusted Net Profit (or Loss) for the Period Attributable to Equity Shareholders}}{\text{Adjusted Weighted Average Number of Shares}}$$

Illustration 12.4. From the following details, calculate:

(a) Basic Earnings per Share

(b) Diluted Earnings per Share.

Net Profit for the year ending 31-12-2019 after Preference Dividend and Tax	₹1,00,000
No. of Equity Shares as on 1-1-2019	50,000
No. of 12% Convertible Debentures of ₹100/- each	1,00,000

Each debenture is convertible into 10 equity shares. The tax rate applicable to the company is 30%.

Solution:

$$\begin{aligned}
 (a) \text{ Basic Earning per Share} &= \frac{\text{Net Profit Available for Equity Shareholders}}{\text{No. of Equity Shares Outstanding}} \\
 &= \frac{1,00,000}{5,000} = ₹20 \text{ per share} \\
 (b) \text{ Diluted Earnings per Share} &= \text{Adjusted Net Profit for the Current Year} \\
 \text{Net Profit after Interest Tax and Preference Dividend} &= ₹1,00,000 \\
 \text{Add: Interest Expense after Tax effect} & \\
 (₹1,20,000 - ₹36,000) &= ₹84,000 \\
 & ₹1,84,000 \\
 \text{No. of Equity shares Resulting from} & \\
 \text{conversion of Debentures} &= 10,000 \\
 \text{Total number of Equity Shares} & \\
 \text{after conversion of Debentures into Shares} &= 60,000 \\
 \text{Diluted Earning per Share} &= \\
 & \frac{\text{Adjusted Net Profit for the Period for Equity Shareholders}}{\text{Adjusted weighted Average no. of Shares}} \\
 &= \frac{₹1,84,000}{60,000} = ₹3.06 \text{ per share}
 \end{aligned}$$

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Price Earning Ratio (PER) or Market Earnings Ratio

This ratio indicates the number of times the earning per share is covered by its market price. This is calculated according to the following formula:

$$\frac{\text{Market Price Per Equity Share}}{\text{Earning Per Share}}$$

For example, if the market price of a share is ₹30 and earning per share is ₹5, the price earning ratio would be 6 (*i.e.*, $30 \div 5$). It means the market value of every one rupee of earning is six times or ₹6. The ratio is useful in financial forecasting. It also help in knowing whether the shares of a company are under or overvalued. For example, if the earning per share of *AB* Limited is ₹20, its market price ₹140 and earning ratio of similar companies is 8, it means that the market value of a share of *AB* Limited should be ₹160 (*i.e.*, 8×20). The share of *AB* Limited is, therefore, undervalued in the market by ₹20. In case the price earning ratio of similar companies is only 6, the value of share of *AB* Limited should have been ₹120 (6×20), thus the share is overvalued by ₹20.

Significance: Price-earning ratio helps the investor in deciding whether to buy or not to buy the shares of a company at a particular market price.

Gross Profit Ratio

This ratio expresses relationship between gross profit and net-sales. Its formula is:

$$\frac{\text{Gross Profit}}{\text{Net Sales}} \times 100$$

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Illustration 12.5. Calculate the gross profit ratio from the following figures:

	₹		₹
Sales	1,00,000	Purchases	60,000
Sales Returns	10,000	Purchases Returns	15,000
Opening Stock	20,000	Closing Stock	5,000

Solution:

$$\begin{aligned}
 \text{Gross Profit Ratio} &= \frac{\text{Gross Profit}}{\text{Net Sales}} \times 100 \\
 &= \frac{\text{Net Sales} - \text{Cost of goods sold}}{\text{Net Sales}} \times 100 \\
 &= \frac{₹90,000 - ₹60,000}{₹90,000} \times 100 \\
 &= \frac{₹30,000}{₹90,000} \times 100 \\
 &= 33\frac{1}{3}\%
 \end{aligned}$$

Significance: This ratio indicates the degree to which the selling price of goods per unit may decline without resulting in losses from operations to the firm. It also helps in ascertaining whether the average percentage of mark up on the goods is maintained.

There is no norm for judging the gross profit ratio, therefore, the evaluation of the business on its basis is a matter of judgement. However, the gross profits should be adequate to cover operating expenses and to provide for fixed charges, dividends and building up of reserves.

Net Profit Ratio

This ratio indicates net margin earned on a sale of ₹100. It is calculated as follows:

$$\frac{\text{Net Operating Profit}}{\text{Net Sales}} \times 100$$

Net operating profit is arrived at by deducting operating expenses from gross profit.

Illustration 12.6. Calculate net profit ratio from the following data:

	₹		₹
Sales less Returns	1,00,000	Selling Expenses	10,000
Gross Profit	40,000	Income from Investments	5,000
Administration Expenses	10,000	Loss on account of fire	3,000

Solution:

$$\begin{aligned}
 \text{Net Profit Ratio} &= \frac{\text{Net Operating Profit}}{\text{Net Sales}} \times 100 \\
 &= \frac{20,000}{1,00,000} \times 100 = 20\%
 \end{aligned}$$

Significance: This ratio helps in determining the efficiency with which affairs of the business are being managed. An increase in the ratio over the previous period indicates improvement in the operational efficiency of the business, provided the gross profit ratio is constant. The ratio is thus an effective measure to check the profitability of a business.

An investor has to judge the adequacy or otherwise of this ratio by taking into account the cost of capital, the return in the industry as a whole and market conditions such as boom or depression period. No norms can be laid down. However, constant increase in the above ratio year after year is a definite indication of improving conditions of the business.

Operating Ratio

This ratio is complementary to net profit ratio. In case the net profit ratio is 20%, it means that the operating ratio is 80%. It is calculated as follows:

$$\frac{\text{Operating Costs}}{\text{Net Sales}} \times 100$$

Operating costs include the cost of direct materials, direct labour and other overheads, viz., factory, office or selling. Financial charges such as interest, provision for taxation, etc., are generally excluded from operating costs.

For example, in the Illustration 12.6 given for the net profit ratio above, when the net profit ratio is 20%, the operating ratio will be 80%. The ratio can be calculated regarding each element of operating cost to sales, viz.

- (i) *Direct Material Cost to Sales* = $\frac{\text{Direct Material Cost}}{\text{Net Sales}} \times 100$
- (ii) *Direct Labour Cost to Sales* = $\frac{\text{Direct Labour Cost}}{\text{Net Sales}} \times 100$
- (iii) *Factory Overheads to Sales* = $\frac{\text{Factory Overheads}}{\text{Net Sales}} \times 100$

Similarly, the percentage of other operating costs such as administration and selling costs to sales can be computed.

Significance: This ratio is the test of the operational efficiency with which the business is being carried. The operating ratio should be low enough to leave a portion of sales to give a fair return to the investors.

A comparison of the operating ratio will indicate whether the cost component is high or low in the figure of sales. In case the comparison shows that there is increase in this ratio, the reason for such increase should be found out and management be advised to check the increase.

Fixed Charges Cover

The ratio is very important from the lender's point of view. It indicates whether the business would earn sufficient profits to pay periodically the interest charges. The

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higher the number, the more secure the lender is in respect of his periodical interest income. It is calculated as follows:

$$\frac{\text{Income before Interest and Tax}}{\text{Interest Charges}}$$

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This ratio is also called as ‘debt service ratio.’

The standard for this ratio for an industrial company is that interest charges should be covered six to seven times.

Illustration 12.7. The operating profit of A Ltd after charging interest on debentures and tax is a sum of ₹10,000. The amount of interest charged is ₹2,000 and the provision for tax has been made of ₹4,000.

Calculate the interest charges cover ratio.

Solution:

$$\begin{aligned} \text{Interest Charges Cover} &= \frac{\text{Net Profit before Interest and Tax}}{\text{Interest Charges}} \\ &= \frac{\text{₹16,000}}{\text{₹2000}} = 8 \text{ times} \end{aligned}$$

In case it is desired to compute the ‘fixed dividend cover’ it can be computed on the following basis:

$$\text{Fixed Dividend Cover} = \frac{\text{Net Profit after Interest and Tax}}{\text{Preference Dividend}}$$

In the above illustration if the amount of preference dividend payable is a sum of ₹1000, the fixed dividend cover will be computed as follows:

$$= \frac{\text{₹10,000}}{\text{₹1000}} = 10 \text{ times}$$

Debt Service Coverage Ratio

The interest coverage ratio, as explained above, does not tell us anything about the ability of a company to make payment of principal amount also on time. For this purpose debt service coverage ratio is calculated as follows:

$$\frac{\text{Net Profit before Interest and Tax}}{\text{Interest} + \frac{\text{Principal Payment Instalment}}{1 - \text{Tax rate}}}$$

The principle payment instalment is adjusted for tax effects since such payment is not deductible from net profit for tax purposes.

Illustration 12.8. Net profit before interest and tax ₹50,000. 10 per cent Debentures (payable in 10 year in equal instalments) ₹1,00,000.

Tax Rate 50%

Calculate the Debt Service Coverage Ratio.

Solution:

$$\text{Debt Service Coverage Ratio} = \frac{\text{Net Profit before Interest and Tax}}{\text{Interest} + \frac{\text{Principal Payment Instalment}}{1 - \text{Tax rate}}}$$

The ratio comes to 1.67. It means net profit before interest and tax covers adequately both interest and principal repayment instalment. Some accountants prefer to compute the debt service coverage ratio as under:

$$\frac{\text{Cash Profit available for Debts Service}}{\text{Interest + Principal Payment Instalment}}$$

Cash Profit available for debt service is computed by adding to net profit items like depreciation, interest on debt and amortization of items like goodwill, preliminary expenses, etc.

However, the former seems to be a better method since by giving the tax effect, it puts the two items interest and principal payment instalment on the same footing.

The higher the ratio, better it is.

Payout Ratio

This ratio indicates what proportion of earning per share has been used for paying dividend. The ratio can be calculated as follows:

$$\frac{\text{Dividend per Equity Share}}{\text{Earning per Equity Share}}$$

A complementary of this ratio is retained earning ratio. It is calculated as follows:

$$\begin{aligned} &= \frac{\text{Retained Earning per Equity Share}}{\text{Earning per Equity Share}} \\ &\text{or} \\ &= \frac{\text{Retained Earnings}}{\text{Total Earning}} \times 100 \end{aligned}$$

Illustration 12.9. Compute the payout ratio and the retained earning ratio from the following data:

	₹		₹
Net Profit	10,000	No. of Equity Shares	3,000
Provision for Tax	5,000	Dividend per Equity Share	0.40
Preference Dividend	2,000		

Solution:

$$\begin{aligned} \text{Payout Ratio} &= \frac{\text{Dividend per Equity Share}}{\text{Earning per Equity Share}} \times 100 \\ &= \frac{\text{₹}0.40}{\text{₹}1} \times 100 = 40\% \\ \text{Retained Earning Ratio} &= \frac{\text{Retained Earnings}}{\text{Total Earning}} \times 100 \\ &= \frac{\text{₹}1,800}{\text{₹}3,000} \times 100 = 60\% \\ &= \frac{\text{Retained Earning per share}}{\text{Total Earning per share}} \times 100 \\ &= \frac{\text{₹}0.60}{\text{₹}1} \times 100 = 60\% \end{aligned}$$

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Significance: The payout ratio and the retained earnings ratio are indicators of the amount of earnings that have been ploughed back in the business. The lower the payout ratio, the higher will be the amount of earnings ploughed back in the business and *vice versa*. Similarly, the lower the retained earnings ratio, the lower will be the amount of earnings ploughed back into the business and *vice versa*. A lower payout ratio or a higher retained earnings ratio means a stronger financial position of the company.

Dividend Yield Ratio

This ratio is particularly useful for those investors who are interested only in dividend income. The ratio is calculated by comparing the rate of dividend per share with market value. Its formula can be put as follows:

$$\frac{\text{Dividend per share}}{\text{Market Price per share}}$$

For example, if a company declares dividend at 20 per cent on its shares, each having a paid-up value of ₹8 and market price of ₹25, the dividend yield ratio will be calculated as follows:

$$\text{Dividend per Share} = \frac{20}{100} \times 8 = ₹1.60$$

$$\text{Dividend Yield Ratio} = \frac{\text{Dividend per Share}}{\text{Market Price per Share}} \times 100 = \frac{1.6}{25} \times 100 = 6.4\%$$

Significance: The ratio helps an intending investor in knowing the effective return he is going to get on the proposed investment. For example, in the above case though the company is paying a dividend of 20% on its shares, a person who purchases the shares of the company from the market will get only an effective return of 6.4%. He, therefore, can decide whether he should opt for this investment or not.

Check Your Progress

1. Why do bankers, financial institutions and other creditors look at the profitability ratios?
2. Define potential equity shares.
3. Why is fixed charges cover very important from the lender's point of view?

12.4 TURNOVER RATIOS

The turnover ratios or activity ratios indicate the efficiency with which the capital employed is rotated in the business. The overall profitability of the business depends on two factors: (i) the rate of return of capital employed; and (ii) the turnover, *i.e.*, the speed at which the capital employed in the business rotates. Higher the rate of rotation, the greater will be the profitability. Thus, overall profitability ratio can be classified into:

1. Net Profit Ratio
2. Turnover Ratio

As already explained the Net Profit Ratio is calculated as follows:

$$\frac{\text{Net Operating Profit}}{\text{Sales}} \times 100$$

Turnover ratio is calculated as follows:

$$\frac{\text{Sales}}{\text{Capital employed}}$$

Turnover ratio indicates the number of times the capital has been rotated in the process of doing business.

When these two ratios are put together, we get the overall profitability ratio.

$$\text{Overall profitability ratio} = \text{Net Profit Ratio} \times \text{Turnover Ratio}$$

$$\begin{aligned} &= 100 \times \frac{\text{Net Profit}}{\text{Sales}} \times \frac{\text{Sales}}{\text{Capital employed}} \\ &= \frac{\text{Net Profit}}{\text{Capital employed}} \times 100 \end{aligned}$$

Illustration 12.10. Determine which company is more profitable.

	A Ltd	B Ltd
Net Profit Ratio	5%	8%
Turnover Ratio	6 times	3 times

Solution: In the above case, if only net profit ratio is seen, Company *B* seems to be more profitable. But actually Company *A* is more profitable, because it has a higher turnover ratio which gives it a higher return on capital employed, *i.e.*, 30% in comparison to 24% in case of Company *B*.

In order to find out which part of capital is efficiently employed and which part not, different turnover ratios are calculated. These ratios are as follows:

Fixed Assets Turnover Ratio

This ratio indicates the extent to which the investments in fixed assets contributed towards sales. If compared with a previous period, it indicates whether the investment in fixed assets has been judicious or not. The ratio is calculated as follows:

$$\frac{\text{Net Sales}}{\text{Fixed Assets (Net)}}$$

Illustration 12.11. The following details have been given to you for Messrs Reckless Ltd for two years. You are required to find out the fixed assets turnover ratio and comment on it.

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	2018 ₹	2019 ₹
Fixed Assets at written-down value	1,50,000	3,00,000
Sales less Returns	6,00,000	8,00,000

Solution:

$$\text{Fixed Assets Turnover Ratio} = \frac{\text{Sales}}{\text{Fixed Assets}}$$

$$\begin{array}{ll} \text{2018} & \text{2019} \\ = 6,00,000 \div 1,50,000 = 4 \text{ times} & 8,00,000 \div 3,00,000 = 2.67 \text{ times} \end{array}$$

There has been a decline in the fixed assets turnover ratio though, absolute figures of sales have gone up. It means, increase in the investment in fixed assets has not brought about commensurate gain. However, the results for next two or three years must also be seen before commenting on judiciousness or otherwise of increase in investments in the fixed assets.

The fixed assets turnover ratio can further be divided into turnover of each item of fixed assets to find out the extent each fixed asset has been properly used. For example:

$$\text{Plant and Machinery to Turnover} = \frac{\text{Net Sales}}{\text{Plant and Machinery (Net)}}$$

$$\text{Land and Buildings to Turnover} = \frac{\text{Net Sales}}{\text{Land and Buildings (Net)}}$$

Working Capital Turnover Ratio

This ratio indicates whether or not working capital has been effectively utilized in making sales. The ratio is calculated as follows:

$$\frac{\text{Net Sales}}{\text{Working Capital}}$$

Working capital turnover ratio may take different forms for different purposes. Some of them are being explained below:

(i) **Debtors' Turnover Ratio (Debtors' Velocity):** Debtors constitute an important constituent of current assets and therefore the quality of debtors to a great extent determines a firm's liquidity. Two ratios are used by financial analysts to judge the liquidity of a firm. They are (i) debtors turnover ratio, and (ii) debt collection period ratio.

The debtors turnover ratio is calculated as under:

$$\frac{\text{Credit Sales}}{\text{Average Accounts Receivable}}$$

The term accounts receivable include 'trade debtors' and 'bills receivable.'

Illustration 12.12. Calculate the Debtors Turnover Ratio from the following figures:

	₹
Total Sales for the year 2019	1,00,000
Cash Sales for the year 2019	20,000
Debtors as on 1 January 2019	10,000
Debtors as on 31 December 2019	15,000
Bills Receivable as on 1 January 2019	7,500
Bills Receivable as on 31 December 2019	12,500

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Solution:

$$\begin{aligned} \text{Debtors' Turnover Ratio} &= \frac{\text{Credit Sales}}{\text{Average Accounts Receivable}} \\ &= \frac{₹80,000}{₹22,500^*} = 3.56 \text{ times} \end{aligned}$$

* 1/2 of (₹17,500 + ₹27,500)

In case the details regarding opening and closing receivables and credit sales are not available the ratio may be calculated as follows:

$$\frac{\text{Total Sales}}{\text{Accounts Receivable}}$$

Significance: The sales to accounts receivable comparison indicates the efficiency of the staff entrusted with collection of book debts. The higher the debtors' turnover ratio, the better it is, since it would indicate that debts are being collected more promptly. For measuring the efficiency, it is necessary to set up a standard figure; a ratio lower than the standard will indicate inefficiency.

The ratio helps in cash budgeting since the flow of cash from customers can be worked out on the basis of sales.

(ii) **Debt Collection Period Ratio:** The ratio indicates the extent to which the debts have been collected in time. It gives the average debt collection period. The ratio is very helpful to the lenders because it explains to them whether their borrowers are collecting money within a reasonable time. An increase in the period will result in greater blockage of funds in debtors. The ratio may be calculated by the following methods:

- (a)
$$\frac{\text{Months (or days) in a year}}{\text{Debtor's Turnover}}$$
- (b)
$$\frac{\text{Average Accounts Receivable} \times \text{Months (or days) in a year}}{\text{Credit Sales for the year}}$$
- (c)
$$\frac{\text{Accounts Receivable}}{\text{Average Monthly or Daily Credit Sales}}$$

Illustration 12.13.

	₹		₹
Credit Sales for the year	12,000	Bills Receivable	1,000
		Debtors	1,000

Calculate the debtors' turnover ratio and debt collection period.

Solution:

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$$\text{Debtors' Turnover Ratio} = \frac{\text{Credit Sales}}{\text{Accounts Receivable}} = \frac{12,000}{2,000} = 6 \text{ times}$$

Debt Collection Period (or Average Age of Receivables)

$$= \frac{\text{Months in a year}}{\text{Debtors' Turnover}} = \frac{12}{6} = 2 \text{ months}$$

Or

$$= \frac{\text{Accounts Receivable} \times \text{Months in a year}}{\text{Credit Sales in the year}} = \frac{2,000 \times 12}{12,000} = 2 \text{ months}$$

Or

$$= \frac{\text{Accounts Receivable}}{\text{Monthly Credit Sales}} = \frac{2,000}{1,000} = 2 \text{ months}$$

The two ratios are interrelated. Debtor's turnover can be obtained by dividing the months (or days) in a year by the average collection period (*e.g.*, $12/2 = 6$). Similarly, where the number of months (or days) in a year are divided by the debtors turnover, average debt collection period is obtained (*i.e.*, $12/6 = 2$ months).

Significance: Debtors' collection period measures the quality of debtors since it measures the rapidity or slowness with which money is collected from them. A shorter collection period implies prompt payment by debtors. It reduces the chances of bad debts. A longer collection period implies a too liberal and inefficient credit collection performance. However, in order to measure a firm's credit and collection efficiency, its average collection period should be compared with the average of the industry. It should be neither too liberal nor too restrictive. A restrictive policy will result in lower sales which will reduce profits.

It is difficult to provide a standard collection period of debtors. It depends upon the nature of the industry, seasonal character of the business and credit policies of the firm. In general, the amount of receivables should not exceed 3–4 months' credit sales.

(iii) **Creditors' Turnover Ratio (Creditors' Velocity):** It is similar to debtors' turnover ratio. It indicates the speed with which the payments for credit purchases are made to the creditors. The ratio can be computed as follows:

$$\frac{\text{Credit Purchases}}{\text{Average Accounts Payable}}$$

The term accounts payable includes 'trade creditors' and 'bills payable.'

In case the details regarding credit purchases, opening and closing accounts payable have not been given, the ratio may be calculated as follows:

$$\frac{\text{Total Purchases}}{\text{Accounts Payable}}$$

(iv) **Debt Payment Period Enjoyed Ratio (Average Age of Payables):** The ratio gives the average credit period enjoyed from the creditors. It can be computed by any one of the following methods:

- (a)
$$\frac{\text{Months (or days) in a year}}{\text{Creditors' Turnover}}$$
- (b)
$$\frac{\text{Average Accounts Payable} \times \text{Months (or days) in a year}}{\text{Creditors' Turnover}}$$
- (c)
$$\frac{\text{Average Accounts Payable}}{\text{Average Monthly (or daily) Credit Purchases}}$$

Illustration 12.14. From the following figures, calculate the creditors' turnover ratio and the average age of accounts payable:

	₹		₹
Credit Purchases during 2019	1,00,000	Bills Payable on 1 Jan. 2019	4,000
Creditors on 1 Jan. 2019	20,000	Bills Payable on 31 Dec. 2019	6,000
Creditors on 31 Dec. 2019	10,000		

Solution:

$$\text{Creditors' Turnover Ratio} = \frac{\text{Credit Purchase}}{\text{Average Accounts Payable}} = \frac{\text{₹1,00,000}}{\text{₹20,000}} = 5 \text{ times}$$

$$\text{Average Age of Accounts Payable (or credit period enjoyed)} = \frac{\text{Months in a year}}{\text{Creditor's Turnover}} = \frac{12}{5} = 2.4 \text{ months}$$

Or

$$\frac{\text{Average Accounts Payable} \times \text{Months in a year}}{\text{Credit Purchases in the year}} = \frac{20,000 \times 12}{1,00,000} = 2.4 \text{ months}$$

Or

$$\frac{\text{Average Accounts Payable}}{\text{Average Monthly Credit Purchases}} = \frac{20,000}{8,333.33} = 2.4 \text{ months}$$

Significance: Both the creditors turnover ratio and the debt payment period enjoyed ratio indicate about the promptness or otherwise in making payment of credit purchases. A higher 'creditors turnover ratio' or a 'lower credit period enjoyed ratio' signifies that the creditors are being paid promptly, thus enhancing the creditworthiness of the company. However, a very favourable ratio to this effect also shows that business is not taking full advantage of credit facilities which can be allowed by the creditors.

(v) **Stock Turnover Ratio:** This ratio indicates whether investment in inventory is efficiently used or not. It, therefore, explains whether investment in inventories is within proper limits or not. The ratio is calculated as follows:

$$\frac{\text{Cost of Goods Sold during the year}}{\text{Average Inventory}}$$

Average inventory is calculated by taking stock levels of raw materials, work-in-process, finished goods at the end of each month, adding them up and dividing by twelve.

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Inventory ratio can be calculated regarding each constituent of inventory. It may thus be calculated regarding raw materials, work-in-progress and finished goods:

- (a) $\frac{\text{Cost of Goods Sold}}{\text{Average Stock of Finished Goods}}$
- (b) $\frac{\text{Material Consumed}}{\text{Average Stock of Raw Materials}}$
- (c) $\frac{\text{Cost of Completed Work}}{\text{Average Work-in-process}}$

The method discussed above is, as a matter of fact, the best basis for computing the stock turnover ratio. However, in the absence of complete information, the inventory turnover ratio may also be computed on the following basis:

$$\frac{\text{Net Sales}}{\text{Average Inventory at Selling Price}}$$

The average inventory may also be calculated on the basis of the average of inventory at the beginning and at the end of the accounting period.

$$\text{Average Inventory} = \frac{\text{Inventory at the beginning of the accounting period} + \text{Inventory at the end of the accounting period}}{2}$$

Illustration 12.15. Following is the trading account of Skylarks Ltd. Calculate the stock turnover ratio:

Dr:		Trading Account		Cr:	
Particulars	₹	Particulars	₹		
To Opening Stock	40,000	By Sales	2,00,000		
To Purchases	1,00,000	By Closing Stock	20,000		
To Carriage	10,000				
To Gross Profit	<u>70,000</u>				
	<u>2,20,000</u>		<u>2,20,000</u>		

Solution:

$$\text{Stock Turnover Ratio} = \frac{\text{Cost of Sales}}{\text{Average Stock}} = \frac{\text{₹}1,30,000}{30,000} = 4.33 \text{ times}$$

Significance of the ratio: As already stated, the inventory turnover ratio signifies the liquidity of the inventory. A high inventory turnover ratio indicates brisk sales. The ratio is, therefore, a measure to discover the possible trouble in the form of overstocking or overvaluation. The stock position is known as the *graveyard* of the balance sheet. If the sales are quick such a position would not arise unless the stocks consist of unsaleable items. A low inventory turnover ratio results in blocking of funds in inventory which may ultimately result in heavy losses due to the inventory becoming obsolete or deteriorating in quality.

12.5 FINANCIAL OR ACCOUNTING RATIOS

Financial ratios indicate the financial position of the company. A company is deemed to be financially sound if it is in a position to carry on its business smoothly and meet all its obligations—both long-term as well as short-term without strain. Thus, its financial position has to be judged from two angles—long-term as well as short-term. It is a sound principle of finance that long-term requirements of funds should be met out of long-term funds and short-term requirements should be met out of short-term funds. For example, if fixed assets are purchased out of funds provided by bank overdraft, the company will come to grief because such assets cannot be sold away when payment will be demanded by the bank. We are giving below some of the important ratios which are calculated in order to judge the financial position of the company.

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12.5.1 Fixed Assets Ratio

This ratio is expressed as follows:

$$\frac{\text{Fixed Assets}}{\text{Long-term Funds}}$$

The ratio should not be more than 1. If it is less than 1, it shows that a part of the working capital has been financed through long-term funds. This is desirable to some extent because a part of working capital termed as ‘core working capital’ is more or less of a fixed nature. The ideal ratio is 0.67.

Fixed assets include ‘net fixed assets’ (*i.e.*, original cost – depreciation to date) and trade investments including shares in subsidiaries. Long-term funds included share capital, reserves and long-term loans.

Illustration 12.16. From the following information compute the fixed assets ratio:

<i>Particulars</i>	₹	<i>Particulars</i>	₹
Share Capital	1,00,000	Furniture	25,000
Reserves	50,000	Trade Debtors	50,000
12 per cent Debentures	1,00,000	Cash Balance	30,000
Trade Creditors	50,000	Bills Payable	10,000
Plant and Machinery	1,00,000	Stock	40,000
Land and Buildings	1,00,000		

Solution:

$$\text{Fixed Assets Ratio} = \frac{\text{Fixed Assets}}{\text{Long-term Funds}} = \frac{2,25,000}{2,50,000} = 0.9$$

12.5.2 Current Ratio

This ratio is an indicator of the firm’s commitment to meet its short-term liabilities. It is expressed as follows:

$$\frac{\text{Current Assets}}{\text{Current Liabilities}}$$

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Current assets include cash and other assets convertible or meant to be converted into cash during the operating cycle of the business (which is of not more than a year). Current liabilities mean liabilities payable within a year's time either out of existing current assets or by creation of new current liabilities. A list of items included in current assets and current liabilities has already been given in the pro forma analysis balance sheet in the preceding pages.

Book debts outstanding for more than six months and loose tools should not be included in current assets. Prepaid expenses should be taken into current assets.

Illustration 12.17. From the following, compute the 'Current Ratio':

<i>Particulars</i>	₹	<i>Particulars</i>	₹
Sundry Debtors	40,000	Sundry Creditors	20,000
Prepaid expenses	20,000	Debentures	1,00,000
Short-term investments	10,000	Inventories	20,000
Loose Tools	5,000	Outstanding Expenses	20,000
Bills Payable	10,000		

Solution:

$$\text{Current Ratio} = \frac{\text{Current Assets}}{\text{Current Liabilities}} = \frac{₹90,000}{₹50,000} = 1.8$$

An ideal current ratio is 2. The ratio of 2 is considered as a safe margin of solvency due to the fact that if the current assets are reduced to half, *i.e.*, 1 instead of 2, then also the creditors will be able to get their payments in full. However, a business having seasonal trading activity may show a lower current ratio at certain period in the year. A very high current ratio is also not desirable since it means less efficient use of funds. This is because a high current ratio means excessive dependence on long-term sources of raising funds. Long-term liabilities are costlier than current liabilities and therefore, this will result in considerably lowering down the profitability of the concern.

It is to be noted that the mere fact that current ratio is quite high does not mean that the company will be in a position to meet adequately its short-term liabilities. In fact the current ratio should be seen in relation to the components of the current assets and their liquidity. If a large portion of the current assets comprises obsolete stocks or debtors outstanding for a long time, company may fail if the current ratio is higher than 2.

The current ratio can also be manipulated very easily. This may be done either by postponing certain pressing payments or postponing purchase of inventories or making payment of certain current liabilities. Consider the following examples:

Example 1:

		₹
Current Assets:	Sundry Debtors	40,000
	Inventories	60,000
	Cash in Hand	1,00,000
Current Liabilities:	Sundry Creditors	80,000
	Bills Payable	20,000
Current Ratio = $\frac{₹2,00,000}{₹1,00,000} = 3.$		

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In case the creditors are paid to the extent of ₹50,000 out of cash in hand, the current ratio will be as follows:

$$\text{Current Ratio} = \frac{1,50,000}{50,000} = 3.$$

Example 2: A business has current assets of ₹30,000 including stock of goods of ₹5,000. Its current liabilities are of ₹15,000. The current ratio is 2. However, if the business should have maintained a stock of ₹15,000, the current ratio would have been as follows:

$$\frac{30,000 + 10,000}{15,000 + 10,000 * } = \frac{40,000}{25,000} = 1.6$$

*Presuming that the goods are purchased on credit.

Significance: The current ratio is an index of the concern's financial stability since it shows the extent of the working capital which is the amount by which the current assets exceed the current liabilities. As stated earlier, a higher current ratio would indicate inadequate employment of funds while a poor current ratio is a danger signal to the management. It shows that the business is trading beyond its resources.

12.5.3 Liquidity Ratio

This ratio is also termed as 'acid test ratio' or 'quick ratio.' This ratio is ascertained by comparing the liquid assets (*i.e.*, assets which are immediately convertible into cash without much loss) to current liabilities prepaid expenses and stock are not taken as liquid assets. The ratio may be expressed as under:

$$\frac{\text{Liquid Assets}}{\text{Current Liabilities}}$$

On the basis of the figures given in the Illustration the liquidity ratio will be computed as under:

$$= \frac{\text{Liquid Assets}}{\text{Current Liabilities}} = \frac{₹90,000 - ₹40,000}{₹50,000} = \frac{₹50,000}{₹50,000} = 1$$

Some accountants prefer the term 'liquid liabilities' for 'current liabilities' for the purpose of ascertaining this ratio. Liquid liabilities mean liabilities which are payable within a short period. The bank overdraft (if it becomes a permanent mode of financing) and cash credit facilities will be excluded from current liabilities in such a case:

The ideal ratio for $\frac{\text{Liquid Assets}}{\text{Liquid Liabilities}}$ is 1.

The ratio is also an indicator of short-term solvency of the company.

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A comparison of the current ratio to quick ratio shall indicate the inventory hold-ups. For example, if two units have the same current ratio but different liquidity ratios, it indicates over-stocking by the concern having low liquidity ratio as compared to the concern which has a higher liquidity ratio.

12.5.4 Debt–equity Ratio

The debt–equity ratio is determined to ascertain the soundness of the long-term financial policies of the company. It is also known as ‘external-internal’ equity ratio. It may be calculated as follows:

$$\text{Debt–equity Ratio} = \frac{\text{External Equities}}{\text{Internal Equities}}$$

The term ‘external equities’ refers to total outside liabilities and the term ‘internal equities’ refers to shareholders’ funds or the tangible net worth (as used in the pro forma balance sheet given in the preceding pages). In case the ratio is 1 (*i.e.*, outsiders’ funds are equal to shareholders’ funds), it is considered to be quite satisfactory.

$$(i) \text{ Debt–equity Ratio} = \frac{\text{Total Long-term Debt}}{\text{Total Long-term Funds}}$$

$$(ii) \text{ Debt–equity Ratio} = \frac{\text{Shareholders' Funds}}{\text{Total Long-term Funds}}$$

$$(iii) \text{ Debt–equity Ratio} = \frac{\text{Total Long-term Debt}}{\text{Shareholders' Funds}}$$

Method (*iii*) is most popular.

Ratios (*i*) and (*ii*) give the proportion of long-term debt/shareholders’ funds in total long-term funds (including borrowed as well as owned funds), while ratio (*iii*) indicates the proportion between shareholders’ funds (*i.e.*, tangible net worth), and the total long-term borrowed funds.

Ratios (*i*) and (*ii*) may be taken as ideal if they are 0.5 each, while the ratio (*iii*) may be taken as ideal if it is 1. In other words, the investor may take debt–equity ratio as quite satisfactory if shareholders’ funds are equal to borrowed funds. However, a lower ratio, say $2/3^{\text{rd}}$, borrowed funds and $1/3^{\text{rd}}$ owned funds may also not be considered as unsatisfactory if the business needs heavy investment in fixed assets and has an assured return on its investment, *e.g.*, in case of public utility concerns.

It is to be noted that preference shares redeemable within a period of 12 years from the date of their issue should be taken as a part of debt.

Illustration 12.18. From the following figures calculate the debt–equity ratio:

Particulars	₹	Particulars	₹
Preference Share capital	1,00,000	Unsecured Loans	50,000
Equity Share Capital	2,00,000	Creditors	40,000
Capital Reserves	50,000	Bills Payable	20,000
Profit and Loss A/c	50,000	Provision for Taxes	10,000
12 per cent Mortgage Debenture	1,00,000	Provision for Dividends	20,000

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Solution: The debt–equity ratio may be calculated according to any of the following methods depending on the purpose for which the information is required.

$$(i) \text{ Debt–equity Ratio} = \frac{\text{External Equities}}{\text{Internal Equities}} = \frac{2,40,000}{4,00,000} = 0.6$$

$$(ii) \text{ Debt–equity Ratio} = \frac{\text{Total Long-term Debt}^*}{\text{Total Long-term Liabilities}} = \frac{1,50,000}{5,50,000} = 0.27$$

$$(iii) \text{ Debt–equity Ratio} = \frac{\text{Shareholders' Funds}}{\text{Total Long-term Funds}} = \frac{4,00,000}{5,50,000} = 0.73$$

$$(iv) \text{ Debt–equity Ratio} = \frac{\text{Total Long-term Debt}}{\text{Shareholders Fund}} = \frac{1,50,000}{4,40,000} = 0.73$$

* Unsecured loan has been taken as a long-term loan.

Significance: The ratio indicates the proportion of owners' stake in the business. Excessive liabilities tend to cause insolvency. The ratio indicates the extent to which the firm depends upon outsiders for its existence. The ratio provides a margin of safety to the creditors. It tells the owners the extent to which they can gain the benefits of maintaining control with a limited investment.

12.5.5 Proprietary Ratio

It is a variant of debt–equity ratio. It establishes relationship between the proprietors' or shareholders' funds and the total tangible assets. It may be expressed as under:

$$\frac{\text{Shareholders' Funds}}{\text{Total Tangible Assets}}$$

Illustration 12.19. From the following, calculate the proprietary ratio:

Particulars	₹	Particulars	₹
Preference Share Capital	1,00,000	Fixed assets	2,00,000
Equity Share Capital	2,00,000	Current assets	1,00,000
Reserves and Surplus	50,000	Goodwill	50,000
Debentures	1,00,000	Investments	1,50,000
Creditors	50,000		
	<u>5,00,000</u>		<u>5,00,000</u>

Solution:

$$\text{Proprietary Ratio} = \frac{\text{Shareholders' Funds}}{\text{Total Tangible Assets}} = \frac{₹3,00,000}{₹4,50,000} = 0.67 \text{ or } 67\%$$

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Significance: This ratio focuses the attention on the general financial strength of the business enterprise. The ratio is of particular importance to the creditors who can find out the proportion of shareholders' funds in the total assets employed in the business. A high proprietary ratio will indicate a relatively lesser danger to the creditors, etc., in the event of forced reorganization or winding up of the company. A low proprietary ratio indicates greater risk to the creditors since in the event of losses a part of their money may be lost besides loss to the proprietors of the business. The higher the ratio, the better it is. A ratio below 50 per cent may be alarming for the creditors since they may have to lose heavily in the event of company's liquidation on account of heavy losses.

Check Your Progress

4. What are the two factors on which the overall profitability of the business depends?
5. What measures the quality of debtors?
6. State the ideal Fixed Assets ratio.
7. What is another name for 'debt-equity' ratio?

12.6 ANSWERS TO CHECK YOUR PROGRESS QUESTIONS

1. Bankers, financial institutions and other creditors look at the profitability ratios as an indicator whether or not the firm earns substantially more than it pays interest for the use of borrowed funds and whether the ultimate repayment of their debt appears reasonably certain.
2. A potential equity share is a financial instrument or other contract that entitles or may entitle its holder to equity shares.
3. Fixed charges cover ratio is very important from the lender's point of view as it indicates whether the business would earn sufficient profits to pay periodically the interest charges.
4. The two factors on which the overall profitability of the business depends are: (i) the rate of return of capital employed, (ii) the turnover.
5. The debtors' collection period measures the quality of debtors since it measures the rapidity or slowness with which the money is collected from them.
6. The ideal fixed assets ratio is 0.67.
7. Another name for 'debt-equity' ratio is 'external-internal' equity ratio.

12.7 SUMMARY

- Ratios can be classified into different categories depending upon the basis of classification.
- As per the Traditional classification, ratios could be classified as: profit and loss account ratios, balance sheet ratios, and composite ratios.
- In order that ratios serve as a tool for financial analysis, they are classified according to their functions as follows: (i) Profitability ratios, (ii) Turnover ratios, and (iii) Financial ratios.
- Profitability is an indication of the efficiency with which the operations of the business are carried on.
- The following are the different profitability ratios: overall profitability ratio, earning per share, price earnings ratio, gross profit ratio, operating ratio, fixed charges cover, debt service coverage ratio, payout ratio and dividend yield ratio.
- The turnover ratios or activity ratios indicate the efficiency with which the capital employed is rotated in the business.
- The following are the different turnover ratios: fixed assets turnover ratio and working capital turnover ratio.
- Financial ratios indicate the financial position of the company. The following are the different financial ratios: fixed assets ratio, current ratio, liquidity ratio, debt-equity ratio, and proprietary ratio.

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12.8 KEY WORDS

- **Accounting Ratio:** It is the relationship expressed in mathematical terms between two accounting figures related to each other.
- **Balance Sheet Ratios:** Ratios calculated on the basis of figures of balance sheet only.
- **Composite Ratios:** Ratios based on figures of profit and loss account as well as the balance sheet. They are also known as inter-statement ratios.
- **Financial Ratios:** Ratios disclosing the financial position or solvency of the firm. They are also known as solvency ratios.
- **Profitability Ratios:** Ratios which reflect the final results of business operations.
- **Turnover Ratios:** Ratios measuring the efficiency with which the assets are employed by a firm. They are also known as activity or efficiency ratios.

12.9 SELF ASSESSMENT QUESTIONS AND EXERCISES

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Short Answer Questions

1. What are ratios to be worked out to study the long-term solvency of a concern?
2. State the formulae to calculate the following accounting ratios:
 - (i) Quick Ratio or Liquidity Ratio
 - (ii) Selling Expenses Ratio
 - (iii) Debt–Equity Ratio
 - (iv) Debtors Ratio or Debt Collection Period
 - (v) Gross Profit Ratio
3. Explain any two of the following:
 - (i) Gross Profit Ratio
 - (ii) Stock Turnover Ratio

Long Answer Questions

1. ‘Accounting Ratios are mere guides and complete reliance on them in decision making is suicidal.’ Elucidate.
2. The four basic group of financial ratios are liquidity, leverage, activity (efficiency) and profitability. Explain their nature and indicate its principal users.
3. Write short notes on:
 - (i) Proprietary Ratio
 - (ii) Debt Coverage Ratio
 - (iii) P/E Ratio
 - (iv) Yield Ratio
 - (v) Market Value/Book Value of Shares

12.9 FURTHER READINGS

Maheshwari, S.N., Suneel K. and Sharad K. 2017. *Advanced Accountancy*, Vol I. New Delhi: Vikas Publishing House.

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UNIT 13 INTRODUCTION TO RATIO ANALYSIS-II

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Structure

- 13.0 Introduction
- 13.1 Objectives
- 13.2 Factors Affecting Efficiency of Ratios
 - 13.2.1 How to Make Effective use of Ratio Analysis
- 13.3 Uses and limitation of ratios
- 13.4 Answers to Check Your Progress Questions
- 13.5 Summary
- 13.6 Key Words
- 13.7 Self Assessment Questions and Exercises
- 13.8 Further Readings

13.0 INTRODUCTION

You have already learnt about the concept and computation of different types of ratios in the previous unit. But are ratios a good tool for financial statement analysis? Do they present reliable results? What are the things that should be kept in mind while working with ratios? All of these topics are the subject of this unit. It is very important that knowledge of these factors are kept in mind so that proper analysis is carried out.

13.1 OBJECTIVES

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

- Explain the factors affect the efficiency of ratios
- Discuss how to make effective use of ratio analysis
- Describe the uses and limitations of ratios

13.2 FACTORS AFFECTING EFFICIENCY OF RATIOS

Ratio analysis is not the best bet when it comes to serving as a tool for financial statement analysis, there are many factors which affects its efficiency. The following are some of them:

- It does not take into account the inflationary changes and relies on real prices. This means that the changes in the inventory and depreciation values will result in different interpretations.

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- It may show different results in case the accounting policies, and operational structure changes. This includes changes in terms of financial metrics which heavily affects the manner of computation. In case this is not similar across different periods and different companies, the ratio will be incomparable.
- It may suffer from problems of misrepresentation of data in case the company attempts window dressing, or the purpose of analysis is murky.
- It is problematic in the sense that it does not take into consideration the seasonal factors like holiday season, weather conditions and geographical locations the different businesses are set in affecting their accounts.

13.2.1 How to Make Effective use of Ratio Analysis

One of the most difficult problems confronting the analyst is the interpretation and analysis of financial ratios. An adequate financial analysis involves more than an understanding and interpretation of each of the individual ratios. Furthermore, the analyst requires an insight into the meaning of inter-relationships among the ratios and financial data in the statements. Gaining such an insight and understanding requires considerable experience in the analysis and interpretation of financial statements. Moreover, even experienced analyst cannot apply their skill equally well to analyse and interpret the financial statements of different organizations. The characteristics may differ from industry to industry and from firm to firm within the same industry. A ratio that is high for one firm at one time may be low for another firm or for the same firm at a different time. Therefore, the analyst must be familiar with the characteristics of the firm of which he is interpreting the final ratios.

The analyst must not undertake the interpretation and analysis of financial ratios in isolation from other information. The following factors must be considered while analysing the financial ratios:

- General economic condition of the firm
- Risk acceptance
- Future expectations
- Future opportunities
- Accounting system of the industry
- Analysing and interpretation system used by other firms in the industry.

The analysis and interpretation of financial ratios in the light of the above-listed factors can be useful but the analyst must still rely on skill, insight, and even intention in order to interpret the ratios and arrive at a decision. The interpretation of the ratios can be made by comparing them with:

- Previous figures – trend analysis;
- Similar firms – inter-firm comparisons;
- Targets – individual ratio set to meet the objective.

- **Trend Analysis:** The analyst usually use historical standards for evaluating the performance of the firm. The historical standards represent the financial ratios computed over a period of time which sets the trend. Trend analysis provides enough clues to the analyst for proper evaluation of the financial ratios. However, the changes in firm's policies over the period must be considered while interpreting ratios from comparison over time. Further, the average of the ratios for several years can also be used for this purpose.
- **Inter-firm Comparisons:** Inter-firm comparisons may advocate the comparisons of similar ratios for a number of different firms in the same industry. Such an attempt would facilitate the comparative study of financial position and performance of the firms in the industry. The published ratios of trade associations or financial institutions can be of great help to the analyst in interpreting the financial ratios. However, the variations in accounting system and changes in the policies and procedures of the firm in comparison with the industry have to be taken care of while making use of inter-firm comparisons.
- **Targets:** Under this method, the interpretation of the ratio is made by comparing it with the standard set for this purpose. Such a standard ratio, based upon well-proven conventions serves as a measuring scale for the evaluation of the ratios. The best example of such standard is the 1:1 ratio, which is to be considered as a good ratio for analysing the acid-test ratio.

Generally speaking, the use of single standard ratio for the interpretation of ratios is not much useful. The accounting experts usually recommend the use of groups of standard ratios for the evaluation of financial ratios.

13.3 USES AND LIMITATION OF RATIOS

Following are some of the uses of ratio analysis:

1. **Simplifies Financial Statements:** Ratio analysis simplifies the comprehension of financial statements. Ratios tell the whole story of changes in the financial condition of the business.
2. **Facilitates Inter-firm Comparison:** Ratio analysis provides data for inter-firm comparison. Ratios highlight the factors associated with successful and unsuccessful firms. They also reveal strong firms and weak firms, over-valued and under-valued firms.
3. **Makes Intra-firm Comparison Possible:** Ratio analysis also makes possible comparison of the performance of the different divisions of the firm. The ratios are helpful in deciding about their efficiency or otherwise in the past and likely performance in the future.
4. **Helps in Planning:** Ratio analysis helps in planning and forecasting. Over a period of time, a firm or industry develops certain norms that may indicate

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future success or failure. If relationship changes in firm's data over different time periods, the ratios may provide clues on trends and future problems.

Thus, 'ratios can assist management in its basic functions of forecasting, planning, coordination, control and communication.'

Limitations of Ratio Analysis

Accounting ratios are subject to certain limitations. They are given below:

1. **Comparative study required:** Ratios are useful in judging the efficiency of the business only when they are compared with the past results of the business or with the results of a similar business. However, such a comparison only provides a glimpse of the past performance and forecasts for future may not prove correct since several other factors, like market conditions and management policies, may affect the future operations.
2. **Limitations of financial statements:** Ratios are based only on the information which has been recorded in the financial statements. Financial statements suffer from a number of limitations, the ratios derived therefrom, therefore, are also subject to those limitations. For example, non-financial charges though important for the business are not revealed by the financial statements. If the management of the company changes, it may have ultimately adverse effects on the future profitability of the company but this cannot be judged by having a glance at the financial statements of the company.

Similarly, the management has a choice about the accounting policies. Different accounting policies may be adopted by management of different companies regarding the valuation of inventories, depreciation, research and development expenditure and treatment of deferred revenue expenditure, etc. The comparison of one firm with another on the basis of ratio analysis without taking into account the fact of companies having different accounting policies, will be misleading and meaningless. Moreover, the management of the firm itself may change its accounting policies from one period to another. It is, therefore, absolutely necessary that financial statements are themselves subjected to close scrutiny before an analysis is attempted on the basis of accounting ratios. The financial analyst must carefully examine the financial statements and make necessary adjustments in the financial statements on the basis of disclosure made regarding the accounting policies, before undertaking financial analysis.

The growing realization among accountants all over the world, that the accounting policies should be standardized, has resulted in establishment of the International Accounting Standard Committee, which has issued a number of International Accounting Standards. In our country, the Institute of Chartered Accountants of India has established the Accounting Standards Board for the formulation of requisite accounting standards. The Accounting Standards Board has already issued 32 accounting Standards including AS 1:

Disclosure of Accounting Policies. The standard has become mandatory in respect of accounts for periods commencing on or after 1 April 1991.

3. **Ratios alone are not adequate:** Ratios are only indicators, they cannot be taken as final regarding good or bad financial position of the business. Other things have also to be seen. For example, a high current ratio does not necessarily mean that the concern has a good liquid position, in case, current assets mostly comprise outdated stocks. It has been correctly observed, 'No ratio may be regarded as good or bad *inter se*.' It may be an indication that a firm is weak or strong but it must never be taken as proof of either one. Ratios may be linked to rail-roads. They tell the analyst, 'stop, look and listen.'
4. **Window dressing:** The term window dressing means manipulation of accounts in a way so as to conceal vital facts and present the financial statements in a way as to show a better position than what it actually is. On account of such a situation, presence of particular ratio may not be a definite indicator of good or bad management. For example, a high stock turnover ratio is generally considered to be an indication of operational efficiency of the business. But this might have been achieved by unwarranted price reductions or failure to maintain proper stock of goods.

Similarly, the current ratio may be improved just before the balance sheet date by postponing replenishment of inventory. For example, if a company has got current assets of ₹4,000 and current liabilities of ₹2,000, the current ratio is 2, which is quite satisfactory. In case the company purchases goods of ₹2,000 on credit, the current assets would go up to ₹6,000 and current liabilities to ₹4,000, thus reducing the current ratio to 1.5. The company may, therefore, postpone the purchases for the early next year so that its current ratio continues to remain at 2 on the balance sheet date. Similarly, in order to improve the current ratio, the company may pay off certain pressing current liabilities before the balance sheet date. For example, if in the above case the company pays current liabilities of ₹1,000, the current liabilities would stand reduced to ₹1,000, current assets would stand reduced to ₹3,000 but the current ratio would go up to 3.
5. **Problem of price level changes:** Financial analysis based on accounting ratios will give misleading results if the effects of changes in price level are not taken into account. For example, two companies set up in different years, having plant and machinery of different ages, cannot be compared, on the basis of traditional accounting statements. This is because the depreciation charged on plant and machinery in case of old company would be at a much lower figure as compared to the company which has been set up recently. The financial statements of the companies should, therefore, be adjusted, keeping in view the price level changes, if a meaningful comparison is to be made through accounting ratios. The techniques of

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current purchasing power and current cost accounting are quite helpful in this respect.

6. **No fixed standards:** No fixed standards can be laid down for ideal ratios. For example, current ratio is generally considered to be ideal if current assets are twice the current liabilities. However, in case of those concerns which have adequate arrangements with their bankers for providing funds when they require, it may be perfectly ideal if current assets are equal to or slightly more than current liabilities.

It may, therefore, be concluded that ratio analysis, if done mechanically, is not only misleading but also dangerous. It is indeed a double-edged sword which requires a great deal of understanding and sensitivity of the management process rather than mechanical financial skill. It has rightly been observed, 'The ratio analysis is an aid to management in taking correct decisions, but as a mechanical substitute for thinking and judgement, it is worse than useless. The ratios, if discriminately calculated and wisely interpreted, can be a useful tool of financial analysis.'

Check Your Progress

1. What is the implication of ratio analysis not taking into account inflationary changes?
2. List some of the factors which must be considered for the
3. Mention an example of non-financial changes which are not revealed by the financial statement and ratio analysis but effect the future profitability.

13.4 ANSWERS TO CHECK YOUR PROGRESS QUESTIONS

1. Ratio analysis does not take into account the inflationary changes and relies on real prices. This means that the changes in the inventory and depreciation values will result in different interpretations.
2. The following factors must be considered while analysing the financial ratios:
 - General economic condition of the firm
 - Risk acceptance
 - Future expectations
 - Future opportunities
 - Accounting system of the industry
 - Analysing and interpretation system used by other firms in the industry.
3. Non-financial changes though important for the business are not revealed by the financial statements. For example, if the management of the company changes, it may have ultimately adverse effects on the future profitability of

the company.

13.5 SUMMARY

- Ratio analysis is not considered to be the best bet when it comes to serving as a tool for financial statement analysis.
- The following are some factors which affect the efficiency of ratios: non-inclusion of inflationary changes, it may show different results based on different accounting policies and operational changes; it may suffer from problem of misrepresentation; does not consider seasonal and geographical factors.
- An adequate financial analysis involves more than an understanding and interpretation of each of the individual ratios.
- The analyst must be familiar with the characteristics of the firm of which he is interpreting the final ratios.
- The following factors must be considered while analysing the financial ratios:
 - o General economic condition of the firm
 - o Risk acceptance
 - o Future expectations
 - o Future opportunities
 - o Accounting system of the industry
 - o Analysing and interpretation system used by other firms in the industry
- The interpretation of the ratios can be made by comparing them with:
 - o Previous figures – trend analysis;
 - o Similar firms – inter-firm comparisons;
 - o Targets – individual ratio set to meet the objective.
- The accounting experts usually recommend the use of groups of standard ratios for the evaluation of financial ratios.
- The uses of ratio analysis is that it simplifies financial statements, facilitates inter-firm comparisons, makes intra-firm comparison possible, helps in planning, etc.
- Accounting ratios are subject to the following limitations: comparative study required, limitations of financial statements, not adequate alone, make be subject to window dressing, does not represent price level changes and has no fixed standards.

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13.6 KEY WORDS

- **Trend analysis:** It is a tool for financial statement analysis which involves computation of percentage changes for different variables over a long period with an aim to have a comparative study of the variables.
- **Standard ratio:** It can be explained as a ratio set based upon well-proven conventions to serve as a measuring scale for the evaluation of the ratios.
- **Window dressing:** It means manipulation of accounts in a way so as to conceal vital facts and present the financial statements in a way as to show a better position than what it actually is.

13.7 SELF ASSESSMENT QUESTIONS AND EXERCISES

Short Answer Questions

1. What are the factors which affect the efficiency of ratios?
2. List the uses of ratio analysis.
3. How do accounting policies affect ratio analysis?
4. Briefly explain how window dressing is used to manipulate ratio analysis.

Long Answer Questions

1. Explain how ratio analysis can be used effectively.
2. Discuss the limitations of ratio analysis.

13.8 FURTHER READINGS

- Maheshwari, S.N., Suneel K. and Sharad K. 2017. *Advanced Accountancy*, Vol I. New Delhi: Vikas Publishing House.
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UNIT 14 INTRODUCTION TO RATIO ANALYSIS-III

*Introduction to Ratio
Analysis-III*

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Structure

- 14.0 Introduction
- 14.1 Objectives
- 14.2 Construction of Profit & Loss account and Balance Sheet with Ratios and Relevant Figures: Inter/Intra Firm Comparisons
- 14.3 Answers to Check Your Progress Questions
- 14.4 Summary
- 14.5 Key Words
- 14.6 Self Assessment Questions and Exercises
- 14.7 Further Readings

14.0 INTRODUCTION

Up till now you have learnt the meaning and computation of different types of ratios. You have also learnt about the uses and limitations of ratio analysis along with the factors affecting it and the manner in which to effectively use ratios for comparisons. In this unit, we will delve into the practical side of things and discuss the preparation of profit and loss account and balance sheet from ratios. You will be presented with illustrations describing intra-firm and inter-firm comparisons using ratio analysis.

14.1 OBJECTIVES

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

- Discuss the construction of profit and loss account and balance sheet with relevant figures
- Describe inter-firm and intra-firm comparisons using ratio analysis

14.2 CONSTRUCTION OF PROFIT & LOSS ACCOUNT AND BALANCE SHEET WITH RATIOS AND RELEVANT FIGURES: INTER/INTRA FIRM COMPARISONS

You have already seen in Unit 12, how the figures from the financial statements can be used for computing different ratios. Conversely, when information is given in the form of ratios, these can be used to construct or in some cases redraft

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financial statements. This is because the items which are used in the formulas for the ratios themselves feature in the different financial statements whether it is profit or loss account or the balance sheet. Since, the explanation of this concept is better understood through numericals, in this section, you will study different illustrations of construction of profit and loss account from ratios.

Illustration 14.1. Following is the profit and loss account and balance sheet of Jai Hind Ltd. Redraft them for the purpose of analysis and calculate the following ratios:

(i) Gross profit ratio; (ii) Overall profitability ratio; (iii) Current ratio; (iv) Debt–equity ratio; (v) Stock turnover ratio; (vi) Liquidity ratio.

Profit and Loss Account

<i>Particulars</i>	₹	<i>Particulars</i>	₹
Opening Stock of Finished Goods	1,00,000	Sales	10,00,000
Opening Stock of Raw Materials	50,000	Closing Stock of Raw Materials	1,50,000
Purchase of Raw Materials	3,00,000	Closing Stock of Finished Goods	1,00,000
Direct Wages	2,00,000	Profit on Sale of Shares	50,000
Manufacturing Expenses	1,00,000		
Administration Expenses	50,000		
Selling and Distribution Expenses	50,000		
Loss on Sale of Plant	55,000		
Interest on Debentures	10,000		
Net Profit	3,85,000		
	<u>13,00,000</u>		<u>13,00,000</u>

Balance Sheet

<i>Liabilities</i>	₹	<i>Assets</i>	₹
Share Capital:		Fixed Assets	2,50,000
Equity Share Capital	1,00,000	Stock of Raw Materials	1,50,000
Preference Share Capital	1,00,000	Stock of Finished Goods	1,00,000
Reserves	1,00,000	Sundry Debtors	1,00,000
Debentures	2,00,000	Bank balance	50,000
Sundry Creditors	1,00,000		
Bills Payable	50,000		
	<u>6,50,000</u>		<u>6,50,000</u>

Solution:

Income Statement

	₹	₹
Sales		10,00,000
Less: Cost of Sales:		
Raw Materials consumed		
(Opening Stock + Purchases – Closing Stock)	2,00,000	
Direct wages	2,00,000	
Manufacturing Expenses	1,00,000	
Cost of Production	<u>5,00,000</u>	

<i>Add:</i> Opening Stock of Finished Goods	1,00,000	
	<u>6,00,000</u>	
<i>Less:</i> Closing Stock of Finished Goods	1,00,000	
Cost of goods sold		<u>5,00,000</u>
Gross Profit		5,00,000
<i>Less:</i> Operating Expenses:		
Administration Expenses	50,000	
Selling and Distribution Expenses	<u>50,000</u>	<u>1,00,000</u>
Net Operating Profit:		4,00,000
<i>Add:</i> Non-trading Income:		
Profit on Sale of Shares		<u>50,000</u>
		4,50,000
<i>Less:</i> Non-trading Expenses or Losses:		
Loss on sale of Plant		<u>55,000</u>
Income before Interest and Tax		3,95,000
<i>Less:</i> Interest on Debentures		<u>10,000</u>
Net Profit before Tax		<u><u>3,85,000</u></u>

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Balance Sheet (or Position Statement)

	₹
Bank Balance	50,000
Sundry Debtors	<u>1,00,000</u>
Liquid Assets:	1,50,000
Inventories:	
Stock of raw materials	1,50,000
Stock of finished goods	<u>1,00,000</u>
Current Assets:	<u>4,00,000</u>
Sundry Creditors	1,00,000
Bills Payable	<u>50,000</u>
Current Liabilities	<u>1,50,000</u>
Working Capital (₹4,00,000 – ₹1,50,000)	2,50,000
<i>Add:</i> Fixed Assets	<u>2,50,000</u>
Capital Employed	5,00,000
<i>Less:</i> Debentures	<u>2,00,000</u>
Shareholders' Net Worth	3,00,000
<i>Less:</i> Preference Share Capital	<u>1,00,000</u>
Equity Shareholders' Net Worth	<u>2,00,000</u>
Equity Shareholders' Net Worth is represented by: Equity Share Capital	1,00,000
Reserves	<u>1,00,000</u>
	<u><u>2,00,000</u></u>

Ratios:

(i) Gross Profit Ratio:	$\frac{\text{Gross profit}}{\text{Sales}} \times 100$	$= \frac{5,00,000}{10,00,000} \times 100 = 50\%$
(ii) Overall Profitability Ratio:	$\frac{\text{Operating profit}}{\text{Capital employed}} \times 100$	$= \frac{4,00,000}{5,00,000} \times 100 = 80\%$
(iii) Current Ratio:	$\frac{\text{Current Assets}}{\text{Current Liabilities}}$	$= \frac{4,00,000}{5,00,000} = 2.67$

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(iv) Debt–Equity Ratio: $\frac{\text{External Equities}}{\text{Internal Equities}} = \frac{3,50,000}{3,00,000} = 1.17$

Or

$= \frac{\text{Total Long-term Debt}}{\text{Total Long-term Funds}} = \frac{2,00,000}{5,00,000} = 0.40$

Or

$= \frac{\text{Total Long-term Debt}}{\text{Total Long-term Funds}} = \frac{2,00,000}{3,00,000} = 0.67$

(v) Stock Turnover Ratio:

(a) As regards average total inventory = $\frac{\text{Cost of goods sold}}{\text{Average inventory}^*} = \frac{5,00,000}{2,00,000} = 2.5$

(* of raw material as well as finished goods)

(b) As regards average inventory of raw materials:

$= \frac{\text{Cost of goods sold}}{\text{Average inventory of raw materials}} = \frac{5,00,000}{1,00,000} = 5$

(c) As regards average inventory of finished goods:

$= \frac{\text{Cost of goods sold}}{\text{Average inventory of finished goods}} = \frac{5,00,000}{1,00,000} = 5$

(vi) Liquidity Ratio:

$\frac{\text{Liquid Assets}}{\text{Current Liabilities}} = \frac{1,50,000}{1,50,000}$

Illustration 14.2. With the help of the following ratios regarding Indu Films, draw the balance sheet of the company for the year 2005:

Current Ratio	2.5
Liquidity Ratio	1.5
Net Working Capital	₹3,00,000
Stock Turnover Ratio (cost of sales/closing stock)	6 times
Gross Profit Ratio	20 per cent
Fixed Assets Turnover Ratio (on cost of sales)	2 times
Debt Collection Period	2 months
Fixed assets to Shareholders Net Worth	0.80
Reserve and Surplus to Capital	0.50

Solution:

Balance Sheet

as on.....

<i>Liabilities</i>	₹	<i>Assets</i>	₹
Share Capital	5,00,000	Fixed Assets	6,00,000
Reserve and Surplus	2,50,000	Debtors	2,50,000
Long-term Borrowings		Stock	2,00,000
(balancing figure)	1,50,000	Bank	50,000
Current Liabilities	2,00,000		
	11,00,000		11,00,000

Working Notes:

If Current Liabilities	= 1
Current Assets	= 2.5
It means the difference or Working Capital	= 1.5
Working Capital is 1.5	= ₹3,00,000
Therefore, Current Assets	= ₹5,00,000
Current Liabilities	= ₹2,00,000
As Liquidity Ratio	= 1.5
And Current Liabilities	= ₹2,00,000
Therefore, the Liquid Assets	
(bank and debtors) (2,00,000 × 1.5)	= ₹3,00,000
Stock (5,00,000 – 3,00,000, i.e., current assets–liquid assets)	= ₹2,00,000
Cost of Sales (as stock turnover ratio is 6)	= ₹12,00,000
Sales (as G.P. ratio is 20 per cent,	
$12,00,000 + \frac{20}{80} \times 12,00,000$	= ₹15,00,000
Fixed Assets are ₹12,00,000/2 since fixed assets turnover ratio is 2	= ₹6,00,000
Debtors are ₹15,00,000/6 since debt collection period is 2 months	= ₹2,50,000
Shareholders' Net Worth $\left(\frac{6,00,00 \times 1}{0.80}\right)$	= ₹7,50,000
Out of Shareholders' Net Worth Reserves and Surplus	= ₹2,50,000
Therefore, share capital	= ₹5,00,000

NOTES

Illustration 14.3. With the following ratios and further information given below, prepare a trading account, profit and loss account and a balance sheet of Shri Narain:

(i) Gross Profit Ratio	25%	(vi) Fixed Assets/Capital	5/4
(ii) Net Profit/Sales	20%	(vii) Fixed Assets/Total Current Assets	5/7
(iii) Stock-turnover Ratio	10	(viii) Fixed Assets	₹10,00,000
(iv) Net Profit/Capital	1/5	(ix) Closing Stock	₹1,00,000
(v) Capital to Total Liabilities	1/2		

Solution:

Trading and Profit & Loss Account
for the year ended...

Particulars	₹	Particulars	₹
To Opening Stock	20,000	By Sales	8,00,000
To Purchases (balancing figure)	6,80,000	By Closing Stock	1,00,000
To Gross Profit c/d	2,00,000		
	<u>9,00,000</u>		<u>9,00,000</u>
To Expenses	40,000	By Gross Profit b/d	2,00,000
To Net Profit	1,60,000		
	<u>2,00,000</u>		<u>2,00,000</u>

Balance Sheet

as on....

NOTES

<i>Liabilities</i>		₹	<i>Assets</i>		₹
Capital:			Fixed Assets		10,00,000
Openings balance	6,40,000		Closing Stock		1,00,000
Add: Net Profit	<u>1,60,000</u>	8,00,000	Other Current Assets		13,00,000
			(balancing figure)		
Liabilities		<u>16,00,000</u>			
		<u>24,00,000</u>			<u>24,00,000</u>

Working Notes:

- Fixed Assets are ₹10,00,000
 $\text{Fixed Assets} \div \text{Capital} = 5 \div 4$
 $\therefore \text{Capital} = 10,00,000 \times 4 \div 5 = ₹8,00,000$
- Capital is 1/2 of Total Liabilities
 $\therefore \text{Liabilities} = 8,00,000 \times 2 = ₹16,00,000$
- Net Profit is 1/5 of Capital
 $\therefore \text{Net Profit} = 8,00,000 \times 1/5 = ₹1,60,000$
- Net Profit is 20% of Sales
 $\therefore \text{Sales} = 1,60,000 \times 100 \div 20 = ₹8,00,000$
- Gross Profit Ratio is 25% of Sales
 $\therefore \text{Gross Profit} = ₹2,00,000$
- Stock Turnover Ratio (*i.e.*, Cost of Sales/Average Inventory) is 10
 $\text{Cost of Sales} = \text{Sales} - \text{Gross Profit}$
 $= ₹8,00,000 - 2,00,000 = ₹6,00,000$
 $\therefore \text{Average Inventory} = ₹6,00,000$
- Closing Stock is ₹1,00,000
 $\text{Average Inventory} = ₹60,000$
 $\therefore \text{Opening Stock} = ₹20,000$
- Fixed Assets are ₹10,00,000
 $\text{Fixed Assets/Total Current Assets} = 5 \div 7$
 $\therefore \text{Total Current assets} = 10,00,000 \times 7/5 = ₹14,00,000$
 $\text{Stock is } ₹1,00,000$
 $\therefore \text{Other Current Assets are } ₹13,00,000$

Illustration 14.4. From the following particulars prepare the balance sheet of Shri Mohan Ram & Co. Ltd:

Current Ratio	2
Working Capital	₹4,00,000
Capital Block to Current Assets	3 : 2
Fixed Assets to Turnover	1 : 3
Sales Cash/Credit	1 : 2
Stock Velocity	2 Months
Creditors Velocity	2 Months
Debtors Velocity	3 Months
Capital Block:	
Net profit 10% of Turnover	
Reserve 2.5% of Turnover	1 : 2
Debentures/Share Capital	
Gross Profit Ratio 25% (to Sales)	

Solution:

Since current ratio is 2, current assets must be twice the current liabilities. In case current liabilities are 'x', current assets will be 2x.

$$2x - x = 4,00,000$$

$$x = 4,00,000$$

	₹
Current Liabilities	4,00,000
Current Assets	8,00,000
Capital Block	<u>12,00,000</u>

Since the total liabilities are ₹16,00,000 (i.e., 12,00,000 + ₹4,00,000), the total assets will also be 16,00,000.

		₹
Fixed Assets	(16,00,000 – 8,00,000)	8,00,000
Turnover	(8,00,000 × 3)	24,00,000
Credit Sales		16,00,000
Cash Sales		8,00,000
Debtors' velocity		3 months
Debtors are therefore	(16,00,000 × 3/12)	4,00,000
Gross Profits	(24,00,000 × 25/100)	6,00,000
Cost of Sales		18,00,000
Stock Turnover		2 Months
Stock is therefore	(18,00,000 × 2/12)	3,00,000
Creditors' Velocity		2 Months
Creditors are therefore	(18,00,000 × 2/12)	3,00,000
Cash balance	(8,00,000 – 7,00,000)	1,00,000
Reserves	(24,00,000 × 2.5/100)	60,000
Profit	(24,00,000 × 10/100)	2,40,000
Block or Fixed Capital		12,00,000
Reserves and Profit		3,00,000
Debentures and Share Capital		9,00,000
Share Capital		6,00,000
Debentures		<u>3,00,000</u>

The balance sheet can now be prepared as follows:

Shri Mohan Ram & Co. Ltd
Balance Sheet
as on

<i>Liabilities</i>	₹	<i>Assets</i>	₹
Share Capital	6,00,000	Fixed Assets	8,00,000
Reserves	60,000	Current Assets:	
Profit and Loss A/c	2,40,000	Debtors	4,00,000
Debentures	3,00,000	Stock	3,00,000
Sundry Creditors	3,00,000	Cash	1,00,000
Other Current Liabilities	1,00,000		
	<u>16,00,000</u>		<u>16,00,000</u>

NOTES

Inter and Intra-firm Comparisons

Intra-firm comparison refers to the analysis of the performance of an organization over a period of time. This means that the present ratios are compared with the past ratios and the changes are then interpreted.

Inter-firm comparison as the name suggests refers to the comparison of ratios of one firm with selected other firms at the same point of time.

In this section, let's observe now inter firm and comparisons can be done through ratio analysis.

Illustration 14.5. The following are the summarized accounts of Unique Ltd and Strange Ltd for the two years 2004 and 2005:

(₹ in lakhs)

Particulars	Unique Ltd		Strange Ltd	
	2004	2005	2004	2005
Turnover	54.12	45.75	17.52	14.47
Manufacturing and Other Expenses	51.04	43.56	14.96	11.82
Depreciation	0.56	0.51	0.60	0.35
Profit before Tax	2.52	1.68	1.96	2.30
	<u>54.12</u>	<u>45.75</u>	<u>17.52</u>	<u>14.47</u>
Intangible Assets	1.65	1.69	—	—
Fixed Assets	8.36	9.41	3.51	2.75
Stock	11.24	12.19	1.77	2.26
Debtors	7.28	8.24	5.82	4.02
Bank	0.93	0.33	4.64	2.46
	<u>29.46</u>	<u>31.86</u>	<u>15.74</u>	<u>11.49</u>
Creditors	9.47	9.26	2.33	1.75
Taxation (Less advance tax)	0.56	0.68	0.87	0.58
Short-term Borrowings	4.24	8.00	4.64	2.16
Long-term Borrowings	2.54	2.10	0.10	—
Capital and Reserves	12.65	11.82	7.80	7.00
Total	<u>29.46</u>	<u>31.86</u>	<u>15.74</u>	<u>11.49</u>

You are required to:

- Indicate and calculate five ratios which in your opinion are relevant in determining the stability of the two companies as going concerns.
- Compare the ratios so determined for the two companies. Indicate what conclusions can be drawn therefrom?

Solution:

(a) The five ratios are calculated below:

Ratio	Unique Limited		Strange Limited	
	2005	2004	2005	2004
(i) $\frac{\text{Net Worth}}{\text{Total Outside Liabilities}}$	$\frac{10.13}{20.04} = 0.51$	$\frac{11.00}{16.81} = .65$	$\frac{7}{4.49} = 1.6$	$\frac{7.80}{7.49} = 0.98$
(ii)* $\frac{\text{Quick Assets}}{\text{Daily Operating Cost}}$ (excluding depreciation)	$\frac{8.57}{43.56/365}$	$\frac{8.21}{51.04/365}$	$\frac{6.48}{11.82/365}$	$\frac{10.46}{14.96/365}$
	$\frac{8.57}{.119} = 72$	$\frac{8.21}{.140} = 59$	$\frac{6.48}{0.032} = 203$	$\frac{10.46}{0.04} = 262$
(iii) $\frac{\text{Current Assets}}{\text{Current Liabilities}}$	$\frac{20.76}{17.94} = 1.16$	$\frac{19.45}{14.27} = 1.36$	$\frac{8.74}{4.49} = 1.95$	$\frac{12.23}{7.84} = 1.56$
(iv) $\frac{\text{Profit before Tax}}{\text{Total Assets}}$	$\frac{1.68}{31.86} = 0.053$	$\frac{2.52}{29.46} = 0.086$	$\frac{2.30}{11.49} = 0.200$	$\frac{1.96}{15.74} = 0.125$
(v) $\frac{\text{Sales}}{\text{Total Assets}}$	$\frac{45.75}{31.86} = 1.44$	$\frac{54.12}{29.46} = 1.84$	$\frac{14.47}{11.49} = 0.126$	$\frac{17.52}{15.74} = 1.11$

* This can also be termed as defensive interval ratio. For 2005 in case of Unique Ltd, the ratio has worked out to be 72 days, while for Strange Ltd it has worked out to be 203 days. This means Unique Ltd can operate on the basis of present liquid resources for 72 days without resorting to next year's revenue while Strange Ltd can operate for 203 days. Strange Ltd is thus in a better position.

(b) The computations in the case of Unique Ltd are showing deteriorating position whereas in Strange Ltd, they are showing a better position in 2005 as compared to 2004. Profitability of Unique Ltd is very poor and is declining. Its liquidity is also poor and declining. The defensive interval of Strange Ltd is much higher as compared to that of Unique Ltd. Thus, Unique Ltd needs to improve its position.

Illustration 14.6. Shamsher Sterling Limited has been operating for two years. The most important facts as appearing from its accounts are as under:

Balance Sheet

Liabilities	First Year ₹	Second Year ₹	Assets	First Year ₹	Second Year ₹
Equity Shares of ₹10 each	1,00,000	1,00,000	Goodwill	60,000	60,000
Reserves	20,000	30,000	Fixed Assets (at cost)	1,40,000	1,60,000
Profit and Loss Balance	30,000	20,000	Stocks	30,000	60,000
Secured Loans	80,000	80,000	Sundry Debtors	30,000	60,000
Bank overdraft		20,000	Advances	10,000	
Sundry Creditors	50,000	70,000	Cash Balances	30,000	—
Provision for Taxation	20,000	20,000			—
	<u>3,00,000</u>	<u>3,40,000</u>		<u>3,00,000</u>	<u>3,40,000</u>

NOTES

Profit and Loss Appropriation Account

NOTES

<i>Liabilities</i>	<i>First Year</i> ₹	<i>Second Year</i> ₹	<i>Assets</i>	<i>First Year</i> ₹	<i>Second Year</i> ₹
Transfer to Reserves	20,000	10,000	Balance b/d		30,000
Manager's Commission	10,000	30,000	Profit for the year after taxation and before depreciation	70,000	50,000
Dividends	10,000	20,000			
Net Profit	30,000	20,000			
	<u>70,000</u>	<u>80,000</u>		<u>70,000</u>	<u>80,000</u>

You find that the total sales amounted to ₹6,00,000 in the first year and ₹5,00,000 in the second year.

Examine the above details and give a step-by-step analysis in a manner which indicates the overall efficiency of the business and its financial position.

Solution:

Shamsher Sterling Limited

Analysis of Working Capital and Financial Position

Overall Performance: The following ratios throw light on the comparative performance of the company over two years:

	<i>First Year</i>	<i>Second Year</i>
1. Net Margin Ratio (Profit as given, Less: Commission to the manager)		10 per cent 4 per cent
2. Capital Turnover Ratio	$\frac{\text{Sales}}{\text{Capital employed}}$	3.53 2.94
3. Return on capital employed	5.29 per cent	11.76 per cent
The following ratios have been found out on further analysis of capital turnover ratio:		
(a) Fixed Assets Turnover Ratio	$\frac{\text{Sales}}{\text{Fixed Assets}}$	4.29 3.12
(b) Stock Turnover	$\frac{\text{Sales}}{\text{Closing Stock}}$	20.00 8.33
(c) Debt Collection Period	18 days	44 days

An examination of the ratios given above makes it clear that the overall performance of the company is much poorer in the second year as compared to the first year. The analysis brings out the following facts:

- (1) The operating ratio has increased from 90 per cent to 96 per cent. This has resulted in decline of the net profit ratio to 4 per cent from 10 per cent. One important reason of this decline is the rise in the commission paid to the Manager by 200 per cent. There seems to be no justification for such an increase. In case the commission paid to the Manager is not considered, while calculating net-margin, it has still declined to 10 per cent from 11.67 per cent on sales. This fall may be either due to:
 - (i) Lower selling prices
 - (ii) Higher prices for materials, etc.
 - (iii) Inefficiency of the management.

The last reason seems to be most probable, because normally the selling price of the articles can be adjusted to cover rise in the costs of the product.

- (2) There has been an all-round decline in utilization of the resources, as evidenced by capital turnover ratio. Even if it is assumed that there has been a fall in the fixed assets turnover ratios because the fixed assets were added towards the end of the year and, therefore, they could not properly be utilized, there seems little justification for a very sharp fall in the stock turnover ratio. On the same basis, there is no justification for increase in the debt collection period. These two ratios are very disturbing and they immediately raise the question regarding the reliability of the two figures of stocks and sundry debtors. The fall in sales but increase in inventories and debt collection period are indicators that the unsaleable items have been included in the stocks and the sundry debtors include doubtful debts. If that is true, the profit figure in the second year seems to be unreliable. Actually, there may be a loss. The management should, therefore, investigate thoroughly to determine the truth.
- (3) The sharp fall in the quantum of sales has raised one more adverse possibility. The company might be operating extremely close to the break-even point. This may ultimately result in losses to the company if the sales decrease still further. The management should, therefore, see that the sales are augmented and the costs are reduced by full utilization of the present facilities and resources available at the disposal of the company.

NOTES

Financial Position: The following ratios reveal the financial position of the company:

	First Year	Second Year
(i) Debt Equity Ratio: Debt/Debt + Equity	34.8%	34.8%
(ii) Fixed assets including Goodwill/Long-term funds	.87	.95
(iii) Current Ratio Current Assets/Current liabilities	1.43	1.09
(iv) Stock/Working capital	1.00	6.00
(v) Sundry debtors/Working capital	1.00	6.00

The company has a precarious financial position as far as short-term solvency is concerned. The decline in the current ratio gives a partial indication of the danger which faces the company. The company has no cash balances. The bank can call upon the company to adjust its overdrafts at any time. The inventories seems to contain unsaleable items. The debtors include doubtful debts. Thus, there seems to be a little chance of the company meeting adequately its short-term immediate liabilities. A small pressure from short-term creditors may put the whole work of the company in jeopardy. This shows that the decisions of the management regarding the following matters are not judicious:

- (i) Increasing the commission to manager
- (ii) Purchasing fixed assets as the time when the sales are declining
- (iii) Paying dividend and that too at double the rate of the previous year

NOTES

Moreover, the company has paid dividend without providing for depreciation on fixed assets. This is clear violation of the provisions of section 205 of the Companies Act. The company will be put to serious difficulties when the assets become useless after their useful life in case the company continues to follow the policy of not providing for depreciation, as it will be almost impossible for the company to replace these assets. The company has also not made any provision for repayment of loan. It should have created a sinking fund for this purpose. The amount of goodwill appearing in the balance sheet of the company is also valueless in view of the fact that the company has extremely low profits.

Management should, therefore, take immediate remedial measures regarding the following matters:

- (i) Better sales performance
- (ii) Cost control and cost reduction
- (iii) Ascertainment of profits of the business according to strict accounting principles
- (iv) Better control over inventories and collection of book debts
- (v) No payment of dividend till the company raises enough cash resources to meet its requirements

Illustration 14.7. The following extracts of financial information relate to Curious Ltd:

Balance Sheet		
<i>as on 31 December</i>		
<i>(₹ in lakhs)</i>		
<i>Particulars</i>	<i>2005</i>	<i>2004</i>
Share Capital	10	10
Reserve and Surplus	30	10
Loan Fund	60	70
	<u>100</u>	<u>90</u>
Fixed Assets (Net)	<u>30</u>	<u>30</u>
Current Assets:		
Stocks	30	20
Debtors	30	30
Cash and Bank balances	10	20
Other Current Assets	30	10
	<u>100</u>	<u>80</u>
<i>Less: Current Liabilities</i>	<u>30</u>	<u>20</u>
Net Working Capital	70	60
Total Assets	<u>100</u>	<u>90</u>
Sales (₹ lakh)	270	300

- (a) Calculate, for the two years debt–equity ratio, quick ratio and working capital turnover ratio
- (b) Find the sales volume that should have been generated in 2005 if the company were to have maintained its working capital turnover ratio.

SOLUTION:

(a)	(i) Debt–equity Ratio		2005	2004
		$\frac{\text{Debt}}{\text{Equity}} = \frac{\text{Loan Funds}}{\text{Share Capital + Reserves}}$	$\frac{60}{40}$	$\frac{70}{20}$
	(ii) Quick Ratio			
		$\frac{\text{Quick Assets}}{\text{Current Liabilities}}$	$\frac{30 + 10}{30}$	$\frac{30 + 20}{20}$
			1.33 : 1	2.5 : 1
	(iii) Working Capital Turnover Ratio			
		$\frac{\text{Sales}}{\text{Working Capital}}$	$\frac{270}{70}$	$\frac{300}{60}$
			3.86 times	5 times

- (b) Sales volume to be maintained

$$5 = \frac{\text{Required Sales}}{70}$$

Sales required for 2005 = ₹350 lakh

Illustration 14.8. The balance sheet of Y Ltd stood as follows as on:

(₹ in lakhs)

<i>Liabilities</i>	31.3.05	31.3.04	<i>Assets</i>	31.3.05	31.3.04
Capital	250	250	Fixed Assets	400	300
Reserves	116	100	Less: Depreciation	140	100
Loans	100	120		260	200
Creditors and Other			Investments	40	30
Current Liabilities	129	25	Stock	120	100
			Debtors	70	50
			Cash/Bank	20	20
			Other Current Assets	25	25
			Misc. Expenditure	60	70
	595	495		595	495

You are given the following information for the year 2004–05:

(₹ in lakhs)

Sales	600
PBIT	150
Interest	24
Provision for tax	60
Proposed dividend	50

From the above particulars calculate for the year 2004–05:

- (a) Return on Capital Employed Ratio
- (b) Stock Turnover Ratio

NOTES

(c) Return on Net Worth Ratio

(d) Current Ratio

(e) Proprietary Ratio

NOTES

Solution:

(i) Return on Capital Employed

$$\frac{\text{PBIT}}{\text{Average Capital Employed}} \times 100 \quad \text{i.e.,} \quad \frac{150}{403} \times 100 = 37.22\%$$

(ii) Stock Turnover Ratio

$$\frac{\text{Sales}}{\text{Average Stock}} \quad \text{i.e.,} \quad \frac{600}{110} = 5.45 \text{ times}$$

(iii) Return on Net Worth

$$\frac{\text{PAT}}{\text{Average Net Worth}} \times 100 \quad \text{i.e.,} \quad \frac{235}{129} = 22.53\%$$

(iv) Current Ratio

$$\frac{\text{Current Assets}}{\text{Current Liabilities}} \quad \text{i.e.,} \quad \frac{235}{129} = 1.82 \text{ times}$$

$$(v) \frac{\text{Proprietary Funds}}{\text{Total Assets} - \text{Misc. Expenditure}} = \frac{306}{595 - 60} = 0.57$$

Working Notes:

(i) Average capital employed		(₹ in lakhs)
	31-3-2005	31-3-2004
Total Assets (excluding Misc. ex)	535	425
Less: Creditors and Other Current Liabilities	<u>129</u>	<u>25</u>
	406	400

Average: $466 + 470 \div 2 = ₹468$ lakh

(ii) Average Net Worth		
Capital	250	250
Reserves	116	100
	366	350
Less: Misc. Expenses	<u>60</u>	<u>70</u>
	306	280

Average: $306 + 280 \div 2 = ₹293$ lakh

Proprietary Funds as on 31.3.2005 mean Net worth as on that date i.e., ₹306 lakh

(iii) Average Stock		(₹ in lakhs)
	$(120 + 100) \div 2 = 110$	

(iv) Profit after Tax (PAT)		(₹ lakh)
PBIT		150
Less: Interest		<u>24</u>
		126
Less: Tax		<u>60</u>
		<u>66</u>

(v) Current Assets as on 31.3.2005		(₹ in lakhs)
Stock		120
Debtors		70
Cash/Bank		20
Other Current Assets		<u>25</u>
		<u>235</u>

Check Your Progress

1. Name the ratio whose formula is: $\frac{\text{Total Long-term Debt}}{\text{Total Long-term Funds}}$.
2. Mention the formula for stock turnover ratio.
3. From the following information calculation the liquidity ratios:
Opening Stock= 90,000, Current liabilities= 90,000, Debtors= 1,05,000,
Cash= 15,000

NOTES

14.3 ANSWERS TO CHECK YOUR PROGRESS QUESTIONS

1. $\frac{\text{Total Long-term Debt}}{\text{Total Long-term Funds}}$ is the formula for debt-equity ratio.
2. The following is the formula for stock turnover ratio: $\frac{\text{Cost of Sales}}{\text{Average Inventory}}$.
3. The liquidity ratios for the information given will be:

$$\begin{aligned} \text{(a) Current Ratio} &= \frac{\text{Current Assets}}{\text{Current Liabilities}} \\ &= \frac{90,000 + 1,05,000 + 15,000}{90,000} = \frac{2,10,000}{90,000} = 2.33:1 \end{aligned}$$

$$\begin{aligned} \text{(b) Liquidity Ratio} &= \frac{\text{Liquid Assets}}{\text{Current Liabilities}} = \frac{1,05,000 + 15,000}{90,000} \\ &= \frac{1,20,000}{90,000} = 1.33:1 \end{aligned}$$

14.4 SUMMARY

Liquidity Ratios

1. Current Ratio = $\frac{\text{Current Assets}}{\text{Current Liabilities}}$
2. Liquid (or Quick) Ratio = $\frac{\text{Liquid or Quick Assets}}{\text{Quick Liabilities}}$

Capital Structure Ratios (or Solvency Ratios or Leverage Ratios)

$$1. \text{ Debt-Equity Ratio} = \frac{\text{Long-term debts}}{\text{Shareholders' Equity}} \quad \text{Or} = \frac{\text{External Equity}}{\text{Internal Equity}}$$

$$2. \text{ Proprietary Ratio} = \frac{\text{Shareholders' Funds}}{\text{Total Assets}}$$

$$3. \text{ Interest Coverage Ratio} = \frac{\text{Earning before interest and taxes (EBIT)}}{\text{Fixed interest charges}}$$

NOTES

Turnover (or Activity) Ratios

$$1. \text{ Inventory (or Stock) Turnover Ratio} = \frac{\text{Cost of goods sold}}{\text{Average inventory at cost}}$$

$$\text{Or} = \frac{\text{Sales}}{\text{Average inventory at selling prices}}$$

$$\text{Or} = \frac{\text{Sales}}{\text{Average inventory at cost}}$$

$$2. \text{ Debtors Turnover Ratio} = \frac{\text{Net credit sales}}{\text{Average debtors}}$$

$$\text{Average Collection Period (in term of days)} = \frac{\text{Debtors}}{\text{Credit sales}} \times 365 \text{ days}$$

$$4. \text{ Working Capital Turnover Ratio} = \frac{\text{Cost of sales}}{\text{Net working capital}}$$

$$5. \text{ Fixed assets turnover Ratio} = \frac{\text{Cost of sales}}{\text{Fixed assets at cost less accumulated depreciation}}$$

$$6. \text{ Capital turnover Ratio} = \frac{\text{Cost of Sales}}{\text{Capital employed}}$$

Profitability Ratios

$$1. \text{ Gross Profit ratio} = \frac{\text{Gross profit}}{\text{Net sales}} \times 100 = \frac{\text{Net sales} - \text{Cost of goods sold}}{\text{Net sales}} \times 100$$

$$2. \text{ Net Profit ratio} = \frac{\text{Net profit}}{\text{Net sales}} \times 100$$

$$3. \text{ Operating ratio} = \frac{\text{Cost of goods sold} + \text{Operating expenses}}{\text{Net sales}}$$

$$4. \text{ Operating profit ratio} = \frac{\text{Operating net profit}}{\text{Net sales}} \times 100$$

5. Expense ratio:

$$(a) \text{ For cost of materials} = \frac{\text{Material consumed}}{\text{Net sales}} \times 100$$

$$(b) \text{ For selling expenses} = \frac{\text{Selling expense}}{\text{Net sales}} \times 100$$

Such ratios may be separately computed for each category of expense.

$$6. \text{ Return on Investment (ROI)} = \frac{\text{Net profit before interest and taxes}}{\text{Total capital employed}} \times 100$$

$$7. \text{ Return on Equity Capital} = \frac{\text{Net profit after interest, tax and preference dividend}}{\text{Equity shareholders funds}} \times 100$$

$$8. \text{ Earning Per Share (EPS)} = \frac{\text{Net Profit after taxes} - \text{Preference dividend}}{\text{No. of equity share}}$$

$$9. \text{ Dividend Payout Ratio} = \frac{\text{Dividend per share}}{\text{Earning per share}}$$

$$10. \text{ Dividend yield ratio} = \frac{\text{Dividend per equity share}}{\text{Market price per equity share}}$$

$$11. \text{ Price Earning Ratio (P/E ratio)} = \frac{\text{Market price per equity share}}{\text{Earning per share}}$$

NOTES

14.5 KEY WORDS

- **Capital Block:** It is another name for fixed capital in accounting which refers to the capital invested in long-term assets.
- **Stock velocity:** It refers to the time period from the receipt of raw materials to the sale of the resulting finished goods.

14.6 SELF ASSESSMENT QUESTIONS AND EXERCISES

Short Answer Questions

1. The following data has been extracted from the annual accounts of a company:

Share Capital:	<i>₹ in '000</i>
20,000 Equity Shares of ₹10 each	200
General Reserve	156
Investment Allowance Reserve	50
15% Long-term Loan	300
Profit before Tax	140
Provision for Tax	84
Proposed Dividends	10

Calculate from the above the following details:

- (i) Return on capital employed
- (ii) Return on net worth

[Ans. (i) 26.4%, (ii) 14%]

NOTES

2. From the following, calculate the basic earnings per share:

Profit for the year ending 31-12-2009 after Interest	
Tax and Preference Dividend	₹18,500
No. of Equity Shares as on 01-01-2009 each fully paid up	18,800 of ₹10

No. of Equity Shares issued on 31-10-2009

Partly paid shares are entitled to participate in the dividend to the extent of the amount paid.

[Ans. Weighted Average number of Shares—1,850 and
Basic Earnings per Share—₹10]

3. From the following, calculate:

(i) Basic earnings per share; and

(ii) Diluted earnings per share

Net profit for the year ending 31-12-2008	₹10,00,000
No. of Equity Shares Outstanding on 31-12-2008	5,00,000
12% Convertible Debentures of ₹100/- each	1,00,000

Each debenture is convertible to 10 equity shares. The company is in 30% tax bracket.

[Ans. (i) ₹2 per share and (ii) ₹1.27 per share]

4. From the following annual statements of Pioneer Ltd calculate the following ratios: (i) gross profit ratio, (ii) current ratio; (iii) liquid ratio; (iv) debt-equity ratio; and (v) return on investment ratio.

Trading and Profit and Loss Account
for the year ended 31 December 2009

Particulars	₹	Particulars	₹
To Materials consumed:		By Sales	85,000
Opening Stock	9,050	By Profit on sale of investments	600
Purchases	54,525	By interest on investments	300
	63,575		
Closing Stock	14,000		
	49,575		
To Carriage Inwards	1,425		
To Office Expenses	15,000		
To Sales Expenses	3,000		
To Financial Expenses	1,500		
To Loss on Sale of Assets	400		
To Net Profit	15,000		
	85,900		85,900

Balance Sheet
as on 31 December 2009

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Liabilities	₹	Assets	₹
Share capital: 2,000 Equity Shares of ₹10 each-fully paid	20,000	Fixed Assets: Buildings	15,000
Reserves	9,000	Plant	8,000
Profit and Loss A/c	6,000	Current Assets:	
Bank Overdraft	3,000	Stock-in-trade	14,000
Sundry Creditors: for expenses	2,000	Debtors	7,000
for other	8,000	Bills Receivable	1,000
	10,000	Bank Balances	3,000
	48,000		25,000
			48,000

NOTES

[Ans. (i) 40%, (ii) 1.92, (iii) 0.84, (iv) (a) $13,000/35,000 = 0.271$,
(b) $13,000/49,000 = 0.271$, (v) $15,000/35,000 = 42.85\%$]

Long Answer Questions

1. From the following information, you are required to prepare a balance sheet:

(i) Current Ratio	1.75
(ii) Liquid Ratio	1.25
(iii) Stock Turnover Ratio (Cost of Sales/Closing Stock)	9
(iv) Gross Profit Ratio	25 per cent
(v) Debt Collection Period	$1\frac{1}{2}$ months
(vi) Reserves and Surplus to Capital	2
(vii) Turnover to Fixed Assets	1.2
(viii) Capital Gearing Ratio	0.6
(ix) Fixed Assets to Net Worth	1.25
(x) Sales for the year	₹12,00,000

[Ans.	₹		₹
Share Capital	5,00,000	Stock	1,00,000
Long-term Liabilities	3,00,000	Debtors	1,50,000
Reserve and Surplus	1,00,000	Cash and Bank balance	1,00,000
Current Liabilities	2,00,000	Balance Sheet Total	11,00,000]
Fixed Assets	7,50,000		

2. You are given the following information pertaining to the financial statement of AYZ Ltd, as on 31 December 2007. On the basis of the information supplied, you are required to prepare the trading, profit and loss A/c for the year ended and a balance sheet as on that date.

NOTES

	₹		₹
Net Current Assets	2,00,000	Ratio of Gross Profit on	
Issued Share Capital	6,00,000	Turnover	25%
Current Ratio	1.8	Net Profit to Issued	
Quick Ratio (Ratio of		Shares Capital	20%
debtors and bank balance		Stock Turnover Ratio (cost	
to current liabilities)	1.35	of goods sold/closing	
Fixed Assets to		stock)	5 times
Shareholders' Equity	80 per cent	Average Age of Outstand-	
		ings for the years	36½ days

On 31 December 2007, the current assets consisted only of stock, debtors and bank balance; liabilities consisted of share capital and current liabilities and assets consisted of fixed assets and current assets.

[Ans.]	₹		₹
Gross Profit	1,87,500	Stock	12,500
Net Profit	1,20,000	Bank balance	2,62,500
Current Assets	4,50,000	Fixed Assets	8,00,000
Current Liabilities	2,50,000	Balance Sheet total	12,50,000
Debtors	75,000]

3. Based on the following information of the financial ratios prepare balance sheet of Star Enterprises Ltd, as on 31 December 2005. Explain your working and assumptions:

Current Ratio	2.5
Liquidity Ratio	1.5
Net Working Capital	₹6,00,000
Stock Turnover Ratio	5
Ratio of Gross Profit to Sales	20%
Turnover Ratio to Net Fixed Assets	2
Average Debt Collection Period	2.4 months
Fixed assets to Net Worth	0.80
Long-term debt to Capital and Reserve	7/25

[Ans. Fixed Assets—₹10,00,000; Current Assets—₹10,00,000; Share Capital and Reserves—₹12,50,000; Long-term Deposits—₹3,50,000; Current Liabilities—₹4,00,000]

4. Following is the profit and loss a/c of A Limited for the year ended 31 December 2008 and balance sheet as on that date. Calculate the different ratios and comment on the financial position of the company.

<i>Particulars</i>	₹	
Net Sales		3,00,000
Less: Cost of goods sold		2,58,000
Gross Profit		42,000
Operating Expenses:		
Selling	2,200	
General and Administration	4,000	
Rent of Office	2,800	9,000
Gross Operating Profit		33,000
Depreciation		10,000
		23,000
Other Income:		
Interest on Government Securities		1,500
Gross Income		24,500
Other Expenses:		
Interest on Bank Overdraft	300	
Interest on Debentures	4,200	4,500
Net Income before Tax		20,000
Tax @ 50 per cent on Net Income		10,000
Net Income after Tax		10,000

NOTES

Balance Sheet

as on 31 December 2008

(₹ '000)

<i>Liabilities</i>	₹	<i>Assets</i>	₹
Sundry Creditors	6,000	Cash	5,000
Bills Payable	10,000	Investments (Government securities)	15,000
Outstanding Expenses	1000	Sundry Debtors	20,000
Provision for Taxation	13,000	Stock	30,000
Total Current Liabilities	30,000	Total Current Assets	70,000
6% Mortgage Debentures	70,000	Fixed Assets	1,80,000
7% Preference Shares	10,000	Less: Provision for depreciation	50,000
Equity Shares	50,000		1,30,000
Reserve and Surplus	40,000		
Total Claims on Assets	2,00,000		2,00,000

[Ans. Gross Profit Ratio 14 per cent, Net Profit Ratio (after considering interest on bank overdraft) 7.56 per cent, ROI 13.53 per cent, Stock Turnover Ratio 8.6, Debt Collection Period 24 days, Fixed Assets Turnover 2.3, Fixed Assets Ratio .76, Debt-equity ratio 70/1000 = 0.7, Current ratio 2.3]

5. India International Limited has been in existence for two years. The following particulars are extracted from its published accounts:

NOTES

Balance Sheet
at year end

Year	Liabilities	1st Year	2nd Year	Assets	1st Year	2nd Year
		₹	₹		₹	₹
	Equity Capital	1,00,000	1,00,000	Fixed Assets	2,08,000	1,98,000
	Reserve	10,000	20,000	Stock	30,000	60,000
	Profit and Loss A/c	14,000	2,000	Book Debts	40,000	80,000
	Loan	1,10,000	80,000	Cash at Bank	30,000	2,000
	Bank Overdraft	—	20,000			
	Creditors	30,000	90,000			
	Provision for Taxation	34,000	13,000			
	Proposed Dividend	10,000	15,000			
		3,08,000	3,40,000		3,08,000	3,40,000

Profit and Loss Account

Particulars	₹	₹	Particulars	₹	₹
Interest on Loan	2,400	4,800	Balance b/d	—	14,000
Directors' Remuneration	10,000	30,000	Profit for the year	80,400	60,800
Provision for Taxation	34,000	13,000			
Dividend		15,000			
Transfer to Reserve	10,000	10,000			
Balance c/d	14,000	2000			
Total	80,400	74,800		80,400	74,800

Sales amounted to ₹6,00,000 in the first year and ₹5,00,000 in the second year. Examine in detail from the point of (i) profitability, (ii) solvency and (iii) sales. Make such other computations as seem expedient to you and write on overall internal analysis of this company.

[Ans.	<i>1st Year</i>	<i>2nd Year</i>
Net Profit Ratio	11.73%	6.16%
ROI (based on Capital at end)	30.08%	15.25%
Current Ratio	1.35	1.03
Stock Turnover	20	8.33
Debtors Turnover	15	6.25]

14.7 FURTHER READINGS

Maheshwari, S.N., Suneel K. and Sharad K. 2017. *Advanced Accountancy*, Vol I. New Delhi: Vikas Publishing House.

Maheshwari, S.N., Suneel K. and Sharad K. 2018. *An Introduction to Accountancy*, 12th edition. New Delhi: Vikas Publishing House.

Jain, S.P. and Narang, K.L. 2001. *Advanced Accountancy*. New Delhi: Kalyani Publishers.

Ahmed, N. 2008. *Financial Accounting*. New Delhi: Atlantic Publishers and Distributors Pvt. Ltd.

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