GAUHATI UNIVERSITY
INSTITUTE OF DISTANCE AND OPEN LEARNING

STUDY MATERIALS

PGDFM (16-PAPER-II)
FINANCIAL ACCOUNTING

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UNIT–I AMORPHOUS BEGINNINGS

Unit Structure :

DEFINITION OF ACCOUNTING

Meaning_: Accounting is a social science. It caters to the needs of the society as well as business. A society is always changing, so also the form of business organization. In order to meet the changing needs of the society, the science of accounting also has changed in form complexity and function. For the purpose of ascertaining the amount of profit earned (or loss incurred), in the enterprise a complete and systematic record of business transactions are required to be maintained. Accounting helps a business in having a complete and systematic record of its business transactions, reporting the results of its operation and interpreting such results for the purpose of effective control of future operations or activities.

Definitions : the term accounting has been defined by different authorities as under:
According to R-N Anthony : " nearly every business enterprise has accounting system. It is a means of collecting, summarizing, analyzing and reporting in monetary terms, informations about business". According to Smith and Ashburne : " accounting is the art of recording, classifying and summarizing in a significant manner and in terms of money, transactions and events, which are, in part at least, of a financial character and interpreting the result thereof".

In whatever way the term accounting is defined, its universally accepted objective is to record all the transactions in monetary units and to report them to its users in useful manner in the form of financial statements. These financial statements provide accounting information which are used by various interested parties for decision making.

1.0.1 Differences between 'Accountancy' and 'Accounting' --

The term 'Accountancy' and 'Accounting' are often considered as synonymous. However, there are some fundamental differences between the two.

The term 'Accountancy' refers to a systematic knowledge of accounting with the principles and techniques of application in accounting. It provides rules, principles methods, concepts and conventions for recording, classifying and summarizing of financial transactions and accounting information in a systematic manner. Accountancy also tells us the methods, procedures and ways how to communicate with the interested parties.

According to Eric L. Kohler *"Accontancy is the theory and practice of accounting: its responsibilities, standards, conventions and activities."*

According to F.W. Pixley, *"Accountancy is the science which deals with recording of monetary transactions of every description"*.

Thus, accountancy is regarded both as a science and as an art. It is the subject which speaks about the principles and practices of Accountancy. Again, accounting is the art of recording, classifying and summarizing the financial transaction in a systematic manner and interpreting the results to achieve predetermined objectives. Accounting is based on the rules, principles and technique of application formulated by the subject, accountancy.

1.0.2 Is Accounting a Science or an Art?

A question arises is whether Accounting is a science or an art? Before deciding whether it is a science or an art or both, it is better to go through the meaning of the two terms – science and art.

Science may be defined as a systematized body of knowledge based on certain principles which have universal application. It establishes the relationship of cause and effect about any occurrence or happening. Scientific knowledge is based on observation, experiments and testing of facts.

As, on the other hand, it the application of knowledge comprising of some accepted theories, principles, rules, concepts and conventions. It helps to achieve the goals and tells us the manner in which we may attain our objectives in the best possible way. The more an art is practiced, the more expert one becomes in it.

Accounting is considered as science because recording, classifying and summarizing of business transactions is done on the basis of certain principles such as principle of double entry system which have universal application. However, in accounting, the relationship of cause and effect is not studied which is a basic feature of pure sciences. It may, therefore, be said that accounting is a science but not a pure science.

Since accounting has to be applied in different organizations and varied situations, it has not been possible to develop principles which have universal applicability. Accounting is based on certain concepts and conventions called Generally Accepted Accounting Principles and is subject to some limitations. It may be influenced by bias and personal judgement of the accountant. The more a person is involved in accounting work, the more proficient he becomes in it. From this point of view, accounting is still an art. It tells us the manner in which some special objectives such as ascertaining the trading results of an entity for a particular period and the financial position of the entity on a particular date can be ascertained.

From the above discussion, it may be concluded that accounting is both a science and an art.

1.0.3 Characteristics of Accounting :

An analysis of the definitions of accounting brings out the following as characteristics of accounting :

(i) ***Accounting is an art :*** Accounting is considered as an art because it requires the application of some special knowledge comprising of some accepted theories and principles.

(ii) *Identification of financial events :* In course of daily activities, a number of events takes place .accounting is concerned with only those events which are of financial nature. These events are termed as economic activities. In other words, only those events which can be measured in terms of money, called business transactions, are identified for the purpose of recording.

(iii) *Recording of business transactions :* Only the business transactions are recorded according to some specified rules in the books of accounts. Books of accounts to be maintained depend on the nature and size of the business. Only those transactions and events which are of a financial character are recorded in accounting. There are a number of events in the business which are very important for business but which cannot be measured and, expressed in terms of money and hence such transactions will not be recorded. For example, the quarrel between the Production Manager and the Sales Manager, resignation by an able and experienced manager, strike by employees and starting of a new business by the other competitor etc. Though these events affect the earnings of the business adversely but as not one can measure the effect of such events in terms of money, these will not be recorded in the books of the business.

(iv) *Classifying the business transactions :* Classification is the process of grouping the transactions or entries of the same type or similar nature in one place. This is done by opening accounts in the ledger. In the ledger, the transaction involving a particular account is recorded in that account only.

(v) *Summarizing the information :* Summarizing involves the preparation of reports and statements from the classified data (ledger) in a manner understandable to the user of accounting information. This involves the balancing of ledger accounts and the preparation of Trial Balance with the help of such balances. Final Accounts, which include Trading the Profit & Loss Account and a Balance Sheet, are prepared with the help of Trial Balance.

(vi) *Recording in terms of money :* Each and every transaction is recorded in the books of account in terms of money only. For example, if a businessman purchases 30 Chairs and 5 Tables, their values in terms of money will be recorded in the books. Similarly, if a business possesses Rs. 5,000 in Cash; Land measuring 1,000 Square Metres; 2 Machines; 5 ton of raw materials; 30 Chairs; 5 Tables, and so on, then in the absence of money measurement these different types of assets cannot be added up and hence cannot give any useful information. Bit if they are expressed in terms of money, they will immediately provide useful information such as, Cash Rs. 5,000; Land Rs. 80,000; Trucks Rs. 2,00,000; Machines Rs. 60,000; Goods Rs. 40,000; Furniture Rs. 20,000 (30 chairs and 5 tables together).

(vii) *Interpretation of the results :* In Accounting, the results of the business are presented in such a manner (i.e., by preparing Trading and Profit & Loss Account and Balance Sheet) that the various parties interested in the business such as proprietors, managers, employees, bank, creditors, etc. can have full information about the profitability and the financial position of the business.

SCOPE AND FUNCTIONS

Scope :- The scope of modern accounting is indeed very wide, it is not merely concerned with record-keeping, but is also concerned with a whole range of activities involving :

(a) Planning; (b) Control; (c) Decision making; (d) Problem-solving;
(e) Performance measurement (f) Co-ordination and directing; (g) Auditing;
(h) Tax-determination and planning; (i) Cost accounting
(j) Management accounting (k) Financial Accounting.

Functions :- The following are the main objectives or functions or utilities of accounting :

(a) ***To keep systematic record of business transactions :*** The main objective of accounting is to keep a complete record of business transactions of the entity. This record is required to be maintained according to specified principles and rules. Keeping of compel record of business transactions helps to avoid the possibility of omission and fraud. For this purpose, all the business transactions are recorded first in Journal or Special Purpose Books and then posted into Ledger.

(b) ***To ascertain the result of operation :*** Another objective of accounting is to ascertain the result of operation carried on by the business during an accounting period. The result of operation may be either profit earned or loss suffered. A Trading and Profit & Loss Account of the business is prepared at the end of each accounting period to ascertain profit or loss. In the profit and loss Account, the revenue of the business is matched with the expenses incurred.

(c) ***To ascertain the financial position of the business :*** The financial position of the business is ascertained by preparing a statement called Balance Sheet. In this statement, the values of all the assets and liabilities of the business are shown. For a businessman, merely ascertaining the profit or loss of the business in not enough. The businessman must also know the financial health of the business. For this purpose, after preparing the Profit & Loss Account a statement called 'Balance Sheet' is prepared which shows the assets and their values on the one hand and the liabilities and capital on the other.

(d) ***To provide information to various parties :*** Another main objective of accounting is to communicate the accounting information to various interested parties like owners, investors, creditors, banks, employees and government authorities etc. This information helps them in taking sound and judicious decisions about the business entity.

ACCOUNTING PRINCIPLES

1.2.1 Meaning of Accounting Principle :

Principle means a general law or rule adopted or professed as a guide to action 'a settled ground or a basis of conduct or practice'. The word 'Principle' when applied in accounting may have different meanings in different contexts. It is not used in the sense of a fundamental accounting truth – it connotes a guiding influence or an accepted rule of action or conduct.

Accounting principles have been defined as the body of doctrine, commonly associated with the theory and procedure of accounting, serving as an explanation of current practices and as a guide for the selection of conventions or procedures where alternative exist.

In simple words, 'Accounting Principles' may be defined as those rules of conduct or procedure which are adopted by the accountants universally for recording and reporting of financial data. These principles bring about uniformity in the practice of accounting.

1.2.2 Generally Accepted Accounting Principles (GAAP) :

Accounting is a practical activity. Historically, the accounting professionals have not been very much concerned about the theoretical base of their profession. But gradually their job has been regarded as supplier of financial information for use by the economic decision makers. With the growth in business and financial activities, this job of an accountant is being put under scrutiny. They have to satisfy all the users of their financial statements. They have to apply certain concepts, conventions and postulates while preparing and presenting accounting information for the assistance of decision makers. The consensus view of the persons engaged in the accounting profession relating to :

- which economic resources and obligations should be recorded as assets and liabilities in financial accounting,
- which changes in assets and liabilities should be recorded,
- when these changes should be recorded,
- how the assets and liabilities and changes in them should be measured,
- what information should be disclosed;
- how it should be disclosed; and
- which financial statement should be prepared.

are referred to as Generally Accepted Accounting Principles (GAAP). GAAP's thus helps to bring about an uniformity in the reporting of financial events of the entities across the industry.

Generally Accepted Accounting Principles (GAAP) is a guide to the accounting profession in the choice of accounting techniques for the purpose of recording, preparing and presenting the financial statements.

1.2.3 Characteristics / Features of Accounting Principles :

The characteristics of Accounting Principles are :

(a) ***Accounting principles are made and developed by men (accountants)*** and, as such, they do not have the authoritativeness of universal principles, like other natural sciences, viz. Physics, Chemistry, Mathematics etc. It is an empirical science i.e. based on what is experienced or seen.

(b) ***The general acceptance of an accounting principle usually depends on how well it satisfies three criteria :*** **Relevance, Objectivity** and **Feasibility.** The word 'relevant' implies that the information will be useful to the users. The word 'objectivity' implies

that the recorded data are reliable and verifiable. The word 'feasibility' implies that the implementation of the principle in practice will be without much complexity and cost.

(c) ***Accounting principles cannot be validated/proved by reference to natural laws,*** as in the case of physical sciences. They are the best possible suggestions based on practical experiences, reasons and observations which have been developed by the persons/authorities engaged in the accounting profession over the years.

(d) Accounting principles are developed for common usage to ensure uniformity and understandability.

(e) Accounting principles are in the process of evolution, i.e., are not in their finished form. On the other hand, they are fast developing.

(f) They are not rigid.

1.2.4 Need / Importance of Accounting Principles :

(a) *Uniformity of Accounting :* Accounting is considered as the language of business. Accounting as a language, to be understandable to all, must follow certain principles uniformly all over the world. Therefore, accounting principles bring about the uniformity in accounting practices.

(b) *Comparability of Accounting information :* Accounting principles, if consistently followed, will make the accounting information comparable over a number of periods. Therefore, accounting information must satisfy the criteria of comparability so that it can be useful to the users.

(c) *Reliability of Accounting Information :* Financial statements show operational results and financial position for the users. Therefore, these information must be uniform and reliable for any decision making purposes. Accounting principles make the financial statements more reliable and non-biased.

(d) *Neutrality in Accounts :* Financial information is required by different classes of users having conflicting interests. Accounting principle help to maintain neutrality in presenting the financial information and leave little scope for statements becoming biased to a particular class of users.

(e) ***Guidelines to Accountants :*** Accounting principles provides guidelines to the accountants in preparing and presenting financial statements in different situations. Thus the scope of personal choice is reduced to the minimum.

1.2.5 Classification of Accounting Principles :

Traditionally, accounting principles were classified into two categories :
(a) Accounting Concepts; and (b) Accounting Conventions.

The International Accounting Standards (IAS – I) has classified the accounting principles into (A) Fundamental Accounting assumptions (Concepts), and (B) Accounting Policies (Conventions).

1.3 ACCOUNTING CONCEPTS :

Accounting is the language of business. The affairs of a business unit are communicated to others as well as to owners, managers, etc. through accounting information which has to be suitably recorded, classified, summarized and presented. If the language is to be understood by all, it must contain certain concepts which are universally understandable. So, the accountants have agreed upon a number of concepts which they try to follow in accounting. These are explained in short as below :-

*1. **Business Entity Concept :***

Accountants treat a business as a distinct entity, separate from the persons who own it. Thus, it becomes possible to record the transactions of the business with the proprietor also. If the businessman introduces cash into the business, he becomes a creditor of the business, and his contribution is recorded as capital. Thus business affairs are not mixed up with the private affairs.

*2. **Money Measurement Concept :***

Accounting records only those transactions which are expressed in monetary terms. Non-monetary events are ignored, even if they are otherwise important, thus, the purchase of furniture will be recorded in the books of accounts while the death of a very efficient manager will be ignored though it may greatly affect the business.

*3. **Cost Concept :***

Transactions are recorded in the books of account at the amounts actually involved. No arbitrary values, put on transactions, are considered. Thus, if a plot of land in Guwahati is purchased for Rs.10,000 though it is worth Rs.1,00,000, Rs 10,000 will be recorded in the books. However, in some cases estimated values are taken into consideration, e.g. depreciation, etc.

*4. **Going Concern Concept :***

It is assumed that the business will exist for a long time and transactions will be recorded with that end in view. This concept classifies expenditure into capital and revenue. Expenditure that will render benefit over a long period is called **capital expenditure** while the expenditure which will be exhausted quickly, say, within a year, is termed as **revenue expenditure**. The purchase of a building is a capital expenditure because it will render benefit over a long period while purchase of stationery is revenue expenditure because stationery will be consumed in a short period, say, in a year.

*5. **Dual Aspect Concept :***

Each transaction has two aspects. If a business has acquired an asset, it must have resulted in any one of the followings:-

(a) Some other asset has been given up; or

(b) Obligation to pay for it has arisen; or

(c) There has been a profit, which the business owes to the proprietor; or

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

The reverse is also true. So the equation is –

Assets =Liabilities +Capital. Or Capital =Assets – Liabilities.

The above equation is called the accounting equation which is explained later on.

6. Realization Concept :

Accounting is a historical record of transactions. It records what has happened but does not record anticipated events. It means legal transfer of goods and services either in cash or on credit creating a legal obligation to pay in future. However, adverse effects of events that have already occurred are usually recorded. Thus, cash realized or a legal obligation to pay is recorded in the books.

7. Accrual Concept :

If an event has occurred, its consequence will follow. If a transaction is not settled in cash, nevertheless it is proper to record the event in the books. Thus expected future cash receipts and payments are considered in accounting. As for example; unpaid salaries and wages, prepaid rent etc. are taken into account.

8. Matching Concept :

Though the business is a continuous affair, its continuity is artificially split into several accounting years for determining the periodical results. Thus, expenses of a particular period are compared with the revenues of that period to determine the net operational results of that accounting period. As for example; rent for twelve months whether paid or not is matched against the revenues earned during these twelve months.

In addition to these, legal position of transactions should be considered while recording such transactions e.g. Hire Purchase transactions.

1.4 Meaning of Accounting Standard :

The word '*standard*' in accounting literature is of a recent origin. Standard is generally known as principle till 1969. At the end of 1969, the British introduced the term 'Standard' when they set up their 'Accounting Standard Streering Committee' and the Americans adopted the same term 'Standard' in 1973 by creating 'Financial Accounting Standards Board.' In India, the term became popular when the Institute of Chartered Accountants of India formed 'Accounting Standard Board' (ASB) in April, 1977.

1.4.1 Definition :

The term 'Accounting Standards' may be defined as written statements issued from time to time by the institutions of accounting profession.

Littleton defines standards as follows : "A standard is an agreed upon criteria of what is proper practice in a given situation; a basis for comparison and judgement; a point of departure when variation is justifiable by the circumstances and reported as such. Standards are not designed to confine practice within the rigid limits but rather to serve as guide-posts to truth, honesty and fair dealing. Again they are not accidental but intentional in origin; they are expected to be expressive of the deliberately chosen policies of the highest types of business and the most experienced accountants. They direct a high but attainable level of performance, without precluding justifiable departures and variations in the procedures employed."

According to Bromwich, accounting standards are uniform rules for financial reporting. The standard sellers seek to prescribe a preferred accounting treatment from the available set of methods for treating one or more accounting problems. They deal with financial measurements and disclosures used in financial statements. They draw the boundaries within which acceptable conduct lies. They reflect society's changing corporate behaviour. They are vehicles in social and political monitoring and control of the enterprise. They provide flexible and realistic working guidelines for accounting practitioners.

Thus Accounting Standards (AS) is standardized accounting practices formulated by a recognized professional body such as Accounting Standard Board (ASB) in India. These standards are observed by the accountants in order to harmonize the operating results and to bring about uniformity in accounting practices.

1.4.2 Benefits of Accounting Standards :

Accounting standards are now a days regarded as a major component in the framework of accounting and reporting practices. They help the accountants to apply these practices as the most suitable for some given circumstance. Followings are the benefits :-

1. Credibility of Financial Statements :

Standards when used in accounting make the financial statements fair to all the groups of users. They imply that among the various alternatives, the most suitable one has been adopted in a given situation. Standards make the statements conform to a particular model for the sake of comparability. Thus they improve the credibility and reliability of financial statements.

2. Benefits to Accountants and Auditors :

Standards provide guidelines for accountants and auditors in the performance of their duties. They can resort to these standards as a shield against any prosecution for alleged lapse of duties such as discovered frauds, etc. Moreover, they are used as controlling techniques by the chartered institutes for the functioning of their members.

3. Measuring Managerial Accountability :

Standards facilitate in determining specific corporate accountability and regulation of the company. They measure managerial skill and improve the profitability of a company. They ensure consistency and comparability of financial statements. They reduce the manipulation of accounts.

4. Reforming Accounting Theory and Practice :

Standards help in the development of accounting theories and in the improvement of existing practices by rectifying their defects where there is any. They make us aware of alternative possibilities for defining and measuring financial performance.

1.5 Recognition and Measurement of the elements of Financial Statement.

ñ To understand and what are financial statements?

ñ To recognize the components of Financial Statements.

ñ To measure the elements of Financial Statements.

The end product of the financial accounting process is a set of reports that are called 'financial statements'. The following generally constitute the financial statements :

(1) Profit and Loss A/c.
(2) Balance Sheet.
(3) Statement of changes in Financial Position (SCFP)

Profit and Loss account, also known as income statement, presents the results of operation of a business enterprise for a period of time. This statement shows net profit or net income of an entity for a period of time. Net profit or income is the difference between revenue and expenses. The profit and loss account indicates how successful a business enterprise has been in achieving its profit goal for a given time span. It also gives the sources and amounts of revenue earned and the different types and amounts of expenses. Net profit indicates an enterprise's accomplishments (expenses) in pursuing its operating activities. When expenses exceed revenue for a period, a business enterprise incurs a net loss.

Balance Sheet shows the financial position of a business on a certain date. For this reason, it is often called the 'statement of financial position'. Balance sheet indicates the inventing and financial activities of a business enterprise at a point of time and shows a firm's assets, liabilities, and equity capital usually at the close of the last day of a month or a year. Assets are economic resources and provides future benefits to a firm such as cash, inventories, debtors, building, plant, patients, goodwill etc. Liabilities are creditors or outsider's claims on the assets of a business enterprise such as creditors, accounts payable, salaries payable, income tax payable, debentures. Liabilities include shareholder's equity as well which are in the form of ordinary shares, preference shares, retained earnings. Shareholder's equity is the shareholder's or owner's claim on the asset of a firm. The shareholders have claims against the assets of a company only after all creditors claims have been met.

A statement of changes in financial position (SCFP) shows where the financial resources (funds) have come from (sources) and where they have gone (uses). SCFP is generally prepared on working capital basis and cash basis. Working capital - based SCFP explains increase or decrease in working capital for a specified period of time. It reports :

(a) Amount of changes in working capital associated with the operating activities of a firm.
(b) Long term financing or other sources that cause an increase in the working capital
(c) Long term investment activities or other uses that causes a reduction in the working capital.

The cash-basis SCFP, is popularly know as the 'Cash Flow Statement'. Cash is considered as the business lubricant. This statement summarizes the flow of cash in and out of the firm over a period of time. It focuses on various items which bring out changes in the cash balance between two balance sheet dates. Cash flow statements cover all items which increase or decrease the cash of a business enterprise. In USA, statements of cash flows is legally required to be prepared by US companies along with Income Statement and Balance Sheet.

Among the above statements, balance sheet is considered as status or stock report and the other two statements - Income Statements and Statement of changes in Financial Position - are known as flow reports. Balance sheets, as stock reports, show the information about the resources of an organization at a specified moment of time. The income statement and statement of changes in financial position (working capital and cash basis) as the flow reports, show the activities of the enterprises for a period of time, say for a year, half-year, or a quarter, and summarize the information provided by the financial statements.

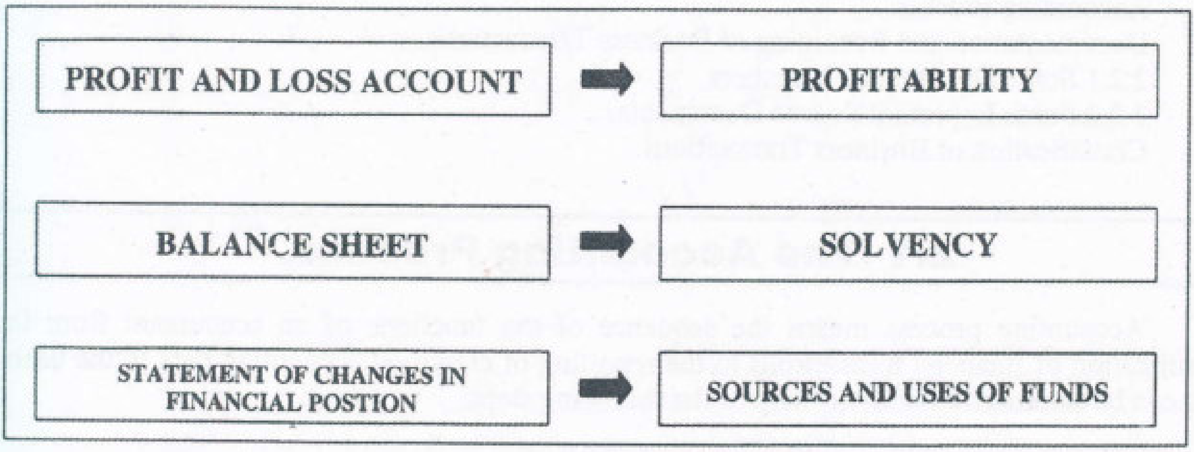


Fig : Information provided by the Financial Statements.

Exercises :-

Q1. Define Accounting and the scope of accounting.

Q2. Briefly explain the functions of Accounting.

Q3. What do you mean by 'Accounting Concepts'?

Q4. What are accounting conventions? Explain them?

Q5. Explain briefly the underlying principles :-

(a) A business unit is normally considered as having an indefinite life. Discuss.

(b) Recognize all losses, anticipate no gain.

Q6. Mention the advantages and disadvantages of Money-Measurement Concept.

Q7. What are the golden rules of accounting?

Q8. Explain in details as how recognition and measurement of the elements of Financial Statements take place.

UNIT–II THE ACCOUNTING PROCESS

Unit Structure :-

2.1 The Accounting Process.

Accounting process means the sequence of the functions of an accountant from the identification of financial transactions to the reporting of classified accounting data to the users. This can be summarized with the help of the following steps:

Accounting Process

1. Identification of Economic Events.
2. Classification of the Business Transactions.
3. Measurement of Values involved in terms of money.
4. Recording of Business Transactions.
5. Summarization of Business Transactions.
6. Analysis and Interpretation of Business Transactions.
7. Communication of Accounting Data.

1. Identification of Economic Events :

Out of the various types of events, the events which have financial implications and which have financial implications and which are relevant to the business are to be identified first as economic events. Such identifications is to be made on the basis of materiality of an event.

2. Classification of Business Transactions :

This process involves the classification of the business transactions on the basis of their nature such as assets, liabilities, capital, revenues and expenses. It facilitates the recording of the transactions in the books of account.

3. Measurement of Value involved in the terms of Moneys :

Accounting is concerned with the monetary value of a transaction. Therefore, in addition to the monetary transactions, non-monetary transactions are also to be valued in terms of money such as depreciation of fixed assets, loss in transit, etc.

4. Recording of Business Transactions :

Business transactions are recorded in terms of money according to the accounting principles, policies and procedures. Recording of transactions should reflect the accounting implications of the transactions.

5. ***Summarization of Business Transactions :***

Recorded transactions are summarized in the form of Ledger Accounts. Trading and Profit and Loss Account and Balance Sheet. They reflect the net implications of the transactions.

6. ***Analysis and Interpretation of Business Transactions :***

Accountant prepares various reports such as purchase report, sales report, expenses report, etc. From these reports and from the Profit and Loss Account and the Balance Sheet, various ratios are calculated to determine the efficiency and progress of the business.

7. ***Communication of Accounting Data :***

Various accounting reports such as various Expenses Reports and Profit and Loss Account and Balance Sheet are made available to the different users for their decision making purpose.

2.2 Documentation and Recording of Business Transactions.

Accounting is said to be meaningless without documentation of business transactions in a systematic and a scientific manner. In order tr understand this scientific procedure let us understand carefully the various source documents and vouchers and how they are being recorded.

2.2.1 Source Documents / Vouchers.

A source document is written document which becomes the basis for recording a transaction in the books of accounts. Such a document is the proof of happening of a transaction. It shows the nature of the transaction, the amount involved in the transaction, the date and the name of the parties involved. Such written documents are called vouchers.

Vouchers include receipts, bills, cash memos, invoices, wages bills, salary bills, traveling allowance bill, counter foils of cheques, registration deeds, customers' agreements and any other form of written proof that shows that a transaction has taken place. Such documents are verifiable documents on the basis of which transactions are recorded in the books of accounts.

As for example; invoice for sending goods out of station, bills for credit sales, cash memos for cash sales, etc. In these cases, original copies are handed over to the buyers but the duplicate copies are kept as records in the business. These duplicate copies are the source documents for making records in the sellers' books of accounts. In this way the duplicate copies of the receipts against incomes received form the source documents of incomes.

Similarly, when goods are bought, the buyer receives the original copies of invoices, bills or Cash memos. These copies work as source documents for the purpose of recording transactions in the books of the buyer.

In the same way, when a payment is made to a party, a receipt is obtained from the party and that money receipt becomes the source document for recording the payment.

Thus receipt from landlord for payment of rent, bus ticket or rail ticket for payment of bus fare or rail fare, salaries or wages bills signed by the employees or workers after receiving payment, receipts for petty expenses are the source documents for recording payments.

Therefore, the first step in accounting is to identify the origin of a transaction which is based on documentary evident known as voucher. Thus a voucher is the basis of identifying and recording a transaction.

Vouchers :

A voucher is a 'Written Document' which is used in support of an entry made in the books of accounts.

Some authoritative definitions of vouchers are given below :

J.R. Baltiboi : "A voucher may be defined as documentary evidence in support of an entry appearing in the books of accounts".

VOUCHER

Lawyer's Book Stall (P) Ltd.

Panbazar, Guwahati-781001

Voucher No	Date 20	
	Rs.	P.
Debit .... Total Rs.		
Credit.. .... Total Rs.		
Accountant/Manager .... Passed By :...........................		

Features of a voucher :

From the above definition, it appears that a voucher has the following features :

1) A voucher is a written document,
2) It describes the transaction in details;
3) It is a documentary evidence of the happening of a transaction;
4) It supports an entry made in the books of account.
5) It substantiates the accuracy of an entry made in the books of account.

Different source documents or vouchers necessary for recording transactions in different books

Name of the Book	Required source documents or vouchers
1. Cash Book	Cash memos (received), Cash Receipts, Cash Receipts issued, Bank Day-in-slips, and other cash vouchers.
2. Purchases Book	Inward Invoice, Bills Received from suppliers.
3. Sales Book	Outward Invoice issued to customers, Bill issued to customers.
4. Purchases Returns Book.	Debit Notes issued to suppliers or Credit Notes received from suppliers.
5. Sales Returns Book	Credit Notes issued to customer or Debit Notes received from customers.

Kind of Vouchers :

Vouchers can be broadly divided into two types :

1) Supporting vouchers; and
2) Accounting vouchers.

2.2.2 Some Important Source Documents.

Some other important source documents are explained below with their respective specimen.

1. Receipt :

When cash is received, a receipt is issued. Such a receipt indicates the data, the amount of payment, details of the payer and the purpose of payment. It should be duly signed by the issuer of the receipt. The counter foil or the carbon copy of the receipt issued is used as a source document for recording the receipt of money. In the same way, when payment is made by the business, the business also receives a receipt from the party to whom payment is made. That receipt is the source document on the basis of which recording for payment is made.

MONEY RECEIPT **M/S SELECTION (Phone No. 0361-2456781)** A dealer in Readymade Garments. Fancy Bazar, Guwahati-1
Received with thanks from M/S Fashion House Shillong...... Rupees ten thousand only.... *(Rs.10,000) for the value received.* For ....s/d........ Manager,

2. Cash Memo :

It is a document which indicates the amount, date and the details of cash purchase and cash sales. When the business makes a cash purchase, it receives cash memos from the seller of the goods. These cash memos work as documents and become the basis for recording cash purchases. Similarly, when the business makes cash sales, it issues cash memos. The duplicate copies of cash memos become the source documents of recording cash sales. Thus a duplicate copy of a cash memo issued for any cash receipt will be treated as the source document for recording cash receipts.

Cash Memo
Goenka Wool House.
Fancy Bazar, Guwahati-781001
A Dealer in Woolen Articles.
Phone No. 0361-2456789

S.L.No.-2456 **Date…………**

Items	Description	Quantity	Rate/Rs.	Amount/Rs.
1	Wool Balls (21)	100	Rs.5	500
2	Woollen Swals (240)	50	200	10,000
3	Sweaters (150)	50	250	12,500
	Total			23,000
	Rupees – Twenty three thousand only			
	Ramesh For Goenka Wool House			

3. ***Invoices and Bills :***

Invoices and Bills are used for credit purchases and sales. In case of credit sale of goods, the business issues invoices/bills which indicate the date, amount, name of the party and details of the goods sold. Invoices/bills are prepared in three copies - the first coy is sent to the buyer by post or through a bank, the second copy is sent with the goods and the third copy is retained in the office. The third copy kept in the office is used as the source document for recording credit sales.

In case of credit purchase of goods, the business receives invoice/bill in original and records credit purchases on the basis of such invoice or bill.

Invoice/Bill No – 0001
GOENKA FASHION HOUSE
Fancy Bazar, Guwahati-781001
Dealer in Ready-made Garments – Ladies and Gents.
Phone – 0361 – 2456781

To M/S Bora Ready-made Garments
R.G. Baruah Road, Guwahati-21
Date :…………

Items no.	Description	Quantity	Rate/Rs.	Amount/Rs.
1.	Full Shirt (231)	20	150	3,000
2.	Pents (561)	50	250	12,500
	Less Trade Discount 20%			3,100
	Net amount Payable			12,400
	Rupees Twelve thousand four hundred only.			

R.Sharma
Manager
E.&.O.E.

4. *Pay-in-Slip :*

When cash and cheques are deposited into bank, we are to fill in deposit slips known as Pay-in-Slips. The main body of the pay-in-slip is retained by the bank and the counter foil of the pay-in-slip is returned to the depositor after duly stamped and signed by the banker. This counterfoil is used as a source document for recording deposits into bank.

5. *Cheque :*

When cheques are issued against payment, each cheque contains a counterfoil where the details of the payment are written. Such counterfoils are used as source documents for payments.

If money is withdrawn from a bank for self use, the details of such withdrawal are written up in the counterfoil. It is used as source document for recording such withdrawal.

6. *Debit Note :*

When goods purchased on credit are returned to the supplier, a 'Debit note' is issued to him. 'Debit note' means that the supplier account is debited with the value of the goods returned. The carbon copy of the 'debit note' becomes the source document for recording the purchase return.

7. *Credit Note :*

When goods sold on credit are returned by the customer, a 'Credit note' is issued to him. A 'Credit note' means that the customer's account is credited with the value of the goods returned. The carbon copy of the 'Credit Note' becomes the source document for recording the sales return.

8. ***Miscellaneous Documents :***

In addition to the above, the following documents are also used as course documents for recording respective transactions. They are correspondences, registration deed, wages sheets, salary bills, electricity bills, water bills, railway or bus tickets, traveling allowance bills, etc.

2.3. Classification of Business Transactions.

I. ***Classification of Transations :***

1) Cash transactions.
2) Credit transactions and
3) Paper transactions.

II. ***Classification on the basis of the entity involved :***

1) External transactions and
2) Internal transactions.

III. ***Classification on the basis of exchange :***

1) Exchange transactions and
2) Non-exchange transactions.

Classification of Transactions

On the Basis of Mode of Payment:	On the Basis of Entity Involved :	One the Basis of Exchange
1. Cash transactions.	1. External transactions.	1 Exchange Transactions
2. Credit transactions, and	2. Internal transactions.	2.Non-Exchange transactions.
3. Paper transactions		

I. **Classification on the basis of mode of Payment :**

1) **Cash Transactions** – Cash transactions are those transactions where the value of the transaction is paid immediately either in cash or by cheque. As for example :- Hari bought goods for Rs.500 in cash from Guwahati Store. It is a cash transaction. In a cash transaction, either the word 'cash' will be mentioned in the transaction or the name of the party will be absent from the transaction.
2) **Credit Transactions** – Credit transactions are those transactions where the value of the transaction is paid later on. As for example :- Shyam purchase furniture valued Rs.1000 from Furniture House on credit. Here the payment is not made immediately after the purchase of furniture. It is to be paid later on. So it is a credit transaction. In such a transaction the words 'on credit' or the name of the party will be mentioned in the transaction.
3) **Paper transactions** – Paper transactions are those transactions where the value of the transaction is not to be met at all. For example :- A loss by fire (uninsured) to the extent of Rs.10,000 is a paper transaction as the value of the transaction is not to be met. The words "cash" or "on credit" will not be used in such transactions.

II. **Classification on the basis of entities involved :**

1. External transactions - External Transactions are those transactions which take place between the business entity and another entity or a party outside the business. Example : Sale of goods to a customer.
2. Internal transactions – An internal transaction is one that takes place within the business entity itself. Example : The depreciation of machinery used in the business.

III. **Classification on the basis of exchange :**

1. Exchange transactions - An exchange transaction results in an exchange of value between two or more parties. Examples : Sale or purchase of goods; payment of rent, etc.
2. Non-Exchange transactions – A non-exchange transaction does not result in an exchange of value. Example – Loss due to fire, flood or thief, depreciation on fixed assts etc.

Exercise :

Q1. Briefly explain the Accounting process.
Q2. What is documentation and recording of business transactions and how is it done?
Q3. Write short note and draw the proforma of the same :-
(a) Cash Memo
(b) Cheque.
Q4. How are business transactions being classified?

UNIT-III ACCOUNTING TRANSACTIONS

Unit Structure :

3.1 THE DOUBLE ENTRY SYSTEM

Double entry system states that each transaction has two fold aspects and the effects of these two fold aspects are opposite in nature. If one aspect, called account, receives a benefit, there must be another aspect or an account to impart that benefit. The system of book-keeping under which both the aspects of every transaction is recorded in the books of account is known as "Double entry system of Book-keeping". Under this system, every transaction is recorded in an accounting format having two sides namely left hand side and right hand side. For a transaction, the account which receives the benefit is called a debtor and it is recorded on the left hand side of the format which, in book-keeping, is known as debit side. At the same time, the other account of the transaction, which imparts the benefit is known as a creditor and is recorded on the right hand side of the accounting format which, in book-keeping, is known as credit side.

Thus, every transaction is recorded in its two-fold aspects. That is why this system is known as Double entry system. Under this system of book keeping for each transaction the debit amount must be equal to the credit amount.

Double Entry System was first propounded in 1340, in Genoa, in Italy, and was used by stewards for rendering accounts in the state; but is was developed in proper form in Venice at the end of 15th century by Fra Luca Pacioli, a Franciscan monk of Italy. He is considered as the father of modern accountancy.

3.1.1 Practical application of the Principle of Double Entry :

All business transactions involve the transfer of value in the form of money, goods or services from one party to another. So, it involves two parties. One party gives some benefit while another party receives the benefit of an equivalent value. For the purpose of recording, the transactions are analyzed further to ascertain the two aspects affected by each transaction. **Most important point to be kept in mind at this stage is that for the purpose of recording, a transaction is required to be analysed from the point of view of the party in whose books of accounts the recording is to be made. This analysis is required in order to ascertain the accounts affected by the transaction.** For example, Mr. A paid Rs.500 to Mr. B. Most important point to be considered is – in whose books of account the recording is to be made? If the recording is to be made in the books of A, from his point of view, we find the Cash has gone out and 'B' has received the same. Therefore, the two-fold aspects are Cash and 'B'. Since an account is maintained for each type of asset and the person to receive the benefit is 'B', the accounts affected are Cash Account and the Account of B. Under Double entry system recording will be made in both Cash Account and in the account of B.

Thus, every transaction has two aspects, viz.

(i) The receiving of value on the one hand; and

(ii) The giving of the same value on the other hand.

Both the receiving and giving aspects take place between the **'two account heads'** of each party involved in the transactions.

3.1.2 Meaning of Account :

An account is a summarized record of all transactions of similar nature relating to a particular person, an asset, an item of income or an item of expense. A businessman should classify and summarize all the business transaction of similar nature or with the same person under respective groups. Each such group or head is known as an 'Account' or 'Account heads'. For example, all dealings with 'Sourav' will be recorded under the heading 'Account of Sourav'. Account is abbreviated as 'A/c'.

Definition of Account :

The term 'Account' has been defined by different authorities. But the best definition of account has been given by R.N. Carter.

According to R.N. Carter, "An account is a ledger record, in summarized form, of all the transactions that have taken place with the particular person and the value specified".

Format of Account :

The account is generally prepared in 'T' form having two sides namely left hand side and right hand side. A specimen form of an account is given below :

Cash Account

Dr.							Cr.
Date	Particulars	J. F.	Amount Rs.	Date	Particulars	J. F.	Amount Rs.

All accounts are divided into two sides. The left hand side of the account is called 'debit side'. It is indicated by 'Dr.' (abbreviation for debit) on the top corner of the left hand side. Right hand side of the account is called 'credit side.' It is indicated by 'Cr.' (abbreviation for credit) on the top corner of the right hand side of the account. The name of the account is written at the top in the centre. The word 'Account' or its abbreviation 'A/c' is added to the name of the account. For example, Building A/c, Furniture A/c, Salary A/c, Ravi.

3.1.3 *Meaning of Debit and Credit :*

In accountancy, to debit an account means to record the transactions on the left hand side on an account which receives the benefit. Left hand side of the account is also called debit side. It is abbreviated as 'Dr.' the word 'debit' originated from the latin word 'Debitum'. It means what is due.

In accountancy, to credit an account means recording the transactions on the right hand side of an account which imparts the benefit. Right hand side of the account is also called Credit side. It is abbreviated as 'Cr.'. The word 'Credit' originated from the latin word 'Credre' which means trust or belief.

3.1.4 *Classification of Accounts :*

For the purpose of recording and ascertaining the two-fold effects, classification of accounts (account head) are necessary. There are two approaches for classification of accounts. They are :

(a) English Approach or Traditional Approach; and

(b) American Approach or Modern Approach.

These are discussed below :

Traditional Classification of Accounts

- Personal account
  - Natural Personal A/c
  - Artificial Personal A/c
  - Representative Personal A/c
- Impersonal accounts
  - Real accounts
  - Nominal accounts (Revenue and Expenses accounts

(i) *Accounts of Natural persons:* Account heads recording the transactions of individual human beings fall into the category of natural persons. For example; accounts of Ram, Jadu, Suresh, Jayanta, Raju etc.

(ii) *Accounts of artificial persons:* Accounts recording the transactions concerning a firm, company, institution, association, organization etc. fall into this category. For example, Gauhati Commerce College A/c, J.B. College A/c, M/s. Baruah Brothers A/c, Assam Tea Company A/c, N.F. Railway A/c.

(iii) *Representative Personal Accounts:* Representative Personal Accounts are the accounts which represent a certain person or a group of persons although the name of the concerned person or persons are not mentioned in the account head. Such type of account head occurs in cases of outstanding expenses, prepaid expenses, income receivable and income received in advance. For example Wages outstanding. For example; Outstanding Salary, Salary Repaid, Unexpired Insurance or Insurance paid in Advance, Commission Received in Advance et.

Note : When any 'Prefix' or 'Suffix' is used before / after any nominal account head, such account is classified as Representative Personal Account under Traditional approach.

(b) Real Accounts : The 'account heads' recording transactions relating to tangible things (which can be seen, touched or physically exchanged such as goods, cash, land, building, machinery, etc. are classified as real accounts). It may be mentioned here that there are some intangible items which do not have a physical shape and which cannot be seen or touched but the presence can be felt and can be bought and sold. For example; goodwill, patents, trademarks, copyrights, etc. They also fall within the category of real accounts.

(c) Nominal Accounts : The accounts recording transactions relating to losses, expenses, incomes and gains are classified as nominal accounts. For example; Salaries, Wages, Rent paid, Discount allowed, Discount Received, Commission paid, Commission Received, Interest paid, interest received etc.

3.1.5 Golden Rules of Accounting :

The rules of debit and credit Under English Approach or Traditional Approach are termed as 'Golden Rules of Debit and Credit'. These rules are as under :

(i) *In case of Personal Accounts :*
Debit the Receiver of the benefit.
Credit the Giver of the benefit.

(ii) *In case of Real Accounts :*
Debit what comes in.
Credit what goes out.

(iii) *In case of Nominal Accounts :*
Debit Expenses and Losses.
Credit Gains and Incomes.

(B) *American Approach or Modern Approach :*

According to the American approach or Modern approach, accounts are classified into five categories as under :

(a) ***Assets Account :*** Assets account are the accounts of assets and properties such as land, building, plant, machinery, patents, cash in hand, cash at bank, investments, inventory, etc. held by an entity. This category also includes the accounts of debtors.

(b) ***Liabilities Account :*** Liabilities accounts are the accounts pertaining to the liabilities of the entity to lenders, creditors for goods, creditors for assets, creditors for expenses, etc.

(c) ***Capital Account :*** Capital is the amount with which the business is started. It is the account of the owner who invests money in the business as capital.

(d) ***Revenue Accounts :*** Revenue Accounts are the accounts of incomes and gains. For example, sales, discount received, interest received, Commission received etc. These accounts are taken into account for preparation of Trading & Profit and Loss Account.

(e) ***Expense Accounts :*** Expense Accounts are the accounts of expenses incurred and losses suffered by an entity. For examples; purchases, wages paid, depreciation, rent paid, rates and taxes, etc. like Revenue Account, expense accounts are also taken into account for preparation of Trading & Profit and Loss Account.

However, in case of sole proprietorship/ partnership form of business, another account called **'Drawings Account'** is also maintained in order to record the transactions relating to withdrawals of cash or goods made by the proprietor / partners for their personal use.

Illustration 1:

Classify the following accounts:

(i)Land; (ii)Building; (iii)Investment; (iv)Furniture; (v)Machinery; (vi)Goodwill; (vii) Cash in hand; (viii)Cash at Bank; (ix) Leasehold property; (x)Trademark; (xi)Closing Stock (Closing Inventory); (xii)Debtors; (xiii)Creditors; (xiv)Loan to Ram; (xv)Loan from Madhu; (xvii)Bank (Loan); (xviii)Tata Iron and Steel Co. Ltd.; a supplier; (xix) Arun Kumar (a customer to whom goods were sold on credit); (xx) Withdrawal by the proprietor personal use; (xxi) Copyright.

Solution :

Classification of accounts :

Land – Assets Account;
Building – Asset Account;
Investment – Asset Account;
Furniture – Asset Account;
Machinery – Asset Account;
Goodwill – Asset Account;
Cash in Hand – Asset Account;
Cast at Bank – Asset Account;
Leasehold property – Asset Account;
Trademark – Asset Account;
Closing Stock (Closing Inventory) – Asset Account;
Debtors – Asset Account;
Creditors – Liability Account;
Loan to Ram – Asset Account;
Loan from Madhu – Liability Account.

Capital A/c;
Bank (Loan) – Liability Account;
Tata Iron and steel co. ltd.; a supplier – Liability Account;
Arun Kumar (a customer to whom goods were sold on credit) – Asset Account.
Withdrawal by the proprietor personal use – Drawings Account;
Copyright – Asset Account.

3.2 INTRODUCTION TO THE BOOKS OF ACCOUNTS.

Recording of transaction is a process of entering the transactions in the proper books of accounts in a systematic manner. It means putting into black and white the transactions that takes place in course of business activities. Normally transactions are first recorded in a book of original entry, called Journal.

Books of accounts are specially printed and ruled books where the accounts of a firm are kept or written up. The two main books of accounts of a business entity are Journal and Ledger.

Different classes of books of accounts :

There are two different classes of books of accounts which are maintained by a business entity. They are :

(a) Books of original entry or Primary book (Journal); and
(b) Principal book or book of Final entry (Ledger).

Books of original entry/ Primary Books:

Books of original entry means the books of accounts where the transactions are recorded as and when they take place. The first book of original entry is called 'Journal'.

3.2.1 Journal

Journal is a book of original entry in which transactions are originally recorded in chronological order (in order of date) from source documents showing the accounts to be debited and credited in a systematic manner. Thus, the Journal provides a date-wise record of all the transactions with details of the accounts and amounts debited and credited for each transaction with a short explanation.

The word 'Journal' has been derived from the French word 'JOUR' means daily records. Journal is a book of primary entry for daily records. Firms having limited number of transactions record them in one primary book called Journal and post them to the concerned ledger accounts. Firms having large number of transactions maintain some special purpose books such as Cash Book, Purchases Book, Sales Book etc. in addition to Journal proper and post them to respective ledger accounts.

3.2.2 Format of Journal

The following is the format of journal :

Format of Journal

Date	Particulars	L.F.	Amount	
			Debit	Credit
			Rs.	Rs.
(i)	(ii)	(iii)	(iv)	

The format of journal is sub-divided into five columns. These five columns are (i) Date, (ii) Particulars, (iii) Ledge Folio (L/F), (iv) Amount (Debit) and (Credit). In these columns following information is recorded :

(i) Date : In this column, the date of the transaction with its month and year is recorded. The year is not repeated against every entry because the year is almost the same. The sequence of the dates and months should be strictly maintained i.e., transaction taking place on January 2, 2005 and so on will be recorded. For example, transactions took place in a business on January 3,2005, January 10,2005, February,5, 2005 and February 9.2005.

The date of the above transactions will be recorded as under :

Date
2005
Jan. 3
" 10
Feb. 5
" 9

(ii) Particulars: In this column, both the debit aspect and credit aspect of each transaction is recorded. The name of account to be debited followed by the word 'Dr.' against that account is written in the first line. In the second line, the account to be credited is written. However, the word 'Cr.' is not written against this account. In the next line, an explanation to the entry called 'narration', is given to explain the transaction. For example, Machinery has been purchased in cash. This transaction will be recorded in the particulars column of the journal as under :

Particulars
Machinery A/c Dr.
To Cash A/c
(Being Machinery purchased)

(iii) Ledger Folio (L.F.): Journal is the original record of the business transactions. All entries from the journal are posted in the ledger accounts. The page number of folio number of the ledger account where the posting has been made from the journal is recorded in the L.F. column of the Journal. For example, if posting is made in Machinery Account appearing at page number 15 of the ledger and Cash A/c appearing at Page 6 of the ledger, 15 will be entered in the L.F. column in the journal against Machinery A/c and 6 will be entered against Cash A/c in the ledger folio column in the journal. It means that journal and ledger are inter-related and the ledger posting is based upon Journal. Therefore, there should be certain reference as regards the page number of ledger, where the account in the journal is being posted.

(iv) Amount (Debit) and (Credit) : Every transaction has got debit and its corresponding credit for the same amount. The amount of the account debited is written at the debit column of the amount column and the amount of the account credited is written at the credit column meant for writing the amount.

(v) Narration : After every journal entry, a brief explanation of the transaction for which the entry has been passed is given. It enables the persons going through the journal entry to have an idea about the transaction. This explanation is known as **'narration'.** Narration is preceded by

the words 'Being' / 'For'. After the narration, a horizontal line is drawn in the particulars column only to separate one journal entry from the other.

Process of Journalising :

The process of journalizing means the steps to be followed for ascertaining the account heads to be debited / credited for a particular transaction. There are three steps involved in the process of journalizing a transaction.

Step 1: Identification of accounts or 'account heads' affected by the transaction.
Step 2: Classification of accounts or account heads.
Step 3: Application of Rules for Debit and Credit.

Types of Journal entries :

Entries recorded in the journal may be of two types :

a) Simple Journal Entry; and
b) Compound Journal Entry.

Simple Journal Entry:

When a transaction affects only one aspect/ account in the debit and on aspect / account in the credit, it is known as Simple Journal Entry.

Compound Journal Entry:

When a transaction affects more than two accounts at a time – one or more accounts being debited/ one or more accounts being credited, such entry is known as Compound Journal Entry.

Illustration 2 : Journalise the following transactions in the books of Mr. A. Bora.

2005		Amount (Rs.)
April		
2	Took a Bank Loan at 10% interest	20,000
20	Advanced a Loan at 12% to Madhu	10,000
21	Goods distributed as charity	300
22	Goods distributed as free samples	500
23	Loss of cash by theft	1800
25	Loss of goods by theft	2000
28	Loss of goods by fire	7000

Solution :

In the books of Mr. A. Bora

Journal

Date	Particulars	L. F.	Dr. Amount (Rs.)	Cr. Amount (Rs.)
2005 April 2	Cash A/c Dr.		20,000	
	To 10% Bank Loan A/c			20,000
	(Being Bank Loan taken at 10% interest p.a.)			
20	12% Loan to Madhu A/c Dr.		10,000	
	To Cash A/c			10,000
	(Being loan advanced to Madhu at 12% Interest p.a.)			
21	Charity A/c Dr.		300	
	To Purchase A/c			300
	(Being goods distributed as charity)			
22	Free Samples / Advertise A/c Dr.		500	
	To purchase A/c			500
	(being goods distributed as free samples)			
23	Loss by Theft A/c Dr.		1,800	
	To cash A/c			1,800
	(being the loss of cash be theft)			
25	Loss by Theft A/c Dr.		2,000	
	To Purchases A/c			2,000
	(being the loss of goods by fire)			
28	Loss by Fire A/c Dr.		7,000	
	To Purchases A/c			7,000
	(Being the loss of goods by fire)			

Explanation :

Apr. 2. The two account heads involved are 'Cash A/c' and '10% Bank loan A/c.' is an asset account. Cash A/c is to be debited as the asset increases. '10% Bank A/c' is a liability A/c. '10% Bank Loan A/c' is to be credited as the liability increase.

Apr.20 The two account heads involved are '12% Loan to Madhu A/c' and 'Cash A/c'. 12% Loan to Madhu A/c is an asset account. 12% loan to Madhu is a loan or advance given by the business to Madhu and it will be receivable in future from Madhu. Such advances is treated as an asset. Therefore, it is to be debited as the asset increases. Cash A/c is an asset account. Cash A/c is to be credited as the asset decreases.

Apr.21 The two account heads involved are 'Charity' A/c and 'Purchase A/c' Charity A/c is an expense Account. Charity A/c is to be debited as the expense increases.

Apr.22 the two account heads involved are 'Free Sample A/c' or 'Advertisement A/c' and 'Purchases A/c'

Free Sample/Advertisement is an expense account. It is to be debited as the expense increases. Purchase A/c is an expense account. Purchase A/c is to be credited as the expense decreases.

Apr.23 The two account heads involved are 'Loss by theft A/c' and 'Cash A/c'. Loss by Theft A/c is an expense account. It is to be debited as the expense increases. Cash A/c is an asset account. So it is to be credited as the asset decreases.

Apr.25 The two account heads involved are 'Loss by Theft A/c' and 'Purchases A/c'. Loss by Theft A/c is an expense account. It is to be debited as the expense increases. Purchase A/c is an expense A/c. so it is to be credited as the expense decreases.

Apr.28 The two account heads involved are 'Loss by Fire A/c' and 'Purchase A/c'. Loss by Fire A/c is an expense A/c. So it is o be debited as the expense increases. Purchases A/c is an expense A/c. So it is to be credited as the expense decreases.

Note : Under modern method Classification of 'account heads' and 'rules for Debit and Credit', losses are also considered as 'Expense'.

Exercise :

Journalise the following transaction :

2005

Jan.1 Naresh started business with a capital of Rs. 50,000

Jan 5 Purchased Goods for Cash Rs. 12,000/-

Jan. 7 Sold goods to Madhu Rs. 3,200/-

Jan 10 Received cash from Madhu Rs. 700/-

Jan 12 Cash sales to Nayan Rs. 800/-

Jan 15 Goods returned by Madhu Rs. 150/-

Jan 18 Purchased Furniture Rs. 3,000/-

Jan 23 Purchased goods from Bhuban on credit Rs. 4,000/-

Jan 25 Paid to Bhuban Rs. 1,600/-

Jan 27 Goods returned to Bhuban Rs. 600/-

Jan 28 Purchased goods from Babla on cash Rs. 6,800/-

Jan 29 Sold goods Rs. 3,500/-, Sales Tax charged 10%

Jan 30 Withdrew goods for personal Rs. 500/-

Jan 31 Used goods worth Rs. 2,000/- for making furniture.

3.3 LEDGER AND LEDGER POSTING

3.3.1 Meaning of ledger :

According to V.G. Vickery "Ledger is a book of account which contains in a suitably classified form, the final and permanent record of traders' transactions." It is essentially a collection of five types of accounts - Assets, Liabilities, Capital, revenue and Expenses.

According to William Pickles - "A Ledger is a most important book of account and is the destination of the entries made in the subsidiary books."

Arther Fieldhouse has rightly said, "Ledger is the permanent store house of all the transactions." Thus Ledger is a book which contains records of all transactions permanently in a summarized and classified form. It is the book of final entry and is the principal book of accounts.

3.3.2 *Need for Ledger :*

The need of a ledger can be summarized as here. A Journal fails to give a complete information regarding an account at a glance at a particular point of time because of the scattered entries of the transactions in different pages. This defect gives birth to ledger. The ledger brings together these dispersed entries regarding an account from the Journal to a place in a condensed and summarized form, and gives a complete picture including its final position at a glance. The necessity of obtaining a summarized and condensed information in respect of each class of transactions at a particular point is the need of a ledger. All information regarding any account is available from Ledger; it is called the king of all books.

3.3.3 *Sub Division of Ledger :*

Ledger can be primarily subdivided into two :-

(i) Personal Ledger; and

(ii) General edger.

Personal Ledger : The Ledger which contains the accounts of persons or organizations is called Personal Ledger. These Accounts are relating to persons or organizations whose goods are bought or to whom goods are sold on credit. The Personal Ledger is again subdivided into (a) Debtors Ledger and (b) Creditors Ledger.

(a) Debtors Ledger : It contains the accounts of debtors to whom goods are sold on credit. It is also called Sales or Sold Ledger. The name "Debtors Ledger" is more appropriate than Sales or Sold Ledger as it contains Debtors' Accounts and not the Sales Accounts.

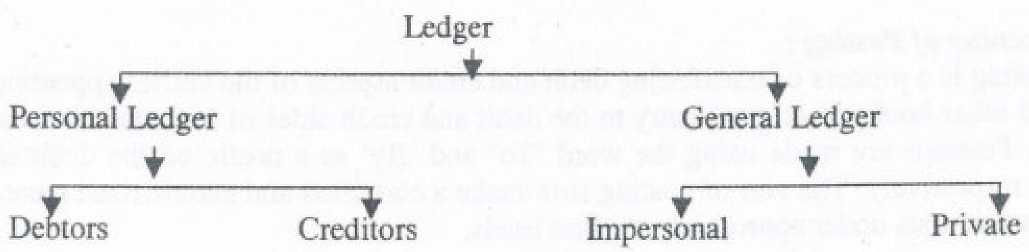
(b) Creditors Ledger : It contains the accounts of creditors from whom goods are bought on credit. It is also called Purchases or Bought Ledger. The name "Creditors Ledger" is more appropriate as it contains the Creditors' Accounts, Purchases Account and not the General. Ledger may be subdivided into :-

(i) Impersonal Ledger and

(ii) Private Ledger.

Impersonal Ledger : Impersonal Ledger contains the accounts relating to Assets, Expenses, Incomes, Cash Book and Petty Cash Book.

Private Ledger : It contains the accounts of confidential nature like Capital, Drawing and Profit and Loss Accounts. Sub-divisions discussed above are shown in a chart as given below:-



3.3.4 Distinction between Journal and Ledger.

Following are the distinctions between a journal and a ledger.

Sl. No.	Points of Distinction	Journal	Ledger
(i)	Nature	Journal is a book of primary entry.	Ledger is a book of final entry.
(ii)	Basis of recording	In journal, transactions are recorded on the basis of voucher.	Here transactions are recorded from the journal.
(iii)	Manner of recording	Here transactions are recorded in order of happening i.e. date wise.	Here transactions are recorded on the basis of 'account heads'.
(iv)	Narration	Every entry in the journal is followed by a narration.	Posting in the Ledger is not followed by any narration.
(v)	Form of information	It provides information in scattered form.	It provides information in a summarized and classified form.

3.3.5 Format of a Ledger Account :

There are two types of forms for writing up Ledger Accounts namely :
(a) Horizontal form; and (b) Vertical or T shaped form. These are discussed below:

(a) A Horizontal Ledger Account is ruled out as follows :

"AB & Co" Account

Date	Particulars	J. F.	Debit Amount (Rs.)	Credit Amount (Rs.)	Debit or Credit	Balance (Rs)

In this form of ledger, balance is ascertained after every transaction. This method is generally used in bank. Where the accounts are maintained in computers through the use of accounting software like Tally, accounts are also prepared in this form.

(b) A Vertical or T shaped form is ruled as under :-

"AB & Co" Account

Dr. Cr.

Date	Particulars	J. F.	Amount Rs.	Date	Particulars	J. F.	Amount Rs.
(1)	(2)	(3)	(4)	(1)	(2)	(3)	(4)

3.3.6 Meaning of Posting :

Posting is a process of transferring debit and credit aspects of the entries appearing in the journal and other books of original entry to the debit and credit sides of the relevant accounts in the ledger. Postings are made using the word 'To' and 'By' as a prefix on the debit side and credit side respectively. The aim of posting is to make a classified and summarized record of all business transactions under appropriate account heads.

3.3.7 Basic Points Regarding Posting :

Basic points to be kept in mind before posing are :

(1) ***Opening of separate accounts :*** Separate accounts should be opened for different 'account heads' in the ledger for posting the different transactions recorded in the journal. For Example; Cash A/c, Salary A/c, Purchases A/c etc.

(2) ***One account for each kind of transactions :***

One account should be opened for each kind of transaction. Transactions taking place during an accounting period relating to that particular account should be posted to that account only. If more than one account is opened for one kind of transactions, the object of summarization of transactions of similar nature will not be achieved. For example, it may be found that in the journal, Cash A/c has been debited during a week, say on six different dates and the same account has been credited on four different dates. For recording in Cash A/c, only one Cash A/c will be opened for transactions taking place on all the days and posting of all entry relating to Cash A/c will be made in that account only.

(3) ***Accounting period :*** All recording in the Journal and post in the ledger is done for a particular 'Accounting Period'. For every accounting period separate set of books should be maintained. Posting of all transactions taking place in a particular accounting period must be made in one set of books.

(4) ***Same account heads in both the books :*** Posting in the ledger should be made in the same account heads as appearing in the journal . no change in the name of the 'account head' should be made.

(5) ***Postings made conveniently:*** Posting may be done at any time but it should be completed before the end of the accounting period. For example the accounts upto date, posting should be made immediately after recording the transactions in the journal.

3.3.8 Balancing of an Account :-

Balancing of an account implies the process of ascertaining the net difference of an account after totaling of both sides – viz. debit side and credit side.

In simple words, balancing means the insertion (writing) of the difference between the total of amount columns of the two sides in the smaller (smaller total) side, so that the (grand) totals of the two sides becomes equal.

Balancing is done periodically, i.e., weekly, monthly, quarterly, half-yearly or yearly, depending on the requirements of the business.

The 'balance' is a term used in accounting which means the difference between the two sides of any account, or the total of the account containing only debits and only credits.

A computerized system will usually print the balance of the account after each transaction, but in a manual system we must calculate the balance. The balance of an account shows the position of an account on the particular day.

3.3.9 Procedure for Balancing an Account :

The following procedure is to be followed for balancing of an account :

(i) ***Totaling the amount columns outside :*** On a rough sheet of paper, the total of the amount column of two sides of the account concerned are to be ascertained.

(ii) ***Determining the balance:*** The difference of the total of two sides, called balance is then fond out.

(iii) ***Entering the balance on the smaller side :*** If the total of the debit side is more, the difference is to be put in the amount column on the credit side, by writing the words 'By Balance c/d' in particulars column. If the total of the credit side is more, the difference is to be put in the

amount column on the debit side by writing the words 'To Balance c/d' in particulars column. This will be done on the date of balancing and the date will be entered in the date column.

(iv) ***Totaling both the columns :*** After putting the difference in the appropriate side of the account, both sides of the account is to be totaled. The total of both the sides will be equal. A thin line above the total and two parallel lines below the total is to be drawn.

(v) ***Taking the balance on the opposite side :*** Lastly, on the next day of the balancing, the debit balance will be written on the debit side by writing the words 'To Balance b/d' in the particulars column. Similarly, the credit balance will be brought down on the credit side by writing the words 'By Balance b/d' in the particulars column.

If the Balance b/d (brought down) appears on the debit side, it indicates that the account has a Debit Balance. On the other hand, if the balance b/d (brought down) appears on the credit side, it indicates that the account has Credit Balance.

Illustration 3

2005

Jan. 30. Received cash on account of Sales Rs. 8x000; Commission received Rs. 500, Interest received Rs. 4,000.

Jan. 31 Paid cash on account of Purchase Rs. 5,000; Commission paid Rs. 1,000, Interest paid Rs. 2,000.

Pass Journal entries and post them in the ledger, also balance them on January 31, 2005

Solution :

Journal

Date	Particulars		L. F.	Dr. Amount (Rs.)	Cr. Amount (Rs)
2005					
Jan. 30	Cash A/c	Dr.		12,000	
	To Sales A/c				8,000
	To Commission received A/c				500
	To Interest Received A/c				4,000
	(Being the receipt of cash on account of sales, commission and intrest)				
Jan. 31	Purchases A/c	Dr.		5,000	
	Commission Allowed A/c	Dr.		1,000	
	Interest Allowed A/c	Dr.		2,000	
	To Cash A/c				8,000
	(Being cash paid on account of purchases, commission and interest)				

Dr. **Cash Account** Cr.

Date	Particulars	J. F.	Amount Rs.	Date	Particulars	J. F.	Amount Rs.
2005				2005			
Jan. 30	To Sales account		8,000	Jan. 31	By Purchase A/c		5,000
	To Interest received A/c		4,000		By Interest Paid A/c		2,000
	To Commission Received A/c		500		By Commission Paid A/c		1,000
					By Balance c/d		4,500
			12,500				12,500
Feb. 1	To Balance b/d		4,500				

Dr. **Sales Account** Cr.

Date	Particulars	J. F.	Amount Rs.	Date	Particulars	J. F.	Amount Rs.
2005				2005			
Jan. 31	To Balance c/d		8,000	Jan. 30	By Cash Ac		8,000
			8,000				8,000
				Feb. 1	By Balance b/d		8,000

Dr. **Purchase Account** Cr.

Date	Particulars	J. F.	Amount Rs.	Date	Particulars	J. F.	Amount Rs.
2005				2005			
Jan. 31	To Cash account		5,000	Jan. 31	By Balance c/d		5,000
			5,000				5,000
Feb. 1	To Balance b/d		5,000				

Dr. **Commission Received Account** Cr.

Date	Particulars	J. F.	Amount Rs.	Date	Particulars	J. F.	Amount Rs.
2005				2005			
Jan. 31	To Balance c/d		500	Jan. 30	By Cash Account		500
			500				500
				Feb. 1	By Balance c/d		500

Interest Received Account

Dr. Cr.

Date	Particulars	J. F.	Amount Rs.	Date	Particulars	J. F.	Amount Rs.
2005 Jan. 31	To Balance c/d		4,000	2005 Jan. 30	By Cash Account		4,000
			4,000				4,000
				Feb. 1	By Balance c/d		4,000

Interest Paid Account

Dr. Cr.

Date	Particulars	J. F.	Amount Rs.	Date	Particulars	J. F.	Amount Rs.
2005 Jan. 31	To Cash account		2,000	2005 Jan. 31	By Balance c/d		2,000
			2,000				2,000
Feb. 1	To Balance b/d		2,000				

Commission Paid Account

Dr. Cr.

Date	Particulars	J. F.	Amount Rs.	Date	Particulars	J. F.	Amount Rs.
2005 Jan. 31	To Cash account		1,000	2005 Jan. 31	By Balance c/d		1,000
			1,000				1,000
Feb. 1	To Balance b/d		1,000				

UNIT IV - TRIAL BALANCE AND PETTY CASH BOOK

Unit Structure :

4.1 TRIAL BALANCE

4.1.1 Definition of Trial Balance :

According to Cropper "A Trial Balance is a classified list of the balances appearing, at any given date, in the Ledger or Ledgers before the closing entries have been made."

It is neither a Journal nor a Ledger Account. It is merely a statement of Ledger Account Balances including the Cash Book balance prepared in a separate sheet of paper with an intention to give a trial to book-keeping process. Thus it is not a part of book-keeping; but a mere technique of testing the arithmetical accuracy of the books.

4.1.2 Special Features of Trial Balance :

A Trial balance has the following special features :-

1) A Trial Balance is prepared on a specific date as indicated by the words 'Trial Balance as on';
2) It contains the list of balances of all the ledger accounts including the balances of cash.
3) It can be prepared with the balances or totals of ledger accounts.
4) The totals of the debit and of the credit columns must be equal.
5) Equality of the totals of the debit and the credit columns proves the observance of the principles of Double Entry System.
6) Non-agreement of the totals of the debit and the credit columns indicates the commission of mistakes some where.

7) Agreement of the totals of the debit and the credit sides does not prove the absence of errors in accounting.

4.1.3 Preparation of a Trial Balance :

A Trial Balance can be prepared at any given date. However, it is usually prepared at the end of an accounting period.

Form :

THERE ARE TWO FORMS (A) JOUNAL FORM AND (B) LEDGER FORM AND CAN BE PREPARED IN EITHER OF THE FORMS.

(a) Journal form, a Trial Balance is prepared generally in a Journal form as given below :

Trial Balance as at.........

Name of accounts	L. F.	Debit Rs.	Credit Rs.

In the column 'Name of Accounts', the name of each account is to be written with its Folio No. in the 'LF' column. Debit amount or Credit amount of respective account is to be written in the Debit or the Credit column.

(b) Ledger form however, a Trial Balance can be prepared in the Ledger form also as given below :

Trial balance as at ....

Dr. Cr.

Name of A/c	L.F.	Rs.	Name of A/c	L.F.	Rs.

Methods of Preparation :

A Trial Balance can be prepared in any of three methods:

1. Total or Gross Trial Balance
2. Net or Balance Trial Balance and
3. Total cum Balance Trial Balance.

Total or Gross Trial Balance :

Under this method, a Trial Balance is prepared with the debit totals and the credit totals of all ledger accounts including the Cash Book. Under this method, the two sides of each ledger account are totaled first. These totals are taken to a sheet of paper, preferably drawn in a form similar to Journal, the debit totals being in the Debit column and the credit totals, in the Credit column. The name of the accounts and the ledger folios (LF) are to be inserted in the respective columns. The accounts have only one side total namely, Expenses and Revenue Accounts, will be inserted in one of the columns only. An illustration is given below :

Trial balance as on 31-12-2004

Name of accounts	L. F.	Debit Rs.	Credit Rs.
Capital Account		-	20,000
Purchases		40,000	-
Sales		-	60,000
Wages		5,000	-
Salaries		6,000	-
Furniture		10,000	2,000
Rent		6,000	-
Remesh		10,000	6,000
Paresh		8,000	14,000
Cash		15,000	12,000
Bank		24,000	10,000
Total		1,24,000	1,24,000

This method is not generally followed because it is a laborious and time-consuming method and balances cannot be easily obtained which are necessary for the preparation of Final Accounts.

Net or Balance Trial Balance :

Under this method, a Trial Balance is prepared with the balances of ledger accounts including the Cash Book. Each ledger account is balanced at the end of a given period before passing the closing entry. The balance is written either on a rough sheet or in the particulars column on the heavier side, preferably with wooden pencil. These balances are taken to a sheet of paper drawn in a form similar to Journal; Debit balances being inserted in the Debit column while Credit balances in the Credit Column.

This is the most popular method and is generally followed. It shows the balances of all ledger accounts at a glance and facilitates the preparation of Final Accounts. Moreover, it can be easily and quickly prepared and such a Trial Balance becomes less bulky.

Example 2

Trial balance as on ....

Name of accounts	L. F.	Debit Rs.	Credit Rs.
Capital Account		-	20,000
Purchases		40,000	-
Sales		-	60,000
Wages		5,000	-
Salaries		6,000	-
Furniture		8,000	-
Rent		6,000	-
Remesh		4,000	-
Paresh		-	6,000
Cash		3,000	-
Bank		14,000	-
Total		86,000	86,000

Total cum. Balance Trial Balance :

Under this method, a Trial Balance is prepared with the Debit and the Credit Totals of both the sides of each account and its balance shown side by side. It is combination of the above two methods.

An illustration is given below :

Example – 1

Total Balance as on ....

Name of accounts	L. F.	Debit Rs.	Credit Rs.	Debit Rs.	Credit Rs.
Capital Account		-	20,000	-	20,000
Purchases		40,000	-	40,000	-
Sales		-	60,000	-	60,000
Wages		5,000	-	5,000	-
Salaries		6,000	-	6,000	-
Furniture		10,000	2,000	8,000	-
Rent		6,000	-	6,000	-
Remesh		10,000	6,000	4,000	-
Paresh		8,000	14,000	-	6,000
Cash		15,000	12,000	3,000	-
Bank		24,000	10,000	14,000	-
Total		1,24,000	1,24,000	86,000	86,000

This method is hardly in use because it is cumbersome.

4.1.4 The suspense Account :

If the Book Keeper fails to locate the cause of difference and if he is in a hurry to close the Book of accounts in order to prepare the Final Accounts, he may open an account known as 'Suspense Account' or 'Difference in Trial Balance Account' with the difference in the Trial balance.

If the credit side of the Trial Balance is heavier, then the Suspense Account is debited with the amount of difference and the amount is placed in the Debit column of the Trial balance under the heading 'Suspense Account'. Conversely, if Debit side is heavier, then the Suspense Account is credited and is placed in the Credit column of the Trial Balance. In the next accounting year, when errors are located, rectification entries are required to be passed to close the Suspense Account. Suspense Account is a temporary Account to accommodate the difference in Trial Balance. It is to be used only in an extreme case and not by way of normal practice, because the existence of a Suspense Account creates doubt about the authenticity of the Books of Accounts and shows a departure from the strict principle of Double Entry.

4.1.5 Nature of Ledger Account Balances :

While preparing a Trial Balance, we are to ascertain the nature of balances of Ledger Accounts. The rules of ascertaining Ledger Account Balance are given below :

I. **Asset Account :**

Asset Accounts shows debit balances. Therefore the following accounts being asset Accounts will show debit balances :

Debit Balance

Goodwill Account.
Land and Building Account
Machinery Account.
Furniture Account
Patent Account
Trade Mark Account
Live stock Account
Vehicles Account
Loose Tools, Spare Parts Account.
Sundry Debtors Account
Bills Receivable Account.
Cash (in hand) Account
Bank (Cash at bank) Account
Loans and advances (granted to others) Account
Prepaid Expenses Account
Accrued Interest Account.
Stock of Stationery (in hand) Account.

II. Liabilities Accounts:

Liabiiities Accounts shows Credit Balances. Therefore, the following Accounts being Liabilities Accounts will show Credit balances.

Credit Balances

(i) Sundry Creditors Account;
(ii) Bills Payable Account;
(iii)Loans and Advances Taken Account;
(iv) Debenture Account;
(iv) Outstanding Expenses Account;
(v) Income Received in Advance; and
(vi)Interest Payable Outstanding.

Revenue Accounts Show Credit Balances.

Credit Balances

Sales Account;
Interest Received Account;
Rent Received Account;
Dividend Received Account;
Royalties Received Accounts
Profit from Branches;
Profit on Consignment.
Sundry / Miscellaneous Receipts Account;
Subsidies Account;
Discount Received Account;
Bad Debts Recovered Account;
Interest on drawings Account;

	Expenses and Losses Debit balance :
	Purchase Account;
	Carriage Inward Account;
	Wages Account;
	Salaries Account;
	Insurance Premium Account;
	Commission Account;
Debit Balances	Rent (Paid) Account
	Traveling Expenses Account;
	Printing and Stationery Accounts,
	Bad Debts Accounts,
	Depreciation Account,
	Fire Loss Account (not covered by insurance)
	Sundry Expenses
	Interest on Capital.

Capital Account shows a Credit balance.
Drawings Account show Debit balances.
Reserve and fund Accounts show Credit balance.

Miscellaneous Accounts

1. Returns Inward shows a Debit balance.
2. Returns Outward shows a Credit balance.
3. Preliminary Expenses show Debit balance.
4. Deferred Expenses show Debit balances.

Illustration 2.

Prepare Trial Balance from the following items of ledger balances as on 31st December.

	Rs.
Capital of Sri Bora	20,000
Furniture	10,000
Prepaid insurance	500
Purchases	50,000
Sales	80,000
Unpaid Salaries	1,500
Interest on Investment Accrued	2,000
10% Investments	20,000
Commission Received	2,000
Carriage	1,000
Printing & Stationary	3,000
Salaries and Wages	9,000
Cash in hand and at bank	7,000
Depreciation	1,000

Solution : **Trial Balance as on 31st December**

Particulars	L. F.	Debit Rs.	Credit Rs.
Capital			20,000
Furniture		10000	
Prepaid insurance		500	
Purchases		50000	
Sales			80000
Unpaid Salaries			1500
Interest on Investment accrued.		2000	
10% Investments		20000	
Commission received			2000
Carriage		1000	
Printing and stationery.		3000	
Salaries and wages		9000	
Cash in hand and at Bank		7000	
Depreciation		1000	
		1,03,500	1,03,500

Illustration 3 :

A book keeper has prepared the following Trail Balance which is wrong. Prepare a correct Trial Balance from the following :

Sl. No.	Heads of Account	L.F.	Rs.	Rs.
1.	Capital			15000
2.	Drawing-		3250	
3	Stock (Jan. 1)		17445	
4.	Returns Inward			554
5.	Carriage Inward		1240	
6.	Deposit with Ananda Gupta			1375
7.	Returns outward			840
8.	Carriage Outward			725
9.	Loan to Ashok @ 5% given on 1st January			1000
10.	Interest on the above			25
11.	Rent		820	
12.	Rent outstanding		130	
13.	Stock (Dec.31)			18792
14.	Purchases		12970	
15.	Debtors		4000	
16.	Goodwill		1730	
17.	Creditors			3000
18.	Advertisement expenses		954	
19.	Provisions for Doubtful Debts			1200
20.	Bad debts		400	
21.	Patents and Patterns		500	
22.	Cash		62	
23.	Sales			27914
24.	Discount Allowed			330
25.	Wages.		754	
			45,095	69,915

Solution :

The Trial Balance is correctly redrawn as follows :

Sl. No.	Heads of Account	L.F.	Rs.	Rs.
1.	Capital			15000
2.	Drawing-		3250	
3	Stock (Jan. 1)		17445	
4.	Returns Inward		554	
5.	Carriage Inward		1240	
6.	Deposit with Ananda Gupta		1375	
7.	Returns outward			840
8.	Carriage Outward		725	
9.	Loan to Ashok @ 5% given on 1st January		1000	
10.	Interest on the above			25
11.	Rent		820	
12.	Rent outstanding			130
13.	Stock (Dec.31)		12970	
14.	Purchases		4000	
15.	Debtors		1730	
16.	Goodwill			3000
17.	Creditors		954	
18.	Advertisement expenses			1200
19.	Provisions for Doubtful Debts		400	
20.	Bad debts		500	
21.	Patents and Patterns		62	
22.	Cash			27914
23.	Sales		330	
24.	Discount Allowed		754	
25.	Wages.			
	Total		48,109	45,109

UNIT-V DEPRECIATION PROVISIONS AND RESERVES.

Unit Structure :

5.1 PROVISION AND RESERVES.

5.1.1 Meaning and Characteristics of Provisions :

In course of carrying out business activities, each and every entity is required to prepare itself for meeting all eventualities both expected and unexpected. In order to ensure that the profit has not been distributed out of capital, it is important that necessary provisions are made and reserves are created out of profit at the time of preparation of final accounts. The terms 'Provisions' and 'Reserves' are different from each other.

The term 'Provision' means the setting aside of an estimated amount to meet known liability or loss the amount of which may not be exactly ascertained. It is a charge against profit to meet certain known liabilities or contingencies. Charge against profit means that the amount should be provided for even if there is no profit. For the purpose of making provision, the amount of provision to be made is debited to the Profit and Loss account in order to ascertain the correct profit.

According to Companies Act, 1956, the term 'Provision' refers to any one of the following amounts :

1. The amount written off or retained by way of providing for depreciation, renewals or diminution in the value of assets; or
2. The amount retained by way of providing for any known liability the amount of which cannot be determined with substantial accuracy.

Examples of provisions :

(i) Provision for Income Tax;
(ii) Provision for Sales Tax;
(iii) Provision for liability for disputed claim.
(iv) Provision for depreciation;
(v) Provision for Repairs and Renewals;
(vi) Provision for doubtful debts;
(vii) Provision for discount on debtors;

Characteristics / Features of Provisions :

a) Provision is made to meet a known liability.

b) Although the liability is known, the amount of such liability cannot be determined with reasonably accuracy. For example, it is almost certain that some of the amount receivable from debtors will become bad but it is not possible to predict the exact amount of such bad debts.

c) Provision is a charge against profits and as such the creation of provision reduces the profits or increases the loss of the year in which it is created. The loss when actually occurs is adjusted against such provision and thus the profit of the year in which such loss occurs is not affected.

d) Provision is created even if there is loss.

5.1.2 Need for creating Provisions :

a) To ascertain the true net profit of the business : For the purpose of ascertaining the true profit of a business, it is necessary that all expenses pertaining to that year, whether paid or not, must be debited to Profit and Loss account. Hence, provision should be made for expenses or liabilities the amount of which cannot be estimated with reasonable accuracy. For example, the provision should be made for expenses or liabilities the amount of which cannot be estimated with reasonable accuracy. For example, the provision should be made for doubtful debts, because the amount of such bad debts cannot be estimated correctly.

b) *To ascertain the true financial position of the business :* In order to see that the Balance Sheet discloses the true and fair view of the financial position of the business, it is necessary that provision is made for all the anticipated losses and expenses.

c) *To provide for known losses in future :* Provisions are made to provide funds for meeting those which are likely to occur in the near future such as provision for bad debt, provision for taxation, provision for repairs, provision for damages likely to arise from a pending suit and such others.

d) *For proper allocation of expenses :* Provision is also required to be made for proper allocation of expenses. For example; total amount to be spent on repairs and renewals during the life of an asset is estimated and spread over on an average basis because the amount of expenses in earlier years would be comparatively lower than that of the later years. Therefore, in order to allocate the expenses on repairs on an equitable basis it is necessary to create provision for repairs. Actual expenses of repairs incurred each year will then be debited to this account. Hence, it will put equal burden on the Profit and Loss account for each year in respect of expenses of repairs.

5.1.3 Nature of balances of Provision and Reserves Accounts :

Any reserve or Provision account usually show credit balance. But there is only one exception i.e. Reserve for Discount on Creditors Account which shows debit balance.

5.1.4 Disclosure in the Balance Sheet :

The amount of provision created is required to be shown in the balance sheet as under:

(i) If the provision is created for liabilities and charges, the amount of provision should be shown on the liability side of the Balance sheet. For example, Provision for Income Tax, Provision for Repairs and Renewals.

(ii) If the provision is created for a definite object such as to meet expected contingency, e.g., doubtful debts, discount on debtors, the provision is shown as deduction from Sundry Debtors on the assets side of the balance sheet.

5.1.5. Accounting Treatment of Provisions :

Provisions are charged against profit. Provisions are created by debiting profit and loss account for specific and known contingency or expected loss, e.g., provision for doubtful debts, provision for discount on debtors and provision for taxation etc. A definite sum is charged every year out of profit and loss account to meet the known contingency. Provisions account should be compulsorily posted at the debit side of profit and loss account, whether the firm earns profit or suffers loss.

The provision against any asset is generally shown as deduction from concerned asset in the balance sheet. For example; Provision for doubtful debts and provision for discount on debtors. They are shown as deduction from debtors on the assets side of the Balance Sheet. Sometimes, the provision may also be shown at the liabilities side of the balance sheet. For example; provision for taxation.

Making provision is a must but creating reserves is discretionary and is done as a matter of financial prudence and subject to availability of profit.

Provision for doubtful debts generally has old balance. The old provision is deducted from the total of bad debts and new provision at the debit side of profit and loss account. In case old provision exceeds the total of bad debts and new provision, the treatment should preferably be made at the credit side of profit and loss account, where the total of bad debts and new provision should be deducted from old provision.

5.1.6 Meaning and Characteristics of Reserves :

Reserve means the amount set aside out of profits and other surpluses to meet future uncertainties. In other words, a reserve is meant for meeting any unknown liability or loss in the future. Reserve is created through appropriation of profits.

According to American Institute of Accounting, 'The use of the term reserve be limited to indicate that an undivided part of the asset is being held or retained for general or specific purpose'.

According to William Pickles, "Reserve means the amounts set aside out of profits and other surpluses, which are not earmarked in any way to meet any particular liability, known to exist on the date of the balance sheet".

Hence, reserve is the undistributed portion of profits of the business which is not paid to the proprietor/owner, but is retained in the business. Creation of reserve does not reduce the net profits but only reduces the distributable profits. It is an appropriation of profits and hence after ascertaining the net profits it is debited to Profit & Loss Appropriation Account. Amount set aside as reserve are also termed as 'Retained Earnings'. As it is an appropriation of profit, the question of setting aside to reserve does not arise if there is loss or if there is no profit.

Examples of reserves :

(i) General Reserve,
(ii) Capital Reserve,
(iii) Contingency Reserves,
(iv) Reserve for expansion,
(v) Dividend Equilisation reserve;
(vi) Debenture Redemption Reserve,
(vii) Capital Redemption Reserve; etc.

Characteristics/ Features of 'Reserves' :

a) Reserve is created out of net profits or divisible profits or 'Undistributed profits'.

b) Creation of reserve is not a legal necessity except in certain cases. (in case of limited company declaring dividend above a specific percentage is required to transfer a minimum specified percentage of profit to reserve. In such a case, creation of reserve is a legal necessity.) Normally, it is created voluntarily for strengthening the general financial position of the business.

c) It is not created to meet any known liability or for providing depreciation.

d) Reserve represents accumulated or undistributed profits and as such they are treated as part of capital fund.

5.1.7 Distinction between Provision and Reserve :

Basis of Distinction	Provision	Reserve
1. Nature	It is charge against profit.	It is an appropriation of profit.
2. purpose	It is created to meet a known liability.	It is created to meet an unknown liability.
3. Necessity	Creation of provision is a legal necessity. Provision have to be provided for even if there is no profit.	Creation of reserves is discretionary. It can be created only if adequate profits have been earned.
4. object	The object of making provision is to show the true financial position of the business.	The object of reserve is to strengthen the financial position of the business.
5. Method of Creation	It is created by debiting to P & L A/c and its creation reduces the net profit.	It is created by debiting P & L Appropriation A/c and, therefore, its creation does not reduce the net profit but reduced the divisible profit.
6. Presentation in Balance Sheet	If it is created against any asset, the same is shown as deduction from the respective asset on the asset side of the balance sheet. Otherwise, it is shown as a separate item on the liabilities side under the head 'Provision'.	It is shown on the liabilities side under the head 'Reserve and Surplus'.
7. Availability for dividends	It is created to provide for a specific loss and hence it cannot be utilized for distribution as dividends among share holders.	Since reserve is not created to provide for any specific loss, it can be used for distribution as dividends among shareholders.

5.1.8 Types of Reserves :

Reserve may be broadly divided into two types viz. Revenue Reserves and Capital Reserves. Revenue reserves are further sub-divided into two types viz. General Reserve and Specific Reserve. This is shown as under :

Reserves

Revenue Reserves | Capital Reserves

General Reserve | Specific Reserve

Revenue Reserves : Revenue reserves are the reserves which are created out of revenue profits which have been earned in the ordinary course of business. This reserve is created by setting aside a part of the profits in order to strengthen the financial position of the business. These are the reserves which are created out of revenue profit which are usually distributable profits. In other words, it is the profit which has been withheld from paying dividend out of the total distributable profit.

Examples of Revenue Reserves are :

(i) General reserve;

(ii) Dividend equalization reserve;

(iii) Debenture redemption reserve; and

(iv) Investment Fluctuation Reserve.

Revenue reserve, therefore, represents undistributed profits and as such they can be utilized for distribution as dividends.

Types of Revenue Reserves :

Revenue reserves may be divided into the following two types :

(A) **General Reserve :** General reserve is the reserve which is created by setting aside a part of the profits in order to strengthen the general financial position of the business and to meet any future contingency, if any. In case of sole proprietorship and partnership firm, it is that part of profit which has not been transferred to Capital Accounts of the proprietors/partners. In case of a company, it is that amount of profit which has not been distributed as dividend but has been retained in the business. However, such reserves are freely available for distribution and are also known as 'free reserves.'

(B) **Specific Reserve :** Specific Reserves are those reserves which are created for a specific purpose and can be utilized only for that purpose but these reserves are also created out of profit. Examples of specific reserves are :

(i) ***Dividend Equalization Reserve :*** Dividend Equalization Reserve is a reserve which is created by a company in order to maintain a steady rate of dividend. In the year/ years in which the profit are sufficient, a part of the profit is transferred to such reserve. It is utilized in the years in which the profits are insufficient to maintain the rate of dividend declared in earlier years.

(ii) ***Debenture Redemption Reserve/Sinking Fund:*** Debenture Redemption Reserve/ Sinking Fund is a reserve created by a company in order to provide fund for redemption of debentures.

(iii) ***Reserve for Replacement of Asset :*** Reserve for Replacement of Asset is a reserve which is created to provide fund for the replacement of a fixed asset at the end of its usable life.

Capital Reserve : In addition to earning normal profits, a business firm may earn capital profits from some sources. For example; profit on sale of Fixed Assets. The capital profit are transferred to Capital Reserve Account. Such reserves are generally not available for distribution as dividend among the shareholders of the company. In case of a limited company, the following are treated as capital profits:

a) Profits prior to incorporation.

b) Premium on issue of shares or debentures.

c) Profit on reissue of forfeited shares.

d) Profit on redemption of debentures.

e) Profit on sale of fixed assets.

f) Profit on revaluation of fixed assets.

All the Capital profits mentioned above are treated as Capital Reserve.

5.1.9 Disclosure in the Balance Sheet :

The amount of reserves (Revenue and Capital) created is shown in the balance sheet as under:

i) Reserve for discount on creditors : Reserve for discount on creditors is shown as deduction from Sundry Creditors on the liabilities side of the balance sheet.

ii) All other reserves: All other reserves are shown on the liabilities side just after capital.

5.2 PROVISION FOR DEPRECIATION.

5.2.1 Meaning and Definition of Depreciation :

The term 'Depreciation' represents loss or diminution or decrease or decline in the value of a fixed asset. The decline in the value of an asset occurs due to wear and tear, obsolescence, effluxion of time or permanent fall in market value. The word 'Depreciation' has be derived from the Latin word 'Depretum' means decline in price.

Definitions :

The term 'depreciation' has been defined by different authorities as under:

According to R.N. Carter "Depreciation may be defined as the permanent and continuing diminution in the equality, quantity or the value of an asset."

According to Spicer & Peglar "Depreciation is the measure of the exhaustion of the effective life of an asset from any cause during a given period."

According to J.R. Batliboi "It is a mater of common knowledge that all fixed assets such as plant, machinery, building, furniture etc. gradually diminish in value as they get older and become 'worn' out by constant use in the business."

5.2.2 Causes of Depreciation :

The value of an asset may decline due to a number of reasons. These are discussed as under :

(1) ***Constant Use :*** Due to the constant use of an asset, wear and tear is caused and as a results their value decreases. For example, use of machine in a factory. As on account of constant use, the value of the machine decreases, it will not fetch the same price at which is was purchased, if the machine is sold by the business.

(2) ***Expiry (Effluxion) of time :*** The value of majority assets decreases with the passage of time even if they are not being put to use in the business. Natural forces such as rain, winds, weather etc. contribute to the deterioration of their values. Again, after purchases an asset such as Machinery, Motor car, Furniture etc., if a business firm wants to dispose them off after say two years, although the assets were not put to use, they will not fetch the same price at which these were originally acquired only because some time has expired or elapsed since the assets were purchased.

(3) ***Expiry of Legal Rights :*** There are certain assets over which legal right to use them is acquired for a fixed period. For example, Lease of Land, Mines, Quarry, Patent right etc. The right to use such asset is generally acquired for a fixed period by making lump some payment. For instance, if a lease of land has been obtained for 20 years for Rs. 4,00,000, it will lose $1/20^{th}$, i.e., Rs. 20,000 of its value each year whether it is utilized or not. At the end of 20^{th} year total amount paid for acquiring the lease right will have to be written off because after the expiry of 20 years, the land will again belong to the original owner.

(4) ***Obsolescence :*** Due to new inventions and improvement in existing technologies the old assets become obsolete (out dated) and may have to be discarded (replaced) even if the asset can

be used. For example, Computers of older versions become obsolete as and when new versions are invented. Again, in a competitive market it is not possible for a manufacturing business of survive if it does not move ahead with time and the improved technology because persisting with the old technology may prove to be costly.

(5) *Accident :* Sometimes, assets may be damaged or destroyed on account of abnormal reasons such as accident, flood, earthquake, fire, etc. For example, a machine may be damaged or destroy due to fire, flood, earthquake etc. or a vehicle may damaged due to accident. In such a case it will be necessary to depreciate the value of such assets accordingly.

(6) *Depletion :* depletion means the decrease in the existing quantity. The decrease in the value of wasting assets such as mines, oil-wells etc. occurs due to their constant extraction. Therefore, it will be necessary to provide for depreciation on account of such depletion.

5.2.3 Methods of Providing or Charging depreciation:

The term 'Methods of Providing or Charging depreciation' refers to the procedure to be followed for calculating the amount of depreciation to be provided on a particular asset. There are various methods for providing depreciation. Each of the different methods is suitable for different assets depending upon the nature and type of the asset and also on the size and nature of the business organization. Various methods of providing depreciation are as under:

1. Straight Line Method or Original Cost Method or Fixed Installment Method
2. Diminishing Balance Method or Reducing Installment or Written Down Value Method.
3. Annuity Method.
4. Depreciation Fund Method.
5. Insurance Policy Method.
6. Revaluation Method.
7. Depletion Method.
8. Machine Hour Rate Method.

1. Straight Line Method or Fixed Instalment :

Straight Line Method or Fixed Installment method is a method of providing depreciation under which depreciation is charged at a fixed percentage on the original cost of the asset. This method is also known as Original Cost Method or Equal installment method. Under this method the amount of depreciation for a particular asset remains same from year to year. The amount of depreciation is calculated by deducting the scarp value from the original cost of the asset and then dividing the remaining balance by the number of years of estimated life. The depreciation so calculated and Charged annually reduces the original cost of the Asset to zero, or its scrap value, as the case may be at the end of its estimated life.

In examination problems, where the rate of depreciation is not stated, the amount of depreciation is calculated by the following formula:

$$\text{Yearly Depreciation} = \frac{\text{Cost of machine} - \text{Scrap value}}{\text{Expected life of the asset}}$$

For example, if the Original cost of the asset is Rs.1,50,000 and its estimated life be 10 years, the scrap value being Rs.10,000. The depreciation to be written off will be

$$Rs. = \frac{1,50,000-10,000}{10} = Rs. \frac{Rs.\ 1,40,000}{10} = Rs.14,000 \text{ every year.}$$

Merits of Fixed Installments Method :

(1) ***Simplicity :*** Calculation of depreciation under this method is very simple and as such the method is widely popular.

(2) ***Equality of Depreciation Burden :*** Under this method, equal amount of depreciation is debited to the Profit and Loss Account of each year. Hence, the burden of depreciation on each year's net profit is equal.

(3) ***Assets can be completely written off:*** Under this method, the book value of n asset can be reduced to zero, which is not possible under some other methods.

Demerits :

1) ***Difficulty in Computation:*** When there are different machines having different life-spans, the computation of depreciation becomes complicated because the depreciation on each machine is required to be calculated separately.

2) ***Unequal charge against income :*** Amount of expenses or repairs go on increasing year by year as the asset becomes older but as the equal depreciation is charged under this method each year, the total burden charged to Profit and Loss Account in respect of depreciation and repairs put together will not be equal each year. The total burden will be lesser in earlier years and heavier during the later year.

3) ***Undue pressure in later years:*** It is a well-known fact that the efficiency and usefulness of a machine is more in the earlier years in comparison to later years. As such, more depreciation should be charged in earlier year in comparison to the later years, whereas, depreciation remains constant from year to year under this method.

4) ***Difficulty in the determination of scrap value :*** It is quite difficult to assess the true scrap value of the asset after a long period, say 15 or 20 years from the date of its installation.

5.2.4 Methods of Recording Depreciation :

There are two methods of recording depreciation in the books of account :

(I) ***First Method: By Charging depreciation to Asset Account*** (without creating Provisions for Depreciation): In this case 'Provision for Depreciation Accounts is not maintained and the depreciation is directly credited to the 'Asset A/c'. Hence, the Asset A/c appears in the ledger at a written down value.

Following entries are passed under **Straight Line Method :**

1. ***For purchase of Asset :***

Asset A/c Dr.
To Cash/Bank A/c/Creditors A/d

2. ***For providing depreciation at the end of each year :***

Depreciation A/c Dr.
To Asset A/c

3. *For transfer of depreciation of Profit and Loss Account at the end of each year :*

Profit and Loss A/c Dr.

To Depreciation A/c

Illustration 1.

On 1st April, 2000 Assam Printers Limited purchased a Machine for Rs.80,000 and it has been decided to charge depreciation at the rate of 10% under original cost method.

Pass journal entries and show Machinery Account and Depreciation Account for the first three years by charging depreciation to Asset Account.

Solution :

In the books of Assam Printers Limited.

Journal

Date	Particulars	L. F.	Dr. Amount (Rs.)	Cr. Amount (Rs.)
2000 April 1	Machinery A/c Dr. To Bank A/c (Being purchase of machine)		80000	80000
2001 March 31	Depreciation A/c Dr. To Machinery A/c (Being depreciation on machine @ 10% p.a. on Rs. 80000 charged.)		8000	8000
March 31	Profit and Loss A/c Dr. To Depreciation A/c (Being the transfer of depreciation to Profit and Loss A/c)		8000	8000
2002 Mar. 31	Depreciation A/c Dr. To Machinery A/c (Being depreciation on machine @ 10 on Rs. 80000 charged.)		8000	8000
Mar. 31	Profit and Loss A/c Dr. To Depreciation A/c (Being the transfer of depreciation to Profit and Loss A/c)		8000	8000
2003 Mar. 31	Depreciation A/c Dr. To Machinery A/c (Being depreciation on machine @ 10% p.a. on Rs. 80000 charged.)		8000	8000
Mar. 31	Profit and Loss A/c Dr. To Depreciation A/c (Being the transfer of depreciation to Profit and Loss A/c)		8000	8000

Machinery Account

Dr. Cr.

Date	Particulars	J. F.	Amount Rs.	Date	Particulars	J. F.	Amount Rs.
2000 April 1	To Bank A/c		80000	2001 Mar. 31	By Depreciation A/c		8000
					By Balance c/d		72000
			80000				80000
2001 April 1	To Balance b/d		72000	2002 Mar. 31	By Depreciation A/c		8000
				Mar. 31	By Balance c/d		64000
			72000				72000
2002 April 1	To Balance b/d		64000	2003 Mar. 31	By Depreciation A/c		8000
				Mar. 31	By Balance c/d		56000
			64000				64000

Depreciation Account

Dr. Cr.

Date	Particulars	J. F.	Amount Rs.	Date	Particulars	J. F.	Amount Rs.
2001 Mar.31	To Machinery A/c		8000	2001 Mar.31	By Profit &Loss A/c		8000
2002 Mar.31	To Machinery A/c		8000	2002 Mar.31	By Profit &Loss A/c		8000
2003 Mar. 31	To Machinery A/c		8000	2003 Mar. 31	By Profit &Loss A/c		8000

Second Method of Recording Depreciation

In this case, the amount of depreciation is credited to 'Provision for Depreciation Account' or 'Accumulated Depreciation Account' instead of 'Asset Account' and hence the Asset Account always appears in the ledger at it original cost. The Balance on the credit side of 'Provision for Depreciation Account' shows the total amount of depreciation accumulated to date.

(i) ***For providing Depreciation :***

Depreciation Account Dr. (with the Annual amount of depreciation)

To Provision for Depreciation A/c Or To Accumulated Depreciation A/c

(ii) ***For transfer of Depreciation to Profit and Loss Account :***

Profit and Loss Account Dr.

To Depreciation A/c.

Illustration 2 : On 1st April, 2000 Brahmaputra Industries Ltd. Purchased Machinery for Rs.80000 and it has been decided to charge depreciation at the rate of 10% under original cost method.

Pass journal entries and show Machinery Account and Depreciation Account for the first four years by creating provision for depreciation account. Accounting year closes on 31st March.

In the books of Brahmaputra Industries Limited.

Journal

Date	Particulars	L. F.	Dr. Amount (Rs.)	Cr. Amount (Rs.)
2000 April 1	Machinery A/c Dr. To Bank A/c (Being purchase of machine)		80,000	80,000
2001 Mar. 31	Depreciation A/c Dr. To Provision for Depreciation A/c (Being provision for depreciation created on machine@10% on Rs.80,000)		8,000	8,000
Mar. 31	Profit and Loss A/c Dr. To Depreciation A/c (Being the transfer of depreciation to Profit and Loss A/c)		8,000	8,000
2002 Mar. 31	Depreciation A/c Dr. To Provision for Depreciation A/c (Being provision for depreciation created on machine@10% on Rs.80,000)		8,000	8,000
Mar. 31	Profit and Loss A/c Dr. To Depreciation A/c (Being the transfer of depreciation to Profit and Loss A/c)		8,000	8,000
2003 Mar. 31	Depreciation A/c Dr. To Provision for Depreciation A/c (Being provision for depreciation on machine@10% on Rs.80,000)		8,000	8,000
Mar. 31	Profit and Loss A/c Dr. To Depreciation A/c (Being the transfer of depreciation to Profit and Loss A/c)		8,000	8,000
2004 Mar. 31	Depreciation A/c Dr. To Provision for Depreciation A/c (Being provision for depreciation created on machine@10% on Rs.80,000)		8,000	8,000
Mar. 31	Profit and Loss A/c Dr. To Depreciation A/c (Being the transfer of depreciation to Profit and Loss A/c)		8,000	8,000

Machinery Account

Dr. Cr.

Date	Particulars	J. F.	Amount Rs.	Date	Particulars	J. F.	Amount Rs.
2000 April 1	To Bank A/c		80,000	2001 Mar. 31	By Balance c/d		80,000
2001 April 1	To Balance b/d		80,000	2002 Mar. 31	By Balance c/d		80,000
2002 April 1	To Balance b/d		80,000	2003 Mar. 31	By Balance c/d		80,000
2003 April 1	To Balance b/d		80,000	2004 Mar. 31	By Balance c/d		80,000

Provision for Depreciation Account

Dr. Cr.

Date	Particulars	J. F.	Amount Rs.	Date	Particulars	J. F.	Amount Rs.
2001 Mar. 31	To Balance c/d		8,000	2001 Mar. 31	By Depreciation A/c		8,000
2002 Mar.31	To Balance c/d		16,000	2001 April 1	By Balance b/d		8,000
				2002 Mar. 31	By Depreciation A/c		8,000
			16,000				16,000
2003 Mar. 31	To Balance c/d		24,000	2002 April 1	By Balance b/d		16,000
				2003 Mar. 31	By Depreciation A/c		8,000
			24,000				24,000
2004 Mar. 31	To Balance c/d		32,000	2003 April 1	By Balance b/d		24,000
				2004 Mar. 31	By Depreciation A/c		8,000
			32,000				32,000
				2004 April 1	By Balance b/d		32,000

5.3 PROVISION FOR BAD DEBTS AND DOUBTFUL DEBTS.

5.3.1 Introduction :

It is a common feature for every business to sell goods in credit. The person to whom goods have been sold on credit are known as 'Debtor' and the total of all the debtors is termed as 'Sundry Debtors '. Sundry Debtors are also termed as 'Book Debts'. The total debtors of a firm may be classified into: Good debts, Bad debts and Doubtful debts.

(i) *Good Debts :* Good debts are those debts which will be recovered in full. In other words, that portion of sundry debtors which will be recovered in full is termed as 'Good Debtors'.

(ii) *Bad Debts :* Sometimes due to the financial difficulty, death or insolvency or dishonesty of a Debtor, full amount due from them may not be recovered from such person/persons. When the business firm finds that a particular amount due from a particular debtor cannot be recovered either in full or in part, the unrecoverable portion is termed as 'Bad Debts'.

When the business entity feels that a particular amount cannot be recovered from a particular debtor, it is meaningless to carry forward the balance in the account of such debtor in the ledger every year. The balance standing to the debit of that account is cancelled. The process of cancellations of balance in the account of a debtor is called 'writing off' bad debts. This is done by recording the following journal entry :

Bad debts A/d Dr.
To Debtors A/c (Individually)
(Being bad debts written off)

In examination problems where the name of the debtor is not given, the entry for 'writing off' bad debts will be as under :

Bad debts A/c Dr.
To Sundry Debtors A/c
(Being bad debts written off)

5.3.2 Need for creating Provision for Doubtful Debts :

As credit sales are made in a particular year during which debtors are created, the profit on such sales is included in the Trading and Profit and Loss Account of that year as revenues are ascertained on the basis of accrual assumption. Doubtful Debts is a business loss arising from credit sales; so it is logical that such a loss is charged against the revenue earned through credit sales of that year according to the matching principle. Moreover, on the basis of the modifying principle of conservatism and according to the principle of revenue recognition, expected loss must be taken into account during that year while ascertaining net profit.

Hence, it is not only fair but also logical that doubtful debts being a business loss in connection with credit sales must be provided for out of the revenue earned during the period so that the Profit and Loss Account of the following year is not burdened with the loss of earlier years.

5.3.3 Provision for Doubtful Debts – How Created:

Since doubtful debts can only be estimated, a provision is created on estimated basis. This is calculated at a certain percentage on the amount of Debtors at the end of the year. The percentage is fixed on the basis of past experience in connection with the realisability of debtors. The provision so created is called 'Provision for Doubtful Debts' or 'Provision for Bad Debts' or 'Provision for Bad and Doubtful Debts'. All these three terms are used interchangeably. Sometimes the term 'Reserve' is used in place of the 'Provision'. It is not proper to use the term Reserve in place of 'Provision' for Doubtful Debts created for the first time in a particular year is carried forward to the next year. In the next year, this provision is terms as 'Old Provision' or 'Existing Provision' and the provision to be created in that year is termed as 'New Provision'. Following journal entry is passed for creating 'Provision for Doubtful Debts':

Profit and Loss A/c Dr.

To Provision for Doubtful Debts A/c

(Being Provision for Doubtful Debts created on Sundry debtros)

Illustration 1.

On 31-12-2004, the Sundry debtors of a firm amounted to Rs.60,800. Out of debtors Rs. 800 is irrecoverable and the same is to be written off as bad debt.

Pass journal entries relating to bad debts and show how the accounts will be reflected in the Profit and Loss Account and the Balance Sheet.

Journal

Date	Particulars	L. F.	Dr. Amount (Rs.)	Cr. Amount (Rs.)
2004 Dec. 31	Bad Debts A/c Dr. To Sundry Debtors (Being the amount of bad debts written off)		800	800
Dec. 31	Profit and Loss Account Dr. To Bad Debt Account (Being the transfer of bad debts to Profit and Loss A/c)		800	800

Note : Since the bad debts are to be written off, the entry for writing off bad debts is required to be passed.

Dr. **Profit and Loss Account for the year ended 31-12-2004** Cr.

Particulars	Amount (Rs.)	Particulars	Amount (Rs.)
To Bad Debts	800		

Dr. **Balance Sheet as at 31-12-2004** Cr.

Liabilities	Amount (Rs.)	Assets	Amount (Rs.)
		Sundry Debtors 60,800 Less: Bad Debts 800	60,000

5.3.4 Creation and Accounting Treatment of Provision for Doubtful Debts:

Where an entity decides to make provision for doubtful debt, a new account called 'Provision for Doubtful Debts Account'/ 'Provision for Bad Debt Account'/ 'Provision for Bad and Doubtful Debts Account' is required to be opened n the ledger. The balance of this account will be carried forward to the next year. While preparing final accounts the amount of provision for doubtful debts will be shown on the debit side of the Profit and Loss Account and the same will be shown as deduction from Sundry Debtors in the Balance Sheet.

The following journal entry is required to be passed for creating 'Provision for Doubtful Debts' :

Profit and Loss A/c Dr.

To Provision for Doubtful Debts A/c

(Being Provision for Doubtful Debts created on Sundry Debtors)

Note : It should be kept in mind that the creation of Provision for Doubtful Debts does not reduce the balance of sundry debtors. The Provision for Doubtful Debts is shown as deduction from sundry debtors in the assets side of the balance sheet for the purpose of showing the amount of sundry debtors at its estimated realizable value.

Illustration 2

Following is the extract of Trial Balance as on 31st December, 2004.

Trial Balance

Sundry debtors	40,000	

Create Provision for Doubtful Debts @5% on Debtors. You are required to pass Journal entry for creating provision for Doubtful Debts. Show the Provision for Doubtful Debts Account as it will appear in the Ledger. Also show how the Provision for Doubtful Debts will appear in the Profit and Loss Account and the Balance Sheet. The accounting year ends on 31st December each year.

Solution :

Journal

Date	Particulars	L. F.	Dr. Amount (Rs.)	Cr. Amount (Rs.)
2004 Dec. 31	Profit and Loss Account Dr. To Provision for Doubtful Debts A/c (Being the creation of Provision for Doubtful Debts % 5% on Sundry Debtors)		2,000	2,000

Dr. **Provision for Doubtful Debts Account** Cr.

Date	Particulars	J. F.	Amount Rs.	Date	Particulars	J. F.	Amount Rs.
2004 Dec. 31	To Balance c/d		2,000	2004 Dec. 31	By Profit and Loss A/c		2,000
				2005 Jan. 1	By Balance b/d		2,000

Profit and Loss Account

For the year ended 31st December, 2004

Dr. Cr.

Particulars	Amount (Rs.)	Particulars	Amount (Rs.)
To Provision for Doubtful Debts A/c	2000		

Balance Sheet as on 31st December, 2004

Liabilities	Amount (Rs.)	Assets	Amount (Rs.)
		Sundry Debtors 40,000 Less: Provision For doubtful debts 2,000	38,000

UNIT–VI FINAL ACCOUNT

Unit Structure :

6: PREPARATION OF FINAL ACCOUNTS

The name of Final Account for an organization varies according to the nature of activities and the needs of the management.

A trading firm prepares a Trading and Profit and Loss Account; a manufacturing business prepares a Manufacturing Account in addition to the Trading and Profit and Loss Account; a social club prepares and Income and Expenditure Account; and a professional man prepares only a Profit and Loss account; in addition to a Balance Sheet.

In case of sole proprietorship form of business, preparation of Final Accounts involves the preparation of a :

(a) Trading Account;

(b) Profit and Loss Account; and

(c) Balance Sheet.

Important points to be kept in mind while preparing Final Accounts L

Final accounts are prepared after the preparation of trial balance. The trial balance contains the balances of all accounts from the ledger. It includes the accounts of all expenses, incomes, assets, liabilities, capital and drawings.

It may be recalled that :

(i) Debit balances usually represent either expenses, losses, assets or drawings and these items always appear in the left hand side of the Trial Balance (Debit side).

(ii) Credit balances usually represent income, liabilities, capital, reserves. These items always appear on the credit side of the Trial Balance.

(iii) In examination problems, if the question is not given in the form of a trial balance, a Trial Balance should be prepared before preparing the final accounts because the balance sheet will not agree if the trial balance does not agree, if there is a difference in the Trial Balance, the difference should be placed to 'Suspense A/c' and shown in the Balance Sheet in order to get the balance sheet agreed.

(iv) All items which appears in the Trial Balance should be shown only once for the same amount whereas items which appears outside the Trial Balance, known as adjustments, have to be shown at two places.

(v) Items which appear on the debit side of the trial balance is shown on the debit side of the Trading Account or on the debit side of the Profit and Loss Account or on the assets side of the Balance Sheet depending on the nature of account.

However, item such as Returns Inward which appear on the debit side of the trial balance is shown on the credit side of the Trading Account as deduction from sales.

(vi) Items which appear on the credit side of the trial balance is shown on the credit side of the Trading Account or on the credit side of the Profit and Loss Account or on the liabilities side of the Balance Sheet depending on the nature of account.

However, Returns Outward account although shows credit balance and appears on the credit side of the trial balance is shown on the debit side of Trading Account as a deduction from Purchases.

Drawings account, although appears on the debit side of the trial balance, is shown as a deduction from Capital on the Liabilities side of the Balance sheet.

(vii) The direct expenses are shown on the debit side of the Trading Account and indirect expenses are shown on the debit side of the Profit and Loss Account and other incomes are shown on the credit side of the Profit and Loss Account.

(viii) Remaining accounts will be the accounts of Assets, Liabilities, Capital and Drawings which will be shown in the Balance Sheet.

(ix) Additional information or adjustments given by way of notes are the matters which have not been recorded in the books of account. These are to be considered by adjusting the items of expenses, losses, assets, drawings, incomes, liabilities or capital as applicable while preparing the Final Accounts. Adjustments require both the Trading and Profit and Loss Account and the Balance Sheet depending on the nature of the adjustment. Sometimes an adjustment may have effects on both sides of the balance sheet only. For example, credit purchase of asset omitted is to be recorded in the books.

(x) No column for L.F. is required to be given in Final Accounts.

(xi) The total of both sides of the Balance Sheet will always be equal.

6.1 : TRADING ACCOUNT

6.1.1 *(a) Meaning of Trading Account :*

Trading account is an account which is prepared for ascertaining the overall result of trading i.e. buying and selling of goods. Ascertainment of overall result of trading is the ascertainment of gross profit earned or gross loss incurred as a result of the trading activities by a business during a particular accounting period. In other words, it is prepared to show the result of buying and selling of goods. If the amount of sales exceeds the amount of purchases and the expenses directly connected with such purchases, the difference is termed as gross profit. On the contrary, if the purchases, and direct expenses exceed the sales, the difference is called gross loss. In this account, the amount of purchases of goods and also the expenses which are incurred in bringing those goods to a saleable state are recorded. In other words, all expenses which relate to either purchase of raw material or manufacturing of goods, called 'Direct Expenses', are recorded in the Trading Account. Thus, trading account is a part of Income Statement.

(b) Meaning of Gross Profit :

Gross profit generated from carrying on the basic activity of a business. The basic activity of a business comprises of buying and selling of goods. The excess of revenue generated over cost of manufacture or purchase of goods is known as gross profit. In other words, gross profit is the excess of Net Sales over the cost of goods sold. This is explained as under :

Gross Profit =Net Sales – Cost of goods sold.
Net Sales =Sales – Sales Returns or Returns Inward.
Cost of Goods sold =Opening Stock (Inventory) +Net Purchases – Closing Stock
Net Purchases=Purchases – Purchase Returns or Returns Outward.

Or

Cost of goods sold = Opening Stock (Inventory) + Purchases + Expenses incurred in connection with purchases and manufacture (Direct expenses) – Closing Stock.

Illustration 1 : From the following information, calculate :
(i) Cost of Goods sold; and (ii) Gross profit :

		Rs.
Opening Inventory		12,000
Cash Purchases	16,000	
Credit Purchases		28,000
Purchase Return		3,000
Cash Sales		39,000
Credit Sales		72,000
Sales Return		4,000

Wages	8,000
Salaries	9,000
Rent	3,000
Other Direct Expenses	14,000
Closing Inventory	5,000

Solution :

Cost of Goods sold =Opening Inventory + Net purchases + Expenses incurred in connection with purchases (Direct Expenses) - Closing Inventory.

=Rs. [12,000 +(16,000 +28,000 – 3,000) +(8,000 +14,000) – 5,000]=Rs. 70,000

Gross Profit =Net Sales – Cost of goods sold.

=Rs. [(39,000 +72,000) – 4,000] – 70,000

=Rs. (1,07,000 – 70,000)

=Rs. 37,000

6.1.2 Contents of Trading Account :

Trading Account is an account like any other account. It has two sides – Debit and Credit. All expenses which relate to either purchase or manufacturing of goods are written on the debit side of the Trading Account.

Items shown on the Debit side of the Trading Account :

(1) Opening Stock (Opening Inventory) : The stock of goods remain unsold at the end of the last year is termed as the opening stock of the current year. In other words, the closing stock of the last year becomes the opening stock of the current year. This item is shown as the first item on the debit side of the Trading account. It should be kept in mind that there will be no opening stock in case of newly started business. Opening Stock will include the Stock of Raw Materials, Semi-finished goods and Finished goods. This item appears on the debit side of the trial balance. Stock of goods is also termed as inventory and, therefore, opening stock is termed as opening inventory.

(2) Purchases : Purchases includes goods which have been bought for resale. The amount of Purchases appearing in the trial balance include cash purchases as well as credit purchases. Purchases account shown debit balance and hence it appears on the debit side of the Trial balance. While preparing the final account, it is shown on the debit side of the Training account.

(3) Purchases Returns : When goods are returned by the business, for some reasons, "Returns Outwards Account" or "Purchase Returns Account" is credited in the books of account and supplier's account is debited. "Purchases Returns Account" shows credit balance and appears on the credit side of the Trial balance. There are two ways of showing purchase returns in the Trading Account. It may be shown by way of deduction from Purchases on the debit side of the Trading Account. Alternatively, it may be shown on the Credit side of the Trading Account. However, normally it is shown by way of deduction from Purchases in order to show the figure of net purchase in the Trading Account.

(4) **Direct Expenses :** In case of a trading concern, all expenses incurred in purchasing the goods, bringing them to the godown and into saleable condition are treated as direct expenses and charged to trading account. For example, carriage inward, freight, wages etc. In case of manufacturing concern, cost of converting the raw materials into finished products form a part of direct expenses. Direct expenses to be debited to trading account include the following.

(a) **Wages :** Wages are paid to workers who are engaged in the production of goods and as such are debited to the trading account. While preparing Trading Account, it should be noted that :

a) If the item 'Wages and Salaries' is given in the problem, it will be shown in the trading account. On the contrary, if 'Salaries and Wages' is given it will be shown in the profit & loss account.

b) If wage are paid for bringing a new machine or for its installation it will be added to the cost of the machine and hence such expenses or wages will not be shown in the trading account.

(b) **Carriage or Carriage Inward or Freight :** Carriage or Carriage Inward or Freight are the expenses which are paid for bringing the goods to the shop or to the factory and hence should be debited to trading account. However, if any carriage or freight is paid for carrying charge of an asset, the amount should be added to the asset account and should not be debited to trading account.

(c) **Manufacturing Expenses :** Manufacturing Expenses such as Coal, Gas, Fuel, Water, Power, Factory Rent, Factory Lighting etc. are the expenses which are incurred in the manufacture of goods and hence these are shown on the debit side of the Trading account (where manufacturing account is not prepared).

(d) **Dock Charges :** Dock Charges are the charges levied on ships and their cargo while entering or leaving docks. If dock charges are paid on import of goods they are shown on the debit side of trading account. If dock charges are paid on export of goods they are shown on the debit side of the Profit and Loss account. In the absence of specific instructions, these are debited to trading account.

(e) **Import Duty or Custom Duty :** custom Duty is paid on import as well as on export of goods. Custom duty when paid on the purchase of goods is charged to trading account and when it is paid on the sale of good it is charged to profit and loss account. In the absence of specific instructions, these are debited to trading account.

(f) **Excise Duty :** Excise Duty is the amount of duty or charges paid to the government on goods manufactured and is, therefore, debited to the trading account.

(g) **Octroi :** Octroi is the amount levied by the municipal authority when the goods enter the city and hence debited to trading account because they are connected with purchases.

(h) **Royalty :** Royalty is the amount paid to the owner of a mine or patent for using his right or patent. Where the payment of royalty is based on production, it is usually charged to trading account because it increases the cost of production. However, if it is specifically stated in the problem that the Royalty is payable on the basis of sales, it will be charged to Profit and Loss account.

(i) **Packing Charges/Packing Expenses :** Packing material are used for packing of materials at different stages.

(a) If packing charges are incurred to make goods saleable or to bring it in a saleable condition, these are direct expenses. They are as such debited to the Trading Account.

(b) If the packing expenses are connected with sales or they have been incurred after the goods have been sold, they are treated as selling expenses and are debited to the Profit and Loss Account.

For example, a manufacturer of biscuits sell biscuits packed in poly packs. In order to make the biscuits available in saleable condition, this primary packing is necessary. Therefore, they are treated as direct expenses. Now, a person purchases three packets of such biscuits and the seller packs these three packets for handing over to the purchaser, the expenses incurred on such secondary packing is indirect and will be treated as selling expenses and debited to Profit and Loss Account.

Items shown on the Credit side of the Trading Account :

(1) **Sales :** Sales account appearing in the Trial Balance, shows the total sales made during the accounting period. This includes both cash and credit sales. Sales account shows credit balance. It is treated as revenue and as such it is shown on the credit side of the Trading account. In respect of sales, the following points must be noted :

1) Only the sale of goods (the product/products in which the business entity deals in) is treated as sales for the purpose of preparation of Trading Account.
2) If sales include sale of fixed asset, it should be deducted from sales.
3) If any goods have been sold on approval and included in sales, it should be deducted from sales, if the approval period has not expired. Such sales should be recorded separately.

(2) **Sales Return :** When goods are returned by the buyers, for some reasons, "Returns Inwards Account" or "Sales Return Account" is debited in the books of account and the buyer's account is credited. 'Sales Return Account' appears on the debit side of the Trial Balance. There are two ways of showing sales returns in the Trading Account. It may be shown by way of deduction from sales in the Trading Account. An alternative way to show the sales returns is to put it in the debit side of the Trading Account. But normally it is shown by way of deduction from sales in order to show the figure of net sales.

(3) **Closing Stock (Closing Inventory) :** The goods remain unsold at the end of the year is known as Closing Stock. It is valued at cost price or market price whichever is less. It includes the Closing Stock of raw material, Closing Stock of semi-finished goods and Closing Stock of finished goods. Accounting treatment of closing stock will be as under :

(a) ***Where the amount of Closing stock is stated outside the Trial Balance***

Normally, the Closing Stock is given outside the Trial Balance. This is so because its valuation is made after the accounts have been closed. It is incorporated in the books by means of the following entry :

Closing Stock A/c Dr.
    To Trading A/c
(Being the incorporation of Closing Stock in the books of account.)

Closing stock account will be posted to the credit side of the trading account and on the other hand, debit aspect of the closing stock account will be shown on the Asset side of the Balance Sheet, in order to complete the double entry.

(b) ***Where the amount of Closing Stock is stated inside the Trail Balance :***

Sometimes, the Closing Stock may be given inside (on the debit side) the Trial Balance. This means that the entry for incorporating the closing stock in the books has already been passed. It implies that the Closing Stock must have been deducted out of Purchases Account. Hence, in such a case, Closing Stock will not be shown in the Trading Account but will appear only on the Assets side of the Balance Sheet.

Again, the Closing Stock may be given both on the debit side and credit side of the Trial Balance. In such a case, the debit balance will be shown on the asset side of the balance sheet and the balance appearing on the credit will be shown on the credit side of the Trading account.

Valuation and recording of closing stock :

Closing stock should be valued either at cost or market price whichever is lower and should be recorded accordingly. While preparing final account, if the figure of both cost price and market price of the closing stock is given, the closing stock will be shown both in the Trading account and the balance sheet either ***at the cost price or market price whichever is lower.*** For example, the cost price of stock held by a trader on 313-2004 is Rs.12,000 and will be recorded in the books of account accordingly.

6.1.3 Journal Entries (Closing entries) relating to preparation of Trading Account :

The preparation of the Trading Account requires that the balances of all such accounts which are due to appear in the Trading Account are transferred to it. The entries required for such transfer are termed as Closing entries. These will be as follows :

(1) ***For transfer of opening stock :***

Trading A/c Dr.
To Opening Stock A/c

(2) ***For transfer of purchases :***

Trading A/c Dr.
To Purchases A/c

(3) ***For transfer of purchases returns :*** The balance of purchases return account is transferred to purchases account or Trading account.

Purchases Return A/c Dr.
To Purchases A/c or Trading A/c

(4) ***For transfer of direct expenses :***

Trading A/c Dr.
To Direct Expenses (Individually) A/c

(5) ***For transfer of Sales***

Sales A/c Dr.
To Trading A/c

(6) ***For transfer of Sales Returns or Returns Inward :***

Trading A/c / Sales A/c Dr.
To Returns Inward A/c

(7) ***For transfer of Closing Stock :***

Closing Stock A/c Dr.
To Trading A/c

(8) ***Entry for closing the Trading account :***

(a) If the credit side of the Trading Account exceeds the debit side :

After passing the above entries, if the total of amounts of the credit side of the Trading Account exceeds the total of amounts of debit side, the difference is termed as Gross Profit. The Gross Profit will be transferred to the credit of a newly opened account called Profit and Loss account. The following entry is passed for the same :

Trading A/c Dr.

To Profit and Loss A/c

(Being the transfer of Gross Profit to the Profit and Loss A/c)

(b) If the debit side of the Trading Account exceeds the credit side :

If the total of amounts of debit side of the Trading Account exceeds the total of amounts of the credit side, the difference will be termed as Gross Loss. It will be transferred to the debit of Profit and Loss Account by means of the following entry :

Profit and Loss A/c Dr.

To Trading A/c

(Being the transfer of Gross Loss to the Profit and Loss A/c)

6.1.4 Specimen Form of Trading Account :

In the books of ………………

Trading Account

For the year ended on …………

Dr. Cr.

Particulars	Amount (Rs.)	Particulars	Amount (Rs.)
To Opening Stock To Purchases Less : Purchase Returns Or Returns outward To Wages To Wages & Salaries To Direct Expenses To Carriage, or Carriage on Purchase To Duty on Purchase To Gas, Fuel and Power To Freight/ Cartage To Manufacturing Expenses, Or Productive Expenses To Factory Expenses, such as : Factory Lighting Factory Rent etc. To Octroi To Dock charges To Clearing charges To Import Duty or Custom Duty To Excise Duty To Insurance Premium (factory) To Royalty on production To Profit and Loss A/c (Gross Profit transferred) [Balancing Figure]		By Sales Less : Sales Returns Or Returns inward By Closing Stock By Profit and Loss A/c (Gross loss transferred) (Balancing figure)	

Illustration 2:

Following is the extract of the Trial Balance of Ram and Shyam firm as on 31.3.2000.

Particulars	Debit Rs.	Credit Rs.
Stock on 1.4.99	10,000	
Carriage on Sales	2,000	
Purchases	80,000	
Discount		2,000
Sales		1,20,000
Purchase returns		2,000
Octroi Duty	5000	
Returns inward	3,000	
Productive wages	15,000	
Freight	2,000	
Excise Duty	1,000	
Coal, gas and water	1,500	
Salaries	5,000	
Trade Expenses	1,000	

Additional information :

(i) Stock on 31.3.2000 Rs.15,000

(ii) Outstanding wages 500

(iii) Goods taken by Ram for Personal Use 1,000

Prepared the Trading Account of the firm for the year ended 31.3.2000

Solution :

In the books of Ram and Shyam

Trading Account

For the year ended 31st March, 2000

Particulars		Amount (Rs.)	Particulars		Amount (Rs.)
To Opening Stock		10,000	By Sales	1,20,000	
To Purchases	80,000		Less : Returns		
Less : Purchase			inward	3,000	1,17,000
Returns	2,000		By Closing Stock		15,000
	78,000				
Less : Goods taken by Ram transferred to his Drawings A/c	1,000	77,000			
To Octroi Duty		500			
To Freight		2,000			
To Excise Duty		1,000			
To Coal, gas and water		1,500			
To Productive wages	15,000				
Add : Outstanding	500	15,500			
To Profit & Loss A/c (Gross Profit c/c)		24,500			
		1,32,000			1,32,000

Note : Trade expenses ordinarily indicate General Expenses and it is indirect in nature and, therefore, taken to Profit & Loss A/c. In case the Trial balance contains both Trade Expenses and General Expenses, Trade Expenses will be treated as direct and will be taken to the Trading A/c and General Expenses will be taken to the Profit & Loss A/c.

Exercise 1:

From the following information of Kalita Printers prepare a Trading Account for the year ended 31st March, 1998.

		Rs.
Fuel		100
Purchases (Adjusted)	9,800	
Sales		15,000
Trade Expenses		500
Postage and Telegrams		100
Commission (received)		300
Discount (allowed)		200
Rent paid		1,500
Returns Inward		200
Carriage Outwards		300
General Expenses		300
Closing Stock	8,000	

Exercise 2:

Fro the following information of M/s. Barua Enterprise prepare a trading Account for the year ended 31st March, 2005

Particulars	Amount (Rs.)	Particulars	Amount (Rs.)
Opening Inventory	5,000	Salaries to Clerk	500
Purchases less returns	8,000	Wages of Office and Shop Assistant	2,000
Sales less returns	10,000	Rent of Office and Shop	100
Wages	2,000	Sundry Expenses	3,000
Freight on Purchases	800	Motive Power	50
Marine insurance on purchases	100	Office lighting and heating	50
Duty on goods imported	300	Carriage inward	100
Closing Inventory	4,000		

6.2 : PROFIT AND LOSS ACCOUNT

6.2.1 Meaning :

After preparing a Trading Account and ascertaining Gross Profit or Gross Loss, we are to prepare Profit and Loss Account in order to ascertain Net Profit or Net Loss. Profit and Loss Account is the statement wherein the various items of profit and revenue earned on one hand and the losses, and expenses incurred on the other hand are collected and set off and the resulting balance represents the Net Profit or Net Loss of the period under review. It means, the expenses for earning the income are set off against that income to ascertain Net Profit or Net Loss. Net Profit increases the owner's equity while 'Net Loss' decreases the owner's equity.

If the gains exceed the losses, the excess is the Net Profit. If the losses exceed the gains, the excess is the Net Loss. American Accountants call this Account a "Loss and Gain Account" which is more appropriate in relation to its formation.

6.2.2 *How to prepare a Profit and Loss Account :*

Profit and Loss Account is credited with the amount of Gross Profit transferred from the Trading Account. In case of Gross Loss, Profit and Loss Account is debited with the amount of Gross Loss. It is credited with all other items of gain such as Interest Received, Commission Received, Discount Received, Rent Received, Dividend Received, bad Debts Recovered etc. Then it is debited with all other expenses and losses except those included in the Trading Account. These expenses are incidental to carrying on business and are broadly grouped under three categories of expenses; viz.

a) Administrative Expenses which include Salaries to Staff, Office Rent, Printing and Stationery etc.
b) Financial Expenses which include Interest on Loan, etc.
c) Selling and Distribution Expenses which include Carriage Outward, Advertisement, etc.

If the credit total is heavier, the difference is called Net Profit and if the debit total is heavier, the difference is called Net Loss.

Transfer of Net Profit or Net Loss :

Net Profit indicates an increase in proprietor's equity or capital by the amount of profit while Net Loss indicates a decrease in owner's equity or capital by the amount. So Net Profit or Net Loss is to be transferred to the Proprietor's Capital Account by passing a journal entry as given below :

(a) For Transfer of Net Profit :
Profit and Loss account Dr.
To Capital Account.

(b) For Transfer of Net Loss :
Capital Account Dr.
To Profit and Loss Account.

6.2.3 *Preparation of Profit and Loss A/c :*

A Profit and Loss Account starts with the amount of gross profit or gross loss brought down from the Trading Account. As such, all those expenses and losses which have not been debited to the Trading Account will now be debited to Profit & Loss Account. These expenses include administrative expenses, selling expenses, distribution expenses etc. These are called 'Indirect Expenses'. Profit and Loss Account is a Nominal Account and as such, all the expenses and losses are shown on its debit side and all the incomes and gains are shown on the credit side of this account.

Items shown on the Debit side of Profit & Loss Account :

(1) **Gross Loss :** If trading account discloses Gross Loss, it is shown as the first item on the debit side of the Profit and Loss Account.

(2) **Indirect Expenses :** Each and every business house is required to incur some other expenses other than the direct expenses in course of their day to day business activities. Such expenses include expense of revenue nature other than the direct expenses such as Office and Administrative expenses, Selling and Distribution expenses, Financial charges etc. These expenses are termed as indirect expenses because they are not directly related to purchase of goods and bringing them into saleable condition. Indirect expenses debited to profit and loss account are stated below :

(a) **Office and Administrative Expenses :** Expenses such as salary of office employees, office rent, lighting, postage, printing, stationery, audit fee, legal charges etc. are treated as Office and Administrative Expenses.

(b) **Selling and Distribution Expenses :** Expenses such as advertisement charges, commission, carriage outwards, bad-debts, packing charges etc. are treated as Selling and Distribution Expenses.

(c) **Financial Charges :** Expenses such as interest on loan, interest on capital, interest on overdraft etc. are treated as financial charges.

(d) **Miscellaneous Expenses :** Expenses such as interest on loan, interest on capital, repair charges, depreciation, charity etc. are treated as Miscellaneous Expenses.

(e) **Other Losses :** Such as loss by fire, loss due to accident etc.

(f) **Provisions :** Such as Provision for doubtful Debts, provision for Discount on Debtors etc.

Items shown on the Credit side of Profit & Loss Account :

(1) **Gross Profit :** If the Trading Account discloses Gross Profit, Gross Profit is shown as the first item on the credit side of Profit and Loss Account.

(2) **Other Incomes and Gains :** All items of incomes and gains such as income from investments, rent received, discount received, commission earned, interest received, bad debts recovered etc. are shown on the credit side of the Profit & Loss Account.

6.2.4 Balancing of Profit and Loss Account :

The balance of the Profit & Loss Account, after posting all nominal accounts to the respective side, is termed as Net Profit or Net Loss. If the credit side of the profit and loss account is more than the total of the debit side, the difference is termed as net profit. On the other hand, if the total of the debit side exceeds the total of the credit side, the difference is termed as net loss. The Net Profit/Net Loss is transferred to the capital account. Net profit is added to the capital whereas net loss is deducted from the capital in the balance sheet.

6.2.5 Distinction between Trading Account and Profit and Loss Account :

Sl. No.	Basis of Distinction	Trading Account	Profit & Loss Account
1.	Items included	Sales and all the items relating to ascertainment of cost of sales are shown in this account.	All the items of indirect expenditure such as salary, rent, bad debts, discount etc. are shown in this account.
2.	Result	The balance of this Account is named as gross profit/gross loss.	The balance of this Account is named as net profit/ net loss.
3.	Transfer of balance	The balance of this Account is transferred to Profit and Loss Account.	The balance of this Account is transferred to Capital account.
4.	Utility	Trading Account shows the trend of business activities. By comparing the Trading Account of consecutive periods steps can be taken to increase profitability.	This Account shows the net result of the business. By comparing net results of consecutive periods, steps can be taken for an all round development of the business.
5.	Sequence of preparation	It is prepared before the preparation of Profit and Loss Account.	It is prepared after the preparation of Trading Account.

6.2.6 *Format of Profit and Loss Account :*

Profit and Loss Account (for the year ending..................)

Dr. Cr.

Particulars	Amount (Rs.)	Particulars	Amount (Rs.)
To Trading A/c		By Trading A/c	
(Gross Loss Transferred)		(Gross Profit transferred)	
Office & Administrative Expenses :		By Rent (Cr.)	
To Salaries		By Rent of premises sub-let	
To Salaries & Wages		By Discount received	
To Rent, Rates & Taxes		Or Discount (Cr.)	
To Printing & Stationery		By Commission Received	
To Postage & Telegram		By Interest on Investments	
To Lighting		By Dividend on Shares	
To Insurance Premium (office)		By Sundry Receipts	
To Telephone Charges		By Bad debts Recovered	
To Legal Charges		By Profit on sale of assets	
To Audit Fees		By Income from other Sources	
To Travelling Expenses		By Apprenticeship Premium	
To Establishment Expenses.		By Sale of Scraps	
To Trade Expenses [see note (ii)]		By Royalty Received	
To General Expenses.		By Subsidy from Govt.	
To Royal on sales.		By Interest on Drawings	
To Establishment		By Capital A/c	
To Commission of Office Manager		[Net Loss Transferred to]	
Selling and Distribution Expenses :			
To Carriage Outwards, or			
Carriage on Sales			
To Advertisement			
To Commission			
To Discount			
To Rebate			
To Brokerage			
To Bad debts			
To Export duty			
To Packing charges			
To Delivery Van Expenses.			
To Wages (Unproductive)			
To Commission to Sales Manager			
Financial Charges :			
To Interest on Loan			
To Bank Charges			
To interest on Overdraft.			
Sundry Expenses :			
To Sales Tax			
To Repairs			
To Depreciation on fixed assets			
To Entertainment Expenses			
To Contingencies			
To Conveyance Expenses			
To Donation and Charity			
To Loss on Sale of Assets			
Provisions :			
To Provision for Doubtful Debts			
To Provision for Discount on Debtors			
To Capital A/c(Net Profit Transferred)			

6.2.7 *Usual Adjustment Entries :*

Journal entries are necessary to adjust the revenue and expenses accounts at the end of each accounting year. They are given below in a tabular form with their effect in the Profit and Loss Account and the Balance Sheet.

USUAL ADJUSTMENT ENTRIES

Adjustment items	Adjustment Entries	Effect to be shown in	
		Profit & Loss Account	**Balance Sheet**
I. To provide for Outstanding expenses	Expense Account (concerned) (a) Dr. To Outstanding Expenses A/c (b)	(a)Debit Side, as an addition to the concerned A/c	(b) Liabilities side
II. To adjust prepaid expenses :	Prepaid Expense A/c (a) Dr. To Expense Account (concerned) (b)	(a)Debit side, as a deduction from the concerned Expense A/c	(b) Assets side.
III. To adjust income earned but not received	Outstanding Income A/c (a) Dr. To Income A/c (concerned) (b)	(b)Credit side, as an addition to the concerned Income A/c	(a) Assets side
IV. To adjust Income received in advance	Income A/c (concerned) (a) Dr. To Income Received in Advance A/c (b)	(a) Credit side, as a deduction from Income A/c concerned	(b) Liabilities side
V. To write off bad debt	Bad Debt. A/c (a) Dr. To Debtors A/c (b)	(a) Debit side	(b) Assets side, as a deduction from Sundry Debtors.
VI. To provide for doubtful debt	Profit and Loss A/c (a) Dr. To Reserve for Doubtful Debt A/c (b)	(a) Debit side	(b) Assets side, as a deduction from Sundry Debtors.
VII. To provide for discount on Debtors	Profit and Loss Account (a) Dr. To Reserve for Discount on Debtors A/c (b)	(a) Debit side	(b) Assets side, as a deduction from Sundry Debtors.
VIII. To provide for discount on Creditors	Reserve for Discount on Creditors A/c (a) Dr. To Profit and Loss A/c (b)	(b) Credit side	(a) Liabilities side, as a deduction from Sundry Creditors
IX. To provide for depreciation on a permanent asset	Depreciation A/c (a) Dr. To (concerned) Asset A/c (b)	(a) Debit side	(b) Assets side, as a deduction from the concerned assets.
X. To adjust interest on proprietor's capital	Interest on Capital A/c (a) Dr. To Capital A/c (b)	(a) Debit side	(b) Liabilities side, as a addition to Capital.
XI. To adjust interest on drawings	Capital A/c (a) Dr. To Interest on Drawing A/c (b)	(b) Credit side	(a) Liabilities side, as deduction from Capital
XII. For goods used as free samples	Free Samples A/c (a) Dr. Or Advertisement A/c (a) Dr. To Purchase A/c (b)	(a) Debit side, and (b) a deduction from Purchase A/c in the Trading Account.	
XIII. Goods used as stationery in office.	Printing and Stationery A/c. (a) Dr. To Purchases A/c (b)	(a) Debit side of the Profit and Loss A/c and (b) a deduction from Purchases in Trading A/c.	

XIV. Loss of stock by fire etc. insured and claim admitted.	Insurance Claim A/c (a) Dr. To Trading A/c (b)	(b) Credit side of Trading A/c	(a) Assets side as Insurance Claim
XV. Loss of stock partially insured and admitted by insurance Co.	Insurance Claim A/c (a) Dr. Loss by Fire A/c (b) Dr. (to be transferred to P/L. A/c) To Trading A/c (c)	(b) Debit side of the Profit and Loss A/c and (c) credit side of the Trading A/c	(a) Insurance claim on the Asset side.
XVI. Loss of stock by fire uninsured	Loss by Fire A/c (a) Dr. To Trading A/c (b)	(a) Debit side of the Profit and Loss A/c and (b) Credit side of Trading A/c	

6.2.8 Closing entries for Preparation of Profit & Loss Account :

The preparation of the Profit & Loss Account requires that the balances of a such accounts which are due to appear in the Profit & Loss Account are transferred to it. The entries required for such transfer are termed as Closing entries. These are as follows :

(1) For transfer of account of various items of expenses and losses :

Profit and Loss A/c Dr.
To Salaries A/c
To Rent, Rates and Taxes A/c
To Printing and Stationery A/c
To Postage and Telegram A/c
To General Expenses etc.

(Being the transfer of nominal accounts showing debit balances to the debit of Profit and Loss A/c)

(2) For transfer of accounts of various items of incomes and gains :

Interest received A/c Dr.
Commission Received A/c Dr.
Rent Received A/c Dr.
To Profit and Loss A/c

(Being the transfer of nominal accounts showing credit balances to the credit of Profit and Loss A/c)

(3) For the transfer of credit balance of Profit & Loss A/c, known as net profit :

Profit and Loss A/c Dr.
To Capital A/c

(Being the transfer of net profit to Capital A/c)

(4) For the transfer of debit balance of Profit & Loss A/c, known as net loss :

Capital A/c Dr.
To Profit and Loss A/c

(Being the transfer of net loss to Capital A/c)

Illustration 1 :

From the following particulars, pass necessary journal entries and prepare a Profit & Loss Account of Mr. K. Barua for the year ending 31st March, 2005.

Particulars	Rs.	Particulars	Rs.
Gross Profit	3,12,000	Discount allowed	3,000
Trade Expenses	2,000	Lighting	780
Carriage on Sales	10,000	Commission Received	840
Office Salaries	15,800	Bad-debts	1,200
Postage and Telegram	720	Discount (Cr.)	600
Office Rent	7,500	Interest on Loan	2,200
Legal Charges	400	Wages (Unproductive)	1,400
Audit fee	1,600	Export Duty	2,300
Donation	1,100	Miscellaneous Receipts	500
Sundry Expenses	360	Advertisement	4,100
Selling Expenses	5,320	Travelling Expenses	2,500

Solution :

In the books of Mr. K. Barua

Journal Entries

Date	Particulars	L. F.	Dr. Amount (Rs.)	Cr. Amount (Rs.)
2005 Mar. 31	Profit and Loss Account Dr.		62,280	
	To Trade expenses Account			2,000
	To Carriage on sales Account			10,000
	To Office Salaries Account			15,800
	To Postage & Telegram Account			720
	To Office Rent Account			7,500
	To Legal charges Account			400
	To Audit Fee Account			1,600
	To Donation Account			1,100
	To Sundry expenses Account			360
	To Selling expenses Account			5,320
	To Discount allowed Account			3,000
	To Lighting Account			780
	To Bad Debts Account			1,200
	To Interest on Loan Account			2,200
	To Wages (Unproductive) Account			1,400
	To Export duty Account			2,300
	To Advertisement Account			4,100
	To Travelling expenses Account			2,500
	(Being the transfer of nominal accounts showing debit balances to the Profit & Loss A/c)			
"	Commission Received Account Dr.		840	
	Discount Received Account Dr.		600	
	Miscellaneous Receipts Account Dr.		500	
	To Profit & Loss Account			1,940
	(Being the transfer of nominal accounts showing credit balances to the Profit & Loss A/c)			

"	Profit and Loss Account Dr. To Capital Account (Being the transfer of net profits to the Capital account)		2,51,660	2,51,660

In the books of Mr. K. Barua

Profit and Loss Account

For the year ending on 31st March, 2005

Dr. Cr.

Particulars	Amount Rs.	Particulars	Amount Rs.
To Trade expenses	2,000	By Trading Account	3,12,000
To Carriage on sales	10,000	(Gross Profit transferred)	
To Office Salaries	15,800	By commission received	840
To Postage & telegram	720	By Discount	600
To Office Rent	7,500	By Miscellaneous Receipts	500
To legal charges	400		
To Audit Fee	1,600		
To Donation	1,100		
To Sundry expenses	360		
To Selling expenses	5,320		
To Discount allowed	3,000		
To Lighting	780		
To Bad Debts	1,200		
To interest on Loan	2,200		
To Wages (Unproductive)	1,400		
To Export duty	2,300		
To Advertisement	4,100		
To Travelling expenses	2,500		
To Capital Account (Net Profit transferred)	2,51,660		
	3,13,940		3,13,940

Exercise 1 :

From the following information of Bulbul Enterprises prepare a Profit & Loss Account for the year ended 31st December, 2004.

	Rs.		Rs.
Gross Profit	21,000	Capital	18,000
Salaries	4,000	Discount received	100
Rent and taxes	500	Repairs	150
Trade expenses	100	Interest paid	50
Discount (Dr.)	200	Bank charges	20
Selling commission paid	2,120	Reserve	4,000
Rebate	100	Bad debts	150
Contingencies	50	Commission (Cr.)	210
Conveyance	200	Machinery	3,500
Petty Cash in hand	80	Sundry receipts	10
Bad debt recovered	120	Goodwill	8,000

6.3 : BALANCE SHEET

6.3.1 Meaning :

At the end of the accounting year, a trader naturally desires to know two things viz.

(a) The results of his trading operation for the period and;

(b) His true financial position at the end of the period.

In order to ascertain the financial results, he prepares Trading and Profit and Loss Account. The Trading Account shows gross profit while the Profit and Loss Account shows the net profit. After ascertaining net profit, the businessman desires to know his financial position and the correctness of his net profit disclosed by the Profit and Loss Account. As assets and liabilities continuously change during the operation of the business, he is also interested in knowing the composition of various assets and liabilities and the amount of capital standing at the end of the period. In order to obtain this information at the end of a trading period, a businessman sets out various assets and liabilities as on that date in the form of a statement which is known as Balance Sheet.

Definition :-

According to CARTER 'A Balance Sheet is a statement drawn up at the end of each trading or financial period, setting forth the various assets and liabilities of the concern as at this date.

However, it is also described as a classified summary of debit and credit balances existing in the ledger after the Profit and Loss Account has been constructed. This is a better definition because it often contains items which are not either assets or liabilities. It is prepared with a view to measure the exact financial position on a certain fixed date. So it is also called a 'Position Statement'

6.3.2 Steps for Preparation of balance Sheet :

Following steps should be followed for preparation of a balance sheet :

(i) All accounts of Assets (i.e. the accounts remaining in the trail balance after the preparation of Trading and Profit and Loss Account) appearing on the debit side of the trail balance will be shown on the 'Assets side of the balance sheet' i.e. the right hand side of the balance sheet, **except drawings account which will be shown on the liabilities side as a deduction from Capital account.**

(ii) All the accounts of Liabilities (i.e. the accounts remaining in the trial balance after the preparation of Trading and Profit and Loss Account) appearing on the credit side of the trial balance will be shown on the 'Liabilities side of the balance sheet' i.e. the left hand side of the balance sheet.

(iii) Net Profit/ Net Loss as shown by the Profit and Loss Account will be added / deducted from capital on the liabilities side of the balance sheet.

(iv) Drawings account which appears on the debit side of the trail balance will be shown on the liabilities side as a deduction from Capital account.

(v) The assets and liabilities should be shown under proper groups.

(vi) The assets and liabilities should be shown in certain order.

6.3.3 *Classification of Assets :*

Assets may be classified as follows :

Assets

- Real Assets
  - Fixed Assets
    - (1) Tangible Assets
    - (2) Intangible Assets
  - Current and Floating Assets
    - (3) Liquid Assets
    - (4) Non liquid Assets
- Fictitious Assets

Assets :

Kohler defines asset as "any cost benefiting a future period". Thus anything which gives a benefit in future may be termed as an asset. Assets, therefore, are various properties or possessions under the ownership of a concern, with the help of which the activities of the concern are carried on, e.g. land, buildings, plant and machinery, furniture, shock, cash, etc. All assets are shown on the Assets Side of the Balance Sheet.

Real Assets :

Real assets are those assets which have some market value. They include assets of permanent as well as of floating nature. Examples are – buildings, plant, stock, cash, etc.

Fixed Assets :

"Fixed Assets are those assets of a busi ıess which are of a permanent nature and are held for the purpose of earning revenue and not with a view to resale". W. Pickles. Examples are – buildings, plant, machinery, furniture, etc. They depreciate- due to wear and tear.

Tangible Fixed Assets :

The fixed assets which have physical existence and which can be seen and touched are known as Tangible Fixed Assets viz. – buildings, land, furniture, etc.

Intangible Fixed Assets :

The fixed assets which have no physical existence and which cannot be seen and touched are known as Intangible Fixed Assets viz. – goodwill, patent right, trade marks etc. However, they are not fictitious assets as they are represented by value.

Wasting assets :

Wasting assets are those fixed assets whose value gradually reduces on account of use and finally exhausts completely viz. – mines, forest, leasehold properly etc.

Fictitious Assets :

Fictitious assets are merely some debit balances not written-off. They are items of expenditure or losses of an unusual character and are not recoupable. They are not represented by any tangible possession or property and hence they have no market value. Examples are – removal of (Business from one place to other) expenses, preliminary expenses, loss or issue of shares and debentures, etc. Fictitious are also called Paper Assets or Nominal Assets.

Current Assets :

They are those assets which are made or acquired and merely held for a short period of time with a view to reselling them at a profit in the ordinary course of business such as stock. They also include such other assets as are constantly circulating and arise out of the business dealings. They are temporarily held for subsequent conversion into money. As for example, debtors, bill, cash at bank etc.

Contingent Assets:

Contingent Assets are such assets which are not at present under the possession of the business but which may or may not be acquired on the happening of a certain event in future. Examples are- claim against damage suit under a contract. They are not recorded in the books of accounts but are shown in the Balance Sheet, on the Assets side as notes in the inner column.

Investments :

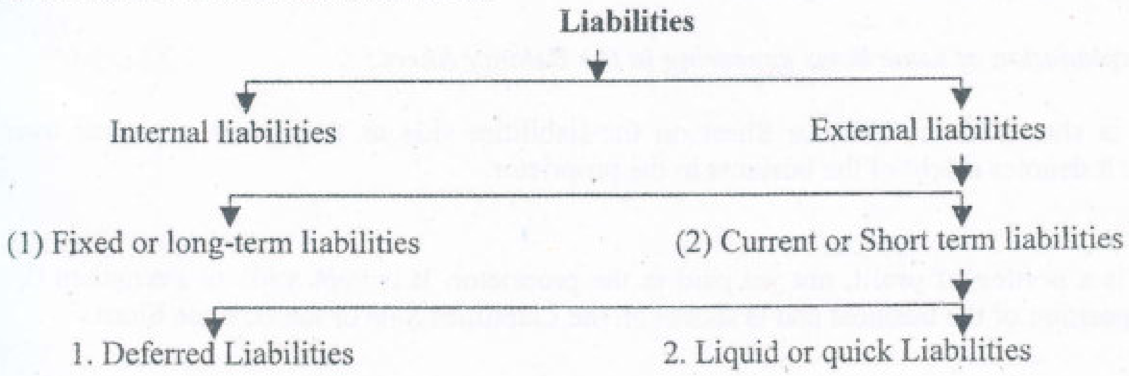
Investments may be short-term investment or long-term investments. When the investments are made for a short period representing temporary surplus of funds, they are treated as current assets as they will be soon converted into cash but investment of long term period which are held for a definite purpose or which represent permanently unutilized funds are called fixed assets.

Sundry Debtors and Creditors :

Sundry debtors and creditors indicates the total of balances of debtors and creditors at the end of the year. They do not represent any particular ledger account. At the end of each financial period, all the outstanding balances of the debtors and creditors are taken out from the Ledger and two separate lists are prepared with those balances. The total of the list of balances of customers' accounts is called Sundry Debtors; while the total of the list of balances of creditors is called Sundry Creditors.

6.3.4 Classification of Liabilities :-

The term liability denotes claims against the assets of the business by the outsiders and the proprietor. According to the American Accounting Association, Liabilities are "claims of Creditors against the enterprise arising out of past activities that are to be satisfied by the disbursement or utilization of corporate resources". All liabilities are shown in the liabilities side or left hand side of the Balance Sheet.



Internal Liabilities :

Internal Liabilities denote proprietor's equity, which consists of capital, reserve and net profit. In case of a net loss, it is deducted from capital.

External Liabilities :

External liabilities are the claims of outsiders against the assets of the business. They are loans taken, creditors, bills payable, bank overdraft, etc. External liabilities are classified into long-term liabilities and short-term liabilities.

Long-Term Liabilities or Fixed Liabilities :

Long term liabilities are repayable after a long period of time and not repayable in one year. They do not require current assets for repayment. Viz. Loan on mortgage, debentures, long term loan from banks or other financial institutions.

Current Liabilities :

Current liabilities are those liabilities which are usually payable within a year. Generally they are paid out of current assets or by creation of current liabilities. The following are the current liabilities in a business.

(i) Accounts payable or bills payable and trade creditors,
(ii) Liabilities for outstanding expenses,
(iii) Bank overdraft,

Deferred Liabilities :-

Deferred liabilities are those liabilities which are repayable in course of less than one year but more than one month.

Liquid or Quick Liabilities :

Debts which are repayable in course of a month are called liquid Or quick liabilities viz. outstanding expenses like salaries, rent, etc.

Contingent Liabilities :

Contingent liabilities are those liabilities which are at present not liabilities but which may or may not arise in future on the happening of a certain event viz. liability on bills discounted, liability under a damage suit, etc.

6.3.5 Explanation of some items appearing in the Balance Sheet :

Capital :

It is shown in the Balance Sheet on the liabilities side as the excess of assets over liabilities. It denotes a debt of the business to the proprietor.

Reserve :

It is a portion of profit, not yet paid to the proprietor. It is kept aside to strengthen the financial position of the business and is shown on the Liabilities Side of the Balance Sheet.

Loan :

If money is borrowed by the business from somebody for the purpose of the business, it is credited to Loan Account. It is a liability of the business and is shown on the liabilities side of the Balance Sheet. If any interest on loan is outstanding, such outstanding interest is also shown in the liabilities side of the Balance Sheet as a separate item named 'Outstanding Interest'.

Conversely, if any loan is granted to any person by the business, 'Loan Account' is debited as an asset. It is to be shown on the assets side of the Balance Sheet. Any interest accrued but not received is also shown on the assets side as a separate item named 'Accrued Interest'

Bank Overdraft :

When the business withdraws money from the bank in excess of its deposits with or without a previous arrangement with that bank, the excess amount so withdrawn is known as 'Bank Overdraft'.

Bills Payable :

It denotes the amount of bills issued to creditors but not yet due for payment. It is a liability of the business and will be shown on the liabilities side of the Balance Sheet.

Liabilities for Outstanding Expenses :

It signifies the liability of the business for expenses incurred during this year and will be shown on the 'Liabilities Side' of the Balance Sheet.

Investments :

When the business has excess money compared to the needs of the business, it invests such fund outside the business in shares, debentures and government bonds. These are 'grouped under the heading' Investments. They are assets and will be shown in the Balance Sheet on the 'Assets Side' as a separate item named as 'Accrued Income from Investment'.

Bill Receivable :

It is the total of the bills received from debtors but not yet due for payment. It is an asset and will be shown on the assets side of the Balance Sheet.

Working Capital :

It denotes the excess of current assets over current liabilities :

Current assets consist of stock debtors, bills receivable, short term investments, cash at bank, cash in hand and prepaid expenses, while current liabilities consist of creditors, bills payable, bank overdraft and liabilities for outstanding expenses. It is that part of the Capital, which is left after the purchase of fixed assets and any long term investment.

Prepaid Expenses :

It denotes payment for services not yet received. So it is an asset and will be shown on the 'assets side' of the Balance Sheet.

Valuation of Assets :

Fixed Assets : Fixed assets are used in the business for the purpose of earning revenue. So they must be valued on the basis of their usefulness to the business which is a going concern. Market value or replacement value need not be considered while valuing fixed assets.

Current or Floating Assets :

Current Assets or Floating Assets are held for the purpose of conversion into cash within a short period. So they are to be valued at the figures at which they are likely to be realized in near future.

In short, fixed assets mush be valued at cost less depreciation while current assets must be valued a cost price or net realizable market price whichever is lower except book debt which should be valued always at realizable value.

6.3.6 Format of Balance Sheet :

Forms of Balance Sheet (Under Permanency Order)

Balance sheet of Mr. X as on .... 20 ....

Liabilities	Rs.	Assets	Rs.
Proprietors' Equity :		***Fixed Assets :***	
Capital		Goodwill	
Reserve/ Reserve Fund		Freehold Land and Building	
Long term Liabilities :		Leasehold Land & Building	
Long term Loans		Buildings	
Current liabilities :		Plant and machinery	
Short term Loans		Furniture and Fittings	
Income Received in Advance		Loose Tools	
Outstanding Expenses		Vehicles	
Sundry Creditors		Patents and patterns	
Bills Payable		Trade Marks	
Bank Overdraft		***Long Term Loans & Advances***	
		Current Asset :	
		Closing Stocks :	
		Raw Materials	
		Work-in-Progress	
		Finished goods	
		Stationery (Stock)	
		Goods on Consignment	
		Prepaid Expenses	
		Accrued Incomes	
		Sundry Debtors	
		Bills Receivable	
		Investment (Short-Terms)	
		Cash at Bank	
		Cash in hand	

Illustration 1 :

From the following information draft a Balance Sheet of M/s Goswami Traders as on 31st December 20.....

Trial Balance as on 31st December, 20...

	Dr. Rs.		Cr. Rs.
Land and Buildings	40,000	Bills Payable	15,350
Investments	15,000	Loan from Bank	10,000
Goodwill	20,000	Loan on Mortgage	20,000
Sundry Debtors	22,750	Sundry Creditors	25,500
Prepaid Expenses	1,000	Outstanding expenses	1,500
Cash in Hand	1,400	Reserve Fund	10,000
Cash at Bank	10,700	Capital	1,05,000
Drawings	9,000	Net Profit	47,000
Bills Receivable	6,500		
Plant and Machinery	20,000		
Closing Stock	50,000		
Furniture	18,000		
Freehold Land	20,000		
<	2,34,350		2,34,350

Solution : Ref. Under Liquidity Order :

Balance Sheet of M/s Goswami Traders
as on the 31st December. 20.....

Liabilities	Rs.	Assets	Rs.
Current Liabilities :		**Current Assets :**	
Bills Payable	15,350	Cash in hand	1,400
Sundry Creditors	25,500	Cash at Bank	10,700
Outstanding expenses	1,500	Investment	15,000
Long term liabilities :		Bills Receivable	6,500
Loan from Bank	10,000	Sundry Debtors	22,750
Loan on Mortgage	20,000	Prepaid Expenses	1,000
Capital and Reserve :		Closing Stock	50,000
Reserve Fund	10,000	**Fixed Assets :**	
Capital on 1,1.20... 1,05,000		Furniture	18,000
Add. Net Profit 47,000		Plant and Machinery	20,000
1,52,000		Land and Buildings	40,000
Less Drawings 9,000	1,43,000	Freehold Land	20,000
		Goodwill	20,000
	2,25,350	<	2,25,350
<<			

Exercise 1 :

From the following Trial Balance of M/s Ram and Sons; prepared a Trading and Profit and Loss Account for the year ended 31st December....20... and a Balance Sheet as on that date.

Particulars	Dr.Rs.	Cr.Rs.	Particulars	Dr.Rs.	Cr.Rs.
Purchases	21,750		Traveling Expense	400	
Discount Allowed	1,300		Commission	425	
Wages	6,975		Carnage Inward	275	
Salaries	2,000		Trade Expenses	705	
Sales		35,000	Interest	100	
Outstanding Trade expenses		475	Insurance	150	
Buildings	5,000		Furniture	200	
Debtors	4,250		Capital		13,000
Creditors		2,100	Cash	7,045	
				50,575	50,575
	<<<	<<		<	

Adjustments :

(a) Stock on 31st December Rs.6,000

(b) Wages Outstanding Rs.500

(c) Salaries Outstanding Rs.425

(d) prepaid Insurance Rs.50

UNIT 7 – CLASSIFICATION OF ASSETS AND LIABILITIES UNDER INDIAN GAAP

Unit Structure: -

7.1: Meaning and Definition of GAAP.

'GAAP' means Generally Accepted Accounting Principles. They refer to accounting principles generally approved by accounting profession. Generally acceptability of accounting principles is not decided by formal vote of accountants but it depends on the general acceptance of the principles by the accounting professions. In this respect the judgement or Lord Denning in the case of Associated Portland Cement Manufacturers Vs. Price Commission, 1974, is an authentic explanation of the words generally accepted. He observed "*It seems to me that the phrase (Generally Accepted) means generally approved accounting principles. It means principles which are generally regarded as permissible or legitimate by the accounting professions. That is sufficient even though only one company applies in practice.*"

GAAP guide the accounting profession in the choice of accounting techniques and in the preparation of financial statements in a way considered to be a good accounting practice. GAAP *are simply guides to action and many change over time.* They are subject changes according to the changing economic circumstances.

According to the Accounting Principles Board (APB) of the USA (Statement No. 4.1970) *Generally accepted accounting principles incorporate the consensus at a particular time as to which economic resources and obligations should be recorded as assets and liabilities by financial accounting, which changes in assets and liabilities would be recorded, when these changes are to be recorded, how the assets and liabilities and changes in them should be measured, what information should be disclosed and which financial statements should be prepared.*"

Thus 'GAAP' are conventional and are based on general acceptance of accounting professions. These principles are developed on the basis of customs, usages, research and practical necessity. *They provide broad guidelines to the accounting profession in choosing accounting techniques while preparing final statements.*

They are good accounting practices and are simply guides to action. They change over time to time according to necessity and customs. As they are consensus views of the accounting professions on accounting procedures and practices, they vary from place to place according to their economic needs and customs. Thus we find Indian GAAP, English GAAP, etc.

In India, organizations like Accounting Standard Board (ASB), Institute of Chartered Accountants of Indian (ICAI), Department of Company Affairs (Government of India), Securities and Exchange Board of India (SEBI), Institute of Costs and Works Accountants of India (ICWAI), Institute of Company Secretaries (ICS), Stock Exchanges etc. are instrumental in the formation of accounting principles.

7.2: Utilities of GAAP.

Accounting practices followed by the accountants are not uniform. They suffer from lack of uniformity and biasness. As a result, financial statements are found unreliable and incomparable. In order to bring about uniformity in practices and remove biasness in the preparation and presentation of financial statements, 'GAAP' have been introduced as general guidelines to action. Thus the utility of 'GAAP' lies in bringing about uniformity, reliability, comparability and neutrality in recording and reporting financial statements.

7.3: Classification of Assets and Liabilities under Indian – GAAP.

Considering the globalization of the Indian economy and the growing prominence of Indian business globally, many Indian business houses will be inclined to adopt International GAAP (Generally Accepted Accounting Principles), or the future Indian GAAP is likely to be heavily influenced by International GAAP. IAS 39 (Financial Instruments: Recognition and Measurement) introduces a radical change in the way classifying financial assets and financial liabilities. This classification in turn determines the basis on which the financial assets or financial liabilities are stated in the balance sheet, and the principles for account the effect of changes in these values in the profit or loss account.

Classification of Financial Assets and Financial Liabilities:
Definitions:
Before we analyse the new accounting requirements, it is essential to understand the definition of these terms. These terms are: -

(a) Financial Instrument
(b) Financial Assets
(c) Financial Liability
(d) Equity Instrument and
(e) Derivative.

IAS 32 (Financial Instruments: Disclosure and Presentation), has definitions of (a) to (d), while item (e) is defined in IAS 39.

a) Financial Instrument is any contract that gives rise to a financial asset of one entity and a financial liability or an equity instrument of another entity. For example, a receivable (financial asset) of one entity will represent a payable (financial liability) of another entity. A entity instrument (or security) is a financial asset for an investor holding the instrument, and is entity of the issuer of the instrument.

b) Financial asset is any asset that is:
   1. Cash;
   2. An entity instrument of another entity;
   3. A contractual right:
      (ii) to receive cash or another financial asset from another entity; or
      (iii) to exchange financial assets or financial liabilities with another entity under conditions that are potentially favourable to the entity or
   4. A contract that will or may be settled in the entity's own entity instruments and is:
      (i) a non-derivative for which the entity may be obliged to receive a variable number of the entity's own equity instruments; or

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      (ii) a derivative that will or may be settled other than by the exchange of a fixed amount of cash or another financial asset for a fixed number of the entity's own equity instruments. For this purpose the entity's own equity instruments do not include instruments that are themselves contracts for the future receipt or delivery of the entity's own equity instruments.

c) Financial liability is the opposite of a financial asset.

d) Equity instrument is a contract that evidences residual interest in the assets of an entity after deducting all of its liabilities, and represents a financial asset of the holder and equity of the issuer.

e) Derivative is a financial instrument or other contract with three characteristics; viz. its value changes in response to a change in the value of an underlying factor (e.g. commodity price, interest rate), it req:iires nil or minimal initial investment, and it's settled at a future date. As can be seen from the definitions above, the definition of financial asset or a financial liability centres around cash, and the contractual right to receive cash/another financial asset or contractual obligation to pay cash/another financial right. Cash represents the basis on which all transactions are measured and recognized in financial statements, hence it is central to the definition of financial asset or financial liability. Standards examples financial asset or financial liability include sundry debtors/creditors, trade debtors/creditors, loans receivable/payable, investments, debentures, and bonds receivable or payable. Physical assets such as stock-in-trade, fixed assets, intangible assets and assets/liabilities that give rise to future economic benefit to receive or obligation to deliver goods or services (such as prepaid expenses, product warranty obligations, deferred revenues) are not financial assets or liabilities because these do not give rise to a present right to receive/pay cash or another financial asset. Also, an important point to note is the need for the existence of a contractual right or contractual obligation to qualify as a financial asset or liability. Accordingly, liabilities or assets arising out of statutory requirements or constructive obligations do not fulfill the definition of a financial asset or liability. In Indian GAAP, there is neither an equivalent standard to IAS 39/32 nor an authoritative definition of financial instrument, financial asset or financial liability.

7.4: Conceptual Framework......Indian GAAP.

- Underlying Assumptions- Accrual basis, Going Concern, Consistency.

- Elements of FS- Assets, Liabilities, equity, performance, income, expenses, Capital maintenance adjustments. Also defines the guidelines for recognition of elements of financial statements.
- Qualitative characteristics- Understandability, Relevance, Reliability, Comparability, true fair view.
- ICAI framework statement was issued in July 2000. This is NOT an Accounting standard in itself and does not override any AS.
- Users identified as – Investors, Lenders, suppliers, Customers, Employees, Government and Public.
- Outlines the measurement criteria for elements of financial statements including Historical Cost, Current cost, Realisable Value.
- Lays down concept of Financial and operating Capital and their maintenance.
- ICAI is working on project to harmonize IGAAP with IFRS. New Accounting standards are on the anvil for Financial instruments, Share based payments, Retirement benefit Plans, Agriculture, Insurance etc.
- GAAP announced by ASB of ICAI. Till date 29 AS announced, and effective 28 GAAP, after withdrawal of AS 8 on R & D. Several guidance notes also issued which members are required to follow up. GAAP also pronounced by SEBI, Listing agreement and statues like Companies Act, RBI Act, Banking Act, IRDA Act, Electricity Act etc.
- Enterprises have been classified in 3 categories for application of Accounting standards: Level 1, Level 2 and Level 3.
- Adoption of Accounting standards issued by ASB is made compulsory for Indian Companies as per Companies Act.

7.5: Balance Sheet under IGAAP (Indian GAAP)

- Balance sheet is required under the GAAPs to give disclosure about assets and Liabilities and as a primary financial statement.
- Format: IGAAP provides two format of Balance Sheet- Horizontal and Vertical format (Part I of schedule VI to the Companies Act, 1956)
- IGAAP does not prescribe any current and non current classification. It rather lists out line items in increasing order of liquidity as sources and application of funds.
- Vertical format requires details of each item in separate schedule, read with notes.
- Additional disclosures include number of shares held by Holding co as well as the ultimate holding co, aggregate value of quoted investments, their market value, amount of guarantee given by the Company on behalf of directors etc.

7.6: Income Statement......IGAAP (Indian GAAP)

- Under Indian GAAP no format is prescribed, but minimum line items have been specified in Part II of Schedule VI to Companies Act, 1956 including Aggregate Turnover, Gross Service revenue for Commission paid to Sole selling agent, Brokerage and discount on sales, depreciation, consumption of stores and spare parts, power and fuel, rent, repairs, rates and taxes etc.

- Any item of expenditure which exceeds 1% of total revenue or Rs. 5000/- whichever is higher should be shown as a distinct items and should not be clubbed as Misc expenses.
- Indian GAAP requires disclosure of several additional information by way of notes like Licensed and installed capacity, actual production details, details of imports, forex earnings and outgo, Net Profit computation u/s 349 etc.
- Requires separate disclosure of exceptional and non recurring items.

Exercise: -

Q1. What do you understand by GAAP? What are the utilities of GAAP?

Q2. Describe briefly the conceptual framework of Indian GAAP.

Q3. How are classification of Assets and Liabilities done under Indian GAAP?

UNIT–VIII COMPANY ACCOUNTS :

Accounting for Share and Share Capital.

Unit Structure :

8.1 : Introduction and Definition

Definition

A company form of organization represents the third stage in the evolution of business organization, the first two stages being Sole Proprietorship and Partnership Firm. It is distinct from other two forms of business organizations and enjoys a separate legal status. The ownership is here divorced from management.

The shareholders contribute towards the finances of the company and undertake a limited liability, but all of them do not and cannot participate in the management of it. It is managed by a Board of Directors elected by the shareholders. This protection of limited liability and other facilities encourage even the small business establishments to adopt the company form of organization. Thus a shareholder acts as a renter of capital and bears a limited liability. In India, companies are governed by the provisions of the Companies Act.1956. Hence, a company is a voluntary association of person formed for some common purpose. It is an artificial person created by law.

Introduction

Strictly speaking, the word "Company" has no legal and technical meaning. It is even used by a partnership firm and a sole trader though they are not companies. Indian Companies Act is also silent in defining the term 'Company'. So we have to depend on judicial pronouncements for its definition.

Justice Lindley has defined a company as "An association of many persons who contribute money or money's worth to a common stock employed for a common purpose the common stock so contributed is denoted in money and is the capital of the company. The persons who contribute it or to whom it belongs are members. The proportion of capital to which each member is entitled is his share. Shares are always transferable though the right to transfer them is often more or less restricted." He further said that a company is "An artificial person created by law with a perpetual succession and a common seal".

According Sec.3(I) (iii) of the Companies Act, 1956 a company means "A company formed and registered under this Act or an existing company". Thus a company is an artificial juridical person having a legal entity separate from its members.

8.2 : Essential Characteristic of a Company :

1. **Voluntary Association**

A company is a voluntary association of persons. Thus a company is formed by the choice and consent of the members.

2. **Legal Entity :**

A company is a legal entity quite distinct and separate from its members. It is as mush as an individual and can hold and deal with any kind of property. It can conduct a lawful business and enter into contracts with others in its own name.

3. **Perpetual Existence :**

A company has a perpetual existence. It is not affected by the death, lunacy or insolvency of its members. Thus the members may come, members may go but a company goes on for ever unless it is terminated by law.

4. **Common Seal :**

A company is an artificial person. Hence, it acts through other natural persons called directors. The directors act as agents of the company. So all the acts of the company are required to be authorized by its common seal which is the official signature of the company.

5. **Limited Liability :**

The liability of the members of a company is generally limited to the extent of the unpaid value of the shares held by him. Thus the creditors of a company are not the creditors of its shareholders and a decree obtained against the company cannot be executed against the shareholders. It can be executed only against the assets of the company. In case of a guarantee company, the members are liable to contribute a specified agreed sum to the assets of the company if the assets of the company fall short of its liabilities in case of liquidation.

6. **Transferability of Shares :**

The shares of a joint stock company are usually transferable and ordinarily the transferee becomes the member of the company. However, in the case of private companies, shares are transferable subject to the restrictions imposed by the company's Articles of Association.

7. **Registration :**

A company comes into existence only after its registration under the Companies Act. But a statutory corporation is formed and commences business as stated in the special Act passed for it by the Parliament or a State Legislature.

8. **Management :**

Shareholders of a company are the owners of shares and not the owners of the company. They are the members of a company and are called "Contributories". They do not and cannot take part in the day to day management of the business of the company. The management of the company is conducted by a body named 'Board of Directors' elected by the shareholders in a general meeting of the members.

9. **Capital :**

The capital of a company consists of a number of small units known as shares and contributors of such a capital are known as shareholders.

8.3 : Kinds of Companies :

From the point of view of formation of companies, can be divided into three classes viz.-

1. Chartered Companies,
2. Statutory Companies and
3. Registered Companies.

Again, the Registered Companies can be subdivided into three classes, viz.-

(i) Companies Limited by Shares,

(ii) Companies Limited by guarantees and

(iii) Unlimited Companies.

Moreover, each of the registered companies can be of two types viz.- Public Limited company and Private Limited company.

Chartered Companies :

These are the companies which are incorporated under a special charter granted by the King or Queen as in the case of England. The examples are the East India Company, the Bank of England etc. Such a company is governed by its charter which defines the nature and powers of the company, and at the same time incorporates it. Such companies have no place in India since independence.

Statutory Companies :

A company formed by a special Act passed either by the central or a state legislature is called Statutory Company. The examples of such companies are – Reserve Bank of India, State Bank of India, etc. Such companies are governed by their respective Acts and have no Memorandum or Articles of Association of their own. Such Companies are usually formed to carry out some special public undertakings. Public service becomes the primary object of such companies.

Registered Companies :

Companies formed by registration under the Companies Act, are known as registered companies. The working of such a company is regulated by the provisions of Companies Act in conjunction with its Memorandum of Association and Articles of Association.

Registered companies are of three kinds :-

(i) Companies limited by shares

(ii) Companies limited by guarantee and

(iii) Unlimited companies.

(i) Companies Limited by Shares :

This is a company where the liability of its members is limited by the Memorandum to the amount unpaid on the shares. If the shares are fully paid, the members have no further liability. This is the most common type of companies in India.

(ii) Companies Limited by Guarantee :

A company limited by guarantee is known as a guarantee company. A guarantee company is a company in which the liability of its members is limited by Memorandum to such an amount as the members may undertake by Memorandum of contribute to meet out the deficiency of the assets of the company in the event of its being wound up. Such a company may or may not have a share capital. If it has a share capital, the members have twofold liabilities viz.-

(a) The liability on the unpaid amount on the shares and

(b) The amount guaranteed.

Such companies are usually formed for non-profit making purposes.

(iii) Unlimited Companies :

An unlimited company is a company where the liability of its members is unlimited. It may or may not have share capital. The members are held liable for the deficiency of the assets to the liabilities of the company in proportion to the interest in the company. In such a case, the liabilities of the company may extend to the personal properties of the shareholders. Though a shareholders can be called upon to pay pro rata, still he is personally liable for the whole of the liabilities of the company like a partner. However, the creditors cannot sue a member directly. He must file a suit against the company first. Such companies are not popular in India.

Each of the registered companies may be either of the two kinds viz.-

(a) Private Company or (b) Public Company.

(a) Private Company :

A private company is one which by its Article of Association

(i) Restricts the right of the members to transfer shares,

(ii) Limits the number of its members to 50 excluding past or present employees of the company who were or are the members of the company.

(iii) Prohibits any invitation to the public to subscribe for its shares or debentures.

A Private Company can be registered with only two members. In this case if two or more persons jointly hold one or more shares, they are treated as one member. A private company is required to add the words "Private Limited" or Pvt. Ltd.

(b) Public Company :

A public company is a company which is not a private company. If the Articles of Association of a company does not contain the requisite restrictions to make it a private limited company, then it is a Public Limited Company. There must be at least seven persons to form a public company though it has no limitation to its maximum number. The shares of a public company are freely transferable. Such a company carries the word 'Limited' or 'Ltd.' at the end of its name.

8.4 : Other Kinds of Companies :

In addition to the above mentioned types of the registered companies, there are some other popularly known registered companies which are as mentioned below :

1. Government Company :

A government company is a registered company in which not less than 51% of the paid up share capital is held by the Central Government or any State Government or State Governments or partly by the Central Government and partly by one or more State Governments. It includes also a company which is a subsidiary of a Government Company.

2. Deemed to be a Public Company :

Section 43 A provides for private companies employing pubic capital to be treated as a Public Company if it fulfils any of the following conditions :

(i) If one or more body corporates hold 25% or more of its paid up share capital.

(ii) If the private company holds 25% or more of the paid up share capital of a public company.

(iii) If the company invites or renews deposits from the public, other than its members, relatives and directors.

(iv) If its average annual turnover during the preceding three consecutive financial years in not less than rupees five cores.

One Man Company :

A one man company means a company in which almost the entire amount of the share capital is held by one person and only a very few shares are allotted to other persons. Shares are allotted to other persons to fulfill the statutory requirements as regards the number of members only. In such a case, the other persons are usually the nominees of the dominant member (Saloman Vs Saloman & Co. Ltd.)

Foreign Company :

A company which is incorporated outside India but which has a place of business in India is known as a foreign company.

Holding and Subsidiary Company :

According to the Companies Act, 1956, a holding company may be defined as "Any company which directly or indirectly through the medium of another company, holds more than half of the equity share capital or other companies or controls the composition of the Board of Directors of other Companies."

A company shall be deemed to be a subsidiary of another if, but only

(a) The other company controls the composition of its Board of Directors;

(b) the other company (i) holds more than half of the nominal value of equity capital or (ii) if it is a company formed before 1st April, 1956 with both equity and preference shareholder equal voting rights, the other company controls more than half of the total voting power; or

(c) It is a subsidiary of any company which is a subsidiary of the other company

Thus a holding company is one which controls one or more other companies either by means of holding shares in that company or companies or by having power to appoint directly or indirectly the whole or majority of the Board of Directors of those companies. A company controlled by a holding company is known as a subsidiary company.

8.5 : Procedure of Forming a Company :

Under Section 12 of the Companies Act, any seven or more persons in case of a public limited company and two or more persons in case of a private company may associate and form an incorporated company with or without limited liability by subscribing their names to the Memorandum of Association.

(a) Promotion,

(b) Incorporation and

(c) Commencement of business.

Promotion :

The word promotion means materialization of an idea into action. The persons who conceive an idea for starting a business and materialize the idea into action are called promoters. They take all preliminary steps and incur necessary expenses for the formation of a company. Thus it includes the conception of an idea and the action for its materialization.

Incorporation :

It is the incorporation which brings a company into existence as a separate corporate entity. The promoters should file the following documents with required fees to the Registrar of Companies of the state in which the registered office of the company is to be situated.

The documents are :-

(i) Memorandum of Association,

(ii) Articles of Association,

(iii) A statement of the nominal capita and where it exceeds rupees twenty five lacs, a certificate from the controller of Capital Issues,

(iv) A notice of the address of the Registered office,

(v) A list of the persons who have consented to become directors of the company,

(vi) A written and duly signed consent of the directors agreeing to act as directors and to pay for qualification shares, if any,

(vii) The agreement, if any, which the company proposes to enter into with any individual for appointment as managing or whole time director,

(viii) A statutory declaration by any of the following persons that all the requirements of the law for registration have been duly complied with,

(a) An advocate of the Supreme Court or High Court.

(b) A secretary or a Chartered Accountant practicing in India and who is engaged in the formation of the company.

(c) An Attorney or a Pleader, entitled to appear before a High Court.

When the Registrar is satisfied that everything is in order, he will issue under his seal and signature a certificate of incorporation which gives the company a legal existence on the specified date. It is a conclusive proof that all the requirements of the Act have been complied with.

8.6 : Commencement of Business :

A private company can commence business immediately after its incorporation. But a public company before it can commence business exercise and borrowing power has to obtain from the Registrar a "Certificate of Commencement of Business". This certificate is issued only when the following conditions are fulfilled.

(1) A prospectus or a statement in lieu of prospectus has been filled with the Registrar.

(2) The minimum subscription has been raised.

(3) The directors have paid for their qualification shares.

(4) A declaration in the prescribed form, by the Secretary or one of the directors, that the aforesaid requirements have been compiled which has been filled with the Registrar.

8.7 : Important Concepts regarding Company :

8.7.1 Memorandum of Association :

The Memorandum of Association is the fundamental document which contains the fundamental rules regarding the constitution and activities of a company. It defines its constitution and objects, and lays down the conditions upon which it is allowed to be formed. Thus it is termed as the Charter or Constitution of a company. It governs the relationship of the company with the outside world. It contains the following clauses –

1. Name clause :

This clause contains the name of the company. The name of a company should not be similar with the name of an existing company. It should contain after its name the word "Limited" or 'Ltd.' in case of a public company and the words "Private Limited" or 'Pvt. Ltd.' in case of a private company.

2. Situation Clause :

This clause contains the name of the state in which the registered office of the company is situated.

3. Objects Clause :

This clause contains the objects for which the company has been formed. It defines and limits the scope of operation of the company.

4. Liability Clause :

This clause defines the liability of the members of the company.

5. Capital Clause :

This clause states the amount of share capital with which the company is to be registered and its division into shares of fixed amount. This is the maximum amount a company can raise from the public as capital.

6. Association Clause :

It states the persons who have signed the Memorandum for forming themselves into an association. They are usually called promoters.

8.7.2 Articles of Association :

The Articles of Association are a set of regulations of the company for its internal management. It contains regulations relating to the issue of share capital, the rights of the different classes of shareholders, the powers and duties of directors, the procedure for holding meetings of directors and shareholders, voting powers, etc. They also contain provisions for the following :

(a) Share Capital and its divisions, (b) Calls on Shares. (c) Underwriting Commission. (d) Alteration of Share Capital. (e) Transfer and Forfeiture of Shares. (f) Accounts and Audit. (g) Dividends and Reserves, etc.

8.7.3 Prospectus :

It is an invitation to the public to subscribe to its share capital. It usually states the number of shares offered by the company to the public, the amount to be payable along with the application for each share, the date when the shares will be allotted and the dates and mode of payment of various calls. Thus it is merely a notice to the public for subscription for any shares or debentures and not an offer of shares or debentures. This should be signed by all the directors and a copy of it should be filed with the Registrar for publication. It depicts an overall picture about the company and helps the investor in their decision making process.

8.7.4 Minimum Subscription :

Minimum subscription is the amount fixed by the Memorandum or Articles and mentioned in the prospectus as the least amount of shares which should be subscribed by the public before the allotment of shares is made. If no such amount is fixed, the whole of the capital offered for subscription must be subscribed by the public, the object of this provision is that sufficient capital is available for the requirements of the company before it commences its business. While fixing the minimum subscription, the following are to be considered :

1. Purchase Price of any property acquired or to be acquired.
2. Preliminary expenses.
3. Commission on shares.
4. Repayment of any money borrowed for the above purpose and
5. Working capital.

8.7.5 Shares :

The capital of a company is usually divided into certain indivisible units of a fixed amount known as "Shares". Under companies Act, 1956, a public company can issue two types of shares, viz., (a) equity share and (b) preference shares. A private company which is not a subsidiary of a public company can, however, issue any kind of shares.

Equity Shares – Equity shares are those which are not preference shares. These shares do not enjoy any preferential right in respect of dividend or repayment of capital. Dividend on these shares is paid at a rate recommended by the directors and declared by the company in general meeting.

Preference Shares – Preference shares are those shares which have (i) a preferential right on dividend to be paid at a fixed rate during the life time of the company, and (ii) a preferential right on capital to be repaid when the company goes into liquidation. Preference shares may be of several types :

(a) cumulative or non-cumulative, (b) participating or non-participating,
(c) redeemable or irredeemable, and (d) convertible or non-convertible.

Cumulative Preference Shares – In case of such shares if dividend in any year cannot be paid due to non-availability of profit, the holders are entitled to get such arrear dividend out of profits of subsequent year or years.

Non-cumulative Preference Shares – In case of such shares if dividend in year cannot be paid, the right to receive dividend for that year lapses, and holders are not entitled to get such arrear dividend out of profits of subsequent years.

Participating Preference Shares – The holders of these shares in addition to a fixed rate of dividend are entitled to share, with the equity shareholders, the balance of profits in some proportion after the rights of the equity shareholders have been reasonably met. These shareholders are sometimes also allowed to share in surplus assets on the company being wound up.

Non-participating Preference Shares – The holders of these shares are entitled to a fixed rate of dividend only and do not share in the surplus profits or assets which all go to the equity shareholders.

Redeemable Preference Shares – These shares, in addition to the preferential right in respect of dividend, enjoy the right to be redeemed, i.e. to be paid back on/or after certain date and/or at the option of the company.

Shares which are not redeemable are termed as irredeemable ones.

Convertible Preference Shares – These shares are given the right of conversion into equity shares within a specified period or up to a specified date.

The preference shares without such right of conversion are termed as non-convertible ones.

8.7.6 Stock :

Stock is simply a set of shares put together in a bundle. It is expressed in money instead of as so many shares. It is, so to say, the aggregate of fully paid-up shares, consolidated and divided for the purpose of convenient holding into different parts. It may be transferred or split up into fractions of any amounts without regard to the original face value of the shares. A company cannot make an original issue of stock; when shares are fully paid up, they can be converted into stock.

Stock and Shares – Distinction

The chief points of difference between stock and shares may be summarized below :

1. A share has a nominal value, whereas stock has no nominal value.
2. A share need not necessarily be fully paid up, but stock is always fully paid up.
3. A share is transferable as a whole, while stock can be transferred in sums of any amount.
4. All shares are of equal denomination. Stock may be of unequal amounts.
5. Shares are distinctively and serially numbered, whereas the stock does not have nay such number.
6. Shares can be directly issued to the public, but stock cannot be issued directly. Only fully paid-up shares can be converted into stock.
7. Stock may be registered or unregistered. In the case of unregistered stock, share warrants may be issued to holders which are transferable by delivery like negotiable instruments. Shares are always registered and not transferable by delivery.

8. A holder of shares is a member of the company and the share certificate is a prima facie evidence of title. On the contrary, the stock holder is not necessarily a member. If the articles of the company so provide, he may be deemed to be a member of the company for any purposes defined in the articles.

8.7.7 ***Entries on issue of Shares :***

(a) When the amount is payable in full along with application the entries will be as follows :

1. On receipt of money with application –
   Dr. Bank A/c
   Cr. Share Application and Allotment A/c
2. On allotment being made -
   Dr. Share Application and Allotment A/c
   Cr. Share Capital A/c.

(b) When the amount is payable in installments the entries will be as follows :

1. On receipt of application money –
   Dr. Bank A/c
   Cr. Share Application A/c
2. On allotment being made -
   (i) For transfer of application money –
   Dr. Share Application A/c
   Cr. Share Capital A/c
   (ii) For allotment money becoming due –
   Dr. Share Allotment A/c
   Cr. Share Capital A/c
3. On receipt of allotment money -
   Dr. Bank A/c
   Cr. Share Allotment A/c
4. On making a call -
   Dr. Share Call A/c
   Cr. Share Capital A/c
5. On receipt of call money -
   Dr. Bank A/c
   Cr. Share Call A/c.

Note : In actual practice all cash transactions will be passed through the Cash Book and other transactions through the Journal.

In actual practice, shares offered to the public for subscription are under or over-subscribed. When the number of shares applied for by the public is less than the number offered for subscription, it is a case of under-subscription. In such a case, if there is no underwriting arrangement the company will have to content itself with the number of applications received and proceed with allotment provided the minimum subscription has been raised. Consequently, entries will be made on the basis of shares applied for.

When the number of shares applied for by the public is more than the number offered for subscription, it is a case of over-subscription. In such a case, allotment cannot exceed the number of shares offered for subscription. Excess application money may be refunded to the applicants for which the following entry will be made –

Dr. Share Application A/c

Cr. Bank A/c

(Treatment of excess applications has been discussed in detail subsequently)

8.7.8 Issue of shares at a Premium :

A company has power to issue shares at a premium, that is, at a price greater than its face value. Sec. 78 of the Companies Act requires the amount of the premium received to be credited to a separate account. The premium for all practical purposes is to be treated as part of the paid-up capital of the company and the provisions of the Act relating to reduction of share capital will be applicable thereto.

According to the same Sec. the share premium account may be utilized by the company for one or more of the following specific purposes :

(1) in paying up unissued shares of the company to be issued to members of the company as fully paid bonus shares,

(2) in writing off the preliminary expenses of the company,

(3) in writing off the expenses of, or commission paid or discount allowed on, issue of shares or debentures of the company,

(4) in providing for the premium payable on the redemption of any redeemable preference shares or any debentures of the company.

The balance of the share premium account is shown on the liabilities side of the Balance Sheet under "Reserves and Surplus".

Entries for recording premium :

Share premium may be payable with application money or with allotment money or partly with application money and partly with allotment money. The entry of recording premium is as under –

(a) When premium is payable with application money -

Dr. Share Application A/c

Cr. Share Capital A/c

Cr. Share Premium A/c

(b) When premium is payable with allotment money –

Dr. Share Allotment A/c

Cr. Share Capital A/c

Cr. Share Premium A/c

8.7.9 Issue of Share at a Discount :

Under Sec. 79 of the Companies Act, a company can issue shares at a discount, that is, at a price less than its face value, only if the following conditions are fulfilled :

(1) The shares to be issued at a discount must be of a class already issued.

(2) The issue must be authorized by a resolution passed by the company in general meeting and sanctioned by the Company Law Board.

(3) The resolution must specify the maximum rate of discount at which the shares are to be issued. But the rate should in no case exceed 10% or such higher percentage as the Company Law Board may permit in any special case.

(4) The issue takes place at least after one year from the date on which the company was entitled to commence business.

(5) The issue must be completed with two months from the date on which the issue is sanctioned by the Board of within such extended time as the Board permits.

(6) Every prospectus relating to the issue of shares must show particulars of the discount allowed and so much thereof as has not been written off at the date of issue of the prospectus.

The discount on shares till the same is completely written off, is shown on the assets side of the Balance Sheet under "Miscellaneous Expenditure".

Entry for recording discount :

The entry for discount, which is usually made at the time of making entry for allotment, is as under –

Dr. Share Allotment A/c

Dr. Discount on Shares A/c

Cr. Share Capital A/c

Illustration 1: Re : Issue of shares at premium and discount

A limited company issued 1,00,000 Equity Shares of Rs.10 each at a premium of Rs. 2 per share and 10,000 5% Preference Shares of Rs.100 each at a discount of 5% payable as follows :

	Equity Shares	Preference Shares
	Rs.	Rs.
On Application	2	20
On Allotment	5 (including premium)	30
On 1st call	3	25
On Final call	2	20

All the shares offered were subscribed by the public and cash duly received.

Make the necessary Journal and Cash Book entries.

Solution : **Cash Book** (Dr. side includes)

		Rs.
To Equity Share Application A/c (Application money received on 1,00,000 Equity Shares @ Rs. 2 per share)	...	2,00,000
" Preference Share Application A/c (Application money received on 10,000 Preference Share @ Rs.20 per share)	...	2,00,000
" Equity Share Allotment A/c (Allotment money received on 1,00,000 Equity Shares @ Rs.5 per share)	...	5,00,000
" Preference Share Allotment A/c (Allotment money received on 10,000 Preference Shares @ Rs.30 per share)	...	3,00,000
" Equity Share 1st Call A/c (1st call money received on 1,00,000 Equity Shares @ Rs.3 per share)	...	3,00,000
" Preference Share 1st Call A/c (1st call money received on 10,000 Preference Shares @ Rs.25 per share)	...	2,50,000
" Equity Share final Call A/c (Final call money received on 1,00,000 Equity Shares @ Rs.2 per share)	...	2,00,000
" Preference Share Final Call A/c (Final call money received on 10,000 Preference Shares @ Rs.20 per share)	...	2,00,000

Journal

			Rs.	Rs.
?	Equity Share Application A/c ... Dr.		2,00,000	
	To Equity Share Capital A/c			2,00,000
	(Transfer of application money to Equity Share Capital A/c on allotment of 1,00,000 Equity Shares as per Board's Resolution dated...)			
	Preference Share Application A/c ... Dr.		2,00,000	
	To 5% Preference Share Capital A/c			2,00,000
	(Transfer of application money to 5% Preference Share Capital A/c on allotment of 10,000 Preference Share as per Board's Resolution Date)			
	Equity Share Allotment A/c ... Dr.		5,00,000	
	To Equity Share Capital A/c			3,00,000
	" Share Premium A/c			2,00,000
	[Allotment money of Rs. 5 per share (Rs. 2 thereof being premium) due on 1,00,000 Equity Shares as per Board's resolution dated ....]			
	Preference Share Allotment A/c ... Dr.		3,00,000	
	Discount on Shares A/c ... Dr.		50,000	
	To 5% Preference Share Capital A/c			3,00,000
	(Allotment money of Rs.30 per share due on 10,000 Preference Shares as per Board's Resolution dated...., the discount of Rs. 5 per share adjusted therewith)			
	Equity Share 1st Call A/c ... Dr.		3,00,000	
	To Equity Share Capital A/c			3,00,000
	(1st call money of Rs.3 per share due on 1,00,000 Equity Shares as per Board's resolution Dated...)			
	Preference Share 1st Call A/c ... Dr.		2,50,000	
	To 5% Preference Share Capital A/c			2,50,000
	(1st call money of Rs.25 per share due on 10,000 Preference Share as per Board's Resolution dated....)			
	Equity Share Final Call A/c ... Dr.		2,00,000	
	To Equity Share Capital A/c			2,00,000
	(Final call money of Rs.2 per share due on 1,00,000 Equity Shares as per Board's Resolution dated....)			
	Preference Share Final Call A/c ... Dr.		2,00,000	
	To 5% Preference Share Capital A/c			2,00,000
	(Final call money of Rs.20 per share due on 10,000 Preference Shares as per Board's Resolution dated...)			
	Share Premium A/c ... Dr.		50,000	
	To Discount on Shares A/c			50,000
	(Discount allowed on issue of shares written off against Share Premium Account as per Board's Resolution dated....)			

8.8 : Class-In-Arrear

Sometimes amounts due on allotment or calls are not received from the shareholders within specified time. The Allotment and Call Accounts in such circumstances will show debit balances representing the unpaid amounts. The total of unpaid amounts on account of various installments is known as "Calls-in-Arrear". This amount may be debited to a "Calls-in-Arrear A/c" and credited to the Allotment or particular Call Accounts or it may remain as debit balances in the Allotment and Call Accounts themselves. Calls-in-Arrear should appear in the Balance Sheet by way of deduction from Subscribed Capital.

Directors are usually authorized, under the Articles, to charge interest on Calls-in-Arrear at the rate mentioned in the Articles. Directors, however, have the right to waive the interest wholly or in part.

8.9 : Calls-In-Advance :

When a shareholder pays with an installment more than the amount called for, the excess amount so received is known as "Calls-in-Advance." Calls-in-Advance can be accepted by a company only when it is authorized by the Articles. Calls received in advance are not entitled to dividend but interest my be paid thereon at a rate not exceeding 6% p.a.

Call received in advance should be credited to a Calls-in-Advance A/c. in case of a subsequent call, the Calls-in-Advance should be shown in the Balance Sheet as a separate item under "Share Capital" and should not be added to the amount of Subscribed Capital.

Illustration 2 :

Complex Ltd. Was registered with a nominal capital of Rs. 5,00,000 in shares of Rs. 100 each 3,000 of which were issued payable as to Rs. 12.50 on application, Rs. 12.50 on allotment, Rs. 25 three months after allotment and the balance to be called up as and when required. All moneys up to holding 100 shares did not pay the amount due. Another shareholder who was allotted 150 shares paid them up in full.

Show the necessary Journal entries to record the above transactions (including cash) and show how the capital should appear on the Balance Sheet.

Journal of Complex Ltd.

			Rs.	Rs.
?	Bank A/c .... Dr. To Share Application A/c (Application money received for 3,000 shares @ Rs.12.50 per share)		37,500	37,500
	Share Application A/c ..... Dr. To Share Capital A/c (Transfer of application money to Share Capital A/c on allotment of 3,000 shares as per Board's Resolution dated....)		37,500	37,500
	Share Allotment A/c ..... Dr. To Share Capital A/c (Allotment money of Rs. 12.50 per share due on 3,000 shares as per Board's Resolution dated....)		37,500	37,500

	Bank A/c ...... Dr. To Share Allotment A/c (Allotment money received on 3,000 shares @ Rs. 12.50 per share)	37,500	37,500
	Share 1st Call A/c ..... Dr. To Share Capital A/c (1st call money of Rs. 25 per share due on 3,000 shares as per Board's Resolution dated....)	75,000	75,000
	Bank A/c ..... Dr. To Share 1st Call A/c : 2,900 x 25 " Calls-in-Advance A/c : 150x 50 (1st call money received on 2,900 shares @ Rs.25 per share and Calls-in-Advance received on 150 shares @ Rs.50 per share)	80,000	72,500 7,500

Note : If Calls-in-Arrear A/c is opened, the entry will be :

Calls-in-Arrear A/c (Rs.25 x 100) ... Dr. Rs. 2,500
To Share 1st Call A/c Rs.2,500
(Arrear on 1st Call transferred)

Balance Sheet of Complex Ltd.

As at .... (includes)

Liabilities Side		Rs.
Share Capital :		
Authorized –		
5,000 shares of Rs. 100 each		5,00,000
Issued –		
3,000 shares of Rs. 100 each		3,00,000
Subscribed –		
3,000 shares of Rs. 100 each, Rs. 50 per share called-up	1,50,000	
Less : Calls-in-Arrear	2,500	1,47,500
Calls-in-Advance		7,500

8.10 : Forfeiture and Re-issue of Shares :

Forfeiture of shares means compulsory termination of membership and confiscation of the shares by way of penalty for non-payment of any call, installment or premium on shares.

A company may forfeit the shares of a member only if it is expressly authorized by he articles to do so. Forfeiture is possible only for non-payment of calls due in respect of the shares. For no other debt the shares can be forfeited. The usual procedure for the forfeiture of shares is as follows :

(1) The Board must serve a notice of the defaulting members requiring them to pay the outstanding calls together with any interest that may have accrued.

(2) The notice must name a further day (not earlier than 14 days) on or before which the required payment is to be made.

(3) The notice must state that the shares in question will be liable to be forfeited if payment of the amount is not made within the specified time.

(4) If the requirements of the above notice are not complied with, the Board may pass a resolution forfeiting the shares.

It may be noted that forfeiture will be valid only if the formalities laid down in the articles are scrupulously observed. Any irregularity in this respect will avoid the forfeiture.

Subsequent to forfeiture, the Board may re-issue the shares subject to the following conditions :

(1) The price charged must not be less than the amount that was in arrear when the shares were forfeited. The law thus permits the re-issue of forfeited shares at a discount provided that the discount does not exceed the forfeited amount.

(2) The Board my pass a resolution sanctioning the re-issue of forfeited shares.

The balance of forfeited shares account is shown on the liabilities side of the Balance Sheet by way of addition to subscribed capital until the shares are re-issued. Any amount remaining in the forfeited shares account after the re-issued. Any amount remaining in the forfeited shares account after the re-issue is a capital profit and should be transferred to Capital Reserve.

Entries on Forfeiture and Re-issue

1. On Forfeiture

Dr. Share Capital A/c – No. of shares forfeited x called-up value per share.

Cr. Different Call A/cs-amount outstanding on such calls.

Cr. Forfeited Shares A/c-amount already received on the shares which are being forfeited.

2. On Re-issue

(a) Dr. Bank – amount received on re-issue

Dr. Forfeited Shares A/c – amount of discount of re-issue

Cr. Share Capital A/c – amount of nominal value considered as paid up.

Note : If the re-issue is at a premium, Forfeited Shares A/c will not be debited but Share Premium A/c will be credited with the amount of premium.

(b) Dr. Forfeited Shares A/c Profit remaining in the Forfeited Shares

Cr. Capital Reserve A/c after re-issue

Illustration 3;

Re : Forfeiture and Re-issue of Shares

The Directors of a company with a subscribed capital of 20,000 Equity shares of Rs. 25 each and 20,000 Preference Shares of Rs. 25 each on both of which Rs. 20 per share were called up, forfeit 200 Equity Shares held by A on which he had failed to pay first and second calls of

Rs. 5 per share each. They also forfeit 400 Preference Shares of B who failed to pay Rs. 5 per share on allotment, Rs. 5 per share on first call and Rs. 5 per share on second call. The Directors further re-issued the forfeited share of A at Rs. 15 per share and those of B at Rs. 17.50 per share, all of which were taken up and paid by C.

Pass the necessary Journal entries to record the above transactions in the books of the company. (Cash transactions are to be journalized.)

Journal of .... Co. Ltd.

			Rs.	Rs.
?	Equity Share Capital A/c' (Rs. 20x200) Dr. To Equity Share 1st Call A/c (Rs.5x200) " Equity Share 2nd Call A/c (Rs.5x200) " Forfeited Shares A/c (Rs.10x200) (Forfeiture of 200 Equity Share on which 1st call and 2nd call were due as per Board's Resolution dated......)		4,000	 1,000 1,000 2,000
	Preference Share Capital A/c² (Rs. 20x400) Dr. To Preference Share Allotment A/c (Rs. 5x400) " Preference Share 1st Call A/c (Rs. 5x400) " Preference Share 2nd Call A/c (Rs.5x400) " Forfeited Share A/c (Rs.5x400) (Forfeiture of 400 Preference Shares n which allotment, 1st call and 2nd call were due as per Board's Resolution dated.....)		8,000	 2,000 2,000 2,000 2,000
	Bank A/c (Rs. 15x 200) Dr. Forfeited Share A/c (Rs.5x200) To Equity Share Capital A/c (Rs.20x200) (Re-issue of 200 forfeited Equity Shares as Rs. 20 per share paid up at Rs.15 per share as per Board's Resolution dated....)		3,000 1,000	 4,000
	Bank A/c (Rs. 17.50x 400) Dr. Forfeited Share A/c² (Rs2.50x400) To Preference Share Capital A/c (Rs.20x200) (Re-issue of 400 forfeited Preference Shares as Rs. 20 per share paid up at Rs.17.50 per share as per Board's Resolution dated....)		7,000 1,000	 8,000
	Forfeited Shares A/c Dr. To Capital reserve A/c² (Profit remaining after re-issue of forfeited shares transferred to Capital Reserve)		2,000	 2,000

8.11 : Over-Subscription and Pro-Rata Allotment :

In case of over-subscription the company will allot only that number shares which it has offered to the public for subscription. Hence the company may make a pro-rata (i.e., proportionate) allotment or it may make a full allotment of some applicants, a partial allotment of others and no allotment whatever to the rest.

If an applicant is not allotted any share, his application money is refunded. On such refund the following entry is made –

Dr. Share Application A/c
Cr. Bank

If some applicants are allotted a smaller number of shares than what they applied for, the excess application money paid by them will not be refunded but will be retained for adjustment towards the amounts due from them on account of allotment or calls. On such adjustment the following entry is made –

Dr. Share Application A/c
Cr. Share Allotment A/c
Cr. Share Call A/c

After making such adjustment if still some surplus amount remains, the same is returned to the applicants. On allotment, the shareholder will pay the amount payable on allotment less the amount already adjusted towards allotment. Similarly on all, the shareholder will pay the amount payable on call less the amount already adjusted towards the call.

In case of partial or pro-rata allotment calculation of calls-in-arrear poses a little difficulty. The arrear is determined after considering the amount already adjusted. For this purpose adjustment pre share is calculated by dividing the amount adjusted towards allotment or call by the number of shares over which adjustment is made. Now the amount adjusted per share towards allotment / call is deducted from the amount payable per share on allotment / call and this represents the arrear per share on allotment / call.

Illustration 4 :

Assam Jute Mill Ltd. Issued 40,000 equity shares of Rs.10 each, payable as Rs.2 on application, Rs.2 on allotment, Rs.3 each on first call and second and final call respectively. Applications were received for 50,000 shares. The company allotted the shares on pro-rata basis and adjusted the excess application money against allotment money. The shares were called and paid up to the first call.

Give Journal Entries, Cash Book and Balance Sheet of the Company :

Solution : **In the books of Assam Jute Mill Ltd.**

Journal Entries

Date	Particulars	L/F	Dr. Rs.	Cr. Rs.
?	Equity Share Application A/c Dr. To Equity Share Capital A/c (40,000xRs.2) (Being share application money @ Rs.2 each on 40,000 shares allotted on pro-rata in the ratio of 4:5, transferred to capital account as per Board's Resolution No ……dated………)		80,000	80,000
?	Equity Share Allotment A/c (40,000 x Rs.2) Dr. To Equity Share Capital A/c (Being share allotment money @ Rs.2 each on 40,000 shares made due as per Board's Resolution No ……… dated……..)		80,000	80,000
?	Equity Share Application A/c Dr. To Equity Share Allotment A/c (10,000 x Rs.2) (Being excess application money @ Rs.2 each on 10,000 application transferred to share allotment account as per Board's resolution No…..dated…..)		20,000	20,000
?	Equity Share First Call A/c (40,000 x Rs.3) Dr. To Equity Share Capital A/c (Being share first call money @ Rs.3 each on 40,000 shares made due as per Board's Resolution No…..dated…..)		1,20,000	1,20,000

Cash Book

Date	Particulars	J.F.	Rs.	Date	Particulars	J.F.	Rs.
?	To equity Share Application A/c (50,000 x Rs.2) (Being the application money @Rs.2 each on 50,000 applications received)		1,00,000				
?	To Equity Share Allotment A/c (Rs.40,000x2-- Rs.20,000) (Being share allotment money @ Rs.2 each on 40,000 shares Rs.20,000 received)		60,000				
?	To Equity Share First Call A/c (40,000xRs.3) (Being the first call money @ Rs.3 each on 40,000 shares received)		1,20,000	?	By Balance c/d		2,80,000
			2,80,000				2,80,000
?	To Balance b/d		2,80,000				

Note :

Allotment of Shares : 40,000 shares had been allotted among the applicants for 50,000 shares. Therefore, the ratio had been 40,000 : 50,000 i.e. 4 : 5. The excess application money on 10,000 applications had been utilized in allotment and the share holders were required to pay (10,000xRs.2) Rs. 20,000 less on allotment.

Balance Sheet of Assam Jute Mill Ltd. as on....

Liabilities	Rs.	Assets	Rs.
Share Capital :		**Fixed Assets :**	?
Authorized :		**Current Assets :**	
...No of equity shares of Rs.10 each	?	Cash at Bank	2,80,000
Issued and subscribed :			
40,000 equity shares of Rs.10 each	4,00,000		
Called up and paid up :			
40,000 equity shares of Rs.10 each. Rs.7 per share called and paid.	2,80,000		
	2,80,000		2,80,000

Exercises :

1. Kamrup Company Ltd. Was registered with an authorized capital of Rs. 3,00,000 divided into 20,000 shares of Rs. 15 each. The shares were issued to the public, payable per share Rs.3 on application, Rs.5 on allotment and the balance in two called of Rs.3.50 each. All application, allotment and first call moneys were received. With regard to the final call, one shareholder 100 shares failed to pay the call money. Prepare Journal, Cash Book and Balance Sheet of the company.

2. Assam Metal traders Ltd. issued 1,00,000 shares of Rs.10 each payable Rs.3 on application, Rs.5 on allotment and Rs.2 on call. Sanju holding 5,000 shares failed to pay allotment and call money. Raju holding 8,000 shares failed to pay call money.

These shares are forfeited and subsequently re-issued as fully paid at a discount of Rs.2, per share. Give Journal entries recording the above transactions.

UNIT–IX COMPANY ACCOUNTS :
Accounting for Debentures

9.1 : Meaning of Debentures :

Borrowing is incidental to business. As such, every commercial or trading company has an implied power to borrow money. In case of non-trading companies, however, there is no such implied power. The Memorandum of Association of a non-trading company must lay down such power to enable it to borrow. The power to borrow is generally exercised by the Board of Directors.

The usual way in which a company borrows money is by issuing debentures. Debenture means a document which either creates a debt or acknowledges it. According to the Companies Act, 1956, debenture includes debenture stock, bonds and any other securities of a company, whether constituting a charge on the assets of the company or not. Sec. 2 (12)

9.1.1 Kinds of debentures :

Debentures may be of following kinds :

1. **Registered debentures** – These debentures are payable to the registered holders who cannot negotiate their holdings, except according to the procedure as laid down in the law.
2. **Bearer debentures** – These debentures are payable to the bearer thereof. They are transferable by mere delivery and are regarded as negotiable instruments. Bearer debentures are also known as unregistered debentures.
3. **Secured or Mortgage debentures** – These debentures are secured by a charge on the assets of the company. In case of default the creditors can make good their dues for the assets charged. The charge may be a fixed or a floating charge.
4. **Simple, naked or unsecured debentures** – These debentures do not have any charge on the assets of the company. They rank as ordinary creditors of the company in liquidation.
5. **Redeemable debentures** – These debentures are repayable after a stated period.
6. **Irredeemable debentures** – These debentures are not repayable during the life-time of the company issuing them, and are also known as perpetual debentures. They become

redeemable when the company goes into liquidation. They also become redeemable in case of serious default on the part of the company, e.g., non-payment of interest.

7. **Convertible debentures** – These debentures are convertible at the option of the holder into shares at stated rates of exchange within or after a certain period.

9.1.2 Entries on Issue of Debentures :

(a) When the amount is payable in installments, entries will be similar as in the case of issue of shares. Premium or discount on issue is, usually adjusted at the time of making entries for allotment.

(b) When the amount is payable in full at a time the entries will be as follows :

1. When debentures are issued at par and are also redeemable at par –

   Dr. Bank A/c

   Cr. Debentures A/c-face value

2. When debentures are issued at a premium, but are redeemable at par -

   Dr. bank A/c-amount received

   Cr. Debentures A/c-face value

   Cr. Premium on Debentures A/c-premium

3. When debentures are issued at a discount, but are redeemable at par -

   Dr. Bank A/c-amount received

   Dr. Discount on Debentures A/c-discount

   Cr. Debentures A/c – face value

4. When debentures are issued at par, but are redeemable at a premium-

   Dr. Bank A/c-amount received

   Dr. Loss on Issue of Debentures A/c – premium payable on redemption.

   Cr. Debenture A/c –face value

   Cr. Premium on Redemption of Debentures A/c-premium payable on redemption.

5. When debentures are issued at a discount, but are repayable at a premium -

   Dr. Bank A/c-amount received

   Dr. Loss on Issue of Debentures A/c-discount on issue plus premium on redemption.

   Cr. Debentures A/c-face value

   Cr. Premium on redemption of Debentures A/c Premium payable on redemption.

9.1.3 Debentures Issued as Collateral Security :

Sometimes a company issues its own debentures as a collateral or additional security in addition to other securities against a loan taken from a bank or any other party. The company incurs no liability against these debentures so long as they remain as additional security. On repayment of the loan the debentures are cancelled. These debentures can, however, be treated as real debentures in the event of default in repayment of the loan, or in the event of liquidation or other event specified in the loan agreement.

No entry is required to be made in the books of the company in respect of issue of debentures as collateral security. Only a note in this respect is given on the Balance Sheet under the loan thus secured.

If, however, it is desired to record such transaction in the books of the company, the following entry will be made :

Dr. Debenture Suspense A/c

Cr. Debentures A/c

Debenture Suspense A/c will be shown on the assets side of the Balance Sheet or on the liabilities side by way of deduction from Debentures A/c. on repayment of the loan the entry will be reversed.

9.1.4 *Writing off Discount etc. on Issue of Debentures :*

Discount or loss on issue of debentures or the cost of issue of debentures should not be completely written off in the year in which the debentures are issued, since the benefit to be derived from the amount borrowed by such an issue will continue till the debentures are redeemed.

If the debentures are repayable at the end of a fixed period, an equal amount of the discount etc. should be written off against Profit and Loss A/c every year during which the debentures are outstanding since each of these years enjoys the benefit derived from the issue of debentures equally.

If, however, the debentures are repayable by installments, the amount to be written off each year against Profit and Loss A/c should be in proportion to the amount of debentures outstanding, so that the years which have the largest benefit from the debentures also bear the largest proportion.

9.1.5 *Interest on Debentures :*

Interest payable on debentures constitutes a charge against profits and it is to be paid whether there are profits or not. Income-tax is required to be deducted at the prescribed rate before paying interest to debenture-holders. The income-tax so deducted is to be handed over to the Government to the credit of the debenture-holders.

On payment of debenture interest the following entry is made –

Dr. Debenture Interest A/c

Cr. Bank A/c.

Illustration 1: -

Show by means of journal entries how you will record the following issues. Also show how they will appear in their respective Balance Sheets.

(i) A Ltd. issues at par 5,000 14% Debentures of Rs. 100 each repayable also at par.

(ii) B Ltd. issues at par 5000 14% Debentures of Rs. 100 each at a discount of 5% to be repaid at par at the end of 5 years.

(iii) C Ltd. issues 12% Debentures of the total face value of Rs.10,00,000 at 105% to be redeemed at par.

(iv) D Ltd. issues Rs. 4,00,000 Debentures (13%) at part but redeemable at the end of 10 years at 105%.

(v) E Ltd. issues Rs. 5,00,000 Debentures (14%) at a discount of 5% repayable at a premium of 10% at the end of 5 years.

Solution :

(i) Journal of A Ltd.

	Bank A/c --- Dr. To 14% Debentures A/c (Issue of 5000 14% debentures of Rs.100 each at par as per Board's Resolution dated...)	Rs. 5,00,000	Rs. 5,00,000

Balance Sheet of A Ltd. as at ......(includes)

Liabilities	Rs.	Assets	Rs.
Secured Loans :			
14% Debentures	5,00,000		

(ii) Journal of B Ltd.

			Rs.	Rs.
	Bank A/c : 7000x95 --- Dr.		6,65,000	
	Discount on Debentures A/c 7000x5 Dr.		35,000	
	To 15% Debentures A/c			7,00,000
	(Issue of 7000 15% debentures of Rs.100 each at a discount of 5% as per Board's Resolution dated.....)			

Balance Sheet of B Ltd. as at ......(includes)

Liabilities	Rs.	Assets	Rs.
Secured Loans :		Miscellaneous Expenditure:	
15% Debentures	7,00,000	Discount on Debentures	35,000

(iii) Journal of C Ltd.

			Rs.	Rs.
	Bank A/c : --- Dr.		10,50,000	
	To 12% Debentures A/c			10,00,000
	" Premium on Debentures A/c			50,000
	(Issue of Rs.10,00,000 12% debentures at a premium of 5% as per Board's Resolution dated.....)			

Balance Sheet of C Ltd. as at ......(includes)

Liabilities	Rs.	Assets	Rs.
Reserves & Surplus :			
Premium on Debentures	50,000		
Secured Loans :			
12% Debentures	10,00,000		

(iv) Journal of D Ltd.

			Rs.	Rs.
	Bank A/c : --- Dr.		4,00,000	
	Loss on Issue of Debentures A/c		20,000	
	To 13% Debentures A/c			4,00,000
	" Premium on Redemption of Debentures A/c			20,000
	(Issue of Rs.4,00,000 13% debentures at par redeemable at 105% as per Board's Resolution dated.....)			

Balance Sheet of D Ltd. as at ......(includes)

Liabilities	Rs.	Assets	Rs.
Secured Loans : 13% Debentures	4,00,000	Miscellaneous Expenditure : Loss on Issue of Debentures	20,000
Current liabilities & Provisions : Premium on Redemption of Debentures.	20,000		

(v) Journal of E Ltd.

		Rs.	Rs.
	Bank A/c : --- Dr.	4,75,000	
	Loss on issue of Debentures A/c --- Dr.	75,000	
	To 14% Debentures A/c		5,00,000
	" Premium on Redemption of Debentures A/c		50,000
	(Issue of Rs.5,00,000 4% debentures at a discount at 5% and repayable at a premium of 10% as per Board's Resolution dated.....)		

Balance Sheet of E Ltd. as at ......(includes)

Liabilities	Rs.	Assets	Rs.
Secured Loans : 14% Debentures	5,00,000	Miscellaneous Expenditure : Loss on Issue of Debentures	75,000
Current liabilities & Provisions : Premium on Redemption of Debentures.	50,000		

9.2 : Capitalization of Profit (Bonus Shares) :

Successful companies do not usually approach the market for new capital. They build up their own resources and when their operations call for additional capital, they can avoid dependence upon prevailing market conditions or outside factors. Capitalization of profits is a process by which profits are permanently acquired for the purpose of the company and it is one of the important methods of accumulating capital and financing industry, and is popularly known as 'ploughing back of profits.'

The profits retained are capitalized, i.e. added permanently to the profits which could have been distributed to the equity shareholders. Bonus shares do not (as is sometimes erroneously supposed) represent a gift, since the effective capital of the company is not increased, nor is the shareholders' interested therein. The effect is simple to acknowledge that the reserves are no longer intended to be or capable of being distributed, and to bring the share capital into line with the capital actually employed.

Advantages of the issue of bonus shares

From the point of view of company –

a) Profits can be distributed without disturbing the liquid position of the company.

b) The disparity between effective capital and actual capital will be eliminated and thus the Balance Sheet will reflect the true position of the company.

c) The rate of dividend will come down to a normal level on account of distribution over an increased number of shares and thereby avoiding resentment either from the workers for increased wages or from the customers for reduced price.

From the point of view of shareholders –

(1) The shareholders receive profits without affecting the company's liquid position; and they can, if they so desire, convert their shares into cash by sale in the market, usually at a high premium.

(2) The shareholders are provided with an opportunity to invest their income in a prosperous company which they cannot hope to get in the market except at a high premium.

(3) If the bonus is applied in extinguishing liability in respect of uncalled capital, the shares will become fully paid-up without involving the shareholders to pay further cash.

(4) The shareholders are not required to pay any income-tax which they would have to pay had the dividend been paid in cash.

Disadvantages of the issue of bonus share

From the point of view of company –

If it is desired to maintain the same rate of dividend after the bonus issue, correspondingly increased profits must have to be earned.

From the point of view of shareholders –

(1) Unless there is increase in profit, the rate of dividend is likely to fall although the total dividend income may be the same as before.

(2) If the rate of dividend cannot be maintained, the market value of the shares will fall.

(3) Issue of bonus shares may encourage speculation in the company's shares resulting into wide fluctuation in their market value which is disliked by an investing shareholder.

Guidelines for issue of bonus shares prescribed by the Central Government

A company cannot issue bonus shares unless, permission of the Controller of Capital issues is obtained under the Capital Issues Control Act, 1947, regardless of the amount involved.

All applications of bonus issue should be signed by a person not below the rank of director/secretary together with a certificate indicating that the information furnished in true and correct and that all the data required in the application form and the guidelines have been furnished.

A certificate from the auditor of the company indicating that the guidelines for the issue of bonus shares prescribed by the Government from time to time are fully met by the company and that all the data furnished in the application is true and correct to the best of his knowledge and information should be annexed to the application.

The following are the guidelines to be taken into consideration by the Controller of Capital Issues while grating permission for issue of bonus shares :

(1) There should be a provision in the Articles of Association of the company for capitalization of reserves etc. If not, the company should produce a resolution passed at the general body meeting making provisions in the Articles of Association for capitalization.

(2) Consequent to the issue of bonus shares, if the subscribed and paid up capital exceeds the authorized capital, resolution passed at the general body meeting in respect of increase in the authorized capital is necessary.

(3) The company should furnish a resolution passed at the general body meeting for bonus issue before an application is made to the Controller of Capital Issues. In the general body resolution, the management's intention regarding the rate of dividend to be declared in the year immediately after the bonus issue should be indicated.

(4) The bonus issue is permitted to be made out of free reserves built out of the genuine profits or share premium collected in cash only.

(5) Reserves created by revaluation of fixed assets are not permitted to be capitalized.

(6) Development rebate reserve/Investment allowance reserve is considered as free reserve for the purpose of calculation of residual reserves test and is also allowed to be capitalized.

(7) The residual reserves after the proposed capitalization should be at least 40 per cent of the increased paid-up capital.

(8) All contingent liabilities disclosed in the audited accounts which have a bearing on the net profits, shall be taken into account in the calculation of the minimum residual reserves of 40 per cent.

(9) Thirty per cent of the average profits before tax (but after providing for preference dividend, if any) of the company for the previous three years should yield a rate of dividend on the expanded equity capital base of the company at 10 per cent.

(10) Declaration of bonus issue in lieu of dividend is not allowed

(11) The company may make a further application for issue of bonus shares only after 36 months from the date of sanction by the Government of an earlier bonus issue, if any.

(12) Bonus issues are not permitted unless the partly paid shares, if any existing, are made fully paid-up.

(13) No bonus issue will be permitted if there is sufficient reason to believe that the company has defaulted in respect of the payment of statutory dues of the employees such as contribution of provident fund, gratuity, bonus etc.

(14) Capital reserves appearing in the balance sheets of the companies as a result of revaluation of assets or without accrual of cash resources will neither be allowed to be capitalized nor taken into account in the computation of the residual reserves of 40 per cent for the purpose of bonus issue.

(15) At any one time the total amount permitted to be capitalized for issue of bonus share out of free reserves shall not exceed the total amount of paid-up equity capital of the company.

(16) Applications for issue of bonus shares should be made within one month of the bonus announcement by the board of directors of the company.

(17) In cases where there is any default in the payment of any term loans outstanding to any public financial institutions, a non-objection letter from that institution in respect of the issue of bonus shares should be furnished by the companies concerned with the bonus issue application.

Right Shares

Under Sec. 81(1) of the Companies Act when a company proposes to increase the subscribed capital by allotment of further shares, such shares must be offered to the present equity shareholders on pro-rata basis. The offer shall be made through letters of right. These shares are called 'Right Shares'. An existing shareholder has the right of renunciation of the offer in favour of his nominee unless otherwise provided in the articles.

As per Sec. 81(1A) the new shares may be offered to outsiders if (i) a special resolution is passed to that effect, or (ii) an ordinary resolution is passed to that effect and approval of the Central Government is obtained on the ground that such offer to the outsiders is most beneficial to the company.

Distinction between Bonus Shares and Right Shares

a) Bonus shares are issued free of cost while right shares are issued against payment.
b) Bonus issue does not enhance the resources of the company although it enhances the dividend responsibility; but right issue enhances both.
c) From the point of view of shareholders bonus issue does not make any material change so far as their earnings are concerned unless the same rate of dividend is continued after the bonus issue. Right issue enhances the resources and hence the income of the company.
d) For bonus issue there must be a specific provision in the Articles, for right issue no such specific provision authorizing such issue is required.

Entries on issue of Bonus Shares

A company may apply its accumulated profits to the issue of 'bonus' shares either by

(a) issuing shares credited as fully paid up; or
(b) applying the 'bonus' to payment of amounts uncalled on shares already issued.

The entries necessary to record the transactions are as follows :-

When Bonus Shares are issued as fully paid shares

(i) On declaration of bonus by the company -
Dr. Profit and Loss Appro. A/c (or other Reserve A/c)
Cr. Bonus Dividend A/c

(ii) On issue of shares at par -
Dr. Bonus Dividend A/c
Cr. Share Capital A/c

(iii) On issue of shares at premium -
Dr. Bonus Dividend A/c
Cr. Share Capital A/c
Cr. Share premium A/c

When Bonus is applied to meet calls due on shares

(i) On declaration of bonus by the company -
Dr. Profit and Loss Appro. A/c (or other Reserve A/c)
Cr. Bonus Dividend A/c

(ii) On making call on shares -
Dr. Share Call A/c
Cr. Share Capital A/c

(iii) On application of the bonus towards payment of call -
Dr. Bonus Dividend A/c
Cr. Share Call A/c

The fact of issue of bonus shares must have to be disclosed in the balance sheet mentioning the number and the amount of shares issued as bonus and the source from which the bonus shares have been issued.

Illustration 2 :

X Ltd. has Rs.5,60,000 in equity Share Capital comprising of 40,000 shares of Rs.10 fully paid and 20,000 shares of Rs.10, Rs.8 paid per share. It has Rs.20,000 in Capital Reserve, Rs.20,000 in Share Premium Account, Rs.70,000 in Capital Redemption Reserve Account, Rs.1,50,000 in General Reserve.

By way of Bonus Dividend the partly paid-up shares are converted into fully paid-up shares, and the holders of fully paid-up shares are also allotted fully paid-up Bonus Shares in the same ratio.

Pass Journal entries showing separately the two types of Bonus issues stated above. It is desired that there should be minimum reduction in free reserves.

Books of X Ltd.
Journal

			Rs.	Rs.
?	General reserve A/c : 20,000xRs.2 --- Dr. To Bonus Dividend A/c (Bonus dividend declared as per Shareholders' Resolution dated....for making partly paid shares fully paid)		40,000	40,000
	Share Final Call A/c --- Dr. To Share Capital A/c (Final call of Rs.2 per share due on 20,000 shares as per Board's resolution dated....)		40,000	40,000
	Bonus Dividend A/c --- Dr. To Share Final Call A/c (Utilization of bonus dividend towards payment of the final call of Rs.2 per share on 20,000 shares)		40,000	40,000
	Share Premium A/c --- Dr. Capital Redemption Reserve A/c --- Dr. General reserve A/c --- Dr. To Bonus Dividend A/c (Bonus dividend declared as per Shareholders' Resolution dated....for issuing fully paid-up shares)		20,000 70,000 10,000	1,00,000
	Bonus Dividend A/c --- Dr. To Share Capital A/c (Utilization of bonus dividend towards issue of 10,000 shares of Rs.10 each to be distributed in the ration of one share for every four held)		1,00,000	1,00,000

Note : 1. General Reserve has been utilized for making partly paid shares fully paid because Share Premium A/c or Capital Redemption Reserve A/c cannot be utilized for this purpose.

2. Capital Reserve arising as a result of revaluation of assets or without accrual of cash resources are not available for bonus issue. Since the source of capital reserve has not been given in the problem it has not been utilized.

3. Ratio of bonus declared is Rs.2 of every Rs.8 paid-up capital. Hence the amount of Bonus Dividend to be declared to the holders of fully paid share is (2/8 x 40,000 x Rs.10) or Rs.1,00,000.

UNIT X – ANNUAL ACCOUNTS OF A COMPANY UNDER SCHEDULE VI OF COMPANY'S ACT 1956

Unit Structure: -

10.1: Form and Contents of Balance Sheet

Section 210 of the Companies Act requires that at every annual general meeting of the shareholders, the Board of Directors of the company shall lay before the company a Balance Sheet as at the end of each trading period. It is laid down in section 211 (1) that every Balance Sheet of a company shall be prepared in the form given in the Part I of Schedule VI of the Companies Act, 1956, or as near thereto as circumstances admit, or in such other form as may be approved by the Central Government either generally or in a particular case. It further states that in preparing the Balance Sheet due regard shall be made, as par as may be, to the general instructions for preparation of the Balance Sheet under the heading "Notes" at the end of Part I of Schedule VI. The objectives of prescribing the form for the Balance Sheet in Schedule VI is to make sure that Balance Sheet exhibits a true and fair view of the state of affairs of the company. Their should be no room for window dressing showing a better position than what actually is, and secret reserves showing a worse picture than what actually is.

If the information required to be given under any of the items in the prescribed form cannot be conveniently shown in the Balance Sheet itself, it should be shown in a separate schedule or schedules to be attached to the Balance Sheet. The form of the Balance Sheet as given in Part I of Schedule VI of the Companies Act is given below.

SCHEDULE VI – PART I

(Section 211)

FORM OF BALANCE SHEET

The Balance Sheet of a company shall be either in a horizontal for or a vertical form.

A. Horizontal Form

Balance Sheet of ………………(Here enter the name of the company) as on…………..
(Here enter the date as at which the balance sheet is made out)

Figure for the previous year Rs. (1)	Liabilities (2)	Figure for the current year Rs. (3)	Figure for the previous year Rs. (4)	Assets (5)	Figure for the previous year Rs. (6)
	SHARE CAPITAL: Authorized ……Shares of Rs…….. each. Issued: (distinguishing between the various classes of capital and stating the particulars specified below, in respect of each class)……shares of Rs…….each. Subscribed; (distinguishing between the various classes of capital and stating the particulars specified below, in respect of each class)…….shares of Rs…….each…..Rs. called up. (Of the above shares…… shares are allotted as fully paid up pursuant to a contract without payments being received in cash) (Of the above shares…… shares are allotted as fully paid up by way of bonus shares). Specified the sources from which bonus shares are issued, *e.g.*, capitalization of profits or Reserves or from Share Premium Account. *Less :* Calls unpaid : *(i)* By Directors			FIXED ASSETS: Distinguishing as far as possible between expenditure upon – (a) goodwill (b) land (c) buildings (d) leaseholds (e) railway sidings (f) plant and machinery (g) furniture and fittings (h) development of property (i) patents, trade marks and designs (j) livestock, and (k) vehicles, etc. (Under each head the original cost and the additions thereto and deductions therefrom during the year, and the total depreciation written off or provided up to the end of the year is to be stated. Depreciation written off or provided shall be allotted under the different asset heads and deducted in arriving	

(ii) By others

Add : Forfeited shares : (amount originally paid up)

(Any capital profit on reissue of forfeited shares should be transferred to Capital Reserve).

Notes :

1. Terms of redemption or conversion (if any) of any redeemable preference capital are to be stated together with earliest date of redemption or conversion.
2. Particulars of any option on unissued Share Capital are to be specified.
3. Particulars of the different classes of preference shares are to be given.

These particulars are to be given along with Share Capital.

In the case of subsidiary companies, the number of shares held by the holding company as well as by the ultimate holding company and its subsidiaries shall be separately stated in respect of subscribed Share Capital. The auditor is not required to certify the correctness of such shareholdings as certified by the management).

RESERVES AND SURPLUS :

(9) Capital Reserves.
(9) Capital Redemption Reserve.
(9) Share Premium Account (Showing details of its uitilisation in the manner provided in Section 78 in the year of utilisation).
(9) Other Reserves specifying the nature of each Reserve and the amount in respect thereof

Less : Debit balance in the Profit and Loss Account (if any).

(The debit balance in the Profit and Loss Account shall be shown as a

at the value of Fixed Assets. [Also see note (11) on page 10.188].

In every case where the original cost cannot be ascertained, without unreasonable expense or delay, the valuation shown by the books is to be given. For the purpose of this paragraph, such valuation shall be the net amount at which an asset stood in the company's books at the commencement of this Act after deduction of the amounts previously provided or written off for depreciation or diminution in values, and where any such asset is sold, the amount of sale proceeds shall be shown as deduction.

Where sums have been written off on a reduction of capital or a revaluation of assets, every balance sheet, (after the first balance sheet) subsequent to the reduction or revaluation shall show the reduced figures with the date of the reduction in place of the original cost.

Each balance sheet for the first five years subsequent to the date of the reduction, shall show also the amount of the reduction made.

Similarly, where sums have been added by writing up the assets, every balance sheet subsequent to such writing up shall show the increased figures with the date of the increase in place of the original cost. Each balance sheet for the first five years subsequent to the date of the writing up shall also show the amount of the increase made).

INVESTMENTS:

Showing nature of investments and mode of valuation; for example, cost or market value, and distinguishing between:

(1) Investments in Government or

deduction from the uncommitted reserves, if any).

(9) Surplus, *i.e.,* balance in the Profit and Loss Account after providing for proposed allocation, namely, Dividend, Bonus or Reserves.

(9) Proposed additions to Reserves

(9) Sinking Funds. (Additions and deductions since last balance sheet to be shown, under each of the specified heads. The word "funds" in relation to any "Reserve" should be used only where such Reserve is specially represented by earmarked investments).

SECURED LOANS :

(1) Debentures.

(2) Loans and Advances from Banks.

(3) Loans and Advances from Subsidiaries.

(4) Other Loans and Advances.

(Loans from directors and/or manager should be shown separately.

(Interest accrued and due to Secured Loans should be included under the appropriate sub-heads under the head "Secured Loans"

The nature of security to specified in each case.

Where loans have been guaranteed by managers and/or directors, a mention thereof shall also be made and also the aggregate amount of such loans under each head.

In case of Debentures terms of redemption or conversion (if any) are to be stated together with earliest date of redemption or conversion).

UNSECURED LOANS :

a) Fixed Deposits.

Trust Securities.

(2) Investments in shares, debentures or bonds.

(Showing separately shares fully paid up and partly paid up and also distinguishing the different classes of shares showing also in similar details investments in shares, debentures or bonds of subsidiary companies).

(3) Immovable properties.

(4) Investments in the capital of partnership firms.

(Aggregate amount of company's quoted investments, and also the market value thereof shall be shown).

(Aggregate amount of company's unquoted investments shall also be shown).

CURRENT ASSETS, LOANS AND ADVANCES :

(A) CURRENT ASSETS :

(1) Interest accrued on Investments.

(2) Stores and Spares parts.

(3) Loose Tools.

(4) Stock-in-Trade.

(5) Work-in-Progress.

[In respect of (2) and (4), mode of valuation of stock shall be stated and the amount in respect of raw materials shall also be stated separately where practicable. Mode of valuation of work-in-progress shall be stated].

(6) Sundry Debtors.

(a) Debts Outstanding for a period exceeding six months.

(b) Other debts.

Less : Provision.

(The amount to be shown under Sundry Debtors shall include the amounts due in respect of goods sold or services rendered or in respect of other contractual obligations but

b) Loans and Advances from Subsidiaries.

c) Short Term Loans and Advances :

(a) From Banks.

(b) From Others.

(Short term loans include those which are due for repayment not later than one year as at the date of balance sheet).

d) Other Loans and Advances :

(a) From Banks.

(b) From Others.

(Loans from directors and/or manager should be shown separately.

Interest accrued and due on Unsecured Loans should be included under the appropriate sub-heads under the head "Unsecured Loans".

Where Loans have been guaranteed by manager, and/or directors, a mention thereof shall also be made together with the aggregate amount of such loans under such head. This does not apply to Fixed Deposits).

CURRENT LIABILITIES AND PROVISIONS:

A. CURRENT LIABILITIES

(1) Acceptances
(2) Sundry Creditors
(3) Subsidiary Companies.
(4) Advance payment s and unexpired discounts for the portion for which value has still to be given *i.e.,* in the case of the companies. Newspaper, Fire Insurance Theatres, Steamship companies, etc.
(5) Unclaimed Dividends.
(6) Other Liabilities (if any).
(7) Interest accrued but not due on loans.

B. PRVISIONS

shall not include the amounts which are in the nature of loans or advances).

In regard to Sundry Debtors particulars to be given separately of :

(a) debts considered good and in respect of which the company is fully secured ;
(b) debts considered good for which the company holds no security other than the debtor's personal security; and
(c) debts considered doubtful or bad.

Debts due by directors or other officers of the company or any of them either severally or jointly with any other person or debts due by firms or private companies respectively in which any director is a partner or director or a member to be separately stated.

Debts due from other companies under same management within the meaning of sub-section (IB) of Section 370 to be disclosed with the names of the companies. The maximum amount due by directors or other officers of the company at the time during the year to be shown by way of a note.

The provision to be shown under this head should not exceed the amount of debts stated to be considered doubtful or bad and any surplus of such Provision, if already created, should be shown at every closing under "Reserves and Surplus" (on the Liabilities side) under a separate sub-head "Reserve for Doubtful or Bad Debts"

(7A) Cash balance in hand.
(7B) Bank Balance –
(a) with Scheduled Banks.
(b) with others.

(8) Provision for Taxation.
(9) Proposed Dividends.
(10) For Contingencies.
(11) For Provident Fund Scheme.
(12) For insurance, pension and similar staff benefit schemes.
(13) Other provisions.

A footnote to the balance sheet may be added to show separately:

(1) Claims against the company not acknowledge as debts.
(2) Uncalled liability on shares partly paid.
(3) Arrears of fixed cumulative dividends.

(The period for which the dividends are in arrear or if there is more than one class of shares, the dividends on each such class that are in arrear shall be stated before deduction of income tax, except that in the case of tax-free dividends the amount shall be shown free of income tax and the fact that it is so shown shall be stated).

(4) Estimate amount of contracts remaining to be executed on capital account and not providing for.
(5) Other moneys for which the company is contingently liable.

(The amount of any guarantees given by the company on behalf of directors or other officers of the company shall be stated and where practicable, the general nature and amount of each such contingent liability, if material, shall also be specified).

(In regard to bank balances particulars to be given separately of –

(a) the balances lying with Scheduled Banks on current accounts, call accounts and deposit accounts;
(b) the names of the bankers other than Scheduled Banks and the balances lying with each such banker on current account, call account and deposit account and the maximum amount outstanding at any time during the year with each such banker; and
(c) the nature of the interest, if any, of any director or his relative in each of the banker [other than Scheduled Banks referred to in *(b)* above].

(B) LOANS AND ADVANCES :
(8) *(a)* Advances and loans to subsidiaries.
(b) Advances and loans to partnership firms in which the company or any of its subsidiaries is a partner.

(9) Bills of Exchange.
(10) Advances recoverable in cash or in kind or for value to be received, *i.e.* Rates, Taxes, Insurance, etc.
(11) Balances with Customs, Post, Trust, etc. (where payable on demand).

[The instruction regarding Sundry Debtors apply to "Loans and Advances" also. The amounts due from other companies under the same management within the meaning of sub-section (IB) of Section 370 should also be given with the names of companies; the maximum amount due from every one of these at any time during the

				year must be shown]. MISCELLANEOUS EXPENDITURE (to the extent not written off or adjusted). (1) Preliminary expenses. (2) Expenses including commission or brokerage or underwriting or subscription of shares or debentures. (3) Discount allowed on issue of shares or debentures. (4) Interest paid out of capital during construction (also stating the rate of interest). (5) Development expenditure not adjusted. (6) Other sums specifying nature). PROFIT AND LOSS ACCOUNT (Show here the debit balance of profit and loss account carried forward after deduction of the uncommitted reserves, if any).	

10.2: General Instructions for Preparation of Balance Sheet

1. Paise can also be given in addition to Rupees, if desired.
2. Dividends declared by subsidiary companies after the date of the balance sheet should not be included unless they are in respect of a capital which closed on or before the date of the balance sheet.
3. Any reference to benefits expected from contracts to the extent not executed shall not be made in the balance sheet but shall be made in the Board's report.
4. Particulars of any redeemed debentures which the company has power to issue should be given.
5. Where any of the company's debentures are held by a nominee or a trustee for the company the nominal amount of the debentures and the amount at which they are stated in the books of the company shall be stated.
6. A statement of investments (whether show n under "Investment" or under "Current Assets" as Stock-in-Trade) separately classifying trade investments and other investments should be annexed to the balance sheet showing the names of the bodies corporate (including

separately the names of the bodies corporate under the same management) in whose shares or debentures, investments have been made (including all investments whether existing or not, made subsequent to the date as at which the previous balance sheet was made out) and the nature and extent of the investments so made in each such body corporate; provided that in the case of an investment company, that is to say, a company whose principal business is the acquisition of shares, stock, debentures or other securities, it shall be sufficient if the statement show only the investments existing on the date as at which the balance sheet has been made out. In regard to the investments in the capital of partnership firms, the names of the firms (with the names of all their partners, total capital and the shares of each partner) shall be given in the statement.

7. If, in the opinion of the Board, any of the current assets, loans and advances have not a value on realization in the ordinary course of business at least equal to the amount at which they are stated, the fact that the Board is of opinion shall be stated.
8. Except in the case of the first balance sheet laid before the company after the commencement of the Act, the corresponding amounts of the immediately preceding financial year for all items shown in the balance sheet shall also be given in the balance sheet. The requirements in this behalf shall, in case of companies preparing quarterly of half-yearly accounts, etc., relate to the balance sheet for the corresponding date in the previous year.
9. Current accounts with Directors and Manager, whether they are in credit or debit, shall be shown separately.
10. The information required to be given unde. any of the items or sub-items in the Form, if it cannot be conveniently included in the balance sheet itself shall be furnished in a separate Schedule or Schedules to be annexed to and form part of the balance sheet. This is recommended when items are numerous.
11. Where the original cost of fixed assets, and additions and deductions thereto, relate to any fixed asset which has been acquired from a country outside India, and its consequences of a change in the rate of exchange at any time after the acquisition of such assets, there has been an increase or reduction in the liability of the company, as expressed in Indian currency, for making payment towards the whole or a part of the cost of the asset, or for repayment of the whole or a part of money borrowed by the company from any person, directly, or indirectly, if any foreign currency specially for the purpose of acquiring the asset (being in either case the liability existing immediately before the date on which the change in the rate of exchange takes effect), amount by which the liability is so increased or reduced during the year, shall be added to, or as the case may be, deducted from the cost, and the amount arrived at after such addition or deduction shall be taken to be the cost of the fixed assets.

Explanation 1. This paragraph shall apply in relation to all balance sheets that may be made out as at the 6th day of June, 1966, or any day thereafter and where, at the date of the notification of the Government of India, in the Ministry of Industrial Development and Company Affairs (Department of Company Affairs), G.S.R. No. 129, dated the 3rd day of January, 1968, any balance sheet in relation to which the paragraph applies, has already been made out and laid before the company in annual general meeting, the adjustment referred to in this paragraph may be made in the first balance sheet made out after the issue of the said notification.

Explanation **2.** In this paragraph, unless the context otherwise requires, the expressions "Rate of exchange". "Foreign currency" and "Indian currency" shall have the meanings respectively assigned to them under sub-section (1) of section 43A of the Income Tax Act, 1961 (XLII of 1961), and Explanation 2 and Explanation 3 of the said sub-section shall as far as may apply in relation to the said paragraph as they apply to the said sub-section (1).

PART III

Interpretation

7. (i) For the purpose of Parts I and II of the Schedule, unless the context otherwise requires :

(a) the expression "provision" shall subject to sub-clause (2) of this clause mean any amount written off or retained by way of providing for depreciation, renewals or diminution in value of assets, or retained by way of providing for any known liability of which the amount cannot be determined with substantial accuracy;

(b) the expression "reserve" shall not subject as aforesaid, include any amount written off or retained by way of providing for depreciation, renewals or diminution in value of assets or retained by way of providing for any known liability;

(c) the expression, "Capital reserve" shall not include any amount regarded as free for distribution through the profit and loss account; and the expression "revenue reserve" shall mean any reserve other than a capital reserve; and in this sub-clause the expression "Liability" shall include all liabilities in respect of expenditure contracted for and all dispute or contingent liabilities.

(ii) Where –

(a) any amount is written off or retained by way of providing for depreciation, renewals or diminution in value of assets, not being an amount written off in relation to fixed assets before the commencement of this Act; or

(b) any amount retained by way of providing for any known liability, is in excess of the amount which in the opinion of the directors is reasonable necessary for the purpose, the excess shall be treated for the purpose of this Schedule as a reserve and not a provision.

8. For the purposes aforesaid, the expression "quoted investment" means an investment as respects which there has been granted a quotation or permission to deal on a recognized stock exchange and expression "unquoted investment" shall be construed accordingly.

10.3: Vertical Form of Balance Sheet

Vertical form of balance sheet inserted as Part B of Part I of Schedule VI to the Companies Act 1956 by G.S.R. No. 220 (E) dated 12-3-1979 is as follows:

B. Vertical Form

Name of the Company ....

Balance sheet as at ....

1	*Schedule No.* *2*	*Figures as at the end of current financial year* *3*	*Figures as at the end of previous financial year* *4*
I. Sources of Funds			
(1) Shareholders funds :			
(a) Capital			
(b) Reserves and Surplus			
(2) Loans funds :			
(a) Secured loans			
(b) Unsecured loans			
Total			
II. Application of Funds			
(1) Fixed assets :			
(a) Gross block			
(b) Less depreciation			
(c) Net block			
(d) Capital work-in-progress			
(2) Investments			
(3) Current assets, loans and advances :			
(a) Inventories			
(b) Sundry debtors			
(c) Cash and bank balances			
(d) Other current assets			
(e) Loans and advances			
Less:			
Current liabilities & provisions			
(a) Liabilities			
(b) Provisions			
Net current assets			
(4) (a) Miscellaneous Expenditure to the extent not written off or adjusted			
(b) Profit and Loss Account			
Total			

Notes :

1. Details under each of the items in Vertical Balance Sheet shall be given in separate Schedules. The schedules shall incorporate all the information required to be given under A – Horizontal Form read with notes containing general instructions for preparation of balance sheet.

2. The Schedules referred to above, accounting policies and explanatory notes that may be attached shall form an integral part of the balance sheet.
3. The figures in the balance sheet may be rounded off to the nearest '000 or '00 as may be convenient or may be expressed in terms of decimals of thousands.
4. A footnote to the balance sheet may be added to show separately contingent liabilities.

In India, Joint Stock Company can prepare its balance sheet either in horizontal or vertical form. Of the two forms of the balance sheet, vertical form is a better form because it speaks out the correlation of every item with the other items and conveys more meaning to the layman.

Illustration 1: - The following information obtained from the books of X CO. Ltd. as on 31st March, 1987 :

	Rs.
Profit & Loss A/c – Debit Balance as on 1-4-86	2,00,000
Preliminary Expenses	10,000
Plant and Machinery	1,00,000
Furniture & Fixtures	20,000
Motor car	15,000
Sales	20,00,000
Miscellaneous Receipts	1,20,000
Opening Stock of Finished Goods	3,00,000
Consumption of Raw Materials	9,00,000
Closing Stock of Raw Material at cost	5,00,000
Bank Overdraft	1,00,000
Share Premium	3,60,000
Share Capital	6,00,000
Unsecured Loan	3,00,000
Sundry Debtors (including Rs. 1,00,000 over six months)	7,00,000
Salaries & Wages	2,00,000
Office Administration Expenses	4,00,000
Selling and Distribution Expenses	1,50,000
Sundry Creditors	4,15,000
Income Tax Advances	3,00,000
Misc. Advances	40,000
Interim Dividends	60,000

The following information is given:

(1) Closing Stock of finished goods at cost is Rs. 6,00,0000.

(2) The original costs of fixed assets are :

	Rs.
Plant and Machinery	2,00,000
Furniture and Fixture	30,000
Motor Car	25,000

Depreciation is to be charged for the year on written down values @ 10% on Plant and Machinery & Furniture and Fixtures and @ 20% on Motor Car. There were no additions or disposals during the year.

(3) The entire Authorised share capital which consists of equity shares of Rs. 100 each has been issued and subscribed. The share capital is paid up to the extent of 30% and there are no calls in arrear.

(4) The unsecured loan was taken on 1-1-87 at 18% interest. Interest is payable half-yearly and necessary provisions are to be made in accounts.

(5) Office Administration expenses include auditor's fee Rs. 5,000 (including fees for taxation services Rs. 1,000) and Directors fees Rs. 3,000.

(6) Taxation Provision is to be created for Rs. 3,50,000.

(7) Preliminary expenses are to be written off.

(8) During the year 2,000 units were sold. (600 units and 900 units of finished goods were in opening and closing stock respectively).

(9) 700 M.T. of the main raw material 'P' were consumed during the year valued at Rs. 8,40,000.

(10) The Directors have proposed a Final Dividend of Rs. 6 on each equity share in addition to the interim dividend already declared.

Prepare Profit & Loss A/c, Balance Sheet and notes on Accounts of the company for the year ended 31-3-1987 keeping in view the requirements of disclosure under the Companies Act.

Solution

PROFIT AND LOSS ACCOUNT ON X CO.LTD.
for the year ending, 31st March, 1987

	Rs.		Rs.
To Opening Stock of Finished Goods	3,00,000	By Sales	20,00,000
" Raw Materials Consumed	9,00,000	" Closing Stock of Finished Goods	6,00,000
" Salaries and wages	2,00,000	" Miscellaneous Receipts	1,20,000
" Office & Administrative Expenses Rs. 4,00,000			
Less: Including therein Audit Fee 5,000 Director's Fee 3,000 = 8,000	3,92,000		
To Director's Fees	3,000		
" Auditor's Remuneration: Audit Fee 4,000 Taxation Service 1,000	5,000		
To Depreciation : Plant & Machinery @ 10% 10,000 Furniture & Fixtures @ 10% 2,000 Motor Car @ 20% 3,000	15,000		
To Interest on Unsecured Loans @ 18% p.a. on Rs. 3,00,000 for 3 Months from 1-1-87 to 31-3-87	13,500		
To Selling & Distribution Expenses	1,50,000		
" Preliminary Expenses	10,000		
" Provision for Taxation	3,50,000		
" Net Profit c/d	3,81,50		
	27,20,000		27,20,000
To Balance b/d (Debit balance on 1-4-1986)	2,00,000	By Net Profit b/d	3,81,500
" Interim Dividends	60,000		
" Proposed Final Dividend @ Rs. 6 per share on 20,000 shares	1,20,000		
To Balance c/d	1,500		
	3,81,500		3,81,500

BALANCE SHEET OF X CO. LTD.

as on 31st March, 1987

	Rs.
Share Capital :	
Authorised :	
20,000 Equity Shares of Rs. 100 each	20,00,000
Issued & Subscribed :	
20,000 Equity Shares of Rs. 100 each	20,00,000
Paid-up Capital :	
20,000 Equity share of Rs. 100each, Rs. 30 per share called and paid-up	6,00,000
Reserves and Surplus :	
Share Premium	3,60,000
Profit and Loss Account	1,500
Secured Loan :	
Bank Overdraft (assumed as secured)	1,00,000
Unsecured Loan :	3,00,000
Current Liabilities & Provisions :	
A. *Current Liabilities*	
Sundry Creditors	4,15,000
Interest accrued on Loan	13,500
B. *Provisions* :	
Provision for Taxation	3,50,000
Proposed Dividend	1,20,000
	22,60,000

		Rs.
Fixed Assets :		
Plant & Machinery at Cost	2,00,000	
Less : Depreciation to date	1,10,000	90,000
Furniture & Fixtures at Cost	30,000	
Less : Depreciation to date	12,000	18,000
Motor Car at Cost	25,000	
Less : Depreciation to date	13,000	12,000
Current Assets, Loans & Advances :		
A. *Current Assets*		
Closing Stock at Cost :		
Finished Goods	6,00,000	11,00,000
Raw Materials	5,00,000	
Sundry Debtors :		
Outstanding for more than 6 months	1,00,000	7,00,000
Others	6,00,000	
B. *Loans and Advances*		
Miscellaneous Advances	40,000	
Income-Tax Advances	3,00,000	3,40,000
		22,60,000

Statistical information required under Schedule VI (to the extent available)

(1) *Quantities of Finished Goods*

Opening Stock	Production	Sales	Closing Stock
600 units	2,300 units	2,000 units	900 units

(2) *Consumption of Raw Materials*

Material	Quantity	Value
P	700 M.T.	Rs. 8,40,000
Miscellaneous	---	60,000
		9,00,000

Exercise 1 : - The following balances are extracted from the books of Cloth Trading Company Private Limited for the year ended 31st December, 1986 :

	Rs.
Share Capital :	
Authorized, issued fully paid (50,000 Equity Shares)	5,00,000
General reserve (as at 1.1.1986)	1,50,000
Furniture (including additions of Rs.5,000 during 1986)	35,000
Office Equipments (as at 1-1-1986)	22,000
Motor Car (purchased on 1-1-1986)	30,000
Sundry Debtors (unsecured)	8,50,000
Advances to staff (unsecured)	10,000
Balance with Post Office in Savings Account (on 28-12-1986)	20,000
Cash in hand	2,000
Balance with Bank of India (including Fixed Deposits Rs.1,00,000)	1,20,000
Loans from Directors (Unsecured)	2,00,000
Liability for Expenses and goods supplied	2,67,000
Provision for Taxation (as at 1-1-1986)	1,00,000
Profit and Loss Account (as at 1-1-1986)	3,000

Closing stock of cloth (20,000 metres)	3,00,000
Advance Tax paid	1,90,000
Depreciation written off upto 31-12-1985 (Furniture Rs.5,000, Office Equipment Rs.2,000)	7,000
Opening stock of cloth (9,000 meters)	1,50,000
Legal Charges (including Rs.3,000 paid to auditors for Tax Representation)	10,000
Salaries of Staff	50,000
Miscellaneous Expenses (including traveling expenses of Rs.4000 in India and Rs.36,000 for visit abroad for exports by managing Director)	2,00,000
Purchase of cloth (12.10 lac metres)	30,39,000
Audit Fees	4,000
Interest on Fixed Deposit with Bank	5,000
Sales (2 lac metres) (including export sales of Rs. 10 lac)	35,00,000

The following further information is also given to you :

a) Rate of Depreciation for (1) Furniture 10%. (2) Office Equipments 15%; (3)Motor car 20%
b) Managing Director is entitled to commission @ 10% on Net Profits subject to maximum of Rs.36,000 per annum.
c) Sundry debtors include Rs. 1,50,000 outstanding for more than 6 months. Out of this Rs.20,000 is considered doubtful for which provision is to be made in the accounts for 1986.
d) Tax liability for 1986 is estimated at Rs.2 lacs for which provision is to be made.
e) The Directors have decided to transfer Rs. 50,000 out of the net profit to General Reserve and have proposed to pay dividend @ 6% on Equity Shares.

You are required to prepare Balance Sheet, Profit and Loss Account and notes on accounts for the year ended 31st December, 1986 from the above information in accordance with the requirements of the Companies Act.

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